RBS

European Rates Weekly

Deflation Motel. You can check in, but you can't check out

Overview (p2): Business as usual, except with lower yield targets. 1) Our 0.13% on 10y bunds is coupled with a 0.70% 30y bund target and we forecast the ECB will buy out to 30yrs. 2) Updated global central bank liquidity views: the ECB takes up the baton handed to it by the Fed. Bullish global risk (stay equity bulls, esp in USA). We introduce an 'aggressive' ECB scenario, which we think is far more likely than not, of moving the b/s to €4.5trn (not just the prior €3.1trn peak). 3) We have argued since Autumn 2014 in the weekly that EURCZK is good risk/reward to play how we see the ECB unfolding; it is now on the move. 4) Buy 1y1y Poland. 5) 5y5y EMU CPI now -40bp since Mr Draghi's Jackson Hole 'QE is coming' speech, pay. 6) Perhaps the world's most important data (no, not payrolls) is out, saying global dis/deflation

Euro Area Macro Strategy (p9): Bunds are not rich. Moderate further weakening in inflation and activity would justify much lower bund yields still. 0.31% is fair now, and 0.13% is our new target. The curve should keep bull flattening: yield grab, QE, lighter German supply and regulation weigh more than reflation. Oil holding at lower levels and headline CPI already falling clinches QE for Jan. Size matters more than design. But design matters for credibility on size, details of what might be bought, and how QE changes the game if stress returns. Only broad programs at pooled or own-risk are realistic in our view. We think pooled risk moderately more likely. *Trades*: 10y Germany to 0.13%, Credit barbell: 30y Ger/Ita vs Fra on nFTK and QE, and 10s30s flattening.

Greece (p25): We look at Greek electoral system; post-election scenarios for a programme extension and a deal. We see a 30% chance of two rounds of elections. A coalition SYRIZA government is most likely. We see plenty of scope for compromise, not Grexit. The mandate for EMU exit will be weak and there is scope for moderation: (a) as part of coalition negotiations, (b) as a U-turn or (c) a compromise as part of the deal on a credit line. We expect the compromise solution, but political risks remain high.

UK (p38): UK data has softened, but the ECB is behind the aggressive rally in Gilts. Gilt outperformance can continue with yield grab. We see value in the 5y and hold 5s30s GBP steepeners boxed vs. USD. But even with 10y Bunds at 0.13%, fair-value for 10y Gilts is above 2%. BoE buybacks take in w/c 26th Jan, but supply is sizeable.

Scandinavia (p43): The Riksbank will use non-standard measures to combat declining inflation expectations, but when? They may cut the policy rate and/or initiate QE in Feb.

Volatility (p47): Political uncertainty and QE anticipation has delayed the move in implied volatility. But QE is coming, yields are being crushed and implied volatility should soon follow.

Technical Outlook (p58): Bunds may correct to 155.54/10 offering buying opportunities for 158.52 and above. Treasuries reverse trend if sustained below 128-00, confirming the Evening Star pattern. Gilts may see trend reversal amid yield candlestick signals; 5-day MA (120.60) break may be a trigger. 10s30s Germany tactical steepening to 80-83bp followed by further flattening towards 64bp. Oil (Brent) is heading to our $42 target. Lower targets are possible.

Trade Recommendation Performance (p62)

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Overview: a €3trn balance sheet? More like €5trn. Long everything (not comms/Asia).

Andrew Roberts

Overview: Business as usual, except with lower yield targets. The new 0.13% on bunds is met with a new 30y bund target of 0.70% and a new forecast by us that the ECB will be out to 30yr, not up to 10yrs. We update our global central bank liquidity chart, and it shows the ECB clearly just takes up the baton that was handed to them by the Fed. Stay bullish risk assets. We introduce an 'aggressive' ECB scenario, which we think is far more likely than not, of moving the balance sheet to €4.5trn (not just the prior €3.1trn peak). As we have argued since Autumn 2014 in this weekly, EURCZK is a superb risk/reward to play how we see the ECB playing out; it is now on the move, met our target, more CZK weakness to come (and a new CB policy target). 5y5y EMU CPI now 40bp under the level that caused Mr Draghi's Jackson Hole 'QE is coming' (my interpretation) speech. Keep paying. Perhaps the world's most important data point (hint: no, it's not payrolls) was out this week, and points to accelerated global disinflation.

A few pointers as an update to our Year Ahead 160 page document, which we are still marketing around the customer base. We think most of it is still valid, even if we have already just about met a number of our targets, such as 0.42% on 10y bunds. We have as a result updated our fair value model and this now gives us a fair value, and a new 10y target, of 0.13% later in this weekly, by Giles Gale, Michael Michaelides, and Marco Brancolini.

We should say at this point that this is not a trough. It is very easy when looking at different scenarios for the data over the coming three months to make a case for negative 10y bund yields. Indeed, I was arguing the case for doing exactly that, but sensibly my colleagues argued there is no need to be overly aggressive when we are already the most bullish bond house. But it is worth noting that just because most are not thinking about certain events, such as **negative 10y yields**, they are entirely plausible. This is especially so when you add on the ECB chatter across newswires about their numerous options, one of which is to take AAA yields down to zero.

We delve into the numerous outcomes for the ECB later in this weekly, please do have a read.

Without repeating the high quality worth of what they write, delving through all the numbers, as far as I am concerned, your key takeaways are much the same as they have always been:

- Large scale QE (small scale QE is already here, with the covered bond buying programme the ECB has in place) is coming imminently, on 22 January.
- Waiting until March – something we have been asked MANY times – is just not feasible, especially with CPI now negative (-0.2%yoy) and set to plunge further in the next two months (-0.3%yoy next month, and then -0.4%yoy the month after that).
- They will buy sovereigns, yes. All investment grade sovereigns are likely to be bought.
- Whether they buy Greece (not investment grade) is a good, up for grabs, question. We suspect they will not do so, but use it as a carrot for negotiation which will take place between the Troika and the new Greek government (which may be angling for a write down of its debt) post the 25 Jan general election. This is especially so if the anti-austerity party Syrizia prevails

(currently 3% ahead in the polls). That situation remains highly fluid, with a 4-way tie for the lead.

National CB buying vs pooling

- The big, other, open question is whether this is **centrally pooled, or controlled by national central banks**. I have been openly discussing this within our team for over a month, and it was Mr Coeure who first brought it up with his vertical & horizontal differentiation all the way back in April 2014. We are still discussing this in our notes, see **Marco Brancolini's** cross asset collaboration with our economist Richard Barwell in this past week for instance. For my money this is a perfectly possible, feasible, way to get every country in the ECB on board.

- In fact, going down the national route may be even more bullish for FI. Why? Because it makes it more likely we have a 'throw the kitchen sink at this problem' outcome, rather than a 'some countries are still dragging their heels at doing these actions' outcome. This is very important for the next €500bn round of QE after this one, once it has been seen to not have worked very well, or as much as hoped (by others), in a few months time, probably late summer.

- So, following this 'national central bank buying' route has no real implications for bund or BTP yields. First off, the capital key is still respected, it is just the idea that the Banca d'Italia does the buying of BTPs. If the teutonic media wants to think comforting thoughts that they have got away with not having to pollute their central bank balance sheets with BTPs, then fair enough, but the fact is if there were issues, the BoI would be reliquified via the Eurosystem's Target 2 mechanism. And so we would just be back to the troublesome old days of when a Target 2 chart was a mainstay of my presentation, showing explicitly the cross asset liabilities of the core during the periphery sell-off during 2011.

- There is one tail risk here, namely that part of throwing the kitchen sink at a problem, is to open up all possibilities. It is very important in my view that we do not get bogged down with trying to be certain of what they will buy or not. For you to make money in the past month, the key has been to be hardline on seeing Jan QE, as we have been, versus whether you were more cautious about whether and when the ECB would act (ie, it was NOT about which exact assets they purchase, it is whether those purchases come at all or not). The hardening of those 'soft on QE' opinions is why 10y BTPs have moved a lovely -20bp in the past one month.

Do not be surprised, or bearish, about non sovereign FI being in some CBs baskets

- Next step? The ECB has been fairly easy to call for some time, very transparent, and is doing exactly that now, leading the market well in telling it what is coming. We think you should be open to them buying a lot of different assets. Will Germany be allowed to buy KfW, agencies, regional/municipal debt? Probably, yes. (Some think KfW is a bank, and we in rates strategy have been firm that banks are off the table because they are regulated by the entity that would buy them and might force haircuts in the future, but this is NOT the case for KfW which has an explicit govt guarantee and should not be treated the same as other banks surely). If an excuse can be made to buy their debt instead of bunds or BTPs, we suspect it will be welcomed with open arms. Anyway, the view we have always held is that is a bit far fetched to expect Germany to fulfil its obligations across the capital key without touching bunds, the outstandings in other assets are just too low. 10y bund fair value is 0.13% even without the exogenous shock of QE. Bonds remain very cheap.

Buying out to 30yrs, not just out to 10yrs

- Last point on the curve. We have previously been pushing 2-10yrs as the sweetspot of buying (ie, be long 10y bunds), but are **now coming to the conclusion that the ECB probably cannot avoid buying along the curve,**

out to 30yrs. See Marco's piece on how that leaves us on 30y bunds (very bullish). New 10s30s target: 57bp, which fits us into a 0.70% 30y outright target. 30y bunds remain cheap.

Who on earth is the ECB going to buy all its bonds from?

CBs lengthening portfolios likely a theme for 2015. Such debt does not go back to the ECB

- We are increasingly asking ourselves who on earth the ECB is going to be buying from, when the past month has seen a wave of European real money buying of European fixed-income duration. This is NOT money which will easily be sold back to the ECB, some is for ALM purposes etc. Moreover, central banks buy debt as part of FX reserve management, but the key here is not to lose money. With 5y bunds 0.01%, we strongly expect CBs globally to lengthen duration of portfolios as they chase positive yields. Again, they are NOT buying for duration purposes, but to keep a positive yield and not shrink reserves. This money, again, will not find its way back to the ECB, because it is held for FX reserves purposes.

Our Global central bank balance sheet forecasts updated

We have now updated our key chart, my personal no.1 chart that I made two years ago and we have been pushing for a very long time. As far as I am concerned, this is the absolute be all and end all, money flood is the key point as my disinflation/deflation theme hardens (which it will in 2015) and CBs are stuck at the zero bound.

(Yes, not all are, and we certainly do like FI in those countries with room for cuts, such as 10y AUD, a market we have loved for a very long time, and still one of the cheapest FI instruments in the world, as it has been for a very long time. We also love, for instance, the front end of Poland, a country that is in dire straight and with a market that does not seem to grasp yet that rates will be 0% very shortly; the authorities are finally getting dovish, and **Poland 1y1y is -37bp** past one month, stay very long, see work by **Marsa Bobanovic**, such as her MPC preview coming on Monday).

What have we done to the chart?

1. We have adjusted it for the end October QQE update from the BoJ.
2. We have NOT YET adjusted it for expected ramping up of QQE (again) in 2015. Perhaps we should? For now, we have not.

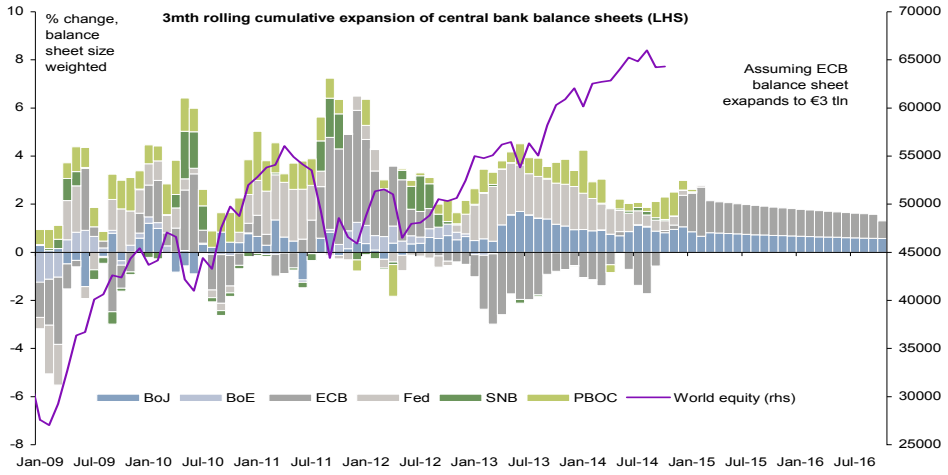
'It is not simply an expectation; it is an intention, but it's not yet a target'.

Mr Draghi

(Source: ECB press conference, Dec 2014)

3. We have changed the ECB balance sheet methodology. Rather than working through the six flow LTROs, the paybacks of LTROs, versus QE injections, over the coming two years, we have taken a linear extrapolation from current ECB balance sheet (€2.2trn), to the maximum balance sheet that the ECB previously reached (€3.1trn), over the next two years. You may notice this obviously assumes QE closer to €1trn, more so than the €500bn QE coming in a few weeks. However, we will call this the conservative (or 'base') assumption, and it is entirely appropriate given the ECB's acceptance of moving back to the old balance sheet level is an '**intention'** (see quote opposite).

Global liquidity, about to flood again. Do not be short risk/equities/credit/BTPs



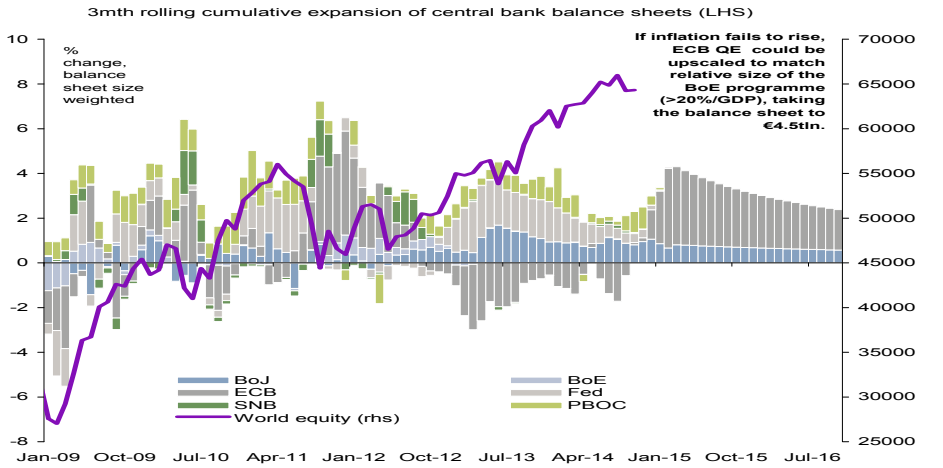
Source: RBS; Bloomberg

We would be amiss not to properly run through our more aggressive (though far more likely in my opinion) profile.

This is for QE in EMU to amount to a similar level that it does in the UK (23% of nominal GDP). That would be €2.3trn of ECB QE. So instead of the €900bn QE to get to the old balance sheet peak (that we show above), there will be another €1.4trn on top of that, taking the balance sheet to €4.5trn.

Here is how a more aggressive (more likely in our view) ECB campaign looks:

'Aggressive' scenario for ECB, takes global liquidity flood to the highs of mid13, even more bullish global risk assets.



Source: RBS

This seems fair enough, and is the sort of level (€4-5trn) that we have been thinking about in terms of just how high the balance sheet goes. Let us not forget that private sector credit growth is running negative (-1.6%yoy, for EMU loans to non-financial corporates), and needs far looser policy.

We need to stay one step ahead in this debate, and we suspect the way to be doing so now is to be thinking 'what happens when the €500bn is seen to be not enough'.

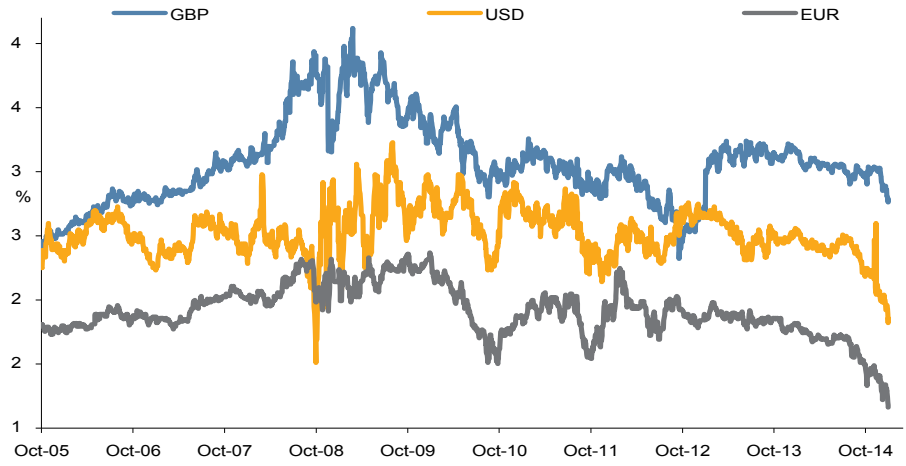
EURCZK been a lovely trade. More coming. Still no.1 risk/reward to play the ECB, as we have argued since Autumn 2014

EURCZK – our absolute no.1 risk/reward European investor play for what we thought was coming from the ECB – has now met target today. This is an asset on the move, 'in play', WATCH THIS asset.

For more, see Marsa Bobanovic & Gabor Ambrus, 'Our long standing anticipation of a move in the EURCZK cap now looks increasingly likely').

There are lots of ways to play our themes. We are, for instance, **short 5y5y EMU CPI**. I have had in my presentation since Spring 2014 **'stay short 5y5y EMU CPI until large scale QE**'. Today this is now at a lovely 1.54%, a hefty 40bp below the level which prompted Mr Draghi's QE announcement at Jackson Hole in the summer (for me, this was THE watershed moment at the ECB, and since then they have been adopting and publishing and acting in a dramatically more dovish manner than before). **I still suspect it a short post January QE, because QE size will be too small.**

5y5y inflation. EMU and US rightly sinking. Keep selling. UK sticky but still too high.



Source: RBS

One play we have been shouting about is within Eastern Europe. We have some great output from Tatiana Orlova, Gabor Ambrus, Marsa Bobanovic, and Anna Tokar, on this – you may remember our RUB77 ruble 'what if' target in the year ahead when it was RUB53 spot (now RUB61.6).

Eastern Europe is 'in play' in 2015

I think Eastern Europe is one of the big, interesting, plays for 2015. Faced with deflation across the board, and zero rates (ex Poland), and weakening export markets - either shut/embargoed/weakening, on the east (Russia) and west (EMU) – and now faced with a much weaker Euro FX which is coming shortly (yes it is, eg think USD1.10 area), and so a forced revaluation of their own FX (which will be rising against their main trading partner) such countries need one thing, desperately: weaker FX.

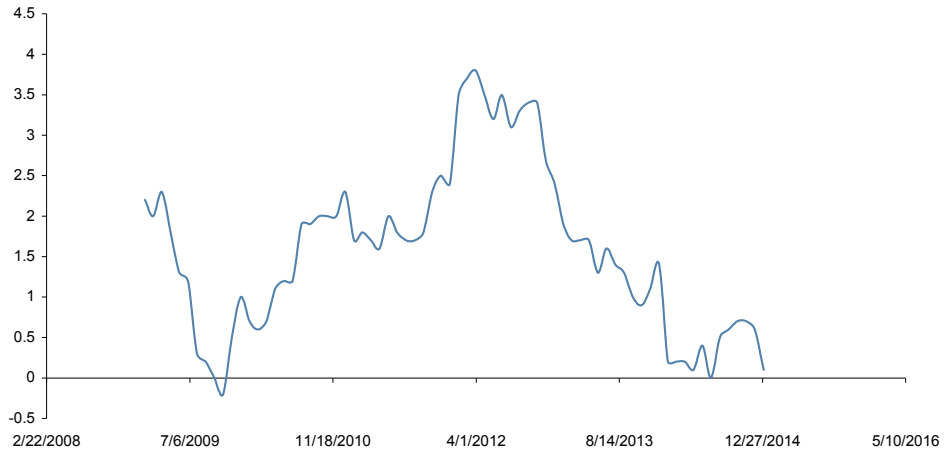
Czech FX is a great example.

I wrote this up for our more developed market UST/bund/Gilt/SEK investor base in Autumn 2014 (29 August, European Rates Weekly, overview called 'Global Liquidity Flood' and where we introduced my new theme of 'no hikes 'til real wage rises', particularly pertinent given the very subdued, but perfectly normal, weak wage in the US data today).

My main reasoning was that I think it is easy for us to focus on bunds and BTPs and miss the myriad of opportunity within Eastern Europe EM.

Playing for a new CZK band is a superb risk/reward, because if we were wrong on the ECB, FX likely stayed where it was, but if we are ok with the call on QE, which seems to be fair comment, then CZK will be on the move. In our view, CZK is great play for this given a central bank (and with governor Mr Singer) who have form for doing so already ie, they are willing to be innovative to problems facing them, and nothing has changed this time, except inflation is weaker.

Czech CPI sinking sharply, as we expected given Russia/EMU.



Source: RBS

Today has seen Czech CPI come in sub consensus (0.1%yoy versus 0.2%yoy expected), and the currency start to motor as our views get hard wired into prices. Marsa has met her short CZK target of CZK28.05, and is now moving this to CZK28.50, with more to come. **Stay long EURCZK** (current level 28.16, target 28.5, stop 27.83).

China is accelerating its exportation of global deflation. Buy everything

What is the most important data point in the world? It most certainly is NOT and has NOT BEEN FOR A LONG TIME payrolls in the US.

I made this point vociferously in the year ahead, and at our year ahead conference in December. It is global output gaps which are statistically significant drivers of inflation rates now. Domestic output gaps do not drive inflation.

Good, as we may have thought.

But we have clear evidence (see year ahead) that, say, US inflation will be driven by what is happening globally, not by, say, US payrolls, or US unemployment levels.

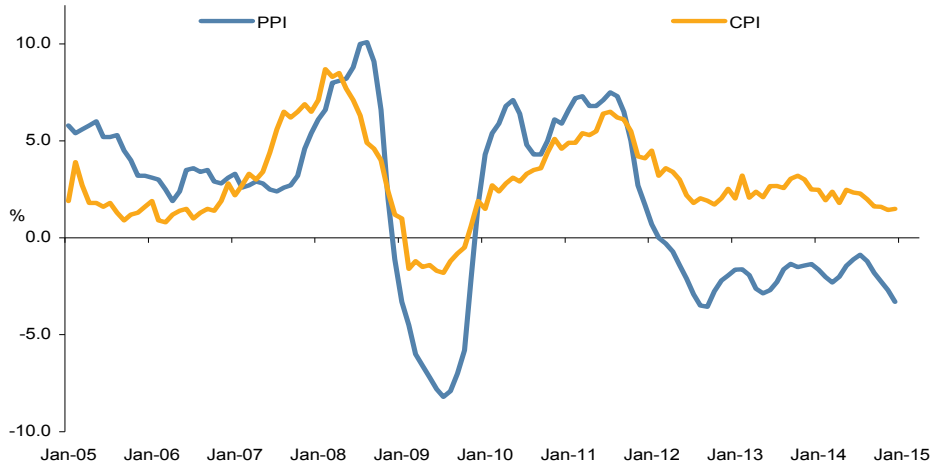
As such, I take little notice of payrolls. **Wages** are, and what did they do? revised down fro 0.4%mom to 0.2%mom for November, and then December's data was -0.2%mom. Hardly the stuff to feed the myriad of bond bears with, and lovely reasoning for why US 10s should be sub 2% and have ample scope to fall a lot further from here. I just cannot understand the argument that FI is rich, anywhere.

Sure, if we are wrong, we will be wrong about the US more so than EMU, and yes, we do like US into EMU trades, but the point is that in absolute yield we like all products.

Why?

Here is what I will call the world's no.1 data point, if nothing else, but to get it raised up the flagpole as a reason for you to be bullish FI.

Chinese PPI deflation is accelerating. Take note. Very global bond bullish, bearish for global goods prices, watch for more global deflation shocks in coming months



Source: RBS; Bloomberg

Thank you.

Giles Gale

Michael Michaelides

Marco Brancolini

Euro Area Macro Strategy

January QE…

We expect ECB QE to be announced on January 22. We would expect implementation to follow swiftly. The council's urgency is clear. ECB members no longer dismiss talk of deflation out of hand, and the risk of second round effects are now driving the agenda. December's negative headline HICP print should settle the matter. Government QE is now consensus, however. Variation is now on size and design. Size dominates design in importance, in our opinion. But we think that size is unlikely to be different to what has been suggested strongly by the balance sheet talk to date. Design will be important in delivering credibility on size. Risk sharing is important, but not the be all and end all. We expect a pooled-risk program for governments, but it is a close call.

Peter Praet points us to action in January

And basically, what we said is in January, so very early, early next year, so we mean January, we are going to make the assessment of the situation also in the oil price…

So the monetary policy meeting in January, I draw your attention to that is the 22nd of January. We will have a meeting before where we will update in a more informal way the assessment of the economic situation, but the monetary policy meeting will be the 22nd of January. So, there's a little bit time of to make our homework on this. **[Dec 9, 2014]**

Source: Peterson institute

Second round effects matter…

Here is where the assessment in the Governing Council diverges: some might say we should "look through" it again, as we always did in the past. Others might say – and I personally lean towards that argument – that in an environment in which headline inflation might become negative and in which inflation expectations are extremely fragile ***we cannot simply "look through"****.*[Peter Praet, 31 Dec]

Overall, in addition to the fairly significant and immediately visible direct downward effects of the recent oil price declines on the energy component of the HICP, ***it is reasonable to also expect downward impacts on other HICP components via indirect effects.*** [ECB Monthly Bulletin, Dec-14]

Source: Boersen Zeitung, ECB

January QE: Size before design

We expect ECB QE to be announced on January 22. We would expect implementation to follow swiftly. The council's urgency is clear. ECB members no longer dismiss talk of deflation out of hand, and the risk of second round effects are now driving the agenda. December's negative headline print should settle the matter.

Readers looking for a detailed discussion can refer to our European Rates Year Ahead 2015. Richard Barwell's ECB QE: timing and tactics (Dec 12) provides significant further colour.

Government QE is consensus. Variation is now on size and design. Most commentators now seem to agree that the ECB will extend its purchase programs to government bonds this month. This comes as no surprise to us. QE in Q1 2015 was our expectation for much of last year. Our anticipation heightened following Jackson Hole, when we thought that December's staff forecasts might provide the cover. Governing council politics led us to cool on December late on. But the timing makes little difference: trading is dictated by the direction of travel, and this has been unambiguous for most of the year, in our view.

1. Size

Credibility on size dominates all other matters of QE design, in our opinion. We don't think there is much room on intended size, at least to start with. The council appears to have come to Draghi's position on the balance sheet ambition. The question that remains is how to deliver. Design is not only important because of what it means for composition and risk sharing, itt is also vital for markets – and the eventual economic impact – that the ECB offers a convincing strategy on this point.

No targets for individual programs. We do not expect the ECB to follow other central banks in specifying a target for purchases. The ECB strategy has been to talk about overall balance sheet size. The other moving parts in the balance sheet and the likely breadth of purchases would make it difficult to be more prescriptive. The flexibility of an aggregate target is probably also valued. Both the current ABS and covered bond purchases are currently open ended subject to the balance sheet target and liquidity available. We expect sovereign QE to be expressed as a development of this overall balance sheet strategy.

€800bn to fill → ~€700bn 'sovereign' QE. That said, we can estimate how much work each program is likely to have to do. The balance sheet maths are relatively straightforward. The ABS and CB programs will roughly offset roll-off from other programs, and the TLTROs might add around €100bn. **This leaves around €800bn for 'QE', most of which we expect to be conducted in government bonds.**

Over around 2 years → ~€30bn per month. We do not expect the ECB to be more prescriptive regarding the pace of purchases. But of course credibility demands that it be seen to be accumulating assets at a pace which is in-line with its guidance on the balance sheet. The introductory statements state that the current purchase programs 'will last for at least two years' and the final TLTRO will settle in June 2016. €800bn over two years implies approximately €35bn/month of purchases. Of these, we expect that government bond purchases will total around €25bn-€30bn.

This is modest compared to QE programs in the US, UK or Japan. But we expect that it will still be supportive for European government paper, particularly where net supply is already light. We capture this directly in our bund and BTP models. (We updated our bund target this week, see below, to 0.13% and we expect 10y Italy to trade toward 1%. (see our European Rates Year Ahead 2015.)

2. Design: how much does the ECB need a compromise and how much does it matter?

We think that QE has the votes in the Governing Council. We count Weidmann, Lautenschlaeger, Mersch, Knot, Hansson and Vasiliauskas as likely opponents. The need for compromise on a first-choice program of pooled-risk purchases is therefore not overwhelming.

But compromise has its benefits. A deal that can be sold to all may be viewed as more credible by the markets, particularly with regard to size. If the initial program needs to be upsized, the market may prefer consensus. (We disagree – if data continues to worsen, we expect that any chosen design would be increased unless the design is inherently self-limiting.)

For us the only serious options are programs at shared-risk or own-risk designs. We are dismissive of AAA-only and the more complicated options for controlling moral hazard, including provisioning and protection-buying.

Size dominates design. To the first order, we do not think that it matters very much whether the expanded purchase program is at shared or own-risk. Flows will prove the main driver.

But there are enough second order considerations that the choice is relevant.

We expect pooled risk purchases by the ECB. We can only imagine own-risk QE if accepted unanimously, which may prove a high hurdle. We also question whether own-risk QE can really mean own-risk anyway. We are also concerned that to the extent own-risk does mean own-risk, it challenges the idea that insisting on ECB seniority in QE may prove counterproductive. But the call is a close one for both of us. Richard Barwell, pragmatically emphasising the power of the possible, pronounced this week narrowly in favour of the own-risk model (The compromises around risk managing QE). But both we and Richard view the arguments as closely balanced.

On the second question let me say let's first design the QE and then we'll be able to answer all these questions. Let me also add that we don't want to cause unintended monetary policy tightening in choosing forms of seniority which would be counter-productive. You all see this point, I believe.

Mario Draghi, December 4, 2014

1. Shared-risk

Risk shared now = risk shared if things go wrong. Pooling risk may help reduce the risk that ECB holdings increase fragility if things go wrong by subordinating holders of free-floating debt. Further still, the market might view the program as a stepping stone to debt mutualisation. This is also our view. Therefore in a good outcome, the advantages of debt mutualisation are not required, but if QE doesn't work, QE should still serve as a cohesive force. The implications for reductions in financial fragmentation would be profound.

At the same time inherently any monetary policy must involve some mutualization of risk, otherwise it's completely ineffective.

Peter Praet, December 9, 2014

In the December press conference, Draghi emphasised that the ECB understands the need to avoid the problems of subordination that insisting on seniority for its holdings would cause. (See sidebar quote.) Mr Praet has repeatedly emphasised that monetary policy involves some pooling of risk and some transfers in all cases.

Still positive for bunds. Note that we do not see this distant shift to debt mutualisation as negative for bunds. As discussed in the previous section, we expect the contraction in the free-floating bund stock to bear down on bund yields.

What would shared-risk government QE look like? Our vision is relatively simple:

- Separate corporate bond and government/public bond purchase programs would be announced.
- Size would be announced only in relation to the balance-sheet target. The four schemes (ABS, CB, Corporate and Government) would simply be proposed as required to serve the balance sheet ambition.
- Purchases under each program would be reported separately in the weekly liquidity statements.
- An intention to buy governments according to the capital key would be asserted, but details of actual holdings of each sovereign may not be disclosed.
- In line with reports in Bloomberg today regarding QE alternatives presented to the Governing Council, and Ardo Hansson's comments, we believe that government Agencies could be included, probably in the government program. We also expect that European supranationals, and especially EIB would be targeted.

