

24 January 2014 | 40 pages

High Grade  
Western Europe

# European Credit Sector Recommendations

## "Yes" with Reservations

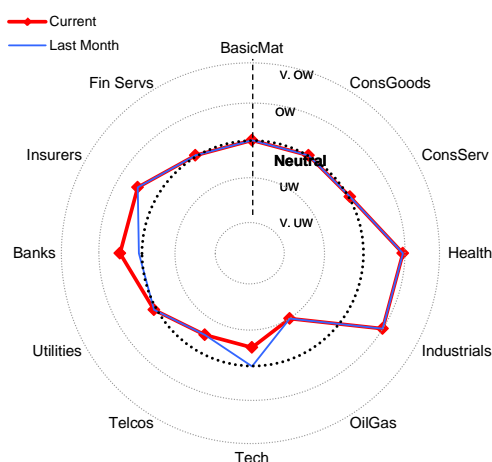
- We remain constructive on credit for 2014. Investors' need to enhance returns, absence of negative catalysts and an ongoing supportive stance from central banks should push the market tighter still, especially in the high beta part. We expect that iBoxx will reach 90bp by year-end.
- Yet we see some unhealthy trends in credit: leverage is increasing, valuations are very tight and demand for credit might be dented by the relative attractiveness of other asset classes. We don't think these will destabilize spreads this year, but they increase the importance of positioning sensibly as the rally matures.
- **Key sector recommendations:** Move to a small overweight on Banks, by looking to add exposure in the new AT1 through the primary market. Remain overweight on selected T1 and LT2 (although many of these bonds tightened in anticipation of LMEs, we see opportunities remaining in the more illiquid bonds), and overweight covered bonds and underweight senior bonds. Keep reducing the overweight in Insurers after recent performance. Move to a small underweight on Technology. Remain overweight on Industrials and Healthcare. Remain underweight on Oil & Gas and selectively underweight on Telcos as fundamentals keep deteriorating and event risk is high. Maintain neutral on the remaining non-financial sectors.

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Figure 1. Citi Recommended Positioning



Source: Citi Research  
All recommendations are made using the iBoxx € index as a benchmark.

Figure 2. iBoxx Weightings by Sector

	Mkt Value (Percent)	Duration	Beta	Wgt. Dur. (Years)	Wgt. Beta (Years)
€ iBoxx	100.0%	4.4	1.0	4.4	4.3
Non-Fin	55.5%	4.8	0.9	2.6	2.4
Fin	44.5%	4.0	1.1	1.8	2.0
Basic Mat.	4.0%	4.6	0.9	0.2	0.2
Cons. Goods	9.5%	4.3	0.7	0.4	0.3
Cons. Serv	3.4%	4.6	0.8	0.2	0.1
Healthcare	2.3%	3.8	0.7	0.1	0.1
Industrials	8.0%	4.6	0.8	0.4	0.3
Oil & Gas	5.1%	4.7	1.0	0.2	0.2
Technology	0.7%	6.8	0.8	0.0	0.0
Telecoms	8.0%	5.0	1.0	0.4	0.4
Utilities	14.6%	5.1	1.0	0.7	0.7
Banks	35.6%	3.9	1.1	1.4	1.5
Fin Servs	4.9%	4.3	0.7	0.2	0.1
Insurance	4.0%	4.7	1.6	0.2	0.3

Source: MarkIt, Citi Research

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

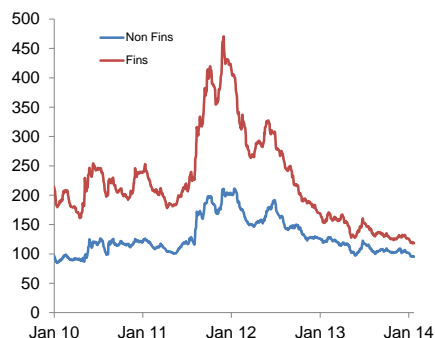
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## Sector and bond recommendations

Figure 2. iBoxx € Corps and Fins



Source: MarkIt, Citi Research

2014 is not a year where we embrace credit whole-heartedly:

Our [valuation report](#) points to a “tight” or “very tight” market for almost all the metrics we follow. Net leverage is likely to increase: although a timid European economic recovery is likely to support EBITDA, we think the easy access to debt will entice companies to increase returns to shareholders. The technical in credit also seems somewhat less strong than in previous years: although our [Survey](#) shows that inflows have rebounded marginally they remain near a five-year low. And positioning already seems quite extended compared with recent history: the aggregate long in our last survey is close to levels last seen in 2009.

But will these risks destabilize the credit markets?

We don't think so for the foreseeable future. Despite Fed tapering, ongoing liquidity injections by global central banks should create an excess demand environment across financial markets in 2014 also. And in a year with comparatively few tangible negative catalysts, we think few investors will feel they can sit and wait for a better entry point, as we outlined in our most recent [Outlook](#).

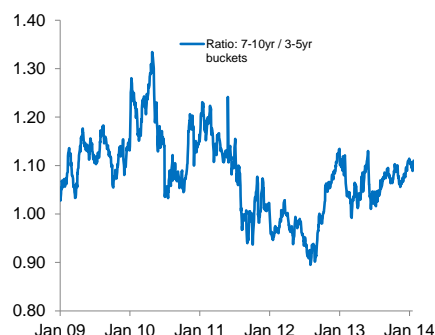
Rather, most investors are seeking to enhance returns by taking more risk (credit, duration, liquidity). This has already been happening for some time – since mid-December alone the iBoxx has tightened, 12 bp, bringing the market to levels last seen in 2006. And high-beta parts of the market are leading the charge.

So while we and many others have longer-term reservations, for the time being people are still voting “yes” and putting money to work. For this reason, we expect the €iBoxx Corp to tighten to [90 bp](#) in 2014.

Some sectors do better than others in terms of valuations and underlying fundamental trends:

- Given that, all in, Banks will continue to deleverage next year, we'd be a small overweight by adding exposure in the new AT1 through the primary market. We'd remain overweight on selected T1 and LT2: most of these bonds tightened in anticipation of an LME, but the most illiquid bonds might still benefit from this theme. We also remain overweight covered bonds against senior unsecured, especially in peripherals: we feel the spread differential between the two is simply too small to ignore given the shift towards a bail-in regime.
- We'd continue to scale back on Insurance: fundamentally, we believe this sector is sound, but it is high beta, spreads are now at levels last seen at the beginning of 2008 and we see some downgrade risk for players exposed to the periphery, which might lead some bonds (like Generali T1) to fall out of the index.
- Within non-financials, move to a small underweight on Technology. We are still neutral on Consumer Services, on valuation grounds and some initial signs of improvements in the sector. We remain neutral on Consumer Goods and on Utilities. We also remain neutral on Basic Materials and Financial Services on valuation grounds and overweight on Industrials. We remain underweight on Oil & Gas and selectively underweight on Telcos.

Figure 3. iBoxx € Non Fins Curve Steepness



Source: MarkIt, Citi Research

We would not follow the market into adding duration risk. We prefer moving down in credit quality to enhance returns (Figure 3): the breakeven to volatility ratio of short-term bonds is very high compared with longer maturity bonds. At the same time, the breakeven to volatility ratio of non-financials BBB-rated is higher compared with the A-AAs ([Figure 5](#)).

## Suggested Picks and Pans

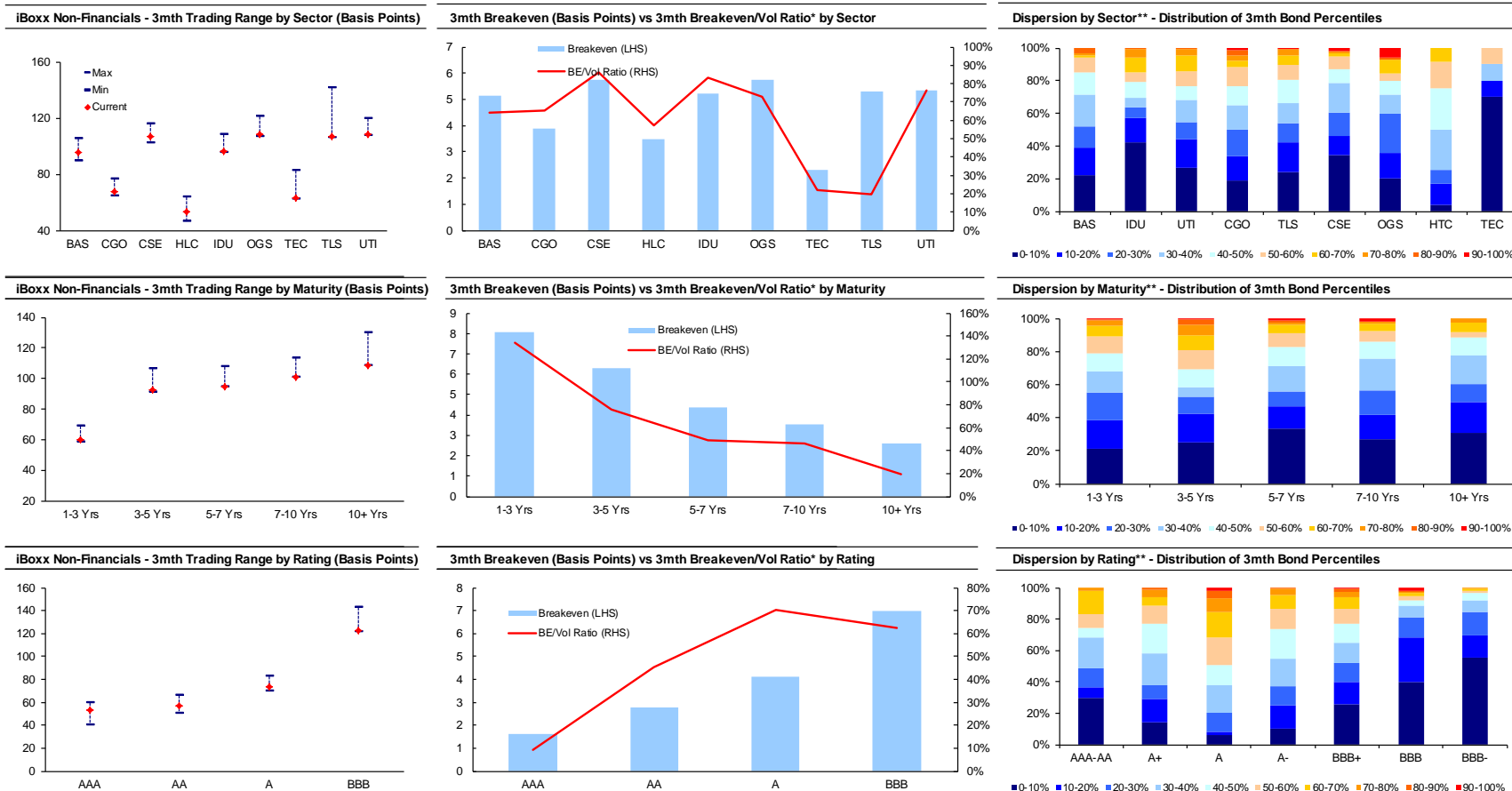
Figure 4. Suggested Picks and Pans<sup>1</sup>

Sector	Position	Picks	Pans
<a href="#">Basic Materials</a>	Neutral	Linde Rio Tinto BHP Billiton	Lanxess BASF Solvay Anglo American
<a href="#">Consumer Goods</a>	Neutral	Pernod-Ricard	RCI Banque
<a href="#">Consumer Services</a>	Neutral	Next Eutelsat	Metro Tesco Reed Elsevier
<a href="#">Health Care</a>	Overweight	Bayer (hybrid) Roche	
<a href="#">Industrials</a>	Overweight	Siemens (hybrid) Alstom Atlantia Hutchison Whampoa	Schneider Electric Bouygues Atlas Copco Volvo (CDS)
<a href="#">Oil &amp; Gas</a>	Underweight		OMV BP ENI
<a href="#">Technology</a>	Small Underweight		Ericsson
<a href="#">Telcos</a>	Small Underweight	Oi KPN	Orange (France Telecom) Belgacom
<a href="#">Utilities</a>	Neutral	Enel Gas Nat EDP	E.ON Fortum
<a href="#">Banks</a>	Small Overweight	Morgan Stanley Lloyds Banking Group KBC JP Morgan Barclays Large Spanish Banks	Smaller Spanish Banks Smaller Italian Banks
<a href="#">Insurance</a>	Small Overweight	Talanx	HanRe Munich Re
<a href="#">Financial Services</a>	Neutral		

Source: Citi Research

<sup>1</sup> To produce individual and sector recommendations we use various scoring systems relative to history and to peers to determine richness and cheapness. We factor in overall spread movements as well as the potential effects of individual credits on a sector. We use this information along with fundamental data and credit-specific news to determine our positioning.

Figure 5. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Non Financials

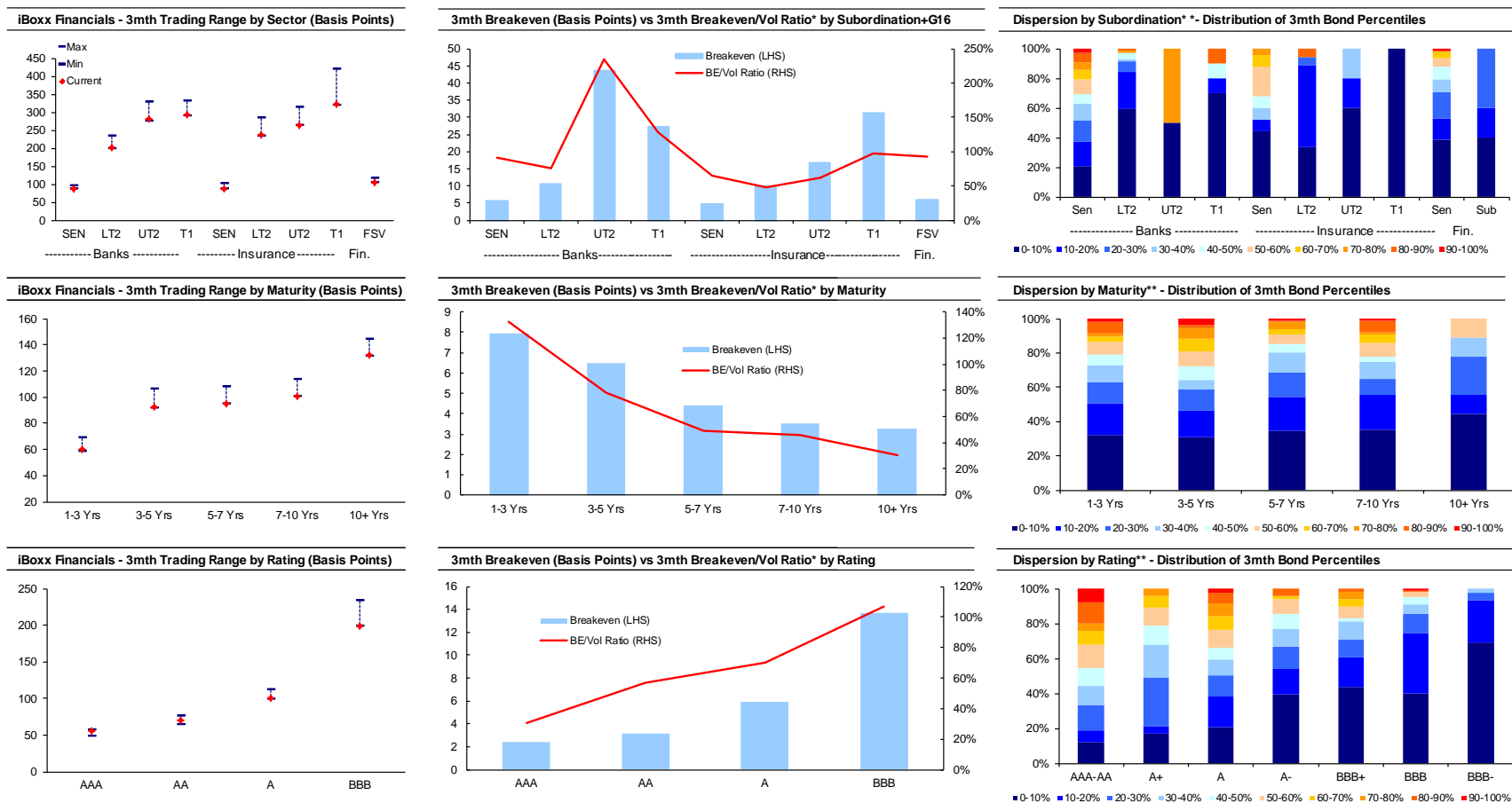


Source: iBoxx, Citi. \* Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

\*\* Dispersion charts aggregate individual bond performance for various buckets (sectors, ratings etc). For each bond the current percentile in the 3mth trading range is calculated. For each bucket the distribution of bond percentiles is then aggregated. Dark red shows the percentage of bonds that are trading at or very near their 3mth highs. Dark blue shows the percentage of bonds at or very near 3mth lows. Light colours show bonds trading mid-range.

