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High Grade
North America

What's left for 2014?

The massive year-end rally reset starting levels: how to position

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- With the last few weeks of the year providing a significant rally to credit spreads, generating ideas and determining sector weights just became a lot more challenging. Our year end 2014 forecast now calls for nonfinancial spreads to widen roughly 30bp and financials to tighten an additional 5bp from current levels, reflecting our expectation for leveraging events in nonfins.

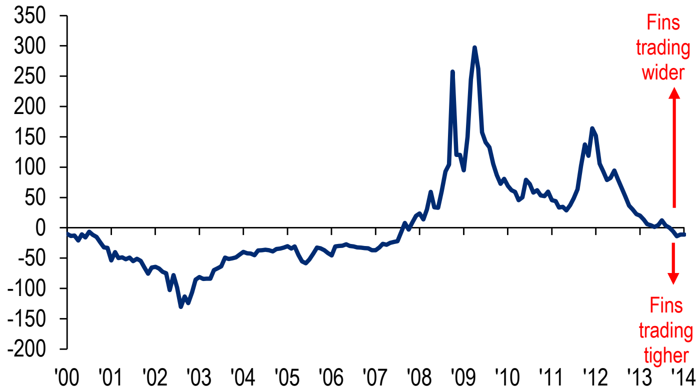
- In this piece, we offer our sector recommendations, single name picks and pans, and a few strategies for trading some of the fundamental themes we expect in 2014.

- **Overweight:** We continue to suggest to overweight financials, primarily banks and life insurers. We recognize that this is likely a crowded trade, but these sectors have further room to run, in our opinion. Financials should continue to trade inside industrials (Figure 1).

  In non-fins, we suggest overweight positions in basic materials and energy, given spreads remain relatively distended. While we are cautious on underlying commodity prices which tend to drive credit spreads, we see value in the credits that have either a diversified business mix or those that have taken actions to reduce debt burdens. In many cases the proceeds from asset sales will be used to improve credit profiles.

- **Underweight:** While high ratings are typically viewed as a positive, we view them as a risk factor heading into 2014. We are especially concerned about releveraging transactions and issuance from the healthcare, tech and consumer products companies. Further, these are the three tightest trading sectors in the IG index, and we do not see much upside from current levels.

Figure 1. Financial less nonfinancial spread, OAS in bp



Source: Citi Research

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

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What's left for 2014?

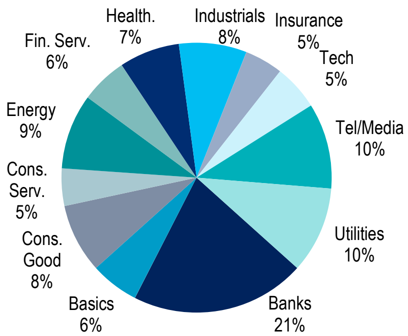
The massive year-end rally reset starting levels: how to position

With the last few weeks of the year providing a significant rally to credit spreads, generating ideas and determining sector weights just became a lot more challenging. While we haven't seen spreads on the index this tight post-crisis, we imagine many are bemoaning that there is nothing to do in the sector.

We agree that things just became more difficult, but we think that this is the year in which credit picking will actually matter. If we look at the single name stories that drove much of the out- and underperformers in 2013, we expect to see much of the same over the next twelve months. However, given the levels at which we are starting the year, we think the removal of some of the technical support in the market will make trading based on fundamentals more likely. Our year end 2014 forecast now calls for nonfinancial spreads to widen roughly 30bp and financials to tighten an additional 5bp from current levels, reflecting our expectation for leveraging events in nonfins.

We have divided this piece into two sections, including our sector recommendations and single name picks and pans, followed by our strategies for trading fundamental themes. We have updated our sector recommendations since we last published this piece, but we note that some of our picks from 2013 are still contenders for outperformance in 2014.

Figure 2. Index Weightings



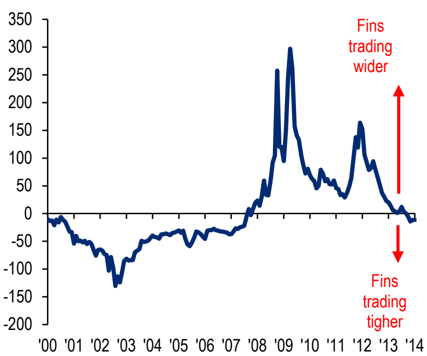
Source: Citi Research, Yieldbook

Sector Recommendations and Picks and Pans

We've every reason to expect financials to continue to outperform nonfinancials/industrials and remain a key source of portfolio alpha in 2014. Yet after outperforming industrials by nearly 40bp over the course of 2013, the point at which financial outperformance ends is inevitably closer at hand than it was a year ago. What's more, there's evidence that the financial overweight is an extremely crowded trade, which has the potential to make a right-sizing of positions back to neutral a technical headache for investors at some point in the future.

