Credit Goldilocks and the two bears

Market comment | Week ahead | iTraxx Roll – Potential Name Changes |

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Credit
Investment Overview
Pan-Europe
Corp. High Grade

Market comment

Recent sessions have been a great illustration of the Goldilocks problem for credit that we highlighted in our Outlook. The week started out looking rosy enough - spreads, in cash in particular, were tentatively grinding tighter in the absence of headlines, suggesting the underlying currents are actually quite supportive.

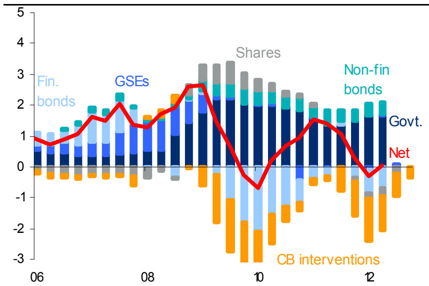
But before anyone could digest the porridge, two bears had made a sudden, albeit rather brief appearance. Weak Eurozone PMIs were an unwelcome reminder of the well-known downside risks to recovery prospects, and although the IFO numbers painted a brighter picture for Germany this was balanced by the downward revisions to the EU Commission's economic forecasts. French figures, in particular, were weak, with the PMI pointing to the lowest level of activity since the dark days of early 2009.

But given that most of Thursday's widening came before the release of the PMIs, the bigger bear was definitely the FOMC minutes. Markets seem to have been particularly taken aback by the sentence "many participants also expressed some concerns about potential costs and risks arising from further asset purchases".

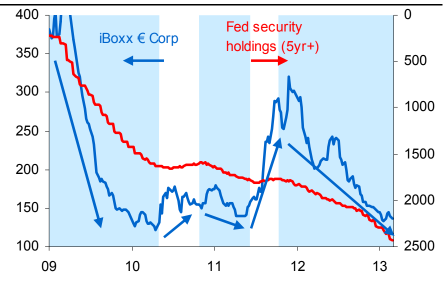
The reaction highlights that European credit is not just exposed to the downside risks of a slump, but also to the upside risks from recovery that will bring an eventual end to central bank stimulus. But just how serious is that?

The answer evidently depends on how much importance you assign to the unconventional central bank policies in the first place. As you may know, we reckon the stimulus has been absolutely pivotal to asset price performance over the last couple of years. In short, we believe central banks have created a huge supply-demand imbalance in securities markets. Not only have central banks 'encouraged' money flows away from deposits and money markets into securities through near-zero percent interest rates, but they have also severely constrained the net growth of investible securities across markets.

Net issuance of new securities vs central bank interventions
4Q rolling, US & Europe, $ tr



iBoxx € Corporate spread vs Fed's holdings of securities (5yr+ maturity)
Bp vs $ tr



European Credit Outlook
19 Feb – Is the Goldilocks Period for Credit at an End?

European Portfolio Strategist
14 Feb – Animal Spirits Rising = Deals

European Credit Derivatives
12Feb – Trade Ideas

What Bail-ins Mean for CDS
11 Feb – SNS Raises Serious Questions about the Value of Sub Protection

Global Structured Credit Strategy
11 Feb – Protecting Against a Rates Backup

The Credit Index Call
5 Feb – On the Cusp

Creditbrief
4 Feb – A False Start?

US Creditbrief
3 Feb – An Unlucky Start for Yield Players?

How Afraid of Rising Rates Should We Be?
1 Feb - How afraid of rising rates should

Source: Haver, Mark-It, iBoxx, Citi Research

In the left-hand chart above the blue/grey bars quantify the net issuance of securities across broad asset classes on a rolling 4-quarter basis, while the orange bars capture the effects of central bank interventions. When these interventions are subtracted from net issuance of securities you are left with the red line – a proxy for the change in the size of the universe of securities that investors can buy. Before the crisis, that universe tended to grow by $2.5-3.5tr per year, but over the last few years there has barely been any growth in securities outstanding after central bank interventions.

With more demand for securities and less supply it is hardly surprising that you get a big squeeze across asset markets. As a consequence there is a striking correlation between asset prices and central bank balance sheet expansion over the last four years. Even in Europe, where markets have clearly been periodically disrupted by sovereign concerns, the relationship between credit spreads and the size of the Fed balance sheet has been pretty solid – as illustrated in the right-hand chart. Granted, it's perhaps not conclusive (or rather, econometric) proof, but in combination the charts make a strong case, in our view.

