



ECB Bond Market Contact Group

Bond market outlook and main developments

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Recent developments and key themes

Forward guidance, Fed tapering, AQR, VLTRO, excess liquidity, political concerns, downgrade risks...

- **Central banks**

- Introduction of forward guidance by ECB & BoE this summer
- Fed tapering (decision not to taper in September)
- Asset Quality Review
- VLTRO
- Excess liquidity (making one year lows)

- **Politics**

- Political uncertainty in Italy continues
- US debt ceiling/fiscal shutdown
- Outcome of German election (strong result for Merkel)
- EM (Fed's prolonged accommodation eases EM pressures somewhat)

- **Economic data/Market levels**

- Improving economic data (PMI & GDP)
- Tight spreads (credit, Bono & BTP)
- Concerns over a Spanish downgrade
- Will financial assistance in Portugal and Ireland end soon?

PMIs above 50 (“expansionary”)

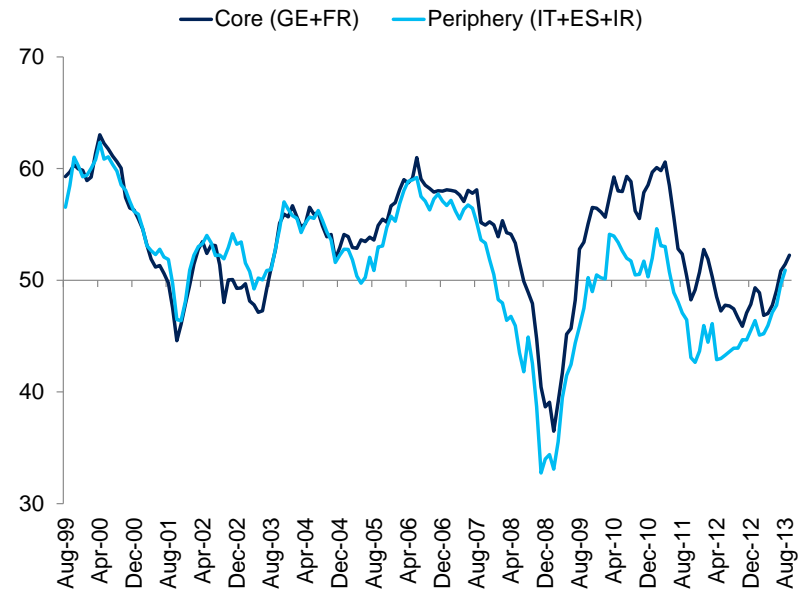
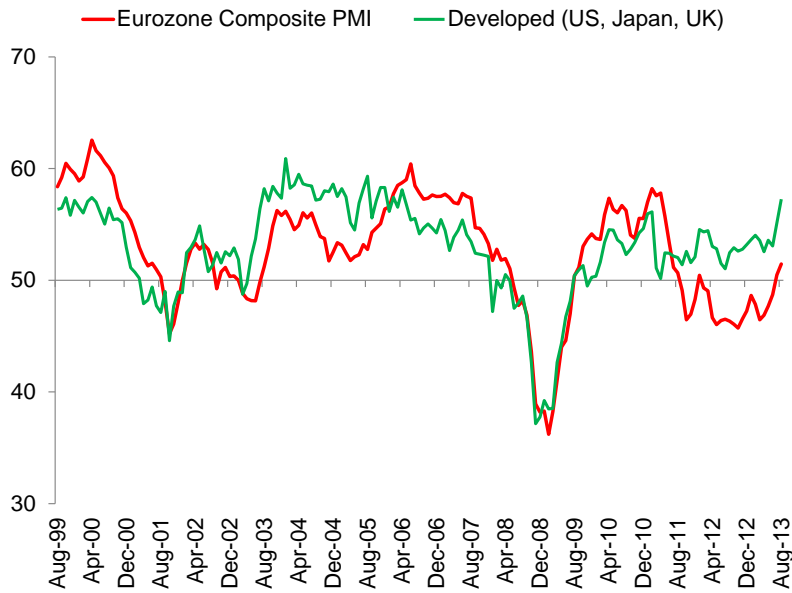
Some improvements in the Euro Area, but still lagging the rest of the world

• Euro Area

- Eurozone composite PMI above 50 but still lagging the rest of the world
- Core and periphery PMI data above 50
- 2Q13 GDP growth was positive for the first time in seven quarters

• Developed (US + Japan + UK)

- PMI’s remain firmly positive (highest since May 2006)
- Positive GDP growth for all three countries in 2Q13

