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Western Europe

Euro Rates Strategy

S&P Lowers France to AA Stable – Market Implications

Peter Goves
+44-20-7986-3215
peter.goves@citi.com

Nishay Patel
+44-20-7986-1007
nishay.patel@citi.com

- **S&P downgrades France:** S&P lowered its rating of France from AA+ Negative Outlook to AA Stable this morning. S&P said the downgrade reflects the view that the French government's economic policies are unlikely to substantially raise France's medium-term growth prospects and that lower economic growth is constraining the government's ability to consolidate public finances.

- **Limited market reaction:** France was already on Negative Outlook which signified prospects for a downgrade over the medium term. The market reaction this morning has been limited (around 2bp wider in the 10yr sector to Germany) and the rating puts France more in line with the EGB credit curve. We do not see this rating action as a significant market event for EMU spreads.

- **France has various market supports:** The rating change reflects an economic reality that the market had more or less already discounted. The more dominant drivers for the OAT sector – and EMU more broadly – remain ECB policy. This is likely to remain supportive and we continue see the market depth and liquidity of France as a key strength in attracting demand. Recent flows also indicate net buying of France over recent weeks.

- **OAT vs Bunds and OLOs:** France has traded well over 2013, with 10yr OAT-Bund spreads now around 50bp. The rating action lends support to the notion that further spread tightening looks limited from current levels. We recommend selling 5yr OATs vs Bunds and OLOs (via a butterfly trade).

- **Continue to prefer SSA-OAT trades:** We continue to see good relative value between core German and Dutch agencies vs France, although entry points have been better. In addition, supranationals such as the EU and EIB continue to look appealing vs OATs in the belly of the curves.

- **Implications for other SSA ratings:** French agencies are likely to have their ratings normalized to S&P's rating of France given the strong connection to the sovereign (EPIC status). The EIB is rated AAA stable and the EU AAA negative outlook and we do not see a rating action on such supras as a necessary or mechanical outcome from S&P's move on France. The EFSF may be impacted (note that it was impacted when S&P downgraded France back in January 2012). However, we do not think this would significantly impact spreads and we continue to see the EFSF as a core, liquid market issuer within the SSA space.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

France lowered to AA Stable by S&P

The rating drivers

Drivers: S&P this morning lowered its long-term rating of France to AA. The outlook is now stable signifying that there is low likelihood of further rating actions anytime soon. The drivers behind S&P's decision included:

- Reforms in the product, labour and services market are positive, but unlikely to "*substantially raise France's medium term growth prospects, and that ongoing high unemployment is weakening support for further significant fiscal and structure policy measures"*.
- "*…lower economic growth is constraining the government's ability to consolidate public finances*".

S&P's expectations: In addition, S&P states that "*political room for additional revenue measures has lessened*". In their opinion, France's current fundamentals and S&P's expectation for how they will evolve, warrant a stable outlook according to their criteria. That is to say, inter alia, they expect the following:

- Continued government commitment to reform
- Net general government debt peaking around 86% in 2015
- Close to zero growth this year and average growth of 1% for 2014-2015
- General government deficit of 4.1% of GDP in 2013 (in line with government's target)

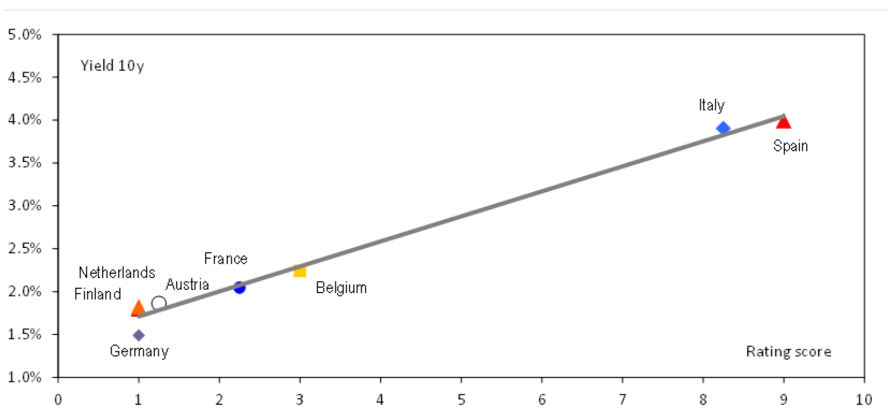
No further rating action likely over the medium term: This is the context S&P views France in and a significant (positive or negative) deviation away from this is the sort of driver that would prompt a re-appraisal. Given the stable outlook, we do not envisage any further rating action by S&P regarding France over the medium term.

