European Credit Outlook

The Year of the Greater Fool's Game? (Strategy)

Hans Lorenzen
+44-20-7986-3568
hans.lorenzen@citi.com

Matt King
+44-20-7986-3228
matt.king@citi.com

Abel Elizalde
+44-20-3569-4446
abel.elizalde@citi.com

Teresa Cascino
+44-20-7986-9580
teresa.cascino@citi.com

Joseph M Faith
+44-20-7986-3050
joseph.michael.faith@citi.com

- **Lots not to like –** Credit is heading down the wrong path in many respects. Valuations are rich, leverage is rising, inflows have dropped dramatically and positions seem very long by recent standards.

- **Too much money…** – Yet central bank policies are keeping supply-demand across financial markets severely imbalanced. Our projections suggest that even with tapering excess demand is likely to remain strong in 2014 (Figure 1).

- **Triggers, what triggers?** What's more, compared to recent years, the visible triggers for 2014 look rather tame. If anything, the biggest risk to spreads this year may well be uncertainty about policy in 2015.

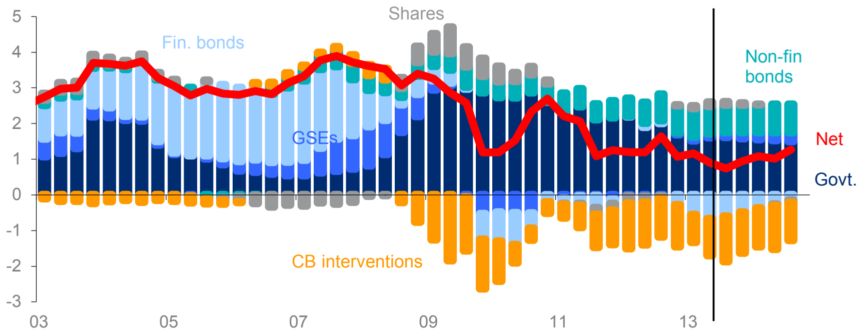
- **"Must make money!" –** Like it or not, credit investors are getting dragged into the old game of leveraging up exposures. Few can afford to wait for a trigger to bring about better valuations, fewer still can make sufficient returns through alpha alone.

- **Reluctant bulls** – So for the time being our central scenario is that 2014 (like 2005 or 2006) will be a year where the imbalances keep ramping up, rather than a year where they correct abruptly.

- **Tighter!** We therefore see spreads ending the year 10-15% tighter than currently with balance of risks probably to the tighter side of that forecast.

This note sets out our views on 2014. The accompanying piece ***"The Year of the Greater Fool's Game? (Positioning & Trades)"*** *discusses how to implement them.*

Figure 1. Net issuance of new securities vs central bank* interventions, 12m rolling, $ tr



Source: Citi Research, Haver. * Federal Reserve, Bank of Japan, ECB.

Executive Summary

Figure 2. Citi 2014 forecasts

	Current	14F target	Excess return	Total return
iBoxx € Corp	105bp	90bp	1.5%	3%
iBoxx € HY	320bp	290bp	2.5%	4%
iTraxx Main	72bp	60bp	1.3%	-
iTraxx Xover	285bp	240bp	5.0%	-

Source: Citi Research. Note: Targets have been revised slightly tighter from the previous forecast on 3 December 2013.

The best way to describe our sentiments on 2014 as a whole is that we are bullish – but for all the wrong reasons.

Bullish, because we still believe that the extraordinary liquidity environment which has dominated the last four years will remain in place this year – despite tapering.

Bullish, because we think that in the absence of attractive assets to buy, and of clear negative catalysts, investors will once again scour markets for ways to enhance return prospects. We think this will happen through the usual formula: more credit risk, more duration, more subordination, more illiquidity risk, more financial leverage and more synthetic leverage. The process of getting into those exposures will in itself tend to push spreads tighter, as reflected in our forecast (Figure 2).

For the wrong reasons, because aside from our doubts about the foundations of much of the economic recovery itself, nearly all the factors that we would normally base our view on credit on seem to be pulling in the opposite direction:

- **Credit fundamentals are deteriorating.** Although the fragile European and global recovery should support earnings, we expect leverage to rise further as companies push shareholder value.
- **Valuations are increasingly unattractive.** Scored against 20 different fundamental metrics, credit spreads come in as 'Tight' or 'Very tight' on every single one of them at the moment. The yield offered by € IG corporate credit is in the 4th percentile looking at the last ten years – hardly a compelling case for investing if you look at credit from a total-return perspective.
- **The marginal money is going elsewhere.** Judging by our survey, inflows into corporate credit have been on a falling trend for 18 months and are now close to neutral at a five-year low. This weakens the technical that has so often left the credit market almost impervious to negative headlines in recent years.
- **Market composition is deteriorating.** We think the European credit market should see a record volume (~€90bn) of subordinated debt issuance next year. While some of that (the AT1 issuance) will remain outside the indices for now, the market will still have to absorb a lot of additional risk.
- **And to top it off, positioning in the credit market is very different.** The rush into beta may have further to go, but already the rally we have seen since September has created a vulnerability through higher-beta exposure in the market. We reckon that it is at least comparable to the one that was exposed by the Fed's change in tone on tapering in May.

We'd argue that markets may be driven by a variant of the Greater Fool's Theory[1], where the underlying rationale for many would in essence be:

"I don't like credit here, but I don't like other assets very much either (other than, perhaps, equities). I don't see what turns the market any time soon and I can't afford to sit and wait for a better entry point, especially while central banks are backstopping everything. I'll have to take more risk and then sell to someone else when I see a trigger ahead. Worst case, I'll be in the same boat as everybody else."

[1] 'The Greater Fool's Theory' says that an investor can rationally buy an asset, not based on its intrinsic value, but based on the expectation that someone else will buy it at a higher price in future.

