Global Rates Strategy
Q4 outlook

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Macro Outlook
Summary of views and main themes in each region

- Reflecting the downward price pressures and the weaker dollar, we anticipate that the ECB will announce an expansion of its QE programme in Q4.

- However, we also think that the series of stimulus measures adopted in China since the summer are likely to stabilise global growth concerns. If correct, US and UK front ends appear expensive.

- The same view should allow an unwind of what has been an unusual degree of divergence in global swap spreads over the last six weeks.

- In the US, the market continues to price for a very dovish Fed lift-off, with low vol on shorter tails, flat front-end curves and a steeper long-end. While disinflation and global concerns may preclude longer maturity yields from breaking higher, we look to fade some of the recent moves to extremes in vol, curves and spreads.

- In Europe, we look at the impact of the potential ECB easing measures. We favour expressing our bullish duration view via conditional trades.

- In the UK, the focus remains on monetary policy. We favour positive carry shorts with limited downside. But, for the risk that domestic data deteriorate and UK hikes are taken off the table, we also add some bullish exposure to our portfolio.
Taking a step back, where are we?

**A short post-crisis synopsis**

Interaction of constrained macro policies, regulatory tightening and weak growth leaves investors 'trapped' in rich assets threatening the effectiveness of QE.
Developed market economies rediscover the soft patch

- US, EUR and Japanese manufacturing data are now all sub-par. We evaluate the manufacturing data releases using PMI headline and new orders, factory orders and industrial production.

- US manufacturing data have seen the sharpest change in direction in the recent releases, and are almost two standard deviations below the recent average.

- Services data are still above their three year average on a global basis, but also seem to have peaked near term.

- By region, US, Japanese and UK data releases have turned sharply lower, while European releases have held up so far.

- For rates, the loss of economic momentum increases the chance of policy stimulus and makes it hard to run negative carry positions.

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service
Labor markets have outperformed modest growth

- Unemployment rates across DMs continue to fall (despite unremarkable growth).
- The poor performance of measured productivity keeps downward pressure on long run expectations for neutral policy rates.
- DM consumer demand is benefitting from the terms of trade shock, signalling that outright deflation risk is low.

Source: Credit Suisse, OECD, Haver

Real retail sales continue solid growth

...despite unremarkable GDP growth
Market link to IP momentum has been poor in 2015

- Our economists see a near-term peak in global IP momentum at a historically low 2% in September.
- Risk appetite has been falling (touching “panic” at the end of September) even as IP momentum strengthened, suggesting that economic surveys and policy commitments may have a larger bearing on the market.
- Normally, equities outperform bonds in the three months after a risk appetite “panic.”

Source: Credit Suisse
While direct channels from EM weakness don’t appear large, indirect channels are hard to gauge

- US and euro area inflation likely more sensitive to Asian risks than GDP
- One area where we expect weakness is in traded goods and commodity prices, which have already slumped in dollar terms
- It is harder to gauge impact on business confidence…
- …but impact on goods inflation is much clearer

**China PPI leads US goods inflation**

**Inflation more sensitive than GDP to Asian risks**

**Traded goods and commodity prices slump**

Source: Credit Suisse, OECD
Will the Chinese economy stabilize toward year-end?

- Our economics team notes that while Chinese growth momentum can stabilize toward year-end, there is a clear structural component to the slowdown.
- The weakening in the Chinese economy has been associated with reduced market expectations for Fed tightening.
- Deflation in the Chinese manufacturing sector is sending corporates a strong signal to slow down investment programmes!
- As seen in August, there is a risk to DM markets if China is thought to be exporting its deflation problem through a weaker currency.
- Reflexivity between China and DM rates markets has increased since the summer. Our core view is that stabilisation will be enough to advance Fed tightening expectations.
Policy divergence in G5 driven by easing central banks

- Divergence is likely to be driven more by BoJ and ECB easing than it is by Fed or BoE tightening.
- We expect additional accommodation from the ECB and BoJ via balance sheet expansion.
- Start of policy tightening has been pushed back for the Fed and BoE amid weaker global and domestic data.
- We think policy divergence has been postponed but not cancelled. It will return to prompt front-end divergence while long ends remain well supported in most markets.

Source: Credit Suisse, Central Banks, National Treasuries
### A timeline of key events that could affect duration

