

European Rates Weekly

ECB: Thoughts on Asset Purchases

- **ECB & QE:** We analyze issues relating to the vertical, horizontal and spatial components of a theoretical asset purchase program by the ECB. Markets have readily identified the optionality of long-EGB strategies, which is especially strong in those portfolios that include peripheral EGBs. In options terms, being long EGBs (positive carry) against a non-zero probability of the ECB deciding to buy assets in the market is like having a call option and being paid the time value.
- **EUR swaps - rolldown vs. location & positioning:** Analysis of DV01 and volatility adjusted rolldown, to be extracted from the forward term structures of par swap rates, suggests a number of rolldown maximizing strategies, such as receiving 3y1y vs. 15y1y.
- **UK rates – disappearing slack:** The jobless report for February ended the original forward guidance and showed that slack in the labour market is being quickly absorbed. We prefer to avoid outright bearish trades for now, particularly given geopolitical risks and negative carry, but like selling gilts on a cross-market basis.
- **Covered bonds:** The Liquidity Coverage Ratio has become a main market mover. Regulatory discrimination of lower rated covered bonds might lead to increased popularity of conditional pass-through covered bonds while some rating agencies might have a competitive edge.

Please note that the usual, full version of the European Rates Weekly will not be published this week due to the Easter holiday.

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ECB: Thoughts on Asset Purchases

We analyze issues relating to the vertical, horizontal and spatial components of a theoretical asset purchase program by the ECB.

Buying EGBs is not difficult...

A LSAP on EGBs is conceptually easy to implement. The ECB only needs to decide the total amount of buying based on their Area Wide Model¹ and the target inflation rate they want to achieve in the medium-term and then distribute this total amount across sovereigns by relative outstanding amounts. In essence, this is what Mr Coeure means by “spatial differentiation”².

...but there are some technical aspects of the EGB market that need to be considered

Figure 1 provides us with an EGBI-based tool to analyze an EGB-LSAP:

- Almost 50% of the total program would be concentrated on France and Italy.
- There are sizeable differences in index duration across issuers, which make “vertical differentiation” less straightforward. Furthermore, the 1-3y bucket includes EUR 1.15 trillion of bonds such that any LSAP would have to be extended to higher curve sectors as well (EUR 945bn in 3-5y, EUR 688bn in 5-7y and EUR 974bn in 7-10y).
- MFIs hold a significant size of the EGBI (35%) and would benefit from a LSAP, just as they’ve benefited from SMP and LTROs. Five years into the crisis, the financial sector seems to still be ECB’s main policy beneficiary.
- The price impact of an EGB-based LSAP should be analyzed in the context of net supply. For example, buying 49bn of RAGBs with a NCR of -7bn has a much larger theoretical price impact than buying 162bn of Bonos with a NCR of +36bn. As Mr Coeure explains, “*asset purchases in the euro area would not be about quantity, but about price*”. We could not agree more.

Figure 1. EGB market and QE

	EMU	Austria	Belgium	Finland	France	Germany	Ireland	Italy	Netherlands	Spain
Market Value	5036	198	325	79	1197	990	96	1179	325	647
%EMU	100%	4%	6%	2%	24%	20%	2%	23%	6%	13%
Yield	1.63	1.27	1.57	1.14	1.33	0.99	1.91	2.40	1.15	2.15
ModDur	6.5	7.1	6.9	6.2	6.7	6.7	5.2	6.3	6.7	5.7
Net Cash Requirement	102	-7	2	2	54	0	1	4	10	36
Gross supply	878	22	32	8	200	173	11	236	49	133
MFI holdings	1768	40	86	14	287	349	51	415	99	297
% EMU	35%	20%	26%	18%	24%	35%	53%	35%	30%	46%
QE 25%	1259	49	81	20	299	247	24	295	81	162
QE 50%	2518	99	162	39	599	495	48	589	163	324

Source: Citi Research

Buying private sector assets is more complex, given the size of EGB markets and the risk parameters of non-sovereign debt

A LSAP involving private-sector assets is more complex from an organizational point of view and may encounter several difficulties resulting from the strong heterogeneity of Eurozone’s financial markets:

- Based on iBoxx indices, sovereign debt has increased by EUR 788bn since the start of the Euro sovereign crisis (+22%). By comparison, the notional amount of

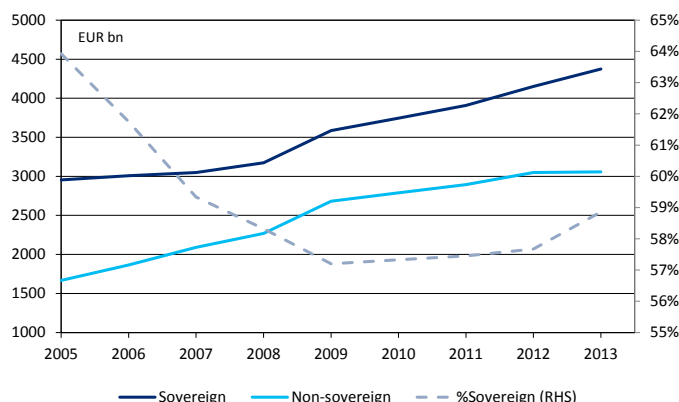
¹ <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp944.pdf?8a82d74538e305b5ec697924d52a73350>

² <http://www.ecb.europa.eu/press/key/date/2014/html/sp140413.en.html>

non-sovereign debt has grown by approximately EUR 375bn (+14%) during the same period.

