

November 2012

*European credit outlook*

# Unlucky '13?

## An imperfect world priced for perfection

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

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Rich, but poor – an inauspicious starting point

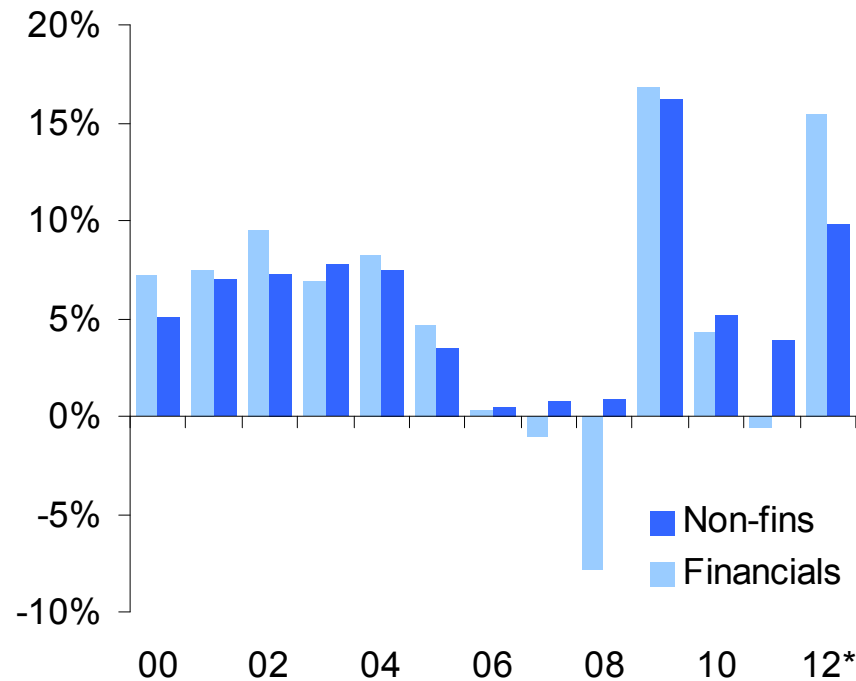
CBs to drown the sorrow?

Better to be good than unlucky

# 2012: A perfect contrarian performance

## The second best year on record ...

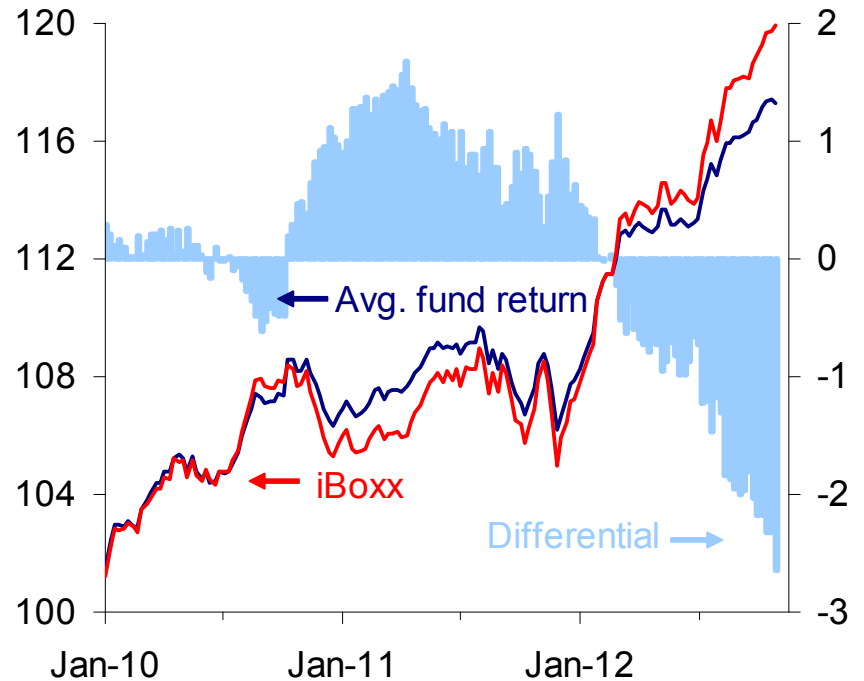
iBoxx € Corporate total return by year



Source: Citi Research, Bloomberg. \*: YTD

## ... caught people out

Cumulative returns, iBoxx vs. IG corp funds, Nov. 09=100



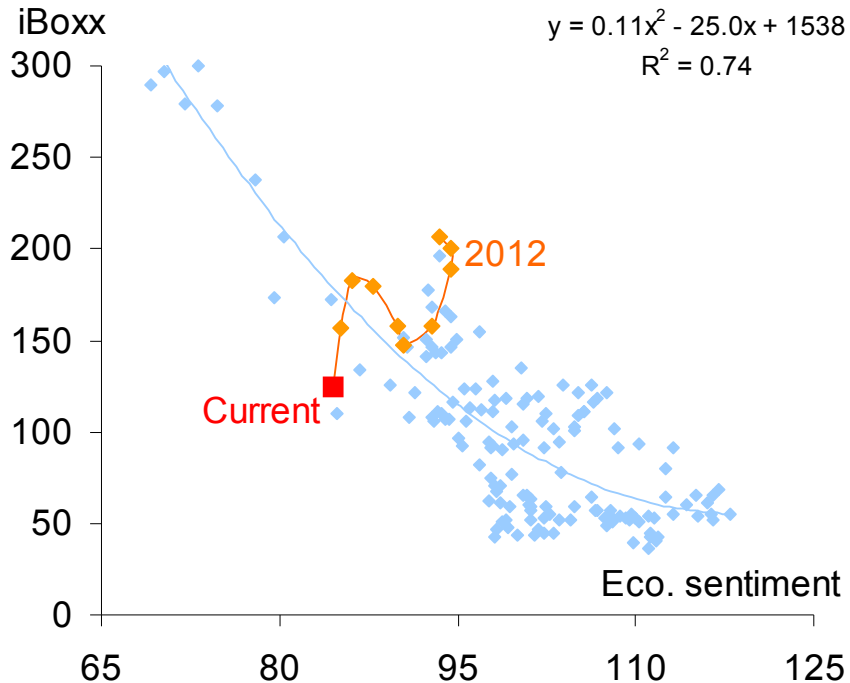
Source: Citi Research, Bloomberg. Note: Based on a sample of about 160 funds benchmarked to an € IG corporate bond index.

## But what do you do for an encore?

# Credit looks pretty much priced for perfection

## Recession no longer priced in

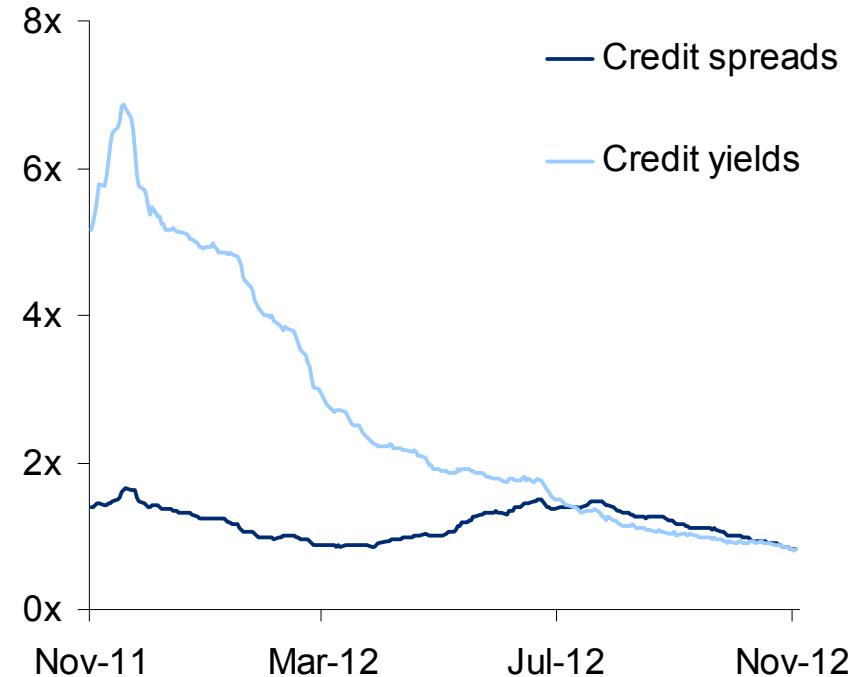
iBoxx € non-fins. vs Eurozone eco. sentiment indicator, 2000-12



