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Risk on

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- More central bank support and distressed valuations should be supportive of risky assets in the short run. We increase risk by reinitiating terminal rate trades in the US and going long breakevens in the US and the UK.
- In the longer run, the deleveraging in China remains a structural problem, but its impact on the core curve will depend crucially on China's FX policy. For now, a significant one-off devaluation remains unlikely
- The ECB all but announced at least another 10bp cut in the deposit rate. A temporary increase in the pace of QE could be a reasonable compromise between resilient domestic data and increased risk of second-round effects and between hawks and doves
- We exit the front-end trade in Europe and maintain our long 5Y Italy to benefit from growing expectations of ECB easing March. We stop out of our long Portugal vs. Italy given the volatility seen this week, but the ECB should now be more supportive for periphery assets in the run up to March
- We discuss the various possible changes to the parameters of the APP. These could include deviation from capital keys, removal of the yield-floor on purchases, increasing the issue limit for non-CAC bonds, expanding the range of eligible assets, extending the maturity of eligible assets and altering the method of purchases
- In the UK, dovish tone from the MPC helped the market push back pricing of the first hike to late 2017. The impact of sterling's depreciation will generate some offsetting pressures to the inflation outlook but uncertainty over the timing of the EU referendum will likely prevent significant retracement at the front end of the money market curve
- Looking forward to the EU referendum, we compare the movements of UK assets in the run up, and following the Scottish referendum and recent general election. The framework would imply increased uncertainty as the EU referendum approaches would lead to an underperformance of cash outright and on a cross market basis as well as a steepening of the curve
- KfW issued a 2Y USD 2bn floater at 3m Libor+16bp, double the original target, showing strong demand non-US Treasury level 1 LCR assets. Dexia Credit Local, jointly issued a 3Y USD 1.75bn bond at ms+83bp. In our view, new DCL is attractive compared to 3Y USD 1.25bn BNG at ms+39bp and 3Y USD 3.5bn Cades at ms+49bp. Given the challenging conditions in the primary market for EUR agencies and supras, USD issuance is likely to stay relatively high, also driven by lower all-in costs
- Long-end USD B/Es look low compared to EUR or GBP markets and short-term USD B/Es could benefit from any stabilisation in risk sentiment and oil prices. In EUR, uncertainty over the core inflation outlook has risen amid higher risks of indirect and second round effects and we stay neutral on B/Es. In GBP, rising RPI inflation and some rebound in wage growth should create a more supportive backdrop for B/Es, which in 10y look cheap relative to commodity, FX and spot RPI trends. We are long the UKTi24 B/E

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Bond Market Strategy

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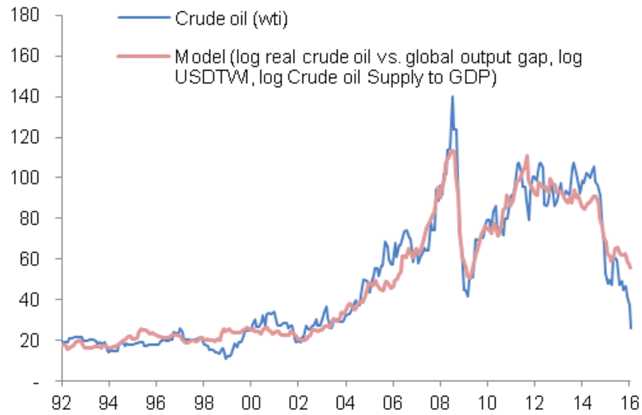
Risk on

The ECB brought forward expectations of further easing, in line with our expectations. Next week, the Fed is likely to reiterate its data dependence and acknowledge the recent weakness in the data, while keeping a tightening bias. This should convince the market that it is likely to adapt its rate path if necessary. Finally, on some metrics, risky assets and oil prices appear to have overshot to the downside. Taken together, this should be supportive of risk in general in the short term. In turn, reduced risk aversion should put some bearish pressure on rates.

Note however that ultimately the weak link is the China/oil nexus rather than the Eurozone or the US. From this perspective, the expected ECB easing, while helpful, is not a major game changer. A more dovish Fed could be more relevant as it would alleviate the pressure on China and oil prices. A stabilization of oil prices would in turn reduce the pressure on the US credit market.

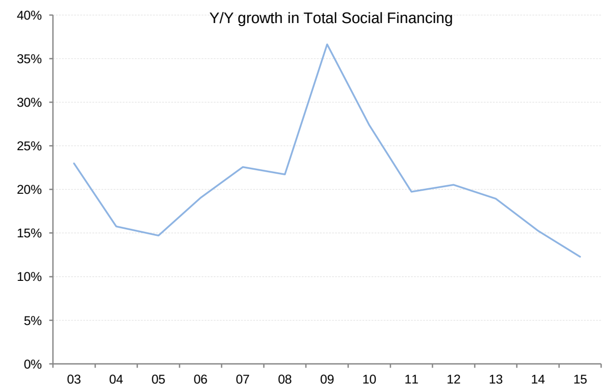
There is also a fundamental difference between the risks posed by China and by oil prices. For the latter market forces are working and should ultimately help reach some form of equilibrium. Also, the marginal economic impact of a % change in oil prices should be reduced as its weight in the consumption basket (and the economy) is declining. Finally, on some metrics, oil prices earlier this week reached historically extreme valuations (see below).

On some metrics, the oil price adjustment is extreme



Source: Deutsche Bank, Bloomberg Finance LP, IEA, Haver Analytics

While credit growth in China remains in double digits



Source: Deutsche Bank, PoBC, Haver Analytics

In the case of China, however, the fundamental problem is one of credit growth that has not adjusted enough; while real rates are too high, the currency appreciated significantly and the GDP deflator is already in negative territory. This assessment was the basis of our analysis suggesting that China rather than Europe was at risk of a 1990 Japan-like outcome. From this perspective, until there is more convincing evidence that the deleveraging in China is complete, the China question will remain alive. However, its impact on global core rates will depend crucially on the FX policy that China adopts. Draghi's assessment on the issue was that China "has the reputation to act responsibly" and is "gaining control over the policy making", i.e. that it is unlikely that China will aggressively devalue its currency. Whether this is sustainable in the long run is debatable. But in the short term, the immediate risks of a large one-off devaluation should be limited.

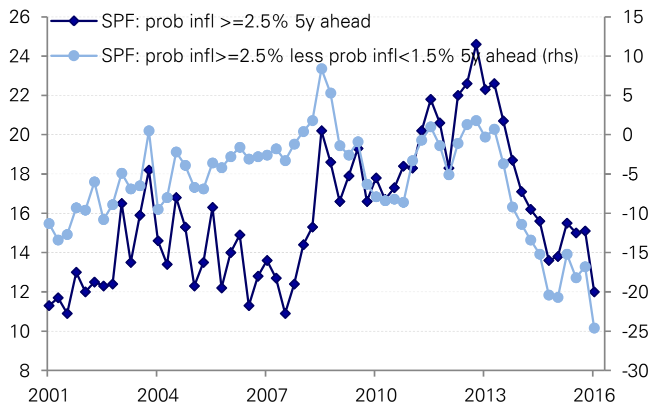
From a trade perspective, we had reduced risk in the new year given the pressures generated by China and oil on risky assets. Since then, there has been a significant adjustment to risky assets and oil prices, while inflation and term premium have been compressed. This leads us to increase risk again. In the US, we enter a long USD30Y breakeven and reinitiate short EDZ8. In Europe, now that the market is fully pricing the 10bp cut by March, we exit our front-end trade. We maintain the long 5Y Italy outright, but exit the 10Y Portugal-Italy tightener given that it went through the stop level. The ECB meeting should be supportive for Portugal as a higher-beta periphery trade but the idiosyncratic risk surround the upcoming 2016 budget (see Euroland Strategy for more details) lead us to prefer to be long 5Y Italy. In the UK, we maintain our term-premium normalization steepener (GBP 5s10s hedged by 2s) and go long 10Y breakevens.

ECB: more than a 10bp deposit rate cut, but not going all-in

The ECB reacted to the deteriorating inflation outlook as Draghi signaled further easing in March. The experience of last December may lead some to question the credibility of the ECB. However, the ECB's doves are on much firmer ground now than ahead of the December meeting. If the ECB were to update its inflation forecast today, it would need to reduce its 2016 inflation projection from 1% to close to zero. Even if the source of low inflation is benign, the risks of second-round effects increase the longer inflation remains low. This is confirmed by the latest SPF, which shows that the risk distribution of longer-term inflation has shifted to the downside. Thus, from this perspective, the outlook more easily justifies further action today, versus the heightened expectations ahead of the last ECB meeting.

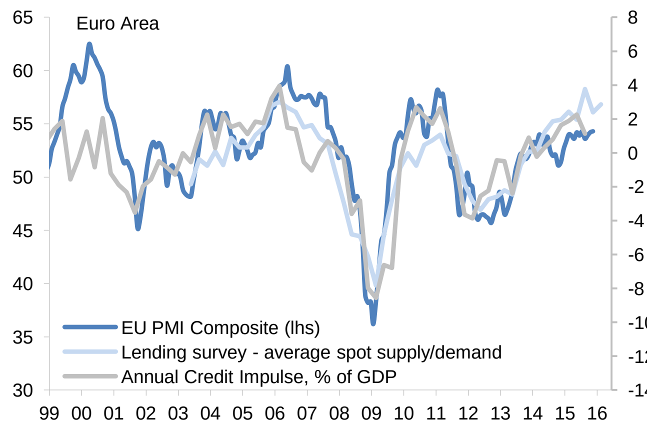
However, the Eurozone economy has remained resilient. This was acknowledged by Draghi and further confirmed by the ECB lending survey released this week. The aggregate supply/demand indicators are consistent with further improvement in credit growth, which in turn should translate into resilient domestic demand. The flash PMIs have declined slightly, but remain at a level consistent with current GDP expectations.

The SPF distribution of inflation risk has shifted to the downside



Source: Deutsche Bank, ECB, Haver Analytics

The ECB bank lending survey is consistent with further improvement in the credit impulse and domestic demand



Source: Deutsche Bank, ECB, Haver Analytics

Even though the ECB's mandate is solely focused on inflation, robust domestic dynamics should be supportive of inflation over the medium term. This suggests that further weakening of the PMIs would be necessary to support the most aggressive easing options.

In practice, Draghi all but announced an additional 10bp cut to the deposit rate. The ECB statement made clear reference to policy rates remaining at "present or *lower* level". Second, Draghi confirmed that the decision to reassess the monetary policy easing was unanimous. Third, as we highlighted last week, the minutes suggested that the hurdle for an additional 10bp cut was low.

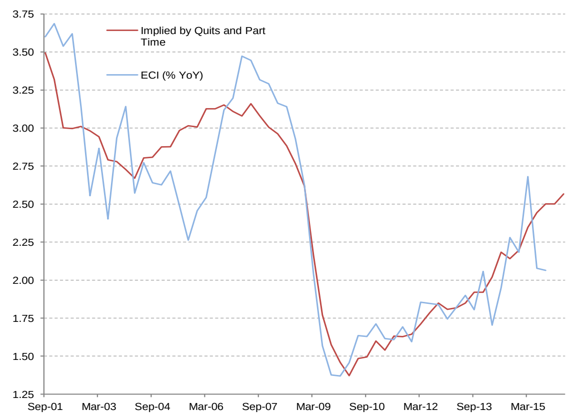
Draghi left all other policy options open and was dovish enough in the Q&A to imply that more than just 10bp cut is likely. However, an extremely aggressive easing, i.e. a significant and permanent increase in the pace of QE, is still likely to face a high hurdle. First, the minutes revealed that the hawks favoured a 20bp cut to the depo in December to changing the terms of the APP. Second, as mentioned above, the domestic data remains relatively resilient. Third, if the ECB expects China to "behave responsibly" it would be paradoxical to increase the pressure on China by easing overly aggressively.

In short, the ECB is more likely to ease than cut the deposit rate by 10bp, but less than a significant and permanent increase of the pace of QE. There are many alternatives, which we discuss in more details in Euroland Strategy. Amongst the various options, the possibility of a temporary increase in the pace of QE is worth highlighting. It would be easier to sell to the hawks, while achieving most of what the doves would be looking for and maintaining a certain degree of flexibility.

