

US Credit Weekly

Squeeze Theory



8 June 2012

[MARKET OUTLOOK](#) | [SINGLE NAME NEWS](#) | [WEEK AHEAD](#) | [RECENT CITI RESEARCH](#) | [US KEY ECONOMIC DATA](#) | [KEY EARNINGS ANNOUNCEMENTS](#)

Market Outlook

It's at times like these that trading becomes extremely difficult and begins to take on elements of game theory. With most investors prudently set up for a continuation of the negative headlines out of Europe, it was perhaps inevitable that markets would change course to follow the path of least resistance: tighter.

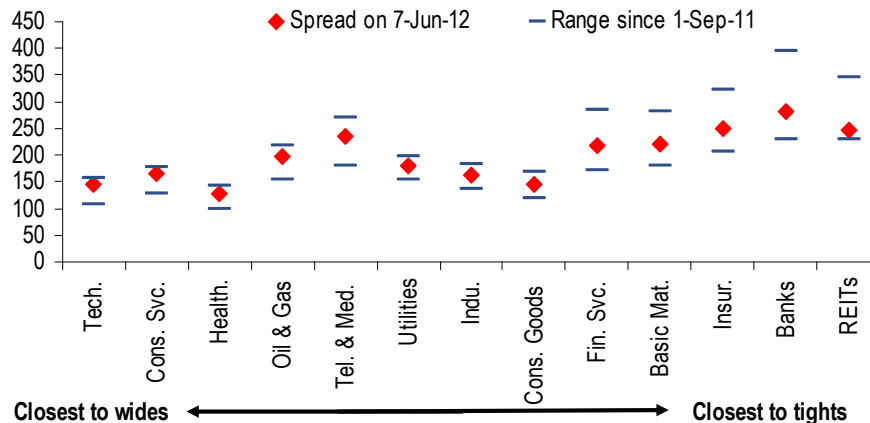
In fact, this was a "risk" that we recently highlighted in our mid-year outlook. Our monthly credit survey suggested investors were the least long they've been prior to any of the three major selloffs of the past two years. And when everyone is playing it close to home, the natural consequence is less forced selling, fewer dislocations or gaps wider, and very frustrated shorts.

So if one was hoping for the opportunity to buy Bank of America on-the-run 10yr bonds at 600bp, it was always going to take far more stress than what we saw in October of last year to get there.

Indeed, the sectors that underperformed the most in the last selloff are the sectors that have outperformed the most this time around, at least if measured relative to how wide they got in the fourth quarter of 2011 (see figure). Moreover, it's these sectors – banks, insurers, and REITs – that performed the best this week as investors looked to take advantage of the positive news.

What Sectors Outperformed/Underperformed?

OAS in bp



Source: Citi, CIRA

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CREDIT

INVESTMENT OVERVIEW

NORTH AMERICA

CORP. HIGH GRADE STRATEGY

Recent Citi Research

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

US TotalCredit

Apr '12 – A Simple Single Name Strategy

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

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The possibility of additional central bank intervention (by the Fed and the ECB) and progress in arranging a direct recap of Spanish banks utilizing EFSF/ESM funds were the main drivers of the rally.

To be fair, the central banks actually did fairly little this week. The ECB left interest rates unchanged and Chairman Bernanke's testimony to Congress was anything but conclusive on the form of future QE (twist or outright) or the need for it at all. That being said, Mario Draghi's comments were widely interpreted as supportive of a future rate cut and additional liquidity measures in July. And the dovish commentary from some voting members of the Fed has been ongoing.

Yet the biggest positive for credit to our minds is not the prospect of additional QE, which we think is likely to have a diminished effect, but the progress being made in recapitalizing Spain's banks. If Spain agrees to the apparently "limited conditionality" that may be on the table in return for an EFSF/ESM recap of its banks, then at least one big European overhang will have been removed.

