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Europe

European Credit Outlook

Hanging on his every word

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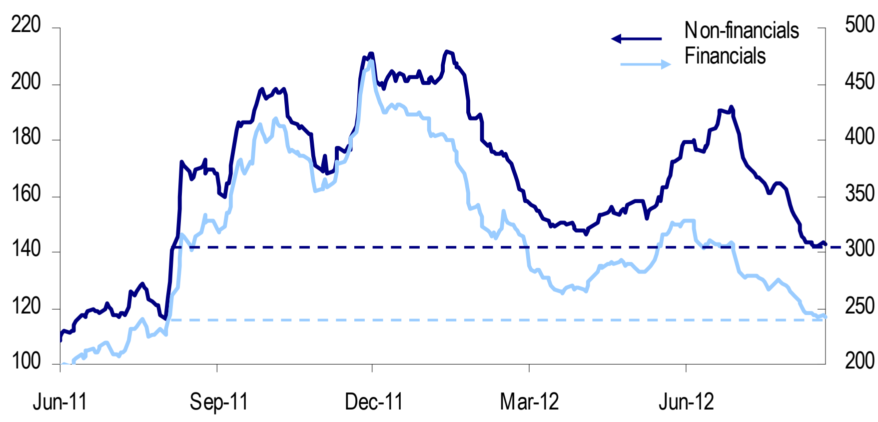
- **Thank you, Mario! –** Draghi's verbal interventions ensured credit markets were able to get through the summer turmoil that had been widely anticipated. But now a lot more is priced in. We'd be surprised if 'headline coordination' between Frankfurt, Berlin, Brussels, Madrid, Rome and Athens can occur in September without disappointing the consensus that has now built up.

- **Near-term technicals look stretched –** While the long-term technical picture remains very supportive and valuations are not unattractive, we think opportunistic longs built up in August make the market more vulnerable here. Spreads are at 1yr tights, supply is set to increase, many funds have little incentive to take risk and the ECB has already attempted subtle expectations management.

- **A pullback, not a major correction –** While we expect spreads to come under a bit of pressure in September, it is unlikely to be the kind of market rout seen so many times over the last couple of years. The prospect of policy intervention will likely keep a firm lid on the desire to be underweight or outright short in most places. Turns in sentiment come too quickly these days.

- **Focus on the opportunities left by the rally –** The seesawing in spreads makes for a difficult directional trading environment for most funds. But we believe current level make decent entry points for a number of RV trades – we recommend adding exposure in the US over Europe, shifting from the softer core to the core, adding in IG over HY, moving from unsecured to secured and further out the maturity curve.

Figure 1. iBoxx Financial & Non-financial spreads at 1yr tights, bp



Source: Citi Research

Hanging on his every word

For all the kerfuffle, the summer turned out a lot less volatile and a lot better in terms of asset price performance than most, we included, had anticipated. The market was very defensively positioned – our survey in June showed the smallest longs in almost three years and cash levels have kept building up over the summer. A tentative stabilization in some of the key economic data[1] has also helped.

But Draghi was the real game changer in our opinion. His reassurances that the ECB would be prepared to "do whatever it takes to preserve the euro" at a speech in London on July 26 coincides with a decisive shift in the performance of many risk assets. While the subsequent ECB council meeting didn't produce any tangible steps, to the market's initial disappointment, Draghi cleverly managed to keep the market in suspense through August by indicating that the ECB would be "designing the appropriate modalities" over the coming weeks.

Now the time to spell out what these imply is nigh. Quite literally, markets are hanging on the implementation of those words.

