Global Rates Strategy
The Global Rates Landscape

Interest Rates

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Global: Widening the net in hunt for returns

Recent weeks have seen developed market sovereign bond yields reach fresh all-time lows almost everywhere. The latest catalyst was the UK's vote to leave the EU, and though near-term economic risks are squarely concentrated on the UK, it is a material enough shock to trigger a fresh wave of safe-haven demand for highly rated debt, and anticipation of easier monetary policy than would otherwise have been expected.

US: USTs – a cure for negative yields globally

US long-end rates are likely to remain low due to diverging US monetary policy versus global counterparts, lower terminal real rate expectations, and global disinflationary pressures, among other factors. We recommend staying long duration via long-end real rates in H2 2016. The global search for positive yield should compound the move lower in US rates. We also like selling gamma volatility and recommend 5s10s BEI steepeners.

Euro Area: Where to position in European rates?

We forecast a gradual rise in 10y Bund yields to 0.15% at end-2016. Rather than taking outright duration risk in core markets we see better value in cross-market and yield curve trades. We expect yields spreads in 30y UK-Germany, 10y US-Germany, 10y US-Italy & 30y France-Germany to compress. We continue to favour EUR 10s30s forward steepeners. Tactically, we recommend selling 10y Italy, with a tight stop.

UK: Assessing the post-EU vote outlook

A month after the shock outturn of the referendum, we consider how UK markets have reacted so far, and how they may evolve over the coming months. We expect aggressive monetary policy easing to be announced in August, with a 25bp cut in Bank Rate and a relaunch of QE in the shape of £75bn of Gilt purchases to be conducted over three months. The impact of more QE, combined with the ongoing hunt for yield and expected intensification of demand from pension funds, is seen triggering a material flattening of the long end of the conventional Gilt curve.

Switzerland: We see a gradual rise in 10yr yields

We expect FX interventions to be the SNB's policy tool of choice to guard against an appreciating CHF and we do not envisage any rate cuts (or a change to the exemption thresholds on sight deposits) within the next 12 months. We prefer to play the front-end of the CHF rates market from the short-side and anticipate a moderate rise in 10yr Swiss yields.

Australasia: Falling boomerangs rarely return

A global market environment characterised by reach-for-absolute-yield should benefit Australia and New Zealand. Our view that both the RBA and the RBNZ will cut rates in August further underpins this notion. Curves are undoubtedly flat, but we would not fight it; we see value in moving out of the front-end into longer tenors given the macro backdrop. If the central banks against our expectations hold rates steady in August, we recommend overseas investors to add to FX-unhedged bond holdings.

Contents

Summary of views

	MONETARY POLICY	DURATION	CURVE
US	- The Fed is to hike once more this year in December, and proceed with two hikes in 2017.	- Long duration bias, via real rates. 10y is to reach 1.35% by year-end, also due to the global search for yield - We prefer real long-end rates	- Neutral on nominal curve, but risks skewed to steeper curves in intermediate rates. Favor 5s nominal vs. 30s real curve flatteners - 5s10s US breakeven curve to steepen
Eurozone	- Extension of QE beyond March 2017 seems increasingly likely	- Underweight the 10y+ sector in core curves as yields should rise gradually. - Long 10yr US Treasuries vs Bunds - Peripheral yields to rise gradually, alongside core yields - Sell 10yr Italy vs UST - Tactically sell 10yr Italy with a tight stop - Remain long 25-30yr France vs Germany	- Bear steepening in 2016. - EUR 10s30s forward steepeners (2yF and 4yF)
UK	- The MPC has made clear significant policy easing is likely to be required in the near future - We expect a 25bp Bank Rate cut on 4th August, and look for £75bn of Gilt purchases over three months as QE returns	- Front end yields have very limited further downside as Bank Rate is unlikely to fall below zero - Longer yields are likely to fall over the second half of the year as QE, safe haven demand, and lower nominal growth expectations all exert downward pressure	- We expect the curve to bull flatten, and recommend 10s30s flatteners
Switzerland	- SNB to remain accommodative and sensitive to any changes in EUR/CHF - No rate rises until 2017	- Play the front-end of the curve from the short side - 10yr yields to rise over the medium-term	- Bear steepening in 2016
Australia	- RBA to cut rates in Aug-16, then remain on hold for the foreseeable future	- Target 1.75% 10y ACGB yields at end-16 (40bp over USTs)	- Limited value in front-end; extension trades attractive amid global reach-for-yield
New Zealand	- RBNZ to cut rates in Aug-16. Beyond that, persistent FX strength could lead to further easing.	- Target 2.15% 10y NZGB yields at end-2016 (40bp over ACGBs)	- Extension trades attractive amid global reach-for-yield

UBS Global Research

Global: Widening the net in the hunt for returns

John Wraith

- Recent weeks have seen developed market sovereign bond yields reach fresh all-time lows almost across the board. Virtually the only exception is the shorter end of the US yield curve, where some expectation of tighter Fed policy over the coming quarters remains intact despite a steady paring back of its anticipated extent over the past two months.

- The latest catalyst for the general drop in yields was the UK's vote to leave the European Union. While the uncertainty and near-term economic downside risks generated by this event are squarely concentrated on the UK, it is a material enough shock to impact on the wider EU, and to trigger a fresh wave of both safe-haven demand for highly rated sovereign debt, and anticipation of easier monetary policy than would otherwise have been expected across major economies.

- We consider and update our views on global sovereign bond markets in the wake of these developments, and identify several opportunities for the months ahead.

US – long 10y real yields, breakeven curve steepeners, implied vol ideas

We expect long end US rates to remain low over the months ahead, due to a combination of factors including lower terminal real rate expectations, global disinflationary forces, and the widespread investor search for positive returns. We recommend staying long duration through long-end real rates through the second half of this year.

The 5s10s sector of the breakeven curve looks particularly flat to us, and the seasonal decline in oil price pressures that tends to occur in the second half of the year after the summer driving season leads us to anticipate steepening of this sector. The wider 5s20s sector of the breakeven curve is also very flat, even more so relative to the same part of the euro area HICPx curve. The box trade is at all-time low levels, and we recommend positioning for a steepening of the US curve relative to its EUR equivalent.

Implied volatilities have started to decline from their recent risk-aversion related spike, but we think short expiry levels can fall further. Later in the year, we expect mounting speculation over possible Fed tightening to trigger a fresh pick-up in volatilities, and therefore recommend selling short expiry vols (such as 3m5y strangles) in favour of longer expiries (9m5y strangles).

Euro Area – modest relative underperformance of German debt

While we don't anticipate a dramatic rise in underlying yields in Germany, we do expect widespread underperformance against a range of other markets. In absolute terms we still expect higher yields over the next six months, but the level of conviction is undermined by several factors. These include the possibility of mounting speculation the ECB may announce an extension of its current QE commitment beyond March 2017, political risks emanating from the fallout from the UK's EU referendum, and political and banking sector related risks in Italy.

While our outright directional call is modest, we have higher conviction in cross market spread convergence and curve trades. Among these, we continue with our existing recommendations to sell 10y Bunds against Treasuries and 30y Bunds against Gilts. Event risk in Italy leads us to recommend selling 10y BTPs against

Treasuries, targeting a move to a flat spread. Tactically, we also recommend selling 10yr Italy outright (between 1.20-1.25%), with a tight stop. On the curve, we think the forward path of 10s30s on the EUR curve looks much too flat and favour steepeners starting 2y forward, or even (our preferred option) 4y forward. Our final underweight Germany recommendation is to continue to sell 25y Bunds against French equivalents (the spread has now narrowed to 45bp), not least because we expect the pattern of Japanese investors favouring diversification into the higher yielding French debt market to persist. We target a continuation of the move to 35bp.

UK – lower yields, 10s30s flatteners, 30y cross market outperformance

After two extraordinary trading sessions in the immediate aftermath of the referendum on EU membership, UK yields (and the currency) have been relatively stable. Intraday volatility has at times been elevated, and there is still a great deal of uncertainty over the timing and nature of the negotiations, but the immediate market reaction has been relatively measured and well-contained. The Bank of England acted fast to ensure the stability of the banking system by extending long-term liquidity operations until the end of September, and cut the banks' countercyclical capital buffer requirements to free up around £150bn of potential additional lending into the economy.

As yet, the stance of monetary policy has not been altered, but we believe the minutes of the MPC's July meeting, together with the content of speeches made by some of its senior members in the wake of the referendum, make it clear that large-scale supportive easing measures are likely to be deployed soon. We expect a 25bp cut in Bank Rate and the relaunch of QE through the initial purchase of £75bn of conventional Gilts over a three-month period to be endorsed at their next meeting on 4th August. This is expected to lead to further outperformance of conventional UK sovereign debt, relative to cross market equivalents, on asset swap, and against QE-ineligible linkers (lower breakevens).

As well as the direct impact from large-scale Central Bank purchases, we think there are other reasons to expect that long Gilts are set to richen, and the yield curve beyond 10y to flatten materially. The huge drop in yields after the referendum has taken private sector defined benefit pension scheme deficits to record levels, and the pressure to better match assets to liabilities and avoid further scheme deterioration in the future will increase demand for long and index-linked Gilts. The ever lower level of yields in shorter maturities also argues for greater demand for long Gilts as the hunt for yield leads investors to extend ever further down the curve.

Our favoured trades to benefit from this expected long end outperformance are long 30y Gilts against Bunds, targeting a decline to 75bp from 117bp at present, and 10s30s flatteners on the curve, targeting a move to 60bp from 88bp currently.

Switzerland – possible SNB easing priced, slightly higher 10y yield

Although the SNB may have to act again as it attempts to hold the EUR/CHF FX rate above the 1.05-1.07 area, we expect most of its efforts to take the form of intervention in the FX market rather than looser monetary policy. Interest rates are already in deeply negative territory, and further easing becomes increasingly problematic and its effects uncertain and questionable. An additional 15-20bp cut is almost fully priced in, and we see very little scope for anything more significant

than that. Given there may be strong reticence to enact that further cut, we prefer to play the front end of the CHF rates market from the short side.

There has long been a close correlation between longer yields in Switzerland and Germany, with the spread tending to widen as yields rise (German debt underperforming). A continuation of this correlation fits with the general theme of relative Bund cheapening outlined above. As Bund yields continue to climb in 2017, so we expect the 10y Swiss swap rate to gradually start heading higher too. An intensification or calming of overall global risk aversion would result in lower, or higher, than anticipated longer yields in Swiss interest rate products.

Australasia – NZ front end preferred to Australia, extend down curves

While we expect the RBA to cut rates at its August meeting, we see no value in shorter dated ACGBs, as easier policy looks fully priced. There is a smaller chance anticipated of an easing by the RBNZ, but we think it is unlikely that they will hold fire if the RBA has indeed cut rates nine days earlier. We therefore see good risk-reward in switching out of front-end Australian debt into NZGBs, a position that should benefit if the Central Banks choose not to diverge with their policy decisions.

Further down the curve, the hunt for yield theme characterising other markets looks likely to have an impact here too, and extension trades are favoured. The Australian yield curve has flattened much more sharply in the sub 5y sector than beyond, and switching out of shorter dated debt into the 7-8y sector looks attractive, in our view. Extending out of 10y debt into longer equivalents also appeals.

If neither Central Bank cuts next month, we recommend overseas investors add to FX-unhedged bond holdings in Australasia – currencies could appreciate in response to perceived reticence to ease policy on interest rate differentials, while yields look unlikely to rise materially due to the global demand for relatively high yielding debt. Shorter end breakevens look too low in both markets in the context of our economists' forecasts for headline inflation in the two economies over the next year or two.

US: USTs – a cure for negative yields globally

Chirag Mirani

Matthias Rusinski

- Due to diverging US monetary policy, lower terminal real rate expectations, and global disinflationary pressures, among other factors, **US long-end rates are likely to remain low**, and we **recommend staying long duration via long-end real rates in H2 2016**. **The global search for positive yield** compounds the move lower in US rates, in our view.
- We forecast **10-year yields at 1.35% by the end of 2016** and 1.50% by the end of 2017, levels lower than current forwards. We prefer expressing this view **via US long-end real rates**, and remain neutral on the curve due to global uncertainty.
- We recommend **selling near-term, three month gamma volatility** via a 3m5y strangle, with strikes set 30bp apart, against going long 9m5y strangle, which should benefit from a likely pickup in volatility at the end of the year.
- We find that the **US 5s10s breakeven curve is too flat** given the recent appreciation in USDCNY and the fall in food futures. Therefore, we recommend a 5s10s BEI steepener, and also suggest a **5s20s US BEI steepener versus 5s20s EUR HICPx swaps flattener** as a cross-market idea.

We expect US rates to remain low due to a divergent US monetary policy (see What to expect when the Fed keeps expecting), global disinflation forces weighing on US inflation, and lower US terminal real rate expectations. We have revised our US interest rates forecast and now expect 10y US rates to be 1.35% (previous: 2.00%) by the end of 2016 and 1.50% by the end of 2017.

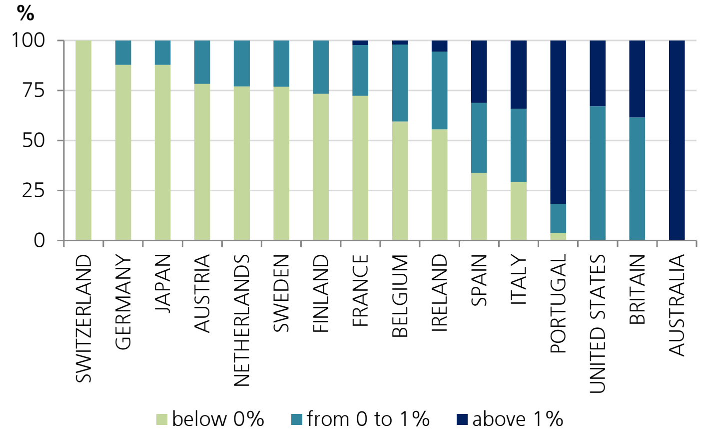
Additionally, we see the drivers to lower yields compounded by the following three factors. For a more detailed view, please see A cure for negative yielding global bonds: USTs.

