Global Credit Strategy Year Ahead

The disappearing act

Credit Analysis

21 November 2017

Credit Strategy
Global

That shrinking feeling

Eight years into a credit cycle and we think the good times could continue. For 2018, the big bullish theme for credit markets will be a scarcity of bonds, in our view.

Relatively, we are most constructive on US high-yield (+6.5% total returns) where easy monetary policy should help the default rate drop again. US high-grade (+2.2% total returns) will likely offer a year of two halves, but tax reform should underpin a first half rally. In Europe, negative rates and ECB corporate QE are proving to be overwhelming tailwinds (+1.5% IG total returns and +4.5% HY total returns). And in Asia (+5.4% HY total returns) improving fundamentals should help spreads compress further.

What's the trade for 2018?

In US high-grade, we think the big story will again be a flattening of non-financial cash bond curves, with 5s30s the sweet spot this time. We are cautious on front-end corporate bonds (repatriation victim) and high-quality credit (Quantitative Tightening victim). But we would be overweight the tech sector (repatriation beneficiary) and telecoms (foreign buying).

In US high-yield, we would overweight lower quality and long duration paper. We also prefer to be long high-yield cash bonds over synthetics. We expect leveraged loans to also tighten significantly next year.

In Europe, we see another year of spread compression playing out, given ongoing corporate bond QE and very low levels of rate volatility. That means BBBs, corporate hybrids and sub financials are again likely to perform better than the market. We prefer "domestics" over "exporters" but are wary of peripheral credits in 2018. In high-yield, we think the sweet spot will be BBs given the record trend in credit rating upgrades.

In Asia, we prefer As over BBBs, and especially like Chinese technology bonds. In high-yield, we like select short-dated single-Bs, and we see China industrials and Indian HY as having the best tailwinds. **In EM corporates**, we expect LatAm names to tighten the most in both high-grade and high-yield.

In Derivatives, we like selling the vol skew to extract alpha. In the US, we like buying S&P puts vs. selling CDX HY puts as a hedge for tax reform uncertainty. In Europe, given the rise in idiosyncratic risk, we like owning senior iTraxx tranches.

The ultimate irony and the ultimate mistake?

What ends "happy days" in corporate bonds? In short, a higher than expected rise in inflation, which breeds a more hawkish than expected response from central banks. Why? Because the great "reach for yield" in global credit has been propelled by the absence of returns elsewhere (since 2009, $25tr of fixed-income securities yielding over 4% have vanished). Thus, inflation and more upbeat central banks would challenge this powerful inflow dynamic. Yet, the aim of today's monetary policy must be to achieve stronger inflation, to ease concerns over the "debt supercycle". The irony, therefore, is that it may end up being central banks themselves that one day end goldilocks in credit markets.

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Timestamp: 21 November 2017 02:02AM EST

Contents

Global outlook: The disappearing act

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The show is not over

By and large, 2017 has been a year of very pleasing credit market performance across the globe. Investment-grade bonds have produced healthy excess returns for the second year in a row: 3.0% in the US and 3.2% in Europe. And while US high-yield has been held back a touch by some event risk before summer (5.2% excess returns), European high-yield has almost matched last year's showing, posting 7.2% excess returns, helped along by a rebounding Eurozone economy.

In the end, populism in Europe proved to be the dog that didn't bark in Q1 this year. That gave way to a familiar credit market story across the globe of strong inflows, foreign buying and a powerful need for yield.

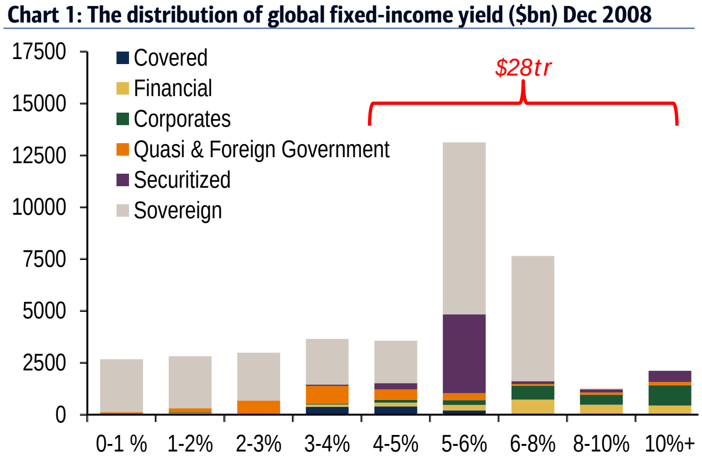
But after an impressive year of spread tightening, is that it for "happy days" in corporate bond markets? We think not. In fact, many of our strategy teams globally expect further spread tightening from their markets in 2018, albeit to varying degrees and driven by a variety of themes. Next year, we forecast 2.2% total returns for US high-grade (but spread widening in 2H), 6.5% total returns for US high-yield, 1-1.5% total returns for European high-grade and 4-4.5% total returns for European high-yield.

That shrinking feeling

One bullish theme is common to most of our global outlooks: that of a scarcity of bonds. Tax reform will likely detract from corporate bond supply in the US next year and, over time, should lead to a slowdown in market growth. In Europe, the surge in corporate cashflow in 2018 will reduce high-grade supply as issuance needs drop. Moreover, in European high-yield, the bond-into-loan refinancing trend should continue to reduce the stock of single-B corporate bonds outstanding.

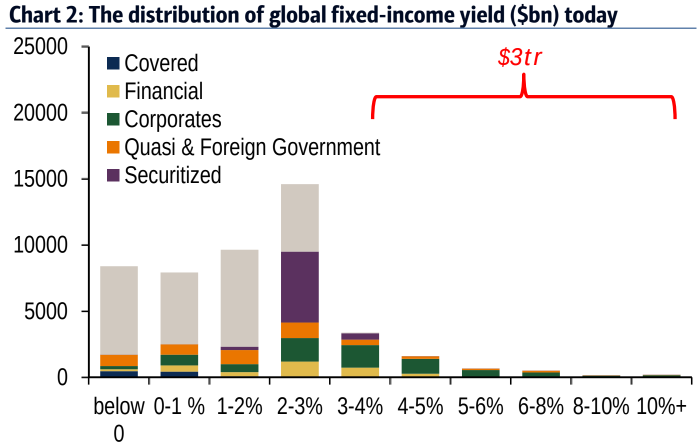
But this is only one part of the story. Investors across the globe are still very much in need of quality yield, in our view. Since the Financial Crisis, the below charts show that the world has lost a staggering $25tr of fixed-income assets that yield above 4%. Until central banks become a lot more hawkish with their commentary, the need for quality yield is unlikely to dissipate, we think.

Chart 1: The distribution of global fixed-income yield ($bn) Dec 2008



Source: ICE BofA Merrill Lynch Global Bond Indices. Global fixed-income GFIM index.

Chart 2: The distribution of global fixed-income yield ($bn) today



Source: ICE BofA Merrill Lynch Global Bond Indices. Global fixed-income GFIM index.

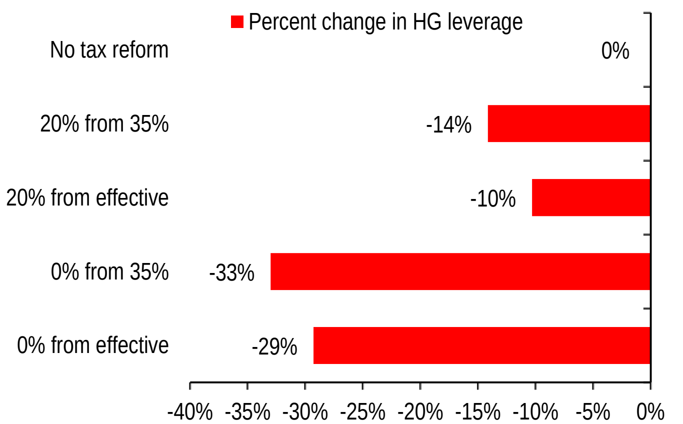
Taxing times

US tax reform is front and centre of our bullish view on US credit next year. At the time of writing, uncertainty remains over the passage of the tax bill and its ultimate shape. Nonetheless, our expectation is for a significantly lower US corporate tax rate, repatriation of foreign cash and limitations on net interest deductibility.

Hans Mikkelsen sees two very important and bullish implications of this. Firstly, net US high-grade supply should decline by a third next year (from $730bn to $487bn) as foreign cash repatriation reduces US corporate issuance needs. Such is the drop, that this will leave US high-grade supply, net of internal funds, at almost zero in 2018. Moreover, repatriation is bullish for 30yr US corporate bonds given the potential supply drop-off (but repatriation could mean weak technicals for front-end credit).

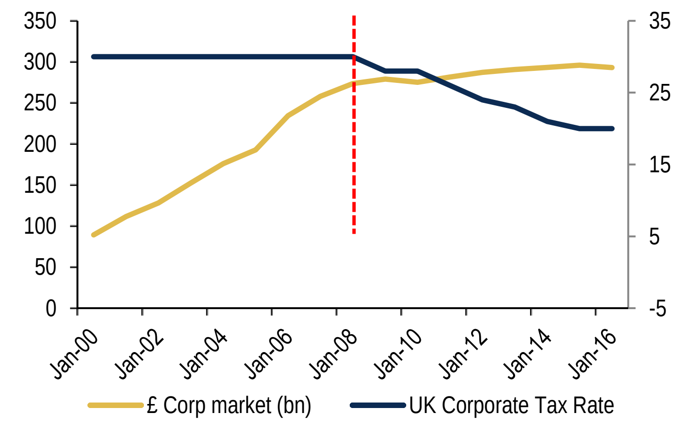
Secondly, a lower statutory tax rate should incentivize US companies to delever, as this is equivalent to an increase in the (after-tax) cost of debt. Thus, US corporates are likely to respond by using relatively less debt going forward. Chart 3 shows the range of deleveraging possibilities, under various scenarios. Tax reform should eventually lead to a 10%-30% reduction in US high-grade leverage, as Hans argues.

Chart 3: Change in gross debt/EBITDA with different corporate tax rate scenarios for US high-grade markets



Source: BofA Merrill Lynch Global Research

Chart 4: Sterling market credit growth slowed down substantially post Lehman, while other credit markets expanded dramatically



Source: BofA Merrill Lynch Global Research. Tax rate (RHS). Bloomberg.

In US high-yield, the changes in net interest deductions become more relevant, especially for some single-Bs and a majority of CCCs. Oleg Melentyev thinks that the more levered names will respond by trying to reduce their leverage over time as they reassess their cost of capital (although tax reform could ultimately push some challenged high-yield names into restructuring). However, with a sizeable drop in the US corporate tax rate, Oleg estimates that the net tax expense will rise for only 6% of US high-yield issuers.

Tax reform equals less debt: the historical precedents

Tax reform suggests a slowdown in US credit market growth lies ahead. Interestingly, the historical precedents for this are strong: the above chart shows the development of the Sterling credit market over the last decade. Note that while most other credit markets expanded strongly post Lehman, because of QE support, the Sterling market failed to grow. While some of this likely reflects the shrinkage in UK bank debt after the financial crisis, we think it's noteworthy that this period corresponds with a consistent drop in the UK's corporate tax rate.

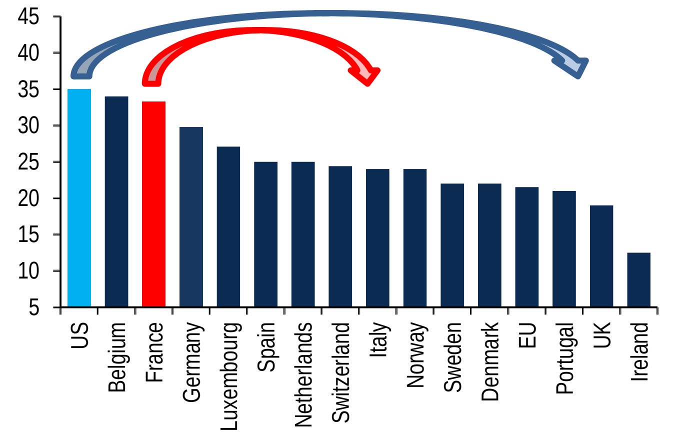
Moreover, in Germany, the growth of high-yield credit has been very slow since 2009, with German high-yield debt outstandings increasing from €6bn to just €23bn over this period. We think this is a relevant case study because Germany has the same 30% of EBITDA limitations on interest deductibility that the US House proposes in its tax bill.

Tax cuts for all?

But we think a large overhaul of US corporate tax won't be lost on European politicians. Chart 5 shows, on a global scale, how significant the US corporate tax proposals are. This should put some pressure on European leaders to think of a suitable response. After all, in today's globalized world, corporate tax can be thought of as a race to the bottom. OECD data highlights that Ireland has maintained high revenues from corporate taxation since 2000 despite having a very low corporate tax rate of just 12.5%. On the other hand, higher tax countries have seen their corporate tax revenue share fall.

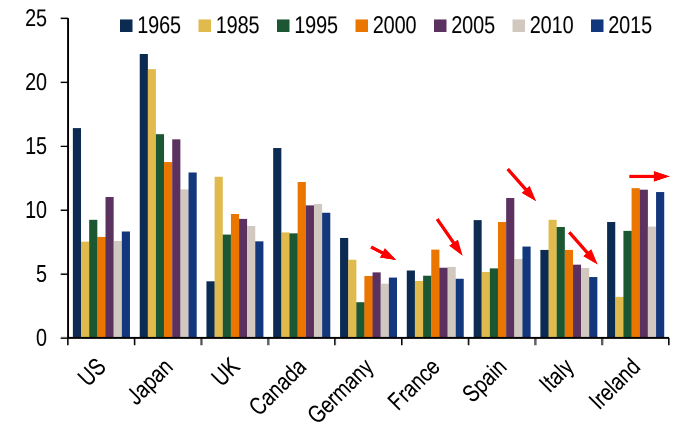
In Europe, Merkel and Macron have begun to talk about the idea of "harmonization" of corporate tax rates, and Macron is pressing ahead with plans to cut France's corporate tax rate from 33% to 25%. Like our US colleagues, we think lower tax should mean a slowdown in corporate debt growth in Europe over time, a longer-term bullish technical.

Chart 5: The spectrum of corporate tax rates (%). The US would achieve a significant cut, on a global scale, if they reduced the rate to 20%



Source: KPMG. BofA Merrill Lynch. We highlight the planned cut in US and French corporate tax rates.

Chart 6: Corporate tax revenues have been falling as globalization disperses tax bases (corporate tax revenues as % total taxation)

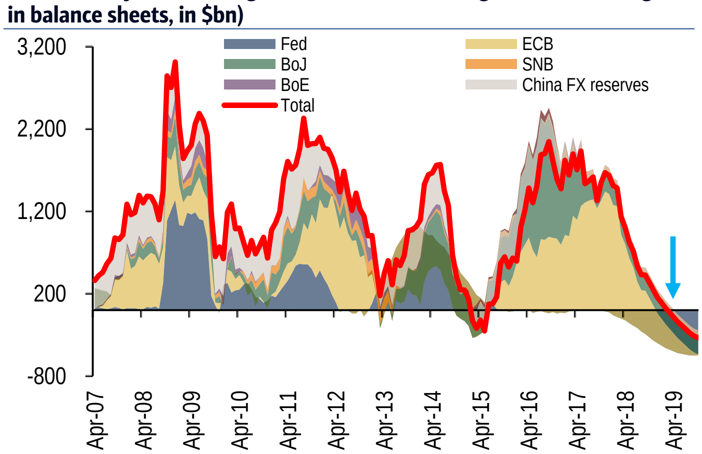


Source: OECD, BofA Merrill Lynch Global Research

From QE to QT

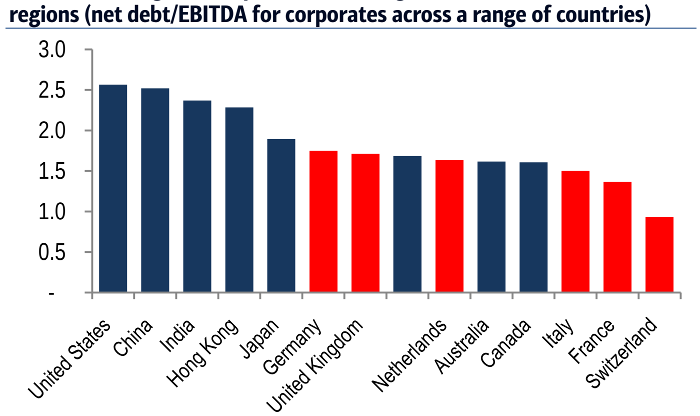
That's not to say that it will be smooth sailing for global credit markets for another year. Central banks are firmly in stimulus reduction mode now ("Quantitative Tightening"). The Fed is slowing balance sheet reinvestments, the ECB will reduce QE from January next year and the BoJ has been buying noticeably less JGBs of late. We estimate the year-on-year change in global central bank asset purchases will turn negative early in 2019. What is likely to be the collateral damage of slowing stimulus for credit investors?

Chart 7: Early 19 is when global YoY "QE" turns negative (12m changes in balance sheets, in $bn)



Source: BofA Merrill Lynch Global Research. Bloomberg. BoE. ECB.

Chart 8: Leverage is Europe is now looking a lot lower than in other regions (net debt/EBITDA for corporates across a range of countries)



Source: BofA Merrill Lynch. MLIQ database. Note we average across issuers excluding financials and special situations (highly levered utilities for example).

In the US, the Fed's balance sheet unwind is important. We think it means weaker IG technicals in the second half of '18, and spread widening over this period. In fact, we forecast a year of two halves for the US IG: 5bp of tightening in 1H, and then 5bp of widening in 2H. Moreover, we see losers from a less easy Fed. Recall that during the Fed's QE era, high quality US credit (AA-rated, for instance) outperformed. Next year, we see some reversal of this, with high-quality credit likely to underperform.

In Europe, QE has been extended (albeit at a reduced rate) and Draghi has pledged to buy "sizeable amounts" of private sector debt next year, which is bullish. But we believe that this has to motivate some companies – especially those that are very deleveraged – to start thinking about pleasing their shareholders rather than bondholders. After all, ECB QE will likely be over at the end of '18. Chart 8 highlights just how deleveraged European corporates are versus their global peers now. Thus, we see idiosyncratic releveraging becoming more common in Europe.

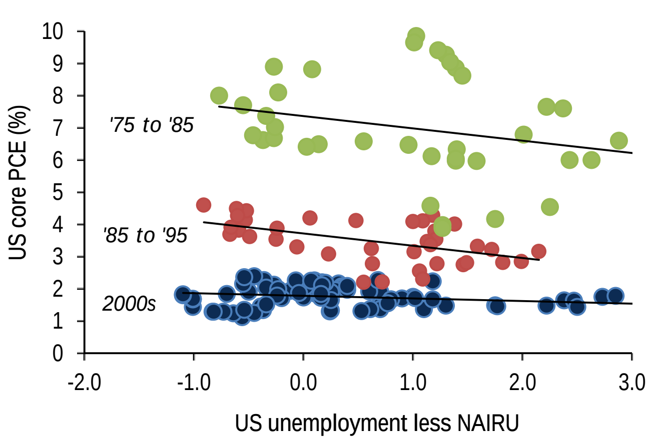
Turning the guardians of stability into pariahs

What do we fear the most in terms of unsettling the relatively supportive credit backdrop? We argue that a quicker than expected rise in inflation would be problematic for corporate bond markets. And given that core inflation globally has been sub-optimal recently, many investors have likely concluded that the Phillips curve is dead. Hence, higher than expected inflation next year would be a surprise for the market, we think.

But why would a rise in inflation be bad when it will help pacify concerns about debt sustainability? Our concern is that it could ultimately lead to more hawkish central banks. The implications of this are:

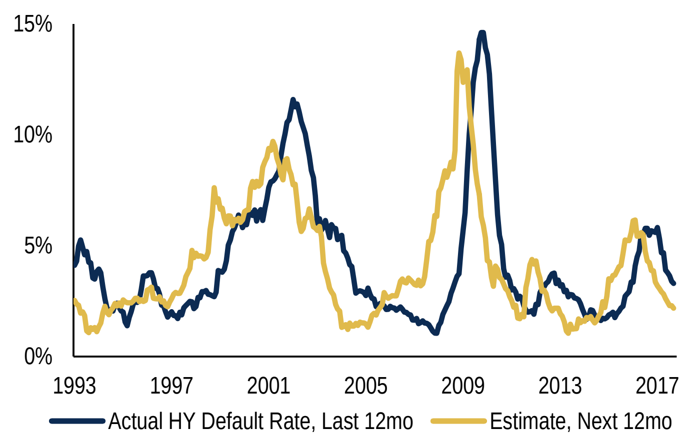
- The US high-grade market has seen big inflows over the last few years from yield-starved foreign buyers in Asia and Europe (given domestic QE policies). But higher inflation in Europe and Asia would lead to higher domestic government bond yields, reducing the need for foreign buying of US credit.
- Likewise, in US high-yield, we forecast the default rate to fall to around 2.3% by this time next year (roughly a drop of 1%) helped by ongoing easy credit conditions in the US and healthy inflows. Yet, if inflation provokes a less patient Fed, then tighter US credit standards and liquidity conditions could hurt the default outlook.
- In Europe, a negative deposit rate is the ECB's response to the lack of inflation. This is motivating a major reach for yield into Euro credit markets. But a quicker rise in European inflation would mean a more hawkish ECB. If rates rise far enough above zero, we believe this reach for yield would be jeopardized.

Chart 9: A flatter Phillips Curve in the US lately



Source: BofA Merrill Lynch Global Research. Bloomberg. Federal Reserve.

Chart 10: US high-yield default rates and BAML expectations



Source: BofA Merrill Lynch Global Research.

How to position in 2018

The top 2018 ideas from our global team encompass a wide range of thematics:

US high-grade

- We expect non-financial cash bond curves to flatten for another year. We think the sweet spot will be 5s30s curves,
- We are overweight the tech sector (repatriation beneficiary) and the telecom sector (strong foreign buying technical),
- We are more cautious on front-end US corporate bonds (victim of repatriation) and high-quality IG bonds (that performed well during the Fed QE years).

US high-yield

- We would overweight lower quality and longer duration paper in 2018. We also prefer cash bonds over synthetics (such as CDX),
- We think loan spreads will tighten faster than HY bonds, but given their shorter-duration returns from loans next year should lag those of HY bonds,
- We also find spread curves to be steep in both BBs and single-Bs.

European credit

- In high-grade, we believe it will be another year of spread compression. We expect BBBs, corporate hybrids and AT1s to again perform better than the market. Long-duration also looks interesting to us as curve flattening has lagged,
- We prefer domestics over exporters given the Eurozone revival. We would be cautious on peripheral credits, though, given the big decline in ECB QE,
- In high-yield, we think the best risk-adjusted reward lies in BBs. The record high in upgrades/downgrades should be supportive for net rising stars in 2018.

Asia credit

- In Asia IG, we prefer As over BBBs. In As, we especially like Chinese tech,
- We also like selective BBBs, such as India BBBs and BBB-rated Chinese SOEs,
- In Asia HY, we prefer selective short-maturity single-Bs. We expect China industrials and India HY to be the main driver for HY tightening in 2018. We are cautious on China and Indonesia property.

EM corporates

- In EM, we are OW LatAm corporates. In HY, LatAm B's offer the highest spreads per turn of leverage,
- We have an OW stance on corporates in Brazil, Argentina, Colombia, India, South Africa, Ukraine and Kazakhstan.

Derivatives

- In Europe, we like selling the vol skew to extract alpha in the credit market.
- In the US, we also like buying S&P puts vs. CDX HY puts to hedge the risk of tax reform legislation falling through.
- Given the rise in idiosyncratic risk, we like owning senior iTraxx tranches.
- As valuations are not cheap anymore, we also like owning downside credit protection in the US through HY cash puts, while selling CDX HY puts against it.

US high grade: Long analysts, short strategists

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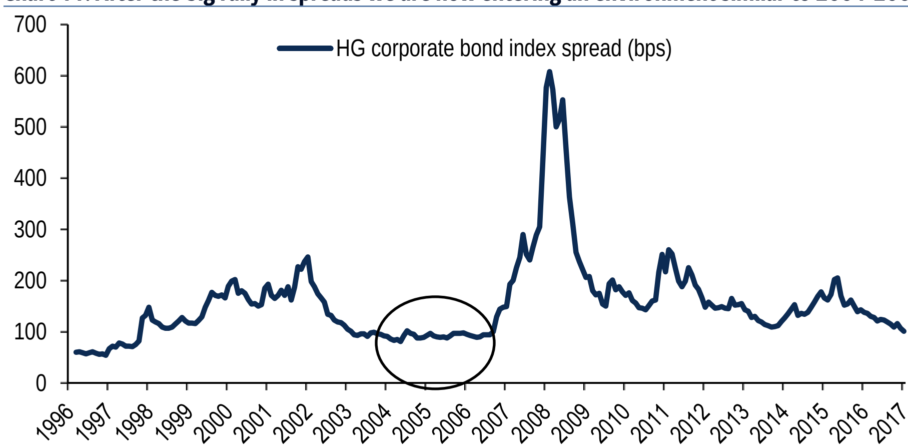
After years where macro dominated, the present low volatility environment favors micro. In fact, already credit spread dispersion has failed to decline with spreads since this summer (see: The return of idiosyncratic risk). Such an environment - which we expect to persist at least until mid-2018 - favors active investment management and credit hedge funds. Fundamental analysis around idiosyncratic risks is now more important than in many years even though we expect market-wide fundamentals to remain relatively stable.

Party like it's 2004

After the big rally in credit spreads over the past nearly two years we firmly believe that the upside – the extent to which is determined by the specifics of corporate tax reform (which we expect as our baseline) – is now more limited. However, in our view corporate bonds remain attractive instruments as recession risk appears remote. For a historical analogy this is like 2004, and investors avoiding corporate bonds stand to underperform most of the time the next several years (Chart 11). Our estimates suggest that credit spreads could widen 15-20bps in 2018 before corporate bonds would underperform Treasuries.

Chart 11: After the big rally in spreads we are now entering an environment similar to 2004-2007



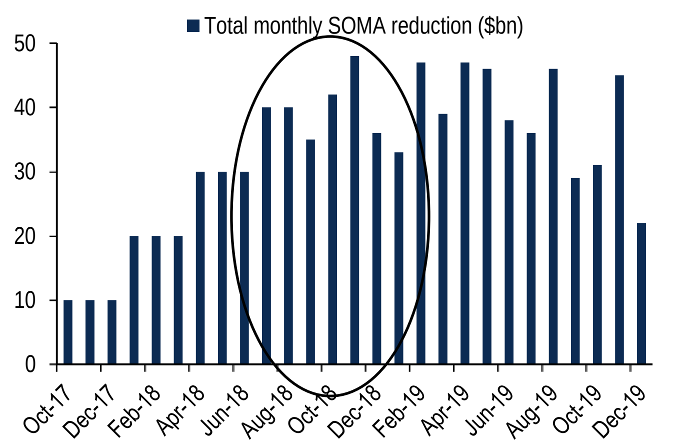
Source: ICE Data Indices, LLC

Technicals worsen in 2H 2018

With stable US and global economic growth, we think the big story of 2018 is that technicals become much more challenging in the second half of the year. The reasons for this shift include the Fed's accelerating balance sheet reductions (Chart 12). At the same time demand for corporate bonds should decline as diminishing total returns lead to lower inflows to high grade bond funds and ETFs. Crucially we expect rising interest rates in Asia to lead to a loss of foreign inflows to our market. Our Japan rates team now expects the BOJ to adjust its yield curve control target to 0%-0.25% for 10-year JGBs in 3Q 2018. As that steepens the curve, they now see 30-year JGB yields breaching the key 1.0% level by 2Q 2018. Recall that Japanese life insurance companies are likely to begin buying domestic bonds when yields reach 1.0% (see: Lifers on the hedge), at the expense of foreign bonds.

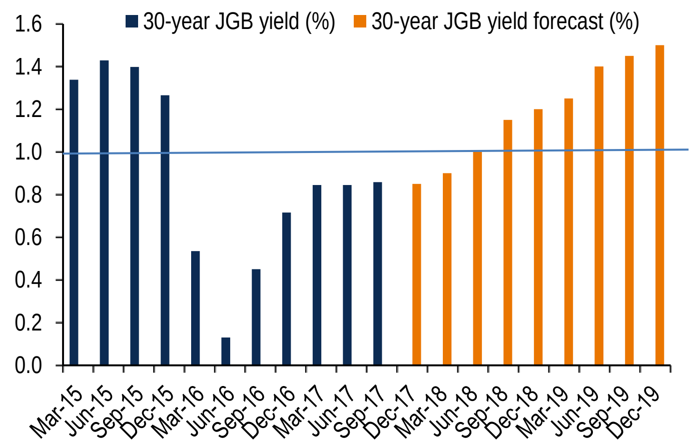
However we are not expecting disorderly conditions as at the same time corporate tax reform, which implies a decline in corporate bond supply, and financial deregulation, which stands to loosen dollar funding conditions, mitigate to some extent the impacts of Quantitative Tightening (QT).

Chart 12:The Fed's balance sheet reduction becomes really large in 2H18



Source: Federal Reserve, BofA Merrill Lynch Global Research

Chart 13: Long term JGB yields to hit 1% in 2Q18

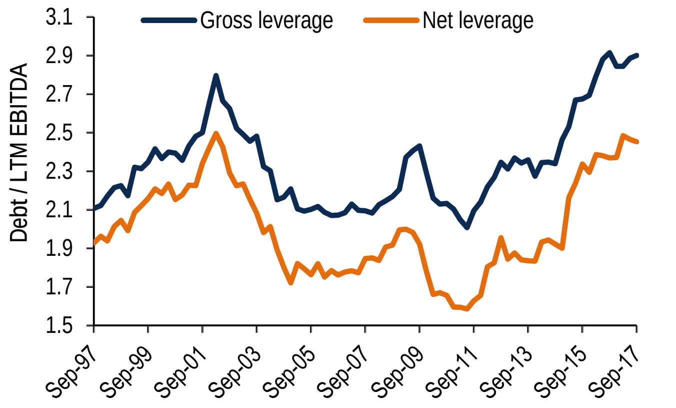


Source: BofA Merrill Lynch Global Research

Early arrival of late cycle balance sheets

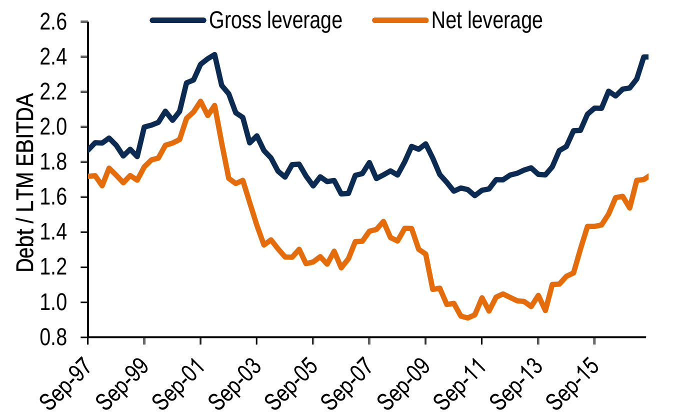
The economic cycle is not young, but also not old. It is fall, not winter. We are not detecting signs of the three predictors of economic recession - tight conditions, excess capacity and bubbles. But corporate balance sheets are late cycle (Chart 14, Chart 15). With an economy expected to grow at a still moderate 2.4% in 2018, profit margin pressure from increasing costs of goods sold, and the lack of other tailwinds for earnings growth, we think that companies once again in 2018 will face pressures to turn to financial engineering in order to grow earnings. However this is mitigated by tax reform, which incentivizes companies to deleverage. As a result we expect overall net leverage to change little in 2018, whereas gross leverage will improve materially as companies with repatriated overseas cash issue much less and actively take out debt, while at the same time there was significant front loading of issuance in 2017. Net, net 2018 is not likely to be the year where concerns about overall fundamentals return.

