November 2014

Euro credit outlook 2015

Shabby Chic!

Why a worn rally needs an ECB refurb

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Agenda

Threadbare & creaky in places

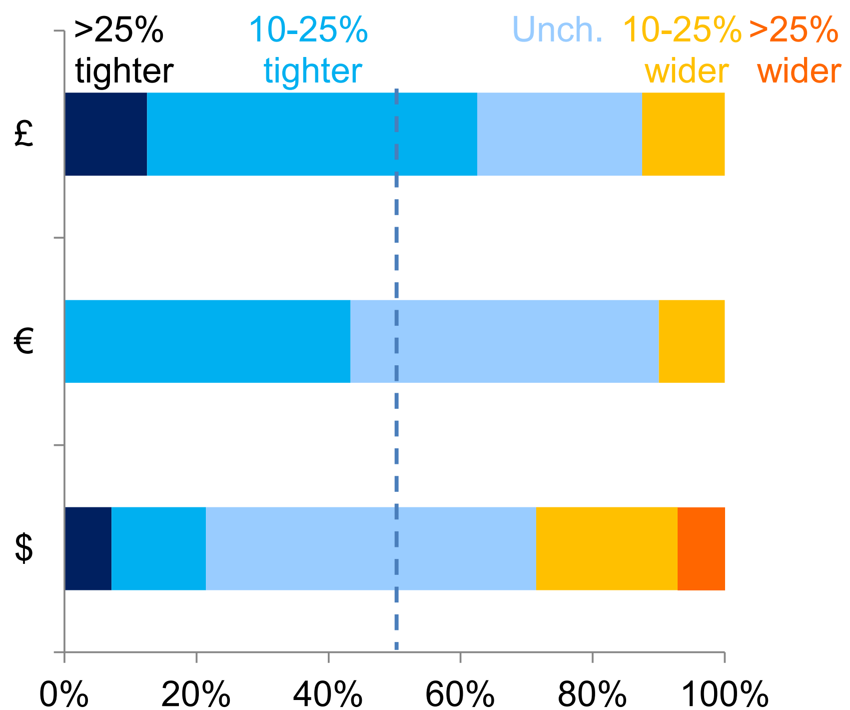
Time for the ECB to get creative?

Give your portfolio the shabby-chic makeover

Not very pleasing to the eye

"Where will spreads end 2015?"

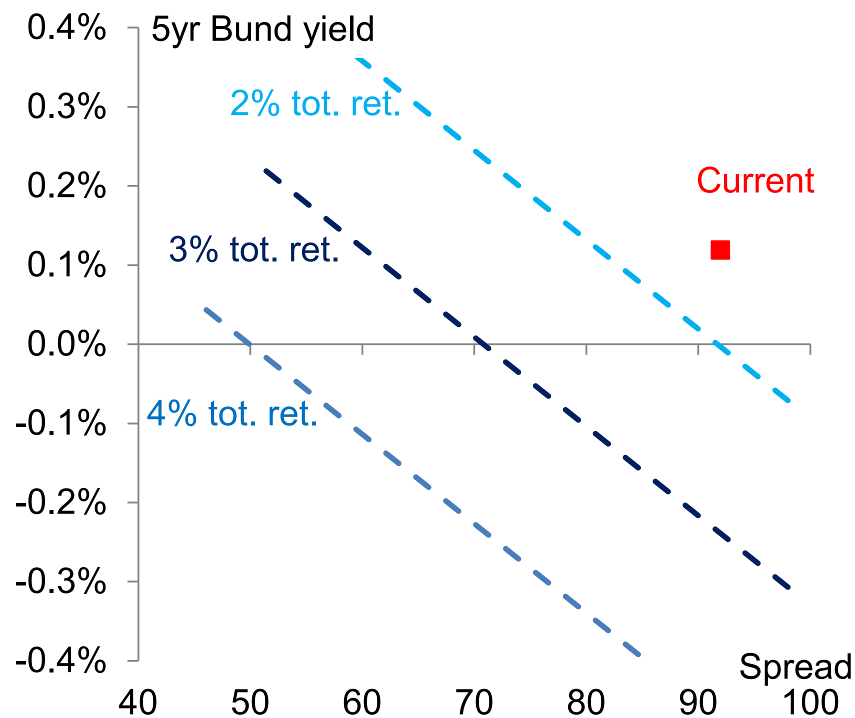
Investor response to Citi Credit Survey, Nov. 2014.



Source: Citi Credit Survey

Even 4% return looks a tall order

End-2015 spread & yield combos to generate x% total return



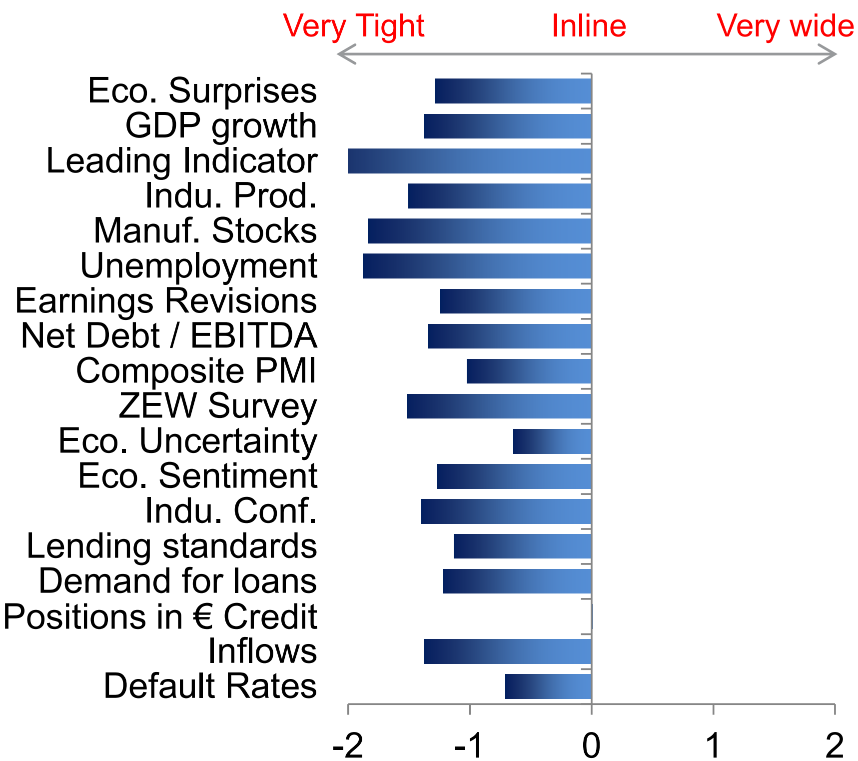
Source: Citi Research. Assumes no change in government-swap spreads.

The fu(rni)ture looks drab no matter how it's arranged

Looking just a tad *passé*?

Tight to fundamentals

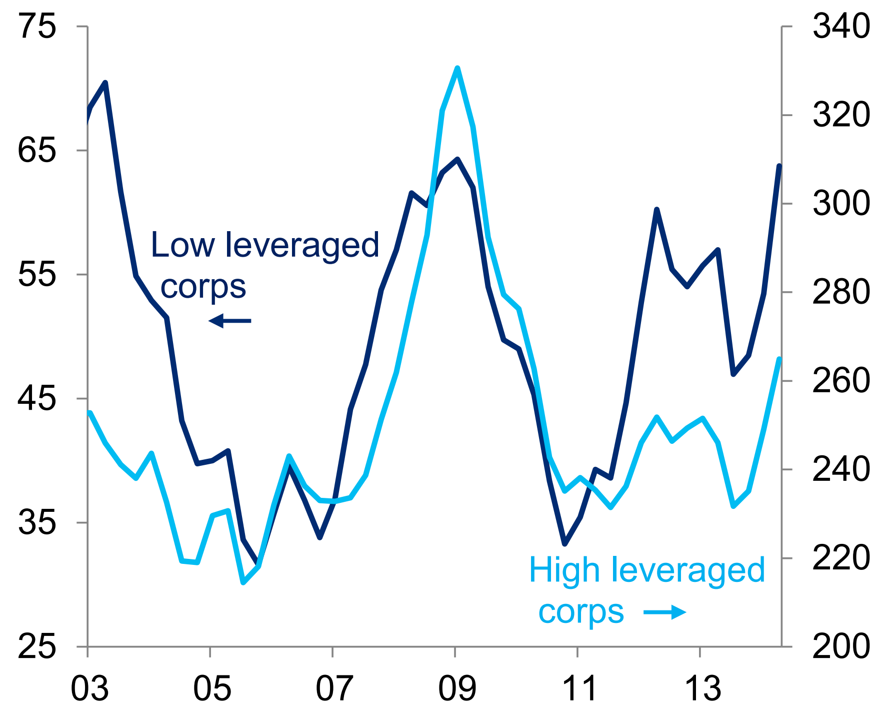
Citi Valuation report – iTraxx vs. 20 fundamental indicators*, σ from long-term relationship



Source: Citi Research, Haver, Bloomberg. Note: Based on t-stat of current spread vs. spread predicted by historical relationship with the fundamental variable.

Balance sheets are weakening

Net debt, % of ann. EBITDA 3Q MA*



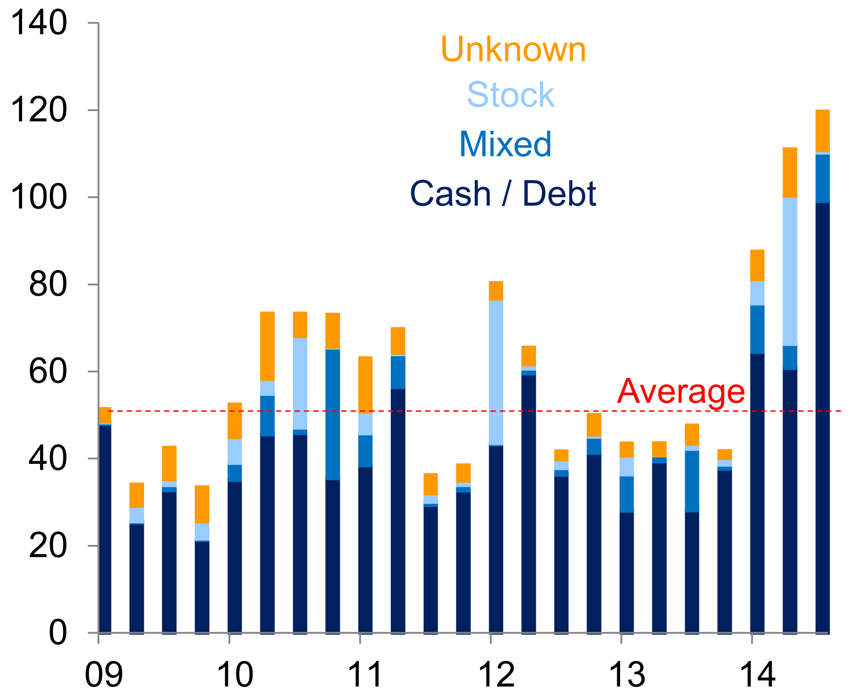
Source: Citi Research, Bloomberg. * Low (high) leveraged corporates: 25th (75th) percentile in sample of non-financial companies in EuroStoxx 600.

Spreads aren't supported by most fundamental metrics

Corporate discipline showing signs of wear & tear

Much of the damage is coming from M&A

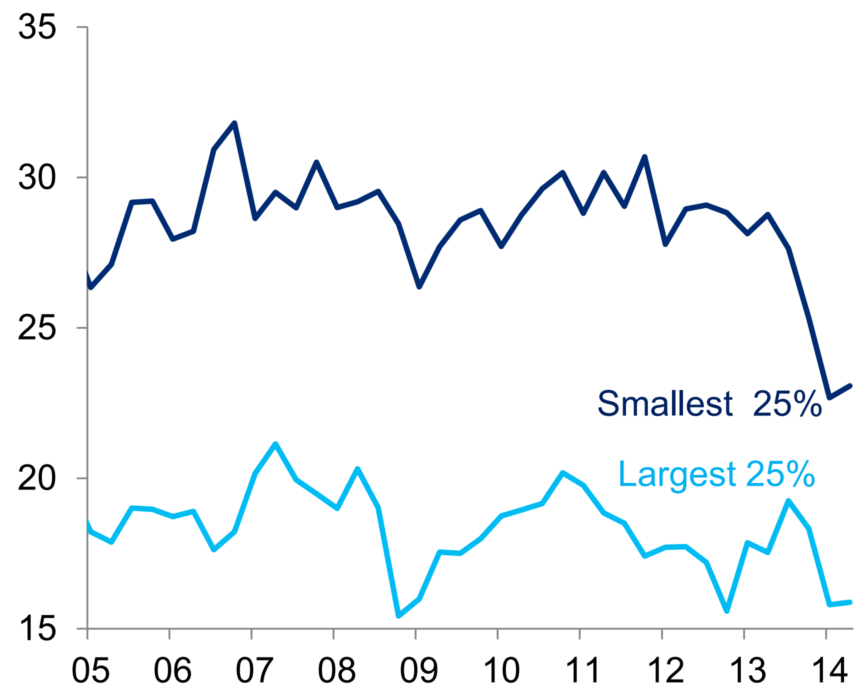
M&A (completed/announced) by a European acquirer, €bn



Source: Citi Research, Bloomberg.

