Morgan Stanley

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Rates Markets Under the Spell of the Euro Crisis

MORGAN STANLEY RESEARCH
Europe

Morgan Stanley & Co. International plc+

Laurence Mutkin
Global Head of Interest Rate Strategy
Laurence.Mutkin@morganstanley.com
+44 20 7677-4029

EUR Economic Outlook: Mild Recession & Persistent Growth Divergence

•DM growth forecast is 1.2%, global 3.5% - below long-term average

•Euro area is in mild recession: a credit crunch could make it deep; modest rebound in 2H

The Great Easing: Central Banks to Provide More Stimulus

•ECB to cut refi to 0.5% during 1Q and to follow up with QE

•Bank of England increased QE in Feb by £50bn

Future of Euro Area/Risk-Free Rate

•Will even German bonds retain their status as 'risk-free' rates?

•Non-German euro-sovereigns in future: duration assets, or credit instruments?

•Supply remains a risk

European Rates Markets under the Spell of the Euro Crisis

•Money markets: 3y LTRO + potential lower Depo rate weigh on EONIA & EURIBOR

•EUR duration/curve: Carry+roll & euro crisis to dominate; traditional curve relationships change

•Euro sovereigns: Credit curve vs.credit spread; low-coupon vs. high-coupon

•UK: Expect more QE: long-end flattening; swap spread widening

•Inflation: Long forward real yields

•Volatility: Earning roll+carry; contingent Bund swap spread trades

Economic Outlook: Policy Make or Break

We cut our DM GDP growth forecasts to 1.2% in 2012 – below its long-term average

- Our 2012 global GDP forecast is now 3.5%, Since the summer, the bumpy, below-par and brittle recovery in the advanced economies has morphed into a crisis of confidence, competency and credibility, due to policy mistakes on both sides of the Atlantic.
- We now expect the ECB to cut the refi rate by another 50bp to 0.5% and potentially engage in larger bond purchases; the Fed to pursue QE3 in spring; and the Bank of England to increase gilt purchases after February.

Euro area has entered recession

- In the euro area, we think the economy has now entered a mild recession. A credit crunch could make it a deep one. We expect a modest recovery in 2H.

Euro Area: Growth, Inflation and Rate Forecasts

Recession Returns

		GDP	CPI	Refi Rate
2012	Q1	-1.4	2.4	0.50
	Q2	0.0	1.9	0.50
	Q3	0.8	1.8	0.50
	Q4	1.0	1.6	0.50
2013	Q1	1.0	1.5	0.50
	Q2	1.0	1.4	0.75
	Q3	1.0	1.3	1.00
	Q4	1.0	1.2	1.25

Note: q/q annualised growth; y/y CPI
Source: Morgan Stanley Research forecasts

US: Growth, Inflation and Rate Forecasts

CCC Crisis

		GDP	CPI	Fed Funds
2012	Q1	2.2	2.4	0.08
	Q2	2.4	2.4	0.08
	Q3	1.7	2.3	0.08
	Q4	2.4	2.2	0.08
2013	Q1	1.0	2.2	0.08
	Q2	1.9	2.2	0.08
	Q3	2.0	2.2	0.08
	Q4	2.1	1.7	0.08

Note: q/q annualised growth; y/y CPI
Source: Morgan Stanley Research forecasts

European Economic Outlook: Three Challenges

Economic challenges:

- A mild recession over the winter could turn into a deep one if a full-blown, area-wide credit crunch materialises. In addition, cyclical discrepancies between member states will likely remain very wide despite the growth differential narrowing slightly.

Financial challenges:

- Europe needs to build a solid firewall to fend off contagion risk across sovereigns through leveraging the European rescue mechanism, bringing forward the ESM, bolstering IMF's resources and facilitating the Greek debt exchange. The more successful governments are in their attempts to contain the sovereign debt crisis, the less it would fall onto the ECB to act as a backstop.

Political challenges:

- Governments will need to implement the 'fiscal compact' agreed on at the December Summit as well as set out a long-term roadmap towards further fiscal integration and eventually, also, joint issuance.

A change in the landscape:

- If policy-makers manage to overcome these challenges, investors will likely be looking at a very different euro area landscape once the clouds of the sovereign debt crisis lift and the benefits of the structural reforms and the rebalancing of individual economies and the whole area become visible.

Euro Area: Growth, Inflation and Rate Forecasts

Recession Returns

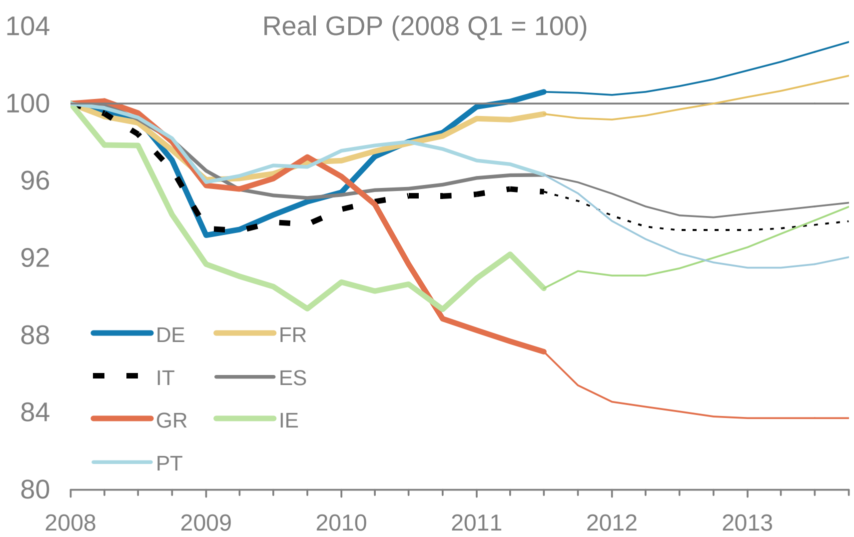
European GDP growth forecasts at a glance

	2010	2011e	2012e	2013e
EU-15	1.9	1.5	-0.1	1.1
EMU	1.8	1.6	-0.3	0.9
Austria	2.3	3.3	0.2	1.5
Belgium	2.3	2.0	0.4	1.6
Denmark	1.3	0.9	0.7	1.5
Finland	3.6	2.7	0.5	1.8
France	1.4	1.6	0.3	1.3
Germany	3.7	3.0	0.3	1.5
Greece	-4.4	-6.5	-4.5	-0.5
Ireland	-0.4	1.1	0.2	2.4
Italy	1.2	0.5	-1.7	0.0
Netherlands	1.6	1.5	-0.2	1.3
Portugal	1.3	-1.2	-3.7	-1.1
Spain	-0.1	0.6	-1.7	0.0
Sweden	5.6	4.7	1.0	2.0
UK	2.1	0.9	0.6	1.8

Source: Morgan Stanley Research forecasts

European Economic Outlook: Divergence to Persist

Country Performance Still Very Divergent



Source: Eurostat, Morgan Stanley Research estimates

European GDP Growth Forecasts at a Glance

	2010	2011e	2012e	2013e
EU-15	1.9	1.5	-0.1	1.1
EMU	1.8	1.6	-0.3	0.9
Austria	2.3	3.3	0.2	1.5
Belgium	2.3	2.0	0.4	1.6
Denmark	1.3	0.9	0.7	1.5
Finland	3.6	2.7	0.5	1.8
France	1.4	1.6	0.3	1.3
Germany	3.7	3.0	0.3	1.5
Greece	-4.4	-6.5	-4.5	-0.5
Ireland	-0.4	1.1	0.2	2.4
Italy	1.2	0.5	-1.7	0.0
Netherlands	1.6	1.5	-0.2	1.3
Portugal	1.3	-1.2	-3.7	-1.1
Spain	-0.1	0.6	-1.7	0.0
Sweden	5.6	4.7	1.0	2.0
UK	2.1	0.9	0.6	1.8

Source: National Statistics, Morgan Stanley Research estimates

UK Economic Outlook: A Year of Two Halves

Economic Challenges

- The economy will stagnate in 1H with consumers buffeted by rising unemployment and tightening credit conditions. Business investment is likely to be subdued while uncertainty prevails and the government sector will remain a drag, although sharply falling inflation will provide some offset. Net exports will provide some support, as weak domestic demand depresses imports.

A Brighter 2H

- Growth should improve gradually in 2H as ‘animal spirits’ are boosted by modest recovery on the continent and the onset of the Olympics. Household spending should be helped by the stabilisation in the labour market and improving real incomes. Non-financial corporates should begin to increase investment as a weak sterling continues to bolster competitiveness.

The Eurozone Remains the Major Risk

- The risks are clearly to the downside. If policy-makers in the Eurozone are unable find a comprehensive solution to the region’s problems, a more pronounced recession is likely on both sides of the channel.

Additional QE

- The Bank of England announced purchase of another £50 billion of gilts in February (pace: £5.1bn/week). The risk is that the MPC may have to significantly ratchet up its purchases.

