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Monthly debt digest

The pain trade

Across the board improvement in Euroland financial conditions, reversing half the tightening of the previous six months

- Broad-based improvement in financial conditions across money, bond and equity markets, with positive feedback loops for investor and real economy sentiment.
- Sovereign debt crisis resolution efforts finally commensurate with the task at hand, the potency of the ECB's 3yr LTRO gambit increasingly apparent.
- Market volumes still generally tepid, the pain trade thereby exposed of overwhelmingly bearish positioning yet to adjust to improving market sentiment.

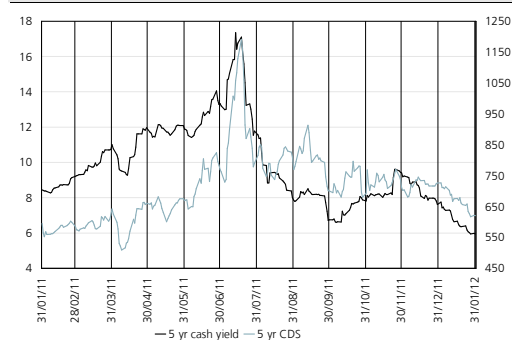
Irish bond yields re-pricing aggressively, with slowly improving fundamentals reinforced by robust market technicals

- Bullish repricing of Irish government debt continues unabated, that shrinking free-float ensuring ever-tighter supply/demand imbalances; government-guaranteed paper in catch-up mode following spread widening extremes.
- Reaffirmed Irish sovereign ratings from both S&P and Fitch (as BBB+ credit) a key reminder of the road already travelled; Moody's disparate stance (BB+) growing in controversy.
- Irish debt exchange in short-dated maturities an unambiguously positive surprise for market participants (and issuer); return to fully-fledged debt issuance no forlorn prospect as 2012 evolves.

Event risks still overhanging the economic/markets outlook, albeit inflexion point in global growth forecasts perhaps already reached

- Elevated concerns over first quarter event risks (government and bank refinancings, rating agency actions, fiscal compact negotiations) now dissipating rapidly.
- Greek "bailout" end-game (with attendant PSI) still nervously awaited, albeit with legitimate expectations of an "orderly" outcome.
- Economic sentiment indicators (nb PMI) already responsive to improving financial conditions; Euroland/global growth expectations now biased for topside revision.

Irish sovereign bond yield and CDS (5 yrs)



Source: Bloomberg

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A rising tide floating all boats

The tide may have gone out on investor risk appetites during the second half of last year, but it has certainly about-turned with a vengeance in the early sorties of 2012. A material improvement in financial conditions is apparent across all the asset classes, and not least in Euroland, where approximately one-half of the tightening of the past six months has now been reversed in the past six weeks. In consequence, feedback loops are once again morphing from negative to positive vis-à-vis investor and real economy sentiment. This is particularly apparent in Euroland sovereign debt space, whereby heightened refinancing concerns heading into the new year have been sharply alleviated by that seamless €100bn+ issuance across both periphery and core. Bond yield and spread normalisation is continuing apace, with the Irish market still in the vanguard of overall market performance. A return of 7.7% was garnered for the month as a whole (per EFFAS bond indices), compared with a 1.7% advance for the Euroland aggregate.

Table 1: EFFAS Bond Market Indices (%)

	January	Q1	YTD
Ireland	+7.7	+7.7	+7.7
(1-3 yr)	+5.3	+5.3	+5.3
(3-5yr)	+6.7	+6.7	+6.7
(5-10yr)	+8.8	+8.8	+8.8
(10yr+)	+9.6	+9.6	+9.6
Euroland	+1.7	+1.7	+1.7
France	+0.5	+0.5	+0.5
Germany	+0.2	+0.2	+0.2
Greece	-0.7	-0.7	-0.7
Italy	+5.8	+5.8	+5.8
Portugal	-13.5	-13.5	-13.5
Spain	+2.4	+2.4	+2.4
UK	+0.4	+0.4	+0.4
US	+0.5	+0.5	+0.5

Source: EFFAS

Q.E.d.

