

European Credit Sector Recommendations

Be long? Not to be long? Or rather belong (to the ECB)?

- While fundamentals get worse as the global economy deteriorates, powerful technicals, mainly created by Central Banks have made it hard for even the most sceptical investor to remain underweight. Yet spreads look increasingly tight to fair value.
- We expect spreads to tighten further, albeit more slowly from here given the absence of a negative short-term catalyst, and we would be moderately long risk. From a tactical perspective, Spanish corporates may outperform further near term, not least following the Moody's affirmation. However, we suspect spreads will come under pressure again over the medium term. Overweight Italian names, especially in 5-7yr space.
- Move to overweight in financials. In Banks, remain neutral senior and overweight LT2/UT2, secured debt and covered, also in Italian banks. Move overweight in Insurers: underweight senior, which looks expensive, but overweight junior debt.
- Within non-financials, downgrade Basic Materials to neutral on global growth concerns. Non financials look cheap to financials on recent history. But we don't really see value in peripheral Telcos and in Utilities as downgrade risks loom. Core Industrials and Consumer Services remain tight to the deteriorating macro and/or fundamental outlook. We still like Consumer Goods, Healthcare and Oil & Gas.

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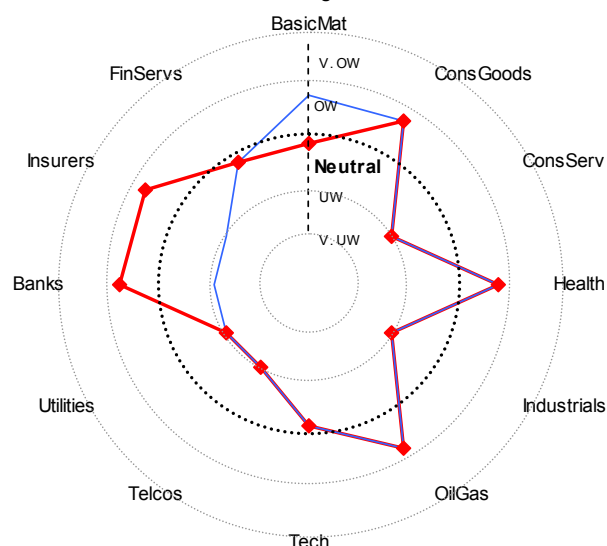
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Figure 1. Citi Recommended Positioning



Source: Citi Research
All recommendations are made using the iBoxx € index as a benchmark.

Figure 2. iBoxx Weightings by Sector

	Mkt Value (Percent)	Duration	Beta	Wgt. Dur. (Years)	Wgt. Beta (Years)
€ iBoxx	100.0%	4.3	1.0	4.3	4.1
Non-Fin	54.7%	4.5	0.8	2.5	1.9
Fin	45.3%	4.0	1.2	1.8	2.2
Basic Mat.	4.0%	4.1	0.5	0.2	0.1
Cons. Goods	9.0%	3.6	0.5	0.3	0.2
Cons. Serv	3.4%	4.3	0.5	0.1	0.1
Healthcare	2.8%	4.4	0.3	0.1	0.0
Industrials	8.0%	4.5	0.7	0.4	0.2
Oil & Gas	4.7%	4.5	0.7	0.2	0.1
Technology	0.3%	3.3	0.5	0.0	0.0
Telecoms	8.5%	4.9	1.0	0.4	0.4
Utilities	14.1%	5.1	1.0	0.7	0.7
Banks	37.3%	3.9	1.2	1.5	1.8
Fin Servs	4.1%	4.3	0.5	0.2	0.1
Insurance	4.0%	4.1	2.1	0.2	0.3

Source: Citi Research, MarkIt

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

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Banks: overweight	26
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Sector and bond recommendations

Weak fundamentals but strong technicals leave us with a rather “Hamlet-like” dilemma: to be (long) or not to be (long)?

From one side, there aren’t many fundamental reasons to be long. Spreads are at levels not seen since August/September 2011, despite a recession in Europe, a slowdown in China and a still feeble recovery in the US, which looks threatened by the fiscal cliff. Uncertainties in Greece still persist. Although the Moody’s rating affirmation is a short-term positive, we still think the medium-term risks to Spanish credit remain to the downside. While policymakers may be committed to the existing prescription for the periphery for now, growing social challenges are looming. Earnings revisions have been negative for the last six months now, yet the current earnings season will likely be the catalyst for more downgrades for Q4 and 2013. Investors tell us that they just want to protect the good year they had so far, and who can blame them?

Equally though, much of this is probably already baked into the consensus and without a specific, imminent negative catalyst, we suspect that technicals will take spreads tighter into year end – albeit much more gradually than in August and September. As we discuss in our monthly [Outlook](#), the ECB and other Central Banks are supporting the markets by creating a squeeze in risk assets, and will continue to do so for the time being. Rather than “being long” because the market is attractive, we feel like we have to go with the Central Banks. In the current environment, market wobbles are probably an opportunity to increase longs. The uncertainty about whether or not Spain enters a programme is unlikely to be a significant negative market trigger, in our opinion. However, the likely difficulties in implementing the tough programme, a likely growth undershoot and growing signs of domestic austerity fatigue all create downside risks for next year.

With these conflicting signals, we could never recommend an aggressive long given the tail risks, but we would be moderately long risk based on our central scenario. Therefore:

- Use near-term tightening in spreads on Spanish corporates to build a longer-term, strategic underweight.
- In Italy, instead, we think spreads can tighten further as the sovereign continues its gradual tightening, although most of the rally is now probably behind us. We therefore recommend being moderately overweight Italian names, particularly in intermediate maturities.
- Within financials, we would move to an overweight, by being neutral on senior and overweighting LT2/UT2, secured debt and covered, also in Italy. In Insurers, as well, we move to overweight in junior debt, while we find senior debt expensive.
- Within non-financials, we move to neutral on Basic Materials, on the basis of a worsening economic outlook. We don’t really see value in peripheral Telcos and, to a lesser degree, in Utilities, as downgrade risks loom. Core Industrials and Consumer Services will likely suffer further from the deteriorating macro environment, and offer little value. We maintain our longs in Consumer Goods, Oil & Gas, and Healthcare.

Suggested Picks and Pans

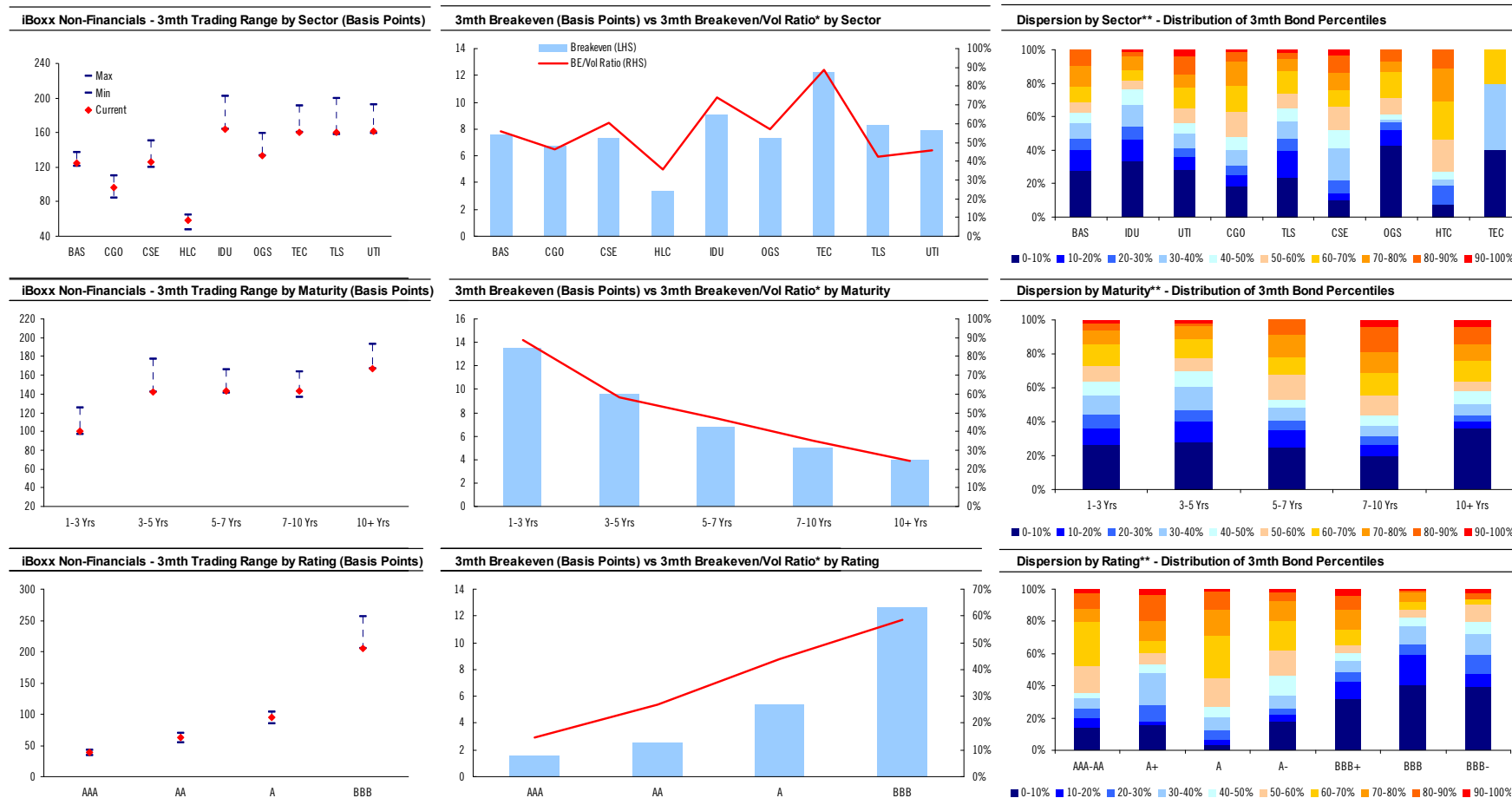
Figure 3. Suggested Picks and Pans¹

Sector	Picks	Pans
<u>Basic Materials</u>	Lanxess BASF	BHP Billiton
<u>Consumer Goods</u>	Pernod-Ricard British American Tobacco Imperial Tobacco	LVMH PPR
<u>Consumer Services</u>		Metro Tesco
<u>Health Care</u>	Roche Sanofi	
<u>Industrials</u>	Siemens Vinci	Schneider Electric Volvo Bouygues Building Materials
<u>Oil & Gas</u>	Gazprom	OMV
<u>Technology</u>	Cap Gemini	
<u>Telecoms</u>	British Telecom	Telecom Italia France Telecom
<u>Utilities</u>	CEZ Group	Spanish Utilities
<u>Banks</u>	American Banks Italian Banks Barclays	French Banks Spanish Banks
<u>Insurance</u>	Swiss Life Generali	Munich Re
<u>Financial Services</u>	General Electric	

Source: Citi Research

¹ To produce individual and sector recommendations we use various scoring systems relative to history and to peers to determine richness and cheapness. We factor in overall spread movements as well as the potential effects of individual credits on a sector. We use this information along with fundamental data and credit-specific news to determine our positioning.

Figure 4. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Non Financials

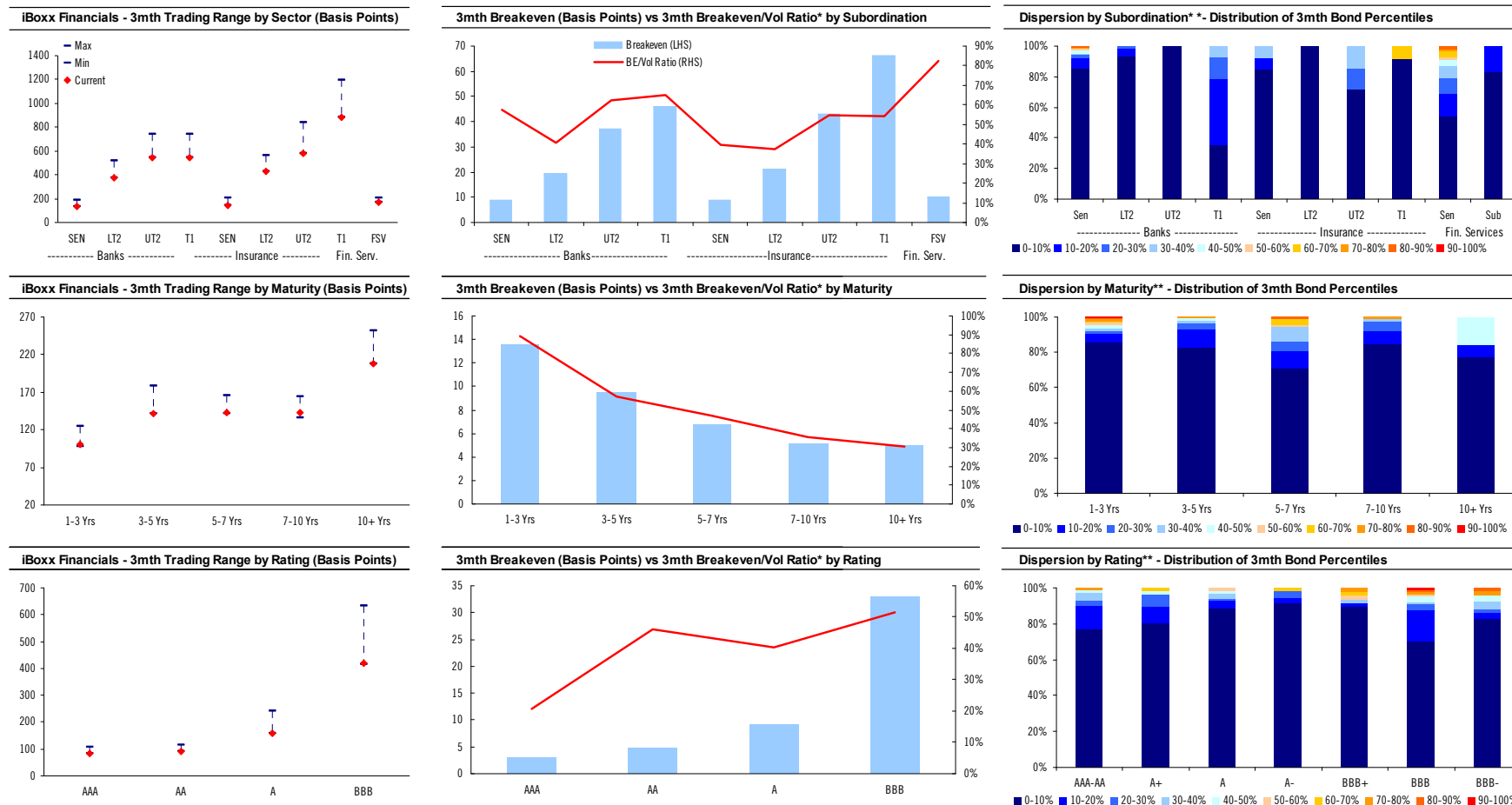


Source: iBoxx, Citi. * Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

** Dispersion charts aggregate individual bond performance for various buckets (sectors, ratings etc). For each bond the current percentile in the 3mth trading range is calculated. For each bucket the distribution of bond percentiles is then aggregated. Dark red shows the percentage of bonds that are trading at or very near their 3mth highs. Dark blue shows the percentage of bonds at or very near 3mth lows. Light colours show bonds trading mid-range.

