

US Credit Weekly

Dark Shadows



MARKET OUTLOOK | BAD REPUTATION: IG9 INDEX | SINGLE-NAME NEWS AND VIEWS | WEEK AHEAD | RECENT CITI RESEARCH | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS

Market Outlook

As far as “soaps” go, the 70s cult classic *Dark Shadows* was in a class by itself. But we’re not exactly sure that makes it deserving of a Hollywood reboot, especially when there’s plenty of real life dark shadows with which to contend at the moment. After the daytime drama this week, high grade credit has finally **begun to crack** in a material way, driven almost exclusively by weakness in financial credits. And, unfortunately, we believe it’s likely to get worse before it gets better.

A growing public acknowledgement of the risk of deposit flight within the eurozone is our chief worry. On Monday, the Greek President warned politicians that the country’s banks had seen roughly €700mm of withdrawals after the most recent round of elections (bankers subsequently revised this upward to more than €1.2bn). And on Thursday, a local Spanish paper, *El Mundo*, reported that €1bn had been withdrawn from Bankia after its partial-nationalization last week.

Viewed as isolated events, it’s difficult to argue that deposit leakage has yet to reach systemic proportions. But having entered the realm of psychology, who can truly know how close Europe is to the tipping point where deposit flight becomes the victim of a self-fulfilling disintegration in confidence? If the situation escalates (as we fear it might), then a deposit guarantee scheme (which at first glance seems very difficult to set up) or draconian **capital controls in Europe** may be the only answer.

In the meantime, as Greece’s public becomes more conscious of the risks they face, the political calculus in Europe is likely to become a lot more complicated. On the one hand, efforts by EU policymakers to frame the next Greek election as a referendum on eurozone membership hold the hope of influencing the polls and may be reinforced by growing talk of deposit flight. Then again, Greece’s left-wing party Syriza may feel that evidence of deposit flight contagion affords them a stronger negotiating position to deliver on a platform that advocates less austerity but continued eurozone membership.

Not surprisingly, it was a bad week to announce news that could be interpreted in a negative way (even if unjustifiably) for Europe’s peripherals. But that didn’t seem to be a concern for the ECB or Moody’s. The former’s move to temporarily suspend lending operations to a handful of Greek banks should not be overblown given the banks still have access to the Emergency Liquidity Assistance (ELA) and will shortly be recapitalized when the HFSF (Hellenic Financial Stability Fund) transfers ownership of the €25bn of AAA-rated EFSF bonds that were part

18 May 2012

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CREDIT

INVESTMENT OVERVIEW

NORTH AMERICA

CORP. HIGH GRADE STRATEGY

Recent Citi Research

Capital controls in Europe
May ’12 – What would they mean for credit?

Default Rates to Climb Rapidly in Q3 and Q4

May ’12 – Tough credit conditions and negative GDP outlook should feed through to European speculative-grade default rates by Q3 2012

Credit Strategy Cheat Sheet
May ’12 – April Survey Results & Investment Ideas

The Credit Index Call
May ’12 – Another HY 10-15 debacle in the making?

US TotalCredit
Apr ’12 – A Simple Single Name Strategy

Investor in subordination
Apr ’12 – Surviving the sovereign cramdown

High Grade Strategy
Apr ’12 – Corporates as Collateral

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

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of the PSI restructuring. Similarly, Moody's decision to cut the ratings of Spain's banks was well telegraphed – even if the timing was uncertain – so a negative reaction is likely unwarranted in that case too.

On the home front, there hasn't been much to dispel the gloom emanating from Europe, but equally the data hasn't been bad enough to warrant additional accommodation at this time, in our opinion. Sure, Thursday's Philadelphia Fed and leading indicators readings drove a 5 point drop in **Citi's economic surprise index**, but its quarter-long decline was largely arrested earlier in the month. So while the Fed members are clearly concerned about the direction of the outlook as evidenced in the April minutes, it's hard to see them engaging in another round of QE in the near term – especially given inflation remains near the mandated target.

If anything, the minutes were significant because the members took the opportunity to once again highlight the “fiscal cliff” awaiting the US in 2013 – a message that is finally attracting political attention. Unfortunately, it increasingly looks like that the “attention” is likely to be counterproductive and devolve into a repeat of the political gridlock experienced last year. While many expect temporary extensions of the various fiscal drags to be put in place during the lame-duck session following November's elections, we believe that partial failure, at the very least, is a risk as the parties increasingly make the “fiscal cliff” into an ideological debate.

And so it seems that wherever one looks it's hard to find reasons to be optimistic about the direction of spreads from here. That's especially true from the vantage point of US credit, which has **dislocated far less than in Europe** and could consequently underperform in contagion scenarios.

But while we remain negative and expect both cash and CDS spreads to continue to widen, the possibility of a dramatic squeeze tighter on the back of any bit of good news should not be discounted. The Street was generally short before the selloff and many cash investors pared back exposure during the first quarter rally. As such, in some respects, credit has been a very frustrating short in many sectors other than the banks, as it has taken quite a lot of negative news to precipitate real money selling. Moreover, those same positive technicals are likely to make any rally a gappy affair. As a result we'd beware shorting anything that's already moved significantly; far better to concentrate on credits that haven't reacted as of yet but might suddenly lurch back to life – dark shadows, indeed.

