

Credit

24 February 2012 | 12 pages

US Credit Outlook

A Fork in the Road

- We remain constructive on credit, but still see significant tail risks to the downside originating from the actions of policymakers in Europe and the US. The rally is likely to continue in the short term, but the pace is slowing and we are concerned another flare up could be on the horizon.
- Investors need to closely watch the Treasury market and the strength of the economic recovery, as the path of interest rates is likely to dictate the magnitude of credit returns for the remainder of the year.

We recommend the following strategies:

- Take advantage of low implied volatility. We like buying payer spreads and longer-dated mezz index tranches as a hedge.
- Swap beta in the financials. Sell large cap US and European banks and buy lower beta credits in other financial sectors. Insurers, subordinated regionals and non-European Yankee bonds provide similar spread while minimizing tail risk.
- Beware the up-in-quality trade elsewhere. We caution against swapping out of higher-beta non-financial credits and into lower-beta ones. AA-rated bonds are now trading within a few basis points of their late-July levels.
- Target shorter-dated BBB bonds, not longer-date A-rated securities. We prefer to generate beta through spread versus moving out the curve.
- Buy high dollar priced bonds. On average, these bonds tend to provide 30bp of additional yield versus their lower coupon brethren, a discount we believe is unjustified.

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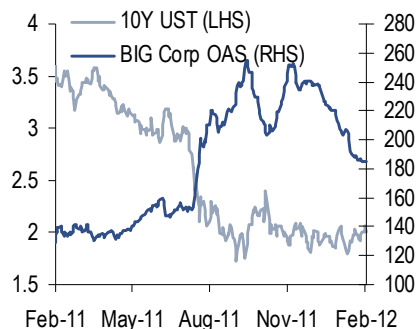
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A fork in the road

After a dizzying LTRO-induced rally, the question for many is, "will there be a second leg to the rally?" We still see plenty of risks on the horizon that make us wary of chasing performance, but with so much easy money sloshing around it's hard to see the market reversing its course in the near term. That being said, at least for high grade, the capacity for spreads to rally meaningfully further from here is totally dependent on what happens with Treasuries.

Figure 1. BIG Corp vs. 10Y UST



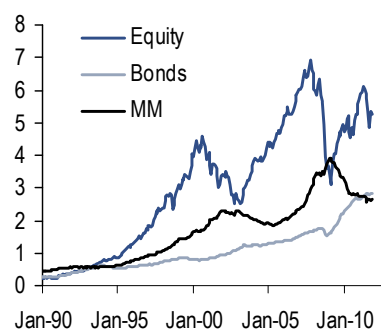
Source: CIRA, Bloomberg

By and large our outlook for credit remains largely unchanged. We still forecast credit to perform well in 2012, but see significant tail risks to the downside originating from policymakers in Europe and the US. What has changed slightly is our base case, which has become bifurcated in light of how the Treasury market has performed over the last three months.

At 185bp, we find high grade spreads near the middle of the 160bp to 220bp range we forecasted in December in our 2012 outlook. But while we're not surprised to see so much performance early in the year, the manner in which spread tightening has occurred is a bit perplexing. Since late November, high grade spreads have rallied nearly 67bp, all while the yield on the 10-year is more or less unchanged. That represents a significant breakdown in correlations and a challenge for investors.

On a yield to maturity basis, investment grade bonds reached all time tights in February and have since had trouble moving lower. But that's not too surprising given the resistance of pension and insurance funds to buying bonds that fail to enhance the yield of their overall portfolio. Eventually there will be capitulation because the alternatives to investment grade bonds are few and it's painful to stay underinvested for long periods of times. Yet the process of lowering bogies is gradual and will likely contribute to a slow grind tighter rather than a gap tighter one.

Figure 2. Mutual Fund NAV's favor Bonds



Source: CIRA, Haver Analytics

The technical backdrop remains unambiguously positive, and the pressure on investors to put money to work remains intense. Coupon income from high grade bonds should generate roughly \$160 billion this year while inflows continue to be steady thanks to accommodative policy worldwide. Against that backdrop, net supply continues to fall. In the US IG market we expect approximately **\$180 billion of net supply¹**, which based on historical norms is not a large number, and in Europe we anticipate supply to decline €150 to €200 billion.

