

Global Rates Strategy

Buy 30yr UK gilts vs Germany

Interest Rates

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Interest Rate Strategy

Trade: Buy 30yr UK vs Germany above 135bp. Target = 75bp. Stop = 165bp.

We recommend buying 30yr gilts vs 30yr Germany above 135bp (current 142bp). We target a 75bp spread in the next 12months and suggest placing a stop at 165bp. The 12m carry on this position is flat.

Markets could reflect a higher probability of BoE QE

While a possible resumption of QE may be deemed considerably more likely in the wake of a vote to leave the EU – given the uncertainty the economy would be confronted with – there is also a realistic prospect that the Bank of England may need to consider additional stimulus, including QE, even if the vote is to remain. [As we wrote recently](#), the growth slowdown in the first half of the year has been more emphatic than we feared, and if momentum fails to reaccelerate fairly swiftly and materially, some MPC members may start to make the case for further easing before long. This too would lead conventional Gilts to richen on a range of measures, including relative to German sovereign debt in our view.

Near term gilt supply outlook & curve changes of the past year favour 30y Gilts

There is no supply at all in the 30y sector of the UK curve for the next three months. This could allow this point on the curve to correct its relative underperformance over the past year. While the 30s50s sector has flattened significantly in the rally, 20s30s has in fact steepened a little over the same period.

Long-end Bund yields are low, recent bull-flattening driven by scarcity concerns

There are good macro and policy reasons for Eurozone yield to be lower than in previous cycles: slower trend growth, a large output gap, and ECB QE compressing term premia. None of this can account for the extremely low level of 10yr yields, however: we find them [at least 70bp too low](#), the result of excess [risk aversion](#) and a scarcity of safe assets which we ultimately expect to reverse.

We expect 30yr Germany to underperform UK gilts in a sell-off

We view the decline in the eligible pool of German bonds for Eurosystem QE purchases in the last few weeks as one of the main drivers behind the sharp bull-flattening in Germany 10s30s over this period as yields in shorter maturities have fallen below the deposit rate. Should our call for higher euro yields materialise, we would expect 30yr Germany to lead the initial sell-off and underperform UK gilts.

A trade for all seasons

Whatever the outcome of the vote on the 23rd June, there is scope for relative outperformance of long dated UK debt in its aftermath on the back of intensifying growth pressures in the UK ([Global Macro Strategy: Could a QE comeback be on the cards for the UK?](#)).

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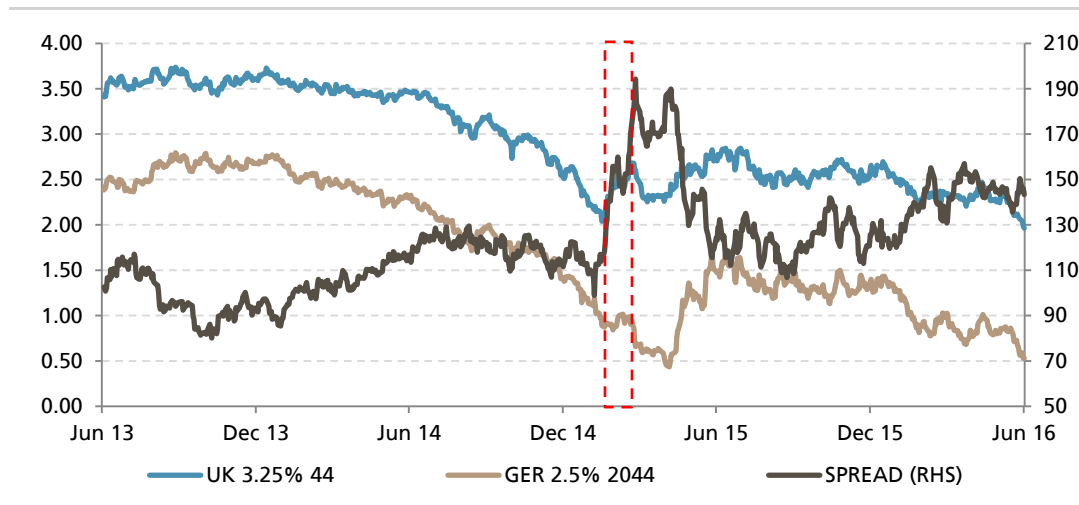
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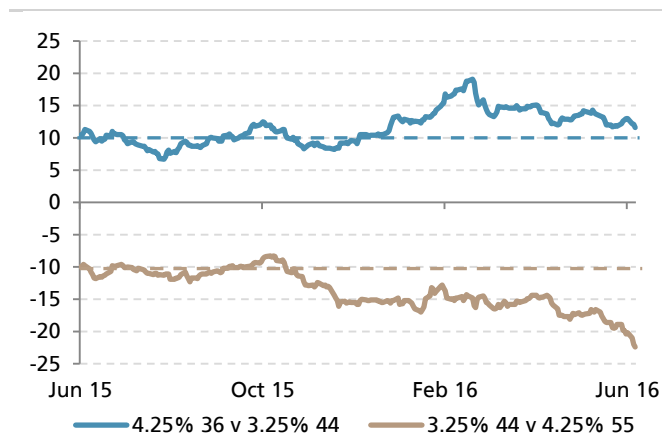
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Figure 1: Yields in 30yr gilts and Bunds have been highly correlated. The spread tends to widen as yields fall. Dotted box refers to period between the announcement of ECB QE (22-Jan-15) and the start of sovereign bond purchases (9-Mar-15)



