The HY Wire

Dissecting the default rate

High Yield Strategy | Global
04 November 2014

Bank of America Merrill Lynch

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Default rate to rise to 2.5% in 2015

We think that default rates next year will be in the 2.5% context before rising to mid- to high-single digits in 2016 and beyond. On a macroeconomic basis, amongst the three factors that lead default rates, quality trends and real rates have remained largely flat since last year, but bank lending standards are loosening at a decreased rate. Additionally, the direction in which all three are trending remains unsupportive of the depressed default rates of the last few years. We also present our analysis of sectors and issuers that will likely get us to a 2.5% default rate on an issuer-weighted basis. Also, we forecast a default rate of 2.4% on a par-weighted basis and 1.5% on a market value-weighted basis.

QE's last bow, inflation's continuing snooze

Although the US economy grew at a better-than-expected 3.5% rate in Q3, the details were weaker than the headline would suggest. Our economists also took down their inflation forecast for next year and have pushed back their expectations for the first hike to September 2015. For HY, the growth picture is supportive. However, we remain cautious for 2015, especially if we rally into year-end.

Flows: All treats and no tricks

Global high yield funds saw an inflow of about $2.9bn, the best one-week gain the asset class has seen since mid-August. The inflow was driven almost equally between US and non-US funds, as the former saw +$1.5bn and the latter saw +$1.4bn.

Issuance: Another moderate week of new supply

Global high yield issuance was similar to last week as 7 new deals for a total of $6.1bn came to market. $5.3bn came from the US and $0.8bn came from Europe. Of the $6.1bn issued last week, $1.6bn was rated BB and $4.5bn was B. Month-to-date, we have seen a total of $26.7bn come to market in October, and year-to-date we now stand at $336.0bn.

Performance: Risk assets outperform

Returns were scattered last week as risk assets tended to outperform. The best one-week performer was EM equities, which gained 2.63%. US equities, as represented by the S&P, were the second-best performers with a return of +2.25%. High yield assets were a little more mixed—EM high yield added 1.01% and European high yield added 0.13%, though US high yield declined 0.04%.

Convertibles: Converts rebound during October

October proved to be somewhat of a reprieve from September's calamity for global markets as returns were generally positive across asset classes as improving economic data and strong corporate earnings outweighed the downturn in oil and fears of Ebola. As such, global convertibles gained 0.93% USD in October, relative to a 0.73% USD gain for global equities.

Recent Publications

[The High Yield Flow Report: All treats and no tricks 30 October 2014]

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The View From Above

QE's last bow, inflation's continuing snooze

In their October meeting, the FOMC decided to taper the last $15bn in asset purchases, bringing an end to QE3. While this was largely expected, the rest of the statement was a little less dovish than market expectations. Despite negative surprises in inflation over the last couple of months, the Fed did not indicate more concern about downside risks to inflation relative to the September meeting. And they saw the risks of persistently below-target inflation as having "diminished somewhat since early this year." USTs sold off right after the statement, with the 5y ending the day about 7bp higher. The minutes, which will be released on 19th November, may show more debate on the matter.

Our Economists have taken down their inflation forecast for next year and expect it to remain at current levels for 2015. Global inflation also continues to remain low, and they expect more central bank balance sheet expansion, particularly from the BoJ and the ECB. They expect the Fed to shift focus from the labor market to inflation over the course of the year and have pushed back their expectations for the first hike to September 2015.

On GDP, the US economy grew at a better-than-expected 3.5% in the third quarter. However, details of the report showed large contributions from defense spending and trade, both of which tend to be volatile and subject to revisions. Consumer spending disappointed, averaging 1.85% from Q1 to Q3 this year compared to 2.7% average quarterly growth in 2013. We continue to expect the US to post solid growth next year and the global ex-US GDP to also show a modest improvement.

For HY, the growth picture is very supportive. However, as we have indicated in the past, a number of factors make us more cautious for 2015 than we were heading into this year. If we rally into year-end, valuations will appear relatively tight and the upside seems limited, particularly as rates keep heading higher. We expect the default rate to tick up, as we discuss below. While our 2.5% forecast for next year is quite low from a historical perspective, it is still headed in the wrong direction. Add that to the end of QE, six years of solid returns in HY since the crisis, decreased dealer risk appetite and poor liquidity in the cash market and the prospect for US HY looks less than spectacular. Pockets of outperformance will be available, however, but it's going to be about credit-picking rather than hopping on to the 'beta train'.

Weekly Recap

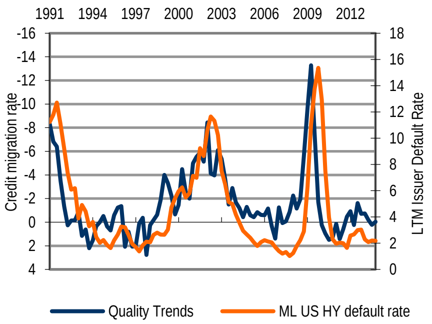
So far, 126 high yield names have reported Q3 earnings. On a year-over-year basis, EBITDA is up 8.7% while debt is up 13.9% and revenue has increased 6.5%. With about one-quarter of companies reporting, on a quarter-over-quarter basis, revenue growth has increased 2.5% while EBITDA growth has increased 2.2%. Since last Thursday, high yield spreads have tightened 3bps from 438bps to 435bps while 5y rates have increased 8bps from 1.49% to 1.57%. In flows, US high yield funds saw solid net inflows (+$1.5bn) as inflows into open-ended funds (+1.7bn) offset outflows from ETFs (-$219mn). US investment grade funds reported another strong week of inflows (now 41 consecutive weeks), adding another $3.2bn. On a par-weighted basis, 66% of our HY index is now trading inside a yield of 6%, similar to last week. US high yield issuance has fallen about $31bn behind last year's record pace as $5.3bn came to market last week in the US.

Table 1: 126 HY companies have reported

YoY Pct Change				QoQ Pct Change			
EBITDA	Debt	Rev	COGS	EBITDA	Debt	Rev	COGS
8.7	13.9	6.5	4.6	2.2	5.0	2.5	1.4

Source: BofA Merrill Lynch Global Research

Chart 1: Issuer quality trends vs HY default rate



Source: BofA Merrill Lynch Global Research

Default rates to rise to 2.5% in 2015

We have pointed out in recent weeks that we expect default rates to rise next year, and how we think the next default cycle is going to follow a similar pattern to that of the 1990s (see The next default wave: Slow and low 23 September 2014). In fact we think that the default rate next year could be in the 2.5% context before rising to mid-single digits in 2016 and beyond. We don't make such a call lightly, as after unprecedented accommodative action and global central bank easing, defaults in high yield have plummeted to all-time lows. And 2015, by most measures, will likely be one that on the surface looks appealing to high yield credit: low absolute level of interest rates, modest to strong US GDP growth, near all-time high interest coverage ratios, and yields that are now 100bp higher than the lows of 2014. We also note that a rise to 2.5% would mark what, under more "normal" times, would be a cycle low and hardly a concerning measure. We don't view the move higher in defaults as one where we're overly concerned about the fundamentals of the broad market, but rather an expression of investor unwillingness to extend credit to troubled companies in a world where QE is over, cash is limited, liquidity is poor and yields and rates are trending the wrong way. We wrote over a year ago that we believed a meaningful pickup in defaults would not occur until later 2016 or early 2017, and we continue to believe this. However, we do think the increase from less than a 1% rate in August this year to above 2% next year deserves some mention.

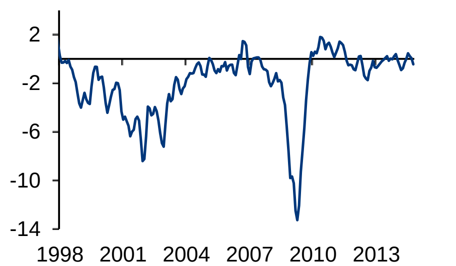
In making this assessment, we looked at both qualitative and quantitative measures as well as discussed several issuers with our fundamental analysts. A 2.5% default rate would represent about 27 or so defaults of the ~1100 issuers in the HY universe. Broadly speaking there are three macro factors that have a direct and measurable impact on default rates—issuer quality trends, bank lending standards and real interest rates. All of these factors have a roughly one-year lead over realized default rates. The factors as they stand today then can be employed towards our assessment of the default rate over the next year. Among the three, quality trends and real rates have remained largely flat since last year while bank lending standards are not loosening at the same rate as a year ago. Additionally, the direction in which all are trending is unsupportive of the depressed default rates of the last few years.

