

Europe Returns

Assessing value across flow and structured credit assets

- **Chase value, not yields** — All-time low yields and little supply have made many European credit investors ignore the relative tightening across different flow and structured assets, and differences in quality of underlying security and issuers.
- **A weak banking sector and 'bail-in' risk boost appeal of secured paper** — The ongoing bank asset review and 'bail-in' risk make secured bonds such as covered and ABS, which has greater transparency, more attractive than unsecured bonds.
- **Core ABS expensive, but value in peripherals and structured credit** — Most core ABS have rallied more than flow corporate credit. However, peripheral RMBS (seniors pick-up 5-100bp over sovereign), CLOs and tranches still look cheap.
- **Asset managers to benefit from bank regulations** — Leverage ratio and liquidity measures should skew bank purchases towards senior mezz and LCR-eligible bonds (and whole loans), providing opportunities elsewhere for non-regulated buyers.
- **Structural leverage better than financial leverage** — Rising financing costs and margin calls due to potential price volatility draw us to non-recourse leverage and high-beta assets, such as CLO equity and ABS mezz, for yield.
- **Flow and structured synthetic risk should see tailwind** — We believe scarcity of balance sheet will favor synthetic trades such as CDS over cash bonds, and credit tranches, and will lead to related technicals such as cheap super-senior risk.
- **Widen asset universe** — We forecast only €75 billion of securitized issuance in 2014 but expect a rebound in peripheral ABS and CLO supply. Investors should look across assets – cash and synthetic, flow and structured – to find the best value in our view.

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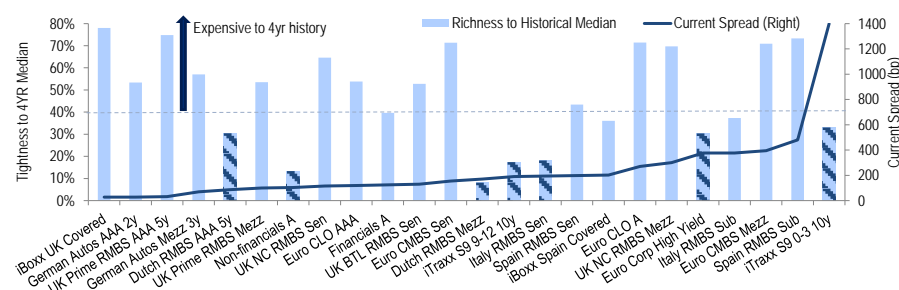
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Figure 1. Corporate and structured asset spreads (bp) and tightness to their median values over a 4-year period. Dashed columns indicate sectors that look cheap on this measure



Source: Citi Research, Markit

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

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Structured Route to Euro Recovery

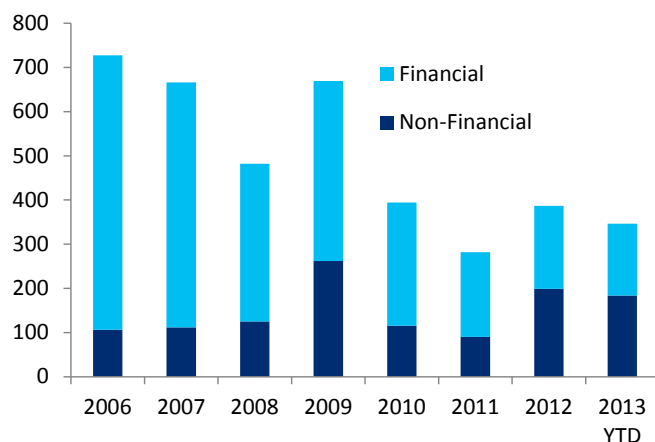
Evidence is emerging gradually of a Euro-wide - core and peripheral - recovery, albeit weak, spurring many investors to add risk at ever tighter yields. At the same time, central bank liquidity has kept investment yields low. The two main victims of the European financial crisis have been savers in core countries and borrowers in peripheral countries. The first group is seeing low returns on their investments, while the second group has been mostly shut out of access to credit. Recent outlook changes from the agencies on the sovereign ratings of Portugal and Spain show that peripheral sovereigns are at least starting to stabilize, even if the trickle-down to smaller corporate borrowers is some considerable time away in our view. Given the low yields and weak recovery, however, we believe investors need to look further afield from plain vanilla fixed income assets to meet their return targets. Moreover, new regulatory costs on banks, insurance companies and pension providers have made a significant dent in the net returns of owning structured assets. In this note, we navigate through the variety of European fixed income assets - flow and structured - to find what should be on investors' shortlist. We recognize that no one size fits all, and so we have tried to distinguish between regulated investors who need attractive returns on regulatory capital, and total-return buyers who are more driven by yields.

Supply - low and not about to recover

Cash corporate and ABS outstanding have been declining, leading to tighter asset yields

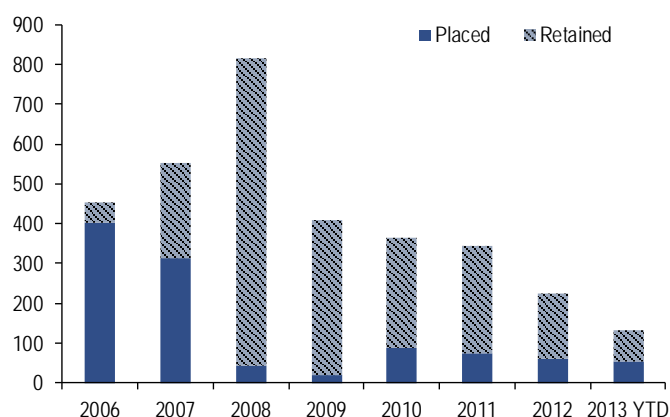
Most investors would prefer to stick to the familiar, but low yields and low net new supply of corporate bonds (*Lots of bonds, little borrowed*) are making cash investors look frequently at the grass on the other side. The alternative source of cash assets, that is, securitized products, has also been paying down. Securitized products issuance has also been affected by regulatory costs, which has made it a less attractive funding source for issuers such as automobile companies and banks. While European regulators have periodically been making positive remarks about the role of ABS in stimulating lending, most policy initiatives have made owning ABS far more expensive compared to the period before the financial crisis. Though the positive technical of low ABS and corporate bond supply keeps spreads tight, it is also frustrating for investors whose bonds are paying down, and need to find new opportunities. Buyers have to be more flexible on their choice of assets.

