2013 Credit Cheat Sheet

Bullish for a bit longer

- **View:** We expect spreads to tighten next year, primarily because the Fed is still pushing investors into the asset class, default risk is low, and net new issuance should be modest. Said differently, we have the same view as everyone else.

- **But More Wary Longer-Term:** But we do see more risk to our view than the typical investor, in part due to market features that may become more problematic as time passes (e.g., credit is an increasingly crowded trade among backward-looking investors). Bottom line: date, don't marry positions.

- **Sector, Curve, and Quality Preferences:** Over- / under-weight positions in very specific segments of the market may be able to provide an outsized impact on portfolio performance. Inside we present both near- and longer-term preferences for each of these market segments.

- **Year Ahead Outlooks:** Our in-depth outlooks for high-grade and high-yield markets will be released in the coming days. We encourage readers to refer to these for market-specific forecasts, rationale, and recommendations.

CREDIT STRATEGY

Stephen Antczak, CFA
+1-212-723-3267
stephen.antczak@citi.com

Jung Lee
+1-212-723-1835
jung.lee@citi.com

SINGLE NAME STRATEGY

Erin Lyons
+1-212-723-1102
erin.lyons@citi.com

INVESTMENT GRADE STRATEGY

Jason Shoup
+1-212-723-6147
jason.b.shoup@citi.com

Sonam T Pokwal
+1-212-723-3807
sonam.t.pokwal@citi.com

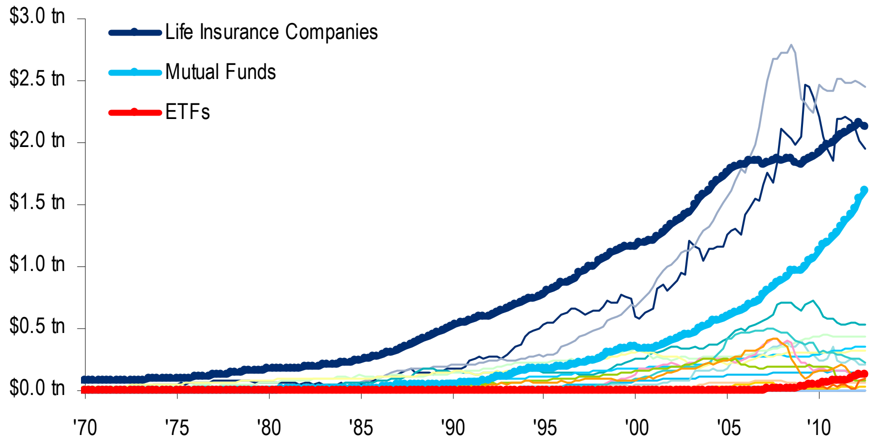
LEVERAGED FINANCE STRATEGY

Michael H Anderson
+1-212-723-3819
michael.henry.anderson@citi.com

Julie Pearson
+1-212-723-3099
julie.pearson@citi.com

Lili Yang
+1-212-723-1104
lili1.yang@citi.com

Figure 1. Total amount of corporate bonds held by various investors – life insurers, mutual funds, and ETFs on the rise



Source: Citi Research, Federal Reserve
Note: As of Q2 2012

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Our 2013 outlook is unfortunately a more-or-less consensus one — cautiously optimistic. While many valuation metrics are not particularly attractive, at the end of the day the Fed will continue to push investors into riskier assets, including corporates. That said, we probably see more risk to this view than the typical investor, particularly in the longer term. **Bottom line: gains are likely in '13, but we firmly advocate not getting "married" to positions.**

This article is intended to serve as a very brief summary of our 2013 views for the overall credit market. We will release in-depth outlooks for the high-grade and high-yield markets in the coming days, and we encourage readers to refer to those for specific forecasts, rationale, and recommendations.