Catalyst-in-chief for such a dramatic turnaround in market conditions has been the actions of the ECB, the enormity of whose LTRO pronouncements in early-December having taken time to fully register in investor mindsets. Super Mario's witting expansion of the ECB's balance sheet, via 3yr LTRO offerings on 21st December (€489bn) and 29th February (€600bn?), represents a de facto QE-styled infusion of excess reserves into the Euroland banking system. This has served to lower Eonia well below the key 1% policy rate, with knock-on uplift (both directly and indirectly) to all fixed income prices. In substance, therefore, the ECB is now actively engaged in the form of QE behaviour long demanded of it to resolve the sovereign debt crisis.

The ECB's largesse is removing all distressed pricings from Euroland short-ends (Greece and Portugal excepted), with carry and roll-down effects then extending their gravitational pull on longer-dated bond yields. In tandem with the formal removal of PSI from the ESM term sheet, such combination provides a compelling inducement for investor re-engagement. However, to the extent that a vast swathe of Euroland real money managers remain either unwilling (agnostic)

or unable (restricted) to participate, the substantial reconvergence of core/periphery spreads represents the new "pain trade" from a performance benchmark perspective.

Irish yields in sustained "normalisation" mode

The Irish government bond market has extended its breakneck performance of the past six months, a cumulative 56.3% gain from the mid-July lows underscoring that fully-fledged "restructuring" panic of mid-2011. Sovereign yields are now sub-5% in 2yr maturities, sub-6% in 5yrs and straddling 7% in 10yrs, while government-guaranteed paper has ratcheted up to 10 points higher in January following sustained (and ultimately unfathomable) spread widening. The Irish market is starved of paper, with no outright sovereign issuance since September, 2010, and with that ostensible €85bn free-float additionally curtailed by accumulated SMP purchases and the "hold-to-maturity" activities of the Irish banks.

The relative appeal of Irish government debt has been reinforced by the credit rating actions of the past four weeks, during which both S&P and Fitch saw fit to reaffirm Ireland's BBB+ status whilst effecting a host of downgrades elsewhere. Clearly, Ireland is now reaping the benefits of having been an (enforced) early mover along the adjustment path towards economic and financial stabilisation, and the ongoing delivery of "Troika" targets for both banking sector restructuring and fiscal consolidation is wholly consistent with its reaffirmed ratings, albeit admittedly at the lower echelons of the investment grade spectrum. Indeed, last month's peer group actions raise a further question mark over Moody's current assessment of Ireland's creditworthiness (BB+), not least given that the main consideration behind this substantially lower rating was the threat of a broader-based PSI application amongst more vulnerable Euroland sovereigns, a threat no longer valid.

Also boosting the Irish market in January was the NTMA's surprise €3.5bn exchange of existing 2014 debt into a freshly-minted 2015 issue, being a "response to approaches from market participants". This reduction in 2014 debt outstanding amounts to 30% of the refinancing needs for that year and thus considerably enhances the government's cash management efforts. Further, the new 2015 issue is now the obvious vehicle with which to pre-fund remaining 2014 obligations, either by way of further switch activity or via outright tapping of the paper as market conditions normalise further during the course of this year. Meanwhile, the crystallisation of significant "carry" gains by Irish banks participating in the late-January exchange will provide a welcome and non-negligible contribution to their P&L accounts this year.

Event risks extant, but diminishing

Bullish momentum in Irish bonds is of course linked to the broader-based improvement in sovereign debt sentiment. Sentiment is a fickle friend, and the all-clear on the Euroland crisis has yet to sound, not least with Greek PSI (and its potential ramifications) still unresolved. Nonetheless, all sides appear to be finally converged on an "orderly" outcome, while the Eurogroup's near-unanimous agreement on a medium-term "fiscal compact" for single currency participants provides another nail in the coffin for the "break-up" brigade. Economic worries persist, but perhaps unduly so, with January's topside PMI surprises an early indication of the benefits to accrue from looser financial conditions.

