

# European Credit Sector Recommendations

## Walking a Tightrope

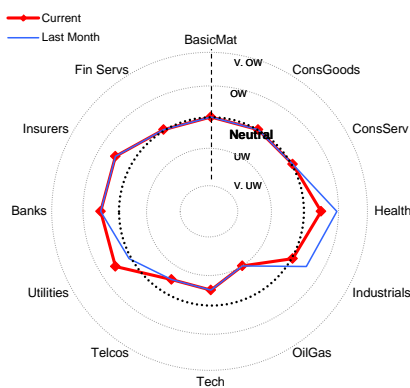
- We remain constructive on credit for 2014, thanks to favourable technical factors. Central bank activity should continue supporting the market, investors' risk appetite remains healthy, positions seem less stretched and we see a pickup in inflows in credit.
- Yet, with valuations tight by any measure, leverage creeping higher and geopolitical risks on the horizon, investing in credit at these levels feels like a fine balancing act. While remaining positive overall, we would reshuffle our credit allocation towards sectors where the risk/reward is more appealing.
- **Key sector recommendations:** Stay overweight on Banks, by looking to add exposure in the new capital securities through the primary market. Remain overweight covered bonds and underweight senior bonds. Maintain a small overweight in Insurers. In non-financials, reduce exposure to hybrids. Move to a small overweight in Utilities, move to neutral on Industrials and reduce the overweight on Healthcare. Remain underweight on Oil & Gas and selectively underweight on Telcos as fundamentals keep deteriorating and event risk is high. Maintain neutral on the remaining non-financial sectors.

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Figure 1. Citi Recommended Positioning



Source: Citi Research  
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%	4.6	0.9	4.6	4.1
Non-Fin	55.5%	4.9	0.8	2.7	2.2
Fin	44.5%	4.2	1.0	1.9	1.9
Basic Mat.	4.0%	4.6	0.9	0.2	0.2
Cons. Goods	9.3%	4.6	0.5	0.4	0.2
Cons. Serv	3.2%	4.9	0.6	0.2	0.1
Healthcare	2.4%	4.0	0.4	0.1	0.0
Industrials	8.0%	4.7	0.7	0.4	0.3
Oil & Gas	5.3%	4.8	1.2	0.3	0.3
Technology	0.9%	7.5	0.7	0.1	0.0
Telecoms	8.3%	5.2	1.0	0.4	0.4
Utilities	14.1%	5.2	0.9	0.7	0.7
Banks	35.7%	4.0	1.0	1.4	1.4
Fin Servs	4.7%	4.5	0.5	0.2	0.1
Insurance	4.1%	4.9	1.9	0.2	0.4

Source: MarkIt, Citi Research

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

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## Sector and bond recommendations

Exactly 40 years ago, in 1974, the French funambulist Philippe Petit walked between the Twin Towers of the World Trade Center in NYC, 400 m off the ground.

Investing in credit markets these days is perhaps not quite as daunting, but it does require a fair bit of funambulism too. As valuations get tighter and tighter as shown by our [Credit Valuation Report](#), it's arguably best not to look down.

The earnings season was uninspiring, recent economic data has been significantly weaker than expected (although at least in part due to weather effects), there is an evident [increasing trend in leverage](#) and obviously geopolitical risks have heightened again with tensions in Ukraine and Venezuela. Yet the iBoxx index has tightened by 6bp since the beginning of February, reaching levels last seen at the beginning of 2008. Most of the tightening happened in the high beta part of the market, in particular in non-financial hybrids, which tightened by about 40 bp over the last month. [iTraxx Main](#) is close to the tights of January, also at levels last seen in early 2008, and [Xover](#) is even tighter.

Yet despite having a bit of vertigo, we remain constructive on credit in 2014. We expect the €iBoxx Corp to tighten to [90bp](#) by year end, supported by central bank activity and healthy appetite for risk, as shown by the strong performance of primary markets. Our [Credit Survey](#) shows some encouraging signs as well: the aggregate long in credit has come down against an uptick in inflows, so it's entirely possible that spreads overshoot that target before mid-year.

This month we make some incremental adjustments to our portfolio towards sectors where the risk/ reward is more attractive, whilst reducing exposure to sectors where valuations are tight and fundamentals show signs of strain.

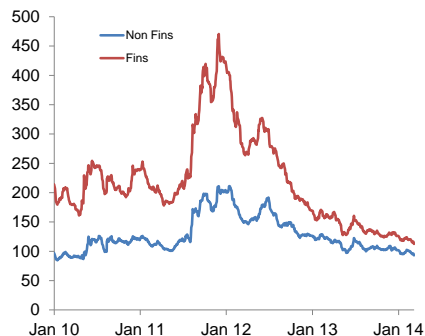
- We remain modestly overweight in Banks, looking to add exposure to the new capital securities via the primary market (as a replacement for some of the best performing non-financial hybrids). Banks will continue to deleverage next year and we expect credit metrics and asset quality to improve. Within the peripherals, we like the Spanish big players on the basis of better asset quality trends than in Italy; moreover, the recent volatility in emerging markets seems more an equity rather than a credit issue. We also remain overweight covered bonds against senior unsecured in peripherals.

- We would maintain just a small overweight in Insurance: fundamentally, this sector is sound, but it is high beta, spreads are now at levels last seen at beginning of 2008 and there is some downgrade risk for players exposed to the periphery because of rating methodology changes, which might lead some bonds (like Generali T1) to fall out of the index.

- Within non-financials, we reduce our exposure to hybrids. In particular, we close our overweight on Bayer's hybrid, which implies reducing our positioning in Healthcare to a small overweight. We move to neutral on Industrials, by closing our overweight on Siemens' hybrid. Industrials are generally sound, but leverage is rising against tight valuations. We reduce our overweight on Linde's hybrid on valuation grounds. We move to a small overweight in Utilities by adding the EDF 5.375% hybrid, which underperformed comparable issues: in general, we like peripheral utilities because we see their fundamentals improving, and spreads are still attractive in spite of their outperformance. We remain neutral on Basic Materials, Consumer Goods, Consumer Services, and Financial Services on fundamentals and valuation grounds. We remain underweight on Oil & Gas and selectively underweight on Telcos and Technology.

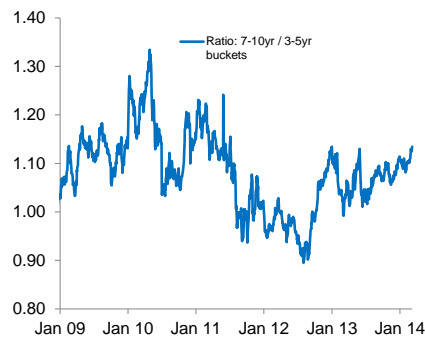
- We still prefer moving down in credit quality to adding duration risk (Figure 4): the breakeven to volatility ratio of short-term bonds is very high compared to longer maturity bonds.

Figure 3. iBoxx € Corps and Fins



Source: Markit, Citi Research

Figure 4. iBoxx € Non Fins Curve Steepness



Source: Markit, Citi Research

## Suggested Picks and Pans

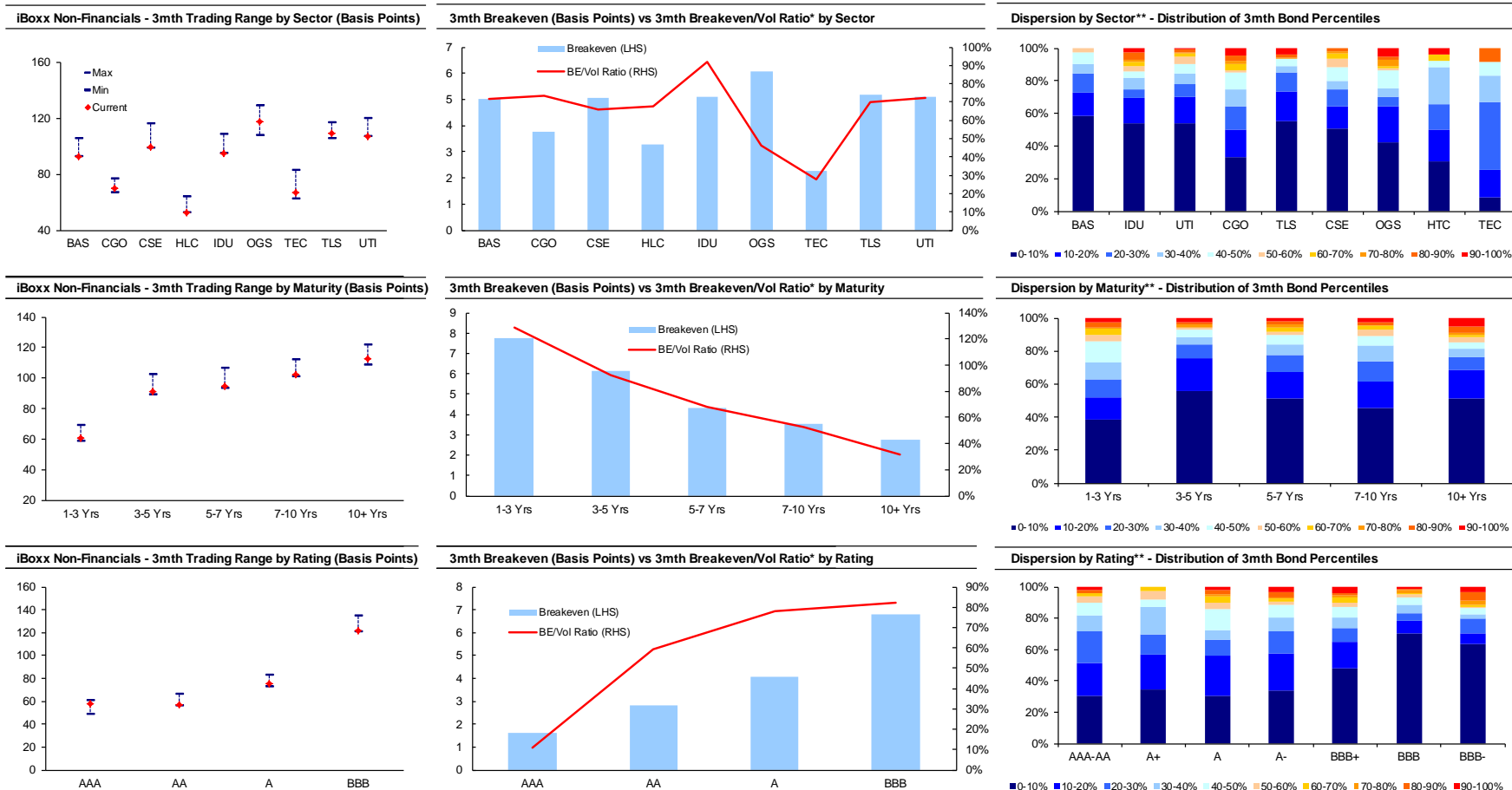
Figure 5. Suggested Picks and Pans<sup>1</sup>

Sector	Position	Picks	Pans
<a href="#">Basic Materials</a>	Neutral	Linde Rio Tinto BHP Billiton	Lanxess BASF Solvay Anglo American
<a href="#">Consumer Goods</a>	Neutral	Imperial Tobacco	Danone
<a href="#">Consumer Services</a>	Neutral	Next Eutelsat	Metro Tesco Reed Elsevier
<a href="#">Health Care</a>	Small Overweight	Roche	
<a href="#">Industrials</a>	Neutral	Alstom Atlantia Hutchinson Whampoa	Schneider Electric Bouygues Atlas Copco Volvo (CDS)
<a href="#">Oil &amp; Gas</a>	Underweight		BP ENI
<a href="#">Technology</a>	Small underweight		Ericsson
<a href="#">Telcos</a>	Small Underweight	Oi KPN	Orange (France Telecom) Belgacom
<a href="#">Utilities</a>	Small Overweight	Enel Gas Nat EDP EDF (hybrids)	E.ON Fortum
<a href="#">Banks</a>	Small Overweight	Morgan Stanley Lloyds Banking Group KBC JP Morgan Barclays Large Spanish Banks	Smaller Spanish Banks Smaller Italian Banks
<a href="#">Insurance</a>	Small Overweight	Talanx	HanRe Munich Re
<a href="#">Financial Services</a>	Neutral		

Source: Citi Research

<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 6. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Non Financials



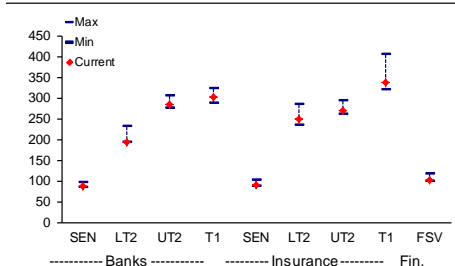
Source: iBoxx, Citi. \* Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

\*\* 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 highs. Dark blue shows the percentage bonds at or very near 3mth lows. Light colours show bonds trading mid-range.