Source: Citi Research, Markit, Haver Analytics

## Breakeven to vol near record low

iBoxx € corp. ann. BE/vol ratio, spreads & yields



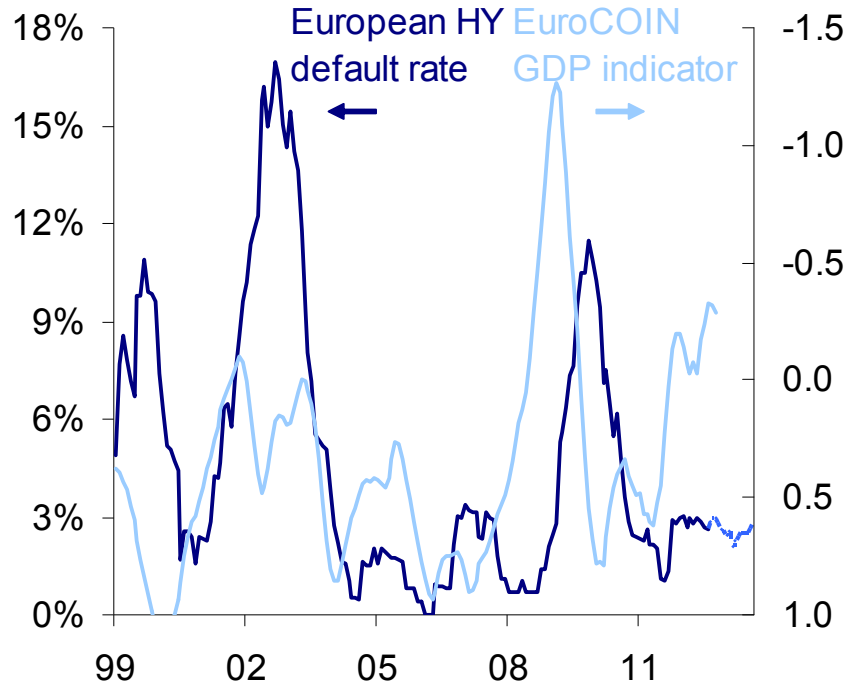
Source: Citi Research, Markit

## Defying the recession with a wafer-thin buffer from carry

# How to ignore the macro backdrop

## Recession not reflected in HY defaults

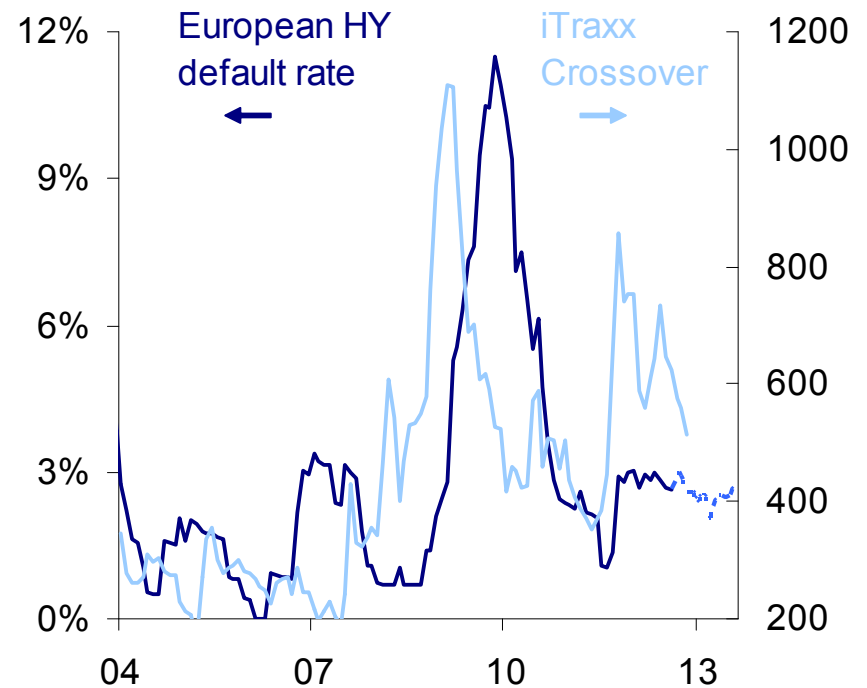
European HY default rate vs EuroCOIN GDP indicator



Source: Citi Research, Moody's, Haver Analytics

## Still upside if defaults stay low?

European HY default rate vs iTraxx Crossover spread (bp)



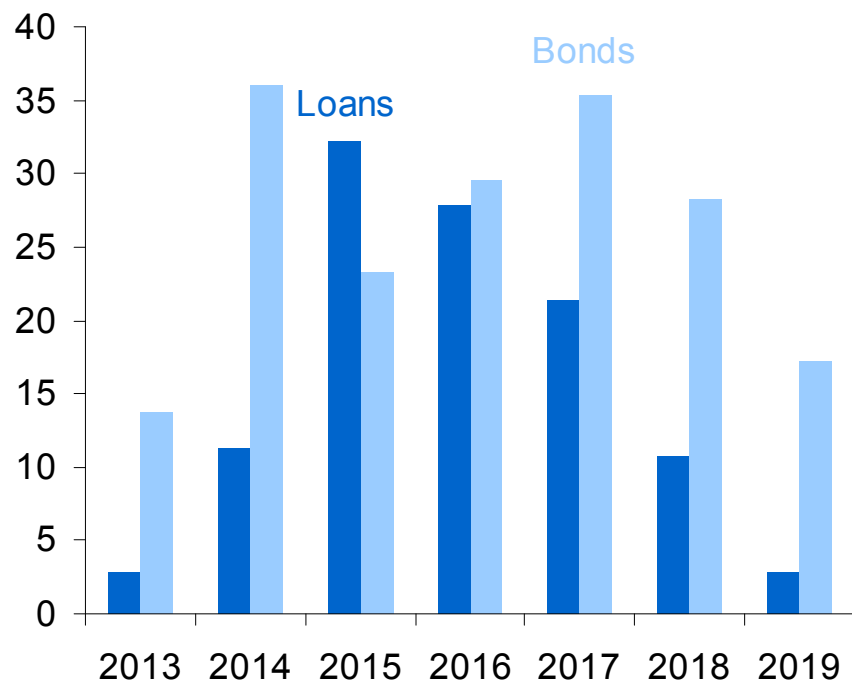
Source: Citi Research, Moody's, Markit

Take comfort in the low level of defaults!

# But why are defaults so low?

## Refinancing has been pushed out

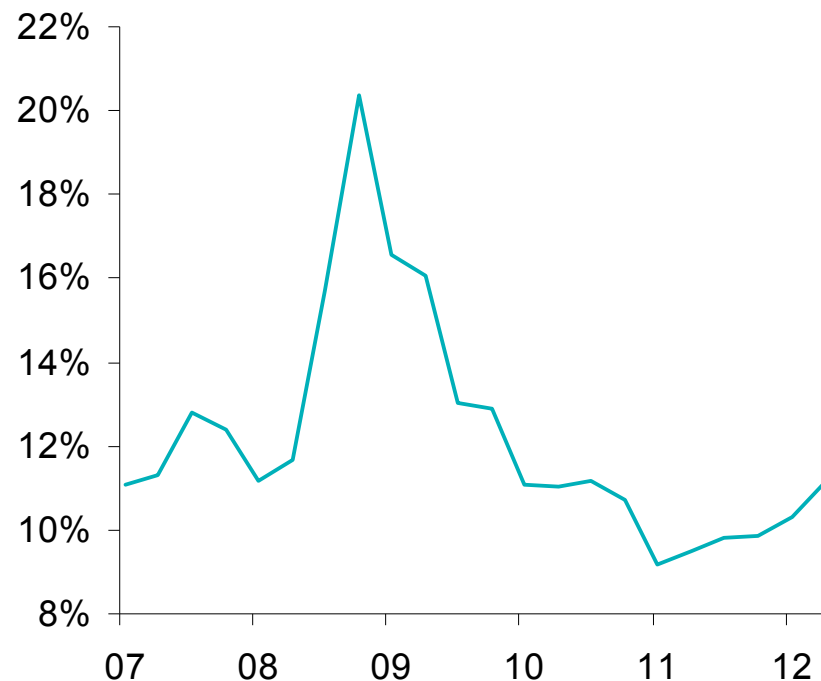
European lev. loan & HY bond maturity profile, € bn



Source: Citi Research, S&P LCD Report Q2 2012, Markit

## Interest expense remains very low

Interest expense, % of EBITDA\*



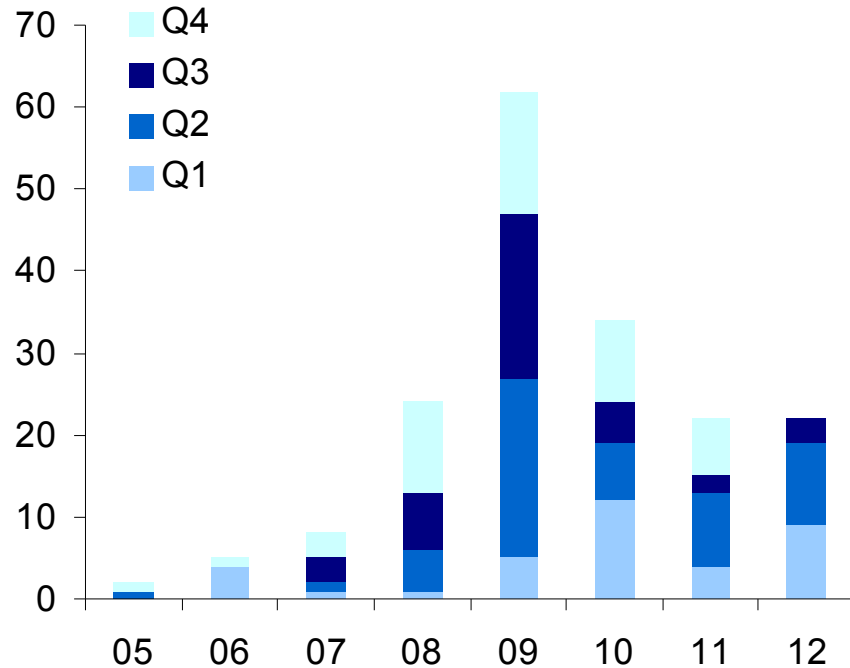
Source: Citi Research, Bloomberg. \*: Based on a sample of 150 European non-financials (mostly IG) in the EuroStoxx 600 index

## Corporate bond market rolling without charging

# Or are they really that low after all?

## Amendments much higher than pre-crisis

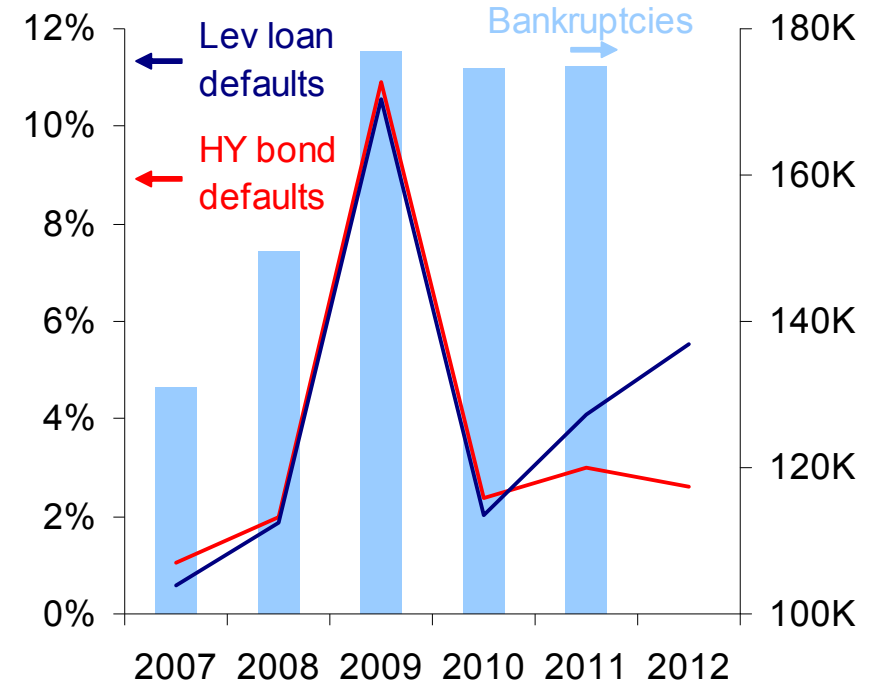
Loan covenant amendment requests (#), Europe



