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Developed Markets
Western Europe

Euro Rates Strategy

Outlook for Irish bonds - stretched valuations or further tightening ahead?

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- **Irish bond returns have been impressive:** Year-to-date, Ireland has returned a very respectable 6.2% according to Citi's EGBI indices. What's more, realized volatility has fallen dramatically putting Ireland in a favourable light on a risk-adjusted basis.

- **The primary market is clearly open:** In terms of bond supply, Ireland has successfully issued €5.75bn YTD including one syndication and two auctions. The NTMA has indicated there will be one to two auctions per quarter going forward. Demand has been firm and Ireland's Investment Grade status and clean exit from its successful Troika programme continue to point to further market support in the hunt-for-yield environment.

- **Current valuations:** Given the impressive rally seen so far, investor attention is now settling on the degree to which the rally can continue. After all, 10yr Ireland is now around 125bp having rallied from over 260bp in June last year.

- **Fundamentals continue to signal improvement:** Together with broader periphery market supports, the rally in Irish yields also reflects its success in implementing its own reform agenda. Ireland fully met Troika targets on fiscal measures and the economy has returned to growth (Citi now expecting 1.8% GDP growth in 2014). Although some uncertainties remain (pertaining mostly to the banking sector), we believe fundamental drivers continue to be supportive for Irish bond performance.

- **Fundamentals now subservient to ECB policy:** In our view, EMU bond market drivers are evidently changing. The market is now being galvanized at the prospect of the ECB embarking on large-scale asset purchases. In this scenario, smaller issuers such as Ireland stand to benefit considerably, in our view.

- **Price action justified as is further tightening:** Although current valuations among many spread markets are gathering attention, we believe the price action in Irish government bonds is justified by a variety of fundamental and technical factors. Looking ahead, we expect further spread compression to core markets, especially in an environment of ECB QE.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Irish bond outlook – yields to get lower still

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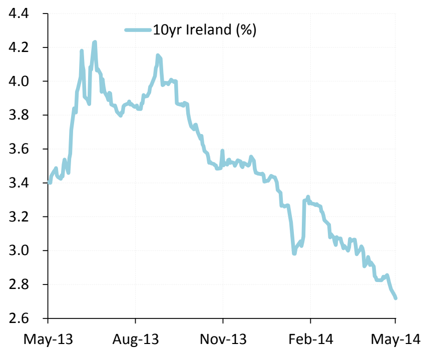
Ireland's return to investment grade status, its clean exit from the successful Troika programme and subsequent collapse in secondary market credit risk premia have certainly been among key milestones for EMU fixed income so far in 2014. Together with wider supports of improved investor confidence and lower systemic risk, the rally in Irish government bonds has also been sustained by Ireland's own fundamental successes. In our view, however, such fundamental improvements have now by and large been discounted by the market and have probably been so for some time. Fundamentals are now subservient to other powerful technical forces, not least growing expectations that the ECB will embark on large-scale asset purchases later this year.

The anatomy of the rally

Figure 1. 10yr Irish bond yields (%)