UK: Growth, Inflation and Rate Forecasts

Will Feel like a Recession

		GDP	CPI	Bank Rate
2012	Q1	0	3.4	0.5
	Q2	0	3.1	0.5
	Q3	0.5	2.4	0.5
	Q4	0.4	2.1	0.5
2013	Q1	0.4	1.9	0.5
	Q2	0.5	1.8	0.5
	Q3	0.5	1.9	0.75
	Q4	0.6	2.1	1

Source: Morgan Stanley Research forecasts

Key Quarterly Forecast Profiles: GDP, CPI and Policy Rates

	2011				2012				2013			
Real GDP (QoQ, SAAR)	**1Q11**	**2Q11E**	**3Q11E**	**4Q11E**	**1Q12E**	**2Q12E**	**3Q12E**	**4Q12E**	**1Q13E**	**2Q13E**	**3Q13E**	**4Q13E**
Global	4.0	2.5	3.5	2.7	3.1	3.6	3.6	3.4	3.5	3.5	3.6	3.4
G10	1.0	0.8	2.2	1.1	0.8	1.4	1.4	1.7	1.2	1.3	1.5	1.7
United States	0.4	1.3	2.0	2.8	2.2	2.4	1.7	2.4	1.0	1.9	2.0	2.1
Euro Area	3.1	0.7	0.8	-1.0	-1.4	0.0	0.8	1.0	1.0	1.0	1.0	1.0
Japan	-2.7	-1.3	6.0	0.5	0.6	1.1	0.8	0.5	1.6	-1.2	0.2	0.8
UK	1.6	0.4	2.0	-0.4	0.0	0.0	2.0	1.6	1.8	2.0	2.0	2.4
EM (YoY)	7.2	6.5	6.3	5.6	5.0	5.4	5.9	6.2	6.4	6.2	6.2	6.1
China (YoY)	9.7	9.5	9.1	8.1	7.8	8.2	8.4	8.8	8.9	8.8	8.7	8.7
India (YoY)	7.8	7.7	7.1	6.7	6.5	6.8	7.1	7.1	7.2	7.4	7.5	7.6
Brazil (YoY)	4.2	3.1	3.2	1.9	2.4	2.1	4.4	5.1	4.5	3.9	4.0	3.9
Russia (YoY)	4.1	3.4	5.0	5.2	4.8	6.1	5.5	4.0	4.7	4.2	4.4	4.2
Consumer Price Inflation (YoY)												
Global	4.1	4.5	4.7	4.2	3.4	3.2	3.2	3.1	3.0	3.0	3.0	3.0
G10	2.2	2.9	3.1	2.9	2.1	1.5	1.4	1.4	1.4	1.4	1.4	1.5
United States	2.2	3.3	3.8	3.4	2.7	1.9	1.9	2.1	2.0	1.9	1.8	1.7
Euro Area	2.5	2.8	2.7	2.9	2.4	1.9	1.8	1.6	1.5	1.4	1.3	1.2
Japan	0.2	0.7	0.8	0.1	-0.7	-1.0	-1.0	-0.9	-0.7	-0.4	-0.4	-0.3
UK	4.1	4.4	4.7	4.6	3.5	3.2	2.7	2.4	2.1	1.8	1.9	2.0
EM	6.0	6.2	6.3	5.5	4.7	4.8	5.0	4.7	4.6	4.6	4.6	4.5
China	5.1	5.7	6.3	4.1	2.4	3.0	4.1	4.1	3.6	3.6	3.6	3.6
India	9.0	8.9	9.2	8.8	8.3	7.8	5.5	4.6	5.7	6.3	6.0	5.8
Brazil	5.4	5.7	6.4	6.6	6.6	6.3	5.9	5.6	5.4	5.5	5.6	5.7
Russia	9.5	9.4	7.2	7.0	5.6	6.1	7.6	6.5	5.6	5.0	5.2	5.5
Monetary Policy Rate (% p.a.)												
Global	3.1	3.3	3.3	3.2	3.2	3.1	3.1	3.1	3.2	3.3	3.3	3.4
G10	0.6	0.7	0.7	0.6	0.4	0.4	0.4	0.5	0.5	0.5	0.7	0.7
United States	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
Euro Area	1.00	1.25	1.50	1.00	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
Japan	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
UK	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00
EM	5.9	6.2	6.3	6.2	6.1	6.0	6.0	6.0	6.1	6.1	6.1	6.1
China	6.06	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56	6.56
India	7.25	7.50	8.25	8.50	8.50	8.00	7.75	7.75	7.75	7.75	7.75	7.75
Brazil	11.75	12.25	12.00	11.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Russia	5.25	5.50	5.25	5.25	5.25	5.50	5.50	5.75	5.75	5.75	5.75	5.75

Note: Global and regional aggregates are GDP weighted averages, using PPPs. Japan policy rate from 4Q10 is a range from 0.00-0.10%, with 0.05 as the midpoint

Source: Morgan Stanley Research estimates

When Is a Government Bond Not a Government Bond?

Germany retains many 'Government Bond' characteristics

but, like all euro-sovs, it technically fails the first test (no-one can print the EUR except the ECB)

Limitations to 'government bond' status didn't matter for EMU's first 12 years:

Euro sovereigns' borrowing was so effortless that the legal fact that they can't print euros was unimportant.

The ECB's exclusive right to print euros is a creation of treaties, which presumably can be altered if needed to avert economic or political catastrophe.

But this status matters now for all euro-sovs except Germany: is it going to matter for Germany too?

Ultimately, we think Germany retains 'duration' status

German bonds in euros will likely 'remain' free of credit risk: ultimately we believe the ECB will stand fully behind Germany, and Germany fully behind the ECB (with treaties & constitutions changed if necessary).

But markets may aggressively test Germany's status in the coming year

'Government bonds' have certain characteristics that make them suitable for government bond portfolios:

- **Definitional characteristics:**
  - Issued by a government in its own currency.
- **Institutional characteristics:**
  - Used by the central bank in its open market operations;
  - Treated by regulators differently from other bonds, e.g., for capital or liquidity purposes;
  - Used in private sector markets as collateral in swaps etc.
- **Behavioral characteristics:**
  - Deep and liquid markets, and usually deep and liquid repo markets;
  - Considered 'flight-to-quality' assets, with a high correlation with other 'pure' duration assets and a low correlation with the performance of risky assets;
  - Diverse investor base.

Non-German Sovereign Bonds: Just Credit?

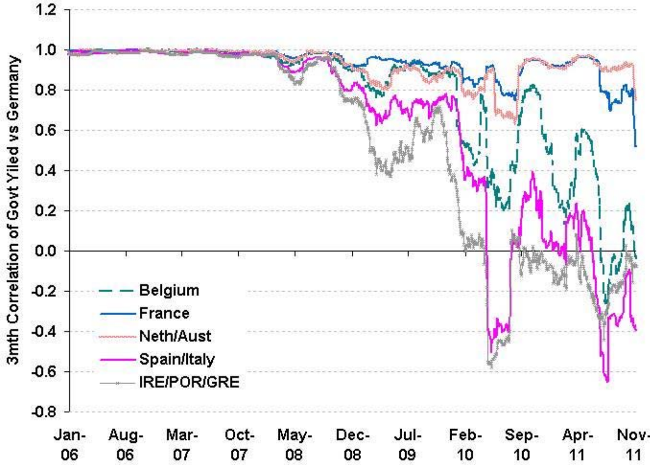
Falling correlations mean that the market now treats all non-German sovereign bonds as spread instruments rather than duration instruments. Implications:

- these sovereigns' role in duration portfolios (e.g., for ALM hedging) should become very much reduced: they need to find a new constituency.
- But the euro sovereign market is very large relative to euro credit markets (~€4.8 trillion - about twice the size of euro corporate bond market (IG + HY)).
- And euro-sovs have relatively low Sharpe ratios

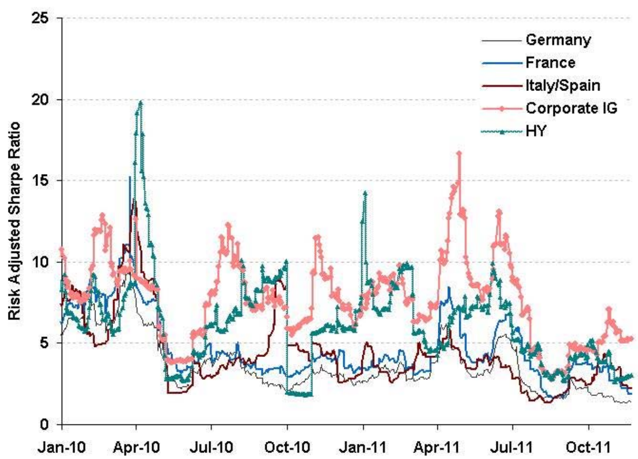
But they could return to being considered duration assets:

- they still retain some of the key characteristics: institutional; large and diverse existing investor base; access to repo at the ECB
- robust fiscal reform would make credit quality less of an issue
- change in the stance of the ECB (following treaty changes if necessary) could mean they would fulfill the strict definitional 'government bond' criterion at a stroke
- an eventual move to common issuance would address the question of correlation with other duration assets, as the common bonds would become the duration asset

Euro-Sovs' Correlations to Germany Have Collapsed



Un-Enticing Sharpe Ratios for Euro-Sovereigns

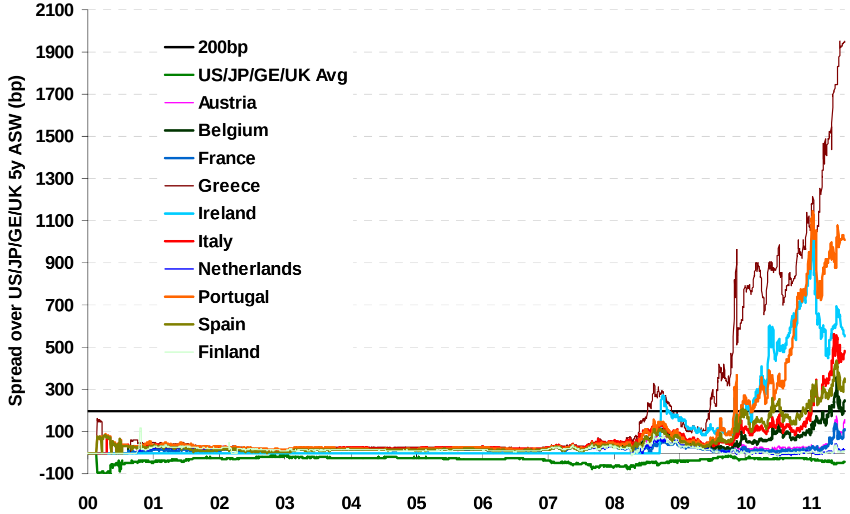


Source: Morgan Stanley Research

Pure Duration Assets Are Increasingly Rare

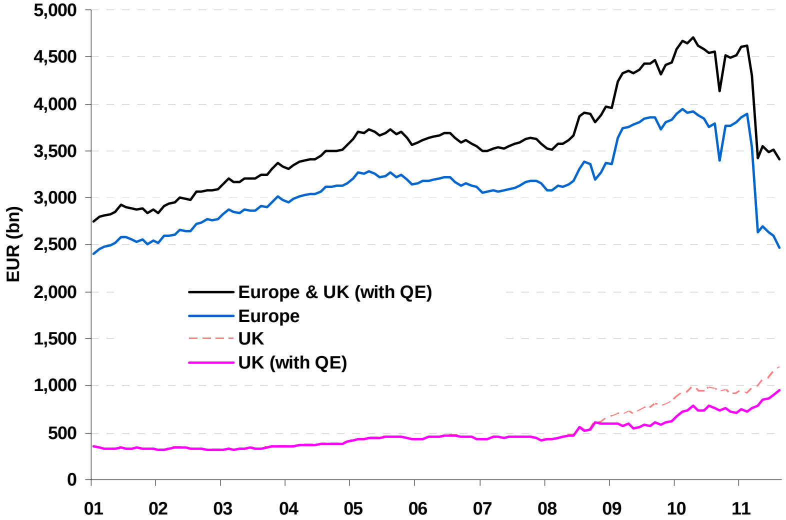
- European government bonds that have high correlation to major world government bond markets are are becoming increasingly scarce
- The total size of Europe + UK duration assets are back to the level of 2001, leading investors to crowd into limited available core countries in Europe: Germany and UK
- Increases the demand for ‘core’ duration

