

What feels wrong is probably right

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

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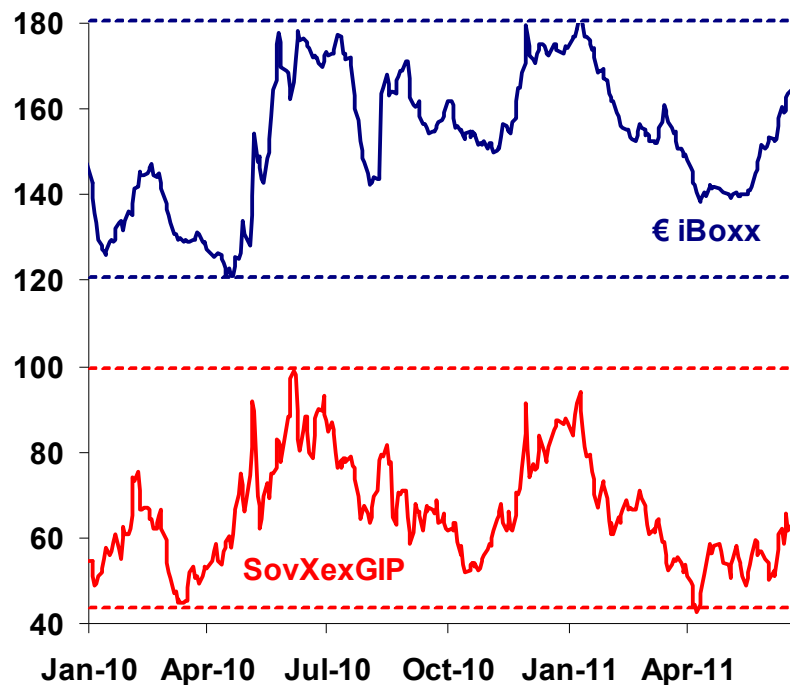
* Presentation prepared on 24 June 2011



IG credit still in a range

European credit is in a range

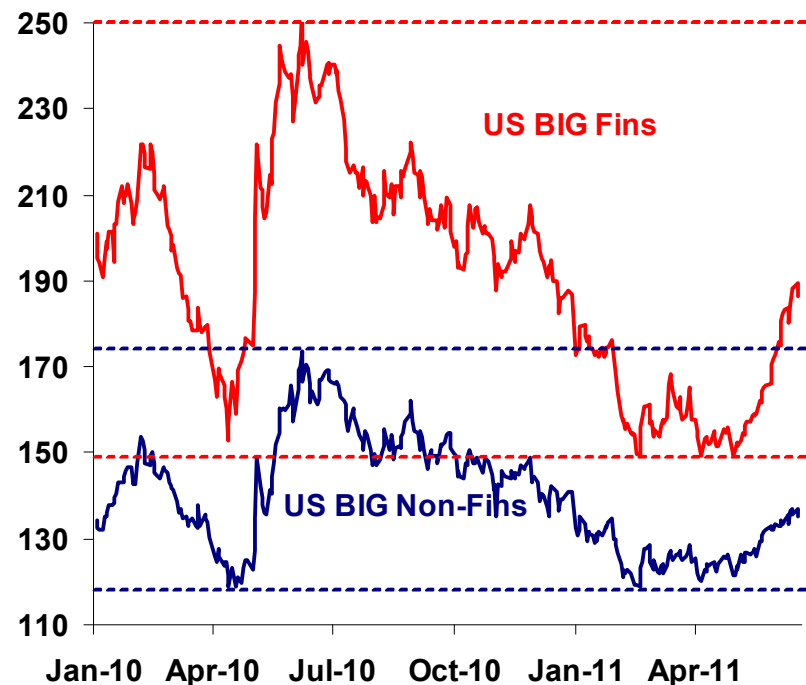
€ iBoxx & SovX ex. PT, IRL & GR, bp



Source: CIRA, Markit

US credit is in a range

US BIG Non-Fins vs. Fins index, bp



Source: CIRA, Markit

Stuck between cheap money & macro uncertainty

A can of worms ...

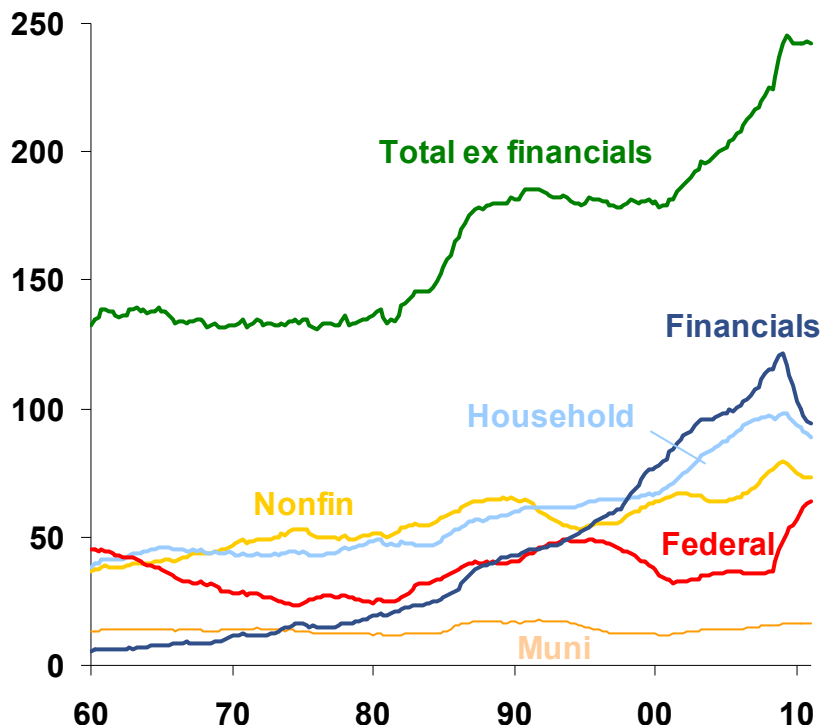
... is best kept rolling

How to keep a lid on it

Debt issues remain unresolved

Still running on max leverage

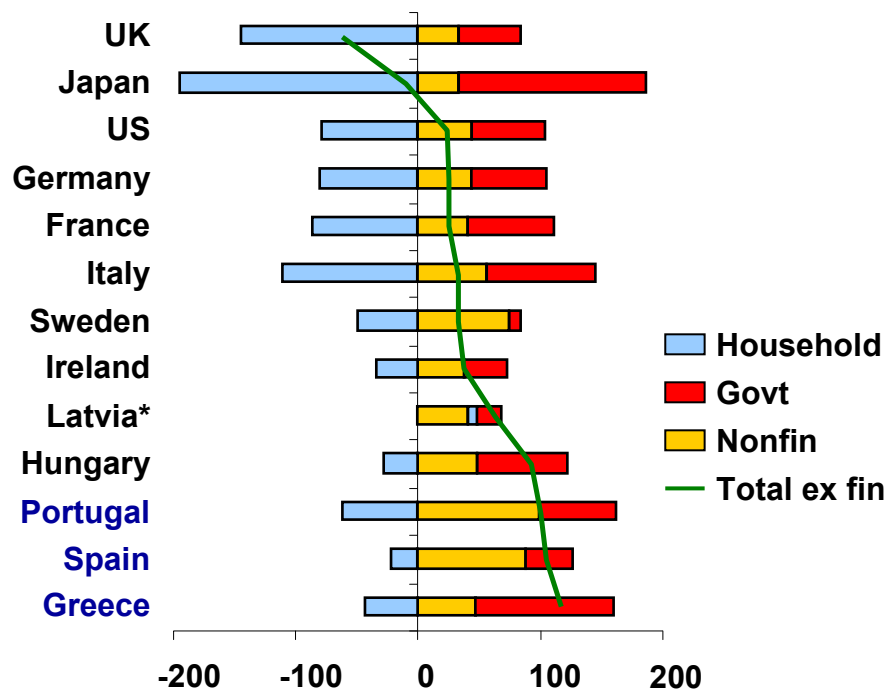
US debt/GDP by sector, %



Source: Federal Reserve Flow of Funds.

Net debt across sectors

Debt minus non-equity, non-property assets, % GDP, 2009



Source: National accounts, Eurostat, Haver Analytics, CIRA calculations.

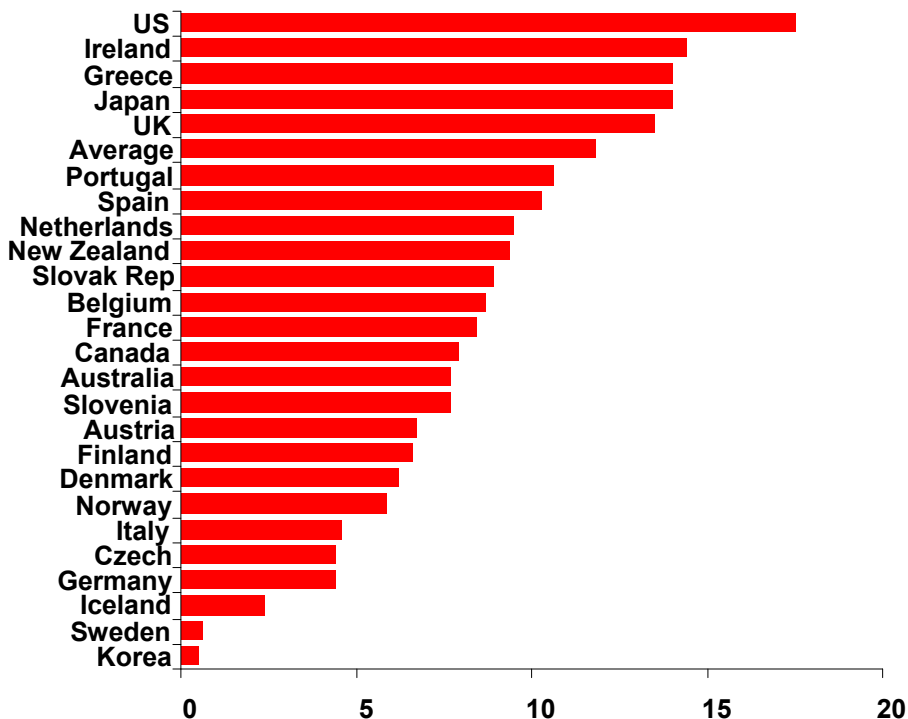
* Latvia data are 2008.

