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Europe

September 13, 2013

European Interest Rate Strategist

Viva España

Euro Sovereigns: Long Spain

We are bullish on Spain in outright terms given the improving economic fundamentals and attractive carry + roll valuations. We also like Spain vs. Italy given the divergent economic and political challenges that the countries face. Thus we recommend long 10y Bonos vs. BTPs and long 3y Spain vs. Germany (p. 3).

UK Strategy: Financial Conditions in the UK

Following BoE Governor Carney's recent comments on monitoring Financial Conditions, we explore creating a market-based FCI for the UK (p. 7).

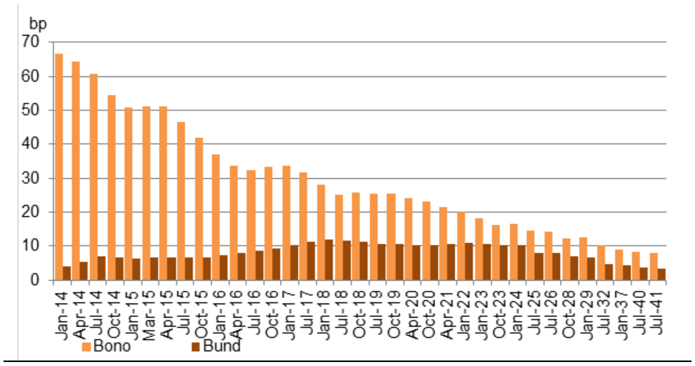
Euro Inflation: Re-entering Our Euro vs French Carry Trade

Having reassessed the trade, we reiterate our preference to be long euro vs French inflation. Because the carry favours French linkers in September and October, French inflation may richen further in the next few weeks. We recommend that investors await these wider levels to enter into the trade (p. 10).

Supply in the Week Ahead: €16.5bn

€16.5bn of nominal supply from GE, FR and SP (versus €24bn average) versus €2.2bn coupons and redemptions. In the UK, UKT 1.25% July 2018 will be tapped for £4.75bn against no cash coming into the market (p. 13-17).

Chart of the Week: 3m Carry and Roll in Bonos



Source: Morgan Stanley Research

Regular Features

Other Global Publications

- US Interest Rate Strategist
- Japan Interest Rate Strategist
- The Inflation Strategist
- UK Strategist – The Gilt Edge
- Agency MBS Weekly

Summary of Rate Views

Our Views	Suggested Strategies
▪ **Euro Duration**	
▪ The ECB remains dovish, and under pressure to ease, given that inflation is well below target, financial fragmentation remains an issue and excess liquidity is reducing potentially detaching eonia from its current low levels. ▪ 10y rates likely to rise due to demanding valuations, subdued systemic risk indicators and improving PMIs.	
▪ **Euro Curve**	
▪ Term premium is rising, but still low: curve should steepen but will continue to trade directionality with the level of rates. ▪ ECB forward guidance should steepen the front end. ▪ EUR 10s30s looks too flat vs. international comparisons – should steepen as supply/demand becomes more balanced: 10s30s steepener carries well. ▪ If funding rates go meaningfully negative, Bobls will outperform on 2s5s10s.	▪ 2s10s steepener+long 2s DV01 ratio: 2.1:1 ▪ Receive EUR swaps 2y1y vs 4y1y ▪ 10s30s steepener, hedged for directionality ▪ 4y forward 10s30s steepener ▪ Long Bobl calls vs. short Schatz and Bund calls, 50:50-weighted
▪ **Sovereign Spreads**	
▪ Market prices sovereign credit risk in Spain and Italy the same, which we think is inappropriate given the divergent economic and political challenges. ▪ Expect euro sovereign spreads to continue tightening, and front-end Spain has attractive carry and roll valuations. ▪ Long-maturity OATs remain attractive as they continue to work well as duration-hedging instruments and offer yield pick-up. ▪ Regulatory pressure to reform reference rates on swaps should cheapen long-dated swaps versus cash bonds. ▪ Spain 10s30s curve has remained too flat versus Germany, despite the tightening in spreads. Recommend steepeners to fade the cheapness in the 10yr spread.	▪ Long 10y Spain vs. Italy ▪ Long 3y Spain vs Germany ▪ Long 30y FRTR vs Germany ▪ Long 30y GE, NL, vs swap ▪ Spain 10s30s steepener versus Germany; long SPGB Jan 23 vs Jan 22 and Oct 23
▪ **UK Rates**	
▪ Curve: Guidance will only protect up to the 2y maturities, hence expect the 5y sector to underperform ▪ 3Q13 supply suggests steepening pressure at the long end, but hedge the position for direction. ▪ Vol to rise in the 3-5y part of the curve as investors bring forward or extend expectations of Ban Rate hikes in response to the economic data ▪ LIBOR/OIS has widened significantly, with gilts following swaps. Hence, 5y gilts are now cheap to Sonia.	▪ Buy UKT 2Q 23 (50%) vs. UKT 3Q 44 (100%) ▪ GBP 1y1y vs. 4y1y (50%) steepener ▪ GBP 2s5s steepener (hedge for direction 100% 2y and 40% 5y) and GBP 5s10s flattener ▪ Long UKT 1 17 vs. Sonia ▪ Long GBP 2y into 1y vol
▪ **Inflation**	
▪ EUR: Long front end on real yield: Cheap, attractive carry. Long euro versus French inflation: French fundamentally rich. Short 5y5y breakevens: Rich to our expectations. ▪ UK: UKTi 52s62s steepener: Ultra-long end needs to cheapen up pre-syndication Long UKTi Jul-16s: Cheap to our economists' inflation forecasts.	▪ Long BTPei16 real yields & DBRi16s vs. TIPS ▪ Pay 5y FR CPI vs. HICPxT swaps ▪ Pay 5y5y HICPxT ▪ Long Mar-52s vs. Mar-62s ▪ Long UKTi Jul-16s on breakeven
▪ **Scandi**	
▪ SEK: 5y s/s spreads are rich to fair value	▪ Short 5y a/s spreads
▪ **Volatility**	
▪ Sell UK gamma vs. long EUR gamma. ▪ GBP 2s5s should widen in a sell-off. ▪ Enter carry trade in EUR front end.	▪ Sell 6m10y UK straddle vs. buy 6m10y EUR. ▪ Enter beta-weighted 3m 2s5s bear-steepener. ▪ Buy 6m3y 1x2 receiver spread

Euro Sovereigns

Long Spain

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Summary

- We are bullish on Spain in outright terms and versus Italy. Our constructive view is based on:
    - Improving growth outlook and progress on reforms
    - Attractive carry and roll valuations
    - A base-case scenario of no re-escalation in the euro crisis and depressed systemic risk
    - Positive market momentum
- In contrast, the reform agenda in Italy has stalled and we see downside risks to the financial sector from the Asset Quality Review set for 1Q14. This may place pressure on the sovereign if it needs to sponsor bank recapitalisations.
- The market prices sovereign credit risk in Spain and Italy the same, which we think is inappropriate given we see divergent economic and political challenges. Thus we recommend:
    - **Long Jan-23 Bono versus May-23 BTP entry:-2bps, target:-100bps, stop: 50bps**
- We also recommend **long 3y Spain vs Germany**, as a lower-risk long peripheral trade, that has attractive carry and roll and should benefit from OMT support in the worst-case scenario.

Long Spain

We are bullish on Spain in outright terms and versus Italy. Thus we recommend investors initiate long 10y Bonos vs. BTPs and long 3y Spain vs. Germany positions. Our case for a constructive stance on Spain is based on:

- Improving economic fundamentals
- Attractive carry and roll valuations
- A base case scenario of no re-escalation in the euro-crisis and depressed systemic risk
- Positive market momentum

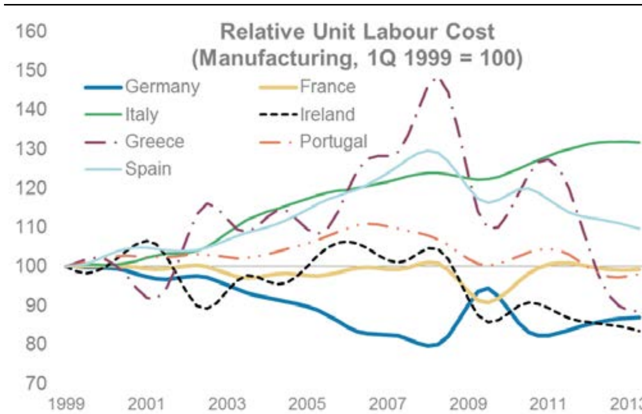
Improving Economic Fundamentals - The New Spain

Our economists have upgraded their outlook on Spain. Morgan Stanley projects that GDP growth has troughed and will move from stabilisation towards average growth of 1% in 2014- 2015 (see *Economics and Banks: The New Spain*, Daniele Antonucci, 9 September 2103). The combination of improved export performance and international competitiveness makes for a sustainable driver for economic growth. Spain's economic activity is picking up, led by strong

Exhibit S1
Spanish Exports are Structurally Strong and Improving

Source: Eurostat, Morgan Stanley Research

Exhibit S2
Falling Relative Unit Labour Costs are Improving Firms' Competiveness



Source: EU Commission, Morgan Stanley Research export performance (Exhibit S1) and this has helped push the current account into surplus. Furthermore, firms' competiveness is improving as relative unit labour costs continue on a downward trend (Exhibit S2). On the other hand, costs are rising in Italy, while costs in Germany and France are roughly unchanged form the previous year. With regards to structural reforms, certainly Spain, versus its neighbours, seems to be an exemplary case for progress, namely on the issues concerning the financial sector, labour market and fiscal framework.

However, we do admittedly still see downside risks. While much progress has been made both on the economic and policy front, the modest recovery over the following quarters may be challenged by:

- The simultaneous deleveraging in the private and public sectors
- Elevated unemployment above 20% is likely to weigh on domestic demand
- While GDP forecasts are positive, the growth upswing is still mediocre

Italy

Assessing Spain versus Italy, it is clear from a fundamental perspective (i.e. GDP growth forecasts, recent retail sales and industrial production data) these countries are likely to follow diverging economic paths over the medium term. Whilst both countries have posted positive 2Q growth, the recovery in Spain, on the margin, appears more substantial in our economists' view. A critical impediment to a sustained recovery is that Italy faces endemic political uncertainty which has dampened the pace of structural economic and institutional reforms. In particular 4Q13 is set to be challenging with votes on VAT tax hikes, 2014 budget, and implications of the recent court verdict in the Senate (see *Italy - Why Politics Matters: The Rules of the Game*, Daniele Antonucci, 9 September 2013). A new electoral law would facilitate stronger majority governments to be formed and alleviate the political impasse. However, as Daniele Antonucci notes, an agreement on new electoral law before fresh elections take place is unlikely to occur before 2014-2015, and he places a subjective probability on this scenario of 35%.

It would be misleading to suggest that Italy has not attempted to implement any reforms. The previous government enacted labour market and product reforms, moreover the current government has tried to address certain aspects of institutional inefficiencies.