A fork in the road

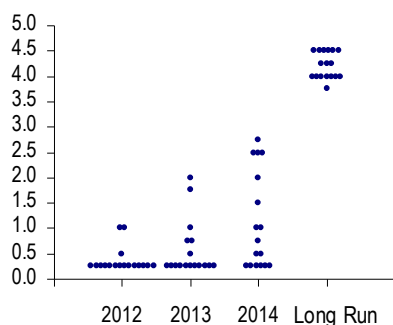
As such, absent a pullback (a big if), one scenario that we envision from here is that 2012 turns into a slow yield grind. Longer-term, Treasuries stay anchored and the yield-focused insurers and pension funds likely continue to reach for it while trying not to compromise the quality of their portfolios. Total returns are likely to be higher at year end, but at the cost of lower excess returns, as spreads would likely compress little from here.

Conversely, if longer-term interest rates back up quickly, a second scenario we foresee is a rapid compression in spreads back to the tights established in the second quarter of 2011, potentially accompanied by a backup in yields. In this scenario, total returns are unlikely to improve much beyond the addition of carry, but excess returns could add another 3-4%.

So will it be scenario one or scenario two? There's no doubt in the minds of most that the longer-end of the Treasury curve is overvalued, but whether we'll see a

¹ 'Issuance In Short Supply: Primary Prospects for Corporates in 2012', Joseph M Faith et al, 22 Feb 2012

Figure 3. Fed Funds Rate Targets*



Source: CIRA, federalreserve.gov

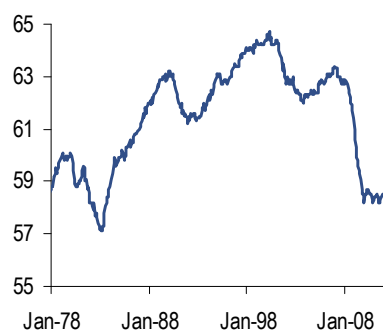
*Each point represents a value of a FOMC Member's judgment of the appropriate level of the target rate at the end of a calendar year.

Figure 4. Citi Economic Surprise Index



Source: CIRA, Bloomberg

Figure 5. Employment-population ratio



Source: CIRA, Haver Analytics

back up any time soon is a wholly different question. We see the 10-year and longer part of the curve as potentially overvalued by as much as 50 to 100bp and think a structural shift lower in yields is unjustified given the strength of the economic data.

As such, we believe that when “Operation Twist” comes to an end in late June, how the Fed progresses with QE will have significant bearing on rates. Recent conversations indicate that credit investors believe there is a 30-60% chance of a QE3 sometime in the next year. That's surprisingly high, but somewhat understandable given Chairman Bernanke's press comments following the most recent Fed meeting, where he seemed to imply that if the economic recovery does not improve then there would be scope for further asset purchases.

Were it only so straightforward. Alas, Bernanke isn't the only vote on the Committee and Fed's new transparent policy framework suggests a significant polarization among members. Some see a need for QE relatively soon, while others want to hike rates by year end. As such, it is likely a consensus will only be reached after first half economic data has been reported.

An economic thaw or just a mild winter?

Given the prominent role the Fed is likely to play in the outlook, trying to gauge the quality of the recovery in 2012 is very important in order to establish a view.

The biggest positive has been on the labor front. January's nonfarm payroll reading of 243K beat consensus expectations by more than 100K and single handedly reversed a slide in Citi's US Economic Surprise Index – a trend that has since been reestablished. Moreover, there's reason to think the gains may be permanent. The four-week moving average of initial claims has fallen to 359K, which is the lowest level since March 2008 and likely portends a strong February payroll number.

