

Another Year On The Edge

US credit outlook 2012

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

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Overview

The macro backdrop ...

... makes for a binary 2012 credit outlook ...

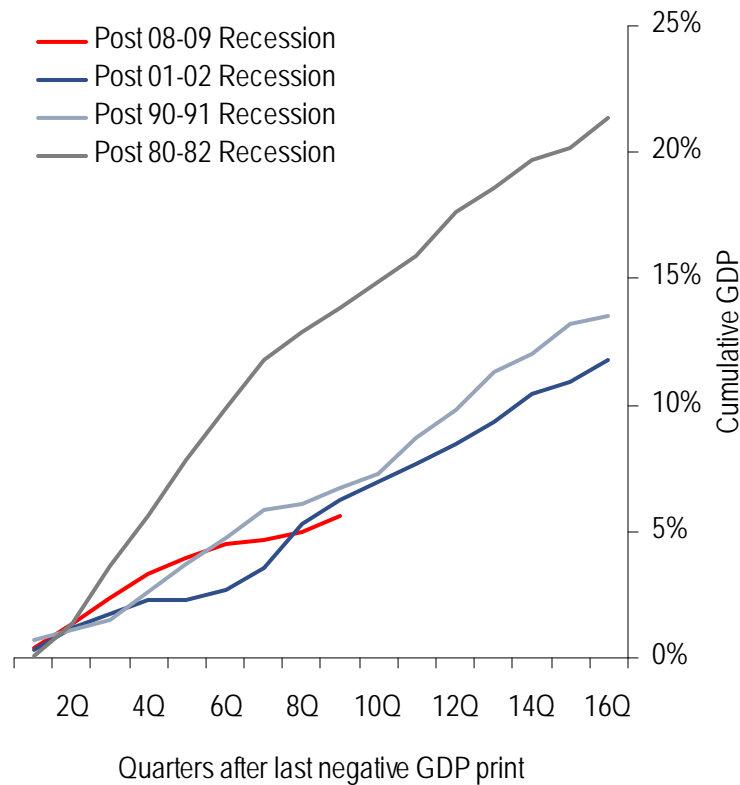
... where generating alpha in credit will be difficult ...

... and requires trading the dislocations and asymmetries ...

... while continuing to hedge tail risk.

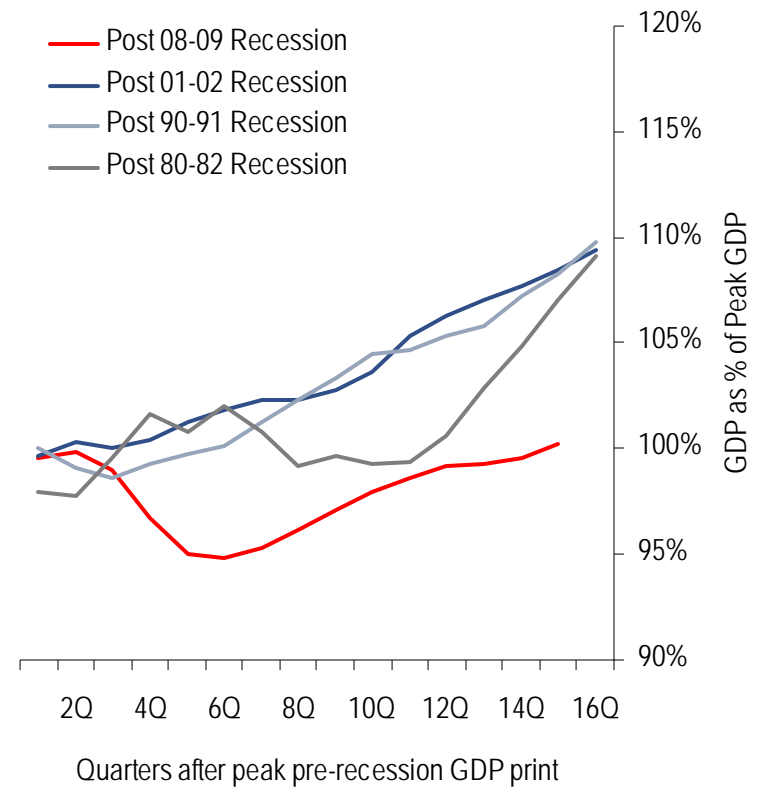
The allure of a normal recovery

Everything looks on track at first glance ...



Source: Bloomberg

... but percentages hide 4yrs of lost GDP

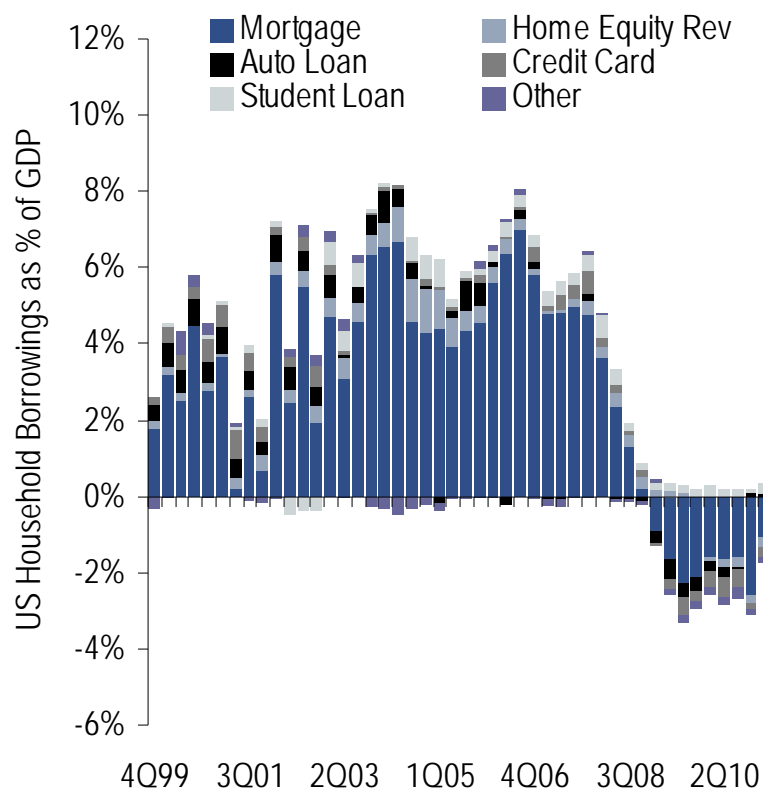


Source: Bloomberg

There's nothing normal about a jobless recovery

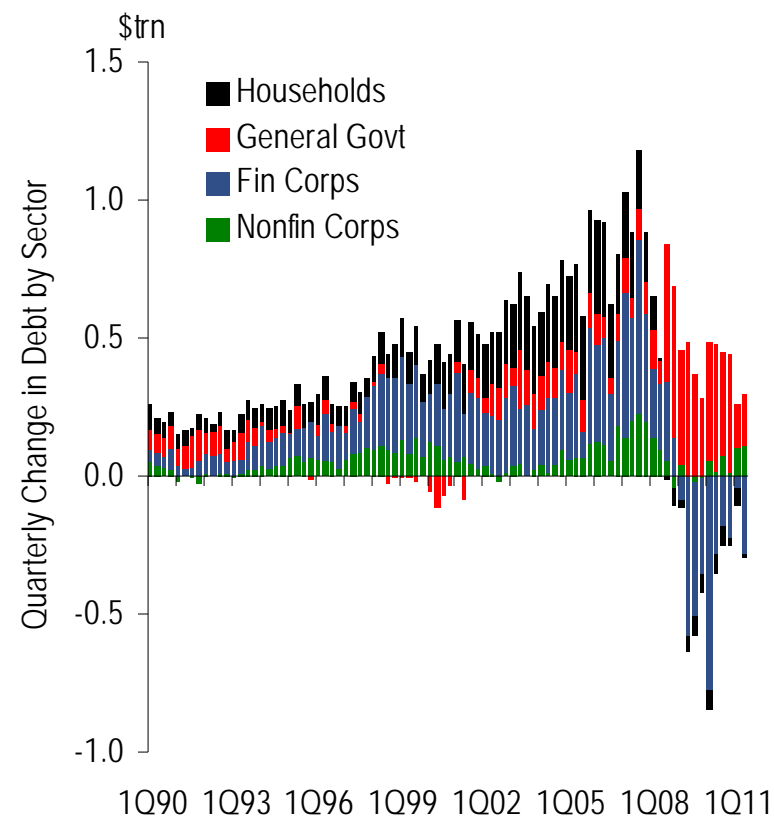
But all is not right with the consumer

Consumers are borrowing less ...



Source: New York Federal Reserve, Haver

... while Uncle Sam is borrowing more

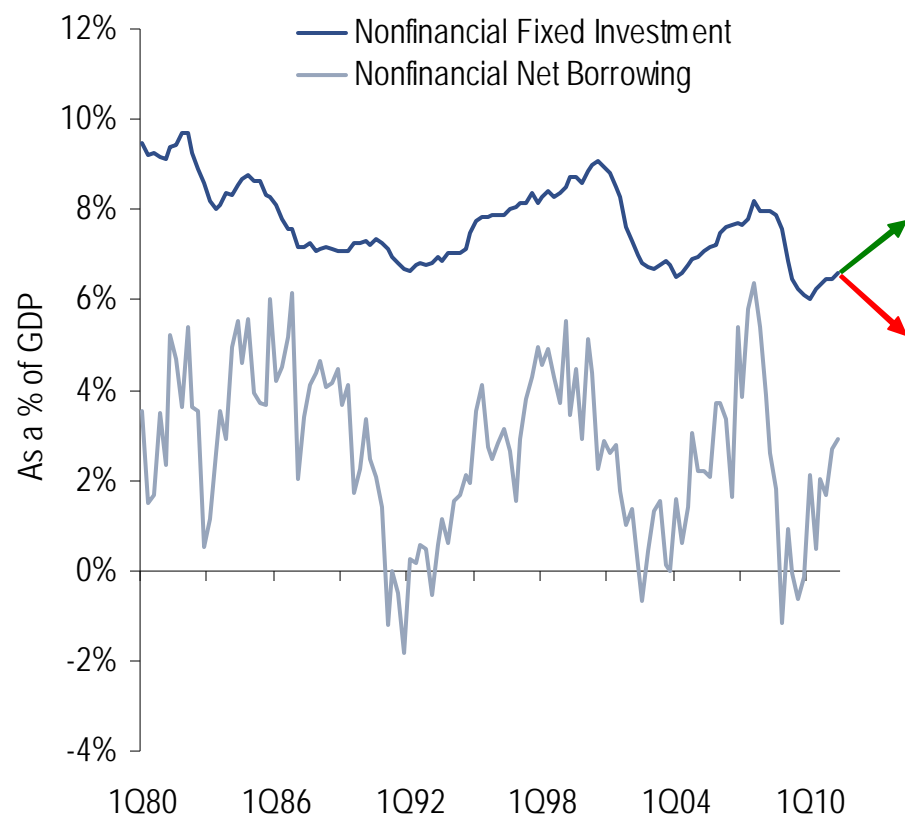


Source: Federal Reserve, Haver

Fiscal tightening will bring an end to the debt party

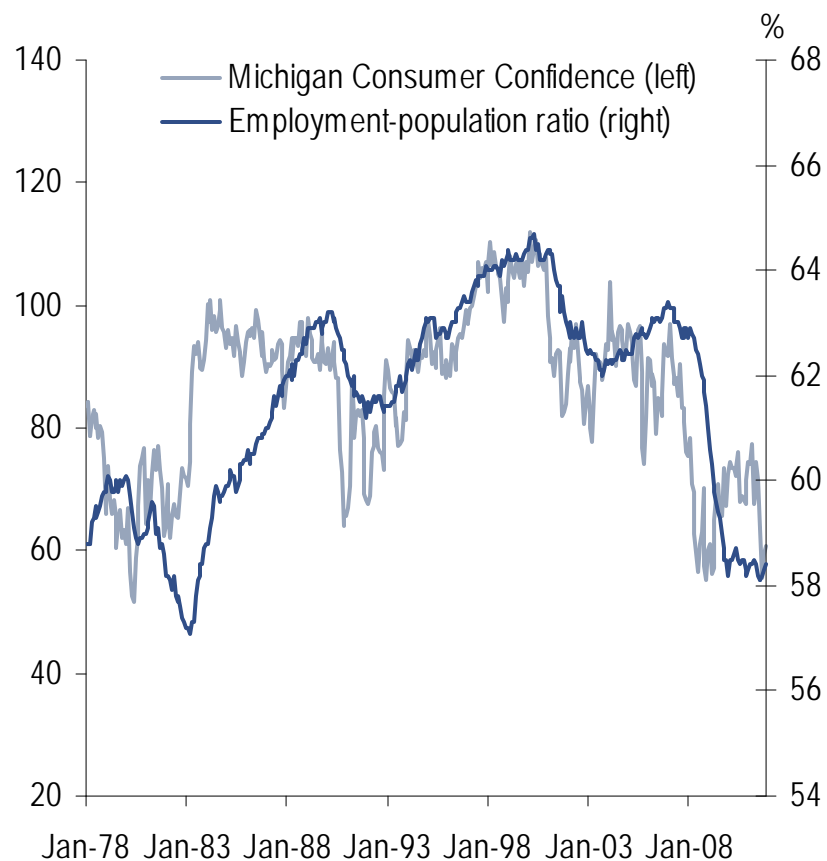
And nonfinancial corporates haven't bought in

So far, corps issuing, but not investing ...



Source: Federal Reserve, Haver

... without confidence in the consumer

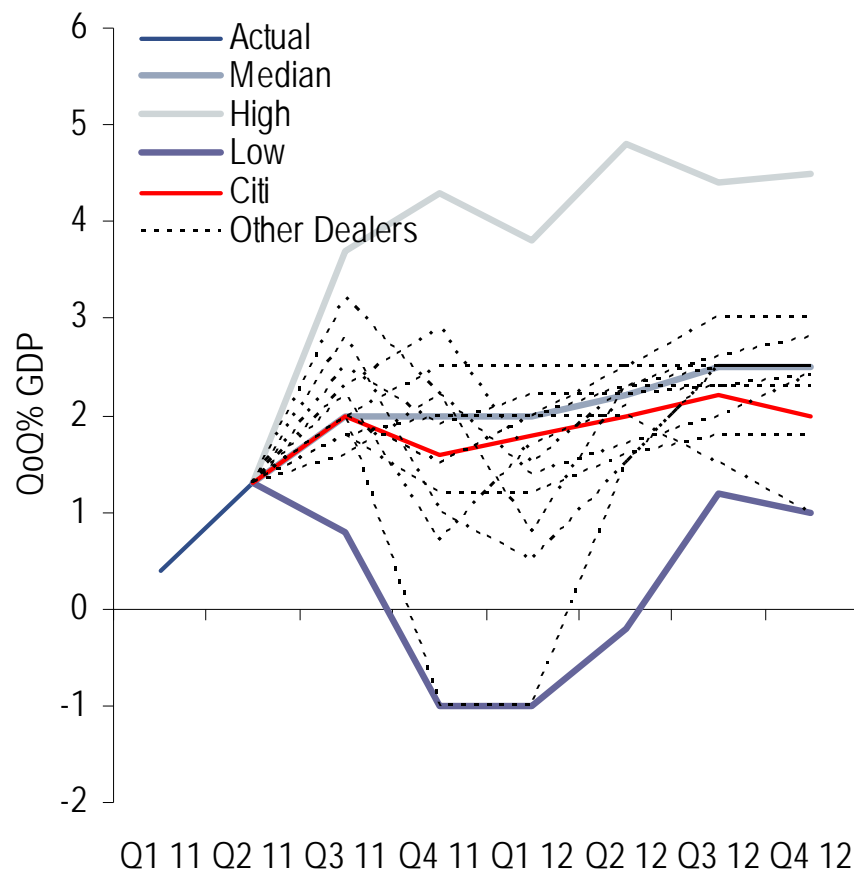


Source: Bloomberg

What to do with all that cash?

So what happens next?

