

## PMs sure are resourceful

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

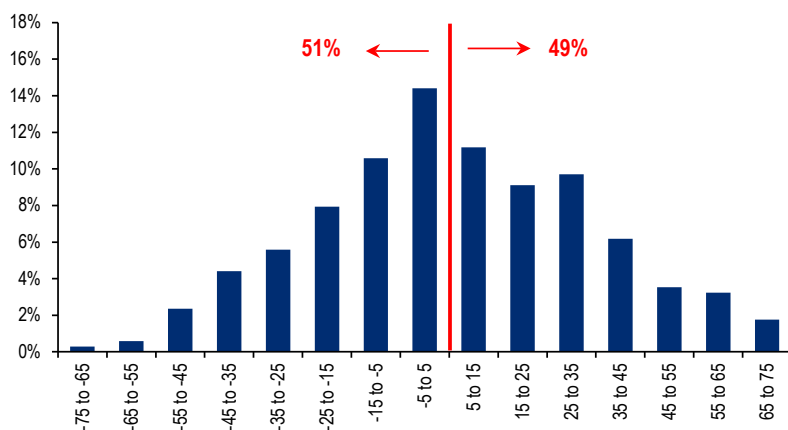
### Market Outlook

The ECB's announcement yesterday was unambiguously bullish for credit. Yankees such Deutsche Bank and Societe Generale rallied ~10bp on the news, domestic banks such as JPM and BAC improved ~5bp, and even lower-beta names such as IBM were pulled along (2bp). We encourage readers to refer to [ECB Cuts Rates, Announces Several Liquidity Measures](#) for a more detailed discussion of the announcement.

We believe that spreads have room for further compression in the near-term, but the problem, of course, is that valuations already feel uncomfortably full. Both the overall cash and synthetic markets are trading at post-Lehman tights, and if we make an apples-to-apples comparison at the single name level many names are through pre-Lehman tights as well. For example, in the figure below we present the difference between current spreads and levels in Jan '07 for around 300 benchmark issuers (on-the-runs, 10-yr tenor). We see that more than half of these on-the-runs trade at or through '07 levels.

So valuations feel full, but we certainly can't advocate fighting the central banks anytime soon. What to do, what to do?

### Spread difference between current and '07 levels for name-matched on-the-run 10-year issues



Source: Citi Research

Note: 2014 minus 2007 levels; Spread moves beyond +/-75 bp not considered; based on 340 issuers

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Credit

North America

### Recent Citi Research

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**US CreditBrief** – No April showers for credit (May'14)

**US Credit Weekly** – The sector selection conspiracy (Apr'14)

**US CreditBrief** – Keep calm and March on (Apr'14)

**Too many unknowns and not enough spread** – the 5 questions that weigh on the outlook for credit (Mar'14)

**Raising money for a credit fund**– A “return parity” framework can help (Mar'14)

**Why do companies buyback rich shares**– and what to do about it (Feb'14)

**Hunting for a Tail Risk Away from EM** – And finding one (Jan'14)

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

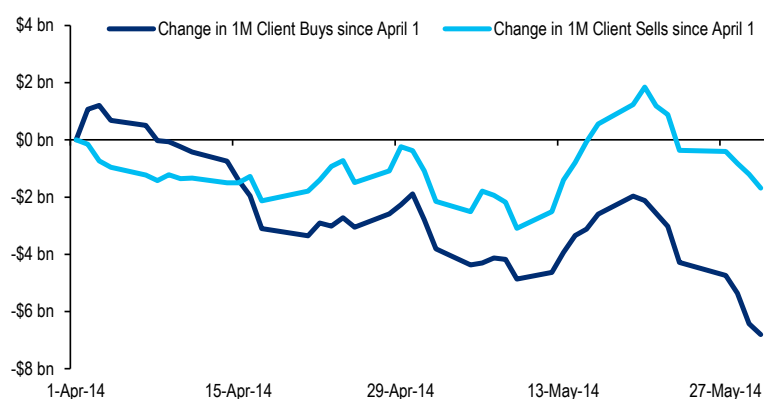
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## Opportunities in a Rich Market

Trading volumes have fallen sharply over the past few weeks — again, spreads are rich and up until yesterday the market was quite boring — but that said why have client buys fallen far more sharply than client sells (see figure)?