2. Own-risk. Seniority by stealth.

Our vision for own-risk QE is a good deal more complex than in shared risk. We see the [check text] main advantages as presentability, and possibly flexibility.

Own risk just for governments or also for corporates? We expect that own-risk is much more likely to be used for a government/public bond program than a corporate bond buying program, which could be run by the ECB at its risk in a similar fashion to the CB and ABS programs.

Interference with OMT. Although this may seem a strong argument in favour of own-risk government purchases, we would not put too much weight on this. Pooled risk QE is also compatible with OMT. If a country avoids problems that might push it toward OMT because QE and reflation is sufficient to protect it, that should be considered legitimate since the purchases were monetary policy. A country facing genuine questions about fiscal sustainability would likely find it needs far more support than QE will provide.

This is just seniority by another name… In the December press conference, Draghi made what he believed to be the consensus view on seniority clear (see sidebar quote on previous page.) Clearly if, on default, a country has to make whole its central bank,

QE purchases are effectively senior. We think this is a serious concern for the own-risk model.

…sort of. There are two ways that own-risk QE is not quite seniority by the back door. First, NCBs generally have some buffer of capital and revaluation reserves that could be used to keep the show on the road. Capital and reserves are pretty irregular across countries however. The Bank of Italy holds €108bn in capital and reserves and revaluation accounts, while the Bank of Spain holds only €14bn. Second, we don't think that a central bank must have positive equity, at least in theory. The NCB could be recapitalised, for example by capital not paid up. (We are not clear on the point of law, but assume that this would be considered an 'overdraft', violating the prohibition on monetary financing.)

Does own risk really mean own risk? Only up to a point. A seller of bonds to the Bundesbank, say, is paid by a new a claim on the Bundesbank (a deposit). If the bonds default, the Buba will not have the funds to make good on its deposits. But in practice it is highly likely that deposit holders will anticipate events that might lead to a sovereign restructuring and possibly EMU exit, and send their deposits abroad. In this case the Buba's liabilities to depositors become Target-2 liabilities to the Eurosystem. If Germany were to wish to default (unlikely as that may seem) on its debt, including that held by the Buba, it could potentially do so without hurting its depositors as long as it also defaulted on its Target-2 liabilities. This is probably impossible without leaving EMU. But making EMU exit more relatively attractive compared to default looks to us to be a serious possible unintended consequence of this style of QE.

Own-risk QE could make EMU exit more attractive than restructuring for a country in fiscal distress. See above.

If bonds are bought at own risk is there any sense in setting strict ratings parameters? We argue above that own risk does not necessarily mean own risk. To protect the eurosystem and to guard against moral hazard, we would expect a ratings floor to be imposed on government bonds – probably investment grade. This is in line with the leaks reported on Bloomberg today on the possible QE options being presented to the Council.

Quotas to be set by the ECB, but not disclosed. We expect that the basic functioning of the program would be that the ECB hand target purchases for classes of debt to each NCB. For government bonds, we would expect that quotas would be set according to the capital key, although especially if NCBs have discretion not to buy their own government's paper, as we expect, another basis such as GDP keys would not seem particularly controversial. We would not expect quotas to be rigid, particularly over short periods. We would not expect total monthly quotas to be disclosed by the ECB, and we would expect as even less likely the disclosure of individual quotas handed to NCBs.

Local buying and own risk = more agility and prudence? If NCB are buying for their own account they may prefer to err too far to caution – i.e. to short-dated own-government paper, reducing the effectiveness of their purchases. We expect that this tendency would be mitigated somewhat by parameters to be set by the ECB.

Recapitalisation on credit losses, but also program success. Bonds bought at low yield in today's deflationary environment may have to be sold back at much higher yield and a loss if the program is successful. This is a particularly serious risk for Germany. The Bundesbank has €105bn in revaluation reserves and capital, so this is probably not a problem. Many NCBs are not strongly capitalised however: the Bank of Spain, for example has only €15bn. Of course the benefit of issuing at a lower yield should make most NCB's comfortable with the idea of requiring a recapitalisation on exit from QE. .

Could an NCB choose not to buy its government paper? We would expect so. This is most clearly a risk for bunds: the Bundesbank may choose not to buy its own governments paper as a point of principle. German alternatives exist: German covered bonds (€95bn), local government paper (€176bn) or German agencies (€166bn). Local government debt might also be controversial for the Bundesbank, however, and liquidity may still be a problem if the Bundesbank is asked to buy €150bn or more of paper over two years. We doubt that it would prefer to buy Dutch or French paper, but we are not certain.

Non fixed-rate government debt could more easily be bought. If an NCB fears losses on fixed-rate bond purchases because QE will eventually restore inflation, it might buy inflation-linked or floating rate debt, where available. It may also be more likely to have the expertise needed to bid and book such instruments.

No limits on maturity spectrum. NCBs may prefer to guard against the risk of program success – reflation – by keeping average maturity as low as possible. But in many cases – Germany especially – the liquidity available may demand some purchases at the long end. We see no reason for the ECB to view this negatively.

Could an NCB boycott the program? Because we would only expect to see own-risk QE as a compromise, we would not expect this design to be chosen unless all NCB governors were signed up. On the other hand we struggle to see how an NCB would be censured for failing to fill its purchase quotas. In this case, we assume that the shortfall would be shared among the remaining NCBs.

3. AAA-only purchases

Richard and Marco in The compromises around risk managing QE, point out that to limit purchases to AAA assets would be to critically limit the size of the program. Moreover, France is more than 40% of the AAA market available and has only one AAA rating (DRBS). A single rating downgrade could force the ECB to sell substantial holdings or abort the program. For this reason, and because we believe that the ECB must seek credibility on size, we discard this option.

4. Forced provisioning or buying of bond insurance

We do not think that this is workable. Either option would only work if paid in, and would therefore add substantially to government supply for many countries.

5. Buying according to debt shares

We think this is impossible because it gains little and violates moral hazard.

QE FAQs

Will the ECB need to raise the deposit rate? No. The corridor – the certainty of earning less on your money at end of day than you will earn if you can find a home for it – should accelerate churn and encourage search-for-yield behaviour. Precedent also suggests no: the corridor was wider than it is now at previous peaks of excess liquidity. The shift from reserve-pull to reserve-push is a meaningful change, but we do not think that financial stability or 'fairness' concerns trump the effectiveness argument in favour of leaving deposit rates low. Monetary policy always creates winners and losers, after all.

Will non-fixed-rate bonds (linkers, CCTs) be bought? We believe that SMP did not include inflation-linked bonds partly because of technical capacity, which we expect should not be a constraint now. Fundamentally the ECB may feel queasy about buying the bonds it relies on for information about inflation expectations. But not to buy them might also be thought of as distortionary. We do not believe that inflation-linked bonds would suffer particularly by being left for private investors to buy as they are squeezed out of their nominals. We think that linkers and floaters are much more likely to be bought in a federal, own-risk design of QE than at pooled risk, however.

Will bonds be bought at negative yields? A bond bought at negative yield generates less in total cash flows over its life than it costs. An NCB buying at a negative yield might reason that such a bond held to maturity or sold on exit from QE is bound to deplete capital.

But the same NCB will probably expect to take deposits of excess liquidity (depending on whether required reserves are adapted to shield banks from this 'tax') up to an amount similar to the liquidity created with each bond purchase. If it pays -20bp, say, on this, it is effectively a levered investor, funding its purchases at -20bp. It may not be much of a buffer, but held to maturity, unless rates go back up, a negative yield is not necessarily a loss-making purchase for an NCB.

More basically, it would seem to us to be potentially riskier to extend out the curve. The capital loss on a 10y bond bought at 0.5% and sold at 2% could be rather more than the loss on a 2y bond bought at -10bp and held to maturity.

Will there be reverse auctions? We strongly suspect not. The universe of instruments is too broad to make it practical, and ECB modus operandi to date has been to buy in the market. If QE is conducted at own risk by NCBs it is possible that home-government debt could be bought in this way. But we suspect in most cases technology might not be prepared in time.

Will government holdings be published? Pooled risk: we expect that holdings for the whole program will be published in the liquidity statistics as for the CB and ABS programs now. With weak conviction we suggest that the ECB, in the spirit of transparency, may choose to publish a breakdown by country of its holdings at some frequency which may not be weekly or even monthly. Own-risk: holdings would be reported by each NCB, and a breakdown of national/international debt holdings may be available.

Will government purchases be made according to the capital key? This is our firm expectation. But as discussed above, if conducted at own risk, NCBs may not choose to fill their quota for purchases with their own governments' debt.

What will the ECBs red lines be? We expect there to be a credit threshold – most likely investment grade. We think 'structured' debt and bank debt will also be off-limits. Beyond this, we think that most paper is likely to be a potential target for either the corporate or the public-bond buying programs, whether at own or pooled risk.

Will QE include Greek government bonds? On shared risks, we would not expect the ECB to purchase Greek government bonds given the uncertainty but may leave open the possibility for the future. Unlike other bonds, such sovereigns would only be bought subject to them being signed up to EU/IMF conditionality. Extending purchases in this way would be used to ensure a broadly pass through of monetary policy to all countries but as a carrot to ensure these countries continue to adhere to their adjustment programmes. We would expect such conditionality to be a pre-requisite of any future Greek government bond purchases.

We would expect the same stipulations to apply to purchases even at own risk, though potentially the future hurdle for Greek government bond purchases would be lower.

Will QE include non EUR paper? We expect not. The ECB will not want its program to be viewed as currency intervention in any case.

Will the ECB repo bonds held for market smoothing? To repo bonds held would directly counteract the liquidity creation that QE is supposed to drive. The ECB's financial architecture, with liquidity provision via reverse operations against broad collateral was originally designed largely to minimise market distortions. We think it would be consistent with this ethos for the ECB to pay attention to distortions unconventional policy is caution. We therefore think that, over time, a facility may be developed for individual issues to be exchanged for alternative collateral in certain circumstances as the program develops, if it appears that QE is creating difficulties in individual issues.

Bunds: we like 10y, we love 30y

Giles Gale

Marco Brancolini

Michael Michaelides

10s30s flattener on yield grab and supply/demand dynamics

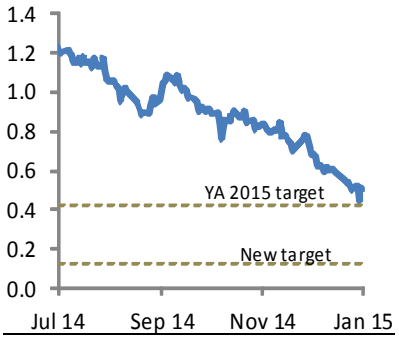
We have revised our target for 10y bunds to 0.13% on Wednesday. While the aim of sovereign QE is clearly reflationist, we think the 30y bund can rally to 0.7%. In terms of curve impact we expect a flattening of the 10s30s sector, as the key theme for 2015 post-QE Eurozone will be an even more aggressive yield grab. Demand will remain high both for core and peripheral long-end bonds, while the nFTK relatively reduces the attractiveness of semi-core for Dutch insurers. We enter a credit butterfly (long Ger/Ita vs Fra) in the 30y sector. Japan can be used as a blueprint for Europe, except that, where the supply of very long-end JGBs ballooned during the yield repression, Germany will reduce its supply of duration to the market in 2015.

We expect 10s30s to flatten on yield grab and supply/demand dynamics

- We have just revised our target for 10y bunds to 0.13%. While the aim of sovereign QE is clearly reflationist, we think the 30y sector will rally too.
- In terms of curve impact we expect a flattening of the 10s30s sector, as the key theme for 2015 post-QE Eurozone will be an even more aggressive yield grab, with investors forced either down the curve or down the credit ladder.
- The yield grab environment favours 30y periphery: after all there are very few assets that yield 3.2% and have a regulatory treatment as favourable as long-end BTPs.
- The now effective nFTK decreases the attractiveness of semi-core govvies vs triple-A sovereigns and higher yielding paper (periphery, but also equity). We like entering a credit butterfly in the 30y sector: long Germany and Italy vs France.
- Insurers are structural buyers of core paper in the very long end. Insurance companies in Northern Europe are among the largest in terms of assets; German and Dutch insurers were already in 2013 the ones whose domestic sovereign portfolio had the longest duration in the Eurozone.
- We look at the reaction of Japanese insurers to the yield repression for guidance: firstly, they didn't decrease their allocation to JGBs (instead, they steadily increased), and, in order to offset the yield repression they extended to the long end, where the government provided a vast amount of supply. We estimate the bond portfolio of major life insurers doubled in duration since 2003.
- This persistent (and growing) demand for core duration will be faced with a reduction in German duration supply. The Finanzagentur plans to materially reduce its supply's average maturity, issuing more Schatz than in 2014, and less of everything else.

Bund Target Update: 0.13%

Where now for bund yields?



Source: RBS

Bunds yields are going to gerd Müller-ed

Things have moved on since we targeted 0.42% for bunds in our Year Ahead 2015.

Germany is the world champion in football, and is blazing a trail in yields too. Inflation and PMI data this week allow us to update our fundamental model. It tells us that 31bp is fair value. But we are still negative on inflation and activity. Projecting forward, 13bp neither demands a structural break, flight to quality, nor an aggressively negative view of fundamentals.

And Kahn go lower still!

We updated our bund model in our Year Ahead. Allowing for QE turning net supply negative and economic fundamentals at the time (PMIs and core inflation), the answer was 0.40-0.45%. The convergence with our $42 oil target and our 42 Year Ahead trades was fortuitous. 42, we proclaimed, was truly "the answer life the universe and everything".

German football stars Thomas and Gerd Müller both wore the #13 shirt. Bunds can get there too.

Kahn wore #1: if our expectations on weak growth and inflation prove to be right even 0.01% will not be rich.

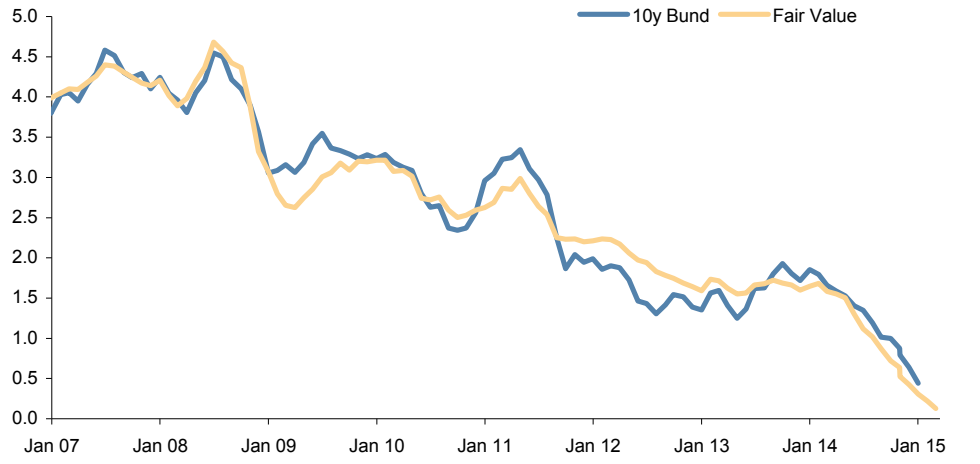
A month ago 0.42% seemed aggressive. No longer. We are now within a few basis points of this level.

More importantly, the data has continued to soften. Updating the model to incorporate yesterday's flash HICP and this week's PMIs our new fair value is 0.31%. Bunds are far from rich. But we expect inflation and activity data to soften further. How far can the bund go? Without being too aggressive we get to 0.13% by the end of Q1.

Japanification no longer… central Europe forges its own path now

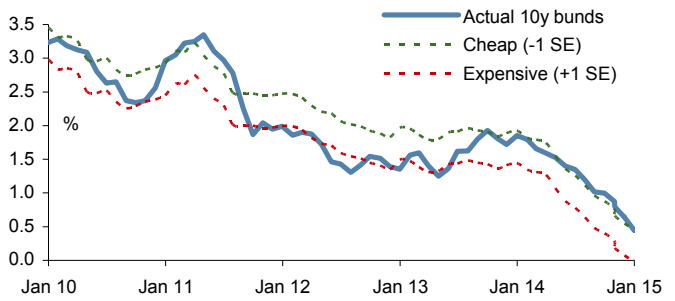
In the year ahead we discussed how German yields can not only converge to Japanese levels (10y JGBs were by then at 0.42%), but go even further – a phenomenon we called ***Swissification***.

RBS 10y bund fair value model



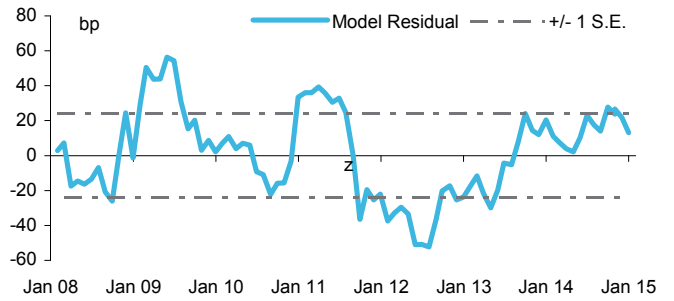
Source: RBS

10y bund fair value is coming down as QE approaches…



Source: RBS

… meaning even now 10y bunds remain cheap



Source: RBS

How do we get to 0.13%? Our bund model includes our usual variables: a proxy for economic activity (manufacturing output PMI), one for inflation, one for the monetary policy stance, plus a forward-looking indicator for net supply and ECB sovereign QE. Our assumptions are 49.5 in PMIs and 0.45% in constant-taxes core HICP return a bund projection of 13bp.

What level would be 'rich' given such fundamentals? The standard deviation of the model is 24bp. Negative yields would not be impossible to countenance as negative net supply squeezes the market.

Note also that the German budget for 2015 envisages a net financing requirement of *zero* for each of 2015, 2016 and 2017. The Commission forecasts a budget surplus for 2016 and the Finanzagentur has shortened duration for its supply in 2015 substantially. This further reassures us in remaining long bunds into 2015.

Spread: Long 10y, long 30y. Bull flattening.

One of the topics currently dividing market participants is the impact sovereign QE would have on the slope in 10s30s.

On the one hand, a case for steepening could be made as the main aim of sovereign QE is clearly reflationist; on the other hand, the hunt for yield could push the rolling flattening out to the very long end. We side with the flattening argument for a number of reasons:

- Germany's 2015 issuance program foresees a substantial reduction in duration supply to market. The reductions are greatest in 5y and 10y, but we expect that this will support flattening generally by exacerbating the shortness of duration overall.
- The new FTK has been implemented, even though the UFR may still change and we expect schemes to be relatively inactive while uncertainty remains. The new regulation also introduces changes on capital requirements for non-AAA governments, that will tend to encourage Dutch pensions to barbell their govvie risk, favouring Dutch and German long-end paper.
- We expect insurance to reach for yield, exacerbating last year's trend. This was also the pattern in Japan as yields fell.
- We do not expect QE to be particularly reflationary, at least in its earliest iterations, so we are inclined to underweight concerns about reflation driving a steeper curve. On the other hand, we do expect it to be supportive for the market through flows.
- We do not expect that sovereign QE will be restricted to the short end. Although we expect the bulk of purchases to be sub-10y, buying may extend along the curve, particularly where credit risk is low and supply is relatively light compared to QE flows – as it is the case in Germany.

- We are concerned that, in the near term, there are signs that the street is stuck with negative gamma in the long end.

New Trade: 10s30s bunds flattener. Enter at 77bp, target 57bp, place stop at 87bp. 3-month carry+roll is -1.3bp.

We have some concerns about the flattener too. We prefer outright longs. Firstly, on a sovereign QE announcement (contingent on its design) 10y may outperform 30y in a knee-jerk for two reasons. (a) The bund future may be a lightening rod for a QE bid, and (b) we believe the view that QE will be reflationary is widely held, although we disagree.

Secondly, we are extremely positive Eurozone sovereigns, so we see very little upside in curve trades right now in general: we would rather be long both 10y and 30y. In any case, to any investor that can withstand some volatility, we recommend entering a 10s30s bund flattener.

Lastly, if we are wrong on direction, we fear that a fundamentally-led sell-off may be led by the long end, which will be relatively less supported by flows.

This leaves us with a target for 30y bunds of 0.7% outright.

Insurers are structural bidders of German/Dutch duration

Insurers are another (large) class of structural buyers of long-end sovereign paper.

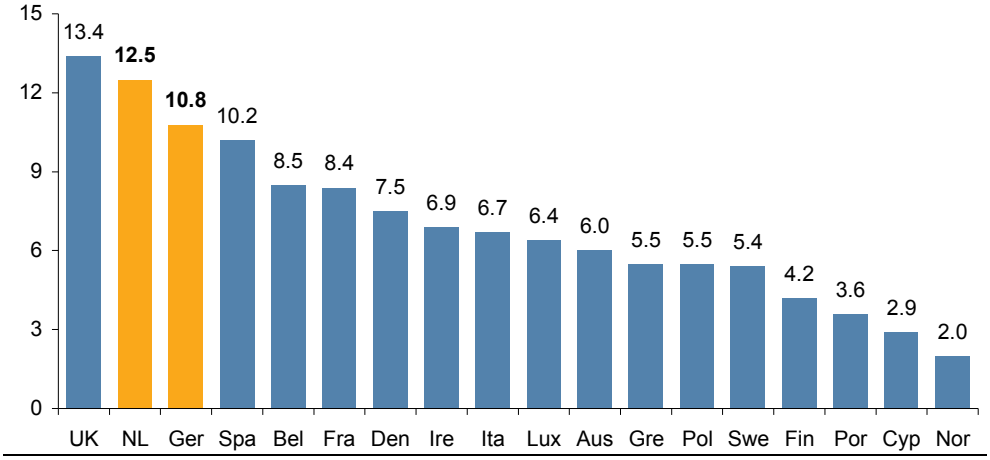
European insurers: Holdings of central government debt by issuer (end 2013)

	Issuer															
Country	**AT**	**BE**	**DK**	**FI**	**FR**	**DE**	**GR**	**IE**	**IT**	**NL**	**PL**	**PT**	**ES**	**SW**	**UK**	**USA**
Denmark	2%	3%	35%	3%	7%	12%		2%	14%	3%			7%		2%	8%
Finland	2%	5%		21%	10%	38%			3%	16%			1%	4%		
France	5%	7%			67%	2%		1%	10%	1%		1%	4%			
Germany	7%	4%		2%	15%	50%		1%	10%	2%	3%	1%	1%			2%
Italy						2%			96%				2%			
Nether.	9%	5%		2%	10%	33%			1%	38%	1%		1%			
Portugal	1%	3%			6%	1%			9%	1%		71%	8%			
Spain		1%			1%	1%			6%				91%			
UK	1%	2%			7%	13%			1%	1%					66%	9%

Source: EIOPA, RBS

The table above shows that Northern European insurers (among the largest size-wise) have large holdings of core bonds, and bunds in particularly. Moreover, Dutch and German insurers in particular are the ones whose government bond holdings have the longest duration: they are structural bidders already, and they are likely to increase duration still in order to meet their yield targets while rates decline further.

Average duration of domestic government bond holdings: holdings of Dutch and German insurers are the ones having the longest duration in the Eurozone



Source: RBS, EIOPA

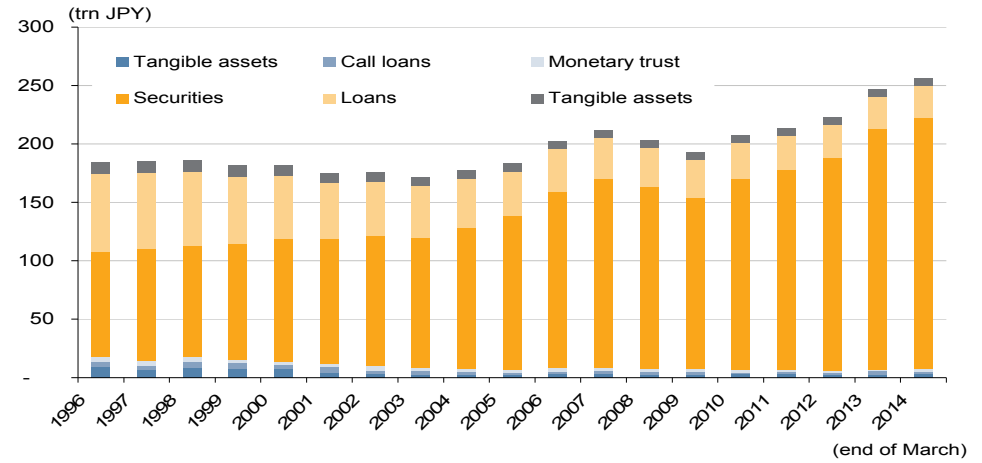
The table above also shows there is a natural bid for Italian paper, used as a yield enhancer. Sovereign QE will compress spreads further, and thus we expect the yield grab will become even more aggressive in 2015. In such a scenario, 30y BTPs look very attractive in our view: there are very few assets that yield 3.2% and have such favourable regulatory treatment.

Lessons from Japan: insurers are likely to extend duration

We have been talking about a Japanification of the European yield curve for most part of 2013 and 2014 (as this runs its course, we have now introduced a new term, *Swissification*). So if Europe really is to share some features with Japan (see pages 33 to 38 of our year ahead) then it makes sense to look at what Japanese insurers did.

The charts below show the asset mix for Japanese life insurers. Note that data excludes Kampo Life (Japan Post Insurance), as this was established in October 2007.

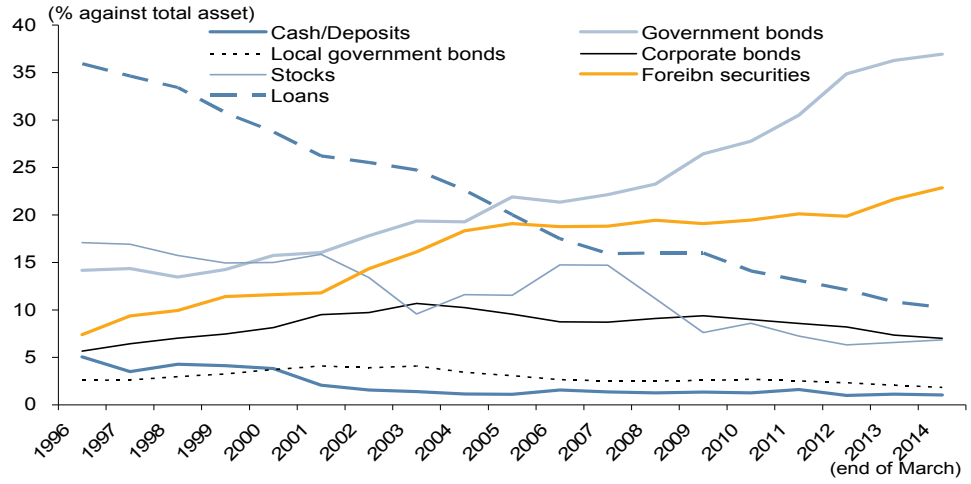
Japan life insurance assets



Source: Bank of Japan

What's the key takeaway? Japanese lifers steadily increased their allocation to JGBs for ALM matching purposes, despite the steady yield decline.

Japan life insurance assets (% of total): Japanese lifers increased their allocation



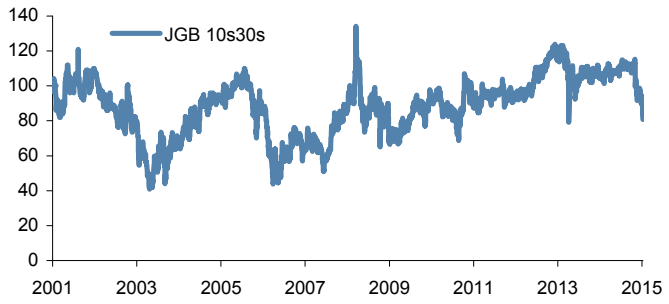
Source: Bank of Japan, RBS

Japanese lifers reacted to the yield repression by extending down the curve. We estimate the duration of the bond portfolio of major life insurance companies to be around 12 years whereas the duration in 2003 was around 6 years.

We think a similar situation can apply to European life insurers, another reason why we expect 10s30s to ultimately flatten.

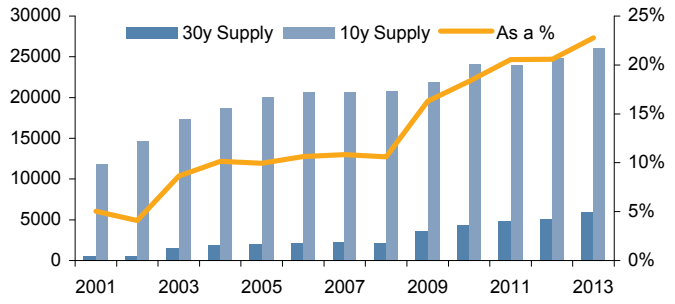
Then again, why didn't JGB 10s30s flatten more (leaving aside the 35bp rally since end Oct-14)? We would ascribe this mainly to technical factors, and notably supply. As JGB yields declined, the Japanese government increased its long-end issuance as a share of the total. 30y supply was 1/25th of 10y supply in 2002, almost a quarter in 2013.

If anything, JGB 10s30s, have steepened until 2014…



Source: Bloomberg

… as the relative supply of 30y vs 10y increased 5x since 2002



Source: RBS, Japanese Ministry of Finance

Germany will reduce 2015 duration supply by €15m/bp

The situation discussed above for Japan (where an increase in long-end supply prevents the curve from flattening) does not apply to core EGBs.

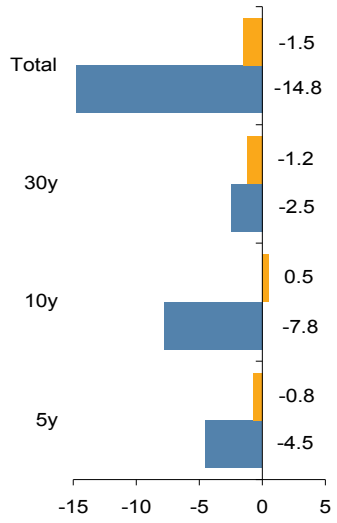
The aforementioned appetite for duration in core EMU bonds is likely to be frustrated in 2015, at least according to the 2015 issuance outlook of the German Finanzagentur.

German issuance by maturity bucket

	2y	5y	10y	30y	Linkers	Total
2015	56	39	46	6	10-14	157-161
2014	52	48	54	7	11	172
YoY Difference	+4	-9	-8	-1	0	-14

Source: Finanzagentur

Germany will reduce the DV01 of its issuance by almost €15mln/bp, the Netherlands by ~€1.5mln/bp



Source: RBS, DSTA, Finanzagentur

Perhaps surprisingly, the German debt office decided to reduce the supply of duration to the market, increasing the Schatz supply and reducing issuance in all other maturity buckets (by €18bn in the segment from 5y to 30y). The target for linkers' issuance is unchanged from last year at €10-14bn – eventually €11bn were issued in 2014.

Dutch issuance by maturity bucket

	3y	5y	10y	30y	Total
2015e*	15	11	16	6	48
2014	16.5	12.5	15.5	6.5	51
YoY Difference	-1.5	-1.5	0.5	-0.5	-3

e*=RBS estimate

Source: DSTA, RBS

The DSTA will also decided be issuing less duration next year. We estimate that in duration terms, Germany will reduce the DV01 of its issuance by almost €15mln/bp, while the Netherlands will reduce it by €1.5mln/bp (see chart on the left handside).