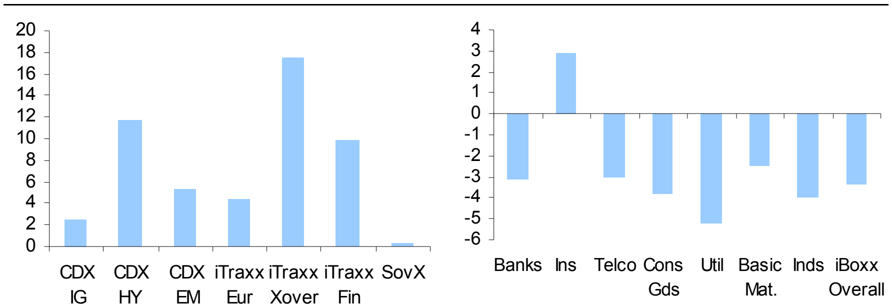
The obvious inference is that credit should also be susceptible to an end to stimulus, especially if that happens before economic and corporate fundamentals have caught up with valuations, as happened the last two times when the Fed paused. The recent increase in corporate leverage and weak state of the European economy is not particularly encouraging in that regard.

On the bright side, we wouldn't exaggerate the immediate importance of the FOMC minutes, which unlike the FOMC statement give voters and non-voters an equal voice. With the current make-up, that tends to make the minutes sound more hawkish than the opinions of the actual policy-setters. Citi economists expect a tapering off in QE only in the second half of the year.

Nonetheless, we should see Thursday's market move as a warning. It's not enough to watch yields – Thursday's widening in credit came even though US and European yields are lower than early in the week. Regardless of what yields do, European credit markets are likely to be nervous and volatile when the Fed does get round to communicating a reduction to stimulus. And from now, expect a growing amount of fretting when the key Fed speakers are about to go on the tapes.

CDS and € iBoxx Cash Index Weekly Movements

Spread Changes, bp



Source: Mark-It, iBoxx, Citi Research

Week ahead (Teresa Cascino)

Italian elections on Sunday and Monday will take central stage next week. According to our political analysts, an alliance between the centre-left led by Pier

we be?

Global Credit Survey
28 Jan – Picking up pennies?

EU & US Economic Data

	Consensus
Monday:	
Tuesday:	
US New Home Sales	380k
US Consumer Confidence	60.6
Wednesday:	
Eurozone Economic Confidence	89.9
Eurozone Indust. Confidence	-13.1
Eurozone Consumer Confidence	-23.6
Thursday:	
Eurozone CPI MoM,YoY	-1.0%,-2.0%
US GDP QoQ	0.5%
Friday:	
Eurozone Unemployment	11.8%
U. of Michigan Confidence	76.3
ISM Manufacturing	52.5

Earnings Announcements

Monday:
PostNL, Exor, Societa' Iniziative Autostradali, Chorus, QBE, Pearson, Berkshire Hathaway, Brisa
Tuesday:
BASF, Vivendi, Mediobanca, CRH, Provident, Macy's, Vivendi, Piaggi
Wednesday:
Holcim, Bouygues, AB Inbev, Red Electrica, Amadeus, Vale, Centrica, Segro, Target, CocaCola Femsa, Heinz
Thursday:
Arkema, Telekom Austria, Erste Group, Bayer, Aeroports de Paris, Delta Lloyd, CEZ, RBS, Veolia, Deutsche Telekom, Snam, Toronto-Dominion Bank, Thales, Elia, GDF Suez, Areva, Luxottica, BAT, Ahold, Direct Line, National Express Group, The Gap, National Bank of Canada, Best Buy
Friday:
Belgacom, Old Mutual, EnBW, Lloyds, Hammerson, UBM, WPP, Bankia

Luigi Bersani and Mario Monti's centrist coalition seems the most likely outcome. This would deliver a stable majority in both the Lower House and even in the Senate, where consensus seems more uncertain about the outcome.

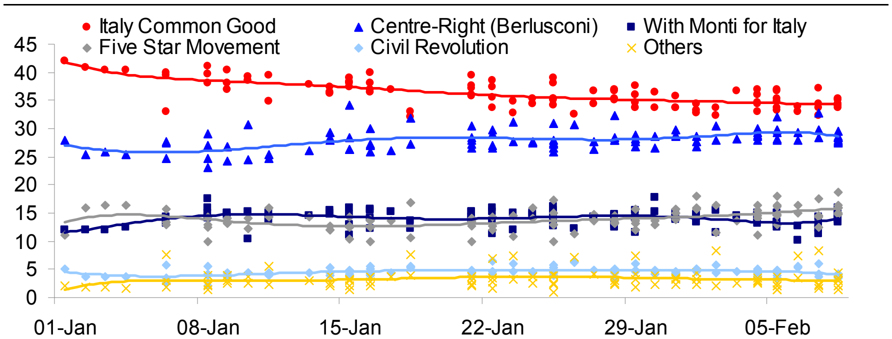
In spite of the recent polls (see chart) showing a narrowing gap between the centre-left and the centre-right coalition led by Berlusconi, our political analysts don't see a victory of Berlusconi's coalition in the Senate as very likely – their model sees just a 7% probability that a Berlusconi coalition through a hung parliament will be able to deny a Bersani-Monti coalition a majority.

