Citi Research
US Credit Weekly

The tax man cometh

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High Grade Strategy

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Credit
Investment Overview
North America
Corp. High Grade Strategy

MARKET OUTLOOK | SINGLE NAME NEWS & VIEWS | WEEK AHEAD | RECENT CITI RESEARCH | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS

Market Outlook

Potential tax changes next year are already having a noticeable effect on the markets. The obvious example in the investment grade market is the recent flood of dividend deals, where a host of companies have announced special equity dividends or have accelerated their 2013 dividend schedule. Indeed, we reckon that approximately $27bn of the high grade issuance since November has been tied to dividend announcements.

In the equity markets, the change to the capital gains rate is also having a clear impact. The 40% of stocks that registered the largest gains through November of this year have since then been roughly flat (up only 0.3%). In contrast, the bottom performing 60% of stocks are up 0.92% since November 1, suggesting to us investors are monetizing profits on their outperformers ahead of year end.

But it's not just the dividend and capital gains tax rates that may change in 2013. The negotiations around the 'fiscal cliff' have put into play a number of corporate tax reforms that if enacted are likely to have broader implications for bond markets. Many of the White House's corporate tax proposals first featured in President Obama's Fiscal Year 2013 budget, which was presented in February of this year and scored by the Congressional Budget Office (CBO) in March, but received almost zero Congressional support.

If the White House is successful in getting these reforms included in any fiscal cliff deal or if they are included in negotiations next year, it's very possible that corporate tax rates increase, contrary to the prevailing assumption that corporate rates are likely to go down. Moreover, these tax increases should disproportionately impact US multinationals, basics, and the energy industry.

The three largest corporate tax proposals from the White House:

1.) Reform the international tax system: The President's preferred method for reforming the international tax system is simply to end the ability of US based multinational firms to indefinitely defer US taxation on foreign income through the active financing exception. The CBO calculates that doing so would raise $168bn in revenue over the next 10 years, and, given that corporate income tax revenues were approximately $200bn in 2011, $168bn spread over 10 years is not an insignificant increase.

Presumably, corporate taxes would be lowered as an offset to a tax increase of this nature in order to make it a more revenue neutral event. Indeed, the Administration seems supportive of lowering the top corporate income tax rate to

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28% from 35% (and potentially even lower for manufacturers), even though it has yet to formally propose such a plan.

In any case, we expect US multinationals to be at a disadvantage to foreign companies operating under territorial tax codes (i.e. a company's worldwide earnings are not taxed by their home country), if the active financing exception is closed rather than the US transitioning to a territorial system itself (a competing proposal).

2.) LIFO repeal of accounting for inventories: The President's framework calls for a repeal of the LIFO (last in, first out) method of accounting. While most companies use the first in, first out (FIFO) treatment, those using LIFO report higher cost of goods sold and lower profits, and in turn face a lower tax bill. By forcing companies to use FIFO, and be in line with international standards, the government would be able to raise tax revenue by an estimated $74bn over the next 10 years.

Companies that use LIFO are required to disclose the value of their "LIFO reserve", which is the difference in the value of inventory under LIFO vs. FIFO. We read the proposal to mean that corporates would be required to effectively pay back taxes on this reserve amount, at current tax rates. Under previous proposals, a 10 year period over which this could be paid has been suggested.

A FIFO mandate would primarily be an issue for energy companies, as using LIFO helps them minimize commodity price volatility. For instance, Exxon has the largest LIFO reserve balance at $26bn. The cash impact should be manageable for most credits, and we do not foresee any major ratings change. One other thing to consider is that assuming all else equal, profitably should improve for former-LIFO users as a lower cost of inventory would boost profits.

3.) Eliminate fossil fuel tax preferences: Companies that produce oil, gas and coal are likely to see large tax increases, as the current proposal calls for the end of $30bn (over 10 years) of tax breaks. One of the bigger tax breaks that's likely to be eliminated is the ability to immediately expense intangible drilling costs, which allows producers to book a lower profit and pay lower taxes. Instead, the costs, such as those incurred to build shafts or tunnels, will be amortized in line with the rules for other corporations.

The other large tax benefit that's likely to disappear is the ability to use the *percentage depletion* method of deducting costs related to wells and mines. The use of *cost depletion* will be required, which expenses costs in the proportion of the share of the resource extracted (ie 10% of reserves are extracted, so 10% of costs can be expensed). Under the percentage depletion method, drillers are currently able to allocate a fixed percentage of income as an expense, allowing some to charge-off an amount greater than the actual cost, thereby lowering profits and taxes.

In addition to these three major potential corporate tax reforms, the White House is also seeking to change the tax treatment of insurance products and carried interest. The Administration calculates that changing the tax code on the former will generate $19bn in additional revenue for the government while changes in carried interest are expected to result in an additional $13bn in revenue. Finally, some Congressional Democrats have also contemplated changing the corporate tax code for pass-through vehicles to bring rates more into line with C-corporations.

