

Buy DBRei 2026 BEI

The breakevens have not responded to the recent recovery in commodity prices and from May onwards exhibited a negative correlation with the oil price, which is historically one of the most significant explanatory variable.

Our model on 10Y Bundei breakeven based on short-term rates, current inflation, Vix volatility index and Brent price showed a large current degree of underestimation. We suggest opening long positions on Bundei 4/2026 vs Bund 2/2026 @ 89pb with a 3 month target at 105bp and stop loss at 80bp.

Over the past months the commodity prices have trended upwards but the market inflation has not reflected this recovery. The rise of commodity indices was driven by the energy component, but also the other sectors have corrected from their lows earlier this year, despite a large intra-sectorial dispersion. The price of WTI increased by 85% from the low of mid-February to date while the CRB index ex energy rose by 10.3% from the low of January.

The breakevens have not responded to the recovery in commodity prices and from May onwards exhibited a negative correlation with the oil price, which is historically one of the most significant explanatory variables (graphic). The upward trend of BEIs, which followed the January ECB meeting was in fact broken after the release of the flash estimate of April inflation, recording a decline larger than expected by market consensus (-0.2% m/m, 0% y/y). The following flash estimate of May data, which marked an increase of inflation by one-tenth, had no significant impact on market inflation.

Last month, BEIs fell across all maturities, but the movement on the European market was of sharp steepening of the 2/10Y spread unlike on the TIPS market where the BEI curve moved slightly in flattening: 2/10Y BEI spread widened by 10bp on the month both on core and peripheral curves, while the 10/30Y spread increased by 7-8pb.

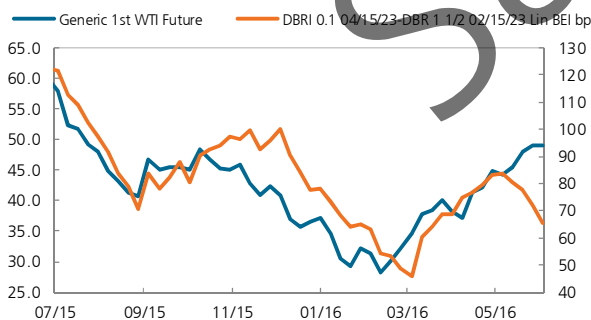
6 June 2016

Intesa Sanpaolo
Research Department

Macroeconomic and
Fixed Income Research

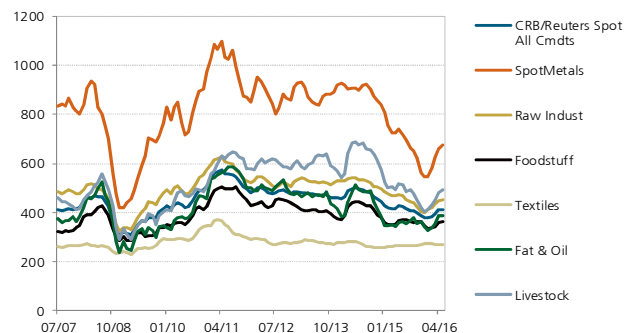
Chiara Manenti
Fixed Income Strategist

WTI and 10Y Bundei breakeven (rx)



Source: Bloomberg, Intesa Sanpaolo

CRB spot index and sub sectors



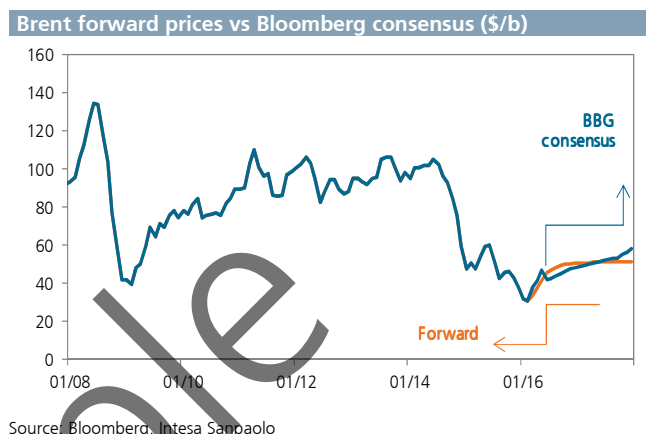
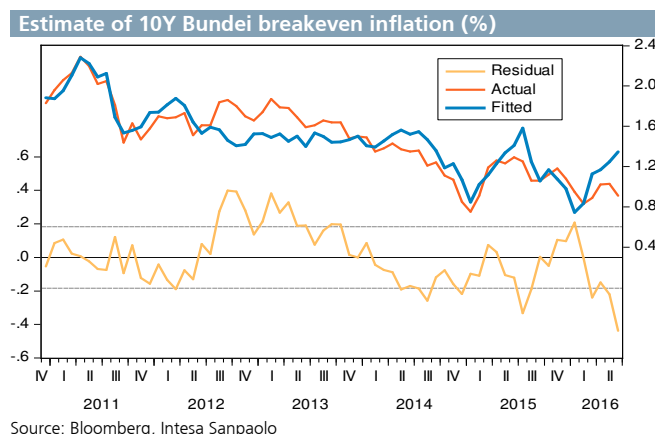
Source: Bloomberg, Intesa Sanpaolo