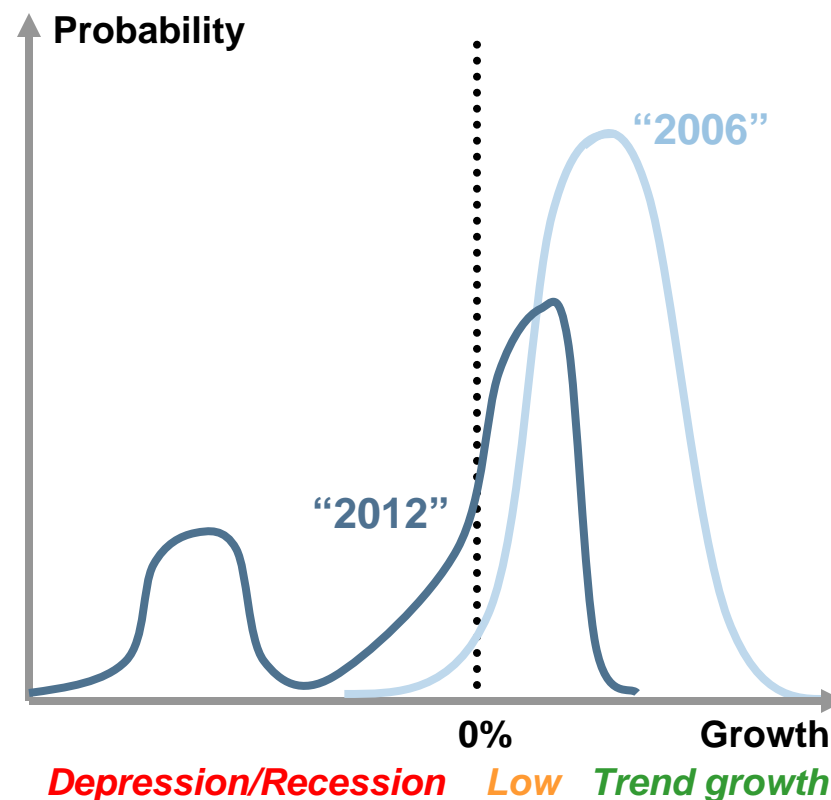
A wide range of economic forecasts ...



Source: Bloomberg, CIRA

... still fail to reflect a binary outlook

Stylized distribution of growth probabilities



Source: CIRA

Forecasts often err by 1% or more 6-9 months out

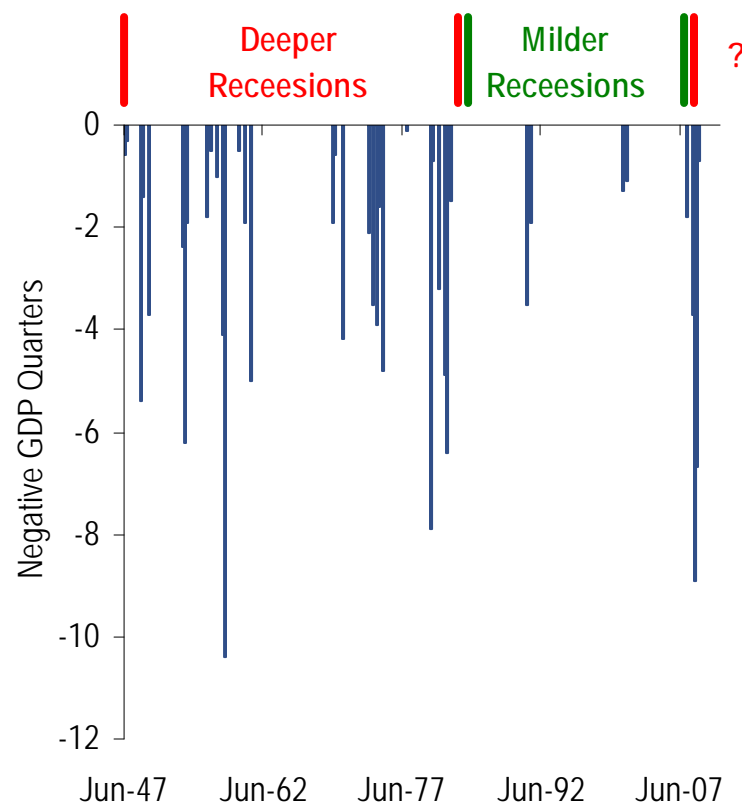
Slow growth is more vulnerable growth

Traditional monetary policy expended ...



Source: Bloomberg

... so volatility could increase



Source: Bloomberg, CIRA

Will rates find a floor in 2012?

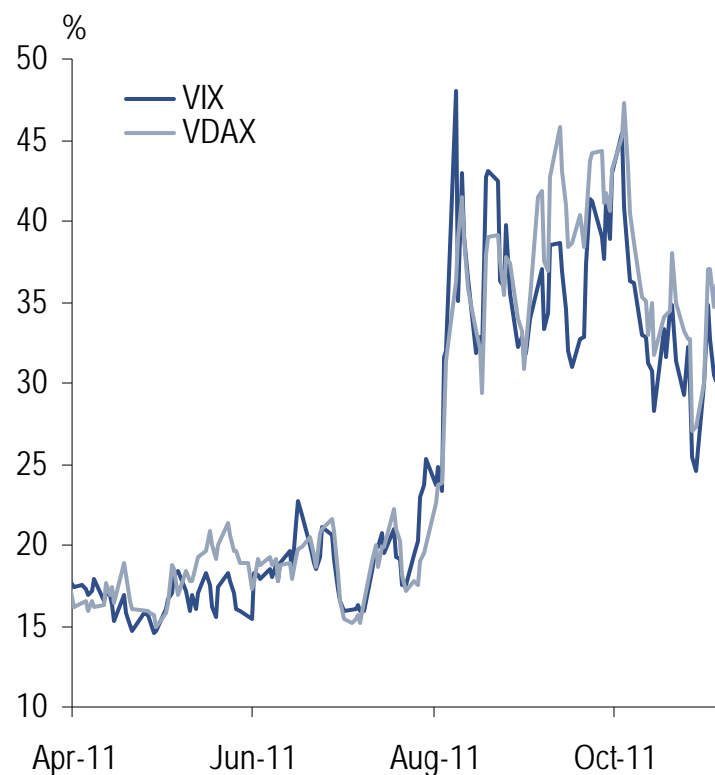
And the more vulnerable, the harder it is to decouple

Spreads have begun to decouple ...



Source: Citi

... but vol hasn't



Source: Bloomberg

Outright levels decoupling, but the drivers aren't

So Europe likely remains a macro risk

A risk unlikely to be resolved quickly ...

... where politics exacerbates volatility

Summary of Citi views on the Eurozone

Default: Greece

Default: Portugal (+Ireland?)

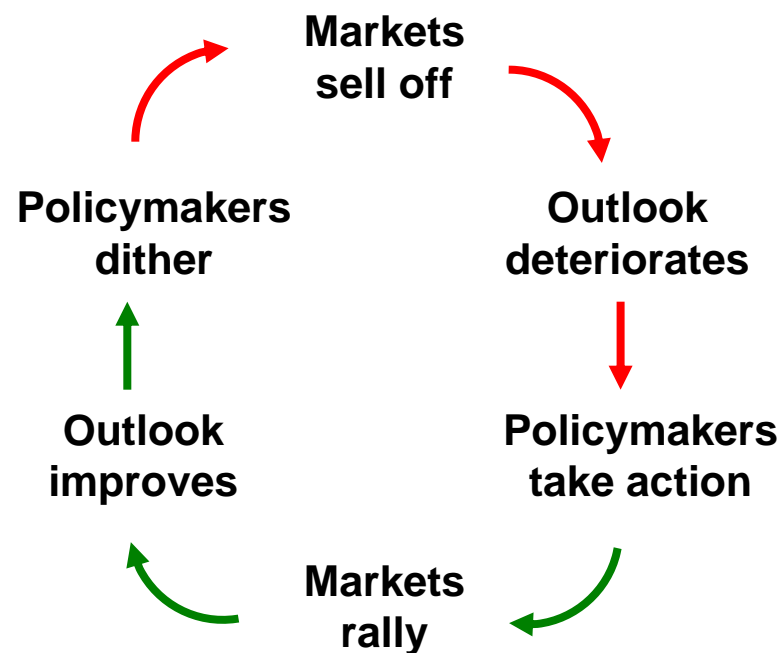
Eurozone recession

External support for Italy

More bank recapitalization

A bigger bazooka

Source: CIRA

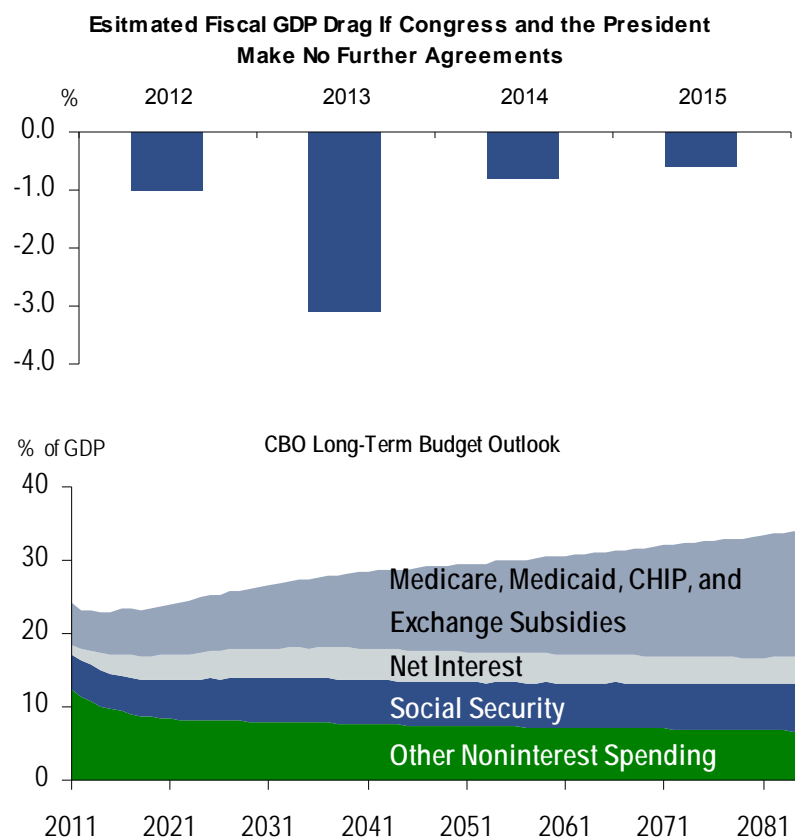


Source: CIRA

An eventual buying opportunity?

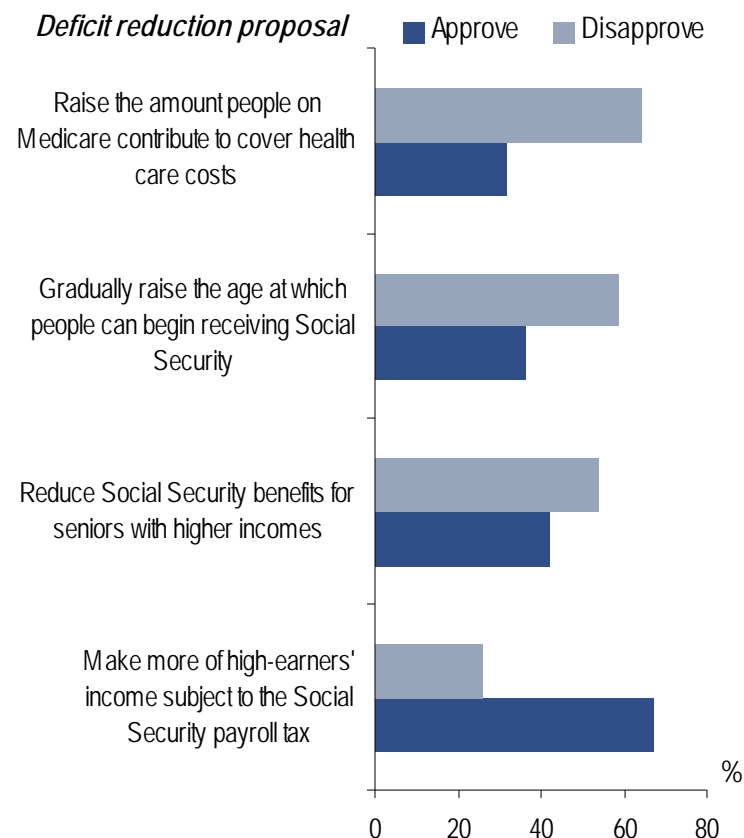
... As will the US fiscal situation

Fiscal austerity, now or later?



Source: CIRA (top), Congressional Budget Office (bottom)

The public wants a fix, but no pain

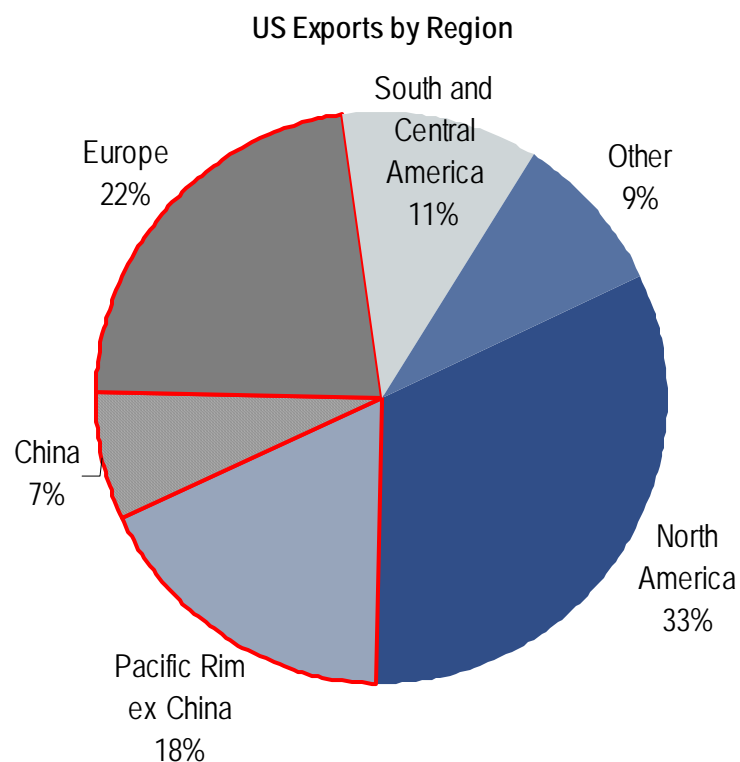


Source: Pew Research Center

4Q 2012 a make or break year for policy

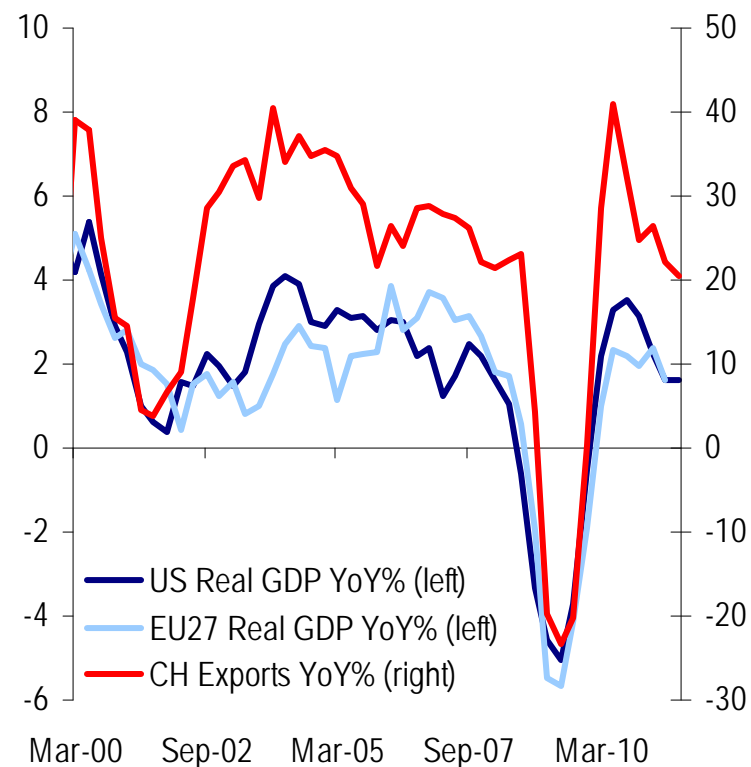
... And global growth, particularly China

Indirect exposure to Europe via China ...



