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North America

High Grade Recommendations

Status quo, but avoid the stories

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- **Overview:** With spreads of Citi's BIG Corp index now flat to our beginning of year level, we continue to see potential for another 20bp of spread tightening in 2013. However, rising rates and concerns in Europe give us enough pause to recommend a Neutral weight for the time being.

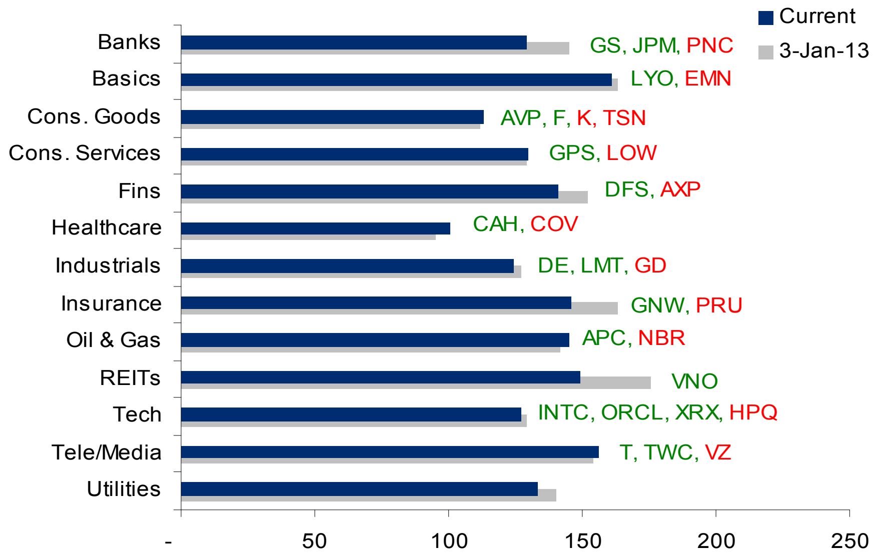
  With the IG market seemingly on autopilot, we suggest portfolio managers focus on avoiding the stories: the handful of names that trade at relatively low spreads and could be prone to levering up to appease shareholders, or those that engage in M&A transactions.

- **Overweight:** We continue to suggest overweighting US-domiciled global banks, life insurers, financial companies and REITs, as we believe these wider-trading sectors have greater scope to tighten and as fundamentals have improved year-over-year in these sectors.

- **Underweight:** The sectors we are less enthused about are those that we believe are more prone to levering transactions and large amounts of issuance, including consumer goods, healthcare, telecom and media.

Figure 1. Sector Spreads and Select Picks and Pans

bp; pick = green, pan = red



Source: Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Status Quo, But Avoid the Stories

Updating our sector recommendations and picks and pans proved more challenging than usual this quarter, as it is becoming increasingly difficult to get excited about the market. Our current call on the investment grade market is Neutral (please see our March 22nd publication - **US Credit Weekly - The cash myth** – for our reasons) so a lackluster view on sectors seems about right.

But even with an unexciting view of the market, sector picking *does* matter. In the table below, we show that in addition to under- and out-performing, sector spreads both tightened and widened over the past three months, meaning it wasn't a one way trade. We haven't seen the diversity of performance in a while.

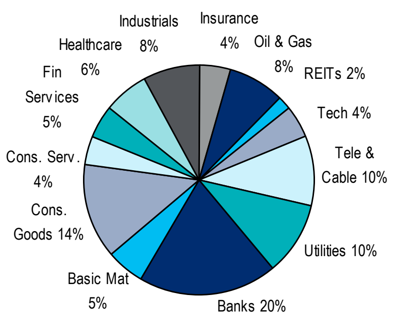
Over the next few months, and actually probably for much of the year, we do not foresee a lot of spread movement tighter at the single name level. Instead, we believe the focus should be on avoiding the stories: the credits that bow to shareholders, or decide to lever up in an effort to grow the business.

We continue to favor financials over non-fins, as we believe the beta stay low, perhaps even in tail risk scenario of a Europe-driven, broad based sell-off. In addition to banks, we like insurers, REITs and financial services firms.

On the flip side, our underweight recommendations on many of the sectors stem from issuance concerns (for either M&A or shareholder returns) that could push sector spreads wider and would likely result in higher leverage. Shareholder activism in the energy space prevents us from recommending an overweight, despite our seeing value at current levels. And while we still see fundamental struggles ahead for much of the tech sector, we think the sector will market perform, as nearly 50% of the of issuance is from five large, low beta credits with rock solid balance sheets.