Risk-on trades

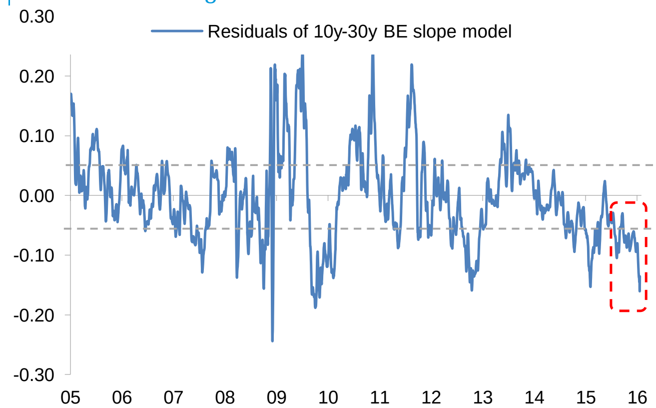
In the US, inflation was marginally lower than expected, while the manufacturing surveys were mixed. The CBO provided an overview of its updated fiscal projections. The CBO projects deficits to be ~0.5% of GDP higher than previously expected (adjusted for calendar effect). While this is a relatively small stimulus, it does confirm that fiscal policy is turning more supportive. Finally, there is some upside risk to the ECI wage inflation released next week. Consensus expects 0.6% q/q, which is consistent with the run rate of ~2.5% implied by leading indicators such as Quits and Part-Time. However, as the y/y rate is currently closer to 2.1%, there is some upside risk that the convergence between ECI and its leading indicators occurs faster than expected.

Some upside risk to ECI wage inflation



Source: Deutsche Bank, BLS, Haver Analytics

Discount embedded in 30Y BE against rest of the BE curve is becoming extreme



Source: Deutsche Bank, Bloomberg Finance LPs

With this in mind, we look for risk-on trades which are attractive from a valuation perspective. The dislocation in long-dated US breakevens stands out on many metrics. The decomposition of the breakeven curve suggests that the 5Y breakeven is cheap against forecasts but is highly sensitive to oil and suffers from the most negative carry. The historically low level of 5Y5Y BE around 1.55% is cheap against long-term core inflation prospects, making the 10Y BE even cheaper than the 5Y BE. Finally measures of excess flatness of 5s30s BE slope or 10s30s BE slope suggest that the 30Y BE is too cheap vs. 5s and 10s, making it the cheapest sector of the TIPS curve (see graph above). The risk of the trade comes from further concession ahead of the upcoming supply of a new 30Y TIPS on 18 Feb and further decline in oil prices.

Similarly, we enter a long 10Y B/E in the UK as well (see Global Inflation for more details). We also reinitiate the short EDZ8, with the view that even a more dovish Fed would help reintroduce some risk premium in the money market curve. Finally, from a relative-value perspective, we recommend short positions in the 10Y sector or via options (see Global Relative Value for a 3M10Y payer ratio financed by selling an expensive OTM 3M10Y receiver).

Emerging Markets

Rates
Gov. Bonds & Swaps
Inflation
Rates Volatility

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Euroland Strategy

- Following the disappointment of the December meeting the ECB once again very strongly communicated a further easing at the March meeting
- A 10bp cut to the deposit facility rate at the March meeting and the possibility of further cuts is the base case. The market is already fully pricing in a 10bp cut for the March meeting and around 60% probability of another 10bp cut
- While the money market curve beyond Mar-17 could flatten further we see limited upside to being received front-end rates at current levels. We exit our received EUR 1x4 FRA
- Despite the ECB's dovishness broader market sentiment is likely to be driven by financial stability concerns in China and oil price developments. Until there is some stability in these segments we refrain from entering outright steepeners on the EUR curve as yet
- Draghi also suggested that technical work would be done to ensure that the full-range of policy options is available to the Governing Council at the March meeting. This is a reasonable indication that the ECB's QE programme could be expanded further
- We discuss the various possible changes to the parameters of the APP. These could include deviation from capital keys, removal of the yield-floor on purchases, increasing the issue limit for non-CAC bonds, expanding the range of eligible assets, extending the maturity of eligible assets and altering the method of purchases
- Some of these changes would imply even more purchases of German bonds relative to current expectations. Nevertheless, any expansion of the QE programme should be beneficial for peripheral government bonds
- The recent volatility in Italian government bonds has been driven by concerns over the NPLs at the weaker banks in the absence of any consolidation of the banking sector in Italy. The acceleration of the process towards establishing a bad-bank should reduce the wider systemic concerns. We therefore maintain our long position in Italy 5Y
- We have been stopped out of our long 10Y Portugal vs. Italy and given the upcoming budget discussions we refrain from re-entering the trade

One more time

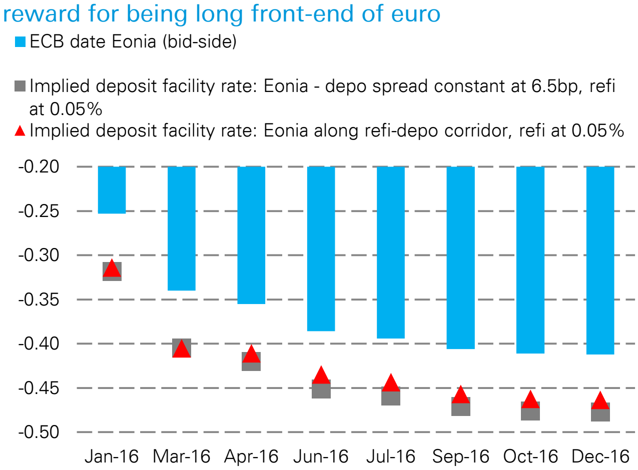
Following the disappointment of the December meeting the ECB has communicated very strongly a further easing at the March meeting. The prepared included the following key dovish statements

- Key ECB interest rates to remain at present or lower levels for an extended period of time
- Given the weakening inflation dynamics, it will be necessary to reconsider the monetary policy stance at the next meeting in March when new staff macroeconomic projections including 2018 forecasts will be made available
- Work will be done to ensure that technical conditions are in place to make the full range of policy options available for implementation

The first two along with the December minutes released last week which indicated that even the hawkish members of the council were in favour of depo rate cuts if easing was necessary would suggest that the easiest course of action is at least a 10bp cut with the possibility of further cuts at subsequent meetings.

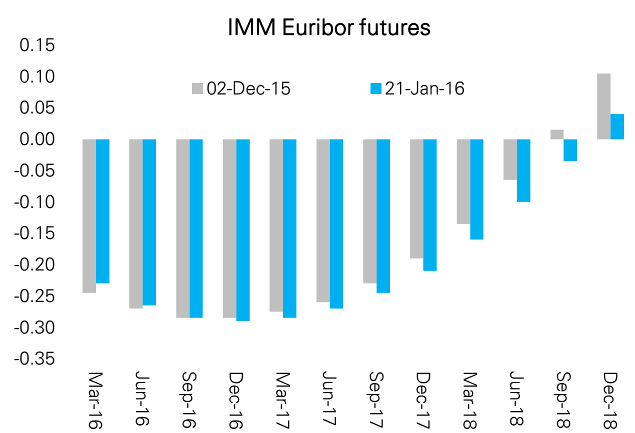
The market is already pricing a 100% probability of a 10bp cut and more than 50% probability of another 10bp cut by the June meeting (see Figure 1). Looking further out on the Euribor curve the market is pricing lower rates and a flatter money market curve than it was before the December meeting (see Figure 2). Given the communication mishap leading up to the December meeting we would expect more balanced commentary from various ECB speakers between now and the March meeting. While we recognize that the market could price in further rate cuts the risk-reward is no longer in favour of positioning for further rate cuts at the front-end of the euro curve. We therefore exit our received position in 1x4 Euribor FRA.

Figure 1: Current market pricing implies reduced risk-reward for being long front-end of euro



Source: Deutsche Bank, Bloomberg Finance LP

Figure 2: Euribor strip lower and flatter than it was before the December meeting



Source: Deutsche Bank, Bloomberg Finance LP

Work to ensure technical conditions allow for full range of policy options

The reference to work being done to ensure that technical factors do not limit the full deployment of all the policy options is strongly suggestive of some expansion of the Asset Purchase Programme (APP).

In our previous work (see Special Report: How much room does the ECB have to expand QE?) we have shown that the primary constraint to a further expansion of the ECB QE programme is the capital key distribution of purchases and the limited availability of eligible bonds in Germany. At the current pace, if all eligible bonds in Germany are purchased, we estimate that the ECB could at the very most continue the APP until Q3 2018. However, the actual limit is likely to be reached much sooner as it is unlikely that the ECB would be able to buy up to the 33% limit of each eligible bond.

With this constraint in mind we discuss the possible changes to the parameters of the APP, the impact it has on reducing this constraint as well as the impact on the level and term structure of yields in core and periphery.

Deviation from purchases according to capital-keys

The ECB could consider the possibility of the purchases of its PSPP deviating away from the capital-key distribution. This would significantly ease the concerns as on aggregate with all other parameters unchanged the ECB could continue the APP until Q4-2019.

The possibility of a deviation from the capital keys would imply less buying of Germany and more of peripheral government bonds (see Figure 3). German bonds account for only 16% of the eligible universe while the capital key share of Germany is 25.6%. On the other hand, Italian bonds account for 24.8% of the eligible universe while the capital key share of Italy is only 17.5%. This should result in a significant decline in government bond yields where the share of PSPP eligible bonds exceeds the capital key share (Italy, France and Belgium) and a potential tightening of Bund ASW and steepening of the Bund curve.

A more moderate version of such a change would be the decision that if the central bank of a large country such as Germany is not able to continue purchasing bonds, the PSPP programme would continue with a lower monthly pace of QE. In principle this has a similar impact as a deviation from capital keys this would nevertheless imply a more limited expansion of the ECB balance sheet which seems to be inconsistent with Draghi's overall message of removing technical limitations to their policy options.

Removal of yield floor

The ECB could remove the limit on only purchasing bonds yielding more than the deposit facility rate. This limitation reduces the amount of German bonds that can be bought by ~EUR 75bn (after applying the 33% issue limit) for the current universe (see Figure 4). The rationale for the yield floor on purchases was to avoid locking in a loss which was reasonable when the deposit facility rate was floored. However, with there being no floor to the deposit facility rate (this was explicitly referenced in the introductory statement at the January meeting) purchases of bonds with yields below the current deposit facility rate would result in "negative carry" for the ECB but would not constitute a guaranteed loss.

Figure 3: German bonds account for only 16% of eligible universe while the capital key share is 25.6%

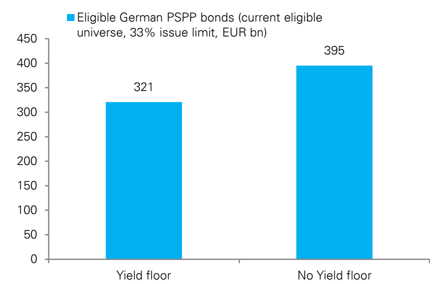
Country	Capital key share	Share of current PSPP eligible bonds (applying 33% issue limit)
Germany	25.6	16.1
France	20.1	25.0
Italy	17.5	24.8
Spain	12.6	12.6
Netherlands	5.7	4.2
Belgium	3.5	5.2
Greece	2.9	n.a.
Austria	2.8	3.4
Portugal	2.5	1.7
Finland	1.8	1.2
Ireland	1.6	2.0
Slovakia	1.1	0.5
Lithuania	0.6	0.1
Slovenia	0.5	0.3
Latvia	0.4	0.1
Luxembourg	0.3	2.8
Estonia	0.3	0.0
Cyprus	0.2	0.1
Malta	0.1	0.1

Source: Deutsche Bank, ECB, Bloomberg Finance LP

The removal of the yield floor and the resultant EUR 75bn increase in eligible bonds in Germany would allow an increased pace of EUR 25bn (i.e. from EUR 60bn to EUR 85bn a month) until Mar-17 or extension of purchases by six months.

Such a change would result in a significant steepening of core curves, especially in Germany as more front-end bonds which are currently ineligible for purchases could be purchased. It should also result in an outperformance of peripheral government bonds as it would suggest that the overall ECB QE envelope can be increased.

Figure 4: Removal of yield floor would allow additional EUR 75bn of PSPP in Germany



Source: Deutsche Bank, Bloomberg Finance LP

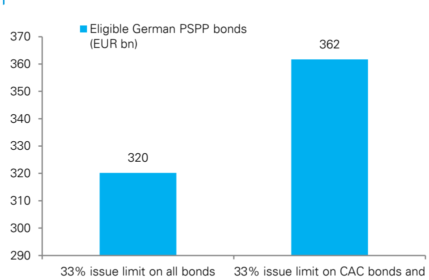
Increasing the issue limit from 33% for non-CAC bonds

The ECB currently has an issue limit of 33% on bonds that can be purchases under the PSPP. The primary rationale for this limit is to avoid interfering with the market mechanism in general and more specifically a restructuring of bonds which include the standard EU Collective Action Clauses (CAC). For bonds with standard CACs a quorum for reserve matter modification is met only if 66 2/3% of the holders of a bond attend the meeting. Therefore, if the ECB owned more than 33% of a given issue it would either have to actively decide for/against a restructuring or it could choose to not attend the meeting which would prevent a quorum from being met. In our view, the ECB would not want to take an active role in any restructuring process and hence the limit of 33% on bonds with CACs should remaining binding. However, the issue limit could be raised above the 33% limit for bond without CACs.

