

European Credit Outlook

Is the Goldilocks Period for Credit at an End?

- **A shaky start to 2013** has served as a useful reminder that credit is exposed both to upside and to downside risks to the economy. While the market feels as if it wants to squeeze again, assuming the Italian election doesn't produce an unworkable result, we expect that these tensions will resurface again periodically.
- **View:** We would use any rally over the coming weeks to reduce exposure again, anticipating better entry points in Q2 or Q3. Excess liquidity is still likely to underpin spreads longer term.
- **Should I be worried about the backup in yields?** A higher proportion of non-dedicated money in credit implies greater sensitivity to rising yields than in previous cycles. While Citi's rates forecasts suggest a repeat of a 1994-style scenario remains unlikely, investors will have to watch for yield turbulence, especially around the time where the Fed begins to scale back QE, probably later this year.
- **Has periphery underperformance gone far enough?** Widening in Spanish and Italian credits YTD by and large reflects idiosyncratic rather than systemic risks. On the whole we remain defensive on periphery credit, but if you need to add exposure then focus on the names that have merely widened in sympathy.
- **Recommended Strategies:** Long covered and T1 versus senior and LT2; 3s5s flattens in CDS, but reduce duration in cash; long Main risk over Crossover.

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Figure 1. Citi Investment Views

Bp, As of 15-Feb 2013	Current	1mth	3-7mth#	Long-term
iBoxx € Corp	140	130	170	125
iTraxx Main	111	100	150	105
Crossover	435	400	550	430
3s5s IG CDS curve	43	35	30	30
5s10s IG CDS curve	42	35	30	30
Basis*	-13	-10	-5	0
IG vs HY**		IG outperf.	IG outperf.	IG outperf.
€ vs \$ IG cash credit		\$ outperf.	\$ outperf.	\$ outperf.
€ vs £ IG cash credit		£ outperf.	£ outperf.	£ outperf.

Source: Citi Research. * As reported in Citi's daily Basis Report. ** Risk adjusted. #: upper target

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

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Is the Goldilocks period for credit at an end?

Figure 2. Citi directional view - 10-15% tighter in 2013, but better entry points

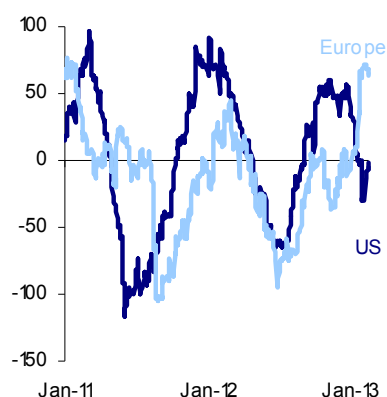
Near-term view: Unless the Italian election ends with a completely unworkable outcome, we expect an absence of catalysts and the usual hunt for returns on excess cash balances will again drive the market tighter. Our [rates strategists believe](#) the recent rise in Bund yields is overdone.

3-7m view: We'd be neutral or less than fully invested in anticipation of better entry points. Expect reminders of risks from both economic upside (indications of a reduction in stimulus, yield volatility, and increasing corporate activism) and downside (poor data and political divisions in the periphery and rating risks).

7-12m view: Ample liquidity will still dominate weak fundamentals over time. We still believe that cash spreads will end the year 10-15% tighter than currently. Some reallocation from credit to equities is likely, but it will be the marginal money as excess liquidity still entails excess demand for risk assets.

