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Europe

Long Insurers vs. Short "Premium" Autos

European Credit Strategy – Trade Ideas

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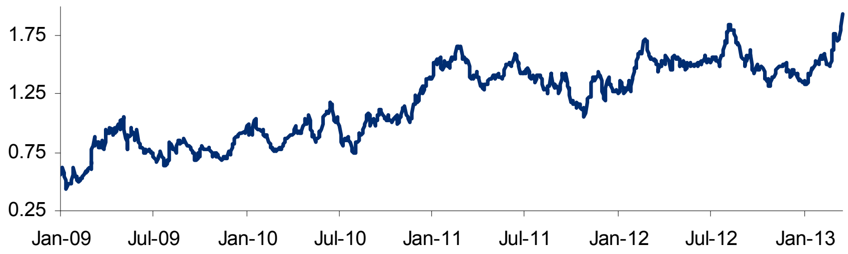
- The top-down macro and bottom-up fundamental situation remains challenging. A short risk position in premium autos (Daimler, BMW and VW) is, in our view, a cheap way to position for this.
- We believe insurers provide a very attractive way to capture the "tail-risk" premium which, in our view, is still priced in current market spreads. We recommend long risk positions in Allianz, Aviva and Axa.
- We view the exposure of this trade as "short the economy, long tail-risks" in the sense that it should perform if the economy continues deteriorating as long as there aren't any sovereign-led tail-events.
- Insurers have substantially underperformed autos during the recent Italian- and Cyprus-led widenings, taking the entry point of the trade to very attractive levels, in our view.

Figure 1. Insurers vs. premium autos baskets – historical spread ratio. Current ratio: 1.9x.



Source: Markit, Citi Research

Figure 2. Long risk – Insurance Basket. 5y 18-Mar EOD mid Markit spreads shown, in bp.

Ticker	Name	5y spread (bp)	Protection	Notional (€m)	Carry (€)*
ALVGR	Allianz	88	Sell	5	44,077
AVLN	Aviva	166	Sell	5	82,769
AXASA	Axa	167	Sell	5	83,260
	Average	**140**		**Total**	**210,107**

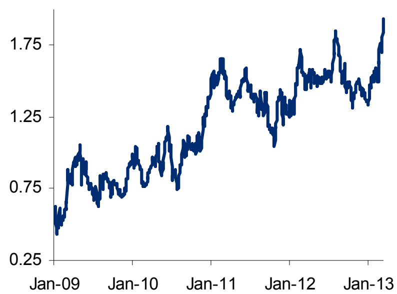
Short risk – Premium Autos Basket. 5y 18-Mar EOD mid Markit spreads shown, in bp.

Ticker	Name	5y spread (bp)	Protection	Notional (€m)	Carry (€)*
DAIGR	Daimler	79	Buy	10	-78,940
VW	Volkswagen	71	Buy	10	-70,652
BMW	BMW	68	Buy	10	-68,026
	Average	**73**		**Total**	**-217,618**

Source: Markit, Citi Research; * Carry assuming CDS trading on a full running basis (i.e. no upfront, coupon = flat spread).

Long risk (senior) insurance vs. short risk premium autos

Figure 3. Insurers vs. premium autos baskets – historical spread ratio



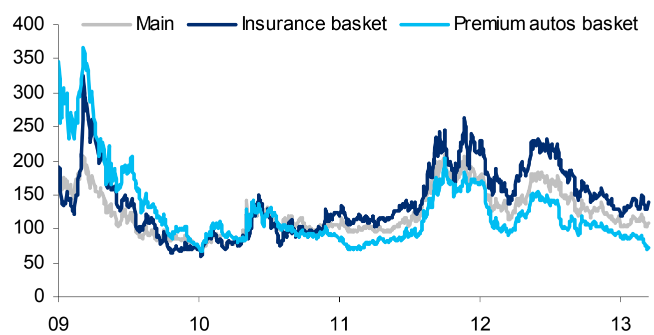
Source: Markit, Citi Research

We recommend investors an (almost) "carry-neutral" trade between a basket of insurance companies and a basket of premium autos (Figure 2). The current spread ratio between the two baskets is 1.9x as Figure 1 shows. Given that the auto basket is trading 1.9x tighter than the insurance basket, for each unit of protection sold in the insurance basket we buy 2 units of protection in the autos basket; this leaves the trade slightly negative carry.

