

Credit

9 March 2012 | 12 pages

Speculative Grade Credit Weekly

Loans versus Double-B Bonds

- The consolidation we experienced this week was not surprising given the high yield market's 5.23% rise over the first two months of 2012, the fastest start since 2001. The primary calendar, which has been at full speed averaging over \$8bn/week since late January, reduced cash balances to more normal levels and dealer positioning hit a new 10-year low at the end of February. Any selling was bound to be exaggerated by the lack of buyers.
- We view the sell off as reflective of moderately stretched positioning and some profit taking. We didn't see anything new in the macro picture to change our view that the market will be strong over the first half of 2012. Indeed, by Thursday afternoon the equity market retraced Tuesday's entire decline, though high yield was still lower.
- Looking further out, we see a potential technical boost from emerging financial companies. By the middle of April, bondholders could receive over \$10bn from the Lehman estate. Fellow finance company, Washington Mutual is also close to returning money to creditors that should total \$6.4bn.
- JC Penney was downgraded this week to BB from BB+ by S&P, a blow to their investment grade goal. We recommend investors sell JC Penney bonds for Limited Brands.
- Two segments of the market that make for an easy comparison are leveraged loans and high-quality high yield bonds. In the current backdrop where loan yields have caught up to double-B bond yields and long-term rates are at all-time lows, having been resilient to the flight-to-risk rally, floating rate loans should look appealing. We propose a few swaps into loans from bonds.

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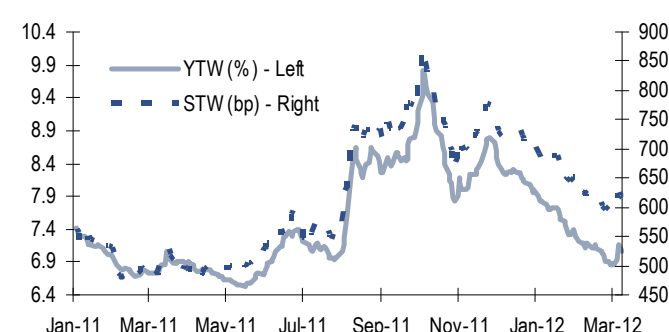
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High Yield Market Recap

	Yesterday's Close		Weekly Change		8-Week Average	
	Price	Spread	Price	Spread	Price	Spread
CDX HY 17	97.19	572	-0.69	18	96.97	576
Citi High Yield Market	102.07	613	-0.67	14	101.31	633
BB Index	106.51	440	-0.67	12	106.09	456
B Index	101.92	646	-0.66	16	101.02	660
CCC Index	90.01	1071	-0.71	15	88.66	1128
Citi Lev Loan Tracker	93.05	581	-0.11	4	92.89	573
Capped Tracker	95.23	531	-0.14	4	94.92	526
CDX IG 17	100.19	96	-0.09	2	100.01	100
Citi US BIG Corporate	112.31	180	-0.62	3	112.09	195
BBB Index	112.34	228	-0.69	3	112.03	245
S&P 500	1365.91		-3.72		1336.74	

Source: CIRA

Citi High Yield Market Index, Yield-to-Worst and Spread-to-Worst



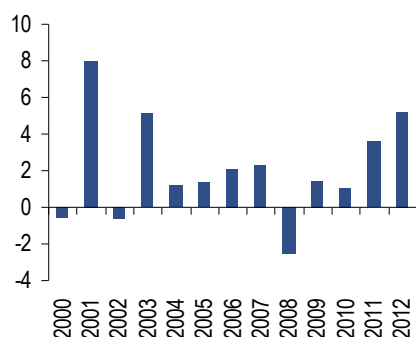
Source: CIRA

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

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It Was Inevitable

HYMI Jan-Feb Total Return (%)



Source: Citi Investment Research and Analysis

The title is not referring to Romney's moderately successful Super Tuesday, but rather the turbulence that the market encountered this week. Consolidation was not surprising given the high yield market's 5.23% rise over the first two months of 2012, the fastest start since 2001. Considering how low rates are, it was an impressive beginning to the year. The primary calendar, which has been at full speed averaging over \$8bn/week since late January, reduced cash balances to more normal levels and dealer positioning hit a new 10-year low at the end of February. Any selling was bound to be exaggerated by the lack of buyers.