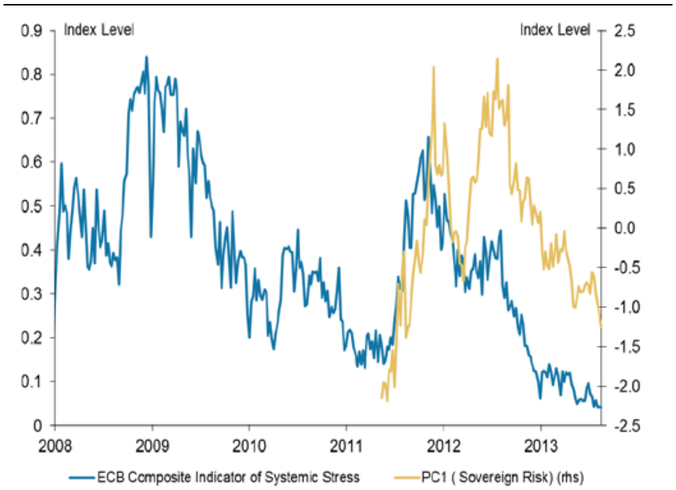
Italy fares better on the fiscal front. Its primary budget *surplus* should stay above 3% of GDP, in contrast to Spain's primary *deficit* of 2.3% in 2014. That said, Spain is undergoing fiscal adjustment to help the budget deficit narrow. In 2014-2015 General government debt/GDP should peak around 132% in Italy, whereas it is yet to stabilize in Spain and will accelerate to 96.2% in 2014 then in 99.1% in 2015 according to our economists' forecasts.

Asset Quality Review Poses a Risk for the Periphery

While the fundamental macroeconomic story for Spain is encouraging, we are concerned about the impact the AQR (Asset Quality Review) on eurozone banks, set for 1Q14, will have on the periphery. On one hand, the review is a longer-term positive for the eurozone, as should create more credibility in the banking system; on the other hand, in the short term, it may create volatility in the markets by highlighting capital shortfalls in peripheral banks. In that scenario, sovereigns may need to come re-capitalise their banks. As Spanish banks have raised €130 billion of capital since 2008, we expect this risk to weigh more on Italy than Spain (see *Economics and Banks: The New Spain*, Daniele Antonucci, Alvaro Serrano et al, 9 September 2013; *European Banks: Don't Underestimate the AQR*, Jackie Ineke, 29 August 2013).

Another potential avenue of further market volatility is that, with systemic risk indicators at their lowest levels in two years, the market might be complacent vis-à-vis the structural issues that the Eurozone still needs to address (Exhibit S3). Thus any negative surprises in the AQR results may place significant upward pressure on peripheral spreads.

Exhibit S3
Euro Sovereign Systemic Risk Indicators



Source: ECB, Morgan Stanley Research

Long 10y Spain vs. Italy

The government bond markets have been pricing the sovereign credit risk in Spain and Italy very similarly. BTP and Bono yield curves trade on top of each other (Exhibit S4) as well as trading with a very high correlation. We think this is inappropriate, given we see a divergent short-term growth and political outlook, as well as differences in longer-term challenges, as outlined above. In some respects, the market is starting to price the improving picture for Spain and for the first time since 1H12 some maturities of Bonos are trading through of BTPs. We note that there is no reason, fundamental or historical, forcing Italy and Spain to trade closely together. Exhibit S5 shows that Spain traded through Italy prior to the euro crisis and indeed during the 2011 political stalemate in Italy.

We therefore recommend investors enter:

- **Long Jan-23 Bono versus May-23 BTP entry:-2bps, target:-100bps, stop: 50bps**

The 3 month carry + roll for the trade is flat. Since we recommended the trade (*Economics and Banks: The New Spain*, Daniele Antonucci, Alvaro Serrano et al, 9 September 2013) it has worked in our favour as 10y Italy has cheapened on the back of political instability. Further slack on the political front should augment this differential. The key risks to this trade are: i) An adverse political, financial sector or economic shock in Spain, which causes Bonos to underperform; ii) An improvement in the Italian economic and political situation which helps BTPs outperform (especially given they have lagged the richening of Bonos in recent months); and iii) Bonos underperform in response to a general flare-up in euro systemic risk, possibly because of their poorer liquidity.

Long 3y Spain versus Germany

As we have highlighted, front-end Spain offers attractive carry + roll returns both on outright and volatility-adjusted terms. Our base case forecast, which assumes no re-escalation in sovereign risk, sees sovereign spreads tightening, and in particular, we see Spain as the clear outperformer. Spain and the periphery should benefit from a “good sell-off” in yields as macro data improves and the safe haven bid for Bunds declines. To gain carry and roll from the spread compression, we recommend investors initiate:

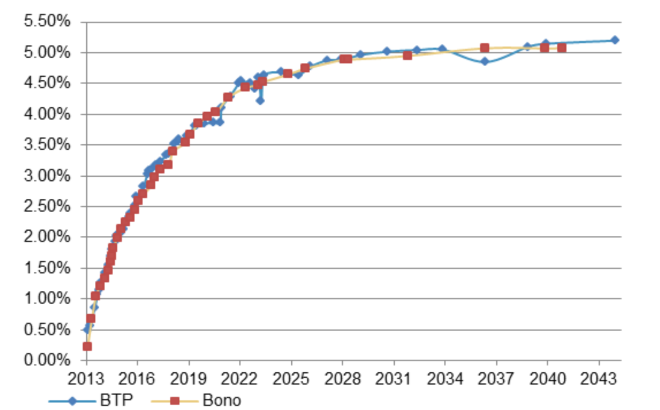
- **Long Oct-16 Bono versus Oct-16 OBL: Entry: 216bp, target: 150bp, stop: 250bp.**

The trade offers carry and roll of 23bps over 3 months. In essence this trade is more of an outright long peripheral risk trade, as a healthier Spain translates to a healthier periphery in general. The recent positive sentiment towards the periphery has the potential to become self-fulfilling. That is to say, that better sovereign funding conditions lessen credit risk and thereby warrant tighter credit spreads.

We have highlighted that trading euro sovereigns spreads with a momentum bias worked well through the sovereign crisis (see *European Interest Rates Strategist: The Trend is Your Friend*, August 16, 2013).Given the tightening of peripheral spreads since the announcement of OMT, a rules-based momentum strategy suggests being long the periphery versus the core. However, we look to limit the credit risk we take by positioning in shorter maturities, which may also

Exhibit S4

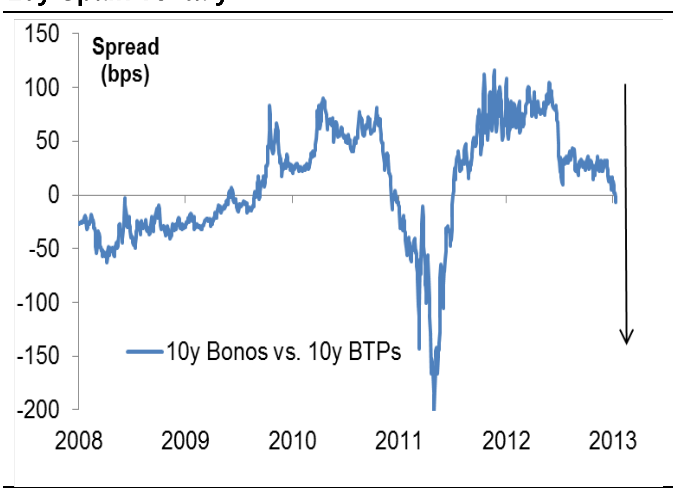
Bono and BTP Yield Curves Trade on Top of Each Other…..



Source: Bloomberg, Morgan Stanley Research

Exhibit S5

10y Spain vs Italy

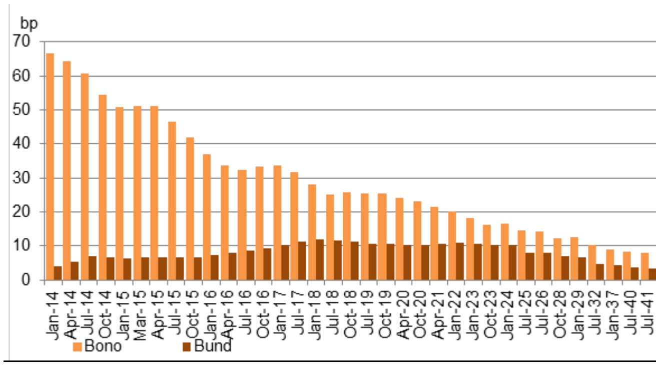


Source: Bloomberg, Morgan Stanley Research benefit from OMT support in the event of a crisis. Furthermore carry and roll is highest at the front end of the Bonos curve and quite low in Bunds (Exhibit S6).

Nonetheless as the key issues facing the monetary union remain unresolved, our trade is vulnerable to an increase in euro systemic risk. The key risks to the trade are: i) An adverse development in Spanish politics or the economy; and ii) A resurgence in the euro sovereign woes, which may cause Bonos to cheapen versus Germany, even if the source of the crisis does not emanate from Spain.

Exhibit S6

Attractive 3m Carry and Roll in Bonos, Especially versus Bunds



Source: Morgan Stanley Research

UK Strategy

Financial Conditions in the UK

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Summary

- During a recent speech in Nottingham, BoE Governor Mark Carney mentioned that the MPC will be monitoring financial conditions.
- We discuss different measures of financial conditions. In our opinion, strictly focusing on financial conditions in the capital markets is not optimal for tracking the 'effective' level of financial conditions in the broader UK economy.
- We would rather follow a more diverse set of macro indicators when judging the cost and availability of credit to the private sector and the likelihood of a policy response from the MPC.
- Elsewhere, in the long end of the curve we are looking to close our (direction-hedged) steepeners into the UKTi 2068 syndication.

Market-Based Financial Conditions Index

Governor Carney noted in last month's Nottingham speech that he will be monitoring financial conditions: "If financial conditions tighten, and the recovery seems to be falling short of the strong growth we need, we will consider carefully whether, and how best, to stimulate the recovery further." But what does he mean when he talks about financial conditions and how can we monitor them?

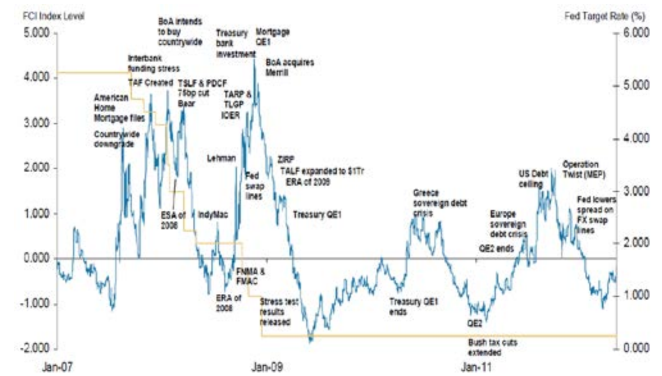
US Financial Conditions Index

One of the indicators used by the Fed when assessing financial conditions in the US is a market-based indicator tracking changes in financial prices and yields (bond yields, stock prices, USD, etc.). This indicator provides a general measure across the macro markets to judge the investment climate and potential economic growth.