Our model on 10Y Bund-ei breakeven based on short-term rates, current inflation, Vix volatility index and Brent price showed a current underestimation of 43pb (134bp fit vs 91bp spot). Also on the 5Y Bund-ei the estimated breakeven shows a large undervaluation of about 45bp (82bp fit 38pb spot). On the OATei curve, the 10Y breakeven appears fair valued, while the BEI on 10Y BTPei is underestimated by 38pb, with a 105bp fit vs 68bp spot. The estimate of 5y5y inflation swap confirms that the greater misalignment of breakeven concerns the long end of the curve: the fitted value of 5y5y swap inflation is equal to 1.73% vs 1.45% spot.

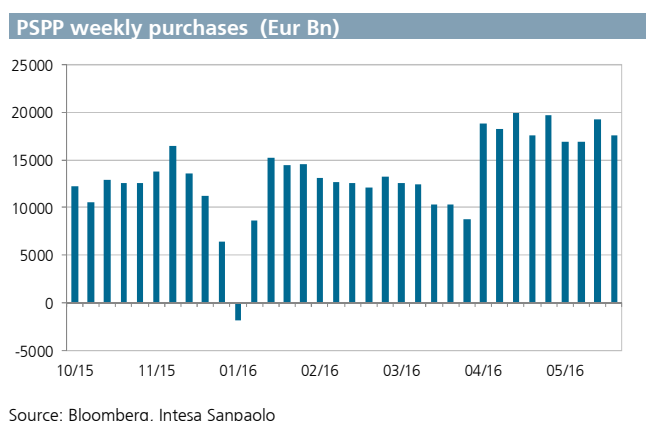
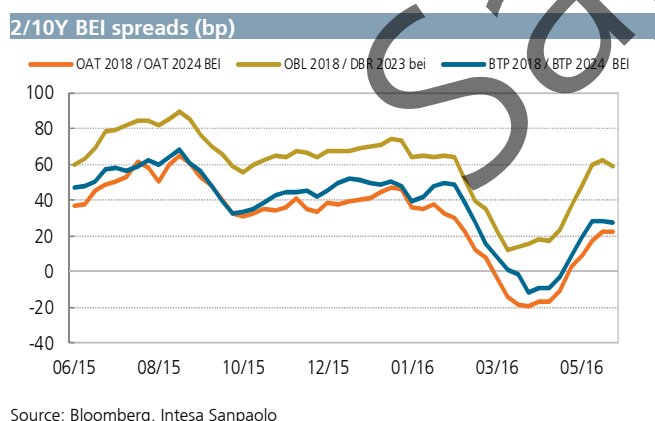
Priced on 06.06.2016

Please read carefully the important disclosures at the end of this publication

We use the Bloomberg consensus estimates of the European inflation, the price of Brent and the 3-month rate to forecast BEI on a 2 year horizon. We keep the Vix stable at the current level. The consensus expects the inflation to reach +0.7% at the end of this year and +1.4% at the end of next year while Brent price is expected at 49 \$/b at the end of 2016 and at 55 \$/b in late 2017. The Brent price dynamic does not change significantly if you choose to use the forward price of oil instead of the Bloomberg consensus because the two series differ only slightly (graph).



The undervaluation of breakeven is not confined to the European market, but extend to the TIPS curve. However our model suggests the misalignment is smaller (15bp on 10Y term). We believe that European breakeven could have been beaten by the ECB purchase programme. In fact the ECB has heavily increased the volumes on sovereigns in April and May, as shown in the chart below, waiting to start buying corporate bonds. The next launch of the CSPP should take pressure off from nominal and facilitate a realignment of breakevens.



