

# Where Will the Money Go in '14?

## Into credit, but...

- **Overview:** Flows are always a difficult topic to grasp because a negative catalyst for one investor type can be a positive for another (think rising rates, mutual fund and insurance company flows). Given these challenges, we introduce a simple framework to assess how much incremental demand might come in the year ahead.
- **Investment Flows in the News:** We focus on potential incremental demand from mutual funds, pensions, insurance companies, and corporate treasury departments. Specifically, we highlight recent history, summarize key drivers of incremental flows looking forward, and provide an expectation for each in '14.
- **Example – A Look at Mutual Funds:** Treasury rates and stock market performance have been two important drivers of mutual fund flows in the post-Lehman era, and based on our analysts' expectations for these variables we could see an outflow of \$28 bn in '14.
- **Conclusion:** Our approach suggests that we could see incremental demand for credit from these four sources in the neighborhood of \$150 bn (which translates to \$429 bn for the whole market). And worth noting is that this figure is in the same zip code as our expectations for net supply.

### CREDIT STRATEGY

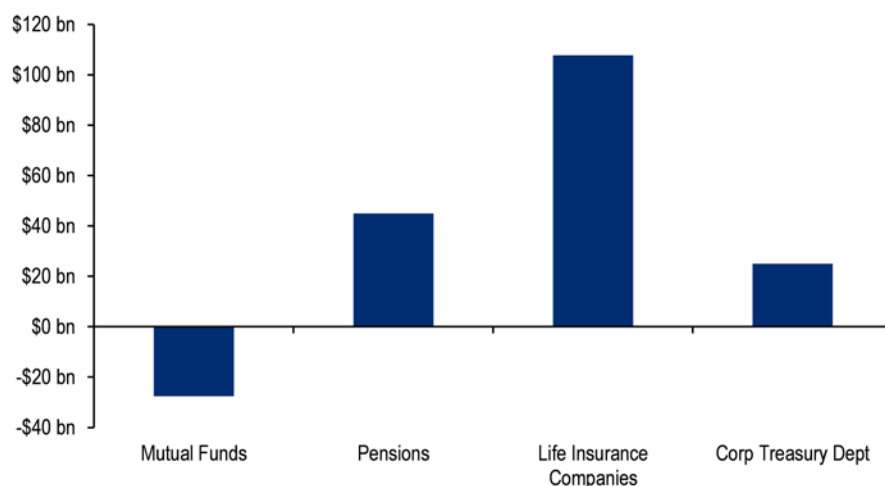
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### BOND PORTFOLIO STRATEGY

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Figure 1. Potential incremental demand for credit by investor types, 2014



Source: Citi Research, Federal Reserve, Bloomberg, EPFR, SNL  
Note: Refer to the article for calculation details

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

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# Where Will the Money Go in '14?

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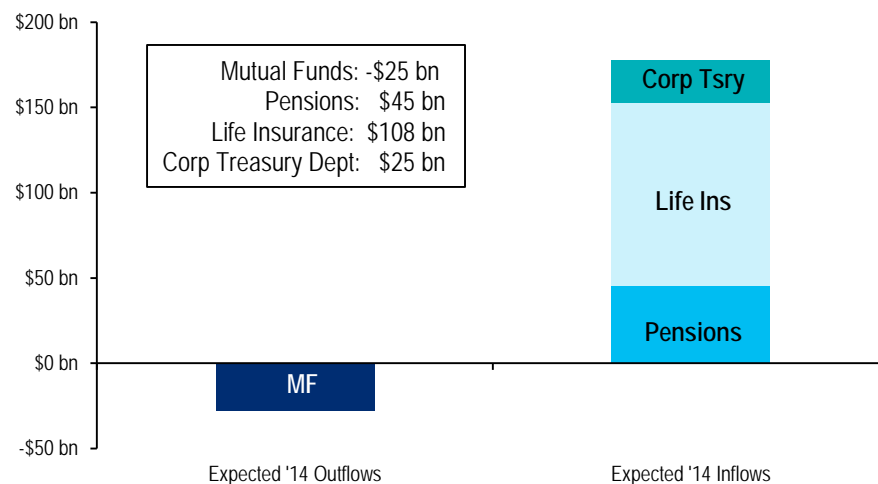
Along with tapering and re-leveraging, flows into (from) credit was one of the more debated topics in '13 — when will the great credit to equity rotation take place, how much money will leave EM for DM, etc. Flows are always a difficult topic to grasp simply because the factors that have a negative influence on one type of flow can often be a positive for another (e.g., rising rates are bad for mutual fund flows, good for insurance demand). But this is particularly true in a QE environment when valuations tend to be a bit distorted, in our view.

