

Credit

18 May 2012 | 14 pages

Speculative Grade Credit Weekly

A Positive Basis Oasis

- Over the past month we have increasingly expressed a more cautious view and last week we downgraded our view on high yield primarily based on full valuations, consistent risk-off signals in other markets and weakening US economic growth. Bolstering our decision were medium-term issues like the domestic political backdrop which are unlikely to move the market significantly in the short run but will limit a summer rally, in our opinion. As a result, our downgrade is unlikely to be short lived; we still recommend investors lighten high yield risk exposure.
- Not surprisingly, the numerous concerns stated above, finally weighed on high yield technicals but the calendar produced another solid week with \$3.8bn pricing through Thursday and new deal secondary performance mixed (i.e. better than the overall market). Non-ETF fund flows were actually positive, according to Lipper but issuance is weighing more on the secondary market as evidence of our estimates of client net selling.
- Heading into this week, the cash market has been notably resilient, relying on the strong technical balance to support valuations. Derivatives, on the other hand, have sold off more significantly as the CDX indices have suffered from macro hedging, relative value comparisons to Europe and ease of shorting. Although cash fell this week, the positive basis now exceeds the level set last fall during the last sovereign-related flare. We recommend a number of positive basis pairs and list out a few important considerations.
- Lastly, we update our default forecasts for the US and Europe. The US high yield default rate is expected to remain very low at least into 2013 while we project the European default to rise to 6% by year end.

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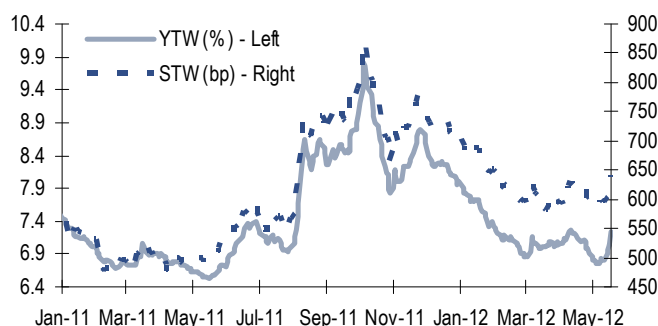
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High Yield Market Recap

	Yesterday's Close		Weekly Change		8-Week Average	
	Price	Spread	Price	Spread	Price	Spread
CDX HY 18	91.81	708	-2.81	75	95.47	611
Citi High Yield Market	101.09	642	-1.46	45	101.87	606
BB Index	105.05	468	-1.18	36	105.70	439
B Index	101.59	670	-1.52	46	102.35	632
CCC Index	88.25	1135	-2.07	77	89.56	1071
Citi Lev Loan Tracker	92.91	599	-1.19	33	93.40	583
Capped Tracker	95.13	543	-1.05	29	95.70	529
CDX IG 18	98.92	123	-0.67	14	100.04	99
Citi US BIG Corporate	112.31	202	-0.21	15	111.82	183
BBB Index	112.16	250	-0.30	16	111.78	231
S&P 500	1304.86		-48.53		1376.23	

Source: CIRA

Citi High Yield Market Index, Yield-to-Worst and Spread-to-Worst



Source: CIRA

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

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Not Many “Likes” For Risk

Over the past month we have increasingly expressed a more cautious view and last week we downgraded our view on high yield primarily based on full valuations, consistent risk-off signals in other markets and weakening US economic growth. Bolstering our decision were medium-term issues like the domestic political backdrop which are unlikely to move the market significantly in the short run but will limit a summer rally, in our opinion. As a result, our downgrade is unlikely to be short lived; we still recommend investors lighten high yield risk exposure.

US Treasury 2s10s Curve (bp)



Source: Citi Investment Research and Analysis, Bloomberg

A host of measures continued to flash risk-off this week amid further Greece-related concerns. Through Thursday, equities dropped another 2-3% while commodities such as oil added to their month-to-date declines. The 2s10s Treasury curve flattened to 141bp on Thursday, setting a new 3-year low. High yield cash finally caught onto the risk-off theme and sold off 1.5 points but still managed to outperform CDX, which dropped nearly 3 points. As the week progressed, cash began to “catch” up to CDS but still has plenty of ground to “make up”.

Picking up where we left off last week, in Europe, the attempts at forming a Greek government have failed and consequently another election will be held on June 17. Our European economists have characterized the election as “crucial for Greek membership in the euro” and with the far-left, anti-bailout party, Syriza, “likely to be the strongest party”, they conclude that a “Grexit¹ is likely over the next couple of months.” The Greek population is overwhelmingly against the austerity requirements of the bailout program but at the same time, the people do not want to leave the eurozone. The standoff by Syriza’s leader indicates a potential Grexit could be contentious.

