

Rates Strategy

Themes and Trades 2017

Pricing the end of the QE era

Andy Chaytor
European Rates Strategy
andy.chaytor@nomura.com

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

The weather is no longer our guide

We know that Milan temperature is correlated to European yields – of course! But...we don't know how. So, back to basics!

5y euro swap yields (%) vs. Milan temperature (degrees C, RHS) for 2015 and 2016





Themes

Short-term:

- Better data, heavy issuance (even seasonally adjusted) and rising inflation battle against positioning to define near-term directional call.
- That should lead to choppy trading with an expectation that yields are biased to rise further in Q1, albeit with significant rallies along the way.

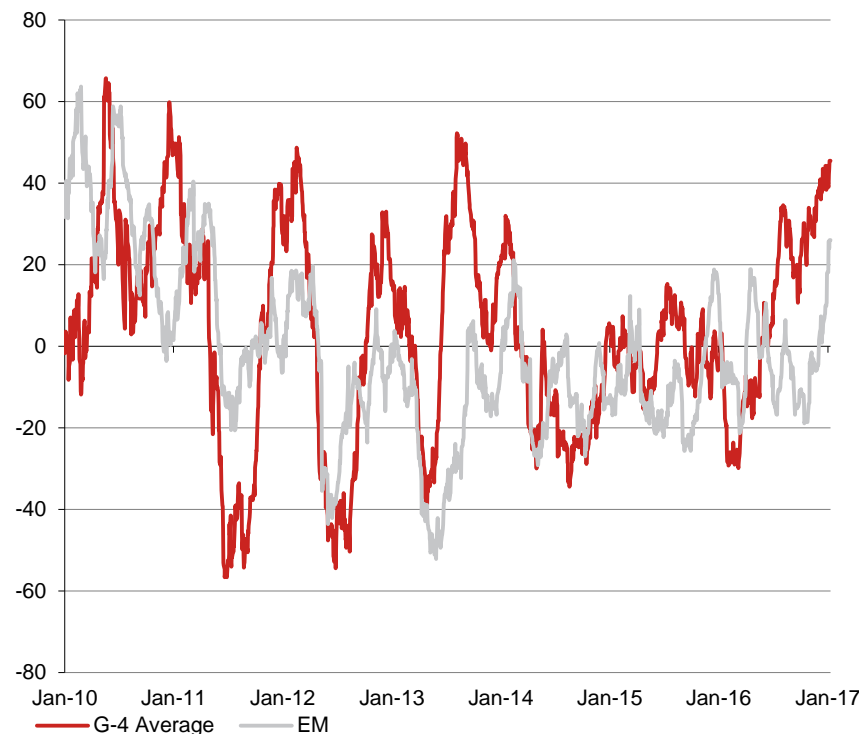
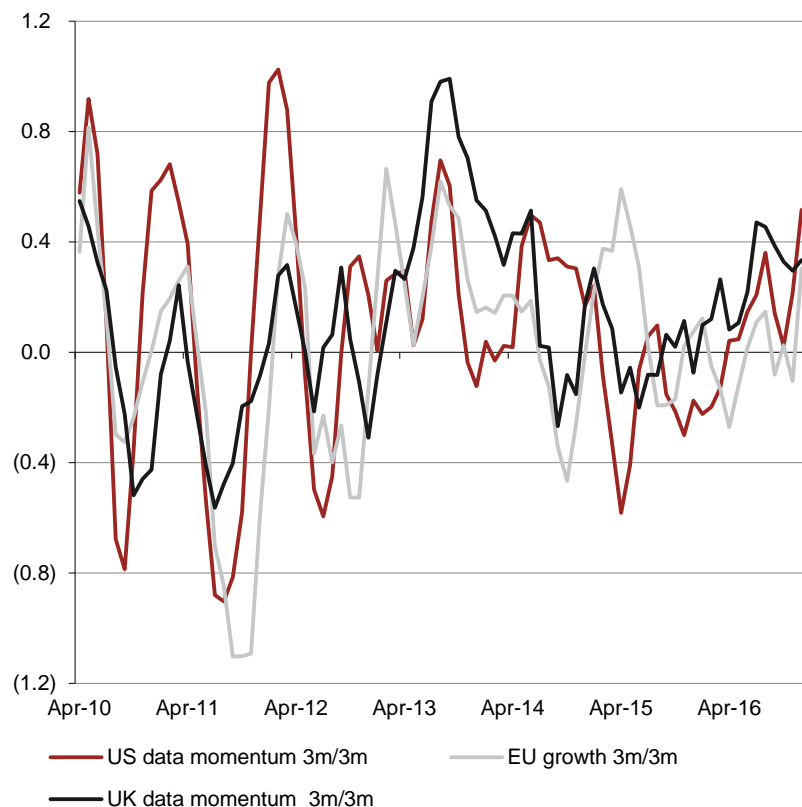
Medium / Long-term:

- Increase in uncertainty is, for now, no bad thing.
- Pricing in the end of the QE era is the dominant structural / secular theme. That means higher term premium (especially for cash bonds), higher volatility in rates markets and decreased cross-market correlations.
- It will also bring focus to bear on the key beneficiaries of the QE era; credit type instruments. This includes peripheral bonds in the euro area.
- Political focus moves from Anglo-Saxon countries to continental Europe. Most, ourselves included, do not expect tail risks to crystallise...but Brexit/Trump will cast a shadow.

Short-term; data are getting better

Data have improved outright and especially vs. expectations.

