

Silence of the bonds

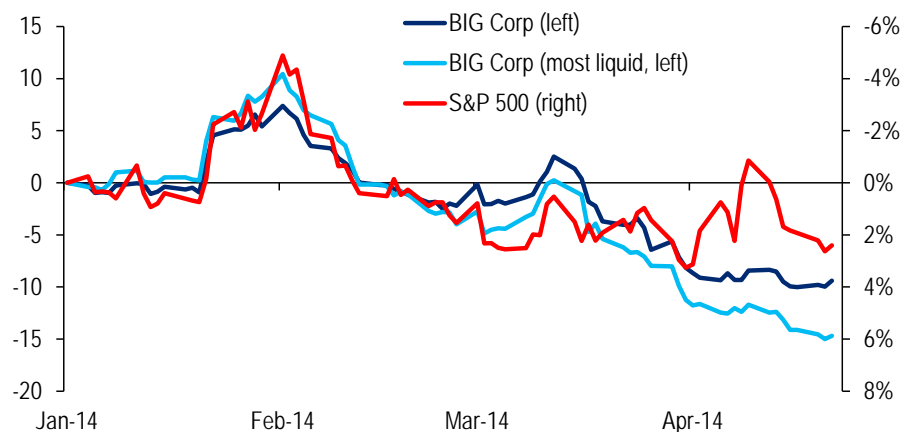
MARKET OUTLOOK | SINGLE NAME NEWS & VIEWS | WEEK AHEAD | Recent Citi Research | US KEY ECONOMIC DATA | KEY EARNINGS ANNOUNCEMENTS

Market Outlook

Although weakness in the equity market has stabilized a bit in recent trading, investor sentiment remains quite skittish. A quick look at some of the drops from the highs among crowded positions — Tesla (-22%), Amgen (-9%), Facebook (-14%), Priceline(-11%), Las Vegas Sands (-11%), and Under Armour (-19%) — and it's easy to see why. In our mind, S&P 500 performance masks tremendously how painful the selloff was.

Investors on the credit side may have raised an eyebrow in the wake of this downturn, but that was about it. The broad credit market tightened 5bp month-to-date and there really wasn't much volatility to speak of. In fact, credit's outperformance is actually far more dramatic if one focuses on the more liquid names. Spreads have tightened 8bp so far in April for an index of the most liquid bonds in each sector (see figure).

Most liquid IG bonds* vs S&P 500, OAS in bp (left), S&P level (right)



Source: Citi Research, Bloomberg

*We take the 25% most liquid bonds in each sector to construct the liquid IG corporate bond index.

So why is credit doing so much better than equity?

In our view, there are both technical and fundamental features that are driving the credit-equity discrepancy. With respect to technicals, both flows and supply have been very supportive. After bottoming out in the middle of last year outflows have been slowing for the last six months and recently turned positive (\$4.2bn mtd). No doubt, the sharp rally in US rates and necessary portfolio rebalancing after last year's equity rally has helped attract money back into fixed income. And

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Credit

North America

Recent Citi Research

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)

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

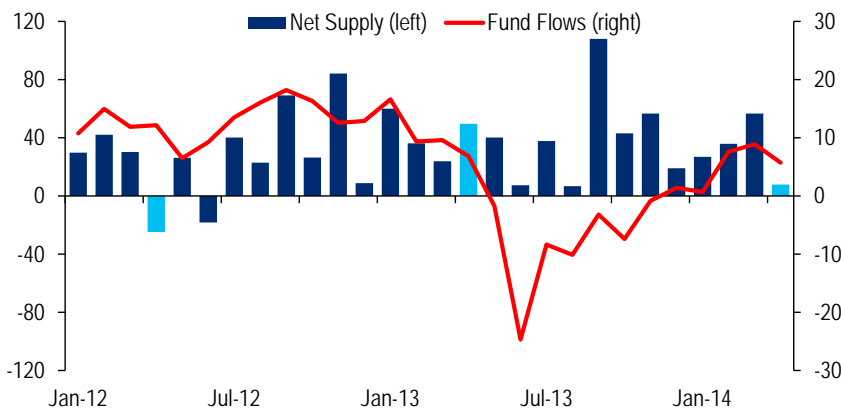
US Credit Outlook - 14 for '14 (part 2), fourteen strategies for 2014 (Dec'13)

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

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the inflows also coincided with a dramatic dearth of supply, both absolutely (39bn mtd) and relative to expectations.

