Signs of Capital Misallocation in Sectors

Bank of America Merrill Lynch

14 September 2018

High Yield Strategy
United States

Oleg Melentyev, CFA
Credit Strategist
MLPF&S
+1 646 855 6379
oleg.melentyev@baml.com

Neha Khoda
Credit Strategist
MLPF&S
+1 646 855 9656
neha.khoda@baml.com

Eric Yu
Credit Strategist
MLPF&S
+1 646 855 8663
eric.x.yu@baml.com

EM had a strong week; we continue to like the risk there

Another good week in the HY space helped push our spreads 17bps tighter (to 335bps) on modestly higher 5yr Trsy yields of +5bps through mid-week. BBs managed to hold their ground despite negative rates contribution with moderate positive total return (+0.20%) and strong excess return of +0.60%. CCCs outperformed on both scales by about 30bps.

All sectors tightened for the week, led by healthcare (VRX, HCA, ENDP), telecoms (FTR, INTEL, S), retail (PETM, NMG), and tech (BMC, FDC, DELL). On the other end, transportation, food producers, and gaming lagged the broad market but tightened nevertheless.

The big story continued to evolve in EM vs DM space, where EM HY has outperformed DM USD HY by 30+ bps in excess returns over the past week, with EM single-Bs outperforming DM comps by 50+ bps. Valuation gaps remain wide and we think this trade is in its early stages – so more to come. The gap in EM single-Bs vs DM comps is still in its 85th percentile of its historical range.

Rates retraced most of their 15bps post-payrolls move higher in the 10yr, after both the PPI and CPI reports showed weakness in their core components. None of this should be a surprise to regular readers of these pages, as we have said for months that rates are likely to struggle on the upside, particularly once they approach 3.0% (currently at 2.97%). We continue to think that 3.25% is going to prove hard to break on the upside, and 3.50% is more of an extreme upper limit in our view.

The 10/2yr yield has made an attempt to normalize, steepening from 19bps late Aug to 26bps in early Sept, but has given up most of that progress and currently sits at 21bps.

In technicals this week, we saw marginal fund outflows (-$200mn), driven primarily by ETFs and no coupon payments to speak of. Calls/tenders were running at about average pace of $3.2bn and there were a couple of chunky maturities, totaling $2.2bn. Looking forward, next week brings the heaviest coupon intake of September ($4.8bn), which is being offset by a relatively slow call/tender volume of $1.5bn and no maturities.

In issuance, the pace of activity has slowed down to $1.3bn this week after $5bn last week although the visible pipeline remained heavy with a couple of large-scale transactions on their way to pricing in coming sessions. MTD Sept stands at $6.3bn and we projected $19bn going into this month.

Overall the tone in the market remains supportive, particularly that some of the worst case scenarios on trade now appear less likely with the US Administration reaching out to China according to news reports. This coupled with Turkish central bank delivering a 625bps rate hike to fight the currency crisis, EM assets were a strong performer this week. EM overweight vs HY remains our favorite trade here. In HY, we continue to find CCCs expensive and think single-Bs are the sweet spot right now, with some moderate incremental exposure to BBs. Overall HY is at the tight end of a range, at 335bps.

Timestamp: 14 September 2018 07:30AM EDT

Over the past year, we have made a repeated argument that this credit cycle has longer to run. In doing so, we have shown how the dynamics of debt growth, capex, leverage, and earnings all point to the same conclusion: we are not likely to be at a point where previous cycles have turned.

