MARKET OUTLOOK

March 2013

Rising rates and the effect on credit spreads

What would happen if rates were to rise by year-end? This question might be one of the main concerns in the minds of investors. In the US, there is some evidence of a recovery, and Citi analysts are cautiously optimistic – despite headwinds from debt ceiling negotiations and the imminent sequestration. Although the Federal Reserve (Fed) has put short-end rate hikes on hold until the unemployment rate reaches 6.5%, there is a possibility that long-end rates may rise on the back of increasing investor optimism. Indeed, US Treasury 10-year yields have risen above 2% on several occasions recently, and Citi analysts expect the year-end level to be at 2.6%

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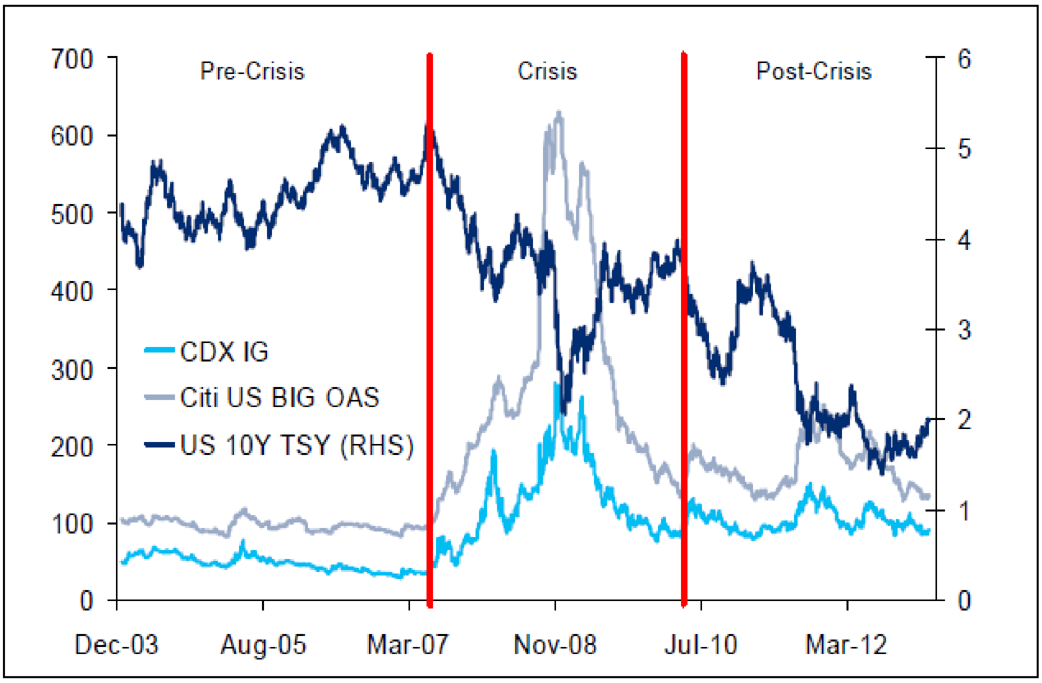
Rising rates and the effect on credit spreads

So what will this mean for credit spreads? Will they be compressed, or will corporate yields rise in tandem, keeping spreads constant or making them go slightly wider? How should investors position themselves for rising rates?

Figure 1: The 3 regimes of relationship between credit spreads and 10-year US treasury yields



Source: Markit, Yieldbook, Citi Research as of 20 February 2013.
(CDX IG – CDX Investment Grade Index; Citi US BIG OAS – Citi US Broad Investment Grade Option-Adjusted Spread; US 10Y TSY – US 10-year Treasury yield)

Three regimes with regard to the rate/credit spread relationship

Looking at the relationship between daily investment-grade bond spreads and US Treasury 10-year yields from 2004 till date, there is a slightly negative relationship between 10-year rates and spread levels, although not strong enough for rates to influence credit spreads significantly.

To understand the relationship further, Citi analysts identify three distinct regimes: a pre-crisis period, a crisis period and a post-crisis period, as shown in Figure 1. The dependency of credit spreads on the level of rates was strong during the period of the financial crisis (2008-2009) due to the flight-to-quality phenomenon, but weaker in the pre- and post-crisis periods. In addition, the factors driving credit spreads appear to behave differently in pre- and post-crisis periods.

