

CreditBrief

Beta battered

- **Spread performance in September** – While the € iBoxx Corp ended September unchanged, synthetics and HY were weaker, with the iTraxx Main widening by 3bp (5%). Spreads rallied following Draghi's rate cut and unveiling of an asset purchase programme on the 4th. Yet the improvement in sentiment proved short-lived. Uncertainty around the Fed's trajectory and weak European data led to a decline in risk appetite. Though a dovish FOMC statement allayed some of these concerns, skepticism about the likelihood and efficacy of increased ECB action led investors to move closer to home. High beta segments were the chief casualty, and € HY spreads experienced their worst month of this year.

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- **The view in brief** – There's clearly little appetite among European credit investors to pre-empt the ECB, and we reckon that many investors feel more inclined to protect year-to-date returns than to take more risk. While it is likely that Draghi will have to put money behind his words this time, we would caution against underestimating his hold on markets. As the focus begins to turn towards 2015, we expect the prospect of artificially suppressed volatility will induce investors to add risk again. We remain long and we would use recent weakness as an opportunity to add high beta exposure.

Figure 1. Credit Index Levels and Monthly Changes over September 2014

		Current	Last Month	Changes	
		30-Sept-14	29-Aug-14	Absolute	Relative
CASH INDICES					
€ iBoxx Indices	Corporate	94	94	0	0%
	Non-Financial	88	89	-1	-1%
	Financial	104	103	1	1%
£ iBoxx Indices	Corporate	157	156	1	1%
	Non-Financial	147	147	0	0%
	Financial	176	171	4	3%
\$ iBoxx Indices	Corporate	132	122	10	9%
	Non-Financial	126	115	11	10%
	Financial	115	105	10	10%
CDS INDICES					
iTraxx	Europe 5yr	60	60	3	5%
	Sen Fin 5yr	61	61	3	5%
	Xover 5yr	242	242	15	6%
CDX	IG 5yr	57	57	8	14%
	HY 5yr	311	311	44	14%

Source: Citi Research, Markit

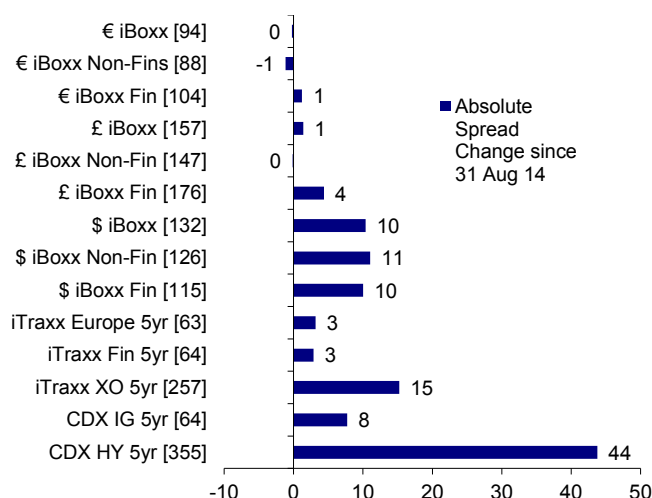
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Broad Market Events