Source: US Census Bureau

... because China has yet to decouple



Source: Haver Analytics, CIRA

What other “unknown unknowns” await?

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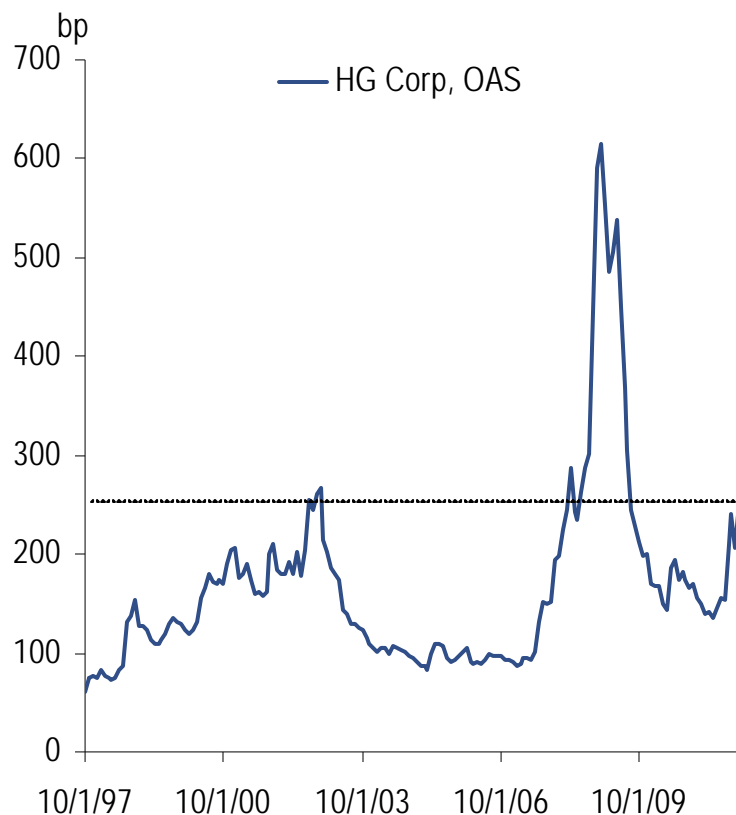
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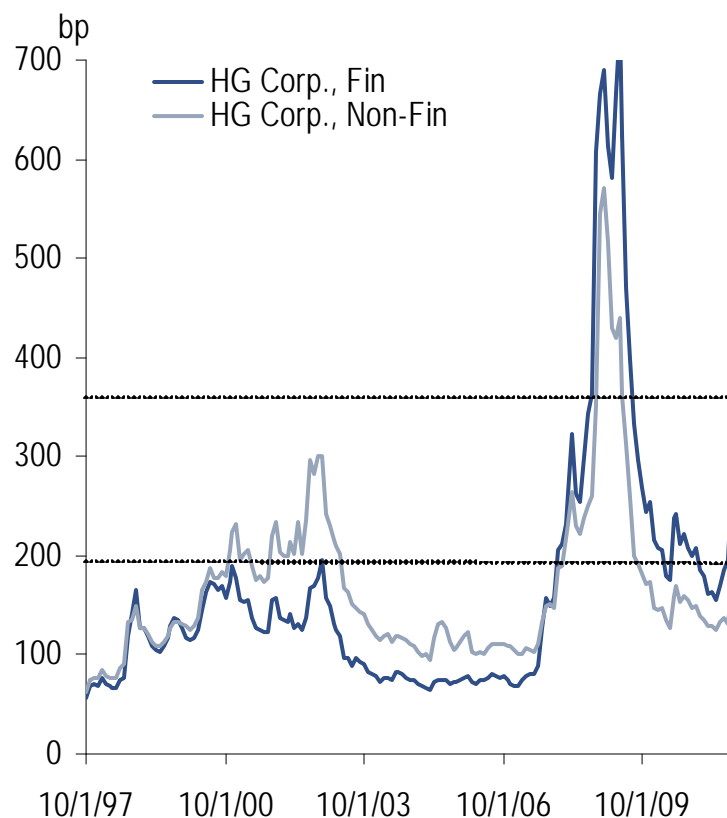
Valuations: Are we really priced for recession?

High Grade at the '01-'02 wides ...



Source: CIRA

... but driven by the financials

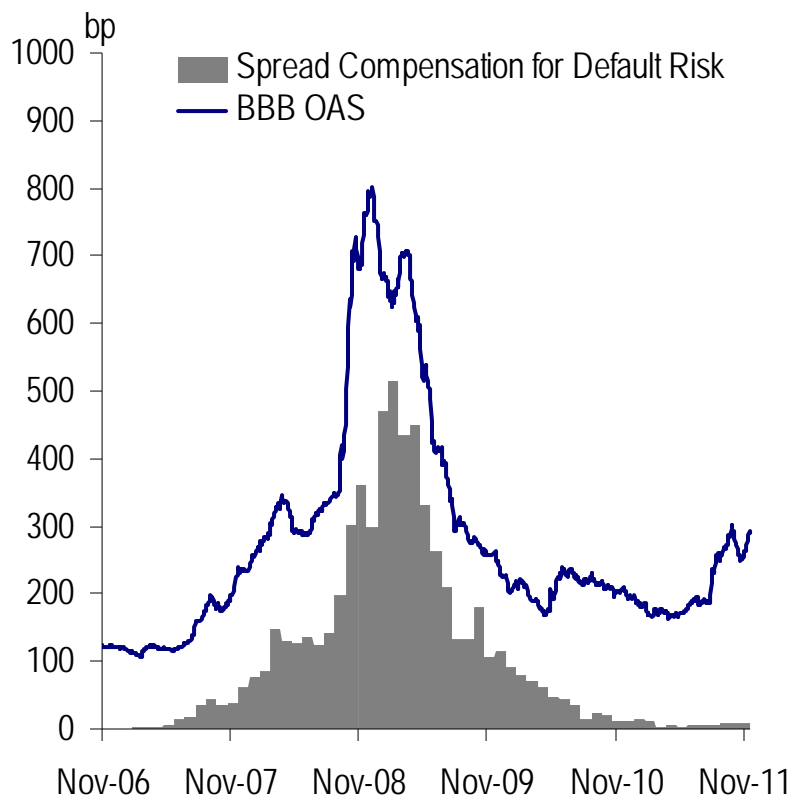


Source: CIRA

Spreads grappling with binary outcomes

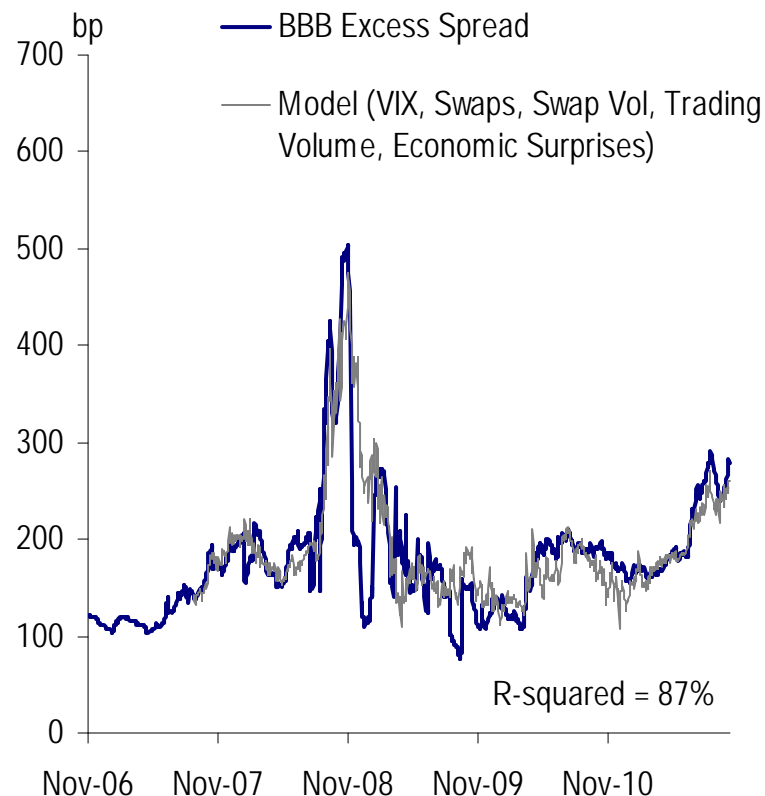
Valuations: What's driving spreads... not default risk

Default risk has receded for HG ...



Source: CIRA, Moody's

... Systemic risk driving spreads

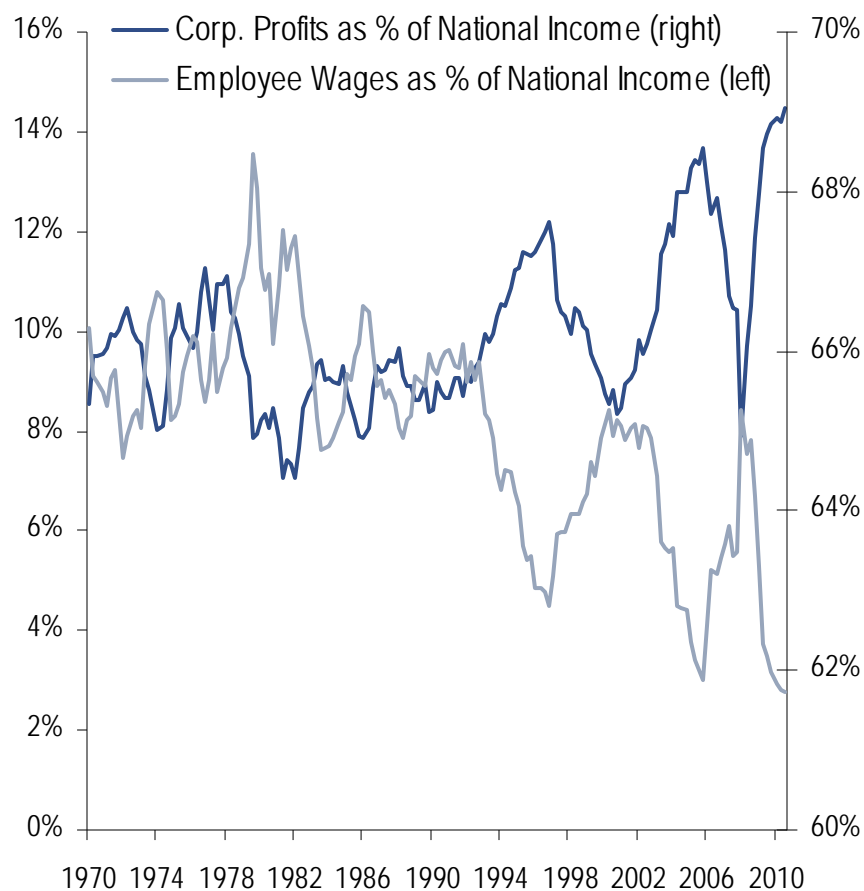


Source: CIRA

Little immediate default risk, lot's of systemic risk

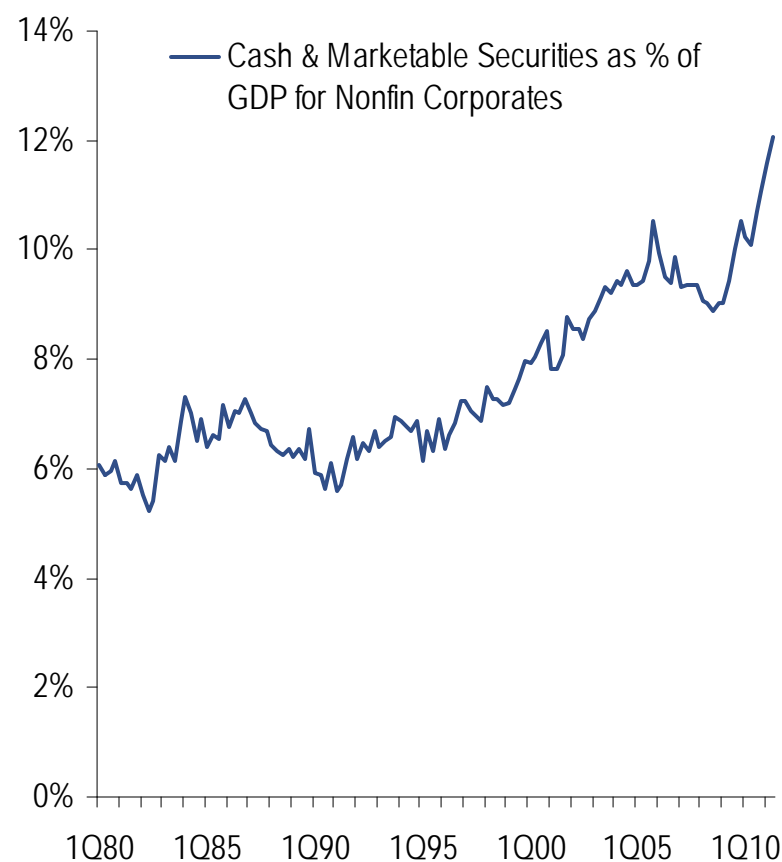
Fundamentals: Corporates in good shape

Profits continue to impress ...



Source: Federal Reserve

... and companies remain flush with cash

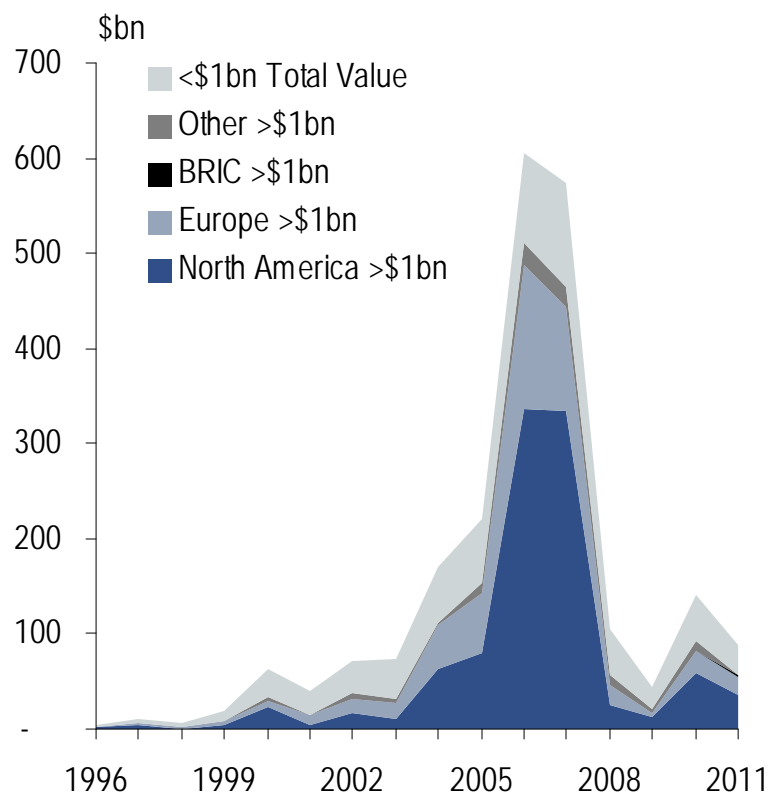


Source: Federal Reserve

Do P/E ratios portend a correction?

