

US Credit Outlook

Back to work, back to reality

- We expect the remainder of the year will be challenging to navigate for investors – starting with an eventful September in Europe and concluding with the resolution to the ‘fiscal cliff’ and, perhaps, ‘Grexit’.
- The Fed and the ECB seem committed to prolonging the rally, but, if history is any guide, their efforts may prove to be a disappointment to markets, which have already run up in advance.
- Second quarter earnings have left much to be desired from the fundamental perspective, and, unless estimates are cut in the coming months, the fourth quarter could be a repeat experience. Longer term, we believe fiscal consolidation will likely impact balance sheets, revenues, and, ultimately, the technicals.
- Central bank easing is modifying the risk-reward across multiple asset classes. We’d be wary of assets that fall in the middle of the risk spectrum. These assets have been bid up to levels that make them uneconomic for many buyers over a longer-term investment horizon once inflation is taken into consideration.
- The timing of this summer’s rally was somewhat surprising to us, but now that valuations are back to the tights of the year, we’d exercise far more caution going forward. To our minds, a modest pullback seems quite likely over the next four months. Underweighting triple-Bs and financials seems like the least nuanced way to drive outperformance.

High Grade Credit Strategy

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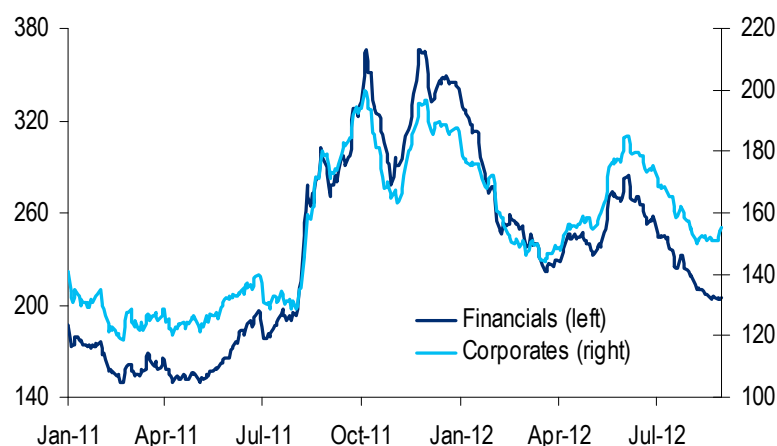
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Figure 1. Citi Broad Investment Grade Corporate Index OAS, in bp



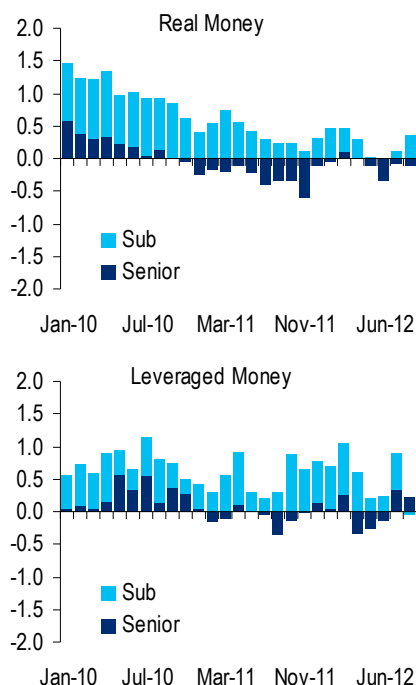
Source: Citi Research

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

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Back to work, back to reality

Figure 2. Citi Credit Survey bank positioning*



Source: Citi Research
*+2 very long, -2 very short

As far as summers go, it's been an unexpectedly good one for credit and much better than we anticipated in June's mid-year outlook. But for many investors that were underweight higher beta sectors ahead of the rally (like financials), we reckon it's been a far less enjoyable experience than the trajectory of spreads would suggest. Our most recent credit survey data suggests that the majority of benchmarked investor have succeeded in getting back to neutral, but, unfortunately, we believe the turning of the seasons just might mark the beginning of a more volatile and macro dominated period ahead where an underweight could prove useful.

Yet even if the remainder of the year ends up being a challenge to navigate, many argue that credit is among the least-worst options from an asset allocation perspective. After all, credit still appears to be an attractive alternative to other fixed income asset classes after adjusting for inflation, and the technical backdrop has rarely looked so favorable given minimal net issuance by corporates and a steady stream of inflows.