Global scarcity of positive yielding government bonds

41% of DM bonds yield negative, fuelling the grab for positive yield

Almost 41% of the developed world's sovereign bond yields are now below 0% and almost 80% are below 1%, as seen in **Figure 1**. Excluding Euro zone peripheral yields and central bank holdings, the global bond universe with yields above 0% is even scarcer, which should prevent US yields from rising.

Figure 1: Global developed world sovereign bonds, bucketed by yield to maturity: 41% of the developed world bond yields are now below zero.



Source: UBS, Bloomberg

Furthermore with USDJPY depreciating and concerns about limits of monetary policy in Japan, the significant foreign bond buying out of Japan looks likely to continue. This buying trend has been more pronounced since the introduction of negative rates by the BoJ in January 2016. Japanese investors have bought around $60bn of US Treasuries in 2016.

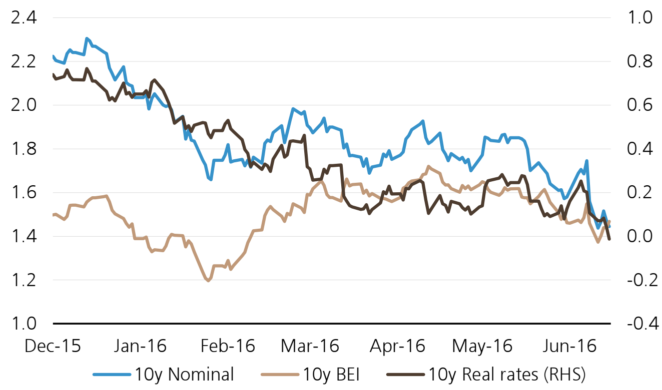
In fact, Japanese investors were record net buyers of overseas bonds during the week of July 14, 2016. This is the largest net buying in a week since the start of data in 2005. On a net basis, they bought ¥2549bn (US $25.1bn) of foreign bonds, compared to ¥427bn (US $4.2bn) the week before. We think negative interest rates in Japan have dramatically shifted investor preference in favour of USTs.

We expect the BoJ to ease further in the coming months and this is likely to be supportive for continued net purchases from Japan, keeping US nominal term premia suppressed.

Weaker global growth expectations and declining term premium

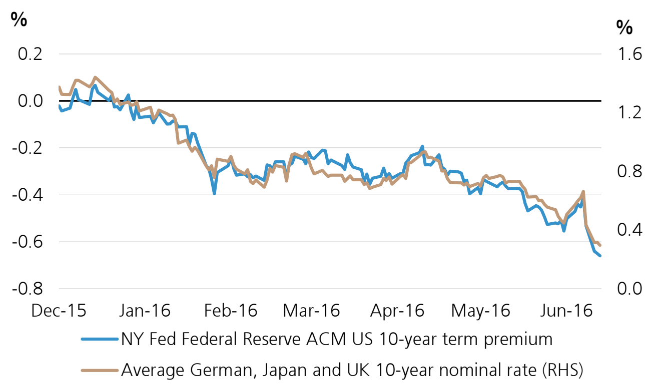
10y nominal rates have declined by about 78bp since the December 2015 hike. Most of the decline in nominal 10y rates is explained by a decline in real rates (see **Figure 2**) and likely real term premium (see **Figure 3**).

Figure 2: US 10y nominal, real and breakevens post December Fed hike



Source: UBS, Bloomberg

Figure 3: Lowest ever US nominal 10-year term premium



Source: Federal Reserve, UBS, Bloomberg

In fact, the decline in US term premium is now at its lowest level in its recorded history (since 1961). US term premium has declined despite hike expectations being pushed back, better US economic data and higher oil prices, which suggests lower global growth expectations is the likely cause. And as can be seen in **Figure 3,** most of the decline has coincided with a decline in global (ex-US) developed world yields. We do not foresee this dynamic changing in H2 2016 with impending easing expectations in the UK, Euro area and Japan.

"Headline" US inflation expectations too low for too long

We also believe that market based "headline" inflation expectations have fallen recently and downside risks to inflation have increased. Importantly, 5y5y breakevens, which traded at 140bp on July 15, 2016, have now diverged from oil prices. The Fed's 5y5y breakeven has been below 2.3% for almost two years now. This persistence makes a reversion back to 2% less plausible, in our view. Also oil futures generally decline in the second half of the year due to the passing of summer driving season demand. Further, the distribution of Inflation expectations

is now asymmetric, showing greater downside. This is evidenced in CPI option data and University of Michigan's 5-10y ahead inflation expectations index (see US rates strategy comment).

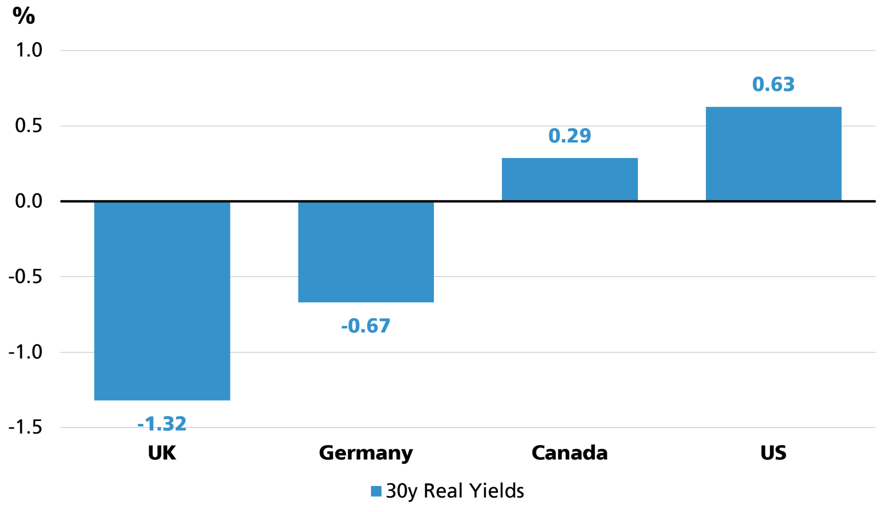
So what is a rates investor to do in this environment? Stay real

US long-end real rates offer better risk-adjusted value relative to global yields

The objective of developed world central banks is to stimulate aggregate demand by reducing real rates. As we have argued previously (see Are low US yields here to stay? and Inflation expectations back in focus), being long the **long-end US real rates remains the best risk-adjusted trade**. US long-end real rates are among the highest in the developed world and remain highly inconsistent with low market based inflation compensation (see **Figure 4**).

The market is pricing in about 110bp PCE inflation outcome in the US, and long-end real rates – at 63bp – are above the Fed's view of terminal rate (the Fed's estimate of long-run nominal rate: 3% minus PCE inflation target: 2% minus CPI-PCE wedge: 0.4%). In terms of cross-market views, the term premia in Euro area are even more compressed than in the US, so we like buying US Treasuries versus German bunds. For related notes, please see Recalibrating our views post referendum.

Figure 4: US 30-year real rates are too high relative to US BEIs and relative to other developed world real yields



Source: UBS, Bloomberg

Implied volatilities to decline: sell gamma

Short-term implied vol has more room to decline, but vols should pick up at the end of the year

Implied volatilities have started to decline recently from their risk-aversion related spike. We believe short-expiry implied volatilities, such as the 3m5y, can decline further. As argued above, we believe the macro environment is supportive of suppressed term premia via the global (ex-US) easing impetus. Longer expiry vols falling into 2017, such as the 9m5y, have experienced a relatively steeper drop recently than the 3m5y.

Towards the end of the year, we expect volatility to increase, regardless of the direction of rates, given a likely hike in December and greater data dependency from the Fed. Therefore, we suggest selling short expiry vols in favor of longer expiries. The 5-year sector should be susceptible to more volatility in a policy related repricing at the turn of the year.

To offer a cushion against intermittent moves, we sell 15bp out-of-the-money options that comprise a short 3m5y strangle. A sample structure is shown in **Figure 5**.

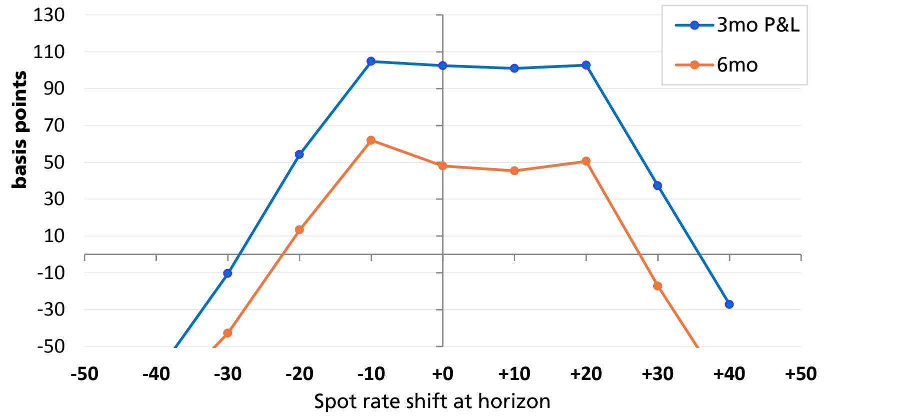
Figure 5: Indicative structure of a short 3m5y strangle vs 9m5y strangle, 20-Jul-2016

Indicative Terms	Notional ($ MM)	Spot	Strike	*Money ness*	Prem (%)	DV01 ($K)	Underl DV01 ($K) recvr/payr	Vega ($K)	Vol (bp/yr)	Theta ($K/d)
SELL Strangle 3m5y				-15/+15	0.83	(1)	-88/89	(32)		12
Recvr 3m5y	(180)	1.15	1.04	ATM -15	0.41	(31)	(88)	(16)	73	6
Payer 3m5y	(180)	1.15	1.34	ATM +15	0.42	30	89	(16)	74	6
BUY Strangle 9m5y				-15/+15	(1.89)	1	49/-49	33		(4)
Recvr 9m5y	100	1.15	1.11	ATM -15	(0.93)	20	49	16	75	(2)
Payer 9m5y	100	1.15	1.41	ATM +15	(0.95)	(20)	(49)	16	76	(2)
				% notional➔	**(0.40)**	0	0	**0**		7

Source: UBS, Bloomberg

The structure is vega neutral, and provides a forward vol exposure at a lower cost of 40bp against about 190bp outright on the 9m5y. It has a solid positive carry of over 100bp in 3 months. Maximum gains should be delivered in a range-bound rates environment (**Figure 6**), which we judge is likely. Our estimates assume constant volatilities. If vols rise towards the end of the year, the 6-month horizon gain on the remaining original 9m5y option should be greater relative to our estimates. The breakeven rate move for this position would be a 25bp rally or a 35bp selloff of the 5y over the next 3 months.

Figure 6: Estimated performance of the short 3m5y strangle vs 9m5y strangle per change in rate, constant volatility



Source: UBS, Bloomberg

Revisit receiver spreads

At the end of May, we recommended a 1x2 receiver spread in 6m5y options, by buying an at-the-money option against a 25bp out-of-the-money receiver. At that time, we targeted an environment of cautious Fed and somewhat lower rates. We find the current environment and outlook ripe for this position as well. Entering such a position today is costless, or even grants a small premium takeout, and should deliver optimal gains in a 20bp rally with no loss in the event of a selloff.

TIPS

BEIs offer long term value but "headline CPI" expectations are likely lower, Breakevens should be range bound in the near term. We see the fair-value of 10y breakevens, now at 147bp, in the range of 170bp to 240bp, an estimate based on long-run CPI realization (10-year average), the Fed's long-term inflation objective, and the 40bp spread between CPI-PCE quoted by Chair Yellen. Breakevens are likely to realize their fair value over time.

Long-end of the US real curve benefits from foreign demand

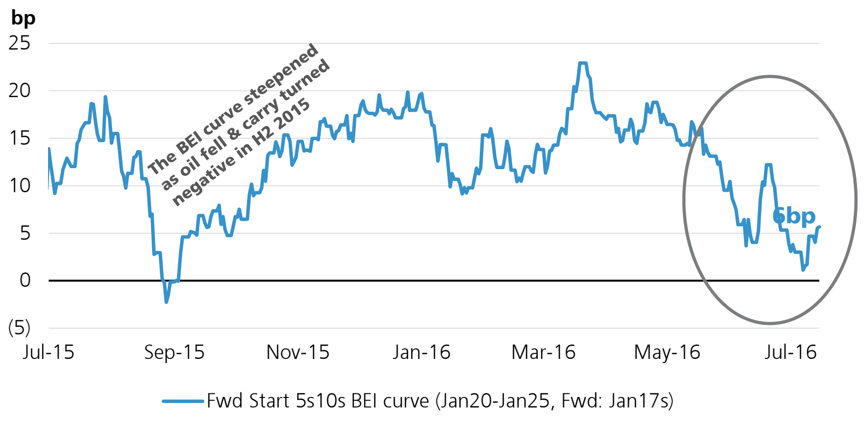
That being said, in the near-term, we think oil prices pose downside risks to breakevens. Concurrently, we find the **long-end of the US real rate curve attractive due to foreign demand**. TIC data (as of June, 2015) shows foreigners bought $77bn in TIPS in 2014-2015 whereas they sold $141bn in nominal coupons. We think this demand will continue.

Relative value trade idea: 5s10s BEI curve steepeners

In relative value, we think the 5s10s breakeven curve is particularly flat (see **Figure 7**) and is ripe for steepening as oil typically declines (more than implied by futures) in the 2nd half of the year due to the end of the summer driving season. We recommend putting on 5s10s breakeven steepeners (**now at 7bp, Exit: 20bp, Stop: 0bp**). We recommend expressing this trade without using near-floor five year issues (April 20s or April 21s).

In H2 2015, the TIPS carry turn and seasonal oil fall steepened the 5s10s breakeven curve by more than 20bp. Last month's 9% fall in food futures and USDCNY appreciation should put pressure on front-end inflation expectations. We also expect TIPS index (series B) to extend by 0.12yrs, supportive for the long-end.

