2 November 2012 | 9 pages

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US CreditBrief

Weak earnings hinder Fed-driven rally

- **Spread Performance in October –** Cash spreads tightened 19bp to 136bp in October as measured by Citi's Broad Investment Grade Corporate Index, in what seemed to be a continuation of September's rally in response to easy Central Bank policy. The road tighter was not without bumps though. Mid-month, weak third-quarter earnings and global growth concerns halted the rally, and spreads backed off from recent tights of 128bp. Financials tightened 23bp on the month, with REITs (-29bp) and banks (-25bp) as the key drivers. Technology (-2bp), industrials (-11bp), and basic materials (-18bp) underperformed, dragging down non-financials (-17bp). IG 19 ended the month unchanged at 99bp, after tightening to 90bp mid-month.

- **View in Brief –** The second half of October has illustrated that despite the positive backdrop provided by ECB and Fed easing, current valuations leave high grade credit spreads more sensitive to fundamental pressures. And if this month is anything to go by, a disappointing 4Q earnings season could pressure spreads still further. What's more, as 2013 draws rapidly closer, the fiscal cliff looms ever closer. We still believe that QE3 and OMT programs will carry the day and drive spreads tighter, but the pace will likely slow as the susceptibility to disappointment grows – whether from China, Europe, or the coming US fiscal adjustment.

Figure 1. High Grade Credit Performance over October 2012

	Current	Last Month	Changes	
	31-Oct-12	28-Sep-12	Absolute	Relative
BIG Corp	**136**	**155**	**-19**	**-12%**
CDX IG 5Y	**99**	**99**	**0**	**0%**
Financial	**156**	**179**	**-23**	**-13%**
REITs	167	196	-29	-15%
Banks	150	175	-25	-14%
Insurance	170	193	-24	-12%
Financial Svc.	144	160	-16	-10%
Non-financial	**126**	**143**	**-17**	**-12%**
Healthcare	83	98	-15	-15%
Energy	130	152	-22	-15%
Consumer Goods	98	115	-16	-14%
Consumer Services	117	136	-19	-14%
Utilities	128	147	-19	-13%
Telco & Media	153	175	-22	-12%
Basic Materials	182	200	-18	-9%
Industrials	112	123	-11	-9%
Technology	117	119	-2	-2%

Source: Citi Research

Broad Market Trends and Events

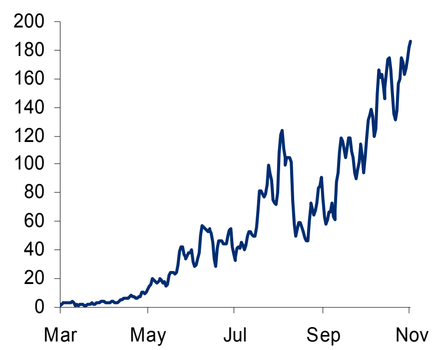
- High grade cash spreads started the month at 155bp with what turned out to be a significant amount of momentum from the Fed's QE3 and the ECB's OMT programs. Over the course of October, the combination of easy Central Bank policy, a sub 8% unemployment rate, and continued strength in the housing sector, drove spreads to tights of 128bp by mid-month, a level last seen after the announcement of QE2. But thereafter, US budget concerns, a weak earnings season, and slowing global growth brought about a reversal with the US BIG Corp widening back out to 136bp. IG 19 lagged the rally in the first half of October and ended the month almost flat to where it began it. We suspect the shorter tenor and lack of bank exposure is partly to blame for underperformance. The lack of the real-money buyer (seller of protection) is likely a culprit as well.

- In last month's credit survey, participants highlighted the so-called fiscal cliff as a major risk factor. The rapidly increasing mention of this topic in headlines (Figure 2) reiterates the increasing concern throughout the month as year-end draws near. Management also highlights this as a top concern in 3Q earnings, and attributes the hesitation in business spending to policy uncertainty.