Quality trends

We have been discussing for the last 12 months the strength of corporate balance sheets, particularly the historically high interest coverage of high yield corporates. However, we have also discussed at length that the main reason for such high interest coverage is due not to all-time high EBITDAs, but rather the suppression of interest rates by the Fed, too much cash chasing too few assets, and investor willingness to extend credit at nearly any price. Much of these factors will change in 2015, in our opinion, leading to lower interest coverage and slow deterioration of quality trends among riskier credits.

Although we have been and continue to be in the "lower for longer" camp, we think both 5s and 10s will increase modestly next year. But perhaps more importantly, any accompanying volatility, and the uncertainty that comes with it, is unlikely to bode well for newly priced debt. Additionally, EBITDA growth today is fine, but not substantial in high yield. At the tights of a typical cycle, EBITDA growth tends to be in the high-teens, whereas over the last 12 months average quarterly EBITDA growth has been in the high-single digits. In our estimation, US GDP growth of 3% is unlikely to yield substantially higher earnings growth than

Chart 2: Trailing 3m migration rate, % of issuers



Source: BofA Merrill Lynch Global Research

Table 2: Securities on a negative watch/outlook

Ticker	Coupon	Maturity	Subsector	Face
BPL	6.05	1/15/2018	Gas Distribution	300
BPL	5.5	8/15/2019	Gas Distribution	275
BPL	4.875	2/1/2021	Gas Distribution	650
BPL	4.15	7/1/2023	Gas Distribution	500
BPL	5.85	11/15/2043	Gas Distribution	400
BPL	2.65	11/15/2018	Gas Distribution	400
BPL	4.35	10/15/2024	Gas Distribution	300
BPL	5.6	10/15/2044	Gas Distribution	300
BWP	5.5	2/1/2017	Gas Distribution	300
BWP	5.875	11/15/2016	Gas Distribution	250
BWP	5.75	9/15/2019	Gas Distribution	350
BWP	3.375	2/1/2023	Gas Distribution	300
EPB	6.5	4/1/2020	Gas Distribution	535
EPB	4.1	11/15/2015	Gas Distribution	375
EPB	7.5	11/15/2040	Gas Distribution	375
EPB	5	10/1/2021	Gas Distribution	500
EPB	4.7	11/1/2042	Gas Distribution	475
EPB	4.3	5/1/2024	Gas Distribution	600
KZOKZ	9.125	7/2/2018	Exploration & Production	1,600
KZOKZ	7	5/5/2020	Exploration & Production	1,500
KZOKZ	6.375	4/9/2021	Exploration & Production	1,250
KZOKZ	4.4	4/30/2023	Exploration & Production	1,000
KZOKZ	5.75	4/30/2043	Exploration & Production	2,000
MUR	7.05	5/1/2029	Exploration & Production	250
MUR	4	6/1/2022	Exploration & Production	500
MUR	2.5	12/1/2017	Exploration & Production	550
MUR	3.7	12/1/2022	Exploration & Production	600
MUR	5.125	12/1/2042	Exploration & Production	350
RIG	7.5	4/15/2031	Oil Field Equipment & Services	600
RIG	6	3/15/2018	Oil Field Equipment & Services	1,000
RIG	6.8	3/15/2038	Oil Field Equipment & Services	1,000
RIG	6.5	11/15/2020	Oil Field Equipment & Services	900
RIG	4.95	11/15/2015	Oil Field Equipment & Services	1,100
RIG	5.05	12/15/2016	Oil Field Equipment & Services	1,000
RIG	6.375	12/15/2021	Oil Field Equipment & Services	1,200
RIG	7.35	12/15/2041	Oil Field Equipment & Services	300
RIG	2.5	10/15/2017	Oil Field Equipment & Services	750
RIG	3.8	10/15/2022	Oil Field Equipment & Services	750
SWN	7.5	2/1/2018	Exploration & Production	600
SWN	4.1	3/15/2022	Exploration & Production	1,000

Source: BofA Merrill Lynch Global Research

what we have seen over the last couple of years, and we believe the risk for growth is to the downside rather than the upside given global headwinds from China to Europe. Furthermore, and central to our view for a low-single-digit return next year, we believe cash, particularly from retail investors, will unlikely flood the market next year while investors will maintain higher cash balances as a buffer to lower dealer inventories and a lack of liquidity. Finally, as we have been discussing for the last 2 months, we believe investors are no longer willing to fund low quality, questionable names as aggressively as in the past for the fear of not being able to sell bonds during periods of redemptions or market weakness. All these factors combined yield a picture where quality trends, particularly of stressed names, but also within acute sectors, look poised to deteriorate in 2015.

We measure these quality trends by the credit rating migration rates within the US HY market on a three-month trailing basis. In calculating the net migration rate, we not only compare the number of issuers upgraded versus those downgraded, but also the extent by which each of them has migrated. For example, two issuers upgraded by one notch has the same effect on our calculation as one issuer upgraded by two notches. This is a concept that commonly used rating models don't employ, yet one we think is important to accurately evaluate the market drift.

In the US HY market quality trends have remained largely flat despite a few minor fluctuations through this year (Chart 2). Although we see quality trends amongst stressed credits deteriorating next year, it is entirely possible that we will see another year at the index level in which quality trends don't indicate a pickup in defaults. However, with more dispersion between names, and the turn to a credit pickers market, we would expect more differentiation between credits by the rating agencies and therefore see more bifurcation between winners and losers.

To this point, there are notable catalysts to the downside for next year, particularly if oil prices continue their fall. The Energy sector, for example, remains an unknown. Given its large concentration within the index (15%), the sector has the potential to completely reverse the course of overall migration trends should oil prices stay stubbornly low. Besides affecting investor sentiment, the implications of large scale energy downgrades also include a potential jump in an already high sector concentration, if a portion of the $122bn BBB3 Energy paper were to transition to the HY index. Table 2 contains a list of BBB3 securities from our IG Energy index with at least one rating agency having it on a negative watch or outlook. The total par value of this subset is ~$27bn vs the current $210bn outstanding in our HY Energy index.

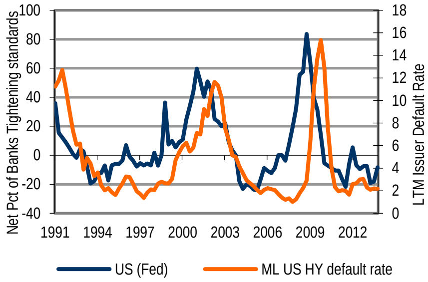
Additionally, if access to capital markets becomes harder for HY issuers as a result of increasing scrutiny surrounding leverage and covenant quality of the deals coming to market, this doesn't bode well for HY issuers. The subsequent deterioration in balance sheet liquidity could also trigger downgrades.

Finally, if consumer spending remains lackluster (see US Economic Watch: A noisy 3-handle), and/or US businesses find it hard to completely decouple from the devolving conditions in Europe, this could bear headwinds for overall issuer credit quality as well.

Bank lending

Lending standards at banks have been consistently loosening for all but one quarter since after the recession, a factor that has been critical to the severely depressed default rates of the last few years (falling through the 1% mark recently). However, the rate at which banks are loosening has been decreasing since 2008, as the pace of recovery is always the highest coming out of a downturn. More recently the Fed Survey has indicated a net 10% lenders loosening their standards compared to the net 20% that were loosening 3 years ago (Chart 3). We believe the momentum is likely to continue to drop as we march towards the end of this credit cycle (and into a new default cycle) and lenders become more cautious of credit worthiness of potential borrowers. Note that while there is no imminent threat of banks completely reversing gear to tighten their standards given the prevailing GDP growth trajectory at a decent 3%, as the effect of QE fades, and issuer credit quality risks come to the fore, banks are likely to rein in lending standards over time. Further, the risk of regulatory reform at banks remains elevated and could ultimately prove to be detrimental to lending. The resurgence of covenant-light loan issuance has already come under scrutiny and tied the hands of capital markets at bigger firms against syndicating highly levered deals. Furthermore with US banks likely to gear their portfolios toward more liquid and less risky assets in order to comply with Basel III LCR rules, they might be incentivized to hold on to their liquid assets rather than provide loans.