We estimate that German PSPP eligible bonds issued before 2013 (all bonds issued from Jan-13 have CACs), with yields above the current deposit facility floor, amount to EUR 592bn by market value. Therefore, for each percentage point increase in the issue limit for non-CAC bonds could raise the amount of bonds bought in Germany by 6bn. The increase in the issue limit from say 33% to 40% in Germany would increase the available German bonds by ~EUR 40bn but would not alter significantly the distribution of eligible bonds across the maturity spectrum (see Figure 5 and Figure 6).

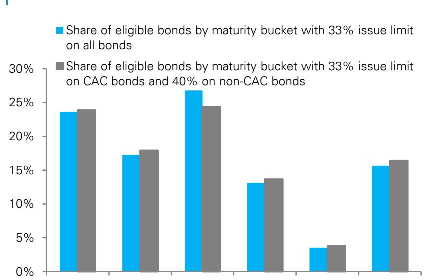
The increase in the issue limit for CACs should allow for an increase in the overall QE envelope while allowing for continued purchases of German bonds. This should lower yields for both core and peripheral government bonds and is unlikely to have any material impact on the term structure.

Figure 5: German PSPP could increase by EUR 42bn if issue limit raised to 40% for non-CAC bonds



Source: Deutsche Bank, Bloomberg Finance LP

Figure 6: German eligible universe by maturity bucket if issue limit increased for non-CAC bonds



Source: Deutsche Bank, Bloomberg Finance LP

Extending the range of assets to be purchased

The ECB could decide to include other assets in its Asset Purchase Programme. This could include corporate bonds – both non-financial and financial. Given the significant widening in corporate credit spreads the ECB could ease financial conditions and funding conditions for the real economy by including corporate bonds in the eligible universe. Further, the concentration of potential eligible corporate bonds in the core countries should not be an issue as the expansion of the eligible universe in the core countries would allow an increased quantum of purchases in the periphery.

The hurdle for purchases of non-financial corporate debt is expected to be significantly higher given that the ECB provides funding to banks on a secured basis and therefore buying their unsecured debt would be logically inconsistent. This is even further complicated now that the ECB has also adopted single supervisor rule and the new bail-in rules which increases the risk of bailing in senior debt.

An extension of the range of eligible assets to include non-financial corporate debt should result in overall tightening of credit spreads (including peripheral sovereign spreads) and probably result in a tightening of Bund ASW as it would imply less buying of German government bonds.

Extending the maturity range

At present bonds with maturity dates between 2Y and 31Y are eligible for purchases. Extending the range on either side would increase the eligible universe for most countries but not in the case of Germany given that bonds <2Y are trading below the deposit facility rate and there are no government bonds with maturity exceeding 31Y. Therefore, this decision taken in isolation would not have any material impact but if taken together with removal of the yield floor could increase the amount of shorter-dated Germany bonds eligible for purchases.

Any increase in the eligibility of bonds is likely to be short-lived as these shorter-dated bonds would mature fairly quickly. After a short-lived relief the increased availability of shorter-dated bonds would be offset by the increase in re-investment needs.

A decision to extend the maturity range, especially to <2Y along with a removal of the yield floor should result in a steepening of the German curve. It should remain supportive of peripheral yields as it would allow an expansion of the overall QE envelope.

Method of purchasing

A move to purchases via auctions, especially one where end-investors could participate directly, might make it easier for the ECB to source some of the bonds held by longer-term investors as there would be greater clarity and transparency. However, we think that such a change is likely to have limited impact from a macro perspective.

Summary

In summary, we believe that the ECB has a number of ways to ease the constraints on increasing the pace or extending the time period of QE. Given the sense of urgency implied by the significant decline in near-term inflation and the risks of these for medium-term inflation expectations we would be of the view that a moderate and/or temporary increase in the pace of purchases cannot be ruled out.

Most of the measures that we have discussed should reduce the pressure on the long-end of core curves, especially Germany, even if the ECB decides to expand the APP. Further, the primary aim of an expansion of the QE would be to ease aggregate financing conditions by lowering peripheral yields.

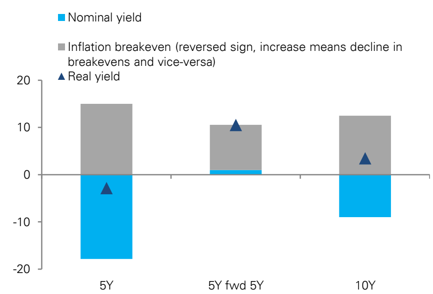
Trade recommendations

Maintain constructive stance on periphery: Stay long Italy 5Y

On aggregate Eurozone GDP weighted 10Y real yields in the Eurozone have gone up relative to their levels before the October meeting largely due to the decline in inflation breakeven levels (see Figure 7). Therefore, it is hard to make the case that 10Y nominal yields in the Eurozone should decline further. Nevertheless, the fact that the ECB could be more aggressive on its QE programme should be supportive of peripheral government bonds. We maintain our long 5Y in Italy.

Italian bonds have seen significant volatility over the past week largely on account of concerns about the situation of NPLs in the smaller and less well capitalized banks and risks of funding pressures on account of senior and subordinated debt issued to retail investors (see note by our Italian banks' analyst). Draghi dismissed some of the concerns about the overall health of the Italian banks. He said that the overall levels of NPLs and provisioning for the NPLs had been thoroughly analyze by the SSM arm, the request for additional information about NPLs was not limited to Italian banks and was related to the management of NPLs rather than any potential increase in capital requirements. Additionally, there were news reports (including Bloomberg) that a bad-bank structure to deal with NPLs could be finalized as early as this weekend. In any case, the increased urgency suggests that policy makers are aware of the risks of significant spillover to the government bond market and hence we continue to express a moderately bullish view on Italian government bonds.

Figure 7: Drivers of Eurozone GDP wtd real yields from before October ECB meeting



Source: Deutsche Bank, Bloomberg Finance LP

Refrain from re-entering strategic steepeners

In our annual outlook we had recommended steepeners on the core curves as a strategic trade for the year. Given the increased risk aversion and decline in 5Y forward 5Y inflation breakevens led us to exit the steepeners tactically two weeks ago.

Notwithstanding Draghi's dovish tone, global risk sentiment is likely to be driven by oil prices and developments in China. Further, the possibility of some expansion of QE could result in some short-term flattening pressure on the curve. We therefore refrain from re-entering the steepeners as yet.

Stopped out of long Portugal vs. Italy

We have been stopped out of our Long 10Y Portugal vs. Italy earlier this week. The Portuguese cabinet approved the 2016 draft budget this week with the intention of submitting it to the European Commission for assessment later today. On the surface, the 2016 budget deficit expected at 2.6% is in line with the Europeans' stability and growth pact requirements as well as Portugal's Excessive deficit procedure. However, the assumptions underpinning the budget may too ambitious, with output expected to grow 2.1% relative to the latest European Commission forecasts of 1.7%, largely on the back of improvements in domestic driven demand. As a result, the risk remains that the EC provide a less favourable assessment of the budget plan, requiring more measures be taken to reduce public deficit and debt levels. In the interim period prior to receiving the EC's assessment (usually within a month), the budget will be debated domestically which also generates the potential for frictions to emerge between the Socialists and their more left leading coalition partners. Ultimately, it is in none of the coalition parties' interests for the budget to fail to pass, and our base case is that a budget agreement will be reached. However, given Portugal's recent vulnerability and the increased political risks over the coming budget talks we refrain from re-entering the trade despite the dovish message from the ECB.

United Kingdom

Rates
Gov. Bonds & Swaps
Inflation
Rates Volatility

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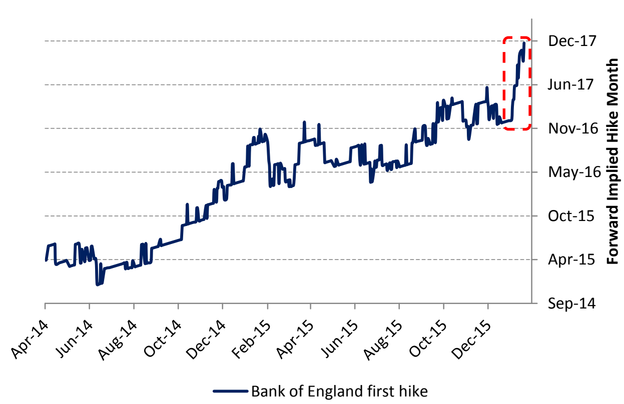
UK Strategy

Front-end update – still pushing back the hikes

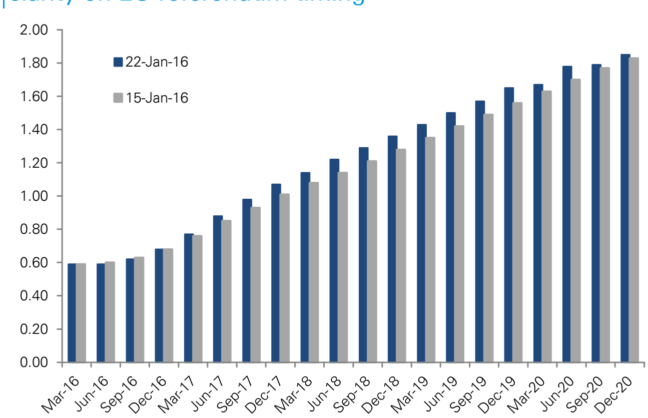
The dovish tone from the MPC, together with Thursday's ECB meeting were supportive of the front end over the week and the market pricing of the first Bank of England hike has been pushed back to late 2017. The front-end move has been significant and as the recent sterling depreciation begins to add offsetting pressures to the inflation outlook, as mentioned by MPC member Weale in an interview on Thursday, the potential for a retracement will increase. At the same time though, Carney and Vlieghe both stepped back from the opportunity to correct current market pricing during their comments this week, suggesting the money market is broadly in line with their views as we head into the February IR. What's more, looking to the very front end (until Dec-16), the money market curve is unlikely to steepen materially until more clarity emerges as to the timing of the EU referendum vote given the market's unwillingness to price a Bank of England move before the vote has been held.

Fig.1 The market has significantly pushed back the pricing of the first hike over the past month



Source: Deutsche Bank

Fig. 2 - The money market curve remains flat over 2016 with the market unwilling to reprice given the lack of clarity on EU referendum timing



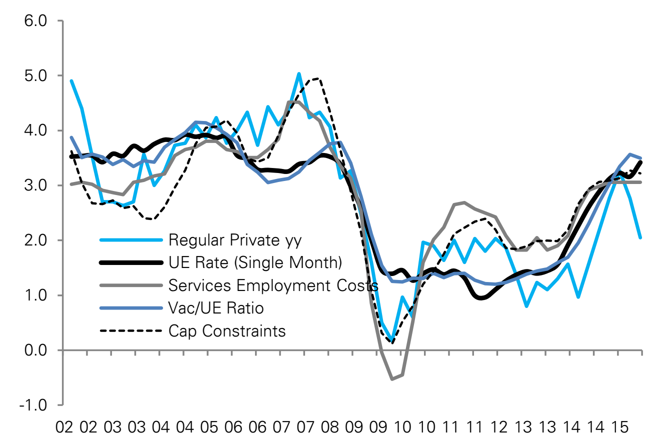
Source: Deutsche Bank, Bloomberg Finance LP

Despite dovishness from the MPC together with mediocre wage data, the fall in sterling is significant

Turning to the MPC speak in more detail, of note were Carney's comparisons between the Fed's recent lift-off and the case for the Bank of England to follow suit. He stressed relative differences in cost pressures, the openness of the UK economy relative to the US, the ability of the Bank to set macro-prudential policy as well as the divergent fiscal policy cycles as the factors behind his view that "now is not yet the time to raise rates". Vlieghe's speech on Monday had a similarly dovish tone, arguing that longer-term drivers from demographic and distributional factors together with the debt overhang will likely keep the path of rates lower than what would be implied by a pre-crisis framework.

Carney also highlighted the slowing momentum in wage growth since summer as an indicator of labour market slack. Here Wednesday's wage data came in above consensus with year-on-year wage growth excluding bonuses at 1.9% while total average weekly earnings were revised higher over September and October. However, these revisions fell largely on the public sector component and while private sector regular pay in November grew 2.3%, better than consensus, this week's wage data remains below the pre-slowdown trend and the Bank's expectations.