We have developed a similar indicator, namely the Morgan Stanley Financial Conditions Index (MSFCI on Bloomberg). We see in Exhibit G1 that extreme levels of FCI have often been followed by strong action by the Federal Reserve. These policy changes have then been followed by an easing of financial conditions

Exhibit G1

US MSFCI and Fed Action Through the Great Recession



Source: Morgan Stanley Research

UK Financial Conditions Index

Following this methodology, we have created a UK Financial Conditions Index. This index provides a measure of financial conditions in the UK economy based on interest rates (10y gilt), equities (UKX Index), foreign exchange (Pound Trade-Weighted Index) and corporate asset swap spreads.

According to this metric (see Exhibit G2), financial conditions are trading close to their easiest level since early 2007, mainly as a result of higher gilt yields and increasing stock prices. In our model higher bond yields are actually a sign of easing conditions as they reflect an improving economic outlook.

Exhibit G2

UK FCI – Easy

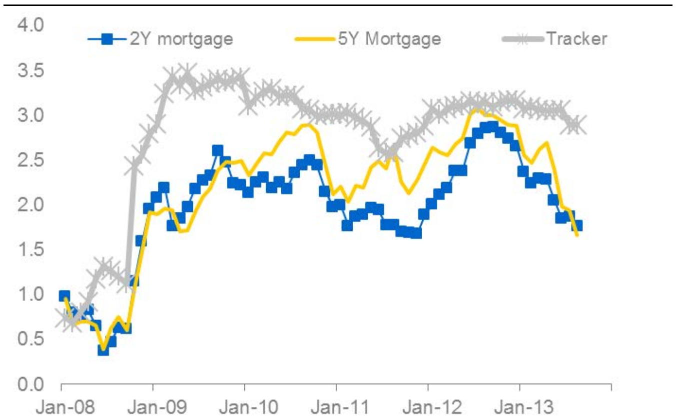
Source: Morgan Stanley Research

Given the historically easy financial conditions currently indicated by our market-based UK FCI, it would suggest that Carney has little to worry about in terms of financial conditions at the present time.

However, the UK financial market-based metric gives a poor assessment of current 'effective' financial conditions and the availability of credit, in our opinion. For example, a sharp rise in UK bond yields driven by expectations of policy tightening in the US (or less policy stimulus in the case of tapering) is unlikely to represent an easing in UK financial conditions. Moreover, a simplistic financial conditions-based index doesn't capture the sharp rise in the spread of bank lending rates (both to households and businesses) since the onset of the financial crisis, nor the willingness (or not) of financial institutions to extend credit. In addition, the difference in structure of credit provision between the UK and US economies would also suggest placing somewhat less emphasis on purely market-based measures of financial conditions for the UK. US credit provision (where a big part of lending is structured and sold back in capital markets) remains much more market-based than in the UK. For example, only the very largest UK companies borrow in the corporate debt market, with most lending by firms still being predominantly bank-based.

Exhibit G3

Interest Rate Spreads to Swaps and Base Rate (bp)



Source: Bank of England, Haver Analytics

We Need an 'Effective' Financial Conditions Index

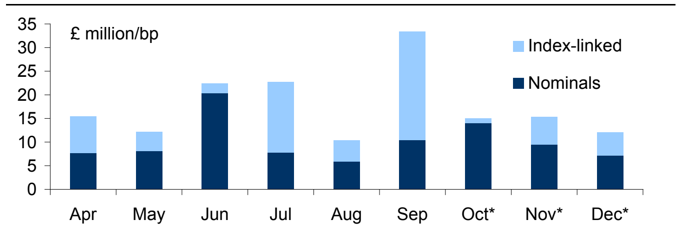
In our opinion, a broader set of financial and macro indicators should be tracked when trying to assess both the current level and likely future changes in 'effective' financial conditions. For example, we would also pay very close attention to surveys of credit conditions (e.g., BoE Credit Conditions Survey), quoted mortgage rates, mortgage approvals, lending rates to businesses, BoE Agents Survey, etc. Ultimately, it is likely to be current and prospective movements in 'effective' financial conditions and their impact on the economy that will likely be more pertinent for judging future monetary policy decisions.

Looking to Close Long-End Steepener into Long-End Supply

Supply in September is very heavy in terms of duration as a result of the UKTi 2068 syndication. If the DMO issues £4 billion of the new linker, then this will equate to £21 million/bp PV01. It would be around double the risk of the ultra-long conventional transaction and likely the largest-ever duration event in the UK (see Exhibit G4).

Exhibit G4

Monthly Supply in Terms of Duration



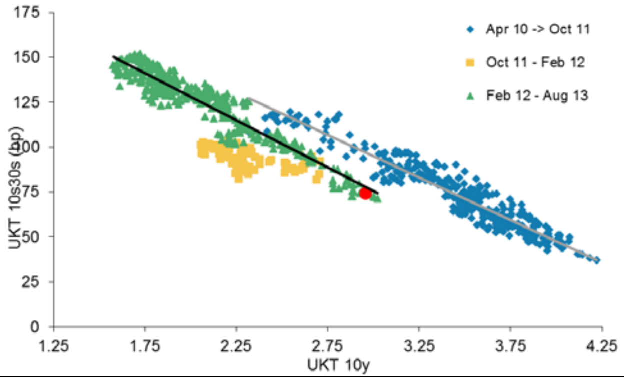
Source: Morgan Stanley Research, DMO; *Morgan Stanley Research estimates

We have held a UKT 10s30s steepener since July (hedged for direction), but will look to close it as we near the syndication (week of September 23). The curve is highly directional with the level of yields – it steepens/flattens by 5bp for every 10bp rally/sell-off in 10y; hence, we suggested a 100% short in 30y versus 50% long in UKT 10y. At current levels of UKT 10y, the curve appears close to fair value (see Exhibit G5), but we believe that the extra supply can steepen the curve beyond fair value.

After the syndication, long-end supply should present few problems. With yields rising, we would expect some of the pent-up demand while yields were so low to be activated. However, the demand will likely be focused on longer maturities, with few natural buyers of the UKT 10y sector. Hence, we would not be surprised if the UKT 10s30s curve flattens beyond fair value into 4Q. The DMO's Remit may well be shrunk in 1Q14 with the expected sale of part of the government's holdings of Lloyds shares, which could raise £5 billion, in addition to proceeds from the privatization of Royal Mail. Finally, the faster-than-expected economic recovery may lead to an improvement in the borrowing figures, although there is little sign of this yet. With this in mind, gilt issuance in 1Q15 may be revised down, with the mini-tenders possibly being cancelled.

Exhibit G5

Monthly Supply in Terms of Duration



Source: Morgan Stanley Research

Euro Inflation Strategy

Re-entering Our Euro vs. French Carry Trade

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Summary

- Having reassessed the trade, we reiterate our preference to be long euro vs French inflation. The potential remains for investors to profit from the outperformance of euro vs French inflation assets over time via the positive carry.
- We take profit on our long 4y HICPxT vs FRFxT position and enter a long 5y HICPxT vs FRFxT trade. Alternatively, real money accounts can take advantage by running persistent underweight OATi positions relative to their benchmarks.
- How the market is currently pricing the euro-French inflation spread is out of line with our fundamental view on the likely path of realised inflation. Furthermore, we find that a strategy of being long euro vs French inflation has been successful in the past, both in bonds and swaps.
- Because the carry favours French linkers in September and October, French inflation may richen further in the next few weeks. Therefore, we recommend that investors hold off for now and look to enter the trade if the spread widens to 33bp.

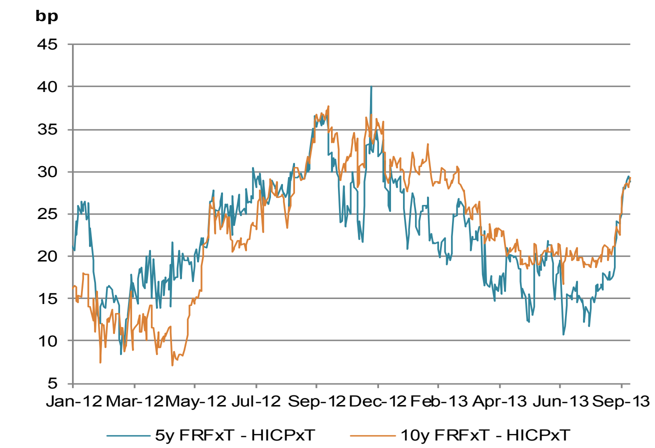
Reassessing and Reiterating

Our long-standing recommendation to be long euro vs French inflation has continued to prove successful. Given that French inflation swaps have recently richened versus euro (see Exhibit E1), now seems an opportune time to reassess this view. Although the euro-French spread is volatile, and may widen further in the coming weeks, we believe that there remains the potential to profit from the outperformance of euro vs French inflation assets over time via the positive carry, and this continues to make it a compelling trade.

We take profit on our long 4y HICPxT vs FRFxT position and enter a long 5y HICPxT vs FRFxT trade. Alternatively, real money accounts can take advantage by running persistent underweight OATi positions if they are part of their benchmark.

Exhibit E1

French Inflation Has Richened Recently



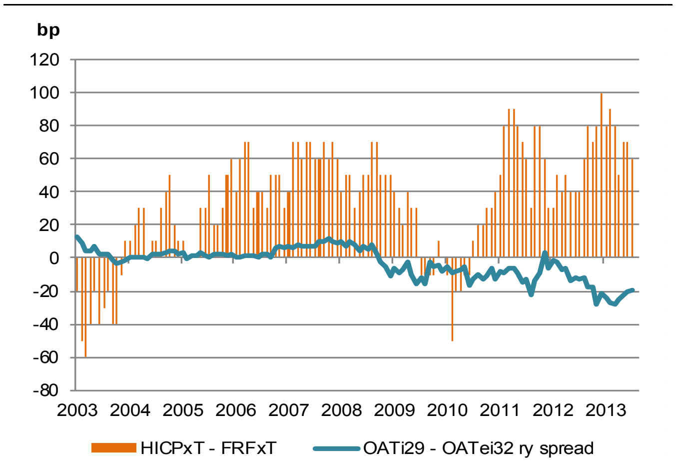
Source: Morgan Stanley Research, Bloomberg

Persistent Richness Unlikely to Fade

French inflation has traded rich to euro ever since 2004. Between 2004 and 2008, euro inflation did trade above French, however the difference in fundamentals should have caused the Euro-French spread to be even wider (see Exhibit E2). Then from 2008, French inflation became significantly richer. The Lehman collapse forced the unwind of long euro versus French positions, which has made investors wary about fading the richness of French inflation ever since. Therefore, FRFxT remains expensive despite the fact that since 2008, HICPxT has printed 40bp higher on average, and the spread was as wide as 100bp in December 2012.