We agree with their analysis, though we see two main factors of uncertainty on the horizon. The first is that Monti might refuse to form an alliance with Bersani's current coalition, unless he dumps the extreme left ally Sinistra, Ecologia and Liberta' (SEL). SEL is expected to win fewer seats in the Senate than Monti's coalition, so this strategy would make sense, but it depends heavily on the results of the polls, in our view. The other risk regards the Five Star Movement and Civil Revolution. Both are pushing anti-austerity, justice and social welfare themes and have received the endorsement of a number of important political and public personalities. There is a risk that these two parties fare better in the polls than expected.

First estimates are expected on Monday afternoon, but it will probably take longer before a clear picture emerges, not least regarding the outcome in the senate. However, if results pan out as our political analysts expect, then we expect it will be a market positive. As with the French election last year, we believe there has been a significant amount of hedging activity going into the election. Without a worst-case scenario and in the absence of near-term catalysts, an unwind of positions would likely be supportive for spreads in the near term.

Italian opinion polls

%



Source: EMG, IPR, SWG, Ipsos, TP, Quorum, Demos, ISPO, Euromedia, SpinCon, Demopolis, Tecnè, SP, Piepoli, Lorien, Datamonitor Bidimedia, Citi Research

While we don't expect much for the CTZ and inflation linked bond auctions of Monday, as the polls will still be open, we would watch Wednesday's BTP auction of 5, 7 and 10 year maturities, which our interest rate strategists expect to be €6bn in size.

This Sunday, we also have the second round of Cyprus presidential elections. After winning the first round with 45.4% of the votes, the conservative candidate Nikos Anastasiades appears quite likely to win against Stavros Malas from the Communist Party. The conclusion of the elections will restart bailout negotiations with European partners, which are likely to feature heavily on the March calendar.

As regards economic data, Spain will release its 2012 budget deficit some time next week. Citi expects it to be 8.1% of GDP, versus an estimate from the EU

Commission of 7% before bank recapitalisation (10.2% after). Watch also for the Euro area Business and Confidence Surveys on Wednesday. In spite of the negative surprise in PMIs this week, consensus expects just some weakness in Industrial Confidence versus last month, while the Economic Climate Indicator is expected in line. From Wednesday it will be possible to repay the second round of LTRO.

On Friday, we would watch US ISM Manufacturing index, which is expected to remain firmly in expansionary territory, albeit slightly weaker than last month.

iTraxx Roll – Potential Name Changes (Abel Elizalde)

The new (Series 19) iTraxx indices will start trading on 20th March, with the provisional and final membership lists published by Markit on Monday 11 March and Friday 14 March respectively.

Although the most important criteria used to determine inclusion in the new Series (spreads, ratings, DTCC trading volumes etc) will only be available at the end of February, we can already form a view regarding the potential candidates to enter/leave the on-the-run index – see Figure 1. We expect four changes in iTraxx Main (none in Financials) and five/six changes in iTraxx Crossover. Our expected changes in iTraxx Main are all due to liquidity considerations. In Crossover, five/six credits are likely to leave the on-the-run indices because they trade too tight, and we expect them to be replaced by Telecom Italia, Infineon and three/four credits from the "Supplementary List", i.e. without liquidly traded CDS but with enough debt issued over the past 12 months.

Figure 1. Potential changes in iTraxx on-the-run indices

From Series 18 to Series 19.

OUT - Main	IN - Main	OUT - Crossover	IN - Crossover
Astrazeneca	Adecco	Clariant	Telecom Italia
SABMiller	JTI UK Fin	INEOS Group	Infineon
Anheuser Busch InBev	Pernod Ricard	Kabel Deutschland Vertrieb	
Telecom Italia	SES	ISS A/S	
		Havas	
		Repsol	
			4 credits from the "Supplementary List"

Source: Citi Research, Markit, Bloomberg.

Appendix A-1

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