The weakness, however, was concentrated and originated from faster money. Long-only accounts were more likely to stay pat and demonstrated no urgency to lighten up on risk. We view the sell off as reflective of moderately stretched positioning and some profit taking. We didn't see anything new in the macro picture to change our view that the market will be strong over the first half of 2012. Indeed, by Thursday afternoon the equity market retraced Tuesday's entire decline, though high yield was still lower. Interestingly in cash, we didn't see as much performance deviation between double-B and triple-C credits as we would have expected given the market's ¾-point drop.

So what caused the retreat? We've seen attributions to growth concerns and Greece. We believe it was more the former than the latter. After all, a potential disorderly Greek default should have boosted gold but the commodity fell nearly 2%. Furthermore, other peripheral yields fell in March, hitting 8-month lows. Growth-related factors, such as oil and copper, were consistently lower. Earlier in the week, the Chinese government announced a 7.5% growth target for 2012, down from 8%.

The Greek exchange deadline passed late Thursday afternoon with the expected result. Enough bondholders consented to the exchange to force the rest of the Greek-law bondholders to the exchange. The trickiest aspect to the exchange relates to the UK-law bonds which must be handled bond by bond rather than by the entire class as is the case with Greek-law debt. In the end, CDS is likely to be triggered by the CAC enforcement, which should be a positive for the market as investors continue to use the product to hedge and manage overall sovereign risk. Without actually fixing the problem, this was probably as good an outcome as we could have hoped for. This is not to say the sovereign story is behind us. As borrowing costs decline, the urgency to implement fiscal and economic reforms will fade, a trend we are already seeing in some peripherals. Compounding this will be the headwind of a potential European recession expanding fiscal deficits. A period of calm, however, is possible.

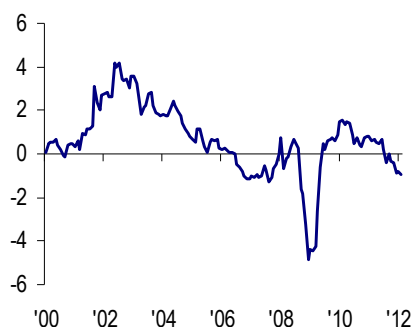
Back here in the US, a Wall Street Journal article on Wednesday afternoon raised the possibility of another round of QE, though in a different form from the prior two rounds. In particular, the program would sterilize the additional purchases where the Fed would borrow back the cash it used to buy the bonds (i.e. a reverse repo operation). The result sounds more like the Twist operation than the first two QE efforts in that the Fed increases the duration of its balance sheet but not the size. As we've seen in the past, further bull flattening of the Treasury curve will compel more investors to move down in credit quality, in our opinion.

Looking further out, we see a potential technical boost from emerging financial companies. A mere 3½ years following bankruptcy, Lehman Brothers emerged on Tuesday and will begin the process of paying back creditors. By the middle of April bondholders could receive over \$10bn from the Lehman estate. Fellow finance company, Washington Mutual is also close to returning money to creditors that should total \$6.4bn. Lehman and Washington Mutual filed bankruptcy within two weeks of each other and are ironically beginning disbursements in close proximity.

News & Views

This week S&P downgraded JC Penney to BB from BB+, a step backwards in the company's longer term plan to achieve investment grade ratings. S&P cited the company's weakening credit profile and expected operational disruptions on the back of its recently announced pricing and merchandising initiatives as reasons for the downgrade. Limited Brands, on the other hand, has posted several quarters of same store growth and improving margins, helped by being somewhat insulated from rising cotton and other commodity costs. We believe the relationship between JCP's 5y CDS (trades at 325bp (mid)) and LTD (180bp) is approaching fair value, but we are surprised by the differential between the cash bonds – [only about 20bp](#) in the intermediate part of the curve. We believe that LTD is priced fairly, and suggest selling JCP bonds as we believe cash spreads have the potential to widen to trade about 120bp behind LTD.

