

March 2013

Living the fairy tale

Can Credit Goldilocks defy the bears?

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Yuck... This porridge is too cold

Ouch... This porridge is too hot

Perfect porridge & a few bear strategies

Note: In this presentation we have confused the word “credit” with “porridge”. We apologise for any inconvenience caused.

Even the bears you thought you'd tamed ...

Spanish downgrade risk

US sequester

Chinese growth

Italian election

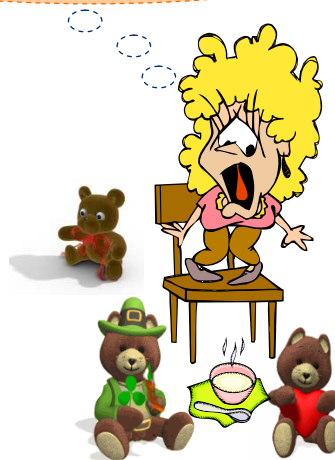
Eurozone recession

Bank bail-ins

Bail-out of Cyprus

Mid-East tension

Independence movements

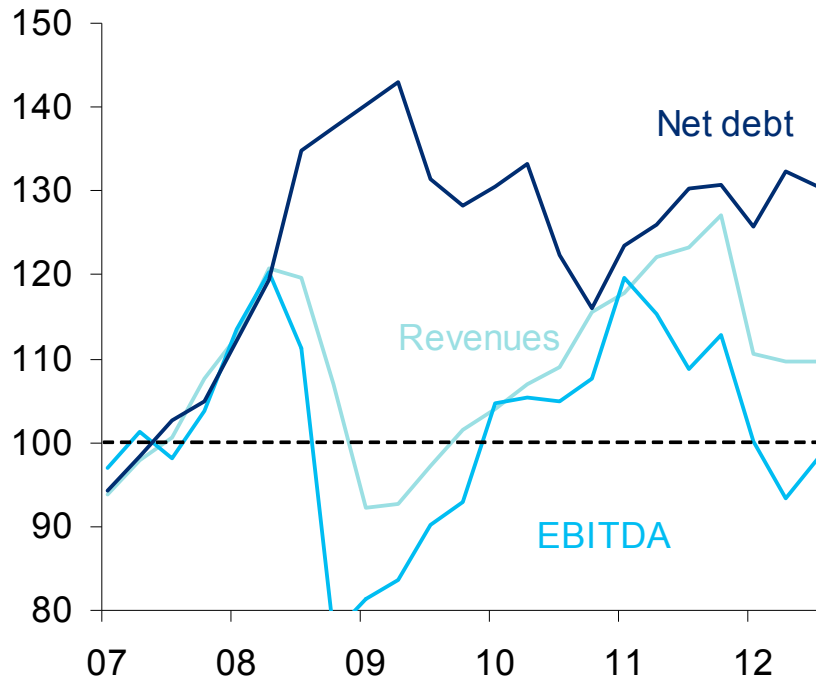


... sometimes spring surprises

Bottom up, it's no fairy tale either

Debt creeping up, EBITDA struggling

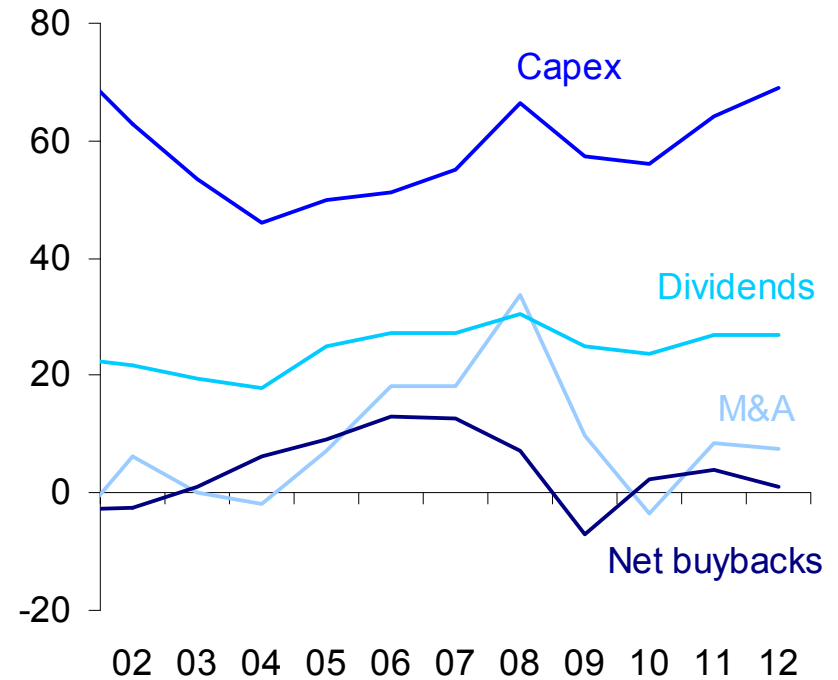
EBITDA, sales & net debt for European corporates ('07=100)*



Source: Citi Research, Bloomberg. *: Based on a sample of 229 non-financial corporates in the EuroStoxx 600 index.

Plain, old capex eating cash flows

European corporate expenditures, % of OCF



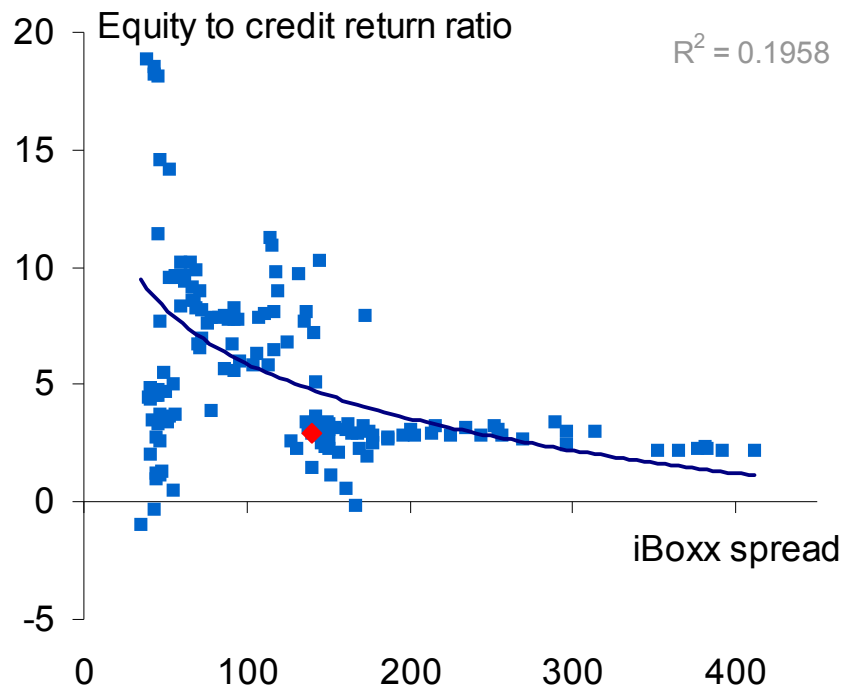
Source: Citi Research, Bloomberg. Note: Based on a sample of 149 non-financial corporates in the EuroStoxx 600.

Leverage is ticking higher

Incremental demand for porridge is cooling

Asymmetric risk/reward to equities

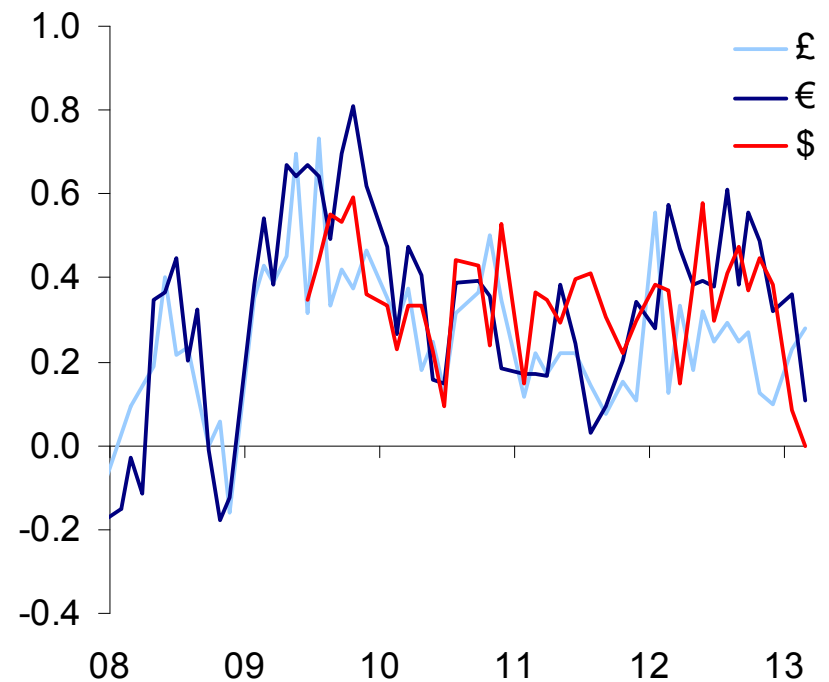
12m credit-equity return ratio vs iBoxx spread, 2000-12