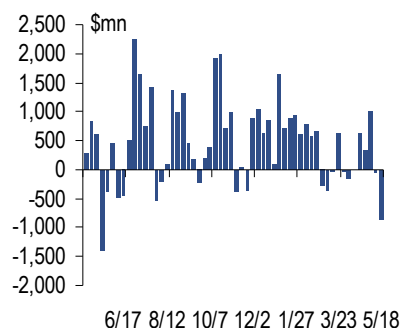
Perhaps more concerning is the deposit flight in Greece, which is just one way that contagion could spread. Greek President Papoulias revealed a 700mn euro outflow on Monday (revised higher by bankers later in the week). On Thursday, El Mundo reported a 1bn exit from Spain’s Bankia. Capital controls could limit deposit flight but are difficult to implement across the entire eurozone and would make normal operations for companies challenging, as our European Credit Strategy colleagues note [European Credit Strategy colleagues note](#).

The market’s tone has become decidedly jittery and any bad news results in amplified price declines. Poor earnings from JC Penney and Bon Ton, for example, pushed bonds 6-8pts and 10pts lower respectively. We wrote in January that the positive psychology at the time was to look for who could be next to announce positive news (such as a refi) and the tone appears to have done a full 180-degree turn since then. That theme was evident in the response to the macro data, which was mixed. Jobless claims held steady at 370k, confirming the stabilization that began last week. Industrial production rose 1.1% in April and housing starts also beat expectations. The poor Philly Fed number, however, was what caught investor attention.

Another standoff is taking place in Washington. The often-advertised “fiscal cliff” is rapidly approaching and politicians finally got around to meeting to discuss this pressing issue. As a reminder, our concern here is that elected officials will use these issues as political footballs during the election season, providing a very cloudy backdrop for companies planning for 2013. Normally investors might expect a grand compromise that pushes the pain further into the future (though that brings some ratings concerns, in our view) but last August’s experience taught us not to underestimate the stubbornness of both parties. Compromise becomes much more onerous when the issues are being used to gain advantage with voters.

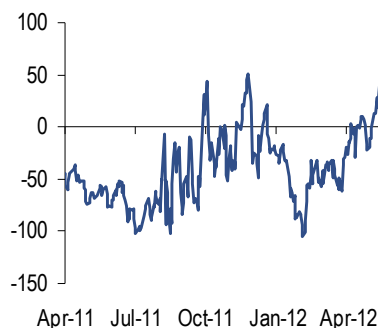
¹ Greek Exit from the eurozone

Estimated Weekly Net Client Positioning



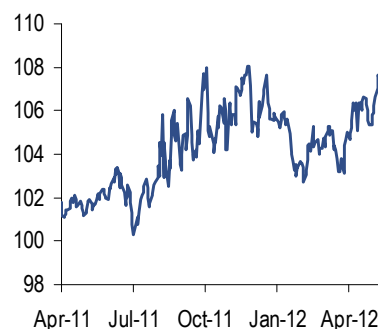
Source: Citi Investment Research and Analysis, Markit, TRACE

CDX HY vs. HYMI Cash Basis (spread, bp)



Source: Citi Investment Research and Analysis, Markit

CDX HY vs. HYMI Cash Basis (\$ price)



Source: Citi Investment Research and Analysis, Markit

Whether it's making the "rich" pay their fair share or refusing to raise the debt ceiling, the serious issues our economy will be facing next year are likely to be the same ones politicians will be using to consolidate power. Comments from both sides this week indicate that they are digging in their heels and we will be fortunate to get a post-election agreement, in our opinion.

Not surprisingly, the numerous concerns stated above, finally weighed on high yield technicals but the calendar produced another solid week with \$3.8bn pricing through Thursday and new deal secondary performance mixed (i.e. better than the overall market). Lipper reported a \$655bn outflow last week, the second outflow of the year but non-ETFs experienced a net inflow. A large block trade was executed on one of the large high yield ETFs which wasn't the result of the usual ETF redemption process and therefore had little effect, if any, on secondary flows. With inflows slowing, the issuance is weighing more on the secondary market. Our estimates of client positioning using TRACE data indicate that net selling by investors this week was the largest since last May. Even though new deals are pricing, managers need to make room for new deals. Further, continued negative headlines will eventually trigger outflows from non-ETF funds which makes us believe there is more weakness to come.

A Positive Basis Oasis

Heading into this week, the cash market has been notably resilient, relying on the strong technical balance to support valuations. Derivatives, on the other hand, have sold off more significantly as the CDX indices have suffered from macro hedging, relative value comparisons to Europe and ease of shorting. Although cash fell this week, the positive basis now exceeds the level set last fall during the last sovereign-related flare.

Investors can take advantage of this dislocation two ways. They can either sell the basis (provided they can borrow the bonds) or they can express a constructive credit view by selling protection instead of buying bonds. The latter is especially attractive if the bonds trade at a high dollar price and therefore are call constrained (which is common with the average price of the High Yield Market Index at \$101). In order to maximize liquidity we recommend investors selling 5-year CDS as opposed to an off-the-run point on the curve.