But margins also under pressure

EBITDA margin, largest 25% versus smallest 25% by revenues*



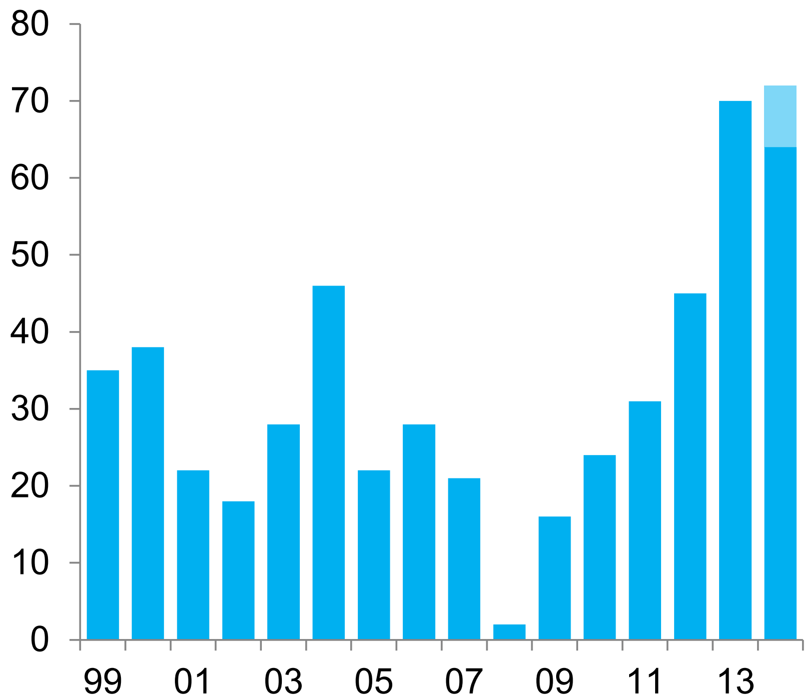
Source: Citi Research, Bloomberg.
* Based on a sample of 320 non-financial companies in the EuroStoxx 600 index.

Releveraging is both voluntary & involuntary

A constant supply of ‘junk’ has added to the clutter

First-time issuers at all time highs

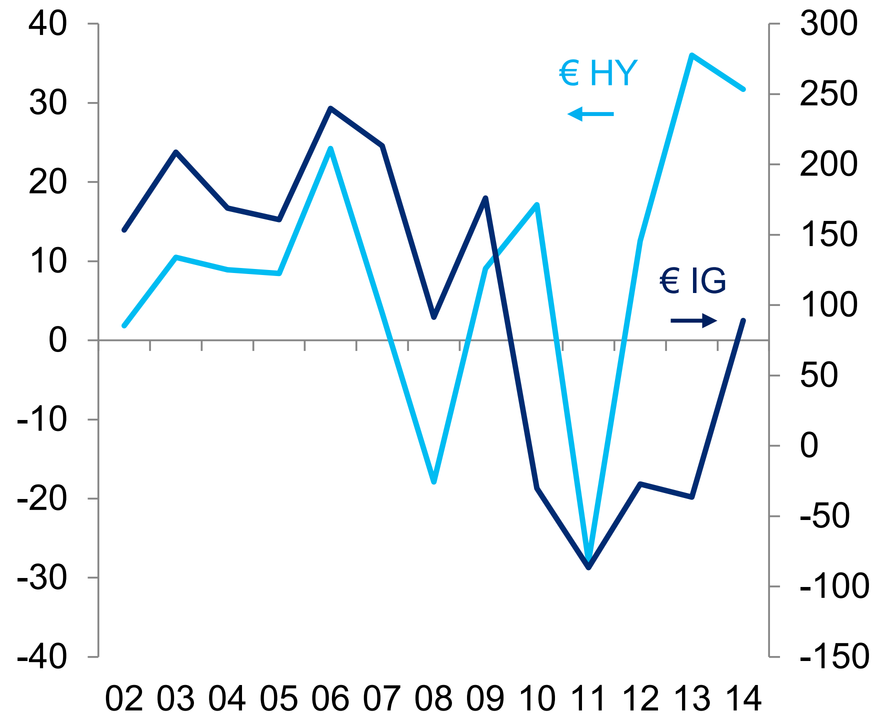
First-time issuers in € HY, count



Source: Citi Research, Dealogic.

HY issuance at all time highs

€ HY & IG net issuance. 2002-14*, €bn



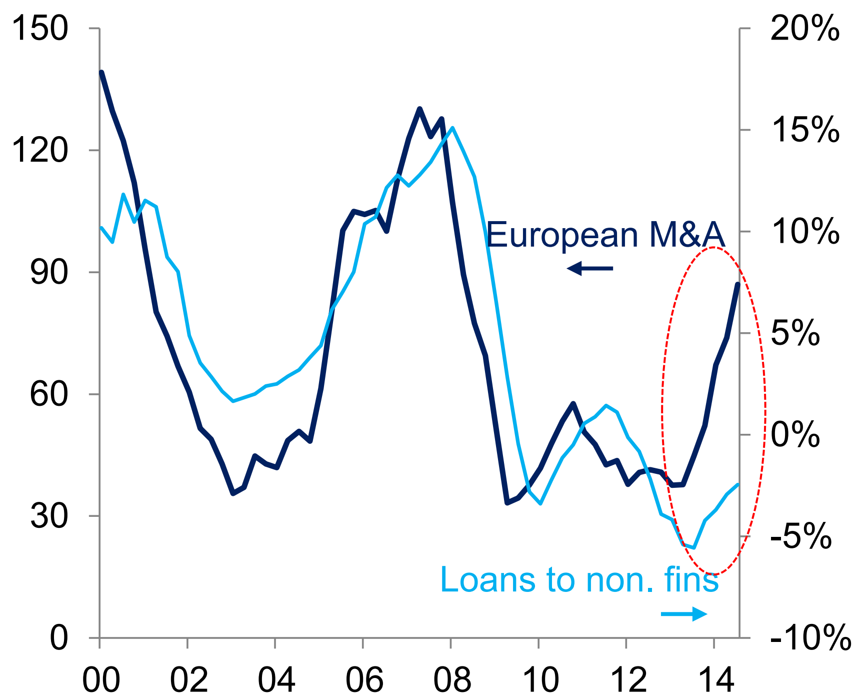
Source: Citi Research, Dealogic. *2014 data runs to 20 Nov.

Where do you place it all?

Make room for more

Gap in M&A vs lending implies more bonds

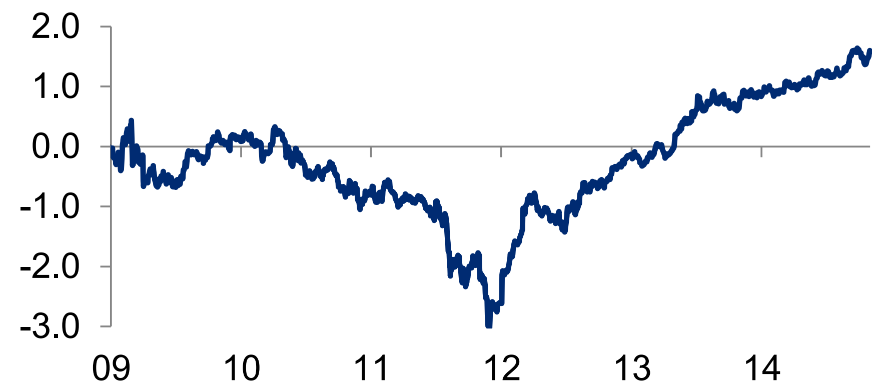
European M&A* (€bn) vs. EZ bank lending to non. fins (% YoY)



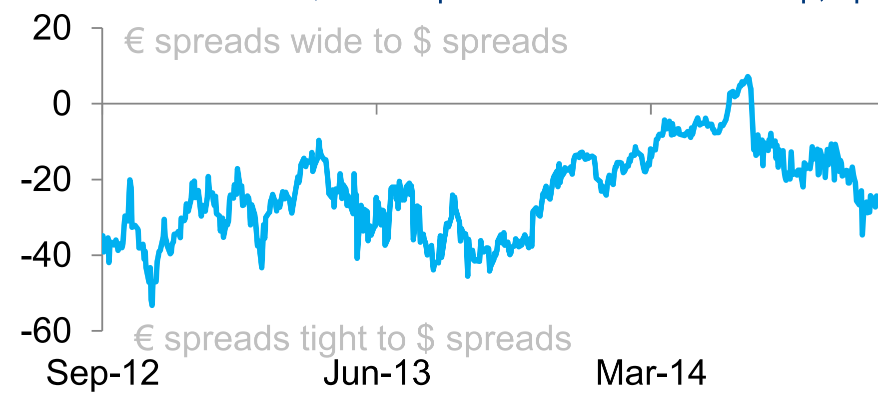
Source: Citi Research. * European acquirers, non-stock financed deals only.

Funding in € is cheap

$ vs € 7-10yr BBB credit yield difference, %



Bond-matched € vs. $ credit spread diff. after basis swap, bp



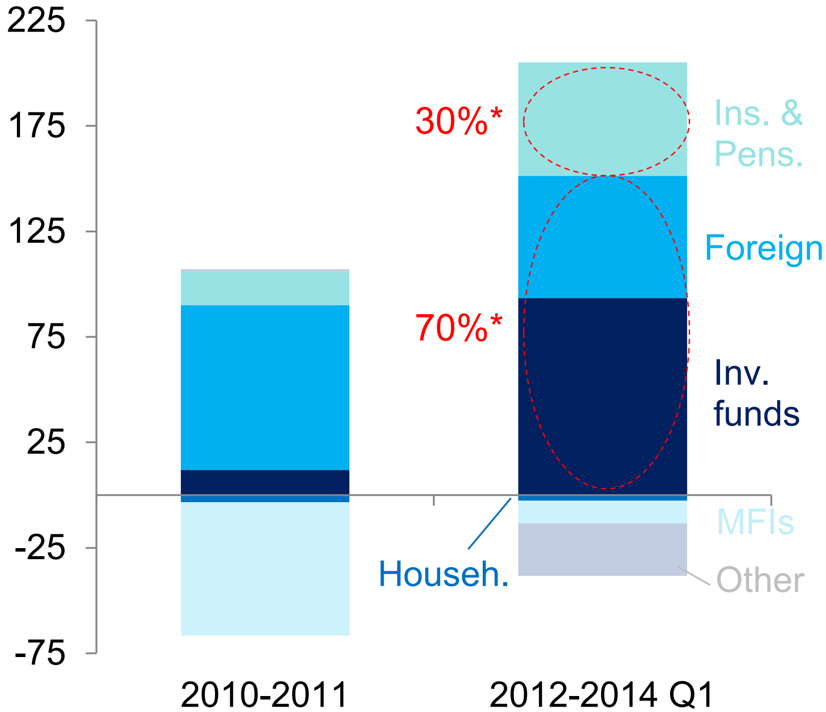
Source (both charts above): Citi Research, Markit, Bloomberg.

IG issuers should be lining up in 2015 too

But where can all that debt be placed?

Demand is from foreign & inv. fund money

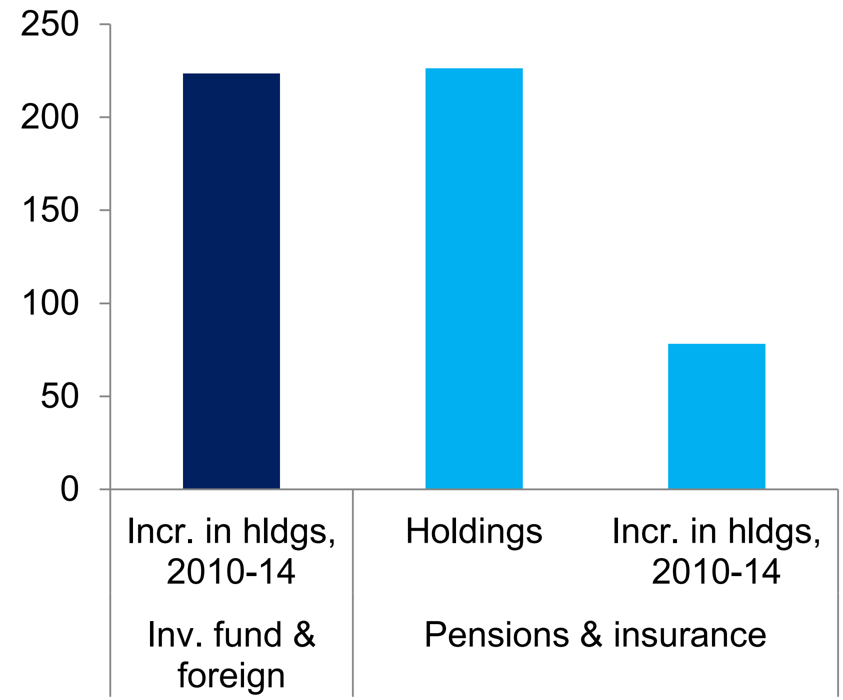
Change in holdings of Eurozone non-financial credit, €bn



Source: Citi Research, ECB. * Percentage of only those investor types with inflows.

