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North America

Putting Tapering into Perspective

The other side of the argument

- **Overview:** Given what happened this spring after tapering fears first cropped up many market participants see it as perhaps the most important near-term catalyst for widening. In this article we test this view, above and beyond the "faster growth will help risk assets" argument.
- **What's Different This Time?** We introduce three factors that may serve to mute the direct impact of tapering. First, while demand will fall sharply post-QE, supply in a number of markets is likely to fall as well. It's supply and demand, right? And by at least some metrics credit spreads may have already priced-in tapering.
- **An Underappreciated Risk:** There are reasons why the "direct" impact of tapering on credit may be more muted than at least some expect, but other assets may be more vulnerable to volatility. Be aware of spillover risk.
- **Trade Idea:** Irrespective of whether spreads widen sharply or not in the wake of a tapering headline dislocations between fundamentals and valuations are likely, in our view. Look to take advantage.

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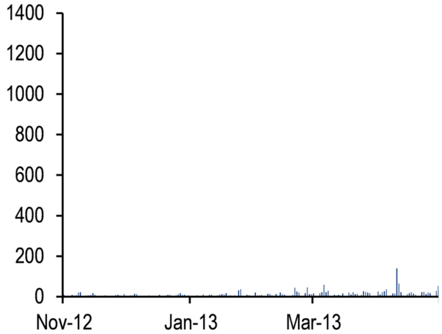
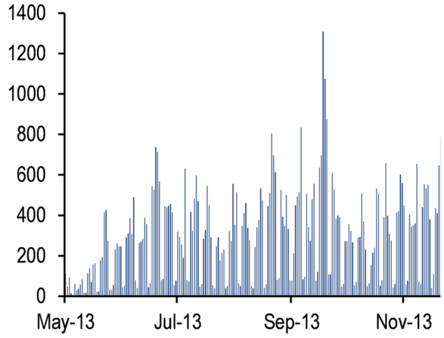
Figure 1. Daily count of news stories on Bloomberg with the word "taper" was minimal during the 6-month period prior to May…



Source: Citi Research, Bloomberg

Figure 2. …but since then there have been an average of 300 stories per day



Source: Citi Research, Bloomberg

Putting Tapering into Perspective

The other side of the argument…

Aside from tight spreads, investors do not seem to be worried about all that much as we head into ’14. There are challenges brewing, such as re-leveraging, but by and large these are seen as tomorrow’s problems, not today’s. The one exception may be tapering, an event that many expect to occur in March at the latest.

The rationale is very straight-forward. QE has forced valuations to, by at least some metrics, unsustainably rich levels. In addition, credit may be held in weak hands (e.g., ETFs & mutual funds) and selling pressure in a rising rate environment could be dramatic. And if selling pressure does ensue the Street probably won’t be able to cushion it given limited balance sheets. This is essentially the script that played out when tapering fears first arose in May / June.

But in this article we want to challenge the consensus a bit, above and beyond the “faster growth will help risk assets” argument. Specifically, we introduce three factors (there are others) that may serve to mute the direct impact of less Fed buying, and in this regard we look at the world in a spread rather than total return context. But of course it’s impossible to argue that there isn’t any tapering risk, and we highlight a factor that may be somewhat overlooked. Lastly we summarize a strategy to cope with this backdrop. Again, the goal is to challenge the consensus.

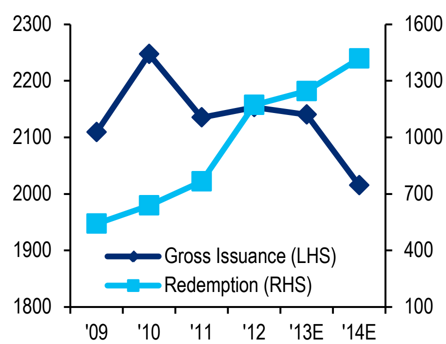
What’s different this time?