- In percent of total, sovereign debt stands now at around 59%. Not surprisingly this measure has stabilized during the crisis after contracting from 64% in 2005 (Figure 2). This is a result of the expansion of government balance sheets at times of tentative private sector deleveraging.
- Looking at the composition of Euro debt more in detail (Figure 3), we notice a significant duration gap between sovereign (6.57y) and non-sovereign debt (4.77y) as well as a large proportion of IG-debt compared to HY.
- Overall, the level of index yields looks already very low compared to Eurozone history. This is not necessarily the case in real yield terms: At the end of 2013, the real yield on an iBoxx EUR overall portfolio was 1.72% and compares to a crisis average of 1.50% (1.05% in 2011 and 0.18% in 2012).

Figure 2. Increasing sovereign debt during the crisis



Source: Markit, Citi Research

Figure 3. A glance at Eurozone's debt markets

iBoxx	Nominal	Yield	Duration
EUR sovereigns	4449	2.14%	6.57
EUR non-sovereigns	3116	1.73%	4.77
EUR overall AAA	2358	1.50%	6.09
EUR corporates	1286	2.05%	4.67
EUR corporates senior	1138	1.89%	4.66
EUR financials	572	2.01%	4.24
EUR HY	270	3.98%	3.06

Source: Markit, Citi Research

Central banks' focus on securitization in general...

In a recently published research note, the ECB has briefly discussed the current situation and the outlook for securitization markets³, drawing the conclusion that promoting a "high-quality" ABS market with transparent collateral pools would facilitate the transfer of risks between the financial and the non-financial sectors. In ECB's view, "promoting" is associated mainly to the legal and regulatory framework. In that sense, the Eurosystem has been able to cut its haircut on ABS to 10% (from 16%) thanks to the introduction of a new loan-level information requirement.

...and on specific collateral types in particular

In the broader context of QE, securitization markets could play a central role. While it's not obvious that QE has a positive effect on inflation and inflation expectations, there is a chance that by intervening on the so-called real economy via certain types of securitized products might – in theory – revive the impaired monetary transmission mechanism. This is the leitmotiv behind AFME's answer⁴ to the ECB on promoting securitization.

Figure 4 shows the outstanding amounts of Eurozone securitized products by collateral type and by country of origin:

³ http://www.ecb.europa.eu/pub/pdf/other/ecb-boe_impaired_eu_securitisation_marketen.pdf

⁴ "AFME welcomes central banks' call for fair ABS rules" (11 April 2014)

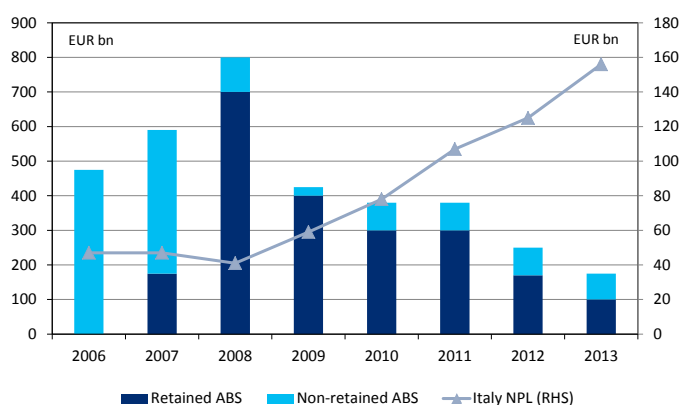
- RMBS are by far the largest securitized market with a share of 66% (EUR 663bn), followed by products that are key in the sense of the transmission mechanism like SME-based structures (140bn, 14%) or ABS based on auto loans, credit cards, consumer loans etc. (EUR 159bn, 16%).
- In terms of “spatial differentiation” of the securitized market, Italy (20%), the Netherlands (28%) and Spain (20%) seem to be the largest originators of structures. However, if we restrict our analysis to the real economy (i.e. ABS and SMEs, 30% of total securitization), then the importance of securitization for the Dutch economy drops to a mere 5%, while rising to 76% in Greece, 45% in Italy and 38% in Spain.

Figure 4. Securitized markets by collateral (outstanding EUR bn)

Issuer	ABS	CDO	CMBS	RMBS	SME	Total	ABS+SME (%)
Austria	0	0	0	2	0	2	0%
Belgium	0	0	0	70	18	88	21%
Finland	0	0	0	0	0	0	100%
France	20	0	2	17	3	42	55%
Germany	36	2	14	17	6	75	56%
Greece	16	2	0	6	10	34	76%
Ireland	0	0	0	46	0	47	1%
Italy	53	4	10	95	36	198	45%
Netherlands	6	2	3	258	9	277	5%
Portugal	5	0	0	29	5	39	26%
Spain	22	1	0	124	53	200	38%
Eurozone total	159	10	30	663	140	1003	30%

Source: AFME, Citi Research

Figure 5. Securitized issuance and non-performing loans in Italy



Source: AFME, BOI, Citi Research

Supply-side measures, but isn't the problem really the demand for credit?

The drawbacks of a LSAP targeting (explicitly or implicitly) the transmission mechanism remains the same: Buying financial assets guarantees that the price of these assets will rise, but there is no guarantee on positive externalities (esp. real or social externalities). Figure 5 highlights the negative effect of the crisis on the issuance of new securitized products in the Eurozone. As the economy contracts and lending conditions deteriorate⁵, non-performing loans cumulate on banks' balance sheets, the origination of new loans slows down markedly and new securitization collapses as a consequence of the shrinking collateral pool.

Pricing and liquidity constraints

All else equal this means that a vast pool of loans remains in the realm of non-marketable assets and would need to be valued and rated before any buying by the ECB can take place. In addition, liquidity constraints the market towards retention of new securitized issuance, thus leveraging the negative effect on credit lending to the non-financial sectors.

Conclusions & Trade Ideas

The high degree of uncertainty surrounding a potential asset-purchase scheme by the ECB results from:

- Where will HICP print in April and May? Will the June Staff-Projection reflect an increased risk of deflation or can the GC maintain its hard line of “no deflation” in the Eurozone?