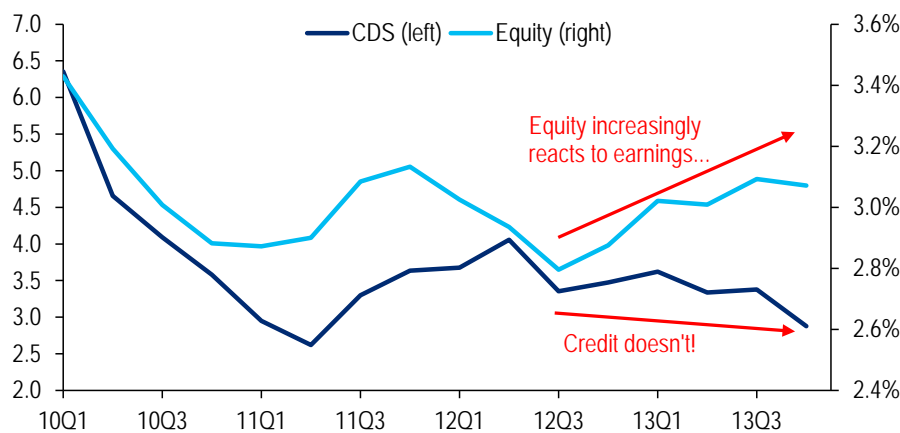
IG net supply and mutual fund flows, in \$bn



Source: Citi Research, EPFR

With regard to fundamentals, credit has, unlike stocks, exhibited meaningfully more immunity to earnings surprises (positive and negative alike). For example, the figure below shows the *magnitude* of 5yr CDS and equity performance on the day of and the day after earnings for a basket of 100 to 150 names each quarter since '10 (and note that we adjust for beta differences). Although both markets show that sensitivity has diminished since '10, in more recent quarters CDS sensitivity has been ebbing even lower while equity reactions have actually been creeping higher.

Equity and CDS price reaction to earnings*, equity in % (right), CDS in bp (left)



Source: Citi Research, Bloomberg

*We calculated the equity price and CDS spread reactions (adjusting for market moves) in a two day period around an earnings announcement (on the day of announcement and the day after). Taking only those where the EPS surprise was more than 1 standard deviation away from the consensus expectations, we measure the average magnitude of equity and CDS reactions in each quarter.

In fact, the insensitivity of credit expands to more than just earnings results; it appears that overall volatility has become far more muted in credit than it has in equities, particularly to the downside. To illustrate this, we looked at 3-month drawdowns in equity and credit as a measure of downside volatility. While drawdowns have hovered around 6% since 2013 for equities, they continue to

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

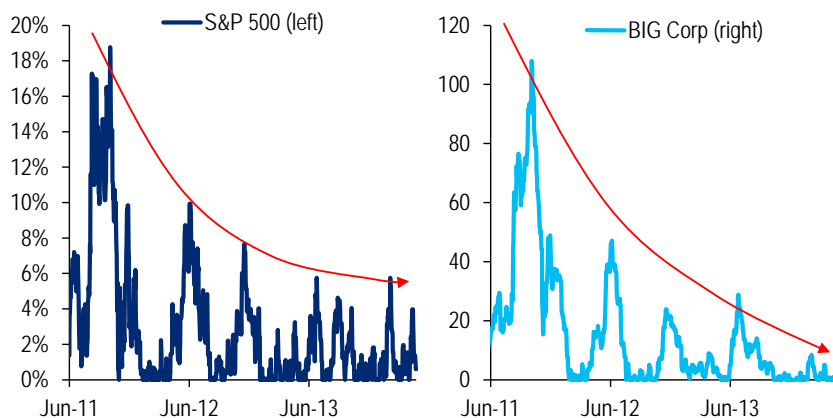
Monday:	<u>Consensus</u>
Pending Home Sales MoM	0.7%
Tuesday:	
S&P/CS Home Price YoY	12.9%
Consumer Confidence Idx	83.0
Wednesday:	
MBA Mortgage Applications	-
ADP Employment Chg	206k
GDP Annualized QoQ	1.1%
Fed QE Pace	\$45bn
Thursday:	
Initial Jobless Claims	319k
Personal Income	0.5%
Personal Spending	0.6%
ISM Manufacturing	54.2
Friday:	
Change in Nonfarm Payrolls	210k
Unemployment Rate	6.6%
Factory Orders	1.5%

Key Earnings Announcements

Monday:
Loews Corp
Hartford Financial
Ecolab
National Oilwell Varco
Corning
Tuesday:
Merck & Co.
Express Scripts
Edison International
Eaton Corp
Lyondellbasell
Boston Properties
Bristol-Myers Squibb
Valero Energy
Archer-Daniels-Midland
EBay
Boston Scientific
Aflac
Genworth Financial
FiServ
Teco Energy
Paccar
AGL Resources
Marriott International
Wednesday:
Time Warner
Dominion Resources
Exelon Corp
Southern Co
Wellpoint

diminish among IG cash names (see figure).

S&P 500 and BIG Corp 90-day maximum drawdowns*, equity in % (left) and IG in bp (right)



Source: Citi Research, Bloomberg

*90-day drawdowns for equities: the maximum percent drop from the highs in any 90-day period.

*90-day drawdowns for credit: the maximum jump in bp from the tightest point in any 90-day period

So the technical backdrop has been supportive, and credit has become less sensitive to not only earnings surprises but surprises in general. We guess that partly explains why the market has been so well bid. But the real question is how much longer can it last. As we **highlighted last week**, tight credit valuations and the lack of volatility likely have quite a bit to do with QE, but the unwind of exceptional monetary support looks to be firmly on pace. And if rates finally move higher, we find it implausible that those first quarter inflows stay put. Add in the rapid pick up in M&A, and the risk-reward starts to look decidedly poor.