The basis trades are even more attractive than they were last fall because bond prices are considerably higher now. As illustrated in the table below, some of the basis packages can be sold for \$112-113. Although defaults are unlikely to accelerate, in certain instances, this trade could benefit from a jump to default.

Bond vs. CDS Comparison

Issuer	Coupon	Maturity	Price	Z-Spread	5-Yr CDS		Basis Package	
					Points	Spread	Points	Spread
SDSINC	7.375	11/15/2018	104.50	525	6.00	655	110.50	130
AMKR	7.375	5/1/2018	103.25	556	9.25	748	112.50	192
FTR	8.250	4/15/2017	104.00	625	9.75	763	113.75	138
CHK	6.625	8/15/2020	90.00	678	13.75	888	103.75	210
GT	7.000	5/15/2022	96.75	570	9.75	763	106.50	193
MGM	7.625	1/15/2017	103.50	574	9.50	755	113.00	181

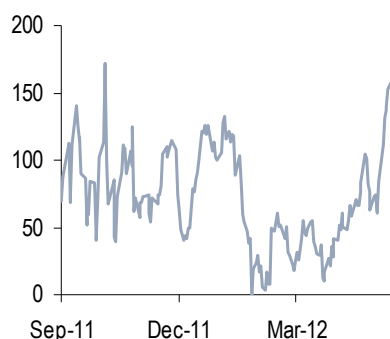
Source: Citi Investment Research and Analysis, Bloomberg

There are a few important considerations when implementing a short basis trade or selling protection in lieu of buying cash. First, the basis can become more positive and given the volatile macro environment this is a very real risk but as we've seen historically the positive typically snaps back (as opposed to the negative basis

environment during the crisis where systemic issues cause CDS to trade tighter than cash for extended periods). Second, CDS liquidity is not as strong as cash liquidity; a situation exacerbated when volatility increases. Lastly, CDS doesn't benefit directly from the search for yield as inflows are generally put to work directly in the cash market, though some excess cash may be "parked" in HY CDX.

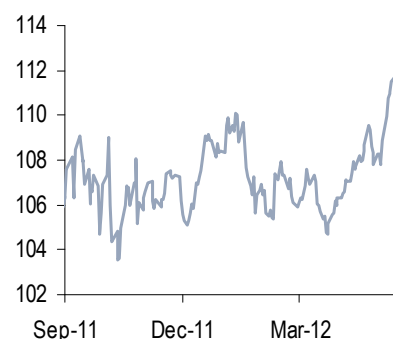
One other important consideration is the cheapest-to-deliver option inherent in the CDS contract. One example is Goodyear, where the '22s are often paired with CDS but have a guarantee and additional protection that the '28s don't have. In a CDS auction, the difference could influence the final recovery but the '28s are very small (\$150mn) relative to the guaranteed bonds (roughly \$2bn across multiple issues).

AMKR 7 3/8 '18 Basis (spread, bp)



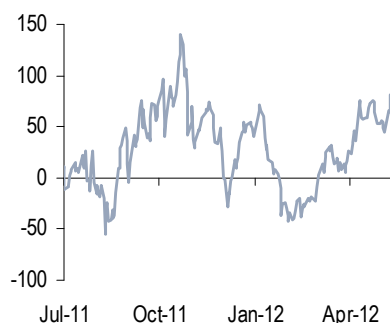
Source: Citi Investment Research and Analysis, Markit

AMKR 7 3/8 '18 Basis (\$ price)



Source: Citi Investment Research and Analysis, Markit

SDSINC 7 3/8 '18 Basis (spread, bp)



Source: Citi Investment Research and Analysis, Markit

SDSINC 7 3/8 '18 Basis (\$ price)



Source: Citi Investment Research and Analysis, Markit

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Default Forecast Update

This is an excerpt from the May 16 publication, [Default Rates to Climb Rapidly in Q3 and Q4.](#)