The main driver during the crisis period was the level of US Treasury 10-year yields which have a strong negative correlation with credit spreads, as would be expected. As10-year yields dropped, credit spreads kept widening in response to the flight-to-quality exhibited by investors.

During non-crisis periods, inflation expectations and the shape of the yield curve become important. The influence of these factors is different during pre- and post-crisis periods.

Rising rates and the effect on credit spreads

In the pre-crisis period (2004-July 2007) – the “old normal” – the main factor influencing credit spreads was the slope of the yield curve, while inflation expectations did not contribute greatly. During this period, the US economy was growing strongly, and in response, the Fed raised the funds rate from a low of 1% (post-2001 recession) to 5.25%. This flattened the yield curve considerably while credit spreads tightened in response to a growing economy.

In contrast, looking at the results for the post-crisis phase – the “new normal” – credit spreads are mainly influenced by inflation expectations. The slope of the yield curve (or the difference between the 3-month and 10-year Treasury yields, as we have defined it) has become less relevant, since the short end of the curve has been artificially kept low by the Fed, which implies that only the long end (10-year) is important in determining the slope.

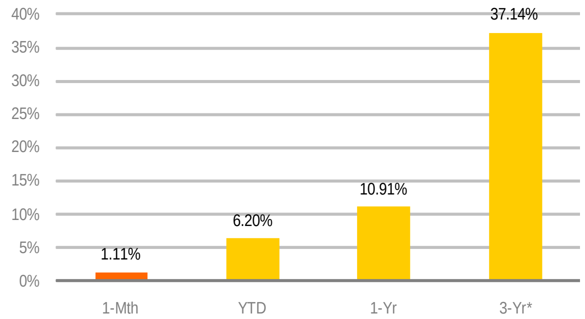
What will happen if 10-year US Treasury yields were to rise to 2.6% by year end?

On balance, Citi analysts believe that we may end the year still in the “new normal” regime, given that the current economy is still suffering from overcapacity and while deflation fears have subsided, we could continue to see weak economic growth. Based on Citi rates analysts’ projections, the 2-year US treasury rate is anticipated to end the year at 0.55% (up from the current 0.27%), and 10-year rate to reach 2.6% by the end of 2013 (assuming an optimistic growth scenario that results in a 6.5% unemployment rate by 2014).

If US 10-year treasury yield rise to 2.6% by year-end, Citi’s models show that cash investment grade spreads should tighten to 116 bps and synthetic spreads to 76 bps. Indeed, Citi analysts believe that a modest rise in rates and inflation expectations should produce a modest tightening in credit spreads.

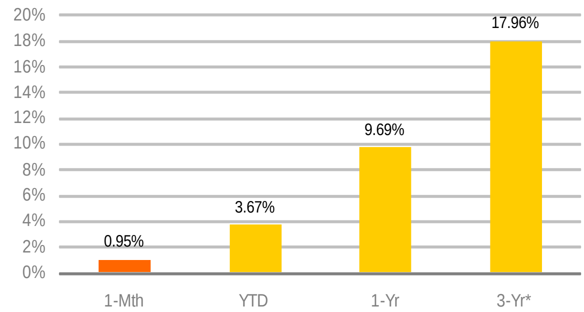
Equity markets

Chart 1:
S&P 500 Index



*Denotes cumulative performance
Performance data as of 28 February 2013
Source: Bloomberg

Chart 2:
Dow Jones Stoxx 600 Index



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Performance data as of 28 February 2013
Source: Bloomberg

United States
Fed may begin to phase down QE late in 2H13

- Support for expansion has improved with widespread hiring, more effective monetary accommodation as reflected in buoyant financial markets, and a strengthening contribution from housing. Short-term volatility due in part to weather distortions has provided an extra lift to 1Q13 GDP but higher taxes are likely to weigh on consumers and overall growth through mid-year. Citi analysts do not expect last minute action to avert scheduled sequestration but delays in implementation could likely allow for modifications that may limit fiscal drag.

- The Federal Reserve's (Fed) aggressive forward guidance and open-ended bond-buying have yielded the longest stretch of accommodative financial conditions since the late-1990s. The drag from fiscal restraint and policymakers' high bar for satisfactory job growth will likely sustain QE at an elevated pace through 1H13 but may begin to taper the pace in 2H13. High unemployment and low inflation suggest no start to exit strategies through 2014.