From unsustainable private borrowing to unsustainable public borrowing

Debt issues remain unresolved (2)

Plug that into your growth forecast

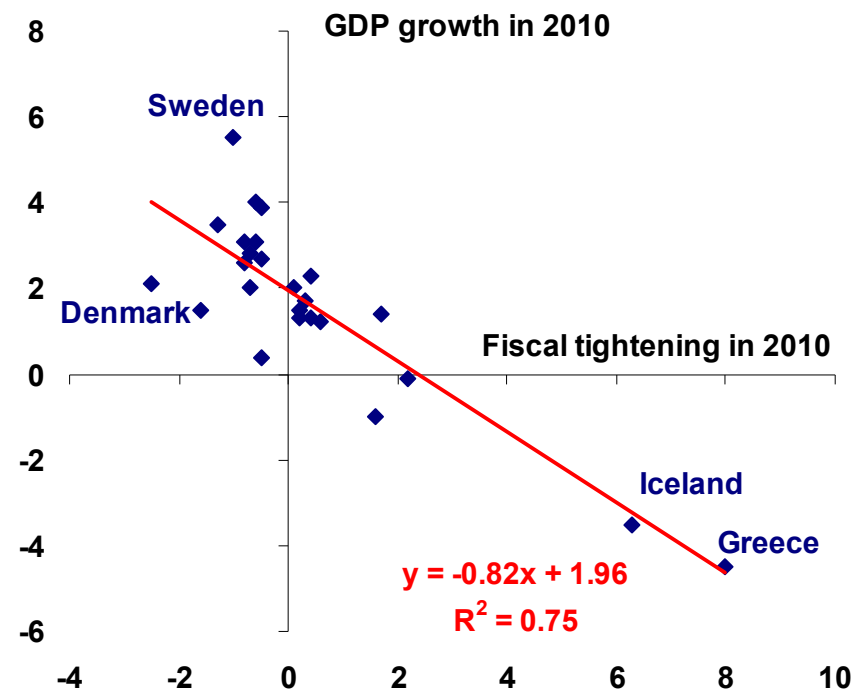
Required tightening, 2010-30, inc age-related, %GDP



Source: IMF *World Economic Outlook*, April 2011.

Fiscal tightening takes a toll on growth

Chg. in struct. deficit vs GDP growth, select countries



Source: CIRA, IMF Global Fiscal Monitor (April 11), IMF WEO (April 2011)

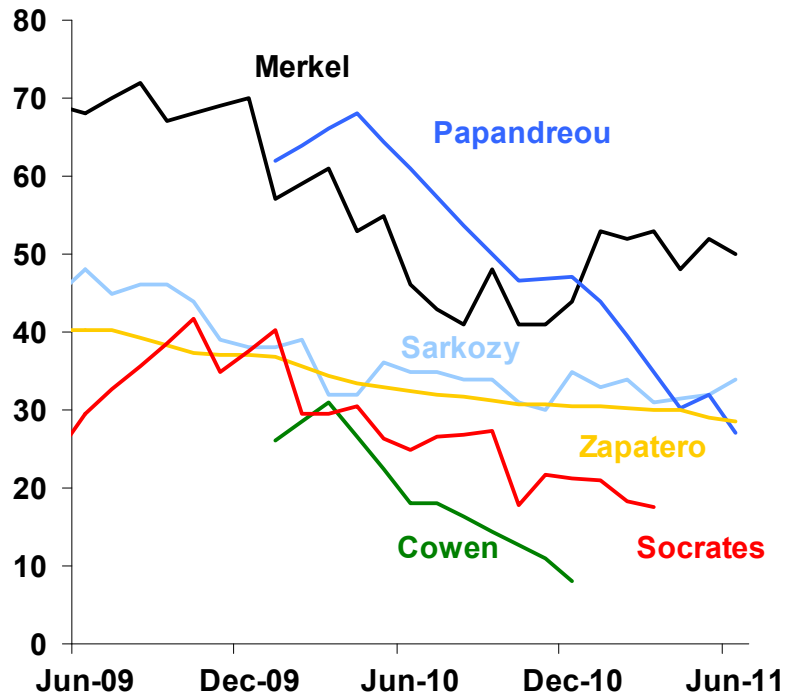
Structural rebalancing will weigh on growth

Periphery problems remain unresolved



The people's verdict on austerity

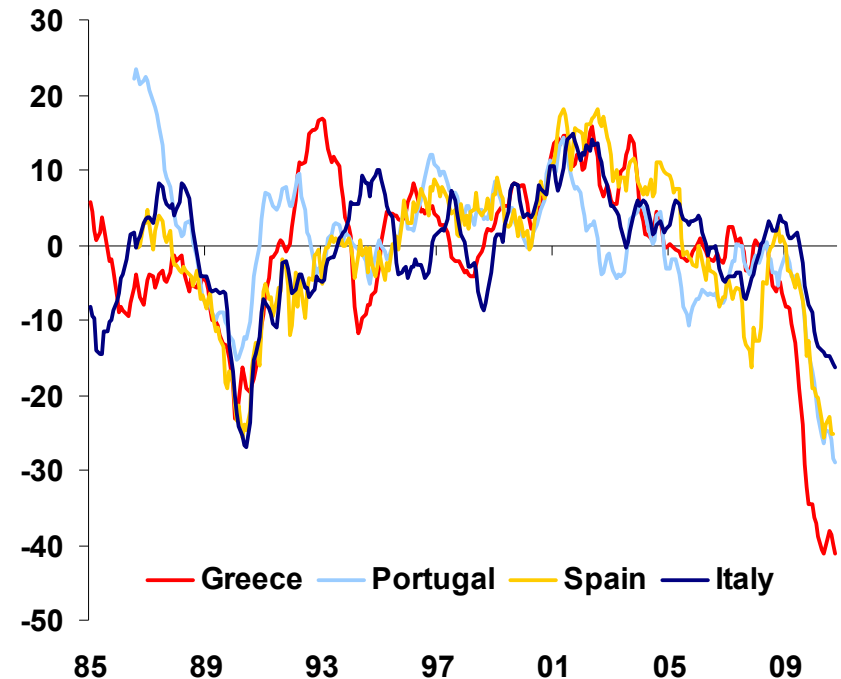
Approval ratings of incumbent politicians, %



Source: CIRA, national newspapers and polling agencies.

Where's the light at the end of the tunnel?

Economic sentiment, difference to Germany, pts



Source: CIRA, Haver Analytics

The biggest risk is domestic sentiment

Can contagion be controlled?

Direct exposure manageable

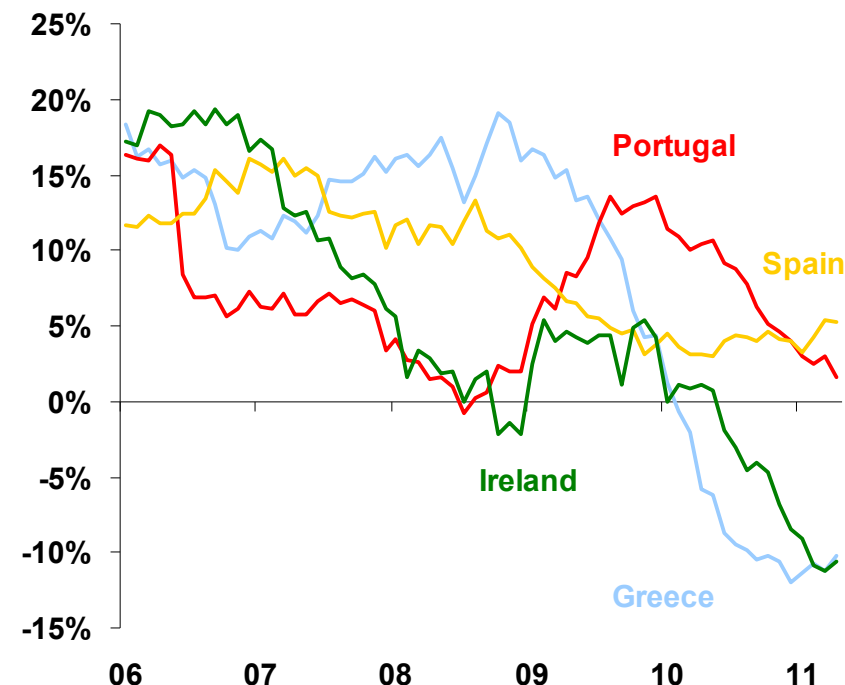
Sovereign debt exposure, € bn

Bank		Greece	Ireland	Portugal	Spain
Bankinter	€				1.7
Barclays	£	0.4		1.0	4.4
BBVA	€	0.1		0.1	31.9
BNP Paribas	€	5.0	0.4	1.9	3.7
Commerzbank	€				
Credit Agricole	€	0.7	0.1	1.1	2.2
Danske	€		0.7		
Deutsche	€	1.1	-0.1	-0.1	1.0
Dexia	€	3.5			
Erste	€	0.8	0.1	0.3	0.2
HSBC	\$	1.9	0.8	0.7	0.1
Intesa SanPaolo	€	0.8	0.2		0.6
KBC	€	0.6			
Lloyds	£				
Monte	€			0.1	0.1
Natixis	€				
Nordea	€	0.2			
Popolare	€	0.1			0.2
Popular	€			0.7	7.6
Raiffeisen	€				
RBS	£	2.0	4.3	0.7	0.8
Sabadell	€			0.1	4.9
Santander	€	0.3		1.6	21.0
SEB	€	0.2		0.1	0.2
SocGen	€	2.1		0.4	1.2
UniCredit	€	0.8	0.1	0.2	0.5

Source: CIRA, Company reports, CEBS 2010 data, Company disclosure. See Nedialkov et al. "[Core Banks Oversold](#)", 22 June 2011

The 2nd order effects may not be

Change in domestic deposits, % YoY



Source: CIRA, Haver Analytics, Eurostat

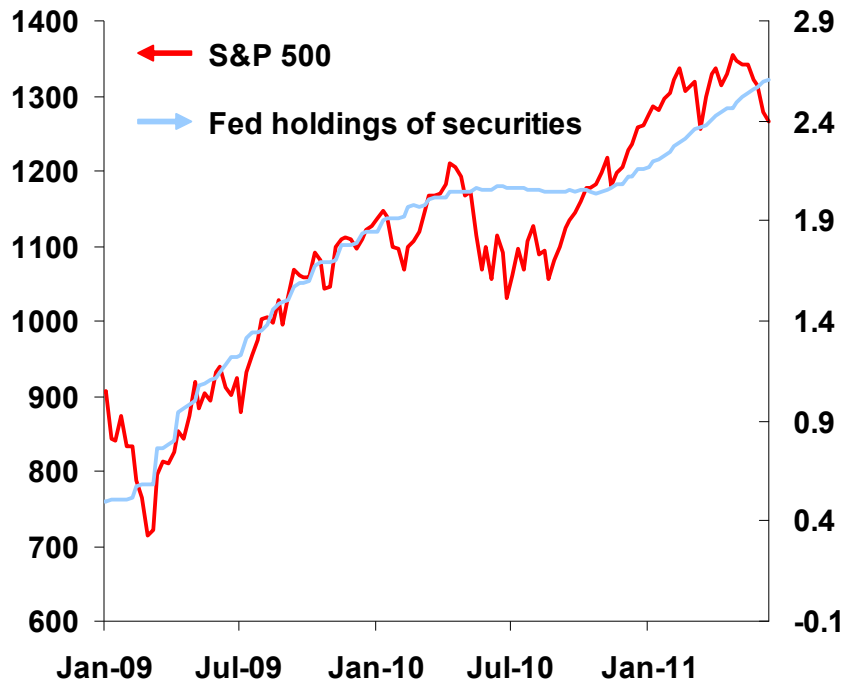
Too many unknowns to run the risk now

To what extent did QE drive returns?