As such, it is with far more trepidation relative to last year that we recommend an overweight in financials for the year ahead. In our view, it's not time to exit the position just yet, given there are no good alternatives and that fundamentals continue to improve as a result of regulatory scrutiny/overreach. That said: we'd preemptively look to take profits if financials do continue to notch gains in 2014. As we noted in **part 1 of our US Credit Outlook**, we reckon a fair differential between financials and industrials could be anywhere from 40 to 50bp, and that's where we'd recommend monetizing the trade (Figure 3).

Figure 3. Financial less nonfinancial spread, OAS in bp



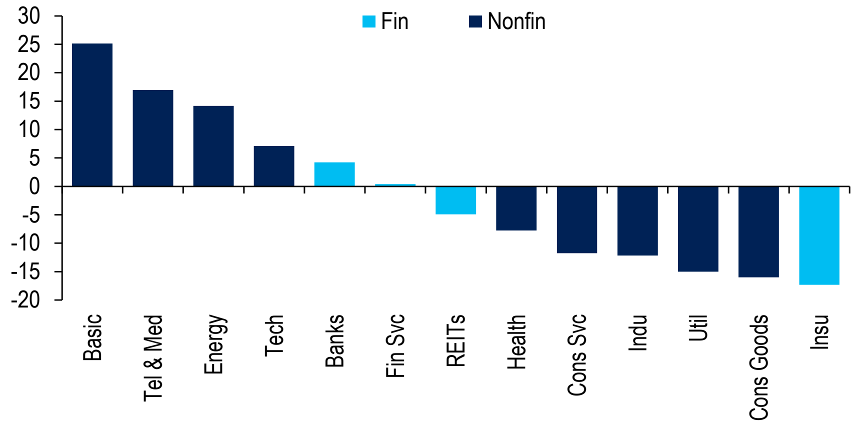
Source: Citi Research

The bulk of our nonfinancial recommendations this year are predicated on the propensity to add debt and increase leverage, investor positioning, and where valuations currently trade. Sure, macro factors will continue to matter, but what we think will really drive alpha opportunities is avoiding the unexpected releveraging transactions, and determining which deals to buy and from which to stay away.

In order to interpret nonfinancial sectors fairly, we find it instructive to compare them to the broader nonfinancials index reweighted to mimic the sector's rating/tenor profile (see "Rating/tenor neutral sector indices" box below for more details).

Using this analysis, we can see that basic materials, telecom/media, and energy look to offer the most premium over their custom benchmark, while consumer goods, utilities, and industrials look to be the most rich (Figure 4).

Figure 4. Difference between actual sector spread and custom index (bp)



Source: Citi Research, Yieldbook
Note: Differences as of December 16, 2013

Rating/tenor neutral sector indices: The question, "which sector trades wider" is more complex than it seems at first—after all, the different maturity and rating profiles of various sectors play a large role in dictating levels, making it hard to tease out the unadulterated sector spread. For example, does telecom/media trade wide to banks because the sector is inherently riskier? Or rather, is it just because it consists generally of longer dated and lower rated debt?

To normalize for these factors and properly answer the question at hand we propose creating a custom benchmark for each sector that adjusts for the impact of rating and tenor differences. It's a relatively straightforward process: If a nonfinancial sector is 50/50 split between single-A and triple-B credits, then we create a custom benchmark which is a 50/50 combination of Citi's BIG Corp nonfinancial single-A index and triple-B index. In this case the custom index would contain no double-As or triple-As because there are no credits with those ratings in the original nonfinancial sector. Likewise, we do the same sort of adjustments to correct for maturity differences. As a result, we can fairly say how much wider a sector trades versus the index without our view being obscured by ratings/tenor considerations.

Putting it all together, we arrive at the following sector recommendations:

Overweight: We continue to like overweight positions in basic materials and energy, given spreads remain relatively distended, and at least in basics, most investors are underweight. While we are cautious on underlying commodity prices which tend to drive credit spreads, we see value in the credits that have either a diversified business mix or those that have taken actions to reduce debt burdens. In many cases the proceeds from asset sales will be used to improve credit profiles.

Given the cyclicality of these two sectors, if we do see better than expected global growth, the benefits should first be felt in energy and basics. We believe that basics will remain somewhat immune to shareholder pressure over the next 6-12 months, and while energy has been a hot spot for activism, few companies have suffered weaker credit profiles as a result.

Figure 5. Sector Spread Change

	Jan '13	Jan '14	△
BIG Corp Index	140	110	(30)
Banks	145	92	(53)
Basic Materials	163	153	(10)
Consumer Goods	112	88	(24)
Consumer Services	129	105	(24)
Energy	142	131	(11)
Financial Services	152	109	(43)
Healthcare	95	85	(10)
Industrials	127	106	(21)
Insurance	163	116	(47)
REITs	176	140	(36)
Technology	129	89	(40)
Telecom & Media	154	138	(16)
Utilities	140	118	(22)

Source: Citi Research
Note: Spreads as of Jan-2-2013 and Jan-6-2014

Underweight: While high ratings are typically viewed as a strength, we view them as risk factor heading into 2014. We are especially concerned about releveraging transactions and issuance from the healthcare, tech and consumer products companies. Further, these are the three tightest trading sectors in the IG index, and we do not see much upside from current levels.