Source: Citi Research, S&P LCD reports

## A different story in lev. loans & bankruptcies

European bond default vs lev. loan default rate & bankruptcies



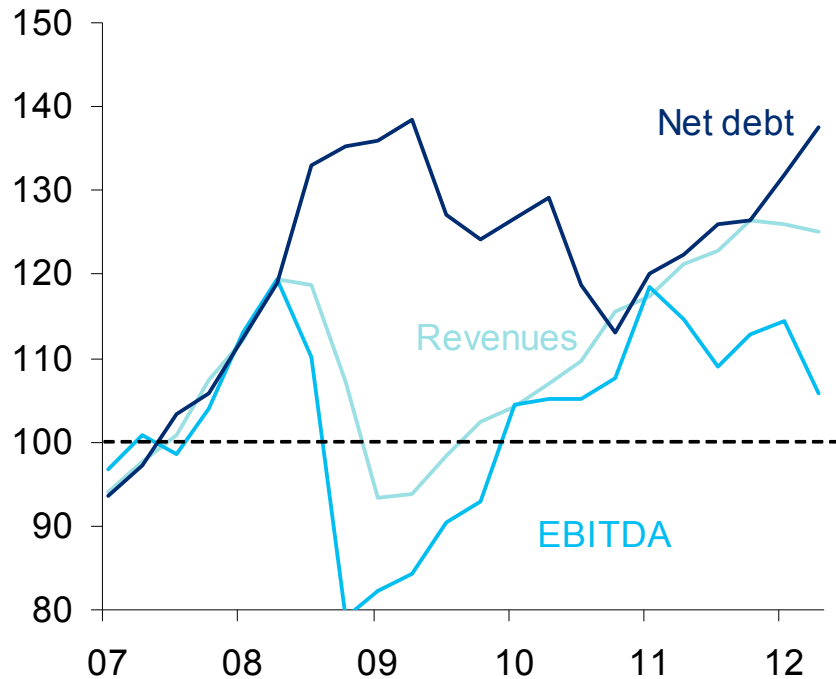
Source: Citi Research, Moody's, S&P, CreditForum.de

Away from the bond market it is a different story

# Micro deterioration increasingly apparent

## Earnings failing to keep up

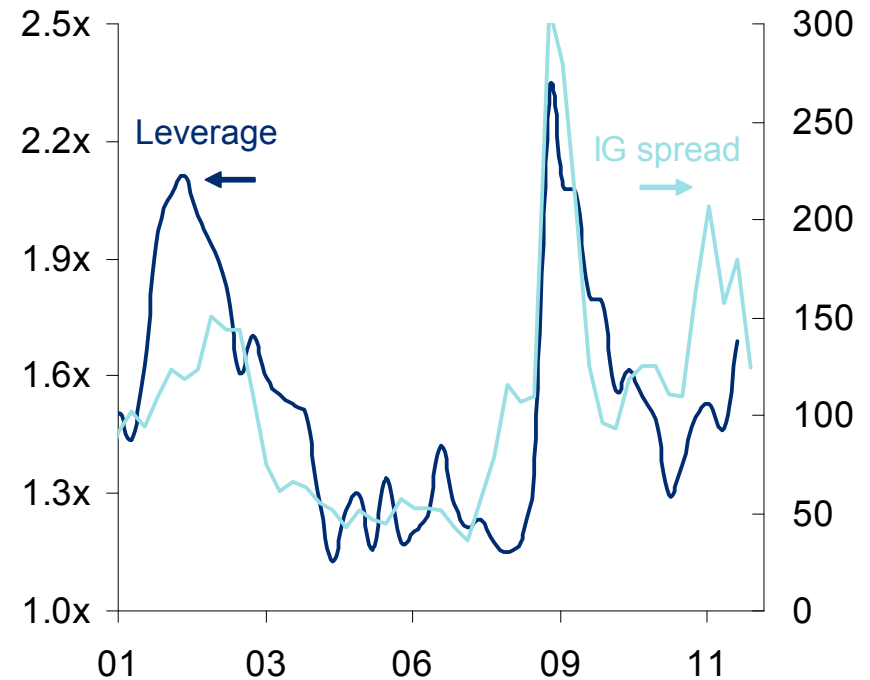
EBITDA, sales & net debt for European corporates ('07=100)\*



Source: Citi Research, Bloomberg. \*: Based on a sample of 290 non-financial corporates in the EuroStoxx 600 index.

## Increasing leverage over spreads

European net debt to EBITDA\* vs iBoxx € IG non-fin. Spread (bp)



Source: Citi Research, Bloomberg, Markit. \*: Based on a sample of 290 non-financial corporates in the EuroStoxx 600 index.

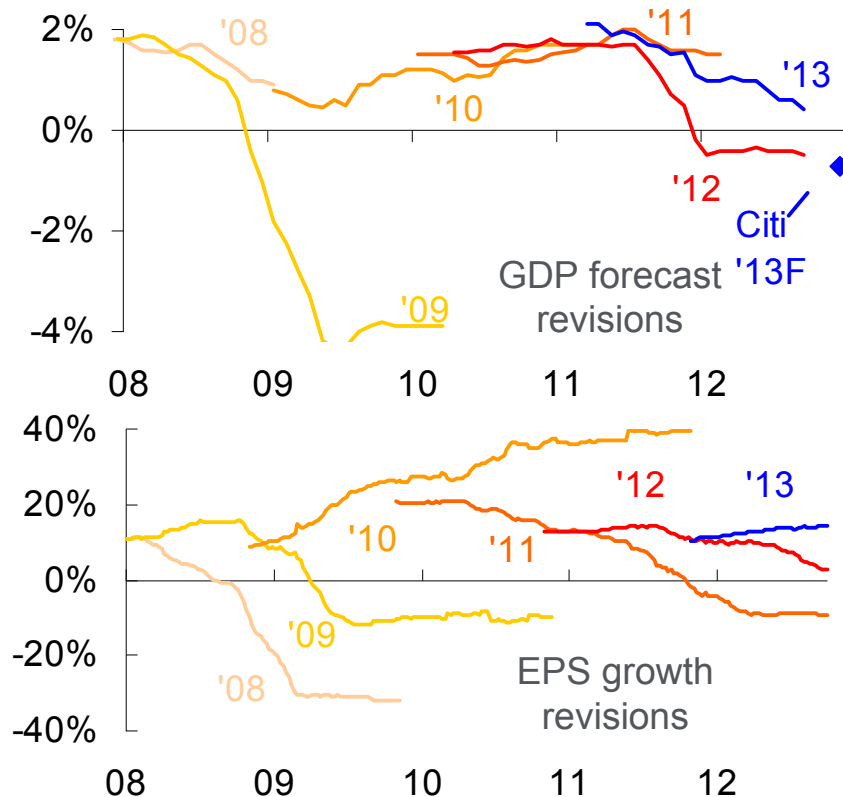
## Tighter spreads belie rising leverage



# Reality bites – there's more to come

## Consensus on earnings vulnerable

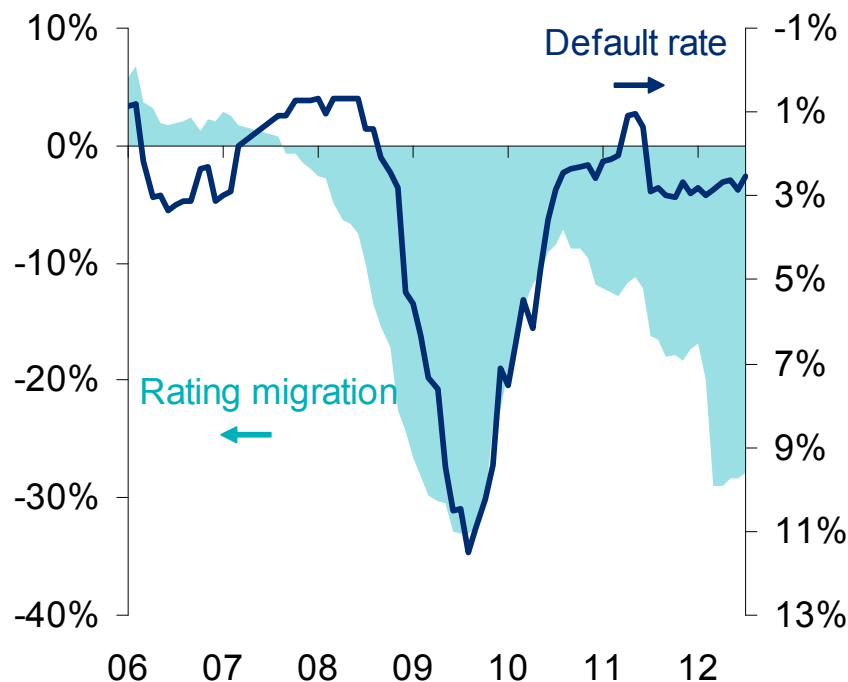
European GDP and EPS forecast revisions, 2008-13F, %



Source: Citi Research, Factset, Bloomberg.