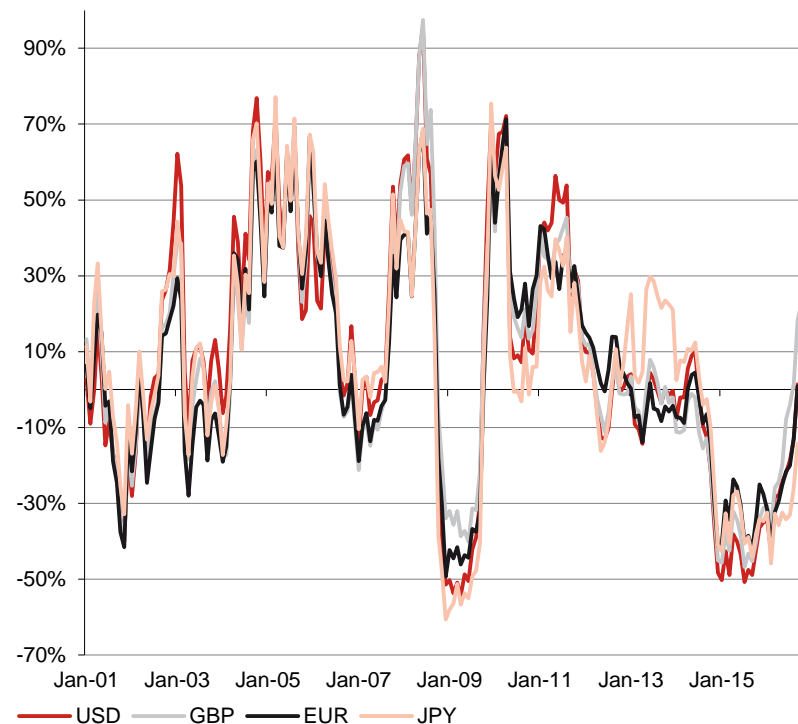
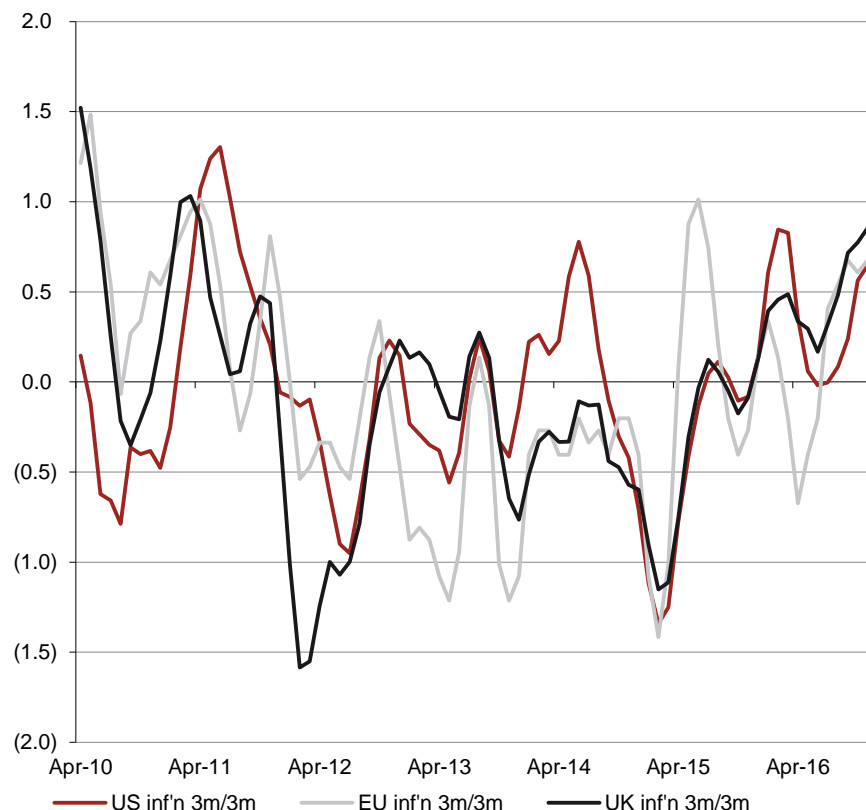
3m/3m standardised moves in select data series (LHS, %) and data surprise index



Short-term; inflation is going higher

It is largely base effects driving inflation higher but the market has proven itself very easily surprised by base effects in recent years.

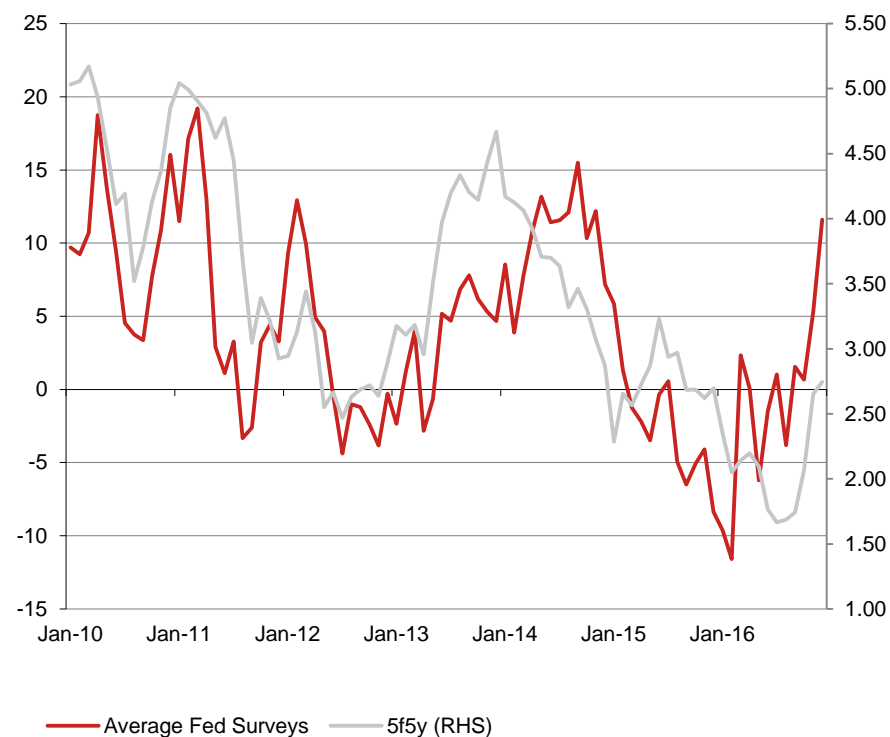
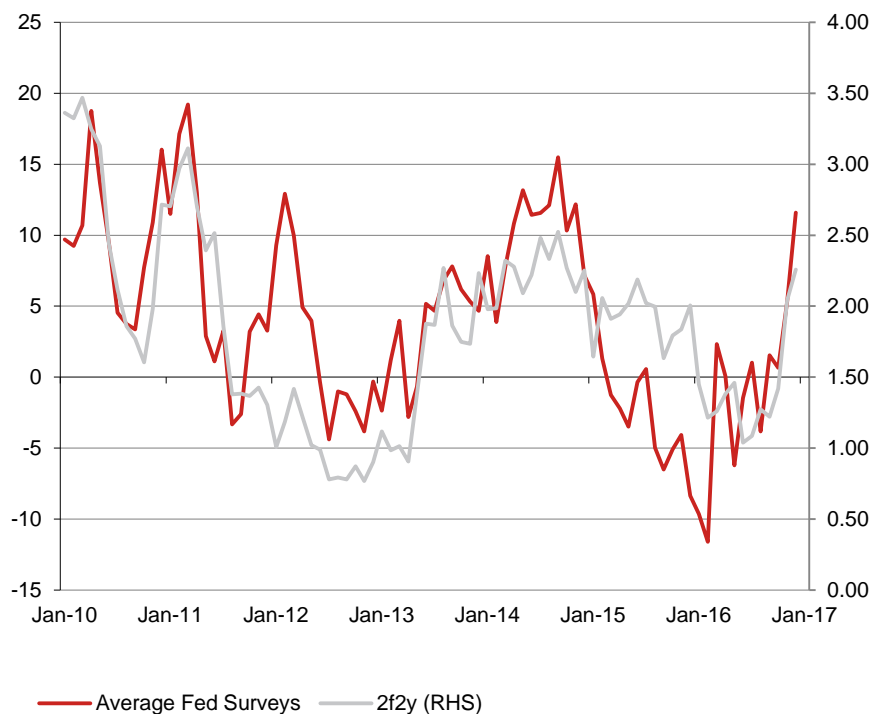
3m/3m standardised moves in select data series (LHS, %) and y/y changes in oil price in select currencies (RHS, %)



