

## We got the Apple, now we need a little juice

MARKET OUTLOOK | SINGLE NAME NEWS & VIEWS | WEEK AHEAD | RECENT CITI RESEARCH | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS

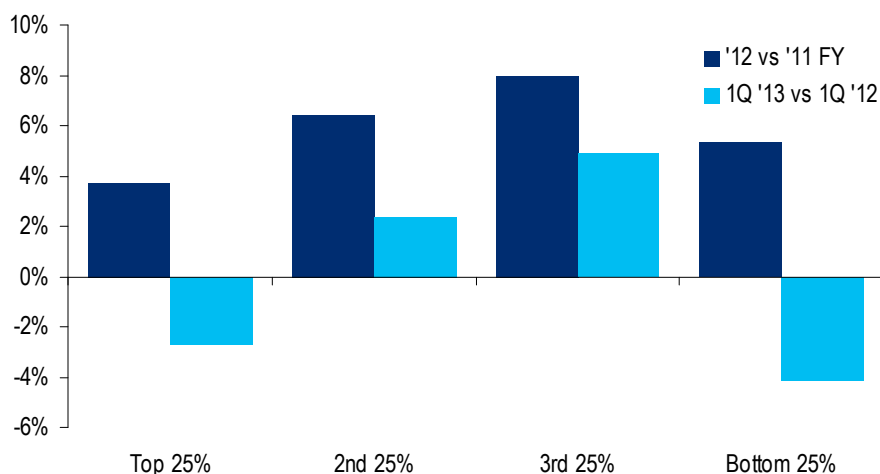
### Market Outlook

For those steadfastly hanging on to the notion that corporate releveraging will turn out to be nothing but a passing fad, we'd imagine that Apple's decision to increase its share repurchase program by \$55bn over the next 3 years and raise debt to do so was a bit like realizing South Korea's Psy may be more than a one hit wonder. Yet while the buyback is notable for its size, as we presume the associated bond deal will be too, what Apple says about the earnings season is just as interesting to our minds.

After all, the Cupertino company didn't exactly exceed expectations when it came to results. As [Citi's equity analyst notes](#), while the buyback could add 2.6% to EPS this calendar year (assuming an average repurchase price of \$400/share), Apple's lowered sales guidance will more than offset the benefit.

It's disconcerting that anemic top line growth has become a common theme this quarter for large cap companies like Apple. Among nonfinancial S&P500 constituents that have already reported 1Q results, revenue growth has been negative for both the top quartile of companies by market cap and the bottom quartile (see figure). That's a departure from 2012, and, more importantly, somewhat unexpected judging by a -1.11% aggregate *sales* surprise.

S&P 500 sales growth by market cap



Source: Citi Research, Bloomberg

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Investment Overview

North America

Corp. High Grade Strategy

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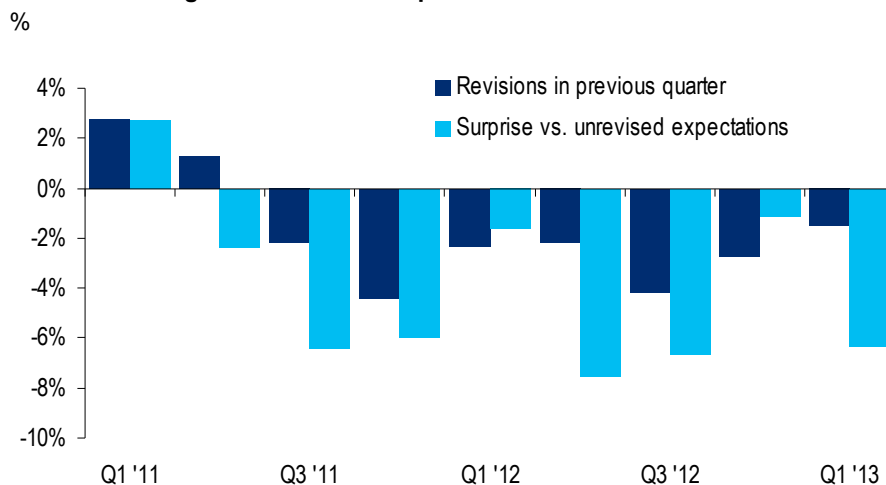
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Predictably, the aggregate *earnings* surprise for S&P500 companies has been positive to the tune of 4.4%. But, as always, we would caution against reading too much into that figure. No doubt, declining share counts and margin expansion have helped the bottom line for most companies. And we reckon the surprise is far more indicative of analysts revising estimates downward throughout the earnings season anyway—thereby making it easier for companies reporting later to beat.

