

August 2013

# Dégustation gourmande

## How to make credit a little tastier

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

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Les entrées

Menu du jour

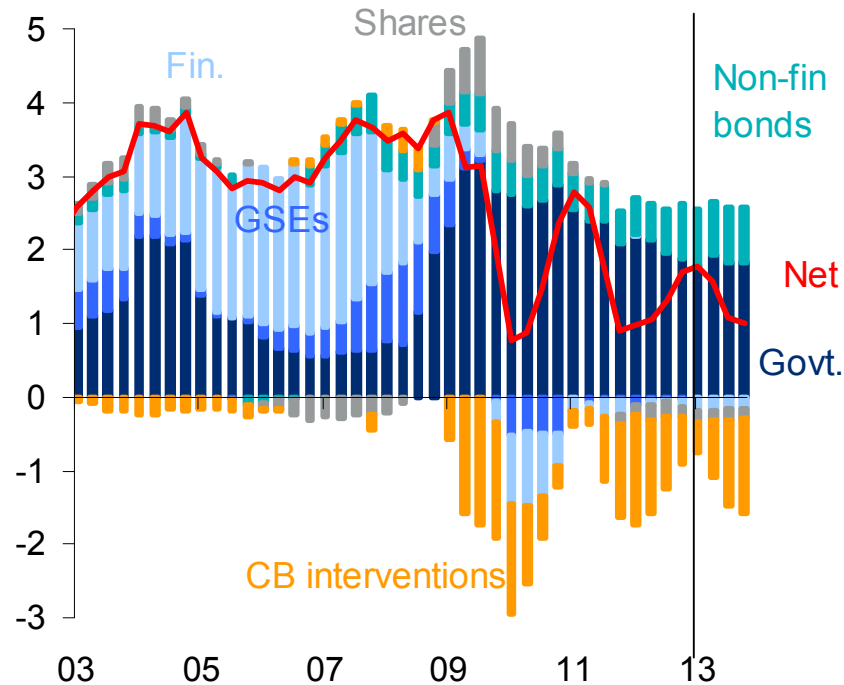
Nos suggestions

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# A little foie gras?

## CBs\* constraining supply of new securities

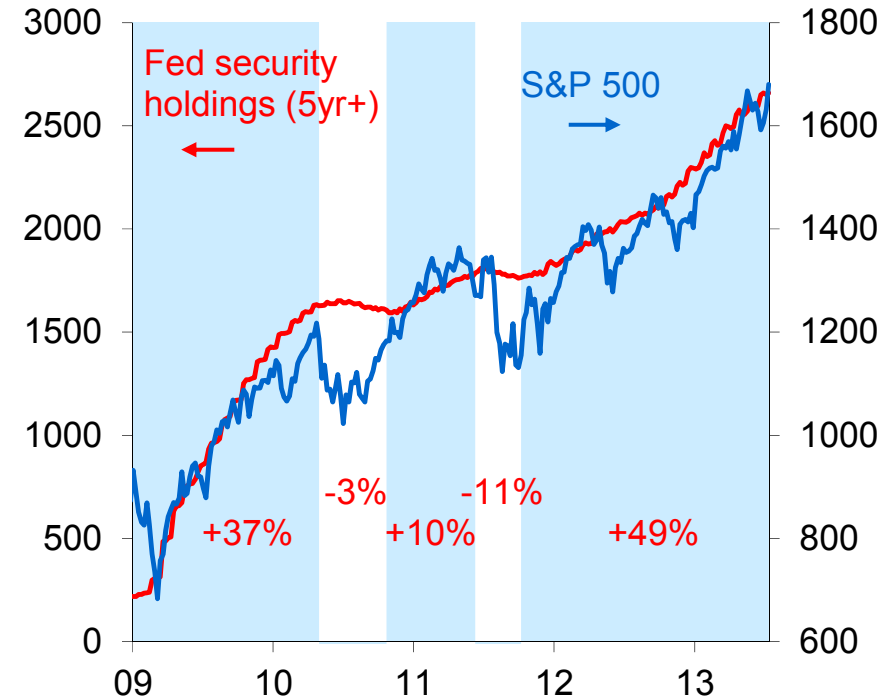
Net iss. of new securities vs CB\* interventions, 12m rolling, \$ tr



Source: Citi Research, Haver. \*: Federal Reserve, BoJ & ECB

## QE is still propping up US markets

Fed's holdings of securities (5yr+ maturity), \$bn, vs S&P 500



Source: Citi Research, Federal Reserve, Bloomberg

Even with tapering, markets are stuffed with liquidity in H2 '13

# Plus ça change, plus c'est la même chose

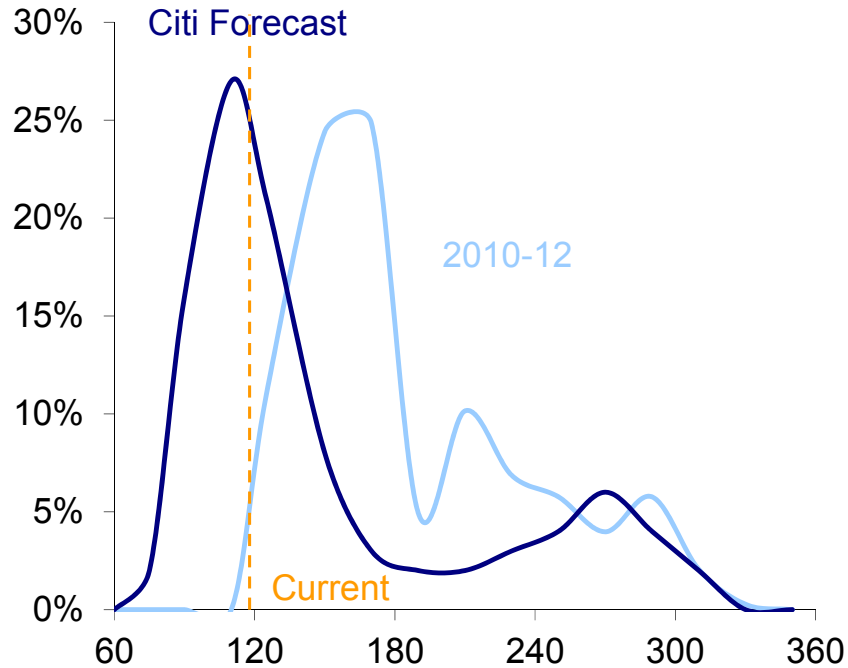


But although the menu changes there are still lots of concerns to choose from

# Chef's reputation is crucial

## Modal forecasts can be misleading

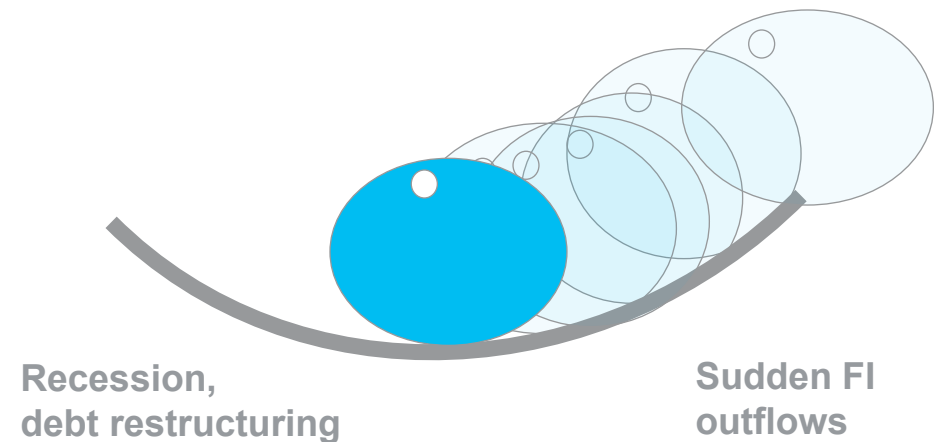
€ iBoxx spread histogram vs stylised 2013 forecast



Source: Citi Research.

## An egg in a bowl

Nudge gently and it comes back. Nudge harder...