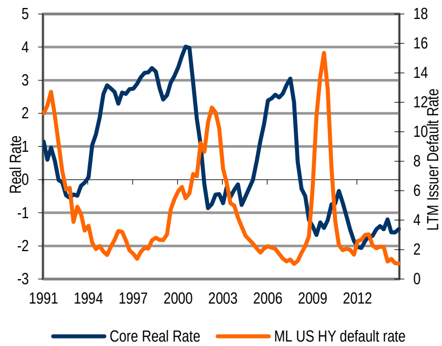
Chart 3: Lending standards vs HY default rate



Source: BofA Merrill Lynch Global Research

In terms of predictive ability, bank lending standards have the highest impact on determining the path of default rates. This is not surprising since this is the most direct way to affect an issuer's liquidity. The looser the standards in making loans to businesses, the better is the business' access to capital, which in turn has a direct impact on their ability to service their debt. Accordingly, our top-down default forecast model is also the most sensitive to this input. We stress here that our call is for defaults to pick up to just 2.5%, not a substantial rate by any measure and still suggestive of strong lending by banks and a healthy overall economy. In fact, this is where some qualitative assessment is important, in our view. Although traditionally the biggest impact to default rates, when discussing such a modest amount of bankruptcies, we think investor willingness to extend credit to already ailing firms is likely the more important factor. As the cycle wears further, however, and the turn becomes more of a "wave", this is when lending standards matter most. As such, we think we're still a couple of years away from being concerned about a tightening of lending standards.

Chart 4: Interest rates vs HY default rate



Source: BofA Merrill Lynch Global Research

Real interest rate

The third and the last factor that affects future defaults is the level of prevailing interest rates. We measure this factor by the core real rate, which is calculated as the difference between the fed funds rate and core CPI inflation. We subtract inflation from the nominal rates and use real rates in predicting default rates because inflation, albeit a controlled amount, actually works in favor of the issuer. As interest rates rise, yields on company debt rise in line with it. Financing for new issuers then likely comes at a higher cost, while existing companies see their coverage ratio decrease absent any improvement in earnings, both of which ultimately lead to a rise in defaults down the road. With the Fed having wound down QE on the back of significant improvements in the underlying growth and employment picture, the first hike in the fed funds rate is widely anticipated to come next year. Further, if the inflation picture remains as benign as at present, the ability of companies to inflate away their debt will remain challenged. Both the components, therefore, are trending towards pushing defaults higher next year.

We note how the rates are trending lower over time, with lower lows and lower highs. However, we think that this shouldn't have an impact on the relationship between interest rates and default rates, and as long as rates move in an upward direction next year, default rates should march higher with them. We also note that interest rates have a slightly longer lead time over default rates compared to bank lending and quality trends. However, changing the time frame used doesn't provide any meaningful advantage[1] in the model's predictive capability, particularly because the extent to which real rates move the needle is relatively low.

Bottom up analysis

In addition to using a top-down approach, we also present our analysis of sectors and issuers that will likely contribute to a higher default rate next year, based on conversations with our fundamental analysts and our strategic views for the economy and the HY market. In scouring through stressed HY issuers, we count about ~15-20 issuers as ones with a higher probability to default than not over the next year. Unsurprisingly, a majority of the credits span the usual suspect sectors—Materials, Retail, Energy and Gaming. These are also the sectors with the worst YTD returns within HY. In our view, it is telling that many of these names could go next year, as it is a sign of investor confidence for the years to come.

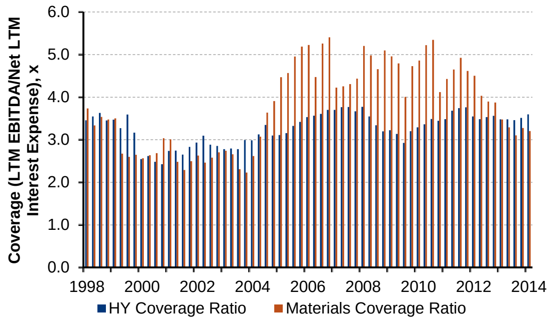
Materials

One of the 3 sectors we entered 2014 with an underweight, the material sector's weak fundamentals have taken a toll on its market performance, making it the 3rd worst performer within the index YTD. The coal subsector faces tough challenges ahead, including but not limited to persistent oversupply in met coal, slowing demand from China for steelmaking and stringent regulatory conditions surrounding thermal coal usage in power plants.

Other miners are also facing headwinds due to the sharp decline in commodity prices amid a supply overhang and signs of slowing demand. The metals and mining sub index has returned -5.1% and contains a handful of companies where liquidity has become a top concern. Top of the list is Walter Energy, whose balance sheet liquidity is worrying (Walter Energy: Liquidity concerns still front and center despite cost cutting), as it is expected to burn through nearly $270mn through 2015 and has about $650mn in liquid assets. Other distressed issuers include Molycorp, Boart Longyear, Alpha Natural and Arch Coal, although the latter two potentially have enough liquidity to weather the storm for longer. Also on the watch-list is Verso Paper, whose fate rests in the outcome of the proposed merger with Newpage.

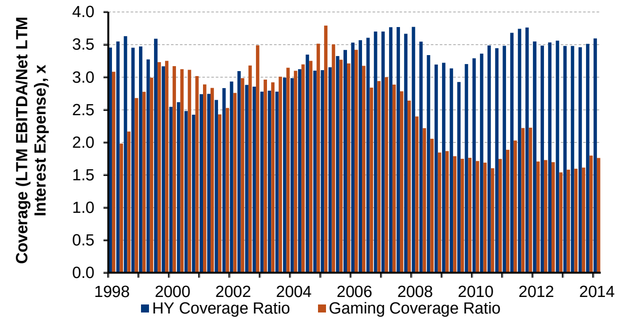
[1] In using a 2-year lead for real rates on default rates in our model, the input's t-stat does improve substantially vs using a 1-year lead as we do for bank lending and quality trends. However, due to a much lower coefficient relative to the other factors, this enhancement doesn't change default rate forecasts in any noticeable way.

Chart 5: Materials coverage ratio dropping vs all HY corps



Source: BofA Merrill Lynch Global Research

Chart 6: Gaming coverage ratio dropping vs all HY corps



Source: BofA Merrill Lynch Global Research

Retail

Retail was the second of our three underweights going into 2014, and we believe it accounts for almost 50% of the names that could default in the near future. The decline in retail spending combined with increased price transparency and a change in consumer spending habits has led to a decline of brick and mortar stores, rendering many capital structures unstable. Companies such as Sears, Radioshack, Quiksilver Inc and American Apparel have been under stress for some time as investors are becoming increasingly concerned about the ability of these declining businesses to continue as going concerns in 2015. Also under pressure are Claire's Stores (Claire's Stores: Not ready to de-Claire a turnaround), Gymboree (Gymboree: Turnaround still in distance) and Toys "R" Us (Toys "R" Us, Inc: 2Q shows stabilization, but recovery still early), which form the next ratchet of companies that could come to a head later in the default cycle.

Gaming and Services

The gaming sector's underperformance can be attributed to the severe decline in CZR's OpCo bonds. In fact, without the -5% decline MTD contributed by CZR, the sector would have been up +1.8%. With a large amount of debt to shoulder and disagreement amongst creditors on the best way forward, the survival of this legacy-LBO capital structure remains questionable come 2016. Within the Services sector, American Seafoods and Altegrity Inc. remain distressed and could have potential liquidity problems on their hands.