We are not arguing that this is irrational – on the contrary, for individual investors whose performance is tracked on a monthly, weekly or daily basis, this argument seems entirely rational – especially against the perception that central banks can no more afford to let the prevailing equilibrium slip today than they could in 2009.

But the sum of that individual rationality is a market with a very obvious vulnerability.

When no one sees an immediate risk of losing, when positions get ever longer and when valuations are stretched further and further as a result, less and less is needed to eventually topple the consensus. Longer-term, it is a recipe for breeding black swans.

So the inherent challenge is to predict how long the Greater Fool's game goes on. As we saw from 2004-07, spreads can underestimate the subsequent cycle for a long time before correcting.

And in our central scenario 2014 is still a ramp-up year. The imbalances do not yet seem glaring enough and the macro agenda, ex ante at least, is the lightest that we have or are likely to see for years.

As such, we forecast 10-15% spread tightening in € IG credit with HY spreads doing slightly better risk-adjusted, and CDS outperforming cash (as detailed in Figure 2). Indeed, during exuberant periods like the one we have seen since September spreads may well breach those targets.

However, the more tension that builds up between market valuations and fundamentals and the more stretched positions get, the more likely a subsequent selloff becomes. For now, we think they will most likely merely be pullbacks within a range.

In what follows, we'll detail these arguments. Yet in a market priced for virtual perfection in a world where the reality under the surface is still anything but, there's a limit to how much confidence we can have in that base case scenario.

So our accompanying piece *"The Year of the Greater Fool's Game? (Positioning & Trades)"* will discuss the strategies we recommend for implementing this view. Essentially, they revolve around how to lever up prudently. We see three principal avenues:

- Take exposure where there is an asymmetry in risk/reward, for instance in CDS curves, and/or where the sensitivity to systemic risk is reduced.
- Take exposure in the liquid parts of the credit market, such as the CDS indices, that allow you to change your exposures quickly if the Greater Fool is called.
- Take non-recourse leverage in structured credit in assets you are comfortable to hold to maturity in all scenarios.

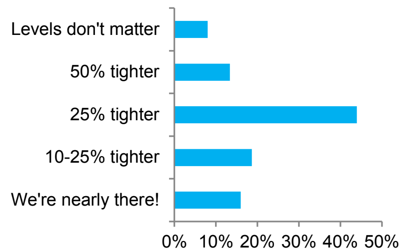
If and when the game comes to an end, you will find him sitting in something illiquid and systemic.

What's not to like?

It's so consensus! Spreads at their post-crisis tights are no obstacle to a very bullish consensus for next year.

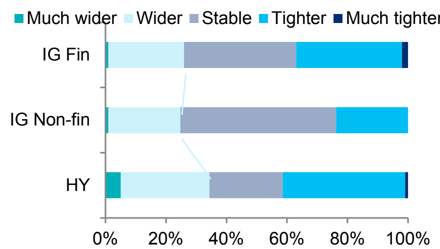
In our November credit survey, just 17% of participants responded that credit spreads are close to the level where they plan to reduce their exposure. Most saw them another 25%+ tighter (Figure 3) from levels then. Similarly, two-thirds of IG investors responded that they expect tighter spreads over the next 12 months in Fitch's fixed income survey (Figure 4).

Figure 3. "Where do spreads have to go for you to reduce your exposure?"



Source: Citi Research

Figure 4. "Where do you expect spreads to be in 12 months?"



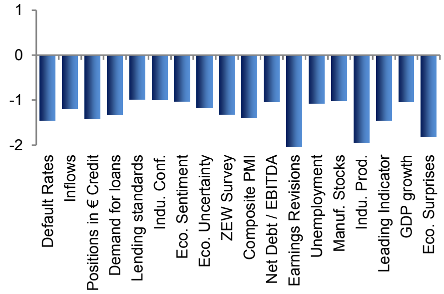
Source: , Fitch "European Senior Fixed-Income Investor Survey 4Q13".

Evidently, if everyone is already positioned for a positive scenario, then that scenario unfolding is unlikely to trigger the incremental portfolio flows that drive actual market performance.

Where's the value? Spreads look tight to fundamentals on every single one of the 20 metrics that we score credit against in our Valuations Report (Figure 5). We often hear the argument that spreads are still significantly wider than they were in 2005-2006, but that was a very different world – the economic environment was significantly stronger and corporate leverage was significantly lower (see below). And who would seriously argue that spreads should get back to the bubble-like levels at the height of the structured credit boom anyway?

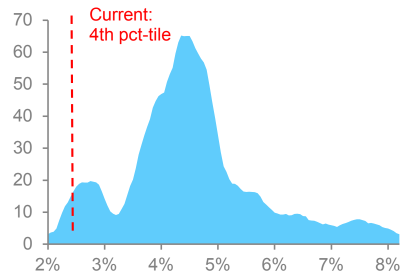
From a total return perspective credit is also a very different proposition today. In 2006, € IG credit yielded about 4.5% compared with barely 2.5% now – looking at the last 10 years' history, that's in the 4th percentile (Figure 6).

Figure 5. iTraxx vs. fundamental indicators*, σ's from long-term relationship



Source: Citi Research. *: Based on t-stat of current spread vs. spread predicted by historical relationship with the fundamental variable

Figure 6. Histogram of € iBoxx yields, 2003-13, frequency (days)

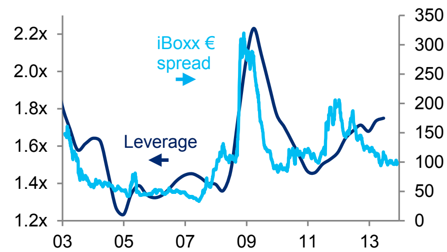


Source: Citi Research, MarkIt

Who is looking after corporate bondholders? By our metrics non-financial leverage has been rising for the past two years now (Figure 7). The rise isn't dramatic like in 2001-02 or in 2008-09, when a sudden collapses in earnings caused leverage to spike. But net debt/EBITDA has risen by about 0.2 turns from the low in 2011 and it's about 0.4 turns higher than between 2005-07.