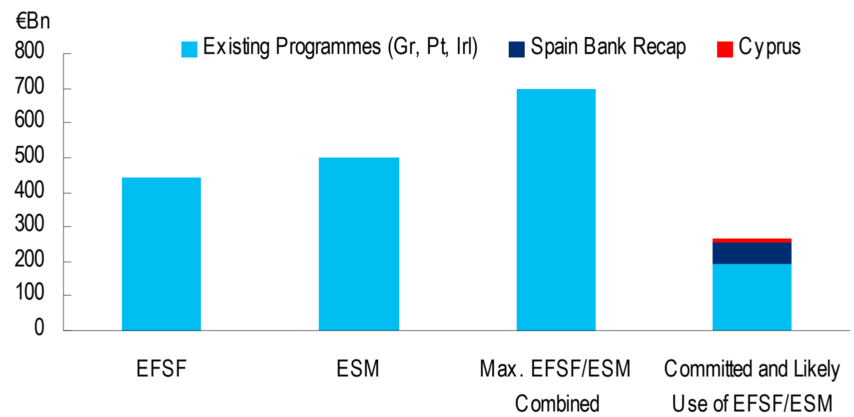
We believe the market may be somewhat overoptimistic about the flow of headlines in September. While the long-term technical picture remains very supportive, we think opportunistic longs in August make the credit market susceptible to a bit of a pullback near term.

Many questions left unanswered

So what is it that Draghi has to spell out to satisfy the market? We'd argue there are at least four issues that need to be addressed[2]:

Size & duration: How big would the 'Conditional Government Bond Purchase Programme' (CGBPP – another acronym to get used to) need to be and how long would it need to be in place?

Figure 2. EFSF & ESM resources and commitments



Source: Citi Research

[1] Our US economic surprises index has recovered from the July low of -65 to about -10 currently – indeed if it were not for the influence of historic figures, the current reading would be higher still. Even the broader G10 index appears to have turned around tentatively in recent weeks – the data is still surprising the consensus on the downside, but not by as much as a month ago.

[2] Our economists have made similar arguments in more detail in 'Euro Weekly: Eventful September Ahead', Jürgen Michels, 23 August.

Our economists calculate that the maximum amount of funding available in the current EFSF and ESM facilities is about €433bn, when existing commitments to Greece, Portugal and Ireland, the Spanish bank recap and the likely funding for Cyprus are subtracted. In reality, the available amount will likely be somewhat smaller when a second bailout has been organized for Portugal and / or Ireland. That firepower has to be weighed against a gross funding requirement of about €373bn over the next year and €703bn over the next two years for Italy and Spain combined (Figure 2).

So to ensure there is enough funding for two years, the ECB would have to commit to buying at least €330bn in the secondary market if it worked fully in tandem with the EFSF/ESM. For comparison, the outstanding on the existing SMP facility is currently €211bn. However, if the ECB wants to ensure funding for two years without EFSF/ESM support (to safeguard its independence or to retain firepower in the rescue facilities), that commitment would obviously grow considerably.[3]

Evidently, the actual amount the ECB would have to buy depends on the pace of foreign net selling and the willingness of domestic investors to roll maturing debts. From that perspective, the bigger the commitment the less the ECB would likely end up having to buy.

It is certainly debatable whether two years will be enough for Italy and Spain to allay investors' fears permanently. But for credit markets an explicit commitment from the ECB would in our view remove the issue from the immediate agenda, allowing credit to trade much more idiosyncratically again (the 'bargaining' and the 'depression' phases in our 'Five stages of grief' framework').

Specificity: How explicit will the ECB be about the details of CGBPP? Draghi will probably provide additional guidance on the conditions for ECB support. For instance, beyond Eurogroup approval for an EFSF/ESM programme, the ECB will probably require countries to meet the targets of the associated MoUs. He may also specify that the target maturities will be up to 1 to 2 years.

However, what the market really wants is a confirmation of size and monthly purchase targets or specific yield targets – as *Der Spiegel* recently reported was being discussed.

If the Council can agree on a number large enough to engender a positive reception in markets, then Draghi may announce the size – as the ECB did with the covered bond purchase programme.

However, last week's press reports that key details may not be disclosed at the next council meeting, citing anonymous 'ECB officials', seem like an exercise in managing market expectations. Even if the decisions are made behind closed doors we see several reasons why the ECB will not be too explicit publicly about the CGBPP, especially early in September.