<table>
<thead>
<tr>
<th>Event Description</th>
<th>Date</th>
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<tbody>
<tr>
<td>16-Oct-15 Final HICP</td>
<td>16-Oct-15</td>
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<tr>
<td>22-Oct-15 ECB meeting</td>
<td>22-Oct-15</td>
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<tr>
<td>26-Oct-15 German IFO</td>
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<td>29-Oct-15 Q3 GDP (1st reading)</td>
<td>29-Oct-15</td>
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<tr>
<td>30-Oct-15 BoJ meeting</td>
<td>30-Oct-15</td>
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<tr>
<td>30-Oct-15 Estimate HICP</td>
<td>30-Oct-15</td>
</tr>
<tr>
<td>2-Nov-15 PMI manufacturing</td>
<td>2-Nov-15</td>
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<tr>
<td>2-Nov-15 Final PMI</td>
<td>2-Nov-15</td>
</tr>
<tr>
<td>2-Nov-15 ISM Manufacturing</td>
<td>2-Nov-15</td>
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<tr>
<td>4-Nov-15 PMI services and composite</td>
<td>4-Nov-15</td>
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<tr>
<td>5-Nov-15 BoE meeting &amp; QIR</td>
<td>5-Nov-15</td>
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<tr>
<td>5-Nov-15 Norges Bank meeting</td>
<td>5-Nov-15</td>
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<tr>
<td>5-Nov-15 BoE QIR</td>
<td>5-Nov-15</td>
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<td>6-Nov-15 US Payrolls</td>
<td>6-Nov-15</td>
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<td>11-Nov-15 Labour market data</td>
<td>11-Nov-15</td>
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<td>13-Nov-15 Retail Sales</td>
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<td>15-Nov-15 G20 meeting in Antalya</td>
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<td>16-Nov-15 Final HICP</td>
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<td>17-Nov-15 Inflation data</td>
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<tr>
<td>17-Nov-15 Estimate for when US Treasury would run out of cash</td>
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<td>18-Nov-15 October FOMC Minutes</td>
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<td>19-Nov-15 BoJ meeting</td>
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<td>24-Nov-15 German IFO</td>
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<td>25-Nov-15 UK autumn statement &amp; spending review</td>
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<td>1-Dec-15 PMI manufacturing</td>
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<td>1-Dec-15 Final PMI</td>
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<td>4-Dec-15 US Payrolls</td>
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<td>16-Dec-15 Final HICP</td>
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<td>16-Dec-15 FOMC Rate Decision, SEP &amp; Press Conference</td>
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<td>17-Dec-15 Norges Bank meeting</td>
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<tr>
<td>18-Dec-15 BoJ meeting</td>
<td>18-Dec-15</td>
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<tr>
<td>20-Dec-15 Spain, General election</td>
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Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service
Weaker growth has depressed vol-adjusted carry

- The deceleration in growth momentum has prompted a decline in yields and the compression of carry across G10 curves.

- Poor liquidity has supported both actual and to some extent implied vol, meaning that carry-to-vol ratios are close to their worst point over the last 6m in many cases.
Limited risk carry trades and shorts are an attractive way to position in the current environment

- We think that 1x2 receiver spreads or ladders are an attractive way to position, given the level of volatility and skew, as well as outright yield levels.

- At the same time, payer skew has declined, allowing for lower cost hedges against an increase in rates using OTM payers.

### Longer expiry USD 30y Payers have the least decay

<table>
<thead>
<tr>
<th>Roll</th>
<th>1y</th>
<th>2y</th>
<th>5y</th>
<th>10y</th>
<th>20y</th>
<th>30y</th>
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<tr>
<td>6m</td>
<td>-78%</td>
<td>-68%</td>
<td>-57%</td>
<td>-47%</td>
<td>-39%</td>
<td>-36%</td>
</tr>
<tr>
<td>1y</td>
<td>-41%</td>
<td>-38%</td>
<td>-29%</td>
<td>-24%</td>
<td>-18%</td>
<td>-17%</td>
</tr>
<tr>
<td>2y</td>
<td>-26%</td>
<td>-23%</td>
<td>-19%</td>
<td>-15%</td>
<td>-11%</td>
<td>-10%</td>
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<tr>
<td>3y</td>
<td>-16%</td>
<td>-15%</td>
<td>-12%</td>
<td>-10%</td>
<td>-7%</td>
<td>-7%</td>
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<tr>
<td>4y</td>
<td>-12%</td>
<td>-11%</td>
<td>-10%</td>
<td>-7%</td>
<td>-5%</td>
<td>-5%</td>
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### Historical Breakevens of 1x2 Rec. Spread

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<th>1y</th>
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<th>5y</th>
<th>10y</th>
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<th>30y</th>
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<tbody>
<tr>
<td>6m</td>
<td>-87%</td>
<td>-81%</td>
<td>-74%</td>
<td>-67%</td>
<td>-62%</td>
<td>-59%</td>
</tr>
<tr>
<td>1y</td>
<td>-49%</td>
<td>-47%</td>
<td>-38%</td>
<td>-32%</td>
<td>-27%</td>
<td>-25%</td>
</tr>
<tr>
<td>2y</td>
<td>-32%</td>
<td>-28%</td>
<td>-24%</td>
<td>-20%</td>
<td>-16%</td>
<td>-15%</td>
</tr>
<tr>
<td>3y</td>
<td>-19%</td>
<td>-18%</td>
<td>-15%</td>
<td>-12%</td>
<td>-10%</td>
<td>-10%</td>
</tr>
<tr>
<td>4y</td>
<td>-14%</td>
<td>-13%</td>
<td>-12%</td>
<td>-9%</td>
<td>-7%</td>
<td>-7%</td>
</tr>
<tr>
<td>5y</td>
<td>-8%</td>
<td>-8%</td>
<td>-8%</td>
<td>-8%</td>
<td>-8%</td>
<td>-8%</td>
</tr>
</tbody>
</table>
Global ASW reflects different factors—poor market liquidity in USD and QE in Europe

- US spreads cheapened most acutely around quarter-end as liquidity, EM selling pressure and elevated funding costs for collateral drove the move.
- EUR spreads, conversely, have richened, reflective of expectations for additional easing from the ECB, suggesting that the ECB has served to buffer EM selling.
- UK spreads, meanwhile, fall between the US and EUR narratives.

Source: Credit Suisse Locus, Central Banks, National Treasuries
Other risks to watch: US Government Debt Ceiling

- Treasury Secretary Lew’s guidance that extraordinary measures will be exhausted around November 5 points to Treasury running out of cash around the middle of the month.

- We estimate that Treasury will exhaust its cash balance around November 17, but this can shift notably depending on tax receipts and non-marketable borrowing.

