

# Supply, Demand & Curve

20 Feb 2012

GLOBAL DEBT RESEARCH

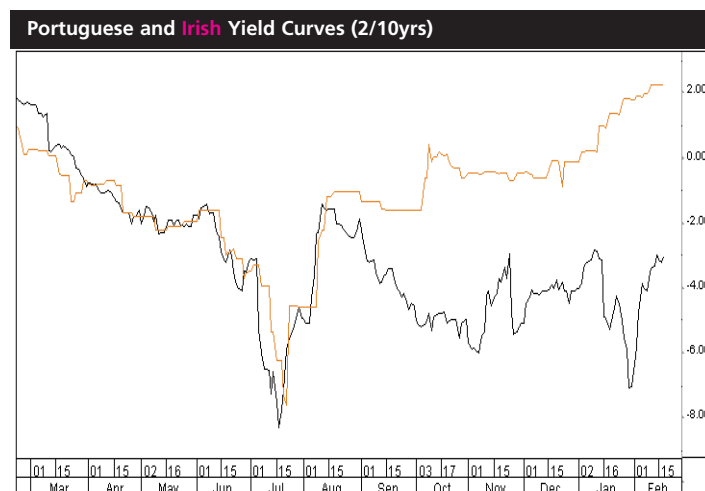
## Portuguese Curve Ball

- Second Greek "bailout" package stumbling to agreement, with targeted debt/GDP ratio supported by ECB machinations
- Enduring contagion fears for Portugal, wherein sustained yield curve inversion betrays misplaced "me too" PSI anxieties
- Renewed official funding support for Portugal desirable on both domestic and systemic grounds; pre-announcement likely

"Regarding the PSI involvement, we have made a major change to the doctrine. We are now sticking to the IMF principles and practises. Our first approach to PSI, which a negative impact on debt markets, is now officially over" (Herman Van Rompuy, 9 December, 2011)

It is a second to midnight, but a deal is nigh. Following yet another week's wrangling amongst Eurozone politicians regarding the E130bn aid package for Greece, Fri's conference call involving Messrs Merkel, Papademos and Monti expressed confidence that today's Eurogroup meeting in Brussels will "find a solution for open questions" so as to finally approve the bailout. Greece's funding deal will be announced alongside that long-negotiated debt exchange for private creditors (PSI), together with some degree of official sector involvement (OSI), however circuitously it is delivered by the ECB and its national central banks. The Hellenic parliament will tomorrow approve the retrofitting of collective action clauses (CACs) on outstanding government debt, so as to maximise "voluntary" participation in the scrambled PSI, while creditor nations will append some modest flex to Greece's 2020 debt sustainability target, following Schaeuble's weekend concession that "the 120% may be 122% or 123%, it musn't be 130%". To be sure, any Greek deal will, of necessity, be accompanied by (implementation) health warnings, but it will also represent another critical step towards arresting contagion risks in the Euroland sovereign debt crisis, thereby accelerating its final resolution. Greece's adverse debt dynamics have proven to be an "exceptional and unique" difficulty for the Eurogroup to overcome, but its policy prescription has not yet been accepted as "exceptional and unique" by an understandably traumatised investor base for Euroland sovereign debt. In this respect, the Portuguese bond market is now the classic case in point.

Troika inspectors returned to Lisbon last Wed to conduct their third review of the country's Adjustment Programme since commencement in late-May, 2011. This nation was an unavoidable victim of Euroland's enveloping debt crisis, given its acute net external liabilities (across the sovereign, banks and non-banks) and sclerotic (1%+) growth potential. A E78bn financial aid package for 2011-14 was agreed, contingent on a credible fiscal consolidation strategy, restructuring of the banking system and, not least, "deep and front-loaded structural reform to boost potential growth, create jobs and improve competitiveness" via enhanced labour and product-market flexibility. A new government



was elected with a strong democratic mandate for programme delivery, and thus far targets are being met, if not exceeded. Indeed, Portugal is now indicating a 4% budget deficit/ GDP outturn for 2011, well below the planned 5.9% level (and 9.8% in 2010), albeit somewhat flattered by once-off measures. However, such fiscal drag is weighing heavily on near-term economic momentum, as is the requisite deleveraging of the domestic banking system. GDP contracted for a fifth straight quarter in Q4/11 (by 1.3%), and a further contraction of 3% is now expected for 2012 as a whole.