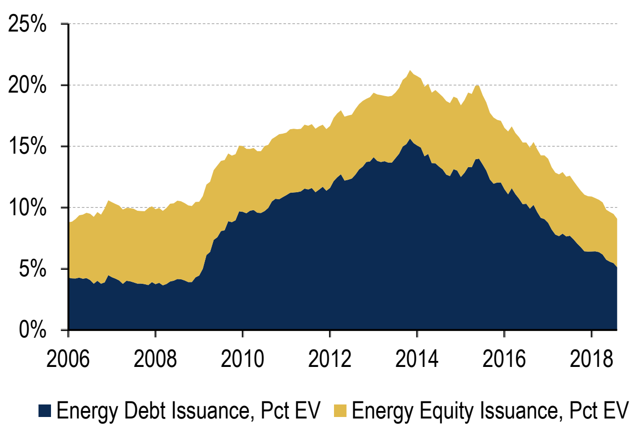
This does not mean that the current cycle cannot turn here – we view trade barriers as the fastest shortcut from where we are (solid economic growth) to an unwarranted contraction. Barring such an unfortunate outcome – and our base case remains that such an outcome is going to be eventually avoided – we think this credit cycle may still have a couple of good years ahead of it.

We also believe that cycles generally do not turn because the broad economy turns. In recent instances, specific industries experienced sharp contractions within their own perimeters before the weakness spread to other related sectors and eventually to a broader economy. Examples include technology and telecom sectors in 2001-2002, real estate and consumer sectors in 2008-2009, and energy and metals in 2014-2015. In the latter example US economy avoided a recession as such, although world GDP has slowed down as much as it did during the post-Lehman trough ten years ago.

One way we could go about identifying industry-level vulnerabilities is to look at capital allocation trends on a sector level. Arguably, a sector that experienced strong growth in new capital raised is more likely to engage in extensive capex and investment projects, leading to higher subsequent production, overcapacity, and price pressures. These developments, in turn, make it likely that such a sector will have to undergo restructuring, consolidation, and liquidation of excess capacity before it becomes investable again.

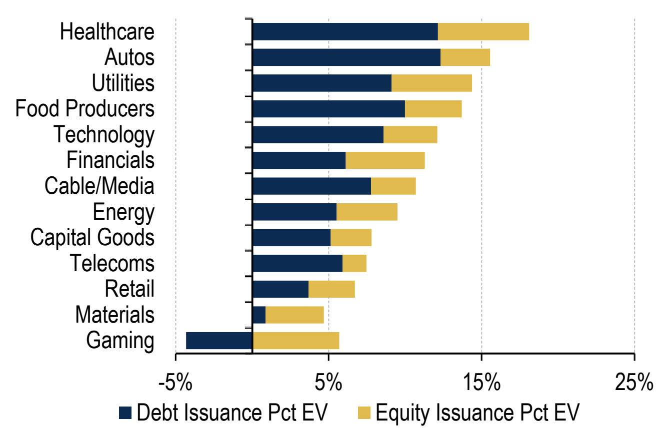
Figure 1 shows how these developments played out most recently in energy, where the shale revolution in 2006-2009 led to a significant increase in new capital being raised. At its peak in early 2015, the sector was running a 5-year cumulative tab of $650bn in new net debt and equity capital formation just in the developed markets. This figure represented more than 20% of total Enterprise Value of the sector at the beginning of that sliding 5yr time-horizon. EM issuers almost certainly made similarly impressive capital raisings during that timeframe, although those figures were not included here.

Figure 1: Energy debt + equity issuance, trailing 5yr pct of EV



Source: BofA Merrill Lynch Global Research

Figure 2: Debt + equity issuance by sector, last 5yrs pct of EV



Source: BofA Merrill Lynch Global Research

Following the commodity meltdown in 2015-2016 and a 25%-plus default rate in HY energy space, we have seen the capital formation slowing down materially, to 5% of EVs in debt and less than 4% in equity. These figures match the lowest levels of new capital raised in energy in the last twelve years. Arguably, with low capital inflows, low capex, and low competition for existing assets, energy represents a better longer-term fundamental value at current levels compared to the opposite extremes of early 2015.

As a reminder, we maintain a generally upbeat view of this sector purely from a HY credit standpoint and expect energy to remain the fastest deleveraging story in our market going forward.

This energy example serves as a recent lesson of extreme peaks and troughs in capital flows and their impact on subsequent sector fundamentals. So where do other industries stand on this scale today? Figure 2 ranks them with x-axis reflecting new net debt (IG+HY) and equity capital being raised in each sector over the past five years, divided by its respective Enterprise Value as of Sept 2013.