Reasons to be bullish

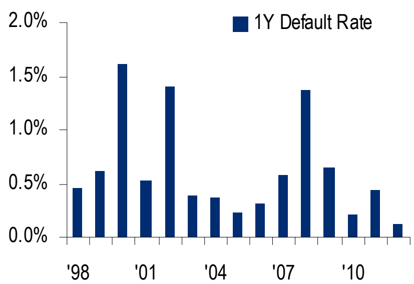
Our base case is that credit spreads will end 2013 at modestly tighter levels, although tightening potential varies meaningfully across market segments (e.g., HG cash -35 to -40 bp vs. CDX.IG -10 bp). Each market has its own nuances, but four positives factors resonate across all:

1. Low default risk: One key reason why we expect tighter spreads is simply because, away from a few idiosyncratic cases, default risk is so low. In fact, our quantitative strategy team's models suggest that defaults over the next year in the high-grade space, for example, could be the lowest ever (Figure 2).

2. Fed still pushing: In fact, one could argue that the Fed may be pushing a bit *too* aggressively at this stage. In Figure 3 we plot monetary policy (defined as the funds rate and the Fed's balance sheet) vs. a "market health" index comprised of economic factors, systemic risk metrics, and valuation metrics. Historically the two have tracked well, but not recently. The health index is firming, but policy is getting easier, not tighter.

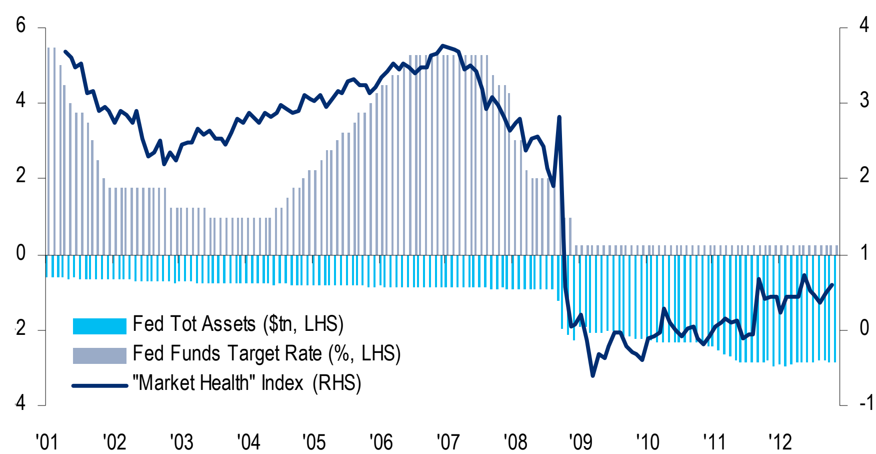
3. Light supply: "Not enough paper" was the resounding complaint from investors for much of the past year. But despite our expectation that companies will re-lever, we do not expect net supply to increase (-5% to -10% YoY).

Figure 2. Implied probability of default in the high-grade market is at its lowest level ever



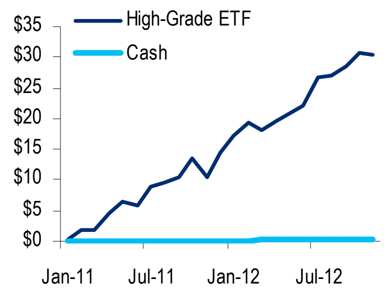
Source: Citi Research
Note: As of as of November 19, 2012; '98 to '11 are yearly averages

Figure 3. Is the Fed pushing too hard to get investors into risky assets?



Source: Citi Research, Bloomberg, BLS
Note: As of October 31, 2012; index based on 30Y BE, employment rate, avg bank CDS spreads, credit spreads

Figure 4. Volatility of a $100 portfolio held in cash is not all that different from the one holding the typical HG ETF, but growth is



Source: Citi Research, Bloomberg
Note: As of November 30, 2012

4. Is credit the new cash? Much has been made of flows from equity into credit, but one could argue that in a no-default environment with muted Treasury rate volatility some investors may be viewing credit as the new cash. Consider a $100 portfolio held in cash vs. one invested in a typical high-grade ETF — neither is volatile, but only one has grown (Figure 4).

