

# US Credit Weekly

## The Most Important Week of the Year?



**MARKET OUTLOOK | THE FED: NO SURPRISES | WEEK AHEAD | RECENT CITI RESEARCH | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS**

### Market Outlook

Against all odds, it appears that EU leaders have made significant progress at this week's summit. Reports today that agreement has been reached to allow the ESM to recapitalize banks directly are a major positive, in our opinion, and go some way to not only breaking the vicious feedback loop between the banks and their sovereigns, but also the systemic link between European credit markets and those within the US.

Of course, there are still a lot of details to be ironed out and plenty of unanswered questions. After all, it's still uncertain how the ESM/EFSSF will fund itself, in what manner Spanish banks will be recapitalized, and what sort of financial assistance will be available to the Spanish and Italian sovereigns. The CDS of both countries is still more than 500bp. But as our **European colleagues argue**, the greatest accomplishment seems to be that policymakers have shown the capability to compromise and in the process have given themselves greater flexibility without actually committing to all that much.

In the US the reaction has been predictable. With the decline in risk taking over the course of the year and many investors underweight the banks, credit markets have been set up for a squeeze tighter for some time, as we've noted on countless occasions. As such, it's not too surprising to see on-the-run bank paper 10-20bp tighter today and strength in other less loved sectors like metals and mining (5-10bp tighter).

Furthermore, it helps that other technicals have been so supportive this year as well. As we detail later in the weekly, supply year to date is running below our 2012 forecasts both in gross and net terms, due in part to a decline in M&A and strategic activity. As a result, at this point there's a good chance that full year net supply fails to hit our below-Street estimates while inflows into credit continue to be strong.

Given such a favorable technical backdrop for credit, the question is still: What's it going to take to push spreads meaningfully wider from here? Going forward the answer will depend to a large part on what happens next. If investors buy into the rally and reverse their financial underweights, then any failure of policymakers to meet investor expectations might be punished much more severely than it was over the past two months. On the other hand, if caution prevails, then US credit could continue to be extremely resilient to exogenous events.

And yet even if downside risks dissipate in the coming weeks, as we suspect they might, there's a case to be made that the upside in credit is not the same as

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CREDIT

INVESTMENT OVERVIEW

NORTH AMERICA

CORP. HIGH GRADE STRATEGY

### Recent Citi Research

**European Credit Weekly  
Terming Out**  
Jun '12 – CP to Bond = Spread  
Widening

**Bid Wanted!**  
Jun '12 – Coping with Market Illiquidity

**US Mid-Year Credit Outlook**  
May '12 – Tré-jà Vu

**Time to Get Out from Down Under?**  
May '12 – Reduce Exposure to Aussie  
Banks

**Capital controls in Europe**  
May '12 – What would they mean for  
credit?

**Default Rates to Climb Rapidly in Q3  
and Q4**  
May '12 – Tough credit conditions and  
negative GDP outlook should feed  
through to European speculative-grade  
default rates by Q3 2012

**Credit Strategy Cheat Sheet**  
May '12 – April Survey Results &  
Investment Ideas

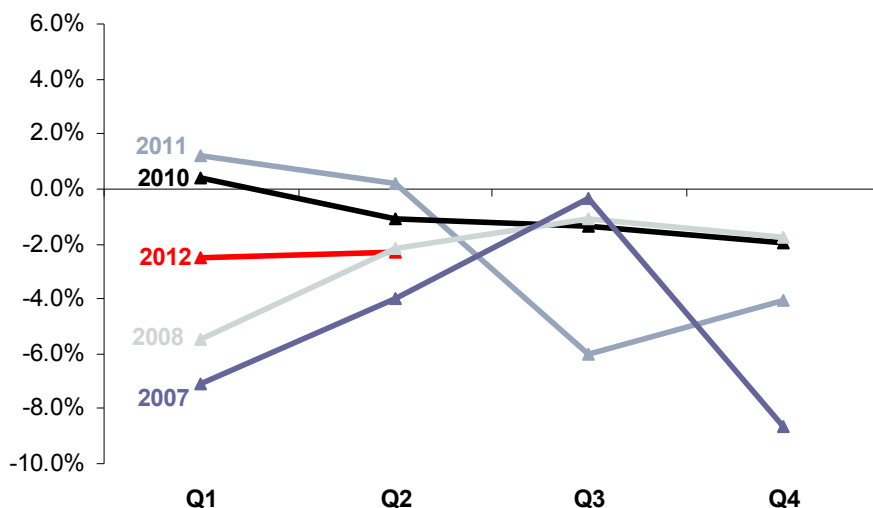
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it was a year ago. For a start, Treasury yields are far lower now than they were in early 2011 and don't look to be in any danger of backing up anytime soon. Moreover, in the last month many corporates have been lowering guidance while analysts have been revising down estimates. Indeed, negative revisions have outnumbered positive revisions 2.5:1 over the last two months. And the last time the ratio was that bad was in 2008, a quarter before the US entered recession.

