

Euro Rates Strategy

Why Spain Is Likely To Further Decouple From The Periphery

- **Spread targets to Germany revised lower** — We lower our 10yr Bono-Bund spread forecast for Q4 from 110bp to 75bp given renewed conviction in Spain's potential to outperform further and our expectation for ECB QE later this year.
- **We expect Spain to be higher rated than Italy** — Spain is rated Baa2 by Moody's with a positive outlook. Across PMIs, unit labour costs and relative political stability, indicators are pointing to improvements in credit quality, especially in terms of the growth outlook (*Euro Economics Weekly*). On balance, we believe Spain is more likely than not to be upgraded by one-notch by Moody's to Baa1 when it next features in Moody's calendar in October. In this scenario, Spain would be higher rated than Italy which has not been the case since early January 2012 (when Moody's rated Spain A1 and Italy A2).
- **Spain is outperforming Italy in both sell offs and rallies** — The entire Spanish yield curve is now lower than that of Italy's. Note that the outperformance of Spain is now not just happening in rallies, but also in sell-offs.
- **Spain to gravitate to the soft core?** — We think it unlikely that Spain trades at a lower yield to Ireland (A-/Baa1) but we do expect a degree of further outperformance versus the non-core. Specifically, we would not fade the move vs Italy and target the 10yr Bono-BTP at -35bp later in Q4 from around -20bp now.

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Euro Rates Strategy

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We expect Spain to de-couple further from the periphery

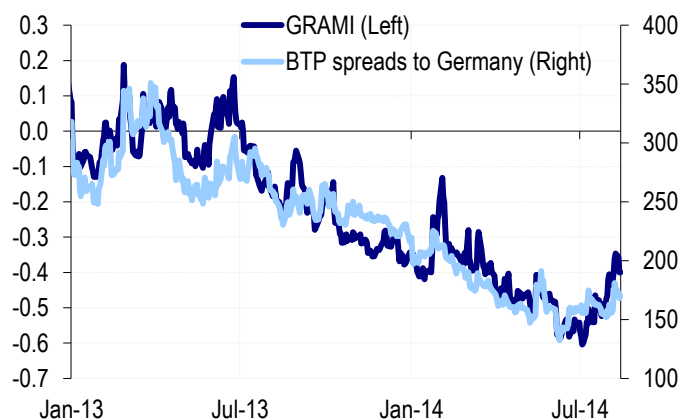
We expect the periphery markets of Greece, Portugal, Italy and Spain to perform further and forecast ongoing spread compression to Germany, largely as a function of ECB policy. However, amid moves *within* the periphery and growing evidence of shifting fundamentals, we see scope for Spain to outperform further. Spain is benefiting from an improved growth environment which should enhance fundamental credit metrics – and we believe there are rising prospects for Spain to be rated higher than Italy over the medium term. Together with recent market behaviour (whereby Spain has been outperforming in both sell offs *and* rallies), we look for 10yr Bono spreads to Bunds to average 75bp in Q4 and would not fade the rally vs Italy. Further fundamental details can be found in our previously published [Rates Strategy Presentation - Italy vs Spain: Macro, Markets & More](#).

Market drivers remain in place for tighter spreads

Various supports for the periphery: From a macro perspective, the configuration of market supports remains conducive for further tightening of the periphery relative to Germany. These include the ongoing hunt-for-yield, ECB policy and QE expectations, the reliable domestic bank bid and low EMU systemic risk. Much of the spread compression envisaged in Q4 and beyond is predicated on the ECB delivering some form of QE later this year as discussed on several occasions ([European Rates Weekly -ECB: Thoughts on Asset Purchases](#)). One key risk to this view could be uncertainties unearthed in the ECB's AQR later in Q4, but in so far as risks are contained to the banking sector, this need not necessarily adversely affect sovereign level public finances (and relatedly secondary market yields), as events in Portugal recently illustrate. Note also that for Spain, various banking sector reforms have already been undertaken during the successful €41bn ESM programme.