The spread ratio between the two baskets has reached the levels we saw last year around the time Draghi made the "whatever it takes" speech and Eurozone break-up fears experienced extreme levels (with discussions around Spain and Italy asking for bailouts to be able to receive ECB support, renewed concerns around the Troika-Greek negotiations etc.) – see Figure 3. Insurers underperformed premium autos mainly as a consequence of the sovereign nature of the sell-off. In the second half of 2012 insurers outperformed autos as sovereign risks receded; however, they have underperformed autos yet again since the start of 2013 – especially recently on the back of the political instability in Italy and the events in Cyprus.

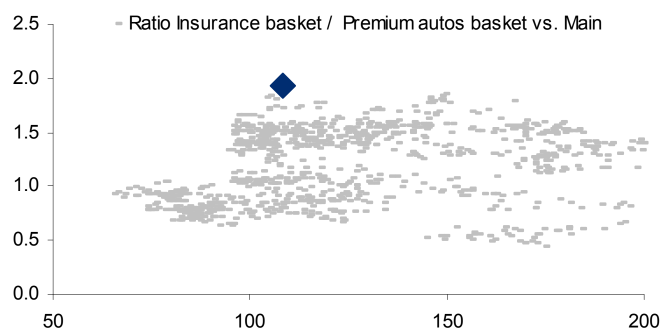
Figure 4 shows average spreads for the insurers and autos basket alongside iTraxx Main spreads, and Figure 5 shows the spread ratio between the two baskets vs. the spread of iTraxx Main since 2009. We believe the current spread ratio between insurers and premium autos represents an attractive entry point to the trade. Since 2009, only during mid-2012 this ratio was above the current level.

Figure 4. Historical spreads – Main, Insurance & Autos baskets
5y spreads in bp, average spreads for the two baskets.



Source: Markit, Citi Research

Figure 5. Spread ratio of insurance / autos vs. iTraxx Main spreads
Y-axis: spread ratio. X-axis: iTraxx Main 5y spread, in bp.

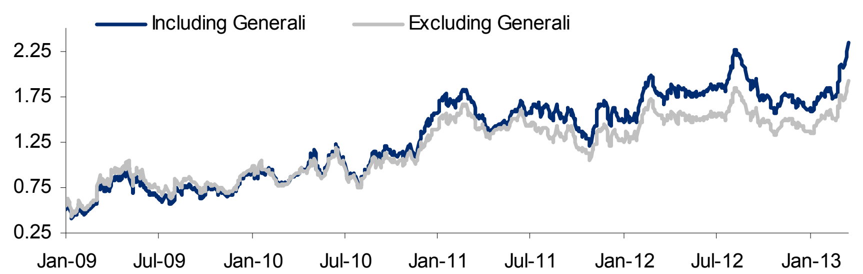


Source: Markit, Citi Research. Daily data since Jan-09.

Investors who prefer not to take the "tail-risk" exposure that the long insurers leg of this trade generates, could go short the premium auto basket against iTraxx Main.

Why not enhance the trade with Generali? Opening a long risk position in Generali in the current environment may not seem attractive to many investors, especially ahead of a likely heated negotiation period between Italian political parties with many potential risks. However, investors who want to take a contrarian view on the Italian political situation could include Generali in the long risk basket of insurers; Generali 5y senior CDS spreads are close to 260bp. The entry point of the trade looks equally attractive including Generali on the long risk basket as Figure 6 shows. See Figure 12 for our company specific views on Generali.

Figure 6. Insurers vs. premium autos baskets – historical spread ratio.
Ratio of average 5y spreads.



Source: Markit, Citi Research

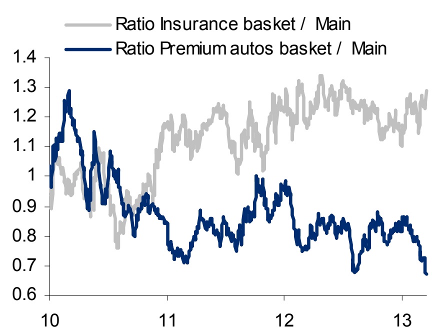
Economic deterioration without tail-risks materialising

Economic deterioration:

Short premium autos (Daimler, BMW and VW)