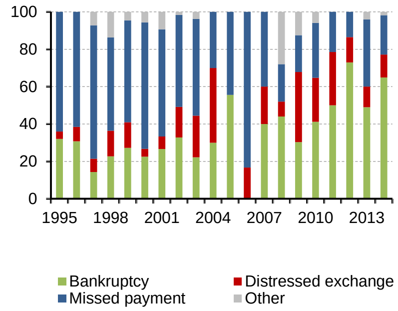
Energy

The third of our three underweights for 2014 was Energy, as we went against the grain with a negative outlook for the sector back in late November 2013. The recent bout of volatility is a reminder of the effect the sector could have on the sentiment of HY investors. In October, Energy was caught in a perfect storm of declining oil prices combined with an oversupply in the offshore oil drilling space, badgering both sides of the demand-supply equation. Within the sector, the issuers of most concern to us include Quicksilver Resources, Venoco, Samson and potentially Hercules Offshore. Some other distressed names—Black Elk Energy and RAAM Global Energy, although not big HY issuers, still pose red flags because of their low liquidity (RAAM), negative free cash flow and impending principal payments in 2015.

The Energy sector is also characterized by a host of first time issuers, many of which have negative free cash flows and some with no prior financial information available, again red flags, in our opinion. Although the bulk of this sector is sheltered from imminent defaults because it requires persistently low commodity prices for a considerable amount of time to default, these statistics are nevertheless worrisome, in our opinion. If there were a prolonged and more intense version of last month's events in the future, we could potentially see a CLEC-like situation, similar to the 2000 credit-cycle (see The HY Wire: The next default wave: Slow and low). Even if defaults don't pick up substantially within Energy, we believe mark-to-market losses could mimic the effect, bringing down portfolio returns next year.

Getting to a 2.5% default rate

Chart 7: Annual defaults by type, %



Source: BofA Merrill Lynch Global Research

Assuming about 15-20 issuers default next year, and the US HY universe stays close to the current 1100 issuers, gives us a default rate of 2%. Here we need to make some qualitative adjustments. We know that because of the 2009 default cycle getting cut short on the back of unprecedented Fed intervention, many companies that would have otherwise gone bankrupt got renewed lifelines. However, the manner in which the life support was provided is also going to affect the number of defaults and the type of recoveries to be expected down the road. For example, we can see from Chart 7 that in the 2009 experience, distressed exchanges were more prevalent than the more traditional defaults attributable to missed payments and bankruptcies in the previous experiences. Further, data from the last credit cycle shows that companies that go through distressed exchanges tend to default subsequently at almost twice the rate as issuers with missed payments. In our sample of 77 default events due to missed payments, and 54 due to distressed exchanges since 2008, 10 and 13 issuers, respectively, have defaulted again. This translates to a repeat default rate of 13% for missed payments and 24% for distressed exchanges, meaning that the higher proportion of distressed exchanges in the 2009 cycle is likely to push the future default rates higher and the recovery rates lower. Throw in a couple of surprises, and we think that a 2.5% rate is a reasonable assessment for 2015.

While on an absolute level a 2.5% default rate does not spell doom by any standard, it is the fact that it is trending up and that the best of times of the credit cycle are behind us that investors should pay attention to. Additionally, we will be the first to admit that the risk to our forecast is to the downside rather than the upside. We do not think that double-digit default rates are likely, barring a recessionary environment, but rather envision a scenario where current distressed firms cause the default rate to rise in 2015 which, when coupled with a rise in Treasury yields, would lead to a retail-driven downturn in high yield bonds and a further unwillingness to lend to stretched corporates in 2016. This combination of events does not freeze capital markets, but rather creates a slow drain of liquidity from corporate issuers that were able to get relatively cheap financing in the last four years.

Par and market value weighted default rates

The above forecast of a 2.5% default rate is issuer weighted. To make a holistic forecast, we also calculate default rates from the standpoints of par and market value. The names we have discussed above represent a total par of $25bn within the HY index, with an additional $16bn on our watch-list. This translates to a 2.4% default rate based on the $1.05tn outstanding notional of the US HY universe and an additional 1.5% if the names from the watch-list are included, for a total of 3.9%. It is worthy to note that should CZR with its $15bn outstanding not default, the base case rate falls to 1%.

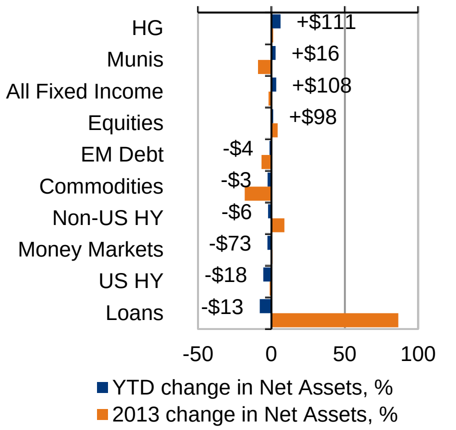
Par default rates, however, do not provide an accurate assessment of the potential for losses, as distressed names already trade at discounted levels. As such an investor doesn't really stand to lose par should a distressed name default. To get around this issue, we have also calculated a market value default rate, which denotes the proportion of current market value of the index that we are forecasting could default next year. This measure currently stands at 1.5%, with a potential to go up to 2.6% should the watch-list be included.

Flows

This is an excerpt from our recently published: The High Yield Flow Report: All treats and no tricks 30 October 2014

Last week nearly all asset classes reported inflows. Global high yield funds saw an inflow of about $2.9bn, the best one-week gain the asset class has seen since mid-August. The inflow was driven almost equally between US and non-US funds as the former saw +$1.5bn and the latter saw +$1.4bn. Within the US, however, mutual funds were the sole contributor to the inflows with a gain of $1.7bn, while ETFs reported outflows to the tune of $219mn.

Chart 8: Annual flows by asset class

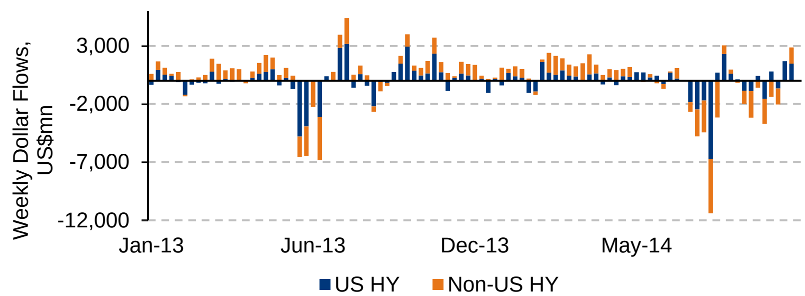


Source: BofA Merrill Lynch Global Research, EPFR Global

Despite the strong showing from high yield funds, equity funds and investment grade funds still saw greater inflows. Equities added nearly $14bn while IG funds added $3.2bn. This marks the 41st week of consecutive inflows for US IG funds. EM bond funds reported a gain of $269mn as hard currency funds added $184mn, blended currency funds added $193mn, and local currency funds lost $107mn.

Other flow activity last week includes inflows into munis (+$99mn), outflows from commodities (-$149mn), and outflows from loans (-$382mn).

Chart 9: Global HY flows distributed between US-domiciled and non US-domiciled funds



Source: BofA Merrill Lynch Global Research, EPFR Global

New Issue Roundup

Bonds

Global high yield issuance was similar to last week as 7 new deals for a total of $6.1bn came to market. $5.3bn came from the US and $0.8bn came from Europe. Of the $6.1bn issued last week, $1.6bn was rated BB and $4.5bn was B. Month-to-date, we have seen a total of $26.7bn come to market in October. Year-to-date we now stand at $336.0bn, only slightly ahead of last year's pace. For comparison, last year at this time we had seen $331.7bn of issuance globally. Europe is about $33bn ahead of last year's pace, while the US is about $31bn behind.