# Chefs will need a delicate touch to get the ingredients right

Les entrées

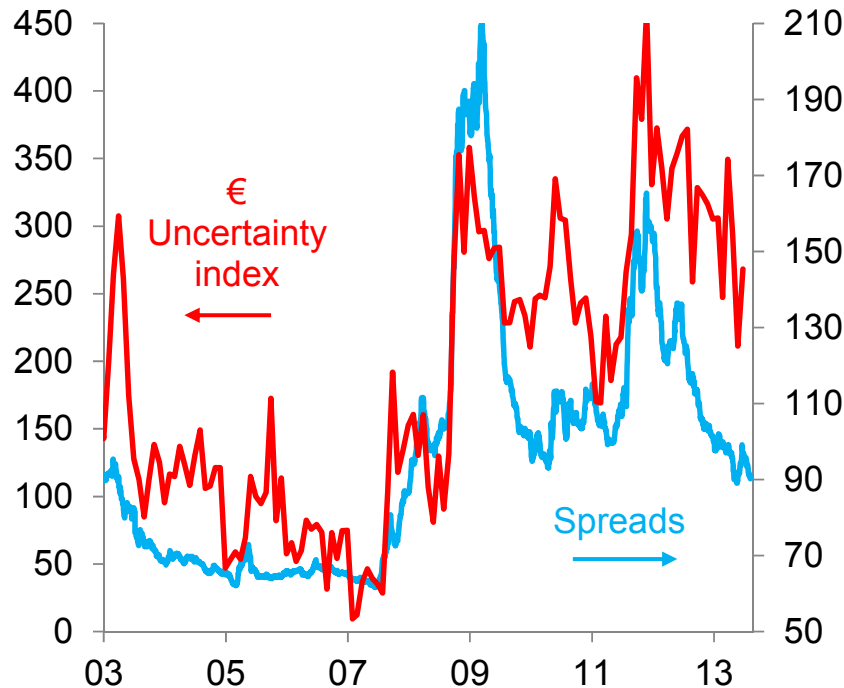
Menu du jour

Nos suggestions

# Coq au Ries(k)ling – Risk/reward is poor

## Spreads don't reflect the uncertainty

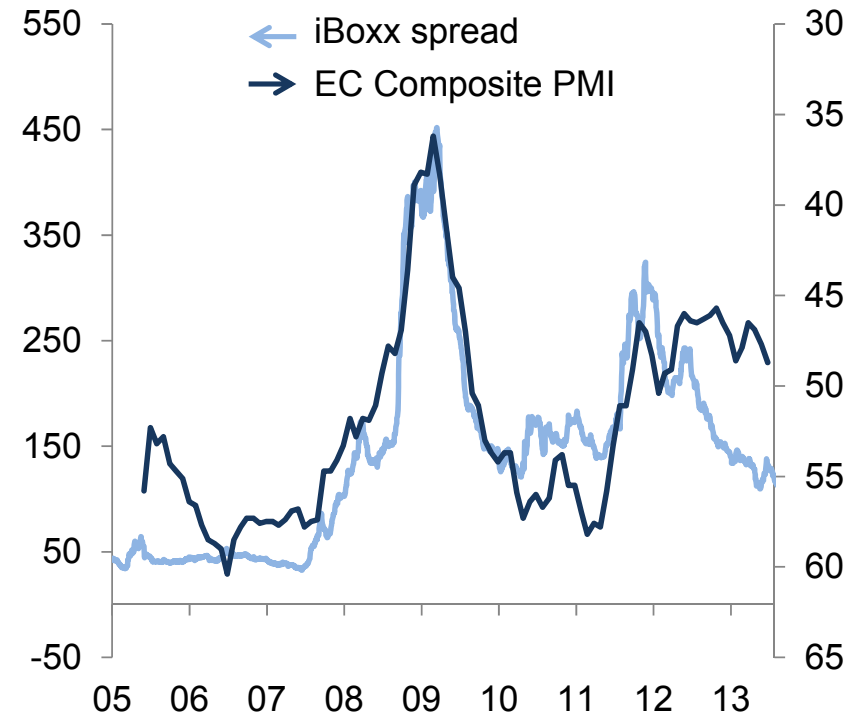
Econ policy uncertainty index vs € iBoxx spreads, bp



Source: Citi Research, [www.PolicyUncertainty.com](http://www.PolicyUncertainty.com), MarkIt

## Spreads don't reflect a tentative recovery

EC Composite PMI vs € iBoxx spreads, bp



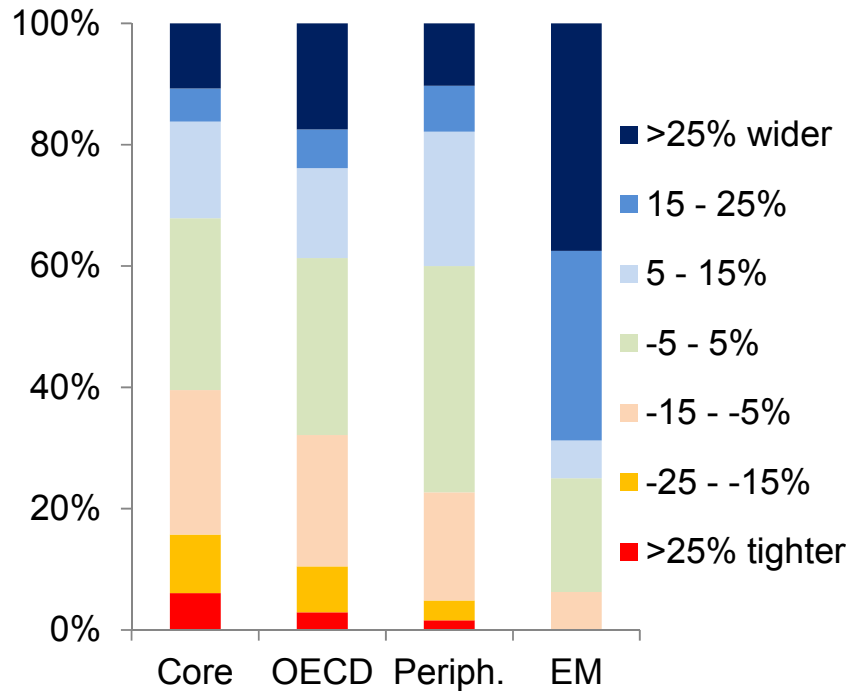
Source: Citi Research

Spreads are tight to most fundamental metrics, but ...

# Coq au Ries(k)ling – Going for another serving!

## Low-beta, 'high-quality' is outperforming

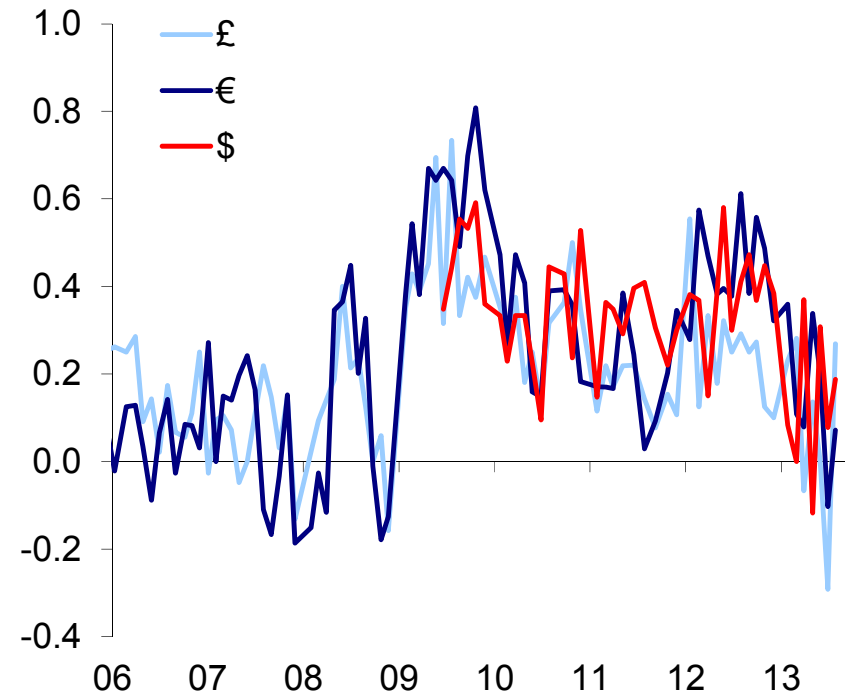
Bond performance distribution, since 24 May, € iBoxx by domicile



Source: Citi Research, MarkIt

## Inflows recovering over the summer?

Reported inflows in the Citi Credit Survey



Source: Citi Research. 2/-2: Very large in-/outflows

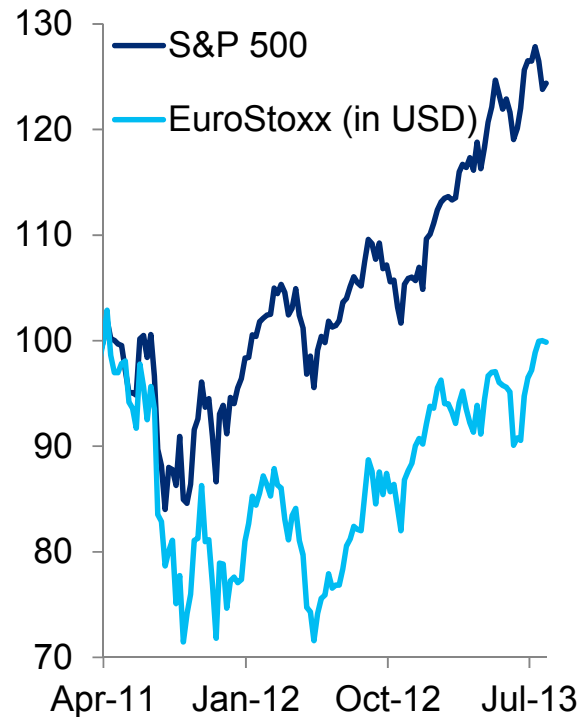
...a cautious rally implies a need, rather than desire, to invest



# Rates-atouille – Should Europe decouple from the US?

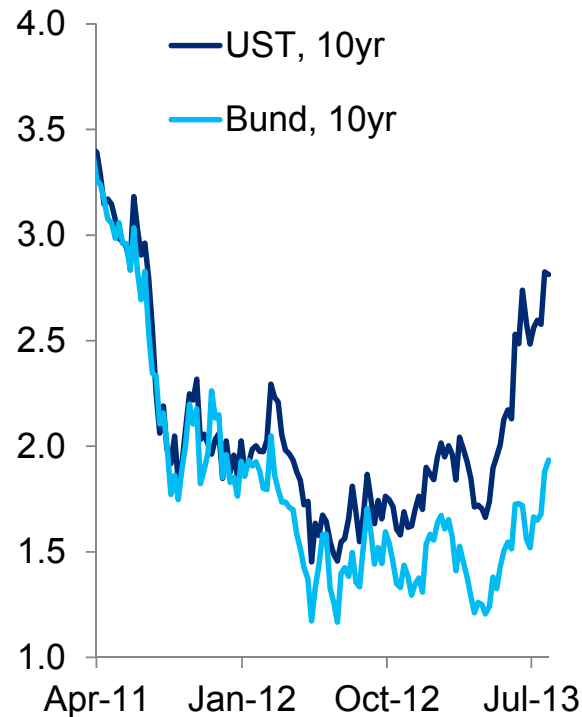
2011: Equity investors decide    2012: Rates investors decide    2013: Credit still undecided