BB Yield to Worst Less Loan Yield to Mat.*



Source: Citi Investment Research and Analysis, S&P LCD. Note: We use the S&P Leveraged Loan Index Spread to Maturity plus the prevailing 3m LIBOR to get a Loan Yield to Maturity

Loans versus Double-B Bonds

Two segments of the market that make for an easy comparison are leveraged loans and high-quality high yield bonds. Historically, relative value typically came down to whether default rates would be high enough to offset the double-B yield advantage. We don't expect default rates to climb in 2012 and in fact the surge in liquidity could push rates lower this year. Normally this backdrop would lead to the conclusion that bonds are better value than loans but we believe higher defaults are not necessary to prefer loans in this environment. Rates have enjoyed a tremendous rally and although they could rally a bit further (i.e. bull flattener) any breakout to the upside will benefit loans (or at least act more as a headwind for bonds rather than loans).

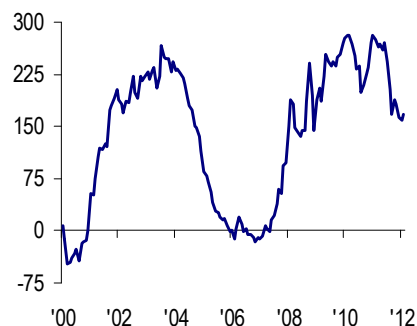
The tremendous rally in risky assets has occurred without Treasury yields breaking out of their recent range. This surprising development likely is related to expectations of some form of QE3. Although short rates are unlikely to move higher, you could see curve steepening as the flight-to-quality bid for Treasuries recedes.

The two main factors that investors should keep in mind when evaluating relative value between high-quality bonds and loans are:

- **Yield advantage:** as the Treasury curve flattened, led by the belly rallying, the yield advantage double-B bonds enjoyed for much of 2010 and 2011 reversed to a yield deficit. The only times loans yielded more than bonds were in 2009 (when technical factors pressured loan prices and thereby provides little guidance for us now) and in periods where the 2s10s curve was flat or inverted (i.e. 2000 and 2006/07). There is some risk that the curve flattens further if the Fed pursues another round of bond purchases (see our discussion in the first section of the piece) but the scope for more flattening is obviously limited given near-record-low Treasury yields.
- **Negative convexity:** one of the biggest drawbacks to loans is the lack of call protection. Although we would agree that investors are exposed to repricing or refinancing risk, we would also argue that double-B high yield has a lot of negative convexity too considering how low yields are. As we noted last week, in order for double-B's to post further price gains, Treasury rates and spreads both need to be supportive. If the Fed disappoints the market and doesn't pursue a third QE, we could see Treasury yields climb. Obviously if the economic outlook rolls over, spreads could widen.

We list a few opportunities to swap into loans from bonds below:

US Treasury Curve 2s10s (bp)



Source: Citi Investment Research and Analysis, Bloomberg

Buy Supervalu, Sell Smithfield

Name	Issue	Rating	Coupon	Maturity	Price	Yield	Yield w Curve	Z Srd	Libor Floor	Amt Out
Supervalu Inc	TL B2 (Ext)	BB /	L+325	10/5/2015	99.63	3.84%	4.18%	337	0.00%	578
Smithfield	Sr. Unsec.	B2 / BB-	7.750%	7/1/2017	114.75	4.58%		342		500
				Difference	15.13	-0.74%		(5)		

Source: Citi Investment Research and Analysis

- Move into a higher rated/lower levered credit and shorten maturity by two years. Take out 15 pts while only giving up 5bps of spread.
- Both credits are exposed to margin pressures stemming from elevated commodity costs, but Supervalu is offsetting the decline with cost cutting.
- Smithfield could be acquisitive (management mentioned Sara Lee's meat business as something it will look at).

Buy Lawson, Sell Fidelity National

Name	Issue	Rating	Coupon	Maturity	Price	Yield	Yield w Curve	Z Srd	Libor Floor	Amt Out
Lawson Software	TL	/ Ba3	L+525	7/5/2017	101.00	6.53%	6.69%	553	1.50%	1,040
Fidelity Nat'l Info.	Sr. Unsec.	Ba2 / BB-	7.625%	7/15/2017	108.50	5.15%		465		600
				Difference	7.50	1.38%		88		

Source: Citi Investment Research and Analysis

- Take out 7.5pts while picking up 88bp of spread. Libor floor provides a minimum 6.75% coupon.
- Both Lawson and Fidelity National benefit from recurring revenue streams that are characteristic of the software / services business model.
- We recognize the 2.0x increase in leverage moving from senior FIS notes to the secured Lawson paper, but given superior margin generation, we believe there is greater upside potential in Lawson particularly given the interest-rate exposure.