Direct correlation between data and market

There has been a passable correlation between an average of selected surveys and US forward rates. You don't necessarily need to appeal to a 'Trump effect' to explain the recent rise in yields, just the data. However, interestingly, the 5f5y rate still looks significantly too low.

Average of selected US surveys (points) and US forwards (%)



Higher DV01 issuance

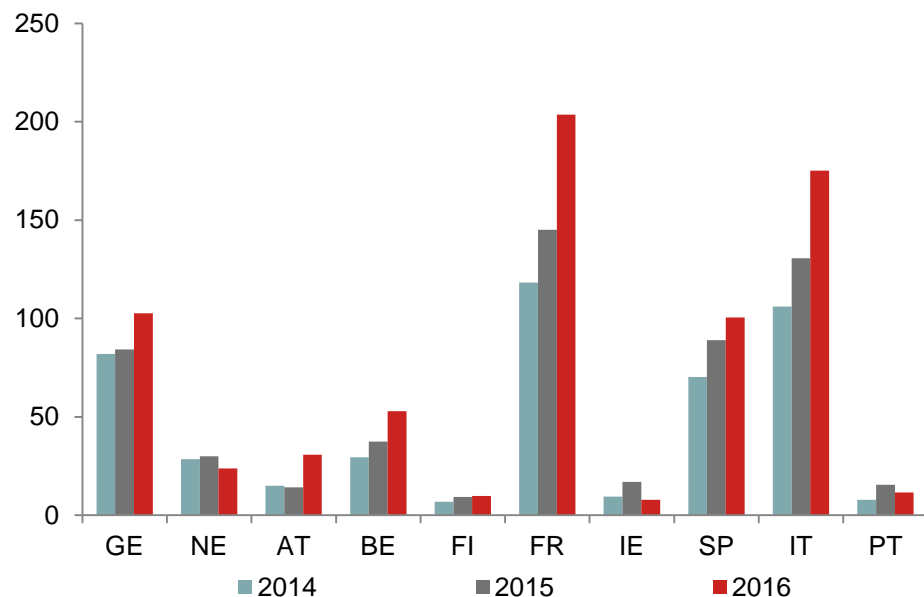
The ECB's ongoing PSPP will also likely keep rates low and encourage higher DV01 supply, as in 2016.

Technical changes may discourage issuers from extending their DV01 issuance too much.

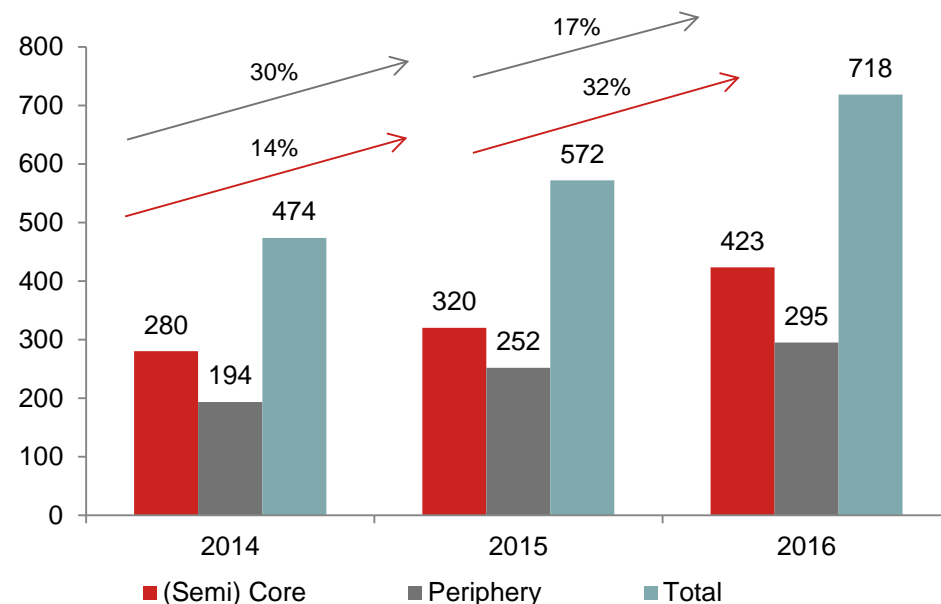
With the deposit rate constraint removed and with buying down to 1yr, this is no longer an incentive for issuers to sell further out on the curve.

We see a risk of (semi) core countries reducing DV01 in 2017, following the sharp rise observed in 2016.

DV01 per country, past three years



DV01 pick-up in 2016 – in particular (semi) core



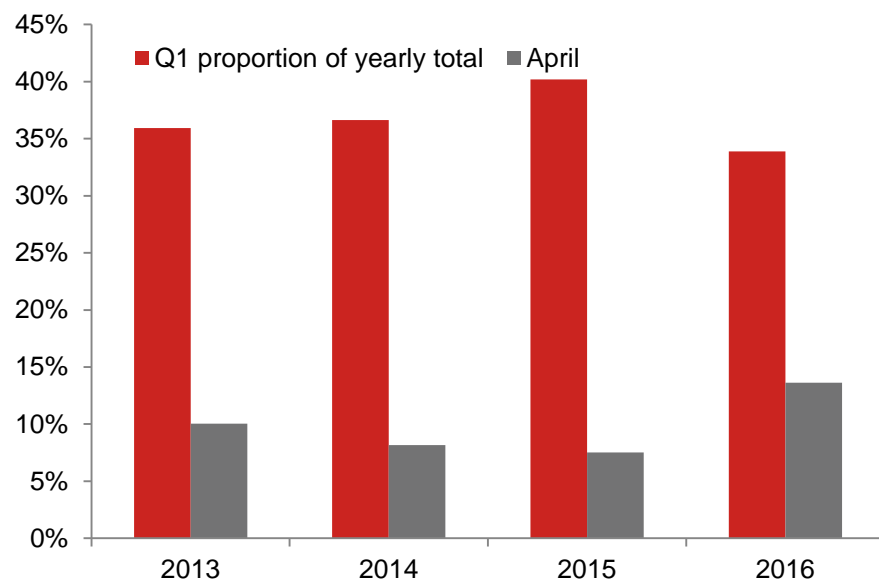
Front-loaded supply into Q1 2017

With the QE era diminishing we assume that in 2017 the market will focus on any hints of tapering and see a risk of higher yields at end-2017.