Risk assets correlate with QE

Fed security holdings, \$tr, vs S&P 500



Source: CIRA, Federal Reserve

Big QE purchases = Big market rally

Weekly cumulative market performance since 2009 by size of Fed purchases of securities

Gain in:	-- Weeks with purchases of: --	
	>\$10bn	<\$10bn
US BIG (bp)	-298	-33
S&P 500 (cum. %)	36%	3%
S&P 500 (points)	355	4
# of weeks	59	67

Source: CIRA, Federal Reserve, Bloomberg

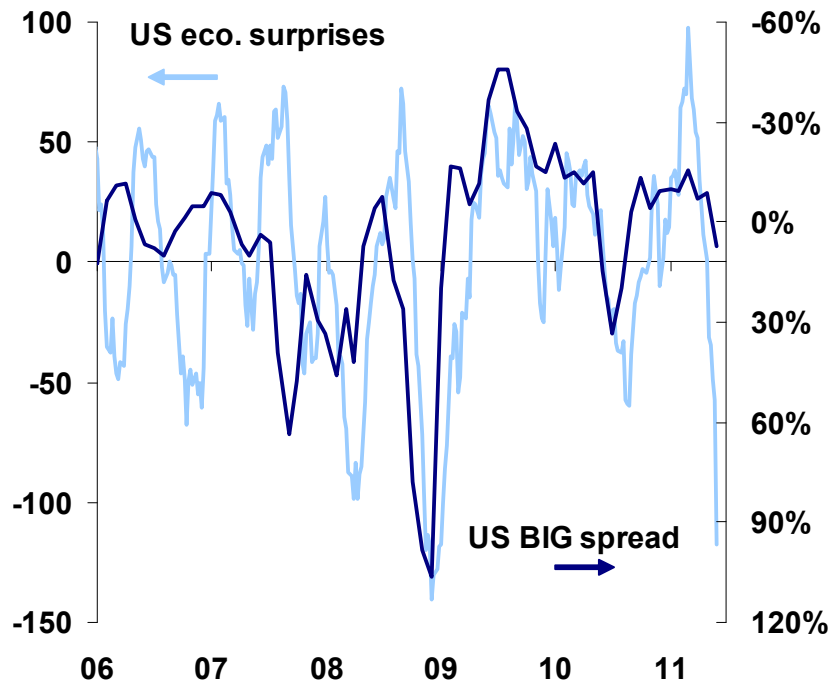
Markets more vulnerable to headlines going forward

Growth concerns emerging already?



Decoupling from the macro story?

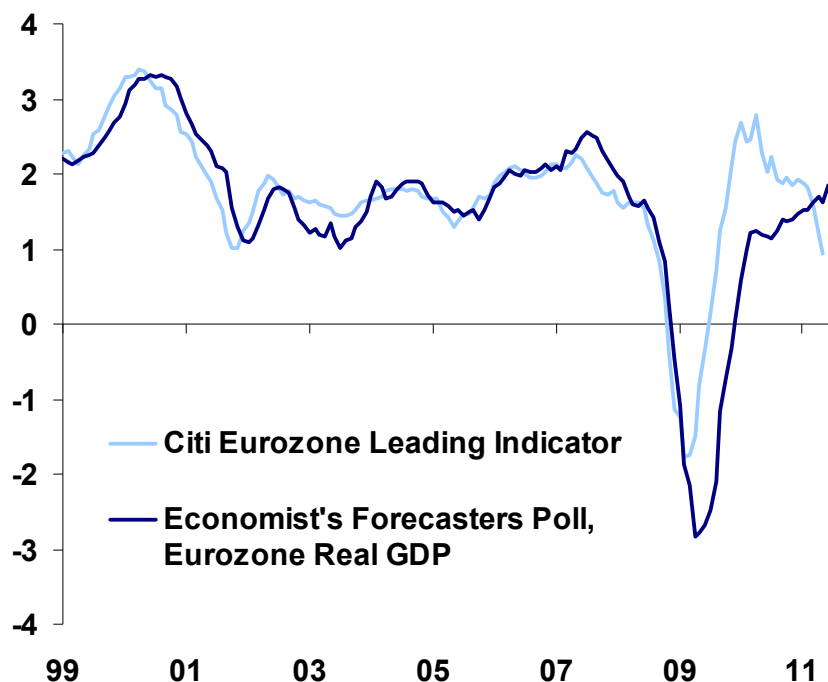
US IG spread, 3m % chg, vs US econ surprises



Source: CIRA

Consensus still seems too optimistic

Citi leading indicator vs consensus, % GDP growth



Source: CIRA, The Economist

Macro surprises have been extremely negative

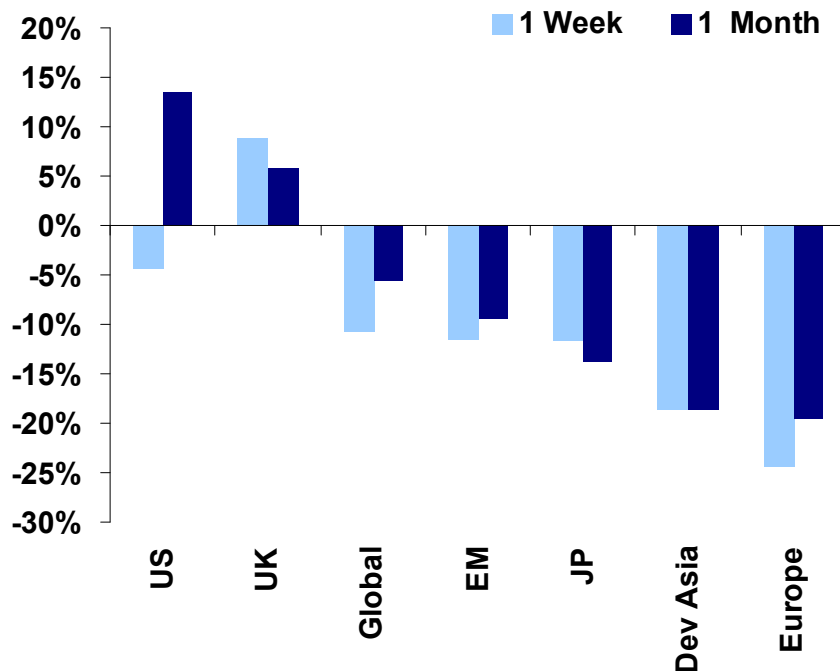
Bottom-up consensus too positive?



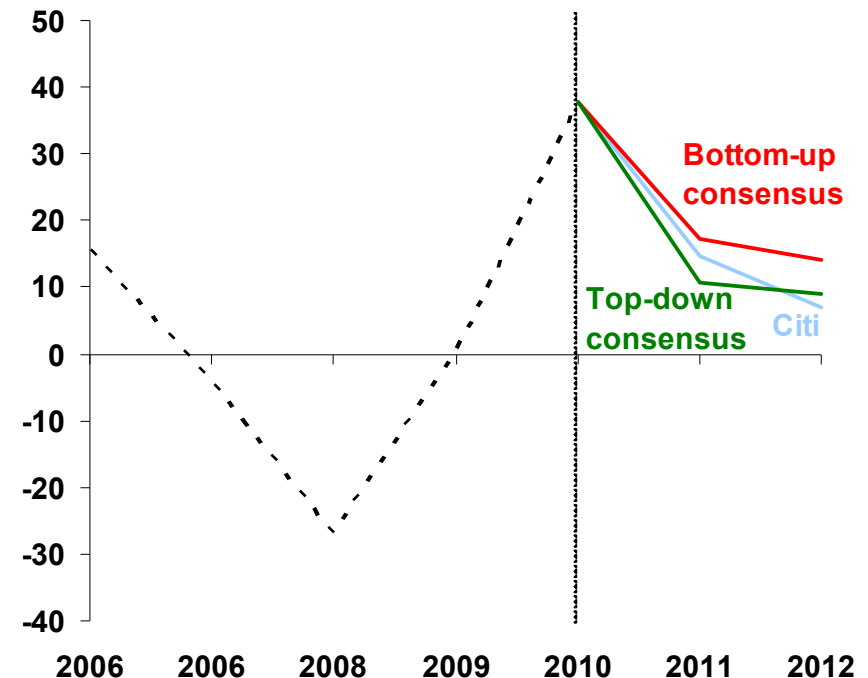
More downgrades than upgrades now but there is further to go!

Net analyst earnings revisions by region, %

S&P 500 operating EPS history & estimates, % YoY



Source: CIRA



Source: CIRA, S&P, Thomson Financial, Bloomberg

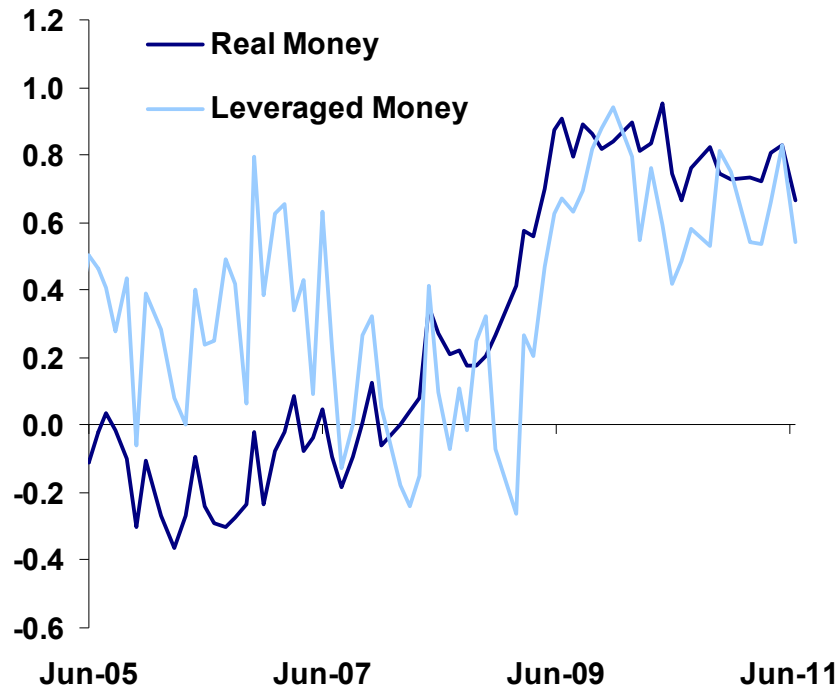
Analysts likely to revise expectations down soon

Positions are still long in credit



Credit investors remain long ...