Pension & insurance buying isn't enough

Eurozone non-fin. bond holdings & inflows, 2010-Q1 2014, €bn



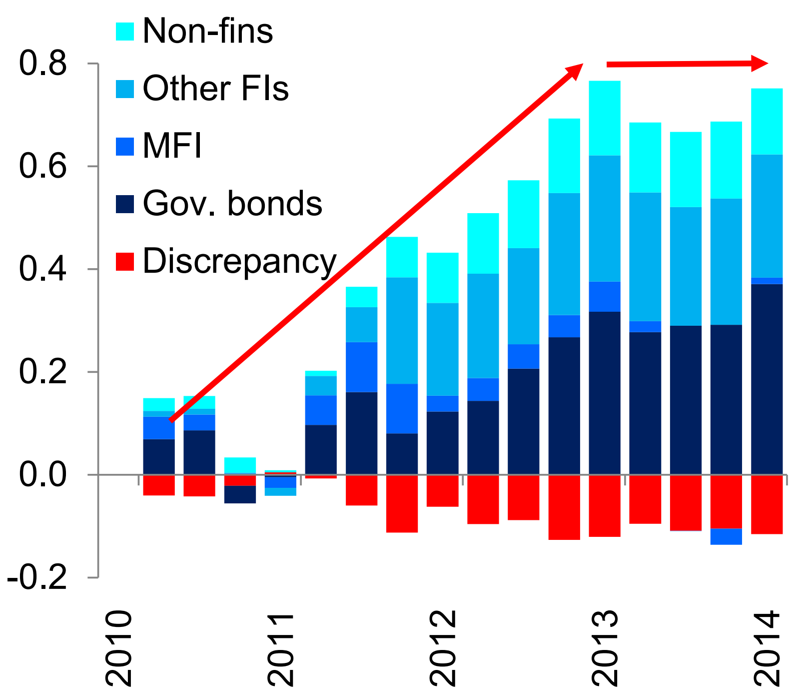
Source: Citi Research, ECB.

Demand contingent on inflows of non-dedicated money

But where can all that debt be placed? (ii)

Foreign flows into € FI waning

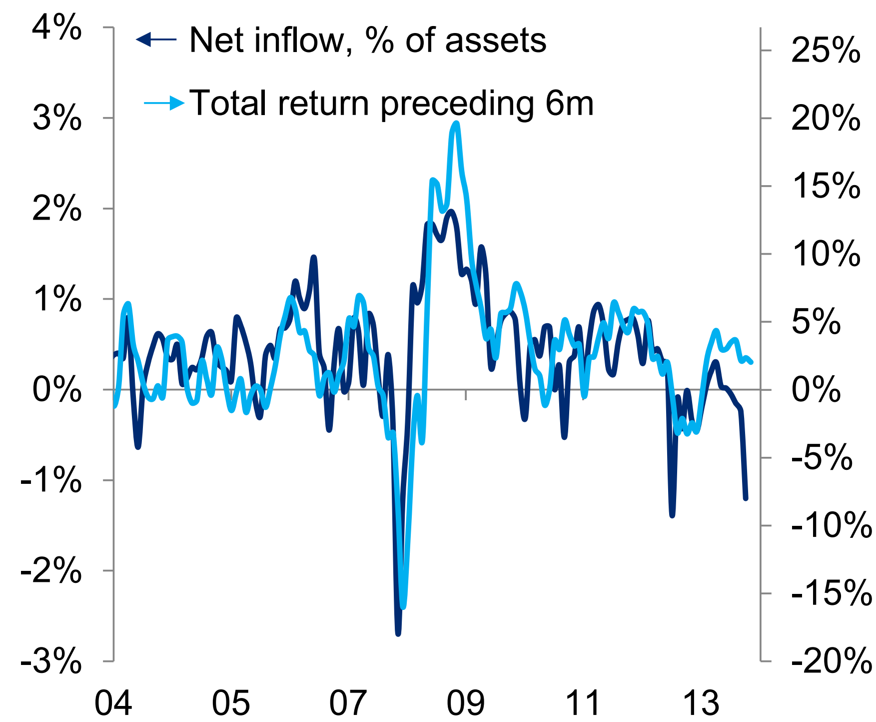
Cum. chg. in holdings of external investors, 2010-14 Q1, €tn



Source: Citi Research, ECB.

Returns drive future credit inflows

IG+HY mut. fund inflows, % assets vs total return previous 6m, %



Source: Citi Research, ICI.

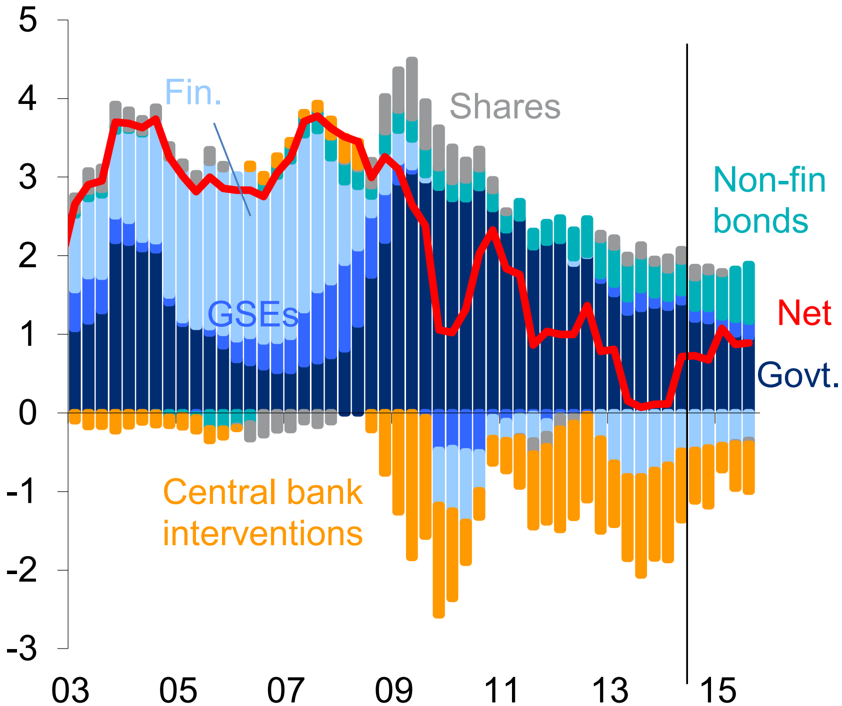
Non-dedicated inflows aren't self-sustaining

It’s not just in credit where 2015 could get messier

Global supply-demand balance shifting

Net iss. of securities vs CB* interventions, 12m rolling, $tn

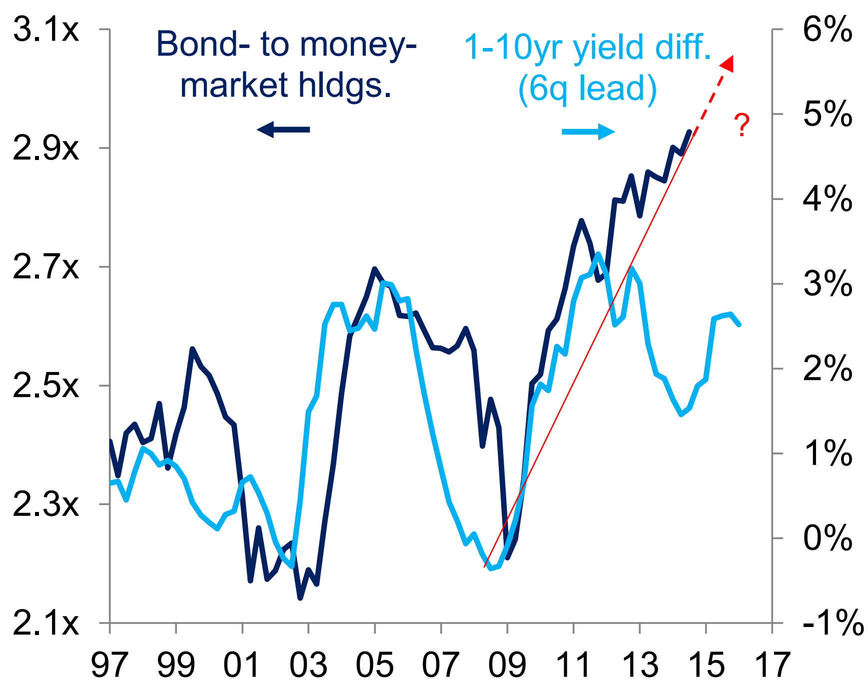
Note: Assumes no ECB QE



Source: Citi Research, Haver. * Bank of Japan, Fed, ECB. Assumes €150bn TLTRO, €12bn/month of ABS/cov. bond buying.

Is demand for FI securities about to turn?

US fixed income holdings / ST investments* (ratio) vs. 1-10yr UST yield differential, % points



Source: Citi Research, Haver, Federal Reserve. *: Household, foreign & retirement investments. Short-term investments exclude on-demand deposits.

More net supply with added possibility of Fed hikes

The 2015 credit out-“look” (before)

Source: “Abandoned living room”, Donald Lachlan, Flickr.

Agenda

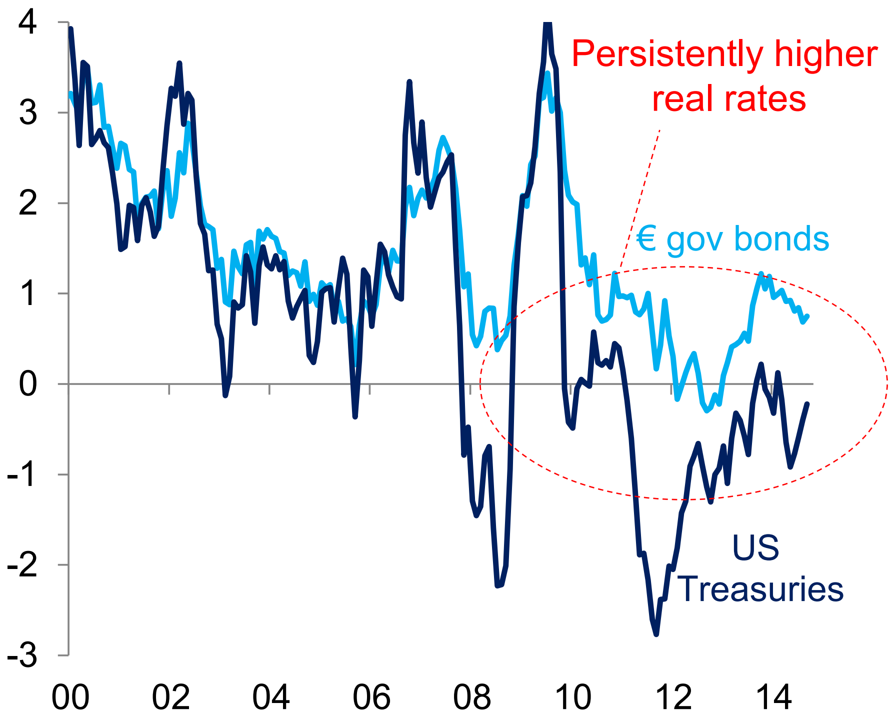
Threadbare & creaky in places

Time for the ECB to get creative?

Give your portfolio the shabby chic makeover

The case for a policy revamp is building

Is € policy really all that easy?
Real yields, € gov. bond index vs. UST index, %



Source: Citi Research, Haver.

It's arguably decidedly tight in the periphery
Yield on new non-fin. loans, <€1m, Italy & Germany

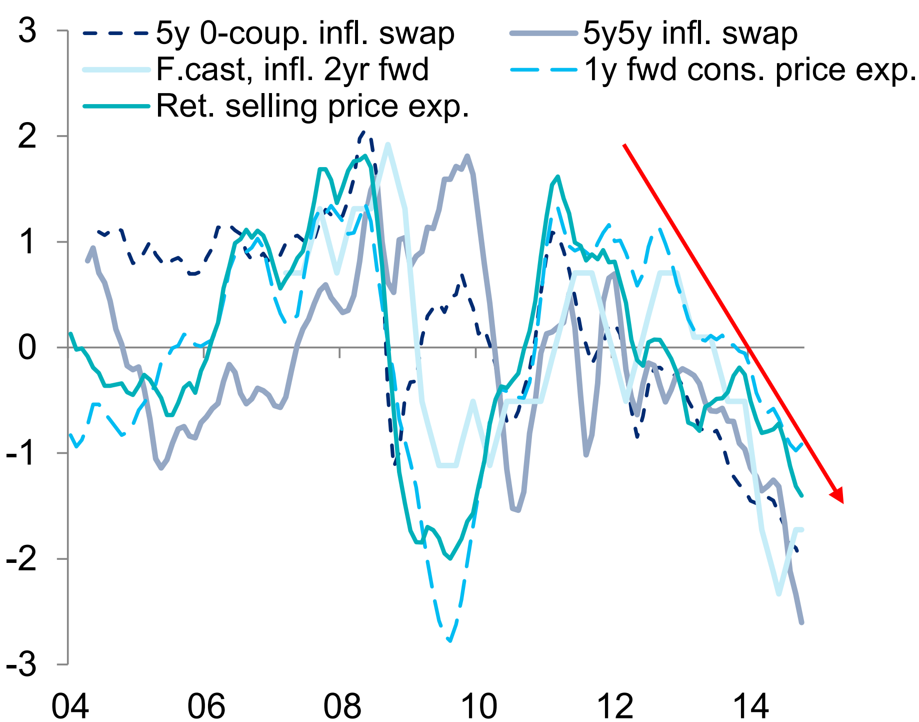
Source: Citi Research, Haver.