Fig. 3 – Despite this week's wage data coming in above consensus, momentum remains below the pre-slowdown trend and the Bank's expectations



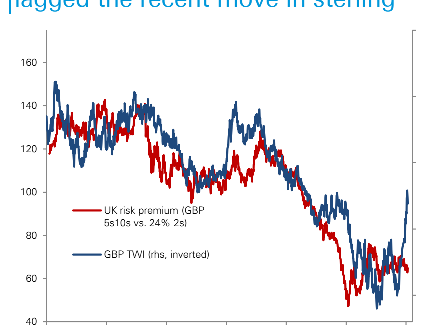
Source: Deutsche Bank, ONS, Bank of England, Haver Analytics, LFS

Fig. 4 – The sterling depreciation however will begin to provide some offsetting pressures to the inflation trajectory and we are now midway through the February IR input period

Source: Deutsche Bank, Bloomberg Finance LP

Despite these more dovish drivers, however, the impact of the sterling's sharp devaluation should not be overlooked. Since the start of December, the broad trade weight has fallen 6.5% while against specific crosses it has fallen 5.5% against the dollar and almost 8% against the Euro. The fall in sterling has now largely unwound the appreciation over 2015 (see fig. 4) and generates offsetting pressures to the impact on inflation from sterling's appreciation since 2013. Indeed, this was flagged by MPC member Weale during an interview published on Thursday. Weale stated that the drop in sterling "could easily offset, or more than offset, the oil-price effects and the wage effects" weighing on the inflation trajectory. In the near term the significant drop in commodity prices is likely to dominate, but looking to the more medium-term outlook a sustained sterling appreciation can help to offset price pressures from an imported inflation perspective as well as helping support core inflation pressures as the full impact passes through.

Fig. 5 – The UK term premium has lagged the recent move in sterling



Source: Deutsche Bank, Bloomberg Finance LP

Furthermore, looking to the February Inflation Report, we are now midway through the input period for the Bank's forecasts. Therefore, provided the move in sterling is sustained over the next week, it will be captured and will help to offset the impact of commodity price falls on the medium-term inflation picture.

Indeed, this UK-specific depreciation (and the associated offsets to the inflation trajectory) represents a key part of our rationale to move our US risk premium trades into the UK (see last week), recommending a GBP 5s10s steepener hedge by the level of rates. The UK term premium remains low relative to the recent currency moves (see fig. 5) while the upcoming EU referendum could begin to exert further steepening pressures on the curve as increased uncertainty is priced in.

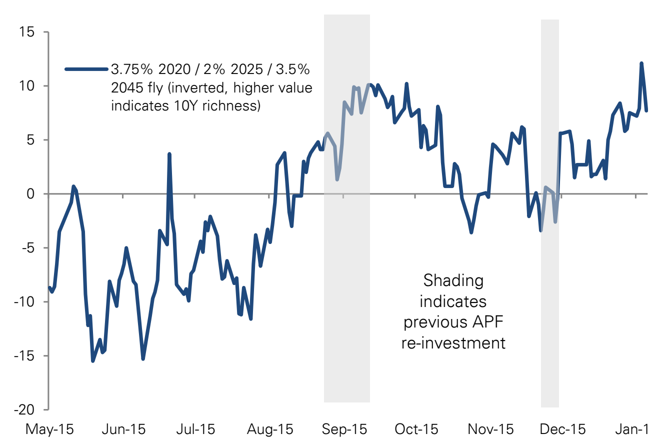
Looking to the January APF re-investments

From Monday the Bank of England will also begin the latest round of APF re-investments. As we discussed last week, the GBP 8.4bn of proceeds from the Jan16 redemption will be split equally between the short, medium and long baskets – equivalent to GBP 2.8bn each. Looking at the baskets in more detail, the supply and demand imbalance is most acute in the medium basket given the limited free float of bonds available for reinvestments. This has helped lead to a richening of the 10Y point on the fly over January so far.

However, the current richness now seems broadly in line with what could be expected based on previous APF periods, suggesting the room for additional performance may be limited. Indeed, once we pass the APF window, the supply and demand dynamics deteriorate as we approach the end of the fiscal year. Redemption and coupon flows are limited while issuance picks up in both nominal and linker space (with the new linker syndication before the end of February). In the shorter term, however, following this week's tap of the 1.5% Jan 21, there is no new issuance until the 9th February, while APF cashflows may provide some support.

Therefore, from a cashflow perspective we would see further richening during the upcoming APF as an opportunity to turn more underweight UK cash as we enter a heavier supply period into the end of the fiscal year.

Fig 6: The 5s10s30s fly has richened into the upcoming APF, suggesting some impact may be priced in



Source: Deutsche Bank, Bloomberg Finance LP, Bank of England

Fig 7: Following the APF reinvestments, supply will pick up over the remainder of the fiscal year, with limited coupon and redemption flows

January APF overview			Supply remaining for the fiscal year			
Date	Basket	Purchases (£bn)	Date	Bond	Amt (Est, £bn)	10Y DV01 equivalent
25-Jan	3-7Y	1.4	09-Feb	UKTi 0.125% Mar 26	1.4	1.7
26-Jan	15Y+	1.4	11-Feb	UKT 3.5% Jan 45	1.9	4.9
27-Jan	7-15Y	1.4	17-Feb	UKT TBA Jul 26	3.1	-
01-Feb	3-7Y	1.4	02-Mar	UKT 1.5% Jan 21	3.7	2
02-Feb	15Y+	1.4	09-Mar	UKT 3.75% Jul 52	1.9	6.3
03-Feb	7-15Y	1.4	10-Mar	UKTi TBA Nov 36	1.4	-

*In the 2nd half of February a 40Y+ linker will also be syndicated

Source: Deutsche Bank, Bank of England, DMO

Gauging the market impact to the EU referendum – lessons from the Scottish referendum and the general election

The upcoming UK-EU referendum represents one of the most important themes for 2016, yet there remains a significant lack of certainty as to the timing of the vote. At present this rests to a large extent on the outcome of Cameron's negotiations at the 18th-19th February meeting of the European Heads of State. Should this yield a result that Cameron accepts, the referendum could be held as early as June.

Given the approaching vote, we assess the potential for asset performance into and out of the referendum using developments around the Scottish referendum and recent general election as a guide. This analysis would suggest the majority of event-related impact is felt in cash, with the curve tending to steepen up to the 30Y point while on a cross-market basis some underperformance can be seen against the US.

Furthermore, if we assume the majority of any pre-event underperformance is reversed in the immediate aftermath of the result, this would suggest a significant proportion of any EU-referendum-led performance could take place in the month directly approaching the vote.

Evidently, this analysis is limited by the extent to which one can judge these events to be the causes of moves during the sample, but it is a useful starting point to consider where the largest impact of the referendum may be felt.

We compare the performance of a range of assets from the period three weeks before each event to the day before. Given the outcome of both the Scottish referendum and general election led to what were seen as more market-friendly outcomes, we can compare the change in the assets in the week following the result, when the market retraced towards the status quo, to get an indication of the impact on prices due to the upcoming vote.

Fig. 8: Performance of UK assets over the Scottish referendum period

Name	28-Aug-14	17-Sep-14	Change (bp)	25-Sep-14	Change over subsequent week (unwind of pricing)
GBP EUR	1.26	1.26	0.1 %	1.28	**1.6 %**
GBP USD	1.66	1.63	-1.5 %	1.63	**-0.1 %**
GBP Trade Weighted	86.98	86.78	-0.2 %	87.72	**1.1 %**
UKT 2 Year Note	0.85	0.85	0.0	0.84	**-1.6**
UKT 5 Year Note	1.72	1.82	10.4	1.80	**-2.1**
UKT 10 Year Note	2.37	2.52	14.6	2.45	**-7.2**
UKT 30 Year Note	2.97	3.17	19.9	3.06	**-10.7**
GBP 2Y Swap	1.23	1.26	3.1	1.26	**-0.3**
GBP 5Y Swap	1.92	2.02	10.0	2.02	**-0.3**
GBP 10Y Swap	2.40	2.56	16.1	2.53	**-3.9**
GBP 30Y Swap	2.79	2.97	18.6	2.89	**-8.5**
UKT 5s10s	65.47	69.60	4.1	64.49	**-5.1**
UKT 10s30s	59.54	64.84	5.3	61.41	**-3.4**
UKT '45-'68 slope	-0.04	-0.03	0.4	-0.04	**-0.3**
GBP risk premium (5s10s hedged with 2s)	77.67	84.50	6.8	80.85	**-3.7**
US-UK 5Y Cash	-8.52	0.92	9.4	-4.82	**-5.7**
US-UK 10Y Cash	-3.54	10.25	13.8	5.74	**-4.5**
US-UK 30Y Cash	10.75	20.33	9.6	15.26	**-5.1**
UK-EU 5Y Cash	153.52	161.81	8.3	162.38	**0.6**
UK-EU 10Y Cash	148.80	146.76	-2.0	147.20	**0.4**
UK-EU 30Y Cash	123.33	116.36	-7.0	114.64	**-1.7**
G A ASW	7.13	7.87	0.7	9.48	**1.6**
GBP swap spread 5Y	20.43	20.23	-0.2	21.78	**1.6**
GBP swap spread 10Y	4.49	3.93	-0.6	7.63	**3.7**
GBP swap spread 30Y	-17.62	-19.52	-1.9	-16.73	**2.8**
GBP swptn norm atm 1Y30Y	60.55	63.33	2.8	58.82	**-4.5**
FTSE 100	6805.80	6780.90	-0.4 %	6639.71	**-2.1 %**

Source: Deutsche Bank, Bloomberg Finance LP

Fig. 9: Performance of UK assets over the 2015 general election

Name	16-Apr-15	06-May-15	Change (bp)	14-May-15	Change over subsequent week (unwind of pricing)
GBP EUR	1.39	1.35	-3.3 %	1.38	**3.0 %**
GBP USD	1.49	1.52	2.1 %	1.58	**3.5 %**
GBP Trade Weighted	89.36	88.46	-1.0 %	91.27	**3.2 %**
UKT 2 Year Note	0.47	0.57	9.6	0.54	**-3.3**
UKT 5 Year Note	1.21	1.48	27.6	1.46	**-1.9**
UKT 10 Year Note	1.61	1.98	37.7	1.98	**-0.2**
UKT 30 Year Note	2.34	2.64	30.2	2.67	**2.4**
GBP 2Y Swap	0.90	1.04	14.0	1.01	**-3.4**
GBP 5Y Swap	1.35	1.63	27.9	1.61	**-1.8**
GBP 10Y Swap	1.70	2.06	36.0	2.05	**-0.6**
GBP 30Y Swap	1.98	2.33	34.5	2.34	**1.1**
UKT 5s10s	40.05	50.04	10.0	51.79	**1.8**
UKT 10s30s	73.52	65.99	-7.5	68.55	**2.6**
UKT '45-'68 slope	-0.05	-0.07	-2.2	-0.08	**-0.8**
GBP risk premium (5s10s hedged with 2s)	56.65	68.11	11.5	68.50	**0.4**
US-UK 5Y Cash	9.32	10.28	1.0	4.01	**-6.3**
US-UK 10Y Cash	28.26	25.93	-2.3	24.77	**-1.2**
US-UK 30Y Cash	23.30	34.93	11.6	38.18	**3.2**
UK-EU 5Y Cash	135.72	139.52	3.8	135.12	**-4.4**
UK-EU 10Y Cash	152.22	139.78	-12.4	128.07	**-11.7**
UK-EU 30Y Cash	184.50	143.68	-40.8	128.89	**-14.8**
G A ASW	7.63	3.85	-3.8	5.23	**1.4**
GBP swap spread 5Y	14.14	15.16	1.0	14.25	**-0.9**
GBP swap spread 10Y	8.26	7.67	-0.6	7.13	**-0.5**
GBP swap spread 30Y	-35.72	-31.40	4.3	-32.77	**-1.4**
GBP swptn norm atm 1Y30Y	82.61	85.62	3.0	83.75	**-1.9**
FTSE 100	7060.45	6933.74	-1.8 %	6973.04	**0.6 %**

Source: Deutsche Bank, Bloomberg Finance LP

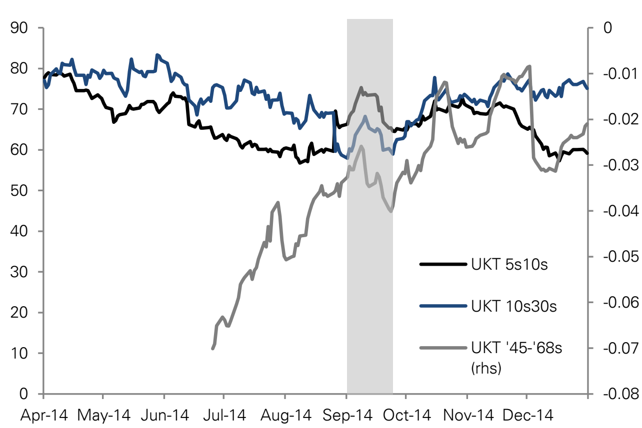
The tables above show the moves for our asset sample over the Scottish referendum and general election. Focusing on the assets, the cash market sold off, with yields higher on the day before the votes than at the start of the sample period. By comparing the change in the week following the votes' results, the analysis suggests the greatest underperformance before the Scottish referendum was seen in longer-end yields with the 10Y and 30Y rallying 7bps and 11 bps, respectively, in the week following. At the same time, however, the general election saw more of a reversal at the front end, with a 3bp and 2bp rally in the 2Y and 5Y points following the results.