Uncertainty about the trigger

⁵ Both in terms of the supply of credit and (perhaps more importantly) the demand for new credit.

Implementation?

- Uncertainty about the implementation of an asset purchase program along its horizontal, vertical and spatial dimensions. We have discussed this point in the lines above.

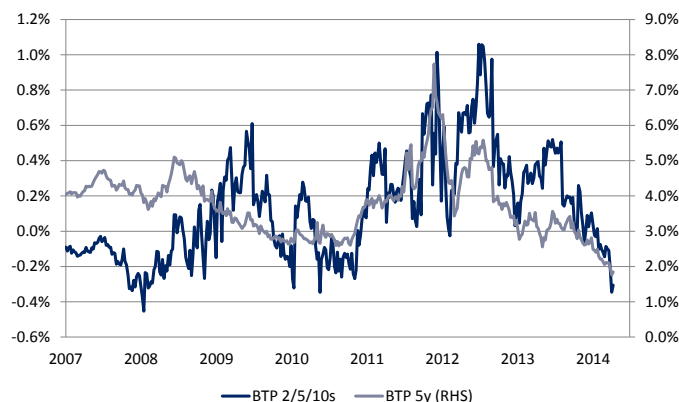
EGBs = call option on the ECB that pays positive theta

Markets have readily identified the optionality of long-EGB strategies, which is especially strong in those portfolios that include peripheral EGBs. In options terms, being long EGBs (positive carry) against a non-zero probability of the ECB deciding to buy assets in the market is like having a call option and being paid the time value.

Duration extension strategies on the BTP curve as 2/5/10s trades close to historical lows

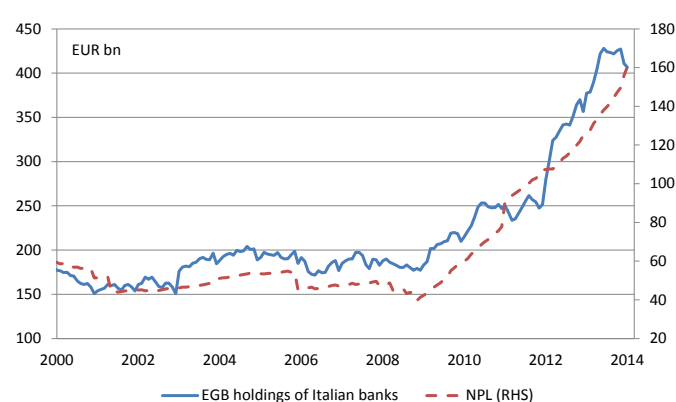
Assuming some degree of vertical differentiation and the involvement of EGBs⁶, we think that a LSAP by the ECB would achieve to lower long-term nominal yields and flatten sovereign yield curves across the Eurozone. Again, this could be particularly the case in markets like Italy where the 2/10s curve is steep compared to core markets (BTP Apr-16 / Mar-24 @235bp vs OAT Apr-16 /May-24 @170bp) and where – as on other curves – the 5y point look very rich in historical comparison (Figure 6). Curve flatteners on the BTP curve could therefore make sense under the scenario of continued QE-type bid for BTPs. The performance of such strategies might also benefit from the continued stopping-in of domestic banks, who find themselves short interest income from AFS books in an environment of increasing non-performing loans (Figure 7).

Figure 6. Duration extension past expensive 5s?



Source: Citi Research

Figure 7. EGB buying vs increasing NPLs



Source: BOI, Citi Research

⁶ Both assumptions are valid given the relatively large size of the EGB market and the insufficient size of the 1-3y sector of the EGBI.

EUR Swaps: Carry vs. Location & Positioning

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The ECB is trying hard to manage expectations: the last round of strong stances taken by ECB officials include Bundesbank Governor's statement that "a QE program is not out of the question" at the end of March up to Draghi saying last Saturday that "the strengthening of the exchange rate requires further monetary stimulus" and ECB Executive Board member Benoit Cœur affirming the following day at the end of his speech in Washington that in order to steer monetary policy at the lower nominal bound "everything must change, so that everything stays the same" (i.e. the ECB does not disregard any available unconventional tool to maintain price stability).

Against such backdrop we measure current rolldown for swap positions across the forward term structures. We have assumed one month rolldown window: in Figure 8 we show one month rolldown PnL for EUR 100mn notional. We adjust for the DV01 in Figure 9 where we compute rolldown PnL per unit of risk. Finally, in Figure 10 we normalise the DV01 adjusted rolldown PnL by bp realized volatility (63 day window).

Figure 8. One-month rolldown for EUR 100mn notional

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
3m	-649	19,250	53,953	84,443	116,730	170,460	204,485	203,012	182,387	168,491	164,901
6m	5,587	29,833	63,864	96,915	129,354	182,275	212,115	205,692	185,240	172,068	169,418
9m	10,163	40,916	76,307	110,953	143,050	192,250	222,871	215,486	194,633	181,716	180,164
1y	14,767	49,015	85,124	115,936	148,467	199,716	218,633	211,260	191,974	179,242	177,838
2y	32,833	71,189	105,661	142,517	169,472	202,349	225,567	204,417	186,383	175,819	176,098
3y	37,825	75,474	108,055	135,983	156,572	180,100	192,122	169,089	151,247	144,095	151,153
4y	34,458	64,353	90,850	112,984	125,826	141,946	144,811	119,234	107,637	99,925	105,692
5y	29,789	53,705	69,081	85,304	94,960	104,771	100,647	80,868	64,844	55,714	61,925
6y	27,974	44,872	61,332	71,220	77,796	82,507	73,948	52,849	40,029	37,641	41,105
7y	20,480	32,838	45,140	51,524	55,819	53,535	42,233	25,174	14,484	13,824	16,078
8y	17,563	28,310	33,571	39,107	39,838	35,035	18,361	317	-11,434	-2,834	-4,725
9y	14,001	18,048	21,827	21,371	20,904	15,794	-4,334	-18,984	-24,699	-18,939	-15,641
10y	7,915	10,198	10,542	9,595	7,115	-3,231	-13,640	-29,397	-34,837	-30,220	-25,180
15y	-3,675	-9,028	-15,242	-21,284	-23,154	-26,273	-37,228	-42,332	-35,780	-33,222	-34,920
20y	-2,736	-5,120	-8,094	-11,632	-13,880	-16,108	-18,792	-12,120	-10,894	-13,582	-13,915
25y	-2,377	-3,884	-5,047	-5,755	-4,809	-2,043	1,922	2,476	-288	-621	1,130
30y	1,241	2,675	4,362	5,636	6,825	8,168	7,458	4,138	3,805	5,892	6,366

