

# What's Baked In, Part One

## Based on earnings indicators, credits that are mispriced

- Looking at recent price action, it seems to a certain extent that fundamentals haven't mattered. Will this be the quarter in which they do?
- Hot topics this quarter will likely be the global demand outlook, commodity price pressures, regulation, leveraging activities, and capex spending.
- Going into earnings season, we looked for spreads that may have lagged the rally or outperformed, and compared this performance to various earnings indicators. We found that there are several opportunities for spread movement post earnings, based on estimates and performance over the past 3 months.
- Our outlier pick is the energy space, as we believe the negative expectations are likely baked into spreads, and we think spreads could tighten from current levels.

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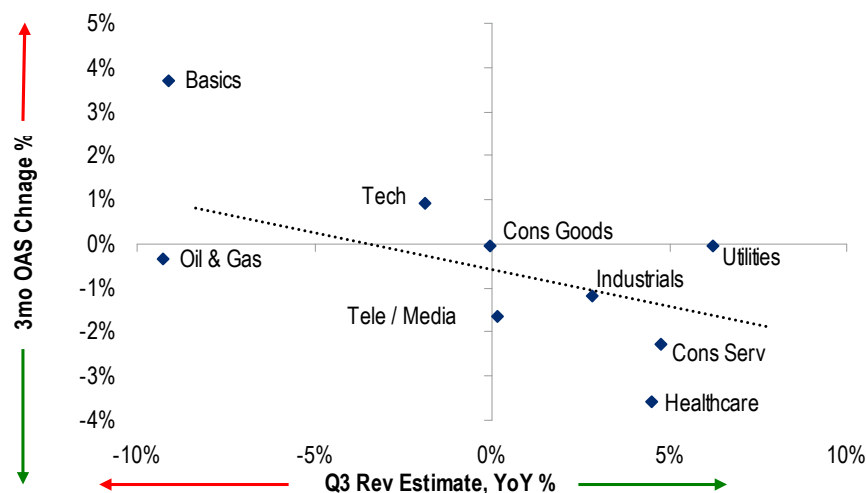
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## IG Beta Adjusted Spread Change vs. Q3 Revenue Expectations



Source: Citi Research

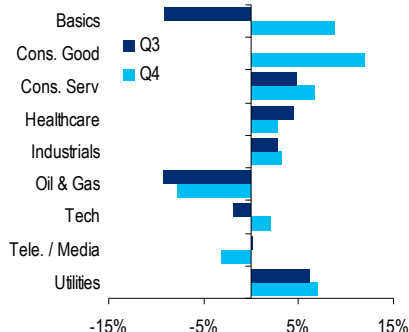
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## Expecting some downside, but where does it matter?

**Figure 1. Revenue Estimates**

YoY % Change, by IG sector



Source: Citi Research, Bloomberg

Note: Expectations are calculated on a bottoms up basis, based on the credits in the IG Index.

As we approach Q3 earnings, it seems that negative expectations have been well telegraphed. Concerns around lackluster growth in China and Europe have already weighed on many companies, prompting some to temper expectations with guidance revisions. Looking at Q3, we expect top line growth to be muted across sectors and margin expansion to be more constrained than in previous quarters. Equity analysts are looking for decent revenue growth in both the third and fourth quarters, as shown in Figure 1, but our view is a little less optimistic. We also note that while this quarter's results are important, we will more carefully look for color on the hot topics from the earnings calls.

To help investors hone in on the important topics this earnings season, we've identified our top concerns and bucketed them according to the sectors that they are likely to significantly impact, Figure 2. We note that these concerns are valid across both investment grade and high yield sectors.

