The HY-Wire

2017 Outlook: Don't be a hero

21 November 2016 Corrected

High Yield Strategy
Global

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The road to success is paved with obstacles

In 2017 we encourage investors to not try and be a hero and chase alpha, but rather to avoid the blowups and control what they can: picking quality credits. Until we know more about the policies of Donald Trump, we are not ready to deem 2017 the year that neither defines the end of the credit or business cycle nor bolsters the case for a significant rise in prosperity. Instead, we brace for year 2 of a rolling blackout and focus on likely paths and outcomes across broad themes that include rates, the USD, flow of capital, and of course, fundamentals.

2017 return forecast: HY 4-5%, loans 3-4%

We think the largest determining factors to next year's returns are whether the "search for yield" story will continue and what a Donald Trump presidency will mean for growth, inflation, currencies and rates. With so many different potential outcomes, we lay out 5 scenarios from best case to worst case, and probability weight each to determine a return. Perhaps unsurprisingly, our probability weighted high yield return yields a very similar outcome as that calculated using the Bank of America Merrill Lynch house view on growth, currencies and the dollar: 4-5%. We expect loans to modestly underperform bonds next year on an absolute basis with a 3-4% gain, although on a risk-adjusted basis we prefer loans.

2017 issuer default forecast: HY 4.0-4.5%, loans 2.0%

On balance, default risk next year appears set to ease to about 4.0-4.5% on an issuer level basis and 2.0-2.5% on a par basis, driven by easier access to capital and improving credit fundamentals. Most of the decrease in defaults is a direct result of an expectation of reduced stress within the Energy sector, where default rates are seen falling to 13%. Ex-energy default rates will also likely experience a modest decline to 2.9%, in line with the overall improving macro backdrop. Based on these assumptions, our recovery model suggests senior unsecured recovery rates of around $40 next year.

2017 new issue forecast: HY $200bn, loans $245bn

Our new issuance forecasting methodology is based on a combination of lending standards, changes in borrowing costs, and trailing migration rates. Our analysis produces a 2017 issuance forecast of $212.7bn which represents a 0.6% decline compared to this year. However, due to fiscal uncertainty and the potential for a corporate tax cut which would increase the after-tax cost of debt, we lowered this value to $200bn for a 6.5% year over year decline in gross high yield issuance. We use similar analysis in order to forecast loan issuance, where we expect supply to decline 10% to $245bn.

Positioning

Our sector positioning is built around shorter duration single-B credits, names that generate a substantial portion of revenue from within the United States, and those that have not engaged in a significant amount of M&A. We also recommend cautiously layering in some higher beta names that are in decent shape in order to capture additional yield. We enter 2017 overweight Energy, Gaming, and Telecom; underweight Autos, Food, Healthcare, Hotels & Leisure, Real Estate, Tech, and Utilities.

Table 1: 2017 forecast summary

Total Return	
Bonds	4-5%
Loans	3-4%
Issuance	
Bonds	$200bn
Loans	$245bn
Default Rates	
US HY (issuer)	4.0-4.5%
US HY (par)	2.0-2.5%
Ex-Energy (issuer)	2.9%
Ex-Energy (par)	1.7%
Loans (issuer)	2.0%
Loans (par)	1.8%

Source: BofA Merrill Lynch Global Research

Refer to important disclosures on page 28 to 30.
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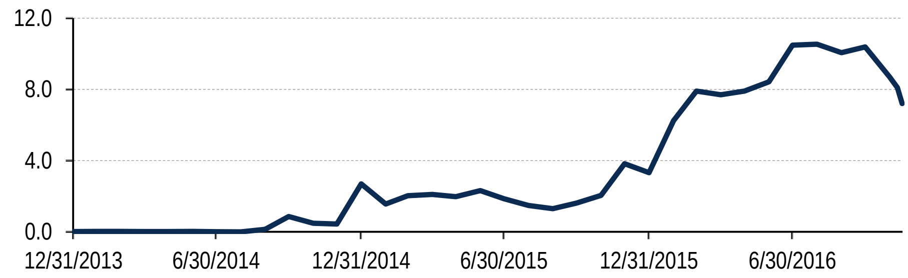
The road to success is paved with obstacles

In 2015 we wondered if high yield had jumped the shark. In 2016 we told investors that like Jennifer Lawrence's character in The Hunger Games, they would need both luck (higher oil prices, better technicals) and skill (superior credit picking) to successfully navigate what we believed would be a volatile and challenging market. In 2017 we believe the road to success will be paved with obstacles and we advise investors to not try and be a hero and chase alpha, but rather avoid the blowups and try and control what they can: picking quality credits. Quite frankly, until we know more about the policies of Donald Trump – whether they be related to the divisive, protectionist campaigner or the more pragmatic, inclusive centrist he indicates he could be – we are not ready to deem 2017 the year that neither defines the end of the credit or business cycle nor bolsters the case for a significant rise in prosperity. Instead, we brace for year 2 of a rolling blackout and focus on likely paths and outcomes across broad themes that include rates, the USD, flow of capital, and of course, fundamentals.

Although at this time we are unconvinced that the market can deliver returns anywhere close to 2016, we think 2017 does have the potential to be a year that surprises to the upside. Unfortunately, we can just as easily envision a year that ends in disappointment. After probability weighting several scenarios (more on this in our total return section) our initial forecast calls for a 4-5% total return for bonds and 3-4% for loans. Consider that over the last 30 years high yield has had a total return of less than 4.5% forty one percent of the time (12 years); removing the year of and immediately after a recession and that figure jumps to fifty percent. Similarly, fifty percent of the time (again excluding the year of and after a recession) the market has returned between 7.4% and 20.5%. Though on the surface this data would suggest the market either does really well or really poorly, we also observe that 39% of the time[1] high yield returns between 2.2% and 4.5%; a high frequency occurrence within a tight range, and consistent with our view at this time.

Our reasons for not being more optimistic rest on our views for an increase in the dollar, higher rates, heightened volatility, idiosyncratic sector risks, uncertainty around commodity prices, political risk and positive technicals that begin to turn in the other direction. In particular, we think 2017 could mark the end of the global QE trade and the perpetual central bank put. In fact, the unwind of negative yielding assets over the last several weeks and months has been remarkable, as we have now retraced all the spring's and summer's increase. What was $10.55tn on July 31st at the height of the "search for yield" frenzy has now become $7.21tn. Meanwhile, positive yielding assets have increased by a corresponding $3tn, implying that fixed income investors now have $3tn of options available to them that were not there just months ago. Given nearly $4tn of European debt is negative yielding, and our view that the stock in Europe is likely to decrease throughout the year, even if JGBs remain at their current levels, we envision a much less friendly technical picture in 2017 than 2016.

Chart 1: The stock of negative yielding assets is falling sharply (values in $tn)



Source: BofA Merrill Lynch Global Research

[1] when not in the year following or of a recession

We balance such concerns, however, with expectations of revenue growth that picks up, a default rate that is significantly below 2016 (4.0-4.5% issuer basis, 2.0-2.5% par relative to 6.8% issuer and 5.5% par in 2016), the possibility of a relatively dovish Fed despite signs of increased growth, and open capital markets. Additionally, though we think one of the biggest stories of 2017 could be the reversal of foreign inflows into US credit markets; high yield does have a distinct advantage over other spread products. With a higher spread and rate cushion to absorb increasing treasury yields, the asset class is uniquely positioned to weather higher rates.

Impact of potential Trump policies

Contract to America

Of course no 2017 Year Ahead can ignore the impact President-elect Donald Trump will have on the economy and markets. Since November 8th there has been a great deal of speculation about what his priorities could be upon taking office and how those priorities might affect various aspects of the markets. As we consider the same, we think a good place to start is by reviewing what he promised his electorate and the limitations he may have in delivering on some of those promises. Although we don't aim to try and interpret Mr. Trump's exact views on a particular policy vs campaign rhetoric, we will at the end discuss our realistic views of what the President-elect is likely to get done. However, we stick to his script to start; accepting what his campaign promised as his vision for America, and take the opportunity to review what we think are the relevant aspects of his "Contract to America" for high yield.

Protection of American workers

Central to Trump's vision for America has been a more protectionist stance on global trade. By appealing to the rust belt, the President-elect has outlined several initiatives for his first 100 days: Taken as is, we view the impact to high yield corporates as likely negative, as highlighted below.

Renegotiate NAFTA

Although this would likely be good for some US-focused companies, the overall impact on the economy and some specific high yield sectors is likely to be a net negative in our view. The reduced trade deficit would likely be more than offset by a decline in output and consumption, we think. Additionally, Canadian companies, which comprise 8% of our H0A0 index, as well as the agriculture, automobiles, and service sectors would be negatively impacted. For example, Mexico is the top export destination for US grown beef, rice, corn sweeteners, apples, and beans, and most cars made in North America have parts sourced from Mexico and Canada.

Label China as a currency manipulator

Labeling China as a currency manipulator on day 1, as Trump has mentioned he would do, as well as imposing as much as 45% tariffs on Chinese imports (he has suggested 5% and 10% tariffs as well), would have meaningful repercussions for the market in our view. In particular, the CNY would have to appreciate off the declaration and we believe a trade war could possibly ensue. Although China imports much less from the United States than the US imports from China, China also controls key parts of the supply chain for very important US companies (for example, Apple), and serves as a large consumer of many products produced by large US corporates. In fact, early last week the Chinese government said in the "Global Times" newspaper that should Trump impose a 45% tariff, "A batch of Boeing orders will be replaced by Airbus. US auto and iPhone sales in China will suffer a setback, and US soybean and maize imports will be halted."

The impact to every day consumers could also be stark as goods sold in places like Walmart would become much more expensive under Trump's trade policies given many goods sold at Walmart are made outside the US. The impact on consumption would be negative, we think, hindering economic growth, while corporate margins in sectors ranging from tech to consumer products would likely fall markedly. Taken at its face value the rhetoric and actions associated with Mr. Trump's plans in this area could be negative for various sectors throughout high yield as well as the US economy.

Lift restrictions on production of $50tn worth of energy reserves

Although negative for environmentalists and clean energy, on net energy independence would likely be a positive for the economy and a benefit to consumers. For high yield, we're not quite certain the benefit is so obvious, however. Production would likely increase significantly, keeping oil prices low and weeding out the weakest and most levered high yield producers. Autos and transportation, meanwhile, would likely benefit from persistently low fuel costs and industrials which utilize raw materials in production would also benefit.

Broader legislative measures

Middle Class Tax Relief and Simplification Act

Higher discretionary income would likely help consumption and investment, thereby helping domestically oriented service companies. However, an increase in the fiscal deficit (note, this will likely be difficult given current Congressional views) would likely cause much higher treasury yields, which would detract from growth and high yield returns.

Repeal Affordable Care Act

Mr. Trump has already backed away from some of his changes to the Affordable Care Act (ACA), but should he move forward, high yield hospital paper would continue to realize stress. At a broader level, those same constituents hurt by trade tariffs are likely to be hurt by repeal, while the middle class is likely to be helped. At a broad economic level, a repeal would probably be net neutral, but discrete sectors would be negatively impacted, we think.

In all, should President-elect Trump follow through on his 100-day plan verbatim, we think the downside would outweigh the upside. On the one hand, although tax cuts, marginal infrastructure spending and lower energy costs would flow back through the economy and lead to higher consumption, a trade war with China, higher consumer prices and fewer people with health insurance would be a net negative, we think. Additionally, as treasury yields increase in the face of a ballooning budget deficit, spread products would likely be impacted. If Trump follows through 100% with his 100 day plan, we would expect Autos, Technology, and Healthcare to underperform.

