

# European Credit Weekly

## A peripheral concern?

- **An abrupt ending** – After weeks of relentless tightening, suddenly spreads are pushing on the higher end of the range we had envisaged going into summer.
- **From issuance to the periphery** – While the initial widening was at least in part driven by the record amount of issuance last week, this week's move was led by periphery spreads – both in rates and in credit.
- **A better entry point** – A 5bp move in the index isn't earthshattering. But in some of the high-beta credits, the 20-30bp of widening represents about as much of a buying opportunity as we think you a likely to see near-term. We would be adding in these here.

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Figure 1. Citi Credit Strategy – Key views & recommendations

	Tactical (View: Long)	Strategic (View: Long)
Cash bonds		<ul style="list-style-type: none"> <li>- Long € &gt; \$ credit</li> <li>- Long Financials &gt; Non-financials</li> <li>- Long subordinated &gt; HY non-fin risk</li> <li>- Releveraged &gt; releveraging credits</li> <li>- Long T2 host CoCos</li> <li>- Long Eurozone &gt; non-Eurozone credits</li> <li>- Long wholesale &gt; deposit banks (UK &amp; US)</li> </ul>
CDS	<ul style="list-style-type: none"> <li>- Sen Fin / Main compression</li> <li>- iTraxx Sub / Sen Fins compression</li> </ul>	<ul style="list-style-type: none"> <li>- Long index flatteners</li> <li>- Main / Crossover decompression</li> </ul>
Options & tranches	<ul style="list-style-type: none"> <li>- Sell straddles</li> <li>- Sell Receiver 1x2s</li> <li>- Buy SenFin vs. Sell CDX IG straddles</li> <li>- Buy SenFin, sell Crossover receivers</li> </ul>	<ul style="list-style-type: none"> <li>- Long junior &gt; Mezz tranches</li> <li>- Long risk Jun-15 Main S9 equity tranche:</li> </ul>
Combined strategies	<ul style="list-style-type: none"> <li>- Sell equity protection; sell straddles</li> <li>- Flatteners vs. OTM payers</li> </ul>	<ul style="list-style-type: none"> <li>-Position for more negative basis</li> <li>-Short bond, long CDS spread duration</li> </ul>

Source: Citi Research. Note: New recommendations/trades highlighted in bold. Tactical horizon: 1-3mths. Strategic horizon: >3mths.

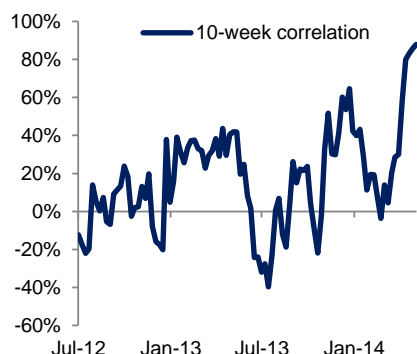
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## A peripheral concern?

Was that it? The sudden volatility in credit really wasn't part of the script (at least not the one handed out to us beforehand...). Whether there's more to come really depends on the underlying cause for the widening in the first place.

Figure 2. Correlation in issuance volumes vs. iBoxx € Corporate spread changes, 10w avg.



Source: Citi Research, MarkIt, Dealogic.

Last week we could pin the blame on the surge in supply to €24.1bn with some justification. It was the biggest week volume-wise in four years. As illustrated in Figure 2, the 10-week correlation between spread changes on the iBoxx € Corporate index and gross IG supply in €s is up to almost 90% – the highest level we've seen in years. But this week has only seen a more pedestrian €9.6bn of issuance and yet the widening continued in the early part of the week.

Corporate credit has been quick to point the finger at periphery sovereign spreads instead. And to be fair, although in the context of the two-year rally, it is not much more than a blip, from a shorter-term perspective, a 45bp move in 10yr BTPs and 60bp in 10yr Portuguese government bonds in the space of 8 sessions is hard to scoff at. The accusation has merit in the sense that in credit too, the widening has been led by periphery issuers like Telefonica, Intesa Sanpaolo, Generali and Gas Natural.