But as our economists note, the labor numbers may overstate the strength of the recovery and do not by themselves constitute a reason to revise upward their GDP forecast – for which Citi expects roughly 2% growth in 2012 and 2013. For a start, mild weather has likely played a large role in the reduced number of layoffs, and there has been scarce improvement in the employment-to-population ratio. This latter metric suggests that there are plenty of workers sitting on the sideline, as demand remains insufficient to create more jobs.

The effect of seasonality adjustments are an open question as well. The sharpness of the pullback in the fourth quarter of 2008 and the first quarter of 2009 has made the seasonal adjustments economists make to many data series suspect – including labor. As a result, many wonder if the winter months are being somewhat flattered by the math, with payback likely to come in Q2 and Q3. Certainly, 2010 and 2011 seem to support such a notion.

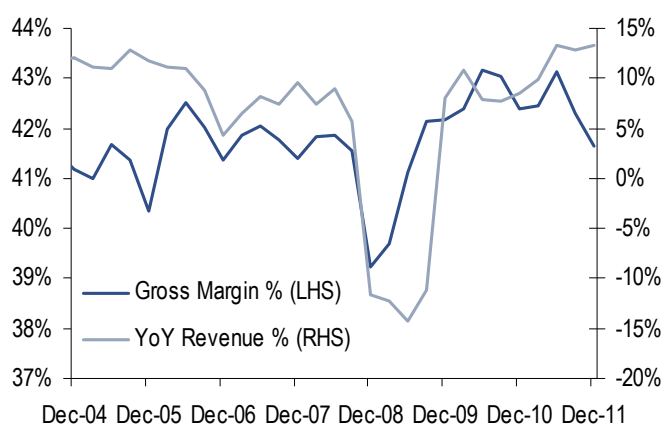
Not surprisingly then, Fed officials seem reluctant to change the direction of policy solely on basis of the labor data. But if gains remain steady, particularly going into the second quarter, a rethink of the maximum accommodation stance may be in order – let alone the prospect for another round of QE.

For their part, company profits seem to be bearing the brunt of some of the labor market improvement – at least temporarily. Fourth quarter EPS relative to analyst expectations came in near the past four year's lows. The deterioration seems to be the result of a decline in margins – which have seemingly peaked – rather than a fall in top line revenues. As [Citi economists point out](#)², away from added compensation

² [‘Labor's Turn to Awaken: Peak Margins but Not EPS’](#), Steven C Wieting, 16 Feb 2012

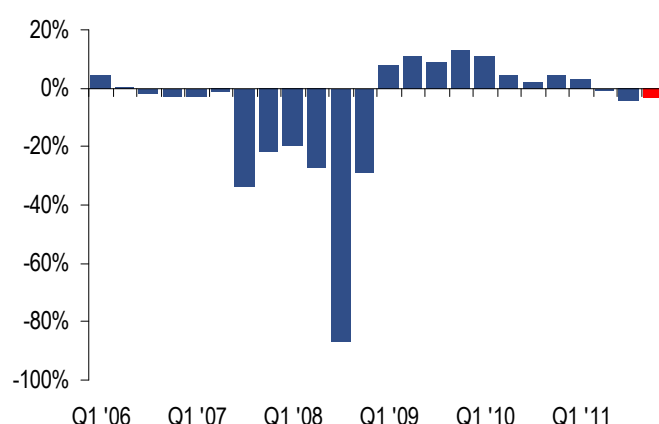
costs, a fall in deficit financed government transfer payments is also likely partly to blame for the destruction of some amount of “labor cost free” demand. For usually an improving labor market tends to support revenue growth and profits simultaneously, as the added compensation costs are typically more than offset by the associated pick up in consumer spending.

Figure 6. S&P 500 Revenue and Margin Trends



Source: CIRA, Bloomberg

Figure 7. S&P500 Earnings Surprise by Quarter



Source: CIRA, Bloomberg

As such, we have minimal concerns about company fundamentals. The relative importance of earnings season has probably grown in light of a fall in correlations. But if macro concerns resurface we still maintain that it will be hard to generate alpha by credit picking, especially when bid-offer is taken into consideration.