But longer term, be aware of "other" risks

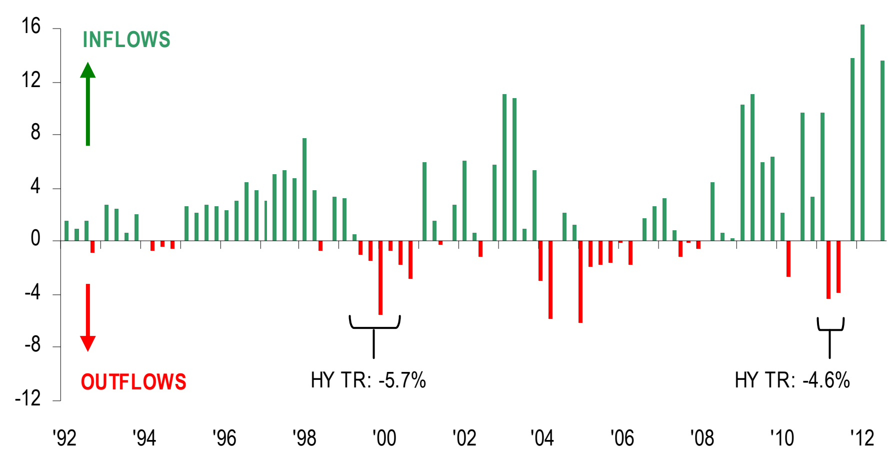
In terms of the risks in 2013, most seem to be still focused on the fiscal cliff here in the U.S., continued challenges in Europe, and to a lesser extent corporate re-leveraging. We agree that these are important, but we also believe that there are some longer-term risks that may not be getting quite enough attention.

1. Long credit is crowded: In Figure 1 (cover page), we plot how ownership of corporate bonds has evolved over time. Fed data shows that most investors have maintained or trimmed exposure in recent years, but three types of investors have been increasing exposure meaningfully — life insurance companies, mutual funds, and ETFs. We expect this trend to continue in the near-term.

But in the longer-term this presents a problem for two reasons: first, mutual fund flows tend to follow total returns; in particular, when total returns are negative outflows increase sharply (Figure 5). And if our economists' expectations for Treasury rates prove to be correct **—** a 2.5% 10-year by the end of '13 **—**negative total returns in the corporate market are certainly possible. *Secondly, who will take the other side if outflows do pick up? With everyone on the same side, any selling pressure could be magnified.*

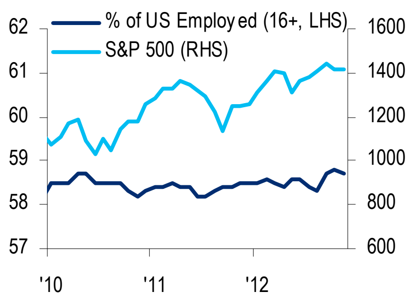
2. Investors have been pushed, not pulled: Fed policy has helped and will continue to help both the fundamental backdrop and valuations in the near-term. However, by some metrics valuations are benefiting more than fundamentals from these efforts. For example, in Figure 6 (next page) we compare gains in the labor market (which is one of the components of our "market health" index) to S&P 500 price performance since '10. We see that the two are trending in different directions — valuations higher, but the labor market more-or-less steady.

Figure 5. Over the years we have seen that mutual fund outflows tend to follow negative total returns in the high-yield space



Source: Citi Research, EPFR; Note: As of 3Q 2012

Figure 6. SPX is higher but labor market conditions remain more-or-less steady



Source: Citi Research, Bloomberg, BLS
Note: As of November 30, 2012; labor data is NSA

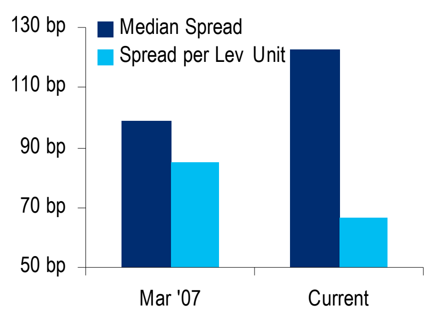
This isn't a problem per se — the labor market could improve and catch up – but there is at least some risk that valuations do the adjusting. This is particularly worrisome if investors do not have much conviction in what they hold. There is at least some chance that we see a scramble to the door.