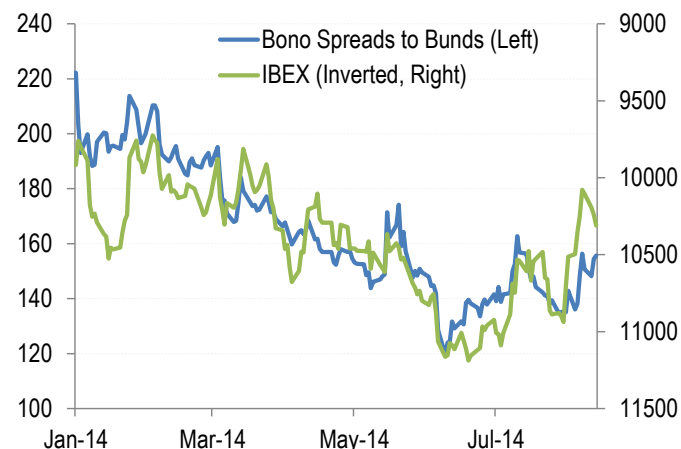
Periphery remains correlate to risk appetite: In terms of market drivers, the periphery overall exhibits less correlation to EMU indicators such as consumer confidence and CPI readings, but more to wider barometers of risk appetite. This can be seen with BTP spreads to Citi's GRAMI index (Figure 1) or Bono spreads with equities (Figure 2). With lower systemic risks, and the ECB firmly in the driving seat, we expect such relationships largely to hold for now.

Figure 1. Citi's GRAMI Index and 10yr BTP spreads to Bunds (bp)



Source: Bloomberg, Citi Research

Figure 2. Spanish equities and 10yr Bono spreads to Bunds (bp)



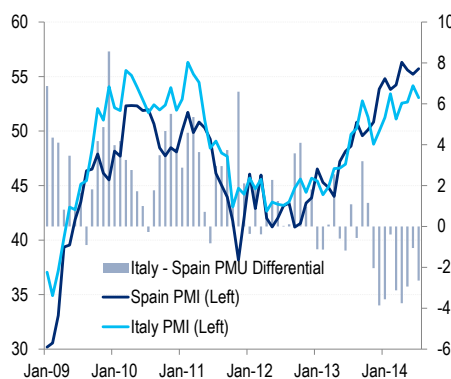
Source: Bloomberg, Citi Research

Within the periphery – credit drivers likely to govern cross market spreads

However, *within* the periphery, we believe relative credit quality remains a key determinant of cross market spreads. One striking example of this has already been seen in Ireland and its own outperformance. For various reasons, we analyse whether Spain is perhaps about to embark on a similar journey (or already has?) using the prism of credit quality in shaping relative spreads to Germany.

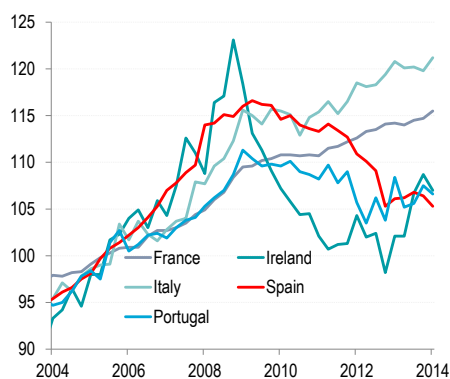
Credit quality now largely a function of growth dynamics: For sovereigns such as Spain and Italy, it is the historically large debt profiles and weak public finances that remain the key credit challenge (*Euro Economics Weekly - Public Debt Sustainability: Has It Really Been Restored?*). Both sovereigns are rated Baa2 by Moody's with prospects for upgrades largely predicated on scenarios that bring fiscal deficits and debt-to-GDP measures more quickly on a downward and sustainable path. Credit quality is therefore governed mostly by the growth outlook. This is in contrast to other similarly rated sovereigns such as Brazil (Baa2) and South Africa (Baa1) where it is the lower wealth levels and institutional strengths that constrain ratings as detailed by Moody's criteria¹.

Figure 3. Spain's Composite PMI consistently ahead of Italy's (Index level)



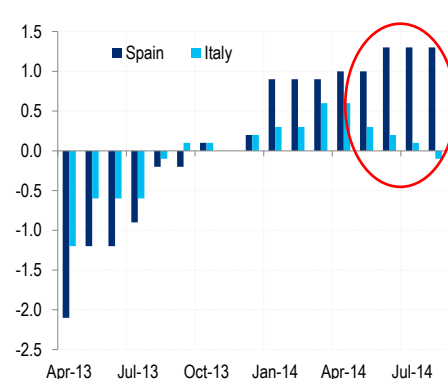
Source: Haver Analytics, Citi Research

Figure 4. Unit Labour Costs



Source: Haver Analytics, Citi Research

Figure 5. Citi 2014 growth forecasts for Spain and Italy over time (%)



Source: Citi Research

Better growth dynamics seen in Spain: If spreads are influenced by credit quality and this in turn is determined in part by the growth outlook, Bono spreads look set to benefit further in our view. Spain has already outperformed Italy on various fundamental metrics, not least given the recent -0.2% Q2 QoQ GDP reading from Italy. The trend has been evident in PMI data for some time now, with Spanish composite PMI being consistently above that of Italy's over the course of 2014 (Figure 3). Similarly, Spain's relatively more favourable performance in unit labour costs over the past few years have led to larger export competitiveness gains than Italy's (Figure 4, *Euro Weekly What's Behind Periphery Growth Outperformance?*).

