Buyers for the retail sale

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- **Retail flows garner significant attention in credit markets, but their impact is not felt evenly throughout our universe. Municipals are the most sensitive followed by high yield and emerging markets. Investment grade bonds tend to weather slowing retail demand better than the other markets. Mutual funds have experienced a modest decline in size across most of our markets with negative flows this year in European IG, US high yield, municipals and EM.**

- **US floating rate leveraged loan funds have been the beneficiary of the move in rates, although the recent Fed decision may cause inflows to slow. Retail funds have doubled in recent years and are close to 20% of the US market now, but CLOs still dominate the market with a 50% share. In Europe, loans' lack of UCITS eligibility inhibits retail participation in the asset class, effectively blocking a potential substitute for the shrinking European CLO buyer base.**

- **Insurance is the largest owner overall of corporate bonds, but in most cases it has not added enough risk to keep up with the growth in the size of the market. This is due to paltry overall yields prior to the rate backup this summer. In the US, we notice a slight uptick in insurance holdings of high yield as a result of the reach for yield.**

- **The well documented shift from equities to fixed income has ceased for pensions, although this appears to be more a result of higher equity valuations than significant selling of bonds. Pensions have also shifted their allocations modestly toward high yield to meet liability targets.**

- **Credit hedge funds have experienced strong growth in AUM. Although leverage remains modest, this has allowed them to garner a larger share of the market. Once again, we believe they are more active in high yield than investment grade.**

Overview

The landmark event of Verizon's record $49bn bond deal this month focused investors' attention on new issues. Robust supply across global credit markets in September was accompanied by a pickup in non-refinancing activity. Although gross supply has been high during most of the post-crisis period, net supply has been quite low or even negative, and as a result demand often felt like it was outpacing supply. We believe that the increase in net supply will eventually serve to re-focus attention on demand in an uncertain rate environment for fixed income.

We believe that the increase in net supply will eventually re-focus investors' attention on demand

The 135bp move in 10-year Treasuries from early May through Labor Day provides a window into how credit markets may react in a rising rate environment. We examine changes in the ownership base of each of the markets we cover to understand potential sources of demand as well as areas that could face selling pressure. The most fickle source of demand is retail. Since this source is also the easiest source to track, it tends to get outsized attention. As we discuss in the individual sections, we believe this attention is warranted for certain markets based on historical ownership, including high yield and municipal bonds. Retail is also becoming increasingly important for US leveraged loans and emerging markets as cross-ownership by developed market fund managers grows. However, in the investment grade market we believe that the effect of retail flows are generally overstated. Instead, the behavior of insurance accounts is the driving factor for the largest asset class we cover.

US investment grade – Still no great rotation

The sharp rise in Treasury yields and concerns about a less accommodative Fed led to a sharp sell-off in investment grade credit in May-June and reignited concerns about a "great rotation" away from credit. Over the past 12 months, we have not seen evidence of this rotation, and have not observed any meaningful shifts in ownership of the asset class (Figure 1). Even though fixed-income mutual funds saw some of their largest outflows ever during the recent sell-off, flows into funds with investment grade corporate holdings are still significantly positive for the year. As a result, mutual fund holdings of the asset class increased slightly. Insurance and pension holdings declined slightly on a percentage basis; however, we believe the almost 100bp increase in investment grade yields since early May is likely to lead to a pickup in demand from insurance companies and pension funds.

Mutual funds

We estimate that mutual funds now hold a slightly higher portion of the investment grade corporate bond universe than a year ago. Although much has been made of the large outflows from bond funds following the sharp move in interest rates that began in May, net flows into investment grade corporate bond funds (and into the broader taxable bond fund category) are positive for the year. Even after the May-July outflows, YTD inflows are over $37bn – close to 2011 inflows for the same time period (Figure 2).

The decline in allocation to investment grade corporates has been more than offset by an increase in funds' AUM

While market participants tend to focus on flows for funds classified by Lipper as "Corporate – Investment Grade", this category primarily comprises total return/agg type funds and contains very few dedicated investment grade corporate bond funds. In fact, less than a third of the assets in this fund category are investment grade corporates, with the rest made up of other fixed-income asset classes. As a result, we believe that investors need to pay attention not only to flows into and out of total return/agg funds, but also to shifts in asset allocation by managers of these funds. Over the past year, the allocation to investment grade corporates within investment grade focused funds has declined approximately 1.5%. However, this decrease has been more than offset by an increase in AUM, leading to a slight rise in mutual funds' share of the asset class.

