

# European Credit Sector Recommendations

## Reducing Risk

- The European crisis has reached a new phase, with peripheral countries not only battling with a deep recession, but also exposed to the contagion risks of a potential Greek euro exit. Conversely, technicals leave the market open to a significant squeeze on any positive developments – especially in CDS.
- We move to Underweight from Neutral for Banking and Insurance, by reducing our longs on companies in core European countries and underweighting companies in weaker core countries. We remain Neutral on Financial Services.
- Within non-financials, we would reduce our exposure to corporates in weaker core countries like France, on the basis of unattractive valuations and their past performance versus their underlying sovereign. We continue to like Industrials, because of their attractive valuations and relatively low leverage, particularly versus consensus “safe havens” like Consumer Goods and Consumer Services, which now look expensive.

**Teresa Cascino**

+44-20-7986-9580

teresa.cascino@citi.com

**Hans Lorenzen**

+44-20-7986-3568

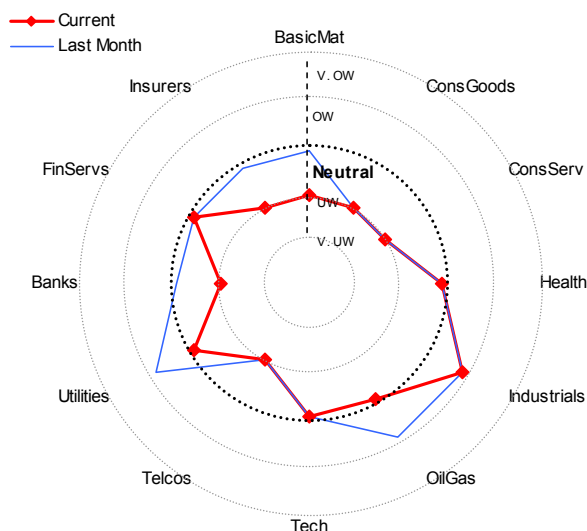
hans.lorenzen@citi.com

**Matt King**

+44-20-7986-3228

matt.king@citi.com

**Figure 1. Citi Recommended Positioning**



Source: CIRA

All recommendations are made using the iBoxx € index as a benchmark.

**Figure 2. iBoxx Weightings by Sector**

	Mkt Value (Percent)	Duration	Beta	Wgt. Dur. (Years)	Wgt. Beta (Years)
€ iBoxx	100.0%	4.1	1.0	4.1	3.9
Non-Fin	54.0%	4.3	0.6	2.3	1.4
Fin	46.0%	3.8	1.4	1.8	2.5
Basic Mat.	3.5%	3.5	0.7	0.1	0.1
Cons. Goods	8.8%	3.2	0.5	0.3	0.2
Cons. Services	3.3%	4.3	0.7	0.1	0.1
Healthcare	3.2%	4.1	0.3	0.1	0.0
Industrials	8.0%	4.3	0.7	0.3	0.2
Oil & Gas	4.9%	4.2	0.5	0.2	0.1
Technology	0.4%	2.9	0.9	0.0	0.0
Telecoms	8.4%	4.8	0.7	0.4	0.3
Utilities	13.5%	5.0	0.6	0.7	0.4
Banks	38.1%	3.8	1.4	1.4	2.0
Fin Servs	3.9%	4.2	0.7	0.2	0.1
Insurance	4.0%	3.8	2.2	0.2	0.3

Source: CIRA

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

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## Sector and Cash Bond Recommendations

It feels as though the IG credit market is on a knife edge. Left unchecked, the European sovereign crisis has the potential to escalate significantly, with the possibility of a Greek exit ("Grexit") or Spanish bank recapitalisation needs triggering a sharp increase in deposit outflows from periphery banks. We already see the signs of a [capital flight](#) from the periphery to core Europe, which, if sustained, conceivably could prompt the reintroduction of [capital controls](#) in Greece and other peripherals.

At the same time, the latest opinion polls suggest the pro-bailout plan parties in Greece are gaining, increasing the probability that Greece may elect a government willing to negotiate the existing plan with European partners, at the very least delaying the likely timing of a possible exit. Moreover, while there are few signs of agreement to date, the right issues (a deposit guarantee scheme, a modified form of Eurobonds and bank recapitalisation) finally seem to be on the political table. Market positioning is so defensive – long cash and loaded up with index protection – that any unexpected positive news would probably drive the market significantly tighter, in our view.

Ultimately though, we fear that market rallies here are self-defeating. Without market pressure we doubt policymakers will be able to make the often domestically unpopular decisions that the market craves. As such, we are reinforcing our defensive recommendation for the month ahead, reducing the beta exposure and moving up in credit quality.

We downgrade the Banks to Underweight from Neutral. While we continue to see value in core banks, we are wary of the fallout of a worsening of the Greek crisis on peripheral banks, but also on French and Austrian ones. We would reduce our beta exposure, by reducing our overweight on core LT2/T1 and covered, while continuing to underweight senior.

Likewise, for the Insurance space we prefer to reduce credit risks and beta exposure by reducing our overweight on core insurers and staying underweight in periphery and in the weaker core, especially considering that insurance remains a consensus long. Finally, in Financial Services we remain Neutral, but we like the current valuations of GE, which is the largest issuer in the universe, as the credit quality of the company continues to improve.

Still, within the non-financial space, we are not keen on the traditional "safe havens": in absolute terms they may not widen an enormous amount, but beta-adjusted we think risk/reward is poor. Consumer Goods and Consumer Services have outperformed the market, but the fundamental challenges these sectors face are not reflected in current valuations in our view. Nor we are particularly keen on Healthcare, where we see increased risks of M&A. Instead, we see value in sectors like Industrials, which have underperformed significantly already. Finally, we are Neutral on Oil and Gas: while the current recessionary scenario is negative for these companies, we think current valuations already incorporate most of the risks of a slowdown in China.

## Suggested Picks and Pans

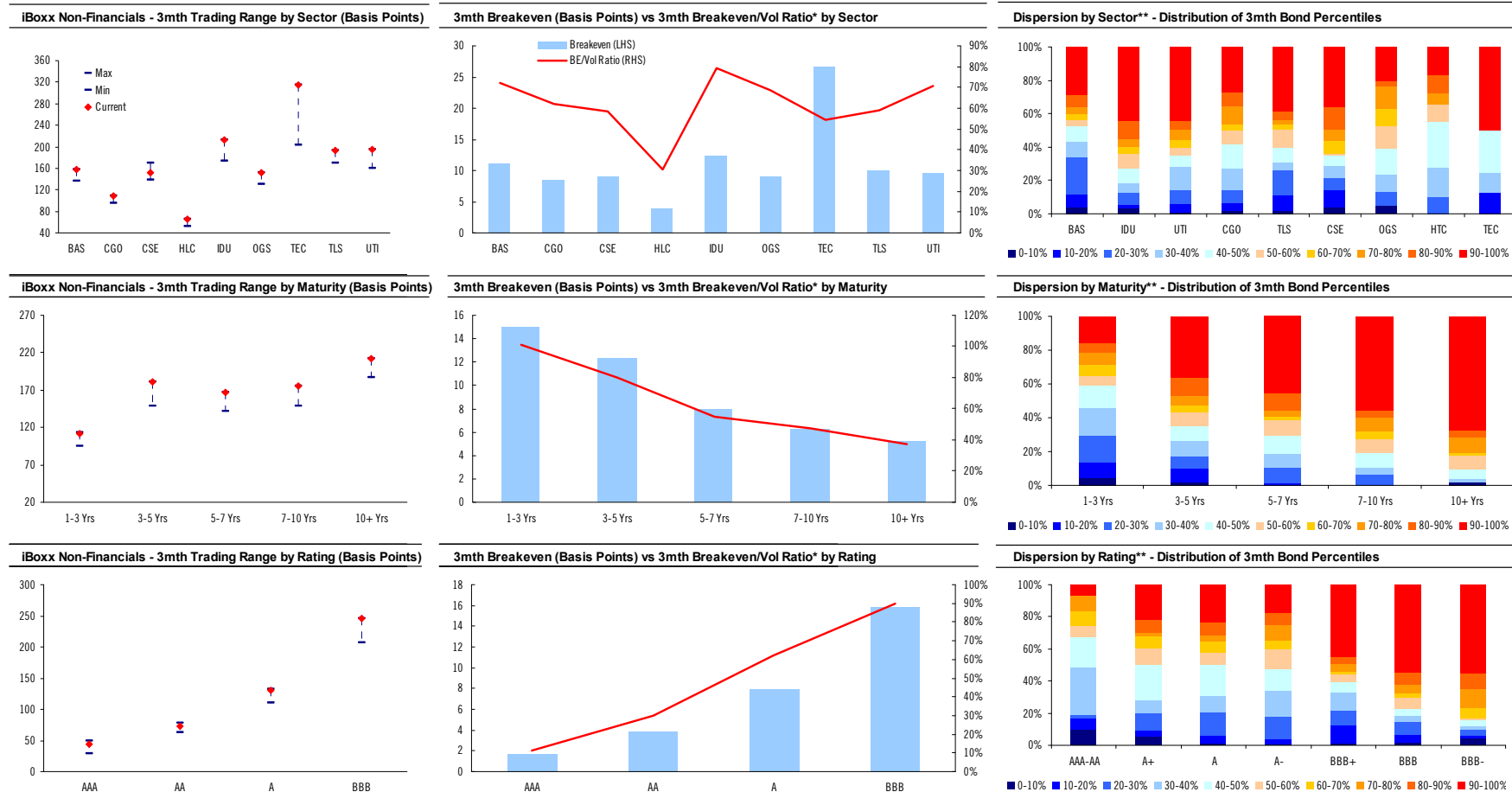
Figure 3. Suggested Picks and Pans<sup>1</sup>

Sector	Picks	Pans
<u>Basic Materials</u>	Arcelor Mittal	Akzo Nobel
<u>Industrials</u>	EADS Siemens	Thales Schneider Electric
<u>Consumer Goods</u>		Renault Peugeot Michelin LVMH PPR
<u>Consumer Services</u>		Casino Guichard Perrachon Lottomatica
<u>Health Care</u>	GlaxoSmithKline	Pfizer
<u>Oil &amp; Gas</u>	ENI	Total
<u>Technology</u>	Cap Gemini	
<u>Telecoms</u>	KPN	Telefonica France Telecom
<u>Utilities</u>	Dangas Veolia	Iberdrola Gas Natural
<u>Banks</u>	UBS HSBC American Banks	Raiffeisen Bank Erste Bank
<u>Insurance</u>	Allianz	Assicurazioni Generali
<u>Financial Services</u>	General Electric Capital Corp	

Source: Citi Investment Research and Analysis

<sup>1</sup> To produce individual and sector recommendations we use various scoring systems relative to history and to peers to determine richness and cheapness. We factor in overall spread movements as well as the potential effects of individual credits on a sector. We use this information along with fundamental data and credit-specific news to determine our positioning.

Figure 4. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Non Financials

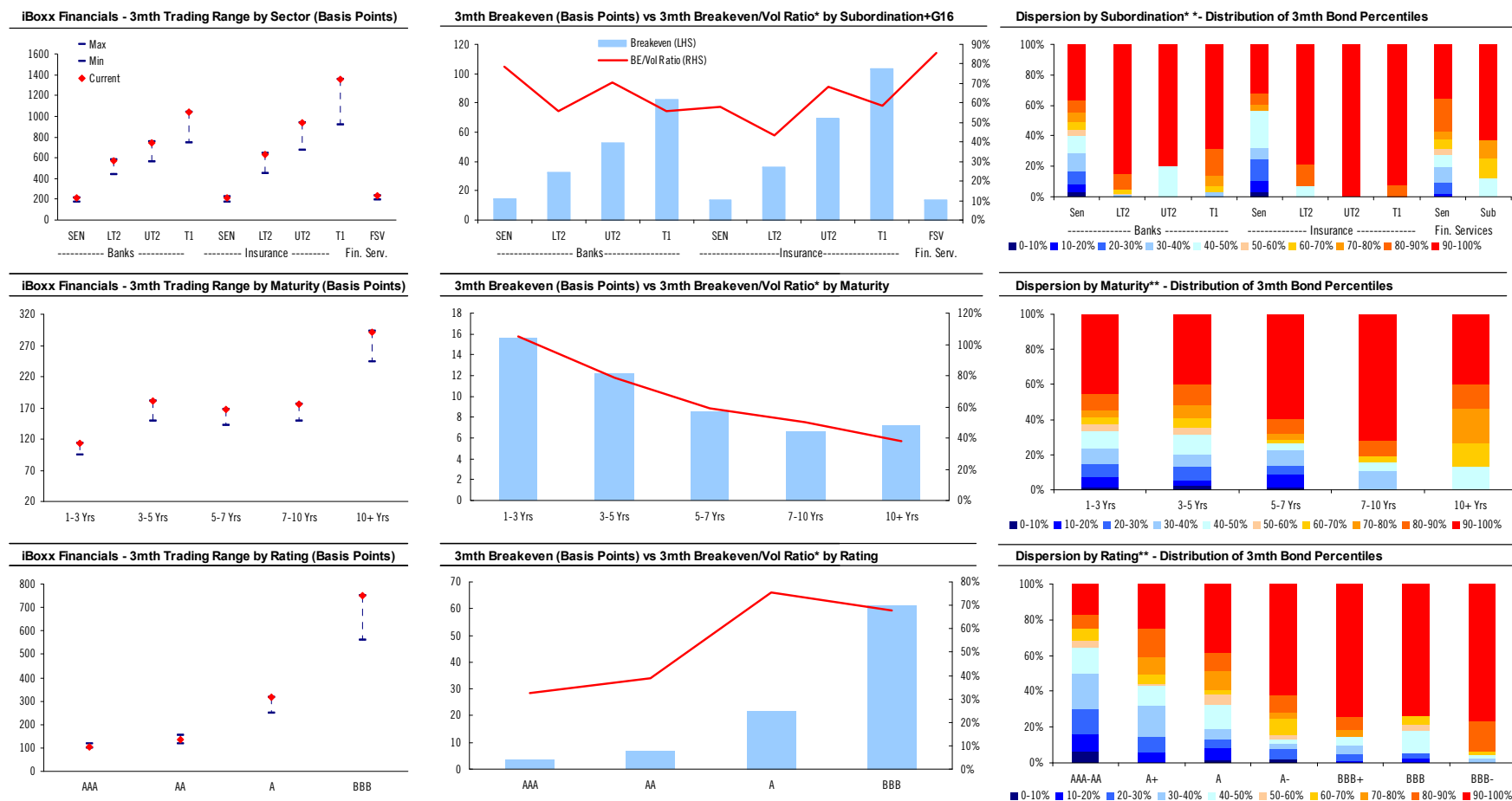


Source: iBoxx, Citi. \* Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

\*\* Dispersion charts aggregate individual bond performance for various buckets (sectors, ratings etc). For each bond the current percentile in the 3mth trading range is calculated. For each bucket the distribution of bond percentiles is then aggregated. Dark red shows the percentage of bonds that are trading at or very near their 3mth wides. Dark blue shows the percentage of bonds at or very near 3mth tights. Light colours show bonds trading mid-range.