Chart 14: Net and gross median leverage for US non-financial high grade issuers



Source: BofA Merrill Lynch Global Research

Chart 15: Net and gross median leverage for US non-financial high grade issuers ex. Energy, Metals and Utilities

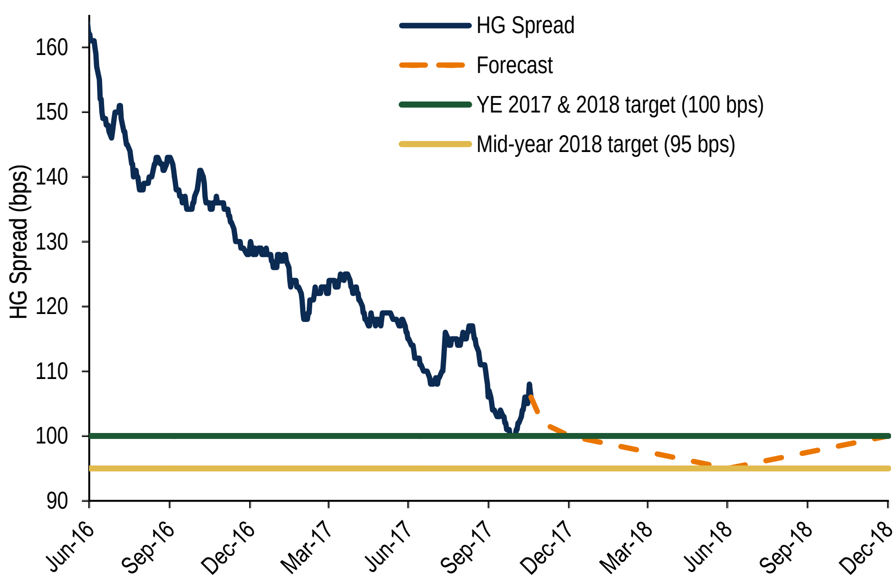


Source: BofA Merrill Lynch Global Research

2018 excess return of 1.8%, total return of 2.2%

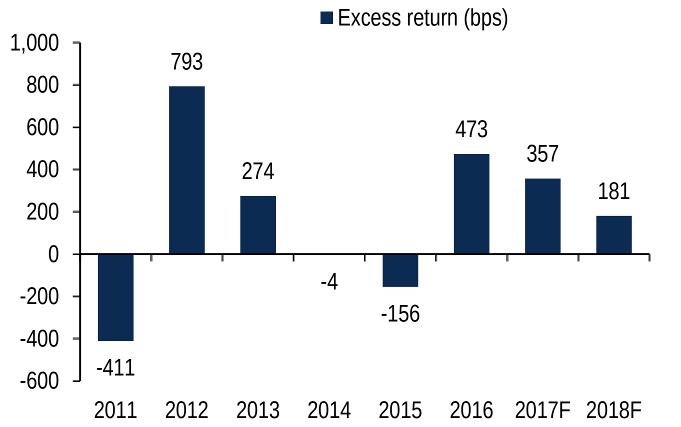
We expect credit spreads to tighten in the first half of 2018, as excess demand conditions prevail, and to give that back in the second half. Specifically our year-end spread target for 2017 is 100bps (vs. 106bps currently), then 95bps for mid-year 2018 and back to 100bps by year-end 2018 (Chart 16). That implies an excess return of 1.8% (Chart 17) and a total return of 2.2% (Chart 18) based on our rates strategy team's forecast for higher interest rates (+35bps in for the 10-year for example). With our outlook for a flatter corporate spread curve we expect 30-year corporate bonds to outperform with excess and total returns of 3.9% and 2.8%, respectively.

Chart 16: 2018 US HG spread forecast



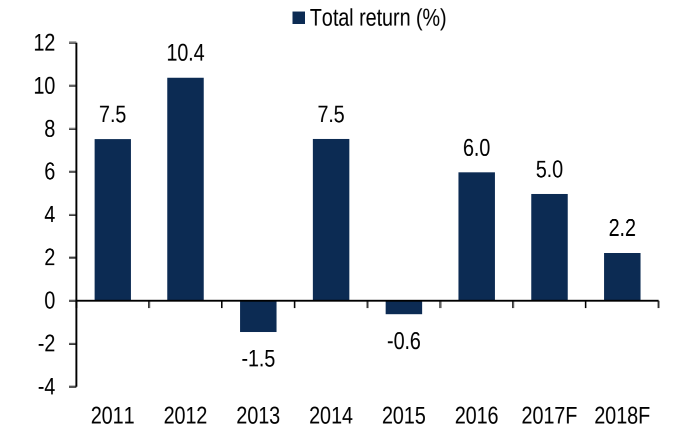
Source: ICE Index Data, LLC, BofA Merrill L:ynch Global Research

Chart 17: 2018 US HG excess returns



Source: ICE Index Data, LLC, BofA Merrill L:ynch Global Research

Chart 18: 2018 US HG total returns



Source: ICE Index Data, LLC, BofA Merrill L:ynch Global Research

Let's do the twist, redux

Our favorite trades remain spread curve flatteners, and we would now expect the 5s/10s flattener begin to work in addition to 10s/30s. Expected financial deregulation supports our view that the CDS-cash basis turns positive (+20bps target) as corporate bonds outperform, and that the 10s/30s banks spread curve will steepen (our only steepener). We prefer to barbell around high quality corporate bonds as QT and financial deregulation lead to underperformance in the segment. Finally our key sector overweights include banks and TMT while we are underweight consumer sectors with structural issues and tight trading industrial sectors.

US high yield: Bonds and Loans Outlook

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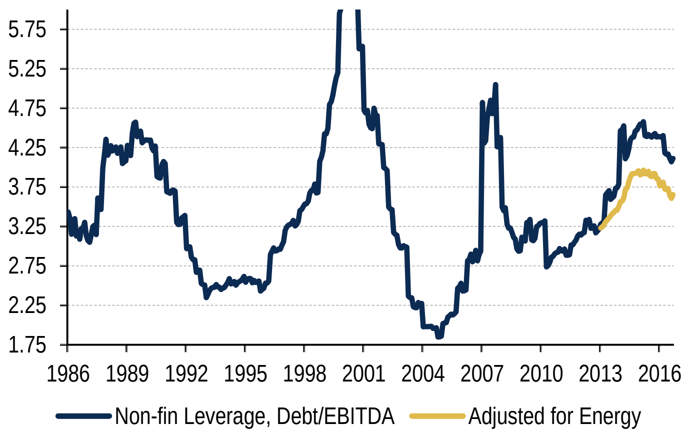
Issuer fundamentals and potential impact from tax reform

US corporate leverage metrics are at elevated levels across the full credit spectrum; however, we find them to be affected, to this day, by energy and commodity names. Chart 19 shows a broad US nonfinancial corporate leverage metric, derived from the Fed's Flow of Funds data on earnings and combined with our own measures of US non-financial debt in both bonds and loans. We use an assumption to arrive at the yellow line on this graph representing ex-energy leverage, where we calculate overall US non-financial corporate earnings excluding the impact of energy losses. The resulting dataset, once adjusted for Energy, suggests that overall US corporate leverage would be closer to cyclical averages, rather than at peak levels. We also use the same earnings data to estimate the overall US non-financial coverage ratio, which is shown in Chart 20 and remains comfortably close to its cyclical peak levels, reflecting continued support from low interest rates.

An important factor that could have a meaningful impact on HY issuer fundamentals is the proposed tax reform, which would potentially limit interest expense deductibility for US corporations. At the time of this writing there are two separate proposals making their way through the House and the Senate. Both target to limit interest deductibility at 30% of pretax income, although definitions of what constitutes such income differ: the House version is aligned more closely with EBITDA, the Senate's proposal is based on EBIT. The Senate version is thus more restrictive in that it reduces the base to the extent of depreciation and amortization expense, thus resulting in a lower deductibility allowance.

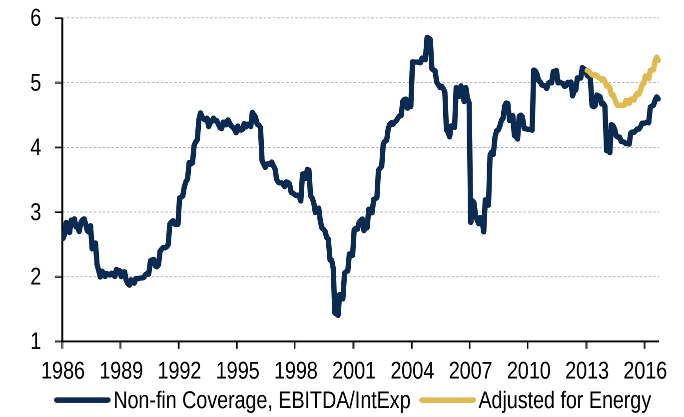
To make further judgment of the potential impact of tax deductibility on issuer fundamentals, we use the Senate proposal as our baseline given its more restrictive nature. The size of the relevant US leveraged finance universe is roughly $1.6trln (US domiciled, USD denominated, HY and loans ex financials and utilities), and the average coupon is 4.7%. This means we are looking at $75bn of annual interest expenses, of which we estimate roughly $35bn would be allowed as a deduction when capped at 30% of EBIT. This $40bn in disallowed interest could therefore face $8bn in incremental tax charges, assuming a 20% new statutory rate.

Chart 19: US nonfinancial corporate leverage (IG/HY/loans)



Source: Federal Reserve, Bloomberg, BofA Merrill Lynch Global Research

Chart 20: US nonfinancial interest coverage (IG/HY/loans)



Source: Federal Reserve, Bloomberg, BofA Merrill Lynch Global Research

We estimate the overall US LevFin dataset to generate $280bn in annual EBITDA, $110bn in EBIT and $75bn in pre-tax income (after the proposed allowed interest deduction of $35bn). Assuming issuers realize the full benefit of the statutory tax rate deduction from 35% to 20%, their tax bill is expected to decline by $11.5bn based on statutory rate cut benefit alone.

This figure represents the high-end of a likely outcome, as many issuers have effective tax rates below 35% today. What makes a precise estimate challenging here is that the extent to which other existing deductions will be preserved is unknown. One of the key provisions relevant to HY investors is the net operating loss (NOLs) allowance, which is described in current proposals to be allowed up to 90% of pretax income for carryforwards, and disallowed for carrybacks.

Capex depreciation is another existing deduction that is actually proposed to increase in the next couple of years, before being reduced subsequently. This suggests that new effective tax rates could be pushed below the 20% proposed statutory rate by retaining these two deductions, thus partially preserving the benefit of the lower statutory tax rate described above. Assuming the benefit is reduced to 10%, down from 15%, the expected dollar benefit of a statutory rate cut declines to $7.7bn for US LevFin issuers, roughly matching the extent of the additional tax burden arising from the partial loss of interest deductibility.

Table 1: Estimates of impact from loss of-interest deductibility by leverage bucket

Leverage Bucket	Pct of mkt	Cumulative Pct of mkt	Pct Interest Disallowed	Tax Impact, pct EBITDA
0..2x	2%	2%	23%	0%
2..4x	21%	23%	24%	1%
4..6x	31%	54%	41%	2%
6..8x	23%	77%	50%	3%
8..10x	10%	87%	71%	6%
10x+	13%	100%	91%	17%

Source: BofA Merrill Lynch Global Research

To put things into further perspective, the $8bn of incremental tax obligations arising from disallowed interest being taxed at a 20% rate translates into 2.7% of the overall US LevFin EBITDA pool. By comparison, the same $8bn translates into 10.3% of the pre-tax income of the same issuer set, highlighting how this is more of an equity, rather than credit, negative factor. We also show how the impact is distributed across the spectrum of debt leverage in Table 1. The second to last column here shows the proportion of interest that would be disallowed under the Senate proposal, ranging from 25% for names levered up to 4x to over 70% for names levered 8x and above. The last column also goes on to quantify how the disallowed portion of interest, taxed at 20% rate, would relate to the size of issuer EBITDAs. Again, the impact is marginal for names levered under 6x (1-3% of EBITDA), rises to 6% for those levered above 8x, and 17% for those over 10x levered.

Overall, our conclusion here is that the leveraged finance market should be able to deal with the consequences of limited interest deductibility, should it become law. While all issuers will be forced to take a fresh look at their capital structures, we think most of them will come to the conclusion that debt remains the cheapest financing option and integral to their capital structure. As such, some may choose to delever modestly, which we think would amount to a fraction of a turn for names levered below 4x and perhaps a full turn for those levered in the 6x to 8x context. Issuers that are levered 8x and above will face harder choices, as they will likely need to delever faster in this scenario. They may have to explore strategic options such as asset sales, equity raises, and mergers. Overall, leverage across the LevFin space is likely to decline should this proposal become law, thus providing a positive fundamental backdrop, albeit at the cost of a shrinking market size in the long-term.

In extreme cases, we believe some distressed issuers may face one extra reason to restructure. Keep in mind that the majority of such companies are not making much of a profit anyway, and thus tax obligations – under old or new regime – are not their primary issue. As such, tax deductibility alone is unlikely to become a restructuring catalyst in-and-of itself. At the same time, it is possible that a cash-flow negative business with high debt leverage in an industry challenged by disruptive technologies may get one more reason to consider an otherwise probable restructuring.

Overall, we maintain the view that the proposed tax reform is likely to undergo material changes as the legislative process continues, although some of the key proposals could be substantially watered down or eliminated altogether. As such, we reserve our final judgment on its effects until we see these proposals signed into law.

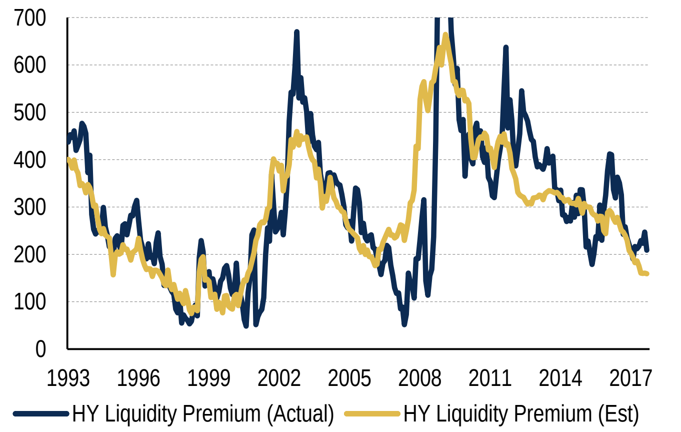
Default rates

We have recently introduced our default rate forecasting model, which deviates from a standard practice of trying to forecast the next 12-month rate, and instead separately estimates four independent, three-month intervals before aggregating the result into a next-12mo view. In doing, so our goal is to achieve greater flexibility by using a variety of indicators, some of which may do a better job estimating near-term defaults while others show an edge over long-term horizons. This approach helps us avoid the need to bootstrap otherwise useful indicators into timeframes where they may have less relevance. We advise readers interested in better understanding the model construction, as well as its historical track record, to refer to the original piece. Here we simply summarize its current signal, which implies that defaults should go lower, from today's 3.3% realized level (Moody's US issuer-weighted) to 2.3% a year from now. The key drivers of our lower default forecast are low levels of volatility; high market accessibility (Sr loan officer survey or SLOS); and fund flow trends, driven by a disproportionate share of global yield income generated by US credit.

Implied volatility remains low even after it has picked up somewhat following recent episode of market weakness. The VIX is still below 12pts here, not far off its lows at around 10pts, while rates vol is at all-time lows. Additionally, recall that our model is using a moving average vol signal in its various time horizons, and as such, a short-term vol spike has little consequence on expected defaults unless it finds reasons to keep building on itself.

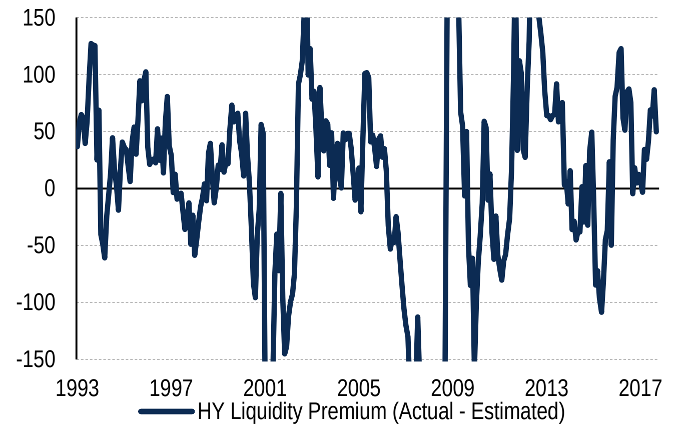
On the market accessibility side, the latest Fed's SLOS has shown further loosening in lending standards to a net 8.5% of reporting banks in October, from 3.5% previously in July. This reading represents the most supportive survey level since Q4 2014, before the energy meltdown, and previously since Q3 2006. As we have shown on a number of occasions, many key indicators of the credit environment today are at levels similar to earlier points in time when credit losses have hit their all-time lows. US credit also continues to attract substantial new institutional and foreign mandates as pension funds rebalance towards higher fixed income allocations, partly to preserve their equity gains and partly because foreign investors continue to find it as a strong relative value option against low yielding domestic alternatives.

Chart 21: HY liquidity premium, actual versus estimate



Source: BofA Merrill Lynch Global Research

Chart 22: Liquidity premium, actual - estimate



Source: BofA Merrill Lynch Global Research

Valuations

In arriving at our HY spread target, we first consider our default rate forecast (2.3% for the next 12 months) and expected distance to recovery (we assume 40% average recovery rate). This translates into roughly 130bps in expected credit loss, which in turn results in 250bps of current HY liquidity premium (LP) based on today's 380bps of HY OAS. While the historical average for this measure is around 300bps, we would expect the LP to be well below average in today's environment. Our analysis suggests the following factors have the greatest explanatory power over the historical variation in HY LPs: bank equities, the overall stock (and not the flow) of QE, real rates (2yr nominal ex core CPI), fund flows into HY/loans, and the 2/10yr yield curve.

The yellow line in Chart 21 represents an estimated value of the next-12mo average HY liquidity premium based on the factors described above, and Chart 22 goes on to show the differential between the actual observed LP and this estimated value. The current estimate for average HY liquidity premiums over the next 12mo is 160bps, compared to its actual observed present day value of 250bps. This leaves us with about 90bps of expected overall HY spread tightening from here, and results in our DM USD HY OAS target of 290bps. This target is 45bps inside of the previous cycle tight set in mid-2014, implying that the HY market could be on its way to setting new spread lows for this credit cycle. Finally, a 290bps HY OAS would be 40bps wide to the previous all-time tights of 250bps, established in both mid-2007 and late 1997.

Total and excess returns

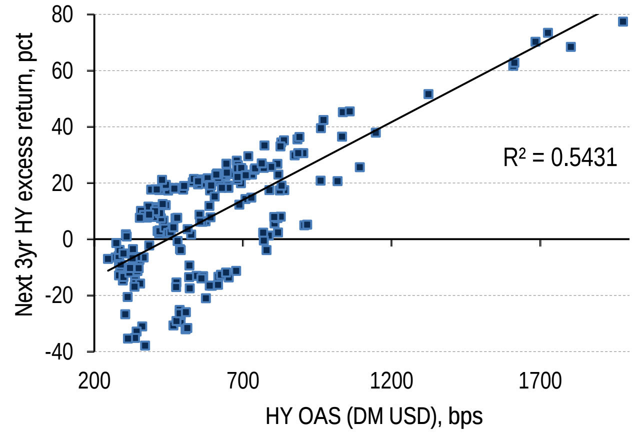
We summarize our views for HY returns next year in Table 2 below. Starting with our spread target of 290bps and our rates strategists target of 2.60% on the 5yr Treasury, we proceed to estimate the assumed change in market value from both components given the index duration. We then add the current index yield as a proxy for coupon income and pull to par and subtract expected credit losses of 1.28%. Note that we are using a 90pt assumption for the current dollar price of bonds that are likely to default over the next year. This assumption comes from our analysis of historical bond prices one year prior to default, which has shown a near 1:1 relationship with the average dollar price of the CCC index at that time. As such, we are using the current level of 90pts on the H0A3 index as an assumption for the current price of future defaulters.

Table 2: Summary of 2018 return forecasts for DM USD HY market

	HY	5yr Trsy
Current spread (yield), bps	380	203
Target, bps	290	260
Predicted Change, bps	-90	57
Effective Duration	4.1	
Capital gain (loss) from spread, bps	365	
Capital gain (loss) from rates, bps	-231	
Total capital gain, bps	134	
Coupon, pct	6.4	
Price, pct	100.2	
Current Yield, bps	641	
Default rate, pct	2.3	
Assumed current price of future defaulters, pts	90	
Recovery rate, pts	40	
Credit Loss, bps	128	
Total Return	6.5	
Excess Return	6.7	

Source: BofA Merrill Lynch Global Research estimates

Chart 23: HY OAS vs next 3 year excess return



Source: BofA Merrill Lynch Global Research

All these inputs result in a 6.5% total return estimate for the US HY index over the next 12mo horizon, and a 6.7% excess return. Overall, this result reflects our view that being in the late stage of the credit cycle could still help this asset class deliver decent performance in the near-term. Longer-term, we remain mindful that the credit cycle could probably turn in the coming years, leading to an eventual repricing in credit risk. This point is particularly relevant given today's spread levels, which are at the tight end of historical ranges. As Chart 23 below demonstrates, the HY market has generally failed to deliver positive excess returns over three-year horizons when starting at below 350bps levels.

New issuance

With $235bn issuance year-to-date and, based on average November/December volumes over the last five years (excluding 2015), an additional $23bn expected during the final 1 ½ months, 2017 is likely to experience a $30bn or 13% year over year increase in DM USD HY issuance. Most of this increase has come in the form of refis, which are up 23% YTD and already $10bn ahead of 2016's entire amount. On the other hand, most other uses of proceeds have seen a negligible change on a year over year basis.

When considering new issue trends for next year, we chose to break our analysis into two groups—refis and ex-refis. Based on historical analysis, we found that volumes across these two groups are driven by a different set of independent variables, described in detail below. For each of these two segments, we forecast next twelve month issuance on a rolling quarterly basis, normalized as a percentage of DM USD notional outstanding. We then combined these two results into a single gross figure, expressed as both a percentage of outstanding and a dollar amount. This methodology has worked well in the past and explained 83% of the variation in next twelve month HY issuance since 2000.

Refis: $152bn, -8%

The three variables that demonstrated the greatest explanatory power to next twelve month DM USD refi issuance were the next twelve month change in OAS, a proxy for 5yr treasury deviation[1], and a lagged variable representing last 6 month refi issuance as a percent of notional outstanding. These three variables had t-stats of -6.7x, -2.4x, and

[1] (Actual 5yr treasury – last 12 month average) / last 12 month standard deviation

+2.8x, respectively, and combined to explain 50% of the historical variation in next twelve month issuance as a percent of outstanding. Although our 290bps spread forecast should be supportive for refis, the nearly 100bp increase in the 5 year treasury over the last 1 ½ years has more influence in the regression and is responsible for the projected 8% decline, to roughly $152bn refis next year.

Ex-refis: $118bn, +26%

Similar to refis, a proxy for 5 year treasury deviation shows a strong historical relationship with next twelve month ex-refi issuance, as demonstrated by a t-stat of +2.4. However, whereas higher rates are correlated with a decline in refis, an increase in treasuries actually suggests *more* ex-refi issuance. This is likely because higher short-term treasury rates are reflective of an improving macroeconomic backdrop, providing greater opportunities for event driven issuance. In addition to risk-free yields, the next twelve month default rate and starting S&P 500 price to earnings ratio were also incorporated into our ex-refi regression and produced t-statistics of -4.7x and -3.8x, respectively. Not surprisingly, both of these variables have a negative correlation with next twelve month ex-refi issuance, meaning a lower default rate and lower P/E ratio have corresponded with higher new issue volumes.

Based purely on this regression, the increase in 5 year treasuries and our expectation for a 2.3% default rate suggest ex-refi issuance should rise to $128bn next year. We note, however, that actual next twelve month ex-refi issuance has consistently been less than that suggested by our analysis since the end of 2014. As a result, we made a $10bn adjustment lower to the value produced by our regression to arrive at an expected $118bn in DM USD non-refi issuance in 2018.

Altogether, the above two considerations result in an expected $270bn DM USD HY issuance next year, or 21.3% of today's outstanding notional. This would represent a 5% increase in 2017's new issue supply, assuming an additional $23bn gets priced between now and year-end. This forecast is based in-part on our default rate and spread views for next year, meaning any significant deviations from these targets could have an impact on next year's issuance. For example, under a slightly more volatile credit environment in which the default rate climbs to 3% while spreads reach 500bps, our analysis suggests issuance would actually decline 4% year over year, to $247bn. At the same time, a 2% default rate combined with 250bp year-end spread would likely result in next year's issuance modestly overshooting our forecast, to $276bn or +7%.

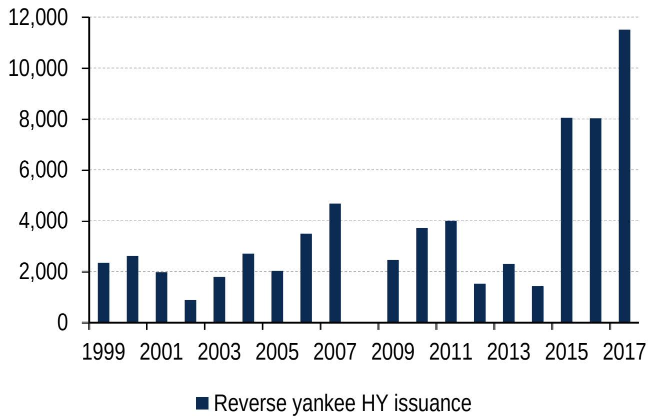
Tax reform impact on issuance

Our issuance forecast presented above excludes any assumed impact from tax reform, as we judge both the prospect of its passage as well as its key provisions to be too uncertain to allow us to maintain a reasonable level of confidence in such assumptions. Thus our issuance forecast will likely undergo changes once such details become available.

In more general terms, we can start with the obvious: that lower interest deductibility will lead to reduced supply, as issuers re-examine their capital structures in light of a new tax regime. Regardless, we expect most corporates to come to the conclusion that debt remains their cheapest form of capital and overall WACC impact is limited.

Chart 24: Reverse yankee HY issuance by year

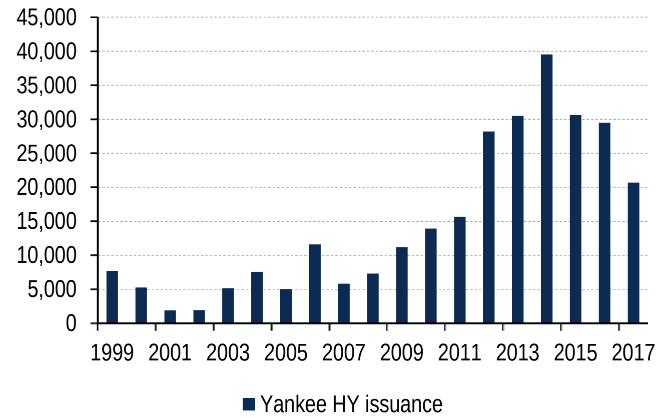
US HY issuers placing debt in EUR/GBP markets



Source: BofA Merrill Lynch Global Research

Chart 25: Yankee HY issuance by year

EU/UK HY issuers placing debt in USD market



Source: BofA Merrill Lynch Global Research

Issuers levered inside of 6x, a group representing half of total LevFin debt outstanding, are likely to exhibit only modest changes in their capital raising plans. We expect issuers in this category to potentially look at reducing leverage by about a quarter-turn, on average, and some may decide to leave it unchanged as their interest expenses are comfortably inside of proposed thresholds. These issuers represent $800bn of total debt, and a quarter turn reduction in leverage would correspond to roughly $55bn.

Issuers in the 6x to 8x leverage range, representing a quarter of debt outstanding, could be looking at removing closer to a full turn of leverage as an initial response to the proposed tax regime. Issuers in this leverage bucket currently have about $340bn of total debt outstanding, and a full-turn corresponds to another $50bn here.

Those levered over 8x represent $350bn of LevFin debt, and this area will see the largest push for strategic initiatives around making the cap structures aligned with the new tax regime. Here, the impact would have less to do with changes in issuance plans and more with asset sales, spinoffs, M&A, and other restructuring options.

Combined, the first two groups would see an aggregate $105bn in potential debt reductions. We expect this figure to be split roughly evenly between bonds and loans (we assume a 50/50 split, in line with existing proportions in debt types). In this scenario, our HY issuance forecast could be reduced by $52.5bn, or a 20%. In loans, where refies take on a much greater share of the total, the same dollar figure translates into $52.5bn/$515bn = 10%.

The final area where we could see a shift in issuance trends as a result of the current tax proposals is where companies choose to issue debt. With the ICE BofAML EUR HY index (HE00) currently yielding 2.19%, just 15bps more than the 5 year US treasury, we have already seen a significant increase in the supply of reverse yankee deals, while yankee issuance has been on a consistent decline (Chart 24 and Chart 25) .

US issuers are now the fourth biggest in the euro HY market, on par with Spanish/UK issuers and trailing very closely behind Germany. And should companies lose the ability to deduct interest expense in the US, we would expect this wave to continue as multinationals choose to issue out of European domiciled subsidiaries. At the same time, foreign entities would be less likely to issue USD-denominated debt, we think. This shift will likely continue to have a larger impact in the high grade market, as has been the case over the last several years, where a greater proportion of companies have international exposure. Regardless, larger high yield cap structures will probably continue to look for attractive M&A targets and cheap financing options in Europe.