Sovereign Swap Spreads vs. Core-Core Countries as Measure for Duration Portfolio



Source: Morgan Stanley Research

Available European & UK Duration Portfolio Size Are Falling…



Source: Morgan Stanley Research

ECB Help for Banks

ECB announced four measures to support banks' liquidity

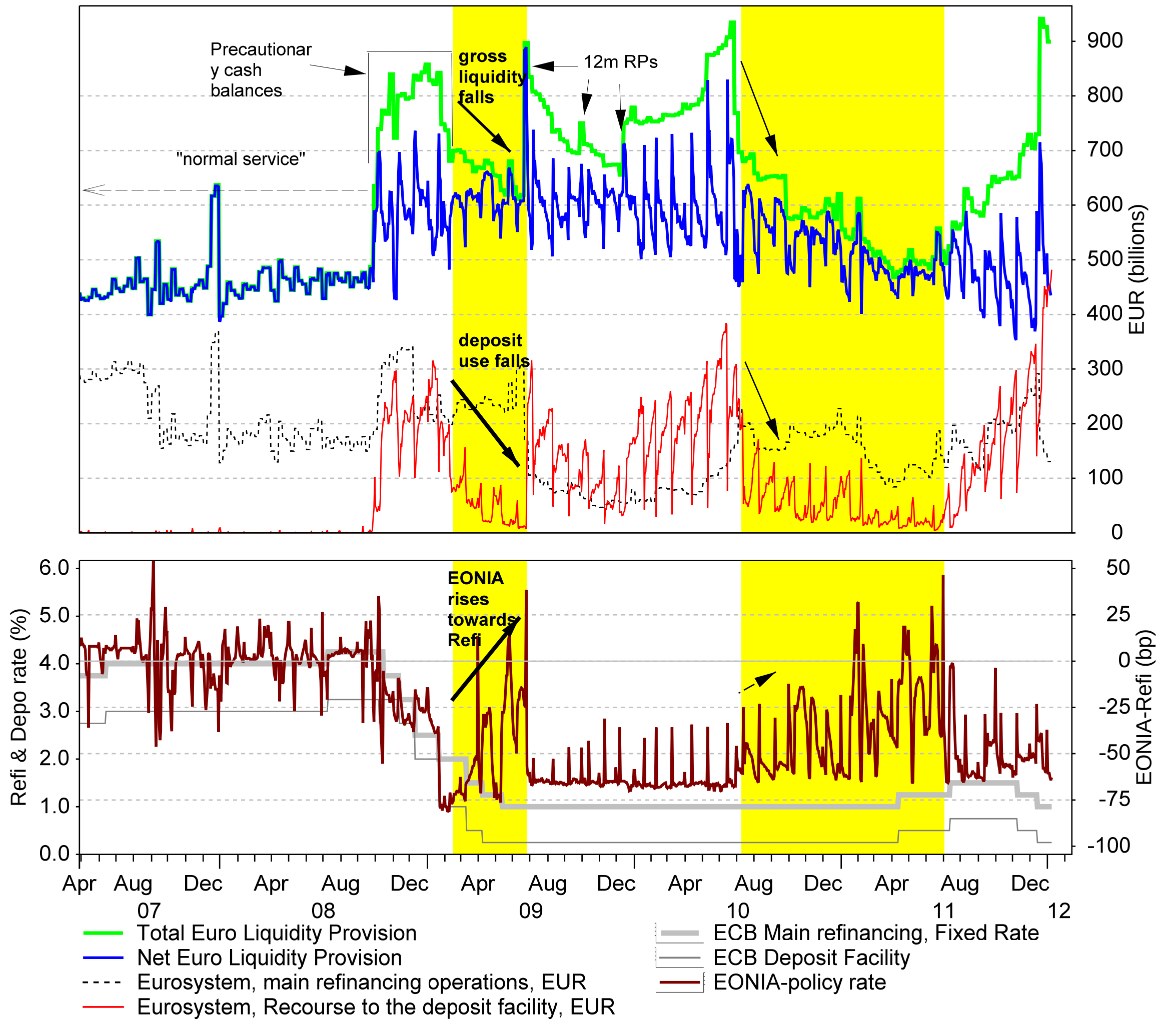
- Two 36-month LTROs, with an early repayment option after one year (October's 12-m LTRO can roll into the Dec 36-m);
- Suspend end-of-maintenance period drain operations
- Reduce required reserves ratio from 2% to 1% – we estimate this will free up ~€104bn;
- Broader collateral eligibility (i) reduce rating threshold for some ABS; (ii) NCBs to take additional credit claims as collateral

Banks' financing 2012, estimates:

- Steady state: €470bn
- After balance sheet reduction: €250bn
- Less Covered Bond issuance: €90bn
- Net need: €160bn (1% of banks assets)

Dec 3y results:

- Gross add: €489bn
- Net: €190bn
- More to come in February
- EONIA to stay low: could go lower



Source: Reuters EcoWin

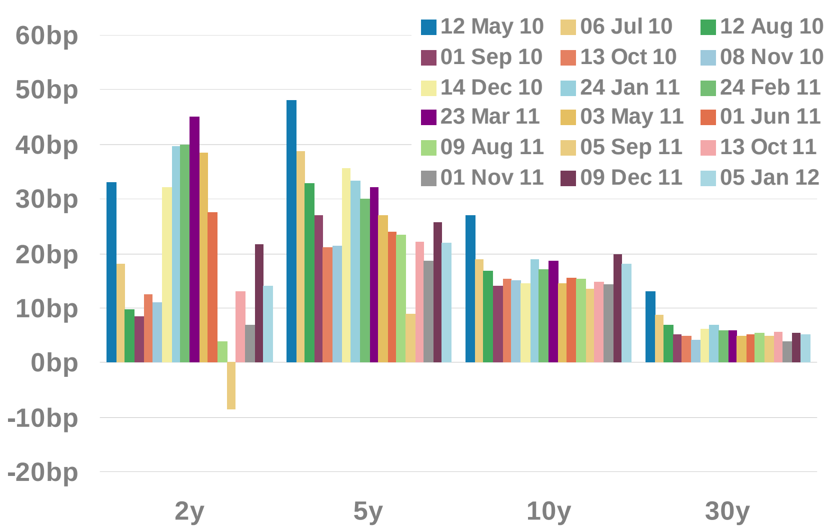
Rates: Carry + Roll Is Key to Value

A bullish outlook for roll+carry trades

- weak growth
- falling inflation
- possible further monetary accommodation

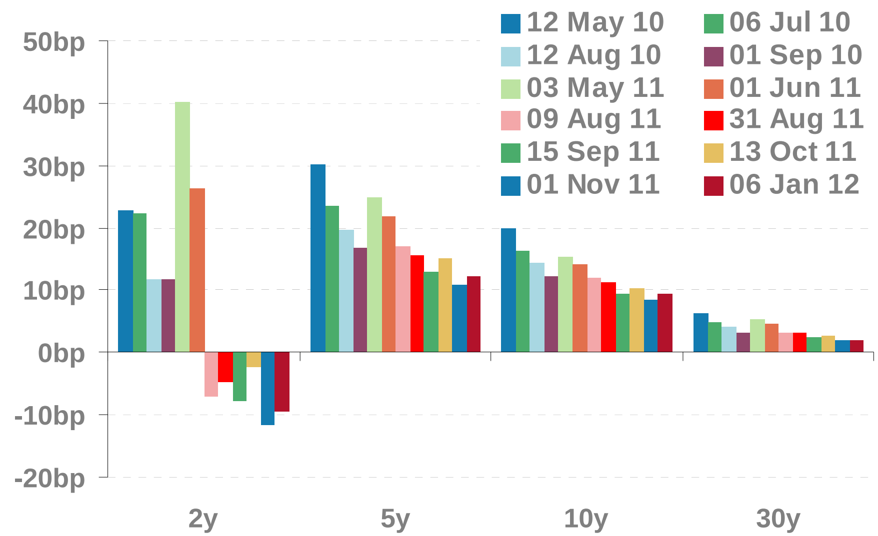
Low financing rates have maintained roll+carry despite lower yields, especially in 5-years

Carry+Roll Revived, Led by 5-Years



Source: Morgan Stanley Research

A Slightly Different Picture in Swaps



Source: Morgan Stanley Research

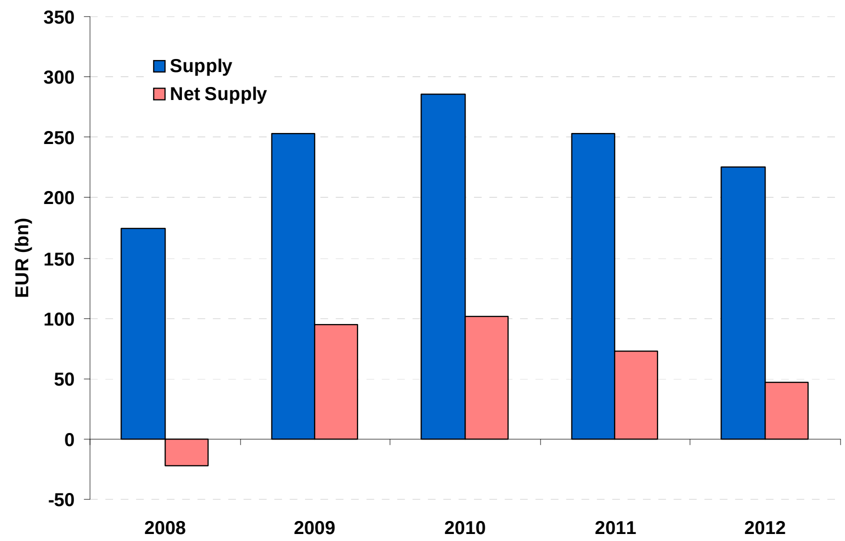
European Sovereign Supply – An Ongoing Concern

2011 European sovereign funding showed worrying signs, with sovereigns, including Germany

2012 issuance will remain elevated due to high redemption, €817bn of gross issuance is expected compared to €814bn

The funding events, will add volatility and uncertainty to sovereign markets in 2012, but 1Q will be a slower start

