13 February 2014
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ECB: OMT - irrelevant; QE - possible

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However, the German Constitutional Court's judgement on OMT and its referral to the ECJ do not represent an impediment either politically or legally for the ECB to embark on a large scale asset purchase programme, in our opinion. QE therefore cannot be fully ruled out. In this piece, we discuss the following:

- The legal support for ECB asset purchases.
- Circumstances in which QE could be implemented.
- How it might be executed, drawing on the experience of the BoE.
- Likely European rates market implications.

Investment implications

- Favour long 10y Bunds vs. Eonia and long 30y periphery ASW.
- Short 10y France vs. Germany and Italy (beta weighted).
- Long HICP inflation via 5s10s flatteners.
- Avoid shorting high coupon small sized off-the-run bonds.

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ECB: OMT - irrelevant; QE - possible

The timing and content of the statement by the German Constitutional Court (GCC) caught the market by surprise earlier this week. With all eyes on the ECB against a backdrop of increasingly low inflation prints, market attention naturally focused on implications for further ECB action.

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QE is not OMT

In asking the ECJ to pass a preliminary ruling on the compatibility of OMT with EU primary law, the GCC has basically said that it does not view OMT to be compatible in its current form (for further details see *Global Rates Atlas – Life in the Polar Vortex*). However, in making the referral, the GCC also clearly lays out the restrictions it views as necessary to ensure compatibility. Namely, sovereign bond purchases

- Should not undermine conditionality of EFSF/ESM assistance programmes,
- Can't be targeted just at a select number of member states,
- Must not expose the ECB to potential losses in the event of a debt restructuring/default,
- Can't be unlimited,
- Must not interfere with price formation.

None of these required constraints is really new news, and so for the ruling on the OMT, it's now a case of waiting to see how long the ECJ takes to opine. However, this point is rather academic: OMT is last year's news. It proved to be a pivotal policy, hugely successful at reducing the redenomination risk in peripheral sovereign bonds. But it has done the job it was intended for, all the more successfully for never needing to be used. Whether or not the ECB now becomes constrained in actual implementation of OMT isn't currently relevant: there is no need or prospect of it being activated in the foreseeable future.

Of much greater import is what the GCC's ruling means for the ECB's ability to undertake QE. And obviously any judgments the ECJ makes about how the ECB conducts monetary policy could have an effect if they are relevant for how the ECB is conducting QE.

The ECB is legally able to implement QE

1. The ECB is independent, that independence is well guarded

It is extremely unlikely that the ECB would reflect any of the criticisms of OMT by the German Constitutional Court in how it would decide to justify and implement a programme of large scale asset purchases.

The ECB would not want to set a precedent where a court of a specific member state – with no jurisdiction over the ECB – was seen to determine and constrain the ECB's behaviour. The ECB's independence is well guarded. Indeed, Article 130 of the Treaty states:

"*neither the European Central Bank, nor a national central bank… shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body*".

Indeed, we think any ECJ judgement on the OMT would only have a bearing on the ECB's conduct of QE if there were specific proscriptions that could clearly be related to QE, which we think unlikely. And equally, the ECB's determined defence and assertion of its independence makes it unlikely that it would wait for the ECJ to pass judgement on the OMT before implementing QE, if QE was needed.

2. The ECB can buy government bonds in the secondary market for monetary policy purposes

In our view, **the Treaty and Statute for the ECB are perfectly consistent with the ECB being able to buy government debt in the secondary market** for the purposes of monetary policy.

First of all, **the "no monetary financing" clause** – Article 123 – **refers to purchases of debt directly from sovereigns**:

"*Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of Member States in favour of… central governments… of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments*".

The specification that purchase of government debt in the primary market is prohibited is important. **It does not outlaw the purchase of debt in the secondary market**.

In fact, the ECB's Statute makes clear that **purchases of debt in the secondary market are a tool the ECB can use** in the implementation of its monetary policy. In the chapter of the Statute on "Monetary functions and operations of the ECB", Article 18 describes the "Open market and credit operations" that comprise the tools the ECB has used to implement policy since its creation in 1998:

"*In order to achieve the objectives of the ESCB… the ECB and the national central banks may*

- ***operate in financial markets by buying and selling outright** (spot and forward) or under repurchase agreement…*
- *conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral".*

The second bullet effectively refers to the day-to-day MRO and LTRO operations that have been the mainstay of monetary policy implementation through the policy rate channel. It's the first bullet that allows the ECB to conduct large scale asset purchases in secondary markets: the only available policy option to ease if the ECB has concluded that policy rates have hit the zero bound.

We judge that **the Treaty or ECB Statute are unambiguously clear that** large scale asset purchases – including of government bonds – are a legal and legitimate policy tool for the ECB to use.

Timing: QE requires a significant slowdown

QE is contingent on a future cut to the ECB's long-term inflation forecast, which

1. is contingent on a cut to the ECB's near-term growth forecast, which
2. requires the PMIs to stop rising and start falling.

That means that the timing of any ECJ hearing or judgement is unlikely to have a material bearing on when or whether the ECB announces QE. We think the development of economic data will determine if and when that happens.

For the other central banks that began large scale asset purchases since the crisis – the Federal Reserve and Bank of England – the QE programmes were announced at the same time as, or just before, policy rates reached the zero bound. That instantaneous shift from cutting rates to buying assets may have been a reflection of the extreme financial and economic emergency central banks were facing at the time. But it may also have reflected a desire on the part of both central banks to demonstrate that they were not impotent at the zero bound.

Clearly, the ECB does not face a situation equivalent to early 2009. But the latter point is still relevant: a central bank will want to demonstrate that it still has monetary ammunition once it concedes that rates are as low as they can go. The ECB realistically only has one substantive shot left in its locker – a cut in its rate corridor by 10bp-15bp, implying a cut in the deposit rate into negative territory – which we think is likely to be fired at the March meeting (*European Economics and Strategy – Going Negative*).

Although we think it is unlikely that the ECB would choose to announce a large scale asset purchase programme at the same time as that, the precedent set by the other central banks means it cannot entirely be ruled out. Despite President Draghi's relatively hawkish tone in the February press conference, he made it clear that the decision in March was very much an open one, dependent upon the new 2016 forecasts that would only be available to the Governing Council at the start of next month:

"Regarding the medium-term outlook for prices and growth, further information and analysis will become available in early March…The reason for today's decision not to act is really to do with the complexity of the situation… and the need to acquire more information. In this sense, today's instance is different from what we had in November… The macroeconomic projections by our staff, which will be coming out… in March, will contain, for the first time, forecasts for 2016, and that is a very significant change in our analysis".