We cannot say we are particularly surprised to see Healthcare at the very top of this list, as we viewed this sector as being structurally overextended and suffering from overcapacity for some time now. The fact that it also very heavy capital inflows in recent years further supports our earlier reservations about this sector, and we maintain our structural defensive positioning here.

While we have not yet published our in-depth views on autos and utilities, the fact that we are seeing them close to the top of capital formation should give investors a pause with respect to their longer-term prospects from this point on.

Conversely, gaming happens to be the only sector in our study that has seen a contraction of net debt over the past five years, and the lowest overall capital formation during the period. To an extent, this could be explained by the fact that our study is limited to developed markets, and thus misses the Macau projects by design. Nevertheless, numbers are what they are, and we think investors need to take this rare and somewhat unexpected datapoint into account.

The other two sectors at the bottom of our ranking are Materials (include Metals) and Retail. These two should not be of any surprise given their recent history, and so again, the argument here is that they may be close to the bottom of their respective capital allocation cycles. As such they have suffered from underinvestment, lack of new capacity (already in place and upcoming), and lack of investor enthusiasm. All of these are ingredients of a bottoming-out process in their cyclical journey, and so we view them more positively based on this scale alone.

Disclosures

Important Disclosures

BofA Merrill Lynch Credit Opinion Key

BofA Merrill Lynch Global Research provides recommendations on an issuer's bonds (including corporate and sovereign external debt securities), capital securities, equity preferreds and CDS as described below. Convertible securities are not rated. An issuer level recommendation may also be provided for an issuer as explained below. BofA Merrill Lynch Global Research credit recommendations are assigned using a three-month time horizon.

Issuer Recommendations: If an issuer credit recommendation is provided, it is applicable to bonds and capital securities of the issuer except bonds and capital securities specifically referenced in the report with a different credit recommendation. Where there is no issuer credit recommendation, only individual bonds and capital securities with specific recommendations are covered. CDS and equity preferreds are rated separately and issuer recommendations do not apply to them.

BofA Merrill Lynch Global Research credit recommendations are assigned using a three-month time horizon:
Overweight: Spreads and /or excess returns are likely to outperform the relevant and comparable market over the next three months.
Marketweight: Spreads and/or excess returns are likely to perform in-line with the relevant and comparable market over the next three months.
Underweight: Spreads and/or excess returns are likely to underperform the relevant and comparable market over the next three months.

BofA Merrill Lynch Global Research uses the following rating system with respect to **Credit Default Swaps (CDS):**
Buy Protection: Buy CDS, therefore going short credit risk.
Neutral: No purchase or sale of CDS is recommended.
Sell Protection: Sell CDS, therefore going long credit risk.

Due to the nature of strategic analysis, the issuers or securities recommended or discussed in this report are not continuously followed. Accordingly, investors must regard this report as providing stand-alone analysis and should not expect continuing analysis or additional reports relating to such issuers and/or securities.
BofA Merrill Lynch Research Personnel (including the analyst(s) responsible for this report) receive compensation based upon, among other factors, the overall profitability of Bank of America Corporation, including profits derived from investment banking. The analyst(s) responsible for this report may also receive compensation based upon, among other factors, the overall profitability of the Bank's sales and trading businesses relating to the class of securities or financial instruments for which such analyst is responsible.
BofA Merrill Lynch fixed income analysts regularly interact with sales and trading desk personnel in connection with their research, including to ascertain pricing and liquidity in the fixed income markets.

Other Important Disclosures

Prices are indicative and for information purposes only. Except as otherwise stated in the report, for the purpose of any recommendation in relation to: (i) an equity security, the price referenced is the publicly traded price of the security as of close of business on the day prior to the date of the report or, if the report is published during intraday trading, the price referenced is indicative of the traded price as of the date and time of the report; or (ii) a debt security (including equity preferred and CDS), prices are indicative as of the date and time of the report and are from various sources including Bank of America Merrill Lynch trading desks.
The date and time of completion of the production of any recommendation in this report shall be the date and time of dissemination of this report as recorded in the report timestamp.