EMU market implications

(1) Limited market reaction – France was already on negative outlook

Today's action by S&P is not a significant market moving event in our view. In one sense, France is now better in line with an ordinal ranking of EMU credit ratings and 10yr yields (Figure 1).

Figure 1. EMU yields vs Blended Rating Score



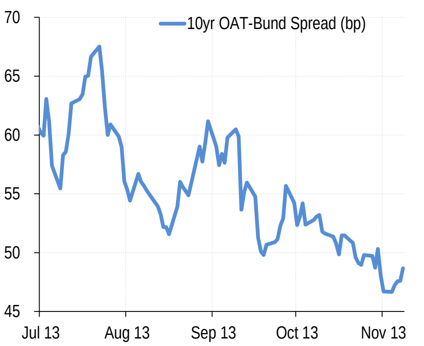
Source: Citi Research, S&P, Moody's, DBRS, Fitch

Market reaction: On the market open, France was around 1bp wider to Germany in the 5yr sector, and 2bp wider in the 10yr sector. This is not dramatic we do not anticipate a re-pricing of France based on this rating action.

Rating affirms what the market has already discounted: The move to AA stable is a reflection of the economic reality that is already widely appreciated. France was already on negative outlook and on several occasions, S&P had stated that "*the outlook on France is negative, indicating that we believe that there is at least a one-in-three chance that we could lower the ratings during 2013*" (S&P Research Update 23rd November 2012). Furthermore, a loss of the AAA standard probably has more psychological importance for the market than intra-Investment Grade rating changes. The reaction this morning further supports this view. .

(2) France has various market supports

Figure 2. France performance vs Germany

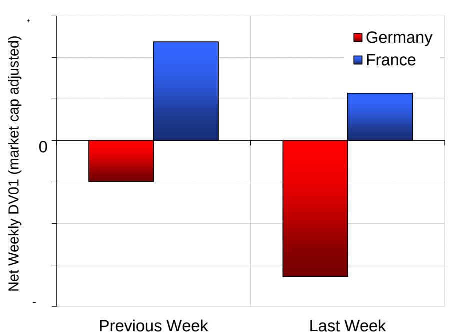


Source: Citi Research

ECB policy: As stated, intra-Investment Grade rating changes tend not to be significant spread drivers. Other factors are much more significant for assessing investment decisions in OATs, not least ECB policy. The surprise decision to cut the refi rate yesterday is a support to all EMU markets, especially the core (*European Rates Weekly*). Furthermore, a further LTRO next year would also provide impetus for a broad-base spread tightening (*Global Economic Outlook and Strategy*).

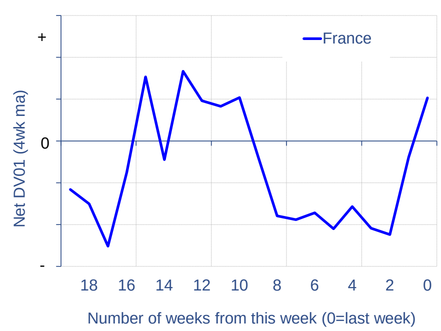
Demand and flows: We continue to see France as the main and important liquid core bond market alternative to Germany. The rating action supports the notion that 10yr OAT-Bund spreads tightening from current levels (~50bp) is probably limited. The last few weeks have seen demand for France[1] (Figure 3). Net demand for France over a four week period has now moved to positive territory (Figure 4). On a more micro level, demand has been concentrate in 2-5yrs and 5-10yrs over the last few weeks (Figure 5). More broadly, anecdotal evidence also indicates that OATs remain the key alternative to Bunds by Asian accounts and the domestic buyer base is and will likely remain an important contributor to the overall demands structure.