Source: Citi Research

Figure 9. One-month rolldown for EUR 100mn notional, adjusted for the DV01

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
3m	-0.1	1.0	1.8	2.1	2.4	2.5	2.2	1.5	1.1	0.9	0.7
6m	0.6	1.5	2.1	2.4	2.6	2.7	2.2	1.5	1.1	0.9	0.8
9m	1.0	2.1	2.6	2.8	2.9	2.8	2.4	1.6	1.2	0.9	0.8
1y	1.5	2.5	2.9	2.9	3.0	3.0	2.3	1.6	1.2	0.9	0.8
2y	3.3	3.6	3.6	3.6	3.5	3.0	2.5	1.6	1.2	0.9	0.8
3y	3.8	3.9	3.7	3.5	3.3	2.8	2.1	1.3	1.0	0.8	0.7
4y	3.5	3.3	3.2	3.0	2.7	2.2	1.7	1.0	0.7	0.6	0.5
5y	3.1	2.8	2.5	2.3	2.1	1.7	1.2	0.7	0.4	0.3	0.3
6y	3.0	2.4	2.2	2.0	1.7	1.4	0.9	0.5	0.3	0.2	0.2
7y	2.2	1.8	1.7	1.5	1.3	0.9	0.5	0.2	0.1	0.1	0.1
8y	2.0	1.6	1.3	1.1	0.9	0.6	0.2	0.0	-0.1	-0.0	-0.0
9y	1.6	1.1	0.9	0.6	0.5	0.3	-0.1	-0.2	-0.2	-0.1	-0.1
10y	0.9	0.6	0.4	0.3	0.2	-0.1	-0.2	-0.3	-0.3	-0.2	-0.1
15y	-0.5	-0.6	-0.7	-0.8	-0.7	-0.6	-0.6	-0.5	-0.3	-0.2	-0.2
20y	-0.4	-0.4	-0.4	-0.5	-0.5	-0.4	-0.3	-0.2	-0.1	-0.1	-0.1
25y	-0.4	-0.4	-0.3	-0.3	-0.2	-0.1	0.0	0.0	-0.0	-0.0	0.0
30y	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.1	0.0	0.1	0.1

Source: Citi Research

Figure 10. One-month rolldown for EUR 100mn notional, adjusted for the DV01 and relative to 63d realized bp volatility

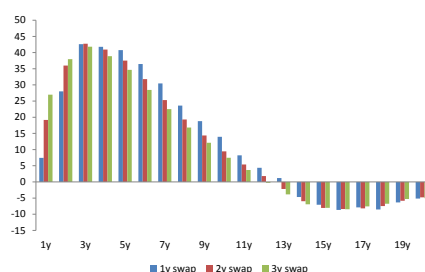
	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
3m	0%	3%	5%	5%	5%	5%	5%	4%	3%	2%	2%
6m	2%	4%	5%	5%	5%	5%	5%	4%	3%	2%	2%
9m	3%	5%	6%	6%	6%	6%	6%	5%	4%	3%	2%
1y	4%	6%	6%	6%	6%	6%	6%	5%	4%	3%	2%
2y	6%	6%	6%	6%	6%	6%	6%	5%	3%	3%	2%
3y	6%	6%	6%	6%	6%	6%	5%	4%	3%	2%	2%
4y	5%	5%	5%	5%	5%	4%	3%	2%	2%	1%	1%
5y	5%	5%	5%	4%	4%	4%	3%	2%	1%	1%	1%
6y	6%	5%	4%	4%	4%	3%	2%	1%	1%	1%	1%
7y	4%	4%	3%	3%	3%	2%	1%	1%	0%	0%	0%
8y	4%	3%	3%	3%	2%	1%	1%	0%	0%	0%	0%
9y	3%	2%	2%	1%	1%	1%	0%	0%	0%	0%	0%
10y	2%	1%	1%	1%	0%	0%	0%	-1%	-1%	0%	0%
15y	-1%	-1%	-1%	0%	0%	0%	0%	-1%	-1%	-1%	-1%
20y	-1%	-1%	-1%	-1%	-1%	-1%	-1%	0%	0%	0%	0%
25y	-1%	-1%	-1%	-1%	0%	0%	0%	0%	0%	0%	0%
30y	1%	1%	1%	1%	1%	1%	0%	0%	0%	0%	0%

Source: Citi Research

One optimal risk & vol adjusted carry strategy is to receive 3y1y vs. 15y1y

Results above offer a number of DV01/volatility adjusted rolldown maximizing strategies. In fact, with Figure 9 and Figure 10 as a guide one attractive combination is a receiving position in 3y1y vs. a paying position in 15y1y. Note that the regions to which these sweet spots belong can be estimated approximately by simply looking at one year par swap spread differences along the various term structures: we show these for one, two and three year tenor swaps in Figure 11.