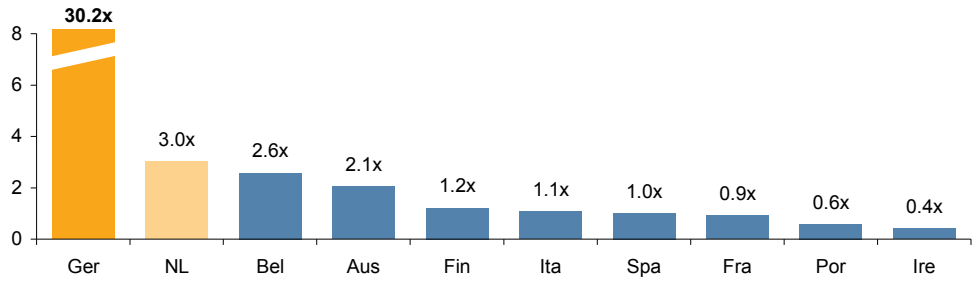
The drought of German duration supply in 2015 is a major reason to be long bunds, on our analysis.

Net issuance and QE: 'Buy the rumour, *buy* the fact'

Net issuance in Germany is planned to be very limited, at around €3bn in medium and long-term paper. Note that if we include redemptions in *Federal Savings Notes*[1] (€1.1bn) and *Securitized Loans*[2] (€1.3bn) net supply falls below €1bn.

We expect the lack of issuance, coupled with ECB purchases under sovereign QE and soft inflation and growth, to drive **10y Germany to 10-15bp**.
Note that the Netherlands also have little supply vs expected ECB QE purchases.

ECB QE purchases as a multiple of 2015 net supply



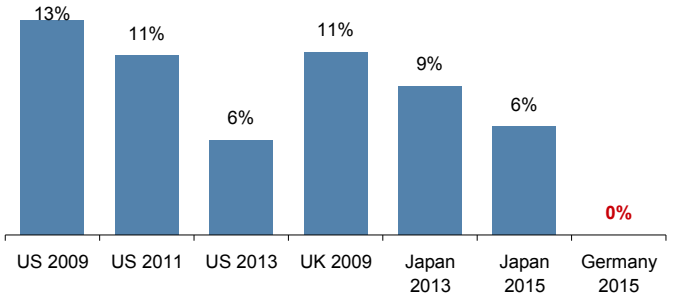
Source: RBS, Debt Management Offices

As we discussed in the year ahead, the lack of net supply/deficit in Germany is one of the reasons why we think the US pattern ("buy the rumour sell the fact", with a sharp post-announcement sell-off) will not apply to an ECB QE.

[1] A type of retail bonds, with a maturity of 6 or 7 years, whose issuance was discontinued since 2013.

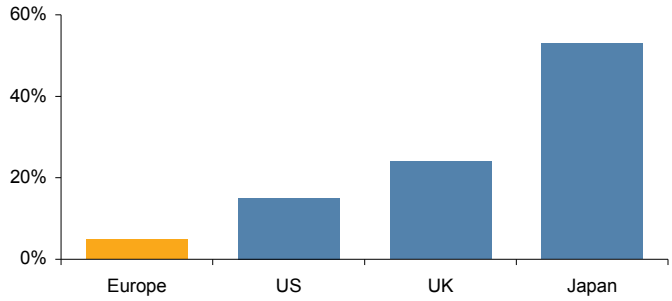
[2] A lot of these were issued in the early noughties (in 2000 they accounted for €73bn or 7.5% of total issuance). Issuance of this paper has been modest since 2010.

In the year government bond purchases were undertaken, UK, US and Japan had large budget deficits: Germany will have a balanced budget next year



Source: Eurostat ,RBS

Total value of QE sovereign purchases as a % of GDP (projections to end-16): we pencil in €500bn of ECB purchases, and BoJ purchases of JPY80tn in 2015 and 2016



Source: RBS, Bloomberg, Fed, BoE, BoJ

The other reasons for which we remain positive QE are Japanification, disinflationary pressures, and weak growth (the drivers, along with positioning, of 2014 tightening), as well as our feeling that the first round of sovereign QE might not be the last easing move by the ECB in this cycle.

nFTK. Curve impact delayed, but positive AAA duration.

On 16 December 2014 the Dutch Senate approved the new FTK (nFTK) regulatory framework for Dutch pension funds. The new regulation has been implemented at the start of this year.

The UFR discount curve for Dutch pension funds will be maintained for the time being and will not yet be replaced by the 'Committee UFR' curve. (The 'Committee UFR' is a moving average of 20y1y rates and therefore more market-based and currently at a lower level.) A move to the committee UFR might drive more duration demand.

We understand that the UFR methodology will be reviewed following the report on the insurance curve to be published by EIOPA next month, but experience suggests that this will take time. We also suspect that there is little impetus to harmonise treatment for pension funds with insurances. Finally, the DNB curve has a number of attractive properties – not least it delivers broadly similar solvency ratios – so there is a chance that the current curve ('DNB UFR') is maintained until further notice.

The markets have long assumed that the new Dutch regulation was a curve steepener: the regulation's postponement could instead have the opposite effect and rather be a source of flattening pressures.

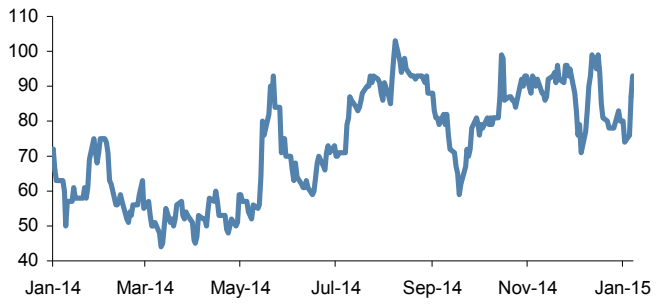
Another key point of the new regulation is the implementation of higher capital charges for non-AAA sovereign bonds – while triple-A sovereigns remain exempt from capital charges. This could have a substantial impact on the asset mixes of pension funds, by decreasing the attractiveness of semi-core govies vis-à-vis triple-A sovereigns and higher yielding paper (periphery, but also equity).

So we are positive 30y both in core and periphery

If you do not want to take an outright long position in 30y sector, we recommend to go long core as (i) the bid for this paper is structural and (ii) if bunds go to 40bp, investors will have to extend, as well as periphery, on the back of general spread compression.

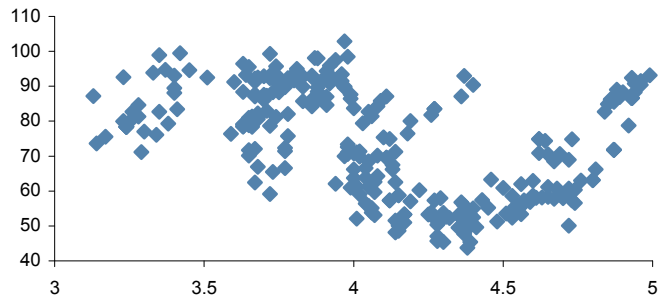
New Trade: Long 30y Italy and Germany vs France in a 1:2:1 credit butterfly. Enter at 93bp, target 75bp, stop at 101bp. 3-month carry is positive by 1.5bp.

The butterfly is at 93bp, still close to the highs



Source: Bloomberg, RBS

The butterfly is not correlated with the 30y BTP (*on x axis*)



Source: Bloomberg, RBS

Greece: Prime for a compromise

Michael Michaelides

Probable SYRIZA victory still leaves room for discussion

We explain the Greek electoral system and importance of which parties enter parliament; post-election scenarios for a programme extension and a deal. We see a 30% chance of two rounds of elections. A coalition SYRIZA government is the most likely outcome; but we see plenty of scope for compromise, not Grexit. The new government doesn't want it and SYRIZA will moderate its stance either (a) as part of coalition negotiations, (b) as a quick but dramatic U-turn or (c) a compromise as part of the deal for an ESM and IMF credit line. We expect compromise. The political risks around a prolonged conflict with Troika remain high nonetheless.

- **Greek electoral system:** We explain the workings of Greek electoral system and the importance of the 3% threshold. The fewer the number of parties entering parliament, the lower the vote share the 'winning' party will need to secure to form a parliamentary majority, given the 50 seat win bonus.
- **Greek polls:** SYRIZA maintains the lead in the polls but its lead over New Democracy is narrowing, with former PM Papandreou's potentially throwing a spanner in the works and Mr Samaras still considered the better Prime Minister.
- **Election outcomes:** We estimate a 75% probability of SYRIZA being the largest party. But given that it is the largest partly, we assign a 70% probability it will need to find a coalition partner. The probability of a second round of elections is high (30%); Greece has often had double election to get the parliamentary arithmetic right.
- **Possible coalitions:** SYRIZA is most likely to form a government with PASOK or To Potami but Mr Papandreou's new party (KDS) is a possibility if it is in parliament. The market should concerned about a SYRIZA coalition with fiercely anti-MoU ANEL.
- **SYRIZA victory:** SYRIZA victory does not mean Grexit. Its mandate is renegotiation not risking Greece's place in EMU. We see three routes for compromise: (A) a moderating coalition partner, (B) a forced U-turn or (B) an agreement with coalition partners after delay (likely alongside a new credit line)
- **Post-election:** SYRIZA will likely ask for an extension to the programme to table counter-proposals but expect Troika to remain tough on the current review.
    - The aggressive scenario sees: no extension, which either means a humiliating U-turn for SYRIZA or the risky scenario where Greek state is funded to June by not paying suppliers and with T-Bills, with Greek banks will no longer be able to repo at the Eurosystem. June is the deadline for a deal. *This is our main concern- political risk in such a scenario (potential government collapse or call for a Euro referendum*
    - The compromise scenario (our base case) sees no deal until after the deadline. This is to present a better 'third package' as a good deal for SYRIZA. The final deal will compromise an ESM and IMF credit lines. This benefits both parties (market funding = no new loans from Europe and lighter conditionality for Greece). SYRIZA won't be allowed to reverse reforms but will get lower primary surplus targets and may be allowed to skew austerity further toward wealth taxes.

Greek electoral system

The Greek electoral system works on 'reinforced proportional representation', which is essentially a "winner's bonus" of seats for the largest party and proportional representation for the remaining seats. This typically means that the party with the largest share of the vote has a majority if it has a sufficiently large share of the 'qualifying votes' (see below).

How are seats shared in parliament?

- Under the Greek electoral system, the largest party will receive a 50 seat bonus, regardless of its share of the vote.
- The remaining 250 seats in the 300 parliament are shared between the parties exceeding 3% of vote; broadly using a system of proportional representation **amongst parties entering parliament** but across different size constituencies.
- This means the number of parties and **cumulative vote share of parties not exceeding the 3% threshold for parliamentary representation vote is critical for determining the vote share required for a parliamentary majority.**

How the 'winning vote share' can vary.

Given the winning party secures 50 seats, the remaining 250 seats are shared broadly according to proportional representation. 151 seats are needed to rule as a majority in the 300 seat parliament; so a potential government needs 101 seats in addition to the bonus.

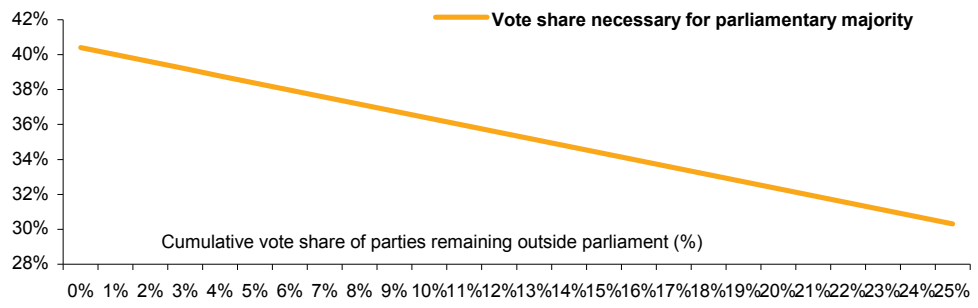
- For example, if all parties voted to enter parliament; for a party to secure 101 seats, they need **101/250 seats = 40.4% of the vote**

However, **as a greater number of parties fail to enter parliament the proportion of the vote necessary to win a majority falls,** as the share of 'wasted votes' rises. This is because the share of the 'valid' votes necessary to win a seat falls.

Broadly speaking, for every 1% of votes going to parties outside the parliament, the share of the total vote the leading party must win to gain an overall parliamentary majority falls by 0.4%.

- If the share of the vote held by parties outside of parliament totals 5%, then a majority can be secured with 38.4% of vote. *I.e. 40.4% - (5*0.4%) = 38.4%, or equivalently each seat is worth 95/250 = 0.38%. Then 0.38%* 101 seats = 38.38%.*
- If the share of the vote held by parties outside of parliament totals 10%, then a majority can be secured with 36.4% of vote. If the share of the vote held by parties outside of parliament totals 15%, then a majority can be secured with 34.4% of vote.

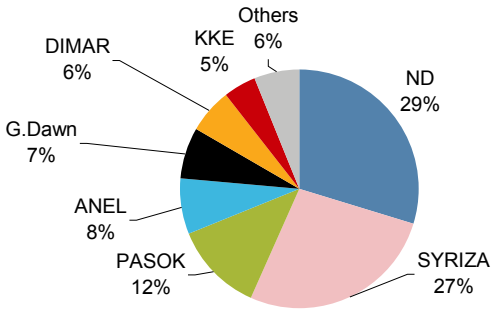
Proportion of vote necessary to secure a parliamentary majority



Source: RBS

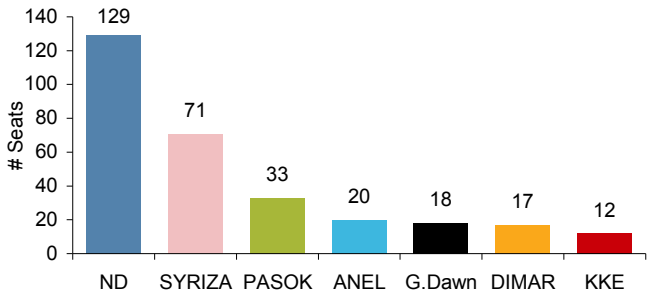
To illustrate the point, if only three parties enter the parliament (hypothetically SYRIZA, ND and Golden Dawn) and eight parties all have 2.99% of the vote (i.e. totalling ~24%), then the winning percentage could be as low as 30.7%. Also remember here when considering polls that in the final count the "don't knows" and spoilt ballots will not count, so each party typically receives a marginally higher share of the votes in the actual results compared to the polls.

Second 2012 general election results



Source: Hellenic Parliament, RBS

Post-election parliamentary composition



Source: Hellenic Parliament, RBS

So what are the possible outcomes?

Broadly speaking there are five possible outcomes from the 25th January elections:

1) SYRIZA wins an outright majority

2) SYRIZA is largest party but needs to form a coalition with one/more parties.

3) New Democracy is the largest party but needs to form a coalition.

4) New Democracy wins an outright majority,

5) New elections as no party has an overall majority and no coalition agreements can be found (e.g. as after the May 2012 elections).

SYRIZA and New Democracy (ND) will be the two leading parties in these elections, as in both the 2012 elections and the 2014 European election. Beyond this, there are eight other parties polling between 2 and 6% all of which could enter parliament (if they exceed the 3% threshold) and most of which are potential coalition partners (see below).

Greek political parties

Party	Leader	Orientation	June 2012 General election result	May 2014 European election result	Possible coalition partners
SYRIZA	Mr Alexis Tsipras	Left-wing (anti-MoU)	26.9%	26.5%	See text below
New Democracy	Mr Antonis Samaras	Centre-right ("pro-European")	29.7%	22.7%	See text below
PASOK	Mr Evangelos Venizelos	Centre-left ("pro-European)	12.3%	8.0%	Could co-operate with either ND or SYRIZA
Democratic Socialist Movement (DKS)	Mr George Papandreou	Centre-left ("pro-European)	n/a	n/a	Could co-operate with either ND or SYRIZA
To Potami	Mr Stavros Theodorakis	Centre-left ("pro-European)	n/a	6.6%	Could co-operate with either SYRIZA or New Democracy
Golden Dawn	Mr Nikos Michaloliakos	Far right	6.9%	9.4%	Will not form coalition (doesn't want to, nor does any party wish to co-operate with them)
Independent Greeks (ANEL)	Mr Panos Kammenos	Right wing (strongly anti-MoU)	7.5%	3.5%	Most likely to form a coalition with SYRIZA given strongly anti-MoU stance. Could co-operate with New Democracy but likely on the condition of Mr Samaras steps aside as ND leader.
Communist party (KKE)	Mr Dimitris Koutsoumpas	Left wing (strongly anti-MoU)	4.5%	6.1%	Unlikely to co-operate with anyone but tail risk of co-operation with SYRIZA
Popular Orthodox Rally (LAOS)	Mr Georgios Karatzaferis	Right wing (strongly anti-MoU)	1.6%	2.7%	Could co-operate with either SYRIZA or New Democracy if enters parliament

Source: Hellenic Parliament, RBS

Post-election: Going through the motions

Regardless of the results, after the elections, the leader of the largest party will be summoned by President Papoulis and given the mandate to form a new government. In the event that SYRIZA or New Democracy has a parliamentary majority, this will be straightforward.

However, if the largest party does not have a parliamentary majority, then the party leader will have the mandate to form a coalition government for three days, and can choose to approach whichever party leaders it wishes to and try and find an agreement . He will have three days to form a government.

Only if such negotiations fail, then the leading party leader would communicate this to the President. The President typically then asks the party leader of the second and third party leaders in turn to try and form coalitions. However, given the winners' bonus of 50 seats, if the leading party fails to form a government; it would be unprecedented for a different party leader to cobble together a parliamentary majority (given the electoral maths).

If all party leaders requested fail to form a government, then **this would lead to a second round of elections**. Nonetheless, given the pending end of the Troika programme, this would no doubt play a role in the decision making process (see our section below for our thoughts on potential further technical extension of the programme).

What are the potential coalition scenarios?

A. SYRIZA-led coalition possibilities

In the more likely scenario of SYRIZA being the leading party, its official line is that it would only seek a coalition with the Communist party (which is very clear that it would reject any such overtures)or other left-wing parties. In our eyes, this is only a tail risk, though any such coalition would likely be both very unstable and have a far greater likelihood of confrontation with the Troika. Note for example, that Euro exit is the Communist party's official policy.

More likely is that SYRIZA would seek a coalition with any of (1) PASOK, (2) To Potami or (3) Democratic Socialist Movement (if they are in parliament). **This is the first and most obvious point at which SYRIZA could moderate its stance on a number of issues**. For example demands for reversing reforms, wanting to reinstate public sector pensions and salaries, may be dropped at this point.

A potential coalition with Independent Greeks (ANEL) however would likely be far more problematic from the markets' viewpoint. This would require ANEL to first enter parliament (they are on the 3% borderline in most polls, see below). However, with SYRIZA and ANEL being from different ends of the political spectrum but united by their 'anti-MoU' stance, then any governance programme will likely be very heavy on convergence involving 'hardline' negotiating stances vis-à-vis the Troika.

In any case, how close SYRIZA would be to a parliamentary majority would be critical to the probability of new election if there is no outright majority. If SYRIZA is the largest party with a sizeable share of the vote (>35%) and is only a few seats short of a potential majority (i.e. 130 seats+); then the risk of new elections is far higher. This may come about since SYRIZA would (intentionally) demand a "too high" price from any potential coalition partner, instead hoping to get a majority in the third round.

Greek general elections

Year (Winner)	Winners' share (%)	Seats
1974 (ND)	54.4	# 220
1977 (ND)	41.8	# 171
1981 (PASOK)	48.1	# 172
1985 (PASOK)	45.8	# 161
1989 #1 (ND)	44.3	145
1989 #2 (ND)	46.2	148
1990 (ND)	46.9	150
1993 (PASOK)	46.9	# 170
1996 (PASOK)	41.5	# 162
2000 (PASOK)	43.8	# 158
2004 (ND)	45.4	# 165
2007 (ND)	41.8	# 152
2009 (PASOK)	43.9	# 160
2012 #1 (ND)	18.9	108
2012 #2 (ND)	29.7	129

# denotes majority Source: RBS

B. New Democracy-led coalition possibilities

In the case of New Democracy, its most likely coalition partners remain To Potami and PASOK given their "pro-European" framework.

Meanwhile a coalition with Democratic Socialist Movement (DKS)- if they are in parliament- given the rivalry between their leader Mr Papandreou and Mr Samaras (the latter succeeded the former as Prime Minister). This coalition is less likely in our view, given DKS would likely request Mr Samaras to step aside as the price of a coalition. Recall the backdrop; ND has trailed in the polls all year. A ND victory from here would be a big personal boon for Mr Samaras so he is highly unlikely to want to step aside.

If ND is actually very close to a parliamentary majority (e.g. 130 seats+), as with SYRIZA, then the risk of a second round of elections is far higher as the government tries to secure a parliamentary majority.

Second round of election are common in Greece

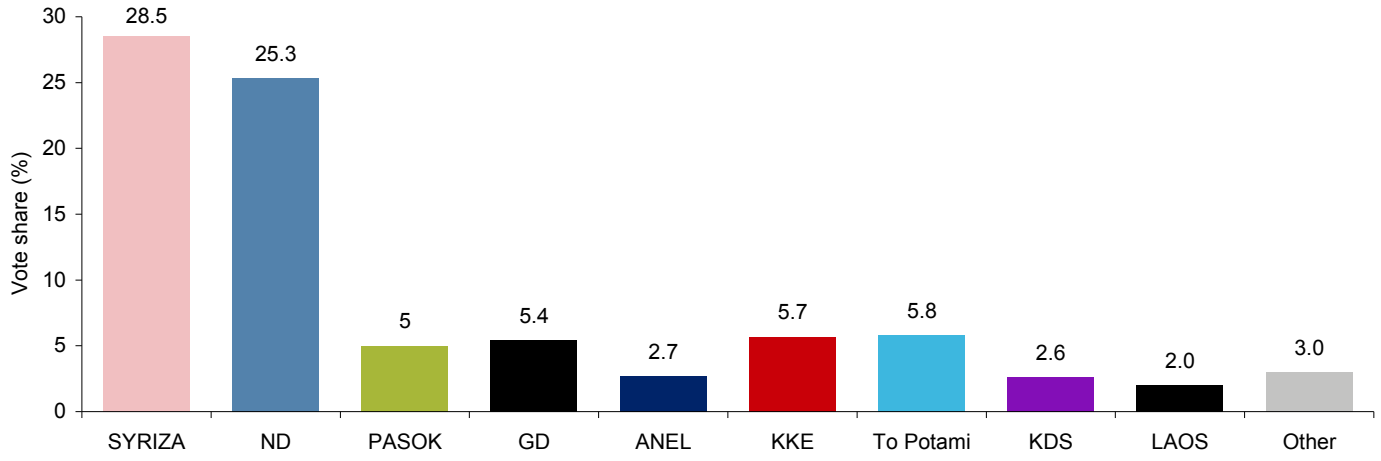
Two rounds of elections are not uncommon in Greece; this was not unique to 2012 . Greece also voted twice in 1989 and once in 1990 until New Democracy converted its poll lead into a number of parliamentary seats that allowed it to govern (see left). **At this stage we estimate the probability of second elections at 30%.**

What do the polls say?

There are arguably four key polling trends within Greek politics relevant for this month's election:

- Firstly, the rise of SYRIZA (and Golden Dawn) at the 2012 elections, as dissatisfaction with traditional parties (ND and particularly PASOK grew)
- Secondly, SYRIZA has held a consistent lead in Greek polling in 2014, confirmed by its victory in the 2014 European elections (see left).
- Thirdly, this lead of late New Democracy has narrowed (but not closed) SYRIZA's poll lead in the run-up and after Presidential elections; in part due to the expressed preference of the public to avoid early elections.
- Finally, the wildcard of former PM Mr Papandreou's new party (Democratic Socialist Movement) could yet impact the state of play: both (a) by fragmenting support for PASOK but also SYRIZA's support, as well as providing a potential coalition partner for either SYRIZA or ND.

Voting Intention: SYRIZA still holds a small lead with eight parties in 2%- 6% internal potentially entering parliament

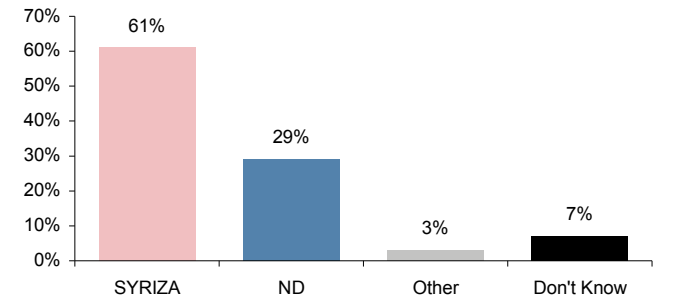


Source: GPO (5-7 Jan), Alco, RBS

So what do we conclude from recent polling?

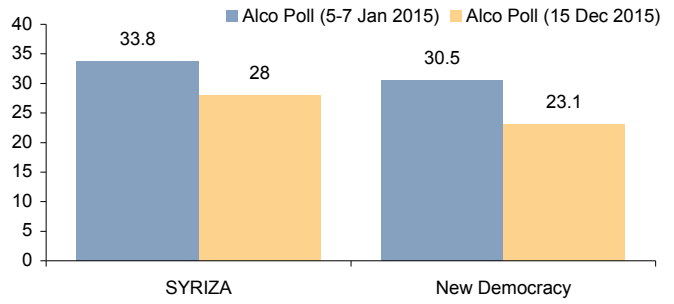
- SYRIZA's clear (but narrowing) lead makes it a favourite to win the election; though more likely than not it will need to form a coalition. The public generally agrees with many of SYRIZA's positions regarding negotiating with the Troika and Greece's debt overhang. However, voters' preference for SYRIZA is not a rejection of the Euro.

Winners' Poll: Most voters expect a SYRIZA government



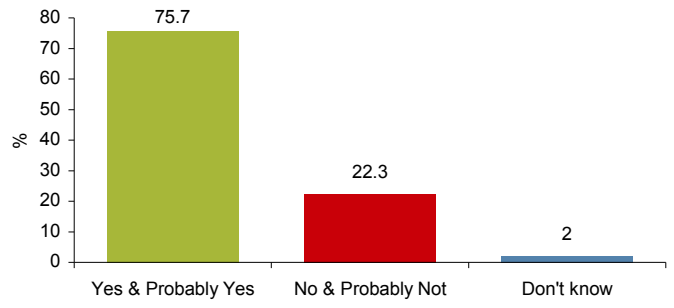
Source: Pulse (5-6 Jan), RBS

SYRIZA lead in voting intentions has been narrowing



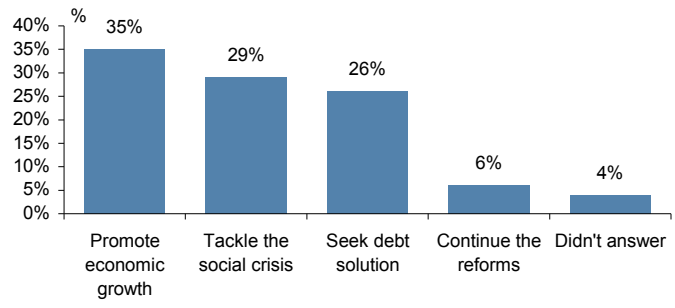
Source: RBS

Most Greeks want to stay within the Euro…



Source: GPO Survey (5-7 Jan), RBS

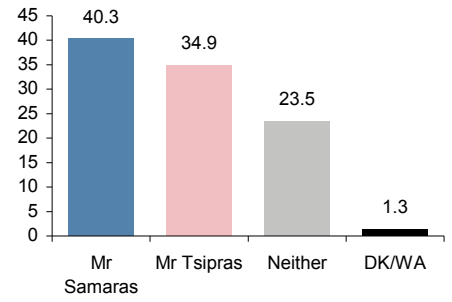
…but believe growth and debt (not reforms) are the priority



Source: RBS

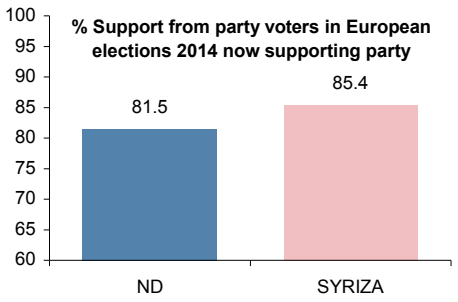
- The election is not yet a done deal however. Mr Samaras is still perceived as a better PM; whilst New Democracy's supporters are not (yet?) as inclined as SYRIZA's to support their party as in previous elections (shown vs European elections below)
- Further movement of support toward Mr Papandreou's new party could yet affect which parties get into parliament. So far his party has done limited damage to SYRIZA but DKS is just shy of 3% only a week after being founded. However, further support moving toward DKS could push PASOK down toward the 3% threshold and cut the SYRIZA lead at top.

Mr Samaras still considered better PM



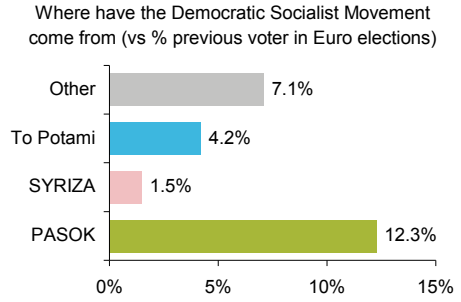
Source: GPO Survey (5-7 Jan), RBS

ND 'core' voters less energised so far



Source: GPO Survey (5-7 Jan), RBS

Could George yet be the wildcard?



Source: GPO Survey (5-7 Jan), RBS

- Finally, the shift in the polls toward the two main parties could yet lead to a majority if a number of parties remaining fail to meet the 3% threshold.

So what immediately happens post-election?

The most pressing issue regardless of which government is elected will be the conclusion of the final review of the second bailout programme and negotiation of the third assistance package/credit line to secure Greece's sovereign funding for 2015 onward. **The Troika programme ends at the end of March, so the time pressure for a deal will be very high regardless of which party is in power.**

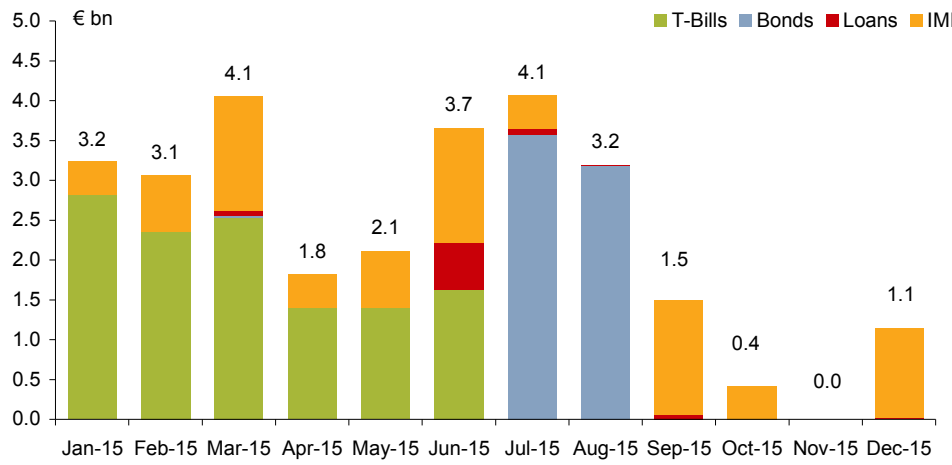
How the outstanding bailout review will be dealt with will strongly depend on which government is elected:

- A New Democracy majority (or coalition) would most likely rush to complete the review using its 'new mandate' to force through any unpopular measures necessary.
- A SYRIZA-led government too would likely ask for an extension to give it some time before presenting alternative proposals to its European partners and avoiding the Troika deadline acting as a Damocles sword over the negotiations, which would likely weaken its stance. *Whether any such extension is granted will be a strong indication how Europe will look to deal with Greece*.
    - If it is rejected then Europe will already be seeking to exercise pressure, with the potential that any new government is forced into a swift agreement shortly thereafter by the Troika (e.g. as was done in the case of Cyprus)
    - If a technical extension is granted, this may be an indication that Europe will seek to find a compromise to avoid some of the side-effects of an escalation in rhetoric and brinkmanship.
- If there is a caretaker government in place because there will be a second round of elections; we would expect any caretaker government to request an **extension of the programme until June** (to avoid losing ECB liquidity). A caretaker government is likely to be granted an extension in our view.

