

The Morning Call

Today's Bobl Auction and Tomorrow's ECB Meeting

- **Today's Bobl Auction:** Germany will issue €4bn of Bobl 0.5% Apr17 today. We think there is scope for a risk-off rally in the wake of disappointment from the ECB meeting and the risk/reward favours short term longs here. Bobls also look relatively cheap vs Schatz and Bunds on the curve.
- **Tomorrow's ECB Meeting:** The extent of the recent move has tilted the risk/reward firmly towards short term long Bund positions. There is a significant risk that the ECB does not deliver further unconventional policy initiatives quickly enough at Thursday's meeting.

Peter Goves

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

Aman Bansal

+91-22-4277-5021
aman1.bansal@citi.com

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Bobl Auction Preview

Today's auction

Details of today's auction...

Germany will issue €4bn of the current 5yr benchmark (Bobl 0.5% Apr17) today. This will be the last tap of the bond, taking the total outstanding amount to €18bn.

The last auction was very strong. This one comes at even lower yield levels...

The last Bobl auction was very strong, with the highest b/c in a year (adjusted for amount retained), and zero yield tail (Figure 1). Today's auction will most likely come at the lowest yield ever for a Bobl.

Figure 1. Demand for the last Bobl auction was the strongest of the last five

Date	Volume (€bn)	Bond	Average Auction Yield	Adjusted b/c*	Yield Tail (bp)	Retention %
04/07/12	4	0.5% Apr17	0.52	2.3	0.0	18%
06/06/12	5	0.5% Apr17	0.41	1.2	0.2	20%
09/05/12	5	0.5% Apr17	0.56	1.2	0.0	19%
04/04/12	4	0.75% Feb17	0.80	1.5	0.2	16%
07/03/12	4	0.75% Feb17	0.79	1.5	0.0	17%
		Average	0.62	1.5	0.1	18%

Source: Citi Research, DMO

*Bid-to-cover adjusted for the amount retained

Relative Value

Bond cheap to peers but no concession

- There is no outright concession, but the auction bond is trading near the cheap end of its tight range vs surrounding issues (Figure 2).

Pick up 9bps by extending 3 months...

- **Domestic curve switch:** Switching from Bund 3.75% Jan17 into the auction bond offers a yield pickup of around 9bps for a maturity extension of 3 months (Figure 3).

Figure 2. Bobl 0.75% Feb17, 0.5% Apr17, 4.25% Jul17 Microfly (bp)



Source: Citi Research

Figure 3. Bobl 0.5% Apr17 – Bund 3.75% Jan17 Yield Spread (bp)



Source: Citi Research

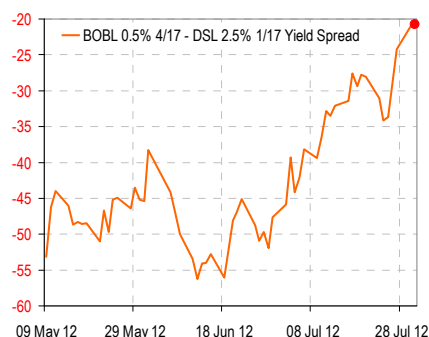
5yr German benchmark at cheapest levels vs France and the Netherlands since May

- **Cross-market:** The 5yr German benchmark is trading at its cheapest level vs its Dutch and French counterparts since its inception in May, with a yield give up of 20 and 44bps respectively (Figure 4 and Figure 5). But if concerned about timing cross-market trades, the most appealing opportunity may be intra-country (see below).

We are wary of the scope for disappointment from the ECB meeting, but 5yr Germany looks cheap vs 2s and 10s when compared to short rates

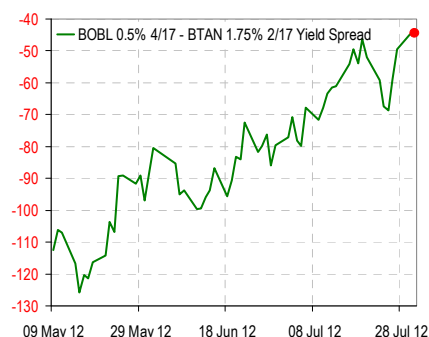
■ **Curve:** There is ample room for 5s to outperform on the curve. A 6-month regression of Germany 2s5s vs the red - green Euribor spread suggests that the curve is about 8bps steeper than short rates suggest (Figure 6). We also expect a further re-steepening of 5s10s of around 9bps (see [IIRS](#), 26 July 2012). On this basis, we think it makes sense to buy 5yr Germany vs 2s and/or 10s in the auction.

Figure 4. 5yr Germany vs Netherlands



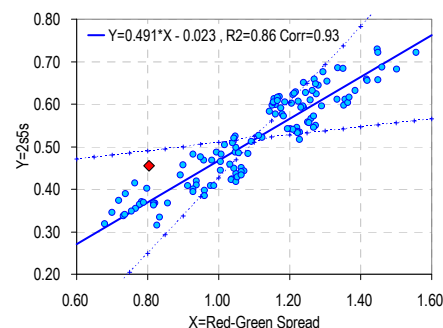
Source: Citi Research

Figure 5. 5yr Germany vs France



Source: Citi Research

Figure 6. Germany 2s5s vs Red-Green Spread



Source: Citi Research

Potential cash flow support

Italy pays €9.3bn of coupons today. Depending on the outcome of the ECB meeting, some of those might temporarily find their way into safe haven countries rather than being reinvested immediately in BTPs.