## Ratings sliding again

European rating drift vs. spec. grade default rate, %



Source: Citi Research, Moody's. Note: Rating drift defined as: (Upgrades - Downgrades) / Rated Issuers

## Set for further downgrades in 2013

# Meanwhile, the political balancing act continues

## Policy inconsistencies are obvious

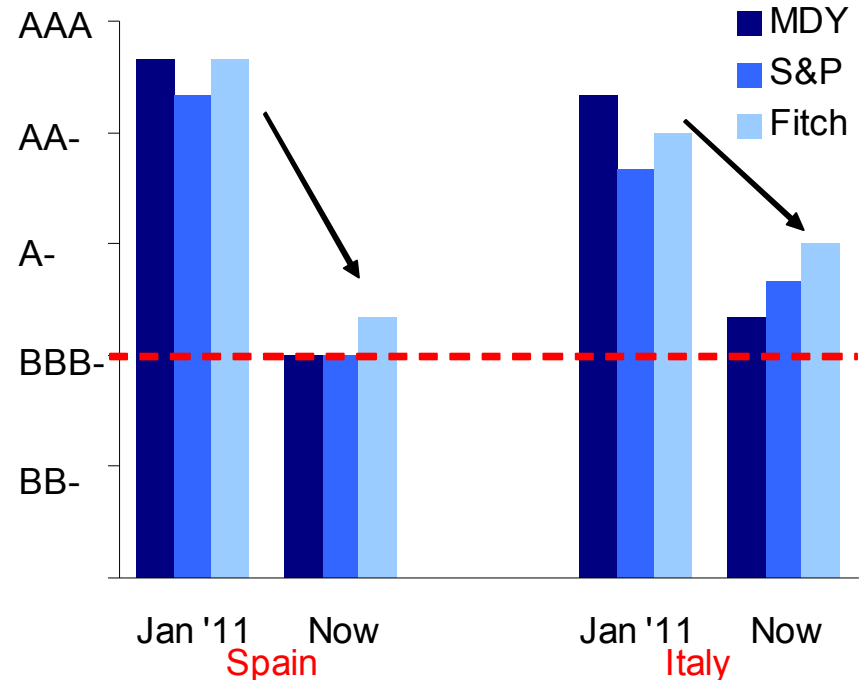
Key policy questions for 2013

- Austerity vs. growth
- Direct ESM bank recaps?
- SSM – how fast, how comprehensive?
- Greek OSI?
- OMT purchases
- OMT pari passu vs 'no monetary financing'
- Growth assumptions in Spanish budget
- Regional fracturing

Source: Citi Research

## Systemic risks linger

Rating transitions, 2011-2012



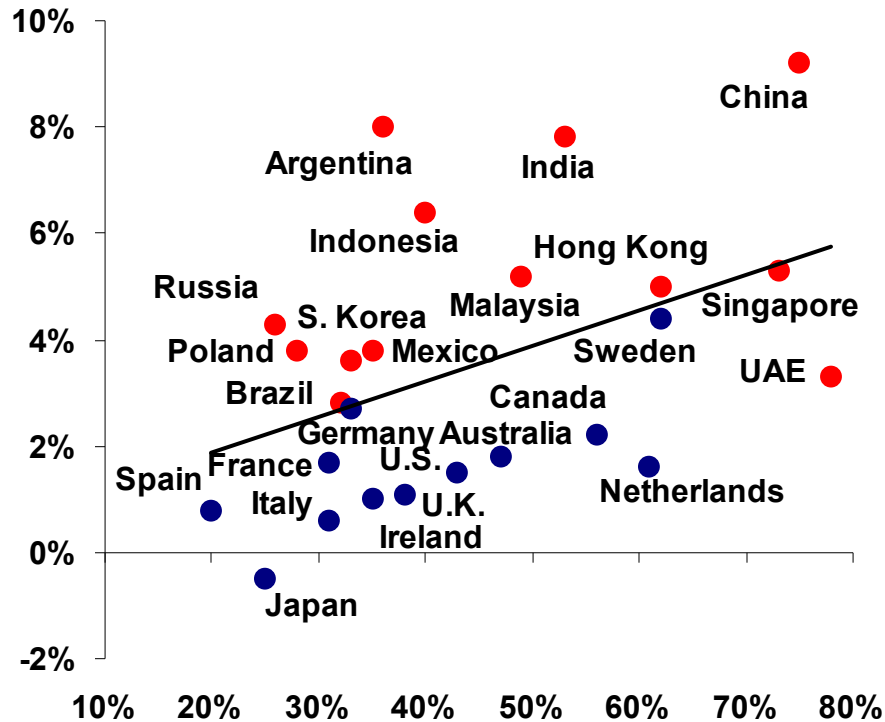
Source: Citi Research

Any missteps prone to cause a fall in markets

# As voter patience runs thin ...

## People want growth!

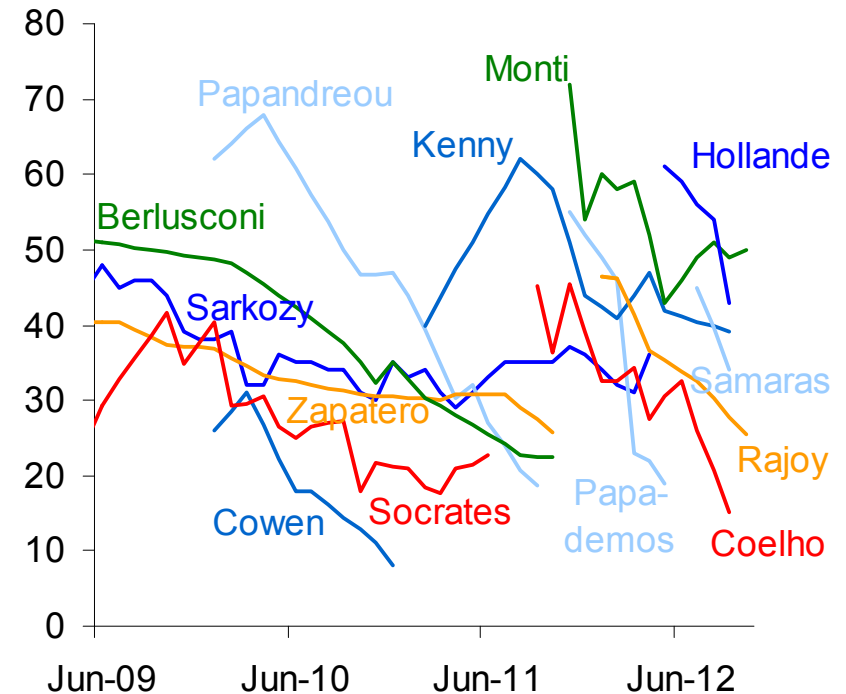
2011 growth vs "trust in government" polls



Source: Edelman Trust Barometer, Haver Analytics.

## Austerity doesn't get you re-elected

Incumbent approval ratings, %



Source: Citi Research, national press, polling agencies

... political room to manoeuvre dwindles

Rich, but poor – an inauspicious starting point

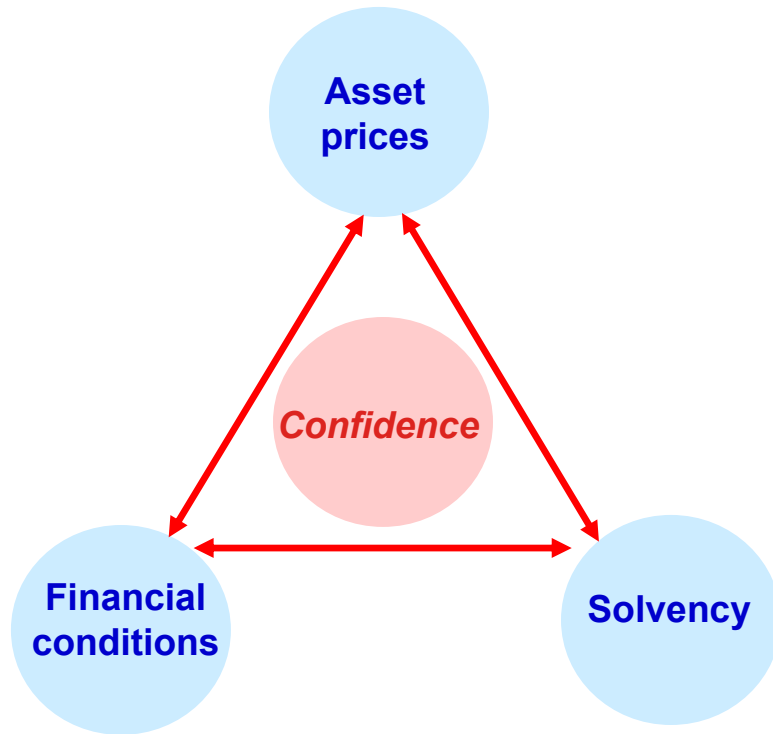
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# Sustaining the least bad equilibrium