Figure 11. Positions of rolldown maximizing points can be roughly estimated via one year par swap spread differences along the term structures



Source: Citi Research

Figure 12. Rolldown maximizing spread looking historically expensive



Source: Citi Research

The risks to the trade are location and positioning. With respect to the former, as illustrated in Figure 12, the 3y1y/15y1y spread is currently hovering at the historical high. In other words, the carry is highest on a historically expensive spread. On the other hand, if the view is taken that the ECB will do its job effectively, it might well be a risk worth taking. With respect to the latter risk, given the current environment vanilla carry trades such as the one we are showing slowly but surely get crowded: whereas it currently isn't ugly, it is not clean either.

Conclusion

ECB has ratcheted up rhetoric over the past few weeks. Analysis of DV01 and volatility adjusted rolldown, to be extracted from the forward term structures of par swap rates, suggests a number of rolldown maximizing strategies, such as receiving 3y1y vs. 15y1y. Investors who consider entering this type of strategy need to ponder on location and positioning risks.

UK Rates – disappearing slack

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International factors, such as Fed/ECB policy expectations, together with geopolitical risks, have helped to keep a lid on gilt yields. Moreover, gilts have often outperformed in the rallies, owing to structural short positioning. Bouts of short covering have, perhaps, helped to prevent a sell-off to date, especially in the front-end given the negative carry. The front-end sold-off following the sharp fall in the jobless rate in February (see below), but there will need to be further hawkish surprises to propel the sell-off further, with the market especially focused on wage growth. While we ultimately expect the hawkish fundamentals to triumph - and push gilt yields above the forwards - for now we prefer to avoid outright bearish trades, particularly given geopolitical concerns and the negative carry. Cross-market trades are, therefore, preferred. We also continue to advocate long positions in front-end break-evens (which benefit from positive carry).

Forward guidance moves from mark I to mark II

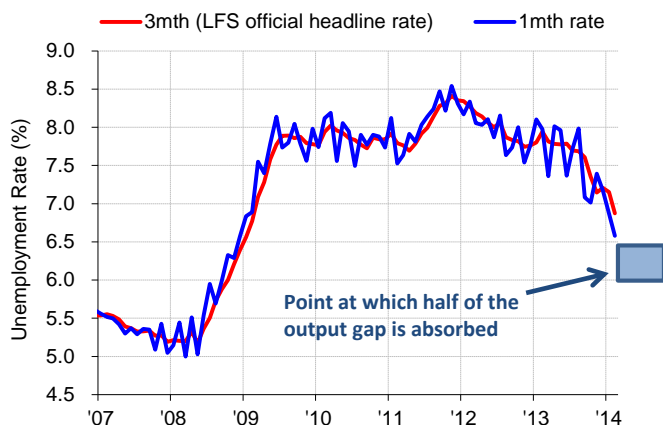
The original forward guidance is now formally over

The three-month average headline jobless rate fell to 6.9% in February from 7.2% in January. This was significantly below the consensus expectation of 7.1% and prompted a sharp re-pricing higher in front-end yields. It also marked the formal end of forward guidance mark I which stated that the MPC would not even consider raising rates until the jobless rate hit 7%. We now enter the more ambiguous forward guidance mark II which was detailed in the February Inflation Report (see [European Rates Weekly](#), 13 February 2014).

Slack in the labour market is being used up

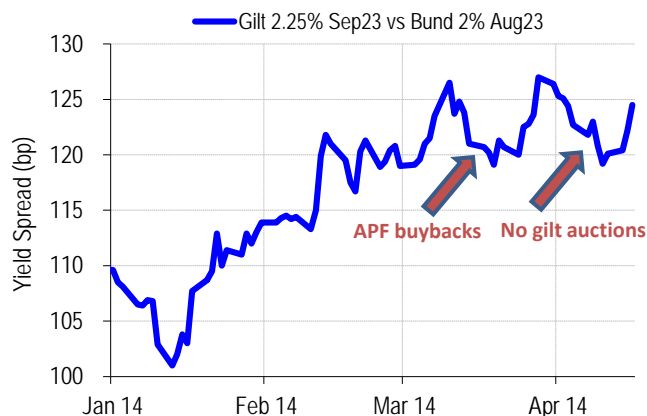
As part of forward guidance mark II, the MPC stated that around half of their estimate of slack (1%-1.5% of GDP) could be explained by the difference between the jobless rate at the time (7.1%) and the equilibrium rate of 6%-6.5%. The latest three-month average rate is 6.9%, but the (less reliable) single-month figure for February was even lower at 6.6%. This highlights how much slack has been already eroded (Figure 13). The MPC put the other half of the slack in the labour market down to “a judgment that employees would like to work more hours than is currently the case”. Measuring slack in the labour market is, of course, inherently difficult⁷, but the bottom line is that slack is being eroded. Of course, there needs to be further evidence of wage pressures before the MPC start hiking rates (weekly earnings ex bonuses rose to 1.4% in February from 1.2% previously, but this was below expectations of 1.7%), but this is likely to come with a lag.

Figure 13. Slack in the labour market is shrinking



Source: Citi Research, ONS.

Figure 14. Recent supports for gilts likely to fade



Source: Citi Research, Bloomberg.

⁷ For a broad discussion, see the speech given by MPC Member Martin Weale entitled ‘Slack and the labour market, 20 March 2014

MPC minutes to be closely scrutinized

Policy views among MPC members are likely to increasingly diverge as slack is eroded and the hiking cycle nears

Another important aspect of the formal end of forward guidance mark I is that the votes of MPC members on policy rates and QE will no longer be as constrained. Furthermore, it is natural that views are likely to increasingly diverge as slack is eroded and the hiking cycle nears. A split vote on policy rates may well emerge in the coming months and, in the very least, the MPC minutes will be closely scrutinized for signs of dissent. The next set of minutes, to be published on 23 April, are likely to be less interesting given that this meeting was conducted under the terms of the original forward guidance. The subsequent set of minutes, published on 21 May, will likely be more interesting as the May meeting will be the first since the 7% jobless threshold was breached.