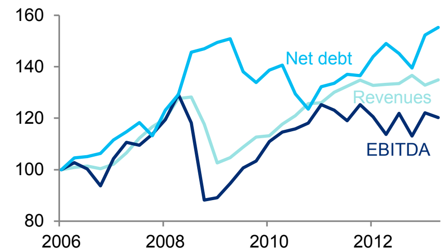
In fact, the last 18 months is the only period in at least a decade where credit spreads and leverage have moved in opposite directions. In the US, where releveraging has run ahead of Europe, non-financial spreads barely tightened during 2013 (compared to 45bp of tightening in financials).

Figure 7. Net debt / EBITDA* vs. iBoxx € non-financial spreads, bp



Source: Citi Research, Bloomberg. * Based on a sample of 251 non-financial corporates in EuroStoxx 600.

Figure 8. Net debt, EBITDA & revenues*, Indexed: Q1 2006 = 100



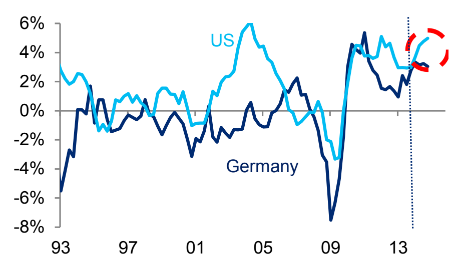
Source: Citi Research. * Based on a sample of 251 non-financial corporates in EuroStoxx 600.

Granted, leverage ratios should receive a boost next year from improving earnings. Our equity strategists forecast European EPS growth of 10%, implying EBITDA growth around 4-6%. At current run-rates for growth in net debt, that would stabilize the leverage ratio in 2014. However, much of the earnings improvement is probably discounted already, so we reckon many companies will have to do more to keep the momentum in share prices going. The temptation to use debt – as has happened in the US – will surely prove irresistible given the exceptional gap between the earnings and the debt yield.

With the difference between expected growth and short-dated interest rates at historically attractive levels in both Europe and more so the US, against the very bearish consensus for capex we do expect some of that releveraging to fund investment (Figure 9) – whether in new or existing capacity. However, we still expect the bulk will come through share buybacks, especially in Europe.

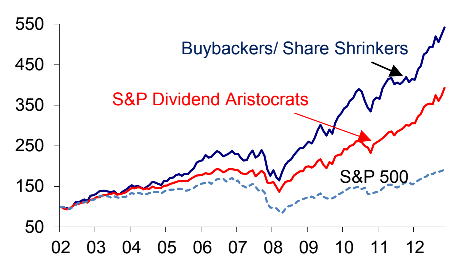
At the end of the day, that is what shareholders want. Figure 10 shows how an index of companies that have aggressively been raising dividends and buying back shares has outperformed both the S&P 500 and the 60 stocks in the S&P 500 with the highest dividend yield (the S&P Dividend Aristocrats index).

Figure 9. Nominal GDP growth minus main policy rate, 1993-2014F



Source: Citi Research, Haver

Figure 10. S&P 500 vs Dividend Aristocrats & index of corps. reducing shares outstanding



Source: Citi Research, Bloomberg

In short, we expect the rise in leverage will continue at a similar pace to the last couple of years. By our metric that would take leverage to the highest level in a decade outside the peak-crisis quarters, when earnings were severely depressed.

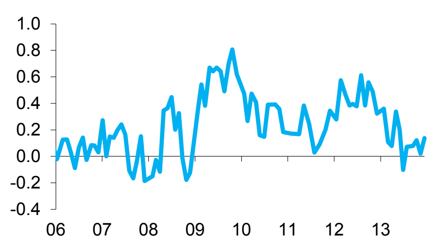
Where's the money coming from? We'd feel a whole lot better if the money was still pouring into credit, but it seems like the lack of value and the weakening metrics are gradually quenching the incremental appetite for credit.

Reported inflows into credit have been on a falling trend for 18 months now, and ended 2013 close to a five-year low (Figure 11). We're not saying that there are no inflows, but our sense is that they are a fraction of what they were, especially in IG space.

Last year we argued against the Great Rotation fad – not because we didn't see better value in equities, but because we felt there'd still be enough risk-seeking money flowing into credit to prevent any negative impact on spreads. That was reflected in the positive correlation between flows into equity and credit mutual funds through the year (Figure 12).

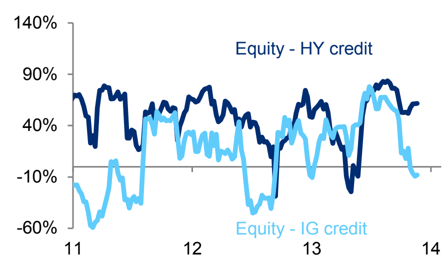
In 2014, we still see a rationale for rotating into equities and we are less confident that offsetting inflows from lower beta parts of the market will be sufficient in the IG space, where the correlation with equity flows has dropped sharply in recent months in the US.

Figure 11. Reported real money inflows, € credit



Source: Citi Credit Survey

Figure 12. 3m correlation in US equity-credit mutual fund flows



Source: Citi Research, EPFR

In our view, the dismantling of that seemingly impervious wall of money, waiting to be invested, takes away a key support that has so often propped up spreads in times of negative headline news.

