

A QE Hangover?

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Market Outlook

The performance of credit and equities this week was hardly a ringing endorsement of the market's confidence in QE3. But is it correct to conclude that the rally is already over? We think not.

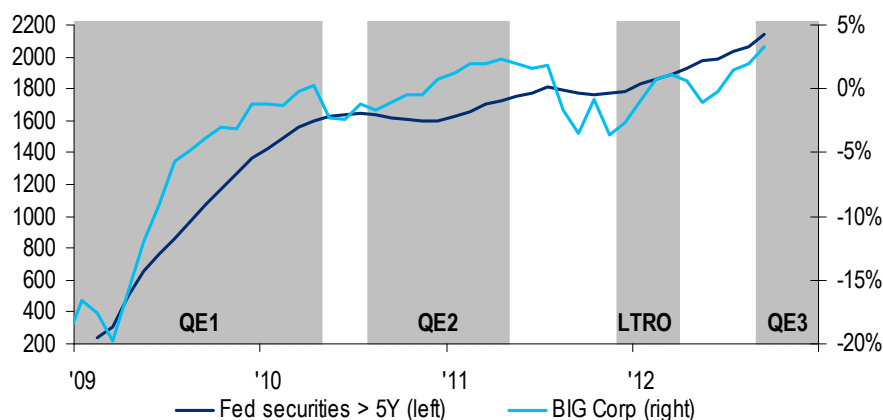
Looking back over the past two years, it's certainly not unusual for markets to take a breather after central bank intervention. Indeed, after Chairman Bernanke launched QE2 at Jackson Hole in 2010, the S&P500 sold off 1.4% over the following two days. And after the ECB introduced the LTROs in December of 2011, the S&P fell by as much as 2% the week after.

As such, it seems a bit premature to be judging the sustainability of the rally just a week following the program's announcement.

What's more, there's plenty of reason to think that the Fed's actions have the capacity to inflate asset prices further given that there seems to be a strong correlation between the size of the Fed's balance sheet and where risky assets trade (see figure).

Corporate performance during QE/ECB intervention

BIG Corp credit returns since '05 (%) vs. and Fed securities holdings >5bn (\$bn)



Source: Citi Research, Yieldbook, Haver

Consequently, at least in credit, we're tempted to blame some of this week's softness on the technicals rather than concerns over QE3's effectiveness. There's been roughly \$75bn of issuance in September so far, and, if next week's

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Credit

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total equals this week's \$25.8bn then it will be the biggest issuance month this year. We can't help but think that so much supply has weighed on secondary spreads and may be running ahead of investor inflows.

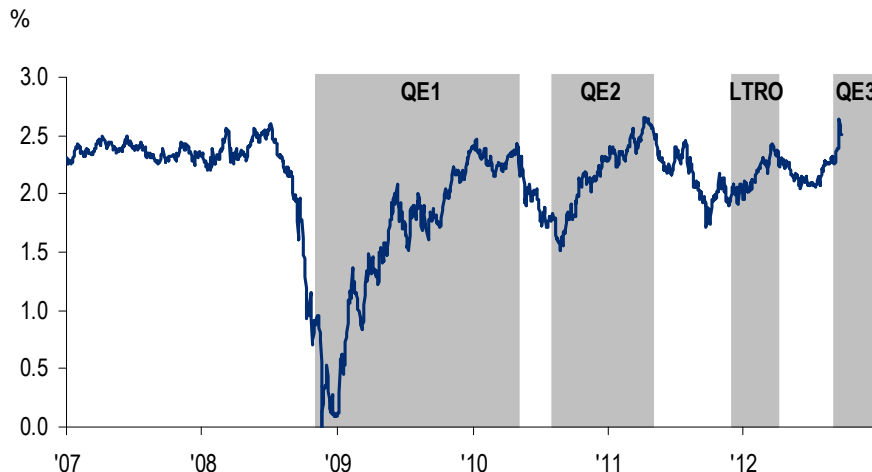
But for those hoping a strong calendar might unlock a few relative value opportunities, we reckon the phenomenon will be temporary as inflows catch up over the next month (just note this week's above average mutual fund inflow) while the pace of issuance simultaneously slows heading into earnings season.

We've also heard the argument that risky assets have struggled because there simply aren't any meaningfully positive near-term catalysts remaining after the latest central bank liquidity injections. But while we're sympathetic to that line of reasoning (especially when one considers the likelihood China continues to disappoint), it's not entirely accurate in our opinion. After all, Citi's Economic Surprise Index returned to positive territory earlier this month, which suggests data will continue to surprise to the upside over the coming weeks. Also, there's still a relatively high likelihood Spain agrees to some sort of conditionality in the coming months that enables the ECB to support the country's debt in the secondary markets, in our opinion.