Figure 3. Weekly net DV01



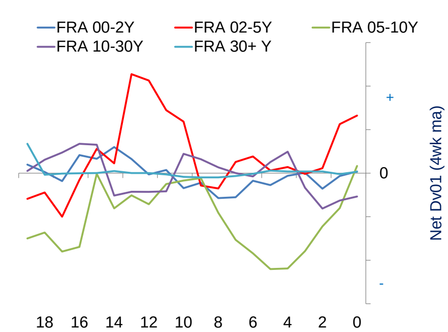
Source: Citi Research

Figure 4. France: Net DV01 across all sectors



Source: Citi Research

Figure 5. France: Net DV01 of sectors



Source: Citi Research

Trading strategies

OAT-OLO spreads and OAT-Bund spreads

Sell OATs vs OLOs and Bunds

Going forward, we would expect renewed interest in EGB carry trades to be more favourable for Belgium than France until year-end. This is based on the slightly better carry profile (for Belgium) and the fact that there is minimal Belgian supply remaining this year. We therefore recommend holding onto 5yr Belgium vs France positions targeting a further 4bps of widening from current levels.

[1] Based on electronically executed flows with Citi

- **Remain overweight OLO Mar18 vs OAT Apr18** (*Belgium - strategy recommendations*)
  - Open 19.5bp. Current 14bp. Target 10bp. Stop 25bp

Over the medium-term, we expect OAT-Bund spreads to widen by 20bps over the next 6months due to a non-supportive cash flow profile in 2014, diverging fundamentals and our expectations of an imbalance between supply and demand in 1H14. Further details can be found in *European Rates Weekly*

5yr Bunds-OAT-OLO butterfly

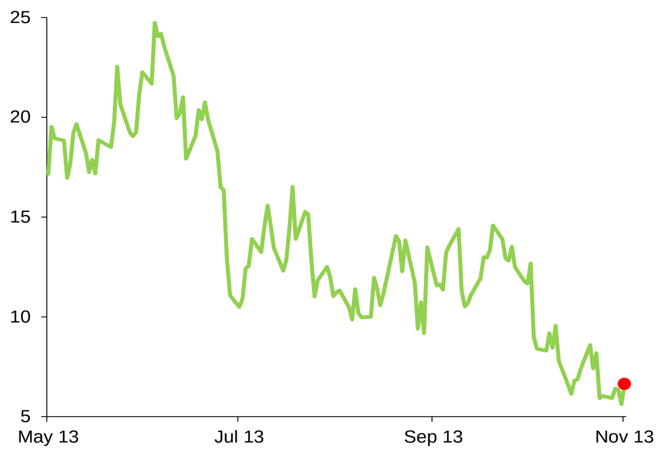
Prior to yesterday's ECB meeting (where we did not expect a rate cut) we recommended selling 5yr OATs vs Bunds[2] on a tactical basis due to the attractive entry level (tight spreads and we are currently at levels where spreads have previously widened) and the prospect of there being some concession in the lead up to the next BTAN supply on 21 November. Furthermore, the cash flows profile is strongly non-supportive for OATs into year-end due to the absence of coupons and redemptions. Although the yield spread is unchanged since our recommendation we feel the risk-reward of this trade has reduced slightly.

Our preferred trading strategy (one with a better risk-reward, in our view) is still to be short 5yr OATs vs Bunds but to add a long OLO position to this structure. This enables the structure to have a slightly better carry profile and provides a slight reduction in risk (to the short OAT vs Bund leg) should investors look to extend along the credit curve. Furthermore, the entry level is still attractive.

Below we highlight two trades that investors may wish to consider. The net carry on these trades is virtually flat (only 1bp against you on a 3month horizon).