So given this backdrop we introduce a “*back-of-the-envelope*” framework to assess how much incremental demand we may see in the year ahead. (And note that we use the phrases “flow” and “incremental demand” interchangeably in this article.)

Before beginning, we want to acknowledge that our approach is undoubtedly simple. For example, we only consider the four types of incremental demand that garnered the most attention in '13 — mutual funds, pensions, insurance companies, and corporate treasury departments — not the whole market. And there are other simplifications as well.

**Key point:** Our framework suggests that we could see incremental demand in the neighborhood of \$150 bn from these four sources in the coming year (Figure 2), which translates to \$429 bn for the whole market.

Figure 2. What can we expect in 2014 in terms of incremental demand for corporates?



Source: Citi Research, Federal Reserve, Bloomberg, EPFR, SNL  
Note: Refer to the article for calculation details

## Mutual fund flows

### Recent history

According to EPFR data, mutual fund flows in the corporate space have totaled \$52 bn through Nov '13, a number that was almost entirely driven by flows into the leveraged loan space (+\$66 bn). In the unsecured space we saw outflows of \$14 bn in high-grade and an inflow of \$688 mm in high-yield.

The difference between flows into the secured and unsecured markets was one noteworthy divergence, and another was how they differed by maturity (Figure 3). Specifically, intermediate- and long-tenor funds in high-grade saw outflows to the tune of \$63 bn while short-term funds saw inflows of \$49 bn.

### Key drivers of future flows

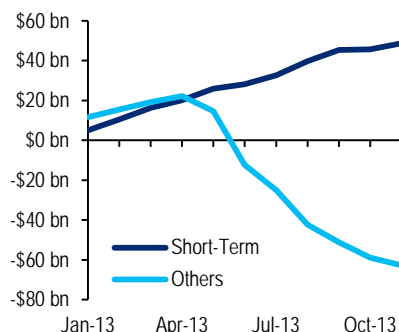
Two key drivers of mutual fund flows in recent years have been the performance of the equity and Treasury markets, respectively. With regard to equities, at least in the post-Lehman era it appears that a risk-on / risk-off mentality exists, and that stocks may not be a competing asset class for credit per se. That is, **at the broad market level what's good for one seems to be good for the other.**

As for rates, in a low default environment the change in Treasury yields tends to drive total returns in credit. And since total returns tend to drive flows into / out of credit mutual funds, rising Treasury yields cause outflows and falling ones inflows.

A regression of these two factors on cumulative fund flows since '09 results in the equation below, and note that the r-squared is 97% (Figure 4). Also note that we focus on cumulative rather than monthly flows because the monthly data is simply too choppy.

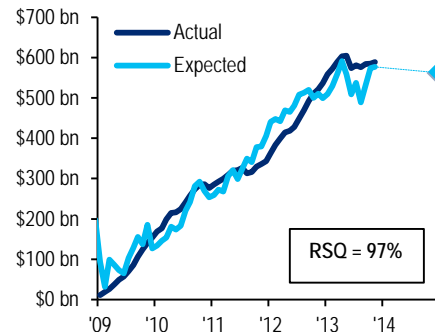
$$-1.072 * 10Y \text{ Treasury Yield (bp)} + 0.428 * \text{SPX} = \text{Exp Cumul Flows since '09 (\$bn)}$$