Source: Citi Research, Bloomberg, Markit

Inflows into credit at a 4yr low

Citi Credit Survey, reported inflows on a +/-2 scale



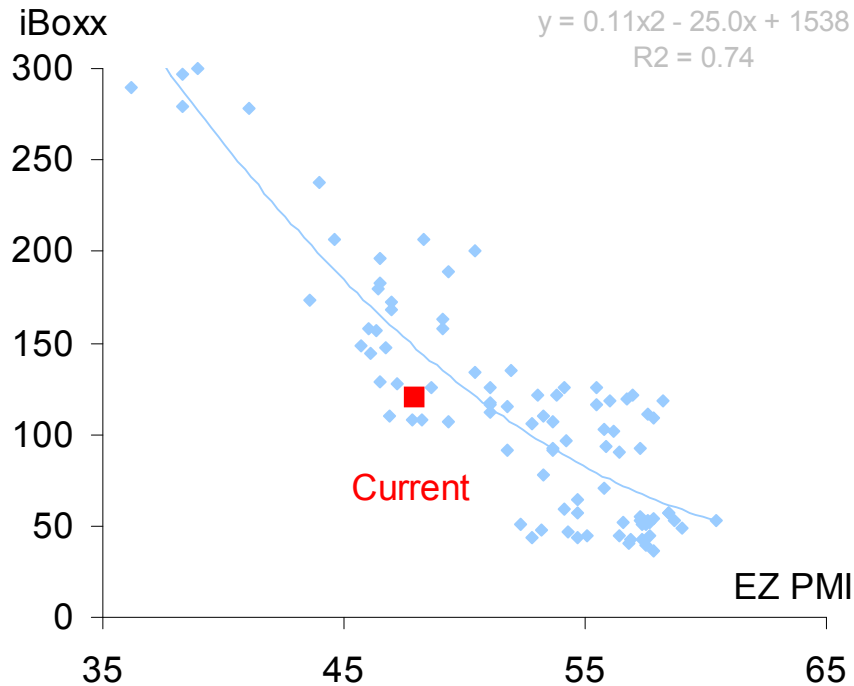
Source: Citi Research.

Risk/reward denting appetite

Close to a bear minimum?

Spreads still inside fair value

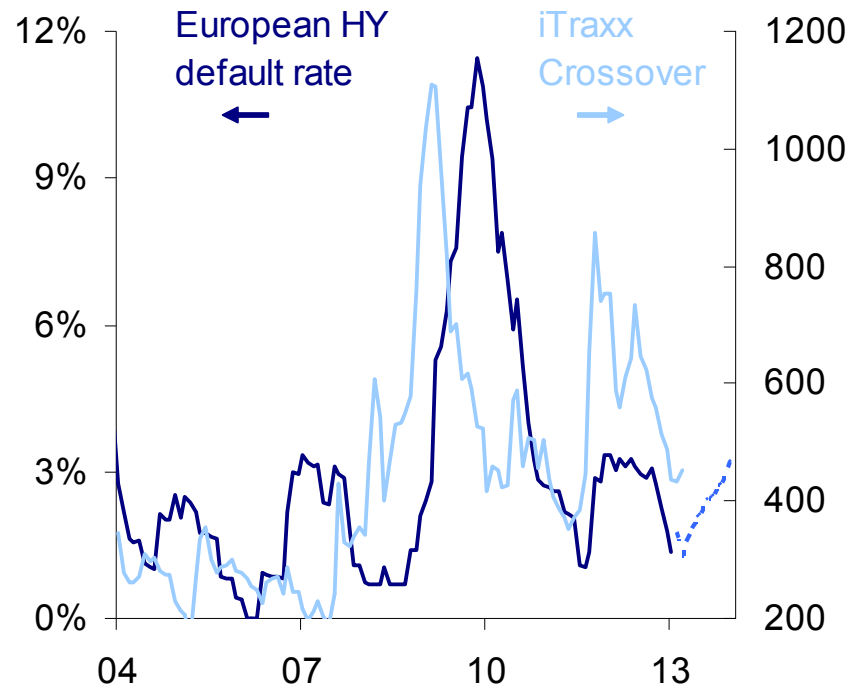
iBoxx € non-fins. Vs Eurozone PMI, 2005-12



Source: Citi Research, Bloomberg.

Not even cheap to defaults any longer

European spec. grade default rate vs. iTraxx Crossover, bp



Source: Citi Research, Moody's, MarkIt.

Porridge on the thin side of most fundamental relationships

Yuck...This porridge is too cold

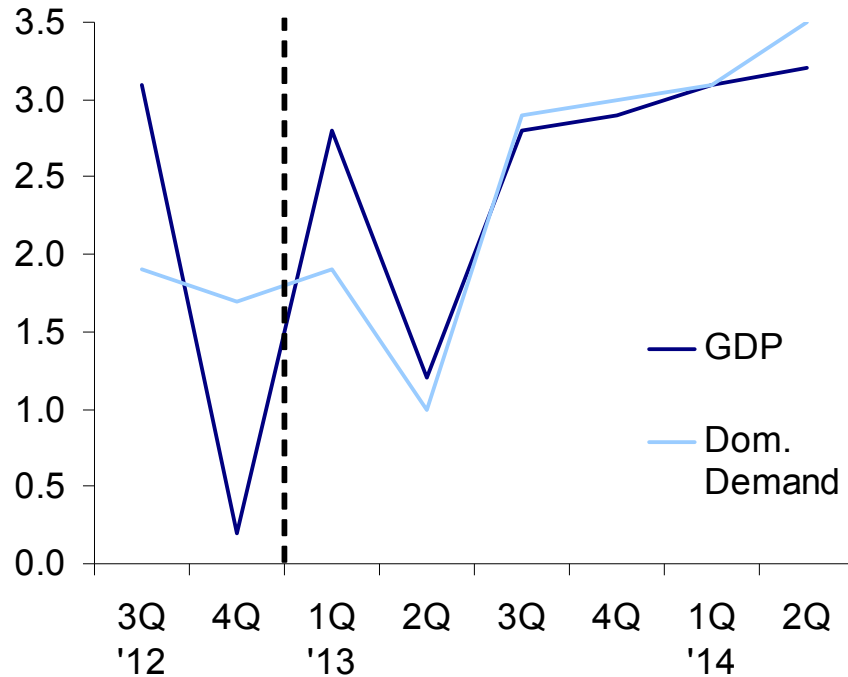
Ouch... This porridge is too hot

Perfect porridge & a few bear strategies

US economy is (finally) heating up

No growth bears in sight

Citi US growth forecasts, 3Q 2012 – 2Q 2014



Source: Citi Research.

“Many participants also expressed some concerns about potential costs and risks arising from further asset purchases...”

FOMC minutes, 29-30 Jan

“... should we continue with the current program of QE? I have argued we should not, that we are pushing on a string.”

R. Fisher, Dallas Fed President, 27 Feb

“I’m a skeptic.” “There is room for doubt on this bold new limit-busting that central banks have done.”

J. Lacker, Richmond Fed President, 5 Mar

“The significant majority of the committee is supportive of the policy that we are taking.”