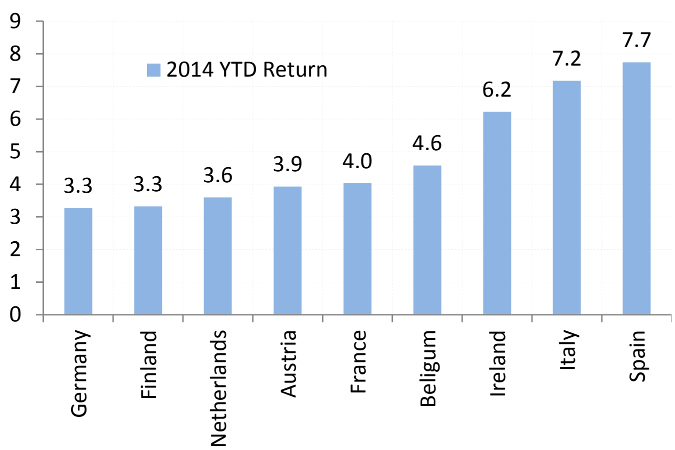


Source: Citi Research

10yr Ireland has rallied some 68bp YTD, currently trading around 2.72% from 3.4% earlier in January. Note in Q3 last year, the same yield was over 4.2%. The price action has generally been characterized by a decisive move lower in yields as the wider recognition of value in Irish government bonds grew and the hunt-for-yield made Ireland ripe for investment opportunities given its return to economic health (Figure 1). Given current valuations, investor attention is increasingly focused on how much further momentum there is in the rally. Our base case detailed in this piece is for spreads to tighten further, spurred in part by ECB policy.

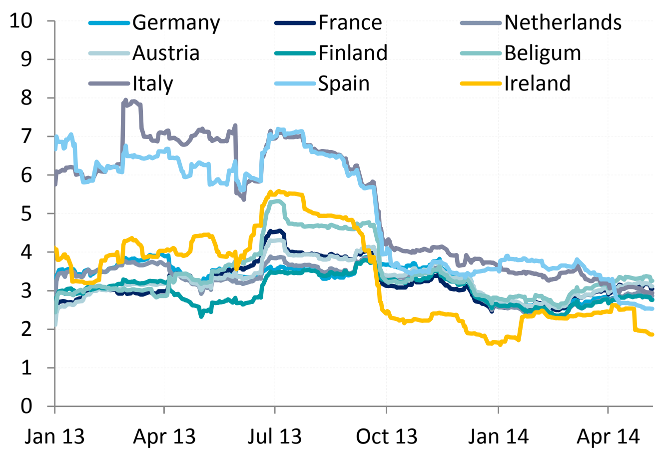
In terms of performance so far in 2014, year-to-date returns stand at a respectable 6.2% based on Citi EGBI indices (Figure 2). What's perhaps more significant is the collapse in realized volatility of such daily index returns. Among the EMU indices, realized volatility for Ireland is now the lowest (Figure 3) and consequently puts Ireland in a favourable light on a risk-adjusted basis.

Figure 2. YTD total return on Citi EGBI indices (%)



Source: Citi Research, Yield Book

Figure 3. Realised volatility in total return indices (3m rolling)



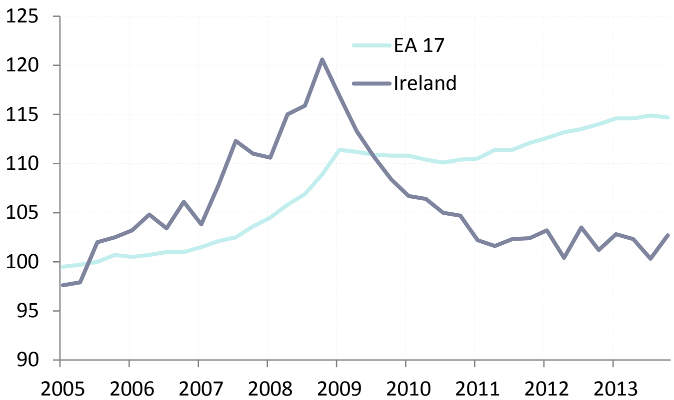
Source: Citi Research, Yield Book

Macro supports – debt-to-GDP to fall in 2014/2015

Citi expects debt to GDP to fall to 121.5% in 2015 from 124% in 2013

Key macro supports underpinning the rally remain Ireland's credible track record of reform and its progress vs peers. For one, unit labour costs for Ireland have fallen dramatically and remain below the euro area average (Figure 4). In addition, various economic forecasters now expect debt-to-GDP to fall in 2014-2015 depending in part on the extent to which cash reserves are run down (Figure 5). Citi expects GDP growth of around 1.8% in 2014 and 3.1% in 2015, with the outlook reflecting stronger activity seen recently in industrial production, retail sales and PMIs (*Global Economic Outlook and Strategy*). As such, we remain broadly constructive on Ireland's economic outlook to the benefit of market yields and its spreads to Germany.