Exhibit E2

Realised Inflation Supported Being Short FRFxT

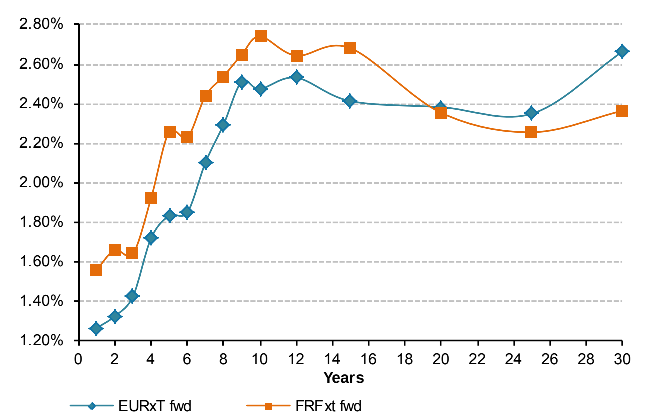


Source: Morgan Stanley Research, Bloomberg

The explanation for the richness of French inflation is well known: *Livret* hedging demand. The French *Livret* savings accounts pay an interest rate that is linked to French inflation and so the hedging demand related to these liabilities keeps French inflation products persistently expensive. Because the potential hedging demand is several times the size of the French inflation market, we don't expect the mispricing to correct any time soon.

Market Implies French Inflation Will Exceed Euro
The 1y forward breakeven curve tells you how the market is pricing the evolution of inflation over time. Exhibit E3 implies that the market expects both euro and French inflation to remain around current levels for the next couple of years, before accelerating steadily. Furthermore, the market is pricing French inflation to be higher than euro for a prolonged period, before later falling below it.

Exhibit E3
Market Implies French Inflation Will Exceed Euro

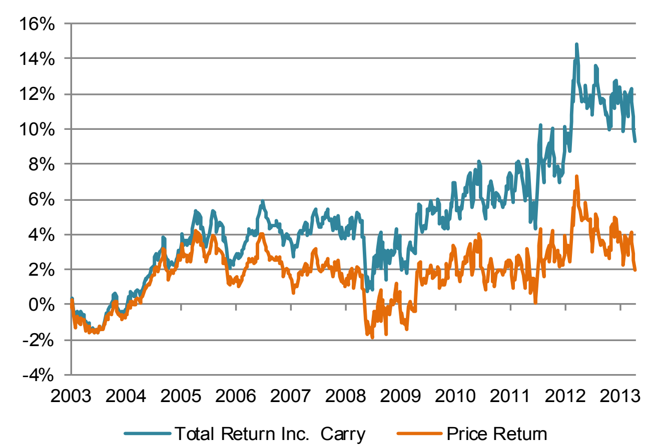


Source: Morgan Stanley Research, Bloomberg

We Disagree With the Market's Pricing
The current market pricing of the euro-French inflation spread is out of line with our economists' forecasts. While we expect French inflation to exceed euro in 2014 by 20bp on average, this is largely as a result of the VAT hike which will be effective from January. Looking further ahead to 2015, we are forecasting French inflation to fall again, and to print largely in line with euro inflation. In contrast, the market is pricing French inflation to exceed euro by around 30-35bp. On the whole, since fiscal policy remains restrictive in France and there remains slack in the economy, this should continue to put downward pressure on domestic prices. This leaves us sceptical that we will see a sustained widening in the realised FRFxT-HICPxT spread.

OATeis Have Outperformed OATis Over the Long Term…
As a result, we still prefer being long euro vs French inflation, relying on euro-linked assets accruing inflation at a relatively higher rate than what is currently priced in by the market. This strategy works better the longer you can hold it for, but has worked impressively in both bonds and swaps. For example, Exhibit E4 shows the cumulative total returns of the OATei32 versus the OATi29. The OATei32 has outperformed by more than 9% over this period. This has not been due to a re-pricing of the spread, but instead the steady accrual of euro inflation at a higher rate than French inflation.

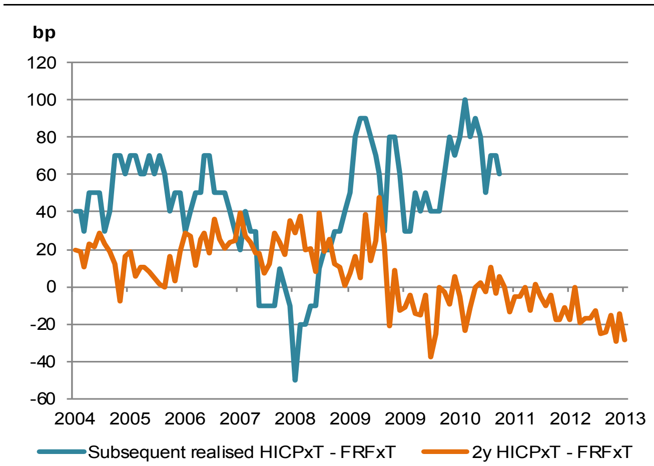
Exhibit E4
OATei32 Has Outperformed OATi29 Over Long Run



Source: Morgan Stanley Research, Bloomberg

…And the Same is True of Inflation Swaps
The same argument can be made for swaps (see Exhibit E5). It shows the spread between 2y HICPxT and FRFxT swaps, and the subsequent realised inflation differential between French and euro inflation. What it shows is that, except for a brief period in 2008, the realised inflation differential has been persistently above what the market has priced in.

Exhibit E5
Market Has Underestimated the Spread



Source: Morgan Stanley Research, Bloomberg

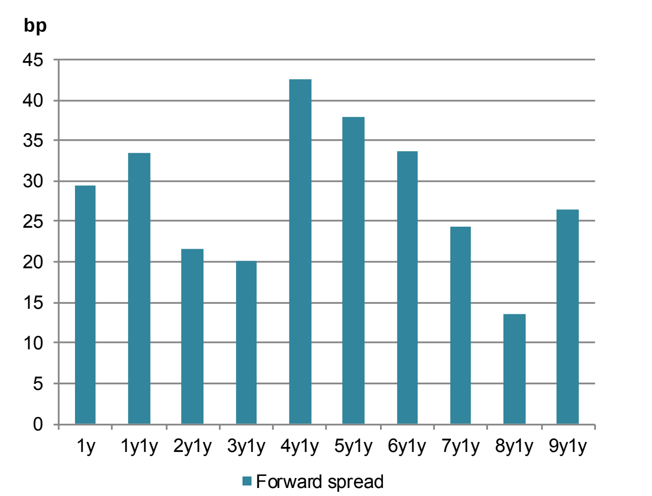
Go Long 5y Euro vs French Inflation

With the largest deviation in inflation priced in around the 5y point, we recommend going long 5y euro inflation swaps versus France (see Exhibit E6). Ideally, this trade works best if you hold it to maturity and accrue the positive carry steadily over time. It works less well as a short-term trade as there is the risk that you get a downward shock to oil prices, which would have more of a negative impact on euro inflation relative to French.

Alternatively, in cash, we continue to recommend being long OATei22 vs OATi23 on real yield. Real money accounts can also look to take advantage of this dynamic by running persistent underweight OATi positions relative to their benchmarks.

Exhibit E6

FRFxT – HICPxT 1y Forward Spread



Source: Morgan Stanley Research, Bloomberg

Picking Your Moment

As we have already mentioned, French inflation has recently richened further versus euro. This makes the trade increasingly attractive to enter. However, we recommend that investors wait a little longer before initiating the trade. This is because the carry favours French breakevens over euro in September and October, which is a factor that could continue to support French inflation products for the time being. With a spot spread of 30bp, we recommend that investors hold off and try to **enter the trade at a spread of 33bp**. In the past, *Livret* hedgers have shown that they are not insensitive to the price of French inflation products so we do not expect the spread to widen much more than this. Indeed, the spread has struggled to richen beyond 35bp in the last two years. Furthermore, in our view, French ALM accounts are increasingly likely to use euro inflation for hedging activity to avoid rich French linkers, which should also help the spread tighten.

Although the entry point is not quite as vital as it is with many trades because you realise profit predominantly via carry, it is worth holding out for a good entry level because it gives you some cushion when marking to market the position.

The risk to the trade is that there is a large downward oil price shock which, if prolonged, would have a bigger negative impact on euro inflation versus French.

Bond Supply Overview

The Week Ahead

In **Europe**, we expect €16.5bn of nominal supply from GE, FR and SP against €2.2bn coupons and no redemptions coming into the market. This is compared to €24bn of average supply from the past three years for the same week. In the **UK**, UKT 1.25% July 2018 will be tapped for £4.75bn against no cash coming into the market. In the **US**, 3y, 10y and 30y issued for a total of $65bn will settle in the week after next when $0.5bn coupons and $33bn redemptions will be paid.

The Coming Five Weeks

In Europe, we estimate about €77bn of nominal supply in the coming five weeks. This is against €13bn of coupons and €46bn redemptions, resulting in a net cash deficit of €18bn. Gross supply and supply, net of coupons will be skewed towards the short end of the curve.

We acknowledge the contribution of Asmita Jimulia, CFA to this report.