3. Valuations getting full: Spread levels are well north of the lows reached in previous credit cycles — high-yield cash is 550 bp now vs. 240 bp in '07 — but in risk-adjusted terms many valuation metrics look a bit less attractive. For example, when considering spread per unit of leverage in the high-grade market (based on the median of around 200 non-financial names) we see that the amount that investors get paid for taking leverage risk is less than in early '07 (Figure 7).

Dollars-at-risk is another metric that seems full. In fact, some non-financial sectors in high-grade currently trade near the cyclical tights in nominal terms, but well *through* the tights after adjusting for high-dollar prices. All-in yields and credit market valuations versus other asset classes tell a similar story.

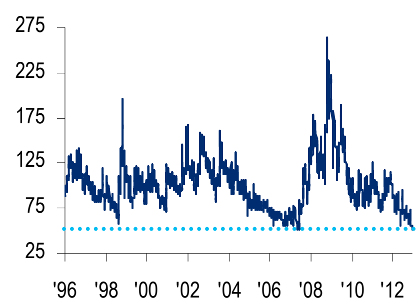
4. Complacency reigns supreme: Investors across asset classes appear to be fairly complacent about the potential for negative catalysts. For example, in Figure 8 we see that implied volatility in the Treasury market is hovering near the all-time lows. The problem is that when we have traded at these levels before we haven't stayed there for all that long.

Figure 7. Spread per unit of leverage is meaningfully lower currently vs. '07



Source: Citi Research
Note: As of March 30, 2007 and December 5, 2012

Figure 8. Rates market volatility is at multi-year lows…but typically doesn't stay here for long



Source: Citi Research, Bloomberg
Note: As of December 4, 2012

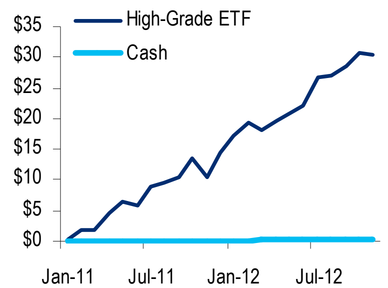
Conclusion

We expect credit spreads to tighten in 2013 (and there is a good chance that a large portion of the tightening occurs early in the year). That said, we probably see more risk to this view than the typical investor, particularly in the longer-term. **Overweight to start the year, and don't be afraid to take gains sooner rather than later.**

While our base case is for modest tightening in the broad market, we do expect that a few segments have the potential to move far more dramatically in spread and / or total return terms (e.g., banks and long-dated bonds). On the following pages, we highlight near- and longer-term strategies for sectors, curves, and quality positioning, and again we encourage readers to refer to our high-grade and high-yield outlooks for more details.

	Near-Term View	Longer-Term View
MARKET DIRECTION	***Overweight***	***Neutral***

Figure 9. Volatility of a $100 portfolio held in cash is not all that different from the one holding the typical HG ETF, but growth is



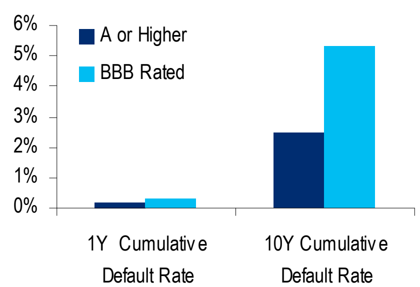
Source: Citi Research, Bloomberg
Note: As of November 30, 2012

Rationale: In the **NEAR-TERM** we are bullish on the broad market in part due to: (1) modest fundamental risk, (2) the Fed pushing investors into risky assets, (3) fairly modest supply, and (4) the possibility that credit is being viewed by "mom and pop" as a low risk asset class (Figure 9).