This report may refer to fixed income securities that may not be offered or sold in one or more states or jurisdictions. Readers of this report are advised that any discussion, recommendation or other mention of such securities is not a solicitation or offer to transact in such securities. Investors should contact their BofA Merrill Lynch representative or Merrill Lynch Global Wealth Management financial advisor for information relating to fixed income securities.
Rule 144A securities may be offered or sold only to persons in the U.S. who are Qualified Institutional Buyers within the meaning of Rule 144A under the Securities Act of 1933, as amended.
SECURITIES DISCUSSED HEREIN MAY BE RATED BELOW INVESTMENT GRADE AND SHOULD THEREFORE ONLY BE CONSIDERED FOR INCLUSION IN ACCOUNTS QUALIFIED FOR SPECULATIVE INVESTMENT.
Recipients who are not institutional investors or market professionals should seek the advice of their independent financial advisor before considering information in this report in connection with any investment decision, or for a necessary explanation of its contents.
The securities discussed in this report may be traded over-the-counter. Retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale.
Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.
This report, and the securities discussed herein, may not be eligible for distribution or sale in all countries or to certain categories of investors.
Information relating to Affiliates of MLPF&S and Distribution of Affiliate Research Reports:
"BofA Merrill Lynch" includes Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S") and its affiliates. Investors should contact their BofA Merrill Lynch representative or Merrill Lynch Global Wealth Management financial advisor if they have questions concerning this report. "BofA Merrill Lynch" and "Merrill Lynch" are each global brands for BofA Merrill Lynch Global Research.
MLPF&S distributes, or may in the future distribute, information of the following non-US affiliates in the US (short name: legal name, regulator): Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd., regulated by The Financial Service Board; MLI (UK): Merrill Lynch International, regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA); Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited, regulated by the Australian Securities and Investments Commission; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited, regulated by the Hong Kong Securities and Futures Commission (HKSFC); Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd, regulated by the Monetary Authority of Singapore (MAS); Merrill Lynch (Canada): Merrill Lynch Canada Inc, regulated by the Investment Industry Regulatory Organization of Canada; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa, regulated by the Comisión Nacional Bancaria y de Valores; Merrill Lynch (Argentina): Merrill Lynch Argentina SA, regulated by Comisión Nacional de Valores; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co., Ltd., regulated by the Financial Services Agency; Merrill Lynch (Seoul): Merrill Lynch International, LLC Seoul Branch, regulated by the Financial Supervisory Service; Merrill Lynch (Taiwan): Merrill Lynch Securities (Taiwan) Ltd., regulated by the Securities and Futures Bureau; DSP Merrill Lynch (India): DSP Merrill Lynch Limited, regulated by the Securities and Exchange Board of India; Merrill Lynch (Indonesia): PT Merrill Lynch Sekuritas Indonesia, regulated by Otoritas Jasa Keuangan (OJK); Merrill Lynch (Israel): Merrill Lynch Israel Limited, regulated by Israel Securities Authority; Merrill Lynch (Russia): OOO Merrill Lynch Securities, Moscow, regulated by the Central Bank of the Russian Federation; Merrill Lynch (DIFC): Merrill Lynch International (DIFC Branch), regulated by the Dubai Financial Services Authority (DFSA); Merrill Lynch (Spain): Merrill Lynch Capital Markets Espana, S.A.S.V., regulated by Comisión Nacional del Mercado De Valores; Merrill Lynch (Brazil): Bank of America Merrill Lynch Banco Multiplo S.A., regulated by Comissão de Valores Mobiliários; Merrill Lynch KSA Company, Merrill Lynch Kingdom of Saudi Arabia Company, regulated by the Capital Market Authority.
This information: has been approved for publication and is distributed in the United Kingdom (UK) to professional clients and eligible counterparties (as each is defined in the rules of the FCA and the PRA) by MLI (UK) and Bank of America Merrill Lynch International Limited, which are authorized by the PRA and regulated by the FCA and the PRA, and is distributed in the UK to retail clients (as defined in the rules of the FCA and the PRA) by Merrill Lynch International Bank Limited, London Branch, which is authorized by the Central Bank of Ireland and subject to limited regulation by the FCA and PRA - details about the extent of our regulation by the FCA and PRA are available from us on request; has been considered and distributed in Japan by Merrill Lynch (Japan), a registered securities dealer under the Financial Instruments and Exchange Act in Japan, or its permitted affiliates; is issued and distributed in Hong Kong by Merrill Lynch (Hong Kong) which is regulated by HKSFC is issued and distributed in Taiwan by Merrill Lynch (Taiwan); is issued and distributed in India by DSP Merrill Lynch (India); and is issued and distributed in