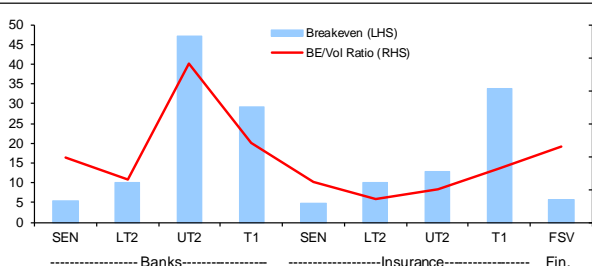
Source: MarkIt, Citi Research

Figure 7. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Financials

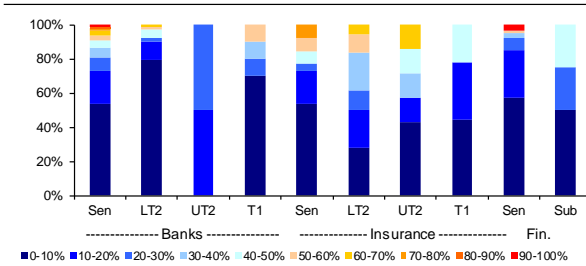
iBoxx Financials - 3mth Trading Range by Sector (Basis Points)



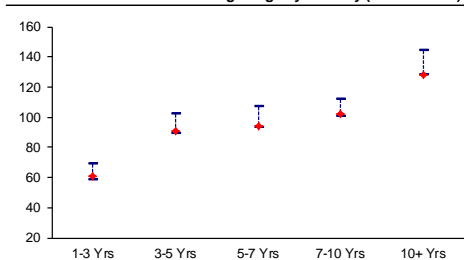
3mth Breakeven (Basis Points) vs 3mth Breakeven/Vol Ratio\* by Subordination+G16



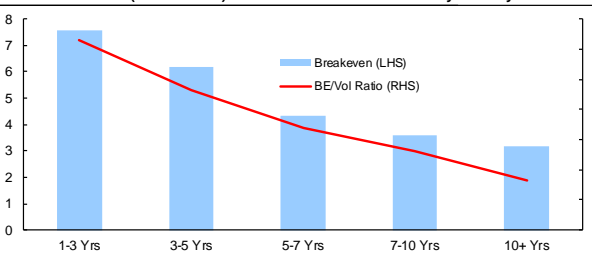
Dispersion by Subordination\* - Distribution of 3mth Bond Percentiles



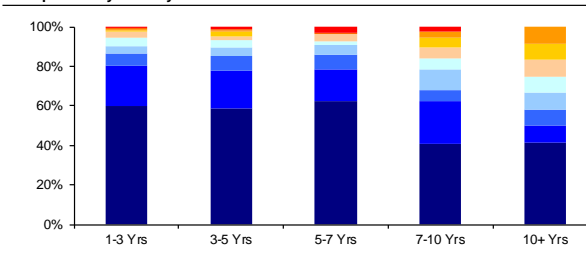
iBoxx Financials - 3mth Trading Range by Maturity (Basis Points)



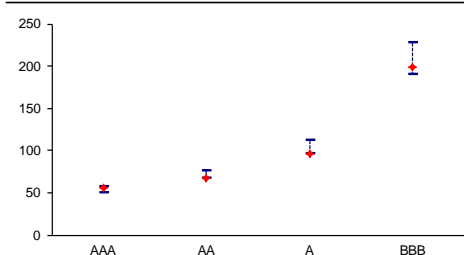
3mth Breakeven (Basis Points) vs 3mth Breakeven/Vol Ratio\* by Maturity



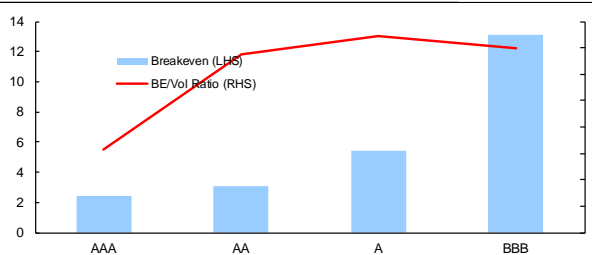
Dispersion by Maturity\*\* - Distribution of 3mth Bond Percentiles



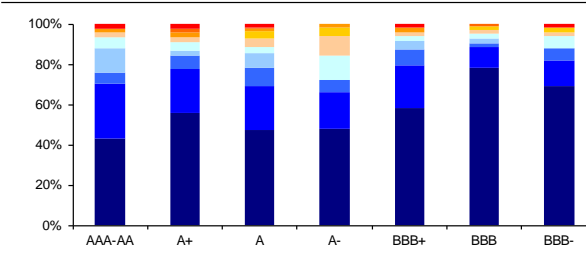
iBoxx Financials - 3mth Trading Range by Rating (Basis Points)



3mth Breakeven (Basis Points) vs 3mth Breakeven/Vol Ratio\* by Rating



Dispersion by Rating\*\* - Distribution of 3mth Bond Percentiles



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 bonds at or very near 3mth tight. Light colours show bonds trading mid-range.

Source: MarkIt, Citi Research

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# Sector Recommendations

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## Basic Materials: neutral

**Remain neutral in Basic Materials: the upside from here is limited**

Basic Materials have outperformed the market over last month, thanks in particular to names like Anglo American, Glencore, International Petroleum and K+S. Demand is showing signs of stabilisation, but it is still very vulnerable to a slowdown in China, and the sector generally suffers of oversupply, in particular on [iron ore](#), which is the main driver of metals and mining performance. However, company fundamentals are improving, commodity prices seem to have stabilised, and demand looks supported by the [global economic recovery](#).

**Company fundamentals are improving, but shareholder friendly activity is more likely**

For these reasons, our equity analysts [turned bullish](#) on metals and mining for the first time in three years: improving bottom-up fundamentals should start to be more evident especially in the second half of the year. However, precisely for this reason, we may see more shareholder friendly activity in this sector. In general, we prefer the globally diversified miners like Rio Tinto and BHP, which are aggressively restructuring their business and where we see a strong commitment to maintain healthy credit metrics.

**Chemicals are likely to engage in more shareholder friendly activity as well**

Demand prospects for [Chemicals](#) are also moderately favoured by the recovery. Our equity analysts expect volume growth of 3-5% YoY in 4Q13. Yet, prices were down 9% in 4Q, in particular butadiene and benzene were down 44% and 12% respectively, while fertiliser prices were stabilising. EBITDA will be mainly driven by company-specific factors like restructuring and cost cutting.

**Reduce overweight on Linde**

We would reduce exposure to Linde's hybrid after the strong performance of the last six months. The company is healthy and its growth prospects are good, but its sales are 40% exposed to emerging markets, while demand from Europe remains sluggish.

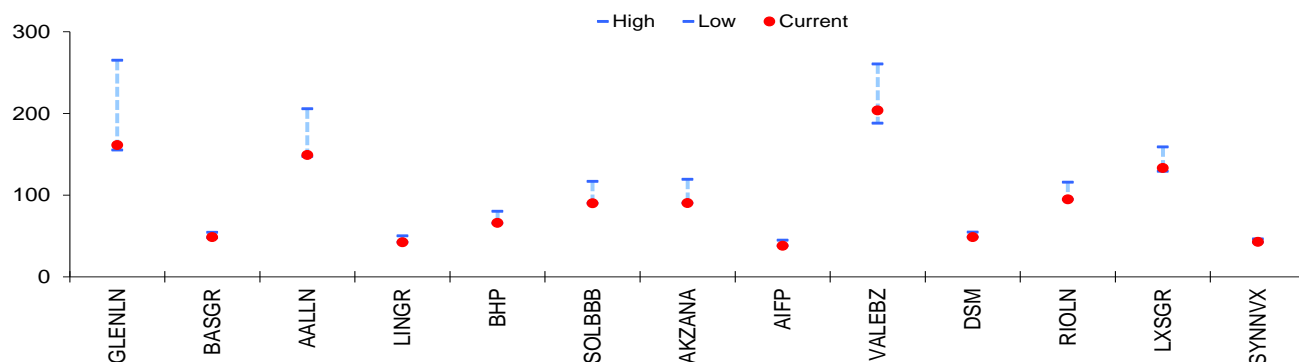
Figure 8. Basic Materials Picks and Pans

Picks	<p><b>Linde:</b> We would reduce our overweight on Linde's hybrid after the strong performance of the last six months. The company is healthy but 40% of its sales come from emerging markets. The sluggish demand from Europe is unlikely to mitigate the negative effects of FX translation on the balance sheet. That said, the growth outlook for this company is healthy and well placed to grow further.</p> <p><b>BHP Billiton:</b> Although Rio Tinto offers better value (admittedly, it has lower ratings than BHP), we think BHP is equally committed to divestitures and cost cutting, as well as reducing net debt. We expect further earnings downgrades due to the weakness in iron ore and coal, but management is committed to improve cost efficiencies and has already started to deliver on this front. <a href="#">Our equity analysts</a> expect net debt to be reduced by \$6bn in FY15. At that point, we may see some share buybacks, but we don't see this as a near-term risk. Bonds have underperformed lower rated and more risky peers in the basic materials universe and we think this is unjustified.</p> <p><b>Rio Tinto:</b> Also Rio Tinto is exposed to iron ore weakness, although it is progressively <a href="#">diversifying itself away from it</a> (our equity analysts expect iron ore to go from being 80% of Rio's divisional EBIT in 2013-14, to 70% in 2015, to less 60% from 2016 onwards). Capex will also decrease – our equity analysts expect it to go from \$13bn in 2013 to \$8.3bn in 2015. Management remains committed to an A rating. We think this conservative strategy will help the company navigate through the challenges of weak commodity markets.</p>
Pans	<p><b>Lanxess:</b> Remain underweight. All the rating agencies have the company on Negative outlook and further downgrade pressure is likely. The company's FY13 results were negatively impacted by significant asset impairments. Moreover, the company reduced guidance for FY14 EBITDA, which will likely trigger earnings downgrades. Our equity analysts expect the supply-demand imbalance for many of its products that is negatively affecting this company to <a href="#">continue in 2014</a> : in particular, they expect global butadiene and synthetic rubber capacity growth in the range of 9-15% this year vs. 3-4% demand growth, so pressure on margins is likely to remain significant in 2014. Moreover, its revenue exposure to emerging markets is quite significant, around 40%.</p> <p><b>BASF:</b> We would maintain our underweight in light of the recent announcement by BASF of its intention to bid for RWE's Dea. The size of the acquisition looks in line with previous deals the company pursued, and we don't see particularly negative implications for leverage in the medium term, so it looks more a near term risk factor. Moreover, <a href="#">although its exposure to Russia seems manageable</a>, sentiment can be hit by the negative news coming from Ukraine as the company has a significant exposure to upstream oil and gas assets in the area.</p> <p><b>Solvay:</b> We remain underweight on the 2104 hybrid, which outperformed the market in the last 6 months, and on senior debt, which is tight to peers. The last results were in line with consensus, but our equity analysts have lowered their EPS forecasts for 2014 and 2015 on higher cost forecasts. Consensus EPS seems still too high and we might see further earnings downgrades.</p> <p><b>Anglo American:</b> Bonds were among the best performers in the basic materials space, together with Glencore and Solvay's hybrid. But the company guided for higher capex for FY14 compared to FY13 (\$7-7.5 bn vs. \$6.3 bn respectively), implying debt increase and cash burn. Net debt guidance was also higher at around \$16-18bn by the end of 2014. To us, the balance sheet of the company remains under pressure, with no evident measures to tackle it. We would prefer Glencore to Anglo.</p>

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

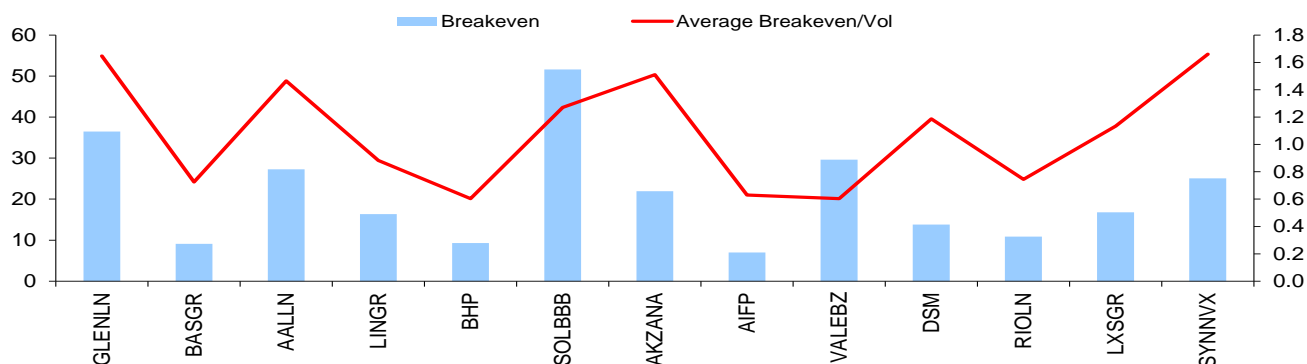


Figure 9. CDS 3mth Trading Range by Sector (bp)



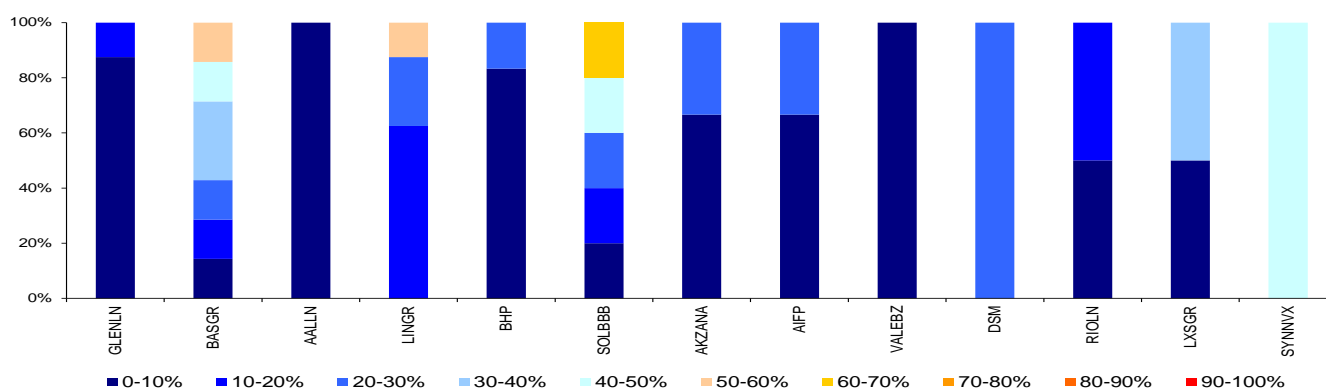
Source: MarkIt, Citi Research

Figure 10. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 11. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Consumer Goods: neutral

### Remain neutral on Consumer Goods

Consumer Goods underperformed the market from September onwards after having reached historical tightness. Within the sector, higher-beta bonds (hybrids, Conti, Renault) generally outperformed. Still, this is the tightest sector of the iBoxx after healthcare. This is justified by its solid fundamentals; however we see comparatively more potential for M&A and increased shareholder returns than in other sectors like Industrials, which offer better value. EM can be an added risk which we don't really find reflected in spreads. Remain neutral.

### Personal & Household Goods earnings season was mixed, but with signs of recovery

In **Personal & Household Goods**, the earnings season was mixed, but with signs of recovery. The recent results by Imperial Tobacco were mixed. 1Q volumes kept declining (-11%), but this was expected and price and product mix supported revenues, which grew by 1%. More relevant for spreads is the potential sale or IPO of the Logista business, which, depending on where funds will be destined, it can help reducing leverage. British American Tobacco results were just about below consensus, but maintained a healthy 7% EBIT growth, thanks to its focus on pricing in mature markets. However, the potential acquisition of the 58% stake in Reynolds it does not already own will impact leverage, and CDS spreads just 3-4 bp off their 5 year tightness do not reflect this. LVMH and Kering are experiencing a recovery in demand, although some brands are still facing difficulties (Gucci and Puma from Kering, for instance). However spreads seem to reflect these concerns already.

### Food and Beverage companies seem more affected by EM concerns.

**Food & Beverage** companies are feeling the pinch of a slowdown in EM more than Personal & Household Goods. FX headwinds and weaker demand from EM have been constant presences of the last earnings season (Danone, Pernod Ricard) [and more earnings downgrades are likely](#). M&A activity is strong in the sector. For instance, although Carlsberg recently enjoyed an impressive growth in organic EBIT, especially thanks to Asia, 2013 cash flows were significantly influenced by M&A activity and future deals may weaken metrics further.