- Meanwhile, the S&P 500 has tacked on nearly 7% since the beginning of the year, but overall IT sector gains have been far less impressive. In spite of this, Citi analysts continue to overweight the sector given better credit conditions, rising capital spending intentions and supportive earnings estimate revisions and valuation.

- Indeed, easier credit drives employment and, in today's world, job growth generally requires equipping employees with tools to do their jobs, thereby encompassing mobile phones, computers, tablets, etc. More interestingly, a study of corporate capex trends highlighted that tech companies are planning to boost their capital investment by more than 10% in 2013, an acceleration from less than 7% in 2012. Hence, it looks like confidence is returning to the corporate sector and especially for technology products and services.

Euro-Area
ECB may cut rates by another 25 bps

- Citi analysts expect GDP growth of -0.5% in 2013 and -0.3% in 2014. After the contraction in 4Q12 GDP (-0.6% QoQ), a stabilisation in GDP in 1Q13 looks likely, but a recovery is not expected in the course of the year. Sentiment data show that the gap between Germany and the rest of the euro area remains large, giving little evidence of positive contagion from improving financial markets into real economic activity in the periphery countries.

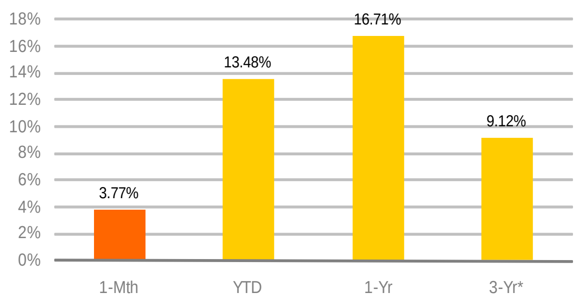
- In Citi's view, the European Central Bank (ECB) is unlikely to provide Fed-style guidance that rates will stay low. In the near-term, the ECB is also unlikely to introduce quantitative easing measures, while the activation of the OMT (open market transactions) depends on government action. With ongoing economic weakness and modest reduction of excess liquidity because of the 3Y LTRO repayments, the ECB may cut the refinancing rate by 25 bps in 2Q. Another cut to 0.25% is anticipated by the year end, probably joined by a cut in the deposit rate to -0.25%.

- From an equity perspective, it made sense to issue equity over debt given the difference between the earnings yield and BBB credit between 1989 and 2001. From 2001 that changed and equity has been consistently higher-yielding than credit — the de-equitisation era. The gap today is wider than anytime during the 2003-2007 period.

- Indeed, CEOs have been cautious since 2008-09. Now, conditions are in place for an increase in corporate activity. More broadly, corporate re-leveraging is expected to pick up. This remains a key part of Citi's re-rating call for equities. Overall, Citi analysts think we are at the start, not the end, of an M&A and re-leveraging cycle.

Equity markets

Chart 3:
Topix Index



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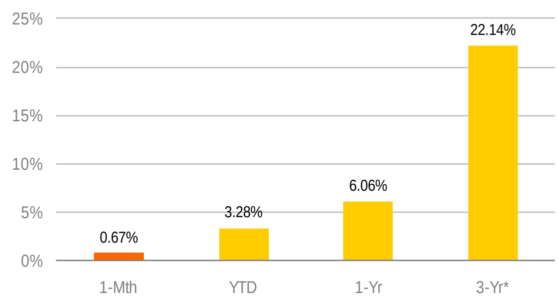
Performance data as of 28 February 2013
Source: Bloomberg

Chart 4:
MSCI Asia ex Japan Index



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Performance data as of 28 February 2013
Source: Bloomberg

Japan
BoJ new leadership to take office on March 20

- The new BoJ governor will take office on March 20. The main policy tools under the new leadership may likely be expanding asset purchases centered on Japanese government bonds (JGBs) further while extending the maximum maturity of JGBs that it purchases beyond three years currently. Citi analysts now expect the new leadership to take these steps at its first policy meeting on April 3 and 4. Meanwhile, depending on economic and financial developments, the BoJ may consider lowering policy rates and/or interest on excess reserves (IOER) going forward.

- Citi analysts expect 2014 to be a very difficult year for the BoJ. First, economic activity will likely slow sharply amid large fiscal drag (more than 2% of GDP) stemming from declines in public works spending and the 3%-point consumption tax hike slated in April 2014. Second, inflation appears unlikely to accelerate as clearly as the BoJ currently anticipates. The BoJ’s latest economic projections show core inflation of +0.9% in fiscal 2014 adjusted for the consumption tax impact. However, actual inflation likely will undershoot these forecasts, putting pressure on the BoJ to expand monetary accommodation.