We suspect the reason is because the primary market has once again become a *relatively attractive source of alpha*. This may be surprising to some given that concessions are fairly small and have been declining (average of 3.1bp in Q1 vs. 2.5bp QTD; note that our numbers are par-weighted rather than a simple average).

### Buying interest has fallen far more sharply than sell interest in the HG secondary market



Source: Citi Research, TRACE

Note: Based on \$1mm+ trade volume

But there are three other factors to consider:

- 1) **PMs are resourceful:** We went through a very simple exercise and assumed that a PM was able to correctly identify the best and worst performers in the context of sector, tenor, rating, and overall market direction. He then over-weights the best performers by 5% and under-weights the worst performers by 5%.

Given these assumptions, the PM would have been able to *beat his index by only 10bp in Q2* (again, our data only goes through Wednesday, so we don't capture the ECB-induced rally). Sector picks were worth 4bp, maturity picks worth 4bp, rating preference 4bp. and -2bp for calling market direction right (negative number is because the QTD spread move was not enough to offset negative carry).

**Alpha that could be generated in Q2 from portfolio positioning and new issue concessions; It all comes from concessions...**

Outperformance from Positioning	
Market	-2 bp
Sector	4 bp
Maturity	4 bp
Rating	4 bp
New Issue Concessions	19 bp
<b>Total</b>	<b>29 bp</b>

**US Credit Outlook - 14 for '14 (part 1),**  
fourteen predictions for 2014 (Dec'13)

**US Credit Outlook - 14 for '14 (part 2),**  
fourteen strategies for 2014 (Dec'13)

**US Credit Outlook - 14 for '14 (part 3),**  
fourteen supply trends for 2014 (Dec'13)

## US Key Economic Data

<b>Tuesday:</b>	<u>Consensus</u>
Wholesale Inventories MoM	0.60%
<b>Wednesday:</b>	
MBA Mortgage Applications	-
Monthly Budget Statement	-\$142.5bn
<b>Thursday:</b>	
Initial Jobless Claims	-
Retail Sales Advance MoM	0.50%
Import Price Index	0.20%
Bloomberg Consumer Comfort	-
<b>Friday:</b>	
PPI Final Demand MoM	0.10%
Univ. of Michigan Confidence	83

## Key Earnings Announcements

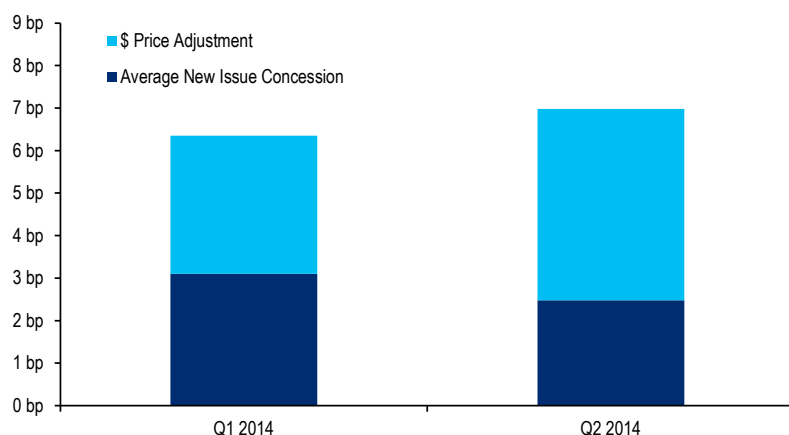
**Wednesday:**  
H&R Block

Source: Citi Research

That's pretty bleak, but if we add new issue concessions to the mix the result isn't quite so bad. When we multiply concession by DV01 — which has risen meaningfully YTD — we see that 19bp could be earned via concessions, or 66% of all potential alpha in Q2 ( $19\text{bp} / [19\text{bp} + 10\text{bp}] = 66\%$ )!