- China has been a front-and-center concern since its GDP, industrial production, and PMI figures all began pointing to a slowdown. What's more, it seems that the China story is finally starting to have an impact on corporate America, as it was highlighted on multiple occasions by management teams as a reason for weak 3Q earnings and lower guidance in 4Q and 2013.

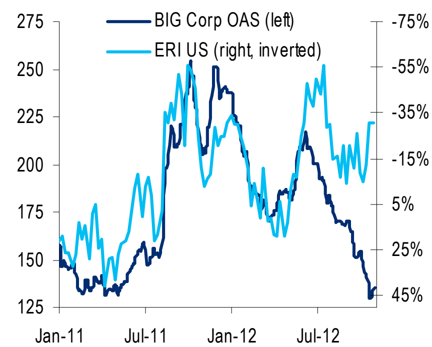
- Spain and Greece headlines affected US credits less than in previous months thanks to the OMT program. The two-notch S&P downgrade of Spanish debt raised concern on the 10th, but didn't result in a sustained, material selloff. Moody's reiteration of its Baa3 rating a week later dismissed fears of near term forced-selling by investors. Market reaction to Spanish bank stress tests was also moderate, despite the arguably under-stressed residential mortgage loans loss assumption of 4.1% (Ireland saw a 12% loss, to put this figure in perspective. Our economist also lowered their probability of the so called "Grexit" from 90% down to 60% (see the October 12 Euro Economics Weekly - Grexit).

Figure 2. "Fiscal Cliff" news count, 10-dma



Source: Citi Research, Bloomberg

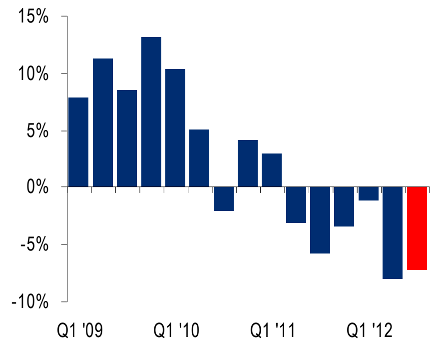
Figure 3. Earnings revisions index and IG spreads, in bp (left)



Source: Citi Research

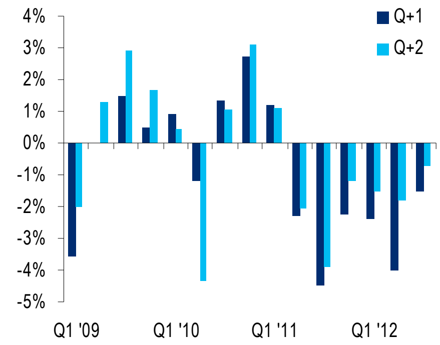
Earnings and guidance: the bad and ugly

Figure 4. S&P 500 earnings surprise*



Source: Citi Research, Bloomberg
*Earnings surprise is calculated as the % difference between reported EPS and expectations at the start of the reporting season.

Figure 5. S&P 500 future quarter revisions*



Source: Citi Research
*Q+1 denotes the earnings season following the currently reporting quarter, i.e. the rightmost dark-blue data point represents revisions to Q4 earnings.

- Preannouncements early in the month foreshadowed what we would see in the remainder of October. Versus unadjusted expectations, corporates had a difficult time beating either revenue or earnings expectations (Figure 4). The surprise versus unadjusted expectations comparable to poor 2Q earnings performance. Even worse, 3Q expectations were already revised down by 4% last season. To us, there's no doubt this contributed to widening in the second-half of the month.

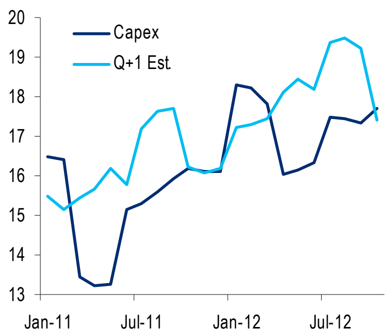
- Corporates struggled to beat top-line estimates for 3Q, even those estimates that have been revised mid-season. For every credit able to beat sales figures, there were roughly two that couldn't. Once again, corporate management teams continued to focus on cost cutting to make bottom-line targets. Colgate-Palmolive, for instance utilized job cuts to buoy itself against high commodity prices.

