

## Only the Nimble

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### Market Outlook

If anyone hasn't noticed, it's been a tough summer for traders of Spanish bonds. In the last two months, the trajectory of Spanish 10yr yields has changed course nine times and the rallies and selloffs have all been between 50 and 110bp in magnitude. For a while it seemed that US markets were content to ignore much of this volatility, but as we found out this week, the fortunes of Spain and the rest of the GIIPS still seem to matter quite a lot to investors on both sides of the Atlantic.

Undoubtedly, part of the reason that Spain and Greece have come back into focus is that the earnings of US companies continue to be so uneven. With more than half of S&P500 companies having reported, we're only now starting to get the full picture, and viewed from the top down perspective it's far less pretty than even last week led us to believe. Relative to expectations, top line revenues have been especially weak, with nearly all sectors surprising to the downside, even as EPS and EBITDA have tended to beat.

But even those sorts of statistics tend to hide the true weakness because equity analysts tend to revise expectations down while earnings season is still ongoing, which explains why some 72% of S&P500 companies manage to beat expectations in a weak quarter.

To get a truer picture of the magnitude of disappointment, it's necessary to freeze estimates prior to the start of earnings season, so that those companies reporting later don't get the benefit of having the bar set lower by the early reporters. And viewed this way, we see that earnings surprises have been about as bad as the third quarter of 2011, which were impacted by the Japanese earthquake and the debt ceiling debate.

### S&P 500 Earnings Surprise Relative to Unrevised Expectations

% Surprise in EPS

27 July 2012

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Credit  
Investment Overview  
North America  
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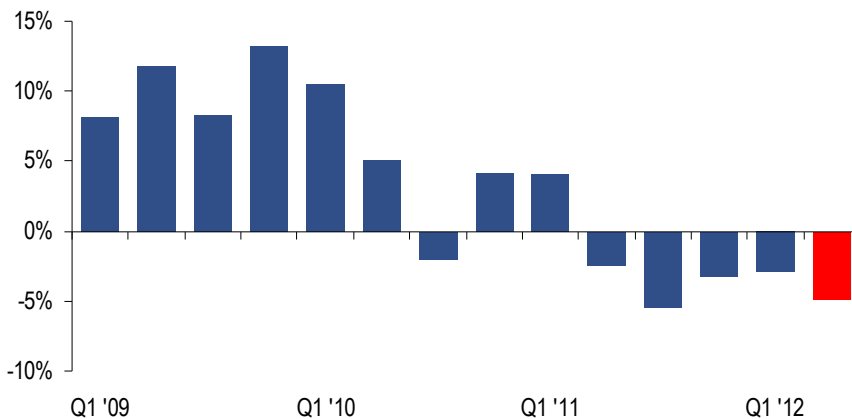
May '12 – Reduce Exposure to Aussie Banks

#### Investor in subordination

Apr '12 – Surviving the sovereign

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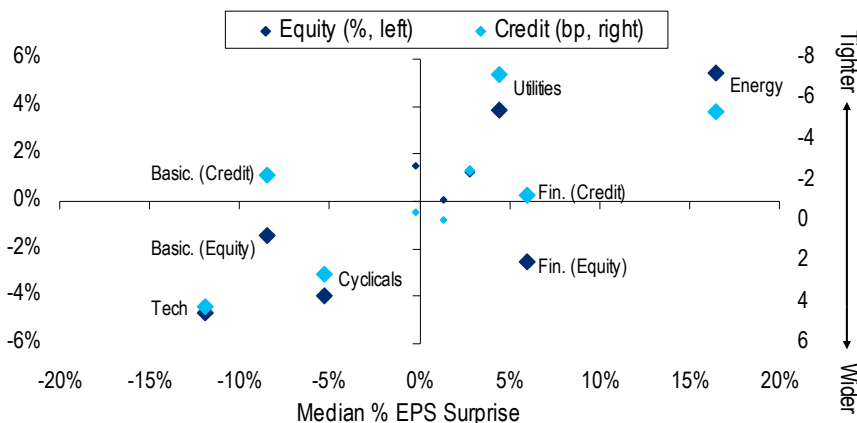
Source: Citi Research, Bloomberg

One can also look at how securities prices have reacted to earnings announcements to try and get a sense of which sectors have been most impacted this earnings season. Given how volatile the market has been, this sort of analysis requires beta adjusting the securities under consideration, so that we correctly isolate idiosyncratic performance. Moreover, it's important to capture performance in the weeks ahead of the reporting season as well as after.

As the below chart illustrates, the results are revealing.

As expected, two of the worst performing sectors so far have been technology and cyclicals, which makes sense given the earnings disappointments relative to rather low expectations. In contrast, the energy and utility sectors have performed well in both the CDS and equity markets this earnings season. Energy had seen significant negative analyst revisions, but has managed to beat those downbeat forecasts. More interesting is the performance of financials and basics. Both have seen significant equity weakness that's not been echoed by the CDS market.