## When a nominal problem turns real

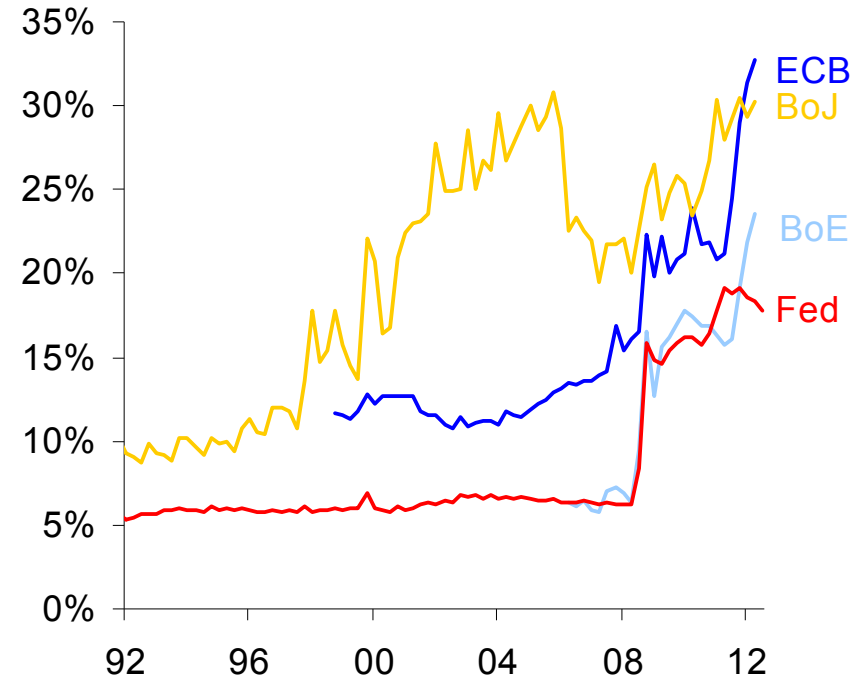
A vicious triangle



Source: Citi Research

## Propping up the system

Central bank total assets to GDP, %



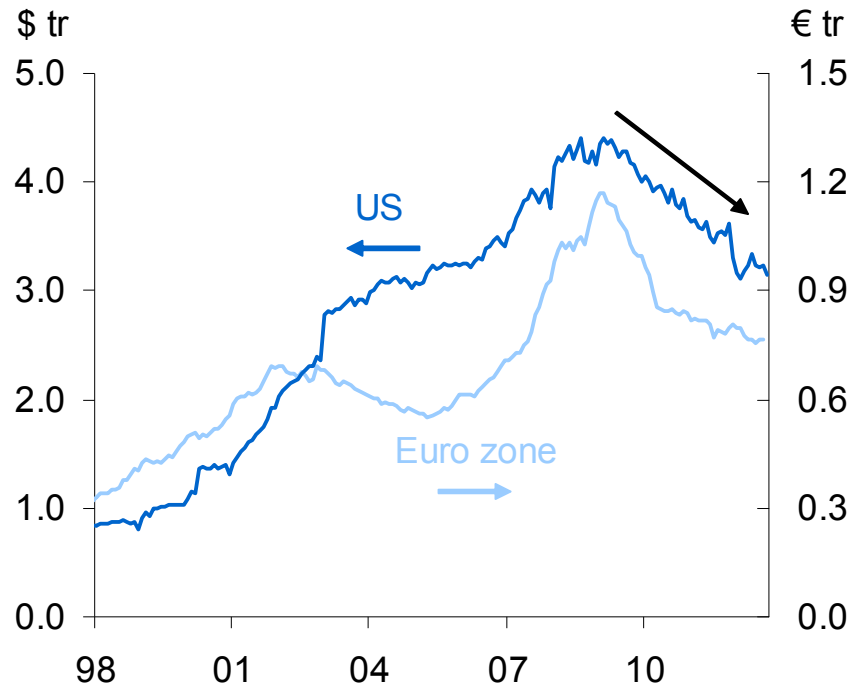
Source: Citi Research, Haver Analytics

## Central banks countering self-reinforcing dynamic

# From QE to asset prices – the “demand effect”

## Faced with no returns ...

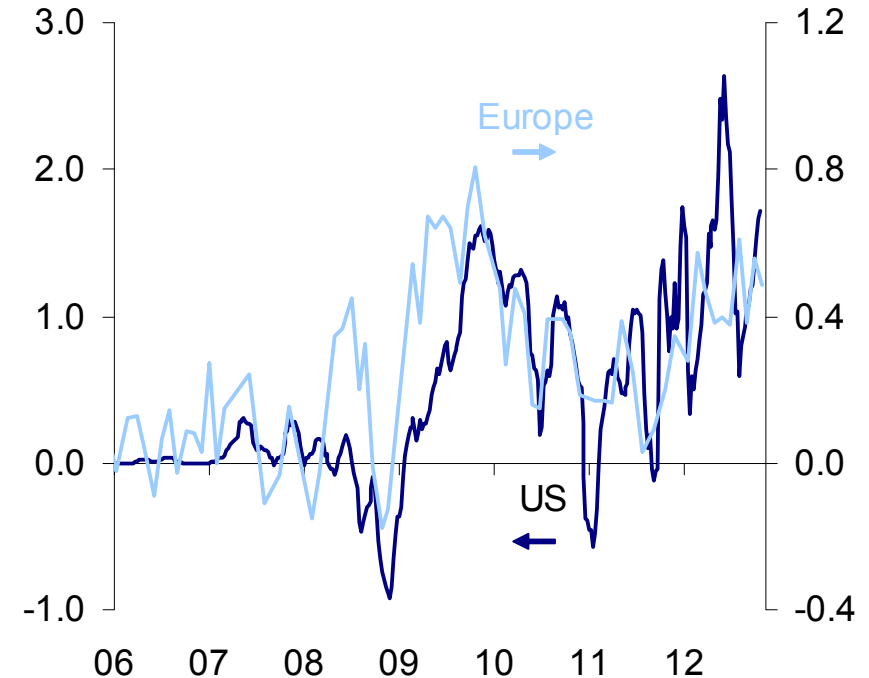
US and European outstandings in money market funds



Source: Citi Research, ICI, Haver

## ... people opt for the risky upside

US weekly mutual fund inflows into corp. credit (\$ bn) vs reported inflows among € investors in Citi's credit survey



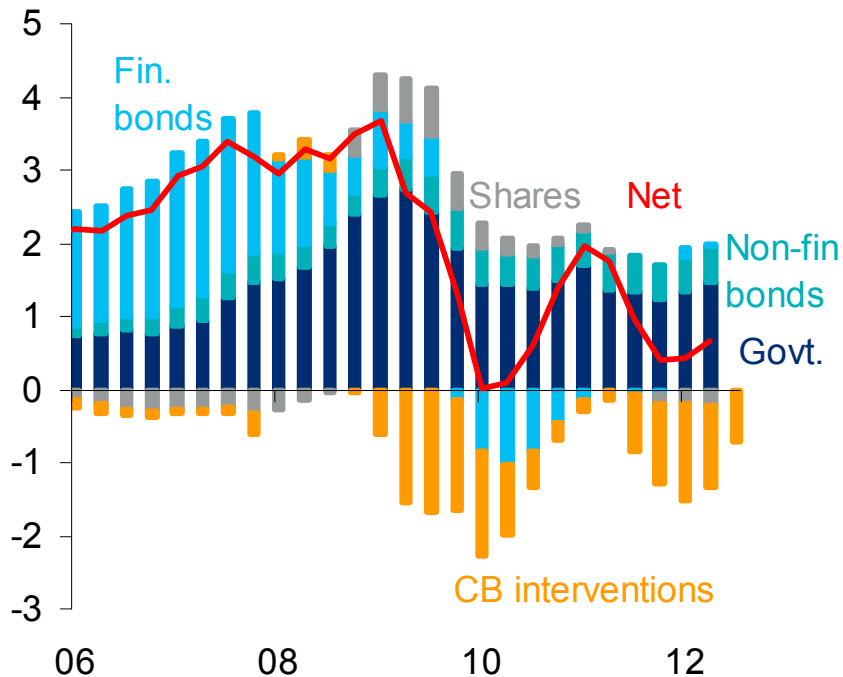
Source: Citi Research, EPFR

Money being forced into risk assets

# From QE to asset prices – the “supply effect”

## CBs constraining supply of new securities

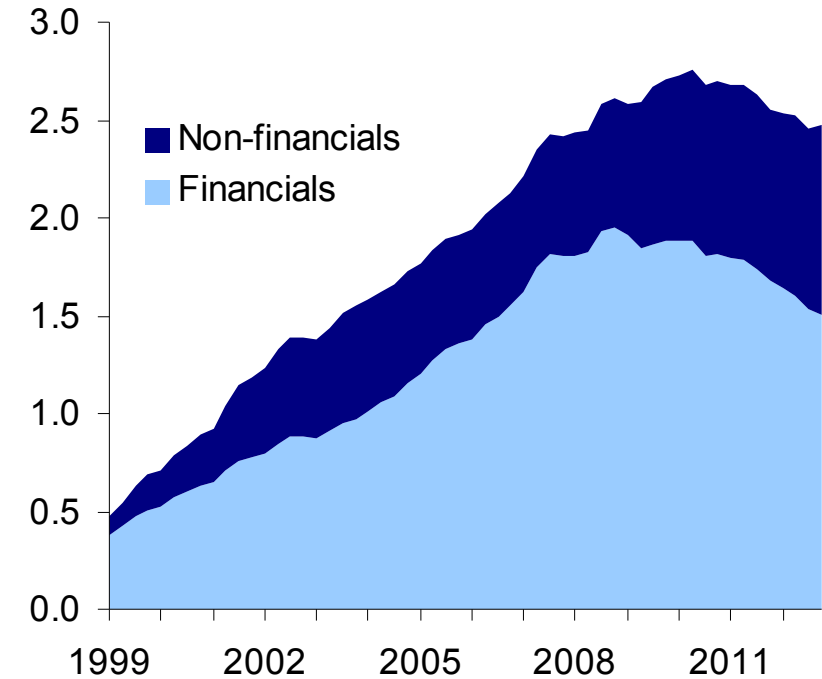
Net iss. of new securities vs CB\* interventions, 12m rolling, \$ tr