In healthcare, we are concerned in particular about pharma credits, as we expect them to engage in M&A transactions in an effort to boost revenues. With patents continuing to expire, we see an immediate need to grow their businesses.

In tech, pressure from shareholders to return cash to investors is likely to intensify. However, with so much of tech cash trapped overseas, coupled with low rates, we expect to see healthy issuance from the sector next year.

Likewise, the consumer goods sector has been fairly immune to leveraging transactions in 2013, but we believe activity will pick up. Given the large multi-national companies that comprise the sector, we could see splits of companies resulting in weaker credit profiles, much like the Kraft / Mondelez transaction.

Note: Our picks and pans are primarily for cash valuations, but our views on the credit apply to CDS as well.

Sector Picks and Pans

Figure 6. Picks and Pans

		Valuation			Risks		Recommendations	
Sector		**Spread (bp)**	**12M Low**	**12M High**	**Liquidity Score**	**1y Implied Default Rate**	**Picks**	**Pans**
Banks	Slight Overweight	92	92	208	39%	0.12%	Bank of America Morgan Stanley	Wells Fargo
	We assign a slight overweight recommendation for the banks sector, and we continue to cite the solid performance, improving capital structures and deleveraging nature of the banks as reason for outperformance, especially as investors will likely look to avoid the leveraging non-fins. We do recognize the crowded nature of the trade, but we believe there is still some room to tighten over the course of the year. If we see outperformance in Q1 / Q2 (some of which came in the last few weeks of the year), we would look to move to neutral at that point. On the back of strong demand in the front end of the curve, we see limited room for continued tightening here and prefer to move into senior ranking, 7-10year paper.							
Basic Materials	Slight Overweight	153	153	214	25%	0.23%	CF Industries Eastman Chemical International Paper LyondellBasell	DuPont Teck Resources
	If we look at our positioning reports, we see that most investors are underweight this sector, and for good reason given the volatility seen in underlying commodity prices for much of the year. We are still cautious on underlying commodity prices given their correlation to credit spreads, but we do see value in the credits that have either a diversified business mix or those that have taken actions to reduce debt burdens. In many cases the proceeds from asset sales will be used to improve credit profiles. Further, given the fundamental headwinds potentially facing the sector, we see little opportunity for shareholder activism or releveraging, making the sector more appealing to investors looking to dodge headlines of that nature.							
Consumer Goods	Underweight	88	88	145	20%	0.09%	Ford Kellogg Tyson	Campbell Soup McDonald's Johnson Controls
	If we look for a sector that has been relatively quiet for much of 2013 in terms of releveraging, it is the consumer goods sector. In the upcoming year, we'd expect to see more debt-funded M&A, splits of companies, and shareholder pressure. Further, if we compare how the sector is priced versus its rating and maturity adjusted spread, we see that it is really one of the mis-priced sectors, trading tighter than its ratings would imply. We think companies benefit from their global presence and strong brands, but in our opinion that sets it up for releveraging, especially as top line growth has become more difficult to achieve.							
Consumer Services	Neutral	105	105	145	13%	0.14%	GAP (cash) Macy's	Kohls Staples VF Corp
	This sector, which is primarily comprised of retailers, underperformed in Q4 as investors sold paper on the back of weak retail sales concerns, and we believe it to now be priced fairly. We don't think growth is going to be fantastic, but current spreads are pricing consumer pullback appropriately. We continue to like housing-related companies, as those companies benefit from the continued rebound in the housing market. In this sector, we like buying BBB-rated credits, as those aren't likely shareholder targets, and instead will focus on reducing debt.							
Energy	Slight Overweight	131	131	169	24%	0.17%	Southwestern Weatherford Western Gas Partners	Transocean Williams Co. Inc.
	We continue to recommend a slight overweight in the Energy sector, recognizing the value in current spreads and at the index level, we see that the sector trades wide for its ratings and maturity composition. We think that there will continue to be pressure on credits from shareholders, calling for splits of companies, increased dividends or buybacks, but at current spreads investors are compensated, in our opinion. However, we expect companies to continue to have success in fending off aggressive plans. Lastly, given the cyclicality of the sector if we do see a pick-up in global growth, the energy sector will be one of the early beneficiaries.							
Financial Services	Neutral	109	106	171	26%	0.12%	Capital One Discover Financial GE Capital Corp.	American Express
	This sector, which primarily consists of asset managers and non-bank card companies, is likely trading at fair value, recognizing the generally high ratings and stable credit profiles. We like DFS' profile, and believe that spreads are most attractive in the non-bank opco paper. We believe AXP looks rich, although we are comfortable with the credit.							
Healthcare	Slight Underweight	85	84	114	22%	0.09%		Pharma credits
	In healthcare, we are concerned in particular about pharma credits, as we expect them to engage in M&A transactions in an effort to boost revenues. With patents continuing to expire, we see an immediate need to grow their businesses. Therefore, while credit profiles can generally handle increased debt loads, we imagine that any issuance could pressure the already tight spreads.							