S&P vs Stoxx in \$, Apr-2011=100



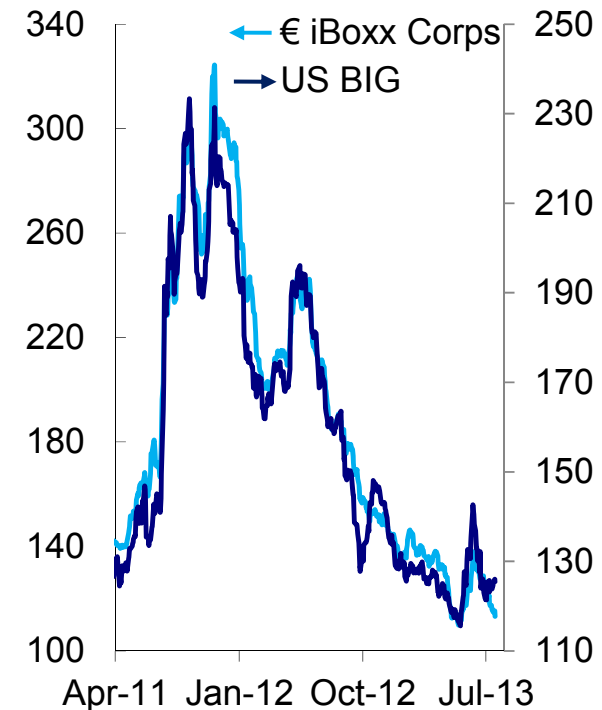
Source: Citi Research, Bloomberg

10yr UST vs Bund yield, %



Source: Citi Research, Bloomberg

€ iBoxx vs US BIG spread, bp



Source: Citi Research, MarkIt

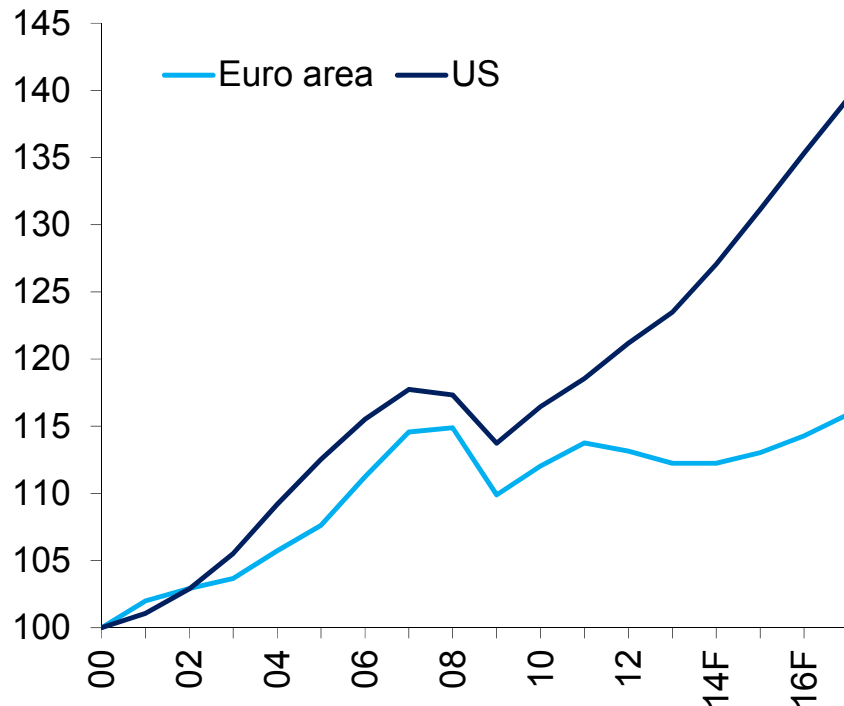
Relative decoupling has already occurred in other markets...

# Rates-atouille – Growth or total return outlook?

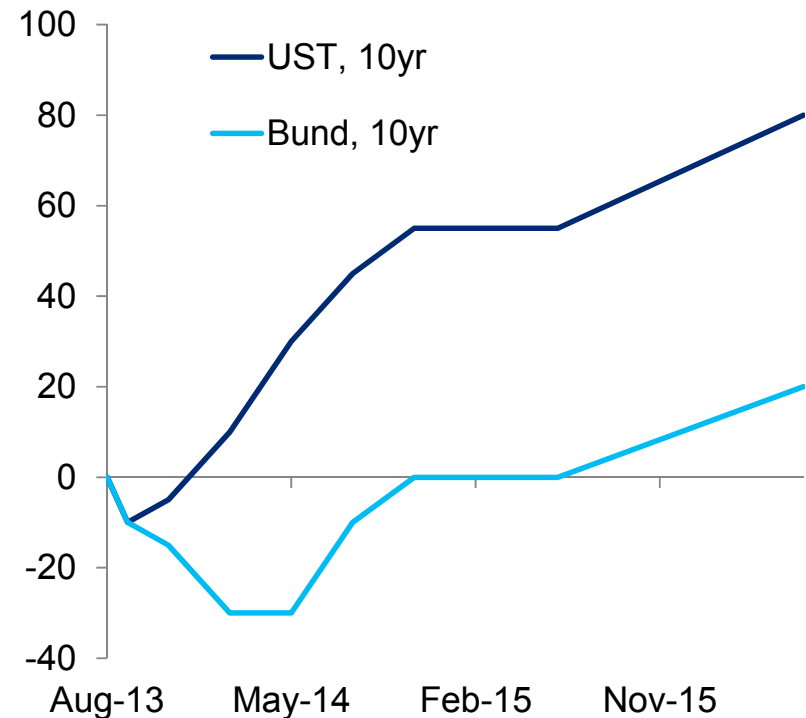
Should US-European spread differential reflect growth or the likelihood of outflows?

Euro area & US GDP level w. Citi forecast, 2000=100

Yield change from current implied by Citi forecast, bp



Source: Citi Research, Haver Analytics. Note: Citi forecast from 2013-17



Source: Citi Research

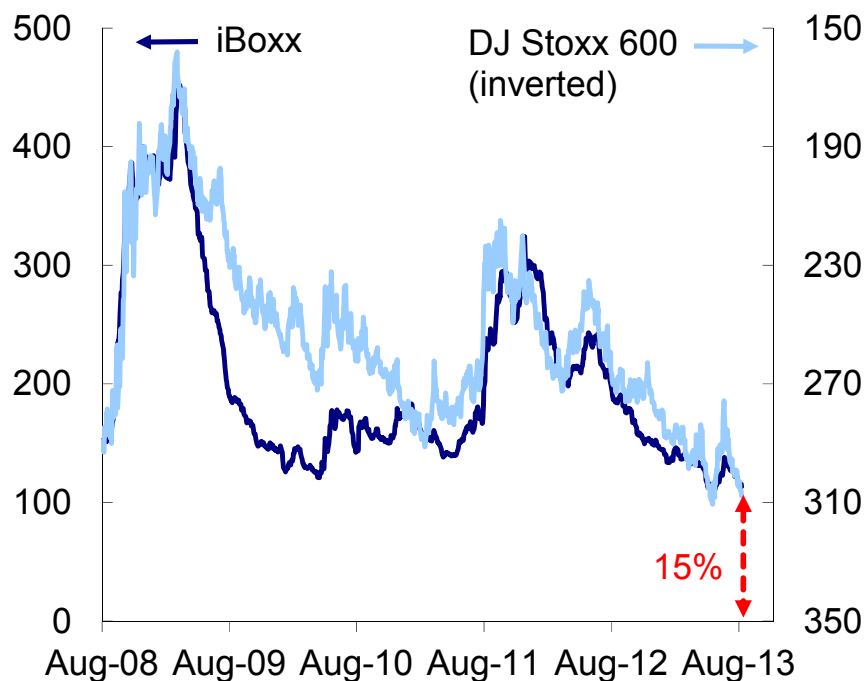
... but ambiguous impact reduces chances of a significant decoupling in credit

# The Great Rotisserie – Rotate into equities?

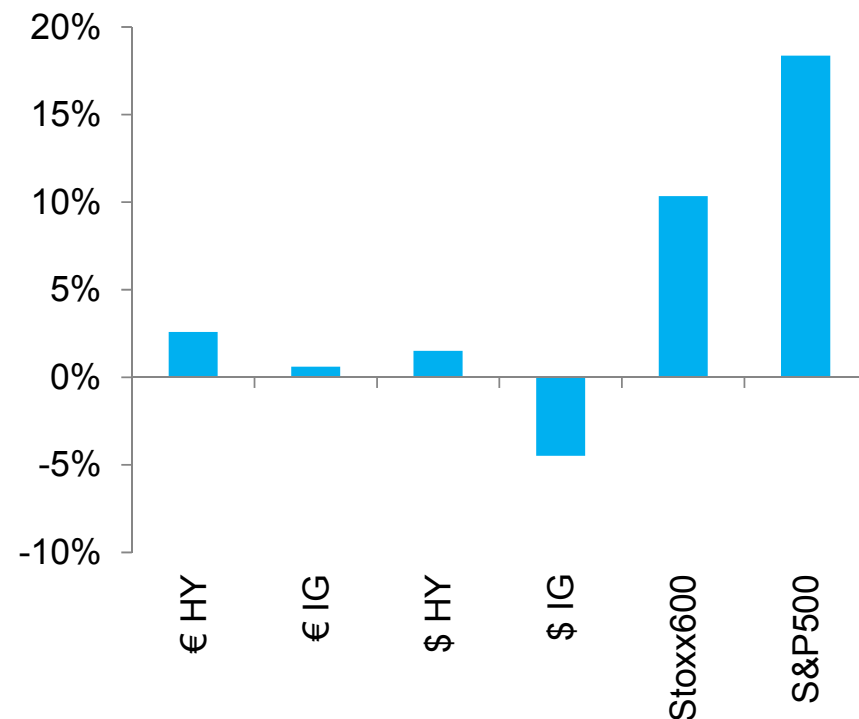
What would credit do if equities rally by 15%? Total returns are totally clear