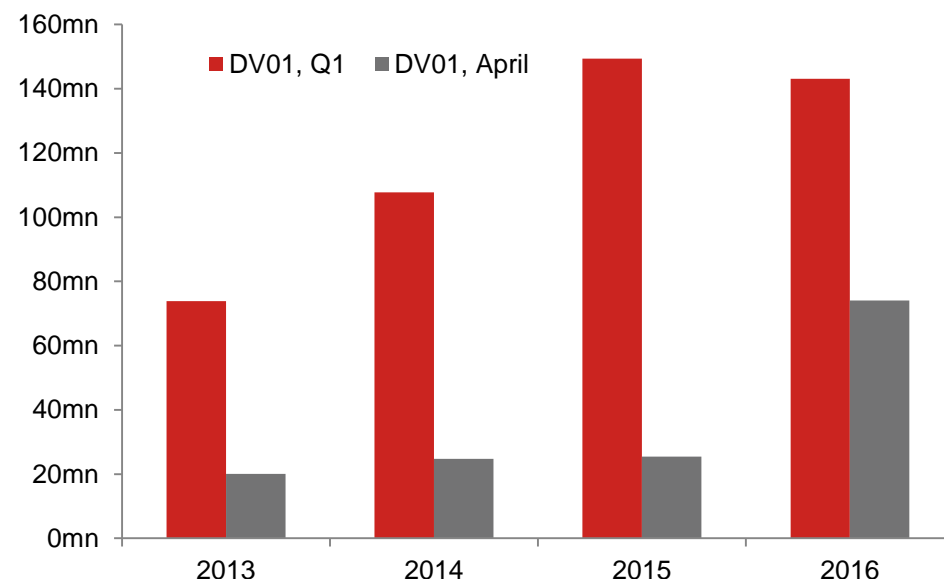
Supply is likely to be skewed more towards Q1.

We think countries restricted by the issuer limit constraints will likely front-load supply to circumvent the issuer limit constraint for as long as possible.

Issued 10yr+ in Q1 and April vs full year



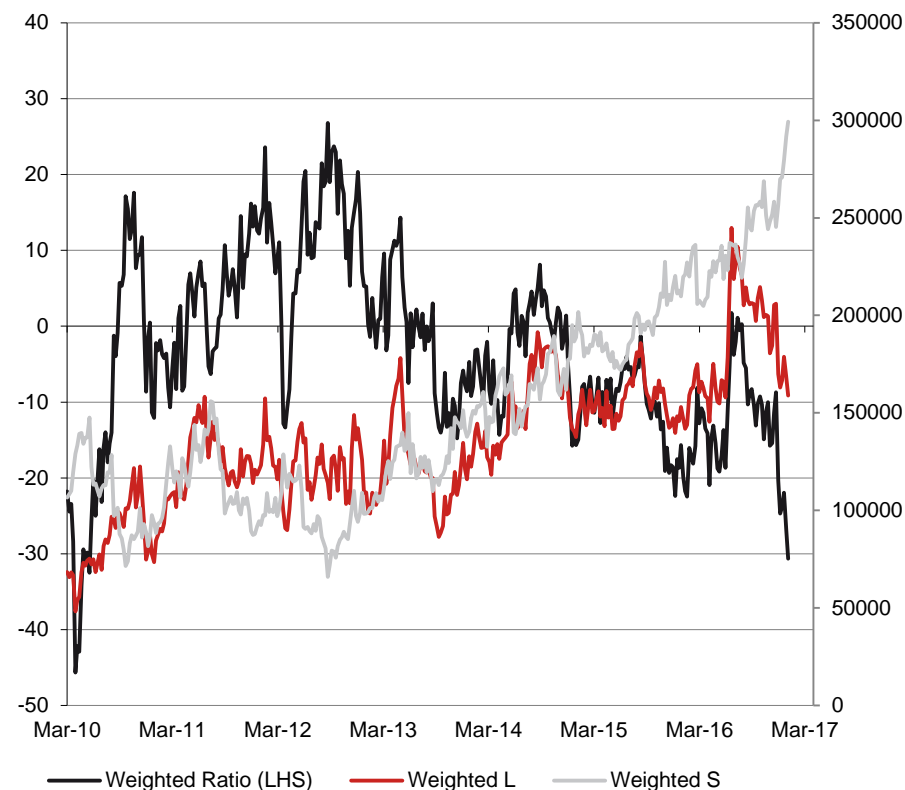
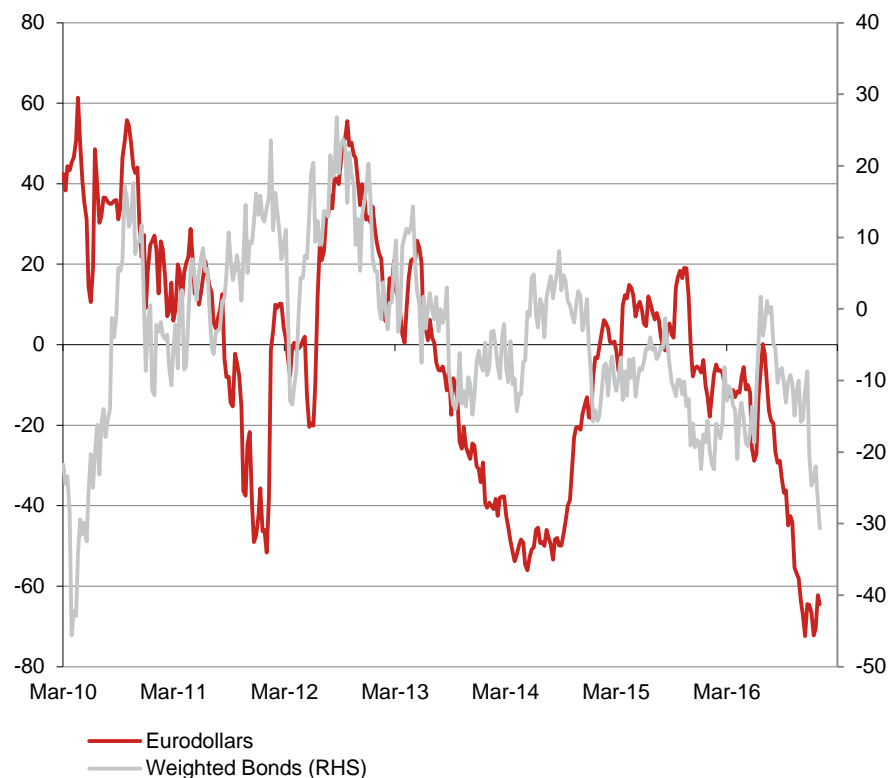
Amount issued 10yr+ in DV01 terms



Treasury futures positioning

The important corollary to this is that positioning seems to be extremely short.

