

European Securitized Products Weekly

Correlation, Volatility and Other Reasons to Like Italian RMBS

- **Immunity from Restructuring** — Italian RMBS debt restructuring is unlikely, in our view and we expect senior notes to be money good. In contrast, Citi economists expect that Italian sovereign debt restructuring will probably be inevitable in 2015 — through maturity extensions and/or coupon reductions.
- **Decoupling from Italian Sovereign** — Italian RMBS' correlation with 5YR Italy Sovereign CDS decreased and the correlation with German CDS increased over the last 4–7 months. Higher correlation with German than Italian CDS suggests that Italian RMBS is likely to be more insulated to the political uncertainties facing Italy in 2013.
- **RMBS Volatility Bests Sovereign** — Weekly spread changes of senior Italian RMBS are 20–34% less volatile than 5YR Italian sovereign CDS. We think that investing in Italian RMBS is a good defence against the uncertainties facing the Italian sovereign debt markets.

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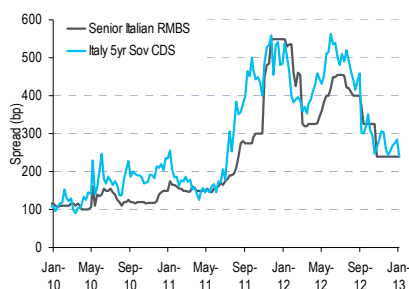
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 1. Italian RMBS and 5YR Sovereign CDS Spreads, Jan 10 – Jan 13 (bp)



Source: Markit and Citi Research

Survey of Relative Value

Italian RMBS is one of our top three calls for 2013¹ and this report examines why we think investing in Italian RMBS is a better strategy than investing in the sovereign. While Italy faces numerous political uncertainties, the Italian RMBS market in contrast, presents a strong fundamental story. The senior Italian RMBS/Italian sovereign CDS spread differential has been stable for the last three years, and current differentials are at par which is attractive to historical differentials (Figure 1). Investing in Italian RMBS is a good defence against the uncertainties facing the Italian sovereign debt markets for the following reasons, in our view:

- **Immunity from Restructuring.** Italian RMBS debt restructuring is unlikely, in our view and we expect senior notes to be money good. In contrast, Citi economists expect that Italian sovereign debt restructuring will probably be inevitable in 2015 — through maturity extensions and coupon reductions².
- **Prepayment Upside.** At a typical 10% CPR, we estimate that the most senior RMBS class could pick up 10–30bp. Italian RMBS have been prepaying at an extraordinarily low 4% CPR area. Sovereign debt restructuring would potentially pave the way for new bank lending, benefitting the residential mortgage sector and accelerating prepayments. Moreover, prepayments have more upside than downside from the current low CPR levels, in our view.
- **Favorable Volatility and Correlation Comparisons.** Italian RMBS demonstrate lower historical spread volatility than Italy's 5YR sovereign CDS. In addition, the correlation of Italian RMBS has diverged strikingly from Italian sovereign CDS for the last four months. This suggests to us that future sovereign debt CDS widening may have a relatively muted effect on Italian RMBS spreads.
- **Strong Fundamental Resi Collateral.** The fundamentals of Italian RMBS are strong as LTVs are low (averaging 56% LTV). Moreover, house prices did not inflate during the bubble years. We prefer deals with greater exposure to Northern Italy because of very long recovery timelines in southern Italy. Average recovery lag for northern Italy is around 3 years while the same for southern Italy is about 9 years.

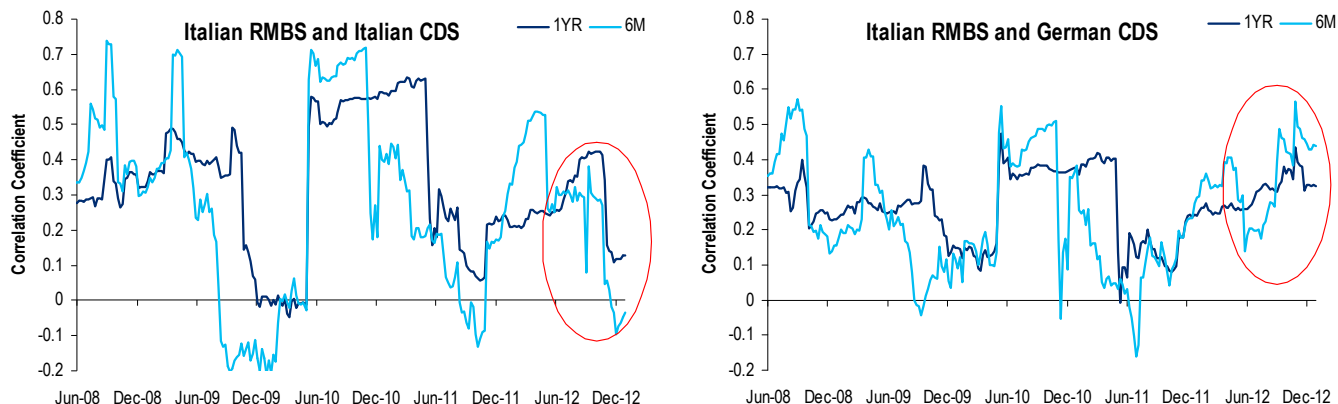
Correlations Show Divergence between Italian RMBS and Sovereign

- **Decoupling from Italian Sovereign.** The correlation between Italian RMBS and 5YR Italy Sovereign CDS has been decreasing since September 2012. Both 1YR- and 6M-rolling correlation coefficients precipitated during the last four months (left chart of Figure 2), suggesting that the market probably has started appreciating the value in quality of RMBS collateral.
- **Correlation with Germany Increasing.** Interestingly, the correlation between Italian RMBS and 5YR German CDS has been increasing since May 2012 (right chart of Figure 2). Higher correlation with German CDS than with Italian CDS further suggests that Italian RMBS is likely to be more insulated to the political uncertainties facing Italy in 2013.