Apart from a potential weakening of the data over the next few quarters, how policymakers close the deficit is still one of the biggest threats to the economic recovery. Over the past few quarters Europe has provided a stark reminder of how ill-timed fiscal restraint can significantly curb growth and worsen debt sustainability analysis, and we are concerned a similar outcome could occur in the US if policymakers misstep. Through the combination of the expiration of the Bush-era tax cuts, the sequestration of spending (as a result of the failed supercommittee), and the expiration of the payroll tax cut (recently extended to the end of 2012), the drag on 2013 growth would be in excess of 3%.

While our [equity colleagues argue](#)³ that a positive resolution could help P/E ratios expand and risk premiums to decline, particularly if reforms to entitlements and the like take effect in the out-years, the same tailwinds are likely to have a diminished effect if high-grade valuations remain at already-lofty levels (at least when measured in yield terms). To our minds, November is likely to bring volatility even if some of the most significant fiscal pitfalls are sidestepped.

European risk: Not dead yet

While a disorderly Greek default has seemingly been averted, Europe remains the number one risk to economic recovery in the US, in our opinion.

To be sure, the European situation is far less acute than it was in October thanks to the ECB's 3y LTRO program. For the southern European banks, that injection of liquidity has essentially allowed them to continue financing current holdings (at a

³ 'Equity Strategy: The Fiscal Fear Factor', Tobias M Levkovich et al, 21 Feb 2012

haircut) and reduce exposure to short term or overnight funding markets. For the northern European banks, use of the LTRO has been much more limited and more of an exercise in building excess liquidity. But even if those funds initially remain on deposit at the ECB, over time banks are likely to draw down funds to buy new securities (the “Sarkozy Trade”), make new loans, or pay back maturing debt (although admittedly all these uses are contingent on confidence). And when they do, the funds are likely to circulate through the Eurozone in a beneficial way long after the second auction concludes on February 29.

But the LTROs notwithstanding, we believe the credibility of policymaking in Europe has been damaged as a result of Greece. For a start, already fragile donor country confidence in the Greeks’ capability to implement reforms and meet GDP projections has taken a turn for the worse. Few investors we’ve met with in recent weeks believe the commitment of the major Greek political parties to new austerity measures will be honored after elections in April, especially given the rise in popularity of the more extreme-to-center parties and statements by New Democracy leader Antonis Samaras.

This lack of faith in Greece’s ability to emerge from recession as a more competitive and fiscally responsible country has encouraged a harder line approach from the remaining AAA-donor countries. So far, the bailout “calculus” has continued to suggest saving Greece is far less costly than letting the country default. But it seems, at least to a few policymakers, that we’re approaching a time when this will not be the case. In our opinion, should Greece require a third bailout, it’s far from certain if the political will be there.

Paradoxically, the success of the LTROs seems to have engendered a renewed *laissez-faire* attitude. But that confidence in the LTRO as a bank firewall is likely misguided and should be seen as a risk by investors. The markets might have exhibited a certain amount of indifference during the bailout negotiations, but we’re hard pressed to conclude that had a Greek default occurred there would not have been larger ramifications.

For one, the LTROs and the EFSF appear to have done little to dissuade bank runs, which we speculate might have occurred had Portuguese and Irish citizens witnessed Greeks losing significant purchasing power as a result of redenomination. Moreover, the media being what it is, we imagine it would become politically difficult to convince constituents in AAA-rated donor countries to endorse any future peripheral bailouts after Greek losses were tallied and publicized.

Moreover, the ECB’s role in the second bailout is likely to have some unintended consequences. By agreeing to swap its Greek bonds acquired through the SMP for CAC-immune ones, private bondholders have been subordinated, at least in a *de facto* sense. If the rating agencies take a dim view of the transaction, than further downgrades to countries where the ECB has purchased bonds could ensue. What’s worse, if the rating agencies set that precedent, then the ECB might find itself disinclined to intervene in markets going forward because it fears setting off a wave of downgrades.