First, Spain and Italy haven't yet applied for support from the EFSF/ESM and probably won't have done so in time for the ECB Council meeting. Making too many specific commitments before they do so would reduce the ECB's bargaining power in subsequent negotiations.

[3] Note also that these figures just cover the sovereigns, not their banks. We are becoming more concerned about the "base case" – in which the banks continue to be able to fund themselves via the ECB – given the pace of deposit outflows, notably in Spain. For that case to continue to hold, we are starting to think a relaxation of collateral requirements may become necessary.

Second, the issue of ECB intervention is obviously a delicate matter in Germany, and the ECB will probably want to avoid providing too much ammunition to antagonists just ahead of the ruling on the ESM and the fiscal compact by the German Constitutional Court on 12 September[4]. While our economists ultimately expect a favourable ruling, it is quite likely that the Court will seek to confer even greater influence on the Bundestag on future matters relating to sovereign bailouts. That may further reduce the political wiggle room in Germany going forward. Similarly, the ECB probably doesn't want to influence Dutch elections on the same day, which are likely to see a shift away from the centrist pro-euro, pro-austerity parties[5], either.

Thirdly, the ECB may not want to be very explicit generically. Granted, the CGBPP is different from the SMP which ECB regarded it as a temporary programme, intended to 'bridge' the implementation of or changes to the EFSF. And this time, Draghi has indicated that interventions would be done in a transparent manner.

However, even beyond the Constitutional Court, very specific commitments might create internal problems for the ECB, not least with the Bundesbank. Moreover, there is an argument that it would reduce the incentive to reform in the recipient countries – by not pre-committing and retaining considerable flexibility in its interventions, the ECB would retain a 'stick' with which to add pressure.

Also in a strategic sense there is arguably good reason to remain comparatively vague. Over the last couple of years, policy announcements have often proven more effective when the market was left guessing, than when actually implemented. One reason is obviously that the bazooka has tended to be smaller than what the market had come to expect. If Draghi finds it difficult to find support for a programme of the size outlined above, then we believe he would likely prefer to sustain the illusion of a big bazooka for as long as possible.

Seniority: A lot has been made of the issue of ECB seniority in the media. At the last ECB press conference Draghi indicated that this would be addressed. However, we remain skeptical. Bonds bought by the ECB through the SMP were never senior to other bond holders *de jure*. It was only with the consent of the Greek government that the ECB avoided participating in PSI at the least minute by exchanging its bonds into new bonds that were not included in the exercise.

The ECB could publicly commit not to exchange any bonds purchased as part of the CGBPP, but it is debatable how credible such a statement would be and it would likely draw criticism in core countries. In fact, the decision to focus on the front end of the curve invariably implies that the ECB will gain seniority in terms of the repayment schedule compared to most other bondholders. We believe the market will continue to believe that it is de facto subordinated to ECB purchases.

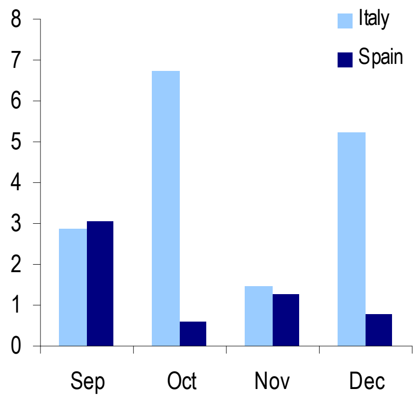
If you set your expectations low…

We have gone through all these aspects in some detail to make the case that the credit market may well end up somewhat disappointed with the outcome of the Council meeting. The ECB may extend its collateral framework further and our economists believe rates will be cut by another 25bp, but the predominant concern in the market remains the funding situation for Spain and Italy.

[4] If the decision is not deferred beyond that.

[5] See Tina Fordham 'Global Political Insights: Glorious 12th?', 20 August.