Figure 4. Unit labour costs (Total economy, SA, 2005 index base)



Source: Citi Research, Haver Analytics

Figure 5. Macro forecasts for Ireland (% GDP)

		GDP Growth (YY %)			Fiscal Balance (% of GDP)			Debt (% of GDP)		
	Date of Forecast	2013	2014F	2015F	2013	2014F	2015F	2013	2014F	2015F
Ireland - Citi Forecast	**30-Apr-14**	**-0.3**	**1.8**	**3.1**	**-7.2**	**-5.5**	**-3.0**	**124.0**	**122.0**	**121.5**
OECD *Economic Outlook*	06-May-14	-0.3	1.9	2.2	-7.0	-4.7	-3.1	123.7	121.9	121.1
EU Commission Forecast	05-May-14	-0.3	1.7	3.0	-7.2	-4.8	-4.2	123.7	121.0	120.4
IMF WEO Forecast	08-Apr-14	-0.3	1.7	2.5	-7.4	-5.1	-3.0	122.8	123.7	122.7
Irish Government	17-Dec-13	0.2	2.0	2.3	-7.3	-4.8	-3.0	124.0	120.0	118.0

Source: Citi Research, OECD, EU, IMF, Ireland

Banking sector uncertainties

Lingering uncertainties within the banking sector

One remaining qualification is the banking sector and the extent of non-performing loans. Moody's maintains a negative outlook on the Irish banking sector overall highlighting ongoing asset quality concerns as a particular credit challenge[1]. Citi economists also note uncertainties over the scale of potential bank losses. As detailed, the rise in mortgage arrears is slowing, but the share of mortgages (on principal dwelling houses) at least 90 days in arrears hit 12.9% in Sep-13 versus 11.9% at end-2012. The need to inject extra capital into the banks played a major role in Ireland's decision to seek a rescue programme, and – until there is greater clarity of the eventual peak in NPLs and mortgage arrears – risks that banks will need further (probably relatively modest) capital cannot be discounted. Further details can be found in Citi's note, *Ireland – After the Programme.*

Bond market analysis

Supply has been met with encouraging demand and Ireland is now auctioning bonds independently

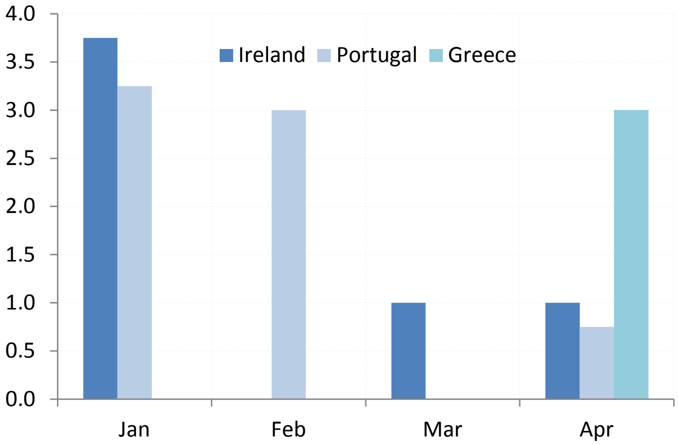
Ireland is fully funded this year. As of September last year, cash reserves were €25.6bn – a clear credit positive. Maturities next year stand at around €9bn (€5bn of which constitute EFSM loans) with the overall profile having benefitted significantly from the extension of officials loans to an average of 19yrs (Figure 7). In terms of supply specifically, to date, Ireland has issued €5.75bn (one syndication and 2 auctions) and has indicated that it will auction one or two bonds per quarter (normally held on the second Thursday of the month in question). Ireland's ability to issue debt – especially with the resumption of auctions – forms part of the wider context of periphery primary market normalization. Portugal is also auctioning bonds (and has also signaled a "clean" exit from its own Troika programme) and Greece successfully syndicated €3bn in the 5yr sector in April (Figure 6).

