

The Morning Call

Italy downgraded, Long gilts vs USTs, SSA RV and Schatz supply

- **Italy downgraded to BBB by S&P:** Last night, S&P downgraded Italy's rating by one notch from BBB+ (Negative Outlook) to BBB (Negative Outlook). S&P state this is to reflect their view of "the effects of further weakening growth on Italy's economic structure and resilience, and its impaired monetary transmission mechanism".
 - **Implications:** The timing of this downgrade will likely be surprising to the market: note that Italy was on Negative Outlook, not Negative Watch. Italy remains Investment Grade by both Moody's (Baa2) and S&P (BBB) and hence there is no immediate implication regarding index membership. The real significance however is the reduction in headroom before being rated sub-IG. Italy is rated just one notch above Spain now and just two notches above sub-IB ratings.
 - **Strategy view:** This credit negative event is likely to weigh on BTP spreads this morning and presents a challenging backdrop for tomorrow's BTP supply. We expect safe haven flows into core EMU in the near-term.
- **MPC guidance – the story so far:** There has been little change in long-end rates since last Thursday's MPC statement. However, the very front-end has richened, the 2s10s curve has steepened and break-evens have widened. All have further to run, in our view. But, we think the best long-term risk-reward trade is to be long gilts vs USTs. In the 10yr sector, we target a 25/35bp widening in the UST-gilt spread.
 - **Trade idea:** Buy gilt 1.75% Sep22 vs UST 1.625% Aug22. Open -10bp, target -40bp, stop +5bp.
- **SSA relative value:** Away from the macro backdrop of Fed tapering and ECB forward guidance, we think some interesting spreads have opened up in the core SSA space. We assess relative value in supras vs France and the yield convergence in the core agency sector.
- **Schatz auction:** Germany will today issue €5bn of the current 2yr benchmark (Schatz 0% Jun15). The auction should be supported by the ongoing demand for the German paper. Today's auction offers a number of trading opportunities:
 - Buy Jun15 vs Apr15 and Jul15
 - Switch from Mar15 or Apr15 to Jun15

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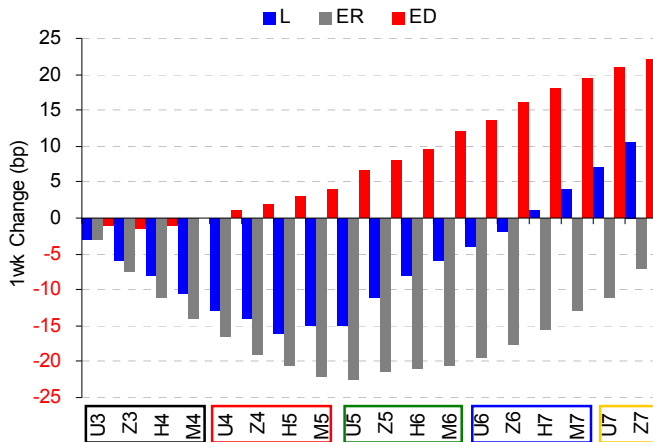
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MPC forward guidance – the story so far

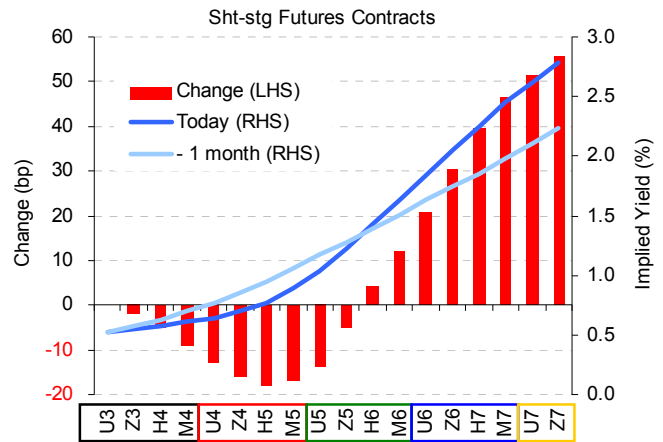
Below we present a selection of charts to illustrate the reaction of the gilt/GBP swap market to last week's MPC statement which strongly hinted at forward guidance from August.

