

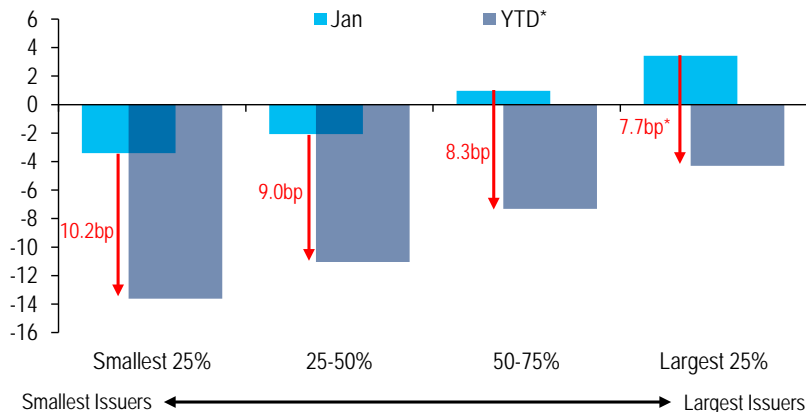
Who you gonna call? Syndicate or trading

MARKET OUTLOOK | SINGLE NAME NEWS & VIEWS | WEEK AHEAD | RECENT CITI RESEARCH | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS

As selloffs and rallies go, the January/February “blip” continues to offer a number of insights into how investors are approaching 2014. On the face of it, there’s a tendency to think there’s not much going on in credit if you’re focused on other more volatile markets; IG corporate bonds ended January about 5bp wider, but have recovered in February to end the month around 5bp tighter year-to-date. In a broader context, that’s hardly the type of swing that attracts much notice these days. Dig a bit deeper though and it’s clear there are strong undercurrents below the surface.

For a start, the rally can’t *really* be characterized as a snap-back. As we noted a few weeks ago, one of the intriguing aspects to the January selloff was the clear underperformance of the larger-and-more-liquid issuers relative to smaller-and-less-liquid ones—which also correlates with triple-B outperformance. Surprisingly, little has changed on that score. Larger complexes didn’t outperform in February as one might have expected with the market rallying; indeed, the underperformance continued (see figure).

Year-to-date OAS change by size, in bp



Source: Citi Research

*For the largest 25% of issuers bucket, we removed one major event-driven outlier.

To our minds, the logical answer for why this is the case is that investors continue to preserve cash in light of current valuations, but are only able to do so by lightening up on bonds that actually trade. That said, as time has passed we suspect that the rationale for keeping cash balances high has in part shifted away from EM risk aversion to positioning ahead of what’s expected to be a large calendar to come—presumably with accompanying concessions.

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Credit

North America

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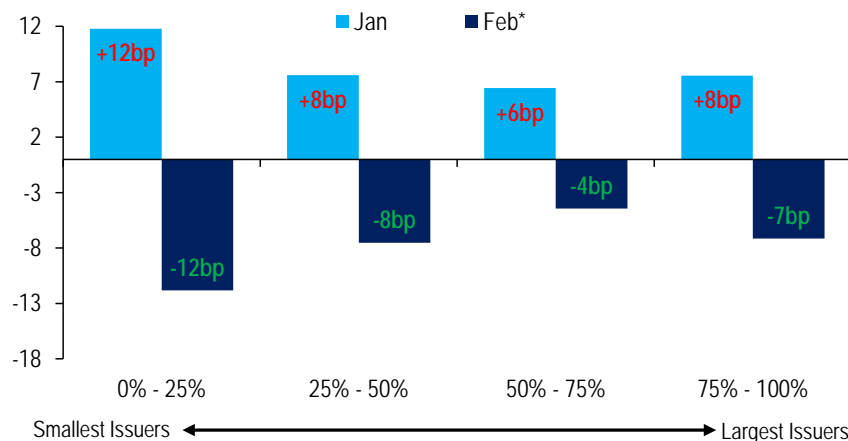
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The fact that bond investors are keeping cash at the ready is even more obvious when looking at what's going on in synthetics. Performance of constituents of the IG CDX index showed no bias against large issuers this month—in fact the 10bp reversal of the January selloff appeared to be predominantly a normal beta spread-retracement. (see figure).

Year-to-date CDS spread change, in bp



Source: Citi Research

*For the largest 25% of issuers bucket, we removed one major event-driven outlier.

Yet trying to maintain dry powder with the intention of being able to deploy it into more attractively valued supply can be a frustrating strategy to pursue, especially when everyone else is doing the same and issuers aren't being cooperative. Indeed, it can quite easily backfire if supply fails to materialize or doesn't come in the anticipated tenors, as was the case with Cisco not issuing a 30y tranche this week and the subsequent outperformance of existing long-bonds.

In fact, it may be that the supply-demand mismatch explains much of the IG credit markets' resilience in 2014. Looking at the average beta and duration of issuance over time suggests that the market is currently seeing issuance that is shorter-dated *and* of higher quality relative to recent history.

That's an unusual pairing and says something about issuer preference across the curve and where demand is the strongest. Typically, when issuance favors higher beta issuers, it comes in the form of shorter duration bonds (see figure). And the opposite is true when issuance is skewed to lower beta issuers. In other words, rarely does the market issue as little "risk" as it has in 2014.