Figure 2. Investment-grade Corporate Issuance, 2006 - 2013YTD (€ bn)



Source: Dealogic

Figure 3. Euro Securitized Products Issuance, 2006 - 2013YTD (€ bn)



Source: Concept ABS, IFR and Citi Research

Yields – at all-time lows

With a flat credit curve, short-dated senior CLO, Dutch and Italian RMBS, and junior credit tranches look appealing

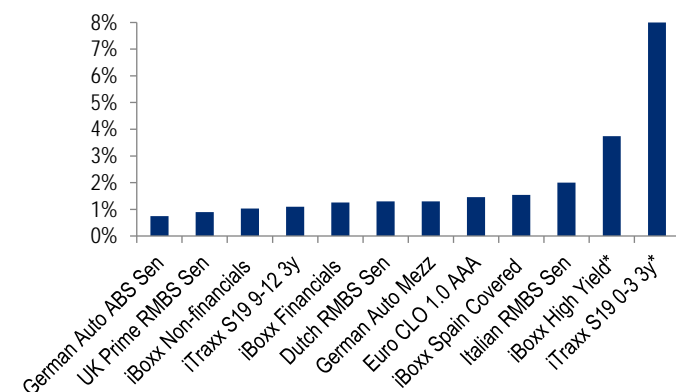
What assets should such flexible cash buyers include in their portfolio? At the same time as low issuance, and largely because of it, spreads across assets are at their tightest for the period after the global financial, and latterly Euro sovereign, crises. Moreover, the low risk-free yield environment means that total yields are, overall, much lower than the period before the crisis. The situation is particularly difficult for European insurance and pension companies that have minimum yield requirements for their guaranteed products.

Figure 4 shows the yields available on short-dated assets, across traditional ABS and corporate and financial bonds. We also include credit-linked notes backed by two iTraxx tranches (assuming that the cash collateral backing the credit tranche yields the risk-free rate). We understand that many investors are sensitive to ratings, so we indicate whether the assets benefit from investment-grade ratings. Figure 5 shows the relative yields across longer-dated assets.

As the charts show, there are opportunities to earn a pick-up over risk-free assets depending on investors' risk and return requirements. Unrated first-loss 0-3 iTraxx Main, for example, offers a high yield for short-dated risk. However, there is significant default exposure. Senior CLO 1.0 and Dutch RMBS tranches, at the low end of the risk spectrum, also offer a pick-up to short-dated peer assets and are highly rated. Investors who like secured peripheral country exposure should also include short-dated Spanish covered and senior Italian RMBS in their shortlist in our view.

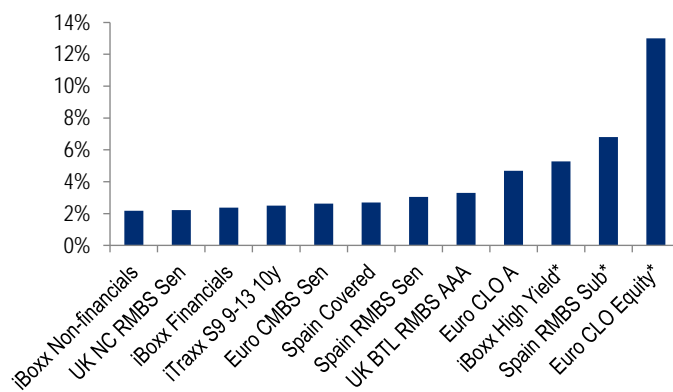
Among our longer-duration picks, we like senior UK BTL tranches for their low credit risk, and, for slightly more risk, Euro CLO mezz. CLO Equity provides attractive yield for their higher risk, which is somewhat mitigated by the European recovery. It is generally true, however, that the credit curve is quite flat and so we think there is better value in shorter-dated assets.

Figure 4. Yields across short-duration (<3yr) assets



Source: Citi Research, Markit *Below investment-grade

Figure 5. Yields across long-duration (>3yr) assets

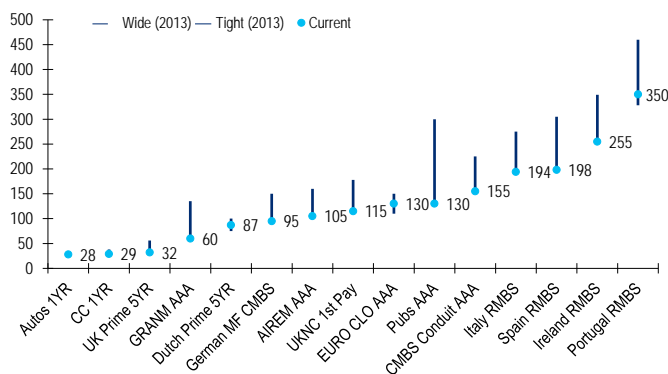


Source: Citi Research, Markit *Below investment-grade

A very few assets look cheap to history

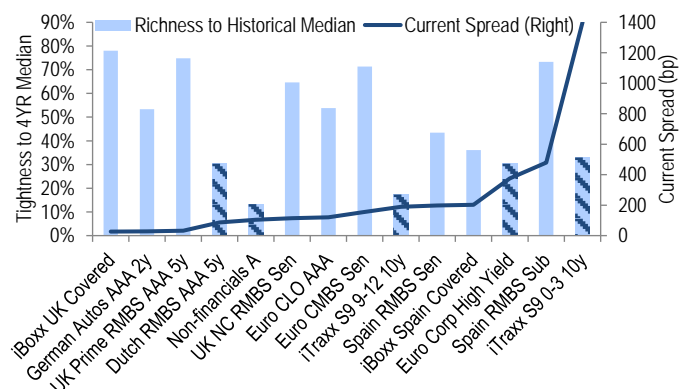
Investors should not only focus on yield, but should also consider the relative tightening across different asset classes. Most assets, as Figure 6 shows, are at their year-to-date tightness, but some still look attractively priced to a longer 4-year period (Figure 7). When we compare current spreads to median levels over the last four years, we find assets such as Dutch RMBS have more tightening potential than UK prime and peripheral RMBS.

Figure 6. Spreads Compared to 2013 Wide and Tight Levels, 2013YTD (bp)



Source: Citi Research

Figure 7. Spreads Compared to median of period between Jan 2010 and now (bp)



Source: Markit and Citi Research

While historical spread analysis is important at a time when all assets have rallied so much (and therefore an indicator of potential downside in the event of a systemic shock) we must balance relative value against fundamentals.

Prefer secured over unsecured

We think that the weak nature of the European recovery makes owning secured risk much more attractive than unsecured risk. Moreover, unless spreads are attractively high for the risk, owning assets whose performance is strongly dependent on that of financial institutions should be treated with caution. The last two years have shown that investors are vulnerable to bank bail-in risk. As a recent article in the FT pointed out, the prospect of bank creditors sitting in the line of fire is causing jitters among bond investors ahead of stress tests by European Union regulators. EU finance ministers' recent June agreement to force creditors in failed banks to take losses has already raised concern among senior bondholders. Moodys' described the agreement as 'clearly credit negative' for bank unsecured investors.

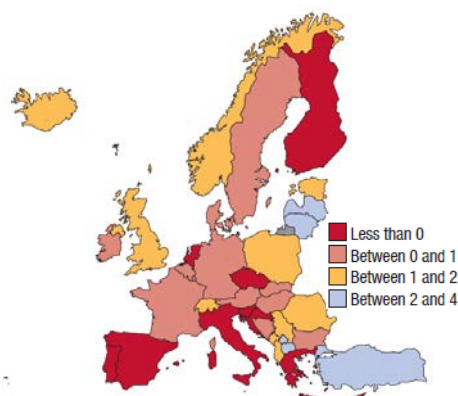
Risk of bank bail-ins makes us prefer secured paper (ABS and covered) over unsecured bank risk, with ABS offering more collateral transparency

European recovery is still fragile and patchy (Figure 8) so that buying risk without the benefit of collateral leaves investors vulnerable to the 'bail-in' risks. The security of property in peripheral Europe is especially important since the region is plagued by a nasty sovereign-bank-corporate nexus (Figure 9) that is threatening weaker corporates in weaker countries. Weak banks have been exacerbating the problems of weak corporates because institutions with thin buffers have been tightening credit conditions. While we agree that peripheral households are in no better shape with high unemployment and falling asset prices, consumer loans are generally secured by a first-lien on collateral and full recourse to borrowers.