- Political uncertainty around the House Speakership clouds the outlook and a protracted stand-off may complicate the Fed’s December decision.

Source: Credit Suisse, US Treasury
Other risks to watch: UK Politics

- Brexit risk: EU referendum will certainly be held by the end of 2017, but it is most likely to be in mid-late 2016. The most recent polls show support for leaving the EU is now in the lead.

- Fiscal risks: Fiscal consolidation continues in the UK, with a commitment by the current government to eliminate the deficit by 2019/20. The Chancellor will launch the Spending Review on 25 November, which will outline how the government will deliver the £20bn of further savings which have been promised.

EU membership poll: Out takes the lead in latest polls

If there was a referendum on Britain’s membership of the European Union and this was the question, how would you vote? See notes for question wording changes

US Rates Outlook

Praveen Korapaty
Carlos Pro
William Marshall
Jon Cohn
Fed pricing and policy considerations
Front-end priced for a very dovish lift-off

- US rates front-end is well through all measures of central tendency of the FOMC’s dots, pricing for an exceedingly gradual path of rate hikes.
- The market is assigning a substantial probability to a “Japanization” style outcome, suggesting a high risk of repricing assuming the Fed does actually raise rates.
- We see scope for front-end steepening even if the Fed stays on hold, and favor EDH6/H7 steepeners.

**ED H6/H7 adjusted for H6**

- Regression residual of EDH6/H7 vs EDH6
  
y = -0.356 x + 36.101
  r: -0.663
  r²: 0.439
  T: -14.021

**FOMC Projections as of 09/17/2015**
- Trimmed Mean Projection (dovish 1, hawkish 4)

**Year-End Market OIS as of 10/13/2015**
- 2015
- 2016
- 2017
- 2018
- Longer Run

**Source:** Credit Suisse, the BLOOMBERGPROFESSIONAL™ service, Federal Reserve
Will disinflation force the Fed to stay on hold for longer?

Three themes continue to drive US inflation: core goods deflation, medical services disinflation, and shelter's outsized positive contribution.

From a top-down perspective, core goods in the US face deflationary pressures from China.

Owners' Equivalent Rent, and shelter broadly, could also taper their pace some.

Medical services faces downward pressure stemming from ACA's incentive schemes.

Source: Credit Suisse (US Economics team), Credit Suisse Locus.
What’s the Fed’s take on why PCE is below 2%?

The Fed has a different time scale. “Transitory factors”, and not slack, have contributed to much of the decline this year.

*Deviation of PCE inflation (fourth quarter to fourth quarter) from 2%, total and portion attributable to specific factors. Other factors include change in relative food prices.

Source: Federal Reserve
Intermediate/long end curve flattening is likely to resume in the medium term...

(Charts assume a December first hike)

10s/30s flattened in the past cycles going into first hike

…as did the 5s/30s curve

Tamed inflation expectations should also reduce substantial steepening risk

Source: Credit Suisse Locus
…though depressed term premia could moderate this flattening

- While we anticipate long-end flattening, we think it is likely to be less pronounced than in previous hiking cycles given a shallower hiking cycle this time around
- That said, consistent with our flattening view, we note that term premium hasn’t risen too sharply in the intermediate and long-end sectors in past cycles
- Structural trades we favor: 10s30s flattener, 3s30s flattener (though we would wait until macro data begin to firm up)
Swap spreads, funding conditions and liquidity
Front-end swap spreads—tight, but still susceptible to flows…

- Front-end swap spreads tightened substantially as EM reserve manager sold Treasuries to combat capital outflows and collateral funding costs rose substantially around the Fed and quarter-end.

- Front-end spreads should widen modestly, but remain susceptible to EM instability and outflows, as holdings of USD reserve assets in EM have fallen recently.

Expect modest 2y spread widening over forecast horizon

2y swap spreads tightened alongside EM FX weakness

EM USD reserve assets have declined in recent months

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service
... and funding, which is likely to remain tight around year-end end

**USD funding tightness has moderated in international markets**

**Funding tightness remains more apparent in domestic markets**

**Funding appears tight around year-end, but not abnormally so**

... and unlike near months, December will likely remain tight

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service
Intermediate and longer-maturity swap spreads

- Further out on the curve, spreads tightened sharply around quarter-end as poor liquidity and elevated costs of financing collateral drove the sharp move.
- We expect spread widening over the forecast horizon, though there are near-term risks to this as issuance picks up after earnings.
- **We favor buying payers vs puts on TY** to position for normalization towards fair value, even if there is some near-term issuance-related tightening pressure.

Collateral funding costs rose sharply around the Fed and quarter-end

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service
The move in inflation breakevens has largely been the result of a repricing of liquidity premia

We find that liquidity risks explain 75% of the volatility of TIPS breakevens’ market risk premium

Inflation risk premium remains negative given global disinflationary pressures

Source: Credit Suisse Locus, Federal Reserve
Market depth has seen some structural shifts, particularly in the US

- Market depth* has declined compared with 2014:
  - In the US, having unsurprisingly declined around year-end, depth has failed to materially rebound
  - In Europe, depth increased with the start of QE, but has evaporated following the May sell-off
- Volumes, meanwhile, have remained relatively steady this year as compared to last:
  - Comparable volume on diminished depth leaves greater scope for gappy price action as market participants try to fit through what amounts to a smaller window

*Measured by the average amount (in $mm) of OTR 10y Treasuries bid/ offered 3 levels wide; using 60-second snapshots from 8:30am to 10:30am. In Europe, we consider Bund and BTP futures, within three levels, intraday
Trade ideas
Trade Idea: EDH6-EDH7 Steepeners