Leveraged loan market

Issuer fundamentals and potential impact from tax reform

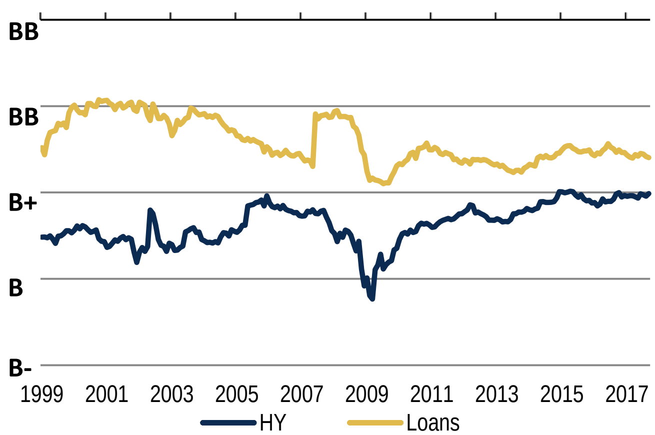
Against the backdrop of supportive macroeconomic variables, we expect loan fundamentals to continue to improve next year. Revenue growth across loan issuers, though off of its peaks, is still clocking at a healthy 10% and is poised to remain in the positive territory. Gross margins have consistently increased since their 2013 lows, and are currently hovering at ~35%. EBITDA margins have also shown improvement since 2015, and look to be near top levels. Although YoY debt growth remains positive, its growth rate has been undershooting EBITDAs, thereby prompting a natural deleveraging of loan issuer balance sheets. We expect this to continue into 2018.

Covenants pose a risk for the next default cycle

The state of loan covenants today has garnered much attention, and for good reason. The unmistakable trend of covlite issuance can be concerning to investors who expect senior secured loans to come with the ability to assert a certain amount of influence over the financial discipline of an issuer. The growing penetration of deals without maintenance covenants reflects the clear upper hand issuers have been enjoying in today's environment characterized by a global dearth of yield. However, being covlite is not a problem in-and-of itself in our opinion, and our research has shown that covlite loans tend to be bigger, better issuers, and in some ways have been better able to navigate difficult financial circumstances.

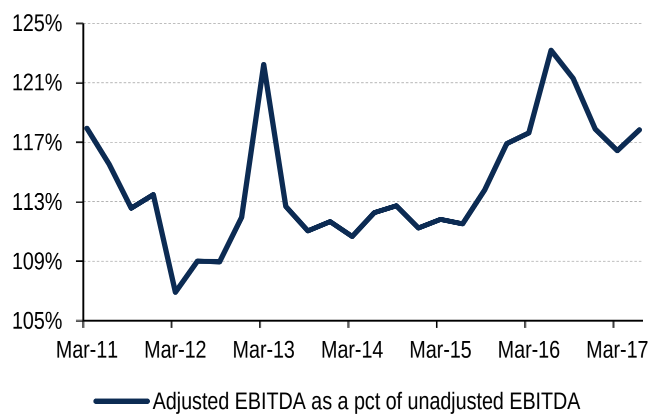
Investing in a loan without maintenance covenants is akin to investing in a secured floating rate bond. Thus, the resurgence of covlite deals is merely a symptom of a larger undercurrent: the convergence between HY bonds and loans, competing for the same issuer market share. We can also see this trend through the converging ratings of these asset classes over time (Chart 26). There are of course structural aspects of loans which sets them apart from bonds, such as their floating coupons and frequent callability. However, we think most other features that have traditionally distinguished loans from bonds, such as maintenance covenants, are on their way out in order to attract additional deal-making. As such, we think the preponderance of covlite deals may further increase from here.

Chart 26: Average index level rating, HY vs. Loans



Source: BofA Merrill Lynch Global Research, S&P LCD

Chart 27: Adjusted EBITDA as a percent of unadjusted EBITDA



Source: BofA Merrill Lynch Global Research

What concerns us more here is the loss of investor protection in other important areas. The flexibility today's documents afford companies to issue incremental debt that dilutes existing liens, make restricted payments, and employ ratio based baskets defined using EBITDA add-backs and cash netting, is potentially more problematic. Collectively, the slippage in these covenants has caused overall loan documentation to decline to its weakest levels yet in this cycle. The two important covenants providing protections against structural subordination and restricted payments have both seen material degradation according to data compiled by Moody's.

EBITDA adjustments are also on the rise, as Chart 27 demonstrates. While some of these adjustments are designed to appropriately isolate ongoing operations, we think investors should exercise particular caution while relying on these measures heavily.

A drop in investor protections is a worrying sign from the standpoint of longer-term market health, and yet is also a natural consequence of the late stage of the credit cycle. With yield opportunities scarce, and demand for paper strong, portfolio managers must constantly compete for new issue allocations. This competition often takes form of accepting lower coupons, looser covenants, greater EBITDA adjustments, and making other issuer-friendly concessions. This behavior carries little nominal cost today as the actual realized credit losses are low, and the immediate value of such investors protections is reduced. Experience teaches us that this is a temporary state of affairs, and that some of these loosely defined protections could eventually come to haunt debt holders. However this experience must also compete in its importance with performing relative to asset managers' benchmarks. This paradox defines the late stage of the credit cycle we are most likely in today, and may remain in during the coming year. And because on balance, borrowers will continue to dictate covenant terms going forward, we think it is prudent for investors to make decisions around the credit, and not around the covenants.

Modest impact from Tax Reform on issuer cashflows

Tax reform is another important aspect likely to have an impact on loan issuer fundamentals. To estimate the impact of interest deductibility cap, we use the subset (30%) of the loan universe that reports earnings publicly. Currently, 44% of those with positive EBITDA in our sample claim more than that threshold, meaning that they are directly affected by the cap proposed by the House. However, this distribution is not uniform across credit quality. Although the number of single-Bs that make it into our sample is nearly half of that of double-Bs, the impact on them is disproportionally higher. As such, 75% of single-B issuers and 36% of double-B issuers remain vulnerable to the proposed 30% cap. Their collective loss of tax shield is about $11bn, meaning these issuers stand to pay $1.2bn more in taxes just because of the deduction cap[2]. Interpolating for the remainder of the loan market, the incremental tax bill stands at only $4bn. Consumer Products, Food, Healthcare, and Energy are sectors where more than half of the constituents are exposed, while others such as Real Estate and Autos are not as heavily affected.

This impact increases if we were to go by the interest deductibility clause outlined in the Senate's proposal, which changes the cap to 30% of EBIT. The Senate's proposal, in its current form, impacts ~70% of issuers in our sample set reporting positive EBIT. Again, this is skewed in favor of double-Bs, where 66% remain vulnerable vs single-Bs at 96%. In this instance, the collective tax shield loss doubles to $22bn for our sample, corresponding to an incremental tax bill of $5.5bn. Projecting for the remaining market, the incremental tax bill amounts to $18bn.

Total returns

In our latest Collateral Thinking report, we discussed our expectation that spreads, and as a result coupons, should head lower next year. Our recently published spread-to-maturity forecast of 315bps is based on HY spreads tightening to 290bps, as well as our house call for libor to reach to 235bps. This translates to ~345bps in the 2yr discount margin (DM) next year. There are several advantages to using a 2yr DM: it better represents the current average life to call of loans outstanding, it has a tighter historical

[2] Note the incremental taxes paid are not = $11bn x 0.35 because some issuers with negative taxable income don't have a loss of tax shield, while issuers who flip from negative to positive taxable income have a loss rate somewhere in the range of 0-35%.

relationship to HY spreads, and it has a low sensitivity to non-credit factors such as libor.

The last factor is important because, conceptually, libor should become less relevant to spread levels as it moves higher. This is because it becomes incrementally more difficult for loan spreads to fully absorb a rate increase. So while the first 100bps increase can (and did this year) lead to a nearly one-for-one spread compression, the next 100bps will likely elicit only half as much of a reaction. This outcome is also reflected in our forecasts: a 40bps lesser increase in libor next year (i.e. total of 60bps instead of 100bps) increases our coupon target by 10bps, while leaving our target 2yr DM (and hence total return, which is discussed later in this report) virtually unaffected.

Table 3: Summary of 2018 return forecast for US Loan market

	Start	Target
Stated Spread, bps	L+330	L+300
Price, pts	98.40	99.00
Avg Life, yrs	2.00	2.00
DM 2yr, bps	417	354
Avg index Libor, bps	150	200
Coupon equivalent, bps	480	500
Current Yield, bps	488	505
Spread change, bps		-63
Spread Duration		1.5
Key Rate change, bps		50
Rate Duration		0
Repricings drag, bps		-30
Capital gain, bps		65
Default Rate, pct		1.2
Assumed current price of future defaulters, pts		90
Credit Loss, bps		33
2018 total return, pct		5.19

Source: BofA Merrill Lynch Global Research estimates

We expect loans to generate between 4.5% to 5.5% in total returns next year, buoyed by a high current income (4.9%), low default loss (33bps) and modest price appreciation.

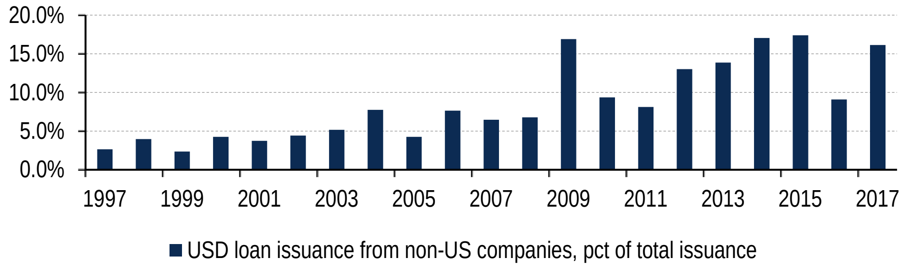
New issuance

With $458bn in global loan issuance through November 10th, this year has already surpassed 2013 for the most active primary loan market. This number doesn't include the nearly $500bn in repricings (also a record) or the final 6 weeks of the year, during which we can could get an additional $20bn based on average seasonal volumes over the last 3 years. This year's net global loan issuance is projected to finish 42% higher than 2016's, with incremental supply coming in the form of refis (+$45bn), acquisitions (+$36bn), and LBOs (+$21bn).

Historically, new money entering as a percentage of the loan market outstanding has increased every year in the last two decades outside of downturns. This year's figure stands at 54%, and assuming next year we see a touch higher proportion, of 55%; this translates to $515bn of new supply for 2018, an 8% increase over this year's levels.

As we break the above figure down into various categories, we see that refinancings are cyclical; M&A deals are on an upswing, while LBO deals have been largely stagnant at 30% of total issuance. In keeping with the cyclicality of opportunistic issuance, we think refinancings could decline by ~25% next year. At the same time, event-driven issuance driven by mergers and LBOs can increase, supported by decent GDP growth and benign credit risk. Within this bucket however, we do not expect LBO volumes to change significantly due to high equity valuations already pushing acquisition multiples above 10x, the highest on record, and making it increasingly harder to source deals that would satisfy LP IRRs.

Chart 28: USD loan issuance from non-US companies, pct of total issuance



Source: BofA Merrill Lynch Global Research, S&P LCD

Tax-reform impact

Because details on what may get ultimately passed remain unclear and are subject to constant change, we choose not to take the impact of tax reform in our issuance target. However some version of the current proposals makes it into law, our projections will likely have to undergo a revision. Interest deductibility is the more straightforward component pushing potential supply lower. The largest impact in this context will likely be on yankee issuance which is clocking in at ~$75bn YTD. This group of issuers could be incentivized to issue in their home countries or other reserve currencies such as the Euro, to the extent they are able to avail more interest deductibility vs. the US post tax reform. Additionally, it may incentivize more levered issuers to cut back on issuance. Our calculations show that to fully offset the impact of the interest deductibility cap in the Senate's version of the bill, loan issuers would likely need to cut down issuance by 10%, with 50% of the impact coming from issuers levered 7x or more, and 25% each from issuers levered 3x-5x and 5x-7x.

European credit: Financial alchemy gone wild

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We expect Euro credit spreads to take another leg tighter in 2018. We forecast 10-15bp of high-grade tightening and 50-75bp of high-yield tightening next year. This should lead to high-grade excess returns of around 1.5-2% and high-yield total returns of around 4-4.5%. Mario Draghi's unique set of policies creates a compelling environment for ongoing spread tightening, we think. Next year, the "shortage of bonds" should be acutely felt across the market given our expectations of a 10% drop in IG supply. Yet, with so much monetary help directed at credit markets, bubbles are a legitimate risk. And with bubbles, comes the threat of them bursting. That leaves a credit market that we think could, ironically, feel very fragile at times and prone to "flash crashes".

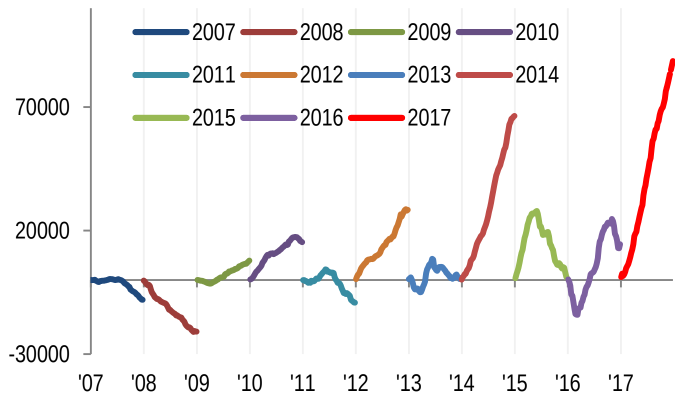
The dominance of CSPP coupled with low rates volatility points to another year where spreads simply compress. Much like in 2017, we expect next year's outperformers to be BBBs, sub financials, corporate hybrids and BBs. Theme-wise, we expect "domestic" names to outperform their exporting peers, but we fear some indigestion in the periphery as ECB QE shrinks. What ends "happy days" in credit? More hawkish central banks. Therefore, we see upside surprises to global inflation as the biggest game changer for the Euro corporate bond market in 2018.

Which leaves us with an uncomfortable feeling despite our bullishness…that the one thing that central banks are so craving (inflation) could ultimately be what ends the incessant reach for yield in European credit.

The great experiment

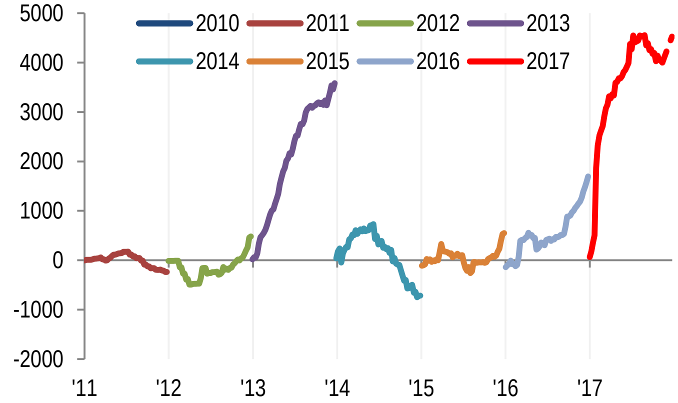
We argue that we are amid a great financial experiment in Europe…namely that of negative interest rates. Not all central banks have felt empowered to venture here in their efforts to resuscitate economies. Yet, the ECB has. By "punishing" the holdings of cash, Draghi's aim has been to endorse more risk-taking, and we would argue that it has indeed worked. In fact, we believe that it has unleashed a great "lust for yield" in Europe. Chart 29 shows that bar one week this year, money has flowed continuously into European corporate bond funds, unperturbed by any shock – be it rates, elections, geopolitics or equity sell-offs. And the magnitude is impressive. The irony, of course, is that European credit yields so little (0.7% for IG, 2.5% for HY). Hence, these flows are now structural, in our view. And we see no reason why they should stop in 2018.

Chart 29: European high-grade credit inflows (cumulative, yearly, $mn)



Source: EPFR Global, BofA Merrill Lynch Global Research. For the remainder of 2017, we extrapolate the year-to-date inflow by the average inflow observed since May '17.

Chart 30: European leveraged loan inflows (cumulative, yearly, $mn)



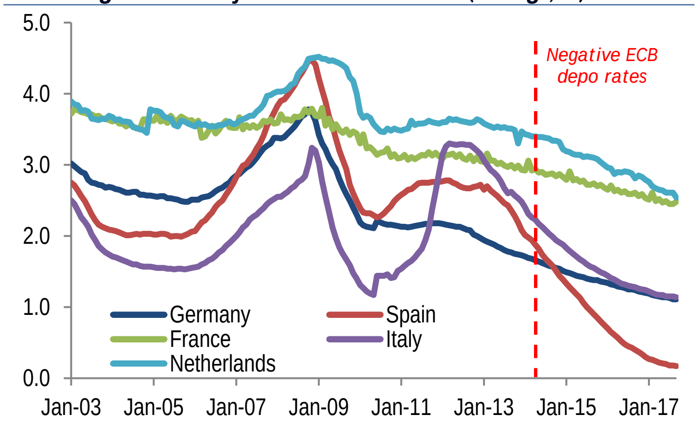
Source: EPFR Global, BofA Merrill Lynch Global Research. For the remainder of 2017, we extrapolate the year-to-date inflow by the average inflow observed since May '17.

Anecdotally, we sense credit inflows are now coming from a vast array of sources, aside from simple reallocation out of government bond markets due to QE. As Chart 31 shows, we think retail investors are finally starting to feel the pinch from the continuous decline in bank deposit rates across Europe. We believe that part of this money is finding its way into higher-yielding credit, and latest data suggests that there is nearly €8tr of household deposits in the Eurozone.

Moreover, we think a second important source of inflow into credit is from European corporates who are likewise finding their cash deposits are starting to be charged at negative rates. We believe this problem is more acute at present in Germany. And Chart 32 shows that the European corporate sector has seen its cash on balance sheet grow to over €700bn now.

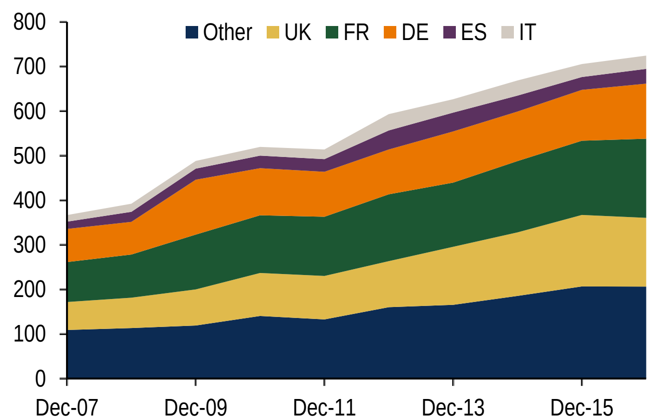
With Draghi pledging a slow and patient end to stimulus – and with the market only pricing in 40bp of interest rate hikes in Europe over the next 3 yrs – we believe that cash-rich investors and households will be pushed into finding suitable higher-yielding alternatives for their money: and that means more credit inflows in our view (see here for how high European High Net Worth Individuals' cash allocations are, for instance).

Chart 31: Household deposit rates continue to fall in the Eurozone motivating a search for yield into credit markets (average, %)



Source: ECB. Deposit rates (%). Commercial bank deposit rates.

Chart 32: Cumulative cash on European corporates' balance sheets (total, Eur mn, by country)



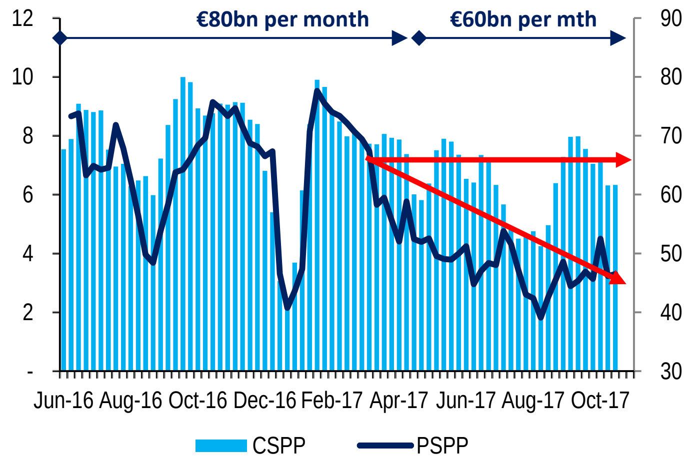
Source: BofAML Global Research. Bloomberg, SXXP index.

In 2018, we forecast Euro high-grade inflows to be around the €100bn mark, slightly exceeding this year's levels.

Draghi loves corporate bonds

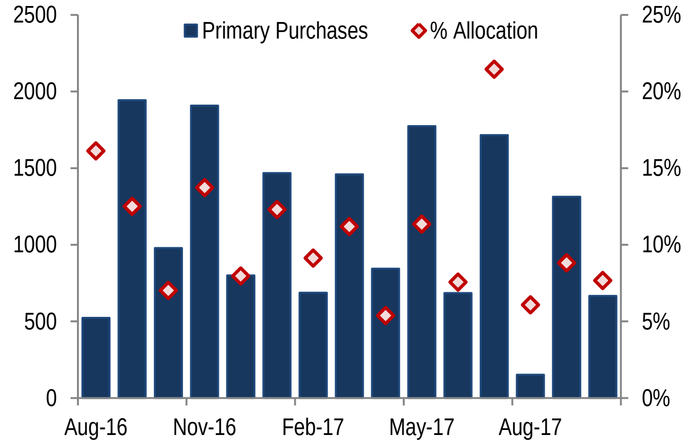
Inflation remains far from the desired 2% level in Europe, and so the ECB plans to push on with QE in 2018. At October's ECB meeting, Draghi stressed that the bank would continue to buy “sizeable” amounts of corporate bonds next year. Whether we get a formal split of how they plan to apportion the €30bn of monthly APP buying remains to be seen. But given the ECB’s scarcity problem in government debt, we see reasons for Draghi to keep CSPP buying high to help facilitate a reduction in government purchases.

Chart 33: CSPP buying has only dropped marginally this year



Source: ECB

Chart 34: What we estimate the ECB is being “allocated” in primary deals

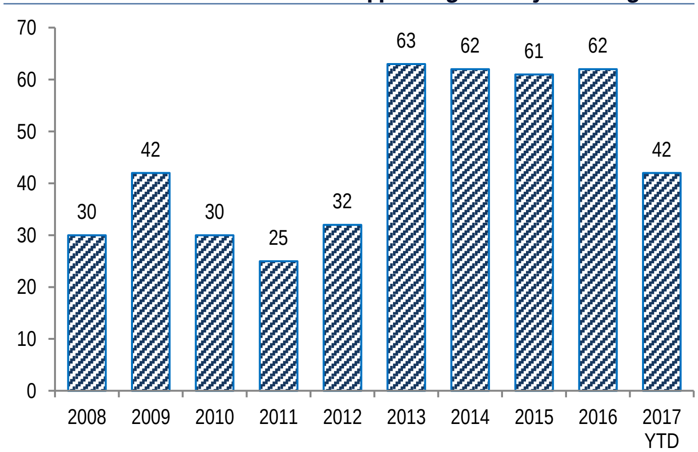


Source: BofA Merrill Lynch Global Research, ECB. “Allocation” (RHS) using disclosed primary data.

History has shown that CSPP fares well in QE tapering episodes – note in Chart 33 that this year’s QE taper from €80bn to €60bn has left credit buying mostly unscathed (after a summer drop). We think the ECB will be happy to keep CSPP high again in 2018. Moreover, with their ability to buy in primary, the programme is far from suffering scarcity issues, and note in Chart 34 that the ECB’s “allocation” in primary still has room to move higher. Politically, we don’t see the programme as being viewed negatively by the Governing Council given few – if any – purchased names have drastically widened (see here). Moreover, we believe that the ECB would like to see more in the way of “debut” issuance (Chart 35), and thus feels compelled to keep CSPP going.

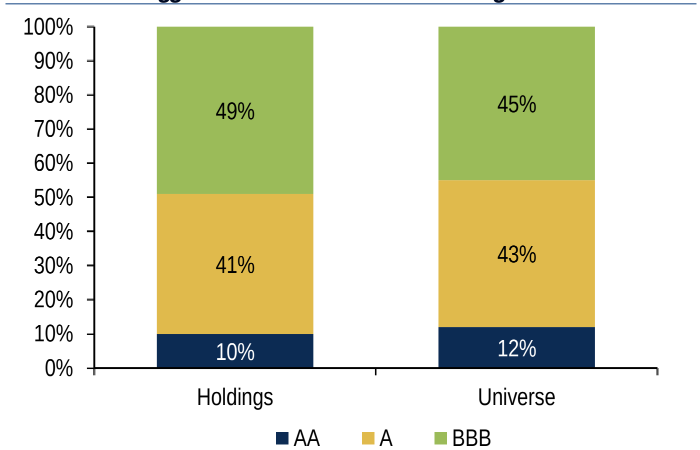
While the monthly numbers are likely to be variable, we expect total CSPP purchases to amount to €70bn next year: a quantum that we think is still very big and bullish for Euro credit.

Chart 35: Euro “debut” issuance – disappointing in the eyes of Draghi



Source: Bloomberg. Eur bn.

Chart 36: The biggest ETF in town? ECB CSPP holdings vs. “benchmark”



Source: BofA Merrill Lynch Global Research

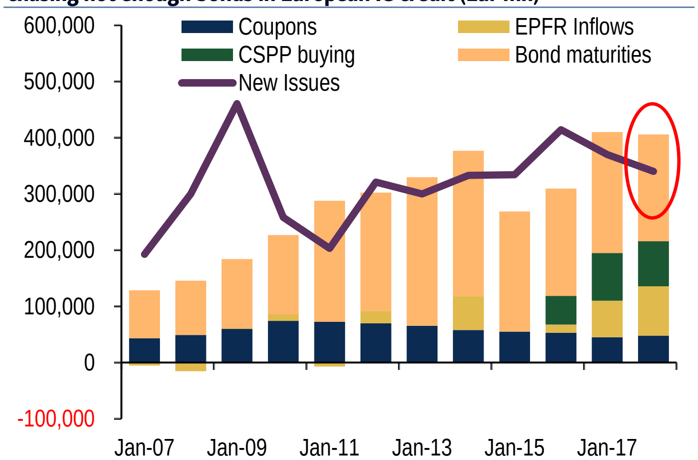
As recent disclosure has highlighted, the ECB has done an exceptional job at remaining market-neutral, across their 1000+ corporate bond purchases. And this is a key objective for the bank – favouring some sectors over others would ultimately weaken the pass through to the real economy of QE. This means we should think of the ECB as a big passive ETF in credit markets – albeit one with a slight bias to compressing spreads, as Chart 36 shows.

The scarcity of bonds in 2018

We think the scale of monetary policy support for Euro high-grade markets in 2018 should not be underestimated. Chart 37 shows that there will likely be far too much money chasing not enough bonds. In particular, the "sources of cash" available in credit markets next year will be heavily supported by inflows and the quantum of CSPP buying (which alone will tally €170bn). Maturities in high-grade will be slightly lower in 2018, but still a healthy €190bn (versus €215bn this year), and coupon payments will be marginally higher at €47bn in 2018 (versus €45bn this year). In total, this amounts to over €400bn of cash firepower in the Euro high-grade market in 2018.

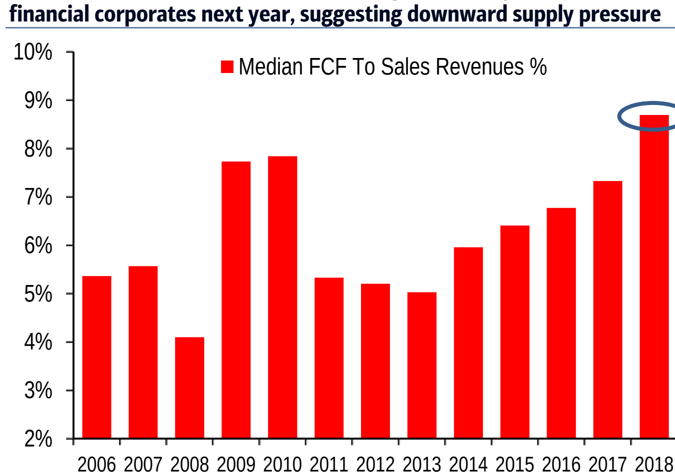
The other important part of the equation is less high-grade supply. We forecast fixed-rate supply to drop by around 10% next year: from €370bn to around €340bn. Why? As Chart 38 shows, thanks to years of focus on cost discipline, European non-financial corporates' FCF is expected to surge next year to a record. As such, we think cash-rich corporates will simply have less need for the same level of refinancing next year: many will be able to fund more of their day-to-day activities from organically generated cash flow. In addition, we forecast a drop-off in bank T2 issuance as many banks have excess T2 capital at present.

Chart 37: More of the same next year should still mean too much money chasing not enough bonds in European IG credit (Eur mn)



Source: EPFR Global, BofA Merrill Lynch. Eur mn. We calculate 2018 high-grade coupon payments and bond maturities. We assume next year's EPFR inflows in IG are €100bn. We assume CSPP buying of €70bn next year. We expect 2018 high-grade supply to be 10% lower than this year.

Chart 38: Record levels to FCF should be generated by European non-financial corporates next year, suggesting downward supply pressure



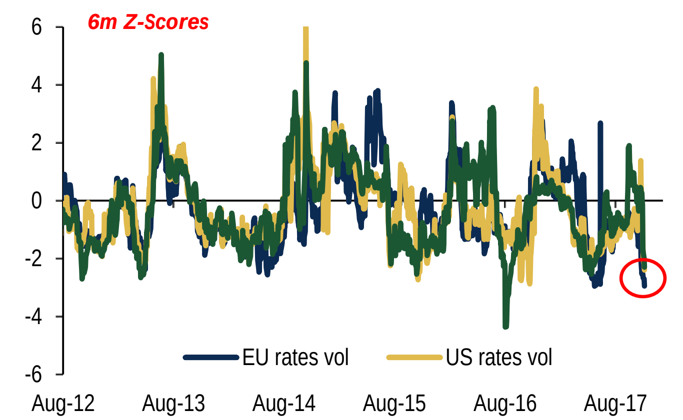
Source: MLIQ, BofA Merrill Lynch Global Research. Using large sample of European corporates.

Putting it all together in Chart 37, therefore, we can see that the market will be roughly "short" of corporate bonds next year to the tune of €70bn (€405bn from sources of cash vs. €340bn of new supply). This will represent a record in terms of corporate bond shortage, in the post crisis era.

To "Bubbleomics" and beyond

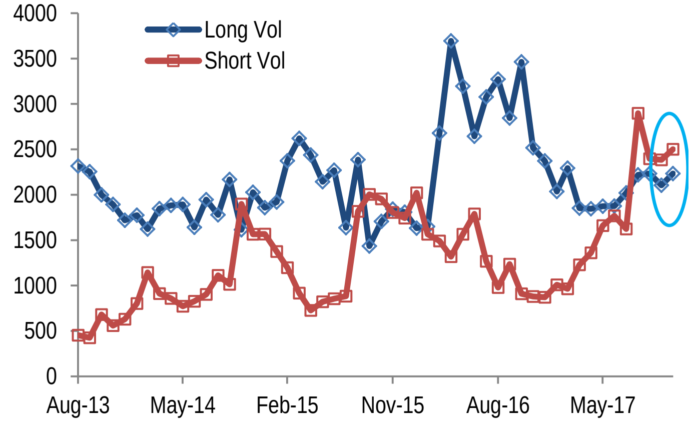
The message from central banks has been one of predictability and prudence lately, even as they dial-back stimulus. The effect has been that the market's belief in central bank "gradualism" has become widespread and unwavering. Note the extent to which rate volatility has collapsed globally, in many cases to record lows (Chart 39). Short volatility strategies have also flourished lately, as highlighted in Chart 40.