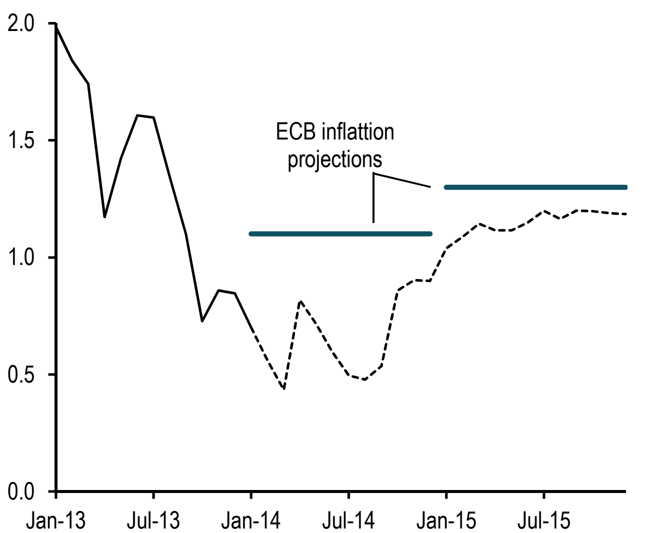
As we noted at the time, the ECB's 2016 forecasts – especially for inflation – are a crucial known unknown for the March meeting. He also pointed out the importance of new money supply, inflation and GDP data in the next few weeks. In our view, given the likelihood that the ECB will revise down its forecasts for inflation in 2014 and 2015 (to 0.8% and 1.1%-1.2%, respectively), the rate it forecasts for inflation in 2016 will be key. Remember that its target is "below, but close to, 2%". If the ECB were to forecast inflation below its target on that time horizon, it would warrant a policy response. Our central expectation is that the ECB will forecast inflation of around 1.5% in 2016, which would justify the token cut we expect.

But a 2016 inflation forecast well below 1.5% would, in our view, allow the ECB to justify the launch of a full blown large scale asset purchase programme. President Draghi would be able to argue the (downside) risk to its price stability objective warranted it. Now, it's not impossible that the ECB could forecast such low inflation in March – we expect headline inflation rates to drop below 0.5% in the next few months. But, against a backdrop of steady but unremarkable improvement in cyclical data, the more likely outcome is that the ECB keeps its powder dry unless or until the upswing loses steam.

In that case, the critical catalyst is likely to be real economic data, particularly business surveys. A key driver of any changes to the ECB's 2016 inflation forecast will likely be changes to its 2014 and 2015 growth forecasts: changes in the amount of expected economic slack would typically have a bearing on expected inflation, with a lag. As the chart below shows, recent developments in the PMI surveys are broadly consistent with the ECB's forecasts for growth.

Exhibit 1: Inflation surprising to the downside

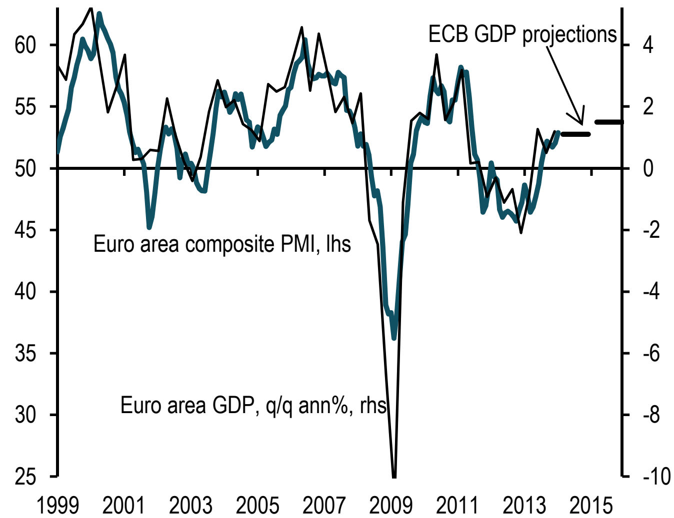
Euro area HICP inflation, with Credit Suisse and ECB projections



Source: Credit Suisse, European Central Bank, Markit

Exhibit 2: Recovery on track for the ECB

Euro area composite PMI and annualised GDP growth, with ECB forecasts for 2014 and 2015



Source: Credit Suisse

We think the trigger for QE would have to be a clear worsening of cyclical indicators, consistent with a clear risk that the euro area slips back into a third recession and triggers deflation. Given the weakening in PMI surveys in other economies (Exhibit 3), there's a clear risk of such an outcome in the next 3-6 months. That means the implementation of a large scale asset purchase programme could happen in the first half of 2014.

Exhibit 3: Can the euro area buck the trend?

Euro area and rest of the world manufacturing PMI new orders

Source: Markit

Implementation: Delegation to NCBs

The ECB's approach to QE, and the assets it could buy, is likely to be flexible (as we discussed in *The ECB's Arsenal*). The key document here is the ECB's guideline on monetary policy instruments and procedures of the Eurosystem. It outlines the four key types of open market operations the ECB can use to achieve its monetary policy objectives. The first three are key parts of the ECB's toolkit, which have been frequently used:

- Main refinancing operations,
- Longer-term refinancing operations,
- Fine-tuning operations,
- Structural operations.

It's the fourth – structural operations – that we think is relevant in considering how the ECB would actually implement QE. In the guidebook the key text is:

"In addition, the Eurosystem may carry out ***structural operations*** *through the issuance of ECB debt certificates, reverse transactions and* ***outright transactions****. These operations are executed whenever the ECB wishes to* ***adjust the structural position of the Eurosystem vis-à-vis the financial sector*** *(on a regular or non-regular basis)… Structural operations in the form of outright transactions are* ***normally executed by the NCBs*** *through bilateral procedures".*

As QE would involve the ECB wishing "to adjust the structural position of the Eurosystem vis-à-vis the financial sector", structural operations are the relevant tool. And it's important that the guidelines state that the implementation of those outright transactions are undertaken by the national central banks.

That suggests to us that the most appropriate means for the ECB to undertake QE would be to delegate purchases to national central banks, proportionately according to the capital key. Delegation would involve national central banks having "constrained discretion" over the assets they buy with the balance sheet allocated. The ECB Governing Council could produce a term sheet describing the assets the central banks were able to buy, as well as any constraints or limitations on amounts.