- The front end appears too flat—EDH6/H7 steepeners are pricing slightly less than two hikes from 2Q16 to 2Q17
- The yield curve has been directional with the level of yields—if we are right about the direction of yields, the curve has ample room to steepen
- At the same time, we think it will be hard for markets to price less than what is being priced now given our outlook for the US economy. EDZ5/Z6, for instance, are pricing only marginally fewer hikes
- At the same time, if the Fed decided to hold off in December, hike probabilities are likely to get further back-loaded into later 2016, again, steepening the EDH6/H7 curve
- Given risk of a soft patch in data in near term, we refrain from initiating trade at current levels, but will look for opportunities to do so.
Trade Idea: 5s10s inflation swap steepeners

- We favor 5s10s inflation swap steepeners to position for downside risk to oil prices amid tamed US core inflation dynamics in the near term.

- As we noted above, the most important driver of inflation in the US (Owners’ Equivalent Rent), may start to moderate on the back of the slowdown in house prices of H2:2014 that followed taper-tantrum in 2013.

- Our technical analysts highlight that below $56.6 in Brent, the recent move likely remains just a corrective bounce prior to a move back to the lows.

- This trade idea is also predicated on the “global growth slowdown” risk, as oil prices tend to be a bellwether for global demand.

- The 5s10s inflation swap curve appears too flat for to the state of Global Risk Appetite.

- See full discussion [here](#).
Trade Idea: Buy Payers vs puts on TYZ5

- Near term normalization of funding conditions and slowing de-risking should allow spreads to revert from historic extremes.

- The options market implies inverse yield and spread directionality – i.e. spreads should widen in a rally, and tighten in a sell-off.

- In reality, the delivered beta of spreads versus yields has been positive, meaning that spreads have widened in sell-offs and tightened in rallies.

- We therefore like expressing a spread widening view conditionally via buying payers versus selling puts on TYZ5.

- See full discussion [here](#).

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Source: Credit Suisse Locus
Trade Idea: Buy 1y2y straddles vs 1y10y straddles

- The eventuality of Fed lift-off should be supportive of vol on shorter tails.
- 1y2y implied vol is at its lowest level versus 1y10y vol, suggesting the expectation of a very unusual lift-off.
- Even after accounting for more dovish Fed expectations, 1y2y vol appears cheap. Furthermore, 2y tails have been out-delivering implied vols, while 10y tails have under-delivered implieds.
- See full discussion here.

Source: Credit Suisse Locus
Trade Idea: Long 3m30y 1x2 receiver spread

- Near-term favor 1x2 premium neutral receiver spreads to position for potential continuation of weakness.

- Global factors will likely continue to drive the long-end, particularly in light of the Fed’s explicit emphasis on the need for caution given risks abroad.

- While we expect a gradual sell-off in 30s, we do not see any near-term catalysts to spur longer maturity yields sharply higher.

- To lose money at expiry, 30y swaps would have to close around all-time lows.

- See full discussion [here](#).

Source: Credit Suisse Locus
European Rates Outlook

Corentin Rordorf
Florian Weber
Marion Pelata
European Macro and ECB policy
ECB: Inflation target remains very optimistic

- Inflation remains far from its medium term target, with little sign of normalization
- Global manufactured good prices should lead to further weakening of core and headline inflation
- Appreciation of the euro is very much an additional risk
- The recent strengthening of the euro reduces the potential to import inflation from abroad

Headline inflation forecast remains optimistic

Imported inflation likely to fall

Source: Credit Suisse, Eurostat
ECB: options ahead of October meeting

- “We will evaluate the likelihood for inflation not only to converge to levels that are closer to 2%, but also to stabilise around those levels with sufficient confidence thereafter”

- Our economics team expect a QE extension at the 3 December ECB meeting

- Recent announcements are hints toward this direction: (i) PSPP – ISIN share limit increased to 33%, (ii) ABSPP – increased proportion of purchases by NCBs relative to external managers, (iii) ABSPP – extension to guaranteed mezzanine tranches, (iv) Bundesbank – repo facility extension to ASL Plus, and finally (v) PSPP – reverse auctions trials to be conducted.

- We also think that an ECB announcement in October will be more impactful than in December, as it will come as a surprise to the market.

- We expect any new ECB action to be broadly bullish for rates

### ECB options ahead of October meeting

<table>
<thead>
<tr>
<th>Policy change or strong guidance at the ECB October meeting regarding:</th>
<th>No policy change or guidance in October</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Duration</strong></td>
<td>QE extension</td>
</tr>
<tr>
<td><strong>Curve</strong></td>
<td>Flatter</td>
</tr>
<tr>
<td><strong>Spreads</strong></td>
<td>Unchanged</td>
</tr>
<tr>
<td><strong>Money Markets</strong></td>
<td>Unchanged, small flattening</td>
</tr>
<tr>
<td><strong>Probability</strong></td>
<td>35%</td>
</tr>
</tbody>
</table>

Source: Credit Suisse
Evidence so far suggests a moderate positive short-term impact, but concerns on long-term consequences are growing while negative rates are a less effective deterrent in an environment of risk aversion.

A change in policy rate would have the benefit of an element of surprise, and open the door to further cuts, forcing the money markets curve to reprice accordingly.