¹ ["Global Securitized Products Strategy: The 2013 European Securitized Products Outlook"](#), Citi, 12 December 2012

² ["Global Economic Outlook and Strategy: Prospects for Economies and Financial Markets in 2013 and Beyond"](#), Citi, 26 November 2012

Figure 2. 1YR and 6M Rolling Correlation of Senior Italian RMBS with 5YR Italian and German Sovereign CDS, Jun 08 – Dec 12

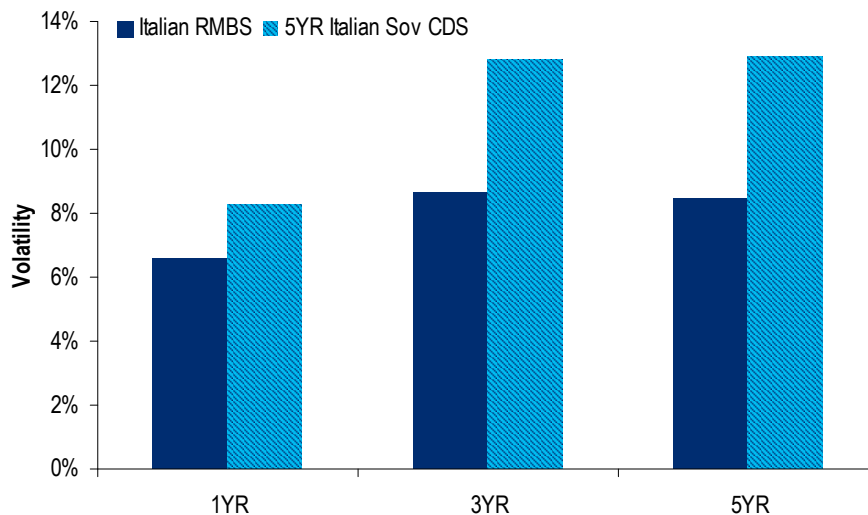


Source: Markit and Citi Research

RMBS Volatility Bests Sovereign

- **Lower Historical Volatility.** 1YR, 2YR and 3YR volatilities of weekly spread changes of senior Italian RMBS are all lower than corresponding volatility of 5YR Italian sovereign CDS (Figure 3).

Figure 3. 1YR, 3YR and 5YR Rolling Volatility of Weekly Spread Changes for Italian RMBS and 5YR Sovereign CDS, as of 4 Jan 2013 (%)



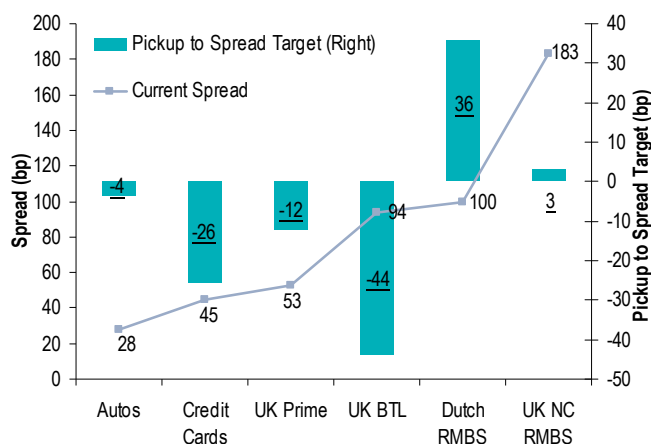
Source: Markit and Citi Research

Relative Value Framework

Pickups to Spread Targets

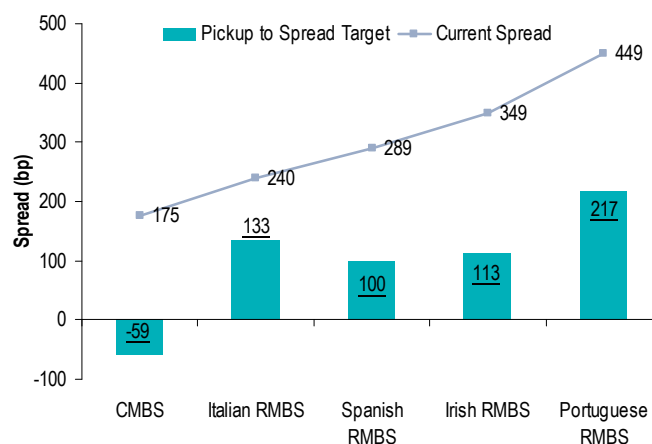
- **Dutch RMBS Offers Pickup.** Dutch RMBS picks up 36bp to our long term spread targets (Figure 4). However, we think that ongoing austerity measures and reduction in tax deductibility of mortgage payments are negative for the housing market. We recommend market weighting senior Dutch RMBS and underweighting subordinates.
- **Italian RMBS Attractive.** Italian RMBS, at EURIBOR +240bp trades 133bp wide to our long term spread target (Figure 5). As discussed earlier in this report, we see Italian RMBS fundamentals as attractive. The sector tightened 75bp in 4Q 2012 and we expect this tightening to continue in 2013.
- **UK Prime Expensive to Spread Targets.** UK prime RMBS spreads are 12bp tighter to their long term spread targets. However, we think that positive technicals due to Bank of England's Funding for Lending Scheme (FLS) will provide strong support to the spreads in 2013.
- **Autos Fairly Valued.** At 28bp, 2YR autos trade roughly in line with their long-term spread targets. Strong demand for high quality and short duration European autos is expected to support auto spreads going forward, in our view.