US

Base case: US defaults to stay around 2.5% till the end of this year

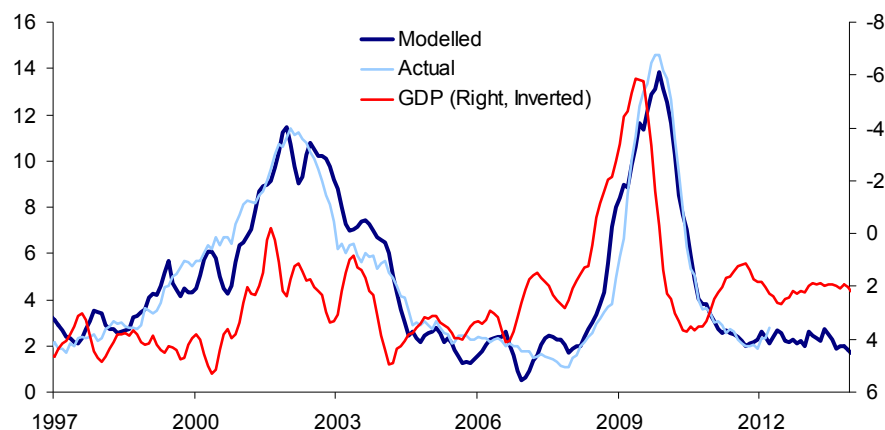
In contrast, we expect the US default rate to remain low into 2013. None of our key indicators are pointing to an increase in default rates. Lending surveys are back in negative territory and our economists' forecasts are for growth to continue.

In contrast, we expect the US default rate to remain low into 2013. None of our key indicators are pointing to an increase in default rates. Lending surveys are back in negative territory and our economists' forecasts are for growth to continue.

As a result, we expect defaults will continue to exhibit many of the same trends we've witnessed over the past 1-2 years. Specifically, defaults will be idiosyncratic and affect credits across a number of sectors. Two factors we will be watching in the future are the legacy LBO balance sheets from the prior cycle and the depressed natural gas market. For the time being, however, the distressed LBOs are likely OK until early next year (at least) and most of the large companies negatively affected by low natural gas prices have sufficient near-term liquidity.

The 2013-14 maturity wall has caused some consternation among some market pundits. We believe much the concern is misplaced because US companies have pushed out their liabilities, taking advantage of the strong demand for high yield product. That is not to say that defaults can't increase over the next 6-12 months. First, companies often default for reasons other than impending maturities. Some of the high-profile defaults over the past few quarters (e.g. American, Dynegy) have surprised us in that the company had ample liquidity to continue operating. Instead, the companies seized the opportune time to implement their bankruptcy plan and didn't want to wait until bankruptcy was involuntary.

Figure 1. Default rates Vs GDP, (%,%)

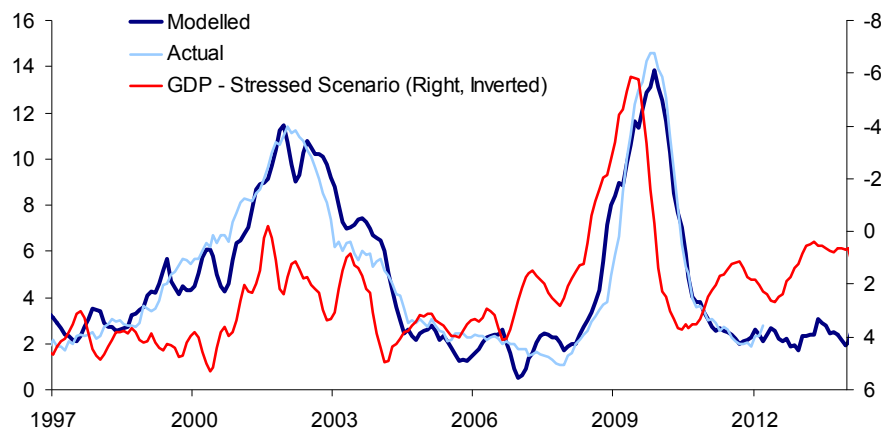


Source: Citi Investment Research and Analysis

Stressed scenario: US defaults rise to 3.0% by May-2013

If 2013 US GDP were to fall to 2% - for example in response to a European financial crisis – the model predicts the default rate would rise to 3% by May 2012/3.

Figure 2. Severe Recession Scenario US Default Rate Forecast vs GDP, (%,%)



Source: CIRA, Moody's, Bloomberg

Figure 3. EU Forecast Model: Explanatory power of factors

Variable	Explanatory	Lags
GDP	51%	6m
SPL	23%	10m
EURIBOR slope	20%	13m
Lending survey	6%	14m