For peripheral country exposure, therefore, the secured nature of ABS (or covered bonds) is particularly attractive. While ABS is generally backed by stand-alone and transparent pools, covered bonds do offer the optionality of originators 'topping-up'

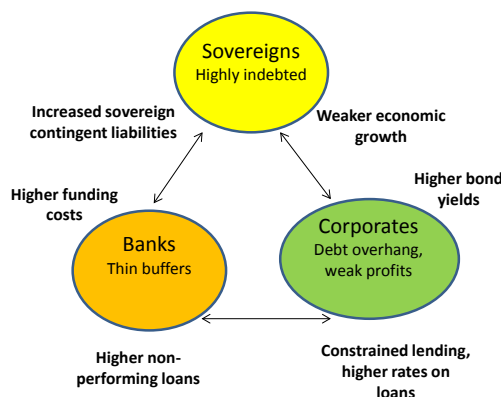
collateral to meet bond covenants (and many borrowers have voluntarily put more than the minimum). We prefer the transparency of ABS (and the spread pick-up of senior RMBS over covered bonds) and also have questions about the quality of collateral that a bank would add in a deteriorating economic scenario. Finally, ABS structures provide senior tranche holders with structural protection that traditional unsecured and covered bonds do not provide.

Figure 8. Europe: 2013 GDP Growth Forecasts, %



Source: IMF

Figure 9. Bank-Corporate-Sovereign Linkage Adverse for Corporates



Source: IMF

The choice between covered bonds, ABS, and even the underlying loans will, however, be affected by differences in investors' regulatory environment as we will see later in the note. In many cases, buying senior securitized bonds is not the most regulatory-capital efficient choice. Our recommendation to buy securitized bonds is all the stronger for those entities such as funds that do not face the same regulation as banks and insurance companies, and who can capture such inefficiencies.

Mortgage or Corporate, Core or Peripheral?

Not all core collateral is pristine, and not all peripheral assets are impaired

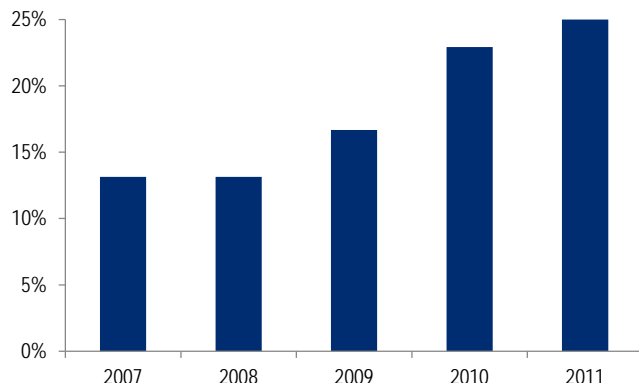
Among secured assets, we prefer those bonds whose cash flows are the least dependent on the credit quality of the originating banks. Most RMBS, even from peripheral countries, offer the benefit of structural protection and a portfolio of low-levered (LTV) mortgages. The exception is Dutch RMBS.

Though we Dutch RMBS because of its cheapness based on historical spread analysis (and cheapness to UK prime), we recognize that mortgage loans are highly levered, with a significant portion of the mortgage pool being underwater (Figure 10). Moreover, investors depend on Dutch originators calling RMBS at the end of the 5-year non-call period. Therefore, the ability to honor calls relies on the strength of the Dutch financial sector ([Going Dutch RMBS - High Leverage Masks Sector Value](#)). Any potential systemic weakness in the Dutch financial sector should have a strong impact on the value of Dutch RMBS.

Conversely, peripheral country RMBS have numerous negative headlines such as high national unemployment, historical overbuilding of homes (Spain) and inefficient mortgage recovery processes (Italy) but can provide attractive investment opportunities. An example is the relatively low LTV Italian mortgage sector and the steady pay-down of Italian RMBS which leads to shorter average lives for investments (Figure 11). It is also worth noting that peripheral RMBS trades wide to sovereigns as our Data Appendix at the back shows. We have highlighted more such opportunities in prior detailed notes ([Spanish RMBS - Rain in Spain... But Sunny on Many RMBS](#), and [Italian RMBS - Truffle Hunting Among Poisonous Mushrooms](#)). Further peripheral RMBS usually trades at a discount assuming low

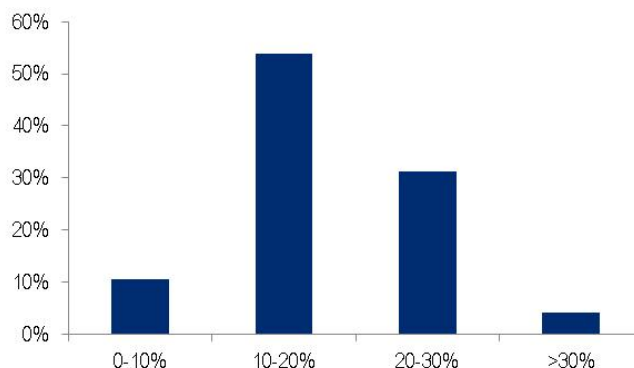
prepayments and can offer upside if the economy and credit conditions improve and loan prepayments rise.

Figure 10. Proportion of under-water mortgages in Netherlands



Source: CBS

Figure 11. Annual pay-down rate of senior Italian RMBS bonds



Source: Bloomberg, Citi Research

While we are agnostic to core versus peripherals in RMBS space and prefer to look at the collateral quality and pricing of notes before discarding RMBS just based on sovereign concerns, we have a clear preference for core corporates. Our reason is the poor access to credit for corporates in weaker countries. If the core country assets are secured, such as the collateral pools within Euro CLOs, the investment thesis is stronger still. Even though the recent rally (Figure 1) has left the product expensive to its longer-term history, it still looks cheap to prime RMBS whether UK or Dutch. The comparison with Dutch RMBS is especially favorable since neither asset qualifies for the liquidity measures recently introduced by BIS for banks. Unsecured investment-grade corporate credit, evident in flow credit or synthetic tranches, is not expensive (and thus attractive) compared to recent price history but is vulnerable to a systemic shock which, in theory, could lead to widespread defaults and low bond recoveries.

We recognize that many investors may not be able to allocate money to peripheral countries. If they have a higher yield targets than senior core ABS tranches or plain vanilla corporate bonds, they may prefer structural or financial leverage.

Structural over financial leverage – value in synthetics

With yields so tight, many investors are looking at leverage to meet return targets. The question is whether to add financial leverage or move down in quality through structural leverage (for example, junior tranches over senior tranches, or CLO Equity over CLO senior debt). We feel there are strong constraints from both the supply and demand base for financial (mark-to-market) leverage, and hence we prefer structural leverage.