That being said, could credit tighten another 10bp before the tights of the cycle are hit? With valuations untethered from fundamentals and seemingly immune to bad news, it would be silly to suggest they couldn't. But if we had to pick a number to go outright negative on the cash markets 100bp on Citi's IG Index seems intellectually attractive, especially as the clouds are finally starting to accumulate on the horizon.

Single Name News & Views

The Forest Fire is Spreading—M&A is on the **rise**, and the sector that has seen the most flurry of recent activity, Healthcare, has taken the market somewhat by surprise. We think this is largely fueled by a competitive response to the Forest Labs-Actavis deal - healthcare companies are wrangling to preserve their position in the industry in its aftermath. Regulatory overhang and challenges in the product pipeline are only adding fuel to the fire.

In our opinion, the most notable aspect of the Valeant / Allergan deal this week was how Valeant managed to stealthily build a ~10% stake through Pershing's cooperation. This leads us to believe many more such deals may be right around the corner, just out of sight.

What makes these even more scary is the sharp and unexpected price action they would be accompanied by, as evidenced by the 100bps jump in Allergan bonds which took investors by surprise. Note that the single-A name would lever up 400% if this transaction went through.

Also of note is that Pfizer (PFE) had been in talks with AstraZeneca (AZN) for the

Metlife
Williams Cos
Nextera Energy
International Paper
Nisource
Actavis
Hess
Phillips 66
Equity Residential
Lincoln National
Duke Realty
Pitney Bowes
Murphy Oil
Thursday:
Enterprise Products Partners
Conocophillips
PG&E
Viacom Inc
Kraft Foods Group
PPL Corporation
Xcel Energy
American Tower
Public Service Enterprise Grp
Kellogg
Cigna
Centerpoint Energy
Exxon Mobil
Western Union
Enbridge Energy Partners
Mylan
Cardinal Health
Marathon Petroleum
L-3 Communications
Host Hotels & Resorts
Avon Products
Bunge
Motorola Solutions
Friday:
Berkshire Hathaway
Cvs Caremark
Chevron
Sempra Energy
Consolidated Edison
Northeast Utilities
Buckeye Partners
Pinnacle West Capital
Marsh & McLennan
Newell Rubbermaid

past couple of months to buy it in a deal that would be valued north of \$100b. Though the deal fell through, the astronomical size of this deal is of particular interest as it sets a new bar for Healthcare deal sizes. It also puts PFE on our radar for a leveraging transaction and we would buy protection through CDS at these levels.

Mining for Value— Barrick Gold (ABX) was reported to be in advanced talks to acquire Newmont (NEM) in an all-stock deal which would have created the largest mining company valued at \$55b. The nature of details released (eg. make up of board and management) reveals to us that the deal was very close to being pushed through. We think it was tabled only due to upcoming earnings.

The deal would be leverage-neutral and positive for ABX debt due to the significant synergies, in our view. The key point of interest and main driver of NEM debt would be whether ABX decides to guarantee NEM debt or not. This is hard to predict as it is heavily dependent on the tax effects of the decision, information that is largely unavailable to investors at this point of time. However, we note that ABX did guarantee Placer Dome's debt in its 2009 acquisition. If it does not in NEM's case, we note that CDS would be rendered valueless due to an orphan-box situation.

Week Ahead

With nearly half of IG credits having reported, results appear to be marginally positive, although we suspect that analysts taking down expectations ahead of releases has at least something to do with this. Looking forward, our focus will largely be on: Loews, Merck & Co, Express Scripts, Time Warner, Dominion Resources, Exelon, Southern Co, Enterprise Products Partners, Viacom, Kraft, Berkshire Hathaway, CVS Caremark, and Chevron.

As if earnings weren't enough on our plates, another FOMC meeting will surely keep us busy. But with economic data seeming to show improvements in the past month, it's hard for us to imagine there will be too many surprises. The consensus expects QE to be reduced by \$10bn (to \$45bn; \$25bn Treasuries, \$20bn MBS). We agree. But we recognize that Yellen is still new to her celebrity-like status, and what she says could roil the market (again).

We have a heavy data calendar next week; the most important being the employment situations report on Friday. With the exception of the latest jobless claims print, recent employment figures suggest firmer labor market conditions. The market continues to expect jobs to be added at a slightly higher pace than last month and unemployment to lower by 0.1%.

Aside from labor figures, we also have consumer spending and ISM manufacturing results, both of which are expected to reflect improving sentiment. Both personal income and spending are also expected to improve, the latter of which was probably boosted by auto demand. On the other hand, the consensus estimates for 1Q GDP is lower than last quarter. The increase in home prices are also expected to slow. Surprisingly, pending home sales are expected to increase 0.7%, even though new home sales this week came far below expectations.

Appendix A-1

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Data current as of 31 Mar 2014

	12 Month Rating			Relative Rating		
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% of companies in each rating category that are investment banking clients	55%	53%	45%	58%	53%	42%

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