Table 3: Global issuance over time ($bn)

	Global	United States	Europe	BB	B	CCC/NR
WTD Oct 31	6.1	5.3	0.8	1.6	4.5	0.0
Wk Oct 24	6.5	4.0	2.6	4.8	1.7	0.0
Wk Oct 17	0.5	0.0	0.0	0.5	0.0	0.0
Wk Oct 10	12.0	9.7	1.3	3.4	7.4	1.2
MTD Oct	26.7	19.3	5.9	10.5	15.1	1.2
September	42.1	32.4	5.5	22.2	12.0	7.9
August	4.7	2.5	1.7	0.0	2.5	2.1
July	34.0	24.9	8.8	6.9	20.7	6.4
YTD 2014	336.0	205.4	114.7	112.1	168.0	55.9
YTD 2013	331.7	236.0	81.3	116.4	148.7	66.6
2013	378.3	270.3	91.5	128.8	172.4	77.2
2012	365.7	280.5	65.5	103.6	198.3	63.8
2011	257.4	189.3	57.2	80.4	131.9	45.1

Source: BofA Merrill Lynch Global Research

A further analysis shows that about 26% of new issues were rated BB, while 74% were B. In terms of seniority, 95% of new issues were senior unsecured last week, while the remaining 5% were secured. Finally, about 57% of deals last week were public offerings while 43% were private placements. This is unusual, as private placements have consistently outpaced public deals all year.

Table 4: New issues breakdown by week, last 3 months

		Ratings				Currency (US$mn equivalents)				Seniority			Deal Type		
	Total	BB	B	CCC	NR	USD	EUR	GBP	CAD	Secured	Senior	Sub	144a w RR	144a w/o RR	Public
07/18/2014	6,901	804	2,845	3,251		5,215	1,569		116	1,861	4,701	338	2,384	4,217	300
07/25/2014	6,362	2,554	1,847	1,051	910	4,255	1,071	1,037		2,157	4,205		1,592	3,666	1,104
08/01/2014	7,623	1,350	5,447	825		5,465	1,888			2,427	5,195		3,045	3,977	600
08/08/2014	2,020		655	950	415	2,020				855	1,165		715	1,305	
08/15/2014	975		800	175		975				175	800		475	500	
08/22/2014															
09/05/2014	11,565	8,050	2,650	865		11,565				750	10,815		3,815	1,425	6,325
09/12/2014	12,168	7,535	2,652	1,730	250	10,680	840	648		500	11,668		6,252	3,948	1,967
09/19/2014	6,377	2,350	2,022	2,005		5,855	386		136	766	5,611		2,200	3,777	400
09/26/2014	10,957	4,300	3,657	3,000		9,700	338	919		3,127	7,830		2,963	4,044	3,950
10/03/2014	2,700	150	2,550			2,700					2,700		1,300	1,250	150
10/10/2014	11,970	3,400	7,395	275	900	11,970				4,145	7,825		5,300	4,670	2,000
10/17/2014	500	500				500					500			500	
10/24/2014	6,509	4,800	1,709			6,000	509			1,709	4,800		4,445	1,013	1,050
10/31/2014	6,083	1,600	4,483			5,800	283			283	5,800		700	1,883	3,500

Source: BofA Merrill Lynch Global Research

At the single name level, the largest last week was the $3.5bn two-tranche offering from CCOH Safari LLC, a special purpose entity under Charter Communications. The first tranche pays a 5.75% coupon and matures in 2024 while the second tranche pays a 5.5% coupon and matures in 2022. The notes were issued to help acquire some of Comcast Corp's cable subscribers, which was part of the Comcast-TWC merger agreement. The proceeds from the offering will remain in escrow until the deal closes. Other large deals last week include the $1.1bn notes from Building Materials Corporation of America and the $900mn two-part offering from Fresenius Medical Care.

Table 5: New issues October 24th – October 30th

Pricing Dt	Name	Size ($)	Snr	Cpn	Maturity	Price	Yield	Moody's	S&P	Type	Sector	Region
10/30/2014	Arrow Global Finance plc	283	Sr Sec Nts	525.00	1-Nov-21	97.50	5.77	B1	BB-	144A for Life	Diversified Finan Serv	Europe
10/29/2014	Huntsman International LLC	400	Sr Nts	5.13	15-Nov-22	100.00	5.13	B1	B+	144A w/RR	Chemicals	United States
10/29/2014	CCOH Safari, LLC	2000	Sr Nts	5.75	1-Dec-24	100.00	5.75	B1	B+	SEC	Media	United States
10/29/2014	CCOH Safari, LLC	1500	Sr Nts	5.50	1-Dec-22	100.00	5.50	B1	B+	SEC	Media	United States
10/28/2014	Jaguar Land Rover Automotive plc	500	Sr Nts	4.25	15-Nov-19	100.00	4.25	Ba2	BB	144A for Life	Auto Manufacturers	Europe
10/27/2014	Carrizo Oil & Gas Inc	300	Sr Nts	7.50	15-Sep-20	100.50	7.35	B2	B	144A w/RR	Oil&Gas	United States
10/27/2014	Building Materials Corporation of America	1100	Sr Nts	5.38	15-Nov-24	100.00	5.38	Ba2	BB+	144A for Life	Building Materials	United States
10/24/2014	Fresenius Medical Care US Finance II, Inc.	400	Sr Nts	4.75	15-Oct-24	100.00	4.75	Ba2	BB+	144A for Life	Healthcare-Services	Europe
10/24/2014	Fresenius Medical Care US Finance II, Inc.	500	Sr Nts	4.13	15-Oct-20	100.00	4.13		BB+	144A for Life	Healthcare-Services	Europe

Source: BofA Merrill Lynch Global Research

Loans

Global loan issuance was not particularly strong last week, as only $2.5bn was priced. Most of the new supply, about $1.1bn, was CCC or not rated, while $0.5bn was BB-rated and $0.9bn was B-rated. Cov-lite issuance totaled $1.0bn and 2nd lien issuance totaled only $0.3bn. Month-to-date, we've seen a total of $16.8bn come to market while year-to-date we have seen a total of $350.1bn. Last year at this time, we had already seen $400.5bn of new loan supply.

Table 6: Global loan issuance over time ($bn)

	Global	BB	B	CCC/NR	Cov lite	2nd lien
WTD Oct 31	2.5	0.5	0.9	1.1	1.0	0.3
Wk Oct 24	2.8	1.1	0.8	0.9	1.3	0.4
Wk Oct 17	2.5	0.0	2.3	0.2	1.4	0.2
Wk Oct 10	8.3	4.3	3.5	0.5	5.2	0.9
MTD Oct	16.8	5.8	7.9	3.1	9.5	1.7
September	42.1	13.9	24.8	3.4	33.2	3.2
August	7.1	0.7	6.0	0.4	3.5	0.1
July	42.8	13.5	23.8	5.5	30.6	4.8
YTD 2014	350.1	103.4	197.7	48.9	247.9	34.1
YTD 2013	400.5	133.2	232.5	34.7	247.8	24.5
2013	454.9	152.8	261.7	40.4	279.1	28.9
2012	295.3	105.0	161.9	28.4	97.5	17.2
2011	231.8	94.3	117.8	19.8	59.1	7.0

Source: BofA Merrill Lynch Global Research

Breaking last week's new supply down further, about 36% of new issues were not rated, 37% were B-rated, 19% were BB-rated, and 8% were CCC-rated. Cov-lite issuance made up about 40% of new supply last week while about 89% of new issuance was term-loan B and about 11% was 2nd lien.