Eurosystem liquidity depends on a programme extension…

In terms of repayment pressure, Greece's next major drains on cash are in July/August (see below). Prior to this, the government has only limited cash reserves according to the existing Finance Minister; however, we could certainly envisage scenario where the government can continue to fund itself, either through rolling over (or even increasing) T-Bills to Greek banks or delaying payment to commercial suppliers (i.e. improving cashflow by building up arrears).

Greece Upcoming Obligations: July is the real problem month



Source: PDMA, RBS

The ECB already made clear yesterday that the continued access of the Greek banks access to Eurosystem liquidity will depend on Greece remaining under a programme- i.e. if the programme lapses liquidity to Greek banks will be turned off. However, this would just mean Greek banks would have to pay more for liquidity operation under Emergency Liquidity Assistance at the Bank of Greece.

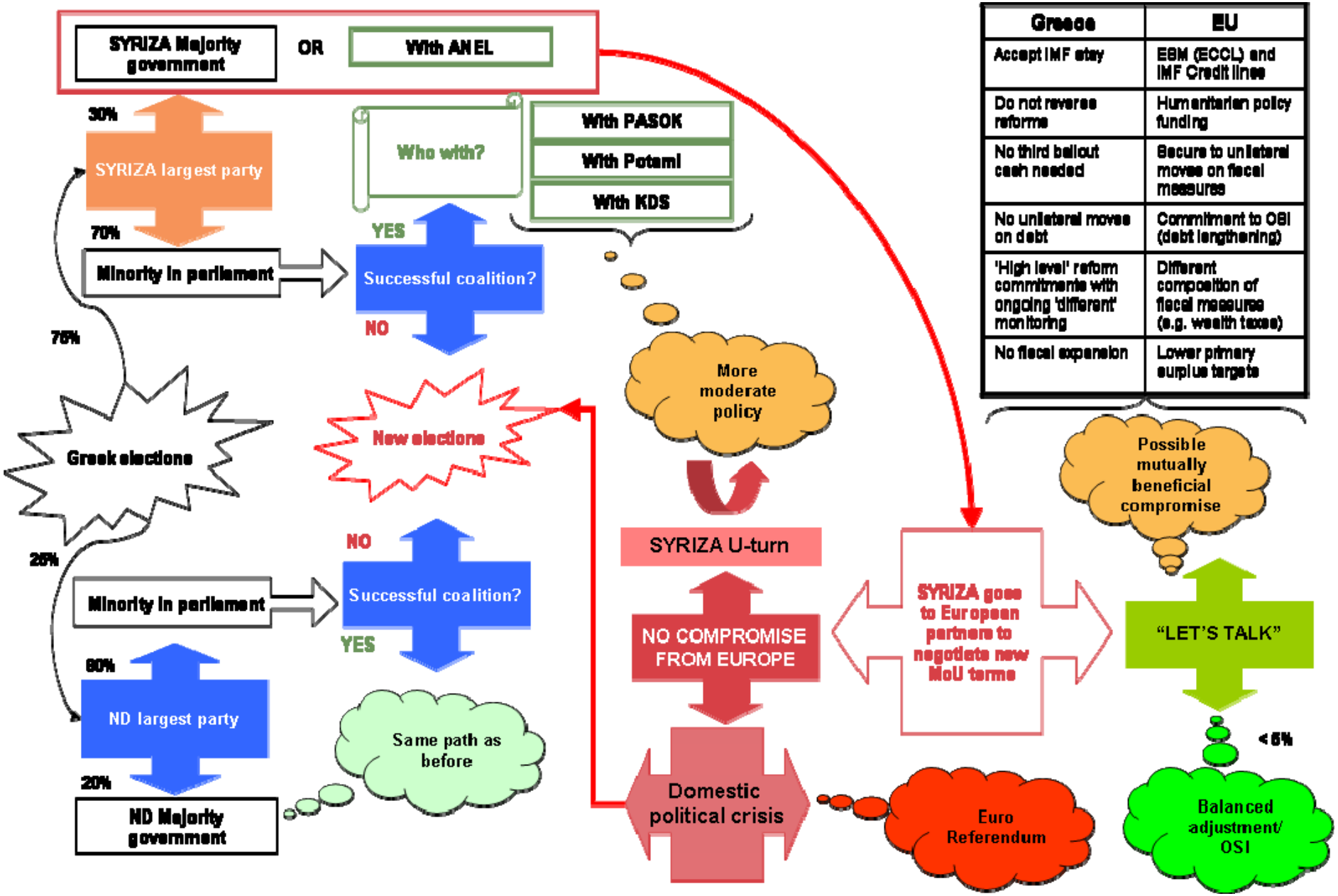
ELA access is a far more serious worry…. June is the pinch point.

A far more critical question would be the Greek banking system's access to ELA. Despite a prolonged stand-off between Greece and the Troika between June and November 2012, when Grexit speculation peaked; the ECB *did not* threaten to (nor actually) cut off the Greek banking system's ELA liquidity. ELA is at national risk and is at the prerogative of the Bank of Greece. Officially, it is only if ELA is deemed to be interfering with the ECB's monetary policy that the Governing Council (under a special weighted voting procedure, where the Executive Board cannot vote) that it can stop any national central bank offering ELA to its banking system.

Cutting ELA would be almost tantamount to pushing the Euro exit button, something we would view as highly unlikely. Press reports since 2012 have made very clear that when faced with any decision potentially causing Euro exit, the ECB would defer explicitly to Eurozone politicians. Again as we have noted from detailed reports of the most acute phase of the Euro crisis, European politicians were very keen that any Euro exit be decided by the Greek population (not 'enforced upon them').

In any case, the time any such discussion would be really relevant in our eyes are ECB bond redemptions in July (see above). As we noted straight after the calling of the election we would expect ELA withdrawal to be one of the '*sticks'* the ECB uses; recall the ECB is one third of the Troika as part of the negotiation with any new government (e.g. much like the infamous ECB letters to Ireland threatening just that). On the other hand potential sovereign QE inclusion if Greece remains under a programme would likely be one of the '*carrots*'. Finally there is a (rather academic) question whether 'unilateral' default on official sector debt within the Euroarea is possible. **This is nowhere near our base case scenario.** Whilst, technically it may be possible (e.g. Greece just refuses to pay the old ECB SMP bonds) and we firmly believe that any Grexit would need to consult the Greek population, which would likely vote to stay in. Nonetheless, in the event of unilateral default by SYRIZA then Europe's politicians and the ECB do theoretically have a red exit button they could push.

Potential Greek election and aftermath scenarios



Greece	EU
Accept IMF stay	ESM (ECCL) and IMF Credit lines
Do not reverse reforms	Humanitarian policy funding
No third bailout cash needed	Secure to unilateral moves on fiscal measures
No unilateral moves on debt	Commitment to OSI (debt lengthening)
'High level' reform commitments with ongoing 'different' monitoring	Different composition of fiscal measures (e.g. wealth taxes)
No fiscal expansion	Lower primary surplus targets

(All probabilities are RBS) Source: RBS

What about renegotiation?

Considering the chart above, we consider there are 5 broadly possible scenarios from any government in place. We have already touched upon two of the more benign scenarios above:

- **A New Democracy victory (outright or in coalition)**. In this scenario, we would expect a closure of the latest Troika package relatively quickly, with Mr Samaras using his political capital to pass any pressing reforms and austerity measures. After this we would expect the discussion to return to a 'third package', the most likely option for which appears to be:

(1) an **Enhanced Conditions Credit Line (ECCL) from the ESM**, backed by the €11bn of funds redirected from the surplus funds set aside for the banking system (HFSF). The aim would be that Greece would raise the bulk of its funding from the market.

(2) **Ongoing IMF involvement** but with less disbursement of funds and rather a Flexible Credit Line of ~€2.5bn

(3) **A new form of supervision from the EU/IMF, with less frequent visits and less intrusive conditionality.** Rather conditionality would be 'broader based' in key areas, which would see reform, rather than line-by-line conditionality as is the case now.

- **A SYRIZA coalition with a 'pro-European party' (PASOK, Potami or DKS).** Given recent polling, we think it more likely than not that SYRIZA will have to form a coalition; most likely with a pro-European party. In the course of coalition negotiations, this will lead to a moderation in SYRIZA's stance on a number of issues (for example retrenchment of existing reform and pay hikes within the public sector).

"*We won't play with the euro, and we won't allow any gamble with Greece's membership in the euro area.*" **Stavros Theodorakis, Leader of To Potami**

In any of these three scenarios, we still expect the new government to attempt to renegotiate certain aspects of the existing and potentially new supervision package. We would expect the sovereign financing arrangement will not look particularly different to that in the scenario above, though some of the give-and-take in the conditions will likely include some element of possible renegotiation (below)

- **A SYRIZA majority government or coalition with Independent Greeks**. Under this scenario, we would expect the government to try and pursue the most aggressive renegotiation strategy. As noted above this will likely involve an initial request for an extension, whilst the new government assesses the Troika's new proposals for the final review, as it finds potential counter-proposals.

Even under a SYRIZA government, we would expect unilateral measures of significant importance to be avoided. For example, we would not rule out some potentially controversial gestures (e.g. raising the minimum wage lowered at the Troika's request); however we would still expect SYRIZA to engage constructively with the Troika. We are not expecting a declaration of imminent cessation of payments to official creditors.

How developments proceed from there will depend on the Troika's attitude. We would expect this to harden to some extent after the election in any case.

- **A very aggressive Troika strategy** would be to refuse to extend the programme and squeeze SYRIZA into trying to close the existing review in four weeks, offering little or no changes to the Troika's previous demands. Given the timescale involved, this would essentially leave SYRIZA two choices:

  (1) **Make an abrupt U-turn** with very limited leeway for changes to the programme. To secure state financing SYRIZA would have to take the sort of austerity measures it has rejected from the start.

This may buy some credibility in discussing a potential new package but the government would no doubt come under pressure from its own MPs, particularly those on the left of the party and/or ANEL if they are in coalition.

- **(2) Exceed the deadline without an official extension.** A stalemate past March, would mean it essentially funded itself by building up of commercial arrears and T-Bill rollovers. Greek banks would lose access to Eurosystem as a result (instead using ELA). The de-facto deadline here is July when Greece has large ECB SMP programme bond redemptions. **This is the most risky scenario in our view.**

We are agnostic as to how a SYRIZA government would respond in this scenario. However, a number of potential responses here could lead to severely heightened political risk. Moreover, in such a scenario the failure of SYRIZA to reach agreement with its creditors' would no doubt raise the spectre of Grexit more prominently; no doubt fuelled by European politicians and possibly the ECB trying to exert pressure.

As we discussed earlier SYRIZA certainly does not have the mandate to even consider Grexit and if this becomes a serious possibility, we would not be surprised if either the government would potentially fall in a vote of confidence leading to new elections- not least since a centrist members of SYRIZA could revolt if a Euro exit is probable. An alternative tail risk would be that a government having been elected to "negotiate a better deal" could potentially openly admit defeat and put the question to the public directly- i.e. hold a referendum as to whether Greece should implement the measures to remain in the Euro. This is neither likely nor our base case but is not a zero probability outcome.

A 'cooperative' Troika strategy would attempt to secure its key demands, whilst working with the new government and at least discussing some of SYRIZA's key concerns. This would involve granting an extension if requested.

We find it unlikely that the Troika will give much on the existing review (i.e. pension fund reformat and further consolidation measures will both be insisted upon in our view). Here the Troika would most likely like to demonstrate that its demands will not change despite the change in government.

However, given this delay in the decision the agreement of a new programme will have to follow closely on the heels of the closure of the review in this case; then a Tsipras-led government would have to commit to new reform measures and deficit targets to secure an ECCL credit line. Here is where a government could secure "some wins from renegotiation" which if presented together with the closure of the package could be presented as SYRIZA delivering on some of its agenda.

Why would Europe co-operate?

Press articles of late in recent weeks indicate that European exposure to Greece is significantly less than it was in 2012 (see below), particularly French banks their Greek subsidiaries. With QE imminent, risks of contagion are likely to be more limited, which could allow European leaders to pursue a more aggressive stance.

We do not disagree with any of the above.? On the other hand; we consider the precedent on Greece far more compelling. Greece did not exit despite a much higher cacophony of Grexit calls in 2012, when Greece's primary deficit was in excess of 10% and would require more than €120bn of further funding in the next two years. Since then Greece has run a primary surplus and growing again. Greece has been able to re-access the market and in fact exceeded a number of the fiscal and growth targets of the second programme (e.g. allowing some social spending before the 2014 European elections). Indeed, our view is that European policymakers will try and maintain the sanctity of the Euro. A potential new agreement on the table would not require any further funding for Greece (just a reallocation of cash leftover in the HFSF).

Finally, the political reaction to initial Grexit discussion this time round has also been notably different, from the Commission, previously hawkish governments such as Austria and even members of the German government have opposed Grexit threats. In our eyes Grexit is a relatively low probability event this time. As we have discussed Mr Tsipras will not have a mandate to take Greece out of the Euro. If elected, we view him as more likely to find an agreement one way or another by July (via U-turn or a compromise).

Our view is that we think there is an acceptable political deal that can be found between a new Greek government and its European partners but 'Grexit warnings' are being used to try and skew the terms of such an agreement to 'more favourable terms' (fewer concessions and more control) for Eurozone countries.

So what could any such compromise look like?

Given the number of pending uncertainties, we will not attempt to forecast what could be a comprehensive deal between a Tsipras-led government and the Troika; however we lay out some potential contours below:

Areas of potential compromise between SYRIZA and the Troika going forward

A SYRIZA led government	Greece's European partners
Accept the IMF will remain as part of the review process but in return for a "different" set up of the Troika with less frequent and intrusive inspections	Offer an ECCL from the ESM and a FCL from the IMF
Accept there will be no restructuring of ECB debt, nor nominal haircuts (at this stage). Unilateral moves on debt avoided	OSI from Eurozone to get more explicit timeline. (vs. indefinite delay before, despite Greece meeting primary surplus criteria)
Commit to high level 'reform principles' which will be monitored under new programme	Accept change in composition in fiscal measures, even if these are skewed toward taxation (and wealth taxes specifically)
No reversal of existing reforms; nor a reversal of public sector pay cuts	No requirement of further funding
No large scale fiscal expansion but limited increase in spending for humanitarian reason (potentially partly funded by structural funds)	Lower primary surplus targets for Greece in coming years

Source: RBS

UK: Sizeable supply despite buybacks

Simon Peck

The UK data backdrop has softened, **but it's the ECB that is in play and behind the aggressive rally in Gilts**. We see risks that **Gilt outperformance continues** as part of the yield grab theme as the ECB embarks upon sovereign QE.

We still **see value in the 5y sector and hold 5s30s GBP steepeners boxed vs. USD**. Having entered at -26bp, currently -15bp, we target a box spread of +10bp.

Even with our **revised 0.13% 10y bund target, our macro model fair-value for 10y Gilts is still >2%**. 2F 2Y/5F 5Y steepeners make sense in our view, but we are cautious, now just 3bp away from our stop. Boxing vs. SEK looks attractive relative to GBP curve directionality and pays +3bp/3m in roll-down.

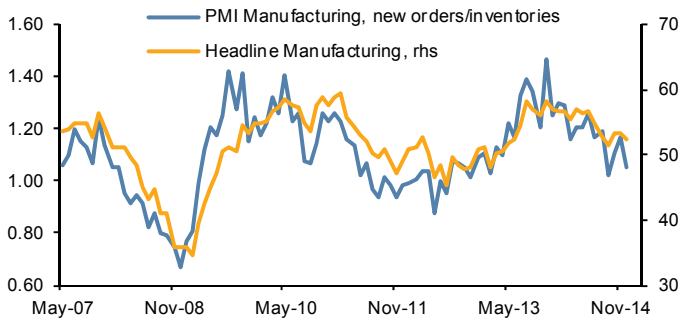
The BoE will complete **three re-investment buyback operations** in the week of 26th January, totalling £4.3bn, but **net supply remains sizeable** (£29m/bp in Jan) and is expected to add to steepening pressure.

The RBS forecast is for CPI inflation to fall to 0.6% in December – the lowest outturn since CPI became the inflation target in 2004 and, symbolically, prompting the first letter from the BoE Governor to the Chancellor.

Since writing our 2015 Year Ahead outlook just four weeks back, core European fixed-income markets have rallied aggressively. Gilts have been no exception, with 10y rallying -28bp (outperforming bunds by 11bp) as 10s30s bull flattened 5bp.

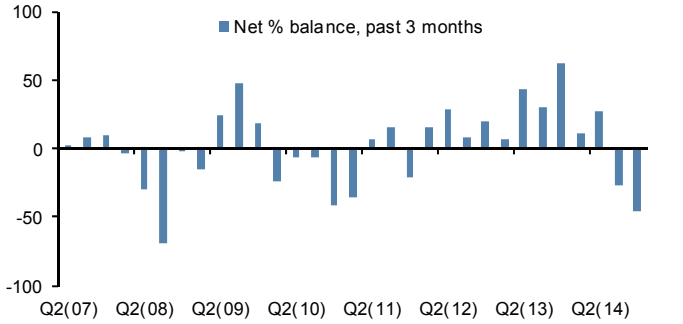
The **domestic data outlook has softened**, with **PMIs turning down** (composite measure -2.4pt to 55.2, manufacturing new orders/inventories ratio falling, indicating further weakness to come) as the **Bank of England Credit Conditions Survey** highlights that **demand for secured lending for house purchases decreased significantly** in Q4.

PMI Manufacturing (new ord/inv leads headline manufacturing)



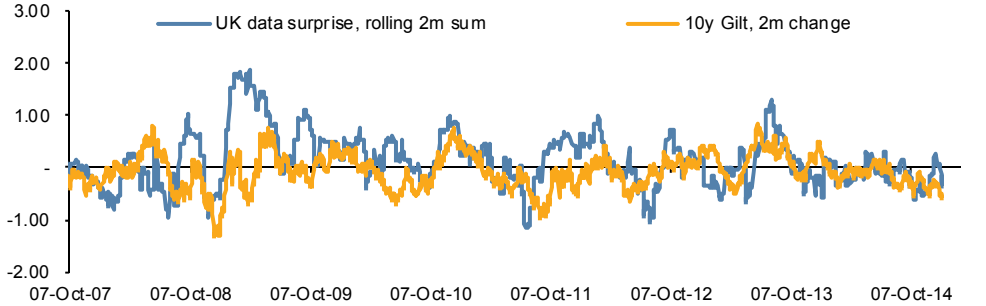
Source: Markit

Household demand for overall secured mortgage lending



Source: Bank of England Q4 (14) Credit Conditions Survey

Global yield suppression impact evident in Gilts vs. UK data surprise index



Source: Bloomberg, RBS

But it is the global disinflation backdrop and the rising prospect of ECB sovereign QE that explain most of the move and indeed hold the key to market price action in coming weeks. As the data surprise chart above depicts, the magnitude of the rally in 10y Gilts more than compensates for the disappointing run of data in recent weeks.

The yield suppression impact of rising demand for bunds (partly QE led, but also aided by Greek political risk) and the limited supply (RBS forecast just £3bn of net bund issuance in 2015) is likely to further bolster relative yield grab demand for Gilts in coming weeks.

Our preliminary UK GDP Tracker estimate for Q4 2014 predicts growth to slow to 0.6% q/q in Q4 2014, down from 0.7% in Q3. See Ross Walkers UK GDP Tracker here.

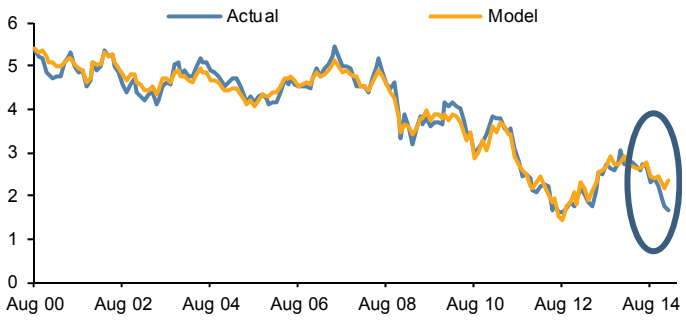
As discussed in the Euro-section of this document, **we expect €500bn of EGB QE (split by ECB capital key) to be announced at the 22nd January ECB meeting** and see risks that bunds rally as much as another 25bp (our recently revised 10y bund target is now just 0.13%). Against such a backdrop there is scope for Gilts to further outperform in the near term.

We noted in our Year Ahead outlook that "*we expect 10y Gilts/bunds to be wider in 12 months time, but see risks that +100bp is tested before new wides are reached*" and we maintain this view.

From a domestic perspective, the big focus for 2015 is the May General Election. Between now and 7th May we believe that term premia will need to rise in accordance with heightened political uncertainty. As our economist Ross Walker discusses in UK Politics – Pre-Election Primer, the outcome is too close to call and the most striking feature of recent polling data is the poor combined performance of the two main parties.

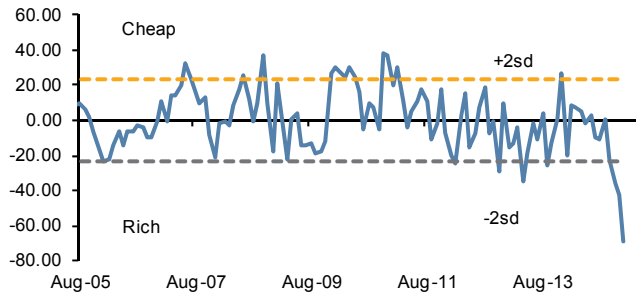
Even accounting for 10y bunds at 0.13%, the implied fair-value for 10y Gilts from our macro model is still 2.15%. So on current pricing that is to say the 10y sector appears 50-70bp too rich!

10y macro Gilt model:



Source: RBS

Regression Residual: extremely rich or regime shift in play?



Source: RBS

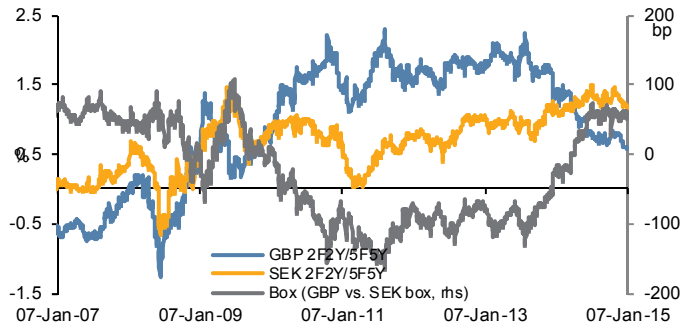
Our 2F 2Y/5F 5Y trade recommendation performed poorly during December, coming under flattening pressure as dovish ECB rhetoric bolstered demand for core fixed-income.

Currently at +58bp, we are near our +55bp stop. Fundamentally **we still believe in steepening into the election**, but as ever, timing is the challenging aspect. If stopped, we will not be rushing straight back into the trade, but we do anticipate some supply led steepening pressure, with the anticipated syndication of IL58's later this month.

One attractive cross market option is to hold the GBP 2F 2Y/ 5F 5Y steepener boxed vs. Sweden. As Par Magnusson highlights in the Scandinavia section of this publication, there are several reasons to believe in SEK bull steepening and even

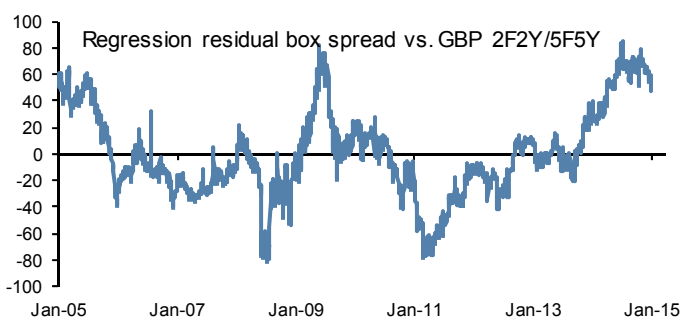
relative to the level of GBP 2F2Y/**5F5Y the cross market box spread looks 45bp too wide relative to the slope of the GBP curve**.

GBP 2F 2Y/5F 5Y steepener boxed vs. SEK



Source: RBS

Box spread regression residual vs. GBP curve



Source: RBS

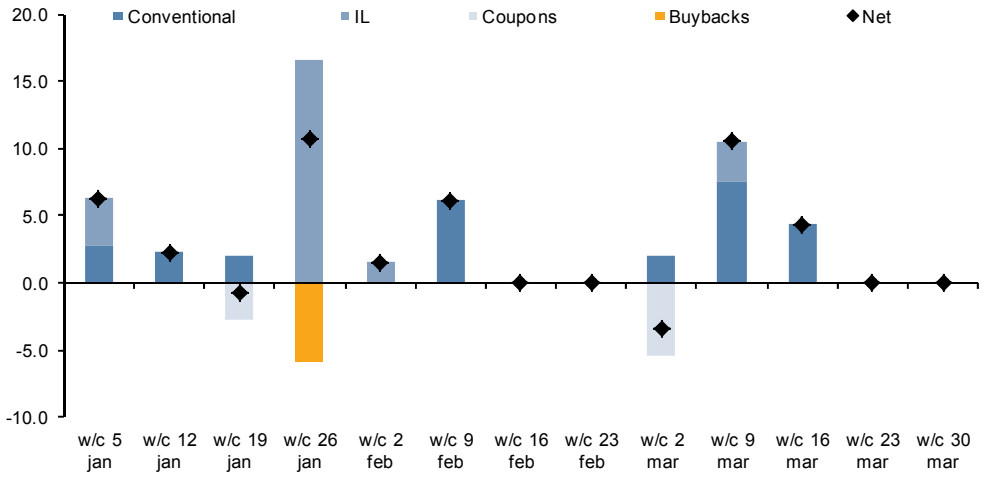
UKT 2.75% Jan-15 reinvestment and the Jan-Mar supply backdrop

As to be expected given the current protocol of re-investment at least until the time of the first rise in Bank Rate, the BoE has announced the re-investment of its QE APF holdings of the maturing 2T15.

Buybacks will take place in the week of 26th January, totalling £4.35bn and split into three equally sized operations of £1.45bn for each maturity sector; 3-7y, 7-15y and 15y+. The range of Gilts eligible for purchase will remain unchanged from previous operations and the BoE does not currently intend to purchase Gilts where the Bank holds more than 70% of the "free float".

In context of the January supply calendar, buybacks are only marginally supportive. In conjunction with coupons and redemptions (£2.6bn and £23.7bn respectively returned to the market) there is a tangible softening impact to the anticipated £18m/bp of risk stemming from the IL58 syndication, but nevertheless there is sizeable duration later in the month to be taken down.

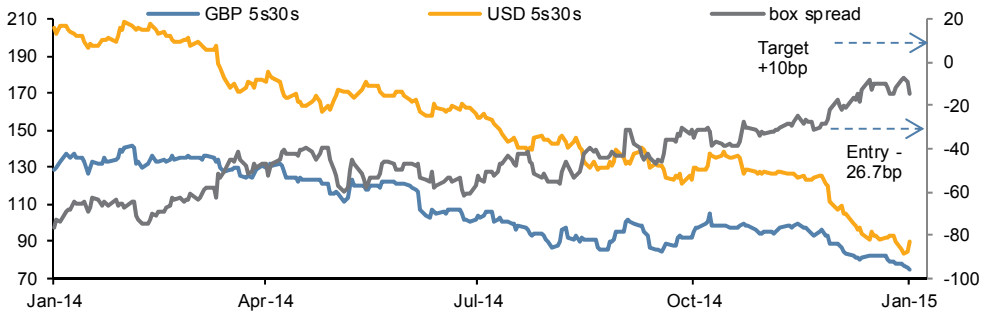
Net supply (£m/bp).



Source: UK DMO, Bank of England, RBS

As noted above, we like steepeners positioning for 10y underperformance, but also hold our 5s30s GBP steepener boxed vs. USD. This trade has performed well so far YTD (PnL of +11bp including carry and rolldown) and positions for a) a bullish front-end GBP bias; (b) a softer pace of BoE policy tightening vs. the Fed (leveraged UK household balance sheet and lower neutral rate etc) and (c) UK curve steepening pressures from rising issuance (RBS Gilt issuance forecast for 2015/16 is £166bn vs. £125.9bn current FY).