A few things to note regarding our picks and pans: our recommendations are primarily for the cash market, and are across the curve, unless noted. Our views are for a three month outlook.

Figure 2. Index Weightings



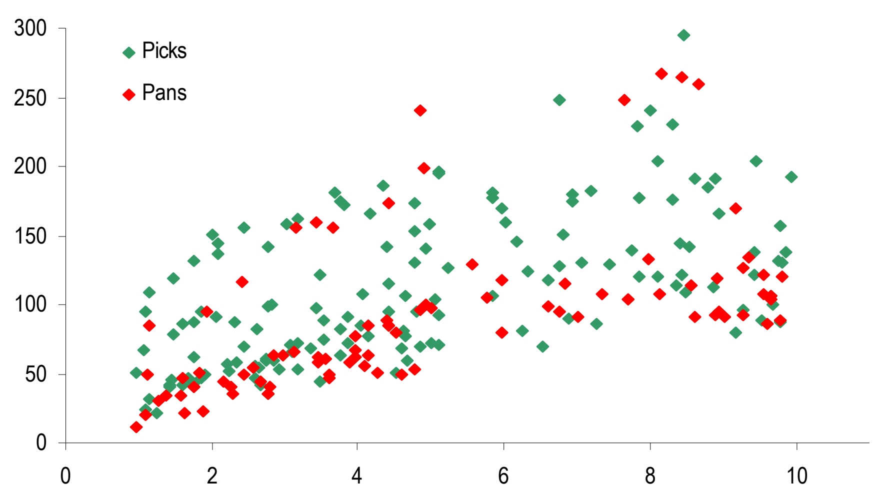
Source: Citi Research

Figure 3. 3M Sector Spread Change

	Jan 3	Apr 10	△
BIG Corp Index	133	134	1
Banks	145	129	(16)
Basic Materials	163	161	(2)
Consumer Goods	112	113	1
Consumer Services	129	130	1
Energy	142	145	3
Financial Services	152	141	(11)
Healthcare	95	101	6
Industrials	127	124	(3)
Insurance	163	146	(17)
REITs	176	149	(27)
Technology	129	127	(2)
Telecom & Media	154	156	2
Utilities	140	133	(7)

Source: Citi Research

Figure 4. Dispersion of Picks and Pans, up to 10y maturity
Years to Maturity (x-axis) vs. OAS (y-axis)