FIGURE 1

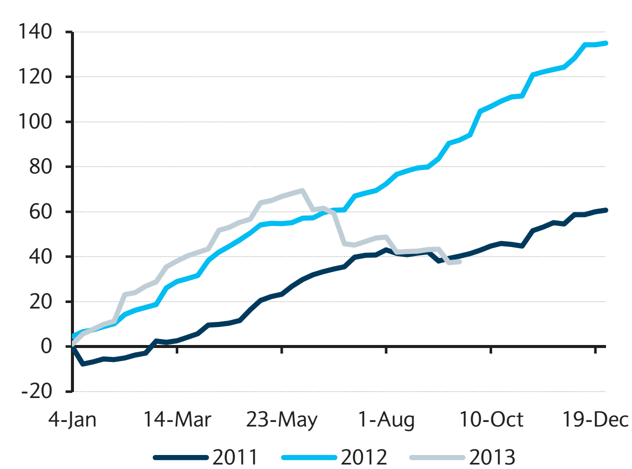
Estimates of ownership of investment grade corporate bonds (% of total universe)

Category	Current Estimates	2012 Estimates
Life Insurance	33-36%	34-37%
P&C Insurance	6-8%	6-8%
Pension Funds	13-15%	15-17%
Mutual Funds	15-17%	14-16%
Banks	6-9%	6-9%
Hedge Funds	2-4%	1-3%
Other*	15-20%	15-20%

Note: *Other includes endowments, foundations, sovereign wealth funds, offshore funds, and direct holdings by households. Source: Bloomberg, Federal Reserve, Lipper/Thomson Reuters, SNL Financial, EPFR, HFR, BarclayHedge, Barclays Research

FIGURE 2

Cumulative investment grade corporate fund flows ($ bn)



Source: Lipper/Thomson Reuters, Barclays Research

Insurance and pension funds

Life insurance companies now hold a slightly lower percentage of the market, as they have not added enough of the asset class to keep up with the growth of this universe. That said, they continue to be by far the largest and most stable buyer of the asset class and, as we discussed in *The Great Rotation: Myth or Reality?* February 1, 2013, they tend to increase their allocation to credit at higher interest rates. We believe that the recent backup in Treasury yields is likely to have led to additional insurance buying, which has not yet been reflected in the data for the latest reporting period, and that further increases in rates could reinforce this trend. The significant flattening in 10s30s credit curves following the Treasury sell-off points to increased buying by insurance, given that they are the primary buyer of long-dated credit.

Life insurance companies, despite holding a slightly lower percentage of the market, continue to be the largest and most stable buyer of the asset class

Pension funds have also decreased their allocations to investment grade credit somewhat and shifted into higher yielding assets, such as high yield credit and alternative investments, driven by their reach for yield to make up their funding shortfall. As part of the same trend, pension funds' shift from equities to fixed income appears to have ceased. However, similar to insurance companies, we believe pension funds may increase their buying of the asset class if Treasury yields continue to increase.

Other buyers

We estimate that banks' allocation to investment grade corporates is largely unchanged from 12 months ago. Most investment grade corporate bond assets within banks – approximately $225bn – are reported as available-for-sale or held-to-maturity. A smaller portion of the corporate bond holdings is held as a trading asset: inventory for the banks' market-making operations. However, even the amount of holdings in this category is likely to be significantly higher than the primary dealer net positions reported by the Fed – the number investors typically look at for dealer inventories – since the Fed provides a net number, while the analysis of holdings requires a gross figure.

We estimate that hedge funds now hold a slightly larger portion of the market than a year ago, primarily as a result of the large growth in AUM of hedge funds with a significant allocation to credit. While the high yield market is likely to have been a bigger beneficiary of this increase in AUM, certain parts of the investment grade market, such as subordinated financials, wider spread or crossover credits, and event risk names, are likely to have received some of the new hedge fund money as well.

US high yield – Retail scales back

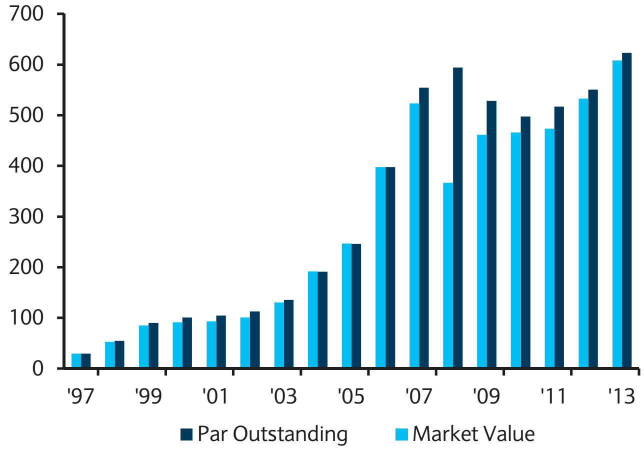
Since we last estimated the breakdown of the high yield buyer base in October 2012 (please refer to *Revisiting Demand – Retail Leads the Way*), the par amount of the Barclays U.S. High Yield Index has grown about 11.5%, to $1.17trn. That said, with the average bond in the index down 1½ pts since then, total assets have grown at a slightly lower pace of 9.9% in the past 11 months (Figure 3). In this year's re-examination of high yield market ownership, we find a few noteworthy changes in the retail, hedge fund, and insurance ownership share (Figure 4).

Retail

Retail has historically been the most readily available and easily quantifiable segment of demand in the high yield market, with fund flows providing investors with regular data points to gauge whether sentiment is deteriorating or strengthening. Indeed, although high yield retail funds account for about a fifth of the overall market by our most recent estimates, their flows are highly correlated to returns, making them a dependable bellwether.

