

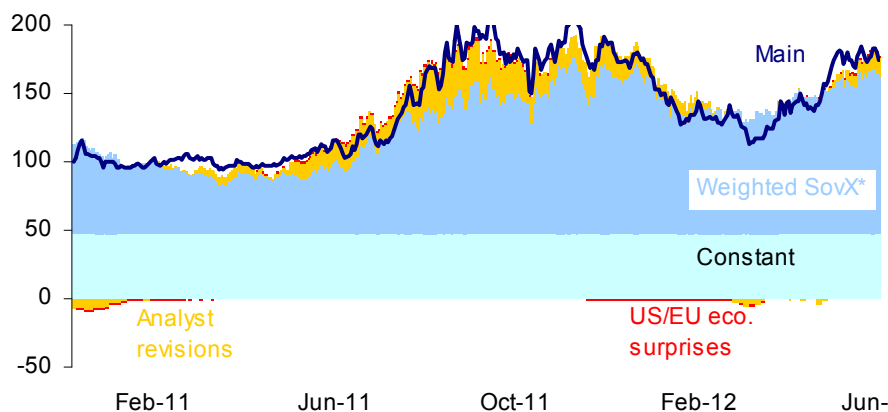
European Credit Outlook

Past the Summit, but Still Uphill

- **A step in the right direction** – European leaders managed to get ahead of the market at the EU summit. They increased their room to maneuver, seemingly without the need for painful national ratifications.
- **The devil is in the delivery** – Yet the ambiguous wording of the summit statement leaves scope for differing interpretations of what was agreed in various European capitals and crucial issues were left unaddressed entirely.
- **On the rating cusp?** Cutting the link between banks and sovereigns may ease the rating pressure on Spain considerably in the near term. But the threat of further downgrades and associated benchmark changes still looms. We expect the number of fallen angels in Spain and Italy to rise substantially in the coming months.
- **Enjoy, while it lasts** – Policymakers have bought time, which they may extend with further policy actions over the coming weeks. Very high cash balances and defensive positioning make the credit market prone to a further squeeze near term. Investors with short investment horizons may seek to benefit by adding generic risk.
- **Staying defensive** – Yet without a rapid succession of further initiatives we believe market enthusiasm will wither, creating renewed pressure on Spain and Italy. Therefore, we recommend fundamental investors keep a position close to neutral, adding in non-financials, but increasing the underweight in peripherals and financials as spreads tighten. We would be long US banks relative to European banks, long covered and ABS relative to senior and overweight IG relative to HY.

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Figure 1. Sovereigns still driving credit – Regression of iTraxx Main against SovX, analyst earnings revisions and US-EU economic surprises, bp



Source: Citi Research, Markit. * SovX is weighted by the distribution of domicile in the Main

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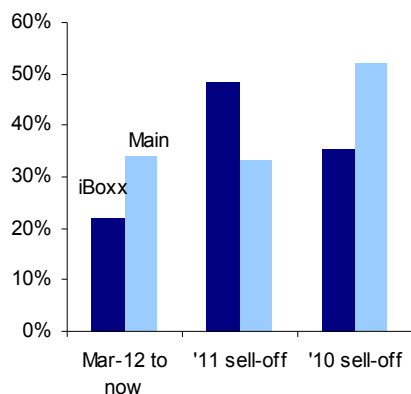
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Is credit really attractive here?

The summit was only a modest step forward, but expectations were so low that it has produced a meaningful bounce across financial markets.

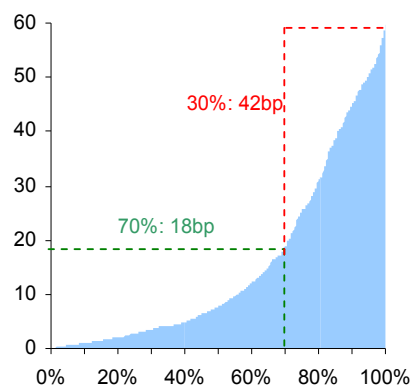
As we've argued many times lately, defensive positioning and lots of cash meant that the market was primed for a rally on good news – not just in credit, but across most asset classes. Even during the widening it was apparent that the sensitivity of credit to sovereign widening was much lower than during previous sell-offs over the last couple of years.

