Real yields are exceptionally low

Source: Bloomberg data, HSBC calculations

* 1yr swap rate – headline CPI inflation (YoY). Note: using monthly data
Normalisation of rates vs flight-to-quality

- China and Eurozone leading the drive to increase real rates
  - Developing and emerging economies hiking because of inflation
  - Fed and BoE have taken a different stance so far
- Rising geopolitical risk prompts flight-to-quality
  - Pushing yields lower than they would otherwise have been
  - Favouring shorter maturity bonds everywhere
- FX and energy prices are key
  - Higher oil prices - impact on growth and inflation
  - Impact of Central Bank intervention

Eurozone – significant challenges

- ECB reacting to inflation expectation shift
- Does headline lead core inflation?
- More scope for short yields to rise as ECB starts to hike
  - ECB expectations could start to reflect 2005-07 precedent
  - or geopolitical risk could mean impetus for rate hikes is reduced
- ECB decision could also be influenced by creditisation-effect
  - Focus will be on the new role of EFSF and bank stress tests
ECB concerned inflation expectations are rising

Policy will be set to ensure inflation is temporary
Headline inflation leads core...

Eurozone headline inflation (LHS) vs Eurozone core inflation (RHS)

Source: Bloomberg data

...with a lag of about seven months

Eurozone headline (advanced 7-months) vs core inflation

Source: Bloomberg data, HSBC calculations
Mean-reversion of Bund yields

![Graph showing the mean-reversion of Bund yields between 2006 and 2011.](image)

Source: Bloomberg data

EUR forward curve shift has so far been parallel

![Graph showing the EUR forward curve shift between 2011 and 2010.](image)

Source: HSBC data

Note: EUR 1yr at forward points, now and six months before possible April hike
Compare with 2005-07 refi move from 2% to 4%

Sovereign ‘creditisation’ impact changed in 2011

- Bund yields and curve inversely related to periphery performance
- Markets realise Germany has to pay
  - How much contingent liability will Germany be prepared to take?
- Revamped EFSF and new ESM have attracted positive headlines
  - ECB’s role in secondary market remains important
  - Policy intention may be to firewall Sovereigns from Banks
    - EUR600bn bank supply this year
- Seniority at least as important as restructuring risk
  - Decision on CACs will be reached by June 2011
  - What happens to legacy bonds from mid-2013
Last year - Bunds benefited from ‘flight-to-quality’

This year - Italy and Spain decouple from periphery
Higher Bund yield offsets Bonos spread tightening

Eurozone 10- to 30-year segment relatively flat
CDS negatively correlated with 30-10yr spread

![Graph showing CDS index and 30-10yr spread over time]

Source: Bloomberg data, HSBC calculations

Eurozone periphery sovereign scorecard

<table>
<thead>
<tr>
<th>Metric</th>
<th>Weight</th>
<th>Greece</th>
<th>Ireland</th>
<th>Italy</th>
<th>Portugal</th>
<th>Spain</th>
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<tbody>
<tr>
<td>TOTAL SCORE</td>
<td>100%</td>
<td>41</td>
<td>33</td>
<td>25</td>
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<tr>
<td>TOTAL HARD DATA SCORE</td>
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<td>23</td>
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HARD DATA

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<tbody>
<tr>
<td>Government Interest payments/Revenues, 2011F</td>
<td>22%</td>
<td>50</td>
<td>35</td>
<td>35</td>
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<tr>
<td>Blended rating</td>
<td>14%</td>
<td>50</td>
<td>35</td>
<td>35</td>
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<tr>
<td>Budget deficit 2011F (% GDP)</td>
<td>9%</td>
<td>35</td>
<td>50</td>
<td>10</td>
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<tr>
<td>Government effectiveness World Bank Index</td>
<td>7%</td>
<td>40</td>
<td>10</td>
<td>40</td>
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<td>20</td>
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<tr>
<td>Debt 2011F (% GDP)</td>
<td>13%</td>
<td>50</td>
<td>40</td>
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<tr>
<td>Unemployment rate 2011F</td>
<td>9%</td>
<td>40</td>
<td>30</td>
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<tr>
<td>Output gap 2011F</td>
<td>8%</td>
<td>50</td>
<td>30</td>
<td>15</td>
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<td>Private savings 2011F (% GDP)</td>
<td>18%</td>
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SOFT DATA

