

## European Credit Outlook

### Caught in a liquidity lure

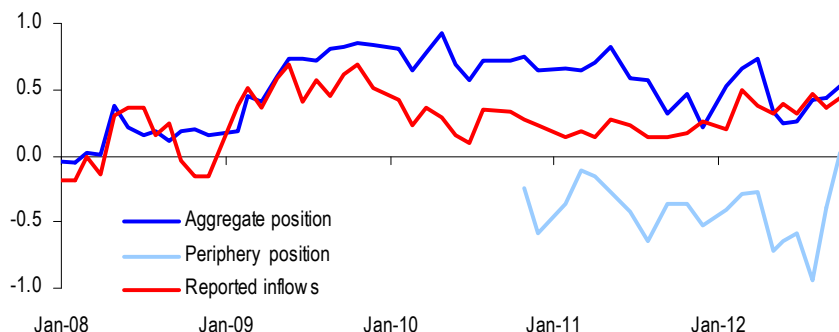
- Spreads are at their tightest level in more than a year, many funds are in performance-protection mode into year end and residual uncertainty about Spain and Greece remains. So credit, perhaps, does not appear attractive here. Indeed, the majority of the rally is over, but regardless we think spreads will gradually tighten further.
- Central banks are engineering a squeeze in risk assets like credit by creating money inflows, shrinking the investable universe and increasing the risk of being underweight. Over the last couple of years, peaks in the market have tended to coincide with the peak liquidity injection on a three-month basis. With their recent initiatives still ramping up, we don't believe this process has run its course yet.
- Additional tightening would see spread levels decouple from perceived fair value based on fundamentals. However, in the absence of identifiable negative catalysts we suspect many investors will feel compelled to participate and take more risk as they assess their options for 2013.
- In this environment, the best performing assets are still likely to be those that are most susceptible to systemic risk – the periphery, financial sub debt and HY credits climbing back up "the cliff".
- For fundamental bears like us, this phase seems frustrating and counterintuitive. The only consolation is that with the spread compression, opportunities to differentiate between good and bad-quality credits will eventually open up. For now though, patience will be required.

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Figure 1. Citi Credit Survey – Reported positions in € credit & level of inflows\*



Source: Citi Research \*: -2: Very short / Large outflows, 0: Neutral / No change, +2: Very long / Large inflows

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# Caught in a liquidity lure

## In a trap or in a lure?

"Liquidity trap" was a term coined by John Maynard Keynes in the aftermath of the Great Depression. He argued that when yields are low enough, expanding money supply won't stimulate growth because bonds and cash are already near-equivalents when bonds pay (almost) no interest. Some would say that it is a pretty apt description of the state of play these days.

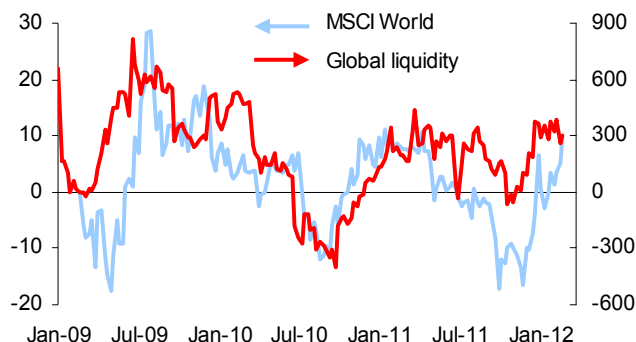
However, most economists today would contend that monetary policy doesn't just impact the economy through interest rates, but also through other several channels, one of which is asset prices.

To our minds, there is very little doubt that central banks have played an absolutely crucial role in propping up asset prices in recent years. We'll leave the debate about the link between asset prices and growth for another day, but we do believe that in so doing they have prevented a much faster and more vicious deleveraging process.

Just look at Figure 2 below, which compares the 3-month change in liquidity provided by the central banks with the 3-month change in global equity markets. We could have used credit spreads instead and it would have made very little difference. Every time the central banks have injected liquidity, markets have responded, although recently most of the response has been preemptive.

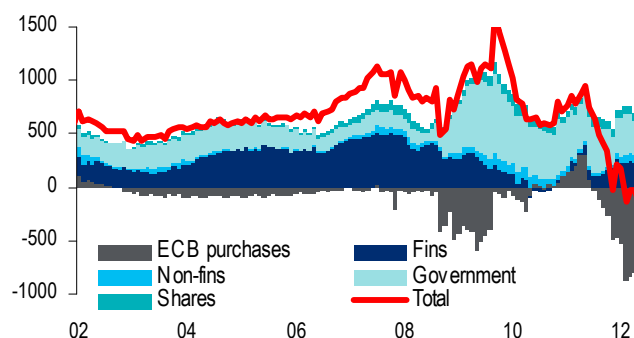
Why have markets responded so resolutely when growth hasn't?