Source: Citi Research, Haver. \*: Federal Reserve & ECB

## € credit market is still shrinking

Outstanding in € IG corp. credit, € tr



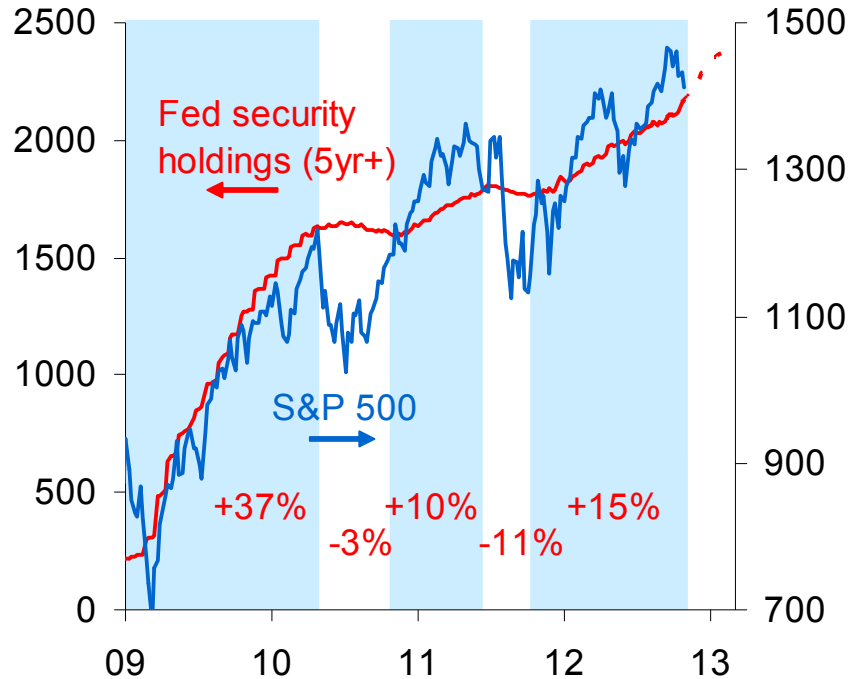
Source: Citi Research, Dealogic

## Central banks shrinking the investible universe

# Hey presto!

## QE is still propping up US markets

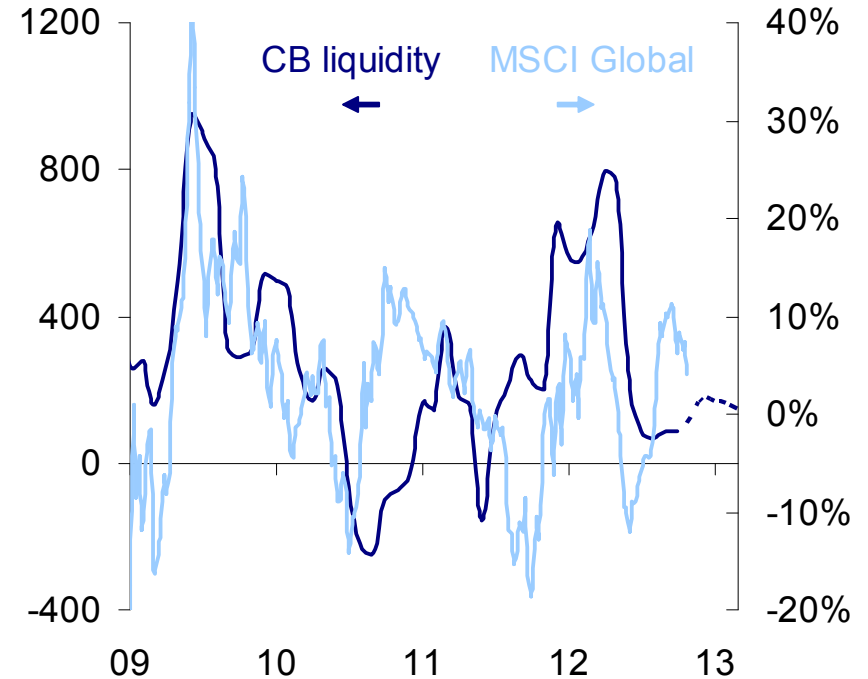
Fed's holdings of securities (5yr+ maturity) vs S&P 500



Source: Citi Research, Haver

## CB liquidity propping up global markets

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



Source: Citi Research, Haver. Note: Global liquidity captures the sum of Fed, ECB, BoJ and BoE asset purchase schemes and the LTROs for the ECB

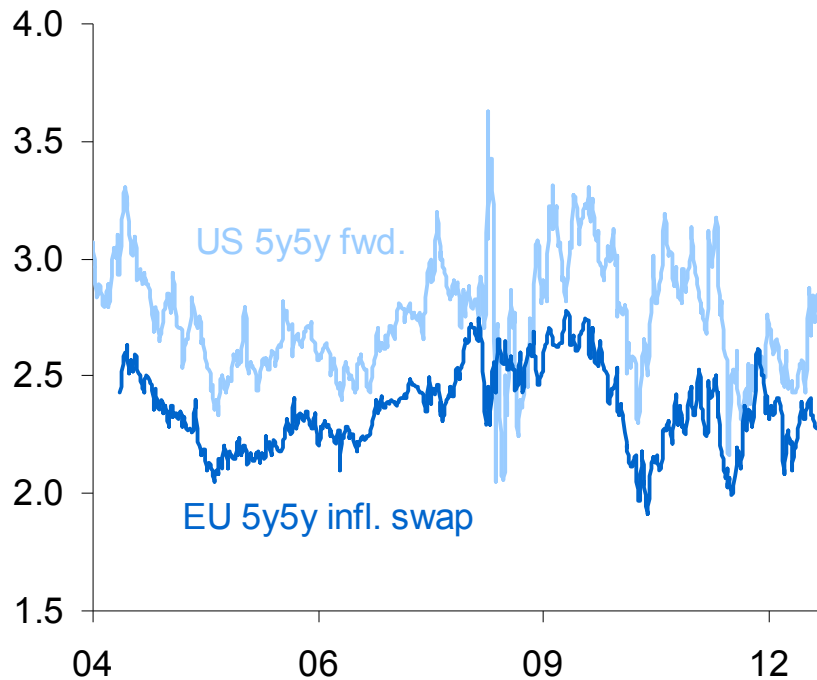
## Spot the impact on asset prices



# Call it financial repression or not ...

## Inflation expectations in check

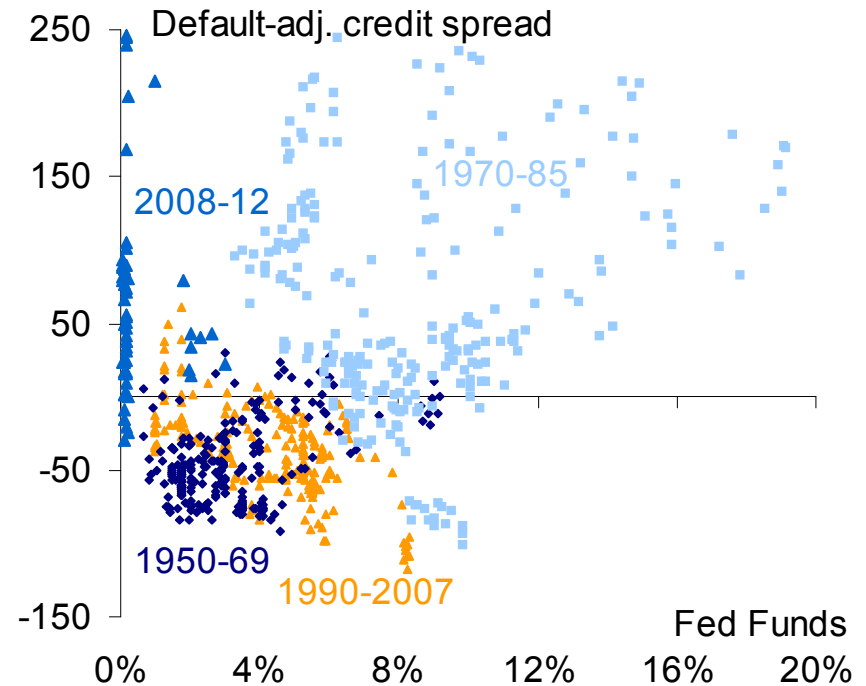
US 5y5y forward BE inflation vs EU 5y5y inflation swap, %



Source: Citi Research, Bloomberg

## Normally low yields => low credit risk premia

Default-adj. US Baa spread (bp)\* vs Fed Funds rate, 1950-2012



Source: Citi Research, Haver, Moody's. \*: Baa credit spread – predicted credit spread in an OLS regression with US default rates.

...credit likes an environment where yields are structurally low

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# Beware of modal forecasts!

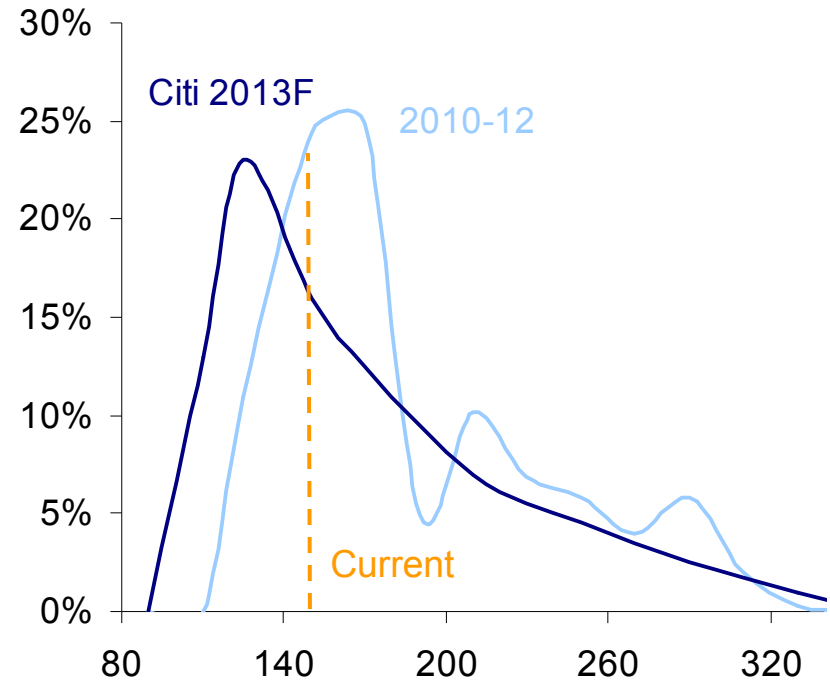
Modest tightening on more stimulus... ...but one headline can render forecasts useless

Citi Credit modal forecasts for 2013

iBoxx spread distribution 2010 w. stylised 2013 forecast

	Current	End-'13F	Total return
iBoxx € Corp	150bp	125bp	2.9%
iBoxx € HY	540bp	425bp	8.0%
iTraxx Main	120bp	105bp	
iTraxx Xover	500bp	425bp	