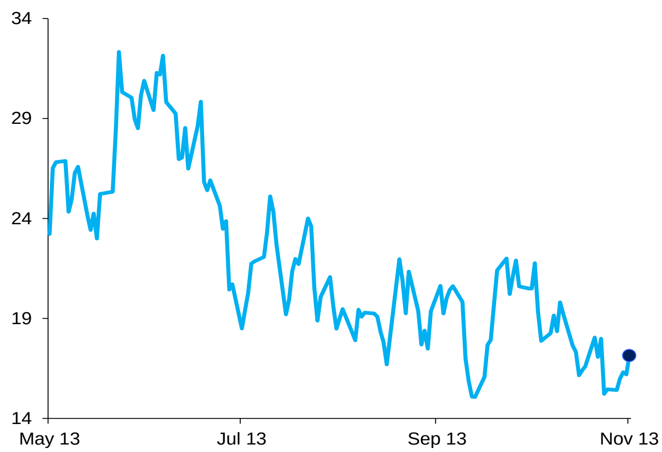
- **Sell BTAN 1.75% Feb17 vs OLO 4% Mar17 and Bobl 0.5% Apr17**
  - Current/Open 6bp. Target 16bp. Stop 1bp
- **Sell OAT 4.25% Oct17 vs OLO 5.5% Sep17 and Bobl 0.5% Oct17**
  - Current/Open 18bp. Target 29bp. Stop 13bp

Figure 6. OLO 4% Mar17, BTAN 1.75% Feb17, Bobl 0.5% Apr17 yield fly



Source: Citi Research

Figure 7. OLO 5.5% Sep17, OAT 4.25% Oct17, Bobl 0.5% Oct17 yield fly



Source: Citi Research

[2] 5yr Bund-OAT trade, 6 Nov 13

Appendix: Relative value

The chart below shows the richest and cheapest French bonds across the curve vs a fitted yield curve and swaps. As show in the table below,

Figure 8. France: richest and cheapest bonds vs a fitted yield curve and swap curve (based on a 6month horizon and minimum maturity of 2yrs)

FRANCE

Versus Fitted Yield Curve

	Rank		ZScore	Issued	Size (€bn)
Richest	1	5.00 Oct16	-1.95	Oct00	29
	2	3.75 Apr17	-1.86	Apr06	35
	3	1.75 Feb17	-1.85	Feb11	20
	4	4.75 Apr35	-1.77	Apr03	21
	5	4.25 Oct17	-1.69	Oct06	28
	5	3.50 Apr20	0.87	Feb10	36
	4	3.25 May45 (30y)	1.10	May12	9
	3	3.50 Apr26	1.16	Apr10	30
	2	1.00 Nov18 (5y)	1.58	Nov12	17
Cheapest	1	3.75 Oct19	2.07	Oct08	32

Versus Swap Curve (CAS)

	Rank		ZScore	Issued	Size (€bn)
Richest	1	3.00 Apr22	-1.48	Feb12	33
	2	3.25 Oct21	-1.39	Oct10	35
	3	2.25 Oct22	-1.35	Oct11	24
	4	5.00 Oct16	-1.35	Oct00	29
	5	3.75 Apr21	-1.34	Apr05	34
	5	3.75 Oct19	-0.51	Oct08	32
	4	0.25 Nov15 (2y)	-0.26	Nov12	21
	3	2.25 Feb16	-0.16	Feb10	29
	2	1.00 Nov18 (5y)	-0.16	Nov12	17
Cheapest	1	2.25 May24	0.00	Nov13	4