- 2) **New issues trade at par, secondaries don't:** Dollar prices have obviously jumped this year as Treasury shorts got squeezed. The average high-grade bond traded at \$106.5 at the beginning of the year, relative to \$109 now. If we assume that each dollar above par is worth 0.5bp, we see that dollar-adjusted concessions have actually been rising, not falling (see figure).

#### New issue concessions after adjusting for dollar price, Q1 vs. Q2

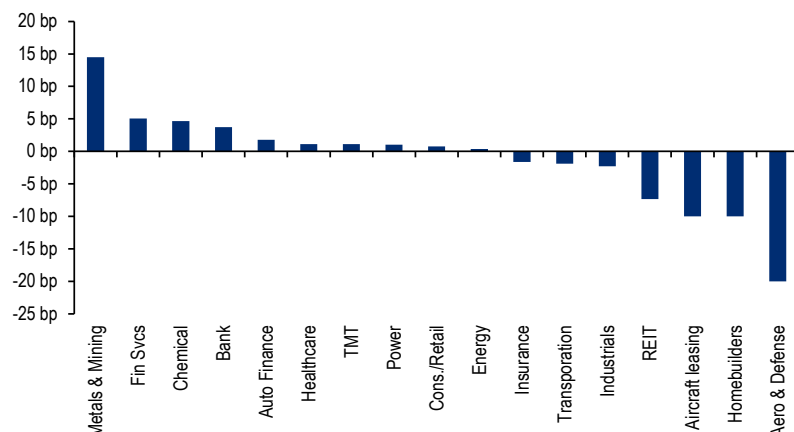


Source: Citi Research

Note: Weighted average based on deal size; we assume 0.5bp / \$1 above par

- 3) **The average hides the opportunity:** On average concessions are small, but the dispersion of concessions across sectors, ratings, tenors and issuers is large. For example, when we consider unadjusted concessions by sector, we see that the averages range from -20bp to +15bp (see figure). There seem to be opportunities to pick your spots, in our view.

#### Average new issue concessions by sector, YTD



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**Key point:** We expect the tone to remain firm in the near-term, but after the ECB news is absorbed by the market in the coming days, PMs should probably continue doing what they have been doing – adding exposure via the primary market.

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### Single Name News & Views

**Action off the trading floor:** M&A and activism continued to make headlines this week. Consumer, Healthcare, and Telecom companies were the most active on the M&A front. As reported in the media, there is speculation once again that InterContinental Hotels (IHG) is up for sale. While Starwood Properties (HOT) is unlikely to be a suitor given its focus on higher-end hotels, Wyndham (WYN) could be a buyer in our view.

The fight for Hillshire Brands (HSH) continued with Pilgrim's Pride (PPC) outbidding Tyson Foods (TSN). However, given Tyson's committed financing, it is likely to walk away with the winning bid. HSH widened on PPC's initial offer (due to PPC's lower credit quality) but has come back since. Given our expectation of the higher-rated TSN being the ultimate acquirer, we like going long HSH if it widens out again on PPC headlines.

Starboard Value LP, the fund that is actively trying to replace the entire Darden Restaurants board with its own directors, also undertook an activist stance against MeadWestvaco (MWV) this week, demanding a sale of certain businesses and real-estate assets. However, as its demands are likely to be accretive to the margins of remaining businesses and not overly-leveraging, we would be buyers of MWV on any meaningful spread widening.

### Week Ahead

Next week is quite light on the economic data front. The US government will release its Monthly Budget Statement on Wednesday, and is expected to run a deficit of \$142.5bn. Import prices will be released on Thursday and are expected to have increased 0.2% over May in spite of the USD strengthening last month.

After inventories dipped in 1Q and contributed to a lower GDP, Wholesale Inventories MoM should be closely watched on Tuesday. They are expected to be an unimpressive 0.6% vs. 1.1% last. Another data point on US businesses next week is the PPI Final Demand MoM out Friday, which is expected to be very subdued at 0.1% vs. 0.6% in April.

On the consumer front, the most important data releases next week are the Retail Sales Advance out on Thursday, with the market expecting a modest recovery at 0.5% (vs. 0.1% in April), and the University of Michigan Confidence number, also expected to show strength at 83.0 (vs. 81.9 in April).

# Appendix A-1

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