Source: Citi Research, Markit

Figure 5. iBoxx EUR Sector Relative Performance – Spread Change and Dispersion Charts – Financials



Source: iBoxx, Citi. * Break-even (Spread/Duration) measures how much widening the carry can compensate for. Dividing by volatility gives a simple measure of likelihood that spread movements will exceed that point.

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Source: Citi Research, Markit

Sector Recommendations

Basic Materials: neutral

The CDS market is long Basic Materials but the bond market is not

Basic Materials are suffering from an increasingly bearish outlook on the economy which is only slowly feeding through to analyst expectations. Admittedly, investor positions are increasingly [short cyclicals](#), and the sector is one of the cheapest relative to the iBoxx. But we remain concerned about the sector's cyclical in the light of weakening demand from China, the US and Europe. Quite interestingly, the CDS market remains tight, but the spreads in the bond market seem to reflect growth concerns better.

Chemicals look more attractive than Basic Resources

It is likely that demand of commodities from China will recover in the near term as the economic stimulus kicks in and the government continues to support economic activity. However, this will only be of partial relief to metal and mining companies. This is why we continue to like the balance sheet quality offered by Chemicals versus Basic Resources. Maintain the sector neutral by overweighting Chemicals and underweighting Basic Resources.

Capex needs for Basic Resources companies likely to put pressure on cash flows

Basic Resources valuations look unattractive when compared to Chemicals. These companies face a number of fundamental issues in the current environment of weakening commodity prices. Our [equity analysts](#) expect the recent stimuli from the Fed and the Chinese government will support commodity demand, but they believe it will benefit more the precious metals market, rather than iron ore or coal. BHP Billiton and Rio Tinto look to be in a particularly unfavourable position from this point of view, because of their committed capex, although they are significantly cutting it back for 2013-2014. Yet spreads on most Basic Resources companies are quite tight and offer very low breakeven to volatility ratios versus Chemicals, in spite of their comparatively worse fundamentals.

Chemicals' demand is also weakening, but valuations look more attractive and companies are managing the downturn conservatively

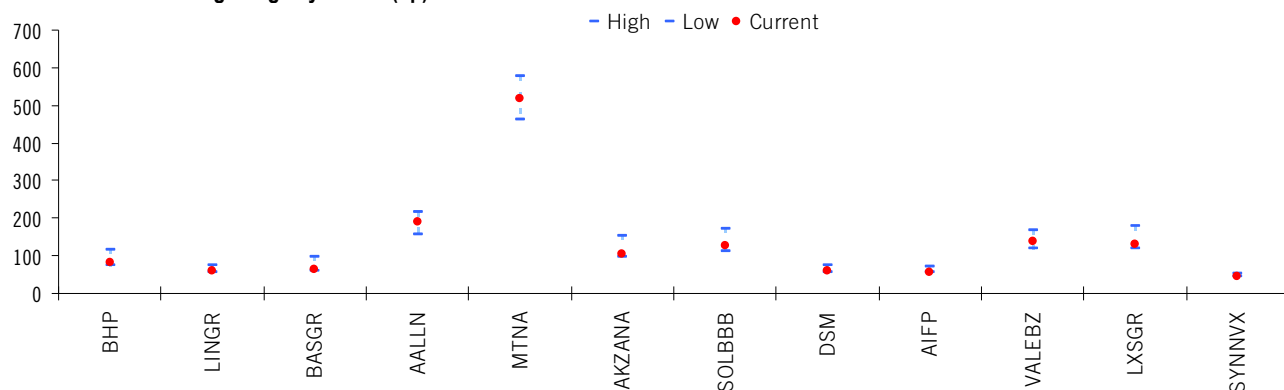
Chemicals face sluggish demand as well. But most European companies in this sector reported solid results in Q2. The weakness in demand is reflected in lower volumes, which [were on average down by 1%](#). But pricing power improved, and the weak Euro supported exports, although margins are weakening. Low leverage and relatively lower capex commitments versus Basic Resources suggest that this subsector is better positioned to withstand a cyclical downturn. Most Chemical companies are engaging in cost cutting programmes in order to face the expected slowdown in demand. Also, currently chemical companies, for instance Lanxess, offer better breakeven to vol ratios than Basic Resources ones, and spreads look more attractive.

Figure 6. Basic Materials Picks and Pans

Picks	Lanxess: The longer maturity bond sold off substantially last month, in spite of the strong fundamentals of this company, which reported solid results in Q2. Lanxess confirmed its guidance; demand for its products is slowing, but the exposure of the company to EM and good pricing power should mitigate what seems just a short term issue.
	BASF: Its bonds underperformed peers in the last three months, although it maintained its EBIT guidance unchanged in its Q2 earnings release. The company showed caution on the demand for its Chemicals portfolio, but Agriculture and Oil & Gas are supported respectively by strong demand trends and improved Libyan oil sales. These factors, together with measures to contain costs (slowing employment growth, accelerating its existing restructuring plan), are likely to stabilize BASF's performance.
Pans	BHP Billiton: High committed capital expenditures, coupled with worsening commodity prices, are weakening BHP credit metrics, which are already substantially weaker than in 2008/09, when commodity prices fell sharply. We acknowledge that the company is strongly committed to a rating in the A region, and that it reduced its capex for 2014, however we don't find current levels attractive enough given the pressures that might arise from a further deterioration of commodity prices.

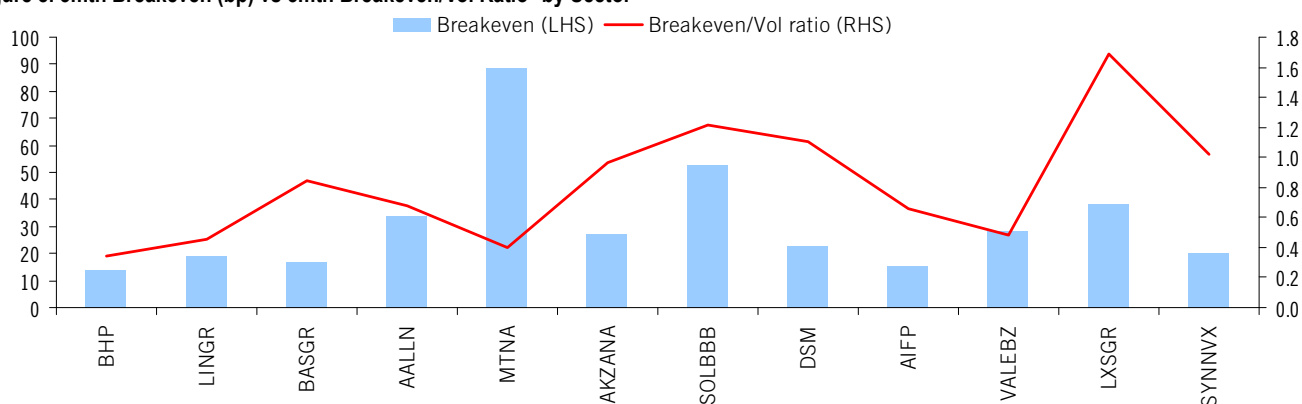
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 7. CDS 3mth Trading Range by Sector (bp)



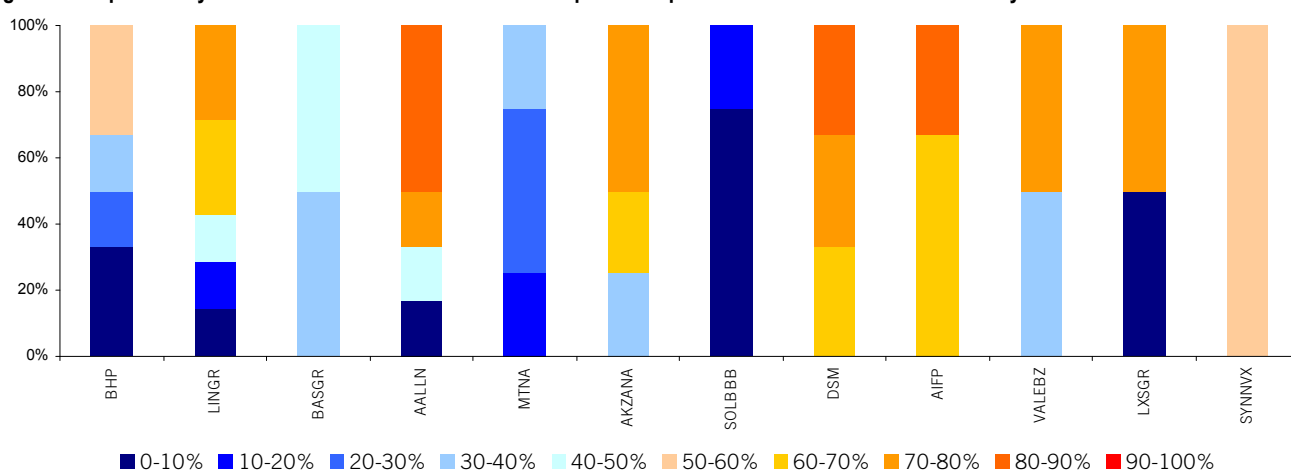
Source: MarkIt, Citi Research

Figure 8. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 9. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

Consumer Goods: overweight

Consumer Goods are underperforming the market, and offer a good opportunity for a defensive positioning

M&A risk is higher in Food and Beverage companies.

Luxury Goods are strong, but spreads don't protect from weakening growth in China. Tobacco companies are more interesting

The crisis of the automotive industry is spreading to the luxury segment.

Consumer Goods continued to underperform the iBoxx last moth. Attractive valuations in the most conservative names offer a good entry point for investors seeking a more defensive stance. At the same time, as peripheral sovereign risk has abated, the "safe haven" status of German auto makers should lose relative importance compared to a weakening outlook in demand.

Food & Beverage probably has the highest M&A risk of any subsector. This can lead to further issuance, and potential ratings volatility. Earnings held up well in general, and the perceived stability of the sector might favour their access to capital markets. However, sales and margins slowed in Europe, although this was in most cases balanced by the exposure of the sector to emerging markets and the wine and spirits segment.

From a credit perspective, **Personal & Household Goods** looks better positioned thanks to good demand trends, especially in luxury goods and tobacco. We have started to see softness in demand growth for luxury goods from China, as the 3Q revenues of LVMH show, and we feel insufficiently protected given the very tight levels of luxury goods producers. We continue to like tobacco companies at current levels, in spite of some M&A risks: while they experienced some weakness in volumes in European markets, showing that this industry is not as defensive as previously thought, we think they offer a better alternative to Consumer Services for a defensive overweight on growth concerns. The main risk we see for earnings is the trend of governments imposing plain packaging, but we don't see this as an immediate threat. Also, there is speculation about M&A, but it is probably not an imminent risk and might even be positive for the sector.

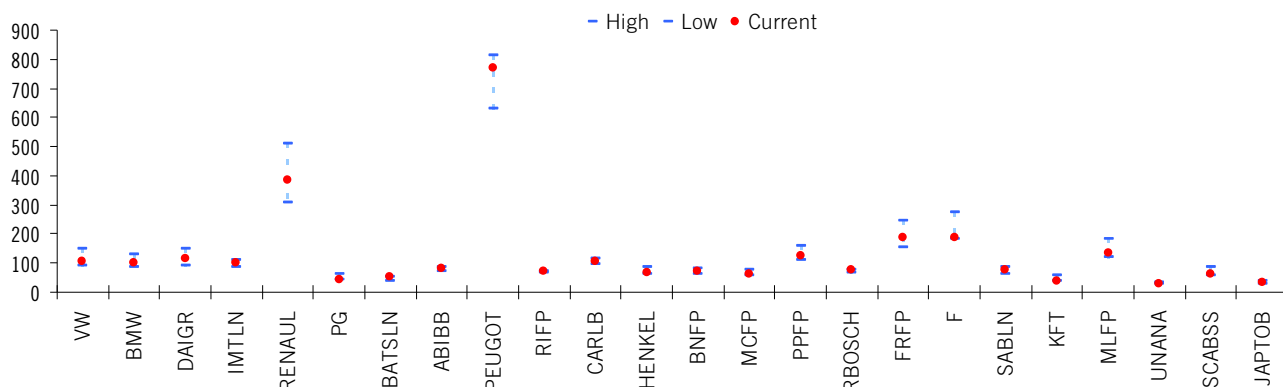
We remain negative on **Automotive & Auto Parts** as the outlook for demand in Europe remains challenged and sales are slowing down. Weakening in demand is now starting to be quite evident also in the more resilient luxury space. We think this will weight on German automakers' valuations now that sovereign risks have abated and their "Core Europe" status is becoming less significant versus earnings performance. Michelin remains a bright spot: our equity analysts believe consensus is focusing too much in the recent weakness in the tyre market, and is underestimating the strong market position and pricing power Michelin has.