Monday	Tuesday	Wednesday	Thursday	Friday
16-Sep	**17-Sep**	**18-Sep**	**19-Sep**	**20-Sep**
US OMO: 11-17y T ,$0.75 - $1.00bn	**DEN:** DGB 1.5% 2023, DKK 3bn* and DGBi 0.1% 2023, DKK 1bn* **US OMO:** 22-30y T ,$1.25 - $1.75bn	**GER:** BKO September 2015 Tap, €5bn **SWE:** SGB 4.25% March 2019 Tap, SEK 3.5bn	**FRA:** OAT Auction(2-5y), €6.5-7.5bn OAT 0.25% November 2015, €3bn*; BTAN 2.25% February 2016, €1.5bn* and OAT 1% November 2018, €3bn* **FRA:** IL Auction, €1.3-1.7bn OATi 0.1% July 2021, OATei 0.25% July 2024 and OATei 1.85% July 2027 **SPA:** Bono Auction, €4bn* SPGB 3.3% July 2016 and SPGB 5.15% October 2028 **UK:** UKT 1.25% July 2018 Tap, £4.75bn **NOR:** NGB Announcement **US:** 10Y TIPS Re-opening, $13bn **US OMO:** 7-10y T ,$2.75 - $3.50bn	**ITA:** CTZ and BTPei Announcement **US OMO:** 22-30y T ,$1.25 - $1.75bn
23-Sep	**24-Sep**	**25-Sep**	**26-Sep**	**27-Sep**
***UK:** New UKTi March 2068 via Syndication, £4bn* **US OMO:** 6-7y T ,$3.00 - $4.00bn	**NETH:** DSL 0% April 2016 Tap, €2-3bn **ITA:** BTP Announcement **NOR:** NGB Aution, NOK3bn* **US:** New 2-Year UST, $35bn* **US OMO:** 22-30y T ,$1.25 - $1.75bn	**ITA:** CTZ Auction, €2.5bn* (Possible CTZ June 2015) **ITA:** BTPei Auction, €1.5bn* **US:** New 5-Year UST, $35bn* **US OMO:** 7-10y T ,$2.75 - $3.50bn	**US:** New 7-Year UST, $29bn* **US OMO:** 22-30y T ,$1.25 - $1.75bn **SWE:** SGBi Auction, SEK 1bn	**ITA:** BTP Auction, €6bn* **US OMO:** 5-6y T ,$4.75 - $5.75bn
30-Sep	**01-Oct**	**02-Oct**	**03-Oct**	**04-Oct**
BEL: OLO Auction Cancelled **US OMO:** 22-30y T ,$1.25 - $1.75bn	**AUT:** RAGB Auction, €3bn* **DEN:** DGB Auction, DKK3bn*	****GER:** Possible OBL October 2018, €4bn* **SWE:** SGB Auction, SEK 3.5bn	**FRA:** OAT Auction, €7-8bn* **SPA:** Bono Auction, €4bn* **UK:** UKT 2.25% September 2023, £3.5bn* **NOR:** NGB Announcement	
07-Oct	**08-Oct**	**09-Oct**	**10-Oct**	**11-Oct**
	ITA: BTP Announcement ****NETH:** Possible DSL 1.25% January 2019 Tap, €2-3bn* **UK:** UKTi 0.125% November 2019, £4bn* **NOR:** NGB Aution, NOK3bn* **US:** New 3Y UST, $31bn*	****GER:** Possible BKO 0.25% September 2015 Tap, €5bn* **US:** 10Y UST Re-opening, $21bn*	**SWE:** SGBi Auction, SEK 1bn **US:** 30Y UST Re-opening, $13bn*	**ITA:** BTP Auction, €6bn* **BEL:** ORIA Auction, €0.25bn*
14-Oct	**15-Oct**	**16-Oct**	**17-Oct**	**18-Oct**
	DEN: DGB Auction, DKK3bn*	****GER:** Possible New 10y DBR, €5bn* **SWE:** SGB Auction, SEK 3.5bn	**FRA:** OAT Auction(2-5y), €7-8bn* **FRA:** IL Auction, €1.3-1.7bn, €1-1.5bn* **SPA:** Bono Auction, €4bn*	

Source: National Treasuries and Morgan Stanley Research

*** Exact details are not out yet.*

**** The exact date of the Syndication is not announced yet and will be conducted in the week commencing*

Eurozone Total Cash Flow (EURbn)

w/c		Country	Supply	Coupons	Redemptions	Net Cash Flow	Approx no. 10y Futures
16-Sep	Mon	AUT		1.25		1.252	
		FIN		0.52		0.52	
		ITA		0.38		0.38	
	Tue						
	Wed	GER	5.00			-5.00	7k
	Thu	FRA	7.50			-7.50	22k
		SPA	4.00			-4.00	16k
	Fri	GER		0.04		0.04	
		GRE		0.01		0.01	
Sub-total			16.50	2.20	0.00	-14.30	
23-Sep	Mon	POR		0.32	5.83	6.147	
	Tue	NETH	2.50			-2.50	5k
	Wed	ITA	2.50			-2.50	4k
		FRA		0.33	10.71	11.03	
	Thu						
	Fri	ITA	6.00			-6.00	33k
Sub-total			11.00	0.65	16.54	6.18	
30-Sep	Mon			4.56	13.51	18.066	
		SPA		0.13		0.13	
	Tue	AUT	3.00			-3.00	17k
		ITA		0.22		0.22	
	Wed	GER	4.00			-4.00	15k
	Thu	FRA	8.00			-8.00	60k
		SPA	4.00			-4.00	11k
	Fri						
Sub-total			19.00	4.91	13.51	-0.58	
07-Oct	Mon						
	Tue	NETH	2.50			-2.50	11k
	Wed	GER	5.00	0.28		-4.72	8k
	Thu	GER		0.43		0.43	
	Fri	ITA	6.00			-6.00	32k
		BEL	0.25			-0.25	1k
		GER		0.64	16.00	16.64	
Sub-total			13.75	1.35	16.00	3.60	
14-Oct	Mon	GER		0.29		0.286	
	Tue	ITA		0.60		0.60	
		POR		0.99		0.99	
	Wed	GER	5.00			-5.00	37k
		POR		0.37		0.37	
	Thu	FRA	7.50			-7.50	22k
		SPA	4.00			-4.00	16k
	Fri	IRA		1.62		1.62	
Sub-total			16.50	3.87	0.00	-12.63	
TOTAL			76.75	12.97	46.04	-17.74	

Source for all: Morgan Stanley, National Treasuries, Bloomberg
Numbers may not add exactly due to rounding
IL's and Floater's cash flows are not included

Exhibit 1: Issuance by Maturity Bucket (with Dur. Equiv.), Coupons & Redemptions
Germany, France, Netherlands, Finland, Austria, Belgium

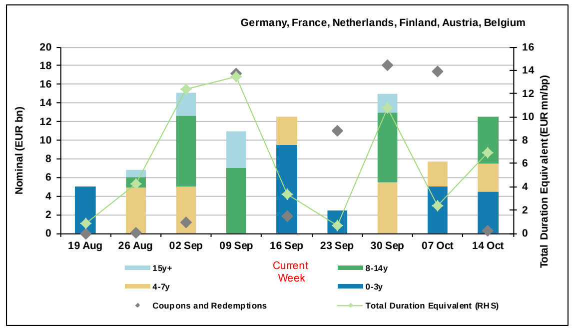


Exhibit 2: Issuance by Maturity Bucket (with Dur. Equiv.), Coupons & Redemptions
Italy and Spain

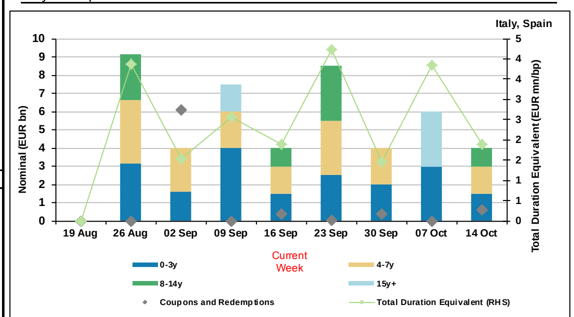


Exhibit 3: Euroland Supply, Coupons & Redemptions by Country, for the coming five weeks

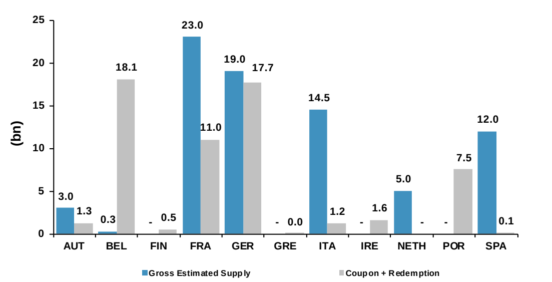


Exhibit 4: Funding Progress (EURbn)

Country	Bond Planned € bn	Bonds Issued through Sep 13, € bn	Issuance Remaining € bn	Bonds Issued through Sep 13, % of Planned
Austria	22.0	15.2	6.8	69.0%
Belgium	43.5	36.604	6.9	84.1%
Finland	13.0	10.5	2.5	80.8%
France*	186.0	142.6	43.4	76.7%
Germany	181.0	134.0	47.0	74.0%
Ireland	10.0	7.5	2.5	75.0%
Italy *	230.0	179.7	50.3	78.1%
Netherlands	50.0	41.5	8.5	83.1%
Portugal *	5.0	5.5	0.0	110.0%
Spain	121.0	96	25.4	79.0%
EMU 16	862	669	193	77.6%
EMU 4	728	559	169	76.8%

* Morgan Stanley estimate.
Germany: €173bn Nominal + €8bn of Est. Linkers
Austria : €20-24bn
Belgium: €40bn of OLOs + €3.5bn of EMTN-program

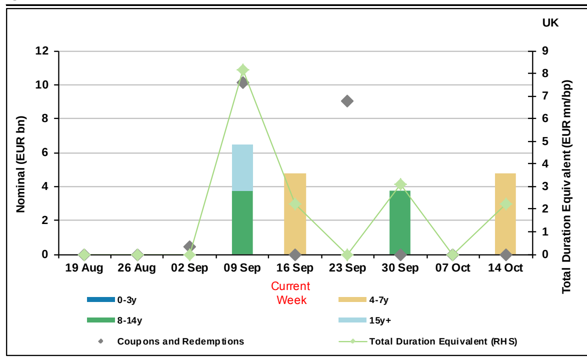
UK, Scandinavia and US Total Cash Flow (Local Currency)

UK (Local Currency bn)

w/c	Country	Supply	Coupons	Redemptions	Net Cash Flow	Approx no. 10y Futures
16-Sep	UK	4.75			-4.75	24k
23-Sep			0.35	8.68	9.03	
30-Sep	UK	3.75			-3.75	34k
07-Oct						
14-Oct	UK	4.75			-4.75	24k
TOTAL		**13.25**	**0.35**	**8.68**	**-4.22**	

** The exact date of the Syndication/Mini Tender is not announced yet and will be conducted in the week commencing

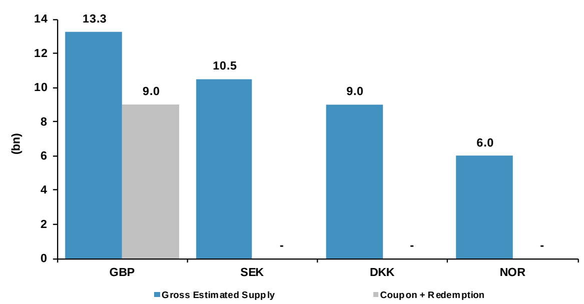
Exhibit 1: Issuance by Maturity Bucket (with Dur. Equiv.), Coupons & Redemptions UK



Scandinavia (Local Currency bn)

w/c	Country	Supply	Coupons	Redemptions	Net Cash Flow
16-Sep	SEK	3.50			-3.50
	DKK	3.00			-3.00
	NOK				
23-Sep	SEK				
	DKK				
	NOK	3.00			-3.00
30-Sep	SEK	3.50			-3.50
	DKK	3.00			-3.00
	NOK				
07-Oct	SEK				
	DKK				
	NOK	3.00			-3.00
14-Oct	SEK	3.50			-3.50
	DKK	3.00			-3.00
	NOK				
SEK Total		**10.50**	**0.00**	**0.00**	**-10.50**
DKK Total		**9.00**	**0.00**	**0.00**	**-9.00**
NOK Total		**6.00**	**0.00**	**0.00**	**-6.00**

