

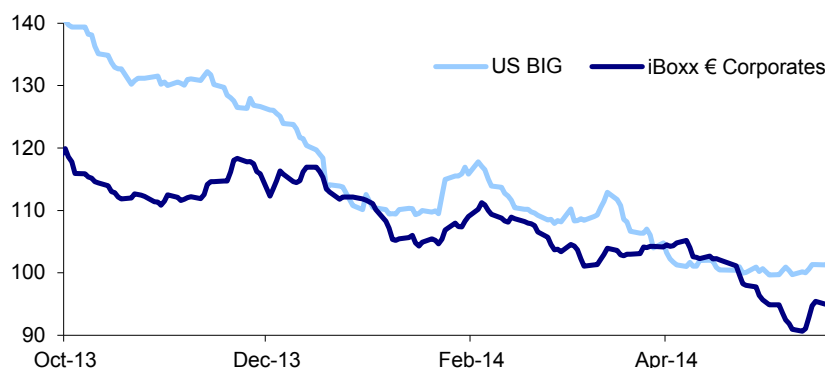
6 reasons to favour € over \$ credit

Why credit is greener in Europe

- **It's not consensus** – At a time where it's hard to be contrarian, positioning against the 15bp outperformance of \$ IG cash credit versus €s is one of the few attractive opportunities, in our view.
- **An asymmetric outlook** – With markets anticipating eventual policy tightening in the US, but equally flirting with the idea of further easing in Europe, we believe the risk/reward between US and European credit spreads is asymmetric.
- **Lots of other reasons** – More generally, the US credit cycle is more advanced than in Europe, and the \$ market is arguably more sensitive to movements in yields, as we saw last year during the "taper tantrum".
- **Cash rather than derivatives** – While the arguments should also apply to CDS, the outperformance of the iTraxx against the CDX indices makes the entry point much less attractive. Given the choice, our preference would be to express the view across a cash bond portfolio.

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Figure 1. US corporate credit spreads outperforming Europe, bp



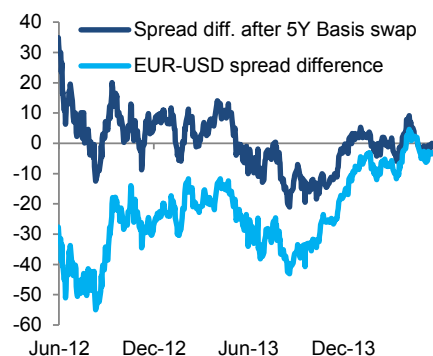
Source: Citi Research

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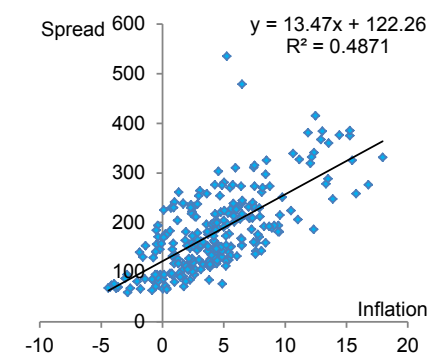
6 reasons to favour European over US credit

Figure 2. \$-€ spread differential* w. adjustment for the 5y basis swap.



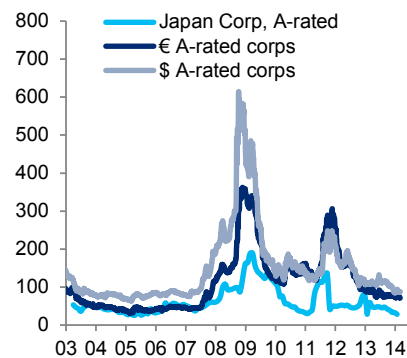
Source: Citi Research, Markit. *: Bonds are issuer-, maturity-, seniority- and price-matched.

Figure 3. Baa-Aaa spread, bp, vs. US cyclically adjusted inflation, %, 1950, 2014



Source: Citi Research, YieldBook, ABD

Figure 4. Japanese, € & \$ A-rated corporate spreads, bp



Source: Citi Research, Moody's, Haver

Over the last seven months, the iBoxx € corporate index has underperformed \$ iBoxx by 15bp¹ (Figure 1). Indirectly, the basis swap is probably partly responsible – at least, when we look at \$ vs € spreads on a matched set of bonds adjusted for the 5y basis swap, about half the divergence disappears (Figure 2). Some of the remainder is probably a catch-up following the outsized reaction of \$ credit to last year's "taper tantrum".

That may explain past outperformance, but we don't think it will extend into the future. Rather, we see a big asymmetry in the balance of risks between the two markets that creates a strong case for € credit outperforming \$ credit from here on.