Figure 3. Remaining Spanish & Italian corporate bond redemptions in 2012, €bn



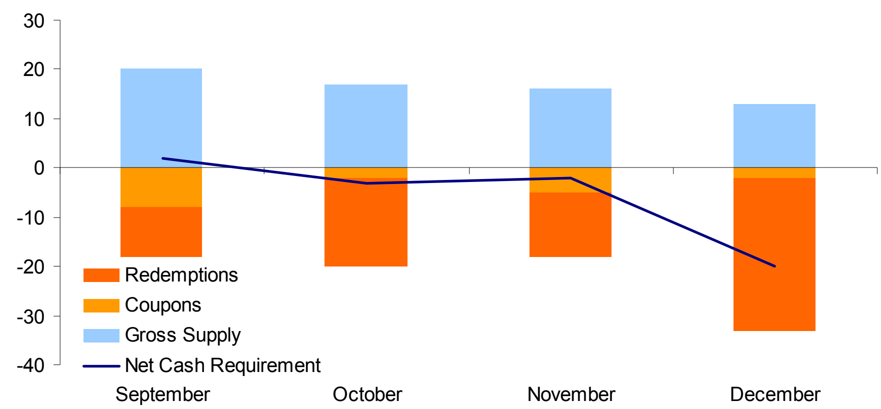
Source: Citi Research

Considering that most credit investors have been very reluctant to face markets from a short/underweight position, this creates downside risks if the council meeting turns out to be a bit of a damp squib on addressing that issue. Indeed, the lack of detail might prove to be the catalyst for the market to return more forcefully for a resolution.

For the remainder of 2012, redemptions for Italian and Spanish corporates look comparatively light (**Error! Reference source not found.**). We expect opportunistic issuance, if market conditions are favourable, but we don't believe that these redemptions create forced issuance.

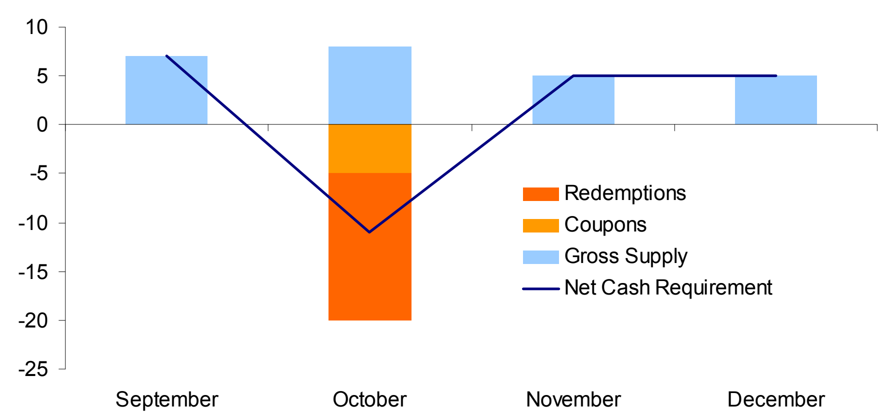
The gross sovereign funding schedule looks heavier – our rates strategists are expecting €66bn of Italian debt to be auctioned and €25bn of Spanish debt.

Figure 4. Italian Sovereign Funding Requirement Until Year-end, €bn



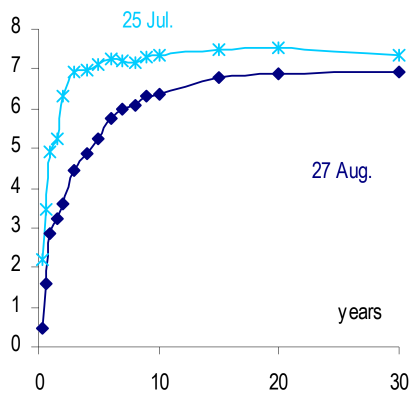
Source: Citi Research

Figure 5. Spanish Sovereign Funding Requirement Until Year-end, €bn



Source: Citi Research

Figure 6. Spanish sovereign yield curve, July & August 2012, %



Source: Citi Research

Obviously, the issuance should be supported by significant redemptions and coupon payments, which imply that the net funding requirements are much smaller – if not negative. However, the question remains how willing investors, foreign in particular, will be to roll these redemptions. Citi Research believes that both countries will have to request support. Is that going to be a smooth process?