Chart 39: Global rates volatility: declining again



Source: BofA Merrill Lynch. Using SMOVEU3M, MOVE3M and SMOVBP3M. 6m Z-Scores.

Chart 40: Short-vol ETF assets have surpassed long-vol ETF assets



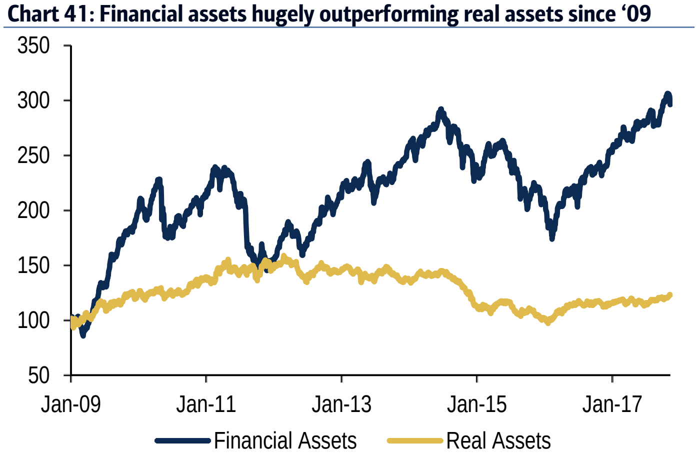
Source: Bloomberg. $mn.

Such low levels of volatility, and belief in dovish central banks, will likely be an elixir for risk assets in 2018, encouraging markets to embrace carry trades. This means huge demand for assets with quality yield. Chart 41 shows the extent to which there has been dramatic "inflation" in financial assets since 2009, rather than in real assets.

But, we also believe that this creates a fertile backdrop for market bubbles to form, and in credit markets in particular. We've highlighted before how 2017 has thrown up many conspicuous – and unnatural – pricing points in credit, such as Euro HY bonds yielding less than US Treasuries and AT1s almost yielding less than bank dividend yields.

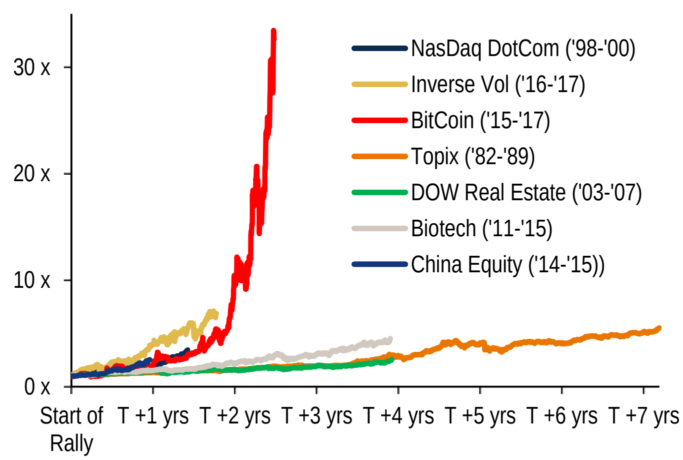
Chart 42 shows that since the financial crisis, the largesse of central banks appears to be inducing quicker and steeper price gains in assets compared to the case historically. In other words, we believe that market bubbles seem to be becoming more "bubbly" as time goes by.

Chart 41: Financial assets hugely outperforming real assets since '09



Source: BofA Merrill Lynch Global Research. Financial assets are: Global IG and HY credit, Eurostoxx600 and S&P 500. Real assets are US and European property, Japan land, Wheat, Oil and Gold. Rebalanced to 100 from Jan '09.

Chart 42: Are bubbles becoming more "bubbly"?

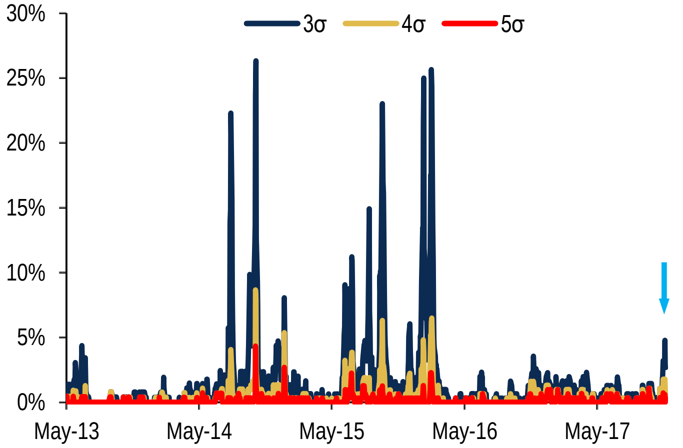


Source: BofA Merrill Lynch Global Research. Bloomberg. Using TPX Index, CCMP Index, DJUSRE Index, NBI index, SHASHR Index, XIV US Equity and XBT Curncy. Data is normalized and rebalanced at 100 at the start date of the rally (lowest data point) and ends at the top of the rally (highest data point).

Paradoxically, a credit market that can be very fragile

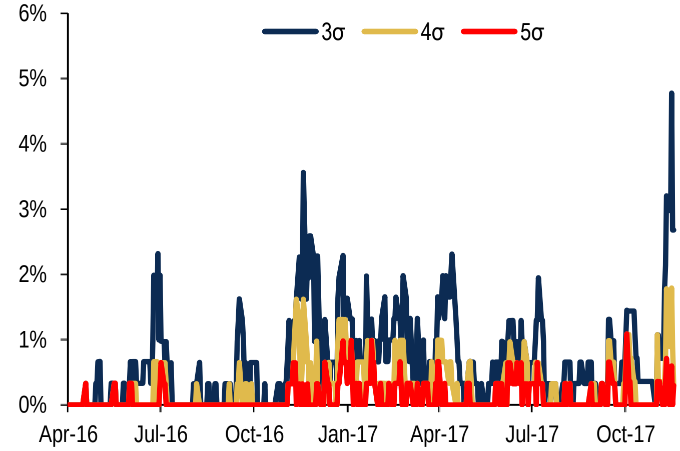
With every bubble comes the risk that it eventually pops, and we sense corporate bond investors have become more preoccupied with this over the last few months. Paradoxically, we think this will lead to a credit market that could feel very "fragile" (read: jittery) at times next year. The change in tone in the credit market over the last few weeks is an example of how quickly the market can doubt the viability of valuations, we think. It's not the first pull-back in spreads that we've seen over the last 2yrs, and we doubt it will be the last.

Chart 43: European high-yield "Fragility" index



Source: BofA Merrill Lynch. Percentage of the market experiencing big Z-score moves (6m average).

Chart 44: European high-yield "Fragility" index



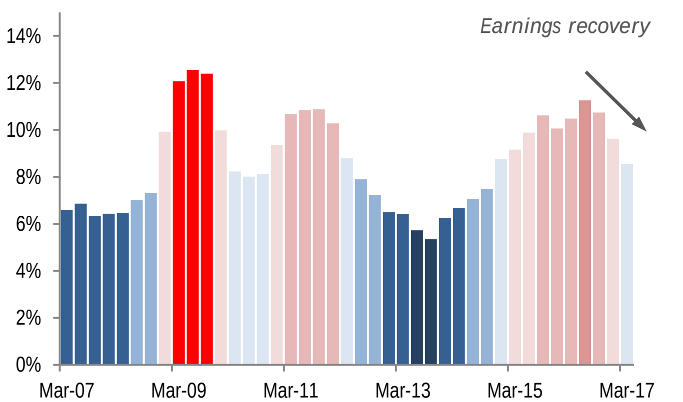
Source: BofA Merrill Lynch. Percentage of the market experiencing big Z-score moves (6m average).

Indeed, we already see evidence of rising "fragility" in Euro credit. The above charts present a "Fragility Indicator" for the Euro high-yield market. We show the percentage of the market (in % weight terms) where bond prices have experienced large standard deviation moves over the previous 6m. Understandably, fragility is high during macro shocks (such as the oil price drop in 2015). But note there has been a clear increase in big standard deviation moves in high-yield lately despite a much healthier European macro environment (and moreover, a big drop in policy uncertainty).

The rise of the Zombies – idiosyncratic risk hidden under the surface

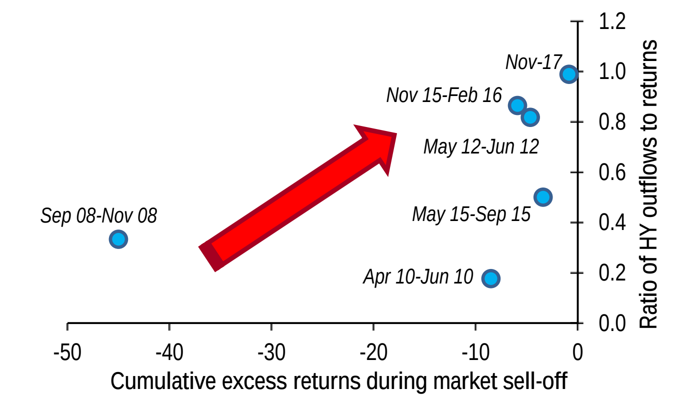
The notion of fragility in credit is underscored by the still-large existence of "zombie" companies in Europe. Chart 45 shows that Europe has a high level of corporates with interest coverage less than 1x. In fact, 9% of European non-financials are classified as "zombies" at present, a level higher than pre-Lehman times. The reality is that while these firms would normally be weeded out by the market, easy monetary policy has allowed them to "paper over" their fundamental cracks. Hence, we see this as a continued source of idiosyncratic risk for the European credit market in 2018.

Chart 45: "Zombies": vulnerabilities in the European corporate sector



Source: BofA Merrill Lynch. Percentage of Stoxx 600 market cap. Firms with interest coverage <1x.

Chart 46: Quicker high-yield fund outflows upon less severe disruptions



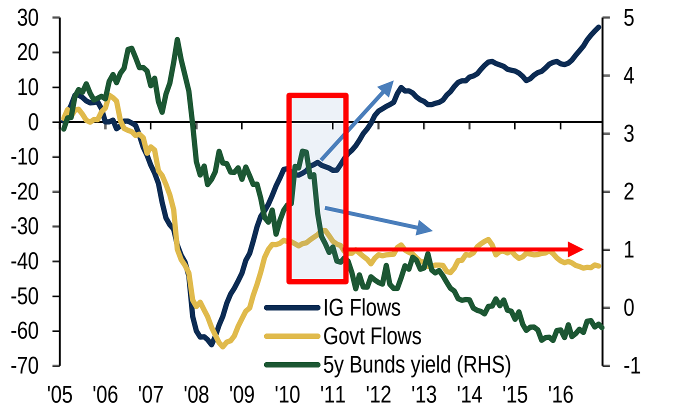
Source: BofA Merrill Lynch, IMF, EPFR global.. HE00 XS returns during shocks vs. EPFR HY outflows.

And given the market's unease about valuations and market structure, we find evidence that over time investors have been trying to "head for the exit" a little bit quicker upon each market disruption (Chart 46). This suggests to us that "flash crashes" in Euro corporate bond markets could be more common in 2018.

What ends "happy days in credit?"

This has become anything but normal times for Euro corporate bond investors due to the weight of ECB intervention. And, hence, what ends today's bullish credit cycle is likely to be very different than in the past. Absent a recession, out greatest concern is an outbreak of more hawkish central banks. Why? Because we think expectations of a tangible, rather than shallow rate hiking cycle is what could ultimately break the great reach for yield trade in European corporate bonds. Note how the reach for yield in Euro credit began to kick-in when 5yr bund yields broke the 1% mark in 2011.

Chart 47: Credit inflows surged when 5yr bund yields broke 1%



Source: BofA Merrill Lynch Global Research, EPFR Global; flows as % of AUM on monthly frequency

Chart 48: Developed economy average wage and labour productivity – at some point wages will need to rise

Source: Oxfam: "An economy for the 1%".

To our minds, three things could provoke a more hawkish-than-consensus narrative from central banks: a return of inflation, financial stability worries and populist politics.

Inflation

The modus operandi of central banks is price stability. In Europe, the ECB craves inflation of close to 2% as this will help support the debt sustainability of the periphery. But, the link between unemployment and inflation has been disappointing in this cycle, leading many to conclude that the Phillips Curve is dead. Indeed, our European economists have found evidence of an overall shift downwards in the distribution of inflation in the Euro Area, implying that inflation weakness is generalized.

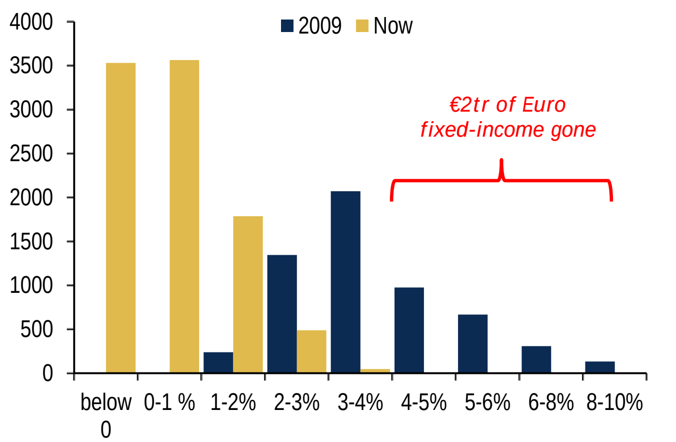
However, economic slack continues to be eroded at the global level given good economic growth. Ethan Harris argues that tight US labour markets might be enough to cajole US wage growth higher. And while we think Europe is some years behind the US is terms of reducing economic slack, due to the periphery crisis, stronger US wage data could start to raise inflation expectations in Europe.

The irony, therefore, is that the one thing that central banks crave could ultimately be destabilizing for the European corporate bond market.

Financial stability concerns

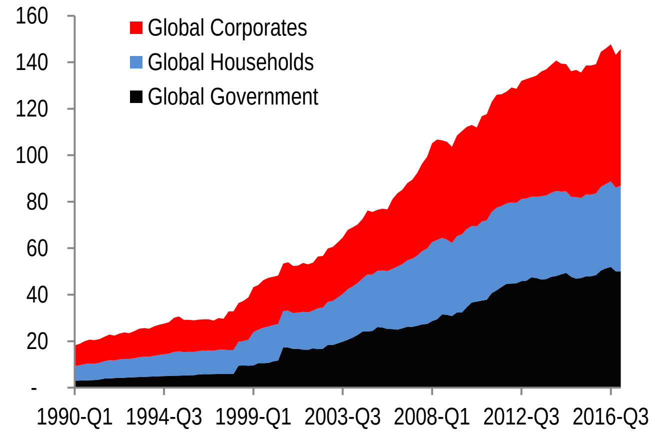
If inflation is slow to materialize, then monetary stimulus will continue to prop-up asset prices. Accordingly, this may place pressure on the ECB to be more mindful of bubbles and financial stability issues. In Europe, the evaporation of fixed-income yield since the start of 2009 has been tremendous. In fact, over €2tr of fixed-income assets that yield above 4% have disappeared in Europe since the start of 2009. And we highlighted above the concerning pricing points that have developed lately in the Euro credit markets.

Chart 49: The great disappearing act – so little yield above 4% now in European fixed-income (Eur bn)



Source: ICE BofA Merrill Lynch Global Bond Indices. European fixed-income EMU0 index.

Chart 50: Global debt growth ($tr) – growth driven more by non-financial corporate debt lately



Source: BIS, BofA Merrill Lynch Global Research,

In addition, patient and predictable central banks have helped extend the debt supercycle over the last few years, as Chart 50 shows. The growth in non-financial corporate debt has been a large component of this lately, especially in France where the increase in corporate debt to GDP has been rapid. Thus, if central banks begin to contemplate curbing stimulus on the grounds of financial stability, the end of "predictable" monetary policy would be a game changer for credit, in our view.

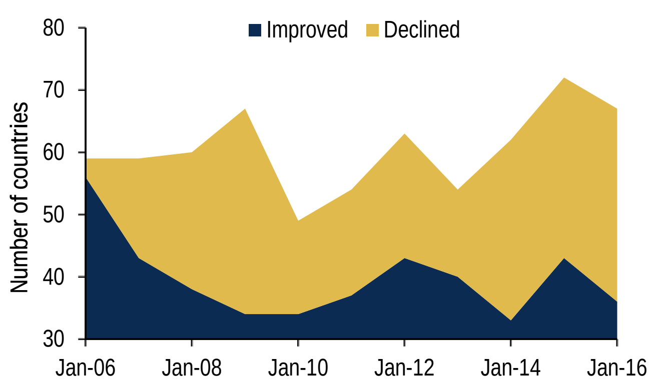
Populist persuasions

2017 was the year where populism barked but didn't bite in Europe. Although a Eurozone breakup vote wasn't embraced, populist parties continue to make their way up the governing chain across Europe.

During the last decade, income inequity has risen, and as we showed here the greater the income inequality across European countries, the higher appears to be the current populist voting share relative to history.

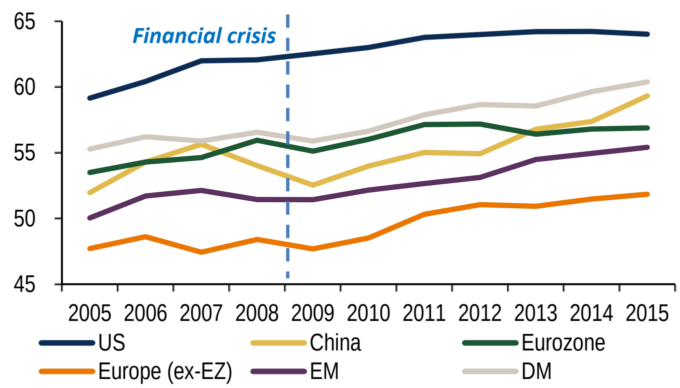
But populist party views are often dominated by the insular thinking of "us first" as opposed to agendas that embrace globalization. Moreover, the populist narrative is becoming more aggressive, confrontational and xenophobic as time goes by. As Chart 51 shows, more countries experienced declines in "freedom" last year compared to those that registered gains in "freedom" – the 11th such consecutive year.

Chart 51: 11yrs of decline in "Freedom". Countries with net declines in their aggregate *Freedom Index* score outpacing those with net gains.



Source: Freedom in the World 2017, Freedom House.

Chart 52: The "connectedness" of countries has grown since the GFC (DHL's Global Connectivity Scores)



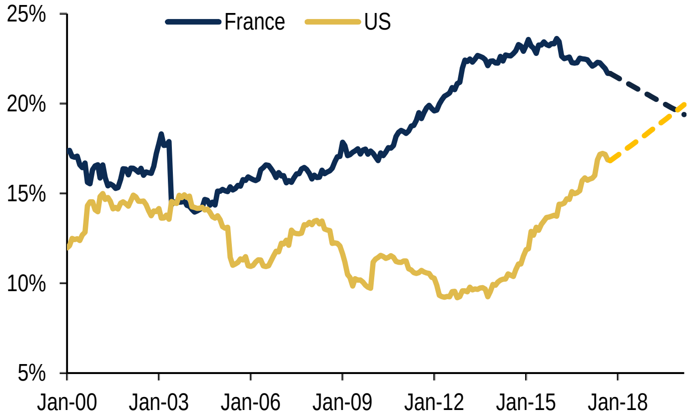
Source: DHL Global Connectivity Scores

This amounts to a test of globalization, in our view. We think this is important as the world has become more "connected" and global since 2009, as corporate supply chains now sneak across many countries (Chart 52). A push-back against globalization could create less efficient supply chains for issuers, which would be inherently inflationary. And by default, this could provoke a more hawkish message from central banks.

The United States of Europe

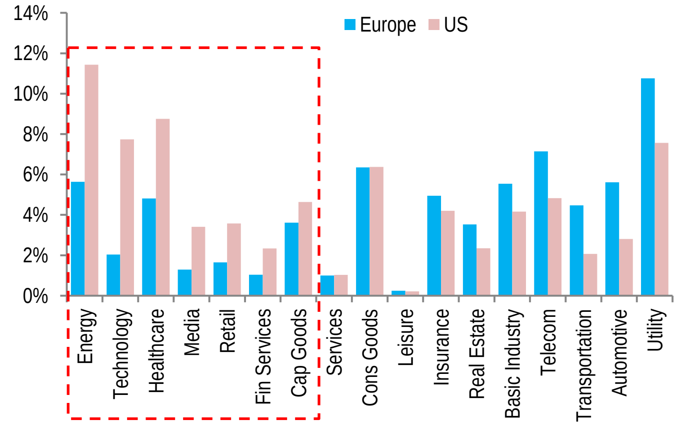
One important theme we expect to continue next year is Reverse Yankee supply. Europe still offers a cheap avenue for US issuers to establish a new investor base and develop a bond curve (especially given Europe's ability to print off-the-run maturities).

Chart 53: US issuers could potentially surpass French issuers as the largest share of the € IG market over the next few years



Source: BofA Merrill Lynch. % of ER00 and projections based on extrapolating recent market growth

Chart 54: Underrepresented IG sectors in Europe, compared to the US (IG index market weight, %). Potential Revere Yankee issuers.



Source: BofA Merrill Lynch Global Research

And as we showed here, by diversifying into Euro issuance, US companies have at times been able to drive a tightening in their US spreads, thus helping to lower their overall cost of debt. Year-to-date, Reverse Yankee issuance has been €60bn. Recent FASB hedge accounting changes (with respect to Net Investment Hedges) may slow down the Reverse Yankee trend somewhat, but nonetheless we still expect a healthy €50bn of Reverse Yankee supply next year.

One important consequence of this, is that the share of US issuers in the Euro high-grade credit market will continue to rise quickly (as much of this is new debt rather than refinancing). At the same time, France's share of the Euro high-grade credit market has been declining over the last few years (we believe French companies are gravitating back towards bank financing). We expect this trend to be exacerbated over the next few years as France cuts its corporate tax rate from 33% to 25% (a lower tax rate should motivate French companies to be less levered over time, and hence will reduce the supply of French debt outstanding).

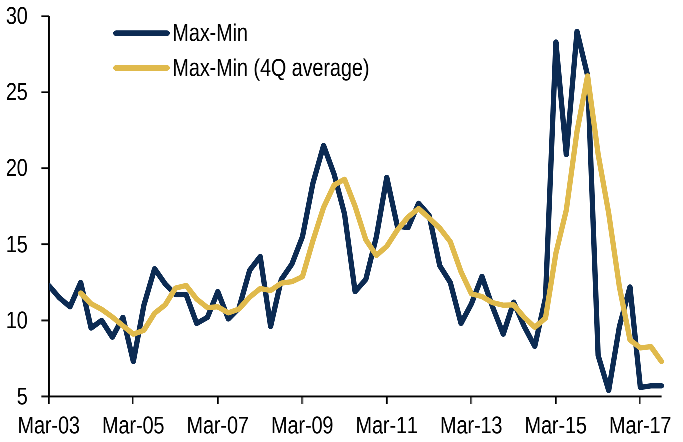
Extrapolating from recent trends, Chart 53 suggests that US issuers are on course to surpass French issuers as the largest share of the Euro corporate bond market over the next few years. For investors, this will mean that Euro credit spreads will become more sensitive to US corporate idiosyncratic risk, and Fed announcements, for instance.

"Domestics" over "Exporters"

Thanks to ECB QE, and a soft rather than hard landing in China, the Eurozone growth outlook is the best it has been in many years. Our economists expect 2.0% Eurozone GDP growth next year. Importantly, this is now becoming a very synchronized upturn in Eurozone growth. Chart 55 highlights the record low difference between the highest and the lowest growth rates across Euro Area countries, at present.

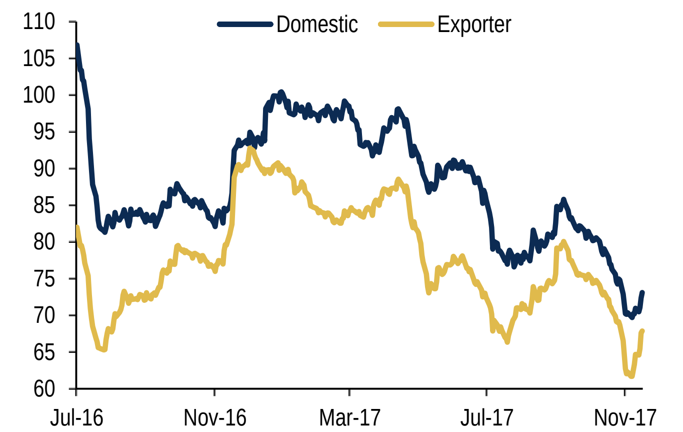
And with a capex revival also underway here, we think this bodes very well for the profitability of Eurozone companies that derive a large part of their revenue domestically. Thus, we think spreads of Eurozone domestically-focused issuers should outperform spreads of their exporting peers in 2018.

Chart 55: Record low difference between growth rates of Eurozone countries at present



Source: Bloomberg. Note recent big divergence is due to Ireland. Max vs. min country growth rates.

Chart 56: German credit spreads: domestic vs. exporters. Domestic credits are wider



Source: BofA Merrill Lynch Global Research. .OAS spread. Using most recent annual sales report.

Where can one find cheap "domestic" credits in Europe given how compressed spreads already are? Chart 56 shows the spread of "domestic" Euro credits against the spread of "exporters" for German names. We find that German domestic non-financial spreads still look quite wide versus their exporting counterparts.

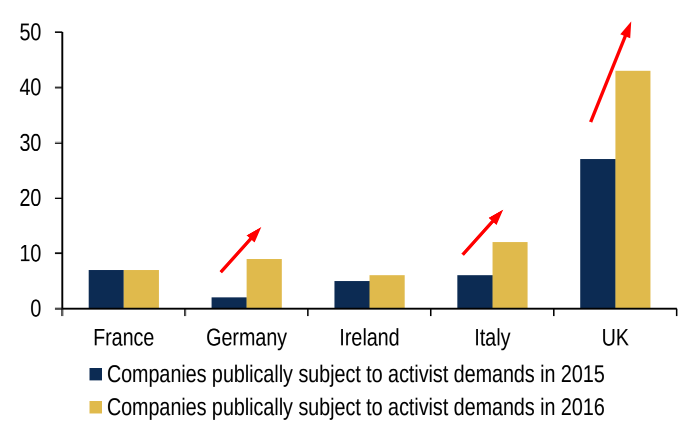
Interestingly, French domestic credits trade tighter than French exporters now.

The urge to splurge

Fundamentally, European corporate balance sheets are in great shape, in our view. Leverage is very low and earnings growth is now at high levels, and importantly earnings haven't faltered as 2017 has progressed (as has frequently been the case previously). But herein lies a risk for Euro credit investors next year, we think.

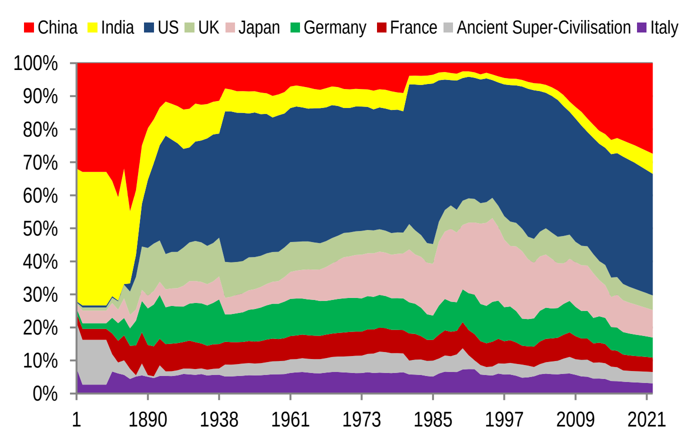
A resurgence in corporate earnings growth is, unavoidably, making European issuers tempting takeover candidates for foreign bidders. The attraction is that European non-financials are starting to look far too deleveraged versus their global counterparts. The chart below shows that shareholder activists are taking much more interest in European corporate opportunities now after a long period of focusing on US releveraging targets. Note the rise in shareholder activism for German, Italian and UK companies.

Chart 57: Shareholder activism is picking up outside of the United Sates recently



Source: Activist Insight annual review 2017. Number of companies.

Chart 58: How the composition of world growth has changed (Country GDP as % of total)



Source: BofA Merrill Lynch Global Research, Angus Maddison, IMF GDP data and estimates between 1980 and 2022. Ancient super-civilizations include Greece, Turkey, Algeria, Iraq, Egypt and Iran.

In Europe, political voices are arguing in favour of legislation that would help restrict foreign takeovers of domestic companies, in particular strategically important companies (i.e. those with a national security interest). China M&A into Europe has been a particular concern for European governments lately. And given the extent to which world growth has rebalanced in favour of China (Chart 58), European governments are cautious about losing their domestic champions to Chinese buyers.

While it is easier for Europe to protect its domestic tech champions on the grounds of national security, it becomes harder to block the foreign takeover of others. Therefore, we believe that European companies will feel under growing pressure to get bigger to fend off the threat of foreign takeovers. If European companies don't lever up, they may be at risk of being bought by foreign bidders.

Who has the greater incentive to releverage in Europe? In Table 4 below, we update a quantitative screen (see more here on the methodology) which predominantly ranks companies based on the difference between their debt and equity costs. Names and sectors near the top have, other things being equal, the greatest incentive to releverage.

Table 4: Corporate event risk screen. The higher the average score, the more we believe a company is likely incentivized to be shareholder-friendly.