### The outlook for the European auto market is improving

The last data from ACEA show that a recovery in the European car market is under way, with a 5.2% growth in January YoY - the 5<sup>th</sup> increase in a row, although from a low comparable. The best performers were Renault and VW. RCI Banque (Renault) bonds benefit from its strong capitalisation and the recent good performance of Renault car sales. However, these strengths look fully priced in. We prefer Jaguar Land Rover, whose sales globally are growing respectably ([+19% global growth in sales in 2013](#)).

### Close overweight on Pernod and underweight on RCI Banque

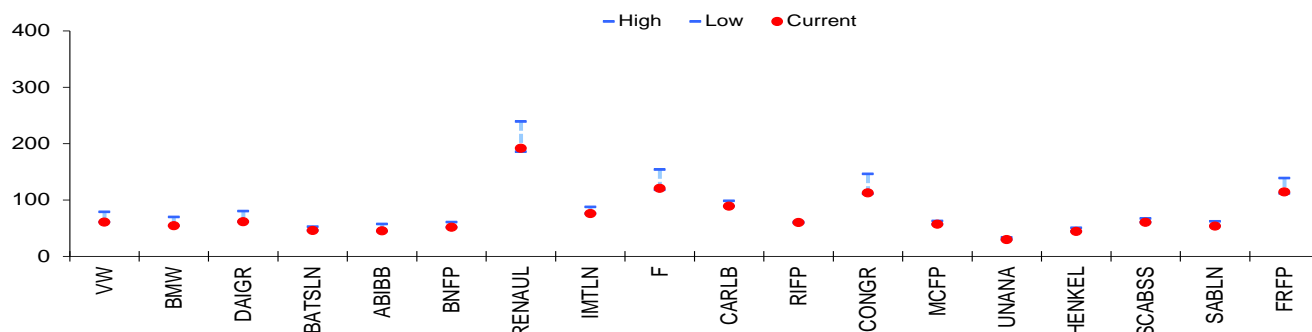
We close our overweight on Pernod Ricard. We still like this company, but spreads are close to their long-term averages and offer little protection against EM deterioration. We also close our underweight on RCI Banque: while we think spreads are uninspiring, the improving outlook of the auto market in Europe and the relatively strong results of Renault suggest that underperformance is unlikely.

Figure 12. Consumer Goods Picks and Pans

	<b>Imperial Tobacco:</b> As expected, 1Q volumes at Imperial Tobacco kept declining (-11%). Product mix supported revenues, which grew by 1%. More relevant for spreads is the potential sale or IPO of the Logista business, which, depending on where funds will be destined, it can help reducing leverage. We like the 2018 and 2019 maturities in particular.
<b>Pans</b>	<b>Danone:</b> Danone profit warned in October and is being hit by its FX exposure. 4Q13 volumes in dairy were below expectations and the beat in Baby was driven by Europe rather than China, indicating ongoing weakness there. M&A risk is another concern to us, which we don't see reflected in spreads. We expect further widening from here.

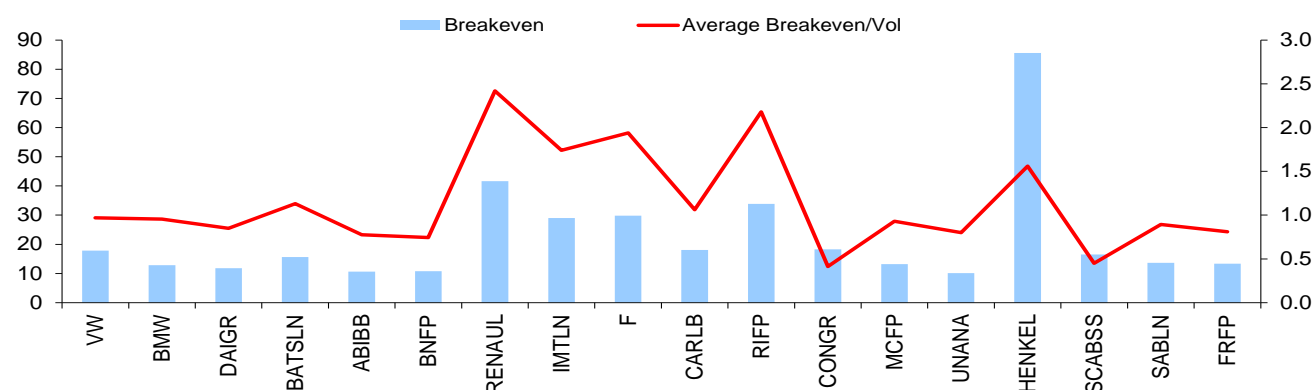
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 13. CDS 3mth Trading Range by Sector (bp)



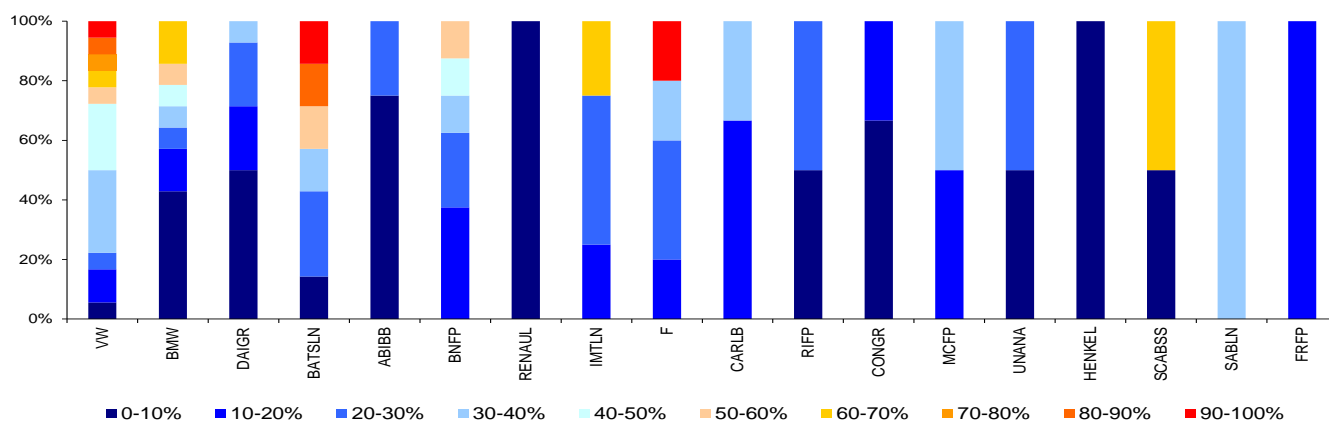
Source: MarkIt, Citi Research

Figure 14. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 15. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Consumer Services: neutral

### Remain neutral on Consumer Services

Consumer Services performed in line with the market since the beginning of the year. We think it is unlikely we will see outperformance from this sector and remain neutral. The challenges facing many retailers (high competition, poor profit growth) are well known, especially in food retail space, but any turnaround will take time and the effect of the European recovery will just mitigate, not solve, them.

### Consumer confidence and purchasing power in Europe are recovering

Consumer confidence in Europe is close to its 2010 highs, suggesting that demand in Europe is stabilising. This is visible in the results of the latest Citi [Household Available Cashflow](#) analysis, and it is likely to benefit the non-food retail space comparatively more than the food space, especially those companies with big online franchises.

### Food retail is the clear underperformer

We would remain more cautious on the food retailers. EM exposure seems to be more an equity than a credit problem, nevertheless the CDS of the most exposed names (Casino, Carrefour, Tesco) widened by 15-20bp in the last week of January, when many EM currencies depreciated. The UK "Big 4" continue to suffer from the [competition](#) of heavy discounters on one side and premium retailers on the other. LBOs may also happen, as shown by Morrison, where the prospect of private equity involvement caused the CDS to shot up by about 90bp. The situation seems a bit better for the French discounters: trade performance at [Casino](#) seems to have leveled off and market share bottomed out, although it didn't provide any specific guidance on FY14 at its last earnings release. Also [Carrefour](#)'s business is showing signs of stabilisation, with LFL sales improving in Spain and a good performance in French hypermarkets. However, spreads seem to incorporate these improvements already, especially for Casino.

### Remain neutral on Media

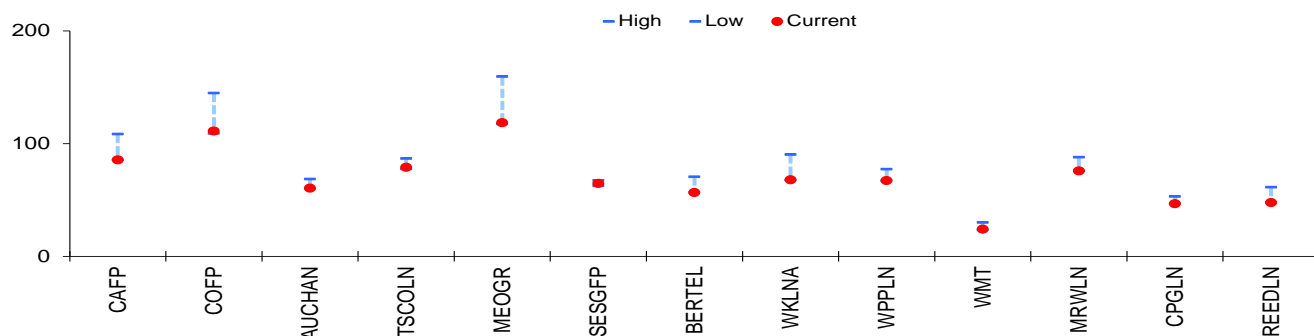
Our equity analysts turned more positive on Media, especially on the ones most exposed to DM, as macro trends are supporting sales growth. However, we would be wary of EM exposure (like [WPP](#)) as negative FX headwinds are likely to hinder revenue growth. There is also potential for M&A and other shareholder-friendly activity.

Figure 16. Consumer Services Picks and Pans

Pick	<p><b>Next:</b> Although the company is taking a more shareholder-friendly stance, we think it is supported by the strong sales performance, and we don't expect it to have a significant impact on leverage. Spreads mostly reflect Next's strengths already, but this remains one of the few bright stars in a challenged sector.</p> <p><b>Eutelsat:</b> the good 1H14 results encourage us to maintain an overweight. Revenues were in line with expectations, and capex was materially below consensus. Net income missed expectations due to tax related matters. The company is guiding for 2.5% revenue growth in 2013-14, which we think is achievable. The company benefits from a backlog of more than 4 years. SES as well reported a solid set of results, but we prefer Eutelsat on valuation grounds.</p>
Pans	<p><b>Metro and Tesco:</b> In <b>Metro</b>, We maintain, but scale back, our underweight on the widening of the 2017 and 2018 maturities. We acknowledge that this company is deleveraging by divesting part of its real estate portfolio. But 2014 guidance looks <a href="#">optimistic</a> (+7.5% EBIT on our equity analysts calculations) and cash flow was weak in 1Q13/14, although it may be due to working capital issues. <b>Tesco</b> was the clear loser of Christmas trading and the political difficulties in Thailand, to which Tesco has some exposure, may weigh on FY13/14. Against such news, bonds seem tight, especially the 2047 bond which we expect to widen further. The recent sale and leaseback transaction of Homeplus in Korea does not help credit metrics, in our view, and we are concerned that the company might engage in more of these transactions. These help short term liquidity but are negative for credit metrics in general.</p> <p><b>Reed Elsevier:</b> CDS spreads have widened by 6bp since the end of January, but bonds widened just 3bp. Its last results were healthy, but the company just announced an aggressive share buyback plan for 2014 (a further £500m through 2014 on top of the £100m it announced back in January). Together with the dividend, it means that all the <a href="#">£1.2 bn FCF of Reed Elsevier is being returned to shareholders</a>. Net debt/EBITDA is now 2.1x, at the bottom of the comfort zone the company has guided for (2.1x-2.5x), so there is scope to re-leverage.</p>

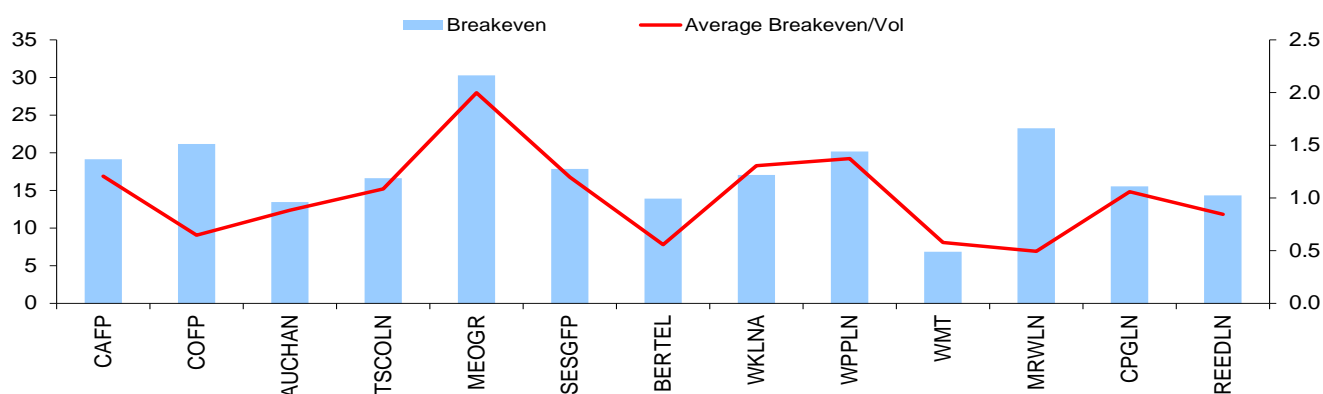
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 17. CDS 3mth Trading Range by Sector (bp)



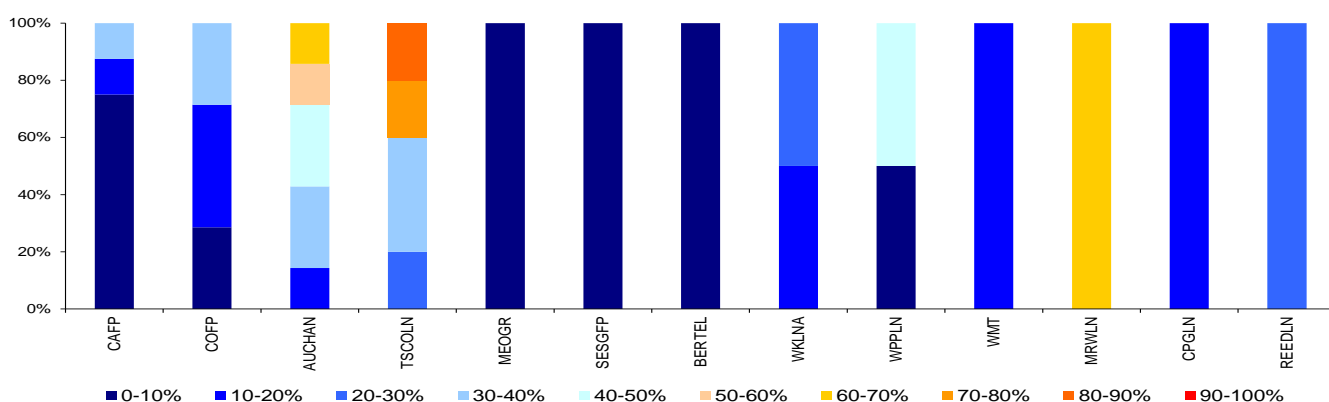
Source: MarkIt, Citi Research

Figure 18. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 19. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\*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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month highs, while dark blue shows the percentage of bonds very near 3-month lows.