Singapore to institutional investors and/or accredited investors (each as defined under the Financial Advisers Regulations) by Merrill Lynch International Bank Limited (Merchant Bank) (MLIBLMB) and Merrill Lynch (Singapore) (Company Registration Nos F 06872E and 198602883D respectively). MLIBLMB and Merrill Lynch (Singapore) are regulated by MAS. Bank of America N.A., Australian Branch (ARBN 064 874 531), AFS License 412901 (BANA Australia) and Merrill Lynch Equities (Australia) Limited (ABN 65 006 276 795), AFS License 235132 (MLEA) distribute this information in Australia only to 'Wholesale' clients as defined by s.761G of the Corporations Act 2001. With the exception of BANA Australia, neither MLEA nor any of its affiliates involved in preparing this information is an Authorised Deposit-Taking Institution under the Banking Act 1959 nor regulated by the Australian Prudential Regulation Authority. No approval is required for publication or distribution of this information in Brazil and its local distribution is by Merrill Lynch (Brazil) in accordance with applicable regulations. Merrill Lynch (DIFC) is authorized and regulated by the DFSA. Information prepared and issued by Merrill Lynch (DIFC) is done so in accordance with the requirements of the DFSA conduct of business rules. Bank of America Merrill Lynch International Limited, Frankfurt Branch (BAMLI Frankfurt) distributes this information in Germany and is regulated by BaFin.

This information has been prepared and issued by MLPF&S and/or one or more of its non-US affiliates. The author(s) of this information may not be licensed to carry on regulated activities in your jurisdiction and, if not licensed, do not hold themselves out as being able to do so. MLPF&S is the distributor of this information in the US and accepts full responsibility for information distributed to MLPF&S clients in the US by its non-US affiliates. Any US person receiving this information and wishing to effect any transaction in any security discussed herein should do so through MLPF&S and not such foreign affiliates. Hong Kong recipients of this information should contact Merrill Lynch (Asia Pacific) Limited in respect of any matters relating to dealing in securities or provision of specific advice on securities or any other matters arising from, or in connection with, this information. Singapore recipients of this information should contact Merrill Lynch International Bank Limited (Merchant Bank) and/or Merrill Lynch (Singapore) Pte Ltd in respect of any matters arising from, or in connection with, this information.

General Investment Related Disclosures:

Taiwan Readers: Neither the information nor any opinion expressed herein constitutes an offer or a solicitation of an offer to transact in any securities or other financial instrument. No part of this report may be used or reproduced or quoted in any manner whatsoever in Taiwan by the press or any other person without the express written consent of BofA Merrill Lynch.

This document provides general information only, and has been prepared for, and is intended for general distribution to, BofA Merrill Lynch clients. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g., options, futures, warrants, and contracts for differences). This document is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of, and is not directed to, any specific person(s). This document and its content do not constitute, and should not be considered to constitute, investment advice for purposes of ERISA, the US tax code, the Investment Advisers Act or otherwise. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this document and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this document.