Figure 3. Cumulative flows into high-grade mutual funds, short-tenor funds vs. others



Source: Citi Research, EPFR  
Note: As of November 2013

Figure 4. Cumulative flows into credit mutual funds since '09, actual vs. modeled



Source: Citi Research, EPFR, Bloomberg  
Note: As of November 2013; Based on Dec estimate calculated by averaging Oct and Nov figures

***Expectation***

So what might be expected in terms of mutual fund flows in the year ahead? Our equity colleagues are expecting the S&P 500 to end '14 at 1900 and our rates strategists see the 10-year Treasury yielding 3.3% at this time next year.

If we drop these expectations into the model equation we could expect cumulative mutual fund flows since '09 to be \$563 bn at the end of '14. Cumulative flows through '13 should end up at \$591 bn (note that we only have data through November at this point).

This means that ***an outflow of \$28 bn from credit mutual funds might be expected over the course of '14*** (\$563 bn - \$591 bn = -\$28 bn).

## Pension flows

### Recent history

The pension world is a bit more of a challenge in terms of recent history because most companies report on a year-end basis (i.e., we are still looking at '12 data). That said, a few companies report off-calendar and have already provided '13 information; this sample suggests that *overall* fixed income assets for private pensions increased 2% in '13. This is not insignificant given that the overall bond market suffered negative returns (-1.4% YTD).

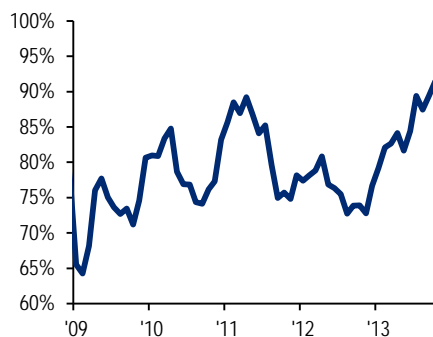
More noteworthy, though, is that the average private pension has moved much closer to fully funded status. We estimate that the average pension was 77% funded at the end of '12, and is currently more than 90% funded (Figure 5).

### Key drivers of future flows

Funded status is an important demand factor for private pension flows as it helps to gauge whether stocks or bonds are more attractive. All else equal, the closer pensions are to being fully funded the greater the willingness of managers to shift portfolios from stocks to bonds to "immunize". **And at current levels, this metric argues for bonds.**

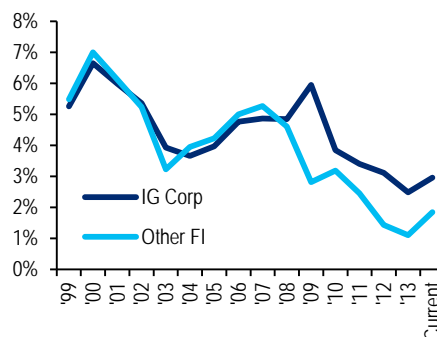
Intuitively, another meaningful pension demand variable is how risky credit is relative to other fixed income assets. Figure 6 shows that default-adjusted yields in the corporate space are now meaningfully higher than other fixed income assets, which would be an argument for corporates as well.

Figure 5. Funded status of private pensions is currently more than 90%



Source: Citi Research  
Note: Based on largest 250 plans

Figure 6. Default-adjusted yields for IG corp vs other fixed income assets are high

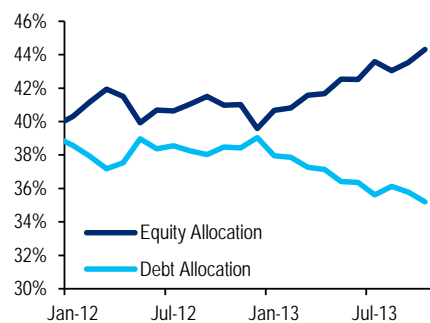


Source: Citi Research  
Note: As of December 1, 2013; We use implied default rates for IG and assume no default risk for other FI assets (Treasury, agency, mortgage)