#### Outperformance in Equity and CDS vs. EPS Surprise



Source: Citi Research, Bloomberg

But to our minds the biggest casualty of second quarter earnings has not been any one company or sector, but the notion that US companies will be unaffected by the challenging global macro backdrop. And as that reality sinks in, it becomes far harder to dismiss other concerns like high Spanish yields or Greece's likely noncompliance with the Troika program. Indeed, one becomes far

cramdown

#### High Grade Strategy

Apr '12 – Corporates as Collateral

#### European Credit Outlook

Apr '12 – Should I stay or should I go?

#### High Grade Strategy

Mar '12 – What's left to rally... and what to buy

#### 2012 High Grade Outlook

Dec '11 – Another Year On The Edge

### US Key Economic Data

<b>Tuesday:</b>	<u>Consensus</u>
Personal Income	0.4%
Personal Spending	0.4%
Consumer Confidence	61.5
<b>Wednesday:</b>	
ADP Employment Chg.	370K
ISM Manufacturing	50.4
<b>Thursday:</b>	
Initial Jobless Claims	370K
Factory Orders	0.4%
<b>Friday:</b>	
Nonfarm Payrolls	100K
Unemployment Rate	8.2%

### Key Earnings Announcements

#### **Monday:**

Anadarko Petroleum Corp  
Loews Corp  
Enbridge Energy Partners LP  
Masco Corp

#### **Tuesday:**

Pfizer Inc  
Edison International  
Energy Corp  
Archer-Daniels-Midland Co  
Genworth Financial Inc  
NiSource Inc  
Valero Energy Corp  
HCP Inc  
Ecolab Inc  
Thomson Reuters Corp  
Allstate Corp/The  
ONEOK Inc  
Northeast Utilities  
Aetna Inc  
Kimco Realty Corp  
DDR Corp

#### **Wednesday:**

American Tower Corp  
Comcast Corp  
Prudential Financial Inc

less assured that the US won't enter recession should Europe continue to show signs of disintegration.

And that's an especially troubling development considering disintegration is increasingly becoming the base case. In their monthly [Global Economic Outlook and Strategy](#) piece, Citi economists write that they now believe the probability that Greece will leave EMU in the next 12-18 months is about 90%. Even with the Spanish bank bailout, they continue to expect that both Spain and Italy are likely to enter some form of Troika bailout for the sovereign by the end of 2012.

As such, there's something disconcerting about the ECB President hinting at restarting the SMP program at the same time that EU officials are reportedly discussing the possibility of a second Greek debt restructuring that would almost certainly have to involve official lenders to make any difference. One has to wonder how extensive these new SMP purchases could be given that the ECB has always been careful to keep the pressure on policymakers to enact solutions of their own and should be cognizant of incurring too much jump risk should a Spanish or Italian OSI be needed at some point in the future.

Nonetheless, markets have so far seemed to react positively to the possibility of the ECB restarting secondary market purchases. But we urge caution. It appears to us that investors and rating agencies alike have become far more sensitive to subordination concerns and cognizant of the de facto seniority enjoyed by the ECB. If downgrades were to follow, the SMP program could end up being extremely counterproductive, in our view.

In the meantime, the events of the past week prove how difficult it is to trade this market, especially given sparse summer liquidity that is likely to continue to deteriorate into August. Only the extremely nimble investor really has a shot at making money over the next month, in our opinion, but getting the calls right will likely prove extremely difficult. After all, just last week we thought the market was set up for a relatively quiet period lasting until Labor Day – Olympic slow down, few European deadlines, etc. We guess there's no point in making that argument any more.

### Single Name News & Views

**Time to sell positive basis?** – There's no doubt that the technicals have been playing havoc on the cash-CDS basis. With so much liquidity coursing through the veins of the financial system, few investors have been willing to part with cash bonds for fear of never being able to get them back. On the other hand, CDS has been a much more popular vehicle for shorting during earnings season.

In a sense, the current state of affairs is the exact opposite of what happened during the credit crisis when deleveraging and a lack of liquidity/capital pushed the basis to ever more negative levels. Back then the basis eventually stopped its relentless march negative when investors were able to buy the basis and lock in significant unlevered "risk free" returns. But is there any analogous threshold for positive basis?

One suggestion is to look at the implied rate short an investor locks in by selling the basis and not hedging Treasuries/swaps. To our minds, a basis package should never get so positive that an investor is able to structure a "free" rate short. Said another way, it's hard to justify a CDS spread that is equivalent to the yield of matched maturity corporate bond. For if the CDS "yield" is greater than the bond yield, why should anyone own the bonds? At that point, it's far better to sell protection because one doesn't run the risk of rates backing up.

