

Euro Inflation Strategy

BTPEi Index Drop Supports OATe/i Auctions*

- **Auction details** – France will re-open €1-1.5bn in total across OATi19, OATe22 and OATe40 tomorrow.
- **Too early to fade the rally** – Real yields and break-evens have rallied strongly ahead of the auction, but we expect this has further to run. There are plenty of near-term supports for OATe/i from cash-flows, month-end and the BTPEi index drop. Against this backdrop, the small-sized auction is likely to be easily absorbed.
- **BTPEi index drop supports core linkers** – The impending BTPEi index event has been long anticipated, but it still likely to put significant pressure on BTPEi at month-end. BTPEi may gap lower, but we would then expect support to emerge from domestic accounts and bargain hunters. Core linkers should benefit from the change.

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

*CORRECTION NOTE: The original version of this note incorrectly stated that the OATi11 will fall out of the index (instead of OATi13) and corrects the respective weights for German and French linkers on page 2.

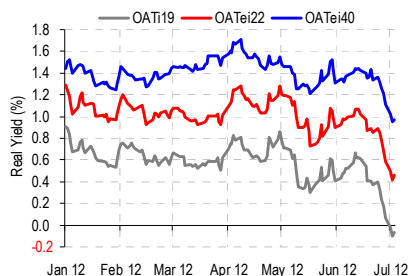
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BTPei index drop supports OATei/i auctions

Auction details: France will re-open €1-1.5bn in total of OATi19, OATei22 and OATei40 tomorrow.

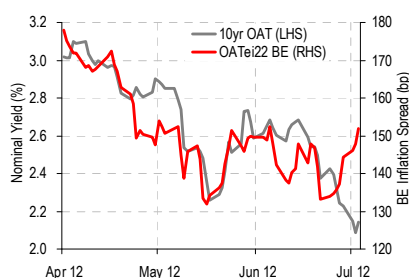
Auction likely to fly: There are plenty of supports for French linkers in the coming days, which should ensure Thursday's auction is well received. On 25 July, there will be €3.4bn coupon payments (split €2bn OATei, €1.4bn OATi). On the same day, €13.6bn of OATei12 will redeem, perhaps prompting some re-investment flows. Then, at month-end, the Citi euro inflation-linked index is projected to extend by a historically significant 0.42 years as OATi13 falls out of the index. If all of that wasn't enough, core linkers now also stand to benefit from the impending removal of BTPei from the Barclays world and euro inflation-linked bond indices.

Figure 1. Sharp rally in real yields



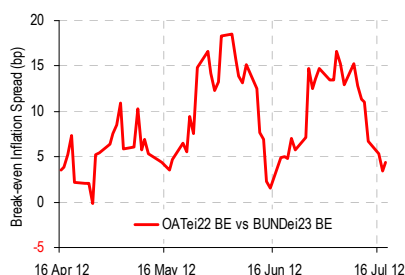
Source: Bloomberg, Citi Research

Figure 2. Break-evens have rallied despite nominal yields moving lower



Source: Bloomberg, Citi Research

Figure 3. OATei22 cheap vs Bunde23 on a break-even inflation basis



Source: Bloomberg, Citi Research

BTPei index drop supports core linkers: On 13 July, Moody's downgraded Italy by two-notches to Baa2. As a result, BTPei will be removed from the Barclays flagship inflation indices which carry minimum ratings criteria of A3/A- from at least two of Moody's, S&P and Fitch. This index event, which will take place at month-end, has been a long time coming, especially following the S&P downgrade of Italy in January (see [Euro Inflation Strategy](#), 19 January). The market should be well prepared for the index change, with those comfortable with investment grade credit opting to switch or adapt their benchmarks. But there will still be forced selling. It is impossible to put a number on how much, but the impact is likely to be far less today than if it had occurred say a year ago. Nevertheless, BTPei are likely to come under further significant pressure at month-end from what already appear very cheap levels (although not as distressed as last November). Following an initial gap lower, we would expect domestic accounts and bargain hunters to then provide some support to BTPei. German and French linkers will benefit from the index change; their weights in the index will rise to circa 24% and 76% respectively.

Real yields surging lower, but too early to fade: French real yields were already moving lower following the ECB rate cut and subsequent yield grab, but the Moody's downgrade of Italy has accelerated the trend. As a result, French real yields have fallen around 50bp in just over a week. As Figure 1 shows, the real yield for OATi19 has dipped into negative territory, OATei22 has fallen below 0.5% and OATei40 has fallen below 1%. These are historically very rich levels, but given the many near-term supports discussed above, we believe it is too early to fade the richness of real yields.

Break-evens rallying from cheap levels: The strong rally in real yields has pushed break-evens off the recent lows, helped along by the recovery in oil prices. Break-evens are unlikely to be able to sustain the rally over the medium-term unless nominal yields begin to move higher (Figure 2). But in the near-term, the BTPei index drop and strong demand for core linkers should push break-evens higher still.

OATei break-evens lagging Bunde23: A supply concession for Thursday's auction is evident from the recent underperformance of OATei22 vs Bunde23 break-evens (Figure 3). We doubt this will persist once the auction is out of the way. OATei stand to benefit in the near-term from re-investment flows and the BTPei index drop. Moreover, Germany may respond to the increased appetite for core linkers with issuance, with Bunde23 a good candidate to be re-opened.

Conclusion – Thursday's auction is likely to fly

Real yields and break-evens have rallied strongly ahead of the auction, but this is unlikely to deter demand. There are plenty of supports for OATei/i in the near-term from cash-flows, month-end and the BTPei index drop. Against this backdrop, the small-sized auction is likely to be easily absorbed, especially with the long-end supported by the large month-end extension.

Appendix A-1

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