Trades – prefer cross-market to outright positions

The MPC won't wait until all the slack has been absorbed before hiking rates

The jobless report was undeniably strong, in our view, and while wage growth is still weak, this is to be expected given the usual lags. The bottom line is that slack in the economy is being used up and the MPC won't wait until it has been competed absorbed before they start hiking rates. We expect the first rate hike at the November meeting vs market pricing of March (although there is now an 82% probability priced for a February rate hike).

For now, we prefer to avoid outright bearish trades, particularly given geopolitical concerns and the negative carry. Cross-market trades are, therefore, preferred.

The return of gilt issuance could widen the spread to Bunds

■ **Stay short 10yr gilts vs Bunds:** We expect 10yr gilts to underperform Bunds further. The recent range continues to hold, but the spread tightening has been helped by APF buybacks and the recent lack of supply (Figure 14). Gilt issuance returns next week with a 5yr auction on 24 April; this will be the first conventional auction since 2 April. There are also no coupon payments of note due into gilts until June. We expect the range to break to the upside and forecast an eventual widening to +160bp. In the very least, we like selling the dips within the established range. See also, the [European Rates Weekly](#) of 3 April 2014.

The MPC may hike around three quarters before the Fed

■ **Stay short 2-5yr gilts vs Treasuries:** We also continue to expect gilts to underperform Treasuries, but would confine this to the 2-5yr sector to best capture our forecast that the MPC hike before the Fed (by around three quarters). See also, the [European Rates Weekly](#) of 27 March 2014.

A long position in front-end break-evens is a bearish trade with positive carry

■ **Stay long front-end break-evens:** We also continue to like long positions in front-end break-evens as a bearish trade with positive carry. Our target for IL17 break-even inflation spread is 3.15%. The current value – following the rally prompted by today's jobless report – is 2.95%. Carry to the 1 July is around +13bp (based on our RPI forecasts) which may slow any further widening as break-evens should, theoretically, narrow to offset the positive carry. However, we think it is more likely that break-evens range-trade and earn the carry. We also prefer to be long as we attach a greater probability to a breakout to the upside than the downside – as the reaction to the jobless report showed. So, while our 3.15% target may only be reached over the medium-term, and probably requires further widening in the RPI-CPI wedge, the risk-reward still favours maintaining longs now. See also, [Global Inflation Strategy](#) of 14 April 2014.

Covered Bond Strategy

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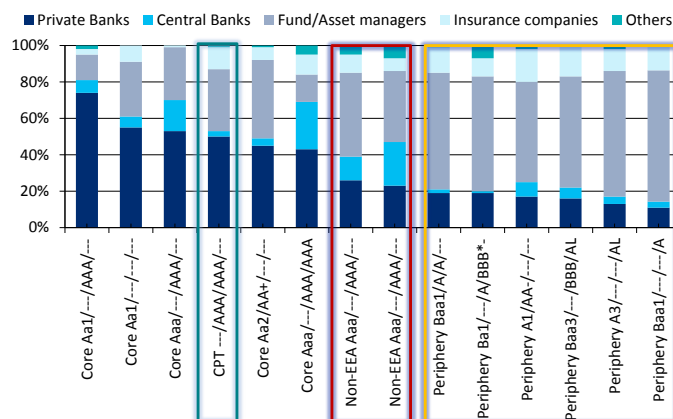
The ongoing discussion around the final LCR composition points out to the importance of covered bond ratings. It also points to the relative attractiveness of structural innovation and of certain rating methodologies. Hence, becoming more innovative with regards to repayment structures and preferring specific rating agencies might lead to better regulatory treatment.

Will regulation lead to rating and structure arbitrage?

LCR is one of the main topics in 2014

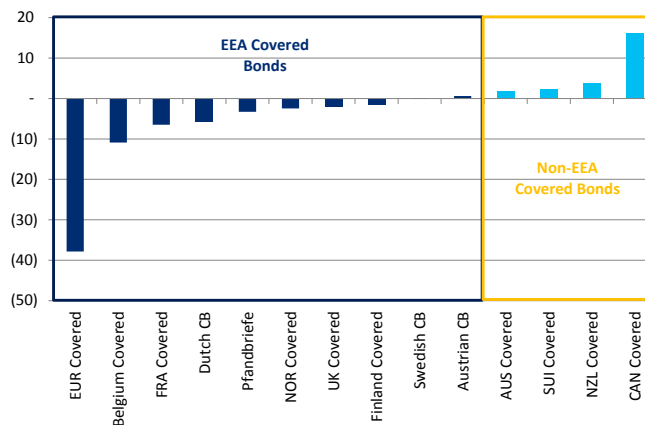
LCR currently is the big elephant in the room of covered bond markets. The final composition and the treatment of covered bonds has the potential to increase demand for highly rated covered bonds, depending if the European Commission follows the proposal of Basel or if it will deviate from that once the final decision is made at the end of June 2014 (see more on that below). The already long lasting period of uncertainty is probably one main driver for the extremely stable secondary market development of (semi-)core covered bonds against swaps during the last months. The importance of this regulation is seen quite impressively when on the one hand comparing spread performance of (semi-)core EEA covered bonds and highly rated non-EEA covered bonds which will most probably not be eligible for the LCR during the last months (Figure 16).