In that respect, we find Moody’s decision to adjust the ratings on nine European sovereign earlier this month to be more significant than many think. The agency downgraded Italy, Spain, and Portugal and maintained negative outlooks for all three. While widely expected, Italy and Spain’s ratings now stand at A3 and further cuts could result in additional collateral haircuts and eventual exclusion from benchmark indexes. As we saw with Portuguese yields in January, dropping out of an index can result in severe price swings and ultimately unsustainable yields.

Figure 8. Moody's Rating Actions on Selected European Sovereigns

| | As of 12th Feb 2012 | | Post 13th Feb Statement | |
|-------------|---------------------|---------------|-------------------------|--------------------|
| | Rating | Outlook/Watch | Rating | Outlook/Watch |
| Austria | Aaa | Stable | Aaa | Neg Outlook |
| Belgium | Aa3 | Neg Outlook | Aa3 | Neg Outlook |
| Finland | Aaa | Stable | Aaa | Stable |
| France | Aaa | Stable | Aaa | Neg Outlook |
| Germany | Aaa | Stable | Aaa | Stable |
| Greece | Ca | Developing | Ca | Developing |
| Ireland | Ba1 | Neg Outlook | Ba1 | Neg Outlook |
| Italy | A2 | Neg Outlook | A3 | Neg Outlook |
| Netherlands | Aaa | Stable | Aaa | Stable |
| Portugal | Ba2 | Neg Outlook | Ba3 | Neg Outlook |
| Spain | A1 | Neg Outlook | A3 | Neg Outlook |
| UK | Aaa | Stable | Aaa | Neg Outlook |

Source: Moody's, CIRA

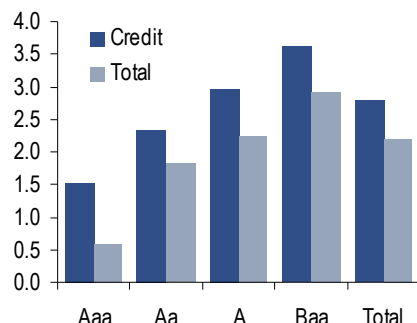
In the case of Portugal, there seems to be a growing concern that the country might end up following Greece's example. But, by all accounts, the country has made commendable progress in its austerity efforts and, unlike Greece, has no immediate funding issues. That being said, while Portugal isn't a near term concern for us, a second bailout may be needed by year end and it could require the use of another PSI exchange should the IMF scale back its future contributions as they did with Greece.

Similarly, Citi economists forecast that "poster child" Ireland is unlikely to hit its debt/GDP targets and will require a longer-than-planned period of fiscal austerity that likely will depend upon continued financial support as well.

And what about core Europe? The Socialist candidate for the French presidency, Francois Hollande, currently leads in the polls ahead of President Sarkozy with the first round of elections set to take place in late April. Should Hollande win, we are concerned that markets might react negatively. Among Hollande's most contentious policy points we find much to be troubled about – his desire to renegotiate the fiscal compact with Germany, balance the budget by 2017, tax bank profits (and bonuses), institute a Glass-Steagall like separation of retail and investment banking, renegotiate the retirement age lower, and eliminate tax breaks are concerning to say the least.

In short: we're still concerned about Europe. The LTROs have gone some way to slowing the pace of the troubles in Europe, but we believe ending it will prove difficult. It would help if policymakers agreed to combine the EFSF with the ESM on March 1 – as has been suggested – and if China made a significant contribution through the IMF. But even if that happens, we still think the patchwork of stability measures lacks the heft to really take European risks off the table for US investors. As such, we continue to watch for the next likely catalysts—the Greek and French elections in April.

Figure 9. YTD Credit and Total Returns



Source: Citi Investment Research and Analysis

So What to Do?

After the Greek deal, it would appear that the market has a few months of runway in which to perform before European elections take center stage and any seasonality effect to the economic data is exposed. We think it makes sense to stay aggressive and ride the global wave of liquidity for another 4-6 weeks, but then gradually reduce exposure.

But the decision really boils down to how nimble is one's portfolio. As we've argued recently⁴, the costs associated with trading in the current environment are rarely justified because of sky-high correlations and punitive bid-offer. Therefore we caution that investors should not get wedded to positions they don't want to hold when liquidity deteriorates – or at least make sure to get compensated for doing so.