Ticker	Country	Description	Sector	Rating	Equity and debt cost difference (%)	Dividend yield less debt cost (%)	Historical stock performance	Cash flow volatility	Average
BRITEL	United Kingdom	BT GROUP PLC	TMT	BBB1	95%	86%	87%	84%	88%
SESGFP	Luxembourg	SES	TMT	BBB2	83%	100%	100%	63%	86%
BMW	Germany	BAYERISCHE MOTOREN WERKE AG	Automotive	A1	96%	70%	86%	89%	85%
ITVLN	United Kingdom	ITV PLC	TMT	BBB3	92%	84%	73%	73%	82%
DAIGR	Germany	DAIMLER AG-REGISTERED SHARES	Automotive	A3	97%	78%	72%	67%	80%
IMBLN	United Kingdom	IMPERIAL BRANDS PLC	Consumer, Retail, Services	BBB2	85%	76%	94%	66%	79%
EDPPL	Portugal	EDP-ENERGIAS DE PORTUGAL SA	Utility & Energy	BBB3	76%	95%	57%	74%	78%
NGGLN	United Kingdom	NATIONAL GRID PLC	Utility & Energy	BBB1	50%	99%	52%	87%	74%
CNALN	United Kingdom	CENTRICA PLC	Utility & Energy	BBB3	86%	97%	95%	13%	72%
LIFP	France	KLEPIERRE	Real Estate	A3	94%	84%	75%	26%	71%
REESM	Spain	RED ELECTRICA CORPORACION SA	Utility & Energy	A3	59%	73%	43%	95%	70%
RIOLN	United Kingdom	RIO TINTO PLC	Basic Industry	A3	80%	93%	82%	20%	69%
HMSOLN	United Kingdom	HAMMERSON PLC	Real Estate	BBB1	88%	57%	100%	42%	69%
ENIIM	Italy	ENI SPA	Utility & Energy	BBB1	90%	92%	76%	10%	69%
TELEFO	Spain	TELEFONICA SA	TMT	BBB2	91%	57%	82%	46%	68%
SSELN	United Kingdom	SSE PLC	Utility & Energy	A3	78%	94%	62%	26%	67%
ULFP	France	UNIBAIL-RODAMCO	Real Estate	A2	41%	75%	50%	100%	67%
PROXBB	Belgium	PROXIMUS	TMT	A2	49%	81%	59%	76%	67%
ADNA	Netherlands	KONINKLIJKE AHOLD DELHAIZE N	Consumer, Retail, Services	BBB2	74%	47%	82%	71%	66%
GSK	United Kingdom	GLAXOSMITHKLINE PLC	Healthcare	A2	83%	87%	80%	6%	65%
SANFP	France	SANOFI	Healthcare	AA3	75%	64%	60%	56%	65%
CAFP	France	CARREFOUR SA	Consumer, Retail, Services	BBB1	63%	68%	100%	40%	64%
EDF	France	EDF	Utility & Energy	A3	45%	79%	100%	48%	64%
MLFP	France	MICHELIN (CGDE)	Automotive	A3	81%	49%	29%	79%	63%
RENAUL	France	RENAULT SA	Automotive	BBB2	100%	71%	43%	21%	63%
ORAFP	France	ORANGE	TMT	BBB1	66%	74%	47%	55%	63%
WPPLN	United Kingdom	WPP PLC	TMT	BBB2	88%	45%	65%	52%	63%
ENGIFP	France	ENGIE	Utility & Energy	A3	63%	91%	91%	12%	63%
PUBFP	France	PUBLICIS GROUPE	TMT	BBB2	86%	55%	71%	38%	62%
REPSM	Spain	REPSOL SA	Utility & Energy	BBB2	93%	81%	67%	1%	62%
ALOFP	France	ALSTOM	Capital Goods	BBB2	53%	98%	90%	14%	62%
SIEGR	Germany	SIEMENS AG-REG	Capital Goods	A1	61%	53%	50%	82%	62%
TOTAL	France	TOTAL SA	Utility & Energy	AA3	81%	88%	38%	21%	62%
SUFP	France	SCHNEIDER ELECTRIC SE	Capital Goods	A3	44%	48%	80%	87%	62%
UU	United Kingdom	UNITED UTILITIES GROUP PLC	Utility & Energy	A3	24%	65%	72%	93%	61%
SGOFP	France	COMPAGNIE DE SAINT GOBAIN	Basic Industry	BBB2	78%	41%	64%	60%	60%
SOLBBB	Belgium	SOLVAY SA	Basic Industry	BBB2	66%	43%	100%	45%	59%
CONGR	Germany	CONTINENTAL AG	Automotive	BBB1	75%	26%	57%	80%	59%
ACEIM	Italy	ACEA SPA	Utility & Energy	BBB1	71%	64%	0%	69%	58%
IBESM	Spain	IBERDROLA SA	Utility & Energy	BBB1	56%	80%	29%	50%	58%
VW	Germany	VOLKSWAGEN AG-PREF	Automotive	BBB1	98%	22%	100%	18%	55%
ELIAV	Finland	ELISA OYJ	TMT	BBB2	28%	67%	18%	94%	55%

Table 4: Corporate event risk screen. The higher the average score, the more we believe a company is likely incentivized to be shareholder-friendly.

Ticker	Country	Description	Sector	Rating	Equity and debt cost difference (%)	Dividend yield less debt cost (%)	Historical stock performance	Cash flow volatility	Average
BAYNGR	Germany	BAYER AG-REG	Healthcare	A3	51%	40%	100%	49%	55%
RDSALN	Netherlands	ROYAL DUTCH SHELL PLC-A SHS	Utility & Energy	AA3	45%	96%	48%	16%	53%
AIFP	France	AIR LIQUIDE SA	Basic Industry	A3	23%	34%	91%	90%	53%
ENELIM	Italy	ENEL SPA	Utility & Energy	BBB2	62%	83%	10%	30%	52%
BATSLN	United Kingdom	BRITISH AMERICAN TOBACCO PLC	Consumer, Retail, Services	BBB1	30%	43%	41%	96%	52%

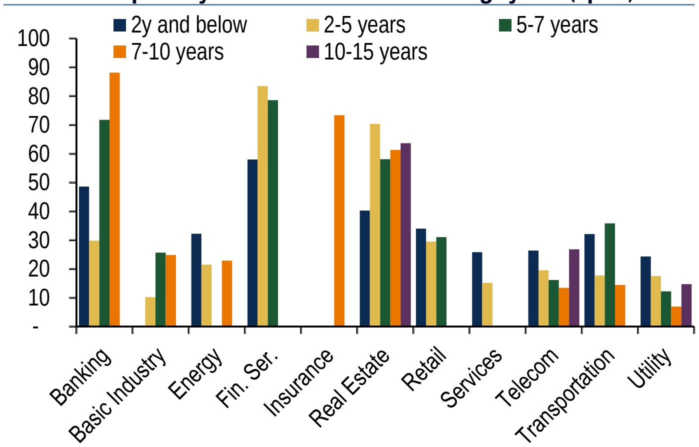
Source: BofA Merrill Lynch Global Research. We calculate 5yr after-tax debt costs using CDS spreads, government bond yields and swap spreads. We adjust for corporate taxes in each country. Using Bloomberg 12m estimated earnings yields and dividend yields.
Cash flow volatility is calculated as the standard deviation of EBIT, divided by the average EBIT, over at least 10 periods of reporting.

Watch out for periphery weakness

Even with much better Eurozone growth, one potential pocket of weakness next year could be the periphery. We believe the driver of this is technical. From January next year the ECB will cut monthly QE purchases from €60bn to €30bn. But as our rates team highlight, active private investors will need to absorb a very large amount of peripheral government bond supply next year. Credit investors should be cognizant of peripheral government bond weakness spilling over into peripheral credit spreads.

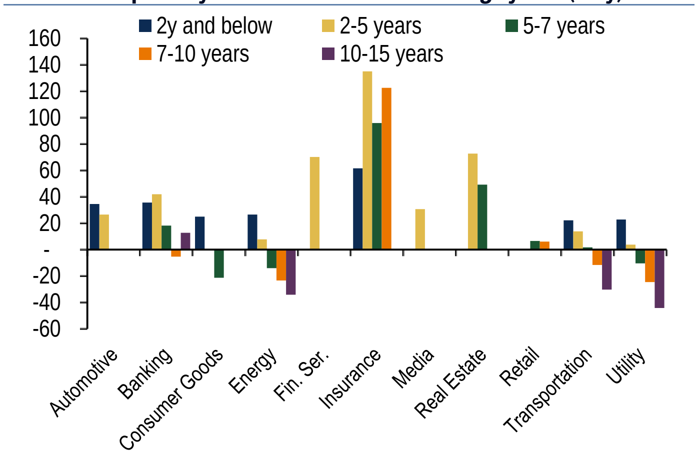
The charts below show which parts of the periphery in credit yield *less* than their respective government bonds. These could be the first parts of the credit market to be vulnerable next year, we think. Note how tight long-dated Italian credit is in the energy, transport and utility sectors.

Chart 59: Corporate yields minus domestic sovereign yields (Spain)



Source: BofA Merrill Lynch Global Research. IG corporates including subs. Bloomberg.

Chart 60: Corporate yields minus domestic sovereign yields (Italy)



Source: BofA Merrill Lynch Global Research. IG corporates including subs. Bloomberg.

How to position in 2018

In summary, we would position as follows:

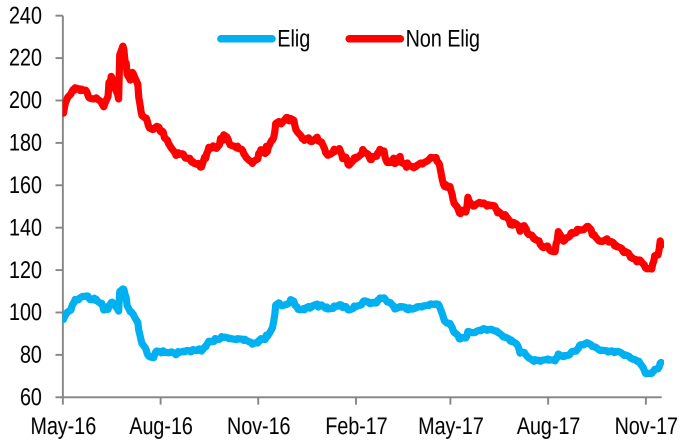
Long beta

We think 2018 will be another year where the higher the beta, the better the full-year performance, given the very low rate volatility backdrop (see the nice chart in our European credit derivatives section underscoring this pattern). That would mean a better-than-market performance from BBBs, corporate hybrids, sub financials and BBs in high-yield (given the strong impact of rising stars).

Non-eligible over eligible

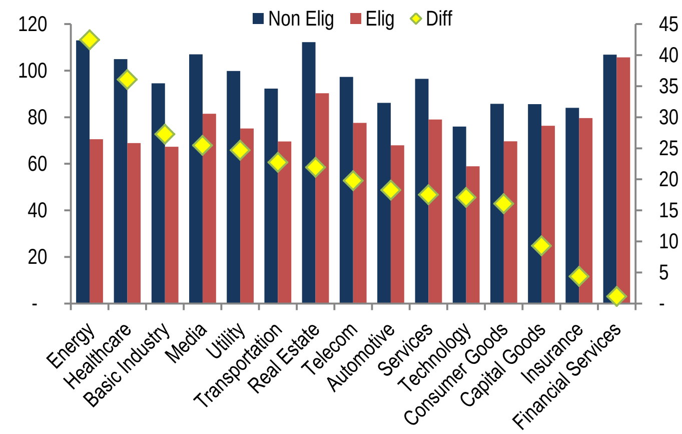
Another way to express the above is that non CSPP-eligible sectors would outperform CSPP-eligible sectors in 2018. The charts below show that while non-eligible has compressed in 2017, spreads have helpfully backed-up in the last few weeks. Chart 62 highlights where the non-eligible/eligible spread difference is the greatest (energy, healthcare and basic industrials, for example).

Chart 61: Eligible vs. Non Eligible Euro credit spreads



Source: BofA Merrill Lynch Global Research, ECB, ICE BofAML Indices

Chart 62: Eligible vs. Non Eligible spread difference by sector



Source: BofA Merrill Lynch Global Research, ECB, ICE BofAML Indices

Long-duration

In our European credit derivatives section we highlight how the flattening in cash credit curves has lagged the flattening in bund curves this year. We think the ECB's longer-duration focus in buying government debt is part of the reason here. Nonetheless, we would expect credit curves to flatten in 2018, and to play "catch up".

Domestics over exporters

We favour owning domestic Eurozone credits over their exporting peers. The cheapest domestic credits, in our view, are German credits.

Country risk

Finally, we favour core over periphery in 2018, although we expect the relationship to be volatile. Our worry with peripheral credits is that their corresponding government debt may be weak at times next year given the big increase in net supply that the private sector needs to absorb. Thus, peripheral government bond weakness could feed through to peripheral corporate bond weakness.

2018 returns forecast

The table below highlights our total and excess return forecast for 2018, inclusive of the Sterling credit market. Note given the uncertainty of Brexit negotiations and the negative impact that it is already having on UK growth and UK consumer credit quality, we forecast just a small tightening of 5bp for the Sterling high-grade market next year.

Recall our view is for 10-15bp of Euro IG tightening next year, and 50-75bp of high-yield tightening.

Chart 63: Illustrative Euro and Sterling Credit Return estimates for 2018

	IG (ER00)	HY (HE00)	Sterling (UN00)
Constant maturity yield change (bps)			
Treasury	23	23	39
Spreads	-10	-70	-5
Curve rolldown (bps)			
Treasury	-14	-16	-5
Spreads	-5	-14	-2
'18 yield change (bps)	**-6**	**-76**	**27**
'18 year-end duration	4.3	3.5	7.3
'18 price change (%)	**0.24**	**2.68**	**-1.99**
Default Rate (40% rec)		1.5%	
Defaults loss		0.95%	
'17 year-end yield (%)	0.75	2.52	2.31
'18 total return (%)	**0.99**	**4.24**	**0.32**

	IG (ER00)	HY (HE00)	Sterling (UN00)
Constant maturity yield change (bps)			
Spreads	-10	-70	-5
Roll down			
Spreads	-5	-14	-2
'18 spread change	**-15**	**-84**	**-7**
'18 year-end duration	4.3	3.5	7.3
'18 spread return (bps)	**66**	**295**	**51**
Default Rate (40% rec)		1.5%	
Defaults loss		0.95%	
'Current spread (bps)	90	270	104
'18 Excess return (bps)	**156**	**470**	**156**

Source: BofA Merrill Lynch Global Research

Euro high yield: High Hopes in High yield

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We do not see a major change in direction for European high yield spreads for the upcoming year. As we believe the ECB will continue dampening volatility and favouring private sector purchases for the remainder of the APP life, higher yielding assets stand to perform better than their IG peers. We think this bodes well for corporate hybrids, sub financials and high yield bonds. Despite current valuations, we think the European high-yield market will go tighter next year by around 50-70bp, resulting in total returns of around 4-4.5% by the end of 2018.

Our expectations in European high yield are:

- **Improving fundamentals**: better earnings, better economies, and more upgrades than downgrades. We think BB fundamentals in particular will improve, while we remain cautious on the fundamentals of single-Bs (weak survivorship bias).
- **Defaults in UK but not in the EU**: here we mark a distinction between Euro and Sterling high yield. We think that Euro high yield will continue to see very low default rates at around 1-1.5%. Sterling high yield, however, could see more defaults as the healthcare and retail sectors suffer under the pressure of Brexit uncertainty.
- **Supply might not be an issue**: we still see more demand than supply for European high-yield next year (assuming no significant outflows). European single Bs and CCCs in particular will continue to issue more in the loan market, but we think the effect of the switch will be less evident than during the previous year, given the growth in HY foreign issuance in euros (mainly Reverse Yankees).

What are the risks to our tightening scenario?

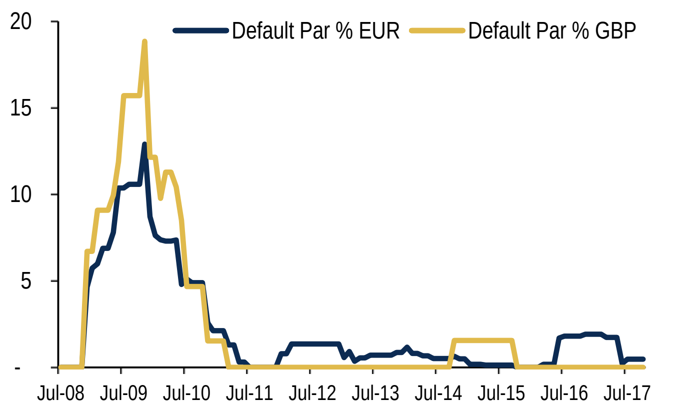
- The main risk for our bullish view is the possible turn in the central banks dovish speech. An increase in rates volatility could easily wipe-out our expected returns in 2018.
- The focus on idiosyncratic risk will come back with the fading of the monetary policy. Given the very tight valuations, we think that “contagion” risks could increase relative to this year.
- We think loans will be the first victims of defaults given that fundamentally “weaker” names are gravitating more towards loans as a financing option. We do not see defaults in loans rising in 2018 but past the QE horizon, tighter monetary conditions could cause some cracks.

Defaults: down in the EU, up in the UK

The default metrics in the European high yield market, contrary to their US equivalents, are currently a lesser worry for investors, and for a good reason: European high yield companies seldom default. We think that for 2018, given the improvement in the economic conditions in the Eurozone, coupled with the continued availability of cheap funding (as the ECB is still doing QE), defaults among Euro HY bond issuers are likely to remain as low as the previous year.

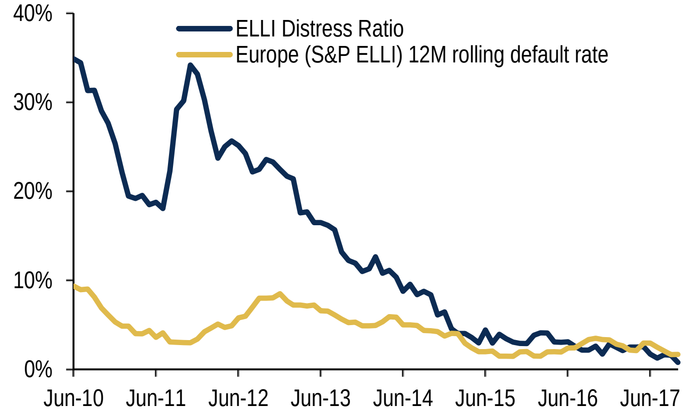
To that statement, however, we add a big caveat. When speaking about Euro HY, we explicitly separate it from Sterling HY. We think that the benign dynamics in the Euro market will not be replicated in Sterling. With the Brexit effect expected to materialise strongly in the UK economy and consumer spending, we think Sterling high yield will see a rise in defaults over 2018.

Chart 64: Euro vs. Sterling high yield realized default rates



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

Chart 65: Loans distressed and default ratios

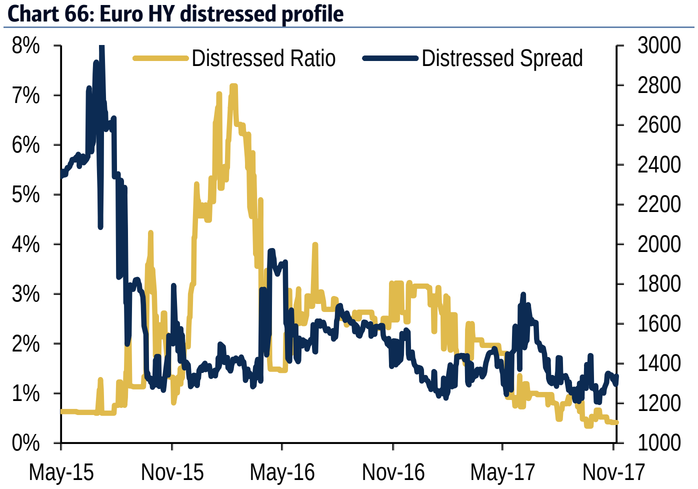


Source: BofA Merrill Lynch Global Research , LCD Comps

The fragility in the sterling market is already apparent when looking at the distress profiles of Euro and Sterling high yield. In the charts below, we look at the % of each market trading above 1000bps, but also the average spread of those distressed bonds. The Euro HY market seems to be in a very conservative "stress" level, at around 1% of the total Euro HY market, but also the spread of these distressed bonds looks to be recovering.

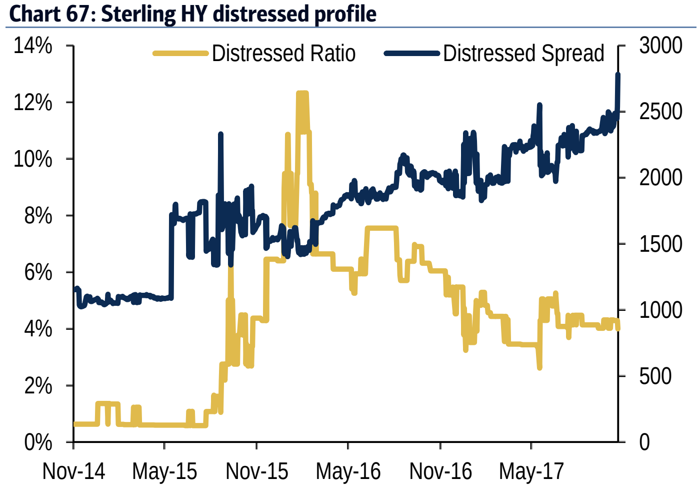
On the Sterling side however, not only has the distressed ratio risen recently, but the distressed bonds' spread seem to be worsening as well.

Chart 66: Euro HY distressed profile



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

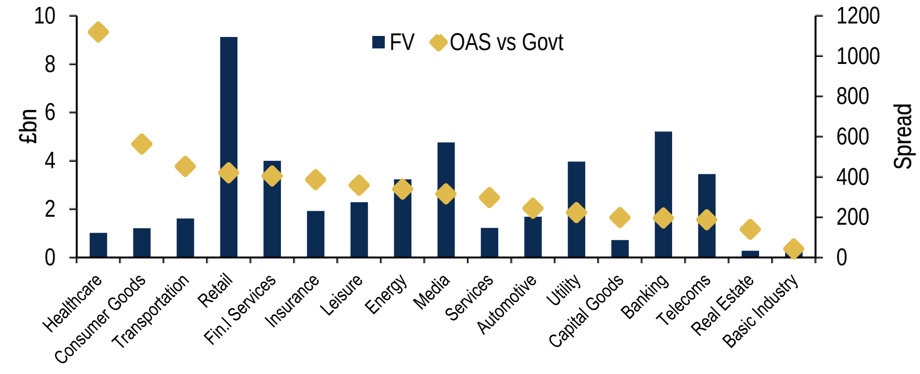
Chart 67: Sterling HY distressed profile



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

These facts tally-up with our economists' views on the weaker outlook of the UK economy, and with our analysts' concerns over the liquidity of names like Newlook, and more generally with the pessimistic tone of the retail, consumer goods and healthcare sectors in the UK. We see a possible rise in defaults for these sectors for 2018.

Chart 68: Widest sectors in Sterling HY



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

Supply vs. Demand – Still in favour of euro HY for '18?

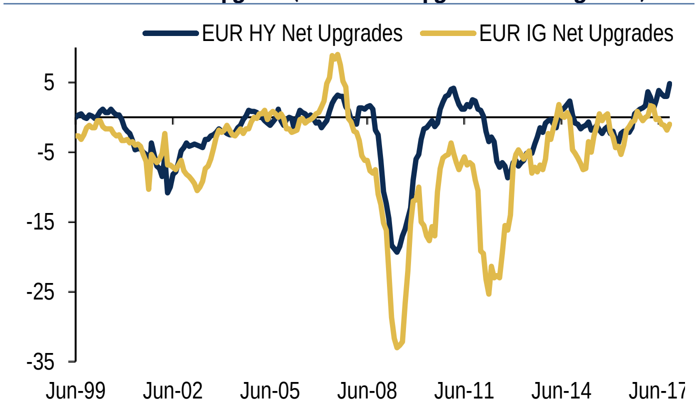
A strong reason for high yield's strong performance over the last couple of years was the shortage of bonds investors (either original HY investors or the new comers from IG looking for yield) faced in the market. Over the course of 2017, we went into depth behind the causes of the shortage and summarized it as follows:

Rising stars vs. Fallen angels

In 2017, many big issuers in the ICE BofAML HY index left to become IG: Anglo American, CNH and Schaeffler to name a few. These are all good examples to illustrate the improvement in the fundamental picture in Euro high yield.

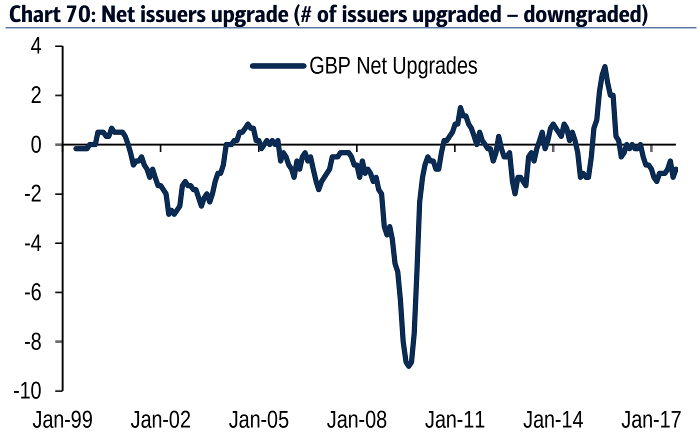
For 2018, we see strong signs of that trend continuing. Among BBs, the fundamentals keep improving, in sharp contrast to lower-rated companies where leverage is ticking up (single Bs and CCCs and below). More interestingly, looking at the trend in net rating upgrades, the Euro HY ratio is now at a historical high, and is diverging from its IG peer (as shown in Chart 69). We note however that on the Sterling side, a notable degradation in ratings continues (Chart 70).

Chart 69: Net issuers upgrade (# of issuers upgraded – downgraded)



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

Chart 70: Net issuers upgrade (# of issuers upgraded – downgraded)



Source: BofA Merrill Lynch Global Research. ICE BofAML indices.

We think that given the current positive outlooks / watches, over €40bn of Euro HY BB bonds have *rising star* potential over the next year, providing no unexpected shocks to the economy or outlook for oil. On the other side of the equation, our estimates for potential *fallen angels* is for less than €20bn (Table 5 and Table 6) when excluding EM names (mostly Pemex in this case).

All in all, we think the positive rating momentum will contribute to further shortage in the BB space as we see more potential upgrade than downgrade by about €15-20bn.

Table 5: Potential Rising Stars

Ticker	Description	FV of EUR and GBP Debt (mn)	Composite Rating	S&P Rating	S&P Outlook	S&P Outlook Date	Fitch Rating	Fitch Outlook	Fitch Outlook Date	Moody's Rating	Moody's Outlook	Moody's Outlook Date
LDOIM	Leonardo Spa	2,894	BB1	BB+	STABLE	28/04/2015	BBB-	STABLE	25/10/2017	BB+	POS	23/05/2017
TITIM	Telecom Italia S.p.A.	11,814	BB1	BB+	POS	12/07/2017	BBB-	STABLE	20/11/2015	BB+	STABLE	09/05/2017
TNEMAK	Tenedora Nemak SA de CV	500	BB1	BB+	STABLE	15/06/2017	BB+	POS	17/11/2016	BB+	POS	11/10/2016
ABVVPS	Autostrada Brescia Verona Vicenza Padova SpA	400	BB1	BBB-	STABLE	18/03/2015	BB+	-	-	-	-	-
BZUIM	Buzzi Unicem	500	BB1	BB+	POS	16/01/2017	-	-	-	-	-	-
CNHI	CNH Industrial Finance Europe S.A	2,897	BB1	BBB-	-	-	BBB-	-	-	BB	STABLE	28/02/2011
GAZPRU	Gaz Capital S.A.	3,250	BB1	BB+	-	-	BBB-	-	-	BB+	STABLE	21/02/2017
MEOGR	Ceconomy AG	1,600	BB1	BBB-	STABLE	26/06/2017	-	-	-	BB+	STABLE	18/07/2017
MPW	MPT Operating Partnership L.P.	1,000	BB1	BBB-	-	-	-	-	-	BB+	-	-
MTNA	ArcelorMittal S.A.	2,600	BB1	BB+	STABLE	24/05/2017	BB+	POS	28/07/2017	BB+	STABLE	24/02/2017
NOKIA	Nokia Corp	1,250	BB1	BB+	STABLE	10/01/2017	BB+	POS	01/03/2016	BB+	STABLE	15/06/2015
PEUGOT	Peugeot SA	2,400	BB1	-	-	-	BB+	POS	16/03/2016	BB+	STABLE	26/07/2017
RURAIL	RZD Capital Plc	1,402	BB1	BB+	-	-	BBB-	-	-	BB+	STABLE	21/02/2017
SBERRU	SB Capital SA	1,000	BB1	-	-	-	BBB-	-	-	BB+	-	-
TTMTIN	Jaguar Land Rover Automotive PLC	650	BB1	BB+	STABLE	16/08/2016	BB+	STABLE	02/09/2016	BB+	POS	26/09/2016
TVOYFH	Teollisuuden Voima Oyj	1,500	BB1	BB+	-	-	BBB-	STABLE	24/05/2017	-	-	-
WIEAV	Wienerberger AG	300	BB1	-	-	-	-	-	-	BB+	POS	10/02/2017
ZFFNGR	ZF North America Capital Inc.	2,250	BB1	BB+	-	-	-	-	-	BB+	POS	09/06/2016
PVH	PVH Corporation	350	BB2	BB+	POS	26/05/2017	-	-	-	BB	STABLE	01/07/2015
TKAGR	Thyssenkrupp AG	4,700	BB2	BB	-	-	BB+	-	-	BB	DEVELOP	21/09/2017
	Total (EUR bn)	43,257										

Source: BofA Merrill Lynch Global Research. ICE BofAML indices. Bloomberg.

Table 6: Potential Fallen Angels

Description	FV (mn)	Composite Rating	S&P Rating	S&P Outlook	S&P Outlook Date	Fitch Rating	Fitch Outlook	Fitch Outlook Date	Moody's Rating	Moody's Outlook	Moody's Outlook Date
Syngenta Finance N.V.	1,000	BBB3	BBB-	-	-	BBB	-	-	BB	STABLE	31/05/2017
Flowserve Corporation	500	BBB2	BBB	NEG	13/01/2017	BBB	NEG	21/04/2017	BBB-	NEG	13/03/2017
Pentair Finance SA	500	BBB3	BBB-	-	-	-	-	-	BBB-	STABLE	09/09/2015
Teva Pharmaceutical Finance IV B.V.	7,000	BBB3	BBB-	-	-	BB	-	-	BBB-	NEG	03/08/2017
Zimmer Biomet Holdings Inc	1,000	BBB3	BBB	STABLE	24/06/2015	-	-	-	BBB-	NEG	07/06/2016
Accor	2,335	BBB3	BBB-	-	-	BBB-	-	-	-	-	-
Discovery Communications LLC	900	BBB3	BBB-	NEG	31/07/2017	BBB-	STABLE	03/11/2015	BBB-	STABLE	27/01/2016
Radiotelevisione Italiana SpA	350	BBB3	-	-	-	-	-	-	BBB-	NEG	12/12/2016
Bharti Airtel International (Netherlands) B.V.	1,750	BBB3	BBB-	-	-	BBB-	-	-	BBB-	NEG	23/05/2017
Total	15,335										

Source: BofA Merrill Lynch Global Research. ICE BofAML indices. Bloomberg.