€ iBoxx index spread, bp, vs EuroStoxx 600

YTD total returns (local currency) by index



Source: Citi Research, MarkIt, Bloomberg



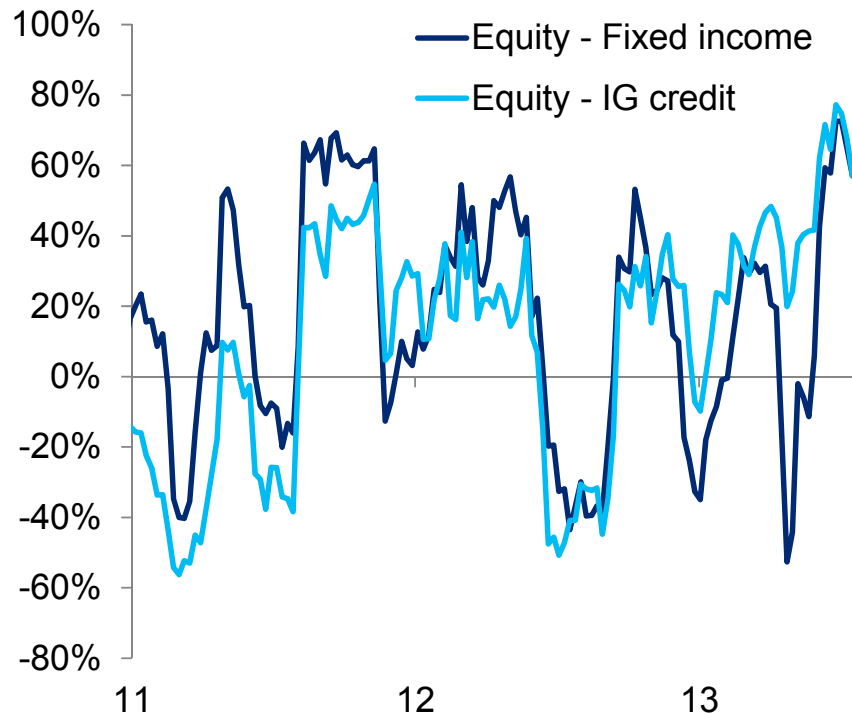
Source: Citi Research, Bloomberg, iShares

The relative value argument is strong but ...

# The Great Rotisserie – too much liquidity to roast spreads

## Flows behave in generic risk on/off pattern

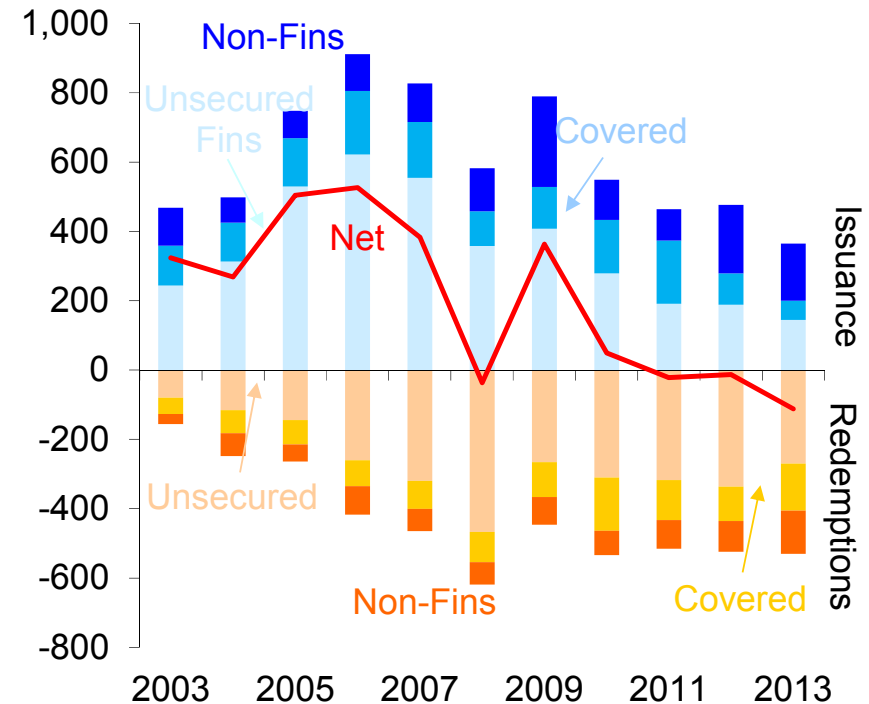
3mth correlation in US mutual fund flows, equity vs. fixed income



Source: Citi Research, ICI, Haver Analytics

## € credit market is still shrinking

€ bond supply & issuance, 2003-13F, €bn



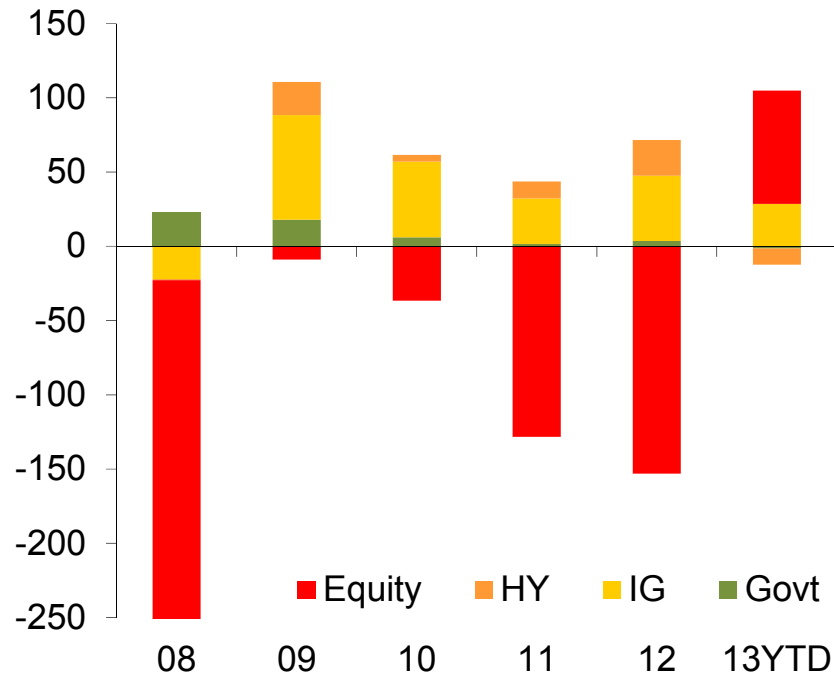
Source: Citi Research, Dealogic

...but we don't expect sustained widening as a result

# Le Grand Fromage – Money chasing ever riskier returns

## Flows heading to ever riskier assets

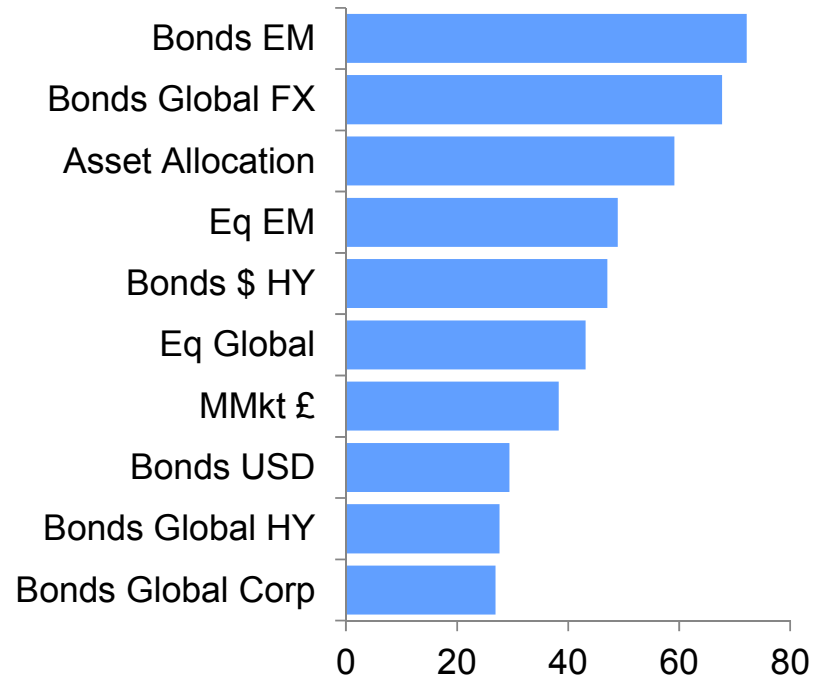
US mutual fund flows by asset class, \$ bn



Source: Citi Research, Haver, ICI

## Reaching for yield

Top selling fund categories in Europe, 2010-12 cumulative, €bn



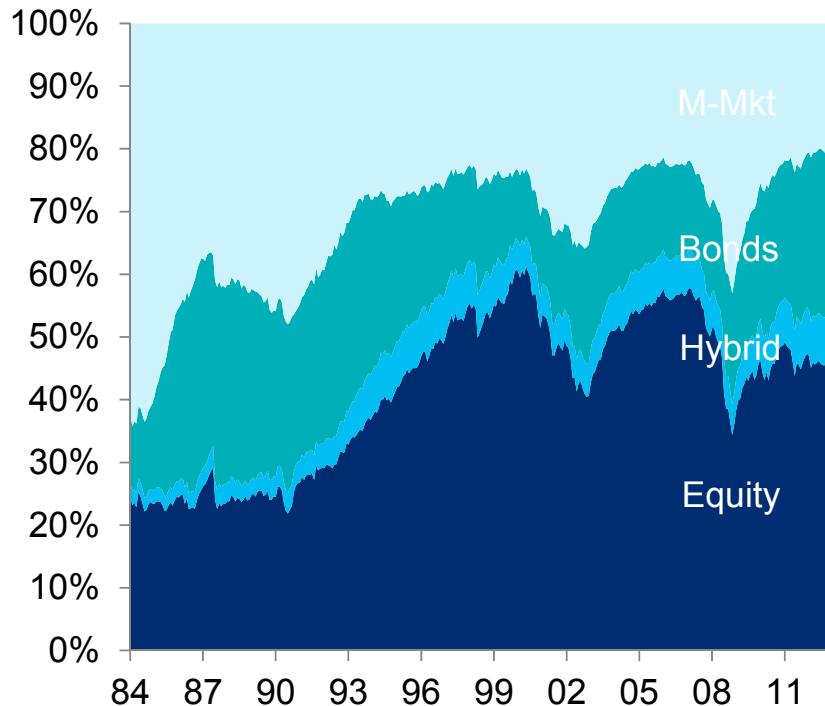
Source: Lipper FMI, Citi Research.