**Figure 2. Topics investors care about, and the sectors that are most influenced by them**

Global Demand	Commodity Prices	Regulation	Leveraging Activities	Capex
Autos / Industrials	Basic Materials	Banks	Consumer / Retail	Oil & Gas
Basic Materials	Consumer / Retail	Healthcare	Healthcare	Telecom & Media
Consumer / Retail	Oil & Gas	Industrials (Defense)	Leisure & Gaming	Utilities
Healthcare (Pharma)	Utilities	Oil & Gas	Telecom & Media	
Oil & Gas		Utilities		
Technology				

Source: Citi Research

### Key topics

- **Slowing global growth.** Europe and China will likely be hot topics, but we also expect management teams to become more cautious on their outlook for the US, especially around fiscal cliff discussions. We expect to hear that global demand continues to be weak, especially for metals and mining credits and some industrials. To this extent, we expect to hear that visibility is becoming increasingly limited.

On a more positive note, we wonder when homeowners will begin to "feel" wealthier on the back of an improving housing market, and will look for color on trends in the lodging and gaming companies. Other clear beneficiaries of the rebound are building products and homebuilders, and color on order and delivery trends will be interesting from the latter.

- **Commodity price pressure.** We see commodity prices as the hot topic this quarter. The focus will range from those commodities under pressure (coal, nat gas, metals) and how they impact the energy, utilities, metals and mining sectors, to those commodities that are at record highs. In particular, we are focused on comments from grocers, food processors and ag producers, as we expect much of the pressure from the currently high grain costs to be a 2013 earnings event; these comments should begin to be heard on Q3 earnings calls. Coupled with a lackluster demand environment, it may prove difficult to pass along the increased costs to consumers. Potential bright spots in relation to commodity prices could be from: 1) apparel companies, as cotton prices have declined more than 30% from year ago levels (and 65% since Q1 2011); 2) chemical producers that benefit from lower natural gas prices; and 3) industrials and others that use basic metals as inputs.

On the broader margin front, after several years of cost cutting, gleaning the extra percentage points of profit, especially on the back of top line pressure, will be difficult. We don't expect margin contraction per se, but improving from already good results could be challenging.

- **Regulation.** We will listen for comments around sequestration (or whatever subsequent form spending cuts take) as they relate to the defense and healthcare sectors. For energy companies, the state of deep water drilling and fracking continues to be uncertain, while utilities will likely be concerned with rate cases and capex requirements.
- **Leveraging potential.** We expect to hear comments from management teams on how they plan to use the general abundance of cash, likely in response to an equity investor's question. Share buybacks and increased dividends are probable, although we believe these will maintain a tempered pace and will generally be prudent to the balance sheet. We also would expect to hear a lot of "looking for opportunistic M&A" as it seems that the ability to issue debt at low rates could prompt activity, although valuations have sizably increased.
- **Capex spend.** Primarily an issue in energy, utilities and telecom, we want to see how capital plans are shaping up for 2013. This will give us an idea of how much paper these companies need to issue, which may begin to come with concessions again in the new year.

## Upside / Downside Potential

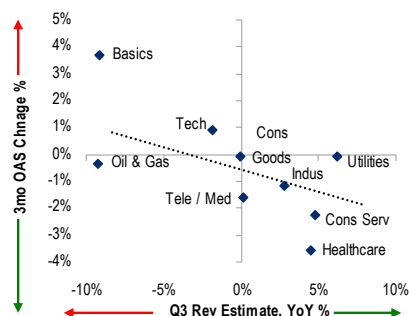
As we look at single names from a strategy seat, we make sure to incorporate the fundamental view and important topics with market technicals. In the case of earnings, we've seen too often companies report 'bad' numbers only to trade tighter. We thought it was worthwhile to compare spread performance over the past three months to various earnings indicators, and identify credits where we think there are opportunities for spread tightening or widening – regardless of how good or bad earnings may come in. For example, a company that has tightened more than the market but has earnings indicators that point negative may have downside potential. On the other hand, a credit whose spread move has lagged the market but is expected to grow earnings and has a positive track record may have upside potential.

We focused our search on members of the BIG Corp and HY Market Indices that also have public equity and analyst estimates readily available. We compared spread performance over the past three months on a beta-adjusted basis for IG; in high yield, we aligned credits into four quartiles based on spread level to better account for relative changes within their quartiles. The earnings indicators we considered were estimates and revisions for Q3 revenues, EBITDA and EPS, Q2's performance in relation to expectations, and the company's 2 year track record in growing earnings.