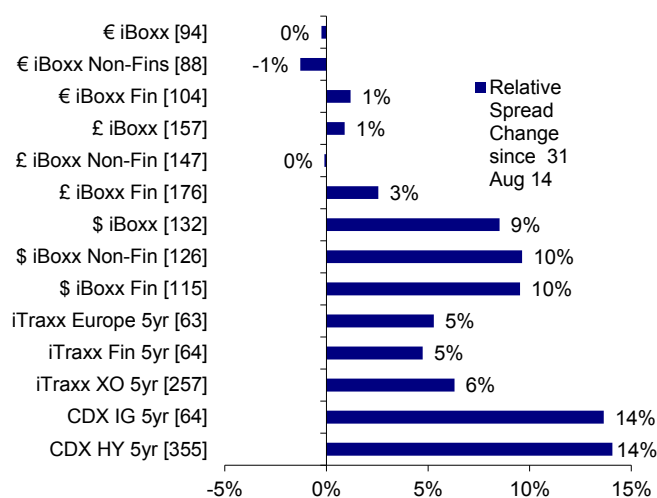
- September was a volatile month for credit: euro IG cash spreads were nearly unchanged on aggregate while synthetics and HY, which ended considerably wider, more fully reflected the risk aversion prevalent in the latter half of the month.
- Spreads tightened following the ECB meeting on the 4th, as Draghi both announced a surprise rate cut and unveiled an asset purchase programme. Yet the fillip proved short-lived, especially for CDS, which began softening on the 8th, following the publication of a San Francisco Fed report which suggested that the market had become too complacent about the direction of US interest rates.
- And even when the FOMC allayed investors' concerns by retaining its pledge to keep rates low for a "considerable time" after the end of QE in its statement on the 17th, credit reverted to widening within a few sessions. The renewed weakness was somewhat attributable to fears of early US rate rises, due in part to the hawkish tilt in the FOMC's "dot-plot". This was aggravated first by worries about a Chinese slowdown and then by concerns that a large US fund would be forced to liquidate some of its holdings due to outflows.

Figure 2. Absolute Monthly Changes in Credit Indices, bp



Source: Citi Research, Markit

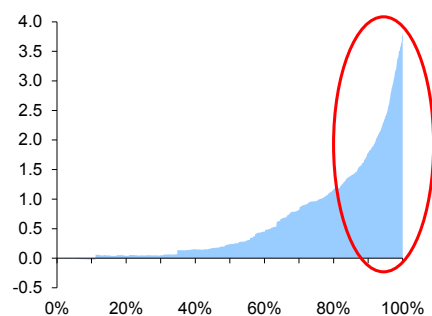
Figure 3. Relative Monthly Changes in Credit Indices, percent



Source: Citi Research, Markit

- But, to our minds at least, the most striking feature of the latter part of September was Draghi's failure to win over investors [We think](#) this resulted from a combination of several factors. For a start, low risk premia and extended investor positioning mean that far more is priced in than previously. And hopes for QE weren't helped by the mixed messages from ECB Governing Council members following his announcement. Along with the high levels of new supply (discussed below) and worries about Fed-xit, we reckon these factors saw credit, along with other asset classes, trading weaker in the latter half of September. Yet from a longer-term perspective, we still believe Draghi's hold on markets is being underestimated, and we remain long as a result.
- For most of the month, there was a considerable divergence in the market reaction to economic data from the US and Europe. While the upward revision to US Q2 GDP on the 26th aggravated fears of an earlier rise in US interest rates than the market was pricing in, a disappointing Eurozone PMI reading on the 23rd and a downbeat IFO survey on the 24th led to a decline in risk appetite. Conversely, the below-consensus European inflation print on the 30th helped to cement hopes that additional ECB easing would be forthcoming, and the indices rallied strongly as a result.

Figure 4. iBoxx € Corp index, cumulative contribution to performance of bonds ranked by beta, 19th – 30th September



Source: Citi Research, Markit.