We prefer structural leverage to financial leverage because of rising financing costs and mark-to-market volatility

Many investors are apprehensive about mark-to-market leverage after the experience of the financial crisis, during which there were significant forced sales by vehicles and levered funds. The fact that prices are at post-crisis highs leads to a tightrope situation where leverage can boost carry, but also brings downside risks if spreads were to correct. On the supply side, banks have more pressure on their balance sheet with the focus on leverage ratios from regulators. It is likely that banks will scale back balance-sheet intensive businesses where returns are low and exposure measures are high. A reduction in repo and reverse repo activity is a likely result ([High Grade Strategy Notes - The Legacy of the Bank Leverage Ratio](#))

(for Credit)). Banks lend money to leveraged counterparties through reverse repo trades, and we believe that the supply of leverage will decline and costs will rise. Term, as opposed to shorter-dated financing, will become scarcer still. For example, the difference in haircuts between a 1-month and a 12-month trade for a high-grade bond in the pre-crisis period was only 6% (2% vs. 8%); the difference between 1-month and 12-month haircuts is now 15% ([How to Earn 10%, Part 1...](#)).

As it turns out, investment-grade corporate and peripheral covered bonds are the very few cash assets where financial leverage gives high returns (Figure 12). Structural leverage, available in CLO and ABS junior bonds and synthetic junior tranches, is more attractive. For example, junior tranches such as CLO Equity and iTraxx Main 0-3% offer yields in the low teens. Synthetic tranches offer the dual benefit of structural leverage and financial leverage (an initial margin is required, with variation margin in the future depending on portfolio losses and mark-to-market drops). With the benefit of leverage through the posting of an initial margin, the 0-3% has an extremely high headline 132% yield. This has led the 0-3% tranche to dramatically outperform more senior tranches such as the 9-12% tranche, even though the latter offers just as high levered returns as shown below.

Figure 12. Yield in different assets, and levered yield based on short-term financing (1-3 mths)

Product	Yield	Haircut	Financing	Levered Yield
iTraxx S9 0-3 10y	14.5%	11%	0.0%	132%
iTraxx S9 9-12 10y	2.5%	2.5%	0.0%	100%
Covered Bonds, Peripherals	3.2%	5%	0.3%	58%
Covered Bonds, Core Country	0.5%	3%	0.2%	9%
IG Corp	2.2%	7%	0.5%	25%
IG HY	5.3%	25%	1.3%	16%
CLO Equity	13.0%	100%		13%
CLO AAA	3.0%	20%	1.4%	8%
Spain Mezz	4.3%	35%	1.8%	7%
CLO A	4.7%	40%	2.0%	7%
Spain Seniors	3.1%	25%	1.5%	6%
UK Prime (Granite)	1.2%	10%	1.1%	2%

Source: Citi Research

Figure 13. Underperformance in senior iTraxx (22-100%) tranches relative to junior tranches



Source: Citi Research

The tranche investor base over the past 4 years has been a very “sophisticated” one, happy to sell equity tranche protection and manage the default risk, enjoying the very high roll down on equity tranches in a no-default environment. Given that the 0-3% tranche is now a crowded trade (Figure 13) and also has exposure to first-loss risk, levering up senior tranches should be viewed as an attractive way to add risk with high enough spread without exposure to first losses (i.e. non-equity tranches in investment grade portfolios).

A pre-crisis synthetic CDO comeback is unlikely, but there will be opportunities in mezz and super-senior tranches, often with leverage

The new potential investor who could be looking at tranches going forward will not want to take default risk, in our view, and is more likely to look into mezzanine tranches (paying a multiple of the spread which indices pay) or levered super senior tranches (taking advantage of how cheap they have become on the back of the strong demand for equity tranches recently). Sell side banks are already actively marketing these type of structures; the only thing left are investors willing to step forward – absence of opportunities to get high spreads elsewhere will increase the willingness of investors to look at these products again. This is the main reason why we think synthetic products, in particular mezzanine and senior tranches, will see tailwind next year.

Mindful of Regulatory (Dis)incentives

Any cross-asset relative value analysis across asset is incomplete without taking into account the regulatory impact on different buyers. European financial institutions have to deal with a multi-faceted (and conflicting) regulatory environment which has skewed asset pricing. Till recently, for example, banks focused on maximizing carry for a given pool of risk-weighted assets (which would favor senior debt over junior debt). The additional focus on bank balance sheet leverage ratios is likely to do the reverse – that is, incentivize banks to buy higher-risk assets (such as double-A tranches or peripheral senior bonds) relative to lower-carry assets (such as European prime RMBS). Moreover, RWA and Leverage Ratio rules also need to be combined with Liquidity Coverage Ratio rules that favour assets such as covered bonds and UK prime over other secured assets. Insurance companies have to worry about their own regulatory capital rules in the form of Solvency II.

Asset managers should benefit from regulatory constraints on banks and insurers

As we see in Figure 14, senior assets such as CLO triple-As look very attractive for European and Asian banks (less so for US, as they cannot use ratings and have a 20% RWA floor). However, new Basel III securitization framework proposals introduced in December 2012 will increase the risk weights and decrease return on capital. Many securitized assets, such as CLO and Dutch Prime triple-As as well as corporate bonds, still look attractive even after these potential changes. Mezz bonds (such as CLO and auto single-As) no longer look that attractive after the changes.

The European Commission, Parliament and EIOPA also recently reached agreement on the Solvency II framework. The regime is now expected to be implemented on 1 January 2016, although there is an extended transitional period after the effective date. The standardized charges for ABS look very punitive, and we suspect most insurers will try to use internal models. Common to both Basel III and Solvency II is the highly favourable treatment for whole loans as opposed to securitizations.

Figure 14. Typical spread, bp, for corporate and mortgage assets and loans, and return on capital

Sector	Spread	Risk-weights (%)			Return on Capital (%)		
		B3*	B3**	Sol-II	B3*	B3**	Sol-II
Auto AAA	28	7	30	200	50.0	11.7	1.8
UK Prime AAA	32	7	58	450	57.1	6.9	0.9
Auto A	70	20	300	687	43.8	2.9	1.3
Dutch Prime AAA	90	7	58	450	160.7	19.4	2.5
CLO AAA	130	7	58	450	232.1	28	3.6
Covered Bonds, AA	140	20	20	62	87.5	87.5	28.2
Corp A	150	50	50	100	37.5	37.5	18.8
UK Prime Resi Loan	200	35	35	15	71.4	71.4	166.7
Peripheral	200	12	141	937	208.3	17.7	2.7
CLO A	300	20	433	937	187.5	8.7	4.0
HY B	400	150	150	750	33.3	33.3	6.7
UK Comm (65%LTV)	250	100	100	100	31.3	31.3	31.3