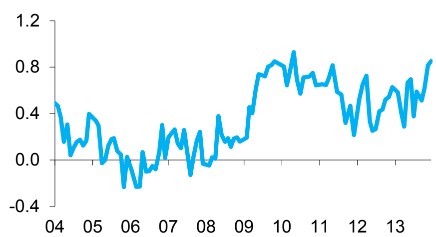
Aren't you long already? Yes, all these concerns could be in the price already. A defensive market is more resilient – we last saw that in September, where a seemingly toxic cocktail of anticipated headlines[2] failed to really put spreads under pressure. However, things have changed a fair bit since.

Our credit survey shows a sharp rise in the aggregate long to a level near an all-time high (Figure 13). Not convinced? Just look at the highly unusual divergence in the performance of low- and high-beta credit.

[2] Including tapering, a very late resolution on the debt ceiling, messy Italian politics, EM uncertainty and lots of supply.

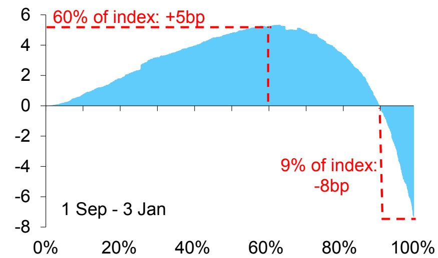
Figure 14 shows how each individual bond, ranked by beta, has contributed cumulatively to the performance of the iBoxx index. Take the 60% of bonds with the lowest beta – they have been dragging the index wider (by 5bp) in the rally. In fact, the index is only tighter because of the huge rally in the 9% of the index with the highest beta.

Figure 13. Reported aggregate position in € credit



Source: Citi Credit Survey

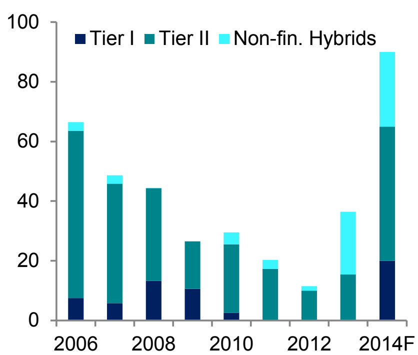
Figure 14. Cum. Contribution to iBoxx spread tightening*, bp



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

This illustrates two points: Most obviously, investors have been getting longer by buying high-beta credit. But equally importantly, the fact that the low beta part of the market has been widening in a generic market rally suggests that there is a lot of switching going on, as opposed to the kind of outright buying we saw in previous rallies. That supports our impression that cash levels in IG have dwindled by more than the market generally appreciates.

Figure 15. Subordinated debt issuance in € with 2014F, €bn



Source: Citi Research, Dealogic

What will you be buying? A final gripe of ours, albeit a rather technical one, is that the market you see today is not the market you will see in a year's time. Aside from deterioration in like-for-like fundamental credit quality we discussed above, 2014 will almost certainly see a significant shift in both supply and index composition towards lower rated, riskier bonds.

We anticipate the highest volume of subordinated debt issuance ever in 2014 - €90bn, split between €70bn of AT1 and T2 issuance from banks and €25bn of non-financial hybrids (Figure 15). Granted, at least the AT1s will probably remain off-index for the time being, but it will still have an impact on the level of risk that the funds that buy them are taking.

Paper Triggers

Before putting on our happy hats (to discuss what's supporting credit after all), let's look at the potential triggers for 2014 that are visible going into the year. If we're right that lots of trends in credit are moving in the wrong direction – and not least that positions are already pretty extended – then surely the market would be ripe for a correction if a negative catalyst suddenly starts to play out?

Fortunately, we're pretty sanguine about the macro drivers this year.

The asset quality review: We'll go out on a limb and state that it would be a big surprise to us if the ECB's comprehensive assessment ends up pulling the rug from under the credit market. The weak framework around the bank union and the single-resolution mechanism makes it very difficult for us to see how the AQR and the stress test can be fully credible. As in previous stress tests, the greatest value probably lies not in the results but in the additional disclosure.

Granted, by bringing forward the bail-in regime for senior unsecured to January 2016, policymakers are giving themselves an additional lever. While it just might be pulled in response to specific capital shortfalls identified at the individual level, we don't see any political appetite to use it systemically – not least because of the holes that would be left in other balance sheets as a result.

Even at the individual level, we suspect that the sliver of bail-in-able junior and senior unsecured debt is too thin to make much difference at many of the banks that are most likely to have a capital shortfall.

So although we have sympathy with the view that senior unsecured spreads, for example, do not adequately reflect depositor preference, we are sceptical that the market will re-price as a consequence of the comprehensive assessment.

ECB policies: Our economists believe the deflationary pressures in the Eurozone will force the ECB to take deposit rates into negative territory by the middle of the year. We reckon the initial reaction in credit markets would be tentative. Aside from the signal such a move would send, the reluctance to lend out cash would likely reduce repo volumes, which would not be good news for ailing secondary market liquidity. However over time, we think the resulting penalty for holding cash should incrementally add to hunt for yield, benefiting higher-beta credit especially.

If anything, we'd be as focused on the debate that seems to be raging within the ECB and other policy circles on whether to risk-weight sovereign debt exposures. While we believe they remain in a minority, there seems to be a part of the ECB's governing council that is concerned about the incentive that (periphery) banks currently have to buy their own sovereign debt.

Draghi has reportedly delayed any move in this direction for now, but Jens Weidmann and others have indicated that this should be an objective for the medium term. 86% of Spanish net bond issuance over the last three years was met by demand from domestic banks. But coinciding with the comprehensive assessment, the uncertainty on sovereign risk weights might still indirectly have some influence on demand for net periphery debt issuance from domestic banks later in the year.

Another way the ECB may impact that demand is by deciding whether or not to do another VLTRO. If the ECB does another VLTRO then it will probably have a shorter maturity than the previous ones (say 1 year as opposed to 3 years) and it may well come with conditions, for instance on lending to SMEs. As such, although it would be a credit positive, we think the impact would be tiny compared to that of the LTROs done two years ago.