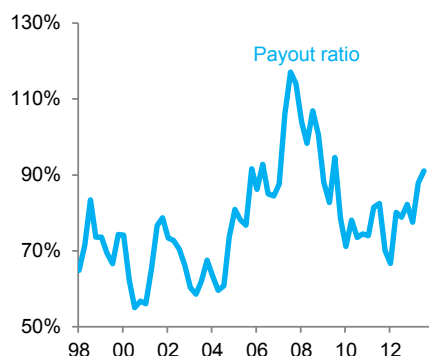
Just consider:

- **ECB QE** – Our economists now have ECB QE from Q4 this year as their central scenario. As discussed in a recent Weekly², for private assets to become a substantial part of the €1tr, or so that the ECB would have to by to lift the inflation path towards target, we reckon it would be difficult to avoid buying corporate bonds directly. Such purchases might or might not impact non-financial corporates, but would very likely involve at least senior unsecured bank bonds. While QE tends to propagate through the global financial system to impact credit across currencies, this would be a more specific, tangible catalyst for € corporate credit than in the \$ market.
- **Policy tightening risk** – While our economists are not expecting Fed hikes until mid-2015, the [uncertainty about slack](#) in the US labour market creates a risk that the market might at some point price a faster turn in policy than currently if the data strengthens, as we have seen in the UK.
- **Inflation or deflation?** If we had to choose between inflation or deflation, then we'd go for the latter. Beyond the likely central bank response, inflation undermines real returns and puts upward pressure on yields. Figure 3 clearly shows credit spreads and inflation are positively correlated. A deflationary environment is likely to bring down the weakest credits, but as we've seen in Japan (Figure 4) higher-quality credit spreads were extremely tight during deflation – due to a combination of low yields, bondholder-friendly corporates and little appetite for equities. Neither Eurozone deflation nor excessive US inflation is Citi's central scenario, but the balance of risks again seems to favour € credit.
- **The relative position in the credit cycle** – The US credit cycle is much more developed than in Europe. Apart from a brief period during the profit slump in 2008-09, US corporates are now paying out a record proportion of earnings through dividends and buybacks (Figure 5). US banks are slowing their [deleveraging](#). In Europe, corporate releveraging is also [taking place](#), but payout ratios remain lower, and banks are likely to continue deleveraging for longer.
- **Supply** – The European credit market is still struggling to stop the shrinkage. [YTD net issuance](#) remains negative. The [US market](#) in contrast continues to see solid growth with \$192bn of net supply in the first five months of the year. While low yields might attract more issuers to the € market going forward – indeed the proportion of US issuers in € issuance has risen sharply over the last year – we still believe the € market technical should be comparatively stronger.

¹ As we discussed in "[European Credit Weekly: Why is European IG cash credit lagging behind?](#)", H. Lorenzen, 17 April.

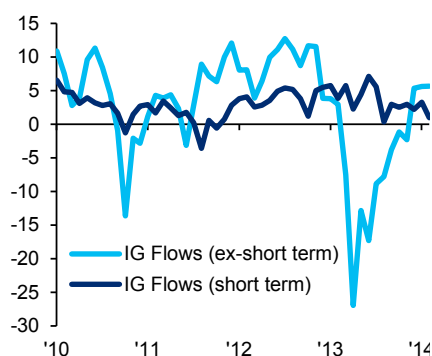
² "[European Credit Weekly: How would ECB QE impact credit?](#)", H. Lorenzen, 25 April.

Figure 5. S&P dividends & buybacks, % of earnings



Source: Citi Research, S&P, Haver

Figure 6. Monthly US mutual fund flows into IG credit, \$ bn



Source: Citi Research, EPFR

■ **Who wants spread duration?** Although spreads in the two markets are comparable, the \$ credit market is much longer-dated with a weighted-average duration of 6.5 years versus just 4.5 years for the iBoxx € Corporate index. Granted, yields have confounded expectations so far this year, but the longer-term trend should be higher: Citi forecasts 10yr UST yields at 3.35% at the end of 2014. The high proportion of total-return sensitive money that has flowed into credit in recent years ought to favour a shorter-duration market like € credit. Indeed, recent US mutual fund flows have shown a clear preference for the short end (Figure 6).

Simply put, the US cycle is more advanced than in Europe; the balance of risks is asymmetric.

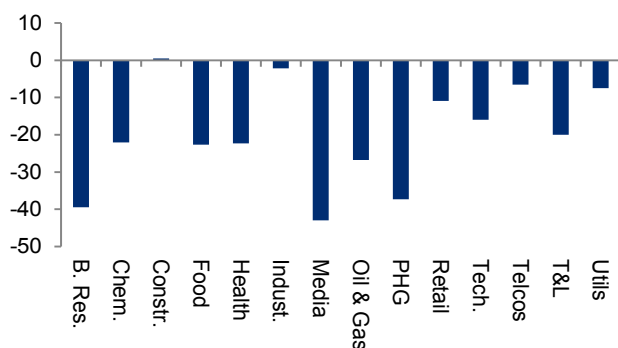
Long € versus \$ cash bonds

So where's the opportunity then? As illustrated in Figure 2 above, it's not that bonds of the same issuer, with the same maturity and seniority, are particularly cheap in € vs. in \$. You can find individual switches where that is the case (but equally you can find switches where the € bond seems expensive to the \$ equivalent).

The outperformance of \$ credit is much more generic than that. It has occurred in nearly every single sector, including financials (Figure 7 & Figure 8), it applies right across the curve and across the rating spectrum (Figure 9 & Figure 10). The only notable exception seems to be in sub-debt, where € spreads have managed to keep up.