*Current application of Basel-III assuming 8% Tier-1 Capital

**Proposed new RWA from Dec 2012 assuming 8% Tier-1 Capital

Source: Citi Research, BIS, EIOPA

Figure 15. LCR Eligible Assets as Proposed by BIS in January 2013

BIS Revised Liquidity Coverage Ratio (January 2013)		
HQLA	Level 1 assets	Coins and bank notes
		Qualifying marketable securities from sovereigns, central banks, PSEs, multilateral development banks
		Qualifying central bank reserves
		Domestic sovereign or central bank debt for non-0% risk weighted sovereigns
HQLA	Level 2A assets (40% limit -15% haircut)	Sovereign, central bank, multilateral development banks, PSE assets qualifying for 20% risk weighting
		Qualifying corporate debt rated AA- or higher
		Qualifying Covered Bonds rated AA- or higher
HQLA	Level 2B assets (15% limit -25% or 50% haircut)	Qualifying RMBS
		Qualifying Corporate debt rated between A+ and BBB
		Common equity shares

Source: BIS and Citi Research

Though the Basel RWA framework favors lower-risk assets, higher-risk assets are attractive from a Leverage Ratio perspective because of the potential to make a similar carry for a smaller notional of risk. We therefore see banks trying to move into double-A risk type senior mezzanine investments leaving triple-As cheap for their credit risk. The last consideration is liquidity. BIS requires banks to maintain unencumbered high-quality liquid assets ('HQLA') sufficient to meet 100% (or more)

of net cash outflows over a 30-day period under a stipulated stress scenario (Figure 15). According to the preliminary results on asset liquidity from the European Banking Association, covered and sovereign bonds were found to be the most liquid asset classes, while ABS was the least liquid among five LCR eligible asset classes during 2008 – 2012. These findings may motivate European regulators to elevate covered bonds to the top ranking (Level 1) among assets eligible for liquidity buffers while RMBS will likely stay in the bottom ranking (Level 2B) category. Investors would therefore, at least for part of their portfolio, move away from corporates and ABS into sovereign and covered bonds.

ABS supply will increase but not enough

Lending in many core countries is up but we do not see a sharp increase in a supply of securitized products. The UK mortgage market is a good example of securitization volumes not keeping up with lending volumes. Recent CML data shows a 37% year-on-year increase in UK gross mortgage lending but we do not expect significant supply from UK issuers next year. We believe there are several reasons for issuers' reluctance to use securitization as a source of funding.

First, the banking system is awash with liquidity. Secondly, despite the recent rally, most big lenders find it cheaper to borrow in the unsecured and covered bond markets than through securitization. As we illustrated in Figure 14, owning whole loans, covered bonds and unsecured bank risk is more efficient for many investors. Thirdly, the different central bank liquidity schemes (such as the UK FLS and the ECB repo-operations) have made it cheaper for borrowers to use government liquidity. Only when these initiatives are withdrawn, or banks face regulatory penalties for using these schemes, do we see a stimulus for using the external securitization markets. Fourth, despite pressures to reduce balance sheet, many banks will own credit assets to meet their income needs. Finally, in some sectors such as CLOs, risk retention rules have restricted the number of eligible sponsors able to put up the initial capital.

Peripheral RMBS and CLO issuance to grow most

We predict biggest year-over-year issuance growth in peripheral securitized and Euro CLO sectors. The strong rally in peripheral spreads this year shows good investor appetite and around six new issue deals totaling €3.1 billion priced in 2013, a 547% increase from the previous year. We think that the positive momentum will continue, as tight spreads and strong investor demand will motivate more issuers to tap securitization markets. The Euro CLO primary market has also experienced a decent recovery in 2013, after a long pause of five years. We think that greater confidence of European investors in the CLO product, combined with more collateral availability as borrowers look to refinance their obligations, will increase Euro CLO issuance to about €10 billion next year. .

Autos, Dutch RMBS, and CMBS appreciable contributors

We think auto ABS will form the biggest share of European securitized issuance next year. Auto ABS is an important funding source for European car manufacturers, and recovery in auto sales in a Euro-area recovery will lead to more issuance. We project €20 billion of placed auto ABS in 2014. Euro CMBS markets also staged a good comeback this year, with around €8.5 billion primary supply. We predict CMBS supply will increase modestly to €10 billion in 2014, due to a potential recovery in UK CRE lending and an upcoming €12 billion in CMBS loan maturities in 2014. We expect Dutch RMBS supply to remain flat at around €15 billion, because the scheduled €7 billion note maturities are approximately same as 2013 and we do not foresee any material change in investor demand for the product next year.

UK securitized issuance to lag

We do not expect significant supply from UK RMBS and credit card issuers next year. Big UK lenders are awash with liquidity because of the Bank of England's

funding programme and the Prudential Regulatory Authority's recent decision to allow well capitalized banks to reduce their holdings of liquid assets. However, smaller building societies and lenders with less stable funding may capitalize on tight spreads and use securitization to fund their balance sheet expansion as the economy recovers. We predict total UK securitized issuance at €8 billion.

Figure 16. Projected Full-Year 2014 Placed European Securitized Products Supply (€ Million)

Sector	FY 2012A*	FY 2013E	YoY % Change	Comments
UK Prime RMBS	3,201	5,000	56%	Big issuers unlikely to issue because they are awash with liquidity but smaller building societies and issuers with less stable funding sources may tap RMBS market
UK NC & BTL RMBS	965	2,000	107%	Expect selective issuers to come to market in small size to capitalize on tighter spreads
Dutch Prime RMBS	14,455	15,000	4%	Dutch issuers to take advantage of tight spreads and strong demand for core country RMBS
Auto ABS	14,256	20,000	40%	A potential rebound in car sales due to ongoing Euro-area recovery should lead to more auto issuance
Credit Card ABS	1,122	1,000	-11%	Some issuers could fund their maturing credit card receivables using ABS but expect little issuance
Euro CMBS	8,484	10,000	18%	We expect 2014 CMBS issuance to be slightly higher than 2013 because of potential recovery in UK commercial real estate lending and upcoming €12 billion CMBS loan maturity in Europe
Euro CLO	6,364	10,000	57%	Greater confidence in the CLO product post the financial crisis combined with a greater collateral supply as European borrowers look to refinance their obligations will lead to more CLO issuance
Peripheral ABS & RMBS	3,058	10,000	227%	Strong rally in peripheral spreads and good investor appetite for the few recently issued deals should motivate more issuers to test primary markets next year
Other ABS [#]	1,195	2,000	67%	Some esoteric ABS deals emerged in 2013 and 2014 could see token issuance of similar deals
Total	53,600	75,000	41%	Expected overall placed supply to increase by 41% next year driven by gains across various sectors

* 2013 year-to-date actual issuance as of 19 Nov 2013

[#] Other ABS includes lease ABS, commercial ABS, German SME ABS and Nordic RMBS

Source: Concept ABS, IFR and Citi Research

Conclusion — Widen investment universe

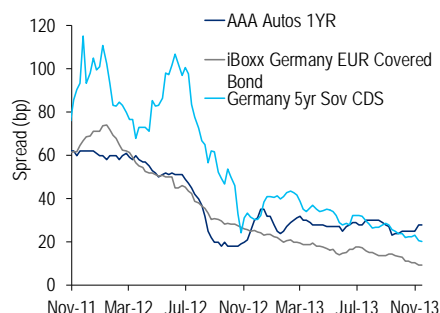
Evidence is gradually of a Euro-wide - core and peripheral – weak economic recovery spurring many investors to add risk at ever tighter yields. Even as they become prepared to allocate money back into European securitized products, they are finding there simply aren't enough assets to buy (let alone at attractive yields). While we do forecast €75 billion of securitized issuance in 2014 (up 41% from this year) and a rebound in peripheral ABS and CLO supply, we do not think that will be enough to widen yields. As such, we believe the supply-demand imbalance will keep cash spreads tight. We therefore advise investors to continually look across assets – cash and synthetic, flow and structured – next year to find the best value at any point in time and make selective use of structural leverage to meet their return targets.