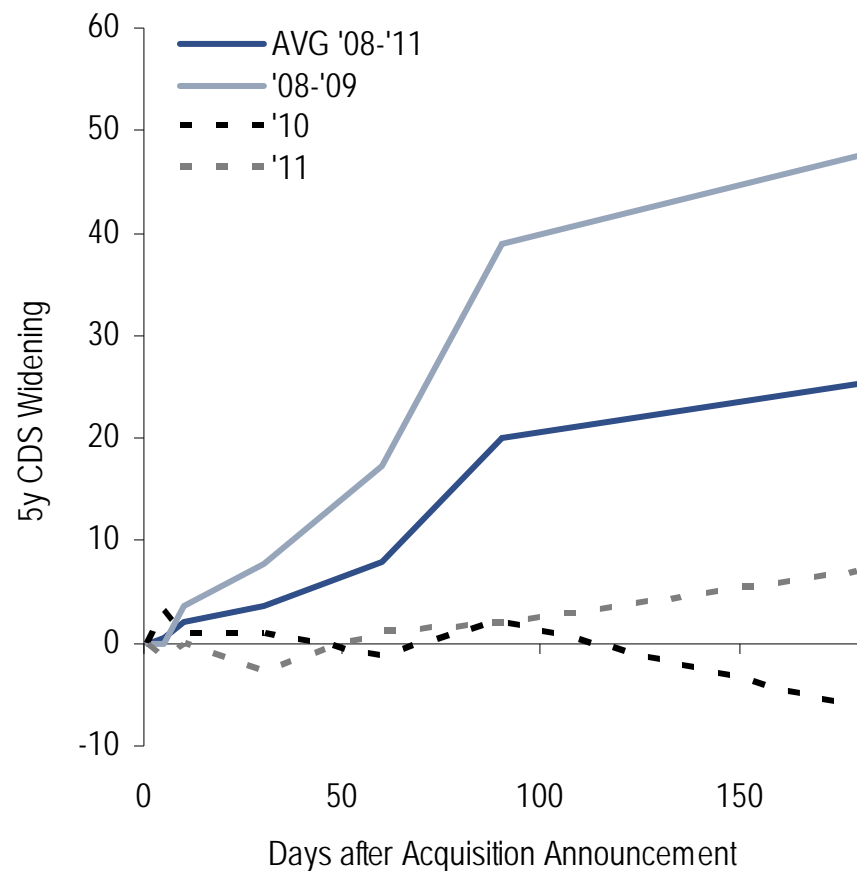
Fundamentals: M&A risk hasn't faded

But relatively few LBOs ...



Source: Bloomberg

... And HG acquirers are not being punished



Source: CIRA

M&A still highly correlated to the macro environment

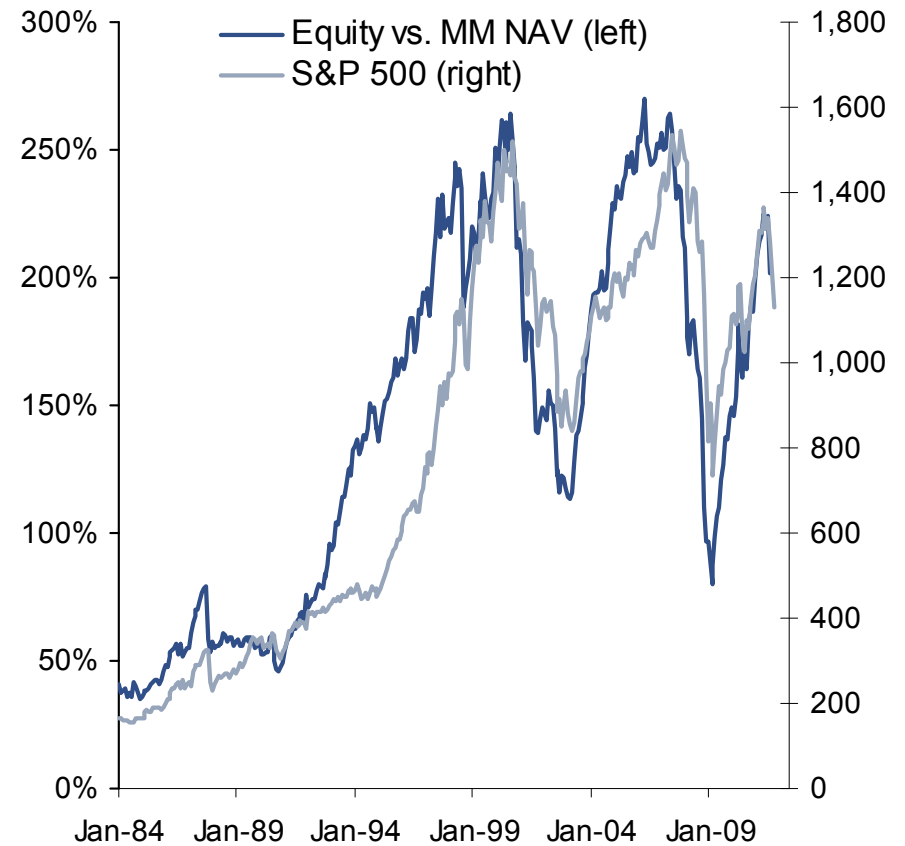
Technical: Effects of QE still present, beware the removal

QE has driven money into HG ...



Source: Federal Reserve, CIRA

... But will it be easy come, easy go?



Source: EPFR, Bloomberg, CIRA

Operation twist a victim of Europe: Is QE3 the answer?

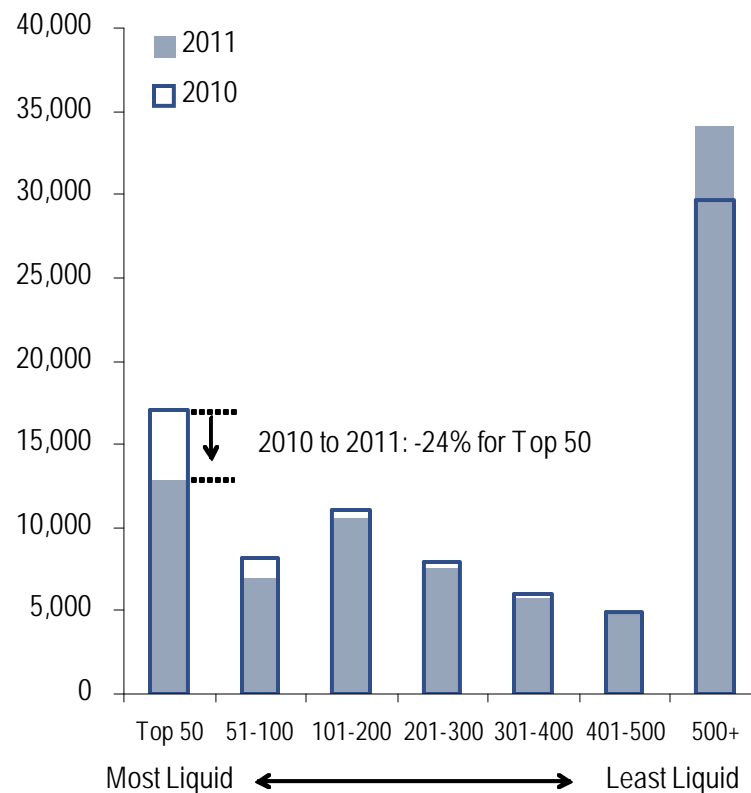
Technical: Regulation is the real mispriced risk

Dealer positions falling, HG growing...



Source: Federal Reserve, CIRA

... And block trades diminishing

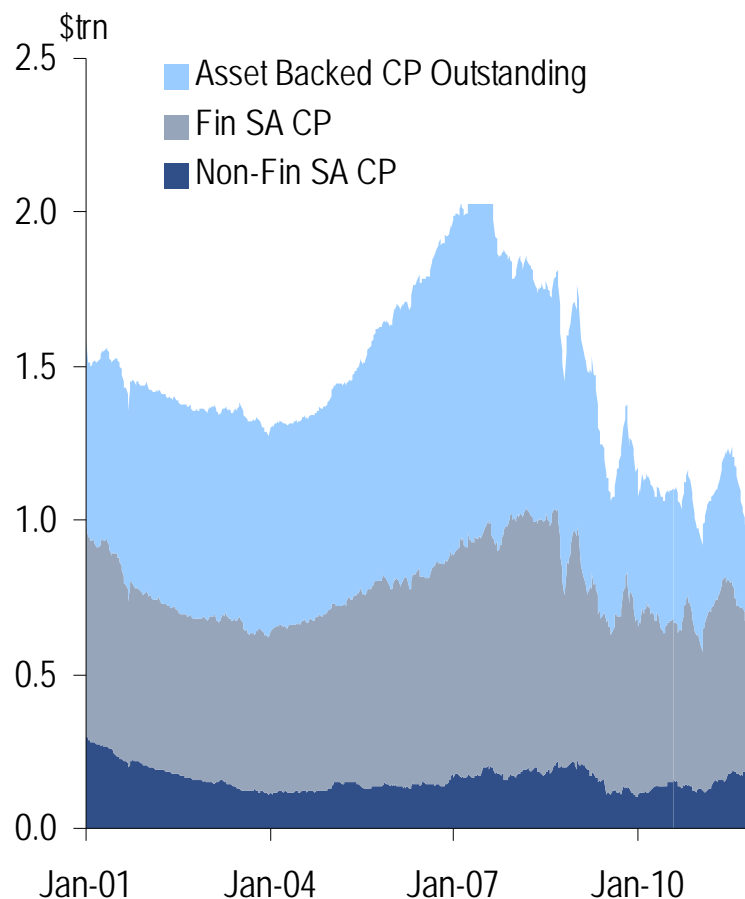


Source: TRACE, CIRA

The secular decline in liquidity likely continues

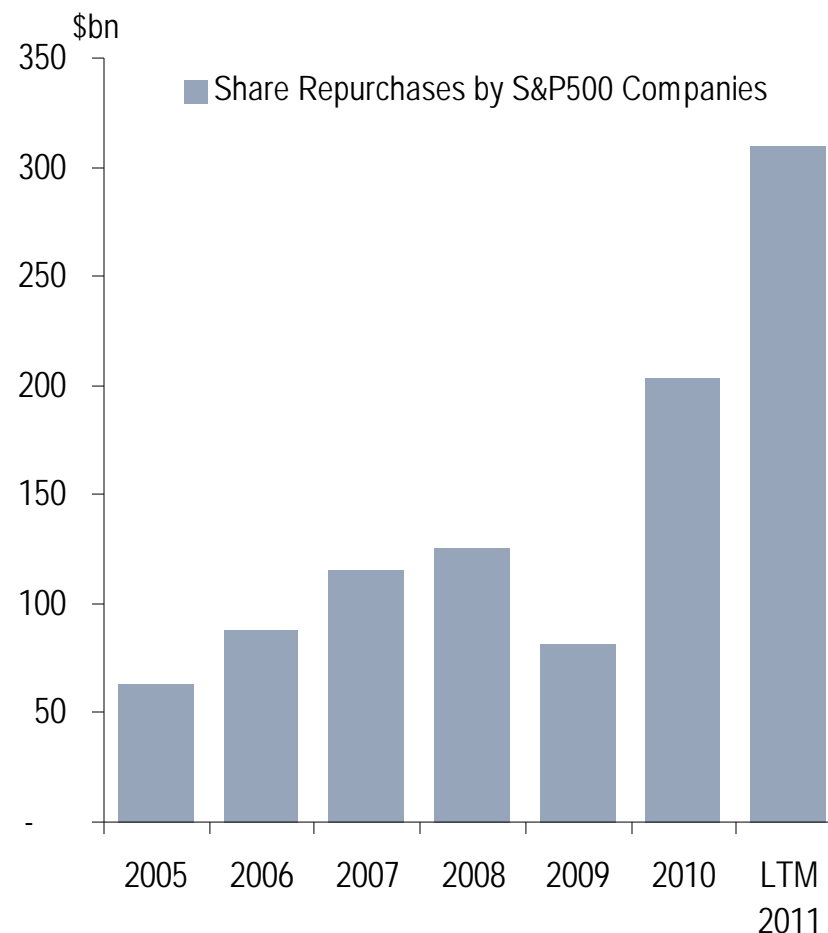
Technical: Increase in HG supply has been structural

The CP trade is nearly finished...



Source: Federal Reserve

... But share repurchases continue

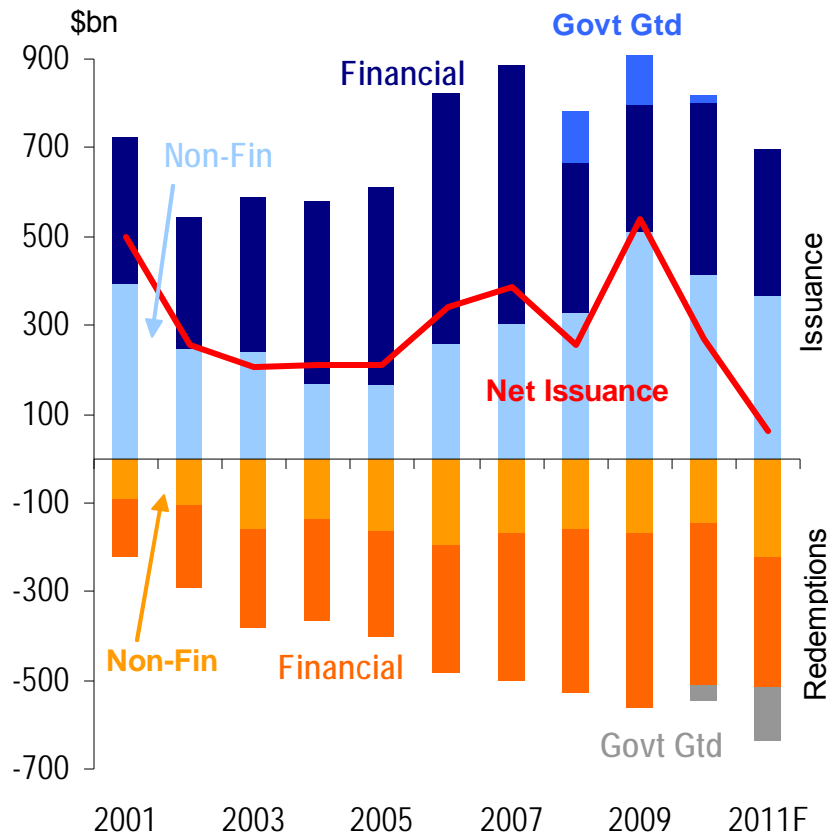


Source: Bloomberg

Growing pains should subside in 2012

Technical: Net supply falling while cash building

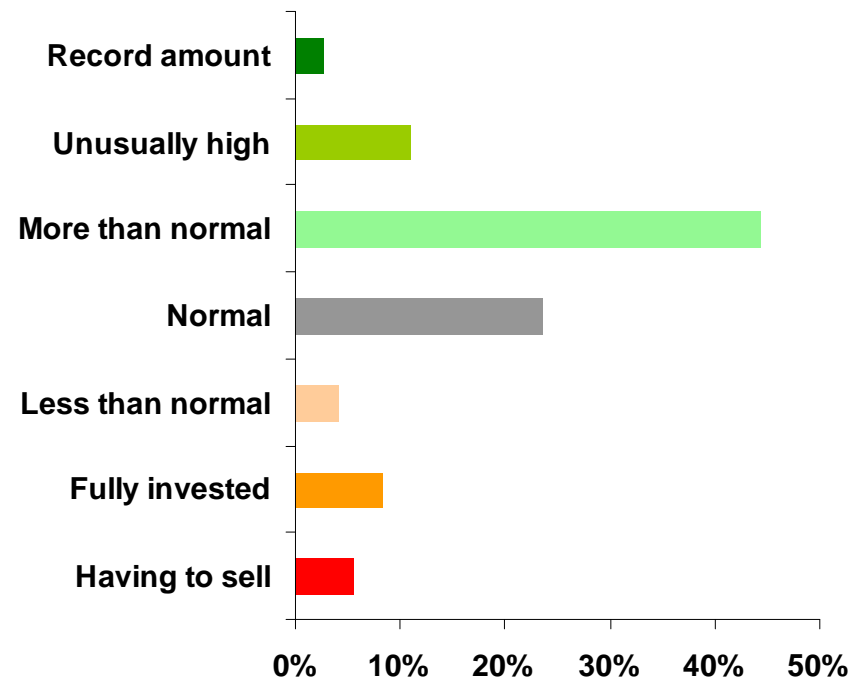
Net Supply Still Positive But Falling ...