Until recently, the Spanish government in particular was rather cold to the idea of applying for support. But we sense that the tone has changed markedly over the summer – not least in response to Draghi's plan. Recent comments that Spain is waiting to see what Draghi's modalities entail, and that the government will do 'what is best for Spain', certainly sound much more open ended than previous rhetoric. However, with front end yields now as much as 250bp lower than in late July, the immediate pressure on Spain has subsided considerably (Figure 6).

A period with a sovereign market in 'no man's land' would invariably weigh on sentiment in the credit market in our view. If the perception that 'nothing happens without market pressure' builds again, a combination of reductions in long positions and leveraged accounts resetting shorts would likely see credit spreads widen further.

A heavy agenda

Of course, it's not all about Draghi, Monti and Rajoy. There are a many other events on the agenda that can influence the outlook for the next few months. September is going to be a busy month.

Figure 7. Visible calendar for September 2012

31-Aug	Jackson Hole Symposium (Bernanke, Draghi)
~01-Sep	Troika returns to Athens
03-Sep	Eurogroup meeting on Italy & Spain (not confirmed)
06-Sep	ECB Governing Council meeting (likely details on the CGBPP)
06-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
	G20 Finance ministers and central bank governors meeting
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	
	Troika assessment on Greece
	Troika assessment on Portugal
	EC expert report (Liikanen Group) on banking sector reform
	Independent assessment of Spanish banks (2nd half of September)

Source: Citi Research

On 31 August, leading central bankers will speak at the Jackson Hole symposium, where although Draghi speaks, the focus is likely to be on Bernanke. The latest minutes from the latest FOMC meeting suggests the committee was closer to acting than the consensus had appreciated – 'many' members judged additional stimulus would likely be warranted unless there is a 'substantial and sustainable strengthening' in the data.

The data has improved subsequently, so Bernanke's comments will likely signal whether the Fed's has become less inclined to intervene further at its 13 September meeting. Our US economists believe the Fed will want to more data before committing to further easing. If correct, that would add another reason why credit market might be in for a bit of a disappointment early on in September.

As if this isn't enough to keep the market pre-occupied, the initial plans for a European banking union are due in the middle of the month. It is almost inevitable in our opinion that this will prompt a vocal debate and lobbying of national interests.

Last, but by no means least, the next troika assessments of Portugal and Greece are taking place in the first half of the month. Our economists expect a second bailout will be necessary later in the year, but the report on Portugal is likely to remain comparatively favourable. However, the assessment of Greece is more finely posed.

Citi's central scenario is that the assessment and concurring negotiations will eventually lead to a compromise that allows Greece to remain in monetary union until the next assessment in December. From recent comments out of Greece and out of Germany the outline of a possible deal is just about visible: Greece gets a modest extension on the delivery of conditionality, but no extra funding. However, even in the best of worlds it is unlikely to give the market confidence that Greece will left in a position where it is able to cope with the required adjustment over time. As such, it is unlikely to provide much support for credit spreads.

Conversely, should the Troika conclude that the programme is off-track, leading to a breakdown in negotiations, there could still be an early departure from EMU. That is not priced into current expectations in our view.

Arguably, clarity on the Spanish/Italian question early on in September would make this outcome more likely, as it would reduce some of the political concerns about associated contagion. Regardless, we'd still anticipate a negative market reaction given that the issue of potential deposit flight remains unresolved.

Just how defensive is the credit market?

