11 August 2014 │ 10 pages

North America

Buy Now

An Argument for Adding on Weakness

- **Overview:** We acknowledge the many challenges facing the market at this stage, but nonetheless believe that a strong argument for adding on weakness can be made.
- **Fundamental Risk Down:** One reason is that the fundamentals seem to have gotten better, not worse, since the sell-off began. For example, Q2 sales are stronger than in recent quarters, and despite spread widening we find that implied default rates have actually declined.
- **Cheap:** Our fair value model suggests that high-yield spreads are now 77 bp cheap. Note that in early June, spreads were about 45 bp rich to fair value, which may be one reason why the market sold off in the first place.
- **The Safety Net Remains in Place**: QE may be coming to an end, but it is likely to continue subduing volatility, at least extreme volatility, for longer than many expect.
- **Investment Conclusion:** In part due to the reasons outlined above, we would look to scale into the high-yield space. Opportunities have emerged in other markets as well, including IG, and inside we highlight one example.

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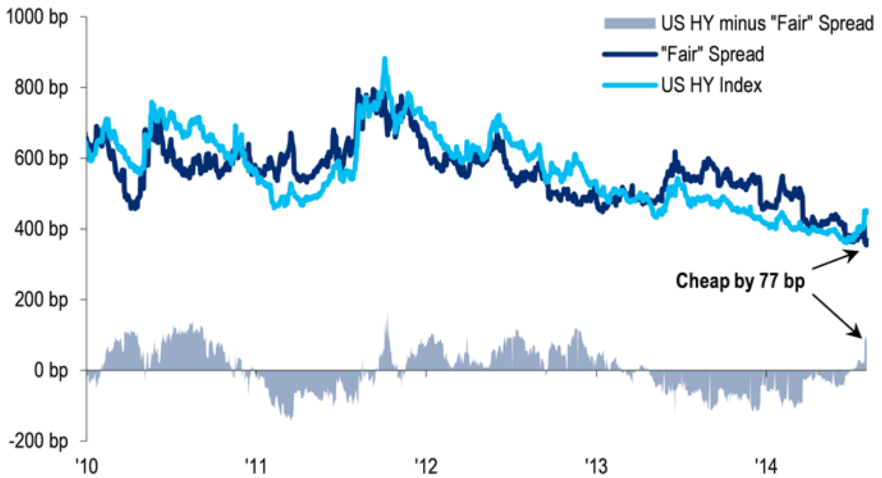
Figure 1. Our model suggests that high-yield is now trading cheap to fair value



Source: Citi Research, Bloomberg, Moody's

Note: As of June 9, 2014; We offset the credit loss by 9-month period forward. Systemic risk measured by adjusted Citi liquidity index; 40% recovery assumed; regression based on Mar '04 to Mar '11 monthly data with an exception of the Sep '08 to Jun '09 period

Buy Now

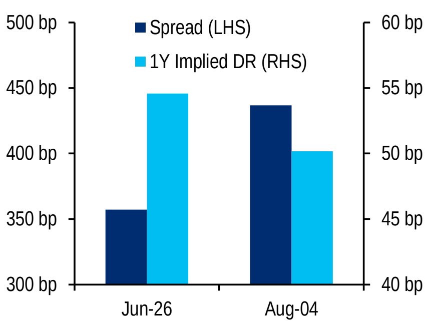
An argument for adding on weakness

Investor sentiment, particularly in high-yield, has softened dramatically in recent weeks. Heavy supply, full valuations, geopolitical risk, and HY outflows were key drivers, but also important is concern that the Fed safety net that has been in place will soon be going away. Said differently, valuations may be forced to face reality.

We acknowledge that these factors certainly present challenges, but that said we believe that a strong argument can be made for adding on weakness at this point. Reasons include: (1) by at least some metrics, fundamentals have gotten better, not worse, since the sell-off began, (2) according to our fair value model, high-yield spreads are cheap, and (3) QE may be coming to an end, but it should continue to subdue risk, at least extreme risk, in the period ahead.

