US CreditBrief

January ’14: No steam for the new year?

- **BIG Corporate widened 3bp in January to 116bp**— It looks like we were right to worry that December’s rally wouldn’t leave much juice to drive January performance. While credit performance started the month muted, risk aversion driven by the combination of mediocre earnings, the start of Fed tapering, and EM weakness drove credit wider in the last two weeks of January.
- **Underperformance was skewed towards sectors with large complexes and high EM exposure**—Financial Services (+12bp), basic materials (+7bp), energy (+7bp), banks (+5bp), and telecom & media (+5bp) underperformed in January. Posting strong earnings, the relatively small REIT sector outperformed all other sectors as it tightened 9bp in January.
- **The view in brief**—Although the news flow would suggest that de-risking is well along its way, the fact is cash spreads haven’t given up much ground this year, and we worry the positioning shake-out still has room to run. With that said, we would rather stay neutral for now and focus on swapping out lower liquidity debt for on-the-run benchmark names that have taken a beating. Longer term, we worry that valuations look too full given Fed tapering and corporate releveraging.

Sonam T Pokwal
+1-212-723-3807
sonam.t.pokwal@citi.com

Jason Shoup
+1-212-723-6147
jason.b.shoup@citi.com

Swati Verma
+1-212-723-3554
swati1.verma@citi.com

Figure 1. High grade OAS performance over January 2014, in bp

	Current	Last Month	Spread Change	
	31-Jan-14	31-Dec-13	Absolute	Relative
BIG Corp	**116**	**113**	**3**	**3%**
IG21	**72**	**62**	**9**	**15%**
Financials	**110**	**105**	**5**	**5%**
REITs	134	143	-9	-6%
Insurance	121	117	5	4%
Banks	99	94	5	5%
Financial Svc.	122	110	12	11%
Non-financials	**119**	**116**	**2**	**2%**
Utilities	119	121	-2	-2%
Industrials	108	108	0	0%
Consumer Goods	91	91	0	0%
Healthcare	85	84	1	1%
Technology	95	93	3	3%
Consumer Svc.	109	106	3	3%
Telco & Media	149	144	5	4%
Energy	137	131	7	5%
Basic Materials	161	154	7	4%

Source: Citi Research, Yieldbook

Broad market trends and events

- In stark contrast to December, Citi's Broad Investment Grade Corporate Index backed up 3bp in January. While credit performance started the month muted, risk aversion driven by the combination of mediocre earnings, the start of Fed tapering, and EM weakness drove credit wider in the last two weeks of January.

- The risk-off environment that defined the latter portion of the month was triggered by a combination of a drop in HSBC China Flash PMI to a 6 month low of 49.6, and reports of an impending default of a Chinese wealth management product. But these were more the straws that broke the camel's back than the sole drivers of weakness. Indeed, the vulnerability of China's debt-fueled growth had been an ongoing concern throughout 2013.

- Fears about China quickly grew into broader EM fears. In particular, investors had turned their focus to EM sovereigns with large current account deficits most vulnerable to capital flight. The Argentinian Peso sold off 14% against the US-dollar promptly after the central bank lifted capital controls and feared the nation was running out of dollar reserves intensified. The central banks of both Turkey and South Africa hiked rates in an attempt to stem their rapidly deteriorating currencies, only to find their efforts had limited impact.

- Once again, the IG21 index underperformed cash markets, widening 9bp in January. As we argued in last month's **US CreditBrief**, we suspect that margin requirements and a lack of synthetic structured credit activity contribute to a structural floor around ~60bp. In our view, the lack of upside combined with the fact that the derivative index provides a way for investors to quickly dump long exposure into a liquid market drove the underperformance of IG21.