So, for example, the ECB could state that national central banks could buy:

- Government bonds of any euro area member state,
- Covered bonds,
- High grade credit (for example of government guaranteed utilities),
- Senior bank debt,
- High grade plain vanilla asset-backed securities.

Exhibit 4: The ECB's capital key (%)

Germany	25.7
France	20.3
Italy	17.6
Spain	12.6
The Netherlands	5.7
Belgium	3.5
Greece	2.9
Austria	2.8
Portugal	2.5
Finland	1.8
Ireland	1.7
Slovakia	1.1
Slovenia	0.5
Latvia	0.4
Luxembourg	0.3
Estonia	0.3
Cyprus	0.2
Malta	0.1
Total	100.0

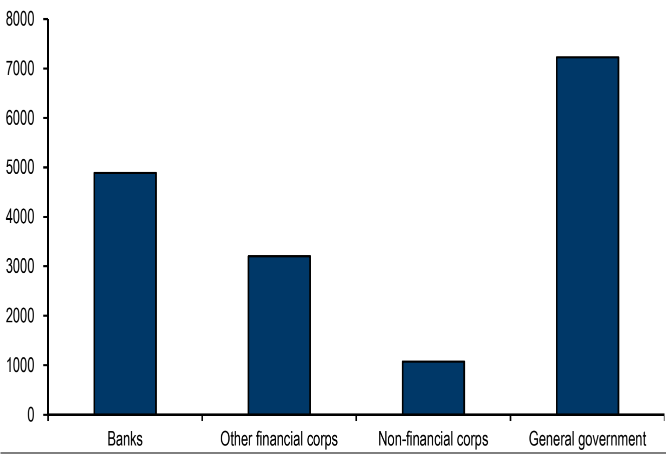
Source: ECB, Credit Suisse

It could also specify that national central banks could only buy up to a certain amount of the outstanding stock (for example 30%) of any specific security type. The ECB Governing Council would then monitor national central bank purchases to ensure they met those guidelines.

That'd give the national central banks a degree of discretion over the purchases they make and allow those purchases to fit with the idiosyncratic nature and distribution of financial liabilities (in terms of sector and duration) in each member state. That flexibility is also important because in some member states, a direct capital key allocation to purchases of sovereign debt would involve much of the outstanding stock being acquired (see *The ECB's Arsenal*).

Exhibit 5: Government debt dominates assets the ECB could buy

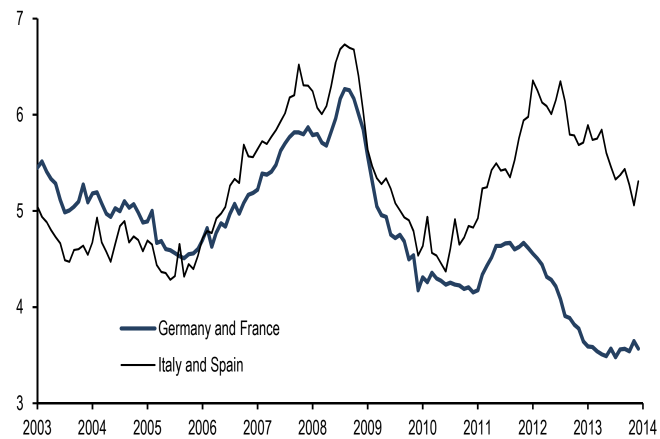
Debt securities issued by euro area residents, €trn



Source: Credit Suisse, European Central Bank

Exhibit 6: Reducing financial fragmentation still a likely policy goal for the ECB

Interest rate on new loans to non-financial corporations less than €1bn, 1-5 year maturity



Source: Credit Suisse, European Central Bank

It'd also allow the ECB to encourage the purchase of private, rather than public, sector liabilities, in order to improve the flow of credit in the euro area economy, particularly in the periphery. Financial fragmentation in the euro area remains considerable, albeit less acute than at the worst of the crisis, and the ECB is likely to favour policies designed to reduce that fragmentation.

But when it comes to purchases, government debt is likely to dominate. And that's because for the ECB to buy assets worth €500bn, or two or three times that, the government bond market is the only one large, deep and liquid enough to suffice. That is why government bonds have been the dominant asset purchased by the Federal Reserve and the Bank of England in their QE programmes (indeed, the Bank of England was allowed and encouraged by the UK government to buy up to £50bn of specific UK private sector assets; it bought approximately none).

Indeed, the ECB found buying small amounts of covered bonds a challenge, only managing to buy €15bn of its second €40bn Covered Bond purchase programme.

Exhibit 5 shows the amount of outstanding debt securities in the euro area at the end of 2013. Government debt dominates. And we'd note that outstanding debt securities in the financial and corporate sectors include all grades. The ECB is only likely to want to buy specific sub-sets of those assets. And the other sector with a considerable amount of debt outstanding – the banks – is currently undergoing the ECB's comprehensive assessment, after which the ECB will assume supervisory responsibility. Given regulations on "bail-in", we think the ECB will be unwilling to buy bank debt, as it would expose the central bank to a considerable conflict of interest.

QE at the BoE: details of the APF

It's instructive to review the manner in which the Bank of England conducted its QE progamme for a read across to the ECB since the constraints facing each institution are similar. The BoE used its "Asset Purchase Facility", created in January 2009, with the programme explicitly authorised by the Chancellor and any losses indemnified by the Treasury. The operations were explicitly aimed at raising market liquidity and money supply, rather than reducing government funding costs – that is, it is a model for "true QE" rather than the more ambiguous goals of the OMT.

How it worked

Assets were initially purchased between March 2009 and January 2010, immediately after Bank Rate first reached the effective zero lower bound. There was then a second spell of buying between October 2011 and May 2012 to combat the renewed risk of inflation undershooting in the face of a potential double-dip recession. The purchases were funded by Central Bank Money (i.e., "printing money").

Significant but finite size: When QE was first initiated, the MPC specified an initial target of £75bn (12.4% of outstanding conventional gilt value at the time), to be invested over three months. As a result of the large programme size, it needed to be implemented gradually to avoid excessive market shocks and distortions. The programme size has always been expressly limited, extending in £25-75bn increments as shown in Exhibit 7. This approach would address the GCC's concerns that could follow from an open-ended approach like Fed QE3. Ultimately, the purchases totaled £375bn (33% of the market).