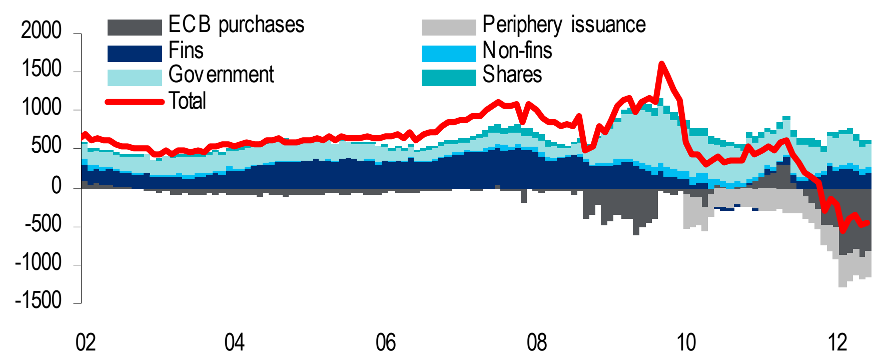
Long-term picture remains supportive

If you buy into the argument that flow of headlines next month may have a slightly more negative bias than the market is currently anticipating, then the natural question is whether that is also reflected in positioning and valuations.

On the brighter side, to our minds there is little doubt that the long-term technical picture remains very supportive – conceivably even more so than we had appreciated previously.

Figure 8 shows the 12-month rolling net issuance (before revaluation effects) of securities, split between shares, corporate securities and government bonds in various shades of blue. At first glance, not a lot has actually happened – net issuance of securities (the sum of the blue areas) is close to its long-term average.

Figure 8. Net issuance of securities by issuer, Euro Zone markets, €bn, 12-month rolling sum



Source: Citi Research, Haver Analytics, ECB

However, for an increasing number of investors in the core, periphery assets are no longer really in their investable universe. In addition, the non-conventional policies of the ECB have drained securities from the market, most obviously through the SMP, but also through the expansion of open market operations.

Subtracting these out, the implication is that for many investors 2012 has been highly abnormal. Rather than the normal €500bn or so increase per annum, the investable universe has arguably shrunk by about €500bn over the last year[6]. There has been no corresponding shrinkage in the net savings that are being ploughed into financial markets. With similar forces at work in the US, we think this shrinkage goes a long way to explain market performance this year despite the pervasive bearishness.

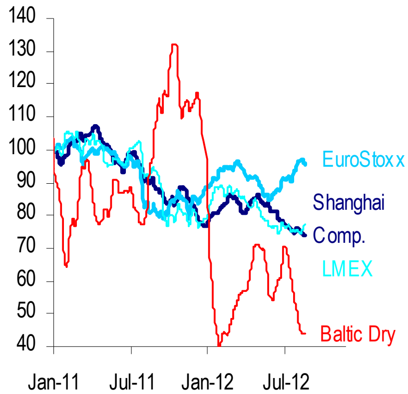
From a valuation perspective, the top-down picture is also comparatively supportive long-term – albeit much less so than a couple of months ago. Our new Credit Valuation Report shows that credit spreads are still between fair value and moderately wide to most fundamental relationships

Short-term the market looks rich

Yet we think the short-term technicals are less supportive. Positions have been creeping longer, and recent price action suggests to us that many opportunistic longs have been built up over the summer. Perhaps more seriously, spreads are the tightest they have been in more than a year in the cash market (Figure 1).

[6] To the extent that Spanish and Italian securities have been pledged as collateral with the ECB there is clearly some double-counting in the number we subtract from net issuance. However, we don't believe this changes the broader conclusion.

Figure 9. EuroStoxx 600 vs Shanghai Comp., LME index & Baltic Dry rate, Jan-11 = 100



Source: Citi Research, Bloomberg

Credit is not unique in that respect. Equity indices in Europe and the US are in a similar position, and implied equity vol is also not far from three-year lows. However, the term structure is still steep, implying that the equity market is pricing in increasing volatility during the autumn.

Moreover, from a global perspective the discrepancy in performance with asset performance in what were supposedly the growth markets is increasingly striking. There is surely a message in the fact that the stock market of the economy dubbed 'the growth engine of the world', China, is at its lowest levels since early 2009 (Figure 9). Base metals are down almost 30% from their peak last year and 15% since February. Freight rates (Baltic Dirty Tanker) have fallen by more than a third this year.