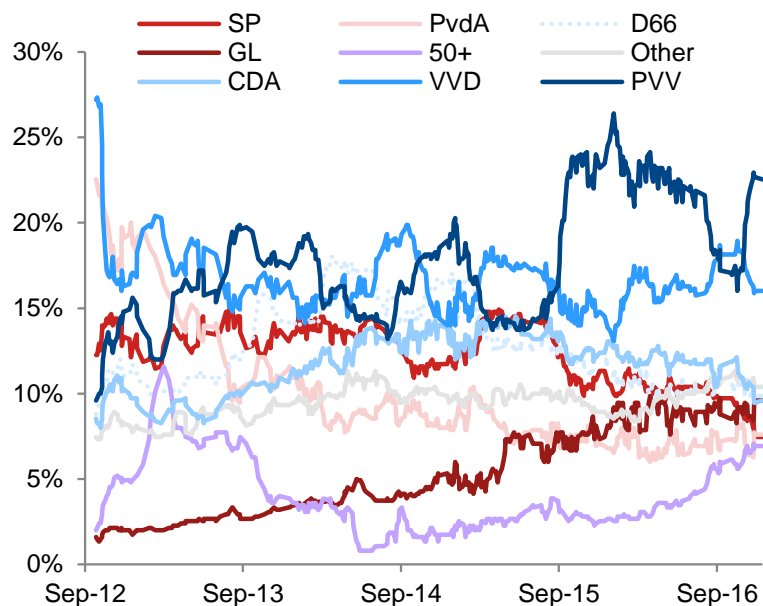
Positioning as a +100 / -100 range (longs minus shorts divided by (longs plus shorts))



Netherlands elections

Eurosceptic party is gaining support in Netherlands – unlikely to enter the coalition but could gain significant power

Netherlands legislative election polls

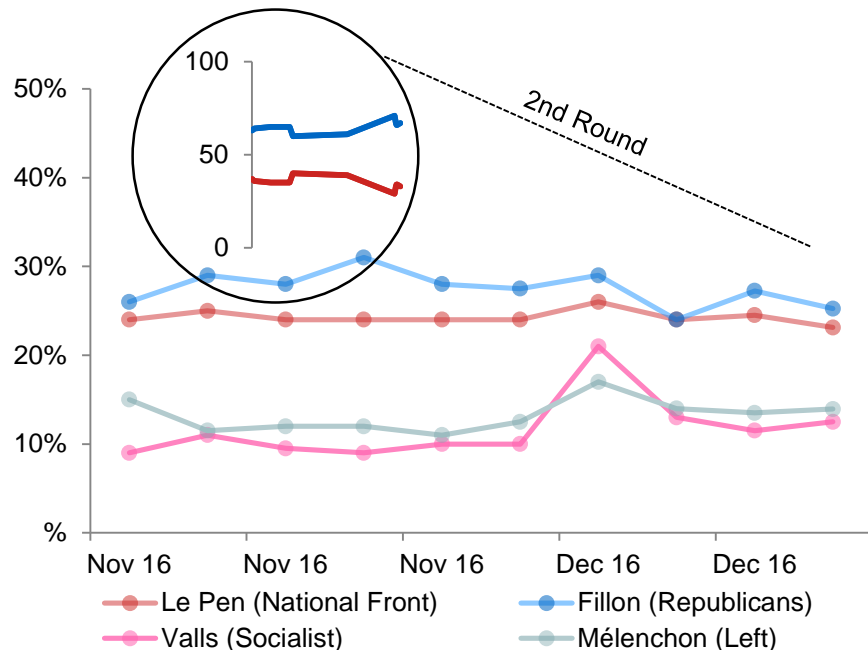


French and German elections

In France, FN candidate Marine Le Pen stands a good chance of reaching the second round. However, the polls suggest that she would then lose to any candidate from either PS or Les Républicains.

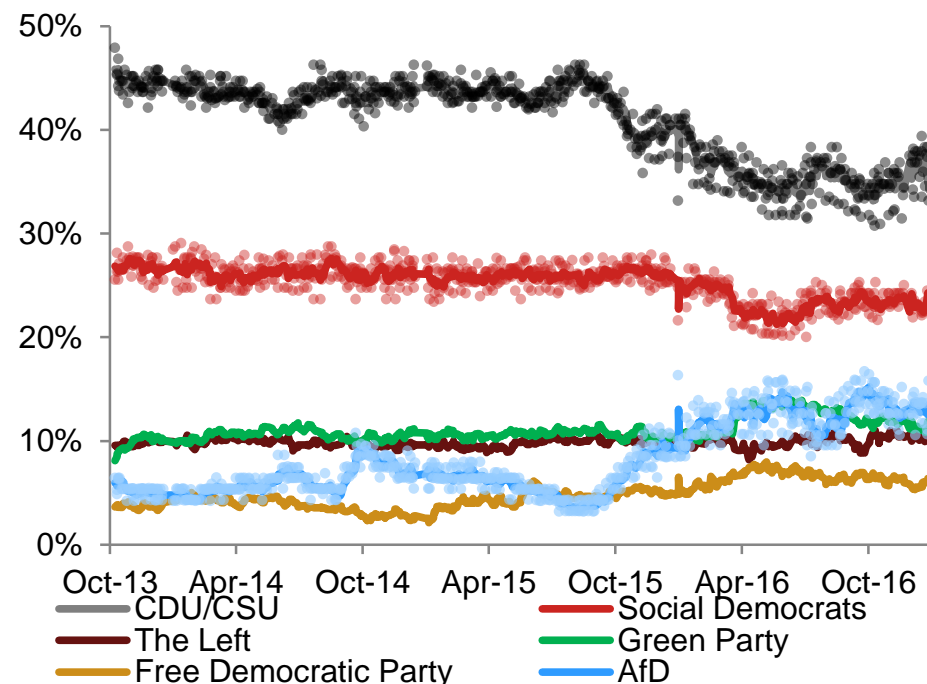
In Germany, the majority in Bundestag is likely to remain split between CDU and SPD, although Eurosceptic AfD is also set to secure seats in the parliament.

