

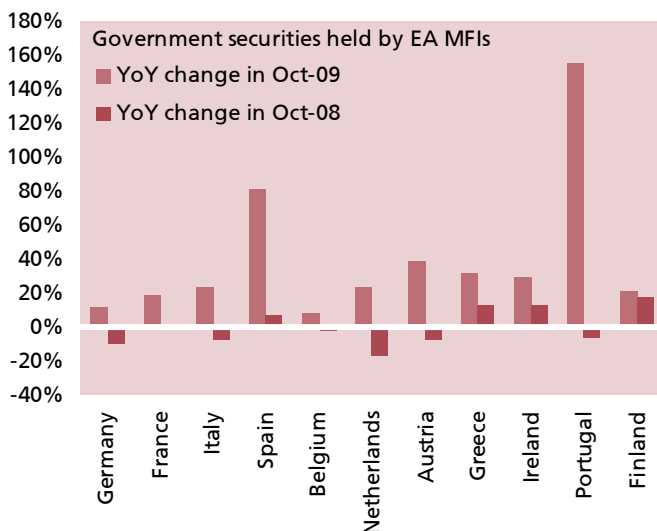


## The weak links of the ECB-funded carry trade

**Some 70% of Greek banks' securities (ex-shares) are likely funded at the ECB's LTRO, which will be withdrawn starting mid-2010. Greek banks have six months to find alternative sources of funding before they are forced to offload domestic government bonds. In Spain, banks have likely absorbed 90% of last year's net government bond issuance. With ECB's excess liquidity not increasing any further, who is going to buy Spanish bonds in 2010? Buy Italy, sell Spain on 10-years at virtually flat spread and flat carry/roll-down.**

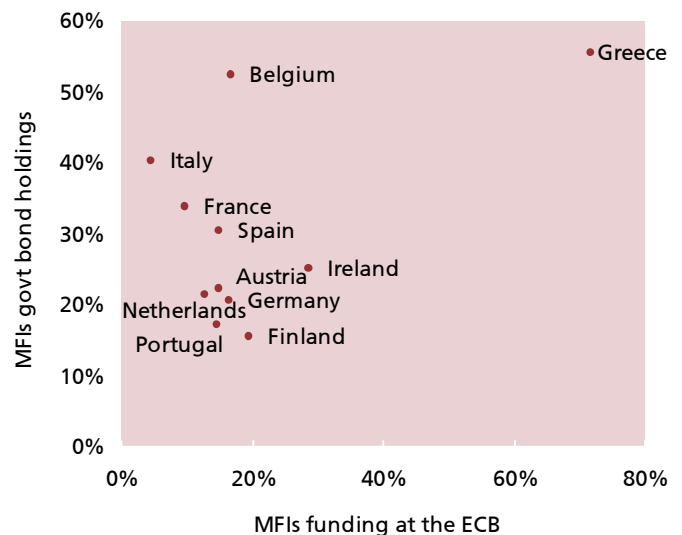
The liquidity boost from the ECB certainly was the most important driver of intra-EA government bond yield spread tightening last year. EA banks have deployed the cash injected by the ECB via the three LTRO (Long-Term Refinancing Operations) into carry trades, exploiting historically steep yield curves as well as wide intra-EA yield spreads. For instance, an investor buying the 10-year Italian BTP one year ago (the BTP 4.25% 03/19) would have earned 60bp (of which 20bp due to roll-down) plus some 20bp carry. Hence, about half the P/L is related to the steepness of the curve (i.e. carry/roll-down). Because the total return from buying the German 10-year benchmark one year ago, the Bund 3.75% 01/19, would have been flat, the other half of the P/L from buying BTPs is coming from a tightening yield spread versus benchmark. Besides the abundant liquidity, banks' appetite for yield has been enhanced by extremely low levels of fixed-income market volatility, improving the carry-to-risk profile of long bond positions.

### Iberian banks have significantly increased their government bond holdings last year



Source: LSR calculations on ECB and EA Central Banks data.

### Who's going to buy Greek government bonds now?



Source: LSR calculations on ECB and EA Central Banks data. Both 'MFIs funding at the ECB' and 'MFIs government bond holdings' figures are percentages of MFIs securities (ex-shares). Data updated to October 2009.