## Healthcare: small overweight

### Move to a small overweight on Healthcare via Roche

The underperformance of healthcare companies versus the iBoxx since August has brought spreads to their six month highs versus the index. We maintain a small overweight on Roche. But we move to neutral on Bayer and remain neutral on the remaining names.

### Most of the risks for demand come from DM; EM demand remains solid

In terms of geographical exposure, we think Pharmaceuticals face risks from DM, Europe in particular, where fiscal austerity is hurting demand. This is pushing European companies to diversify into generics. On the contrary, although demand growth from EM slowed down since 1Q13, we [can still expect healthy growth rates](#) from this area. Also demand from US remains healthy.

### There is potential for M&A, but the risk is manageable

The risk of M&A is increasing though, as low yields provide cheap financing for expansion in growth areas like cancer immunotherapy (a rapidly growing field where Roche has a competitive position). However, most of the firms have the financial flexibility to manage medium-sized M&A in our view; therefore we don't see these as a major problem.

### Close overweight on Bayer's hybrid

We close our overweight on [Bayer's hybrid](#). The weak 4Q results are not of particular concern to us as the company has a strong credit profile, can count on new launches in healthcare and has several products which could be launched soon. However, the spread on the hybrid rallied strongly since the beginning of February and now it is one of the tightest in the non-financials universe space.

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Figure 20. Healthcare Picks and Pans

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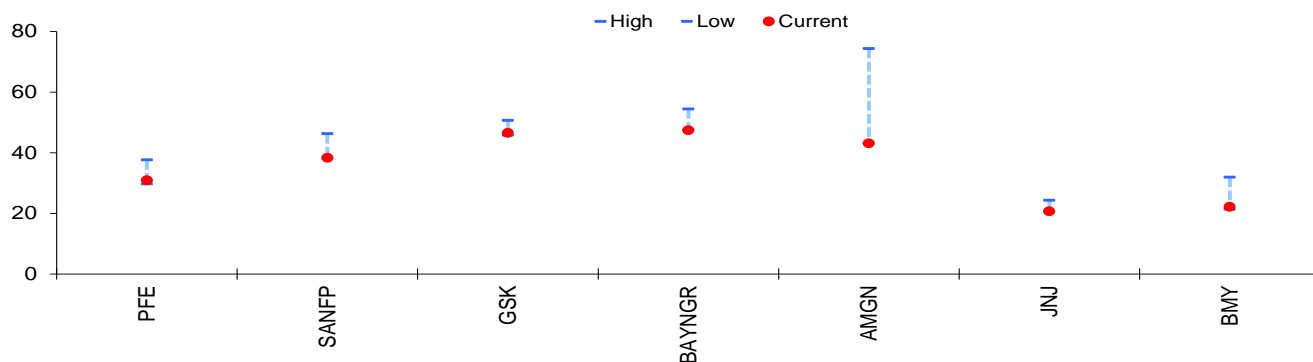
Picks	Roche: We remain overweight. It has quite a strong pipeline for blood cancer drugs, Alzheimer's, etc. and we see an opportunity in the development of <a href="#">immunotherapy drugs</a> which the company is actively pursuing.
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Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

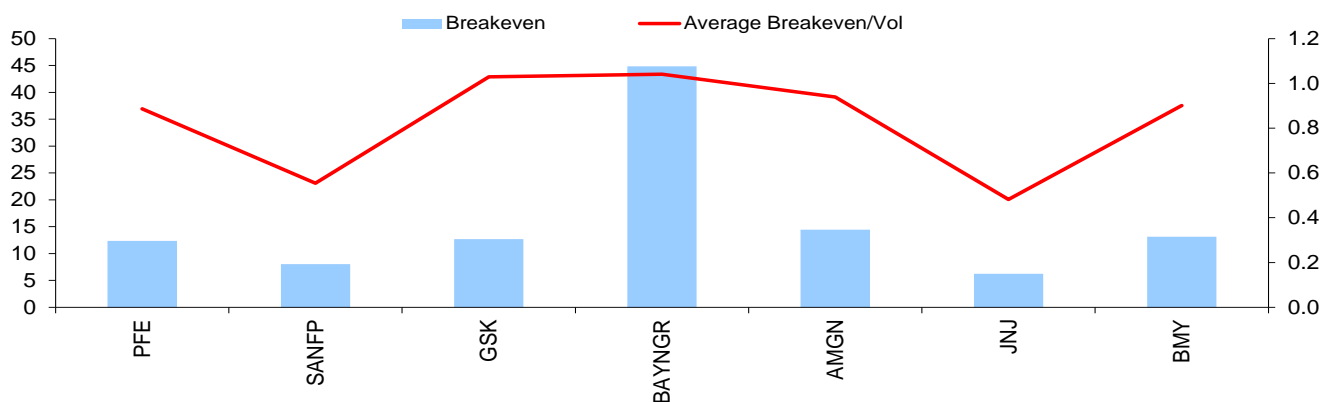
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Figure 21. CDS 3mth Trading Range by Sector (bp)



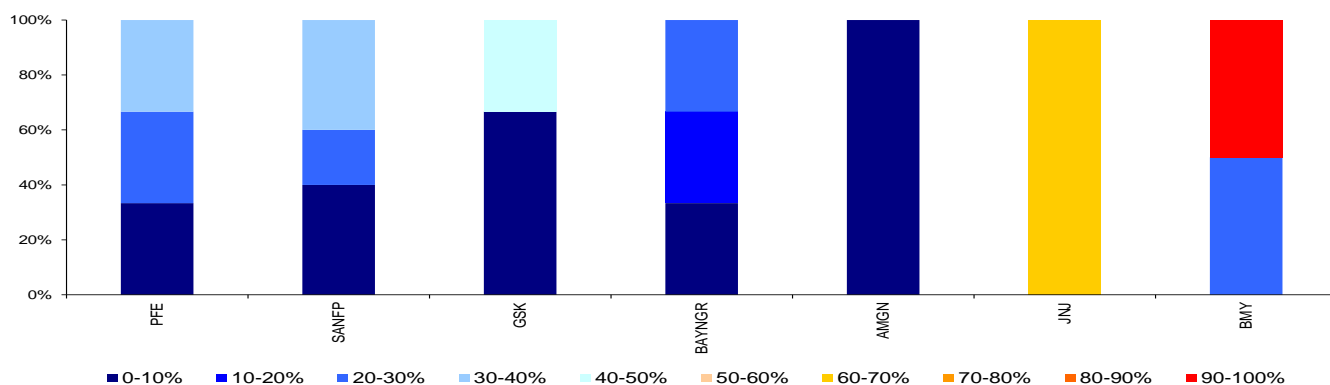
Source: MarkIt, Citi Research

Figure 22. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 23. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Industrials: neutral

### Move to neutral on Industrials

While most periphery exposed companies (Abertis, Atlantia) have consistently outperformed peers over the last six months, the low beta part of the sector has underperformed, together with Alstom and Vinci. We like the sound fundamentals of Industrials, and we prefer them to Consumer Goods as M&A risk seems lower, and valuations better. However, we move to neutral because this sector is re-leveraging somewhat faster than others.

### Industrials are increasing leverage

As shown by our [study on leverage](#) in Europe, while on average credit quality remains strong, Industrials are among the sectors where we are seeing leverage increasing, in particular in Construction companies. We don't expect credit quality to deteriorate massively from here. But the trend is evident, and does not support further outperformance.

### We remain bearish on mining capex

It's hard to become more positive on mining capex yet. Our [survey](#) indicates that 2014 will still see significant demand pressures. Although the rate of decline shows some signs of deceleration, over the past 3 months a number of the key mining companies announced capex cuts. And 57% of our survey's respondents said that they are considering lowering capex budgets further.

### 2014 should see an improvement in demand for cement companies

2013 EBITDA growth in cement companies has been muted; however 2014 should show some signs of demand stabilisation from US, [UK](#), Germany, Poland. FX headwinds weighed heavily on companies like Lafarge and Heidelberg Cement and remain a risk.

### Reduce overweight on Alstom; close overweight on Siemens' hybrid

Alstom bonds have recovered marginally since the profit warning and we would use the tightening to reduce our overweight. We also close our overweight on Siemens' hybrid on valuation grounds.

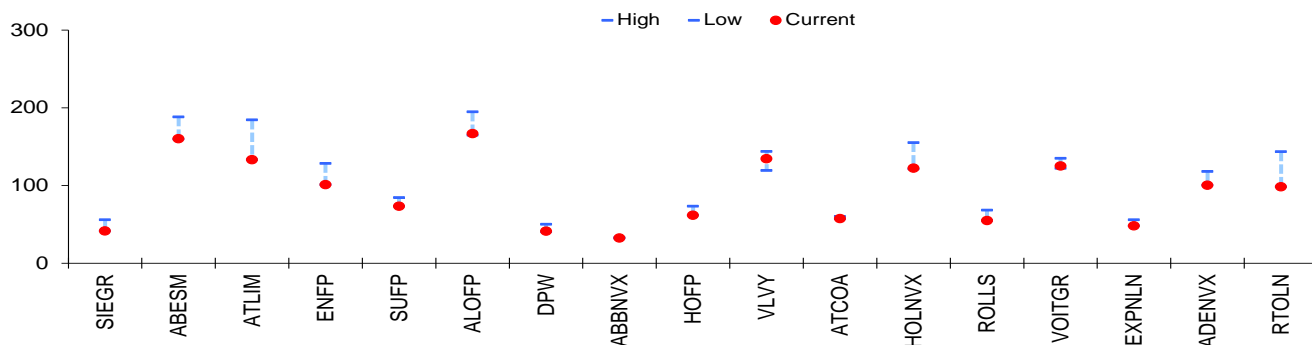
Figure 24. Industrials Picks and Pans

Picks	<b>Alstom:</b> Given the uncertainty on future cash flows, we would use the recent tightening to scale back our overweight somewhat. Yet the company is committed to selling assets (the company is currently discussing <a href="#">the sale or IPO of a stake in its Transport business</a> , from which it could raise between €700m-€1,900m) and management comments suggest that they might cut dividends. There has also been a talk of a potential rights issue. We think the company has flexibility to defend its credit metrics.
	<b>Hutchison Whampoa:</b> Remain overweight on the hybrid. It has an acquisitive strategy and some EM exposure. However, rating agencies guided that the company is able to manage bolt-on acquisitions within its rating. This company gets 50% of its revenues from Europe. Results beat expectations and the company is planning an IPO of 25% of the retail division A.S Watson & Co, whose proceeds could be used to fund its acquisitions.
	<b>Atlantia:</b> We remain overweight. Atlantia has a more conservative financial policy than Abertis, and will benefit from improving growth prospects now that merger with Gemina is completed. Moreover, Italian traffic seems to be bottoming out, and margins have remained stable even in 2012, the year of the largest traffic drop in Italy.
Pans	<b>Volvo:</b> Jan '14 truck deliveries came out surprisingly strong at +26% YoY, although admittedly versus easy comparables. The company is also delivering on its cost cutting program and is actually ahead of expectations already, according to <a href="#">our equity analysts</a> . Yet we find it unlikely that demand will recover significantly from here, therefore bonds and CDS so close to its <a href="#">July 2011</a> levels are not attractive, in our view.
	<b>Schneider Electric and Atlas Copco:</b> remain underweight <b>Atlas Copco:</b> this company is one of the most exposed to EM, both in mining capex and in other sectors like Compressors. It maintained a flat guidance for 2014, suggesting ongoing challenges. Orders intake continued to decrease, and the company expects more production cuts in the Mining and Rock division. The cost cutting plan seems insufficient to improve the situation. We would reduce our underweight on <b>Schneider Electric</b> at the shorter maturities, which have widened more than the longer ones. The last results were in line with consensus, with growth coming from North America and Asia, where the residential market is growing and the non-residential is stabilizing. However, the outlook for the company remains uncertain and the recent FY14 guidance seems aggressive, therefore we remain underweight.
	<b>Bouygues:</b> Price competition in France remains fierce as shown by the recent very advantageous 4G offer by Free (4G access at no additional cost, plus increased data allowance) and the new offers that Bouygues plans to launch. The ongoing difficult trading conditions make us bearish on the French telecoms space in general. Most of Bouygues bonds are tight versus their 6 month history.
	<b>PostNL:</b> PostNL is continuing with divestitures. It recently sold part of its TNT Express stake after the sale to UPS failed last year. Perhaps the company will do more divestitures, but we think spreads are tight, especially in the CDS space. They don't offer much protection for execution risk in our view. The sharp drop in the equity market on its last earnings release suggests the market is not comfortable with the outlook, and we expect the uncertainty to be reflected in credit as well.