Figure 4. Core Sectors Spread Pickup to Spread Targets, as of 4 Jan 2013 (bp)



Source: Citi Research

Figure 5. CMBS and Peripheral Sectors Spread Pickup to Spread Targets, as of 4 Jan 2013 (bp)

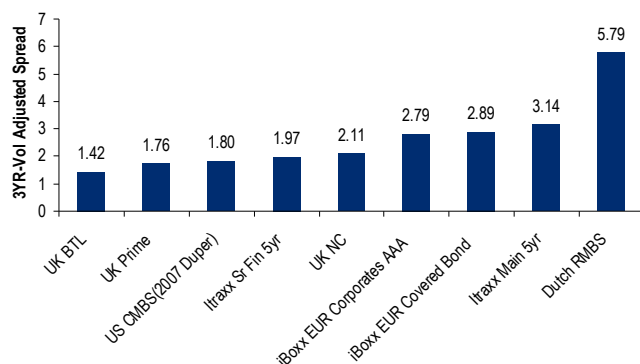


Source: Citi Research

Volatility Adjusted Spread Multiples

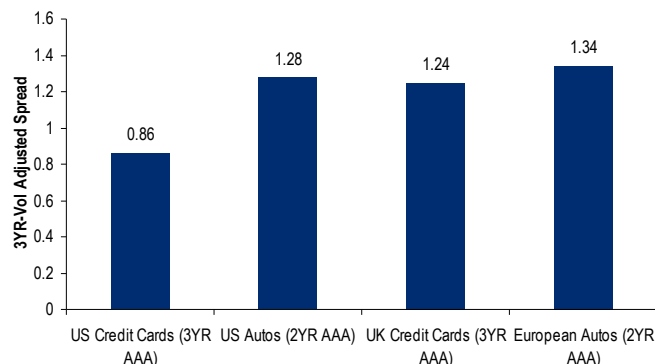
- **Dutch RMBS Most Attractive.** Dutch RMBS is the most attractive sector on a volatility adjusted spread basis. The sector has a volatility adjusted spread multiple of 5.79, the highest among the European credit sectors (Figure 6).
- **European Autos and Credit Card ABS Best US.** UK credit card's 3YR volatility adjusted spread multiple at 1.22 and European auto ABS' multiple at 1.34 are slightly higher than the corresponding multiples for their US counterparts at 1.30 and 1.28 respectively (Figure 7). Moreover, European autos and credit cards offer pickups of 20bp and 33bp, respectively, to their US counterparts.

Figure 6. Selected RMBS and Credit Sector Vol Adj Spread Multiples Comparison, as of 4 Jan 2013



Source: Markit and Citi Research

Figure 7. Core US-UK Sector Vol Adj Spread Multiples Comparison, as of 4 Jan 2013

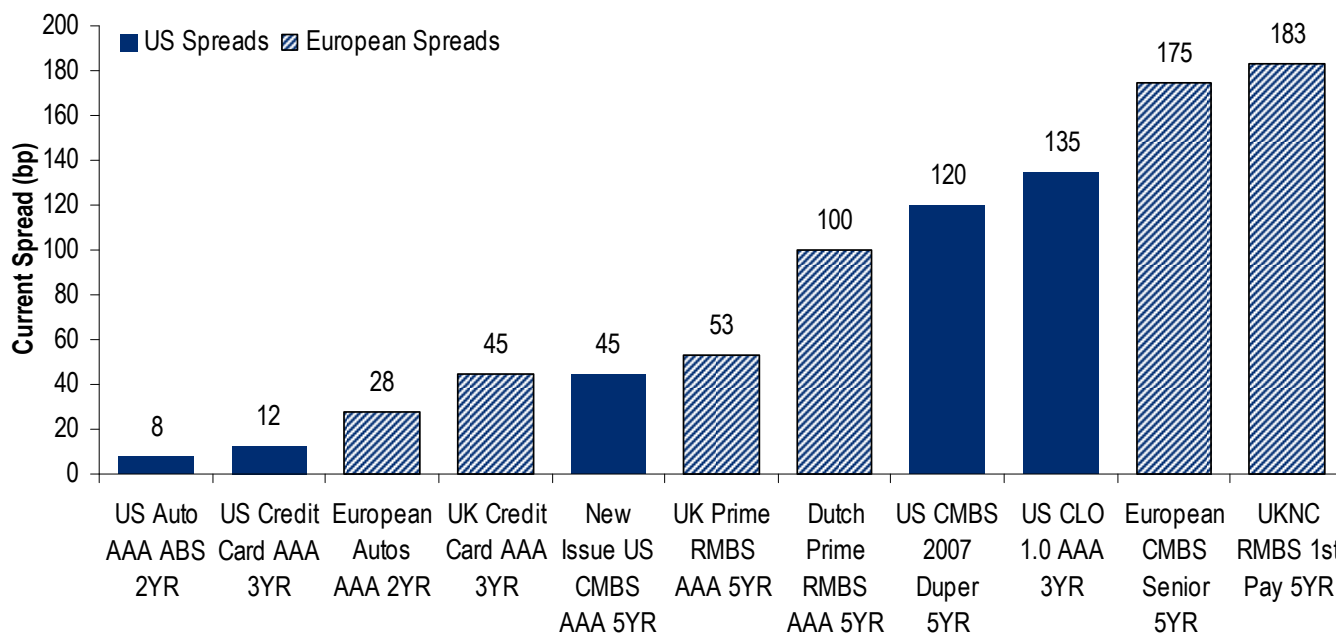


Source: Citi Research

European Securitized Attractive to US

- **Pickup to US Securitized.** European securitized products look very cheap compared to US. For example, UK prime RMBS triple-A trades 8bp wide to new issue US CMBS triple-A spreads (LIBOR + 45bp). UK non-conforming RMBS (EURIBOR +183bp) and European CMBS (EURIBOR +175bp) offer attractive pickups to 5YR US CMBS Duper and 3YR Triple-A US CLO 1.0 (Figure 8).
- **Credit Cards and Autos Cheaper.** UK credit cards (EURIBOR + 45bp) and European Autos (EURIBOR+28bp) offer pickups of 33bp and 20bp respectively to their US counterparts.

