

# US Credit Weekly

## Recalculating Route



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

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### Market Outlook

Some might say that the market has lost its direction during the past few months. And while that certainly is one way to describe recent oscillations, a better analogy to our minds is that we're parked in the middle of a seven way intersection trying to decide which road to take. Everyone basically knows in which "direction" each economic road leads from here, but until the GPS in the car finishes recalculating, it's impossible to determine the route that we'll be taking.

By far the biggest source of uncertainty continues to be Europe, as our latest [Global Credit Survey](#) of investors highlights. But given that European investors have increased their shorts in the periphery and decreased their longs in the core while US investors have also pulled back their credit exposure (in particular to banks), the market may be far less vulnerable to negative surprises than earlier this year. Investors simply aren't as overextended as they were and, if anything, they are positioned such that any performance out of the periphery or the US bank space could be quite painful.

From a fundamental basis we can't argue with the direction consensus positioning has taken in recent months. Indeed, we've [argued for a while](#) that big US banks offer inferior risk/reward relative to other financial sectors like insurance and regional banks, and with Treasuries showing renewed strength it's harder to envision a plausible scenario which leads to meaningfully tighter spreads in the near term. Similarly, our [European colleagues](#) have recently turned neutral on the European debt markets, so it seems our global outlook has rapidly become consensus.

Still, there's plenty of reason to tread cautiously even if that's a dangerously popular view. On both sides of the Atlantic the economic data are deteriorating, as this week's disappointing European PMIs and the US labor data confirm. Of course, in each case the drivers of that deterioration are very different. In Europe, it's austerity that seems to be to blame. Whereas, in the US the weakness has been attributed to seasonal payback – the magnitude of which is still in question. Nonetheless, on both continents [Citi's economic surprise indices](#) have moved into negative territory, which is rarely a good sign for credit.

The first round of the much anticipated European elections are also finally upon us with the French, Germans, and Greeks all going to the polls in the coming days. At this point the outcomes seem close to being a foregone conclusion, but the consequences for the Eurozone are far from certain.

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**CREDIT**

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**INVESTMENT OVERVIEW**

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**NORTH AMERICA**

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**CORP. HIGH GRADE STRATEGY**

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### Recent Citi Research

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

**The Credit Index Call**  
May '12 – Another HY 10-15 debacle in the making?

**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

**US Credit Outlook**  
Feb '12 – A Fork in the Road

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See [Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures](#).

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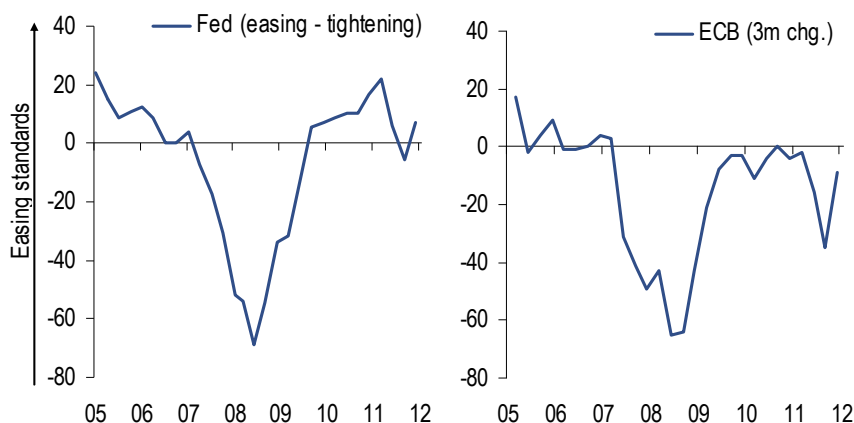
Yet as many have learned the hard way, economic fundamentals and political failure aren't such a problem when central banks have capacity and are willing to engage. But as we heard from the Fed last week and the ECB this week, more accommodation is unlikely to be forthcoming any time soon – although, both banks stand at the ready. In some sense, the position is understandable. Why act when Spanish and French **auctions are progressing smoothly**, there's been improvement in bank lending from 4Q11 (see figure below), and rates are already exceptionally low?

But haven't we tried the "wait and see" approach to stimulus before without much success? Particularly in Europe, political pressure for greater accommodation seems to be growing. Yet while the ECB President may expect economic recovery, he seems unwilling to go so far as to ensure it. Calls for a growth compact are all well and good. But if the end game is just more structural reform (which *is* necessary) then the probability of a repeat of 4Q11 sometime in 2012 seems likely.

And so, in short, while we find ourselves negative on the economic backdrop and the possibility of proactive accommodation, the investment community is already playing defense to some extent. As such, we believe it will take a sustained deterioration in fundamentals or an exogenous shock to growth (like a bad resolution to the US fiscal cliff) to precipitate a significant selloff. But our best guess as to the time frame for any disruption of that type is probably skewed to the second half of the year.

In the meantime, we prefer to stay neutral on **investment grade credit** rather than outright negative in order to preserve carry and benefit from any temporary squeezes tighter. And yet, we've lost track of the number of times our car's GPS has belatedly informed us of a turn we should have made half a mile ago; we expect routes will need to be recalculated more than once in the coming months.