Source: CIRA

Figure 5. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Financials



Source: iBoxx, Citi. \* Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

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Source: CIRA

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# Sector Recommendations

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## Basic Materials: Underweight

The fragile state of the global economy (with concerns about China adding to European woes) ought to weigh heavily on Basic Materials. The sector's relatively low leverage, coupled with the resilience of earnings in Q1 2012, and a timid trend of earnings upgrades, might attract investors in the current volatile environment. But we are concerned about its cyclical nature in the light of the weakening demand from China in particular, which we don't see reflected enough in spread widening. We are Underweight.

Demand in **Metals & Mining** seems likely to continue being weighed down by the weak European economy and comparatively soft growth in the US and China. In China in particular, inventories of copper, coal, aluminum and iron ore are all increasing. The recent earnings season surprised very moderately to the upside, helped by a recovery in production after operational headwinds (Anglo American) and cost cutting (Arcelor Mittal). But the strength of the South African rand is driving up the cost base of businesses like BHP and Anglo American, and broadly we see little sign that spreads provide enough of a cushion against weakening demand.

The European **Chemical** sector also looks vulnerable. It has benefited from increasing demand after the heavy destocking of 4Q11, and this has been reflected in the last earnings season, but the outlook remains challenged as demand is weak and producers are scaling down production worldwide. Higher natural gas prices in Europe versus the US put European exporters at a disadvantage in emerging markets vs US peers. Companies are having to cut costs to maintain margins. Only a few companies specialised in agrochemicals, gases and some performance materials (Lanxess, Linde) have been even able to improve pricing, and even here growth in volumes was flat. We see signs of stabilisation in this subsector. Generally, while we expect demand in the automotive industry to stabilise at low levels, we are not optimistic: we think construction in Europe will still be subdued and therefore demand for PVC and other performance chemicals will continue to be weak. Therefore, we prefer to be Underweight for the time being.

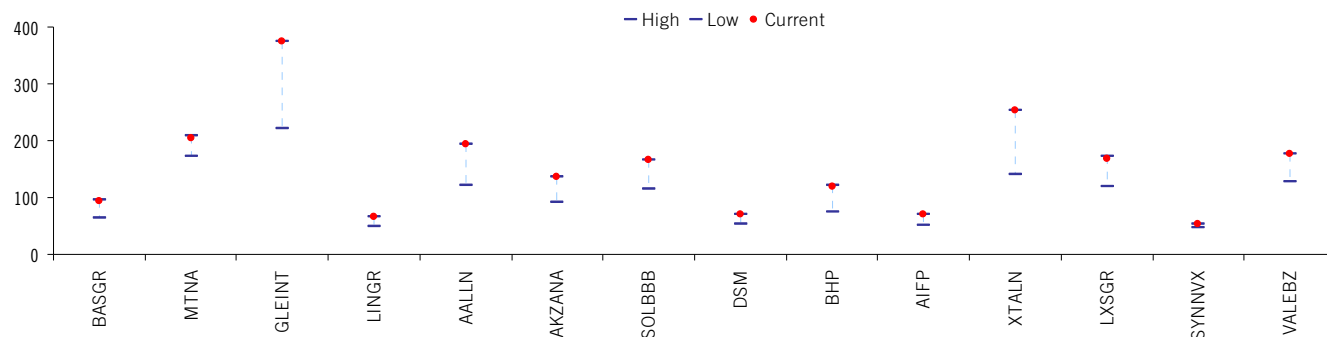
Figure 6. Basic Materials Picks and Pans

<b>Picks</b>	<b>ArcelorMittal:</b> The company is at risk of being downgraded to high yield, as rating agencies consider it to be more leveraged than peers, and CDS spreads seem to have largely priced in a downgrade. However we think the widening is now overdone. Our equity analysts are quite optimistic on divestments, and the company is clearly committed to them, although there is execution risk. MT NA has already reached its June 2012 target for net debt (\$22.5 bn). Also, it recently announced some asset sales which will help to reduce debt, showing that the company is committed to remaining investment grade. Of course, as a cyclical business, we expect it to be negatively affected by concerns on the global economy, but at these levels we feel well protected for this risk and see potential for tightening both in the bond and the CDS markets.
<b>Pans</b>	<b>Akzo Nobel:</b> Akzo bonds are very tight, both relative to their history and versus CDS. We think this is due to powerful market technicals, but we don't think spreads adequately compensate for the beta risk compared to peers. Moreover, we think that its credit quality will be negatively affected by increased contributions to its pension funds, high input prices (titanium dioxide in particular) and slow demand from the Construction Sector, partly mitigated by the commitment of the company to cut costs.

Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

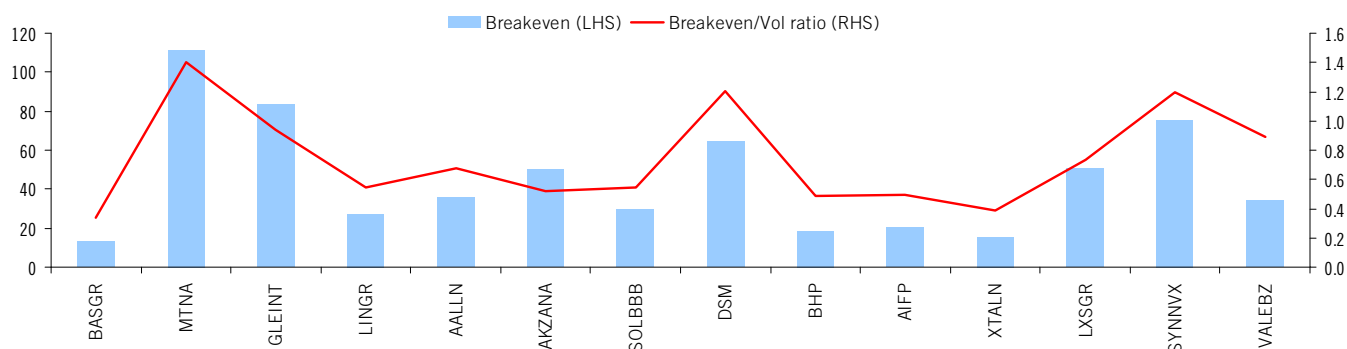


Figure 7. CDS 3mth Trading Range by Sector (bp)



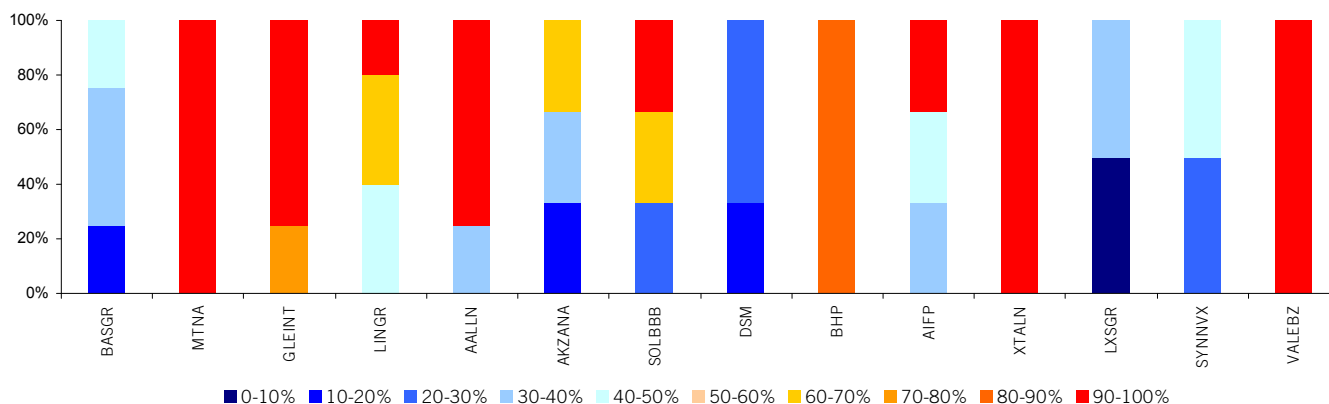
Source: MarkIt, CIRA

Figure 8. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 9. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Industrials: Overweight

Industrials have widened more than other non-financial sectors in the past month's sell-off. Moreover, this widening has been driven not only by the peripheral names, but also by those in the core, to our minds creating significant value. We recommend increasing towards neutral on the peripherals – which seem unlikely to tighten significantly ahead of Greek elections, but conversely are probably quite well supported by existing shorts – and going outright long several of the companies in the core which are trading close to recent historical wides.

Admittedly, earnings have mostly surprised to the downside, in particular for the Construction sector (Holcim, Bouygues, Saint Gobain) and in Defence (Finmeccanica, Thales). Moreover, companies have in most cases been cautious on their guidance or left it unchanged, and earnings revisions are trending down as risks to the general economy increase. Although in general leverage is not high, pressures on demand and in some cases on funding remain.

But – as elsewhere – to our minds the main driver of spreads is sovereign risk, and in industrials it seems better reflected than elsewhere. The recent sell-off in French industrial names leads us to close our shorts on Vinci, Saint Gobain, and Alstom, with the latter in particular now close to [historical wides versus the sovereign](#). Where sovereign risk is less of an issue, at names like EADS and Siemens, the widening seems even more overdone (see below). Investor positions in our [Global Credit Survey](#), while increasing, are still far from their highs reached in March.

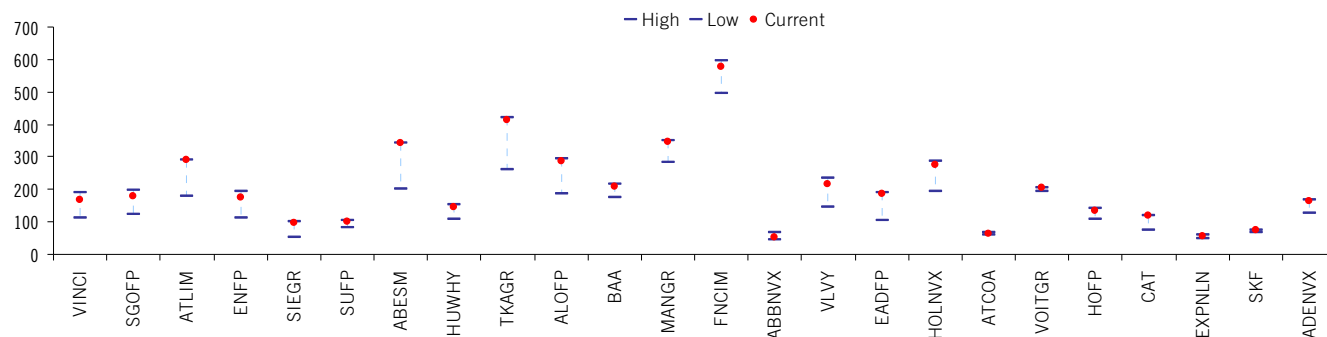
There are, however, a few exceptions to the rule. Despite the widening of the last two weeks, we think that Thales looks too tight to the French sovereign, given the lacklustre growth prospects of its sector and its revenue concentration in Europe. We also remain negative on infrastructure companies.