But what triggered the shift in risk appetite? It was probably a confluence of factors. The weak Q1 GDP numbers, especially in Italy, the suggestion of a Greek retroactive capital gains tax (which was subsequently dismissed) and the report that KBC will risk-weight government bonds at the request of the Belgian central bank may all have played a part.

More generally, there may have been some unease about the European Parliamentary elections this week. That the burgeoning pan-European anti-European alliance (we're still chewing on the irony in the very concept) looks set to have a very strong result shouldn't come as a surprise to anyone, but perhaps the uncertainty about how other market participants would react was enough to prompt some to de-risk in the anticipation of the event.

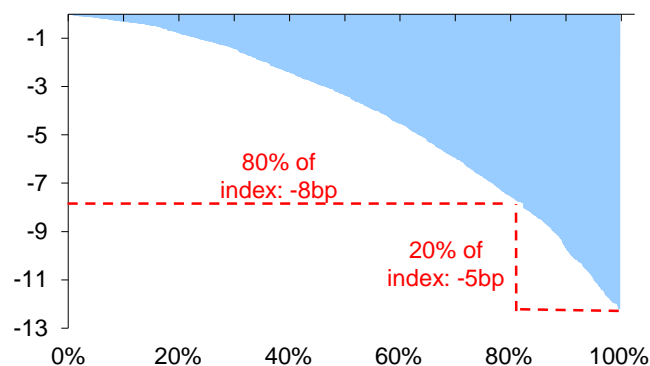
And finally, we sense growing misgivings about the upcoming ECB meeting – be it in response to Weidmann's suggestions that the ECB might not act in June or doubts about the efficacy of a negative deposit rate with or without associated liquidity injections, some investors have expressed that they felt market valuations were pinning too much on the ECB.

The salient point about these is that none of them seem particularly likely to have much staying-power for the time being. Yes, the rise of the Eurosceptic vote is clearly a negative for cohesion and, in turn, the back-stop mechanisms that maintain the status quo in markets, regardless of your views on the EU. But once the actual result is out of the way, what is the specific negative catalyst that one could position for? The market may or may not get excited by what the ECB decides on 5 June, but as [we argued last week](#), the real value to us of any ECB action lies in the signal it sends. Indeed, the very weakness in the data over the summer that might merit concerns about valuations from a fundamental perspective increase the likelihood of more concerted ECB intervention (i.e. large-scale asset purchases) later this year. And from a spread perspective, that should be the overriding consideration.

Ultimately, we still view the recent volatility as mostly a trimming in long positions (not least in the street). Figure 3 and Figure 4 show the cumulative distribution of cash market performance, where individual bonds are ranked by beta, in the rally from 17 April to 12 May and in the subsequent widening since 12 May. The

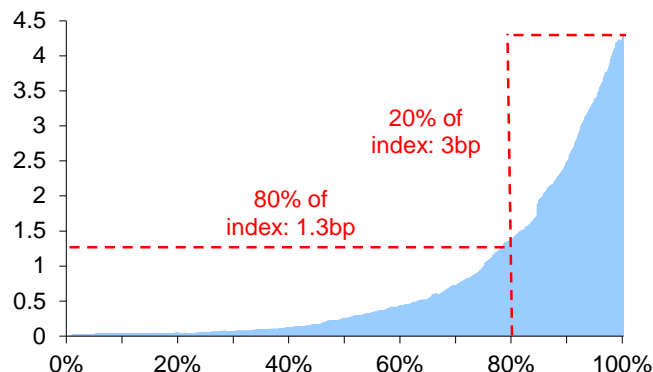
difference is striking. Whereas the rally was pretty broad based – the 80% of bonds with the lowest beta made up >60% of the rally in the iBoxx € Corporate index – the sell-off has been rather concentrated – the 20% of bonds with the highest beta has been responsible for 70% of the widening in the index.