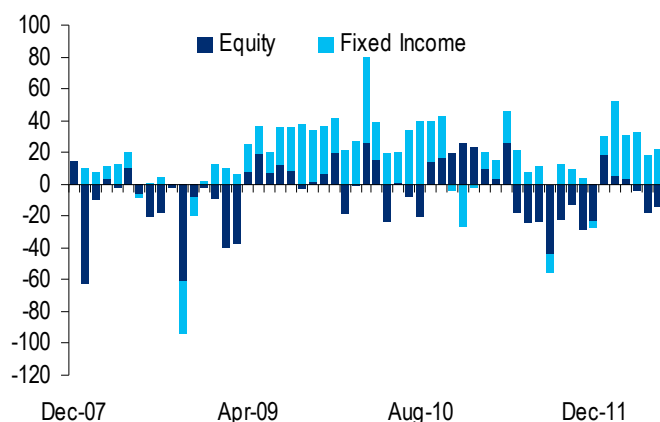
Furthermore, the Fed and the ECB seem committed to prolonging the rally. Indeed, it's possible that the central banks succeed in cushioning any disappointing news to come and thereby provide the backdrop for investment-grade credit to rally through the year-to-date tight, at which the market is currently stalled (see first page graph).

But we wouldn't count on it, or, for that matter, the technicals.

One recurring lesson of the last few years is that the threats of central bank intervention tend to be far more effective than the actual programs. It takes quite a lot of chutzpah to short the markets after Draghi's "whatever it takes" comments and the FOMC's ever more dovish statements and minutes, but it's a different story now that the cat's out of the bag and markets are reflecting central bank action.

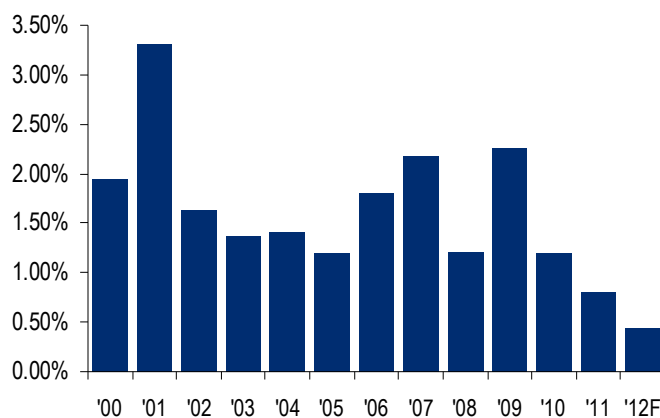
As such, if the ECB and Fed driven enthusiasm started to fade rather soon, we wouldn't be surprised. After all, the risks to the outlook haven't receded during the rally, as we will discuss in the remainder of this piece. If anything, the markets have turned a blind eye to the recent spate of negative developments in Europe and China.

Figure 3. Monthly equity and fixed income fund flows, \$bn



Source: Citi Research, EPFR

Figure 4. High grade corporate net supply, as a % of the index universe*



Source: Citi Research, Dealogic
*the index referenced is Citi's BIG Corporate Index.

Moreover, we're increasingly worried that second quarter results could prove to be an inflection point in the corporate fundamental story and that America's fiscal situation could damage private sector balance sheets and impair revenues.

As investors return from their summer holidays, there are plenty of catalysts that are likely to highlight the reality that the central bankers lack the tools and the mandate to permanently remove the downside from the market. The ECB and the Fed may be successful in buying the market two to three months of reprieve, but, unfortunately, the monetary policies that are really needed are just not politically feasible, in our view.

In the final section of this outlook, we recommend a number of trading strategies tailored to today's unique market environment. Overall, our inclination is to approach credit from the short side over the next 3-6 months, but with the utmost caution. As laid out in our 2012 full-year outlook¹, we continue to believe that Citi's Investment Grade Corporate Index will trade within a 60bp range, of which we're once again nearing the tights. We're not arguing for a market route, but a modest pullback looks significantly more likely than a continuation of the rally.

Why Europe is still a longer term worry

By no means do we think investors truly believe that policymakers are close to solving the European crisis; however, there seems to be an unusually high level of complacency, especially when it comes to positioning, ahead of what's likely to be a rather eventful September.