Figure 10. Industrials Picks and Pans

<b>Picks</b>	<p><b>EADS:</b> CDS has slightly underperformed peers with similar beta (BAE Systems), and we think this is unjustified. The company has a very conservative financial policy, and enjoys a strong market position in commercial aerospace. The growth area is in fuel-efficient planes, thanks to strong demand from civil aerospace. It benefits from a very strong backlog, which mitigates the cyclical nature of the industry. Its credit metrics are quite strong. EADS also has a good position and backlog in Defence; however growth is not likely to come from here in the next few years. Although currency and funding risks might erode profitability, so far they have been managed very well. As such, we think it is an attractively valued defensive play compared to peers for the recessionary environment Europe is facing.</p> <p><b>Siemens:</b> CDS, senior and sub bonds have all widened sharply, underperforming companies with similar beta (Rolls Royce). We think this is now overdone. Consensus earnings estimates are at a 9-month low, yet its restructuring efforts are already well underway, and capex should fall from here. 1Q earnings showed pricing pressures in the energy sector and slow demand growth from industrials, but margins were well maintained. Shareholder-friendly activity is a risk to its cash pile, but we doubt they would really want to lever up, especially in this environment. With so much in spreads – especially the sub bonds – we think it warrants an overweight.</p>
<b>Pans</b>	<p><b>Thales:</b> the whole Defence sector in Europe is suffering from weakening demand, and Thales is no exception. About 50% of its revenues come from Europe. Yet its bond is extremely tight to its history, and <a href="#">its CDS has outperformed France</a>, bringing the spread between the two to its tightest levels since summer 2011.</p> <p><b>Schneider Electric:</b> Bonds look much too tight given the lack of growth in the infrastructure and real estate markets in Europe, China and the US. <a href="#">Current CDS</a> also looks tight versus companies exposed to the construction business like Vinci, and compared to its historical performance, especially versus last August.</p>

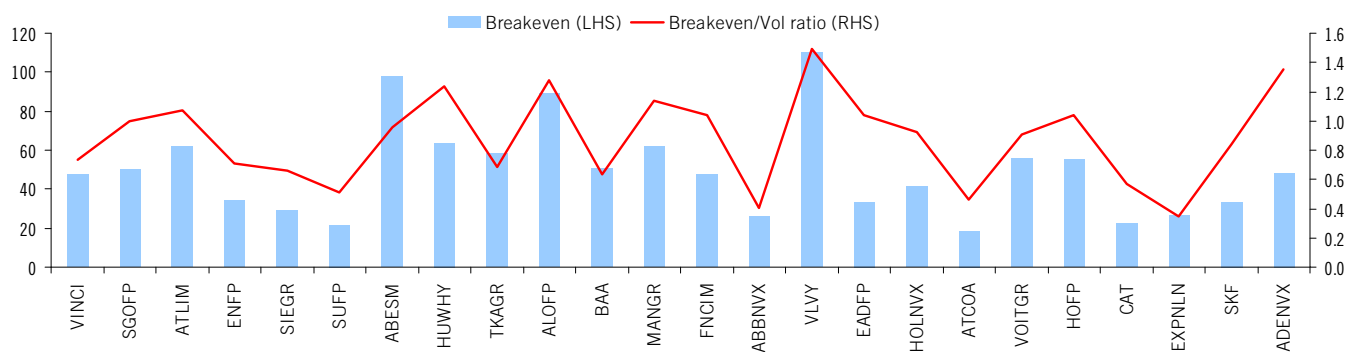
Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

Figure 11. CDS 3mth Trading Range by Sector (bp)



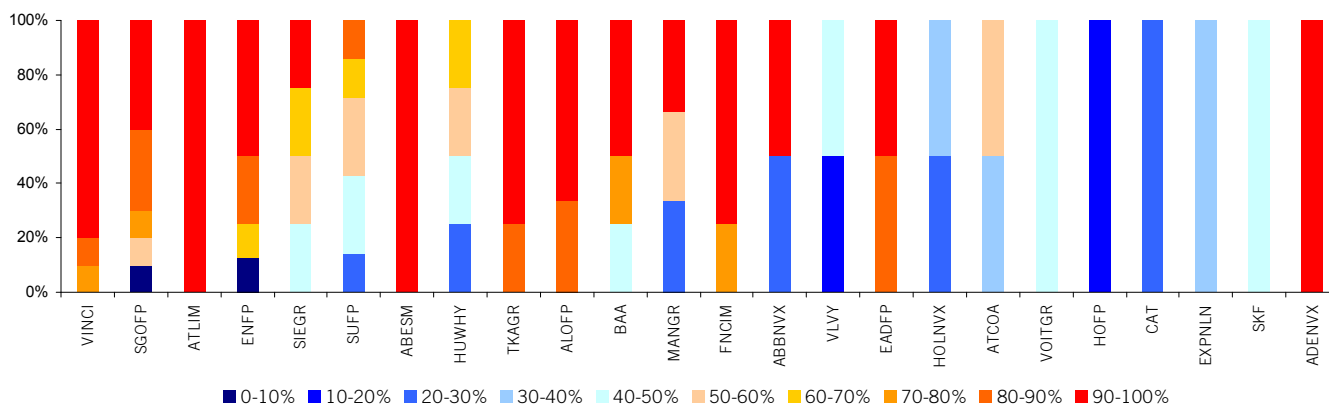
Source: MarkIt, CIRA

Figure 12. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 13. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

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## Consumer Goods: Underweight

Because of its relative defensiveness, Consumer Goods has outperformed iBoxx Corporates over the past month, reaching levels that we find unattractive in the face of the ongoing challenges the sector faces.

In the **Food and Beverages** space, the weakening of demand for beer is apparent in Europe and Russia, and raw materials inflation against a backdrop of weak demand is an issue for margins. However, North America and Brazil, and in general premium spirits, are showing resilience. Companies with exposure to emerging markets and/or a focus on health and specialist products (Nestlé) are faring better. However, we worry that the cheap funding available to stronger credits may encourage M&A activity as recently indicated by Diageo and Danone.

From a credit perspective, **Personal & Household Goods** look better positioned thanks to still good demand trends, especially the luxury goods and the tobacco sectors. However, valuations largely incorporate any upside already, and we feel insufficiently protected from the risk of weakening demand in China, which would negatively affect luxury goods producers.

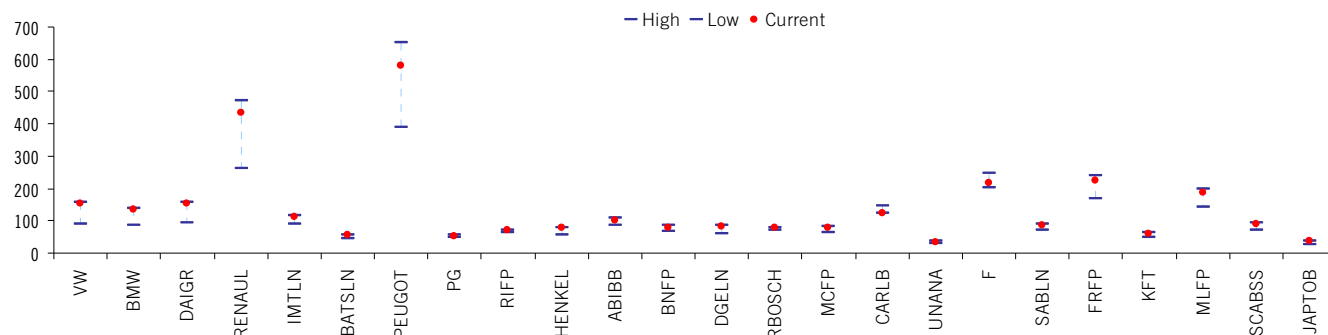
Likewise, we remain negative on **Automotive & Auto Parts**. This is the main focus of our Underweight recommendation. Peugeot and Renault have widened versus their sovereign in the last month to the point that we are comfortable reducing our shorts. However, Michelin is still at record tightness versus France. While its last results were supported by healthy revenues, in spite of the critical situation of auto demand in Europe, we think the CDS outperformance versus France is unjustified by the weak outlook for the European car industry. Luxury auto producers and mass producers with stronger geographical and product diversification (i.e. BMW and VW) are better placed than peripherals thanks to relatively resilient demand for luxury products, but this is reflected in valuations already in our view.

Figure 14. Consumer Goods Picks and Pans

Pans	<p><b>Michelin:</b> we think Michelin <a href="#">CDS is too tight to France</a>. The company beat revenue expectations in its Q1 results, thanks to good pricing. However, we think that weakening tyre volumes in Europe might have a negative effect on Michelin's pricing power, which has helped to mitigate weakening demand in Q1. We see weakening trends in replacement tyres in Europe, in particular in the commercial vehicle markets, but also in North and Latin America.</p> <p><b>Renault:</b> The recent widening in Renault <a href="#">CDS</a> prompts us to reduce our shorts, but we are still underweight the bonds. We are not comfortable with Renault's <a href="#">medium-term bonds</a> trading so tight to their own history, given that they suffered massively during last year's sell-off. The European market remains weak, and we are less optimistic than the market that growth in auto demand outside Europe will be enough to offset this.</p> <p><b>Peugeot:</b> We find that Peugeot bonds are remarkably tight compared to their history especially when compared to their <a href="#">January 2012</a> levels. The company is about to start an alliance with GM, with GM buying a 7% stake. This should improve synergies, but very few details have been released. We regard the alliance as a long-term positive, but we don't expect benefits in the near-term. The recent rights issue has helped to stabilise the balance sheet, but the company remains in a fragile state, due to its operating leverage in a weak market.</p> <p><b>LVMH and PPR:</b> these names have benefited from resilient luxury good demand from East Asia, China in particular. However, the Chinese market might suffer from a hard landing, and these are two of the tightest names in the Consumer Goods universe. For example, another luxury name like BMW has roughly the same level of exposure to East Asia, but is underperforming LVMH. At these levels we recommend an underweight.</p>
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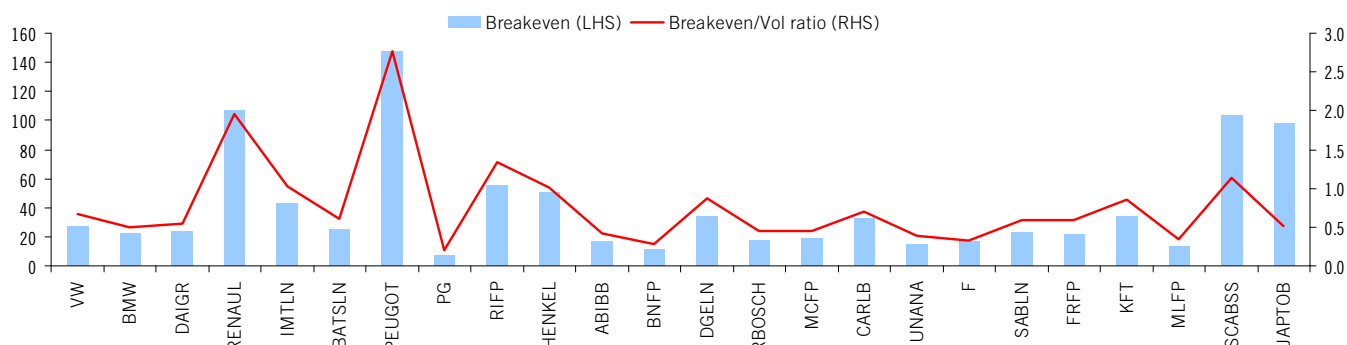
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Figure 15. CDS 3mth Trading Range by Sector (bp)



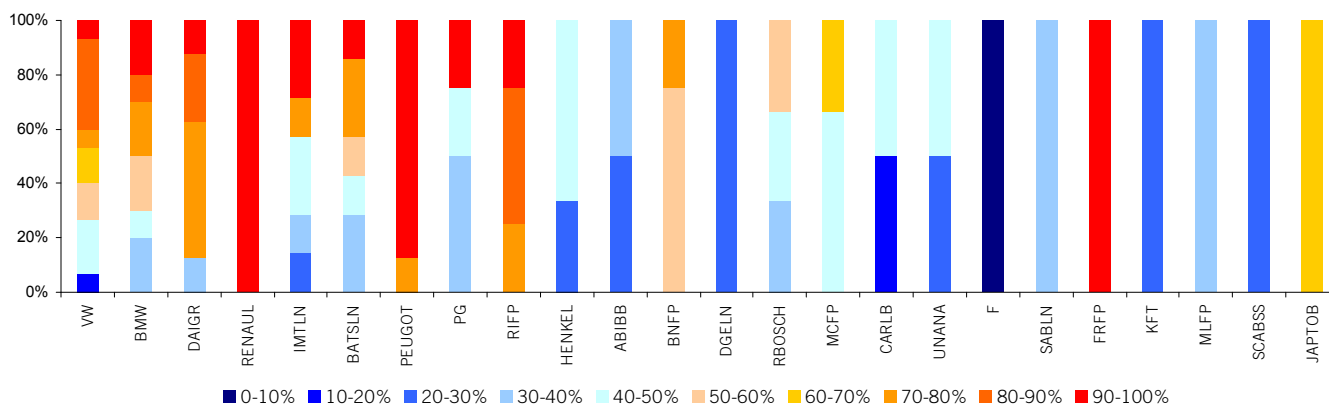
Source: MarkIt, CIRA

Figure 16. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 17. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



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## Consumer Services: Underweight

Consumer Services suffers from the twin woes of sovereign risk and fundamental challenges. For the French and Italian names, we do not think spreads have moved sufficiently to reflect even current (never mind future) widening in their sovereigns. Yet nor do we like even those companies which are not directly exposed to sovereign risk, in light of the operational challenges they face and their tight valuations.