		Valuation			Risks		Recommendations	
Sector	**View**	**Spread (bp)**	**YTD Low**	**YTD High**	**Liquidity Score**	**1y Implied Default Rate**	**Picks**	**Pans**
Industrials	**Neutral**	**106**	**106**	**163**	**13%**	**0.10%**	**Eaton Corp**	**Deere** **Ingersoll-Rand**
	We assign a neutral rating to this sector: Though we can see a continued focus on shareholder returns, most of it should be funded with free cash flow. M&A will also likely be a key theme in this sector, but we'd expect most to be smaller, bolt-on deals. As far as aerospace and defense companies are concerned, continued pressure on military budgets is likely, but we expect the companies to continue to post solid results.							
Insurance	**Overweight**	**116**	**116**	**211**	**15%**	**0.22%**	**Hartford '42** **Lincoln National '36** **Prudential**	
	We continue to see Insurers as solid performers for the next few months, as the sector should benefit from their improving capital levels and deleveraging nature. Life insurers are preferred over P&C credits, although we are still constructive on the fundamentals of the P&C business, and levels look to have run significantly tighter. For life insurers, the rising rate environment should help their profitability longer term and allow them the ability to ramp up some of their less profitable product offerings.							
REITs	**Neutral**	**140**	**140**	**212**	**10%**	**0.17%**	**Health Care REIT** **Ventas**	
	We continue to fundamentally like REITs, but given the significant rally we've seen this year and their sensitivity to rising rates, we recommend a neutral weight. Operating metrics and cash generation remain solid, and we do not foresee a significant building / acquisition boom requiring new debt. Healthcare REITs are a sector to watch as the US healthcare system is altered by Obamacare.							
Technology	**Underweight**	**89**	**89**	**146**	**25%**	**0.10%**	**Hewlett-Packard**	**Cisco** **Intel** **Oracle** **Pitney Bowes**
	Despite weakness in demand for underlying tech products, bonds from this sector have outperformed over the past few months, which we attribute in part to the generally high rating for the sector. However, while current spreads appear to be in line with its rating and maturity profile, we do not think they pay investors enough for the risk of large releveraging transactions. In fact, the sector's high ratings actually make it more likely to see debt-funded share buybacks, in our opinion, as those with A-ratings tend to have the flexibility to lever up. Lastly, product innovation has lagged at many of these companies, and we don't foresee significant growth or margin improvement, providing one more reason for shareholders to push for buybacks. We suggest an underweight in the tech sector, expecting that issuance will likely pressure spreads more than fundamentals.							
Telecom & Media	**Neutral**	**138**	**138**	**194**	**39%**	**0.11%**	**Time Warner Inc.** **Verizon**	**AT&T** **CBS**
	The Verizon deal, and other large potential deals, pushed this sector wider for much of 2013. However, now that the mega deal is complete, and taking our cues from how VZ paper traded post issuance, we've upgraded our recommendation to neutral from underweight. While we are still concerned about potential deals that we expect would push spreads wider, we think that the sector should perform in line with the index. We note that the sector still trades wide to the tune of 15bp compared to its ratings and maturity profile. Lastly, given the uncertain nature of any Time Warner Cable deal given the players discussed, we'd prefer to be neutral given the range of possible outcomes.							
Utilities	**Neutral**	**118**	**118**	**186**	**5%**	**2.13%**	**MidAmerican (HoldCo)**	**GenCos**
	We expect this low beta, domestically domiciled sector to be fairly insulated from spread pressure resulting from market-moving headlines. We like the regulated utilities over genco paper, as these credits are able to recoup any commodity cost swings. Issuance risk remains, but recent deals have been well bid and have not impacted overall spreads.							

Source: Citi Research

Strategies: Trading fundamental themes

In our 2014 **US Credit Outlook - 14 for '14 (part 2), fourteen strategies for 2014**, we detail trade ideas for high grade investors. In the following section, we republish those trades that pertain to fundamental themes and specific companies. Please see the full document for our team's other recommendations.

#1. Stay positioned for the LME trade—it's not dead yet

With cash-rich balance sheets, relatively low interest rates, and management teams thinking about their 2014 capital plans, we expect to see additional tender offers and liability management trades from IG credits early in the year. We see tenders coming primarily from two camps – those looking to push out maturity profiles and those wishing to take out high-dollar/high-coupon bonds.

The amount of paper that can potentially be tendered is significant—there is nearly $350bn of index-eligible debt maturating in each of 2015, 2016 and 2017, and our screen of high-coupon/high-price bonds nets about $108bn. We'd expect most tender offers to be funded with new, longer-term debt, much like we saw with AT&T, MO, YUM or BAC. But we're also likely to see opportunities in conjunction with asset sales, as companies will likely need to reduce their debt load given their lower asset base.

