NOMURA Periphery Trading Desk comment on Portugal

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Now that the circus of the Greek PSI is behind us, and having been extremely active in PGBs over the last few weeks (easily our highest PGB trading volumes in the last 12 months) I thought I would send out an update of the latest views and thoughts I've heard from clients around Portugal, to which I've added some of my thoughts. The sheer number of possible scenarios, the inherent uncertainty and the number of moving parts makes Portugal unique (and also extremely interesting), and in my note below I hope to touch upon various angles / points of view I've come across.

Flows

Firstly, a round-up of what people have been doing in PGBs (and please take my estimates of flow volumes with a pinch of salt, I can only guess what the rest of the street is seeing)–

Domestic bank treasuries and asset managers – have been almost exclusively buyers. Whilst the bid for the short end 12s, 13s and 14s has slowed appreciably, the interest has now shifted to longer in the curve. 80% of the buying we have seen has been focussed on 18-23s, and in the last 4-5 days we have also seen buyers of 15-17s. My estimate is that in the last 3 weeks domestics have taken out approximately 1.5 bln of paper from the market.

Credit / Distressed / HY funds – A few accounts have initiated flatteners (13s into 20s, 14s into 21s and so on), one account has been buying 2019 – 2023s versus going short Italy and Spain via CDS. A vast majority of these accounts however have been outright buyers in the last 3 weeks – for a few of them this is the initiation of new long positions (predominantly in 16s -18s), or represents the long leg of a spread/curve trade and for others this is a reduction of short positions they had established in Jan before the downgrades. I estimate net buying from this type of investor to be about 500m of bonds mainly focussed on 19-23s.

Cash CDS basis players – Most basis players (at least the lucky ones) went long bonds v CDS following the downgrade collapse in bonds. Since then we have seen a mixture of profit taking from the ones that got in early and new buyers of cash versus CDS. More recently we have seen CDS widen out relative to bonds (last few sessions), and we are seeing profit taking of those who are long 16s and 17s v CDS, and we are seeing new buyers of 21s and 23s versus CDS. My estimate is that this class of investors have been net sellers of 5y PGBs and net buyers of 10y (flattener) with no overall supply/demand of paper.

Real Money - RM accounts have been sellers of bonds. We have seen bonds come out from accounts based in Spain (10y), Germany (10y), Switzerland (10y), Asia (2-3y) and Brazil (5-10y) but a bulk of the paper I estimate to have come from France (2-30y) and the Benelux region (5-10y). My estimate of the size of this flow is around 2 bln. We are aware of more than one RM account who is contemplating an increase of their PGB holdings but this flow has not yet materialized.

EM and rates based hedge funds and US/UK RM accounts have been sidelined, and apart from a one day intervention to the tune of 150m the ECB SMP has been quiet.

Client views

In my previous note I talked about the extremes of opinion that existed around the likelihood of PSI in 2012. Almost all clients we've spoken to are unanimous in agreement that with 14-16% yields and sub investment grade rating, Portugal is highly unlikely to be able to return to markets in the next 12 months – this means that a new bailout package in 2H 2012 (i.e. during the next IMF review when they are first likely to encounter a funding gap over a 12m horizon) is a near certainty. Most people I've spoken to expect the new bailout package to extend until the end of 2014, whereas there are some who believe that this might stretch to 2015 and even 2016. Most estimates for the size of the bailout (assuming 2015 horizon) range from 30 bln (very optimistic) to 60 bln (very pessimistic growth collapse scenario). To put this in perspective, our economist Dimtiris puts the number somewhere near 50 bln for 2014/2015 – which he believes is a conservative estimate.

However, the interesting thing is that there seems to be a swing in opinion around non domestic investors as to whether or not the bailout package will come with PSI. For a long time, market participants always assumed PSI would be an automatic formula (the taste of Deauville lingers on), but increasingly more and more market participants are coming round to the view that a new bailout package will <u>not</u> involve forced losses for bondholders. While most domestic accounts we've spoken to have been the earliest proponents of this view, it is increasingly finding support from hedge funds, many of whom have recently travelled to Lisbon, met with finance ministry officials, the treasury, IMF staffers etc. The clear feedback from the Lisbon visits was that Portugal is a very different animal to Greece – there is more credibility, a strong mandate, more social cohesion etc. Additionally, Portugal's debt stock is significantly lower and the IMF, for the moment, seems to be inclined to give the government the benefit of doubt. Core European policymakers have been extremely careful not to rock the boat – clients have noted that recent comments from Finnish and German finance ministers have been very benign and the silence has been deafening – the party line remains that PSI in Greece was a one-off, and this can either be interpreted as support for the programme or just simply that these policy makers themselves haven't made up their minds yet. My personal opinion is that it is a mixture of both.

Whilst there are clear political hurdles to a new bailout package in Germany and the rest of core Europe, the fact that the EFSF mandate is already agreed also means that this hurdle may not be as high as people think (assuming that Italy and Spain continue to be able to fund in markets, and that the EFSF is able to continue to issue privately, there is a huge buffer available for Portugal – Dimitris estimates more than 150 bln left over even after a 50 bln Portugal bailout). The argument in the German, Dutch, Austrian and Finnish parliaments may not be whether to release more funds from scratch, but instead about whether to approve the next clip of funding for Portugal via EFSF – <u>having already agreed on the need for the EFSF to exist</u>.

The risks to this "no PSI in 2012" view are clear –

1. The political climate is subject to change both in Lisbon and core Europe. This is important because the use of the EFSF requires unanimity from creditors / guarantors and the mandate / credibility of the Portuguese government is important for keeping the troika on board.

