

J.P. MORGAN 2015 OUTLOOK

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Euro area government bond supply: Summary

- We forecast €765bn of conventional bond issuance in 2015, down from €802bn in 2014
- The largest drop in issuance will come from Italy and Germany, whereas supply in France and Spain is likely to be close to 2014 levels
- We expect net issuance of conventional bonds to drop below €200bn for the first time since 2008, partly helped by the higher than usual proportion of conventional redemptions in Italy
- Net issuance will be negative in Germany even before the likely impact of ECB QE
- Total Euro area linker issuance for 2015 is expected to be around €6bn lower than 2014 at €76bn; France and Italy might change the coupon payment month of their bonds
- After the decline in 2014, we expect the stock of T-bills to be broadly unchanged in 2015
- January-February calendar: expect the usual large amount of syndicated deals

2015 gross conventional supply €765bn from €802bn in 2014

We forecast €65bn of gross conventional issuance in 2015

Gross conventional supply by country and by quarter; J.P. Morgan forecast; countries sorted by GDP size; €bn

	1Q15	2Q15	3Q15	4Q15	2015	2014	2013	2015 vs. 2014
Germany	39	37	42	29	147	161	173	(14)
France	56	54	38	37	185	185	175	0
Italy	53	53	33	32	170	180	153	(10)
Spain	44	41	22	18	125	128	126	(3)
Netherlands	19	14	9	9	50	51	52	(1)
Belgium	12	8	7	6	33	32	40	1
Austria	6	5	3	3	17	21	22	(4)
Finland	4	2	4	1	10	11	12	(1)
Ireland	6	1	1	6	14	12	8	2
Greece	0	0	0	0	0	6	0	(6)
Portugal	6	2	4	3	14	16	12	(2)
Total	244	217	162	142	765	802	773	(37)

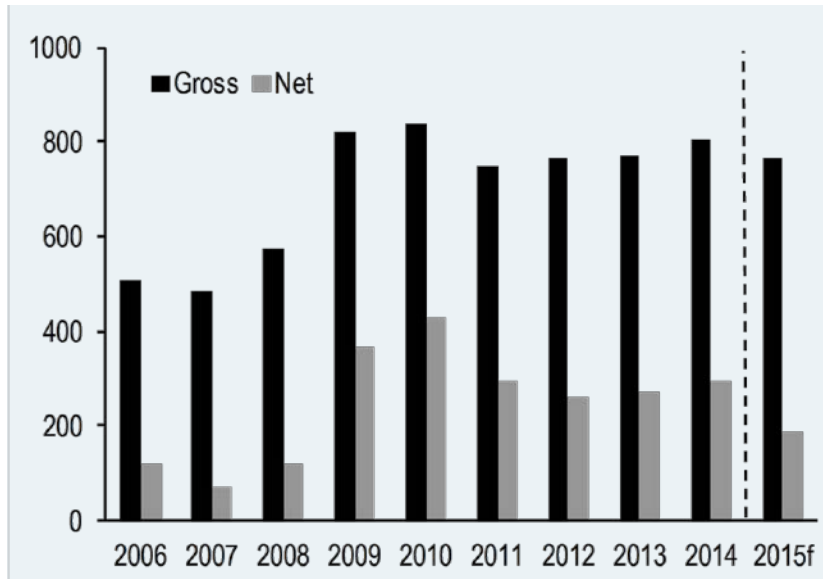
Note: We track supply on auction date basis rather than on settlement date basis

- We forecast 2015 gross conventional bond issuance forecast at €765bn from around €800bn in 2014
- At country level :
 - The largest drop in issuance will come from Italy and Germany
 - Supply in France and Spain is likely to be close to 2014 levels

Net conventional bond issuance will drop below €200bn

Net supply of conventional bonds will decline markedly

Gross and net issuance by year; Euro area; €bn



Net supply in Germany will be negative

Gross and net issuance by country; €bn

	2015			2014			Difference		
	Gross	Redemption	Net	Gross	Redemption	Net	Gross	Redemption	Net
Germany	147	155	(8)	161	144	17	(14)	11	(25)
France	185	104	82	185	104	82	0	0	0
Italy	170	139	31	180	90	90	(10)	50	(60)
Spain	125	85	41	128	68	60	(3)	17	(20)
Netherlands	50	37	13	51	32	19	(1)	5	(6)
Belgium	33	22	10	32	19	13	1	3	(3)
Austria	17	13	4	21	22	(1)	(4)	(9)	5
Finland	10	5	5	11	7	4	(1)	(2)	1
Ireland	14	2	12	12	3	10	2	(1)	2
Greece	0	7	(7)	6	10	(4)	(6)	(3)	(3)
Portugal	14	6	8	16	11	4	(2)	(5)	4
Total	765	574	190	802	509	293	(38)	65	(103)
Core	442	336	106	460	327	133	(19)	9	(27)
Periphery	323	239	85	342	182	160	(19)	57	(76)
Memo: Italy's total (conv. + non-conv.)	269	203	66	283	194	89	(14)	9	(23)

- We expect net issuance of conventional bonds to drop below €200bn for the first time since 2008
- Such a sharp drop compared to 2014 is partly due to the higher than usual proportion of conventional redemptions in Italy
- Net issuance will be negative in Germany even before the likely impact of ECB QE

ECB QE: Risk-sharing, impact on supply

Only 8% of government and agency credit risk will be shared, but does it matter?

J.P. Morgan expected split of purchases by type of instrument and risk sharing

	Exp. Monthly pace of purchases (€bn)	Risk sharing (%)	Risk sharing (€bn)
Covered bonds / ABS	10	100%	10.0
European Institutions	6	100%	6.0
Central governments & agencies	44	8%	3.5
Total	60	33%	19.5
Memo: Additional purchases	50	19%	9.5

* The ECB stated that they intend to buy 12% of the non-covered bonds and ABS size in European institutions.

Net purchases of central government and agency bonds will exceed net issuance

Estimated monthly ECB purchases of central government and agency bonds based on capital key adjusted for Greece vs. average monthly estimated gross and net issuance in 2015; €bn

	Monthly ECB purchases	Monthly gross issuance	Monthly net issuance	Monthly net issuance – ECB purchases
Germany	11.2	13.1	0.2	-11.1
France	8.9	17.0	7.3	-1.6
Italy	7.7	21.8	5.5	-2.2
Spain	5.5	12.3	5.1	-0.4
Netherlands	2.5	4.5	1.4	-1.1
Belgium	1.5	2.9	1.0	-0.5
Greece	1.3	0.1	-0.4	-1.7
Austria	1.2	1.6	0.5	-0.7
Portugal	1.1	1.2	0.7	-0.4
Finland	0.8	0.8	0.7	-0.1
Ireland	0.7	1.2	0.8	0.0
Euro area 11	42.5	76.4	22.6	-19.9

