3 April 2014 | 11 pages

High Grade
North America

US CreditBrief

Keep calm and March on

- **IG Corporates tightened 3bp in March to 105bp**—On the one hand, economic data continues to be mediocre at best, and geopolitical risks are no doubt on the rise. But on the other, the technical backdrop for credit appears as robust as ever.
- **Financials underperformed nonfinancials by 2bp**—While it's tough to see the impact of geopolitical risks on overall spreads, investor preference has clearly shifted away from sectors more impacted by global risks. Banks, arguably the most exposed, ended March flat, dragging financial performance down substantially.
- **The view in brief**—Credit chugged along tighter, suffering only a brief hiccup midmonth at the height of Russia-US/Europe tensions. Indeed, even the midmonth hawkishness from Yellen did little to hurt spreads. While we chalk up credit's resilience to strong technicals, we are growing increasingly cautious. Geopolitical risks have risen, and despite what Yellen *says*, the Fed's *forecasts* still point towards an increasingly hawkish Fed. While we remain neutral on the market in the short term, we continue to expect spreads to widen by year-end and prefer to go down-in-quality, up-in-liquidity, and increase our cash holdings to take advantage of the dips.

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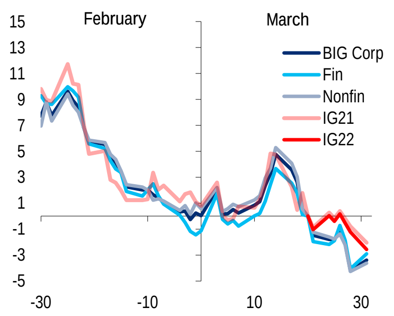
Figure 1. High grade OAS performance over March 2014, in bp

	Current	Last Month	Spread Change	
	31-Mar-14	28-Feb-14	Absolute	Relative
BIG Corp	105	108	-3	-3%
IG21	61	64	-3	-4%
Financials	98	100	-2	-2%
REITs	121	129	-8	-6%
Insurance	110	114	-4	-3%
Financial Svc.	102	102	0	-1%
Banks	91	91	0	-1%
Non-financials	108	112	-4	-4%
Telco & Media	129	135	-6	-4%
Technology	83	89	-6	-6%
Consumer Svc.	100	105	-5	-5%
Energy	123	128	-5	-4%
Consumer Goods	84	88	-4	-5%
Industrials	100	103	-3	-3%
Utilities	113	116	-3	-3%
Healthcare	79	82	-3	-3%
Basic Materials	149	151	-2	-2%

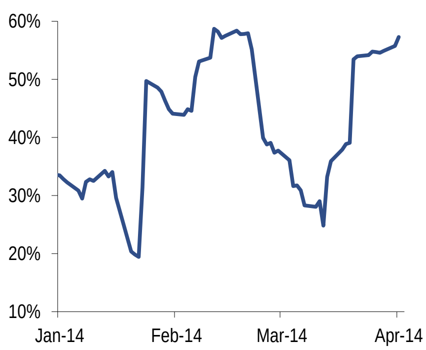
Source: Citi Research, Yieldbook

Figure 2. High grade spread performance, in bp since Feb 28th



Source: Citi Research

Figure 3. 5yr CDS pairwise correlation, 1mo rolling correlation in %



Source: Citi Research

Broad market trends and events

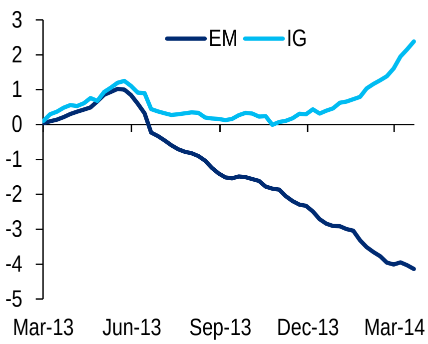
- Yellen's fumble midmonth, rising geopolitical risk out of Crimea, and no end to the EM weakness in sight have kept the financial media well occupied during March. Yet credit spreads paid very little mind and rallied 3bp tighter to a new post crisis low of 105bp. While Yellen's not-so-subtle backtracking and Putin's withdrawal of some troops at the very tail end of the month are surely tailwinds, they provide a poor explanation for credit's resilience last month. We reckon that a positive technical backdrop has kept IG credit spreads in check—not only are IG mutual funds benefiting from EM outflows, but lack of supply in the wider world of fixed income (ex-corporates) has kept demand well in excess of supply.