2. Economic growth may disappoint strongly leading to a breakdown in social cohesion (a la Greece) and causing the IMF to change its assessment and call for immediate debt reduction.

3. The funding situation for the periphery may deteriorate sharply with Italy, Spain yields > 6.5% again and increasing the burden on EFSF, which may then be unable to issue at reasonable yields in sizes that would be meaningful – this means that one way or another creditors will have to find "new money" to lend. This becomes a totally different ball game.

The implications of "no PSI in 2012" are also interesting. In a scenario where new bailout funds are agreed until 2015 – the credit curve steepens sharply. 13s would trade at par, 14s probably around 90, 15s around 80-85 (reflecting some risk of the package derailing en route due to fiscal slippage etc). But what happens to longer bonds (16s – 37s) not covered by the new bailout is open for debate. On the one hand, the lack of forced PSI and increased troika support might encourage new buyers to come back into the market (similar to Ireland) betting that bonds will not be restructured, while on the other investors may note that paying back 12s, 13s, 14s at par greatly decreases the stock of PGBs as a % of overall debt that is available for future restructuring - <u>subordination</u>. The 2037s is effectively the most junior tranche of Portuguese debt. Most clients I've spoken to believe that the initial reaction of a "no PSI" type scenario will be a strong rally in these bonds, but there are a few who believe that the subordination risk is more important, and would rather sell into any rally.

To summarize, the three scenarios people are talking about (with my estimate of what the consensus probabilities for each scenario and pricing implications for 2y, 4y and 9y part of the curve) are –

1. PSI in 2012 – growth numbers disappoint <u>in the coming quarter</u>, there is meaningful fiscal slippage, IMF and EU decide immediate debt reduction is required (20% probability)

13s trade at 75	(-15)
6.4 16s trade at 50/55	(-20)
21s trade at 45/50	(-5/-10)

2. No PSI in 2012, new bailout extended to 2014/2015, growth numbers turn out close to forecasts, however the market suspects that debt reduction will be required at some point – but this is in all probability at least several years away (60% probability)

13s trade at 100	(+10)
6.4 16s trade at 80/85	(+10)
21s trade at 65/70	(+10/+15)

3. No PSI in 2012, new bailout extended to 2014/2015, growth numbers turn out as expected with signs that recovery is on the way, investors willing (as in the case of Ireland) to invest new money into Portugal (20% probability)

13s trade at 100	(+10)
6.4 16s trade at 90/95	(+20)
21s trade at 80/85	(+25/+30)

Note – in scenario 1, the 13s may well trade a lot lower than 75, but anyone who has followed the trajectory of the GGB 4.3 12s will know that there will always be holdout premium until the very end (“hope is always the last thing that dies”), in scenario 2 the path of the 21s may be unclear since we don’t know to what extent the market will worry about the subordination of bonds, but most people seem to think (and I agree) we will get a rally first to 65/70 before people focus on the negatives.

The really interesting thing is that over the next 3-4 months until the next IMF review makes things clearer, the market may veer between pricing in these scenarios at various times depending on news flow and data – the odd aggressive comment from Schaeuble or an incendiary article in Der Spiegel might push us towards scenario 1 while a prolonged period of silence might cause the market to gradually gravitate towards scenario 2 or 3. This leaves a pretty wide set of feasible prices for the coming few months - the 13s could trade anywhere between 75 / 100, 16s between 55 / 80 and 21s between 50 / 80! What then is the right trade to do here?

Why I (and a few others) like the 10y sector

Weighted payoffs in various probability sets (Sc1/Sc2/Sc3)

Very pessimistic <--→very optimistic

Issue	80/15/5	70/25/5	60/30/10	50/35/15	40/40/20	30/50/20	25/55/20	20/60/20	10/70/20
13s	-11	-9.75	-6	-3.5	-1	1.5	2.75	4	6.5
16s	-13.5	-12	-7	-3.5	0	3	4.5	6	9
21s	-1.85	-0.75	3.3	6.25	9.2	11.4	12.5	13.6	15.8

The table above is a simple representation of the payoffs under different market outcomes (starting from currently prevailing prices). In the 80/15/5 column, the market attaches a 80% chance of PSI in 2012 (scenario 1), only 15% chance that PSI is delayed (scenario 2) and only 5% chance that Portugal turns into Ireland (scenario 3) – in such a market you can expect to lose 13.5 points on 16s and 11 points on 13s, but only around 2 points on 21s – provided you agree with my assessment on what prices will be under each of these scenarios (I concede there is significant scope for disagreement). At the other end of the spectrum on the right is a scenario where there is only a 10% chance of PSI (at least one hedge fund we speak to subscribes to this view) – here the 21s rocket up by 16 points and 13s and 16s gain 6.5 and 9 points respectively.

What I’m trying to demonstrate is that based on current prices, the 21s (10y sector in general) are easily the best risk adjusted long – there is minimal downside in the next 3-4 months (am not talking about eventual recovery here, just what the market could reasonably price in over this time horizon) – but if the market starts to become optimistic the upside of scenarios 2 and 3 really kicks in. This is one of my core views at the moment, and is also a view that some (but not all) clients share. For me the risk/reward to owning 13s-15s seems poor (in spite of the potential upside) and I would wait for a 4-5 point selloff before going long 5y paper. Technicals support the view for the moment – the domestic bid remains robust, and hedge funds are showing continued appetite to buy, but we will have to see a slowdown in selling from RM before prices can move higher.

Comments welcome.