

European Credit Weekly

It's Too Late To Read The Safety Card Now

- Credit feels like it is at a pivot point.
- Most likely, CDS shorts are unwound and high beta cash regains its poise.
- However, the possibility of outflows and widespread cash selling cannot be dismissed.

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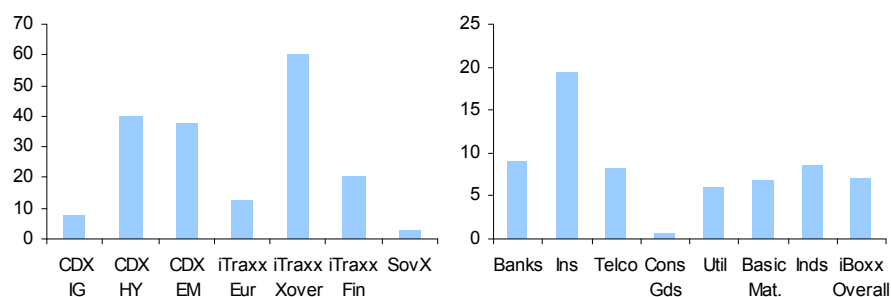
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Figure 1. CDS and € iBoxx Cash Index Weekly Spread Changes, bp



Source: Markit, Citi Research

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

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Market Comment

It's been yet another turbulent week in credit. Like the passengers on a recent flight from Singapore to London, where a sudden 20-metre drop left the aisles in chaos and the ceiling covered in coffee, credit investors are currently sitting very uncomfortably. And yet just as on that flight, our instinct is that it would take a much bigger shock to do any lasting damage, and that a low reading for NFP today has the potential to allow spreads to recover.

Markets' focus on the all-important non-farm payrolls figure out this afternoon hasn't prevented them from reaching for the sick bag in the meantime. A week that began with Japanese equities hitting a six-week low saw the weakness spilling over into Europe, with the Eurostoxx down by 3% on the week and the iTraxx Main wider by 10bp. However, despite the recent bout of volatility, it doesn't quite feel like the panic button has been pushed just yet. Although synthetics and the higher beta parts of the credit market were considerably wider over the course of the week, core names have emerged relatively unscathed, with investors not feeling panicked enough to start selling the safer parts of their cash holdings (Figure 2).

The sharp reduction in long positions in the iTraxx indices has been accompanied by high skews and an elevated basis; while investors are increasing their index shorts and have even got rid of some of their single name CDS positions, they have yet to really sell down their core cash holdings.

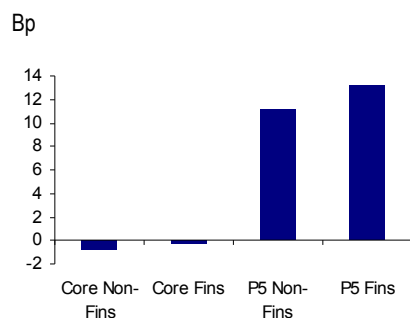
And though the jump in Spanish and Italian sovereign yields was disconcerting, all they have done is revert to levels last seen in April; still far from panic mode. And core rates, which led the sell-off over the last few weeks, were actually fairly calm, with the rest of the market in catch-up mode. US Treasury and JGB yields ended the week a little lower than where they began, whilst Bund yields were only slightly higher.

As we stressed last week, with little other significant economic news on the horizon, it will be today's NFP that sets the tone for Fed guidance going into the summer. If today's NFP figure disappoints, not only should concerns over an imminent reduction in asset purchases diminish, but markets are also likely to reassess their expectations for when the first rate hike will occur, and US Treasury yields should continue moving sideways at a minimum. Given how closely performance in the iTraxx Main has tracked US Treasury yields so far this year, a slowdown in the sell-off in core govies should allow the Main (and some of the higher beta names in cash) to regain some of their poise too. With consensus having moved a long way towards expecting near-term tapering already, we think there is a good chance of this.

That said, a poor NFP figure sparking a concerted rally in credit is by no means a foregone conclusion. Our main concern revolves around the risk of outflows. The flows which are now producing cash selling in EM, and which this week took US HY mutual funds to negative net inflows YTD, could take on a momentum of their own. Should a poor NFP figure today inspire only a weak rally that begins to fade by the end of the afternoon, we'd take that as a bearish sign for credit both next week and more broadly.