- If the March FOMC meeting is any indication, Yellen may find it just as difficult to navigate the exit from ultra-accommodative monetary policy as Bernanke did last summer. While Yellen's suggestion that the Fed's bond buying program would end in the fall was generally in line with consensus, her suggestion that the Fed could raise rates six months thereafter was not. Moreover the committee increased their inflation expectations and lowered their path of unemployment—both pointing to tighter monetary policy. Surprisingly, even though risky-assets showed signs of weakness more broadly, credit was extraordinarily resilient, both in the synthetic and the on-the-run cash markets.

- By the end of the month, Yellen was in full damage control. The newly minted Fed chairperson took advantage of her spotlight in a Chicago conference to highlight that an "extraordinary commitment is still needed for some time to come." And while this did not change the fact that the Fed projections continue to point to an increasingly hawkish central bank, IG cash and CDS were quick to rally into month-end on these headlines—strange, particularly because the market did not react to Yellen's mid-month hawkishess!

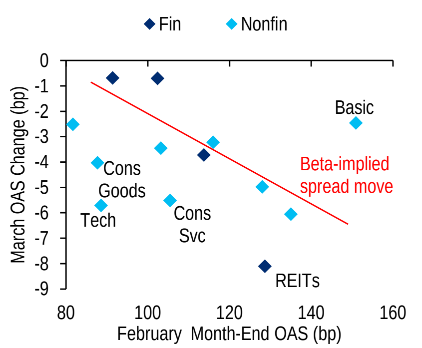
- Credit appeared to be a lot less resilient to concerns of rising geopolitical risks. For one, pairwise CDS correlations have risen from just over 30% to 60% over the year (Figure 3). But more broadly, Russia-Ukraine event-risk contributed to the majority of both CDX index and IG spread volatility. Russian troops gathering on the Crimean border and escalating tension between Russia and the western powers drove IG21 nearly 6bp wider in the first half of the month. But worries quickly dissipated following the Crimean referendum on the 16th, where the majority voted in favor of annexation by Russia. Despite imposition of sanctions on Russian officials by the EU and US, both cash and credit had completely reversed earlier weakness a week later. We can at least partially attribute the rebound to Putin's well-received speech on the 18th. News of withdrawal of troops from the region at the tail end of the month was also a positive.

Figure 4. EM vs IG corporate mutual fund flows, in $bn



Source: Citi Research, EPFR

Figure 5. March spread performance vs. level, in bp



Source: Citi Research

- To our minds, the resilience of credit last month is attributable to a surprisingly strong technical backdrop. For one, there's been growing evidence that IG credit markets in the US have started to become a net beneficiary of the flows out of EM (Figure 4). Our **global credit survey** agrees with this observation, pointing as well to rising inflows in March. On the other hand, it's hard to imagine that the $113bn flood of supply during the month wasn't a drag on credit, especially since the market was looking for a much lower number. But as we highlighted in **our weekly**, the dearth of supply across the rest of investment grade fixed income has left IG as one of the two primary asset classes where investors can invest.

Sector performance

- Financials only tightened 2bp in March, half of what we saw in nonfinancials (-4bp). While this was a reversal of most of February's 3bp outperformance, financial tightening last month can be attributed almost entirely to REITs and insurance. In fact, REITs ranked as the top performing sector, tightening 8bp in March. And although this move is nothing to take lightly, it only translates to 6% of BIG Corp performance, thanks to the small size of the sector in terms of debt outstanding. Half of the REITs' performance came at the start of the month, probably at least in part due to the positive tone at Citi's Global Real Estate Conference. The second half came at the end of the month—as one of the most rates-sensitive sectors, REITs was a major beneficiary of the dovish commentary from Yellen in Chicago. National Retail Properties (NNN) and DDR Corp (DDR) led the sector, tightening 23bp and 19bp, respectively.