Indeed, the wildcard potential source of alpha is from tender offers that are part of a debt-reduction strategy. Take Apache: the management team recently tendered for low-coupon, newly-issued debt, which was perplexing to many. Why would a company take out below par debt? But the objective was to offset losses from making whole their 2015 bonds. Because the transactions will be funded with proceeds from an asset sale, leverage improves.

We see the most potential for tenders in the energy and telecom/media sectors. While there are many high-dollar utility bonds, the sector is unlikely to be an active tender participant as the regulated nature of the sector makes the tax and accounting issues more difficult to navigate.

For total return investors, we suggest buying bonds that could be tender candidates. As the average IG tender in Q4 has come at a 40bp premium, we think identifying these credits is one way to achieve alpha. In the table below, we show bonds that look like good candidates, in our opinion (Figure 7).

Figure 7. Tender Candidates

Ticker	Company	Sector	Number of bonds	Amount of bonds ($mn)	Average Price ($)
ABIBB	Anheuser-Busch	Consumer Goods	9	7,044	129.09
APC	Anadarko Petroleum	Energy	8	7,025	124.13
BHP	BHP Billiton	Basic Materials	2	2,073	120.37
CMCSA	Comcast	Media	15	13,990	122.74
COP	ConocoPhillips	Energy	8	7,071	130.05
EOG	EOG Resources	Energy	1	350	122.92
FDX	FedEx	Industrials	1	750	126.45
HES	Hess	Energy	4	3,050	123.60
IP	International Paper	Basic Materials	5	4,356	128.83
RAI	Reynolds American	Consumer Goods	3	1,400	118.84
RIO	Rio Tinto	Basic Materials	3	4,000	125.88
TWX	Time Warner Inc.	Media	8	7,652	123.23

Source: Citi Research, Yieldbook
Note: based on our screen of bonds trading above $115, with a coupon in excess of 6%. Prices as of Dec. 16, 2013.

#2. Give a credit a second chance?

Fool me once, shame on you; fool me twice, shame on me. It's advice that investors would arguably be wise to take heed of when evaluating credits that have increased leverage over the past year. Yet at the same time the temptation to buy a recently-levered credit trading at wider spreads on the assumption that there's deleveraging to come is great. So what's a paranoid yield-hungry investor to do?

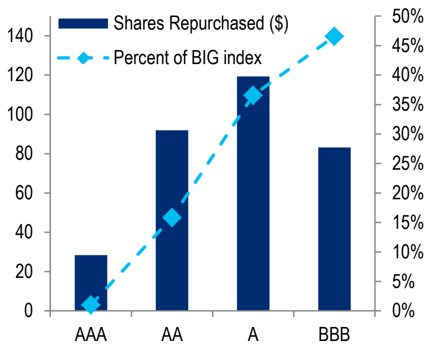
Most likely such decisions will be a credit-by-credit call; however, we think it's not unreasonable to expect that companies that have levered up to fund M&A (i.e. Verizon) are probably in debt-reduction mode for the next few years, while companies that have issued debt to buy back shares (i.e. Viacom) could be repeat offenders in 2014.

What's more, there's clear evidence that the companies most likely to add debt with the aim of repurchasing shares tend to be higher-rated, while triple-B companies more often use debt to fund M&A (Figure 8). Indeed, it makes sense that highly-rated credits are adding debt given that the primary markets have been wide open and the consequences have been limited, both in terms of spreads and ratings (Figure 9).

As such, when it comes to buying companies that are releveraging we tend to favor triple-Bs where the likelihood of recidivism is lower. But a measure of selectivity is still required. For instance, in the case of Verizon, bonds were priced in a way that left plenty of room for tightening, and spreads were more in-line with the higher level of debt. However, other recent deals, such as Heinz or Thermo Fisher Scientific, already seem to bake in several years of deleveraging, leaving little room for error.

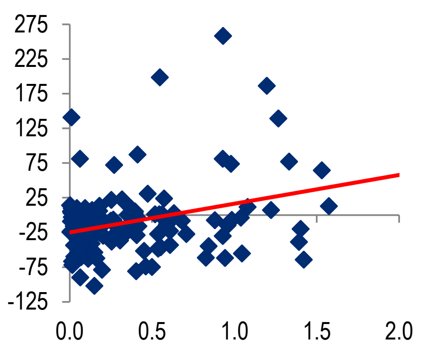
Alternatively, in Figure 10, we show companies that screen well as potential leveraging candidates; they include companies that have under 2.0x leverage, issued debt in 2013 and where stock price performance has lagged the S&P500. We focus on companies with an A-rating or higher, as this seems to be the ratings class most willing to lever up. In our opinion, potential candidates to underweight include:

Figure 8. Share repurchases (LTM) vs. BIG Corp weights, repurchases in $bn (left), and weights in % (right)



Source: Citi Research, DealLogic, Bloomberg

Figure 9. Change in OAS (y-axis) vs. net debt/EBITDA increase (x-axis) by issuer, OAS in bp