Figure 5. Visible calendar for Sep. 2012

Visible Calendar for September	
1-Sep	Troika returns to Athens
3-Sep	Eurogroup meeting on Italy & Spain (not confirmed)
6-Sep	ECB Governing Council meeting
6-Sep	BoE MPC meeting
11-Sep	Deadline for EU Commission detailed proposal on banking union
12-Sep	German Constitutional Court ruling on ESM & fiscal compact
	Dutch General election
13-Sep	FOMC rate decision
14-Sep	Eurogroup meeting on banking union
	Greek government to outline further budget cuts
20-Sep	Rajoy & Monti meet
20-Sep	ECB Governing & General Council meeting (no press conference)
22-Sep	Holland/Merkel meeting
During the month	
	EC expert report (Liikanen Group) on banking sector reform
	Independent assessment of Spanish banks (2nd half of September)

Source: Citi Research

On the 6th, the ECB meets and, in addition to the rate cut that Citi economists expect, we're likely to get further details on the new conditional government bond purchase program (CGBPP). To be blunt: There are more than a few questions to be answered, not the least of which is the size and duration of the new program. Those calling for the ECB to commit to unlimited and unsterilized intervention are likely to be disappointed, in our opinion. And we think some of the other details will also be a let down for the market.

For instance, it seems unlikely that the ECB will indicate specific spread targets relative to Bunds. As our European colleagues argue², doing so would probably be unwise for a number of reasons. For a start, Spain and Italy haven't signed up for the new program yet – so why remove the pressure to do so – and yield targets would likely further erode incentives to implement austerity afterward. Moreover, it's probable that such a commitment would further complicate the political situation in donor countries like Germany and the Netherlands.

As is, resolving an issue like the seniority problem is going to be complicated enough. We expect that the ECB will argue that by exclusively purchasing short term debt, the central bank isn't really a preferred creditor. Alternatively, they could pledge to avoid the type of last minute exchange used to circumvent the haircuts that were applied to Greek bonds. In any case, we think investors and the rating agencies are unlikely to be persuaded.

What's more, there's a host of other potential European market catalysts in September: the Troika assessments for Greece and Portugal will be delivered in the first half of the month, the German Constitutional Court will rule on the legality of the ESM on the 12th, and the Dutch will go to the polls on the same day.

¹ 'US Credit Outlook: 2012, Another Year on the Edge', Jason Shoup et. al, 16 December 2012

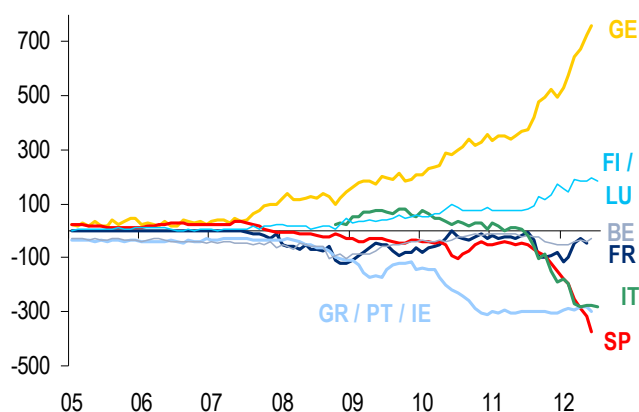
² 'European Credit Outlook: Hanging on his every word', Hans Lorenzen, 28 August 2012

Broadly speaking, Citi economists expect the outcome of all three events to be favorable, but close-run affairs. The Dutch will eventually get a government, but there's likely to be a shift toward more extreme anti-austerity, euro-skeptic parties. The German Constitutional Court will probably uphold the ESM and the fiscal compact, but may require the Bundestag to have greater influence going forward or request more detail from the ECB. And, finally, it seems likely that while Portugal's assessment should be benign, Greece's is far more finely posed.

Indeed, many of the US investors we have talked to recently seem to be of the opinion that either Greece will not be forced out of the European Monetary Union (EMU), or that its exit would be a non-event. Citi economists believe that the Troika's assessment and current negotiations will result in a compromise that avoids a 'Grexit' until the next assessment in December. However, bridging the gulf between the demands of German and Greek policymakers seems near impossible, and, as such, Citi's central scenario puts the probability of a 'Grexit' as high as 90% over the next twelve months.

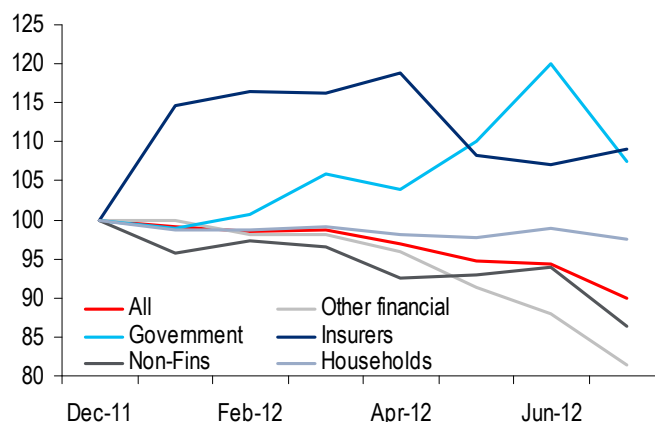
That's a worry because the issue of capital flight has yet to be addressed in a convincing manner and if Greece were to leave the EMU, the issue would invariably jump to the forefront as the risk of contagion would rise. It's notable, that July's ECB data indicates that deposit flight is accelerating from Spain and Italy while Target2 balances have risen at an alarming pace.