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

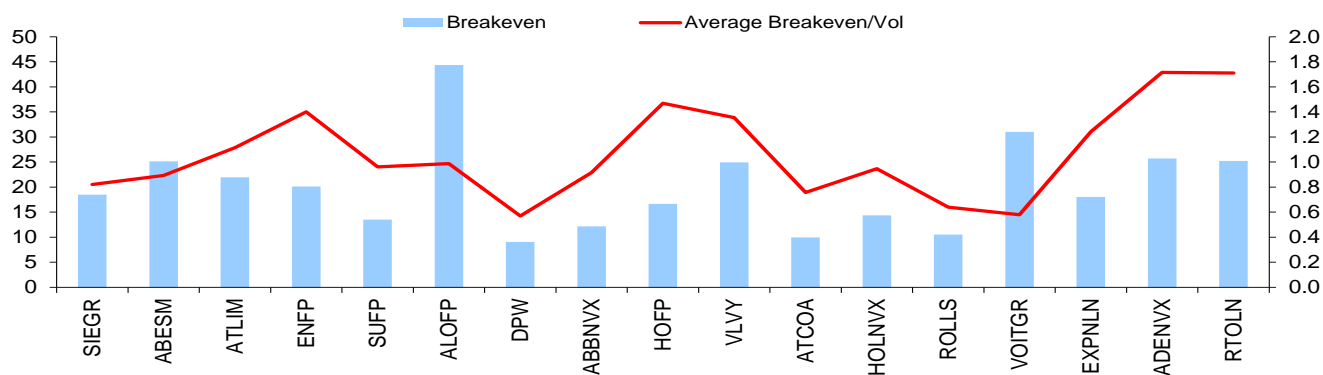


Figure 25. CDS 3mth Trading Range by Sector (bp)



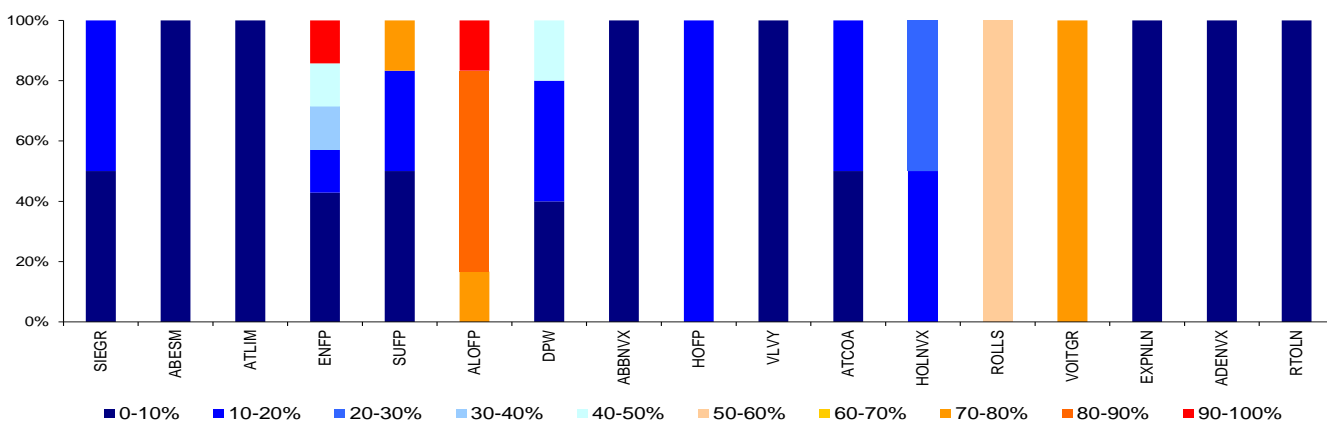
Source: MarkIt, Citi Research

Figure 26. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 27. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Oil & Gas: underweight

**Maintain underweight on Oil & Gas, but close underweight on OMV**

Oil & Gas spreads are widest among non-financials and we expect them to continue underperforming the iBoxx as they have done in the last couple of years. Oil prices are recovering and this supports sentiment, however most of the value is in EM companies (Petrobras, Pemex, Gazprom), on which we remain cautious given the challenging outlook and the weak technical. We close our underweight on OMV, given that spreads have underperformed remarkably over the last six months, but overall remain negative on the sector.

**Citi upgraded its forecasts for Brent prices; the Ukraine situation may offer further support**

Citi has recently [revised](#) its forecasts for Brent prices up to \$103/bbl from \$98/bbl for 2014 and to \$95/bbl from \$93/bbl in 2015, reflecting better demand and some supply issues. In the short term, oil demand is being supported by the economic recovery and bad weather in US. Geopolitical tensions may well [impact](#) prices, especially in case of export sanctions against Russia. However, this would also increase risks of retaliation for the many oil companies which have assets in Russia. We suspect Russia's position as the number to exporter globally, after Saudi Arabia, makes any lasting supply disruptions very unlikely. There may be a more meaningful risk to gas supplies to Europe. We still regard it as comparatively low, but it may help to support prices.

**The earnings season was only mildly positive**

There isn't much to cheer about for European companies. The earnings season for the main European oil producers has been only mildly positive against low expectations, and earnings expectations continue to be downgraded.

**Capex is still too high**

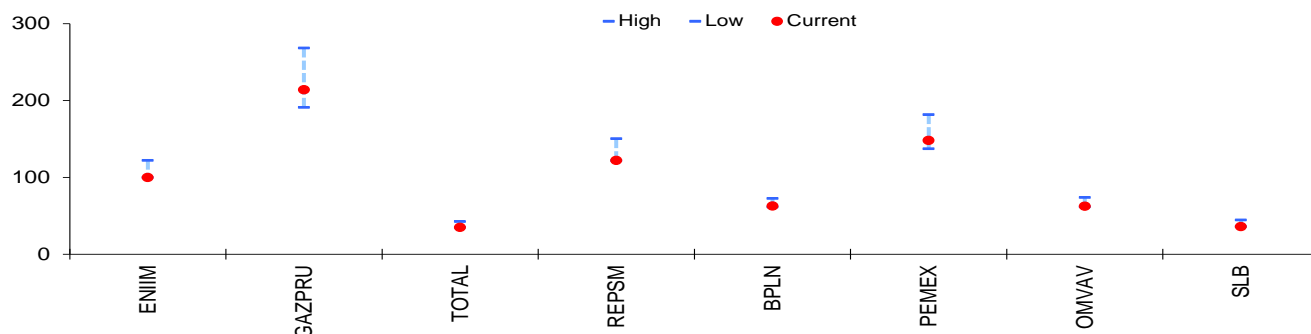
The capex commitments of the oil industry as a whole remain high and sticky. Some companies have acknowledged the problem and have started to cut on it (Shell, Total). Other companies (ENI) are funding it with asset sales and own funds.

Figure 28. Oil and Gas Picks and Pans

Pans	<p><b>ENI:</b> although the last results were more or less in line with consensus, ENI's earnings were negatively affected by several disruptions in its E&amp;P business, which is already suffering from slow demand. The company is funding its extensive capex plan with asset disposals and internal funds, so we don't expect net debt to increase much from here. But the outlook feels muted at best, and this company is one of the few outperforming ones in the Oil &amp; Gas space over the last 6 months, which seems unjustified given its challenges.</p> <p><b>BP:</b> We would reduce our underweight on BP as bond valuations are now wide to their six month history and in acknowledgment that earnings power at this company seems to be recovering. But we remain concerned about the need this company has to ramp up investments in order to support operating cash flow. Admittedly, BP will partly fund these investments with asset disposals: however, our equity analysts believe that the cash flow growth BP can expect from its portfolio is just 3-4%, just enough to cover current dividends, but below what peers can achieve. For this reason, we are concerned that the company may feel the pressure to reward shareholders via re-leveraging.</p>
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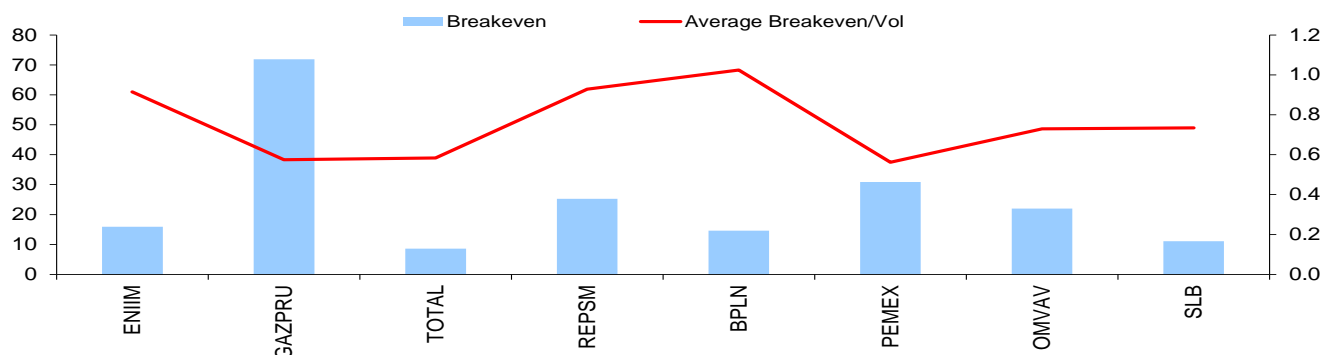
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 29. CDS 3mth Trading Range by Sector (bp)



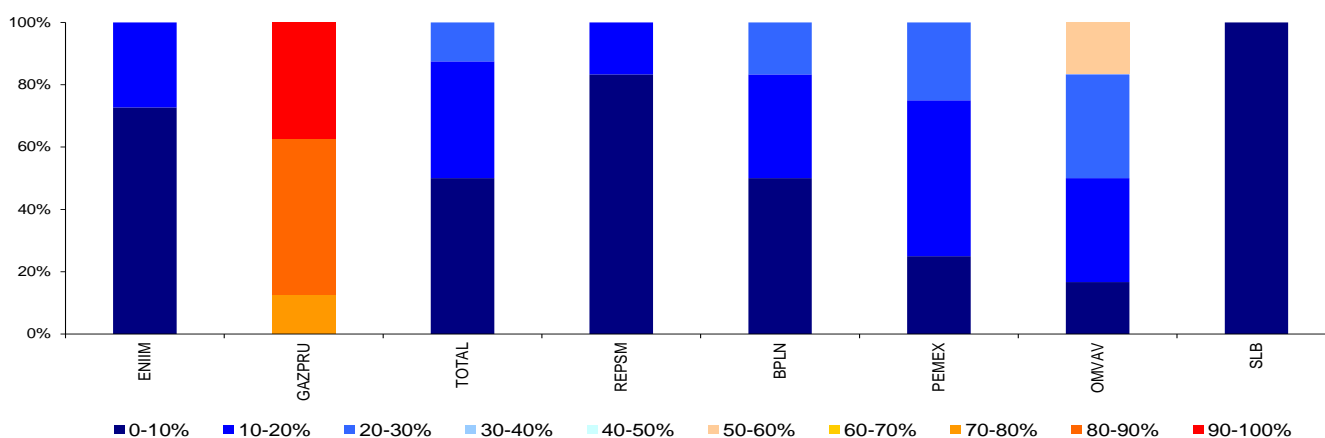
Source: MarkIt, Citi Research

Figure 30. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 31. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Technology: small underweight

**Maintain a small underweight on Technology: M&A risk is on the rise**

We like the strong fundamentals of this sector, which benefit from very low leverage. However we believe the easy access to debt this sector enjoys, together with its good cash position, creates a favourable environment for [M&A](#), particularly for the most mature companies like IBM or CapGemini. Remain moderately underweight: most of the bonds mature in or after 2020, as spreads are the second tightest of the universe after Healthcare.

**Company-specific drivers make us uncomfortable with the sector at current levels**

Company-specific drivers as well make us not very comfortable with this sector at current levels. Microsoft recently appointed Mr. Nadella, a company insider, as CEO, while preserving a strong role for Mr Ballmer and Mr. Gates. So we wonder how much he will be willing to move beyond the current Window-centric strategy and expand in cloud computing.

**Revenues at Ericsson are likely to be flat next year, CapGemini maintained its FY guidance, but bonds are very tight**

Ericsson delivered a strong set of 4Q results, thanks to strong licensing revenues and some one-off items from an agreement with Samsung on some intellectual property right infringements. However, excluding the settling, Ericsson actually missed expectations. Our equity analysts believe revenues will be flat at best this year, due to tough comparables. Ericsson faces also a very competitive pricing environment and is guiding for an increase of 8-9% YoY in R&D expenses for this year. We acknowledge that the scarcity of the bonds and the relative illiquidity of the CDS might make it hard to express a negative view, not least because of its very strong balance sheet, but we would be cautious on this company at current levels.

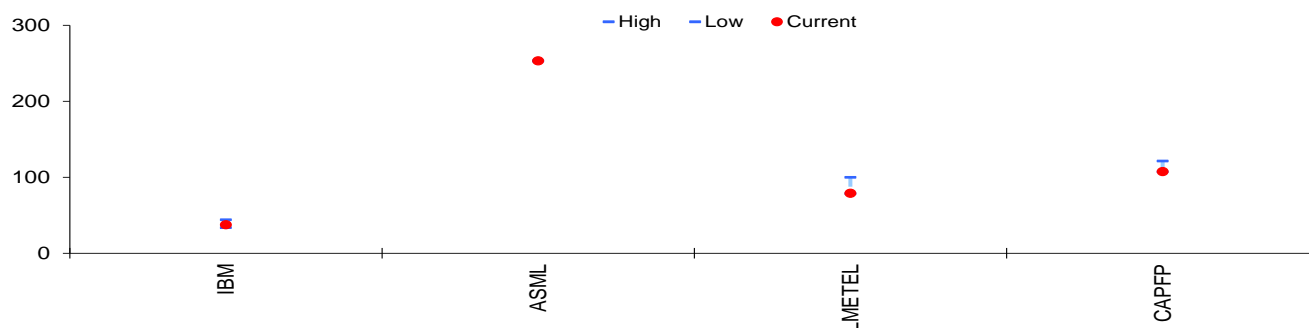
CapGemini maintained its full year guidance at its last sales and revenue release in November. But spreads close to their 2 year tightts look uninspiring, especially as there is a possibility that it may engage in M&A.

