

# The Morning Call

## Month-end, flash HICP, EMU ratings, supra supply and volatility

- **Month-end index changes:** Projected EGBI changes should be most supportive for France, followed by the Netherlands, Germany and Italy. On a weighted duration basis, the Dutch index is projected to extend by its largest amount in 3 years. On individual curves, we expect index changes to be most supportive for the 30yr Netherlands and 10yr Ireland.
- **Euro inflation:** The flash estimate for euro area inflation in February will be released tomorrow. Following the final January release (and new weights), our economists have raised their forecast to 0.7% YoY (but with a risk of 0.6%). Today's inflation data from Germany will likely shape final expectations. The states will begin releasing from 8am with the final number due at 1pm. The inflation data will help to inform next week's ECB decision (and the market will react accordingly), but we doubt that an outcome of 0.6% or 0.7% will make much difference to the outcome (the Citi forecast is for a 15bp cut in the refi rate).
- **BTP auction:** Italy will re-open €2.5bn-€3.5bn of BTP May19 and issue €3.5bn-€4.5bn in a new BTP Sep24 today. Reinvestment flows from €7bn of coupon payments and €13bn of redemptions are supportive, as are month-end index extensions. Please see yesterday's [Morning Call](#) for details.
- **Tomorrow's rating calendar:** We expect Germany's rating to be revised from Aaa negative to Aaa stable tomorrow by Moody's. Regarding Austria, it is far from certain how Moody's will assess the Aaa negative rating given ongoing event risk surrounding its banking sector. Although there is clearly a risk of a downgrade, on balance, we believe Austria's rating will remain Aaa negative tomorrow. We expect S&P's rating of Belgium also to remain at AA negative tomorrow.
- **European supra supply in full swing:** European supra supply is a very topical theme for investors at the moment. Together with a rise in green bond issuance, this week saw the first ESM bond of the year. The next signpost in euro supra supply will be EU issuance – this supra has indicated a pipeline of €2.6bn for Q1 2014.
- **2s20s conditional bear flatteners:** Excess liquidity is currently around €125bn and without monetary policy innovation we expect it to collapse to €45bn by the end of the year. As a result the front-end could exhibit some volatility on the back of upward pressure on EONIA and EURIBOR fixings.

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## End-February EGBI Projection

Aman Bansal, CFA

This is a summary of EGBI projections published last week. Click [EMU Month-End Index Projections](#) for the full note.

We expect the effective duration of the EGBI to increase by 0.09 at the end of February. This would be the largest February change in 6 years. At the EGBI level, the projected changes should be supportive for the 10yr sector on the curve.

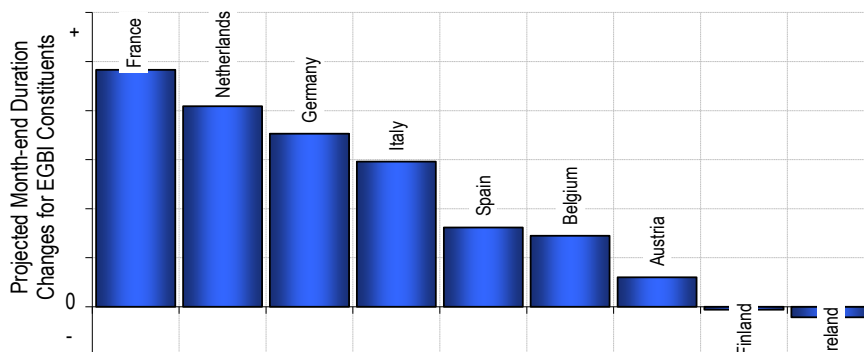
### Projected changes broadly supportive for EGBs

- At a country level, we expect the Spanish index to extend by its largest amount in 2 years. This is followed by the Irish index, which should extend by its largest amount in a year. This should put flattening pressure on the two cash curves.
- For EGBI portfolios, it is the weighted duration change that is most relevant. On this metric, we project France to extend the most, followed by the Netherlands, Germany and Italy (Figure 1). Furthermore, the Dutch index is projected to extend by its largest amount in 3 years (5yr z-score of 2.33).

Projected changes most supportive for France, followed by the Netherlands, Germany and Italy

Dutch index projected to extend by its largest amount in 3 years (weighted terms)

Figure 1. Weighted duration change at the end of February



Source: Citi Research

Support for 30yr Netherlands and 10yr Ireland

- On domestic curves, we expect index changes to be most supportive for the 30yr Netherlands and 10yr Ireland. Apart from this, changes should also be relatively supportive for 10yr Germany and 5-10yr Spain. The changes should also put flattening pressure on 10s30s DSL (Figure 2).