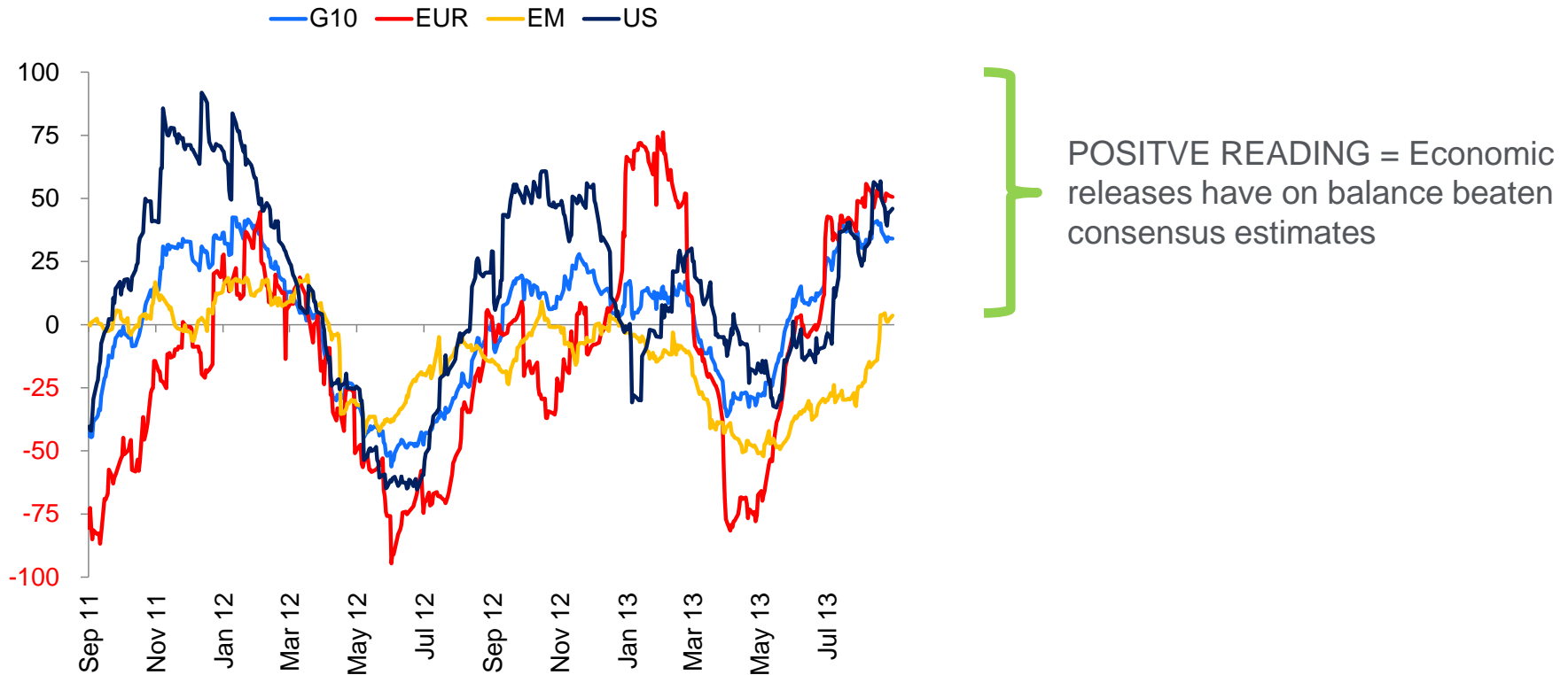


Data releases vs consensus expectations

The improvement in data has exceeded consensus expectations

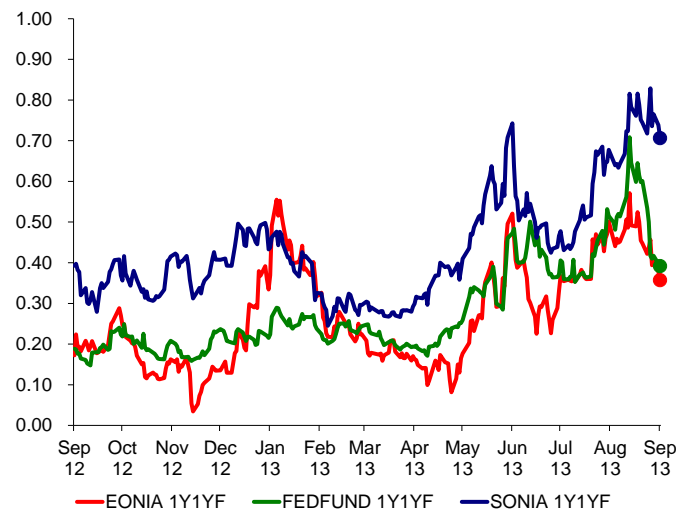
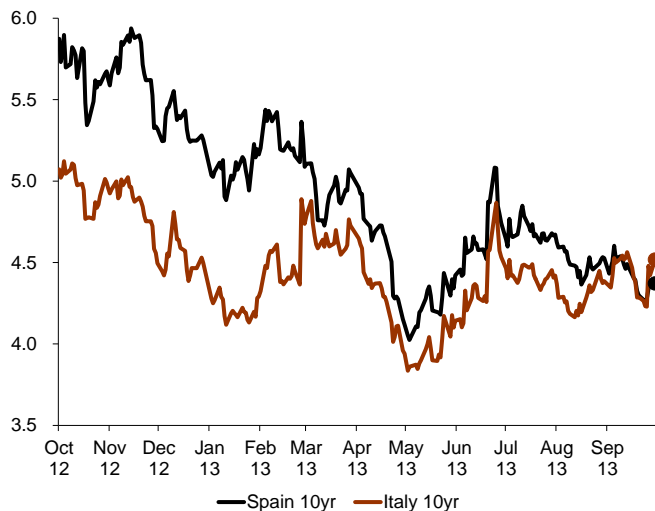
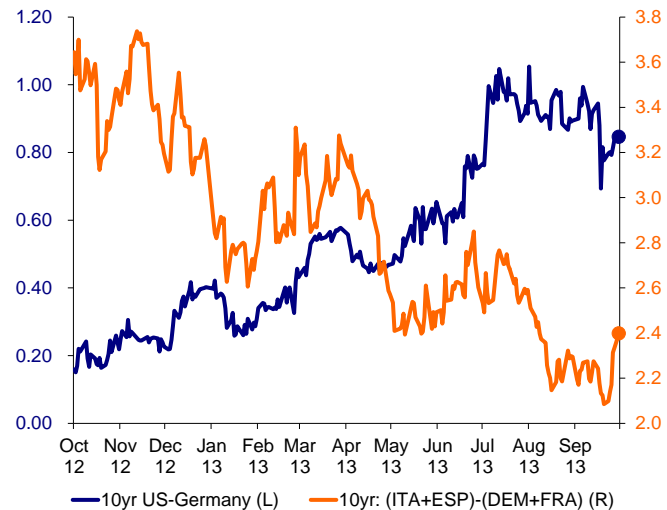
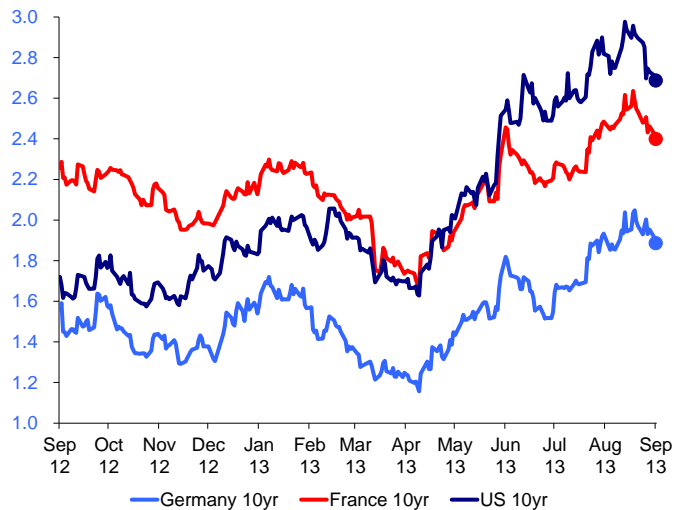
● Citigroup Economic Surprise Index