1Q12 Issuance Slowdown Compared to Recent Years



2012 Issuance Forecast

2012 Supply Table	Germany	France	Italy	Spain	Netherlands	Austria	Finland	Belgium	Greece **	Ireland **	Portugal **	Total
Redemption	157	99	193	46	34	10	6	26	33	6	11	***621***
Central Govt Budget Deficit *	13	82	54	51	12	11	2	13	9	14	8	***269***
Other funding needs	10	0	0	0	0	0	0	0	0	0	0	***10***
Total Borrowing Requirement	**180**	**181**	**247**	**98**	**46**	**21**	**8**	**39**	**42**	**20**	**19**	***900***
Net Bill Issuance	0	-1	0	0	-14	0	0	0	0	0	0	***-15***
Other Funding Source	0	4	0	0	0	0	0	13	0	0	0	***17***
2012 Net Bond Issuance	23	79	54	51	26	11	2	0	N/A	N/A	N/A	***246***
2012 Gross Bond Issuance	**180**	**178**	**247**	**98**	**60**	**21**	**8**	**26**	**N/A**	**N/A**	**N/A**	***817***

* Morgan Stanley Esimate, Central Govnt Deficit is proportioned to the General Govnt Deficit by % of Central Govnt Debt to total Government Debt

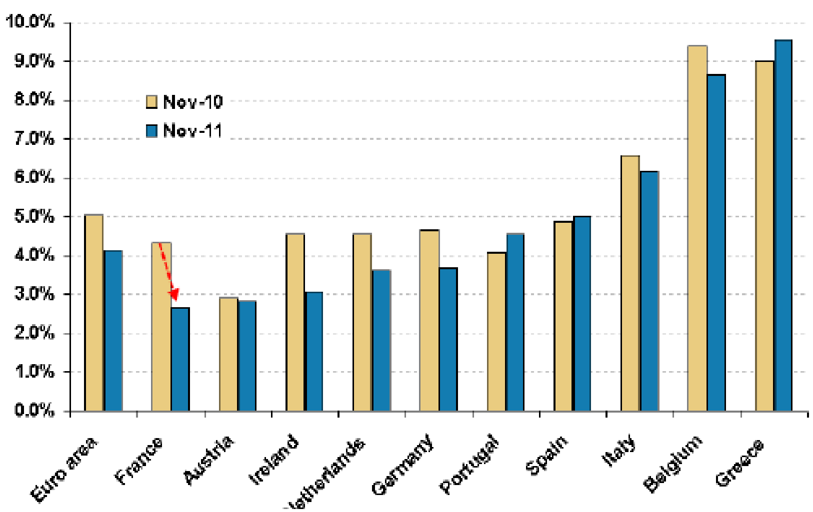
** Estimate for funding reqirement, but not necessarily by issuing in the market

Source: Morgan Stanley Research

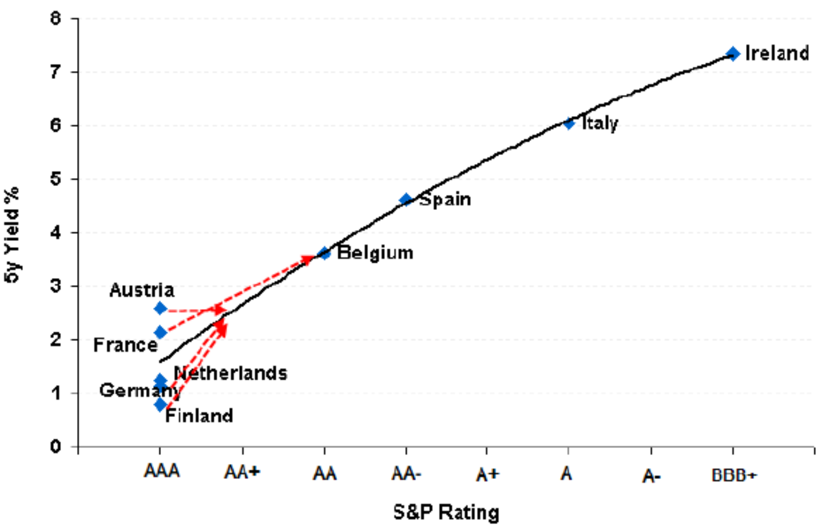
European Banks – Potential to Buy More Govt Bonds

- Upcoming supply maybe more supportive by the next 3y LTRO, as banks have capacity to establish more carry trades
- In particular, French banks can absorb more 2-5y OAT/BTANs
- But downgrade risk is a key downside for an early move

European Banks, French in Particular, Reduced Government Bond Holdings in 2011



Downgrade Risk Being Fully Priced in Yet?



Source: Morgan Stanley Research

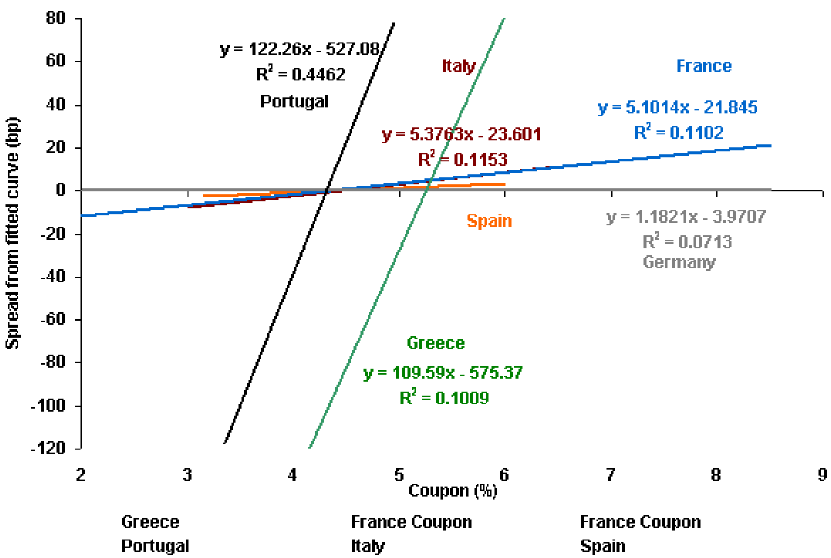
Euro-Sovs: Low- versus High-Coupon

There is a clear – and non-linear – relationship between the richness/cheapness of a borrower's low- versus high-coupon bonds and that country's spread over Germany

Owning a low-coupon versus high-coupon portfolio is an excellent hedge against the tail risk that any given sovereign spread begins to widen, in our view

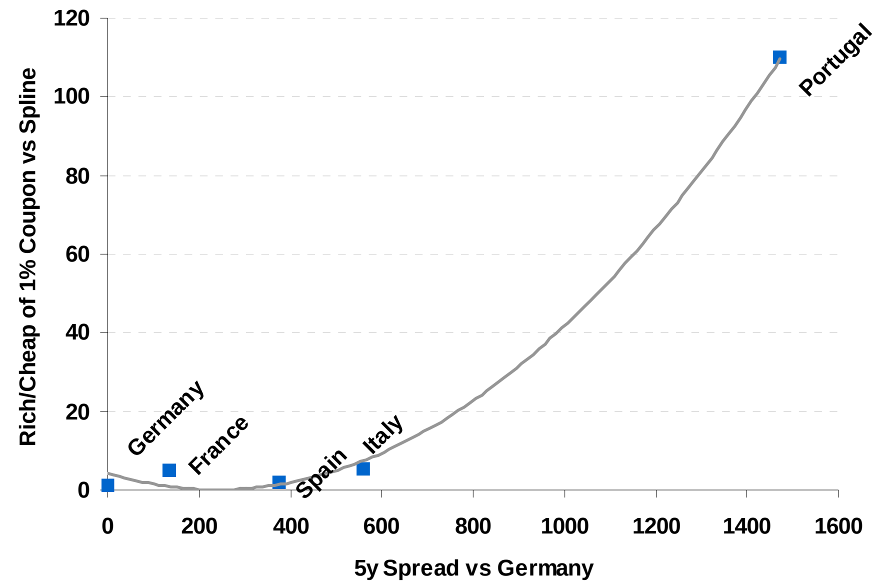
We recommend low vs. high-coupon portfolio in: Portugal, Ireland, Italy, Spain and France

High Premium for Low-Coupon Bonds



Source: Morgan Stanley Research

Low-Coupon Premium Rises as Spread Widens



Source: Morgan Stanley Research

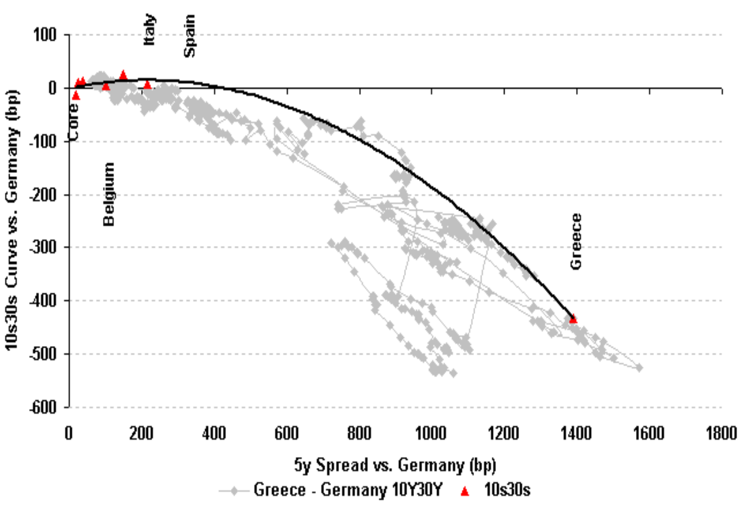
Euro-Sovs: Credit Curve versus Credit Spread: Overview