What is likely to get done

As mentioned above, though we are not in the business of interpreting Donald Trump's exact views and actions, given what we know about the makeup of Congress and his other promises to his electorate, we feel we can postulate on what we think is likely and unlikely in his first 100 days.

First, we do not expect President-elect Trump to increase infrastructure spending significantly. In fact, it was rarely a focal point of his campaign. Additionally, given that Congress has many "deficit hawks" that were willing to allow the US to default on its obligations, even if some Democrats are willing to work with Trump, we believe that infrastructure spending is likely to be kept in check; in our view that is not necessarily bad given the unwanted effects on treasury yields that a major growth spurt could incite (we discuss this in our total return scenarios below). Additionally, it is difficult to see the benefit of starting a trade war, particularly if Mr Trump is looking out for lower-income Middle America. We think a more likely outcome would be to label China as a currency manipulator, which would likely cause markets to initially fall and the CNY to appreciate. However, we would also expect him to employ a give-and-take approach with China where solutions are found that are mutually beneficial to both countries and not overly harmful to consumers. And although tax breaks are likely to occur and will be helpful to consumption, a repeal of the ACA is very unlikely in 2017 in our view; insurers have commitments to 20mn Americans and a re-write of the ACA would likely take a significant amount of time. During the process, however, we would expect hospitals to continue to underperform.

As we consider Trump's proposals and balance those that seem doable with those that seem less likely in his first 6 months to a year, we are left with a variety of house views that both lead to headwinds and tailwinds for high yield. As mentioned above, we see the biggest headwinds for high yield as a reversal of the search for yield argument (Trump affects this at the margins), a higher dollar, higher rates, and an increase in volatility while tailwinds include improved fundamentals, a lower default rate, and a decent spread cushion.

Headwinds

Unfortunately, as this goes to print, the stage is not entirely set for 2017. With 6 weeks to go, there is still a lot that can happen in the market. Take for example the 100bp backup between November 17th 2015 and year end or the 70bp backup during the same time in 2014 (which was a 120bp increase until a rally over the last 2 weeks of the year). Even in the last 15 trading days yields have increased nearly 80bp; and with the November 30th OPEC meeting looming, we would expect another December swoon should production cuts not materialize. Our commodity strategists feel confident that a cut is likely, however, as Saudi's budget woes likely incentivize it to push a deal. This leaves four main challenges ahead for the market, and one very large wildcard.

Dollar increase

First and foremost, we expect the dollar to continue to rally in 2017, hurting earnings and margins for a large swath of high yield. Back in April 2015 we wrote in The HY Wire: The FX effect, that a surprisingly large proportion of HY revenues come from abroad and investors should expect lower revenue growth because of a strengthening dollar. Although less so the case today, the same principles hold. Luckily, unlike in 2014 when the dollar appreciated nearly 25% vs. the Euro, our FX strategist is calling for a much more modest 6% appreciation next year. This will minimize the impact to EBITDA, but no doubt still have an effect. Chart 2 to the side shows the relationship between year-over-year changes in the dollar versus year-over-year changes in quarterly EBITDA growth (ex-Energy). The chart clearly suggests that US high yield is very sensitive to FX moves. Table 2, meanwhile, highlights that the 5 sectors with the highest amount of foreign sales exposure (41% on average) account for 30% of all HY revenue; and although Energy produces very little in non-domestic sales, a stronger dollar will affect oil prices, thereby impacting another large portion of the market significantly.

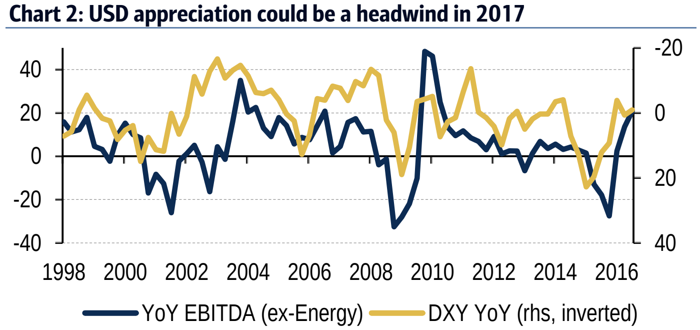
Given the strengthening dollar, a fall in earnings growth and a pickup in treasury yields, we're concerned that unless sales growth accelerates meaningfully in 2017, ex-Commodity fundamentals may disappoint relative to 2016. And although we were becoming emboldened by what appeared to be stronger revenue growth in Q3, as more companies report we are finding that unfortunately our optimism may have been misplaced; sales growth for Q3 now stands at just 3.7% whereas 11 days ago it was 8%.

Table 2: US Domiciled High Yield companies reporting foreign sales

Sector	Weight in index	Total sales	Foreign sales	Pct foreign sales	Pct of total sales
Technology	6%	83,347	46,937	56%	6%
Materials	11%	134,209	52,553	39%	10%
Automotive	2%	35,289	13,319	38%	3%
Com Services	4%	93,334	32,981	35%	7%
Transportation	1%	70,707	24,475	35%	5%
Capital Goods	3%	55,570	17,634	32%	4%
Cons Products	1%	15,678	4,930	31%	1%
Utilities	3%	35,346	10,494	30%	3%
Gaming	3%	26,002	5,398	21%	2%
Retail	3%	134,613	26,797	20%	10%
Telecom	10%	14,274	2,508	18%	1%
Financials	8%	187,464	30,804	16%	14%
Hotels & Leisure	2%	36,384	5,896	16%	3%
Media	11%	80,880	12,823	16%	6%
Energy	15%	86,896	8,518	10%	6%
Food	3%	64,514	5,253	8%	5%
Health Care	9%	148,748	9,819	7%	11%
Real Estate	5%	68,269	1,035	2%	5%
Total	100%	1,371,523	312,175	23%	100%

Source: Bof AMerrill Lynch Global Research, Bloomberg

Chart 2: USD appreciation could be a headwind in 2017

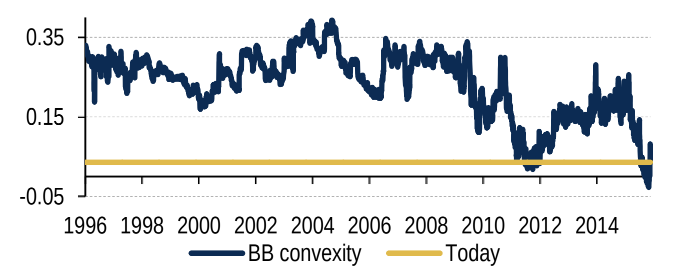


Source: BofA Merrill Lynch Global Research, Bloomberg

Rates Increase

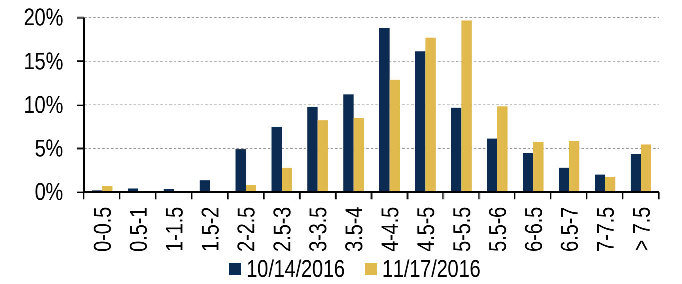
With a stronger dollar we also expect higher rates next year, and our strategists agree. In addition to forecasting that the 5y will increase to 2.25% from today's 1.68%, they also believe we'll see higher real rates and bear flattening in 5s10s of about 10bp. The curve move is something we'll be watching with interest, as for every 10bp flattening in 5s10s the market tends to lose 0.3% of total return over the course of a year. With double B convexity near all-time lows (Chart 3) and BB yields showing great sensitivity to rates (Chart 4: as rates increased the last month the entire yield distribution for double Bs shifted right), we think this creates an environment where even small moves in treasuries would have a big impact.

Chart 3: BB convexity is near all-time lows



Source: BofA Merrill Lynch Global Research

Chart 4: In the last month the yield distribution for BBs shifted right



Source: BofA Merrill Lynch Global Research

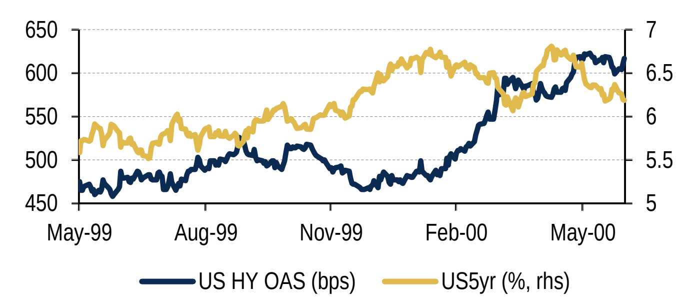
Another example of rate sensitivity can be seen when looking at September of this year: Rates declined 3bp during the month but also included a period in the middle of the month when the 5y increased 12bp. Total returns for nearly all paper with 7+ years until maturity had a negative total return- meaning that despite lower rates from start to finish, the market couldn't shake the mid-month selloff in govies (Table 3). The move since November 4th has been even starker (though also includes a period where Healthcare has been under pressure). Double B paper greater than 7 years is off nearly 2 points in 2 weeks as the entire market has fallen 0.6 points. Similarly, from June 1999 to June 2000, a period when GDP averaged above 5% and the 5y increased about 70bp, high yield's total return was -0.97% as defaults and rate risk brought down performance (Chart 5).

Table 3: Longer dated HY couldn't recover from the Sep rate increase

	Years to Maturity									
	<2	2..	3..	4..	5..	6..	7..	8..	9..	10+
BB1	0.1	0.0	0.0	0.1	0.0	-0.1	-0.2	-0.4	-1.1	0.0
BB2	0.2	0.3	0.5	0.4	0.4	0.6	0.0	0.1	-0.2	0.4
BB3	-0.5	0.3	0.3	0.0	0.3	0.0	-0.2	-0.2	-0.5	-1.1
B1	0.2	0.4	0.5	0.5	0.1	0.2	-0.4	-0.5	-0.5	-0.6
B2	0.0	0.6	0.4	0.1	0.2	0.1	1.1	-0.2		
B3	0.3	0.2	0.9	0.8	1.3	1.0	0.5	0.3		5.7
CCC1	1.1	1.4	1.2	1.0	0.8	-0.2	0.4			
CCC2	1.3	2.3	2.6	1.7	2.9	0.2				
CCC3		1.2	1.1	1.2						
CC/C	5.0	-1.9	0.0	3.3						

Source: BofA Merrill Lynch Global Research

Chart 5: HY spreads can widen into higher rates

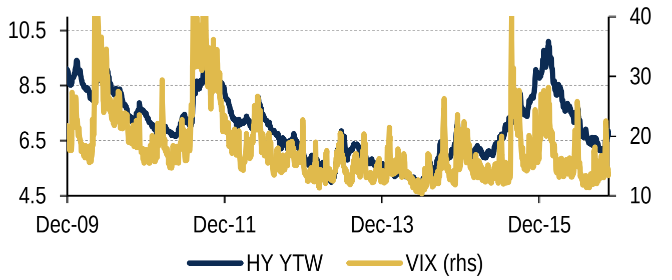


Source: BofA Merrill Lynch Global Research, Bloomberg

Volatility up

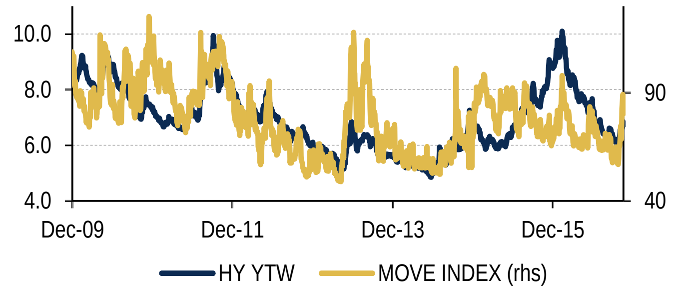
We also think one of the key certainties next year is for higher uncertainty: expressed through an increase in volatility. While the economic outcomes of a Trump presidency remain unclear, given his polarizing nature and campaign platform of disrupting the status quo, we think Donald Trump's presidency is likely to yield consistent spikes in equity vol. Additionally, with Central Banks indicating an aversion to quantitative easing and negative interest rate policy, we think the Fed, ECB and BOJ will likely cause rate volatility to increase throughout the year. Both of these measures of uncertainty could spell trouble for high yield, we think. Credit investors want the certainty of earning coupon and payment of principal, and any measure that may indicate less confidence in such an outcome typically causes yields to increase. See Chart 6 and Chart 7 below that show as volatility increases - both equity vol as well as rates vol - high yield yields tend to increase in concert.