Figure 8. Selected Securitized Product Spreads to SWAPS, LIBOR and EURIBOR Comparisons, as of 4 Jan 2013 (bp)



Source: Citi Research

Summary of Recommendations

Looking ahead to 2013, we recommend a credit barbell strategy but with greater exposure to high yield peripherals and other high quality alternative to UK prime RMBS. European securitized products remain favourable in comparison to US sectors, despite the strong rally in recent months. We think the search for additional yield will drive peripheral spreads tighter in 2013 and strong technicals will support core sector spreads at current tight levels.

We outline our recommendations below in Figure 9.

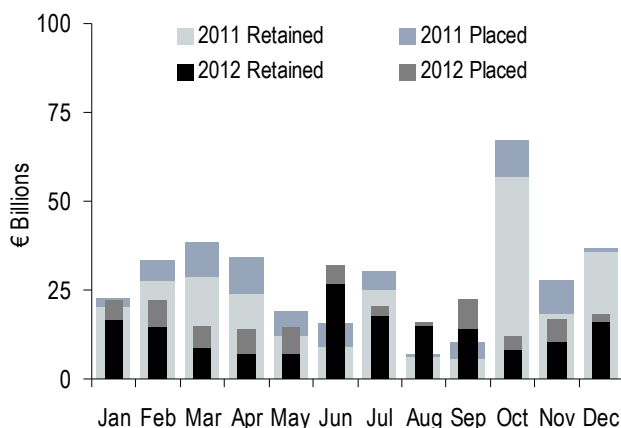
Figure 9. European Securitized Products Sector Recommendations

Category	Sector	Senior	Subordinate	Comments
Top Calls				
	Italian RMBS	Overweight	Overweight	Low LTVs, relatively low house price declines, and positive net mortgage lending
	UK Credit Cards	Overweight	Overweight	Short WAL, attractive pickup to comparable US credit cards with equivalent credit performance
	UK BTL RMBS	Overweight	Overweight	Strong fundamentals like rising rents and falling homeownership, supported by low interest rates
Core				
	UK Prime RMBS	Marketweight	Marketweight	Favourable technicals to support spreads
	UK NCRMBS	Marketweight	Underweight	Credit performance likely to deteriorate fast when interest rates rise but we think seniors are well protected
	Dutch RMBS	Marketweight	Underweight	Falling house prices and rising unemployment a concern but strong demand for core RMBS a positive
	Australian RMBS	Overweight	Marketweight	Credit performance better than UK prime RMBS, low doc loans potential concern for subordinates
	Autos	Overweight	Overweight	Short duration, high quality. Very few comparable short and high quality credit alternatives to this sector
Peripherals				
	Irish RMBS	Marketweight	Underweight	Very high indexed LTVs to impact subordinate recoveries but tender likelihood to support spreads
	Portuguese RMBS	Marketweight	Underweight	No major housing boom but high unemployment and negative economic growth outlook a concern
	Spanish RMBS	Marketweight	Underweight	Further house price drop likely but bad bank plan and possibility of tenders overall positive for the sector
Other				
	CMBS	Marketweight	Underweight	Seniors are protected but a large maturity pipeline in 2013 and beyond to impact recoveries
	Pubs	Underweight	Underweight	This sector requires in-depth bespoke corporate analysis

Source: Citi Research

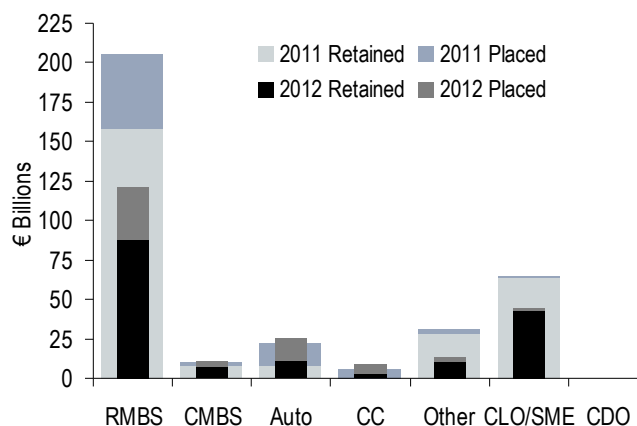
New Issuance

Figure 10. Placed and Retained Issuance by Month, 2011–2012 (€ billions)



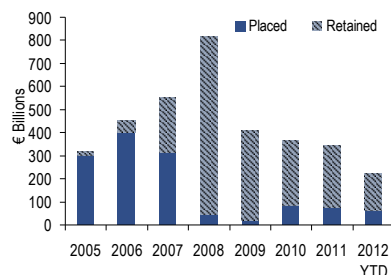
Source: Concept ABS, IFR, Informa and Citi Research

Figure 11. Placed and Retained Issuance by Sector, 2012 (€ billions)