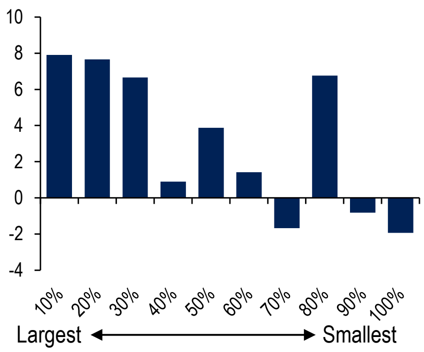
- The "sell what's liquid" theme also drove the underperformance of larger issuers (see **"Small is Beautiful"**). Figure 2 shows that the largest 30% of the BIG Corporate Index sold off an average 6-8bp, or at least twice as much as the overall index.

- Investment grade corporate bond TRACE volumes totaled $301bn in January, leaving no doubt that the selloff was more than just quote driven. But the proportion of client buys to sells did not jump lower this month, suggesting the selloff thus far has been anything but panicked (Figure 3). The results of our **monthly client survey** agrees. It shows that positioning hasn't deteriorated all that much since December.

- While headlines have focused predominantly on EM, we suspect that a mediocre earnings season is at least partly to blame for January's weakness in credit. True, a cursory glance at 4Q earnings suggests that 4Q has in fact been better than analyst expectations. But look a little further, and you'll see that the proportion of companies reporting guidance below consensus has spiked in the last month. Just the same, the proportion guiding above consensus have dropped (Figure 4).

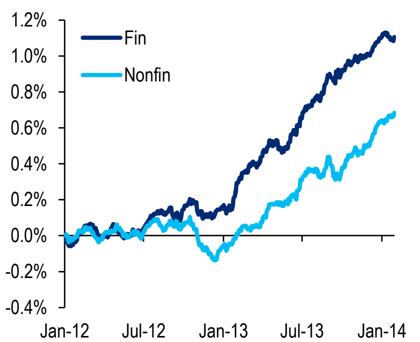
- Starting with a drop in nonfarm payrolls at the beginning of the month, January economic data was far less supportive of QE tapering compared to December. Home sales, durable goods orders, vehicle sales, and University of Michigan Confidence, all failed to meet market expectations. However, many attribute the disappointing data to December's incremental weather, and the Fed tapered QE to $65bn per month regardless.

Figure 2. January spread performance by size split into deciles, in bp



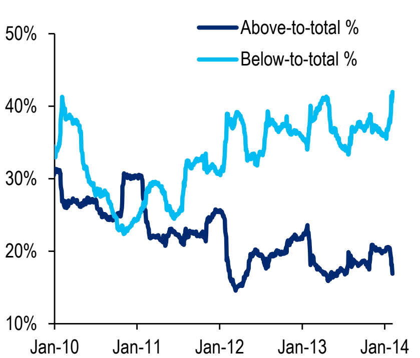
Source: Citi Research

Figure 3. IG client net-buy volume, cumulative since Jan '12 as a % of outstanding



Source: Citi Research, TRACE

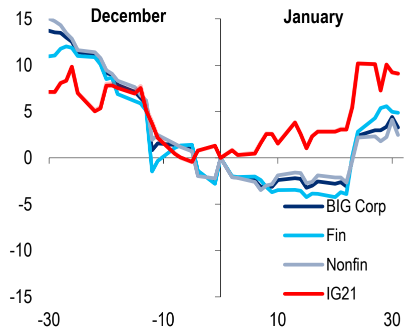
Figure 4. Percent of companies guiding above/below consensus, in a rolling 3-mo period



Source: Citi Research, TRACE

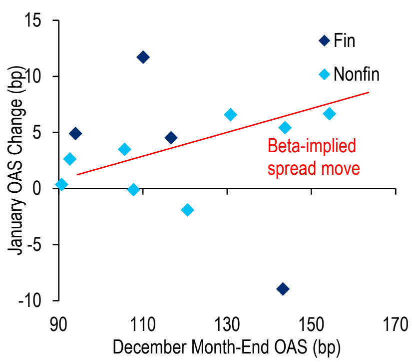
Sector performance

Figure 5. High grade spread performance, in bp since December 31th



Source: Citi Research

Figure 6. January spread performance vs. level, in bp



Source: Citi Research

- While the results of our **credit survey** suggest that long positions in high-beta sectors remained intact while lower beta positioning were pared back, price action in January suggests the contrary. Figure 6 illustrates that, if anything, higher beta sectors actually underperformed.