However, the pass-throughs from money markets to FX and from FX to inflation are far from clear in this environment, and are likely to be affected by a growing number of factors independent of the ECB’s policy reach (Fed, China, etc.).
ECB: The market is pricing for a deposit rate cut

- The market is pricing a 40% probability of a 10bp deposit rate cut.
- Eonia fixing is a factor of (i) excess liquidity, (ii) funding stress, and (iii) policy rates.
- A QE extension/acceleration should have little to no impact on Eonia forwards. But a deposit rate cut would.

The probability of a -12.5 strike on ERH6 is at 40%...

... and the probability of a cut by dec-16 is at 50%
In a deposit rate cut scenario, 5y should outperform

- When comparing with SEK or DKK, we see that EUR 5y is quite rich now both as a spread to 2s and on the 2s5s10s fly, hence we could expect to see 5y underperform in the event of a further depo cut.

| Front-end rate moves since negative policy rates for EUR, CHF, SEK and DKK |
|---------------------|------|------|------|------|
| Deposit rate       | CHF  | SEK  | DKK  | EUR  |
| Level              | -0.75| -1.1 | -0.75| -0.2 |
| YTD change         | -0.5 | -0.75| -0.2 | 0    |
| Last change        | 15/01/2015 | 08/07/2015 | 06/02/2015 | 03/09/2014 |
| Turned negative    | 18/12/2014 | 16/04/2014 | 05/09/2014 | 05/06/2014 |
| 2s                 | Now  | -0.8 | -0.17| 0.31 | 0.05 |
|                   | Dneg | -0.60| -1.12| -0.15| -0.29 |
|                   | DLast| -0.20| -0.02| 0.36 | -0.21 |
| 5s                 | Now  | -0.53| 0.49 | 0.68 | 0.35 |
|                   | Dneg | -0.50| -1.11| -0.05| -0.37 |
|                   | DLast| -0.10| -0.08| 0.42 | -0.15 |
| 10s                | Now  | 0.07 | 1.36 | 1.30 | 0.96 |
|                   | Dneg | -0.33| -0.96| -0.13| -0.61 |
|                   | DLast| 0.03 | -0.06| 0.54 | -0.18 |
| 2s5s               | Now  | 28   | 66   | 38   | 30   |
|                   | Dneg | 11   | 0    | 10   | -8   |
|                   | DLast| 10   | -7   | 7    | 6    |
| 5s10s              | Now  | 60   | 87   | 62   | 61   |
|                   | Dneg | 17   | 15   | -8   | -24  |
|                   | DLast| 13   | 3    | 11   | -3   |
| 2s5s10s            | Now  | -32.2| -20.85| -24.12| -30.72 |
|                   | Dneg | -6   | -15  | 18   | 16   |
|                   | DLast| 26   | 6    | 42   | 46   |

Source: Credit Suisse, National Treasuries, the BLOOMBERG PROFESSIONAL™ service; DNeg means change since last time the central bank made a change in its target rates and DLast means change since the target rate first turned negative.
ECB balance sheet expansion

- ECB balance sheet expansion until August 2017 possible with the current pace and yields unchanged
- A rally significantly shortens this time frame
- An accelerated pace and extension is only possible if yields remain unchanged

**ECB balance sheet expansion could face significant challenges in 2016**

<table>
<thead>
<tr>
<th>ECB central government purchases</th>
<th>Bonds eligible in €</th>
<th>Remaining available</th>
<th>per month</th>
<th>Current</th>
<th>+ 20bn / month</th>
<th>+ 40bn / month</th>
<th>Yield shift lower by 25bp</th>
<th>50bp</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>285</td>
<td>212</td>
<td>9.7</td>
<td>May-17</td>
<td>Dec-16</td>
<td>Sep-16</td>
<td>Dec-16</td>
<td>Jul-16</td>
</tr>
<tr>
<td>Netherlands</td>
<td>94</td>
<td>78</td>
<td>2.1</td>
<td>Jun-18</td>
<td>Oct-17</td>
<td>Apr-17</td>
<td>Jul-17</td>
<td>Feb-17</td>
</tr>
<tr>
<td>Finland</td>
<td>24</td>
<td>19</td>
<td>0.7</td>
<td>Nov-17</td>
<td>Apr-17</td>
<td>Dec-16</td>
<td>Feb-17</td>
<td>Oct-16</td>
</tr>
<tr>
<td>Austria</td>
<td>58</td>
<td>50</td>
<td>1.0</td>
<td>May-19</td>
<td>Jun-18</td>
<td>Oct-17</td>
<td>May-18</td>
<td>Aug-16</td>
</tr>
<tr>
<td>France</td>
<td>432</td>
<td>375</td>
<td>7.7</td>
<td>Jun-19</td>
<td>Jul-18</td>
<td>Nov-17</td>
<td>Nov-18</td>
<td>Feb-18</td>
</tr>
<tr>
<td>Belgium</td>
<td>103</td>
<td>94</td>
<td>1.3</td>
<td>Feb-21</td>
<td>Oct-19</td>
<td>Nov-18</td>
<td>Jul-20</td>
<td>Apr-19</td>
</tr>
<tr>
<td>Ireland</td>
<td>42</td>
<td>37</td>
<td>0.6</td>
<td>May-20</td>
<td>Mar-19</td>
<td>Jun-18</td>
<td>Sep-19</td>
<td>Mar-18</td>
</tr>
<tr>
<td>Italy</td>
<td>494</td>
<td>445</td>
<td>6.7</td>
<td>Oct-20</td>
<td>Jul-19</td>
<td>Aug-18</td>
<td>Apr-21</td>
<td>Aug-20</td>
</tr>
<tr>
<td>Spain</td>
<td>233</td>
<td>198</td>
<td>4.7</td>
<td>Nov-18</td>
<td>Feb-18</td>
<td>Jul-17</td>
<td>Mar-19</td>
<td>Dec-18</td>
</tr>
<tr>
<td>Portugal</td>
<td>36</td>
<td>29</td>
<td>0.9</td>
<td>Jan-18</td>
<td>Jun-17</td>
<td>Jan-17</td>
<td>Apr-18</td>
<td>Jan-18</td>
</tr>
</tbody>
</table>