To correct for this revision bias, we prefer to look at the aggregate earnings surprise relative to a “frozen” beginning of the quarter estimate. Viewed this way, it’s clear that first quarter earnings haven’t been nearly as positive as advertised. Indeed, to our minds it looks as if the Street failed to revise expectations sufficiently low enough in the 3 months prior to 1Q earnings, and have since been proved far too optimistic (see figure).

#### S&P 500 earnings revisions and surprises



Source: Citi Research, Bloomberg

So how disappointing have the earnings numbers actually been in an outright sense?

**Citi economists** were looking for 1Q EPS to grow 5% year-on-year for the S&P500, but the aggregate earnings growth rate among the 267 companies that have reported so far has been a meager 1.87% (excluding share repurchases). That’s troubling, especially if the second half of the S&P500 yet to report were to turn in similarly weak growth numbers. Frankly, 1Q might already be bad enough that full year estimates—Citi expects 6% year-on-year EPS growth—may already be blown.

At the very minimum, disappointing 1Q EPS puts incremental pressure on companies to either deliver stronger results in the second half of the year, or to reduce share count by issuing debt for share repurchases, as Apple plans. Unfortunately, given that analysts are rapidly taking down estimates for 3Q and 4Q, we believe it’s likely to be more of the latter and less of the former. In other words, don’t be surprised to see more than a few companies issuing their own “iBonds” in the coming quarters, provided the deal see robust demand.

So how ‘bout them Apples? Where you making ‘em?

**US Credit Outlook** – 2013, Good to the Last Drop (Dec '12)

**IG Corporate Supply Outlook** – More gross, less net (Dec '12)

#### US Key Economic Data

	<u>Consensus</u>
<b>Monday:</b>	
Personal Income	0.4%
Personal Spending	0.1%
Pending Home Sales	1.0%
<b>Tuesday:</b>	
S&P/CS Home Prices	0.8%
<b>Wednesday:</b>	
ADP Employment	150k
ISM Manufacturing	51.0
Total Vehicle Sales	15.25mn
<b>Thursday:</b>	
Initial Jobless Claims	345k
<b>Friday:</b>	
Unemployment Rate	7.6%
Chg in Nonfarm Payrolls	145k

#### Key Earnings Announcements

<b>Monday:</b>
Express Scripts Holding Co
Loews Corp
Newmont Mining Corp
Hartford Financial Svcs Grp
<b>Tuesday:</b>
Pfizer Inc
Enterprise Products Partners
Nextera Energy Inc
Edison International
Aetna Inc
Public Service Enterprise
HCP Inc
Valero Energy Corp
Nisource Inc
Ecolab Inc
Oneok Partners LP
Boston Properties Inc
Archer-Daniels-Midland Co
<b>Wednesday:</b>
Comcast Corp
Time Warner Inc
Exelon Corp
Merck & Co
Prudential Financial Inc
Metlife Inc
CVS Caremark Corp
Viacom Inc
Devon Energy Corporation
Phillips 66
American Tower Corp
CBS Corp

## Single Name News & Views

**Upgrade cycle?** – Contrary to what one might have expected to see, there's been very little evidence of selling to make room for Apple—or Microsoft for that matter. Indeed, according to TRACE trade data, investors have been net buyers of all the high quality/low beta tech names over the last three months, with Intel and Oracle the most popular (see figure).

Not surprisingly, it's been a far different story when it comes to the higher beta credits within the sector. Cumulative net sales by clients of the two PC retailers grappling with secular headwinds have reached roughly \$600mm over the past three months.

If anything, that implies to us that market technicals may be near perfect for Apple. With many investors likely underweight the sector after reducing holdings in the PC retailers, there should be plenty of dry powder to absorb a higher rated alternative.

Yet exactly how big Apple's inaugural deal will be and when it will come is still uncertain. We'd expect it to set the record for a tech deal, and thereby surpass Intel's \$6.125bn multi-tranche offering from last December. But beyond that, it's hard to guess how much paper the company might try to bring at one time. Presuming the deal is \$10bn or less and it comes relatively soon, we'd expect repricing within the tech sector to be minimal.