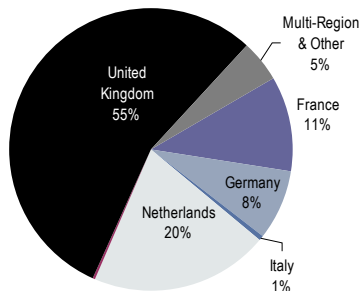
Source: Concept ABS, IFR, Informa and Citi Research

Figure 12. Annual Historical Placed and Retained Issuance, 2005–2012 (€ billions)



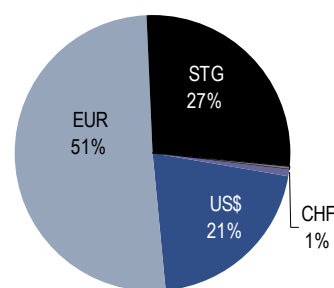
Source: Concept ABS, IFR, Informa and Citi Research

Figure 13. Placed Issuance by Region, 2012 (% of Total, € Equivalent)



Source: Concept ABS, IFR, Informa and Citi Research

Figure 14. Placed Issuance by Currency, 2012 (% of Total, € Equivalent)



Source: Concept ABS, IFR, Informa and Citi Research

Figure 15. Placed and Retained Issuance by Sector, 2011 and 2012 (€ million)

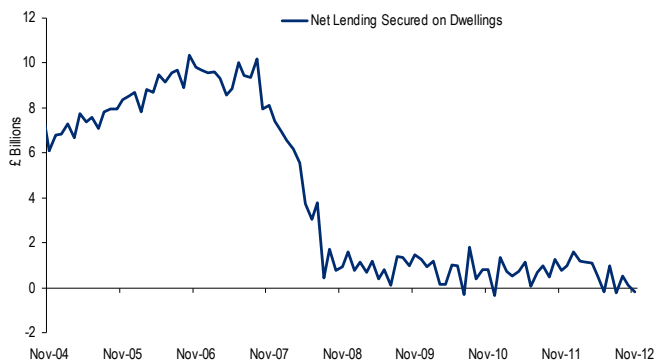
	RMBS		CMBS		Autos		Credit Card ABS		CLO/SME		Other		Total	
	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011
Placed	33,928	47,014	3,936	1,600	13,921	14,392	5,591	6,140	990	1,342	3,459	3,031	61,825	73,518
Retained	87,137	158,766	7,460	8,569	11,364	7,977	3,067	177	42,879	63,262	10,145	28,614	162,052	267,365
Total	121,065	205,780	11,395	10,169	25,285	22,368	8,658	6,317	43,869	64,604	13,604	31,645	223,877	340,883

Source: Concept ABS, IFR, Informa and Citi Research

Collateral and Macro Trends

UK

Figure 16. Net Lending Secured on Dwellings, Nov 04 – Nov 12



Source: Bank of England and Citi Research

- Net lending secured on dwellings dropped to -£169 million in November from £111 million in the previous month
- Net lending secured on dwellings has been in a narrow range of -£0.22billion — £1.17 billion since the crisis

UK

Figure 17. Bank of England Mortgage Approvals, Nov 04 – Nov 12

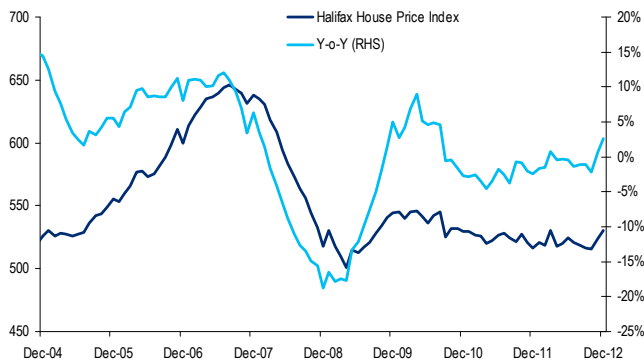


Source: Bank of England and Citi Research

- Mortgage approvals increased to 54,036 in November 2012 from 53,071 in the previous month
- November was the fifth consecutive month of increase in mortgage approvals which remain 57% below the pre-crisis peak level of November 2006

UK

Figure 18. Halifax House Price Index, Dec 04 – Dec 12

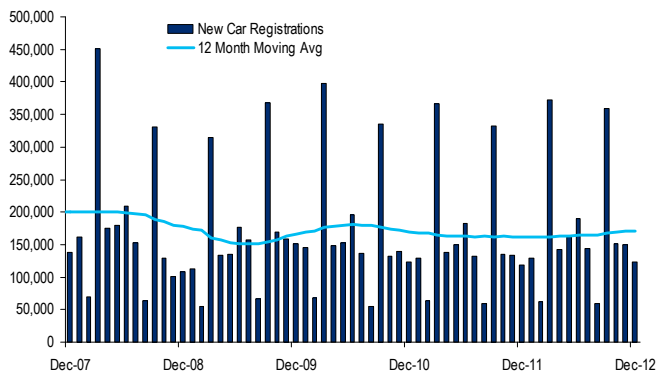


Source: Lloyds TSB and Citi Research

- Halifax house price index increased to 530.3 in December 2012 from 523.6 in the previous month
- Average UK house prices increased 2.7% year-over-year in December 2012 but remain 17% below the pre-crisis peak of August 2007