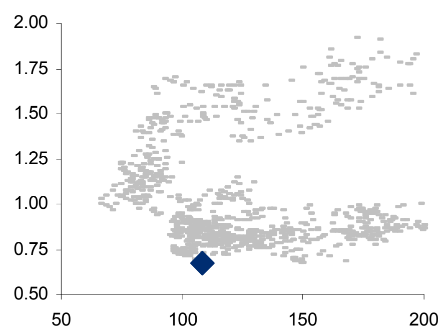
The top-down macro and bottom-up fundamental situation remains challenging. A short risk position in premium autos (Daimler, BMW and VW) is, in our view, a cheap way to position for this. Although premium autos have exhibited a low beta with respect to the overall credit market, their spread ratio to iTraxx Main remains very low (see Figure 7 and Figure 8) and we expect them to underperform the market as the challenges facing the global auto industry become more acute. The exposure of the auto sector to the global economy and the tight levels at which these premium auto credits are trading (73bp on average) make them an attractive way to source protection against any further spread widening, in our view.

Figure 7. Spread ratios baskets vs. Main
5y spread ratios.



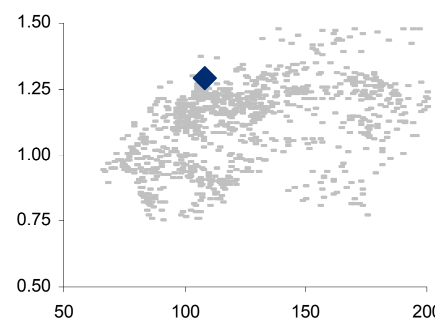
Source: Markit, Citi Research

Figure 8. Autos / Main ratio vs. Main
Y-axis: spread ratio insurance basket / Main. X-axis: iTraxx Main 5y spread, in bp.



Source: Markit, Citi Research. Daily data since Jan-09.

Figure 9. Insurance / Main ratio vs. Main
Y-axis: spread ratio insurance basket / Main. X-axis: iTraxx Main 5y spread, in bp.



Source: Markit, Citi Research. Daily data since Jan-09.

As we highlighted in our latest *European Credit Sector Recommendations* (26 February), the crisis in the automotive industry is spreading to the luxury segment. As a consequence, we remain negative on Automotive & Auto Parts as the outlook for demand in Europe looks challenged and sales are slowing down. At their recent FY12 results, Daimler, VW and BMW expressed caution over their prospects in 2013. January European car registration data showed weakness in car registrations in particular for VW; the February car registrations released today confirm this trend. Daimler, BMW and VW remain among our favourite "Pans" in the consumer sector (see Figure 10). We struggle to reconcile the deteriorating fundamental outlook for the auto industry with the outperformance of auto CDS spreads vs. iTraxx.

Figure 10. Consumer Goods Pans - *European Credit Sector Recommendations* (26 Feb)

BMW and VW	While BMW sales are holding up better than VW, in the last earnings release, BMW management acknowledged some pressure on auto margins, which might worsen in the near future. At the current levels and given the outlook for European auto demand (which is quite important for BMW) we think there are better alternatives for a conservative positioning within Consumer Goods. VW sales are starting to suffer, as shown by the last data from KBA in January and ACEA. We think the current tight spreads don't offer protection from a further weakening of demand for VW.
Daimler	This looks like the weakest German auto maker in our view, and again at the current levels and given the outlook for European auto demand we think there are better defensive alternatives. The company guided for auto demand growth of 2-4% in FY13 which is above our equity analysts 1.3% forecast. Still, the recent data on auto sales in Europe paint a bleak picture of auto demand in the Old Continent, and we think Daimler will be affected as well.

Source: Citi Research

Capture the sovereign risk premium priced in the insurance sector

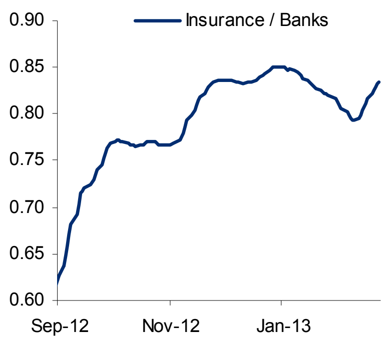
Long insurance companies (Allianz, Aviva and Axa)

Senior insurance debt provides an attractive way to capture the "tail-risk" premium which, in our view, is still priced in current market spreads. Insurers have underperformed iTraxx Main for the most part of the last three years on the back of the sovereign concerns that have driven valuations since 2010. As Figure 7 shows, the spread ratio between our insurance basket and iTraxx Main moved from 0.7 in mid 2010 to above 1.3 in 2012. After outperforming Main in the second half of 2012, the insurers/Main spread ratio has moved back to 1.3x during the recent Italian- and Cyprus led widenings – Figure 9.