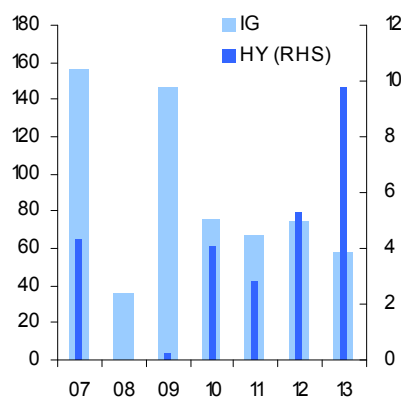
Source: Citi Research

Figure 3. Citi US & Euro eco. surprises



Source: Citi Research

Figure 4. €IG & HY issuance YTD, €bn



Source: Citi Research, Dealogic

Credit is in a classic Goldilocks dilemma:

We've had it so good. After Draghi announced the OMT the porridge seemed just about right – perceptions of near-term systemic risks have receded, and yet the economic outlook in Europe has been too weak to threaten any kind of withdrawal of stimulus with an accompanying rise in rates.

The majority view going into 2013 was that the porridge would continue to simmer away nicely for an extended period. And in many respects, the story has unfolded pretty much as credit would have wanted.

Top down, the two issues that could have jeopardised the nascent US recovery – fiscal cliff and the debt ceiling – were pushed back. Although the Eurozone is in recession, the economic data is providing the biggest positive surprise in two years (Figure 3)!

Bottom up, the sudden flurry of M&A and LBO activity, mainly in the US, along with a few notable negative surprises has reminded people of single-name risks. But on the whole the earnings season has 'delivered': 68% of S&P 500 names have beaten lowered expectations.

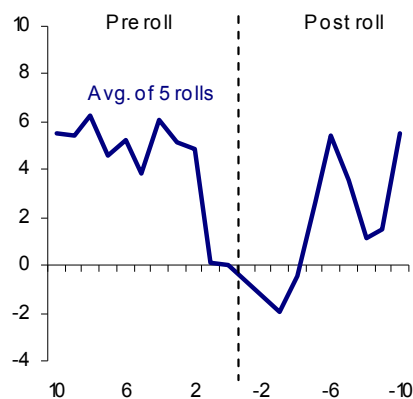
Supply in the € HY market has been very strong, with €9.8bn issued YTD (Figure 4), but in [investment grade issuance](#) of €58.1bn is lower than the run-rate over the last few years. As companies come out of the blackout periods we would expect issuance to pick up again, but we see few signs of a deluge here.

So why are spreads now hovering almost where they ended 2012? We suspect that the market has come to the realisation that maintaining the porridge at the right temperature is increasingly difficult.

The 30-40bp rise in Bund yields in January illustrated how vulnerable carry trades in credit are, with yields near historical lows. We sense a growing unease among central bankers about the asset price inflation resulting from their unconventional policies. Although cash levels remain sound, consensus longs in the Street and among real money have left spreads vulnerable to a pullback.

Equally, we've seen the uncertainty about the outcome of the Italian election, the derivatives losses at Monte dei Paschi, and the corruption allegations against the ruling Partido Popular in Spain blow a cold wind over periphery credit.

Figure 5. iTraxx Main spread performance around index rolls, bp



Source: Citi Research, MarkIt

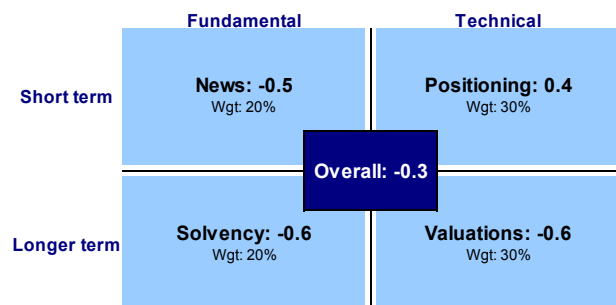
The recent sell-off now seems to have abated. Our rates strategists believe the rise in Bund yields is overdone and Street positions have been brought down somewhat. Assuming the Italian election does not produce an unworkable outcome, we see few negative catalysts until the negotiations on Cyprus heat up in March.

So the yield-hungry are coming back for another helping of porridge. For the nimble there may be an opportunity in the very short term with spreads heading back to or even overshooting our full-year targets. Cypriot issues notwithstanding, the CDS indices in particular tend to do well in the period going into the roll, as people close existing index-based portfolio hedges (i.e. sell protection) (Figure 5). Much of it tends to unwind afterwards, but that's another story!