Our model forecast an increase of 10Y Bundei BEI to 146pb the end of 2016 and to 152pb in 3Q17. On the BTP curve the forecast sees a breakeven in the 130pb area in late 2016. We suggest opening long positions on Bunde 4/2026 vs Bund 2/2026 @89pb with a 3 month target at 105bp and stop loss at 80bp. The carry on long breakeven position is zero on a 3 month horizon on Bunde 2026 (while on BTPei 2026 the carry is negative by 3bp).

Carry on European linkers (Eur HICP ex tob) based on swap inflation

Bond	Coupon %	Real Yield	08-Jul-16		08-Aug-16		06-Sep-16		06-Oct-16		06-Nov-16	
			Forward Real Yield	Carry bp	Forward Real Yield	Carry bp	Forward Real Yield	Carry bp	Forward Real Yield	Carry bp	Forward Real Yield	Carry bp
BTPS 2.1 09/15/17	2.10	-0.49	-0.47	2	-0.45	4	-0.54	-5	-1.08	-59	-0.88	-40
OBLI 0 3/4 04/15/18	0.75	-0.57	-0.56	1	-0.56	2	-0.61	-4	-0.96	-39	-0.84	-27
FRTR 0 1/4 07/25/18	0.25	-1.12	-1.13	-1	-1.12	-3	-1.22	-11	-1.12	-42	-1.47	-36
BTPS 1.7 09/15/18	1.70	-0.43	-0.42	1	-0.41	2	-0.45	-2	-0.73	-30	-0.63	-19
BTPS 2.35 09/15/19	2.35	-0.36	-0.35	1	-0.35	1	-0.38	-1	-0.54	-18	-0.46	-10
SPGBEI 0.55 11/30/19	0.55	-0.34	-0.33	1	-0.32	2	-0.34	0	-0.50	-16	-0.44	-10
DBRI 1 3/4 04/15/20	1.75	-0.90	-0.91	0	-0.91	-1	-0.94	-4	-1.10	-20	-1.06	-15
FRTR 2 1/4 07/25/20	2.25	-1.05	-1.05	-1	-1.06	-1	-1.09	-5	-1.25	-20	-1.21	-16
BTPS 2.1 09/15/21	2.10	-0.03	-0.02	1	0.00	2	-0.01	1	-0.11	-9	-0.06	-3
FRTR 1.1 07/25/22	1.10	-0.88	-0.89	0	-0.89	0	-0.91	-2	-1.01	-12	-0.98	-9
DBRI 0.1 04/15/23	0.10	-0.88	-0.88	0	-0.88	0	-0.90	-2	-0.98	-10	-0.95	-8
BTPS 2.6 09/15/23	2.60	0.26	0.27	1	0.28	2	0.27	2	0.21	-5	0.25	0
FRTR 0 1/4 07/25/24	0.25	-0.75	-0.75	0	-0.75	0	-0.77	-1	-0.84	-8	-0.81	-6
BTPS 2.35 09/15/24	2.35	0.53	0.54	1	0.55	3	0.55	2	0.50	-3	0.54	1
SPGBEI 1.8 11/30/24	1.80	0.58	0.60	1	0.61	3	0.61	3	0.55	-3	0.59	1
DBRI 0.1 04/15/26	0.10	-0.83	-0.83	0	-0.83	0	-0.84	-1	-0.90	-7	-0.88	-5
BTPS 3.1 09/15/26	3.10	0.71	0.72	1	0.74	3	0.74	3	0.69	-2	0.73	2
FRTR 1.85 07/25/27	1.85	-0.54	-0.54	0	-0.54	0	-0.55	-1	-0.60	-6	-0.58	-4
FRTR 0.7 07/25/30	0.70	-0.38	-0.37	0	-0.37	0	-0.38	0	-0.42	-4	-0.40	-2
SPGBEI 1 11/30/30	1.00	1.01	1.03	1	1.04	2	1.04	2	1.01	-1	1.03	2
FRTR 3.15 07/25/32	3.15	-0.36	-0.36	0	-0.35	0	-0.36	0	-0.40	-4	-0.38	-2
BTPS 2.35 09/15/35	2.35	1.02	1.03	1	1.04	2	1.04	2	1.02	0	1.04	2
FRTR 1.8 07/25/40	1.80	-0.15	-0.15	0	-0.15	0	-0.15	0	-0.17	-2	-0.16	-1
BTPS 2.55 09/15/41	2.55	1.29	1.30	1	1.31	2	1.31	2	1.29	0	1.31	2
DBRI 0.1 04/15/46	0.10	-0.55	-0.55	0	-0.55	0	-0.55	0	-0.57	-2	-0.56	-1