In the **retailing** space, we continue to be bearish on Carrefour on fundamental reasons: it is exposed to peripheral Europe, its sales trends and credit metrics have been weakening and it just went through a management change, so it is unlikely we will have a turnaround strategy in the next one or two months. However, after its recent widening, we reduced our short position. As regards Casino, CDS are still uncomfortably tight to its sovereign, in our view. Although Casino is engaging in asset sales to maintain its rating, it could see its leverage increase if its acquisition of a further stake in Monoprix from Galeries Lafayette goes ahead. Bonds are just starting to widen after trading very tight to their sovereign, and we expect some more widening as the market adjusts to a heightened perception of sovereign risk.

While leverage and cyclicity are relatively low in the sector, the economic outlook in Europe is not favourable to retailers: European consumer confidence is still feeble and BRC LFL sales data for the UK are still weak. Both Carrefour and Tesco management promised action to improve the profitability of their business, but we doubt these will be significant or bring results in the medium term as these companies have already failed to address these issues in the past.

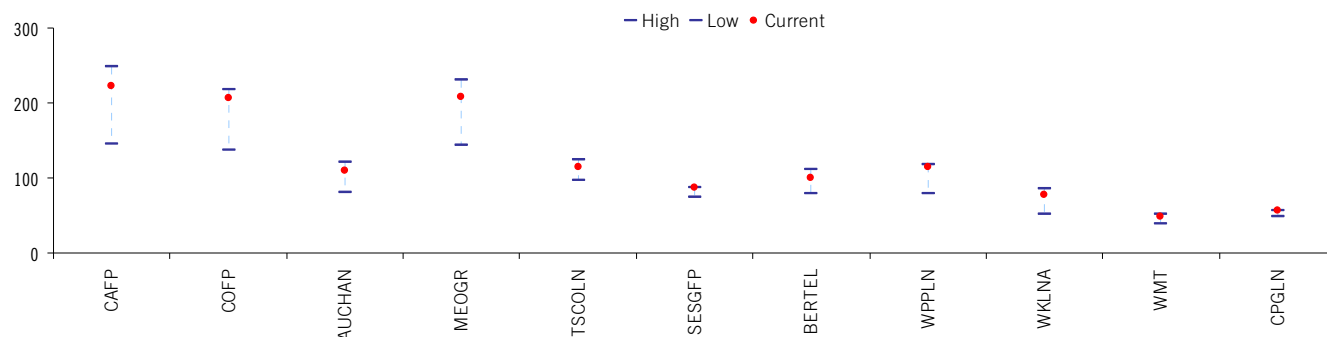
As regards the low-beta **Media** names, most companies in this subsector have been able to diversify into more defensive investments (pay TV, specialised channels and publications). Also, there are a number of events this year (Olympics, elections in France, Jubilee year in the UK) which have supported revenues even in a weakening economy. However, after these events are over, the outlook for revenues will weaken significantly, and we think this is not reflected in valuations, which are very tight to history, especially in CDS. At these levels, we are also concerned by the relatively high leverage of the sector, particularly at Wolters Kluwer.

Figure 18. Consumer Services Picks and Pans

<b>Pans</b>	<b>Casino Guichard Perrachon:</b> <a href="#">CDS is trading at record tight to its sovereign</a> , and bonds also look tight compared to their own history in most cases. Casino is engaging in asset sales to maintain its credit rating, and we think these will help mitigate the risks for leverage which could come from the potential acquisition of a further stake in Monoprix from Galeries Lafayette. While the company is making an effort to diversify into emerging markets and it looks better positioned than Carrefour, we are worried about contagion risks from the sovereign given its 50% exposure to France.
	<b>Lottomatica:</b> We think the bonds trade too tight to the sovereign and we are conscious that should the pressure on Italian government bonds continue, spreads on Lottomatica bonds are liable to underperform. The bonds' <a href="#">outperformance</a> is all the more surprising given the company's concentration in Italy. On top of purely technical factors, thanks to the anti-cyclical characteristics of gaming, this is an area at risk of tax hikes in times of downturns, which could affect Lottomatica's cash flows.

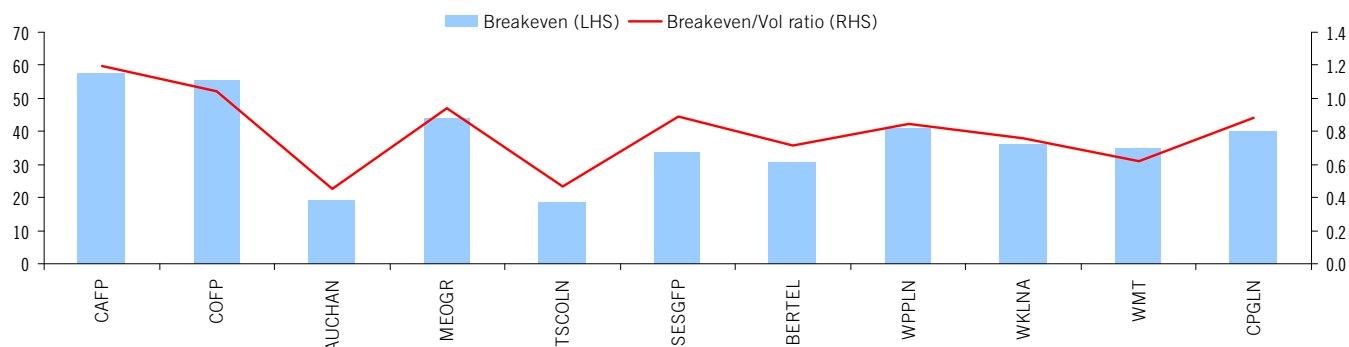
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Figure 19. CDS 3mth Trading Range by Sector (bp)



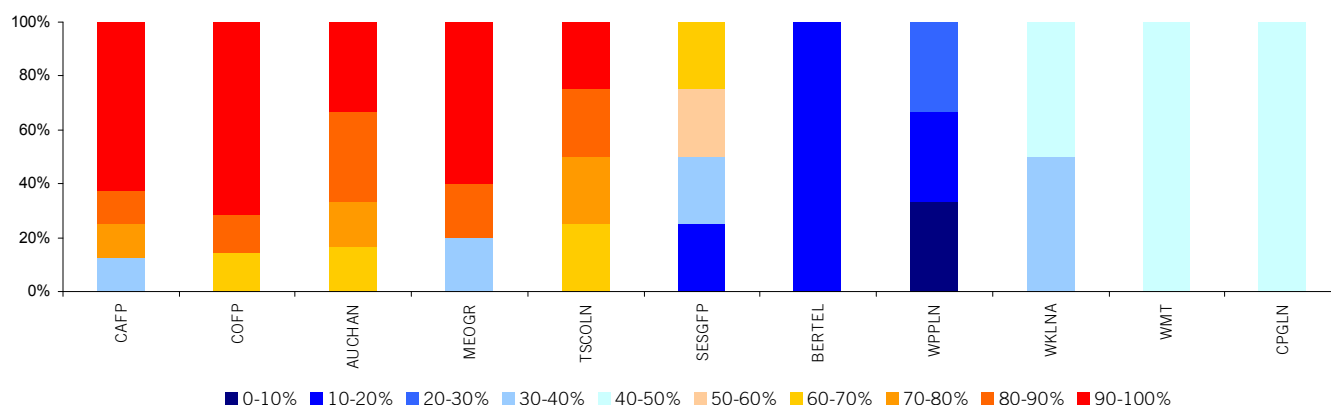
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Figure 20. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 21. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, CIRA

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## Healthcare: Neutral

Healthcare is tricky. On a long-term basis, we think spreads are too tight to fundamentals, but the sector is likely to remain a comparative safe haven in periods of market volatility.

One fundamental issue is the need to strengthen the product pipeline. Balance sheets are strong currently, but we expect they will weaken over time as favourable funding costs encourage debt-financed M&A and/or share repurchases. Several names in the index are likely to pursue acquisitions of smaller competitors to obtain new patents, however most of them have the flexibility to manage medium-sized M&A.

Moreover, we believe fiscal austerity in Europe is likely to weigh increasingly on revenue growth going forward. Growing competition from generic drugs will hamper the profitability of patents and hence pricing power further. We think companies with a strong Phase III testing pipeline, like GSK, or which are more geographically and product diversified, like Bayer, are better positioned to withstand these challenges.

Despite our long-term fundamental concerns, the sector is likely to remain a comparative safe have against short-term market volatility. As such, given our more defensive top-down stance, we remain neutral on the sector.

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### Figure 22. Healthcare Picks and Pans

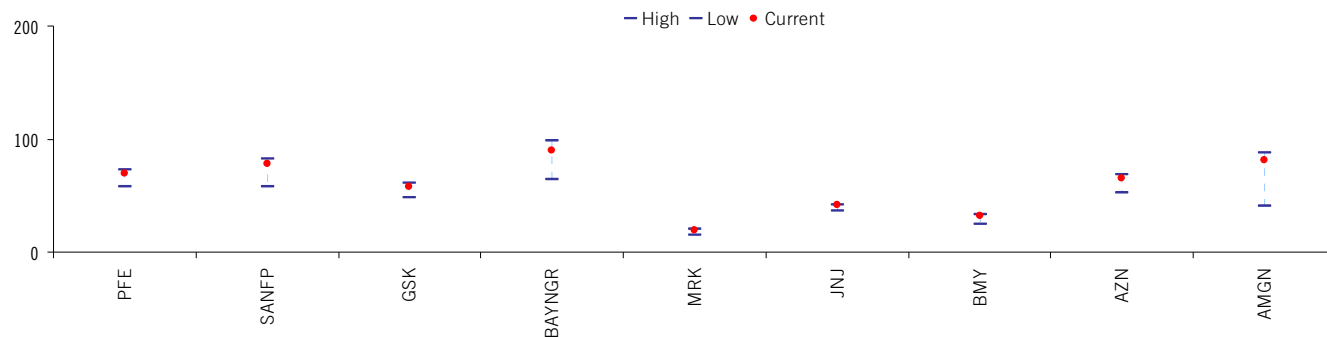
<b>Picks</b>	<b>GlaxoSmithKline:</b> GSK has many products in the 3rd phase of testing (about 30), and is already getting the benefit of newly generated sales from newly developed products. There are still risks that some drugs don't make it through their final testing, but we expect sales to improve as new products come to the market, leading to a general improvement of the creditworthiness of GSK. CDS is already gradually pricing in this positive outlook, but some long-dated € and £ bonds are still lagging behind.
<b>Pans</b>	<b>Pfizer:</b> Despite being one of the largest pharmaceutical companies in the world, with strong cash flows and relatively low leverage, Pfizer's product portfolio is weak, as many of its patents will expire in the next few years. While it is strongly investing in R&D and has about 15 products in Phase III testing, this will take time to bear fruit. Because of the weakness of its patent portfolio, the company has a high acquisition appetite. We suspect that this is the main reason why it is divesting from non-core businesses in an effort to improve its debt metrics. Its debt metrics are quite strong, and we don't think an acquisition would be very detrimental to its creditworthiness, however, €-denominated bonds are tight, and given the risks involved we don't see value.

Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

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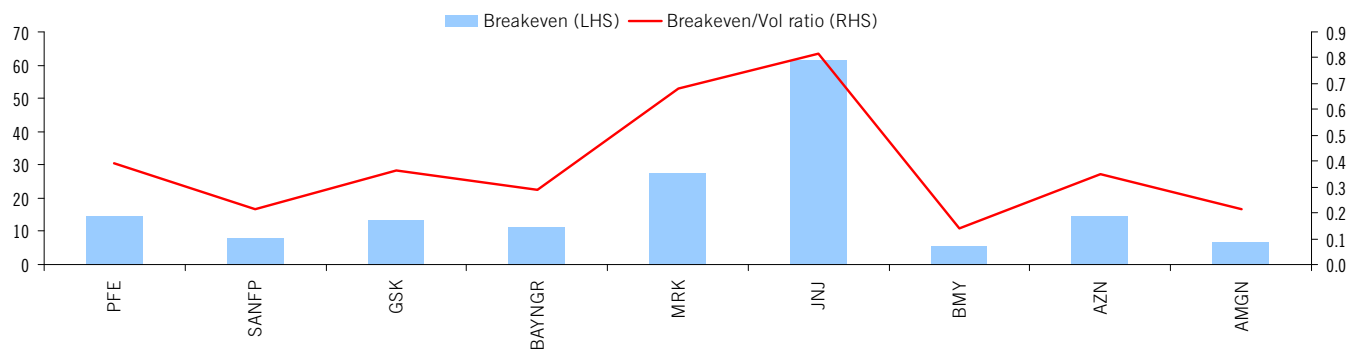


Figure 23. CDS 3mth Trading Range by Sector (bp)



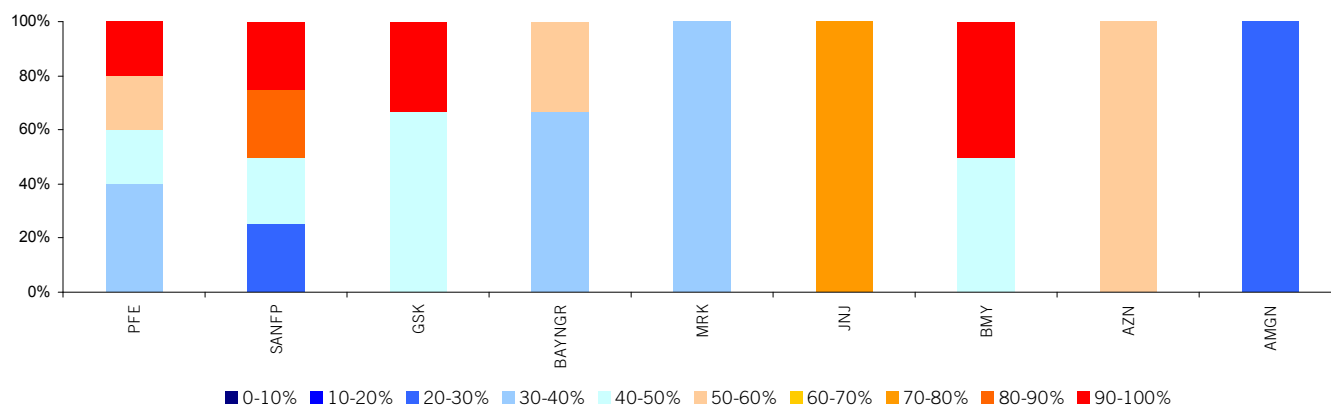
Source: MarkIt, CIRA

Figure 24. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 25. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Oil & Gas: Neutral

Thanks to their strong balance sheets, Oil & Gas companies have performed well versus other sectors in the recent sell-off. However, the outlook for oil prices for the rest of the year has weakened. Demand is stalling, prospects for the European and Chinese economy are not positive for the medium term and a number of fundamental and political factors suggest the market is not set for a turnaround. We therefore downgrade the sector to Neutral.