Figure 2. Summary of price pressures on individual domestic curves

	2yr	5yr	10yr	30yr	
Germany			↑		Germany
France			↑		France
Austria				↑	Austria
Belgium				↑	Belgium
Spain		↑	↑	↑	Spain
Italy			↑		Italy
Ireland		↑	↑		Ireland
Netherlands			↑	↑	Netherlands
	2yr	5yr	10yr	30yr	

Source: Citi Research

## Supra issuance in full swing

Peter Goves

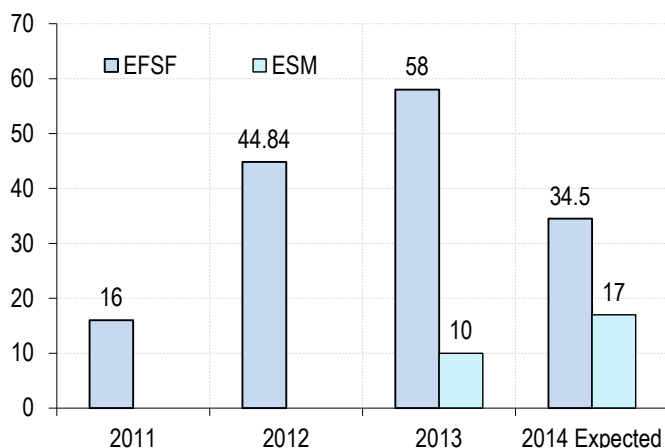
There has been a raft of euro supra issuance recently and we expect more to follow as the EU has indicated €2.6bn for Q1. We detail recent trends and our near-term expectations

### ESM 2014 debut - €6bn in the 7yr sector

The ESM issued its first bond of the year with €6bn in the 7yr sector at MS+7. This complements its issuance last year in the 5yr and 10yr sectors. Going forward, we continue to expect the ESM's relative "scarcity" premium to be an influential factor in the secondary market.

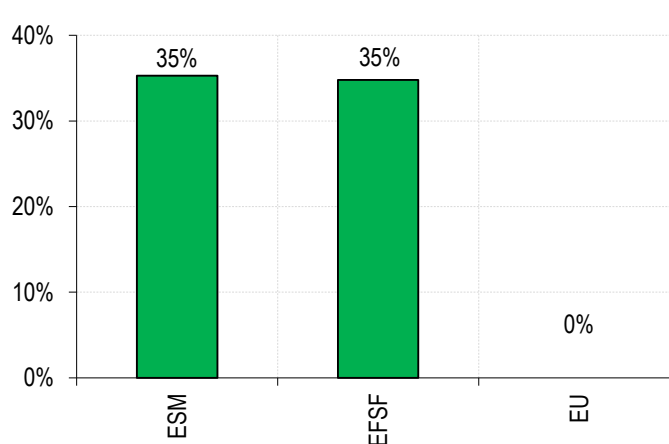
Following this issue, the ESM is now 35% the way through its 2014 funding target of €17bn. At 35% the way through, the ESM is at a similar level to EFSF (which has issued €12bn out of an expected €34.5bn). Figure 4 indicates completion rates for the EFSF, ESM and EU.

Figure 3. EFSF and ESM gross issuance (€bn)



Source: Citi Research, EFSF, ESM

Figure 4. Issuer Completion Rates (%)



Source: Citi Research

### The return of the EU - €2.6bn expected in Q1

One salient feature of the supra supply pipeline this year will be the opportunity to buy EU bonds once again in the primary market. Note that the EU did not issue any benchmarks last year and has indicated a provisional target of €2.6bn in Q1 and €2.1bn in Q2 for 2014. We continue to see various fundamental supports for this supra (rated AA+/Aaa) and the relative lack of supply is also a positive technical.

Updated weekly issuance details – including new issue performance – can be found in our [Weekly Chart-Pack](#) and full details on the supranationals detailed here can be found in our primer, [Supranationals in focus – overview and opportunities](#).

## EUR vol: 2s20s bear conditional flatteners

Matteo Regesta

Excess liquidity is currently around EUR 125bn and without monetary policy innovation we expect it to collapse to EUR 45bn by the end of the year. As a result the front-end could exhibit some volatility on the back of upward pressure on EONIA and EURIBOR fixings.