Figure 2. Widening in corporate credit indices relative to Spain 5yr CDS



Source: Citi Research, Markit

Figure 3. iBoxx, cumu. Contribution to index change from tightens, ranked by beta, bp (3 April to 27 June)



Source: Markit, Citi Research

For example, the iBoxx index only widened 20% as much as Spanish 5yr CDS from April to late June. In H2 2011, the corresponding number was about 50% (Figure 2).

Similarly, Figure 3 shows that the 70% of bonds in the iBoxx index that had the lowest beta have contributed only 18bp of widening since April. In contrast, the 30% with the highest beta have contributed 42bp to the widening of the index. In other words, it was an extraordinarily concentrated sell-off – despite the obvious systemic risks, investors were very reluctant to part with what they perceive as core holdings.

If the ECB follows up with a rate cut and another LTRO this week, then it would add to the sense that there is a coordinated policy effort under way to shore up markets. It would be futile to stand against the short-term tightening momentum of a market scrambling to put underinvested cash to work. Were European policymakers to reach an agreement on support from the EFSF/ESM for Italian and Spanish primary issuance pro-actively, then the rally would likely receive another boost.

But until European policymakers address the fundamental questions being asked by markets we think these rallies are ultimately self-defeating – when markets perform, pressure on policymakers is lifted and without that pressure they are unlikely to make the difficult and domestically unpopular decisions that the market craves. As such, we see the market continuing to trade in fits and starts over the coming months, responding to the policy measures on offer, but then relapsing as it becomes clear that they are not lasting solutions.

Spreads do not appear overly attractive here – Crossover below 650bp is not cheap against our default rate forecast of 6% at the end of 2012 (Figure 4)¹. Adding this to all the uncertainty, we don't feel inclined to chase the market tighter. We would stay close to neutral, using any tightening to get shorter/more underweight.

Lack of solidarity is at the root of the European problem

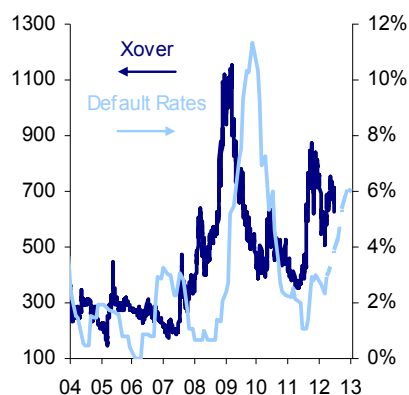
Only a matter of weeks ago, the immediate market sell-off was ascribed by many to the lack of an elected government in Greece and the need for bank recapitalisation in Spain. In the end, the outcome of both was about as benign as one could realistically hope for. Yet the rallies that followed lasted just a few hours before sentiment turned negative again.

To us, this illustrated that the market has really been asking a much more profound question: where is the limit to solidarity within monetary union?² The constraints to sovereign support currently are plain to see – the EFSF and the ESM are capped, key countries are not prepared to sign up for Eurobonds or a comprehensive deposit guarantee scheme, and even the ECB's willingness to provide liquidity directly is limited to a point beyond which banks are referred to national ELAs.

¹ See ['Default Rates to Climb Rapidly in Q3 and Q4'](#), Michael Hampden-Turner, 16 May.

² We have also set out this view in a recent presentation ["Make Up or Break Up"](#), 20 June 2012

Figure 4. iTraxx Crossover, bp, vs European spec. grade default rate with Citi forecast



Source: Moody's, Citi Research

Without a committed lender of last resort, it may be entirely rational for investors to keep selling down sovereign exposure, even at these wide spread levels. For instance, we calculate that a risk-averse investor looking to invest in a 4% 5yr bond should require a spread of ~675bp over swaps, if he/she sees a 10% chance of euro exit with default and a 10% chance of just a default over the lifetime of the bond³.

These numbers are not meant to reflect our expectation, but simply that under plausible scenarios even long-term investors may rationally demand a yield at which a sovereign would not sustainably be able to fund itself. It is a self-reinforcing dynamic: as yields and volatility are 'allowed' to rise without policy intervention, people's perceptions of the probability of default and/or exit are likely to rise as well, prompting them to seek a higher risk premium than they would have done at a lower yield.