However, to us, the central message is that at these tight levels, where risk/reward to fundamentals is poor, wobbles are likely to be a recurring phenomenon. Every time the porridge congeals a little at the top or starts to burn at the bottom, an overextended consensus is likely to get nervous at any whiff of bear.

So unlike for Goldilocks, we reckon the trick to 2013 is never to get tempted into a good snooze after far too much porridge. Rather, we remain close to neutral here and would reduce on spread tightening over the coming weeks.

Figure 6. Citi Investment Matrix, Overview



Source: Citi Research. Scale: -2: Very credit negative, 0: Neutral, 2: Very positive. News and Solvency scores are relative to consensus.

Figure 7. Citi Investment Views

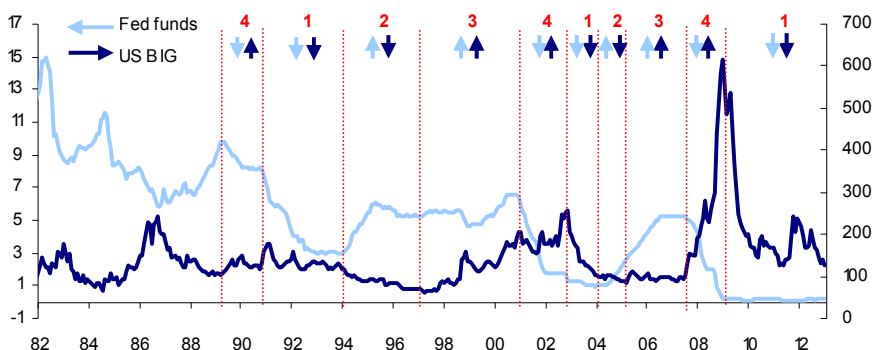
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Should I be worried about the backup in yields?

The answer isn't as straightforward as you might think. The correlation between spreads and yields is far from stable. Rather, it tends to oscillate in a cyclical pattern¹ (Figure 8).

Figure 8. US IG credit spreads (bp) versus Fed Funds rate (%)



Source: Citi Research, Haver Analytics

In a normal cycle, the rise in rates/yields that comes with the early part of economic recovery tends to coincide with tightening credit spreads (phase 2 in Figure 8). The positive effect of an improving growth outlook and fundamentals effectively supersedes negative effects of higher yields. It is only when rates normalise and the recovery matures that the correlation between rates and credit turns positive (phase 3).

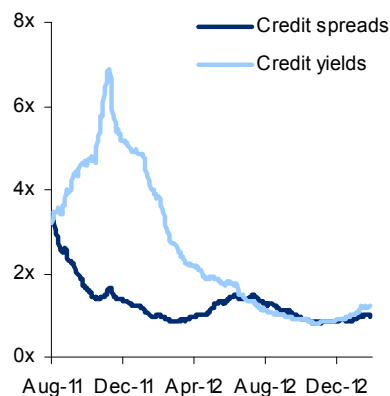
So with the Eurozone in recession and the US growing anemically, history says you shouldn't be too worried about a backup in rates, if it merely reflects the expectation of a return to growth.

Yet on this occasion we'd put history aside. This time the sensitivity of credit to rising yields should be significantly higher than previously for several reasons.

As our US colleagues have pointed out², a very high proportion of inflows into credit over the recent years are likely to be non-dedicated and total return sensitive. Inflows into credit mutual funds and ETFs make up almost two-thirds of the total inflows into US credit since 2009. A large part of that money is likely to be retail.

Moreover, the risk/reward of taking credit risk looks very poor. In Figure 9, we plot the ratio between 12-mth break-evens and realized volatility from both a total return and a credit return investor's perspective. Break-evens obviously measure how much widening investors can tolerate before the carry is wiped out, while the volatility gives a sense of how likely it is that market movements will exceed that buffer. Not only is that ratio below one in both spread and yield terms, but for a total return investor it is striking that the ratio has dropped dramatically from as much as 6x only just over a year ago.