Chart 6: HY YTW vs equity vol (VIX)



Source: BofA Merrill Lynch Global Research, Bloomberg

Chart 7: HY YTW vs rate vol (MOVE)



Source: BofA Merrill Lynch Global Research

Technicals

Perhaps our biggest concern for the longer term outlook for US high yield is a shift in central bank policy; made worse due to the fact that such a move is unlikely to be a result of strong macro fundamentals, but rather because of the acknowledgment that negative interest rate policy is causing harm to the financial sector. Take for example, US pension funds where funding ratios are at just 75 percent, issues for insurance company asset/liability management, and revenue difficulties for the European banking industry (year-over-year revenue declines of 4%). And if much of the argument for spread products has been 1) foreign inflows creating a positive supply/demand technical on the back of $10.5tn in negative yielding assets and 2) a lack of concern of rate risk because of ever-accommodative central banks, a pullback from such a stance could have enormous consequences not only for longer duration paper, but the market as a whole.

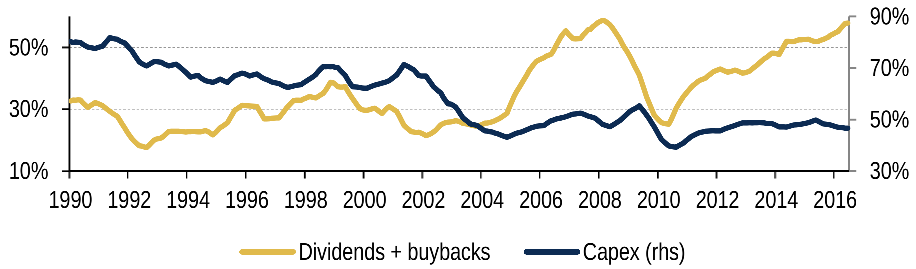
Furthermore, our conversations with foreign investors and Core plus accounts would indicate that they have become reluctant buyers of double B paper and would be willing to pull out in a volatile environment and move money back to their mandate (IG, JGBs, etc.). As noted above, as we watch $10.5tn in negative yielding assets globally fall to $7.2tn, we are concerned that the trend has already begun, limiting the "where are you going to find yield" argument and incentivizing investors to buy IG corporates, Treasuries and foreign fixed income over high quality high yield.

Wildcard: Growth and Political Risk

The single biggest risk to high yield in 2017 is not rates, the dollar or even a reversal in technicals; though all would be harmful to various extents. The biggest risk, in our view, is how potential protectionist policies of Donald Trump could affect business confidence and consumer spending so negatively that growth is inhibited and corporates look to reduce employees to increase margins and justify high equity multiples. Our economists have brought down their GDP forecast in light of the new President by 50bp in Q1 and Q2 to 1.8% and left their full year forecast for 2017 at 1.9%. Although the markets have taken to a positive growth story, our Economics team's view is that trade uncertainty and a reduction in business confidence outweigh the positives of tax reform, repatriation of corporate cash and limited infrastructure spending in the first half before yielding a positive growth story in the back half.

We think until we know more, their base case seems reasonable to us for Q1 and Q2, though we believe that a slump could continue into Q3 and Q4 as well. One of the more common positive views we have heard about Trump's policies is that a tax holiday for cash held overseas would be a boon to corporate investment. Although it may be, history would suggest otherwise. In 2004, for example, the last time corporate cash was repatriated, companies used the money to reward shareholders through stock buybacks and dividends. Given corporate America's propensity to engage in such shareholder friendly activity over the last several years, coupled with their lack of capex investment (Chart 8), we see no reason why we should expect CEOs and CFOs to suddenly decide to spend on investments or buying back bonds, and alternatively fully expect a significant return of capital to equity investors.

Chart 8: S&P spending on dividends and buybacks is near 30yr highs while capex has plummeted



Source: FactSet

Should Trump's Presidency result in social unrest, akin to what we have seen in Chicago, Boston, Los Angeles, Philadelphia and New York, we think business confidence could further suffer, potentially creating a paralysis among C-suites. Though this is not our base case, we think political risk and the potential for policy mistakes to hinder growth are higher than the market is pricing in today.

Alternatively, if Trump is able to usher in a period of significant growth, we again question the benefits to high yield. With significant GDP growth we would expect inflation to increase rapidly and likely cause the Central Bank to become more aggressive. Should 3% 10y yields or greater materialize under such a scenario, we wonder if underlying revenue growth would be able to make up for an increase in debt costs. Although high yield would likely do well under such a scenario at first, we would be wary as we enter 2018 and be concerned over a 1999-2000 repeat.

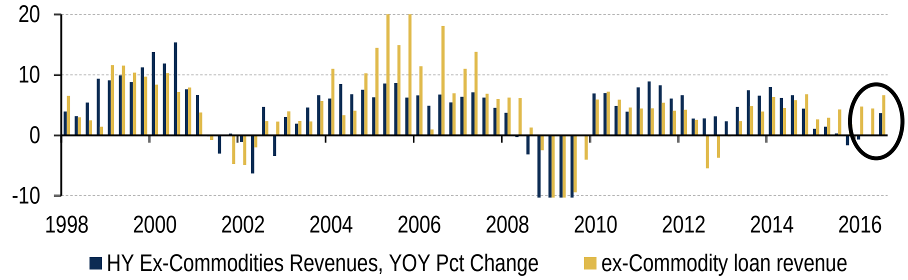
Tailwinds

Although there are major headwinds to the market in 2017, many of which we expect regardless of Donald Trump's policies, there are also several tailwinds. Perhaps chief among them is the willingness for the Federal Reserve to remain cautious, at least to start the year, given what they believe is remaining slack in the labor force. Additionally, should OPEC reach a deal on November 30th as our commodity strategist's expect, we can remove one major headwind to the market for next year. Furthermore, given the rates shock since the election and Healthcare's recent woes, there is a distinct possibility that yields continue to rise into December 31st, leaving room for compression next year even in the face of challenges. And finally, we have seen that although the ECB appears to be shying away from QE, the BOJ is certainly keeping the pedal to the metal for now after announcing unlimited buying of JGBs to keep its commitment to maintaining the 10y at 0%. The willingness to keep JGBs low will likely continue to have a positive effect on the demand for yield from Asian investors, even if the biggest beneficiary is likely high grade, not high yield.

Revenue Growth

In addition to the tailwinds mentioned above, we are optimistic, though admittedly less so than just a few days ago, about the trajectory of revenue growth. Although one quarter does not set a trend, Q3 sales growth for both bonds and loans seems to be the best since late 2014 (Chart 9). More importantly, however, we are optimistic that should President-elect Trump be able to enact tax reform next year, personal spending could increase and help consumer oriented companies and sectors with primarily domestic revenues, particularly in the back half of the year. As we mentioned earlier, although our economists reduced their GDP forecast for Q1 and Q2, they become more optimistic as the year wanes and approaches 2018. And although Healthcare firms may take a hit under a potential repeal of portions of the ACA, and the dollar will affect revenue and EBITDA, we think the overall market will benefit from a low revenue base in 2015 and most of 2016. Coupled with an expectation for lower issuance, we hope to see leverage fall as well, even as the dollar strength hurts.

Chart 9: Q3 revenue growth was the best since late 2014 (ex-Commodities)

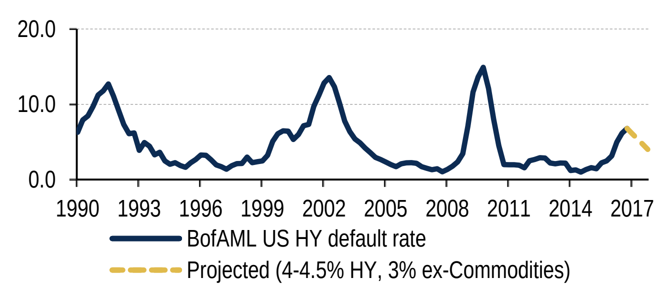


Source: BofA Merrill Lynch Global Research

Default Rate

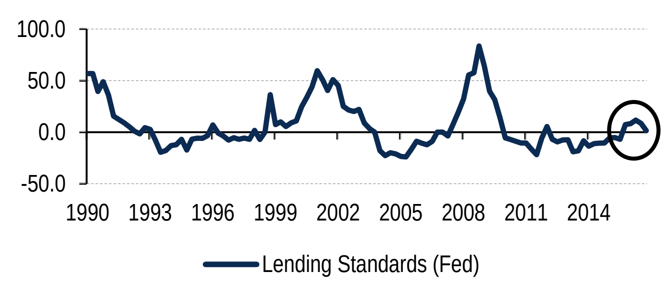
Although we'll spend more time on our expectations for the default rate in the coming sections, we believe that a reduction in the headline default rate for high yield will give some investors comfort with the asset class. After projecting a 6.5% issuer rate (4-5% par) for 2016 the market is currently running at a 6.8% (5.5% par) - nearly spot on with our expectations. And next year we think this falls to 4.0-4.5% on an issuer basis (2.0-2.5% par) as fewer Energy companies file, creating a feel good sentiment about fundamentals if growth is okay. And though there is no doubt that financial conditions have tightened in the face of a big rise in LIBOR and rates, the latest Senior Loan Officer's Survey report shows a decline in the number of banks reporting a tightening of lending standards. Our expectation is that banks will wait to tighten standards again as market volatility and higher yields do the job for them, though do think we could see further loosening if growth accelerates and "risk-on" becomes a theme for next year.

Chart 10: Issuer default rate projected to decline to 4.0 -4.5% next year



Source: BofA Merrill Lynch Global Research

Chart 11: Decline in default rate mostly due to easier lending standards



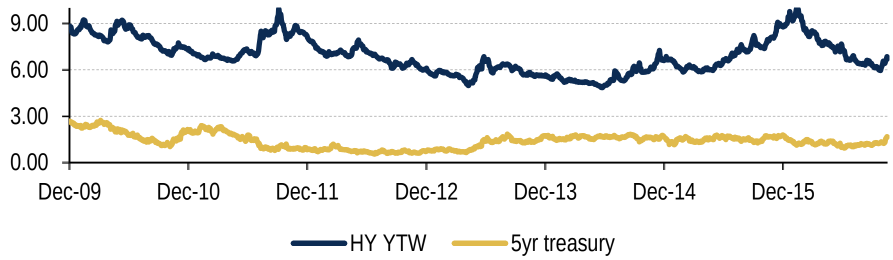
Source: NY Federal Reserve

Spread Cushion

In the face of potentially improving fundamentals and a lower default rate, we also believe that the downside for high yield is fairly limited - even in a higher rate environment - given the spread and yield cushion it enjoys. As we mentioned above, we view rates as a concern for the market in 2017 when considering our total return forecast, but at the same time we could see tighter spreads even in the face of a move in treasuries.