French Presidential elections polls



Source: Elabe, Ifop-Fiducial, Cevipof Ipsos-Sopra Steria, BVA, Kantar Sofres – one point, Harris, Odoxa and TNS Sofres.

German Federal election polling

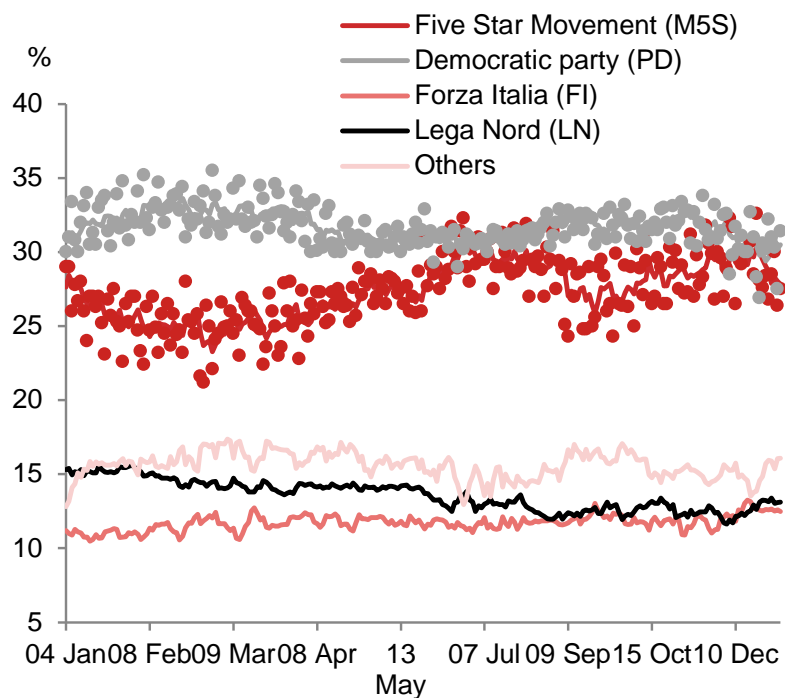


Source: INSA, Emnid, Infratest dimap, GMS, Forsa, Ipsos, Allensbach and Civey.

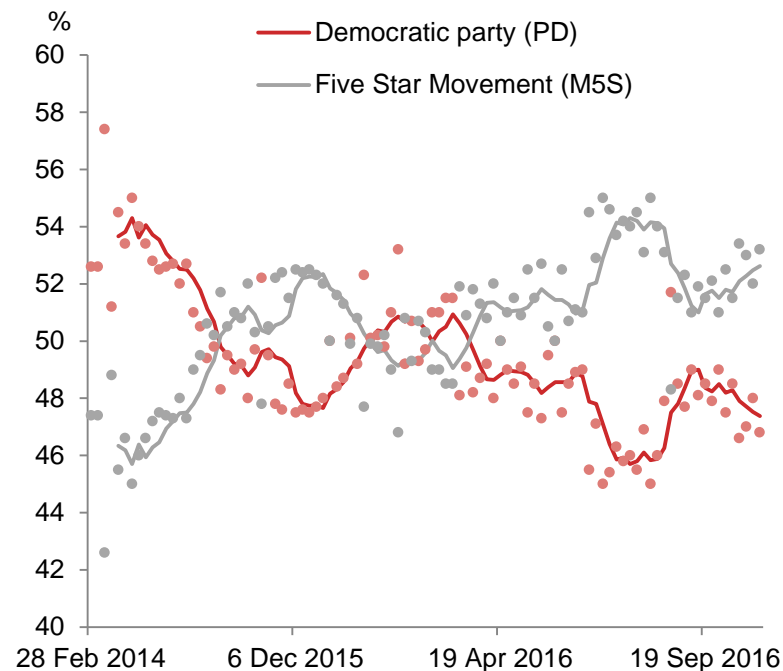
Italy – election polls

Matteo Renzi's Democratic party (PD) is leading in the polls for the first election round. But it falls behind the Five Star Movement (M5S) for the second round.