Figure 2. CB liquidity injections\* (\$bn) vs. MSCI World (%), 3m chg.



Source: Citi Research, Datastream. \*: Global liquidity captures the sum of central bank asset purchase schemes and the LTROs for the ECB.

Figure 3. Net issuance of securities by type in Euro zone, €bn\*



Source: Citi Research. \*: 12m rolling

The answer, we think, is that in their attempts to free markets from the liquidity trap, central banks are ensnaring markets in what we'll call a "liquidity lure".

That lure is three pronged:

- By lowering rates to zero (and potentially promising to keep them there), central banks are forcing money out of money markets and deposits into riskier assets for higher returns. In corporate credit, the corollary has been almost continuous inflows since late 2008.
- Through balance sheet expansion – that is buying assets or funding them for a long period of time without rehypothecating them (lending them out) – the central bank is shrinking the universe of investable assets in the market. The red line in Figure 3 above, which shows the net issuance of securities in Europe on a rolling 12-month basis after the effect of long-term ECB repo operations, clearly illustrates the point.

- Lastly, through the signalling value. By sending an implicit message to markets that the central bank is intent on supporting asset valuations, perceptions of risk/reward change – it is much more uncomfortable to be underweight/short unless there is a specific, tangible negative catalyst.

In the initial phases, strong asset returns make the lure too enticing to resist – who would have predicted that investment grade credit would generate total returns of 10.5% in 2012?

Yet the catch is equally obvious: When the returns have been had, investors end up with a distorted trade-off between risk premia and fundamentals. Or more bluntly, swamped with cash and faced with fewer assets on offer, investors end up buying assets at levels where they don't perceive they are being fully compensated for the risks they are ultimately running. From that position, there is no painless escape.

### **Getting the credit investors on the hook**

We believe the liquidity lure is a key force behind the gravity-defying performance of many risk assets, including credit, this year<sup>1</sup>.

Why else would credit spreads be near cyclical tight and equity markets near 5-year highs? All metrics in our [Valuations Report](#) suggest credit spreads are now in line with or tight to past relationships with most relevant fundamental variables. Only a couple of months ago, credit spreads were either wide or very wide to those same relationships. Many periphery credits are now trading at less than half the spread the market demanded in June. Financial spreads, even including periphery banks, have retraced 90% of the range from the tight in 2011.

This is all the more counterintuitive considering that the Eurozone is in recession, the Chinese slowdown is more serious than anticipated and the US now faces an unresolved fiscal cliff. For 23 weeks in a row, analysts have been revising their earnings estimates lower, and top-down forecasts suggest they will have to reduce them further. But markets just don't seem fazed.

We also think the liquidity lure is causing many of the peculiar or counterintuitive RV trends we've seen across financial markets this year:

- the coincident rally in bonds and equities;
- the outperformance of European over US credit despite a deepening recession;
- the hardening of "softer core"<sup>2</sup> correlations with Germany (both in credit and in rates space) over the summer;
- the positive basis;
- the strong outperformance of developed markets over many parts of EM;
- the reduced sensitivity of cash credit spreads to sovereign volatility;
- the outperformance of banks over non-financials in a sovereign crisis; and last, but by no means least;
- the outperformance of the periphery over the core despite sharply worsening fundamentals

So to our minds, the credit market has definitely had a good chomp at the bait.

<sup>1</sup> We made a similar argument in our recent presentation "[The Hot Potato Problem](#)"

<sup>2</sup> France, Austria and Belgium becoming almost 100% correlated with Germany again after the French elections.

## Reel 'em in slowly

Over the last few weeks, we've seen signs of unease with the prospect of credit being reeled in further. At least, spreads have started to respond to forces pulling in the opposite direction:

The most obvious factor is the all-too-predictable re-emergence of conflicting messages from policymakers.

From the statement by three core Finance Ministers against using the ESM for legacy-asset problems in direct bank recapitalisations, to divisions about banking supervision, to the protracted negotiations with Greece and not least the uncertainty about a Spanish programme, one thing is clear: as soon as systemic risk premia across financial markets recede, the diverging agendas become apparent again.

These have been timely reminders that the longer-term issues are not resolved with central bank liquidity alone. Yet to our minds, the key point is that they have not triggered the sharp market responses that one would have expected a few months ago.

It is almost certainly already a consensus view that Spain will apply for a programme in the coming weeks. However, even if the status quo were to drag on, would credit investors sell out aggressively against the prospect of a sudden announcement that an application has been made? We doubt it – for the time being at least, the market believes that the OMT is a credible systemic backstop. Conversely, because the application is expected, the subsequent reaction should also be muted.