- Japan’s revision index has risen since October 2012, and in January 2013 it entered positive territory. However, Citi analysts believe that the revision index is unlikely to rise from here. Yen weakness against the dollar has begun to prompt complaints from other countries. Indeed G-20 members took the harder line on manipulating currency rates for competitive purposes even though they did not single out yen weakness. Also, it is likely to be more difficult for firms to produce positive surprises with the economy having entered a recovery phase.

- Since 2009 there has been a strong relationship between the revision index and TOPIX. Thus Citi analysts believe that sluggish growth for the revision index could signal a slower pace for TOPIX’s gain.

Asia Pacific
Inflation remains benign

- Asia's inflation remains benign so far, while 4Q12 economic activity continues to surprise positively in Thailand, Malaysia and Philippines, while disappointing in India. Citi analysts expect further monetary easing in India and Korea, the latter partly in response to defensiveness about the JPY. Most central banks should remain on hold for now as monetary conditions are already sufficiently accommodative, with an eventual bias to tighten later this year, e.g. in Thailand & Indonesia.

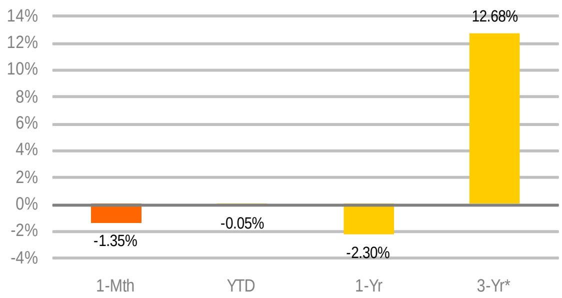
- Based on economics, there is no evidence that ASEAN has witnessed greater change than North Asia. GDP growth, working-age demographics, productivity, reserve coverage ratio, local interest rates and sovereign ratings all rank higher in North Asia.

- Current account surpluses are equally good. ASEAN ranks higher in a smaller share of exports going to the rest of the world and in a higher weight of domestic consumption in GDP. North Asia is at the same levels if we exclude China.

- ASEAN does better on profitability ratios such as higher ROEs, ROA & EBIT margin. ASEAN enjoys higher margins than North Asia and its global peers. With the exception of HK, North Asian margins are inferior to their global peers. Higher margins in ASEAN have been somewhat attributed to a lower democracy index and higher corruption perceptions.

- Meanwhile North Asia is less geared, has higher asset turn, has grown sales and, more importantly, shown higher earnings growth. Factor analysis shows North Asia could likely outperform along with global economy growth, a return of risk appetite and a value investing style.

Chart 5:
MSCI Emerging Markets Index



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Source: Bloomberg

Emerging Markets
Positive on Latam equities

- The main theme across Emerging Europe is policy uncertainty. The Turkish central bank has cut its rate corridor against a background of rapid loan growth; the Hungarian central bank may be about to pursue unconventional measures under a new governor; the South African Reserve Bank is facing a growing risk of stagflation; and the Russian central bank may be facing a similar risk.

- Although valuations are attractive (at 8.4x 2013E earnings, compared to 10.8x for GEMs), sentiment on Emerging Europe remains poor and earnings momentum appears weak with a slower rebound in earnings growth expected in 2013 (6-7%).

- Within CEE currencies, mounting domestic weakness and rich valuation is likely to keep CZK and especially HUF weak against a rising euro, but PLN may hold up better. Within MEA, RUB and ILS are forecast to strengthen, but both ZAR and to a lesser extent TRY, are expected to be relatively weak. Meanwhile, Citi analysts expect further short-term appreciation across Latin America in the next 3 months.

- Within Latin America, concerns over Brazil's inflation outlook continue escalating, but the recent rise may prove temporary. Meanwhile, the outlook in Argentina continues to deteriorate, and some adjustment to the FX regime cannot be ruled out.

- Citi analysts are now positive on Latin American equities after its severe underperformance in 2012 and the expectation of strong earnings and accommodating central banks. Preferred markets include Mexico (expectations of another strong earnings forecast in 2013, structural reform and a cheap peso) and Brazil (strong earnings rebound expected this year).