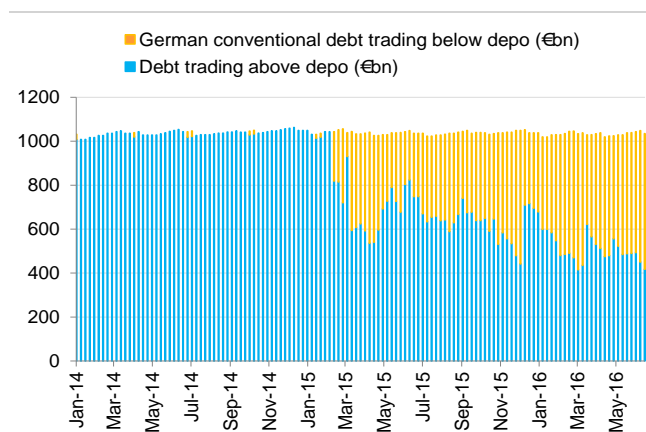
Source: BS Research, Bloomberg

Figure 2: The 20s30s sector of the conventional Gilt curve is slightly steeper than a year ago, while the 30s50s sector is considerably flatter



Source: UBS Research, Bloomberg

Figure 4: Around 60% of German bonds outstanding have a yield below the deposit rate resulting in a decline in the pool of Germany bonds available for QE purchases



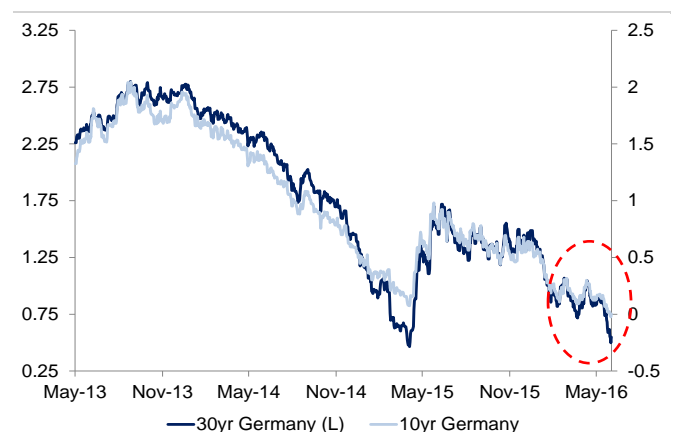
Source: UBS, Bloomberg, Reuters

Figure 3: 30y Gilts have cheapened noticeably on a fly with 20y and 50y wings



Source: UBS Research, Bloomberg

Figure 5: ...this along with the low level of Germany yields has resulted in 30yr Germany outperforming the 10yr point



Source: UBS, Bloomberg

Valuation Method and Risk Statement

Risks include, but are not limited to, market risk, credit risk, interest rate risk, liquidity risk, inflation risk, and exchange rate risk. Furthermore, valuations may be adversely affected during times of high market volatility and thin liquidity.

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