## Mispriced Credits

In general, we believe that the market usually gets it right, and spreads tend to move in anticipation of earnings. However, sometimes names are overlooked and opportunities arise. The credits highlighted below reflect our estimates for names that may have moved too far and not far enough, based on the metrics mentioned above.

**Figure 4. IG Beta Adjusted Spread Change vs. Q3 Revenue Expectations**



Source: Citi Research, Bloomberg

**Figure 3. Investment Grade - Spreads Not Reflecting Earnings Expectations?**

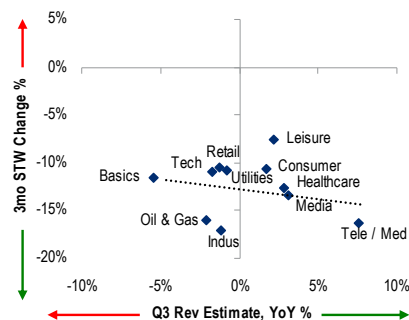
Our Candidates for Spread Movement, Post Earnings

Market Indicators					Earnings Indicators			
Name	Sector	OAS	3mo. OAS Range	3mo. Equity Δ	3Q Rev Est%	3Q EPS Est %	3M Rev. Revision	2Q EPS
Lagging the Rally								
CBS Corp	Media	161	144-197	9.5%	4%	20%	-1%	Beat
Ensco	Energy	172	143-216	13.0%	20%	46%	0%	Beat
Halliburton	Energy	153	137-177	13.8%	9%	-8%	1%	Beat
Home Depot	Retail	121	107-142	19.4%	3%	14%	0%	Beat
Molson Coors	Consumer	152	133-177	6.4%	30%	27%	29%	Beat
Rallied too far?								
Archer Daniels	Consumer	133	119-148	-1.9%	-3%	-31%	0%	Miss
Avon Products	Consumer	176	150-215	-2.6%	-7%	-41%	-4%	Miss
Potash Corp	Basic Mat.	71	70-104	-8.5%	-7%	-14%	-4%	In line
Staples Inc	Retail	104	79-157	-12.7%	-2%	-4%	0%	Miss
Walgreen Co	Retail	140	138-189	21.6%	-1%	-18%	0%	Beat

Source: Citi Research, Bloomberg

Note: We beta adjust spreads to remove the contribution that can be explained by aggregate market moves over the past three months.

**Figure 6. HY Spread Change vs. Q3 Revenue Expectations**



Source: Citi Research, Bloomberg

**Figure 5. High Yield - Spreads Not Reflecting Earnings Expectations?**

Our Candidates for Spread Movement, Post Earnings

		Market Indicators			Earnings Indicators			
Name	Sector	STW	3mo. STW Δ	3mo. Equity Δ	3Q Rev Est%	3Q EPS Est %	3M Rev. Revision	2Q EPS
Lagging the Rally								
Avis Budget Car Rental	Consumer	499	(3)	-0.6%	36%	97%	-3%	Beat
B/E Aerospace Inc	Industrials	352	6	-3.1%	20%	8%	0%	Beat
Belo Corp	Media	419	(29)	23.4%	18%	72%	2%	Beat
Crown Castle	Telecom	314	42	10.8%	16%	-4%	5%	Beat
Range Resources	Energy	335	(32)	13.4%	23%	-20%	-5%	Beat
United Rentals	Industrials	470	(39)	-6.3%	77%	9%	2%	Beat
Rallied too far?								
DineEquity Inc	Retail	460	(119)	28.9%	-21%	9%	-3%	Beat
McMoran Exploration	Energy	651	(266)	-17.8%	-38%	127%	-6%	Miss
Steel Dynamics	Basic Mat.	386	(85)	-9.0%	-12%	-33%	-8%	In line
Tesoro Corp	Energy	274	(168)	71.4%	-13%	-9%	-15%	Beat
Visteon Corp	Auto	468	(135)	20.4%	-20%	-37%	-2%	In line

Source: Citi Research, Bloomberg

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