Figure 9. 12m BE/Vol ratio on iBoxx



Source: Citi Research, MarkIt

¹ See 'Do rate hikes matter for credit?', H. Lorenzen, 23 March 2011 for details.

² 'How Afraid of Rising Rates Should We Be? More than usual', Stephen Antczak et al., 1 February 2013.

It seems very unlikely to us that credit can sustain the very high information ratio which has been one key 'selling point' in attracting new money in recent years. While equities have also risen for a lot of the last eight months, the risk / reward is inherently less skewed to the downside than in credit here.

A slow creeping rise in yields is probably manageable for credit spreads, but when you see sharp movements like the one that left [total returns in credit YTD](#) at down more than a percent in late January, it risks driving outflows. If expectations of rising yields become entrenched, we believe it would have a pronounced impact on spreads through a transitional period.

Yet that 'if' is a big one. In Europe, [our rates strategists](#) don't expect the rise in rates to continue. They forecast 10-year Bund yields will average 1.59% this year – 10bp less than currently.

In the US, they have 10yr yields at 2.6% at the end of 2013, so 60bp higher than currently, but still implying a much slower pace going forward than we have seen so far this year.

While that should be manageable for the year as a whole, from a credit perspective, we see two risks:

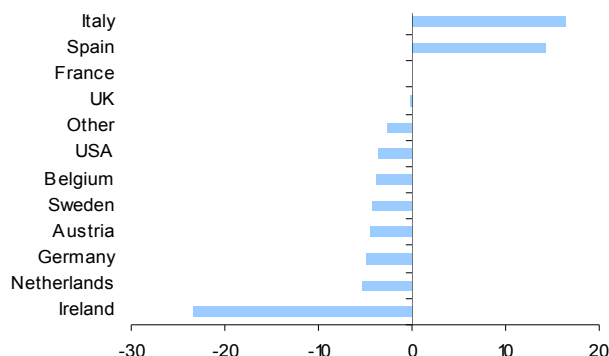
- Rates markets may not behave nicely all year. Given the policy uncertainty yield movement may be jerky, periodically impacting credit. Even if there is a decoupling between US and European yields, European credit spreads would probably remain correlated with US credit spreads.
- More broadly, before we contemplate the conventional rise in yields associated with a *reversal* of monetary stimulus, markets have to navigate an *end* to additional stimulus. Given how correlated the performance of risk assets has been with central bank balance sheet expansion since 2009, any scaling back of QE in the US in H2 2013 would pose a significant test to markets.

In the next section we discuss some ways of mitigating the risk from rising yields without paying away too much carry.

Has periphery underperformance gone far enough?

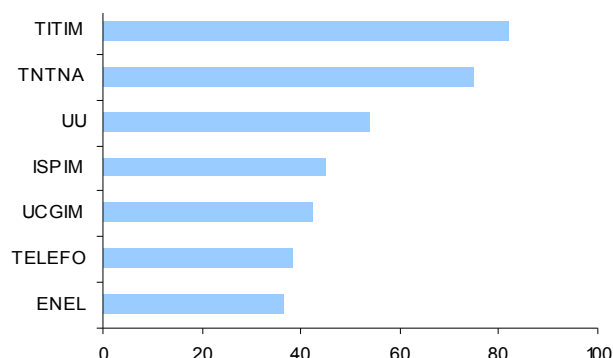
One of the principal recommendations in our [Outlook for 2013](#) was to move up in credit quality and away from perceived systemic risk. We were not anticipating this shift would happen as quickly as it did in January (Figure 10). Spanish and Italian telecoms and utilities are among the worst performing credits so far (Figure 11)

Figure 10. iBoxx corporate spread performance YTD, by domicile (bp)



Source: Citi Research, MarkIt

Figure 11. iTraxx Main – 10 biggest wideners YTD (bp)



Source: Citi Research, MarkIt

What's behind the underperformance?