Figure 1. UK policy rates expectations have fallen, especially the Reds



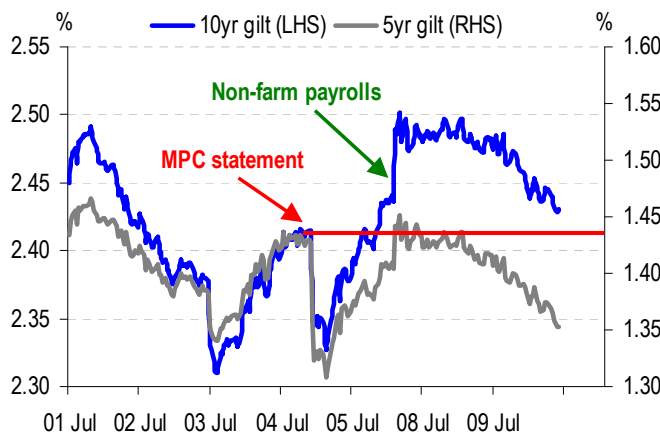
Source: Citi Research, Bloomberg.

Figure 2. But the Blues are still much higher than a month ago



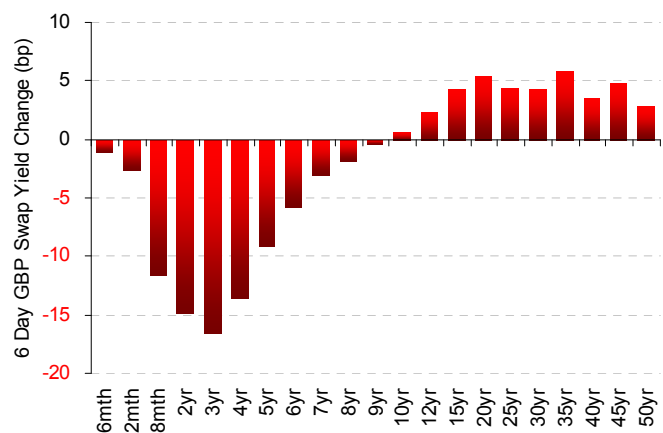
Source: Citi Research, Bloomberg.

Figure 3. Long-end yields are a touch higher and the curve is steeper



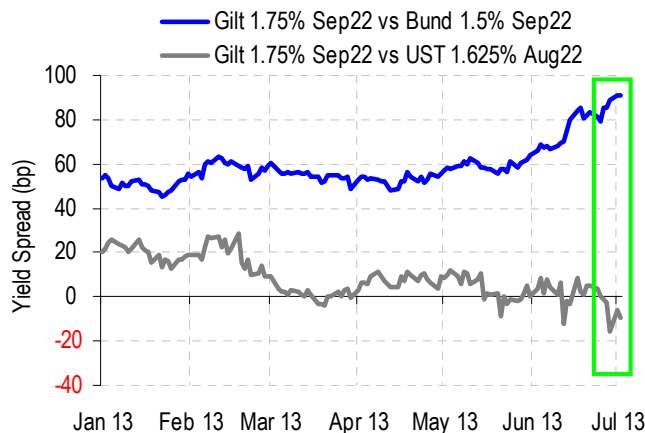
Source: Citi Research, Bloomberg.

Figure 4. The 3yr sector has richened the most, 4/5yr may yet catch up



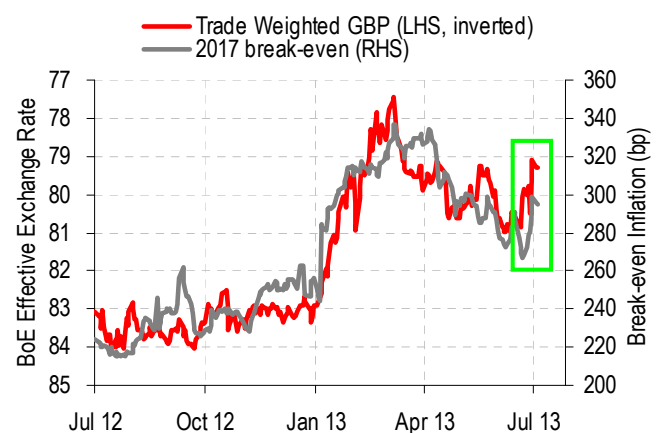
Source: Citi Research, Bloomberg.

Figure 5. Gilts have started to outperform USTs, but not Bunds



Source: Citi Research, Bloomberg.

Figure 6. The currency has weakened and break-evens have widened



Source: Citi Research, Bloomberg.