Swaps also rallied back after the results of both votes, although to a lesser degree. 30Y swaps in particular stand out given they rallied back by 9bp in the week following the Scottish referendum while staying steady after the election results. This makes sense given the much longer-term impact of the Scottish referendum relative to the election of a government to rule for five years. Extrapolating to the EU referendum, the permanent nature of a vote to exit suggests we are more likely follow the Scottish referendum experience, suggesting 10Y and 30Y points may be vulnerable to increased risk premium pricing, despite the experience of the general election.

From a curve perspective, the analysis would also suggest the potential for steepening in the run up to the vote should we repeat the Scottish experience. Here the cash curve flattened back 4-5bps in 5s10s and 10s30s in the aftermath of the result, while at the longer end the slope between the 45s and 68s also flattened back.

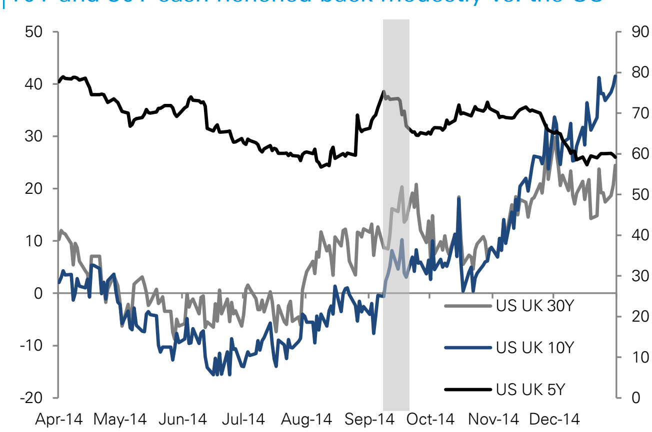
On a cross-market basis the market impact is less clear, with underperformance seen against the US but outperformance vs Europe. Against the US, in the week following the Scottish results the UK outperformed the US by ~5bp across the 5Y, 10Y and 30Y points. During the 2015 election, a similar move was observed, but more in the front end with 5Y UK outperforming 6bps while the 30Y point underperformed the US. Against Europe, the analysis would suggest the UK outperformed over the Scottish referendum period, suggesting moves in Europe perhaps dominated as drivers of the spread. Taken together, the cross-market moves suggest the UK could underperform vs. the US as we approach the EU referendum vote, with the 5Y and 10Y points potentially most vulnerable.

Fig. 10 – The cash curve steepened before flattening back after the Scottish referendum result



Source: Deutsche Bank, Bloomberg Finance LP

Fig. 11: Following the Scottish referendum result UK 10Y and 30Y cash richened back modestly vs. the US



Source: Deutsche Bank, Bloomberg Finance LP

Summing up, therefore, the analysis would suggest that as we approach the EU referendum, the increase in uncertainty and political risk premium associated with the Scottish independence vote and the recent general election could act to cheapen cash, steepen the curve and drive UK underperformance vs. the US.

Global

Credit
Covered Bonds

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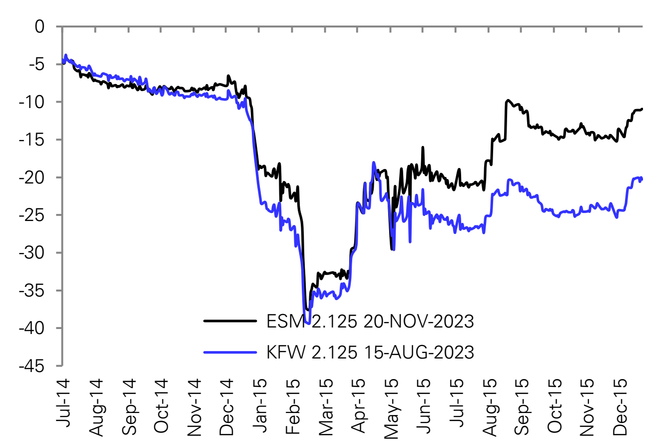
Covered Bond and Agency Update

- The ECB reported a weekly increase of CBPP3 holdings of EUR 2.075bn, i.e. EUR 146.006bn as of 15 Jan compared to EUR 143.931bn as of 8 Jan. In our view, the increase was mainly driven by primary market purchases, amounting to EUR 1.2bn, with secondary market purchases significantly lower than last year's average of almost EUR 400m, likely below EUR 200m.
- At an IFR conference, an ECB representative highlighted the challenges of implementing CBPP3 and the intension to "strike a balance between the targets expected to achieve while not exacerbating market distortion". However, it was also clarified that the ECB can buy up to 70% per ISIN.
- A Fitch survey shows that around two thirds of investors are gradually shifting towards other assets due to CBPP3. 40% of investors want to maintain their covered bond holdings. Investors said that low secondary market liquidity and CBPP3 are the main concerns.
- CFF issued a 10Y EUR 1bn covered bond at ms+25bp, Credit Agricole a long 4Y EUR 1.5bn at ms+10bp and BNP a long 5Y EUR 750m at ms+6bp. Moreover, at least 5 new issues are in the pipeline. Hence, given the broader market environment, the primary market is anything but inactive.
- Spreads continued to widen this week, also driven by secondary market selling, mainly in peripheral covered bonds, with traders unable to absorb larger positions.
- Monte Dei Paschi (MPS) conditional pass-through covered bonds (CPTCB) with an expected maturity in Nov 2025 widened most by around 20bp. In our view, besides significant issuer credit quality concerns, the fact there is no historical precedent for CPT structures in a weaker market environment weighs on spreads.
- We highlight that the higher ratings of CPTCB, A2/-/BBB/Ah in case of MPS, refer to the expected and not the legal final maturity. In our view, spreads will recover in case the bad-bank solution becomes effective. However, despite high voluntary and even committed OC of 20.5%, we are cautious regarding CPTCB in general. We argue that pass-through, though unlikely, cannot be excluded, a detail the market so far still largely ignores.
- In our view, CPTCB partly combine structural features of RMBS with the dynamics of covered bonds. For example, in case of new issuances or cover pool increases, depending of the maturity of new covered bonds and/or cover assets, all amortisation scenarios change substantially.
- The usual inversion of credit curves in the event of strongly worsening issuer credit quality may not necessarily be justified. For example, in some scenarios, earlier maturing bonds could redeem to a large extend by incoming cash-flows while other bonds are not in pass-through mode yet.
- Driven by the announcement of the Bank of Portugal to consider the two banks as systemically important on a domestic level, and the following upgrade of unsecured ratings, Fitch upgraded the covered bond ratings of Montepio and Santander Totta to BBB- and A- respectively. In our view, Portuguese covered bonds are too tight compared to Portuguese RMBS.

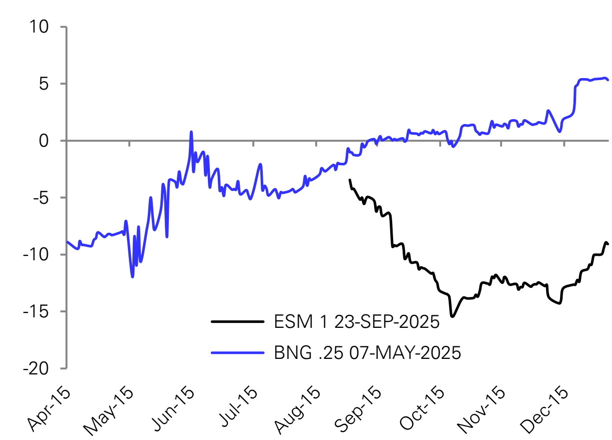
- KfW bonds significantly outperformed ESM and CADES since March 2015. CADES 4.375% Oct 2021 widened 9bp and CADES 4% Oct 2019 widened 7.5bp since the end of 2015. We highlight that supras are usually priced versus swaps and French agencies are priced versus sovereigns, making comparisons difficult.
- Dutch BNG 0.25% May 2025 widened strongly since new issuance and underperformed ESM 1% Sep 2025. In our view, even though a quick tightening seems unlikely, BNG is attractive relative to ESM. Both bonds are PSPP eligible.
- KfW issued a 2Y USD 2bn floater at 3m Libor+16bp, double the original target size, showing the strong demand for USD non-US Treasury level 1 LCR assets. Together with the 3Y USD 5bn last week, KfW has issued USD 7bn ytd already, suggesting an ongoing strong focus on low all-in costs.
- Dexia Credit Local, guaranteed by France, Belgium and Luxembourg on a joint but not several basis, issued a 3Y USD 1.75bn bond at ms+83bp. In our view, the spread is attractive, also compared to new 3Y USD 1.25bn BNG at ms+39bp and 3Y USD 3.5bn Cades at ms+49bp. According to Bloomberg, the bonds are not level 1 LCR eligible in the US (but in the EU).
- Given challenging conditions in the primary market for EUR agencies and supras, USD issuance is likely to stay high from a historical perspective, also driven by lower all-in costs. With KfW issuing in total up to EUR 10bn equivalent more in 2016, the absolute volume of USD issuance is unlikely to decline even if its share would decline from the 45% in 2015. For the first time, the USD share (EUR 28bn equivalent, 45% of total funding) exceeded the EUR share (EUR 23bn, 37%) in 2015.
- The outstanding volume of USD-denominated European agency and global supranational bonds amounts to USD 918bn. Supra USD bonds amount to USD 465bn and agency USD bonds amount to USD 453bn. Among agencies, KfW has the highest outstanding USD bond volume (USD 148bn), followed by BNG (USD 33bn). Among supranational entities, EIB has the highest outstanding volume of USD denominated bonds (USD 146bn), followed by IBRD (USD 99bn).

Figure 1: ASW spreads of ESM Nov 2023 versus KfW Aug 2023



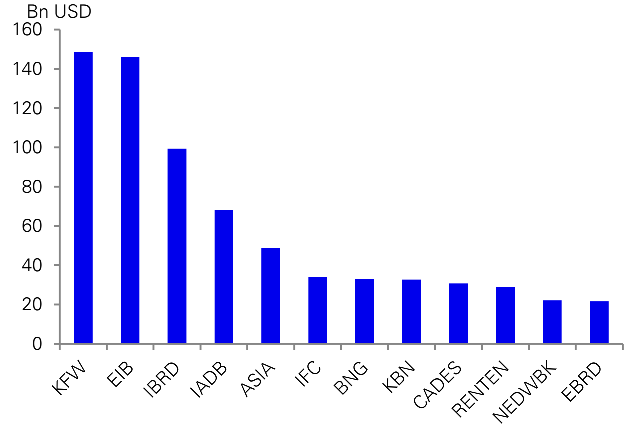
Source: Deutsche Bank

Figure 2: ASW spreads of ESM Sep 2025 versus BNG May 2025



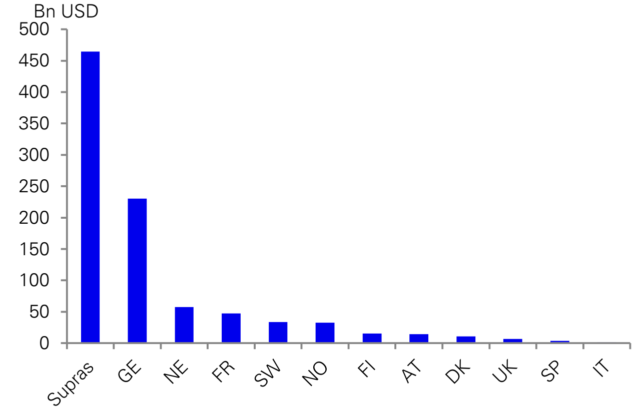
Source: Deutsche Bank

Figure 3: Outstanding volume of USD denominated agency and supra bonds (with at least USD 20bn)



Source: Bloomberg Finance LP, Deutsche Bank

Figure 4: Outstanding volume of USD denominated agency and supra bonds by country



Source: Bloomberg Finance LP, Deutsche Bank

Please find more details in our separate publications "Covered Bond and Agency Update".