FIGURE 3

U.S. High Yield Index par and market value ($bn)



Source: Barclays Research

FIGURE 4

Estimated share of U.S. high yield bond holdings

Category	2013	2012	Y/Y Chg
HY Mutual Funds and ETFs	19-22%	22-25%	-3.0%
IG / Income Funds	18-21%	18-20%	unch
CLOs / Loan Funds	2-4%	2-4%	unch
Offshore Funds	5-8%	5-8%	unch
Hedge Funds	16-22%	12-18%	+4.0%
Pension Funds / Sep Accts	13-17%	14-18%	-1.0%
Insurance Portfolios	11-15%	8-12%	+3.0%
Other	1-4%	4-7%	-3.0%

Source: Bloomberg, Lipper, EPFR, HFR, SNL Financial, Barclays Research

Retail assets in dedicated high yield funds have been somewhat volatile in the past year, growing as much as 7% from October to May, before retreating quickly as rates spiked and the Fed signalled the potential for the pace of asset purchases to slow. We estimate that dedicated U.S. high yield mutual funds and ETFs currently hold $210-240bn of the U.S. high yield market, down $21bn or about 9% since last year. Significant outflows on the retail front have largely been attributable to duration concerns, which had been relatively mild until they flared up with rates in early May. Meanwhile, high yield closed-end fund assets have doubled to about $14bn this year, partly in response to a desire for leverage in a low yield environment, and partly to mitigate the risk of high fund flow volatility on fund performance. In aggregate, we estimate that high yield mutual funds and ETFs have given up approximately 4% of their share of the U.S. high yield market.

We estimate that high yield mutual funds and ETFs have given up 4% of their share of the U.S. high yield market

While retail portfolios dedicated to the high yield market have seen some erosion in demand, growth rates for retail funds focused on income generation and the investment grade market have kept pace with the growth in overall high yield assets, and they still hold 18-20% of the overall credit market, by our estimates. We believe the IG/income fund segment of the retail market has likely shifted its allocation slightly towards equities and high yield at the expense of IG corporate debt, due to a combination of ultra-low yields and higher duration risk in the latter.

Secondary sources of retail demand, such as loan funds and offshore funds, have seen strong growth in their asset bases in the past year. However, in both cases the absolute increases were not sufficient to materially affect their share of high yield market ownership. Retail demand for loans has been extraordinarily high this year, as rate risk has increased (see US Loan section below), but we estimate that loan funds continue to hold approximately $30-40bn in high yield bonds, keeping their share of U.S. high yield assets at 2-4%. Meanwhile, offshore retail assets have grown about $15bn in the past year, to $75-85bn, and their holdings of U.S. high yield put them more squarely at 5-8%. The growth in offshore assets comes despite a continued decline in the popularity of so-called Toshin funds (offshore vehicles that add a currency overlay on top of U.S. high yield portfolios), following significant declines in growth currencies such as the Brazilian real and Australian dollar. Duration is once again the explanation, as short duration funds with assets from abroad have had significant inflows in the past 12 months.

Hedge funds and institutions

The amount of U.S. high yield bonds being managed by hedge funds has grown significantly in the past year. We estimate that hedge funds hold $220-290bn in high yield (accounting for leverage), or 17-23% of the market, making a 5% y/y increase in market share. The dynamic for pension funds and separate accounts is somewhat more complicated; our analysis suggests that a small decrease in fixed income allocations was counterbalanced by a shift towards higher yielding assets. However, by our estimates, the former outweighed the latter, with the overall share for that source of demand declining slightly to 13-17%.

Meanwhile, the relative scarcity of yield across fixed income assets has pushed insurance portfolios further down the quality spectrum over the past year. An analysis of portfolio holdings of the top 25 L&H and top 25 P&C insurers shows that segment of the market growing significantly faster than the overall market. We estimate that insurers now hold $135-185bn in U.S. high yield assets, or 11-15% of the market, for a 3% increase in share over the last year. While insurers may be comfortable with the incremental credit risk, further increases may be difficult due to the higher risk weighting of non-investment grade debt.

US leveraged loans – Remarkable growth in retail

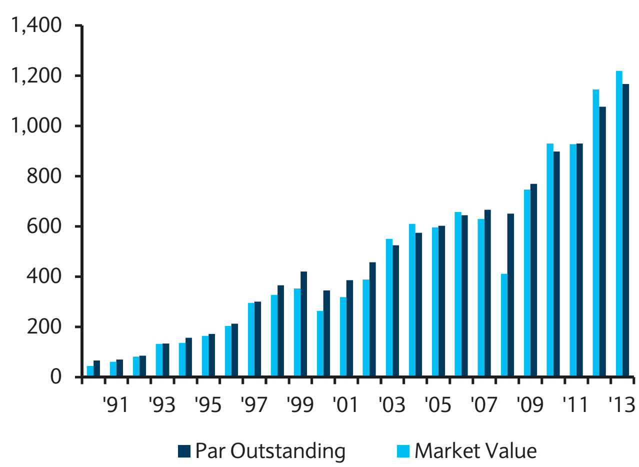
While duration risk has been a concern for several years, the level of market anxiety reached fever pitch this year, which substantially benefited the loan asset class due to its floating rate nature. Indeed, since October 2012 the par amount of loans in the S&P/LSTA Leveraged Loan index has increased 15.9%, to $618bn (Figure 5). Further, unlike bonds which have shed about $1.50 on average, the loan index is up 2pts over the past 12 months, putting loan asset growth at 18.3% y/y, including price appreciation.