- Risk aversion over the latter part of the month was felt most keenly in higher beta parts of the market, with sub-financial debt and HY particularly affected, as a decline in risk appetite led to underperformance of consensus longs as investors sought to reduce exposure to non-core and off-benchmark assets. Sub financials suffered following a glut of AT1 deals early in the month, some of which were perceived to be poorly executed. This was aggravated by market speculation about an imminent wholesale downgrade of bank sub debt by S&P during the penultimate week of September. This materialised on the 29th, when S&P downgraded 88% of the European financial hybrid securities it rates, citing, among other factors, a higher risk of coupon non-payment in future.
- And in HY, the collapse of Phones 4U in early September took the market by surprise. Especially given the influx of lower-rated first-time issuers to the market this year, many investors began to re-evaluate some of their previous enthusiasm for € High Yield as a product. As a result, it was a chief casualty of the declining appetite for off-benchmark exposure in the latter part of the month, and spreads on the € iBoxx HY widened by 39bp, their worst monthly performance so far this year. With HY likely to benefit from the “crowding out effect” should ECB QE materialize, defaults at cyclical lows and the technical picture stronger than many appreciate, [we think](#) this weakness is looking increasingly overdone.
- Even in the IG space, it was the highest beta bonds which led the weakness from 19th: as Figure 4 illustrates, the 20% of bonds with the highest beta contributed 70% of the widening in the index. Despite the reduction in risk appetite, investors still proved reluctant to cut their core cash holdings, and this contributed to the strength of IG spreads throughout the month.
- Sterling cash spreads, which ended the month slightly wider on aggregate, proved far more volatile than their euro counterparts over September. This was partially due to the Scottish referendum, as illustrated by the relief rally following the “no” result on the 18th. Yet, to our minds, sterling underperformance versus euros, particularly in names with little Scottish exposure, has more to do with the divergence in outlooks between the UK and Europe. While sterling spreads are beginning to price in the prospect of rising UK rates, euro IG spreads are benefitting from the prospect of increased ECB action. Consequently, we expect euro IG spreads to continue outperforming their sterling counterparts over the coming months.

Sector Moves

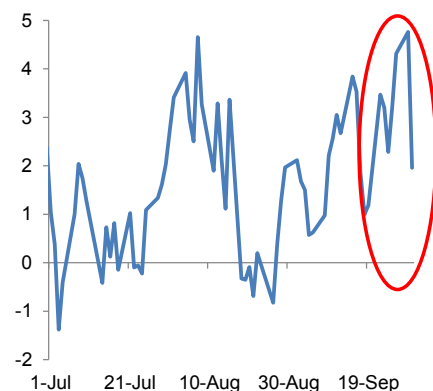
- As our [heatmap](#) shows, sector-level moves over August were mostly rather muted, in line with a cash market that was little changed on aggregate. Yet there was a fair amount of divergence on the single-name level.
- Insurers sold-off as investors reduced their high-beta exposure as they sought to move closer to home in the latter part of the month. The sector widened 14bp on a DV01-weighted basis, with MunichRe (+32bp) a key underperformer.
- Raiffeisen (+44bp) was among the weakest performers in the Banks sector, after it warned of a net loss for the year on the 23rd due to additional risk costs, mainly in its Ukrainian business. Unicredit (+29bp) suffered from the deteriorating outlook for its Italian home base, as doubts arose as to whether it would meet its full-year €2bn net profit target. And Barclays (+10bp) softened after it was fined by the FCA for failing to keep clients’ assets separate from its own, with fears of further penalties still to come.

- Consumer Services widened by 4bp. This was led by Tesco, which ended September 48bp wider, after it announced that it had overstated its H1 profits by £250mn. This led all three rating agencies to put their BBB rating of the company on review for downgrade. Especially given that Tesco wasn't previously considered to be on the cusp, concerns that a downgrade to HY would lead to forced selling led to a concerted widening in the company's spreads.
- Basic Materials (+2bp) softened, due to a downgrading of the outlook for commodity prices. Anglo American (+20bp) was the weakest performer, as the declining outlook for commodities was compounded by growing concerns about its restructuring programme. Vale (+11bp) suffered from uncertainty about the upcoming Brazilian elections.
- Anheuser-Busch InBev (+16bp) was an exception to the general tightening trend in Consumer Goods (-1.5bp). This followed widespread media reports that it was trying to line up debt financing for an acquisition of its rival, SAB Miller, in a "megadeal" that would merge the world's two largest brewers.