Source: Federal Reserve

... Leaving money on the sidelines

How much cash in your funds?
Citi Credit Survey, 18 November 2011



Source: CIRA

Off/On issuance here to stay

Forecast: 5 Scenarios for Spreads in 2012

Our base case scenario

	Current Values	Scenario 1 EU Collapse US Enters Recession	Scenario 2 Sovereign Stresses Continue	Scenario 3 Decade of Delevering	Scenario 4 Moderately Bullish	Scenario 5 Very Bullish
VIX	35%	↑	—	↓	↓	↓
10y Swaps	2.0%	—	—	—	↑	↑↑
Rates Vol	80bp	↑	—	↓	↓	↓↓
Turnover	0.3%	—	—	—	↑	↑↑
Eco. Data	40	↓	—	—	↑	↑↑
Excess Spread	245bp	250bp	215bp	155bp	140bp	115bp
Default Comp.	5bp	200-400bp	5bp	5bp	5bp	5bp
US BIG Spread	250bp	450-650bp	220bp	160bp	145bp	120bp

Source: CIRA

Beware strategists bearing modal forecasts

Overview

The macro backdrop ...

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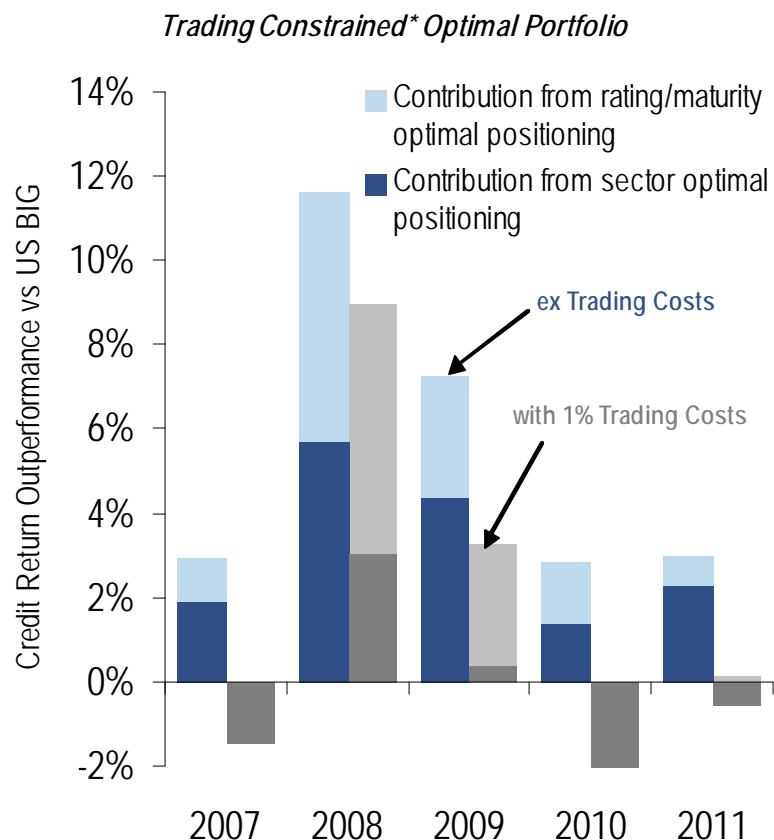
... where generating alpha in credit will be difficult ...

... and requires trading the dislocations and asymmetries ...

... while continuing to hedge tail risk.

Getting all the calls right isn't worth as much as you think

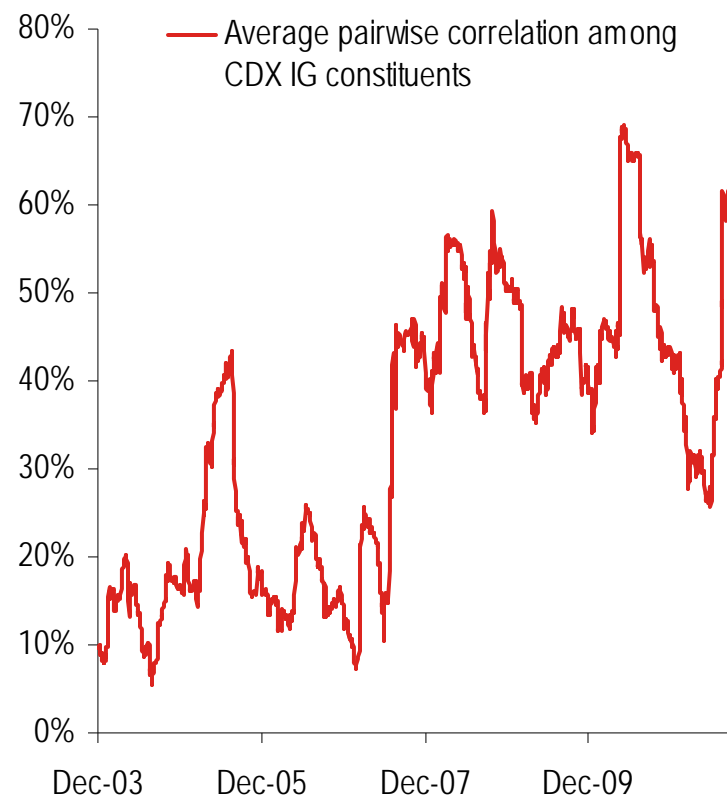
Perfect sector positioning ...



NB: Constrained trading restricts the amount of month-to-month sector and duration reallocation that can occur in the portfolio.

Source: CIRA

... matters less with sky-high correlations

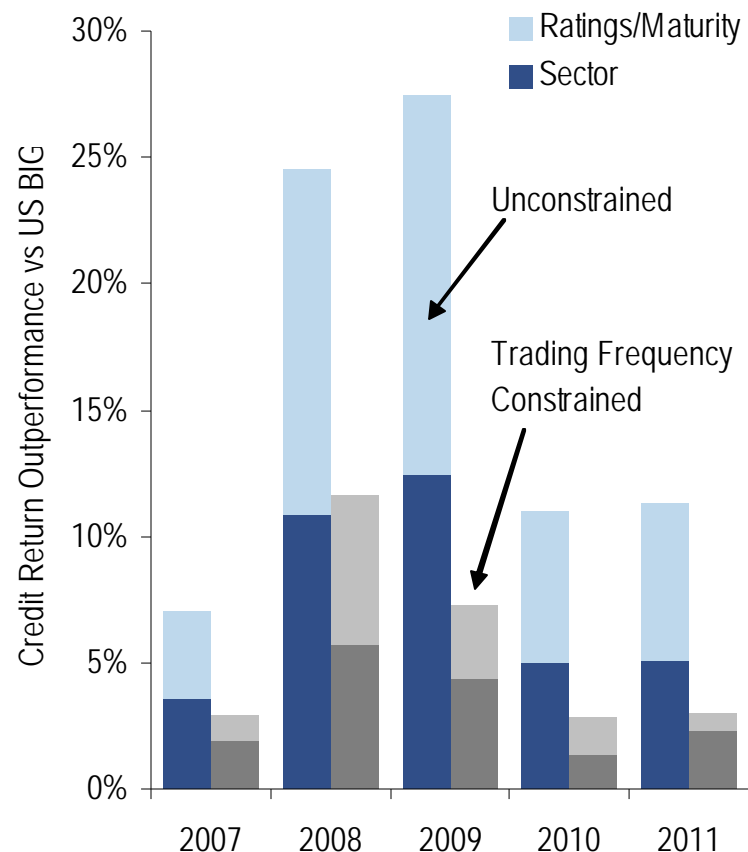


Source: Markit, CIRA

Financials: The only sector call that really matters

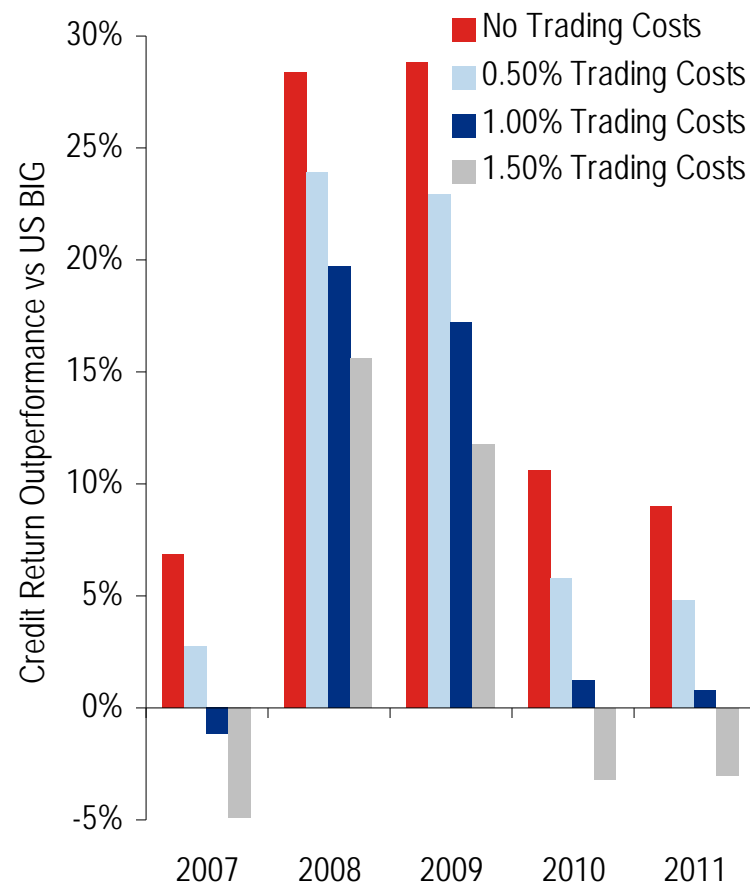
Staying nimble helps a lot...

Big gains for unconstrained fast money ...



Source: CIRA

... but trading costs increase too

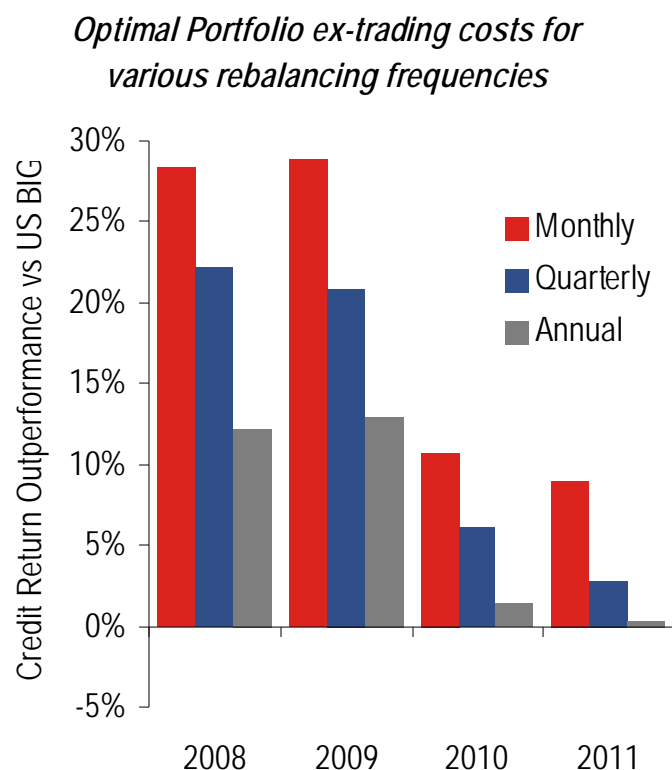


Source: CIRA

Use overlay strategies to become more nimble

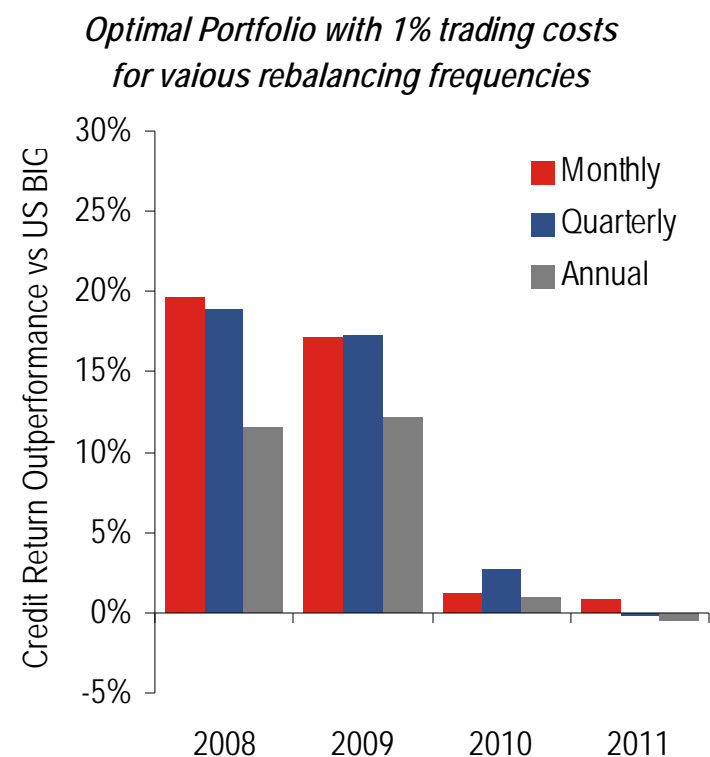
... As does trading less frequently

Quarterly rebalancing maximizes returns ...



Source: CIRA

... and minimizes trading costs

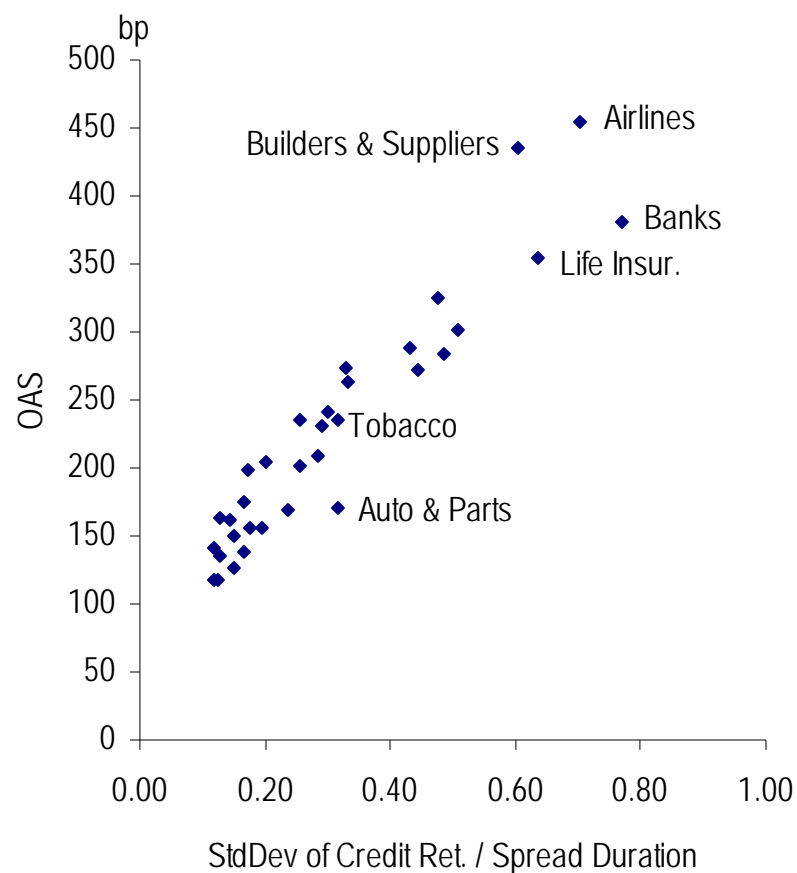


Source: CIRA

Cash rebalancing should be done quarterly

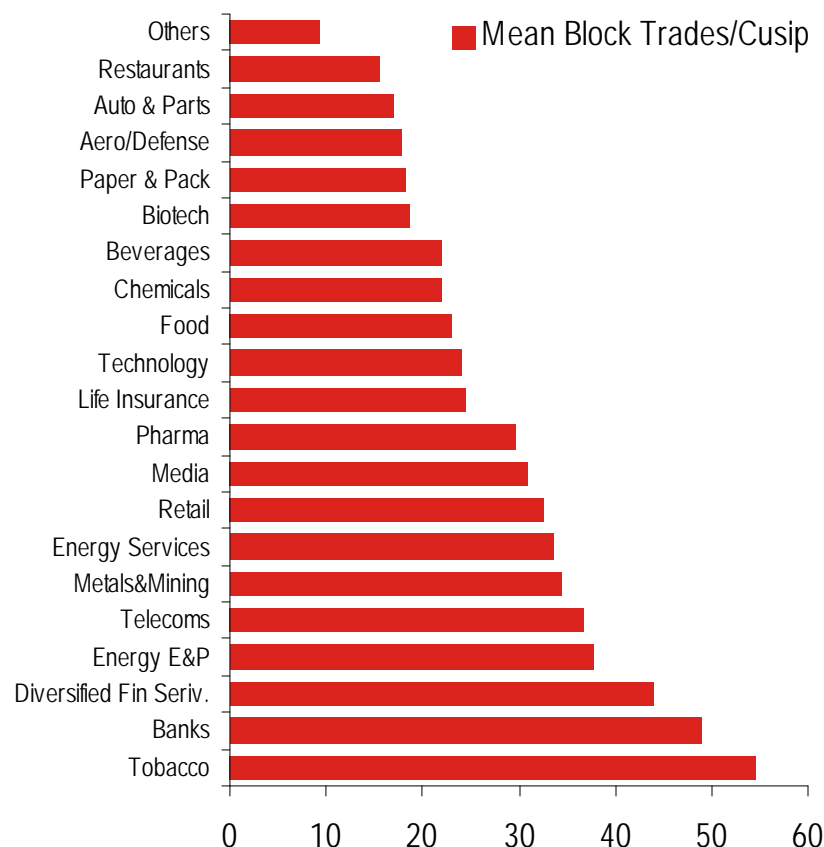
Beware of Sharpe Ratios

Ratios calculated from index data ...