Global | Rates
Gov. Bonds & Swaps
Inflation

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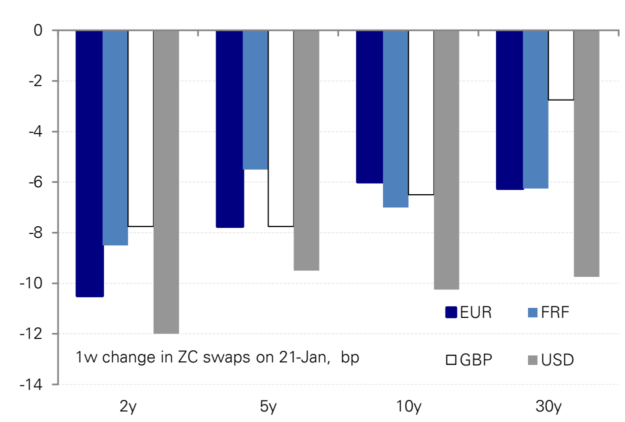
Global Inflation Update

- Long-end USD B/Es look low relative to EUR or GBP markets and compared to short-term USD B/Es and could benefit from any stabilisation in risk sentiment and oil prices on the back of more dovish central banks. We see some upside for 30y USD B/Es.
- In EUR, the uncertainty about the core inflation outlook has risen given recent prints, weaker compensation data, expected indirect effects from lower commodities and higher risks of second round effects. We stay neutral on B/Es. OATei and DBRei 2018/2020 forwards look relatively low.
- In GBP, recent currency weakening, rising RPI inflation and some rebound in wage growth should create a more supportive backdrop for UK B/Es once oil prices and risk aversion stabilise. 10y B/Es look cheap relative to commodity, FX and spot RPI trends. We are long the UKTi24 B/E.

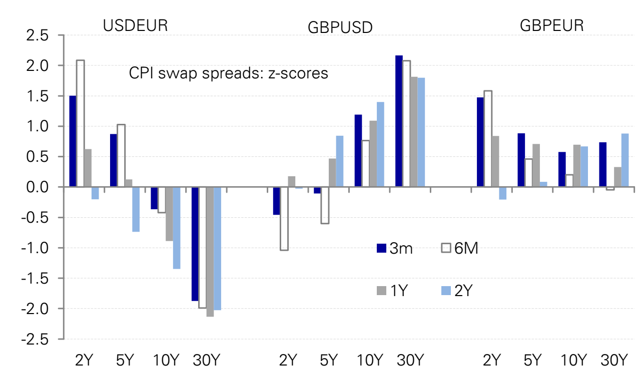
Breakevens globally continued to decline through most of this week (chart 1), as risk sentiment deteriorated further and oil prices were down again, but seemed to find some support at the end of the week, in parallel with global markets. USD markets underperformed, with the B/E curve down broadly in parallel beyond the very front-end (chart 1); 5y5y fell to new lows below 1.90% in swaps, as the USD long-end B/E sensitivity to risk and oil remains high, and demand for new 10y TIPS turned out weaker than expected. EUR and GBP curves mostly steepened (chart 1).

1. B/Es down further



Source: Deutsche Bank

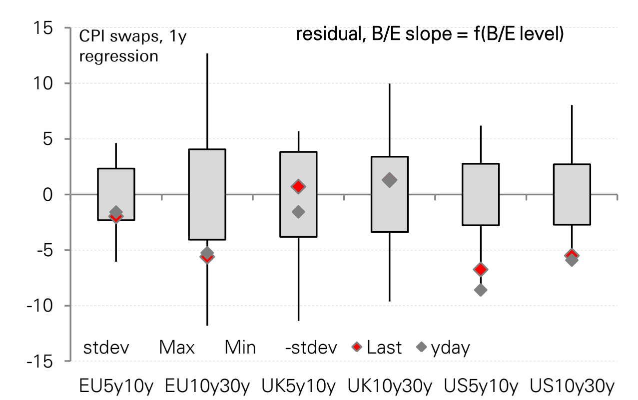
2. Cross market B/E spreads vs past averages



Source:, Deutsche Bank

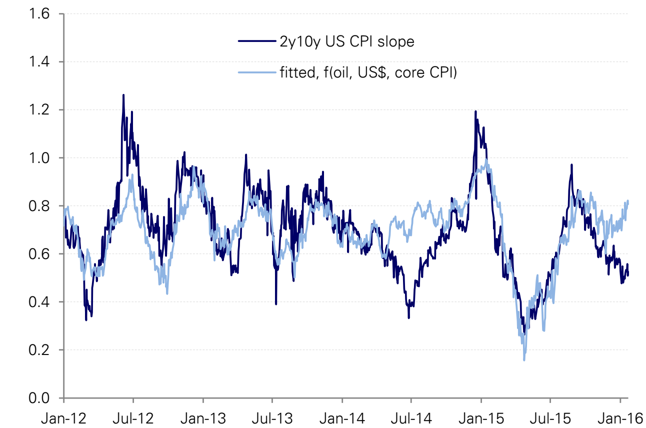
Looking at cross-market spreads shows GBP B/Es across the curve somewhat higher than EUR ones compared to past averages (chart 2), as could have been expected given the UK market's lower sensitivity to oil and risk sentiment. The largest moves have recently however occurred in long-end USD/EUR and GBP/USD spreads, with 30y USD/EUR (GBP/USD) about two standard-deviations below (above) past averages (chart 2). As discussed last week, this is above all a reflection of the unusual flatness of the USD B/E curve, even taking into account typical directionality (chart 3), or trends in oil prices, the US dollar and US core inflation (chart 4). Against that backdrop, long-end USD B/E may benefit most in any stabilisation in risk sentiment and oil prices. A dovish ECB has brought some support for risk, while a reiteration by the Fed next week that the policy rate path is conditional on data could be a positive as well; a more dovish message there would reduce pressure on oil and China. We see some upside for 30y USD B/Es from here.

3. US B/E curve flat against level of B/Es...



Source: Bloomberg Finance LP, Deutsche Bank

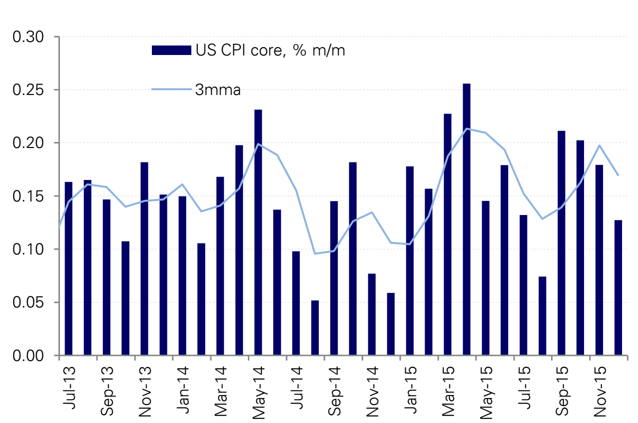
4. ...and against oil, the US$ and core CPI



Source: Bloomberg Finance LP, Deutsche Bank

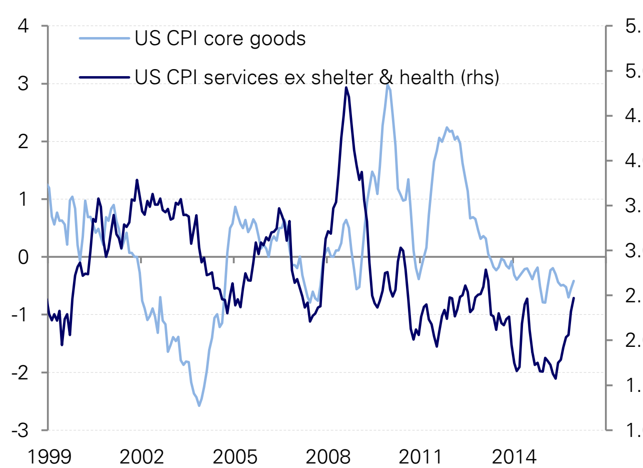
December core inflation prints have been mixed, revised marginally higher in EUR (but still below pre-flash forecasts) and higher than expected in the UK (although driven by volatile travel prices, see below). US core CPI was up 0.12% m/m, which compares to a 3m run-rate of 0.20% (chart 5). Some moderation in momentum seemed likely (average consensus was 0.15%), given unusually large price rises in November and October, but this was still fractionally below expectations. There have nevertheless been a few encouraging signs in US core inflation recently.

5. US core CPI slightly lower again in December



Source: US BLS, Deutsche Bank

6. US core CPI components

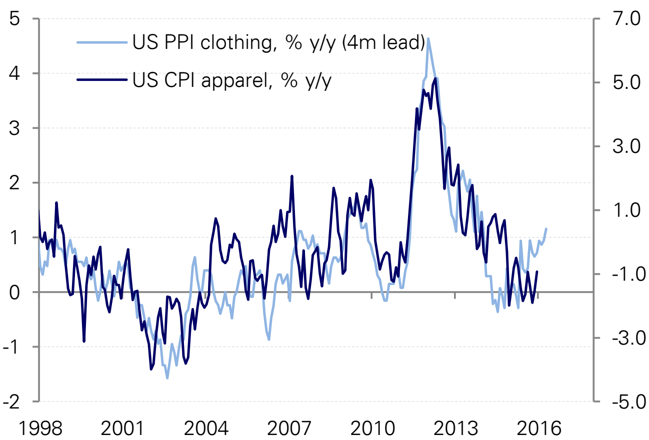


Source: US BLS, Deutsche Bank

First, core goods inflation has stabilised in recent months (chart 6). Past declines in commodity production costs and exchange rate appreciation will continue to exert downward pressure through this year, and renewed declines remain the baseline, but domestic output prices have recently been surprisingly resilient which may provide more support than currently projected (chart 7). Second, medical services inflation—while having moderated in

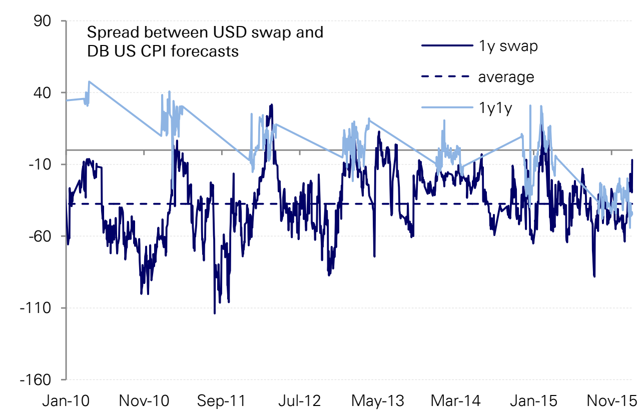
December after strong gains in October and November—may have bottomed and could rise this year as wage growth picks up. Finally, services CPI excluding shelter and medical items has risen from the depressed levels recorded in late 2014/early 2015 (chart 6), which could reflect some normalisation in domestic price trends. In sum, while external factors have deteriorated again, domestic trends have been on the positive side.

7. US domestic output prices resilient



Source: US BLS, Deutsche Bank

8. US 1y & 1y1y CPI swaps vs CPI forecasts

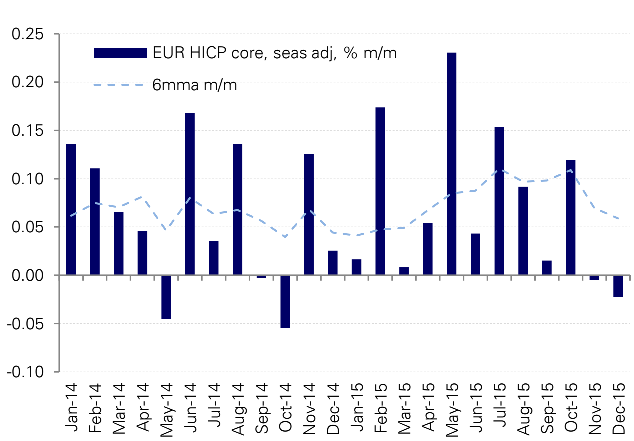


Source: Bloomberg Finance LP, Deutsche Bank

Comparing front-end valuations to CPI forecasts after the recent strong market moves and revisions, shows 1y US CPI swaps close to our projections, which is unusual by past standards (chart 8), especially given the recent acceleration in oil deflation. 1y1y on the other hand has continued to cheapen, and is now about 40/50bp below forecasts, the lowest since 2010 (chart 8). We would see more value in 1y1y than in 1y.

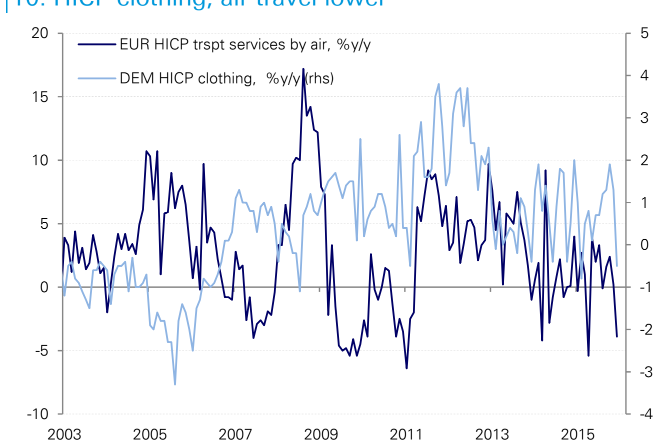
In EUR, December inflation has been revised marginally higher, but core HICP stayed below the pre-flash consensus, and continues to show a loss in momentum at the end of last year (chart 9). Some of this may be temporary given the strong declines in volatile clothing and air travel components (chart 10), but the uncertainty about the strength in core recovery momentum has increased given recent prints, weaker compensation data as well as ongoing declines in commodities and associated expected downward pressure on production costs.