We estimate that CLOs continue to hold 46-52% of U.S. loans, making their share of the asset class unchanged

CLOs

As we noted last year in *Revisiting Demand – Retail Leads the Way*, CLO creation has accelerated since 2011. Year-to-date issuance of $58bn has already exceeded our estimates of legacy vehicle amortisation due to reinvestment periods ending, and the consequent growth in CLO assets has generally kept pace with the broader loan market. We estimate that CLOs currently hold $280-320bn in U.S. loans, making their share of the asset class unchanged year-over-year at 46-52% (Figure 6). Notably, although CLO creation has been robust this year, it has slowed somewhat since an FDIC rule change on April 1 that made it more expensive for banks to hold AAA tranches. Indeed, anecdotal evidence suggests that higher spreads on AAA tranches (which are currently printing in the L+135bp to L+140bp

FIGURE 5
U.S. leveraged loan par and market value ($ bn)



Source: S&P LCD

FIGURE 6
Estimated share of U.S. leveraged loan holdings

Category	2013	2012	Y/Y Chg
U.S./European CLOs	46-52%	46-52%	unch
High Yield/Institutional/Hedge Funds	14-19%	15-20%	-1.0%
Mutual Funds (Open, Closed, ETFs)	16-19%	12-15%	+4.0%
Total Return Swaps (TRS)	4-6%	5-7%	-1.0%
Insurance (P&C & Life)	3-5%	3-5%	unch
Other (Banks, Dealers, Private)	8-13%	10-15%	-2.0%

Source: Bloomberg, Lipper, EPFR, HFR, SNL Financial, Barclays Research range) have been a significant impediment to new deals printing, as potential equity tranche investors shy away due to unappealing IRRs. A further risk to CLO creation is risk retention. As they stand, risk retention rules will likely be a significant headwind to new CLO deals (see *No Exemptions*, 6 September 2013, for more details) and could ultimately make other sources of loan demand more important. However, risk retention rules will not take effect until 2016 at the earliest, pushing out the timing of the potential shift in the buyer base.

Retail

While the picture for CLOs is a mix of near term positives and medium-to-long term uncertainty, retail demand has been more clear-cut. Inflows into loan retail funds have been remarkably consistent, averaging more than $900mn per week in the past 66 weeks and accelerating to $1.5bn per week since the brisk sell-off in rates that began in early May. In the process, retail funds have nearly doubled their asset base since our last analysis of loan ownership in October. They currently hold $100-120bn in U.S. loans, by our estimates, or 17-20% of that market, for a 5% increase in share since last year. Although the upside argument to owning loans has become much less compelling, the value proposition of carry with a lower beta than high yield and minimal duration risk could be sufficient to keep retail flows positive for some time; the biggest risk to the growth in retail ownership comes from the Fed's efforts to keep rates low for a while longer, which we believe could slow inflows but should not lead them to reverse course.

Other sources

The sell-off in rates and subsequent outflows from high yield in May and June affected high yield managers' ownership of loans, but anecdotal evidence suggests that institutional buying absorbed much of the retail selling. By our estimates, that net effect is a 1% decrease in the overall share of U.S. loans held by high yield, institutional and hedge funds. We believe the size of the total return swap market is essentially unchanged y/y, which translates to a loss in share relative to the significant growth in the asset class.

Municipals: Retail still dominates

The municipal market has remained around $3.7trn in size since 2011, after peaking at $3.8trn in 2010 following the expiration of the 2009-10 Build America Bond (BAB) program (Figure 7). From 2011 onward, muni redemptions have slightly outpaced issuance, resulting in modest negative net supply. This occurred as new money issuance as a percentage of total supply decreased (as governments were reluctant to take on capital projects), while the low interest rate environment spurred a pickup in refunding activity. With 2013 results indicating slightly negative net supply thus far, the size of the overall muni market remains unchanged for the time being.

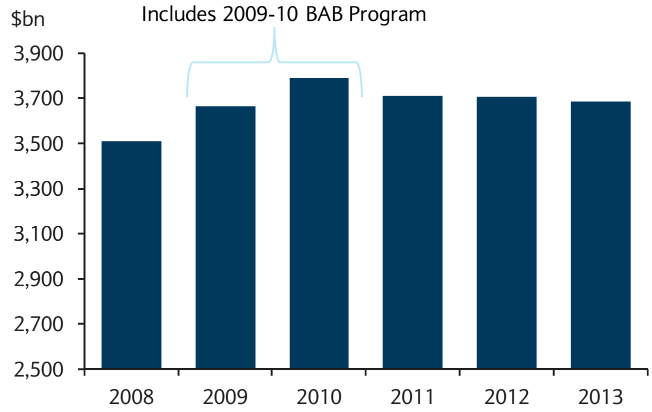
Within retail, allocation has shifted away from the individual/household level towards municipal credit mutual funds

Changes in allocations of municipal bonds have also been modest over the years (Figure 8). The buyer base for the municipal market is primarily retail, with individuals and mutual funds (a proxy for retail) holding 73% of the $3.7trn market. Insurance companies hold about 12% of muni assets while other buyers (including state and local retirement funds) hold a negligible amount. Besides the fact that retail remains the predominant driver of muni demand, we make two observations about Figure 8.