In fact, not all EA banks seem to have rushed into the carry trade in the same way. Data from national central banks suggest that there is significant dispersion within the EA in terms of MFIs funding at the ECB, with Italian and Greek banks being the least and the most reliant on LTRO, respectively. Crossing the information on banks' funding with that

on banks' government bond purchases over 2009 provides an indication of which country is looking more vulnerable to the ECB-funded carry-trade eventually being unwound this year.

The left-hand chart above shows that, as of October 2009, Iberian banks had been the ones buying by far most government bonds over the previous 12-month period. Spanish banks' holdings of government securities were up some 80% y/y. Although we do not know exactly whether they increased their holdings of Spanish government securities rather than other government bonds denominated in euros, we strongly suspect they had a strong preference for their national bonds. Over the period Jan/Oct 2009, Spanish banks bought €50bn government bonds, enough to absorb almost 90% of the Spanish net issuance over the same period of time. Spanish banks' bond purchases have likely kept Spanish government bond yields lower than they otherwise would have been. We look at the recent decoupling between the Spain/Germany 10-year yield spread and the equivalent spread in CDS offers as providing a rough indication of how overvalued Spanish government bonds are. The current 85bp spread in 10-year Spain/Germany CDS would usually be consistent with a 10-year spread in government bonds north of 100bp, vs. the current 60bp. Hence, one might say that 10-year *Bonos* look more than 40bp overvalued.

As far as Greece is concerned, in October 2009 more than 70% of Greek banks' securities (ex-shares) were likely funded via the ECB long-term refinancing operations, up from 8% in January 2008. As the excess liquidity in the Eurosystem will be scaled back starting mid-2010, i.e. when the first LTRO comes to expiration, Greek banks will either find alternative sources of funding or they will have to shrink their balance sheets. In turn, that would likely become a problem for the Greek government, as more than 50% of the securities (ex-shares) held by Greek financial institutions are government bonds, most likely domestic bonds (see right-hand chart above). As of October 2009, Greek banks had €41.9bn funded at LTROs. We estimate that around €24bn of that is due to expire with the first LTRO at the end of June 2010 (it is worth noting that the net issuance of Greek government bonds in 2009 was €24bn).

Although liquidity in the EA will likely stay ample until mid-2010, it is not going to increase any further, meaning that the fuel for further yield spread tightening is likely over. With intra-EA government bond yield spreads having already tightened significantly, and given ballooning public deficits, we see the downside on our yield spread wideners as being limited, ultimately being represented by the cost of carry of the strategy. In fact, the negative carry on yield spread widening positions looks small relatively to the historical volatility of spreads.

**Long Italy vs. short Spain on 10-years.** We recently recommended selling Spain vs. benchmark on the 10-year (see GIO Update, December 15th, 2009), which we still look at as being an attractive way of expressing our strategic intra-EA yield spread widening view. We now also advise selling Spain against Italy on the 10-year maturity at a virtually flat yield spread and flat carry/roll-down, which we expect to be less market-directional and more driven by the countries' relative fundamental/fiscal perspectives.

As Italian banks are the least reliant on the ECB funding, their government bond holdings look less vulnerable to the withdrawal of QE than those of Spanish banks. Also, although the 40% share of government bonds in Italian banks' securities (ex-shares) is above the EA average, it is mainly reflecting the large stock of Italian public debt (the same as for Belgium and Greece). On public finances, Italy looks in much better shape than Spain. The Italian primary deficit in 2009 was about one fifth of the Spanish deficit, at 1.8% and 9.9% of GDP respectively. Also, although the Italian debt/GDP ratio is twice as high as the Spanish, investors will likely be more sensitive to public deficit rather than public debt figures, as it is deficits driving debts higher more than the other way around. On economic growth, although Italy has chronically been underperforming the rest of the EA countries over the past decade, it is now looking stronger than Spain, whose skyrocketing unemployment rate is yet to fully show its dampening effects on the economy. Last but not least, it is worth noting that €95bn have so far been repatriated in Italy as a result of the *scudo fiscale* tax amnesty. The Italian government is expecting an extra €30bn to follow by April 2010, which would bring the total amount of repatriated funds to almost 10% of Italian GDP. Apart from increasing government revenues, such an amount of money being poured into the Italian economy could bring some upside surprises on domestic growth numbers over the coming quarters.

**Trade structure:** buy BTPS 4.25% 09/19 vs. sell duration-weighted Bonos 4.30% 10/19 at -1bp spread and flat 3-month carry and roll-down.

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