Will EM muddle through? The explosion in debt that has coincided with the enormous inflows of return-seeking money makes parts of EM particularly vulnerable to the prospect of tighter (US) monetary policy. We already saw that last year.

Although rather simplistic, the convention has become to focus on economies with a combination of 1) rapid credit growth, 2) external funding requirements due to current account deficits and 3) open capital accounts. Several key economies like Brazil, India, Indonesia, South Africa and Turkey share a number of these characteristics. All are also highly sensitive to commodity prices – albeit in rather different directions.

However, the fact that markets have already coined the term 'the fragile five' illustrates that none of these risks are particularly new or surprising. Indeed having gone through the volatility of last summer, the issues should be comparatively well understood by now. Similarly, the well-trodden issues surrounding the longer-term sustainability of the Chinese growth model probably won't gain further traction until there is a more concerted shift in policy stance. To date, we haven't seen many signs that that's going to happen any time soon.

Our EM economists have aptly dubbed the EM outlook as more of a 'chronis' rather than a crisis - no abrupt chaos necessarily, but rather a series of smaller adjustments in asset prices as investors get used to a world where EM is no longer characterized by rapid, export-led growth and large accumulations of FX reserves. Rather EM is adjusted to slower growth, slightly weaker sovereign balance sheets, and more reliance on domestic spending.

There is clearly still a chance that markets decide to discount this structural shift abruptly through rapid portfolio outflows, leading to a liquidity crisis. As we've highlighted previously, hard currency EM corporate debt has predominantly been bought by non-benchmarked investors, who are unlikely to be particularly committed in adverse market conditions. But the risk of that outcome has diminished in the last six months. We expect periods of EM-induced volatility this year, but a crisis that would jeopardise the outlook for European credit is not our central scenario.

Too much supply? Over the last few years issuance has generally been regarded as market supportive – at least it's been taken as confirmation of benign market conditions. Yet with less cash around we reckon that the secondary market might view issuance rather less favourably through parts of the year. As already discussed, there was a significant increase in switching in the latter half of 2013. Unless inflows into credit pick up, we'd expect to see more switching still on the assumption that supply volumes will increase further in 2014 (Figure 16).

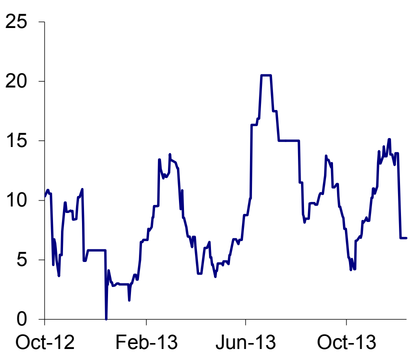
Across € IG and HY we expect €146bn of net supply this year – that's a considerable amount compared to net supply in 2013 of €65bn and gross supply of €450bn. Moreover, we expect €90bn of that to be subordinated, compared to less than €40bn last year.

Figure 16. Citi supply forecasts for 2014, gross & net, Currency bn

		--- Gross issuance ---			Redemptions	Net iss.
		2013	2014F	YoY%	2014	2014F
Euros	Corporates	204	224	10%	130	94
	Senior Fins	160	176	10%	237	-61
	Tier II	24	45	88%	7	38
	Tier I	3	20	567%	-	-
	HY	57	60	5%	10	50
Sterling	Corporates	25	28	12%	7	21
	Senior Fins	11	13	14%	9	4
	HY	11	13	14%	1	12

Source: Citi Research, Dealogic.

Figure 17. Avg. new issue premium, € IG*, bp



Source: Citi Research. *: 25-day moving average

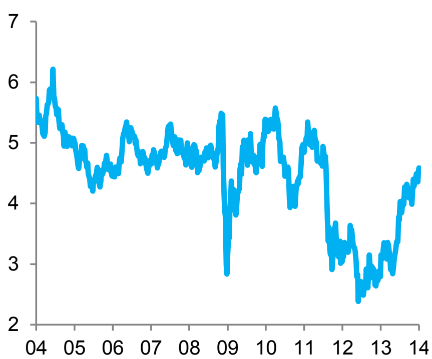
To us this does imply a significant shift in the supply-demand balance (within credit as opposed to the wider financial market). We'd expect that to be reflected in a higher new issue premium on average (Figure 17).

Is supply going to be a significant trigger though? We think that's unlikely, as the vast majority of it should be opportunistic. We can see supply periodically causing market indigestion, prompting a temporary widening in the secondary market. However, we think the primary offer would diminish quickly in response, thus helping to restore balance to the market.

We will be detailing our views on the primary market and supply forecasts in a separate piece shortly.

Higher yields: With all the total-return-based money in credit and the experience from last summer, the impact any further rise in yields will have on spreads is still hotly debated. In most respects, Citi's view is comparatively sanguine: Against the prospect of a tepid recovery and the ECB having to ease further during the year our rates strategists see European yields remaining virtually unchanged through the year across the curve.

Figure 18. US 5yr-5yr forward, %



Source: Citi Research, Bloomberg

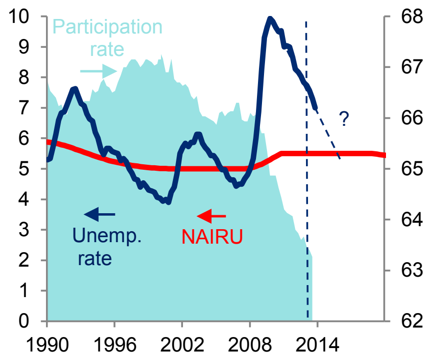
Even in the US, they think the upward momentum in 10-yr yields should slow significantly, ending the year at 3.3%. That's about 30bp higher than currently – compared to the 130bp rise we saw during 2013 – reflecting that a lot more is baked in now. The 5yr-5yr forward is already at 4.6% (Figure 18) - in line with the average we saw from 2005-07. They see scope for 20bp or so of \$-curve bear flattening due to 2-5yr underperformance, but that is hardly a shift that is dramatic enough to really impact the shorter-dated parts of the credit market (not least HY) meaningfully.