B. Bernanke, Fed Chairman, 27 Feb

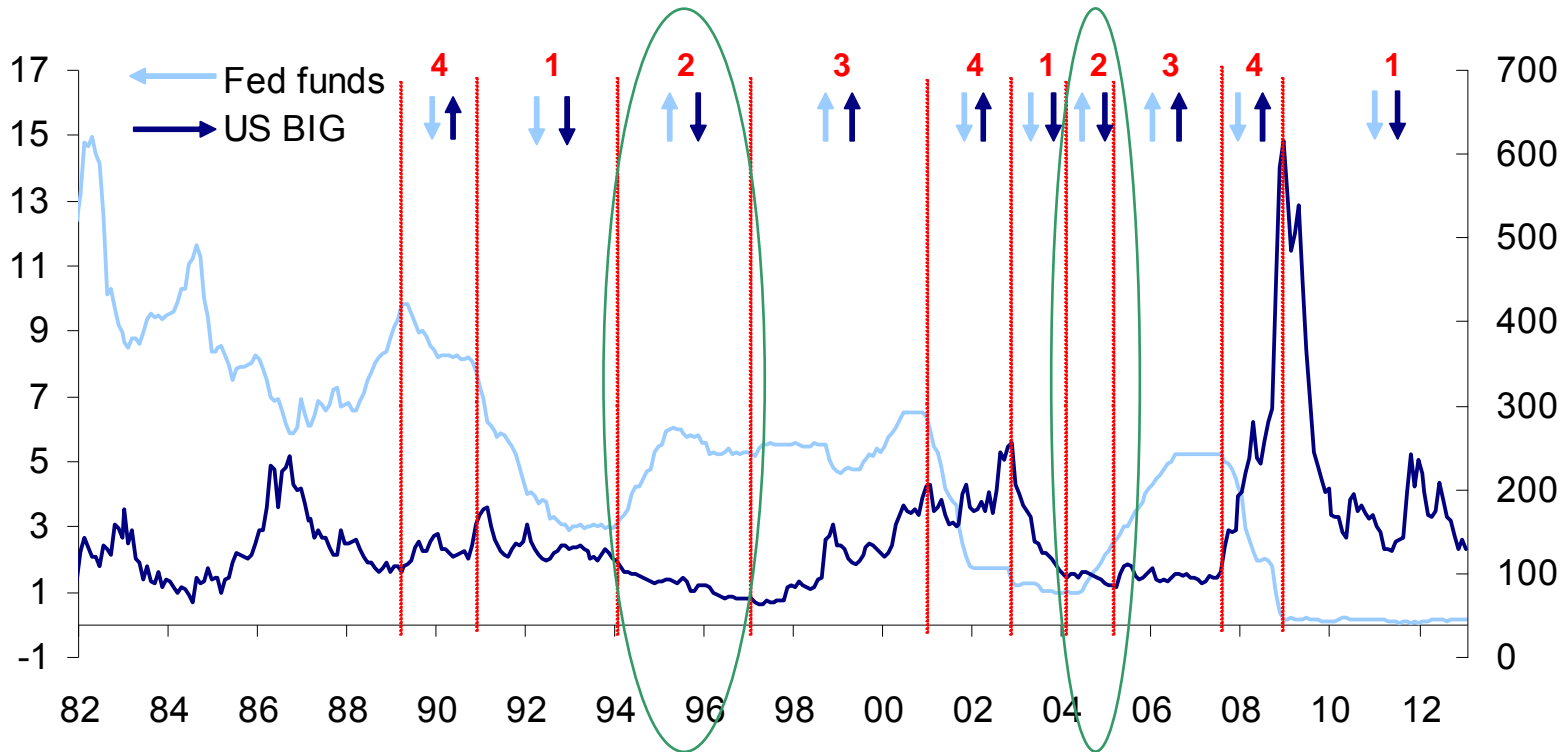
Source: Federal Reserve.

Will it cause a stir by the Fed?

Porridge & policy rates – a cyclical relationship

Early in the policy tightening cycle, spreads normally tighten

Fed Funds rate, %, vs US IG credit spreads to Treasuries, bp



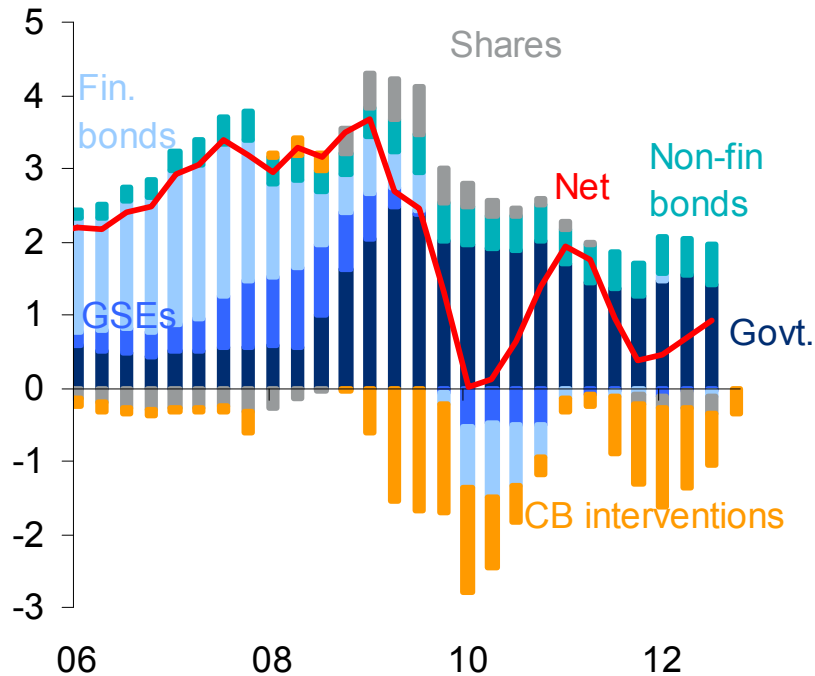
Source: Citi Research, Haver

For porridge, recovery normally dominates policy early on

But in a “make-markets-believe” asset price recovery...

CBs constraining supply of new securities...

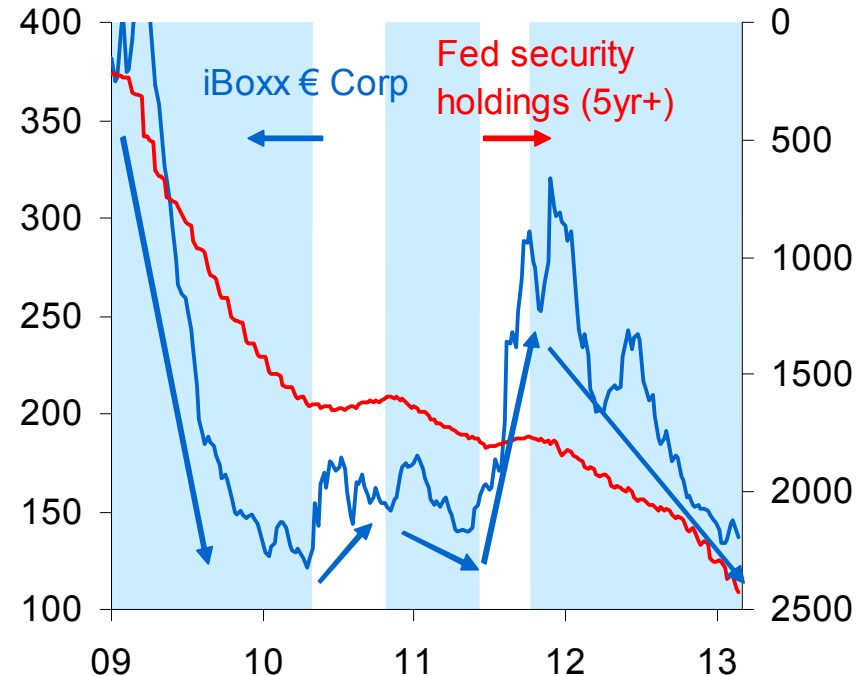
Net iss. of new securities vs CB* interventions, 12m rolling, \$tr