Figure 7: 5s10s BEI curve is too flat: Steepeners look attractive for H2 2016

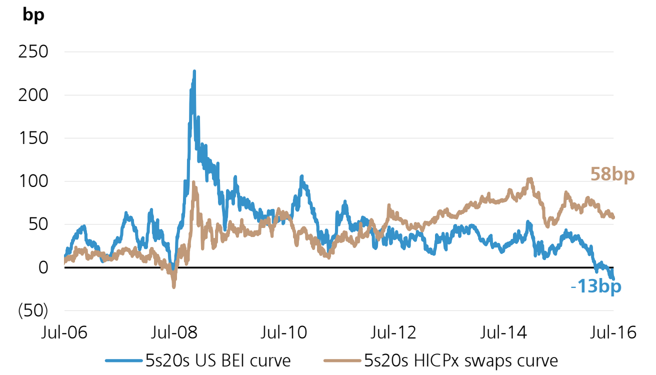


Source: UBS, Bloomberg

Cross market: 5s20s US BEI steepener v 5s20s EUR HICPx swap flattener

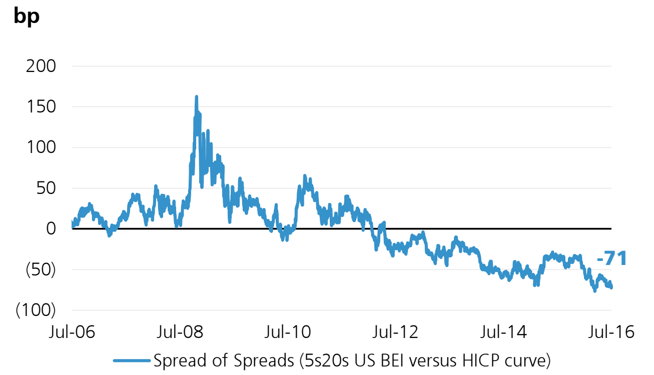
In cross-market linkers space, the breakeven curve in the US is very flat relative to the Eurozone (see **Figure 8** and **Figure 9**). This is despite the fact that core CPI in the US is running at 2.2% whereas EUR HICPx (excluding food, energy, alcohol and tobacco) is running at 0.8%. Specifically, we recommend putting on **5s20s breakevens steepeners in the US and 5s20s HICPx flatteners in Eurozone (Entry: -65bp, Exit: 0bp, Stop: -80bp).**

Figure 8: 5s20s US breakeven curve has flattened versus EUR HICPx inflation swaps curve



Source: UBS, Bloomberg

Figure 9: Spread of spreads: US 5s20s inflation curve vs EUR HICPx 5s20s inflation curve is at all-time flat levels



Source: UBS, Bloomberg

Tail event and micro relative value: Buy floors

In terms of tail deflation event value along the curve, we recommend being overweight April 20s and April 21s for their par floor. In terms of micro relative value, we find Jan 22s, Jul 23s, Jul 24s Jan 27s, Jan 29s, Feb 43s, Feb 44s to be cheap whereas we find Jan 20s, Jul 21s, Jul 22s, OTR Jan 26s and Feb 46s to be rich. Based on this micro relative value setup, we believe the best 5s10s breakeven steepener construction is likely in Jan 20s versus Jan 27s. Jan 27s will become eligible for the 1-10y TIPS index in January, 2017. This could richen the Jan 27s TIPS issue quite meaningfully as we get closer to January.

Euro Area: Where to position in European rates?

Nishay Patel

- **Summary of yield view:** A combination of lower developed market yields, political uncertainties and accommodative monetary policy is unlikely to result in a large sell-off in 10y Bunds over the next 6 months. We now envisage a moderate rise in the 10y Bund yield to 0.15% at end-2016, followed by a further rise to 0.50% by end-2017.
- **Summary of trades:** Rather than taking outright duration risk in core markets we see much better value in cross-market and yield curve opportunities. We expect yields spreads in 30y UK-Germany, 10y US-Germany, 10y US-Italy and 30y France-Germany to converge. We continue to favour EUR 10s30s forward steepeners. Tactically, we recommend selling 10y Italy, with a tight stop.

We see the following factors impacting core euro area markets over the coming months and anticipate yields rising gradually, rather than sharply:

(1) Euro Area fundamentals, ECB policy and base effects

Following the outcome of the UK referendum our economics team have cut their growth forecasts for the Eurozone due to the major uncertainty shock that has been created on top of the impact of weaker UK activity. They argue that the economic fallout in the Eurozone will likely be a function of: (a) how the exit negotiations between the EU and UK proceed; and (b) whether the EU will, over time, move towards greater integration or disintegration. The negative impact on Eurozone business sentiment and hence fixed investment is likely to be more meaningful than trade-losses vis-à-vis the UK.

Figure 10: Eurozone growth forecasts

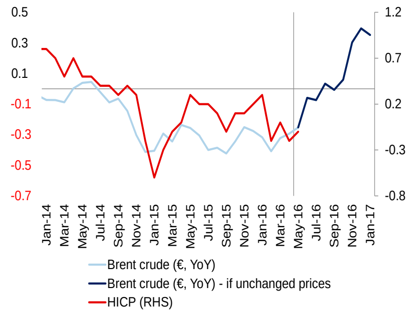
	%Y/Y	2015	2016F	2017F
Base Case	Real GDP	1.6	1.5	1.3
	Nominal GDP	2.8	2.3	2.9
Substantial Downside	Real GDP	1.6	1.4	0.8
	Nominal GDP	2.8	2.0	2.2

Source: UBS Research, Eurostat

We think the to-be-expected deceleration in Eurozone growth will likely skew the ECB's decision further towards an extension of asset purchases beyond March 2017, with a decision likely due on 8 September or 8 December. This is likely to keep core euro area yields well below the levels implied by fundamentals but not necessarily stop them from rising gradually, as expectations of an extension to ECB QE are largely priced in, as are concerns of a scarcity of German bonds.

Upcoming base effects from the fall in oil prices last year vs 2014 point to upward pressure on German yields over the coming months (Figure 11). Furthermore, with the ECB front-loading asset purchases by €15bn ahead of the summer months we would expect to see €15bn fewer purchases between the middle of July and end-August. We expect 10y German yields to rise to 0.15% by end-2016.

Figure 11: Brent crude YoY vs Eurozone HICP



Source: UBS Research, Eurostat, Bloomberg

(2) Political developments and the banking sector

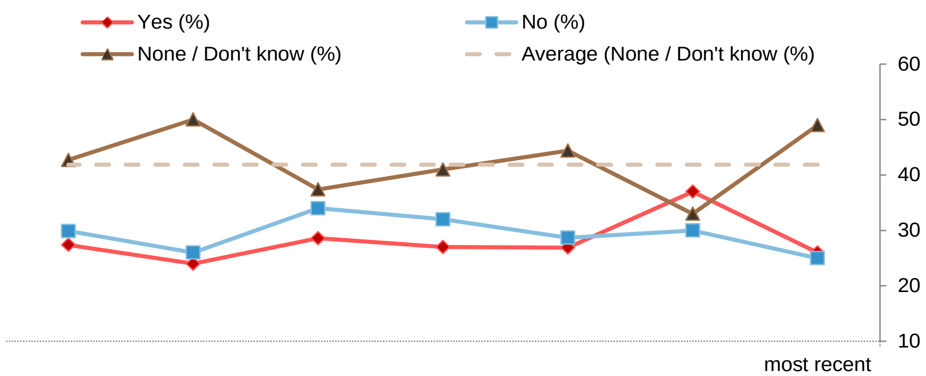
Following the announcement of a new UK Prime Minister, attention will be paid to post-referendum negotiations between the UK and the EU. As both the timing of discussions and the nature of a potential exit (confrontational or amicable) are unclear, any developments relating to the UK's participation in the EU is likely to be one of the major risks to our view on European rates markets in the medium-term.

Another key risk for rates markets will be the outcome of the Italian referendum on constitutional reform which is likely to be held in October, especially with a number of opposition parties campaigning against the proposed reform. PM Renzi has previously stated that he would resign and leave politics if he lost the

referendum and the latest set of opinion polls point to a close outcome (Figure 12)[1].

If PM Renzi were to resign, it would not automatically trigger new elections (which are currently not scheduled to take place until 2018), but it must be noted that if a snap election were to be held, the latest set of opinion polls point to a small gap between the anti-establishment party (5-star movement) and the ruling PD.

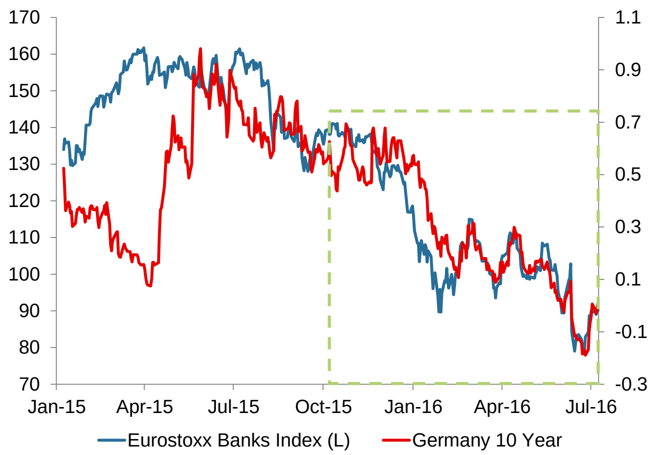
Figure 12: Polling data on the 2016 Italian constitutional referendum (last seven)



Source: UBS Research, various polling agencies (EMG Acqua, IPR Marketing, Euromedia Research, Istituto Ixe, Demos&Pi, Ipsos SRL

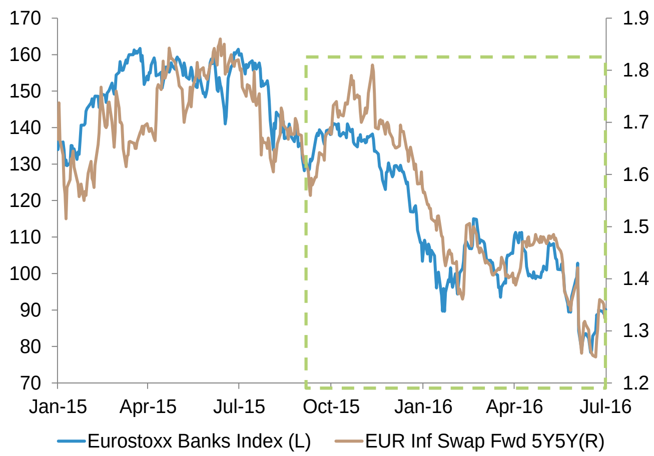
Our Italian bank analyst's note points to the need for further clarity on the potential capital needs in the Italian banking system and how these would be met. Upcoming EBA stress tests (29 July) could improve clarity on the immediate need for fresh capital, albeit with only five Italian banks taking part and the lack of pass/fail marks may mean the market will look for read-across, possibly amplifying concerns. The eventual choice on how capital needs will be addressed will depend on many things, including the size of any capital need/political agreements. Among the four options that our banks team highlight, a bail-in would be the most extreme option as the wider system could be impacted, resulting in wider peripheral spreads should it materialise.

Figure 13: 10yr Germany yields have been highly correlated with European bank stocks



Source: UBS Research, Bloomberg

Figure 14: Inflation expectations (5y5yF) and European bank stocks have been closely linked



Source: UBS Research, Bloomberg

[1] However, it must be noted that a large portion of those polled (over 42%) are undecided and could clearly shift the balance in due course.

As far as core euro area 10y yields are concerned, it can be seen that 10y German yields have been closely linked with European bank stocks and inflation expectations. We expect bank stocks to continue having a strong impact on core euro area yields, along with political developments in Italy.

(3) Accommodative policy globally & demand for positive yields

The prospect of further easing by major central banks globally remains high - we envisage a rate cut and QE by the BoE, more stimulus from the BoJ and a rate cut by the RBA in August. With appetite for positive yielding assets remaining high we would expect to see strong demand for Eurozone bonds if there was a material rise in yields from here.

How to position: spread convergence & forward steepeners

Although the outlook for European related risk events is uncertain what is clear to us is that outright duration plays in Europe are unlikely to yield significant risk-adjusted returns over the medium-term. Instead we see much better value in cross-market opportunities that capture a convergence between yields in global developed markets and are not hindered by large negative carry.

We particularly like **selling 10y Germany vs US** and target a 100bp spread by end-2017. In our base case scenario (which has not materialised yet due to the flow effects in European bonds), we expect Bund yields to move closer to the US in a rising yield environment as the market prices in a higher growth and inflation outlook in the euro area.

However, one of the main drivers behind the fall in developed market bond yields in recent months has been a result of external concerns surrounding the outlook for central bank policy in light of risks to global growth. Should these risk fears intensify we would expect the spread between 10y US and Germany to converge mainly from a larger fall in US Treasury yields than Bunds.