Ongoing diversification of the demand structure

In terms of demand and ownership structure, as of December 2013, the proportion of resident holdings has grown to 47.3% from 27.8% in December 2012. Demand so far in 2014 has been strong as investors hunt for returns in an otherwise low yield environment. Over time, we expect a gradual diversification in the demand structure of Irish debt to evolve, which the restoration to investment grade status now enables.

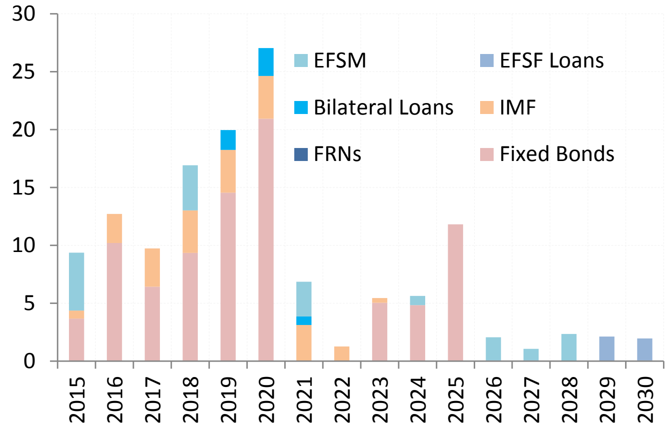
[1] Moody's Investor Services Banking Sector Outlook: "*Ireland*" 21st March 2014

Figure 6. Periphery market supply YTD



Source: Citi Research, DMOs

Figure 7. Ireland maturity profile (up to 2030), €bn



Source: Citi Research, NTMA

Fundamentals now subservient to ECB expectations

Ireland has benefitted from both idiosyncratic and wider systemic factors

Successful austerity implementation, the return to growth and Ireland's fully funded position for 2014 are all fundamentally positive, but in general such factors have now been largely discounted by the market, in our view. Ireland's success story was already apparent early last year when it was already undertaking syndicated debt sales (*Improving prospects for Ireland*). The wider recognition of value, the suppression and containment of tail risks and broader improvements in investor confidence have all been crucial in understanding the rally. However, going forward, fundamentals are now subservient to other powerful forces, including the ever-present "hunt-for-yield" and, more importantly, ECB policy.

ECB policy now central to the outlook

Growing expectations that the ECB will loosen policy further, probably in the guise of large-scale asset purchases later in the year have provided fresh market support. Citi expects some form of QE later in 2014 (*The ECB And QE: "Whatever it Takes", Redux*) and, in our view, this has become an overriding factor when assessing EMU bond market behaviour. Therefore, although the rally in Irish (and Spanish and Italian) yields has been impressive, we see scope for further performance. 10yr Ireland currently trades at around 126bp to Germany. In a scenario of QE in Q3/Q4, we have published forecasts of this spread moving to 80bp on average later this year, as detailed in *Global Economic Outlook and Strategy*.

Outlook – despite valuations, spreads to tighten further

Our base case is for some form of QE later this year

In conclusion, although tail risks remain, central bank policy continues to play a crucial role within the EMU periphery. Markets are now caught in a virtuous circle with many yields probing new lows (10yr Italy recently traded below 3%, for example). Ireland has also been supported by its own fundamental successes and the return to Investment Grade status by Moody's (and we expect further upgrades in 2014). However, prospects of ECB QE are now overriding other drivers and rising expectations of action are likely to be support further spread tightening to Germany, in our view. Even though yields have moved a long way relatively quickly, we find it hard to be anything other than constructive on Irish yields in the quarters ahead.

Appendix A-1

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