

## Developed Market Rates

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# Euro Rates Strategy

## Spanish bond auction should clear, but that's not the point

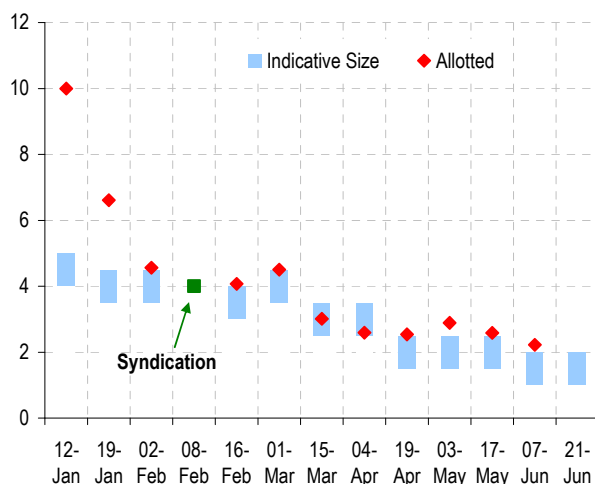
- Spain will hold a hotly anticipated bond auction this Thursday. In this note, we look at prospects for the auction in the context of wider market forces.
- The back-up in yields and the small size on offer should ensure that there is sufficient demand at the point of the auction, predominantly from domestics.
- However, such an outcome doesn't fundamentally change anything. Spain has already admitted that it needs help to recapitalise its banks and our economists argue that Spain may, at some point, require further help at the sovereign level.
- Market access is clearly strained, as indicated by the level of yields, concessions demanded and falling auction sizes. Moreover, after this auction, there are 12 further auctions scheduled by Spain for the rest of the year (with the next one on 5 July).
- The indicative size range for the auction is €1-2 billion. Although Spain's 2012 bond issuance is well progressed, we estimate that the average auction size needs to rise to around €2.65bn over the remainder of the year to meet the annual funding need.
- For many, sentiment is unlikely to improve in the absence of a response from the ECB. This is more likely to be in the form of a rate cut and more liquidity than a resumption of the SMP, but we not convinced even this will stem the rise in periphery yields for long.

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Figure 1. Spanish Auctions: Indicative Size vs Amount Allotted



Source: Citi Investment Research and Analysis, Spanish DMO.

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

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# Euro Rates Strategy

## Spanish bond auction should clear, but that's not the point

**Auction details:** On Thursday, Spain will re-open 3.4% Apr14, 4% Jul15 and 5.5% Jul17. Unlike the last auction on 7 June, there will be no 10yr.

The auction is likely to raise the target amount, but this is unlikely to bring much relief

There are 12 remaining auctions scheduled for 2012. Spain needs to issue around €2.65bn per auction

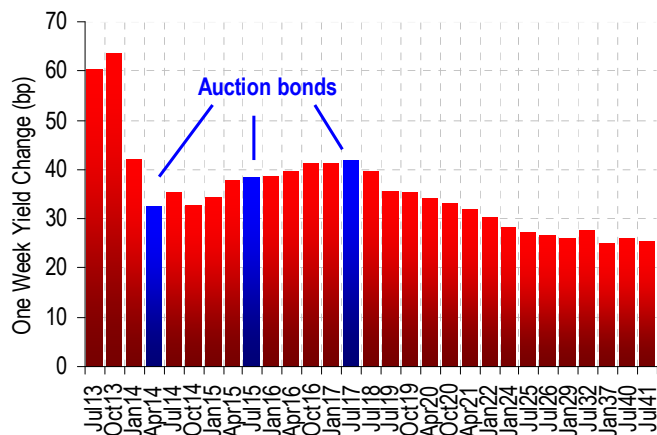
Yields are high, the curve is flattening, Spain has converged with Ireland

**Auction risks have risen, but there should be sufficient demand:** The challenging backdrop of this auction needs little introduction. Market conditions have deteriorated since the Spanish bank bailout, which effectively nationalized the bank debt. We believe the market is pricing a much higher probability that a full sovereign bailout will be needed as market access becomes increasingly strained. The risk of an auction 'accident' has certainly increased and periphery issuance is requiring ever higher yield levels to clear. However, we believe that this auction, like all the others that have come before it, will raise the target amount almost entirely thanks to domestic support. But this is unlikely to bring much relief beyond the very near-term, not least given the clearing yield level and the frequency of supply.

**Size range stays low, but is it now too low?** The indicative size range is €1-2 billion, the same as the last auction. Spain has issued slightly more than the indicative range over the last few auctions, but not by much. Spain's 2012 bond issuance is well progressed; we estimate that funding will be 62% complete following Thursday's auction. However, that still leaves €32bn (our estimate) still to be issued over the remaining 12 scheduled auctions. The average need is €2.65bn per auction, implying Spain will need to increase the indicative size range again assuming market conditions improve.