UK

Figure 19. New Car Registrations, Dec 04 – Dec 12

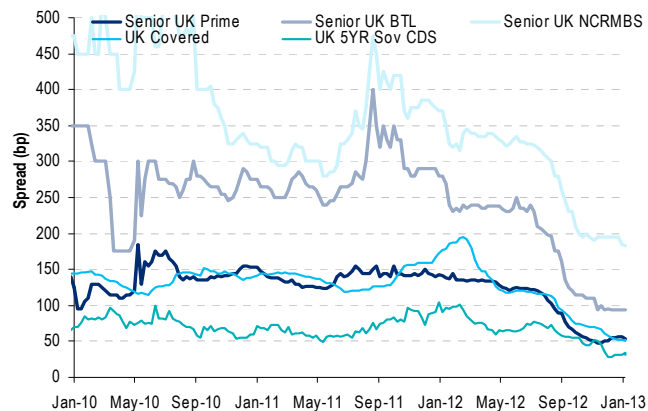


Source: Society of Motor Manufacturers and Traders and Citi Research

- New car registrations declined to 12,560 in December 2012 from 149,190 in the previous month, but were up 3.6% year-over-year
- 12-month moving average of new car registrations increased for the tenth consecutive month to 170,382 in December

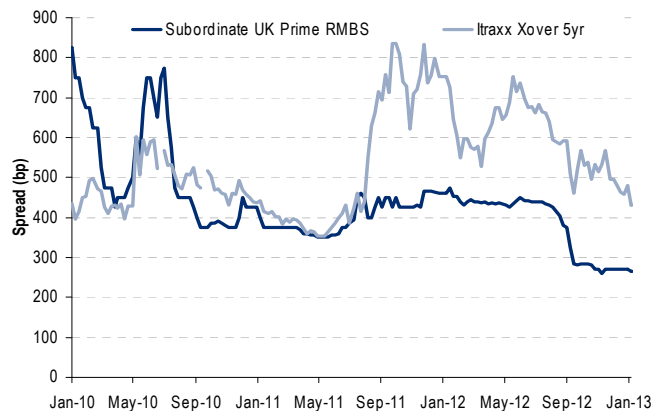
Relative Value Charts

Figure 20. UK RMBS Seniors Versus Indexes, Jan 10 – Jan 13



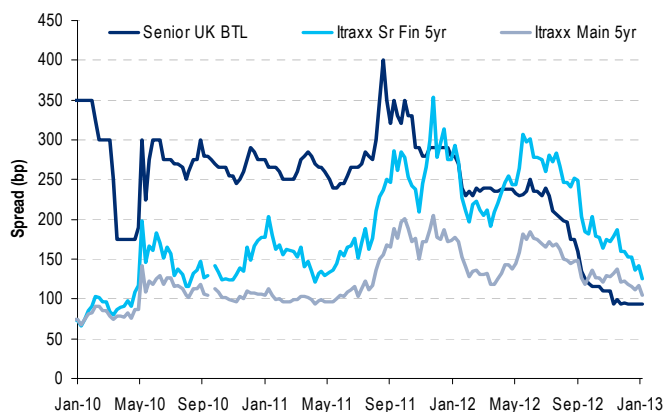
Source: Markit and Citi Research

Figure 21. UK Prime RMBS Subordinates Versus Index, Jan 10 – Jan 13



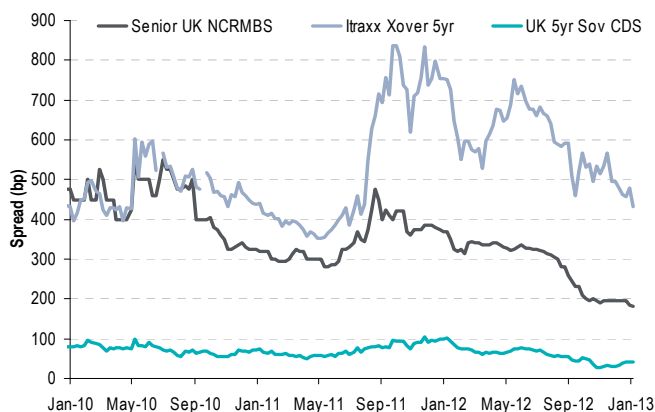
Source: Markit and Citi Research

Figure 22. UK BTL RMBS Seniors Versus Indexes, Jan 10 – Jan 13



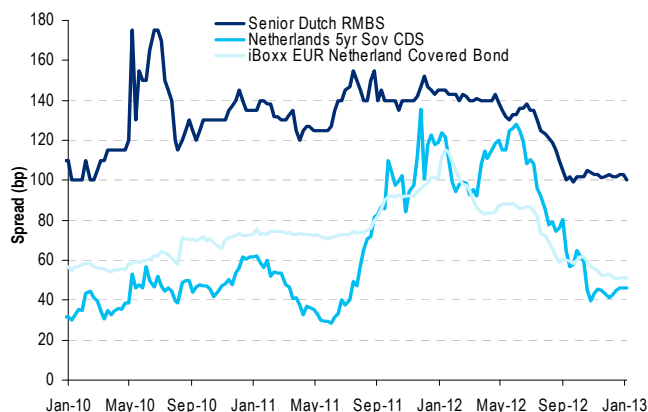
Source: Markit and Citi Research

