

## Euro Rates Strategy

### Spain: could an upgrade stem the market weakness?

- **Upgrade potential for Spain this Friday:** Moody's has rated Spain Baa2 with a positive outlook since February 2014 (when it upgraded the sovereign by one notch from Baa3). Ongoing fundamental improvements are likely to be viewed positively by the rating agencies - underscored recently by Spain's 0.7% reading for Q4 2014 QoQ growth. We believe Spain is likely to be upgraded by Moody's which could come as early as this Friday when it next features on Moody's calendar.
- **However, other drivers are dominating:** Clearly, headline risk on Greece continues to dominate the wider market tone and this has been a key driver behind the slightly softer EMU spread environment. Ongoing volatility in Greece cannot be ruled out given the elevated event risk. It is for this reason that we much prefer relative, rather than absolute, value and we currently see tactical merit in being long 5yr Spain vs Italy.
- **Spain vs Italy trade idea:** Spain has cheapened amid focus on the rising support for Podemos. However, note that Spain's general election isn't expected until Q4 this year and our political analysts' base case is for Podemos not to be part of the next Spanish government (a minority government led by PP or a mainstream coalition is deemed more likely, [Global Political Insights - Déjà vu? The Return of EU Political Risk, Greece and Beyond](#)). Together with the near-term upgrade potential, relative supply dynamic and the recent price action, we like switching into Spain from Italy here.

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

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## Long Spain vs Italy supported by likely upgrade

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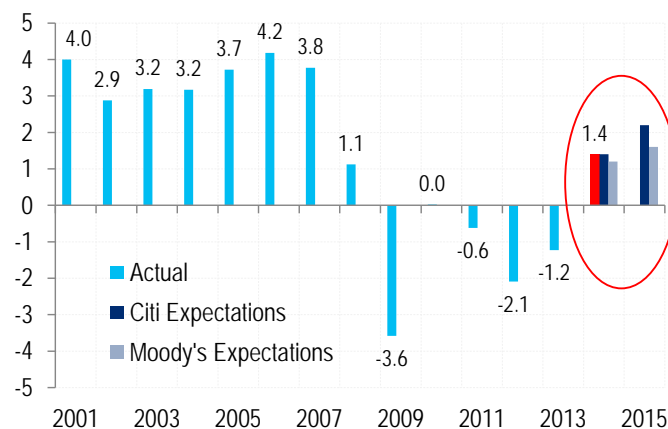
Ongoing fundamental improvements are likely to be viewed positively by the rating agencies and the wider market. Yet in terms of the recent price action, Spain has cheapened vs (lower / similarly rated) peers probably reflecting wider event risk and political concerns. Note also that Spain's general election isn't expected until Q4 this year and our political analysts' base case is for Podemos not to be part of the next Spanish government (a minority government led by PP or a mainstream coalition is deemed more like, [Global Political Insights - The Return of EU Political Risk, Greece and Beyond](#)). Together with the near-term upgrade potential, relative supply dynamic and current spreads, we see merit in tactical long Spain vs Italy positions.

### Upgrade potential by Moody's this Friday

**Spain rated Baa2 positive outlook:** Moody's has rated Spain Baa2 with a positive outlook since February 2014 (when it upgraded the sovereign by one notch from Baa3). Unlike S&P, which rates Italy one notch lower at BBB- vs its rating of Spain at BBB, Moody's currently rates Spain and Italy at the same rating level of Baa2. In its latest Credit Opinion (21<sup>st</sup> November 2014), Moody's indicated that they "would consider upgrading the rating if we anticipated that the public debt ratio can be brought onto a declining trend within our forecast horizon. This could be achieved through a faster pace of fiscal consolidation and/or stronger nominal GDP growth than under our current baseline assumption".

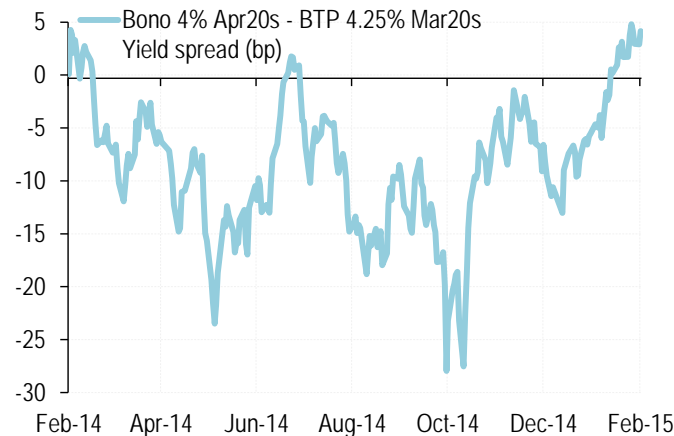
**Positive growth surprise in Spanish GDP growth – a credit driver:** Ongoing fundamental improvements for Spain remains a trend, recently underlined by GDP data. Moody's expected 2014 GDP to be 1.2% whereas Spain surprised to the upside with a 1.4% reading (a 2% YoY rate for Q4 alone). Furthermore, Citi expects growth to be around 2.2% vs Moody's 1.6% in 2015 (Figure 1). Stronger growth is likely to be viewed positively by rating agencies and perhaps further support a rating notch difference between peers such as Italy (as indeed S&P's ratings do).

Figure 1. Spanish real GDP growth, YoY %



Source: Citi Research, Instituto Nacional de Estadística, Haver, Moody's

Figure 2. 5yr Spain has cheapened vs Italy (yield spread, bp)



Source: Citi Research

### Trade idea – long 5yr Spain vs Italy

**Not tapping the 5yr in this week's supply:** We believe an upgrade this week is likely to support Spanish spreads over the medium term. More immediately, we note that Spain is not tapping the 5yr sector this week when it issues up to €4.5bn across Bono Oct17s and Bono Apr25. We also note that the net cash requirement after QE is more supportive for Spain (+€1bn) than Italy (+€16bn) in March ([Supply Monitor](#)).

**Risks – politics and sentiment:** One risk for being long Spain vs Italy concerns how wider event risk and domestic politics may be affecting sentiment. First, attention on new parties is likely to remain in focus given the situation in Greece. As our economists note, while the situation remains fluid, Citi's base case is that a (likely two-stage) deal between the Greek government and its creditors remains the most likely outcome (thereby avoiding Greek government default and/or Grexit) and that the political incentives on both sides favour talks to go 'to the wire' before a deal can be reached ([Euro Area - Greece – After The Feb 16 Eurogroup Meeting](#)). Second, Moody's – and us – acknowledge the eventful political calendar for Spain itself this year amid the sudden rise in support for Podemos. However, note that Spain's general election isn't expected until Q4 this year and our political analysts' base case is for Podemos not to be part of the next Spanish government (a minority government led by PP or a mainstream coalition is deemed more likely, [Global Political Insights - Déjà vu? The Return of EU Political Risk, Greece and Beyond](#)).

**Strategy view:** Together with the near-term upgrade potential, relative supply dynamic and the recent price action, we like switching into Spain from Italy here.

Buy Bono Apr20s vs BTP Mar20s at 4bp. Target -10bp, Stop +11bp.

## Appendix A-1

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