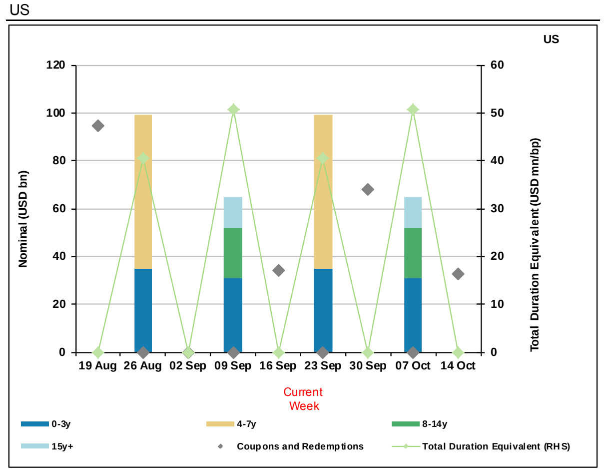
Exhibit 2: UK and Scandinavia Supply, Coupons & Redemptions For the Five Weeks From 16 Sep



US (Local Currency bn)

w/c		Country	Supply	Coupons	Redemptions	Net Cash Flow	Approx no. 10y Futures
16-Sep		US		0.53	33.36	-31.11	
		US					
		US					
		US					
23-Sep		US					
	Tue	US	35.00				78k
	Wed	US	35.00				200k
	Thu	US	29.00				226k
30-Sep		US		5.87	62.31	-30.82	
		US					
		US					
		US					
07-Oct		US					
	Tue	US	31.00				105k
	Wed	US	21.00				226k
	Thu	US	13.00				297k
14-Oct		US		0.52	32.28	-32.20	
		US					
		US					
		US					
TOTAL			**164.00**	**6.92**	**127.95**	**-94.13**	

Exhibit 3: Issuance by Maturity Bucket (with Dur. Equiv.), Coupons & Redemptions US



Source for all: Morgan Stanley, National Treasuries
Numbers may not add exactly due to rounding
IL's and Floater's cash flows are not included

T-Bills Supply Calendar

Date	Country	Details	Tenor (Months)	Maturity	Crncy	Amount (bn)
16-Sep-13	**NOR**	NGTB Auction			NOK	
16-Sep-13	**FRA**	BTF Auction	3	19-Dec-13	EUR	3.4-3.8
16-Sep-13	**FRA**	BTF Auction	5	20-Feb-14	EUR	1.2-1.6
16-Sep-13	**FRA**	BTF Auction	12	18-Sep-14	EUR	1.4-1.8
16-Sep-13	**NETH**	DTB Aution	4	30-Dec-13	EUR	2
16-Sep-13	**NETH**	DTB Aution	7	31-Mar-14	EUR	2
16-Sep-13	**US**	B Auction	3		USD	30
16-Sep-13	**US**	B Auction	6		USD	25
17-Sep-13	**US**	B Auction	4W		USD	30*
17-Sep-13	**US**	B Auction	12		USD	22
17-Sep-13	**BEL**	BGTB Auction	3	19-Dec-13	EUR	
17-Sep-13	**BEL**	BGTB Auction	12	18-Sep-14	EUR	
17-Sep-13	**SPA**	SGLT Auction	6		EUR	
17-Sep-13	**SPA**	SGLT Auction	12		EUR	
17-Sep-13	**GRE**	GTB Auction	3	20-Dec-13	EUR	1
18-Sep-13	**POR**	PORTB Auction	3	20-Dec-13	EUR	Total 1.25-1.5
18-Sep-13	**POR**	PORTB Auction	18	20-Mar-14	EUR	
20-Sep-13	**UK**	UKTB Auction	1	21-Oct-13	GBP	1
20-Sep-13	**UK**	UKTB Auction	3	23-Dec-13	GBP	0.5
20-Sep-13	**UK**	UKTB Auction	6	24-Mar-14	GBP	1
23-Sep-13	**GER**	BUBILL Auction	12	24-Sep-14	EUR	3
23-Sep-13	**FRA**	BTF Auction			EUR	
23-Sep-13	**US**	B Auction	3		USD	30*
23-Sep-13	**US**	B Auction	6		USD	25*
24-Sep-13	**US**	B Auction	4W		USD	30*
24-Sep-13	**SPA**	SGLT Auction	3		EUR	
24-Sep-13	**SPA**	SGLT Auction	9		EUR	
25-Sep-13	**SWE**	SGTB Auction			SEK	
26-Sep-13	**ITA**	BOT Auction			EUR	
27-Sep-13	**UK**	UKTB Auction	1		GBP	
27-Sep-13	**UK**	UKTB Auction	3		GBP	
27-Sep-13	**UK**	UKTB Auction	6		GBP	
30-Sep-13	**NOR**	NGTB Auction			NOK	
30-Sep-13	**FRA**	BTF Auction			EUR	
30-Sep-13	**US**	B Auction	3		USD	30*
30-Sep-13	**US**	B Auction	6		USD	25*
01-Oct-13	**US**	B Auction	4W		USD	30*
01-Oct-13	**BEL**	BGTB Auction	3	16-Jan-14	EUR	
01-Oct-13	**BEL**	BGTB Auction	6	20-Mar-14	EUR	
04-Oct-13	**UK**	UKTB Auction	1		GBP	
04-Oct-13	**UK**	UKTB Auction	3		GBP	
04-Oct-13	**UK**	UKTB Auction	6		GBP	
07-Oct-13	**FRA**	BTF Auction			EUR	
07-Oct-13	**NETH**	DTB Aution	3	30-Dec-13	EUR	
07-Oct-13	**NETH**	DTB Aution	9	30-Jun-14	EUR	
07-Oct-13	**US**	B Auction	3		USD	30*
07-Oct-13	**US**	B Auction	6		USD	25*
08-Oct-13	**US**	B Auction	4W		USD	30*
09-Oct-13	**SWE**	SGTB Auction			SEK	
10-Oct-13	**ITA**	BOT Auction			EUR	
11-Oct-13	**UK**	UKTB Auction	1		GBP	
11-Oct-13	**UK**	UKTB Auction	3		GBP	
11-Oct-13	**UK**	UKTB Auction	6		GBP	
14-Oct-13	**NOR**	NGTB Auction			NOK	
14-Oct-13	**FRA**	BTF Auction			EUR	
15-Oct-13	**BEL**	BGTB Auction	3	16-Jan-14	EUR	
15-Oct-13	**BEL**	BGTB Auction	12	16-Oct-14	EUR	
15-Oct-13	**SPA**	SGLT Auction	6		EUR	
15-Oct-13	**SPA**	SGLT Auction	12		EUR	
15-Oct-13	**US**	B Auction	3		USD	30*
15-Oct-13	**US**	B Auction	6		USD	25*
16-Oct-13	**US**	B Auction	4W		USD	30*
16-Oct-13	**US**	B Auction	12		USD	22*
16-Oct-13	**POR**	PORTB Auction	3	17-Jan-14	EUR	Total 1.25-1.5
16-Oct-13	**POR**	PORTB Auction	9	18-Jul-14	EUR	
18-Oct-13	**UK**	UKTB Auction	1		GBP	
18-Oct-13	**UK**	UKTB Auction	3		GBP	
18-Oct-13	**UK**	UKTB Auction	6		GBP	

Note: The calendar is based on schedules announced by each country. No Schedules for the coming period have been announced Finland.
*Morgan Stanley estimates
Source: National Treasuries, Morgan Stanley

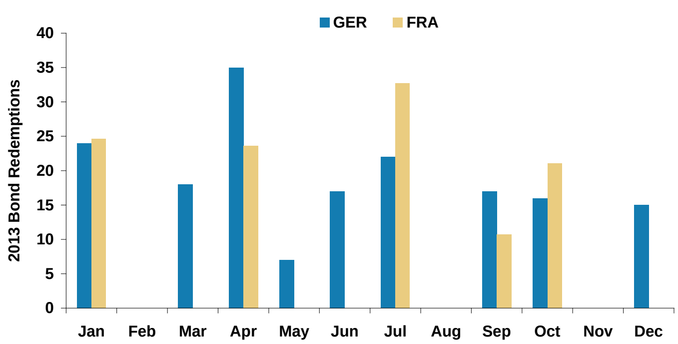
European Government Redemptions

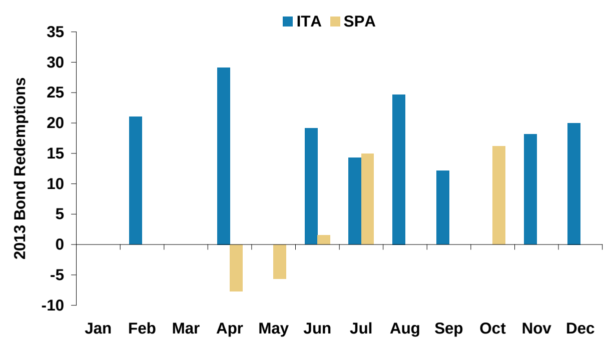
Current Amount of Domestic and International Bonds, *And Bills,* Outstanding (EURbn)

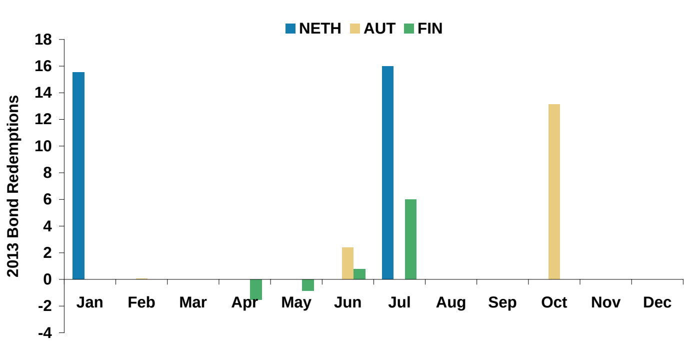
2013	GER		FRA		ITA		SPA		NETH		GRE		BEL		IRE		AUT		POR		FIN		Total	
Jan	24.0	7.0	24.7	37.5	0.0	21.3	0.0	5.4	15.5	0.0	0.0	7.4	0.0	0.0	0.0	0.5	0.0	0.0	0.0	1.3	0.0	0.2	64.2	80.6
Feb	0.0	7.0	0.0	30.5	21.0	19.3	0.0	9.2	0.0	4.9	0.4	3.6	0.0	4.9	0.0	0.5	0.1	0.0	0.0	2.2	0.0	0.0	21.5	82.1
Mar	18.0	7.0	0.0	24.6	0.0	19.0	0.0	12.3	0.0	6.1	0.0	3.0	12.8	3.5	0.0	0.0	0.0	0.1	0.0	2.6	0.0	0.0	30.8	78.1
Apr	35.0	0.0	23.6	32.3	29.1	18.0	-7.7	7.7	0.0	7.2	2.7	3.2	0.0	0.0	5.6	0.5	0.0	0.0	0.0	1.2	-1.5	1.5	86.9	71.5
May	7.0	0.0	0.0	36.7	0.0	0.0	-5.7	5.7	0.0	6.4	5.6	3.2	0.0	0.0	0.0	0.5	0.0	0.0	0.0	2.4	-0.8	0.8	6.1	55.7
Jun	17.0	6.0	0.0	29.7	19.1	16.4	1.5	9.6	0.0	0.0	0.9	3.6	0.1	6.4	0.0	0.5	2.4	0.4	0.0	1.5	0.8	1.3	41.8	75.4
Jul	22.0	7.0	32.8	28.5	14.3	20.4	14.9	5.0	16.0	3.8	0.6	3.6	0.0	5.8	0.0	0.5	0.0	0.0	0.0	2.0	6.0	0.0	106.6	76.6
Aug	0.0	7.0	0.0	37.5	24.7	18.3	0.0	11.4	0.0	4.0	2.2	2.6	0.0	4.3	0.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0	26.9	85.8
Sep	17.0	7.0	10.7	29.5	12.1	19.8	0.0	7.6	0.0	5.5	0.0	1.4	15.2	4.9	0.0	0.5	0.0	0.0	5.8	0.0	0.0	2.3	60.8	78.3
Oct	16.0	7.0	21.1	29.5	0.0	17.2	16.2	7.3	0.0	3.4	0.0	1.6	0.0	3.4	0.0	0.0	13.1	0.4	0.0	2.0	0.0	1.1	66.4	72.9
Nov	0.0	7.0	0.0	12.6	18.1	15.7	0.0	10.0	0.0	2.4	0.0	1.6	0.0	2.5	0.0	0.0	0.0	0.3	0.0	0.5	0.0	0.0	18.1	52.6
Dec	15.0	4.0	0.0	11.5	20.0	22.2	0.0	8.2	0.0	3.5	0.0	0.0	0.2	1.9	0.0	0.0	0.0	0.6	0.0	0.5	0.0	0.0	35.2	52.4
Total	171	66	113	340	159	208	19	99	32	47	12	35	28	38	6	4	16	2	6	16	4	7	565	862