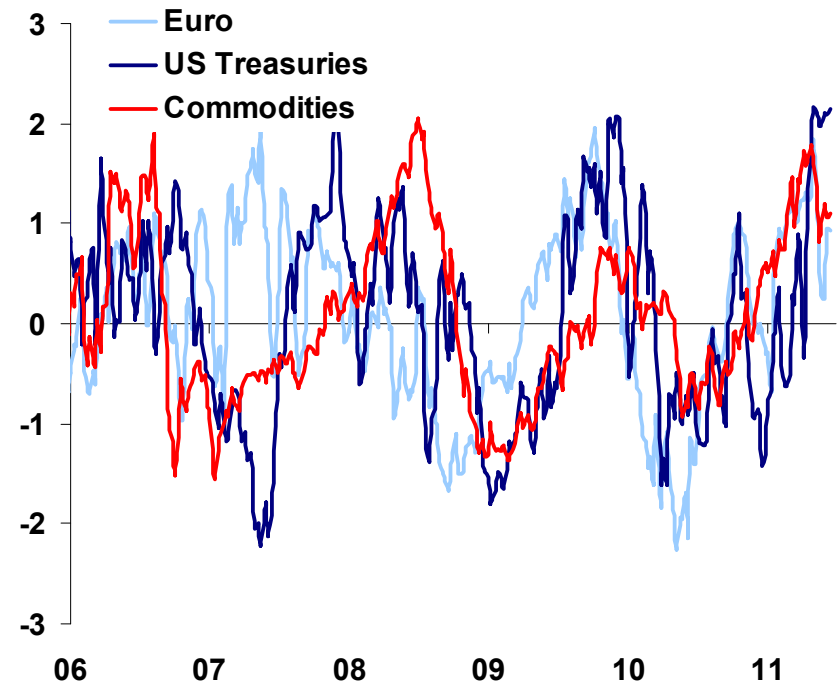
Citi Credit Survey, +/-2: Very long/short



Source: CIRA

... and other assets look vulnerable too

CFTC net futures positions, st.devs. from 2yr avg



Source: CIRA, CFTC, Bloomberg

Vulnerable to more bad headlines

A can of worms ...

... is best kept rolling

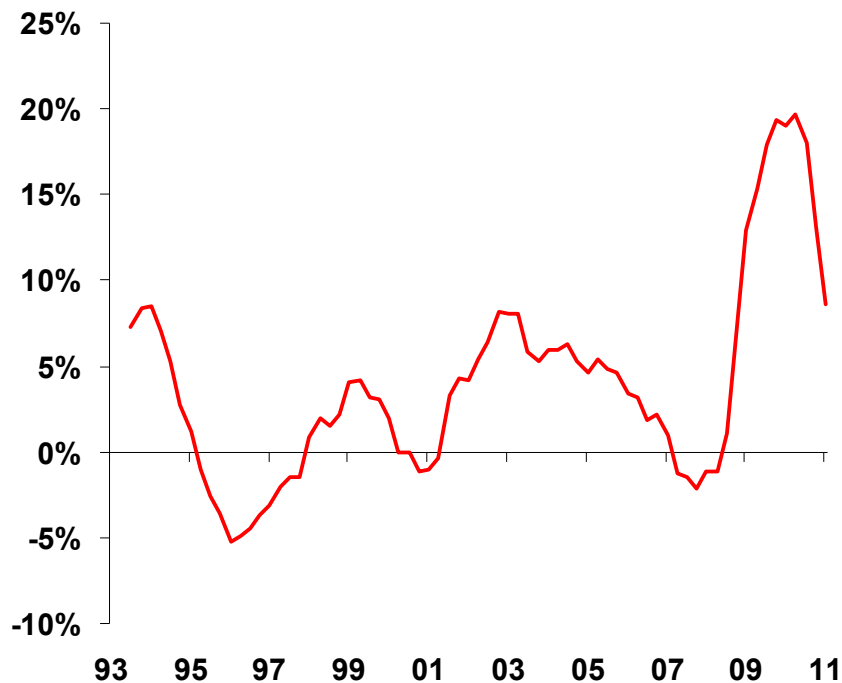
How to keep a lid on it

Supply lots of liquidity ...



Money for nothing ...

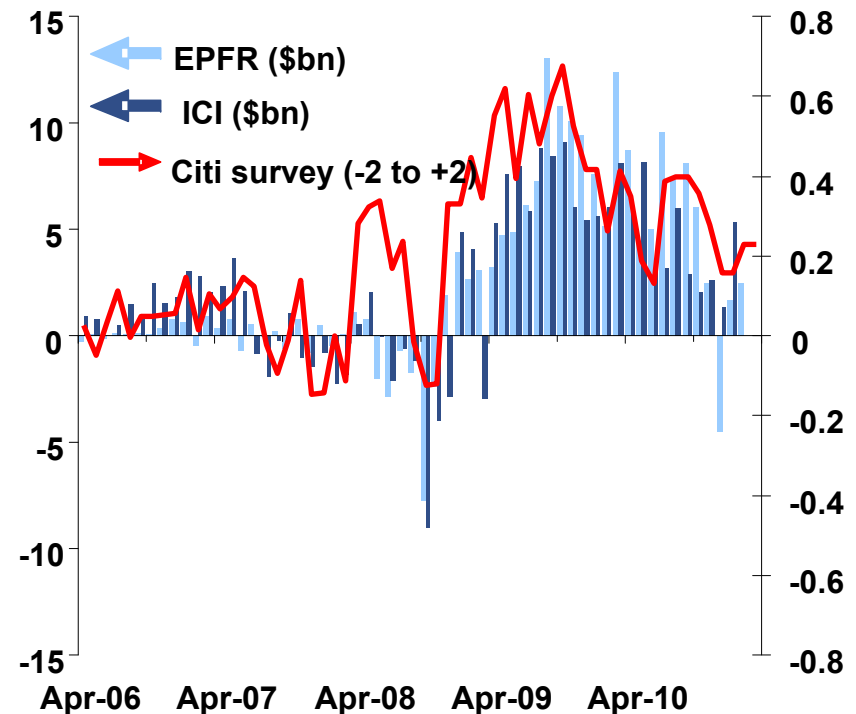
*Global excess liquidity index**



Source: CIRA, Haver. *: 2yr excess growth in M2 over GDP for major economies

... keeps the liquidity flowing into credit

Mutual fund inflows vs Citi credit survey



Source: CIRA, EPFR, ICI

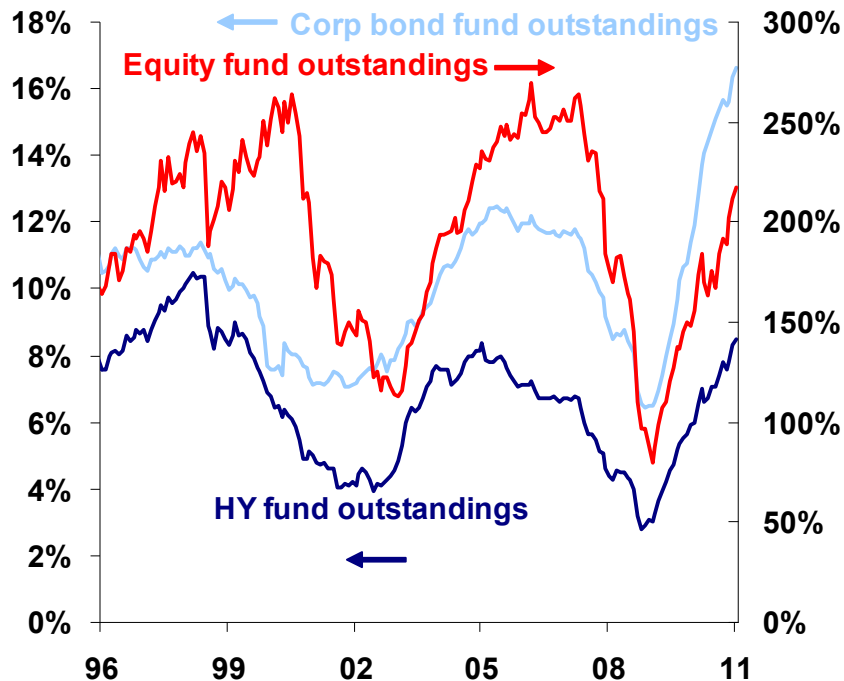
... to keep the inflows coming

Make it expensive to sit on the fence ...