Source: Credit Suisse
Foreign selling supports the ECB balance sheet expansion …

- International reserve managers are key owners of euro area sovereigns
- Foreign ownership in core countries is around 50%. Although this tends to include foreign holders within the euro area
- Chinese reserves have been falling since the beginning of 2014
- We believe Chinese reserves are representative of Asia ex-Japan reserve flows
- Hence, selling by those investors is likely to support the ECB’s balance sheet expansion
- We believe the 5-7y sector would be most at risk in case of further selling
- Japanese investors sold European fixed income heavily in April and June

Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service, ECB 2014
... but supply is falling into year-end

- Falling net supply into year-end and purchases from the ECB should outweigh selling flows from reserve managers
- End of October beginning of November period should be particularly supported
- December will have negative net supply for the whole month

Heavy issuance period is coming to an end in Europe

Notional (in € billion, red upcoming weeks)

Source: Credit Suisse, National Treasuries, the BLOOMBERG PROFESSIONAL™ service
Duration, curve, and vol
European Duration view: Conditionally bullish

- Economic weakness risks further downside surprises to global inflation
- ECB inflation projections remain overly optimistic and will likely be revised lower again
- Extension beyond Sep 2016 or acceleration of QE purchases would be a strong dovish signal
- Weaker European equities and a stronger currency add to growth risks in Europe
- Uncertainty around Fed lift-off
- Against this, oil prices and risk appetite have improved
- Expressions:
  - EUR 5s10s flattener
  - Sell 3y2y payer spread
  - Buy 6m10y ATM/-14/-28 receiver ladder
  - Long RXZ5C 158.5/160 call spreads
  - Long 5y France
  - Receive SEK 2y1y or SEK 2y2y vs. Bobl

Source: Credit Suisse
Carry trades in Europe

- High vol-adjusted carry positions have generally richened in EUR, GBP, CHF and SEK.

- SEK rates, however, look cheap relative to other European markets.

- 2y1y and 2y2y in EUR and SEK appear to be the best carry points.

- Expressions:
  - Long 5y France
  - Receive SEK 2y1y

5y France and 2y Germany offer good carry & entry

Source: Credit Suisse Locus
Trade Idea: EUR 5s10s flattener

- The 5s10s curve is currently trading wide vs. the current level of 10y yields.
- PCA also argues for a flattener despite the recent correction.
- 5s10s carries flat; however, over the short term, we believe it still represents a better long than an outright 10y.

5s10s carry is turning flat

PCA residuals

5s10s is too high to the level of yields
Trade Idea: Sell EUR 3y2y Payer Spread (ATM vs. 50 OTM)

- Sell 100mm 3y2y ATM Payer vs. Buy 100mm 3y2y 50 OTM Payer for 30cts.
- Trade is long delta (4k) and short vega (-1.6k Normal Vega).
- The trade’s value in 1-year in unchanged environment is 16 cts, a 46% roll-down.
- 3y2y is artificially high due to hedging of caps.
- Payer Spread premium is historically high.
- See full discussion here.

Volatility and Rate Roll highest in 3y sector

Payer Roll-Down Grid

Payer Spread Premium is historically high

31
30
29
28
27
26
25
24
23
22
21

Source: Credit Suisse Locus

Return on Forward Premium in Unchanged Environment
Coloring according to 2y percentile, red being low
Trade Idea: Buy 6m10y ATM/-14/-28 receiver ladder

- Buy 100mm 6m10y ATM rec. vs. Sell 100mm 6m10y 14 OTM rec. and Sell 100mm 6m10y 28 OTM rec.
- Trade is short delta at inception (-12k) and short Vega (-19k normal Vega).
- Max Payout between 90bps and 75bps. Trade starts losing money at yield below 61bps.
- Receiver skew is currently trading rich, volatility has been trading lower when 10y swap was around 50bps
- See full discussion [here](#).

Receiver ladder and trade breakevens

![Receiver ladder and trade breakevens](Image)

Trade turns long delta as it ages

![Trade turns long delta as it ages](Image)

Source: Credit Suisse Locus
Trade Idea: Buy Dec OTM Bund call spread for view of gap lower in yields

- Bund volatility is cheaper than swaption vol so buying tail risk for lower rates is best expressed via listed options.
- We would expect wider swap spreads in a large rally.
- Trade idea: Buy 158.5/160 Call Spread on RXZ5 (Dec expiry) for 26cts. (ref. 156.86 on the benchmark)
- Payout ratio of 5.8 is reached if benchmark bund trade below 32bps at expiry. Delta of Call spread is 16%.
- See full discussion [here](#).