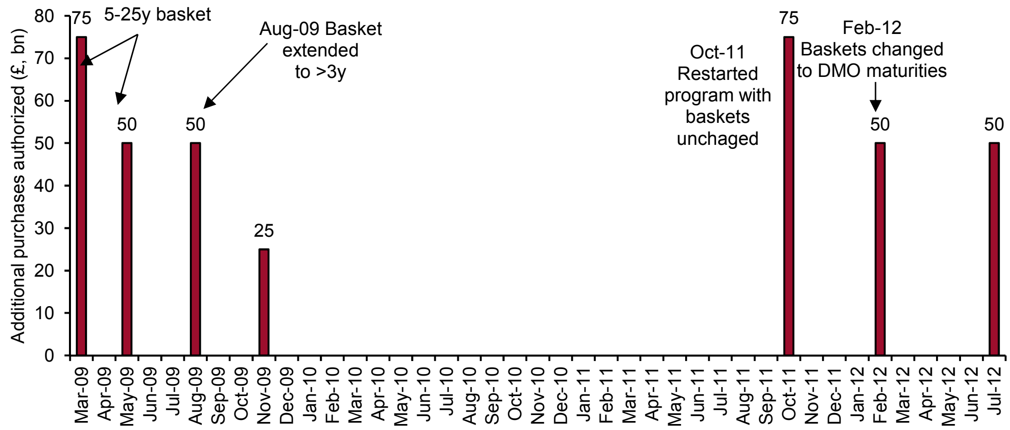
Avoiding auctions: Gilts issued within one week (on either side) of a purchase operation, either their first issuance or a tap, were excluded. This avoided interfering with primary market pricing, as the GCC highlighted in their list of concerns. Given the buying programs generally lasted for several months, these two-week exclusions of individual bonds had limited impact on the overall portfolio.

Evolving maturity distribution to avoid squeezes: The initial maturity range for gilt purchases was 5-25 years. This was to avoid the risk of distorting the super-long sector, which is generally in high demand from LDI investors. This range was widened to 3y+ as the Bank's holdings increased and the free floats of some bonds became constricted.

Repo back to the market: As the Bank's share of the total issuance of some gilts grew, they made their holdings available for repo borrowing by market participants to further avoid squeezes and minimize distortions. The highest share of Bank ownership is currently 62% of the 4 22s.

Range of asset types: Linkers and small issues (outstanding <£4bn) were excluded, and the Bank would not hold more than 70% of any single bond's free float. The original period of buying included both buying and selling corporate bonds and commercial paper, with the aim of supporting market liquidity. Although the mandate from the Treasury included authorization to buy and hold up to £50bn of corporate assets, the Bank decided against this and the APF now holds only gilts.

Exhibit 7: BoE QE announcement timeline



Source: Credit Suisse, Bank of England

Auction mechanics

The BoE implemented QE through reverse auctions; each of which was for a pre-specified total cash value of gilts within a given maturity bucket. The original auctions were evenly split between maturity buckets of 5-10 and 10-25 years, with smaller allocations to 3-5 and 25+ years added in August 2009. The most recent auctions (to reinvest redemption proceeds) used even splits between 3-7, 7-15 and 15+ year buckets, reflecting the maturity categories the DMO use for issuance.

Exhibit 8: Largest BoE shares of gilts

Bond	% held by BoE	First issued
UKT 4 03/07/22	62%	2009
UKT 4 1/4 12/07/27	56%	2006
UKT 8 06/07/21	48%	1996
UKT 5 03/07/25	48%	2001
UKT 4 1/2 03/07/19	48%	2008
UKT 8 12/07/15	46%	1995
UKT 5 03/07/18	45%	2007
UKT 8 3/4 08/25/17	42%	1992
UKT 6 12/07/28	42%	1998
UKT 1 3/4 01/22/17	41%	2011
UKT 4 1/4 06/07/32	41%	2000

Source: Credit Suisse

The amount of each individual bond bought during an auction was not pre-determined, only the total amount between all bonds. The allocation was based on the attractiveness of offers for each gilt relative to market yields.

In practice, the purchases were well distributed across bonds and broad patterns are hard to discern. On average, the percentage held by the BoE is greatest for bonds first issued pre-2002, but these bonds have much smaller sizes The individual bonds in which the APF holds the greatest share of include a mix of old and (then) new issues, as shown in Exhibit 8.

ECB QE scenarios

A large scale asset purchase programme by the ECB would have a significant impact on some euro area countries' bond markets. Based on our economists' deficit forecasts (Exhibit 9), Exhibit 10 illustrates the percentage of outstanding government bonds the ECB would own (via the NCBs) if they implemented a €1 trillion QE programme, running over the next 12 months.

Exhibit 9: Deficit projections (in € bn)

	2014	2015
Germany	0	-6
France	78	76
Italy	43	37
Spain	59	53
The Netherlands	20	19
Belgium	10	9
Austria	6	5
Finland	4	4

Source: Credit Suisse

Such a programme would be particularly supportive of Germany. Based on our assumptions, purchases would represent approximately 18% of German debt stock in 2014 and an additional 11% of the debt stock, excluding NCB holdings, in 2015.

Non-German core countries would also benefit more from a QE programme than semi-core countries such as France and Belgium. In particular, Belgium would benefit the least given its relatively high deficit and large amount of outstanding bonds relative to its ECB capital key.

Exhibit 10: % of outstanding debt stock purchased under €1 trn QE programme

Source: Credit Suisse

Impact of different purchase scenarios

The implications for individual bonds and different parts of each sovereign curve clearly depend on how each individual NCB chose to implement purchases. We outline four potential scenarios in Exhibit 11 and assume a €1 trillion 12-month QE programme.

Exhibit 11: Potential purchase scenarios

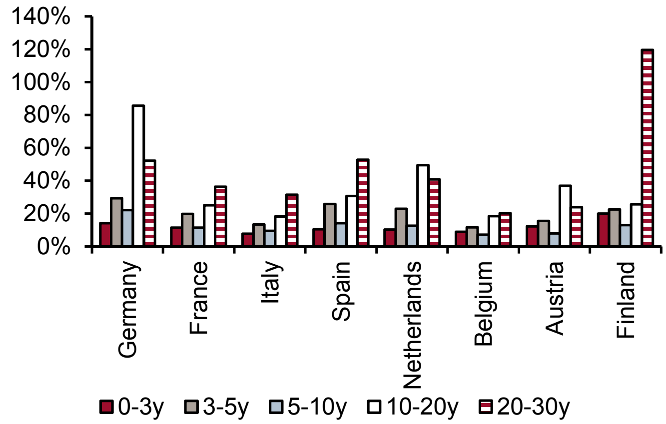
	Scenario 1	Scenario 2	Scenario 3	Scenario 4
0-3y	20%		13%	17%
3-5y	20%		13%	13%
5-10y	20%	33%	50%	50%
10-20y	20%	33%	13%	8%
20-30y	20%	33%	13%	17%

Source: Credit Suisse

If purchases are split equally across the curve (scenario 1), this would be beneficial for the longer end of the curve. However, it would require purchases of more than 100% of outstanding long-end Finnish bonds (see Exhibit 12).