The rush out of money markets

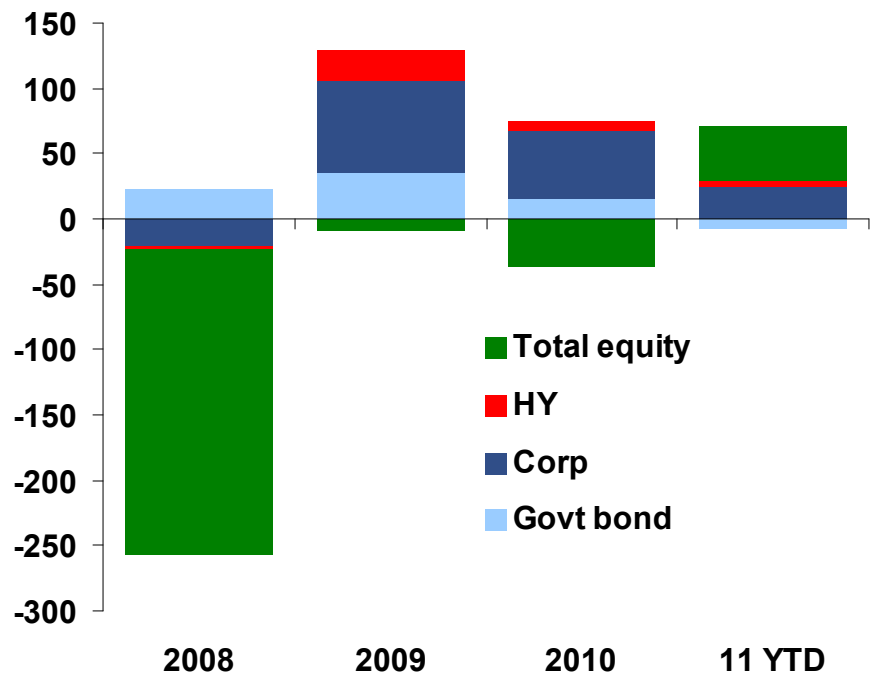
Mutual fund investments, % of m-mkt outstanding



Source: CIRA, ICI

First govies, then credit, now equities

US mutual fund flows by asset class, \$bn



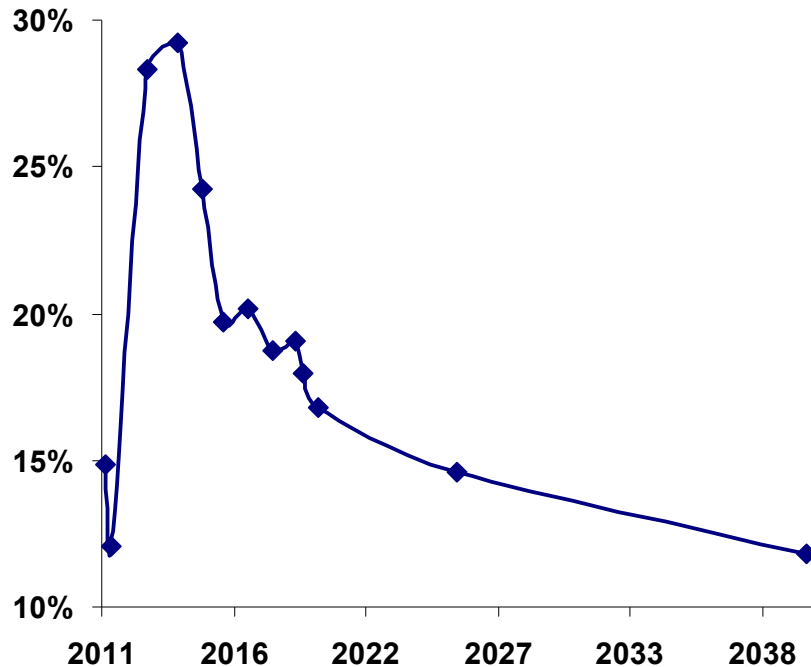
Source: CIRA, ICI

... to force people into riskier assets

Keep the can rolling over ...

Defaulting, but not yet!

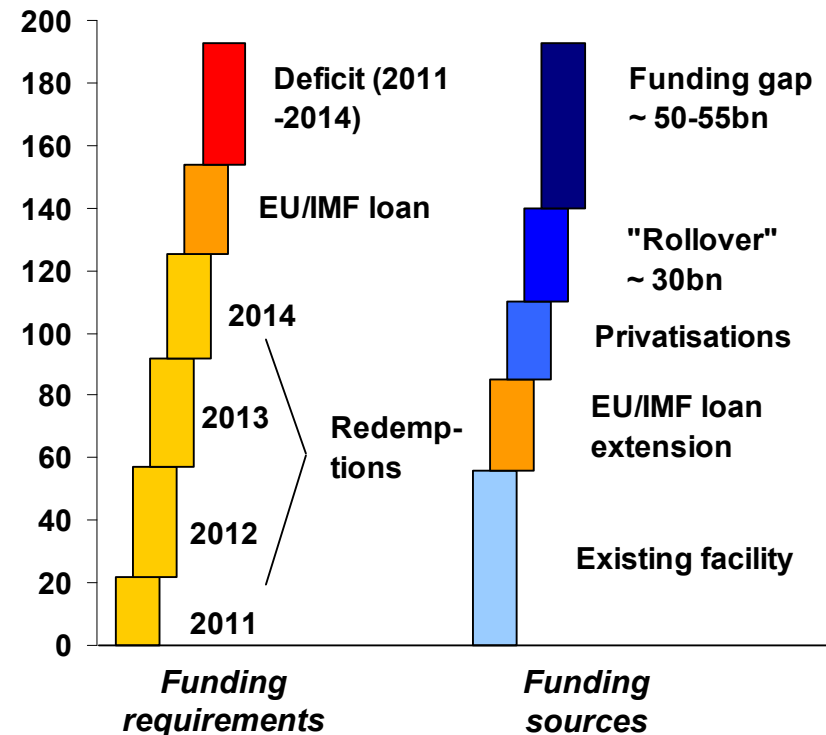
Greek yield curve, 23 June 2011



Source: CIRA, Bloomberg

Plugging the funding gap

Greek funding requirements & sources, 2011-14, €bn



Source: CIRA, IMF

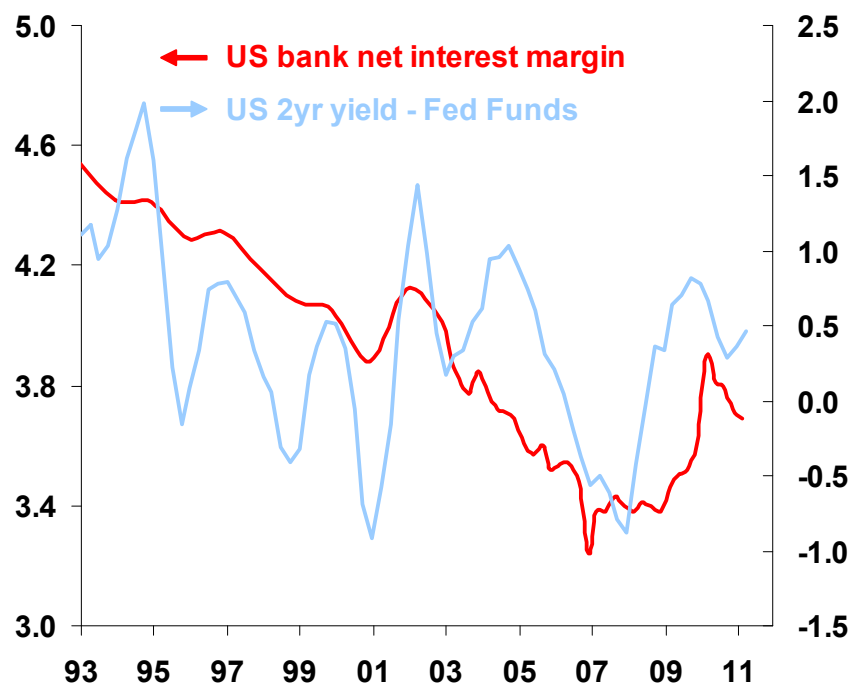
... to persuade markets that default is not imminent

Keep the profits coming ...



Recap the banks with a steep curve

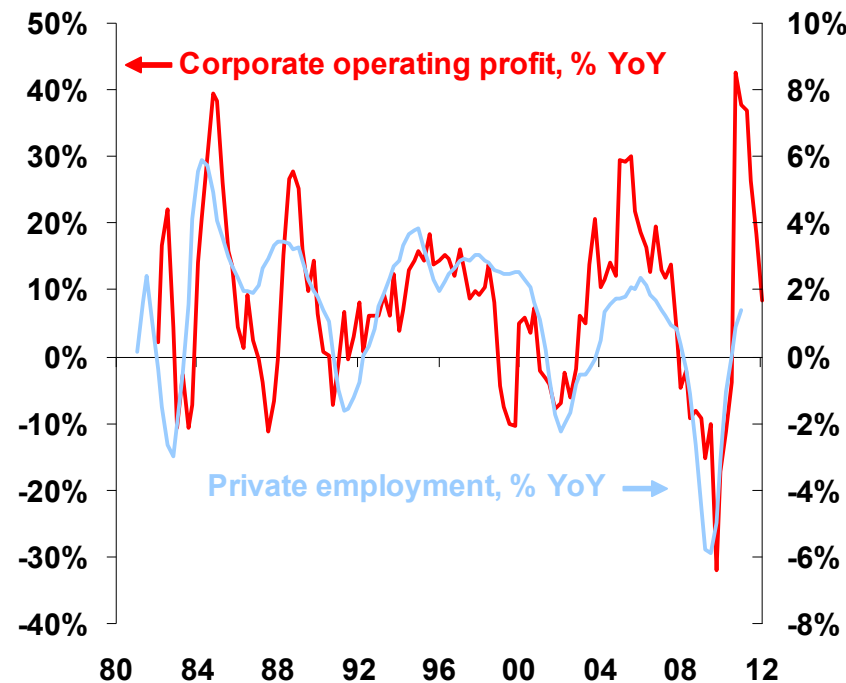
US bank net int. margin vs 2yr yield - Fed funds