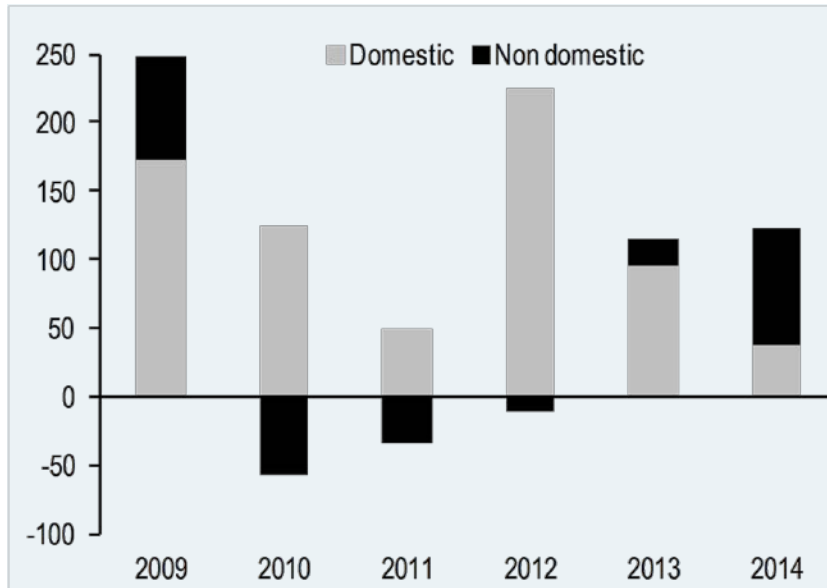
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Monetary and financial institutions (MFIs): back to non-domestic

European banks have been increasing exposure to non domestic sovereign securities in 2014

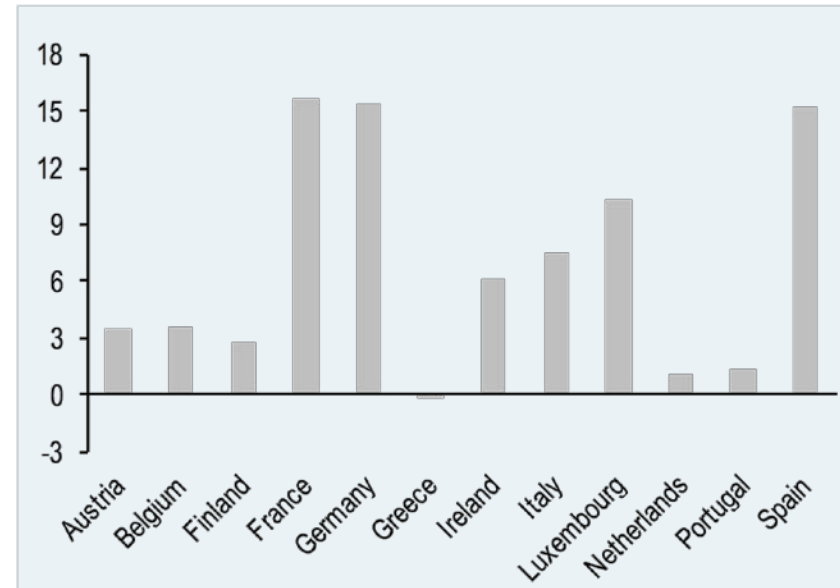
Net purchases of sovereign securities in the first 11 months of each year; by jurisdiction; €bn



Source: ECB, J.P. Morgan

Interest in foreign securities is widespread by jurisdiction

Net purchases of non-domestic sovereign securities between January and November 2014; €bn

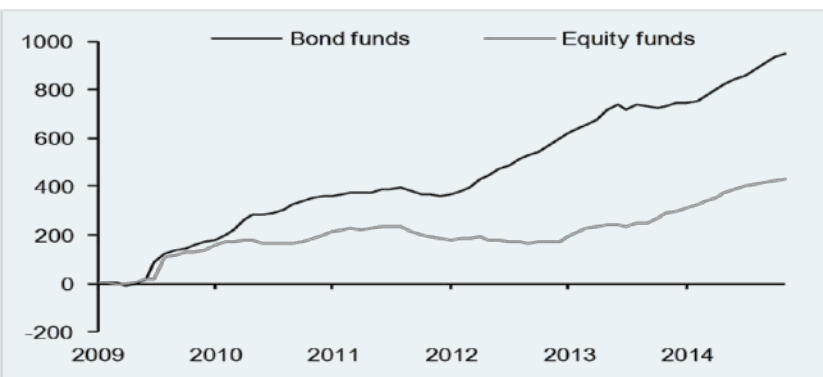


Source: ECB, J.P. Morgan

Investment funds: healthy inflows into bond funds continue

Euro area bond funds have seen net inflows in every month of 2014 (latest data Oct14)

Cumulative flows into bond and equity funds in the Euro area; €bn



Source: ECB

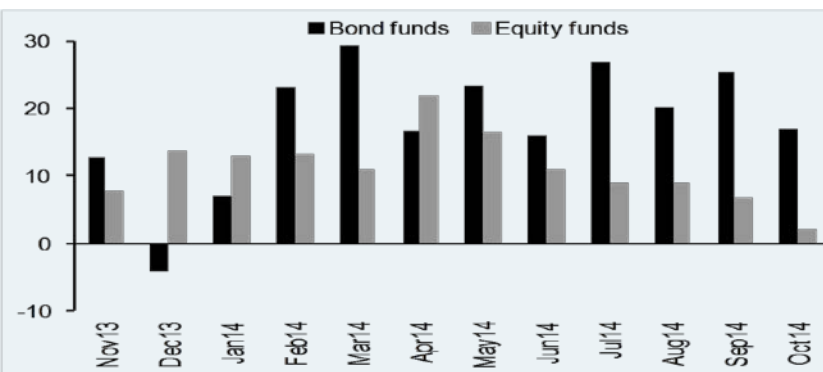
In 3Q14 purchases were concentrated in foreign securities, with little going to euro govies

Euro area investment funds net flows into debt securities; €bn

	Grand total	Euro			RoW
		Total	Gen. gov.	Other	
2010	53	(4)	(7)	3	57
2011	32	(9)	(17)	8	41
2012	258	74	14	60	184
2013	203	87	58	116	0
1Q14	107	65	28	37	44
2Q14	88	35	11	24	53
3Q14	89	17	8	9	72
Memo: size	3,542	1,955	913	1,042	1,587