Figure 23. UK NCRMBS Seniors Versus Indexes, Jan 10 – Jan 13



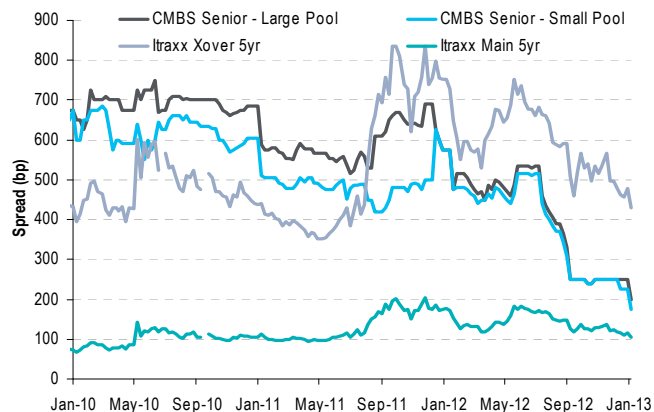
Source: Markit and Citi Research

Figure 24. Dutch RMBS Seniors Versus Indexes, Jan 10 – Jan 13



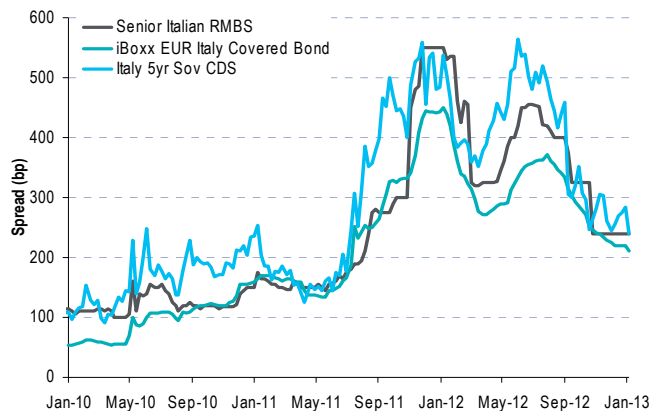
Source: Markit and Citi Research

Figure 25. CMBS Senior Spreads Versus Indexes, Jan 10 – Jan 13



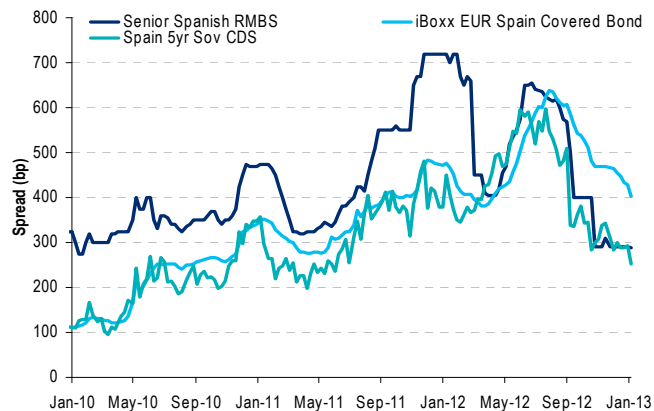
Source: Markit and Citi Research

Figure 26. Italian RMBS Seniors Versus Indexes, Jan 10 – Jan 13



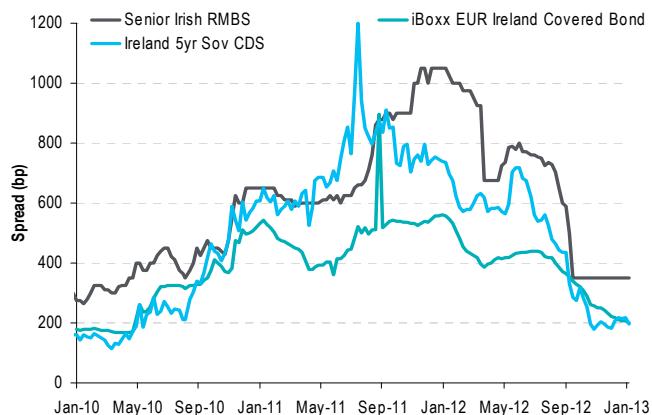
Source: Markit and Citi Research

Figure 27. Spanish RMBS Seniors Versus Indexes, Jan 10 – Jan 13



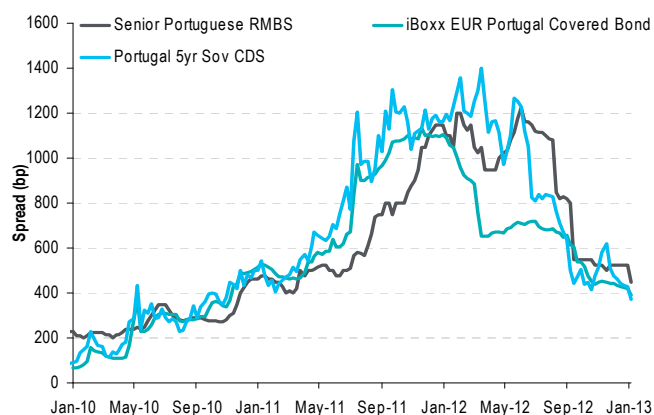
Source: Markit and Citi Research

Figure 28. Irish RMBS Seniors Versus Indexes, Jan 10 – Jan 13



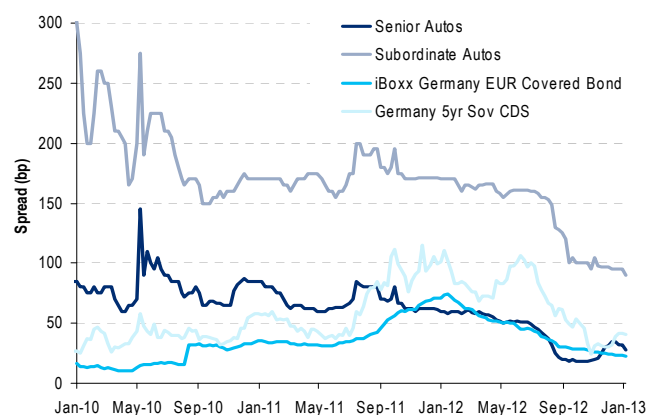
Source: Markit and Citi Research

Figure 29. Portuguese RMBS Seniors Versus Indexes, Jan 10 – Jan 13