We are neutral in the **LONGER-TERM** in part because we believe that: (1) long-credit is a crowded trade, (2) investors have been "pushed" into their positions, (3) at least some longer-term valuation metrics appear full, and (4) investors appear to be somewhat complacent about negative catalysts. The probability of these issues weighing on the market is likely to increase over time, in our view.

QUALITY VIEW	***Down-in-quality***	***Neutral***

Figure 10. Market implied cumulative default rates by rating, 1-year vs. 10-year



Source: Citi Research
Note: As of December 7, 2012

Rationale: In the **NEAR-TERM** we are still comfortable edging down the quality spectrum, in part because short-run default risk is so low and on a risk-adjusted basis spreads down the quality spectrum look relatively wide. For example, the average spread for the single-A or better bond is currently 112 bp, and our quantitative strategy team's models suggest that 1-year default risk is 20 bp. But the typical triple-B issue trades at 195 bp, and its 1-year default risk is essentially the same (29 bp; Figure 10).

But **LONGER-TERM** fundamental risk is very different, in part because companies are re-leveraging. In fact, our models show that the 10-year default risk for the typical BBB bond is more than twice as much as the average single-A or better credit (5.3% vs. 2.5%; Figure 10).

Source: Citi Research

	Near-Term View	Longer-Term View
MATURITY PREFERENCE	***Overweight back-end***	***Overweight Intermediates***

Figure 11. Yield curve between the front- and back-end in the high-grade is very steep

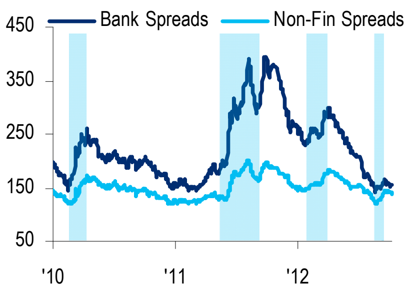
Source: Citi Research
Note: As of December 7, 2012; 1-3Y vs. 10Y+ index curve

Rationale: In the **NEAR-TERM** we favor the back-end for reasons that include: (1) the back-end is higher-beta and could benefit if the risk-on scenario that we expect comes to fruition, (2) curves are steep and could benefit from a back-up in Treasuries combined with a reach for yield (Figure 11), (3) the back-end has underperformed as investors look to avoid duration to protect year-to-date performance, but this is a "crowded" short, and (4) the market doesn't always value high-dollar prices properly, in our view, resulting in attractive opportunities.

LONGER-TERM we would place more weight on intermediate maturities primarily due to roll potential and relative value considerations. Specifically, the front-end does not provide much yield / spread, and the back-end may be particularly vulnerable to corporate re-leveraging and potentially from a rotation from credit into equities (most comparable duration to the typical stock).

SECTOR STRATEGY	***Overweight Banks***	***Underweight Technology***

Figure 12. Bank sector may no longer be overly susceptible in a risk-off scenario



Source: Citi Research
Note: As of December 7, 2012

Rationale: In the **NEAR-TERM** we believe that banks offer an attractive risk / reward profile: (1) although banks have tightened dramatically, many are still well above the broad market and could grind tighter in a risk-on scenario, (2) the beta of the sector has fallen dramatically in recent trading, and as such may not be overly susceptible in a risk-off scenario (Figure 12), and (3) from a fundamental perspective many of the concerns surrounding the industry have been more or less addressed.

LONGER-TERM we are very mindful of the fact that the typical corporate has been re-levering, but the degree of leverage increase and spread per unit of leverage varies meaningfully by sector. We have found that tech space has been aggressively levering up to fund shareholder friendly activities (e.g., HPQ), and by issuance from companies with relatively few real assets (e.g., AMZN, EBAY). Spreads have not increased at the same pace, and as such compensation per unit of leverage has gone down meaningfully.

Source: Citi Research

Appendix A-1

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