Portugal's primary balance will move into progressively larger surplus from 2012 onwards (to a projected +3.4% by 2015), with an overall 3% deficit/ GDP ratio in 2013 delivering a potential 116% debt/GDP peak, below the current Italian mark and that targeted 120% Greek ratio. Of course, such baseline forecasts depend on a gradual recovery in GDP growth (towards 2% real), and a stabilisation of debt servicing costs c 5.2% of GDP. Clearly, Portugal's fate is not in its own hands in either respect, with exogenous factors fated to bear down on both growth (global trade) and debt-servicing (market interest rates) outlooks. With Portugal slated to renew bond market refinancing from H2/13, and current (and prospective) yield levels a major barrier to re-entry, the case for committing official funding support beyond 2013 is a compelling one, at least until such time as the slow-burning benefits of structural economic reform have made themselves apparent to dubious bond market participants.

PSI has now been replaced by "IMF protocol" regarding any future ESM implementation of liquidity support programmes, the "ex ante" private creditor "bail-in" risk of the former being supplanted by the "ex post" last resorts of the latter. If Portugal ultimately falls short in its economic reform efforts, debt restructuring may follow, but append such risks to medium-to-longer dated Portuguese debt, and not to the shorter-dates. SD&C missing in inaction for the week ahead, returning 5th March.

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**Market Watch**

**Duration Risk : 2 yr Portuguese Yields ( with trendline & 55wma )**



Another ratings downgrade for beleaguered Portuguese sovereigns last week, although this time with limited market fall-out. Moody's one-notch adjustment to Ba3 from Ba2 leaves the sovereign even more deeply embedded in *sub*-investment grade terrain. However, all benchmark expulsions were completed in Jan (following the S&P junking), and enforced investor liquidations had already done their worst to Portuguese bond yields by Jan's end. This month has seen a corrective and across-the-curve pull-back in bond yields, and most especially so in 2yr maturities, last week threatening a key breach of trendline and 55wma support *circa* **13.20%**. This bond market is hopelessly illiquid, so pricing signals are unreliable, but a sustained break of these long-term barriers has major technical ramifications. Indeed, a break below **11.90%** will complete the triple-top reversal.

Once again, the Brent/WTI oil price differential is back in the news, re-widening aggressively since the turn of the year. That continued insufficiency of pipeline capacity to usher crude stocks away from Cushing is dampening all WTI pricings, while a reinvigorated Brent (back to 10-mth peaks *circa* \$120) is now consolidating its status as global benchmark for an oil market whose supply/demand balances are evidently tighter than pre-supposed (*per* end-Jan IEA report). Nonetheless, WTI has finally hitched a ride alongside Brent's bullish endeavour, its triangular channel base-build at **\$95.50** providing the springboard for last week's breakout through **\$100.15** to Fri's **\$103.24** close. The **\$103.74** early-Jan peak is the immediate barrier, beyond which lies the longstanding **\$105.40** target, being 76.4% retrace of the May/Oct downmove. Above here, and **\$114.83** allures.

**Yield Curve / Spread Risk : Crude Oil (WTI, with t/lines & 55/200dmas)**



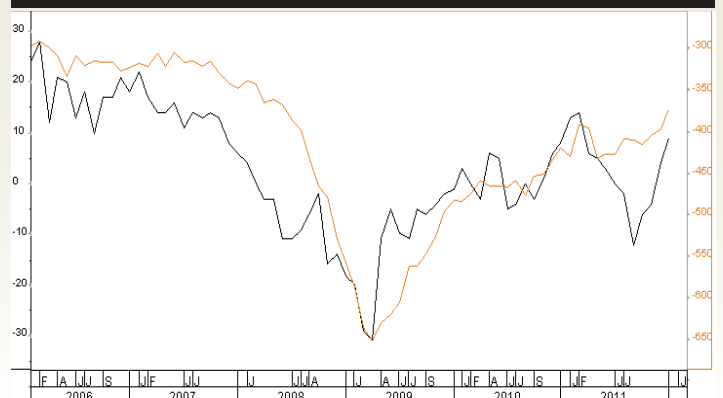
The sharp revival in investor risk appetites since the turn of the year has pulled some of the "safe-haven" rug from underneath the US dollar, such correction reinforced by decidedly aggressive long USD speculative positions. The Dollar trade-weight had topped out at **81.78**, atop the twin recovery peaks of Nov/10 and Jan/11. The subsequent sell-off was ultimately braked at **78.36**, being a 38.2% retrace of the 2011/12 upmove. Last week's bounce was prompted by a confluence of events, *viz* Moody's broadside regarding the UK's AAA credit rating, renewed QE by the BOJ and, not least, the tragedy-comedy that is the Greek "bailout" fuzz. With a Greek deal finally in the mix, a rallying single currency will retard the TWI, albeit the stated forex intervention intentions of both BOJ and SNB providing some *contra*. A sideways meander beckons within the 2012 range.