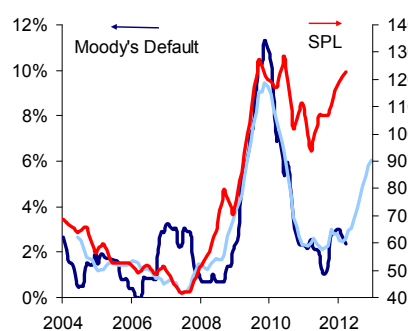
Source: CIRA

Europe

Base case: European defaults rise to 6% by Dec-2012

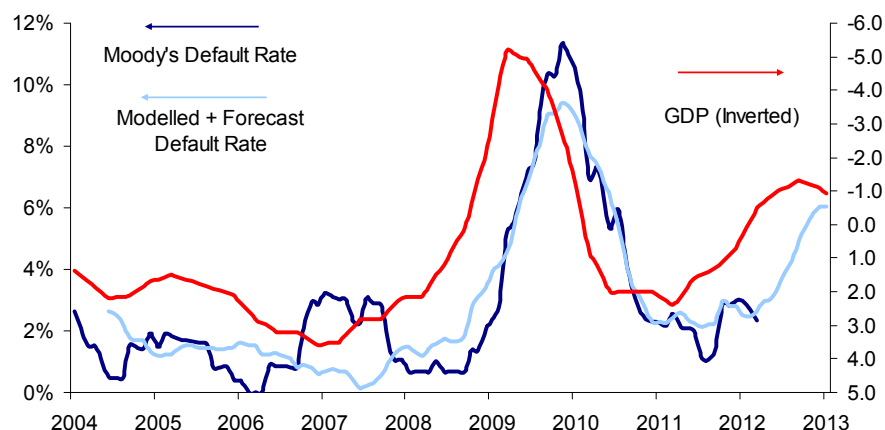
According to our base case scenario, European 12m trailing Speculative Grade Default Rate, which is currently at 2.35%, is set to rise steadily to 6% by December 2012 (Figure 5). This forecasted rise is mostly a result of the drop in GDP growth (Figure 3) since second half of 2011 and our forecast of a continuous drop until 4th quarter of 2012. Another factor affecting this quick rise in default rates is the Spread per unit of Leverage (SPL) which has risen sharply in the past 6 months as spreads continue to widen while corporates continue to deleverage.

Figure 4. European Default Rate Forecast vs SPL, (% ,bp)



Source: CIRA, Moody's, Bloomberg

Figure 5. European Default Rate Forecast vs GDP Growth, (%,%)

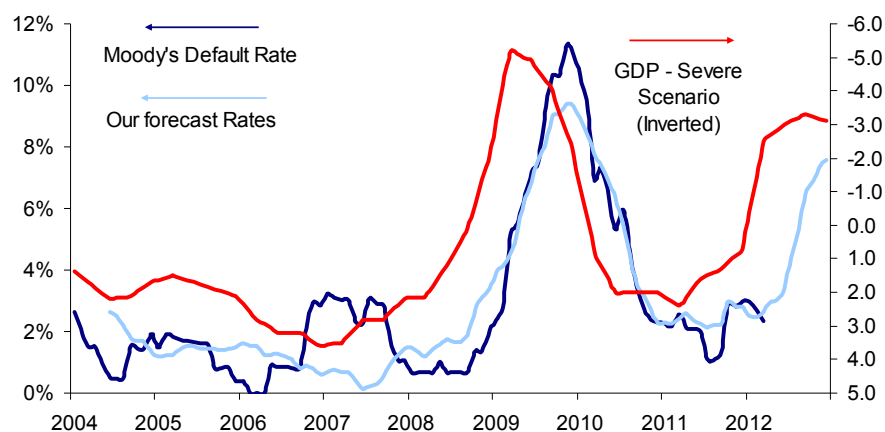


Source: CIRA, Moody's, Bloomberg

Severe scenario: European defaults rise to 7.5% by Dec-2012

Forecasting GDP in extreme situations is, almost by definition, subject to quite a degree of error. Our base case is that progress on a resolution of the crisis is quite gradual but the disorderly tail-event seems ever closer. Therefore, we have chosen some severe recessionary scenarios in which we lower GDP a further 2%. This is quite severe, although not as severe as 2008, which is in line with historic W-shaped recessions where the first half is not as severe as the first.

Figure 6. Severe Recession Scenario European Default Rate Forecast vs GDP, (%,%)

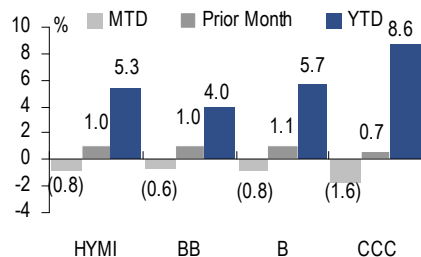


Source: CIRA, Moody's, Bloomberg

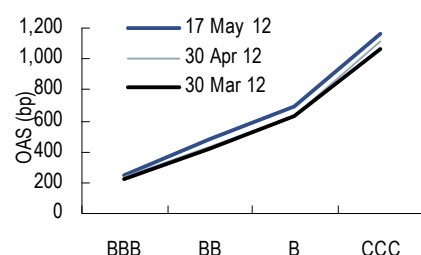
The last time that defaults were this high was back in 2008/9 and Crossover was 750bp and above with Main at 140bp. With a large number of periphery names in the Crossover spreads are 750bp already suggesting the market is increasingly pessimistic about defaults and tail-risk. The lag period between Crossover widening and speculative-grade default rates peaking was seven months which would take us from now until December.