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<tr>
<td>Contingent liabilities (% of 2009 GDP)</td>
<td>16.7%</td>
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<td>Average life of outstanding bonds (years)</td>
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<td>Debt to be refinanced over the next 12 months (% of total)</td>
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<td>Foreign holdings (% of outstanding)</td>
<td>16.7%</td>
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<tr>
<td>Banking exposure to other peripheries (% of GDP)</td>
<td>16.7%</td>
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<td>Bank refinancing (% of 2010 GDP)</td>
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<td>40</td>
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Source: HSBC, Bloomberg, ECF, Eurostat, EFFAS, World Bank, Eurosystem, BIS, Moody’s
Previous score in brackets

Note: Lower scores reflect better credit quality where scores range from 10 to 50
Eurozone periphery sovereign scorecard: Raw data

Source: HSBC, Bloomberg, EC, Eurostat, EFFAS, World Bank, Eurosystem, BIS, Moody’s

Note: Lower scores reflect better credit quality where scores range from 10 to 50

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**HARD DATA**
- Government Interest payments/Revenues, 2011F: 22% 14.8 10.0 10.5 8.8 6.5
- Blended rating: 14% 11.0 4.8 4.0 6.0 2.5
- Budget deficit 2011F (% GDP): 9% 7.4 10.3 4.3 4.9 6.4
- Government effectiveness World Bank Index: 7% 0.6 1.6 0.4 1.1 1.0
- Debt 2011F (% GDP): 13% 150.2 107.0 120.2 88.8 69.7
- Unemployment rate 2011F: 9% 15.0 13.5 8.3 11.1 20.2
- Output gap 2011F: 8%
- Private savings 2011F (% GDP): 16% 11.1 18.9 18.8 14.4 20.7

**SOFT DATA**
- Contingent liabilities (% of 2009 GDP): 16.7% 0.6 214.8 - 3.8 3.1
- Average life of outstanding bonds (years): 16.7% 7.4 6.5 7.3 6.3 6.4
- Debt to be refinanced over the next 12 months (% of total): 16.7% 12.1 11.0 17.3 19.3 21.7
- Foreign holdings (% of outstanding): 16.7% 67.0 82.0 51.0 86.0 41.8
- Banking exposure to other peripheries (% of GDP): 16.7% 0.6 40.2 2.9 2.5 10.1
- Bank refinancing (% of 2010 GDP): 16.7% - 23.8 11.8 16.6 14.0

**Key data for fiscal sustainability measures**

Source: European Commission data

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth (%)</th>
<th>HICP (%)</th>
<th>Budget deficit (% of GDP)</th>
<th>Debt (% of GDP)</th>
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<td>Finland</td>
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<td>2.1</td>
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<td>Euro area</td>
<td>1.7</td>
<td>1.5</td>
<td>1.5</td>
<td>1.8</td>
</tr>
</tbody>
</table>
Shift to fiscal sustainability is more challenging

![Bar chart showing required primary surplus (% of GDP) for different countries.](chart)

- At present
- Using 5% funding

Source: HSBC, Bloomberg, EC

* Current funding rate of 5.25% used  ** Current funding rate of 5.83% used  Note: Forecasts are from EC Autumn 2010 report

Seniority questions for legacy bonds after mid-2013

![Bar chart showing bonds and bills outstanding (EURbn) for Greece and Ireland.](chart)

- Bonds and bills outstanding
- EU/IMF financing

Source: Bloomberg data, HSBC calculations

* As of mid-2013, based on no new bond issuance in the meantime. Assumes bills are unchanged
Summary of main views

- Significant challenges remain as Eurozone ‘muddles through’
- ECB exit policy and intervention
- Eurozone curve and spreads also driven by ‘creditisation’
- Seniority and restructuring concerns
Global Fixed Income Research

Global Fixed Income Research Tools
Disclosure appendix

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