Source: CIRA, Haver Analytics, FDIC, Bloomberg

Hope profits turn into jobs

US non-fin profits (advanced 1y) vs. priv. employment, % YoY



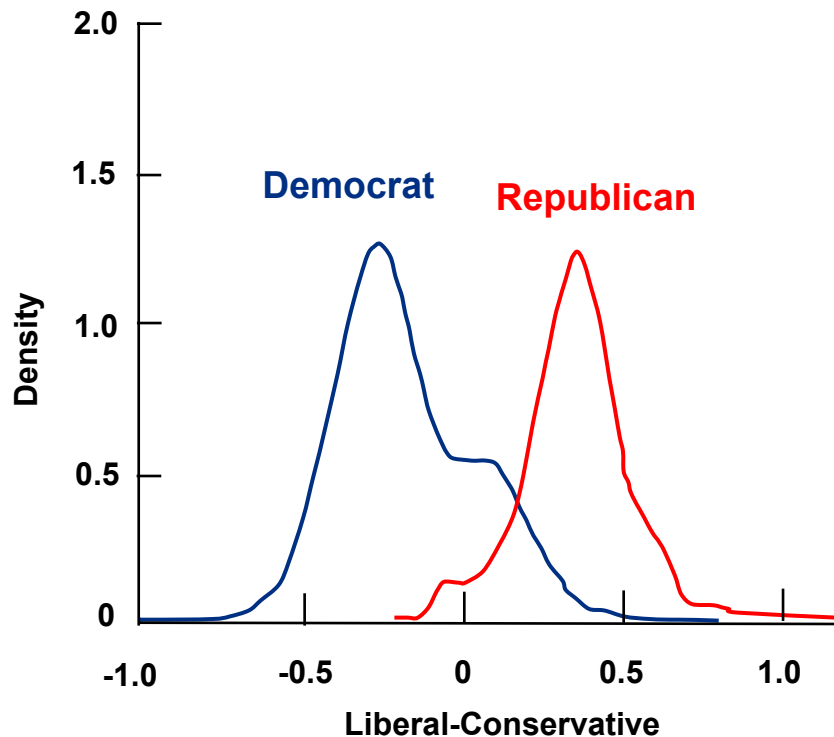
Source: CIRA, Haver Analytics

... in the hope that corporates can drive growth

Postpone the fiscal problems

The open-minded 1960s

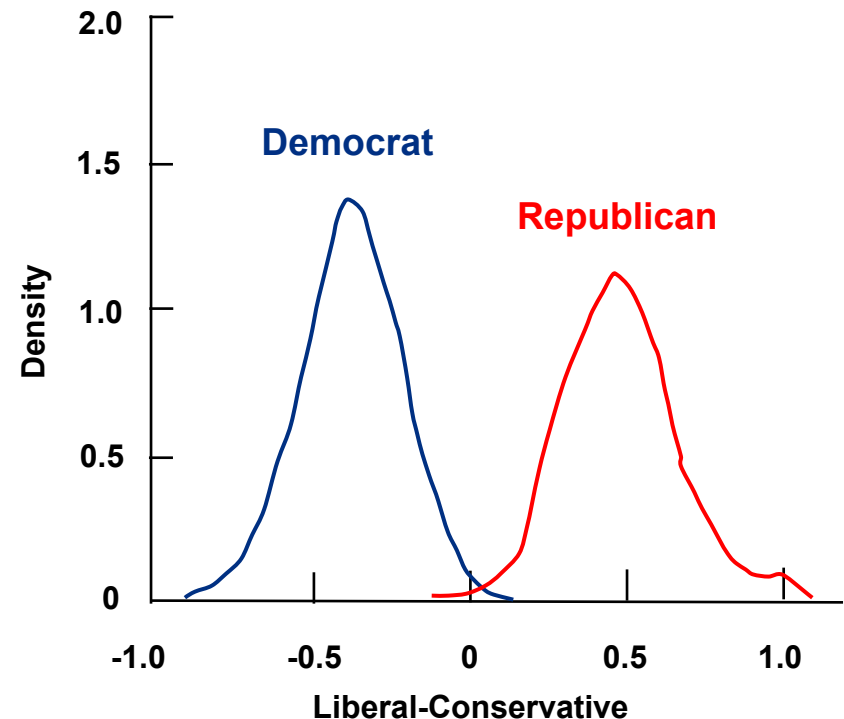
Voting patterns in 90th Congress (1967-68)



Source: R. Carroll et al., "Who is more liberal, Senator Obama or Senator Clinton?" April 18, 2008. See also "Won't You Be My (Hyper-Partisan) Neighbor?", P. Orszag.

The hard-nosed 2000s

Voting patterns in 110th Congress (2007-08)



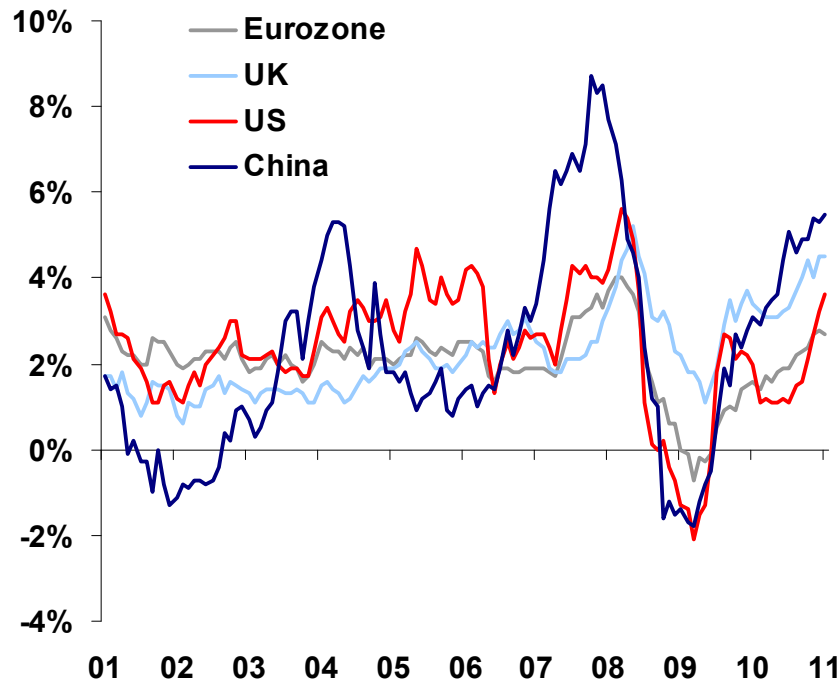
Source: R. Carroll et al., "Who is more liberal, Senator Obama or Senator Clinton?" April 18, 2008. See also "Won't You Be My (Hyper-Partisan) Neighbor?", P. Orszag.

Do the bare minimum to raise the debt ceiling

Inflation? Who cares about inflation

Headline inflation rising everywhere

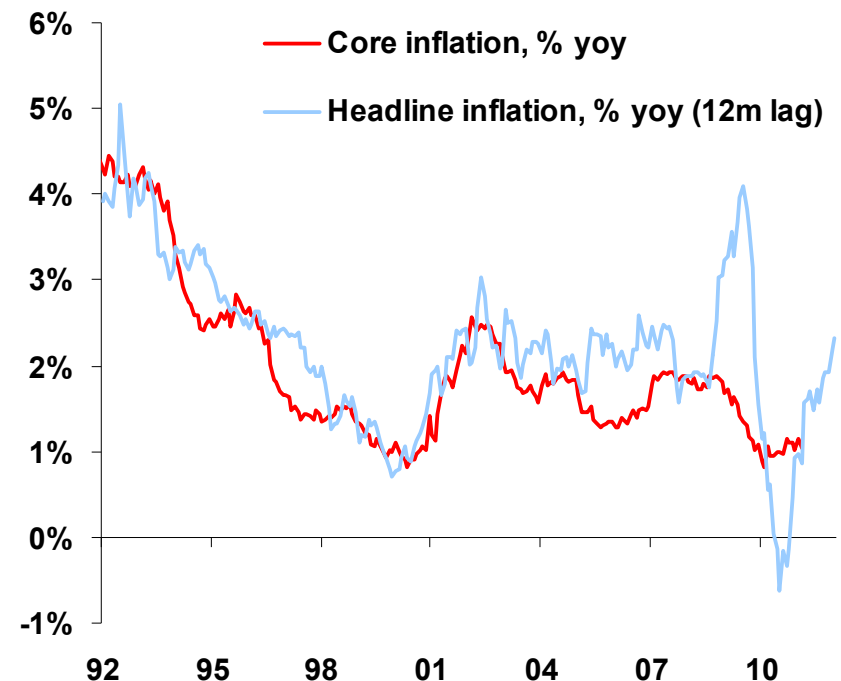
Headline inflation, select countries, % YoY



Source: CIRA, Bloomberg

Headline leads core inflation

Eurozone headline and core HICP, % YoY



Source: CIRA, Haver Analytics, ECB

Only the ECB responding to headline inflation

A can of worms ...

... is best kept rolling

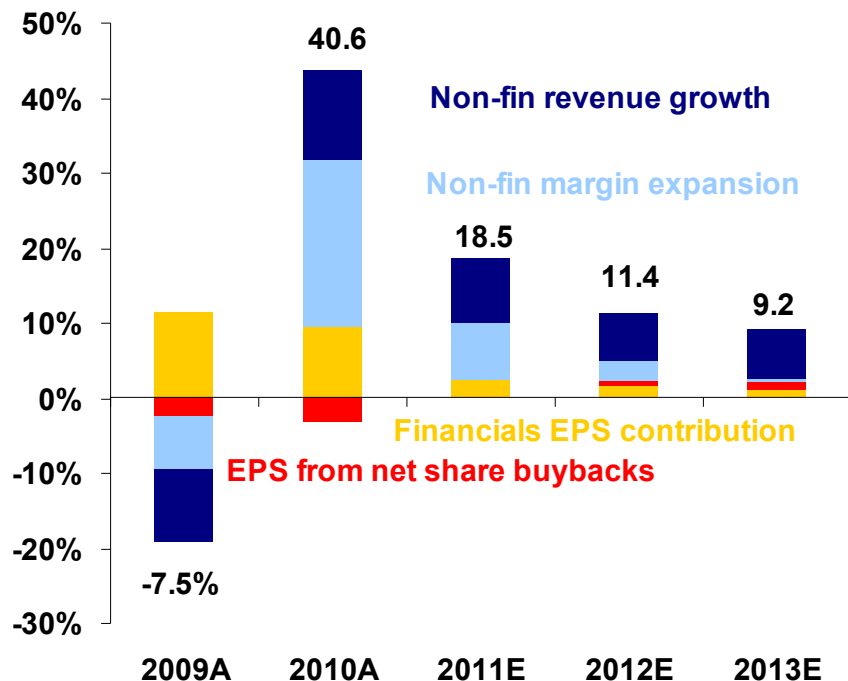
How to keep a lid on it

Find an asset that isn't constrained



Profit growth? Slowing, but positive

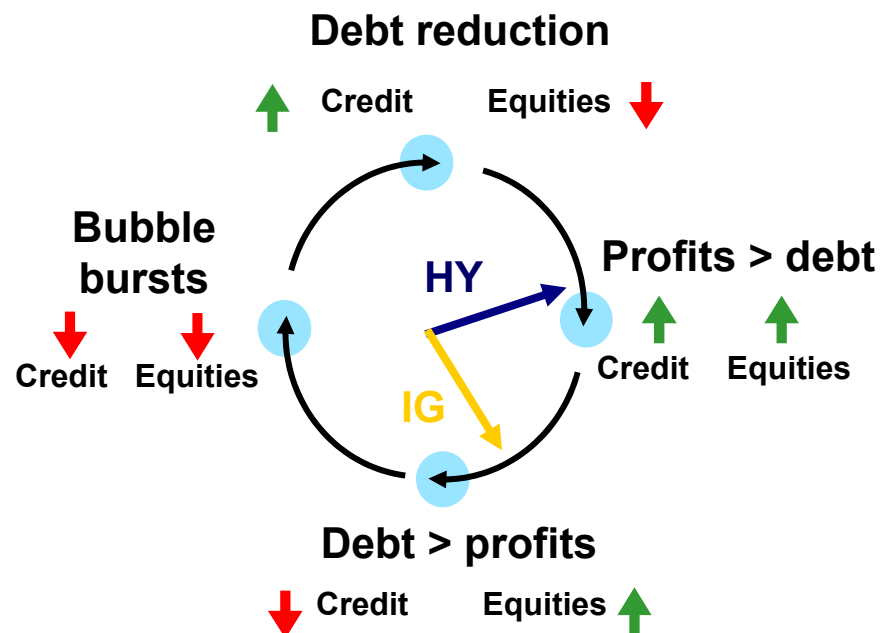
Citi top-down global EPS forecast, % YoY