Most likely, the path will not be orderly at all times and we may well see overshoots within the year. Such periods with pressure on yields are likely to spill over to credit spreads as they did in 2013. But we think the sensitivity is significantly reduced as rising yields is not a contrarian view the same way that it was last May.

To us, the salient point is that after negative risk-free total returns in 2013, this year investors should be facing zero or even positive returns. In periods of comparative stability the higher level of yields in itself should, if anything, be a positive for credit.

What about 2015? Paradoxically, the biggest risk to 2014 is arguably 2015: any market unease about actual rate hikes already next year should be significantly greater than it was about tapering, in our view.

Figure 19. US unemployment rate vs NAIRU & the labour market participation rate, %



Source: Citi Research, Haver Analytics.

The extent to which central banks are committed to "forward guidance" is likely to be near the top of people's agenda's already in the second half of this year – especially if inflation turns out less benign than forecast. Consider that based on the recent trajectory the US unemployment rate will hit the NAIRU (non-accelerating inflation rate of unemployment) by the middle of 2015 (Figure 19).

The case for maintaining policy accommodation for an extended period of time is to a large extent contingent on reversing the rapid decline in the labour market participation rate. The rate of decline does seem very likely to slow. But the negative trend didn't start with the financial crisis – it started nearly 15 years ago, suggesting that the Fed is also contending with structural changes in the labour market. If that's the case, then it's not too farfetched to argue that there might be less slack in the economy than is currently perceived. If the market were to price such a scenario of higher future US inflation during the year, then it would almost certainly imply wider credit spreads also in Europe.

For our US colleagues this is one of the principal reasons why they see $ credit spreads performing better in the first half of the year than in the second.

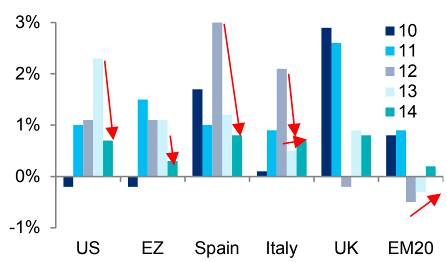
So what *is* there to like about 2014?

Based on that tirade you might think we'd be bearish on 2014. Far from it. Our concerns about credit fundamentals and weaker technicals have to be balanced against the broader backdrop:

"Steady as the economy goes". 2014 may be more about a cyclical and policy-induced upturn rather than a structural shift in sustainable growth, but our economists' outlook paints the least troublesome picture we've seen in years.

This is in large part due to a significant reduction in the pace of fiscal consolidation in a number of key economies (Figure 20). The global economy is expected to grow by 3.1%, compared to 2.4% in 2013 and 2.8% on average since 2008 (Figure 21).

Figure 20. Ann. chg. in cyclically adjusted primary balance, %



Source: Citi Research, IMF Fiscal Monitor

Figure 21. Select Citi forecasts

	2013F	2014F	2015F
Global	2.4	3.1	3.3
US	1.7	2.7	3.1
Euro Area	-0.4	0.9	1.0
EM	4.6	4.9	5.0
€/$	1.32	1.39	1.4
£/$	1.58	1.73	1.75
UST, 10yr	2.30	3.04	3.55
Bund, 10yr	1.60	1.80	2.00

Source: Citi Research

Moreover, the growth disparities, although still significant and painful, appear less alarming than in previous years when taken together. US growth should rebound nicely as the effect of the sequester and fiscal tightening eases. Just removing these two factors should get growth close to 3%.

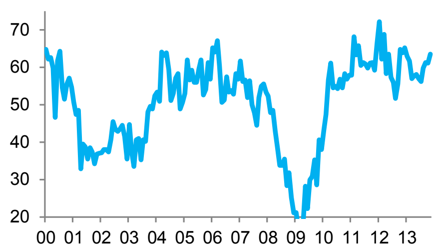
In Europe, the recovery should remain anaemic, with a real deflation threat in a number of periphery economies. However, with nearly every country seemingly out of recession, it would be hard to argue that there hasn't been a relative improvement.

Even in EM, Citi expects a small acceleration in growth this year, despite the longer-term imbalances in a number of economies.

Economists (like strategists) obviously don't get it right every time. But many of the divergent trends in Europe have diminished, most diffusion indices point to a broadening recovery (Figure 22), and forecast revisions have dropped dramatically (Figure 23). It all suggests that near-term macro risks really have receded for now.

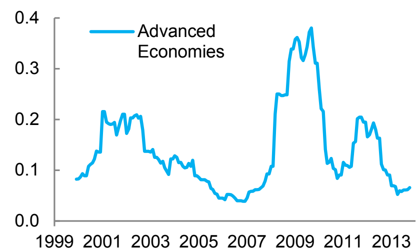
It's by no means a sizzling outlook, but it's enough to lift the corporate top line and it should be enough to keep credit ticking over with a low level of defaults.

Figure 22. Non-farm payroll one month forward diffusion index



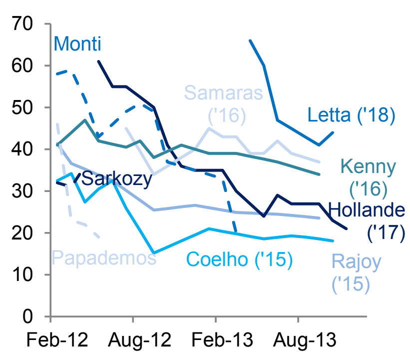
Source: Citi Research, Bureau of Labor Statistics, Haver

Figure 23. St. dev. in Citi growth forecast revisions



Source: Citi Research

Figure 24. Approval rating of incumbent leaders in select countries, %



Source: Citi Research, various national polling agencies. Note: Next scheduled election year in brackets

"Phew, we don't have to ask voters" Voters probably won't be cheering their axe-wielding policymakers in 2014. At least judging by opinion polls, approval ratings of incumbent governments remain very low in the European countries that have had to do the belt tightening (Figure 24).