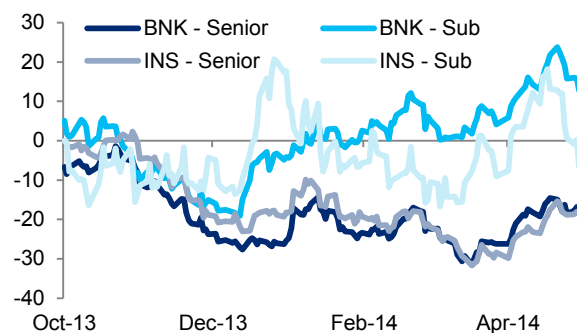
We would therefore overweight € credit versus \$ credit at the generic portfolio level. Our forecasts for end-2014 imply € corporate credits spreads tightening by more than 15bp to 80bp (in z-spread terms). Conversely, our US colleagues expect \$ credit spreads to widen by 25bp to 125bp (in terms of OAS to Treasuries). Though such a divergence would be unusual given the tight correlation between credit markets historically, we'd argue that the differences in outlook are equally uncommon.

Figure 7. Sector performance differential: € - \$ spreads from 1 Oct 2013 to 21 May 2014, bp



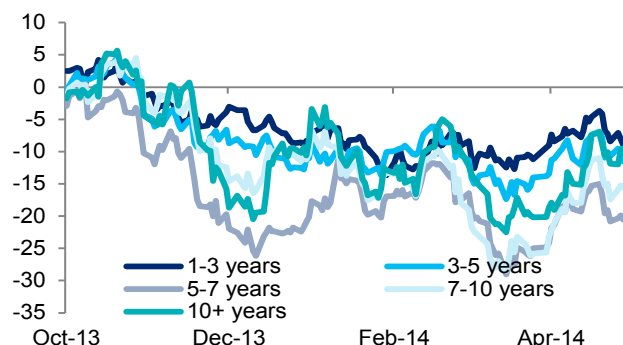
Source: Citi Research, MarkIt

Figure 8. Sector performance differential: € - \$ spreads from 1 Oct 2013 to 21 May 2014, bp



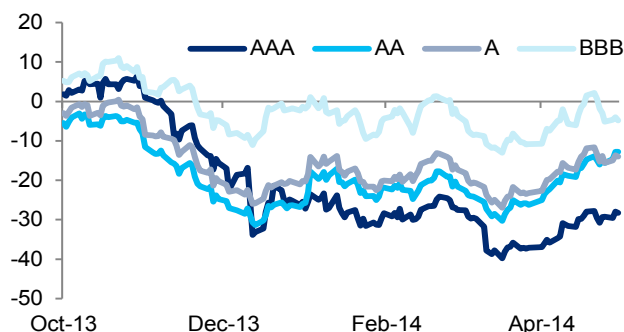
Source: Citi Research, MarkIt

Figure 9. Performance differential by maturity bucket: € - \$ spreads from 1 Oct 2013 to 21 May 2014, bp



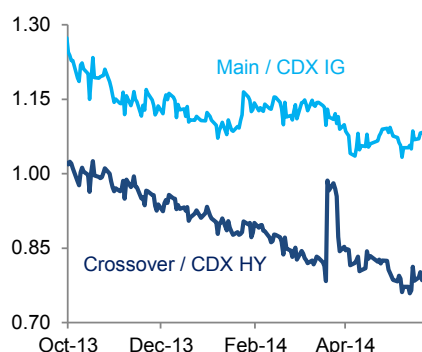
Source: Citi Research, MarkIt

Figure 10. Performance differential by rating bucket: € - \$ spreads from 1 Oct 2013 to 21 May 2014, bp



Source: Citi Research, MarkIt

Figure 11. Main / CDX IG & Crossover / CDX HY ratios



Source: Citi Research, MarkIt.

Could you do the CDS indices? The entry point is less attractive than in cash; iTraxx Main has outperformed CDX IG slightly and Crossover has outperformed CDX HY significantly (Figure 11). However, the asymmetry in the outlook is very similar in CDS as in cash. So for accounts for whom switching \$ credit exposure to € is not appropriate, we would recommend selling iTraxx Main protection against buying CDX IG protection in a ratio of 1:1.

Could you do HY? Similarly in HY, the argument also seems less compelling. € spreads have underperformed \$ spreads less in HY and it is less likely that ECB QE would impact HY credit directly. However, we would prefer to be in € HY credit to being in \$ HY credit here, too.

Could you do £ instead of €s? Although there are also some good switches from \$ to £ credit, we think the case for being long £ over \$s is much less clear cut. The risk of rising yields is at least as high as in the US. Our economist expects the Bank of England to hike rates already in Q4 2014. And there is no prospect of a squeeze on spreads from QE. Moreover, there is the uncertainty about demand for the long end in £ following [Osborne's proposal to liberalize the annuity market](#). £ spreads are a bit wider than € spreads, but we suspect they will remain so for the foreseeable future.

Appendix A-1

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