Figure 10. Consumer Goods Picks and Pans

Picks	<p>Pernod-Ricard: We continue to be long Pernod, as spreads look attractive given its improving financial risk profile and lack of M&A appetite compared to peers. The company delivered a good set of results. Thanks to its product diversification and its exposure, it managed to offset weakness in Europe.</p> <p>British American Tobacco and Imperial Tobacco: These companies have experienced some weakness in their European markets (especially Imperial Tobacco) which surprised investors, but our equity analysts believe it is just a temporary event. Moreover, better pricing and exposure to emerging markets are likely to support revenues. There is a medium-term risk regarding the introduction of plain packaging in their major markets, but it does not look like an immediate threat to revenues, therefore we see current underperformance as an opportunity to pick up two defensive names in Consumer Goods. Also, there is some speculation regarding the potential acquisition of Imperial Tobacco by Japan Tobacco, but a takeover does not look imminent at this stage, and consolidation in the sector might even be a positive.</p>
Pans	<p>LVMH and PPR: these names have benefited from resilient luxury good demand from East Asia, China in particular. However, although a soft landing of the Chinese economy is Citi's central scenario the downside risks are rising. LVMH's last Q3 revenue release is a sign that demand for luxury goods from China is weakening. These are two of the tightest names in the Consumer Goods universe and significantly exposed to China. Admittedly, spreads at PPR are likely to be supported by the spin-off of Fnac. But at these levels we maintain our underweight.</p>

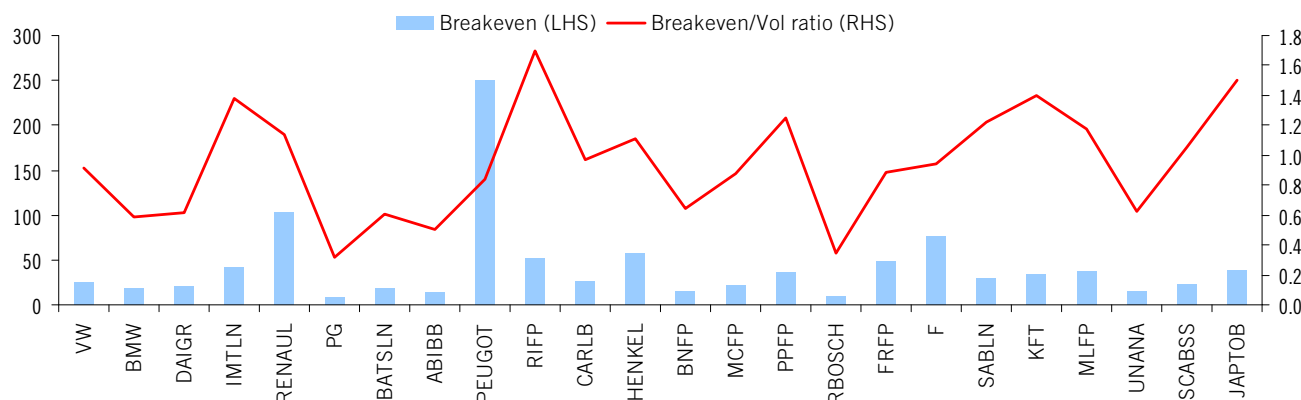
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Figure 11. CDS 3mth Trading Range by Sector (bp)



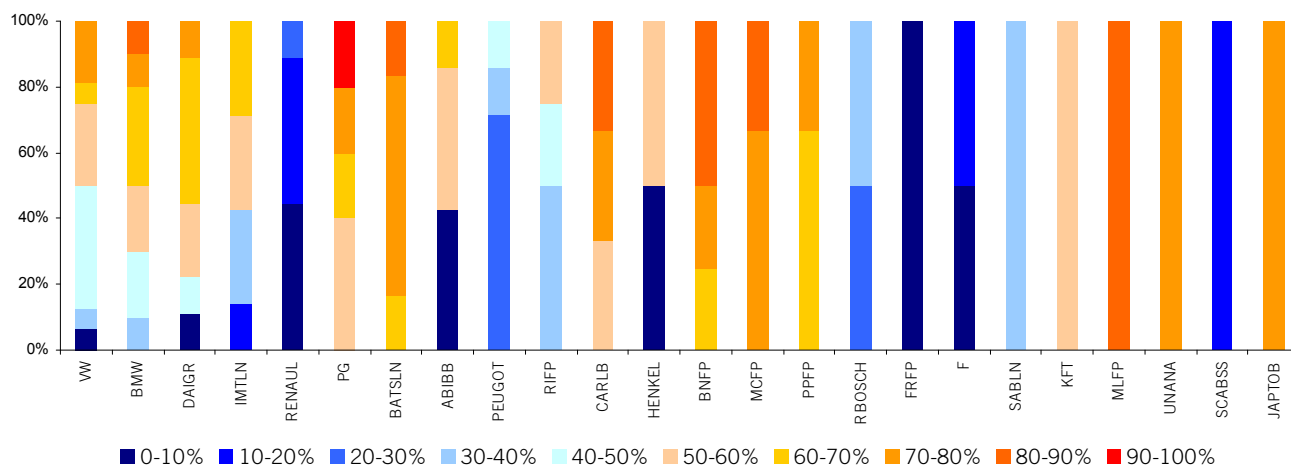
Source: MarkIt, Citi Research

Figure 12. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 13. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



Source: iBoxx, Citi Research

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Consumer Services: underweight

We remain negative on Consumer Services as the sector's fundamentals are deteriorating.

Consumer Services suffers from several fundamental challenges and from a longer-term perspective to some extent it is exposed sovereign risk. It has underperformed the iBoxx EUR substantially in last month's beta driven rally, bringing valuations versus the index back to June '12 levels. The re-rating may start to make some individual names a more attractive opportunity for defensive investors. But we are wary of a sector facing high competition, stagnant profitability and a deteriorating macroeconomic outlook. Maintain underweight.

Data on retail sales continue to be weak

In **retailing**, retail sales data across Europe continue to be weak. The tough operating environment is weighting on operating performance, as shown by the weakness of Metro and Tesco. While UK businesses might be supported by relatively positive September BRC data, showing like-for like sales growth of 1.5% against expectations of -0.2%, we think this is just a temporary boost. European consumer confidence is still feeble and business sentiment is weakening also in the core countries.

Media are being supported by one-off events, but there is no visibility in the medium term

As regards the low-beta **Media** names, most companies in this subsector have been able to diversify into more defensive investments (pay TV, specialized channels and publications). Also, there have been a number of events this year (Olympics, elections in France, Jubilee year in the UK) which have supported revenues even in a weakening economy. However, now that these events are over, the outlook for revenues should weaken significantly, and we think this is not reflected in valuations, which are very tight to history, especially in CDS. At these levels, we are also concerned by the relatively high leverage of the sector, particularly at Wolters Kluwer.

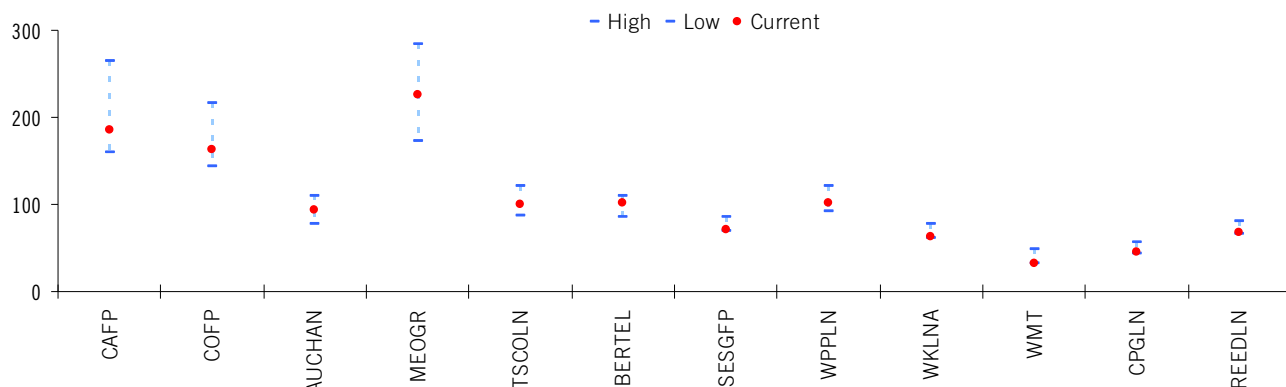
Figure 14. Consumer Services Picks and Pans

Pans **Metro:** In its Q2 earnings release, Metro showed an improved cash flow generation, thanks to an increase in trade payables, perhaps associated with the strong increase of LFL sales in Germany on the back of Euro 2012 and the switchover to digital in the country which occurred on 30th April. However, as expected, the company profit warned. Management reiterated its growth expectations, but we think these are too optimistic, and we remain negative on the name

Tesco: The company is benefiting for a mild pick up in LFL sales in the UK, however its market share did not stabilize yet. Its international performance is also lagging behind as sales per square foot are still weak versus international competitors. The company is facing a tough operating environment in the US as well. Yet it performed more or less in line with stronger companies like Wal-Mart or Auchan over the last month.

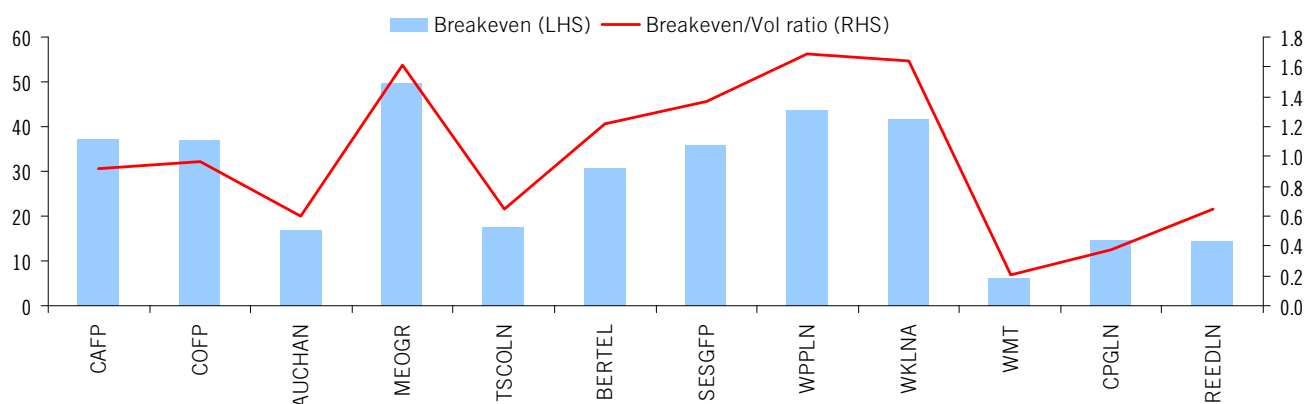
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Figure 15. CDS 3mth Trading Range by Sector (bp)



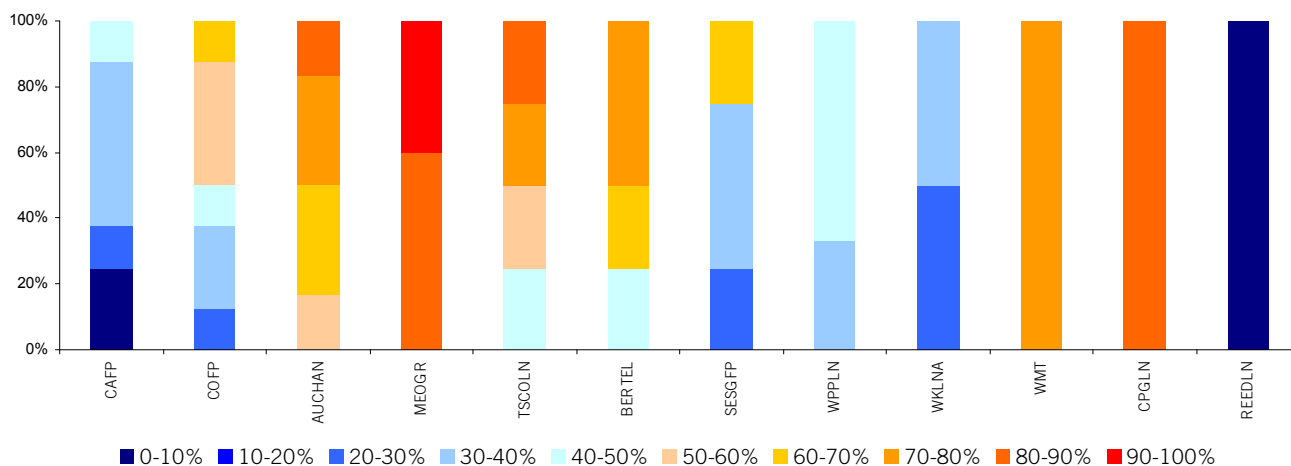
Source: MarkIt, Citi Research

Figure 16. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 17. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



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Healthcare: overweight

Healthcare can be a safe haven and looks attractive versus Consumer Services

On a long-term basis, Healthcare still looks expensive to the market given the long term challenges it faces. However, to recent history spreads have cheapened up a fair bit, and for investors looking to get more defensive after the rally, we think there is a decent entry point compared to a sector like Consumer Services. We are overweight.

M&A risk is high as pharma companies need to acquire patents

One fundamental issue is the need to strengthen the product pipeline. Balance sheets are strong currently, but we expect they will weaken over time as favourable funding costs encourage debt-financed M&A and/or share repurchases. Several names in the index are likely to pursue acquisitions of smaller competitors to obtain new patents, however most of them have the flexibility to manage medium-sized M&A.

Revenue growth is constrained by austerity measures and competition with generics

Moreover, we believe fiscal austerity in Europe is likely to weigh increasingly on revenue growth going forward. Growing competition from generic drugs will hamper the profitability of patents and hence pricing power further. We think companies with a strong Phase III testing pipeline, like GSK, or which are more geographically and product diversified, like Bayer, are better positioned to withstand these challenges.

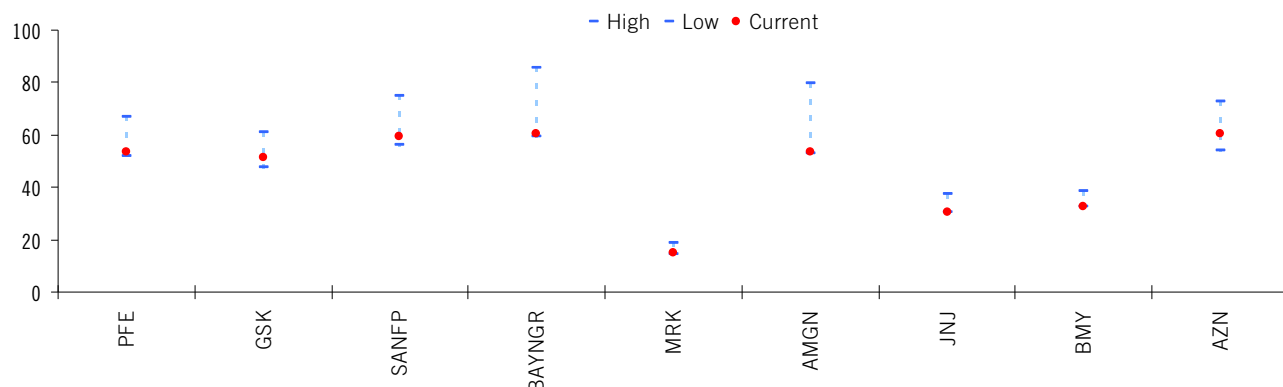
However, despite our long-term fundamental concerns, the sector is likely to stay a comparative safe haven against short-term market volatility, and we think it offers better value versus Consumer Services thanks to its stronger demand outlook and higher quality balance sheets.