Growth expectations rising for Spain, falling for Italy: Expectations are also diverging between Spain and Italy: Citi economists now expect Spain to grow by over 1% in 2014 and this expectation has been rising over several months in our *Global Economic Outlook and Strategy*. Conversely, our economists have lowered the Italian GDP forecast to -0.1% in 2014 (*Europe - Sovereign Debt Update 12 August*), down from 0.6% previously expected in March (Figure 5). Furthermore, Citi expects Spanish GDP to outperform Italian GDP over the coming three years.

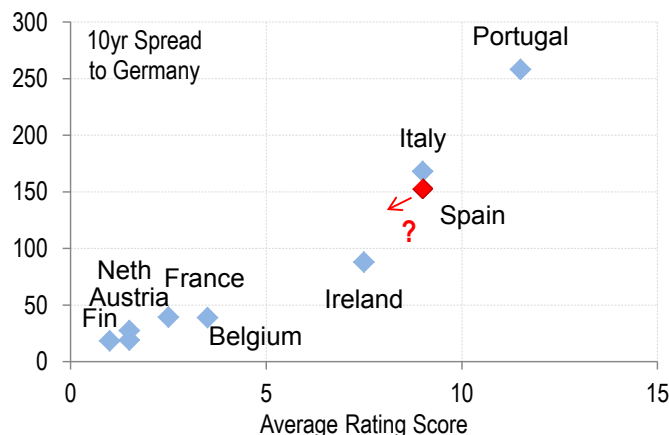
¹ Moody's Investor Services: "Spain, Italy & Ireland: A Peer Comparison With Emerging-Market Baa-Rated Sovereigns". 23rd June 2014

We expect Spain to be rated higher than Italy

Spain rated Baa2 on positive outlook by Moody's: Spain is rated Baa2 by Moody's and is one of only two EMU sovereigns to have a positive outlook (the other being Cyprus). Specifically, Moody's states it would consider upgrading Spain if debt ratios can be brought down within its forecast horizon which could be achieved through "a faster pace of fiscal consolidation and/or stronger nominal GDP growth than under our current baseline assumption". Moody's expects GDP growth Spain in 2014 of 1.2% (Citi 1.3%) and expects 1.7% in 2015 (Citi 1.9%). Furthermore, Moody's notes that risks for Spain emanating from the banking sector have declined materially given the various bank recaps, the successful and smaller-than-expected ESM programme and the establishment of Sareb. The positive outlook is also underlined by expectations for ongoing improvement in domestic demand, especially associated with investment and wage moderation.

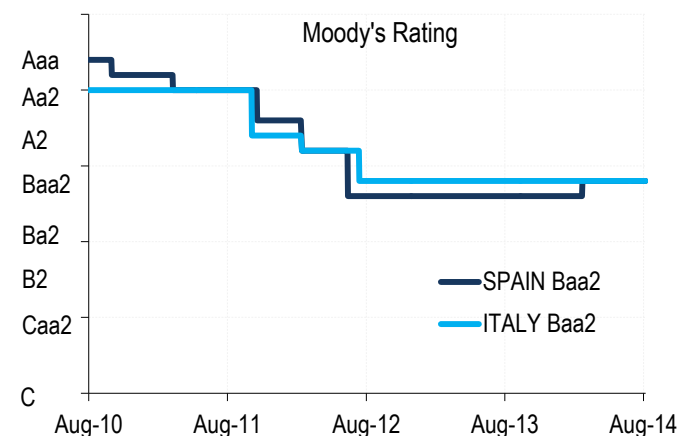
Upgrade of Spain is our base case: The positive outlook indicates increased prospects for an upgrade by Moody's for Spain. We believe this is likely to occur at the next entry of Spain in Moody's calendar which is 17 October. A one-notch upgrade would put Spain at Baa1, akin to Ireland (Baa1) and one notch higher than Italy (Baa2). While fixed income drivers extend beyond fundamentals alone, the ordinal ranking of 10yr EMU yields generally conforms to credit quality assessments. An upgrade would therefore be supportive for a slightly tighter spread to Germany (Figure 6).