Irish economy

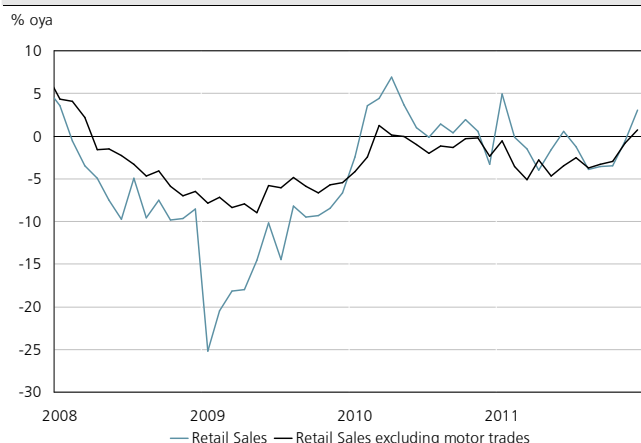
Table 2: Tax revenues, January 2012

	Jan 2012	Jan 2011	% change
Income tax	1260	987	27.7
VAT	1725	1674	3
Corporation tax	271	72	276.3
Excise	289	281	2.7
Stamps	47	41	13.3
Capital gains	30	18	64.1
Capital acquisitions	6	7	-5
Customs	16	21	-24.4
Levies	0	0	
Total	3665	3131	17

Source: Department of Finance

Tax revenues up 17% in January - Tax revenues in the first month of the year were up by 17% compared with January 2011. However, the late payment of €261m in corporation taxes expected in December raised the annual comparison. This means the €500m shortfall in corporation taxes was effectively €231m, or 5.9%. Income taxes were up 27.7% on the year, but this reflects the full-year impact on the new universal social charge and tax band changes last year. So it is too early to draw any firm conclusions on the underlying strength of income taxes. More striking was the 3.0% growth in value added taxes on January 2011. This reinforces our view that consumer spending has bounced back, following the strong performance of retail sales in late 2011.

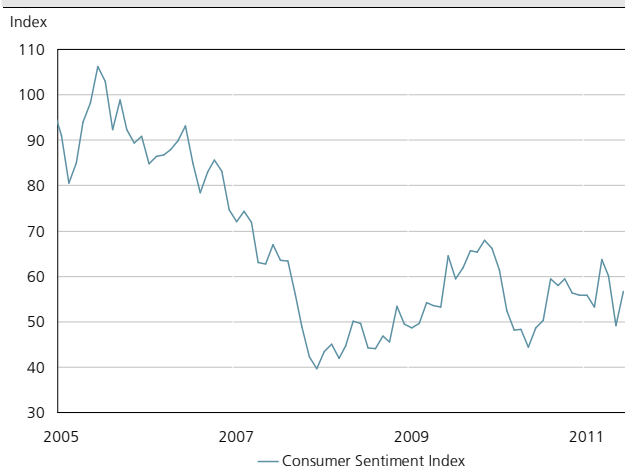
Figure 1: Retail sales growth



Source: Central Statistics Office

Retail sales expand again in December - Retail sales rose by 2.1% in December, up 3.0% on an annual basis. Excluding the volatile motor trades sector the rise was less pronounced, up 0.2% in December and 0.7% on the year. One factor pushing up sales may be that consumers have brought forward spending ahead of the 2% value added tax increase to 23% in January. Nonetheless, even excluding the volatile motor trades sector, annual retail sales growth was positive in December for the first time since May 2010. That said, poor weather explained a sharp 1.3% fall in retail sales in December 2010, followed by a 1.4% expansion in January 2011. So the annual comparison may fall back from December's reading.