1. Δ Supply + Δ demand = Δ price

QE is obviously a huge source of direct demand in the rates space, and a large indirect source elsewhere. All else equal when tapering takes place demand in the rates markets will fall sharply, and of course a spillover effect will be felt among risk assets. *But all else is not equal.* When considering tapering impacts it is very important for credit investors not to lose sight of supply dynamics in the rates space. Consider them in the Treasury market:

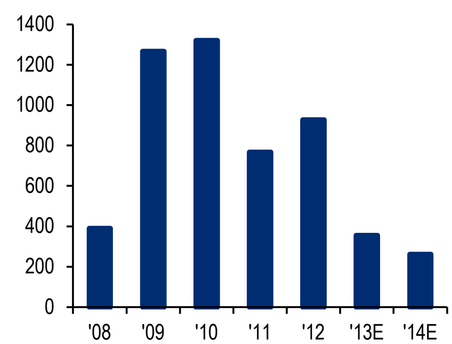
- ’14 gross issuance is expected to be at its lowest level in more than 5 years ($2,015 bn, Figure 3).
- At the same time Treasury maturities are expected to be at their highest level ever ($1,418 bn, Figure 3).

Figure 3. ’14 gross Treasury supply expected to be at a multi-year low, maturities at an all-time high



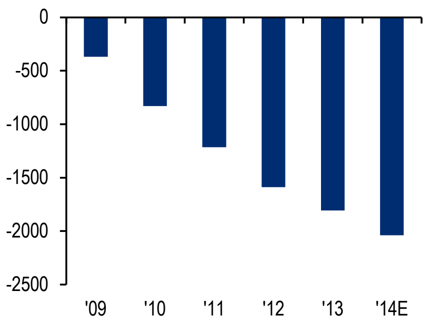
Source: Citi Research

Figure 4. Net supply less Fed purchases expected to be at the post-Lehman low



Source: Citi Research

Figure 5. Cumulative net issuance of non-agency RMBS and agency debt since ’08



Source: Citi Research

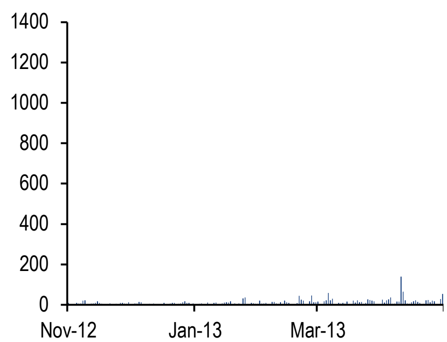
- This means that even if tapering occurs next March the amount of Treasury bonds needed to be absorbed by the market (net supply less Fed purchases) will be at the lowest level in the post-Lehman era (Figure 4, previous page).

And what’s going on in the Treasury market is not the only noteworthy story. Just as important is the extent to which other rates markets are shrinking. For example, Figure 5 shows that the agency market and the non-agency RMBS market have shrunk $1,807 bn since ’08! **With or without QE, there is a lot of cash looking for a home and fewer places to put it.**

2. Not exactly new news

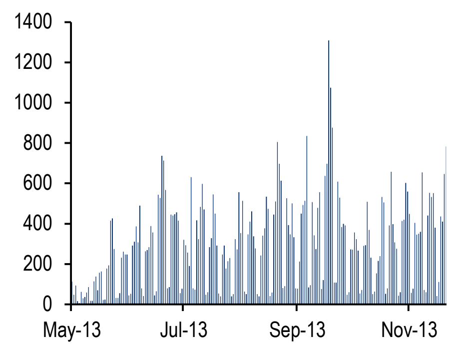
One of our basic tenants is that the markets are efficient…maybe not perfectly, but at least reasonably. In this regard, it’s important not to forget that the QE tapering topic has been in the news for over six months. In fact, Figure 6 shows that in the six months prior to the May scare the word “taper” appeared in news stories on Bloomberg an average of 11 times per day. This number has jumped to 300 times per day since then (Figure 7). How often does old news really have a meaningful impact on prices?