In the table below, we identify a number of basis packages that trade near this

MetLife Inc  
Dominion Resources Inc/VA  
Time Warner Inc  
Exelon Corp  
Devon Energy Corp  
Williams Cos Inc/The  
Williams Partners LP  
Hartford Financial Services Group Inc  
Harley-Davidson Inc  
Lincoln National Corp  
AGL Resources Inc  
Marathon Oil Corp

#### **Thursday:**

American International Group Inc  
Kraft Foods Inc  
Time Warner Cable Inc  
Duke Energy Corp  
Sempra Energy  
Xcel Energy Inc  
CenterPoint Energy Inc  
Apache Corp  
Ameren Corp  
Kellogg Co  
CBS Corp  
American Water Works Co Inc  
SCANA Corp  
Cigna Corp  
Pitney Bowes Inc

#### **Friday:**

Procter & Gamble Co/The  
Viacom Inc  
EOG Resources Inc

pivotal threshold. Investors can either sell basis in the traditional manner or, as we would suggest, do the trade without hedging the rates leg.

### Shorting Treasuries through Basis Packages

Credit	Bond	Bond			5Y CDS	Basis	
		Z-Spr.	Yield	Price		Spread	Implied Tsy. Yld*
AT&T Inc	T 1.7 Feb-17	57	1.20	102.3	82	25.0	0.38
GE Electric Cap Corp	GE 2.9 Jan-17	107	1.81	104.6	140	33.0	0.41
BHP Billiton	BHP 1.625 Feb-17	68	1.31	101.4	100	32.0	0.31
Caterpillar Inc	CAT 1.5 Jun-17	46	1.28	101.0	98	52.0	0.30
Kohls Corp	KSS 6.25 Dec-17	120	2.08	121.1	185	65.0	0.23
Berkshire Hathaway	BRK 1.6 May-17	38	1.18	101.9	120	82.0	-0.02
Xerox Corp	XRK 2.95 Mar-17	192	2.69	101.1	292	100.0	-0.23

Source: Citi, Bloomberg, Pricing as of 7/27/12

\*Implied treasury yield is calculated as the bond yield minus 1/100 x CDS spread.

**Yankee Telecoms** – One of the more frustrating aspects to trading Eurodollar telecom paper is the technicals. It's primarily why the long bonds of a name like France Telecom trade 20-30bp tighter than its German peer, Deutsche Telekom, even though FRTEL 5y CDS trades 40bp wider than DT CDS. For whatever reason, FRTEL bonds are better put away and investors, primarily Europeans, continue to buy the dollar bonds. On the other hand, the same sort of technicals seem to be less strong in DT bonds.

As our [European colleagues note](#), the theme is not confined just to the European telecoms space, but is part of a much broader trend going on in the "soft core". Corporates. In countries like France, corporates have been outperforming their "hard core" peers throughout July. Undoubtedly, some of this is related to short covering. But we think it's also the natural consequence of a Europe in which negative rates are becoming far more common. As the quest for yield has grown, countries on the cusp, like France, have been the prime beneficiaries.

So is it worth fighting the technicals at this point? Fundamentally, we think it makes sense to be short FRTEL \$ long bonds against DT \$ long bonds and would recommend doing so, simply on the grounds that France's economy is likely to be far more challenged than Germany's in the coming years. But it's a trade we expect might take a while to come to fruition. In fact, given the strength of the technicals, we wouldn't be surprised to see FRTEL CDS rally to parity with DT CDS beforehand. Although, that's not a trade we would necessarily advocate.

### Week Ahead

With just over 60% of the S&P 500 index results reported, Q2 earnings season is decidedly weak. Headline names will still be topical, especially for sectors with a low number of reporters – utilities, staples, and energy, for instance. Anadarko, Pfizer, Duke Energy, Apache, and Proctor & Gamble will be in focus next week.

But with the ECB and FOMC meetings both taking place next week, the impact of earnings could be muted in comparison, especially with QE chatter picking up. Draghi's comments this week ignited hopes that the SMP could be restarted, but we remain skeptical this will be announced at next week's meeting. However, Draghi might reiterate recent dovish comments and continue to hint at future market intervention. On the home front, we aren't expecting the Fed to announce QE either. We think the use of dovish language is as far as the Fed will go this month.

The Fed is likely to get an early look at the monthly employment numbers which will be released on Friday, so the statement will be highly scrutinized. Nevertheless the expectation for employment is weak, although consensus is for a small improvement based on recent declines in weekly claims data. Other key

economic data include consumer confidence and personal and spending, for which the consensus expectation remains soft.

Next week will be critical for peripheral bond auctions as these will be the last auctions before the summer break. On Monday, Italy will auction € 5.5 bn of BTP at 3, 5 and 10 year maturities. We also expect Spain to auction € 2.8 bn Bonos at the 2 and 5 year maturity. Coinciding large coupon payments could provide support, if one assumes the market is willing to reinvest in these sovereigns.

# Appendix A-1

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