Table 7: New issue breakdown by week, last 3 months

		Ratings						
	Total	BB	B	CCC	NR	TLb	2nd Lien	Cov Lite
07/25/2014	6,226	630	4,766	190	640	5,741	485	4,441
08/01/2014	14,059	8,509	4,660	442	448	13,617	442	8,491
08/08/2014	5,638	720	4,673	80	165	5,558	80	2,240
08/15/2014	100				100	100		
08/22/2014	25				25	25		
08/29/2014								
09/05/2014	6,578	3,188	3,090	245	55	5,728	850	6,203
09/12/2014	11,208	2,000	8,136	645	427	10,318	890	7,598
09/19/2014	16,628	4,740	10,338	625	925	15,728	900	13,175
09/26/2014	3,065	2,100	705	140	120	2,925	140	1,895
10/03/2014	5,362	1,905	2,857	200	400	4,902	460	5,022
10/10/2014	8,253	4,275	3,473	305	200	7,398	855	5,170

Table 7: New issue breakdown by week, last 3 months

	Total	Ratings BB	B	CCC	NR	TLb	2nd Lien	Cov Lite
10/17/2014	2,533	25	2,278	230		2,303	230	1,350
10/24/2014	2,774	1,050	828	359	538	2,415	359	1,341
10/31/2014	2,523	480	938	190	915	2,243	280	1,000

Source: BofA Merrill Lynch Global Research

At the single-name level, the largest deal last week was the $520mn offering from Tecomet Inc. The deal is cov-lite and priced to yield 450bps above Libor. Proceeds from the deal are going to be used to acquire Symmetry Medical Inc's OEM business and refinance existing debt. Other large loan deals last week include the $480mn offering from Southeast PowerGen and the $475mn offering from Panda Stonewall.

Table 8: Top 10 largest new issues, October 24th – October 30th

Launch Dt	Issuer	Deal Name	Deal Size ($)	New Institutional Money ($)	Moody's	S&P	Asset Backed	Cov Lite	Proceeds	Sector	Region
10/29/2014	Tecomet Inc	Tecomet (TL 11/14)	520	520	B2	NR	No	Yes	Acquisition	Healthcare	United States
10/28/2014	Southeast PowerGen	Southeast PowerGen (11/14)	551	480	Ba2	BB	No	No	LBO	Utilities	United States
10/29/2014	Panda Stonewall	Panda Stonewall (11/14)	475	475	NR	NR	No	No	Project Financing	Utilities	United States
10/24/2014	Media General Inc	Media General (Add-on TLb 11/14)	325	325	Ba3	BB-	No	No	Acquisition	TV	United States
10/29/2014	Express Energy Services LP	Express Energy (TL 11/14)	220	220	B3	NR	No	No	LBO	Oil & Gas	United States
10/30/2014	NAVEX Global	NAVEX Global (TL 11/14)	200	200	NR	NR	No	Yes	LBO	Computers & Electronics	United States
10/29/2014	Tecomet Inc	Tecomet (2nd Lien 11/14)	190	190	Caa2	NR	No	Yes	Acquisition	Healthcare	United States
10/27/2014	Abaco Energy Technology	Abaco Energy (11/14)	200	175	B3	B	No	No	LBO	Services & Leasing	United States
10/30/2014	US LBM Holdings LLC	US LBM (Add-on 11/14)	150	150	NR	NR	No	No	Acquisition	Building Materials	United States
10/24/2014	Novetta Solutions LLC	Novetta Solutions (11/14)	165	140	NR	NR	No	No	Acquisition	Computers & Electronics	United States

Source: BofA Merrill Lynch Global Research

Performance Summary

Returns were scattered last week as risk assets tended to outperform. The best one-week performer was EM equities, which gained 2.63%. US equities, as represented by the S&P, were the second-best performers with a return of +2.25%. High yield assets were a little more mixed—EM high yield added 1.01% and European high yield added 0.13%, though US high yield declined 0.04%. The CDX HY index was the second worst performer with a drop of 0.23%. Leveraged loans saw moderate gains with a +0.28% return. Finally, Treasuries posted the weakest performance last week with a loss of 0.35% (Table 9).

Within the US, rating performance was also very scattered. AAAs (+0.7%) and BBs (+0.8%) each gained, while all other rating buckets declined. The weakest bucket was CCCs, which dropped 0.25% (Table 7).

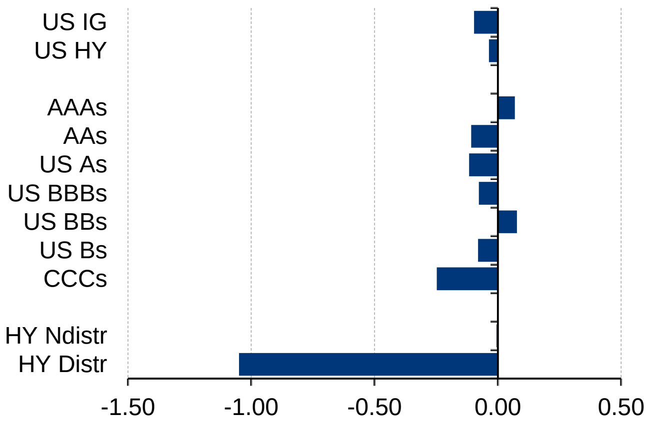
On sectors, performance was varied with 13 out of 18 high yield sectors gaining on the week. Transportation led, adding 0.30%, followed by Financials (+0.19%) and Real Estate (+0.18%), while Energy (-0.80%) Gaming (-0.27%), and Retail (-0.23%) underperformed (Chart 11).

Table 9: Total returns across asset classes

Ticker	Name	WTD (%)	MTD (%)	YTD (%)
GA05	5yr TRSY	-0.35	1.11	2.90
CDXHY	CDX.HY	-0.23	1.47	2.24
C0A0	US IG	-0.10	1.07	7.13
M0A0	Mortgages	-0.04	1.00	5.25
H0A0	US HY	-0.04	1.03	4.67
CDXIG	CDX.IG	-0.02	0.38	1.31
U0A0	Municipals	0.00	0.71	9.11
G0QI	TIPs	0.01	1.14	5.38
HE00	EU HY	0.13	0.06	4.77
EMIB	EM IG	0.14	1.05	7.18
LCDI/ALL	Lev Loans	0.28	0.13	2.24
EMGB	EM Govts	0.56	1.53	9.47
EMHB	EM HY	1.01	0.29	5.39
SPX	S&P 500	2.25	1.13	7.91
MXEF	EM Eqty	2.63	0.22	0.49

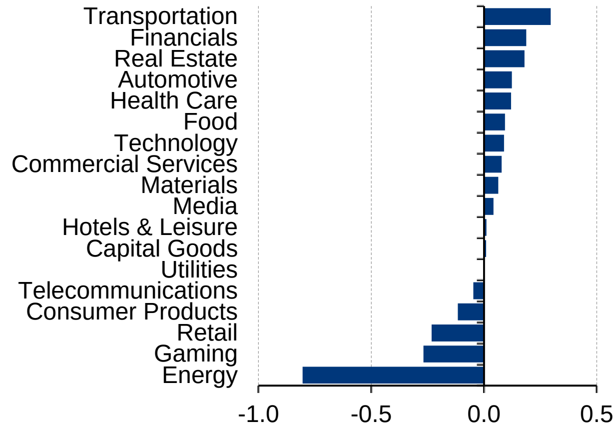
Source: BofA Merrill Lynch Global Research

Chart 10: Segment and rating returns, week-to-date



Source: BofA Merrill Lynch Global Research

Chart 11: Sector returns, week-to-date



Source: BofA Merrill Lynch Global Research

Last week's top performers were dominated by Cliffs Natural Resources, which took the first three and the fifth spots (Table 10). The 4.875's (+7.5%), 5.9's (+6.3%), 4.8's (+6.2%), and 6.25's (+2.8%) each gained on a strong Q3 earnings beat and an optimistic earnings call. Other leading performers last week include the Gymboree 9.125's (+3.1%), and the Acco Brands 6.75's (+1.6%).

Table 10: Top 10 performers October 23rd – October 30th

Issue	Rating	Price	Yield (%)	ZSpread	Px Change	Px Change (%)	Volume
CLF 4.88 '21	BB1	76.17	10.00	804	5.3	7.5	113
CLF 5.9 '20	BB1	80.90	10.67	891	4.8	6.3	41
CLF 4.8 '20	BB1	76.25	10.26	838	4.4	6.2	30
GYMB 9.13 '18	CCC3	33.19	47.75	4635	1.0	3.1	12
CLF 6.25 '40	BB1	68.94	9.49	678	1.9	2.8	94
ACCO 6.75 '20	BB3	106.45	5.12	359	1.7	1.6	14
RRD 6 '24	BB3	100.93	5.87	356	1.6	1.6	8
AFFINI 7.88 '18	CCC3	79.09	14.85	1340	1.2	1.5	42
NCR 4.63 '21	BB3	99.40	4.74	278	1.5	1.5	5
TRIBAL 9.75 '21	CCC1	103.17	8.92	717	1.2	1.2	9

Source: BofA Merrill Lynch Global Research

Bottom performers last week were primarily energy names (E&P specifically), though the worst performer was a metals and mining company (Table 11). The leading laggard was the Alpha Natural Resources 6.25's, which declined 12.7% from the low price basis of 46.19. Nonetheless, E&P names in the bottom 10 included Samson Investment Co (-6.3%), Midstates Petroleum 9.25's (-6.0%), and Halcon Resources 9.75's (-5.2%), among others.