Source: Citi Research



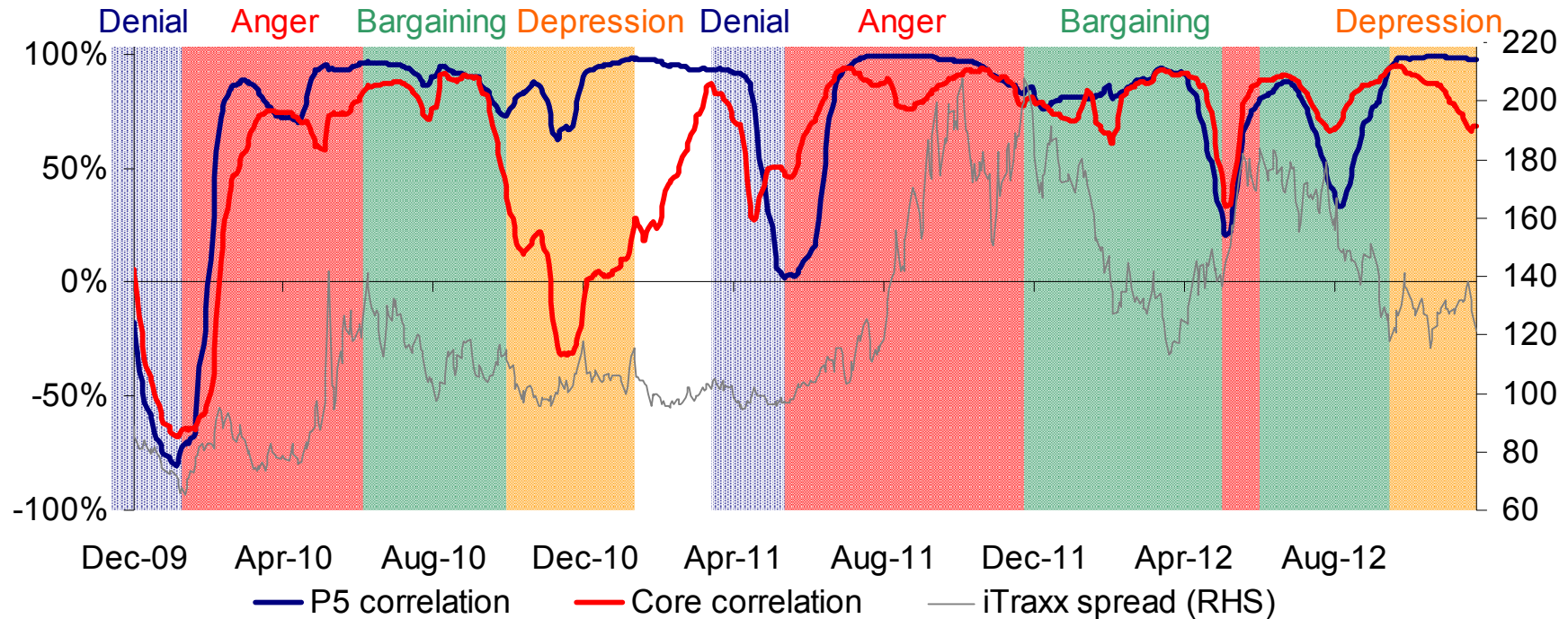
Source: Citi Research, Markit

Point estimates mask a lop-sided distribution

# As long as solvency remains in question

## Flipping between idiosyncratic and systemic risk environments

Correlation of SovX constituents with periphery and core corporates respectively vs iTraxx Main, bp



Source: Citi Research, Markit

We're still trapped in the grief cycle. What do you do?

# Take $\beta$ to generate excess return?

How can you generate 60bp of excess return? Where would you like to 'be'?

Assumes spreads tighten by ~20% generically\*

Stylised 'desirable' sectoral characteristics

	BBBs	Sub debt	Periph. debt		Staple products	Large orderbk.	Low leverage	Deleveraging	Stable margins	Consolidated	Not periphery	Global market
iBoxx weighting	40%	11%	13%	Cons. Goods	✓	✓			✓		✓	
Req. portfolio weighting	66%	22%	39%	Oil & Gas		✓	✓			✓		✓
Req. overweight	26%	12%	26%	Health Care	✓				✓		✓	✓
				Basic Mat.		✓				✓	✓	
Portfolio $\beta$	1.20	1.18	1.44	Industrials			✓			✓		✓
Breakeven (% widening)	27%	24%	23%	Utilities	✓							
				Cons. Svs.					✓			
				Technology			✓					
				Banks				✓				
				Insurance				✓				
				Telecomm.				✓				

Source: Citi Research, Markit. \*: As per Citi forecast on p. 20

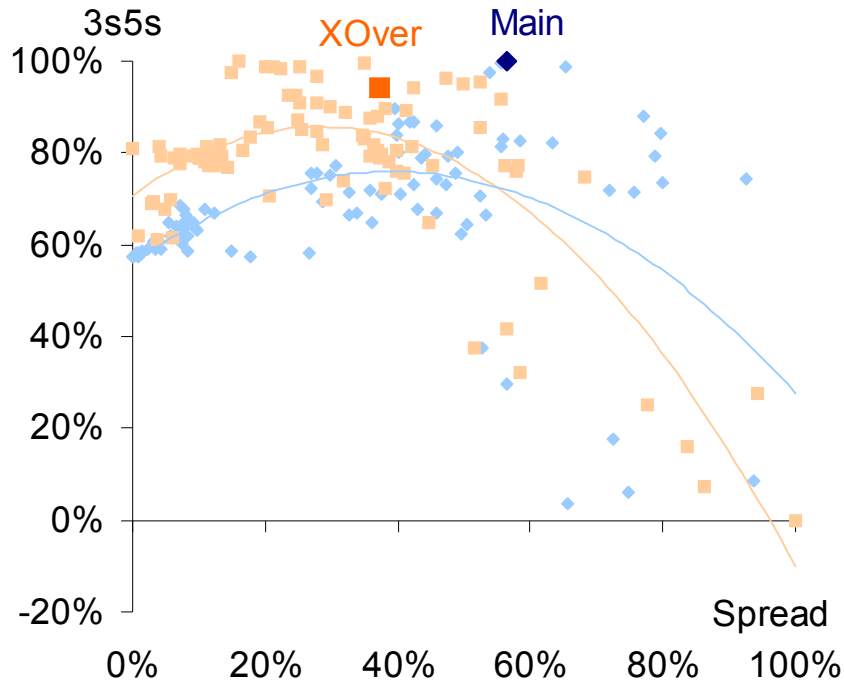
Source: Citi Research

Only if you have nerves of steel and a long-term horizon

# Take advantage of market distortions?

## Front end still looks crowded ...

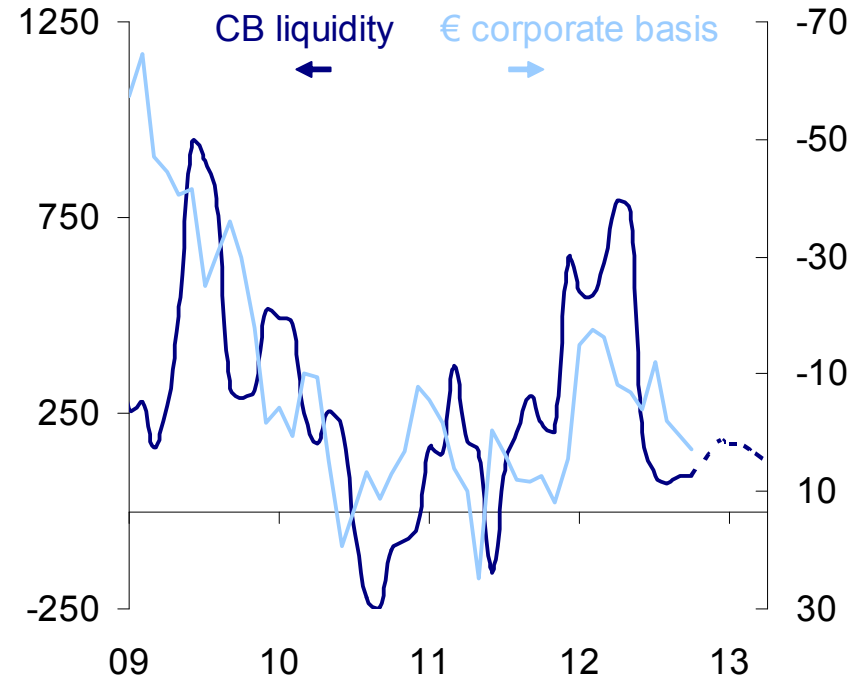
Main & XOver - level vs 3s5s differential, percentiles from '05



Source: Citi Research, Markit

## ...but neg. basis goes against the CBs

€ corporate credit basis vs CB liquidity injections (\$bn), 3m chg.