Figure 2: Consumer confidence

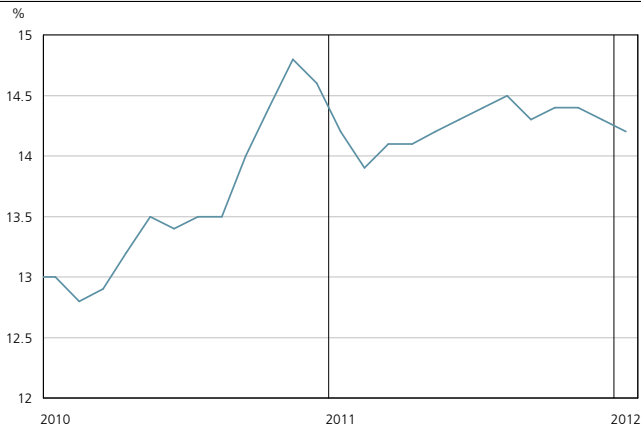


Source: Thomson Reuters Datastream

Consumer confidence rebounds from low in December - Irish consumer confidence rebounded to a reading of 56.6 in January, well above the 49.2 print in December but below the 63.7 peak level for 2011 recorded in October. This small rebound chimes with broader improvements in January sentiment readings across the euro area, as the ECB's full allotment 3 year repo operation has been perceived as addressing funding concerns for both European banks and sovereigns. The rebound in January confidence was reflected in both the expectations and current economic climate sub-components.

Irish economy

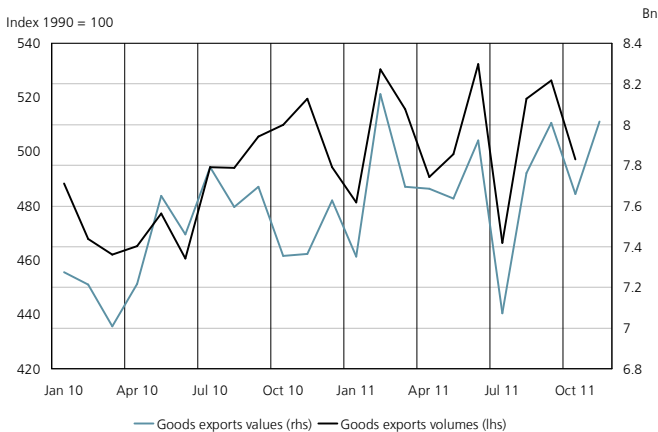
Figure 3: Unemployment rate



Source: Central Statistics Office

Unemployment falls to 14.2% in January - The seasonally adjusted unemployment rate fell to 14.2% in January from 14.3% in December and its lowest level since June 2011. Seasonally adjusted, the numbers on the live register of social welfare claimants fell to their lowest level, 439,600, since April 2010. However, these declines in social welfare claimants and the unemployment rate may largely reflect falling participation in the labour force and emigration rather than a recovery in employment.

Figure 4: Merchandise exports



Source: Central Statistics Office

Irish goods export values rebound in November - The value of Irish goods exports rose to €8.0bn in November, up from €7.7bn in October. The level of nominal goods exports was at a similar level to September, following October's sharp fall. Coupled with a decline in imports from €3.9bn to €3.7bn, the goods trade surplus expanded to €4.3bn, a record outturn. The rebound in November suggests that there is little evidence as yet of a sharp negative impact on demand from the slowdown in the euro area. Also, the fall in goods export volumes during October is likely to unwind in November, given the rebound in nominal goods exports data.