CB chefs have made this the most popular dish in 2013

# Le Grand Fromage – Tourists have been piling in

## Money market holdings at a record low

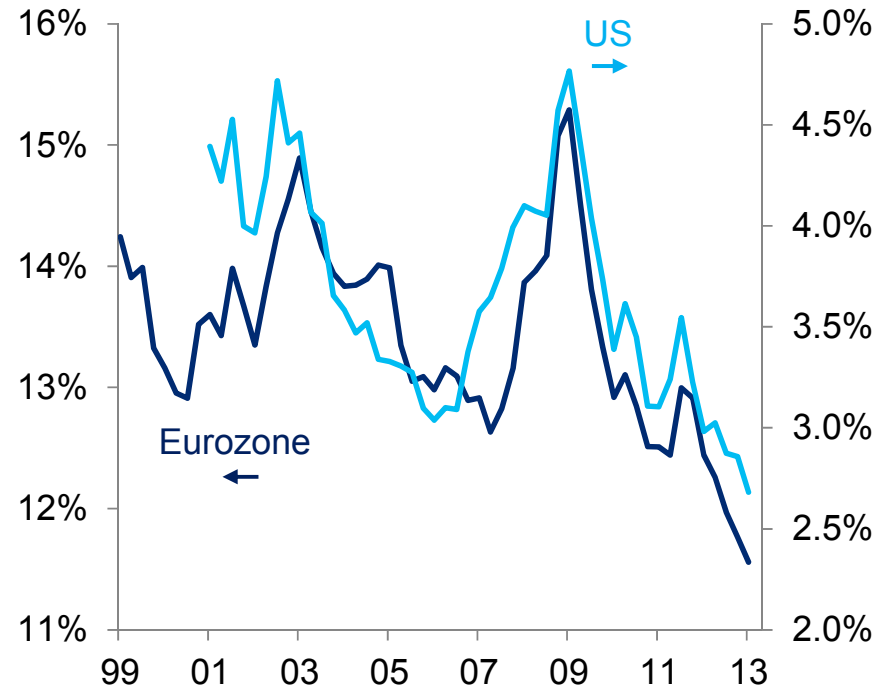
US mutual assets, proportion held by asset class



Source: Citi Research, Haver, ICI

## Cash holdings at a record low

Eurozone & US pension and insurance holdings of cash & equivalents, % of total assets



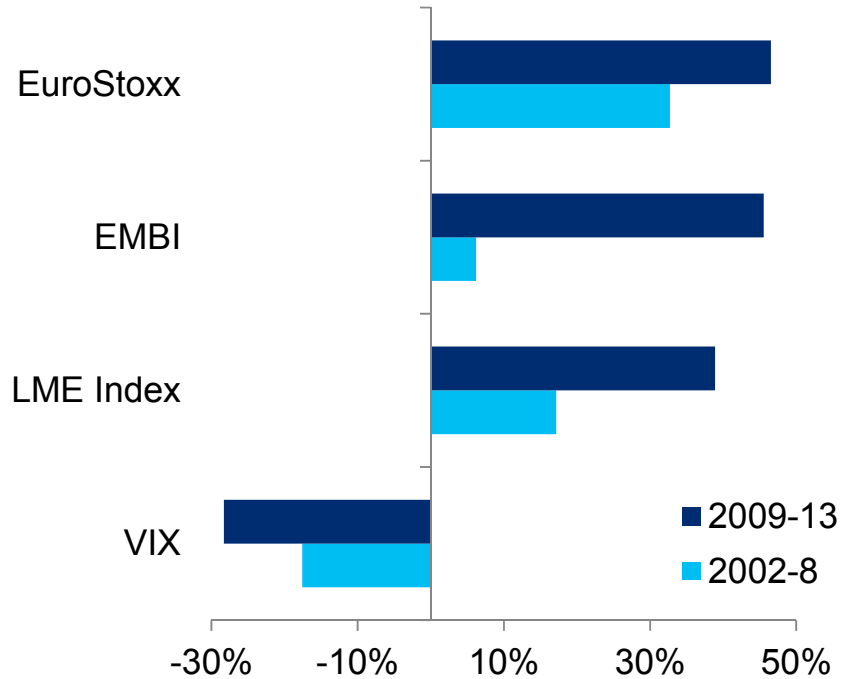
Source: Citi Research, Flow of Funds, ECB, Haver. Note: Definitional differences mean that levels are not directly comparable between the two series.

Aggressive asset allocations suggest demand is vulnerable to sentiment

# Le Grand Fromage – A bitter aftertaste?

## Excess liquidity keeps things correlated

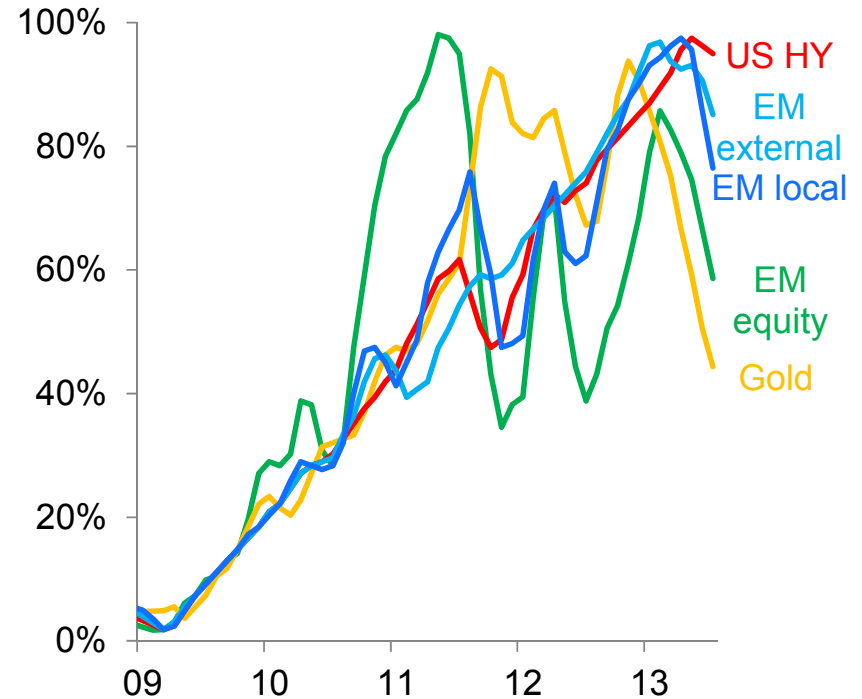
Correlation of weekly returns to iBoxx spread returns



Source: Citi Research

## Some assets have lost their mojo

Cum. total returns by asset class, 2009-13 in percentiles



Source: Citi Research, Haver

Most hyped assets have seen rapid reversals

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Nos suggestions



# Nous vous proposons

## Citi credit investment recommendations

As of 28 August 2013

- ✓ **Tactical stance:** Neutral (as of 23 August)
- ✓ **Strategic stance:** Modest long
- ✓ Short spread duration, long credit risk
- ✓ Long cash & high- $\beta$  against low- $\beta$  (risk-adjusted)
- ✓ Long equities over credit (risk-adjusted)
- ✓ Positive basis trades in Financials
- ✓ iTraxx Fins sub-sen compression
- ✓ Maintain low cost tail hedges

Source: Citi Research

## Citi € credit spread targets

As of 28 August 2013

	Current	H2'13 range	12m target
iBoxx € Corp	115bp	100-140bp	100bp
iTraxx Main	103bp	85-140bp	80bp
iTraxx Xover	420bp	375-530bp	350bp