**Foreign Exchange Risk : USD Trade-Weight ( with retracements )**



Last week's flatlining NFIB headline sentiment reading for Jan (93.9 vs 93.8 Dec) may have mildly disappointed, but sub-components reaffirm the more optimistic leanings of the past six months. Small businesses have lagged the recovery of larger firms since the US economy troughed in mid-2009 (on credit constraint grounds), and were further constrained in mid-2011 by those temporary demand (oil price) and supply (Japanese *tsunami*) dislocations. That latter dip has now passed, and the improving credit conditions are galvanising small firms into a more expansive mode. Sales expectations have now rebounded to 11-mth highs, while the job openings index has returned to *pre*-Lehman levels. Small firms are typically responsible for *c* 60% of payroll creations in economic expansions, so the catch-up underway is reinforcing the step improvement in jobless claims.

**Fundamental Risk : US NFIB Sales Expectations & Jobless Claims (4wma)**



## Global Investment Themes

### Strategic

- \* Global growth forecasts on the wane, impacted by higher oil prices, EM policy tightening and, most especially, the all-pervasive sentiment shock of a cascading Euroland debt crisis. Global GDP consensus now +2.3% for 2012, with G10 a scant +1.3%, and Euroland -0.2%.
- \* Current forecasts mired with uncertainty, not least given the binary nature of potential crisis-resolution outcomes in Euroland. Topside surprises are obvious risks, reinforced by more accommodative policy stances (nb EM), robust corporate sectors and reviving credit impulses.
- \* Risk premia in benchmark government bond markets clearly debased by historical comparison, but ongoing suppression of G10 monetary policies to accommodate broad-based fiscal consolidation providing a natural cap to bond yields via policy duration effects.
- \* Corporate bond markets still supported by robust credit metrics (eg balance sheets, default rates) and a somnolent M&A cycle, continuing to project the most attractive risk-adjusted profile amongst the major asset classes. HY particularly inviting as risk appetites revive. FX markets as much focused on relative money quantities as they are relative price, given major policy rates increasingly mired at the lower bound. Euro the recent fall guy in this respect, but debt crisis past its peak, and positioning/sentiment data at bearish extremes. Gold bid.

### Tactical

- \* Volatility back on the rise in b/mark govie markets from depressed readings, harbinger of bearish reversal risks as "safe haven" exigencies abate. Base-building ever more apparent *per* med-term yield charts, so continue to sell all rallies in a short duration stance.
- \* Intermediates still the most vulnerable bucket in global yield curves on relative valuation grounds, any bearish directional shift taking its toll on 5-10y mats. UK *ultras* a weaker link on QE3 re-orientation.
- \* Trsy/Bnd spreads continue to flatline between 0-10bps in 10yr mats, but shifting real economy relativities portend widening impulse. Still long Aud in the USD *bloc*, and long Euroland periphery (nb Ireland) vs core. Stay short UK gilts amongst "opt-out" markets, neutral JGBs, and long IL.
- \* US cash credit spreads back to early-Aug tightness in both high grade (212bps) and high yield (620bps), but some corrective widening now in E/land markets (synthetic-led) as renewed Greek jitters take hold. The last minute of the last hour, but orderly outcome is nigh. O/wght.
- \* Major currency pairs still locked into a sideways meander, absent that topside Yen/USD break on surprise BOJ (QE) largesse. A Grecian end-game still the pivotal play, with Eur/USD coiled in a 1.3000-1.3300 range, and still *uber* short spec positioning highlighting squeeze risk.