Source: MarkIt, Citi Research

Figure 6. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Financials



Source: iBoxx, Citi. \* Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

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Source: MarkIt, Citi Research

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# Sector Recommendations

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## Basic Materials: neutral

**Remain neutral in Basic Materials: the upside from here looks limited**

A scenario of moderate global growth next year provides some support to demand for Basic Materials. But we find it [unlikely](#) that the glut of supply this sector suffers will be cleared in 2014. Demand remains highly vulnerable to a [slowdown in China](#), and may be dampened by [tight liquidity conditions](#), measures to cool the surging real estate market and a slowdown in infrastructure spending. US tapering is also likely to strengthen the USD, which would put pressure on commodity prices.

**We expect an easing in the current earnings downgrade cycle in Basic Resources**

Companies have been cutting capex and reducing their cost bases aggressively, and next year is unlikely to be any different. We therefore expect an easing in the current earnings downgrade cycle. But apart from this, it's hard to identify positive catalysts here. For this reason, we prefer the globally diversified miners like Rio Tinto and BHP, which are aggressively restructuring their businesses. In the case of Glencore, we think its progress has been priced in already and we close our overweight.

**Chemicals are likely to engage in more shareholder-friendly activity**

Demand prospects for Chemicals are also moderately favoured by the recovery. Yet, margins have been under pressure in 2013 and there are few hints that this will reverse next year. EPS growth is also likely to be slow, and this will cause more pressure from shareholders for M&A and share buybacks. The winners in this field should be the companies with access to raw materials and not least, energy, like US chemicals. European companies look poorly placed on this front.

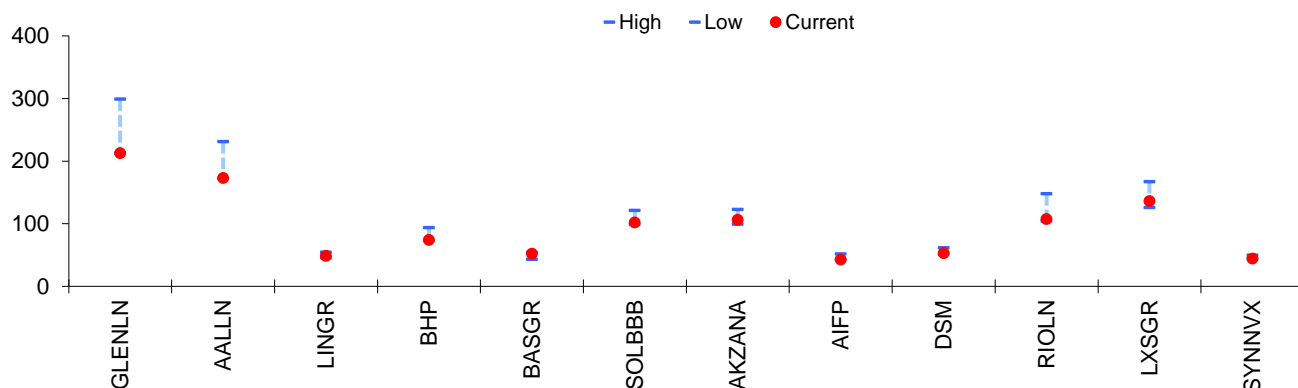
Figure 7. Basic Materials Picks and Pans

Picks	<p><b>Linde:</b> Within an uninspiring sector, this company is maintaining healthy sales growth and a good contract pipeline, although its <a href="#">last results</a> were negatively affected by adverse FX movements. While we worry about investors having record longs in hybrids already, and Linde's is far from the cheapest in the sector, we would still consider it as a means of picking up beta without moving into the periphery.</p> <p><b>BHP Billiton:</b> Bonds have been underperforming in the last three months, probably linked to fears around Fed tapering, as with other mining companies exposed to EM. Also in June and September bond spreads widened around the time of Fed announcements. But the market seems to have absorbed the tapering news quite well, and it's time to focus on the fundamental drivers. Although Rio Tinto offers better value (admittedly, it has lower ratings than BHP), we think BHP is equally committed to divestitures and cost cutting, as well as reducing net debt. Management guided for a 25% capex reduction in 2014.</p> <p><b>Rio Tinto:</b> The company is shrinking its asset base and cutting capex. In a year where we expect companies to engage in more shareholder-friendly activities, this is one of the few where debt management will remain in focus in 2014, owing to management's commitment to an A rating. Net debt reached \$22bn in 2013, but any excess cash, from either ongoing cost cutting or divestments, will be used to reduce it. We think this conservative strategy will help the company navigate through the challenges of weak commodity markets.</p>
Pans	<p><b>Lanxess:</b> Remain underweight. All the rating agencies have the company on Negative outlook and further downgrade pressure is likely. The company continues to experience volume and price erosion, and its market share is under pressure. Recent recovery in performance polymers demand is due mainly to customer restocking, rather than underlying growth. We expect more producers to emerge in the next few months. The company is also likely to suffer from FX headwinds. For these reasons, we are unconvinced by the tightening we have seen in the last month. We think CDS reflect our concerns much better.</p> <p><b>BASF:</b> We would maintain our underweight in light of the recent announcement by BASF of its intention to bid for RWE's Dea, especially now that two additional bids have emerged, as reported by Bloomberg. However, the size of the acquisition looks in line with previous deals the company has pursued, and we don't see particularly negative implications for leverage in the medium term. If spreads widen on the deal (during past acquisitions we have seen 10-15 bp of widening), and if the movement is wide enough at that point, we would consider closing our underweight.</p> <p><b>Solvay:</b> The hybrid has outperformed the market in the last 6 months, despite the company cutting 2016 recurring EBITDA guidance by 20%, due to slow organic growth. But we remain underweight: our equity analysts expect more downgrades to come given the ongoing challenges of rare earths, soda ash, polyamide and emerging biochemicals, and FCF remains below the sector average. We think there is better value in hybrids like RWE's, where management looks clearly committed to restructuring the business.</p> <p><b>Anglo American:</b> An uninspiring production report in 3Q shows a concerning weakness in iron ore, although other segments were better than expected. Management provided more details on its restructuring plan at its December investor day; however our <a href="#">equity analysts</a> believe progress on it will take some time, and we find it unlikely that we will see a turnaround in the next two years. Bond spreads seem to reflect some of these concerns, but further underperformance is likely, in our view.</p>

Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

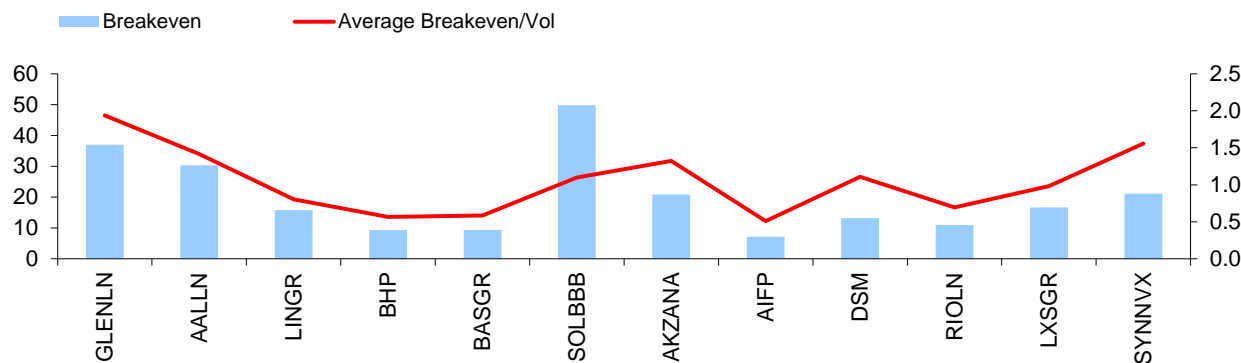


Figure 8. CDS 3mth Trading Range by Sector (bp)



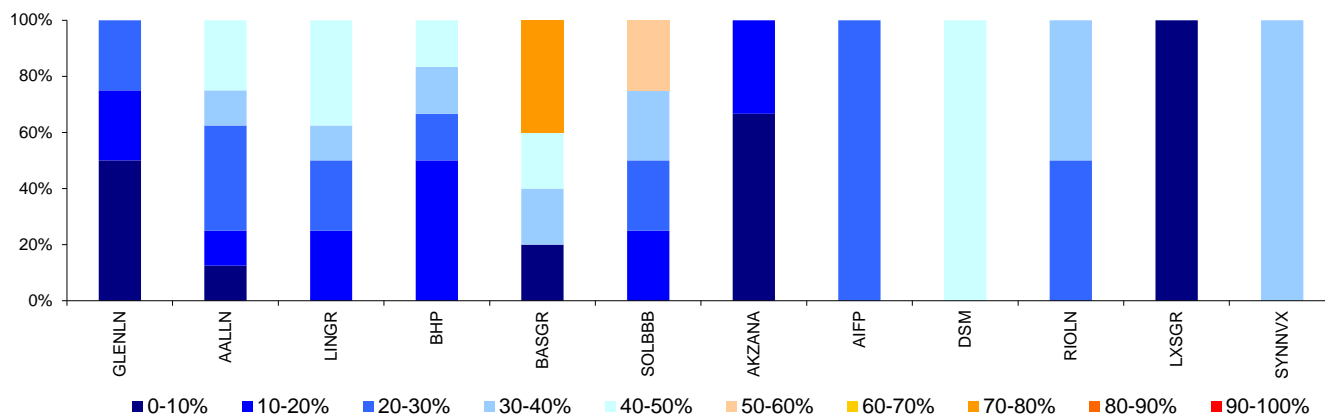
Source: MarkIt, Citi Research

Figure 9. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 10. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Consumer Goods: neutral

### Remain neutral on Consumer Goods

Consumer Goods underperformed the market from September onwards after having reached historical highs, but it is still the tightest sector of the iBoxx after Healthcare. Within the sector higher beta bonds (hybrids, Conti, Renault) generally outperformed. The exceptions were the VW hybrids, which seem to have lagged, and look cheap to comparable non-financial hybrids. While fundamentals in the sector are solid, there is potential for M&A and increased shareholder returns, which we don't really find reflected in spreads.

### Personal & Household Goods are seeing slower demand growth due to the EM slowdown

Although credit metrics remain strong, the main problems we see in **Personal & Household Goods** next year are slower demand growth due to the EM slowdown and FX headwinds should capital outflows from EM gain pace. The luxury segment is in a similar situation: LVMH and Kering enjoy healthy credit metrics, but sales growth is slowing down and margins are weakening, reflecting a need to simplify their structure and in some cases revive and reposition their brands. However, spreads seem to reflect these concerns already.

### Food and Beverage companies seem more affected by EM concerns

**Food & Beverage** companies are feeling the pinch of a slowdown in EM perhaps more than Personal & Household Goods. The whole sector has been swept by earnings downgrades, which will likely continue in 2014E in spite of low input prices. Citi is below consensus on EPS for most companies.

The slowdown in emerging markets does not look like a permanent challenge, though. With their favourable demographics and per capita income trends, we think [emerging markets](#) will continue generating sales growth for consumer goods companies. However, we might see more negative headlines on the names most exposed to these countries, and FX headwinds are likely to weigh on earnings.

### The car market shows some mild sign of improvement

Car sales in Europe are finally increasing from very low levels and China and US continue to see healthy sales growth rates. Such improvement, however, looks already reflected in the valuation of premium German **automakers**. In the premium space, we think only Jaguar Land Rover is still attractively valued: its sales performance remains strong, although a weak parent weighs on this company. We remain negative on the French automakers at current valuations. In the short term, a capital increase at Peugeot gives the company some breathing space, but its structural woes remain.

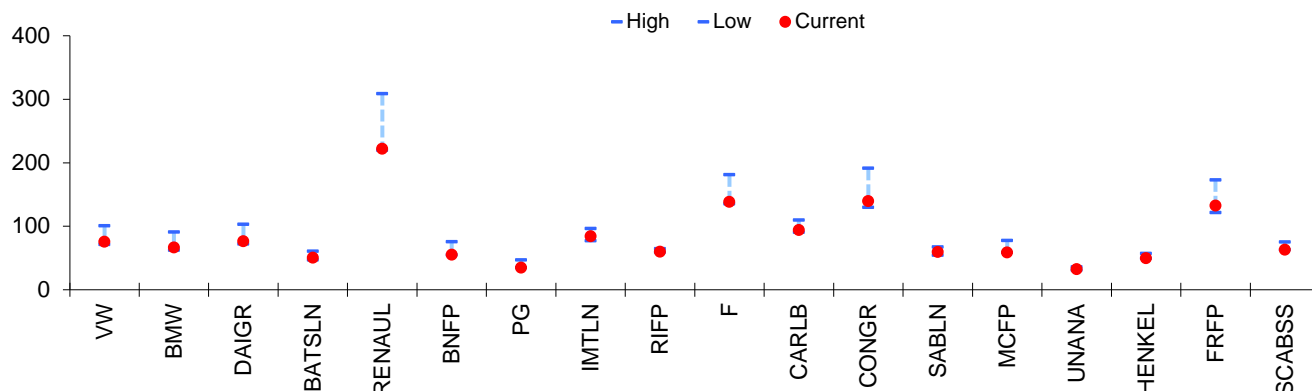
We close our overweight on Luxottica as spreads have reached all-time highs.