Source: Citi Research

Sector Picks and Pans

Figure 5. Picks and Pans

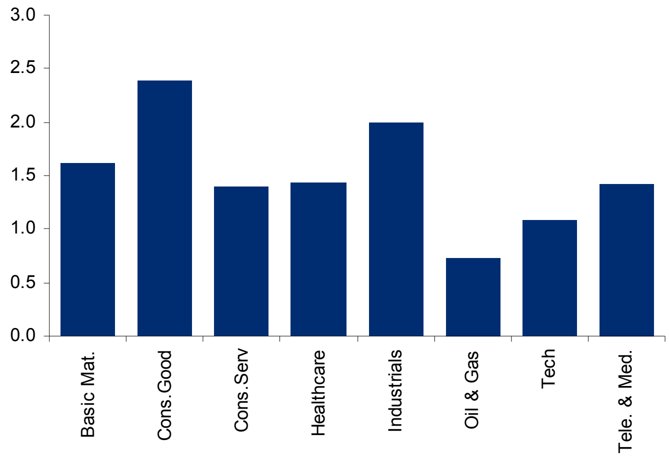
		Valuation			Risks		Recommendations	
Sector		Spread (bp)	12M Low	12M High	Liquidity Score	1y Implied Default Rate	Picks	Pans
Banks	Overweight	129	123	300	31%	0.09%	Goldman Sachs JPMorgan '23s	PNC Financial U.S. Bancorp
	We maintain our overweight call in banks for Q2, but recognize that this is a popular pick and we may not see significant continued spread tightening. However, we appreciate that the beta for this sector has declined over the past six months, and as concerns in Europe continue to bubble, we would prefer to be overweight a lower beta sector that provides some spread. We prefer the US domiciled global banks, especially over their European counterparts, and appreciate the strength of their capital bases and balance sheets. We remain cautious on regional banks, as margin pressure and regulatory requirements may hit the smaller players a bit harder. A recovery in the US housing market could help boost earnings, via loan growth and better recovery rates for NPLs.							
Basic Materials	Neutral	161	150	231	17%	0.14%	Freeport-McMoRan Lyondell	BHP Billiton Eastman Chemical
	We have reduced our Overweight recommendation to Neutral for Basic Materials, recognizing that these credits are probably trading at fair value. Global growth prospects, impacted by excess capacity in China, continue to limit upside potential for spreads, but we believe current spreads compensate investors for this risk. We still see value in the sector, but it seems that at least for the near term spreads will trade range bound as investors wait to see signs of growth and commodity price improvement. We continue to suggest a reduction in exposure to chemical companies, as the improvement in natural gas prices may hamper margins and spreads look priced to perfection.							
Consumer Goods	Slight Underweight	113	92	152	16%	0.06%	Avon Products Colgate Ford	Anheuser-Busch InBev Kellogg Tyson
	We continue to suggest a slight underweight in this sector. While the credits in this sector sell market-leading brands and have solid balance sheets, we expect M&A, and even potentially company splits, to be a key theme in 2013. With the sector providing a yield of 2.44%, we see little opportunity for outperformance, and expect global players to be hampered by exposure to Europe. Despite better corn prices heading into this growing season, we expect the margin pressure to finally show in those companies that are tied to the commodity, as it usually takes 6-9mo for the prices to show up in results. Lastly, despite the lack of IG ratings all around, we believe Ford has considerable scope for tightening.							
Consumer Services	Neutral	130	111	170	13%	0.12%	GAP Macy's	CVS Caremark Lowe's VF Corp
	We expect Consumer Services, which is primarily comprised of retailers, to be impacted by the lower growth environment. However, consumer demand has been surprisingly resilient, but we expect the growth of same store sales to begin to wane in 2013, albeit not to the detriment of credit metrics. For housing-related retailers, we believe expectations of a rebound are priced in. While we are comfortable with the credit metrics of VF Corp, we are cautious of potential large, debt-funded acquisitions.							
Energy	Neutral	145	123	205	19%	0.13%	Anadarko Pioneer Nat. Res. Southwestern	Nabors
	We continue to suggest a Neutral weighting. We believe energy companies are poised to post year-over-year performance improvements on the back of modest oil and gas price forecasts. However, we expect a focus away from fundamentals and more scrutiny on what companies are doing to keep shareholders happy. As we've seen, pressure from shareholders for increased share repurchase, dividends and asset sales has set the tone for continued pressure, often at the expense of bond holders, in our opinion. We caution against a short bias in the space, however, as M&A could also be an option and could drive spreads tighter if some of the majors decided to acquire the smaller players.							
Financial Services	Slight Overweight	141	134	233	25%	0.15%	Discover Financial GE Capital Corp.	American Express
	We've upgraded our recommendation to slight overweight, recognizing that this sector, which primarily consists of asset managers and non-bank card companies, should benefit from the continued reach for yield in higher-rated credits. We continue to prefer to extend out the curve in this sector, as one is being compensated for the steepness and high dollar prices. We believe AXP looks rich, although we are comfortable with the credit.							
Healthcare	Slight Underweight	101	79	131	16%	0.06%	Cardinal Health St. Jude Medical	Covidien Pharma credits (near term)
	With the acquisitive nature of the sector, the continued uncertainty around fiscal spending, and the relative unattractiveness compared to other sectors, we continue to suggest an underweight position in healthcare. While the high ratings and non-cyclical nature of the sector will keep it well bid over the medium term, we are cautious of the pharma sector, as many companies work to grow after 2012's round of patent expirations and as potential issuance could send spreads wider in the near term. Further, despite underperformance in Q1, we think that spreads could widen further as investors move down in quality in a search for yield, hampering this generally highly-rated sector.							