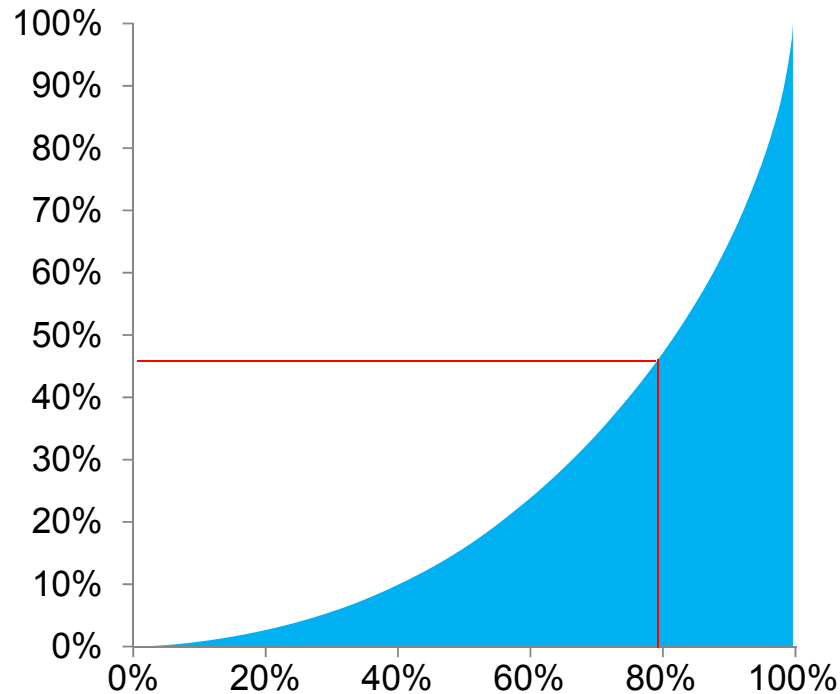
Source: Citi Research

# Trade against the range; hedge the downside tail

# “Credit Suzette-ible”: Long cash and high- $\beta$ over low- $\beta$

20% of bonds account for >55% of volumes

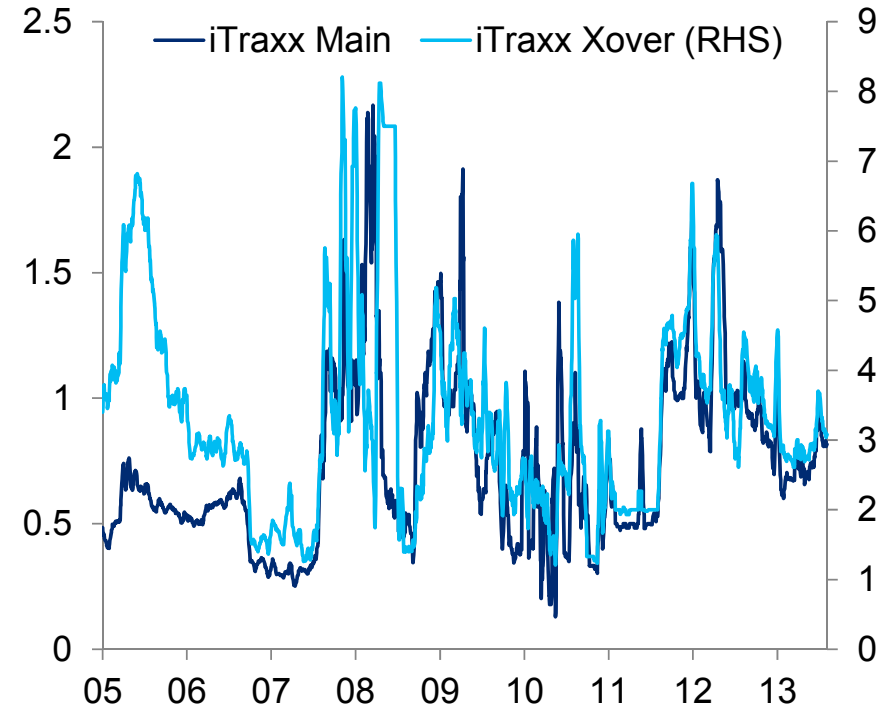
Cumulative contribution to traded volumes of the iBoxx index\*



Source: Citi Research, ISMA. \*: Bonds ranked starting with the least traded first and most traded last.

Liquidity issue illustrated by spiky bid-offers

iTraxx Main & Crossover bid-offer spread, bp



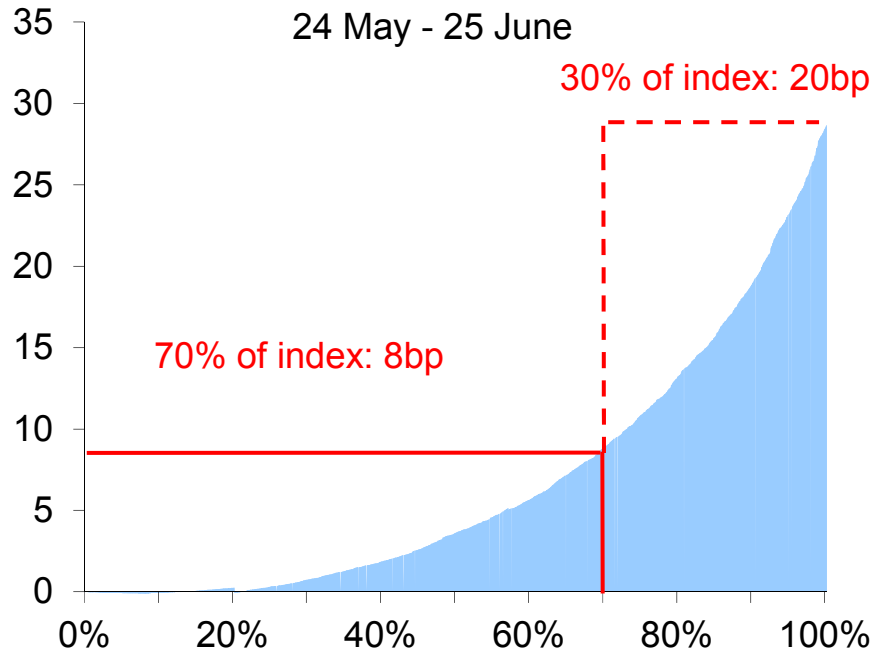
Source: Citi Research, Bloomberg

## Consensus ‘defensive’ long is vulnerable to outflows

# “Credit Suzette-ible”: Long cash and high- $\beta$ over low- $\beta$

## € credit: Bulk of June widening in high- $\beta$

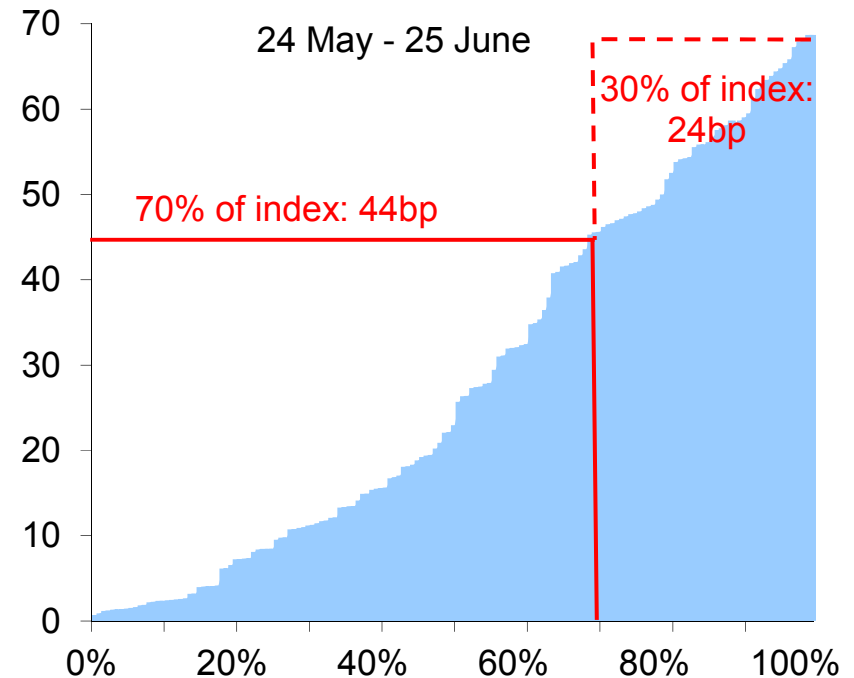
Cum. contribution to iBoxx spread widening\*, bp



Source: Citi Research, MarkIt. \*: Bonds ranked by beta.

## EM credit: Bulk of June widening in low- $\beta$

Cum. contribution to EM bond widening in \$ iBoxx\*, bp



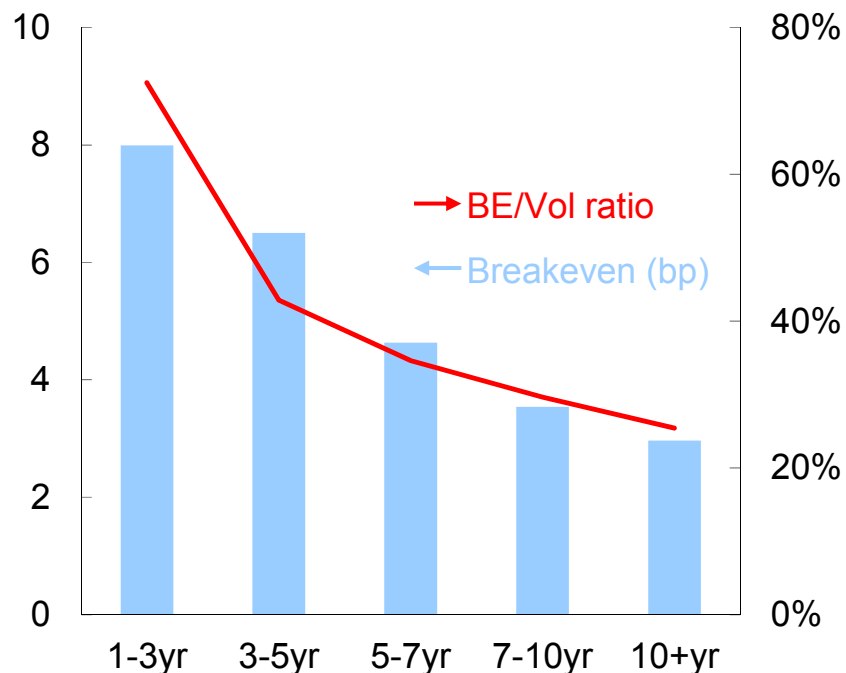
Source: Citi Research, MarkIt. \* Bonds ranked by spread.