Figure 18. Healthcare Picks and Pans

Picks	Roche: Medium and long term bonds have underperformed peers last month and we think this is unjustified. The company is weathering the austerity measures better than peers thanks to a well diversified portfolio. Company guidance has been cautious at the Q2 earnings release, but our equity analysts believe the recent volume pressure the company experienced in Europe will be likely offset by cost cutting measures and EM growth.
	Sanofi: The company leveraged up to fund the acquisition of Genzyme in 2011; however, debt metrics have improved substantially since and rating agencies expect further deleveraging over time. It has a relatively strong product pipeline over the next few years, also thanks to the partnership with Regeneron, which provides Sanofi with access to antibody development capabilities. For instance, the cancer drug Zaltrap has been recently approved by the US FDA for use in combination with other drugs to treat colorectal cancer. Management is focusing on cost savings, and the company benefits from EM exposure. Sanofi underperformed peers last month.

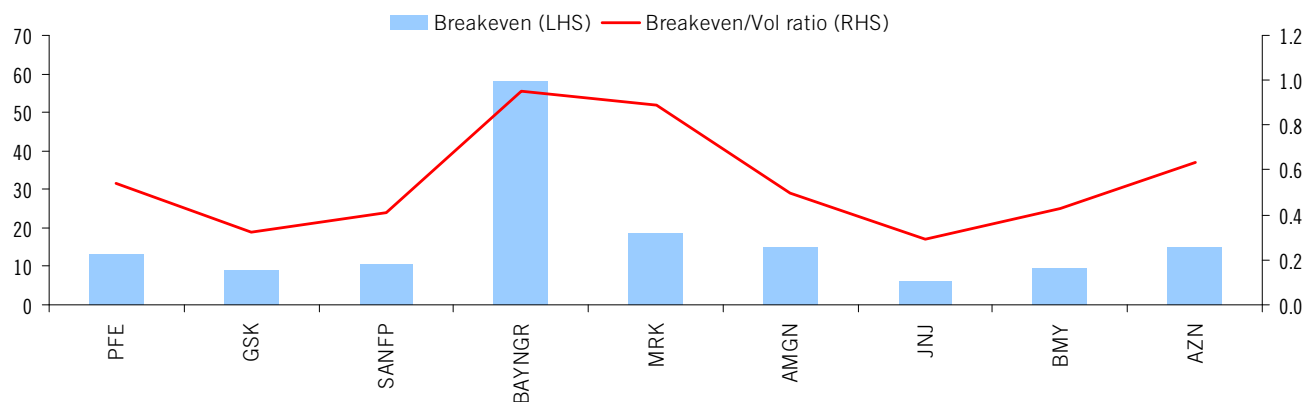
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Figure 19. CDS 3mth Trading Range by Sector (bp)



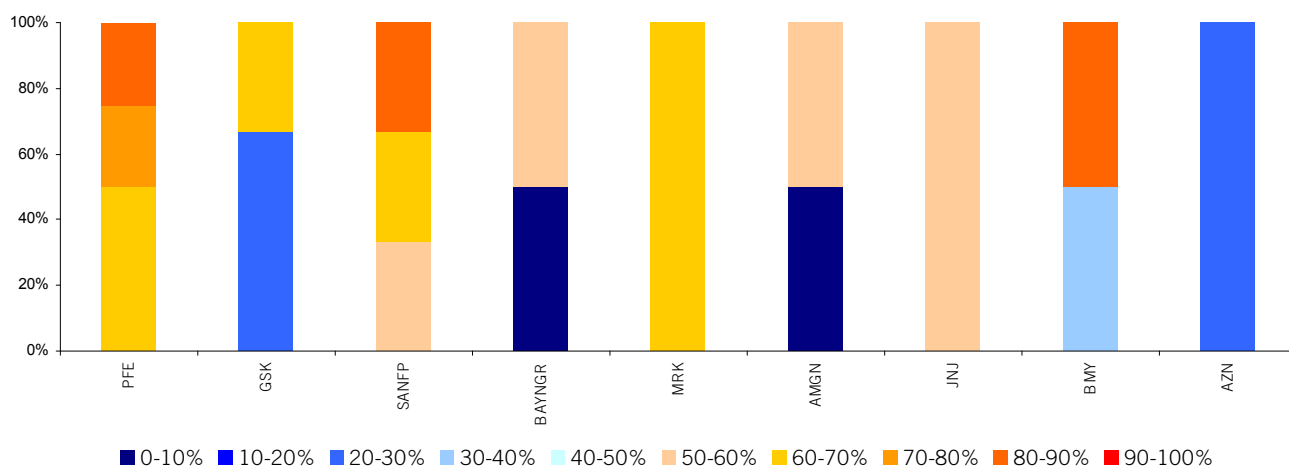
Source: MarkIt, Citi Research

Figure 20. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 21. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth history



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Industrials: underweight

We remain underweight on Industrials as valuations are now unattractive given the cyclical outlook

Industrials have benefited from their limited periphery exposure and their geographic diversification. However, they have sharply underperformed the iBoxx Corp in the financials-driven rally of September. In spite of this, we don't find Industrials attractive given the current negative outlook for the Chinese and European economy. Earnings revisions remain negative. The fact that investors report a long position in our [Global Credit Survey](#) suggests the sector is comparatively crowded. Maintain an underweight, although reduce after recent underperformance.

Truck and Defence companies look vulnerable

Most core industrials look unattractive at the moment, as the recession in Europe and China bites. We maintain our short on Volvo given the worsening outlook for truck demand worldwide, which is affecting prices. We think it is unlikely Volvo will deliver on its profit targets in such a challenging environment. Prospects for Defence companies are also weakening, as shown by the slightly weaker than expected results of Rheinmetall, as governments seek to trim their budgets and the potential consequences of US fiscal tightening loom.

We are unconvinced about the strong performance of Finmeccanica. Atlantia and Vinci look better

We are also unconvinced by the strong performance of Finmeccanica. We wouldn't be short for now (the company plans the sale of Ansaldo Energia and that would be a small positive) but its fundamentals are weakening so the rally just reflects an improvement in sentiment towards Italy, in our view. Atlantia's bonds remain comparatively tight, but CDS has lagged in the rally – providing a decent entry point in a defensive name for anyone looking for Italian exposure. We are positive on companies like Vinci in bond space, as it has underperformed substantially versus peers recently. It still seems to carry a sovereign risk premium that isn't reflected in the sovereign itself any longer.

Some core companies have performed well, but demand for industrial goods is weakening

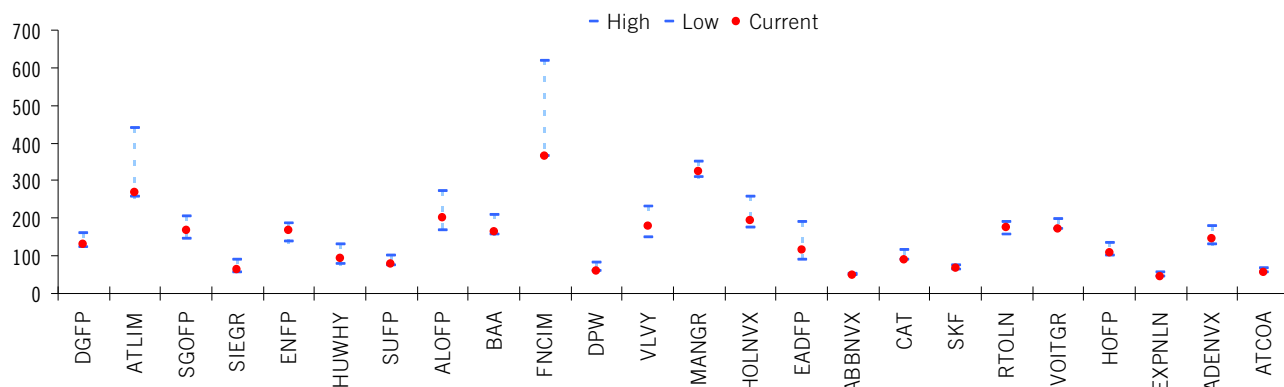
While some individual credits are holding up well to the competitive environment, as proven by the positive results of ABB, demand for capital, industrial and construction goods is weakening. Many companies, like Siemens, have had to adjust their guidance down. On the brighter side, leverage, in general, is not very high. We also expect just modest issuance, as the sector does not look very driven to expand or engage in M&A.

Figure 22. Industrials Picks and Pans

Picks	Siemens: we continue to like Siemens in the longer maturities. Even adjusting for the share repurchases that were announced recently, the company remains quite lowly leveraged. Moreover, the management is committed to restructuring which, according to our equity analysts, will be key given the difficult economic environment the company is facing. On this basis, they are more bullish than consensus on earnings.
	Vinci: The company is experiencing some weakness, as traffic is lower and margins on some new products will be lower than expected. However, we think expectations adjusted to the downside after Vinci released its last earnings and guided down on operating margin, and we don't expect further negative surprises. The company's financial situation remains solid, and the order backlog is quite long.
Pans	Schneider Electric: We are surprised that Schneider bonds sold off less than peers, given the lack of growth in the infrastructure and real estate markets in Europe, China and the US. They also recently announced that they will engage in M&A, while its end markets remain lacklustre. Current CDS also looks tight compared to its historical performance, especially versus end 2011, given below peer profitability and acquisition risks.
	Volvo: We are sceptical that Volvo can really deliver on the growth targets it outlined on the latest Capital Markets Day (increasing truck gross margins by 300 bps, reducing truck cost of sales by 10%, reduce selling expenses to 5% of revenue, and reduce R&D spend to SEK11.5bn, with a target profitability of 6%), especially if growth is to come from its "value" range or by further expansion in the already competitive German market. While its strong credit metrics offer support to bonds and CDS, we are concerned that spreads are too tight given the weakening outlook.
	Bouygues: The company has recently raised its sales guidance, driven by construction and road building, but margins are likely to remain low as the outlook for real estate and telecoms in France is problematic. Its telecoms business is experiencing declining revenues, in line with the telecoms market, and its order book, while increasing thanks to commercial real estate, is stagnating on the residential side.
	Building Materials: We think Saint Gobain and Holcim are too tight versus other industrials given the weak outlook for the industry. With its high exposure to Europe, we expect Saint Gobain to be particularly affected by weakness in the European real estate market. While the company announced further cost cutting measures in July, we think this is unlikely to protect margins. Holcim is being supported by its higher exposure to emerging markets and solid trends in North America. But it is suffering from its exposure to Europe as well and at the current levels we think the company offers little cushion against a further deterioration there.

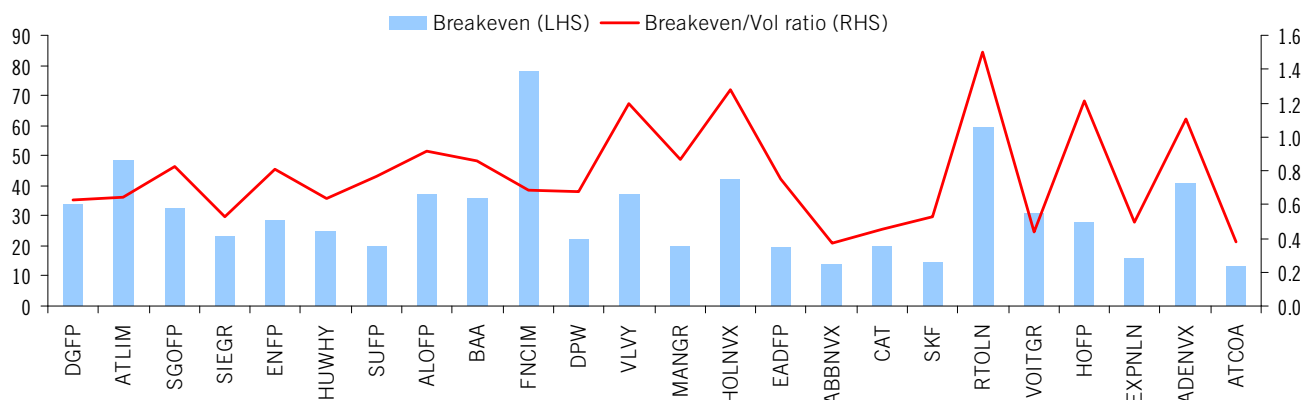
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 23. CDS 3mth Trading Range by Sector (bp)



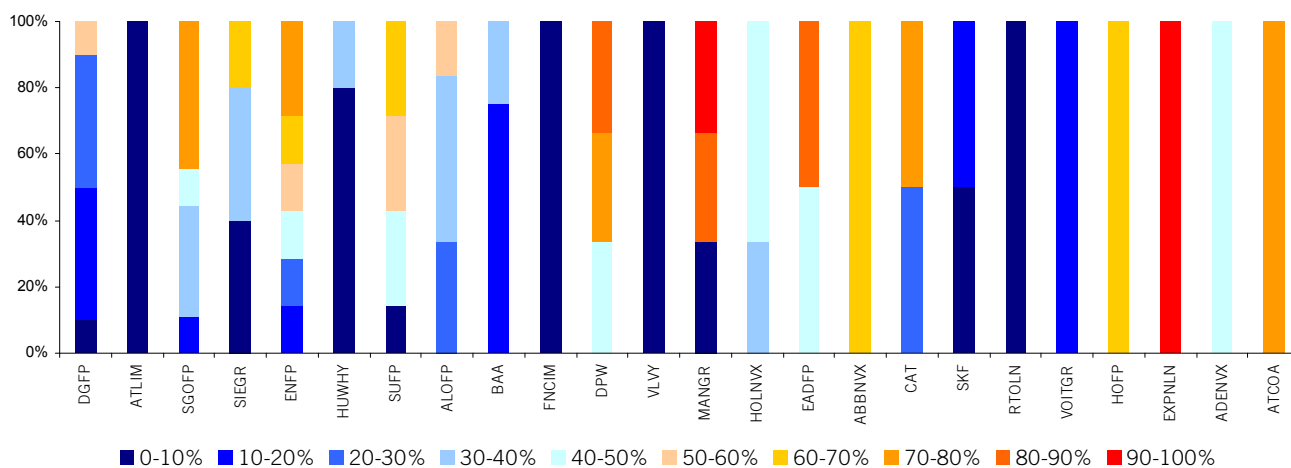
Source: MarkIt, Citi Research

Figure 24. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 25. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

Oil & Gas: overweight

Oil & Gas demand outlook is perhaps poor, but valuations are attractive

At first glance, the outlook for the Oil & Gas industry is perhaps not that rosy: demand is stalling, as Europe lingers in recession and the Chinese economy appears to be slowing more rapidly than previously envisaged. A number of fundamental and political factors suggest the market is not set for a rapid turnaround. However, relative to the rest of the non-financial universe we feel the sector is still attractively valued. Factoring in the conservative balance sheets of the bulk of the names in the index, we think the sector still merits a small overweight.