- To our minds, the factors that best explain outperformance was small-size and low liquidity. The REITs sector is very well characterized by both these attributes, and as such, it's no surprise that the sector led all others, ending January 9bp tighter. The sector also benefitted from being an underperformer in 4Q, as well as from notably strong earnings—rent growth has returned to REITs for the first time since 2007. Simon Properties Group (SPG) was one of the best performers in the space, tightening 16bp on the back of a big earnings beat, a particularly strong occupancy rate, and strong 2014 guidance. DDR Corp and Kimco Realty (KIM) were close seconds, both tightening 15bp each.

- Other financials didn't fare as well in January as REITs did. Banks and financial services widened 5bp and 12bp, respectively. Both sectors (but Banks in particular) had a very strong run in 2013, and as such were among the most vulnerable to a selloff. Despite the relatively strong earnings among money center banks, these credits remained a victim of their liquidity. Goldman Sachs (GS), JPMorgan (JPM), and Bank of America (BAC) each sold off 8-10bp in January. Yankee banks didn't fare much better in the global risk-off environment—the particularly high exposure of HSBC to emerging markets put the bank on particularly weaker footing (+14bp). But one of the worst performing credits in the bank/fin services space was SLM Corp, which widened 35bp on the back of the combination of a big earnings miss and talk of a potential student loan reform bill.

- Basic materials was one of the worst performing nonfinancial sectors, backing up 7bp in January. Underperformance was driven primarily by a number of large credits with substantial operations in Latin America, including Southern Copper (SCCO), which gapped out 30bp in January. Worse still was Cliff Natural Resources (CLF), which widened 78bp on the back of activist intervention. Casablanca Capital took a 5% interest in the company and has been pushing for a spin-off of the international business and converting the US business into an MLP—actions that could deteriorate Cliff's balance sheet and put its IG rating at risk.

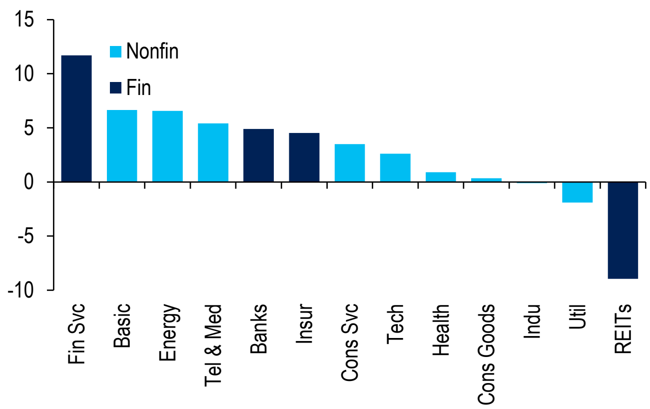
- Energy (+7bp) tied basics for the worst performing nonfinancial sector in January. And like basics, underperformance was led by EM credits, or credits with high EM exposure. Ecopetrol (ECOPET), Petrobras (PETBRA), and CNOOC (CNOOC Ltd) widened 38bp, 32bp, and 20bp, respectively. Transocean (RIG) was an outlier among US credits, widening 22bp on the back of activist pressures. Weatherford's 11bp backup on the other hand, was a result of disappointing forward guidance.

- Telecom and media widened 5bp in January. Like banks, the sector contains large benchmark issuers which are prone to be used as risk-reduction tools. As a result, it's no surprise to us that AT&T (T) and Verizon (VZ) underperformed their peers, backing up 9bp and 10bp in January, respectively. Elsewhere, acquisition-related headlines continue to dominate. But at least for the next six months, an AT&T-Vodafone deal is off the table as AT&T said it has no plan to make a bid for Vodafone (VOD) in a response to a request from the UK takeover panel.