Source: Citi Research, Haver. *: Federal Reserve and ECB

... helping to prop up credit markets

iBoxx € Corp, bp vs Fed security holdings (5yr+ maturity), \$bn



Source: Citi Research, Haver, MarkIt

... don't expect normality

Life as the Goldilocks asset class has its drawbacks

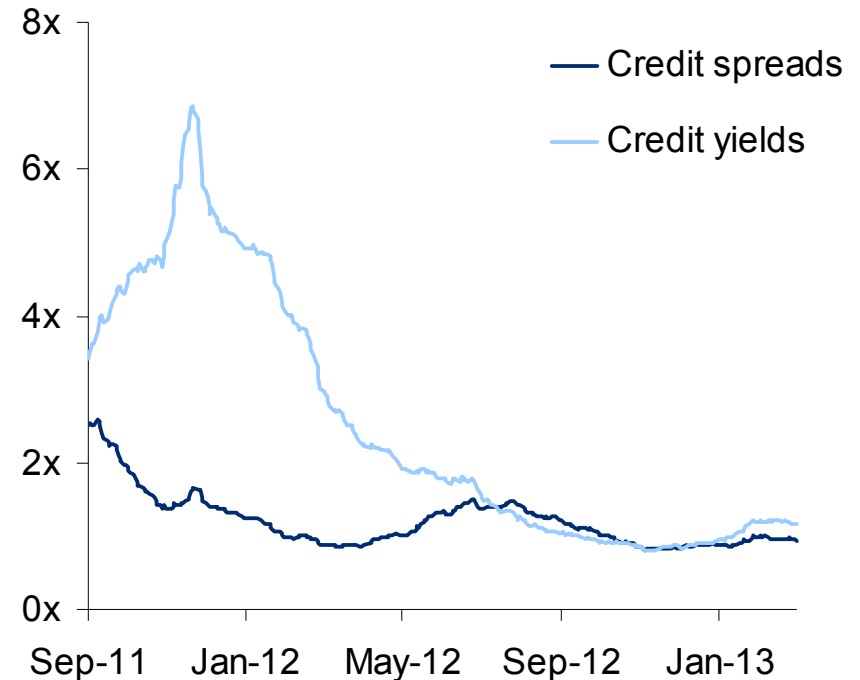
2/3 of inflows have a large retail component

Holders of corporate bonds

Risk/reward is poor in total return terms

iBoxx € Corporate index ann. BE/Vol ratio, spreads & yields

	3Q '12 holdings	Chg. from 1Q 09 ----- In \$	In % ----
Mutual Funds	\$1.7tr	+\$697bn	+69%
Life Insurance	\$2.2tr	+\$301bn	+16%
Non-US	\$2.4tr	+\$127bn	+5%
ETFs	\$0.2tr	+\$113bn	+328%
P&C Insurance	\$0.4tr	+\$87bn	+32%



Source: Citi Research, Federal Reserve. See '[How afraid of rising rates should we be? More than usual](#)', S. Antczak et al., 1 February 2013

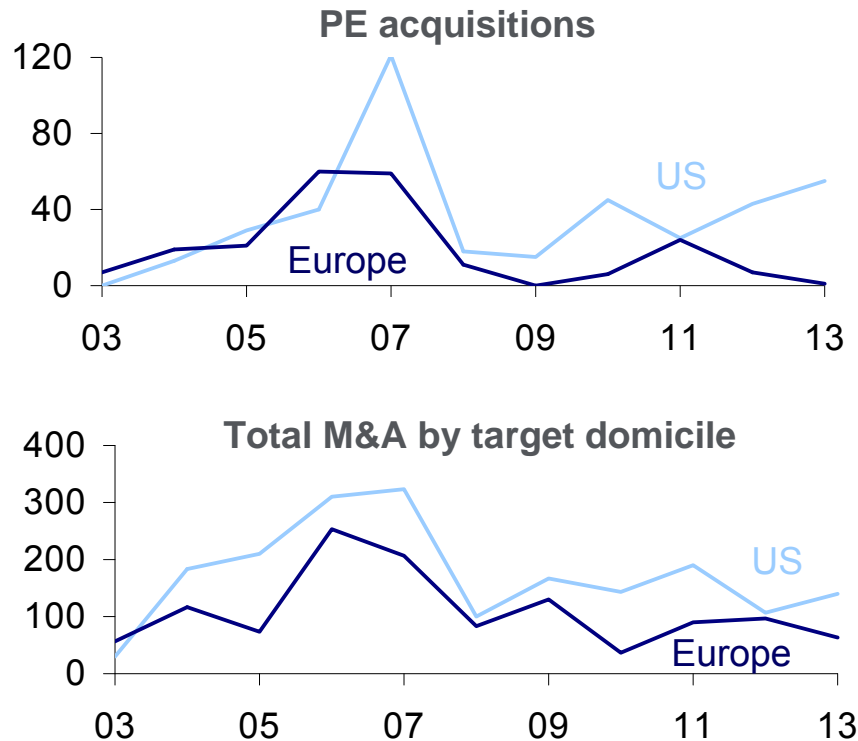
Source: Citi Research, MarkIt

A lot of non-dedicated, total return money in porridge

Still early days for the LBO and M&A revival

Pickup in US activity; Europe lagging

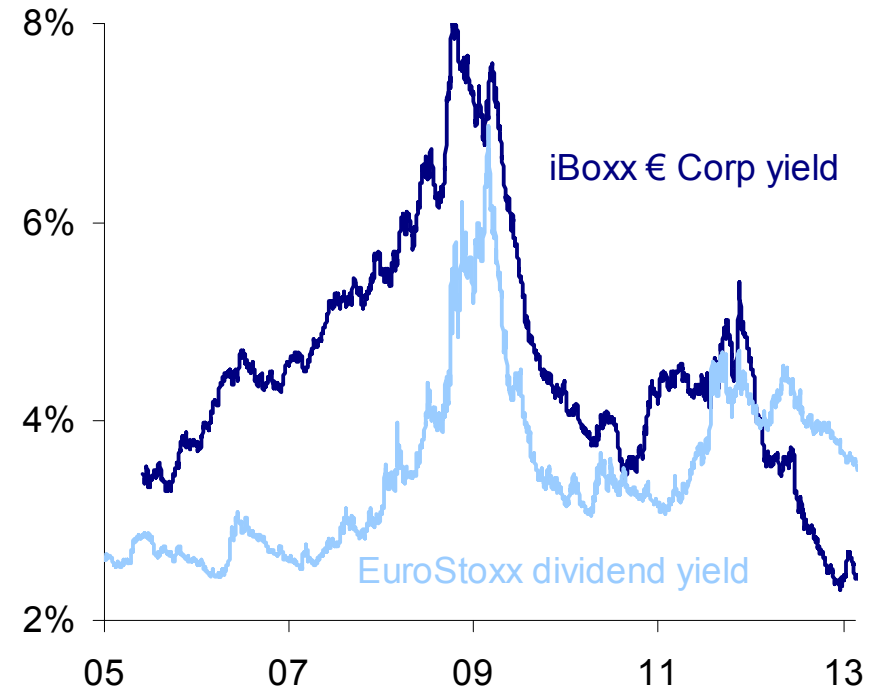
European & US PE acquisitions and total M&A per quarter, \$bn



Source: Citi Research, Bloomberg.

Cheaper to be shareholder friendly

iBoxx € Corporate yield vs EuroStoxx 600 dividend yield, %



Source: Citi Research, Haver, MarkIt.