Figure 11. Consumer Goods Picks and Pans

Picks	<b>Pernod Ricard:</b> Spreads are suffering as sentiment is being negatively affected by slower EM sales growth. <a href="#">Our equity analysts</a> believe that the difficulties in China will likely prevent Pernod from achieving its FY14 EPS guidance. Yet the company is conservative and has strong credit metrics. We like its defensiveness. Moreover, we believe this company has lower M&A appetite than peers, and it is strongly committed to an IG rating: we don't expect significant shareholder-friendly activity from it.
Pans	<b>RCI Banque (Renault):</b> We acknowledge that Renault's sales volumes are improving overall (with growth in Europe, Americas and Africa offset by a decline in Asia) and that it is gaining market share in key emerging markets. However, FX risks remain an issue for the company as a whole. RCI Banque has outperformed the auto sector on a mix of marginally improving trends and investors' perception that it could receive government support if needed. But at current levels, the risk-reward is not attractive, in our view. Jaguar Land Rover, or even Continental and Valeo, look like better alternatives to us.

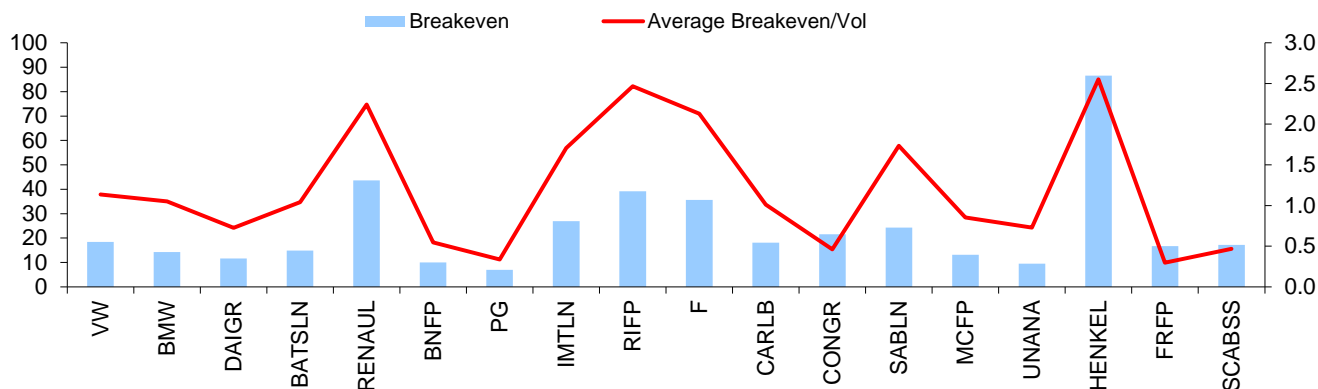
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 12. CDS 3mth Trading Range by Sector (bp)



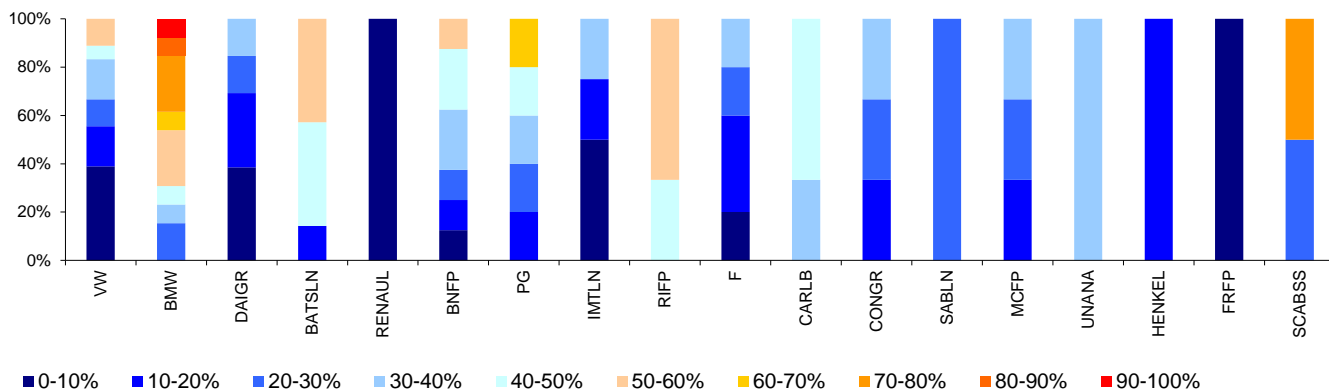
Source: MarkIt, Citi Research

Figure 13. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 14. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Consumer Services: neutral

### Remain neutral on Consumer Services

The challenges facing many retailers (high competition, poor profit growth) are well known, especially in food retail space. However, the underperformance of the sector, now at its widest levels versus the iBoxx since 2010, suggests most of the bad news is in the spread.

### Signs of a recovery in consumer confidence and purchasing power are starting to emerge

Consumer confidence in Europe is steadily recovering, although it remains weak. Households across Europe are finally starting to feel the benefit of a recovery, especially in UK. This is visible in the results of last Citi's [Household Available Cashflow](#) analysis and suggests a stabilization of demand in Europe. This is likely to benefit the non-food retail space comparatively more than the food space, especially those companies with big online franchises.

### Remain cautious on food retailers

We would remain more cautious on the food retailers. We are starting to see the first signs of stabilization, for instance at Casino, but credit metrics in companies like Metro and Tesco remain fragile and offer little protection should trade deteriorate from here. The last Kantar data show that Tesco's trade performance in the crucial Christmas period was poor. We turn underweight on this name again, especially after the December rally brought the [2047 bond](#) to levels close to all-time tights.

### Remain overall neutral on Media

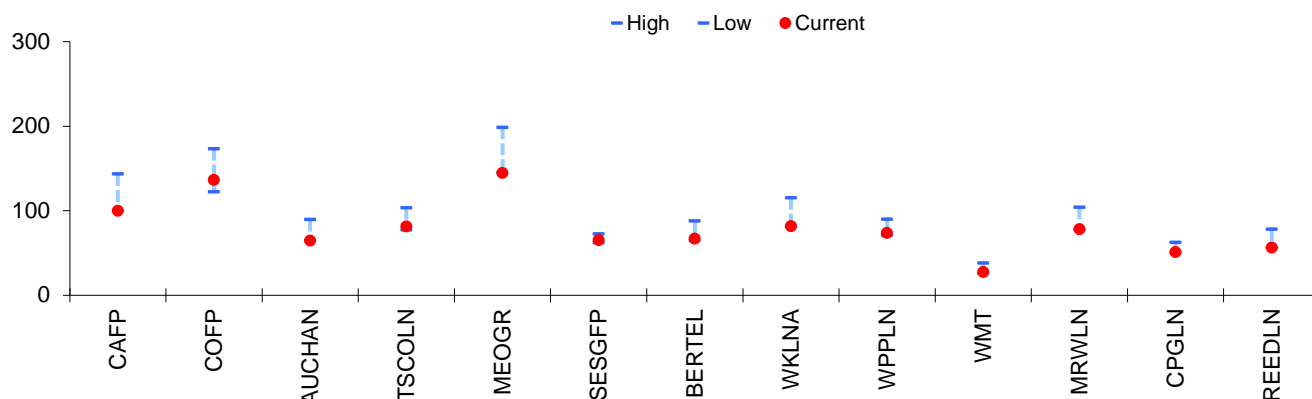
Our equity analysts have turned more positive on Media, especially on the names most exposed to DM, as macro trends are supporting sales growth. However, we would be wary of EM exposure (like WPP) as negative FX headwinds might hit sentiment. There is also potential for M&A and other shareholder-friendly activity. Reed Elsevier, for instance, has recently announced an additional £100m share buyback program. While the amount is small, it highlights the company's intentions regarding its cash usage, against which spreads look tight. Similar arguments can be made regarding WPP: the company has recently acquired a 30% stake in a strategic consultancy firm and a media monitoring company. Spreads close to their 2012 tights seem rich to us.

Figure 15. Consumer Services Picks and Pans

Pick	<p><b>Next:</b> CDS and bonds have rallied hard in the past months reflecting improvements in business prospects and deleveraging. But we expect Next to continue growing its sales and gain market share, and maintain or improve its margins. The last <a href="#">Christmas trading statement</a> shows a very good performance. Next announced that they will use their surplus cash to reward shareholders, but we don't expect this to impact leverage. Spreads mostly reflect Next's strengths, but this is one of the few bright stars in a challenged sector.</p> <p><b>Eutelsat:</b> this high-quality credit underperformed the market up to December over concerns regarding oversupply and slow sales growth. But the solid result for SES suggests good prospects for Eutelsat as well. Eutelsat might restate guidance to take into account the acquisition of Salmex (which would have positive implications for revenue growth). All in, our equity analysts expect 1.3% revenue growth next year. Although spreads have tightened in January, we think there is still value in the bonds.</p>
Pans	<p><b>Metro and Tesco:</b> Metro's CDS spreads have reached their 2011 levels now. We acknowledge that this company has finally entered a turnaround phase, with management reducing capex and deleveraging by divesting part of its real estate portfolio. But valuations at their mid-2011 levels seem to have priced in all the positive news already. Tesco was the clear loser in terms of Christmas trading. Against such news, the bonds seem tight, especially the 2047 bond, which has reached levels we feel uncomfortable with. The recent sale and leaseback transaction of Homeplus in Korea does not help credit metrics, in our view, and we are concerned that the company might engage in more of these transactions. These help short-term liquidity but are negative for credit metrics in general.</p> <p><b>Reed Elsevier:</b> Reed Elsevier's CDS is now at its 4-year tights. While we are comfortable with its growth profile, the company is engaging in share buybacks. These do not look a problem in terms of leverage, but they indicate the intentions of the company in terms of cash usage, which tight spreads don't seem to reflect.</p>

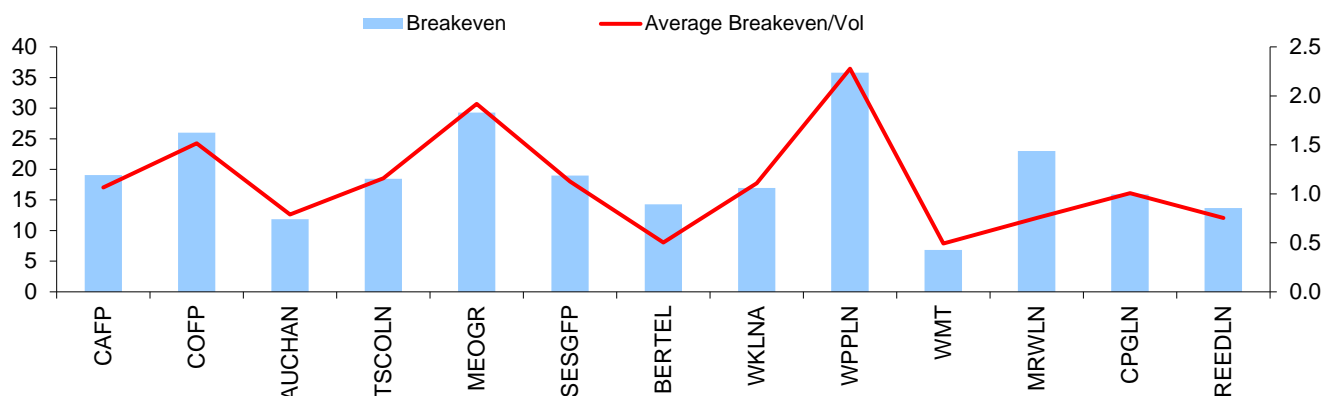
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Figure 16. CDS 3mth Trading Range by Sector (bp)



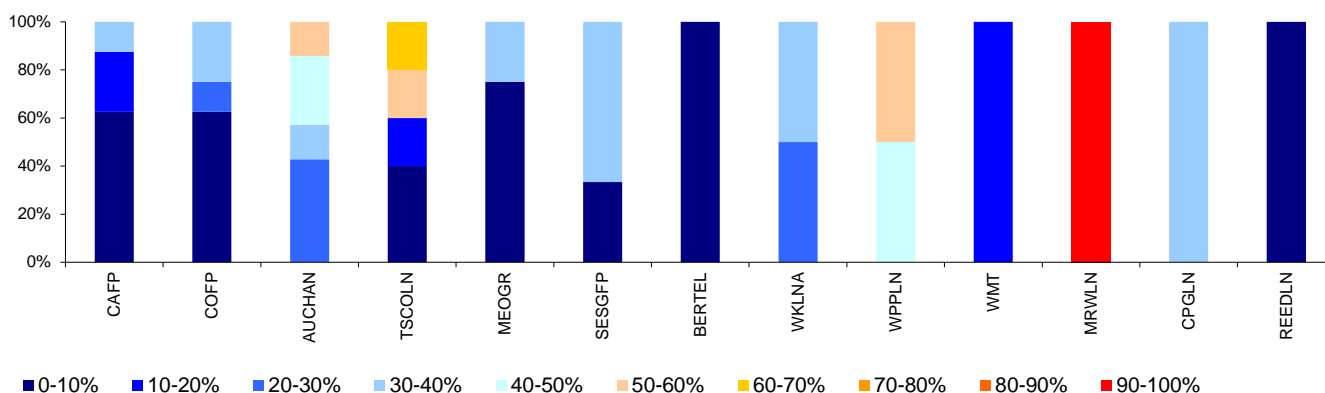
Source: MarkIt, Citi Research

Figure 17. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 18. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

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## Healthcare: overweight

**Maintain an overweight on Healthcare via the high beta names**

The underperformance of healthcare companies since August has brought spreads to their 1-year highs. We maintain a small overweight on Bayer and Roche. We would stay neutral on the remaining names.

**No meaningful risks coming from EM and not many patent expires**

Pharmaceuticals should continue to benefit from modest revenue growth next year, owing to product innovation and, apart from a few exceptions like AstraZeneca or Bristol-Myers-Squibb, limited exposure to patent expires. The slowdown in EM does not seem a major risk to us for pharmaceuticals: we expect sales growth to remain healthy in these areas.

**DM sales growth is more at risk than EM growth**

The most relevant risks to sales growth come from fiscal austerity in DM, in our view. As healthcare expenditures as a % of GDP are increasing, pricing pressures will remain significant, especially in European austerity-hit countries. European companies, in particular, are mitigating this risk by moving into generics.

**M&A activity is a risk but not a major concern**

The risk of M&A is increasing, though, as the current favourable funding costs provide a good source of financing to expand in growth areas like cancer immunotherapy (a rapidly growing field where Roche has a competitive position). However, most of the firms have the financial flexibility to manage medium-sized M&A, in our view; therefore we don't see this as a major problem.