Real monetary policy isn't as easy as it should be

The case for a policy revamp is building (ii)

Inflation expectations are nose-diving

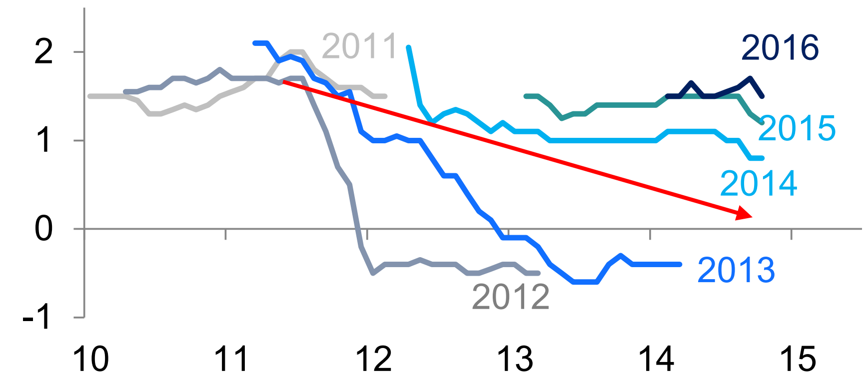
Various measures of inflation expectations, st.devs from 10y avg.



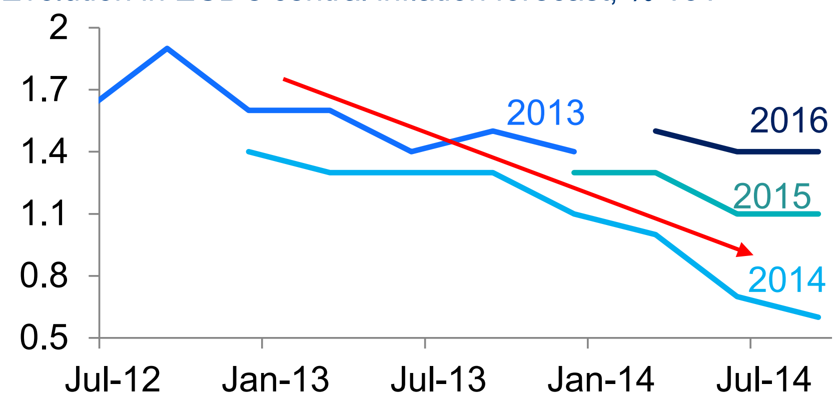
Source: Citi Research, Bloomberg. Haver.

Disappointment seems relentless

Evolution in consensus Eurozone GDP forecast, % YoY



Evolution in ECB's central inflation forecast, % YoY



Source: Citi Research, ECB, Bloomberg.

A poor track record gives forecast reversion limited credibility

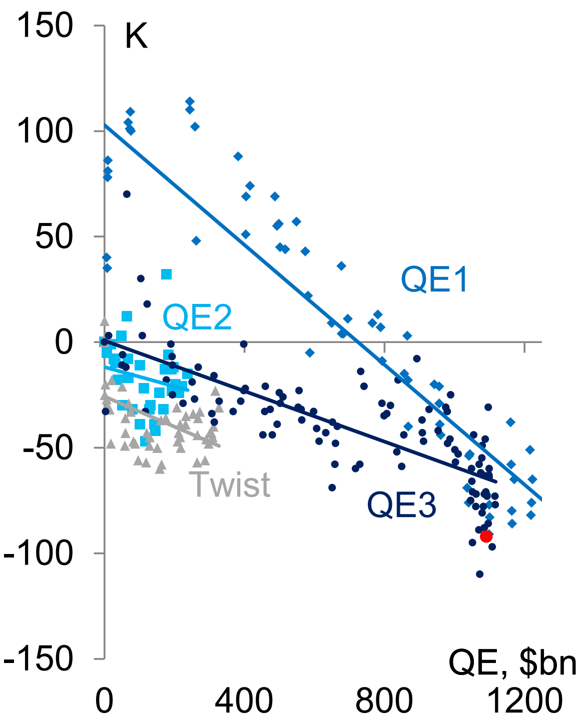
Did the Fed makeover produce the desired results?

Jobless claims: Fell each time

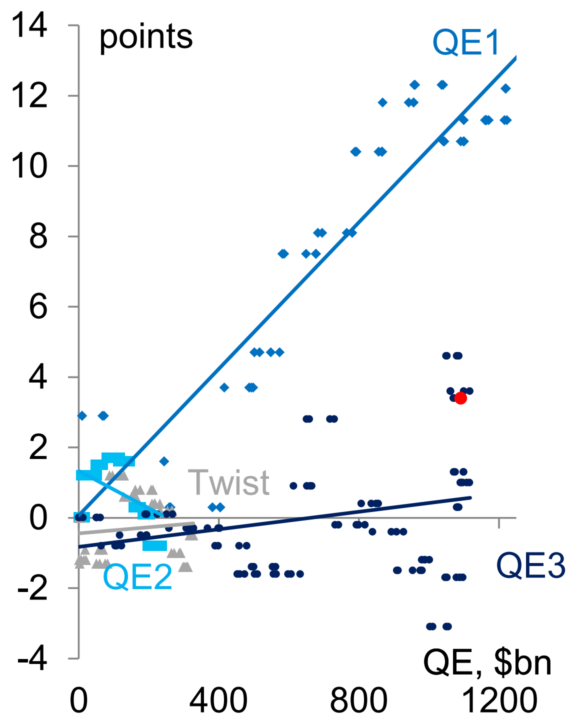
ISM: Gain clear only w. QE1

Inflation expectations*: QE3 didn't deliver

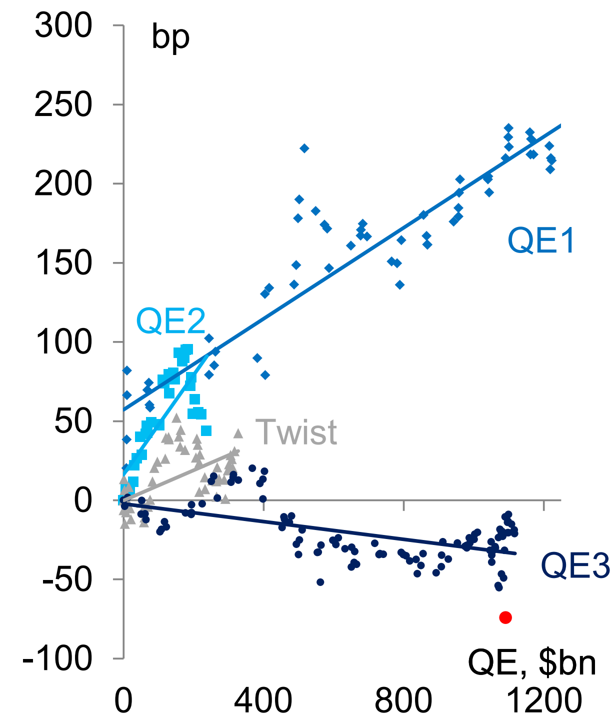
Cumulative increase in Fed holdings of long-dated securities, $bn, vs. cumulative change in index



Source: Citi Research, Haver.



Source: Citi Research, Haver.



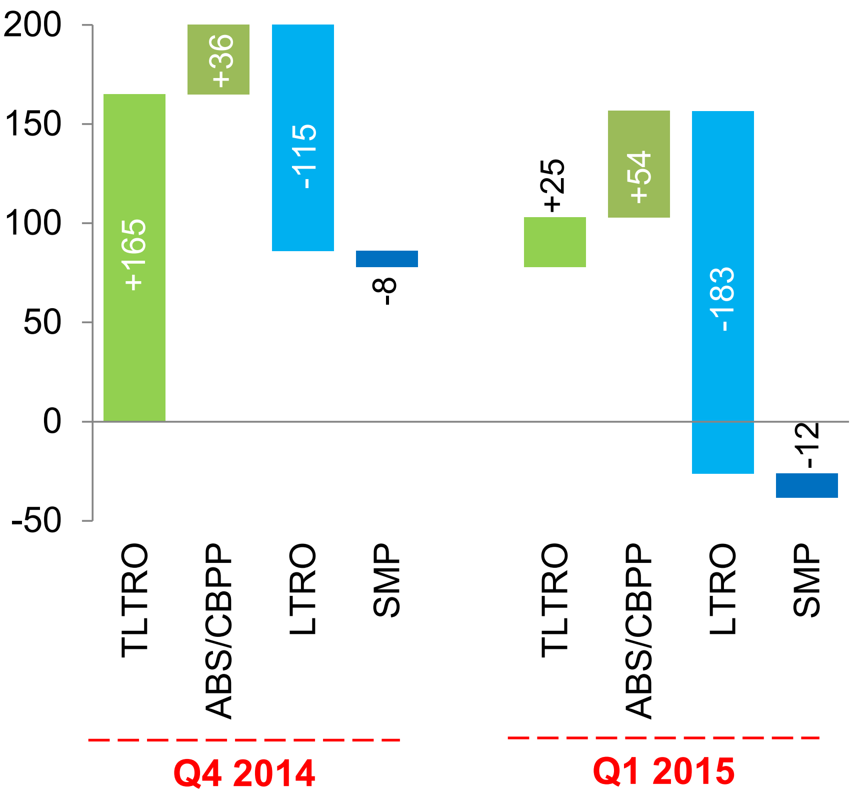
Source: Citi Research, Haver, Markit. * 5yr breakeven inflation

The evidence for the economic impact is mixed

So why go shabby chiQuE?

ECB's balance sheet set to shrink further

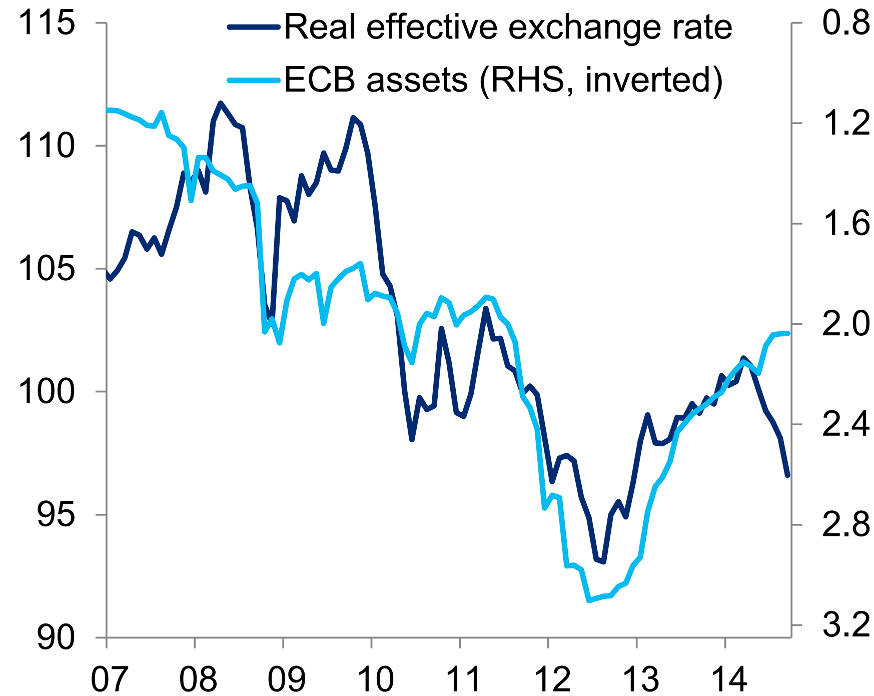
Eurosystem, selected est. in- and outflows w. Citi forecasts, €bn



Source: Citi Research, ECB. See Euro Economics Weekly, G. Menuet, 7 November 2014 for details.

FX channel: One reason why size matters

Real effective euro vs ECB assets, €tn

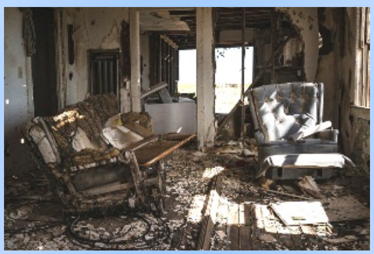


Source: Citi Research, ECB.

Current measures are not enough to hit the target

The ECB could adopt a different style …

Pretend status quo is okay
(Do nothing)



- Avoids difficult decisions
- Fail mandate for 3+ years
- Boost fringe parties

Cutting-edge minimalism
(Cut rates further)

- Weaker €
- Distortive effects likely to accelerate at lower bound

DIY
(Tweak TLTROs, hope banks lend)

- May avoid balance sheet shrinkage
- Tried before. What did the LTROs do for inflation?