If anything, the risks from a breakdown in Greek negotiations or from a growing fragmentation within Spain are more important, but we suspect they are more likely to crystallise going into 2013 than imminently. For instance, the reported pressure on European institutions by the IMF to haircut their Greek exposures could gain traction quickly, but our economists believe it somewhat less likely in the run up to US elections and amid the Spanish uncertainty.

Clearly, the slight wobble in credit was not just headline driven. The perceived lack of value discussed above also played a part, along with the recent shift in positioning.

With €28bn of net supply in September, and a record volume from periphery issuers, many of the 'burning' underweights in the periphery were covered. In fact, our latest [Credit Survey](#) suggests that the huge consensus underweight in the periphery earlier this year has been almost eliminated.

Added to that, we think there is a generic reduction in risk appetite, which has tempered demand somewhat – most accounts will be more concerned with protecting their 10% returns than growing them into year end.

But as soon as issuance died down, the tightening has resumed. To us, this illustrates that the liquidity lure is still the dominant driver.

We suspect it will be a similar story with earnings season. Consensus has already been revised significantly lower, and for the US, earnings expectations for Q3 are actually negative for the first time in eleven quarters. Longer term, chances are that the process has further to run – our equity strategists predict global earnings growth

of 7% in 2013, compared with the 13.1% bottom-up consensus. However, we suspect that most companies have guided so that their actual numbers meet the revised consensus. The market is likely to punish disappointments harshly, but we believe this will tend to be at the individual rather than at the aggregate level.

Effectively, unless one of the tail risks becomes a much more central scenario we think that credit spreads will continue to be reeled in gradually.

At the macro level, the peak in markets over the last couple of years has tended to coincide with the point where liquidity injections over a three-month period reach their peak. As the Fed will only begin to ramp up purchases now and the OMT isn't even off the ground, that point is still some way off.

### **Conclusion: Hooked until it snaps again**

Central banks, especially when they are acting in coordinated fashion, have the ability to create an equilibrium for asset prices and credit risk premia that differs markedly from the 'natural' state – at least temporarily. The credit market is just a microcosm of that broader story.

Quite simply, they will (indirectly) keep investor pockets filled with cash, whilst restricting the volume of assets for sale. Remember how tight credit spreads got in the middle of an extended recession and deflationary environment in Japan?

But Europe is evidently not Japan. Many sovereigns today do not have the "luxury" of a big current account surplus and the ability to run large fiscal deficits for more than a decade as Japan did. Tail risks, be it Grexit, Catalan independence, Italian elections or "just" popular unrest, are bound to resurface in our view.

The challenge will be to balance the two when investors lay their strategies for 2013.

We are quite confident that over the coming months there will be times when the liquidity will push spreads considerably tighter than they are even today. We have adjusted our [spread targets](#) lower to reflect that view.

Our sense is that the pain trade in the market is that the low spread, low vol environment continues for longer than is consensus because it would compel many to go longer than they are currently to enhance their return potential for 2013. That view is probably easier and less consensus to implement now than it will be by January.

Almost invariably the higher beta, non-consensus trades will outperform – led by the assets that you are fundamentally least comfortable with, not least in the periphery. However, there are other ways to position for this scenario, which may feel a little less awkward:

BBs and BBBs outperform As and AAs, even risk-adjusted. And the 'contrarian' sectors outperform. Despite all the global growth concerns over the last three months, cyclical sectors, like industrials and basic materials, along with non-consensus sectors, like telecoms and utilities, have done better than lower-beta, safe haven sectors like consumer goods, services and healthcare. In our central scenario, that continues for the time being, although as spreads get tighter, single-name events and conventional cyclical factors will increasingly matter.

Banks also tighten further relative to non-financials in the hunt for yield, coupled with a re-rating of the sector as perceptions of systemic and bail-in risk subside for

the time being. Similarly, European spreads are likely to compress against the US and curves will increasingly tend to flatten.

So until investors can see an identifiable negative catalyst we expect very little resistance to the liquidity lure.

Yet when people feel spreads don't compensate for the underlying fundamental risks, they're likely to de-risk at the first sign of trouble. In the current liquidity environment, the inevitable consequence will be gapping credit spreads.

It will be nigh on impossible to predict the turning point. It is hard enough to forecast what European policymakers agree in late-night meetings, but timing the reaction by ordinary people in the streets can never be much more than guesswork.

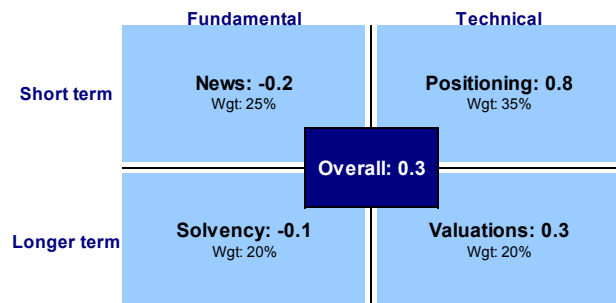
What you can do first is to assess the preconditions. Right here, the majority of the rally in absolute terms is done. Resistance to further tightening is clearly increasing. But equally, investor scepticism and the apparent desire by policymakers to buy more time suggests to us that the next proper pullback is probably some time away. We don't feel that complacency is rife just yet.