Figure 6. TARGET2 Balances, \$bn



Source: Citi Research, Haver Analytics

Figure 7. Spanish deposits by sector, indexed to 100 in Dec '11



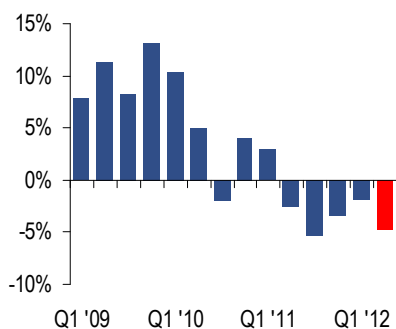
Source: Citi Research, Haver Analytics

Fundamentals and the Fiscal Cliff

High grade investors have long taken comfort in a strong corporate fundamental story amidst a very volatile macro backdrop. After all, by historical standards leverage remains low, cash on the balance sheet is high, and margins continue to expand as companies have been able to sustain cost cutting measures initiated during the great recession. But an underwhelming second quarter suggests that slower growth may be starting to impact earnings. And with the 'fiscal cliff' rapidly approaching there's scope for quite a bit more deterioration ahead, in our view.

It's not that second quarter earnings were terrible, per se. Top line revenues were weak, but margins remained strong. The issue seemed to be with the setting of expectations. If one were to evaluate second-quarter earnings relative to where bottom-up analyst estimates were a month prior to the beginning of the reporting

Figure 8. Consensus earnings surprise*



Source: Citi Research, Bloomberg

*Earnings surprise is calculated as the percent difference between reported EPS and expectations at the start of the reporting season.

period (so as to remove the effect of on-going revisions), it's clear that the quarter was a disappointment to the analyst community. From a historical context one has to go back to the third quarter of 2011 to find a quarter where analyst estimates were off by so much, and that quarter was impacted by the tsunami and the debt-ceiling negotiations.

What's more, the possibility that a similar narrative unfolds in the fourth quarter appears to be quite high. Bottom up consensus estimates envision a third quarter that's relatively flat to the second in terms of revenue and earnings, but the expectations for the fourth quarter of 2012 and 2013 as a whole are far higher. To our minds, these look overly optimistic even before considering the potential impact from the 'fiscal cliff'.

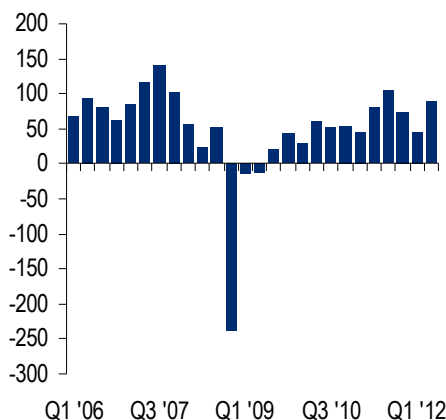
And yet, as Citi economists note³, one really can't form a complete earnings outlook for late 2012 or 2013 without taking a view on the actions of policymakers. For if a compromise can not be reached to avoid the 3%-plus GDP drag from taking effect, it's almost a certainty that earnings will suffer. Conversely, for the sake of fairness, it should be noted that a lame-duck reprieve has the potential to be interpreted as a significant positive, especially if analysts have already taken down fourth quarter estimates.

In any case, all too often bondholders have a habit of dismissing these types of earnings concerns as solely an equity story. But as one investor recently remarked to us, "it's a problem for equities now, but management will invariably make it a credit one". Indeed, dividends and share repurchases have been increasing for some time now.

While bondholders may be okay with the current level of shareholder friendly activity provided ratings remain unaffected, it's an increasingly fine line for CFOs to walk given that their P/E multiples in the current environment tend to be a function of both their company's prudence and ability to return capital to shareholders.

As such, we find the fundamentals to be far more precariously poised than others.