Buy Neiman Marcus, Sell Hanesbrands

Name	Issue	Rating	Coupon	Maturity	Price	Yield	Yield w Curve	Z Srd	Libor Floor	Amt Out
Neiman Marcus	TL B	BB- / B2	L+350	5/16/2018	99.00	4.94%	5.36%	398	1.25%	2,060
Hanesbrands	Sr. Unsec.	B1 / BB-	6.375%	12/15/2020	103.00	5.83%		435		1,000
				Difference	4.00	-0.89%		(37)		

Source: Citi Investment Research and Analysis

- Take out 4pts to shorten maturity by 2.5 years while giving up 37bp of spread.
- Hanes has greater commodity exposure and leverage is relatively similar through both securities.
- We note that Neiman Marcus is in a state of flux as it weighs possible exit strategies for its sponsor, including a dividend deal. We view the loan as having enough security to withstand any pressure from payouts to management.

Buy Ashland, Sell CF Industries

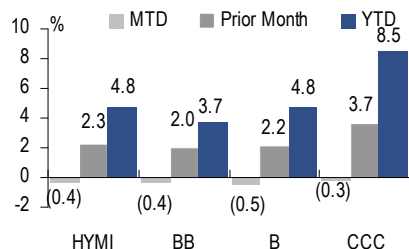
Name	Issue	Rating	Coupon	Maturity	Price	Yield	Yield w Curve	Z Srd	Libor	Amt Out
									Floor	
Ashland Inc	TL B	BB / Baa3	L+275	8/23/2018	100.38	3.68%	4.28%	284	1.00%	1,397
CF Industries	Sr. Unsec.	Ba1 / BB+	6.88%	5/1/2018	117.00	3.75%		239		800
				Difference	16.63	-0.07%		45		

Source: Citi Investment Research and Analysis

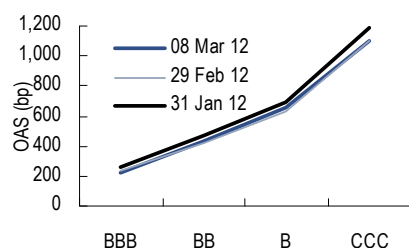
- Take out 16pts and 45bp to move into a credit that has a similar credit profile. Ashland's term loan has \$101 soft call protection through August 2012.
- CF has staged a significant rally this year on the back of hopes for a ratings upgrade to investment grade. We believe there is limited further upside in the name, even if it does reach investment grade.

HY Performance Review (As of Thursday)