Source: Bloomberg, Intesa Sanpaolo

Intesa Sanpaolo Research Department – Head of Research Gregorio De Felice		
Tel. +39 02 879+(6) – 02 8021 + (3)		
Macroeconomic Analysis		
Macro & Fixed Income Research		
Luca Mezzomo	62170	luca.mezzomo@intesaspaolo.com
Fixed Income		
Sergio Capaldi	62036	sergio.capaldi@intesaspaolo.com
Chiara Manenti	62107	chiara.manenti@intesaspaolo.com
Macroeconomics		
Guido Valerio Ceoloni	62055	guido.ceoloni@intesaspaolo.com
Anna Maria Grimaldi	62118	anna.grimaldi@intesaspaolo.com
Paolo Mameli	62128	paolo.mameli@intesaspaolo.com
Giovanna Mossetti	62110	giovanna.mossetti@intesaspaolo.com
Alessio Tiberi	32834	alessio.tiberi@intesaspaolo.com
Forex Markets		
Asmara Jamaleh	62111	asmara.jamaleh@intesaspaolo.com
Commodities		
Daniela Corsini	62149	daniela.corsini@intesaspaolo.com
Research Assistant		
Simonetta Melotto	62102	simonetta.melotto@intesaspaolo.com

Appendix

Analyst Certification

The financial analysts who prepared this report, and whose names and roles appear on the first page, certify that:

- (1) The views expressed on companies mentioned herein accurately reflect independent, fair and balanced personal views;
- (2) No direct or indirect compensation has been or will be received in exchange for any views expressed.

Specific disclosures

The analysts who prepared this report do not receive bonuses, salaries, or any other form of compensation that is based upon specific investment banking transactions.

This research has been prepared by Intesa Sanpaolo S.p.A. and distributed by Banca IMI S.p.A. Milan, Banca IMI SpA-London Branch (a member of the London Stock Exchange) and Banca IMI Securities Corp (a member of the NYSE and FINRA). Intesa Sanpaolo S.p.A. accepts full responsibility for the contents of this report. Please also note that Intesa Sanpaolo S.p.A. reserves the right to issue this document to its own clients. Banca IMI S.p.A. and Intesa Sanpaolo S.p.A. are both part of the Gruppo Intesa Sanpaolo. Intesa Sanpaolo S.p.A. and Banca IMI S.p.A. are both authorised by the Banca d'Italia, are both regulated by the Financial Services Authority in the conduct of designated investment business in the UK and by the SEC for the conduct of US business.

Opinions and estimates in this research are as at the date of this material and are subject to change without notice to the recipient. Information and opinions have been obtained from sources believed to be reliable, but no representation or warranty is made as to their accuracy or correctness.

Past performance is not a guarantee of future results.

The investments and strategies discussed in this research may not be suitable for all investors. If you are in any doubt you should consult your investment advisor.

This report has been prepared solely for information purposes and is not intended as an offer or solicitation with respect to the purchase or sale of any financial products. It should not be regarded as a substitute for the exercise of the recipient's own judgement.

No Intesa Sanpaolo S.p.A. or Banca IMI S.p.A. entities accept any liability whatsoever for any direct, consequential or indirect loss arising from any use of material contained in this report.

This document may only be reproduced or published together with the name of Intesa Sanpaolo S.p.A. and Banca IMI S.p.A..

Intesa Sanpaolo S.p.A. and Banca IMI S.p.A. have in place a Joint Conflicts Management Policy for managing effectively the conflicts of interest which might affect the impartiality of all investment research which is held out, or where it is reasonable for the user to rely on the research, as being an impartial assessment of the value or prospects of its subject matter. A copy of this Policy is available to the recipient of this research upon making a written request to the Compliance Officer, Intesa Sanpaolo S.p.A., 90 Queen Street, London EC4N 1SA.

Intesa Sanpaolo S.p.A. has formalised a set of principles and procedures for dealing with conflicts of interest ("Research Policy"). The Research Policy is clearly explained in the relevant section of Intesa Sanpaolo's web site (www.intesasanpaolo.com).

Member companies of the Intesa Sanpaolo Group, or their directors and/or representatives and/or employees and/or members of their households, may have a long or short position in any securities mentioned at any time, and may make a purchase and/or sale, or offer to make a purchase and/or sale, of any of the securities from time to time in the open market or otherwise.

Intesa Sanpaolo S.p.A. issues and circulates research to Major Institutional Investors in the USA only through Banca IMI Securities Corp., 1 William Street, New York, NY 10004, USA, Tel: (1) 212 326 1199.