Figure 9. Share repurchases have grown, change in capital shares in millions



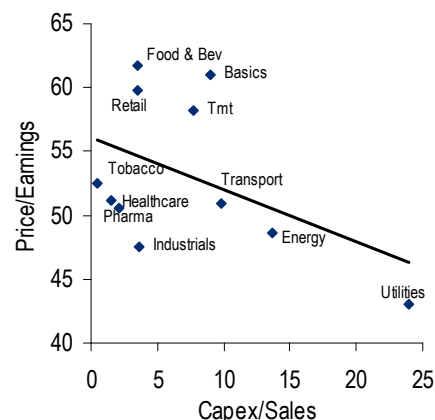
Source: Citi Research, Bloomberg

Figure 10. S&P500 dividend yield, %



Source: Citi Research, Bloomberg

Figure 11. The more the savings, the higher the price, %



Source: Citi Research, Bloomberg

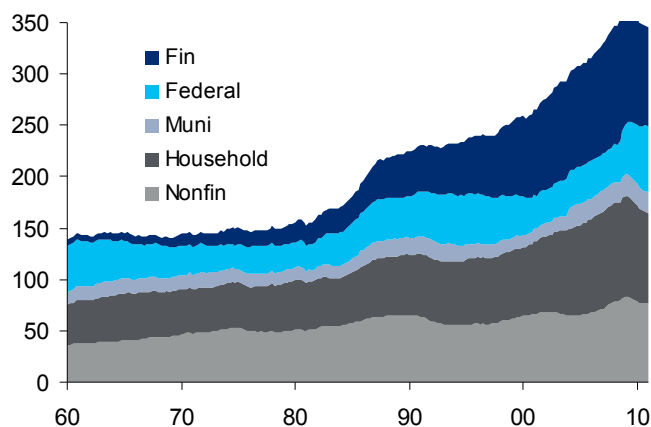
³ 'Portfolio Economics: Profits Approaching Wall after V-Shaped Rebound', Steven Wieting, 16 August 2012

Moreover, the focus on avoiding the 'fiscal cliff' risks detracting from the real work of setting the US on the least economically painful course of long-term deleveraging, which has yet to begin (see figure). Under the baseline forecast of the Congressional Budget Office (CBO), government revenues as a percentage of GDP need to rise to nearly 25% by 2040 in order to match the growth in long term entitlement liabilities. But absent entitlement reform or significantly higher growth, it seems quite likely that the extra revenue will need to come from an increase to corporate or income taxes. No prizes for guessing which is politically more feasible.

Of course, the market has been far less able to enforce fiscal discipline on the US through higher interest rates, in contrast to Europe's peripherals. As such, there really is very little reason why one should expect fiscal consolidation sooner rather than later, notwithstanding the current political agenda.

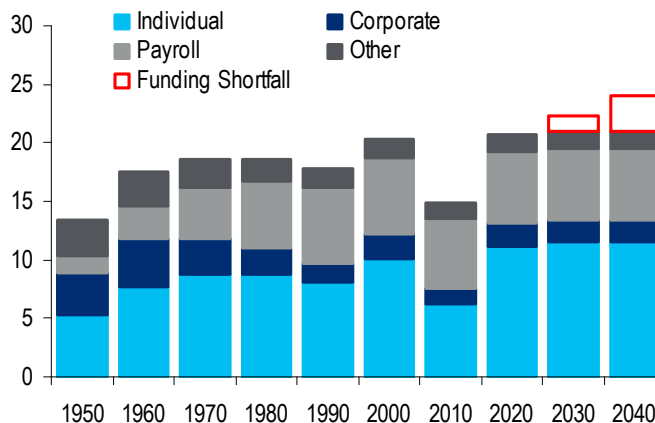
But for those that believe the technicals are unassailable in credit, it's worth bearing in mind that a turn in the fundamentals is likely to diminish the relative attractiveness of the asset class. And in today's poor liquidity environment, the outflows need not be all that great to push valuations wider.

Figure 12. Indebtedness of the US, as a % of GDP



Source: Citi Research, Haver Analytics, US Flow of Funds

Figure 13. CBO government revenue vs. baseline spending forecasts*, as a % of GDP



Source: Citi Research, Congressional Budget Office

*Funding shortfall is calculated as the difference between the baseline forecasts of the CBO's long-term spending forecasts and the sum of all current government revenue expectations.

Under the mattress or into equities

The actions of central banks could also end up threatening the technicals. Certainly, we've witnessed the negative impact to risky assets in recent years when the Fed and the ECB are not actively engaged in some form accommodation⁴. As such, there seems to be some latent concern among investors as to how asset prices might respond once the central banks begin to unwind their balance sheets, whenever this occurs. And yet, it is the unintended consequences of a continuation of QE and QE-like programs that leave us most concerned.