- Within retail, allocations have shifted towards mutual funds and away from the individual/household level. One driver of this trend may have been the bond insurance downgrades that began in 2007-08, which rendered individual credit analysis in the muni sector much more crucial. This has induced individuals to shift toward separately managed accounts (SMAs) and mutual funds in order to receive the benefits of diversification and professional management. While SMAs are grouped within the individual/household category, our data pick up the move toward mutual funds over the years.

FIGURE 7

The size of the muni market over the years



Source: Federal Reserve Flow of Funds, SIFMA, Barclays Research

FIGURE 8

Share of muni bond holdings

	Percentage of Total			
Category	**2013**	**2012**	**2011**	**2010**
Individuals/Households	44%	45%	49%	49%
Mutual Funds[1]	28%	29%	27%	26%
Banks[2]	11%	11%	9%	8%
Insurance[3]	12%	12%	12%	12%
Other[4]	4%	4%	4%	4%

Note: (1) Includes mutual funds, money market funds, close-end funds and exchange traded funds. (2) Includes commercial banks, savings institutions and brokers and dealers. (3) Includes property-casualty and life insurance companies. (4) Includes nonfinancial corporate business, nonfinancial non-corporate business, state and local governments and retirement funds, government-sponsored enterprises and foreign holders.

Source: Federal Reserve Flow of Funds, SIFMA, Barclays Research

- Bank buying of muni bonds picked up meaningfully in 2012 ($60bn of incremental buying), with at least another $20bn in the first half of 2013. We believe this uptick is likely due to improved bank profitability, attractive value in munis, the tax-exemption benefits of bank qualified bonds, and the relatively low risk-weighting of the muni asset class as a whole. We do not expect recent changes under Basel III to meaningfully change bank demand for munis in 2014.

As retail represents the largest portion of the muni buyer base, retail buyers are crucial to the overall demand outlook. We focus on muni mutual fund flows as a proxy for retail market sentiment, as granular weekly and monthly data are not available at the household or individual level. Despite the doom-and-gloom sentiment that has persisted in the past few months, we think there is cause to be optimistic. After the Fed recently announced that it will not yet taper asset purchases, we are cautiously optimistic that fund outflows will reverse in the short term.

European Investment Grade

Year-to-date, investment grade credit funds have suffered small outflows in Europe, while institutional investors appear to be raising their allocations to credit as interest rates and equity valuations rise. This is consistent with expectations for demand that we discussed in "Fund flows remain a lagging indicator," *European Credit Alpha*, 12 July 2013.

IG credit funds have suffered small outflows in Europe while institutional investors have raised their allocations to credit

In June, as markets focused on US retail fund outflows, we laid out our expectations for retail flows in Europe. Based on our analysis, we saw little risk of extremely large outflows from European retail funds despite the much-debated "great rotation." Up to the end of August, European retail funds saw c.£550mn (0.65% of AUM) of outflows from sterling investors and c.€2.1bn (1.82% of AUM) from euro investors. These small moves leave their holdings of credit (as a % of the index) essentially unchanged since the start of the year (Figure 9). We expect retail flows to remain weak for the rest of 2013, as retail investors are likely to favour equities, given their recent outperformance. The total returns outlook for investment grade credit remains dim, despite the Fed delaying tapering, which suggests that credit fund flows will remain weak outright and, in particular, relative to equity funds (Figure 10).

In contrast, we expect institutional investors – which hold the majority of investment grade credit (c.60% of €-credit and c.79% of £-credit) – to remain net buyers of IG bonds. Though heavily lagged, available data on insurance groups and pension funds in Europe suggest that this is happening. ONS data show that these investors bought £4.2bn of credit in the

FIGURE 9

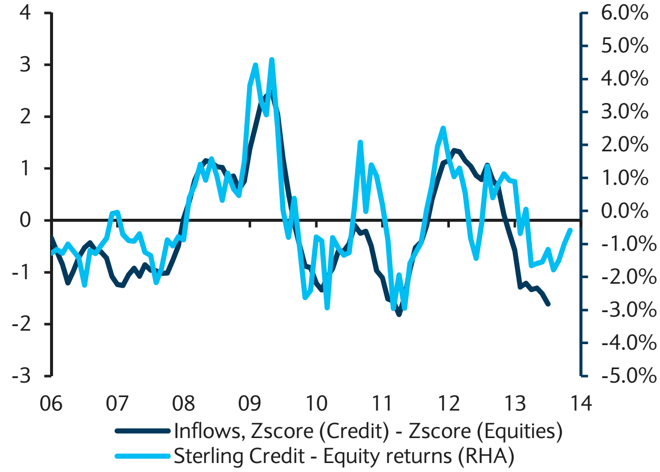
Estimated holders of EUR- and GBP-denominated IG credit

	EUR	GBP
Investment Funds	27%	14%
Insurance Groups	52%	55%
Pension Funds	7%	23%
Other	14%	7%

Source: IMA, Barclays Research

FIGURE 10

Relative fund flows vs Relative total returns (Credit - Equity)



Source: Bloomberg, IMA, Barclays Research

first half of 2013, as credit allocations recovered from their lows of Q4 2012. Our analysis suggests that rising yields and higher equity valuations lead to increased credit investment by insurer and pension funds, respectively, a theme that appears to be playing out in 2013.