1. Fundamental risk down, not up

Figure 2. Spread and implied default rate for the typical single-B bond, June vs. current



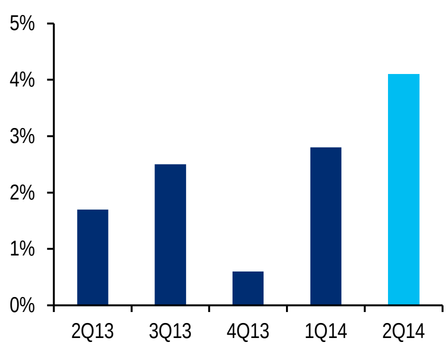
Source: Citi Research
Note: Based on 366 single-B rated bonds

Spreads began leaking wider in late June, but what is interesting to us is that by a number of metrics the fundamental backdrop has improved, not deteriorated, since then. For example, about 80% of S&P constituents have reported Q2 results so far, and total sales for these companies are up 4.1% YoY, much higher than what we have seen in recent quarters (Figure 3). And it's the same story with earnings — up 9.8% in Q2 vs. 4.3% in Q1 (Figure 4).

And closer to home (from a credit investor's point of view), Citi models suggest that default risk in at least some parts of the credit market has declined since the sell-off began. To illustrate, in Figure 2 we contrast the change in spreads and the change in implied default risk for a typical single-B issuer. We see that spreads rose from 357 bp to 436 bp, while default risk dropped from 55 bp to 50 bp over the same period.

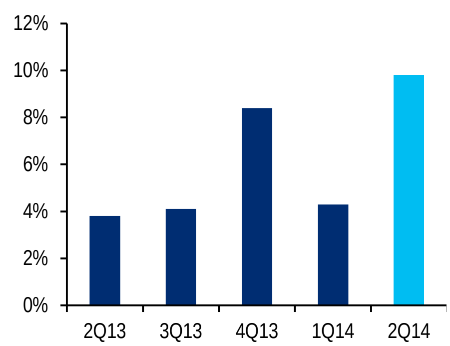
There may be problems in the current environment, but they don't appear to be fundamental in nature. In our experience, setbacks resulting from non-fundamental factors tend to be fairly short-lived.

Figure 3. Q2 sales growth much higher than what we have seen in recent quarters



Source: Citi Research, Company reports
Note: Based on 80% of SPX constituents (market cap)

Figure 4. And we see a similar trend with regard to earnings growth



Source: Citi Research, Company reports
Note: Based on 80% of SPX constituents (market cap)

In fact, in a recent study, we examined the performance of high-yield during years when negative but non-fundamental events occurred. We found that high-yield generated positive returns during the year of:

- The Asian financial crisis: +14.9% in ’97.
- Long-Term Capital & Russian default: +2.8 in ’98.
- Auto downgrades / correlation crisis: +3.8% in ’05.
- BP oil spill & Goldman investigation: +15.6% in ’10.
- Sovereign debt crisis: +6.2% in ’11.
- Taper worries: +6.6% in ’13.

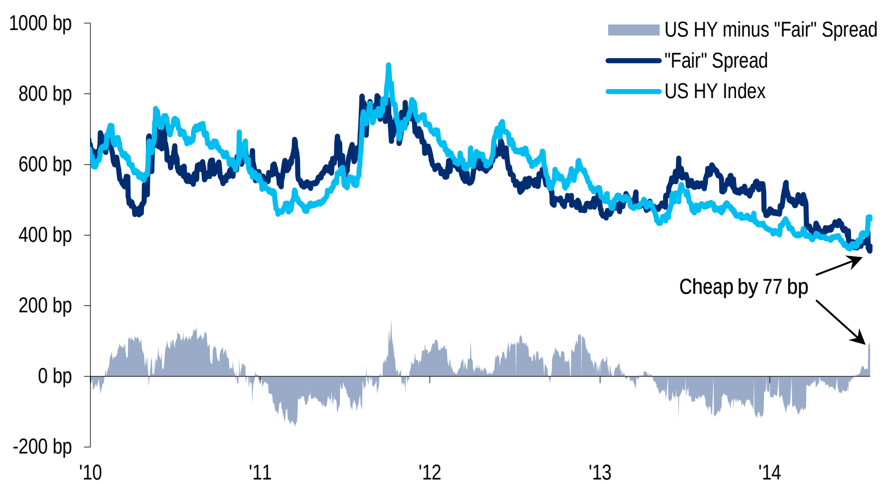
For more detail please refer to this publication, but the bottom line is that fundamentals matter, and valuations and fundamentals appear to be dislocating.