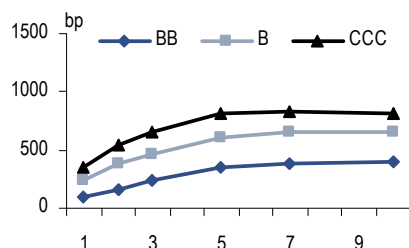
Index Total Returns



HY Risk Curve

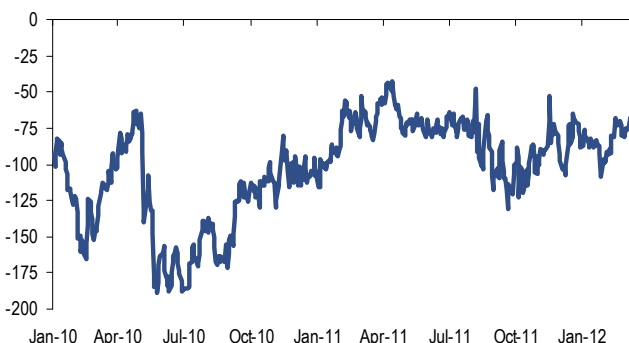


Median HY CDS Curves by Rating



Source: CIRA, Markit

Median High-Yield Non-Call Liquid Basis



Source: CIRA

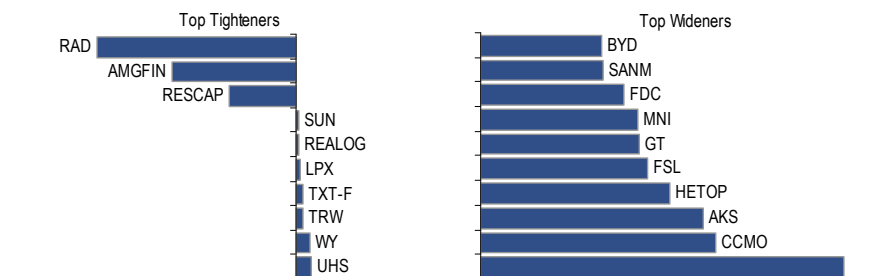
- High yield bonds were down 2/3 point this week. Citi's High Yield Market Index yields 7.06% which translates to a 613bp spread and \$102.07 price.
- Triple-C paper (-0.28%) was hit the least this week, and leads double-B (-0.38%) and single-B credits (-0.47%) in March.
- Nearly all major sectors are down this month. Retail (+0.03%) and consumer products (-0.02%) are the top performers, while power (-0.95%), and basic materials (-0.94%) are lagging.

Cash Performance by Sector, February

Sector	YTW(%)	MTD(%)	YTD(%)	Sector	YTW(%)	MTD(%)	YTD(%)
Auto Mfg/Vehicle Parts	5.137	-0.33	5.01	Media & Entertainment	9.020	-0.61	7.72
Basic Materials	7.318	-0.94	3.30	Paper & Packaging	6.901	-0.31	4.71
Building/Bldg Products	7.169	-0.29	8.55	Power	8.615	-0.95	1.06
Consumer Products	6.533	-0.02	4.17	Retail	6.866	0.03	4.53
Energy	6.638	-0.34	2.75	Service	7.606	-0.06	5.49
Finance	7.299	-0.02	6.72	Technology	7.841	-0.70	7.28
Healthcare	6.719	-0.33	4.61	Telecom & Cable	6.642	-0.66	4.73
Leisure & Gaming	7.980	-0.37	6.14	Transportation	8.037	-0.21	5.92
Manufacturing	6.867	-0.52	3.21	HYMI	7.064	-0.41	4.80

Source: Citi

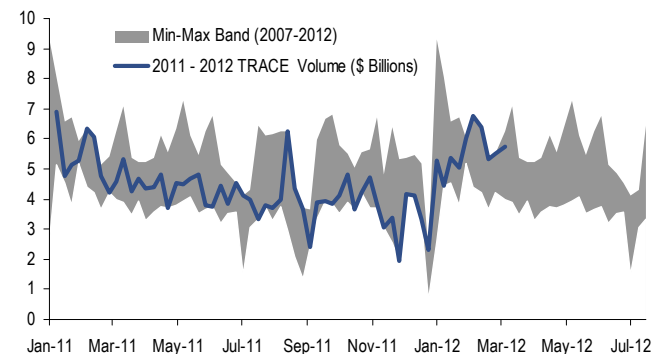
HY 17 CDX Underlying Performance, 2 Mar – 8 Mar (pts)



Source: Markit

Source: Markit

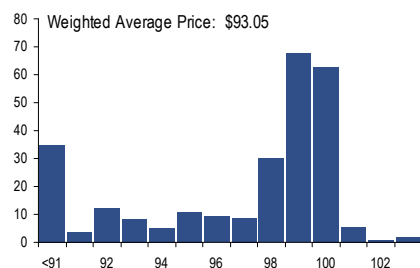
HY Bonds Traded Volume, 5-Day MA



Source: TRACE

Leveraged Loan Tracker (As of Thursday)

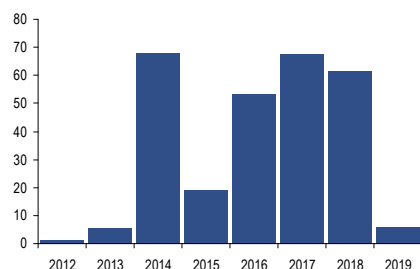
Loan Price Distribution (Market Value, \$bn)



Note: Price distribution of the loans in the Leveraged Loan Tracker.