Despite Rajoy's woes and Italian election uncertainty, only a small part of this can really be attributed to a rise in perceived systemic risk. Although still in recessionary territory, economic sentiment in both countries has been rising for the last 4-5 months. Moreover, Spanish and Italian 10yr spreads to Bunds are still tighter this year. If anything, we've seen a number of negative economic surprises in France in recent months with seen no corresponding underperformance of credit. So macro is not the main driver.

We think the majority of the underperformance of Italian credits is likely down to single name issues – derivatives losses at Monte dei Paschi, the downgrade of Telecom Italia, which now makes it eligible for the Crossover index, probes into senior management of ENI and Finmeccanica. In Spain, the widening in Telefonica could be explained away by a very tough operating environment, with double-digit declines in domestic markets and a slowdown in LatAm. However, the widening in the Spanish utilities seems to be more of a show of solidarity than anything fundamental to us.

Evidently, their high beta implies that periphery credits would likely outperform in any retracement. We would not chase such a tightening given our long-term concerns, but if you are looking to increase exposure somewhat then it is those credits that have widened on solidarity rather than anything tangible that we would focus on.

Recommended Strategies

Barbell the bank capital structure

We have favoured a long in covered bonds and in junior bank debt against senior for a long time, but ongoing events are making this stance ever more compelling and we would now also switch from LT2 into UT2 and T1.

The expropriation of SNS sub debt has yet again highlighted that in restructuring, the difference in recovery rates between different parts of the subordinated capital structure tends in our view to be significantly smaller than what has been assumed historically. Obviously, one should still allow for coupon-deferral and extension risk, but we think LT2 should trade at a smaller premium to T1 than previously. Risk-adjusted, we would move from LT2 debt into T1, especially where there is a significant cash price differential.

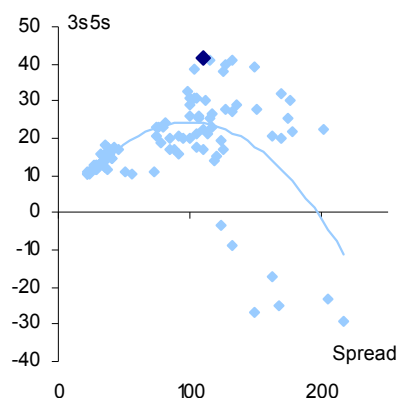
What about senior? SNS could be seen as a vindication of the market assumption that senior debt is money good at maturity. However, senior bail-in had clearly been on the discussion table. The Dutch Finance Minister indicated in a letter to parliament that he wanted 'all private parties, senior bondholders included, to be liable to foot as much of the bill as possible'. However, 'this option was dropped [...], because of expected adverse effects on financial stability.'

It seems to us that many national governments would prefer senior bail-in to politically-sensitive tax payer recaps. And presumably only central bank resistance is keeping them in check. Yet the ECB has under Mario Draghi become much less vocal in its opposition to bail-ins more broadly.

The Irish restructuring of the IBRC (formerly Anglo Irish) appears to be the next step that could finally pierce the sanctity of senior unsecured. In the liquidation of IBRC, the transfer of assets to NAMA will leave no recovery for senior unsecured bondholders, if a valuation of these assets falls short of the value of the bonds provided by NAMA to the Central Bank of Ireland, according to Moody's.

Considering that senior bondholders in the Cypriot banks are also on the line and there have been suggestions to bring forward senior bail-in under the Recovery and Resolution Directive to 2015, we think the coming weeks hold significant uncertainty which isn't reflected in current spreads. Covered bonds which fall outside the bail-in regimes seem a much safer place to reside – especially, where the spread premium to senior unsecured is comparatively small, as in Italy and Spain.