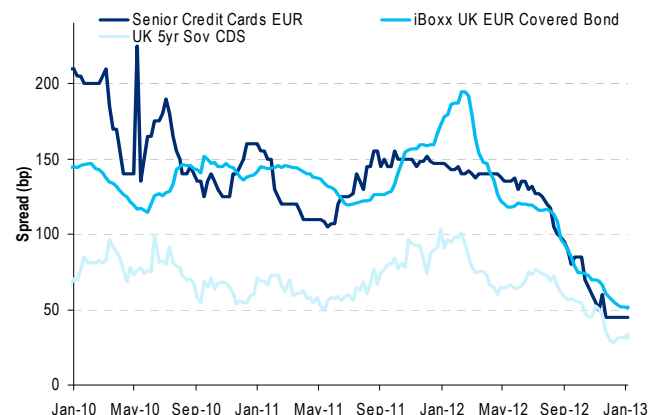
Source: Markit and Citi Research

Figure 30. Auto ABS Spreads Versus Indexes, Jan 10 – Jan 13



Source: Markit and Citi Research

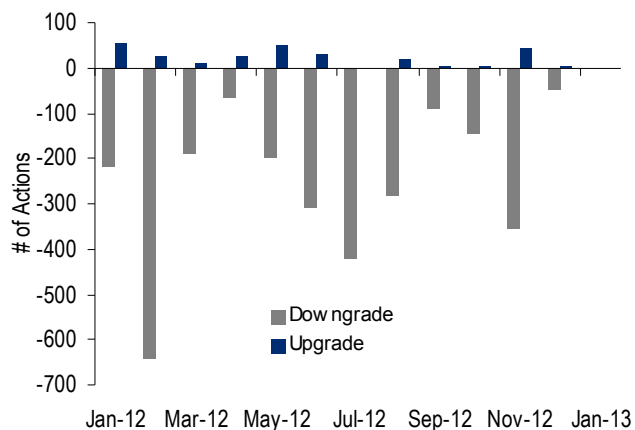
Figure 31. Credit Card ABS Spreads Versus Indexes, Jan 10 – Jan 13



Source: Markit and Citi Research

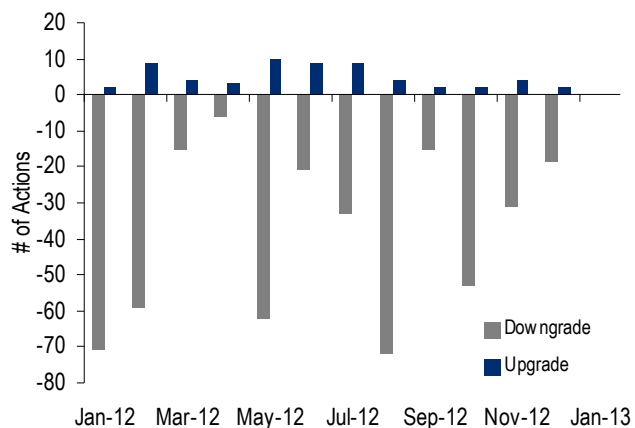
Rating Actions and Trends

Figure 32. European RMBS Rating Actions, Jan 12 — Jan 13



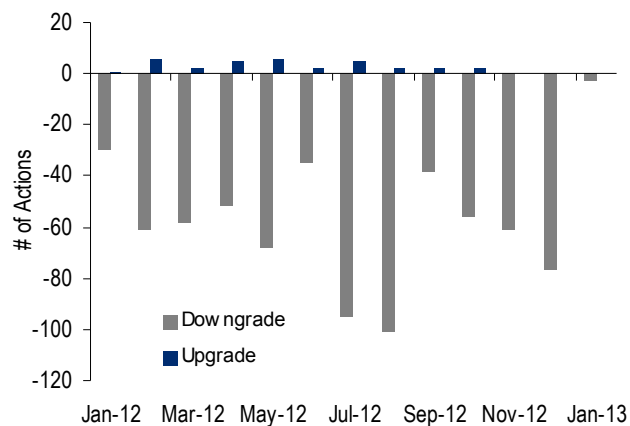
Source: Moody's, S&P and Fitch

Figure 34. European ABS Rating Actions, Jan 12 — Jan 13



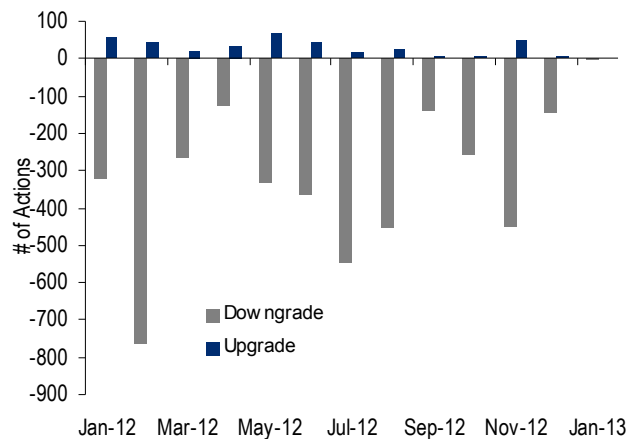
Source: Moody's, S&P and Fitch

Figure 33. European CMBS Rating Actions, Jan 12 — Jan 13



Source: Moody's, S&P and Fitch

Figure 35. European Total Securitized Products Rating Actions, Jan 12 — Jan 13



Source: Moody's, S&P and Fitch

Appendix A-1

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