**2m Implied Volatility is Cheap for Bund Option**

**Bund and Swaption Implied Volatility**

- 2M ATM Bund Vol
- 2m9y Swaption Vol
- Spread, rhs

**2m Bund Vol and Bund Call Skew**

- 2M ATM Bund Vol
- Implied Vol Spread (Bund 2M 3Pts OTM Call - Bund 2M ATM)

Source: Credit Suisse Locus
Trade Idea: Receive SEK 2y1y or receive SEK 2y2y vs. Bobl

- Inflation likely to surprise on the downside to Riksbank's path
- TNS Sifo Prospera survey shows that 5-year inflation expectations were down from 1.8% in June to 1.7% in September
- Riksbank remains firmly on an easing course
- Absolute carry in SEK significantly higher than in EUR
  - 37bp annually for SEK 2y1y vs. EUR
  - SEK 2y2y offers approximately 12bp 3m carry while the Bobl carry is only 5bp
- See full discussion [here](#)

Alternative:
- Receive SEK 2y2y vs. Bobl
Periphery
Bullish periphery

- Crisis has forced improvements to labour market regulation, leading to better functioning labour markets.
- Reforms are boosting potential growth from the labour force participation side.
- Lending rates are converging:
  - ECB measures are supporting improvement in funding rates for peripheral SMEs.
  - Spanish SME lending rates are falling rapidly.
  - Italian SME lending rates are back to 2010 levels.
- ECB QE is reducing peripheral sovereign financing costs:
  - Cost of servicing sovereign debt is falling rapidly.
  - Italian debt servicing costs are expected to fall by 1% of GDP.
  - Savings could be used to accelerate debt reduction.
  - Use fiscal capacity of support growth measures.

Source: Credit Suisse, OECDMarket, EuroStat.
Political risk lower in the periphery

- Italy
  - Italy's political situation has stabilized.
  - However, overall strong support anti-system parties is a concern for the medium-term

- Spain
  - Catalonia regional election supported a majority for Catalonia independence
  - Central government elections in December are likely to see a centre-left or centre-right majority
  - However, political uncertainty will remain high in Spain until then.

- Greece: New Syriza government without radical left

- Portugal: Uncertainty has increased after the loss of the absolute majority for the centre-right

Source: Thomson Reuters DataStream, Markit, Credit Suisse
Carry trades in the periphery

- Portuguese front-end offers superior carry and entry level
- Front-end in Italy and Spain has better entry level and better carry than belly longs
- Italy offers better entry and similar carry than Spain
- 5s10s steepener in Italy and 7s10s steepener in Spain appear attractive
Trade Idea: Long 3y PGB

Rationale

- QE purchases should continue to benefit Portugal
- Portugal is the highest beta play on positive periphery view
- Portugal has improved its competitiveness more than Spain or Italy
- Remaining 2015 issuance is pre-funding
- Portugal should continue to benefit from the strong Spanish recovery

Risks

- Greece creating spill-over
- Uncertainty after the elections in Portugal
UK Rates Outlook

Daniela Russell
Duration view and policy outlook
Duration view

- We are cautious on the outlook for duration: global growth momentum has weakened, Fed hikes have been pushed back and the ECB looks increasingly likely to ease further.

- Furthermore, the strength of UK data is now also coming into question, having previously been so robust.

- Nevertheless, we are wary of just how quickly expectations can shift from tightening to easing, and *vice versa*.

- So, we’re now looking for confirmation about whether the recent slowdown in data is just a blip, or the start of a more prolonged slowdown in growth.

- In our base case, we think the softening will prove temporary, but given how sensitive the market is to downside data surprises, we recommend a neutral duration stance until there is more clarity.

Source: Credit Suisse, DataStream
Monetary policy: Let the data do the heavy lifting

- The MPC has shown a consistently cautious approach to raising rates

- This will continue: the subdued inflation outlook gives them plenty of scope to keep policy loose for some time to come

- The market may be pricing the first hike out as far as February 2017, but the MPC is unlikely to want to push back while the outlook is so uncertain

- Instead, the MPC is likely to let the data do the heavy lifting and cause the market to re-price

- Hence, at the November QIR, we could see the “turn of the year” rhetoric morph into something more “data dependent” – a la Fed

- We favour positive carry shorts with limited downside. But, should the risk domestic data soften further and UK rate rises are taken off the table, we overlay an additional long in 1y1y on our existing GBP 1y1y vs 2y1y steepener

- Top trades:
  - GBP 1y1y vs. 2y1y steepener (in a 2:1 ratio)
  - Jun 17 – Dec 17 short sterling steepener
  - GBP – EUR 5y1y widener

Source: Credit Suisse Locus
MPC happy to be behind the curve

- Over the last two years, the MPC has consistently reacted to news that slack has been diminishing faster than expected in a consistently dovish way.

- So, the MPC’s patience is not new (as we highlighted back in May), but it does certainly look set to continue.

- The October MPC minutes noted that some members now see a shorter lag in the response of inflation to rate changes.

- Furthermore, the MPC downplayed the recent rise in ULCs, instead emphasising reasons why they are growing closer to a rate of 1.2%, rather than the punchy 2.2% headline number.

- This implies the MPC is pleased to be behind the curve, and that it will be patient and wait for spot inflation to pick up before hiking.

Source: Bank of England, Credit Suisse
Inflation balancing act set to persist…

- The rate decision hinges on the inflation outlook in the medium term, i.e., how the opposing forces of rising domestic cost pressures and external disinflation evolve.
- These opposing forces will persist in 2016: core goods inflation will stay weak, while core services inflation will only rise slightly.
- As a result, core inflation will remain around 1% throughout 2016.
- Headline inflation will pick up as the energy and food components rise. However, it will still only increase very gradually.
- Indeed, our economists forecast headline CPI inflation to remain below 1% until April 2016, and it will still be well below target at 1.5% at the end of 2016.
- The subdued inflation outlook gives the MPC plenty of scope to keep policy loose for some time to come.