European policymakers should be applauded for their efforts this week, as it may prove to be the most pivotal week of the year for risk assets. But when the dust settles, we wouldn't be surprised to see credit spreads still trading far wider than many expect.

## 2012 looking like 2008...Revisions to S&P 500 EPS Estimates



Source: Bloomberg, CIRA

Note: Change was calculated from two months prior to quarter-end. Only names with revisions were included (about 70% for 12Q2).

## Single Name News & Views

**News Corp Split** – The announcement of News Corp's split into Entertainment and Publishing companies was met with spread tightening as investors seem to approve of the move and the initial capitalization plans. In the past the company has benefited from the diversification offered by the different divisions, but while the split will bring an end to that relationship and leverage will likely tick higher initially (to about 2.7x), we still like the credit because of its growth prospects and historically prudent balance sheet management. We believe that over time the company should trade more in line with its **media peers**, and as such spreads should continue to tighten.

**Healthcare Mandate Upheld** – After several months of waiting for a decision from the Supreme Court on the constitutionality of Obamacare, there was little reaction in the credit space around the decision to uphold the bill. Spreads barely moved on the news, while stocks mostly reacted positively. In general we prefer Hospital credits (which are HY rated) as they should see a sizeable benefit to charge-offs from uninsured patients, and we are somewhat cautious on HMOs; pharma, products and service companies should see a modest increase in demand. Focus now turns to the November Presidential elections, as Romney, if elected, is expected to push for a repeal of the law. Until that time, we expect spreads to be range bound in this traditionally **low-beta sector**.

## US TotalCredit

Apr '12 – A Simple Single Name Strategy

## Investor in subordination

Apr '12 – Surviving the sovereign cramdown

## High Grade Strategy

Apr '12 – Corporates as Collateral

## European Credit Outlook

Apr '12 – Should I stay or should I go?

## High Grade Strategy

Mar '12 – What's left to rally... and what to buy

## High Grade Strategy

Feb '12 – Replicating the Bank Sector, Minus the Tail Risk

## 2012 High Grade Outlook

Dec '11 – Another Year On The Edge

## US Key Economic Data

<b>Monday:</b>	<u>Consensus</u>
ISM Manufacturing	52.0
Construction Spending MoM	0.2%
<b>Tuesday:</b>	
Factory Orders	-0.2%
Total Vehicle Sales	13.95mn
<b>Thursday:</b>	
Initial Jobless Claims	-
ADP Employment Change	95K
ISM Non-Manufacturing	52.9
<b>Friday:</b>	
Chg. in Nonfarm Payrolls	93K
Chg. in Private Payrolls	99K
Unemployment Rate	8.2%

## Key Earnings Announcements

### Monday:

Acuity Brands Inc.

**Anheuser Busch Inbev buys Modelo** – The beer maker announced a \$20bn acquisition of the remaining 50% of Grupo Modelo, the maker of the best selling US import (Corona) that ABIBB does not already own. Leverage out of the gates increases to about 2.9x, but the company indicated that it targets under 2.0x leverage in 2014 and ratings agencies have suggested that the company will maintain its A/A3 ratings. With \$14bn of committed 2- and 3-year facilities, we expect issuance at some point to refinance this debt with longer-term paper, and until then we expect spreads to remain about **10-15bp behind fair value**.