- G10, EUR and US economic data releases have strongly exceeded consensus expectations
- EM data releases have been roughly in line with forecasts
- EUR data releases have exceeded consensus estimates the most



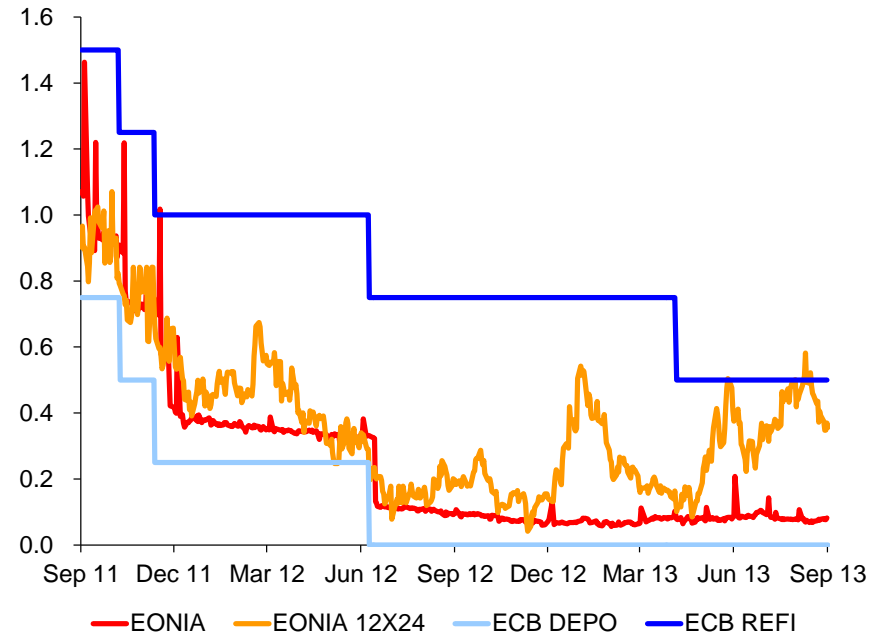
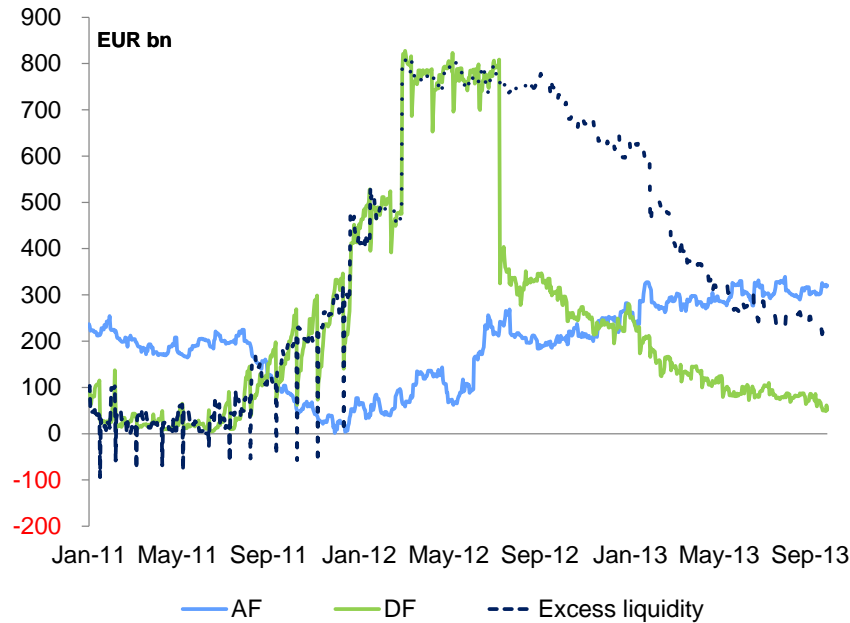
Global Yields and Spreads