Source: Citi Research

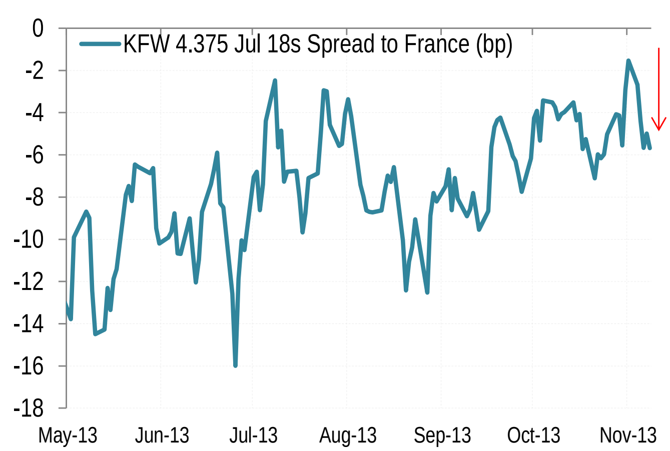
SSA market implications

(1) Relative value and SSA-OAT trading strategies

Agencies: We have recently detailed trading strategies in being long certain SSAs vs France. In particular, spreads between 5yr KfW and France have tightened since we detailed the relative value in our *Euro SSA and Covered Bond Monthly*. Across the curve, spreads between KfW and France have moved around 4bp-5bp over the last week making entry points now less attractive (Figure 9). A similar theme is apparent in Dutch agency spreads vs France.

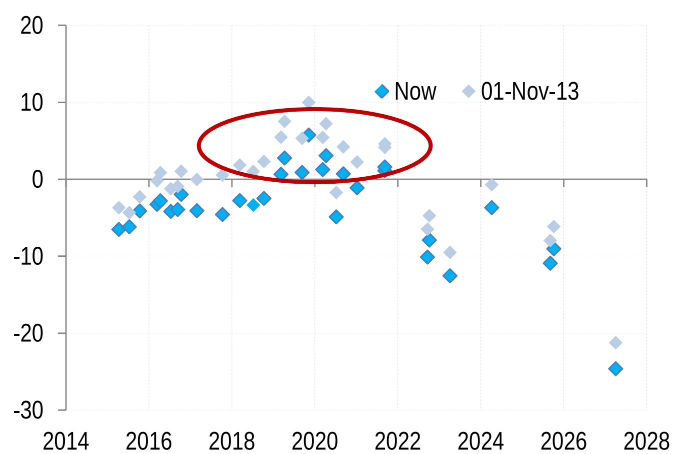
Supranationals: We continue to see good relative value between supranationals such as the EIB and EU vs France. Switches into supras and out of France can still be made at a flat spread or even a small pick-up (Figure 10). They also remain near the wide end of recent trading ranges. Further details can be found in our *Strategies for trading supranationals*.

Figure 9. KfW has rallied vs France over the last week



Source: Citi Research

Figure 10. EIB's spread curve to France (bp)



Source: Citi Research

(2) Implications for other SSA ratings

A key question the downgrade of France poses is what it might mean for other issuers within the SSA space, both in terms of direct rating changes and spread implications for the market. The connection between France and SSAs differs depending on the fundamental characteristics of the guarantee in question. We can also take a look at what S&P did the last time France was downgraded back in January 2012. Here, within days, the EFSF and CADES had their ratings normalized, but at the time, the AAA ratings of EIB and EU were affirmed (Figure 11). As S&P stated when it normalized the rating of CADES in January 2012, "*Under our methodology applicable to government-related entities (GREs), we equalize the ratings on GREs with their related sovereign when we believe there is an "almost certain" likelihood that they would receive timely and sufficient extraordinary support from that sovereign.*"[3]

Figure 11. What happened when France was last downgraded by S&P in Jan 2012

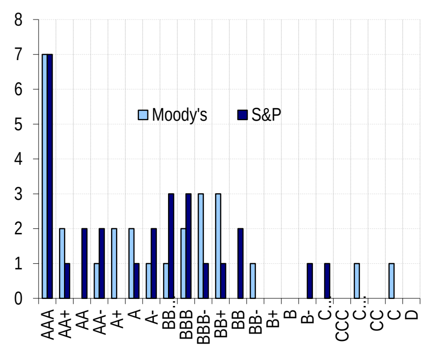
	S&P Rating		January Report Date
France	AA+ Neg	↓	13-Jan-12
EFSF	AA+ Neg	↓	16-Jan-12
EIB	AAA Neg		16-Jan-12
CADES	AA+ Neg	↓	17-Jan-12
KfW	AAA Stable		17-Jan-12
EU	AAA Neg		20-Jan-12

Source: Citi Research, S&P, Bloomberg.