Chart 9 below highlights the yield differential of US high yield versus the 5y treasury; clearly showing that the current gap of 500bp has room to compress should fundamentals remain accommodative. And although double Bs are unlikely to escape pain should treasury yields increase, we think single Bs and CCCs could perform okay. In fact, over time the beta between single B spreads and 5y rates has been -1.44 while for triple C spreads it has been -2.06 .This contrasts with triple B and single A betas to the 10y of -0.42 and -0.25 respectively. Should rates increase as we expect, high yield single B and triple C paper, with their more negative spread betas, would be insulated better than their higher quality peers.

Chart 12: HY spreads have additional room to compress should fundamentals remain accommodative



Source: BofA Merrill Lynch Global Research, Bloomberg

Wildcard: Dovish Fed despite good growth

Just like in our headwind section, the market next year also has a wildcard factor that could take returns far above our estimate. The most likely of which includes a scenario where central banks continue with negative interest rate policy and the Fed remains dovish despite a US growth story that begins to emerge as not too hot, but not too cold. The prospects for this seem remote in our view, but may not be so hard to imagine. In all likelihood, as we mentioned above, Donald Trump will not able to get everything he wants through Congress in year 1. Tax cuts most likely won't come into effect until late next year, infrastructure spending expectations, as we mentioned before, will probably be tempered, and parts of Obamacare are likely to remain. During this time Obama's America likely has further to run, while the expectations for a higher growth environment create excitement and a desire to add risk.

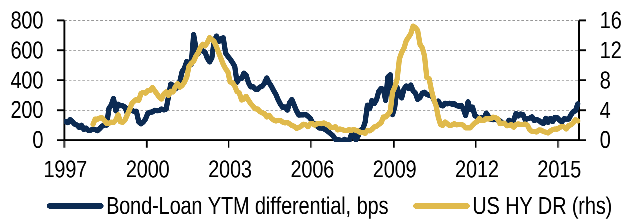
In some ways, a Trump presidency may be the best thing in this scenario as it may put the Fed in a guarded position. For example, it is entirely possible to hear a lot about being tough on trade and immigration without a follow through on policy; just enough uncertainty to keep the Fed cautious but not enough to stifle growth. Additionally, even if repatriation does nothing to increase capex spending, the return of wealth to shareholders could drive stock valuations higher and help high yield realize a tailwind.

Returns

Last year we called for loans to modestly underperform non-commodity bonds, but outperform on a risk-adjusted basis. In 2017, we expect a similar relationship, once again calling for loans to modestly underperform bonds, but on a risk-adjusted basis, prefer loans over bonds at the moment. With our expectation for rates to increase, duration risk would be more consequential for spread products than credit risk, impacting fixed rate products more than floating. Loans are well placed to be insulated to duration risk given a heavy majority of them will be floating next year (our year end LIBOR forecast is 105bp while the average floor on the LCD index is 98bp). There is a chance that existing issuers try to avoid floating by switching from the 3m LIBOR benchmark to the 2m rate given the historically wide 3m1m spread, but we have previously dispelled the longevity of that trade. Meanwhile, outside of a few troubled sectors we don't think there are enough catalysts to drive credit and default risk higher for loans. Barring a recessionary environment, we think credit risk is going to be relatively benign given the secured nature of the asset class and expectations of easing default pressures, especially in comparison to bonds. Therefore on balance, tailwinds for Loans marginally outweigh headwinds at this point we think, and Loans should be able to partially offset the expected 45bp increase in LIBOR next year and compress to ~450bp spread levels. Bonds meanwhile are likely to tighten only modestly into rising treasury yields, as the expected 40bp increase in the 5y won't be offset by 1:1 spread tightening (we expect 15bp of tightening).

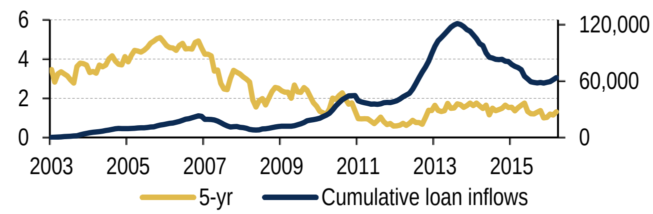
Bonds generally outperform loans in risk on years, and underperform them in risk off years; which is why the bond over loan yield differential peaks during times of crises and comes back in coming out of a default cycle as growth slowly takes hold (Chart 13). Most of our past relative value calls have centered on labeling the year ahead of us- will it be one where risk premium increases or one where it decreases? Next year is not one of those years, i.e. there are so many unknowns in the wake of the election, OPEC, dollar and the economy that it is somewhat of a fruitless exercise to make that determination with conviction at this point. What we do know is that there are headwinds and tailwinds affecting both asset classes to various degrees. Both are likely to see increasing yields, partial spread compression and a drag on fundamentals from the dollar and volatility.

Chart 13: Bonds generally outperform in risk on years and underperform in a selloff



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

Chart 14: Cumulative retail flows into loan funds

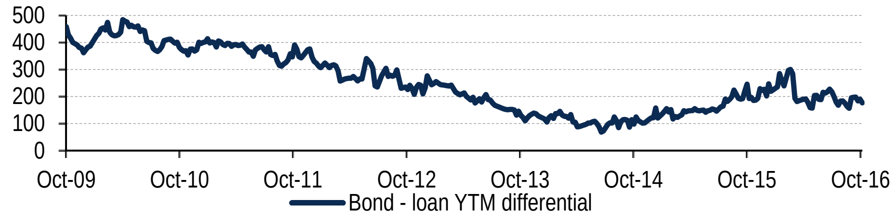


Source: Lipper, EPFR Global

However, loans also have the potential benefit of higher demand from loan mutual funds relative to bond mutual funds given their floating rate nature and our expectation of a soaring LIBOR (projected to reach 150bps by end of 2017). Historically, an increasing rates backdrop (or the expectation of it) has coincided with retail money flocking to loan mutual funds. This makes intuitive sense because in periods of increasing rates, when duration risk is hurting spread products, loans offer some of the only places in fixed income to get yield without the threat of rate-induced price losses. Additionally, we think that CLOs will continue to be a stable buyer in the loan market; a luxury that bonds don't enjoy.

On an outright basis, we are expecting to see bonds to return 4-5% and loans to return 3-4%. On a risk adjusted basis, however we think loans will outperform bonds as the total return differential doesn't justify the incremental risk in bonds. In terms of relative yield, we think both bonds and loans will back up ~25bps next year on the back of the increase in 5y rates and LIBOR. This implies that the bond over loan yield differential - which is 200bps today (Chart 15) - is expected to stay flat to slightly lower next year.

Chart 15: Bond – loan YTM differential expected to stay flat next year



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

Bonds: 4-5%

As mentioned above, with so many uncertainties in 2017, we take a little bit of a different approach to our total return forecast for bonds this year. Last year the most important thing to get right was the Energy call. This year, however, assuming OPEC cuts on November 30th, we think the biggest variables are whether the search for yield

Bank of America Merrill Lynch

story will continue and what a Trump presidency will mean for growth, inflation, currencies and rates. With so many different potential outcomes, we lay out 5 scenarios from best case to worst case, and probability weight each to determine a return. Perhaps unsurprisingly, our probability weighted return yields a very similar outcome as that calculated using the Bank of America Merrill Lynch house view on growth, currencies and the dollar: 4-5%.

Scenario 1: 15% chance, 9% total return

Our best case scenario for 2017 is one where central banks remain very accommodative, likely maintaining the current stock of negative yielding debt at about $7tn. The Fed, meanwhile, would maintain a cautious stance as it considers the impact of President Donald Trump's policies, and continues to indicate that it is willing to let the economy "run hot" for a period of time. Growth under this scenario would be neither too hot nor too cold, running at about 2-3% while 5y treasuries would likely find it difficult to breach 1.85% as low foreign yields keep US bonds depressed. Additionally, in an ideal world, crude would increase to $50-60/bbl, the issuer default rate is near our forecast of 4.0-4.5% (2.0-2.5% par), earnings and revenue growth are at least consistent with what we have seen so far in Q3 (mid-single digits) and capital markets are wide open. Even under this best case scenario, we find it hard to construct a total return of more than 9% as defaults would still erode 1-2pts of performance; and after such a strong 2016 in double B paper, most of the performance would have to come from single Bs and triple Cs. However, triple Cs can't carry all of the performance at just 12% weight, so most of the heavy lifting on returns would therefore need to come from single Bs.

Scenario 2: 25% chance, 6.5% total return

In our second scenario, we maintain everything we mentioned in scenario 1, only central banks indicate a reluctance to maintain negative interest rate policy indefinitely. We have already seen a $3.5tn reduction in negative yielding assets and should the ECB meaningfully pull away from NIRP later in the year, we believe the stock could fall by another $3tn. Such a move would likely have a major impact on double B paper and longer duration single Bs while lower quality and shorter duration paper would perform well. In this scenario, we see a year that earns investors coupon.

Scenario 3: 40% chance, 4.5% total return: Our base case

We think the most likely scenario resides with our house calls. Under this scenario, President-elect Trump creates a volatile first half where growth actually suffers before reversing course in the second half. Despite not being the growth the market necessarily expects, the anticipation keeps 5y rates moving higher next year towards 2.25% but the Fed only hikes once because of perceived slack in the labor force and GDP that at least in Q1 and Q2 is still sub 2.0%. Like in scenario 2, the ECB begins to pull the reins in on NIRP, causing the stock of negative yielding assets to fall to about $4tn, reversing some of the reach for yield play the market saw so strongly in 2016. Meanwhile, the issuer default rate meets our target of 4-4.5% (par 2.0-2.5%), issuance declines modestly, and spreads only offset about 15bp of the 40bp 5y increase, causing yields to increase. Earnings, hurt by dollar strength, would revert lower than Q3 2016, but revenue growth would remain in the low single digits. Under such a scenario, we estimate high yield likely returns a sub-coupon, but not bad 4.5%.

Scenario 4: 10% chance, 4.5% total return

Although scenario 4 has the same total return as scenario 3, the path to realizing it is quite a bit different. In this case, we would expect a replay of 1999-2000, only not as bad of a default scenario. Growth takes off and accelerates towards 4%, the Fed becomes aggressive in its hiking, the 5y increases towards 2.5% but the negative impact from an increase in rates is partially offset by improved earnings. Additionally, idiosyncratic sectors and names would succumb to unsustainable debt loads in a higher rate environment, causing an issuer default rate that likely surpasses our 4.0-4.5%

issuer rate. Though the year isn't a bad one for high yield, it underperforms what might otherwise be expected given strong growth.

Scenario 5: 10% chance, -2%

Scenario 5 is our catch-all for all that could go really poorly for the market: A recession, a major slowdown in China that negatively impacts markets or another collapse in oil prices, for example. We would bucket in this scenario the potential for a severe policy misstep by Donald Trump or the Fed, a European banking or sovereign crisis, or a very negative shock to earnings or employment. Clearly most of these scenarios would bring concerns of a recession, if not spark a recession themselves, and so we put a small 10% chance on a negative total return year akin to 2015.