Figure 6. Daily count of news stories on Bloomberg with the word “taper” was minimal during the 6-month period prior to May…



Source: Citi Research, Bloomberg

Figure 7. …but since then there have been an average of 300 stories per day



Source: Citi Research, Bloomberg

3. Priced-in?

In an attempt to quantify the extent to which tapering may be priced-in we compared the price action this spring with spread changes that normally result from sharply rising Treasury rates. Specifically, we looked at periods over the past 30 years when the 10-year rose by 1% or more over a fairly short period of time. We found twelve such periods.

Typically we see dramatic tightening when Treasury yields rise sharply. On average high grade spreads tightened 62 bp during these periods and high-yield tightening averaged 202 bp (Figure 8, next page). In fact, there is not a single period in which spreads did not tighten in high-grade, and there was only one time in high-yield. But we saw the exact opposite happen this spring, with *widening* of 18 bp and 78 bp in high-grade and high-yield, respectively (Figure 8, next page).

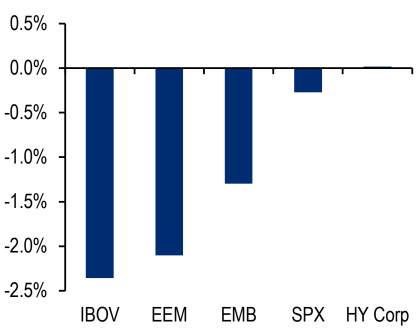
Perhaps the difference between what normally happens and what happened this spring — 80 bp in high-grade and 280 bp in high-yield — was the pricing in of tapering.

Figure 8. Relationship between Treasury yields and credit spread changes was very unusual this spring

Period	10Y Treasury Yield Change	HG Spread Chance	HY Spread Chance
May '83 to Jul '84	+3.57%	-47 bp	—
Dec '86 to Oct '87	+2.45%	-79 bp	—
Mar '88 to Mar '89	+1.15%	-38 bp	—
Aug '89 to May '90	+1.22%	-20 bp	+132 bp
Oct '93 to Dec '94	+2.52%	-39 bp	-66 bp
Feb '96 to Sep '96	+1.36%	-13 bp	-94 bp
Oct '98 to Feb '00	+2.25%	-20 bp	-122 bp
Nov '01 to Apr '02	+1.16%	-31 bp	-227 bp
Jun '03 to Jun '04	+1.28%	-32 bp	-228 bp
Jul '05 to Jul '06	+1.22%	-7 bp	-43 bp
Jan '09 to Jan '10	+1.63%	-380 bp	-962 bp
Sep '10 to Apr '11	+1.00%	-39 bp	-207 bp
Average	**+1.73%**	**-62 bp**	**-202 bp**
May 1st to June 28th	**+0.86%**	**+18 bp**	**+78 bp**
Difference	—	**80 bp**	**280 bp**

Source: Citi Research, Bloomberg
Note: All months are month-beginning

Figure 9. Tapering fears weighed on sentiment on December 2nd, but total returns varied dramatically



Source: Citi Research, Bloomberg
Note: From November 29 to December 2, 2013 total return for HY and price returns for others

Key point: Tapering may be a concern, but there are reasons why it may not be as much of one as many expect. In fact, we have seen signs in recent trading that U.S. credit may be fairly immune to tapering headlines.

For example, Figure 9 shows the response of various assets on December 2nd to stronger than expected economic data and renewed tapering fears – IBOV and EEM were down -2.4% and -2.1%, respectively, suggesting that investors were worried. But the high-yield market was *up 0.02%.* Hmm…

But be aware of spillover risk

One can argue that while the direct impact of tapering on credit spreads may be muted by various factors, other risk assets may be more vulnerable to volatility. For example, munis and EM may be more susceptible in part because the fundamental backdrop is less certain than it is in credit and liquidity conditions could play a role as well.