Figure 5: Irish PMI indicators

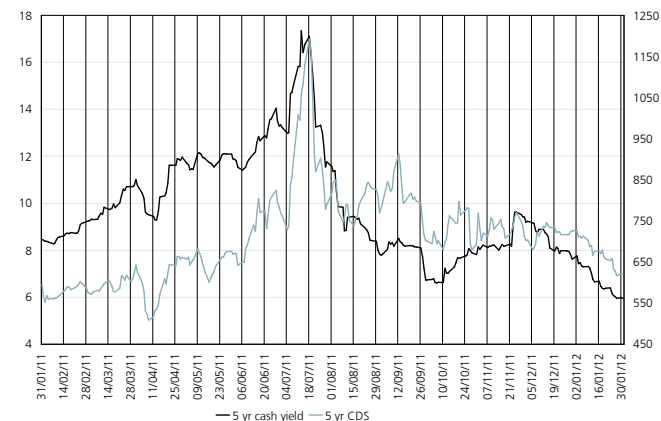


Source: Markit Economics

Purchasing managers indices (PMI) remain below 50 no change level - The PMI index for manufacturing fell from 48.9 in December to 48.3 in January. The PMI for services fell marginally to 48.3 in January from 48.4 in December. However, the correlation between the Irish PMI surveys and official GDP sectoral output data is relatively poor compared with other European economies. So the PMI surveys need to be interpreted with caution. The construction sector PMI has not yet been released for January; however, the 49.9 December reading was the highest since the contraction of the Irish construction sector commenced in 2007.

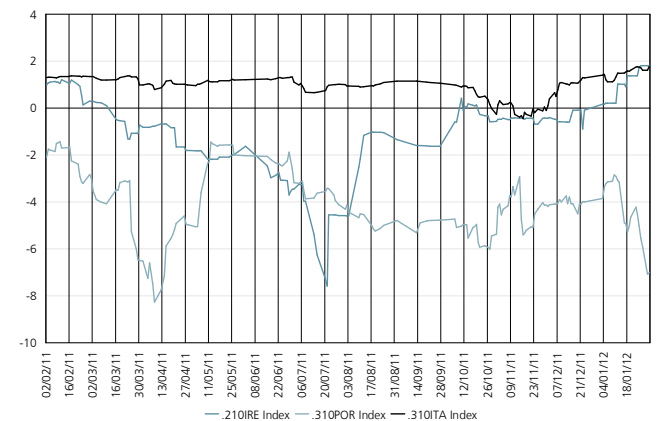
Irish sovereign

Figure 6: Irish sovereign bond yield and CDS (5 yrs)



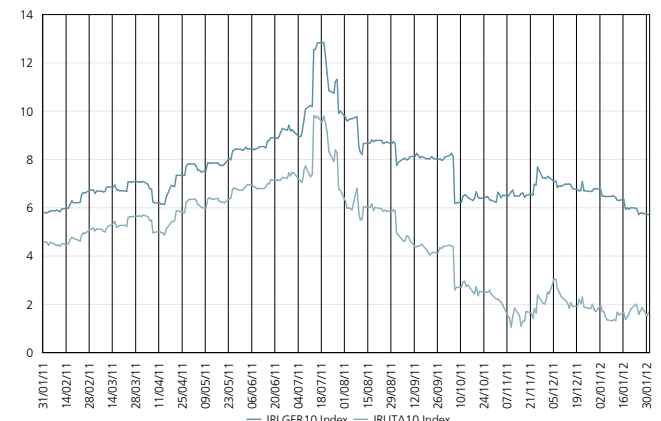
Source: Bloomberg

Figure 7: Irish, Italian and Portuguese yield curves (3/10 yrs)



Source: Bloomberg

Figure 8: Irish 10 yr sovereign spreads (Germany and Italy)



Source: Bloomberg

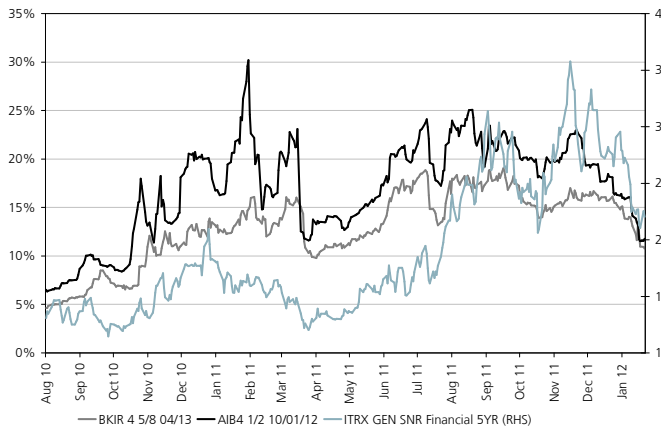
Yield levels - An exuberant across-the-curve performance by Irish government bonds during January, building on the sharp gains recorded in December, and returning yield levels to pre-Troika (November, 2010) terrain. Once again, shorter dates were predominant in the rally, 2yr yields declining by 293bps over the period, compared with declines of 167bps in 5yr paper, 96bps in 10yrs and 92bps in 15yr maturities. The 4.5% coupon for the new (exchanged) 2015 issue compares with a 5% coupon (on 10yr paper) when last the NTMA parleyed with the market in September, 2010, a remarkable comparison in light of the subsequent road travelled. Daily trading volumes were ostensibly robust at an average €692m, albeit clearly distorted by the €3.5bn exchange of 2yr for 3yr paper late in the month.