When you need cash, you sell what you can

# “Brie-keven de Meaux” – Short duration, down in credit quality

## Carry better protected at the front end

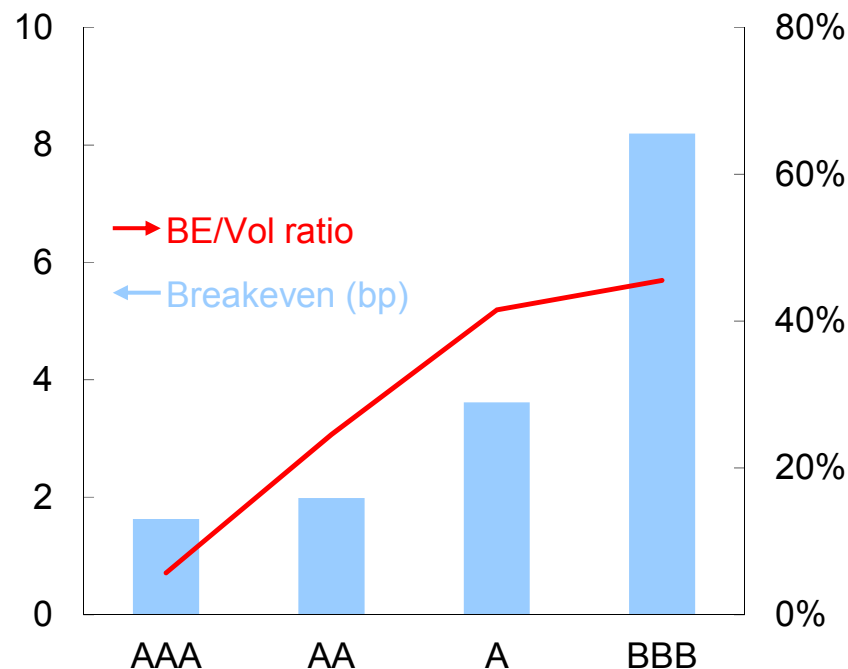
iBoxx non-fins breakeven vs. BE/vol ratio by duration, 3mth



Source: Citi Research, Markit

## Carry better protected down the curve

iBoxx non-fins breakeven vs. BE/vol ratio by rating, 3mth



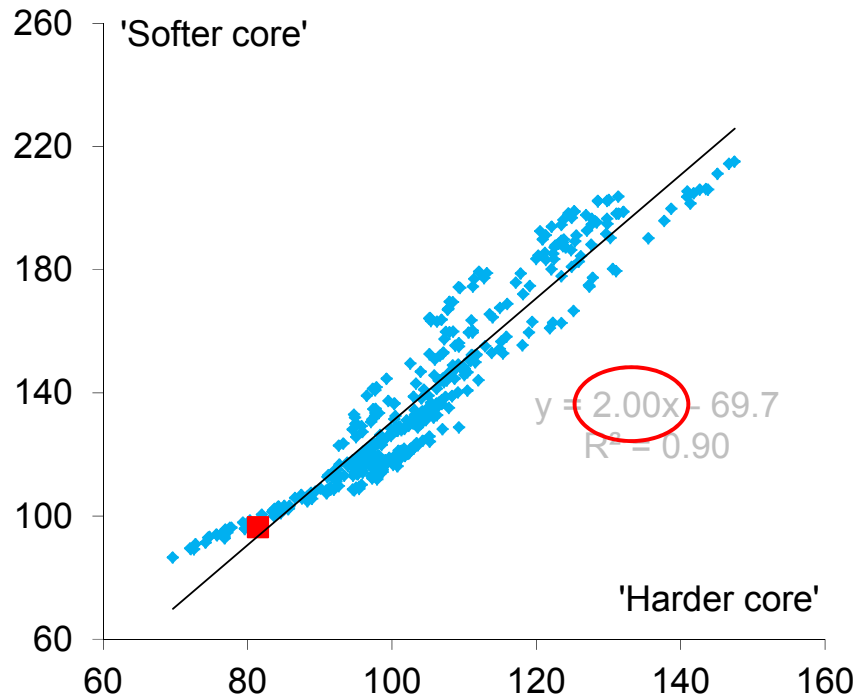
Source: Citi Research, Markit.

Limit the downside, when upside is only carry

# “Credit Brûlée” – Reduce your $\beta$ without losing carry

## Softer core bonds look tight to harder core

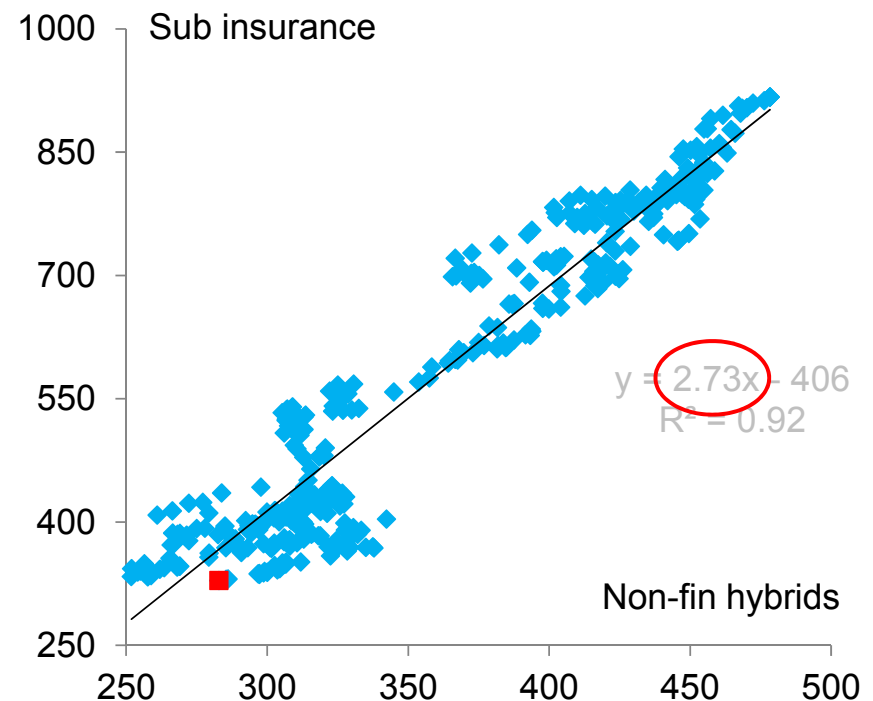
Spreads on harder vs softer core bonds in iBoxx 2012-13, bp



Source: Citi Research, MarkIt.

## Fins sub debt more volatile than hybrids

Sub insurance vs non-fin hybrid spreads in iBoxx 2012-13, bp



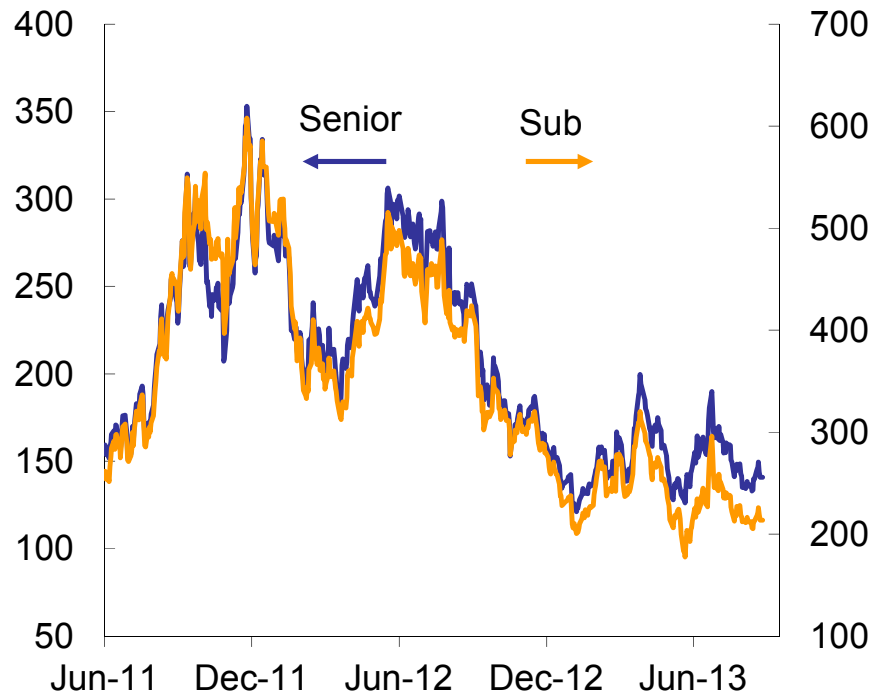
Source: Citi Research, MarkIt.