Admittedly, we'd be the first to argue that it is not the 'good or bad' that matters, but the 'better or worse than expected'. And Europe has not fared worse, economically or politically, than was anticipated at the beginning of the year, while China clearly has. So it is not surprising, perhaps, that Europe has done comparatively better while the adjustment to expectations was unfolding.

But at some stage you have to take a step back and consider whether the process can continue. At a time where the domestic economy is in recession, can European asset prices continue to ignore the signal such key indicators are sending about the global outlook and, in turn, corporate earnings?

Seesawing set to continue

We don't take issue with the argument that the outlook has improved considerably now that the ECB appears to have accepted that it needs to play a bigger role in the European sovereign crisis – we highlighted as much in the June outlook. At a minimum, the downside risks have diminished. That invariably made a defensive market liable to squeeze, as it has done over the summer.

We also concur that that the chance of further credit spread tightening longer term has increased substantially.

Regardless, however, the market looks decidedly overbought to us in the near term. Cash levels may be high, but with many funds already above their full-year targets, their incentive to take risk in the remainder of 2012 is low. Faced with the slight policy disappointment we expect, we suspect opportunistic longs get scaled back, given a combination of continuing lack of clarity about Spanish and/or Italian funding, much less attractive valuations, and a likely pickup in supply ahead of the Q3 earnings season.

What we are arguing for is not a big correction, but a pullback over the next few weeks. Risk/reward in € cash, in particular, looks poor with spreads at one-year lows, having outperformed US peers and spreads in the CDS market.

Evidently, the picture can change very rapidly if and when more visibility on the policy front emerges. If potential funding issues for Italy and Spain are been addressed and the prospect of a Greek exit is pushed beyond the immediate horizon, then the tightening in credit spreads is likely to resume. The speed of transition from one state to the next will almost invariably make the outlook very difficult to trade for funds with large portfolios.

If you can't be nimble, then look at some of the opportunities the rally has opened up instead:

- **Switch exposure from Europe to the US –** The outperformance of European credit over the last couple of months make it more attractive to move exposure to the US, especially in financials. For all the long-term risks associated with fiscal tightening in the US, for the time being the economic outlook is considerably better and the sovereign risk far, far lower.

- **Reset shorts in softer-core corporates –** corporates in the softer core (France, Austria and Belgium) have outperformed over the summer. We reckon this reflects the shortage of 'investable assets' – if you have cash, you need yield and you don't want periphery risk, then it's tempting to look at the cheaper assets that still remain in your universe. Having underperformed in Q2, 'softer core' corporates fitted the bill in July and August. Yet we reckon the spread to German peers is now again too low again.

- **Overweight IG to HY –** While high yield has benefited from the low-interest rate environment, a deteriorating economic outlook - coupled with the negative effects of potential benchmark changes medium-term - to our minds favours IG, especially in Europe.

- **Long covered/ABS and hybrid debt selectively versus underweight senior –** The effective subordination of unsecured bank debt makes investment in bank bonds more binary. We'd rather take more risk in assets with security.

- **Reduce systemic risk by moving out the curve –** there is a strong consensus long at the front end, which has left many curves very steep. We still think this crowded trade is susceptible to an increase in systemic risk – especially in banks.

Figure 10. Citi Investment Matrix, Overview

	Fundamental	Technical
Short term	**News: -0.8** Wgt: 30%	**Positioning: 0.3** Wgt: 30%
Longer term	**Solvency: -0.7** Wgt: 20%	**Valuations: 0.2** Wgt: 20%

Overall: -0.2

Source: Citi Research. Scale: -2: Very credit negative, 0: Neutral, 2: Very positive. News and Solvency scores are relative to consensus.