Positive on High-grade corporates and Emerging market debt

US Treasuries

Starting in late January, a new trading range appears to be intact with 10-year yields comfortably trading between 1.8% and 2.0%. That said, the dovish FOMC statement on January 30, and last month's employment report, reminds us that substantial headwinds still exist. This should help cap any material move higher in long-term benchmark rates near term.

US Corporates

While corporates are still poised to outperform other areas of fixed income this year, spreads should tighten only modestly from here. Valuations are less compelling now as yields trade near historic lows and spreads hover around post-crisis tights. Considering lower quality spreads still remain relatively wide, Citi analysts expect triple-B credits are likely to outperform.

US High-Yield

High yield returns have been more resilient than investment grade securities due to better carry and strong continued fund inflows as a result of improved risk appetites. While spreads may tighten further this year, lower absolute yields are likely to limit the pace of spread compression.

Emerging Market Debt

Debt markets in the emerging nations have benefitted from improved fiscal balances and more credible monetary regimes. Easing inflation pressures allow central banks more room to ease (or at least, not hike), boosting fixed income asset markets.

Euro Bonds

Citi analysts prefer Bunds and Gilts over Treasuries as economic and fiscal headwinds are more supportive to the bond market and should keep yields range bound and safe haven sentiment intact.

Asia Bonds

Asia's external sovereign debt has benefitted from low US Treasury rates, strong bond mutual fund inflows, and encouraging economic policy objectives. Citi analysts favour higher yielding and less US correlated government bonds — INR government bonds and frontier markets (LKR & VND Treasury bonds) and expect higher beta sovereign dollar bonds to outperform.

Currencies

USD: Losing ground in near term

As the pure risk on/risk off model has faded, the USD has been much less weak despite strong risk appetite/ rising equity markets. In part this may be down to easy money elsewhere, although US economic outperformance is important too. Citi's forecasts anticipate full Fed accommodation remaining in place over the near term with the USD losing ground. Over 6-12 months, the picture is more mixed, with the dollar gaining in G10 and some EMs but Asian currencies strengthening.

EUR: Mixed performance

Two distinct groups of factors have been driving EUR/USD recently. At one end, monetary factors that were mainly negative from mid-2011 to mid- to late-2012 have turned more mixed or even positive. The ECB has allowed its balance sheet to contract, albeit passively, as LTROs repayments have taken place. At the same time, the Fed is back in expansive mode as QE3 asset purchases increase the Fed's balance sheet. Overall, Citi analysts forecast upside to 1.35 over 0-3 months with some pullback towards 1.31 over 6-12 months as USD generalised strength kicks in and Fed accommodation begins to be withdrawn.

GBP: Likely to extend losses

Not only have UK data remained relatively weak but signals from the Bank of England suggest that an extension of highly accommodative policy will be forthcoming despite inflation likely remaining above the 2% target two years ahead. BoE outgoing Governor King has twice called for a lower real exchange rate to be a tool of policy in re-balancing the economy towards external demand as private deleveraging and public fiscal austerity depress domestic spending. In this light, Citi analysts expect EUR/GBP to be relatively stable near-term, probably generating some retracement in pound which is now very oversold. But over 6-12 months, we see EUR/GBP at 0.89 and GBP/USD at 1.47.

JPY: Move loses momentum

The USD/JPY move is losing momentum, probably reflecting a combination of factors, including positioning shifts, but a series of ostensibly confusing comments from officials close to the Abe administration has created some doubt for now amongst market participants as to whether the short term objectives for the forecasts have been achieved. Citi analysts think probably not and expect a little further upside, but for sure the upside path from here may be less rapid, at least until or unless USD vs. Asia more generally changes direction. Citi analysts forecast a move into the 95-100 range over 0-3 months and expect this to be sustained over 6-12 months, partly with the help of a broader period of USD strength at that horizon.

AUD: May slip to parity against USD

AUD tends also to be correlated with risk appetite and with movements in Asian currencies more generally. Citi analysts remain constructive on both though recent nervousness about Fed QE intentions has dented the former while limited downside on USD/CNY fixings has constrained the latter. The final key factor is the RBA. Citi economists still expect policy rates to fall further, partly because the impact so far of the 175bp of policy easing has been less than in prior easing episodes. Overall, Citi analysts forecast 1.04 over 0-3 months in the context of still-strong risk appetite, slipping to parity over 6-12 months in the context of a stronger USD generally over that horizon.