Figure 12. iTraxx Main – level vs 3s5s (bp)



Source: Citi Research, Markit

3s5s flatteners in CDS, but shorten duration in cash

Over the last couple of weeks CDS curves have re-steepened to near their record highs.

We believe the front end is crowded, and susceptible to any rise in systemic risk or sign that short-term default rates might be on the increase. Wider spreads should lead to flatter curves. Equally, if technicals drive spreads tighter then we reckon people hunting for yield will be forced out along the curve, also prompting flattening.

The dynamic is illustrated in Figure 12 – the relationship between spreads and steepness is bell shaped. As such, the duration-weighted flattener trade is like a straddle, where you suffer carry and roll-down if spreads remain where they are, but you have upside if spreads move in either direction.

With curves so steep, the usual negative carry of the CDS flattener is almost eliminated, making this a very attractive entry point – either via iTraxx indices or via

single names with very steep curves (chemical names like BASF or Bayer or banks like BNP Paribas, HSBC or UBS).

While we would move out on the curve in CDS (DV01-weighted), in cash we would do the opposite – reduce spread duration.

Many cash curves are comparatively steep also, but unlike in CDS, the cash curves are not steep enough to compensate for the additional duration risk.

The carry on DV01-neutral curve extensions in cash will be negative at the portfolio level. In equal notionals, the price volatility remains significantly higher further out the curve, even adjusting for the higher spread volatility of the front end. The breakeven of the 3-5yr bucket is 2.5 times higher than that of the 10+ year part of the € curve. Additional spread vol at the front end of the curve won't make up for anything like that differential in a sell-off.

If we were bullish on the market then we would happily take duration risk. But at these levels, extending duration in DV01-neutral terms could leave you bleeding carry, while extending in equal notional exposes you to poor risk/reward.

We would shorten cash duration here, especially in non-financials, where the curve isn't even steep in the first place.

Long Main risk vs. Crossover

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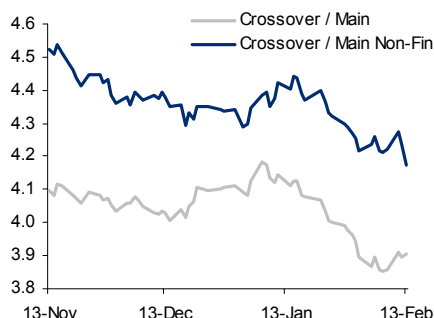
iTraxx Crossover has started the year outperforming both Main and Main Non-Financials, taking the spread ratios between the indices to record low levels, as Figure 13, Figure 14, Figure 15 and show. We see very little fundamental reason for this (see [European credit outlook 2013](#), 3 Jan) as we believe both the economic picture and corporate fundamentals continue deteriorating, and should have a larger impact on high yield companies. We would take the current entry point to go long risk Main and short Crossover (see [European Credit Derivatives Trade Ideas](#), 12 Feb). Investors that want to avoid risk on Financials, given the renewed concerns around the banking sector, can trade Crossover vs. Main Non-Financials (which can be “constructed” going long risk Main and short risk Senior Financials).

Figure 13. Crossover vs. Main & Non-Financials
Ratio of on-the-run 5y spreads.



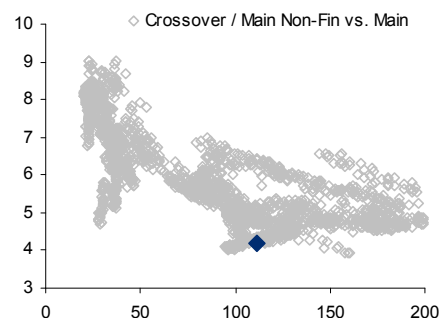
Source: Citi Research, MarkIt.

Figure 14. Recent movements
Ratio of on-the-run 5y spreads.



Source: Citi Research, MarkIt.

Figure 15. Crossover / Non-Financials vs. Main
Y-axis: ratio of spreads. X-axis: Main spreads, in bp



Source: Citi Research, MarkIt.