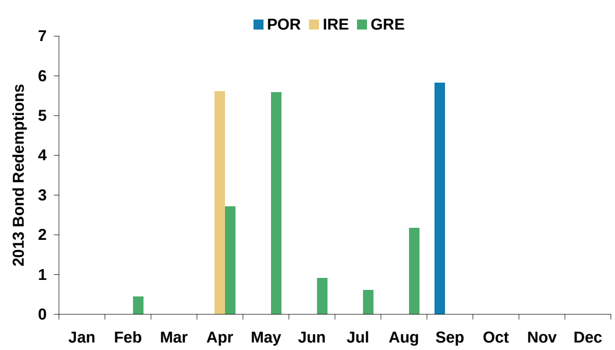
2014	GER		FRA		ITA		SPA		NETH		GRE		BEL		IRE		AUT		POR		FIN		Total	
Jan	24.0	7.0	21.7	6.7	14.5	9.8	14.2	5.4	15.7	2.2	1.9	0.0	0.0	1.5	7.6	0.0	1.3	0.2	0.0	1.4	0.3	0.0	101.1	34.2
Feb	0.0	3.0	0.0	7.5	0.0	9.7	0.0	8.4	0.0	0.0	0.0	0.0	0.2	1.5	0.0	0.0	0.0	0.3	0.2	1.5	0.0	0.0	0.5	32.0
Mar	15.0	3.0	0.0	5.3	13.4	7.8	0.0	8.1	0.0	0.0	0.0	0.0	13.0	1.3	0.0	0.0	0.0	0.0	0.0	1.7	0.0	0.0	41.5	27.2
Apr	19.0	3.0	21.7	15.6	15.3	8.9	15.4	7.2	0.0	0.0	0.0	0.0	0.0	1.6	0.0	0.0	0.0	0.0	0.0	1.5	0.0	0.0	71.4	37.8
May	0.0	3.0	0.0	7.1	12.8	7.0	0.0	3.3	0.0	0.0	7.8	0.0	0.0	1.6	0.0	0.0	2.0	0.0	0.0	2.6	0.0	1.8	22.7	26.3
Jun	15.0	3.0	0.0	8.2	19.4	7.0	0.0	8.3	0.0	1.2	0.0	0.0	0.0	1.4	0.0	0.0	0.0	0.0	6.0	0.0	0.0	0.0	40.5	29.1
Jul	25.0	0.0	27.2	0.0	14.9	0.0	16.4	0.0	16.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	9.6	0.0	0.0	1.3	0.0	0.0	109.5	1.3
Aug	0.0	0.0	0.0	0.0	27.2	0.0	0.0	0.0	0.0	0.0	5.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	32.7	0.0
Sep	15.0	0.0	15.2	0.0	29.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	13.8	0.0	0.0	0.0	0.5	0.0	0.0	1.5	6.5	0.0	80.3	1.5
Oct	17.0	0.0	21.2	0.0	0.0	0.0	21.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	11.1	0.0	7.8	0.0	0.0	0.0	79.0	0.0
Nov	0.0	0.0	0.0	0.0	14.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	14.7	0.0
Dec	14.0	0.0	0.0	0.0	29.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.0	0.0	0.0	0.0	0.0	0.0	1.1	0.1	0.0	43.8	1.1
Total	144	22	107	50	190	50	68	41	32	3	15	0	28	9	8	0	24	0	14	13	7	2	638	190

Bond Redemptions by Country (excluding T-Bills, EUR Bn)









Source: Morgan Stanley Research

2013 Base Case Yield Forecasts: Bunds and UK

Bunds

	O/N	2y	5y	10y	30y
Spot	0.08	-0.04	0.36	1.34	2.19
Q1 13	-0.10	-0.09	0.37	1.42	2.34
Q2 13	-0.10	-0.06	0.45	1.52	2.44
Q3 13	-0.10	0.01	0.58	1.66	2.58
Q4 13	-0.10	0.04	0.62	1.68	2.58

UK

	O/N	2y	5y	10y	30y
Spot	0.40	0.24	0.73	1.75	3.08
Q1 13	0.45	0.21	0.67	1.74	3.10
Q2 13	0.45	0.24	0.80	1.88	3.20
Q3 13	0.45	0.37	0.94	2.08	3.30
Q4 13	0.45	0.45	1.10	2.20	3.40

Source: Morgan Stanley Research

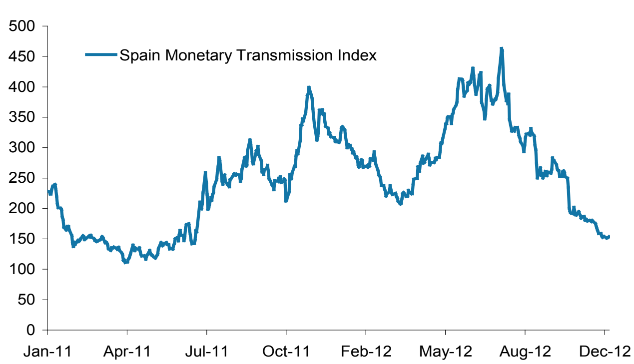
2013 Eurozone Spread Forecasts

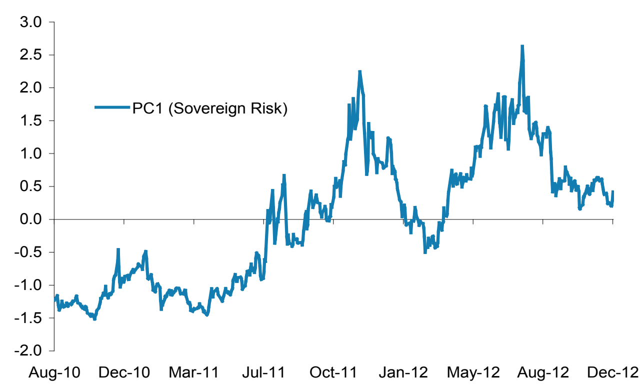
2013 European Sovereign Spread and Yield Forecast

Spread YE 2013	Spain 5y	Italy 5y	Belgium 5y	France 5y	Austria 5y	Netherlands 5y	Sweden 5y
Spot	440	340	60	40	30	20	56
Base	390	300	65	45	35	10	60
Bull	285	265	45	20	15	5	45
Bear	575	525	100	90	85	60	75
Change vs. Spot YE 2013	**Spain 5y**	**Italy 5y**	**Belgium 5y**	**France 5y**	**Austria 5y**	**Netherlands 5y**	**Sweden 5y**
Base	-50	-40	5	5	5	-10	4
Bull	-155	-75	-15	-20	-15	-15	-11
Bear	135	185	40	50	55	40	19
Yield % YE 2013	**Spain 5y**	**Italy 5y**	**Belgium 5y**	**France 5y**	**Austria 5y**	**Netherlands 5y**	**Sweden 5y**
Spot	4.76	3.76	0.96	0.76	0.66	0.56	0.98
Base	4.52	3.62	1.27	1.07	0.97	0.72	1.22
Bull	3.15	2.95	0.75	0.5	0.45	0.35	0.75
Bear	6.37	5.87	1.62	1.52	1.47	1.22	1.37

Source: Morgan Stanley Research

Sovereign Risk Measures





Source: Morgan Stanley Research

European Government Ratings Tracker

Ratings of 13-Sept-13		Aaa/AAA	Aa1/AA+	Aa2/AA	Aa3/AA-	A1/A+	A2/A	A3/A-	Baa1/BBB+	Baa2/BBB	Baa3/BBB-	Ba1/BB+	Ba2/BB	Ba3/BB-	B1/B+	B2/B	B3/B-	Below B3/B	Govt Budget Balance (% of GDP)	Gross General Govt Debt (% of GDP)
UK	Moody		STA																-6.4	77.1 *
	S&P	NEG																		
	Fitch		STA																	
Germany	Moody	NEG																	0.2	80.4
	S&P	STA																		
	Fitch	STA																		
France	Moody		NEG																-3.9	93.4
	S&P		NEG																	
	Fitch		STA																	
Austria	Moody	NEG																	-2.4	75.4
	S&P		STA																	
	Fitch	STA																		
Netherlands	Moody	NEG																	-3.6	74.7
	S&P	NEG																		
	Fitch	NEG																		
Finland	Moody	STA																	-1.7	56.4
	S&P	STA																		
	Fitch	STA																		
Belgium	Moody				NEG														-2.7	100.4
	S&P			NEG																
	Fitch			STA																
Spain	Moody										NEG								-8	100.2
	S&P										NEG									
	Fitch									NEG										
Italy	Moody									NEG									-2.6	129.1
	S&P									NEG										
	Fitch								NEG											
Ireland	Moody											NEG							-7.2	119.8
	S&P								POS											
	Fitch								STA											
Portugal	Moody													NEG					-5	129.4
	S&P												STA							
	Fitch											NEG								
Greece	Moody																		-4.3	173
	S&P																STA			
	Fitch																STA			

Source: Morgan Stanley Research, Moody's, Standards & Poor, Fitch
STA: Outlook Stable
NEG: Outlook Negative
DEV: Outlook Developing
OW-: On Watch Negative
POS: Outlook Positive
SD: Selective Default