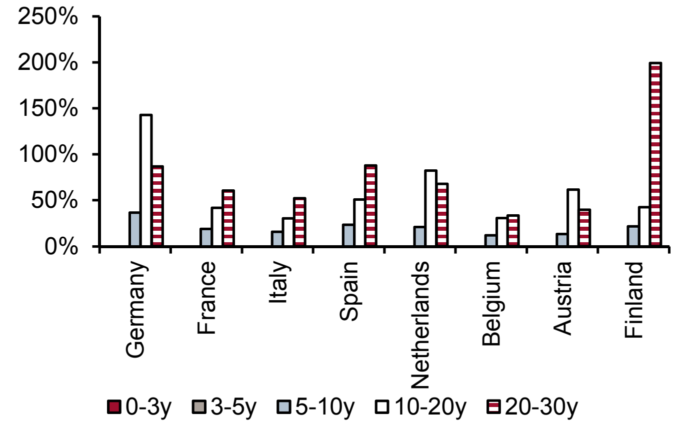
Scenario 2 assumes that the purchases are tilted towards the longer end of the curve. Our analysis indicates that such a scenario is relatively difficult to implement since it would entail the NCBs buying a large portion of the outstanding debt stock in many countries (see Exhibit 13).

Exhibit 12: Scenario 1: Purchases split equally across the curve.



Source: Credit Suisse

Exhibit 13: Scenario 2: Purchases focused on 5y and longer maturities

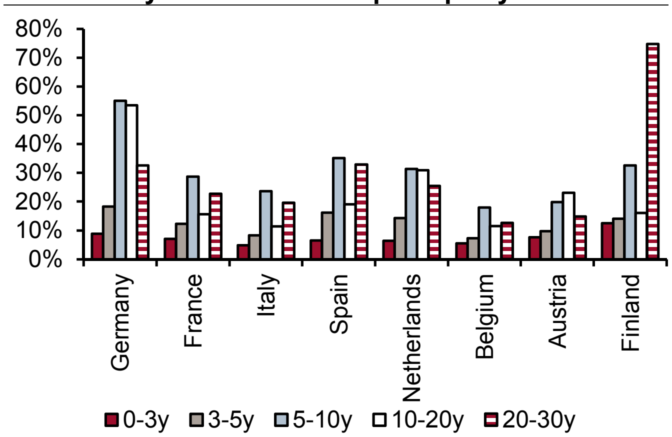


Source: Credit Suisse

Scenarios 3 and 4 assume that 50% of the purchases are done in the 5-10y sector. In scenario 3 we assume that the remainder is split equally across the other maturity buckets. Such a scenario could add to steepening pressure on the German 10s30s curve since the Bundesbank would be buying approximately 50% of the outstanding bonds in the 5-10y sector but only 30% of the bonds in the 20-30y sector (see Exhibit 14).

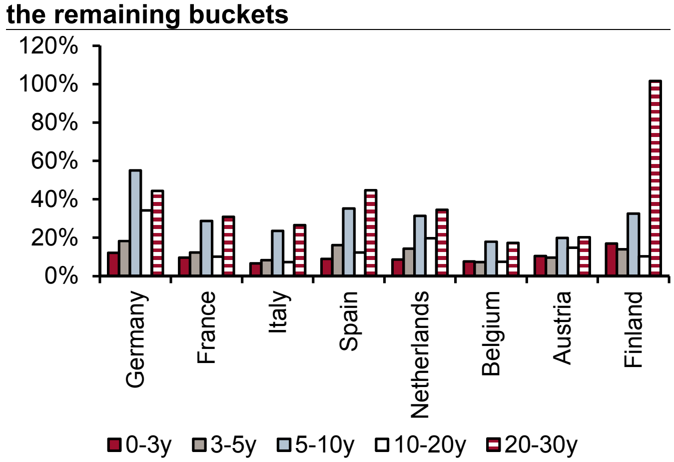
In scenario 4, we assume that purchases are split 17% in the 0-3y and 20-30y sectors and 8% in the 3-5y and 10-20y sectors. Such a scenario would distribute the percentage of the outstanding bonds bought relatively evenly across the different buckets, with the exception of Finland (see Exhibit 15).

Exhibit 14: Scenario 3: 50% of purchases focused on the 5-10y and remainder split equally



Source: Credit Suisse

Exhibit 15: Scenario 4: 50% in the 5-10y bucket, 17% in the 0-3y and 20-30y buckets and 8% in each of the remaining buckets



Source: Credit Suisse

Avoid shorting old high coupon off-the-runs

The impact on bond-by-bond relative value is somewhat dependent on the underlying scenario for the purchases and the assumed threshold. However, for most scenarios we think that old high coupon off-the-runs that tend to trade cheap on the curve and are smaller in size should outperform if the ECB starts QE, while rich and relatively large bonds should underperform. Exhibit 16 shows the bonds that should benefit and Exhibit 17 shows the bonds that should underperform if the ECB starts a QE programme.