That's why it is so important to keep the perceived risks and market uncertainty down. The EU summit clearly succeeded in doing that to some extent, as for once the market saw policymakers doing more than had been anticipated. But, in our opinion, it provided only a small part of the answer that the market will ultimately require and equally, it opened up new questions.

Past the summit, but still uphill

We won't rehash the summit conclusions themselves here⁴. But the market has paid remarkably little attention to the omissions from and the convenient ambiguities in the statement:

- Beyond the recurring debate about size, the potential funding issues for the ESM, let alone the EFSF, were not addressed at all. We suspect the EFSF would find it difficult to find sufficient demand at acceptable spreads, if it had to issue enough to even partially cover the funding needs for Italy and Spain. It remains to be seen how much better access to markets the ESM would have, but as yet, there is no suggestion that the ECB is prepared to provide the ESM with a banking license.
- Equally, the direct capital injections into Spanish banks raise a number of questions. If capital is pumped directly into banks, rather than through the FROB, then presumably that will have to be equity or preferred shares, in which case they would invariably be subordinated to existing creditors. That issue could perhaps be addressed with a contingent guarantee from the Spanish sovereign, but then the market ought to look through the off-balance-sheet structure and decide that Spain's solvency position is essentially unchanged from before the summit. Alternatively, EU partners might want to limit their risk by ensuring that banks are well capitalised before they inject capital. However, that would presumably be very bad news for bank bondholders, as we see very few other sources of capital than bail-ins. As such, unless core countries are suddenly willing to move from the top to the back of the pecking order, either the improvement in Spanish debt metrics is only optical, or the statement may well prove a bad harbinger for bank bondholders.

³ We assume 20% recovery in the exit scenario and 40% recovery in the default scenario and that the event happens in year 3. The excess return required to compensate for risk-aversion is calculated using the same principle as in our Rock Bottom Spread methodology that Sharpe ratios over time tend to converge on a value around 0.5. Using the realised volatility on 5yr Spanish debt YTD it is then possible to back out the excess return required from that assumption.

⁴ For a comprehensive analysis see "[Summit outcome – Preliminary Assessment](#)", J. Michels, 29 June

- Setting up an 'effective single supervisory mechanism, involving the ECB' is easier written than done. In practice, the concessions required if governments are to hand over meaningful influence over domestic banking systems seem a monumental obstacle to us. Post-summit comments by a German government spokesman suggest that Germany is not willing to accept any fig-leaf institution to pave the way for direct recapitalization of banks through the ESM. The chances of a hold-up, either at the intergovernmental level or in a national parliament are high, in our view.
- Moreover, markets seem to have forgotten recent concern about bank runs now that a government has been formed in Greece. However, a renegotiation of the terms of the 2nd Greek bailout will still be complicated and our economists continue to believe that there is a better than 50% chance that Greece will end up leaving the euro over the next 12-18 months. In that regard, it was hardly reassuring that the statement was silent on the prospect of a pan-European deposit guarantee scheme – even an inadequately funded one.
- Last but not least, it still remains to be seen whether and under what conditions Spain and/or Italy would seek financial assistance from the rescue facilities in order to lower their funding costs. Indeed, Dutch PM Mark Rutte made the following comment about Monti's request for EFSF/ESM bond buying in the secondary market: "That's not going to happen. They wanted an interest-rate cap. That's not going to happen either." Can a compromise be found without a further sell-off in markets?

Policymakers have given themselves more time and flexibility with the agreement. Moreover, it is encouraging that it transcends previous red lines in several places as the market looks for answers about the extent of European solidarity. Equally, though, they have left crucial questions that the market is bound to seek answers to, in our view. So what does this imply going forward?

Half full?

To us, the best one can realistically hope for from a market perspective is that policymakers keep filling in the blanks over the coming weeks. In this regard, the signal another ECB multi-year LTRO would send is as important as the actual liquidity injection.