But the incentive to reward shareholders is strong

Yuck... This porridge is too cold

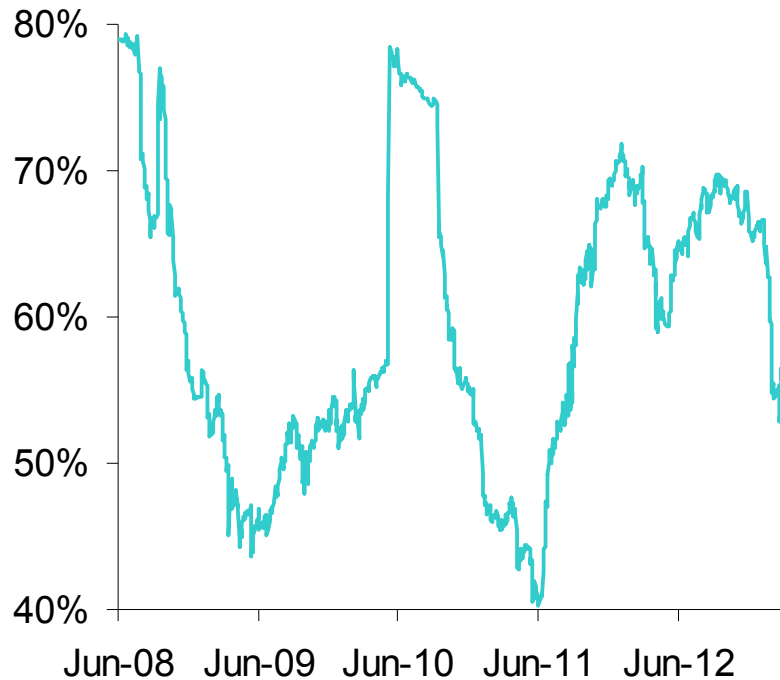
Ouch... This porridge is too hot

Perfect porridge & a few bear strategies

It's not all Grimm

People still believe in the OMT backstop

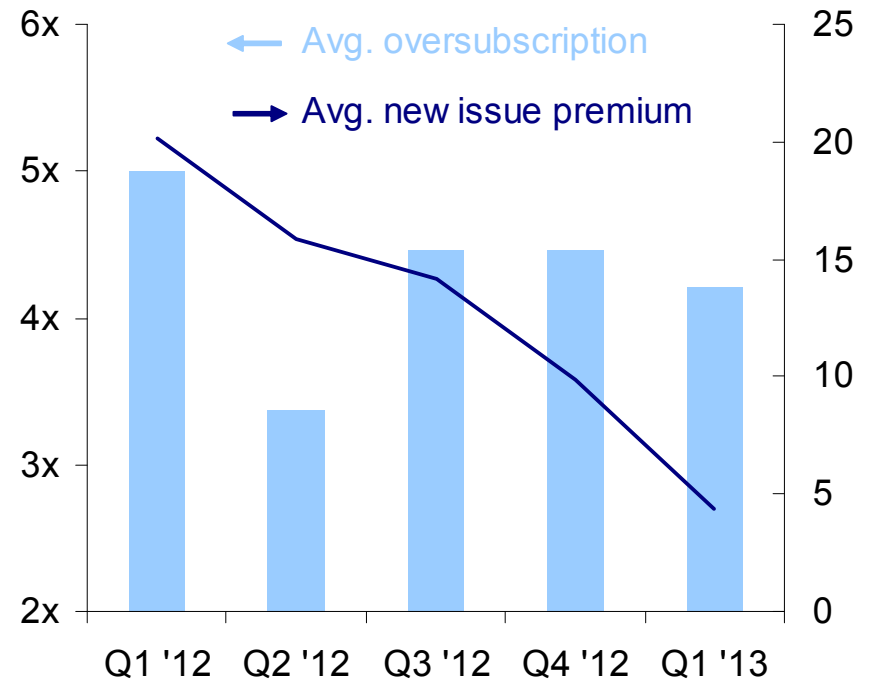
Average 90-day pairwise spread correlation, iTraxx Europe



Source: Citi Research, MarkIt.

New € bonds remain in demand

Average new issue oversubscription & premium to secondaries, bp



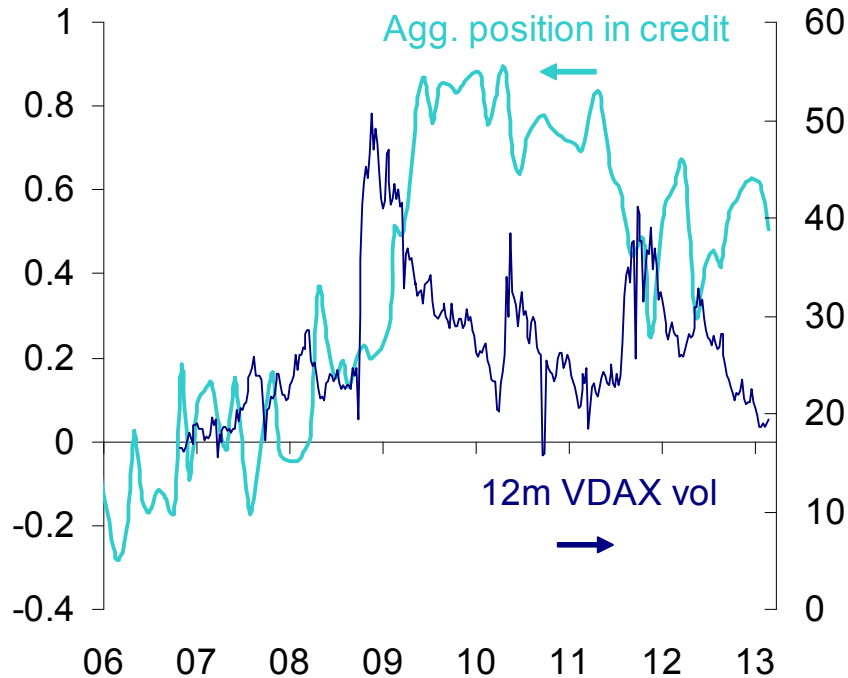
Source: Citi Research, Dealogic.

While Draghi keeps a lid on things,
porridge still has strong supporters

But the Goldilocks strategy seems consensus

Long & not expecting a rise in vol

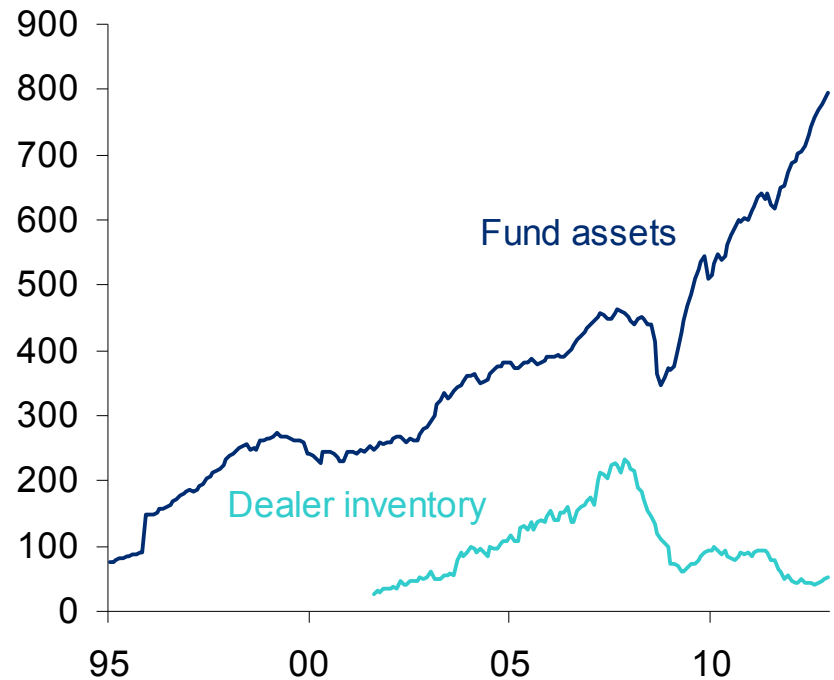
Reported aggregate long in credit, +/-2, vs 12m VDAX vol, %



Source: Citi Research, Bloomberg.

Yet there's no exit when you want it

US credit mutual fund assets vs dealer inventory, \$bn (IG+HY)



Source: Citi Research, Haver.

“Eat, sleep & run just before any bears return”

In a conditional equilibrium

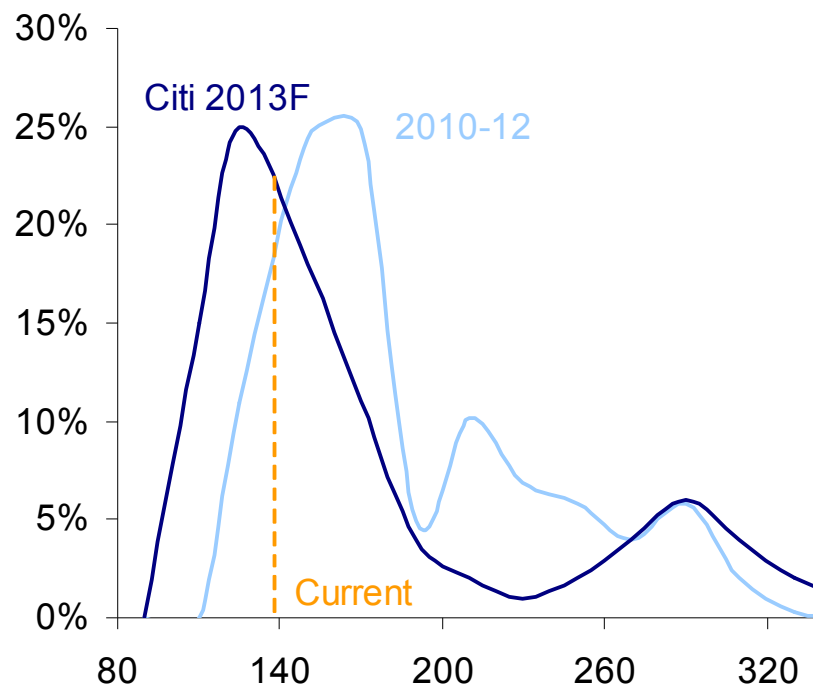
A little more upside with a big “but” – point estimates mask a lop-sided distribution

Citi Credit modal forecasts for 2013

iBoxx spread distribution 2010-12 w. stylised 2013 forecast

	Current	End-'13F	Total return
iBoxx € Corp	140bp	125bp	1.7%
iBoxx € HY	445bp	425bp	3.0%
iTraxx Main	110bp	105bp	
iTraxx Xover	420bp	430bp	

Source: Citi Research.