Figure 11. Citi Investment Views

Bp, As of 18/07/12	Current	1mth	3-6mth	Long-term
iBoxx € Corp	185	200	165	140
iTraxx Main	145	170	130	115
Crossover	595	660	550	500
3s5s IG CDS curve	39	35	30	20
5s10s IG CDS curve	28	25	20	10
Basis*	9	10	20	-10
IG vs HY**		IG outperf.	IG outperf.	IG outperf.
€ vs $ IG cash credit		$ outperf.	$ outperf.	€ outperf.
€ vs £ IG cash credit		€ outperf.	£ outperf.	€ outperf.

Source: Citi Research. * As reported in Citi's daily Basis Report. ** Risk adjusted

Figure 12. Citi Investment Matrix, Detailed Scores

Category	Score	Weight	Comment / view
News	**-0.8**	***30%***	
Visible agenda	-1.1	*14%*	Prospect of policy support encouraging, but consensus. Scope for near-term disappointment
Greek renegotiation	-2	*5%*	Agreement on extension likely in September, but our economists still put Grexit probability @90% >> consensus
Spanish / Italian funding	-1	*4%*	Large gross funding need in Q4. Market pressure likely required for either country to seek support
Dutch election / German Constitutional Court	-1	*1%*	Unlikely to post immediate obstacles, but may increase perception of long-term bailout paralysis
US fiscal deficit / debt ceiling	0	*1%*	Likely to be last minute again and subject to market pressure, but not immediately
Bottom-up review of Spanish banks	-0.5	*2%*	May well uncover further shortfalls. However, bailins likely limited to a few small banks for now
2nd Portuguese bailout	0	*1%*	Probably won't include PSI given fragile market conditions
Potential agenda	-0.4	*9%*	
ECB intervention (CGBPP/LTRO)	-0.25	*5%*	Consensus now; vague outline of measures likely at next meeting, but action only after a request for support
Federal reserve QE	-0.25	*2%*	Our economists are not expecting QE in Sep., but consensus also seems to have scaled back that expectation
Middle East tension	-0.75	*2%*	Doesn't seem priced in beyond the oil market. Recent rhetoric suggests there are downside risks
Micro event risk	0	*0%*	Very small
Macro event risk	-0.5	*4%*	Large and growing - in Europe, but also elsewhere
Economic surprises	-0.5	*3%*	Converging on 0 in the US & off lows in EZ. Citi forecasts suggest eco. surprises will remain neg.
Positioning	**0.3**	***30%***	
Credit survey positions	0.5	*12%*	Positions still defensive, but less so than earlier in the summer
Credit survey inflows/outflows	1	*8%*	Inflows holding up well; funds still cash rich
Market trading patterns	-0.5	*6%*	Recent demand mostly real money, but Street not trading short either.
Primary market issuance	-0.5	*3%*	Issuance likely to pick up in September. First deals likely fine, but expect some indigestion later
Liquidity	-0.5	*1%*	Poor. Volumes likely to improve in September but the exit remains far too small for comfort
Solvency factors	**-0.7**	***20%***	
Systemic / idiosyncratic risk environment	-1	*7%*	Market trading more idiosyncratically, though systemic risks abound.
Economic cycle	-0.75	*7%*	Europe is in recession. Global cycle deteriorating faster than consensus
Leverage trends	0	*2%*	Leverage is low, but bottom-up earnings estimates are too optimistic for H2
Policy environment	-0.5	*4%*	Progress has been made, but compromises have disappointed before in the delivery
Valuations	**0.2**	***20%***	
Relative to fundamental relationships	0.75	*7%*	Our valuations report suggests credit is moderately wide to long-term fundamentals
Relative to history	-1	*7%*	Wide to long-term range but cash is at 1yr tights
Relative to equities	0.75	*2%*	Credit is moderately wide to equity relationships
Relative to rates / sovereigns	1	*4%*	Low rates & yields likely pushing more money into credit over time

Source: Citi Research. Scale: -2: Very credit negative, 0:Neutral, 2: Very positive. News and Solvency scores are relative to consensus.

Appendix A-1

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