More important still will be whether EU leaders can proactively agree on funding support for Italy and Spain. Both the Dutch and the Finnish PMs have very openly ruled out using EFSF/ESM funds to support the secondary market, but they have been silent about the primary market. Considering the emphasis on increased flexibility in the statement and Monti's request, optimistically one could envisage a compromise, where member states agree to let the EFSF/ESM support the primary market issuance of Italy and Spain without a formal IMF programme.

Assuming foreign private investors would remain net sellers, such partial funding would have to work in conjunction with further demand from domestic banks, funded by ECB LTRO money. This would not constitute a lasting solution, but in combination with an agreement on the Greek austerity programme it would remove some of the immediate triggers that have crippled markets – and the broader economy – in recent months.

In conjunction with the fact that the net cash requirement (after redemptions) is actually negative for Italy and Spain for the next three months as a whole, such a solution just might buy more time.

Crucially, retaining the notion of market access might also be the key to avoiding the rating downgrades that would take Spain and/or Italy out of the conventional government bond benchmarks.

Or half empty?

But this all assumes that policymakers will act ahead of market expectations, rather than reacting to developments as they have mostly tended to do over the last couple of years.

Unfortunately, we doubt this is how things will play out. First, the market rally reduces the pressure on policymakers. Our economists believe that the ECB's announcement yesterday that it is tightening rules on the usage of government-guaranteed bank bonds as collateral reduces the chance of an additional LTRO in July.

Second, it seems likely that a bailout programme would still largely depend on a more conventional fixed amount of funding over a specified timeframe. Third, judging by the differential in risk premia today, it seems likely that Spain would apply for funding ahead of Italy. From a systemic risk perspective, we would regard that as a negative.

Spelling out how much funding Spain might need over the next couple of years would make it all too easy for the market to calculate the spare capacity available for Italy. Given the size of the current facilities, that capacity would almost certainly be deemed insufficient, thus reinforcing the perception that there would be no buyer of last resort for Italian debt. It is easy to envisage a situation where the market pressure on Italy rises substantially as a result.

Our central scenario remains that the market in due course will be underwhelmed with the policy response following on from last month's summit. There are just too many unanswered questions and, considering that the compromises associated with a bailout come at considerable political costs domestically, they aren't likely to be addressed without further market stress.

What happens to credit when a sovereign goes HY?

The summit has probably reduced the immediate likelihood of rating downgrades of Italy and Spain – not least Moody's' Baa3 rating on Spain.

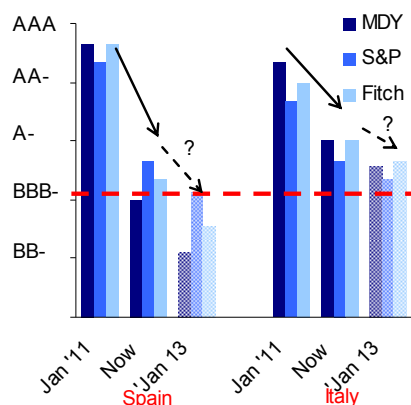
However, over the medium term we continue to believe that downside risks are compounded by the likelihood that more formal programmes would prompt rating agencies to downgrade Spain and Italy further. Portugal, Greece and Cyprus all lost their investment-grade (IG) status before or relatively shortly after applying for a bailout. Only Ireland has managed to remain IG with two rating agencies. Full programmes for Spain and conceivably Italy raise the very real prospect that they too could drop out of conventional government bond benchmarks.

The downward momentum in ratings is evident. Based on a simple extrapolation of downgrades over the last 18 months, Spain would be HY with at least two rating agencies by the end of the year (Figure 5). But it could happen considerably faster.

What would that mean for corporate credit? We see two channels of transmission – one direct and one indirect.

The indirect channel is a general rise in risk aversion. Even if the consensus view is already underweight on Spain and Italy, that does not mean that weightings are zero. Mandates of many funds simply make it impossible to deviate from benchmark by more than a certain amount. However, these same mandates often do not permit off-benchmark holdings, implying there would be forced selling if either were to drop out. When that happened to Portugal in January, yields spiked 500bp in two weeks.