Source: CIRA

... don't take into account liquidity



Source: CIRA, TRACE

“Gappy” markets make traditional methods suspect

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The macro backdrop ...

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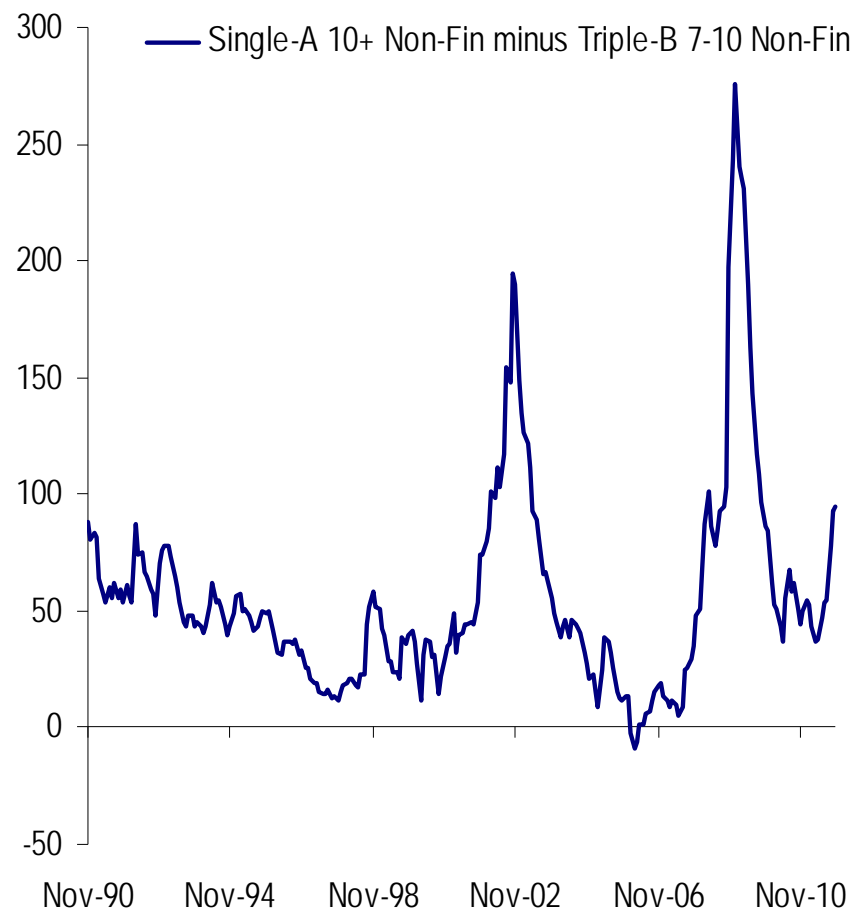
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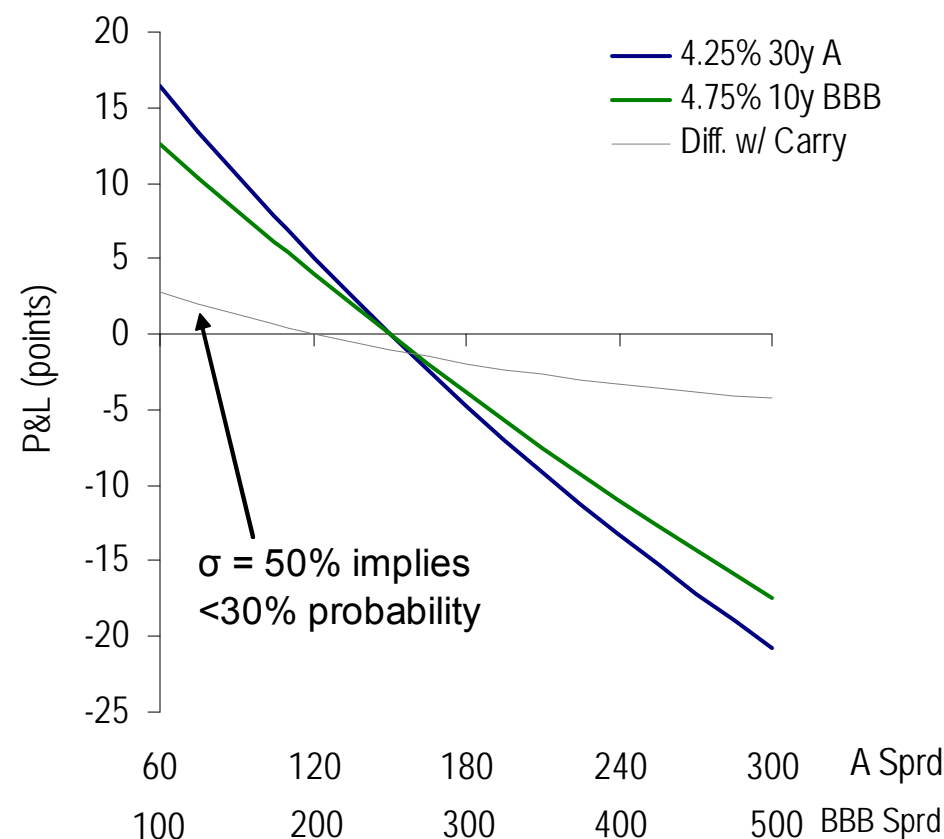
Extend or descend?

Age old tradeoff ...



Source: Citi

... currently favors spread over duration

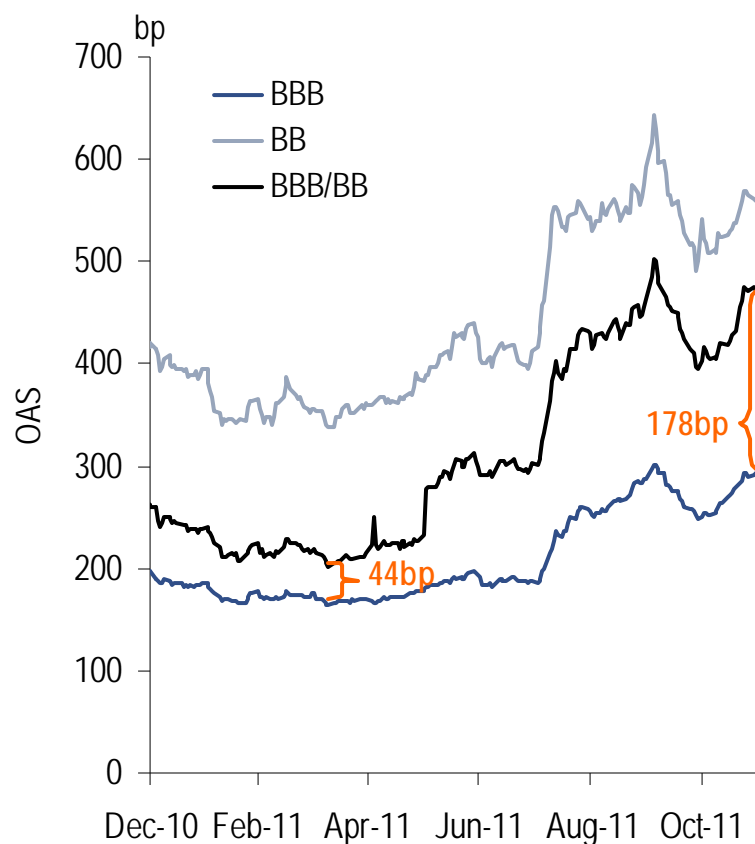


Source: Citi, CIRA

Favor carry over duration, given minimal default risk

5Bs – worth the risk?

The fall from HG isn't so far anymore ...



Source: Citi

... but is still a job for credit analysts

Financials	Name	Index Debt
SLMA	SLM Corp	9,640
DFS	Discover Bank	2,000
LAZ	Lazard Group	1,072
COF	Capital One	1,650

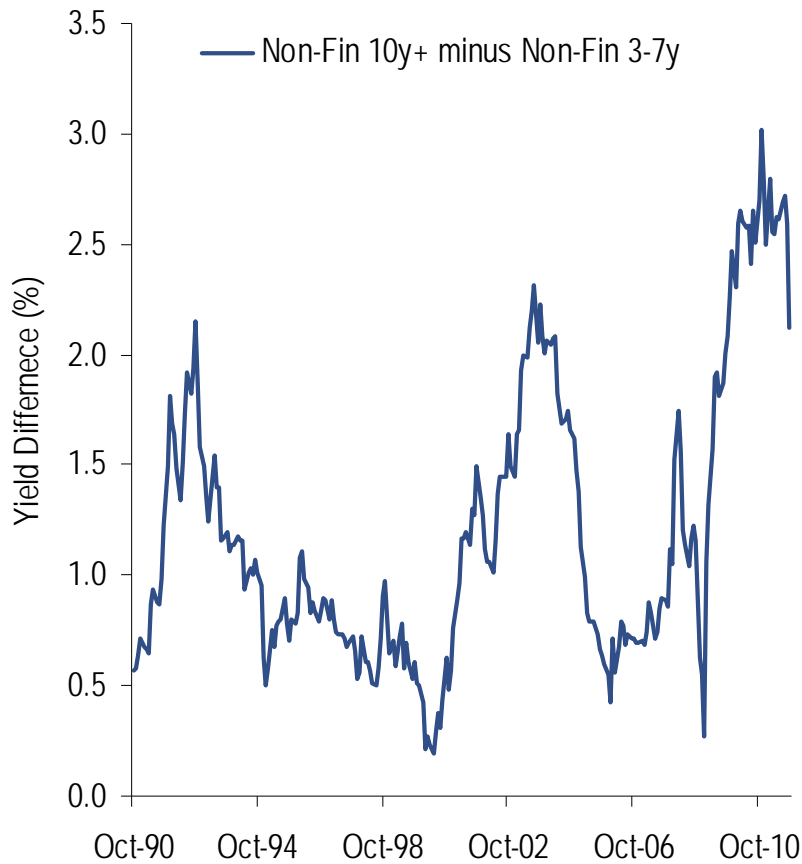
Non-Financials	Name	Index Debt
MDC	MDC Holdings Inc.	750
DDR	DDR Corporation	1,196
WY	Weyerhaeuser Co.	2,906
GCI	Gannett Co.	750
GPS	GAP Inc	1,250
CTL	CenturyLink Inc.	9,696
MAS	Masco Corp	2,896
WYNN	Wynn Resorts	2,200
EP	El Paso Nat Gas	2,463
BRCD	Brocade Communications Systems	600
M	Macys	4,492
OC	Owens Corning	1,548
TSN	Tyson Foods	1,448
FE	FirstEnergy Corp	1,500

Source: Citi

Value in BBs, but 5Bs have a catalyst

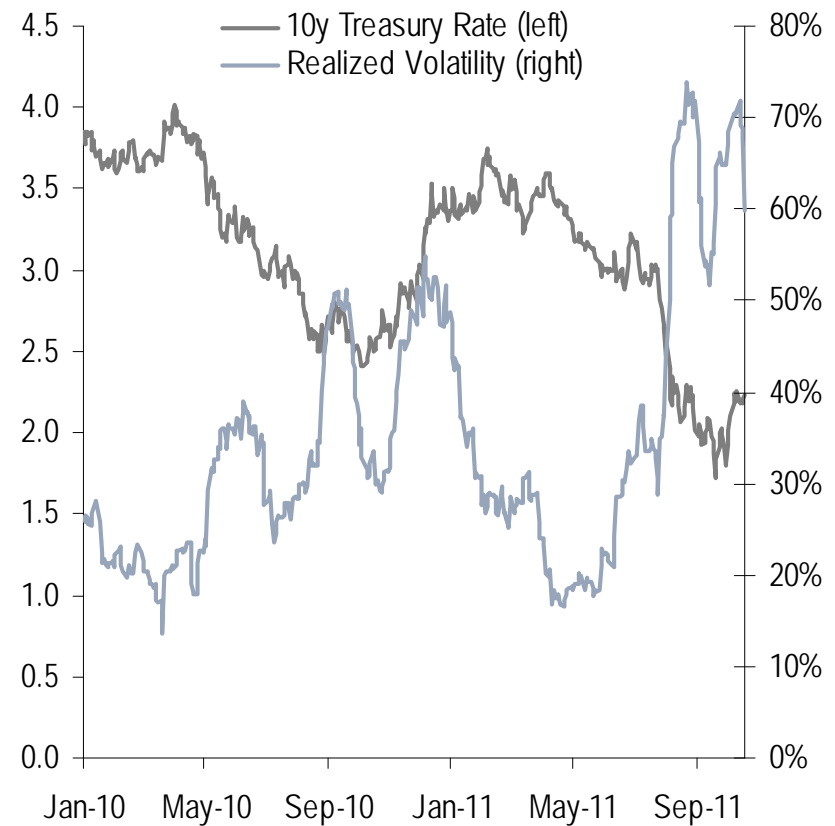
The chase for yield

Most yield is at the long end ...



Source: Citi

... but should you buy or wait?