### Expectation

Given this backdrop, **we expect pension demand for corporates to be \$45 bn in '14** as a base case scenario. The following assumptions underlie this view:

Figure 7. Equity vs. debt allocations are expected to become more balanced



Source: Citi Research  
Note: Based on largest 250 plans

- Funded status of the typical private pension will approach 100% in '14
  - Stocks rallied about 25% in '13, which pushed the average pension asset allocation from approximately 40% stocks / 40% bonds to 45% stocks / 35% bonds (Figure 7). Returning to a more balanced allocation would produce about \$100 billion in demand for fixed income, and based on past history 45% would be allocated to credit.
- (Another example of what's good for stocks is good for credit, BTW.)
- While some pensions will maintain current allocations to take advantage of a hoped-for continued rally in equities, others (especially the more highly-funded plans) will likely shift still more into fixed income to reduce risk

## Life insurance companies

### Recent history

Demand from insurance companies picked up after the rate back up this spring. Based on a sample of 19 companies we calculate that \$148 bn of corporates and structured credit were purchased in the first three quarters of this year (Figure 8), with the bulk of these purchases occurring in Q2. The rise in purchases in Q1-Q3 represents an increase of 16% from the comparable period in '12. And for reference, YoY growth was 10% in '12 for these companies, and 7% in '11.

### Key drivers of future flows

Intuitively, three factors that should influence demand for corporates by insurance companies are:

- The overall economic backdrop, which captures people's ability to buy policies
- Absolute yields available to be earned within the corporate market
- The interest rate that needs to be paid out to policy holders, which could capture insurers' desire to underwrite new policies

In terms of modeling, we use the unemployment rate to capture the first variable, the yield on the average 30-year high-grade bond the second factor, and the median fixed annuity crediting rate (the cost of policies) of select insurance companies for the last factor.

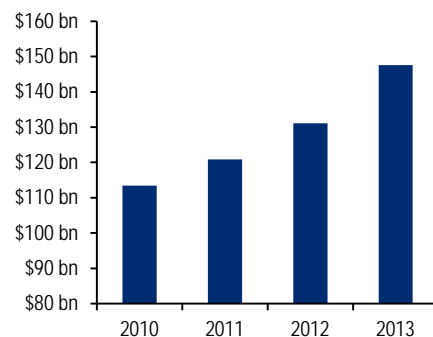
A regression of these three variables on the amount of corporate debt held by insurance companies results in the following equation and has an r-squared of 94% (Figure 9).

$$-4.58 * \text{Crediting Rate (bp)} + 1.63 * \text{Long Corp Yield (bp)} - 0.13 * \text{Unemp Rate (bp)} + 2,690 = \text{Exp. Corp Holdings (\$bn)}$$

### Expectation

If we use our economists expectation for unemployment (6.4%), our strategists' expectations for long corporate yields (4.45% Treasury, 165 bp credit spread), and a slight uptick in crediting rates in the wake of higher Treasury yields (3.1% from 2.9% currently), we would see an increase in **incremental corporate demand from insurance companies of \$108 bn in '14**.

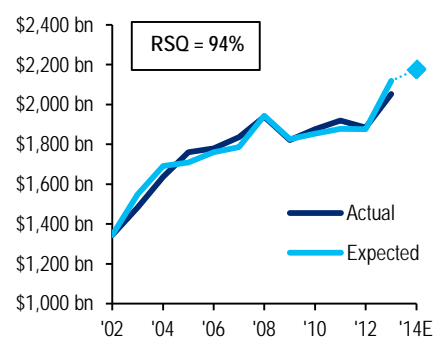
Figure 8. Amount of corporates purchased during the Q1 to Q3 period



Source: Citi Research, SNL

Note: Based on AEL, AFL, AIG, AMP, ATHN, GNW, HIG, ING, KCLI, LNC, MET, PFG, PL, PRI, PRU, SFG, SYA, TMK, UNM; Acquisitions based on filed dates