We identify four main themes in our note. First, peripheral exposure looks well-placed to benefit from a European recovery. However, peripheral countries are plagued by a weak financial sector, and therefore we prefer secured assets especially ABS to unsecured bank bonds. Second, we prefer structural leverage to financial leverage because of rising financing costs and potential mark-to-market volatility. Third, synthetics too should do well in the current balance sheet constrained environment. Synthetic trades involving junior credit tranches should gain traction, and could lead to cheapening of super-senior risk, to which investors can subsequently add leverage. Finally, unregulated entities like asset managers could take advantage of bank and insurance regulations that are skewing demand toward LCR eligible assets, senior mezzanine bonds, and whole loans.

Data Appendix

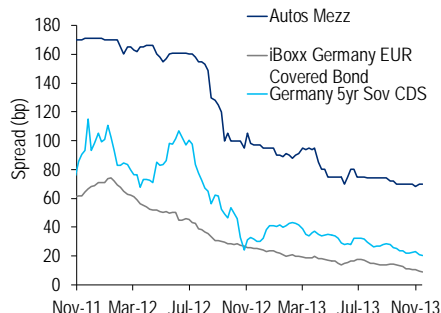
Auto and Credit Card ABS Spreads and Relative Value

Figure 17. European Auto Seniors Versus Indexes, Nov 11 – Nov 13



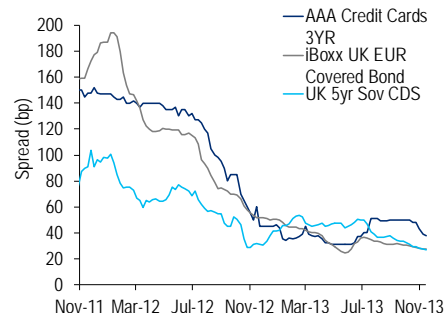
Source: Markit and Citi Research

Figure 18. European Auto Mezz Versus Indexes, Nov 11 – Nov 13



Source: Markit and Citi Research

Figure 19. UK Credit Card ABS Versus Indexes, Nov 11 – Nov 13



Source: Markit and Citi Research

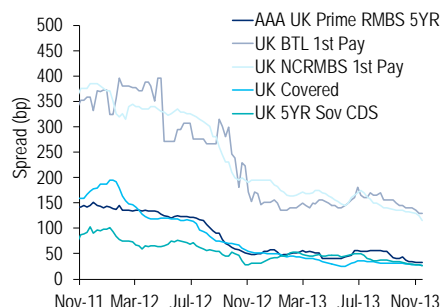
Figure 20. European Autos and UK Credit Card ABS Spread Changes and Statistics, 2013YTD

Country	Product	Product	Current	Δ1-week	Δ1-month	Δ1-quarter	Δ1-year	2013 Low	Δ from Low	2013 High	Δ from High
Europe	Autos	1YR	28	0	3	-1	3	23	5	32	-4
		3YR	40	0	-5	-5	-	38	2	45	-5
		5YR	50	0	-10	-10	-	50	0	63	-13
		Mezz	70	0	0	-4	-27	68	2	95	-25
	Automobile and Parts Index	iBoxx EUR Automobile & Parts	71	2	4	23	-25	47	23	91	-20
Germany	Covered Bonds	iBoxx EUR Germany	9	0	-2	-5	-16	9	0	23	-13
	Sovereign CDS	Sovereign 5YR	20	0	-2	-8	-11	20	0	43	-23
UK	Credit Cards	1YR	29	0	-9	-9	-	25	4	38	-9
		3YR	38	-1	-10	-11	-22	31	7	51	-13
		5YR	43	-3	-12	-14	-32	42	1	63	-20
		Mezz	105	0	-5	-5	-	89	16	127	-22
	Covered Bonds	iBoxx EUR UK	27	0	-2	-4	-25	24	3	50	-23
	Sovereign CDS	Sovereign 5YR	27	-1	-3	-10	-5	27	0	53	-27

Source: Markit and Citi Research

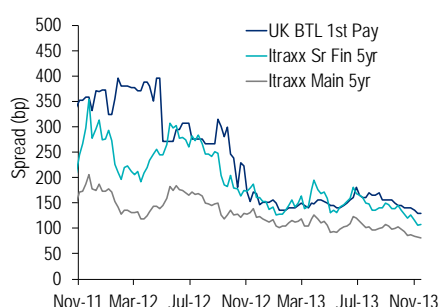
Core RMBS Spreads and Relative Value

Figure 21. UK RMBS Seniors Versus Indexes, Nov 11 – Nov 13



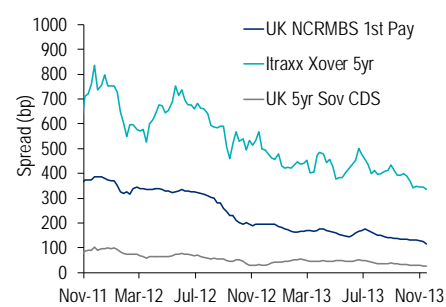
Source: Markit and Citi Research

Figure 22. UK BTL RMBS Seniors Versus Indexes, Nov 11 – Nov 13



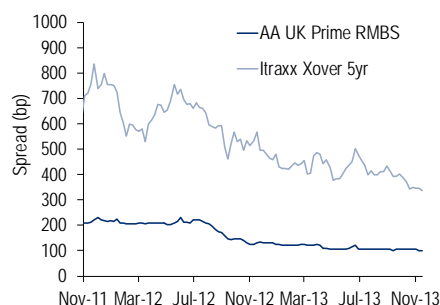
Source: Markit and Citi Research

Figure 23. UK NCRMBS Seniors Versus Indexes, Nov 11 – Nov 13



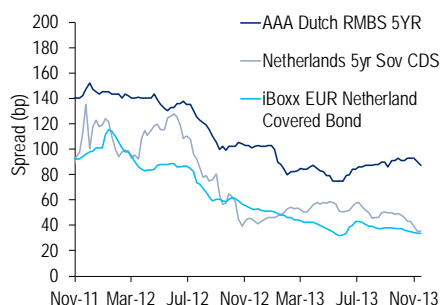
Source: Markit and Citi Research

Figure 24. UK Prime RMBS Subordinates Versus Index, Nov 11 – Nov 13



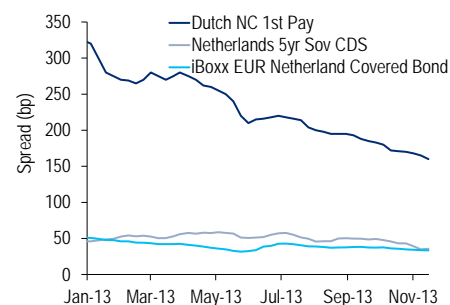
Source: Markit and Citi Research

Figure 25. Dutch RMBS Seniors Versus Indexes, Nov 11 – Nov 13



Source: Markit and Citi Research

Figure 26. Dutch NC 1st Pay Versus Indexes, Jan 13 – Nov 13



Source: Markit and Citi Research

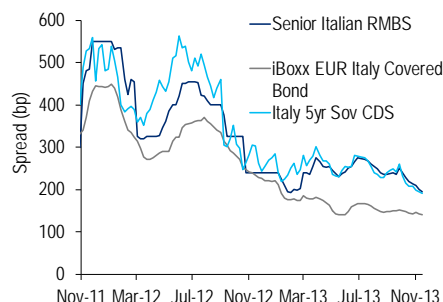
Figure 27. UK Prime, UK NC, UK BTL, Dutch Prime and Dutch NC Spread Changes and Statistics, 2013YTD