Supply concerns have been eased by the almost full return to production of Libyan wells, intervention of Saudi Arabia in increasing production and a weakening in demand which left inventories high. Also, the victory of Francois Hollande in France might imply a further easing of the relationship between Iran and Europe. While an attack on Iran by Israel can not be excluded, the oil market sees it as unlikely. Although we might have some seasonal price increases as we enter the summer, the oil forward curve is moving downwards. This is negative for the profitability of oil companies.

Partly mitigating the negative short-term scenario, the European market is well positioned for the longer term, essentially because of its ample reserves and technological advantage in off-shore exploration, which is expected to grow in coming years: we think it will benefit from this competitive advantage once the economy stabilises.

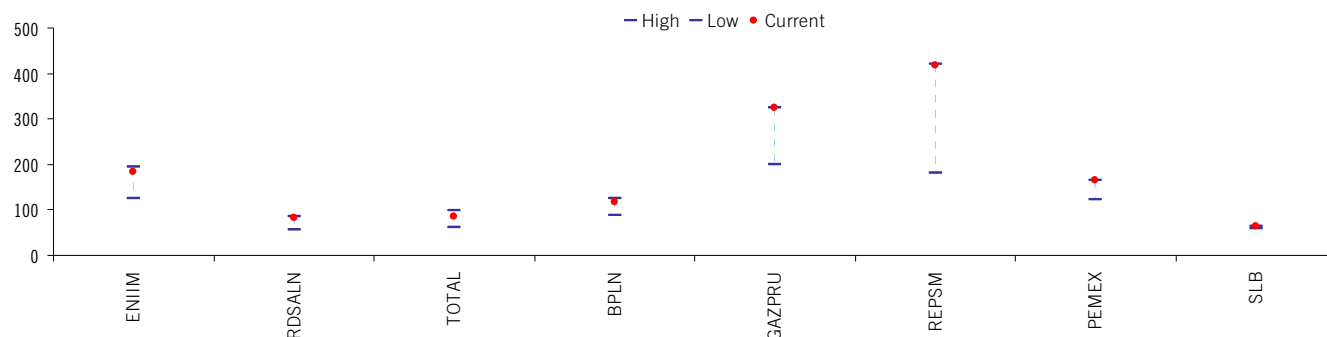
Growth in the European natural gas markets remains slow on ample supply. The positive is that some European midstream players which buy gas from Gazprom have renegotiated their long-term take-or-pay contracts. They will now be linked to spot gas prices, rather than oil prices, which had been squeezing their margins previously. ENI is one of the companies that benefits the most, which we don't think is reflected in current valuations. Gazprom, on the contrary, seems to be subject to a number of political risks on which we are not completely comfortable, in particular the possibility that the Government imposes further dividend increases and higher gas extraction taxes in Russia. These could negatively affect the creditworthiness of the company and we prefer to remain neutral on it until these matters are clarified.

Figure 26. Oil and Gas Picks and Pans

<b>Picks</b>	<b>ENI:</b> The company is mainly concentrated in upstream operations, which is a positive in the current environment. Also, its Reserve Replacement ratio improved in 2011 to 142%. New E&P projects in Mozambique are also faring well. It managed to renegotiate its long-term gas supply contracts with Gazprom, easing the margins squeeze it is suffering in its gas business: this is a positive which we don't see fully reflected in market prices, in particular at the long end of the bond curve, which is now quite wide compared to peers.
<b>Pans</b>	<b>Total:</b> Total is suffering from its underinvestment in the development of its resources. The gas spill in Scotland seems to be under control. However, we see M&A risk and higher capex needs versus peers. Our equity analysts highlight that Total's investment strategy is positioning the company at the upper end of the cost curve compared to peers (please see report on <a href="#">Total (TOTF.PA)</a> ). Current valuations do not make this name very attractive compared to peers in light of these risks, in our view.

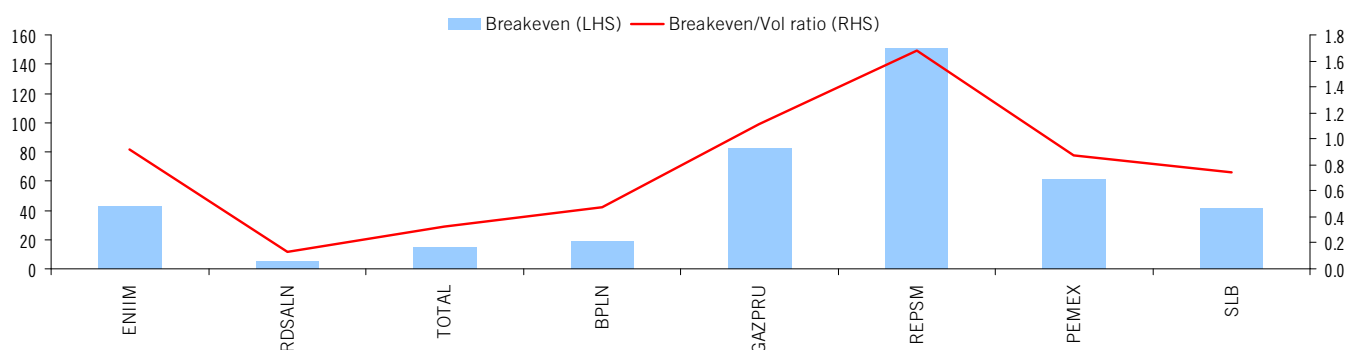
Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

Figure 27. CDS 3mth Trading Range by Sector (bp)



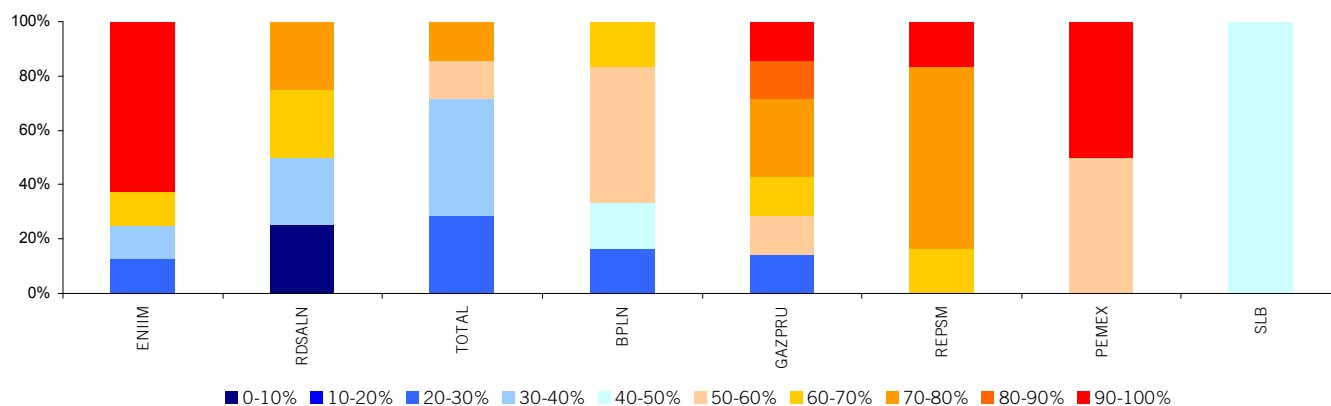
Source: MarkIt, CIRA

Figure 28. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 29. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Technology: Neutral

Having underperformed during the last beta-driven rally, we expect the technology sector to remain in line with the wider market, with a bias to outperformance once Nokia falls out of the iBoxx € index by the end of the month following its downgrade to 'junk'.

As previously discussed, the long-term growth outlook for mobile broadband is positive, as global penetration rates are still low and there are still huge needs for transmission infrastructure. However, cyclical demand, harsh competition and high R&D expenditures remain challenges to the sector. This situation is currently exacerbated by the weakening profitability of telecom operators, which is prompting them to hold back on capex. However, Ericsson is seeking to maintain its lead in the sector through investments, which are intended to consolidate its position in mobile data, cloud computing and Wi Fi. While we don't expect these investments to bear fruit in the short term, they are a long-term positive for the company. Therefore, we don't see much upside or downside at the current valuations.

The consulting business, instead, is promising. From one side, Cap Gemini is showing good revenue momentum, indicating solid demand levels, in spite of the recessionary environment in Europe. We see some weakness in the consulting business of IBM, but other sectors of the company are performing in line with expectations and it trades very tight to the rest of the sector.

Contrary to most sectors, Tech's breakeven to volatility ratio has been trending up even during the rally. Spreads are wide to long-term history although leverage is almost non-existent for Nokia and Ericsson, but we don't see catalysts for a tightening.

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### Figure 30. Technology Picks and Pans

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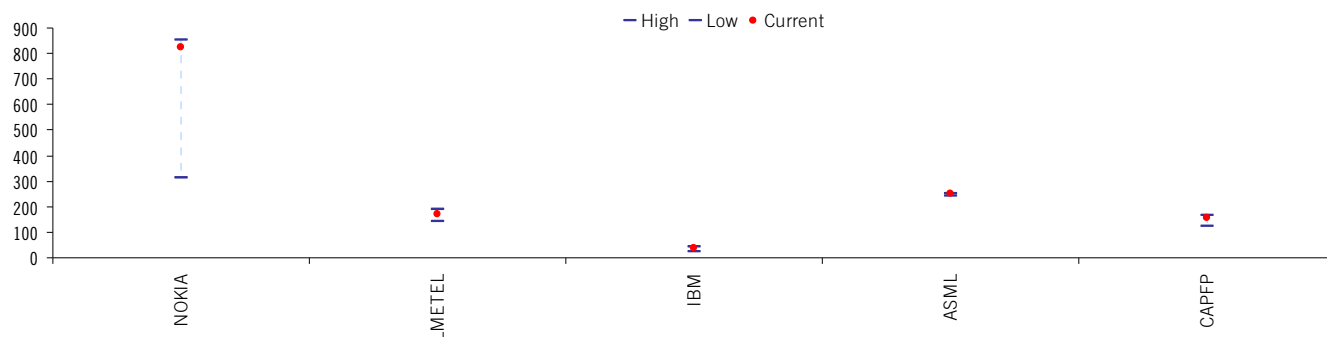
**Picks** **Cap Gemini:** Cap Gemini is showing good revenue momentum, indicating solid demand levels, in spite of the recessionary environment in Europe, thanks to strong growth in North America, Asia, Northern Europe and Germany. The book-to-bill ratio is holding up, although Q1 bookings were slightly weaker than last year.