Figure 9. Actual vs. expected amount of corporates held by insurance companies



Source: Citi Research, Federal Reserve

Note: Based on median fixed annuity crediting rates of AEL, FBL, LNC, PL, SYA (year average); year-end long-bond yields and unemployment rates

## Corporate treasury departments

### Recent history

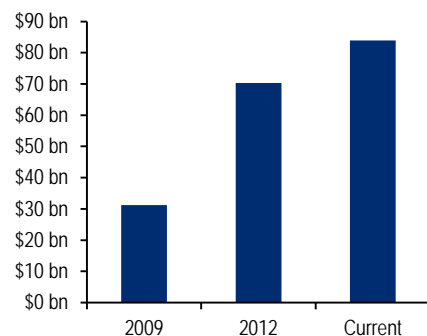
Demand for corporate bonds from corporate treasury departments has been growing sharply in recent years. Based on a sample of 20 companies the size of holdings increased from \$31 bn in '09 to \$84 bn currently (Figure 10). We acknowledge the small sample size, but note that this sample accounts for the majority of cash equivalents held by non-financial S&P 500 firms.

### Key drivers of future flows

Factors that appear to have been drivers of demand from treasury departments in recent years include:

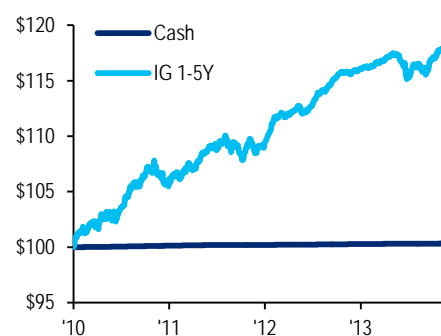
- **Amount of cash and cash equivalents held:** Levels have been on the rise in an era of moderate capex spending. For example, our sample of companies now have over \$600 bn of cash and equivalents, up from about \$300 bn in '09
- **Yield of fixed income vs. cash:** This is essentially a measure of how much cash could become a cash equivalent
- **Default risk in the credit space:** This is a guide to how much of cash equivalents could be held in corporates. In a low default environment, much higher returns are available via corps than cash and other cash equivalents without all that much more volatility (Figure 11)

Figure 10. Amount of corporate debt held by a sample of companies



Source: Citi Research, Bloomberg  
Note: Current as of Q3 '13; Based on sum of 20 companies (MSFT, GOOG, ORCL, AAPL, GM, CSCO, PFE, PCLN, JNJ, INTC, CMCSA, EBAY, BA, MRK, AMGN, VMW, EMC, HUM, NTAP, SYK)

Figure 11. Performance of cash vs. front-end IG corporates since '10



Source: Citi Research  
Note: As of December 6, 2013

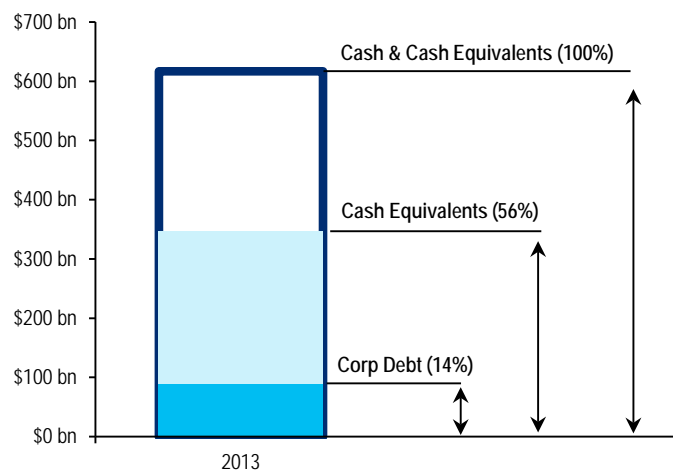


**Expectation** As a base case, we expect demand for corporates to be \$25 bn. This view is based on the following assumptions:

- Amount of cash and cash equivalents grow at 5%, a modest assumption given the 9% increase in '13 (through Q3)
- The percentage of cash and cash equivalents being held in the form of cash equivalents increases by 6 percentage points (Figure 12 and Figure 13) the same annual rise that has occurred in '13
- Among cash equivalents, the split between credit and others continues to evolve as it has in recent years so that slightly more flows into credit

Note that this forecast only captures demand for short-maturity corporates, and does not take into account any long-term investment flows.