2. Cheap, cheap, cheap

A second reason to add is simply because high-yield spreads appear cheap to fair value at this point. Our fair value model is based on the assumption that spreads are compensation for default risk and liquidity/mark-to-market risk. We use Moody’s forecast to gauge default risk, and an index comprised of traded and observable assets in other markets (e.g., VIX, swaptions) to measure liquidity / MTM risk. Essentially, this index allows us to observe what other markets are charging for MTM risk so that we can allocate a comparable amount to credit spreads. We encourage readers to refer to this publication for more detail.

According to our model, the fair value for high-yield is currently 369 bp. But the typical bond is trading at 446 bp, which suggests that credit investors may be overcompensated for liquidity / MTM risk to the tune of 77 bp (Figure 5). Worth noting, high-yield was trading rich to fair value back in June, which may be one reason why the market sold off in the first place.

Figure 5. Our model suggests that high-yield is trading cheap to fair value



Source: Citi Research, Bloomberg, Moody’s

Note: As of June 9, 2014; We offset the credit loss by 9-month period forward. Systemic risk measured by adjusted Citi liquidity index; 40% recovery assumed; regression based on Mar ’04 to Mar ‘11 monthly data with an exception of the Sep ‘08 to Jun ‘09 period

3. The safety net remains in place

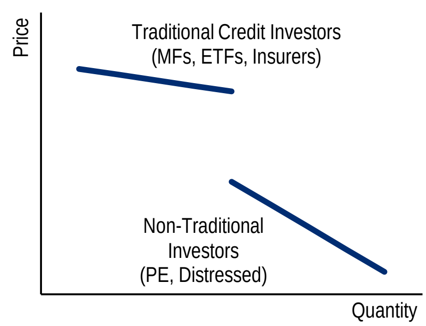
With regard to concerns about the Fed safety net going away, we see reasons why its effects may remain in place for longer than some expect. We highlight one example in this section.

Multiple demand functions

When the market encounters a severe negative catalyst, prices fall until an incremental source of demand emerges, and this source is often a non-traditional one. To this new buyer, risk-adjusted returns may mean absolutely nothing. What is important are **risk-adjusted returns in the context of the investor's bogey, and this bogey can be very different from a typical credit investor's.** Said differently, traditional and non-traditional credit market participants can have very different demand functions (Figure 6).

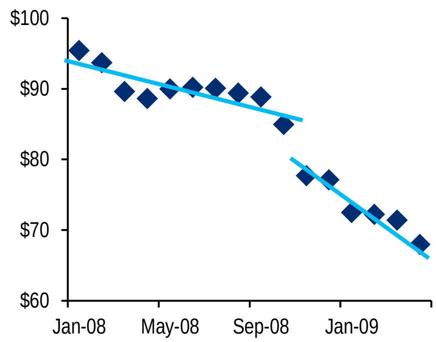
To illustrate, consider the price action of triple-A CLOs during the '08 setback (Figure 7). We see that for the first ten months of the year prices trended from $95 to $85, and declined at a very consistent pace. But over the next few months, prices fell from $85 to $68 — the pace of decline shifted sharply as non-traditional buyers such as hedge funds, private equity investors, and distressed funds had to be enticed into the market.

Figure 6. HYPOTHESIS: The demand functions for traditional and non-traditional credit investors can be very different



Source: Citi Research

Figure 7. OBSERVATION: Triple-A CLO price action in '08 exhibited gapping as we moved from traditional to non-traditional investors

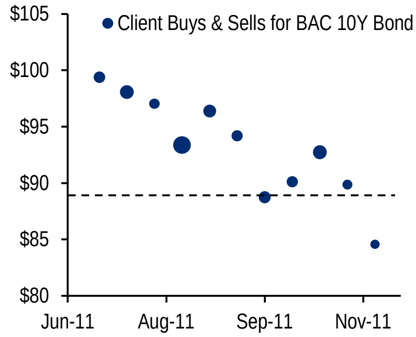


Source: Citi Research

A second important point is that the volume traded to this new buyer is often quite small. This is true in the triple-A CLO example, but for the sake of variation consider a more recent one; in Figure 8 we show the price decline and amount traded for the BAC 5s of '21 in the latter half of '11, and note that the size of each data point represents end-client trading activity over a two-week period (i.e., bigger dot = more trades).