Taking all 5 of these scenarios and probability-weighting the returns suggests a total return for next year of 5%. With our most likely scenario yielding a 4.5% return, we think a range between 4% and 5% seems a reasonable starting place entering the year. Recall in our introduction, nearly 50% of the time in a non-recessionary year the market returns between 2.2% to 4.5%, further bolstering our confidence that 4.0%-5.0% seems as good a forecast as any. In Table 4, we highlight the math that brings us to our 4% return: a 2.5% par default rate, 40% recovery, a 40bp increase in the 5y and 15bp of spread tightening.

Table 4: HY likely to return 4-5% next year

	HY	5yr Trsy
Current Spread (bp)	485	185
Target (bp)	470	225
Predicted Change (bp)	-15	40
Spread Duration	4.0	
Tsy Change (bp)	40	
Total Change in Yield (bp)	25	
Capital Gain (bp)	-100	
Current Yield (bp)	667	
Default Rate (%)	2.5	
Index Price	97.7	
Default Issuer Price	70	
Credit Loss (bp)	107	
Total Return (next 12 mo, %)	4.60	

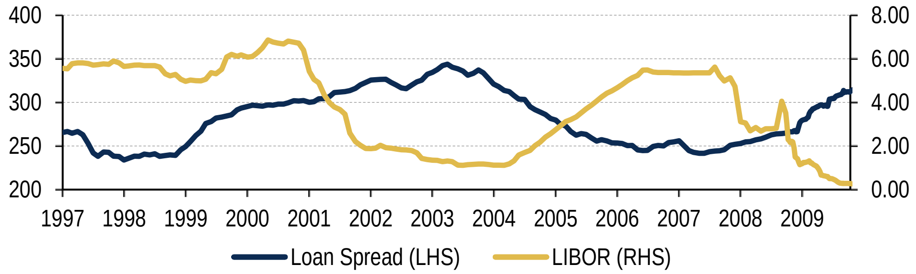
Source: BofA Merrill Lynch Global Research

Loans: 3-4%

LIBOR is expected to go up nearly 45bp next year as our rates strategists believe. We think Loan spreads should be able to partially compress into this rate increase, and history offers ample evidence to support this outcome. Looking back at the interaction of LIBOR and loan coupons shows a clear inverse relationship between them (Chart 16). We only show the period prior to 2010 because post crises loans are structurally incomparable to the floating loans we expect next year. In non-recessionary conditions, issuers are able to counter the increase in their base rate by issuing lower coupons. Having said that, next year we think it will be difficult to offset all of the increase and as a consequence we will likely get an overall yield backup.

The best period to draw analogies to is between 2004 and 2006 –LIBOR systematically increased by a total of 430bp while loan coupons decreased by 65bp, having an almost one-to-one effect on spreads. During this period, loan yields backed up almost 350bp and total returns were +13.5% (5.5% annualized) even as prices hovered around par, while loan mutual funds garnered a cumulative inflow of $20bn. We think next year will mark the beginning of a similar environment- where loans float with rising LIBOR, yields back up as spreads compress and generate positive total returns in the context of retail inflows. Granted we don't expect LIBOR to increase nearly as much as it did between 2004 and 2006; nevertheless, the concept remains relevant with only the scale being different this time around.

Chart 16: Loan coupons are inversely proportional to LIBOR



Source: S&P LCD, Bloomberg

While the case for being in loans is strong, we do think headwinds will keep loan spread compression in check. We have already discussed our expectations for higher volatility next year, which is net negative for spreads. Additionally, the two largest loan sectors (Technology and Healthcare) are exposed to idiosyncratic risks Take the Healthcare industry, for example, currently under the threat of the Affordable Care Act being repealed under a republican controlled congress and White House. Although the sector has backed up 16bps in terms of spread and 52bps in yield since elections, there is a real risk of Healthcare being the next sector in our "rolling blackout scenario" to roll over in the wake of hospital and drug reforms; the latter being very much on the table despite Clinton's loss. Technology on the other hand is experiencing uncertainty given the potential for protectionist policies under Trump. If nationalism becomes a priority for the White House next year, and trade friction leads to trade wars, we think Technology is likely to be impacted the most given that it has the highest exposure to foreign sales amongst US corporate sectors. Finally, if rates and the dollar continue to climb next year like our strategists expect, there is likely to be a meaningful drag on revenues. Consider 2015, where the 25% strengthening of USD/EUR caused a revenue drag of 3% on HY revenues in 2015. We are forecasting the USD to appreciate another 6% against the Euro in 1H17, which should kick-start the second leg of revenue loss due to currency for US companies, though to a lesser extent vs 2015.

Putting all of this together, we have developed the following total return forecast for loan returns in 2017. Similar to last year, and like our bond forecast above, total returns are an aggregation of 3 main components: capital gains, current income and credit losses. The two biggest changes from last year are: 1) we assume a key rate duration of 0 given that loans will be floating next year, and 2) we assume a drag on returns from repricing activity which we think will increase in 2017 as higher quality loans break and stay above par, giving issuers an opportunity to reprice to lower yields. Using our expectation of a 1.8% par default rate for loans, and a current income of 410bps we estimate a total return of 3%-4% for 2017 as detailed in table 5 to the right.

Table 5: Loans likely to return 3-4% next year

	Loans	LIBOR
Current (bp)	470	105
Target (bp)	450	150
Predicted Change (bp)	-20	45
Rate Duration	0.0	
Spread Duration	2.5	
Avg Par Coupon (bp)	396	
LIBOR/Tsy Change (bp)	45	
Total Change in Yield (bp)	25	
Repricings (bp)	-35	
Capital Gain (bp)	15	
Current Yield (bp)	407	
Default Rate (mkt val wtd) (%)	1.8	
Index Price	97.2	
Distressed Issuer Price	80	
Credit Loss (bp)	34	
Total Return (next 12 mo, %)	3.89	

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

Risks to outlook

The biggest tail risk to loan returns is around growth and volatility. If GDP surprises to the downside next year in the wake of Republican policies falling short of delivering an economic turn-around, or worse, a looming recession, loan spreads are likely to widen even if LIBOR increases. This would be similar to the LIBOR back up in 1999-2000 (the aforementioned poor period for bonds as well) when an increase in LIBOR of 170bps was accompanied by loan spreads increasing 20bps. This scenario would also be one where defaults edge higher than anticipated, thus dragging total returns down on both accounts.

While not our base case, if OPEC fails to reach a deal this month, we think it would be the final nail in the coffin for the cartel. In a scenario where there are no production caps on OPEC countries, and the US is beginning to increase its output, we can envision WTI plunging back to early 2016 levels, exposing Energy issuers to heavy price losses once again. Having said that, Energy does not comprise a significant proportion of the loan index (4%) and the downside risk in oil will matter lesser to loans than bonds.

Another appreciable risk is unfavorable technicals. Should expectations of LIBOR's increase become muted, demand could suffer. And should raising money for some of the ailing levered companies become punitive in the bond market, they could tap secured funding at lower price points, pushing loan issuance higher and putting pressure on loan spreads. On the flip side, should CLO issuance exceed our analysts' expectations of $60bn that would help fan returns to a certain extent.

Default forecast

HY issuer: 4.5%, par: 2.5%. Loan issuer: 2%, par: 1.8%

Default pressures within the US are set to ease in 2017 largely because of a large reduction in Energy defaults. During 2015 and the first half of this year, a collapse in oil prices and a tightening of lending standards helped to contribute to default rates increasing to the highest level since 2009. Given commodity companies were the biggest HY capex generators in the first half of this credit cycle, their early fortunes had a trickle-down positive effect on other companies' top lines. However, when they struggled to remain afloat and were forced to cut capex (amongst other things), this had an impact on the bottom lines of other closely associated sectors, such as Capital Goods and Commercial Services, making their access to capital tougher as well.

Now, after four straight quarters of tightening, the Q3 2016 Senior Loan Officer Opinion Survey (SLOOS, done over the three months ending Oct 2016), showed that lending standards to corporations have remained roughly unchanged. Furthermore, credit quality standards have also improved over the second half of this year owing to the steadily declining number of downgrades. Finally, the core real rate has gone sideways even as nominal rates have picked up. From the context of issuer liquidity and access to financing, inflation needs to be discounted from nominal rates because it increases the ability of companies to pay back their debt (the higher the inflation, the lesser valuable today's $100 would be vs. what it was 5 years ago when the company borrowed it).

Table 6: Default forecasts

	All	Energy	ex-Energy
Total issuers	1059	158	901
Defaulted issuers	43	21	22
2017 HY default rate (issuer)	*4.5%*	*13.3%*	*2.9%*
LTM default rate (through Oct, issuer)	*6.8%*	*26.0%*	*3.5%*
Total par	1,133,209	180,273	952,936
Defaulted par	28,716	12,985	15,732
2017 HY default rate (par)	*2.5%*	*7.2%*	*1.7%*
LTM default rate (through Oct, par)	*5.5%*	*22.4%*	*2.2%*
2017 Loan default rate (issuer)	2.0%		
LTM default rate (through Oct, issuer)	2.7%		
2017 Loan default rate (par)	1.8%		
LTM default rate (through Oct, par)	2.5%		

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

As we mentioned earlier in the piece, we expect the issuer default rate next year to ease to about 4.0-4.5% from the current 6.8% levels and 2.0-2.5% from 5.5% on a par basis. As Table 6 shows, we expect most of the decrease in defaults to be a direct result of fewer Energy defaults, where we think rates will decrease to 13% and 7% on an issuer and par basis respectively. Ex-energy default rates will also likely experience a modest decline, in line with the overall improving macro backdrop.

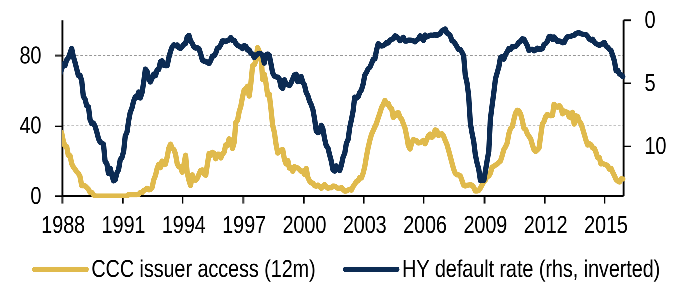
However, the path to lower default rates will not be linear in our opinion. Our model, which is a leading indicator of defaults by roughly one year, suggests the trailing 12 month issuer weighted default rate will peak in Q1 at around the 6% mark and ease to 4.5% by the end of 2017. This is not to say that defaults will increase going forward, but rather that 1Q 2017 likely stands to have more default events compared to 1Q 2016. So, on a rolling 12-month basis we lose the benefit of the lower 1Q 2016 rates as we move forward into the first quarter of next year. From then on however we think that both default events and the LTM default rate will decline, reflecting the improved collective macro and micro backdrops that existed in the back half of 2016.

For Loans, we expect issuer weighted default rates to end 2017 near 2%, 70bps below today's levels. Loan defaults also depend on lending standards and Loan migration rates. And just like for bonds, loan migration rates have also been on an upswing since 2015 and that is contributing to expectations of lower defaults next year. Granted loans are set to end 2017 with a lower default rate than today, but not before reaching peak LTM default rates in Q1 of next year of around 3% (Chart 21). On a par-weighted basis, we think loan defaults will end 2017 even lower, closer to 1.8%, i.e. the same differential to issuer weighted default rates as exists today.