Source: ECB

Monthly flows into bond and equity funds in the Euro area; €bn

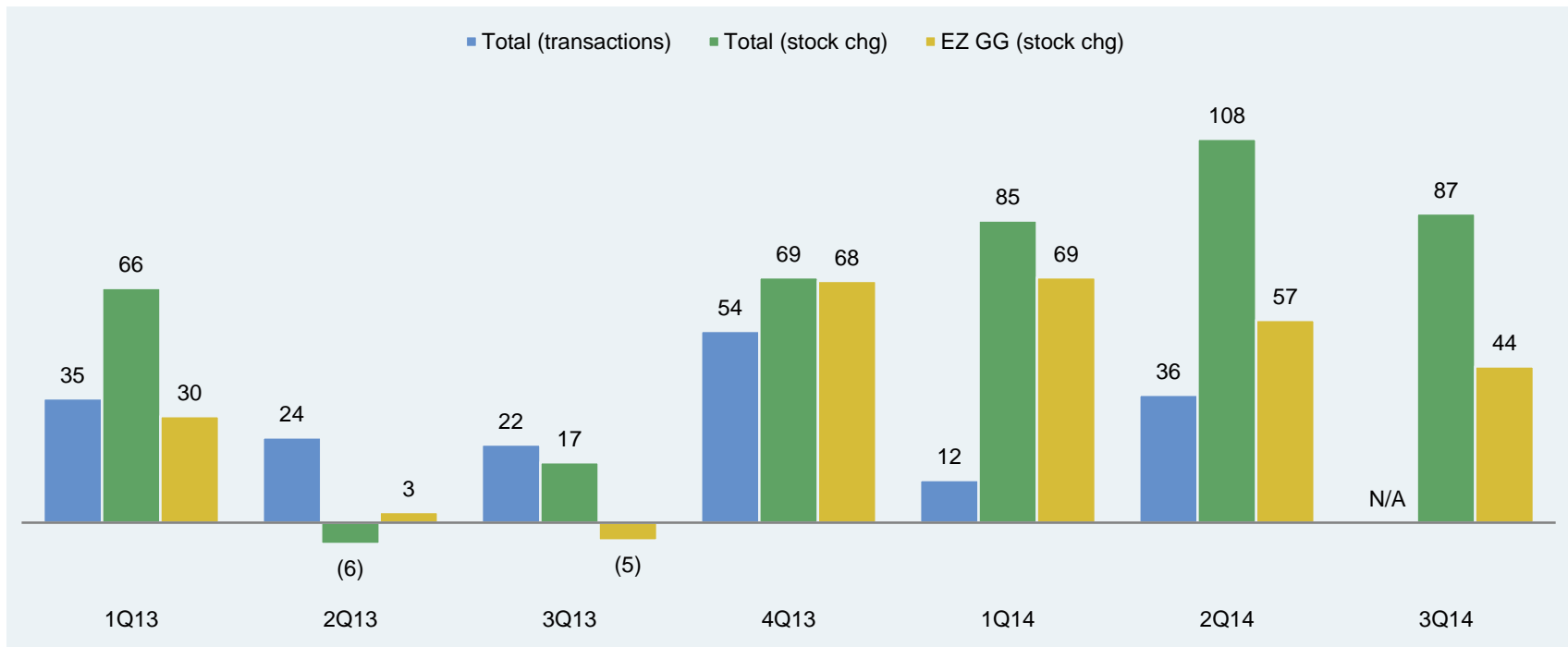


Source: ECB

Insurance companies: bond inflows remain positive

Insurance companies have been net buyers of government securities in 2013 and 2014

Quarterly changes in outstandings or net transactions¹; total debt securities and Euro area general government; €bn



Source: ECB

¹ The difference between the total stock change and total net transactions is revaluations

- The stock value of debt securities swelled in first three quarters of 2014 due to falling yields, but we have limited data on transactions

Non-domestic inflows: lower Euro starting to bite?

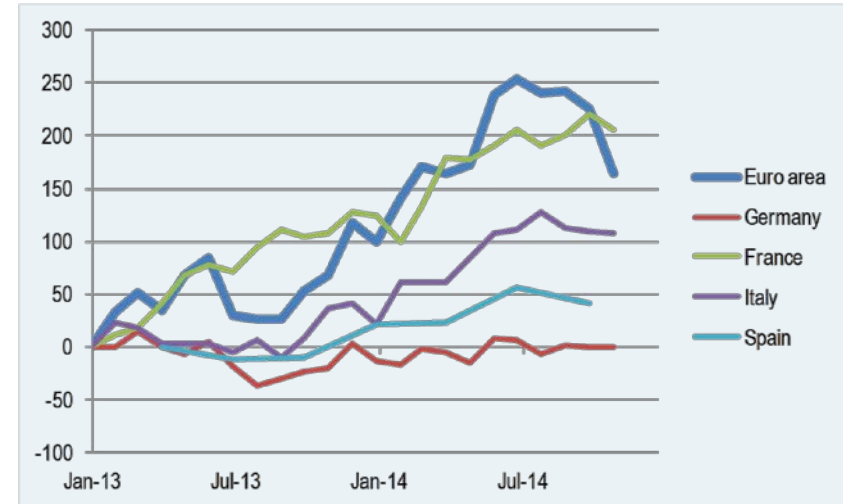
Euro area saw big outflows from outside the region in July, August and October

Euro area BoP; debt securities split by maturity and type of issuer; €bn

	Total	Short-end	Long-end	General govt
2013 monthly avg.	8	1	7	10
1Q14 monthly avg.	22	1	20	19
2Q14 monthly avg.	30	8	22	31
3Q14 monthly avg.	(9)	5	(14)	(17)
Jul-14	(14)	11	(25)	(23)
Aug-14	3	11	(8)	(28)
Sep-14	(17)	(6)	(10)	0
Oct-14	(62)	(26)	(36)	(34)

Source: ECB, revised BPM6 methodology

Cumulative BoP flows; debt securities; since January 2013; €bn



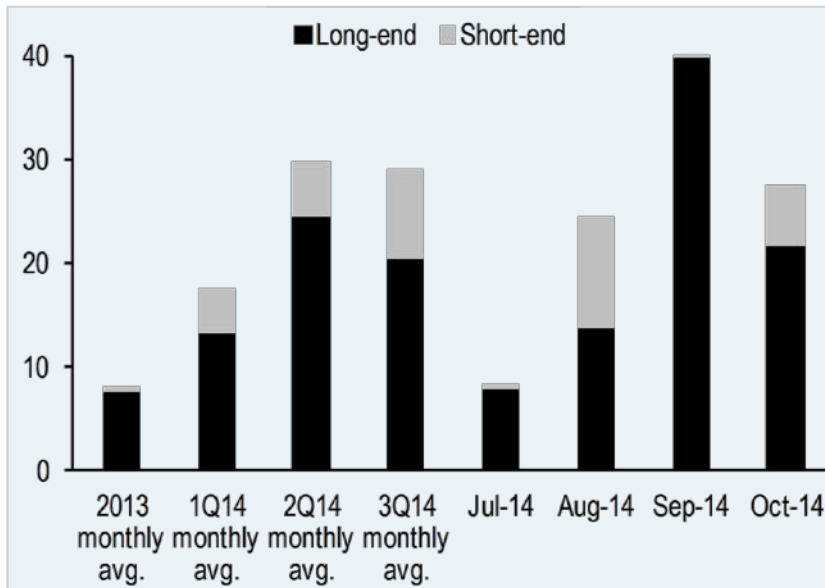
Source: ECB and national central banks

- Based on the new methodology, between July and October, Euro area fixed income markets saw big outflows
- In particular non Euro area investors were sellers of government debt securities in July, August and October

Euro area flows into foreign assets are accelerating

Euro area investors stepped up purchases of foreign assets

Euro area BoP; purchases by Euro area investors; debt securities split by maturity; €bn



Source: ECB, revised BPM6 methodology

Where are the purchases coming from?