First round



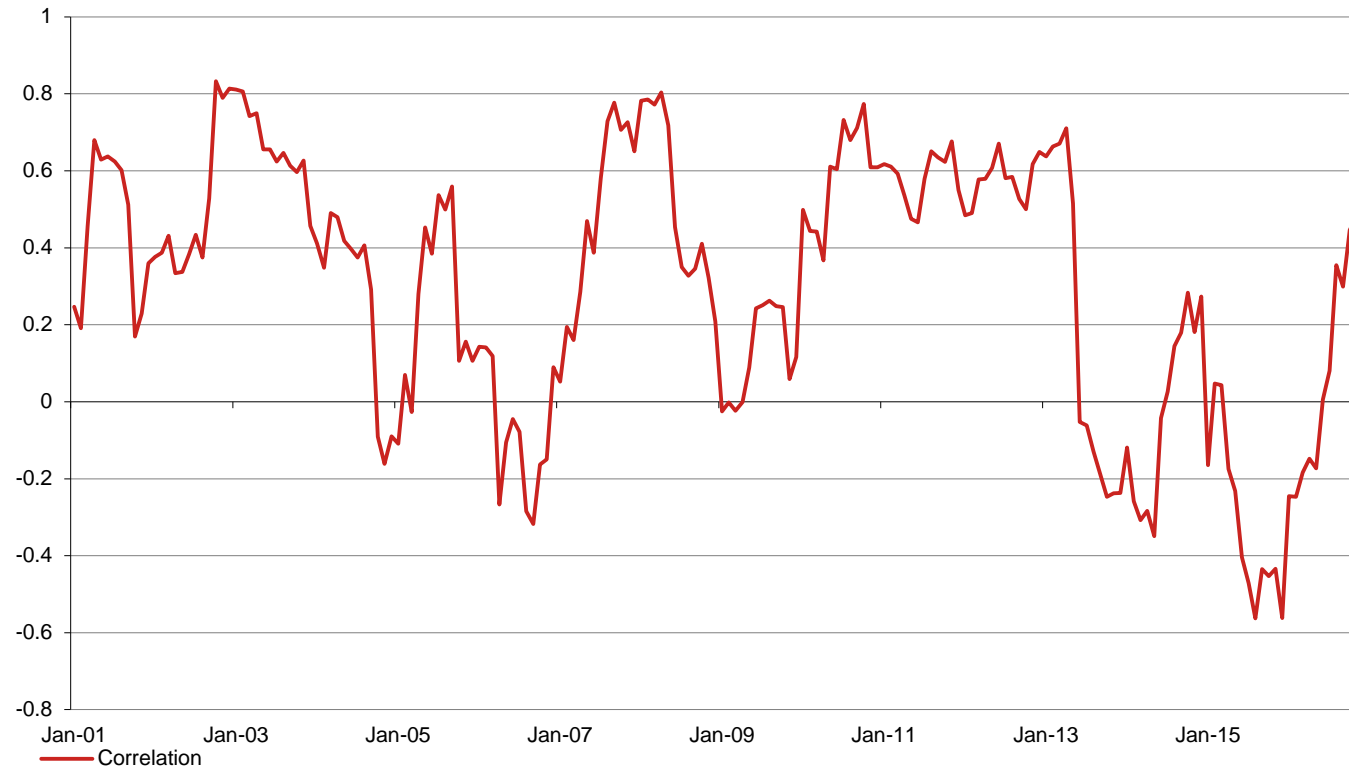
Second round



Cross-asset correlations

Abnormal paradigm: Yields and equities are normally positively correlated. The net result of this was a 'double win' for credit-type instruments which saw performance from both the risk-free and risk-spread side.

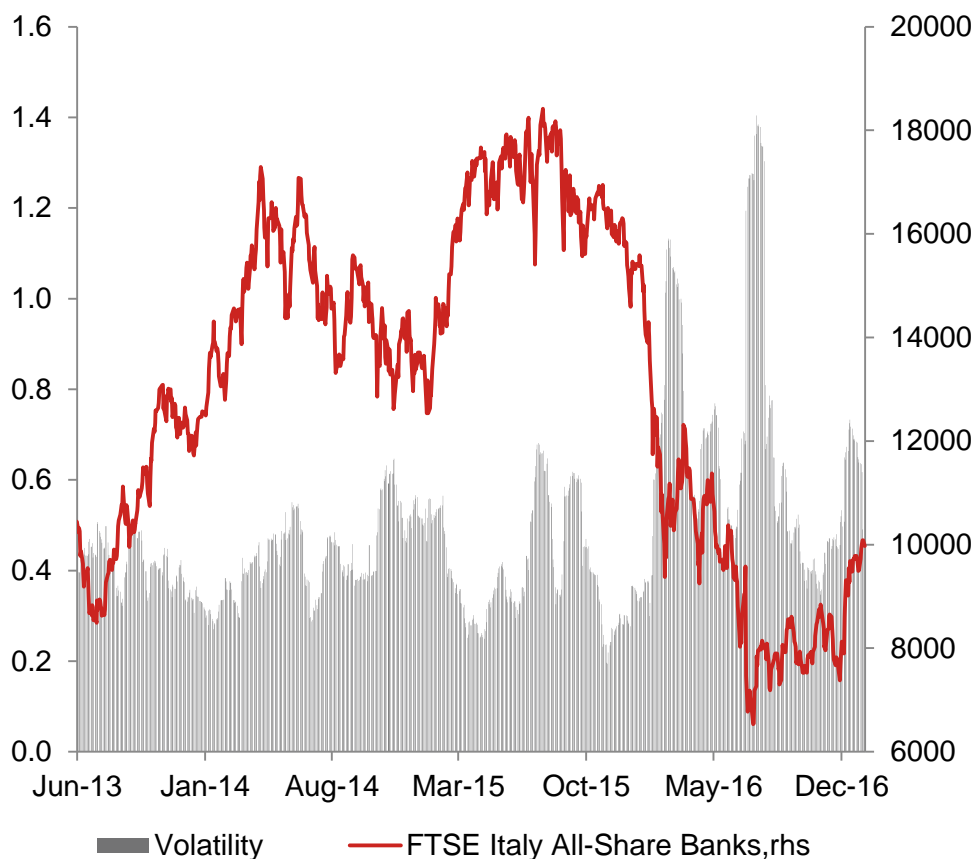
Rolling 12 correlation of 1m changes between 10yr German yields and the E-Stoxx index



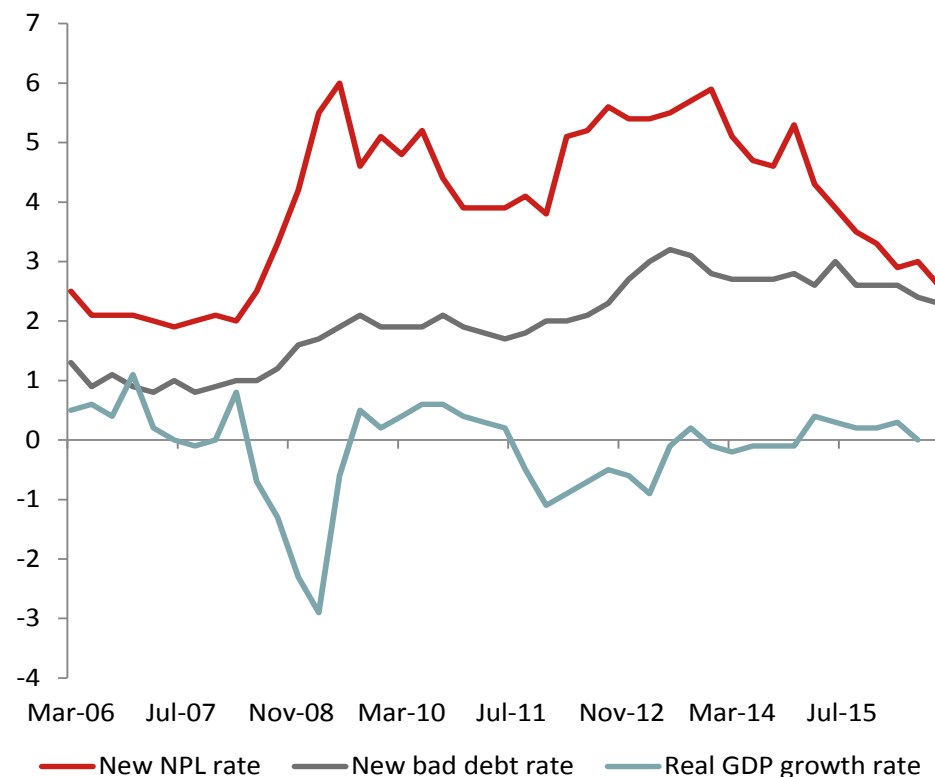
Italian banking system burdened by high NPL levels

The Italian banking system's NPLs account for around 18% of total gross loans

FTSE Italy All-shares Banks have come back, while monthly volatility remains high



In Q3 2016 NPLs as a proportion of total loans fell to 2.6%,



Note: Annualized quarterly flows of adjusted NPLs and adjusted bad debts in relation to the stock of loans at the end of the previous quarter net of adjusted NPLs and adjusted bad debts; data seasonally adjusted where necessary. NPLs consist of bad debt, past-due and other loans
Source: Central Credit register, Banca D'Italia, Nomura.