Summary of trading strategies:

Sell 10yr Bunds vs UST targeting 100bp by end-2017

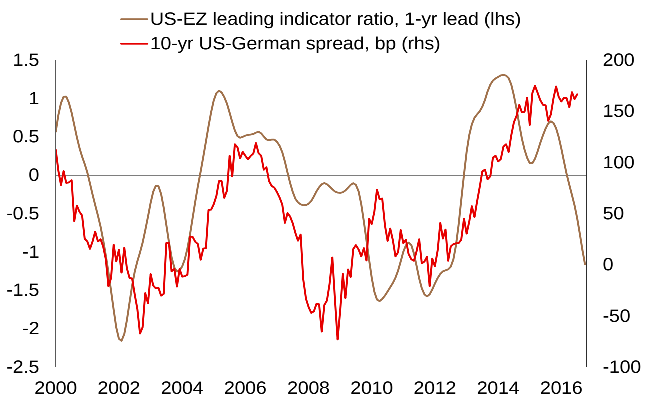
Sell 10yr Italy outright (tactical, 1.50% target)
***or*, sell 10yr Italy vs US (target 0bp)**

Sell 30yr Germany vs UK gilts (target +65bp)

EUR 10s30s fwd steepeners (4yF preferred)

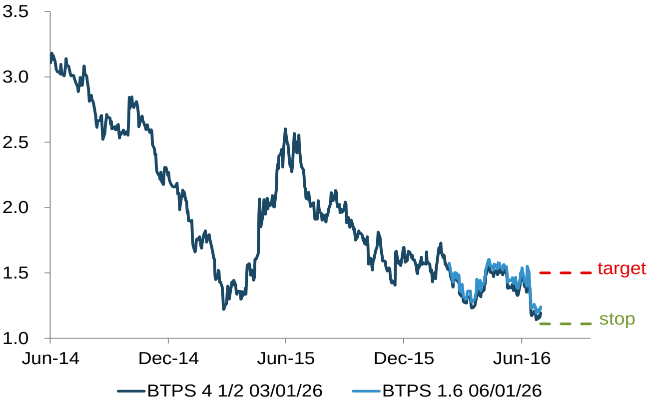
Extend target on long 25-30yr France vs Germany (to +35bp)

Figure 15: 10yr US-Germany yield spread vs OECD leading indicators



Source: UBS Research, Bloomberg

Figure 16: On a tactical basis we suggest selling 10yr Italy outright, with a tight stop at 1.10%



Source: UBS Research, Bloomberg

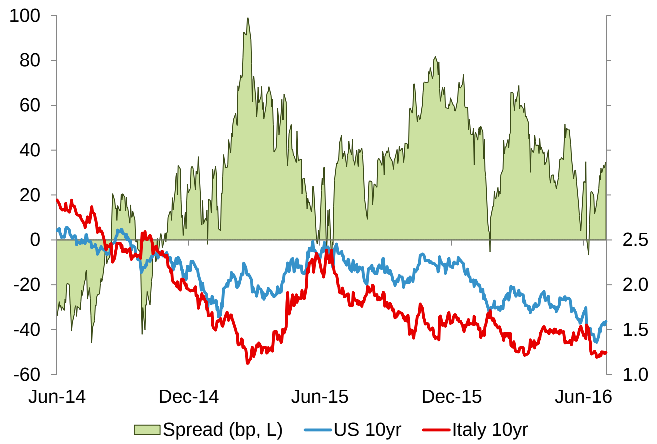
Our expectation of core euro area yields rising gradually over the next few months (supported by upcoming base effects and fewer asset purchases by the ECB), combined with the fact that the 10y Italy-Germany spread is already at our year-end target of 125bp, implies a gradual rise in 10y Italian yields. As mentioned earlier, event risk in Italy over the next two months is high (in both the banking sector and politically) and an escalation of either risk is likely to result in higher

Italian yields. On a tactical basis, we suggest **selling 10y Italy between 1.20-1.25%** (targeting 1.50% with a tight stop at 1.05%).

Another way to capture the prospect of tighter 10 US-German spreads while hedging against an escalation of the Italian risks identified earlier is to **sell 10y Italy vs US Treasuries** above 35bp (with a target level of 0bp). Current levels offer an attractive entry point for fresh positions.

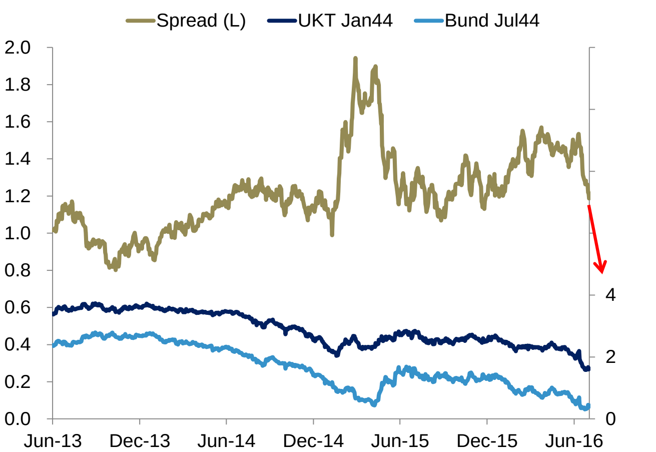
We still see value in **selling 30y Germany vs UK gilts**, a trade that should benefit from our expectation that the BoE will restart QE in the coming months. The absence of 30y gilt supply until 20 September and our view that long-end Bund yields are at least 70bps too low is supportive for this position in both the short- and medium-term. We maintain our target spread level of +75bp.

Figure 17: Enter long 10yr UST vs BTPs at spread above 35bp with a target spread of zero



Source: UBS Research, Bloomberg

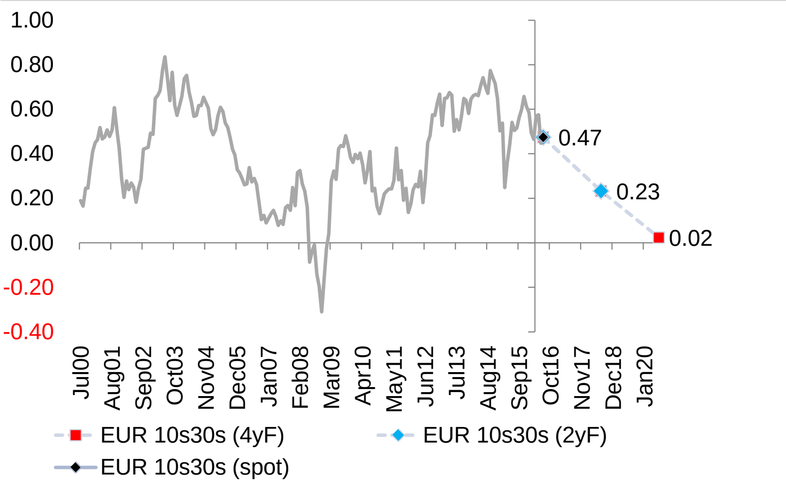
Figure 18: We still expect 30yr gilts to outperform Bunds and target a +75bp spread



Source: UBS Research, Bloomberg

EUR 10s30s forward steepeners in 2yF (and 4yF, our preferred point), we think, offer an attractive way to position for a gradual rise in core euro area yields that we envisage while benefiting from positive carry of 25bp every two years. Market expectations that EUR 10s30s will be only 2bp in four years' time are too pessimistic, in our view. Rather, we see a strong case for EUR 10s30s to be steeper than the current spot curve by that time.

Figure 19: EUR 10s30s spot and forwards (2yF and 4yF)



Source: UBS Research, Bloomberg

Scarcity concerns over the availability of German debt have resulted in the 10s30s yield curve being highly directional with 8-10y rates as the pool of eligible bonds falls as yields beyond the 7y point drop below the deposit rate.

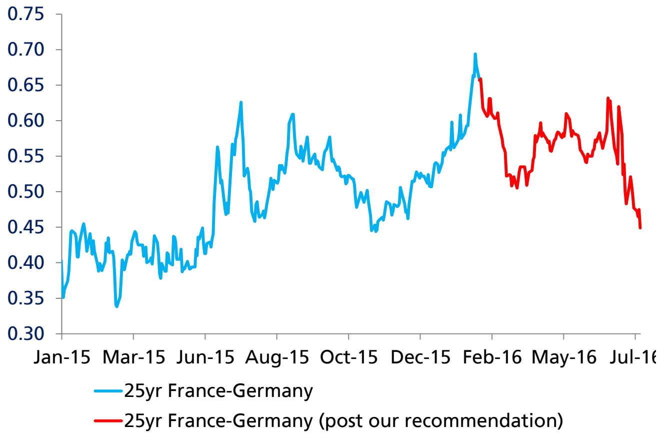
We expect the ECB to run out of German bonds to buy within the next 6 months, but if the rules on the QE programme were to be changed to increase the pool of eligible bonds we would expect to see a steeper Bund curve.

We previously recommended[2] being long 25y France v Germany at +61bp to capture our expectations of further demand for OATs by Japanese investors and a reduction in the risk premia in core government bond spreads as fundamentals in the euro area improve.

Our latest analysis of Japanese investor flows into overseas markets continues to show that the French government debt market is the preferred euro area sovereign market for Japanese investors and we see no reason for this to change, in light of the prospect for further easing by the BoJ in the coming months, and the relative attractiveness of OATs vs USTs or JGBs when currency-hedged.

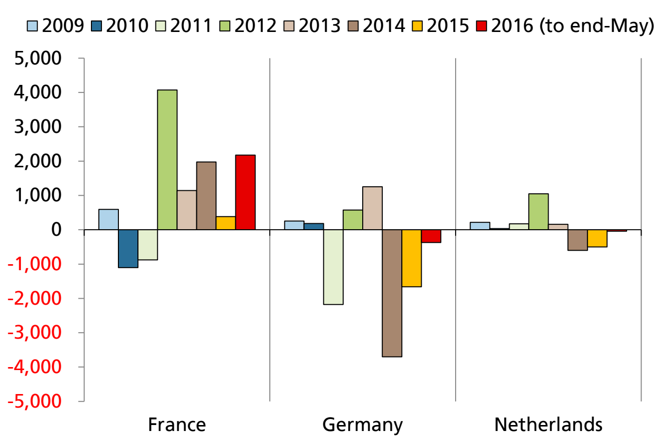
The 25y France-Germany spread continues to tighten, by about 15bp since the UK referendum, and is currently around +45bp. In light of increased event risk, we **extend the target on long 25y France vs Germany to +35bp** and tighten the stop to +55bp to lock in gains.

Figure 20: We expect the France-Germany 25y yield spread to tighten further and suggest extending the target to +35bp



Source: UBS Research, Bloomberg

Figure 21: Japanese investors' net purchases of DM sovereign bonds for selected countries per calendar year (2016 to May, ¥bn)



Source: MoF Japan, UBS

[2] European Rates Comment France: Fade the recent underperformance of the long-end vs Germany, 8 February 2016

UK: Assessing the post-EU vote outlook

John Wraith

- Almost a month after the UK electorate voted to leave the EU, the UK yield curve is reflecting a very different outlook to that anticipated prior to the referendum. The MPC opted not to cut in July, but made clear that **easing is highly likely in the near future**. We expect action in August, with a cut in Bank Rate to 0.25% and an additional £75bn of Gilt purchases to be conducted over three months as QE returns to the UK.

- The big, swift fall in sterling will help cushion the likely blow to domestic activity that should result from the crystallisation of widespread and serious political and economic uncertainty following the vote. As during the financial crisis, **this may on one hand help the economy to rebalance and recover more quickly, but on the other should lead to a spike in imported and headline inflation** that could complicate the MPC's decision making and test their credibility.

- The Governor of the Bank of England has already addressed the potential difficulties of dealing with insufficient demand at the same time as above target inflation, and as was the case after the financial crisis **we are confident any dilemma will be resolved in favour of additional stimulus being sanctioned**. Inflation expectations remain firmly under control, and as higher headline inflation will be a consequence of a weak pound and thus squeeze disposable incomes, it may in effect become a reason to deliver further stimulus rather than a reason to withhold it.

- The dramatic fall in Gilt yields that was one of the consequences of the vote to leave the EU has **pushed the cumulative deficit of private sector defined benefit pension schemes to a record £384bn** (PPF 7800 estimate). On previous occasions over the past decade when scheme balances have deteriorated significantly, pension funds' demand for Gilts has tended to increase. Over recent quarters, that has not occurred, with pension funds delaying purchases ahead of the referendum. **There is likely to be a rise in demand for longer dated debt** now the vote has passed.

- **Demand for long Gilts may also strengthen as investors move further down the curve in the hunt for yield**. Until now, the bull flattening of the conventional Gilt curve that has gathered momentum since 2015 has not extended beyond the 10y sector, but with 10y yields dropping sharply since the referendum, they have now fallen below the outright levels that triggered a grab for yield even further down the curve and drove sharp long end flattening on core Eurozone yield curves from late 2014.

- **Mounting anticipation of a return of QE is also likely to boost demand for long Gilts.** As with prior rounds of QE in the UK, we would expect purchases to be confined to conventional Gilts, and as before would therefore expect them to richen relative to international equivalents, on asset swap, and relative to index-linked debt. Some of these moves have already begun since the referendum, and we reiterate our recommendation to position for a narrowing of the yield spread between 30y Gilts and 30y Bunds, and forecast a material flattening of the 10s30s sector of the conventional curve.

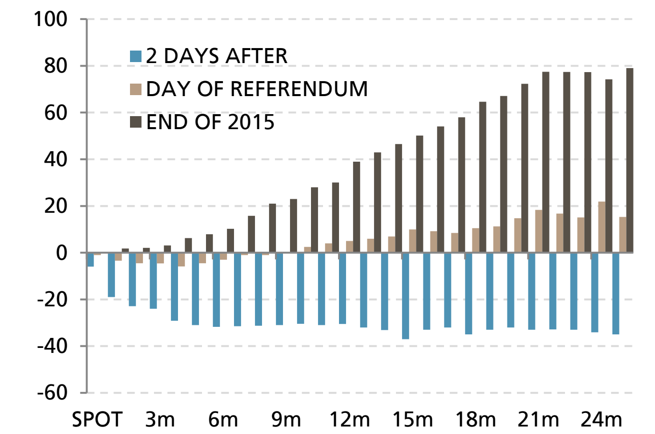
Monetary policy expectations transformed by the referendum outcome

While UK economic data had been gradually losing momentum over the first six months of the year, there was still an expectation that the next change in the stance of monetary policy would be a tightening. The anticipated timing of the first hike had moved out steadily since the start of the year – from November 2016 in January to around the middle of 2018 by the day of the referendum – but the expected direction of travel was the same.