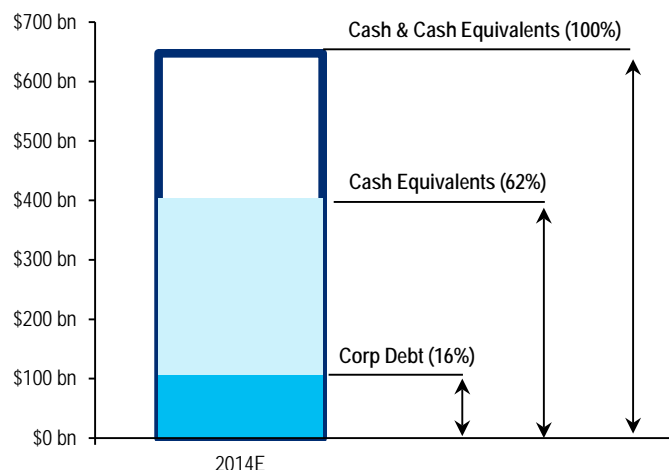
Figure 12. In 2013, 56% of cash at companies was held in the form of "cash equivalents." Of this corporates made up a good portion



Source: Citi Research, Bloomberg

Note: 2013 year-end figures estimated based on '12 to Q3 '13 changes; Based on sum of 20 companies (MSFT, GOOG, ORCL, AAPL, GM, CSCO, PFE, PCLN, JNJ, INTC, CMCSA, EBAY, BA, MRK, AMGN, VMW, EMC, HUM, NTAP, SYK); Sample represent 65% of the non-fin SPX ST investments; Cash equivalents represent short-term investments only

Figure 13. In 2014 we expect the cash pile to grow, a bigger proportion of the pile to be held in the form of "cash equivalents," and more cash equivalents to be corporate bonds



Source: Citi Research, Bloomberg

Note: Based on sum of 20 companies (MSFT, GOOG, ORCL, AAPL, GM, CSCO, PFE, PCLN, JNJ, INTC, CMCSA, EBAY, BA, MRK, AMGN, VMW, EMC, HUM, NTAP, SYK); Sample represent 65% of the non-fin SPX ST investments; Cash equivalents represent short-term investments only

Figure 14. We could see overall incremental demand of about \$429 bn in '14

	Expected Flows
Mutual Funds	-\$27.6 bn
Pensions	\$45.0 bn
Life Insurance Companies	\$107.8 bn
Corp Treasury Dept	\$25.0 bn
Total	\$150.2 bn
Divide by 35% ↓	
Overall Corporate Market	\$429.1 bn

Source: Citi Research, Federal Reserve, Bloomberg, EPFR, SNL

Note: Refer to the article for calculation details

## Summary

So the good news is that despite the concern of many market participants about various market features, including seemingly full valuations, tapering, rising rates, and re-leveraging, it appears that the credit market will nonetheless experience positive incremental demand.

But that said, the incremental demand estimate does not appear to be all that high relative to net supply. We have to ballpark it, but based on Fed data we estimate that the four investor types that we examined account for around 35% of the overall credit market. If we use this number to gross up, we get a flow estimate for the overall corporate market of \$429 bn ( $\$150.2 \text{ bn} / 35\% = \$429.1 \text{ bn}$ ).

Since three of the four investor types we focused on play in the high-grade market for the most part, net supply in this space may be the right comp. We expect net supply in high-grade in the coming year to be in the neighborhood of \$450 bn. Maybe not bad, but probably not an argument for spread tightening either.

The bottom line is that our incremental demand expectation suggests that spreads could be stuck this year, and may in fact have more room to leak wider than many expect.

## Appendix A-1

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