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Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

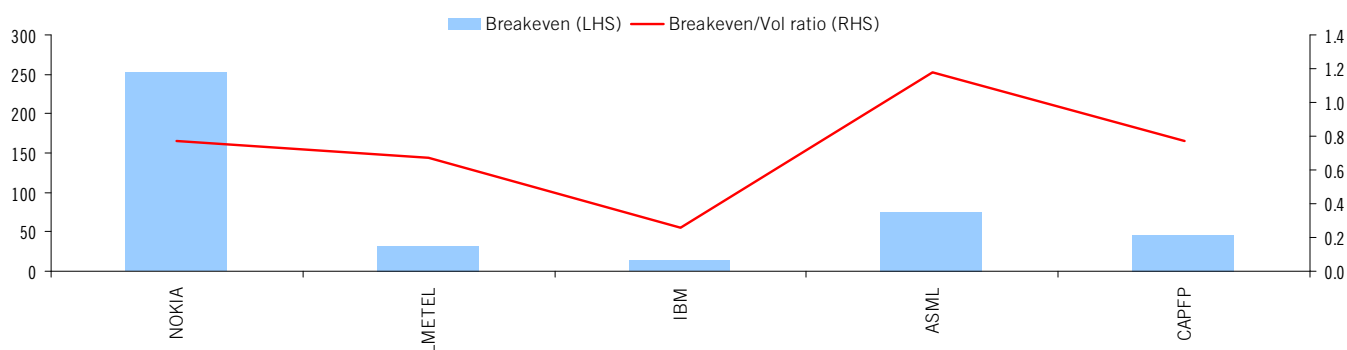
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Figure 31. CDS 3mth Trading Range by Sector (bp)



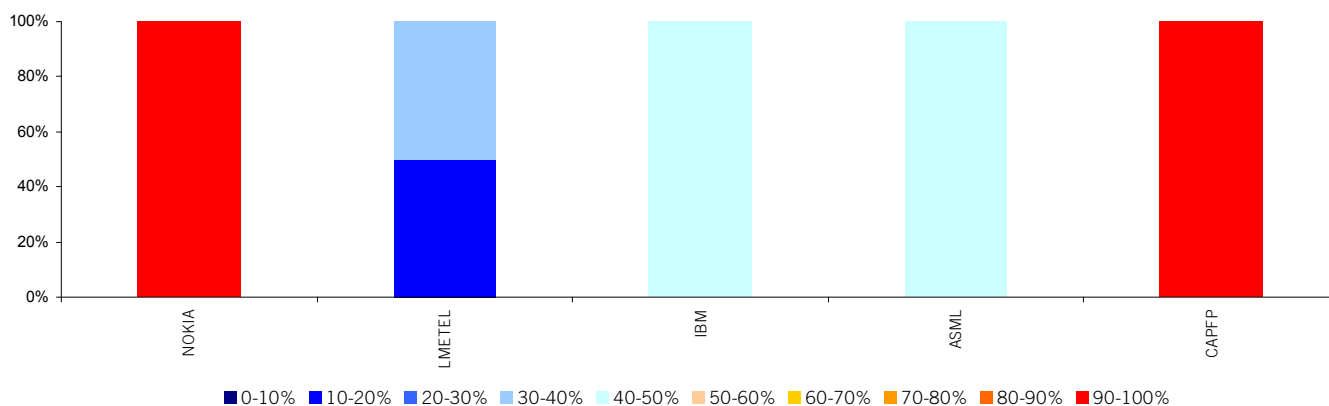
Source: MarkIt, CIRA

Figure 32. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 33. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Telecoms: Underweight

Weakening demand, especially in mobile, and increased competition are still weighing on Telecoms' profitability and in turn increasing event risk. In our view, the market has been slow to respond to the long-term fundamental challenges facing companies like FT. KPN is also likely to suffer from the entrance of a new competitor in the Dutch market, but we think the credit will benefit from an acquisition of a 28% stake by America Movil. Our [Global Credit Survey](#) suggests that the sector remains a consensus long, and actually exposure increased over the last month. We remain Underweight, although we are inclined to selectively reduce our shorts given the recent market performance.

Cost reduction, for instance through cuts to workforces, is still a major challenge in the sector, particularly ex-state monopolies. Incumbents would benefit from changes to labour regulations now under discussion in countries like Italy and Spain. The final discussions around the new regulations are expected to be concluded by next month. However, against strong domestic opposition it is far from certain these will be implemented. Moreover, there is an ongoing need for capex to maintain market share. Operating leverage is therefore high and sticky.

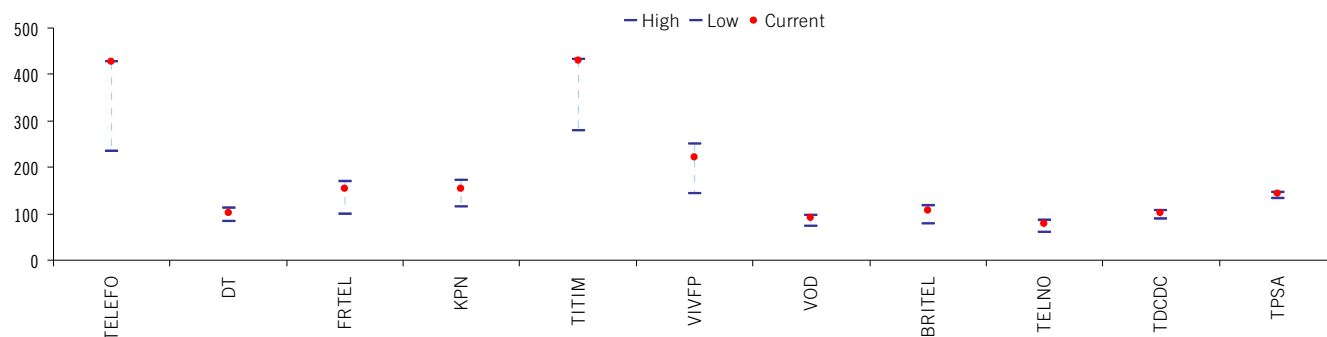
Sovereign risk remains the principal spread driver for peripheral telcos. In the current operating environment, we believe any deleveraging will be slow and we see downgrade risks as profitability is eroded. Telefonica has been outperforming its sovereign recently, but at the current levels we continue to be nervous about its sensitivity to sovereign risks, given the challenges that the company faces. We are less concerned about Telecom Italia, whose revenues are holding up well and deleveraging plans going ahead, but still sovereign risk is dominant. We'd stay underweight bonds in both cases – they are tight to sovereign spreads, recent history and now to CDS. That said, given PT's fundamentals and the fact that it is fully funded until 2014, we maintain our [short Portugal sovereign CDS position versus selling PT protection](#).

Figure 34. Telecommunications Picks and Pans

<b>Picks</b>	<b>KPN:</b> the credit should benefit from the acquisition of a 28% stake by America Movil, and we see potential for the CDS to outperform the sector on this news. Indeed, with this acquisition America Movil is quite close to full control of KPN and the market is likely to infer that America Movil will try and increase its stake to gain it. This would imply a convergence between the CDS spreads of KPN (now at around 153) and America Movil (now at around 120). However, the company is likely to suffer from the entrance of new competitors in the Dutch market.
<b>Pans</b>	<b>Telefonica:</b> Telefonica <a href="#">CDS</a> is again very tight to Spain. Telefonica bonds look even worse, being still comparatively tight to history, CDS and to Spanish sovereign bonds, so we would remain underweight. European revenues in general, and Spanish in particular, have been very weak. Telefonica is making investments to stabilise its market share in the UK and Spain, but this is unlikely to improve profitability any time soon. Also, the weak growth outlook does not help the company to deleverage. <b>France Telecom:</b> Current CDS and bond prices don't adequately reflect the long-term risks arising from the aggressive market strategy of the new French telecom provider Free, in our view. We also believe France Telecom is vulnerable to any widening in the sovereign should there be contagion from Italian and Spanish risk premia.

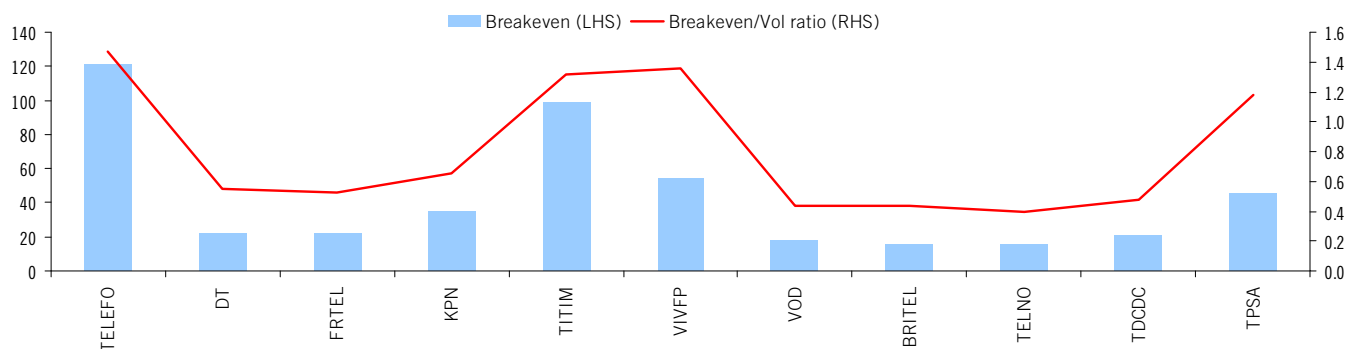
Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

Figure 35. CDS 3mth Trading Range by Sector (bp)



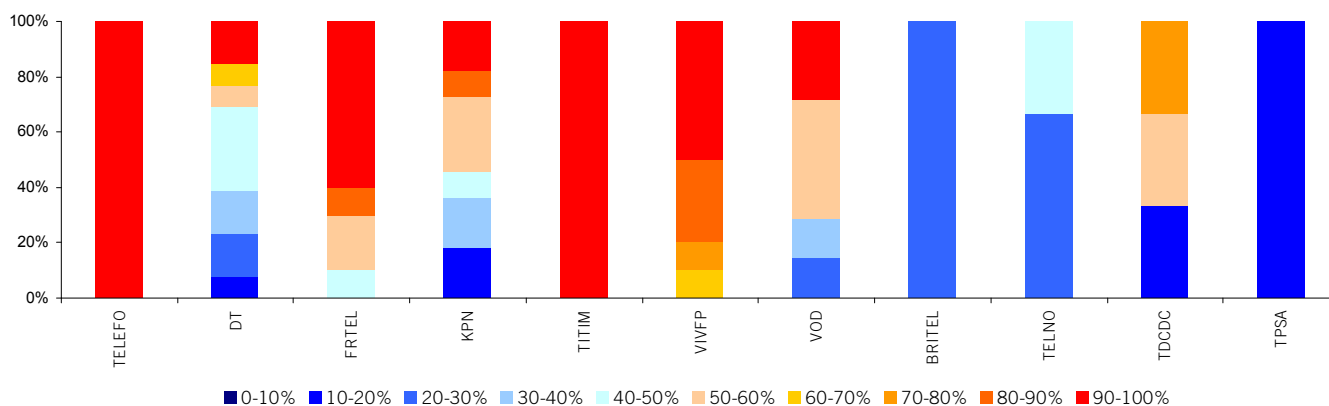
Source: MarkIt, CIRA

Figure 36. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 37. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Utilities: Neutral

The underperformance of Utilities versus most other non-financial sectors in iBoxx over the last couple of years is very palpable. In some cases, valuations in Utilities are close to their 2008 highs. We are overweight the core utilities, although they have in most cases outperformed the market as investors reach for safe havens. At the same time, we remain concerned about a significant part of the sector, i.e. those periphery credits (in particular Gas Natural and Iberdrola), which look tight to their sovereigns, especially considering their funding needs. All in, we are Neutral.

Leverage in the sector remains high and capex requirements going forward will limit the scope for debt reduction.

At EdP, underperformance has now been so great that we are close to wanting to cover shorts. EdP spreads are not only close to their own wides; they are also close to their [widest levels in a year relative to Portugal CDS](#). This is probably due to its likely ejection from investment-grade indices (already junk with S&P and Moody's, it remains in iBoxx thanks to a BBB+ rating from Fitch, but this is on review for downgrade). Once this happens, though, this suggests covering outright short positions, and perhaps even going long versus a short in the sovereign.

The sovereign crisis increases event risk across the whole of the Utilities sector. Privatisations, which imply acquisition risk and rating volatility, or other forms of regulatory intervention (like tax increases) remain an important consideration. But at these spread levels, these concerns seem close to being priced in. We still struggle with the large gap between the peripheral names and the very tight names in the core, but on balance are still biased to remain underweight the Spanish names, and slightly less so the Italians (which look less tight to the sovereign). The core names may be expensive, but seem likely to remain as good a place as any to hide in a period of considerable stress.

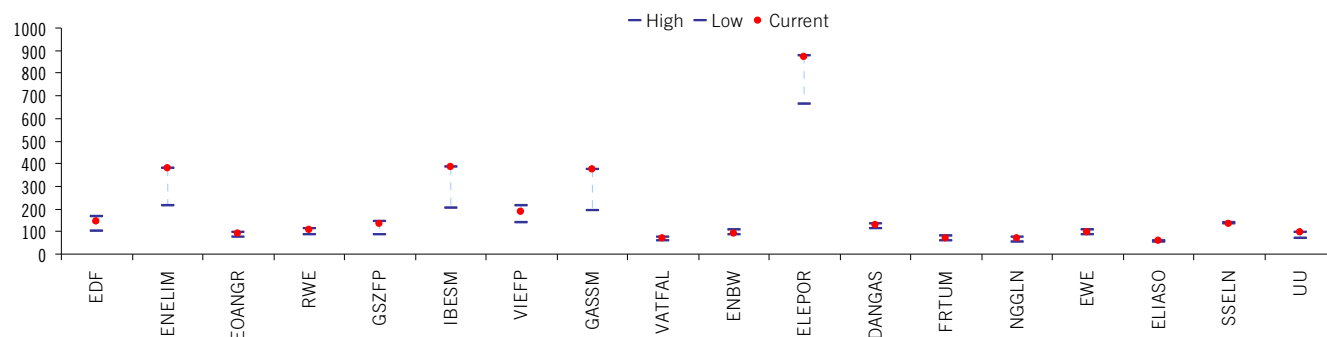
Figure 38. Utilities Picks and Pans

Picks	<p><b>Veolia:</b> The CDS valuation does not seem to give much credit to the substantial restructuring programme the company is engaging in. Yet we think it is credible and aims at preserving credit ratings, improving risk management, reducing costs and improving overall profitability.</p> <p><b>Dangas:</b> We like both CDS (though rather illiquid) and the perps, thanks to a mix of attractive valuations and improving corporate fundamentals. The company is quite conservative and comparatively low leveraged. It is also engaged in a growth programme which will likely cause the company to issue more debt in coming years. However, the planned investments should improve its competitiveness and we do not see them as a risk to spreads.</p>
Pans	<p><b>Iberdrola and Gas Natural:</b> Compared to other peripheral utilities, the CDS of these two companies are very tight to the sovereign. Given their leverage, we are concerned that spreads might not yet adequately reflect the increased funding risk they face. There is also some possibility that ahead of the introduction of the sovereign naked shorting ban, the CDS and bonds of these companies become an alternative way to express a negative view on the sovereign.</p>

Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

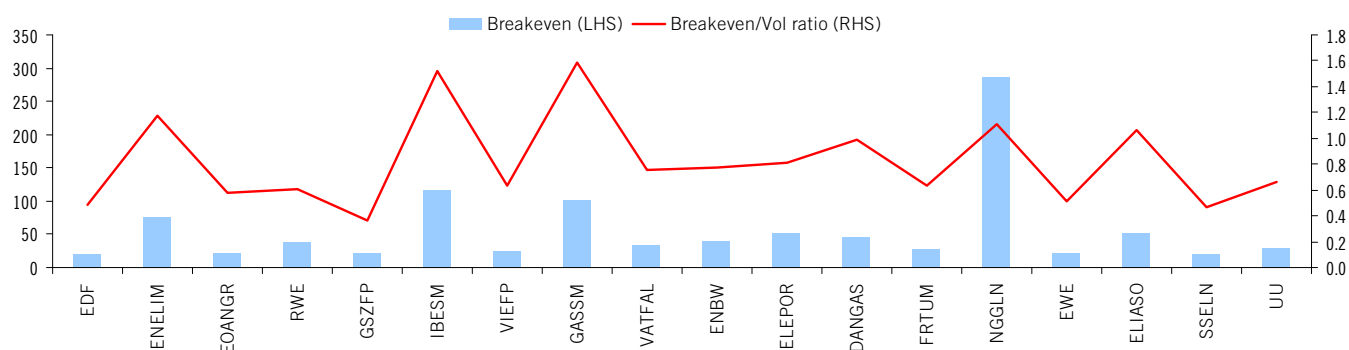


Figure 39. CDS 3mth Trading Range by Sector (bp)



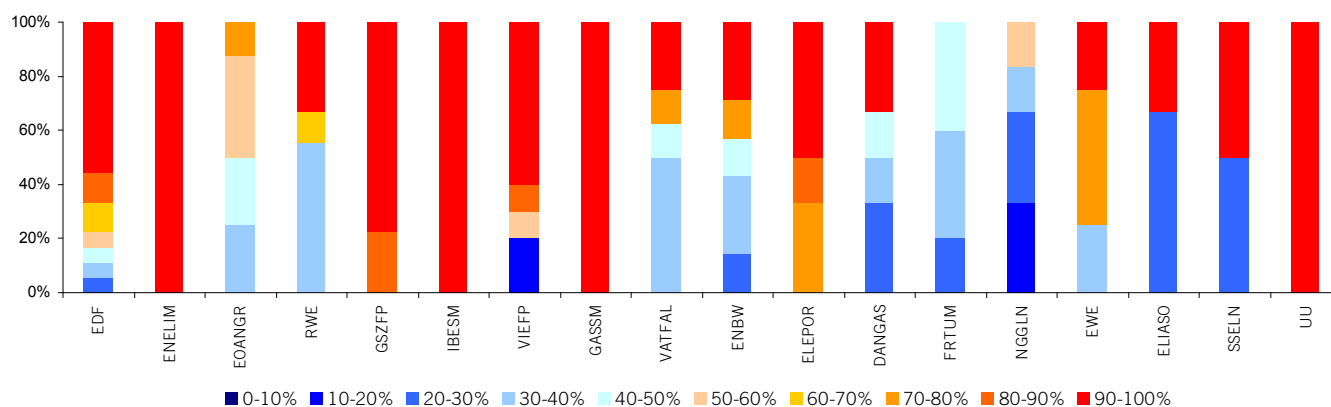
Source: MarkIt, CIRA

Figure 40. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 41. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Banks: Underweight

Political uncertainty still calls for a defensive approach in the banking sector, even if CDS valuations are approaching their December 2011 wides in many cases. Indeed bonds are still quite tight compared to the same period.

There is clearly scope for a short squeeze should the situation in Greece stabilise or should European policymakers come up with more comprehensive answers to the crisis. But the risks still seem skewed to the downside to us. However, current pressure on sovereigns is likely to weigh further on banks, especially in cash. Our macro concerns prompt us to downgrade the sector to Underweight, reducing exposure by scaling back the beta-adjusted overweight on core LT2/T1, and covered, while underweighting senior and peripheral debt.

The LTRO supported trading activity in the last quarter, favouring banks with significant trading operations, or somehow shielded by the sovereign risk issue (Northern banks, UBS, Barclays, SocGen). But while this was reflected in the last earnings season, we expect the current market volatility and lack of volumes to take their toll on next earnings season. Peripheral banks continue to suffer from their worsening asset quality and higher provisioning.

The increase in periphery holdings of domestic sovereign debt has only strengthened the link to the sovereign in recent months. LTRO or not, capital injections or not, their fate is intertwined with that of the sovereign in our view. The sustained deposit outflows from Greece are increasing the risk that capital controls may eventually have to be invoked, making us more bearish on peripherals than previously.

We would be underweight not only on banks in the periphery, but also on banks located in weaker core countries, like France even after recent underperformance. We are also negative on Austrian banks with European EM exposure which have widened less than the French ones, as contagion from Greece is likely to affect countries like Hungary as well. On the contrary, core banks with conservative business models (like UBS) have sold off in line with the wider market, and we think this is overdone.

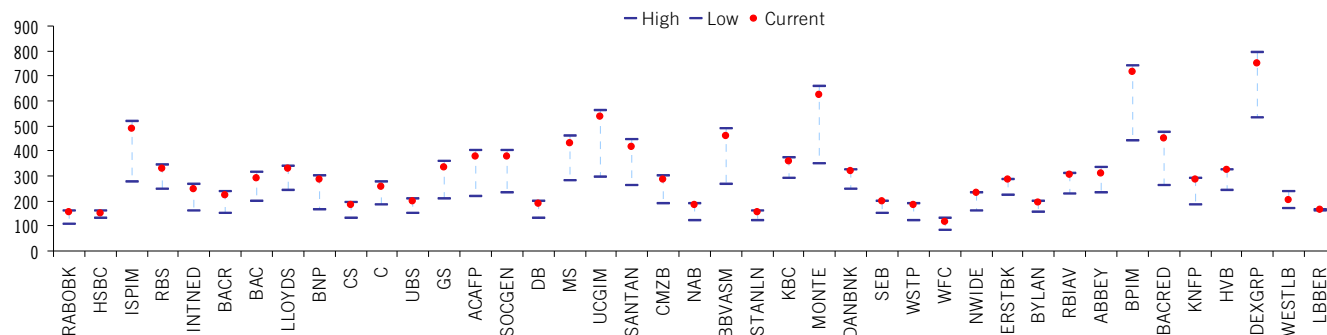
The switch from unsecured to secured funding (most obviously with the ECB), and the future shift to special resolution regimes, substantially reduce expected recovery rates on senior. We believe a renewed widening in sovereign spreads is all it would take to increase concern about such issues, as we have seen happening in Spain. Therefore we are underweight on the sector by reducing our overweight on core LT2/T1, and covered (which has been lagging) while underweighting senior and peripheral debt.

Figure 42. Banks Picks and Pans

Picks	<b>UBS:</b> We find current valuations of LT2 and T1 capital quite attractive compared to other banks. There is tangible progress on deleveraging and on the repositioning of UBS from investment banking and trading back to wealth management.
	<b>HSBC:</b> HSBC T1 capital slightly outperformed peers in the recent sell-off, but it should outperform more, in our view. Asset quality deterioration in the US is slowing, and we expect a positive performance of its wholesale and commercial banking. Also, the bank estimates to have a 10.3% capitalisation ratio by 2013, although core T1 ratio declined due to Basel 2.5 rules and some consolidation effects.
	<b>American banks:</b> The modest US recovery remains largely on course, leading to a gradual improvement of credit quality and even some modest loan growth. While US banks' revenues are challenged by regulatory changes, low interest rates, and a troubled housing market, their exposure to Europe is minimal (although they would still be exposed to market volatility should the situation in Europe again fall out of control). We like JP Morgan in particular: the weakness recently caused by the announcement of losses on its credit positions is likely to be only temporary.
Pans	<b>Raiffeisen Bank:</b> In light of the potential contagion effects that a further deterioration of Greece would have on Emerging European countries, we feel uncomfortable with current valuations, which are remarkably tight to French banks. The situation in Hungary is still quite difficult as the Government does not look committed to the reforms the EU requires. RBI's latest FY11 results show further deterioration of asset quality, driven by Central Europe, and also some deposit outflows which brought the loan to deposit ratio from 118% to 122%.
	<b>Erste Bank:</b> Erste suffers from all the same exposures, with Hungary constituting 4.5% of average RWA and 36% of common equity. NPLs are high both in and outside Hungary. We don't see these risks fully reflected in the valuations of bonds in particular.

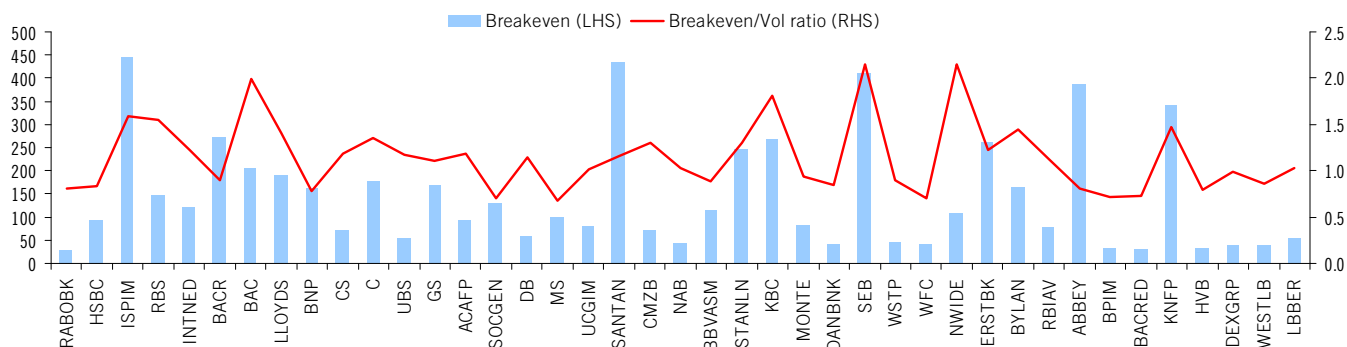
Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

Figure 43. CDS 3mth Trading Range by Sector (bp)



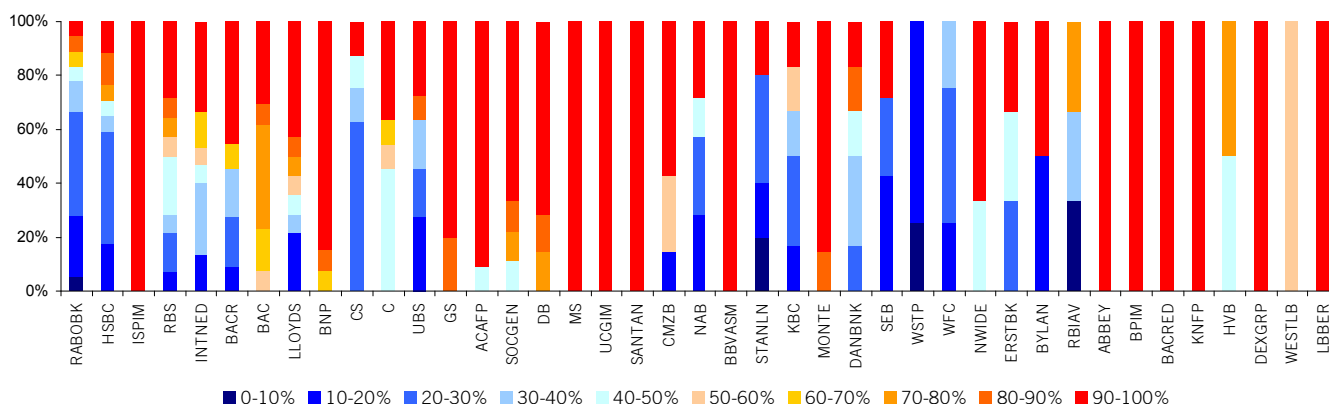
Source: MarkIt, CIRA

Figure 44. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 45. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tight.

## Insurance: Underweight

Similarly to the Banks, also in the Insurance space we prefer to take a defensive stance and reduce our beta exposure. Insurance sub debt seems to have reacted comparatively more than bank sub debt to the widening in Spanish and Italian sovereign CDS. We are close to December wides in the CDS, but bonds are still tight compared to the same period, in our view. As in banks, we see potential for a short squeeze, but our macro outlook is prompting us to be increasingly defensive.

Senior valuations do not look very attractive versus banks. Moreover, with current investor [positioning](#) on insurance now as long as ever, we sense a pain trade here. So, with the banks, we prefer to reduce credit risks and beta exposure through an overweight on core insurers and increasing the underweight in the periphery and in the weaker core countries.

Fundamentals in insurance are under pressure on multiple fronts. Revenue growth has been slow, especially for discretionary products. Ultra-low US, UK and German yields have pushed up the present value of their liabilities, while markets pressures re-emerging and increasing risks from peripheral exposure have reduced the average yield of insurers' asset portfolios.