Country	Product	Product Detail	Current	Δ1-week	Δ1-month	Δ1-quarter	Δ1-year	2013 Low	Δ From Low	2013 High	Δ From High
UK	Prime RMBS	AAA 1YR	28	0	0	-7	-	23	5	38	-10
		AAA 3YR	30	0	-2	-15	-	30	0	47	-17
		AAA 5YR	32	0	-3	-23	-16	32	0	56	-24
		Mezz	100	0	-5	-5	-30	100	0	125	-25
		Buy to Let									
	PARGN	PARGN 1st Pay	130	0	-10	-25	-41	130	0	180	-50
		PARGN 2nd Pay	225	-10	-15	-20	-	225	0	275	-50
		PARGN 3rd Pay	330	-10	-20	-35	-	325	5	375	-45
		AIREM AAA	105	-2	-3	-15	-	103	2	160	-55
	Non-Conforming RMBS	AIREM AA	165	0	-30	-75	-	165	0	250	-85
		AIREM BBB	285	-5	-15	-45	-	285	0	350	-65
Netherlands	Prime RMBS	NC 1st Pay	115	-10	-17	-25	-80	115	0	183	-68
		NC 2nd Pay	200	-5	-23	-35	-	200	0	315	-115
	Covered Bonds	iBoxx EUR UK	27	0	-2	-4	-25	24	3	50	-23
		Sovereign CDS	27	-1	-3	-10	-5	27	0	53	-27
	Non-Conforming	AAA 1YR	52	-3	-3	2	-	33	19	55	-3
		AAA 3YR	70	-5	-6	0	-	54	16	76	-6
		AAA 5YR	87	-3	-6	-3	-14	75	12	100	-13
		Mezz	170	-10	-15	-15	-	160	10	200	-30
		NC 1st Pay	160	-5	-11	-35	-	160	0	320	-160
	Covered Bonds	NC 2nd Pay	215	-5	-12	-35	-	215	0	365	-150
		NC 3rd Pay	395	-5	-25	-65	-	395	0	675	-280
		iBoxx EUR Netherland	33	0	-2	-4	-19	32	2	51	-17
	Sovereign CDS	Sovereign 5YR	36	1	-8	-14	-9	35	1	59	-23

Source: Markit and Citi Research

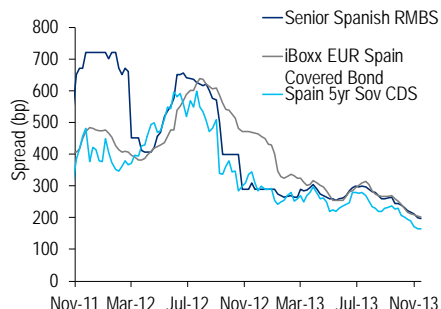
Peripheral RMBS and Relative Value

Figure 28. Italian RMBS Seniors Versus Indexes, Nov 11 – Nov 13



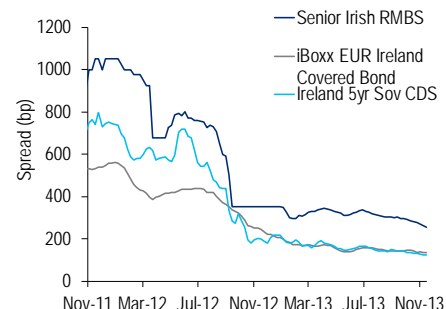
Source: Markit and Citi Research

Figure 29. Spanish RMBS Seniors Versus Indexes, Nov 11 – Nov 13



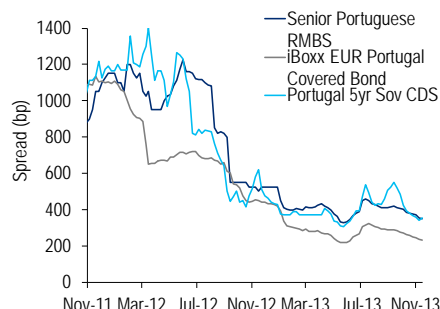
Source: Markit and Citi Research

Figure 30. Irish RMBS Seniors Versus Indexes, Sep Nov 11 – Nov 13



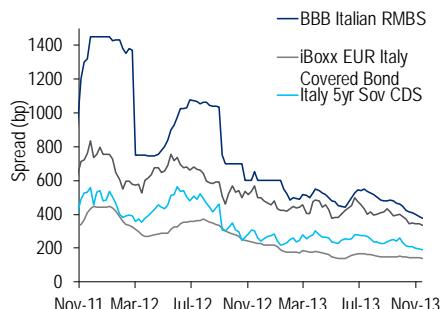
Source: Markit and Citi Research

Figure 31. Portuguese RMBS Seniors Versus Indexes, Nov 11 – Nov 13



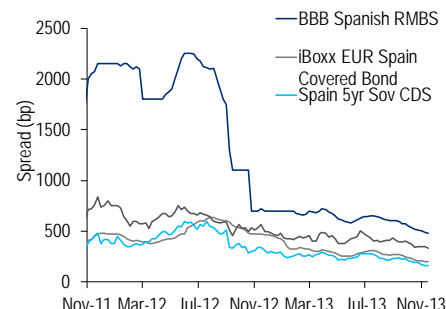
Source: Markit and Citi Research

Figure 32. Italian RMBS Subordinates Versus Indexes, Nov 11 – Nov 13



Source: Markit and Citi Research

Figure 33. Spanish RMBS Subordinates Versus Indexes, Nov 11 – Nov 13



Source: Markit and Citi Research

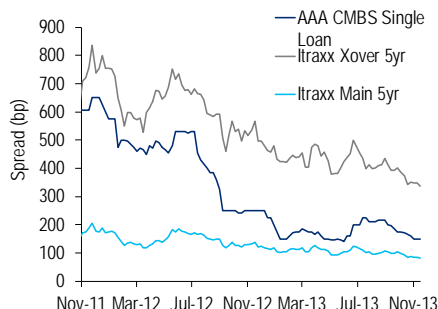
Figure 34. Peripheral RMBS Spread Changes and Statistics, 2013YTD

