

Euro Rates Strategy

Spain confirmed at Baa3...what next for yields?

- **Moody's keeps Spain Baa3:** Moody's concluded its review of Spain's rating at Baa3 but has kept the sovereign on Negative Outlook. Spain is also rated BBB- (Negative Outlook) by S&P.
- **Market positive and supportive for yields:** As such, the negative impact of a further Spanish downgrade has been averted (including expulsion from some benchmark indices) and the current stasis and improved sentiment may last a little longer than most previously expected.

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

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Moody's keeps Spain at Baa3...what next?

Market access is key

After an extended period of uncertainty, Moody's finally concluded its review (which began mid June) of Spain's rating on 16th October. The sovereign remains Investment Grade at Baa3 but on Negative Outlook (Figure 1). Key drivers behind this confirmation include:

- Reduced risk of Spain losing market access
 - Moody's expects Spain to access a precautionary credit line soon which would be more flexible than a formal Troika programme
 - Credible backstop of the ECB's OMT reduces the risk of loss of market access
 - Monitoring of Spain's progress, possibly involving the IMF, is a credit positive
- Spain's commitment at fiscal and structural reform
- Bank recap package should alleviate solvency issues within the financial sector

The confirmation of the Investment Grade rating was a welcome relief to the market. Across the curve, spreads to Germany rallied some 40bp and 10yr Bunds rose 9bp (17th October). The favourable conclusion has served to erode some of the credit risk premium embedded within Spanish yields. Going forward, this is supportive for peripheral primary markets (and risk appetite) more generally.

Steepening pressure likely in the event that aid is sought

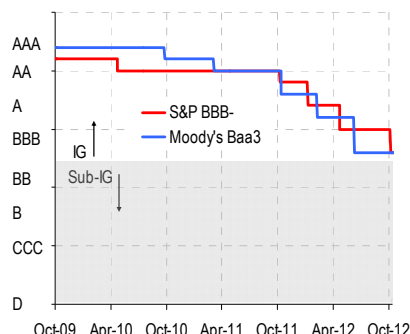
The prospect of unlimited ECB purchases is highly likely to provide a degree of insulation to the front end of Spain's yield curve. Furthermore, appetite is strongest for shorter dated sectors (as indicated at primary auctions) which has increasingly become the preferred habitat for domestic accounts. Should Spain enter a programme (such as an EFSF/ESM ECCL) that consequently unlocks potential OMT purchases then we would expect steepening in 2s5s and 2s10s from the prevailing yield levels at activation. Of course, uncertainty will remain regarding precisely if and at what level the ECB will engage in secondary market purchases. However, for now, some of the pressure on Spanish yields has subsided and in the near term, market access appears reasonably secure.

Negative Outlook by Moody's (and S&P) – what to watch out for

Given the current climate of a somewhat artificial, but improved sentiment, investors are increasingly focused on what could derail the current market tone. In our view, much of the rally is predicated on Spain formally requesting aid. Lack of progress on this front is unlikely to be a near-term market positive. Over the longer-term, both Moody's and S&P continue to have Spain on Negative Outlook and Citi expects much weaker growth prospects next year (Figure 2). Furthermore, Moody's indicated that risks to their baseline scenario were "high".

Should growth markedly undershoot base expectations to the extent that debt sustainability is further called into question, then ratings pressure is likely to re-emerge. Exogenous shocks from euro area policy making (such as lack of progress in banking union) and from any potential sovereign exit from the EMU are also key variables in how Spain's rating might evolve over the medium-term. For now however, one potential negative has been averted (including expulsion from some benchmark indices) and the current stasis and improved sentiment may last a little longer than most previously expected.

Figure 1. Spain's Rating History



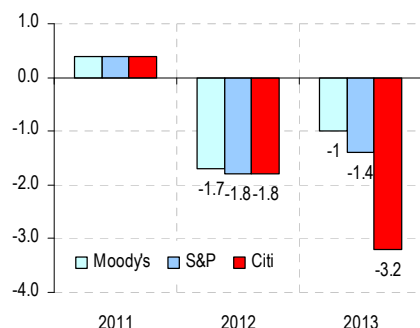
Source: Moody's, S&P, Citi.

Much bigger reaction in spreads to Moody's Baa3 confirmation compared with the relatively muted reaction to S&P's recent two notch downgrade

For now at least, market access appears reasonably secure

Risks reduced but not totally removed

Figure 2. Real GDP Growth Expectations (%)



Source: Moody's, S&P, Citi.

Appendix A-1

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