5s30s GBP steepener boxed vs. USD



Source: RBS

DMO issuance schedule (RBS size est)

	Bond	Risk £m/bp (est)
06-Jan-15	2¾% Treasury Gilt 2024	2.8
07-Jan-15	0⅛% Index-linked Treasury Gilt 2044	3.5
15-Jan-15	4½% Treasury Gilt 2034	2.3
20-Jan-15	2% Treasury Gilt 2020	2.0
27-Jan-15	0⅛% Index-linked Treasury Gilt 2058	16.6
04-Feb-15	0⅛% Index-linked Treasury Gilt 2024	1.5
12-Feb-15	3½% Treasury Gilt 2045	6.2
03-Mar-15	2% Treasury Gilt 2020	2.0
10-Mar-15	3½% Treasury Gilt 2068	7.5
12-Mar-15	1⅛% Index-linked Treasury Gilt 2037	3.0
19-Mar-15	New conventional 7 September 2025	4.3

Source: RBS

22nd January Gilt coupons

	Coupon	Nom Outst.	BoE hold	DMO hold	Free Float	TOTAL	To Market
2T15	2.75	28.81	4.08	1.03	23.70	0.40	0.33
2 16	2	32.47	7.98	1.56	22.93	0.32	0.23
1T 17	1.75	28.90	11.16	0.98	16.76	0.25	0.15
1Q 18	1.25	34.47	2.43	0.47	31.57	0.22	0.20
1T 19	1.75	30.21	2.18	0.41	27.62	0.26	0.24
2 20	2	12.33	0.00	0.00	12.33	0.12	0.12
3Q 44	3.25	27.05	1.83	0.36	24.86	0.44	0.40
3H 45	3.5	11.67	0.00	0.07	11.60	0.20	0.20
3T 52	3.75	21.96	6.64	0.59	14.73	0.41	0.28
4 60	4	20.97	7.43	0.89	12.65	0.42	0.25
3H 68	3.5	13.63	0.38	0.13	13.12	0.24	0.23
						£3.3bn	**£2.6bn**

Source: RBS

UK Gilt holdings data

	Nom. Out	BoE Hold	Latest Buybacks	DMO Holding	Free Float (bn)	Free Float (%)	Left to buy?	Operation day
2.75% 2015	28.81	4.08	-	1.03	23.7	85.3%	-	-
4.75% 2015	38.39	15.09	-	6.70	16.6	52.4%	-	-
8% 2015	10.50	4.72	-	3.29	2.5	34.5%	-	-
2% 2016	32.47	7.98	-	1.56	22.9	74.2%	-	-
4% 2016	35.11	11.04	-	5.92	18.1	62.2%	-	-
1.75% 2017	28.90	11.16	-	0.98	16.8	60.0%	-	-
8.75% 2017	11.03	4.58	-	3.65	2.8	37.9%	-	-
1% 2017	31.69	3.59	-	0.68	27.4	88.4%	-	-
5% 2018	34.86	15.69	-	5.83	13.3	46.0%	4.6	Mon
1.25% 2018	34.47	2.43	-	0.47	31.6	92.9%	21.4	Mon
4.5% 2019	35.96	17.32	-	2.69	16.0	47.9%	6.0	Mon
1.75% 2019	30.21	2.18	-	0.41	27.6	92.7%	18.7	Mon
3.75% 2019	28.43	11.49	-	1.36	15.6	57.6%	7.5	Mon
4.75% 2020	32.95	14.03	-	4.94	14.0	49.9%	5.6	Mon
2% 2020	12.33	0.00	-	0.00	12.3	100.0%	8.6	Mon
3.75% 2020	24.32	4.65	-	1.16	18.5	79.9%	11.6	Mon
8% 2021	23.82	11.28	-	7.42	5.1	31.2%	-	Mon
3.75% 2021	28.08	7.07	-	1.20	19.8	73.7%	11.7	Mon
4% 2022	37.54	23.27	-	1.52	12.8	35.4%	1.9	Wed
1.75% 2022	28.74	3.17	-	0.50	25.1	88.8%	16.6	Wed
2.25% 2023	27.18	2.22	-	0.38	24.6	91.7%	16.5	Wed
2.75% 2024	26.63	1.68	-	0.14	24.8	93.6%	16.9	Wed
5% 2025	34.70	17.01	-	7.11	10.6	38.4%	2.3	Wed
4.25% 2027	30.67	17.14	-	5.33	8.2	32.4%	0.6	Wed
6% 2028	18.82	8.07	-	5.38	5.4	40.0%	1.3	Wed
4.75% 2030	31.53	12.81	-	4.58	14.1	52.5%	6.1	Tue
4.25% 2032	35.06	14.49	-	7.48	13.1	47.5%	4.8	Tue
4.5% 2034	28.05	8.11	-	1.09	18.9	69.9%	10.8	Tue
4.25% 2036	26.30	5.94	-	6.40	14.0	70.2%	8.0	Tue
4.75% 2038	24.93	8.09	-	6.45	10.4	56.2%	4.8	Tue
4.25% 2039	19.54	6.54	-	0.93	12.1	64.9%	6.5	Tue
4.25% 2040	24.58	7.46	-	1.13	16.0	68.2%	9.0	Tue
4.5% 2042	26.35	7.25	-	5.22	13.9	65.7%	7.5	Tue
3.25% 2044	27.05	1.83	-	0.36	24.9	93.1%	16.9	Tue
3.50% 2045	11.67	0.00	-	0.07	11.6	100.0%	-	Tue
4.25% 2046	21.15	4.98	-	5.01	11.2	69.2%	6.3	Tue
4.25% 2049	19.56	5.21	-	2.25	12.1	69.9%	6.9	Tue
3.75% 2052	21.96	6.64	-	0.59	14.7	68.9%	8.3	Tue
4.25% 2055	23.73	8.15	-	5.28	10.3	55.8%	4.8	Tue
4% 2060	20.97	7.43	-	0.89	12.6	63.0%	6.6	Tue
3.5% 2068	13.63	0.38	-	0.13	13.1	97.2%	9.1	Tue

Source: RBS, Bank of England, UK DMO

Scandinavia

Par Magnusson

Absolutely bullish Sweden and Denmark, relatively bearish Norway

The Riksbank will deploy non-standard measures to combat declining inflation expectations, but when? They may cut the policy rate and/or initiate QE in February, but caution prescribes positioning for such actions that could well be taken sometime during H1 rather than specifically in February. I remain bullish SEK rates, and my preferred way to position for a bull market right now is to enter a 5-10yr box trade positioning for a relatively flatter SEK curve vis-à-vis the GBP curve in that segment. I also recommend buying 10yr Danish government bonds as an alternative to Bunds. Danish bonds have proven a decent hedge in times of EMU turmoil and the carry is better in Denmark than in Bunds. In Norway dovish expectations are stretched relative to Sweden and the UK. I like being paid JUN15 NOK FRA vs. being received the equivalent GBP FRA.

In the Year Ahead 2015 published a month ago I laid out my baseline view on how I think the market will work out this year. My main points can be summarised as:

1.) Central Banks in Japanified economies such as Sweden, the EMU and Japan will continue to do everything they can to push up inflation. Expect maximum expansionary monetary policy

2.) The UK is more likely to follow in the footpath of Europe than USA. The UK is still a market where rate hikes will be removed from market prices

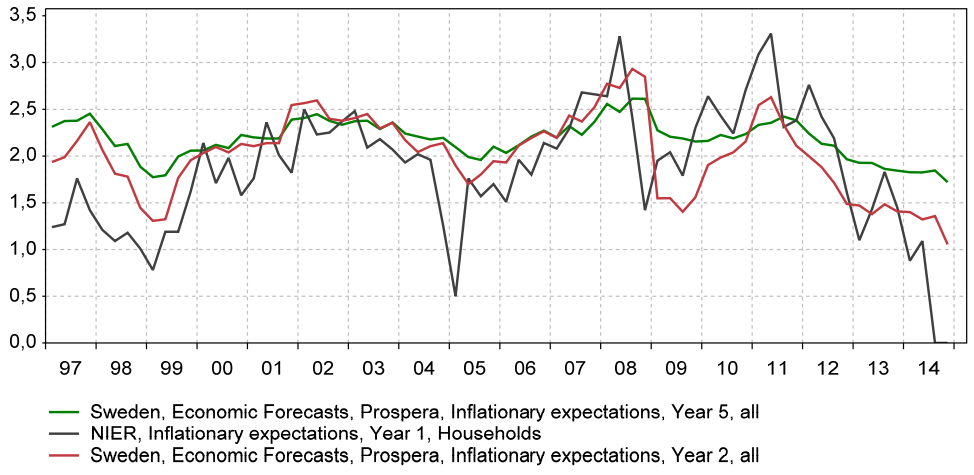
3.) Even if the USA is best in class among the majors, there are still great impediments to hiking as much as the market expects. The USD appreciation is one obvious factor that has tightened monetary conditions in the USA, but I also maintain my main reservations against premature policy hikes, which are that risk-reward dictates tightening too little, too late rather than too much, too soon, and that a higher discount rate may trigger an asset price recession

4.) Traders will be very wary about losing money in short positions. Negative carry especially in the USD market is costly, and losses will be difficult to recover in a low absolute returns and low volatility environment. Carry positions are attractive. Short covering will be a looming danger

5.) Political risk is high. Likely higher than what the market discounts. I find the spread between 2yr Greece and 2yr Portugal strangely wide. If Greece exits the EMU I find it hard to believe that any “firewalls” will prevent severe turmoil among other peripheral EMU markets. China, Russia and USD-funding and commodity-dependent Emerging Markets may also cause trouble for the market. This is safe haven bond bullish.

My views have not changed and I maintain my long-held bullish view on yields in general, and Swedish yields in particular. In my opinion it is just a matter of time before the Riksbank embarks on some form of non-standard measure. The minutes published earlier today showed a virtually unanimous Riksbank MPC in terms of non-standard measure preparedness. If inflation and inflation expectations continue to remain far too low, the Riksbank will be ready to act. The latest readings for inflation expectations over the next 1, 2 and 5 years all show all-time low levels.

Swedish inflation expectations at all-time lows



Source: Ecowin

It has also become quite clear that there is a rather strong resistance to FX intervention as a first course of action. All MPC members have expressed a preference for a negative policy rate and/or some form of QE before implementing some form of FX intervention.

While I personally find the academic case for an FX intervention stronger than for a negative policy rate or QE in Sweden, I must concede that the Riksbank MPC does not seem to be in agreement. A rate cut into negative territory and/or a QE announcement seem like plausible measures at the next few meetings.

I am quite uncertain about whether the Riksbank will act at its next meeting in February or wait until April. On the one hand there should already be ample arguments for a more aggressive monetary policy in Sweden, and if the ECB embarks on QE at its next meeting moral suasion may push the Riksbank to do the same in February. Moreover, the Greek election may have created a more dangerous economic and financial situation by mid-February, so that could trigger a more aggressive policy by the Riksbank.

But on the other hand there is very little new data out since the December meeting. The January inflation data, which is an important data point partly due to their revealingpotentially deflationary basket substitution effects, will not be published until after the February policy meeting. If they didn't cut in December, why should they cut in February when there is so little new information?

Opting for caution I prefer positioning for a more aggressive Riksbank policy by April or June. A February rate cut and/or QE will lower money market rates in the JUN15 contracts as well, so I prefer focussing on those. I still see good value in selling the JUN15 SEK FRA outright at 0.21%. That is only 5bp below the current 3m STIBOR fixing, and should the Riksbank cut its policy rate or push more cash into the bank sector via QE the interbank rates should come down more than that.

My colleagues in EUR rates strategy have moved their Bund target all the way down to 0.13%, and I would argue that the 10yr SGB yield could fall even more in terms of basis points.

The 10yr SGB-Bund spread is currently 35bp and the 10yr SEK-EUR swap spread is 40bp, and both the facts that the scope for lower yield mathematically is greater in SGB and the higher carry is in SGB relative to Bunds speak in favour of being long 10yr SGB.

10yr is my favourite part of the Swedish curve and I see a good case for a flatter 5-10yr segment in the SEK curve. Indeed, I find the fact that the 5-10yr segment is 20bp steeper in SEK rates than in GBP rates interesting. In a rates-bullish scenario there we should see the 5-10yr part of the SEK curve bull flatten, whereas there is a much greater chance for a bull steepening in the GBP curve than in the SEK curve.

Entering a 5-10yr SEK-GBP box trade where one positions for a relatively flatter SEK curve will bring a positive carry near 1bp/month to boot.

New recommendation: Rec 10yr SEK and pay 5yr SEK at the same time as you pay 10yr GBP and rec 5yr GBP at a box spread of 20bp. P/L: 0/30

The 5-10yr segment in the SEK curve is too steep relative the GBP curve

Source: Ecowin

As noted above, I remain concerned about the economic-political risk in the EMU and the upcoming Greek election on 25 January could be the first major flash point. Judging by current opinion polls Syriza looks like the next governing party and that likely spells trouble for the agreements made by Greece and the so-called Troika.

My colleagues covering EUR rates will elaborate on this further, so I shall restrict myself to pointing out that it is a very significant risk to financial stability in the EMU.

The question of how to hedge oneself against renewed EMU turmoil is something that weighs heavily on many investors. At least a hedge that does not cost a great deal in terms of negative carry or has to combat potential ECB OMT.

In a situation where one wants to be long safe-haven bonds that are a Bund substitute, but at the same time not own a financial asset that implicitly could be saddled with a mutualisation of EMU government debt, I think Danish government bonds are attractive.

The Danish bond market has worked as something of a hedge against EMU turmoil on earlier occasions due to its properties as a safe haven bond market with a currency peg to the EUR (implicitly to a DEM or “Northern EUR” if it would come to that), but at the same time not a member of the single currency grouping with the potential fiscal obligations that could ensue from such a membership.

Also, if potential EMU turmoil should arise we have previously seen that there has been appreciation pressure on the DKK, which forced the Danish central bank to intervene by lowering its policy rate. Such a scenario would obviously be bullish Danish government bonds. Consequently, I see good value in buying the 10yr DGB at a level 30bp above the 10yr Bund as an alternative.

Finally, a few words on the Norwegian market. The rout we experienced in the NOK market on 16 December was a dear lesson to NOK FX bulls like myself. The NOK is a very dangerous currency to take positions in when the oil price is in free fall and Norges Bank surprises the market. Still, even though the Norwegian market has been highly volatile over the past month, I think there is relative value to be had in trades involving a NOK leg.

The 3M NOK FRA JUN15 currently trades at a screen price of 0.98% which implies close to 50bp lower Norwegian policy rate during H1 2015. I think such a valuation offers good risk-reward to be paid NOK by buying the JUN15 FRA contract. Admittedly, Norges Bank could decide to cut the policy rate by another 50bp if the oil price continues to plummet and/or there is some sort of international financial turbulence, but barring that I do not see Norges Bank cutting more than that so soon.

On the contrary, given the fact that the NOK currency is 5% weaker than forecast by Norges Bank in its forecast update from December, the monetary conditions are already more expansive than expected. In my view it would probably take a disaster for Norges Bank to cut by more than the 50bp that is discounted already.

Norwegian monetary policy expectations are very stretched given the weak NOK

Source: Ecowin

However, since disasters do happen it may be more prudent to buy the JUN15 NOK FRA in a spread trade against selling the JUN15 SEK FRA, or why not the equivalent GBP FRA that is currently discounting a 7bp higher British policy rate? My preference is the spread against the GBP FRA.

Volatility

Clement Mary Dauphin

Giles Gale

Volatility to follow the yield crush

QE is coming, yields are being crushed and implied volatility should soon follow. The global fixed income rally between late December and early January has taken yields to fresh lows in Europe and we believe there is potential for them to go even lower. Political uncertainty and QE anticipation has delayed the move in implied volatility. We believe that Greece is not the menace it once was and that memories of 2011/2 are a poor guide to risks now. Investors should be prepared for a crush in rates volatility.

Global risk event calendar

EUR: The EUR Volatility market is divided between expectations of a volatility crush coming from ECB's quantitative easing and the nervousness around the risks surrounding the Greek political situation, and to a lesser extent QE design. While underlying rates are much lower than they were a month ago, implied volatility is higher. This is true for short dated expiry as the market wants to be protected against brutal realised volatility, but this is also true for the belly of the surface. Within a month the 5y5y forward swap has declined by almost 0.40% while the implied volatility is 1.50bp normalised higher. We reiterate our bearish view on 5y5y EUR volatility.

CMS monitor

UK: Since the beginning of the year the GBP market is trading very similar to December last year with a strong receiving interest at the long end of the curve. At the time of writing our Year Ahead 2015, we were comfortable with selling low strikes on 30y underlying as we thought that we had reached a floor level. We viewed the UK in a different light to the Euro Area. A big step up in gilt supply and political uncertainty was to weigh more heavily. We also believed that supply and domestic political uncertainty would give a lift to GBP yield in 2015. Early year trading has been as squeezy as December and has put our recommendations in low strikes under serious pressure. With serious duration coming at the end of the month with IL58s, we hold on for now.

Rates option flows monitor

Very light volume in EUR this week while volumes similar to last year are going through in USD.

Vol grid and weekly changes

Global Risk Event Calendar

Global risk event calendar

Date	Holiday?	Event	Qualitative Risk Weight (1-5)	Remarks	Expiry
08-Jan-15			3		
09-Jan-15		US Payrolls	2		
12-Jan-15					
13-Jan-15					
14-Jan-15					
15-Jan-15					
16-Jan-15		US CPI			**1w**
19-Jan-15	US				
20-Jan-15					
21-Jan-15		BOE Minutes			
22-Jan-15		ECB press conference	3		
23-Jan-15					**2w**
26-Jan-15	Australia	1st Results from Greek Elections			
27-Jan-15		US Durable goods			
28-Jan-15		FOMC decision	3		
29-Jan-15					
30-Jan-15					
		February			
02-Feb-15					
03-Feb-15					
04-Feb-15					
05-Feb-15					
06-Feb-15		US Payrolls	2		
09-Feb-15					**1m**
10-Feb-15					
11-Feb-15		BoE Inflation Report	2		
12-Feb-15					
13-Feb-15					
16-Feb-15	US Canada				
17-Feb-15					
18-Feb-15		BOE Minutes			
19-Feb-15					
20-Feb-15					
23-Feb-15					
24-Feb-15					
25-Feb-15					
26-Feb-15		US CPI US Durable Goods			
27-Feb-15					
		March			
02-Mar-15					
03-Mar-15					
04-Mar-15					
05-Mar-15		ECB press conference	3		

09-Mar-15			**2m**
10-Mar-15			
11-Mar-15			
12-Mar-15			
13-Mar-15			
16-Mar-15			
17-Mar-15			
18-Mar-15	FOMC decision + Press conference BOE minutes	3	
19-Mar-15			
20-Mar-15			
23-Mar-15	Result of Swedish Snap Election	2	
24-Mar-15	US CPI		
25-Mar-15	US Durable goods		
26-Mar-15			
27-Mar-15			
30-Mar-15			
31-Mar-15			
	April		
01-Apr-15			
02-Apr-15			
03-Apr-15			
06-Apr-15			
07-Apr-15			
08-Apr-15			
09-Apr-15	MPC Meeting	3	**3m**
10-Apr-15			
13-Apr-15			
14-Apr-15			
15-Apr-15	ECB press conference	3	
16-Apr-15			
17-Apr-15			
20-Apr-15			
21-Apr-15			
22-Apr-15	BOE Minutes		
23-Apr-15			
24-Apr-15			
27-Apr-15			
28-Apr-15			
29-Apr-15	FOMC Decision+Press Conference		
30-Apr-15			
	Later in 2015		
07-May-15	UK General Election		
between 20-Sep-15 and 11-Oct-15	Portuguese Legislative Election		
20-Dec-15	Spanish General Election (Deadline date)		

Source: Bloomberg, RBS

Euro Area

EUR Gamma bid, Stay short 5y5y.

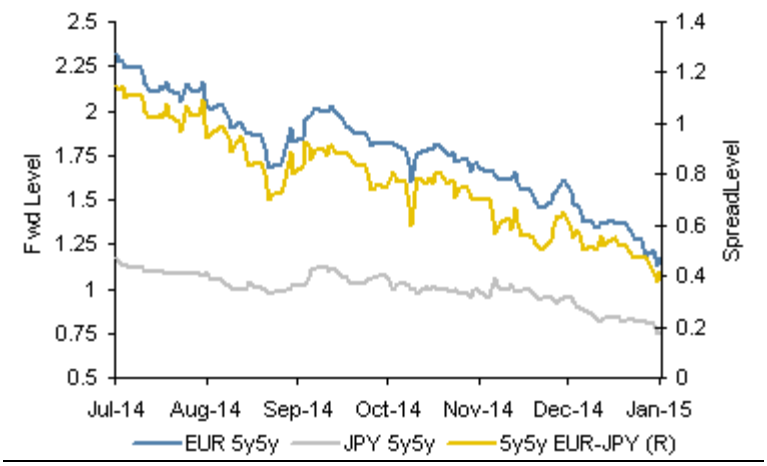
EUR Market has been rocked by the Greek political situation and the uncertainty around the outcome of the General election taking place on the 25th of January. This lifted short dated expiry options. At the same time, the curve has been flattening dramatically led by some good receiving flow in the back end of the curve as the yield grab continues. This led to a 5% jump in 30y swap realised volatility. As a consequence the top-right corner of the EUR surface has been very well bid.

We have updated our Bund target to 0.13% and we believe that as the market keeps rallying, the curve should flatten more.

Trade Update: Stay Short 5y5y Geared collar.

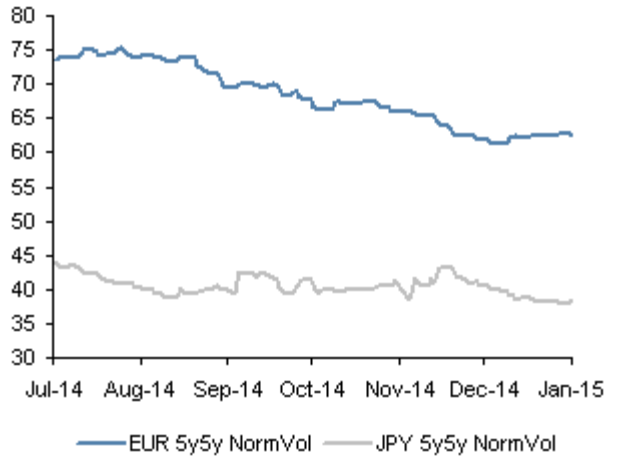
In our Year Ahead 2015 our strongest conviction was for a Japanification of the EUR yield curve and volatility surface. We believed EUR 5y5y forward would converge with JPY 5y5y. At the time of recommending the trade, the EUR 5y5y forward was 1.54% against 0.96% in JPY. The forwards are now 1.17% and 0.72% respectively and the spread is now 0.13% tighter.

EUR – JPY 5y5y Forward convergence



Source: RBS

EUR JPY Normalised Volatilities



Source: RBS

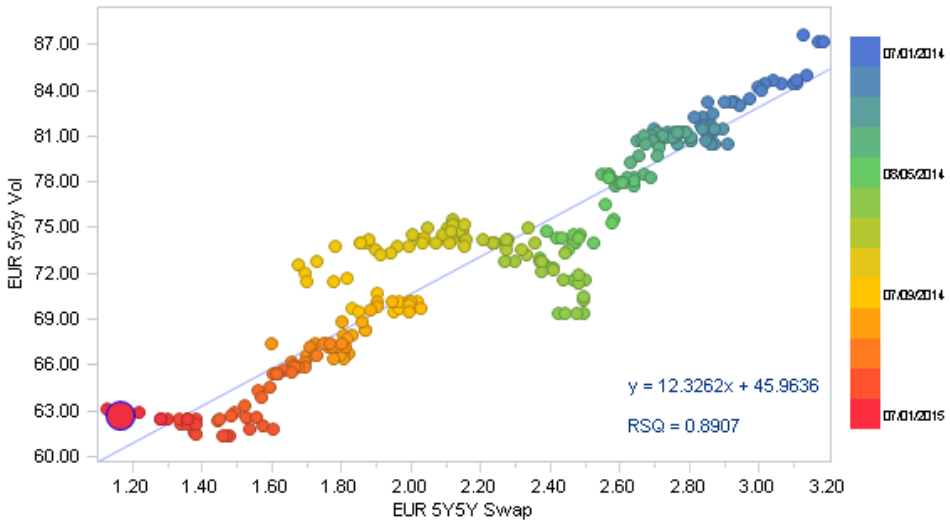
It would be immodest to say we thought the move would happen that quickly but our conviction was nonetheless very strong regarding the direction 5y5y would take. This week we have updated our bund target to 0.13% as we believe that the EUR curve is now following its own dynamic and we might see levels never seen even in JPY.

The trade we recommended in our Year Ahead was done at zero cost. We were buying a slightly in the money 5y5y receiver with a strike at 1.58% and selling the payer with a strike set at 2.38% in twice the notional. This trade is now making 180 bp profit. In line with our revised bund target, we hold this trade. If your conviction isn't that strong and think most of the move has happened, bear in mind there are another potential 100 bp to grab in roll down in the next 12 month if rates stay at current levels.

As our conviction remains strong we recommend initiating new trades at current rates levels. On the volatility front we are still bearish on 5y5y sector in EUR, and as you can see from the second chart above 5y5y volatility is slightly higher than it was in December 2014; this is mostly due to higher gamma on the back of the Greek political instability. This leveraged collar trade has the double advantage of being short volatility

and long rates. Some of the rate move has already happened but the volatility has been lagging, so even at present levels we believe the trade still has some juice given that volatility has some catch up to do.

EUR 5y5y Normalised volatility regressed over 5y5y forward level



Source: RBS

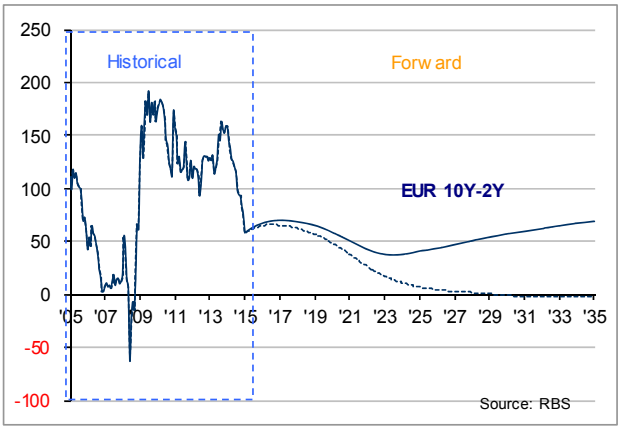
From the simple linear regression above we could imply that 5y5y should have come down by 4.5 normalised vol, to reflect the recent rally in the forward.

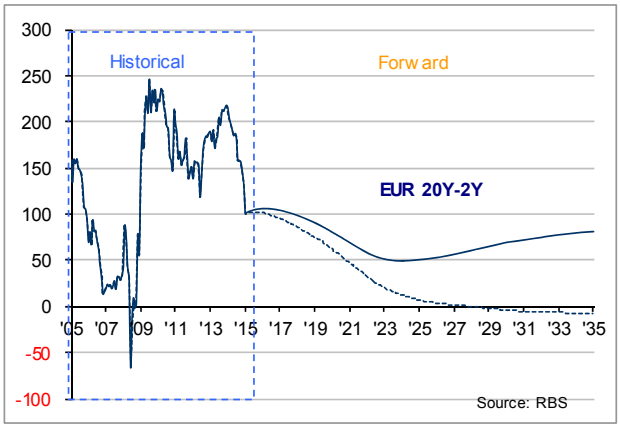
CMS Monitor Update.

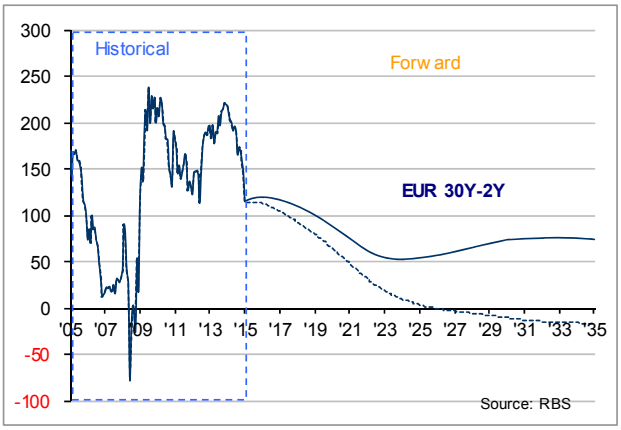
Given the recent flattening of the EUR curve we are updating our CMS monitor. Most of the flattening move happened in spot space while the spreads in forward space are slightly steeper. Please find our CMS Monitor update at the end of the volatility section.

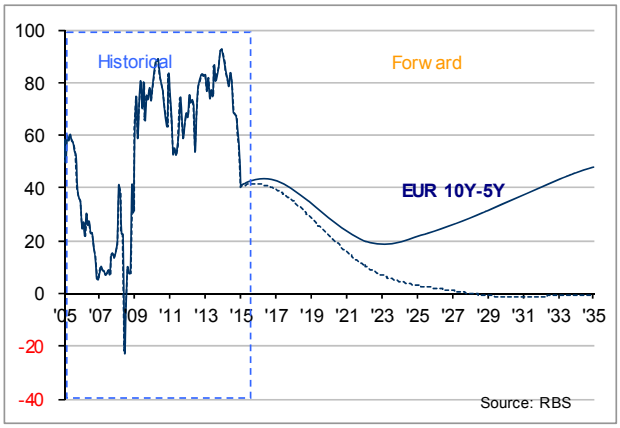
EUR CMS Spreads - Historical and Forward Levels **09-Jan-15**

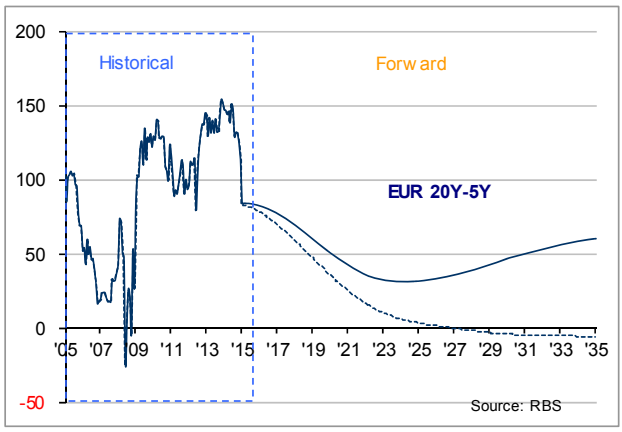
Convexity Adjusted Fwd
Unadjusted Fwd











Spread	10y-2y
Most recent inversion	Sep-08
Fwd Inversion	NO
Inversion Risk	LOW

Comment

Historically popular swap pair embedded in range accrual and leveraged Steepener notes. Positions in 2s10s spread option are smaller now, but are still causing a inverted correlation term structure after 10y maturity (buying flow of 10y-2y 0.00% strike floor pushes the spread volatility up and correlation down). We see a low risk of inversion in the short to medium term as we believe the front end of the EUR curve will remain at low levels due to weak growth and inflation.

Spread	20y-2y
Most recent inversion	Sep-08
Fwd Inversion	NO
Inversion Risk	LOW

Comment

Another popular spread among investors, 20y-2y does have similar properties to 10y-2y. The correlation term structure is also distorted by market position even if once again positions are lighter than they use to be.
Insurers are under less pressure to receive the long end of the curve however we expect the need for yield grab will cause the curve to flatten as the rally continues. Nevetheless we maintain our view that the inversion potential is low given the absolute level of 2y swap

Spread	30y-5y
Most recent inversion	Dec-08
Fwd Inversion	NO
Inversion Risk	LOW

Comment

30y-5y swap pair positioning is relatively low, and doesn't exhibit the same extent of distortion as other pairs. 30y-5y forwards are flatter than 20y-2y, which makes it comparatively more attractive as a yield enhancement product. In our view, inversion risk is remains low because of the yield crush at the front of the EUR curve

Spread	30y-10y
Most recent inversion	Feb-09
Fwd Inversion	NO
Inversion Risk	MILD

Comment

More popular than 30y-5y, 30y-10y forwards are unsurprisingly even flatter. This works in favour of yield enhancement, however the relatively high correlation does mitigate a bit this relative pickup in a range accrual format. Our view is that the 30y-10y spread will remain steep in the foreseeable future. However we would qualify the inversion risk as mild given 30y-10y has been more inverted and for a longer period of time than the other spreads above. We also have the view that 10s30s spread will flatten in a rally and the yield grab continues

Historical Forward CMS spreads as of 09-Jan-15

Steeper
100
50
20
0
-5
-30
Flatter

FwdStart	Historical	2s10s	2s20s	2s30s	5s10s	5s20s	5s30s	10s20s	10s30s
2y	0d	69	103	116	42	76	89	34	46
	3m Ago	112	158	165	66	111	119	46	53
	6m Ago	132	175	179	72	115	118	43	46
	1y Ago	138	165	161	66	94	90	28	24
	2y Ago	134	169	174	69	105	110	36	40
	5y Ago	103	127	112	50	73	59	24	9
5y	0d	58	80	88	28	50	58	22	29
	3m Ago	86	104	106	40	58	60	19	20
	6m Ago	88	99	97	41	52	49	11	9
	1y Ago	74	73	66	31	31	24	-1	-7
	2y Ago	79	84	88	36	41	45	5	9
	5y Ago	59	56	40	32	29	14	-3	-19
10y	0d	42	51	55	22	31	35	10	13
	3m Ago	39	40	42	20	20	23	0	3
	6m Ago	35	21	15	15	1	-5	-14	-20
	1y Ago	14	2	-0	1	-11	-14	-12	-14
	2y Ago	12	6	21	1	-5	10	-7	9
	5y Ago	16	-9	-21	2	-22	-35	-24	-36
20y	0d	70	83	75	49	61	54	13	5
	3m Ago	42	51	58	36	45	52	9	16
	6m Ago	40	37	32	32	28	23	-3	-8
	1y Ago	20	30	33	14	24	27	11	14
	2y Ago	22	54	80	16	48	74	33	58
	5y Ago	-1	-4	30	1	-2	32	-3	31
30y	0d	81	43	56	63	26	38	-37	-25
	3m Ago	45	26	42	39	20	35	-19	-4
	6m Ago	47	29	38	32	15	24	-18	-8
	1y Ago	63	91	92	41	68	70	27	28
	2y Ago	64	95	112	40	71	88	31	48
	5y Ago	34	86	107	25	76	97	51	73

Source: RBS

This table shows the historical level of the forward spreads. It highlights the historical evolution of a given index and a sense of its historical range.