Figure 5. Rating transition, 2011 to now with extrapolation



Source: Moody's, S&P, Fitch, CIRA

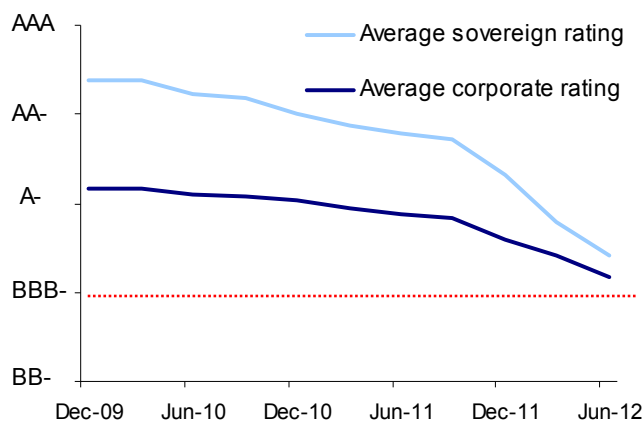
With the ECB not currently willing to make purchases through the SMP, the only potential source of demand for such forced selling we can see currently is domestic banks. However, it seems unrealistic to us to assume that they would be in a position to absorb anything approaching the likely volume of debt for sale – especially considering that they too would likely have to contend with higher margin requirements on their existing collateral posted. So there is a big question, where the support for the secondary market would come from – one that credit markets simply couldn't ignore, in our view. Banks and financial institutions in particular seem vulnerable to the likely mark-to-market impact on their balance sheets.

However, beyond this second order effect, the credit market would likely be hit through a much more direct channel – corporate downgrades that would follow.

On paper, rating agency guidelines leave analysts with considerable flexibility to rate corporates higher than the sovereign. S&P will allow corporate and ABS securities to be rated up to six notches higher than the sovereign, if the issuer is geographically and judicially diversified. Moody's would normally only uplift by two notches, but, as with Fitch, may choose to disregard sovereign ratings almost entirely if the corporate is deemed sufficiently independent and diversified.

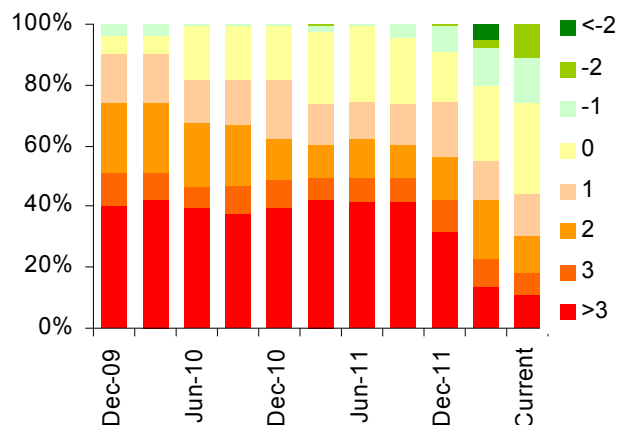
However, in practice the linkages between sovereign and corporate ratings are very apparent. Based on a sample of 111 corporate issuer ratings from the three agencies, Figure 6 shows that the pace of corporate downgrades has been comparatively slow through much of the sovereign crisis. But, as sovereign rating downgrades have accelerated and levels have converged on average corporate ratings, the momentum in corporate rating downgrades has clearly accelerated this year.

Figure 6. Periphery sovereign & corporate ratings converging



Source: Citi Research, Moody's, S&P, Fitch

Figure 7. Sovereign – corporate rating differentials*. Distribution based on a sample of 111 ratings of periphery corporates



Source: Citi Research, Moody's, S&P, Fitch. * A negative number (in green) indicates the corporate has a higher rating than the sovereign in which it is domiciled.

In Figure 7, we take this analysis a step further by looking at how the distribution of rating differentials to the sovereign has evolved over time. So for example, the first red bar shows the share of ratings in our sample that were more than three notches below the sovereign in December 2009. Greens show ratings above the sovereign. It is clear that these have become more common than previously, but equally it is clear that the uplift tends to very small. Only 9 in our sample were uplifted by 2

notches – and none above that. 88 ratings were still flat to or below the sovereign. As such, it seems more than likely to us that sovereign downgrades into HY will cause a similar shift in corporate credit. It may not happen immediately, but over time we would expect the majority of corporate issuers to follow the sovereign⁵.