Source: Citi Research

Figure 10. Repeat offender candidates; be cautious of releveraging and issuance

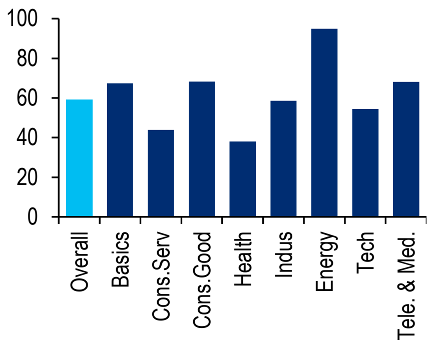
Name	Sector	YTD Debt Change ($)	Ratings	Q3 13 Leverage	YTD Equity Price Change
Apple Inc	Tech	16,960	/ AA+	0.3x	6.7%
Wal-Mart	Retail	7,686	Aa2 / AA	1.7x	16.4%
Chevron	Energy	6,389	Aa1 / AA	0.4x	13.4%
Oracle	Tech	4,351	A1 / A+	1.4x	4.5%
Philip Morris	Cons. Goods	3,961	A2 / A	1.9x	2.5%
IBM	Tech	2,911	Aa3 / AA-	1.5x	-7.9%
Procter & Gamble	Cons. Goods	1,354	Aa3 / AA-	1.9x	23.8%
Altria Group	Cons. Goods	998	Baa1 / BBB	1.8x	18.9%

Source: Citi Research, Bloomberg, Moody's, S&P

#3. Remember the fundamentals

As fundamentals gradually start to play a larger role as far as influencing valuations against a backdrop of weaker technicals, we believe it will be increasingly important that investors ensure they are paid appropriately for the credit risk they undertake. One way we evaluate this is to look at spread per turn of leverage; in doing so we can analyze relative value opportunities both across and within sectors.

Figure 11. Spread per turn of normalized leverage, by sector, OAS in bp



Source: Citi Research, Moody's, S&P, Bloomberg
Note: market value weighted spreads and leverage

To actually trade this theme, we look at relative value opportunities within sectors. For example, in the tobacco space, we can compare Lorillard and Reynolds. The credits trade about 25bp apart and hold the same mid-BBB rating, but Lorillard is 1.7x levered versus Lyondell's 2.1x. On a per turn of leverage basis, LO provides 108bp while Reynolds only provides 73bp. In the table below we show other pairs where investors have an opportunity to pick up additional spread (Figure 12).

Figure 12. Relative value trades based on spread per turn of leverage

	Company	Sector	Ratings	Average Spread (bp)	Normalized Leverage	Spread / Leverage (bp)
Buy	Lorillard	Consumer Goods	Baa2 / BBB-	181	1.68	108
Sell	Reynolds American	Consumer Goods	Baa2 / BBB-	154	2.09	73
Buy	Kraft	Consumer Goods	Baa2 / BBB	107	2.53	42
Sell	Mondelez	Consumer Goods	Baa1 / BBB-	109	3.92	27
Buy	Teva Pharma	Healthcare	A3 / A-	117	2.29	51
Sell	Baxter	Healthcare	A3 / A	70	2.56	28
Buy	Motorola Solutions	Tech	Baa2 / BBB	52	1.70	112
Sell	Pitney Bowes	Tech	Baa2 / BBB	56	3.55	50
Buy	Apache	Energy	Baa2 / BBB	98	0.92	108
Sell	ConocoPhillips	Energy	Baa2 / BBB	85	1.09	78

Source: Citi Research, YieldBook
Note: spread represents the weighted average spread by issuer.

In general we prefer more spread per turn of leverage, but in some cases the credits that provide the most spread per turn are exactly those that could lever up. If we look at names like Apple, Google or Microsoft, these tech companies provide more than 150bp of spread per turn of leverage, purely due to their relatively low levels of debt. However, we believe that these are exactly the types of companies that could easily increase the amount of debt on their balance sheets.

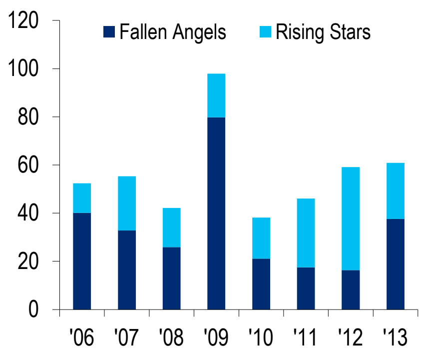
At a sector level, we find energy credits to be the most attractive from a spread per turn of leverage perspective while healthcare to be the least after normalizing for industry differences (Figure 11).

Normalizing leverage: We acknowledge that an "A" rating in one sector may entail a very different leverage profile than in another. In order to make a fair comparison of leverage across sectors, we normalized the leverage metrics by rating for each sector using Moody's industry rating methodology guidelines. So for an A-rated tech company with 1x leverage, we add half a turn or so to put it on par with other industries because allowable leverage for a given rating tends to be more conservative in the tech sector. This sort of normalization differs for each sector, but the end result allows for fair comparison across sectors, and in turn, spread per turn of leverage across sectors as well.