We expect institutional investors to remain net buyers of European IG bonds

In the euro market, based on ECB data, it appears that institutional investors were also net buyers of corporate credit. Balance sheet data show that holdings of non-financial and MFI (bank) debt rose 3% in Q1, well in excess of the 0.55% total return of our benchmark index over that period. In both the Euro and Sterling space, institutional investors appear to have been buying investment grade bonds from less traditional investors, increasing their share of the index by 1-2pp, while the investment fund share has remained broadly unchanged.

European high yield bonds

In Figure 11, we present our updated high yield estimates of the European high yield buyer base. The overall market (including financials) has grown by roughly 15% so far in 2013, and we believe all of the listed demand sources have contributed to this growth in nominal terms. However, only the retail buyer base appears to have gained share relative to last year's estimates. With European mutual funds reporting a 70% y/y increase in AUM, and global fund holdings larger by 26%, asset growth in the retail channel appears to be materially outpacing the market overall. Conversely, no single category appears to have unduly lagged, meaning retail likely took a small amount of share from each one.

In European high yield, retail has gained share relative to last year's estimates

FIGURE 11

Estimated Pan-Euro high yield market share by buyer type

Pan-Euro HY Bond Holdings (including fins)	2014
Retail (Mutual Funds, ETFs, Investment Trusts, Private Banks)	25-30%
UK Insurance and Pension Funds	10-15%
EU Insurance and Pension Funds	15-20%
IG Funds	10-15%
Hedge Funds	15-25%
CLO	<5%
Other	5-10%

Source: EPFR Global, Bloomberg, Intex, ECB, UK ONS, Barclays Research

Four markets, not one

While the shares listed in Figure 1 cover the entire cash index, the European high yield bond market is really four different sub-markets, with differing investor bases. While there is certainly some overlap, fallen angels, CCCs, financials, and regular way non-financial high yield corporates each have their own investor profiles:

- Fallen angels are held disproportionately by investment grade managers and within insurance portfolios, not all of whom sell such credits immediately upon a downgrade. However, the proportion of IG managers decreases over time if the credit eventually refinances in the high yield market, as not all of the legacy holders roll their exposure into a new deal, particularly if a return to investment grade does not appear imminent.
- Financials are also held disproportionately by IG managers, most of whom are familiar with banking credits and many of whom consider subordinated financials to be effectively investment grade instruments, provided that the senior unsecured credit rating is reasonably strong. Many regular way European high yield managers are benchmarked ex-fins, and even those that have full market benchmarks may not be sufficiently familiar with hybrids and other subordinated financial debt to support market weight exposure.
- European CCCs are held disproportionately by hedge funds and distressed managers. Unlike in the US, the CCC part of the European market is small enough that regular way managers can effectively ignore it without risking enormous tracking error versus their benchmark. To the extent that there is CCC rated new issue, it is often PIK dividend deals which investment grade and insurance portfolio managers (and even some regular way high yield managers) will not touch.
- Regular way (e.g., non-fallen angel, non-financial, non-CCC rated) high yield is held by everyone, but disproportionately so by the benchmarked retail and institutional managers who are underweight CCCs and financials, per the above.

Retail matters: The global manager share of European high yield is increasing

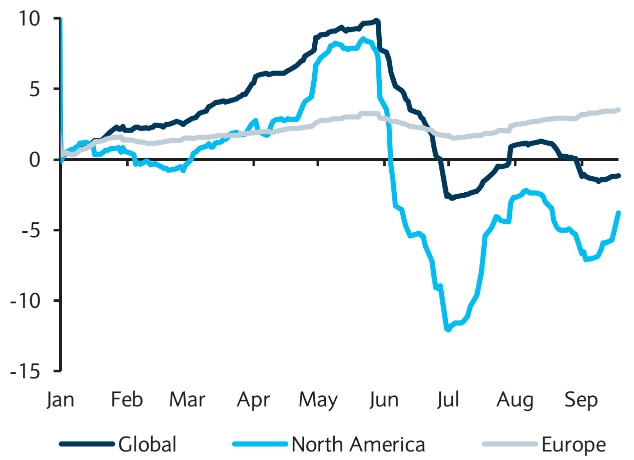
The fastest-growing component of the European high yield buyer base is undoubtedly retail, albeit in some cases this growth is from a fairly low base. As of the end of August, European high yield ETFs had grown by 70% y/y, to 2.6bn USD-equivalent in assets under management. Meanwhile, European high yield mutual funds have also grown 70% y/y, to 24.6bn USD-equivalent. This compares to 26% growth for global mutual funds, 14% growth for North American mutual funds, and just 5% for North American high yield ETFs, which have seen significant outflows this year.