Exhibit 16: Bonds that should benefit from QE

Germany	France	Italy	Spain
DBR 5.625 Jan 2028	FRTR 6.00 Oct 2025	BTPS 8.50 Dec 2023	SPGB 5.15 Oct 2028
DBR 6.25 Jan 2030	FRTR 3.25 May 2045	BTPS 7.25 Nov 2026	SPGB 4.20 Jan 2037
DBR 5.50 Jan 2031	FRTR 4.00 Apr 2055	BTPS 5.75 Feb 2033	SPGB 5.15 Oct 2044
DBR 4.25 Jul 2039		BTPS 5.00 Aug 2034	
DBR 4.75 Jul 2040		BTPS 5.00 Aug 2039	
		BTPS 5.00 Sep 2040	

Source: Credit Suisse

Exhibit 17: Bonds that should underperform in a QE environment

Germany	France	Italy	Spain
DBR 1.50 Feb 2023	FRTR 2.75 Oct 2027	BTPS 4.75 Aug 2023	SPGB 4.40 Oct 2023
DBR 4.750 Jul 2034	FRTR 5.75 Oct 2032	BTPS 4.50 Mar 2024	SPGB 4.80 Jan 2024
DBR 4.000 Jan 2037	FRTR 4.75 Oct 2035	BTPS 4.75 Sep 2028	SPGB 4.65 Jul 2025
DBR 3.250 Jul 2042	FRTR 4.00 Oct 2038	BTPS 5.25 Nov 2029	SPGB 5.90 Jul 2026
DBR 2.500 Jul 2044		BTPS 4.00 Feb 2037	SPGB 4.70 Jul 2041

Source: Credit Suisse

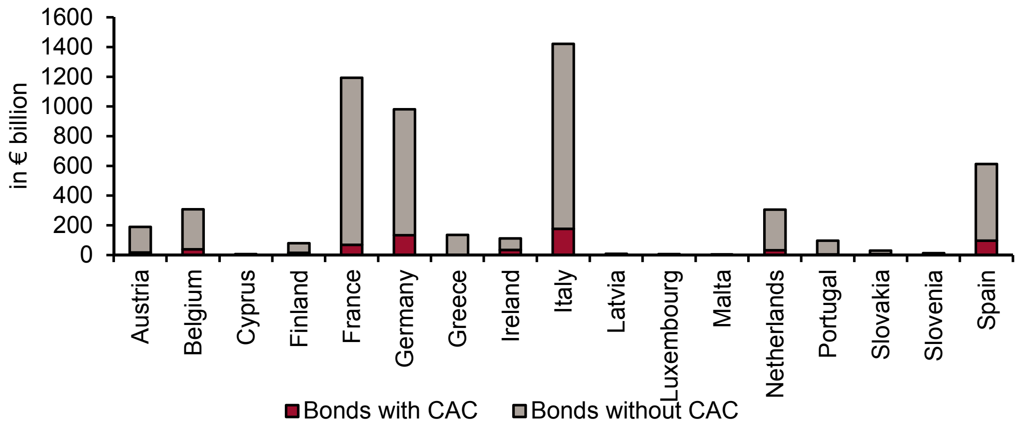
The presence of CACs complicates matters slightly

Two of the differences between the situation in the euro area vs. the US or UK when it comes to (national) central bank purchases of sovereign bonds are the presence of Collective Action Clauses (CACs) in all recently issued bonds, and the existence of non-domestic law debt.

The ECB did not buy international law bonds under the SMP programme and we believe it is unlikely they would do so under any QE programme.

CACs are more complicated. As we discussed in *CAC'd!*, the ECB (and in fact the NCBs in aggregate) are limited to purchasing an upper threshold of one-third of notional outstanding to avoid holding a blocking stake in any bond with a CAC. Since the ECB can clearly not take losses in the event of a sovereign debt restructuring/default event, the question is whether the ECB would be comfortable owning a blocking stake – with the market connotations this would have.

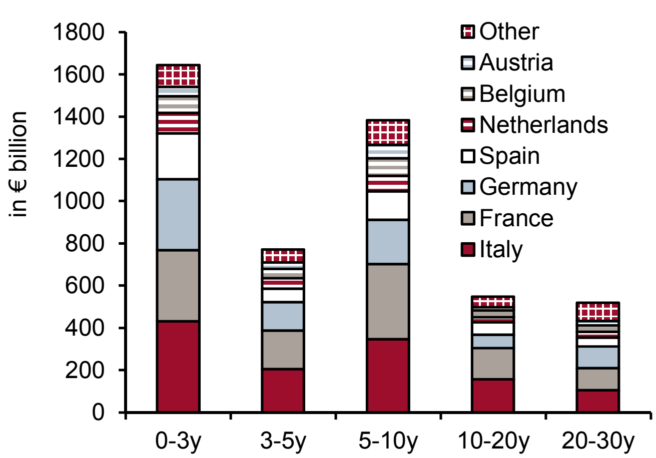
Exhibit 18: Bond amount outstanding with and without CACs



Source: Credit Suisse

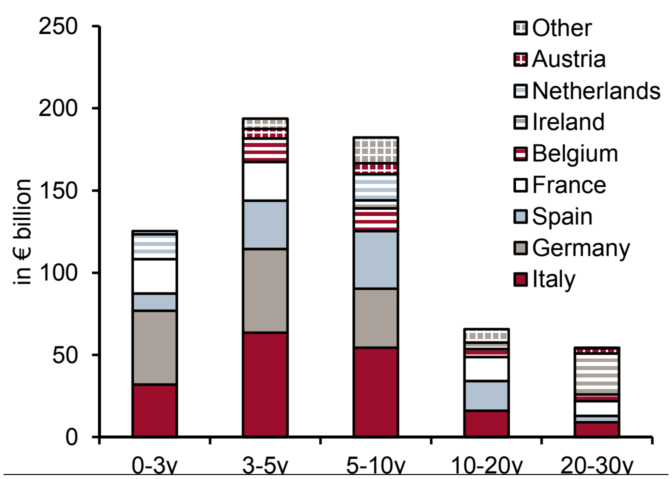
Non-CAC bonds represent the vast majority of debt outstanding (Exhibit 18), and so, at least initially, the ECB could easily focus on older debt. This would also clearly negate any concerns regarding primary vs. secondary market purchases. However, we think the signal it would send would be too unpalatable – as bonds with CACs become the market standard for euro-zone debt, there is likely to be little appetite for anything that is seen to make bonds without CACs more appealing to investors than those with CACs. We think it is most likely, therefore, that the ECB targets debt with and without CACs to ensure there remain no pricing differentials between the two.