Supply looks to be carefully managed by interventions from US and Saudi Arabia; China remains a risk for demand

Oil prices have rallied over the summer on the back of the threat of a strike by Israel against Iran, but Citi continues to believe this is [a low probability event](#) ahead of the US elections. QE across the world also fuelled the rally. However, both Saudi Arabia and the US are increasing production and it is likely that the US will release some of its strategic petroleum reserves in order to control price increases. Also, the market is clearly concerned about the risks of a demand shock that would result from a hard landing in China. However, this is not Citi's base scenario: our economists believe that [growth in China will increase to 8.2% in Q4](#), bringing the annual growth rate at 7.9%.

The next earnings season is likely to be positive

Our [equity analysts](#) expect the next earnings season to be positive for oil producers, as resilient oil prices helped to balance maintenance activities and outages occurring during the summer. On aggregate, Citi is 3% ahead of consensus.

We remain uncomfortable with risk/reward on Repsol in the medium term given its exposure to Spain.

Gazprom is likely to outperform peers after it renegotiated gas contracts with European companies

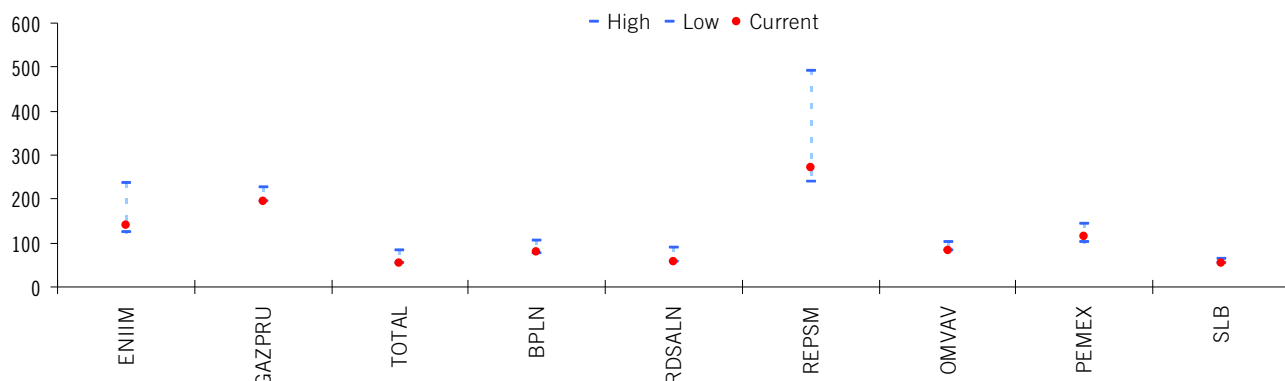
Gazprom has largely terminated the renegotiation of oil-linked gas contracts with its European partners, implying a 10% discount on existing contract prices, and this of course had a hit on earnings. But volumes remained healthy. Moreover, while the Russian Parliament has still to approve a new regulation regarding an increase in dividends for state-owned enterprises, current proposals do not constitute a material risk to Gazprom's conservative leverage policy. For these reasons, we think its underperformance versus peers in the last six months is significantly overdone.

Figure 26. Oil and Gas Picks and Pans

Picks	Gazprom: The renegotiation of gas contracts of course hit earnings, however volumes remained healthy. Moreover, while the Russian Parliament has still to approve a new regulation regarding an increase in dividends for state owned enterprises, current proposals do not constitute a material risk to Gazprom's conservative leverage policy, in our view. Therefore, we find Gazprom's underperformance largely unjustified.
Pans	OMV: We are not attracted by OMV at current spreads. The company's net income has been supported by the return to production of Libyan wells and stronger performance of its German and Austrian downstream operations. But this company remains comparatively highly leveraged, and its asset disposal programme looks ambitious.

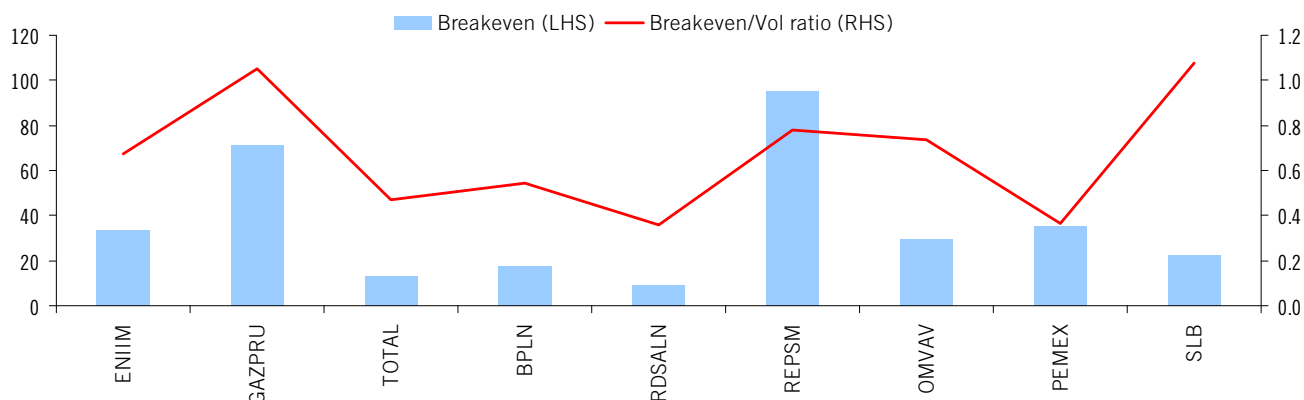
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 27. CDS 3mth Trading Range by Sector (bp)



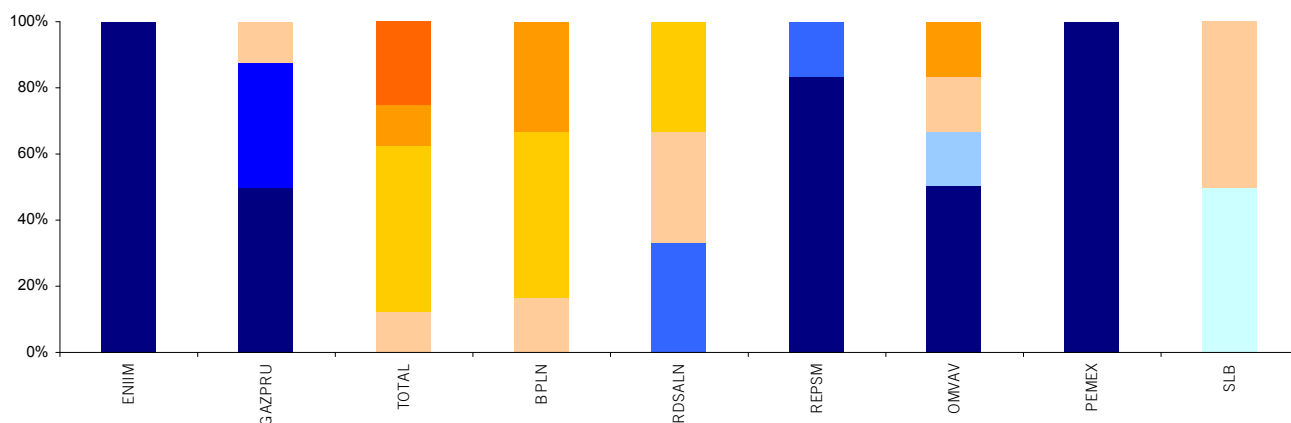
Source: MarkIt, Citi Research

Figure 28. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 29. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tight.

Technology: neutral

We expect Technology to perform in line with the market

Technology slightly underperformed the market. We don't see many catalysts for outperformance here, as the sector is very cyclical. We remain neutral.

The long term outlook for technology is positive, but cyclical pressures are strong

As usual, the sector's performance is really the amalgamation of differing trends at the individual level. Our least favourite part of the sector is semiconductors, where we see further cyclical downside.

For Ericsson, the long-term growth outlook for mobile broadband is positive, as global penetration rates are still low and there are still huge needs for transmission infrastructure. However, cyclical demand, harsh competition and high R&D expenditures remain challenges to the sector. This situation is currently exacerbated by the weakening profitability of telecom operators, which is prompting them to hold back on capex. Admittedly, Ericsson is seeking to maintain its lead in the sector through investments, which are intended to consolidate its position in mobile data, cloud computing and WiFi. The impact of these projects on margins is expected to decrease in 2H12. It is also likely that some of Ericsson's customers increase their capex in networks and electronics. This should provide some support to spreads in the medium term, but in our opinion it does not really change the fundamental outlook of the company, therefore we don't see an immediate catalyst here.

The Consulting business is growing

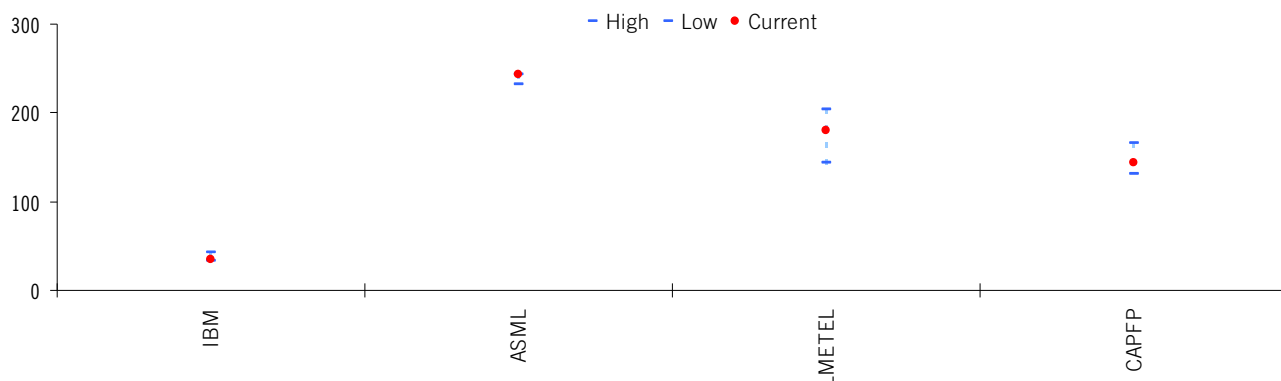
Our favourite subsector, instead, is consulting. Cap Gemini is showing good revenue momentum, indicating solid demand levels, in spite of the recessionary environment in Europe. We see some weakness in the consulting business of IBM, but other parts of the company are performing in line with expectations, so we see no immediate catalyst for spreads in either direction.

Figure 30. Technology Picks and Pans

Picks **Cap Gemini:** Cap Gemini is showing good revenue momentum, indicating solid demand levels, in spite of the recessionary environment in Europe, thanks to strong growth in North America, Asia, Northern Europe and Germany. The book-to-bill ratio is holding up, although Q1 bookings were slightly weaker than last year.

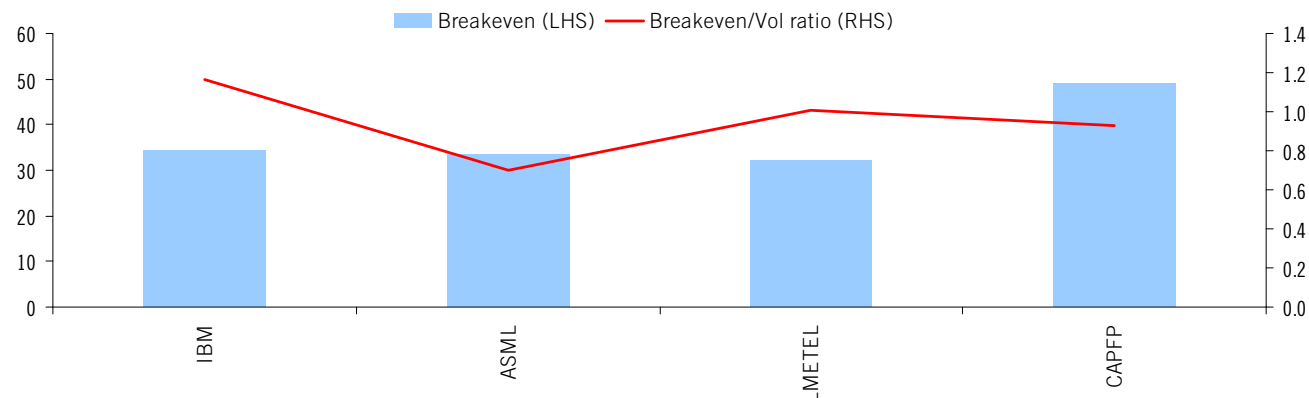
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 31. CDS 3mth Trading Range by Sector (bp)



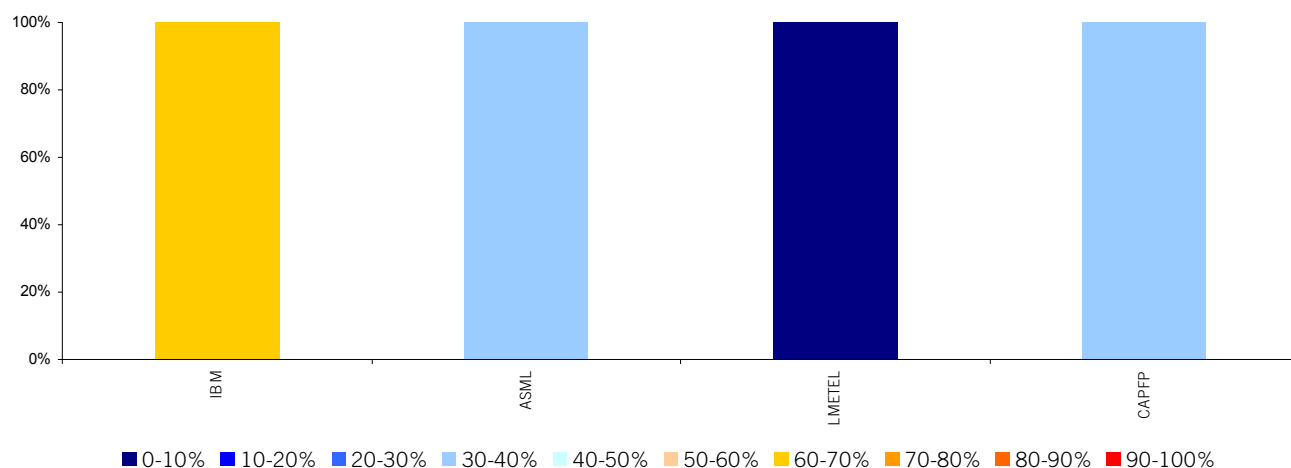
Source: MarkIt, Citi Research

Figure 32. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 33. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth highs, while dark blue shows the percentage of bonds very near 3mth lows.

Telecoms: underweight

Telcos suffer from increasing competition, weakness in demand and weakening margins

Profitability is a major challenge for this sector

We believe any deleveraging will be slow and we see downgrade risks as profitability is eroded

Telecom Italia might continue tightening, but there are too many unknowns to feel comfortable at these levels.