- Insurance companies and pension funds do not appear to have increase their holdings of foreign debt securities in 3Q14
- Mutual funds bond investments have been skewed to non-Euro area debt securities in 2014, especially in 3Q14
- BIS data on bank balance sheets in 3Q14 will be released by the end of January

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Germany yields slightly higher than the forwards, still room for tighter intra-EMU spreads

German yields have bottomed in our forecast

J.P. Morgan interest rate forecast; German benchmarks unless otherwise stated; %

	23-Jan	1Q15	2Q15	3Q15	4Q15
ECB refi	0.05	0.05	0.05	0.05	0.05
2Y	(0.17)	(0.15)	(0.15)	(0.15)	(0.15)
5Y	(0.03)	(0.05)	0.00	0.00	0.00
10Y	0.36	0.45	0.60	0.60	0.60
30Y	1.08	1.15	1.30	1.30	1.30
2s/10s (bp)	53	60	75	75	75
10s/30s (bp)	72	70	70	70	70

Tighter intra-EMU spreads across the board

J.P. Morgan interest rate forecast; curve-adjusted 10Y spread to 10Y Germany; %

	23-Jan	1Q15	2Q15	3Q15	4Q15
Austria	8	10	10	10	10
Belgium	24	20	15	15	15
Finland	8	10	10	10	10
France	19	20	15	15	15
Ireland	60	50	40	40	40
Italy	115	100	70	70	70
Netherlands	8	10	5	5	5
Portugal	208	150	100	100	100
Spain	106	85	60	60	60
Wtd. peri. Spread**	114	95	67	67	67

* Adjusted for maturity mismatch by taking the difference in maturity matched swap spreads.

** Weighted peripheral spread computed against Germany for Greece, Ireland, Italy, Portugal and Spain (weighted by the size of their outstanding bond market).

- On a 1Y horizon, our 10Y Bund forecast is barely above the forwards
- Intra-EMU spreads still have room for tightening

Why higher 10Y Bund yields?

The 5yr forward rate in Germany has been correlated with the 5yr EUR inflation swap rate and the increase in the G4 central bank balance sheet

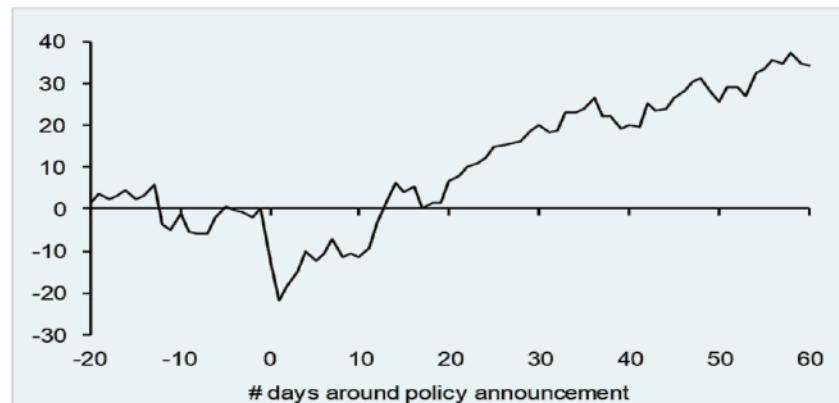
5yr German forward par rate regressed against 5yr EUR inflation swap rate and cumulative increase in the G4 central bank balance sheet; since January 2007; %

	Coefficient	T-stat
Intercept	1.0	8.8
EUR 5Y 5yr inflation swap rate (%)	1.5	32.1
Increase in G4 central bank balance sheet ¹ (%G4 GDP)	(11.2)	(65.5)
R-squared		83%
Standard error (%)		0.35

Source: Central Banks and J.P. Morgan
¹ 1% of G4 GDP is around €300bn

The announcement of QE operations in other countries has had an immediate downwards impact on yields on the day of the announcement but yields often rebounded afterwards

Average change in 10Y yields around key QE announcements in the US, UK and Japan¹; bp



¹ US QE1: 18 Mar 09, QE2: 3 Nov 10, Operation Twist: 21 Sep 11, QE3: 12 Dec 12; UK QE: 6 Mar 09; Japan QQE: 4 Apr13

- Higher Bund yields on
 - Upward surprise on growth
 - Buy-the-rumour sell-the-fact around sovereign QE
 - OPEC agreement
 - Pressure from higher US interest rates
- Why only modest sell off?
 - Inflation does not pick up aggressively
 - G4 monetary stimulus continues

Headline risks on the horizon in 2015

There are a few headline risks on the horizon in 2015 but we expect them to have only a temporary impact

Main upside and downside risks to J.P. Morgan baseline scenario

Item	Date	Importance	JPM baseline
Internal factors			
ECJ ruling on OMT	14-Jan	***	Market positive
Politics - Greece	25-Jan	**	Market negative, but no contagion
Politics - Italy	1Q-2Q15	**	Market neutral (1/4 positive tail)
Politics - Spain	2Q-4Q15	**	Wobbles but no ultimate damage
Macro - Italy	Recurrent	**	Market positive
Politics - Portugal	3Q15-4Q15	*	Broadly market neutral
Rating actions	Recurrent	*	Overall market neutral
External factors			
US rate sell off	1H15?	**	Any volatility shock will be temporary
Geopolitical risks	Recurrent	**	No adverse impact, risks to the downside
Spillover of BoJ QQE	Recurrent	*	Modest impact on Euro assets

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The big picture... ABS & Covered Bonds in 2015

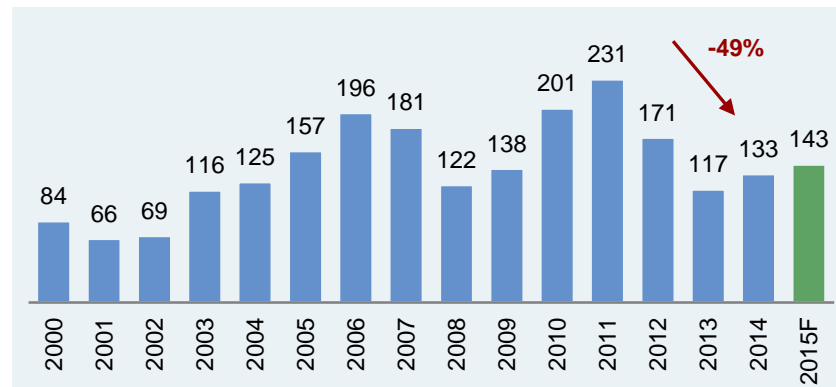
- 2015 will be largely determined by the behaviour of the ECB
 - ABS & Covered Bonds *currently* take centre stage as part of the ECB's Quantitative Easing efforts
 - Assessing ECB's assertiveness when executing QE becomes the most important analysis
- What we know today:
 - Spreads in both asset classes have rallied
 - CBPP3 pushes covered spreads inside the sovereign for peripheral jurisdictions
 - ABSPP pushes spreads to levels not seen since early 2008
 - Is the ECB leaving investors behind?
 - Issuance volumes should improve
 - Covered Bond issuance should improve at the margin
 - Unlikely to be a significant change in current funding patterns
 - ABS issuance should improve more notably
 - Markets should open that currently remain closed (such as Spain)
 - More subordinated risk positions should be placed with investors
- Regulation remains a potential roadblock for more whole-hearted investor engagement, especially for securitisation positions
 - Return-on-capital is our key metric
 - *Relative* regulatory treatment is as important as *absolute* treatment
- Yield compression will help originators, but is likely to hurt investors

Primary markets—Stabilisation in gross issuance volumes in 2014, with expectations of market growth in 2015