Exhibit 19: Split of outstanding bonds without CACs



Source: Credit Suisse

Exhibit 20: Split of outstanding bonds with CACs



Source: Credit Suisse

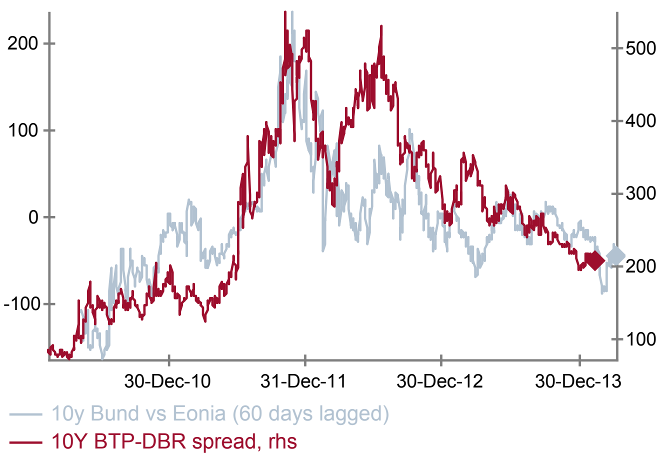
Good QE trades

Portfolio of long Bund vs. Eonia and long 30y BTP or SPGB ASW

We highlighted that German ASW is cheap in our Global Rates outlook and recommended being long Bund vs. Eonia (see *Global Rates outlook 2014*). Independently of the potential for QE, we still favour this trade on a portfolio construction basis since it providescheap protection with positive carry. Bund vs. Eonia tends to widen when there is stress in peripheral markets (see Exhibit 21). The 10y BTP-DBR also tends to move three months after the move in Bund vs. Eonia. Our regression analysis indicates that the 10y BTP-DBR spread moves by 6.7bp for each 1bp move in Bund vs. Eonia (see Exhibit 22).

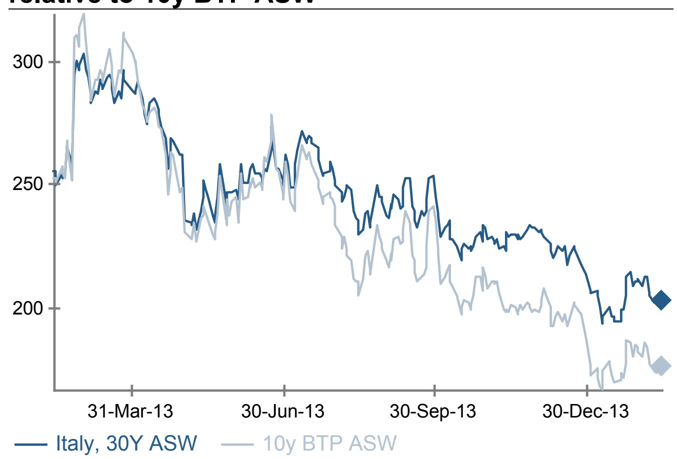
We think a large scale asset purchase programme by the ECB would lead to peripheral outperformance versus swaps, as the market reduces the credit risk in these markets. Given the current valuations we think 30y ASW should outperform 10y BTP ASW (see Exhibit 22).

Exhibit 21: 10y Bund vs. Eonia appears to be correlated with 10y BTP-DBR spread



Source: Credit Suisse Locus

Exhibit 22: 30y BTP ASW still trades too wide relative to 10y BTP ASW

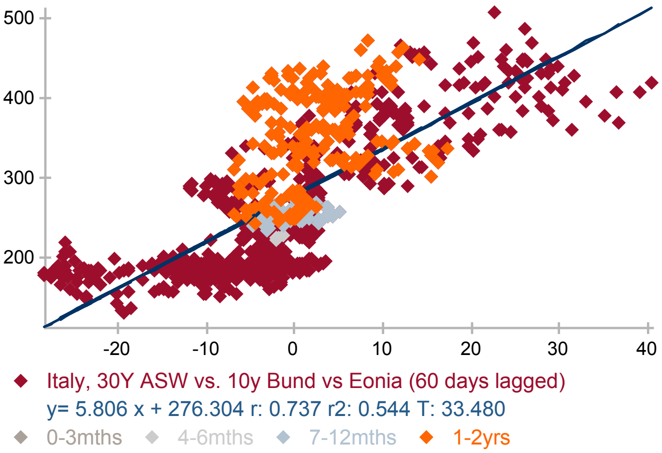


Source: Credit Suisse Locus

Our analysis indicates that the 30y BTP ASW tends move by 5.8bp for each 1bp move in 10y Bund vs. Eonia (see Exhibit 23).

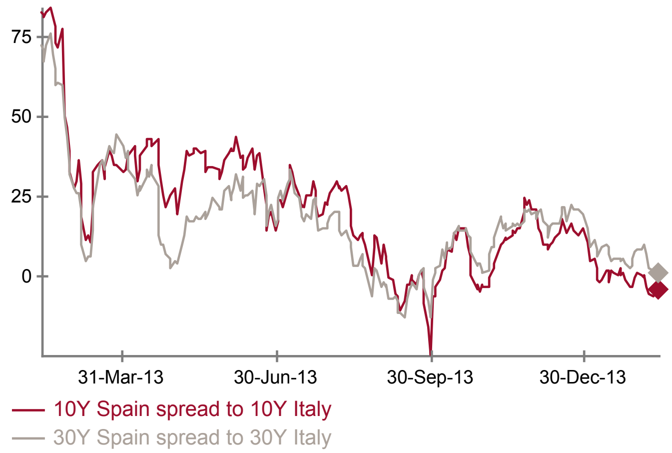
30y Spain looks slightly cheap relative to Italy in particular compared to the 10y spread. 10y Spain already trades with a lower yield than 10y Italy, while it is still the opposite in the 30y (see Exhibit 24).

Exhibit 23: 30y BTP ASW spread tends to move by 5.8bp for a 1bp move in Bund-Eonia



Source: Credit Suisse Locus

Exhibit 24: 30y Spain-Italy vs. 10y Spain Italy



Source: Credit Suisse Locus

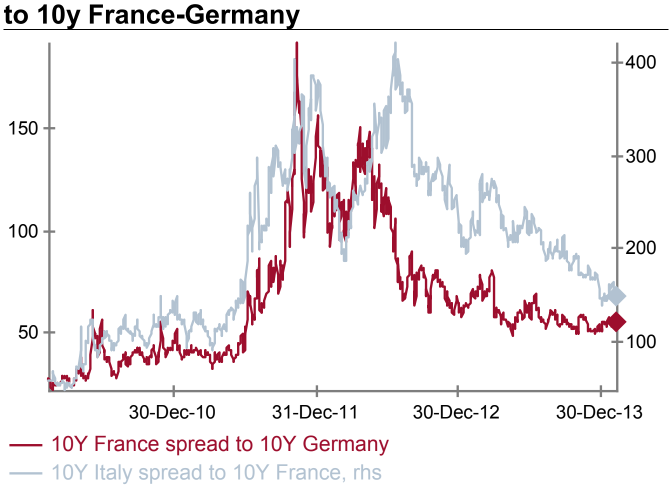
Italy issued 30y bonds on 13 February, we do not expect them to tap that sector in the next few months.