Country	Product	Product Detail	Current	Δ1-week	Δ1-month	Δ 1-quarter	Δ1-year	2013 Low	Δ from Low	2013 High	Δ from High
Italy	RMBS	AAA Italy	194	-6	-24	-41	-46	193	1	275	-81
		AA Italy	253	-7	-27	-32	-	253	0	325	-72
		A Italy	302	-8	-28	-53	-	302	0	440	-138
		BBB Italy	376	-9	-39	-104	-274	376	0	600	-224
	Covered Bonds	iBoxx EUR Italy	141	-2	-4	-6	-93	140	1	211	-71
	Sovereign CDS	Italy Sovereign 5YR	191	-3	-17	-36	-112	191	0	300	-109
Spain	RMBS	AAA Spain	198	-2	-24	-62	-112	198	0	305	-107
		AA Spain	312	-3	-23	-63	-	312	0	410	-98
		A Spain	440	-4	-35	-95	-	440	0	690	-250
		BBB Spain	480	-5	-40	-125	-245	480	0	725	-245
	Covered Bonds	iBoxx EUR Spain	202	-2	-15	-63	-267	202	0	401	-199
	Sovereign CDS	Spain Sovereign 5YR	163	-1	-30	-57	-180	163	0	296	-132
Portugal	RMBS	AAA Portugal	350	-5	-30	-60	-150	328	22	460	-110
		AA Portugal	405	-5	-35	-75	-	405	0	595	-190
		A Portugal	500	-5	-40	-90	-	500	0	740	-240
		BBB Portugal	565	-5	-35	-100	-	565	0	840	-275
	Covered Bonds	iBoxx EUR Portugal	231	-6	-26	-62	-217	218	13	392	-161
	Sovereign CDS	Portugal Sovereign 5YR	353	14	-27	-106	-267	304	49	548	-195
Ireland	RMBS	AAA Ireland	255	-5	-25	-47	-95	255	0	349	-94
		AA Ireland	485	-5	-40	-70	-	440	45	600	-115
		A Ireland	610	-5	-40	-90	-	575	35	750	-140
		BBB Ireland	845	-5	-40	-97	-	750	95	1000	-155
	Covered Bonds	iBoxx EUR Ireland	134	0	-8	-9	-108	134	0	200	-66
	Sovereign CDS	Ireland Sovereign 5YR	124	0	-6	-16	-74	124	0	197	-73

Source: Markit and Citi Research

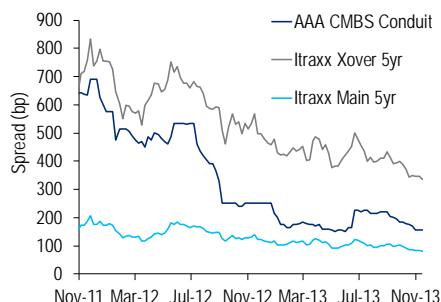
CMBS and CLO Spreads and Relative Value

Figure 35. AAA CMBS Single Loan Versus Indexes, Nov 11 – Nov 13



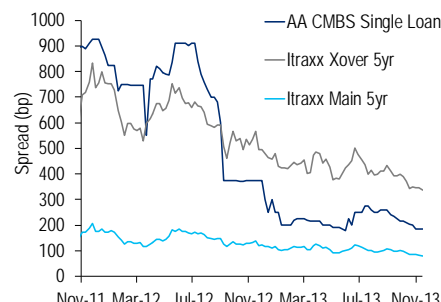
Source: Markit and Citi Research

Figure 36. AAA CMBS Conduit Versus Indexes, Nov 11 – Nov 13



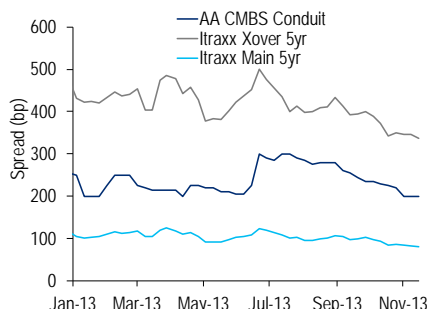
Source: Markit and Citi Research

Figure 37. AA CMBS Single Loan Versus Indexes, Nov 11 – Nov 13



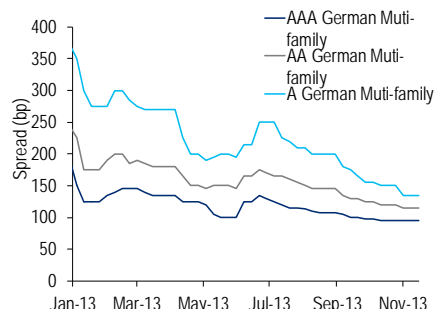
Source: Markit and Citi Research

Figure 38. AA CMBS Conduit Versus Indexes, Jan 13 – Nov 13



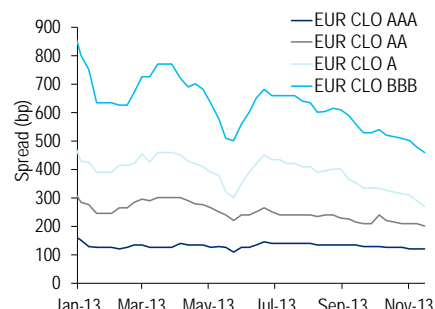
Source: Markit and Citi Research

Figure 39. German Multifamily Spreads, Jan 13 – Nov 13



Source: Citi Research

Figure 40. EUR CLO Spreads, Jan 13 – Nov 13



Source: Citi Research

Figure 41. CMBS, WBS and CLO Spread Changes and Statistics, 2013YTD

Country	Product	Product Detail	Current	Δ1-week	Δ1-month	Δ 1-quarter	Δ1-year	2013 Low	Δ from Low	2013 High	Δ from High
Europe	CMBS	AAA German Multi	95	0	0	-13	-	95	0	150	-55
		AAA Single Loan	150	0	-15	-65	-100	140	10	225	-75
		AAA Conduit	155	0	-20	-65	-95	150	5	225	-70
		AAA Fixed	100	-5	-10	-25	-	100	0	225	-125
		AA German Multi	115	0	-5	-30	-	115	0	225	-110
		AA Single Loan	185	0	-20	-75	-190	180	5	275	-90
		AA Conduit	200	0	-25	-80	-175	200	0	300	-100
		AA Fixed	100	-3	-35	-70	-	100	0	250	-150
		A German Multi	135	0	-15	-65	-	135	0	350	-215
		A Single Loan	360	0	-35	-90	-340	250	110	450	-90
		A Conduit	395	0	-25	-80	-305	270	125	475	-80
		A Fixed	205	-5	-35	-75	-	205	0	495	-290
	CLO	AAA	120	0	-5	-15	-50	110	10	150	-30
		AA	200	-10	-15	-40	-220	200	0	300	-100
		A	270	-20	-50	-130	-305	270	0	460	-190
		BBB	460	-20	-55	-155	-615	460	0	800	-340
	WBS	AAA	130	0	-15	-50	-	130	0	300	-170
		AA	135	-5	-40	-80	-	135	0	350	-215
		A	210	-5	-40	-85	-	210	0	425	-215
		BBB	350	-10	-65	-140	-	350	0	600	-250

Source: Markit and Citi Research

Notes

Appendix A-1

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