Bad Reputation: IG9 10y Index

One apparent by-product of JP Morgan's \$2 billion hedging loss is that the **IG9 10y arb** has rapidly moved back toward fair value. But as the IG9 10y index has widened, arb investors have begun to unwind trades put on when the skew was far more negative. In recent days, this has created weakness in the single-name CDS of IG9 credits relative to non-IG9 credits. This week we take a look at ways to take advantage of this temporary technical, namely by selling protection in IG9 credits that have been especially impacted and buying protection on non-IG9 competitors. Of course, these are pair trades we also recommend from a fundamental perspective. In any case, it's best to do these trades using some ratio.

IG9 vs. Non-IG9 Credits

Sell Protection (IG9 Credits)	Bid Spread (bp)	Buy Protection (Non-IG9 Credits)	Offer Spread (bp)	Ratio	Chart
Anadarko	200	Can. Nat. Resources	137	1:1	APC vs. CNQ
Bristol-Myers Squibb	31	Medtronic	70	2.5:1	BMJ vs. MDT

European Credit Outlook

Apr '12 – Should I stay or should I go?

High Grade Strategy

Mar '12 – What's left to rally... and what to buy

US Credit Outlook

Feb '12 – A Fork in the Road

What Investors Are Thinking

Feb '12 – “Sure, technicals are great. But didn't we see this last year?”

High Grade Strategy

Feb '12 – Replicating the Bank Sector, Minus the Tail Risk

2012 High Grade Outlook

Dec '11 – Another Year On The Edge

US Key Economic Data

Tuesday:	<u>Consensus</u>
Existing Home Sales	4.62mn
MBA Mortgage Applications	-
Wednesday:	
House Price Index MoM	0.3%
New Home Sales	335K
Thursday:	
Durable Goods Orders	0.5%
Initial Jobless Claims	-
Friday:	
U.of Michigan Confidence	77.8

Key Earnings Announcements

Monday:

Campbell Soup Co
Lowe's Cos Inc

Tuesday:

AutoZone Inc
Medtronic Inc
Best Buy Co Inc
Analog Devices Inc
Dell Inc

Wednesday:

Hormel Foods Corp
Eaton Vance Corp
Hewlett-Packard Co
Boston Properties LP

Thursday:

Medco Health Solutions Inc
HJ Heinz Co
Costco Wholesale Corp

Hewlett-Packard	194	Cisco	91	1:1	HPQ vs. CSCO
McDonald's	28	Yum! Brands	77	3:1	MCD vs. YUM
Safeway	277	Clorox	86	1:1	SWY vs. CLX

Source: Citi Investment Research and Analysis

Single Name News and Views

Still Cautious: In February we published **High Grade Strategy Notes - Replicating the Bank Sector, Minus the Tail Risk** in which we suggested swapping out of large, money center bank bonds and into other financial asset classes. Our thesis was that one could reduce the volatility experienced by the largest banks and pick up similar amounts of spread, all while still filling their financial sector bucket. While the trade is less compelling at current levels, we still believe that broadly speaking, regional banks, insurance companies and other financial companies can provide similar spread (depending on the bank comp) with lower volatility. Bonds we like include **PNC sub paper (220bp for 6y paper)**, **Discover Financial (250bp for 5y)** and **Capital One sub bank paper (250bp for 7y)**.

Week Ahead

Last week we had mentioned that we could see economic forecasts tempered leaving room for positive surprises. Rapidly growing concern about developments in Europe has reduced bullish expectations more quickly than we thought. New and existing home sales next week are expected to show some improvement from last month, likely influenced by positive results in housing starts this week. Durable goods orders are expected to come in strong as well.

Moody's may hold off on its bank downgrades next week, but the schedule seems to be in flux. That said the downgrades are not our top concern here – especially because they are well telegraphed. Still, we are mindful that any actions may have an amplified effect when coupled with lower volumes ahead of Memorial Day Weekend. To date, the downgrades have not been materially worse than what was expected, as today's reaction to the Spanish downgrades in the broader market illustrates. The most direct implications will be the loss of P1 ratings in money markets, but CP markets are largely closed to weaker banks anyway and the reliance on CP has been greatly reduced since 2008. Some subordinated debt issues will lose their investment grade ratings, but we believe this has been widely anticipated.

Over the weekend, investors will have an eye on the G8 Summit in Camp David. We may have headlines from the G8 summit, where Greece's worsening situation is likely to dominate the agenda. We doubt that the Europeans will be bullied into decisive action so far ahead of Greek elections. Likewise, Wednesday's European Council emergency meeting is likely to be only preparatory ahead of the EU summit of 28 and 29 June. On Friday, the German Parliament votes on the Fiscal Compact: a smooth approval is expected.

Appendix A-1

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