We briefly review the various sectors in turn below. In general, we not think rating changes will lead to significant re-pricing within the sector at large

French agencies: The closest SSA sector associated with France is its agency sector. However, note that the largest issuer in this space – CADES – is no longer rated by S&P. The last research update by S&P was in February 2013 where the rating was affirmed at AA+ negative outlook, but then withdrawn because S&P "*chose not to continue ratings surveillance on an unsolicited basis*". At the time, S&P equalized the rating of CADES to France due to the critical and integral link the agency has to the sovereign. Due to the EPIC status French agencies generally enjoy, we would expect ratings of French agencies to be normalized to AA for those rated by S&P. We would not expect this to affect secondary market levels significantly and continue to expect French agencies to trade generally tight to the sovereign. For more details, see our *French agencies and covered bonds in focus* .

Figure 12. EU and EIB Rating Distribution



Source: Citi Research

EU: The EU is rated AAA negative outlook by S&P and due to fundamental characteristics (for example its low level of debt, strong legal framework), we do not think a downgrade of the EU is mechanical fall out due to the move on France. Specifically, in their last summary on the EU (4th December 2012), S&P stated "*The negative outlook reflects our view that there is at least a one-in-three chance that we could lower the rating by 2014. Downward rating pressure could build if we were to downgrade a 'AAA' rated EU member (currently these are Denmark, Finland, Germany, Luxembourg, Netherlands, Sweden, and the U.K.) or should there be further deterioration in the overall creditworthiness of its 27 members.*"

EIB: The EIB is rated AAA stable by S&P – having recently had its own "negative outlook" removed on 22nd October following the €10bn increase in its paid-in capital. It has the support of 28 EU member states, good asset quality and strong legal and market franchise. Its stable outlook reflects the low chance of a rating change over the medium term.

EFSF: The EFSF was downgraded shortly after the downgrade of France to AA+ by S&P back in January 2012. For various reasons, its rating is more closely connected to large guarantors within its structure. We would not be surprised if the EFSF had its rating normalized to France based on what S&P have previously indicated, although again this is not certain and not altogether "mechanical". However, we believe the market impact from this would be limited and we would still see the EFSF as a core market and liquid issuer within the SSA space. Specifically, in their last Summary (December 2012), S&P stated that:

[3] S&P "Rating Actions Taken on 25 Eurozone Government Related Entities Following Sovereign Actions" 19th January 2012.

The negative outlook on the EFSF mirrors the outlook on the 'AA+' rated sovereign guarantors, the Republic of France and Austria. This is based on our weakest-link approach, equalizing our issuer credit rating on the EFSF with the long-term foreign currency rating on the highest rated guarantors (plus liquid securities held by the EFSF) that allow full coverage of the EFSF's effective maximum borrowing capacity approved by member states.

We could lower the rating if we were to downgrade any of the currently 'AA+' or 'AAA' rated guarantors to 'AA' or below.

Conclusion

The one notch downgrade by S&P to AA Stable is not a significant market event in our view. The market reaction has been limited and we continue to see various supports for the OAT market in general. ECB policy clearly remains accommodative and Citi's base case is for another LTRO next year.

In terms of trading strategies, the rating action lends support to the notion that further spread tightening of OAT-Bund spreads looks limited from current levels. We recommend selling 5yr OATs vs Bunds and OLOs (via a butterfly trade). Within the SSA space we continue to see relative value between core agencies and supras vs France. Related rating actions in the French SSA sector should not be altogether surprising and in general, we do not expect this to cause a significant disturbance in secondary market spreads.

Appendix A-1

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