Within two days of the confirmation that the UK had voted to leave the EU, this expectation was transformed, with the market fully pricing in an imminent cut in Bank Rate to 25bp, and a high probability of a further near term cut towards zero (Figure 22). While MPC members have repeatedly suggested in the past that negative rates under any circumstances are unlikely in the UK, even this scenario has now been priced in over the next year with a reasonably significant probability (Figure 23)

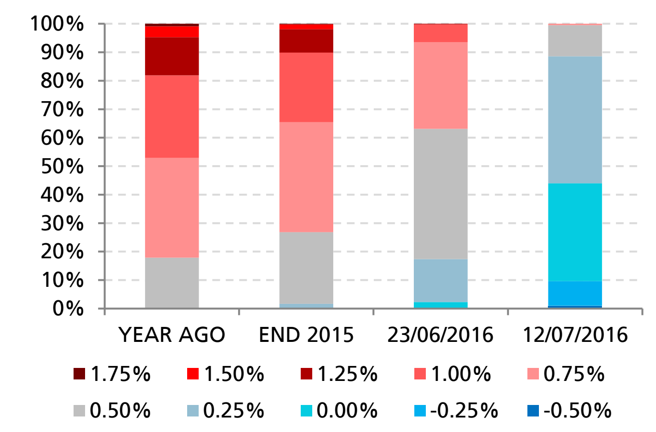
Within two days of the referendum, the front end was fully pricing in a 25bp rate cut, and a high probability of further easing beyond that

Figure 22: Expected change in 1m OIS rate compared to current SONIA rate, x months forward (bp)



Source: Bloomberg, UBS Global Research

Figure 23: Where will Bank Rate be in one year? Implied probabilities from OIS swaps market at different dates



Source: Bloomberg, UBS Global Research

Against market expectations, but in line with our forecast, the MPC opted not to cut Bank Rate at their July meeting. Although this triggered quite a strong reaction in sterling and short end rates, we don't think it in any way signals a less dovish intent than was previously anticipated. Indeed, the tone of the minutes if anything pointed to a higher likelihood of an aggressive response going beyond conventional rate cuts, and led us to **bring forward our forecast of additional QE from February 2017 to as soon as the next meeting on the 4th August**. Specifically, the minutes stated that "most members expected monetary policy to be loosened in August", and confirmed that the Committee had "an initial exchange of views on various possible packages of measures", hinting at a combination of different policy responses being enacted next month, in our view in the form of a cut in Bank Rate and a resumption of QE.

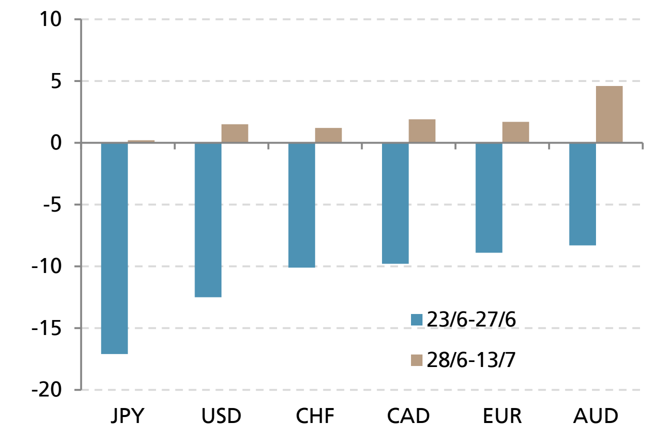
The MPC did not cut Bank Rate in July, but made clear an intention to act soon and decisively to address the expected sharp economic slowdown

The day after the MPC meeting and minutes, the text of [a speech made by BoE Chief Economist Andy Haldane] was released, confirming that for him at least, aggressive and rapid easing is indeed merited. He asserted that "given the scale of insurance required (in light of the shock to activity likely to have been caused by the referendum outturn), a package of mutually-complementary monetary policy easing measures is likely to be necessary. (It) needs to be delivered promptly as well as muscularly…and by promptly I mean next month".

The plunge in sterling cushions the blow to domestic demand

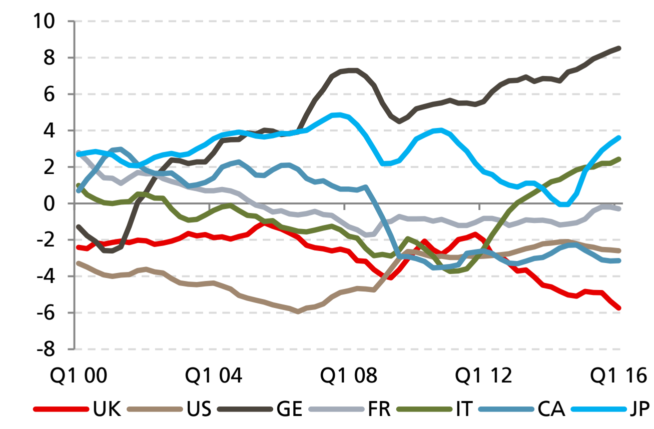
The unexpected outcome of the referendum sent sterling spiralling lower, with the trade weighted index falling by -8% in just two trading days following the result. Although volatility has remained fairly high since then, the overall performance of the pound since those early moves has in fact been remarkably stable, as shown in Figure 24. This decline has broadly been welcomed by the Bank of England, with the Governor observing that it is a necessary adjustment to absorb some of the impact of the sudden shift in the expected trajectory of the UK economy. It will help reduce the scale of the current account deficit (a particularly acute problem for the UK – Figure 25), enhance the competitiveness of UK exporters, and give domestic producers an advantage over their international competitors.

Figure 24: Change in sterling against selected currencies in the two days after the referendum, and the following two and a half weeks (%)



Source: Bloomberg, UBS Global Research

Figure 25: Current account balance for G7 countries (% of GDP), 2000-2016



Source: Bloomberg, UBS Global Research

Higher inflation a likely consequence, but it won't prevent easier policy

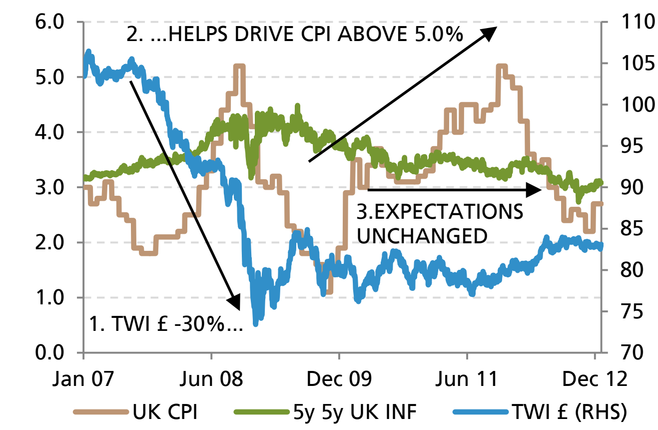
The precipitate decline in sterling seen in the immediate aftermath of the referendum result followed a long period of much more gradual, but cumulatively material, declines in the currency. The trade weighted sterling index is currently around 15% below its levels of a year ago, and a move of this magnitude should powerfully stimulate imported inflation pressures over the coming months and quarters. This development has already been predicted by the Bank of England, with Governor Mark Carney warning in his speech of the 30th June that the MPC may in due course have to weigh up the conflicting impact of elevated inflation on one hand, and insufficient activity and demand on the other.

"…the MPC will face a trade-off between stabilising inflation on the one hand and avoiding undue volatility in output and employment on the other. The implications for monetary policy will depend on the relative magnitude of these effects"

Mark Carney, BoE Governor, 30th June 2016

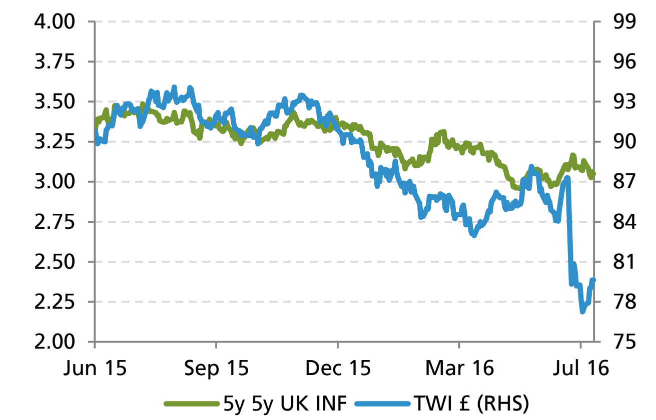
In our view, this trade-off is sure to be resolved in favour of providing additional stimulus to offset the downside risks to activity, rather than withholding it due to higher headline inflation. As this inflation should be in very large part due to the weaker pound, it in no way reflects the strength of domestic demand, and by squeezing disposable incomes it should exacerbate the risks to consumption and thus becomes effectively a reason to ease rather than a reason not to. Certainly, this was the lesson from the period after the financial crisis, when aggressive easing was conducted even though CPI rose to as high as 5.2% during the same period. Inflation expectations – well anchored now as they were then – gave the MPC the freedom to act to address insufficient demand without any concerns about damaging their inflation-targeting credibility (Figure 26, Figure 29).

Figure 26: Trade weighted sterling, headline CPI, and inflation expectations before and after the financial crisis



Source: Bloomberg, UBS Global Research

Figure 27: So far, the big drop in sterling over the past eight months has not dislodged inflation expectations



Source: Bloomberg, UBS Global Research

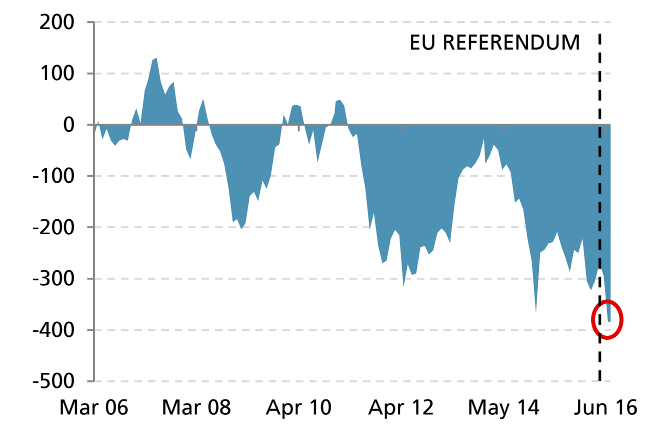
Sharp drop in longer yields sends pension funds into record deficit

Among the violent market moves that occurred following the referendum outcome were very pronounced declines in longer dated UK interest rates and bond yields. This triggered a large rise in the net present value of the liabilities of defined benefit pension funds, because future estimated payments are discounted off long dated yields and thus result in a higher present value when yields fall.

Market moves after the EU referendum generated a record deficit for UK defined benefit pension schemes

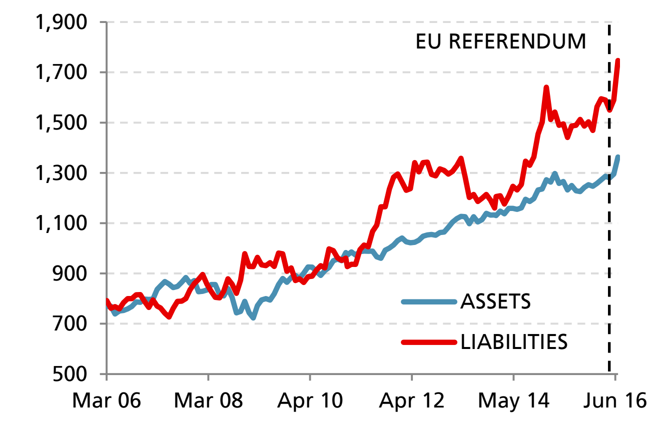
The Pensions Protection Fund publishes a monthly index (PPF 7800) to track the performance of these schemes, and revealed that at the end of June, this huge fall in long dated yields had driven cumulative scheme deficits to a record -£384bn (Figure 28). Although the rise in UK equity prices that was another response to the vote to leave the EU did help increase the value of schemes' assets over last month by £68bn to a record £1,363bn, this was overwhelmed by the £157bn increase in the net present value of their liabilities to £1,747bn (Figure 29)

Figure 28: Cumulative UK private sector defined benefit pension fund scheme balance (PPF 7800 index, Mar 2006-Jun 2016, £bn)



Source: Pension Protection Fund, UBS Research

Figure 29: Cumulative UK private sector defined benefit pension fund scheme assets and liabilities (PPF 7800 index, Mar 2006-Jun 2016, £bn)

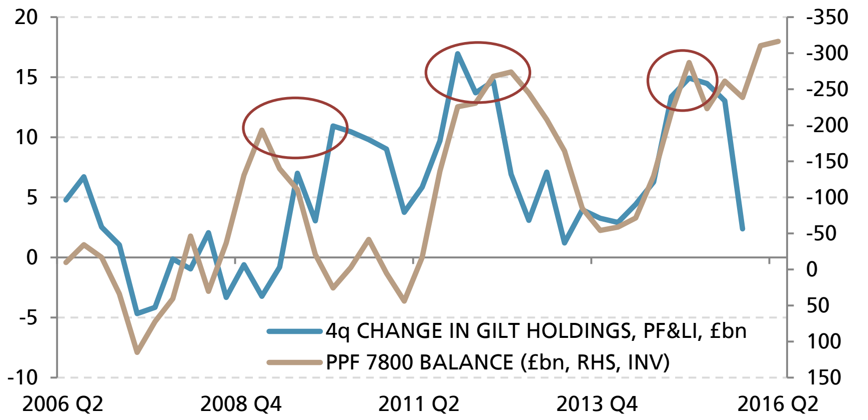


Source: Pension Protection Fund, UBS Research

Predicting how pension funds' demand for Gilts will develop is always uncertain, but this big deterioration in schemes' funding position should increase the pressure for them to better match their assets to their liabilities and thus to avoid the impact

of further drops in yield that are not offset by sufficiently large rises in the value of their (other) assets in the future. As Figure 30 shows, there has been a tendency in the past for periods of high and rising scheme deficits to either presage (ie, 2009-2010) or closely coincide with (ie, in 2012 and 2015) a jump in demand for Gilts from domestic non-financial institution investors, and we expect to see a similar pattern again over the coming quarters.

Figure 30: Change in Gilt holdings of UK pension funds and life insurers, and PPF 7800 defined benefit pension fund scheme balance (3m ave), Q2 2006-Q2 2016



Source: Pension Protection Fund, DMO, UBS Global Research

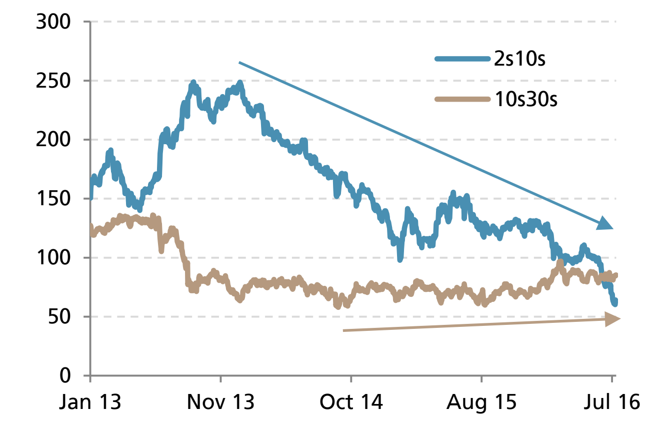
Hunt for yield likely to magnify pension fund demand at the long end

Demand for long Gilts should be magnified by investors extending down the curve in the hunt for yield

The long-term nature of pension funds' liabilities, and the fact that as a result the discount rate used to calculate the present value of those liabilities is linked to long end yields, means pension funds acting to align their assets and liabilities concentrate their purchases in long conventional and index-linked Gilts. We therefore expect to see a strong performance in long Gilts over the coming months, and this is likely to be magnified by a tendency for other investors too to switch their focus further down the yield curve.