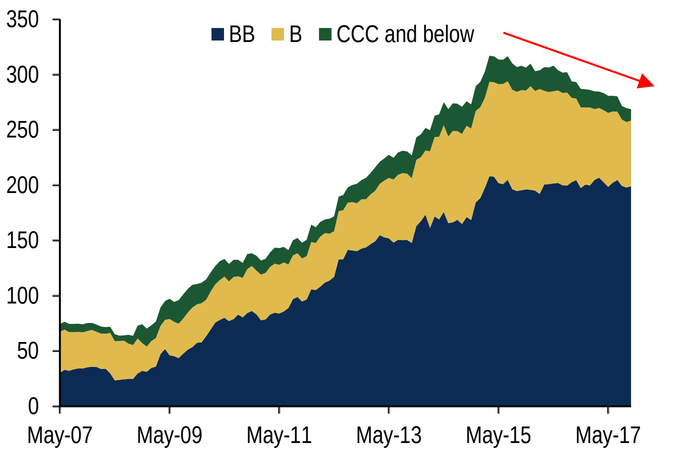
Gross issuance: American optimism

The slow and steady decline in issuance in high yield during ’14 to ’16 worked out largely in favor of tighter spreads. The lower rated companies in particular took advantage of the Central bank’s efforts to ease lending, and refinanced heavily out of bonds and into loans (more on this here).

From the 2015 peak, ICE BofAML’s single-B and CCC indices shrunk by 31% and 56% respectively (Chart 72 below). BBs on the other hand were more focused on improving their leverage ratios and therefore refrained from leveraging up. This, in addition to the general unease over the macro picture for credit pre-CSPP resulted in very low supply in 2014 and more acutely in 2016.

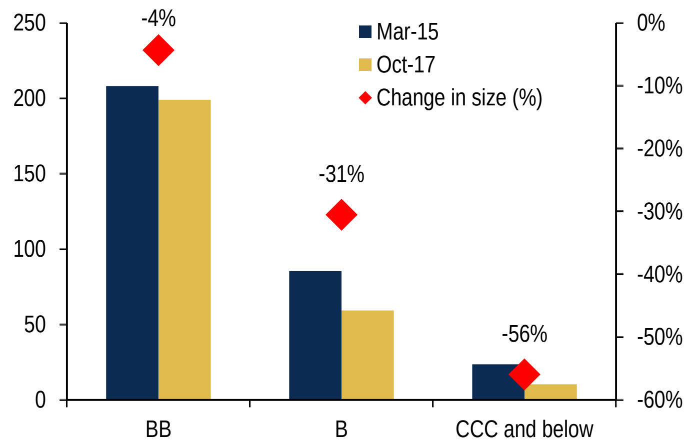
But 2017 marked a “revival” of supply in the euro high yield bond space. Aided by a significant improvement in earnings, high yield companies have resumed their issuance cycle. Already in 2017, supply has proved very healthy for European high yield. We think that 2018 represents the one last possibility that corporates will have to issue at low yields – while the ECB is still present in the credit market.

Chart 71: HY market size since the GFC (€bn)



Source: BofA Merrill Lynch Global Research. ICE BofAML indices

Chart 72: Change in size from 2015 peak by rating

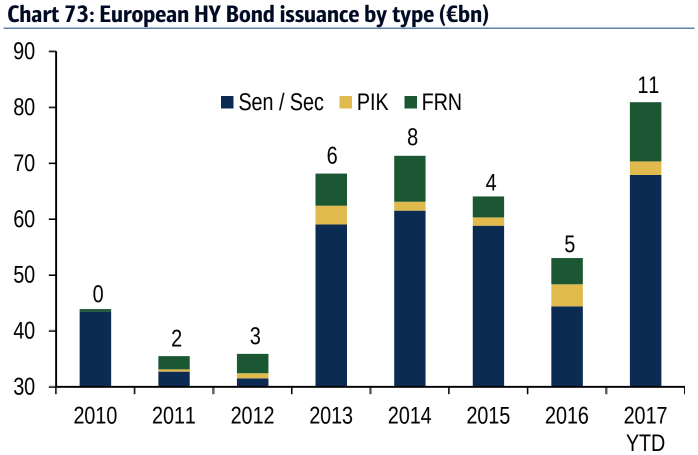


Source: BofA Merrill Lynch Global Research. ICE BofAML indices

We also take into account the growing presence of Reverse Yankees and FRNs in the high yield Euro space:

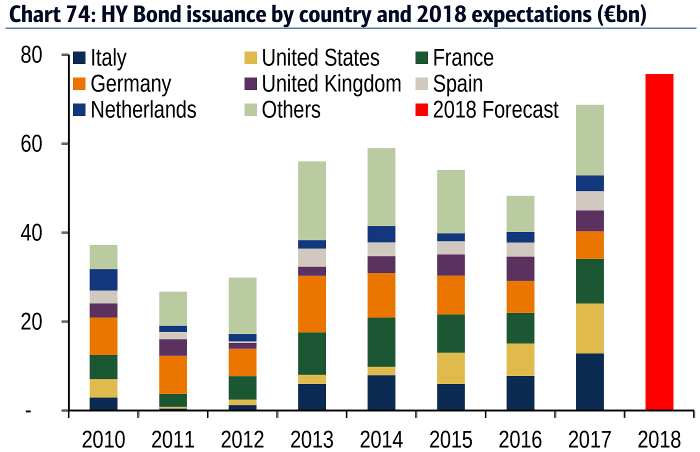
- **FRNs** are being popularized by the protection they offer from rates volatility, and their short duration makes them a good cash alternative for credit investors.
- **Reverse Yankees** have long been present in the Euro high-grade credit market but only started to appear as a sizeable chunk of European high-yield recently. Foreign issuers come to the euro market at a higher premium than their European peers, making them attractive for investors. They also provide a welcome source of diversification. Knowing that, US issuers are keener to issue in the euro market, especially names that already have sales exposure to Europe. We think that for 2018, the HY American issuers will continue to come to the euro market, contributing (along with FRN issuers) to an overall HY gross issuance around 10% above this year's.

Chart 73: European HY Bond issuance by type (€bn)



Source: BofA Merrill Lynch Global Research. LCD

Chart 74: HY Bond issuance by country and 2018 expectations (€bn)



Source: BofA Merrill Lynch Global Research. LCD. Forecasts includes FRNs.

What could accelerate this forecast? We think that the tax reform in the US could have an amplifying impact on Reverse Yankees supply in Euro high yield. The current proposed reform limits the interest expense tax-deductibility advantage for companies with a coverage ratio below 3.3x. The average coverage ratio across all US HY corporates is 3.5, which places almost half of these corporates under the threat of losing a significant advantage. This section of the reform will of course be much more significant only for the very highly levered companies in the US.

That said, we still believe that if the policy changes currently happening on the other side of the Atlantic push a small percentage of the US HY market towards issuing in euros, this will still be very significant for the Euro high-yield market given the large difference between the two markets' sizes (€270bn vs. $1.26tn).

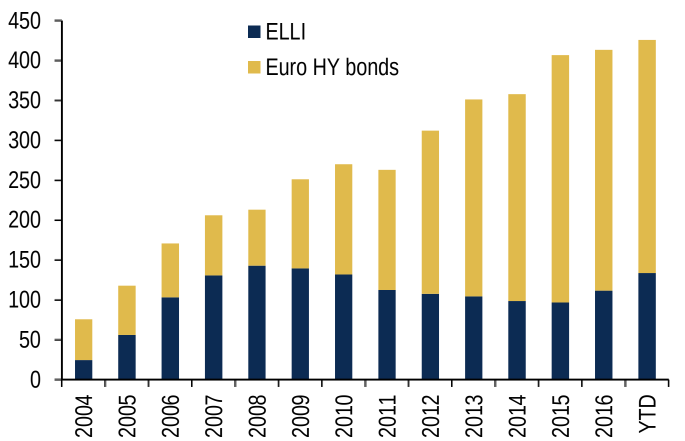
Adding to that, one possible consequence to US tax reform is that US multinationals issue more in Europe where interest expense is still deducible (assuming issuers have operations/revenues there). Naturally, away from the USD market, the Euro credit market is the most viable option. While we think other considerations will be taken ahead of the interest expense deductibility for US HY corporates when thinking about issuing in the Euro high-yield market, it remains a consideration for potential sources of more Euro HY supply for 2018.

Still in the mood for loans?

We think that for 2018, loans will continue to grow at higher rates than bonds for European high yield issuers, creating a particularly strong technical for lower-rated high yield bonds.

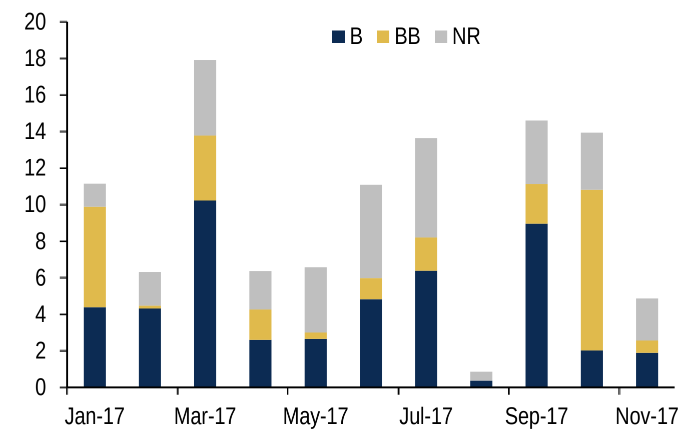
This has been the case for the past few years, as we have seen this among single-B companies choosing to refinance their bonds with loans (we detailed this theme in our latest HY publication, here). So far this year, single-B issuance has accounted for 45% of total loan issuance, vs. 24% BBs (Chart 76).

Chart 75: European Loans vs. bonds market size growth €bn



Source: LCD Comp

Chart 76: Loan issuance by rating €bn

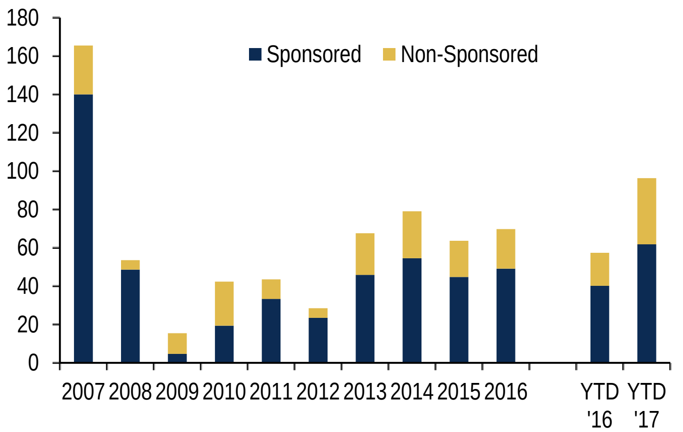


Source: LCD Comp

The loan dynamics should remain largely supportive for single-B bonds in 2018. CLO managers are keeping a healthy appetite for loans – and we expect this to continue for the upcoming year. CLO activity has reached post-crisis record high (Chart 78), and recently we also have noted the incoming of US CLO managers to the euro market, adding to the overall demand.

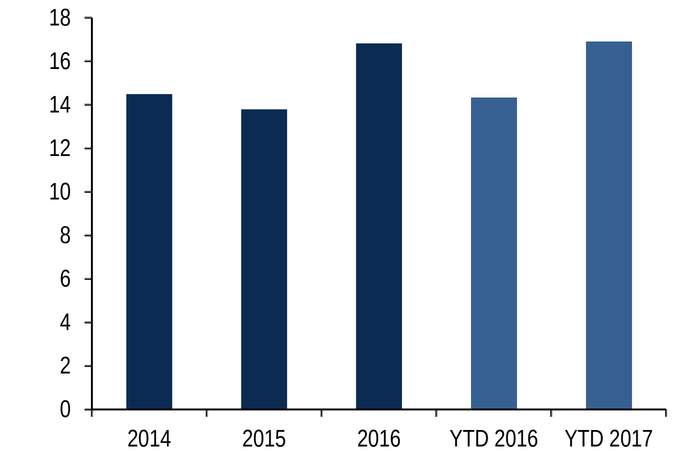
This stems from the recent introduction in the US of the risk retention rule, putting it finally in equal hands with the European regulation and therefore removing an advantage of US CLO issuance vs. Europe. Our structured products team also believes that Asian demand for euro CLOs will remain strong in 2018 (more on this here).

Chart 77: Sponsored vs. Non sponsored deals (€bn)



Source: BofA Merrill Lynch Global Research. LCD Comp.

Chart 78: Euro CLO activity (€bn)



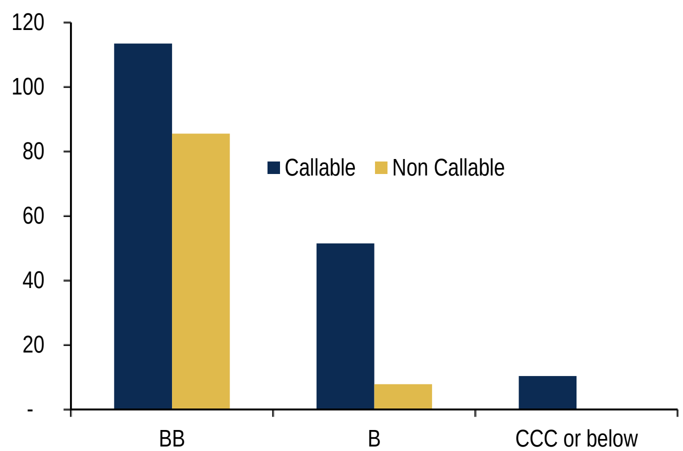
Source: BofA Merrill Lynch Global Research. LCD Comp.

Call me, maybe?

For 2018, our estimate for redemption is a total of €66bn, including €29bn currently priced to be called next year (Chart 80). As we expect rates volatility to remain low over next year, we think the portion of the market priced to next call date will remain significant (now at 27% of the market, 47% when including the names maturing at next call date).

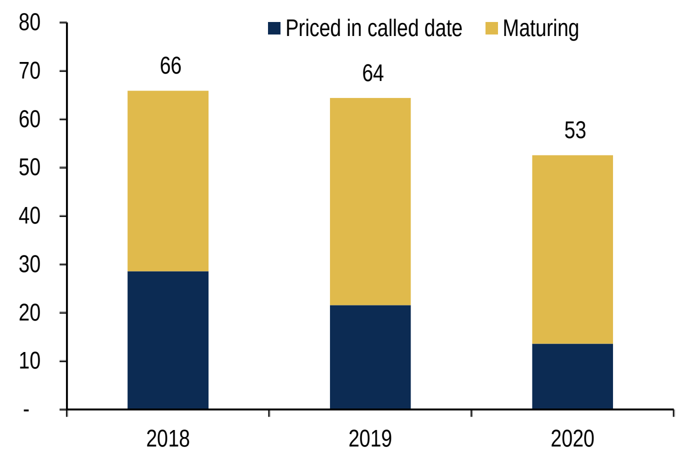
Should the central bank become less dovish, we think the extension risk would be mostly focused in single Bs and below (Chart 79).

Chart 79: size of callable/non-callable in the HY market €bn



Source: BofA Merrill Lynch Global Research. Bloomberg

Chart 80: Euro HY redemptions €bn



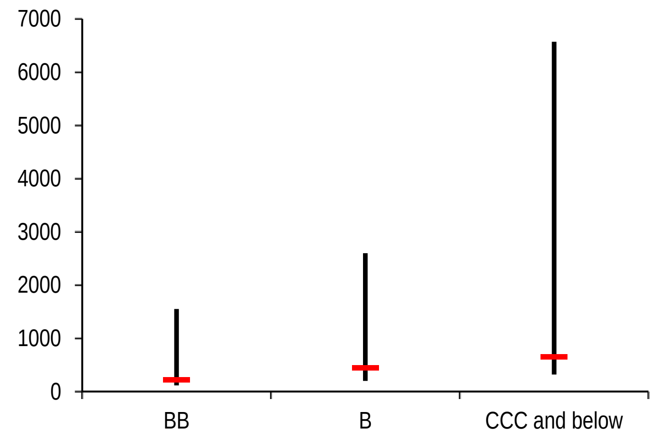
Source: BofA Merrill Lynch Global Research. Bloomberg

Valuations – Nowhere to hide (the cash)

Despite the current valuations, we think the HY market will go tighter next year by between 50-70bp, resulting in a total returns of around 4-4.5%. This is largely a consequence of lack of higher yielding alternatives in fixed income as well as the shortage technical described above. A low rates volatility environment helps yield look more attractive from a risk adjusted perspective, just like for European IG.

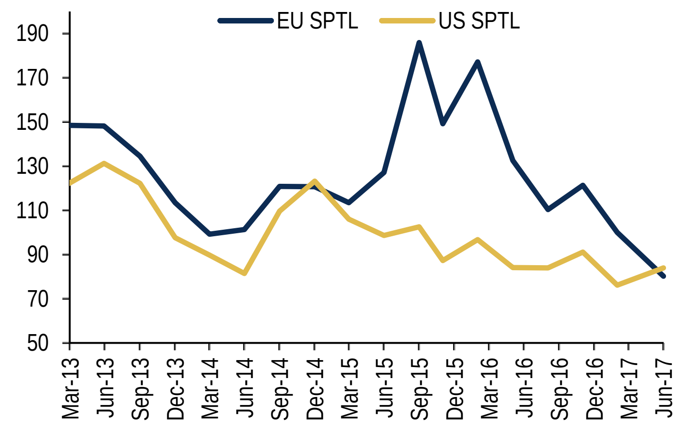
We think that the scope for replicating previous years' performance however is limited. Spreads are already near historical tights (Chart 81) and B-rated and lower corporates leverage is increasing, thus making European credit catch up with their US peers in term of spread per turn of leverage.

Chart 81: HY bonds are quickly reaching historical lows (OAS spread)



Source: BofA Merrill Lynch Global Research. ICE BofAML indices

Chart 82: Euro vs. USD HY spread per turn of leverage



Source: BofA Merrill Lynch Global Research. ICE BofAML indices

But we think that does not necessarily make US HY more attractive for European investors. In the tables below, we run the differential of Euro and Dollar HY spreads by a rating/maturity matrix. We then adjust for the cross-currency basis swaps and the 3M6M convention (more on the cross currency relative value here). The resulting data shows that for most of the euro HY market, once adjusted for the full hedging costs, Euro credit still offers more value than its dollar peer. We therefore think that US spreads need to go much wider before becoming a viable option for European investors, which is not what our US HY credit strategist Oleg Melentyev expects for the upcoming year (see the US high yield: Bonds and Loans Outlook views above).

To his point – also mentioned on the High Yield Strategy report HY Relative value toolbox - current valuations in US and Euro HY, with the perspective of where both regions are in their credit cycle, points to more performance to come in Euro BBs.

Table 7: Euro vs. USD HY fully hedged

	Euro - US ASW Spreads				
	0 - 3Y	3 - 5Y	5 - 7Y	7 - 10Y	>=10Y
BB	-5	9	14	2	-25
B	-74	79	17	-36	-152
CCC	-282	-161	-127	-57	-

	Euro Size (bn)				
	0 - 3Y	3 - 5Y	5 - 7Y	7 - 10Y	>=10Y
BB	57	67	65	41	5
B	9	34	16	9	2
CCC	1	3	6	1	-

Source: BofA Merrill Lynch Global Research. ICE BofAML indices, Bloomberg.

Asia: Don't let the year of the dog drown under the supply

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Favorable outlook but how much upside from here?

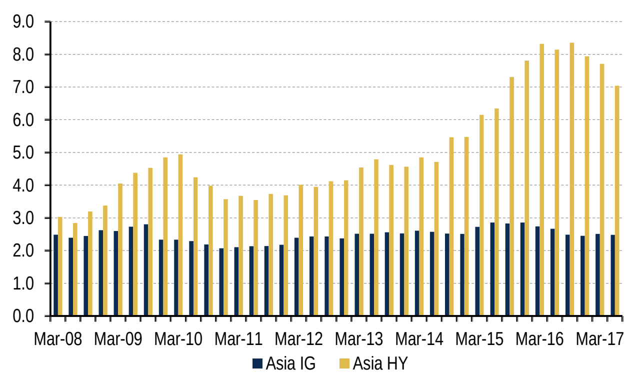
Credit market performance has been better than expected in 2017 thanks to healthy economic growth coupled with relative low interest rates and inflation, which have continued to drive the search for yield phenomenon. As we move into 2018, we see economic growth as a favorable trend. The GEMcycle, which tracks EM activities, just rose to its highest level in four years. Global economic data remains positive as the Global Wave improved for the 18th consecutive month. Recent China macro data suggests that, despite the intensification of financial deleveraging since late 1Q, the negative impact on investment seems fairly muted in 2017. Given the favorable backdrop, we expect Asia credit fundamentals to remain decent following the improving trend this year.

However, despite the favorable outlook which seems reasonably stable, we see the greatest risks from a higher than expected interest rate (or a sharp increase in rates) which could possibly be driven by a pick-up in inflation that drives global monetary policy to be more hawkish or a delayed pass from US tax reform from 2017 to 2018. Geopolitical risk around the Korean peninsula is still a tail risk that in our view markets are not fully pricing in. In Asia, after almost two years of major spread/yield tightening, we see tightening potential as capped as Asia IG and Asia HY are merely 43 bps/176bps away from all time tights, respectively. We also see rising risks on potential policy missteps from China as its policymakers are expected to maintain tight financial conditions in order to promote financial deleveraging.

Expect fundamental trends to be decent in 2018E

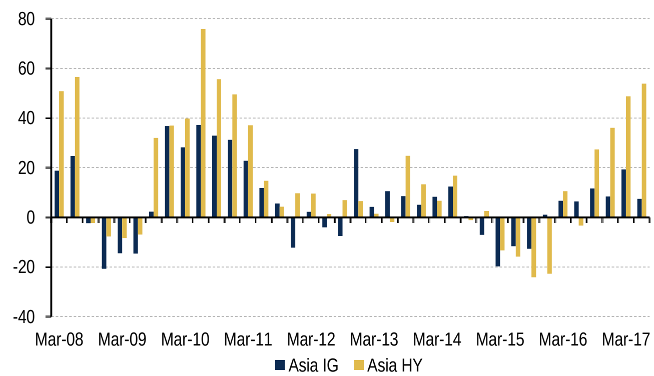
Asian corporate earnings witnessed decent growth in 1H17. Fundamentals improved for both investment-grade and high-yield bonds as strong earnings growth provided a buffer for leverage, while stabilization of commodity prices helped commodity-related companies realized decent improvements in earnings and leverage trend.

Chart 83: Improving Asia leverage trend



Source: BofA Merrill Lynch Global Research

Chart 84: Strong EBITDA YoY (%) growth



Source: BofA Merrill Lynch Global Research

We expect IG credit to continue to improve in 2018, given a more positive macro backdrop as our economists expect Asia GDP growth to be stable in 2018. We expect Asia IG companies to sustain stable revenue growth, and capex and M&A to remain at a manageable pace, which together should lead to a stable leverage. In addition, Chinese IG corporate will likely witness fundamental improvement, given continuing regulatory efforts in de-leveraging.

Meanwhile, overall, we expect HY leverage to trend up slightly, driven by Chinese HY property's aggressive land banking and potential slowdown in contracted sales after a strong year in 2017. However, we do not expect the impact on leverage to be extensive, as companies that can issue USD bonds are already stronger developers with more market share in China amid the market consolidation trend. For other HY industrial credit, with cost and capex control being implemented continually, and given the strong commodity price outlook, we expect a stable outlook in top-line and credit fundamentals. As a result, overall, we see a decent fundamental picture for both IG and HY in 2018.

Expect gross supply/net supply to rise 6%/29%

Higher net supply likely to weaken technicals

As of November 2017, we have seen US$227bn in USD fixed-rate supply from Asian issuers, which is a record year for supply and higher than 2016 by 51% YoY. Low market volatility, lower-than-expected interest rates, and difficulties for Chinese issuers to issue onshore were the main reasons. We expect the strong issuance trend to continue to end-2017 and reach a total of around US$240bn for 2017.

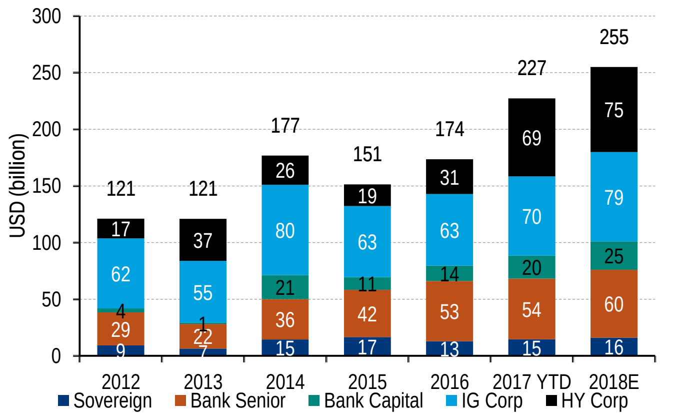
In 2018, we expect supply to further grow by 6% to US$255bn in our base case. Despite declining maturities next year, we believe the driver will again come from China as onshore tightening and financial deleverage makes the offshore market easier to access and more attractive from a cost perspective, in our view. In addition, we believe China's one-belt-one-road (OBOR) initiatives, if implemented successfully, will drive up funding needs for SOEs that are involved in the projects. Consequently, we expect supply to be at 8.5% of the outstanding market (quarterly average), which is higher than the 7.7% average between 2016 to 2017.

After considering maturities, coupons and calls/tenders, Asia net supply is expected to be about US$138bn in 2018, about 29% above the US$107bn expected in 2017. This suggests supply technicals could be weaker in 2018 given stronger supply and lower maturity.

China to be the main driver and swing factor for supply

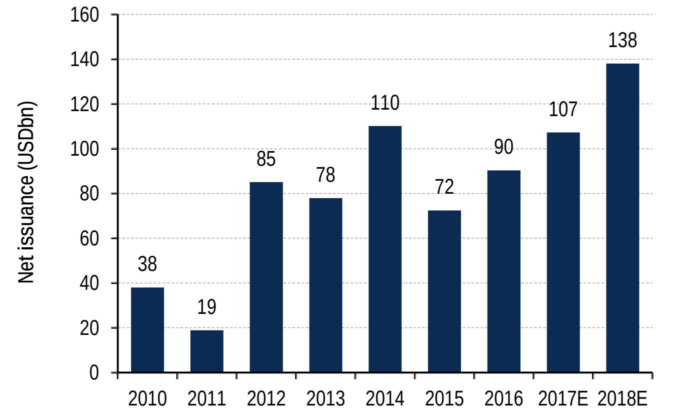
China has dominated new issues over the past couple of years. It accounted for about 63% of new issuance in 2017, driven by favorable issuance cost and easier access than the onshore market. We expect this trend to continue in 2018. There are a few swing factors that could lead to higher or lower issuance numbers than our base case targets, mainly: (1) NDRC's attitude toward Chinese offshore issuance: if it goes for stricter control on issuance, then offshore issuance would mainly be for offshore refinancing, resulting in no increase in net supply; but if it loosens control, issuance will likely be much higher. (2) Progress of OBOR: if the implementation is delayed, then the funding needs for SOEs will be lower. (3) Approval for bank capital onshore: as mentioned in our previous report, there have been no preferred shares issued in China onshore so far in 2017, as they are likely still pending regulatory approval. If the regulator starts approving preferred share issuance onshore, we expect cheaper onshore funding costs to alleviate offshore supply risk; but if not, then USD AT1 supply will likely be higher. (4) Relative valuation between onshore and offshore corporate bond market: given the onshore deleveraging and financial tightening, onshore yield has materially risen in 2017. The current yield difference of onshore corporate yield over US$ yield is almost 2% for investment grade and about -0.8% for HY. The relative cost advantage in the offshore market, together with difficulties to access the onshore market this year, has increased Chinese issuers' incentives to issue in the USD bond market. If this trend continues in 2018, we will likely see more issuers, including first time issuers take the opportunity to tap the offshore market.

Chart 85: Asian USD fixed-rate supply trend and forecasts



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 86: Net supply likely to increase in 2018



Source: BofA Merrill Lynch Global Research

Expect low single-digit returns in our base case

Given the positive growth outlook and stable credit fundamentals, we expect Asia credit to continue to grind tighter as demand and fund flows remain intact. However, given the rich valuations and likely heavy supply, we believe the upside is fairly limited. We expect Asia IG spreads to tighten by 11bp and HY to tighten by 28bp in 2018. In our base case, we expect Asia IG and HY to provide low single-digit returns, with HY outperforming IG in 2018.

Table 8: Scenarios of total returns

	Base Case			Bull Case			Bear Case		
	Asia	IG	HY	Asia	IG	HY	Asia	IG	HY
Current Spread (bps)	162	116	398	162	116	398	162	116	398
YE18Target (bps)	148	105	370	100	75	225	234	165	586
Change (bps)	-14	-11	-28	-62	-41	-173	72	49	188
Duration (yrs)	4.5	4.7	3.4	4.5	4.7	3.4	4.5	4.7	3.4
Tsy Change (bps)	54	55	48	-16	-15	-22	84	85	78
Total Yld Chg (bps)	40	44	20	-79	-56	-195	156	134	266
Capital Gain/Loss (bps)	-180	-206	-69	353	264	662	-698	-628	-904
YTW (%)	3.5	3.0	6.0	3.5	3.0	6.0	3.5	3.0	6.0
Price ($)	103	103	101	103	103	101	103	103	101
Coupon (%)	4.0	3.6	6.3	4.0	3.6	6.3	4.0	3.6	6.3
Mkt Val (US$bn)	663	554	109	663	554	109	663	554	109
Credit Loss (bps)	5	0	31	5	0	31	5	0	31
Total Return, to YE 2018 (%) F	2.2	1.5	5.4	7.5	6.2	12.7	-3.0	-2.7	-3.0
Excess Return, to YE 2018 (%) F	2.2	1.7	4.6	4.4	3.1	9.5	-1.7	-1.1	-2.7

Source: BofA Merrill Lynch Global Research

In our base case, we expect rates to increase next year, but to be mainly front-loaded and to remain stable in the second half. As a result, we expect IG spread to widen at beginning of the year as the rate spikes given its higher sensitivity to rates, and then narrow once interest rates stabilize. In terms of supply, we expect higher net supply, mainly driven by China. We expect higher China onshore rates to continue, providing incentives for issuers to tap the offshore market. We also look for NDRC to slightly loosen its control of offshore issuance compared with 2017, leading to lower technical support, which would cap the upside for credit performance despite fund inflows and demand remaining stable.

We expect Asian IG credit (EMIA) spreads to tighten by about 11bp, driven by China and India, on which we are overweight. Asian HY spreads (EMHA) are expected to tighten by about 28bp, driven by high beta industrial names. This equates to total returns of +1.5% for IG and +5.4% for HY, assuming Treasuries rise 56bp/55bp for 5/10yr to 2.6% and 2.9%, respectively, by end-2018, adjusted to match the average duration of the markets.

Excess returns are +1.7% and +4.6%, respectively. We therefore prefer HY to IG and like the short-end of curve which is less sensitive to interest rate risks.

IG: single-As show more value than BBBs

Despite our preference for HY over IG, we still think IG credits provide some value in terms of pickup over the US, given the sector's resilient performance when major market shocks arise. Our expectation of continuing improvement in IG credit fundamentals in 2018 should also support the outlook for the sector. Although current valuations are not particularly attractive with spreads pick-up over the US under the historical average (19bps vs average of 36 bps), single-A and BBBs are still providing some pick-up over US in terms of absolute spread and spreads per turn of leverage. We prefer As over BBBs as BBBs spreads over As are at 5 year tights currently. In single As, we especially like Chinese tech. But we also like selective BBBs for example India BBBs due to positive macro backdrop and BBB rated Chinese SOEs that are expected to benefit from SOE consolidation.