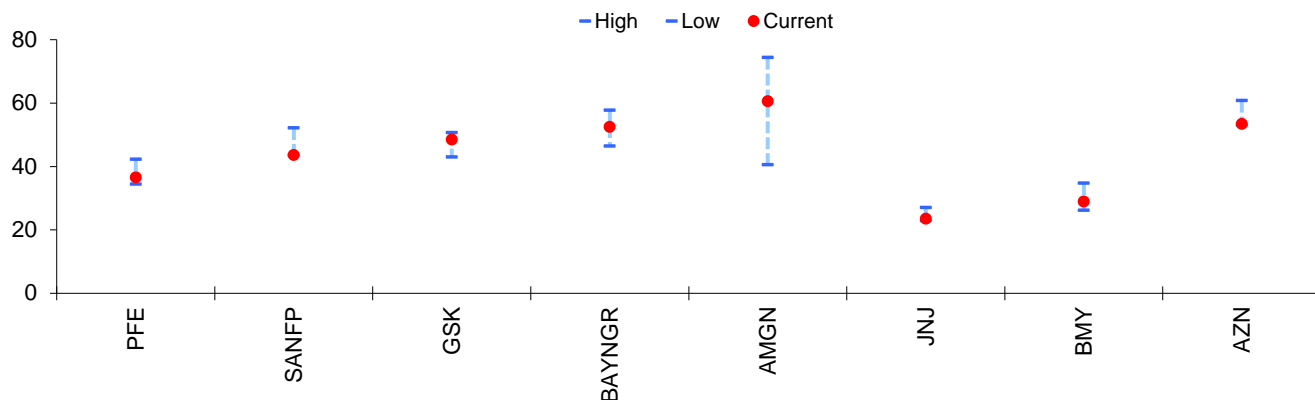
We close our overweight on Amgen: spreads are now on the tight side of their 1-year range.

Figure 19. Healthcare Picks and Pans

Picks	<p><b>Roche:</b> We remain overweight. It has quite a strong pipeline for blood cancer drugs, Alzheimer's, etc. Its last results showed strong performance across its whole product pipeline and we could likely see consensus upgrades.</p> <p><b>Bayer:</b> We maintain our overweight in the <a href="#">subordinated bond</a>; we see it as a good way to increase beta exposure via a company with strong credit fundamentals. We think the underlying earnings momentum of new drugs will offset the weakness of part of its drug portfolio. Although FX headwinds caused the recent <a href="#">earnings</a> underperformance versus expectations, underlying revenue trends remained strong. The decision to divest its share of diabetes JV to AstraZeneca is also positive, in our view, as it frees resources to focus on more profitable products.</p>
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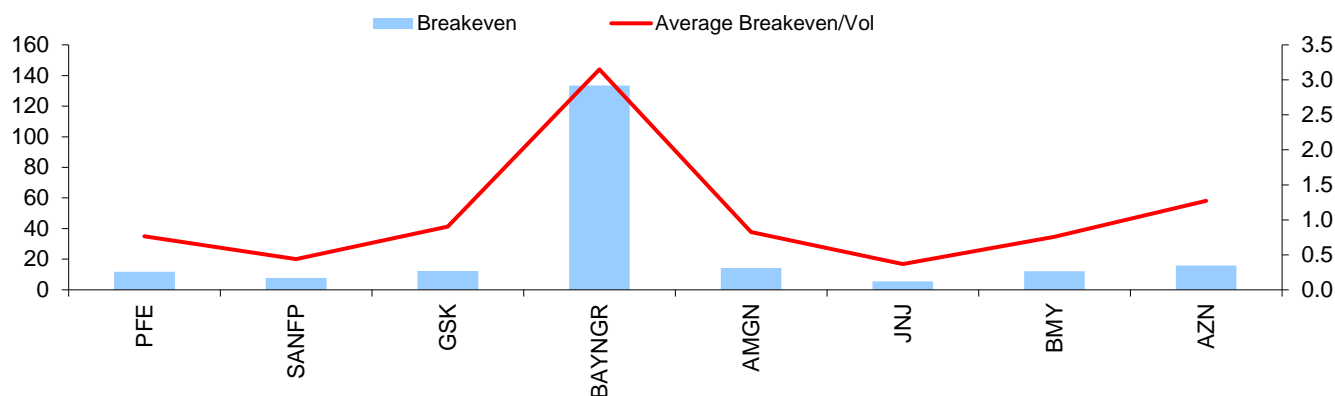
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 20. CDS 3mth Trading Range by Sector (bp)



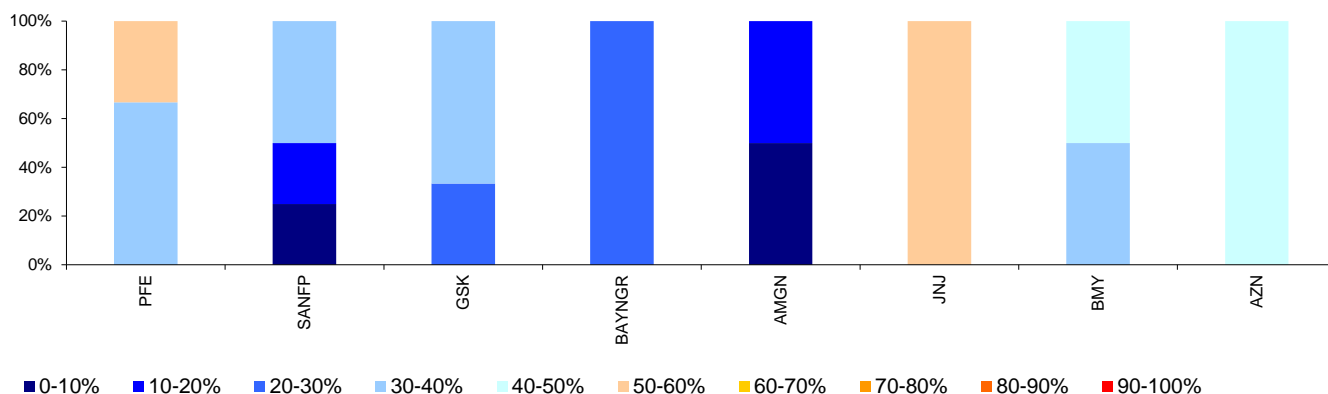
Source: MarkIt, Citi Research

Figure 21. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 22. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Industrials: overweight

### Remain overweight on Industrials

The names supporting the good performance of this sector are mainly the high beta names like Abertis and Atlantia. The low beta names, on the contrary, seem to have been the relative underperformers, especially in the last two months. We like the sound fundamentals of this sector, and we prefer them to Consumer Goods as M&A risk seems lower, and valuations better.

### Challenges at a company level are still evident in Industrials

The PMI manufacturing index for Europe is holding steady above 50, yet some sectors continue to face headwinds. We remain bearish on mining capex as most basic materials companies have reduced their capex for the coming years and demand seems likely to remain lackluster. However, we see the first signs of improvement in [Civil Aviation](#), which is experiencing an increase in production and orders, although aviation companies are suffering from the cuts to defense budgets.

### We remain cautious on construction exposed to Europe and EM

From a fundamental perspective, the outlook for Construction remains sluggish, although it is stabilizing: real estate markets in Europe will likely be flat next year, but [some areas](#) are seeing growth (UK, Germany, Ireland), especially in residential markets, while the non-residential segment remains lackluster. US growth rates are also likely [to improve further](#), especially in residential. Construction companies have engaged in capex and cost cutting and benefit from low energy prices as well. Yet these improvements in demand are likely to be offset by capacity additions, especially in emerging markets. Against this scenario, bonds look to us fairly priced.

### Close overweight on Abertis

We close our overweight on Abertis: the bonds have performed well over the last few months and spreads now look tight now versus its investment strategy.

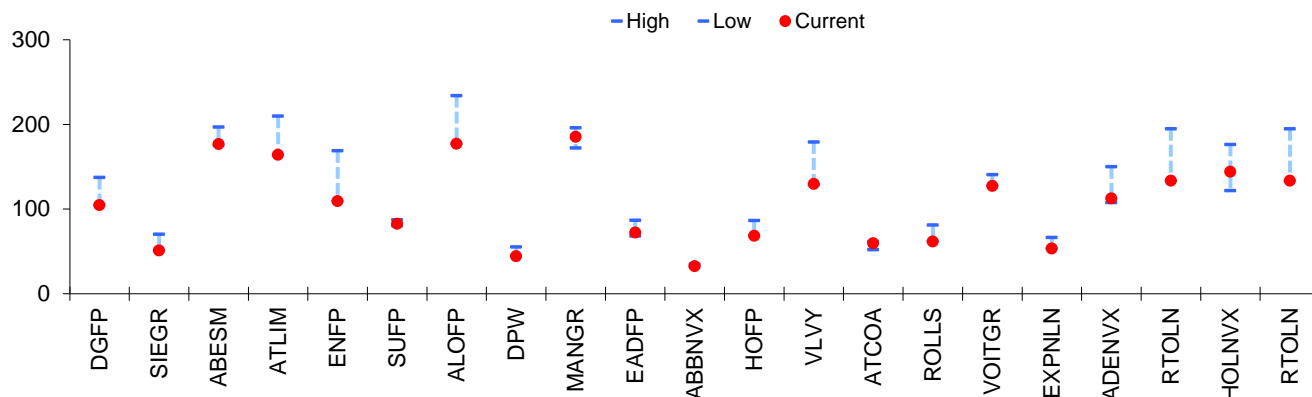
Figure 23. Industrials Picks and Pans

Picks	<p><b>Alstom:</b> The company issued a profits warning based on weakness in sales of thermal power equipment. Management guidance on negative FCF in 2H14 has also weighed on sentiment. CDS widened 20bp on the news, bringing the <a href="#">ratio</a> of CDS to iTraxx Main to levels not seen since 2007. Yet, the company is committed to selling assets (potentially €2bn) and management comments suggest that they might cut dividends. Management has also stated that the company does not need to renegotiate its covenants. There has also been market commentary around a potential rights issue. While the news is broadly negative, we think the company has flexibility to defend its credit metrics. We wouldn't add to our position on the widening, but with much bad news already priced in, we would not follow the market in buying CDS or selling bonds now.</p> <p><b>Hutchison Whampoa:</b> It has an acquisitive strategy and some EM exposure. However, rating agencies guided that the company is able to manage bolt-on acquisitions within its rating. This company gets 50% of its revenues from Europe. We like the subordinated bond in particular.</p> <p><b>Siemens:</b> In spite of its December rally, we like the hybrid bond, which might be called, in our view, as the company does not really need such an expensive form of funding. The company reduced its profit margin guidance recently and is reorganizing its reporting lines, which we think will streamline the business.</p> <p><b>Atlantia:</b> We remain long. Atlantia should benefit from improving growth prospects now that merger with Gemina is completed. Moreover, Italian traffic seems to be bottoming out, and margins have remained stable even in 2012, the year of the largest traffic drop in Italy.</p>
Pans	<p><b>Volvo:</b> The CDS of Volvo looks quite tight given the challenges the company faces. Volumes continue to suffer in spite of the support given by the Euro VI regulation, and we are concerned that management could feel compelled to enhance shareholder value to the detriment of credit-holders. The bond reflects this weakness much better, in our view, and we would be neutral.</p> <p><b>Schneider Electric and Atlas Copco:</b> remain underweight Atlas Copco and Schneider Electric in spite of the December and January rally. Earnings expectations on both companies were adjusted down in October and November, and spreads widened over the same period, but we don't see anything on the horizon now to justify the rally of December and January. We remain concerned about sluggish growth in the infrastructure and real estate markets in Europe and China and the weak outlook for mining capex, which could still surprise negatively. In general, EADS or Hutchison Whampoa are better choices than Schneider Electric or Atlas Copco, in our opinion.</p> <p><b>Bouygues:</b> Price competition in France remains fierce (see the recent downgrade of Orange by Moody's), as shown by the recent very advantageous 4G offer by Free (4G access at no additional cost, plus increased data allowance). This makes it difficult for Bouygues to improve its 4G pricing. The ongoing difficult trading conditions make us bearish on the French telecoms space in general.</p>

Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

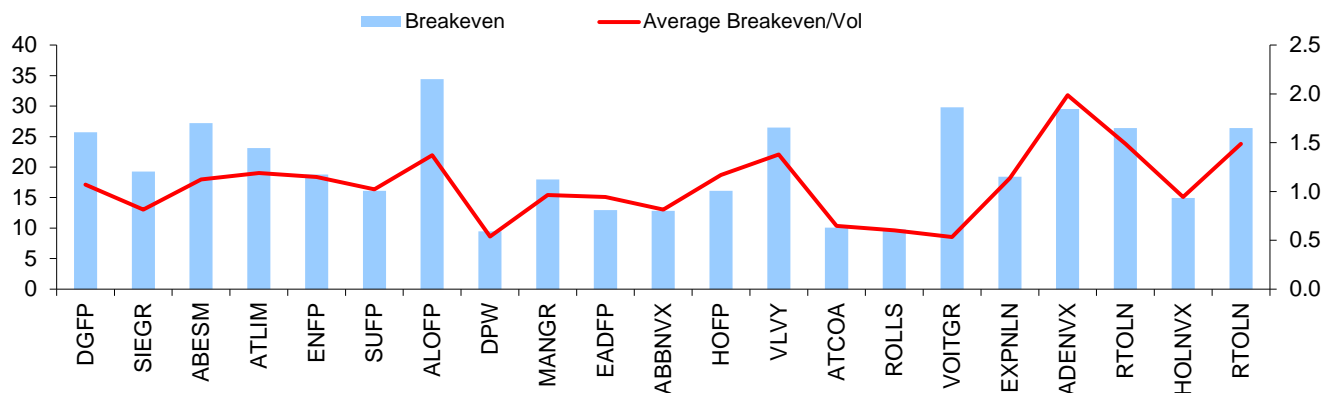


Figure 24. CDS 3mth Trading Range by Sector (bp)



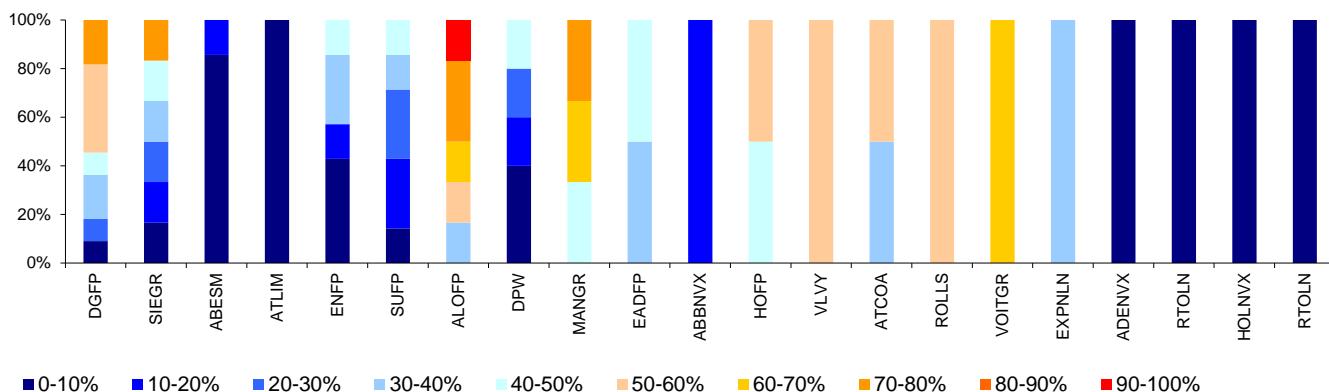
Source: MarkIt, Citi Research

Figure 25. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 26. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Oil & Gas: underweight

### Maintain underweight on Oil & Gas

Oil & Gas is very wide to the iBoxx; however, we find it hard to see positive catalysts on the horizon for now. We remain underweight.