HY Performance Review (As of Thursday)

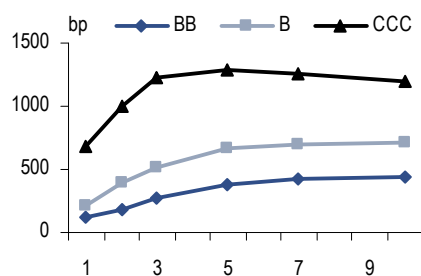
Index Total Returns



HY Risk Curve



Median HY CDS Curves by Rating



Source: CIRA, Markit

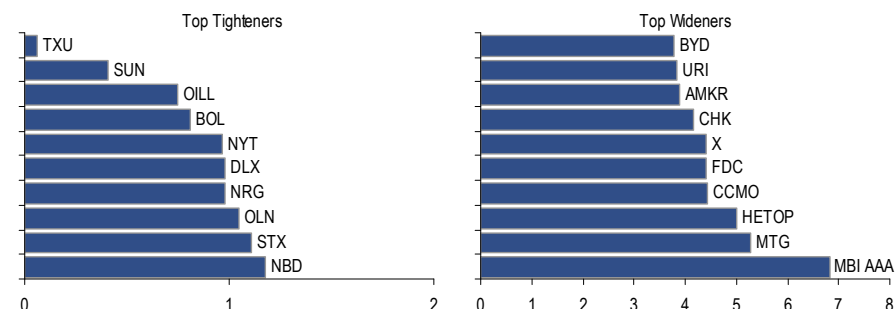
- High yield bonds were down 1.5 points this week. Citi's High Yield Market Index yields 7.25% which translates to a 642bp spread and \$101.09 price.
- Double-B paper (-0.63%) outperformed this week, and is leading both single-B (-0.78%) and triple-C (-1.64%) credits in May.
- Power (+0.33%) and building/building products (+0.02%) are the top performers this month, while technology (-1.82%) and media & entertainment (-1.67%) are lagging.

Cash Performance by Sector, February

Sector	YTW(%)	MTD(%)	YTD(%)	Sector	YTW(%)	MTD(%)	YTD(%)
Auto Mfg/Vehicle Parts	4.97	-0.58	6.72	Media & Entertainment	9.67	-1.67	6.74
Basic Materials	6.95	-0.70	3.25	Paper & Packaging	7.05	-1.24	5.34
Building/Bldg Products	7.30	0.02	10.35	Power	8.54	0.33	2.28
Consumer Products	6.60	-0.33	5.18	Retail	6.99	-0.98	5.17
Energy	7.04	-1.16	2.24	Service	7.76	-0.29	6.97
Finance	6.85	-0.09	9.43	Technology	8.13	-1.82	6.95
Healthcare	7.03	-0.78	5.05	Telecom & Cable	7.26	-1.41	3.76
Leisure & Gaming	8.02	-0.92	7.54	Transportation	7.89	-0.28	8.52
Manufacturing	6.35	-0.56	4.50	HYMI	9.67	-1.67	6.74

Source: Citi

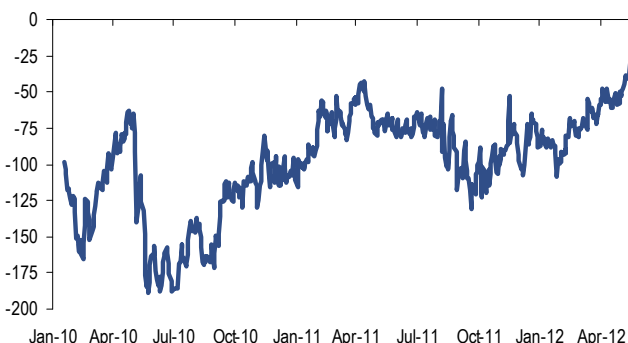
HY 18 CDX Underlying Performance, 10 May – 17 May (pts)



Source: Markit

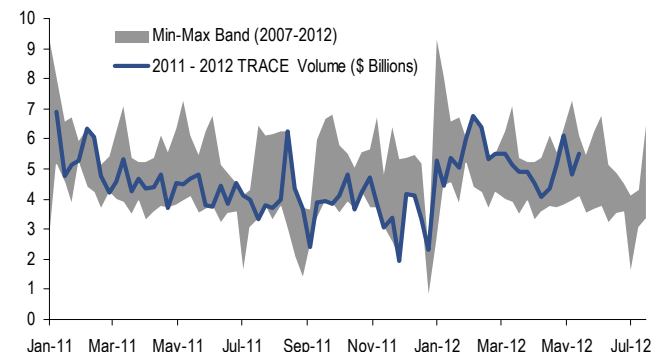
Source: Markit

Median High-Yield Non-Call Liquid Basis



Source: CIRA

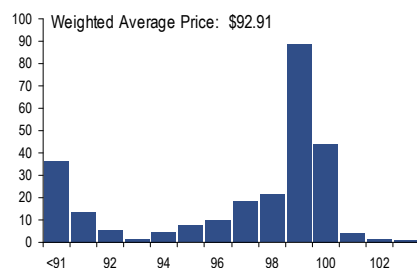
HY Bonds Traded Volume, 5-Day MA



Source: TRACE

Leveraged Loan Tracker (As of Thursday)