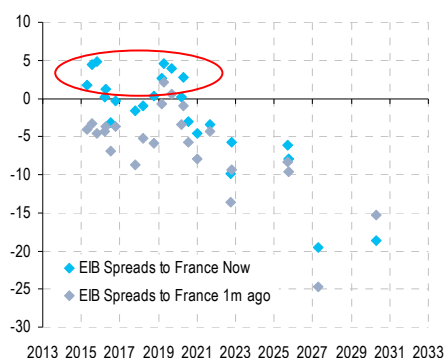
SSA Relative Value Themes

Away from the macro backdrop of Fed tapering and ECB forward guidance, we think some interesting spreads are beginning to open up in the core SSA space. Specifically, the recent move lower, in core EMU yields, has widened some SSA spreads to sovereigns such as France. Secondly, the convergence in core agency yields can make for opportunities to step up in quality at very little yield give up.

(1) Relative value between supras and France

Supranational spreads to France have been trending wider over recent weeks. Regarding EIB, spreads to France are now positive in the 2yr-7yr sectors (Figure 7). This has largely been driven by the OAT leg, given the sharper move lower in French government bond yields (Figure 8). Some spreads are now out of recently established ranges and are at levels which we expect will attract buying interest (Figure 9). A similar pattern can be seen in EU bonds (which in some cases trade flat to France) and note this supra has recently adjusted its supply pipeline, moving €4.7bn of issuance previously expect in 2013 into the first two quarters of 2014.

Figure 7. EIB spreads to France (bp)



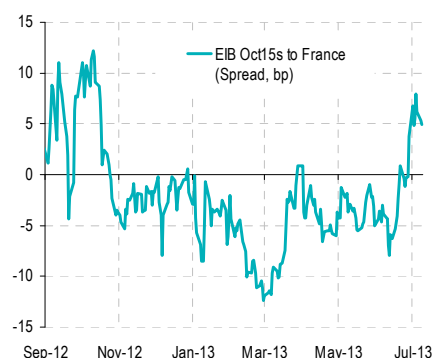
Source: Citi Research

Figure 8. EIB Apr19s and France Apr19s Yield



Source: Citi Research

Figure 9. EIB vs France in the front end

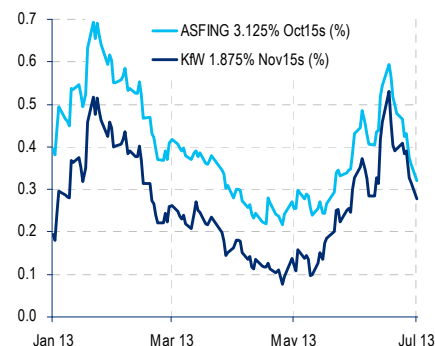


Source: Citi Research

(2) Convergence in core agencies

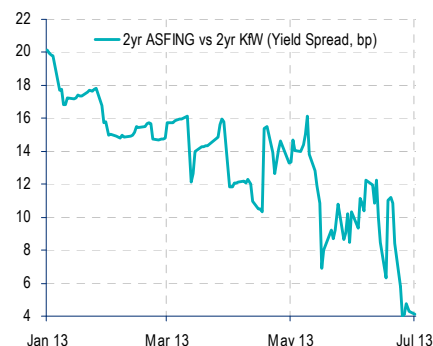
Yields in the front-end of core agencies are converging leading to noticeable spread compression. For example, spreads between Austria's ASFING and Germany's KfW are now approaching flat (Figure 10, Figure 11). Both are explicitly guaranteed by their sovereign, but KfW is better rated by S&P (KfW is AAA/Aaa, ASFING is AA+/Aaa in line with Germany and Austria's ratings). Such levels allow for move-up in quality trades at historically low yield give-up.