Forward CMS Spreads zScores

Steeper
2
1
-1
-2
Flatter

FwdStart	zScore	2s10s	2s20s	2s30s	5s10s	5s20s	5s30s	10s20s	10s30s
2y	6m	-3.21	-3.96	-3.94	-5.00	-6.10	-4.79	-4.00	-0.85
	1y	-3.57	-4.86	-4.86	-5.94	-4.10	-1.93	-0.84	0.40
	2y	-4.51	-5.00	-3.96	-5.35	-2.47	-1.01	-0.13	0.88
	5y	-2.68	-1.60	-0.61	-1.36	-0.26	0.48	0.84	1.43
5y	6m	-8.27	-5.00	-2.39	-9.36	-1.65	0.02	1.13	1.62
	1y	-4.94	-1.15	-0.27	-3.33	0.16	0.82	1.46	1.84
	2y	-3.23	-0.34	0.22	-2.15	0.70	1.18	1.94	2.26
	5y	-0.52	0.76	1.04	-0.63	1.33	1.51	2.31	2.08
10y	6m	0.59	1.65	1.63	0.69	1.66	1.63	1.97	1.80
	1y	1.16	1.99	2.07	1.26	2.16	2.21	2.95	2.71
	2y	1.79	2.63	2.51	1.88	2.76	2.41	3.15	1.61
	5y	1.86	2.91	2.30	2.00	2.71	1.95	1.98	1.25
20y	6m	3.79	2.95	1.86	2.44	1.95	0.93	0.91	-0.21
	1y	2.83	2.76	2.20	2.15	2.17	1.39	1.00	-0.49
	2y	3.79	3.00	1.01	2.92	2.12	0.31	-0.22	-0.98
	5y	3.03	1.45	0.30	2.61	1.00	-0.25	-0.38	-1.55
30y	6m	2.75	1.96	1.45	2.72	2.07	1.10	-1.88	-2.80
	1y	1.87	-0.33	-0.28	2.66	-0.42	-0.37	-1.60	-1.77
	2y	1.04	-1.06	-0.99	1.85	-1.14	-1.05	-2.14	-1.91
	5y	0.28	-1.77	-1.63	1.19	-1.84	-1.66	-2.89	-2.24

Source: RBS

zScores are an easy way to rank the level of the different spreads compared to their own history. It shows which spreads are steep or flat on an historical basis.

Term Structure of Implied correlation versus realised correlation

	Maturity	2s10s	2s20s	2s30s	5s10s	5s20s	5s30s	10s20s	10s30s
	Realised*	83%	72%	67%	96%	88%	83%	95%	91%
Implied ATM Correlations	6m	65%	53%	41%	92%	76%	57%	92%	82%
	1y	71%	59%	46%	93%	78%	60%	93%	85%
	2y	81%	70%	60%	93%	82%	69%	94%	89%
	3y	85%	76%	67%	94%	86%	76%	95%	90%
	4y	85%	78%	70%	94%	87%	78%	95%	91%
	5y	86%	80%	74%	95%	88%	81%	95%	92%
	10y	80%	78%	76%	94%	86%	82%	93%	91%
	20y	77%	77%	77%	93%	84%	80%	92%	89%

**Realised correlation is calculated as the 5y average of 180days rolling window* *Source: RBS*

Implied Correlation has an inverse relationship with spread volatility (a high correlation is associated with low spread volatility). A note where the coupon accrues daily as long as the curve is steeper than a given boundary, the note buyer is selling selling spread volatility. The higher the spread volatility (lower correlation) the higher the yield enhancement

UK

December 2014 continues

The GBP market continues to trade at very similar levels to December last year, with strong receiving interest at the long end of the curve. At the time of writing our Year Ahead we were comfortable with selling low strikes on 30y underlying. We expected much increased supply together with the general election (where the only relative certainty in our view is fiscal slippage whoever wins). Market moves have proved us wrong so far. As such, we are putting some of our trade on the watch list. For now we hold on. The supply story will have an early test in two weeks with IL58s.

Trade Update: 30y Low strikes structure on watch list. Given the recent moves in the sterling long end, we are going to keep a close eye on the two trades involving 30y low strikes that we recommended in our Year Ahead and we will reconsider them at the end of the month once supply has started. As a reminder, we recommended buying 1y30y 100 basis point wide collar and buying 1y30y 1x2 receiver spread (buying the ATM strike and selling the ATM-35bp receiver in twice the notional).

Top left volatility richness: In our Year Ahead we recommended to sell front end cap floor volatility as we have a strong conviction that the front end of the curve is going to remain very stable in GBP.

We also believe that the market is still too biased towards pricing rate hikes. In such an environment the 1y1y swaption straddle offers very low breakeven levels on the lower side of the rate spectrum.

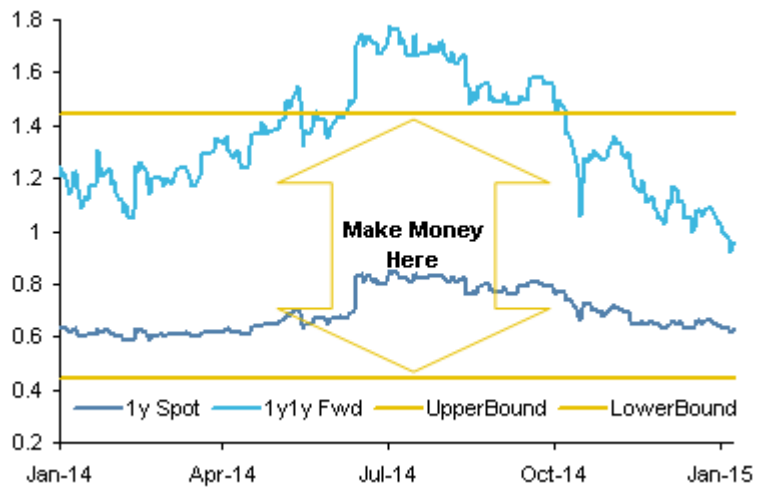
The straddle is worth 50bp upfront. By shorting it one would need 1y GBP swap to fix 0.50% under (or above) the strike, ie at 0.44% for the trade to lose money.

Trade Recommendation: Sell 1y1y ATM Straddle with 50% delta hedge

Sell 1y1y ATM Straddle with a 0.94% strike

With a 50% delta hedge the trade has a 35bp roll down in a year.

Short 1y1y GBP ATM swaption Straddle



Source: RBS

Rates options flows monitor

Over +40 OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	0	0	54	0	38	**92**
3m	0	0	0	0	0	0	0	**0**
6m	0	0	0	0	0	0	0	**0**
1y	0	0	0	50	27	0	113	**190**
2y	0	0	50	75	0	0	75	**200**
3y	0	0	0	0	120	25	0	**145**
5y	0	195	0	100	0	0	55	**350**
10y	0	0	0	0	50	22	0	**72**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**195**	**50**	**225**	**251**	**47**	**281**	**1,049**

Over +40 OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	0	500	232	0	157	**889**
3m	0	0	0	0	271	0	383	**654**
6m	0	366	0	0	184	0	204	**754**
1y	1,277	120	0	0	0	0	56	**1,453**
2y	0	0	446	30	134	2	27	**639**
3y	439	183	0	0	588	0	19	**1,229**
5y	0	0	0	192	340	180	140	**852**
10y	0	0	0	0	176	0	0	**176**
20y	0	0	0	0	0	0	0	**0**
Total	**1,716**	**669**	**446**	**722**	**1,925**	**182**	**986**	**6,646**

ATM to +40 OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	0	70	157	0	21	**248**
3m	0	0	0	0	100	25	73	**198**
6m	0	0	0	0	0	0	100	**100**
1y	0	0	0	0	0	0	50	**50**
2y	0	0	0	0	0	0	0	**0**
3y	0	0	0	0	0	0	0	**0**
5y	0	0	0	0	0	0	0	**0**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**0**	**0**	**70**	**257**	**25**	**244**	**596**

ATM to +40 OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	545	156	789	953	0	81	**2,524**
3m	780	366	0	0	310	0	0	**1,456**
6m	0	0	0	0	136	48	44	**228**
1y	499	139	0	0	39	0	48	**725**
2y	0	0	0	0	14	0	1	**15**
3y	0	0	0	0	70	0	0	**70**
5y	0	0	0	0	0	0	0	**0**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**1,279**	**1,050**	**156**	**789**	**1,522**	**48**	**174**	**5,018**

ATM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	200	582	1,174	3	27	**1,986**
3m	0	380	0	0	160	25	0	**565**
6m	0	0	0	0	17	0	0	**17**
1y	0	0	0	110	147	0	338	**595**
2y	0	0	0	0	0	0	0	**0**
3y	0	0	0	0	305	200	0	**505**
5y	0	240	0	38	20	0	40	**338**
10y	0	0	0	0	40	0	13	**53**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**620**	**200**	**730**	**1,863**	**228**	**418**	**4,059**

ATM	1y	2y	3y	5y	10y	20y	30y	Total
1m	2,494	1,754	332	566	2,631	0	314	**8,091**
3m	1,317	1,273	0	196	1,053	0	103	**3,942**
6m	10	10	0	108	664	0	163	**955**
1y	798	120	0	520	524	40	48	**2,050**
2y	1,158	0	0	104	162	0	0	**1,424**
3y	100	0	0	0	108	0	1	**209**
5y	0	0	0	0	216	0	0	**216**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**5,877**	**3,157**	**332**	**1,494**	**5,358**	**40**	**629**	**16,887**

-40bp OTM TO ATM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	0	0	88	0	0	**88**
3m	0	0	0	0	0	0	7	**7**
6m	0	0	0	0	0	0	0	**0**
1y	0	0	0	0	0	0	100	**100**
2y	0	0	0	0	0	0	0	**0**
3y	0	0	0	220	100	0	0	**320**
5y	0	0	0	0	0	0	5	**5**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**0**	**0**	**220**	**188**	**0**	**112**	**520**

-40bp OTM TO ATM	1y	2y	3y	5y	10y	20y	30y	Total
1m	878	0	96	0	430	0	58	**1,462**
3m	1,317	1,198	0	0	272	0	56	**2,843**
6m	0	0	0	96	116	0	0	**212**
1y	0	19	60	120	147	0	0	**346**
2y	0	0	0	0	52	48	48	**148**
3y	0	0	0	0	35	0	0	**35**
5y	0	0	0	0	120	32	0	**152**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**2,195**	**1,217**	**156**	**216**	**1,172**	**80**	**162**	**5,198**

UNDER -40bp OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	0	0	0	0	0	**0**
3m	0	0	0	0	0	0	0	**0**
6m	0	0	0	0	0	0	0	**0**
1y	0	0	0	0	0	0	100	**100**
2y	0	0	0	0	0	0	0	**0**
3y	0	0	0	74	352	0	0	**426**
5y	0	0	0	0	0	0	0	**0**
10y	0	0	0	0	0	0	0	**0**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**0**	**0**	**74**	**352**	**0**	**100**	**526**

UNDER -40bp OTM	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	6	68	0	0	0	**74**
3m	0	1,381	0	0	148	0	40	**1,569**
6m	0	0	0	0	320	0	48	**368**
1y	0	1,155	60	177	671	0	80	**2,143**
2y	0	0	0	0	0	0	0	**0**
3y	0	0	0	128	96	0	0	**224**
5y	0	0	0	0	0	80	0	**80**
10y	0	0	0	0	60	0	0	**60**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**2,536**	**66**	**373**	**1,295**	**80**	**168**	**4,518**

Total	1y	2y	3y	5y	10y	20y	30y	Total
1m	0	0	200	652	1,473	3	86	**2,414**
3m	0	380	0	0	260	50	80	**770**
6m	0	0	0	0	17	0	100	**117**
1y	0	0	0	160	174	0	701	**1,035**
2y	0	0	50	75	0	0	75	**200**
3y	0	0	0	294	877	225	0	**1,396**
5y	0	435	0	138	20	0	100	**693**
10y	0	0	0	0	90	22	13	**125**
20y	0	0	0	0	0	0	0	**0**
Total	**0**	**815**	**250**	**1,319**	**2,911**	**300**	**1,155**	**6,750**

Total	1y	2y	3y	5y	10y	20y	30y	Total
1m	3,372	2,299	590	1,923	4,246	0	610	**13,040**
3m	3,414	4,218	0	196	2,054	0	582	**10,464**
6m	10	376	0	204	1,420	48	459	**2,517**
1y	2,574	1,553	120	817	1,381	40	232	**6,717**
2y	1,158	0	446	134	362	50	76	**2,226**
3y	539	183	0	128	897	0	20	**1,767**
5y	0	0	0	192	676	292	140	**1,300**
10y	0	0	0	0	236	0	0	**236**
20y	0	0	0	0	0	0	0	**0**
Total	**11,067**	**8,629**	**1,156**	**3,594**	**11,272**	**430**	**2,119**	**38,267**

Vol grid and weekly changes

US ATM normvol grid (bp): one-week changes (left-hand chart) and Thursday EOD levels (right-hand chart)

USD	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	32.1	63.7	82.0	92.7	91.1	89.4	88.2	87.2	86.7	86.4	85.8
1m	30.8	61.3	78.7	88.9	87.4	85.8	84.6	83.7	83.2	82.9	82.3
2m	37.1	63.8	79.3	87.6	86.2	84.9	83.6	82.7	82.2	81.8	81.2
3m	41.9	66.0	79.6	86.1	84.9	83.8	82.5	81.5	81.0	80.6	79.9
6m	55.6	72.5	81.6	85.4	84.0	82.7	81.0	79.9	79.1	78.4	77.0
1y	74.1	83.2	86.6	88.0	86.2	84.2	81.8	80.1	78.9	77.8	75.7
2y	94.3	94.8	93.9	91.2	89.4	87.0	83.3	80.8	79.3	77.9	75.1
3y	102.2	99.4	97.3	92.9	90.9	88.1	83.1	80.2	78.8	77.5	74.9
5y	103.7	100.4	98.0	93.9	91.7	88.9	82.6	79.2	77.8	76.4	73.7
7y	100.5	97.3	95.4	92.0	89.5	86.3	79.8	76.3	74.9	73.4	70.7
10y	93.9	91.6	89.7	86.1	83.6	80.5	74.1	70.7	69.1	67.7	65.1
15y	79.7	77.0	76.0	73.8	72.2	70.2	64.6	61.5	60.2	59.0	56.7
20y	70.4	68.3	67.4	65.7	64.3	62.5	57.4	54.6	53.6	52.6	50.3
30y	64.5	63.0	62.3	61.2	59.7	58.0	53.4	50.9	49.8	48.7	51.1

USD	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	2.8	8.1	16.0	23.5	23.7	23.9	24.1	24.3	24.4	24.6	24.9
1m	-0.7	1.1	7.3	14.1	14.6	15.0	15.3	15.6	15.8	16.1	16.5
2m	-0.4	0.1	5.3	10.4	11.6	12.8	13.1	13.4	13.7	13.9	14.4
3m	-1.9	-1.5	2.7	6.3	8.3	10.2	10.6	11.0	11.2	11.5	12.0
6m	-2.1	-2.1	1.4	3.1	5.0	6.8	7.2	7.4	7.7	8.0	8.5
1y	-1.8	-1.7	0.8	2.1	3.3	4.6	5.0	5.3	5.5	5.8	6.3
2y	-2.9	-1.4	-0.2	2.0	2.7	3.7	3.9	4.1	4.2	4.4	4.7
3y	0.5	0.8	0.9	1.1	1.8	2.7	3.0	3.2	3.3	3.4	3.6
5y	3.9	3.7	3.1	2.1	2.6	3.2	3.3	3.4	3.4	3.5	3.6
7y	4.0	3.6	3.2	2.6	2.9	3.2	3.3	3.4	3.5	3.5	3.6
10y	3.9	3.8	3.4	2.8	3.0	3.1	3.3	3.4	3.5	3.5	3.7
15y	4.0	3.6	3.4	3.1	3.1	3.3	3.7	3.9	4.0	4.1	4.4
20y	3.4	3.1	3.0	2.8	2.9	3.0	3.3	3.5	3.6	3.7	3.9
30y	3.4	3.2	3.0	2.8	2.9	2.9	3.2	3.4	3.5	3.6	4.4

Source: RBS

EUR ATM normvol grid (bp): one-week changes (left-hand chart) and Thursday EOD levels (right-hand chart)

EUR	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	21.7	23.0	26.0	31.9	43.7	58.8	65.1	70.9	76.2	81.1	76.6
1m	21.5	23.2	26.3	32.4	43.7	58.1	67.0	72.7	76.8	79.2	74.8
2m	20.9	22.5	25.6	31.7	42.6	56.2	64.0	68.7	71.8	73.3	68.9
3m	19.8	20.4	24.0	31.0	41.4	54.4	61.6	65.7	67.7	69.3	64.8
6m	20.4	20.2	24.3	32.3	42.2	54.6	60.9	64.4	66.3	68.0	63.6
1y	20.4	22.1	26.5	35.0	44.6	56.4	60.2	62.4	63.5	64.5	60.1
2y	26.8	32.5	36.3	43.8	50.5	60.1	61.4	62.3	62.5	63.0	58.5
3y	38.1	43.7	46.6	52.5	56.9	63.1	62.7	62.6	62.0	61.6	57.2
5y	56.3	59.4	60.5	62.8	64.6	67.2	63.3	61.6	59.1	56.9	52.4
7y	66.9	67.8	67.8	67.9	68.4	69.1	64.0	61.1	57.6	54.3	49.9
10y	71.4	72.5	72.1	71.4	71.2	71.0	64.2	59.9	56.1	52.9	48.4
15y	67.9	68.7	68.4	67.9	67.7	67.5	59.9	54.4	51.0	47.8	43.4
20y	63.2	64.1	63.8	63.4	62.9	62.2	54.8	49.2	46.2	43.3	38.8
30y	53.7	53.8	53.5	53.0	52.2	50.9	44.8	40.1	38.1	36.1	31.7

EUR	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	-0.5	-0.5	-1.0	-2.0	0.5	4.0	6.6	8.9	11.1	13.1	13.1
1m	-0.5	-0.5	-1.0	-2.0	0.5	3.9	6.4	8.7	10.8	12.8	12.8
2m	-0.5	-0.5	-1.0	-2.0	0.1	3.0	4.8	6.5	8.0	9.5	9.5
3m	-0.8	-0.8	-1.4	-2.5	-1.2	0.6	1.5	2.4	3.2	3.9	4.0
6m	-0.5	-1.0	-1.2	-1.5	-0.7	0.5	1.2	1.8	2.4	3.0	3.0
1y	-1.0	-1.0	-1.2	-1.5	-0.9	0.0	0.5	0.9	1.3	1.7	1.7
2y	-0.5	-0.0	-0.3	-1.0	-0.6	-0.0	0.5	1.1	1.5	2.0	2.0
3y	-0.5	0.0	-0.2	-0.5	-0.2	0.2	0.8	1.3	1.8	2.2	2.2
5y	-0.7	-0.2	-0.2	-0.0	0.4	1.0	1.2	1.4	1.6	1.7	1.7
7y	0.5	0.5	0.6	0.7	0.9	1.2	1.4	1.5	1.6	1.7	1.7
10y	0.5	1.0	1.2	1.5	1.5	1.5	1.2	1.2	1.2	1.5	1.5
15y	0.5	1.0	1.2	1.5	1.6	1.8	0.9	0.8	0.6	0.4	0.4
20y	0.5	1.0	1.2	1.5	1.6	1.7	1.1	1.0	0.7	0.4	0.4
30y	0.5	1.0	1.2	1.5	1.6	1.7	1.4	1.3	0.9	0.4	0.4

Source: RBS

Vol grid and weekly changes (continued)

UK ATM normvol grid (bp): one-week changes (left-hand chart) and Thursday EOD levels (right-hand chart)

GBP	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	21.6	41.9	61.3	79.5	81.1	81.5	80.1	78.8	77.8	77.3	73.0
1m	21.5	41.8	61.0	78.8	80.5	80.9	79.5	78.2	77.2	76.7	72.5
2m	25.3	46.9	64.1	79.7	81.3	81.7	80.1	78.5	77.1	76.6	72.4
3m	29.1	52.0	67.2	80.5	82.2	82.5	80.7	78.9	77.0	76.5	72.3
6m	41.0	61.9	73.0	82.1	83.2	82.9	80.1	77.8	75.8	75.2	71.1
1y	64.2	76.5	81.5	85.0	84.0	82.8	79.6	76.7	74.3	73.1	69.0
2y	86.1	90.2	91.3	88.8	86.4	83.3	79.5	76.3	73.8	72.6	68.6
3y	93.8	92.8	91.0	88.5	85.3	81.6	77.5	73.8	71.5	70.2	66.3
5y	94.2	91.6	89.4	84.9	82.0	78.0	74.0	70.2	67.6	65.8	62.2
7y	89.3	87.1	85.0	81.3	78.5	75.5	71.1	67.3	64.7	62.9	59.4
10y	82.1	79.9	78.3	75.6	73.7	70.8	66.6	63.0	60.3	58.1	54.9
15y	73.7	72.1	70.5	67.4	65.9	63.3	59.7	56.6	53.7	51.6	48.7
20y	68.1	66.6	65.1	62.1	60.5	58.1	54.6	51.0	48.0	45.7	43.2
30y	59.5	58.0	56.5	53.4	52.0	49.9	46.6	43.2	40.2	37.9	35.8

GBP	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	-4.6	-4.0	-2.5	0.3	0.2	0.2	0.3	0.5	0.7	0.8	0.8
1m	-4.6	-4.0	-2.5	0.3	0.2	0.2	0.3	0.5	0.7	0.8	0.8
2m	-4.9	-3.8	-2.3	0.5	0.4	0.3	0.5	0.6	0.8	0.9	0.9
3m	-5.3	-3.7	-2.2	0.7	0.6	0.6	0.7	0.8	0.9	1.0	1.0
6m	-4.0	-2.3	-1.1	1.1	1.0	0.9	1.0	1.1	1.2	1.3	1.2
1y	-0.2	-0.1	0.3	1.2	0.9	1.0	1.1	1.1	1.2	1.3	1.2
2y	1.2	0.8	0.9	1.2	1.1	1.0	1.1	1.1	1.2	1.3	1.2
3y	1.8	1.2	0.2	1.3	1.2	1.1	1.2	1.2	1.3	1.4	1.3
5y	1.4	1.3	1.3	1.3	1.3	1.2	1.3	1.3	1.4	1.5	1.4
7y	1.3	1.3	1.3	1.4	1.3	1.3	1.3	1.3	1.3	1.4	1.3
10y	1.3	1.3	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.2
15y	1.3	1.3	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.0
20y	1.2	1.2	1.1	1.1	1.1	1.0	1.0	0.9	0.9	0.9	0.9
30y	1.0	1.0	1.0	0.9	0.9	0.9	0.8	0.8	0.8	0.7	0.7

Source: RBS

JPY ATM normvol grid (bp): one-week changes (left-hand chart) and Thursday EOD levels (right-hand chart)

JPY	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	6.8	7.5	9.2	12.6	17.6	22.0	30.8	39.6	40.7	41.8	41.8
1m	7.3	8.0	9.5	13.5	18.8	23.5	32.7	42.4	43.6	44.7	44.7
2m	8.7	9.4	10.7	14.4	19.3	24.1	32.2	41.0	42.1	43.2	43.2
3m	10.2	10.9	11.9	15.5	19.9	24.9	32.0	39.8	40.8	41.9	41.9
6m	10.6	11.2	12.2	16.0	20.3	25.2	30.6	36.6	37.6	38.5	38.5
1y	11.7	12.4	13.2	17.4	21.5	26.6	31.4	37.1	38.0	39.0	38.9
2y	14.9	15.7	17.4	23.0	27.4	31.8	35.2	39.8	40.6	41.4	41.3
3y	20.2	21.0	22.9	28.8	32.8	36.2	38.5	42.2	42.8	43.4	43.3
5y	32.0	32.1	33.6	38.1	40.7	42.2	43.3	45.6	45.6	45.6	45.5
7y	44.0	43.1	43.0	44.1	45.3	45.9	46.3	47.6	47.6	47.7	47.6
10y	54.9	53.5	51.9	49.7	49.6	49.1	49.7	50.8	50.6	50.4	50.4
15y	56.7	54.2	53.7	52.7	51.6	50.5	51.3	52.1	52.0	52.1	52.2
20y	59.0	56.4	56.0	55.1	52.8	51.8	52.2	53.1	53.1	53.2	53.5
30y	62.2	58.5	57.7	56.1	53.0	51.6	52.6	53.7	54.1	54.4	54.2

JPY	1y	2y	3y	5y	7y	10y	15y	20y	25y	30y	40y
1wk	2.1	2.3	3.0	4.5	6.8	8.9	14.0	19.0	19.5	19.9	19.9
1m	0.1	-0.0	0.3	1.1	2.2	3.5	7.0	10.8	10.9	11.1	11.1
2m	-0.1	-0.1	0.0	0.3	1.0	1.9	4.5	7.3	7.4	7.5	7.5
3m	-0.1	0.0	-0.1	-0.1	0.4	0.7	2.7	4.8	4.8	4.9	4.9
6m	-0.2	-0.3	-0.3	-0.3	-0.2	0.2	1.3	2.5	2.5	2.5	2.5
1y	-0.4	-0.3	-0.3	-0.2	-0.0	0.1	0.9	1.7	1.7	1.7	1.7
2y	0.2	0.2	0.1	-0.3	-0.4	-0.2	0.1	0.7	0.7	0.6	0.6
3y	0.9	1.0	0.6	0.0	-0.1	-0.1	0.0	0.3	0.3	0.3	0.3
5y	0.8	0.5	0.4	0.1	-0.0	-0.2	-0.1	-0.0	-0.1	-0.1	-0.1
7y	1.8	1.3	1.0	0.7	0.4	0.3	0.4	0.5	0.4	0.4	0.4
10y	1.2	0.8	0.4	-0.0	0.4	0.4	0.3	0.4	0.4	0.3	0.3
15y	0.8	0.5	0.6	0.7	0.6	0.5	0.6	0.6	0.6	0.6	0.6
20y	1.1	0.7	0.8	0.9	0.8	0.8	0.8	0.9	0.8	0.9	0.9
30y	2.6	1.8	1.7	1.6	1.3	1.1	1.2	1.4	1.5	1.6	1.6

Source: RBS

Technical Outlook

Dmytro Bondar

Bunds may see a correction to 155.54/10 offering buying opportunities for 158.52 and above targets. Treasuries would be poised for trend reversal should the price sustain below 128-00, confirming the Evening Star pattern. Gilts may see trend reversal amid yield candlestick signals; 5-day MA (120.60) break may be a trigger. 10-30 Germany to see a tactical steepening to 80-83 bps followed by further flattening towards 64 bps. Oil (Brent) is heading to our 42 target with sub-40 levels possible after a consolidation.

Technical Levels

Bunds	Treasuries	Gilts
RES	**RES**	**RES**
158.52	130-13	122.00
158.09	129-27	121.67
157.48	129-03	121.48
157.00	128-15	120.96
SUP	**SUP**	**SUP**
155.54	128-00	120.32
155.10	127-10	119.28
154.62	126-26+	118.24
153.70	126-11	117.60

Source: RBS

Bunds daily chart with Fibonacci projections, 20-day MA and 20/5/5/3 slow stochastics

Source: RBS, Bloomberg chart used with the permission of Bloomberg LLP

Bunds: daily price charts suggest the market would see a correction for the next few days, but remain constructive overall towards the 158.52 target and potentially above. The 157.00 resistance was broken, but the price failed to close above and saw a subsequent bearish gap, which points to a likelihood of a minor correction, as the price action deviated from the trendline (being in effect since mid last year) and momentum oscillators reached a deeply overbought region.

If so, there would be a strong support at 155.54, which is formed by both the 161.8% Fibonacci level and the 20-day moving average. Below that there is also a trendline support and Fibonacci retracement at 154.62/154.00. Once the correction is completed, a further move North towards 158.09/52 targets would be expected. Only a break of the trendline and the 153.70 retracement would require the view re-assessment.

Overall, favour using potential dips to 155.54 / 155.10 to add to longs for 158.52 and above with a caveat of a sustained break below 153.70.

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Treasuries 10-yr chart with Fibonacci projections, 10/3/3 slow stochastics and 50-day MA

Source: RBS, Bloomberg chart used with the permission of Bloomberg LLP

TY1 – The yield tested the 1.94% resistance area, as the price chart formed an evening Doji star pattern, which would come into play should the price sustain below the 128-00 pivot point. Also, a break below the 127-29 retracement may be used as a trigger (the 176.4% Fibonacci projection from the Apr-May 2014 impulse wave). If so, a pull-back to the first support of 127-07 would be likely with a further move beneath the level targeting 126-12+ and potentially sub-126 levels (e.g. 125-18). Alternatively, if the pattern is negated and the bearish gap of 128-15 is closed, a further move North to 129-27 may occur.

Gilts daily continuation chart with Fibonacci swing extensions, 10/3/3 slow stochastics and 5/20-day MA

Source: RBS, Bloomberg chart used with the permission of Bloomberg LLP

Gilts – The market may experience a change in trend, as the inside session formed on a daily generic yield chart on the 7 January was confirmed by a subsequent negative day. This occurred after reaching the key 1.61% yield target, suggesting that once the yield sustains above the 1.67% bullish gap, a bearish trend reversal may be declared. The daily price chart keeps testing the 5-day MA, which if broke, would trigger a move towards 119.30 with further downside potential should the trendline be broken. For now, it is important to see if a sustained break below the 5-day MA (120.60) occurs.

Germany 10-30 daily chart with Fibonacci retracements, 5/20/50-day MA and 20/5/5/3 slow stochastics

Source: RBS, Bloomberg chart used with the permission of Bloomberg LLP

Germany 10-30– the curve reached 73 bps, being the full swing extension from the Nov-Dec impulse wave and a level of strong support being in effect since mid-2013, as 10/3/3 slow stochastics turned positive in the oversold region after displaying positive divergence. These indicate a corrective period of curve steepening should follow towards 80 – 83 bps. After that I believe there will be a good chance of breaking through the 70 bps support for a further flattening to 64 bps.

Brent monthly candlestick chart with Fibonacci retracements, 5-month MA and 10/3/3 slow stochastics

Source: RBS, Bloomberg chart used with the permission of Bloomberg LLP

Oil Brent – is testing a minor support of 50, which once broken, would see a move towards our key target of 42. There are no reversal signals on the long-term and short-term charts, hence it is most likely the price would not take too long to break below 50. Longer-term an oversold monthly slow stochastics may see some consolidation within the 42 – 50 area, but the absence of a positive divergence of the oscillators with the

price action implies a possibility of sub-40 levels (such as 20 and 10) to be tested later in the year once the consolidation is completed and 42 level is broken.

Trade Recommendation Performance

Giles Gale

Please see below for details of our P&L history for 2014.