Global managers' reported mutual fund flows have been roughly flat year-to-date, although not without significant interim volatility (the 2013 high water mark was nearly $10bn). Conversely, dedicated European funds have seen relatively consistent inflows, with just a small blip during June's volatility (Figure 12). Despite dedicated European funds' slightly better flows this year, we believe global funds are a more important demand source for the European high yield market, because of re-allocation opportunities across geographies.

Global funds are an increasingly important source of demand for the European high yield market because of re-allocation opportunities across geographies

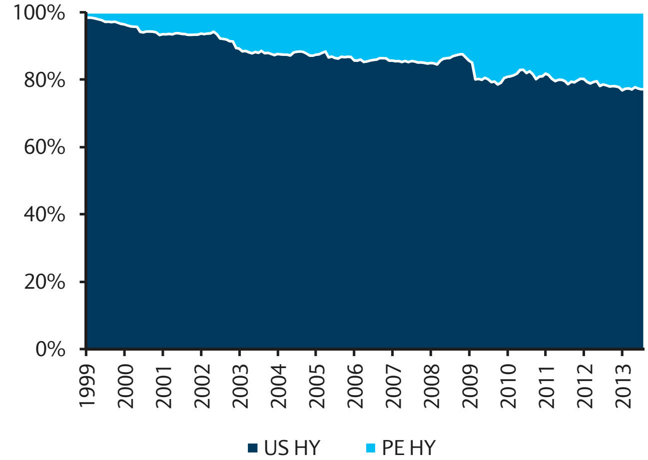
Anecdotal evidence suggests that global funds' aggregate allocation is moving toward a less underweight position in Europe relative to the US. Given their large collective size ($176bn in global high yield AUM according to EPFR), even a small change in allocation can drive a meaningful increase in European market share. A market weight allocation would be approximately 80% US / 20% Europe, but the majority of global managers are based in the US, and many are still building out their European research and trading footprints. Their portfolios tend to exhibit home market bias, with an allocation to European high yield in the teens rather than a full 20% market weight. Since the European

FIGURE 12
Year-to-date mutual fund flows by geography



Source: EPFR Global

FIGURE 13
Relative share of total par outstanding



Source: Barclays Research

market is growing faster than the US, global managers must increase their allocation just to avoid becoming more underweight as Europe makes up an ever-larger share of global high yield par (Figure 13).

Completing the European retail community are the less-easily tracked pools of money that do not report fund flows, but still represent mass-market buyers. Dedicated European high yield closed-end funds are essentially non-existent, but a few global closed-end funds appear to have overweight allocations to Europe. In addition, a lot of European retail money is funnelled through private banks, which often pool investor money into a structure that is somewhat like a mutual fund (but often also somewhat like a structured product), and then farm it out to high yield managers to run. Assuming that these sources are growing roughly in line with the more visible mutual fund universe, our estimate of retail's aggregate market share now stands at 25-30% of the overall market.

European leveraged loans

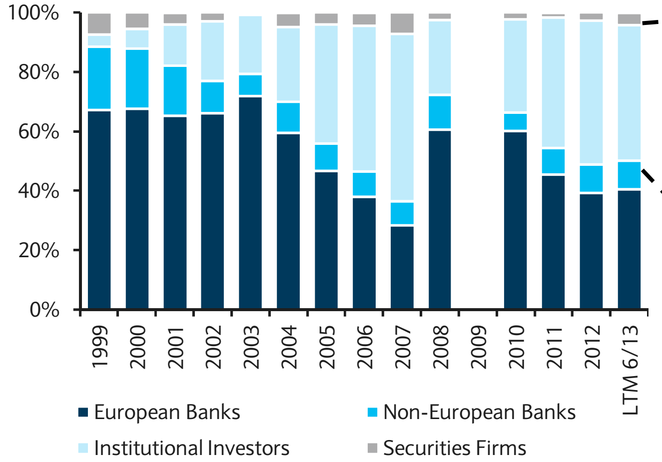
CLOs reign supreme among institutional investors, accounting for 70% of the institutional loan market in Europe today

The loan market in Europe has historically been bank-dominated, but the past decade has brought significant changes to this arrangement. As recently as 2003, 80% of loan syndications were distributed to banks, according to S&P LCD (Figure 14). In the final few years of the credit boom, institutional investors took increasing amounts of market share away from the banking system (share that banks are in no hurry to reclaim today given ongoing regulatory pressure to de-risk balance sheets). Among institutional investors, CLOs reigned supreme, accounting for 60-80% of non-bank primary market allocations during the pre-crisis period (Figure 15). Today, CLOs account for a shade under €70bn of the ~€100bn institutional loan market in Europe.