As credit spread widens, credit curve first steepens then flattens

There is a 'cusp' at which credit curve steepening turns to flattening

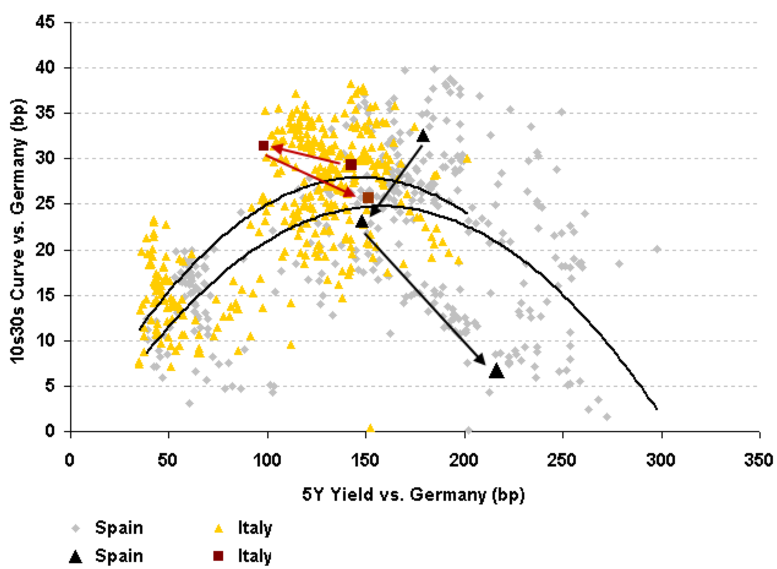
We generally recommend 10s30s credit curve flatteners, which should benefit from continuing volatility and provide a good hedge against further peripheral spread widening

Curve versus Spreads 10s30s: Comparing to the Greece Experience



Source: Morgan Stanley Research

For 10s30s Credit Curve, the Cusp Is around 150bp on 5y Spread (arrows show Mar->Apr->now)



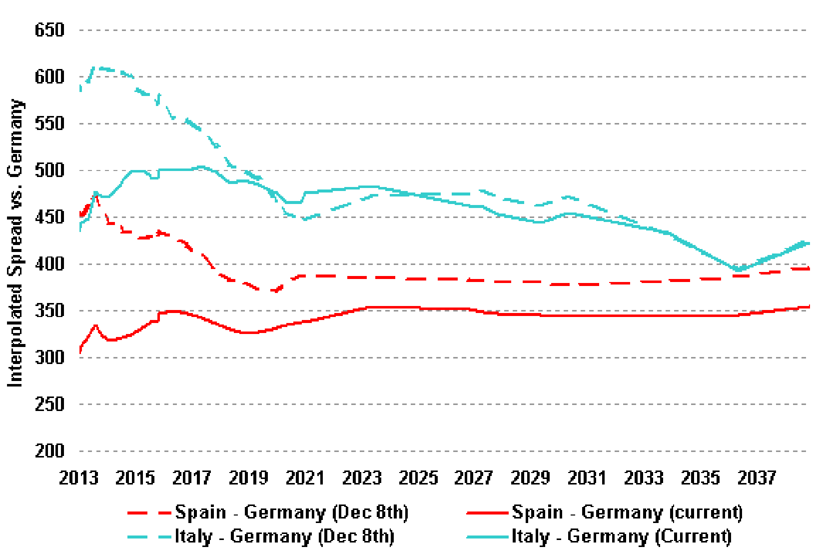
Source: Morgan Stanley Research

Euro-Sovs: Credit Curve versus Credit Spread: Italy

3y LTRO has kept Italy 2s5s artificially steep

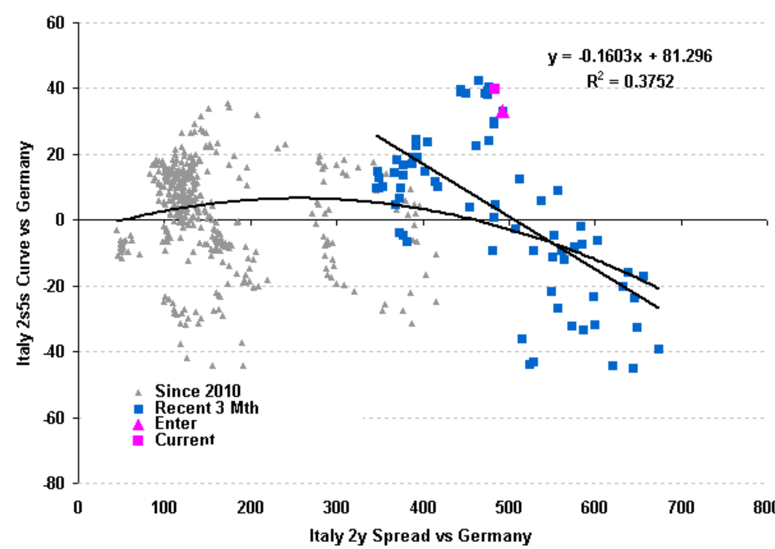
- SMP has concentrated buying in 10-years and shorter, but had little effect on the front end
- The 3y LTRO has spurred buying on the front end, which tightened front-end spreads considerably
- Both Spain and Italy's front-end curves steepened, but Italy's back-end remains inverted
- We think Italy 2s5s curve versus Germany is too steep now despite the LTRO effect, positive spillover should flatten the credit curve bullishly

Spain & Italy Curve Steepened on LTRO Effect



Source: Morgan Stanley Research

Italy 2s5s Credit Curve: Too Steep



Source: Morgan Stanley Research

Euro-Sovs: Credit Curve versus Credit Spread: Spain

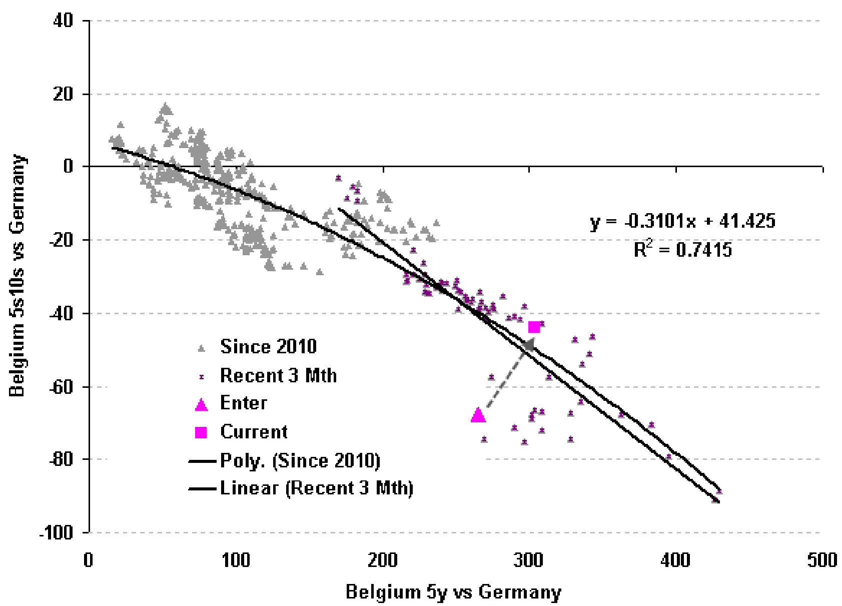
Belgium 5s10s was too steep versus the spread

- Belgium curve has steepened back to be in line with where spread suggests

Spain 10s30s flattener

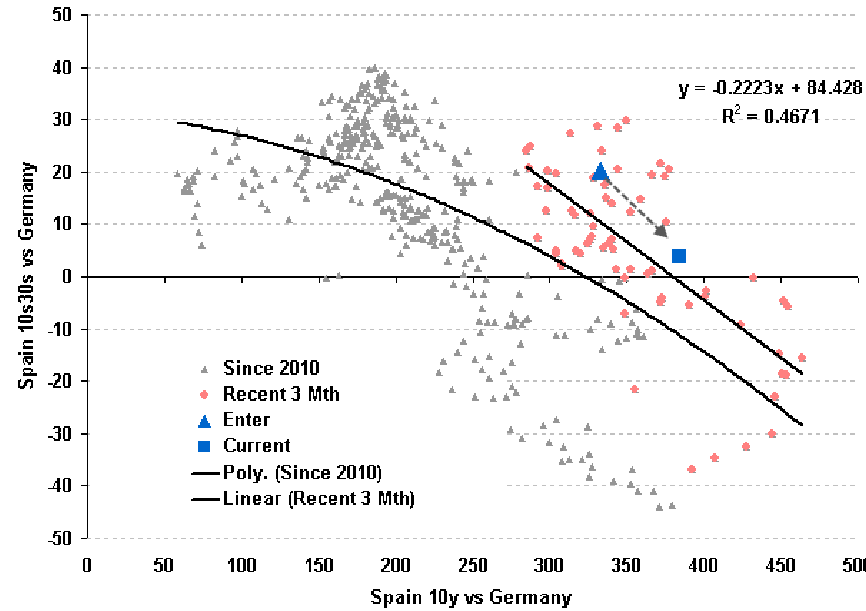
- Spain curve has started to flatten as Spain underperformed in cash and CDS, and more so as supply pressure mounts

Belgium 5s10s Credit Curve Is Back Where it Should Be



Source: Morgan Stanley Research

Spain 10s30s Has Flattened as Supply Pressure Mounts

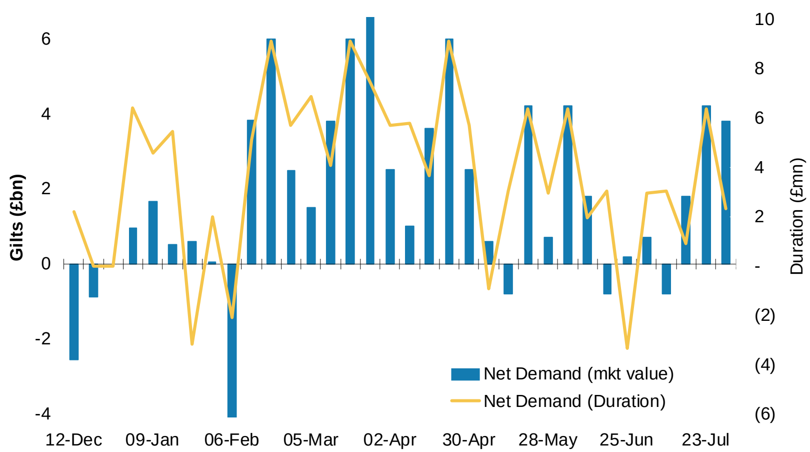


Source: Morgan Stanley Research

Gilt Yields Head Lower

- Economic backdrop of slow growth, falling inflation, rates on hold and favourable carry/roll in the belly of the curve is bullish for gilts
- Bank of England announced £50bn of asset purchases in February
- This would take the BoE holdings of the nominal market (>3y) to 51% by August
- Between Jan and August, we expect the DMO to auction £89bn of nominal
- Net effect is the removal of the equivalent duration of over 1.4mn gilt future contracts

Net Demand for Gilts over the Next Six Months



Source: Morgan Stanley Research, BoE and DMO

UK Long-End: Aim of QE Is to Flatten the Curve

BoE says that it believes the most important way in which QE works is the 'portfolio substitution effect'.