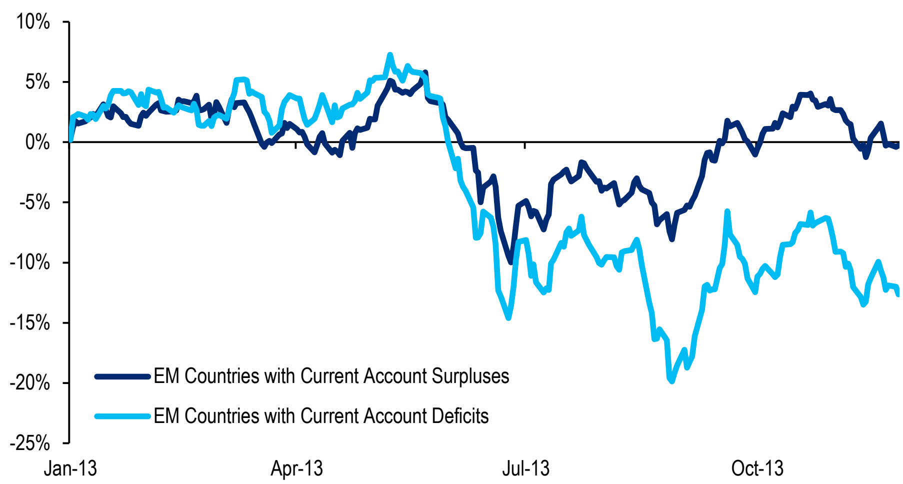
1. Vulnerable fundamentals elsewhere?

Let's start with the fundamental backdrop and focus on EM. Concerns about growth prospects and funding stability in EM clearly weighed on the market when tapering fears first appeared in the spring. But despite the firmer sentiment in the markets since then, EM investors still seem quite skittish about at least portions of their space.

To illustrate, in Figure 10 we plot the performance of two groups of EM equity indexes – one comprised of countries with current account surpluses and one with deficits. Both groups suffered this spring, in fact almost in lock-step, but the more "defensive" of the two has essentially returned to pre-spring levels. Comparatively, the group with current account deficits really has not recouped any lost ground since then.

Key point: Investors appear skittish about at least portions of EM, and a skittish investor base could mean dramatic outcomes, good or bad. Who knows what could happen?

Figure 10. YTD equity market performance of EM counties with current asset surpluses vs. current asset deficits



Source: Citi Research, Bloomberg
Note: As of November 26, 2013; CAS countries include Taiwan, Malaysia, Philippines, Russia, China; CAD countries include South Africa, India, Indonesia, Brazil, Mexico, Thailand; current account as of Q3 '13

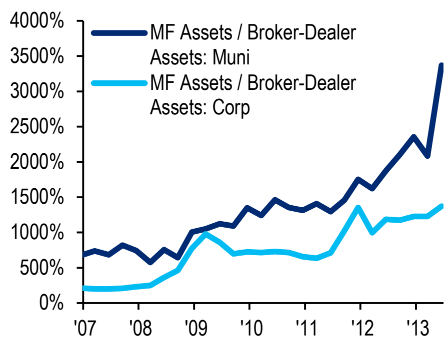
2. Small dealer balance sheets

Many credit investors are concerned about potential outflows in light of limited dealer balance sheets. But how does this risk in credit compare to other markets, such as the muni space? In Figure 11 we compare the ratio of bonds held by mutual funds to those held by the Street in the two markets. The latest data show that mutual funds hold $1,883 bn corporate bonds and the Street owns $137 bn, or a ratio of 13.7x. (Note that we use total assets rather than net dealer positions due to a data series break.)

But in the muni space mutual funds hold $641 bn and the Street holds $19 bn, which means that mutual funds' position size is over 30x bigger than the Street's. Figure 11also shows that this number in the muni space has increased exponentially in recent years.

Key point: Not coincidently, 2 of the 3 most volatile setbacks in the muni market since '25 have occurred in the past three years (Figure 12).