Commentary

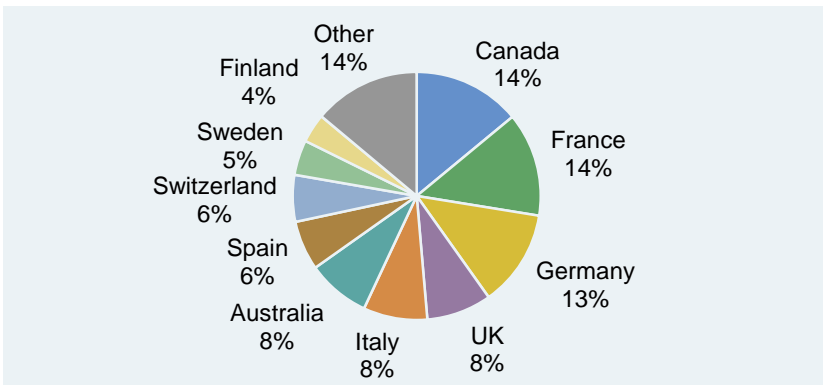
- Global issuance of €133bn of benchmark bonds in FY2014
 - 13% higher than FY2013
 - **Forecast of €143bn for 2015**
- Eurozone issuance of €75bn of benchmark bonds in FY2014
 - 5% higher than FY2013
 - **Forecast of €87bn for 2015**
- Official sector alternatives continues to offer a competitive alternative to wholesale market funding

Total public benchmark covered bond issuance (€bn)



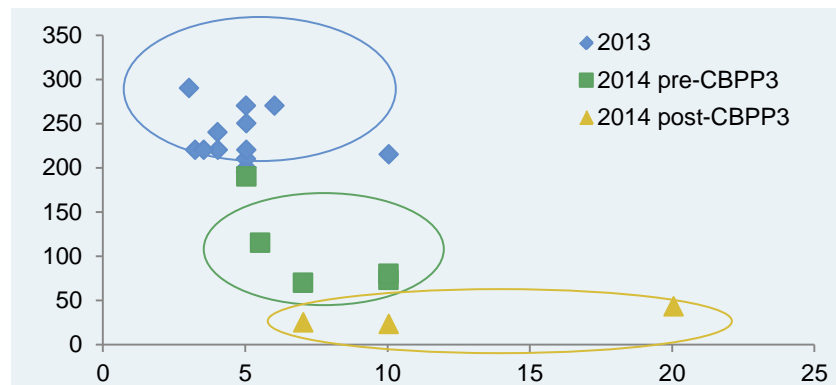
Source: J.P. Morgan

Total public covered bond issuance by jurisdiction, %



Source: J.P. Morgan.

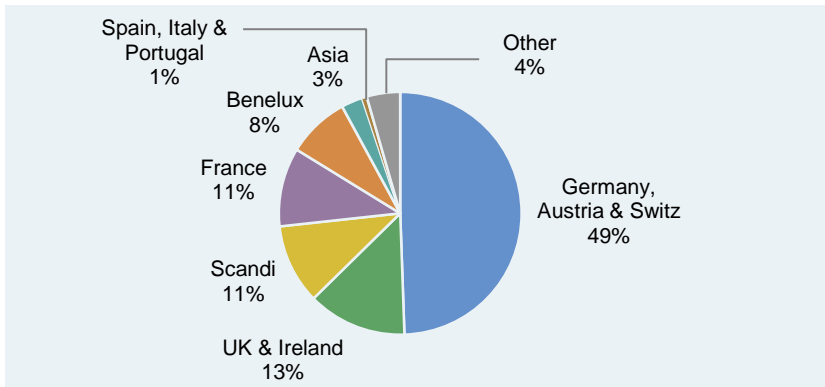
Impact of official sector on new issue pricing: Cedulas



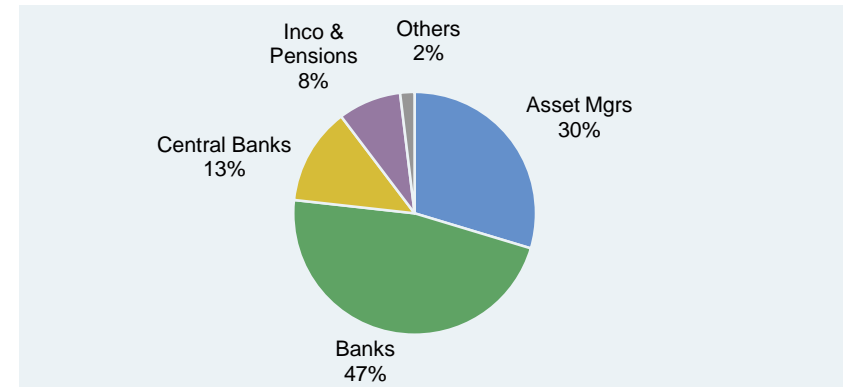
Source: J.P. Morgan

Who is buying what? A story of two markets... banks drive northern European investing, AMs take over in the south...

Investors by jurisdiction and investor type (%) in 2014 core issuances, %

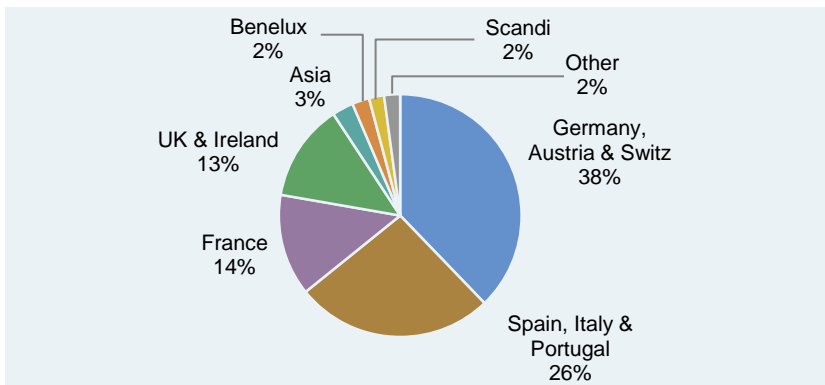


Source: J.P. Morgan

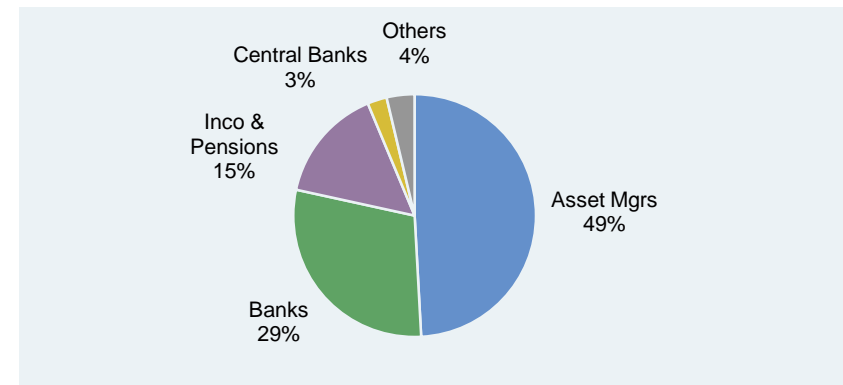


Source: J.P. Morgan

Investors by jurisdiction and investor type (%) in 2014 peripheral issuances, %



Source: J.P. Morgan



Source: J.P. Morgan

Outlook 2015–Market set to get smaller... yet again

Supply and redemptions overview (€bn)