A structural redesign
(Get aggressive on ABS)

- Lending just might benefit
- ECB buys credit risk at inflated prices (Weidmann counter)

Move out
(Buy foreign bonds)

- Not monetary financing
- The ECB “does not target FX”
- Blatant beggar-thy-neighbour policy

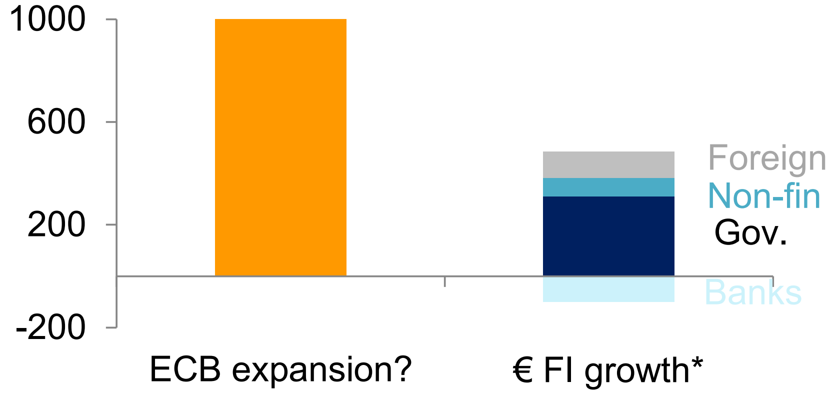
Source: Citi Research, Flickr.

… but all available alternatives come with drawbacks

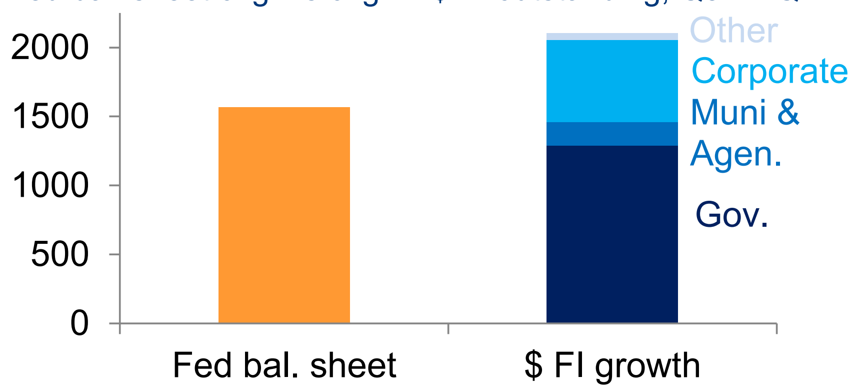
Mood board #1: ECB discards credit, but hoovers up govies

QE distortion should be bigger in Europe

Pot. ECB expansion vs. chg. in € fix. inc. outstanding, €bn



Fed bal. sheet chg. vs chg. in $ FI outstanding, Q3'12-Q2'14, $bn

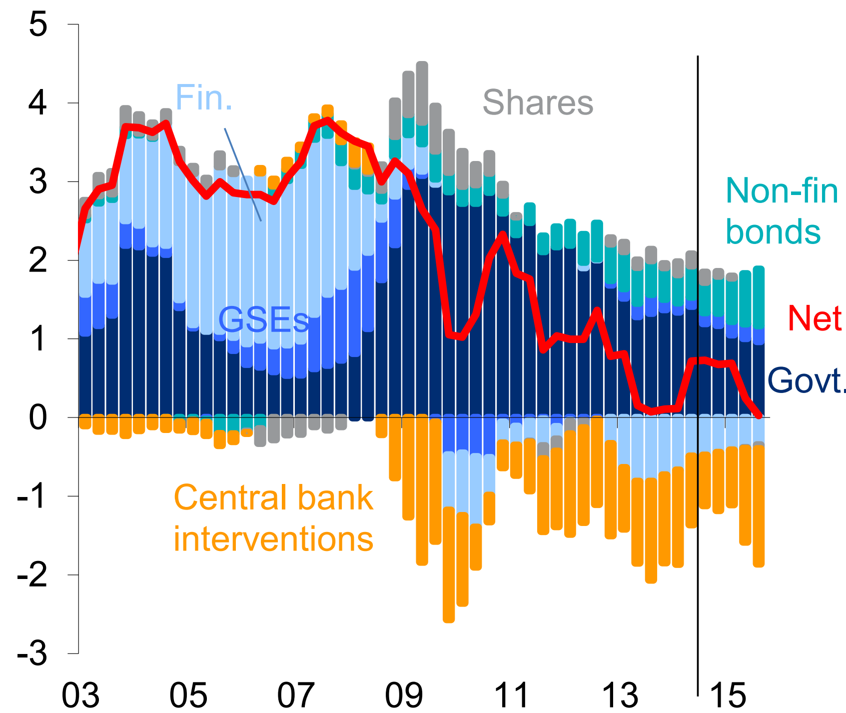


Source: Citi Research, Haver Analytics, ECB Federal Reserve.
*Annual average from 2010-13.

Global net supply would hit a new low

Net issuance of securities vs CB* interventions, 12m rolling, $tn

*Note: Assumes ECB intervention***



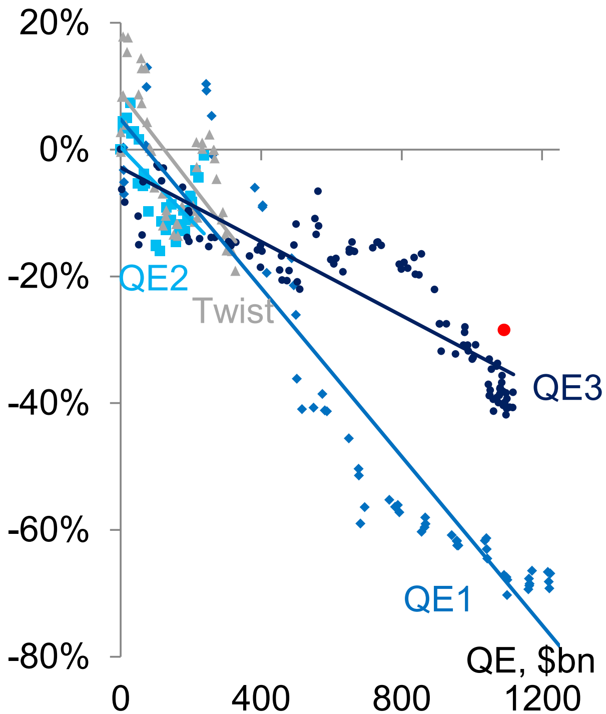
Source: Citi Research. * Federal Reserve, BoJ, ECB.
**€150bn of TLTROs, €40bn of ABS purchases in Q4, €750bn of QE in 2015.

Distortion should lead to crowding down and out

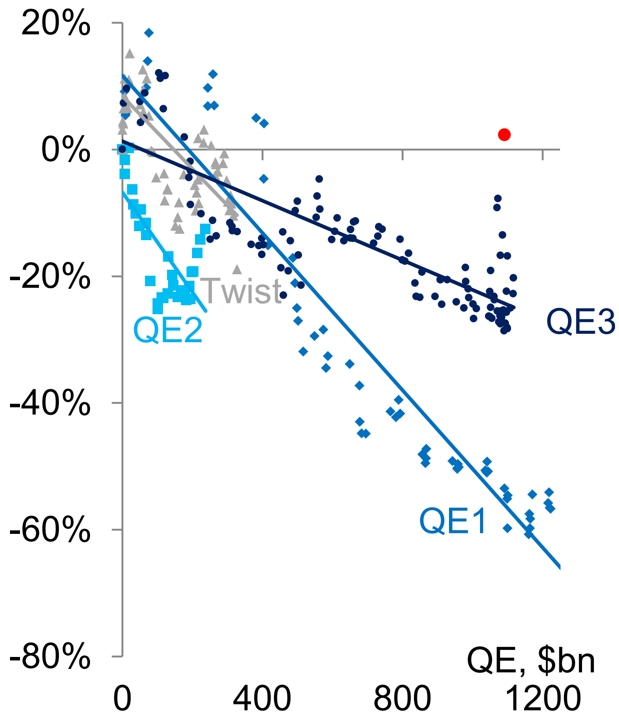
Mood board #1: ECB discards credit, but hoovers up govies

$ IG: QE3 less effective | $ CCCs: QE3 came undone | € IG: Mirroring $ spreads

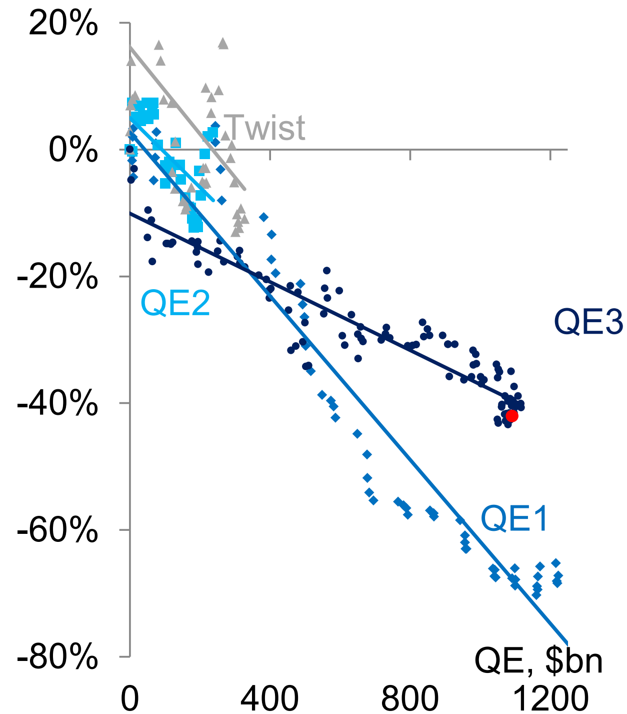
Cumulative increase in Fed holdings of long-dated securities, $bn, vs. cumulative percent spread change



Source: Citi Research, Haver.



Source: Citi Research, Haver.



Source: Citi Research, Haver, MarkIt.

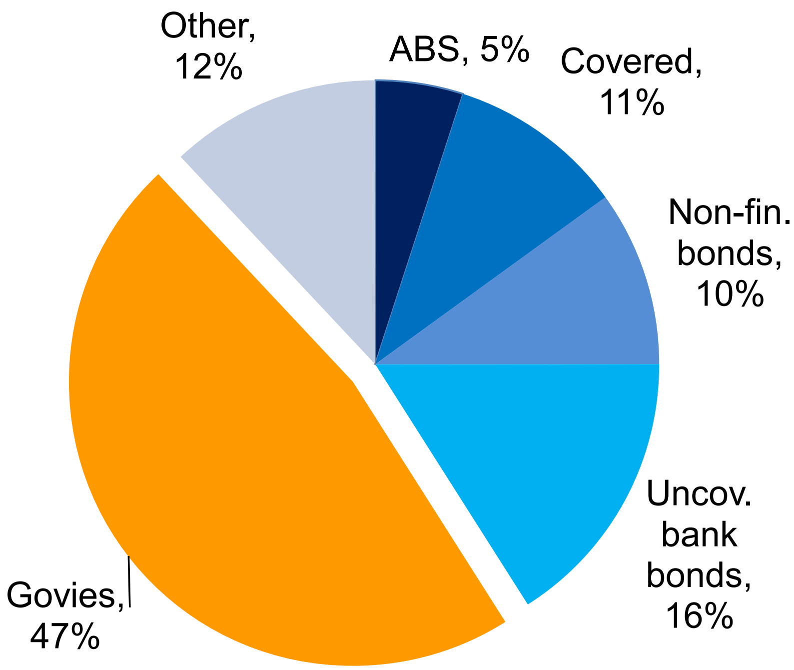
Effect is waning*, but spreads should tighten nonetheless

* Compare the gradient under QE3 to previous programmes

Mood board #2: Corporate bonds *are* on the "to-do" list

The ECB's €14tn pool of eligible assets

Distribution of eligible assets for the Eurosystem, Q4 2013



Source: Citi Research, ECB. See Euro Economics Weekly, G. Menuet, 7 November 2014 for details.

What could the ECB buy in corp. space?

Likely criteria for future ECB corporate bond purchases

- ✓ IG only (except in HY sovereigns)
- ✓ But also BBBs (otherwise no periphery)
- ✓ Senior only – no sub debt
- ✓ Fixed & FRN
- ✓ €-denominated issues only
- ? Probably Eurozone-domiciled issuing entities only*
- ? Possibly non-financials only

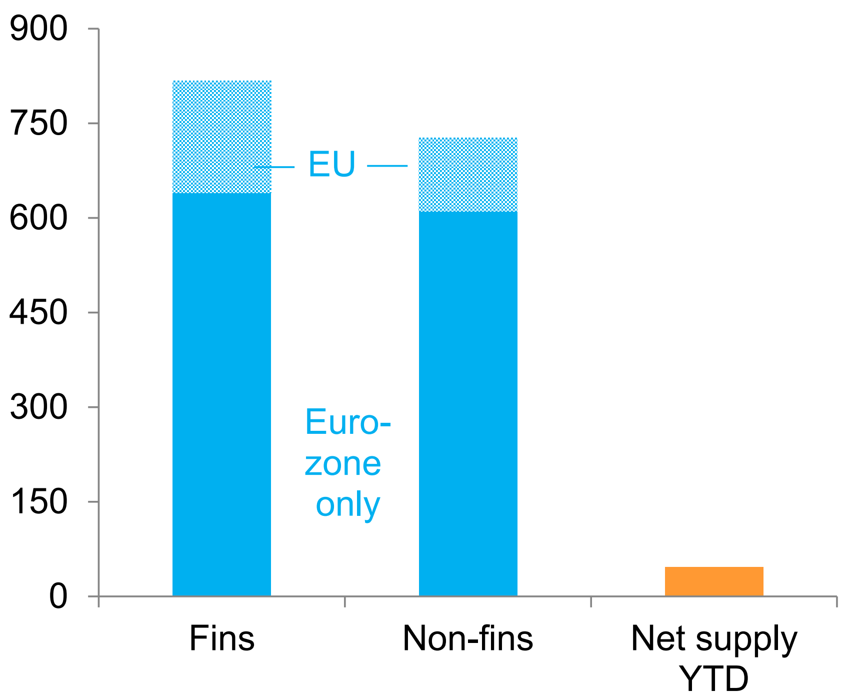
Source: Citi Research. *ABS/covered bond buying programme only covers assets issued in the Eurozone only, unlike the funding operations.