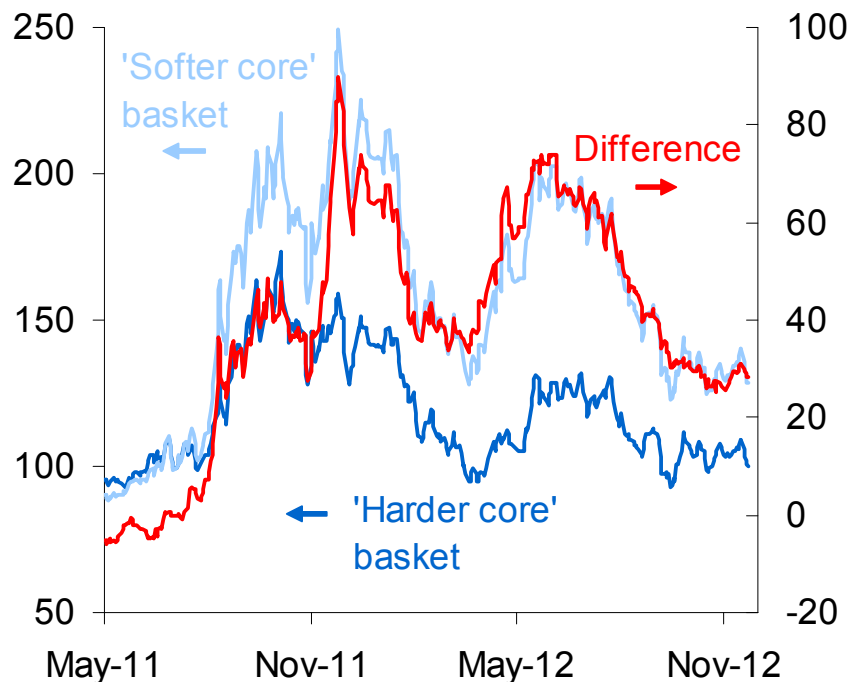
Source: Citi Research, Markit, Haver

Curves unlikely to get steeper; basis is a liquidity trade

# Move up in “quality” at low cost

## Systemic risk priced out of “softer core”

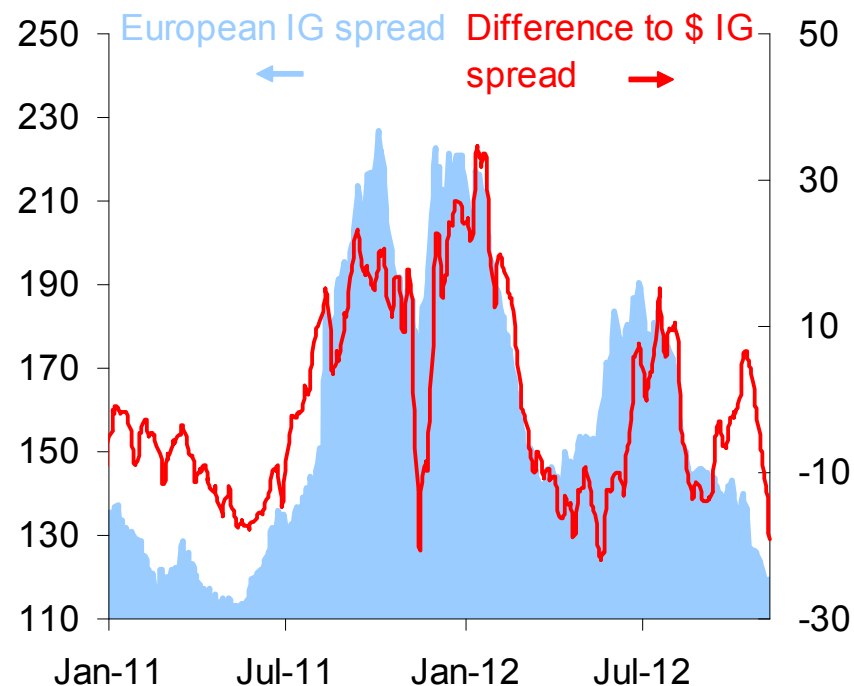
Basket of “softer” vs “harder” core corporates, bp



Source: Citi Research, Markit. \*: “Softer core” consists of select French and Belgian credits, “Harder core” consists of select German, Dutch, Swiss and UK credits.

## Systemic risk priced out of € credit

US vs Euro Broad Investment Grade Non-fin. Index, bp



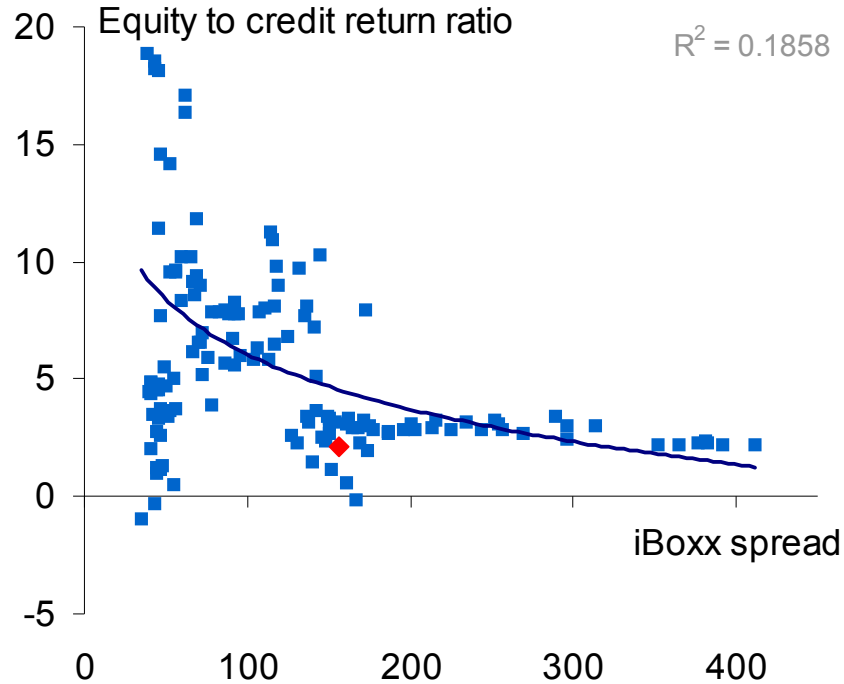
Source: Citi Research, YieldBook

## Cheaper now to position against European policy mishaps

# Asymmetries can work in your favour

## Asymmetry: Debt-equity ratio isn't linear

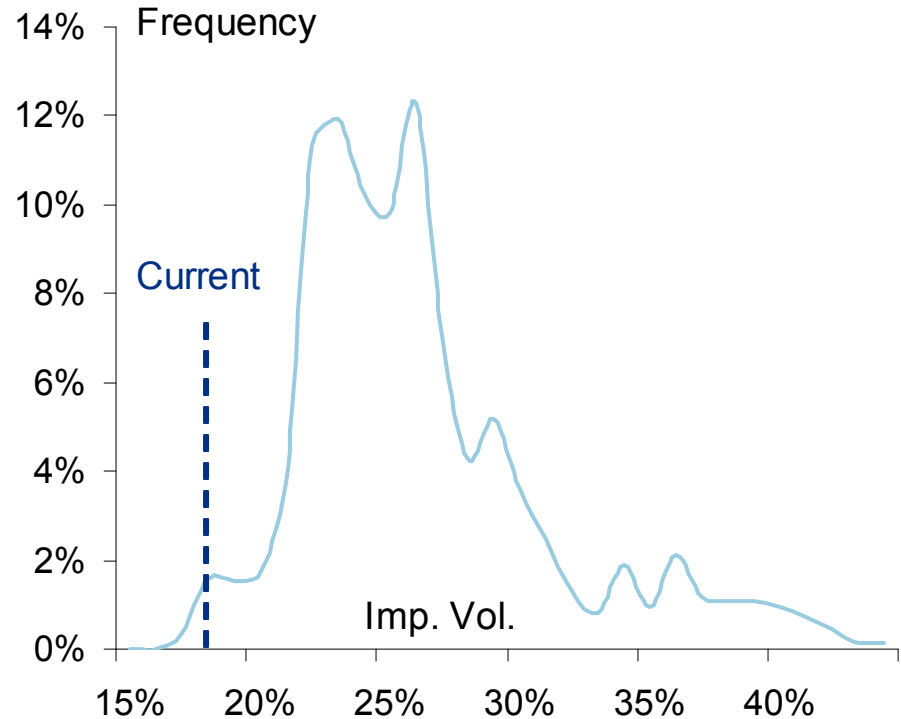
12M credit-equity return ratio vs iBoxx spread, 2000-2012



Source: Citi Research, Bloomberg, Markit

## Long-term imp. vol. doesn't get much lower

3-year histogram of 1y ATM implied vol on SX5E



Source: Citi Research, Bloomberg

Carry apart, some hedges seem very one-sided

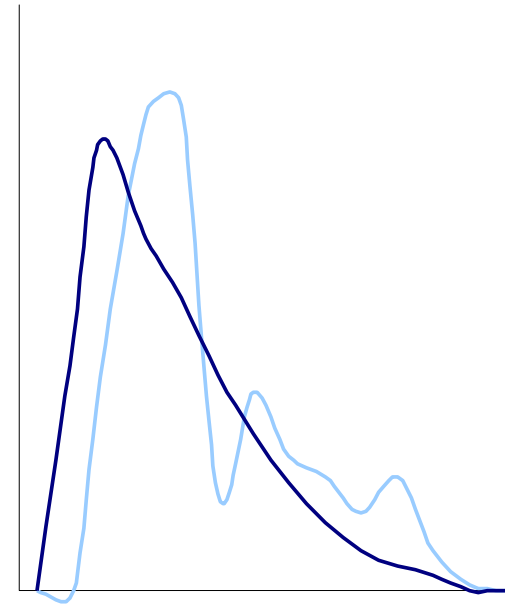
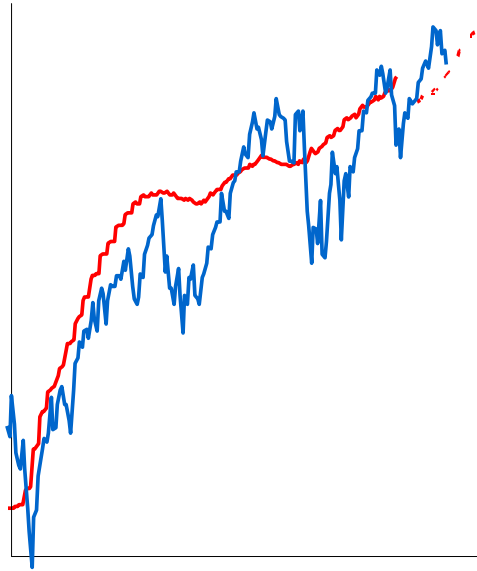
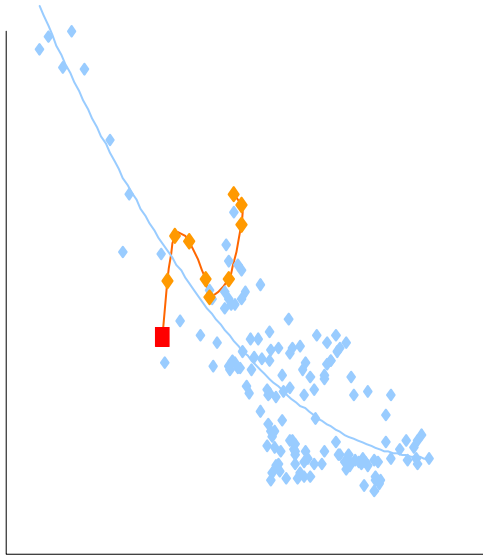


# Conclusion

Rally increasingly at odds with fundamentals

Yet central banks will squeeze you to take more risk

But not without periodic resistance



Source: Citi Research

Positive returns? Probably  
Better entry points? Almost certainly

# Appendix A-1

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