⁴ 'Do Rate Hikes Matter For Credit: Removal of policy accommodation liable to weigh on spreads, Hans Lorenzen, 23 March 2011

Exceptionally low interest rates are bad for banks, insurers, and, more generically, anyone wishing to save money. Of the three, it's the situation of the savers that is most untenable.

In particular, those wishing to retire at 65 or thereabouts are in for a nasty surprise when they start to run the numbers. Given that real yields are negative for Treasury bonds inside of 20-years, the steady stream of inflows into investment grade bond fund that hold a mixture of government, agency, and high grade corporate securities, will simply fail to return an adequate rate of return commensurate with the current savings rates of most retirement savers. What savers need to do is find higher asset returns or increase their personal savings rate.

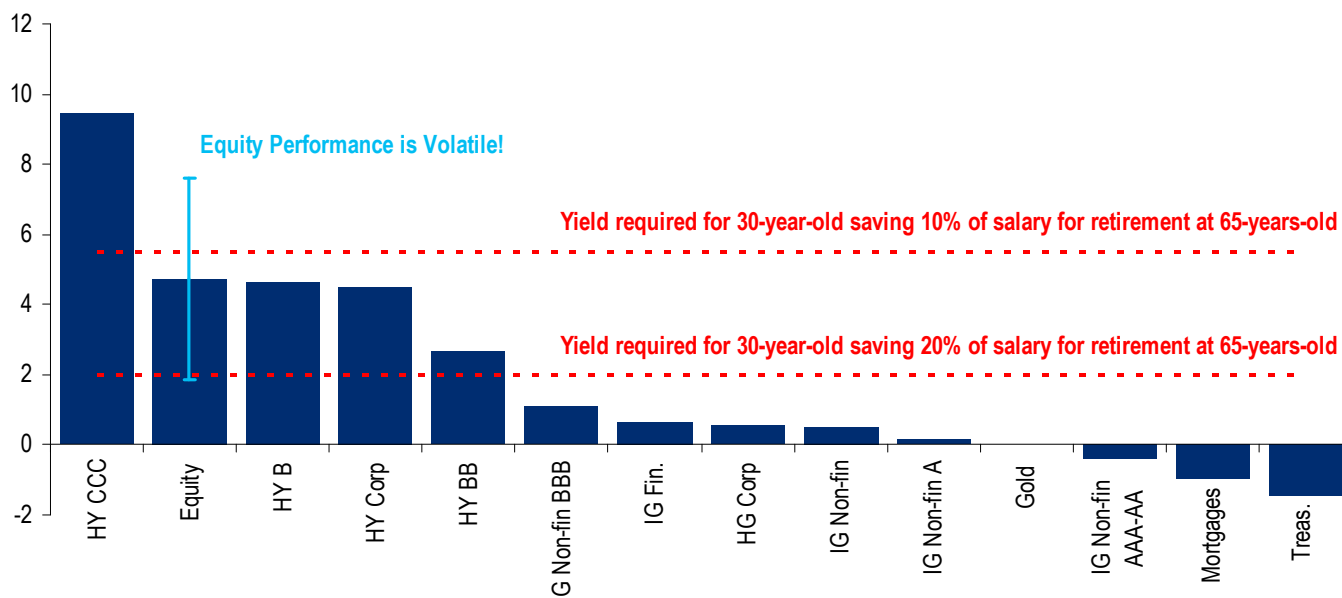
And therein lies the crux of the problem facing the central banks.

Ideally, the Fed and ECB want to encourage investors to buy riskier assets and corporates to borrow more with the hope being that wealth effects, corporate risk taking, and Keynes' animal spirits will revive the economy.

But so far the US has failed to respond to Fed's treatment plan and the inflows into bond funds continue unabated while corporate net issuance is nonplused. One presumes investors are wary of returning to an asset class, like equities, that performed so miserably over the last decade amid global growth concerns.

But an unintended consequence to resisting the Fed is that the average retirement saver will need to double their rate of savings in order to be able to retire even five years later than originally planned. If and when that sort of analysis enters into the collective consciousness of the typical American, the economic impact is likely to be grim. As we've seen in the UK, higher savings rates lead to lower consumption, a decline in corporate profits, and recession.