Figure 32. Technology Picks and Pans

Pans	Ericsson: We acknowledge that the scarcity of the bonds and the relative illiquidity of the CDS might make it hard to express a negative view on this company, not least because of its very strong balance sheet, but even after the underperformance of October and November, current levels seem too tight versus its recent history, given that the growth prospects for this company into 2014 look not very inspiring. We would be underweight the bonds. CDS is also quite tight versus its history and we don't find the risk/reward very inspiring
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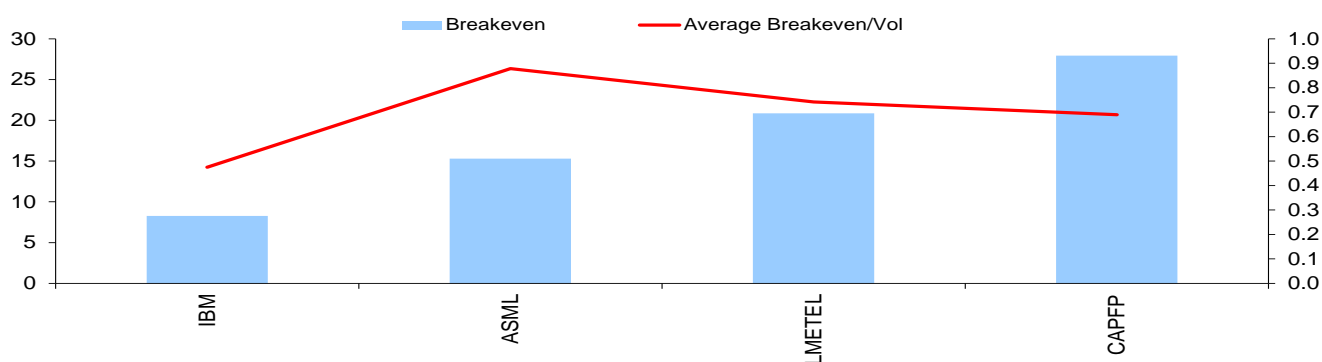
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 33. CDS 3mth Trading Range by Sector (bp)



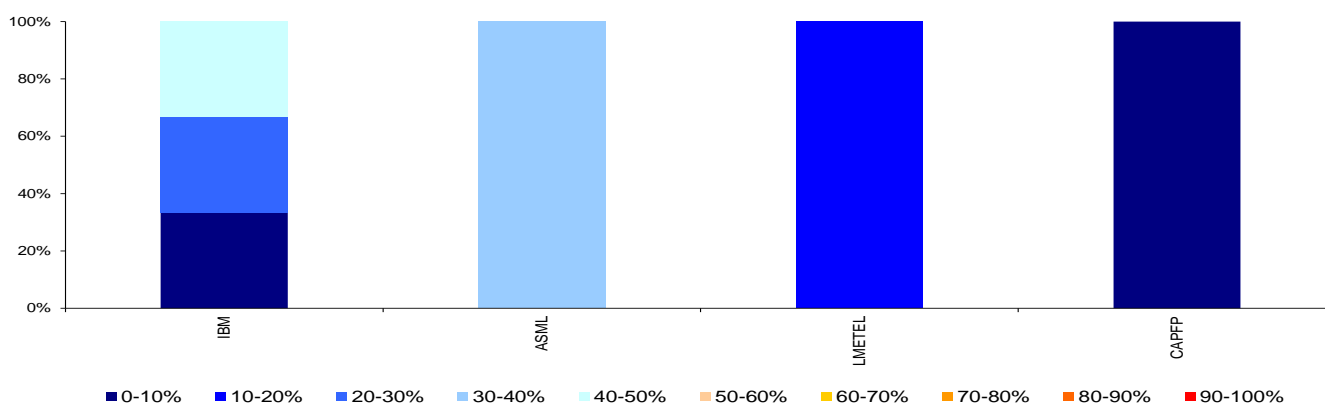
Source: MarkIt, Citi Research

Figure 34. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 35. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Telecoms: small underweight

**Telcos trade at similar spreads to Utilities on average, yet risks seem higher**

The fundamental outlook for telcos seems uninspiring: the sector continues to be plagued with high competition and low margins. Most of telco companies (57%) missed lowered expectations. Event risk in this sector remains high. Yet, the sector is trading at spreads similar to Utilities, where earnings expectations seem to have bottomed, companies are deleveraging and event risk is lower. Maintain a small underweight.

**Competition pushes capex up, but it is hard to monetize it**

Stiff competition implies that companies need to increase capex to maintain market share, but low pricing power often makes it difficult to monetize the expenditure. Our equity analysts are generally bearish on this front, even on well-established players like Vodafone. 2014 guidance is likely to be cut down further. However, given telcos' limited financial flexibility, we expect more equity and hybrids issuance, especially from KPN, Telekom Austria, Telecom Italia and Telefonica.

**Consolidation is a long-term positive, but event risk is high**

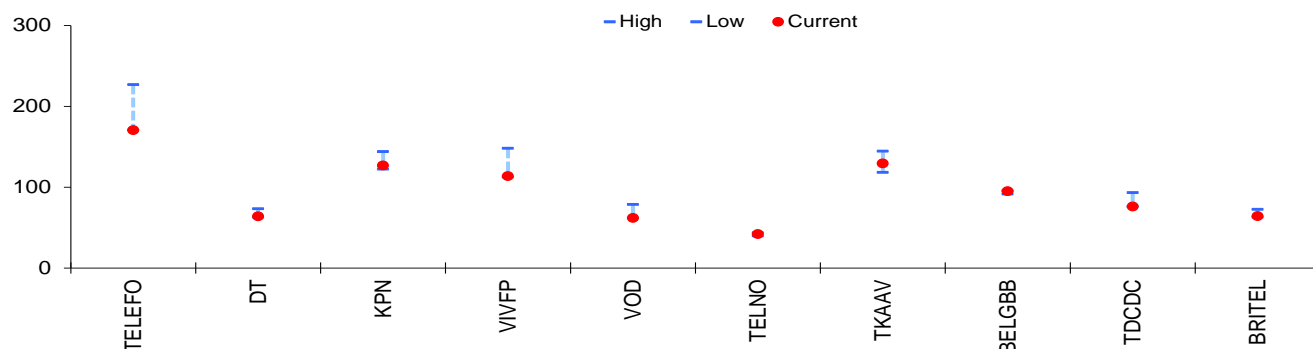
Consolidation should ease competitive pressures in the medium term, and benefit especially the weaker players. However, we worry that M&A activity is going to weigh on spreads, especially in the current scenario of limited financial flexibility within current ratings and valuations and easy access to debt. Moreover, we are concerned that in a context of easy access to debt, the incentive to reward shareholders rather than bondholders remains even though credit metrics are under pressure from weak or negative EBITDA growth. For this reason, we prefer to maintain a small underweight on the sector as a whole.

Figure 36. Telecommunications Picks and Pans

Picks	<p>Oi: spreads widened in January following the turmoil in EM, however they rallied again in February. We would continue to reduce the overweight on the tightening. We are not particularly concerned about the company and we don't see imminent threats in the short term, but we think sentiment on the company is likely to reflect the wider EM outlook. We find better value in the \$ bonds.</p> <p>KPN: we like KPN senior and hybrids. The last results were broadly in line with consensus. Although revenues are generally suffering from the presence of "no-frills" brands in the Dutch market, the fixed line business remains solid. The company cut capex guidance in and is engaging in disposals. Moreover, AMX's commitment to KPN is likely to continue, according to management's comments. Another bid cannot be excluded. The sale of E-plus to Telefonica Deutschland is another tailwind, although the deal may face the opposition of European regulators. Management, however, is confident that the deal will be approved.</p>
Pans	<p>Orange (France Telecom): Remain underweight. <a href="#">Revenue trends</a> at the company remain weak and our equity analysts expect Orange to revise down its 2014 guidance. Citi expect net debt to EBITDA to edge higher at 2.16x in 2014. Revenue trends are likely to remain weak, and Citi expects them to decline by about 5%. Competition in France is worsening as Bouygues will likely cut prices as well. Cost cutting measures are not enough to offset this.</p> <p>Belgacom: Remain underweight. The market is extremely competitive in Belgium and although Belgacom's market position is good, we think aggressive pricing could damage its profitability. We do not feel that this is adequately reflected in spreads.</p>

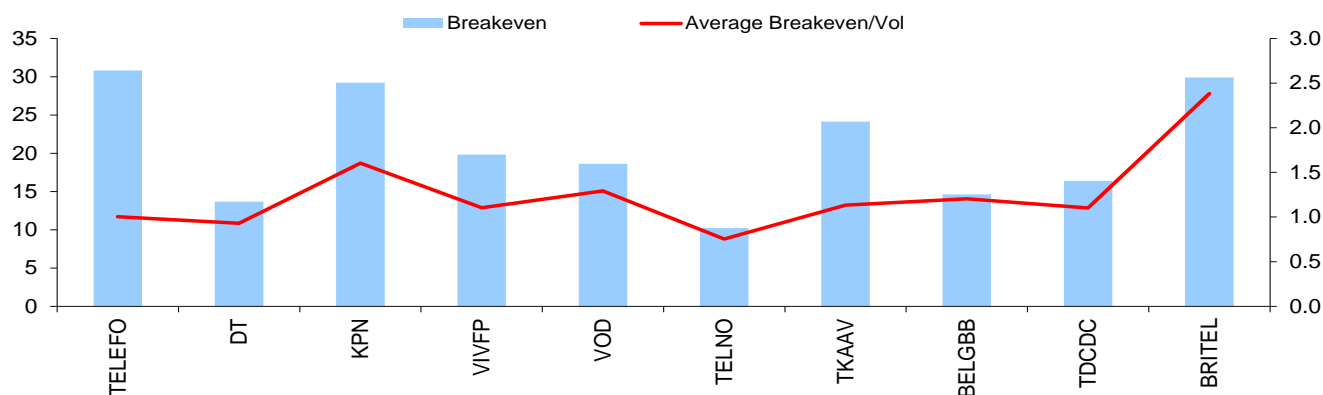
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Figure 37. CDS 3mth Trading Range by Sector (bp)



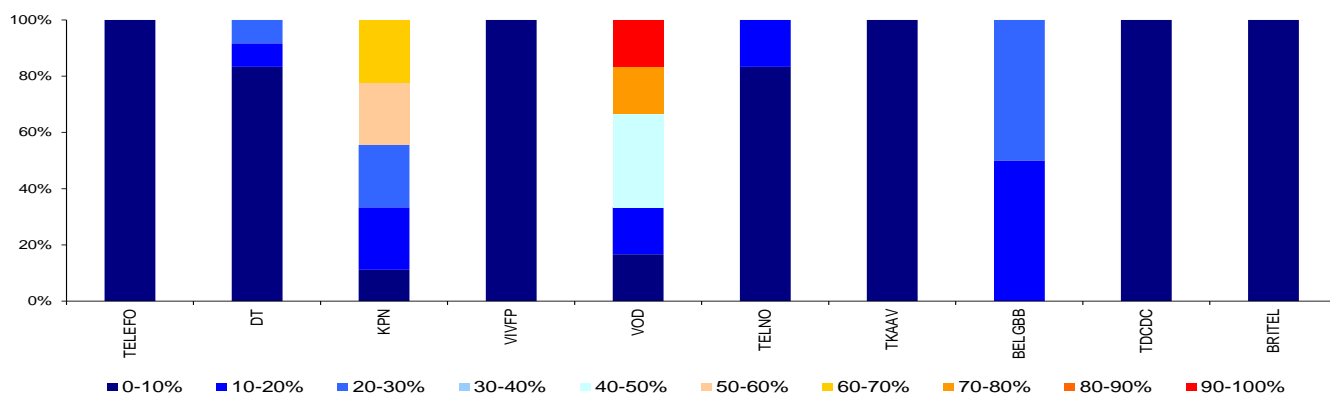
Source: MarkIt, Citi Research

Figure 38. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 39. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

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## Utilities: small overweight

### Move to a small overweight in Utilities

Over the last month Utilities outperformed the market in particular in the high beta part of the sector (junior bonds, peripherals). We think select hybrids still offer value, and would be overweight. Overall, we move to a small overweight.

### Structural and regulatory challenges, but 2014 should be the bottom year

From a fundamental perspective, utilities continue to grapple with poor growth and high leverage. But our [equity analysts](#) predict 2014 will be the bottom for earnings, expecting a decline of 4.3% (versus -8.9% in 2013), followed by a recovery to +5.5% in 2015. The decline in consensus expectations is slowing. Subdued inflation and declining power prices should mitigate the risk of regulatory intervention (at least in Europe ex-UK) and low interest rates favour debt management.

### Peripheral utilities are deleveraging more aggressively than core ones, but this starts to be reflected in valuations

Battered by sovereign risks, peripheral companies have been more conservative and proactive than core utilities in cutting their capex and managing their leverage. With sovereigns now having stabilised, peripheral utilities offer the most compelling risk return profile, in spite of their outperformance in the last months. However, some company specific drivers need to be taken into account.

For instance, we would prefer Gas Natural to Iberdrola. Although Iberdrola is making some progress on deleveraging through non-core disposals, it is more exposed to the Spanish tariff deficit and is more dependent on renewables, a sector which has seen State subsidies heavily curtailed.

Among the other peripheral companies, we would close our overweight on [A2A](#): leverage at this company is increasing due to a contraction in EBITDA, as weak electricity prices in Italy were only partly compensated by an improved hydro output and management efforts might not be enough to mitigate this. Our equity analysts believe earnings growth to lag the sector over the next couple of years.

### Financial conservatism will continue next year

Financial conservatism will continue to be a key topic this year, especially for peripheral companies. We are likely to see more equity issuance and asset disposals, and we don't expect transformational M&A in this sector.

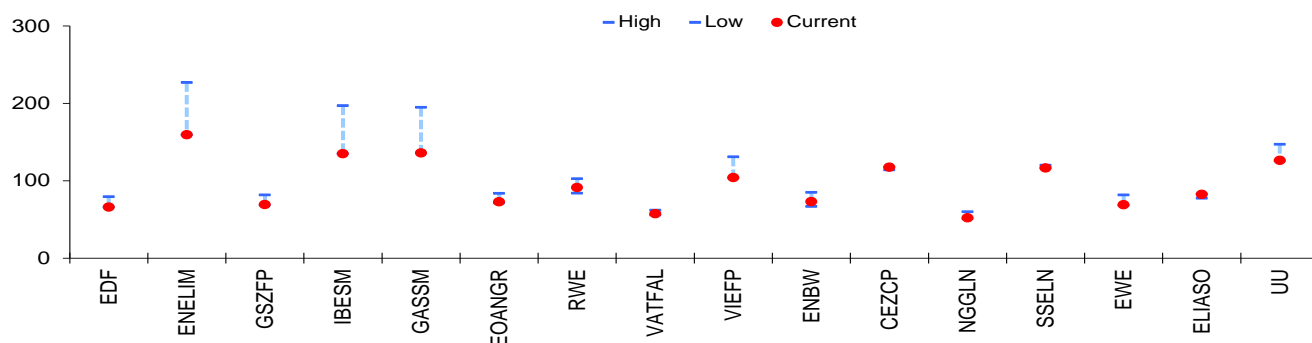
Figure 40. Utilities Picks and Pans

Picks	Enel: the company is suffering from some headwinds on FX and is experiencing some margin pressure in Spain. However, our equity analysts believe its 2015 targets (EBITDA of €16bn, net profit of €3.3bn and net debt of €37bn in 2015) are achievable thanks to cost reduction, although there is some downgrade risk depending on the impact of the Spanish Energy Reform. The company benefits from good liquidity and a favourable maturity profile.
	Gas Nat: It delivered a solid FY13, showing a recovery in its Spanish electricity and gas operations. Its exposure to the Spanish tariff deficit is relatively modest compared to Iberdrola. The upcoming gas market reform in Spain poses some risks but we think they will be manageable
	EDP: its commitment to deleveraging, capex cutting and its favourable earnings trends paint a supportive picture. It recently sold off a part of its Portuguese tariff deficit receivables, highlighting its commitment to improve credit metrics. Its exposure to the Spanish Energy Reform might pose some risks, but we would be buyers on any spread weakness.
	EDF: Although they recovered some lost ground in the last month, we like the hybrid bonds relative to peers: probably the bonds have underperformed because of recent high new issuance in this space from EDF, but we don't expect the company to issue more hybrids for now. The FY13 numbers were solid, and management guided for a 3% growth in EBITDA for 2014, which is in line with <a href="#">Citi's expectations</a> .
Pans	E.ON: Remain underweight. The company has shown a strong commitment to deleveraging by almost completing its deleveraging plan. However, the decline in earnings is material and unlikely to revert for now. Spreads remain among the tightest of the space, in spite of their underperformance versus the iBoxx recently. We expect it has further to run. However, we would express a negative view on the German electricity market through E.ON rather than RWE, as the planned sale of Dea could provide a positive catalyst for RWE.
	Fortum: After announcing the sale of its Finnish business, Fortum is still engaging in asset sales. Management indicated that proceeds will be used to repay debt. This is supporting spreads, but we believe they remain tight against disappointing operational results. In spite of the poor earnings outlook, the company also increased its dividend, showing an equity-friendly attitude. We would reduce our underweight on the longer maturities, but the shorter ones offer no value in our opinion, and we remain underweight.