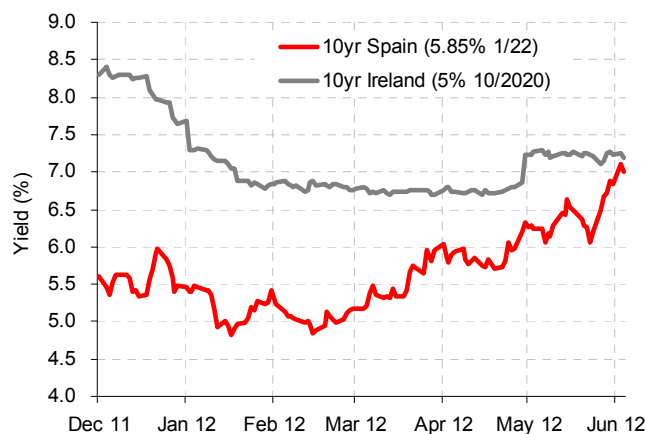
**Signs of strain:** With 5yr Spanish yields currently around 6.5% and 10s just above 7%, you don't need to look far for signs of strain. However, it is also worth pointing out that the Spanish 2s10s curve has resumed its flattening momentum in the last few days and that Spanish yields have almost converged with Ireland, a programme country (Figure 3).

Figure 2. Spain, One Week Change in Yields (bp)



Source: Citi Investment Research and Analysis

Figure 3. Convergence of 10yr Spain & Ireland



Source: Citi Investment Research and Analysis, Bloomberg.

**Bank audit and LCH:** Potential headline risks ahead of the auction include the first independent audit report on Spanish banks which is expected to show a capital shortfall of between €60-70bn (see [Euro Area: Sovereign Debt Crisis Update](#)). The report, due later this week, should produce a headline number, but the more detailed second report has now been pushed back to September. There are also some concerns that LCH may hike the initial margin requirements for Spanish bonds soon to reflect wider spreads.

**Clearing yields continue to rise**

**Auction watching, bonds and bills:** Yesterday's Spanish T-bill auction was watched very closely by the market, a further indication of the pressure Spain is facing. In the event, Spain sold the maximum €3bn in total of 12- and 18-month bills, but only after the yields had risen 70-80bp during the morning. The 12-month bill was issued at a yield of just over 5% compared with a little under 3% in May. The yield on the 18-month bill rose to 5.1% compared with 3.3% in May.

**Relative value is largely irrelevant**

**Limited relative value:** There is limited bond-specific relative value at this auction, but that is hardly surprising. The auction concession can be seen in the level of yields and at the sector level (Figure 2). For what is worth, the auction bonds, if anything, look a little rich. The Jul15 and Jul17 are two of the richest bonds to the fitted curve and versus swaps (based on Z-scores). Relative value flies also look relatively unappealing. However, it is worth noting that the Apr14 is trading special in repo which should boost demand for this issue.

**SMP reactivation seems unlikely here**

**Don't count on SMP reactivation:** There appear to be growing expectations in the last couple of days that the SMP will be reactivated imminently, probably fuelled by comments from Spain and Italy appealing to the ECB to lower spreads (see [Euro Area: Sovereign Debt Crisis Update](#)). This appears to be wishful thinking. The ECB are likely to act at the next meeting on 5 July, probably with a rate cut and more liquidity provision. However, a reactivation of the SMP and/or a target spread level seem highly unlikely to us at this stage.

**Further LTROs are more likely, but even they may not stem the rise in periphery yields**

**Further LTROs are likely to bring only temporary relief:** Even if the ECB do announce extra liquidity provision, we are not convinced even this will stem the rise in periphery yields for long. A new LTRO (3yr or longer) should help support periphery auctions going forward, but we suspect that large concessions will still be needed as domestics banks, already heavily laden with domestic sovereign debt, make room to buy primary issuance by selling in the secondary market. If this scenario proves right, further LTROs are likely to prompt a knee-jerk tightening in spreads, but this would be the signal to sell in our view.

**Conclusion – auction should clear, but that's not the point**

**Demand should be sufficient**

Thursday's auction in Spain is attracting widespread attention, with good reason. However, the auction metrics themselves are unlikely to tell us much. The back-up in yields and the small size on offer should ensure that there is sufficient demand at the point of the auction, predominantly from domestics. It wouldn't be a huge surprise if Spain managed to issue a little above the indicative size range.

**An average auction won't change anything**

However, such an outcome doesn't fundamentally change anything in our view. Spain has already admitted that it needs help to recapitalise its banks and, eventually, our economists argue that Spain may require further help at the sovereign level. Market access is clearly strained, as indicated by the level of yields. Moreover, after this auction, there are 12 further auctions scheduled by Spain for the rest of the year (with the next one on 5 July). And we haven't even talked about Italy yet. Where Spain goes, we believe Italy is likely to follow as the recent escalation in the crisis has shown us. This puts a lot of pressure and expectation on the 28/29 June summit, but history teaches us to be cautious.

## Appendix A-1

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