UST & Bund yields have broken ranges / EMU has core-non core bounced off the lows.
 Bono's trading through BTP's / Volatile front-end



ECB: Liquidity Analysis

Declining excess liquidity. EONIA fixings have been fairly stable. EONIA forwards below the refi-rate

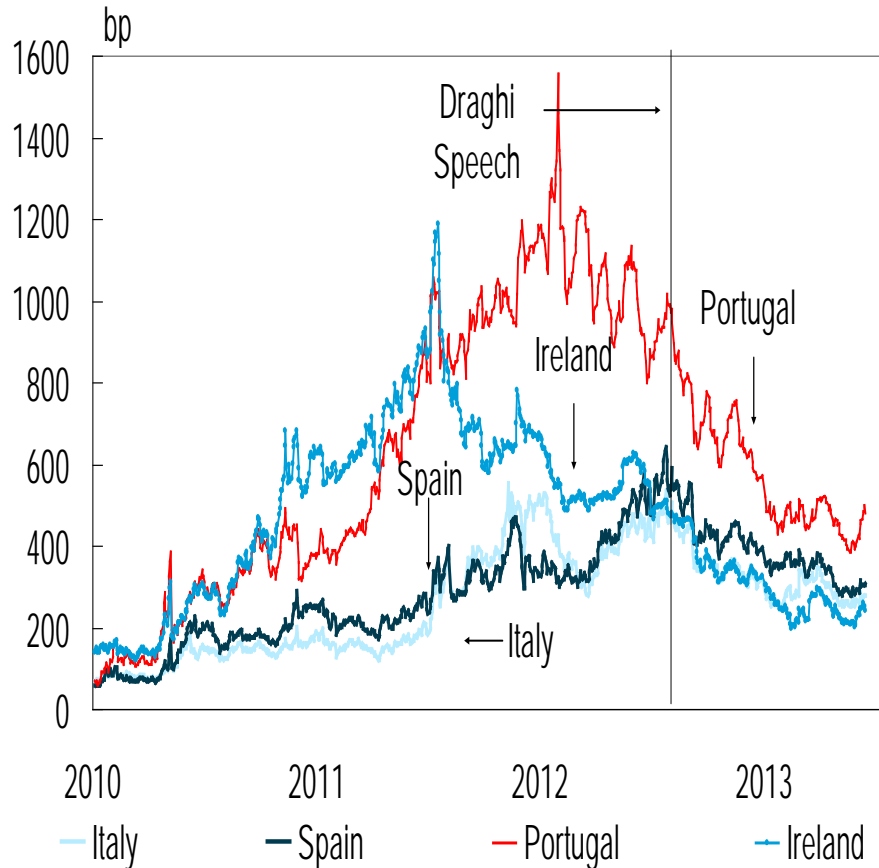


Source: ECB, Citi Research

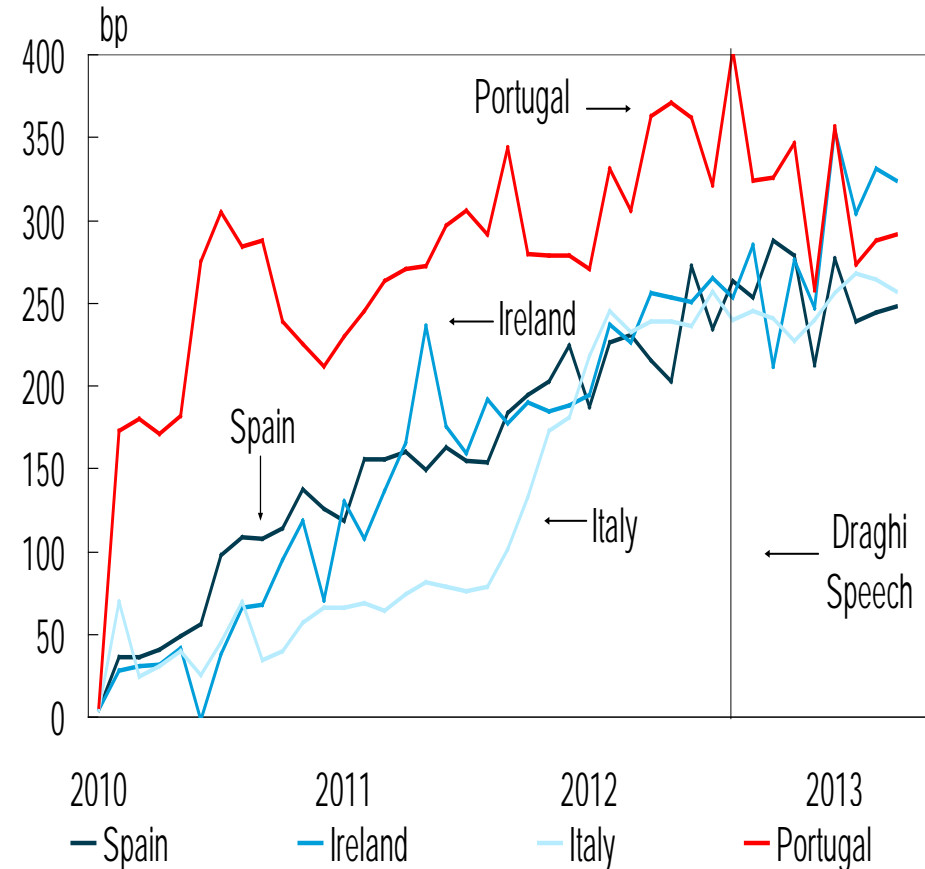
- Excess liquidity has declined by ~€597bn since early March 2013
- Current levels of excess liquidity ~€215bn have drawn attention to two main areas: (1) outlook for EONIA fixings and (2) will we get another LTRO?
- Little or no structural impact on average Eonia fixings so far (around 8bp over depo rate)
- EONIA 1Y1YF below the refi-rate (breached 50bp in early September)