Figure 10. 2yr ASFING and 2y KfW (%)



Source: Citi Research

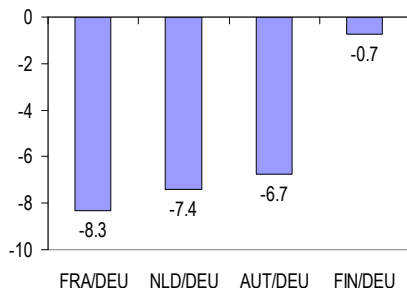
Figure 11. 2yr ASFING vs 2yr KfW (bp)



Source: Citi Research

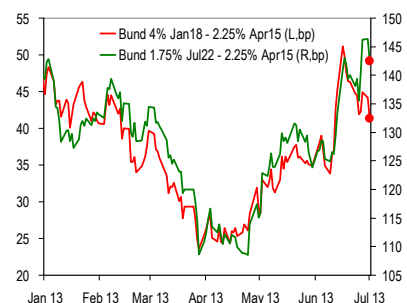
Attractive RV at today's Schatz auction

Figure 12. Last two week 2yr spread change (bp)



Source: Citi Research

Figure 13. Both 2s5s and 2s10s look historically steep



Source: Citi Research

Auction details: Germany will today issue €5bn of the current 2yr benchmark (Schatz 0% Jun15). Today's auction will mark the last reopening of the current 2yr benchmark and would take its total amount outstanding to €15bn. Following today's auction, Germany will have completed around 57% of its 2013 estimated gross issuance target (€183bn).

Auction history: The last five Schatz auctions have had an average bid-to-cover (adjusted for amount retained) of 1.6x, a 0.2bp yield tail and a 16% retention rate.

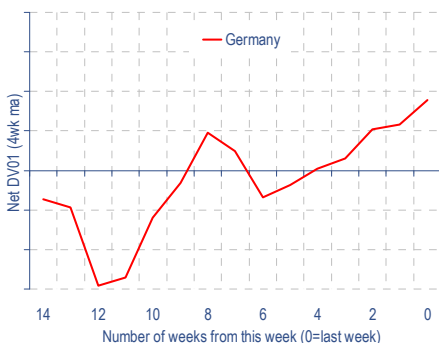
Recent price action: Though German yields have performed well in the last two weeks, taking 2yr yields close to 1yr average levels, 2yr core spreads to Germany have tightened (Figure 12). On the curve, both 2s5s and 2s10s look historically steep (Figure 13).

Secondary market demand: German paper has seen strong demand in secondary market in the last few weeks¹ with the 4weeks moving average at 15 weeks high (Figure 14). We expect today's auction to be supported by the ongoing demand for Germany.

Trading strategies

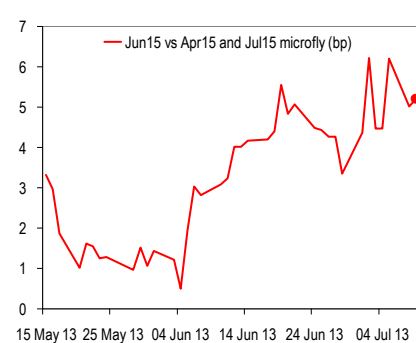
- **Buy Jun15s vs surrounding issues:** Jun15 is currently the third cheapest bond vs a fitted German curve. Buying Schatz 0% Jun15 vs 2.25% Apr15 and 3.25% Jul15 at 5bp looks attractive (Figure 15). Further, the net 3month carry on this trade is 1bp.
- **Switches on the curve:** The historical steepness of 2s5s provides attractive switch opportunities for accounts looking to extend on the curve. Switching from 0.25% Mar15 or 2.25% Apr15 to the auction bond offers a yield pick up of 3bp with a maturity extension of only 3months and 2months respectively (Figure 16).

Figure 14. Demand for Germany at 15 weeks high



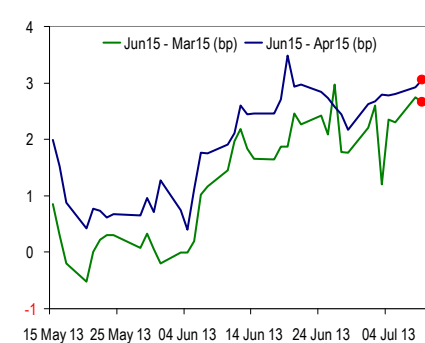
Source: Citi Research

Figure 15. Microfly: Buy Schatz Jun15s vs Apr15 and Jul15



Source: Citi Research

Figure 16. Switch from Schatz Mar15 or Apr15 to Jun15 with a positive 3month carry of 0.8bp



Source: Citi Research

Conclusion: The auction bond looks cheap vs surrounding issues, on the domestic curve. We see attractive value in switching into the auction bond from Mar15 or Apr15. The auction should be supported by the ongoing demand for the German paper.

¹ Please see [European Flow Monitor](#) for further details.

Appendix A-1

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