Italian banking sector

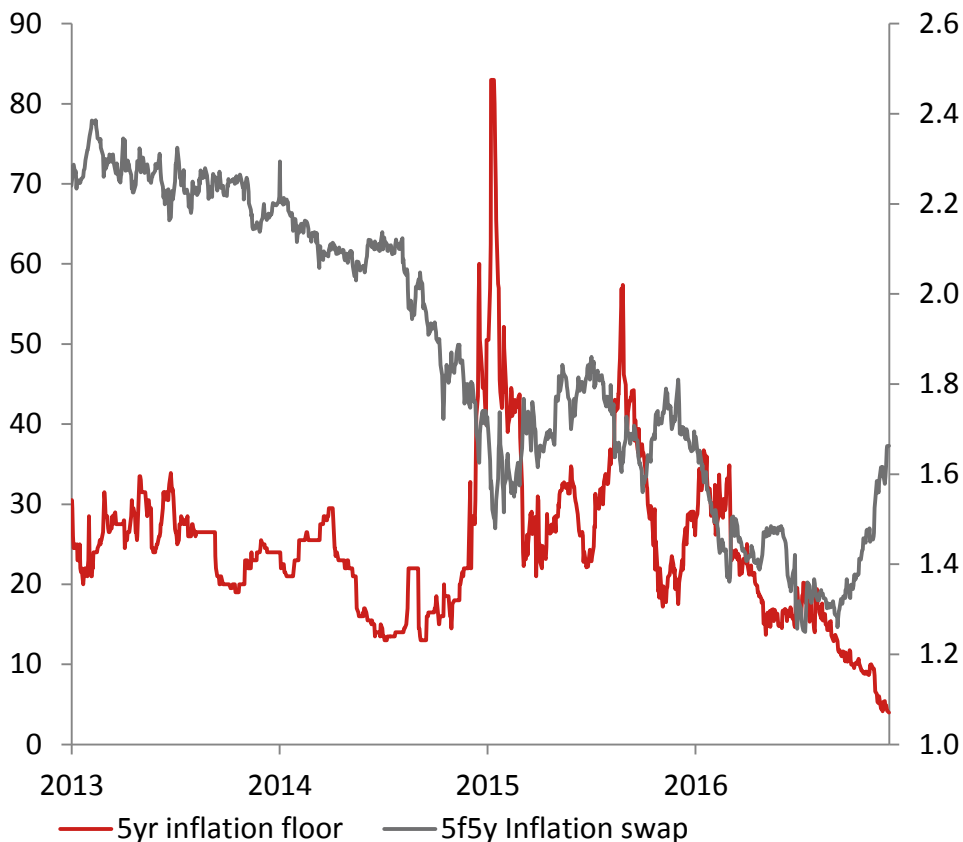
BTPs have normalised since the referendum from a valuation perspective



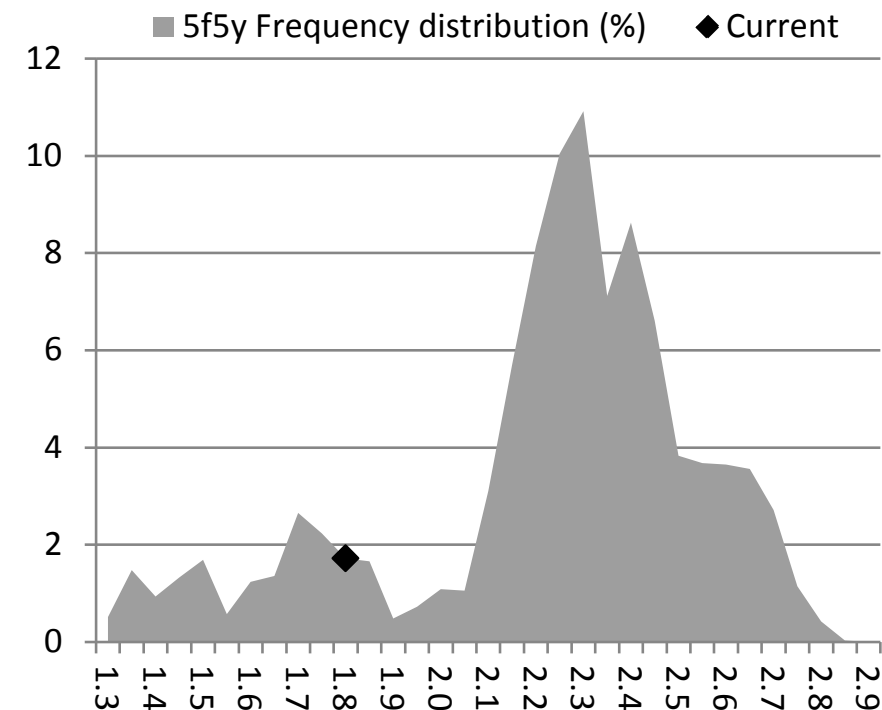
5y5y inflation swap rate yet to return to bulk of the distribution

The cost of inflation floors reflects less concern about deflation, but inflation is still not increasing.

Price of deflation floors (cents, lhs) and 5f5y inflation swap rate (%), rhs)



Inflation expectations remain historically low



Source: Bloomberg and Nomura European Economics.

Trades:**Euro Area:**

- 5s30s ASW curve trade
- 2f5s30s EUR swaps steepener
- Long OLO Jun-38 vs. short OAT Apr-36
- Short BTP Oct-19 vs. long BTP Oct-23
- 10s30s SPGB flattener vs. BTP steepener
- 10s30s SPGB flattener vs. DBR steepener

Other:

- UK: Bias to long the belly (5-7y area) via both front-end flatteners and long-end steepeners.
- US: Looking for a pullback (rally) in rates near-term, Trump optimism to peak in Q2, then a constructive environment through balance of 2017.

Appendix A-1

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