#4. Shoot for finding the Angels, not the Stars

Identifying rising star candidates is a known source of outperformance for many investors. But so much of the movement depends on who already owns the bonds, and what those investors' constraints may be. If we look at Figure 13, we see that in 2013, more paper (by par amount) was downgraded than upgraded. The downgrades were driven by leveraging transactions (Heinz, Dell, BMC Software) and less so by weakened credit profiles (Virgin Media, CenturyLink). The upgrades tended to be smaller companies that have worked their way up the ratings scale.

Figure 13. Outstanding amount impacted by rating changes, in $bn



Source: Citi Research

But as we've observed over the past few years, it may be more profitable to trade the crossover candidate ahead of the ratings move. In some cases the actual upgrade does little to move spreads in the direction one would expect.

Take Ford's upgrade by Moody's in May 2012 that moved the bonds into IG indices. Upon the ratings change, spreads surprisingly widened. We suspect that many added Ford bonds to their IG books prior to the move, and once the news was out demand waned, but weaker global auto sales didn't help their case either. However, given that spreads were still relatively wide, when S&P upgraded Ford to IG in September 2013, the bonds performed well.

Conversely, ArcelorMittal spreads actually improved after being downgraded. We think that high yield investors were happy to have a new name to trade, and given its weight in the index, there was a strong bid from benchmarked investors. Further, compared to other high yield metal companies, Mittal spreads looked attractive given its leading market position and manageable leverage.

As we look to the new year, we've identified our potential crossover candidates (Figure 14). The companies poised for an upgrade, in our opinion, are those that have worked to improve credit profiles, coupled with a more favorable macro environment. While most of the spreads of these credits have already improved, we still see room for tightening upon an upgrade. In the case of GM, its closest comp is Ford which now trades at an average spread of 129bp. While we wouldn't expect GM to rally to Ford's level, we would expect buying on the back of an upgrade.

For our potential falling angels, we believe that spreads for the most part already reflect a downgrade to high yield. To be sure, there will be some forced selling from IG accounts, but we imagine that with the BB index only offering an OAS of 321bp, many of these credits could be attractive to high yield investors and as a result, spreads could tighten.

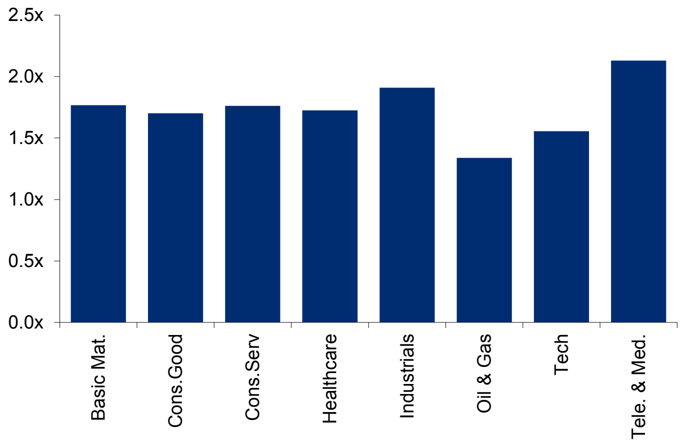
Figure 14. Rising Star and Falling Angel candidates

Rising Stars	Ratings and Outlooks	Amt of debt ($mn)	Avg Spread (bp)
Celanese (CE)	Ba2 / Pos, BB+ / Stable	1,500	224
General Motors (GM)	Ba1 / Stable, BB+ / Pos	8,500	183
Rockwood Specialties (ROC)	Ba1 / Pos, BB+ / Pos	1,250	196
Toll Brothers (TOL)	Ba1 / Stable, BB+ / Stable	2,250	220
Falling Angels	**Ratings and Outlooks**	**Amt of debt ($mn)**	**Avg Spread (bp)**
Alcoa (AA)	Ba1 / Stable, BBB- / Neg	6,927	255
AngloGold Ashanti (AU)	Baa3 / Neg, BB+ / Stable	3,000	512
Avon (AVP)	Baa2 / Watch Neg, BBB- / Neg	2,350	277
Transocean (RIG)	Baa3 / Neg, BBB- / Neg	2,900	161