Financing Conditions Not Supportive of Economic Recovery

10-year Government Bond Spreads vs. Germany



Lending Rates on New Business Loans (up to €1m, above 1Y) Spreads vs. Germany



Sources: ECB, BIS and Citi Research

Forecasts: Global Yields, Spreads and Central Bank Policy

Main highlights

• UST

- Higher yields: 10s moving to average 3.50% in 1Q15
- Tapering to begin by end-2013 (base case) or early 2014
- Main risks to forecasts come in the form of a US growth shock (in either direction), and China and EM could be factors in this.

• Bunds

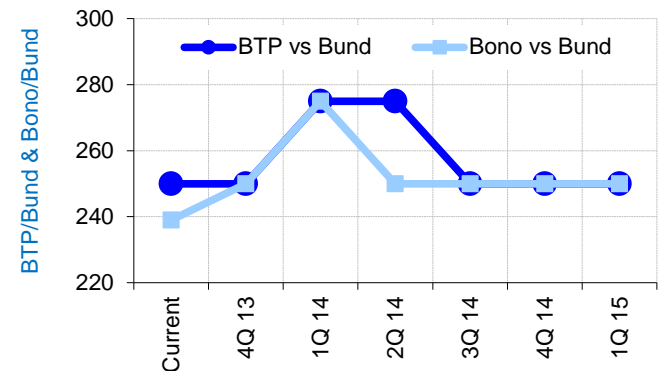
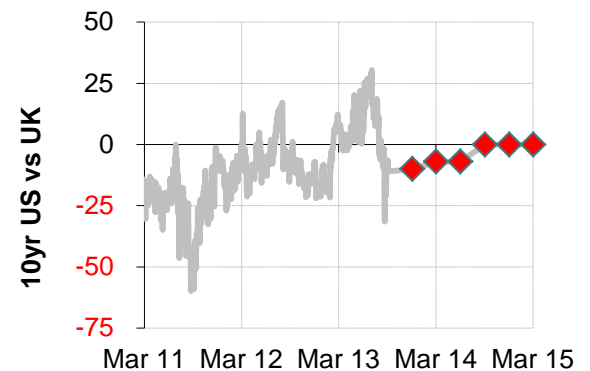
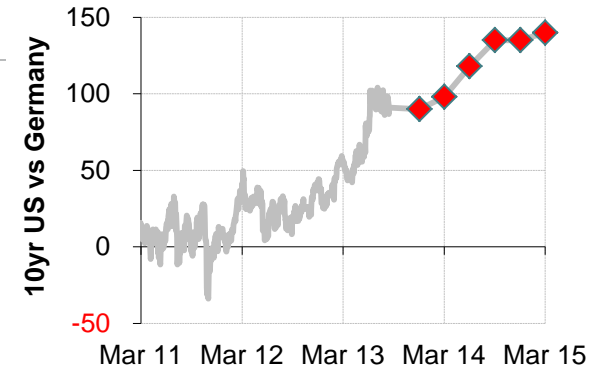
- Growth and inflation outlook continue to point to low core yields
- Bunds to range trade around 1.80% in the coming quarters
- ECB expected to keep monetary policy loose.

• Gilts

- BoE to hike rates in 2015
- 2yr gilts to reach 1% by 1Q15
- 10yrs to move 10-15bp higher per quarter in 2014
- Bear steepening to eventually give way to bear flattening in late-2014

• Spreads

- UST-Bund and gilt-Bund spreads to widen further
- UST-gilt spreads to remain close to flat
- BTP/Bund and Bono/Bund spreads to temporarily widen in 1Q14 (onset of supply and prospect of fresh elections in Italy)



Peripherals: Growth, Ratings, Financial assistance

• Euro Area

- As a whole the EA exited recession in Q2
- Nominal GDP remains down in YoY terms for peripherals
- Government debt/gdp ratios are likely to rise for a range of peripheral countries