Yield curve - Those excess reserves generated by the ECB's LTRO aggression (with more to follow) are now washing their way through Euroland capital markets, providing the wherewithal for a dramatic normalisation of sovereign yield curves (Portugal excepted). Short-end "carry" is the trade d'annee, with the rich pickings generated by late-2011 dislocations now rapidly harvested by banks and non-banks alike. The Irish yield curve has played its full part in this rampant re-steepener, with 2/10yrs rising by 197bps to +190bps last month. The NTMA's exchange offering of 3yr for 2yr paper straddled 5% yields, the 2yr having traded above 10% as recently as late November, and not to forget that grotesque 22% peak of July last year.

Yield spreads - Ultimately, the success of the ECB's LTRO initiatives will be gauged by the degree of core/periphery spread reconvergence, last year's divergences having "broken the transmission channel" for the conduct of monetary policy. So far so good in this respect. Euroland sovereign spreads have sharply reversed their widening trends of 2011, most aggressively so in the shorter dates, but with osmotic pressure for reconvergence building further out the curve. The 2yr Irish/German spread collapsed by 296bps to +494bps last month; the 10yr spread more modestly so, by 107bps to +565bps, a 12-mth low. Irish yields converged with their inner periphery peers in the shorter dates, whilst generally move in sync at the longer end.

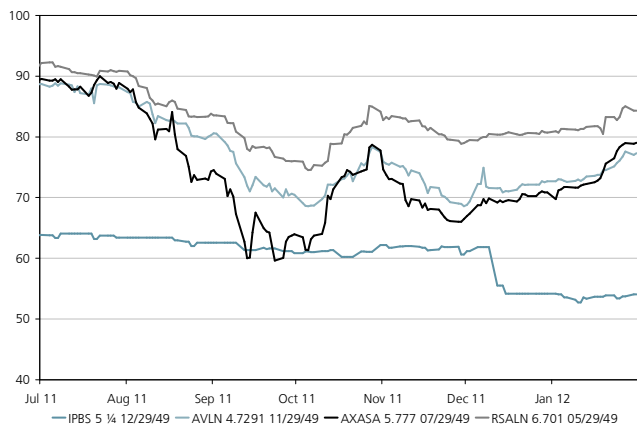
Irish credit

Figure 9: Irish covered banks' unsecured bond yields



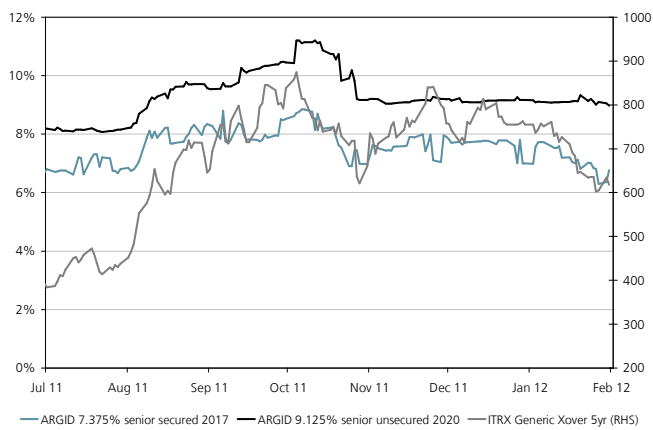
Source: Bloomberg

Figure 10: IPBS life perpetual bond (with comparisons)