All bps are equal, but some are more equal than others

# “Profit-de-rolls” – Bank on a new contract

## Sub is outperforming senior in general

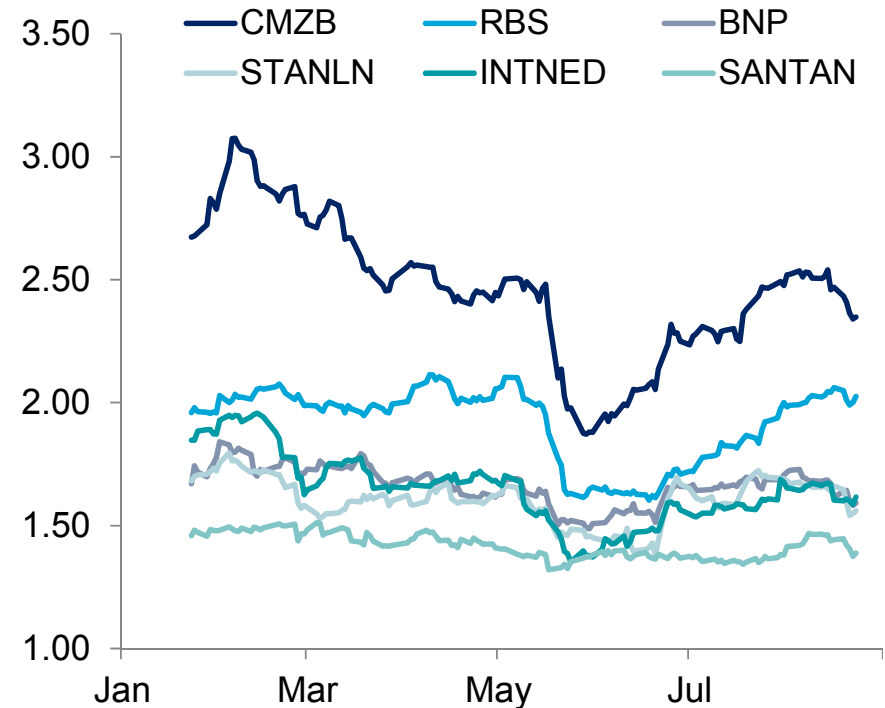
iTraxx Senior & Sub Financial spreads, bp



Source: Citi Research, MarkIt

## But there are individual laggards

Sub-senior spread ratio for select credits



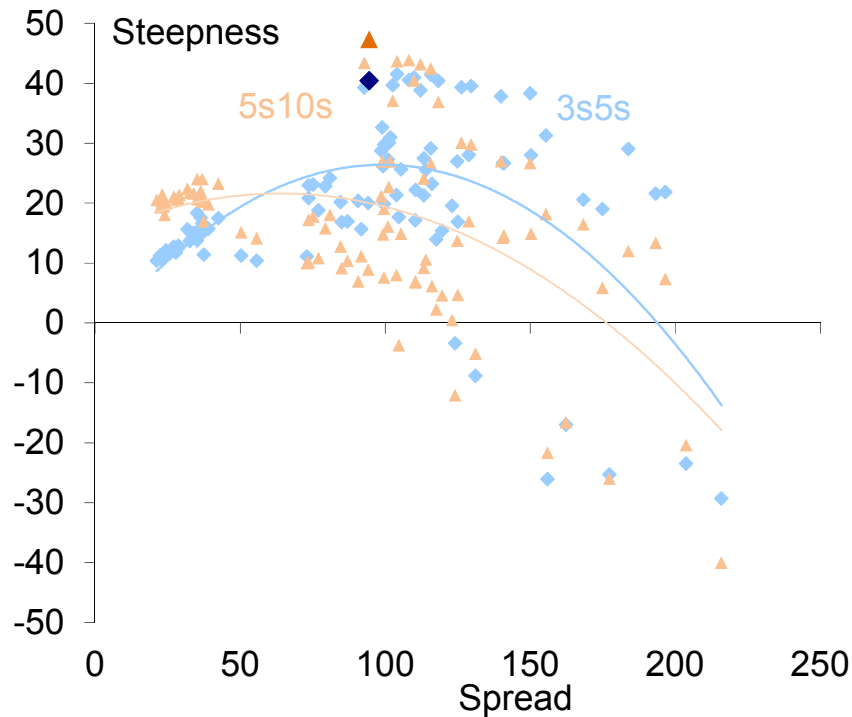
Source: Citi Research, MarkIt

## Sub CDS spread to compress further on deliverability issues

# “Soufflé à la vanille ou exotique” – Hedge the tail

## Expect flattening in a blow out

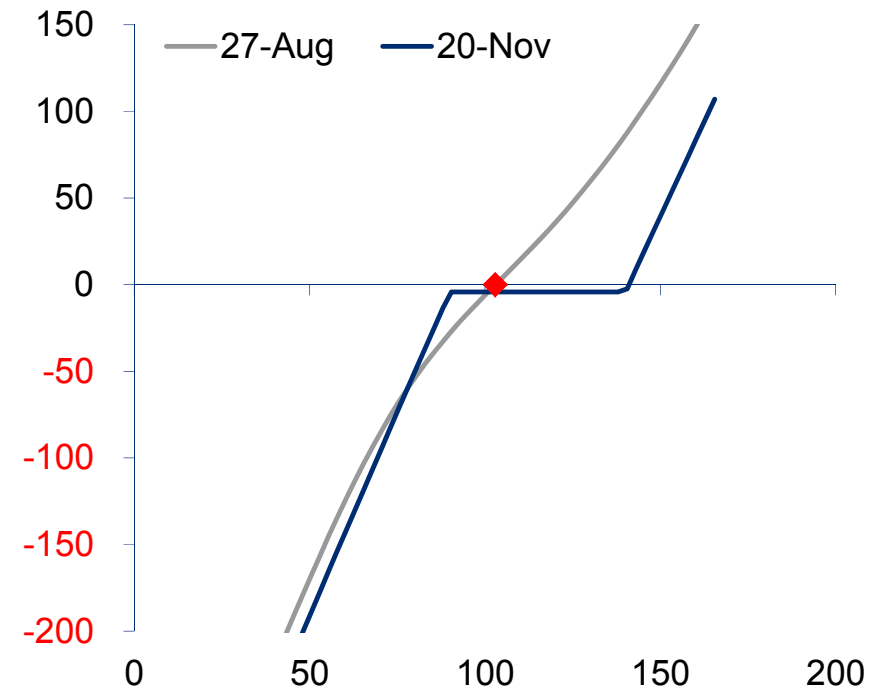
iTraxx Europe 3s5s and 5s10s differentials, 2005-13, bp



Source: Citi Research, MarkIt

## Forego the unlikely upside for protection

iTraxx Main risk reversal\* payoff, € per €10,000 notional

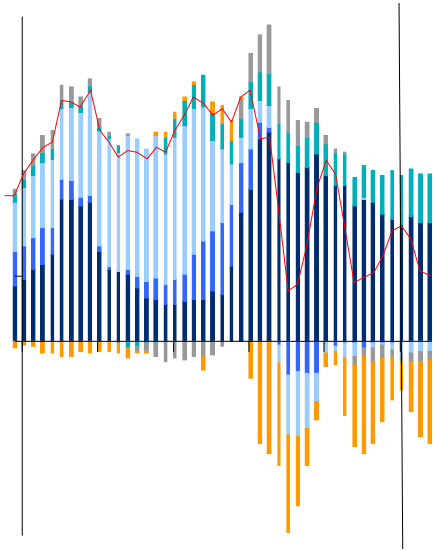


Source: Citi Research, MarkIt. \*: Sell a 90-strike receiver, buy a 140bp-strike payer

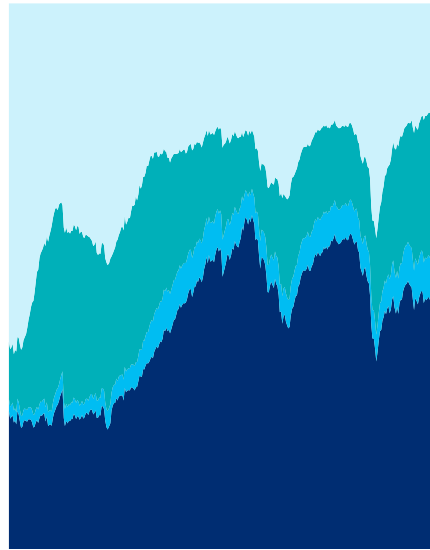
## Cheap hedges to back up the strategic long

# Conclusion

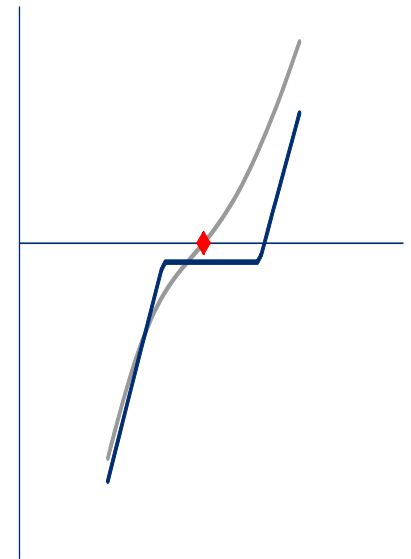
The CB chefs have tempted investors to the table



Signs of gluttony emerging



Try to avoid any bouts of indigestion



Source: Citi Research, MarkIt, Bloomberg

As the appetite fades, you have to be a little more picky



# Citi sector & single-name recommendations

As of 16 August 2013

Sector	Position	Picks	Pans
Basic Materials	Underweight	Linde, Rio Tinto	BHP Billiton, Lanxess, BASF, Akzo Nobel, Solvay
Consumer Goods	Neutral	Inbev, Pernod-Ricard	BMW, Daimler, VW
Consumer Services	Underweight	Lottomatica	Metro, Tesco, Casino, Carrefour
Health Care	Overweight	Bayer, Roche, GSK	
Industrials	Neutral	PostNL, Abertis, Alstom	Schneider Elec., Bouygues, Atlas Copco, Finmeccanica
Oil & Gas	Underweight		OMV, BP, Shell
Telecoms	Underweight	BT	Orange, Belgacom, Telecom Italia
Utilities	Overweight	Italian utilities	RWE, E.ON
Banks	Neutral	BNP, Credit Agricole, Barclays, Lloyds, Morgan Stanley, Goldman Sachs	Spanish Banks , Australian banks, smaller Italian banks
Insurance	Overweight	Swiss Life, CNP Assurances, Talanx	HanRe, Munich Re
Financial Services	Underweight		Gecina, Klepierre

Source: Citi Research

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