		Valuation			Risks		Recommendations	
Sector	**View**	**Spread (bp)**	**YTD Low**	**YTD High**	**Liquidity Score**	**1y Implied Default Rate**	**Picks**	**Pans**
Industrials	**Neutral**	**124**	**114**	**170**	**11%**	**0.06%**	**Deere & Co.** **Lockheed Martin**	**General Dynamics**
	Industrial spreads are little changed over the past few months, suggesting that this generally sleepy credit will continue to be a quiet sector. Spreads are still trading at the wider end of their recent range, and defaults are low, but we believe constrained global growth prospects will keep spreads in this zip code. We are becoming a bit more concerned with the global credits that have significant exposure to Europe, as the continent could present a meaningful drag on earnings. Lastly, on the whole, the industrial credits in the IG index should be able to weather sequestration-related pullbacks.							
Insurance	**Slight Overweight**	**146**	**146**	**258**	**11%**	**0.21%**	**Genworth** **Prudential**	
	Like banks, we see scope for the life insurers to outperform over the next 6-9 months, especially at the back end of the curve. With an expected back-up in treasuries over the next year, there is an expectation that insurers should be able to earn closer to their breakeven levels. Earnings growth will likely be constrained and potentially hampered by goodwill write downs, but these should not meaningfully impact spreads. The biggest risk to an overweight position is a faster-than-expected downgrade of the sector. We have a neutral view on P&C credits, as valuations are likely fair.							
REITs	**Slight Overweight**	**149**	**149**	**256**	**9%**	**0.17%**	**Healthcare REITs** **Vornado**	
	Over the past few months, the illiquidity premium for REIT bonds has collapsed, causing us to rethink our sector positioning. We still like the fundamentals of the sector, with strong operating metrics. We believe the sector will perform better in a market sell-off, as we view the underlying assets should hold their value better than those of other sectors. We still believe healthcare REITs offer the most value in the sector, and are a bit more cautious on Retail REITs.							
Technology	**Neutral**	**127**	**110**	**150**	**21%**	**0.15%**	**Intel** **Oracle** **Xerox**	**Hewlett-Packard**
	We temper our position on the tech sector, moving to a neutral recommendation, as macro headwinds and releverageing events are likely fairly priced into spreads. Also, nearly 50% of the bonds outstanding in the sector are issued by five large, lowly levered credits, whose spreads have recently repriced wider. While we think there are plenty of opportunities for single name underperformance, the higher beta names only account for 25% of sector outstanding, we believe limiting the extent to which sector spreads can widen. We are especially cautious on the PC makers, as recent data points to a massive drop in shipments, and we believe that upcoming results will be worse than expected.							
Telecom & Media	**Slight Underweight**	**159**	**142**	**244**	**23%**	**0.09%**	**AT&T** **Comcast** **Time Warner Cable**	**Verizon**
	Our recommendation for Telecom and Media is a slight underweight, due primarily to M&A and releveraging risks, and that the sector could be pushed wider on the back of substantial issuance. We view Verizon spreads as having the most downside, as we think it is likely that they pursue the remaining stake of Verizon Wireless, and that deal could bring north of $50bn of paper to the market. While we do not see any fundamental problems with the sector, we believe many companies are looking for opportunities to buy assets, likely bringing with it higher leverage.							
Utilities	**Neutral**	**132**	**120**	**186**	**5%**	**0.09%**		
	We expect this low beta, domestically domiciled, and generally illiquid sector to be fairly insulated from spread pressure resulting from European headlines. We like the regulated utilities over genco paper, as these credits are able to recoup any commodity cost swings. We prefer shorter-dated bonds as we believe one is not being compensated adequately at the back end of the curve, especially those bonds with high dollar prices.							