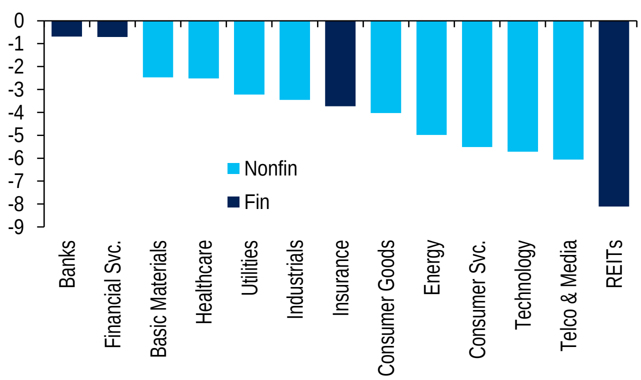
- Considering the fact that banks are among the sectors most exposed and vulnerable to global headline risks, it should come as no surprise that the sector was among the non-performers last month. Although banks were flat on aggregate, the annual stress tests and CCAR results drove dispersion among bank spreads. Other than Zion (ZION) which failed the stress tests, virtually all others passed the Fed's tests (although Bank of America (BAC) and Goldman Sachs (GS) had to resubmit their capital plans) and were sold in anticipation of issuance for buybacks ahead of 1Q results. Yet with that said, it was the European investment banks that underperformed the banking sector the most, presumably because of their proximity and greater exposure to the current risks—Credit Suisse (CS), Barclays (BACR), and Deutsche Bank (DB) each widened 6-8bp in March. In an interesting twist, outperformance was concentrated among LatAm banks—Banco do Brasil (BANBRA) tightened 60bp while Bancolombia (BCOLO) tightened 40bp. While EM in general fared well last month after taking a beating earlier this year, LatAm credits were also the primary beneficiaries of EM money rotating out of CEEMEA and into LatAm as investors sought a relative EM safe haven.

- TMT was the best performing sector among nonfinancials, tightening 6bp in March. As we've highlighted before, the sector's size and large number of benchmark issues has popularized it as a risk-on/risk-off product. To our minds, this drove a bulk of the sector's performance in March. Yankee telecom credits continued last February's strong performance, and led sector performance last month—America Movil (AMXLMM) and Telefonica (TELEFO) tightened 11-13bp each. In other news, the sector saw a flurry of tender activity. Pitney Bowes (PBI), for instance, funded a $350mn tender with lower coupon 10yr debt, and tightened 15bp over the course of the month. In another example, Verizon (VZ) tendered for $8.2bn of 2-to-4 year paper, and concurrently issued across the curve with substantially lower coupons. The credit was only a middle-of-the pack credit however, and tightened 5bp on the month.

- Consumer services and consumer goods tightened 5bp and 4bp, respectively. Macy's (M) was among the top performers this month, continuing its march tighter after displaying stellar results and strength from its unique position as the biggest department store in US. Aside from this, a number of hotel properties rallied this month on the back of an improving leisure outlook—Wyndham (WYN) and Starwood Properties (HOT) tightened 14bp and 23bp, respectively. Activist or event-driven names were also among the top movers this month. This includes Darden Restaurants (DRI) which tightened 26bp as it finalizes the spin-off of Red Lobster, its least profitable segment, while fending off activist demands for a real estate separation. Among the worst performing consumer credits was Beam (BEAM), which leaked 6bp wider as its shareholders approved the acquisition by Suntory in late March. And finally, in the usually quiet tobacco space, Reynolds American (RAI) backed up 5bp on potential talks of acquiring Lorillard (LO) in a $20b deal.

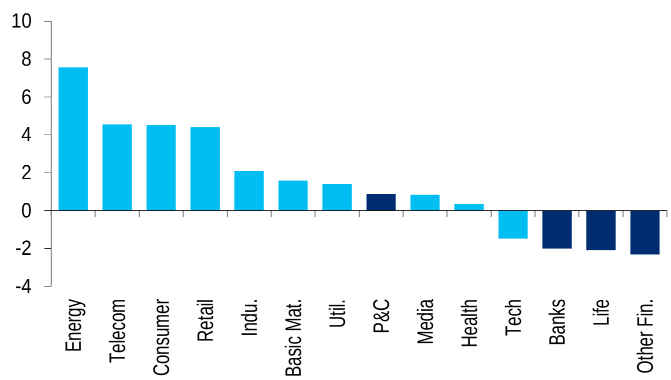
- Energy was right behind consumer services, tightening 5bp for the month. Lat-Am-names were at the top of the list, with Ecopetrol (ECOPET) and Petrobras (PETBRA) among the top performers, tightening 24bp and 14bp, respectively. Petrobras' strong performance came in spite of a number of negative headlines during the course of the month (S&P downgrade, corruption allegations, production declining) on top of a whopping $8.5bn of new debt—so far the biggest dollar bond sale of 2014.

Figure 6. Mar '14 cash sector performance*, in bp



Source: Citi Research
*Citi BIG Corp index universe constituents used for calculations.