### The outlook for energy prices remains subdued

Citi has recently [downgraded](#) its forecasts for Brent prices from \$107.5/bbl to \$97.5/bbl for 2014 and from \$102.5/bbl to \$92.5/bbl in 2015, reflecting a deteriorating supply picture and lower geopolitical risks. Our equity analysts also downgraded their EPS forecasts for European oil companies by around 10% in 2014 and 11% in 2015, well below consensus.

### Oversupply and competition from alternative sources of energy will likely continue to weigh on oil & gas

European companies are suffering from a number of competitive pressures. The importance of renewable energies is increasing, especially in Europe. Longer term, the use of fracking technology also in Europe could also put pressure on gas prices. The outlook for European refiners continues to be challenged by strong competition from US and Asia and oversupply; however, in spite of deteriorating supply/demand dynamics, most companies have been slow at cutting production, so we expect more rationalization and market consolidation to come in 2014.

### Capex still looks too high

The capex commitments of the oil industry as a whole remain high and sticky, eating on average [up to 90% of cash flow](#). True, some companies are starting to ponder a capex slowdown, but on average Citi still expects a capex growth rate of about 3%. Apart from few exceptions (Shell, Total), it seems like the industry is adapting very slowly to an environment of subdued oil prices.

### The winners should be the low-cost producers

In a scenario of subdued oil price growth, we think the relative winners will be the low-cost producers like Repsol and BG, but these are already fairly valued, in our view.

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#### Figure 27. Oil and Gas Picks and Pans

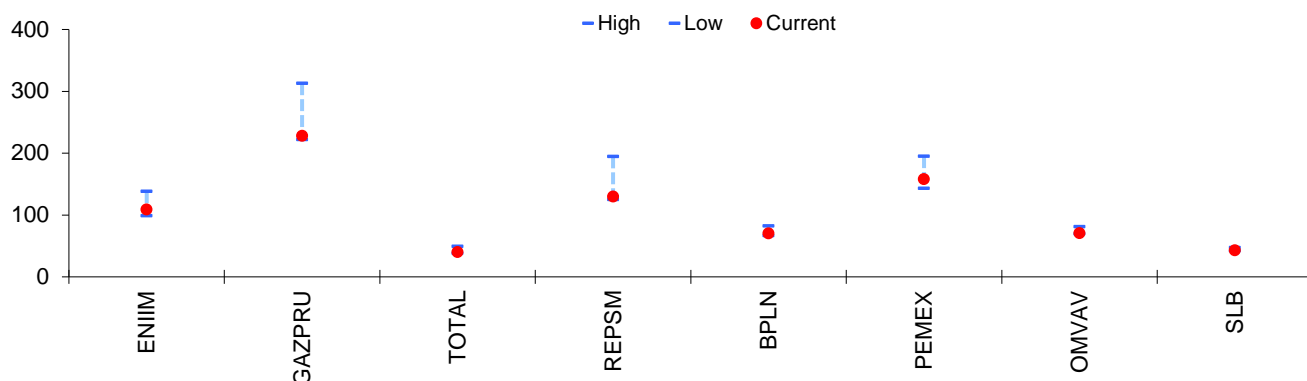
Pans	<p><b>OMV:</b> Seems tight given operational challenges. Refining and petrochemical margins are weakening. The company is divesting some assets, but recent acquisitions will require additional capex in an uncertain scenario for the newly acquired assets.</p> <p><b>ENI:</b> the recent profit warning of Shell is a reminder of the challenging situation the refinery business is facing. About 45% of revenue at ENI comes from refining. Moreover, the company faces several production problems in Africa, and Italian gas margins are likely to weaken. Although the Upstream business remains strong, the Downstream business is generating negative cash flows. Our <a href="#">equity analysts</a> believe the market is underestimating the challenges this line of business poses to ENI.</p> <p><b>BP:</b> The last earnings release was relatively positive. Yet we remain underweight as net leverage is slightly up and the asset sales the company is planning will be mainly used to reward shareholders. Also the dividend has been increased. At a level around 40bp, CDS spreads seem to us too tight. Bonds were better value after the widening between September and November, but the December rally has left spreads at uninspiring levels again, in our view.</p>
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Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

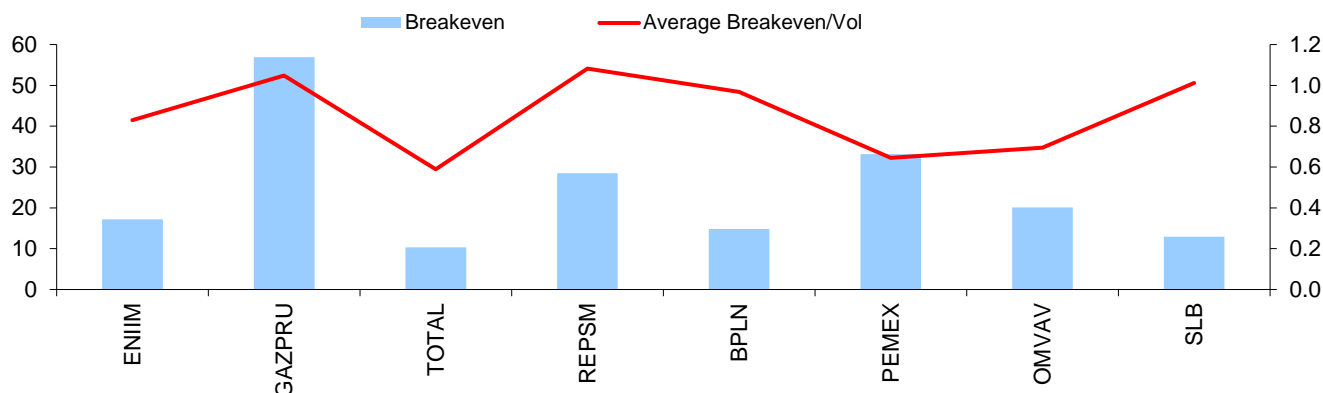
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Figure 28. CDS 3mth Trading Range by Sector (bp)



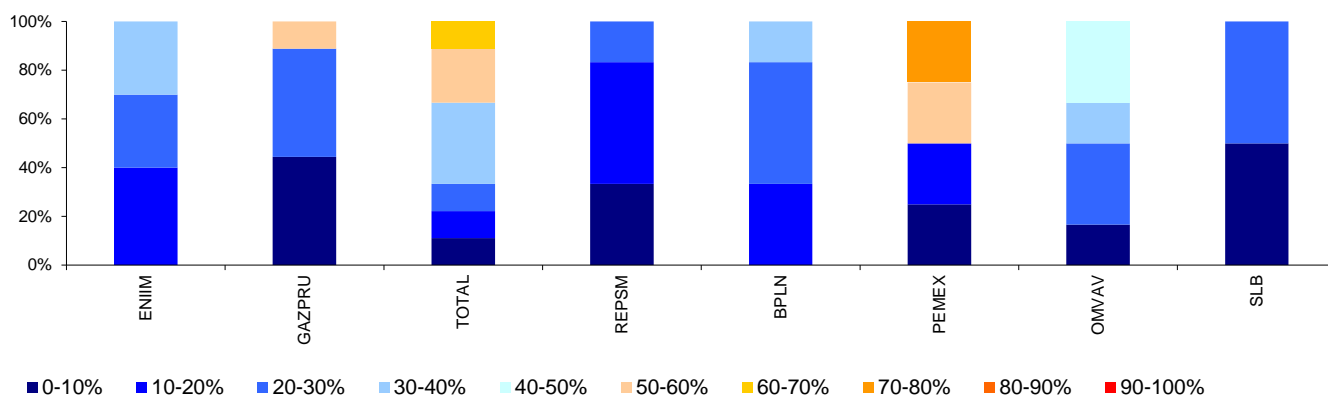
Source: MarkIt, Citi Research

Figure 29. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 30. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Technology: small underweight

**Move to a small underweight on Technology**

**The sector will likely experience moderate growth in 2014, but it looks priced in already**

**Revenues at Ericsson are likely to be flat next year, CapGemini maintained its FY guidance, but bonds are very tight**

We like the strong fundamentals of this sector and we don't see negative catalysts that would turn investors bearish. But, after the December and January tightening, levels look uninspiring. We would move moderately underweight. This sector is cyclical and most of the bonds mature in or after 2020, but spreads are now the second-tightest in the market after Healthcare.

[Hiring](#) in the software sector in US keeps increasing, led by R&D, suggesting that companies see growth coming from product expansion. Oracle sales came out in line with consensus in December and the company is pursuing minor acquisitions. Sales and marketing expenses offset the slight revenue upside we saw in its last earnings release, but the 12c database solution could provide some revenue upside. Microsoft is still looking for a new CEO, but revenues are stabilizing, owing to the positive performance of enterprise products. But these improvements look priced in already. The same can be said for ASML: its [demand prospects](#) remain positive, in our view; however spreads at their historical tightness do not look very inspiring.

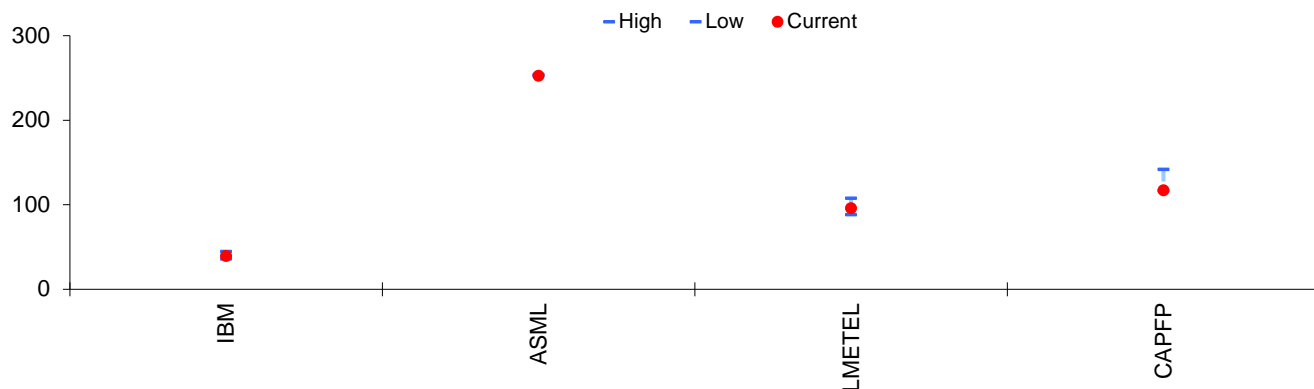
Ericsson has been experiencing an increase in demand last year due to the needs of the telco industry to update its European network. But our equity analysts believe revenues will be flat at best next year, due to tough comparables. Ericsson faces also a very competitive pricing environment. We acknowledge that the scarcity of the bonds and the relative illiquidity of the CDS might make it hard to express a negative view, not least because of its very strong balance sheet, but we would be cautious on this name at current levels. CapGemini maintained its full-year guidance at its last sales and revenue release in November. But spreads close to their 2-year tightness look uninspiring.

Figure 31. Technology Picks and Pans

Pans	Ericsson: We acknowledge that the scarcity of the bonds and the relative illiquidity of the CDS might make it hard to express a negative view on this company, not least because of its very strong balance sheet, but even after the underperformance of October and November, current levels seem too tight versus its recent history, given that the growth prospects for this company into 2014 do not look very inspiring. We would be underweight the bonds. CDS is also quite tight versus its history and we don't find the risk/reward very inspiring.
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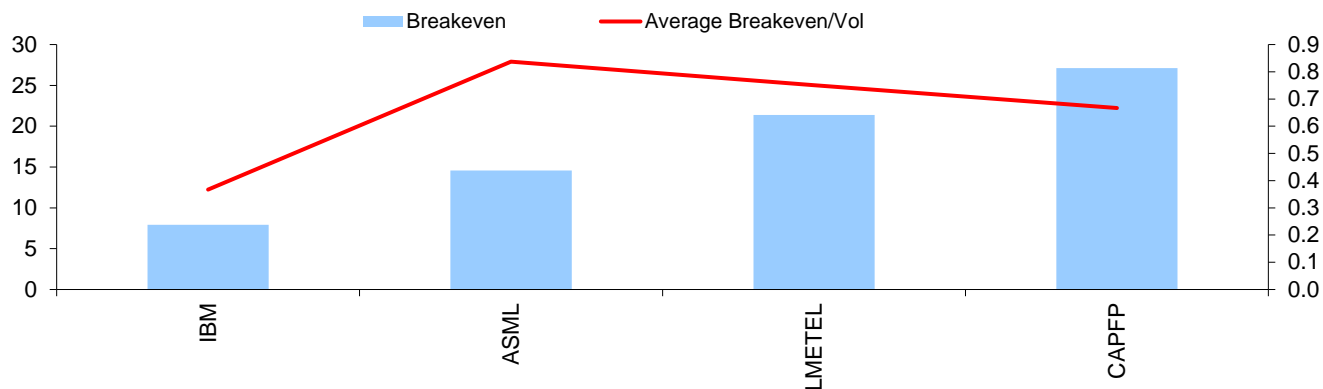
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 32. CDS 3mth Trading Range by Sector (bp)



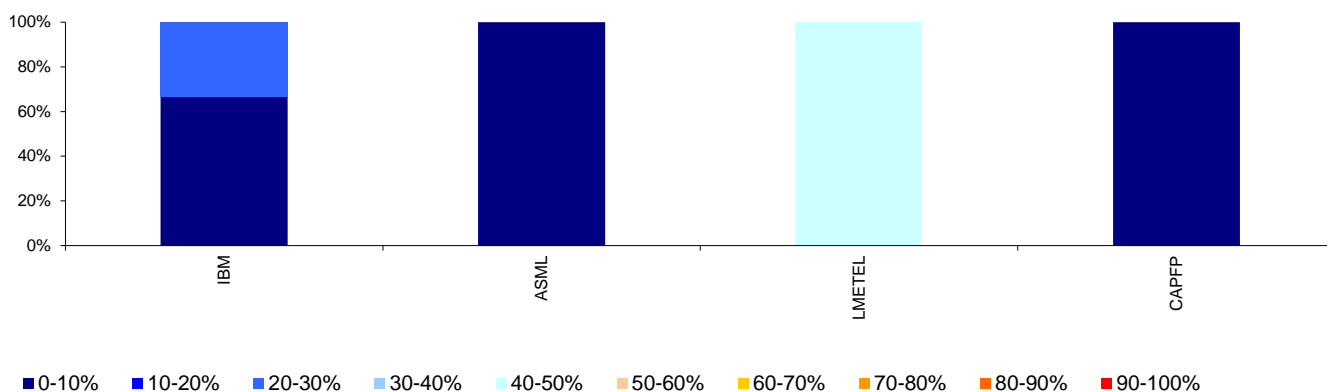
Source: MarkIt, Citi Research

Figure 33. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 34. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Telecoms: small underweight

**Telcos trade at similar spreads to Utilities on average, yet risks seem higher**

The recent exclusion of Telecom Italia from iBoxx caused the average spread on telcos to drop substantially, providing a more realistic picture of the relative value this sector offers, in our view. And all things considered, we believe it is not a great value proposition, especially when considered versus Utilities, which is coming to terms with structural problems through deleveraging and disposals, and where M&A risk is less evident. Yet the two sectors trade at similar spreads.