- Portfolio substitution' acts by cutting term premia. The low levels of yields in the 5y sector suggests this has been done in the front end of the curve, but not in the long end.

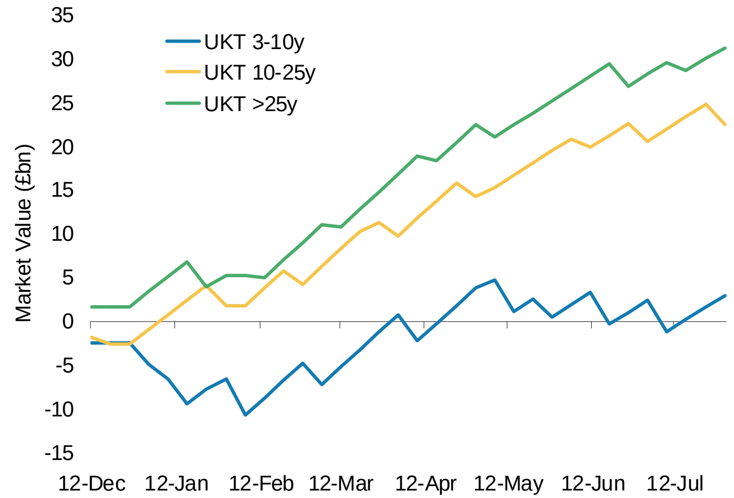
Hence, BoE is skewing buyback towards the long end:

- 3-10y free float is roughly equal to the size of the free float in the 10-25y and >25y maturity buckets put together
- But BoE is to buy twice as many securities in the >10y maturities and the DMO supply is half as much as in the 3-10y sector

If QE works, yields should rise and the curve should flatten.

- 5s30s flattened by more than 50bp during QE1

Cumulative Demand/Supply of Gilts in Each Maturity Bucket – Continues to Support Flatteners



Demand and Supply Dynamics across the Gilt Market Favour Long End

£bn (Mkt value)	3 -10y	10 -25y	>25y
Free Float	375	203	185
BoE Demand	51	51	51
DMO Supply	48	29	20

Source: Morgan Stanley Research, BoE, DMO

UKT Asset Swaps: Gilts to Outperform

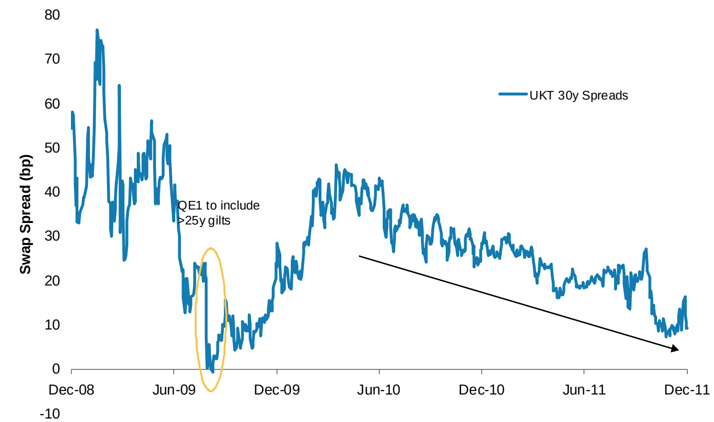
BoE is targeting the long end with its asset purchase programme.

When the BoE extended QE to the long end in 2009, UKT 30y spreads richened to flat versus swaps.

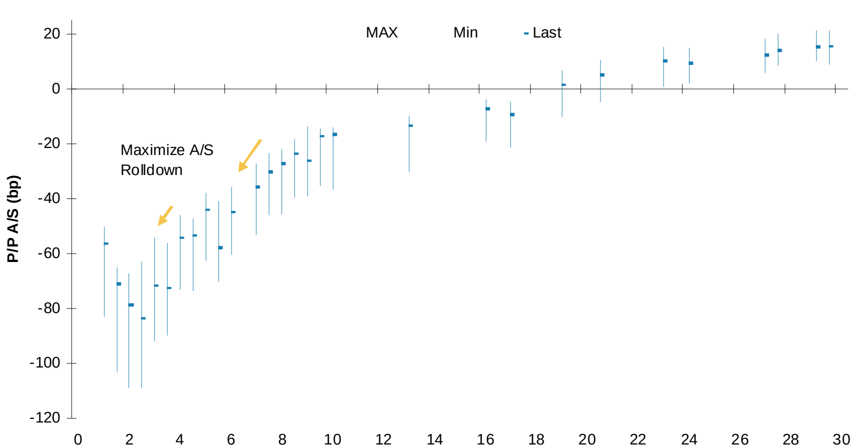
Richer spreads are also supported by:

- The ruling coalition’s commitment to fiscal austerity
- Libor/OIS widening
- UK banks building liquid asset buffers
- The declining number of AAA bonds globally

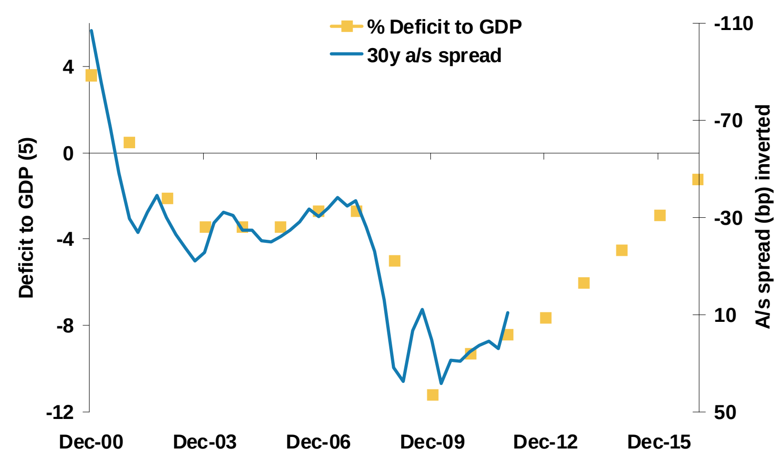
UKT 30y Swap Spread Have Room to Richen



Substantial ASW Roll in the 7y Sector



UKT 30y Asset Swap Spreads and Budget Deficits



Source: Morgan Stanley Research, Bloomberg

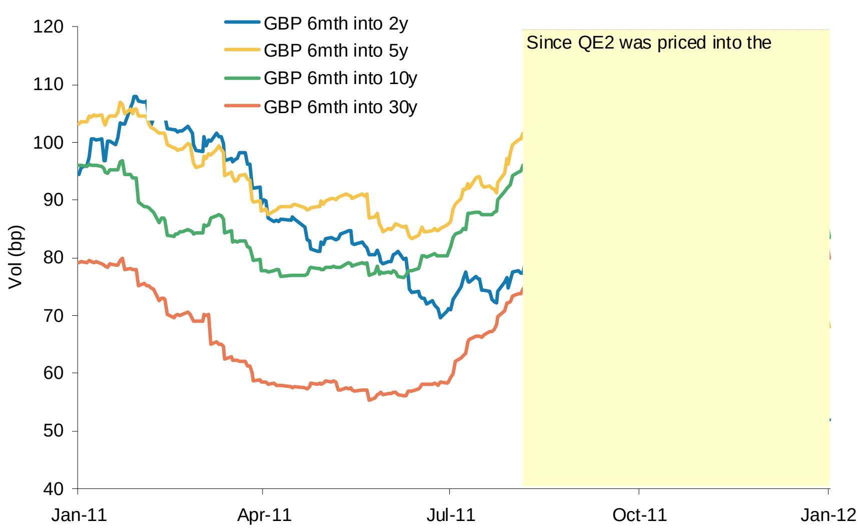
GBP15s40s Flattener – On the 'Cusp'

With <5y yields falling below 1%, the curve is becoming increasingly directional (either bull-flattening or bear-steepening) – see chart for GBP 5s30s. Therefore, one would expect that yields would have to rally for the curve to continue to flatten.

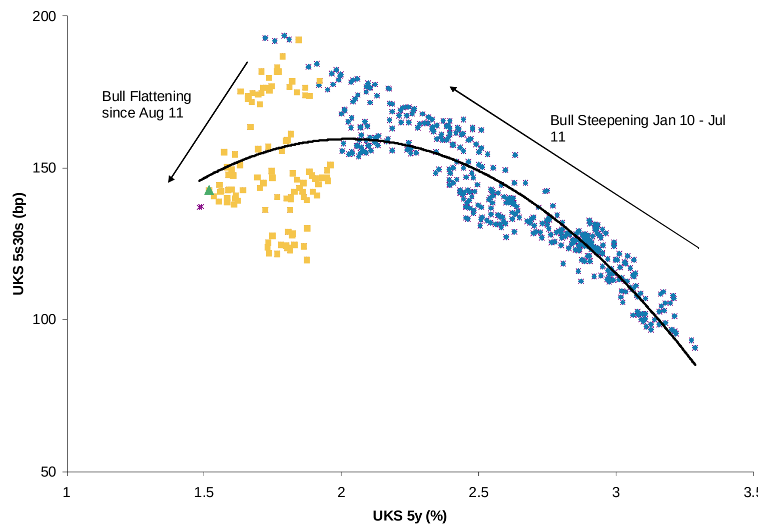
This bull-flattening/bear-steepening has been priced into the implied volatility market, with GBP 5y gamma falling below 30y gamma and 10y gamma just above. A complete reversal of the vol surface at the beginning of 2010.

To diminish some of this directionality, we recommend moving flatteners further out the curve. GBP 15s40s curve appears to be on the 'cusp' – if yields continue to rally, the curve should begin to bull-flatten, however, if yields sell off, the curve should bear-flatten, particularly if the sell-off is substantial.