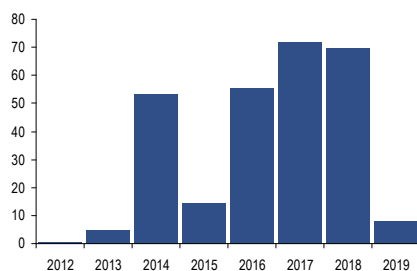
Loan Price Distribution (Market Value, \$bn)



Note: Price distribution of the loans in the Leveraged Loan Tracker.

Source: CIRA, Markit

Maturity Wall (Notional, \$bn)

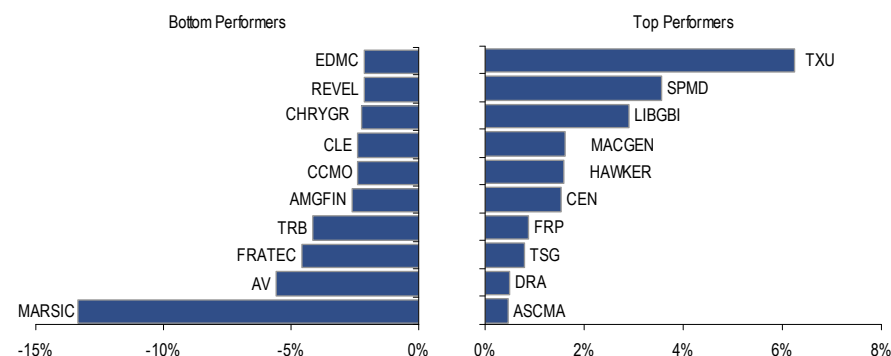


Note: Maturity wall of the loans in the Leveraged Loan Tracker.

Source: CIRA, Markit

- The Leveraged Loan Tracker lost 1.24% last week, taking the year-to-date performance to +3.81%. The Tracker's average price and spread are \$92.91 and 599bp, respectively.
- The Capped Tracker lost 1.07% last week; year-to-date performance is now +3.98%.
- Power (+3.62%) is the top performer this month, while energy (-2.28%) and finance (-2.09%) are lagging.

Leveraged Loan Tracker Issuer Performance (%), May



Source: CIRA, Markit

Source: CIRA, Markit

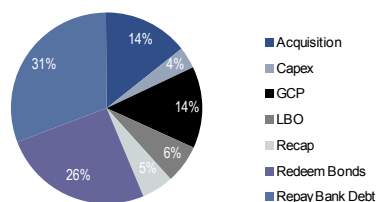
Leveraged Loan Tracker Capped and Uncapped Total Returns by Sector

	Uncapped							Capped						
	Current			Month-to-Date		Year-to-Date		Current			Month-to-Date		Year-to-Date	
	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change
All Loans	\$258,056	92.91	599	-0.47%	18	3.81%	-6	\$236,980	95.13	543	-0.65%	21	3.98%	-18
Auto Mfg/Vehicle Parts	3.77%	98.40	391	-1.03%	31	4.55%	-40	4.10%	98.40	391	-1.03%	31	4.63%	-40
Basic Materials	4.80%	98.47	395	-0.68%	9	2.50%	23	5.23%	98.47	395	-0.68%	9	2.95%	23
Building/Bldg Products	1.22%	95.56	575	-0.83%	28	3.91%	2	1.33%	95.56	575	-0.83%	28	4.30%	2
Consumer Products	4.92%	99.44	365	-0.34%	11	3.88%	-185	5.35%	99.44	365	-0.34%	11	3.89%	-185
Energy	1.19%	96.22	646	-2.28%	70	-1.44%	145	1.30%	96.22	646	-2.28%	70	-1.27%	145
Finance	2.80%	87.47	795	-2.09%	48	5.98%	1	3.04%	87.47	795	-2.09%	48	5.43%	1
Healthcare	13.61%	99.32	382	-0.41%	10	3.19%	2	14.51%	99.34	383	-0.41%	10	3.50%	1
Leisure & Gaming	4.90%	95.89	528	-0.94%	28	5.21%	-52	4.58%	96.65	494	-0.89%	9	4.53%	-58
Manufacturing	2.74%	94.28	625	-0.12%	0	0.38%	100	2.98%	94.28	625	-0.12%	0	0.69%	100
Media & Entertainment	11.32%	82.13	1,121	-1.63%	62	8.02%	-124	9.86%	82.11	1,157	-1.50%	63	8.07%	-141
Paper & Packaging	1.33%	99.46	474	-0.33%	7	2.19%	179	1.45%	99.46	474	-0.33%	7	2.25%	179
Power	7.05%	69.22	1,450	3.62%	-87	-2.66%	321	4.15%	81.07	1,043	1.48%	-22	-0.43%	217
Retail	11.77%	99.06	397	-0.51%	20	3.70%	-12	12.81%	99.06	397	-0.51%	20	3.62%	-12
Service	5.50%	96.13	499	-0.09%	8	8.49%	-166	5.99%	96.13	499	-0.09%	8	8.27%	-166
Technology	9.85%	97.13	480	-0.42%	16	5.63%	-94	8.90%	97.91	461	-0.48%	17	4.63%	-83
Telecom & Cable	12.81%	98.15	443	-1.02%	28	2.47%	52	13.94%	98.15	443	-1.02%	28	2.34%	51
Transportation	0.42%	96.06	472	0.37%	-10	11.64%	-415	0.45%	96.06	472	0.37%	-10	11.64%	-415