The main rationale for the underperformance of insurance companies over the last few years has been attributed to their holdings of sovereign debt. However, they failed to materially outperform Main during the second half of last year as sovereign and bank spreads aggressively tightened on the back of Draghi's "whatever it takes" speech. As Figure 11 shows, insurance companies underperformed banks during the last part of 2013. We believe investors who want to express the view that politicians and central banks will continue administering all the necessary measures to prevent a sovereign-led tail-event should enter long risk positions in insurance companies. We think insurers offer better value than banks in the financials space.

Figure 11. Insurance / banks spread ratio

5y spreads ratio, average for all insurance and bank credits in iTraxx Main.



Source: Markit, Citi Research. 10-day moving average.

With this in mind, we think Aviva, Allianz and Axa offer the best value versus Main and versus our basket of core automakers at the moment. We review them individually in Figure 12.

Moody's placed Allianz and Axa on Negative outlook back in February 2012, on the back of their sovereign exposure. Moody's also put Aviva on review for downgrade on concerns regarding its last results, sovereign exposure, and disposals plans Given the subsequent rating downgrades of many European countries (Spain, Italy, France and UK), the risk that Moody's downgrades the insurers has increased. However, we think that this risk is already priced in CDS spreads and, from a relative value perspective, insurers are a good spot to be long risk given their solvency levels.

Figure 12. Insurance Companies in our long portfolio

Aviva	Moody's has recently put the company on review for downgrade on concerns over its ability to deleverage, the impact on business of its restructuring plan and its European exposure. However, we think the rating risk is already priced in. Our equity analysts believe the restructuring plan Aviva is going through is credible. It implies a simplification of its complex legal structure (the consequent one-off charges are the main cause of its 4Q earnings miss and dividend cut, in our view), but also a reduction in leverage by selling assets, in an effort to progressively align it with peers. We believe its earnings and capital generation remain strong. We expect Aviva to continue its deleveraging process and to call bonds this year.
Allianz	The company delivered a good set of results in 4Q, underpinned by strong Property and Casualty and good inflows in asset management, while showing some weakness in Life and Health. The solvency ratio continues to be strong at 197%. The company's guidance of around €9.2bn of operating profit in 2013 for 2013 is slightly below Citi's expectations, but it is still solid.
Axa	The FY12 results show a steady improvement in margins, especially in asset management and insurance, although earnings were in line with consensus. Moreover, Axa is making good progress in its restructuring plan and has increased its cost savings target by €200mn to €1.7bn, due to lower planned acquisition costs in its life business.
Why not enhance the trade with Generali?	
Generali	Generali disappointed on its FY12 results, but mainly because of one-off restructuring costs and accounting changes. Operating margins were robust, and free cash flow generation remained strong. The solvency ratio also was stronger than Citi's expectations thanks to an ongoing shift towards less capital intensive instruments. The company is actively restructuring its business, which is a long term positive, but it implies some execution risks. Among the insurers included in Figure 12, Generali has the highest exposure to the Italian sovereign. Yet, according to our equity analysts, as long as there is no restructuring of Italian or Spanish debt which would force insurers to mark their holdings to market, the exposure is manageable. As part of its strategy, Generali will likely retire senior debt and issue hybrids. This should provide support to the CDS. Although we believe the risk of a rating downgrade is higher than for Aviva, Axa and Allianz, we would argue that the CDS spread offers reasonable compensation for this risk.

Source: Citi Research.

As we argue in our latest *European Credit Sector Recommendations* (26 February), insurers have virtually no encumbered assets with the ECB, their exposure to Southern European debt looks manageable and they have strengthened their credit metrics substantially as they prepare for the introduction of Solvency II. The long-term nature of insurers' liabilities gives them more flexibility to adapt to periods of market distress. Insurers have been de-risking substantially since the onset of the 2008 financial crisis. Non-core assets have been sold, risks associated to their product portfolio have been reduced, and capital ratios have improved. In spite of the challenges that the current low yield environment poses to them, insurers have managed to stabilise their profit margins, as the pressure from low yields on non-life products has been offset by pricing actions and even moderate growth in life products. This has been reflected in moderate earnings growth so far, which we think will continue. Despite the delay in the implementation of Solvency 2, insurers have been quite proactive in strengthening their capital ratios to prepare for the upcoming legislation.

Appendix A-1

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