Source: Credit Suisse
Moreover, we think the inflation risks are skewed to the downside because:

(i) Core goods inflation has further to fall as the effect of past sterling strength continues to pass through

(ii) Further weakness in China poses downside risks to the UK inflation outlook: there is a close link between Chinese PPI and core goods inflation in the UK
But market already pricing a very gloomy economic outlook

- Current market pricing is consistent with a very pessimistic outlook for growth and policy, with the first hike priced out as far as Feb-17
- This is hardly surprising given recent data-flow and the risks to the outlook we have mentioned
- However, it is worth remembering that UK consumers are enjoying a “Goldilocks” scenario: low inflation, low unemployment, rising wages
- So if:
  - We see a better global backdrop
  - An increased chance of a Fed hike
  - We see evidence the recent softening in domestic data is temporary
  - UK wage growth continues to rise
- Then the front-end is very expensive

Source: Credit Suisse, Credit Suisse Locus
Favoured front-end trades

- We favour positive carry shorts with limited downside.

- This enables us to express our base case view that: rate hikes in the UK are still some way off, but – given how little is being priced – will perform well if rates come under pressure
  - Jun 17 – Dec 17 short sterling steepeners
  - GBP – EUR 5y1y wideners: as shown in the chart on the right, this location offers the best carry and roll down (x-axis) although we admit the entry point is slightly less favourable now vs. previously (y-axis shows 3m z-score of GBP-EUR spread)

- But, at this point, the market is highly sensitive to downside data surprises. So for the risk that UK rate rises are taken off the table (e.g., if domestic data soften further and spreads to the consumer), we overlay an additional long in 1y1y on our existing GBP 1y1y vs 2y1y steepener to give it a bullish bias
  - GBP 1y1y vs. 2y1y steepener (in a 2:1 ratio)

5y1y is the sweet spot for GBP-EUR wideners

UK growth data has been softening

Source: Credit Suisse Locus, the BLOOMBERG PROFESSIONAL™ service
3 key areas of focus for the November QIR

- As we head towards the November QIR, the much-discussed “turn of the year” timeframe for a possible rate hike is also fast approaching.

- Set against that, the market is still pricing the first hike out as far as February 2017 (hardly consistent with “turn of the year”)

- But we don’t think the MPC is in any hurry to push back against this; instead it would prefer to let the data cause the market to re-price.

- At the QIR, there are 3 aspects that we will be focusing on:
  - The vote: we think there is a strong chance we see a 7-2 split
  - The fan chart: likely to show inflation slightly above target at the medium-term horizon
  - The rhetoric: dovish

- Overall, we think the tone of the QIR will be sufficiently dovish to offset the relatively more hawkish innovations of a second dissenter and the fan chart.
All eyes on the inflation fan chart

- We expect the inflation fan chart to show CPI slightly above target at the 2-3y horizon
- Since the August QIR:
  - Front end rates are considerably lower
  - Sterling is much weaker (and our technical analysts are warning of further downside)
  - Oil is lower
- Inflation is therefore likely to be revised down in the near-term, but there is pressure for the fan chart to show inflation above target in 2-3 years due to lower rates and weaker sterling…
- …however, we think the MPC is unlikely to want to push back strongly against market pricing with risks still elevated
- Therefore, the fan chart is most likely to show CPI only slightly above target, as heightened external risks weigh on the outlook
A 7-2 vote, but a dovish tone

- We think there is a strong chance that Forbes will join McCafferty in voting for a hike in November.
- The November QIR will contain analysis on the pass through of sterling strength into CPI.
- This is likely to corroborate Forbes’ independent study that there is less pass-through.
- Coupled with continued evidence of rising domestic inflationary pressure, we think this will be sufficient for Forbes to vote for a rate rise.
- However, we think the QIR as a whole will still strike a cautious tone: (i) the inflation outlook is still very subdued, (ii) domestic data have softened, (iii) external risks remain elevated, and (iv) (they will not say it but) the Fed is now less likely to go.
- Ultimately, the “turn of the year” rhetoric could morph into something more “data dependent” – à la Fed…
Trade ideas
Trade Idea: UKT 10s20s flattener

- UK curve is too steep and is an attractive way to position for higher rates
- 20y point is cheap on the curve
- ECB/BoJ stimulus should keep a reasonable bid for duration globally, suggesting that the long-end should remain fairly well supported
- Meanwhile we take profit on our short 30y gilts vs. Germany trade. Heavy long-end issuance in euro may weigh on 30y Germany
Trade Idea: UKT 55s68s flattener

- Convexity is cheap at the long-end of the UKT curve
- Under most assumptions of volatility, UKT 55s68s flatteners should be profitable
- The ultra-long is currently upward sloping, providing an attractive entry point
- The UKT 55s is trading rich on the curve in that sector
- We recommend UKT 55s68s flatteners as a medium-term trade
Disclosure Appendix

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<table>
<thead>
<tr>
<th>Global Recommendation Distribution**</th>
<th>Buy</th>
<th>Outperform</th>
<th>Market Perform</th>
<th>Underperform</th>
<th>Sell</th>
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<tbody>
<tr>
<td>(&lt;1% banking clients)</td>
<td>(&lt;1%) (&lt;1% banking clients)</td>
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<td>(&lt;1% banking clients)</td>
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</table>

*Data are as at the end of the previous calendar quarter.

**Percentages do not include securities on the firm’s Restricted List and might not total 100% as a result of rounding.

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