Source: Citi Research

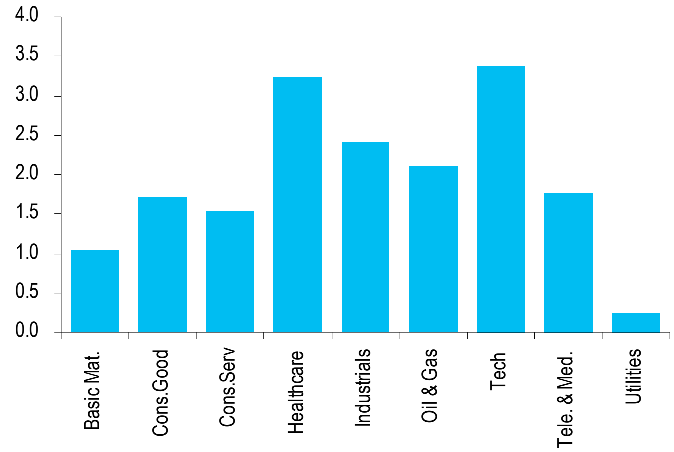
Appendix

Figure 6. Average Leverage



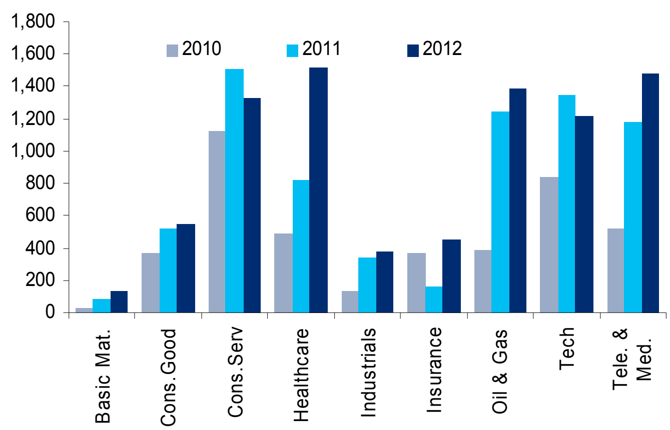
Source: Bloomberg, Citi Research

Figure 7. Average Cash Balance ($bn)



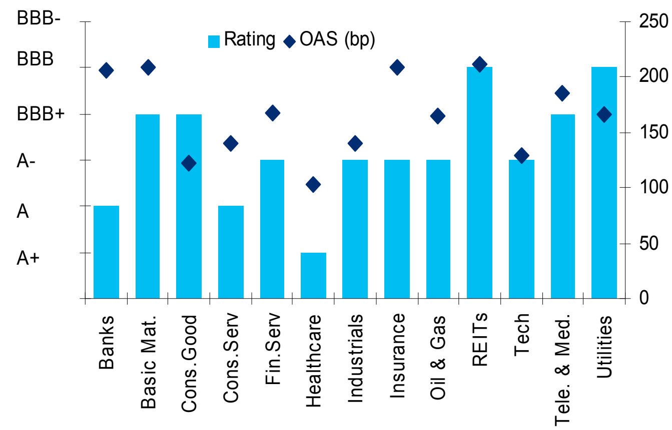
Source: Bloomberg, Citi Research

Figure 8. Average Share Repurchases ($mn)



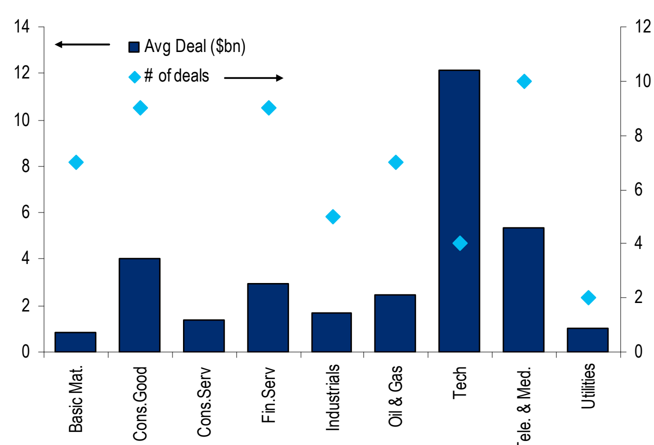
Source: Bloomberg, Citi Research

Figure 9. Weighted Rating vs. Spread



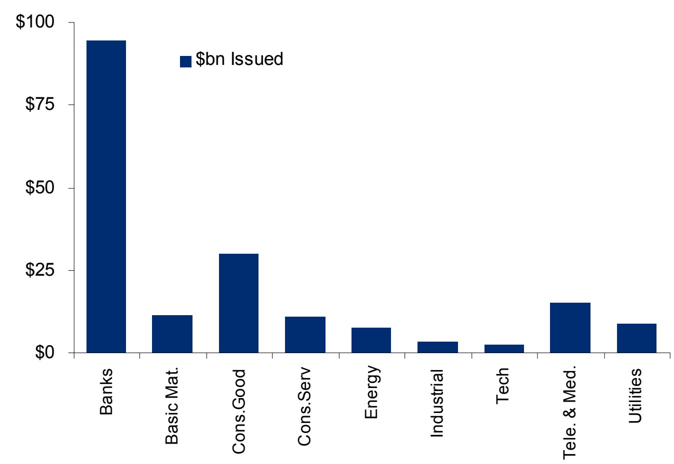
Source: Bloomberg, Citi Research

Figure 10. YTD M&A by Sector



Source: Bloomberg, Citi Research

Figure 11. YTD Issuance by Sector



Source: Bloomberg, Citi Research

Appendix A-1

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