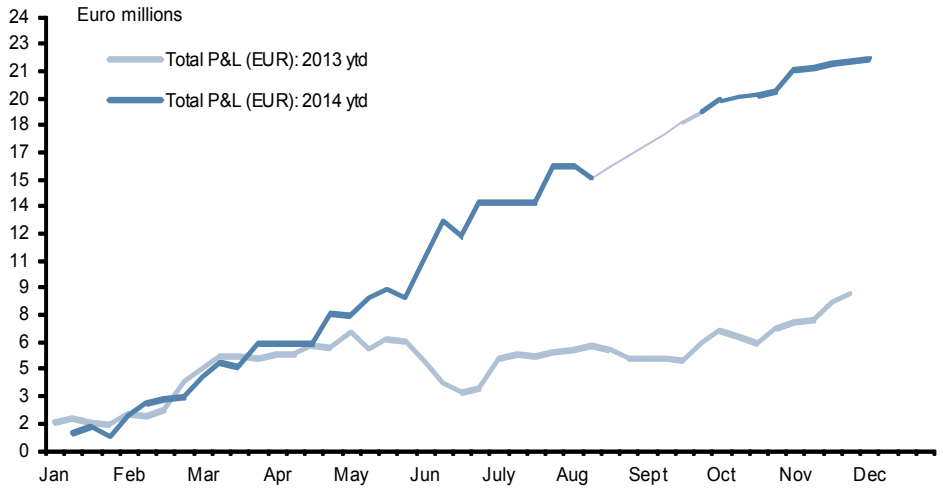
The trades monitored include 204 trades since our Year Ahead 2014, published on November 29, 2013, with the exception of EM European and hybrid recommendations.

All trades monitored in this document are now considered 'closed'. Please see our Year Ahead 2015, published on December 8 for details of our current trade recommendations.

2014 P&L full year

(total P&L of closed trades + total P&L of open trades)

2014 P&L= €21.36m



Source: RBS

NB: First revaluation January 10, 2014 reflects P&L Change from Year Ahead 2014 publication on November 29, 2013

Portfolio was not revalued in September 2014

Since simulated trades have not actually been executed, the results may under or overcompensate for the impact of certain market factors such as lack of liquidity. No representation can be made that any account will, or is likely to achieve profits or losses similar to those shown.

Past results are not indicative of future performance.

Summary of trading recommendations

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
EUR										
Sell EUR 10m 50bp-wide 1y5y collars	The experience of 2013 has been of long periods of lower-for-longer trades eking out gains and brusque back-ups. The skew responded by richening in payers. I look for this dynamic to break in 2014 and the lower-for-longer trade to consolidate again.	0.1	-169.5 bp	-223.8 bp			125.0 bp	-50.0 bp	-€ 54,312	Year Ahead 2014
BTP steepener BTP4.5% 03/24 v 4.75% 09/44	Higher duration supply from Italy vs lower natural demand for long Italian risk	10.0	103.1 bp	82.5 bp	95.0 bp	76.0 bp			-€ 174,276	Jan Early Market Thoughts
Long IRISH 2017	The decision to go it alone in 2014 is credible. Expect moody's upgrade by Q2. Fundamentally Ireland has core-European characteristics. The high debt level is the challenge.	- 9.8	1.810%	1.428%	1.300%	2.150%			€ 443,944	Year Ahead 2014
Portugal 10s30s flattening	10y supply plus EM driven concerns for the credit	- 0.1	48.0 bp	51.7 bp	40.0 bp	54.0 bp			€ 9,615	Rates Weekly 24 Jan
Dec-15/Dec-16 Euribor Steepener	We think ECB activism risk means a steeper term premium	-	59.0 bp	49.0 bp	75.0 bp	53.0 bp			-€ 60,000	Rates Weekly 10 Jan
Long Portugal 2037	30y is the cheapest price PGB on the curve. Look for locals to massage yields lower into ECCL discussions and expect leniency to the 'good student' on debt relief. This is also something of a high beta play on SPGB.	- 5.9	6.278%	5.377%	5.500%	6.900%			€ 355,933	Year Ahead 2014
Long 5y Italy vs Germany	ECB easing is still to come and should be supportive for Periphery. Domestics are increasingly focused in 5y as short dates carry less and long end issuance picks up.	- 0.1	207.6 bp	163.6 bp	150.0 bp	250.0 bp			€ 323,399	Year Ahead 2014
Long 3y Ireland vs Belgium and Germany	Gradual convergence of Ireland to semi-core levels on high debt/good student and index re-entry	- 0.1	183.0 bp	147.3 bp	150.0 bp	200.0 bp			€ 189,095	Rates Weekly 17 Jan
PCA weighted fly: eur3F1Y long vs. 1F1Y and 10F1Y (-134%;100%;-78% risk weights)	Purely tactical trade based on sample of the last 3m which covers both bull and bear moves	- 11.3	-181.0 bp	-185.4 bp	-175.0 bp	-186.0 bp			-€ 49,867	Rates Weekly 7 Feb
Bund ASW widener	We think that the seasonality of the spread has changed - there is no longer start-of-year tightening pressure. Our model valuation also suggests wideners.	0.2	18.0 bp	29.8 bp	35.0 bp	12.0 bp			€ 108,343	Jan Early Market Thoughts
Buy FRTR 1% 11/18 future vs CTD BKO 0% 12/15	We are looking for yield grab as the ECB fights disinflation. This is a 2s5s flattener and a spread tightener for France.	9.6	88.3 bp	80.0 bp	70 bp	105 bp	18.3 bp	-16.7 bp	€ 129,195	Year Ahead 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
3m vol weighted Rec 1y1y USD vs EUR	(a) Dovish Fed expectations , (b) low inflation may mean the correlation breakdown in 1y1y is reversed	4.1	-2.0 bp	-0.2 bp	-12 bp	4 bp			-€ 54,916	Rates Weekly 7 Feb
Cash for cash extension, sell PGB 4.2% Oct16 into PGB 3.85% 2021	We expect increasing extensions from domestics as very low yields and above par prices on short-end bonds are likely to be rolled for better duration exposure	- 10.7	5.50%	4.71%	0.0 bp				€ 756,564	Rates Weekly 7 Mar 2014
Long PGB Feb 2024	We remain positive across periphery. We went long 10y PGBs on 11 Mar, only for a sharp sell-off to stop us out. This was blip according t ous and we get long again at current levels	- 10.3	4.60%	4.03%	0.0 bp	0.1 bp			€ 601,867	Rates Weekly 14 Mar 2014
Receive 2y EUR swap	Post-FOMC weakness brought an already high rate to a 2-month high, and as per our analysis, the retracement is usually larger than the initial sell-off.	- 10.0	52.0 bp	45.9 bp	45 bp				€ 91,640	Rates Weekly 21 Mar 2014
Beta weighted long in USD 5y5y vs EUR with 50% risk on the USD leg	We don't see Feb payroll data as a game changer and expect steady course of tapering. We are constructive on Europe and hence beta weighing on the trade	6.5	148.0 bp	136.0 bp			17.0 bp	-6.0 bp	-€ 53,125	Rates Weekly 7 Mar 2014
Buy SPGB 2.75% 2019, sell UST 1.5% 2019	We continue to be long periphery and ECB inertia is buying opportunity for SPGB. Also US forward guidance potentially moving to BoE's style of qualitative guidance (NY Fed Dudley's recent comment)	- 0.4	35.0 bp	21.5 bp	-50.0 bp	50.0 bp			€ 135,737	Rates Weekly 7 Mar 2014
Buy Nether4% 07/18 vs. RAGB1.15% 10/18 in ASW	A relative value trade as RAGBs suffering from higher debt and uncertainty risks emanating from the banking sector	- 0.1	-2.4 bp	-4.6 bp	-7.0 bp				€ 14,912	Rates Weekly 14 Feb
Buy ECB Aug'14 OIS	The research view is clearly bullish - and tactically bear in mind the failure to drain the SMP cuts tail risk for Eonia spikes. We doubt the ECB will want to use intermittent SMP drain failures as a policy tool - so markets should be geared to refi easing risk, with some speculation of negative rates.	- 10.1	10.0 bp	14.5 bp	1.0 bp	15.0 bp	9.0 bp	-5.0 bp	-€ 50,595	Year Ahead 2014
EUR 20s40s 2y forward steepener	We have a strategic bias towards more long end steepening and see expect the highs to be tested on ALM paying flows this year and higher duration supply. We expect long end paying flows to continue from Nordics and in ultra's from Dutch accounts as the market transitions to a new hybrid contracts, for a start date of 2015.	0.4	-6.5 bp	0.1 bp		-9.0 bp			€ 65,874	Rates Weekly 10 Jan

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Long 1y1y EUR OIS	1y1y is above the refi rate. We think there are easing risks.	10.0	31.0 bp	8.9 bp	10.0 bp	40.0 bp			€ 212,013	Jan Early Market Thoughts
Rec 5y5y CHF vs pay 70% risk in EUR	EUR rates have got richer versus CHF. There seems to have been regime shift and one that we embrace.	- 3.0	27.3 bp	-7.3 bp	-12.0 bp	45.0 bp			€ 124,780	Year Ahead 2014
Long Irish 4.4% Jun 2019 vs OBL #169 0.5% Apr 2019	We are more positive on Irish paper as the market increasingly becomes two-way and boasts semi-core like fundamentals. We remain long periphery and do not change our fundamental view. Trade has a 3m carry & roll worth of 4bp	0.1	81.0 bp	101.6 bp	60.0 bp	95.0 bp			-€ 137,350	Rates Weekly 16 May 2014
Buying ERZ4 vs EDZ4	ECB liquidity adds should see the contract go back to the highs, with easing being a bonus. We think that USD OIS would evolve towards a more GBP like risk premia	0.2	-1.0 bp	-7.0 bp	12.0 bp	-6.0 bp			€ 49,704	Rates Weekly 25 Apr 2014
Long PGB Jun 2018 vs IRISH Oct 2018	We expect IGCP to tap the PGB Feb 24 in its first auction post-bailout and we enter this trade in order to exploit falling yields	0.1	106.0 bp	125.6 bp	75.0 bp	125.0 bp			-€ 156,453	Rates Weekly 17 Apr 2014
Outright long 3.25% FRTR May 2045	We cover the rally in the 30y sector; We already are long France in front-end with 2s5s flatteners against bunds and are also long France 10y against OLOs	- 10.4	2.99%	2.85%	2.85%	3.05%			€ 155,412	Rates Weekly 17 Apr 2014
Buy FRTR 1% 11/18 future vs CTD BKO 0% 12/15	We are looking for yield grab as the ECB fights disinflation. This is a 2s5s flattener and a spread tightener for France.	0.6	89.0 bp	53.0 bp	50.0 bp	75.0 bp			€ 387,607	Rates Weekly 14 Mar 2014
Long Mar 15 Euribor future	We think new low on Euribor fixings plausible on the back of a refi cut to 10bps and negative rate risks	- 10.0	35.0 bp	20.0 bp	20.0 bp	43.0 bp			€ 150,000	Rates Weekly 7 Feb
Receive 5y5y EUR vs JPY	We are concerned about mini-Japanification of Europe at the same time as Japan's output gap is closed and Abenomics is gaining traction. The inflation rates have already crossed.	- 0.5	174.0 bp	122.1 bp	100 bp	165 bp			€ 549,376	Rates Weekly 10 Jan
3F 1s30s EUR steepener	We would love to say something new but still think the combination of anchored ECB rates and increasingly short end forwards versus scenario analysis of Fed outcomes, BoJ largesse, and the commodity price fall makes this trade a key expression of multiple themes.	0.7	155.5 bp	180.6 bp	163.0 bp	140.0 bp	29.5 bp	-40.6 bp	€ 76,870	Year Ahead 2014
Long 10y Spain vs Italy	We see SPGB upgrade risk on reforms, and Italian BBB- risks on no reform and recession.	- 0.2	8.5 bp	-24.6 bp	-40.0 bp	25.0 bp			€ 342,023	Year Ahead 2014
Pay the belly in the EUR 3s5s8s	Trade well correlated with the EUR2s5s10s but has a low carry/roll costs and is more statistically extreme	0.0	-21.6 bp	-25.4 bp	-15.0 bp	-25.0 bp			-€ 37,514	Rates Weekly 30 May 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Box trade selling BTP 2.5% May-2019 and buying BTP 4.75% Sep-28, vs long DBR 3.5% Jul-19 and short DBR 4.75% Jul-28	We like yield grab and forward rates in periphery but in core rates we anticipate steepening out of 5y, as there is no credit compression to play out, and it is German and Dutch banks that get hit on negative rates	0.0	45.6 bp	53.0 bp	30.0 bp	52 bp			-€ 70,712	Rates Weekly 9 May 2014
10y Bund ASW widening	We think ASW wideners are a cheap way to get exposure to financial repression via negative rates	- 10.1	-24.6 bp	-23.9 bp	-34.0 bp	21.0 bp			-€ 12,614	Rates Weekly 25 Apr 2014
Long 5y BTP	Yield grab and lower yield environment; Improved environment for periphery due to positive stress test results for banks	- 9.9	2.430%	1.427%	1.500%	2.250%			€ 1,060,665	Rates Weekly 31 Jan
Long 10y France vs Germany	We think core outperform in the yield compression	- 0.2	61.0 bp	35.4 bp	40.0 bp	80.0 bp			€ 229,542	Rates Weekly 24 Jan
Long 30y Germany vs Netherlands	New 30y DSL and withdrawal of domestic regulatory support for long Netherlands	10.7	14.0 bp	6.9 bp	30.0 bp	6.0 bp			-€ 93,042	Rates Weekly 17 Jan
EUR2s5s 1y flattener	We think the curve to bull flatten into the ECB meeting and beyond as ZIRP becomes more binding	- 0.2	71.4 bp	47.4 bp	50.0 bp	70.0 bp			€ 247,988	Rates Weekly 21 Feb
EUR10s20s 10y steepener	ECB risks mean the long end should have more risk premium. It gives us an exposure to a) Our directional bias on rates into the ECB and b) Germany 30y issuance impacts	0.5	-25.6 bp	-19.5 bp	-20 bp	-28 bp			€ 41,354	Rates Weekly 21 Feb
Buy 5y Portugal on asset swap	Positive credit. Extension trades have been popular since investor limits on overall exposure have driven grab for duration, leaving 5y cheap.	-	-223.6 bp	-223.6 bp			130.0 bp	175.0 bp	€ 736,585	Rates Weekly 04Jul 2014
Long PGB Feb 2019	We move our position to the 5 year sector after our 10 year long hit its target of 4.00%	- 9.7	2.895%	2.299%					€ 766,083	Rates Weekly 28 Mar 2014
Long BTP 3.75% Apr 2016 out of SPGB 3.5% Apr 2016	We expect both Italy and Spain to continue to rally across the curve (prefer SPGB over BTPs in the 10y sector). In the short-end (2y), we expect the unjustified differential to be corrected imminently	0.1	10.0 bp	14.3 bp		15.0 bp			-€ 19,908	Rates Weekly 25 Apr 2014
Long 10y Portugal vs Spain	IMF repayment possibility and QE trade	- 0.0	99.7 bp	128.6 bp	60.0 bp	120.0 bp			-€ 292,271	Rates Weekly 10 Oct 2014
Short 10y UK RPI vs long 10y EUR HICPx	Breakevens to compress in UK due to supermarket price war and BoE hawkishness.	0.0	166.7 bp	177.8 bp	150.0 bp	175.0 bp			-€ 111,581	Rates Weekly 10 Oct 2014
Buy 2y Sept Euribor (2RU6) 99.375/99.125 put spread	Cheap bearish trade via mid-curve Euribor greens. It exploits the market's bearish risks via bullish positioning enthusiasm for ECB easing, which makes Greens a good place to go.	-	-3bp	0bp					-€ 30,000	Rates Weekly 30 May 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Long the wings of Euribor U4-H5-U5	We enter this trade on the back of our expectations of ECB cutting both refi and depo rate. The trade makes sense in a number of ECB outcomes(e.g. SMP monetisation, ABS purchases, a capped LTRO)		-	-4.5 bp	-1.1 bp	5.0 bp	-8.0 bp			€ 34,000	Rates Weekly 30 May 2014
Long EIB vs OAT in 20y	EIB more likely to be bought in QE beyond 10y		0.1	-11.1 bp	-9.2 bp	-27.0 bp				-€ 114,059	Rates Weekly 10 Oct 2014
Long 2s5s10s in EUR vs USD	EUR FX Rally implies more bullish curve vs Dovish Fed		0.1	-73.3 bp	-65.4 bp	50 bp	85 bp			-€ 31,168	Rates Weekly 10 Oct 2014
Short June 2015 ED vs 2yf 1y	Lower for longer but without being outright long- i.e. it is a timing trade		0.0	153.5 bp	147.8 bp	110 bp	170 bp			€ 44,561	Rates Weekly 10 Oct 2014
5y5y receive EUR vs JPY	Curev Japanification as the EUR curve prices either deflation risks or QE which would imply aggressive lower for longer.	-	0.8	-0.850%	-0.518%	3.500%	3.250%			€ 332,144	Rates Weekly 26 Sep 2014
Sell Jun-15 EURIBOR	QE associated measures to ease impact on banking sector (deposit rate hike or allowing some of additional funds to be held in current account)		10.0	99.930%	99.930%	99.230%	99.320%			€ 10,000	Rates Weekly 26 Sep 2014
Long UKIL58 breakeven	Very little supply, breakevens are overly depressed due to syndication overhang and short-run yield beta as nominals have squeezed	-	0.4	3.311%	3.262%	3.500%	3.250%			-€ 72,752	Rates Weekly 15 Aug 2014
EUR 7s10s30s Long middle	QE is increasingly likely. Japanification will drive rolling flattening but 10s30s will remain steep as long-term inflation risks remain and regulatory roll-back continues.		0.7	-28.0 bp	-36.4 bp		32.0 bp			€ 80,234	Rates Weekly 15 Aug 2014
Long 5y Italy vs 2y Spain	Flattener to position for TLTRO extension trades and lower for longer. Extra juice from Italy/Spain spread being too wide in 2y.	-	1.2	-70.7 bp	-50.7 bp	40 bp	89 bp			€ 194,106	Rates Weekly 01 Aug 2014
Rec CHF 5y5y vs EUR	Statistically-based trade	-	1.5	0.142%	0.236%	9 bp	-5.0 bp			€ 111,499	Rates Weekly 18Jul 2014
Rec 9y1y vs 5y spot 88-100 wtd	We like Japanification = Rolling curve flattening.		0.3	-186.4 bp	-186.4 bp			135 bp	183 bp	€ 414,153	Rates Weekly 18Jul 2014
Receive EUR 20F5Y vs EUR25F5Y	25y is cheap. Correlation analysis of EUR25F5Y/20F5Y to 20s30s slope does suggest that the forward trade has an edge		0.7	-25 bp	-25 bp	-20.0 bp	-26.0 bp			€ 189,588	Rates Weekly 27 Jun 2014
5s30s BTP steepener vs 2s10s USD swap flattener	Soft repo in EUR cash and rising risks of a front end USD breakout, gives a periphery steepener against a USD flattener		0.6	54 bp	70 bp	100 bp	25 bp			€ 236,926	Rates Weekly 13 Jun 2014
Pay USD 2F3Y vs receiving EUR 2F3Y and GBP 2F3Y	USD 2F3Y is rich to the IMF nominal GDP projection, while the GBP sell-off now makes this 2F3Y look fair, while EUR is cheap	-	10.0	103.0 bp	160.0 bp	160.0 bp	80.0 bp			€ 570000	Rates Weekly 23 May 2014
Long 5y Spain vs 6m1y USD swap	We see short-dated Spain much tighter (100bp is our 10y target. 5y should be tighter). Short front USD is a global rates hedge.	-	3.0	140 bp	65 bp	50 bp	150 bp			€ 925,664	Rates Weekly 11 Apr 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Long FRTR 2.25% May 2024 vs BGB 2.6% Jun 2024	Shorter on Belgium curve could benefit from the flatter curve and semi-core yield grab. Belgium's supply schedule of issuing only beyond 5y is also supportive for this trade		0.1	12.0 bp	6.2 bp	25.0 bp	5.0 bp			-€ 74,061	Rates Weekly 4 Apr 2014
Cash for cash extension of BTP 5.25% Aug17 into BTP 4.5% Mar24	Post-OMT in Italy and Spain, and more recently in Ireland and Portugal, firstly curves steepen and the next logical step will be flattening further down the curve. This trade increases duration exposures and is ultimately a bullish trade on sovereigns	-	12.5	4.266%	2.494%	3.500%	4.800%			€ 2,277,073	Rates Weekly 28 Feb 2014
Buy 10y bunds and pay 30y swaps	Negative rates should induce higher risk premium into long dated rates. We already have a EUR1s30s 3y forward as a core trade.		3.1	85 bp	91 bp	100 bp	78 bp			-€ 33,483	Rates Weekly 14 Feb
Eur 2y forward, 1 year 3m6m basis compression	We expect to see the spot rate flatten; The structural flow shifts are favourable to the trade on bank recaps	-	0.0	15.0 bp	10.9 bp	10.0 bp	17.5 bp			€ 40,549	Rates Weekly 7 Feb
EURUSD cross currency basis 1y, Receive EUR vs Pay USD	Euro area stress trade: look for more demand to borrow USD / lend EUR through the basis swap. Historic level looks very attractive.		0.1	-3.6 bp	-1.0 bp	-10.0 bp	1.0 bp			-€ 25,849	Rates Weekly 24 Jan
Long 7y BTP	The sweet-spot on the curve is in the 6 to 8 year sector. We are shifting our long 5y BTP trade into 7 years	-	9.6	2.021%	1.507%	1.500%	2.250%			€ 658,837	Rates Weekly 6 Jun 2014
Italy 10s30s steepener vs short 28% 5y	Tactically bearish 5y while we expect extension trades into 10y.		4.8	-257 bp	-269 bp			13 bp	-6 bp	€ 197,057	Rates Weekly 17 Jan
Long ITRAXX vs short 10y20y	QE trade for unanchoring of long end, but think QE includes corporate bonds		10.0		-27.5bp from inception			30 bp	-15 bp	-€ 274,612	Rates Weekly 14 Nov
GBP											
Buy Dec-14 Short Sterling	The market prices substantial probability of a rate hike in 2014 or early 2015. This looks very unlikely given the improved inflation outlook. Expect instead the BoE to adapt its forward guidance.	-	10.0	0.820%	0.870%	0.720%	0.870%			-€ 49,895	Rates Weekly 10 Jan
Rec 1y1y GBP vs EUR	The front end of UK is high and steep. We expect the BoE to be dovish as it considers how to adjust communication to replace Forward Guidance.		0.2	-79.0 bp	-83.9 bp	40.0 bp	82.0 bp			-€ 60,439	Rates Weekly 24 Jan
2s10s, 1y forward steepener	Extension of forward guidance should depress the short end, push middle-dated forwards higher. Carry and roll is +3bp/month.		0.0	153.0 bp	148.3 bp	163.0 bp	148.0 bp			-€ 46,835	Rates Weekly 10 Jan
GBP 3s10s swap steepener. 3m carry and rolldown is worth 7bp	Market is already pricing a very reasonable path for bank rate over the next 5 yrs. We think 3s should be relatively well supported vs 10s and the trade offers attractive risk/award	-	0.0	147.0 bp	135.0 bp	160.0 bp	135.0 bp			-€ 73,130	Rates Weekly 7 Mar 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Pay GBP 5f 5y and Receive 15f15y	Reflation should boost 5y5y toward US levels. 15y15y will stay supported by strong pension scheme solvency.	- 0.1	-14.0 bp	16.1 bp	-100.0 bp	5.0 bp			-€ 321,666	Year Ahead 2014
Pay Aug MPC dated Sonia	Our favourite trading theme remains UK underperformance vs Europe, but as a tactical MPC Minutes play we see good risk reward in paying Aug-14 MPC dated Sonia	10.0	46.0 bp	46.6 bp					-€ 20,004	Rates Weekly 13 Jun 2014
Pay 5y GBP swaps vs EUR	We think there is even more juice to be had cross market in the 5y sector. The short end forms the next UK engine of underperformance, which fits with our money curve steepeners/bond curve flatteners	- 0.0	121.0 bp	143.1 bp	200.0 bp	100.0 bp			€ 290,387	Rates Weekly 9 May 2014
1f1y vs 2f1y GBP steepener vs USD	We stopped out of 3s10s steepeners and now enter a new cross-market trade: Reds/Greens steepeners boxed vs USD	- 0.1	27.0 bp	21.0 bp		38.0 bp			€ 57,840	Rates Weekly 28 Mar 2014
Buy 4T20s vs 4H19s and 3T21s	Relative value trade: Even vs the outright level of 3y rates, 4.75% 2020 looks cheap in the 1:2:1 micro fly trade	0.0	-414.251%	-63.199%	-6.5 bp	-2.0 bp			-€ 20,000	Rates Weekly 6 Jun 2014
Long GBP 5y ASW. Buy UKT 1.75% 2019 against matched maturity swaps	Help to buy raises a potential £130bn of new mortgages which is likely to result in a considerable amount of fixed rate paying.	- 1.1	-6.0 bp	-15.3 bp	-25.0 bp	4.0 bp			€ 163,941	Year Ahead 2014
Long 5s in GBP 2s5s10s fly	Combining the need for higher Gilt term premia further along the curve with our theme of lower neutral rates, the stand out trade is to position for the outperformance of 5s in the 2s5s10s fly, which is in essence a play on whites/reds flattening	0.1	2649.90%	-466.00%		32.0 bp			€ 294,313	Rates Special 24 June 2014
Enter 10s30s GBP vs EUR box (UK flattener)	On the back of our arguments of EUR 10s30s steepening (primarily bias towards ECB action in June) and on a cross market basis we think GBP flatteners boxed vs EUR offer an attractive proposition	0.9	18.0 bp	32.3 bp	50.0 bp				€ 115,968	Rates Weekly 9 May 2014
2y2y/5y5y GBP swaps steepening	Lower inflation pressures, high inflation response to GBP and quantitative tightening	0.5	83 bp	67 bp	120 bp	60 bp			-€ 157,080	Rates Weekly 31 Oct 2014
Long 5y UK Gilt ASW	New issue discount is too big. History shows this discount is quickly reduced.	- 0.6	80.8 bp	70.8 bp	77.0 bp	85.0 bp			€ 127,049	Rates Weekly 26 Sep 2014
Long 5y GBP ASW	Rolling existing trade based on stronger housing market and rising rates driving fixed rate paying	0.3	15.5 bp	12.2 bp	25.0 bp	10.0 bp			-€ 29,874	Rates Weekly 26 Sep 2014
Jan/Feb 2015 Sonia OIS steepener	We expect February rate hike. Less than 25bp or January hike are unlikely and market should reflect this.	- 0.0	12.0 bp	1.4 bp	19 bp				-€ 102,031	Rates Weekly 15 Aug 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
10s30s EUR bullish flattening via receivers	FTK changes most recently suggest more receiving pressure. The possibility of ECB success against deflation means flattening, not steepening.		-	73.2 bp	73.2 bp			45 bp	-15 bp	€ 0	Volatility Weekly 04 July 2014
GBP UKT 5y20y30y fly, short middle	20s looks rich on charts. Upcoming supply should help correct.		0.6	79 bp	61 bp	88 bp	73 bp			-€ 199,685	Rates Weekly 01 Aug 2014
Buy DBR 1.5% 2022 and Sell UKT 1.75% 2022 at a spread of +109bp	Strong growth and supply in UK compared with disinflation problems in EUR		0.4	109 bp	124 bp	170 bp	90 bp			-€ 19,442	Year Ahead 2014
Sell UKT 4.5% 2042 vs. matched maturity swaps	Solvency II suggests swaps discounting for with profits business with well over £100bn FI assets. Urgency might be felt to get in ahead of clearing in Feb.		0.0	20.4 bp	19.9 bp	35 bp	14 bp			€ 224,345	Year Ahead 2014
Sell 20m 16bp OTM 1y5y payer swaptions to buy 8m ATM 1y15y payer swaptions	The choice of 1y5y should ensure the maximum benefit to go-slow on the bank rate, while the 1y15y aims to hit the sweet spot between asset sales (the avg maturity of APF now is 12.5y)	-	0.2	73.7 bp	73.8 bp			45.0 bp	-15.0 bp	-€ 8,396	Rates Weekly 28 Feb 2014
Scandinavian											
Sell SEK Mar'15 RIBA outright	Lower FRA Rates from mid-2014 onwards		10.0	102.3 bp	54.0 bp	60.0 bp	115.0 bp	42.3 bp	-12.7 bp	€ 421,679	Year Ahead 2014
Buy SGBi 3108 (Jun-22) outright	A good hedge against the risk of a trade war induced energy price shock	-	9.9	0.519%	0.248%	0.300%	0.650%			€ 102,375	Rates Weekly 14 Mar 2014
Receive 2y and 10y SEK vs pay 2 x 5y SEK in a risk neutral position (2.45x in 2s and 0.53x in 10s)	The most attractive risk-reward in the SEK rates curve right now is in the 2-5-10 yr curvature. Barbell stands at 12bp mid-screen, which is very high given the low potential for further FRA-curve flattening from SEP14 and onwards		0.1	12.0 bp	20.2 bp		18.0 bp			-€ 32,016	Rates Weekly 30 May 2014
Sell 2yr SGB Jun14 future and receive the ASW	Relative value trade; 2yr SGB-ASW spread stands out in terms of width compared to the 5yr and 10yr benchmarks with a positive carry		####	38.0 bp	41.6 bp	25.0 bp	45.0 bp			-€ 44,839	Rates Weekly 28 Mar 2014
Rec 4y1y GBP and SEK vs USD	Sweden is in deflation and we think it will have difficulty recovering from there. SEK vs US and UK has better protection on a sell off than SEK vs EUR.		0.1	72.5 bp	12.7 bp			200.0 bp	100.0 bp	€ 385,785	Rates Weekly 18Jul 2014
Position for a 2-10y SEK flattener	The 2-10yr curve in SEK IRS is around 142bp steep and in SGB futures 156bp steep, and the carry in a flattener position (rec 10s, pay 2s) is very positive. Rolling flatteners are the name of the game.	-	2.8	156.0 bp	94.6 bp	100.0 bp	180.0 bp			€ 700,025	Scandi Rates Strategy 3 Jul 14
Receive SEK 3y2y and pay SEK 1y2y	We expect that policy rates won't be hiked as quickly once policy is reversed in Sweden. Riksbank is on course to be more dovish and we think that the same logic applies in forward rates where a "normalisation" of rates is discounted	-	0.6	90.0 bp	54.8 bp	50.0 bp	110.0 bp			€ 413,070	Rates Weekly 13 Jun 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Receive 2y2y NOK vs pay 2y2y EUR	We enter this trade on the back of our expectations that Norges bank can keep a policy rate that is 125-150 bp higher than in the EMU and Sweden		11.0	170.0 bp	92.4 bp	140.0 bp	190.0 bp			€ 310,850	Rates Weekly 30 May 2014
Long 2y NOK	We are concerned about the Norwegian housing market, and think the Norges Bank might be too.	-	0.7	1.830%	1.050%	1.500%	2.000%			€ 50,069	Rates Weekly 24 Jan
Enter a Sep14-Sep15 NOK FRA flattener	Norges bank is definitely further away from an expansionary monetary policy, however, we think it is more likely that they would have a cut rather than a hike the rate a year from now		-	17.0 bp	-2.5 bp		30.0 bp			€ 174,882	Rates Weekly 9 May 2014
Buy 5y SGB vs OAT	There is greater scope for cheaper repo funding in Sweden than in France.		0.1	57.9 bp	1.3 bp	30.0 bp	70.0 bp	28 bp	-12 bp	€ 452,027	Year Ahead 2014
Rec 2y2y SEK vs EUR	SEK rates are priced to rise more than EUR rates in the forward space. That offers good risk-reward for receiving SEK rates	-	0.1	100 bp	16 bp	60.0 bp	125.0 bp	39.8 bp	-25.2 bp	€ 835,179	Year Ahead 2014
Rec 2y2y NOK vs EUR	NOK rates are priced to rise more than EUR rates in the forward space. That offers good risk-reward for receiving NOK rates		0.8	142 bp	94 bp	100 bp	175 bp	41.7 bp	-33.3 bp	€ 400,467	Year Ahead 2014
Rec 5y5y USD vs NOK	USD curve is far steeper than current NOK curve.	-	1.1	52 bp	48 bp		65 bp	52 bp	-13 bp	€ 205,691	Year Ahead 2014
Sell NOK Jun 14 FRA	Lower FRA Rates from mid-2014 onwards		9.1	163.5 bp	103.0 bp	125.0 bp	185.0 bp	38.5 bp	-22 bp	€ 547,903	Year Ahead 2014
NOK Mar-15/Mar-16 FRA steepener	Very weak NOK should push rate cuts out the curve		10.0	-4 bp	-2 bp	-25.0 bp	5.0 bp			-€ 20,000	Rates Weekly 7 Nov
Long 10y Sweden vs Germany	Deflation risks in Sweden are beyond even those in Europe and DBR has little headroom compared to SGB		10.0	35 bp	33 bp	15.0 bp	45.0 bp			€ 15,369	Rates Weekly 7 Nov
USD											
Euro$ Red/Green flattener EDZ5 vs EDZ6	Mean reversion in the funds rate is already priced in. It is not possible to have this level of certainty at this point.		-	121.0 bp	105.0 bp	105.0 bp	133.0 bp			€ 158,282	Jan Early Market Thoughts
1s3s5s 1y fwd USD swap fly, receive middle	Weaker global growth, low inflation pressure, dovish Fed shift, but still risk of hike too early		0.0	37 bp	3767.55%	10.0 bp	45.0 bp			-€ 3,484	Rates Weekly 31 Oct 2014
Receive USD 5y5y swap versus paying 15y15y	Trade motivated by a go-slow by the Fed as in 2004. 5y5y has already done much of the mean reversion.		2.9	2.0 bp	29.9 bp	50.0 bp	-67.0 bp		-6.0 bp	€ 94,807	Rates Weekly 21 Mar 2014
Receive USD 5y5y swap versus paying 1y1y and 15y15y	We seek to buy the rates that have normalised against those that have not. Alternative trade to USD 5y5y versus 15y15y		1.9	333 bp	190 bp		405 bp			€ 1,388,570	Rates Weekly 21 Mar 2014
Options Trades											