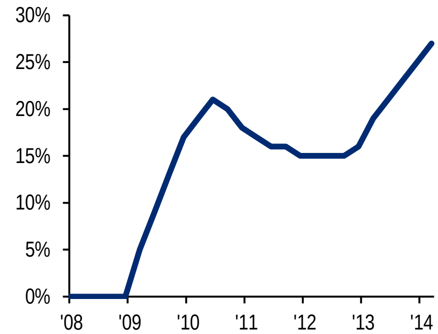
From July to October, the pace of price declines was fairly steady and volume averaged 33 trades per two-week period. But in late November, we saw a dramatic drop of about $5, and there were only 18 trades. Our traders note that traditional credit investors such as mutual funds and insurance companies were not the buyers at this point, but equity and hedge funds were.

Figure 8. Average prices and total trading activity for BAC 10Y in '11 (bigger dots = more trades)



Source: Citi Research, TRACE
Note: Block size of $5mm+ only

Figure 9. The Fed currently owns almost 30% of the mortgage market



Source: Citi Research, SNL

Back to the Fed

This is important because in the wake of QE **a large proportion of bonds may never see the light of day again**, and as such we may avoid being in the position of having to find a non-traditional buyer. Volatility, at least *extreme* volatility, should be lower as a result.

For example, when tapering is said and done, the Fed's balance sheet will be about $4.5 tn vs. sub $1 tn pre-crisis. In a relative context, Figure 9 shows that the Fed owns about 27% of the mortgage market. It's extremely difficult to envision the Fed ***ever*** being a forced seller, which means that the chance of the market potentially needing a non-traditional buyer in mortgages is far lower. **In other words, more stability since we probably won't shift from one demand curve to another.**

4. Investment conclusion

As discussed above, we see reasons to add-on-weakness, particularly in the high-yield space, and we would encourage readers to refer to *High Yield - Opportunities Post July Sell-Off* for a list of specific ADD CANDIDATES.

It's also worth pointing out that opportunities have emerged elsewhere. For example, in Figure 10 we present a basket of high-grade issues that offer the following advantages vs. the typical high-grade bond:

- **Higher yield & spread:** On average, ADD CANDIATES yield 3.15% and have a spread of 117 bp, vs. 2.88% and 103 bp for the typical issue in the broad market.

- **More liquidity:** The issues highlighted have liquidity scores of 33% on average, relative to 26% for the average issue in the market. Please refer to this publication for more detail on liquidity scores.

- **Less volatility:** Absolute volatility and volatility as % of spread both favor ADD CANDIDATES (46 bp and 71%). These figures for the average bond in the market are 54 bp and 91%, respectively.

Figure 10: ADD CANDIDATES that have good carry and liquidity, but exhibit relatively modest volatility

Issue	Years to Maturity	Rating	Par Amount ($mm)	Price ($)	YTW (%)	Spread (bp)	1Y Spread Vol (bp)	1Y Range as % of Spread	Liquidity Score
BAC 5s of '21	6.8	Baa2 / A-	2000	111.4	3.1	108.0	45	82%	46%
BACR 5.14s of '20	6.2	Baa3 / BBB	1094	108.8	3.5	162.9	50	69%	28%
ESV 4.7s of '21	6.6	Baa1 / BBB+	1500	108.9	3.2	117.8	42	53%	45%
ETP 4.65s of '21	6.8	Baa3 / BBB-	800	108.1	3.3	124.7	51	83%	26%
K 4s of '20	6.4	Baa2 / BBB+	850	106.6	2.9	88.5	54	35%	31%
LLL 4.75s of '20	5.9	Baa3 / BBB-	800	108.9	3.1	123.7	52	87%	29%
MO 4.75s of '21	6.7	Baa1 / BBB+	1500	110.7	3.0	95.5	40	82%	26%
Average	6.5	Baa2 / BBB	1221	109.0	3.15	117	46	71%	33%
IG Index	10.2	A3 / A-	720	109.4	2.88	103	54	91%	26%

Source: Citi Research
Note: As of August 7, 2014

Appendix A-1

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