Figure 3. Cum. iBoxx perform., bonds ranked by  $\beta$ , 17 Apr–12 May, bp



Source: Citi Research, MarkIt

Figure 4. Cum. iBoxx perform., bonds ranked by  $\beta$ , 12 May–22 May, bp



Source: Citi Research, MarkIt

From a glass-half-empty-perspective, it is an indication that the pain trade in the market is beginning to shift from a relentless hunt for yield driving almost linear tightening to a more balanced market, where negative catalysts are used as an excuse to take profits. But from a glass-half-full perspective, market valuations have just been stress tested again and the lack of panic selling anywhere should serve to reinforce the status quo. If fund managers had been worried about something more serious, like end-investor outflows, then we would have seen much more selling in low-beta credits too in an attempt to raise cash. The fact that credit spreads were able to ignore the renewed drift in periphery sovereigns on Thursday is another indication to us that we are ultimately pretty well supported here. In the options space, the demand for payers already seems to have abated and, if anything, fast money are now taking the other side and selling payers.

With spreads now at the wider end of the near-term range that we indicated two weeks ago, in calling for a tapering of the rally, we'll put our heads on the block and argue that this is probably about as much of a buying opportunity as you are going to get this side of summer. In the high-beta credits at least, there is a better entry point – now, will you be brave enough to take it?

## The week ahead (Joseph Faith)

Politics will take centre stage next week, with few top-tier data releases and only a small number of companies yet to report earnings.

The Ukrainian presidential elections take place on Sunday. Poroshenko, the pro-Western so-called “Chocolate King of Ukraine”, is the clear frontrunner. The latest polls show that he has the support of 44.6%. If he fails to win an outright majority, the top two candidates will meet in a runoff on June 15. Our Political Strategists have summarised their thoughts in [this note](#).

Elections for the European Parliament will be held in most EU member states on the same day. The vote is likely to highlight the strength of anti-establishment sentiment, with anti-EU parties challenging for first place in several countries. The mainstream left are also likely to make a strong showing, and our Political

Strategists foresee a continuation of recent trends in Europe, in which social democratic governments have gained power as a result of the weakening “austerity-consensus”.

EU leaders will meet in Brussels on Tuesday to discuss the outcome of the Parliamentary election and to begin discussions on choosing the next president of the European Commission.

On the data front, the consensus expects US durable goods orders, also out on Tuesday, to have declined in April, following two months of the biggest gains since mid-2013. Despite the expected drop, the elevated level in March makes it seem likely that we'll still see a sharp rebound in investment spending over Q2 as a whole.

US Consumer Confidence, out on the same day, is expected to show a small increase to 83.0, from 82.3 last month, still below its level in March. Ongoing concerns over labour market conditions and recent rises in food prices are likely to preclude stronger gains.

The revised estimate for US first-quarter GDP, out on Thursday, is forecast to show an annualised decline of 0.6%, well below the first estimate of a 0.1% gain. Subsequent data on trade, construction spending and factory inventories have led economists to lower their estimates. Our economists expect a sharp rebound over the next two quarters, led by growth in private domestic demand and supported by a strong financial tailwind and plenty of slack.

#### Key Economic Indicators (26 May – 30 May 2014)

<b>Tuesday 27 May</b>	<b>Consensus Forecast</b>	<b>Last</b>
US Durable Goods Orders	-0.7%	2.6%
US Consumer Confidence	83.0	82.3
<b>Wednesday 28 May</b>	<b>Consensus Forecast</b>	<b>Last</b>
Eurozone Economic Confidence	102.2	102.0
Eurozone Industrial Confidence	-4.0	-3.6
Eurozone Services Confidence	3.5	3.5
US Q1 GDP	-0.6%	0.1%
<b>Friday 30 May</b>	<b>Consensus Forecast</b>	<b>Last</b>
Chicago PMI	60.0	63.0
U. of Michigan Confidence	82.8	81.3
Source: Bloomberg		