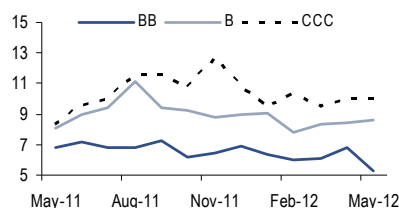
Source: Citi Investment Research and Analysis, Markit

Issuance Tracker (As of Thursday)

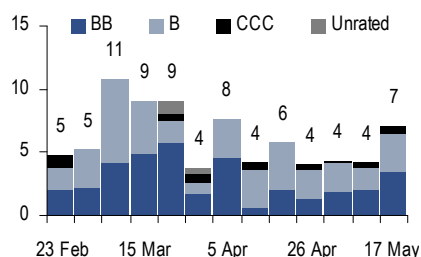
Breakdown of Use of Proceeds, 2011-2012



Weighted Average Coupon by Rating (%)



Weekly Issuance by Rating (\$bn)



Note: USD denominated issuance only.

Source: CIRA

- The primary market continues to be strong. 8 companies issued \$3.8 billion through Thursday.
- The forward calendar looks strong with 14 companies seeking around \$4.9 billion.

Bond Deals Priced in the Market for May 10 – May 17 (\$ in Millions)

Date	Issuer	Amt	Coupon	Maturity	Ratings	Use of Proceeds
05/17/12	AerCap Aviation Sol'ns	300.0	6.375	5/30/2017		
05/17/12	Frontier Comm.	500.0	9.250	7/1/2021	Ba2/BB	Redeem Bonds
05/15/12	Northern Oil & Gas Inc	300.0	8.000	6/1/2020	Caa1/B-	Repay Bank Debt
05/15/12	Sally Holdings	700.0	5.750	6/1/2022	Ba3/BB+	Repay Bank Debt
05/15/12	Inmet Mining Corp	1478.8	8.750	6/1/2020		
05/14/12	Speedy Cash Inc	91.6	10.750	5/15/2018	B3/B	GCP
05/14/12	Kodiak Oil & Gas Corp	156.0	8.125	12/1/2019	Caa1/B-	Repay Bank Debt
05/11/12	Magnum Hunter	443.9	9.750	5/15/2020	Caa1/CCC+	Acquisition
05/11/12	Penn Virginia Corp	600.0	8.375	6/1/2020		
05/11/12	Libbey Glass Inc	450.0	6.875	5/15/2020		
05/11/12	Schmolz & Bickenbach	EUR 258 323.1	9.875	5/15/2019	B1/B+	Repay Bank Debt

12 Transactions 5,593

Note: Some deals might be removed for compliance reasons; therefore the sum of the deals might not equal the total. Non-USD deals are included.

Source: CIRA

Representative Bond Transactions Currently in the Market (\$ in Millions)

Issuer	Amount	Term	Priority
Mastro's	102.0	5.0	Sr. Secured Notes
Carrols Restaurants	140.0	8.0	Sr. Secured 2nd Lien Notes
NGPL PipeCo	550.0	7.0	Sr. Secured 1st Lien Notes
Univar	750.0	7.0	Sr. Unsecured Notes
Global Brass & Copper	375.0	7.0	Sr. Secured Notes
Roofing Supply Group	200.0	8.0	Sr. Unsecured Notes
Consolidated Communications	350.0	8.0	Sr. Unsecured Notes
Kaiser Aluminum	200.0	8.0	Sr. Unsecured Notes
HudBay	400.0	8.0	Sr. Unsecured Notes
Molycorp	650.0	8.0	Sr. Secured Notes
Generac Power	425.0	8.0	Sr. Unsecured Notes
OPI International	125.0	5.0	Sr. Secured 1st Lien Notes

Source: Citi Syndicate

Appendix A-1

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