But unless the Greek or the Italian governments collapse, it is unlikely that voters will be asked[3]. Evidently, protests could resurface, but against the prospect of economic stabilisation, less fiscal tightening and a slightly better outlook for employment, even here the catalysts are less apparent.

There will probably be a lot of media noise around the US mid-term elections in November, but at this point the threat they pose to credit is less evident.

The most significant risks probably lie in EM. Not only will there be elections in key economies including Turkey, India, Indonesia, South Africa and Brazil, but domestic tensions can quickly flare, as we have seen recently in Turkey, Thailand and the Ukraine. Yet these three examples also prove that unless the market sees repercussions spreading internationally, there is little impact on European credit.

Still too much money and not enough assets to buy: To be frank, we don't think there's any macro risk premium left in credit spreads now. But what matters here is that in the absence of a tangible trigger investors are still being enticed into taking more risk by the global central banks. In all the fuss about the impact of tapering last year, we think that much of the market lost sight of the bigger picture:

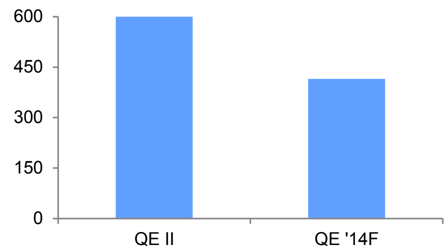
Assume linear tapering from January to September and we estimate that the Fed will still do more than $400bn of QE this year – that's about 70% of the entire QE II programme (Figure 25).

[3] Beyond the elections for the European Parliament, where Euro-sceptic parties may win as much as a third of the vote, judging by some estimates.

Moreover, remember what is happening in a global context. In 2013, the ECB (largely involuntarily) ended up reducing excess liquidity substantially though LTRO repayments. While it remains to be seen what the ECB will do this year, it is unlikely that it will cause a similar reduction in global liquidity this year. Moreover, the BoJ of Japan currently seems more likely to expand the pace of QE than to reduce it.

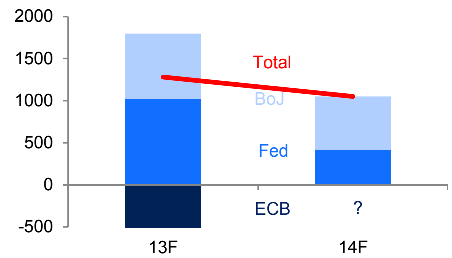
In aggregate, combining the net liquidity injections by the Fed, the ECB and the BoJ together, the picture looks little changed from 2013 (Figure 26).

Figure 25. QE2 vs expected QE in 2014, $bn



Source: Citi Research

Figure 26. Net central bank liquidity, $bn



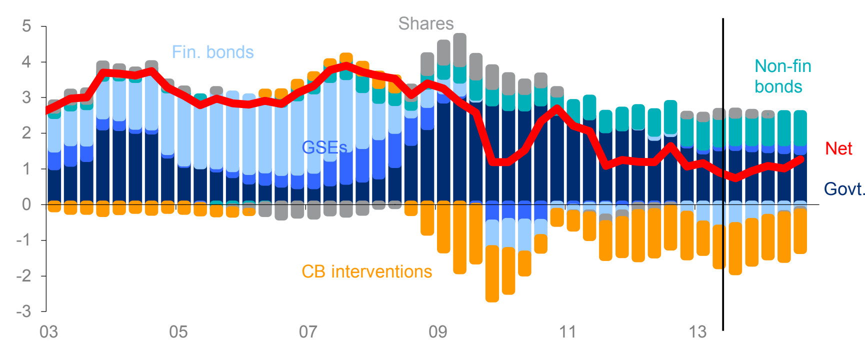
Source: Citi Research

The implication is that the universe of securities across asset classes that investors will be able to buy *still* won't be growing nearly fast enough to keep up with likely demand in 2014.

Our proxy for the net growth in the investible universe of securities (the red line in Figure 27) combines net issuance of securities across asset classes for Europe, the US and Japan, from which we have subtracted central bank interventions[4].

It shows that the annual growth in the supply side of the securities markets has effectively declined from $3-4tn to between $1-1.5tn – a two-thirds drop – over the last few years. Based on our forecasts for issuance and central bank interventions next year, it is unlikely that the net issuance of securities returns to anything like the 'natural' rate.

Figure 27. Net issuance of new securities vs central bank* interventions, 12m rolling, $ tr



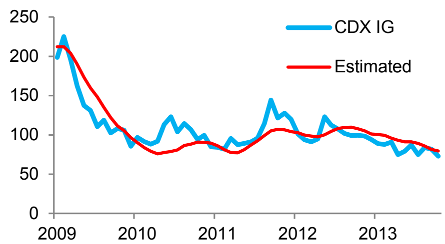
Source: Citi Research, Haver. * Federal Reserve, Bank of Japan, ECB.

Coupled with solid demand for securities as a result of low returns on risk-free deposits, we think the rally in recent years is to a large extent driven by an enormous global supply-demand imbalance. So to us, the likelihood that the net supply of securities will remain almost as constrained in 2014 is a key reason to be comparatively bullish in the central scenario – also on credit.

[4] See 'Too much money, not enough assets to buy', Hans Lorenzen, 25 April 2013 for details.