Citi Investment Matrix

Figure 16. Citi Investment Matrix, Detailed Scores

Category	Score	Weight	Comment/view
News	-0.5	20%	Data surprising positively, but we see a few negative catalysts on the horizon
Positioning	0.4	30%	Positions are long, but cash levels and inflows remain supportive
Solvency factors	-0.6	20%	While we are in an idiosyncratic environment many fundamental metrics are still weakening
Valuations	-0.6	30%	Credit may be attractive to even lower yielding assets, but looks tight to most other comps
Overall directional view:	-0.3	100%	
News	-0.5	20%	
Visible agenda	-0.6	8%	Near-term news flow looks comparatively neutral with the exception of the Cyprus risk
Italian election	1	3%	Split houses is a long-term negative, but weakened reform capacity is consensus. Contrarian ST bounce likely
Cypriot bailout	-2	3%	Senior bail-in a real prospect. Market may ignore for now (hence low weighting), but precedents are being set!
US sequester	-0.5	1%	Market seems comparatively indifferent to the sequester. Debt ceiling has been pushed back
ECB rate cut	1	0%	Our economists still view this as a distinct possibility in Q2. Supportive, but not a game changer
Banking union	-1	1%	Expect progress slow progress with key decisions deferred until after German election. But market unconcerned
Potential agenda	-1.3	5%	Long-term risks seem skewed to the downside
Indication from the Fed that QE will slow in H2 2013	-1.5	3%	This is a real prospect in Q2. Recent commentary suggests a minority of the FOMC is already uncomfortable
Bail-in regimes are brought forward	-1	2%	Some chance of this happening. Watch out for IBRC liquidation and Cypriot bailout
Spanish request for a programme	-2	0%	Unlikely in the current market environment (hence weighting). A long-term negative
Micro event risk	0	2%	Recent US corporate actions will inevitable also come to Europe. Expect they will remain the exception for now
Macro event risk	-0.5	2%	Limited appetite for volatility ahead of German election and agreement to disagree at G20, but macro vol will return
Economic surprises	1	3%	Although our economists' forecasts imply this is unlikely to last, eco. surprises are very positive
Positioning	0.4	30%	
Credit survey positions	-1	6%	Investor positions remain long with a creep into higher beta
Credit survey inflows/outflows	0.5	6%	Inflows are much less of a positive than in 2012. Marginal money is already moving elsewhere
Cash levels	0.5	6%	Cash levels remain sound, but pressure to buy has lessened
Market trading patterns	1	3%	Having overextended a bit street positions have now been reduced. Market feels ST squeeze
Primary market issuance	-0.5	3%	Decent volumes (record in HY), helping to bring down excess cash. A lot of beta being introduced.
Central bank liquidity	1.5	6%	Despite LTRO repayment, excess liquidity is still what's ultimately underpinning valuations
Solvency factors	-0.6	20%	
Systemic / idiosyncratic risk environment	0	5%	Idiosyncratic environment for now. However, we struggle to see much further upside. LT risks still linger
Economic cycle	-1	5%	Data slightly better from a very weak base. Consensus on Europe more optimistic than Citi forecasts
Leverage trends	-1	5%	Corporate leverage rising faster than is widely appreciated.
Policy environment	-0.5	5%	More progress made in '12 than we had anticipated, but going gets tough without market pressure
Valuations	-0.6	30%	
Relative to fundamental relationships	-1	7%	Spreads are tight to most fundamental relationships in our valuations report
Relative to history	-1.5	7%	Spreads are near the bottom of a two-year range
Relative to equities	-1	8%	Capped upside in credit clearly favours a gradual shift of some TR money into equities
Relative to rates / sovereigns	1	8%	In the hunt for yield we still expect some fixed income money to flow towards credit

Source: Citi Research. Scale: -2: Very credit negative, 0:Neutral, 2: Very positive. News and Solvency scores are relative to consensus.

Appendix A-1

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