Considerable scope for disappointment from the ECB meeting

Conclusion: risk/reward favours risk-off rally after ECB

The twin shocks of Moody's downgrading German rating outlook to negative and the statement by Mario Draghi to do "*whatever it takes to preserve the euro within our mandate*" resulted in Bobls cheapening by 18bps last week. We think there is scope for a risk-off rally in the wake of disappointment from the ECB meeting and the risk/reward favours short term longs here.

Trade 1 – butterfly...

On the domestic curve, switching into Bobls from Bunds and Schatz makes sense.

Trade 2 – directional...

From a macro perspective buying Germany outright looks appealing at current levels.

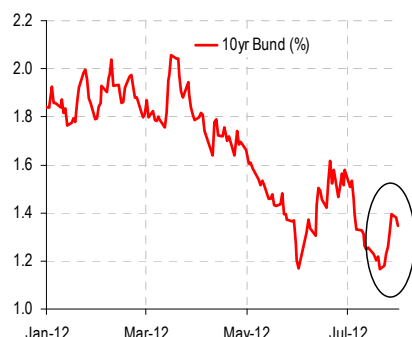
Buy Bunds Ahead of the ECB Meeting

Asymmetric risk-reward - too much already in the price

The bottom line...

Summary: The short term risk-reward favours longs in core markets, and in Germany in particular. The scope for disappointment from the ECB meeting is significant given how much is already in the price. Spanish and Italian spreads have already rallied 100bps since last week.

Figure 7. 10yr Bunds (%)



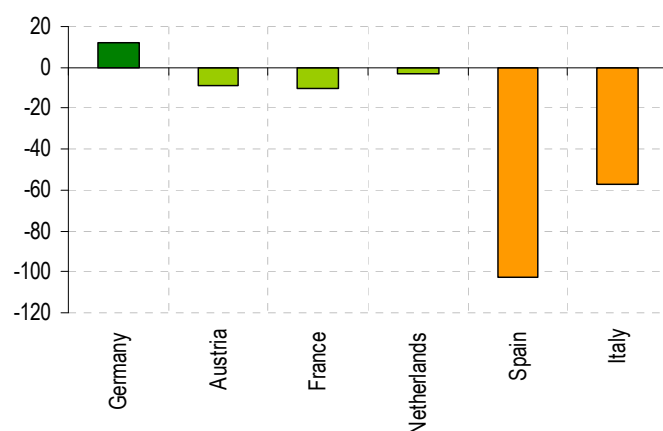
Source: Citi Research

ECB meeting – what we do and don't expect: Although there is a chance the ECB might cut interest rates tomorrow, we expect the Governing Council to keep rates unchanged (*Euro Economics Weekly - ECB*). What is more certain is the likelihood of encouraging language for future action. While there are signs that the ECB might change its stance on ESM access to ECB's lending operations, we do not expect that the ECB will do a u-turn on this issue as early as August.

ECB action only likely after government action: In a speech in London, ECB President Draghi commented that "within our mandate, the ECB is ready to do whatever it takes to preserve the euro." In our view, this suggests the ECB is less opposed to supporting sovereign bond markets again either indirectly through multi-year LTROs or directly via the SMP. However – and this is the key point - such action is only likely to be taken after governments have taken action first (*ECB - Draghi Willing To Do "Whatever it Takes to Preserve the Euro"*).

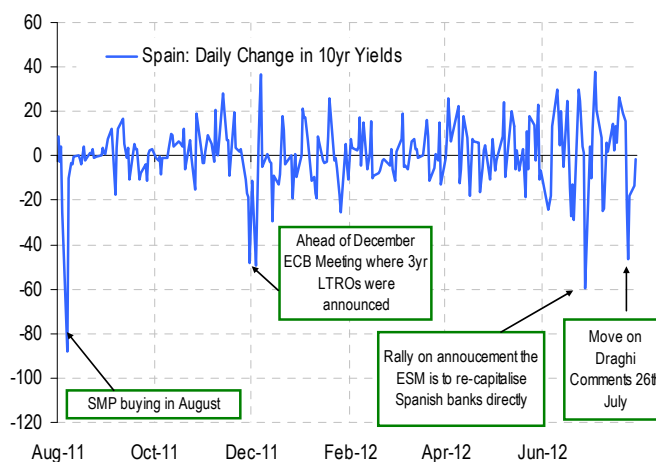
A lot is already in the price: The market reacted to Draghi's comments with a sharp risk-on rally. Bund yields rose to 1.4% from a recent low of 1.16% on 20th July and Spanish yields are 100bps off their highs. 10yr Bonos rallied 43bp on the day of the Draghi comments (26th July). There have only been three other occasions over the last year when they have rallied more strongly, each of which around a key policy announcement or action (Figure 9).

Figure 8. Changes in 10yr Yields since 24th July



Source: Citi Research

Figure 9. Daily Changes in 10yr Spanish Yields (bp)



Source: Citi Research

Conclusion: The extent of the recent move has tilted the risk/reward firmly towards short term long Bund positions. There is a significant risk that the ECB does not deliver further unconventional policy initiatives quickly enough at Thursday's meeting and disappoints the market. We recommend positioning for a short term risk-off rally in core markets.

Appendix A-1

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