Source: CIRA, Markit

Maturity Wall (Notional, \$bn)

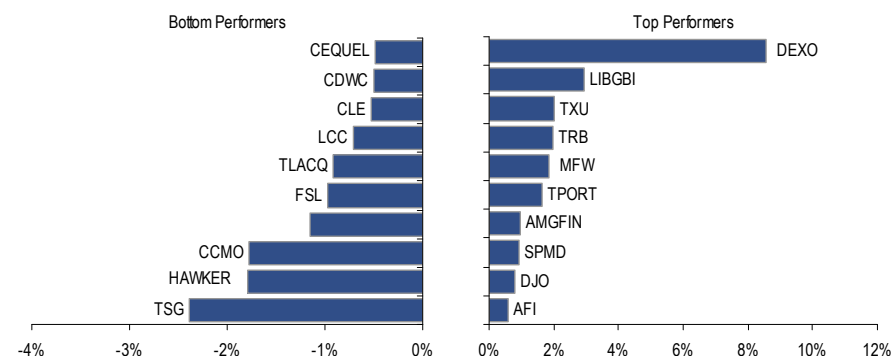


Note: Maturity wall of the loans in the Leveraged Loan Tracker.

Source: CIRA, Markit

- The Leveraged Loan Tracker lost 0.02% last week, taking the year-to-date performance to +3.06%. The Tracker's average price and spread are \$93.05 and 581bp, respectively.
- The Capped Tracker was down 0.05% last week; year-to-date performance is now +3.29%.
- Power (+1.22%) is the top performer in March, while transportation (-0.70%) and media & entertainment (-0.29%) are the bottom performers.

Leveraged Loan Tracker Issuer Performance (%), March



Source: CIRA, Markit

Source: CIRA, Markit

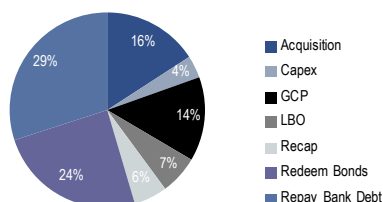
Leveraged Loan Tracker Capped and Uncapped Total Returns by Sector

	Uncapped							Capped						
	Current			Month-to-Date		Year-to-Date		Current			Month-to-Date		Year-to-Date	
	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change
All Loans	\$262,917	93.05	581	0.04%	7	3.06%	-23	\$239,990	95.23	531	0.01%	7	3.29%	-30
Auto Mfg/Vehicle Parts	3.83%	98.70	389	-0.08%	6	3.74%	-42	4.19%	98.70	389	-0.08%	6	3.74%	-42
Basic Materials	4.40%	98.57	370	-0.12%	4	1.91%	-3	4.82%	98.57	370	-0.12%	4	1.91%	-3
Building/Bldg Products	1.21%	96.57	545	-0.01%	3	3.93%	-27	1.33%	96.57	545	-0.01%	3	3.93%	-27
Consumer Products	5.23%	98.30	515	0.08%	-5	2.70%	-35	5.73%	98.30	515	0.08%	-5	2.70%	-35
Energy	1.22%	100.33	528	0.05%	1	1.59%	28	1.34%	100.33	528	0.05%	1	1.59%	28
Finance	3.12%	89.19	724	0.43%	-7	5.57%	-71	3.42%	89.19	724	0.43%	-7	5.57%	-71
Healthcare	13.18%	99.29	369	0.05%	-1	2.56%	-10	13.82%	99.31	371	0.05%	-1	2.52%	-10
Leisure & Gaming	5.62%	96.77	508	-0.03%	4	4.40%	-71	5.31%	97.25	492	-0.02%	4	3.97%	-60
Manufacturing	2.76%	95.79	536	-0.16%	9	1.12%	11	3.02%	95.79	536	-0.16%	9	1.12%	11
Media & Entertainment	11.32%	82.52	1,072	-0.29%	38	7.73%	-174	9.85%	82.23	1,116	-0.04%	36	7.58%	-182
Paper & Packaging	1.95%	100.00	392	0.10%	0	1.83%	97	2.13%	100.00	392	0.10%	0	1.83%	97
Power	7.24%	69.77	1,330	1.22%	-26	-4.95%	201	4.50%	82.25	903	0.63%	-10	-1.70%	78
Retail	11.62%	99.05	377	-0.02%	1	2.96%	-31	12.73%	99.05	377	-0.02%	1	2.96%	-31
Service	5.42%	94.56	548	-0.05%	6	5.99%	-118	5.94%	94.56	548	-0.05%	6	5.99%	-118
Technology	8.02%	96.41	482	-0.06%	18	4.70%	-92	6.69%	97.35	471	-0.13%	24	3.95%	-73
Telecom & Cable	13.46%	98.92	412	-0.10%	9	2.35%	22	14.74%	98.92	412	-0.10%	9	2.36%	21
Transportation	0.40%	91.75	672	-0.70%	37	5.99%	-214	0.43%	91.75	672	-0.70%	37	5.99%	-214