It remains to be seen if policymaker goals will be accomplished by such a recap. First off, it's surprising that Germany is now willing to entertain an unconditional rescue, even if recent rhetoric hints at a softening stance. Second, it's far from certain that a recapitalization will halt deposit flight without a euro-wide guarantee scheme. After all, deposit flight in Greece has tended to be very momentum driven and insensitive to political or economic developments. Third, depending on how the recap is structured, the Spanish sovereign's liabilities may increase as solvency concerns go unaddressed.

Nonetheless, the apparent progress is a positive in our opinion – albeit one with plenty of caveats, remaining uncertainty, and a timetable that is likely dependent on the release of the IMF and Oliver Wyman reports. That being said, with 10yr Treasuries now at roughly 1.60% and unlikely to trend much higher in light of QE discussions, the scope for spread tightening is somewhat curtailed. As such, our enthusiasm is tempered because the risk-reward for high grade credit – at least in spread terms – has gotten worse as Treasuries have ratcheted lower. After the initial squeeze tighter ends, we think spreads will have a hard time adding to gains. Moreover, we're cognizant that when it comes to Europe the details have tended to disappoint.

Single Name News and Views

Upside for lagging credits? - If one believes that this rally has legs, in the table below we have listed credits whose performance has lagged and spreads still trade at the wide end of this year's range, presenting possible long opportunities. We believe there could be scope for continued tightening given recent positioning, but we believe the upside is greater for CDS over bonds.

Lagging Credits

Company	Chart	5y CDS (bid)	bp from Wides	bp from Tights
Basic Materials / Paper				
Barrick Gold	ABX	165	-10	61
Freeport-McMoRan	FCX	190	-14	64
International Paper	IP	167	-13	60
Newmont Mining	NEM	172	-10	71
Insurance				
MetLife	MET	280	-43	89
Prudential Financial	PRU	240	-28	95
Oil & Gas				

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

Tuesday:	<u>Consensus</u>
Import Price Index	-1.0%
Monthly Budget Statement	-\$108.8B
Wednesday:	
MBA Mortgage Applications	-
Producer Price Index	-0.6%
Advance Retail Sales	-0.1%
Thursday:	
Current Accounts Balance	-\$132.1B
Consumer Price Index	-0.2%
Initial Jobless Claims	-
Friday:	
Empire Manufacturing	14.00
Industrial Production	0.1%
Capacity Utilization	79.2%
U of Michigan Confidence	77.5

Key Earnings Announcements

Thursday:

Kroger

Anadarko	APC	212	-12	77
Hess	HES	211	0	95
Pioneer Natural Resources	PXD	195	-27	68

Technology

Avnet	AVT	208	-35	60
Dell	DELL	204	-7	98
Hewlett Packard	HPQ	183	-24	91

Source: CIRA

Note: Spread range of Jan. 2, 2012 – June 7, 2012 was used.

The Week Ahead

Citi's economic surprise index is now at lows not seen since Sep '11. But that means expectations may finally be subdued enough that we could see positive surprises next week from PPI, CPI, retail sales, and industrial production. Softer food and energy should keep a lid on inflation. With spring/summer spending seasons behind us and little change in personal income, consensus expectations lean towards weaker retail sales data.

Despite the busy calendar, the markets focus will still likely be on Europe, starting with the 1st round elections in France this weekend. In Greece, focus continues to be on the popularity of left-wing, anti-austerity parties. But with no polling allowed before the June 17 elections, the market is effectively in a quiet period. Of course, the threat of a demonstration by municipal employees (essential in setting up voting centers and the like) leaves us concerned about a possible derailment of the process.

On Monday, investors should expect the IMF report on Spanish banks to provide much needed clarity on the troubled lenders and perhaps set the tone for the scope of any forthcoming aid. In addition, we expect that Moody's will release its downgrades of global capital markets banks sometime next week. This is well telegraphed and is likely largely already baked into levels, but with bank spreads holding in relatively well in May versus previous sell-offs, any negative catalyst could move spreads meaningfully wider.

Italy will auction bonds on Thursday: Citi estimates a total size of €4.3 bn in 3y and 15y maturities.

Appendix A-1

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