Basis and Skews

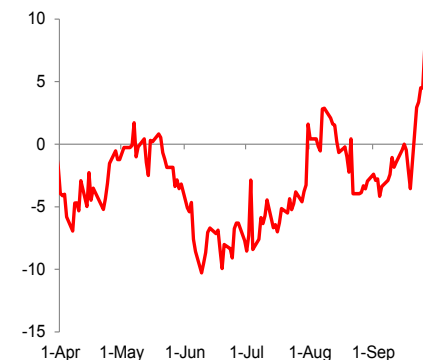
- The skew on the iTraxx Main increased relatively consistently from the 22nd until the 29th as growing risk-aversion led investors to set index hedges (Figure 5). The weakness also filtered down into single-name CDS while IG cash spreads remained more resilient as investors sought to retain their core holdings despite the increased risk aversion. As a result, the aggregate basis on the € iBoxx increased (Figure 6).

Figure 5. iTraxx Main Skew vs. Intrinsic, bp



Source: Citi Research, Markit

Figure 6. Aggregate Basis on € iBoxx Corp, bp



Source: Citi Research, Markit

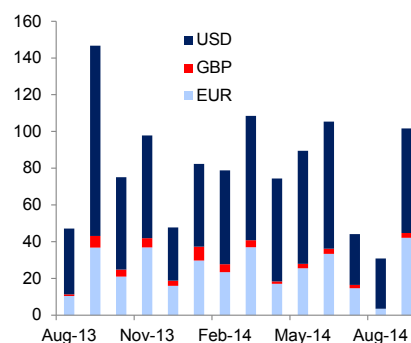
- With ECB interventions likely to have a crowding out effect due to the spillover from ABS to credit, the technical supporting cash bonds should remain strong, and this should aggravate cash's outperformance relative to CDS over the coming months. The skew moved down sharply during the final session as the dissipating risk aversion led investors to remove some of their hedges and the index rallied as a result.

Supply in September – Back to business

- September saw a resurgence in primary activity, following a very subdued August. The \$223bn issued across euros, dollars and sterling in the IG space was the highest monthly total so far this year. A wave of European M&A was the impetus for much of the pick-up in euro IG non-financial issuance, as receptive conditions prevailed in the primary market for most of the month. The €33bn issued was the highest monthly total since 2012. Despite the widening in dollar cash spreads, \$ supply surged as issuers sought to take advantage of low all-in yields.
- The low primary market volumes expected in the senior bank space over the rest of the year, due to the cheap ECB funding on offer under the TLTRO programme, helped drive demand for the deals launched in September. The €26bn of IG financial issuance in euros was the highest monthly total since June. Morgan Stanley, Barclays, Credit Suisse and Goldman Sachs found strong demand for their deals, all with maturities of over seven years.
- Euro-denominated AT1 saw a surge in issuance at the beginning of the month. While some of the deals from core banks received a strong reception, both Santander and Unicredit saw their new AT1 bonds trade considerably wider as sentiment deteriorated, with each ending the month 3 points below where they started trading.
- Poor performance of several recent deals decreased investor appetite for Euro non-financial HY issuance, and the tone soured further after the collapse of Phones 4U. With spreads remaining weak in the second half of the month, issuance volumes were muted and the €4bn of HY deals launched in September was well below this year's monthly average of €6.5bn.

Figure 4. Global Non-Financial Issuance

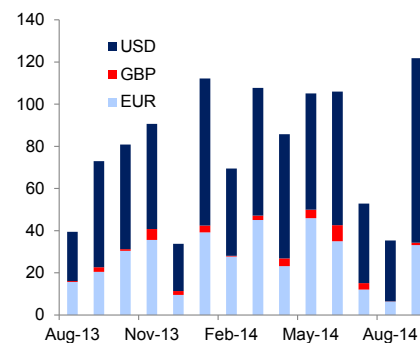
Investment grade, \$bn



Source: DCM Analytics, Citi

Figure 5. Global Financial Issuance

Investment grade, \$bn



Source: DCM Analytics, Citi

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