Figure 6. EMU credit curve (10yr spread to Germany vs average rating score of S&P and Moody's)



Source: Bloomberg, S&P, Moody's, Citi Research

Figure 7. Moody's rating of Spain and Italy



Source: Moody's, Citi Research

Moody's lowered its Italian GDP forecast to -0.1% this year: We agree with Moody's that Italy's recession is likely to have negative effects on fiscal policy and the overall political climate². We do not expect any upgrade of Italy over the medium term by Moody's which rates the sovereign Baa2 with a stable outlook. Furthermore, in its earlier piece, Moody's also noted that "Several of Italy's institutional strength indicators are lower than those of its European peers, one reason why we see no upward rating potential in the next 12-18 months"³.

² Moody's Investor Service: "Italy's Recession Adds Headwinds to Country's Fiscal and Structural Reform". 11 August 2014

³ Moody's Investor Services: "Spain, Italy & Ireland: A Peer Comparison With Emerging-Market Baa-Rated Sovereigns". 23 June 2014

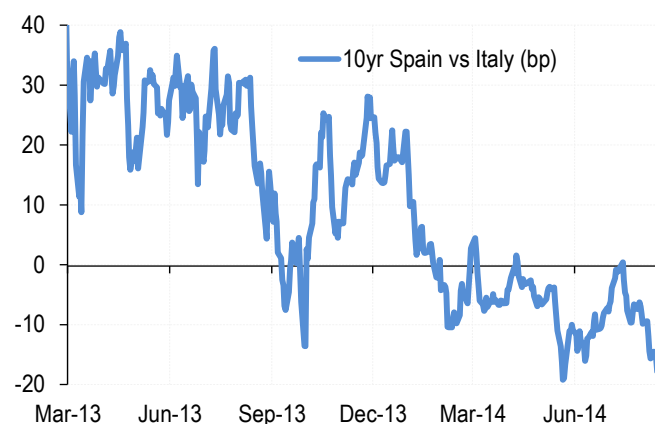
S&P rates Spain BBB stable, but Italy BBB negative: Only in early June did S&P affirm its rating of Italy at BBB but kept the rating on negative outlook. S&P stated that this reflects its view that “*risks to the public sector balance sheet from weak real and nominal growth prospects*”. A downgrade of Italy by S&P is not our base case. However, the fact that S&P has its rating of Italy on negative outlook while Moody’s has its rating of Spain on positive outlook supports the case that at present, Italy and Spain appear to have different potential rating trajectories.

Spread dynamics – decoupling already started

No longer mean-reverting, now trending? Market dynamics have convincingly moved from the general mean-reversion behaviour witnessed in Q1 and Q2 last year, when Spain traded 20bp-40bp over Italy. In fact, the entire Spanish yield curve is now lower than that of Italy’s, with the 10yr spread at around -19bp (Figure 8). Spanish outperformance in 2014 was one of our key strategic themes in our outlook last year, but given recent fundamental and technical dynamics, we now have increased conviction in this trend continuing.

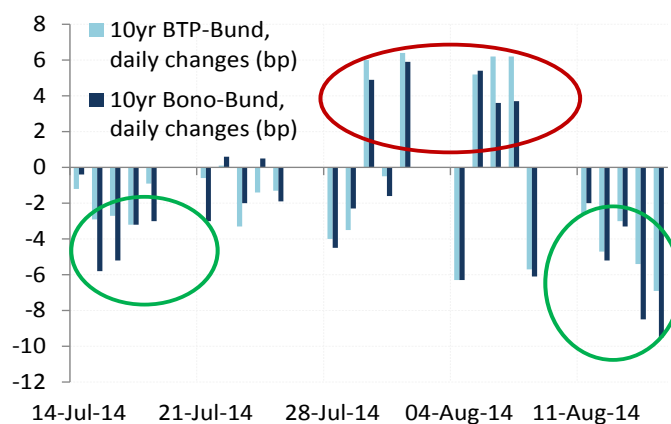
Spain outperforms in sell offs and rallies: Subtle changes can also be detected in cross market spread behaviour. Note that the outperformance of Spain is not just happening in rallies, but also in sell-offs (Figure 9). In times of market turbulence and periphery volatility, it is Italy that has tended to widen more on average.

Figure 8. Range bound or trending?



Source: Citi Research

Figure 9. Daily changes in 10yr Bono and BTP spreads to Bunds (bp)



Source: Bloomberg, Citi Research

Near-term supply unlikely to materially impact BTP-Bono spreads: From a technical perspective, the net cash requirement over September is more favourable for Italy (€-16bn) than Spain (+€12bn), but then in October this situation reverses to be more beneficial for Spain (-€21bn) than Italy (+€11bn). While this may create a degree of intra-month spread variation, it is unlikely, in our view, to dominate drivers more fundamental in nature for the overall trend in the remainder of the year. Furthermore, in terms of ownership, non-residents have returned to Spain more quickly than Italy as another sign of widening investor engagement (*Italy vs Spain*).