Table 11: Bottom 10 performers October 23rd – October 30th

Issue	Rating	Price	Yield (%)	ZSpread	Px Change	Px Change (%)	Volume
ANR 6.25 '21	CCC1	46.19	22.18	2027	-6.7	-12.7	10
CZR 10 '18	C	15.16	89.90	8868	-2.1	-12.2	19
SAIVST 9.75 '20	CCC1	75.46	16.95	1525	-5.1	-6.3	26
MPO 9.25 '21	CCC1	86.11	12.40	1050	-5.5	-6.0	16
ANR 9.75 '18	CCC1	64.54	25.91	2468	-3.6	-5.3	9
HKUS 9.75 '20	CCC1	85.39	13.50	1174	-4.7	-5.2	15
ACI 7.25 '21	CCC2	37.81	28.76	2692	-1.9	-4.7	25
SD 7.5 '23	B3	90.92	9.08	693	-4.4	-4.6	17
EXXI 7.5 '21	B3	84.05	10.76	876	-3.3	-3.8	11
SD 8.13 '22	B3	93.37	9.32	722	-3.4	-3.5	16

Source: BofA Merrill Lynch Global Research

Rating Actions

Last week we saw a relatively small amount of ratings actions on high yield issuers, with upgrades largely outpacing downgrades, four initiations, and six drops. The most notable upgrade last week was Moody's lifting of First Industrial LP's senior unsecured debt to investment grade (from Ba1 to Baa3). The ratings agency cited the company's improving credit profile, which is supported by lower leverage levels and strengthening fixed charge coverage as the reason for the upgrade. Moody's also raised Level 3 Communication's unsecured debt from Caa2 to Caa1 last week in response to the company's acquisition of TW Telecom Inc. Other names that stand out include S&P's lifting of Sanmina Corp from BB- to BB and Moody's raising of Building Materials Corp of America from Ba3 to Ba2.

On downgrades, we only saw one last week as S&P lowered Cannery Casino Resorts from B to B-. S&P's rationale is based on their belief that the company's operating performance will continue to deteriorate, increasing the likelihood of a covenant violation.

Finally, we saw a sizeable amount of initiations and drops. Notably, S&P withdrew its ratings on Metaldyne due to the completion of a merger-related refinancing. The ratings agency also withdrew coverage of CAP-CON Automotive Technologies, Vantage Pipeline, and The Great Atlantic & Pacific Tea Co Inc, among others.

Table 12: Ratings actions on high yield issuers

Date	Action	Company Name	Rating Type	Agency	Curr Rtg	Last Rtg
10/24/2014	Upgraded	Harron Communications LP	LT Local Issuer Credit	S&P	BB-	B+
10/27/2014	Upgraded	Building Materials Corp of America	Senior Unsecured Debt	Moody's	Ba2	Ba3
10/29/2014	Upgraded	First Industrial LP	Senior Unsecured Debt	Moody's	Baa3	Ba1
10/29/2014	Upgraded	Health Net Inc/CA	Senior Unsecured Debt	Moody's	Ba2	Ba3
10/29/2014	Upgraded	Level 3 Communications Inc	Senior Unsecured Debt	Moody's	Caa1	Caa2 *+
10/30/2014	Upgraded	Sanmina Corp	LT Local Issuer Credit	S&P	BB	BB-
10/27/2014	Initiated	Abaco Energy Technologies LLC	LT Local Issuer Credit	S&P	B-	
10/28/2014	Initiated	Media General Financing Sub Inc	Senior Unsecured Debt	Moody's	B3	
10/29/2014	Initiated	Express Energy Services LLC	LT Local Issuer Credit	S&P	B	
10/29/2014	Initiated	Tecomet Inc	LT Local Issuer Credit	S&P	B	
10/29/2014	Downgraded	Cannery Casino Resorts LLC	LT Local Issuer Credit	S&P	B-	B
10/28/2014	Dropped	CAP-CON Automotive Technologies Inc	LT Local Issuer Credit	S&P	NR	B+
10/28/2014	Dropped	Metaldyne Corp	LT Local Issuer Credit	S&P	NR	B+
10/28/2014	Dropped	Metaldyne LLC	LT Local Issuer Credit	S&P	NR	B+
10/28/2014	Dropped	Vantage Pipeline US LP	LT Local Issuer Credit	S&P	NR	BB-
10/29/2014	Dropped	Great Atlantic & Pacific Tea Co Inc/The	LT Local Issuer Credit	S&P	NR	CCC
10/30/2014	Dropped	Astoria Generating Co Acquisitions LLC	LT Local Issuer Credit	S&P	NR	B

Source: BofA Merrill Lynch Global Research

Relative Value

Cash v. CDS

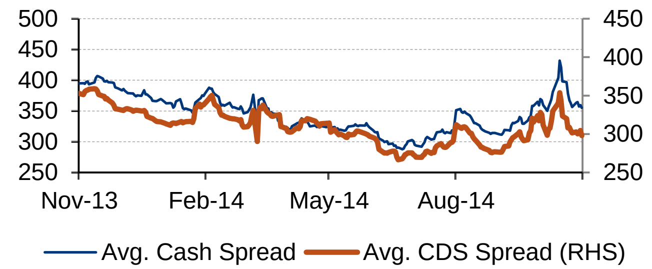
The high yield cash index tightened more than CDX HY over the week (Table 13). While CDX HY tightened by 2bps, our high yield cash index was 8bps tighter. For IG, the cash index's spreads were unchanged over the week while CDX IG tightened 1bps. The average cash-CDS basis for the CDX HY issuers we track became more negative (Chart 13). The average basis now stands at -57bps, about 2bps wider over the week.

Table 13: CDX vs. ML Cash Indices

Index	Spread	1W-Chng	1M-Chng	3M-Chng
CDX IG	64	-1	-9	-11
HG Cash	127	0	7	17
CDX HY	344	-2	-36	-37
HY Cash	430	-8	-10	26

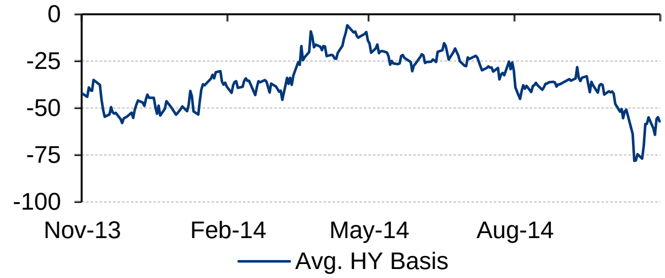
Source: BofA Merrill Lynch Global Research, 5y spreads for CDX, OAS for cash

Chart 12: Average cash and CDS spreads for CDX HY issuers



Source: BofA Merrill Lynch Global Research, Average spreads for a selection of issuers in the On The Run CDX HY index. Currently includes 82 HY20 constituents.

Chart 13: Average cash-CDS basis for CDX HY issuers



Source: BofA Merrill Lynch Global Research, Average basis for a selection of issuers in the On The Run CDX HY index. Currently includes 82 HY20 constituents.