The outperformance of Telcos last month continues to be concentrated in Telefonica and Telecom Italia as sovereign risks receded. Yet fundamental trends in these two countries remain weak: weakening demand, especially in mobile, and increased competition are still weighing on profitability, and in turn increasing event risk. Moreover, our [Global Credit Survey](#) suggests that the sector remains a consensus long, and exposure increased last month. Remain underweight.

Cost reduction, for instance through cuts to workforces, is still a major challenge in the sector, particularly ex-state monopolies. Incumbents will benefit from changes to labour regulations now approved in Italy and Spain. However, there is an ongoing need for capex to maintain market share. Operating leverage is therefore high and sticky.

In the current operating environment, we believe any deleveraging will be slow, and we see downgrade risks as profitability is eroded. In response to this, some companies in the sector (Telefonica, France Telecom, KPN) are cutting dividends and restructuring in an effort to reduce leverage. This is a positive, but not a game changer in our view. In particular, Telefonica has been quite aggressive in reducing its dividends and restructuring its corporate organization as seeks to reduce the risk of further downgrades resulting from rating action on Spain. S&P recently clarified that the maximum rating differential between Telefonica and Spain can be three notches if Spain remains IG, and two if Spain falls into the HY category – however, S&P then proceeded to put Telefonica on review for downgrade following the Spanish downgrade. Moody's maintained its investment grade rating on Spain. Its policy would allow a maximum differential of two notches between Spain and Telefonica, while the current rating differential is just one notch. The company is still on negative watch, although after the sovereign affirmation a downgrade seems less likely. Telefonica looks a better alternative fundamentally to Telecom Italia, but the medium-term sovereign uncertainty keeps us neutral for now.

Continuing tightening of its underlying sovereign might support valuations for Telecom Italia. But we remain cautious about its outperformance versus peers. There is a possibility that Telecom Italia could spin off its fixed line network. This would likely free up resources to pay debt down, but rating agencies might downgrade the company regardless.

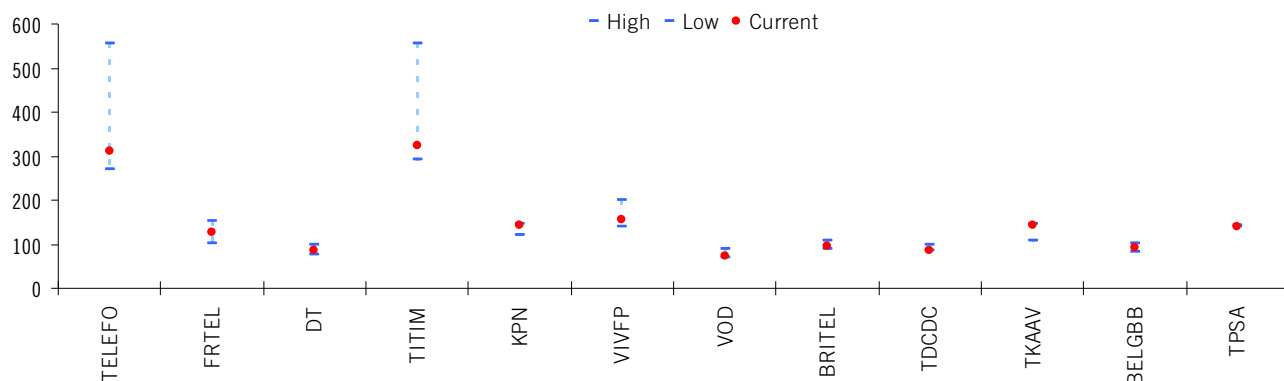
Among the peripherals, we continue to like PT. It has already navigated through the benchmark transition issue. Admittedly, our economists think the sovereign will fail to meet its 2012 deficit targets and that it will require a debt restructuring plan in the next three years, but PT itself is fully funded until 2014 and we think it could squeeze further in the near term.

Figure 34. Telecommunications Picks and Pans

Picks	British Telecom: The company reported below consensus 1Q13 results (sales -6% yoy, below consensus, EBITDA +2% yoy, in line with consensus), and therefore underperformed comparable safe havens in the telecoms space. BT however reiterated its guidance for 2013 and 2014, so we think its underperformance is overdone.
Pans	Telecom Italia: Telecom Italia's valuations look stretched given the risks of a downgrade should a spin off of its network occur. No announcement has been made by the rating agencies so far, but historically this is what happened in such circumstances. Moreover, while it is better positioned in the internal fixed line market than its competitors, TITIM is suffering from weakness in the mobile sector in line with other mobile operators.
	France Telecom: This is one of the companies in the "soft core" which is benefiting from strong market technicals in spite of weakening fundamentals. Current CDS and bond prices don't adequately reflect the long-term risks arising from the aggressive market strategy of the new French telecom provider Free, in our view. We also believe France Telecom is vulnerable to any widening in the sovereign should there be contagion from Italian and Spanish risk premia.

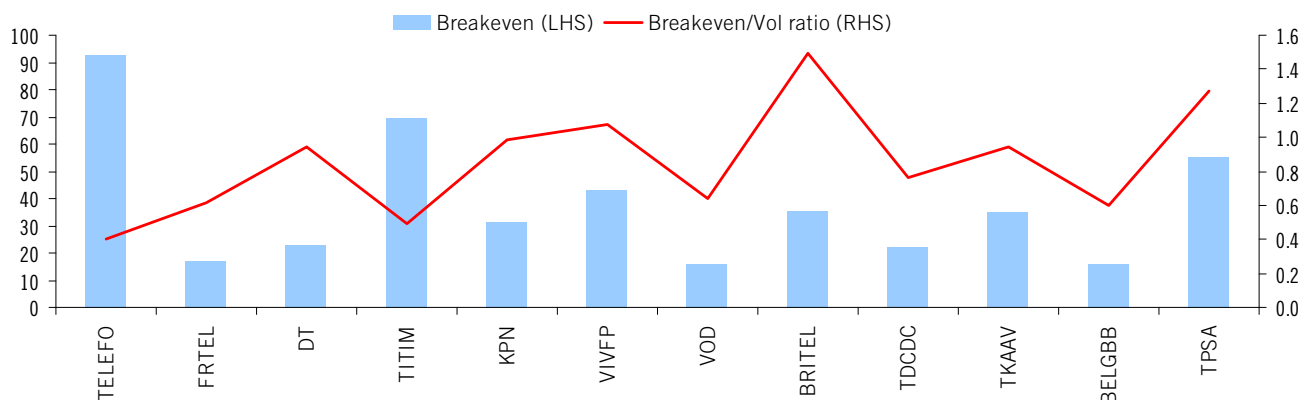
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 35. CDS 3mth Trading Range by Sector (bp)



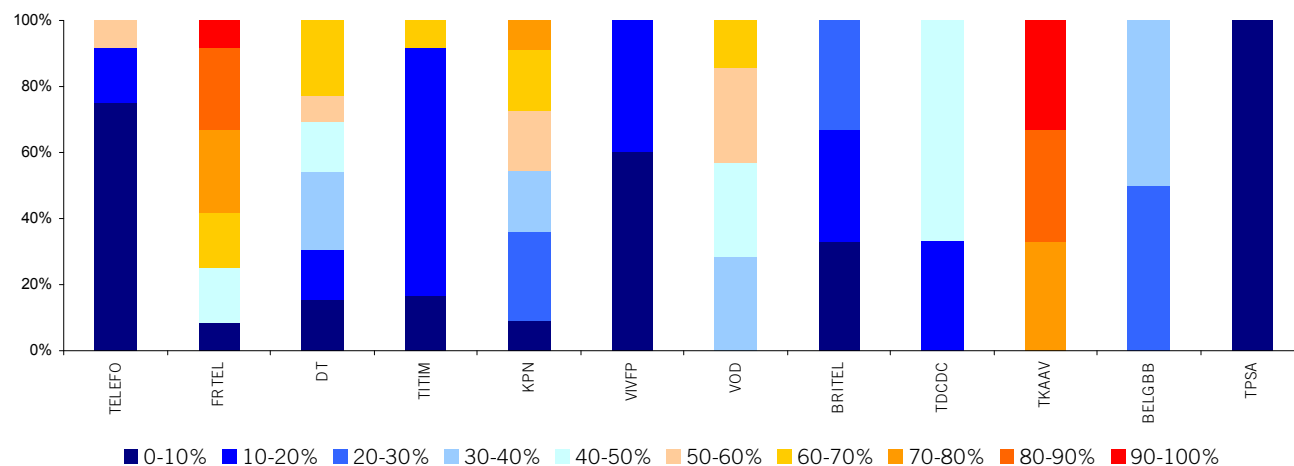
Source: MarkIt, Citi Research

Figure 36. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 37. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

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Utilities: underweight

Although Core Utilities underperformed, we think they are still not attractive given the outlook, while peripherals spreads can still come under sovereign-related pressure

We remain underweight on Spanish utilities. We are neutral on Enel

EdP is at historic wides versus Portugal

Sovereign event risk remains high in the sector

We maintain our neutral on core country utilities on the basis of a weak outlook for energy supply in Europe. The outlook for energy prices is not positive as there is oversupply, and earnings expectations have been cut by 3.3% in the last four months.

As regards the periphery, the recent news is a short-term positive for the utilities exposed to Spain. Moody's rating affirmation removes much of the near-term downside risk - the market would probably view Spanish request for a programme as a further positive. Moreover, the impact of Spanish regulation is likely to be less negative than previously feared. This is good news for Iberdrola and Gas Natural.

However, we would remain underweight from a long-term perspective. Although peripheral utilities are working to strengthen their balance sheets, leverage in most remains comparatively high. And we believe that the sovereign-related headlines could put spreads under renewed pressure in due course, as discussed in the introduction on page 2. As such, we would use the current tightening to reduce exposure further.

Enel is going through a [corporate reorganization](#) which will improve its leverage profile. It is reducing its capex in Europe, reducing leverage in Italy and Spain and intends to raise capital to fund some of its international operations. We think spreads have some scope to tighten further if the situation of Italy holds up. However, risks are relatively high as Enel is exposed to Spain via Endesa, and we would remain neutral for the time being.

EdP was downgraded to BBB- by Fitch at the beginning of August. EdP CDS spreads are now at one of their [widest levels in a year relative to Portugal CDS](#). Although the company is relatively highly leveraged, we think it is a good moment to go long EdP, versus Portugal. EdP would be negatively affected by redenomination risk, should Portugal leave the euro. But our economists think this is [unlikely](#). And we reckon the company ought to be able to weather milder scenarios – including a Portuguese sovereign restructuring within EMU – quite well.

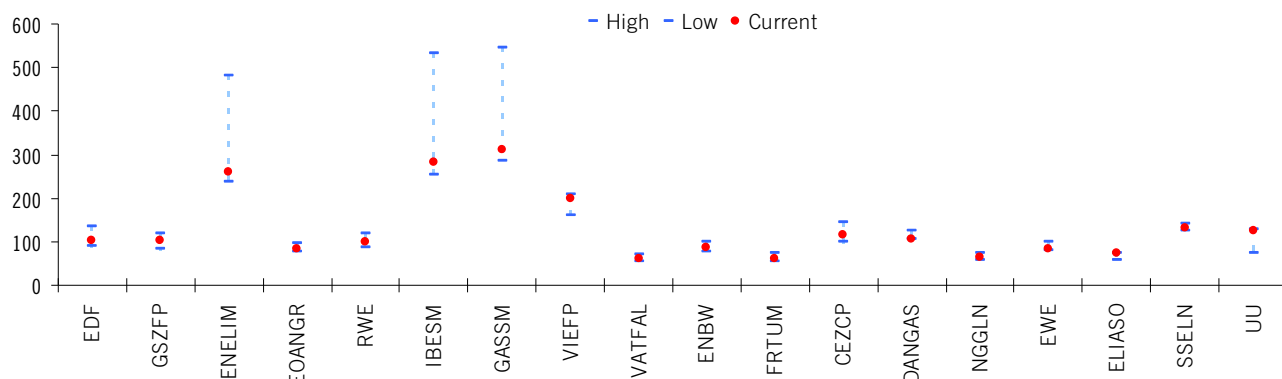
The need for fiscal consolidation creates event risk across the whole of the Utilities sector. Privatisations, which imply acquisition risk and rating volatility, or other forms of regulatory intervention (like tax increases) remain an important consideration. While the sector has rerated significantly already, the combination of fundamental, regulatory and sovereign headwinds makes it hard for to see material performance potential for the time being.

Figure 38. Utilities Picks and Pans

Picks	CEZ: We like Cez after recent underperformance versus peers. In spite of some uncertainty over its nuclear expenditures and weakness in energy prices which is affecting the whole sector, Cez is maintaining healthy volumes and a strong cash flow. Management is maintaining realistic full year guidance.
Pans	Spanish Utilities: While the impact of the Spanish regulations is likely to be less negative than expected for Spanish utilities, medium term risks for Spain are still significant. These companies are highly leveraged, and while they are deleveraging, we think their efforts will not be enough to shield them from spread volatility should Spain request a bailout but then encounter difficulties in implementing the conditions attached. This would likely threaten the investment grade status of these companies.