#### Earnings Releases (26 May – 30 May 2014)

<b>Tuesday 27 May</b>
Vienna Insurance Group, Espirito Santo, Ardagh Packaging, Cegedim
<b>Wednesday 28 May</b>
Ahold, Eurobank Ergasias
<b>Thursday 29 May</b>
Costco, Sberbank, Abercrombie & Fitch, Alpha Bank
<b>Friday 30 May</b>
Piraeus Bank
Source: Bloomberg

Recent Research Publications	Author	Date
<b>European Credit Research</b>		
<a href="#">Synthetic Credit Tranches Teach-In</a>	Abel Elizalde	May 22, 2014
<a href="#">iTraxx Tranches Views &amp; Trades: last squeeze to Jun-15 Series 9 Main Equity</a>	Abel Elizalde	May 21, 2014
<a href="#">Substitution in extra time: why sub-senior decompression has gone too far</a>	Joseph Faith	May 20, 2014
<a href="#">European Credit Derivatives: the tightening has legs ... no sign of synthetic hedgers</a>	Abel Elizalde	May 12, 2014
<a href="#">Riding the wobble and avoiding the snap</a>	Matt King	May 6, 2014
<a href="#">Global Credit Survey: Not as benign, but should still be fine</a>	Joseph Faith	April 30, 2014
<a href="#">European Credit Sector Recommendations: When the surreal becomes everyday...</a>	Teresa Cascino	April 29, 2014
<a href="#">Time to move on?....From 3s5s to 5s10s: iTraxx Curves Views &amp; Trades</a>	Abel Elizalde	April 25, 2014
<a href="#">When will the credit cycle turn?: And would spread actually widen?</a>	Hans Lorenzen	April 24, 2014
<a href="#">ECB and BoE on Euro ABS Recovery: Doctor is there but only some will get treated</a>	Ratul Roy	April 14, 2014
<a href="#">European Credit Derivatives: Index tightening overdone? What are the best carry trades?</a>	Abel Elizalde	April 8, 2014
<a href="#">When will the credit cycle turn?: Long on borrowed time</a>	Hans Lorenzen	April 2, 2014
<a href="#">CreditBrief: What didn't happen</a>	Joseph Faith	April 2, 2014
<a href="#">Where do we expect iTraxx rolls to trade?</a>	Abel Elizalde	March 19, 2014
<a href="#">Beta of European Financials to US Corporates looks underpriced</a>	Abel Elizalde	March 18, 2014
<a href="#">Looking for carry but afraid of adding more outright longs?</a>	Abel Elizalde	March 11, 2014
<a href="#">Credit Brief: Unfazed</a>	Joseph Faith	March 4, 2014
<a href="#">European Credit Derivatives – Views and Trades: Slow grind tighter from here – what are the best carry trades?</a>	Abel Elizalde	February 27, 2014
<a href="#">New 2014 CDS Definitions: What's new? What's changing? Why? When? How?</a>	Abel Elizalde	February 26, 2014
<a href="#">Corporate Leverage: Should you be worried?</a>	Hans Lorenzen	February 24, 2014
<a href="#">iTraxx Tranches Views &amp; Trades: Sell equity protection and sell straddles</a>	Abel Elizalde	February 20, 2014
<a href="#">Options vs. curves: playing with tail risk</a>	Abel Elizalde	February 13, 2014
<a href="#">European Credit Outlook 2014: (Positioning &amp; Trades)</a>	Hans Lorenzen	January 17, 2014
<a href="#">European Credit Outlook 2014: The Year of the Greater Fool's Game? (Strategy)</a>	Hans Lorenzen	January 17, 2014
<b>US Credit Research</b>		
<a href="#">US Credit Derivatives View: What to do now?</a>	Anindya Basu	April 15, 2014
<a href="#">How To Find Value In Credit Options?Relative value across strikes and maturities</a>	Anindya Basu	April 11, 2014

Source: Citi Research

## Appendix A-1

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