- Tech only backed up 3bp in January, but thanks to sizeable cash-piles for many companies in this sector, we nevertheless saw lots of noise from the activist community. Icahn continues to pressure Apple (AAPL), and Elliott continues to do the same for Juniper (JNPR). The credits are 7bp and 16bp wider, respectively. Besides these two credits, underperformance within the sector came from mediocre earnings. IBM saw little-to-no EPS growth after adjusting for buybacks and cost cutting, while Motorola Solutions (MSI) suffered from weak 1Q guidance. Both credits widened 7-8bp as a result.

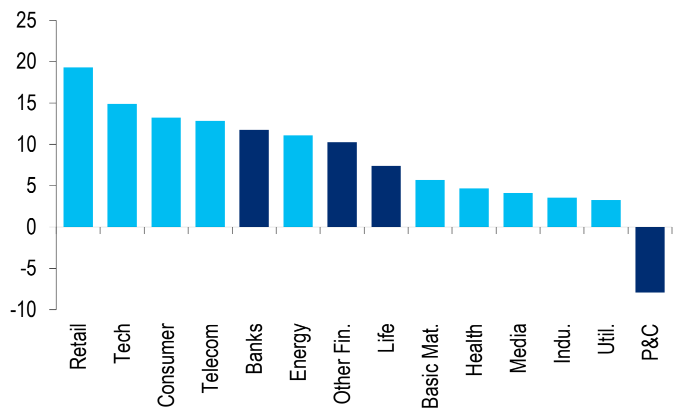
- Consumer goods was flat in January, ranking it among the best performing nonfinancial sectors. With that said, the sector has seen a flurry of takeovers in the beverage space. One of the worst performing credits this month was Beam Inc (BEAM), which widened 23bp on Suntory Holding's (SUNTZ) announcement that it would be taking over the company.

Figure 7. Jan '14 cash sector performance*, in bp



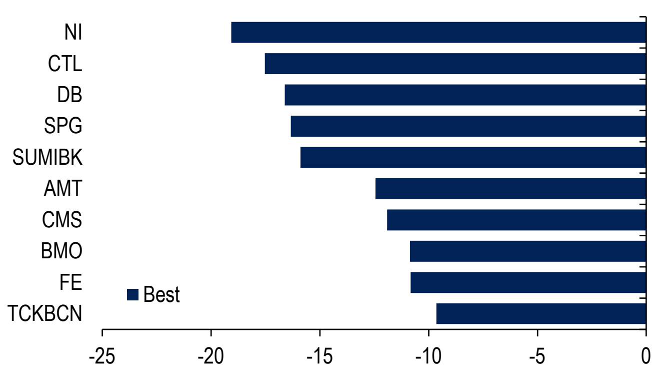
Source: Citi Research
*Citi BIG Corp index universe constituents used for calculations.

Figure 8. Jan '14 CDS sector performance*, in bp



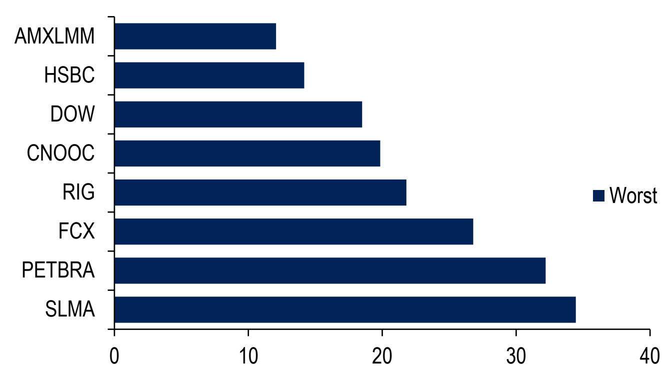
Source: Citi Research"
*The sectors above include all IG20 constituents plus the 6 primary US banks.

Figure 9. Best OAS performers in Jan '14*, in bp



Source: Citi Research
*OAS change in January '14 of all index-eligible debt. The credit must have at least $5bn of index-eligible debt and have seen $250mn+ trades in the past 3 months.