CDS Indices

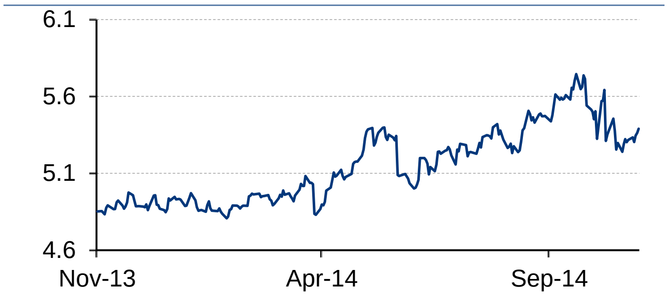
CDS indices were all tighter on the week (Table 14) except for iTraxx XO. CDX HY 23 and iTraxx Main each tightened 2bps, while CDX IG tightened 1bps. iTraxx XO widened 5bps. The spread ratio between HY and IG is now 5.39, a bit higher than last week's ratio of 5.32 (Chart 14). The XO-HY spread differential is now 12bps, 7bps wider than last week's differential (Chart 15).

Table 14: CDS Indices – spread, intrinsic and skew

Index	5y Spread	1W-Chng	1M-Chng	3M-Chng	5y Intrinsic	1W-Chng	1M-Chng	3M-Chng	Skew	1W-Chng	1M-Chng	3M-Chng
CDX IG	64	-1	-9	-11	72	-1	-3	-1	-8	0	-6	-10
CDX HY	344	-2	-36	-37	343	-3	-20	-1	1	2	-16	-36
iTraxx Main	65	-2	-7	-11	69	0	0	-4	-3	-1	-7	-8
iTraxx XO	356	5	-19	-37	354	1	-5	-9	1	4	-14	-27

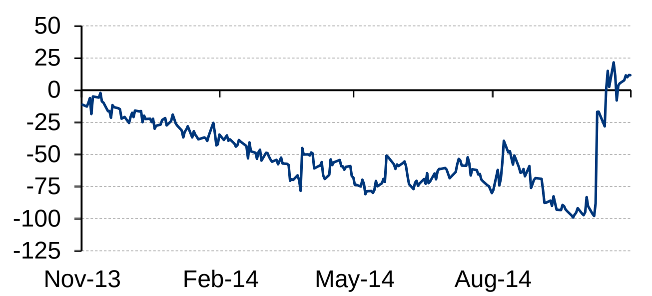
Source: BofA Merrill Lynch Global Research

Chart 14: HY/IG



Source: BofA Merrill Lynch Global Research

Chart 15: XO-HY

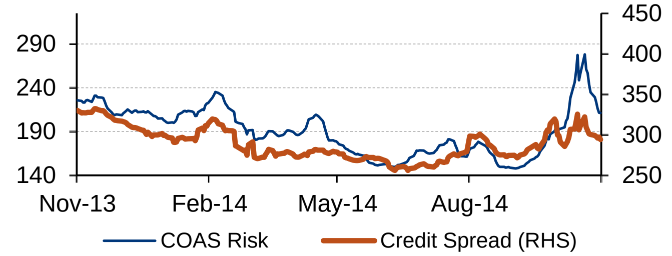


Source: BofA Merrill Lynch Global Research

Credit v. Equities

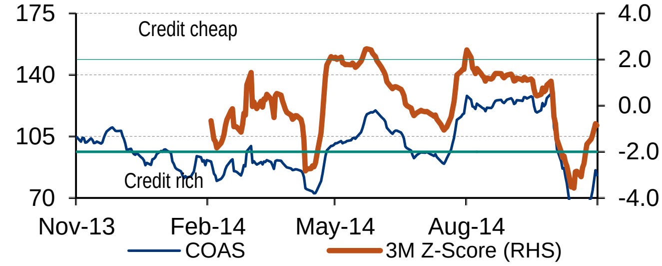
Average spread for our HY universe tightened 6bps compared to a 24bps decline in the equity implied credit risk (Chart 16). The US HY COAS value increased from 66 to 83 over the week and its 3m z-score is now at -0.85, indicating that credit screens slightly rich relative to equities (Chart 17).

Chart 16: US HY COAS Risk vs. Spread



Source: BofA Merrill Lynch Global Research

Chart 17: US HY COAS & Z-Score



Source: BofA Merrill Lynch Global Research

CLOs

Market View

This is an excerpt from our recently published: CLO Weekly: Where do CLOs stack up? 31 October 2014

US secondary activity picked up this week, with BWIC volumes increasing to about $830mn tilted slightly towards 2.0/3.0 deals. Over half of this week's line items were from tranches with AAA original ratings. We have begun to see a basis of 5-10bp develop between Volcker-compliant and non-compliant deals. About $200mn worth of equity line items also came to the market, although the majority did not end up trading.

In Europe, secondary market supply was focussed on 1.0 mezzanine and 2.0 equity this week, with a total of around €100mn appearing on BWICs. Spreads appeared to soften on the debt tranches, retracing some of the gains from the previous week. This is in line with broader credit markets, with iTraxx XOver widening from 350 on 24-Oct-14 to 364 on 30-Oct-14, for example, having tightened the previous week from 374. 2.0 equity also traded relatively weakly, with estimated IRRs of around 11-12%, compared to around 9% a few weeks ago.

Primary activity remained elevated this week in the US with five new deals priced including Anchorage's $523mn 2014-2, Covenant Credit Partners' $525mn CLO II, Marathon's $461mn Marathon CLO VII, Telos' $360mn 2014-6 and Onex's $514mn OCP CLO. No pricing details were provided for these deals. Year-to-date, over $103.7bn worth of broadly syndicated and middle-market CLO deals have priced. We look for about $120-130bn of issuance in the US by year-end, although some of this supply may leak into 2015.

In Europe, ALME Loan Funding III priced from Apollo, with coupon spreads on the floating rate tranches pricing at E+123, 200, 265, 345, 545 and 655bps over Euribor, respectively, for the AAA to single B tranches. The deal also included fixed rate AAA and AA tranches, which priced with coupons of 1.711% and 2.654%, respectively. The €411mn deal takes YTD issuance to €12.0bn for European CLOs, reaching our initial target for the year with two months to spare. With a handful of deals still in the pipeline, we expect to see some of these emerge before year-end, most likely taking total issuance to €13-14bn.

Convertibles

October proved to be somewhat of a reprieve from September's calamity for global markets as returns were generally positive across asset classes. Growth expectations were hampered as the IMF cut its global growth forecast for 2015 amid ongoing geopolitical tension and frothy equity markets and Germany reduced its 2014 and 2015 growth estimates, while US economic data varied.

September payrolls beat expectations, although ISM manufacturing and factory orders both came in below analyst expectations. Perhaps the most prominent theme during October was the rapid decline of oil prices to multi-year lows due to a global supply glut. The International Energy Agency issued a report indicating that oil demand will expand at the slowest pace since 2009, although OPEC is expanding its output to maintain its market share. All the while, fears of spreading Ebola spooked markets. Despite the gloomy tone, markets benefitted from strong US corporate earnings, improved Eurozone manufacturing activity, and a rebound in Chinese industrial production. As such, global convertibles gained 0.93% USD in October, relative to a 0.73% USD gain for global equities. High yield added 0.61% USD, IG gained 0.37% USD, and government bonds fell 0.17% USD. Year-to-date, global converts have maintained a 3.43% USD return, only behind equities (+4.92% USD) and investment grade bonds (+3.68% USD).

Table 15: Global performance on a USD basis

	Global		US		Europe		Asia		Japan	
	YTD	Oct '14	YTD	Oct '14	YTD	Oct '14	YTD	Oct '14	YTD	Oct '14
Govt	1.2%	-0.2%	4.8%	1.1%	0.4%	-0.5%	9.1%	1.9%	-3.8%	-1.7%
IG	3.7%	0.4%	7.0%	0.9%	-2.5%	-0.4%	7.5%	0.9%	-5.0%	-1.9%
HY	3.0%	0.6%	4.8%	1.1%	-4.6%	-0.7%	7.5%	0.7%	--	--
Equity	4.9%	0.7%	11.0%	2.4%	-4.4%	-2.5%	6.7%	2.7%	-3.9%	-4.4%
Converts	3.4%	0.9%	9.3%	1.5%	-8.2%	-1.1%	3.1%	0.1%	-4.3%	-1.2%

Source: BofA Merrill Lynch Global Research

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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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