Figure 7. Feb '14 CDS sector performance*, in bp

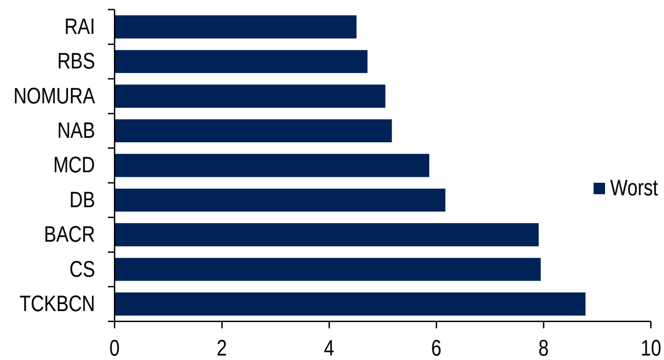


Source: Citi Research"
*The sectors above include all IG20 constituents plus the 6 primary US banks. Note that spreads are not roll adjusted.

Figure 8. Best OAS performers in Mar '14*, in bp

Source: Citi Research
*OAS change in March '14 of all index-eligible debt. The credit must have at least $5bn of index-eligible debt and have seen $250mn+ trades in the past 3 months.

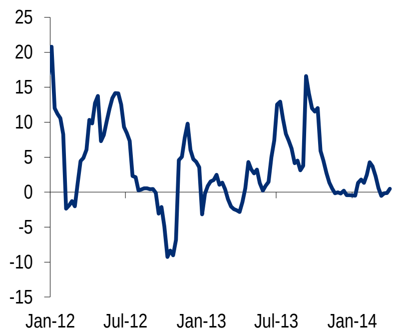
Figure 9. Worst OAS performers in Mar '14*, in bp



Source: Citi Research
*OAS change in March '14 of all index-eligible debt. The credit must have at least $5bn of index-eligible debt and have seen $250mn+ trades in the past 3 months.

Supply: bounce back in new issuance

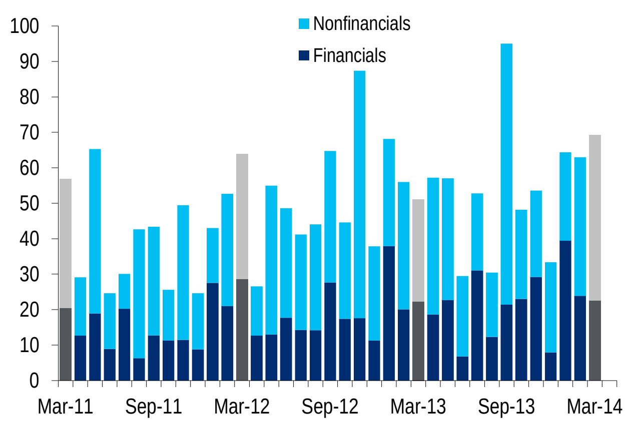
Figure 10. IG New issue concessions, 30-dma in bp



Source: Citi Research

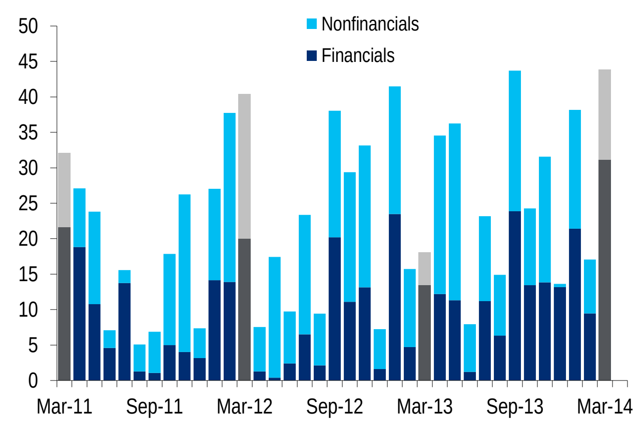
- The primary market bounced back from February's slowdown with $113bn of new debt in March ($53.7bn in financials and $59.5bn in nonfinancials). This marks the second heaviest March calendar we have on record, and puts us slightly ahead of pace to reach our $940bn annual target.
- Year-to-date supply at the end of March has totaled $295bn, 18% higher than in the first quarter of 2013. This growth in supply however, has come disproportionately from non-US financials. In fact, the year so far has seen a nearly 50% increase in this subsection of the market, primarily from developed markets. Yankee nonfinancials on the other hand only saw a 10% increase versus 1Q '14.

Figure 11. Domestic issuer supply, in $bn



Source: Citi Research, Dealogic

Figure 12. Non-US issuer supply, in $bn



Source: Citi Research, Dealogic

Appendix A-1

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Data current as of 31 Mar 2014	Buy	Hold	Sell	Buy	Hold	Sell
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