9. EUR core HICP momentum has slowed



Source: ECB, Deutsche Bank

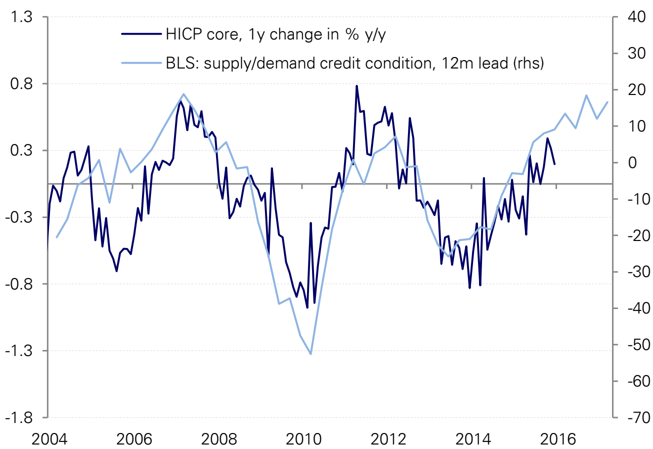
10. HICP clothing, air travel lower



Source: Eurostat, Deutsche Bank

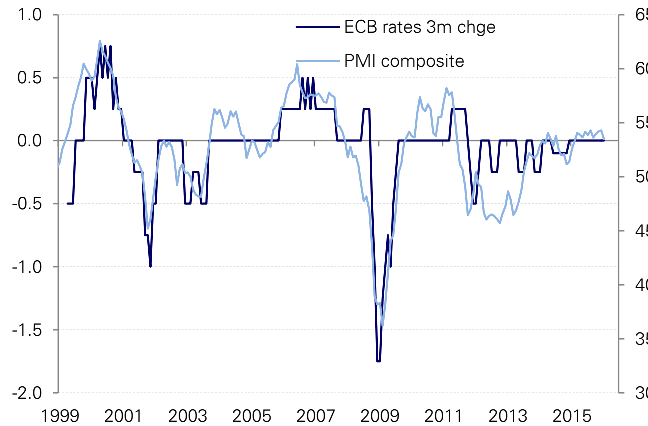
Economic data on the other hand has remained encouraging, with in particular this week's BLS pointing to an ongoing improvement in credit conditions, which would be conducive for a normalisation in domestic inflation as well (chart 11). The composite PMI in January has fallen 0.6pts below the Q4 average, but is consistent with Q1 GDP growth around 0.4% q/q and—on its own—with the ECB on hold (chart 12).

11. Credit conditions improving



Source: ECB, Eurostat, Deutsche Bank

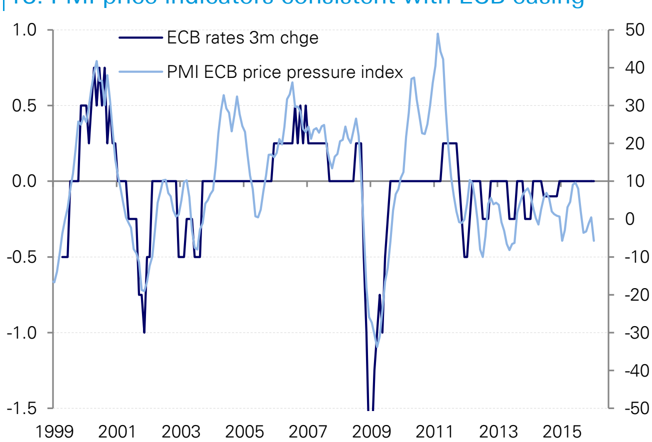
12. PMI activity consistent with ECB on hold



Source: Bloomberg Finance LP, Haver, Deutsche Bank

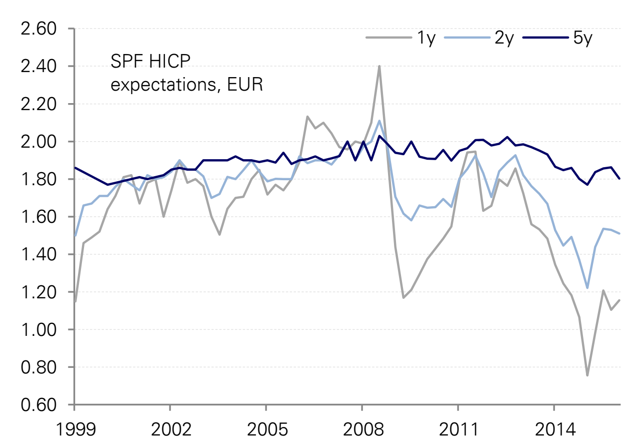
Inflation surveys, on the other hand, have as expected deteriorated, with PMI input prices falling to the lowest since January 2015, and PMI price indicators in ECB easing territory (chart 13). Moreover, the Q1 SPF outcome would seem consistent with the ECB's observation that the risk of second round effects needs to be closely monitored. Shorter-term predictions were resilient with 1y and 2y ahead projections about stable (chart 14), but may have fallen further since the survey period (5-11 January). 5y ahead projections declined to 1.80% however (from 1.86), which was the lowest since Q1 2015 (chart 14), while the 5y ahead risk distribution shifted further to the downside, with upside risks seen lowest and downside risks highest on record (chart 15).

13. PMI price indicators consistent with ECB easing



Source: Bloomberg Finance LP, Haver, Deutsche Bank

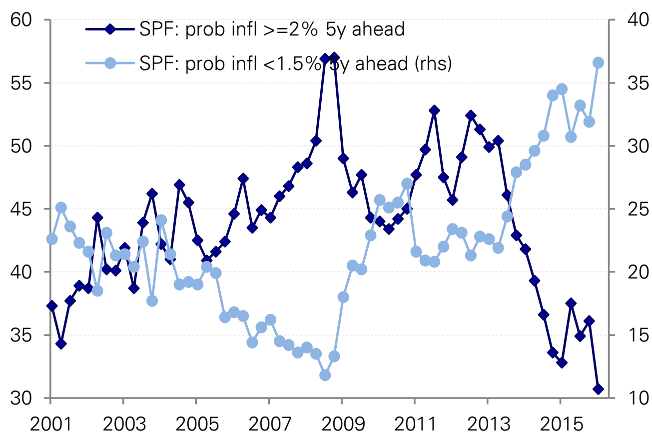
14. 5y SPF expectations ease



Source: ECB, Deutsche Bank

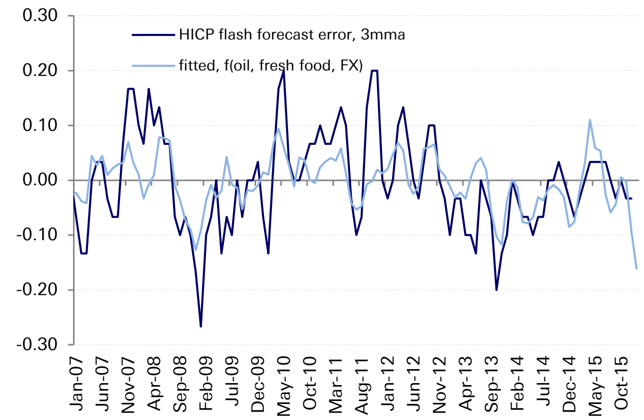
Against that backdrop, further ECB easing is expected for March, but scope for ongoing direct FX effects may be more limited now, both because of reduced scope to surprise on the rate front and because of China's focus on the trade-weighted currency. On balance, we expect an only slow rise in core inflation towards 1.3% at the end of the year.

15. SPF 5y ahead risk distribution shifts lower



Source: ECB, Deutsche Bank

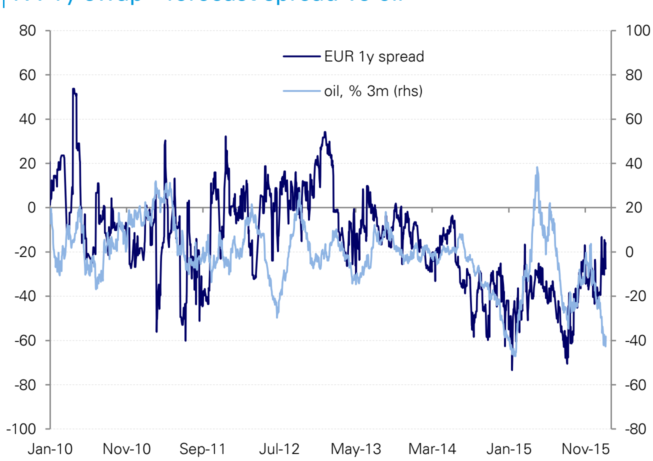
16. Downside risks for upcoming HICP prints?



Source: Bloomberg Finance LP, Eurostat, Deutsche Bank

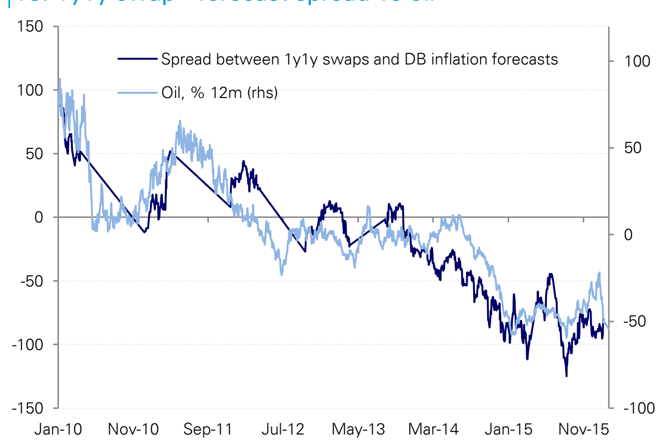
At the headline level, the recent oil price declines will mean steep declines in consumer petrol prices in January and February, and will continue to put downward pressure on HICP gas through this year; we see overall HICP energy reaching lows below -10% y/y this spring (from -5.8% in December). Meanwhile, further declines in seasonal food inflation look likely in the coming months, while processed food inflation is expected to remain subdued for now. On balance, we expect headline inflation to rise to 0.3% y/y in January, before easing again towards zero in February. The risks may be on the downside given that the combination of lower oil, a stronger currency, and slowing fresh food inflation in the past has often produced downside surprises on monthly HICP prints (chart 16).

17. 1y swap - forecast spread vs oil



Source: Bloomberg Finance LP, Deutsche Bank

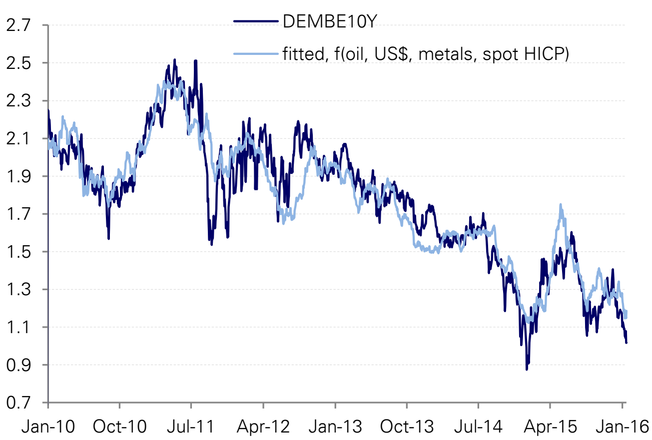
18. 1y1y swap - forecast spread vs oil



Source: Bloomberg Finance LP, EC, Deutsche Bank

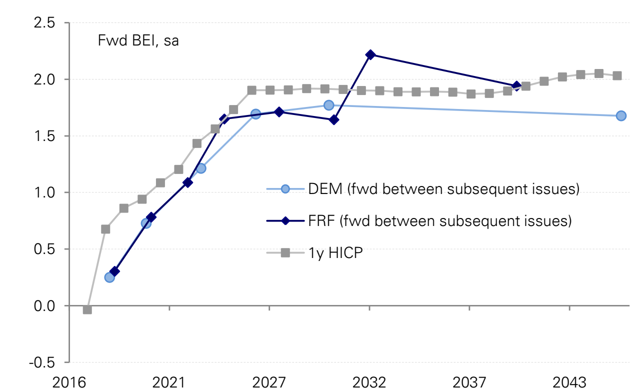
Front-end swap valuations have moved broadly in line with forecast revisions, with the 1y swap-forecast spread tightening somewhat (to 10-20bp) despite lower oil inflation (chart 17); 1y1y swaps have stayed close to 80bp below forecasts (chart 18). 5y B/Es are back to fair to slightly cheap against commodities and spot inflation on our models (from slightly rich last week), while 10y remains somewhat cheap (chart 19). Risk sentiment is showing some signs of stabilisation at the time of writing, which would seem like a necessary condition for a recovery in EUR B/Es. Given the still negative spot inflation momentum, and uncertainty about core trends, we stay neutral for now. Across OATei and DBRei curves, 2020 maturities are the cheapest issues against our HICP forecasts, with (seasonally-adjusted) B/Es around 45bp, and we estimate 2018/2020 forward B/Es (chart 20) at about 0.73% (DBRei20) and 0.78% (OATei20), close to 20bp below swaps. On the OATei curve, the OATei30 is cheap compared to OATei32 (chart 20).