Nationality of risk	2013 Benchmark redemptions	2013 Benchmark issuance	2013 Net supply	2014 Benchmark redemptions	2014 Benchmark issuance	2014 JPM Forecast benchmark issuance	2014 Net supply	2014 JPM forecast net supply	2015 Benchmark redemptions	2015 JPM Forecast benchmark issuance	% Change on 2014	2015 Forecast net supply
Australia		11.4	11.4		9.6	12.0	9.6	12.0	3.6	10.0	4%	6.4
Austria	3.3	3.0	(0.3)	4.0	3.0	3.0	(1.0)	(1.0)	3.0	4.0	60%	1.0
Belgium		4.5	4.5		4.0	4.0	4.0	4.0		4.0	0%	4.0
Canada	4.9	9.2	4.3	8.7	18.7	9.0	10.0	0.3	9.9	12.0	(36)%	2.1
Denmark	1.8	1.1	(0.7)	3.3	2.5	2.0	(0.8)	(1.3)	3.0	3.0	80%	0.0
Finland	0.5	3.3	2.8	3.9	5.0	4.0	1.2	0.2	4.5	5.0	0%	0.5
France	22.5	17.3	(5.3)	22.2	17.3	22.0	(4.9)	(0.2)	23.0	22.0	28%	(1.0)
Germany	40.1	15.5	(24.6)	32.5	17.9	20.0	(14.7)	(12.5)	21.1	20.0	22%	(1.1)
Ireland	6.5	3.0	(3.5)	3.0	1.3	3.0	(1.8)	0.0	7.3	3.0	140%	(4.3)
Italy	7.2	8.8	1.6	3.1	13.5	8.0	10.4	4.9	5.8	10.0	(5)%	4.2
Luxembourg	1.4		(1.4)	0.5		0.0	(0.5)	(0.5)		0.0		0.0
Netherlands	3.0	2.8	(0.3)	6.0	2.0	4.0	(4.0)	(2.0)	5.0	3.0	50%	(2.0)
New Zealand		1.0	1.0		0.8	1.0	0.8	1.0	0.5	2.0	167%	1.5
Norway	4.1	8.8	4.7	2.6	3.9	6.0	1.3	3.4	6.5	4.0	3%	(2.5)
Portugal	2.0	0.8	(1.3)	4.4	2.5	1.5	(1.9)	(2.9)	2.0	4.0	60%	2.0
Spain	37.0	10.3	(26.7)	50.2	8.8	12.0	(41.4)	(38.2)	36.4	12.0	37%	(24.4)
Sweden	4.7	10.6	5.8	9.8	5.6	10.0	(4.2)	0.2	6.8	10.0	22%	3.3
Switzerland	1.5	3.6	2.1	2.5	5.8	4.0	3.3	1.5	4.9	5.0	9%	0.1
United Kingdom	10.8	1.6	(9.2)	11.3	11.2	5.0	(0.1)	(6.3)	19.7	8.0	(29)%	(11.7)
Other	5.3	0.8	(4.5)	8.2	0.0	0.0	(8.2)	(8.2)	1.2	2.0		0.8
Global	156.4	117.1	(39.3)	176.1	133.2	130.5	(42.8)	(45.6)	164.2	143.0	11%	(21.2)
Eurozone	123.4	69.0	(54.4)	129.7	75.1	81.5	(54.6)	(48.2)	108.2	87.0	24%	(21.2)

Source: J.P. Morgan

Outlook for Covered Bonds–Bigger, tighter, but less appealing

- Hard to forecast the ECB's exact impact on the market into 2015, BUT:
 - Likely to encourage some marginal issuance, however existing official sector alternatives also provide a funding alternative
 - Net issuance will remain negative
 - Spreads will be tighter, stretching investor relative value considerations
 - Secondary spreads have tightened further and have consistently outperformed government bond indices in both the core and the periphery
 - CBPP3 exacerbates current spread trends
- Expect to see a shift towards longer durations from Eurozone primary markets
 - Targeted Long Term Refinancing Operation (of up to 4 years)
 - Senior should fill the 5-7year maturity bucket, leading to more covered supply in the 7+ year area
 - SME covereds to make an appearance?
- A number of investors and issuers are concerned that aggressive buying in the ECB's CBPP programme could squeeze traditional investors out, leaving poor liquidity and allocations
 - Sensitive moves to date
- Regulatory environment remains supportive for the asset class:
 - LCR inclusion as Level 1 asset for European benchmarks
 - Relative treatment under Solvency II compared to Securitisation bonds

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ABS Primary markets—Could do better... much better

Overview of primary market activity

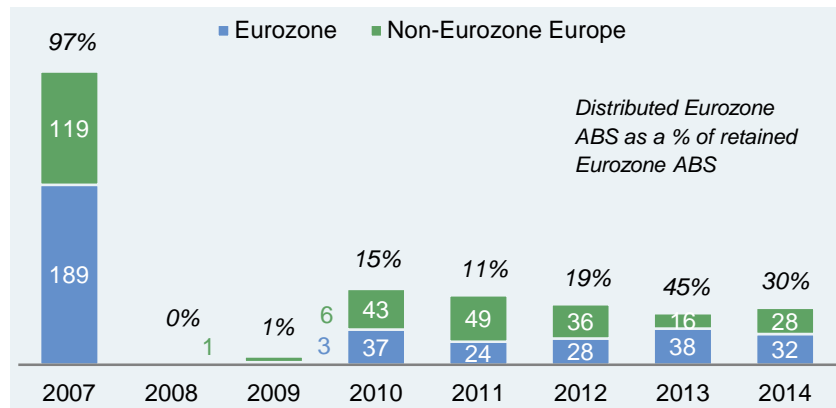
- Total international ABS issuance of €80.8bn, 9% increase over 2013 (€73.8bn)
 - €32bn Eurozone (FY13: €39bn)
 - €28bn Non-Eurozone Europe (FY13: €14bn)
 - €21bn Australia (FY13: €20bn)
- We **forecast issuance of €95-100bn** in 2015, with the increase (+€20bn) driven by the European ABS markets
 - We attribute this growth almost exclusively to the ABSPP
 - JPM estimate of €75bn ABSPP p.a., with 30% bought by investors
- This presents us with a problem:
 - Sum of redemptions of distributed European ABS bonds in the last year was €143bn
 - New issuance volumes over the same period of €60bn
 - This resulted in **negative net issuance of €83bn** in 2014.
- Where redemptions exceed new volumes, we see the danger of:
 - Investor accounts' attention drifting away from the product
 - Issuers being unable to rely on market access when needed
 - Recent positive official sector pronouncements supporting a smaller (and therefore less important) product... too little, too late?
- While European securitisation markets continue to offer investors (and originators) only "funding bonds", **we believe the outlook for the market's health looks challenging**

Total international ABS issuance volumes, €bn



Source: J.P. Morgan International ABS & CB Research

Distributed Eurozone and non-Eurozone Europe issuance patterns over time, €bn



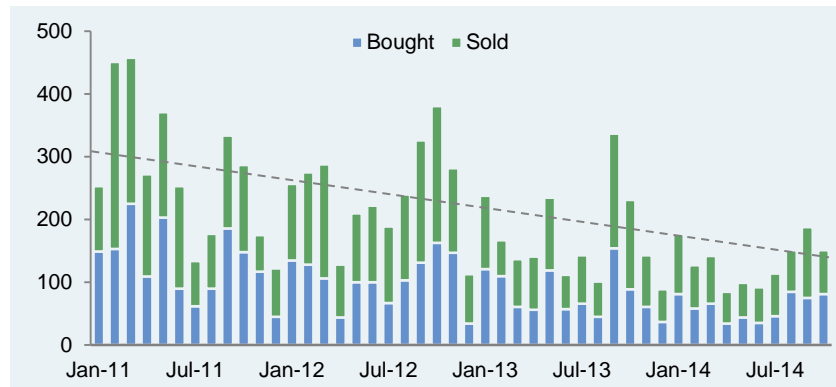
Source: J.P. Morgan International ABS & CB Research