The ECB is short of 'acceptable' markets to intervene in

Mood board #2: Corporate bonds *are* on the "to-do" list

€0.6-1.5tn is eligible, but free float is small

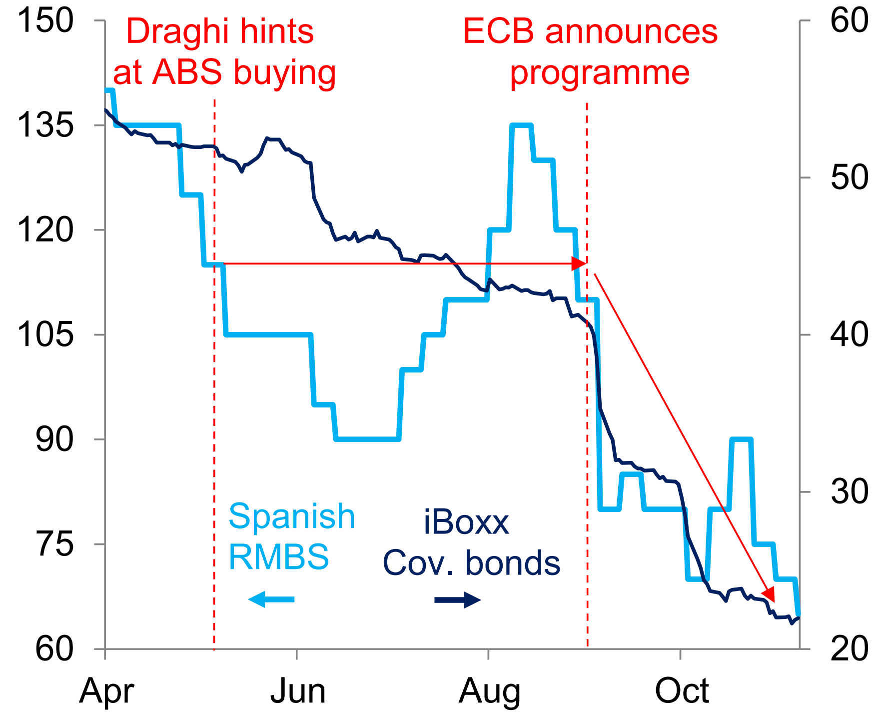
Est. bonds outstanding eligible for ECB corp. QE, €bn



Source: Citi Research, Dealogic, Bloomberg, ECB.

ABS spreads halved before the ECB started

Spain senior RMBS vs. iBoxx covered bond index spreads, bp



Source: Citi Research, Markit.

Small amount, but a big impact on spreads

The desired credit out-“look” for 2015 (after)

Source: “Charming Light Pink Shabby Chic Bedroom Design with White Classic Nightstand Table and Floral Bedding Set also Transparent Chandelier” via Colorsox.com. Creative Commons Attribution 2.0

Agenda

Threadbare & creaky in places

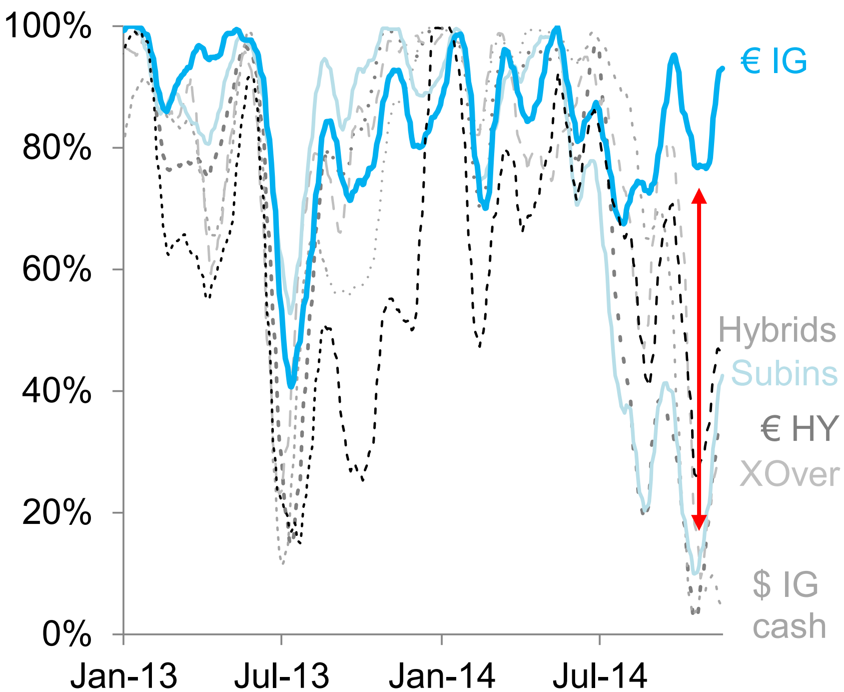
Time for the ECB to get creative?

Give your portfolio the shabby chic makeover

Time to roll up your sleeves

The retreat from off-benchmark to home?

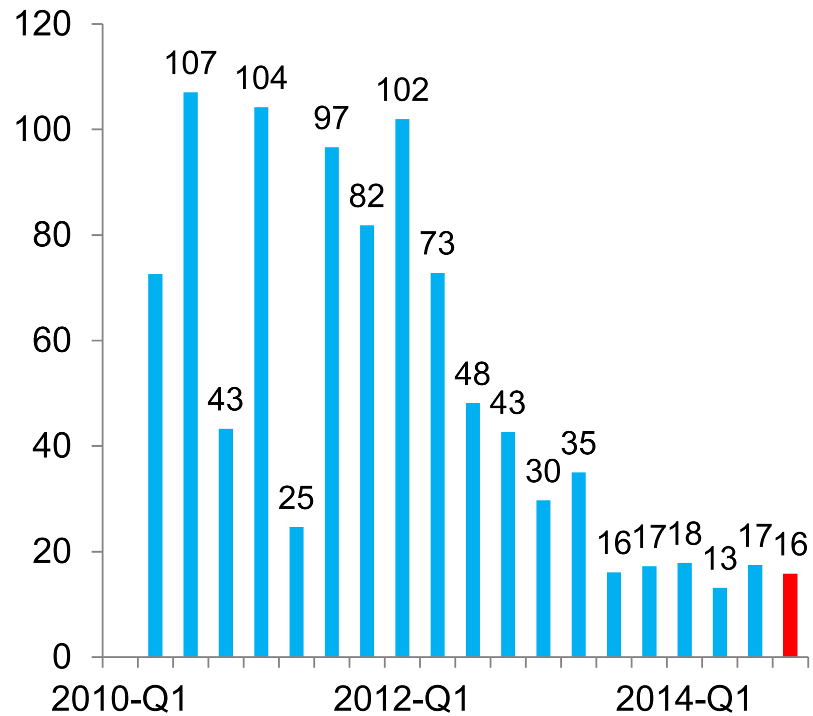
Position in 6m range, 15d mov avg (100% = highest valuation)



Source: Citi Research.

Not enough alpha even w. perfect foresight

“Perfect foresight” excess returns* in iBoxx € HY, bp



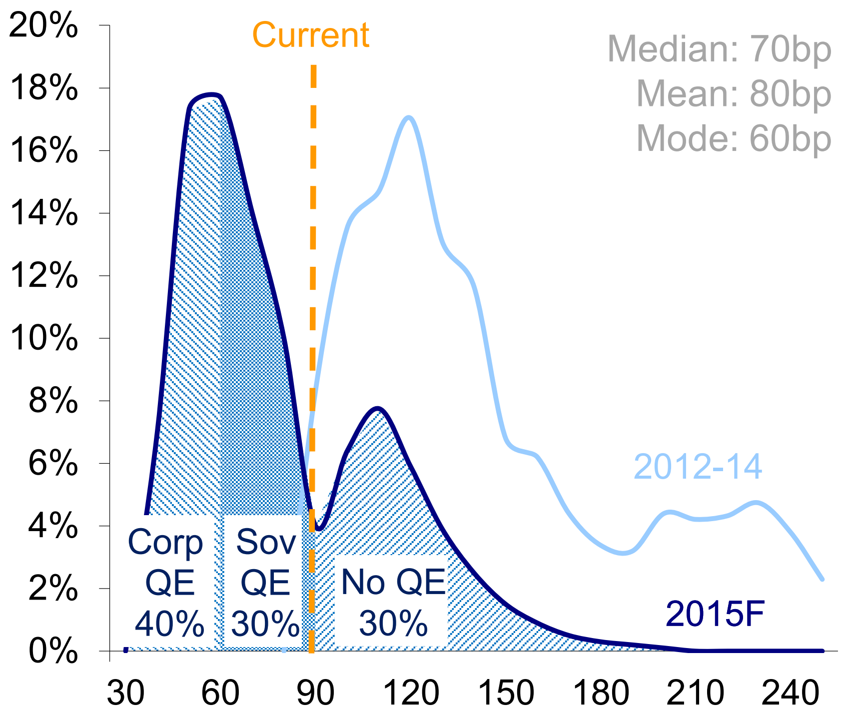
Source: Citi Research, MarkIt. *Excess return on a 5% overweight in the two best performing sectors and a 5% underweight in the two worst sectors, quarterly rebalancing.

Benchmark-hugging + alpha won’t pay enough in 2015

Keep your portfolio *à la mode*

A tired rally will only endure w. ECB support

Stylised distribution of spread outcomes for 2015 vs. 2012-14



Source: Citi Research.

Spreads 20-25% tighter in 2015 in IG & HY

Citi median forecasts for end-2015

	Current	15F target	Excess return	Total return
iBoxx € Corp	90bp	70bp	1.9%	1.7%
iBoxx € HY	365bp	295bp	4.4%	4.5%
iTraxx Main*	63bp	50bp	-	-
iTraxx Xover*	355bp	295bp	-	-

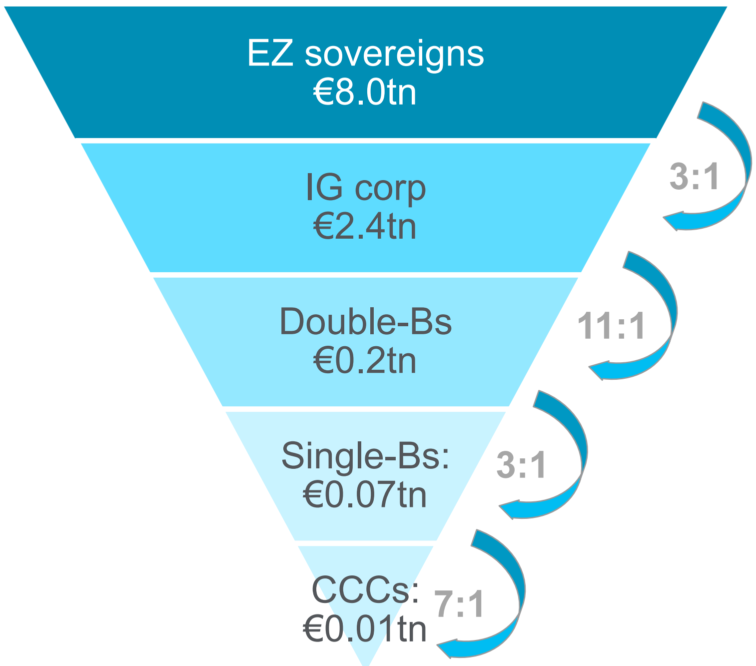
Source: Citi Research. *5yr equivalent of the S22 indices.