Securities and other financial instruments referred to herein, or recommended, offered or sold by BofA Merrill Lynch, are not insured by the Federal Deposit Insurance Corporation and are not deposits or other obligations of any insured depository institution (including, Bank of America, N.A.). Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

BofA Merrill Lynch is aware that the implementation of the ideas expressed in this report may depend upon an investor's ability to "short" securities or other financial instruments and that such action may be limited by regulations prohibiting or restricting "shortselling" in many jurisdictions. Investors are urged to seek advice regarding the applicability of such regulations prior to executing any short idea contained in this report.

This report may contain a trading idea or recommendation which highlights a specific identified near-term catalyst or event impacting a security, issuer, industry sector or the market generally that presents a transaction opportunity, but does not have any impact on the analyst's particular "Overweight" or "Underweight" rating (which is based on a three month trade horizon). Trading ideas and recommendations may differ directionally from the analyst's rating on a security or issuer because they reflect the impact of a near-term catalyst or event.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

UK Readers: The protections provided by the U.K. regulatory regime, including the Financial Services Scheme, do not apply in general to business coordinated by BofA Merrill Lynch entities located outside of the United Kingdom. BofA Merrill Lynch Global Research policies relating to conflicts of interest are described at https://go.bofa.com/coi.

MLPF&S or one of its affiliates is a regular issuer of traded financial instruments linked to securities that may have been recommended in this report. MLPF&S or one of its affiliates may, at any time, hold a trading position (long or short) in the securities and financial instruments discussed in this report.

BofA Merrill Lynch, through business units other than BofA Merrill Lynch Global Research, may have issued and may in the future issue trading ideas or recommendations that are inconsistent with, and reach different conclusions from, the information presented herein. Such ideas or recommendations reflect the different time frames, assumptions, views and analytical methods of the persons who prepared them, and BofA Merrill Lynch is under no obligation to ensure that such other trading ideas or recommendations are brought to the attention of any recipient of this information.

In the event that the recipient received this information pursuant to a contract between the recipient and MLPF&S for the provision of research services for a separate fee, and in connection therewith MLPF&S may be deemed to be acting as an investment adviser, such status relates, if at all, solely to the person with whom MLPF&S has contracted directly and does not extend beyond the delivery of this report (unless otherwise agreed specifically in writing by MLPF&S). If such recipient uses the services of MLPF&S in connection with the sale or purchase of a security referred to herein, MLPF&S may act as principal for its own account or as agent for another person. MLPF&S is and continues to act solely as a broker-dealer in connection with the execution of any transactions, including transactions in any securities referred to herein.

Copyright, User Agreement and other general information related to this report:

Materials prepared by BofA Merrill Lynch Global Research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of BofA Merrill Lynch, including investment banking personnel. BofA Merrill Lynch has established information barriers between BofA Merrill Lynch Global Research and certain business groups. As a result, BofA Merrill Lynch does not disclose certain client relationships with, or compensation received from, such issuers. To the extent this material discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this material. BofA Merrill Lynch Global Research personnel's knowledge of legal proceedings in which any BofA Merrill Lynch entity and/or its directors, officers and employees may be plaintiffs, defendants, co-defendants or co-plaintiffs with or involving issuers mentioned in this material is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, discussed with, and may not reflect information known to, professionals in other business areas of BofA Merrill Lynch in connection with the legal proceedings or matters relevant to such proceedings.

This information has been prepared independently of any issuer of securities mentioned herein and not in connection with any proposed offering of securities or as agent of any issuer of any securities. None of MLPF&S, any of its affiliates or their research analysts has any authority whatsoever to make any representation or warranty on behalf of the issuer(s). BofA Merrill Lynch Global Research policy prohibits research personnel from disclosing a recommendation, investment rating, or investment thesis for review by an issuer prior to the publication of a research report containing such rating, recommendation or investment thesis.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

The information herein (other than disclosure information relating to BofA Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. This information may contain links to third-party websites. BofA Merrill Lynch is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this information and is not incorporated by reference. The inclusion of a link does not imply any endorsement by or any affiliation