About the forecasting model

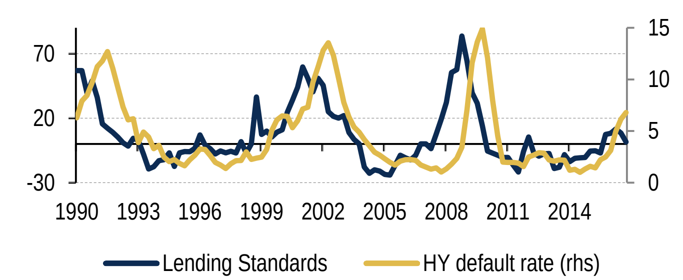
We use three main criteria to forecast HY default rates: the Senior Loan Officer Opinion Survey (SLOOS), credit migration rates, and real rates in the economy. When combined, these three inputs have an 85% correlation over the next 12 month trailing default rate at any given point in time. This makes sense because looser lending conditions, a higher proportion of upgrades, and lower real rates all make it easier for an issuer to secure funding and hence maintain balance sheet liquidity. For Loans we use a two factor model - rates don't have a meaningful impact on the asset class, especially since they are floating in nature. We have explained the relevance of all three model inputs to the expected default rate in detail in our previous year ahead, and we use the same criteria to forecast the top down expected default rate for 2017 as well.

Chart 17: CCC issuance rate highly correlated with default rate



Source: BofA Merrill Lynch Global Research

Chart 18: SLOOS is the best predictor of HY default rates

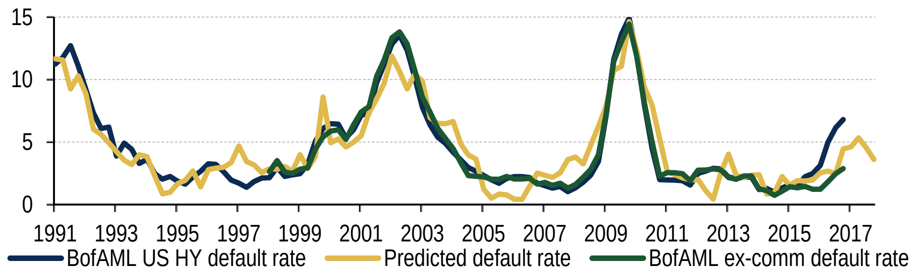


Source: BofA Merrill Lynch Global Research, Federal Reserve

Our HY model is most sensitive to the lending standards as reported by senior loan officers on a quarterly basis- a measure that has declined from a relative high of 11.6% in April of this year to 1.5% today (Chart 18). The survey reflects the ability of medium sized enterprises (annual sales greater than $50mn) to get funding from regional banks. Since HY issuers fit this criterion, this survey is also well correlated with their ability to tap the bank lending market. Another way to assess issuer access to funding is by tracking the proportion of risky companies that have been able to tap the HY capital markets on a trailing 12-month basis. While this too has a high predictive power of defaults (Chart 17), it doesn't add enough incremental explanatory power to justify adding an additional variable. Further, the lead time of the risky issuance model is less consistent than the lending survey. Hence we choose to rely on SLOOS for the purpose of our model. Just like for bonds, SLOOS is a good indicator of the level of default rates for loans a year later. However, in the case of loans, the default rates are more sensitive to the asset class's migration rates than the lending survey, quite the opposite of bonds.

Another interesting point to note about the SLOOS report is that it does a much better job of estimating defaults when they are being driven by a systemic factor, such as a turn in business cycle or an all-encompassing macro event. On the other hand, it undershoots when defaults are driven by idiosyncratic events in individual sectors such as what we witnessed in the 2015 commodity bust. Our forecasted default rate for 2015 thus happened to be lower than the realized headline default rate but higher than the ex-commodity rate (Chart 19). In thinking about next year, we see Energy companies having a decreasing but still positive impact on headline HY default rates. As a result, we have made a qualitative adjustment upward to our model-forecasted default rate (3.6%).

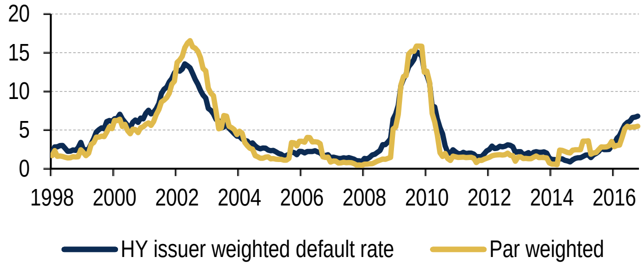
Chart 19: Model forecast closer to the ex-commodity default rate



Source: BofA Merrill Lynch Global Research, Federal Reserve

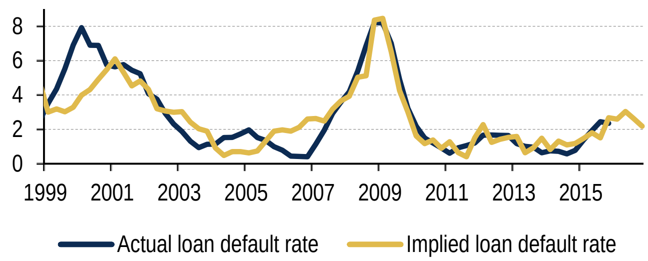
We also reconcile our top-down HY view with a bottom-up one by looking at all potential candidates for restructuring within the asset class and separating those likely to default next year. This assessment also points us in the 4% LTM default rate range by the end of 2017 on an issuer weighted basis. On a par-weighted basis, we think the default rate will be less, closer to 2.5% since a large share of defaults next year are expected to come in the form of restructurings such as exchanges, rather than chapter 11 filings. Since distressed exchanges involve a reduced defaulted par-amount compared to bankruptcies, which throws the entire capital structure into default, we think the gap between issuer and par weighted default rates will be higher vs. 2016. This is also in agreement with our view that next year is not likely to mark the end of the business cycle and it is typically only in recessionary scenarios where par weighted default rate exceeds the issuer weighted one (Chart 20). As a result, the gap between the issuer and par increases the further we are from a downturn as issuers are able to negotiate restructurings with creditors.

Chart 20: Issuer default rate has been less than par weighted



Source: BofA Merrill Lynch Global Research

Chart 21: Our model suggests a 2.2% default rate for loans next year



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

Recovery rates to trend higher

Due to mean reverting default rates, we think 2017 will be a year where recovery rates will also trend higher. Our recovery model generates an expected recovery rate depending on future expectations of par default rates and debt-to-asset ratios. As we have established above, HY par default rates are set to decrease to a 2.5% level. Additionally we think that the debt to asset ratio will also come in somewhat as issuers mend their balance sheets in the context of higher revenues and lower debt placement (we expect net negative issuance amongst HY issuers in 2017). Plugging in early 2015 levels for the debt-to-asset ratio, we get an expected recovery rate of ~$40 for next year for senior unsecured debt.

New issue forecast

Bond issuance to decrease 5-8% to $200bn

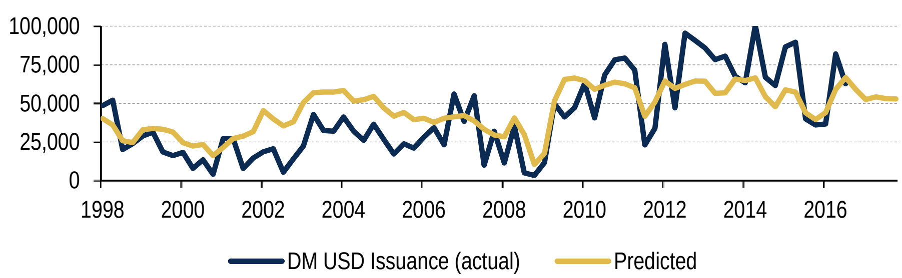
With $200.7bn in issuance year-to-date and roughly $13bn in the pipeline between now and year-end, we estimate high yield primary activity in 2016 will fall roughly 16% from 2015's level. We expect almost the entire decline to come from a steep drop in acquisition related issuance, which fell from $80.85bn in 2015 to just $41.5bn this year. On the other hand, refis were roughly equal to 2015's levels with $122bn in both years. Next year however, we expect the opposite trend to take hold against a backdrop of increased borrowing costs that limits the ability to opportunistically refinance existing debt.

When forecasting issuance in past years, we have mostly relied on a subjective estimates based on a reference period similar to today's environment. While this has worked well in most cases (our 2016 bond issuance forecast should be within 5% of the actual value at year-end), we decided to introduce a quantitative model in order to provide a more objective analysis that can be substantiated through historical analysis. Our analysis, described in detail below, produces a 2017 issuance forecast of $212.7bn which represents a 0.6% decline compared to this year. However, due to fiscal uncertainty and the potential for a corporate tax cut which would increase the after-tax cost of debt, we lower this value to $200bn for a 6.5% year over year decline in gross high yield issuance next year.

About our high yield issuance forecasting analysis

In order to estimate aggregate supply in 2017, we chose to group quarterly issuance in buckets by 3 broad uses of proceeds—refis, acquisitions, and others (LBOs, GCP, capex)—and develop a unique forecasting method for each individual group. We then sum these forecasts to derive our collective 2017 issuance volume estimate. As shown in Chart 22, our analysis shows a 0.78 correlation with historical realized values since 1998. Notably, our forecasting method tended to overestimate actual supply in the pre-crisis years and underestimate post-crisis volume. In our opinion, this is indicative of the influence quantitative easing has played on market technicals by fueling ultra-low cost of debt. In addition to potential tax cuts, this gives us a second reason to take a $13bn haircut to our model-generated issuance value: as the ECB and Japan begin to recognize the unintended consequences of QE and gradually reduce global stimulus next year, we think issuance could be pushed lower than what our analysis suggests.

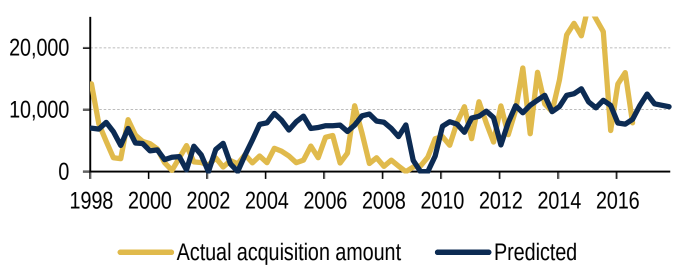
Chart 22: Our forecasting analysis a strong indicator for quarterly HY issuance



Source: BofA Merrill Lynch Global Research

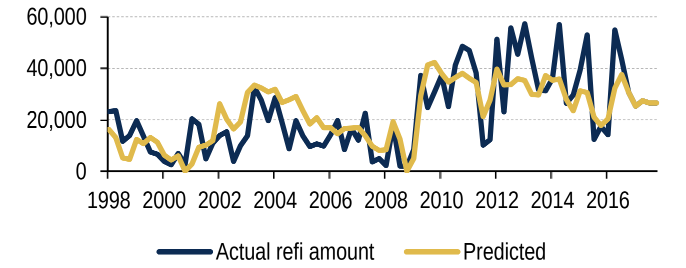
When estimating refi issuance, we look at the trailing 6 month percentage change in HY YTW, the trailing 3m migration rate, and the Federal funds rate at the beginning of the period (Chart 23). All 3 inputs serve as proxies for determining the relative change in borrowing costs across our universe. For example, if a greater proportion of issuers are upgraded versus downgraded, the marginal cost of borrowing will gap lower because of the higher credit rating; those issuers will be then incentivized to refinance existing debt in order to increase net profit margins. In order to forecast supply for acquisition related purposes, we consider lending standards based on the Senior Loan Officer Opinion Survey and the HY YTW as it stood at the beginning of the quarter. These two factors help to determine the general willingness of banks to lend and the relative cost of borrowing, and show a strong correlation with realized refi amounts (Chart 24). Finally, we group together all remaining issuance categories including LBOs, GCP, and capex and estimate future volumes using a trailing 6 month percentage change in HY YTW. While this is a relatively simplistic methodology, historically these uses of proceeds make up a small proportion of overall issuance and therefore have little impact on our aggregate analysis.