The positive performance of the markets in Q1 benefited insurers' portfolios this earnings season, especially in the non-life sector, with earnings generally surprising to the upside, but sovereign risks don't make us optimistic for the next quarter. .

We continue to expect some LME activity from the insurers (Old Mutual, Allianz, Swiss Re, Prudential, among the others), which would provide support to current levels. Differently from banks, the insurers engaging in LMEs are relatively well capitalised, so their main motivations for LMEs are to reduce interest coverage, and manage their refinancing needs (e.g. refinance their debt for cheaper in another currency, like many Swiss insurers).

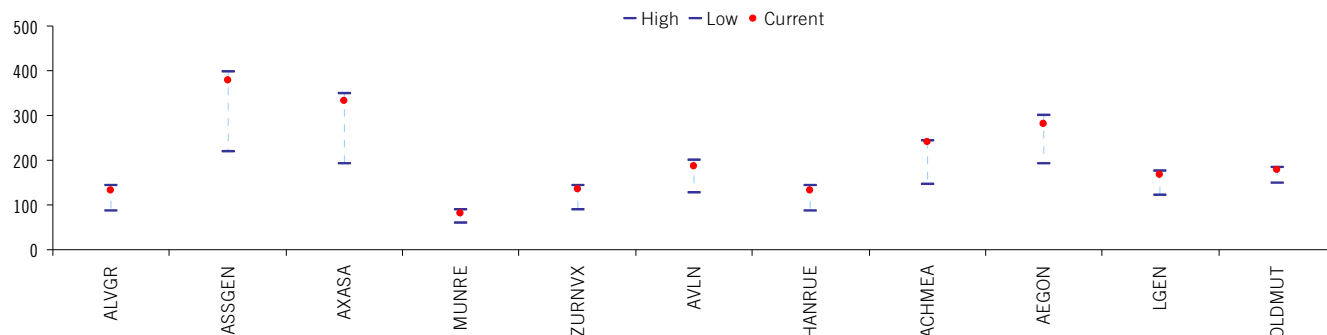
Acquisition risk is higher than in most other sectors as insurers seek to consolidate their positions in core business areas and/or attempt to expand into high-growth markets like the Asian one. However, these acquisitions are being financed mainly internally or with equity.

Figure 46. Insurance Picks and Pans

<b>Picks</b>	<b>Allianz:</b> The subordinated bonds widened substantially because of their relatively high beta, but we believe they are a candidate for an LME, which should provide support to prices. The quality of the business, confirmed by its positive 1Q results, makes us comfortable to take subordinated exposure at the current levels.
<b>Pans</b>	<b>Assicurazioni Generali:</b> The company has a good business mix, with strong market positions in Europe and CEE. Moreover, it is able to generate quite high profits in Italy as the Italian market is not very competitive. However, it is one of the most exposed to sovereign risk. This exposure could negatively affect its capital base. Moreover, its asset gearing is quite high, which adds to its capital weakness. The fact that the Euro zone, and Italy in particular, is in recession again does not bode well. The CDS is moving in line with Italy and is quite wide on an historical basis, but some senior bonds are still too tight, in our view.

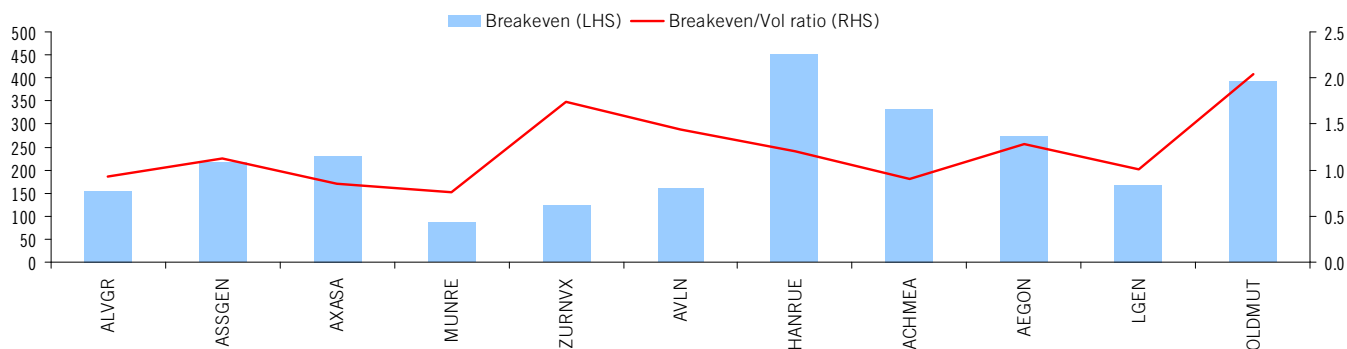
Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

Figure 47. CDS 3mth Trading Range by Sector (bp)



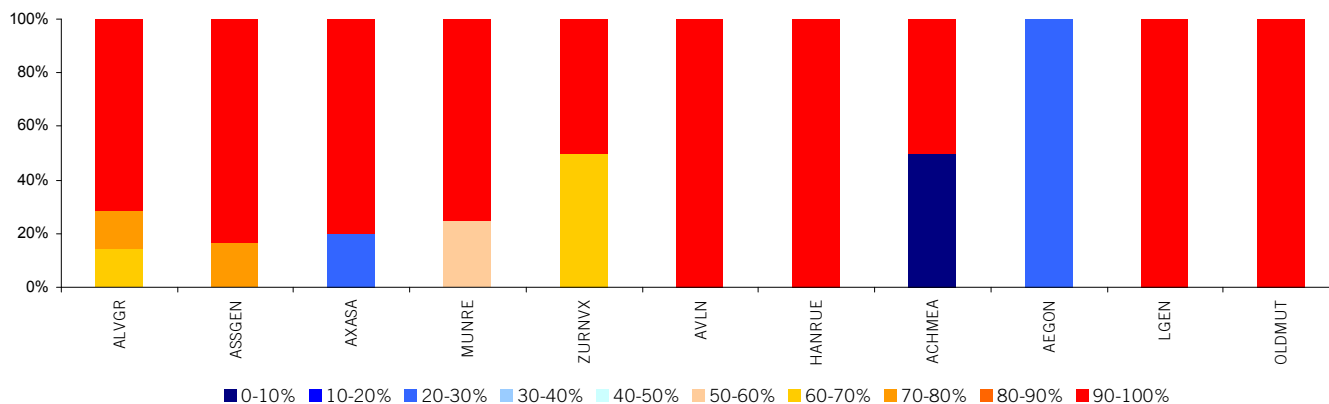
Source: MarkIt, CIRA

Figure 48. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 49. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Financial Services: Neutral

We are still not keen on the Financial Services industry. However, the sector is half dominated by GE bonds, which we find attractive at the current levels. Most of the remaining companies are heavily exposed to real estate, where we still see downside risks at current spread levels.

Recovery at GE is continuing, with GECC resuming its quarterly dividend to parent company GE (set at 30% net income), plus a special \$4.5 bn cash dividend this year. This suggests that the Fed audit of GECC is proceeding smoothly. GECC is still heavily exposed to commercial real estate loans, a sector which has yet to stabilise, however its €-denominated bonds widened in line with the rest of the market. We think this is overdone and we would go long on them to diversify from European risk.

The fragility of real estate markets keeps us cautious about gaining exposure to many of the other property-related names in the sector (Hammerson, Klepierre, Gecina). We think bond investors wanting to go anywhere near this space would do much better to buy equally or higher-rated CMBS, RMBS or ABS instead: spreads trade much wider for structures which to our minds are considerably more robust.

Our favorite sub-sector within Financial Services is therefore Cards & Payments. The secular shift towards electronic payments ought to benefit incumbents, and new regulations are much less of a burden than is the case for banks.

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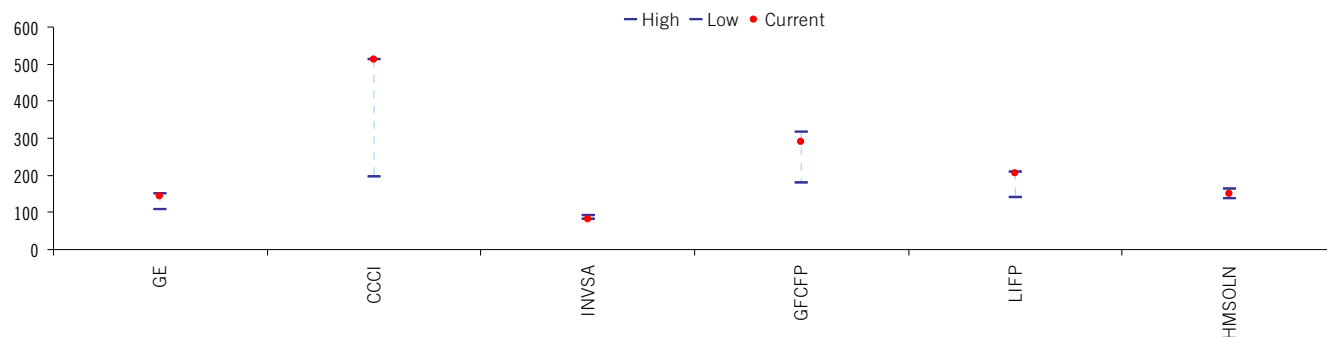
### Figure 50. Financial Services Picks and Pans

<b>Picks</b>	<b>GECC:</b> GECC is resuming its quarterly dividend to parent company GE (set at 30% net income), plus a special \$4.5 bn cash dividend this year. This suggests that the Fed audit of GECC is proceeding smoothly. GECC is still heavily exposed to commercial real estate loans, a sector which has yet to stabilize, however its €-denominated bonds widened in line with the rest of the market, and we think this is overdone.
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Source: CIRA. Please refer to the footnotes on page 4 for our methodology.

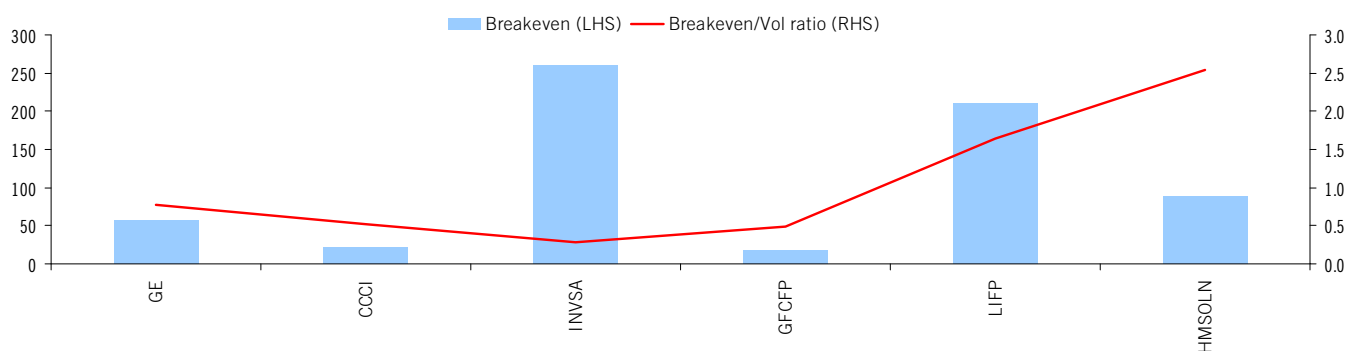
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Figure 51. CDS 3mth Trading Range by Sector (bp)



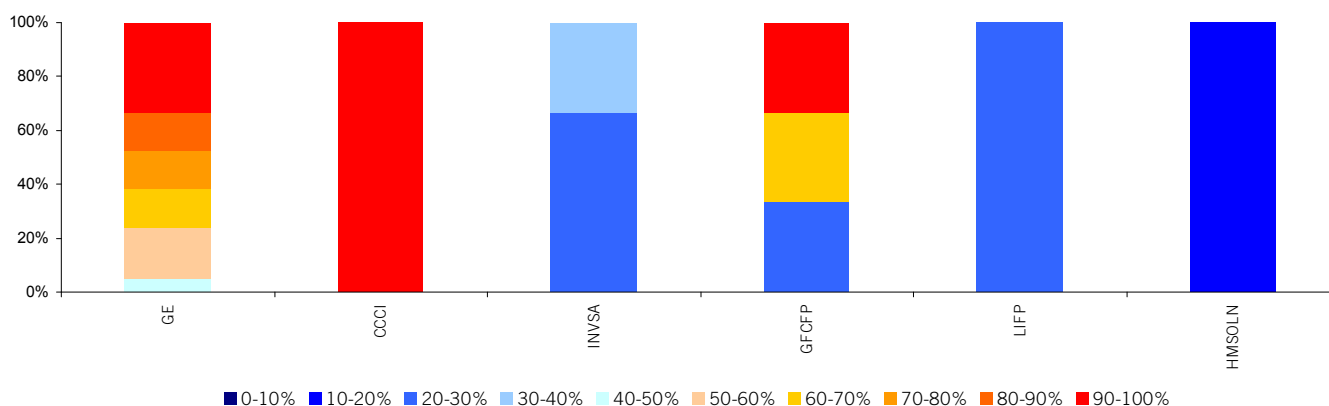
Source: MarkIt, CIRA

Figure 52. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, CIRA

Figure 53. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, CIRA

\* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

## Notes



## Notes

## Notes

## Appendix A-1

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A member of the household of Matt King, Strategist, holds a long position in the securities of JP Morgan Chase & Co.

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