Residents in Italy: This document is intended for distribution only to professional clients and qualified counterparties as defined in Consob Regulation no. 16190 of 29.10.2007, as subsequently amended and supplemented, either as a printed document and/or in electronic form.

Person and residents in the UK: This document is not for distribution in the United Kingdom to persons who would be defined as private customers under rules of the FSA.

US persons: This document is intended for distribution in the United States only to Major US Institutional Investors as defined in SEC Rule 15a-6. US Customers wishing to effect a transaction should do so only by contacting a representative at Banca IMI Securities Corp. in the US (see contact details above).

Valuation Methodology

Trading Ideas are based on the market's expectations, investors' positioning and technical, quantitative or qualitative aspects. They take into account the key macro and market events and to what extent they have already been discounted in yields and/or market spreads. They are also based on events which are expected to affect the market trend in terms of yields and/or spreads in the short-medium term. The Trading Ideas may refer to both cash and derivative instruments and indicate a precise target or yield range or a yield spread between different market curves or different maturities on the same curve. The relative valuations may be in terms of yield, asset swap spreads or benchmark spreads.

Coverage Policy And Frequency Of Research Reports

Intesa Sanpaolo S.p.A. trading ideas are made in both a very short time horizon (the current day or subsequent days) or in a horizon ranging from one week to three months, in conjunction with any exceptional event that affects the issuer's operations.

In the case of a short note, we advise investors to refer to the most recent report published by Intesa Sanpaolo S.p.A.'s Research Department for a full analysis of valuation methodology, earnings assumptions and risks. Research is available on IMI's web site (www.bancaimi.com) or by contacting your sales representative.

Disclosure of potential conflicts of interest

Intesa Sanpaolo S.p.A. and the other companies belonging to the Intesa Sanpaolo Banking Group (jointly also the "Intesa Sanpaolo Banking Group") have adopted written guidelines "Modello di Organizzazione, Gestione e Controllo" pursuant to Legislative Decree 8 June, 2001 no. 231 (available at the Intesa Sanpaolo website, webpage http://www.group.intesasanpaolo.com/scripts/lir0/si09/governance/eng_wp_governance.jsp, along with a summary sheet, webpage <https://www.bancaimi.com/en/bancaimi/chisiamo/documentazione/normative>) setting forth practices and procedures, in accordance with applicable regulations by the competent Italian authorities and best international practice, including those known as Information Barriers, to restrict the flow of information, namely inside and/or confidential information, to prevent the misuse of such information and to prevent any conflicts of interest arising from the many activities of the Intesa Sanpaolo Banking Group which may adversely affect the interests of the customer in accordance with current regulations.

In particular, the description of the measures taken to manage interest and conflicts of interest – related to Articles 69-quater and 69-quinquies of the Issuers' Regulation issued by Consob with Resolution no. 11971 of 14.05.1999 as subsequently

amended and supplemented, Article 24 of "Rules governing central depositories, settlement services, guarantee systems and related management companies" issued by Consob and Bank of Italy, FINRA Rule 2241 and NYSE Rule 472, as well as the FCA Conduct of Business Sourcebook rules COBS 12.4.9 and COBS 12.4.10 - between the Intesa Sanpaolo Banking Group and issuers of financial instruments, and their group companies, and referred to in research products produced by analysts at Intesa Sanpaolo is available in the "Research Rules" and in the extract of "A business model for managing privileged information and conflicts of interest" published on the website of Intesa Sanpaolo S.p.A.

At the Intesa Sanpaolo website, webpage http://www.group.intesasanpaolo.com/scripts/sir0/si09/studi/eng_archivio_conflitti.jsp you can find the archive of Intesa Sanpaolo Banking Group's conflicts of interest.

Furthermore, in accordance with the aforesaid regulations, the disclosures of the Intesa Sanpaolo Banking Group's conflicts of interest are available through the above mentioned webpage. The conflicts of interest published on the internet site are updated to at least the day before the publishing date of this report.

We highlight that disclosures are also available to the recipient of this report upon making a written request to Intesa Sanpaolo S.p.A. – Macroeconomic and Fixed Income Research, Via Romagnosi, 5 - 20121 Milan - Italy.

Banca IMI S.p.A., one of the companies belonging to the Intesa Sanpaolo Banking Group, acts as market maker in the wholesale markets for the government securities of the main European countries and also acts as Government Bond Specialist, or in comparable roles, for the government securities issued by the Republic of Italy, by the Federal Republic of Germany, by the Hellenic Republic, by the European Stability Mechanism and by the European Financial Stability Facility.

Sample