Second, be selective in where you take risk. For example, we still think there is genuine relative value in secured over unsecured assets in many places. Why would you hold unsecured exposure, when you can find equivalent assets with at least some form of security trading at risk premia that are not much lower?

Third, as spreads tighten from here we would very gradually start to look at decompression trades. Eventually, as the beta squeeze subsides we suspect the next phase will see much greater differentiation between credits. We'd begin where the asymmetry is most apparent: assets that trade with no premium to comparables with lower systemic risk – for instance, between French and German low-beta corporates. Similarly, recent price action has left many periphery CDS too steep in the 3-5-year space in our opinion.

Admittedly, the fundamental, value-driven investor adding exposure in credit here will feel no more comfortable than a fish out of water, but for now there probably is no escaping the liquidity lure.

Figure 4. 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 5. Citi Investment Views

Bp, As of 18/07/12	Current	1mth	3-6mth	Long-term
iBoxx € Corp	170	160	140	125
iTraxx Main	130	120	115	100
Crossover	545	515	490	450
3s5s IG CDS curve	40	35	30	20
5s10s IG CDS curve	30	25	20	10
Basis*	5	10	10	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

Figure 6. Citi Investment Matrix, Detailed Scores

Category	Score	Weight	Comment / view
<b>News</b>	<b>-0.2</b>	<b>25%</b>	
Visible agenda	-0.1	17%	Headline frenzy has lessened. Market sensitivity reduced into year end
Greek renegotiation	-0.5	4%	Citi still sees high Grexit risk medium-term, but we expect the issue will be deferred for now
Spanish / Italian bailout request	0.5	4%	Spain biding its time. Some market pressure may be necessary, but systemic implications reduced
Banking union negotiations	-0.5	3%	Expect delays to implementation - and in turn to ESM ability to recap banks. Probably consensus
US fiscal deficit / debt ceiling	0	2%	Likely to be last minute again and subject to market pressure, but not an immediate market negative
2nd Portuguese bailout	0.5	1%	Probably won't include PSI given fragile market conditions
Chinese slowdown, commodity prices	-0.5	3%	Flow of headlines will probably remain negative at least until new leadership is in place
Potential agenda	0.0	3%	
Middle East tension	-0.5	1%	Doesn't seem priced in beyond the oil market. Downside risks, but imminent action increasingly unlikely
Bank bail ins	0.5	1%	Bail-ins still not getting much political traction
EMU breakup	0	1%	ECB actions increase interdependencies, but if even one country leaves it could destabilize others
Micro event risk	0	0%	Very small
Macro event risk	-0.5	2%	Reduced, but what remains is mainly negative now that CBs have blinked
Economic surprises	-0.5	3%	Citi forecasts suggest eco. surprises will retain a neg. bias
<b>Positioning</b>	<b>0.8</b>	<b>35%</b>	
Credit survey positions	0	7%	Progressively less defensive in recent months. Expect low risk app. into year end.
Credit survey inflows/outflows	1.5	7%	Inflows holding up well; funds still cash rich. CB liquidity should prompt further inflows
Cash levels	1	7%	Reduced sharply by issuance, but still higher than normal
Market trading patterns	-0.25	3%	Recent demand mostly real money, but Street not trading short either
Primary market issuance	0	4%	Record issuance in September. Expect more near-term, but long-term volumes subdued
Central bank liquidity	1.5	7%	Market preempting the intervention, but effect likely to last at least while liquidity injections ramp up
<b>Solvency factors</b>	<b>-0.1</b>	<b>20%</b>	
Systemic / idiosyncratic risk environment	0	7%	Tail risk not perhaps reduced as much as consensus, but equally CB liquidity underestimated
Economic cycle	-1	5%	Europe is in recession. Global cycle deteriorating faster than consensus
Leverage trends	-0.5	3%	Leverage is low, but bottom-up earnings estimates are too optimistic for H2
Policy environment	0.75	5%	Policymakers realise that inst. frameworks need structural changes, but it'll take time
<b>Valuations</b>	<b>0.3</b>	<b>20%</b>	
Relative to fundamental relationships	-0.25	6%	Our valuations report suggests credit is now fair value to slightly expensive
Relative to history	-1	5%	Cash is at 1yr tight
Relative to equities	1	3%	Credit is moderately wide to equity relationships
Relative to rates / sovereigns	1.5	6%	Low rates & yields likely pushing more money into credit over time

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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