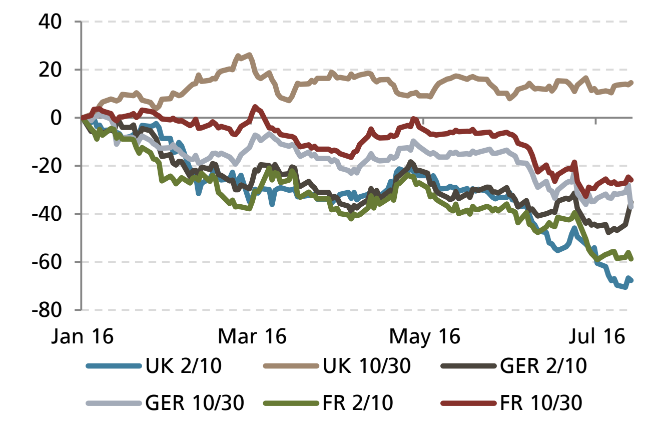
The conventional Gilt curve out to the 10y area has generally been flattening steadily since the taper tantrum came to an end in late 2013, with the persistently low level of shorter dated yields forcing investors to extend further down the curve in the hunt for yield. As yet, that flattening trend has not extended beyond the 10y sector, however (Figure 31), in contrast to the behaviour of these yield curves in core Eurozone sovereign debt markets over recent months, where the flattening has occurred not just in the 2s10s sector, but out to the 30y sector as well (Figure 32).

Figure 31: Generic Gilts – 2s10s and 10s30s Jan 2013-Jul 2016 (bp)



Source: Bloomberg, UBS Global Research

Figure 32: Generic 2s10s and 10s30s yield spreads in the UK, Germany and France, change since 1 Jan 2016 (bp)



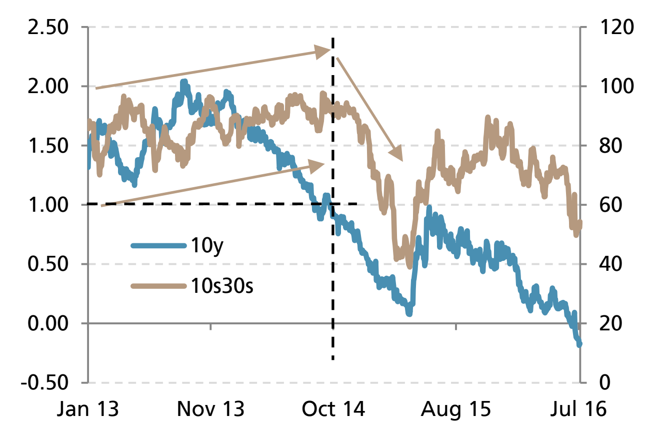
Source: Bloomberg, UBS Global Research

We believe there are two main reasons why relative demand at the long end has been stronger in the core Eurozone markets than the UK, and both are factors that may soon trigger a similar flattening of the 10s30s sector of the yield curve in the UK too – the first is the very low level reached by 10y yields earlier in the year that encouraged investors to extend further down the yield curve to seek higher returns, and the second is the impact QE has on longer dated debt on the back of strong Central Bank demand.

10y yields dropping below 1.0% in Germany was the trigger for flattening in the 10s30s sector. 10y Gilts have recently dropped below that level too.

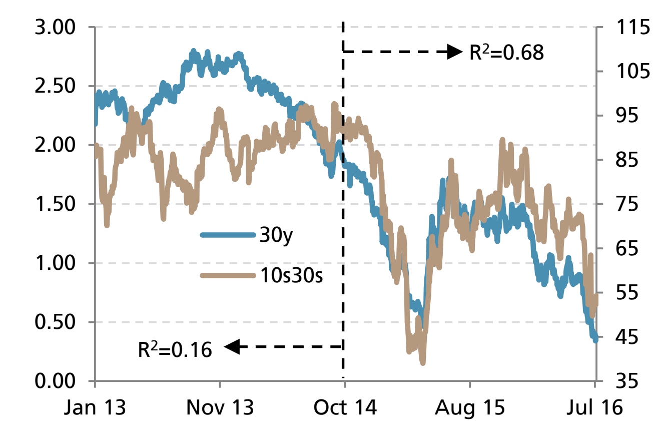
In the case of Germany, it was only after 10y Bund yields broke decisively below 1.00% in late 2014 that the long end started to outperform and the yield curve to flatten (Figure 33), illustrating that it was when mid maturity yields got that low, investors felt that the balance between the need for greater returns on one hand, and the higher delta and thus volatility of performance of the long end on the other had finally tipped in favour of the former. Since then, as Figure 34 shows, the 10s30s sector has been much more directional, flattening during times of falling yields and steepening during sell-offs (as the pressure to extend and seek greater returns ebbs and flows).

Figure 33: 10y Bund yields dropping below 1.00% was a trigger for the 10s30s sector of the yield curve to start flattening…



Source: Bloomberg, UBS Global Research

Figure 34: …and since then, there has been a strong directional correlation between outright yields and the 10s30s sector of the yield curve



Source: Bloomberg, UBS Global Research

In the wake of the referendum result last month, 10y Gilt yields decisively – and for the first time ever – broke below 1.00%. We believe they are set to stay there, and indeed to move lower over the coming months, and anticipate the same behaviour from investors in search of yield as seen in Germany over the past year and a half. We expect 10s30s on the conventional Gilt curve to become well correlated with outright yields, and to flatten as those yields push lower over the rest of the year.

Mounting anticipation of QE a further fillip for the long end

We expect the MPC to cut Bank Rate to 0.25% on 4th August, and to endorse £75bn of additional QE to take place over the following three months

With the MPC reticent to cut Bank Rate below zero under any circumstances, market attention will soon start to focus increasingly on what other policies may be introduced to help address ongoing slowing of the UK economy over the coming months, if the modest amount of conventional ammunition together with the big fall in market rates and the currency are not in themselves sufficient to turn the tide (possibly with easier fiscal policy also assisting in due course). As a result of comments made in the minutes of the MPC's July meeting, **we now expect £75bn of asset purchases over three months to be announced following the August meeting as QE is reintroduced**. The speech made by Andy Haldane – referred to above – strengthens our conviction that an announcement along these lines may well be imminent.

Should the MPC choose to follow a programme similar to the one followed in the second wave of QE in the UK between October 2011-October 2012 (and the latter part of the first wave in 2009-10 once the maturity buckets had been adjusted partway through the programme), the Bank of England's Asset Purchase Facility (APF) will inject an equal amount of reserves into three sections of the conventional Gilt curve (3-7y, 7-15y, and more than 15y of residual maturity).

In risk terms, the purchases of long Gilts have a far greater impact than those of short and medium dated debt

As Figure 35 shows, there is a larger amount of debt available to be purchased at the long end (the Bank has a limit of 70% of the remaining free float), so there is less chance of a shortage of stock causing a general richening of the sector, but in indicative risk terms, the APF's purchases will have a far greater impact than in the medium, or short, sector. To work out the basis point value of £10bn of purchases in each sector, we have assumed the APF will buy each issue in the sector in proportion to the remaining free float of each bond.

Figure 35: Summary of QE-related dynamics of the conventional Gilt portfolio as at 14th July 2016

RESIDUAL MATURITY	TOTAL IN ISSUE £bn	BoE HOLDING £bn	70% OF FREE FLOAT £bn	AVAILABLE TO BoE £bn	bpv PER £10bn £m
3-7y	270.70	84.00	176.81	92.81	4.80
7-15y	209.79	71.09	130.81	59.72	9.48
>15y	393.41	101.24	245.10	143.86	32.59

Source: Bloomberg, Bank of England, UBS Global Research

We recommend 10s30s flatteners in conventional Gilts, and continue to favour buying 30y Gilts against 30y Bunds

The much more significant market impact that will be exerted at the long end if evenly spaced QE is reintroduced, as we expect, will magnify the flattening pressure we see being exerted by pension fund demand and the tendency of other investors to push further along the yield curve in their hunt for yield. **We recommend entering 10s30s flatteners in conventional Gilts (generic spread currently at 85bp, target 60bp, stop at 100bp). We also reiterate our prior recommendation to buy 30y Gilts against 30y Bunds (currently at 117bp, target at 75bp, stop at 165bp).**

Switzerland: updated yield forecasts

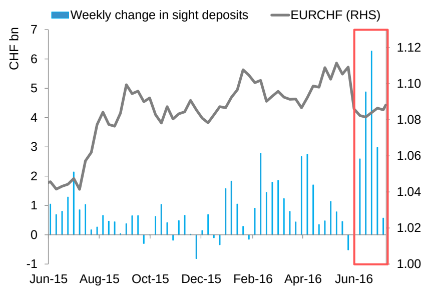
Nishay Patel

- We forecast a gradual rise in 10yr Swiss yields (to -0.10% by end-2017), supported by an anticipated rise in German yields, Swiss CPI and EURCHF. 10yr Swiss yields are unlikely to turn positive until at least 2018, in our view
- FX interventions are expected to be the policy tool of choice to guard against an appreciating CHF and we do not envisage any rate cuts (or a change to the exemption thresholds on sight deposits) within the next 12 months. We suggest fading any moves that imply a 20-25bp rate cut within the next 12 months.

Signposts for the months ahead

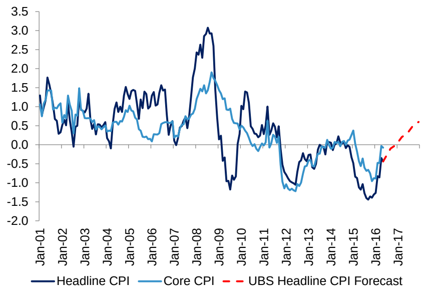
- On the domestic front we expect market participants to pay attention to movements in the Swiss franc over the coming weeks and changes in weekly sight deposits at the SNB. The last few weeks have seen a small increase in sight deposits following much larger increases in previous weeks, as the CHF has depreciated slightly.
- The latest CPI data in Switzerland showed YoY inflation remained at -0.4%. The July CPI reading due to be released on 8 August will shed some more light on whether the pick-up in inflation so far this year will continue. Our economics team looks for CPI to increase to 0% by end-2016.
- The agenda for September is busier: 2Q-16 GDP and August CPI will both be released on 6 September and the SNB will meet on 15 September.

Figure 36: EURCHF vs weekly change in sight deposits (4wk rolling average)



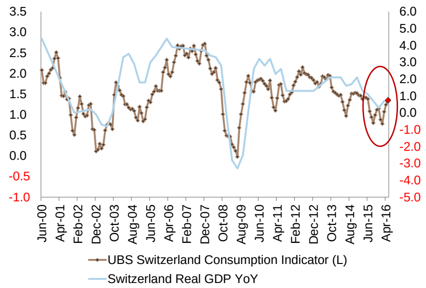
Source: Bloomberg, SNB, UBS

Figure 37: Swiss inflation: core and headline (YoY change)



Source: Haver, UBS

Figure 38: UBS Switzerland Consumption Indicator vs Switzerland Real GDP YoY



Source: UBS, Bloomberg

A gradual rise in 10yr Swiss yields, alongside Germany

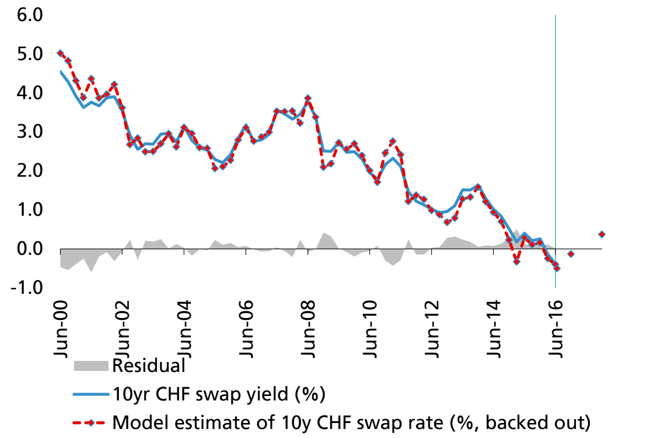
The outcome of the UK referendum has prompted a change to our economic forecasts in a number of economies (including Switzerland) and a revision to our yield forecasts in US Treasuries, German Bunds and UK Gilts[3]. Switzerland is no different and we now expect 10yr Swiss yields to end 2016 at -0.40% and 2017 at -0.10%. The bias is for yields rising less than we expect if risk aversion continues to remain persistently high, as this could result in a longer than expected period for core European rates to realign with fundamentals.

[3] We now expect 10yr German yields to moderately rise to 0.50% by end-2017 and 10yr US Treasuries yields to rise to 1.50%.

Modelling 10y CHF swap yields using nominal growth and policy rate differentials between Euro area and Switzerland to back out the implied 10yr swap yield points to yields remaining low and rising gradually.