* Net Debt

EUR Rate Strategy Portfolio

Trade Idea	Rationale	Entry Date	Levels					Performance		Publication
			Entry	Current	Target	Stop	Units	Chg over period	1 wk chg	
Curve										
Rec EUR 2y1y vs pay GBP 2y1y	We believe the UK recovery is likely to be stronger than that of the Eurozone, hence, the spread between the respective front end yields should widen.	30-Aug-13	-34	-54	-50	-23	bps	-20.5	-5.2	*Failed to Impress*
Receive EUR Swaps 2y1y vs 4y1y	ECB forward guidance should steepen the front-end	12-Jul-13	102	107	140	80	bps	4.9	-1.0	*Guiding A Steeper Front-end*
2s10s Bunds steepeners, regression weighted in a 2s:10s DV01 ratio of 2.1:1	Term premium is rising, but still low: curve should steepen unless sell-off reverses, the curve steepening necessitates we increase the weighting in 2s to 2.1	24-Jun-13	134	152	150	120	bps	18.0	13.3	*Unwinding Extreme Valuations*
2s10s EUR swaps steepeners, weighted DV01 ratio of 1.6:1	Term premium is rising, but still low: curve should steepen unless sell-off reverses	07-Jun-13	96	125	110	90	bps	29.3	1.0	*The Fragility of Confidence*
10s30s Bund Steepener (Regression-weighted)	EUR 10s30s looks too flat vs international comparisons, should steepen as supply/demand becomes more balanced, and the steepener carries positively	26-Feb-13	144	154	185	126	bps	9.5	0.3	*Looking For Steeper Curves*
4y forward 10s30s Swaps steepener		26-Feb-13	-4	-19	20	-25	bps	-15.1	0.3	*Looking For Steeper Curves*
5s30s FRA-OIS basis curve steepeners	FRA-OIS curve should steepen as we expect the IOSCO taskforce to focus on positively shaped curves	28-Sep-12	-3	-10	10		bps	-7.5	-0.2	*LIBOR Lives On…For Now*
30s50s flattener in Swaps	We expect long-end hedging demand to remain strong in spite of the early adoption of S2 discount curves	06-Jul-12	14	7	0	18	bps	-7.3	-0.3	*A Bumpy Road Ahead*
1s2s Steepener in EONIA	Best risk/reward in the front end	27-Apr-12	7.0	14.3	25.0	0.0	bps	7.3	-2.3	*Discounting a Dovish Draghi*
1s2s Steepener in EURIBOR	If the market begins to worry that the next ECB move may be higher rather than lower policy rates, front-end rates will rise	24-Feb-12	-4.0	19.2	8.0	-10.0	bps	23.2	-1.5	*Beyond the LTRO*
Sovereign Spreads										
New: Long 3y Spain vs. Germany	Expect euro sovereign spreads to continue tightening, and front-end Spain has attractive carry and roll valuations.	13-Sep-13	216	216	150	250	bps			*Viva Espana*
New: Long 10y Spain vs. Germany	Market prices sovereign credit risk in Spain and Italy the same, which we think is inappropriate given the divergent economic and political challenges.	13-Sep-13	-2	-2	-100	50	bps			*Viva Espana*
Buy 30y OAT vs. Bunds	OATs remain attractive as they work well as duration-hedging instruments and offer yield pick-up	19-Jul-13	88	82	65	80	bps	-6.4	3.9	*Le Tour De France*
Long Jan 23 vs Jan 22 & Oct 23	SPGB Jan-23 is cheap on z-spread measure and offers relative value opportunities versus surrounding bonds	26-Jul-13	11	12	0	18	bps	0.7	0.1	*Long End Ahead of the ECB*
Spain 10s30s steepener versus Germany	Spain 10s30s curve has remained too flat versus Germany despite the tightening in spreads. We recommend putting on steepener to fade the cheapness in the 10yr spread	03-May-13	-28	-20	-5	-42	bps	8.3	-0.4	*Green Light From Draghi*
Buy 30y Netherlands bonds on asset swap	Regulatory pressure to reform reference rates on swaps should cheapen long-dated swaps vs cash bonds	26-Apr-13	15	17	-10	25	bps	2.2	-0.5	*Not Too Big To Replace*
Buy 30y Germany bonds on asset swap		26-Apr-13	-4	-2	-15	5	bps	2.2	1.9	*Not Too Big To Replace*
Inflation										
Short 5y5y Euro Breakevens	Current levels inconsistent with bearish outlook	23-May-13	2.27	2.25	2.00	2.35	Yield (%)	-0.02	-0.02	*Inflation Strategist-The Dog That Didn't Bark*
New: Long 5y FR CPIxT vs. HICPxT	Carry trade to benefit from fundamental richness of French inflation.	13-Sep-13	33	33	10	45	bps			*Viva Espana*
Close: Pay 4y FR CPIxT vs. HICPxT	The euro vs. French spread is at a fundamentally unjustified extreme, especially in swaps	28-Nov-11	14.1	2.3			bps	-11.8	-1.2	*Inflation Strategist*
Volatility										
Buy 100x OEU3 call strike 126.75 vs sell 50x DUU3 call strike 110.70 and 50x RXU3 call strike 114.50	If funding rates go meaningfully negative, Bobls will outperform on 2s5s10s	24-May-13	0..0				cents			*A Potential Sea-Change*
Buy 6m10y 20 Wide Payer spread	The combination of a high level of skew, low volatility and low rates should prove attractive for the purchase of payor spreads	11-Apr-13	8.00	8.00			bps running			*Fade the Rally*
Sell ERM3 99.25/99.50/99.75 put fly vs buy ERZ3 99.25/99/98.75 put fly	Euribor has little chance of setting close to 50bp	07-Feb-13	3.00	3.00			cents			*Lackluster Response*
Buy ERZ3 99.50 C Sell 0RZ4 99.25 C	We believe that ultimately Euribor will fix higher but too much is priced by this December; we recommend Euribor dec13/dec14 Bull Wideners	18-Jan-13	5.0	5.0			bps	0.0	0.0	*Perfect Storm for Euro Rates*
1y1y 50 Wide Payor Spread	1y1y payor spreads offer an attractive hedge for libor-stresses going forward	01-Feb-12	14.0	0.0			bps	-14.0	-1.2	*Hedging Risk Off*
1y2y 50 Wide Payor Spread	Cheap way to hedge against a risk-off led, bear flattening move in the curve.	01-Feb-12	16.0	0.0			bps	-16.0	-3.3	*Hedging Risk Off*
EUR 4y1y Receiver	Carry rich to volatility	09-Jul-12	60.0	93.8			bps running	33.8	33.8	*Cool Down with Carry*

*Our trades represent hypothetical, not actual, investments. Reported returns do not take into account transaction fees and other costs. Past performance is no guarantee of future results. All current levels are as of the date of publication. *EUR Trade Tracker - Data Package*, September 13, 2013.
Source: Morgan Stanley Research

GBP Rate Strategy Portfolio

Trade Idea	Rationale	Entry Date	Levels					Performance		Publication
			Entry	Current	Target	Re-assess	Units	Chg over period	1 wk chg	
Curve										
Long GBP 1y1y (100%) vs GBP 4y1y (22%)	The sharp sell-off in short sterling indicates that people had still been holding onto longs in the front end. If they were not confident before, we believe that investors must now be even less confident that the MPC will 'protect' their outright longs with dovish rhetoric or action.	30-Aug-13	-33	-33	-11	-45	bps			*Failed to Impress*
Pay GBP 5s10s	With the 'end of easing' theme continuing, we expect the front-end to steepen and GBP 5y to underperform the curve.	16-Aug-13	101	104	80	112	bps	2	3	*The Trend Is Your Friend*
Buy UKT 2Q 23 (100%) versus selling UKT 3Q 44 (50%)	Substantial long end supply this summer	12-Jul-13	99	75	115	92	bps	-25	-10	*Guiding a Steeper Front-end*
Rec GBP 2y1y vs 4y1y	Forward guidance may extend as far as 2016	05-Jul-13	116	150	150	90	bps	34	-2	*All Doved Up*
Rec GBP 2s5s (100% 2y vs. 40% 5y)	Forward guidance and a potential Bank rate cut should steepen the front end	05-Jul-13	70	95	100	55	bps	25	2	*All Doved Up*
Buy UKT 1 17 spread vs SONIA	5y gilts are close to their cheapest levels vs SONIA	28-Jun-13	19	16	10	25	bps	-3	-1	*Unwinding Extreme Valuations*
Buy UKT 4H 2032 vs selling UKT 4 22 and UKT 3Q 42 at	Expect the UKT 20y belly to outperform the wings.	01-Mar-13	71	76	60	77	bps	4.6	-1.7	*Guarda e passa*
Inflation										
Long UKTi Mar-52s vs. Mar-62s	Ultra-long end should cheapen up if the DMO announces a UKTi 2068, as we expect. Mar-62s should underperform.	16-Aug-13	-7.00	-6.00	2.00	-12.00	bps	1	1	*The Trend Is Your Friend*
Long UKTi Jul-16 on Real Yield	Cheap to our economists' inflation forecasts	09-Aug-13	-1.95	-1.92	-2.25	-1.75	Yield (%)	0.03	0.03	*Is Positive Carry the Road to Hell?*
Long 10y UKTi vs. OATei breakeven	Pension fund support & FX support UKTis	07-Feb-13	118	138	138	111	bps	20	0	*Another Tail Docked*
Volatility										
GBP 2y into 1y straddles at 76 cents	Pricing for the end of easing mean vol should rise	21-Jun-13								*The End of Easing*
Sell GBP 1y into 2y and 1y into 10y ATM receivers vs buying 1y into 5y 2bp OTM receivers for zero cost	GBP 2s5s10s should outperform if yields stay low	19-Apr-13	0.00	0.00			cents			*Anticipating UK Disappontment*
Sept 13 Short Sterling 99.50 – 62.5 – 75 call fly	Payout better reflects the probability of the event of a rate cut	15-Feb-13	2.00	2.50			cents			*Looking For Steeper Curves*
SEK Rates										
Short 5Y on 2s5s10s fly	End of Easing to cause 5y to underperform	04-Dec-18	33	33	50	20	bps			*Back to School Forecast Update*
SEK 5Y ASW tightener	5Y ASW look rich on our fair value model.	14-Jun-13	-60	-56	-40	-70	bps	4.1	0.3	*The End of Easing*
Long SEK 3y vs. EUR	The spread is very wide and the risks in Sweden are towards a rate cut	15-Mar-13	98	107	80	107	bps	9	5	*Releasing Low Yield Pressure*

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Source: Morgan Stanley Research

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(as of August 31, 2013)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**978**	**34%**	**400**	**38%**	**41%**
Equal-weight/Hold	**1280**	**44%**	**491**	**46%**	**38%**
Not-Rated/Hold	**114**	**4%**	**28**	**3%**	**25%**
Underweight/Sell	**510**	**18%**	**137**	**13%**	**27%**
Total	**2,882**		**1056**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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