

## The Morning Call

### Today's gilt auction and tomorrow's BTP supply

- **10yr gilt auction:** The UK DMO will today re-open £3.5bn of UKT 1.75% 9/2022. The auction is likely to be well supported, in our view. The new 10yr is one of the cheapest bonds in the 5-20yr sector of the gilt curve. Moreover, Mediums stand to benefit the most from the resumption of QE.
- **Tomorrow's BTP Supply:** Tomorrow Italy will issue €2.5bn-€3.5bn in a new 3yr benchmark, BTP 4.5% Jul15 and €1bn-€1.75bn across BTP Sep19, BTP Mar22 and BTP Aug23. We expect the auction to be met with the usual domestic demand and the small average size in the 10yr sector bonds should be supportive.

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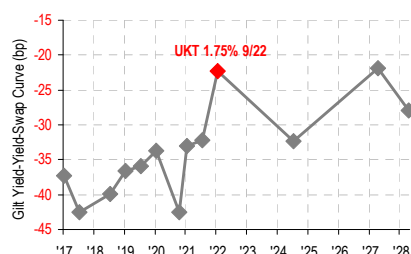
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## Gilts: Mediums to be supported by QE

**Auction details:** The UK DMO will today re-open £3.5bn of UKT 1.75% 9/2022. This is the first re-opening for the 10yr benchmark since it was newly-issued via auction on 21 June. A second re-opening is scheduled for 13 September.

Figure 1. The new 10yr is cheap vs swaps



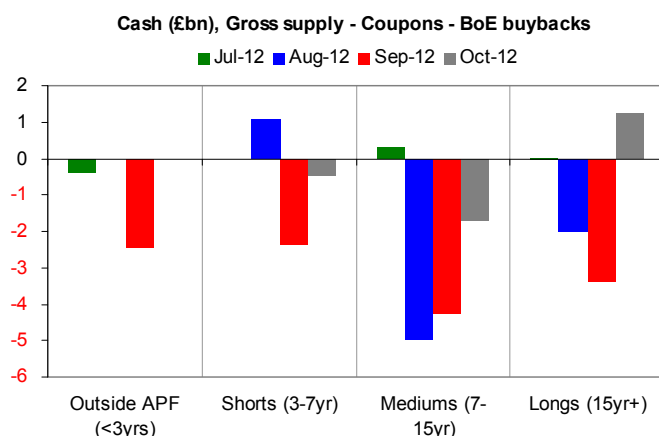
Source: Citi Research

**Attractive on the curve:** The new 10yr is one of the cheapest bonds in the 5-20yr sector of the gilt curve on an asset-swap basis (Figure 1). This should encourage switches out of surrounding issues and also outright asset-swap buying from those who, like us, hold a bullish view on Mediums over the summer months (see below).

**Eligibility for the APF:** This re-opening will take the total outstanding to £7bn meaning the bond will become eligible for APF buyback (which has a minimum size requirement of £4bn). However, the bond cannot be bought until after the usual one-week post-auction embargo. In other words, the Sep22s will not be eligible for the APF until the 7-15yr operation on the 25 July.

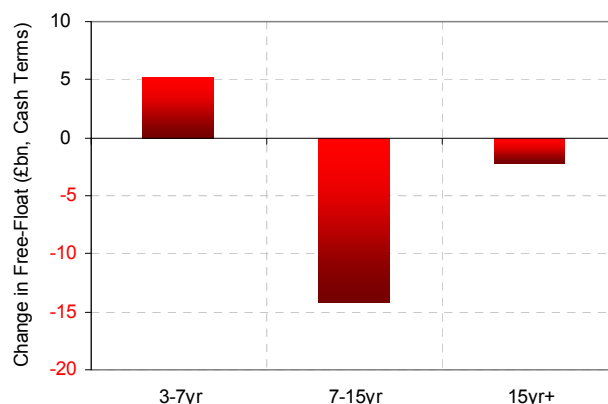
**Mediums to be well supported by QE3:** The resumption of QE favourably alters the net cash requirement for gilts over the coming months. In other words, APF buybacks, together with coupon payments, will outweigh issuance (Figure 2). This is especially true for Mediums which benefit from lack of issuance in August and then from large coupon payments (£3.6bn) in September. Moreover, by the end of October (when the £50bn QE extension will be exhausted), the free-float for Mediums is likely to have fallen markedly (taking into account issuance, APF buybacks and bucket shifts). This contrasts with much smaller changes for the other buckets (Figure 3). The combination of supportive net cash-flows and a dwindling free-float should be supportive for Mediums over the summer months.

Figure 2. Mediums to benefit from negative net cash requirement



Source: Citi Research, Bloomberg, DMO, Bank of England.

Figure 3. Projected change in free-float from £50bn QE extension



Source: Citi Research, Bloomberg, DMO, Bank of England.

### Conclusion – Sep22s offer value, both relative and outright

Today's 10yr gilt re-opening is likely to go well, in our view. There is likely to be plenty of demand for the 10yr given that it is the main liquidity point of the curve and that this is the penultimate gilt auction before the four week issuance break for the Olympics. Moreover, the Sep22s offer relative value within the 10yr sector. This should encourage switches out of neighbouring issues (aided by yesterday's APF operation). There are also likely to be buyers of the new 10yr vs swaps. Over the coming months, Mediums stand to benefit the most from the resumption of QE given supportive net cash-flows and a dwindling free-float.