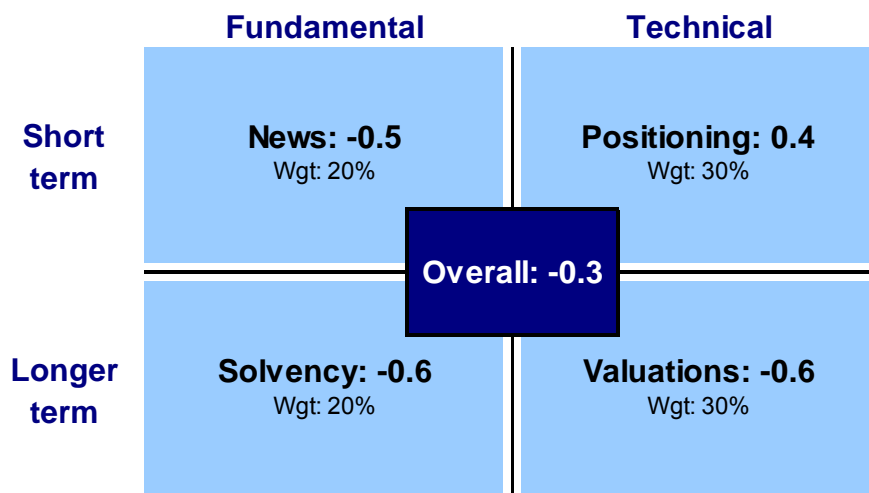
Source: Citi Research, MarkIt.

Shake confidence a little and it returns; shake it too much...

How we'd have our porridge

Citi's Credit investment matrix

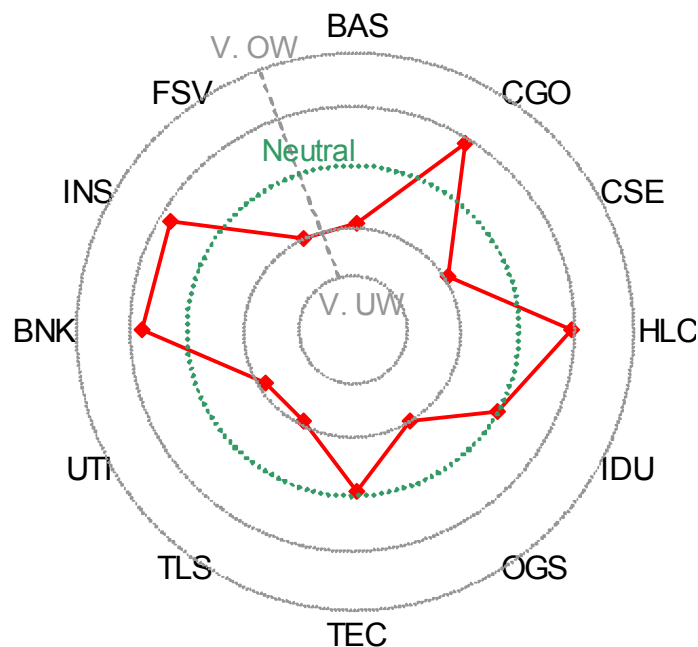
Key views on a scale from -2: very negative to +2: very positive



Source: Citi Research.

Sector weightings

As reported in the "European Credit Sector Recommendations"



Source: Citi Research.

Consolidate – or keep eating, but closer to the door
(neutral – or long with hedges)

Potential trading strategies for 2013

Investing in options is not suitable for all investors. Please see the disclosures concerning the risks of investing in options below and discuss whether this particular options strategy is suitable for you with your Financial Advisor



“Perfect porridge”



“Baby bear”



“Papa bear”

Trade	Market	No correction	Sell-off in range	Systemic
Long core over periphery	Cash, CDS	×	✓	✓
Long ‘hard’ over ‘soft’ core*	Cash, CDS	×	✓	✓
Long US to Europe	Cash	-	✓	✓
Long non-fins over fins	Cash, CDS	×	-	✓
Long IG over HY (MainEx vs XOver)	Cash, CDS	×	-	✓
Long covered & T1 vs senior & LT2	Cash	-	-	✓
CDS Flatteners	CDS	(✓)	-	✓
Long equities over credit	Equity vs credit	✓	-	-
Long periphery corps to core fins	Cash, CDS	✓	-	×
Long Main to CDX IG	CDS	✓	-	×
Risk reversal in options	CDS options	(✓)	×	✓
Payer 1x2 through options	CDS options	-	✓	xx

Source: Citi Research.

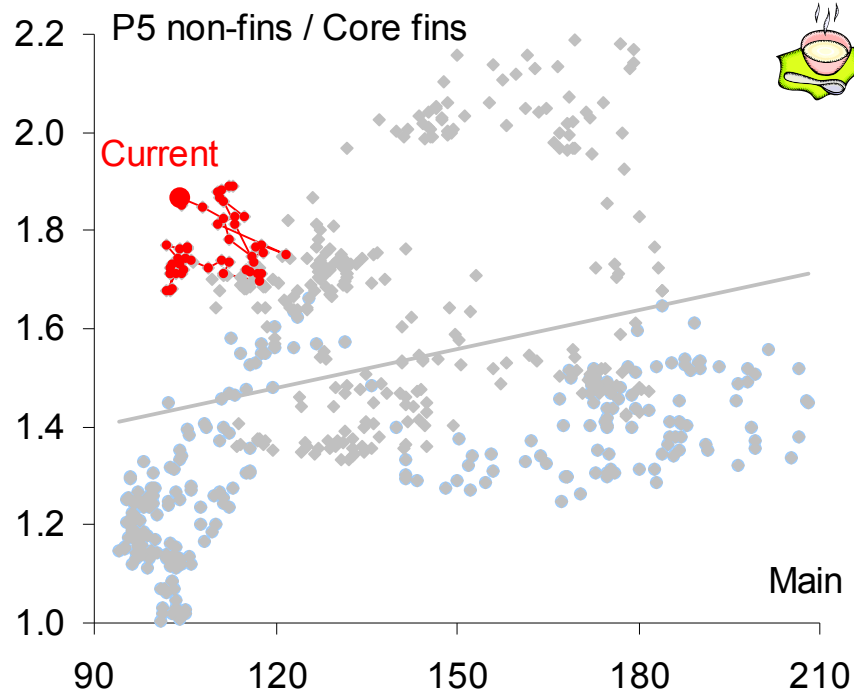
Note: Soft core consists of corporates in France, Austria and Belgium.

Mix & match to give your portfolio the right profile

“Perfect porridge” strategies at the tight end of the range

Periphery corporates very wide to core fins

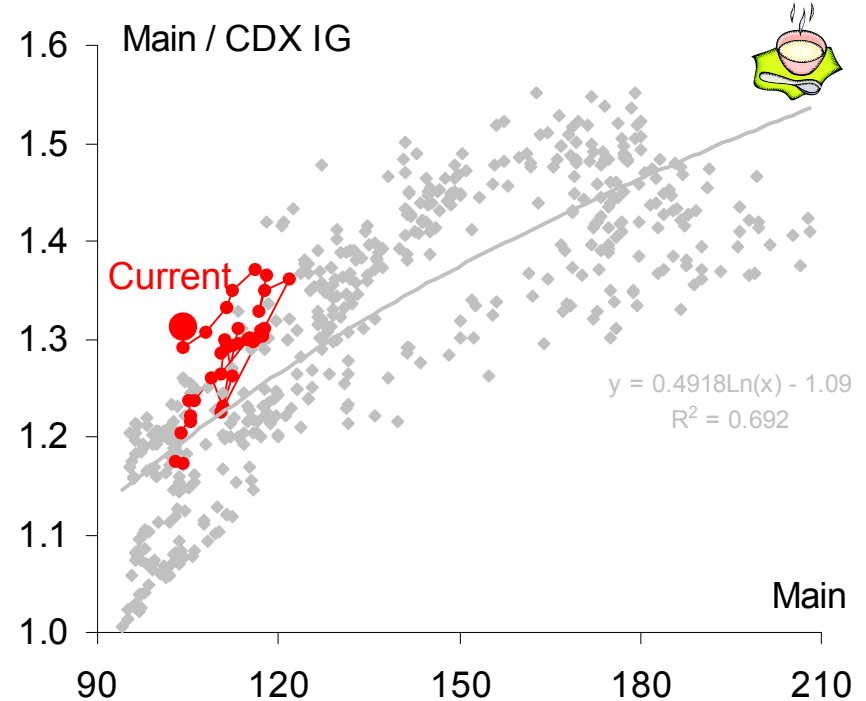
iTraxx Main P5 non-fins / core fins vs Main, bp, Jan 11-Mar 13



Source: Citi Research, MarkIt.