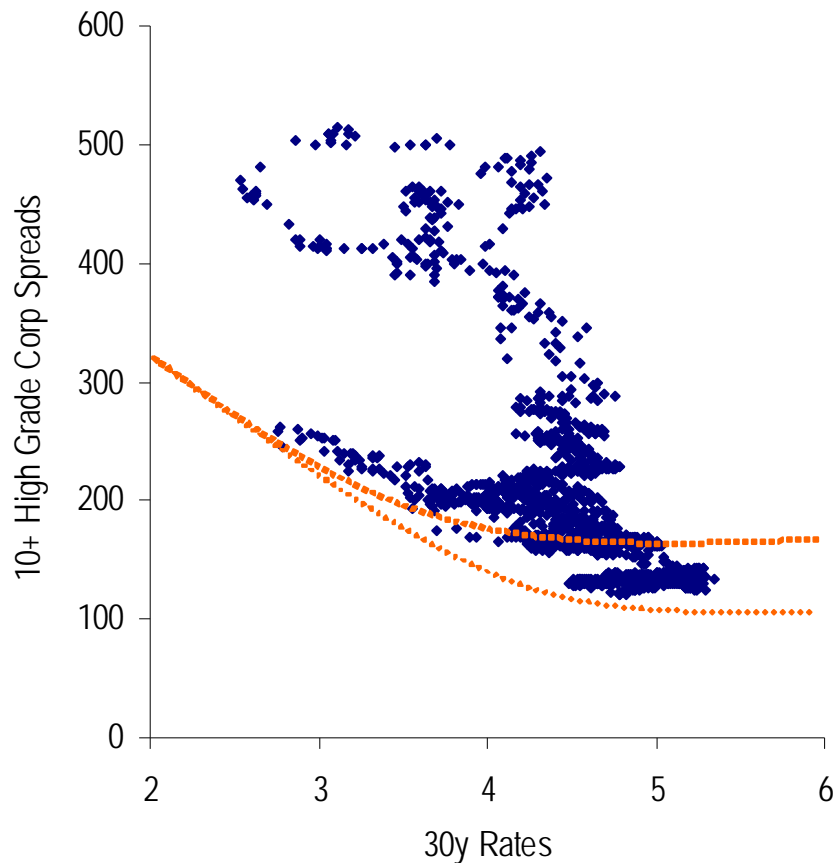


Source: Bloomberg, CIRA

Wait for treasury vol. to fall before chasing yield

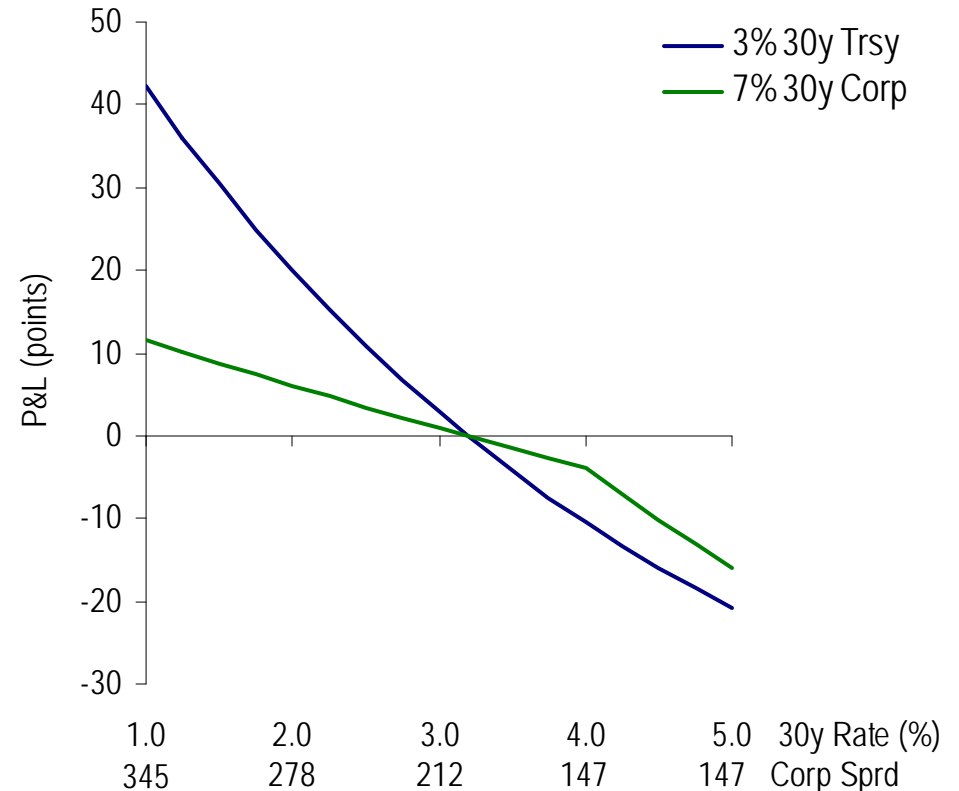
Treasury hedging 30y corporates

Spreads are neg. correlated w/ rates ...



Source: Citi

... DV01 rate hedging = short convexity



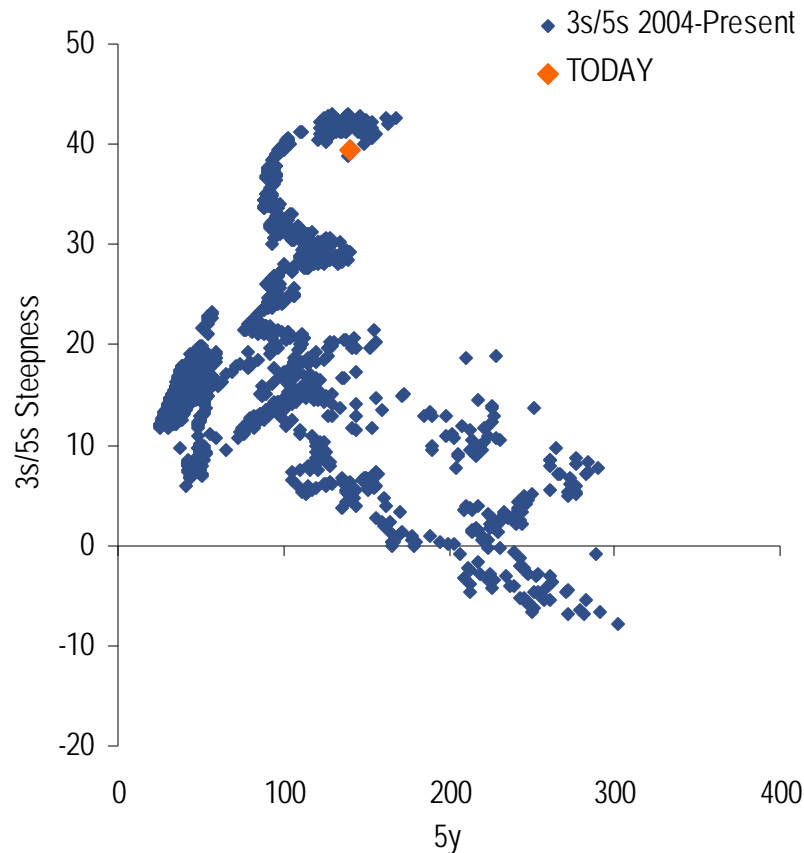
Source: CIRA

Long end looks like a relatively bad total-return prospect



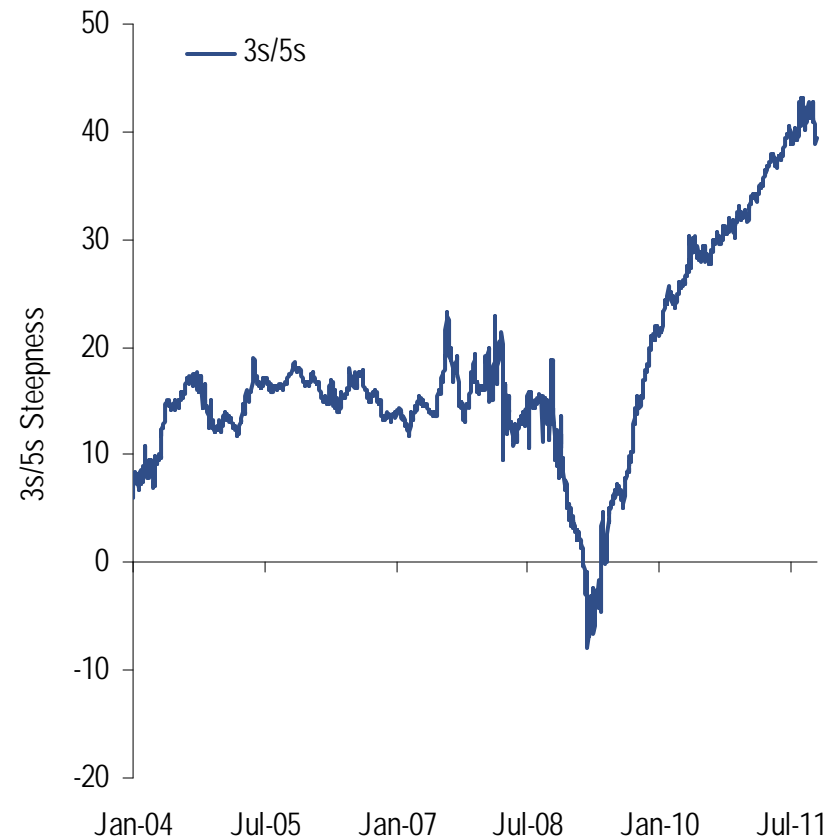
CDS curves too steep?

CDS curves are probably too steep ...



Source: Markit, CIRA

... but move slowly absent recession

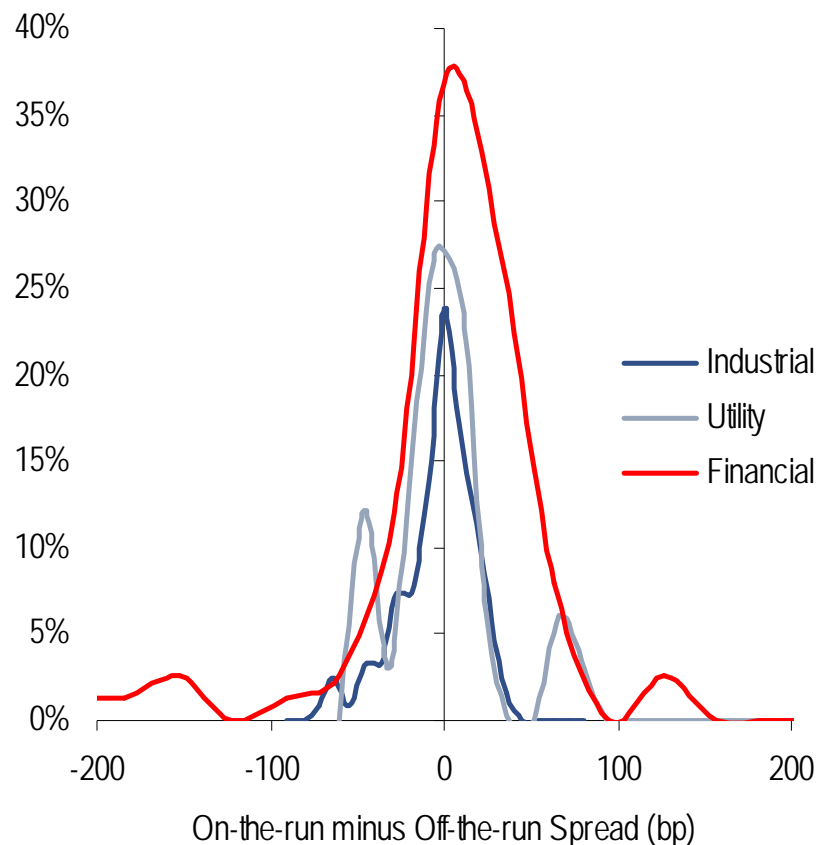


Source: Markit, CIRA

Curves should flatten in the EU and stay steep in the US

Off-the-run vs. on-the-run

Value in the tails ...



Source: TRACE, CIRA

... provided it actually trades

Move Into the Off-the-Run and Pick

Buy			Sell			Pick
Bond	ZSprd	Price	Bond	ZSprd	Price	
MET 7.717 '19	187	125.0	MET 4.75 '21	159	107.0	28
VZ 5.25 '13	43	106.2	VZ 1.95 '14	17	102.6	26
RBOS 3.95 '15	365	97.3	RBOS 4.375	340	99.0	25

Move Into the On-the-Run and Pick

Buy			Sell			Pick
Bond	ZSprd	Price	Bond	ZSprd	Price	
HPQ 1.55 '14	80	100.1	HPQ 1.25 '13	45	100.3	35
GE 2.95 '16	175	99.7	GE 2.25 '15	149	98.6	26

Source: CIRA

Watch TRACE for liquidity opportunities



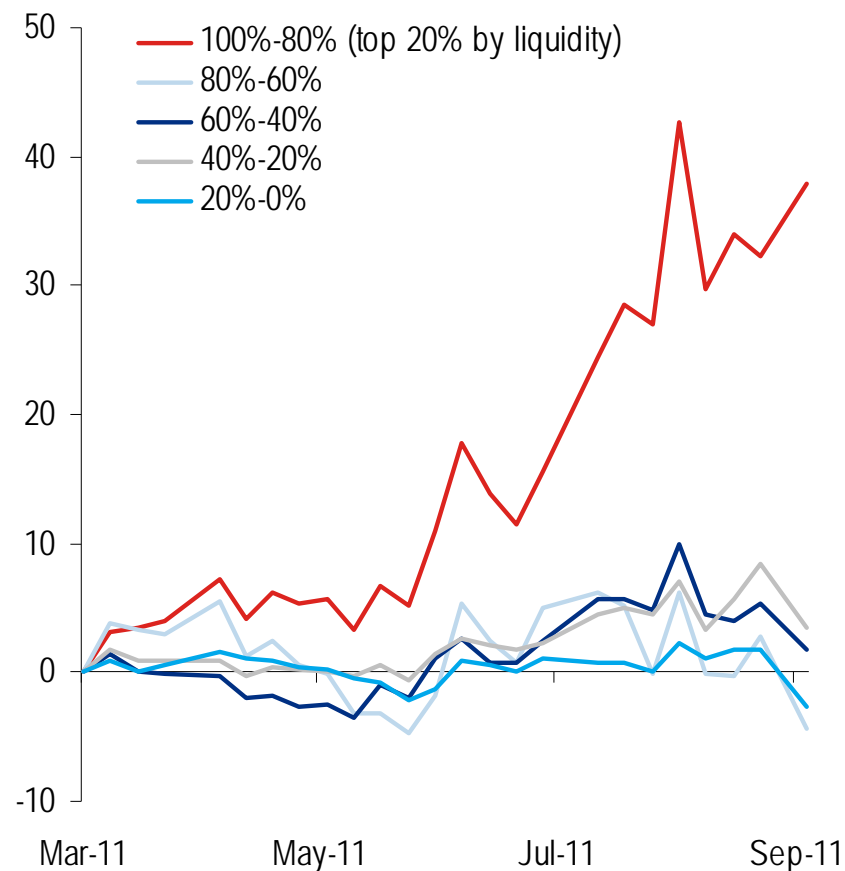
Mind the cost of liquidity

In cash ...



Source: TRACE, CIRA

... and CDS



Source: Markit, CIRA

Monitor real bid-offer, not Bloomberg run bid-offer

The dollar price debate

Typical dollars-at-risk argument ...