Figure 14. Real yields of various asset classes*, %



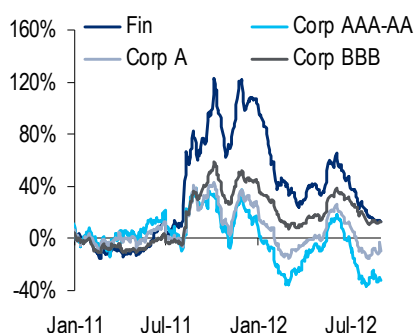
Source: Citi Research, Bloomberg

*Real yields are calculated as the difference between the yield of each asset class (earnings yield in the case of equities) and 30-year treasury breakeven rates. These rates are assumed to prevail until retirement. Equity performance volatility depicted in light blue is calculated from the minimum and maximum earnings yields in the past 5 years. Real yields required for given salary contributions (in red) are calculated for a 40 year old retiring at 65, and aiming to have 10x his annual salary upon retirement.

To our minds, one of the few ways to avoid a savings trap is for the central bank to double down and start buying riskier assets. The Fed's apparent intention to target mortgages is a start. But given that the product trades less than 50bp behind Treasuries, it's hard to envision MBS purchases really engendering the necessary amount of risk taking to set off a positive chain reaction. Unfortunately, the more ambitious programs targeting corporates and equities seem politically unfeasible given that they would likely require congressional approval, which is unlikely to be forthcoming given the government's experience with past investments.

As our European colleagues argued in a recent investor presentation⁵, what's fundamentally at stake is the whole concept of Markowitz's efficient frontier. Central banks have been unsuccessful in making safe assets unappealing to investors who view slower growth and the fiscal imbalances as greater threats. As such, the Fed and the ECB's measures have backfired in a sense. The scarcity value of safe assets has increased and there's already a portion of the investor base that clearly values the return of capital more than the return on capital.

Figure 15. High grade par-spreads*



Source: Citi Research

*par-spreads are calculated by adjusting spreads for dollar-price.

In investment grade credit this is evident in the extremely rich valuations placed on non-financial corporates rated single-A and higher. For this portion of the market only, spreads are through the tight of last year and potentially at all-time tight provided one adjusts for the fact that dollar prices have risen as Treasuries have rallied – particularly at the back end of the curve. What's more it could get worse.

If the central banks fail to spur an appropriate amount of risk taking, we see no reason why highly rated corporate debt will not continue to richen along with Treasuries, even as triple-Bs and financials fall away as deteriorating fundamentals eventually call into question their safety. Clearly, this is the scenario that Bernanke and his peers hope to avoid at all costs, as is often communicated in the Chairman's warnings to Congress. For if policymakers insist on addressing the country's fiscal imbalances with measures that subtract from near term growth, they risk undermining the Fed's efforts to inflate asset prices by harming corporate prospects/fundamentals.

Investment strategies

Play the bifurcations: The uncertainty around whether central bankers will succeed or fail in their monetary efforts to stimulate the economy while policymakers try to tackle the fiscal issues argues for barbell positioning across asset classes.

On the one hand, it makes sense to own the riskiest most convex assets in anticipation that the Fed and ECB's current and future methods ultimately work and policymakers can minimize the pain of fiscal consolidation.

On the other hand, since the probability the central banks fail in this endeavor is nontrivial, holding a portion of ones' capital in safe assets with little principal risk may also be warranted. Moreover, it's the remaining safe assets that are increasingly being tied up as collateral in the "shadow" bank markets. Given the actions of central banks, their scarcity value could substantially grow.

⁵ 'Saving for broke: Why zero is the place to start', Matt King, August 2012

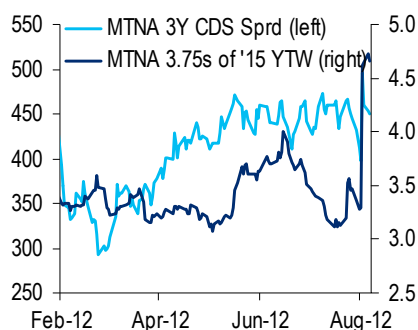
In either case, where one needs to take a relatively cautious approach is with assets that fall in the middle of the risk spectrum, like triple-Bs and double-Bs. The inflation-adjusted yields of these assets are so low that they are literally deficient to meet the investment targets of many economic actors.

Yet allocations to middle-of-the-risk-spectrum assets continue to grow because the majority of investors think the US economy will muddle through almost indefinitely. To our minds, that's tantamount to believing that while the Fed and the ECB will be unsuccessful in reinvigorating the economy through continual rounds of easing, policymakers in the US and Europe won't do any lasting harm to corporates in their efforts at tackling deficits and debt in a low growth environment. That seems like an implausible scenario to us and one that we doubt plays out without volatility.