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Buy £50m GBP 10y10y 100bp-wide collar	10y10y collars cheapened dramatically in H2 2013. It wasn't on the scale of 2y30y, but the volatility of the 10y10y collar is lower, it never plumbed the depths in 2012, it is not beholden to ALM flows to anything like the same degree, and it is contrary to the likely dynamics of GBP vega in a sell off (LOBO trades still mean Bermudan books should go longer vega in a rally and shorter in a sell off). Options trade expressed in bp fwd premium	0.1	5.0 bp	-49.6 bp			40.0 bp	-10.0 bp	-€ 50,000	Year Ahead 2014
Buy 1y10y USD payer spread vs EUR payer spread	The USD-EUR rates spread is not justified by historical fundamentals, including spreads in such metrics as PMI and CPI. Options trade expressed in bp fwd premium	0.3	152.8 bp	172.8 bp			500.0 bp	-200.0 bp	€ 19,953	Year Ahead 2014
Buy 1y3y ATM EUR receiver	We expect the market to price in increasingly extended low rates in Europe. If expectations are unchanged, the roll-down alone makes for a 1y return of 53% on the premium.	0.1	0.0 bp	0.0 bp			35.0 bp	-20.0 bp	€ 5,362	Year Ahead 2014
Short 5y EUR vs 10y USD through 9m5y payers	Think 5y EUR could be vulnerable to shakeout on US strength, no decoupling. 10y USD supported by high fwd rates and domestic 'ALM' Options trade expressed in bp fwd premium	0.1	-82.5bp	-112.8bp			20.0 bp	-10.0 bp	-€ 30,343	Year Ahead 2014
Sell 119.5 puts for 20 ticks (0.3125) to buy $115k payers on 3 Jul 14 / 31 Aug 18 swaps struck at 1.557%	The Jun FV contract has actually been cheapening again. The historic swaption/CBOT vol charts show that the premium for exchange vol is currently high in 5s and 10s. The result is that the zero cost spread widener in puts/payers is not far from that.	0.0	0.0bp	0.7bp					€ 4,896	Rates Weekly 21 Feb
USD 20m ATM straddles vs receive fixed on USD 5.25m 10y swaps	We expect that the focus on 2015 rate hikes and the path of tapering until then will likely boost rates and volatility	0.1	0.0 bp	-10.0 bp			25.0 bp	-10.0 bp	-€ 100,000	Rates Weekly 28 Feb 2014
Enter EUR 2s5s10s 1 year forward	We like the trade on the basis of hardening of our probabilities of ECB action over past several weeks. The trade is directional but is 3bp cheaper to the correlation with 5y	10.0	-13.6 bp	-22.7 bp	-20.0 bp	-9.0 bp			€ 63,988	Rates Weekly 9 May 2014
Buy EUR 10m 20y20y receivers and 32m 20y20y payers	Easy to hold… vol rolls up and discounting outweighs option time value. Looking for a change in callable demand due to higher rates and/or changed behaviour following Solvency II. Options trade expressed in bp fwd premium	0.1	1250.0 bp	1164.0 bp			60.0 bp	-24.0 bp	-€ 361,041	Year Ahead 2014

Trade recommendations entered in 2014
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Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Buy Jun-14 Schatz 110.6/110.8/110.9 broken call fly vs. selling 110.1 puts	We see Schatz richening on depo cut speculation, and potentially trading in sub-zero in the event that ECB cuts the depo rate into negative.	- 8.3	-2.5 bp	2.5 bp			10.0 bp	-5.0 bp	€ 55,400	Rates Weekly 14 Feb
Vol weighted EUR5s10s flattener	The idea is 10y rallies more than 5y and so we look at a beta or norm vol weighted trade. Pay 5y with 100% risk and receive 10y with 90% risk	1.0	64.0 bp	70.3 bp	53.0 bp	69.0 bp			-€ 54,775	Rates Weekly 30 May 2014
EUR 2s10s30s, PCA weighted with a long in 10y; weights are -38.7%; 100%; -115.8%	A trade out of our PCA analysis wherein we like the risk allocation, as the yield curve Japanification means that 10s30s should structurally be steep relative to the 2s10s curve	5.1	118.7 bp	128.1 bp	124.0 bp	116.0 bp	5.0 bp	3.0 bp	€ 54,038	Rates Weekly 23 May 2014
Buy €10m 6m30y ATM+50bp payers against selling €10m 6m10y ATM+50bp payers	Tail curve is inverted between 10y and 30y. Use this to buy a 6m payer swaption on the 10y20y rate cheaply (you keep the correlation risk by doing this, rather than a midcurve option). This is in tune with our US-EUR no decoupling view and less ALM support for long end EUR theme.	0.0	14.1 bp	12.7 bp			20.0 bp	-10.0 bp	-€ 14,139	Year Ahead 2014
Buy 6m5y USD receiver spreads struck ATM/ATM-34bp for 15bp	Uncertainty is not high and the Yellen communication machine may well keep things that way. But risk events are packed into the first half. Options underprice this. Options trade expressed in bp fwd premium	0.0	34.0 bp	0.0 bp			340.0 bp	-150.0 bp	€ 60,321	Year Ahead 2014
Buy 6m 3.3%/3.7% single-look cap spread on the USD CMS 2y/30y spread	Fed-led reflation should be a negative for the long end as the inflation anchor is deliberately loosened and tapering reduces the frictional support for bonds. 2s30s single-look spread cap to take exposure to the steepening pressure. Options trade expressed in bp fwd premium	-	-40.0 bp	0.0 bp			250.0 bp	-100.0 bp	-€ 107,038	Year Ahead 2014
Sell 1y1y GBP payers, 11 bp OTM vs buying 1y1y USD payers	Getting bearish on the Fed vs the BoE	-	0.0 bp	0.0 bp			50.0 bp	-25.0 bp	€ 0	Rates Weekly 28 Mar 2014
Buy Jun 14 Euribor 100.00 Calls	We see prospects of good return should the market continue to rally on the prospect of negative interest rates	####	0.5 bp	0.0 bp			10.0 bp	-0.5 bp	-€ 5,000	Rates Weekly 14 Feb
Long 1y1y GBP 28bp-wide receiver spread vs 1y1y EUR receiver	GBP curve is high and steep. In cyclical slowdown and with dovish BoE there is much more scope for a rally in GBP than in EUR.	0.1	0.0 bp	-32.1 bp			28 bp	-15 bp	-€ 150,000	Rates Weekly 24 Jan
Sell 119 strile puts for Jun 20 expiry, buy $115.9k Jun 20 expiry mid curves on 3Oct14/30Nov19 swaps at same level for zero cost	A way to trade for a swap spread widener in a sell-off is back on.Exchange traded vols compared to swaptions are high and spreads are wider since mid-april.	####	164.3 bp	201.9 bp					€ 118,159	Rates Weekly 16 May 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
5s30s EUR steepeners in receiver swaptions	Weak structural demand for the long sector. ECB inaction storing up problems for future	0.1	119.8 bp	131.7 bp			30.0 bp	-20.0 bp	€ 214,106	Rates Weekly 28 Mar 2014
Buy 30bp wide receiver spreads on GBP 6m2y, 1bp OTM funded by 30bp wide receiver spreads on 6m2y USD	If hikes are priced out then there is much upside in GBP. On the other hand, short sterling is already priced for a Q115 hike and nearly 25bp a quarter in 2015/16	-	0.0 bp	0.0 bp					€ 35,000	Rates Weekly 21 Feb
Buy 20bp 3m6y USD wide payer spreads funded by 20bp wide EUR payer spread	USD inflation risks are mounting and FOMC is moving to the next stage, while, European inflation risks look subdued	-	0.0 bp	0.0 bp			20.0 bp	-10.0 bp	€ 33,500	Rates Weekly 14 Mar 2014
GBP10s30s bearish steepeners; 100m vs 44.25m for £90k/bp risk per leg at expiry/strike	Top right is cheap in vols and payer skew. The trade is to own the vol in this sector.	-	-42.5 bp	-42.5 bp					€ 0	Rates Weekly 30 May 2014
Short 10y on 5s10s20s fly in payers by buying middle swaption	1oy has outperformed 5s and 20s significantly and we expect it to underperform in a sell-off	-	1.2 bp	0.8 bp			120.0 bp	-65.0 bp	€ 0	Rates Weekly 25 Apr 2014
Sell EUR 5y5y straddles	A negative vol trade. The 5y5y is high on the grid and a benchmark gridpoint Options trade expressed in bp fwd premium	9.0	689.3 bp	1030.1 bp			150.0 bp	-100.0 bp	-€ 340,798	Year Ahead 2014
Buy 5y5y 1.8% strike receivers	The trade rolls down positively (17% return over 1 yr). This protects against a fall to 60bp in normvol - a level seen only relatively briefly in 2007. Coupled with our earlier trade short 5y5y, this effectively transforms the view to a "sell-receiver spreads" view, with a delta hedge	- 32.8	156.3 bp	410bp					€ 1,551,447	Rates Weekly 30 May 2014
Buy Dec-14 Euribor 99.875 calls and sell 99.375 puts	We like this structure because on generics, the 4th Euribor contract has not traded below 99.3 since Apr 2012	- 4.9	1.5 bp	4.3 bp			16.5 bp	-5.5 bp	€ 27,500	Rates Weekly 14 Feb
Buy EUR 1y1y straddles vs 2x strangles at zero cost	Limited volatility around current levels much more than a big repricing at this point	- 10.9	0.0 bp	46.9 bp			30.0 bp	-20.0 bp	€ 468,928	Rates Weekly 7 Mar 2014
Sell EUR 1y1y straddles for 50bp upfront	Curve seems to be priced. And we don't see rates hikes coming in early 2015	10.4	0.0 bp	0.0 bp			60.0 bp	-20.0 bp	€ 179,988	Rates Weekly 7 Mar 2014
Buy EUR 1y2y 30bp wide receiver spreads for 13bp running	Closing long 1y2y receivers and buying less vol	- 0.3	-26.3 bp	-5.7 bp			20.0 bp	-10.0 bp	€ 205,837	Rates Weekly 7 Mar 2014
Sell EUR 1y30y 3% payers for 74.3bp	The Dutch FTK looks even more likely to be delayed, meaning that pension funds sit on their hands unless rates rise materially making OTM payer an attractive sell	- 0.3	0.0 bp	0.0 bp					€ 103,215	Rates Weekly 23 May 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
EUR steepener 3y1y vs 10y20y	The back is justified by the idea that the ECB has been active (no bazooka though) and so long end should trade weak. This is a consensus trade for now that has moved already - but we think it has more room to go	1.5	195.0 bp	182.0 bp	225.0 bp	170.0 bp			-€ 121,543	Rates Weekly 6 Jun 2014
Buy EUR1y2y and EUR1y10y receiver swaptions, vs sell EUR1y5y 4.5bp OTM	2s5s10s is at extremes compared to 2s5s. 5y underperforms on the butterfly if Europe's old normal becomes its new. It also underperforms if Japan is Europe's future	0.4	-31.4 bp	-35.7 bp					-€ 35,402	Rates Weekly 30 May 2014
Buy USD 5y30y swaption straddle vs 5y5y	We expect that a steeper curve should result in increased interest in CMS steepeners. Options trade expressed in bp fwd premium	- 0.6	-8.3 bp	-21.8 bp			200.0 bp	-80.0 bp	€ 175,102	Year Ahead 2014
Payer fly in June 2015 Short Sterling puts: 1x2.5x1 weights	Market prices too much probability of more than one hike by August 2015, and too much of nothing at all. Pin one or two moves by August 2015 to make money on this fly.	0.0	0 bp	7 bp			25.0 bp		€ 72,531	Rates Weekly 31 Oct 2014
2s5s USD flattening in receiver swaptions	Global slowdown, dovish shift in FOMC, inflation likely to stay low.	1.5	-92 bp	-103 bp			12 bp	-7 bp	-€ 6,302	Rates Weekly 31 Oct 2014
5s10s USD steepening in receiver swaptions	Global slowdown, dovish shift in FOMC, inflation likely to stay low. But growth relatively positive and 5y5y fully pricing realistic longer term neutral rates.	0.1	68 bp	66 bp			15.0 bp	-7.0 bp	-€ 5,096	Rates Weekly 31 Oct 2014
10s30s bullish steepener in receiver swaptions	QE to squash the curve in front end but undermine long end. Dutch support for long end is going away, as reminded by FTK in Dutch parliament at time of trade recommendation.	- 0.6	59 bp	62 bp			15.0 bp	-8.0 bp	€ 5,153	Rates Weekly 17 Oct 2014
10s30s bullish steepener in receiver swaptions, but selling 2x risk on 1y30y OTM receivers	As above, but low strike skew in EUR long end should fall as ALM rollback allows pensions more leeway on hedging at low rates.	0.7	34 bp	62 bp			15.0 bp	-8.0 bp	-€ 7,439	Rates Weekly 17 Oct 2014
Sell ATM-80bp/ATM+100bp 2y30y strangles in EUR	Volatility is higher than likely to be experienced. CVA/Dutch receiving risks are reduced, inflation risks very modest on the upside for rates	4.4	0 bp	0 bp			200.0 bp	-100.0 bp	-€ 418	Rates Weekly 10 Oct 2014
50bp wide receiver spread in EUR, paid by Japanese receiver spread	5y5y EUR trade on Japanificatiopn of curve	2.0	84 bp	75 bp			25 bp	-15 bp	-€ 918	Rates Weekly 26 Sep 2014
Sell EUR 15y10y EUR vs USD	Low yield levels will lead to greater activity from German insurers on callables, pushing down volatility	1.1	0 bp	0 bp			300.0 bp	-100.0 bp	€ 4,455	Rates Weekly 26 Sep 2014
USD 5s10s steepeners in a rally via receiver swaptions	Expect dovish Fed noises from Jackson Hole and Fed. The Fed will hike later in order to fight inflation, not markets.	-	0.82%	0.82%	3.50%	3.25%			€ 0	Rates Weekly 15 Aug 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
6m expiry 2s5s bullish steepeners in EUR receiver swaptions	We think that if the ECB cuts interest rates to negative, there is possibly upside in short-rates. Doing more now may mean doing less later. We think that 2y rates can fall on further rate cuts.		0.0	-36 bp	-23 bp					-€ 282,785	Rates Weekly 16 May 2014
Sell UK 18m3m capfloorlet straddles for 16.25bp fwd premium	BoE Minutes didn't bring any more surprises and the market has priced around 24bp for Nov, which appears to be too much. Some rates hikes look highly likely even if inflation slows a little further. Sell vol		2.3	0 bp	0 bp					-€ 52,464	Rates Weekly 20 Jun 2014
Receive GBP 6m5y swaption receivers vs USD	Stress buildup between data and rhetoric can make central banks change minds. Market has now priced around 80% for a 25bp/quarter path from Nov. Any outside shock can pull that back	-	5.4	41 bp	-1 bp	30 bp	-20 bp			€ 2,276,998	Rates Weekly 20 Jun 2014
Sell EUR 2y5y 3% Payer	On the same terminal rate discussion as mentioned in our 2014 outlook we refresh the idea of selling high payer strikes		0.0	0 bp	40 bp			40.0 bp	-20.0 bp	€ 403,794	Rates Weekly 25 Apr 2014
1y expiry 2s10s30s in payer swaptions; Sell it in 1y10y	Bearish trade. It will take substantially lower inflation, crucially driven by weaker domestic demand to push back the rate hikes by a quarter or two		0.1	0 bp	0 bp					€ 5,229	Rates Weekly 21 Mar 2014
Buy 50m GBP 3y10y ATM payers vs 150m 5y2y payers for zero cost	The testimony at the TSC on QE exit plans suggests our central case of QE gilt sales once bank rate reaches around 1.5% in early/mid 2016		0.5	13 bp	15 bp			30 bp	-10 bp	-€ 93,336	Rates Weekly 14 Mar 2014
3y expiry single-look cap on 1y/30y EUR CMS	1y roll makes back premium plus 45%. This is a conservative way to express the steepener and should appeal to those who dislike entering at already historically steep levels.	-	0.0	175 bp	180 bp			40 bp	-20 bp	-€ 12,004	Year Ahead 2014
Buy EUR 20y20y straddles vs 10y20y 1:1 ratio	RV trade on Solvency II theme for German insurance… 20y20y gives you 10y extra optionality compared to 10y20y for free. Options trade expressed in bp fwd premium		2.9	-369 bp	-274 bp			200 bp	-100 bp	€ 94,302	Year Ahead 2014
Buy EUR 20y20y straddles vs 5y5y. 1:5 ratio.	5y5y has been very well supported and should be hit in what looks like a low volatility environment into early next year. Vega should find support as German insurance reduces appetite for callables. Options trade expressed in bp fwd premium		10.1	-1579 bp	-1941 bp			200 bp	-100 bp	-€ 361,639	Year Ahead 2014
Sell EUR 2y5y 3% Payer	Core view is roll down and lower vol. This decays quickly and is protected against sell off to top of levels we see as possible. Options trade expressed in bp fwd premium	-	0.0	80 bp	64 bp			60.0 bp	-35 bp	€ 158,894	Year Ahead 2014

Trade recommendations entered in 2014
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Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Short 5x10 capfloors vs 5y5y EUR straddles	RV trade. 5x10 capfloors look expensive. Options trade expressed in bp fwd premium	-	2.1	0 bp	6 bp			50.0 bp	-20 bp	€ 60,310	Rates Weekly 17 Jan
Sell EUR 5y5y5y vol through triangle	5y5y5y looks very high for a lower vol environment Options trade expressed in bp fwd premium		0.1	225 bp	231 bp	175 bp	245.0 bp	50 bp	-20 bp	-€ 64,970	Rates Weekly 17 Jan
Buy 10y10y USD vs EUR ATM swaptions	Historic levels look good. US callable supply has been light. Options trade expressed in bp fwd premium		1.2	5 bp	26 bp			30.4 bp	-7.6 bp	€ 138,471	Rates Weekly 17 Jan
Buy 15y30y GBP straddles	Look for the reasons for GBP vega's relapse into pariahood to fade or end in 2014, in particular a new year for dealers, and support for EUR vega. Options trade expressed in bp fwd premium	-	10.3	1972 bp	2639 bp			300 bp	-140 bp	€ 413,738	Year Ahead 2014
Buy GBP 1y30y receivers struck at 3.3% (30y spot is 3.32%) and sell receivers at 3.1% and 2.9% for zero cost.	LDI collar demand has steepened receiver skew. This is a bullish protection trade, that loses only in a rally to all-time lows, and makes in a 60bp range. Options trade expressed in bp fwd premium		19.4	-5 bp	134 bp			400.0 bp	-200.0 bp	€ 138,666	Year Ahead 2014
Buy 50bp wide 1y10y SEK receiver spreads funded by selling 48bp wide receiver spreads on 1y10y GBP	UK is recovering fast, inflation expectations are not at risk and rate hikes are on the immediate agenda. While Sweden is mired in delfation already if you look at headline rates. ECB may be shy of QE but Riksbank is not and can be bolder. 10y should rally.		6.5	2 bp	-34 bp					-€ 362,912	Rates Weekly 20 Jun 2014
Sell 3% US CPI Caps	USD CPI will have to set above approx 3.8% every year for five years to lose money on this trade. Options trade expressed in bp fwd premium		-	375 bp	208 bp			75 bp	-25 bp	€ 167,376	Year Ahead 2014
Buy 2y10y vs 2y5y and 7y5y USD ATMF Swaptions	Historic level for triangle is very high	-	0.7	400 bp	399 bp			100 bp	-40 bp	-€ 11,945	Rates Weekly 24 Jan
Inflation Linked											
Receive 30y zero coupon RPI	A stronger economy should support stronger stocks and stronger sponsors. Higher real yields should support breakeven inflation.		0.0	3.740%	3.680%			0.0 bp	0.0 bp	-€ 220,284	Year Ahead 2014
Receive 30y RPI vs fixed	Pension schemes are wealthier than in a long time and uncertainty about new fiscal year supply likely to support activity. Options trade expressed in bp fwd premium		40.2	3.6875%	3.6499%			300.0 bp	-140.0 bp	-€ 140,000	Linked-Up 14 Jan
Long 50y RPI zero coupon swap	Light supply into fiscal year end, strong LDI demand, ASW valuations not compelling for buyers.		-	3.635%	3.608%	3.730%	3.610%			-€ 32,894	Rates Weekly 31 Jan
Long 10y USD breakeven inflation vs 5y	5y may come under pressure due to oil, while 5y5y does not look high.	-	0.0	14.5 bp	8.0 bp	33.0 bp	5.0 bp			-€ 49,686	Rates Weekly 31 Jan

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale	Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Buy OATei18s at 94bp, Sell BTPei18s on breakeven at 81bp	BTPei18s have outperformed the OATei18s by around 10bp on breakeven. At similar levels of breakeven, it is worth owning French breakevens	- 0.5	-13.1 bp	-18.6 bp			10.0 bp	-6.0 bp	€ 106,475	Linked Up 4 Mar 2014
5s10s EUR breakeven flattener	5y looks well priced to balance risks of disinflation. As the theme develops, it should infect the 10y. Buy OATei 18 vs 24	- 0.2	47.0 bp	22.8 bp	32.0 bp	60.0 bp			€ 249,278	Rates Weekly 31 Jan
Buy BTPei Sep-16s outright	Implied breakeven is very low. If inflation realises there, the ECB will need to be very supportive of inflation and by extension Italian spreads. Conversely, if inflation is higher, you have a lot of upside before ECB hikes come into play to hurt the roll-down	- 12.7	0.90%	0.01%			117.7 bp	39.2 bp	€ 1,173,303	Year Ahead 2014
Buy IL17s -1.56% on real yield vs pay GBP 5y5y swaps	This is the reflation trade. The MPC gets behind the curve, reflating the front and the market looks for moderation beyond.	1.8	-538.0 bp	-488.8 bp			675.0 bp	475.0 bp	-€ 472,844	Year Ahead 2014
5s30s EUR real rate steepening	5s30s real rates are prices to invert in three years time. 5s30s nominal does not. This doesn't make sense. 5y reals might be high if deflation is expected, but it would have to be dramatic to invert the real curve. Japan demonstrates this.	1.4	77.0 bp	61.7 bp			30.0 bp	-9.0 bp	€ 90,000	Year Ahead 2014
Receive 1y CPI-U on the Mar14 base	Inflation seems to start rising for the next few months; in the core components, rents and OER have been very strong; also base effects in the PCE deflator also point to increased general inflation pressures	8.5	1.65%	2.17%			25.0 bp	-15.0 bp	€ 214,376	Linked -up 12 May 2014
Long 30y RPI zero coupon swap	(1) Light supply in linkers over the remainder of the year, (2) a supportive medium-term environment for long-dated real rates due to pensions reforms, (3) good pension scheme solvency despite low yields, (4) ALM accounts aiming to meet risk-reduction targets over the remainder of the year, (5) reduced real yield expectations.	12.5	0.0 bp	0.0 bp	0.0 bp	0.0 bp			-€ 27,500	Linked-Up 21Jul 2014
Long 30y RPI zero coupon swap	Market indigestion after IL68 supply looks over. Supply is now light, especially in the 30y. 50 asw valuations still look attractive and may generate paying in the ultra-long end, but 30y asw are less attractive	13.6	3.568%	3.540%	3.650%	3.540%			-€ 172,140	Rates Weekly 21 Feb

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Enter EUR 2y2y breakeven swap widener	Notable ECB action like rate cuts allied to Odyssean guidance or a fwd commitment to buy assets, can weaken the euro Fx. We do not want to hold this trade for long given the -ve carry of 4.5bp/3m and our disinflationary view.		10.2	1.320%	1.430%	1.50%	1.25%			€ 55,000	Rates Weekly 16 May 2014
5s10s BEI flattening in EUR HICPx	Timid ECB response to continue to drive down inflation expectations, so extend this further out on curve		9.8	0.42%	0.51%	42bp	51bp			€90,000	Rates Weekly 26 Sep 2014
Long 5y EUR iota	Short dated linkers are cheap compared to inflation swaps (except for DBRi)	-	9.2	-24 bp	-30 bp			10 bp	-7 bp	-€ 80,759	Rates Weekly 15 Aug 2014
5s10s EUR HICPx steepener and iota widener, long Italy	Breakeven curve too flat. Iota too wide. Italy too cheap.	-	9.2	261 bp	221 bp			30.0 bp	-15.0 bp	€ 91,217	Rates Weekly 15 Aug 2014
Buy IL20s vs IL17s and IL22s on real yield	IL20s are cheap, though not new, it still is puzzling despite high liquidity	-	0.3	21 bp	20 bp			6 bp	-3 bp	€ 243,517	Rates Weekly 13 Jun 2014
Sell OBLi18s vs OATei18s in breakevens	German linkers have outperformed French earlier this year and have held onto it, despite having nothing special to offer: suffer supply pressure, no liquidity advantage, have a lower yield and no roll-down to sweeten the risk/reward if inflation comes in low.		0.1	23 bp	26 bp	10 bp	6 bp			€ 8,501	Linked Up 10 Jun 2014
Sell OATi19s on the 17s/19s/21s fly	Relative value trade: Looking at the z-spread OATi19s are expensive on the 17s/19s/21s French inflation fly		0.1	-14 bp	-6 bp					€ 149,482	Linked Up 10 Jun 2014
Buy BTPei21s at 1.11% breakeven and sell OATei20s and 22s at 1.16% and 1.30% respectively	Italian breakevens are cheap and the trade looks an easy pickup trade given the fact that liquidity isn't a problem either	-	0.2	15 bp	-1 bp			15 bp	-8 bp	€ 291,254	Linked Up 10 Jun 2014
Long UK IL20s vs IL19s	IL20s are the only really cheap bond on the curve, the other 8m linkers having richened closer to fair value.	-	0.1	-19 bp	-11 bp			5 bp	-3 bp	€ 76,812	Rates Weekly 31 Jan
Pay the 20y in the 10s20s30s RPI swap barbell	Middle-dated breakevens look expensive. 10y10y is over 4% in swaps. This is largely because 10s20s is very steep.	-	0.9	28 bp	33 bp	18.0 bp	33.0 bp			-€ 43,861	Year Ahead 2014
Own OATei18s vs BTPei18s on breakeven	The French issue prices inflation to be lower than the Italian issue. We remain positive on Italian breakevens catching up, but this is for other issues where inflation is at a discount to France		0.5	21 bp	-9 bp		10 bp	-6 bp		-€ 587,737	Linked Up 2 July 2014
Buy April-18 TIPS outright	4y TIPS price 2% inflation. In a more modest reflation there are 250bp of rate hikes that might not happen. Roll down of 100bp is a big cushion.	-	9.4	-0.65%	0.10%		35 bp	-15 bp		-€ 728,445	Linked Up 2 July 2014

Trade recommendations entered in 2014
Please see our Year Ahead 2015 for current trade recommendations

Trade Details	Rationale		Delta €k)	Entry (Level)	Current (Level)	Target (Level)	Stop (Level)	Target (upfront bp)	Stop (upfront bp)	P&L (€)	Write-Up
Buy BTPei Sep-19s vs 18	4y TIPS price 2% inflation. 4y German linkers price 1.13%. In a reflation TIPS can clearly price in 40-50bp further before the Fed comes into play. In a disinflation, there is very little upside in 4y German nominal yields, while 5y TIPS have 100bp of roll.	-	1.0	-6 bp	2 bp	25 bp	-10 bp			-€ 74,643	Linked Up 2 July 2014
Buy Jan-24 TIPS at 2.19% and sell Jan-19s at 2.08% with equal proceeds	Sentiment on TIPS has stabilised; EPFR data for TIPS funds show that outflows from North America real rate funds have almost stopped		0.7	-11 bp	-33 bp			20.0 bp	-10.0 bp	-€ 1,306,371	Linked Up 4 Mar 2014
Buy BTPei Sep-19s vs 18	BTPei18s are too rich on the curve. As an on-the-run bond they should cheapen accordingly.	-	0.6	26 bp	1 bp	12 bp	31 bp			€ 235,647	Rates Weekly 31 Jan
Buy UK IL17s - Sept 17 nominal yield bond	Market pricing of RPI less MIPS, as probably implied by the path of nominal rates, is consistent with sub-1.5% CPI in 2016		0.1	2.96%	2.17%	3.250%	2.700%			-€ 1,006,831	Linked -up 12 May 2014
Buy OATei18 vs OAT 4% Apr-18s	Short dated OATei look attractive. Assuming 117.57 for the April HICPx print, we think that this breaks even if trend inflation averages 1.1% over the next year		0 bp	1.08%	0.16%			12.0 bp	31.0 bp	-€ 816,506	Linked -up 12 May 2014
Buy BTPei Sep-16s outright	The trade was recommended in our Year Ahead 2014 back in Nov 13 and it hit the target of 100bps. We extend the target.	-	7.7	8 bp	75 bp			50 bp	-20 bp	-€ 238,097	Linked -up 12 May 2014
Pay inflation in 5y5y EUR HICP Pay on 20m 10y and rec in 20m 5y	We expect the disinflation theme to press out the curve. Roll down for short inflation trades is strong this far out with 5y5y 15bp over 4y5y.	-	11.5	2.19%	1.65%	1.750%	2.350%			€ 605,494	Year Ahead 2014
Long 2y8y US CPI through cash for cash extension in TIPS	Expect consumer revival in US and breakevens are very low		1.3	2.004%	1.768%			40 bp	-25 bp	-€ 242,599	Rates Weekly 14 Nov
5s10s breakeven flattener in Spanish linkers	Expect rolling flattening of breakeven curve, or bullish flattening on QE. Spanish RV works well for this trade, as well as the supply cycle.		-	46 bp	51 bp			30 bp	-15 bp	-€ 39,652	Rates Weekly 14 Nov

Source: RBS

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