High-Dollar 10y Bond Price	Par Priced 10y Bond, Same Issuer	Extra Dollars at Risk
120.0	— 100.0	= 20.0

Par Priced Bond Spread: 200bp	Implied Ann. Default Rate
Par Loss Given Default: 60%	3.3%

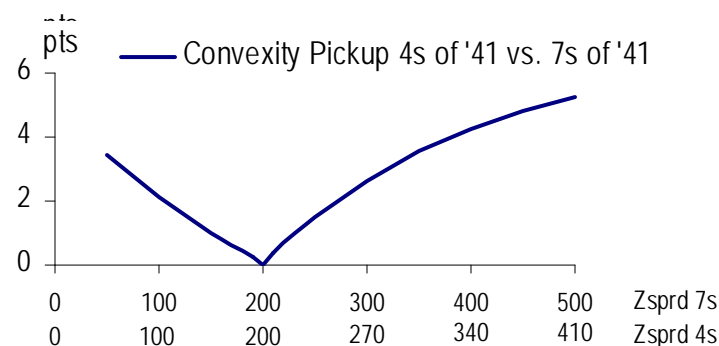
Extra Dollars at Risk	Implied Ann. Default Rate	Extra Spread Needed
20.0	x 3.3%	= 66bp

Source: CIRA

... but default risk isn't driving spreads

At the long end, convexity is part of the answer

Example	7% 30y	4% 30y	Diff.
Price	134.71	86.47	48.24
Convexity	3.222	3.846	-0.62
DV01	14.680	16.332	-1.7
Z-Spread	200	200	0



If $\sigma_{\text{Sprd}} = 10\%$, option = 49bp (20%, 89bp)

Source: CIRA

Don't fall for the dollar price discount

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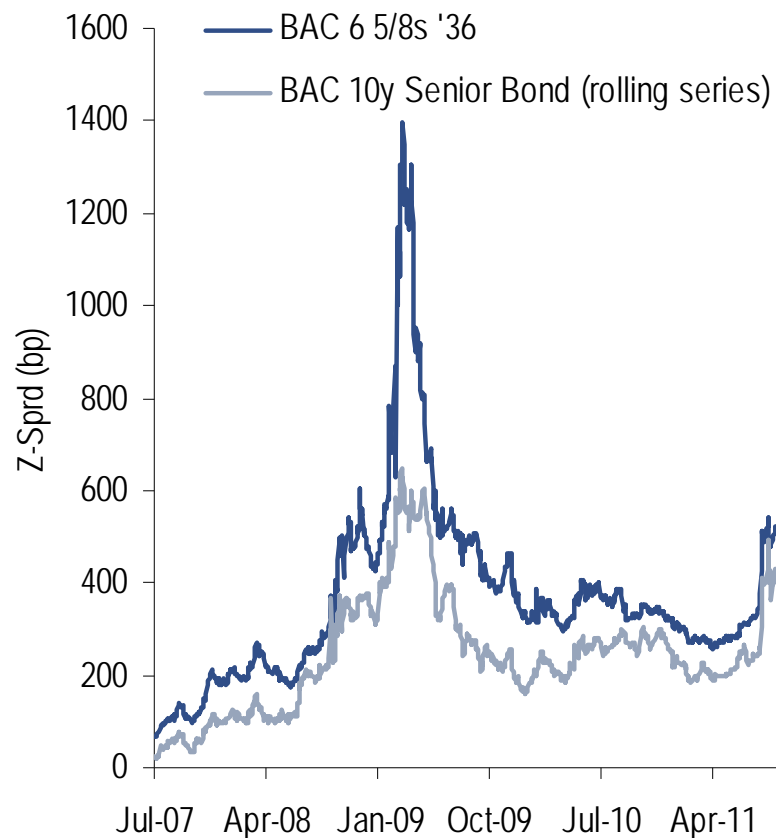
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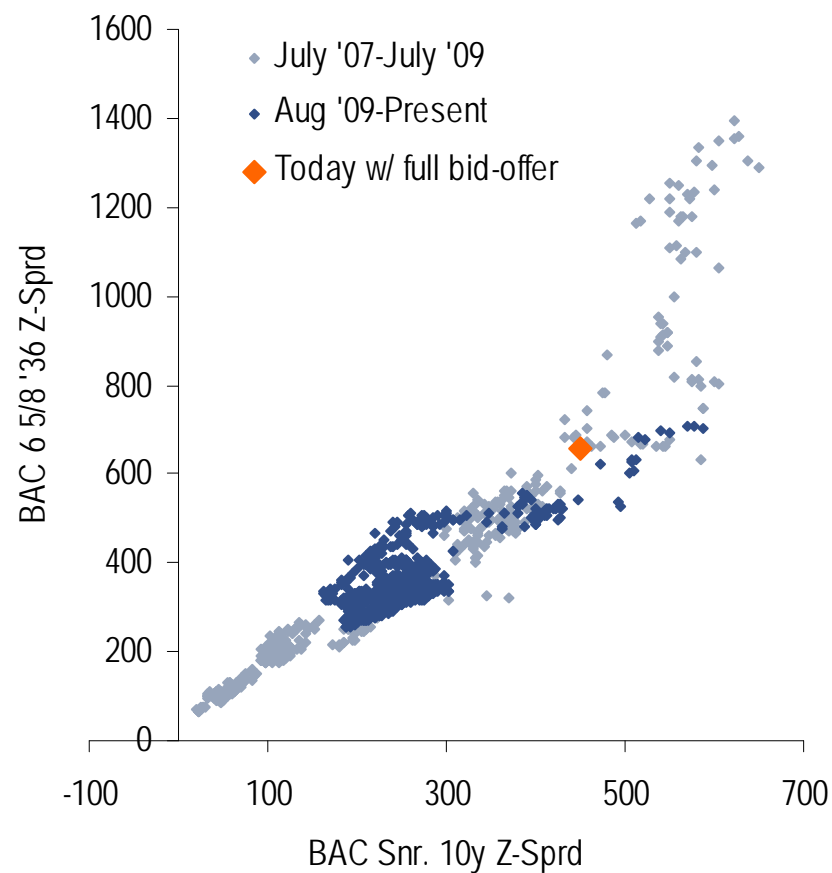
Senior vs. hybrid capital

TruPS/Prefs trade too tight vs '08-'09 ...



Source: Citi

... Opportunity to pick up "Free" convexity

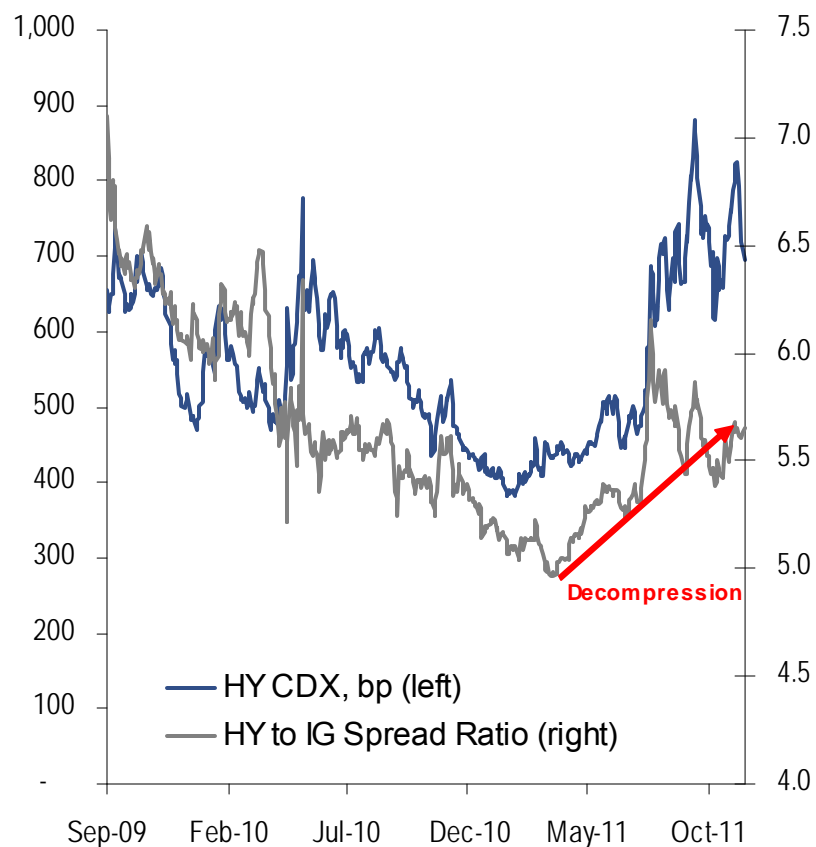


Source: CIRA

Use a ratio of 1.8 senior to 1 hybrid

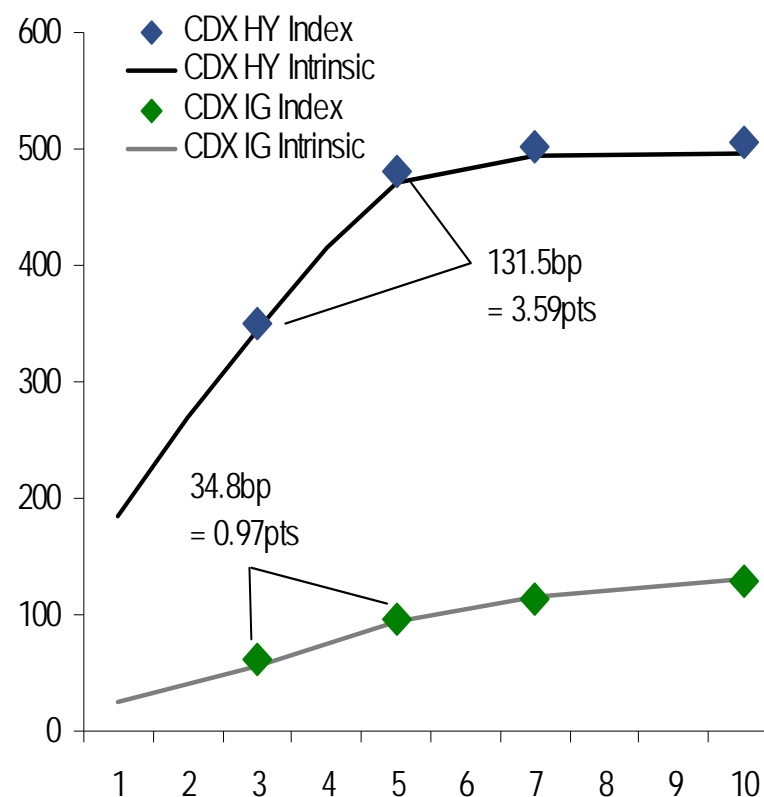
IG vs. HY CDX indexes

HY and IG decompress in selloffs ...



Source: Markit, Citi

... And the rolldown is better in IG

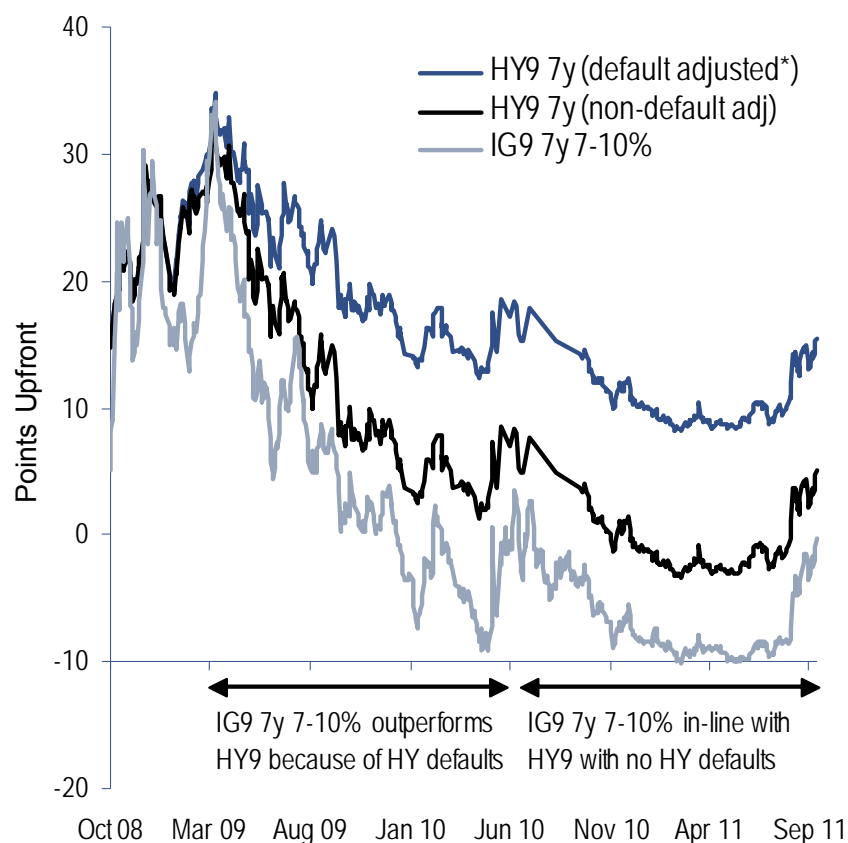


Source: CIRA

A less technically-driven overlay

IG vs. HY decompression in tranches

In '09 IG9 7y 7-10% outperformed HY9 ...



Source: Markit, Citi

... Because of accumulated defaults

IG9 Top 10 Widest Names

Name	5y Sprd	5y Pts
MBIA Insurance Corp	2,910	49.1
Radian Group	1,922	37.6
Istar Financial	1,228	18.3
Liz Claiborne	778	10.5
RR Donnelley	661	6.4
Lennar	605	4.3
Pulte Homes	590	3.6
Sprint Nextel	552	2.2
Gannett Co.	524	1.0

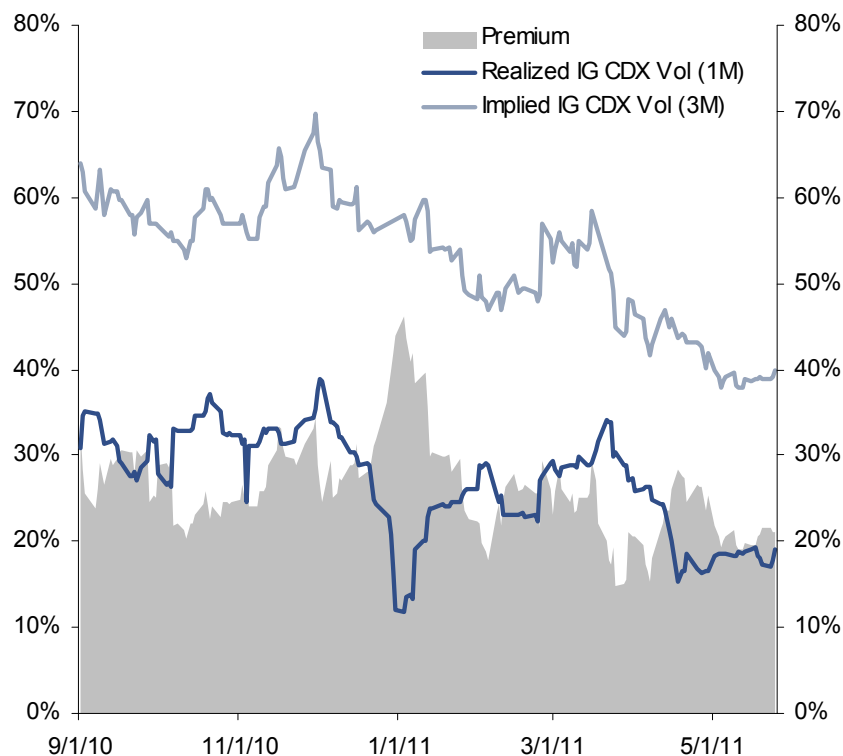
HY9 Top 10 Widest Names

Name	5y Sprd	5y Pts
Hovnanian	3,156	58.4
Energy Future	2,723	52.5
American Airlines	2,365	47.4
Clear Channel Com.	2,123	48.2
Dynegy	2,079	36.9
Eastman Kodak	1,878	37.9
Beazer Homes	1,567	32.3
Realogy	1,498	30.2
First Data	1,214	25.2

Cheap default protection

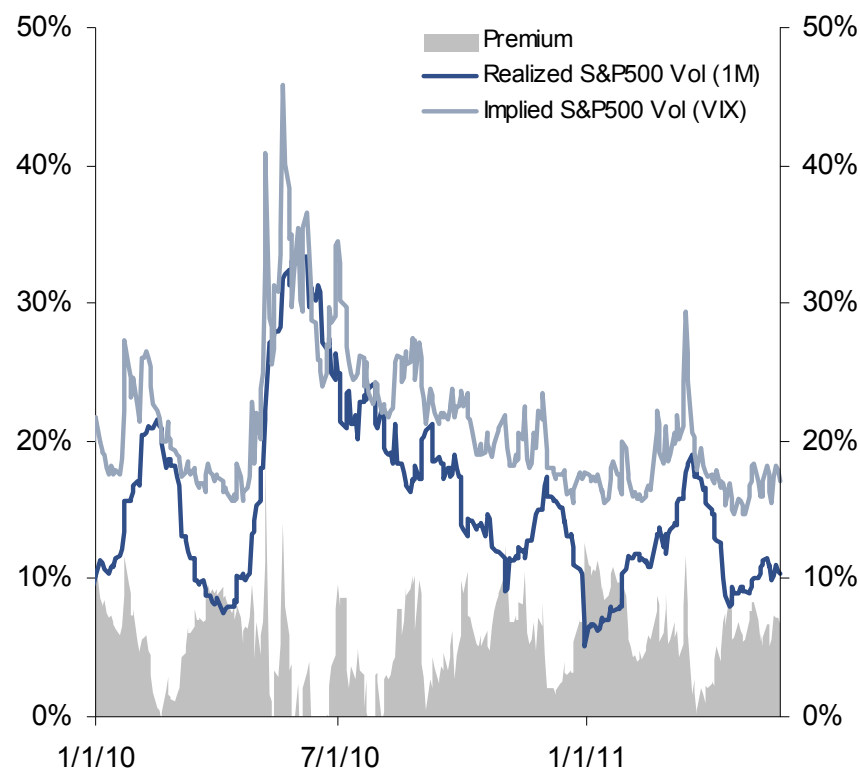
Use the credit vol premium to buy protection elsewhere

Implied credit vol is too high ...



Source: Markit, CIRA

... Equity market realized-implied tighter



Source: Bloomberg, CIRA

Capitalize on high cross asset correlations

Appendix A-1

Analyst Certification

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