Secondary markets—Quieter, but with the periphery playing a larger role

Overview of secondary market activity

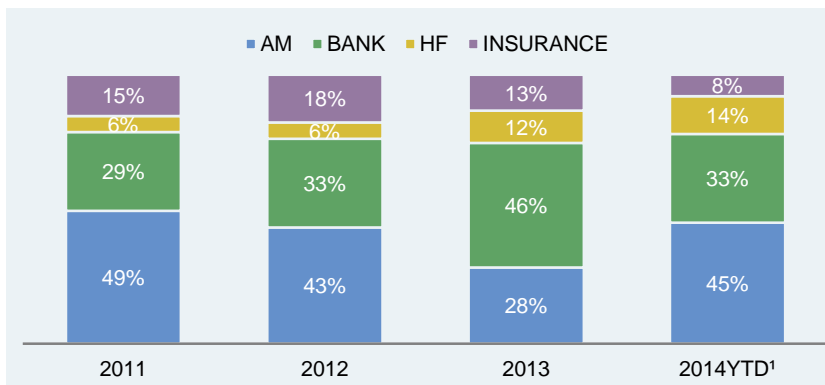
- Secondary markets continue to function well, although total trading volumes have declined, a function of:
 - Redemptions and tenders
 - Bond amortisations
 - Reduced number of distressed sellers/increase of 'happy holders'
- Trading counterparties this year show a recovery in the role of AMs
 - 2013 saw banks sell to AMs
 - YTD2014 sees banks sell to both AMs and other banks
- Appetite for Italian exposures, and SME backed bonds more broadly, drive differences in traded assets in 2014

Trading activity, # trades



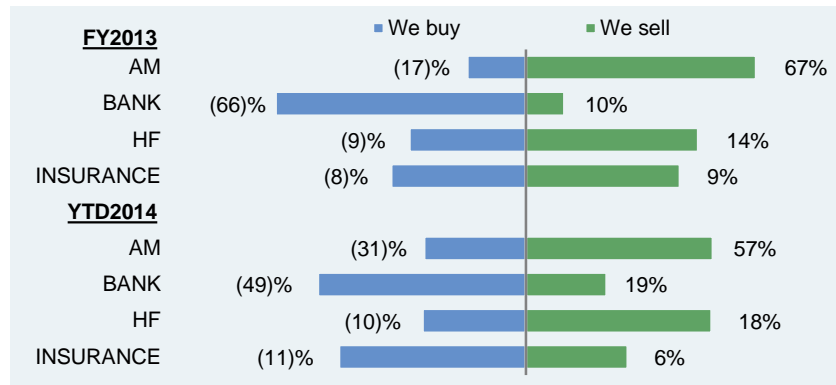
Source: J.P. Morgan Trading

Trading counterparties by type, %



Source: J.P. Morgan Trading
¹ As at 30th November

Trading counterparties by activity, %



Source: J.P. Morgan Trading

Investor demand faces roadblocks (1)... Solvency II significantly increases insurance company capital charges for securitisation investment

Example #1–Dutch RMBS

- AAA Senior 5yr at 3mE+39
- BBB Sub10yr at 3mE+115

'Initial proposal'

- Single hierarchy for all ABS investments
 - 'AAA' Capital = 35%, ROC = 1.1%
 - 'BBB' Capital = 80%, ROC = 1.4%

'December 2013 proposal'

- Eligible 'Type A' securitisation benefiting from lower risk factor at the Senior level
 - 'AAA' Capital = 21.5%, ROC = 1.8%
 - 'BBB' Capital = 78.8%, ROC = 1.5%

Final October 2014 rules

- Lower senior 'Type A' securitisation risk factor
 - 'AAA' Capital = 10.5%, **ROC = 3.7%**
 - 'BBB' Capital = 100%, **ROC = 1.2%**

Example #2–Spanish RMBS

- A+ 6yr maturity at 3mE+93
- BB 10yr maturity at 3mE+230

'Initial proposal'

- Single hierarchy for all ABS investments
 - 'A+' Capital = 76%, ROC = 1.2%
 - 'BB' Capital = 80%, ROC = 2.9%

'December 2013 proposal'

- Eligible 'Type A' securitisation benefiting from lower risk factor at the Senior level
 - 'A+' Capital = 59.2%, ROC = 1.6%
 - 'BB' Capital = 82.0%, ROC = 2.8%

Final October 2014 rules

- Lower senior 'Type A' securitisation for lower rated exposures
 - 'A+' Capital = 18%, **ROC = 5.2%**
 - 'BB' Capital = 100%, **ROC = 2.3%**

Example #3–Dutch & Spanish Covered Bonds

- AAA Dutch 5Y covered at MS+2
 - Capital = 3.3%, **ROC = 0.6%**
- A+ Spanish 5Y covered at MS+50
 - Capital = 6.7%, **ROC = 7.5%**

Source: J.P. Morgan International ABS & CB Research

Investor demand faces roadblocks (2)... Basel's revised securitisation framework also increases the costs of ABS investors for banks... but not as much as Solvency II

Example #1–Dutch RMBS

- AAA Senior 5yr at 3mE+39
- BBB Sub10yr at 3mE+115

Basel II treatment

- 'AAA' Capital = 0.7%, ROC = 55.7%
- 'BBB' Capital = 6%, ROC = 19.2%

December 2013 proposals

- 'AAA' Capital = 2.5%, **ROC = 15.6%**
- 'BBB' Capital = 13%, **ROC = 8.8%**

Final December 2014 rules

- 'AAA' Capital = 2.0%, **ROC = 19.5%**
- 'BBB' Capital = 10.5%, **ROC = 10.9%**

Example #2–Spanish RMBS

- A+ 6yr maturity at 3mE+93
- BB 10yr maturity at 3mE+230

Basel II treatment

- 'A+' Capital = 1%, ROC = 93.0%
- 'BB' Capital = 43%, ROC = 5.3%

December 2013 proposals

- 'A+' Capital = 6.5%, **ROC = 14.3%**
- 'BB' Capital = 23%, **ROC = 10%**

Final December 2014 rules

- 'A+' Capital = 5.0%, **ROC = 18.6%**
- 'BB' Capital = 18.0%, **ROC = 12.8%**

Example #3–Dutch & Spanish Covered Bonds

- AAA Dutch 5Y covered at MS+2
 - Standardised Capital = 1%, ROC = 2%
 - FIRB Capital = 0.38%, **ROC = 5.3%**
- A+ Spanish 5Y covered at MS+50
 - Standardised Capital = 2%, ROC = 25%
 - FIRB Capital = 0.67%, **ROC = 74.6%**