Yet again, therefore, we find ourselves at a pivot point. Probably the near-term trade is to buy risk in some of the assets that have moved the most (like the CDS indices), against selling some of the core credits which have yet to budge, but would be vulnerable in the case of real outflows. And yet liquidity in cash may already have diminished to the point where such selling is difficult. Rationally, you would think that credit was built to withstand much bigger shocks than this, and indeed we suspect that that is the case. There have been many similar shocks to date (the CDS widening and bank equity sell-off post-Cyprus comes to mind) which have blown over completely. That said, as for the passengers on the plane, it does feel distinctly uncomfortable, and yet by this stage there is precious little we can do about it.

Figure 2. Spread movements in € iBoxx this week



Source: Markit, Citi Research

Week ahead

There are few top-tier data releases out next week. With the earnings season over, investors are unlikely to have many headlines to digest. Besides the Eurozone Industrial Production figure for April out on Wednesday, which the consensus is expecting at -0.2% (sharply down from the 1% growth seen last month), there will be little in the way of potentially market-moving data out of Europe.

Attention will instead be focused on the German Constitutional Court. On Tuesday and Wednesday, the court will be hearing a petition from a coalition of academics and left-wing politicians against the OMT. We aren't expecting a decision until after Germany's federal elections in September, and it's unlikely, given past form, that the court will rule decisively against the ECB. But the debate pitting Bundesbank president Jens Weidmann against his former colleague Jörg Asmussen, representing the ECB, should prove interesting.

On Friday, US Industrial Production for May is expected at 0.2% (up from -0.5% in April), with the forecast improvement highlighting the contrast between a US economy that is slowly returning to growth and the recession still ongoing in Europe. Also on Friday, the finance and labour ministers of Germany, France, Italy and Spain will meet in Rome to coordinate their policies regarding unemployment ahead of the European Council meeting later this month. However we doubt that there will be many substantial decisions taken at this stage.

Key Economic Indicators (10 June – 14 June 2013)

Monday 10 June	Consensus Forecast	Last
ISM Manufacturing	50.5	50.7
Wednesday 12 June	Consensus Forecast	Last
Eurozone IP (MoM, YoY)	-0.2%, -1.3%	1.0%, -1.7%
Thursday 13 June	Consensus Forecast	Last
ECB Monthly Report		
US Advance Retail Sales	0.4%	0.1%
Friday 7 June	Consensus Forecast	Last
US IP	0.2%	-0.5%
U. of Michigan Confidence	84.5	84.5
Sources: Bloomberg		

Key Earnings (10 June – 14 June 2013)

Tuesday 11 June
Remy Cointreau
Thursday 13 June
Heidelberger Druckmaschinen
Sources: Bloomberg

Recent Research Publications	Author	Date
European Credit Research		
European Credit Derivatives – Trade Ideas iTraxx Series 9 vs. Series 19 Equity Tranches	Abel Elizalde	June 5, 2013
CreditBrief – Not quite May-day	Joseph Faith	May 31, 2013
Global Credit Survey- Where does the long come from?	Joseph Faith	May 29, 2013
Financial CDS to get a re-vamp – ISDA to introduce a new CDS contract to accommodate bail-ins	Abel Elizalde	May 21, 2013
European Credit Derivatives – Trade Ideas: Hedges via Crossover “Bearish Ladders”	Abel Elizalde	May 16, 2013
European Credit Sector Recommendations – Swallow the sugar, but be wary of the medicine	Teresa Cascino	May 14, 2013
Too much money, not enough assets to buy – Inside the global supply-demand imbalance	Hans Lorenzen	Apr 25, 2013
Mind the gap – Investing in repressed markets	Matt King	Apr 22, 2013
European Credit Derivatives – Trade Ideas: Views & Trades on iTraxx Series 9 Tranches	Abel Elizalde	April 18 2013
Beware of retail and food releveraging	Teresa Cascino	Apr 18, 2013
A European Financial Transaction Tax – When good politics make for bad market economics	Hans Lorenzen	Apr 10, 2013
US Credit Research		
FOMO – Fear of Missing Out outweighs all others	Stephen Antczak	May 7, 2 013
How to earn 10%, Part 2 – Best ways to lever up credit – the short-dated, synthetic way	Anindya Basu	Apr 8, 2 013

Source: Citi Research

Appendix A-1

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