Vol Pricing for Bull Flattening and Bear Steepening



UKT 5s30s Switched from Bull-Steepening to Bull-Flattening



Source: Bloomberg, Morgan Stanley Research

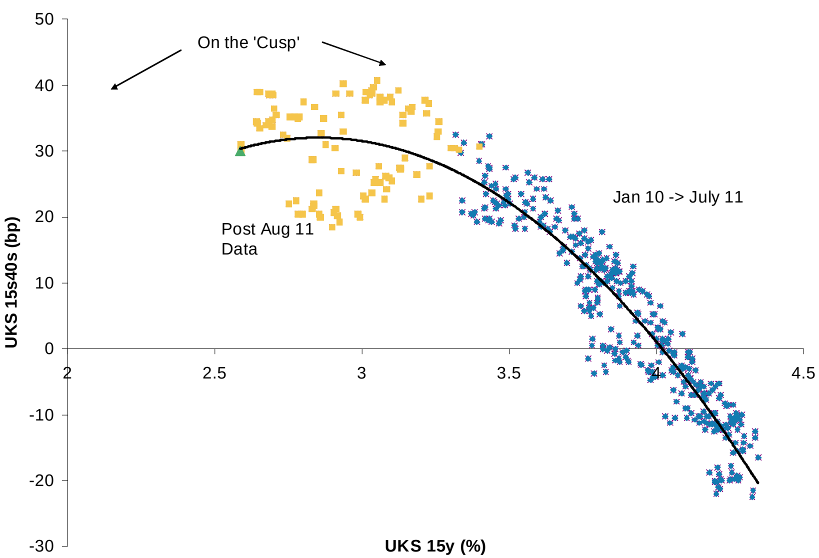
GBP15s40s Flattener – On the 'Cusp'

Supportive Reasons for Further Curve Flattening

More QE – despite the more resilient-than-expected economic data, the MPC announced a further £50bn of QE in February. QE will be more evenly spread along the curve. Inflation is falling and should also take some of the risk premia out of long-end yields.

Supply – The minutes from the Consultation Meeting between the GEMMs and HM Treasury regarding the 2012/13 Remit mentioned that "a number of recommendations were made for increasing medium issuance" to ensure a "well functioning liquid futures contract", while GEMMs only favoured a "modest increase in long conventional issuance". Hence, we expect a higher proportion of medium issuance than longs in FY 2012/13

On the Cusp – the Curve Is Set for Either Bull or Bear-Flattening



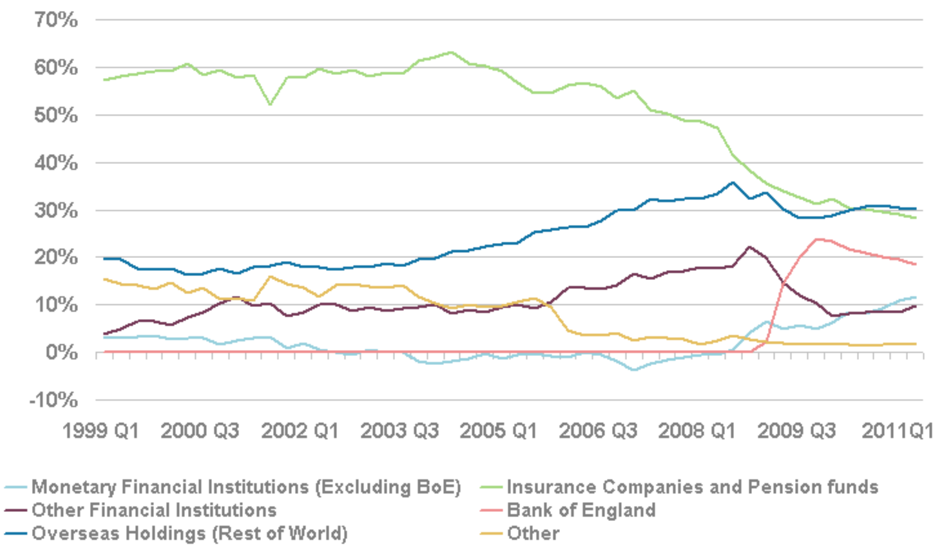
Source: Bloomberg, Morgan Stanley Research

Gilt Holdings: Change in Composition

- Since QE was started in 2009, insurance companies and pension funds' market share of gilts has decreased by around 20 percentage points. Monetary financial institutions' market share has increased by around 10 percentage points in the same period.
- But both pension funds and insurance companies and MFIs have been ongoing buyers of gilts
- The BoE now has a 20% market share of gilts.

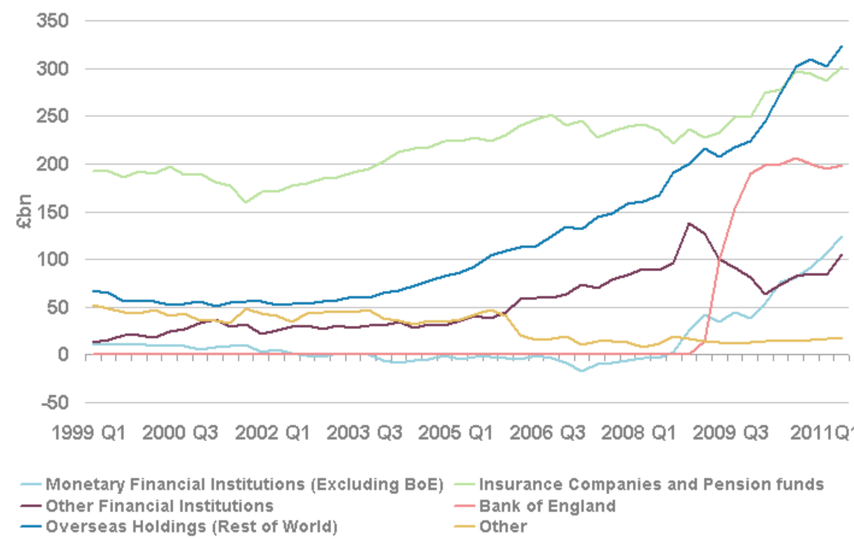
Gilt Holdings by Sector

% of market



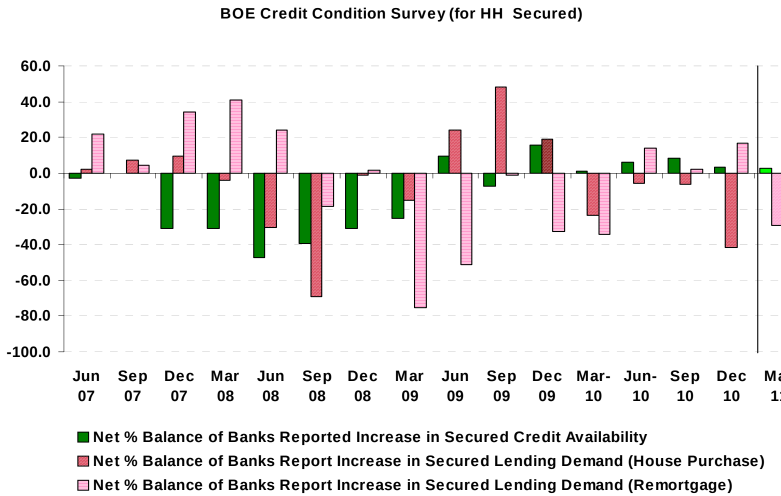
Gilt Holdings by Sector

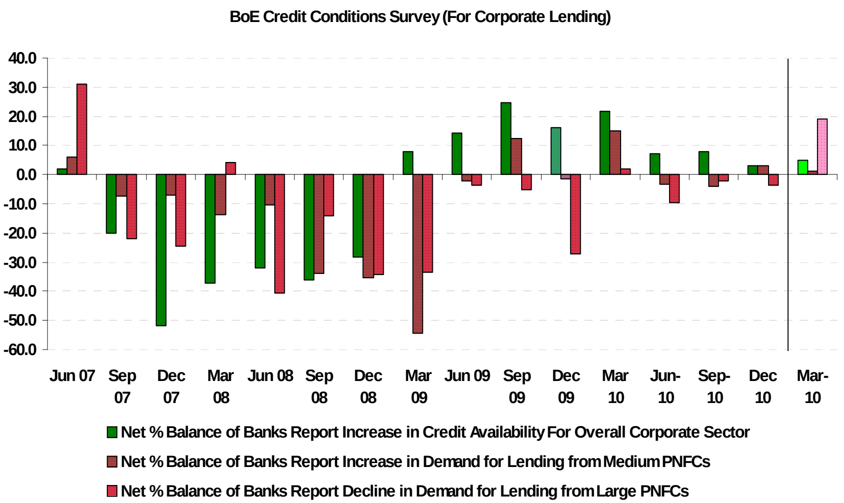
£bn

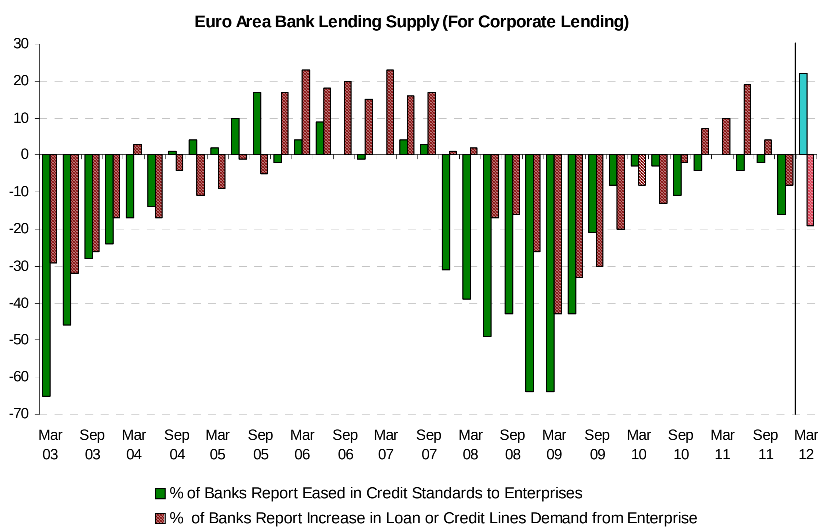


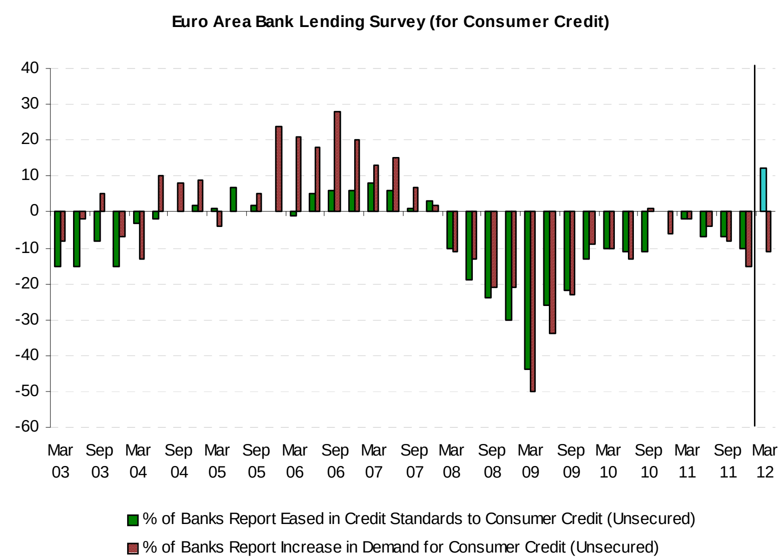
Other Financial Institutions = Non-bank credit grantors, mortgage and housing credit corporations, securitization SPVs;
Other = Households, Local Government and Public Corporations
Source: Morgan Stanley Research, BoE, ONS