Main wide to CDX IG

iTraxx Main to CDX IG ratio vs. iTraxx Main, bp, Jan 11-Mar 13



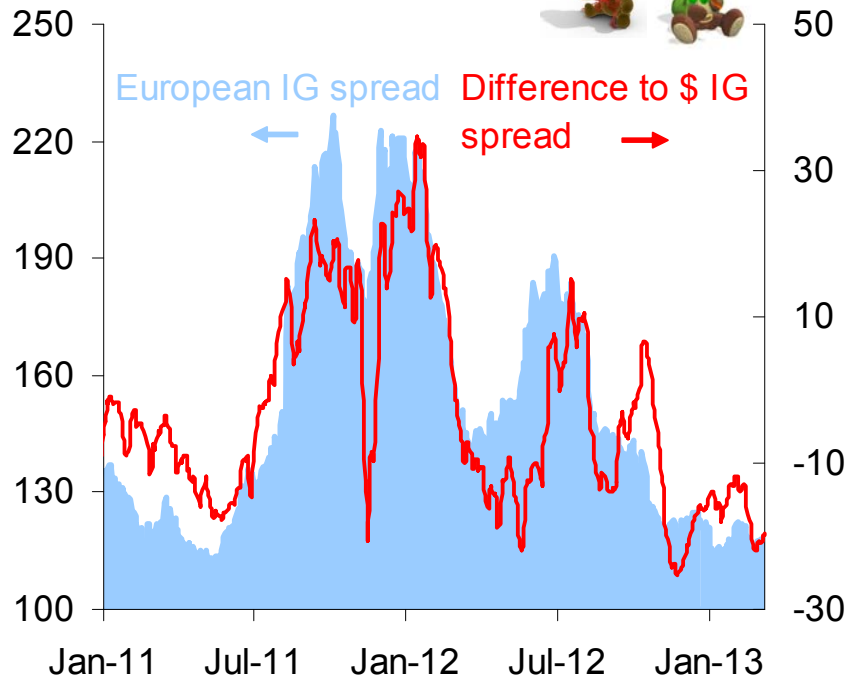
Source: Citi Research, MarkIt.

Rather than going long, find relationships out of kilter

Yet with Europe still deep in the woods ...

Prefer voluntary to involuntary releveraging

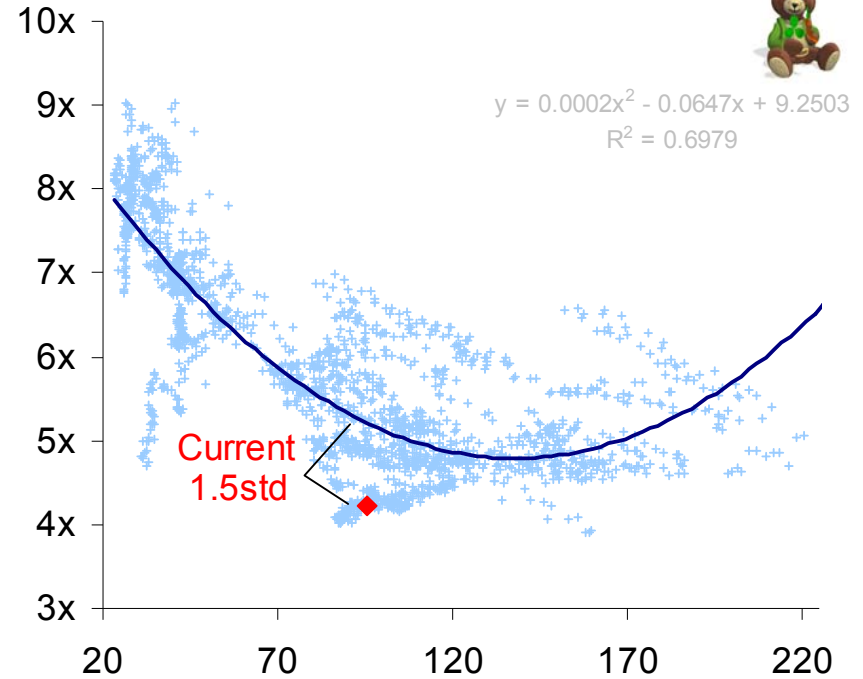
US vs Euro Broad IG non-fin. index, bp



Source: Citi Research, MarkIt.

HY/IG ratio: tight & vulnerable to bears

Crossover to Main ex. Fins ratio vs Main ex. Fins spread, bp



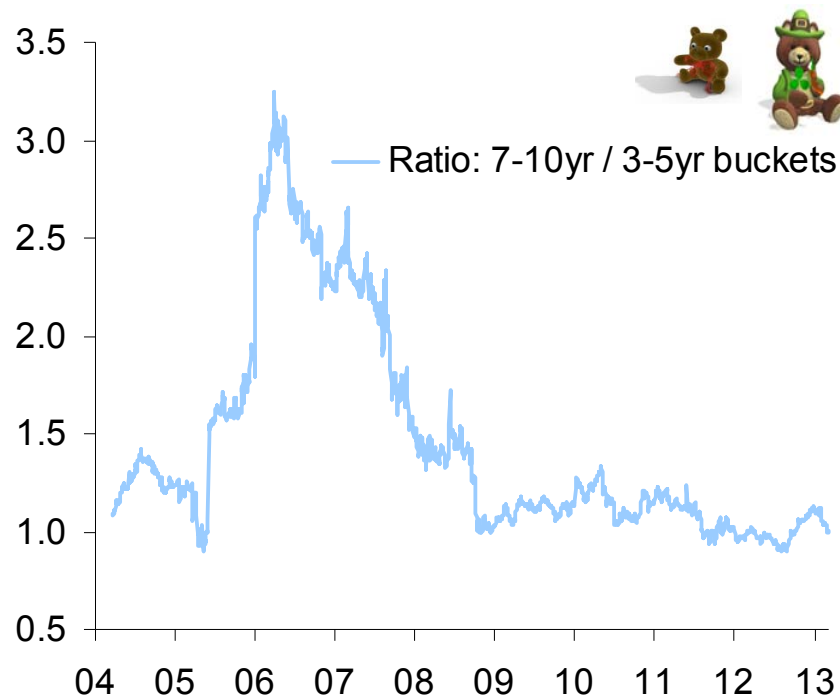
Source: Citi Research, MarkIt.

... try to avoid the bears: Long US, & IG over HY (β -adj.)