As such, we think investors should be looking to hold on to those scarce-but-safe assets and range trade the middle-of-the-risk-spectrum assets. Of course, it's important to be mindful of the divide between the two, as cuspy credits, more than ever, will likely exhibit outsized reactions when crossing over. With that in mind, the "play the bifurcations" strategy currently argues for underweighting triple-Bs, financials, and weaker single-A non-financials, as we're currently near the tights of the year.

Watch the positive basis for clues: In order to observe how rich cash bonds have become, at least in a relative sense, we find ourselves increasingly monitoring the CDS market and the cash-CDS basis in particular. In aggregate, the basis has become more positive this year (less negative) as the two markets have increasingly become disconnected. Needless to say, this too is an unintended consequence of central bank intervention, in our opinion.

Figure 16. ArcelorMittal CDS spread vs. cash yield, bp (left) and % (right)



Source: Citi Research

As such, we're reluctant to blindly sell the basis since its equivalent to leaning against the central banks. A better approach, to our minds, is to focus on selling the basis for credits on the cusp. Situations like ArcelorMittal, where the cash-CDS basis was exceptionally positive prior to the S&P downgrade, should be repeatable in other credits. We'd also recommend selling positive basis in weaker single-A credits that might be downgraded to triple-B.

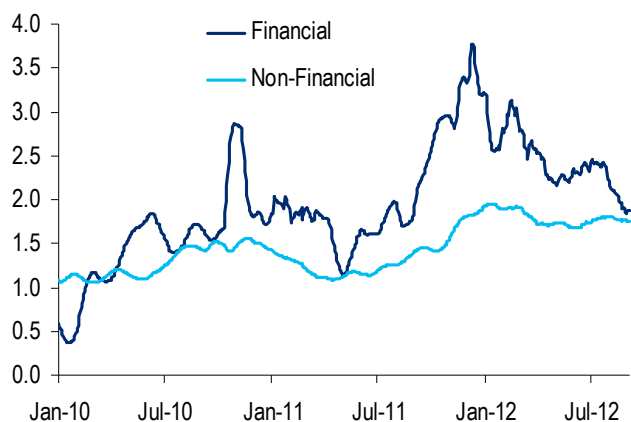
At the very least, real money investors should consider using positive basis as an early warning signal. There's probably no need to reduce one's holdings to a double-A non-financial bonds with an exceptionally positive basis, but it might be unwise to ignore the information in the CDS market for bonds that are more precariously rated.

Finally, we like selling positive basis in credits where the CDS spread trades wider than the yield of the issuer's matched-maturity bond. From the real money perspective this type of relative value situation makes little sense. Essentially, an investor can swap to a higher "yielding" CDS product and reduce their interest rate duration at the same time. Alternatively, hedge funds can construct a near costless interest rate short by selling the package and leaving the rate component unhedged.

Know your extension trade: The temptation to pick up spread at the long end of the curve has invariably increased as 30-year corporates have lagged the rally. As Figure 18 shows, credit curves have steepened throughout the year, but much of this is a purely a function of what 30-year rates have done. As the dollar prices of 30yr corporates have risen, the discount investors apply to high dollar bonds has also steadily increased. The result is that credit curves appear much steeper than where new issue or par priced curves actually trade.

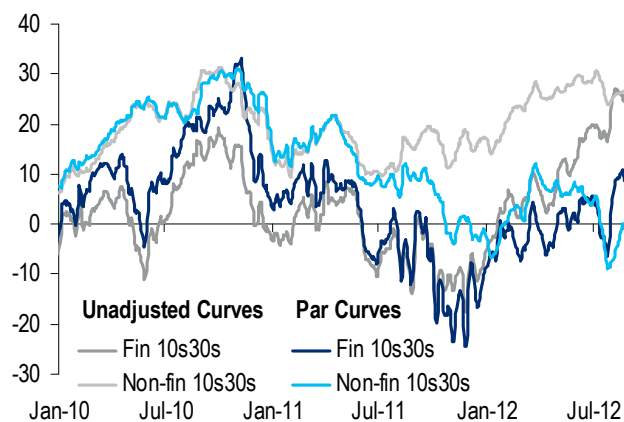
As such, we remain somewhat cautious on recommending the longer end of the corporate space. There are certainly sectors where one can find truly steep curves and above average compensation for the extra dollar price risk, but there are plenty of sectors where extending makes far less sense. To our minds, extending should be done on a case by case basis after adjusting for dollar price.

Figure 17. Implied historical dollar price adjustment, bp/\$



Source: Citi Research

Figure 18. Dollar-price adjusted 10s30s spread curves*, 5-DMA in bp



Source: Citi Research

*par-spreads are calculated by adjusting spreads for dollar-price.

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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