**A full analysis of the impact of QE on gilt cash-flows and free-floats can be found in the latest [International Interest Rate Strategist](#).**

## Tomorrow's BTP Supply

**Auction details:** Tomorrow, Italy will issue €2.5bn-€3.5bn in a new 3yr benchmark, BTP 4.5% Jul15 and €1bn-€1.75bn across BTP 4.25% Sep19, BTP 5% Mar22 and BTP 4.75% Aug23.

**Issuance progress:** A total allotment of €5.25bn (the maximum of the indicative range) would put Italy ~57% through its expected bond supply calendar for 2012. Italy's mid-month BTP auction in August has been cancelled which is not surprising given the precedent set in previous years.

**Yield gyrations:** Yields in Tier2 markets remain volatile (Figure 4) and Italian yields continue to oscillate on relatively thin secondary market flows. The backdrop remains fundamentally challenging and our economists expect Italy will likely request assistance from the EFSF/ESM before the end of the year or early 2013. Indeed Italian PM Monti has recently stated that "*it would be hazardous to say that Italy would never use*" the European rescue mechanisms for bond market support measures ([Euro Area: Sovereign Debt Crisis Update 11<sup>th</sup> July](#)).

**New 3yr benchmark:** Interpolating between BTP Jun15s and BTP Aug15s provides an ASW level of around 357bp for the maturity of the new 3yr benchmark (BTP4.5% Jul15, Figure 5). At the time of writing, this equates to a yield spread of 1-2bp over the old 3yr benchmark (BTP Mar15). However, we would expect a relatively large concession to the estimated fair value to emerge today and the morning of the auction.

**Bear flattening:** There has been noticeable bear flattening on Italy's curve, with the 3yr sector wider by 30-40bp over the last week (Figure 6). We would also expect a broad based concession over the 10yr sector to build as the auction draws nearer.

**Relative Value:** On a more micro level, the bonds themselves are beginning to cheapen vs neighbouring issues. This can be seen in the yield fly of BTP Mar22 vs BTP Sep21 and BTP Sep22 as indicated in Figure 7.

Figure 4. Italy 2yr, 5yr and 10yr Yields (%)

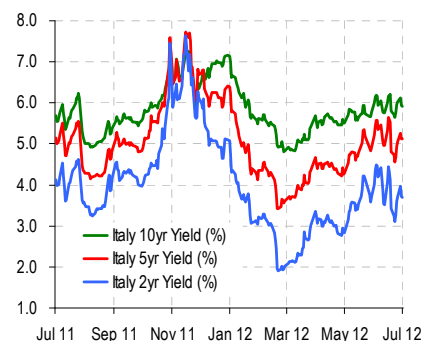


Figure 5. Italy's 3yr Sector, ASW Curve (bp)

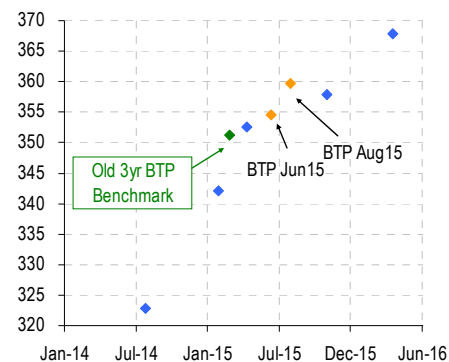


Figure 6. 1-week BTP Yield Changes (bp)

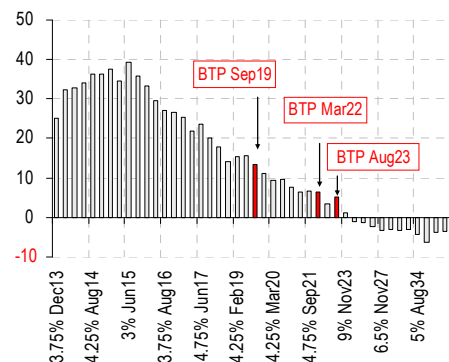
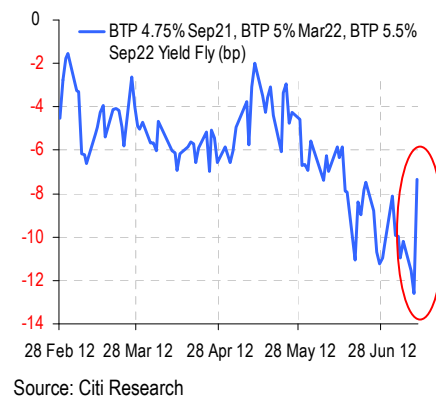


Figure 7. BTP Mar22 vs BTP Sep21 and BTP Sep22, Yield Fly (bp)



### Conclusion

Higher yields in the front of the curve are likely to be supportive and in general, we expect the auction itself to be met with the usual domestic demand. Relative value on the auction bonds in the 10yr sector is starting to emerge and the small average sizes should be supportive.

## Appendix A-1

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