With QE a central scenario, spreads should tighten 20-25%

Assume liquidity will seep through any gap…

It only takes a small percentage to move

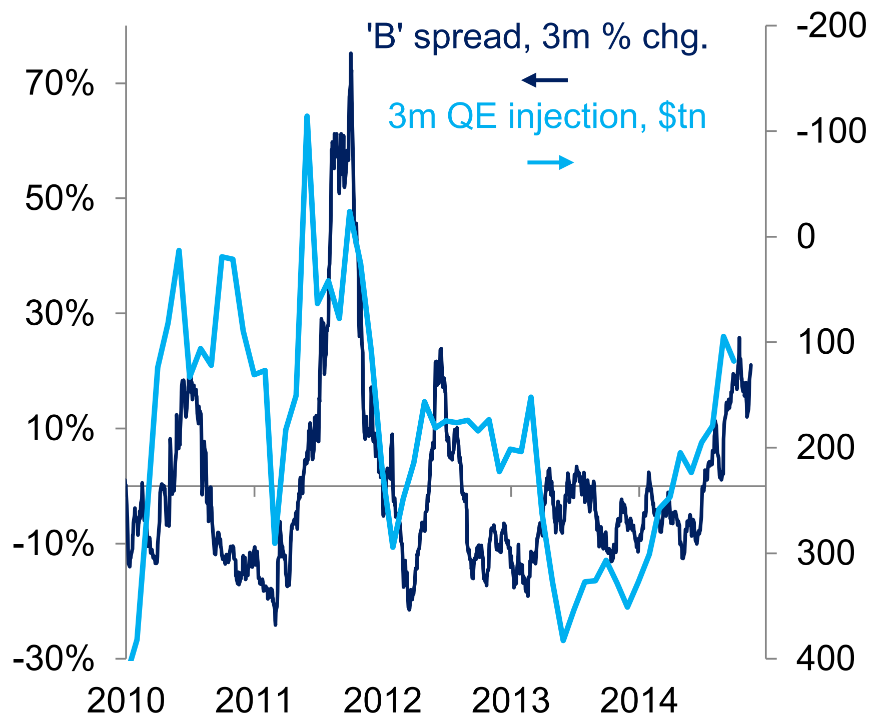
€ fixed income amounts outstanding, €tn



Source: Citi Research, ECB, Dealogic, MarkIt.

7 instances of QE suggests that it does

€ single-B spreads vs. central bank QE*, 3m changes



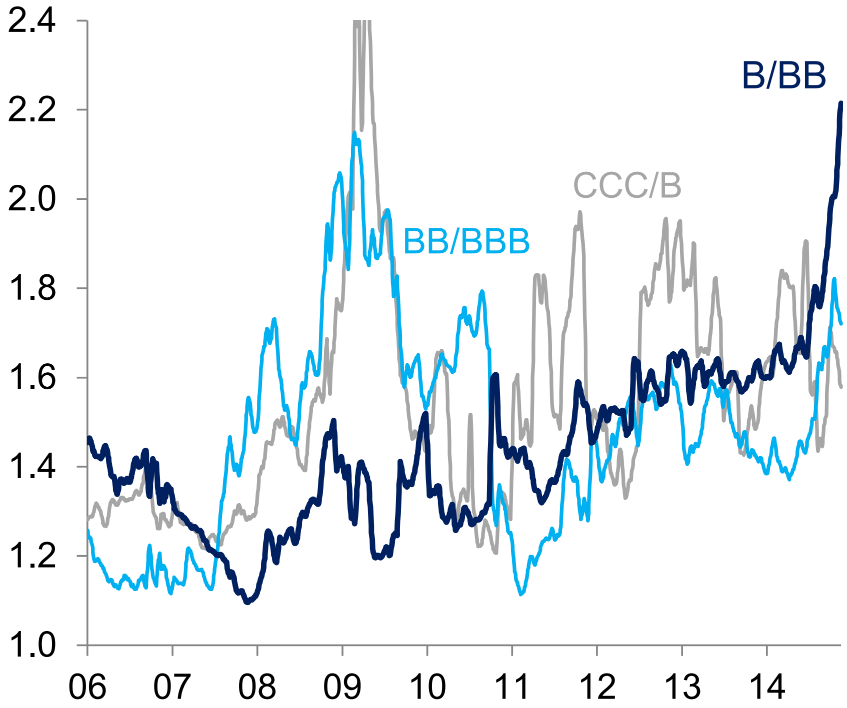
Source: Citi Research, Haver, MarkIt. *BoE, BoJ & Fed purchases > 5yrs.

… between target & current expected returns, forcing you down in quality

"So where's the trades, man?"

Bs are historically cheap in RV terms

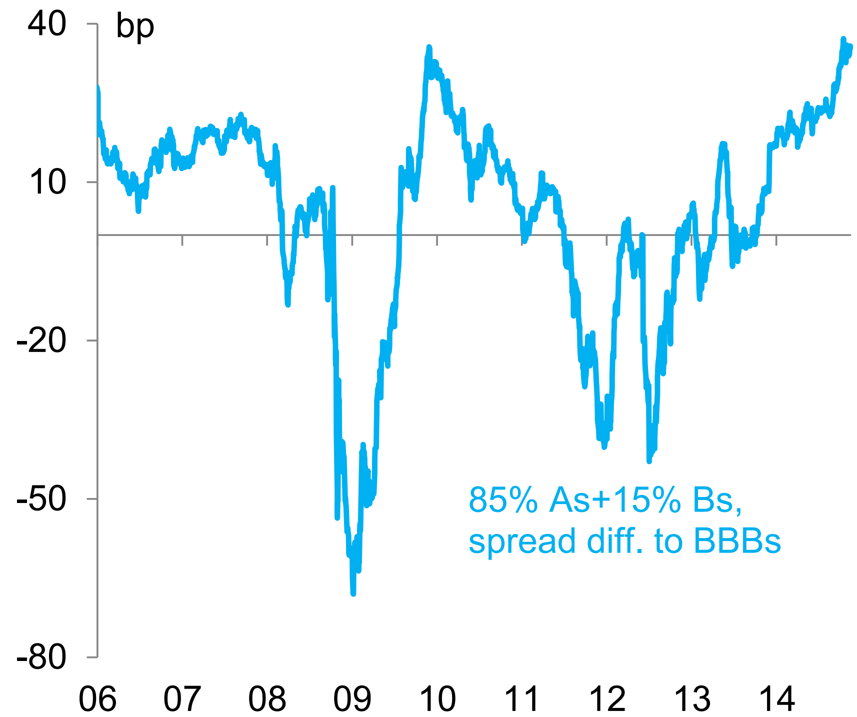
iBoxx B/BB, BB/BBB & CCC/B yield ratios, 10d MA



Source: Citi Research, MarkIt.

Barbell, if you don't want more risk

A portfolio of 85% single-A non-fins & 15% single-Bs, spread difference to iBoxx BBB non-fins, bp



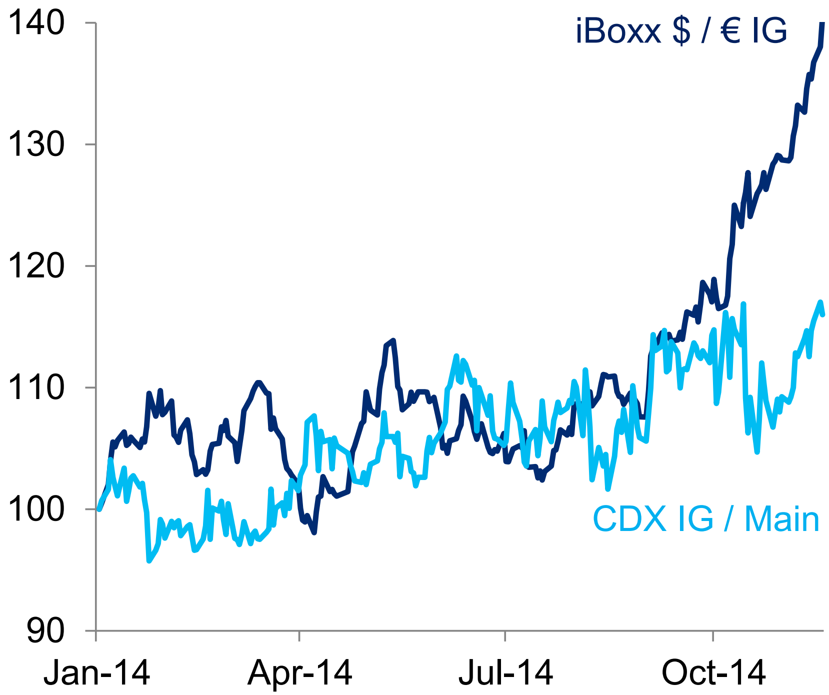
Source: Citi Research, MarkIt.

Top call for 2015: β-strategies will return (Be long Bs)

Valuations in the neighbourhood should benefit …

Main should outperform CDX IG

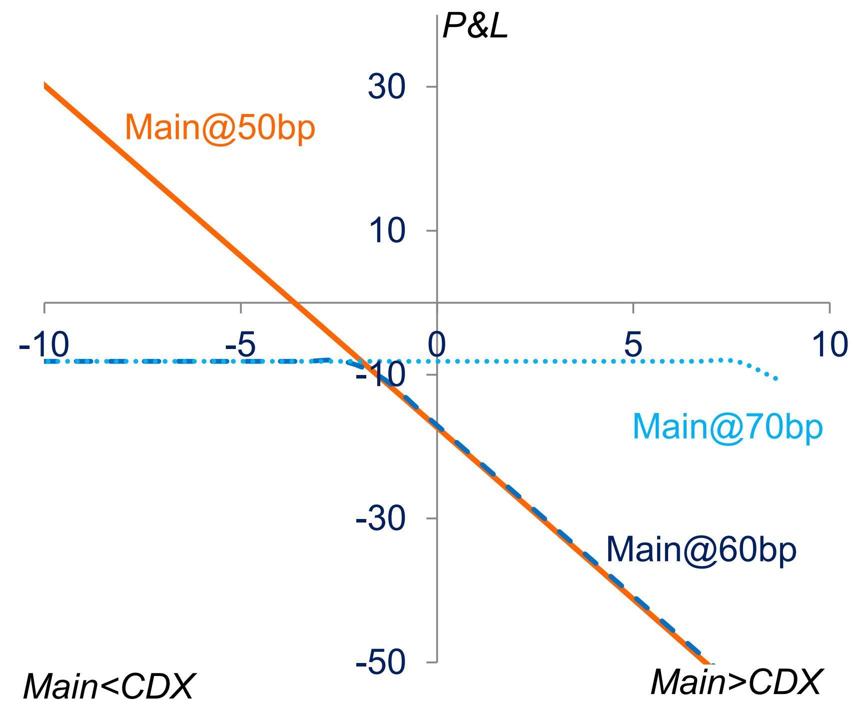
CDX IG/Main ratio vs iBoxx $/€ IG ratio, Jan-14=100



Source: Citi Research, MarkIt.

Buy Main, sell CDX IG receivers*

P&L vs. CDX-Main spread differential, strikes set @ 60bp



Source: Citi Research, Markit. *Pricing as of 22 Nov. 2014*

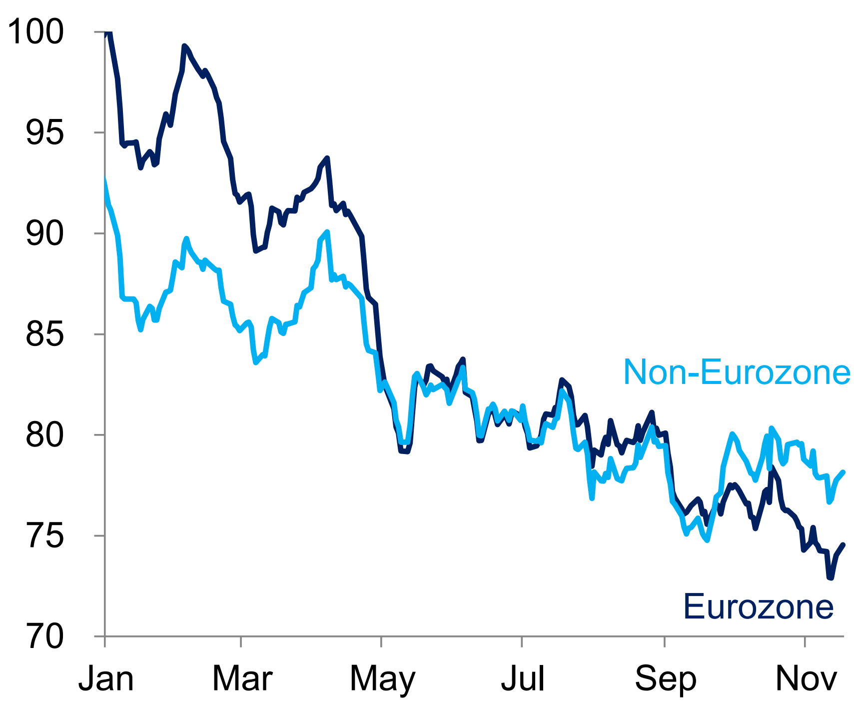
… but not as much as the € market itself

* This trade is presented for illustration purposes only – it is not one of our open recommendations (see our Credit Weekly for a full list of open trades)

“I only take cash (bonds)!”

Bonds in the ECB’s sights to outperform

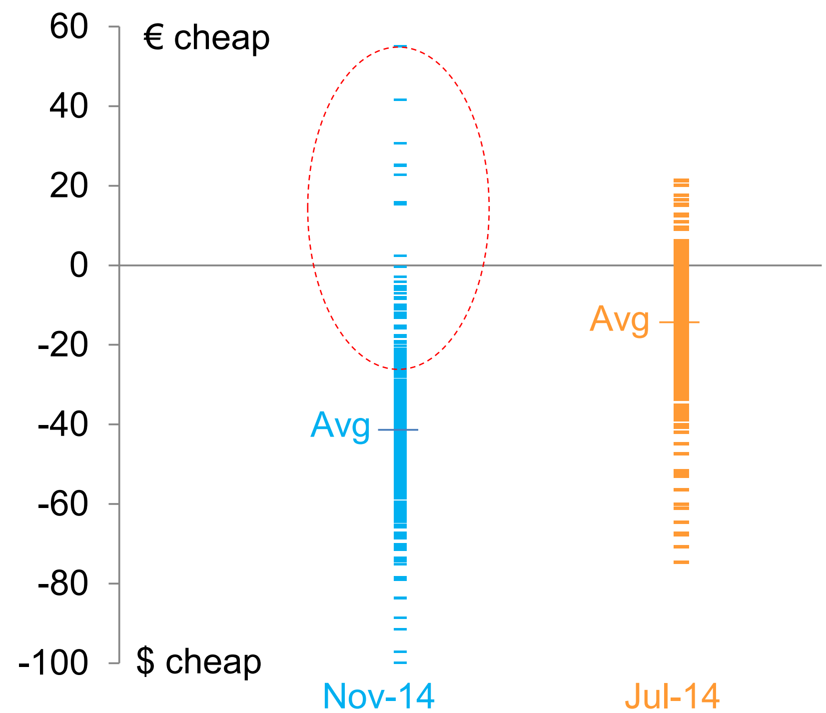
Spread of EZ domiciled vs. non-domiciled issuers, bp



Source: Citi Research, Markit.