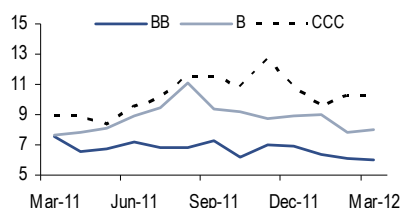
Source: Citi Investment Research and Analysis, Markit

Issuance Tracker (As of Thursday)

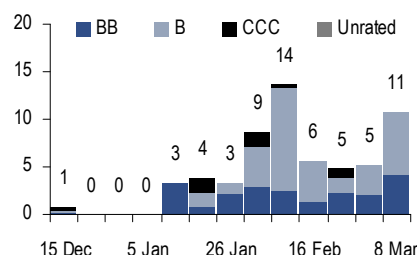
Breakdown of Use of Proceeds, 2011-2012



Weighted Average Coupon by Rating (%)



Weekly Issuance by Rating (\$bn)



Note: USD denominated issuance only.

Source: CIRA

- The primary market continues to be strong. 15 companies issued \$7.5 billion through Thursday.
- The forward calendar looks light with three companies seeking around \$1.5 billion but could be supplemented with additional opportunistic deals.

Bond Deals Priced in the Market for Mar 2 – Mar 8 (\$ in Millions)

Date	Issuer	Amt	Coupon	Maturity	Ratings	Use of Proceeds
03/08/12	B/E Aerospace	500.0	5.250	4/1/2022		
03/08/12	Verso Paper Hldgs	341.2	11.750	1/15/2019		
03/08/12	Covanta Holding Corp	400.0	6.375	10/1/2022		
03/08/12	EV Energy Partners	515.0	8.000	4/15/2019	B3/B-	Repay Bank Debt
03/07/12	CMS Energy Corp	299.1	5.050	3/15/2022	Ba1/BB+	Redeem Existing
03/07/12	Community Health	1025.0	8.000	11/15/2019		
03/07/12	Concho Resources Inc	600.0	5.500	10/1/2022	B1/BB+	Repay Bank Debt
03/06/12	Masonite International	103.5	8.250	4/15/2021	B3/B+	GCP
03/06/12	Berry Petroleum Co	600.0	6.375	9/15/2022		
03/05/12	Key Energy Services	205.0	6.750	3/1/2021	B1/BB-	Repay Bank Debt
03/05/12	Bombardier Inc	500.0	5.750	3/15/2022	Ba2/BB+	Redeem Existing
03/05/12	Hexion US Finance	450.0	6.625	4/15/2020		
03/05/12	Bill Barrett Corp	400.0	7.000	10/15/2022	B1/BB-	Repay Bank Debt
03/05/12	Fidelity National	700.0	5.000	3/15/2022	Ba2/BB+	Repay Bank Debt
03/02/12	Eco-Bat Finance PLC	EUR 300	395.9	7.750	B1/B+	GCP
03/02/12	Hornbeck Offshore	375.0	5.875	4/1/2020	Ba3/BB-	Repay Bank Debt
03/02/12	Transunion Holding Co	600.0	9.625	6/15/2018	Caa1/B	LBO
03/02/12	Gategroup Finance	EUR 350	461.9	6.750	B1/NA	GCP
19 Transactions		9.272				

Note: Some deals might be removed for compliance reasons; therefore the sum of the deals might not equal the total. Non-USD deals are included.

Source: CIRA

Representative Bond Transactions Currently in the Market (\$ in Millions)

Issuer	Amount	Term	Priority
Cenveo Corp	450	8.0	Sr. Unsecured Notes
Neuberger Berman	800	8.0	Sr. Unsecured Notes

Source: Citi Syndicate

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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