**The sector is still challenged**

From a fundamental perspective, we still don't feel confident with telcos as a whole. Although the modest cyclical upturn is likely to improve consumer telephone spending, competition remains stiff, and we expect revenue growth to remain subdued at best. The need to maintain market share and differentiate offerings is putting upward pressure on capex; however, competitive pressures on pricing make it very hard to monetize these investments, so it is hard to expect them to drive revenue growth. Given telcos' limited financial flexibility, we see the possibility of additional equity and hybrids issuance, especially from KPN, Telekom Austria, Telecom Italia and Telefonica, as one potential relevant support.

**Consolidation is a long-term positive, but event risk is high**

Against the fundamental challenges, consolidation is a medium-term positive, especially for the weaker players, which are suffering disproportionately from competitive pressures. For instance, in Italy a potential acquisition of Wind by Hutchison Whampoa (recently the press reported inconclusive talks between Hutchison and Wind's parent company VimpelCom, although the companies in question have not commented), would be a positive also for Telecom Italia, in our view, because the elimination of a market player would reduce competitive pressures. Less competitive markets might be beneficial for telcos, but we worry that M&A activity could weigh on spreads, especially given limited financial flexibility within current ratings and valuations and easy access to debt.

Moreover, we are concerned that in a context of easy access to debt, the incentive to reward shareholders rather than bondholders remains even though credit metrics are under pressure from weak or negative EBITDA growth. For this reason, we prefer to maintain a small underweight on the sector as a whole.

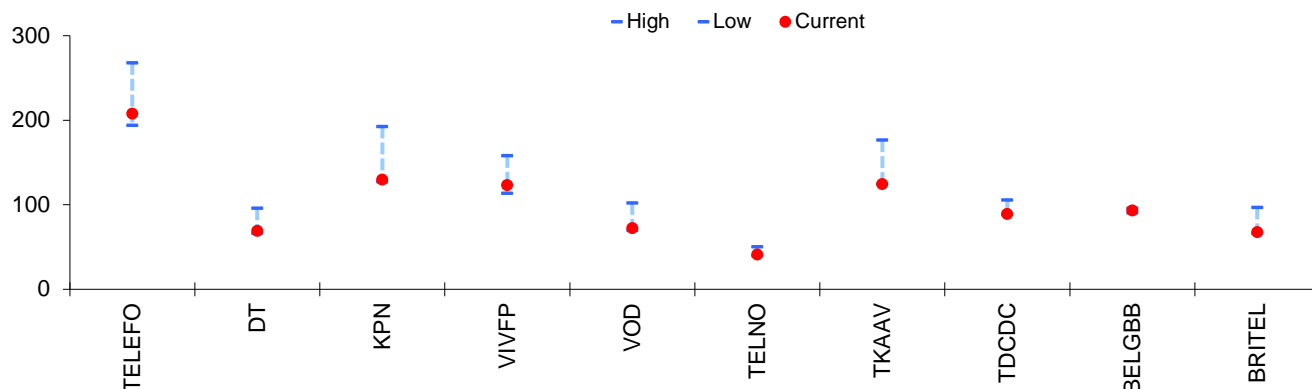
We move to neutral on BT. We still like the company, but the bond is very tight to its history.

Figure 35. Telecommunications Picks and Pans

Picks	<p>Oi: Spreads tightened remarkably over December, and we think it is time to start reducing our overweight on the € bonds, especially if they keep rallying. We are not particularly concerned about the company: we still think the merger with Portel is positive, and we don't see imminent threats in the short term, but we think that the fact that Brazil will have an election later this year and the current unrest are might dent sentiment. We find better value in the \$ bonds.</p> <p>KPN: We still find value in KPN hybrid bonds. The company has cut capex guidance and is engaging in disposals. Moreover, AMX's commitment to KPN is likely to continue, according to management's comments. Another bid cannot be excluded. The approval of the E-plus sale is another tailwind. Management sounded upbeat on KPN's business prospects, which is likely to help sentiment.</p>
Pans	<p>Orange (France Telecom): Remain underweight. Revenue trends are likely to remain weak, as the <a href="#">price war with Free</a> in the French market intensifies. Competition with Free remains fierce also in Belgium and Poland. We think it is <a href="#">unlikely</a> that operating cash flow (EBITDA-capex) will stabilize in 2014 and that net debt/EBITDA will decrease to 2.2x as suggested by management. Cost cutting measures are unlikely to be enough to offset this, in our view.</p> <p>Belgacom: Remain underweight. Its last results showed positive trends in mobile additions, but we see a risk that the company <a href="#">increases leverage</a> to pay dividends, and some uncertainty regarding the strategy of its newly appointed CEO. The market is also extremely competitive in Belgium and although Belgacom's market position is good, we think aggressive pricing could damage its profitability. We are worried that this is not adequately reflected in spreads still close to their 2-year highs.</p>

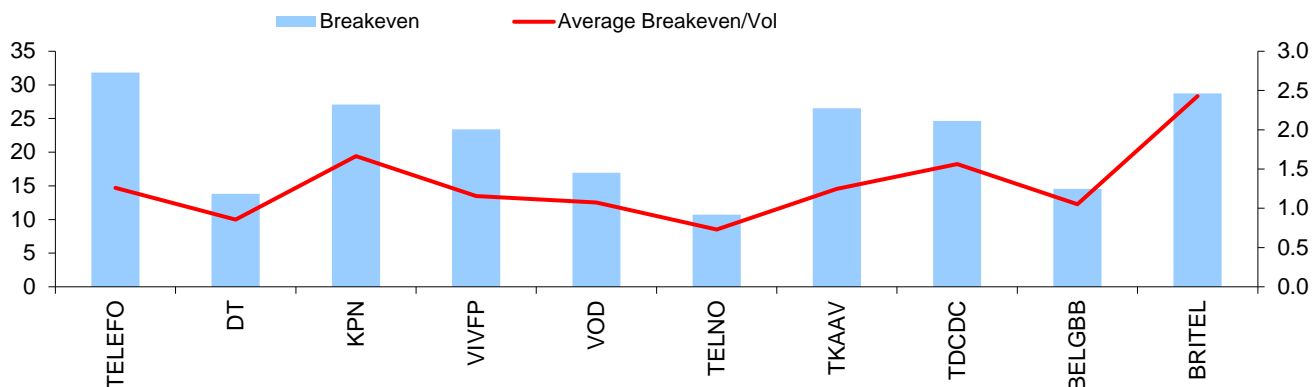
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 36. CDS 3mth Trading Range by Sector (bp)



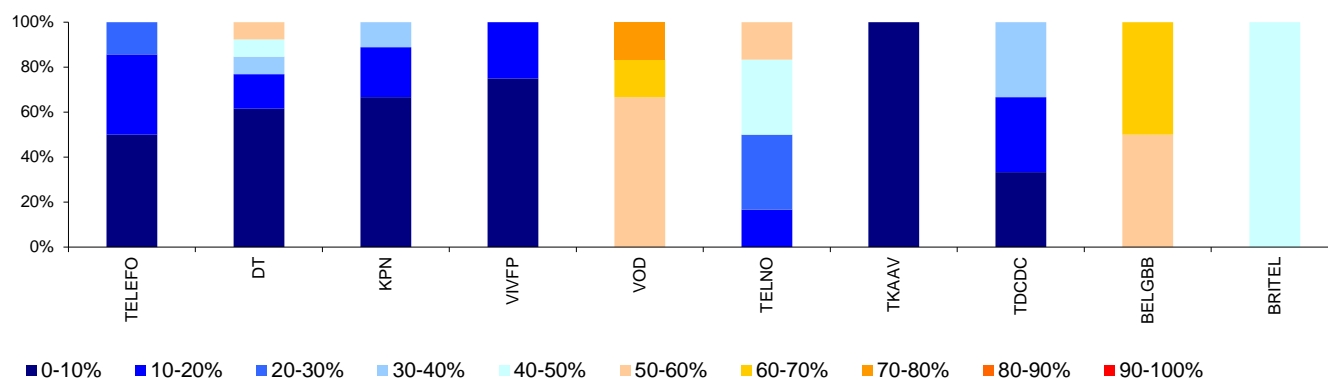
Source: MarkIt, Citi Research

Figure 37. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 38. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Utilities: neutral

### Remain neutral in Utilities

Utilities have been one of the best-performing sectors over the last six months, owing mainly to the high beta bonds in the sector, i.e. hybrids of core utilities and in peripherals. Senior bonds of core utilities continue instead to underperform, and we remain negative on them. Overall, we remain neutral.

### Structural and regulatory challenges

In part the divergence in performance reflects the market's appetite for beta, but there are also some more fundamental reasons. All utilities face the same problems across Europe. We expect demand to remain weak. This is due in part to the anaemic economic recovery in Europe, but there are also structural reasons at work, i.e. increased energy efficiency and oversupply. Regulatory intervention, in the form of taxes and price controls, are also real challenges to Utilities' cash flows.

### Peripheral utilities are deleveraging more aggressively than core names, but this is starting to be reflected in valuations

However, peripheral companies have been more conservative and proactive than core utilities in cutting their capex and managing their leverage. This, together with reduced sovereign risks, has allowed these companies to access the market at relatively low costs and to maintain a strong liquidity, and supported their outperformance. Looking forward, however, company-specific drivers are likely to become more relevant. For instance, we would prefer Gas Natural to Iberdrola because the latter is more exposed to the Spanish tariff deficit and is more dependent on renewables, a sector that has seen state subsidies heavily curtailed. Another example is Terna: the company looks in good shape, but it is trading close to core and higher-rated companies like RWE. We recommend switching any long in this company into RWE, which is actively deleveraging. Among the other peripheral companies, we would be more cautious on [A2A](#): leverage at this company is increasing due to a remarkable contraction in EBITDA, as weak electricity prices in Italy have been only partly compensated by an improved hydro output and we think management efforts might not be enough to mitigate this.

### Financial conservatism will continue next year

Financial conservatism will continue to be a key topic next year, especially for peripheral companies. We are likely to see more equity issuance and asset disposals, and we don't expect transformational M&A in this sector. We find it more unlikely than for other sectors that these companies could re-leverage to pay dividends, at least for the remainder of 2014. We also expect more hybrid issuance, which could offer a good entry point to this sector this year.

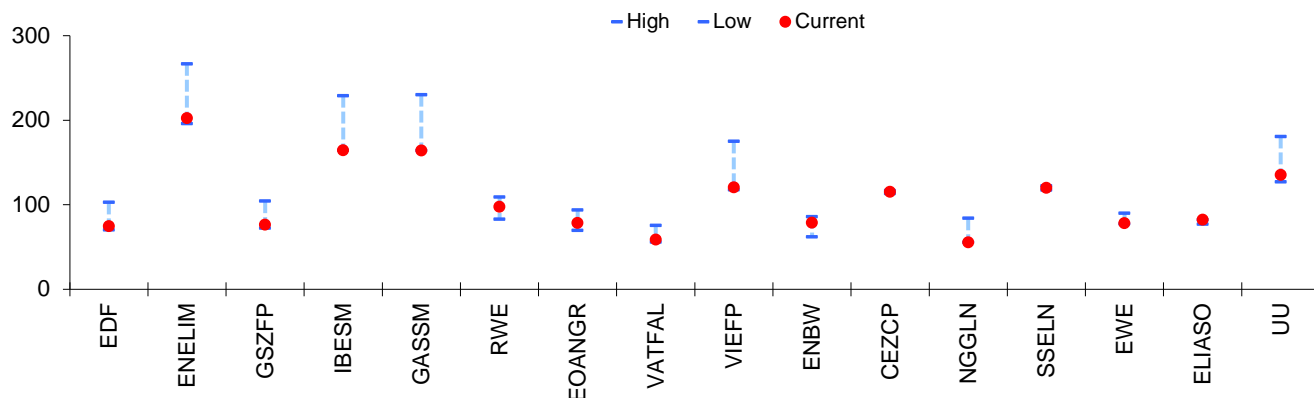
Figure 39. Utilities Picks and Pans

Picks	<b>Peripheral Utilities:</b> The cost cutting and de-leveraging process that has been dominating peripheral utilities in 2013 looks set to continue. We see cost cutting continuing at Enel, Red Electrica and Iberdrola. The low cost environment should also support moderate capex expenditures, leading to improved efficiency. Although demand is likely to be subdued, especially in peripheral countries, the low inflation environment is favourable to utilities because it reduces regulatory pressures, which have been quite significant so far. Regarding <b>Italian Utilities</b> , we <b>remain constructive on Enel</b> , where we see further cost reduction in the form of capacity reduction and rationalization of production, although there is some downgrade risk depending on the impact of the Spanish Energy Reform. The company benefits from good liquidity and a favourable maturity profile. At current levels, however, we close <b>our overweight on Terna</b> : this company is strong, but Terna is likely to be more affected by declining power prices than other Italian utilities, and valuations do not look compelling to us. For investors willing to maintain exposure to the periphery, we think <b>Gas Nat is a better alternative</b> . Its exposure to the Spanish tariff deficit is relatively modest compared to Iberdrola, and its EBITDA trends remain resilient. The upcoming gas market reform in Spain poses some risks but we think they will be manageable. We also like <b>EDP</b> : its commitment to deleveraging, capex cutting and its favourable earnings trends paint a supportive picture for this company's bonds. The increase in net debt we saw at its Q3 results was due mainly to an increase in its regulatory receivables, something the company is committed to reducing. Its exposure to the Spanish Energy Reform might pose some risks, but we would add to positions on any spread weakness.
Pans	<b>E.ON:</b> The company has shown a strong commitment to deleveraging by almost completing its deleveraging plan. However, the decline in earnings is material and unlikely to revert for now, in our view. Spreads remain among the tightest in the space, in spite of their underperformance versus the iBoxx recently. We expect this has further to run. <b>RWE</b> seems a better alternative to us, especially as the planned sale of Dea could provide a positive catalyst. <b>Fortum:</b> Spreads have been rallying hard after that the company announced the sale of its Finnish distribution division for €2.55bn, above market expectations. More asset sales are likely in Norway and Sweden. Management indicated that proceeds will be used to repay debt. In light of this, we would reduce our underweight on the longer maturities, but the shorter ones seem priced for perfection, and we remain underweight. The earnings outlook remains quite weak, in our view.

Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

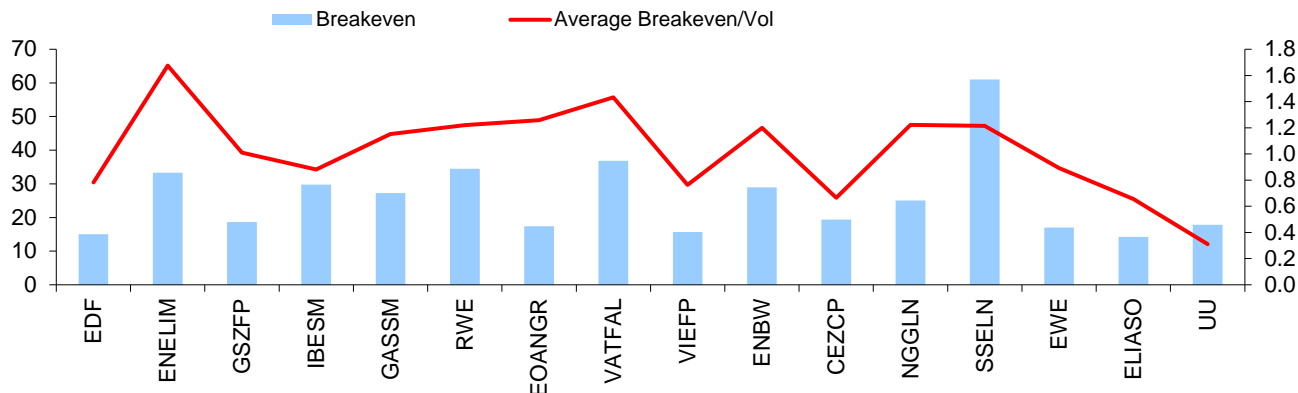


Figure 40. CDS 3mth Trading Range by Sector (bp)



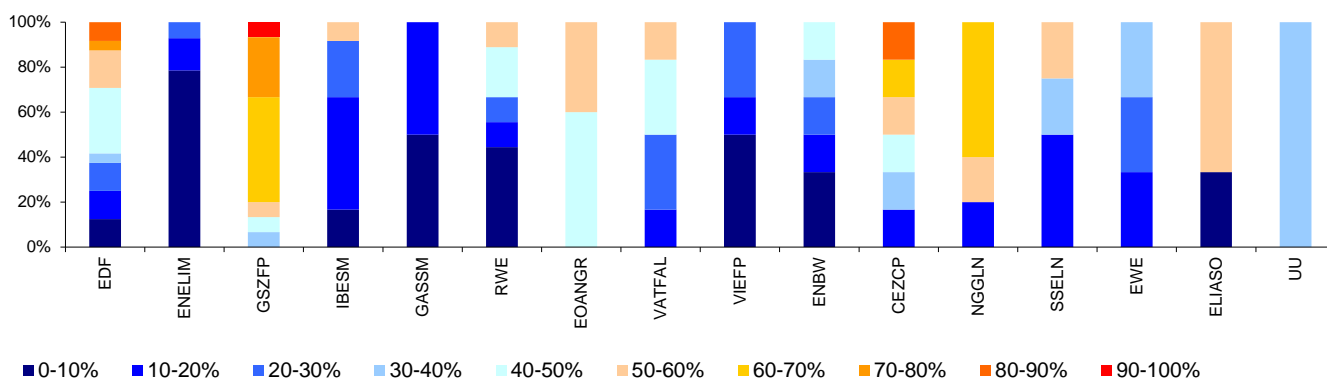
Source: MarkIt, Citi Research

Figure 41. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 42. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Banks: small overweight

### Move to a small overweight on Banks

Over the last month, Banks have slightly underperformed the market, due mainly to the lower-beta bonds. Subordinated bonds and peripherals, instead, have performed strongly versus the iBoxx. We move to a small overweight in this sector, by looking to add exposure in the new AT1, maintaining our overweight into T1 and LT2 and covered bonds and remaining underweight senior bonds.

### Core banks will likely strive to expand revenue and profit growth

In general, we expect deleveraging to continue, but at a slower pace than in the last few years. With a mild recovery now on globally, we expect the healthier banks from US and Europe to focus on expanding revenue and profit growth, both organically and through acquisitions, particularly in North America and Asia. We see this being driven mainly by the need to expand, rather than taking advantage of low valuations. Profits are likely to be boosted by resurgent IPO activity, bond issuance and loans, as well as progressively improving asset quality and net interest income.

### Peripheral banks will still be exposed to weakening asset quality

The outlook for peripheral banks is more complex, in our view. Weakening asset quality and slow loan and net interest income growth will continue to afflict them, with negative implications for their capital base and profitability. High unemployment, a sluggish recovery and real estate markets still under pressure remain significant issues. However, Spanish banks look to us comparatively better positioned than Italian banks in terms of asset quality trends: our equity analysts believe that Spanish asset quality deterioration should stop in 2015. We would take advantage of this by selectively going overweight on CaixaBank, BBVA and Santander. The situation of Italian banks is, however, more difficult, due to a higher proportion of corporate loans versus consumer and comparatively [worse economic growth prospects](#) for the next couple of years. Uncertainties remain over the stress test methodology the ECB will use, especially as regards the treatment of sovereign exposures; however, we expect it to be milder than the US CCAR.

### Prefer covered bonds to senior in the periphery

In light of these risks, we still prefer covered bonds to senior in the periphery. Although they have outperformed senior over the course of last year, the spread differential is still too small to induce us to ignore the relative safety of covered bonds vs. senior, especially given the bail-in provisions included in the RRD.

### Focus on primary market to get exposure to new junior bank capital

Capital optimization will remain in focus next year as the new Basel III requirements are phased in. We expect banks to carry on LMEs as needed to replace non Basel III compliant issues, but valuations suggest to us most of this has been priced in, leaving opportunities just in the more illiquid bonds. That said, we would hold on those Italian and Spanish old-style capital securities in anticipation of LMEs. We think the primary market for Basel III compliant issues could provide a better way to get exposure to junior capital. Judging from the reception of the recent ACAFP T1 bond, we think the market will absorb primary issuance of the new capital securities with no major difficulty.

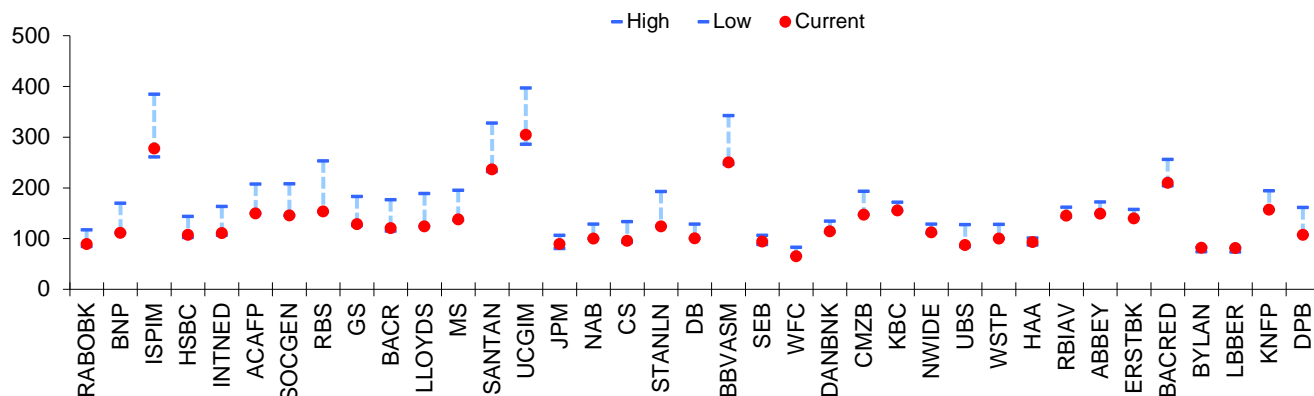
We close our overweight on BNP Paribas. We like the company fundamentals, but spreads look in line with their long-term history and do not seem to offer compensation for the weakness we are seeing in the French economy.

Figure 43. Banks Picks and Pans

Picks	<p><b>Morgan Stanley:</b> Remain overweight on MS, as its ongoing de-risking strategy progresses: we wouldn't be surprised to see it trading inside GS once its repositioning is completed. The fact that S&amp;P is keeping Morgan Stanley on Negative outlook ahead of the implementation of the Volcker rule is not a major concern to us in light of its de-risking strategy: we don't expect spreads to react significantly to a downgrade related to this issue. Another driver of the rating is the progress on the Ordinary Regulatory Authority: as for other US banks, we might hear more comments from the rating agencies as more details are released by the Fed. But we think that both the market and the rating agencies have come to terms with the fact that government support is likely to be much less than before.</p> <p><b>JP Morgan:</b> <a href="#">We like the LT2 bond in particular, which seems cheap to Goldman Sachs' LT2 bond</a>, in spite of the higher ratings and lower business risk. Its last results were just slightly ahead of consensus: however, the high number of litigation and other one-time charges may have negatively affected sentiment. Our equity analysts see potential for strong growth in 1H14; therefore we see its relative underperformance at the T2 level as a buying opportunity.</p> <p><b>Barclays:</b> we like the \$-denominated T2 CoCo and we expect the company to issue more Basel III compliant issues, which may offer a good entry point to get exposure to this bank. We think the way CRD IV will be implemented in the UK, i.e. by allowing AT1 to be included in the numerator of the leverage ratio and to adjust the exposure measure (i.e. the denominator of the leverage ratio) for initial and variation margins, will help Barclays achieve the 3% leverage ratio, which is a positive. Barclays is also making progress on asset reduction and on capital.</p> <p><b>Lloyds Banking Group:</b> Although the bonds have rallied a lot over the last six months, we remain overweight, as sentiment on Lloyds is likely to remain positive. Many bonds are still trading at levels similar to Barclays, while they should trade inside, in our view, given the lower risk profile of the business. In CDS, this has already <a href="#">happened</a>. Lloyds is continuing in its deleveraging process, net interest margins are improving and we think we will continue to see consensus upgrades on this name.</p> <p><b>KBC:</b> Capital levels at KBC are progressively increasing. The company will likely <a href="#">repay all the state aid</a> by the end of 2014. The EC embargo on calling bonds expired on the 31<sup>st</sup> December, opening up new opportunities for capital management exercises. This is why <a href="#">we like the T1 bond</a>. However, the trade might take a bit of time to perform, as the company may opt not to call any bonds during the AQR.</p> <p><b>Larger Spanish Banks:</b> Our economists are marginally more positive on the economic prospects for Spain than for Italy. According to our equity analysts, Spanish NPLs should peak in 2015E. Moreover, their profitability seems to be improving, owing to higher loan yields and (mostly) lower deposit costs. In contrast, we expect Italian asset quality deterioration to remain a concern in the next couple of years. We think <b>BBVA, Santander, and Caixa Bank</b> are the best Spanish banks to reflect these improved trends: their capital positions are strong. We expect more LMEs and new issuance in the new capital securities space. While the rally in old-style securities we have seen recently suggests that LMEs have probably been priced in, <b>we would look with interest at new issuance of capital instruments from these banks.</b></p>
Pans	<p><b>Smaller Spanish and Italian banks:</b> The difficulties the Italian and Spanish economies still face make us uncomfortable with the smaller players in these economies. We believe asset quality and profitability will remain under pressure in the near future, counterbalancing the deleveraging efforts of these banks. For this reason, although we do not expect the upcoming AQR to pose systemic challenges to the European banking system, we think the weaker peripheral players are most at risk. In terms of seniority, we find the senior bonds particularly uninspiring, given tight valuations and bail-in risk. <b>We maintain our neutral on the Italian larger players.</b></p>

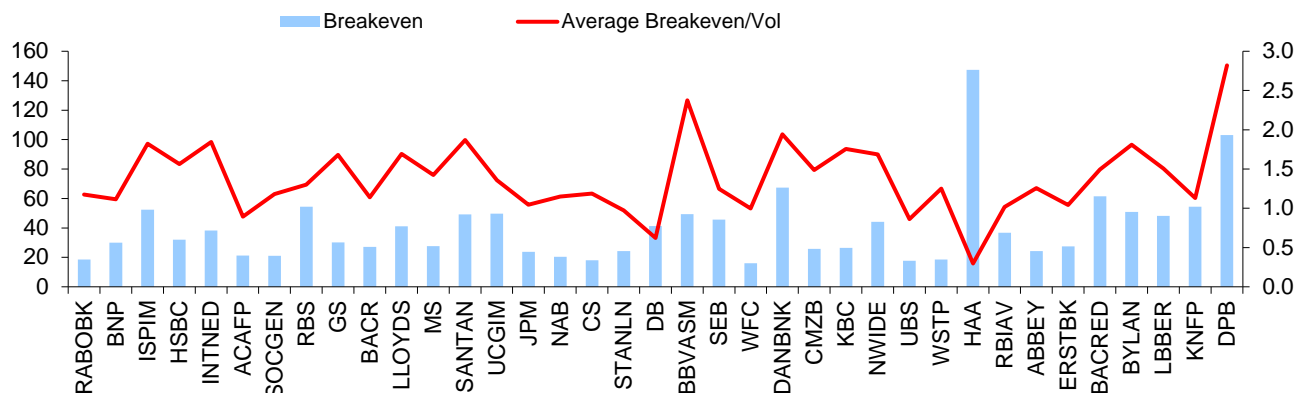
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 44. CDS 3mth Trading Range by Sector (bp)



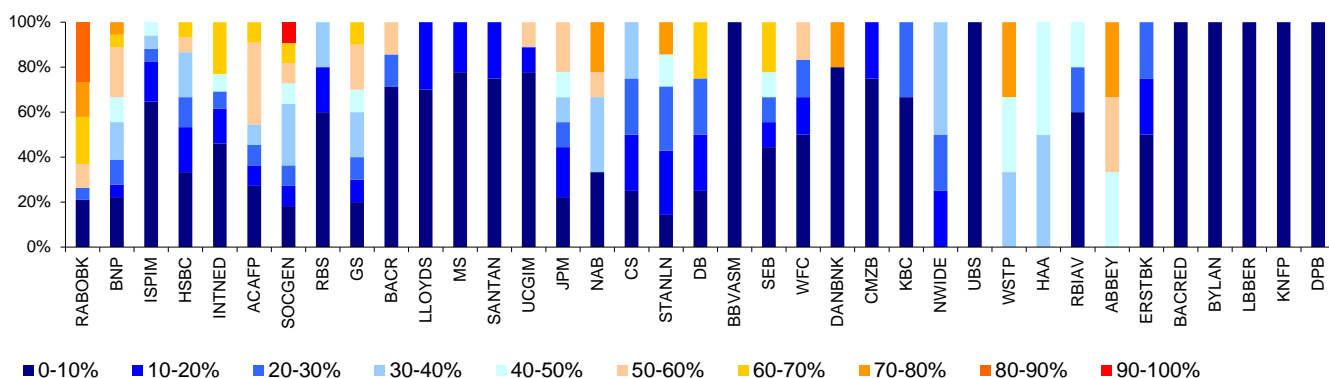
Source: MarkIt, Citi Research

Figure 45. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 46. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

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## Insurance: small overweight

### Reduce overweight on Insurers

Insurers continued to outperform the iBoxx last month, reaching spread levels last seen in early 2008. Given their high-beta nature, we would expect spreads to perform further in a risk-on environment. However, with investors very [long](#), we find risk-reward less and less compelling here. We advised investors to start scaling back positions at the margin in our November issue, and we recommend continuing to do so.