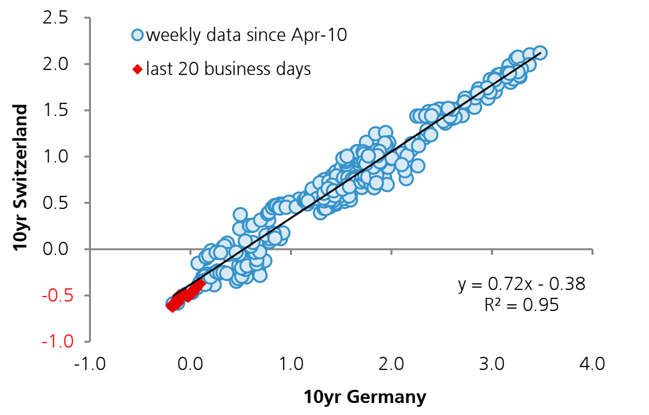
- Strategy: Be underweight the 10yr sector of the Swiss curve

Figure 39: Our model suggests that 10y CHF yields will remain low and rise only gradually



Source: UBS Research, Bloomberg

Figure 40: 10y Swiss yields continue to remain highly correlated with German yields (which we expect to rise)



Source: UBS Research, Bloomberg

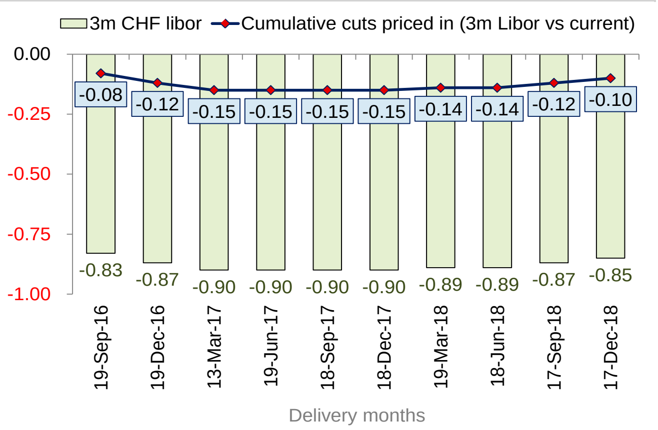
Short-end yields

The Swiss franc has been relatively stable since the outcome of the UK referendum, prompting a reduction in market expectations of a 25bp rate cut by year-end (Figure 42).

We expect FX interventions to be the policy tool of choice to guard against an appreciating CHF, as frequently noted by the SNB. A further cut in the interest rate (or a change in exemption thresholds on sight deposits) would only be an option, in our view, if substantial intervention is required by the SNB to keep EURCHF above 1.05-1.07. We expect EURCHF to move higher and our base case is for no further cuts to the policy rate and we view market expectations of a 15bp cut within the next 12 months as too dovish.

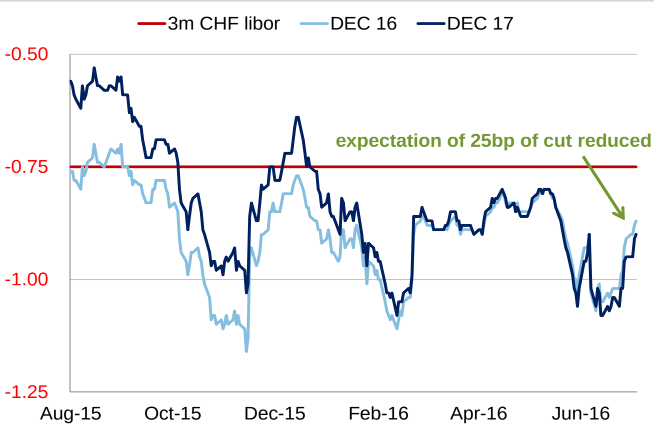
- Strategy: Fade any moves that imply a 20-25bp rate cut within the next 12 months.

Figure 41: Cumulative policy rate cuts priced in



Source: UBS Research, Bloomberg

Figure 42: 3m Euroswiss futures have priced in 15bp cut



Source: UBS Research, Bloomberg

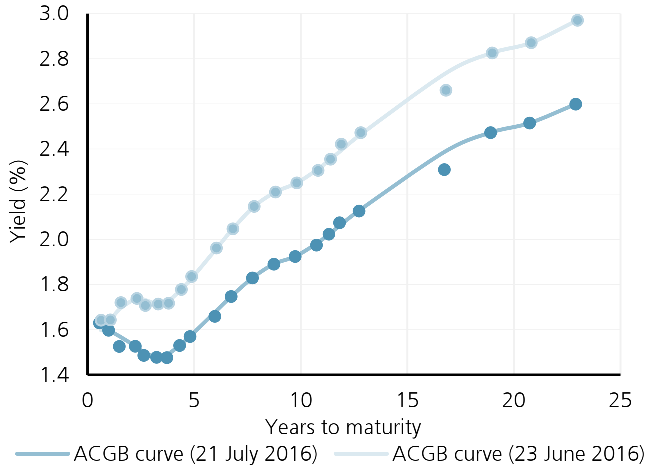
Australasia: Falling boomerangs rarely return

Joakim Tiberg

- A global market environment characterised by **reach-for-absolute-yield should benefit Australia and New Zealand**. Our view that both the RBA and the RBNZ will cut rates in August further underpins this notion. Curves are undoubtedly flat, but we would not fight it; we see value in moving out of the front-end into longer tenors given the macro backdrop.
- We expect the increase in headline inflation between now and year-end to be smaller in Australia than New Zealand and the US. **This poses risks that Australia could underperform on a cross-market basis. However, shorter Aussie breakevens look attractive. NZ breakevens remain unduly cheap, in our view**.
- **If the central banks, against our expectations, hold rates steady in August, we recommend overseas investors add to FX-unhedged bond holdings**. Relatively high yielding markets with a reluctance towards rate cuts could in the current yield-grab environment be expected to see rapidly appreciating currencies, but not necessarily higher yields (similar to developments post the RBNZ's on-hold decision in June).

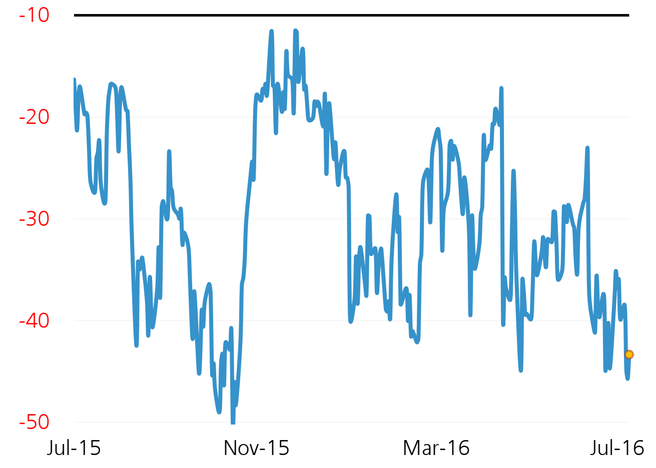
A *full-length version* of this article was published on 11 July.

Figure 43: The ACGB curve: current vs. the day before the UK leave vote



Source: Bloomberg, UBS. Conventional bonds. As of 11 July 2016.

Figure 44: Market expectations of change in the RBA Cash Rate over one year (AUD OIS 11m1m – RBA Cash Rate, bp)

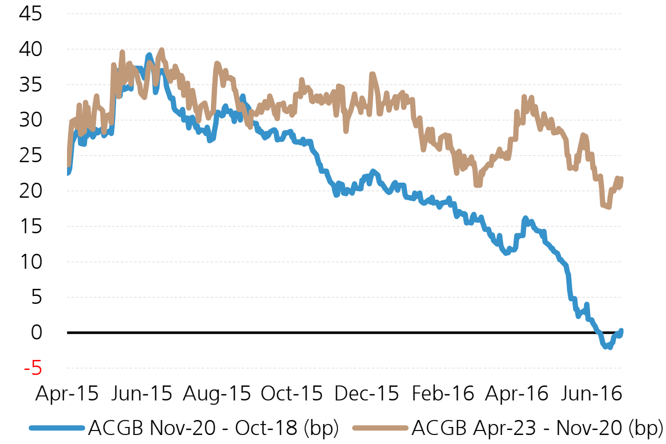


Source: Bloomberg, UBS

In terms of important data points ahead of the central bank meetings in August, we look to Australia Q2 inflation on 27 July. UBS forecasts 1.1% YoY and 1.6% YoY in headline and underlying CPI, respectively. Upside surprises add to the likelihood of on-hold rate decisions.

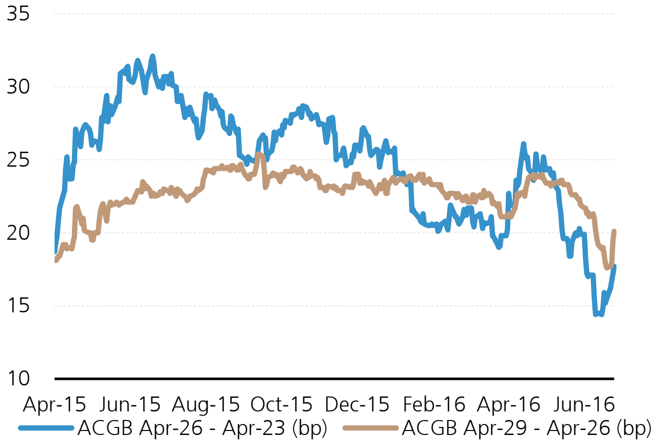
While we call for August rate cuts, we see limited value in front-end of curves. The ACGB curve is inverted to the ~4-5y point (Figure 43), and the market is pricing in ~43bp of easing over the next 12 months, towards the wider end of the recent range (Figure 44). We see better risk-reward in extending from <5y bonds into the 7-8y sector (Figure 45), and the 10y sector into 12y+ tenors (Figure 46). Tenors beyond the front-end could to a larger extent also be expected to benefit from any global yield grab.

Figure 45: Extension trades from <5y bonds into the 7-8y part of the curve look attractive



Source: Bloomberg, UBS

Figure 46: Extensions beyond 10y also seem attractive

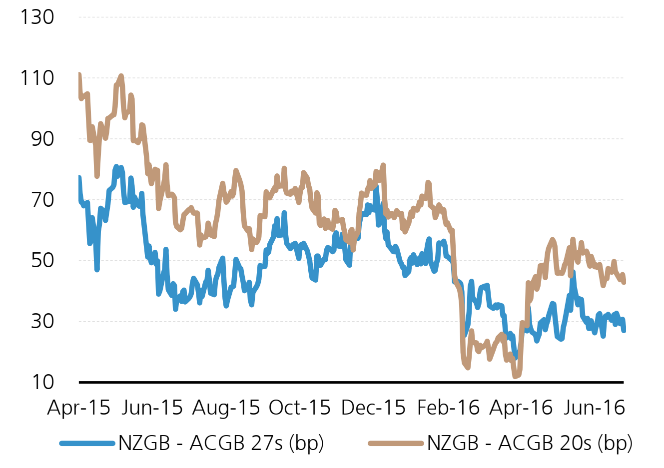


Source: Bloomberg, UBS

We do not have a strong view on Aussie – US spreads in the near-term. A perfect storm of growing expectations of easing from the RBA combined with the global macro backdrop has so far in particular benefited the 10y sector on a cross-market basis. However, as we now consider the front-end of the Aussie curve quite rich, we see the near-term path largely dependent on how Fed rhetoric develops from here.

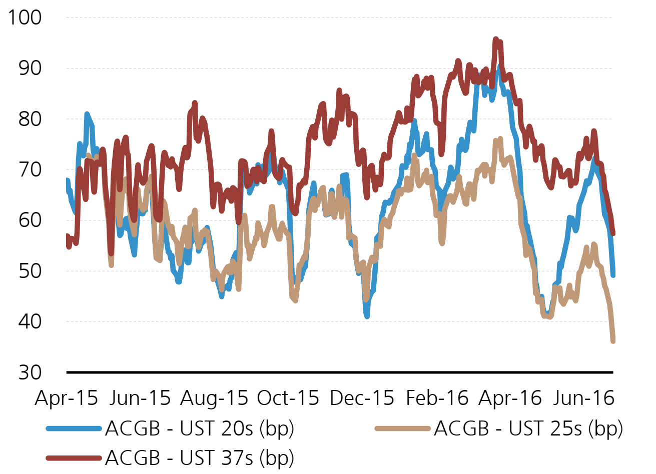
In New Zealand, we see value in front-end bonds vs. ACGBs going into the August central bank meetings. Chances are that the RBNZ will come out on a stronger easing bias amid a too-strong-for-comfort currency.

Figure 47: Shorter NZGBs still look a bit cheap vs. ACGBs going into central bank meetings in August



Source: Bloomberg, UBS

Figure 48: Bonds: Aussie – US spreads (bp)



Source: Bloomberg, UBS

On inflation, our economists expect the increase in headline CPI between now and year-end to be smaller in Australia than New Zealand and the US[4] (Figure 49). This poses risks that 10y Australian breakevens could underperform on a cross-market basis.

[4] In short, the reason why base effects will be less pronounced in Australia is because of a smaller Australian fuel component and a higher tax component of fuel than in the US CPI. Further, Aussie prices rose by a relatively strong 1.7% YoY in Q4-15. Elsewhere, New Zealand saw a large drag from food in Q4-15, resulting in a record low 0.1% YoY inflation print.

Figure 49: Headline CPI forecasts for the US, Australia and New Zealand (YoY, %). It gets warmer in the US first

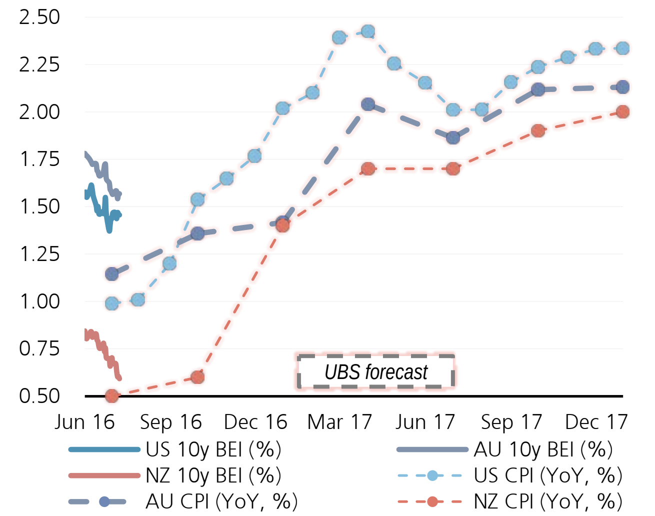
	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17
US	0.7	1.4	1.0	0.9	1.1	1.0	1.0	1.0	1.2	1.5	1.6	1.8	2.0	2.1	2.4	2.4	2.3	2.2	2.0	2.0	2.2	2.2	2.3	2.3	2.3
Australia	1.7			1.3			1.1			1.4			1.4			2.0			1.9			2.1			2.1
New Zealand	0.1			0.4			0.4			0.6			1.4			1.7			1.7			1.9			2.0

Source: Bloomberg, UBS (incl. forecasts)

However, shorter Aussie breakevens look attractive. With inflation likely to bottom out in Q2 at 1.1% before bouncing to 1.4% in Q3, we see upside in linkers 2018-2022 post Q2 CPI. The 2018 Aussie breakevens trade ~103bp, 2020s ~127bp and 2022s ~147bp. UBS' headline inflation forecasts from now until end-2017 averages a year-on-year pace of 172bp.