Chart 23: Actual acquisition issuance vs forecasted (HY)



Source: BofA Merrill Lynch Global Research

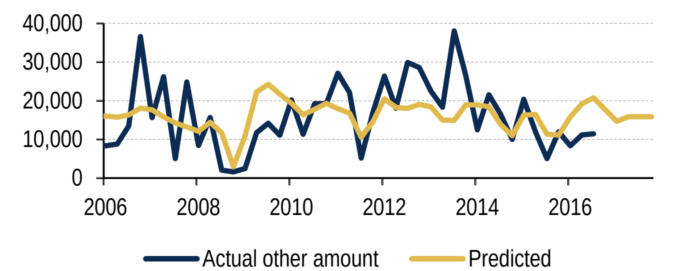
Chart 24: Actual refi issuance vs forecasted (HY)



Source: BofA Merrill Lynch Global Research

Using our base case year-end input values of 2.25% for the 5yr, 7.29% YTW, and 0.75%/1% Federal Funds rate, we estimate a 3% decline in acquisition-related issuance next year, a 16% decline in refis, and a 20% increase in 'other' issuance (Table 7). Should HY performance exceed our expectations next year and return our best-case scenario 9% (implied HY YTW of 6.20%), we think next year's issuance would increase to $220bn. On the other hand, if our pessimistic total return forecast of -2% holds (implied HY YTW of 8.9%), our analysis suggests we would see $175bn in issuance next year.

Chart 25: Actual 'other' issuance vs forecasted (HY)



Source: BofA Merrill Lynch Global Research

Table 7: Bond issuance to fall by 5 to 8% in 2017

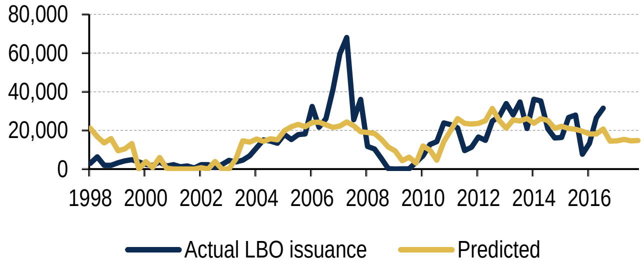
Use of proceeds	2016 YE forecast	2017 YE forecast	Pct change
Refi	126,630	105,785	-16%
Acquisition	45,978	44,668	-3%
Other	41,329	49,547	20%
Total	213,937	200,000	-7%

Source: BofA Merrill Lynch Global Research

Loan issuance to decrease 10-12% to $245bn

We use a similar methodology to forecast loan issuance next year; the major difference being that we chose to break out LBO supply as a separate bucket because it makes up a greater proportion of total issuance. In order to forecast LBO volumes in 2017, we considered the trailing 12-month return of the S&P 500, its backwards-looking P/E ratio 12 months prior to the beginning of each quarter, and lending standards from the Senior Loan Officer Opinion Survey, This methodology works well for most historical periods, although it significantly underestimated supply during the LBO boom of 2007 (Chart 26). While not ideal, this is acceptable for forecasting issuance next year given our expectation that we will not see a similar LBO boom.

Chart 26: Actual LBO issuance vs forecasted (loans)



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

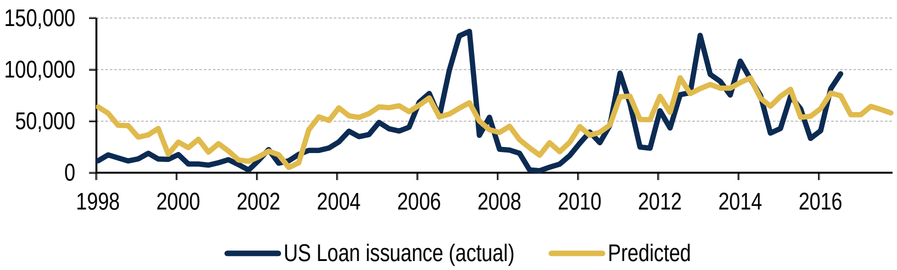
Table 8: Loan issuance to fall 10 to 12% in 2017

Use of proceeds	2016 YE forecast	2017 YE forecast	Pct change
Refi	89,207	71,730	-20%
Acquisition	86,421	85,312	-1%
LBO	61,547	59,297	-4%
Other	44,849	28,661	-36%
Total	282,024	245,000	-12%

Source: BofA Merrill Lynch Global Research

After combining the results of the four separate uses of proceeds estimates, we derive an aggregate loan issuance forecast of $245bn in 2017 – a 12% decline from this year's $282bn (Chart 27). Although we expect loan supply to decline by a greater percentage relative to bonds next year, in terms of absolute dollar amounts we think the former will continue to outpace by roughly $45bn. This is mostly due to the fact that loan issuance in 2016 has been the 3rd best on record in the post-GFC world, and we find it difficult to imagine this pace continuing in the face of a rising risk-free environment.

Chart 27: US Loan issuance projected to decline to $245bn in 2017



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

Positioning: shorter duration, US focused, organic growth

A look in the rearview mirror

Although we were one of the most bearish strategy houses on the street from September 2014 through June 2016, we have also recognized that real money investors need to stay invested and hedge funds can't short high yield indefinitely. As such, we have always tried to identify pockets of value as they appear. In November 2013, we moved Energy, Retail, and Materials to underweight, while advocating for an overweight in Healthcare, Autos, and Technology. In late 2014 we highlighted the relative strength of the consumer, and swapped Technology companies with Hotels and Leisure and Commercial and Consumer Services, while maintaining our underweights from the prior year. In our year-ahead report last year we said clients should buy those names that sold off the most and barbell the risk-on strategy with long duration double Bs and if possible, triple Bs. On January 25th, during the worst of the selloff, we recommended clients begin to "nibble" on fallen angels, those firms who generate their revenue domestically, and don't rely on M&A for growth. In the summer, we recognized the worst was behind us within Energy and became cautiously overweight the sector, preferring to invest within E&Ps and Midstream instead of Servicers, which are typically a second derivative of oil prices. Shortly thereafter we took advantage of the post-Brexit selloff to move from our cautious stance, recommended taking off our duration trade and instead suggested migrating positioning to the belly of the risk spectrum: single Bs. And finally, on October 3rd, we highlighted that we thought the year's tightening was now behind us and that 4 catalysts had appeared until year end: most prominently, rate risk and the beginning of the unwind of years of the QE trade.

In addition to our sector recommendations, we recently highlighted our preference for companies that have not engaged in debt financed M&A given that they tend to have worse EBITDA growth, margin changes, and spread performance over the next 3 years. And when combined with our concern for an increase in borrowing costs, we think there could be significant knock on effects for companies that have engaged in a growth through acquisition strategy. Finally, for the last several months we have cautioned against reaching out the curve in order to increase yield due to underappreciated risks of rising interest rates and all-time low BB convexity.

Modestly defensive into 2017

Below we revisit our sector positioning for next year, which is based on a combination of quantitative measures, macro views, and input from our fundamental analysts. Across all sectors we continue to prefer shorter duration single-B credits, as well as names that generate a significant portion of revenue from within the United States and those that have not engaged in a significant amount of M&A. We also recommend cautiously layering in some higher beta names that are in decent shape in an effort to recapture additional yield. Our positioning below constructs a portfolio that marginally under-yields the index, preserves cash, and heeds our Commodity and Rates strategists' calls for higher oil and treasuries in 2017. With a yield give up of about 10bps, we would expect the portfolio below to see mid-single digit returns for next year. And with a nearly 3% weighting in cash, we have built a buffer for redemption risk should rates or geopolitical shocks prompt greater than expected outflows next year. Notably, we shifted our view on Health Care from overweight to underweight given a continued buildup in leverage, as well as the potential for significant reforms in the near term which could exacerbate stress within health care operators and pharmaceutical companies.

Table 9: 2017 sector positioning

Sector	Weighting	OAS	Spread per turn	YoY Rev	Pct foreign revenue	Acquisition pct	Ranking in model
Energy	OW	581	104	-13%	10%	22%	5
Gaming	OW	392	73	7%	21%	0%	10
Telecommunications	OW	534	131	10%	18%	38%	6
Capital Goods	MW	496	123	-6%	32%	26%	13
Commercial Services	MW	543	79	1%	35%	28%	17
Consumer Products	MW	419	116	-3%	31%	27%	16
Financials	MW	441		0%	16%	15%	14
Materials	MW	439	110	0%	39%	35%	18
Media	MW	488	149	7%	16%	27%	1
Retail	MW	577	111	0%	20%	27%	7
Transportation	MW	762	267	-10%	35%	24%	4
Automotive	UW	355	162	3%	38%	18%	11
Food	UW	430	102	1%	8%	25%	9
Healthcare	UW	573	129	4%	7%	37%	2
Hotels & Leisure	UW	360	75	3%	16%	21%	12
Real Estate	UW	357	128	13%	2%	17%	3
Technology	UW	446	184	10%	56%	28%	8
Utilities	UW	543	83	-3%	30%	35%	15

Source: BofA Merrill Lynch Global Research, Bloomberg

Overweight

Energy

We remain overweight Energy on the expectation that OPEC will orchestrate a production cut this month. Years of underinvestment in the sector has led to decline rates that have brought the supply-demand roughly in balance. Technicals remain strong as the sector still remains underweighted by investors. Additionally, equity markets are rewarding issuers that are delevering and keeping within their cashflows, which is healthy from a fundamental perspective. However, increasing US rates and a stronger dollar generally are headwinds for global oil demand, especially in EM countries. Additionally US supply could increase if the Trump administration decides to allow drilling on federal lands. And most importantly, OPEC's internal cartel politics could get in the way of a production cut this month despite its obvious economic appeal. Should the cut not be delivered, it would amount to voiding our sector view completely given the significant downside risks involved.

Therefore we approach our overweight with caution- overweight E&Ps, and midstream, coupled with underweight Services and downstream. We like E&Ps in the context of $45-and-above oil, and since our house call is for oil to average $59 next year, we think these companies could have more room to run. We think some midstream names have more room to tighten and perhaps move to IG. We don't like services given our uncertain view on how much oil can increase next year, and thus are willing to give up some attractive yield plays in the offshore drilling sector to protect our downside. We are also underweight refining given weak crack spreads, room to increase capacity, and headwinds from energy credits.

Telecommunications

Although we are slightly less constructive on Telecommunication fundamentals compared to some of our other overweight sectors, with a yield 44bps above the index and relatively small default risk, we think it is an ideal candidate to add yield to our portfolio next year. Contrary to our general dislike of M&A, we recognize the merits within Telecom because of the significant economies of scale and need to increase market share in an oligopolistic industry. In fact we think that even if intra-industry consolidation is blocked due to antitrust laws, interest from cable companies to acquire telecom plays will likely remain strong next year, potentially providing upside. We also think organic sales growth will remain healthy next year relative to other sectors because of the small amount of revenue that is generated from foreign sources. Additionally, datacenters, just like midstream energy, are IG candidates and have more room to tighten in our view.