As such, we continue to believe that credit spreads will return to their QE2 tightness in the near term. Further out, as we argue in our most recent presentation '[How the technicals could crack](#)', we're far less positive, primarily because we believe America's savings crisis, fiscal indebtedness, and declining corporate fundamentals could conspire to crack the technicals supporting the market. Certainly, the rapid rise in inflation breakevens and their pattern of rising during past QE periods should give investors pause given where corporate yields trade (see figure).

Said another way, we view this week as the lull between the pre-QE-party and the after-QE-party. It's not the QE hangover; that will come later and present a much bigger headache.

Breakeven inflation rates after QE/ECB intervention announcements



Source: Citi Research, Bloomberg

and Losers

US Key Economic Data

Tuesday:	<u>Consensus</u>
Consumer Confidence	63
MBA Mortgage Applications	-
New Home Sales	380k
Thursday:	
GDP QoQ (Annualized)	1.7%
Personal Consumption	1.7%
Durable Goods Orders	-4.5%
Pending Home Sales MoM	-0.3%
Friday:	
Personal Income	0.2%
Personal Spending	0.5%
U of Michigan Confidence	79.0

Key Earnings Announcements

Tuesday:
Carnival Corp
Thursday:
McCormick & Co
Discover Financial
Nike Inc
Friday:
Walgreen Co
Plains Creek

Single Name News & Views

10y BBBs – So what should one buy in this market? We like moving down in quality and buying relatively stable 10y (and under) BBB paper as we believe this paper has the most headroom for continued spread compression in the near term

(1-2 months). Our favorite sector is still telecom and media given relatively attractive levels, a somewhat defensive track record during past sell-offs, and relatively stable revenue streams. That being said, we'd suggest staying in the on-the-run bonds for this short term tactical call. Our favorite picks include: DTV '22s (\$102.70, g spread of 179bp), Comcast '22s (\$103.60, 96bp), Motorola Solutions '22s (\$103.56, 160bp), and Omnicom '22s (\$104.63, 136bp).

Light Loads – Recent comments from a handful of transport companies seem to be foreshadowing a less-than-hoped-for picture of the US economy. Norfolk Southern commented that it sees Q3 volumes declining 2%, led by a 13% drop in coal shipments, and FedEx cut its full year EPS forecast by about 10%, driven by cuts to its global growth estimates. While short positions in rails are difficult given the minimal basis point swings, we suggest shorting some of the commodity producers that drive rail demand. One name which we think is too tight is Alcoa, as we believe the steel market will continue to suffer depressed volumes and prices. At 297bp, current levels are only 50bp off the tights and 170bp off the 12 month wides, indicating that CDS may have scope to widen quite a bit.

Week Ahead

Although the economic calendar will likely be dominated by European news, there are still a few key data points to highlight in the US. The consensus expectation for new home sales suggests the housing market recovery remains on track. The market expects aircraft demand weakness to be reflected in poor durable goods orders, despite recent strength in autos. Consumer spending is expected to increase 0.5%, continuing July's pickup. However, consumer income is expected to slow from 0.3% to 0.2%, raising concerns that spending growth rates cannot persist.

Spain will be in the spotlight next week. Draghi is meeting Merkel on Tuesday. No agenda for the meeting has been published, but we doubt they will be comparing holiday snaps.

On Thursday, the Spanish Cabinet is expected to approve the 2013 Budget, which will be presented to Parliament on Friday. Spain is reportedly working with EU authorities to ensure that the measures to a large degree mirror the conditionality associated with a future rescue program. As such, it is likely that there will be emphasis on the pension system and other longer-term structural reforms.

Moreover, the government is expected to release Oliver Wyman's stress tests on the Spanish banks and their loan-loss provisioning. Given the public predictions from the likes of BBVA's chairman that the capital shortfall will be comparatively close to the June estimates, and well below the €100bn "wallet", we suspect that much of the market reaction will hinge on the level of detail disclosed – that is, the extent to which the market will be able to test the shortfalls independently. It is likely that we will receive an indication of the levels at which the bad assets will be transferred to the bad bank as well.

Italy will come back to the markets on Tuesday and Thursday. Citi expects €1.8bn CTZ and €0.8bn BTPei on Tuesday and €7bn BTPs with 5- and 7-year maturities on Thursday. As with recent peripheral auctions, we do not expect they will have much impact on the credit market.

Appendix A-1

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