Source: Bloomberg

Figure 11: ARGID 2017 and 2020 yields (\$)



Source: Bloomberg

Dramatic tightening of unsecured spreads - The January repayment of an IBRC unsecured bond, reduced liquidity concerns due to ECB support and improving sovereign yields all combined to produce dramatic spread tightening in Irish unsecured bank debt. Exceptional liquidity support has been apparent for Irish banks for some time, particularly through ELA borrowing and collateral creation through own-bond issuance. Such support has now been reinforced by the 3 year LTRO offerings of the ECB, although Ireland's total monetary reliance continues to fall through the banks' deleveraging process. The pool of unsecured bonds also continues to shrink, thereby offering technical support - €6bn of the outstanding €10bn of bonds are set to mature this year.

IPBS life bond in limbo awaiting Group restructuring

- Despite a marked rebound in January for life and insurer perpetual bonds, Irish Life's perpetual bond remains stagnant in a low-to-mid 50s price range. A restructuring plan for Irish Life and Permanent has yet to be agreed and is now deferred until the end of April, with the Government indicating that the outstanding €1bn capital injection will not be completed before the end of June. However, separation of the bank and life insurance companies - to be completed by April - should prove to be a positive catalyst for perp bond performance.

Ardagh taps market for \$420m of funding

- Taking advantage of the recent improvement in market conditions, Ardagh managed to raise \$420m of funding after tapping the existing 2017 secured and 2020 unsecured \$ notes. The proceeds will be used for general corporate purposes, including two acquisitions currently under consideration. The Group's enviable funding position - no significant maturations prior to 2016 - allows the group's acquisitive consolidation strategy to continue unchecked, and follows the €85m Boxal acquisition in December last year. The Group also intends to establish a receivables securitisation programme that will replace its current revolving credit facility.