Europe and UK – Supply and Demand of Credit Remains Weak



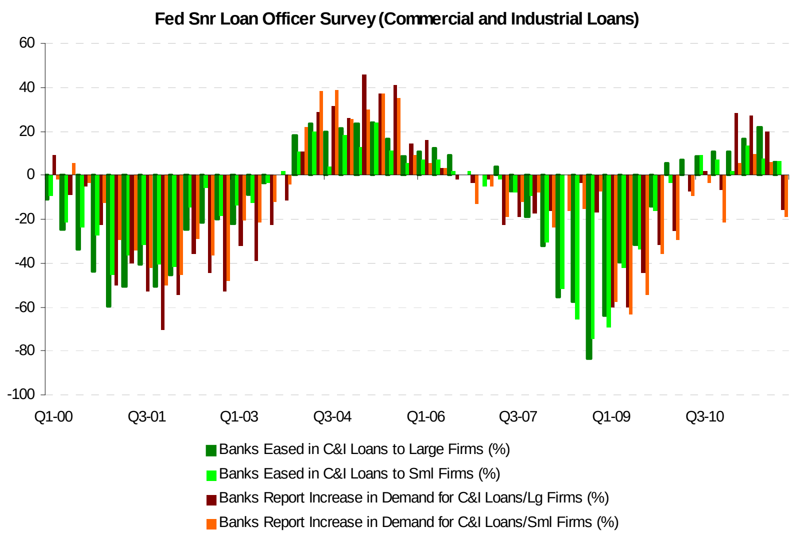


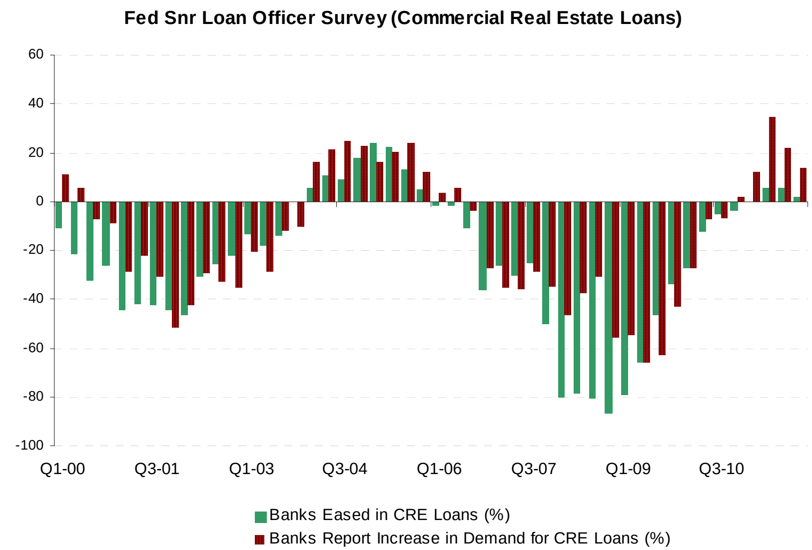


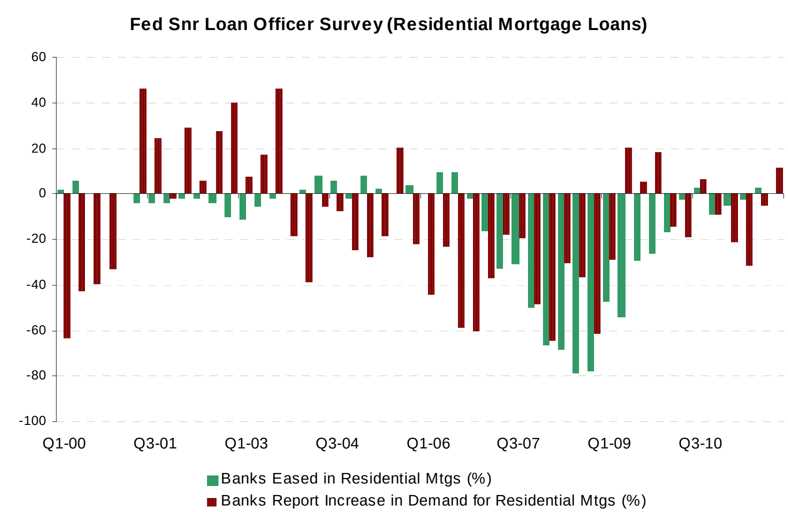


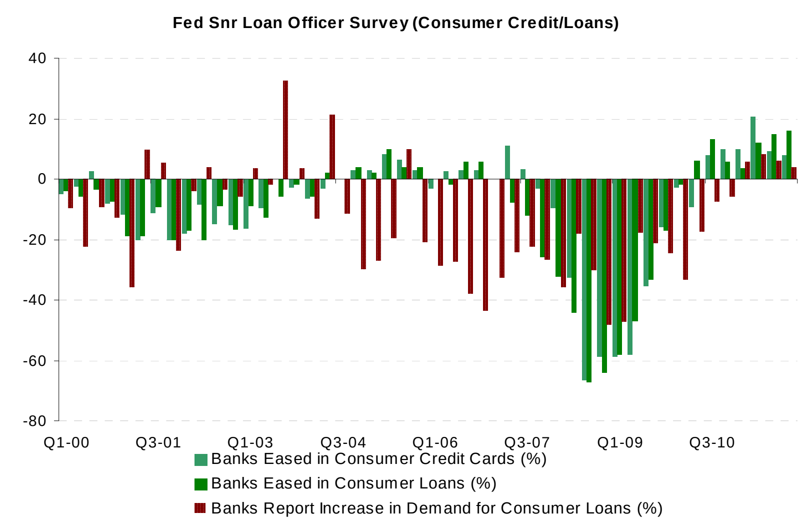
Source: BoE, ECB, Morgan Stanley Research

US – Better Supply for Credit



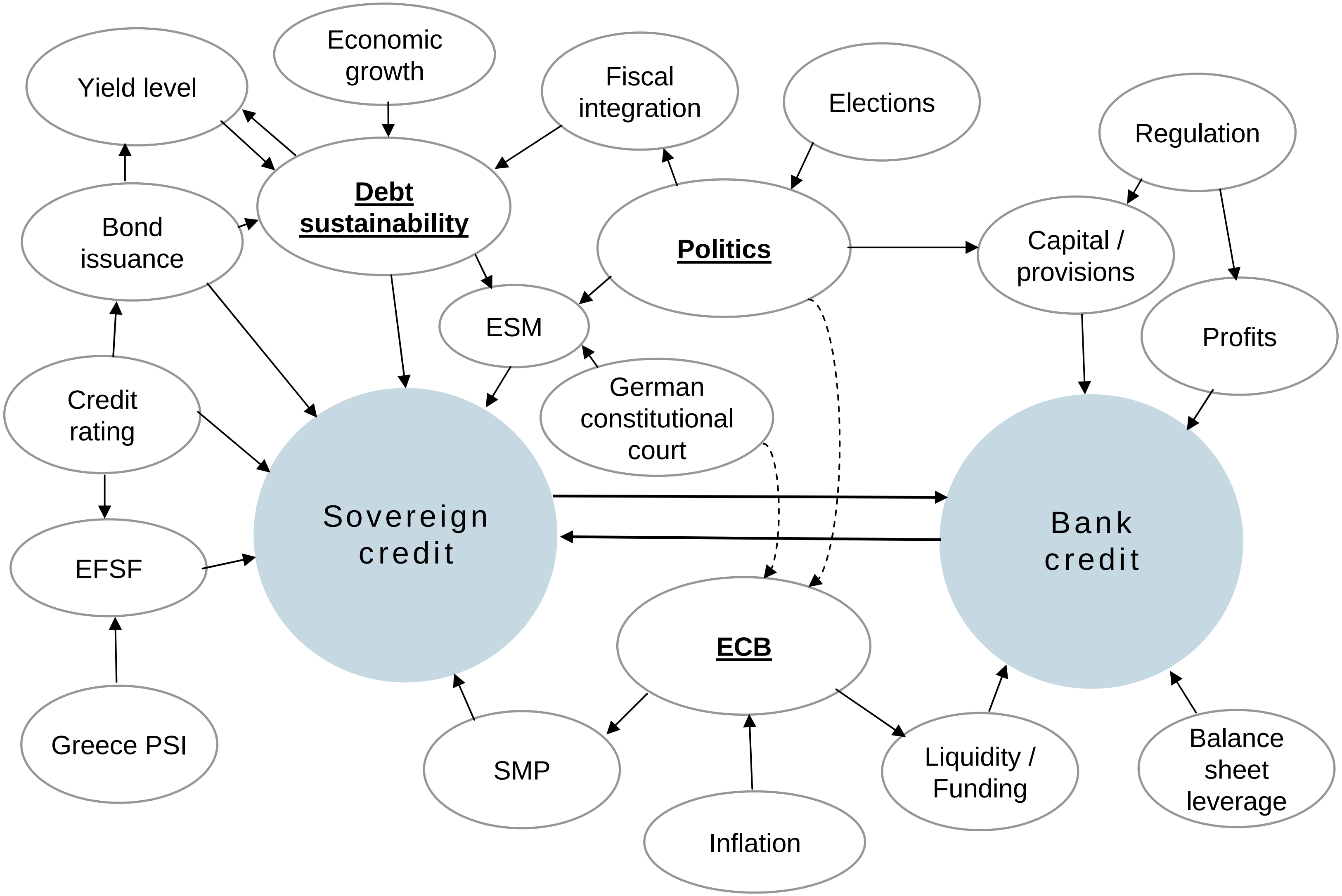






Source: Federal Reserve, Morgan Stanley Research

Euro Sovereign-Bank Nexus: Lots to Solve



Source: Morgan Stanley Research

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The Americas	Europe	Japan	Asia/Pacific
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New York, NY 10036-8293	London E14 4AD	Tokyo 150-6008	Kowloon
United States	United Kingdom	Japan	Hong Kong
+1 212 761 4000	+44 (0)20 7425 8000	+81 (0) 3 5424 5000	+852 2848 5200