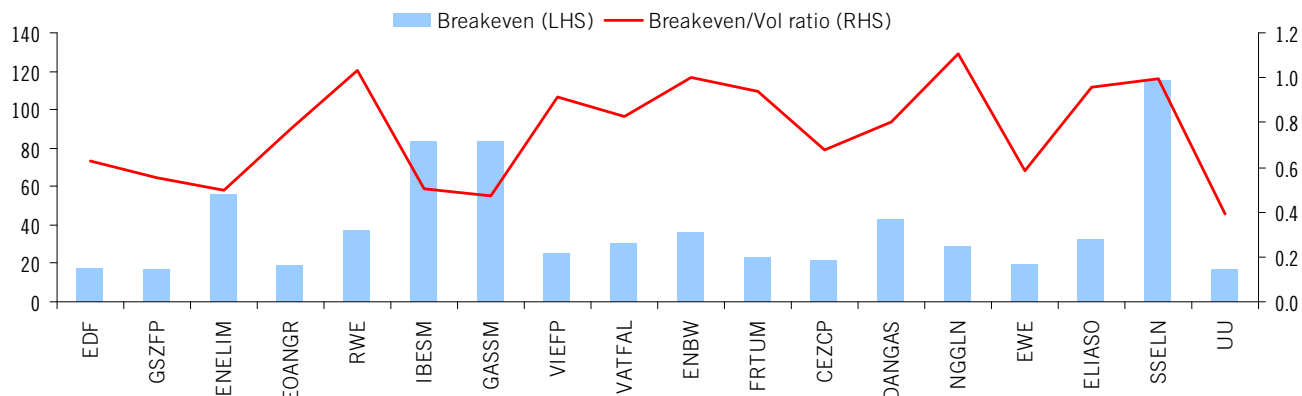
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 39. CDS 3mth Trading Range by Sector (bp)



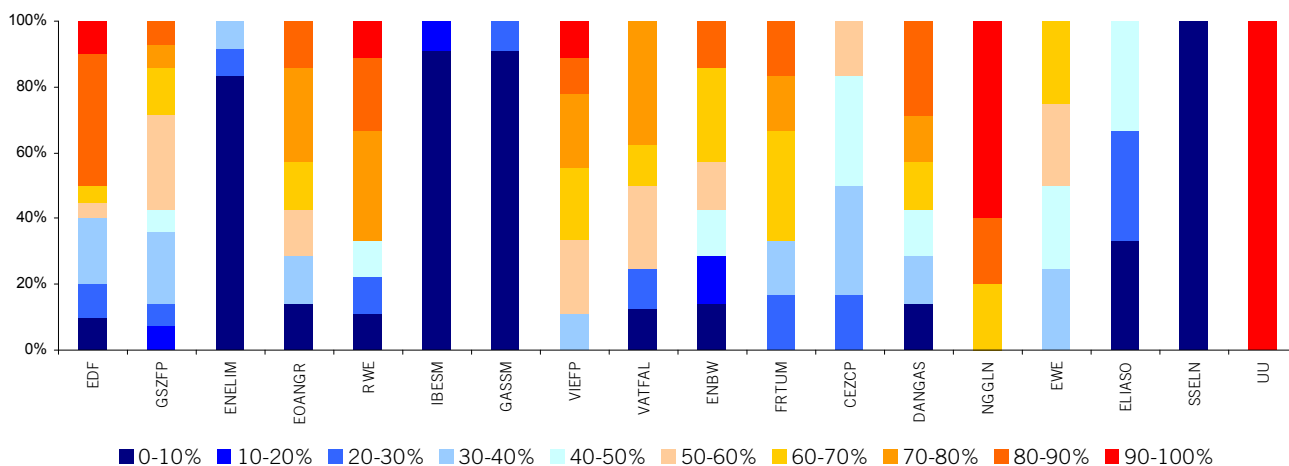
Source: MarkIt, Citi Research

Figure 40. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 41. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

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Banks: overweight

Move to overweight in Banks. Although most of the rally is behind us, we still expect spreads have further to tighten

Admittedly, our defensive stance on banks in September means that we have missed much of the rally that followed the ECB's announcement of the OMT with most soft core and peripheral banks now trading at the tight end of their six-month range. Spreads now appear to be consolidating and some near-term negative risks loom. However, we still believe that the backstop which the ECB is now implicitly providing to sovereigns will see bank spreads tighten further. Hence we (belatedly) raise our recommendation to overweight.

Overweight Italian banks, remain underweight the Spanish ones

Among the periphery banks, we prefer the Italian names, which we believe may tighten further with the sovereign. Therefore, we recommend a small overweight in Italian banks, especially at the short maturities, whilst retaining a more defensive position on Spanish names.

Risks for Spanish banks are substantial in the short term.

The main unknowns currently are whether Spain will seek a bailout (consensus seems to be it will) and what role the ESM will play in the recapitalization of the Spanish banking system, after finance ministers from Finland, Germany and the Netherlands agreed that the ESM will not be used directly to meet recapitalization needs arising from legacy assets. This increases the likelihood that recapitalization of Spanish banks will have to be on the sovereign's balance sheet. We do not believe this is good for bondholders – not least considering the possibility that the stronger banks will be 'encouraged' to invest in weaker ones. We are increasingly inclined to reduce exposure to the Spanish banking system at current levels.

Earnings in Europe are expected to remain weak

Earnings in Europe are expected to remain weak, and indeed weaken further in many places, as asset quality continues to deteriorate, causing increased provisioning particularly in peripheral banks. The US bank outlook is brighter, as we believe capital markets businesses will have done comparatively well in Q3. However, as we saw with JP Morgan earnings, the ultra-low interest rate environment is affecting deposit margins. Medium-term, signs of increasing regulatory forbearance are positive for earnings trends.

Senior debt doesn't look attractive. We prefer junior or secured

Our last [Credit Survey](#) shows that real money investors increased their positions in Bank senior debt sharply over last month, while they reduced their allocation to Subs slightly. Fast money investors took the opposite position. Some recent developments are definitely positive for senior debt. Indeed, the most recent Special Resolution Regimes are not as harsh as expected on senior debt, and the ECB will be pari passu to other creditors in the OMT. Still, the switch from unsecured to secured funding (most obviously with the ECB), reduces expected recovery rates on senior debt. Therefore we are only neutral on senior, preferring a barbell of covered/securitized bonds and selective holdings of LT2/UT2.

We like American and UK banks.

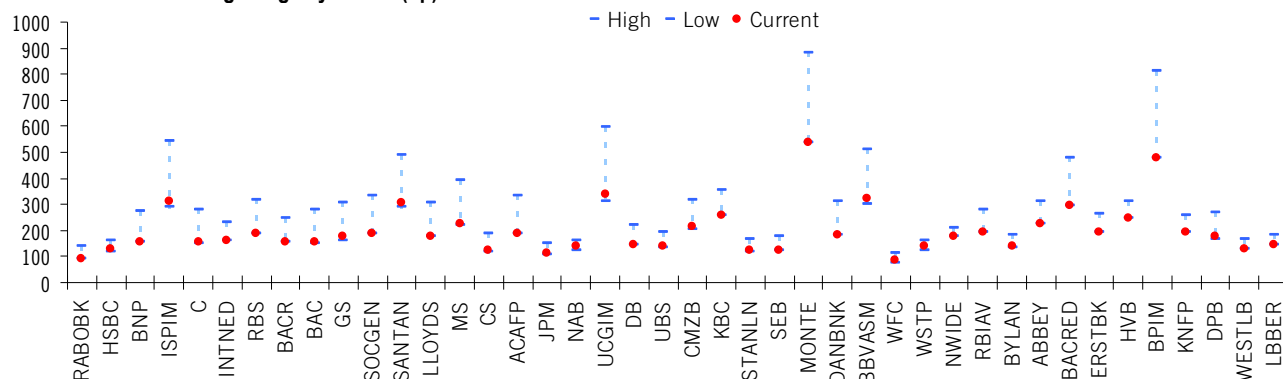
We think American banks remain attractive at current levels. Also some European and UK banks (BACR, INTNED) have underperformed the rally and we think they offer opportunities.

Figure 42. Banks Picks and Pans

Picks	<p>American banks: The modest US recovery remains largely on course, leading to a gradual improvement of credit quality and even some modest loan growth. While US banks' revenues are challenged by regulatory changes and low interest rates, their exposure to Europe is minimal (although they would still be exposed to market volatility should the situation in Europe again fall out of control). For these reasons, our analysts are mildly optimistic on their earnings prospects for next quarter. Still, to us they offer spreads and breakeven to volatility ratios that are quite attractive versus their European counterparts. Also, we might see some banks to continue calling their TRUPS and other subordinated debt back if economically viable, in order to comply with Basel III.</p> <p>Italian banks: These banks have been benefiting from the improved market sentiment towards their sovereign. At current valuations, most of the rally is likely behind us, but we think spreads in these banks have further to tighten, in particular at the junior levels. Admittedly, their asset quality is deteriorating quite rapidly and, apart from Mediobanca, their exposure to Italian sovereign debt is huge, but we think the retrenchment of sovereign risks remains the main spread driver in the short term.</p> <p>Barclays: Its underperformance is mainly due to its recent management change, which created uncertainties in their business strategy, in particular regarding its investment banking/capital markets arm. However, these concerns seem largely priced in. Moreover the bank continues to be a healthy player in the UK retail and business banking arena, with good volume growth and stable margins.</p>
Pans	<p>French banks: BNPP & SocGen's underlying divisional performance has been as expected, in spite of some weakness in French retail revenue growth and weak IB. Balance sheet trends are incrementally positive: in particular SocGen improved its capital and BNPP reduced its funding to Italy. Credit Agricole is still in the process of selling Emporiki, with some interest shown by some Greek banks, with the considerable unknown of whether ACAFP will have to do further capital injections to be able to sell it. So, in general French banks are slowly delivering in de-risking and rebuilding their capital base. But the way is still long, and we think current levels don't offer adequate protection against risks from their exposure to sovereign risk and the European economy.</p> <p>Spanish banks: We recognize that Santander and BBVA are quite geographically diversified. However, their exposure to Spain and Portugal is still significant. Recent data show that liquidity pressures on Spanish banks eased somewhat (borrowing from the Eurosystem fell in September for the first time in twelve months, Target 2 liabilities of the Bank of Spain fell in September for the first time after fifteen months) but the risk of a capital flight remains high. There are still many uncertainties on whether the bank bailout of the Spanish banks will weight on the sovereign or not. While the recent rating affirmation by Moody's is positive, the medium term outlook for Spain remains challenged. Also, even if a Spanish request for a bailout would be a short term positive, implementation risks are high and we are sceptical about the ability of Spain to live up to austerity targets next year. Still, Spanish banks trade more or less in line with Italian banks. While their larger size and geographic diversification can partly explain this, we see too many short-term risks to be long this sector.</p>

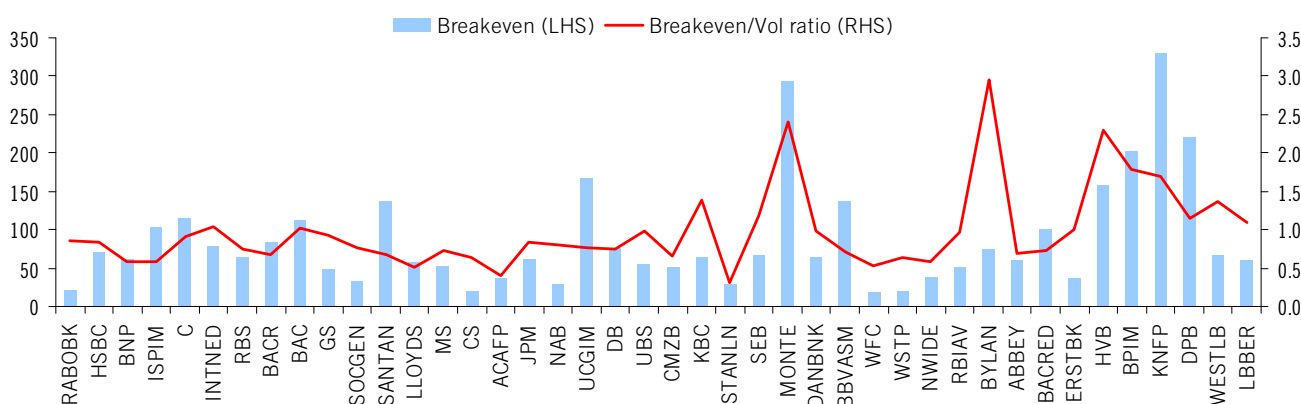
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 43. CDS 3mth Trading Range by Sector (bp)



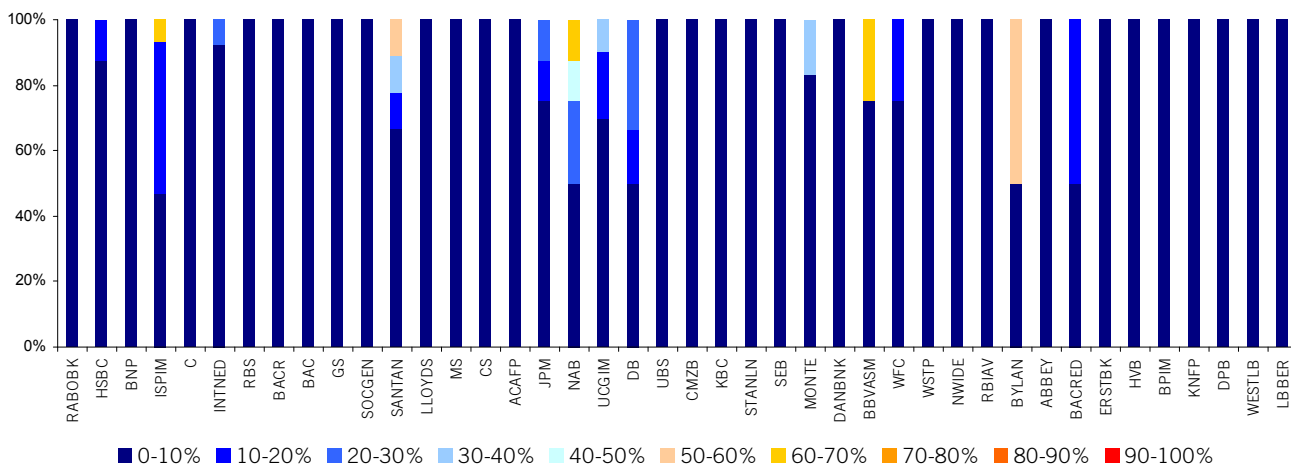
Source: MarkIt, Citi Research

Figure 44. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 45. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

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Insurance: overweight

We are positive on Insurers, and move overweight

Insurers continue to look [cheap to banks](#) on a long term basis, although they outperformed them in the recent rally, but current investor [positioning](#) on insurance is quite long. On balance, we still think insurers are a better place to look for beta exposure than Banks, in particular at the subordinated level. Senior debt instead looks expensive. As sovereign risk abated, bonds of insurers exposed to peripherals rallied a lot, but we still think there is some more way to go, especially when compared to some of the peripheral banks. All in, we would be overweight the sector through sub debt.

We expect earnings to remain resilient, although vulnerabilities to the business model of most insurers remain

We don't expect many surprises from the incoming earnings season. As there have not been significant events requiring large payouts in the last quarter, earnings will likely be driven by general asset performance, offset by the small rise in yields. Longer term low yields are pushing insurers into riskier asset classes like equity and HY debt, which may increase future earnings volatility gradually. But insurers are managing the current situation reasonably well, and in most cases have stuck to their guidance.

Generali looks a good alternative to Italian banks

Compared to Italian banks, Generali has lagged behind during the rally, particularly at the senior and at the LT2 level. Yet we think from a credit perspective its exposure to Italy is more manageable than for the banks. There is some downgrade risk as rating agencies evaluate the strategy of the new management, but it should be already priced in.

LMEs will continue to provide support to prices of core insurers

Some further LME activity is possible from the stronger insurers (Swiss Life, which is likely to use the proceeds from its last CHF issue to refinance existing debt; Old Mutual). This would provide further support to current levels. The insurers engaging in LMEs tend to be relatively well capitalized, so their main motivations for LMEs are to increase interest coverage, and manage their refinancing needs (e.g. refinance their debt for cheaper levels in another currency, as many Swiss insurers are doing). Also, we expect issuance to be mainly in the T2 space, as we are still waiting for details on the treatment of existing T1 in the Omnibus II Directive.