Source: Citi Research, Moody's, S&P

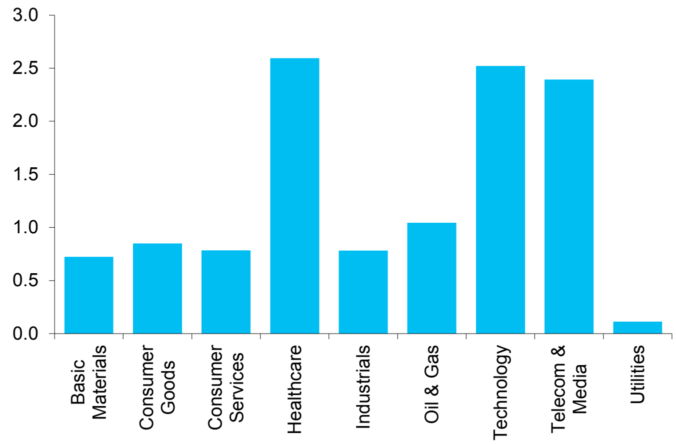
Appendix

Figure 15. Average Leverage



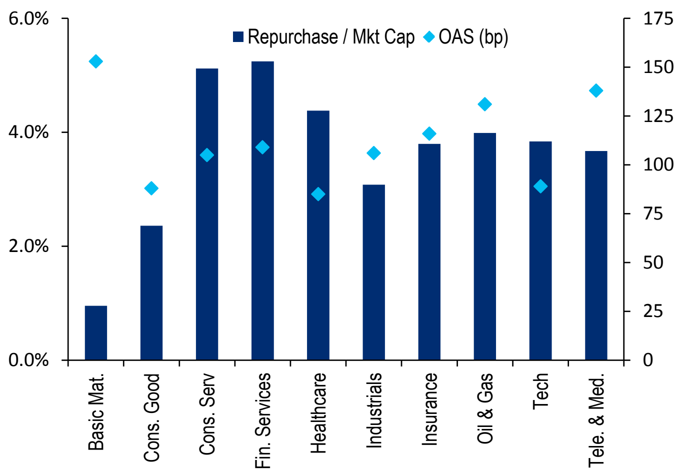
Source: Bloomberg, Citi Research

Figure 16. Average Cash Balance ($bn)



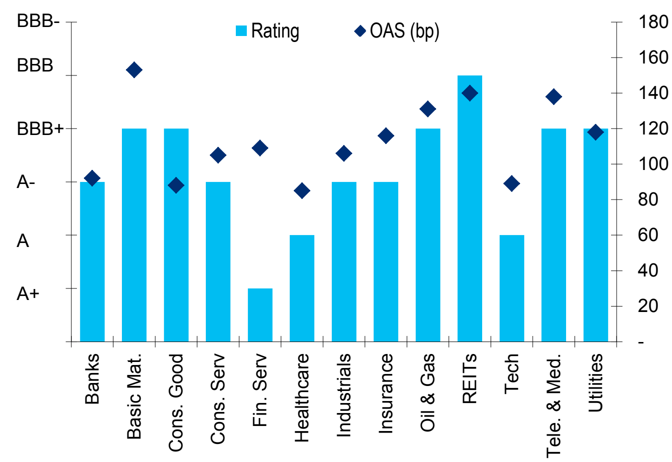
Source: Bloomberg, Citi Research

Figure 17. Share Repurchases / Market Cap (%) vs. OAS (bp)



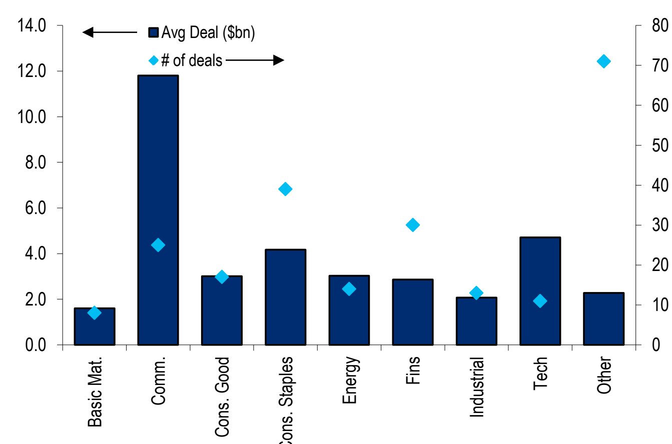
Source: Bloomberg, Citi Research

Figure 18. Weighted Rating vs. Spread



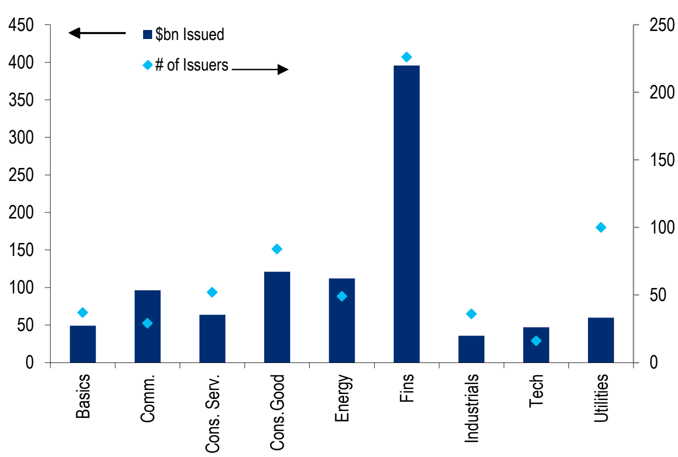
Source: Bloomberg, Citi Research

Figure 19. 2013 M&A by Sector



Source: Bloomberg, Citi Research

Figure 20. 2013 Issuance by Sector



Source: Bloomberg, Citi Research

Appendix A-1

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