## Model Portfolio

Country	Benchmark*		Market	Duration	Yield Curve			Issuer	ActiveFx**
	Weight	Duration			1-5	5-10	10+		
US	22.30%	5.61	-	-	N	-	N	HG/HY	-
Canada	2.03%	7.05	-	-	N	-	N	HG/HY	N
Australia	0.37%	4.70	N	-	N	-	N	HG/HY	N
Germany	10.65%	5.87	-	-	N	-	N	HG/HY	Base
France	9.24%	5.77	N	-	N	-	N	HG/HY	Base
Holland	2.66%	5.22	-	-	N	-	N	HG/HY	Base
Italy	9.71%	6.91	+	-	N	-	N	HG/HY	Base
Spain	3.67%	5.97	+	-	N	-	N	HG/HY	Base
Belgium	3.07%	5.72	+	-	N	-	N	HG/HY	Base
UK	5.32%	8.04	-	-	N	-	N	HG/HY	-
Sweden	1.00%	4.79	N	-	N	-	N	HG/HY	+
Denmark	1.02%	4.44	N	-	N	-	N	HG/HY	N
Japan	28.95%	5.61	N	-	N	-	N	HG/HY	N
		6.00		-					

\* JP Morgan

\*\*Euro Base

## Best Trade

Long 5yr and 30yr Treasuries vs 10yr Treasuries at 0bps



Another week of stronger-than-expected US data flow across the housing, manufacturing, labour market and retail sectors, the Citi Economic Surprise Index thereby sustaining its elevated readings of the past 4 months. Bernanke's Fed remains stoically accommodative, although the prospects for additional stimulus at the margin (be it conventional QE or another Twist) appear to be receding, based on the latest FOMC minutes (from late-Jan). The existing Twist is now about half-way through its \$400bn operation, and proffers ongoing support to the *ultra*-long end. Meanwhile, the policy duration effect of Ben's "at least through late 2014" rate commitment is applying an obvious dead-weight to shorter-end maturities. This leaves the intermediate segment, conspicuously expensive on fundamental and risk metric (VIX, SovX) grounds, now primed for underperformance.

## Event Watch

	Monday 20 Feb	Tuesday 21 Feb	Wednesday 22 Feb	Thursday 23 Feb	Friday 24 Feb
UNITED STATES	Holiday	CFNAI (Jan) 3 & 6 mth T-bills 2 yr Treasuries	ICSC/ Redbook (18 Feb) MBA Survey (17 Feb) Exist Home Sales (Jan) EIA Stocks (19 Feb) 4 wk T-bills 5 yr Treasuries	Initial Claims (18 Feb) Mass Layoffs (Jan) FHFA Hse Prices (Dec) Cons Comfort (19 Feb) 7 yr Treasuries	Michigan Sent (Feb) New Home Sales (Jan) Williams Speech (NY) Bullard Speech (NY) Plosser Speech (NY) Dudley Speech (NY)
CANADA	Holiday	Retail Sales (Dec) Wholesale Trade (Dec)	30 yr Real Return	Employ Earnings (Dec) BOC Review	G20 FinMin Meet Carney Speech (NY)
JAPAN	Leading Indicator (Dec) Trade Balance (Jan)	All-Industry Index (Dec)		20 yr JGB	BOJ CSPI (Jan)
AUSTRALIA		RBA Minutes (Feb) Stevens Speech	Wage Prices (Q4) Ellis Speech	Stevens Test	
EUROLAND	IRL HICP (Jan) FIN HICP (Jan) FRA INSEE Surv (Feb) ITA Indust Ords (Dec) Eurogroup Meet (Brsls) Praet Speech	EUR Cons Conf (Feb) SPA 3 & 6 mth T-bills EFSF 6 mth T-bills	GER Import Prices (Jan) FRA HICP (Jan) EUR PMI-flash (Feb) ITA HICP (Jan) GER 2 yr Schatz	IFO Survey (Feb)	GDP (Q4) FRA Cons Conf (Feb) ITA CTZ/BTPei
UNITED KINGDOM	R/move Hse Prices (Feb) 50 yr Linker (synd)	PSNCR (Jan)	MPC Minutes (Feb)	BBA Lending (Jan) CBI Indust Trends (Feb)	GDP (Q4) Services Index (Dec)
SWEDEN			Unemployment (Jan) 7 & 10 yr SGBs	10 yr i/L	
DENMARK					

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