## US and European Bank Credit Standards



Source: Citi Investment Research and Analysis, Bloomberg

## Earnings Update

This week we started to see a number of beats across sectors, and more importantly, post solid year-over-year growth. The credit profiles of those reporting this week showed improvement, and insurers, REITs and TMT credits have generally fared better than some consumer-focused sectors. The biggest underperformers were Prudential (weaker demand in key segments) and Sara Lee (lower volumes and higher commodity costs). We believe these generally

## What Investors Are Thinking

Feb '12 – "Sure, technicals are great. But didn't we see this last year?"

## 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>Wednesday:</b>	<u>Consensus</u>
Wholesale Inventories	0.6%
<b>Thursday:</b>	
Trade Balance	-49.9B
Initial Jobless Claims	370k
Monthly Budget Statement	\$30.0bn
<b>Friday:</b>	
Producer Price Index YoY	2.1
U. of Michigan Confidence	76.4

## Key Earnings Announcements

### Monday:

Plains All American Pipeline LP  
Pitney Bowes  
Tyson Foods

### Tuesday:

Walt Disney  
Energy Transfer Partners LP  
XL Group  
Health Care REIT  
Ralph Lauren Holdings

### Wednesday:

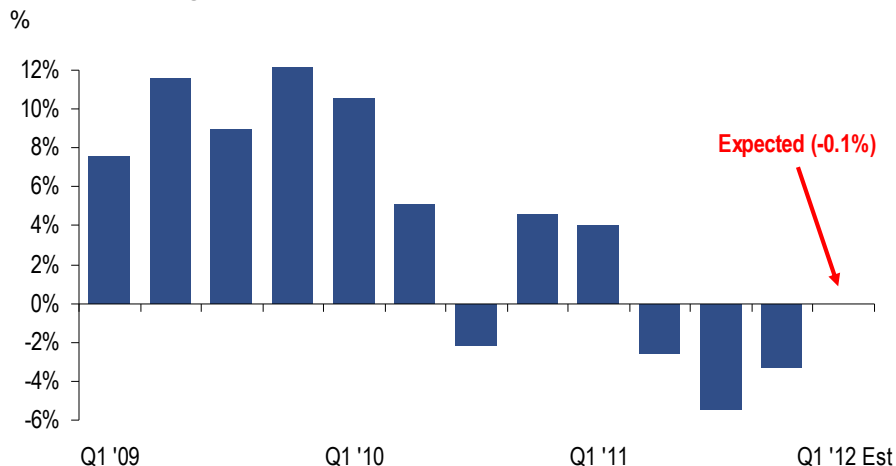
CenturyLink  
Cisco Systems  
News Corp  
Enbridge  
Teva Pharmaceutical Industries Ltd  
BanColombia SA  
Macy's Inc  
EOG Resources  
Boston Properties  
Southern Natural Gas

### Thursday:

ArcelorMittal  
Express Scripts  
Kohl's Corp  
Nordstrom  
Medco Health Solutions  
Westar Energy

strong earnings have benefitted spreads despite an uncertain economic backdrop as the ability to grow earnings and maintain balance sheets has lent support for continued buying.

### S&P 500 Earnings Surprise (Ex Revisions)



Source: Citi Investment Research and Analysis, Bloomberg

### Single Name News and Views

This week **CF Industries** was upgraded to Baa3 / Positive outlook by Moody's, and will now be a constituent of investment grade indices, creating a positive technical and a good relative value opportunity versus other IG chemical credits. We continue to like the name and believe that CF spreads should compress to be in line with the rest of the sector, potentially allowing for a **few more points of upside**.

We've identified a few more candidates that exhibit investment grade credit profiles and may achieve matching ratings over the medium term, and as such suggest buying:

- **TRW** – Recent results beat expectations and the company raised its F12 guidance; net leverage is 0.3x. Bonds currently trade **around 260-290bp** for 5y paper, and this could be one of the first auto suppliers upgraded to IG.
- **Lyondell** – With net leverage of 0.5x, decent earnings and strong liquidity, Lyondell bonds look attractive at spreads around 300bp, especially **when compared to Dow** (Baa3 / BBB, ~150bp). Further, Lyondell should continue to benefit from the depressed natural gas market, as the cost of its ethane inputs are lower and help margins.
- **Seagate** – Q1 earnings came in ahead of estimates, confirming our view that Seagate has the credit profile of an investment grade tech company (net leverage of 0.3x). However, given the company's history of returning value to shareholders and aggressive capex spending, we believe that until the company shows a commitment to more conservative fiscal policies, it is unlikely to receive an upgrade from the rating agencies. However, at **spreads north of 400bp** for 6y paper, STX bonds look attractive versus other IG tech companies.

### Week Ahead

The US economic calendar is light next week. Investors will likely focus on US Wholesale Inventory data for March on Wednesday, with consensus expecting

0.6%, down from 0.9% in February. On Friday, we have the provisional reading of the University of Michigan Confidence Index for May, expected flat at 76.4.

With earnings season largely priced in, the main focus will be an onslaught of European elections. We think the French presidential elections on Sunday carry the most weight with a chance of the French choosing a socialist president. The Greek presidential election, a German state election, and Italian local elections will also take place over the weekend.

On Thursday, the ECB will publish its Monthly Report and the Bank of England will announce interest rates, but no change is expected. Also, the European Commission growth forecasts are due on Friday. One thing to watch out for here are any discrepancies with the growth assumptions in the austerity plans recently submitted to the European Union as this will provide indications about the ability of countries to deliver on their promises.

# Appendix A-1

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