€ credit is expensive but not universally

€-$ spread difference on cross-currency bond pairs*,bp



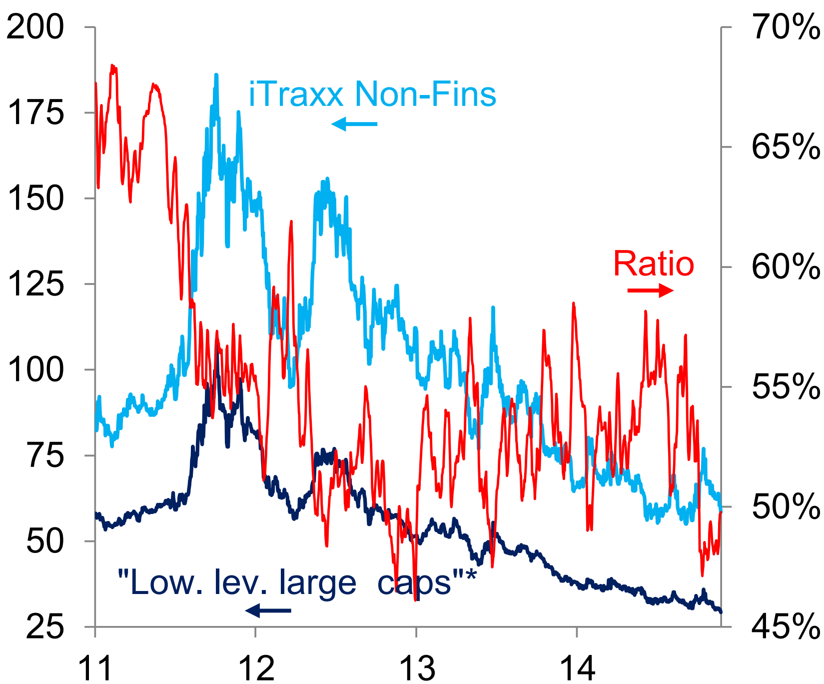
Source: Citi Research, MarkIt. * Bonds are matched on issuer and seniority. Maturity mismatch < 30%, Cash price difference < 5 points.

Buy € issuers, buy € bonds that are flat to $ & £ equivalents

"Any trades that don't need an overhaul?"

Avoid the likely "low-beta releveragers"

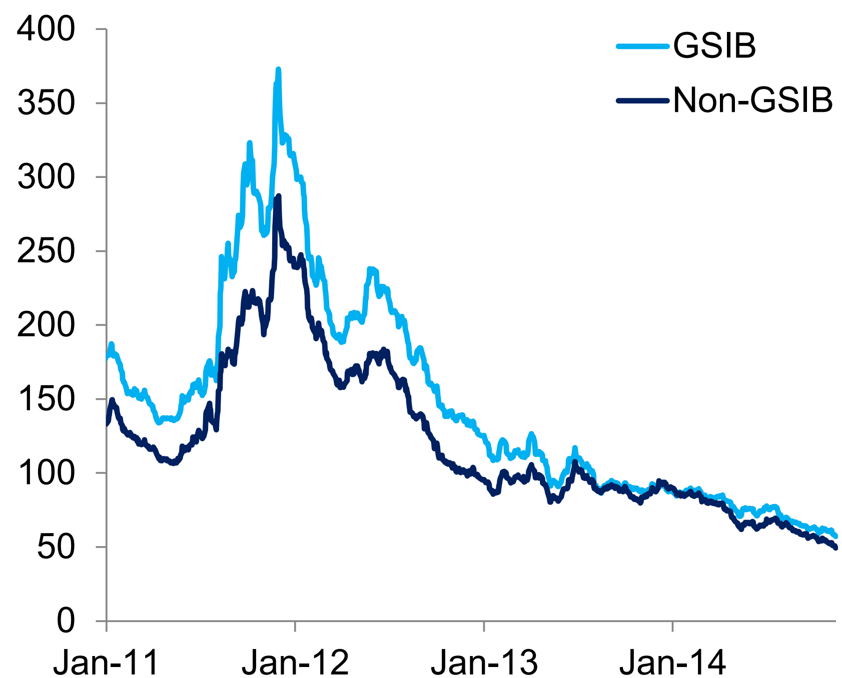
Basket of 10 large caps with low leverage* vs. iTraxx non-fins, bp



Source: Citi Research, Markit.

TLAC positive for existing sen. GSIB debt

Senior unsecured spreads for GSIB* and non-GSIBs, bp

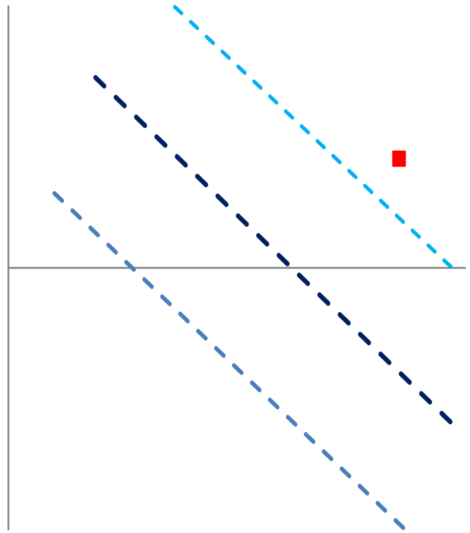


Source: Citi Research, MarkIt. * Global Systemically Important Banks

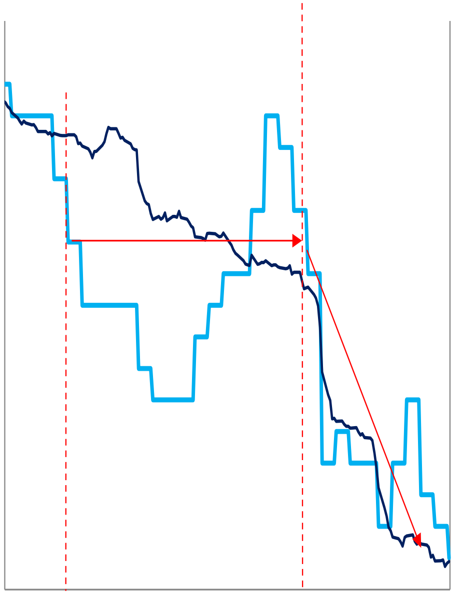
Negative basis in HY & long senior GSIB bonds

The ECB may not be keen to get the tool kit out

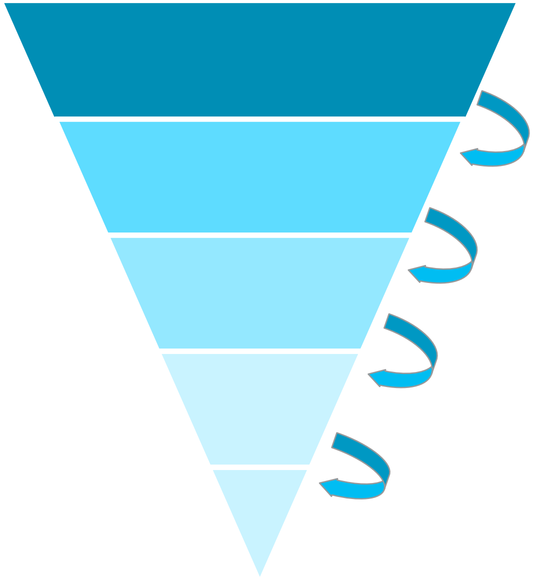
Rickety investment case …



… will get a gloss-over …



… sprucing up even the 'junk'!

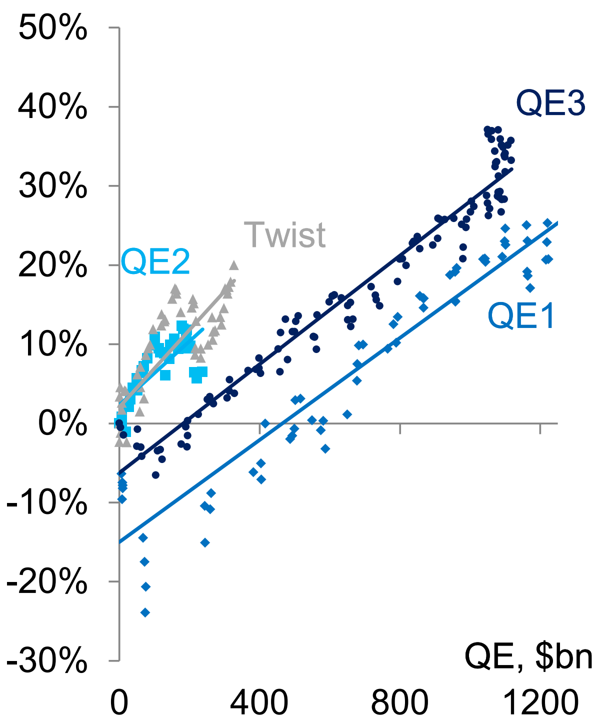


But don't underestimate the impact of their handiwork

App. 1: Did the Fed makeover have the desired result?

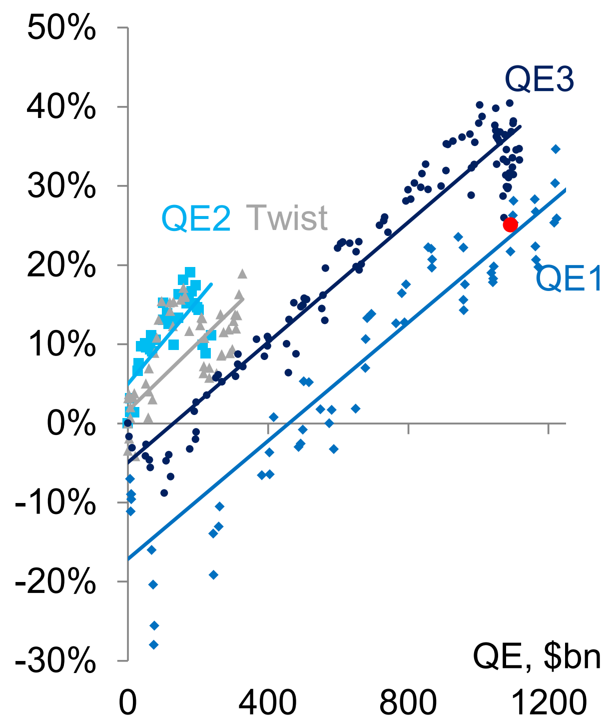
S&P: $33bn => ~1% gain

Cum. increase in Fed holdings of long-dated securities, $bn vs. cum. market performance (%)



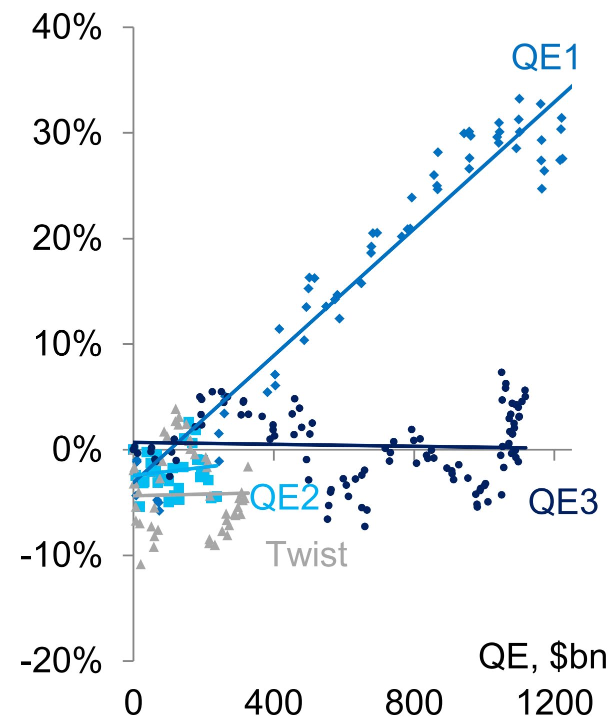
Source: Citi Research, Haver.

Mid-cap*: Similar w. late dip



Source: Citi Research, Haver. * Russell 2000.

EM*: No joy after QE1



Source: Citi Research, Haver. * FTSE All EM All-cap, USD

QE impact on US equities has been remarkably stable*

* Gradient in the two left-hand charts is very similar across QE iterations

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Appendix A-1

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