Source: J.P. Morgan International ABS & CB Research. Note: assuming 10% capital

Outlook—Half full, half empty

- The most difficult year to produce an Outlook publication, owing to the impending involvement of the ECB as a purchaser in the asset class
- Spreads have significantly rallied since the ECB's purchase announcement in June. Meaningful activity, however, is yet to commence, leaving us uncertain as to the institution's assertiveness when executing. ABS's role as a vehicle for private sector QE further hampers our ability to accurately assess the ECB's exact intentions
- With ECB-inspired spread-tightening should come more economically feasible primary market issuance. We expect one significant beneficiary of the ECB's involvement in the asset class to be the Spanish ABS markets, which should resume activity, after being moribund since 2008. Our original forecast of FY14 issuance of €78.5bn looks appropriate (YTD €72.6bn), with a forecast uplift for FY15 volumes to €95bn
- Furthermore, through the significant repricing of senior, ECB eligible spreads, the economics of full-stack securitisation have notably improved. We continue to believe the attractiveness of securitisation as a funding-only tool remains marginal, particularly given the region's preference for covered bond issuance. Should the recent liability repricing lead to full-stack placement and thereby risk-transfer and asset deconsolidation for the region's banks, however, securitisation should have a secure future
- Investor base continues to face significant regulatory re-writes, which generically increase the amount of allocated capital required for investment. Insurance investors are challenged by the adoption of final Solvency II rules, while banks await the final determination of the Basel Committee
- Our top recommendations are peripheral seniors which will directly benefit from ECB purchases, along with assets outside the ABSPP, such as UK and Australian risk which will ultimately benefit from repricing—but as a second order effect

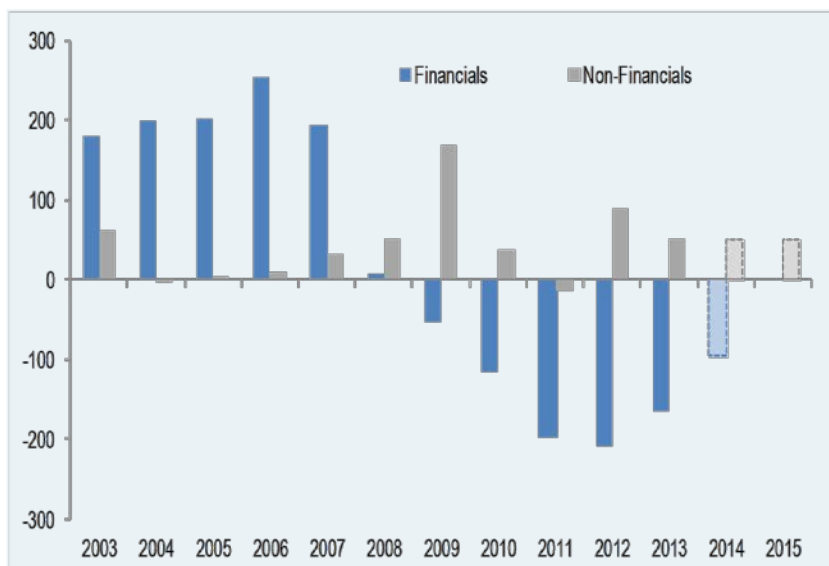
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Euro area corporate bond markets

EUR-denominated investment grade net issuance

2014/15 numbers are estimates; €bn



Source: J.P. Morgan

Euro-denominated high grade issuance history

2014/15 numbers are estimates; €bn

	2008	2009	2010	2011	2012	2013	2014	2015
Total gross issuance (€bn)	346	423	297	215	315	324	352	360
Redemptions	287	311	375	421	440	435	390	310
Total net issuance (€bn)	60	112	(78)	(206)	(125)	(111)	(38)	50
Financials gross Issuance (€bn)	213	170	179	125	126	139	155	200
Redemptions	206	221	294	319	336	302	242	200
Financials net issuance (€bn)	7	(51)	(115)	(194)	(209)	(164)	(87)	0
Non-financials gross issuance (€bn)	133	253	118	90	188	185	197	160
Redemptions	81	89	81	102	104	133	148	110
Non-financials net issuance (€bn)	52	164	36	(12)	84	52	48	50

Source: J.P. Morgan

- For Financials, 2015 €-denominated gross issuance will be €200bn (vs. €155bn in 2014), with zero net-issuance (vs. -€87bn in 2014)
- For Non-financials, 2015 €-denominated gross issuance will be €160bn (vs. €197bn in 2014) with net-issuance of €50bn (vs. €48bn in 2014)

Supranational/Agency funding requirements are set to level off after several years of decline

Supra / Agency borrowing requirements 2011–2015E

Year	Borrowing Requirements (\$bn)
2011	718
2012	696
2013	653
2014	616
2015E	622

Top European issuers borrowing requirements '14-'15E

	2014 (€bn)	2015E (€bn)
EIB	62	60
KfW	55	57.5
EFSF	34.5	13.5
ESM	15	14

Main Themes of 2014

- Spread compression driving the SSA market's secondary performance
- Hunt for yield pushing investors further out the curve – issuers accommodating longer tenors
- Slight decrease in EUR syndicated issuance volume due to large reduction in ESM/EFSF funding requirements
- Pressure of regulatory changes weighing on banks balance sheets, increasing the cost of business

EUR/USD 5-year cross currency basis (bps)



Source: J.P. Morgan as of 21st January 2015

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Central Securities Depositories Regulation: ESMA Consultation

Buy-in

A mandatory buy-in will be initiated, if securities are not delivered to the receiving party within 4 (7) days after the intended settlement date:

- **Scope** All failing settlements in EU CSDs, irrespective of underlying economic transaction/type of instrument.
- **Extension period** 4 business days for liquid bonds and shares. 7 business days for non liquid bonds and shares, ETF's, DR's, certificates and other instruments. 15 days for SME growth market instruments.
- **Securities Financing** Repo and stock lending transactions are subject to buy-ins, including the first leg (contrary to current practice) Short-term financing transactions (2 x 4 days or less for liquid instruments) are exempted.
- **Cash Compensation** If buy-in is not successful. Extra compensation in case the trade price is higher than the execution price (not if it's lower)
- **Implementation** 18 months after the publication of the Regulatory Technical Standards (ESMA proposal)

Example : impact on typical repo trade

A mandatory buy-in period increases the probability of a incurred loss at a multiple of the expected profit, decreasing the incentive to provide liquidity:

- A typical one-month repo trade on a Euro government bond generates about 5/10 basis points of profitability. The expected profit for 100 million € trade would therefore be: $0.05\% * 30 \text{ days} / 360 * 100 \text{ mio } \text{€} = \mathbf{4,167 \text{ €}}$
- If at maturity, the cash lender fails to deliver back the bonds, he could be "bought in" at the current cash market offer price. Consider that the average cash bid-offer spread on a 5 year Euro Government bond is about 10 cents.
- The cash lender needs to sell the "bought in" bonds to flatten his cash position, he would materialise a loss of $0.10 \text{ cents} * 100 \text{ mio } \text{€} = \mathbf{100,000 \text{ €}}$
This assumes no time delay between buy-in execution and liquidation of the position

Potential impacts on bond markets

Mandatory buy-ins significantly increase the exposure of repo and cash market participants to large losses, and could lead to:

- Reduction in the market makers liquidity provision: increased risk, pre-location of less liquid securities and higher buy-in price volatility
- Widening bid-offer spreads
- Split markets between short term (8 days or less: exempted) and longer term. Shift of term repo into short-dated repo

In times of stress, when settlement failures rise and/or certain bonds are in particular demand, this trend will be exacerbated.