Acquisition risk is higher than in other sectors

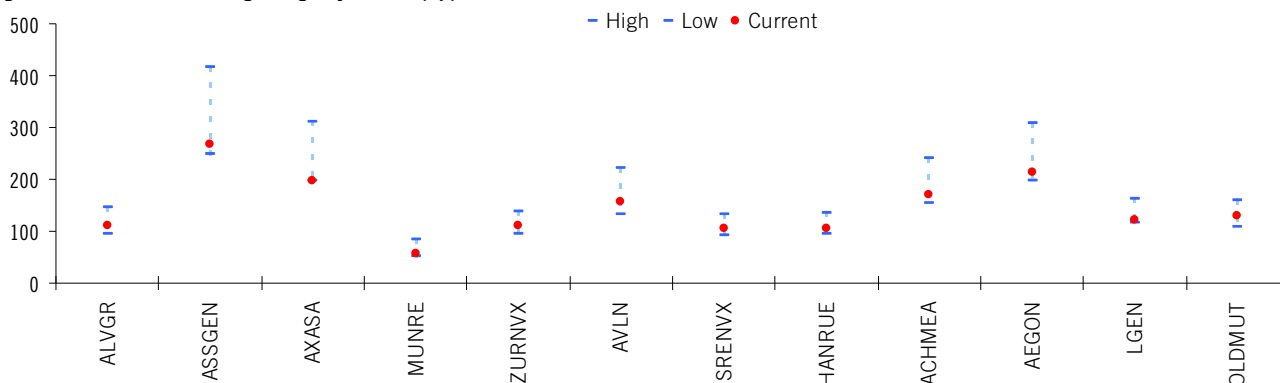
Acquisition risk is higher than in most other sectors, as insurers seek to consolidate their positions in core business areas, and/or attempt to expand into high-growth markets like Asia. However, these acquisitions are mainly being financed internally or with equity.

Figure 46. Insurance Picks and Pans

Picks	<p>Swiss Life: this high quality insurer has recently issued CHF bonds and will likely use the proceeds to refinance its outstanding sub debt. While its profitability is being impacted by extra-low interest rates (as is happening to other insurers) and its concentration in traditional life insurance products, its strong capital position and prudent management are a definite plus.</p> <p>Assicurazioni Generali: Compared to Italian banks, its exposure to sovereign risk is more manageable and in light of this we find it surprising that it underperformed the Italian banks in the recent rally. The company has a good business mix, with strong market positions in Europe and CEE. It is able to generate sound profits domestically as the Italian market is not very competitive. Admittedly, its asset gearing is quite high, which weakens its capital position, and the current recessionary environment in Europe is not a positive. But we think Generali is actually a more conservative company than most Italian banks. There is some downgrade risk as rating agencies evaluate the new management</p>
Pans	<p>Munich Re: being one of the most conservative names in the universe of insurers, Munich Re is now trading very tight to its history and to its peers. We feel more attracted by similar credit risk profiles like Swiss Re or Zurich, which offer similar spreads for lower levels of spread volatility.</p>

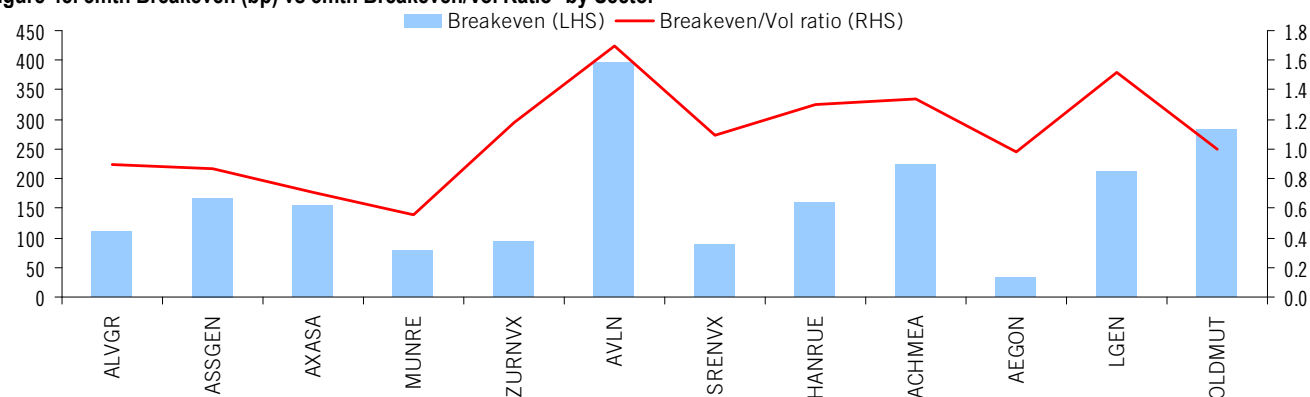
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 47. CDS 3mth Trading Range by Sector (bp)



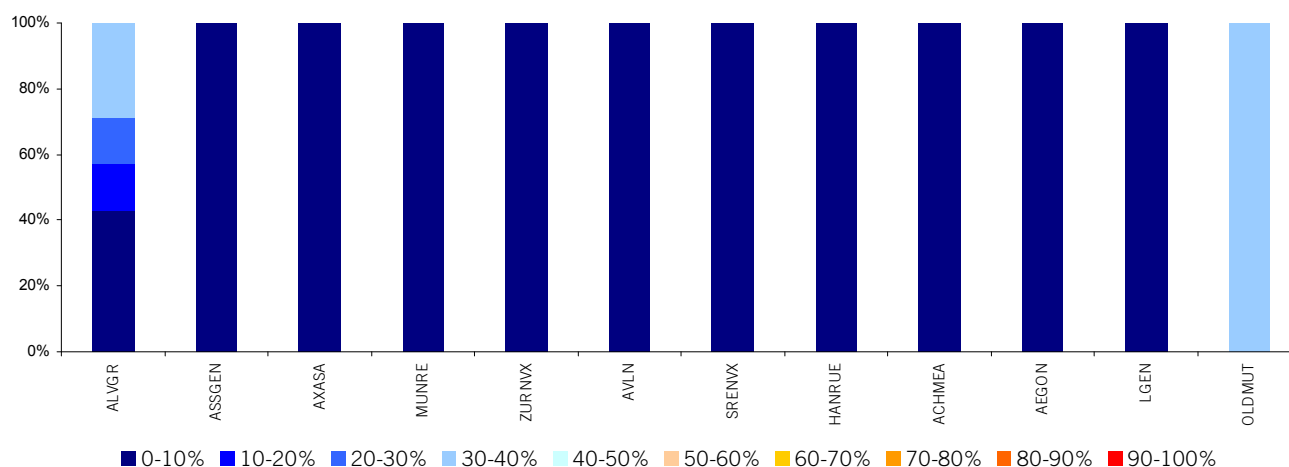
Source: MarkIt, Citi Research

Figure 48. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 49. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

Financial Services: neutral

While we are neutral on the sector, we find GECC bonds attractive

We remain neutral on the Financial Services industry. The sector is dominated by General Electric Capital Corporation bonds, which we continue to like. Most of the remaining companies are heavily exposed to real estate, where we still see downside risks at current spread levels.

GECC is continuing to de-risk and margins are improving

While its Q2 revenues were down about 8% YoY, reflecting an ongoing reduction in assets, GECC benefited from profits in its real estate division, and healthy net interest rate margins. Also its parent company GE is continuing to deliver strong results, thanks to good pricing in energy, good margins in industrials, and good cost control. The company maintained its guidance and there is no significant M&A on the horizon.

We remain concerned about the real estate exposure of most financial services companies

The fragility of real estate markets keeps us cautious about taking exposure to many of the other property-related names in the sector (Hammerson, Klepierre, Gecina). We think bond investors wanting to go anywhere near this space would do much better to buy equally- or higher-rated CMBS, RMBS or ABS instead: spreads trade much wider for structures which to our minds are considerably more robust.

We are positive on credit card issuers for the longer term

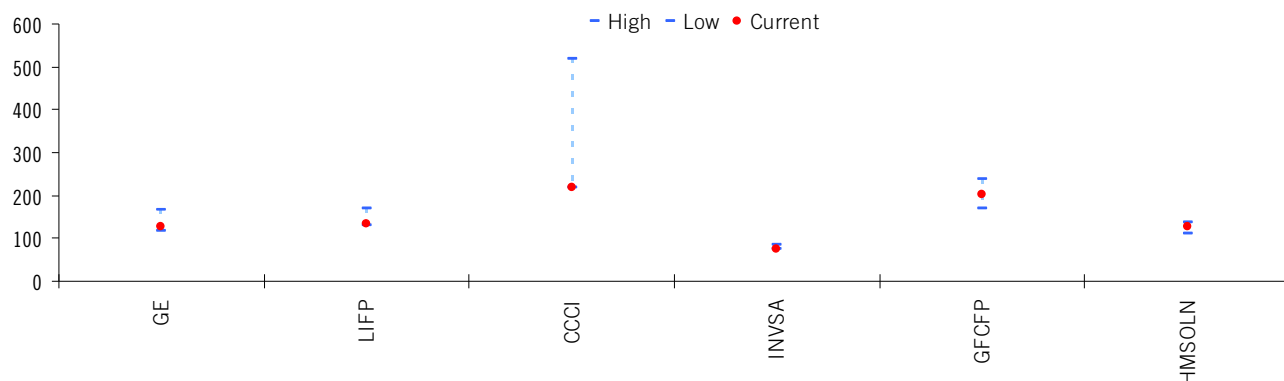
Our favorite sub-sector within Financial Services is therefore Cards & Payments. The secular shift towards electronic payments ought to benefit incumbents, and new regulations are much less of a burden than is the case for banks.

Figure 50. Financial Services Picks and Pans

Picks **GECC:** the company is continuing to dispose of its non core assets, and this is hitting revenues, but its real estate portfolio is solidly profitable and net interest margins are healthy. We expect these positive trends to continue. .

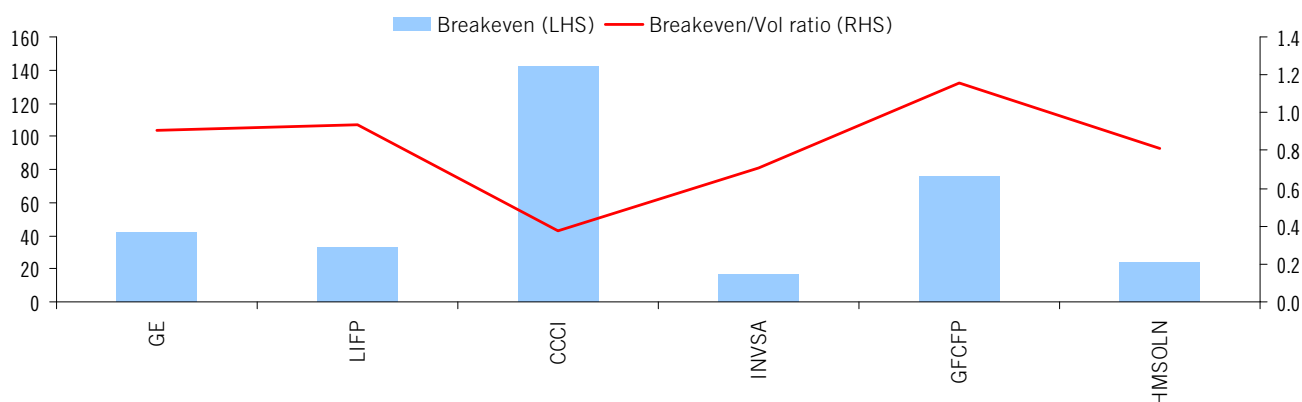
Source: Citi Research. Please refer to the footnotes on page 4 for our methodology.

Figure 51. CDS 3mth Trading Range by Sector (bp)



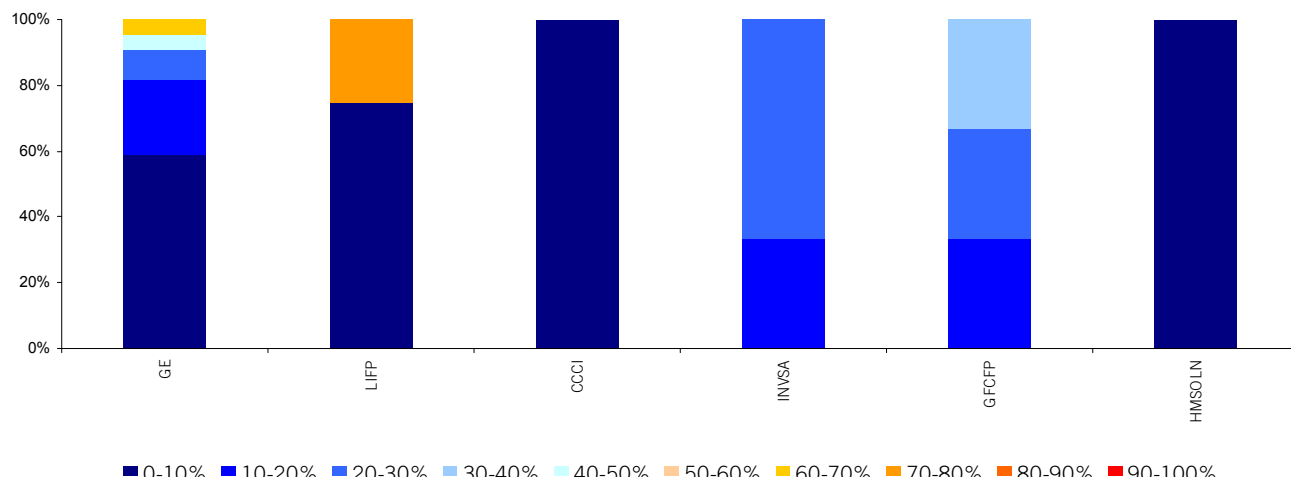
Source: MarkIt, Citi Research

Figure 52. 3mth Breakeven (bp) vs 3mth Breakeven/Vol Ratio* by Sector



Source: iBoxx, Citi Research

Figure 53. Dispersion by Issuer - Distribution of Current Bond Spreads Expressed as Percentile of 3mth History



Source: iBoxx, Citi Research

* The breakeven (Spread/Duration) measures how much widening the carry can compensate for. The breakeven to volatility ratio measures the likelihood that spread movements will exceed that point. In the dispersion chart, we calculate the current percentile for each bond in the 3mth trading range, and then we aggregate the distribution of percentiles by issuer. Dark red shows the percentage of bonds trading close to 3mth wides, while dark blue shows the percentage of bonds very near 3mth tights.

Notes

Appendix A-1

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