## The Week Ahead

Despite the July 4<sup>th</sup> holiday mid-week, the economic data calendar is quite heavy. Key numbers include ISM manufacturing and vehicle sales early on in the week, both of which have slowed as of last month. After Wednesday, those of us in the office will focus our attention on the monthly employment data. Weak Q2 nonfarm payrolls and employment figures have been a headwind for markets, but with estimates tempered we could see numbers go either way at this point.

Despite the break in the US, European markets will still be in full swing. We think the market could grind tighter early in the week as it digests the EU summit. Wednesday's meeting between Hollande, Merkel and Monti is important, as in addition to possible developments on a plan for a banking union, there may be indications of what the MoU on bank recapitalizations will contain, including how the EFSF will be used as bridge funding before the implementation of the ESM.

Against this negative backdrop, we think the BoE and ECB monetary policy meetings occurring on Thursday next week are likely to provide strong support for the market. Citi expects the BoE to resume QE next week and expand it further in coming quarters. Separately, our economists believe the ECB might announce that it intends to restart its multi-year LTRO program, which would provide an upside surprise to the market.

On Thursday, Spain will test the market with a bond auction, which Citi expects to involve EUR 2.5 bn of 2y and 5y Bonos.

## Revising Supply Downward

Although supply this year appears to be front-loaded, realized supply is still below the pace many expected in the beginning of the year. To our minds, this results in part from lower strategic activity and equity share repurchase activity than expected. Inclusive of Yankees, there has been \$482bn of gross high grade issuance year-to-date of which \$250bn has been financial paper and \$232bn non-financial. But this issuance has only resulted in \$55bn of net supply in 2012. In order to reach our full-year target of \$150bn of net supply, either the second half non-financial issuance would need to surpass the first half of the year or financial issuance would need to make up the difference. And to our minds neither prospect seems all that likely. Consequently, we think the dearth of supply will continue to support valuations, all else equal, and are revising our full-year gross and net supply forecasts downward by \$30bn.

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### 2012 High Grade Corporate Supply Estimates

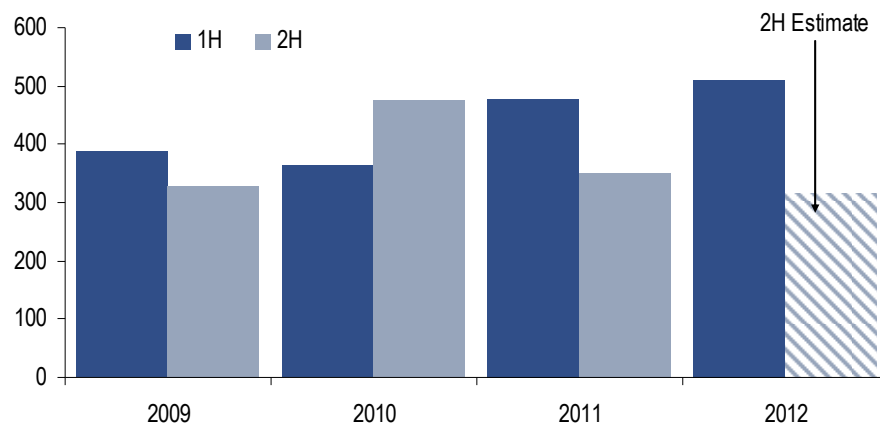
\$bn

	Financial	Corporates	Aggregate
<b>Gross Issuance</b>			
FY Estimates in Jan.	365	490	855
FY Estimates in Jun.	365	462	827
<b>Net Issuance</b>			
FY Estimates in Jan.	-119	272	153
FY Estimates in Jun.	-119	244	125

Source: Citi, CIRA

### 2012 High Grade Supply appears front-loaded

\$bn



Source: Citi, CIRA, Dealogic

# Appendix A-1

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