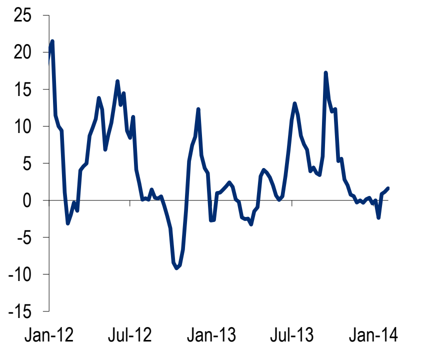
Figure 10. Worst OAS performers in Jan '14*, in bp



Source: Citi Research
*OAS change in January '14 of all index-eligible debt. The credit must have at least $5bn of index-eligible debt and have seen $250mn+ trades in the past 3 months.

Supply: decline YoY, but not light

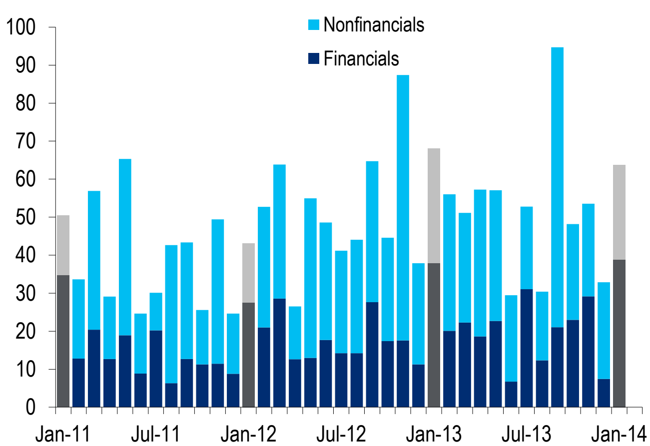
Figure 11. IG New issue concessions, 30-dma in bp



Source: Citi Research

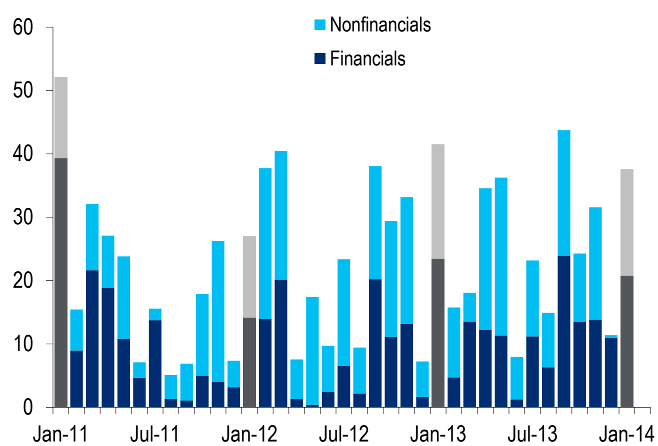
- We forecasted in December that investment grade corporates would issue $940bn this year. The $101.3bn of new issuance in January (split $59.6mn in financials and 41.7mn in nonfinancials) amounts to 11% of this target, and establishes a pace consistent with our forecast.
- But while a $100bn-plus supply month is nothing to balk at, the pace of issuance has pared back nearly 8% year-over-year. It is no surprise that this reduction in supply is skewed heavily towards nonfinancials (-13% YoY), which tend to approach issuance in a more opportunistic fashion.
- Foreign issuers also came to market with less debt (-10% YoY) than they did a year ago. We suspect that this is the result of dollar-funding becoming more expensive and the cross-currency basis swap normalizing, as we discussed in our **supply outlook**.
- New issue concessions continue to be low in January, averaging ~2bp over the last 30 days. New issue concessions were worse after EM-fears took hold mid-month, particularly for non-US issuers and banks. Orange SA (ORAFP), Toyota Motor (TOYOTA), and Morgan Stanley (MS) suffered some of the highest concessions—18bp, 16bp, and 13bp, respectively.

Figure 12. Domestic issuer supply, in $bn



Source: Citi Research, Dealogic

Figure 13. Non-US issuer supply, in $bn



Source: Citi Research, Dealogic

Appendix A-1

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