On the other hand, if Apple chooses to wait and the economy strengthens, pricing conditions could actually deteriorate in the face of rising yields.

Allstate Corp

**Thursday:**

American International Group

P G & E Corp

Kraft Foods Group Inc

Xcel Energy Inc

Sempra Energy

PPL Corporation

International Paper Co

Kellogg Co

Actavis Inc

Gilead Sciences Inc

Cigna Corp

**Friday:**

Berkshire Hathaway Inc

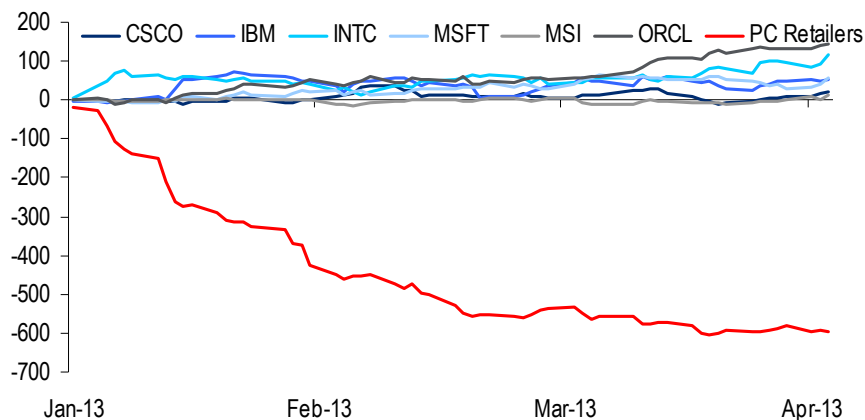
Duke Energy Corp

Consolidated Edison Inc

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### YTD net client purchases for technology credits\*

\$mn



Source: Citi Research, Bloomberg

\*Net purchases are calculated as the volume bought minus the volume sold by non-dealers.

Volumes are measured from TRACE-reported trades greater or equal to \$1mn. TRACE records trades larger than \$5mn at \$5mn.

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**Prologis goes pro-debt holders** – Prologis is one company that's clearly bucked the releveraging trend this quarter. The company ended 2012 with leverage of 9x—the highest among all IG REITs—but has since received \$3bn from its international business segments. And on Thursday Prologis tapped the equity market for \$1.3bn with the intention of using \$1bn to repay debt. All told, the moves will reduce leverage to 6x, which is the company's year-end target.

How long leverage will stay at 6x is another question entirely. Prologis has a \$2bn development pipeline and will likely need to tap the debt markets at a later stage, given the company's REIT structure.

In the meantime, it's likely the company repays a combination of the following: the \$363mm convertible bond that becomes callable in May, the \$325mm of bond coming due in June, and the \$890mm outstanding on its credit line at year-end.

As one would expect given the credit positive nature of news (even if only temporary), **CDS tightened 10bp on the announcement**. In the coming weeks, we expect S&P to upgrade Prologis from BBB- to BBB (Moody's and Fitch are already at Baa2/BBB).

### **Week Ahead**

While Japan's golden week festivities most likely will keep the nation out of the headlines next week, we will nonetheless have more than enough on our plates with earnings in full swing. Bellwethers reporting next week include Express Scripts, Pfizer, Aetna, Comcast, Time Warner Inc, Prudential Financial, and Metlife.

Wednesday's FOMC statement is likely to remain accommodative and indicate that QE will continue at the current pace. We will be looking to minutes later next month for a better indication of changes in the Fed's view. The ECB will announce its rate decision on Thursday. A 25bp cut is widely anticipated, with our **economists expecting** a further cut by the end of the year. They do not expect a cut in the deposit rate, and also reckon any action to reduce collateral requirements (most likely a reduction in haircut on ABS of SMEs from its current 26%) will not take place until June.

The flurry of data disappointments in the past month suggests that expectations have been too optimistic as of late (CESIUSD Index on Bloomberg). The worry is that the consensus for next week's nonfarm payrolls to bounce from 88k last month to 145k may be too optimistic as well. Personal spending and income releases on the other hand are expected to reflect a slowdown.

Italian politics will also be in the news next week. A vote of confidence in Letta's proposed new government is scheduled for Monday; however, the government lineup has not been presented yet. This may influence the bond auction Italy is having on the same day, after the modest weakness we saw in yields this week.

# Appendix A-1

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