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

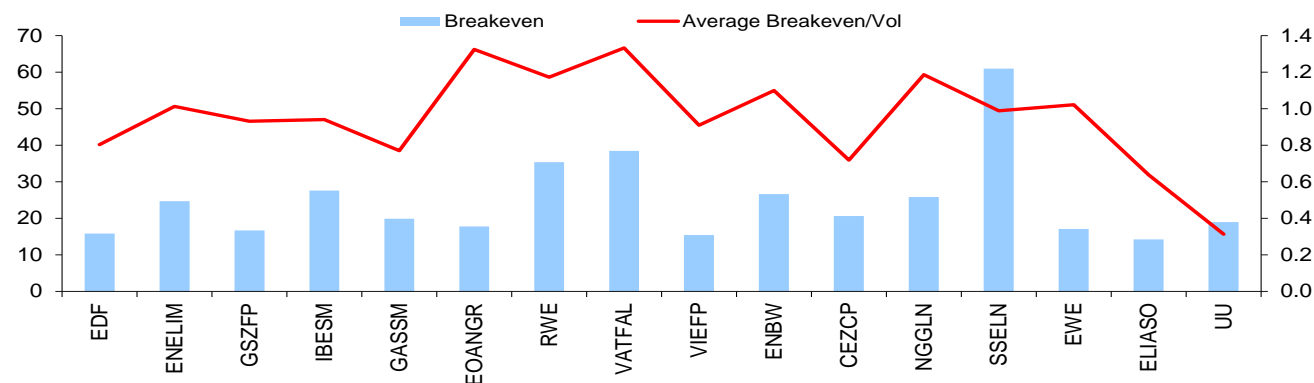


Figure 41. CDS 3mth Trading Range by Sector (bp)



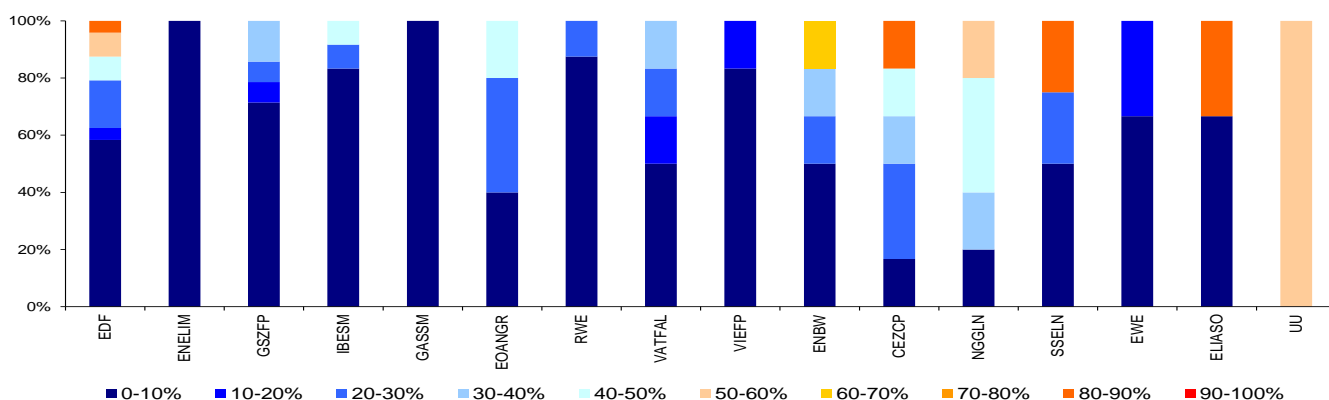
Source: MarkIt, Citi Research

Figure 42. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 43. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

## Banks: small overweight

### Maintain a small overweight on Banks

Banks have underperformed the market last month. Senior bonds were the relative underperformers: apart from specific stories like Hypo Alpe Adria, most of the underperformance comes from the core names. Junior bonds on the contrary, outperformed across the board, apart from Erste Bank and Raiffeisen.

We would maintain a small overweight in this sector by looking to add exposure in the new AT1, maintaining our overweight into T1 and LT2 (away the high cash-price bonds with call risk) and covered bonds and remaining underweight senior bonds.

### The earnings season reflects increasing provisioning ahead of the AQR

The earnings season reflected the need for peripheral banks to prepare for the upcoming AQR. Although earnings surprises have been mostly negative, many banks have strengthened their balance sheet by increasing provisions for bad loans and reclassified assets more conservatively. We have also seen banks announcing rights issues, especially in Italy, where asset quality trends have been deteriorating. Earnings for core and soft core banks were in line or marginally ahead of consensus. Overall, capital ratios are improving and some banks (especially the Nordics) are or are planning to increase dividends. Although loan demand remains weak, the last [lending survey](#) by the ECB shows that banks credit conditions are slowly improving. This will have positive effects on net interest income over time.

### Peripheral banks will still be exposed to weakening asset quality

These trends give us more comfort regarding the outlook for peripheral banks in general. We remain more concerned about Italian banks versus Spanish ones: political instability, a higher proportion of corporate loans versus consumer and comparatively [worse economic growth prospects](#) are likely to weigh on asset quality for the next couple of years, and we expect more loan reclassifications and increasing provisions as more details on the AQR emerge, although the decision of some banks to engage in rights issues is a positive. Spanish banks seem comparatively better positioned in terms of asset quality trends: our equity analysts believe that asset quality deterioration should stop in 2015. Moreover, the [recent volatility in emerging markets](#) seems more an equity rather than a credit issue. We would take advantage of this by selectively going overweight on [CaixaBank](#), [BBVA](#) and [Santander](#), which underperformed Italian banks recently.

### Prefer covered to senior bonds in the periphery

We still prefer covered bonds to senior in the periphery. The spread differential is still too small to induce us to ignore the relative safety of covered bonds vs. senior, especially given the bail-in provisions included in the RRD.

### Focus on primary market to get exposure to new junior bank capital

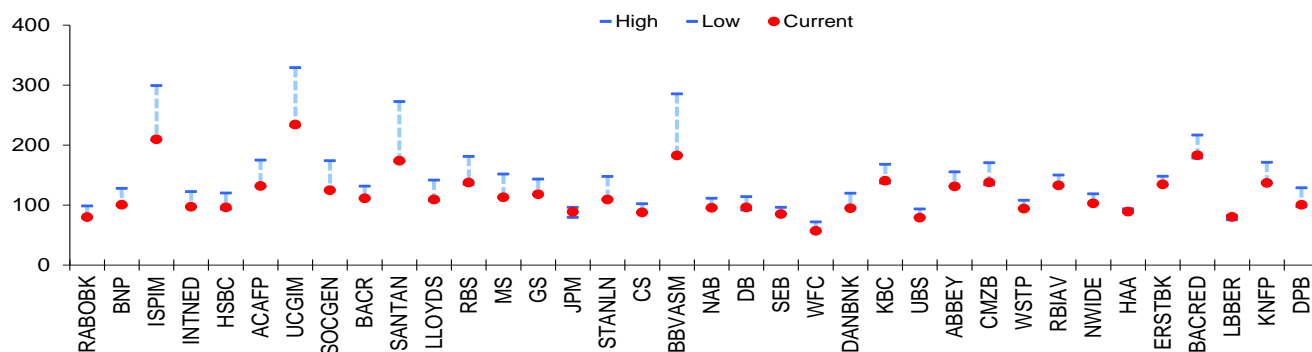
Several of the strongest banks (DB, CS) seem to have taken a more aggressive approach to capital optimization by calling old bank capital at or just slightly above par, making us more selective in maintaining our exposure to old style capital securities. Favorable LMEs are still more likely at weaker peripheral banks, as they try to facilitate the issuance of new capital securities.

Figure 44. Banks Picks and Pans

Picks	<p><b>Morgan Stanley:</b> Remain overweight on MS. Spreads are slowly converging to Goldman Sachs, but we would expect MS to trade inside Goldman Sachs as its de-risking strategy progresses. The implementation of the Volcker rule is encountering uncertainties and difficulties, but the fact that S&amp;P is keeping Morgan Stanley on Negative outlook ahead of it is not a major concern to us: we don't expect spreads to react significantly to a downgrade related to this issue. Another driver of the rating is the progress on the Ordinary Regulatory Authority: as for other US banks, we might hear more comments from the rating agencies as more details are released by the Fed. But we think that both the market and the rating agencies have come to terms with the fact that government support is likely to be much less than before.</p> <p><b>JP Morgan:</b> <a href="#">We still like the LT2 bond in particular, which trades in line to Goldman Sachs LT2 bond</a>, in spite of the higher ratings and lower business risk. Its last results were just slightly ahead of consensus; however the high number of litigation and other one-time charges might have negatively affected sentiment. Our equity analysts see potential for strong growth in 1H14.</p> <p><b>Barclays:</b> we still like the \$-denominated T2 CoCo and the LT2 bonds in general. Barclays has just achieved a PRA leverage ratio of 3%, but it is targeting a 3.5% for 2015. Capital was 9.3%, and they are guiding for 10.5% in 2015. We expect the company to issue more Basel III compliant issues which may offer a good entry point to get exposure to this bank. Although results were tainted by weaker investment bank and retail profits, Barclays is also making progress on asset reduction and on capital. We would be more cautious on the T1 non steps after that management remarked that they see value in legacy hybrids as loss absorbing capital. This suggests they might become LT2 capital rather than being called. These bonds sold off at the announcement, but we don't see an opportunity there..</p> <p><b>Lloyds Banking Group:</b> Results were in line with expectations. We note in particular the improvement in impairments (-22% QoQ, -59% YoY) and in NPLs. Although bonds rallied a lot over the last six months, we remain overweight, as sentiment on Lloyds is likely to stay positive. Many bonds are still trading at levels similar to Barclays, while they should trade inside. In CDS, it already <a href="#">happened</a>. Lloyds is continuing in its deleveraging process, net interest margins are improving and we think we will continue to see consensus upgrades on this name.</p> <p><b>KBC:</b> Although capital levels at KBC remained flat over the last quarter, we continue to like this company as it is progressively mendsf. The loss in 4Q was widely expected and was driven by an increase in loan loss provisions at KBC Ireland. The company will likely <a href="#">repay all the state aid</a> by the end of 2014. The EC embargo on calling bonds expired on the 31<sup>st</sup> December, opening up new opportunities for capital management exercises. This is why <a href="#">we like the T1 bonds</a>. However, the trade might take a bit of time to perform, as the company may opt not to call any bonds during the AQR.</p> <p><b>Larger Spanish Banks:</b> Our economists are marginally more positive on the economic prospects for Spain than for Italy. According to our equity analysts, Spanish NPLs should peak in 2015. Moreover, their profitability seems to be improving, thanks to higher loan yields and (mostly) lower deposit costs. On the contrary, we expect Italian asset quality deterioration to remain a concern in the next couple of years. We think <b>BBVA, Santander, and Caixa Bank</b> are the best Spanish banks to reflect these improved trends: their capital position is strong. We expect more LMEs and new issuance in the new capital securities space. While the rally in old style securities we have seen recently suggests that investor friendly LMEs have been probably priced in, <a href="#">we would look with interest at new issuance of capital instruments from these banks</a>.</p>
Pans	<p><b>Smaller Spanish and Italian banks:</b> The difficulties the Italian and Spanish economies still face make us uncomfortable with the smaller players in these economies. We believe asset quality and profitability will remain under pressure in the next future, counterbalancing the deleveraging efforts of these banks. For this reason, although we do not expect the upcoming AQR to pose systemic challenges to the European banking system, we think the weaker peripheral players are most at risk. In terms of seniority, we find the senior bonds particularly uninspiring, given tight valuations and bail-in risk. <a href="#">We maintain our neutral on the Italian larger players</a>.</p>

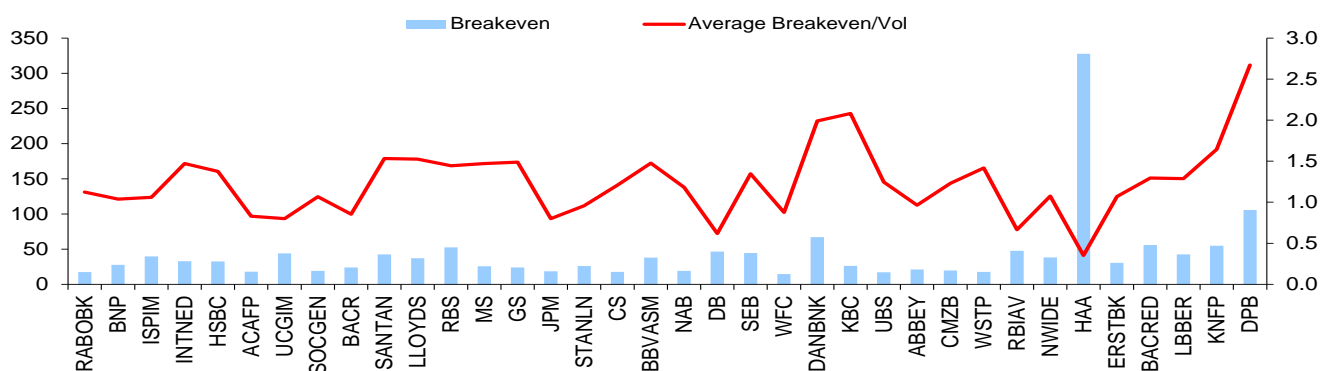
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 45. CDS 3mth Trading Range by Sector (bp)



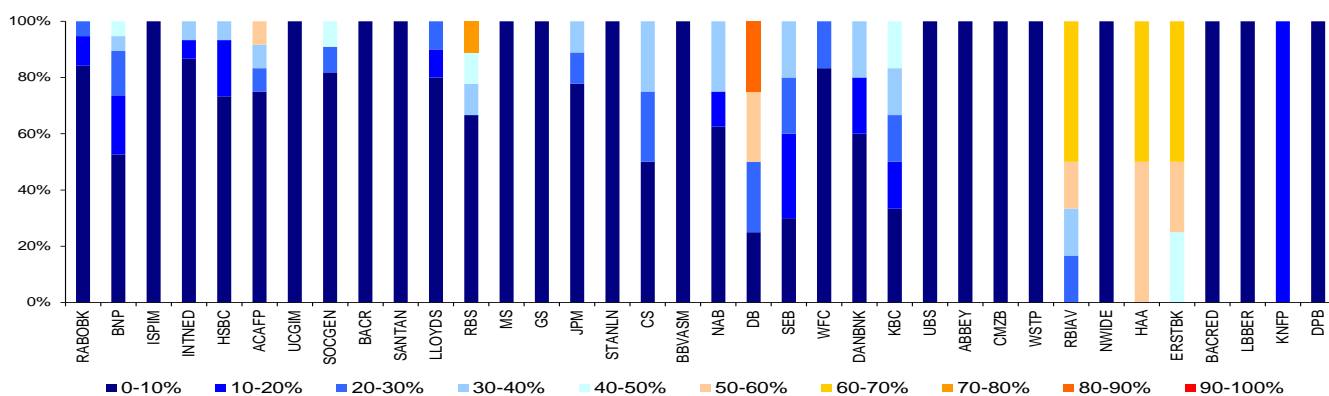
Source: MarkIt, Citi Research

Figure 46. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 47. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

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## Insurance: small overweight

### Reduce overweight on Insurers

Insurers outperformed the iBoxx last month; spreads are quite close to levels last seen in early 2008. We don't really see a significant trade opportunity here; however we are reassured by the fact that the consensus long appears to have been [reducing](#) this year. We recommend a small overweight.