### We think Insurers are in better shape than Banks

It's not that we have particular fundamental concerns. Although Insurers [look slightly expensive](#) relative to Banks at the moment, we think they are in much better shape. The credit metrics of the sector remain strong and we see room for further improvement. Profitability should rise further, owing to prudent underwriting and strong pricing trends. Rising investment rates are likely to have a positive effect on the asset quality and returns of insurers' portfolios. The low yield environment has indeed pushed many of them into illiquid and riskier assets. Compared to other insurers, the life insurers will see less of a benefit, as they will have to contend with competition from other savings products. However, as long as the rise in interest rates is gradual, they should have the flexibility to adjust to the new environment.

### Sovereign risks are decreasing, but downgrade risks are still relevant

Sovereign exposure is less of a problem for insurers than for banks, but sovereign-related downgrades remain a risk: for instance, S&P recently revised its criteria on rating corporates above their own sovereign rating, introducing a sovereign default stress test on the corporates. This led the rating agency to place Generali on credit watch negative. In the event Generali does not pass the stress test, its senior S&P rating would be capped by Italy's sovereign rating, likely implying that the subordinated bonds would be downgraded to high yield and leave the iBoxx Corp. At current spreads, we think such risk is not properly priced in, and we would prefer to wait for the end of February when S&P should resolve the credit watch. Although less liquid, at current spreads we think [SLHNVX 5.849% 29/4/49](#) makes more sense.

We also remain cautious on Dutch insurers, as the unit-linked compensation issue is not resolved yet, the Dutch economy is sluggish and Solvency 1 ratios are under pressure.

### Capital base and underwriting policies are strong

In general, insurers maintain a strong capital base and prudent underwriting policies: we think the sector as a whole is well positioned to expand. We expect both life and the P&C insurance segments to continue their expansion into high-growth areas like Latin America and Asia, where penetration rates are still relatively low.

### The implementation of Solvency II will have a minimal impact on Insurers

The long timeline for the implementation of Solvency II requirements suggests that the impact on insurers' balance sheets will be minimal.

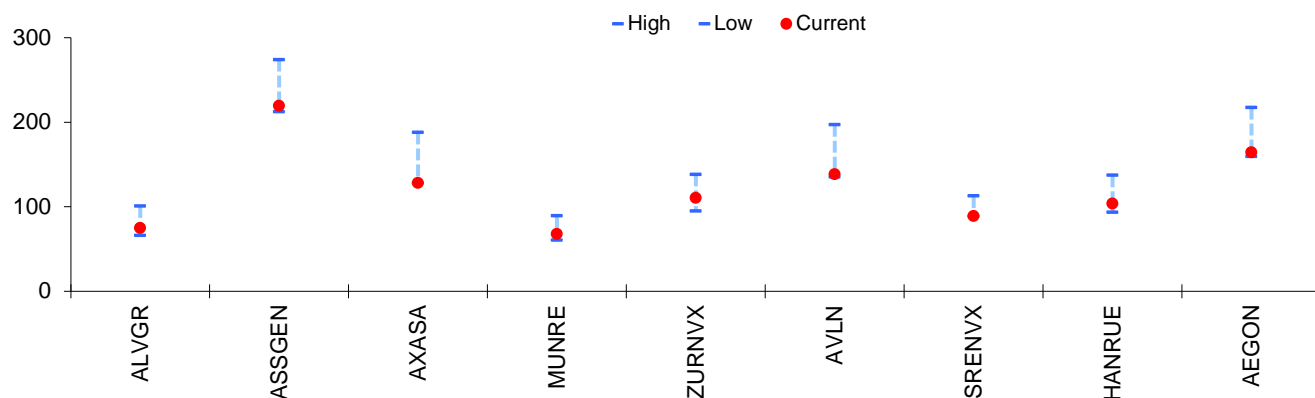
However, this outlook is increasingly reflected in spreads already and the sector has moved from being one of our favourite sectors to being a modest overweight now.

Figure 47. Insurance Picks and Pans

Picks	<b>Talanx:</b> Earnings prospects for this company remain strong and the large losses occurred in 2013 are likely to improve pricing in 2014E. It is carrying out a cost cutting program that should deliver €245m by 2016, according to <a href="#">our equity analysts</a> . Management indicated that the largest benefits of this program will be visible from 2014. The company's net income guidance for 2014 seems conservative given the strength of the business. We like the LT2 bond in particular.
Pans	<b>HanRe and Munich Re:</b> We like their strong credit metrics. But they trade very tight to history and peers. There are no negative catalysts in sight, but at current spreads we think there are better opportunities elsewhere in Financials. Moreover, we are concerned that reinsurers could face pressures on pricing, which could put pressure on ratings, according to a recent report by S&P. Low funding costs could be an incentive to enhance shareholders' return at the expense of bondholders.

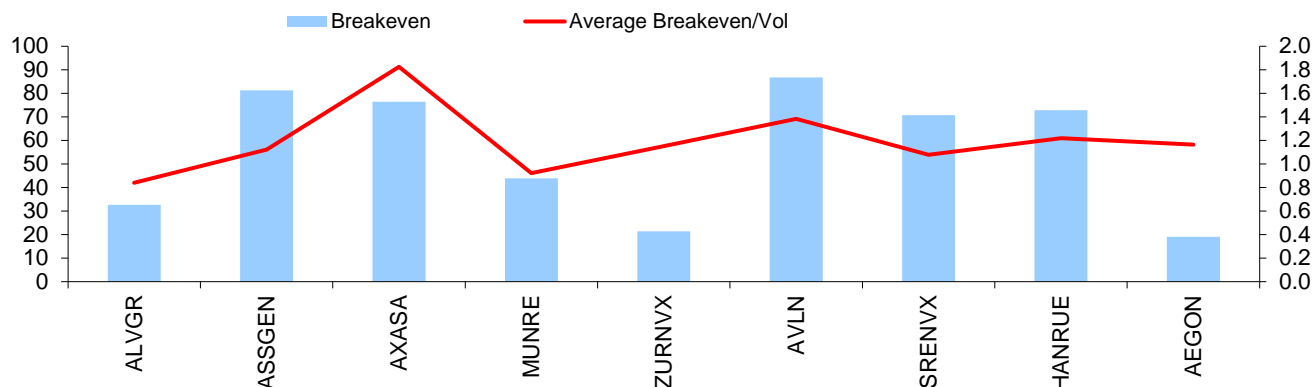
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 48. CDS 3mth Trading Range by Sector (bp)



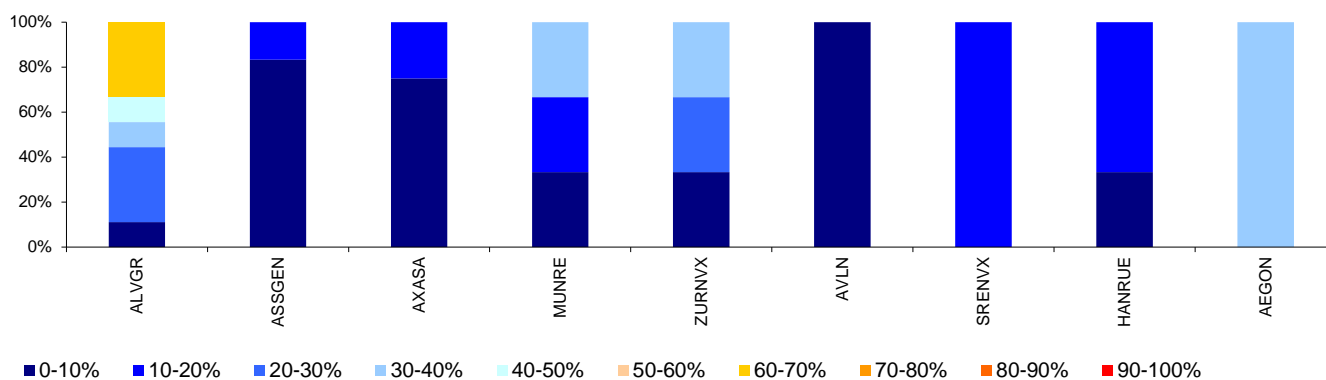
Source: MarkIt, Citi Research

Figure 49. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 50. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

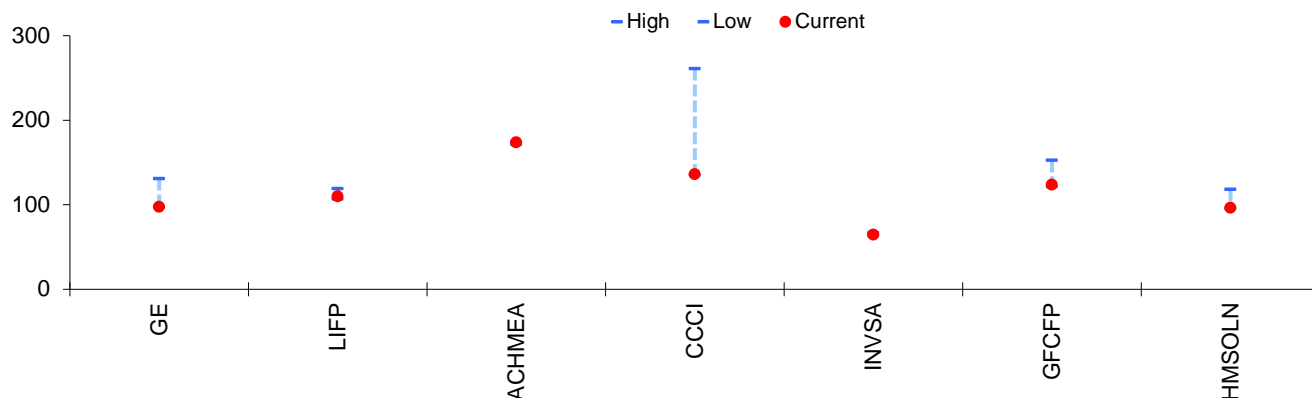
## Financial Services: neutral

### Remain neutral on Financial Services

We remain neutral on the Financial Services industry. The mild recovery we are seeing in Europe implies better prospects for real estate, supporting the current tight valuations. However, we think bond investors looking to invest this space [would do much better to](#) buy equally or higher-rated CMBS, RMBS or ABS instead: spreads trade wider, for structures that to our minds are more robust. The rest of the sector is dominated mainly by General Electric: bonds have rallied back after having widened in November and December, perhaps in anticipation of the December dividend hike. But most of the value has been realized already. Also CDS looks fairly valued.

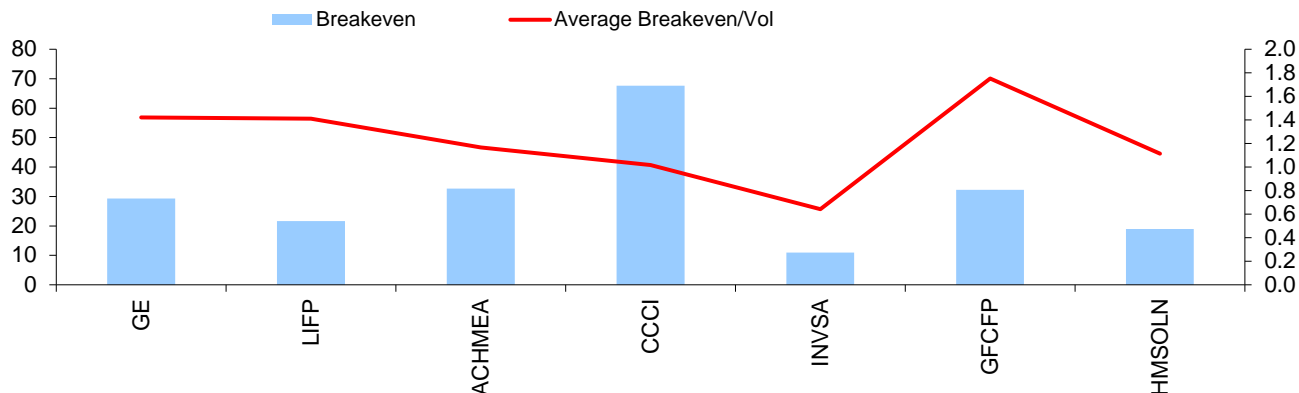


Figure 51. CDS 3mth Trading Range by Sector (bp)



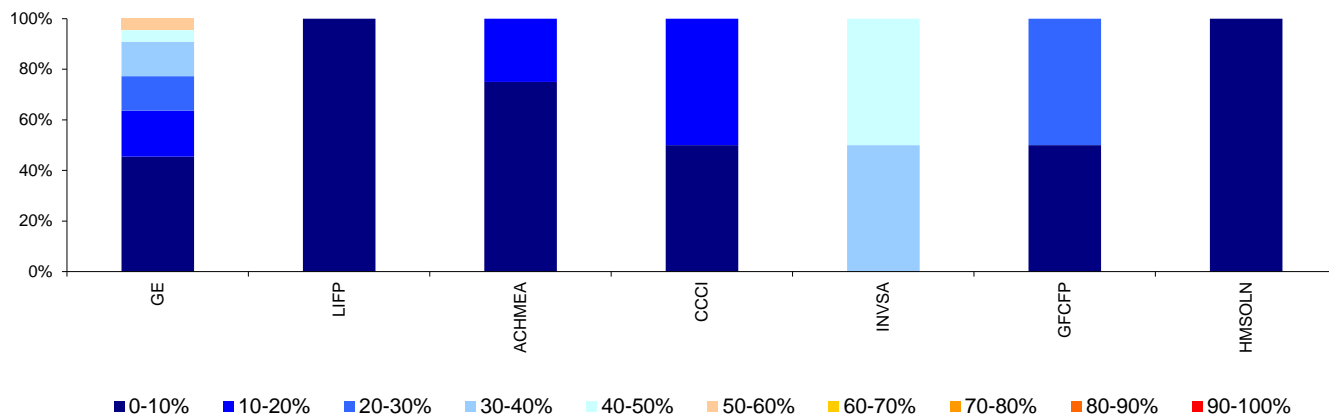
Source: MarkIt, Citi Research

Figure 52. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 53. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

**Notes**

# Appendix A-1

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