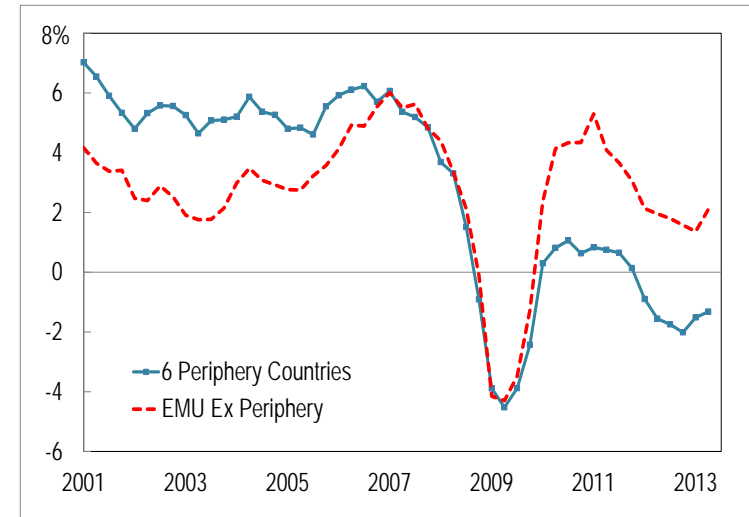
• Italy/Spain

- Downgrade risks remain: Spain & Italy are both on Negative Outlook by Moody's and S&P
- Concerns over Spain being ejected from bond indices
- Political pressures in Italy remains

• Ireland

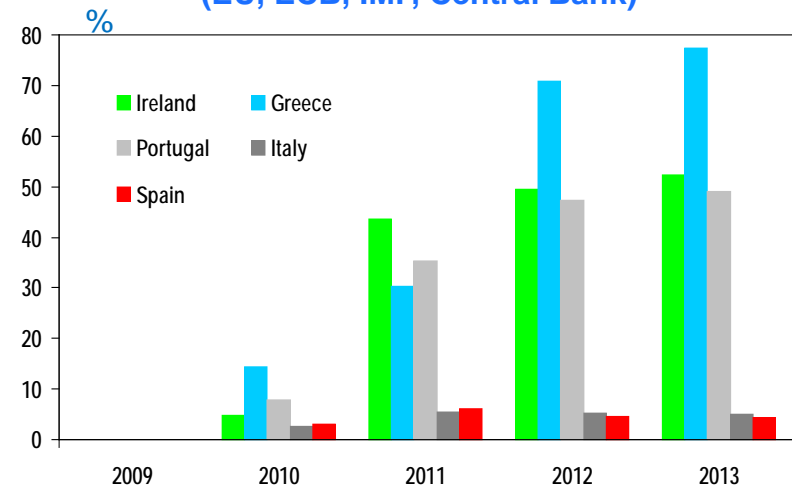
- Moody's revised its Ba1 rating Outlook to "Stable" from "Negative" on 20 September.
- Sub-IG (Moody's) and IG (S&P)
- 2 syndications this year (€7.5bn). Next step is to conduct regular bond auctions
- Conditional ESM program to extend post-2013? Would provide OMT backstop

Euro Area – Nominal GDP YoY, 2001-13



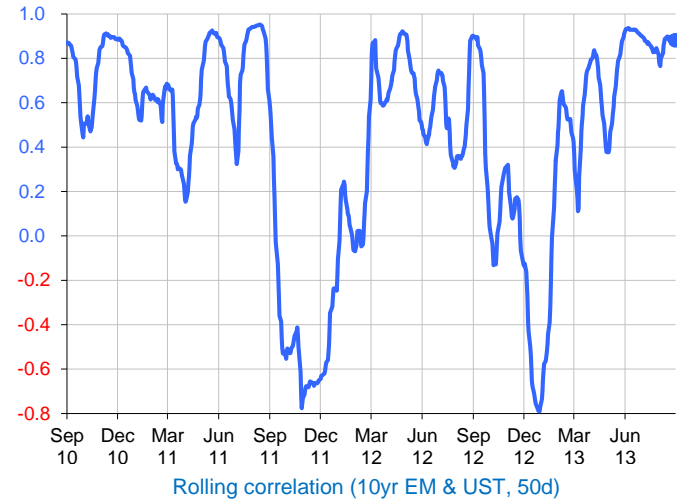
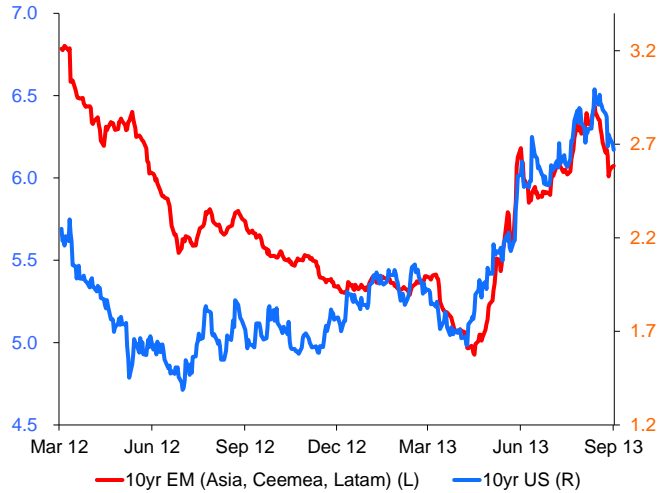
6 periphery countries are Italy, Spain, Portugal, Greece, Ireland and Cyprus