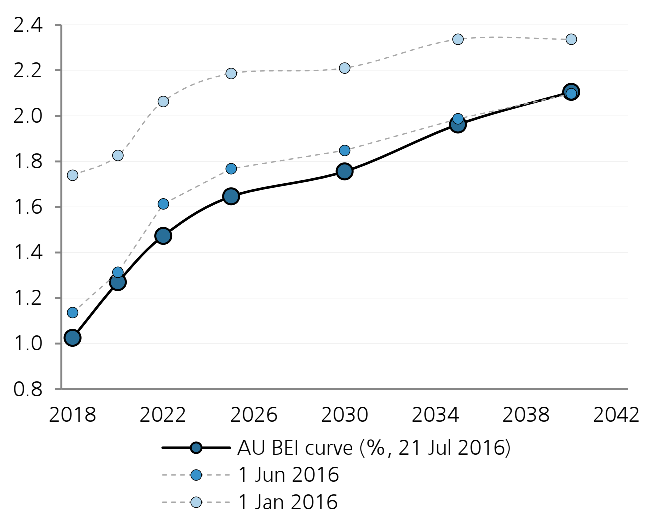
In New Zealand, 10y linkers remain unduly cheap at ~65bp on a breakeven basis. This compares to our Q4 CPI forecast of 140bp YoY.

Figure 50: Current 10y US, Australian and New Zealand breakevens vs. UBS' headline inflation forecast to end-17



Source: Bloomberg, UBS (incl. forecasts)

Figure 51: Front-end Aussie breakevens have dropped ~70bp this year. Recovery likely post Q2 CPI



Source: Bloomberg, UBS

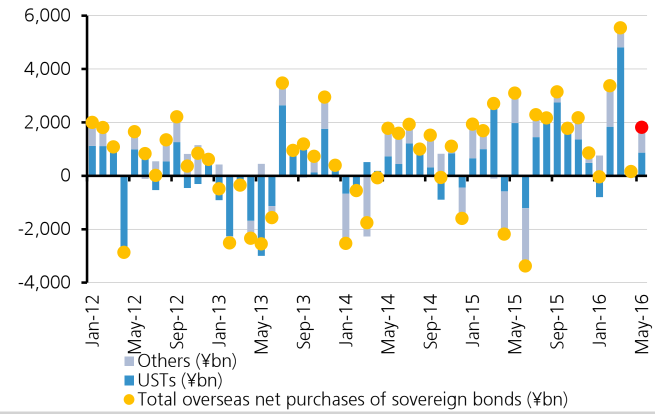
Japan: What Japanese Investors are buying

Joakim Tiberg

Nishay Patel

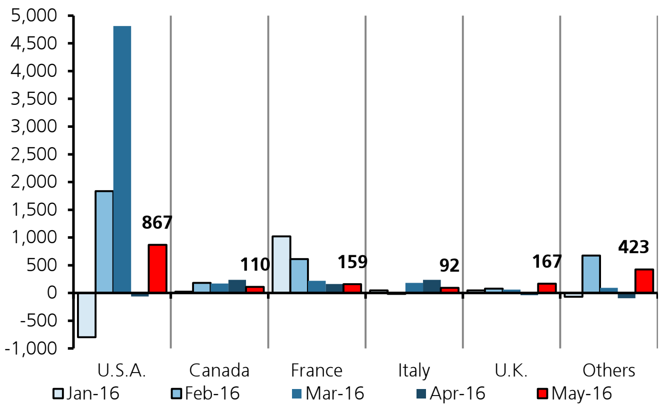
- We have previously described how Japanese investors have been significant net buyers of foreign assets – predominantly DM government bonds – in light of the BoJ's negative interest rate policy. Net purchases have recently regained momentum, following a slowdown around the turn of the Japanese fiscal year.
- Japanese net buying of sovereign bonds recovered in May (¥1.8tn vs. ¥0.2tn in April), though was still well below the record level seen in March (¥5.5tn). US Treasuries made up for nearly 50% of all net purchases. France, Japan's historically preferred euro market, saw modest net buying of ¥159bn, roughly unchanged from April. Elsewhere, Canada and Italy saw continued net purchases, albeit at a slightly slower pace than in April.

Figure 52: Japanese investors' monthly net purchases of sovereign bonds: US Treasuries vs. others



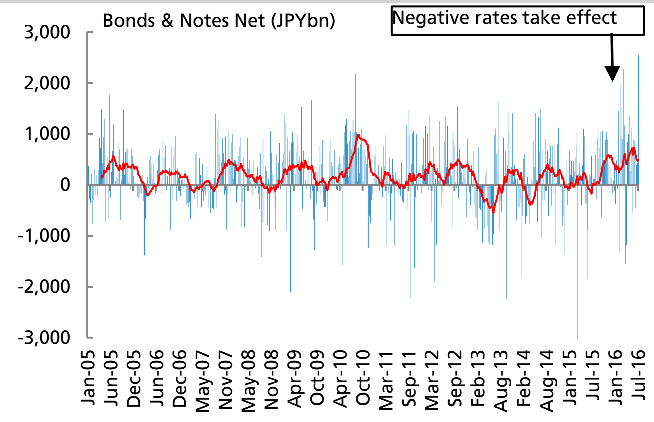
Source: MoF Japan, UBS

Figure 53: Japanese investors' net purchases of DM sovereign bonds per month for selected markets (¥bn)



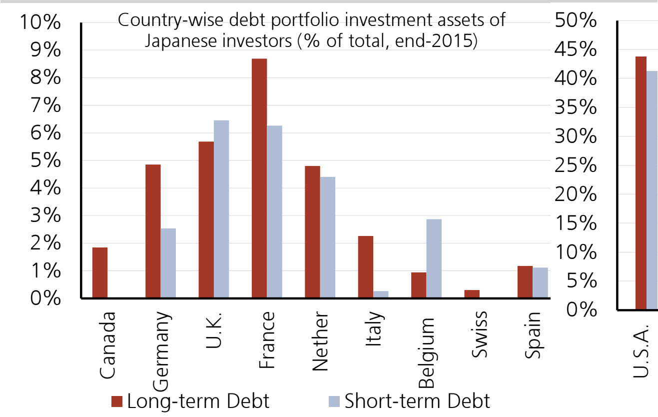
Source: MoF Japan, UBS

Figure 54: The more recent but less granular weekly flow data indicates that Japanese investors' net purchases of foreign bonds picked up further since May. Purchases in the first week of July were the largest on record.



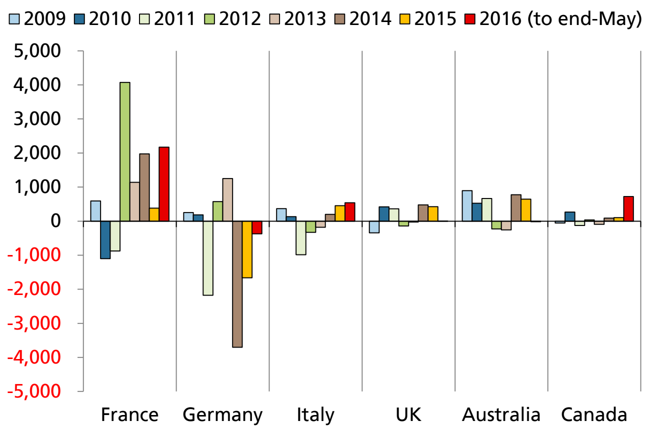
Source: MoF Japan, UBS *The MoF data is based on reports from designated major investors*

Figure 55: The US is Japanese investors' single biggest overseas market, making up for >40% of foreign fixed income allocation. In Europe, France is preferred



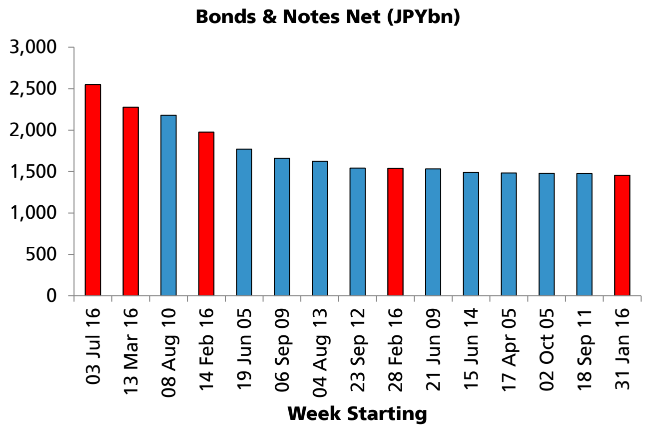
Source: BoJ, UBS

Figure 56: Japanese investors' net purchases of DM sovereign bonds for selected countries per calendar year (2016 to May, ¥bn)



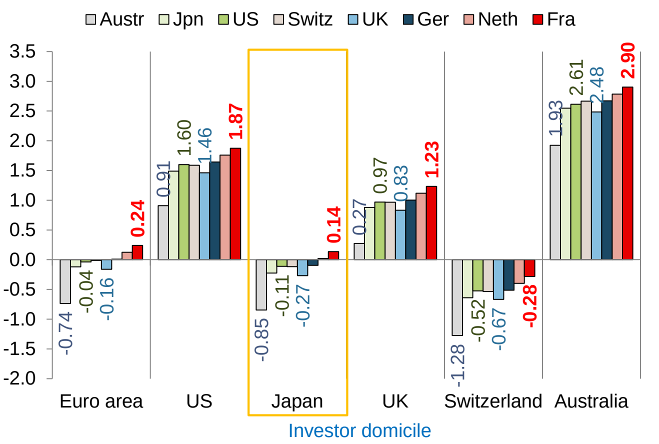
Source: MoF Japan, UBS

Figure 57: Net purchases of foreign bonds by Japanese residents (¥bn), ranked by the fifteen largest weeks (since the start of the data in 2005). Red bars = weeks in 2016



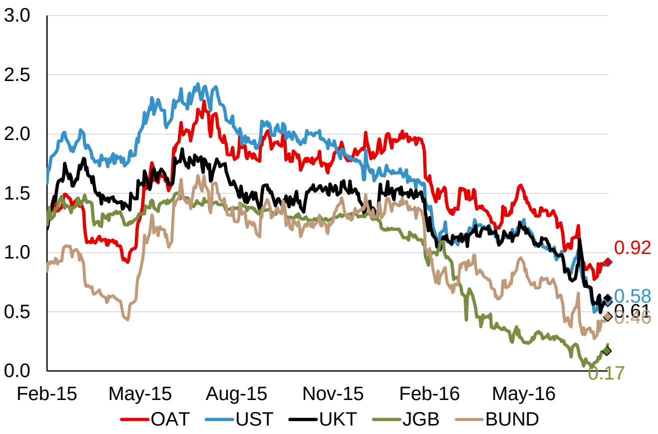
Source: MoF Japan, UBS

Figure 58: 10yr FX-hedged yields* for investors in various domiciles (%): French & US bonds stand out as attractive



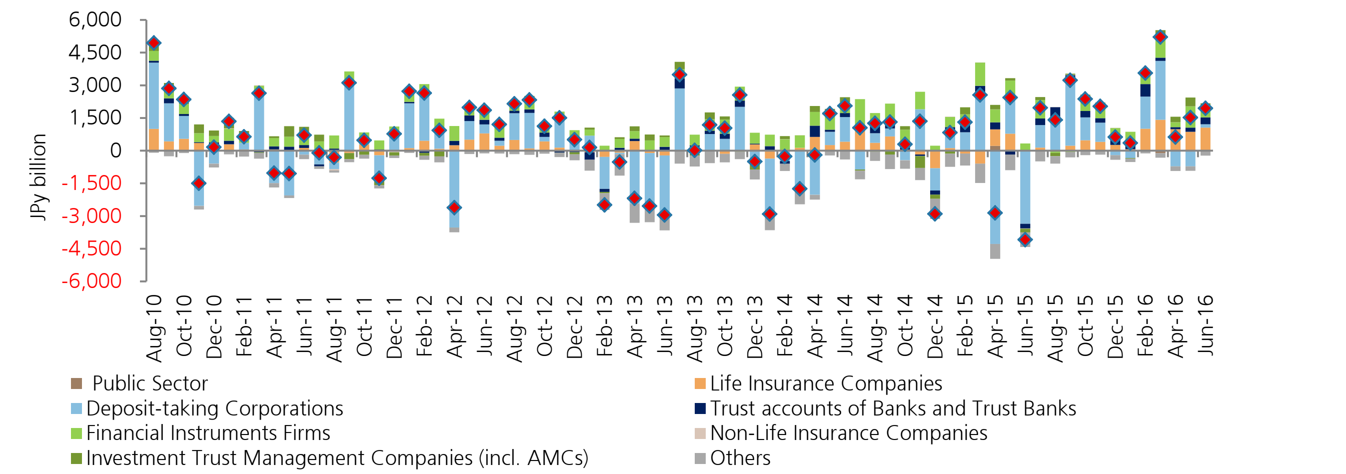
Source: UBS, Bloomberg * Using 1-year FX-forwards

Figure 59: 30-year FX-hedged yields* for Japanese investors (%): overseas bonds comparatively attractive



Source: UBS, Bloomberg * Using 1-year FX-forwards

Figure 60: Japanese residents' net purchases of foreign long-term debt securities by investor type (¥bn). Net purchases further increased in Jun-16 (¥1945bn) and have shown an upward trend since Apr-16.



Source: MoF Japan, UBS

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We would like to thank Maria Jaworska for her assistance in preparing this research report.

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