Source: CIRA

Ticking onwards – especially in IG

The leverage clock

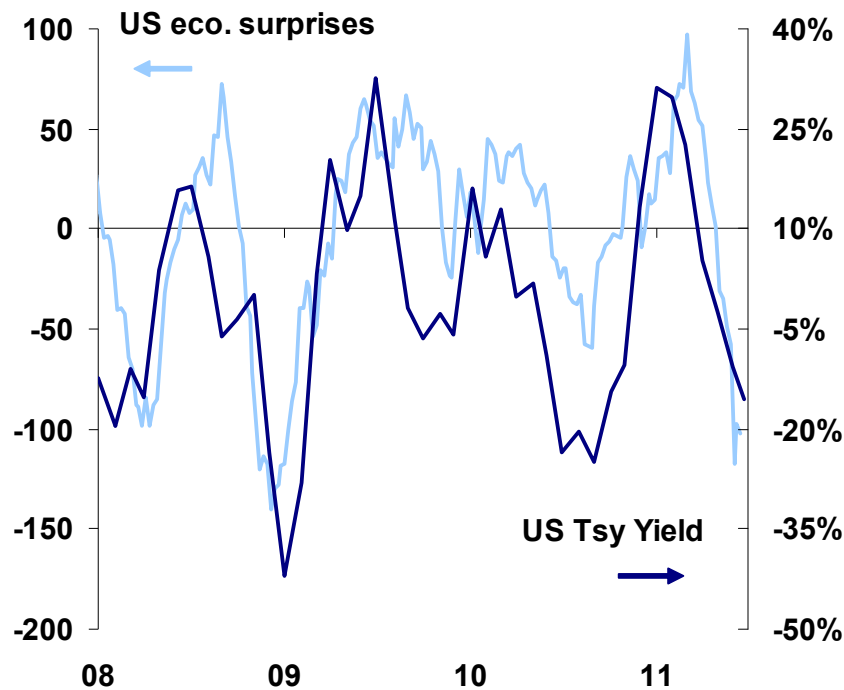


Source: CIRA

Shareholders in the driving seat

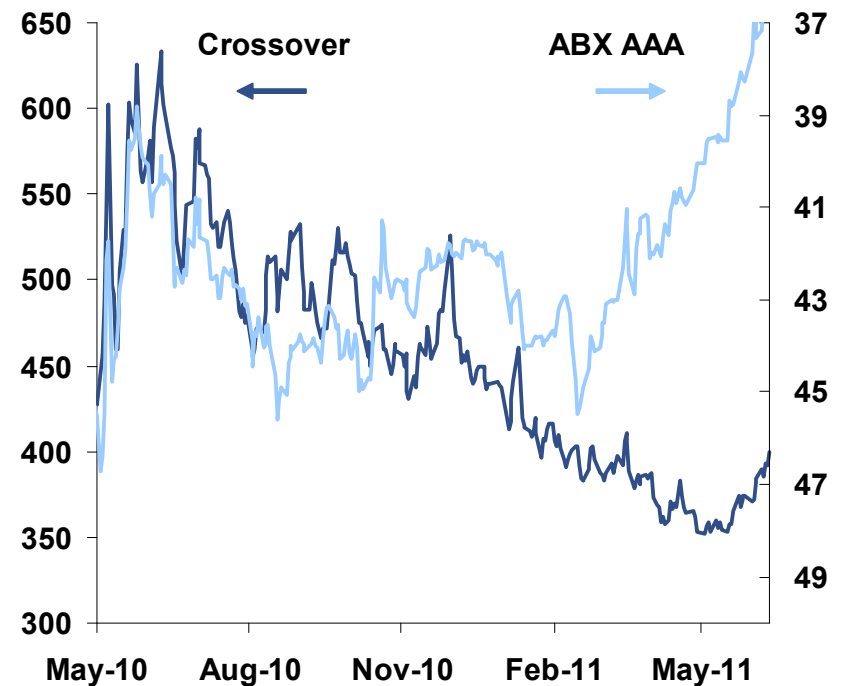
Downside better reflected in other assets?

Yields *have* tracked macro surprises
UST 10yr yield, 3m % chg, vs US econ surprises



Source: CIRA, Bloomberg

What should you infer from subprime?
ABX AAA index (price) vs. iTraxx Crossover, bp



Source: CIRA, Markit

Bullish? Be short US yields

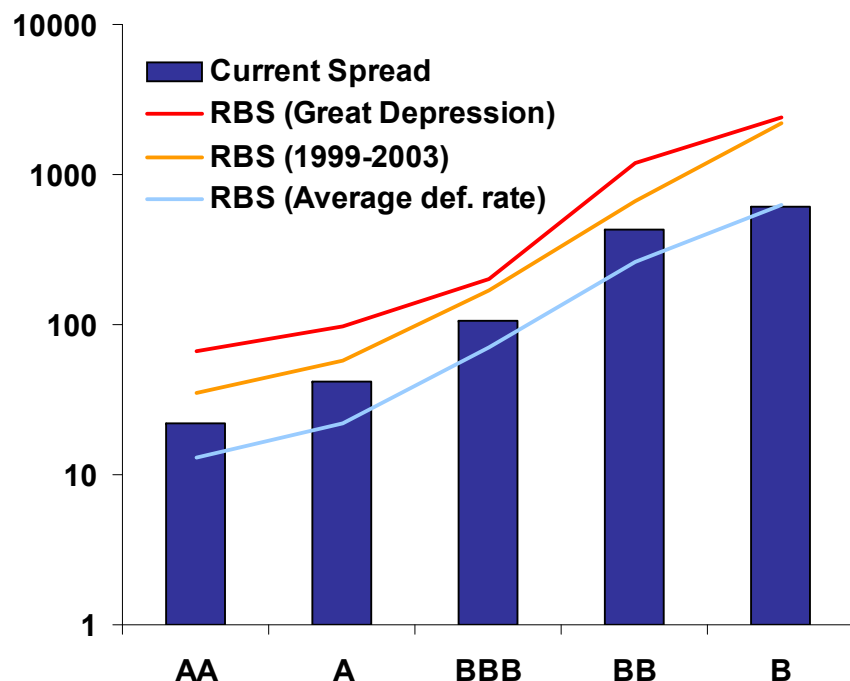
And within credit?



Spreads not cheap to avg. default cycle

Citi Rock Bottom Spreads vs. US IG spread

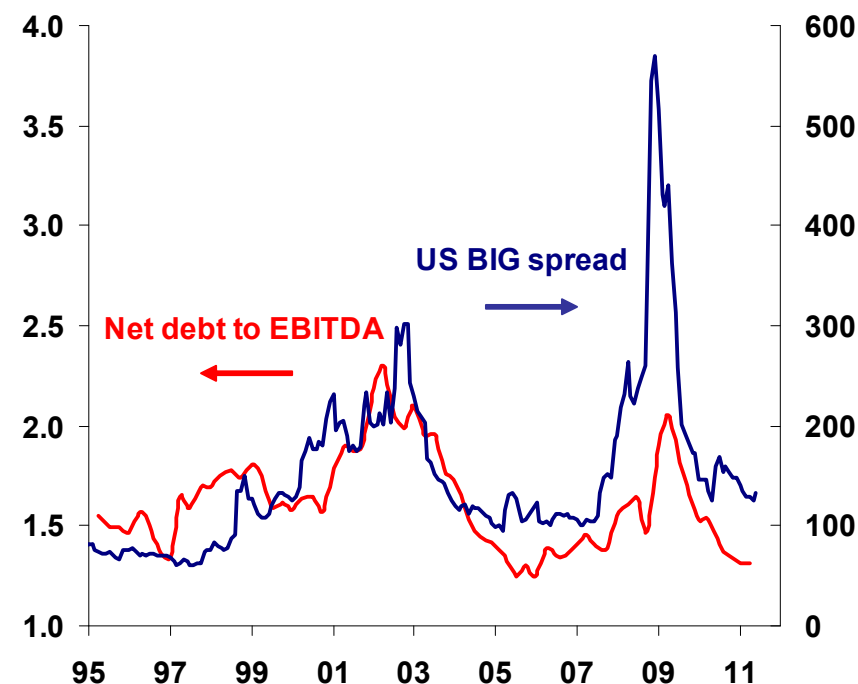
Bp (log scale)