Share of Govt Debt In Official Hands (EU, ECB, IMF, Central Bank)

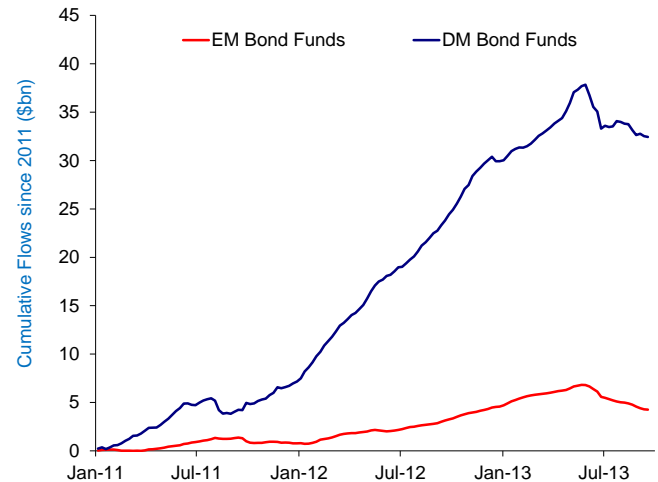
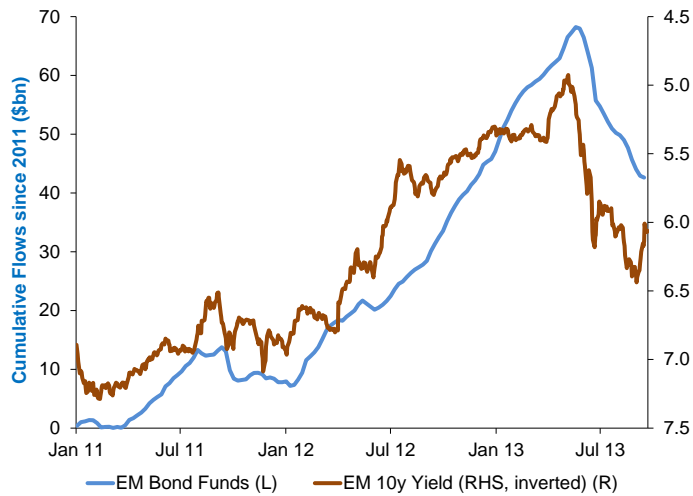


Is risk on/off essentially taper or not taper?

EM vs UST: Correlation between EM yields and UST has picked up since Bernanke's comments on 25 May

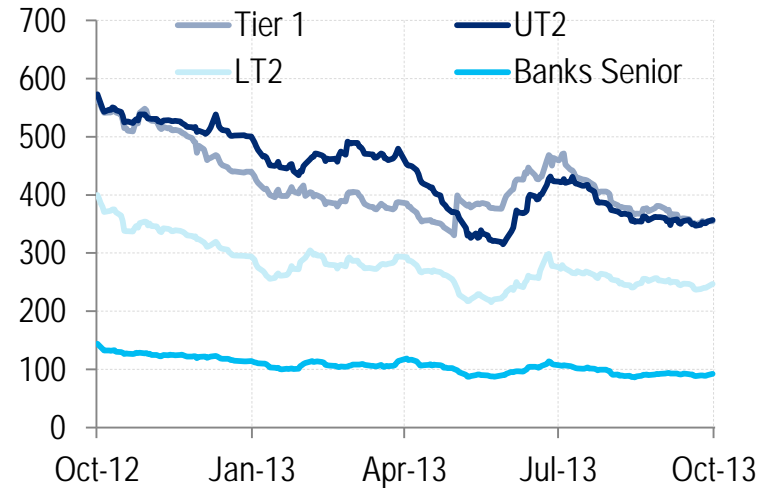
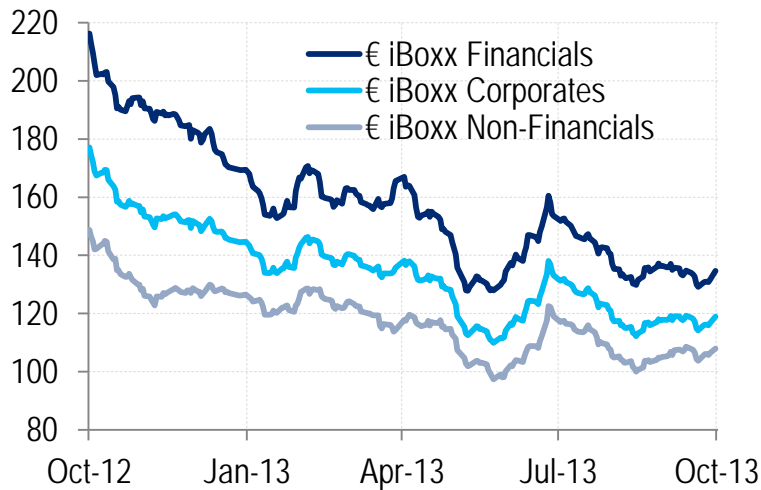