Targeting -35bp for 10yr Bono-BTP spreads

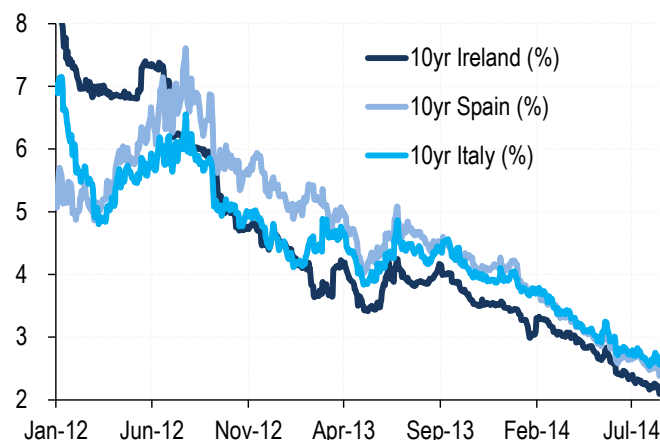
For the varying fundamental reasons and technical considerations detailed above, we would not fade Spain’s outperformance of Italy. In an environment of a Moody’s upgrade for Spain and ongoing divergence in growth prospects between Italy, a more negative Bono-BTP spread is justified in our view.

Buy Bono 3.8% Apr24 vs BTP 4.5% Mar24 at -19bp Target -35bp, Stop -9bp.

Why Spain is (and is not) like Ireland

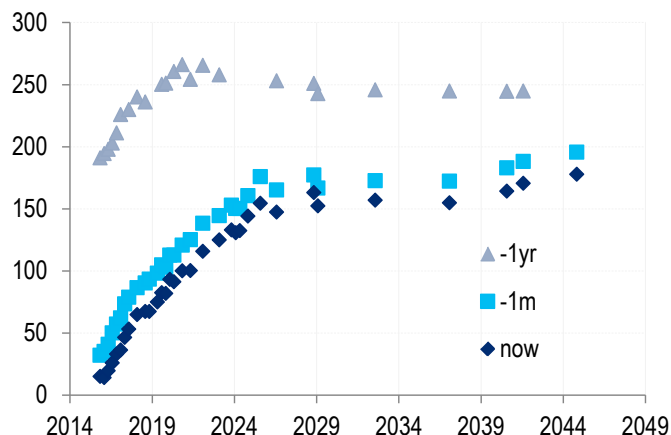
Could Spain de-couple akin to Ireland? While we believe that Spain is likely to continue to outperform Italy, and consequently tighten to Germany, it might be tempting to compare performance with that of Ireland. However, we think this analogy can only go so far and we think Spain is unlikely to trade meaningfully below Ireland over the near term in our view. Note that the catalysts of Ireland's performance had various idiosyncrasies. For one, Ireland is the only EMU sovereign in recent times to be restored from non-investment grade to investment grade status (Moody's rated Ireland Ba1 in January and now rates Ireland Baa1). This helped widen Ireland's investor base and spur demand. In addition, Ireland successfully emerged from its Troika programme and is also higher rated by S&P at A- compared to Spain's BBB rating.

Figure 10. 10yr yields performance and Irish outperformance



Source: Citi Research

Figure 11. Spain's spread curve to Germany (bp)



Source: Bloomberg, Citi Research

Updated targets for 10yr Bono-Bund spreads to 75bp in Q4

However, although Spanish yields are unlikely to trade as low as Ireland's in the near-term, we are revising our 10yr Bono-Bund spread forecasts. This is a function of our view for ECB QE in Q4, but is also based on ongoing improvements in Spanish fundamentals and technicals as detailed above.

We now expect 10yr Bono spreads to Bunds to near 75bp in Q4 from our previous forecast of 110bp.

Conclusion – Spain to outperform further

While fixed income drivers extend beyond fundamentals alone, especially given the abundant central bank liquidity provision, the ordinal ranking of 10yr EMU yields generally conforms to relative credit quality assessments. Given that credit metrics are now highly influenced by the growth outlook, ongoing fundamental improvements for Spain are likely to precipitate an upgrade by Moody's, in our view, which has the sovereign on positive outlook. Together with ECB policy, we look for further performance in Q4 targeting a 10yr Bono spread to Bund of 75bp and we would not fade the rally vs Italy (targeting the 10yr cross market Bono-BTP spread of -35bp).

Appendix A-1

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