Databank

Table 3: Rolling twelve month databank												
	Feb 11	Mar 11	Apr 11	May 11	Jun 11	Jul 11	Aug 11	Sep 11	Oct 11	Nov 11	Dec 11	Jan 12
Activity												
GDP (quarterly)		1.8%			1.4%			-1.9%			n/a	
Consumption		-1.8%			0.1%			-1.3%			n/a	
Investment		3.1%			-0.1%			-20.9%			n/a	
Government		-1.5%			-1.1%			-1.3%			n/a	
Exports		3.1%			1.1%			0.8%			n/a	
Imports		0.0%			-0.8%			-1.5%			n/a	
PMI-manufacturing	56.7	55.7	56.0	51.8	49.8	48.2	49.7	47.3	50.1	48.5	48.6	48.3
PMI-services	55.1	51.1	50.2	50.5	52.4	51.7	51.1	51.3	51.5	52.7	48.4	48.3
PMI-construction	47.8	46.1	43.7	41.1	40.5	42.1	43.5	40.1	45.2	47.7	49.9	n/a
Industrial production	-1.6	-1.4	1.3	0.2	-1.4	1.4	6.1	-4.1	6.7	-9.5	n/a	n/a
Retail sales	-0.8	1.8	-0.8	1.0	1.0	-1.5	-0.3	-0.4	0.4	1.9	2.1	n/a
Trade balance (€m)	3,828	3,873	2,748	3,940	4,099	3,236	3,749	4,172	3,724	4,310	n/a	n/a
Housing completions	880	1,052	863	814	884	873	802	915	775	938	850	n/a
Sentiment												
Consumer sentiment	50.3	59.5	57.9	59.4	56.3	55.9	55.8	53.3	63.7	60.1	49.2	56.6
Labour market												
Jobless claims	441.4	442.8	442.2	444.9	447.3	448.0	448.7	443.7	445.9	446.4	442.8	439.6
Unemployment rate	13.9	14.0	14.0	14.2	14.2	14.3	14.4	14.3	14.3	14.4	14.3	14.2
Employment (quarterly)		1,804.2			1,821.3			1,805.5			n/a	
Public finances												
Exchequer balance (cumulative YTD, €bn)	-2.0	-4.0	-6.9	-7.2	-7.8	-9.3	-10.9	-11.1	-12.6	-11.8	-15.3	-0.4
Inflation												
Consumer prices - Main	2.2	3.0	3.2	2.7	2.7	2.7	2.2	2.6	2.9	3.0	2.5	n/a
Consumer prices - HICP	0.9	1.2	1.5	1.2	1.1	1.0	1.0	1.3	1.5	1.7	1.4	n/a
Producer prices	0.6	0.9	-0.8	-0.6	-1.0	-0.4	-1.0	0.2	2.5	1.9	2.4	n/a
House Prices	-1.7	-1.7	-1	-1.2	-2.1	-0.8	-1.6	-1.5	-2.2	-1.5	-1.7	n/a
Banking - Covered Group €bn												
Irish private sector lending	187	185	182	181	180	179	178	178	157	157	157	n/a
Non-resident lending	121	113	113	111	106	106	105	108	102	101	98	n/a
Government lending (NAMA bonds)	31	28	28	28	28	29	29	29	29	29	29	29
Total Assets	608	584	572	543	536	539	540	541	533	527	518	n/a
ECB borrowing	86	79	74	71	70	68	68	70	69	70	67	n/a
ELA borrowing	69	66	53	53	55	56	55	53	48	46	44	n/a
Private sector deposits	109	106	108	107	104	103	102	102	102	101	102	n/a
Non-resident deposits	84	78	76	75	70	71	71	71	70	67	68	n/a
Capital/assets %	7.9%	7.6%	7.8%	8.2%	8.6%	12.5%	12.2%	12.3%	12.2%	12.3%	12.7	n/a
Guaranteed liabilities		111			123			100			n/a	
Banking - domestic Ireland												
Deposit rate - wgt'd average outstanding	1.54%	1.54%	1.60%	1.63%	1.64%	1.69%	1.71%	1.75%	1.78%	1.81%	n/a	n/a
Loan rate - wgt'd average outstanding	3.76%	3.75%	3.90%	3.92%	3.96%	4.09%	4.12%	4.12%	4.19%	4.11%	n/a	n/a
H/hold loans Irish res. (inc. securitised, €bn)	167	166	166	165	165	164	163	163	164	163	163	163
NFC loans Irish res. (inc. securitised, €bn)	92	91	90	90	90	90	90	90	89	89	89	n/a
Household deposits (€bn)	93	93	93	92	92	92	91	92	92	91	91	n/a
NFC deposits (€bn)	33	32	32	32	31	31	31	31	32	32	31	n/a
Homeowner arrears >3mths		6.3%			7.2%			8.1%			n/a	
Market data												
2 year government yield	7.90	9.87	12.00	11.47	13.51	14.37	7.65	7.52	8.80	9.50	8.00	5.07
5 year government yield	9.22	11.01	11.96	11.89	13.33	11.77	7.85	6.75	7.81	9.41	7.62	5.95
10 year government yield	9.34	10.22	10.57	11.04	11.70	10.86	8.62	7.46	7.97	9.15	8.26	7.30
15 year government yield	9.07	9.62	9.62	9.97	10.64	9.85	8.34	7.24	7.81	8.90	8.01	7.09
5 year CDS	585	640	661	669	738	800	775	698	705	715	710	620
B/mark GGB yield (BKIR 4 15)	10.7%	11.0%	11.6%	11.9%	13.8%	13.8%	12.7%	12.5%	12.3%	12.9%	14.4%	10.5%
B/mark covered yield (BKIR 3.25 15)	9.2%	9.2%	9.0%	9.8%	11.0%	11.4%	11.7%	11.4%	11.1%	11.0%	11.0%	9.6%
B/mark senior unsecured yield (AIB 5.625 14)	13.2%	15.9%	12.3%	13.6%	17.3%	15.4%	20.9%	18.2%	16.0%	18.4%	18.1%	14.7%

Source: Davy

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