Country selection: Overweight China, India; marketweight Indonesia, Korea, HK, Malaysia; underweight the rest

Within Investment grade, we are **overweight**: China for the low beta feature and stable fundamentals will be supportive for spread compression for Chinese IG credit relative to the US corporates and other Asia countries, in our view. India on the back of bank recapitalization plan which will likely be a substantial support for recovery. **Marketweight**: Hong Kong on strong credit fundamental but unattractive valuations, Korea on geopolitical risk, Indonesia on rich valuation after outperformance this year and concerns on fundamental deteriorating. Malaysia on strong economic growth despite unattractive valuations. **Underweight:** other countries (Singapore, Thailand) on uncompelling valuation.

HY: Better values in Bs than BBs

Asia HY is currently trading very close to its historical tights, and provides little pickup over US HY. If we take into account the underlying leverage, both Asian BBs and Bs are trading inside US and other EM regions. As a result, we see limited potential for spreads to tighten, with carry being the prevalent source for returns, especially given the higher volume supply expected next year.

However, within Asian HY, the spread differentials of BB over BBB has picked up since 2H 2017 and has been at a level approximately the widest for the past 12 months. We acknowledge credit selection is the key when going down the credit curve and hence we suggest overweight select names with short-dated maturity or with operational improvements in Bs space for yield enhancement. We expect China industrials and India HY to be the main driver for HY spread tightening in 2018, while we are cautious on China and Indonesia property.

Like China industrial and India; underweight China and Indonesia property

We expect China industrials and India HY to be the main driver for HY spread tightening in 2018. We like Chinese industrial names as valuations are attractive with short duration in both BB and B space. We expect solar utilities to maintain stable growth and are positive on car rentals from both industry supply and demand perspectives. We are also overweight India HY. Despite tight valuations, lack of supply, low currency volatility and improving macro outlook justify the valuations, in our view. We are positive on commodity-related companies on stable price outlook, which could lead to earnings improvements.

GEM corporates

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Lower but still positive returns expected in 2018

For 2018, we expect returns for EM corporates to be lower compared to 2017 but we are still expecting spreads to tighten given a strong fundamental and technical backdrop. Our colleagues' forecast for higher U.S. rates (+30 to +45 bps in 2018) will prevent total returns from reaching the levels we've seen in 2016-2017. The key risk for spreads is a policy mistake by the Fed or ECB which drives a more volatile move in UST yields and fund flows. We expect country selection to be very important given various idiosyncratic country stories and geopolitical risks.

We expect returns of 1.9% for IG and 5.4% for HY

Our baseline forecasts call for EM IG spreads to tighten -11 bps (to 130bps) and EM HY spreads to tighten -39 bps (to 370bps). Given BofAML's U.S. interest rate forecasts (2.65% 5yr; 2.90% 10yr), this leaves us with overall EM corporate total returns of 3.2% for 2018. By region, we expect total returns of 4.7% for LatAm, 3.7% for EEMEA and 2.2% for Asia.

Tighter spreads driven by strong technicals, fundamentals

We think **EM IG** spreads will tighten in line with US IG spreads. We expect **LatAm IG** to tighten the most (-21bps to 180 bps), assuming there are no major negative shocks from NAFTA or the Mexican elections, and expect **Asia IG** to tighten -11bps to 105 bps. In **EEMEA we see IG** spreads tightening -11bps to 135 bps given the strong local and Asian bid in the Middle East. Risks to our outlook for spreads are wider US IG spreads which spills into our market, escalation in geopolitical risks, a collapse of NAFTA talks and wider sovereign spreads.

Our baseline for **EM HY** spreads is more optimistic and based on our expectation for lower defaults and a gradual and slow unwind to G3 central bank asset purchases which support continued reach-for-yield behavior across asset classes. We expect **LatAm HY** spreads to tighten -45 bps to 440 bps, **EEMEA HY** to tighten -35 bps to 285 bps, and **Asia HY** to tighten -28 bps to 370 bps. The risks to our baseline forecast for EM HY are higher market volatility, negative political/macro shocks in Brazil (25% of EM HY), high supply volumes in China, a big drop in commodity prices and geopolitical risks.

Mexico, Turkey, SoAf and Middle East under the spotlight

We expect a high degree of volatility around Mexico as NAFTA negotiations and the Presidential elections will impact the MXN and corporate bonds. Volatility will also likely remain high in Turkey (geopolitical risks and reliance on foreign money), South Africa (domestic politics and fiscal) and the Middle East (geopolitics). Going into 2018, we have an OW stance on corporates in Brazil, Argentina, Colombia, India, South Africa, Ukraine and Kazakhstan, and an UW stance on UAE, Qatar, Saudi Arabia, Malaysia, Singapore, and Thailand. We have a MW view on corporates in other major countries (China, Russia, Turkey).

We expect default rates to come down

Our baseline scenario assumes that only 10 index-eligible issuers will default in EM in 2018, equating to an **issuer default rate of 1.8%** (par rate of 1.5% ex-PDVSA). This sample includes companies where our analysts view the default probability at around 50% or more. Regionally, we expect to see 6 defaults from LatAm (2.9% issuer rate), 3 from Asia (1.7%) and 1 from EMEA (0.6%). If a PDVSA default officially takes place in 2018, then our par default rate would rise to 6.9%. Under our pessimistic scenario we could see 17 defaults across EM, amounting to an **issuer default rate of 3.0%.**

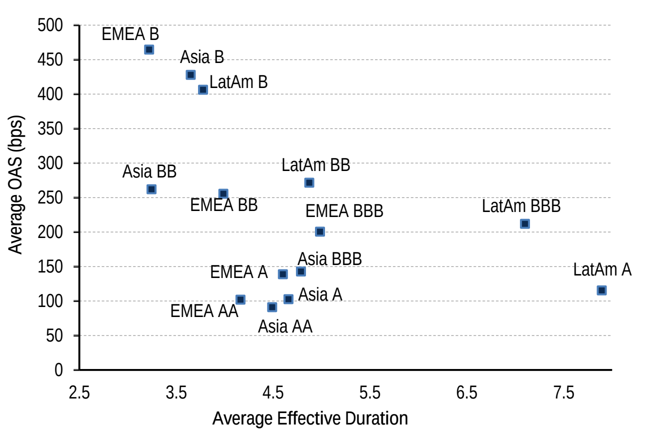
Regional Positioning Views

OW LatAm: LatAm's 2018 regional GDP growth is expected to improve the most vs. 2017 (from 1.1% to 2.4%) driven by the recovery in Brazil and Andean countries. Credit fundamentals are expected to continue their positive trend. Valuations wise, LatAm A and BBB credits offer similar absolute spreads vs. other regions but with a longer duration. Compared to gross leverage LatAm has an edge over Asia but not over EMEA. In the HY space (47% of LatAm), LatAm B's offer the highest spreads per turn of leverage, driven by Argentine names, while in the BB space LatAm is in the middle of the pack. Despite these mixed valuations, we expect the region to outperform given continued improvement in credit fundamentals and relative isolation from most geopolitical risks. Elections in several key countries will be important to watch. Within LatAm, we have a preference for corporates in Brazil, Argentina and Colombia.

MW EEMEA: EEMEA benefits from the strongest credit metrics which results in high spreads per turn of leverage across rating buckets. Regional growth is expected to be stable at 2.4%. However, geopolitical risks for the region are high given the GCC conflict, Saudi-Iran tensions, and Turkey's geopolitical risks. We think that CIS countries and South Africa are relatively insulated from these risks and should benefit from stable/higher commodity prices, but volatility will likely remain high in MENA and Turkey. MENA credits should be supported by the strong local bid but spreads are right. Within EEMEA, we have a preference for corporates in South Africa, Kazakhstan, Ukraine and dislike some of the very low yielding countries which are also exposed to high geopolitical risks (UAE, Qatar and Saudi Arabia).

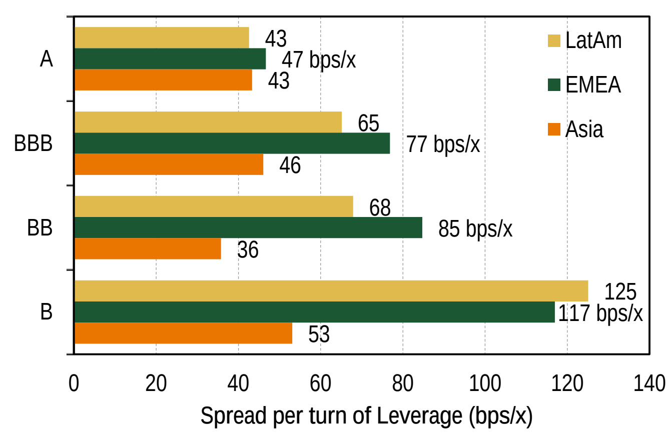
UW Asia: Asia IG spreads have been very stable over the last year and have largely tracked US IG spreads. Asian IG credit therefore trade very tight, with A and BBB spreads offering the lowest spreads versus other regions. While technicals in the region are very strong and the macro situation is stable, we think the region will underperform in a strong market given its tighter spreads. **Asia HY's** absolute valuations look more in line with peers, but once we account for the region's high leverage, Asia HY looks much less appealing. In addition, we expect supply volumes to remain robust and potentially weigh on some of the technicals for the market. Within Asia IG and HY we have a preference for Indian corporates and dislike some of the very low yielding countries (Singapore, Thailand and Malaysia).

Chart 87: Average corporate spread (y-axis) vs. duration (x-axis)



Source: ICE Data Indices, LLC. BofA Merrill Lynch Global Research. As of 11/10

Chart 88: Spread per turn of gross leverage for corporates by rating



Source: ICE Data Indices, LLC. BofA Merrill Lynch Global Research, company reports. As of 11/10

Issuance and technicals to remain supportive

We expect US$400 bn of EM new issuance in 2018: this number is largely driven by Asia (63% of the total) as well as our expectation that central banks will be unwinding their QE policies in a gradual manner. We expect demand for new issues to remain strong given low net supply levels outside of China and improving fundamentals across EM issuers. The largest use of proceeds will likely be for refinancing and general corporate purposes.

We expect US$254 bn of new USD/EUR issuance from Asia. We expect volumes to remain very high in 2018 due to the tighter onshore market in China. We expect financials to account for $85-$95 bn, IG corporates to account for $80-$90 bn and HY corporates to account for $75 bn. Due to the large uncertainty around the Chinese regulator's approval for offshore deals, we also incorporate a low scenario where issuance totals $200 bn and a higher scenario of $293 bn.

We expect US$72bn of new issuance from LatAm. This would represent a ~-10% decline from YTD levels, driven by a lower amount of maturities coming due (given successful liability management exercises) as well as muted capex needs. We expect financials to account for $16 bn of issuance and corporates (including quasis) to account for $56 bn. First time issuers could total $7-$10 bn from the region.

We expect US$74bn of new issuance from EEMEA, with financials accounting for $25 bn and corporates for $49 bn. Our numbers include around US$20 bn of issuance from Russian names, $15 bn from UAE, $7.5 bn from Turkey, $4 bn from Poland, $3.5 bn from Kazakhstan, $2 bn each from Qatar, Ukraine and Saudi Arabia and $1.5 bn from Nigeria. Our numbers include around $15-$20 bn from first time issuers (YTD we have had $16 bn). Downside risks to our forecast are heighted geopolitical risks.

Maturities and coupons should take US$212 bn out of the market. In 2018 we will see US$138 bn of maturities for bonds in the ICE BofAML EMCB index. Asia accounts for US$73 bn of these maturities, followed by EMEA ($50 bn) and LatAm ($16 bn). In EMEA only $40 bn represents maturities from non-sanctioned names. Coupon payments should total US$74 bn, with LatAm and Asia each accounting for $28 bn and EMEA for $19 bn.

Liability management exercises- amid favorable borrowing costs and a desire to reduce leverage, EM corporates called or tendered more than US$60 bn of bonds in 2017, with more than half coming from LatAm corporates ($32 bn). We assume calls and tenders will total US$45 bn in 2018, with calls expected to be around $20 bn and tenders around $25 bn.

We expect EM corporate net supply to be US$143 bn. We expect net supply to remain high in Asia at $142 bn (vs. $126 bn YTD), driven by high gross issuance and a slightly lower amount of maturities compared to 2017. Most of the net supply will come from China, which has been well absorbed due to the strong local bid. We expect net supply to remain low in LatAm and EEMEA: we are expecting $7 bn from LatAm and -$5 bn in EEMEA. In EEMEA the decline in net supply is largely driven by $10 bn of maturities coming due from Russian sanctioned issuers that can't refinance in the external markets.

Crossover demand: US IG and HY investors increased their allocations to EM this year, driven by more attractive valuations. In addition, during the year we heard from many European based institutional investors about receiving new allocations to EM. This was a very positive technical factor for the market, and we expect this trend to continue from Europe as long as government and corporate bond yields stay low. Our colleagues' forecasts for European and U.S. credit spreads are to tighten as well, so we expect EM to continue to receive inflows from crossover investors as long as relative valuations remain somewhat attractive.

Credit derivatives: Too soon to call the end

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Years of loose monetary policies and record-low rates have contributed to a rising universe and stock of assets that experience "bubbly" valuations. While global leverage is at record highs, Europe HY yields have recently set new lows and US stocks record highs. Housing markets across the globe are well above pre-crisis levels and sub-debt instruments trade at multiyear tights. Amid a record-low vol environment and a plethora of negative-yielding assets investors have embraced yield, wherever it exists.

Amid record low vol backdrop and central banks that are more dovish than hawkish, we find plenty of tailwinds for credit spreads and vols in 2018. We think that the market will continue on the same path for a bit longer.

However, we are not oblivious to geopolitical risks and rich valuations. We are also mindful of rising dispersion among high yield issuers on the back of rising idiosyncratic risk. The risk of an inflation shock is remote but hedges are needed.

For 2018, we look for alpha in selling payers vol via owning ladders and reach for quality yield via longs in the senior part of the capital structure, as we prefer to stay away from idiosyncratic risks. We like hedging with put spreads against moderate spread widening, and owning iTraxx Main 5s10s CDS steepeners to hedge against an unexpected pick-up in inflation and steeper rates curves.

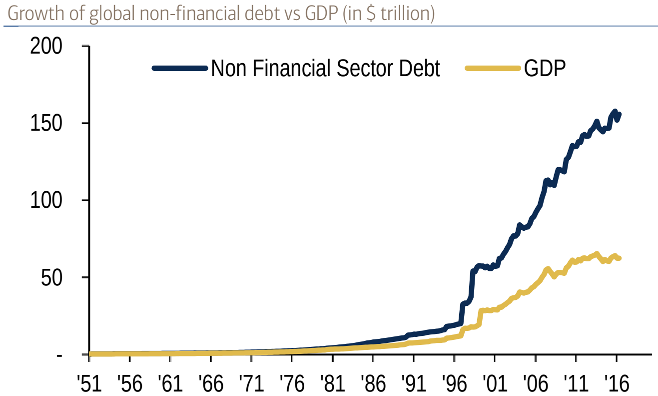
Last but not least, Brexit poses a risk of decompression in the CDS market, but the reach for yield could continue in the cash market. Record low rates vol is pushing fixed income investors to embrace more subordination and rating risk. We would add liquidity via TRSs and believe this bull market has legs. The end game is inflation…but it's still not in sight.

Why it's so hard to quit (QE)

Higher rates and tighter monetary policies, is the only way to manage stretched valuations. But while central banks are embarking on this long journey, they have become more cognisant that higher "uncertainty" and a volatility shock could be very damaging for the economy. For that reason **central banks remain the largest sellers of vol in the market.**

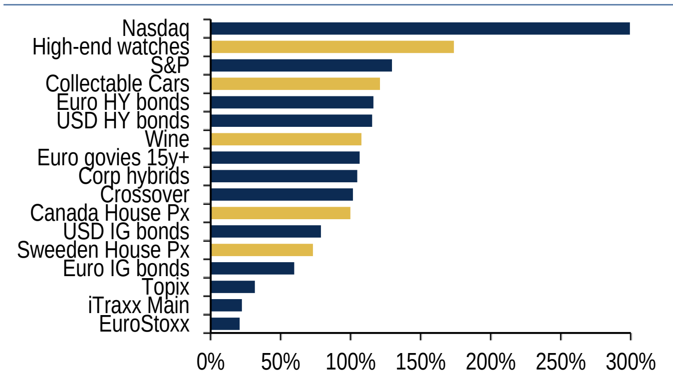
Chart 89: Global system leverage at the highest level in history

Growth of global non-financial debt vs GDP (in $ trillion)



Source: BofA Merrill Lynch Global Research, BIS. Data for 26 countries.

Chart 90: Financial and non-Financial assets returns in the past 10 years



Source: BofA Merrill Lynch Global Research, ICE BofAML indices, Bloomberg, thecollectorsindex.com

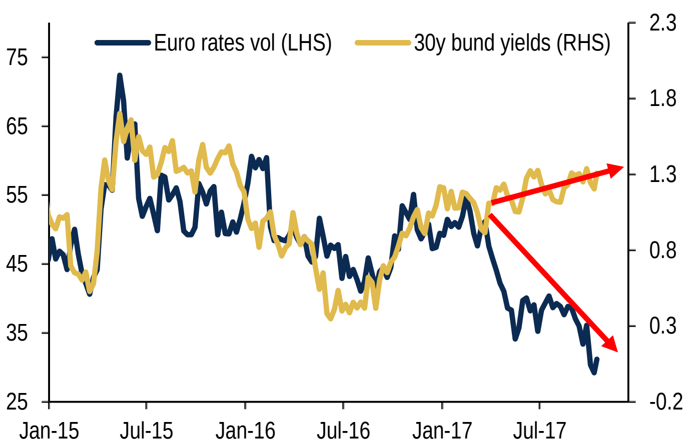
Central banks have spent almost $10 trillion of QE-money over the past decade in an effort to reflate the global economy. In the process, they sparked a debt super-cycle. We find that while global debt has mounted to more than $150trillion (government, household and non-financials corporate debt), global GDP is just above $60trillion. Amid a rising pool of rate-sensitive assets and markets, central banks have been hostages of their own policies.

It's not just debt demand that has been spurred on by easy and patient central banks, it's also debt supply. The irony in today's world is that central banks are maintaining loose monetary policies to generate inflation; in order to ease the pain of a debt "super-cycle". But that itself was partly a result of highly predictable and loose monetary policies in recent years.

Now that policies need to be normalised as growth has been steadily improving, central banks are being careful about how they communicate rate policies. They learnt their lesson during the 2013 Fed taper tantrum, and the 2015 bund sell-off. As the ECB is running out of assets to buy, monetary policy has moved from QE to strong forward guidance to manage rates volatility.

Chart 91: A fine balancing act

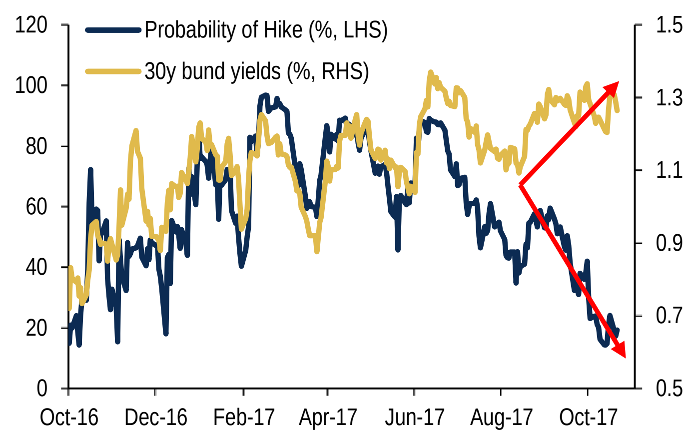
While yields are trending higher, implied vols are much lower



Source: BofA Merrill Lynch Global Research; smoveu3m index

Chart 92: Normalisation, without adverse consequences

Even though yields have been moving higher markets are pricing lower possibility of a rate hike in the following 12 months



Source: BofA Merrill Lynch Global Research , Bloomberg WIRP page December 2018 meeting expectations

So far, the ECB has managed to allow yields to move higher while suppressing volatility. Interestingly, even though long-term bund yields have moved higher, the market is still pricing lesser probability of a rate hike over the following 12months. This is exactly what the ECB wants: a normalization of monetary policy while maintaining "price stability" and keeping the rates hiking cycle as shallow and as long as possible.

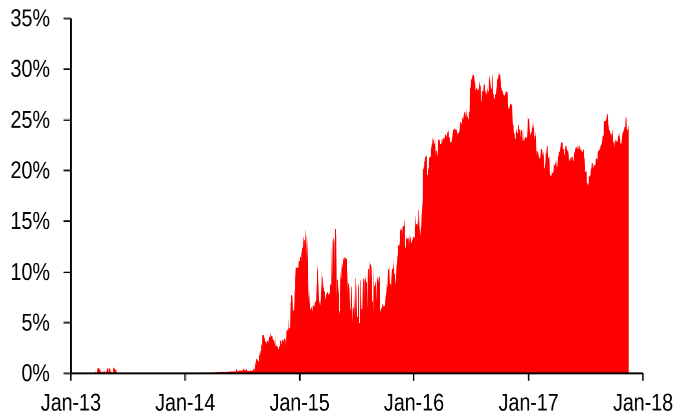
Rates vol is now at record low levels across the globe. A gigantic rate-sensitive stock of assets is at risk should the rate normalisation come too far too fast. As a result, central banks have been coating hawkish actions with dovish messages. Should rates vol remain low, we feel comfortable with our call for tighter spreads and low credit implied vol levels, while flows into the asset class should remain buoyant.

Theme #1: Valuations are not cheap - enhance liquidity

Valuations stopped being cheap a long time ago; but as 2017 has shown, they can keep getting richer and richer. Higher yielding parts of the credit market have rallied to multiyear tights, making us feeling less comfortable. Being cognisant of the need for yield in a low-yielding environment, we advise credit investors to embrace macro products to reach for liquidity. Adding TRS as part of bond portfolios can improve liquidity characteristics as TRS products exhibit better b/o costs.

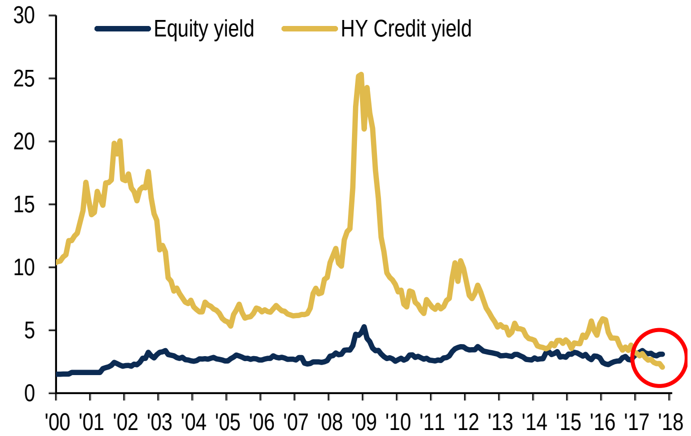
25% of the global fixed income assets are still in negative-yielding territory (Chart 93). Fixed income investors continue to reach for yield. As credit investors' yield targets remain too high against the current low yield backdrop, they have resorted to adding rating and subordination risk. As a result, European HY yields only ~2% - the lowest ever. We think that 2018 will be another year of positive performance; however, diminishing returns and deteriorating risk/reward in the long run justify caution, we think.

Chart 93: Amid a large amount of negative-yielding assets



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 94: First time ever stocks are cheaper than credit



Source: BofA Merrill Lynch Global Research, European equities trailing dividend yield (Stoxx 600) vs European high-yield credit

We think that the best way to remain long, but enhance liquidity is by embracing macro synthetic products like TRSs. TRSs effectively allow investors to participate in future market performance via a product that benefits from lower transaction costs than those for the underlying bonds. For example the 6-month iBoxx Euro HY contract trades at ~0.25pts b/o (0.4-0.5pts normalised to the price). Note that average b/o costs to transact on the underlying bonds are almost 1pt, as we highlighted in our Credit market liquidity note.

Theme #2: More beta compression

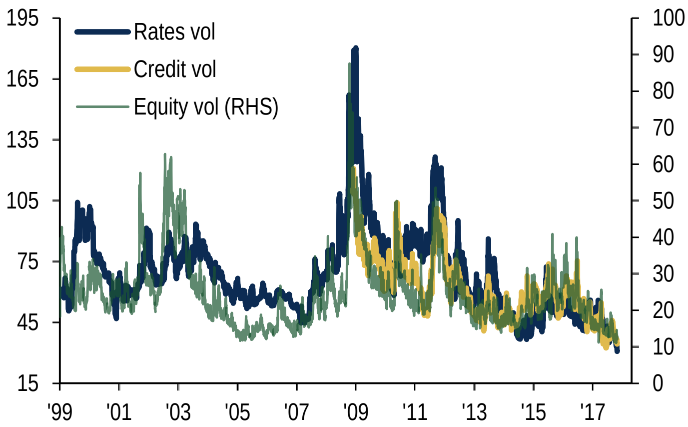
Strong macro and high central bank predictability are pushing cross asset vols to record lows. As central banks try to avoid introducing volatility to the system, we think the reach for yield trade could remain in vogue next year. Valuations are not cheap, but the recent move wider in beta is providing better levels to add risk. As investors are punished for investing their wealth in bunds and deposit rates at banks are at record lows, they should keep reaching for yield in positive-yielding assets. In our view, long beta is still a good way to position amid dovish central bank rhetoric.

So far this year we have seen record-low levels for implied vols across a plethora of asset classes. This has been a tremendous tailwind for higher risk pockets in credit. In simple terms the lower the risk for an investment, the better the risk/reward profile. As a result, when volatility has declined at these levels, investors are happy to move into higher risk assets, as our latest survey has shown.

The reach for yield has been a pivotal tailwind for such behaviour; with still ~25% of global fixed income assets in negative-yielding territory, fixed income investors reached for yield in the highest beta pockets of credit. This behaviour has also been well rewarded, with risk/reward being the highest among pockets that offer higher yields while also bearing the highest risk. As per Chart 96, we find that bank capital, XO CDS index, HY, single-Bs, sub-insurers and corporate hybrids rank among these pockets that offer the best risk/reward profile.

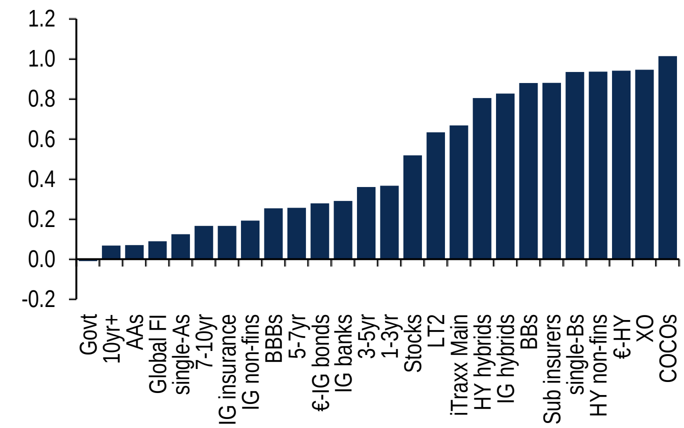
We think that from a top-down perspective amid a low rates vol backdrop, investors will keep favouring higher risk/reward assets within the fixed income space as they reach for yield, amid a plethora of assets that offer little or even negative yield.

Chart 95: Record low volatility across asset classes...



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 96: Reach for yield = reach for best risk/reward

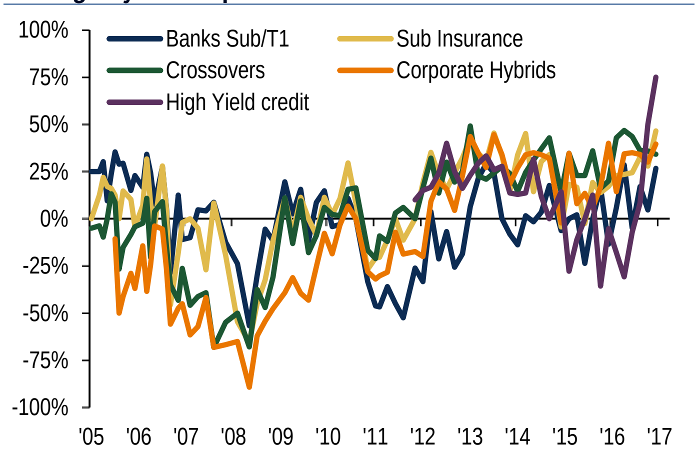


Source: BofA Merrill Lynch Global Research. We present the ratio of the past 12months average performance of each sector vs the standard deviation of these total returns, ICE BofAML indices

Theme #3: The last beta trade

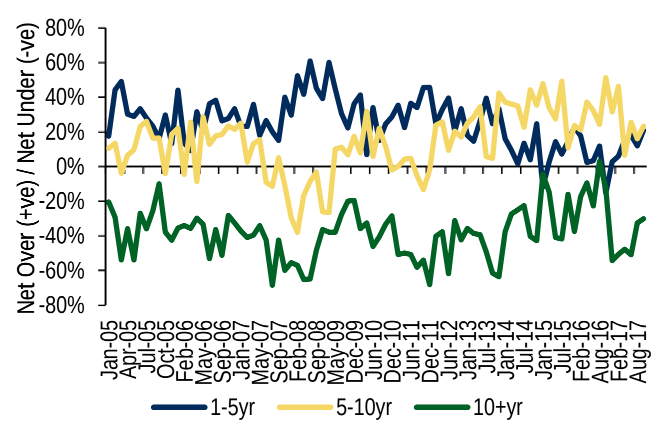
Investors have embraced most of the beta trades available: long bank capital, long corporate hybrids, long sub-insurers and long high yield credit. The last beta trade that has not been made yet is duration. Against the current backdrop of anaemic inflation, high central bank predictability and a shallow hiking cycle, we prefer to add some duration.

Chart 97: Large OW in high beta pockets in credit as investors are starving for yield and spread



Source: BofA Merrill Lynch Global Research. Net percentage of investors.

Chart 98: But credit investors are staying away from duration on the back of fear for the reflation trade



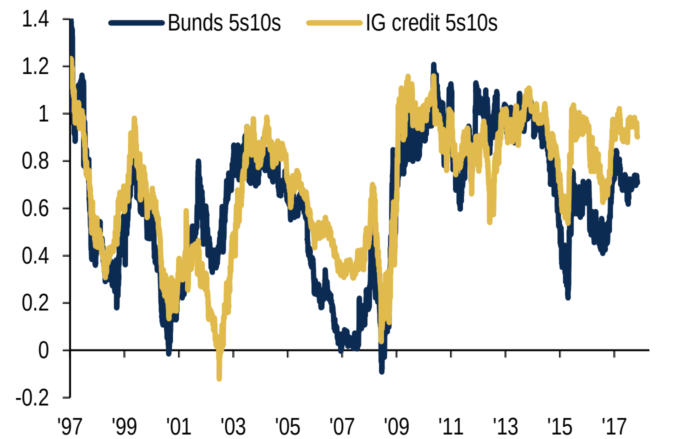
Source: BofA Merrill Lynch Global Research. Net percentage of investors.