Figure 15. Order book composition of the latest deal in 2014: bank treasury investment behavior



Source: CBR, The Cover, Bloomberg, Citi Research; CPT: Conditional pass-through

Figure 16. Spread performance May 2013 - now: comparison of EEA and non-EEA covered bond segments, ASW-Spread, bp



Source: Markit, Citi Research

Highly rated EEA covered bonds are well sought by bank treasuries

Rating differentials become a more important topic as yield levels compress

On the other hand, regulation leads to order books which make us conclude that the most important investor group – bank treasuries – is driven to a great extent by the LCR eligibility criteria. In some of the latest deals where the LCR eligibility of the bonds issued is expected not to be given, the share of bank treasuries has been clearly below average. This affected peripheral and non-EEA covered bonds, although the latter to a lesser extent. Moreover, it seems as if bank treasuries were quite relaxed on the repayment structure: the latest conditional pass-through covered bond program which has been issued in March was predominantly sought by banks (51% of the order book, Figure 15). Hence, it becomes increasingly clear that formerly higher yielding segments lose the main argument to be bought: the absolute yield level. Hence, as this competitive edge cannot be relied on to the same extent than some months ago, the regulatory lack of competitiveness of these bonds due to the rating differential become a main threat for further performance. Hence, regulation might drive certain issuers to potentially higher rated conditional pass-through covered bonds.

This is an excerpt of the latest [Covered Bond Strategy: Will regulation lead to rating and structural arbitrage](#), including an in-depth analysis of LCR options, conditional pass-through covered bonds and the rating agencies' stance on it.

Tradesheet

Record of Open Trades

Figure 17. Record of our Open Trades

Region	Trade	Levels	Rationale + Publication Date	
UK / US	Sell 5yr gilts vs UST	Open 7bp Current 12bp P&L 4.5bp Target 30bp Stop -5bp	The recent outperformance of 5yr UK vs the US looks stretched given respective policy rate outlooks Euro Rates Weekly, 27 March 2014	
Cross Market	Sell gilt 1.75% Jul19 at 1.93% Buy UST 0.875% Jul19 at 1.86%			
EUR	Buy ERM4 and sell EDM4	Open -5bp Current 2bp P&L 7bp Target 5bp Stop -10bp	Attractive entry levels and benefits from ECB policy rate view Euro Rates Strategy, 11 March 2014	
Money Market	Buy ERM4 at 99.69 Sell EDM4 at 99.74			
EUR	Buy BNG 2.5% Nov17 vs DSL 2.25% Jan18	Open 10bp Current 10.5bp P&L -0.5bp Target 3bp Stop 14bp	Tactically good entry point for spread compression trade European Rates Weekly, 27 February 2014	
SSA	Buy BNG 2.5% Nov17 at 0.63% Sell DSL 2.25% Jan18 at 0.53%			
EUR	Sell BTPei19 vs BTPei17 and BTPei23	Open -46bp Current -36bp P&L 10bp Target -26bp Stop -56bp	Fade the richness of 5yr BTPei. European Rates Weekly, 20 February 2014	
Inflation	Buy BTPei17 at 1.04% Sell BTPei19 at 1.53% Buy BTPei23 at 2.48%			
EUR	Sell BTPei18 break-even vs OATei18	Open 13.5bp Current 14bp P&L 1bp Target 28bp Stop 6bp	BTPei likely to reverse some of the richness now that Boblei18 and OATei18 auctions are over. European Rates Weekly, 20 February 2014	
Inflation	Sell BTPei18 break-even at 79.5bp Buy OATei18 break-even at 93bp			
EUR	BTP 10s30s steepener	Open 106bp Current 124bp P&L 18bp Target 144bp Stop 90bp	Macro factors, cash flow profile, expect strong demand for new 10yr BTP and +ve carry are supportive for steepeners European Rates Weekly, 20 February 2014	
Curve	Buy BTP Aug23 at 3.49% Buy BTP Sep44 at 4.54%			
EUR	Buy OATei20 and OATei24 vs OATei22	Open 2bp Current 4bp P&L 2bp Target 10bp Stop -2bp	OATei22 looks too rich on the curve; OATei24 likely to perform after auction is out of the way Euro Inflation Strategy, 19 February 2014	
Inflation	Buy OATei20 at 0.10% Sell OATei22 at 0.42% Buy OATei24 at 0.72%			
UK	Buy IL gilt 2017 break-evens	Open 2.71% Current 2.94% P&L 23bp Revised Target 3.15% Revised Stop 2.70%	We believe that RPI-CPI wedge to widen over the medium-term UK Rates Strategy, 18 February 2014 Revised: UK Inflation Strategy, 25 March 2014	
Inflation	Buy IL gilt 2017 break-evens at 2.71%			
EUR	Buy 30yr Netherlands vs Austria	Open 14bp Current 15bp P&L 1bp Target 24bp Stop 8bp	Close to historically tight levels. Uncertainty surrounding the Austria banking sector should weigh on Austrian bonds European Rates Weekly, 12 February 2014	
Cross Market	Buy DSL Jan42 at 2.67% Sell RAGB Jun44 at 2.81%			
UK / US	Sell UKT 2.25% Sep23 vs UST 2.5% Aug23	Open 6.5bp Current 5bp P&L -2bp Target 30bp Stop -5bp	We expect the MPC to hike three quarters ahead of the Fed European Rates Weekly, 23 January 2014	
Cross Market	Sell UKT 2.25% Sep23 at 2.82% Buy UST 2.5% Aug23 at 2.77%			
EUR	Long Bund Jan37 vs DSL Jan37	Open 12bp Current 8bp P&L -4bp Target 22bp Stop 7bp	Optically attractive entry level + relative supply pressures are more favourable for Bunds than DSLs European Rates Weekly, 9 January 2014	
Cross Market	Buy Bund 4% Jan37 at 2.72% Sell DSL 4% Jan37 at 2.84%			
EUR	Long 10yr Spain vs Italy	Open 20bp Current 1bp P&L 20bp Target -25bp Stop 45bp	Spain has a stable rating and lower political risks compared with Italy European Rates Weekly 5 Dec 2013	
Cross Market	Buy Bono 4.4% Oct23s at 4.26% Sell BTP 4.5% May23s at 4.06%			

Source: Citi Research Note: Futures trading involves a substantial risk of loss.