- Even more disconcerting is the extent of guidance cuts for FY '12 or '13. Downward-to-upward guidance revisions were roughly in a 2-to-1 ratio, with US political/fiscal-cliff uncertainty and weakness in international demand among the top reasons for the pessimism. EPS guidance was not lowered as dramatically, but the implication is that this is because of expected cost trimming measures, such as reductions in business spending or workforce cuts.

- The rebound in September durable goods orders only partly offset the August drop. The figures are indicative of weakness in equipment spending and likely lower future capex by corporates (Figure 6).

- The top down employment figures appear at odds with earnings discussions. The sub 8% employment rate was questioned by some and with corporate management guiding toward more job cuts to come (Newell-Rubbermaid, Colgate-Palmolive, and Corning to name a few) the "improvement" may ultimately be short lived.

Figure 6. S&P 500 current quarter capex and next quarter capex consensus, per-share



Source: Citi Research, Bloomberg

Sector Performance

- Broadly speaking, non-financial outperformance was driven by beta for the first half of the month, and earnings results in the second half. The lowered tail risk associated with Europe helped financials to rally by 31bp, to a tight of 148bp mid-month. Starting from a tighter level, non-financials were only able to tighten 24bp to 119bp mid-month. Bright spots in earnings results were concentrated in financials, particularly in banks and REITs. Once the third-quarter earnings season started, non-financials gave back 30% of their tightening while financials only gave back 24%.

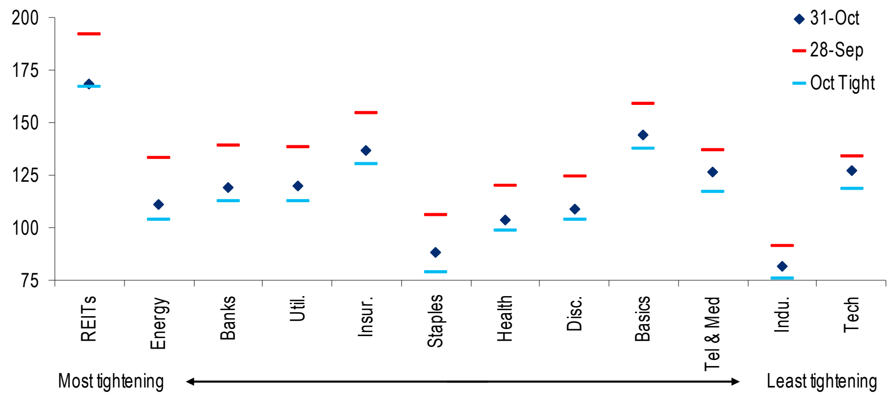
- Within financials, REITs proved to be the strongest sector, tightening to 167bp (-29bp). This is a result of not only great 3Q results and forward guidance, but also a stronger housing market, as indicated by economic data over the past several months. New home sales, existing home sales, and housing starts all showed significant improvement during the month. The likes of Ventas, Simon Properties, and Prologis were able to beat both 3Q top and bottom line estimates. All three credits also took it a step further and raised full year guidance as well.

- Big bank names also proved to be an outperforming sector in 3Q. With the exception of Wells Fargo, all the other big US banks/broker dealers beat top line and bottom line estimates. For the most part, FICC and equity trading operations improved from last quarter, and most banks showed improved tier 1 capital ratios. Even Bank of America, which was a relative underperformer in terms of FICC trading and investment banking revenues in 3Q, saw its 10-year tighten 21bp.