Gaming

We like this sector due to the potential for activity to pick up in regional gaming subsector which is exposed to roughly the same electorate which stands to benefit from the economic benefits of a Trump presidency. Additionally the Vegas convention business could get a boost from corporate activity growth under the new political regime. While we recognize that the sector already trades over 100bps tight to the index, we are in it for some of the higher yield plays which according to our fundamental analysts have low default risks. Finally, we view the sector as also somewhat of a defensive play. Due to hard assets and significant tax exemptions, Gaming tends to be a less volatile consumer cyclical industry that we believe will only perform poorly in the event of a harsh downturn. And with modest deleveraging and flattish issuance expected, one would expect Gaming to outperform next year. This sector is the lightest of our overweights.

Cash

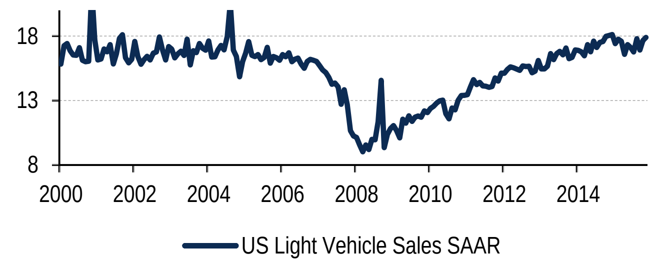
Although we expect Treasuries to underperform in 2017, we think next year will see heightened volatility as global rates increase and the Fed continues its hiking cycle. This will likely cause short bursts of high demand for investor redemptions, which we would prefer to fund via cash on our balance sheet instead of forced selling during a period of reduced liquidity. In our opinion, prudent cash management will be crucial for outperformance next year; we have therefore elected to hold about 3% of our portfolio in cash and its equivalents.

Underweight

Automotive

Though SAAR remains strong (Chart 28), we believe this is already baked into the sector's tight valuation. At the same time, we think tail risk scenarios from protectionist trade policies have the potential to take Autos wider next year, while the low yield will likely mean the sector underperforms should the market trade sideways. Additionally, because the sector generates 38% of its revenue growth from outside the US, further dollar appreciation should have a significant impact on earnings. While we think Autos would outperform under a market selloff, this is not our base case for next year and we think greater value can be found in sectors that trade wider to the index.

Chart 28: SAAR remains strong, though has likely plateaued



Source: Bloomberg

Technology

There is a great deal of uncertainty around Technology names next year and how they will respond to Trump's potential trade and fiscal policies. Because the sector generates 56% of its revenue from outside the US (the most of any industry), it stands to lose in any potential trade war. Partially netting this out is the potential for a second Homeland Repatriation Act which would allow these companies to bring back cash held overseas, which they could use to invest in capex or pay down existing debt. However most of this cash is held by IG Tech companies and may not be enough to move the needle in HY. On balance, we prefer to remain underweight the sector until we attain more clarity around trade and tax policies.

Healthcare

This industry faces a lot of uncertainty under the new Trump administration. The Republican clean sweep means it will likely become incrementally easier for Congress to repeal or replace the Affordable Care Act which has been a major driver of returns for hospitals. Additionally, some of the largest names in the sector are default candidates in the near term. If capital markets remain open they may be able to kick the can down the road by issuing secured paper, but the worsening industry fundamentals leave us uncomfortable with the sector despite its relatively wide valuations today.

Hotels & Leisure

Hotels & Leisure ranks poorly on a quantitative basis given its paltry 5.26% yield and sub 4% revenue growth in each of the last 4 quarters. And with the hotel cycle rolling over and a dim outlook of just 0 to 2% revpar growth in 2017, we see little opportunity for spreads to compress further. Although the sector will likely outperform in the event of a major downturn as they did in 2015 (+5.17% vs -4.64% index), we don't envision another negative return for high yield next year.

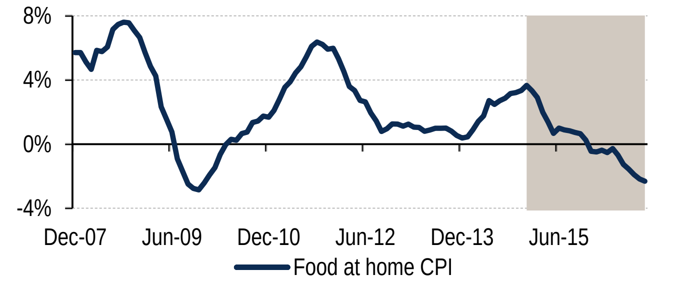
Utilities

Being unregulated, the single biggest driver of HY Utilities' performance is natural gas prices. Utility companies do well in extreme weather conditions – a hot summer and a cold winter—both of which cause natural gas prices to spike and provide issuers an opportunity to lock in prices for ~3 years through forward contracts. The last time we saw extreme weather conditions was the polar vortex of 2013, which means most attractive hedges will roll off into 2017, exposing these companies to NatGas price fluctuations. With a warm winter so far and dwindling hopes of NatGas price recovery, we can expect to see Utility companies struggle to grow earnings in the face of reduced power demand as household energy efficiency increases. Additionally, given Utilities' increased sensitivity to interest rates, we think a leg higher in treasuries would cause the sector to suffer disproportionately.

Food

In our opinion, Food revenues will continue to be down next year due to persistent oversupply of meat and dairy in the market. This has caused disinflationary/deflationary pressures, which have sequentially worsened throughout this year and are expected to continue through the first half of 2017 (Chart 29). We may start to see price stabilization in the back half, although there remains a great deal of uncertainty around longer term damaging effects to corporate balance sheets. It also doesn't help that the sector trades 64bps tight to the index and would likely outperform only in a severe downturn, which is not our base case.

Chart 29: Food prices have been on a persistent decline since 2015

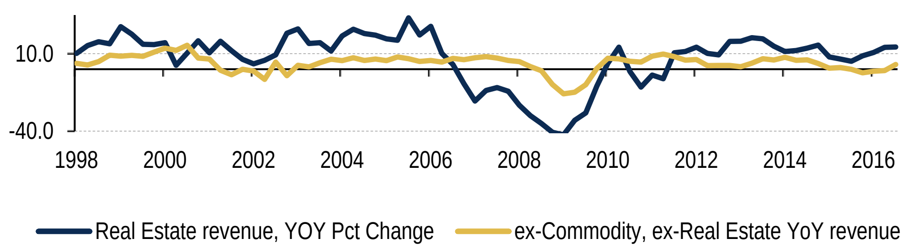


Source: Bloomberg

Real Estate

We don't like the real estate sector because of its tight valuations and headwinds from rates which will increase mortgage costs next year affecting the pace of home building. As such our outlook on residential construction is slowing down considerably to 2.2% from 4% this year. We thus believe the sector, which already yields 140bp less than the index, has more downside risk than upside from a potential acceleration in GDP growth.

Chart 30: Real Estate revenues have been stronger than the rest of the market since 2011



Source: BofA Merrill Lynch Global Research

Marketweight

Financials

Although investment grade Financials have significantly outperformed over the last several weeks on higher rates and the potential for regulatory reform, we think these factors will have a reduced impact on HY Specialty Finance. For instance, consumer finance companies that lend to lower quality subprime consumers at a rate significantly above prime, stand to get hurt as demand dwindles with higher rates. Additionally, we think a number of payday companies could restructure next year given their unsustainable capital structures and near term debt maturities. Case in point, Moody's recently downgraded 7 separate issuers due to heightened risks of a distressed exchange. Large cap structures have a stable outlook but already trade in the 3-4% context. However, the mortgage servicers do stand to directly benefit from higher rates but they constitute a very small proportion of the sector. Finally, any potential deregulation under the Trump administration would benefit most of the sector.

Materials

The Materials sector is made up mostly of Metals/Mining names (54%), though also consists of Packaging (21%), Chemicals (20%), and Forestry/Paper (5%). Although the outlook for base metals has increased overnight with the Trump presidency given the campaign's focus on deregulating coal etc, we think a lot of the upside to coal and steel names has already been priced in. On the flip side, we think Copper and Aluminum names have more room to run given decent fundamentals. Specific to Chemicals, there is a significant amount of operating leverage and the industry is very GDP sensitive, so we think they would outperform next year only in an environment where fiscal stimulus provides a bigger than expected boost to GDP. Paper continues its secular decline while packaging is relatively more defensive.

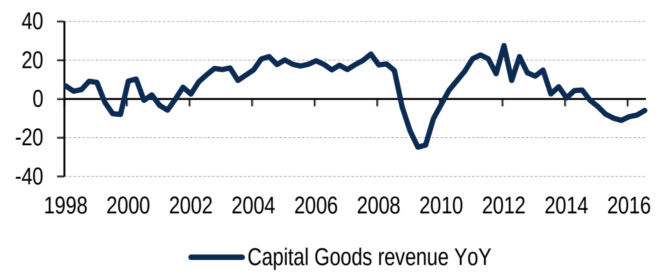
Commercial Services

Based on our quantitative measures, Commercial Services ranks 14th out of 18. With just 75bps spread per turn of leverage (5th worst), we feel we are not being adequately compensated for the credit risk. Additionally, 28% of all issuance proceeds have been used for M&A purposes since 2014, which is the 5th worst of any sector. However, the sector also has tailwinds in the form of a turn-around of business sentiment should it happen with tax and regulatory reforms.

Capital Goods

Due to a large proportion of revenue generation outside the United States (32%) and 8 consecutive quarters of negative revenue growth, Capital Goods ranks as the third worst sector based on our quantitative measures. And because it is one of the most cyclical industries, in our opinion Capital Goods could underperform significantly in the event of a slowdown next year. While this is neither ours nor our economists' base case, the probability is not insignificant. At the same time however, Trump's Energy policies that would provide a boon to E&P capital expenditures would likely help turn revenue growth positive next year. If OPEC does not cut on November 30th, though, we will likely change our position along with Energy.

Chart 31: Capital Goods rev has been on a consistent decline since 2012



Source: BofA Merrill Lynch Global Research

Retail

The Retail sector has been a space we have shied away from for the last several years. Although it offers a higher yield and has relatively little non-US sales (20%), we view the secular decline in the industry as reason enough to abstain from overweight positioning. And while the sector needs to be restructured over the longer term to account for the demise of brick-and-mortar stores and make way for ecommerce, in our opinion companies have sufficient liquidity and have taken positive steps towards reducing their debt burdens to help them in the near to medium term.

Media

TV broadcasting has been and continues to be a poster child for a growth through acquisition strategy, a formula we have proven to be generally detrimental to fundamental and credit performance over a 3 year span. Additionally, in our opinion most companies will find it difficult to show year over year growth given that this was an election year and very conducive to advertising. We prefer to be invested in Cable, given its defensive nature and consistently growing revenue due to its subscriber-based model. At the same time, we think Print and Publishing companies are going through a secular decline as individuals increasingly consume the end product through tablets and smartphones. While we think this trend will eventually emerge within Cable companies as well, in the near term wireless alternatives will likely be viewed as a supplement to existing cable subscriptions and not a replacement.

Transportation

With a current spread of 762bp, Transportation offers the highest spread of any sector by 181bp (next highest is Energy at 581bps). However, it is also the smallest sector by market value and represents just 0.84% of the overall high yield index, so any variation in positioning will have little impact of the overall portfolio. We caution against diverging from a marketweight within Transportation because idiosyncratic risks related to a single issuer will have a significant impact on the performance of the overall sector, so we prefer to stay closer to home in the space.

Consumer Products

The Consumer Products sector outperformed in 2015, and for good reason. Consumer oriented businesses that are domestically oriented were a winning formula in a risk off environment driven by commodities and manufacturing. Coupled with their generally defensive nature and okay margins, it also held up well in the beginning of this year and likely will under future risk-off environments should one manifest itself next year. However, under our base case of sideways trading with a minor backup in yields we would expect Consumer Products to trade in line with the index.

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