19. 10y B/Es against oil, commodities



Source: Bloomberg Finance LP, Deutsche Bank

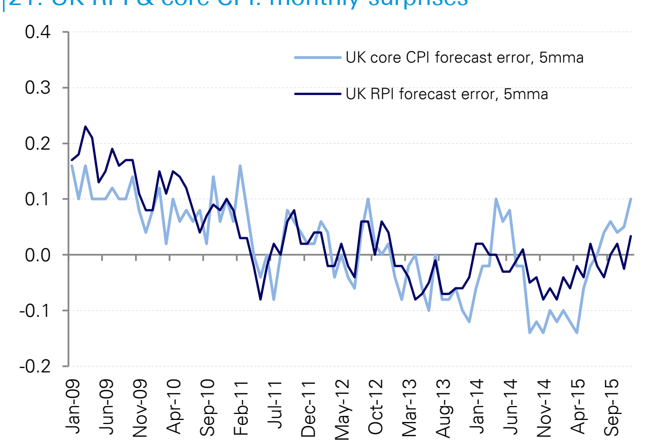
20. 2018/2020 B/E forwards low



Source: Bloomberg Finance LP, EC, Deutsche Bank

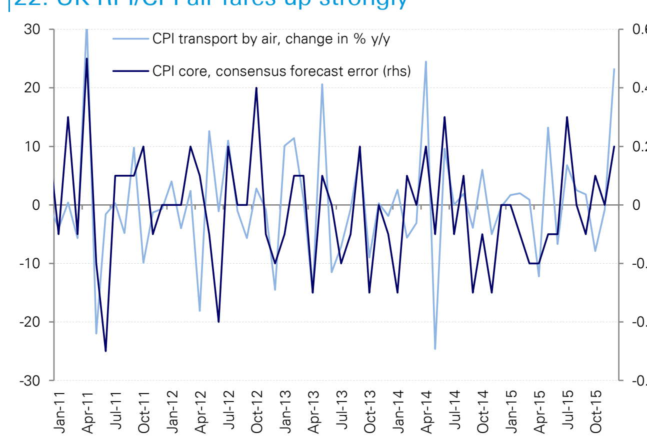
UK B/Es have risen through the week, helped by somewhat stronger RPI and wage news. RPI (as well as core CPI) surprised to the upside in December, rising to the highest since December 2014. Both core CPI and RPI inflation have no longer tended to surprise to the downside in the past few months (chart 21), suggesting that the underlying trend has been stabilising.

21. UK RPI & core CPI: monthly surprises



Source: Haver, Bloomberg Finance LP, Deutsche Bank

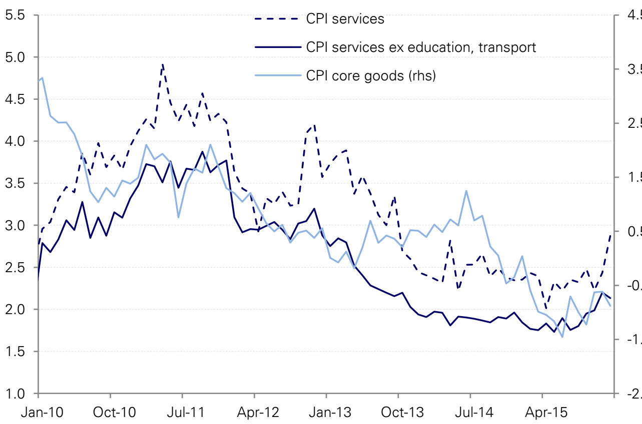
22. UK RPI/CPI air fares up strongly



Source: Haver, Deutsche Bank

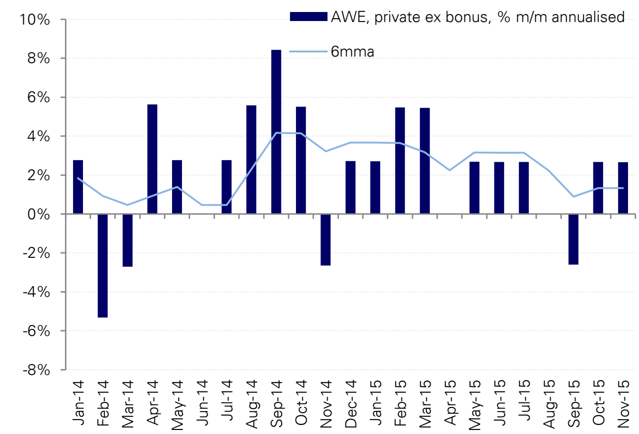
That said, the details of the report were much more mixed, and the upside surprise was above all due to a sharp increase in volatile transport services prices (chart 22), which on its own explains about 0.15pp of the change in headline CPI and about 0.2pp of the rise in core inflation between November and December. A rise in air fares of this magnitude tends to reverse and this is a downside risk for January (chart 22). Food and core goods inflation on the other hand both fell and were weaker than expected, while services excluding transport also eased slightly (chart 23). Despite the softer underlying December details, core CPI inflation has been stabilising and in services even rising slightly in recent months (chart 23), and we se RPI inflation rising gradually this year, which should provide some support for B/Es.

23. Core ex transport slightly lower



Source: Haver, Deutsche Bank

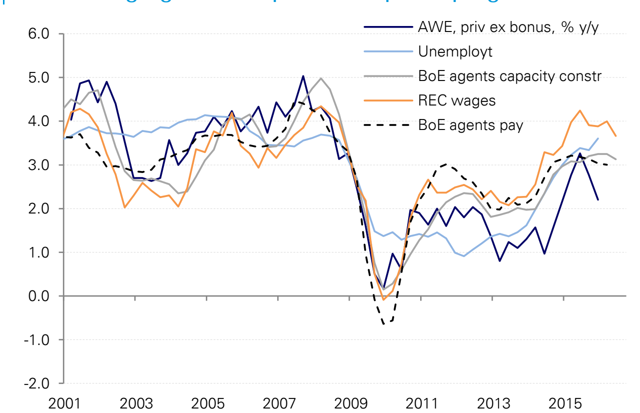
24. UK wage momentum has slowed



Source: Haver, Deutsche Bank

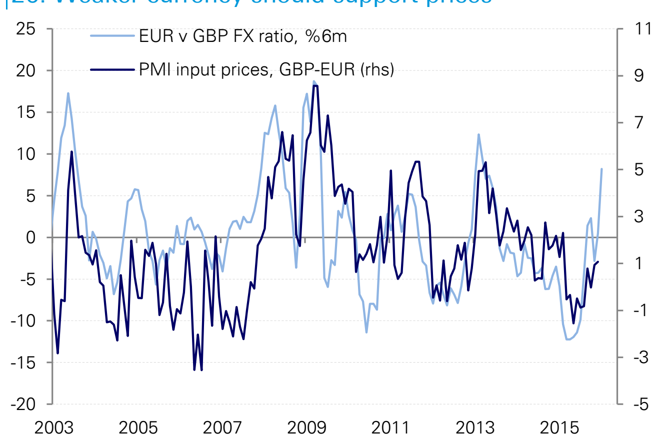
November (ex-bonus) earnings data was slightly higher than consensus, but wage momentum remains weak; the annualised 6m run-rate has fallen from 3%+ in H1 2015, to 1.3% in November (chart 24). Alternative indicators point to higher pay growth and we are expecting a recovery in the coming quarters to levels more consistent with current inflation forecasts (chart 25).

25. UK wage growth expected to pick up again



Source: Haver, Deutsche Bank

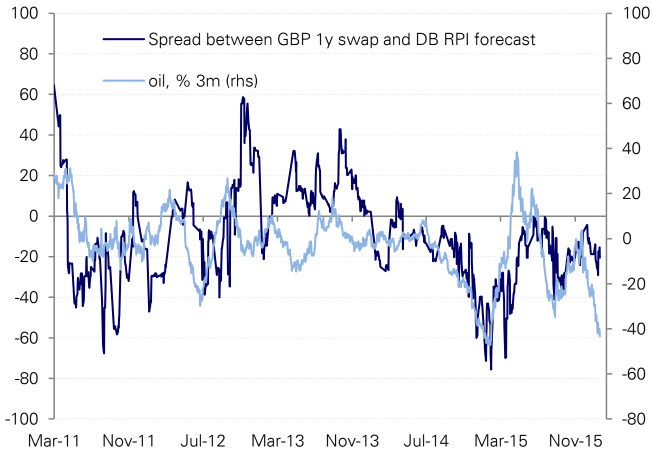
26. Weaker currency should support prices



Source: Bloomberg Finance LP, Haver, Deutsche Bank

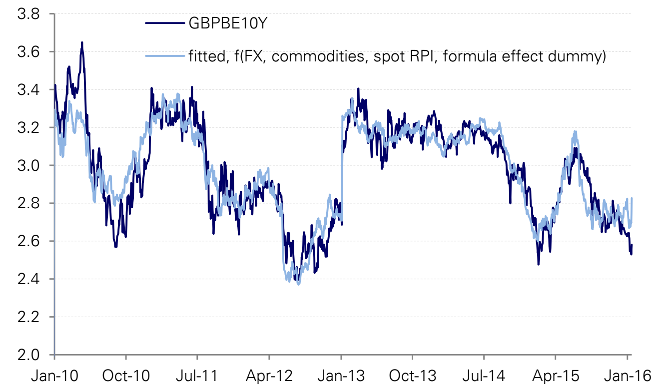
The currency has been more stable this week, but recent depreciation can be expected to lead to somewhat better upstream price data in the coming months, at least in relative terms (chart 26). This, together with the expected rise in headline RPI inflation and some rebound in wage growth, should create a more supportive backdrop for UK B/Es once oil prices and risk aversion stabilise. 1y swaps are about 15bp cheap to our RPI forecasts, which is relatively resilient given the drop in oil (chart 27). 10y B/Es are about two standard-errors cheap to our models based on commodities, the currency and spot inflation (chart 28). We are long the UKTi24 B/E.

27. 1y RPI swap – forecast spread vs oil



Source: Bloomberg Finance LP, EC, Deutsche Bank

28. 10y B/Es cheap



Source: Bloomberg Finance LP, EC, Deutsche Bank

EUR & GBP Yield Forecasts

1: Germany yield forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
2Y	-0.45	-0.40	-0.35	-0.30	-0.30	-0.30
5Y	-0.24	-0.20	-0.10	0.00	0.10	0.15
10Y	0.48	0.55	0.70	0.85	1.10	1.15
30Y	1.26	1.35	1.50	1.65	1.85	1.90

Source: Deutsche Bank

3: France yield forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
2Y	-0.38	-0.35	-0.25	-0.20	-0.20	-0.20
5Y	-0.04	-0.05	0.05	0.15	0.25	0.30
10Y	0.79	0.85	1.00	1.15	1.40	1.45
30Y	1.84	1.90	2.00	2.10	2.30	2.35

Source: Deutsche Bank

2: EUR swaps forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
3M	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
2Y	-0.14	-0.05	-0.05	0.00	0.00	0.00
5Y	0.14	0.20	0.25	0.35	0.45	0.45
10Y	0.79	0.85	1.00	1.10	1.25	1.30
30Y	1.42	1.50	1.60	1.70	1.80	1.80

Source: Deutsche Bank

4: Italy yield forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
2Y	0.00	-0.10	-0.10	-0.05	-0.05	-0.05
5Y	0.51	0.45	0.40	0.45	0.55	0.55
10Y	1.53	1.50	1.50	1.60	1.80	1.85
30Y	2.67	2.70	2.70	2.80	2.90	2.95

Source: Deutsche Bank

5: UKT yield forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
2Y	0.43	0.60	0.60	0.60	0.70	0.80
5Y	1.06	1.20	1.25	1.30	1.40	1.50
10Y	1.71	1.80	1.90	2.00	2.20	2.40
30Y	2.49	2.50	2.60	2.70	2.90	3.10

Source: Deutsche Bank

6: GBP swaps forecasts

Forecasts	22-Jan-16	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
3M	0.59	0.61	0.62	0.89	0.91	1.16
2Y	0.87	1.04	0.95	0.95	1.05	1.15
5Y	1.28	1.43	1.50	1.55	1.65	1.75
10Y	1.72	1.90	2.00	2.10	2.30	2.50
30Y	1.91	2.05	2.20	2.30	2.50	2.70

Source: Deutsche Bank

Note:

- Forecasts last updated on 22 Jan 2016
- These yield forecasts could conflict with trade recommendations in the publication

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Source: Deutsche Bank

Appendix 1

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Additional information available upon request

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