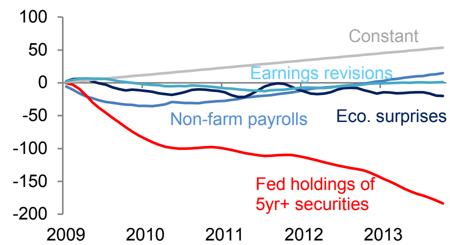
To strengthen the case for that link between central bank actions and market performance, we've regressed US credit spreads (in differences) against 1) the Fed's holdings of long-dated securities (in differences), 2) US GDP[5], 3) non-farm payrolls, 4) US economic surprises and 5) US earnings revisions. It's pretty clear from Figure 28 and Figure 29 below that most of the cumulative contribution to spread tightening in this simple framework is coming from the Fed's balance sheet, rather than the fundamental economic variables.

Figure 28. CDX IG vs. estimated in an OLS regression*, bp



Source: Citi Research, Haver.

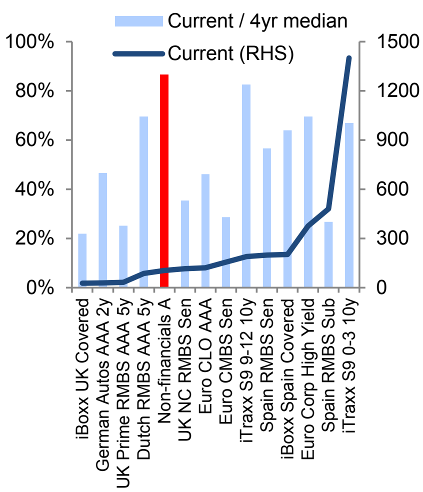
Figure 29. Cum. contribution to estimated CDX IG spread change, bp



Source: Citi Research, Haver.

* Regression in differences of CDX IG against US economic surprises, non-farm payrolls, S&P earnings revisions & change in Fed holdings of 5yr+ securities.

Figure 30. Current spreads across select asset class, current (bp) & % of 4yr median

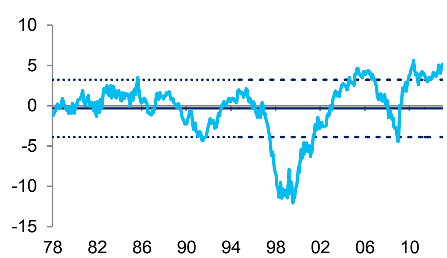


Source: Citi Research, MarkIt.

Everything is expensive – pretty much... Although we regard corporate credit as expensive, another reason to be somewhat optimistic is that this is almost a universal phenomenon across asset classes. For instance, it might seem tempting to stray into other, typically less liquid, parts of the credit market in the hunt for better value. While our structured strategists do like peripheral RMBS and European CLOs, they too are grappling with the tightness everywhere. As they have illustrated (Figure 30), looking at current spreads versus the median for the last 4 years, non-financial credit, if anything, stands out as having lagged recently.

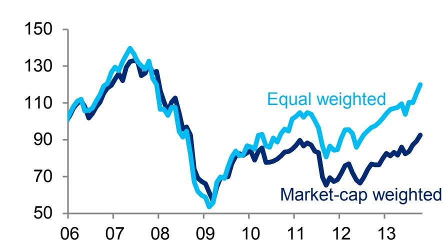
Even in the darling asset class of the day – equities – attractive opportunities are getting harder and harder to come by. To be clear, we do still prefer long equity versus credit strategies, where possible, but there too valuations are full, if not stretched already in many places. The rally in small-caps, for instance, has left valuations at historical extremes versus large caps in both Europe and the US (Figure 31 & Figure 32).

Figure 31. Russell 2000 P/E less S&P 500 P/E
Dark blue line = avg. Dotted lines = +/- 1 st.dev.



Source: Citi Research.

Figure 32. EuroStoxx, equal vs. market-cap. weighted, Dec 2005 = 100



Source: Citi Research, Bloomberg.

[5] Which turned out statistically insignificant.

"Must lever up to make money!"

But the best reason to be bullish on 2014 is probably the perverse situation in which credit finds itself at the moment:

The negative trends are perhaps not hard to spot, but in the absence of an immediate trigger, *lower* risk premia mean that investors have to take *more* risk to meet their targets. In that sense at least, it's eerily reminiscent of 2005-06.

The only way that credit investors can expect *ex ante* to make their required excess returns this year is, in our view, through leverage. It's just not likely that there will be enough of a premium in primary markets or enough of a divergence in bottom-up fundamentals to allow sufficient excess returns through alpha strategies alone.

That process of leveraging up inherently drives the market tighter. When someone buys €10mn of AT1 bonds or TITIMs it impacts aggregate spreads by more than when someone buys a senior bond issued by Siemens in the same amount. When an investor takes more spread duration the index tightens. When a hedge fund takes mezz risk in a synthetic CDO, the dealer on the other side will sell protection (delta-hedge), typically on the CDS index, to keep his ATM exposure flat. Spreads tighten.

As long as it continues, the whole process is self-reinforcing. Markets are performing, vol is low, financial conditions are benign for the economic recovery, which all seems to justify taking the risk in the first place! The fact that the concentration of risk is rising whilst underlying credit metrics and technicals are weakening all along ends up being masked.

Indeed, at this point it perhaps seems more likely that spreads overshoot our targets for a good part of the year than they undershoot them. 'Micro triggers' like the ones we referred to above are likely to emerge during the year, prompting corrections in extended positions. But as long as they're not changing the fundamental outlook or undermining the central bank backstop, we reckon they'll remain confined to the ranges.

And so for an extended period of time – potentially several years – anyone trying to argue that it'll all end in tears – as we're sorely tempted to do – will probably look like the Greater Fool.

Didn't the FT just recently label us as 'Credit Cassandras'? Hmm …

Notes

Appendix A-1

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