In recent years, credit investors have had to add beta to reach for yield, as they have struggled to find any in low-beta sectors. Longs in Crossovers, high yield and sub paper (both fins and non-fins) have been added. However, the only beta trade that has yet to be embraced is duration. There has been some nibbling in recent months as per our survey results (Chart 98), but nothing in comparison with the moves seen in summer 2016 on the back of the ECB QE announcement.

Not only is positioning favourable, but also valuations, we think. For those investors that are happy to hold instruments that exhibit higher interest rate sensitivity, we think there is value in locking better yields.

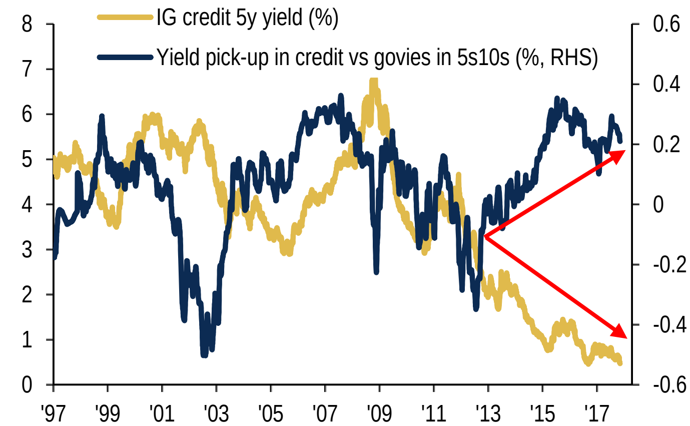
We find that the yield pickup on the 5y5y part of the credit curve over what is on offer in the bund market is attractive, especially when the broader yield levels have been moving lower in the past few years (Chart 100).

Chart 99: Credit curves much steeper than bund curves (in yield terms)



Source: BofA Merrill Lynch Global Research; ICE BofA Merrill Lynch indices, we use the ER0C and the average of ER04 & ER09 (to calculate the 10y tenor)

Chart 100: Good yield pickup by extending in credit

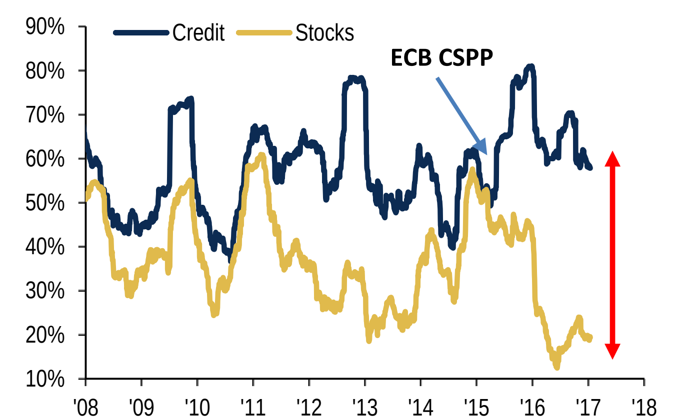


Source: BofA Merrill Lynch Global Research; ICE BofA Merrill Lynch indices, we use the ER0C and the average of ER04 & ER09 (to calculate the 10y tenor)

Theme #4: Rising dispersion in high yield market

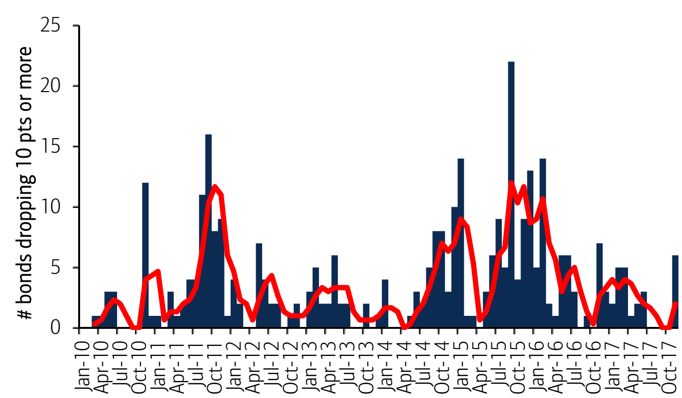
Idiosyncratic risk is picking up again. With spreads at the tights among the majority of names the risk is that idiosyncratic risk could take lot of P&L away. Stock picking is important in a tight spread environment, as mistakes can be costly. For that reason, we see higher risks for the first loss tranches for the XO index. We see better risk/reward in the 20-35% and 35-100% tranches and we think higher quality tranches with thicker subordination will outperform as investors are looking for "quality" yield.

Chart 101: CSPP boosted pairwise correlation in credit, but not in equites, which were untouched by the QE mania



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 102: Reach for yield mania pushed our Plunging bond tracker to zero recently. Idiosyncratic risks are back though so far this month



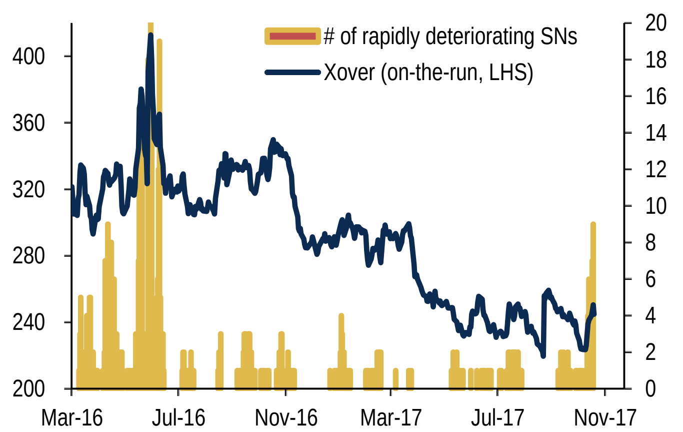
Source: BofA Merrill Lynch Global Research; we extrapolate MTD performance for the full month of November 2017

We see signs of rising dispersion among high yield issuers in the synthetics market: New Look, Boparan, Altice, Pizza Express, Astaldi to name a few. We think that in a low spread and yield environment investors should not close their eyes and buy everything just for the yield. Stock picking is back, we believe. Pairwise correlations among credit have been high on the back of CSPP. But this has not been the case in equity land. We think that the high inter-correlation between names in credit and consequently low dispersion is now starting to turn, with the view that a year from now QE will be behind us. We would suggest preparing and positioning for the eventual end of the indiscriminate bid for yield.

With spreads still close to multiyear tights, we think that idiosyncratic risk flare-ups will become more painful. Plunging bonds indicator has been at zero for the past four months, highlighting the reach for yield. But so far this month quite a few names have been down multiple points (Chart 102). Additionally, UK names have underperformed recently in the high-yield market. We think there is scope for more underperformance of the UK complex given continuing deadlock in the Brexit negotiations.

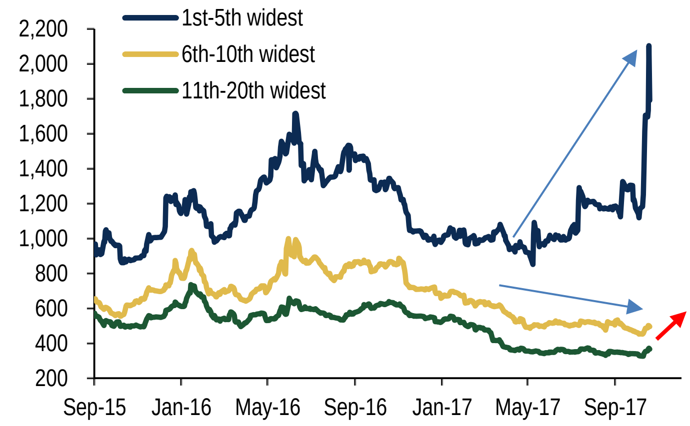
Altogether, this has resulted in increased dispersion across the high-yield market. Note the spread widening that we have witnessed in the tail despite XO moving tighter so far this year (Chart 104, 1st to 5th widest names). We think that rising idiosyncratic risks and Brexit will ultimately feed into tighter names too (Chart 104, 6th to 10th widest).

Chart 103: Idiosyncratic risk is back among HY issuers



Source: BofA Merrill Lynch Global Research; RHS # of names vs 75 names in total that widened more than 20% over 10 day periods

Chart 104: Dispersion is rising rapidly



Source: BofA Merrill Lynch Global Research. Average spread per bucket

As we approach the end of QE in Europe, our long-term trades need to take into consideration the eventual end of the reach for yield mania. At that point, rising dispersion will push investors to embrace safety over yield, and credit investors should be positioned in the senior parts of the capital structure. For that reason, we prefer to be long risk via senior rather than junior tranches in Crossover. We think that the top two tranches (25-35% and 35-100%) should fare better than the two junior tranches (0-10% and 10-25%).

Theme #5: Extract alpha in vol land by selling the skew

One could say that vols are close to record lows and question how much room they have to retrace further. We say that vols are high for the level of spreads and realised vol we see in iTraxx Main. Payer ladders can still provide alpha in the vol market with tail risk protection overvalued in vol terms.

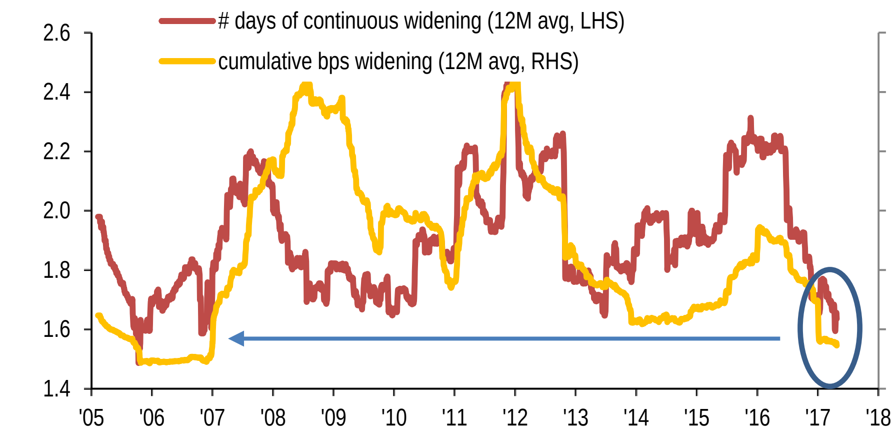
Record low vol across major asset classes and most importantly in rates market, has instigated the strongest risk-assets bull market since the GFC. The "buying-the-dip-mentality" has been largely adopted by investors that are happy to deploy cash to own assets at better levels. We find that iTraxx Main is enjoying best technicals since 2007. Note that the number of days of continuous widening has dropped significantly to 1.6days – average over the past 12 months. Not only that, but the cumulative bps widening the index "suffered" in the past 12 months is as low as 1.5bp (Chart 105).

Additionally, despite implied vols been near to record lows in the credit market, realised is even lower. Implied vol premia, forward and backward looking are expensive, we think (Chart 106). Note that forward realised vol is higher than implied vol only in 10-15% of the cases (using 3m or 1m forward realised vol).

Not only implied vols are high vs realised, but also are high vs spreads. Even though out-of-the-money vols (130% 3M) are more than 18 points higher from the lows, spreads are more than 17bp tighter (in the S27) over that period (the past six months). We think hedgers are happy to buy vol at these levels, as the absolute value cost to lift tail risk protection – via OTM puts/payers – has reduced amid a tighter spread backdrop.

However, this is not the case in vol terms, especially when realised vol is that low, and skews are that steep.

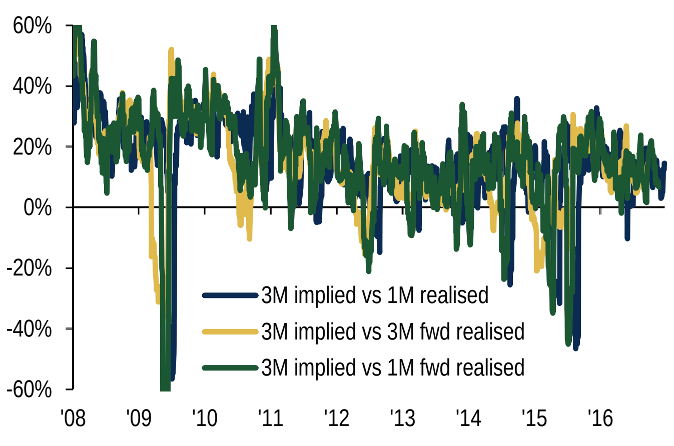
Chart 105: Sell-offs are short-lived and more moderate



Source: BofA Merrill Lynch Global Research

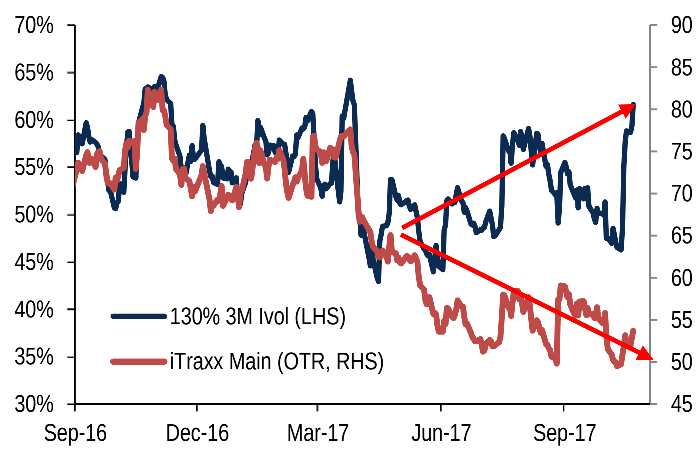
We think that iTraxx Main payer ladders are attractive at these levels. We are happy to be long risk at a wider level while selling the steep payer implied vol skew. We think the robust performance of IG credit vs other risk assets during the recent pullback shows how strong the technicals are on our market. Alpha seekers can use option structures like payer ladders to add alpha to their portfolios.

Chart 106: Implied vol remain expensive vs realized



Source: BofA Merrill Lynch Global Research

Chart 107: Higher vols vs tighter spreads



Source: BofA Merrill Lynch Global Research

Theme #6: Brexit = decompression

The XO vs Main trade has been well correlated to sterling. Rising uncertainty around Brexit and how negotiations will progress makes us believe that XO has little room to outperform Main. Long XO vs iTraxx Main payers is another way to trade the theme. The options structure bears no risk should Brexit and idiosyncratic risks abate pushing spreads tighter and indices to compress.

So far the reaction to rising Brexit-related uncertainty has been relatively muted. Our work shows that the XO vs iTraxx Main pair trade is highly correlated to the sterling market (Chart 108). This is the result of the high concentration of high-beta UK names - something we have highlighted here. Decompression between XO and Main is more likely than not.

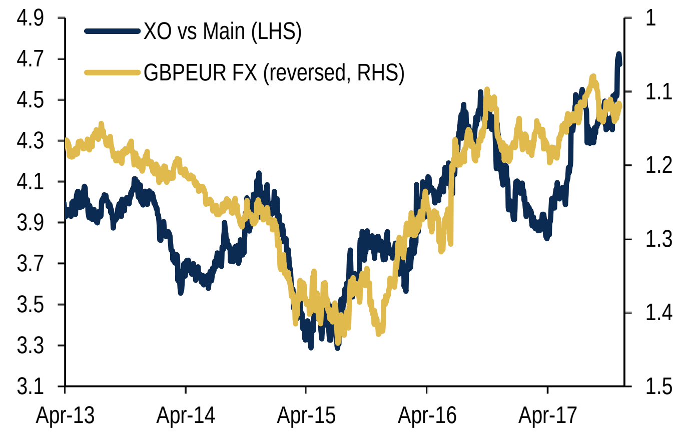
Talking credit technicals

IG cash investors seem to be sitting on high cash balances, according to our latest Credit Investor Survey. We think that high grade cash investors will be happy to continue buying the dips. Wider levels will be a better buying opportunity, especially as positioning looks relatively in line with average historical levels.

Note, however, that positioning in the high yield market seems more stretched; it is currently at record-highs, according to our latest investor survey. For this reason, potential weakness - and higher volatility - would have more of an adverse effect on the high-yield market, which has significantly outperformed its high grade counterpart so far this year.

Even though they also have strong cash balances, we think that high yield investors' more stretched positioning could force them to be buyers of protection sooner rather than later vs their IG counterparts.

Chart 108: XO vs Main highly correlated to sterling (market levels)



Source: BofA Merrill Lynch Global Research, Bloomberg; based on roll adjusted time series

Relative Value: The last mile

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The idea of developing a theme for the calendar year ahead has always been somewhat of an artificial construct; not much changes at the stroke of midnight on 31st December, or at least no more so than it does every midnight hour. It has been particularly hard to get away from this in compiling our thoughts for 2018. Our house forecasts for the US economy and credit returns next year are very similar to their performance this year. In a similar vein, we think credit volatility will continue to remain subdued for the most part of 2018.

That volatility is low is undeniable. That it needs to be higher is debatable. Yes, policy uncertainty is high and the risk of geopolitical flare-ups remains elevated. But these risks are hard to price or time with any precision. On the other hand, the constancy of central banks and the steady improvement in global economic data are immediate and far easier to evaluate. To us, low volatility doesn't represent complacency as much as helplessness in the face of a large amount of capital chasing too few assets. Time and again over the last two years, the cost of being underinvested has proven to be higher than the benefit of sitting it out.

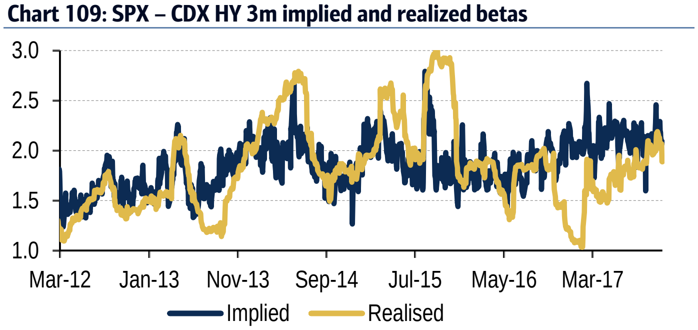
Of course, like every other one before it, this cycle too will age and eventually turn. When the economy falters and default risk becomes material, volatility will spike up. For now however, we're still in the last mile, the final stretch of this extremely long business cycle. Our trade ideas for the next year focus on low cost hedges, positive carry trades, and holdouts that have yet to embrace the rally and may yet want to catch-up.

To hedge risk of tax reform legislation falling through

Buy S&P 500 puts, sell CDX HY puts

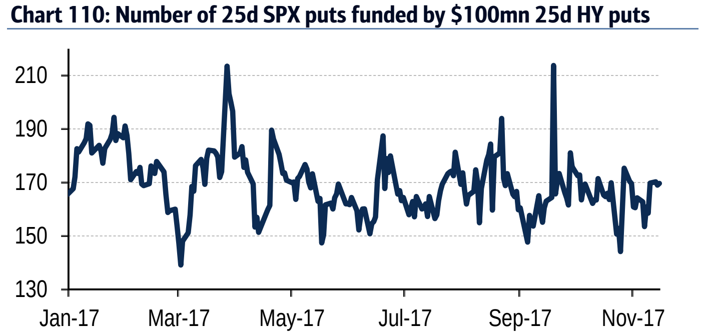
This scenario would hurt equities more than credit. Most of the immediate benefits of the current proposals accrue to shareholders, while low quality credits may even be detrimentally affected by the elimination of full deductibility of interest expenses. To hedge or position for this scenario, we recommend buying S&P 500 puts, funded by selling CDX HY puts. As Chart 109 shows the option implied beta between SPX and HY is in line with what they have been realizing. And in the event that tax reform is abandoned or delayed materially, we'd expect the realized beta between the two to spike up, similar to what occurred in 2013-14 and 2015-16.

Chart 109: SPX – CDX HY 3m implied and realized betas



Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

Chart 110: Number of 25d SPX puts funded by $100mn 25d HY puts



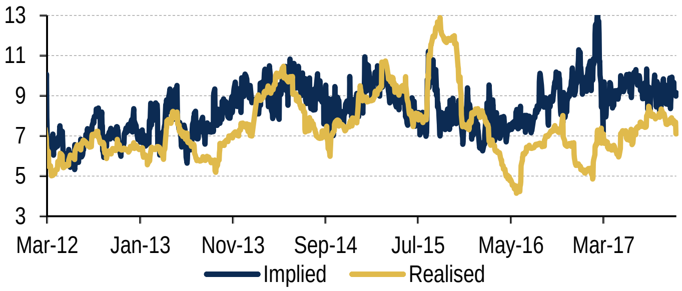
Source: BofA Merrill Lynch Global Research

To hedge credit against a surge in rates volatility

Buy IG payers

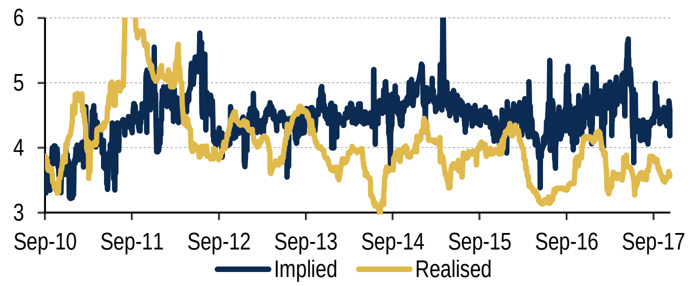
Really this is a catch-all for multiple tail risks, be that a central bank policy mistake, a bond market crash, a geopolitical flare-up or trade wars. Though the direction of rates will vary across these events, volatility is likely to surge if any of them occurs. Puts on high grade credit offer the best hedge for this scenario, in our opinion. We think it is better executed through CDX IG payers rather than a trade in a HG cash product, because depending on the exact scenario that materializes, the latter may benefit from the negative correlation between rates and spreads. IG volatility looks cheap relative to stocks, HY and until a week back even relative to rates. This isn't necessarily a mispricing, rather an indication that the market assigns a low probability to an extreme tail event, which is what IG offers protection against.

Chart 111: SPX – CDX IG 3m implied and realized betas



Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

Chart 112: CDX HY – CDX IG 3m implied and realized betas



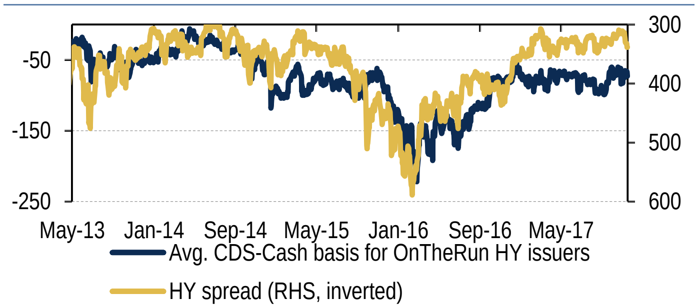
Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

For downside protection in credit

Buy high yield cash puts, sell CDX HY puts

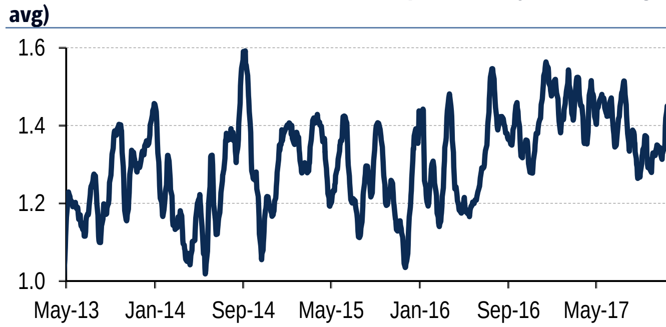
The CDS-cash basis is much less negative now than it was last year. However, even though CDX is near/inside its 2014 tights, the basis has struggled to compress beyond a certain level. The limiting factor we think has been funding. The other interesting thing about the basis, since 2013, has been its directionality – it turns more negative when spreads widen and more positive when spreads rally. The increasing popularity of ETFs, especially in HY, as a way to express views on credit, ensures that the lag that used to exist between bonds and CDS has all but disappeared. At the same time, bonds do carry a liquidity premium, which typically increases in risk-off. Together, this implies that the basis will likely remain directional, becoming more negative into a sell-off and vice-versa.

Chart 113: Basis for HY issuers



Source: BofA Merrill Lynch Global Research

Chart 114: Ratio of HYG to HY 3m 25delta put volatility (10d moving avg)



Source: BofA Merrill Lynch Global Research

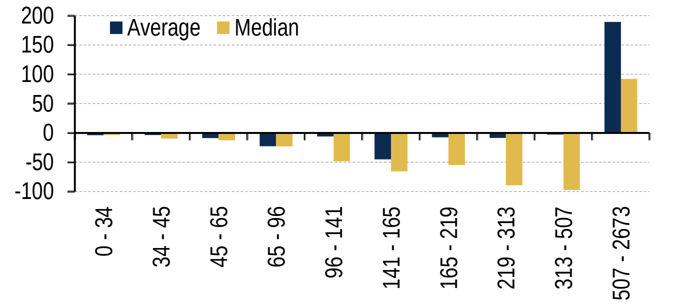
This pattern opens up an interesting opportunity between CDX HY and HYG volatility. In a recent piece we discussed how a principal component analysis (PCA) of volatility across IG, HY, HYG and LQD suggests that HYG volatility is almost full explained by credit (CDX) volatility and the CDX-cash index basis. The directionality of the basis relative to spreads also implies that HYG tends to realize more volatility in general compared to HY. We like owning downside credit protection through HY cash puts, while selling CDX HY puts against it.

Dispersion and a HY long for those with conviction

Dispersion has been relatively high in credit since 2015. Even so, it is startling, that in a year where stocks have been on a tear and we've had positive excess returns across credit, the widest part of the market did not deign to participate (Chart 115).

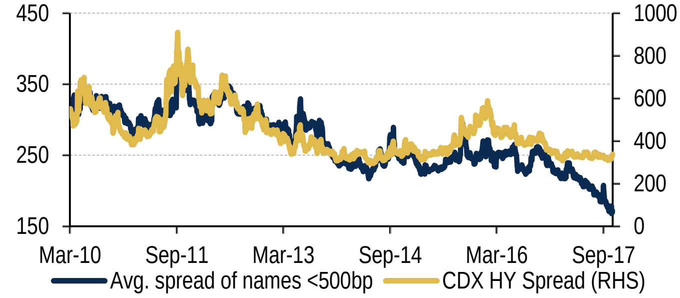
Chart 115: YTD change in 5y CDS for different spread cohorts

For issuers in CDX29, grouped by spread deciles as of 31-Dec-2016



Source: BofA Merrill Lynch Global Research

Chart 116: Tight names have massively outperformed HY index



Source: BofA Merrill Lynch Global Research

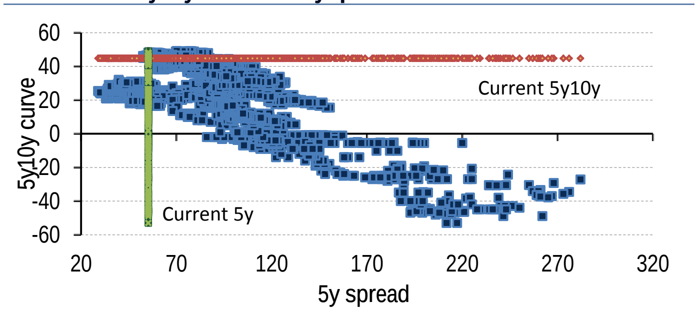
For CDX HY to tighten significantly from here dispersion has to decrease and wide names have to outperform. It is difficult to see how this is accomplished, in the absence of 'animal spirits'. After all, the dispersion exists because of elevated jump and idiosyncratic risk. Another point of concern surrounding the HY tail names is tax reform. If passed, the legislation in its current form is hardly beneficial to these issuers. It may put some business models and capital structures into question while the benefit of a lower tax rate is a moot point for several names in this cohort.

However, for those who are bullish HY for 2018 with a high level of conviction, the best way to express this view is through a long equity tranche trade as it is immediately sensitive to the performance of the wide tail names. The tranche has persistently underperformed the rest of the capital structure this past year and stands to benefit the most from a true 'risk-on' rally.

Curves, a long and a carry trade

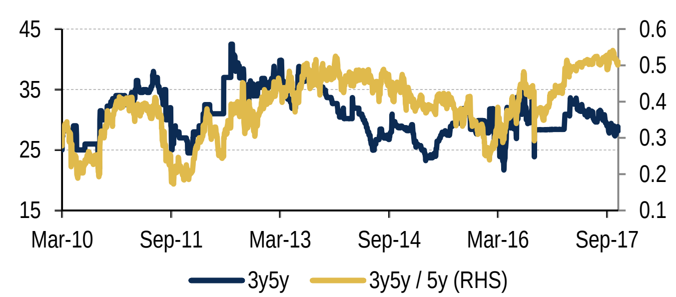
Credit spread curves are very steep. This may be in part related to higher longer term uncertainty versus low near-term risk as a consequence of central bank actions. As it pertains to IG, relative liquidity may play a role too. The 10y point is far less liquid than the 5y and the steep curve partly reflects this premium. The 3y on the other hand has benefited from the recent revival of the synthetic CDO market which has led this tenor to tighten at a quicker pace than the 5y (Chart 118).

Chart 117: IG 5y10y relative to 5y spread



Source: BofA Merrill Lynch Global Research

Chart 118: CDX IG 3y5y curve



Source: BofA Merrill Lynch Global Research

Long 10y IG

The 5y5y forward spread for IG is 156bp, almost 3x the 5y spread. We think 10y IG provides good value as a long, especially now that the 5y is at post-crisis tights. As Chart 117 shows the curve has rarely been steeper than current levels. The passage of tax reform legislation should be positive for the 10y part of the curve. Corporates have indicated that most intend to deploy repatriated cash holdings towards paying down debt. Also, the elimination of full interest expense deductibility for tax purposes will increase the cost of debt relative to equity, encouraging companies to de-lever over time. Low liquidity and onerous capital requirements for banks have kept the 10y spread elevated. However, for yield starved investors who are less sensitive to daily mark-to-market, 10y IG stands as one of the few spots in high grade credit that hasn't rallied whole-heartedly.

3y5y DVO1-neutral flattener

While the 3y5y curve has begun flattening in absolute terms, we think it has more to go, especially if spreads continue to rally. Since the 3y is limited on the lower end, further tightening in credit should lead to more bull flattening. As Chart 118 shows, relative to the 5y, 3y5y is close to the steepest ever. We like a 3y5y DVO1-neutral flattener in IG. The trade is positive carry and roll. Unlike an equal notional curve trade, which is more directional, the DVO1-neutral weighting will perform even with bear flattening. The risk to the trade is that the curve steepens with wider spreads, which is certainly possible, but less likely we think from current levels.

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