Credit barbell of short France vs. Germany and Italy

Another way to position for potential large scale asset purchases by the ECB is a credit barbell of short France vs. Germany and Italy, where an investor positions for a France-Germany widening and a risk-adjusted France-Italy tightening.

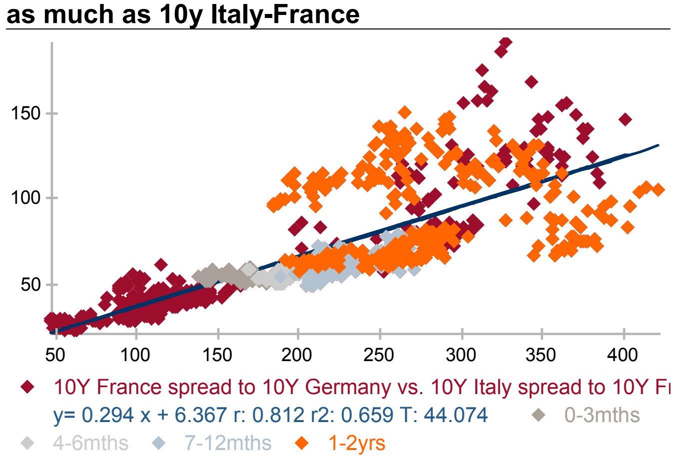
10y France-Italy and 10y France-Germany appear to be correlated but 10y France-Italy appears to be trading too wide relative to the 10y France-Germany spread (see Exhibit 25).

Exhibit 25: 10y Italy-France looks too wide relative to 10y France-Germany



Source: Credit Suisse Locus

Exhibit 26: 10y France-Germany tends to move 29% as much as 10y Italy-France

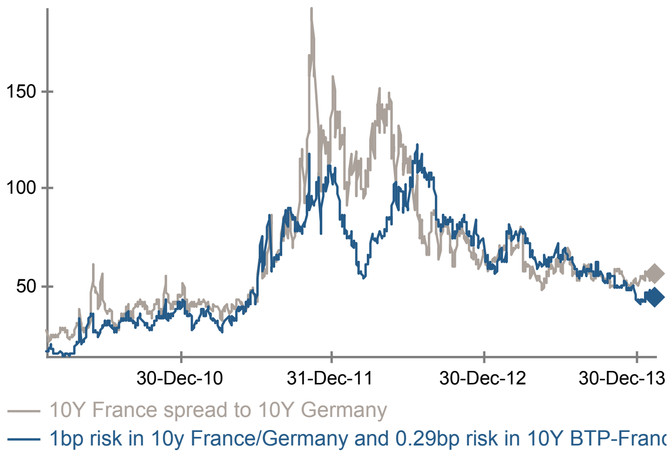


Source: Credit Suisse Locus

Our regression analysis indicates that 10y France-Germany moves by approximately 0.29bp for each move 1bp in 10y France-Italy (see Exhibit 26).

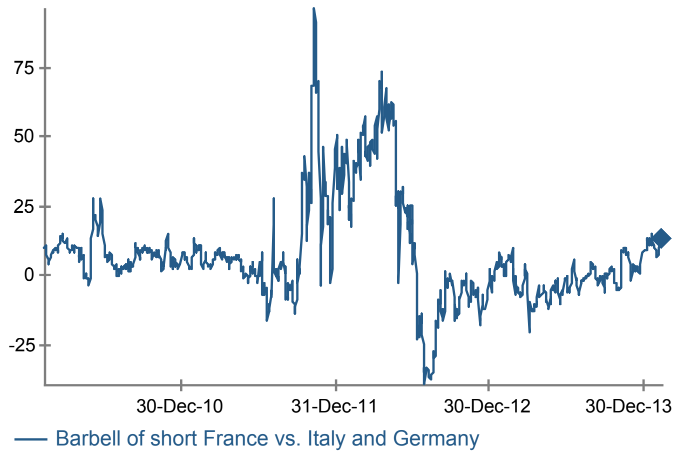
Exhibit 27 shows the movement of 10y France-Germany and 10y France-Italy using the beta from our regression analysis and Exhibit 28 illustrates the barbell movement.

Exhibit 27: France-Germany and 29% Italy-France



Source: Credit Suisse Locus

Exhibit 28: Barbell move with 29% risk in Italy-France and 100% in France-Germany

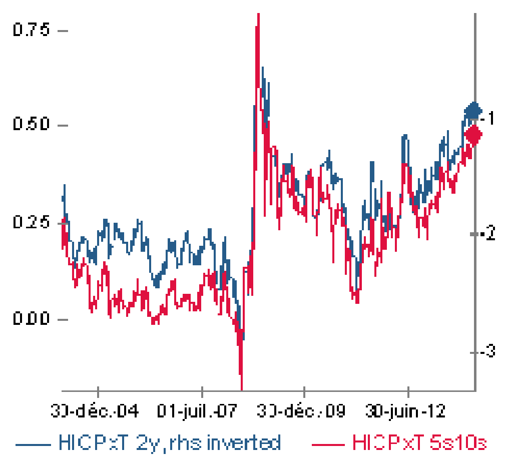


Source: Credit Suisse Locus

Go long EUR HICP via 5s10s flattener

Earlier this week, we recommended entering a EUR HICP 5s10s flattener as a cheap long inflation proxy, on the view that breakevens trade based on flows and are too low versus fundamentals. While QE is being discussed more, it has so far failed to boost inflation expectations, with EUR HICP 5y5y relatively sticky (although currently on the very low end of its range at 2.15%).

Exhibit 29: 5s10s steepened in line with the repricing of front-end inflation



Source: Credit Suisse Locus

Given the EUR 10y inflation swap is below 1.70% and the 5y is at 1.19%, we see the first of the following outcomes as slightly more likely: (i) expectations improve, in which case 5y should rise more than 10y as observed historically, (ii) inflation expectations fall further, but the move should be more parallel across maturities, and (iii) steady outlook, but given the very low negative carry, there is no harm in keeping the position.

March will be a decisive month, with the ECB releasing for the first time its 2016 forecasts, either to justify monetary easing or unchanged rates. If markets start to anticipate a strong inflation stimulus by the ECB, 5y should lead the way. The risk is a divergence between what the market is ready to believe, and what the ECB is ready to deliver, but in any case the HICP curve shouldn't reprice a lot from current extreme levels.

Please also see *Macro Tactics* for an index of assets that we expect to perform well if the ECB embarks on large scale asset purchases.

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