Beta and duration of investment grade corporate issuance*

pensions are locking in (Nov'13)

Where is all the M&A? – Traditional arguments point to more deals, but why haven't we seen more? (Oct'13)

Corporate leverage in the crosshairs

– And why it's finally starting to matter for valuations (Oct '13)

The Legacy of the Bank Leverage

Ratio (for Credit) – (Sep '13)

US Key Economic Data

	<i>Consensus</i>
Monday:	
ISM Manufac.	52
Personal Income	0.2%
Personal Spending	0.1%
Wednesday:	
MBA Mortgage Applications	-
ADP Employment Change	155K
Thursday:	
Initial Jobless Claims	81.2
Factory Orders	-0.5%
Friday:	
Nonfarm Payrolls	150k
Unemployment Rate	6.6%
Trade Balance	-\$39.3B

Key Earnings Announcements

Tuesday:

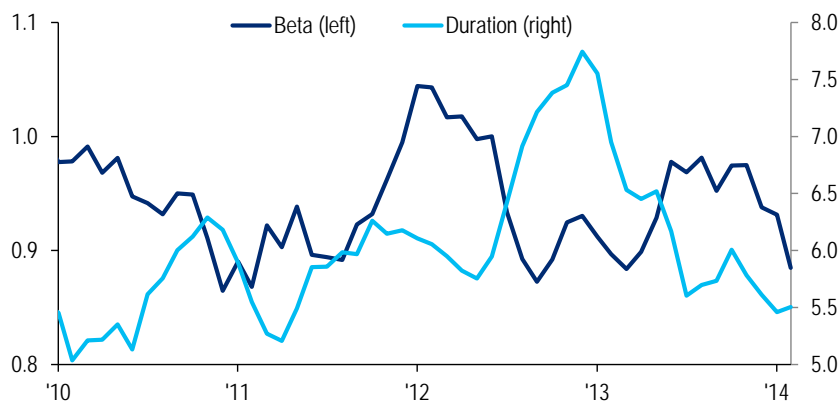
AutoZone

Thursday:

Staples

H&R Block

Kroger



Source: Citi Research, Dealogic

*Beta is with reference to the Citi BIG Corporate index.

The natural question is what to do at this juncture: keep waiting for the issuance flood gates to open or capitulate and buy the underperforming secondary bonds now? For those inclined to wait the drought out, there's some evidence the primary market could be softening and supply is on the way: this week was the second heaviest of the year and the average oversubscription at times dipped well below levels that have prevailed through most of February.

Then again, if issuance continues to come precisely where it's less desired, it might not matter how much supply is on the horizon. Indeed, we think it unlikely that the average concession in March surpasses 10bp, which is roughly how much the larger-and-more-liquid issuers have already underperformed by YTD.

So as the late-and-great Harold Ramis might say: Who you gonna call?
Syndicate or the trading desk?

Single Name News & Views

Missed Target—Retailers have had a tough go of it so far in 2014. Even though management teams tried to temper expectations ahead of 4Q releases (KSS, TGT, and WMT, for example), many retailers *still* managed to disappoint. And to make matters worse, full-year 2014 guidance failed to inspire (WMT, TGT, TJX, and KSS).

But as they say, there's always a silver lining. In this case, it's Macy's (M). We didn't expect to see significant margin expansion at the retailer considering the holiday season was so heavy on promotions. But Macy's proved that as the biggest department store by revenue, it has a measurable amount of bargaining power over its suppliers. The company also continues to build out its online business (highest % capex in the industry), providing features like to-store shipping that many of its competitors don't yet have.

In an environment geared toward carry, Macy's is just the sort of triple-B that we're comfortable chasing. Downside catalysts are limited and the stability of the credit makes it look far more attractive to us than a number of other tighter-trading retailers, like Target.

Indeed, not only did Target guide toward a particularly weak FY14, but the company's botched Canada roll-out and the ongoing saga around the credit-card breach leave us with the impression that the risks remain to the downside even if the equity analyst community has been quick to move on. At the very least, the potential for a decline in loyalty and store traffic in the medium term—which could

increase old inventory and deflate margins—seems a strong possibility. Even worse, the company's prime real estate target has put it on activists' radars.

As such, we recommend [swapping out of TGT 4% '42 into M 5.125 '42](#) as an intermediate-term play.

Week Ahead

Only a handful of names will report next week as the earnings season draws to a close. AutoZone is on Tuesday and Staples, H&R Block and Kroger are on Thursday.

On the other hand, the economic calendar is filled with important numbers, especially labor data as ADP will be released on Wednesday, Initial Jobless Claims on Thursday, and NFP on Friday. Employment numbers have been weak the past couple months (with bad weather being the chief cited reason), and this weakness is likely to persist in Feb numbers, with another sub-200 NFP expected by the market. That being said, there will continue to be focus on the unemployment rate. The consensus is calling for an unchanged number, but the impact of the expiration of long-term unemployment benefits could be a wildcard.

The Fed and the market alike will no doubt spend much of next week debating the impact of weather. With the housing market having demonstrated unusual strength this week in the New Home Sales and House Price Index, we will watch MBA Mortgage Applications on Wednesday. We will also closely follow ISM Manufacturing, Personal Income and Personal Spending on Monday, as well as the Trade Balance on Friday.

Appendix A-1

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