Source: CIRA

But low leverage suggests some upside

S&P 500 leverage, x, vs US IG spread, bp



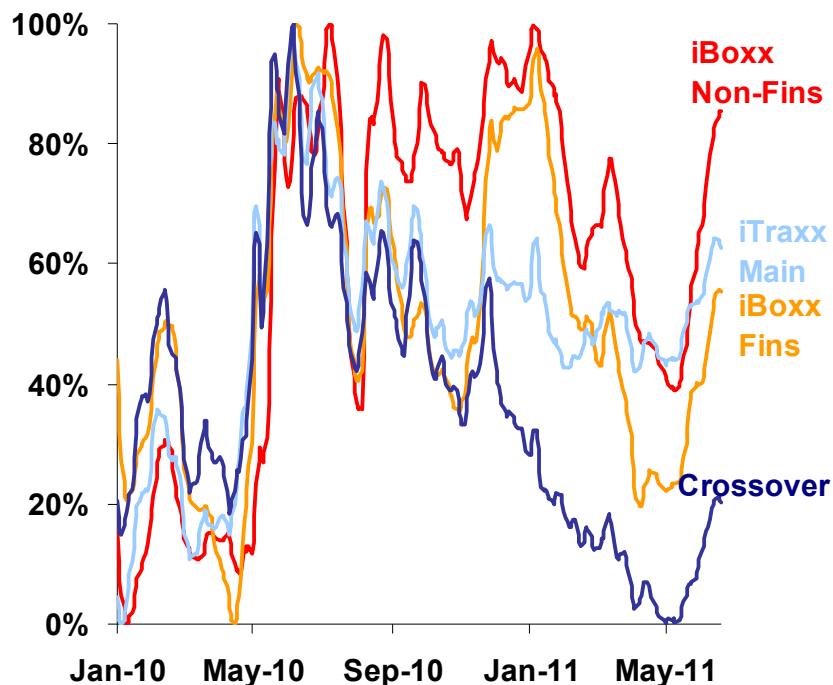
Source: CIRA, Bloomberg

Valuations: not obviously cheap, not obviously rich

Range roving

Divergences in € performance

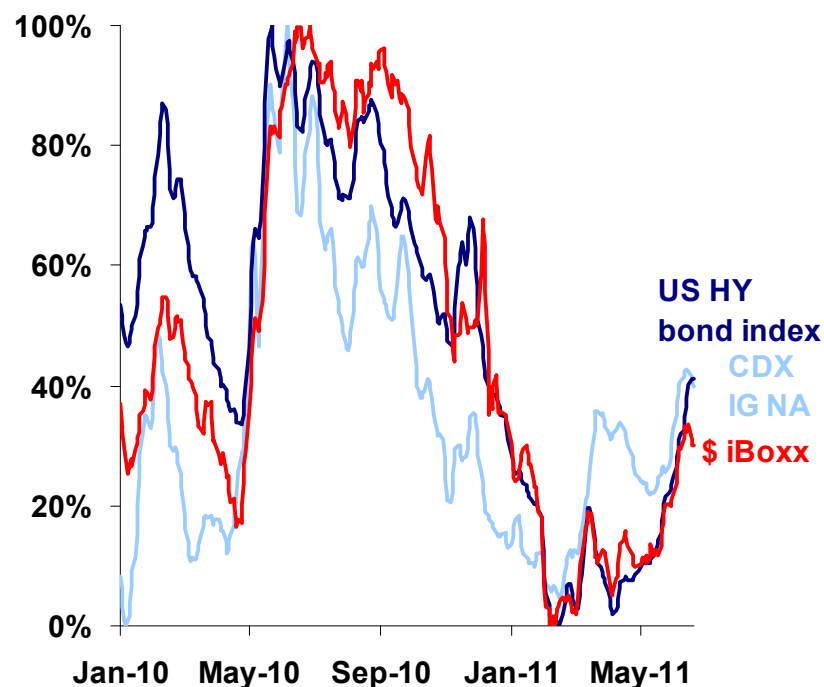
€ credit indices, percentiles since Jan10



Source: CIRA, Markit

Convergence in \$ performance

\$ credit indices, percentiles since Jan10



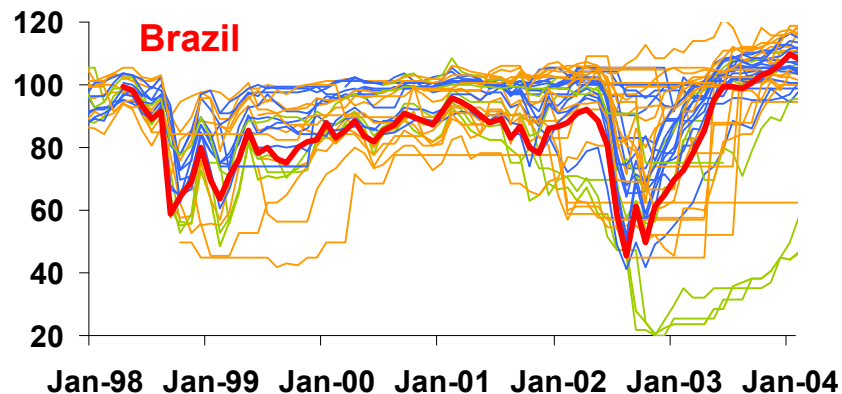
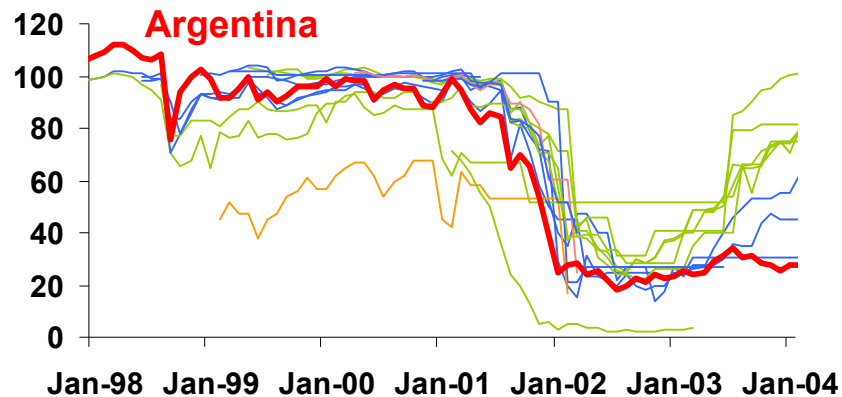
Source: CIRA, Markit, Yield Book

Not all parts of the credit market have sold off equally

Trade the periphery carefully

Select sovereign vs. corp. bond prices

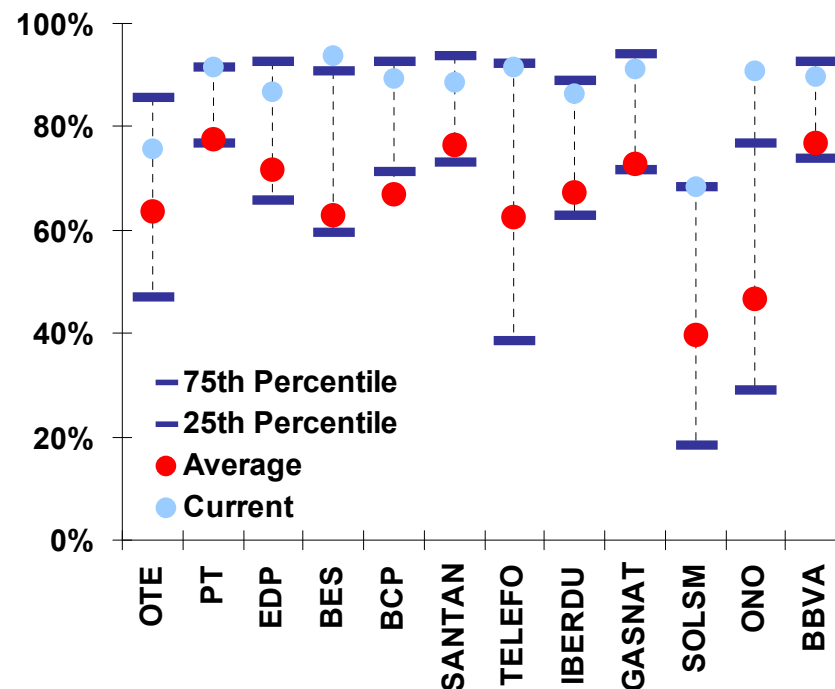
— Govt — Bank — Industrial — Telco/Utility



Source: CIRA

High correlations with the sovereign

Corporate 3m correlation with sovereign since Jan10



Source: CIRA, Markit

Only buy when you are bullish on the sovereign

Recommendations



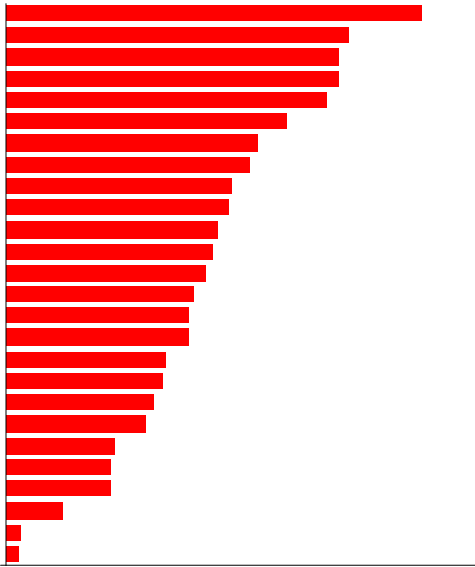
Themes	Recommendations
Policy-driven uncertainty	More volatile than directional; beware strategists bearing forecasts! Trade the ranges - it'll feel wrong, but probably end up right
Low conviction + consensus trades	Better to leverage good fundamentals than chase yield in poor assets Beware of index hedges
Sovereign-driven systemic risks	Still no/little political appetite to address solvency issues Look for tail risk hedges - LoVol vs iTraxx Crossover is one example
European periphery	Slippage in austerity programmes likely evident later this year. Periphery corporates will not decouple.
Rate hikes & end of the QE2	'Technical strength' likely to diminish - market more susceptible to news Ultimately, still too much cash chasing assets for a sustained selloff in 2011
Asset rotation	Inflows have faded in IG and are probably peaking in HY ST risk / reward favours a short in UST, LT favours flows going to equities

Source: CIRA

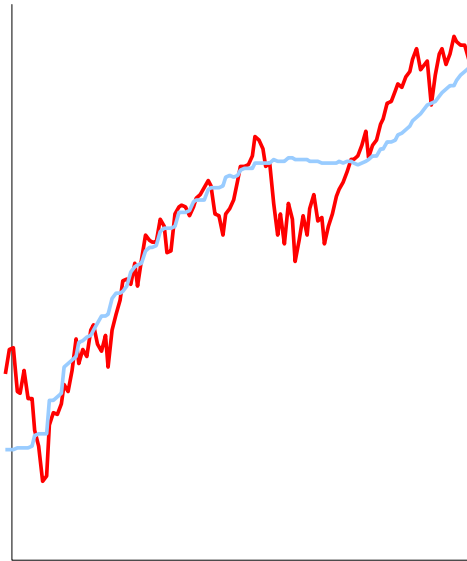
When the world feels okay, be worried; when it feels horrible, expect another kick of the can

Conclusion

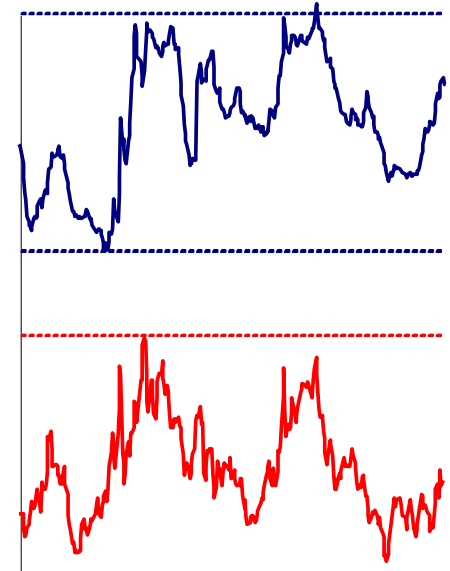
We all know it's not sustainable



But policymakers want to delay the inevitable



Which means you have to position carefully



In a range, what feels wrong will probably end up right

Appendix A-1

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