Figure 11. Ratio of mutual fund to Street assets in the muni and corporate markets



Source: Citi Research, Federal Reserve
Note: As of 2Q 2013

Figure 12. Largest 3-month moves in the muni index since '25

	Start	End	BP Change
1	Oct-10	Jan-11	+143 bp
2	Feb-87	May-87	+140 bp
3	May-13	Aug-13	+110 bp
4	Feb-33	May-33	+102 bp
5	Jan-94	Apr-94	+93 bp

Source: Citi Research, Bond Buyer
Note: Based on 20Y AA+ muni index

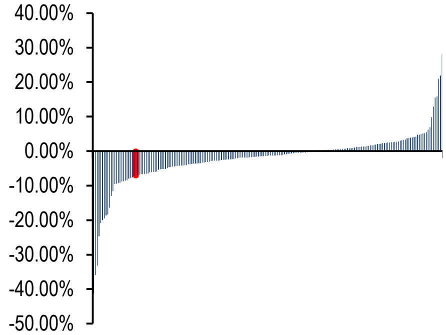
Trade idea

The knee-jerk reaction to any tapering announcement may very well be spread widening, but a reasonable argument can be made that the direct effect of less Fed buying may be far more modest than many expect. That said, spillover risk may be underappreciated by the consensus and dislocations of various sorts may emerge. But they are likely to be transient, in our view, and we would look to take advantage.

- **Dislocations between fundamentals & valuations:** One thing that may happen in the wake of any tapering announcement is dislocations. To illustrate and using history as a guide, in Figure 13 we present spread changes for 200 benchmark high-grade names in May and in Figure 14 we present the change in implied default risk for the same issuers and ordered in the same way. We can see that spread moves do not correspond with changes in default risk very well at all.

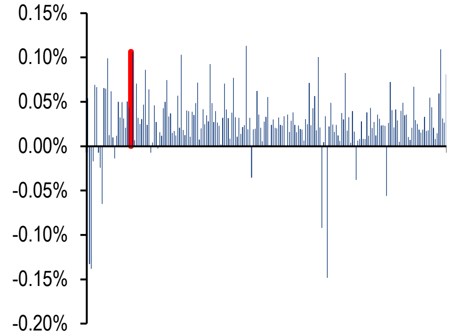
For example, spreads for FE cash bonds (highlighted in red) ticked 7 bp tighter during May, but default risk rose rather than declined (+10 bp). Seems like a potential opportunity, should we see a repeat.

Figure 13. Spread change in May for select IG issuers



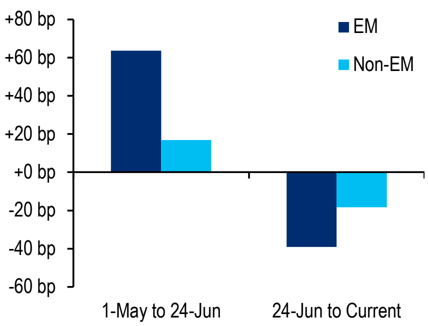
Source: Citi Research

Figure 14. Change in the implied default probabilities for same issuers in May



Source: Citi Research

Figure 15. Spread changes of EM vs. DM corporate bonds



Source: Citi Research
Note: Current as of November 26, 2013; Based on EM bonds in the IG index

- **Out-of-index opportunities are likely:** We would also look to take advantage of out-of-index opportunities that may emerge in the wake of tapering-induced pressure, specifically in either the EM or muni markets. This strategy is largely based on the view that, for the reasons highlighted above, dislocations between valuations and default risk could be more acute there than in credit. This is essentially what we saw this spring.

  But it is worth noting that even for investors confined to the index, opportunities may be available. In Figure 15 we compare the performance of EM and DM index-eligible corporate bonds this past spring; on average, the EM bonds widened 64 bp, relative to 17 bp for the DM securities (Figure 15). But Figure 15 also shows that underperformance didn't last all that long.

Summary

Many see tapering as a key near-term catalyst for widening, but there are reasons why this fear may be a bit overstated. One reason why is because while demand will diminish in a post-QE world, supply in a number of markets is likely to be down as well. And it's not as if tapering is new news. In fact, by at least some metrics the credit market may have already priced it in.

Of course, it's impossible to argue that there isn't tapering risk. Perhaps one underappreciated risk is that other risk assets, such as munis and EM, may be susceptible to volatility and there could be a spillover effect on credit spreads. Irrespective of whether spreads widen sharply or not in the wake of a tapering headline, dislocations are likely. Look to take advantage.

Appendix A-1

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