- The worst performing sector in October was technology. After tightening roughly 33bp since mid-June, performance has been challenged by fundamentals as well as heavy positioning. In many cases, it appears that poor 3Q earnings numbers brought about capitulation by the longs and the relinquishing of nearly all the spread gains made since September. Slimmer margins were a concern for Avnet and Intel's management teams, and weaker guidance by Texas Instruments only adds to concerns for that sub-sector. All in all, the technology sector ended the month just 9bp tighter. The sector also includes Hewlett-Packard, one of a handful of notable credits to end the month wider (another being MTNA).

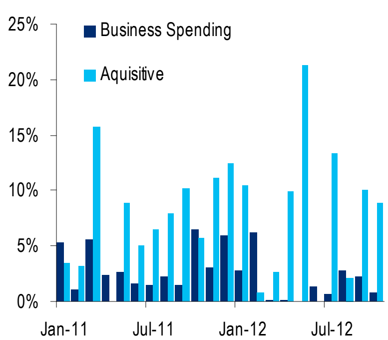
- Industrials and basic materials were also among the worst performers in October (-11bp and -18bp, respectively). As highlighted above, weakness in Chinese demand came to the forefront this month, hurting revenue expectations for materials names. Alcoa cut aluminum guidance figures, highlighting a weaker Chinese economy. Potash also singled out weaker Chinese demand as a driver for lowered guidance. Industrial names were hurt by global slowdown and reduced business spending overall. Cummins and Caterpillar both referenced reduced orders as a reason for weak 3Q results and lower FY guidance.

Figure 7. On-the-run sector OAS, sorted by best-to-worst October performance in bp



Source: Citi Research

Figure 8. Debt earmarked for business spending or M&A, as a % of total supply

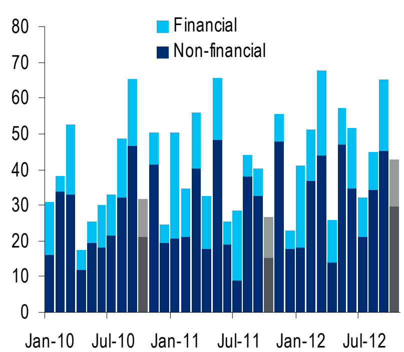


Source: Citi Research, Dealogic

Supply: funding the rainy-day account

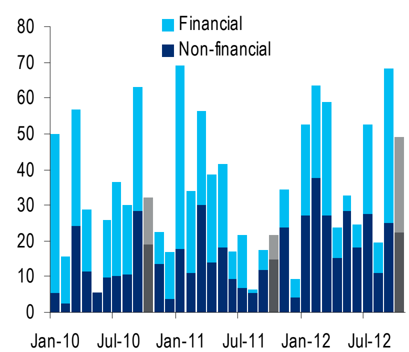
- High grade supply in October was $92bn ($41bn Financials, $51bn Non-financials), lagging last month's $133bn primarily as a result of earnings blackout periods. Nevertheless, this month ranks as the second-heaviest since 1Q, and the heaviest October on record. Compared with '08 to '11 where October issuance contributed to 5-9% of the ytd supply, this month's 10% contribution is notable. It's likely that management concerns over the fiscal cliff and ever lower yields (BIG Corp yields hovered in the 2.70% context in October) are partly to blame for the heavier-than-normal October.
- Of course, opportunistic borrowing does not mean management teams have somewhere to put their money to work. For instance, debt earmarked to be at least partially used in acquisitions represents 9% of total supply, down from 10% in September and 13% in July. Debt that was at least partially earmarked for business investments was less than 1% versus 2.2% in September and 7% last October.
- October financial issuance came in just under two-thirds of September's figure, as did domestic non-financials. Yankee non-financial supply only dropped 10% and contributed to much more of the total issuance in October than previously.

Figure 9. Domestic issuer supply, in $bn



Source: Citi Research, Dealogic

Figure 10. Non-US issuer supply, in $bn



Source: Citi Research, Dealogic

Appendix A-1

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