Figure 18. Record of our Open Trades (continued)

EUR	Sell France vs Belgium and Germany		Open	6bp		
			Current	10bp		
Cross Market	Sell BTAN 1.75% Feb17 at 0.51% Buy OLO 4% Mar17 at 0.66% Buy Bobl 0.5% Apr17 at 0.30%		P&L	4bp	Attractive entry level, possible auction concession and non-supportive cash flow profile for OATs into year-end	
			Target	16bp		
			Stop	1bp	Euro Rates Strategy, 8 November 2013.	
EUR / UK	Sell UKT Sep23 vs DBR Aug23		Open	85bp		
			Current	124bp		
Cross Market	Sell UKT 2.25% Sep23 at 2.60% Buy DBR 2% Aug23 at 1.75%		P&L	39bp	Entry levels are attractive for medium-term gilt-Bund wideners	
			Target	140bp	European Rates Weekly, 24 October 2013.	
			Stop	58bp		
			Revised Stop	85bp	Revised Stop: UK Rates Strategy, 11 November 2013	
UK	Sell 30yr gilt swap spreads vs 10yr		Open	20bp		
			Current	25bp		
Swap spread	Sell gilt 3.25% Jan44 ASW at 20bp Buy gilt 1.75% Sep22 ASW at 0bp		P&L	5bp	Fiscal risks, supply pressures and the absence of QE to put sleepening pressure on the gilt curve.	
			Target	50bp		
			Stop	10bp	UK Rates Strategy, 30 July 2013	
EUR	Receive EUR 10y2y vs 12y3y		Open	4bp		
			Current	18bp		
Curve	Receive EUR 10y2y at 3.1% Pay EUR 12y3y at 3.14%		P&L	14bp	Cheapness of the sector due to legacy ASW positions. The trade offers a positive roll-down for relatively low volatility	
			Target	25bp		
			Stop	-5bp	The Morning Call, 23 January 2013	
UK	Sell GBP 2y2y ATMf straddle		Open	76bp		
			Current	22bp		
Volatility	Sell GBP 2y2y ATMf (1.04%) straddle at 76bps		P&L	54bp	The fundamental backdrop in the UK supports selling GBP 2y2y vol	
			Target	0bp		
			Stop	114bp	IIRS 12 July 2012	

Source: Citi Research

Summary of Recent Publications

Date	Publication	Topic	Page	Region
15-Apr-14	NOTE	European Flow Monitor: Net demand for non-core improving	-	EUR
14-Apr-14	NOTE	SSA Strategy: Weekly Chart-Pack and Market Monitor: 4th April – 11th April	-	EUR
11-Apr-14	NOTE	Covered Bond Strategy: Norwegian covered bonds and asset encumbrance	-	EUR
10-Apr-14	European Weekly	Greece – market access and implications	8	EUR
		UK: How and when will QE be unwound?	10	UK
		Vol: Trading Citi's view on BoE via options	13	EUR
		Euro Inflation – headwinds remain	16	EUR
		SSA: Opportunities in Eurofima?	19	EUR
		Covered Bond Strategy	21	EUR
10-Apr-14	NOTE	UK Rates Strategy: How And When Will QE Be Unwound?	-	UK
10-Apr-14	NOTE	Weekly Supply Monitor: Euro, UK and US Supply Outlook	-	Global
8-Apr-14	NOTE	Euro SSA Strategy: Relative Value Insights – opportunities in Eurofima?	-	EUR
7-Apr-14	NOTE	SSA Strategy: Weekly Chart-Pack and Market Monitor: 28th March – 4th April	-	EUR
7-Apr-14	NOTE	European Flow Monitor: Decoupling between core & non-core	-	EUR
3-Apr-14	European Weekly	EGB: Q1 Performance & Q2 Allocation	8	EUR
		EUR Vol: Vega RV Analysis & Trades	10	EUR
		UK Rates – Gilt-Bunds and betas	12	UK
		Market Technicals: EGB Liquidity Snapshot	14	EUR
		Greece: Three items for the outlook	16	EUR
		Ireland: Q2 issuance calendar and outlook	17	EUR
		Euro Inflation: New Bundeis30	18	EUR
		Supportive SSA cash-flows in April	20	EUR
		Covered Bond Strategy	21	EUR
3-Apr-14	NOTE	Weekly Supply Monitor: Euro, UK and US Supply Outlook	-	EUR
3-Apr-14	NOTE	Euro SSA and Covered Bond Monthly: APEC – the rising covered bond market	-	EUR
2-Apr-14	NOTE	Euro SSA Strategy: Supportive cash-flows in April	-	EUR
1-Apr-14	NOTE	UK Rates Strategy: Scenario analysis for new 30yr gilt future*	-	UK
31-Mar-14	NOTE	Euro Rates Strategy: EMU Supply In April: NCR Most Supportive For France*	-	EUR
31-Mar-14	NOTE	European Flow Monitor: Strong Buying Of Portugal Last Week	-	EUR
31-Mar-14	NOTE	European SSA Strategy: Weekly Chart-Pack and Market Monitor: 21st – 28th March	-	EUR
28-Mar-14	NOTE	European Rates Strategy: The month-end RV pack	-	EUR

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Appendix A-1

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