Some bears need different handling in cash and CDS

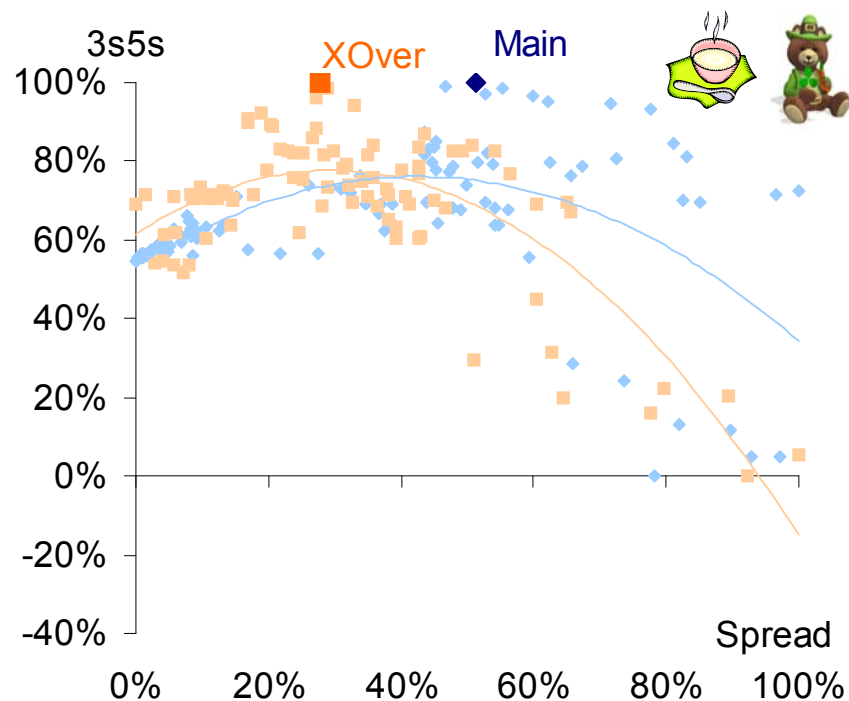
The maturity curve in cash is too flat

iBoxx € Non-Financials: spread ratio of 7-10yr vs 3-5yr buckets



The maturity curve in CDS is record steep

Main & XOver – level vs 3s5s differential, percentiles since '05

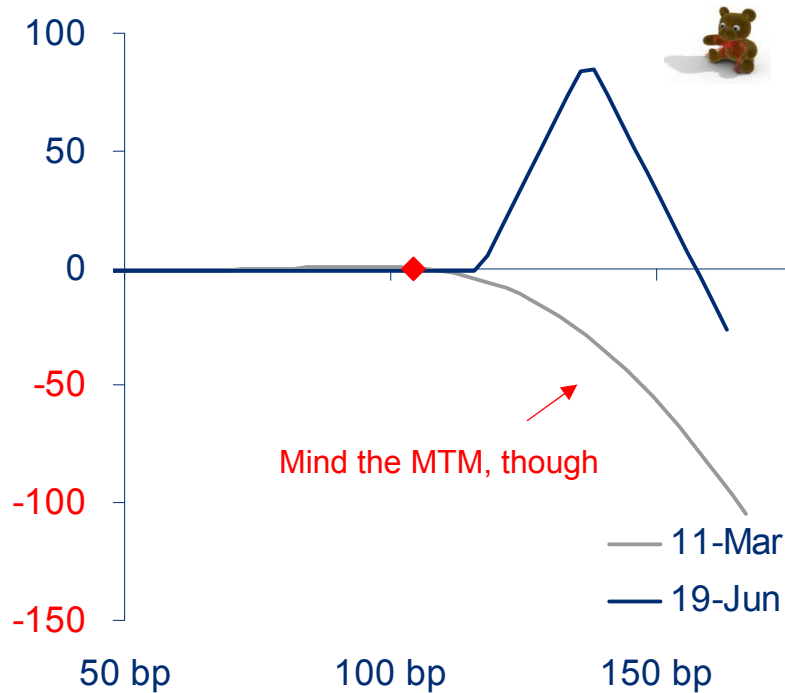


Short duration in cash; flatteners (DV01-neutral) in CDS

If you're running long, consider all hedging options

If you believe in the OMT...

iTraxx Main payer 1x2* payoff, € per €10,000 notional

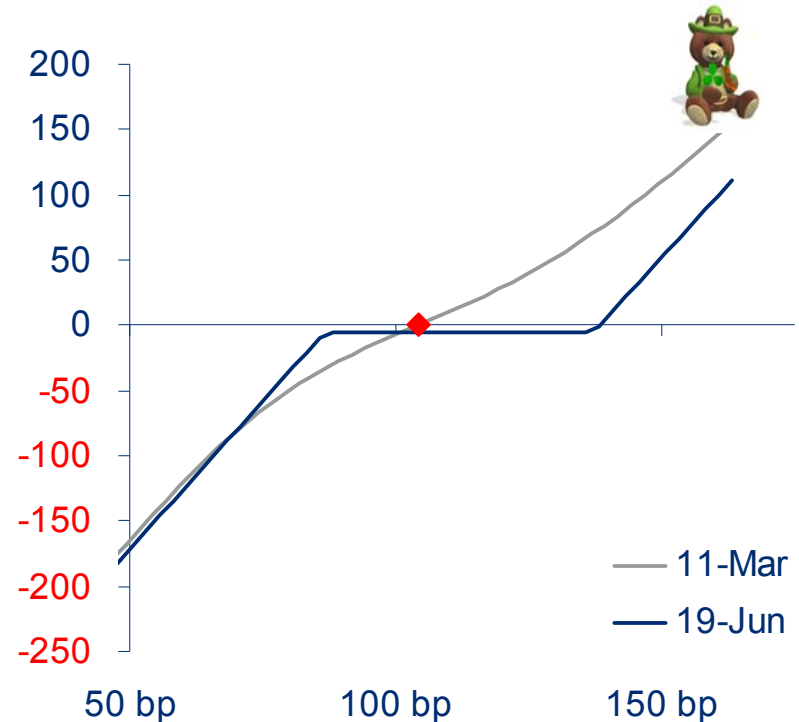


Source: Citi Research, MarkIt.

* Buy a 120-strike payer, sell two 140-strike payers.

If you don't believe in the OMT...

iTraxx Main risk reversal* payoff, € per €10,000 notional



Source: Citi Research, MarkIt.

* Sell a 90-strike receiver, buy a 140-strike payer.

Taking precautions now could pay off later

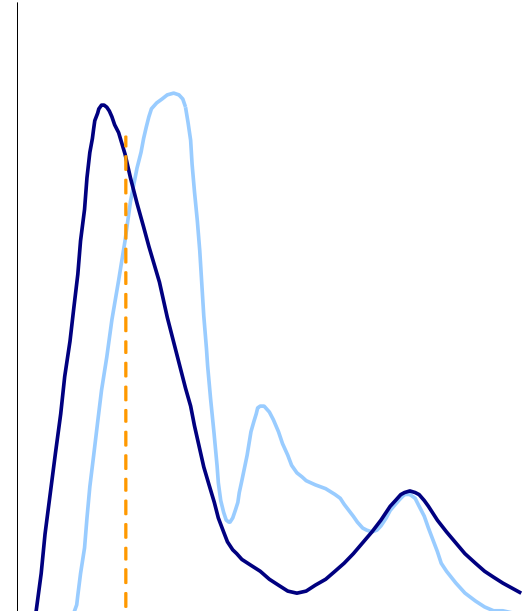
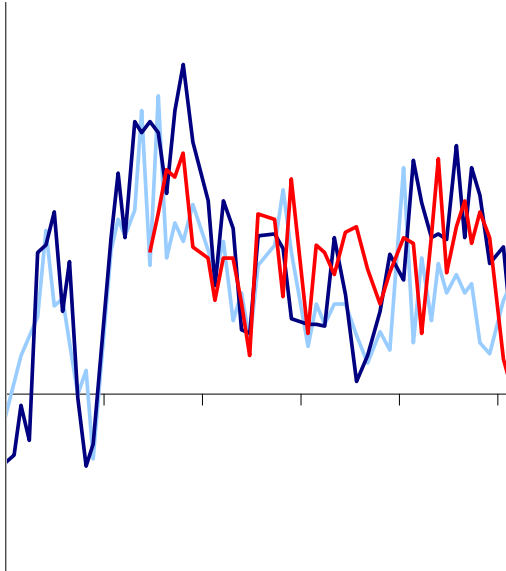
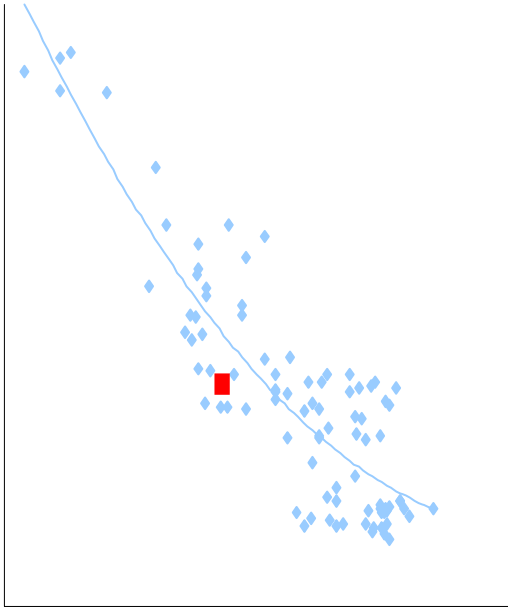
The 1x2 payer strategy allows clients to profit in a small contained selloff at little cost if spreads tighten, but leaves them at risk of significant losses in a bigger correction. The risk reversal allows clients to hedge a sharp correction associated with a return of systemic risk at little cost by giving up the upside from further tightening that would take spreads further away from fundamental valuations. Please note that these are illustrative examples only and are not intended as recommendations.

Conclusion – wait for better entry points

Porridge less appealing

Goldilocks looking tired

Bears still lurking



Porridge is best eaten
while the bears are busy chasing others away

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