But why should debt investors care about tax changes at all, as it's usually a company's pre-tax earnings that are of most interest to bond investors? To our

driven rally

High Grade Strategy Notes
Oct '12 – Debunking the Dollar Price Discount

What's Baked In, Part One
Oct '12 – Based on earnings indicators, credits that are mispriced

What's Baked In, Part Two
Oct '12- Earnings "Relief Rally" Candidates

How the technicals could crack
Sep '12 – And why muddle through just won't cut it

US Key Economic Data

Tuesday:	*Consensus*
Wholesale Inventories	0.4%
Wednesday:	
MBA Mortgage Applications	-
Monthly Budget Statement	-$145.0bn
Thursday:	
Advance Retail Sales	0.4%
Producer Price Index	-0.5%
Initial Jobless Claims	370k
Friday:	
Consumer Price Index	1.9%
Industrial Production	0.2%
Capacity Utilization	78.0%

Key Earnings Announcements

Wednesday:
Costco Wholesale Corp.
Thursday:
Adobe Systems Inc.

minds, the reason is obvious: Higher corporate tax rates likely increase the pressure on management teams to engage in more shareholder friendly behavior. Just look at the jump in dividend deals or the liability management trades to take out high coupon long-dated debt. Frankly, we'd be prepared for a much more contentious tug of war between debt and equity investors, as company's look for ways to share the pain of higher corporate taxes with debt holders.

In more ways that one, 2013 is likely to be the year of the tax man. We hope you can enjoy the holidays anyway, and we thank you for your support this past year. The next *US Credit Weekly* will be published in January.

Single Name News & Views

Long bonds and the cliff: Since mid-October, the credit return of Citi's Broad Investment Grade Corporate Bond Index has dropped by roughly 140bp. What's notable, to our minds, is that 80% of this loss has come from the 30y part of the curve.

As such, those looking for a reversal of the recent sell off in January, may want to consider adding to long bond exposure. In the following table, we list sizable financial and nonfinancial issuers by ratings bucket where long end bonds have underperformed.

Long bond underperformers with notional greater than $750mm
OAS performance since October 19th

	Financials		Non-financials	
AAA-AA	GE 5.875s of '38	+31	MSFT 4.5s of '40	+36
	BRK 4.4s of '42	+21	WMT 5.875s of '27	+33
	RABOBK 5.25s of '41	+16	IBM 4s of '42	+31
A	PRU 6.625s of '37	+25	INTC 4.8s of '41	+64
	WLP 4.65s of '43	+23	APA 4.75s of '43	+58
	WFC 6.6s of '38	+22	T 5.55s of '41	+47
BBB	AXASA 8.6s of '30	+35	CLF 6.25s of '40	+119
	GS 5.95s of '27	+26	ADT 4.875s of '42	+70
	CI 5.375s of '42	+18	ETP 6.5s of '42	+68

Source: Citi Research

M&A picking up: This week we saw M&A activity across several sectors. **CSC** announced the sale of its credit services business to Equifax for $1bn in cash. CSC plans to use up to $400mm for share repurchases, another $400mm to fund its pension plans, and the remainder for general corporate purposes. We think this is a good move for the company, as its liquidity profile improves while it is making strides in its efforts to reposition the company. However, given the significant rally the **5y CDS has experienced, moving 100bp in the past month**, we suggest buying protection as this company could quickly intensify its shareholder-friendly slant.

In healthcare, **Baxter** announced a $4bn acquisition of Gambro, a Swedish dialysis product company. Longer term, the deal should help Baxter achieve its growth plan. However, near term we do not see much room for spreads to tighten with $3bn of issuance on the horizon and ratings pressure due to the increase in leverage – S&P downgraded the company on Thursday night from A+ to A, and Moody's has the company on review for downgrade.

Freeport-McMoRan (FCX) announced that it will make a big bet on the oil and

gas business through the acquisition of Plains Exploration and Production (PXP) for $6.9bn and McMoRan Exploration (MMR) for $3.4bn in cash and equity, plus assumed debt. FCX is paying a 39% premium for PXP and 74% over MMR's closing price. Currently with a net cash position, leverage should be a manageable 1.7x pro forma for the transaction, and the company plans to use its estimated $9bn of free cash generation in 2013 to repay debt and fund capex. As such, the rating agencies affirmed FCX's Baa3 / BBB ratings, although Moody's has kept a negative outlook on the company. While we expect FCX bonds to move a bit wider in anticipation of a new debt deal, we think **5y CDS looks like the better short at 155bp** given the integration and potential end market challenges FCX faces.

Week Ahead

The FOMC meeting will likely be the highlight next week. The market expects the Fed to replace Operation Twist, which expires at the end of '12, with unsterilized purchases ($45bn in treasuries on top of $40bn in mortgages).

Although today's employment report was encouraging, the Fed will likely maintain its current course of action, as recent data has been relatively weak, aside from housing (and more recently labor). That said, retail sales are expected to show a slight improvement from last month as we hope to see the benefit from a strong start to the holiday season and rebound from Superstorm Sandy. Industrial production (later on in the week) is expected to have grown slightly last month.

As far as fiscal cliff negotiations are concerned, the next two weeks are likely to be crunch time. We view the past two weeks as posturing, but if a deal is going to get done before Christmas, substantive negotiations must begin soon.

In contrast, European leaders are already back at the negotiating table. On Wednesday, EU Finance Ministers will again meet to discuss a banking union. We think it is unlikely that Germany will give up its resistance, not the least toward handing supervision of its smaller banks to the ECB, and therefore we expect key decisions to be deferred. On Thursday and Friday, the outcome of the Greek bond buyback program, which closes tonight, will be assessed and the IMF will decide on whether to extend its tranche of loans.

Spain will also come back to the markets on Thursday: our interest rate strategists expect €3.5bn of issuance. The auction this week was not particularly well received, so look out for further signs of weakness ahead of the heavy schedule early next year.

Appendix A-1

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