For those that feel the need to begin expressing a cautious stance early (a notion we are very sympathetic to), option-type strategies probably offer the best hedge, although we offer at least one alternative in our recommendations below (swap beta in financials) and a few other observations. Namely, that high quality paper is by far the richest segment of the market.

For those that want to continue riding the liquidity wave just a little longer, perhaps in the hope that a Treasury sell-off is right around the corner (another notion we are very sympathetic to), targeting BBB-rated intermediate paper and picking up high-dollar bonds seems the way to go.

A fuller description of these strategies follows:

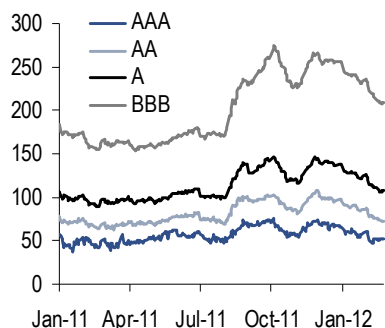
- **Implied vols are low, take advantage:** As our European colleagues' argue⁵, the Greek situation is very binary. If a hard default occurs sometime this year, then spreads will almost surely head wider. If able, we like buying payer spreads and longer dated mezzanine index tranches (IG9 10y 10-15% for instance) to hedge this risk.
- **Swap beta in the financials:** For many, the banking sector has become the portfolio lever most easily pulled to express risk-on/risk-off, as bonds tend to be the most liquid. But as a result spreads tend to move to extremes in both directions. At the moment we find high-beta bank cash to be extremely rich, both in Europe and in the US. As such, we recommend swapping out of European banks into US banks where possible, but also recommend swapping out of high beta US banks into lower beta financials in other sectors. As we highlighted earlier this month⁶, many of these swaps can be done with limited spread give-up. Essentially, investors lose liquidity, but can potentially outperform by hundreds of basis points in a sell off.

⁴ 'Why It's So, So Hard to Outperform Now... and What to Do About It', Stephen Antczak et al, 30 Jan 2012

⁵ 'European Credit Outlook: Will Lots of Liquidity Really Cleanse Credit Markets?', Hans Lorenzen, 8 Feb 2012

⁶ 'High Grade Strategy Note: Replicating the Bank Sector, Minus the Tail Risk', Jason Shoup et al, 15 Feb 2012

Figure 10. BIG Corp Non-Fin Spreads



Source: Citi Investment Research and Analysis

- **Beware the up-in-quality trade elsewhere:** Away from the financials, we caution against swapping out of higher-beta credits into lower-beta ones. AA-rated non-financials have rallied back to within a few basis points of their late July levels (i.e. right before the Euro selloff), while BBB-rated non-financials are still 40bp wide. Frankly, we find it strange that considering the market as a whole is showing some sensitivity to yield. One would expect that the highest rated credits would struggle to recapture the spread lost because of the late July/early August rate move, not the lowest rated credits. As such, if one's investment thesis going forward is that a repricing of the interest rate curve is likely to generate a second leg to the rally (our scenario two), then there's little to be gained by moving up in quality.
- **Target shorter-dated BBB bonds, not long-dated A-bonds:** We still favor intermediate BBB-rated bonds over longer-dated higher quality paper. The rally has favored this recommendation which we first expressed in our 2012 outlook, but we reckon there is more room to run if rates sell off. Yes, long-end paper is most poised to benefit from a steepening of the interest rate curve, but such a move is not likely to favor higher quality paper so much. If the choice is between generating beta through spread versus moving out the curve, we still choose spread.
- **High dollar priced bonds:** For those that think a reach for yield environment might persist for some time, we continue to advocate high dollar priced bonds. On average, they tend to yield 30bp more than their lower coupon brethren (and sometimes quite a bit more), a discount we think largely unjustified.

We plan on launching a new publication with more detailed US sector analysis and portfolio recommendations in the coming weeks. Therefore, from this edition these recommendations will no longer be published in the US Credit Outlook.

Appendix A-1

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