Currently, we estimate that there is about €65bn and €84bn of Spanish non-financial and financial debt outstanding in the IG market, while in Italy the corresponding figures are €78bn and €215bn. Accordingly, Spanish and Italian corporate debt represents just over 6% and 12% of outstanding IG corporate debt, respectively. However, compared to the existing HY market in € the Spanish and Italian outstandings in IG look very large at 65% and 125%!

IG credit funds do tend to have greater flexibility to hold off-benchmark exposures than sovereign funds, and pent-up cash in HY could to some extent facilitate the transfer. However, HY funds probably won't be in a hurry to pick up the paper. The transition of hybrid financial debt into HY a couple of years ago illustrates that it can still be a very painful process in mark-to-market terms.

It need not be your central scenario to be relevant. With every sovereign downgrade from here, we believe the market will have to price a higher and higher probability that Spain and possibly Italy end up leaving the benchmarks eventually. In mark-to-market terms, such anticipation can be bad as, if not worse than, the event itself.

The wider perspective on credit

Fear has been the overriding factor over the last couple of months preventing credit spreads from rallying. Now that fear has subsided temporarily following the summit, the technical tensions in the market have been released.

This is not just a question of short covering by the Street and leveraged accounts, but the accumulation of cash over the last few months has left many real-money funds more underweight than they want to be currently. While CDS has led the move, we expect cash markets will make up ground gradually.

We anticipate a significant pick-up in issuance over the next couple of weeks. This may help to address the excess demand situation, but we doubt there will be enough to satiate the market completely. So if your investment horizon is comparatively short, then we think there is still merit in adding generic risk, if for instance, we see a pullback following tomorrow's ECB council meeting.

However, if you are managing a large cash portfolio that takes weeks to turn around, then we believe the window of opportunity is too short to make it worth chasing.

For one, value in the credit market does not look particularly compelling here, as argued above.

However, above all it is the likelihood that the sell-off in rates markets will have to get far worse before there is a real prospect of even temporary policy solutions that prevents us from getting bullish here. With limited upside and downside much harder to cap, risk/reward isn't attractive, in our view.

⁵ If the sovereign downgrades are limited to high double-BB, then it is likely that some of the big issuers in terms of volume, such as Santander and Telefonica, would manage to retain IG status.

We would therefore not go much beyond neutral with the following biases:

- Short/underweight financials to non-financials – Financials outperformed their betas substantially in the sell-off. This is partly justified by the fact that, unlike last year, there is no liquidity crisis in the banking system currently, by the willingness to recapitalise banks without sacrificing bondholders (at least till now) and by positive technicals resulting from large net redemptions. However, financials are more exposed to systemic risk than other sectors – not least due to their mark-to-market sensitivity. The risks surrounding Spain and Italy are highly systemic. Moreover, we are not convinced that the summit was actually good news for bank debt – to us, the risk of bail-ins has increased.
- Long US versus European banks – The widening in Spanish and Italian spreads was barely reflected in spreads on European banks in the core. However, given the large exposures – both direct and indirect – we believe the increase in systemic risk should be reflected much more in their spreads than for US counterparts.
- Long covered/ABS and hybrid debt selectively versus underweight senior – The effective subordination of unsecured bank debt, makes investment in bank bonds a more binary proposition. That speaks for barbellings between bonds with security or hybrid capital, where the subordination risk is already priced in. Relatively speaking, we believe the risk to senior is underpriced.
- Overweight IG to HY – Unwinds of crowded positions have seen the Crossover index outperform the Main in relative terms lately. However, in both cash and CDS, generically we prefer IG to HY in Europe. HY spreads do not look particularly attractive relative to our forecast for European default rates. However, more importantly the risk of the significant benchmark changes discussed above strongly favours the IG market.
- Use rally to underweight periphery corporates further – Our [credit survey](#) clearly illustrates that there is a large consensus underweight on periphery credit. The sharp short squeeze probably has further to run. However, medium term we think the bigger issue is likely to be the growing number of fallen angels in these countries – with or without the sovereigns. That is likely to cause renewed pressure on spreads.

The rally may have left the market on a roll going into the summit, but we still expect the going will be uphill for much of the remainder of the year.

Appendix A-1

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