UCITS hinders retail access, leaving no offset for shrinking CLOs

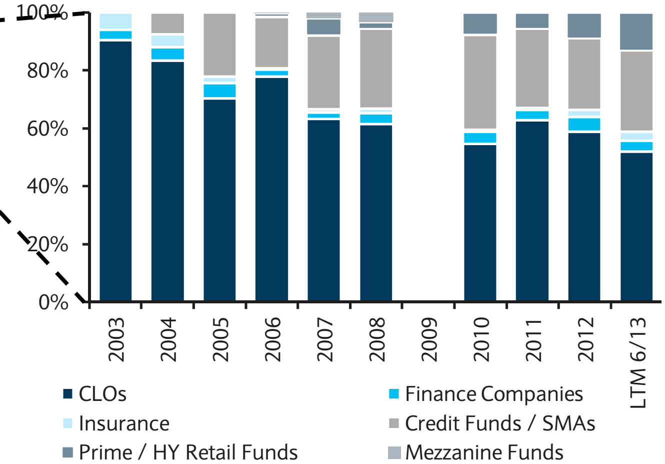
Unfortunately for loan issuers, the CLO universe is shrinking, as most pre-crisis deals have exited reinvestment, and equilibrium appears to be at least a year away. By the end of 2014, essentially all pre-crisis European CLOs will be out of their reinvestment periods, meaning that the c.€70bn in legacy CLOs will be amortizing at c.25-30% per year (assuming a 35% collateral repayment rate and some limited opportunities for CLO managers to roll exposure outside of reinvestment). This means that €15-20bn in net CLO creation will be needed to offset legacy amortization. We think a more likely outcome for 2014 is €10-15bn in new CLOs, of which at least a quarter are likely to refinance called legacy deals, leaving perhaps €10bn in net new CLO creation. As a result, the European CLO universe could shrink by €5-10bn in 2014. Absent a source of replacement demand, the loan market is likely to follow.

FIGURE 14
Primary market share by investor type



Source: S&P LCD

FIGURE 15
Primary market institutional investor breakdown



Source: S&P LCD

One potentially significant source of demand is excluded from participation in the European loan market, as leveraged loans are not an eligible investment under Article 50 of the UCITS IV Directive. While SICAV vehicles are available in some EU member states, the lack of UCITS eligibility prevents loan funds from selling freely across borders, which acts as a significant inhibitor to growth in the retail channel. The primary industry group, the Loan Market Association (LMA) has been actively discussing with the European Commission possible changes to UCITS eligibility rules, so far without effect. The commission's primary concerns regarding the loan product are around secondary market liquidity and trade settlement times. So far, these limitations have prevented retail investors from picking up the slack.

Absent movement on the UCITS issue, we do not believe an alternative source of demand will surface to offset the net negative demand from the CLO buyer base. While TRS is slowly becoming available, it is unlikely to accelerate significantly given the ongoing pressure on European bank balance sheets. Without leverage, prospective returns from current levels are unlikely to entice significant growth from the hedge fund community, and the European loan holdings of other institutional buyer types (insurance, prime funds, finance/business development companies, and mezzanine funds) are all relatively small. As such, we expect the European leveraged loan market to shrink for a fifth consecutive year in 2014, perhaps to around €80-85bn by the year-end. At that point, CLO creation should be nearing an equilibrium point, potentially putting a floor under market size pending the identification of incremental buyers.

Emerging markets – Slowing demand

We believe that crossover investors have already substantially reduced their EM exposure and will eventually begin to add EM risk

The rapid expansion in the EM credit universe over the past three years (~30% CAGR) has attracted sizeable allocations from funding pools such as retail, global pensions/endowments and EM/non-EM official institutions. This robust flow of funds has been partly driven by a stretch for yield and desire for diversification.

But diverging macroeconomic trends in EM/Asia and DM, combined with the prospects for normalisation of monetary policy in developed markets, have dented demand from non-dedicated investors, as well as retail investors. Our sense is that retail demand will continue to be weak amidst rising UST rates, that there is some downside risk to institutional demand, but that crossover investors have already substantially reduced their EM exposure and will eventually begin to add EM risk.

- **Retail/private banks**: Following the volatility and underperformance of credit over the summer, and the expectation of rising rates, the retail bid has weakened. While inflows have recently picked up, we think the pace is unlikely to match Q1 13 or previous years. In addition, we think alternative asset classes (such as EM equities, which are also relatively cheap to DM peers) are likely to take some flows from EM credit, especially in a rising UST rate environment (this investor segment rarely hedges US rates). The weakening retail bid is particular important in Asia; private banks own c.15% of Asia credit.

- **Institutional investors**: Anecdotal evidence suggests that institutional allocations to EM/Asia credit have remained sticky. However, the typical timeline of the institutional decision making process means that current flows are unlikely to reflect the fact that volatility-adjusted returns are considerably less favourable now. Relative to developed markets, we think the fundamental case for EM also looks less compelling now (compared with six months ago). The effects of these factors are likely to be seen in coming quarters in the form of a slower pace of institutional flows to EM.

- **Crossover investors**: We believe these allocations to EM credit were mostly tactical in nature and they have reversed, at least partly, since Fed tapering discussions came to the fore. Once EM growth stabilizes, the close correlation between EM credit spreads and UST yields should diminish; this should encourage crossover investors to re-engage with EM corporates.

- **In-region demand:** Demand from regional institutions has grown for EM credit in recent years with pockets of allocations from Malaysia, Thailand, Korea, China and Taiwan. Following the delay to Fed tapering, if flows return to Asia local-currency markets, we could see a stronger bid from these in-region investors for USD bonds. Taiwanese and Korea demand remains strong, a trend we believe will support some parts of credit markets.

- **Japanese retail**: So far this year, these investors have been net sellers of risk. But with yen expectations anchored, we expect Japanese retail fund deployment to EM to pick up from Q4 13 onwards.

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