Bond Flows: Large EM outflows since mid-2013 has pushed yields much higher

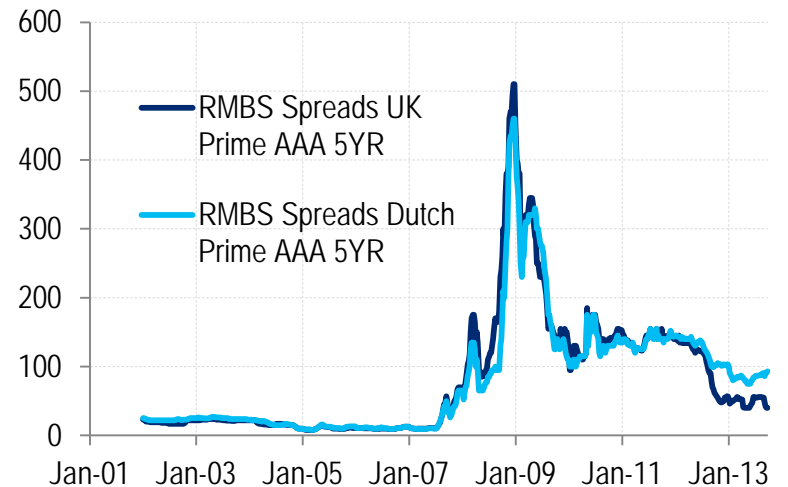
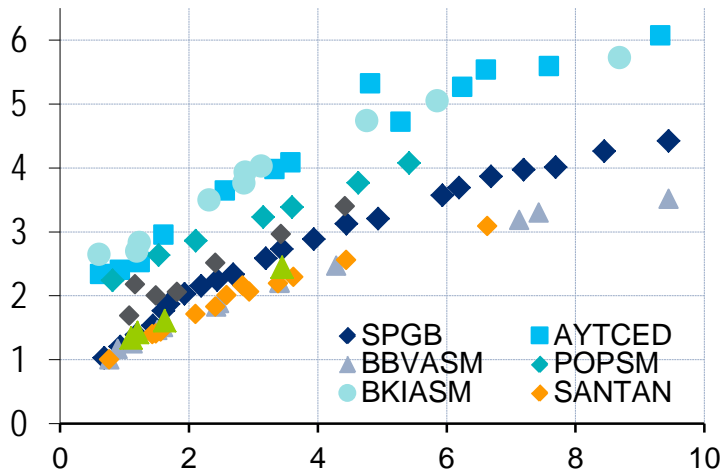


Spread markets within the European bond universe

Technicals supportive for senior and subordinated corporate spreads to grind in further

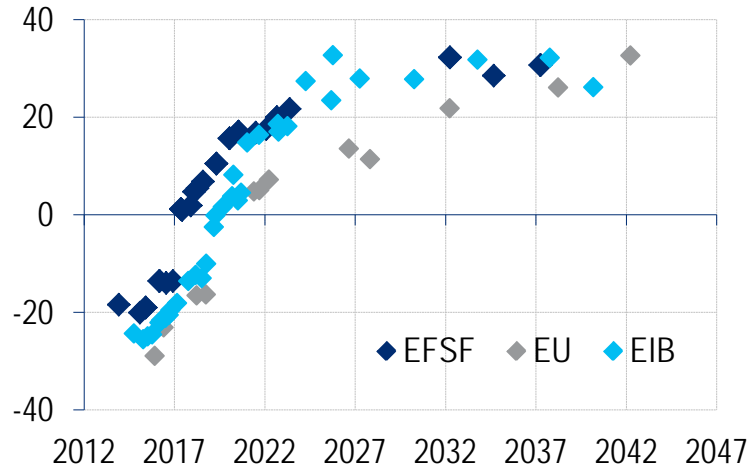


Lack of supply beneficial for covered bonds (some of which now trade inside their govt curve)



SSA market welcomes a new issuer – the ESM to issue in October

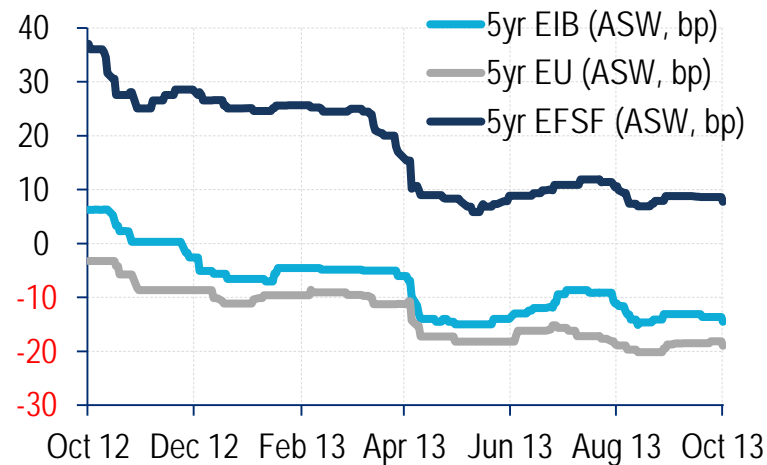
European suprationals (ASW curves, bp)



ESM in brief

- Paid-in capital ultimately of €80bn
- Maximum lending capacity of €500bn
- Permanent intergovernment organisation established under international law
- €100bn allocated for Spanish banks
- €9bn allocated for Cyprus
- Provisional issuance schedule of €9bn for 2H 2013

Healthy demand & performance of supras



Enhanced features likely to ensure core status