In the meantime long-tail options look richer than short-tail options on basic RV measures (Figure 6 to Figure 9).

Figure 5. Evolution of EUR 2s20s



Source: Citi Research

Figure 6. Implied/Riz ratios (21d)

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
1m	137%	154%	156%	159%	154%	155%	159%	167%	168%	170%	170%
2m	116%	137%	147%	153%	152%	153%	159%	166%	165%	168%	169%
3m	114%	134%	145%	148%	148%	150%	158%	167%	166%	167%	168%
6m	108%	129%	142%	145%	151%	158%	168%	175%	176%	178%	180%
9m	108%	130%	147%	149%	155%	163%	173%	181%	181%	184%	185%
1y	113%	128%	141%	143%	152%	164%	173%	181%	183%	187%	186%
2y	130%	143%	146%	157%	164%	175%	190%	192%	195%	198%	197%

Source: Citi Research

Figure 7. Implied/Riz ratios (63d)

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
1m	139%	143%	137%	134%	131%	130%	127%	128%	130%	131%	130%
2m	120%	130%	130%	132%	131%	129%	128%	128%	128%	129%	130%
3m	116%	128%	129%	129%	129%	130%	129%	130%	130%	130%	130%
6m	105%	120%	126%	127%	132%	137%	136%	137%	138%	138%	139%
9m	104%	117%	126%	129%	134%	137%	139%	140%	141%	142%	142%
1y	111%	116%	124%	127%	133%	139%	141%	142%	143%	145%	144%
2y	112%	120%	123%	132%	137%	140%	146%	147%	150%	151%	151%

Source: Citi Research

Figure 8. Implied/Riz ratios (121d)

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
1m	139%	116%	107%	105%	102%	101%	101%	104%	106%	107%	107%
2m	116%	103%	102%	102%	101%	100%	102%	103%	104%	105%	106%
3m	109%	101%	101%	100%	100%	102%	103%	106%	106%	106%	107%
6m	88%	92%	97%	97%	101%	106%	108%	110%	112%	112%	114%
9m	81%	90%	96%	99%	103%	107%	111%	114%	114%	115%	116%
1y	80%	89%	95%	99%	103%	109%	113%	116%	117%	118%	118%
2y	87%	94%	97%	103%	108%	112%	119%	121%	123%	124%	125%

Source: Citi Research

Figure 9. Implied/Riz ratios (255d)

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
1m	89%	83%	85%	86%	87%	88%	90%	94%	96%	97%	97%
2m	81%	78%	85%	88%	90%	91%	95%	97%	98%	98%	99%
3m	71%	74%	83%	87%	90%	94%	98%	101%	101%	101%	103%
6m	68%	76%	83%	88%	94%	100%	105%	107%	108%	108%	109%
9m	70%	80%	88%	92%	97%	103%	109%	112%	113%	113%	113%
1y	72%	82%	89%	94%	100%	106%	113%	116%	116%	117%	116%
2y	83%	89%	93%	100%	107%	112%	118%	121%	122%	123%	123%

Source: Citi Research

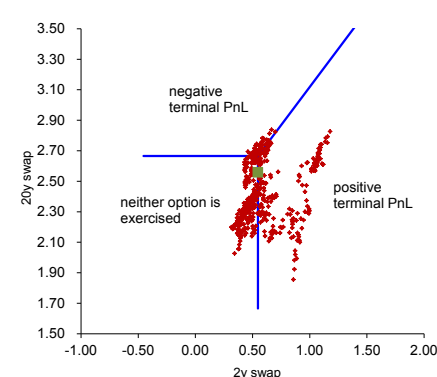
Long positions at the front-end vs. the long end look attractive from a funding standpoint given the generous implied volatility differential. For instance the 6m2y/6m20y implied volatility spread is worth around -20bp (Figure 10). In turn PV01 neutral six month forward 2s20s bear conditional flatter can be executed at zero cost with 6m20y payer struck 12bp out of the money. Figure 11 shows the attractive decomposition of the the terminal payoff of the trade (red sample shows dynamics of 2s20s over the past two years).

Figure 10. Evolution of 6m2y/6m20y implied volatility spread



Source: Citi Research

Figure 11. Decomposition of terminal payoff of 6m fwd 2s20s conditional bear steepener



Source: Citi Research

## Appendix A-1

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