### We think Insurers are in better shape than Banks

Fundamentals in the sector support tight valuations and are set to improve further. Although Insurers [are more or less in line](#) with Banks at the moment (apart from T1, where insurers are more expensive), we think they are in better shape. Unless it gets further delayed, the vote on the Omnibus II directive should bring more clarity on regulatory capital, which however is quite strong. The credit metrics of the sector remain healthy and we see room for further improvement. Profitability should rise further, thanks to prudent underwriting, strong pricing trends and cost efficiency. Rising investment rates and a supportive macro scenario are likely to have a positive effect on the asset quality and returns of insurers' portfolios. The low yield environment has indeed pushed many of them into illiquid and riskier assets.

Relatively speaking, the life insurers will see less of a benefit, as they will have to contend with competition from other savings products. However, as long as the rise in interest rates is gradual, they should have the flexibility to adjust to the new environment. Reinsurance is another area where we see limited upside at current levels, essentially because valuations are tight (against, admittedly, very strong fundamentals) and we see some weakness in pricing trends.

### Sovereign risks are decreasing, but downgrade risks are still relevant

Some uncertainty regarding sovereign related rating actions lingers on the names where sovereign risks are more relevant. Overall, sovereign exposure is less of a problem for insurers than for banks, but S&P recently revised its criteria on rating corporates above their own sovereign rating, introducing a sovereign default stress test on the corporates. This led the rating agency to place Generali on credit watch negative. The end of the review period has been pushed to the end of March. In case Generali does not pass the stress test, its senior S&P rating would be capped by the Italy one, likely implying that the subordinated bonds would be downgraded to high yield and leave the iBoxx Corp. At current spreads, we think such risk is not properly priced in, and we would prefer to wait for when S&P should resolve the credit watch. We would prefer the [SLHNVX 5.849% 29/4/49](#) to Generali's T1.

### Remain cautious on Dutch insurers

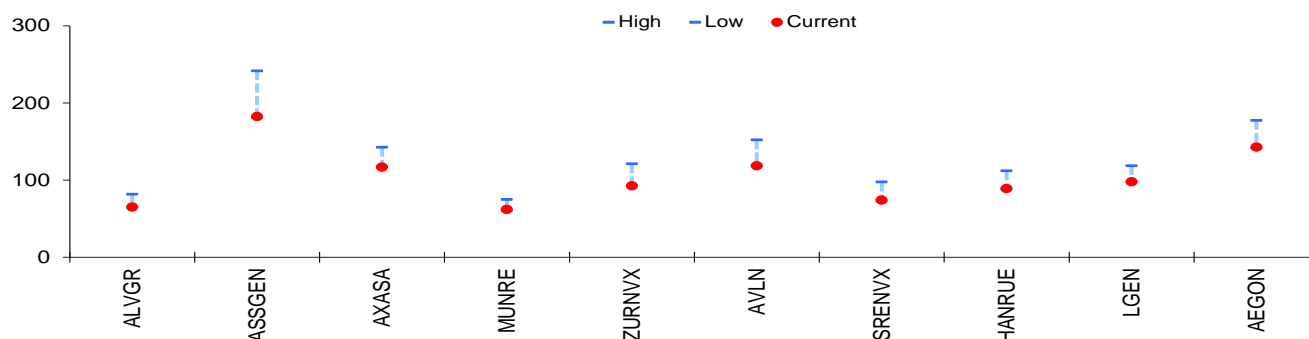
We remain cautious on Dutch insurers, as the unit linked compensation issue is not resolved yet, the Dutch economy is sluggish and Solvency 1 ratios are under pressure.

Figure 48. Insurance Picks and Pans

Picks	<b>Talanx:</b> Earnings prospects for this company remain strong and the large losses occurred in 2013 are likely to improve pricing in 2014. It is carrying on a cost cutting program which should deliver €245m by 2016, according to <a href="#">our equity analysts</a> . We like the LT2 bond in particular.
Pans	<b>HanRe and Munich Re:</b> We like their strong credit metrics. But they trade very tight to history and peers, and this does not seem to reflect the comparatively tougher business conditions of reinsurers. There are no negative catalysts in sight, but at current spreads we think there are better opportunities elsewhere in Financials. Low funding costs could be an incentive to enhance shareholders' return at the expense of bondholders.

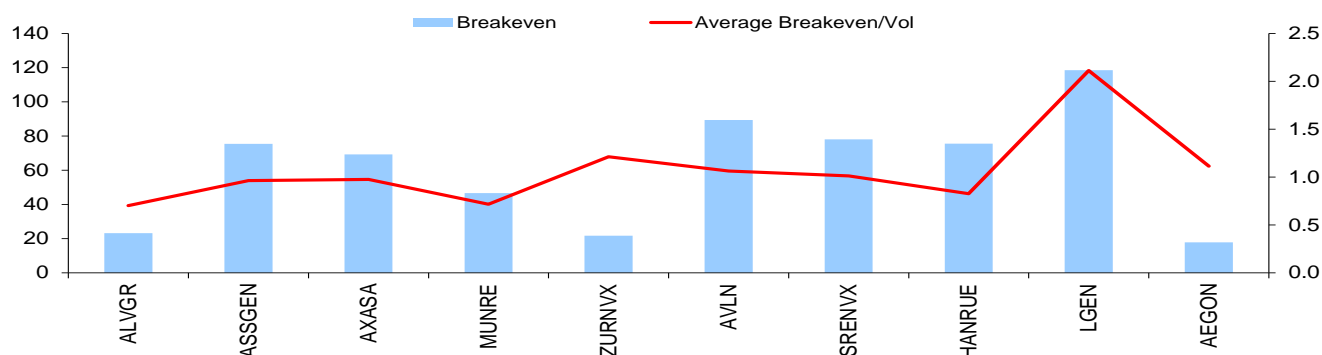
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 49. CDS 3mth Trading Range by Sector (bp)



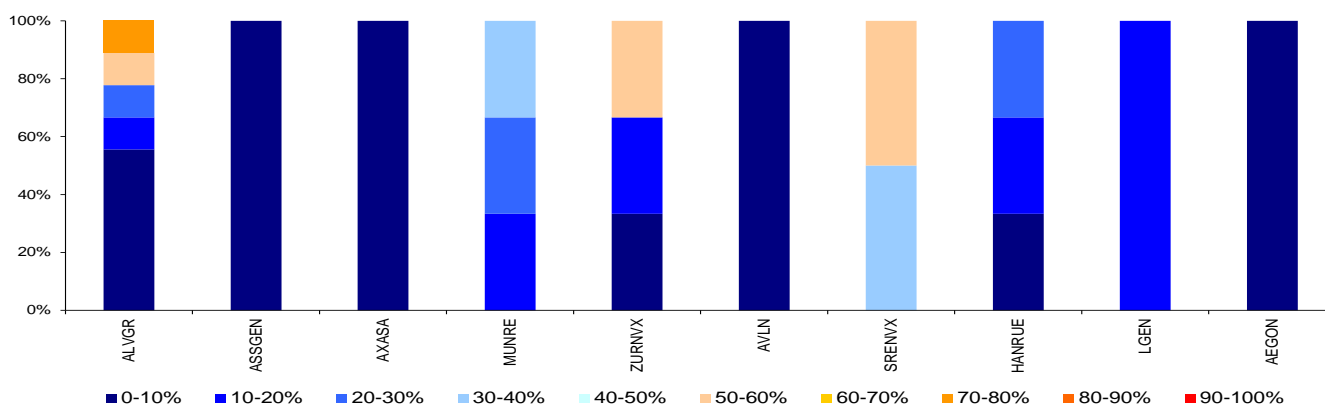
Source: MarkIt, Citi Research

Figure 50. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 51. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

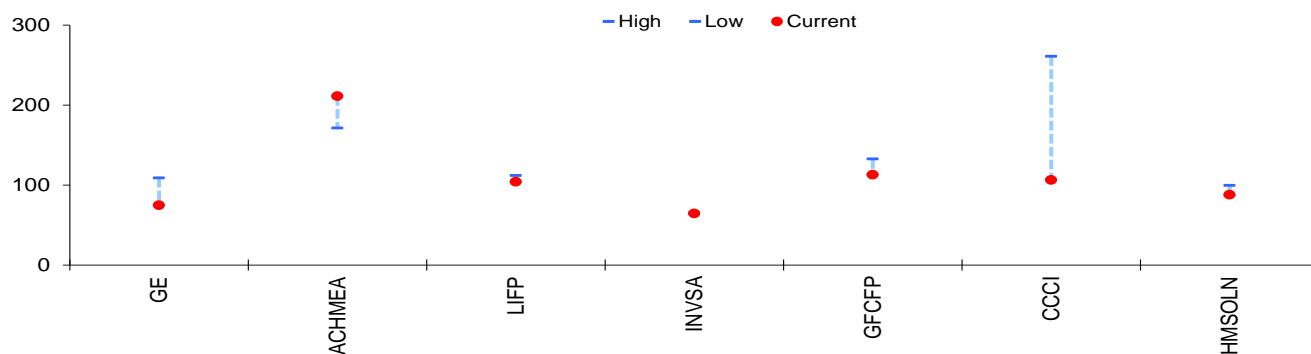
## Financial Services: neutral

### Remain neutral on Financial Services

Remain neutral on the Financial Services industry. Although the improvement in the real estate sector supports the tight valuations of this sector, we think bond investors wanting to go anywhere near this space [would do better to](#) buy equally or higher-rated CMBS, RMBS or ABS instead: spreads trade wider, for structures which to our minds are more robust. The rest of the sector is mainly dominated by General Electric, where we don't see much scope for performance in either direction.

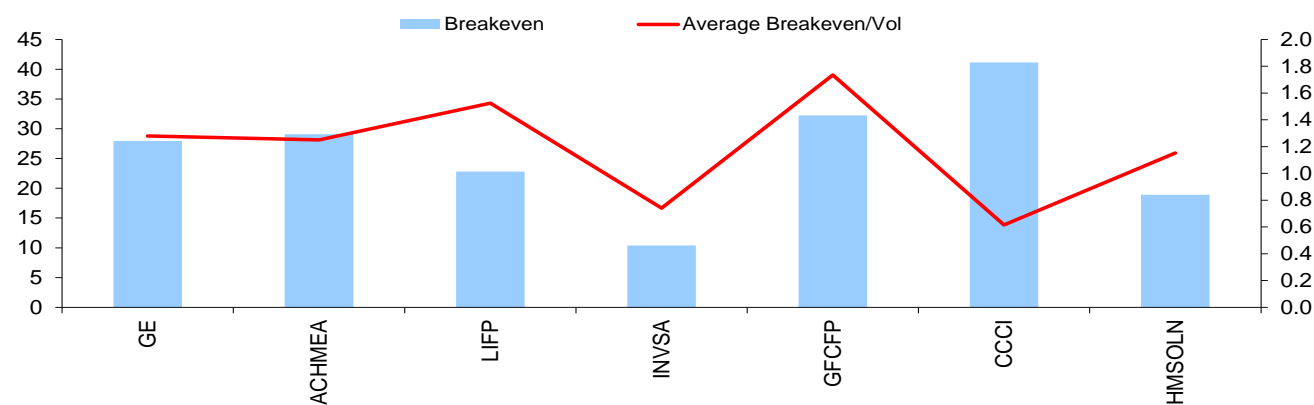


Figure 52. CDS 3mth Trading Range by Sector (bp)



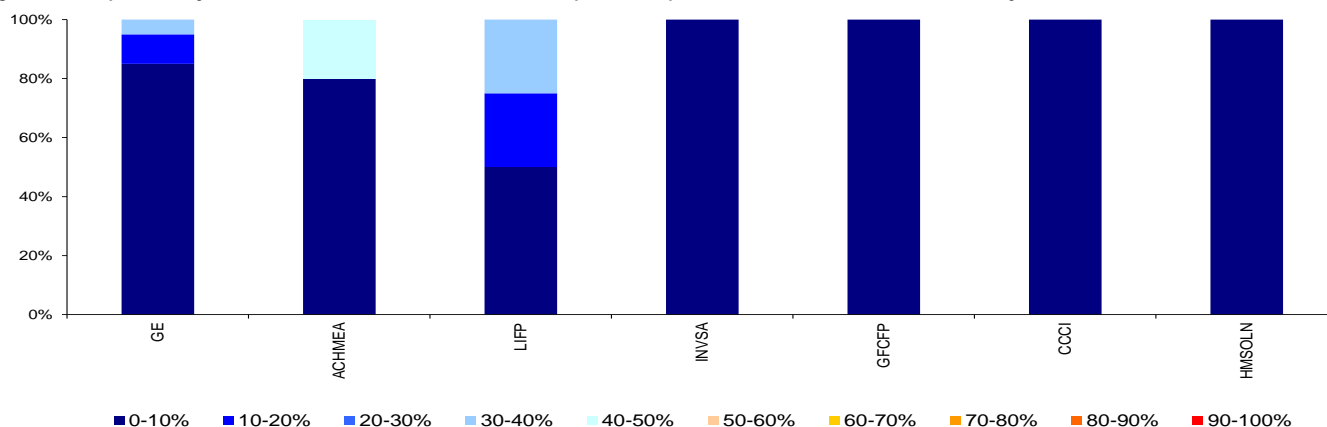
Source: MarkIt, Citi Research

Figure 53. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio\* by Sector



Source: iBoxx, Citi Research

Figure 54. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

\* 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 3-month trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3-month wides, while dark blue shows the percentage of bonds very near 3-month tights.

**Notes**

**Notes**

## Appendix A-1

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