Sector Selections

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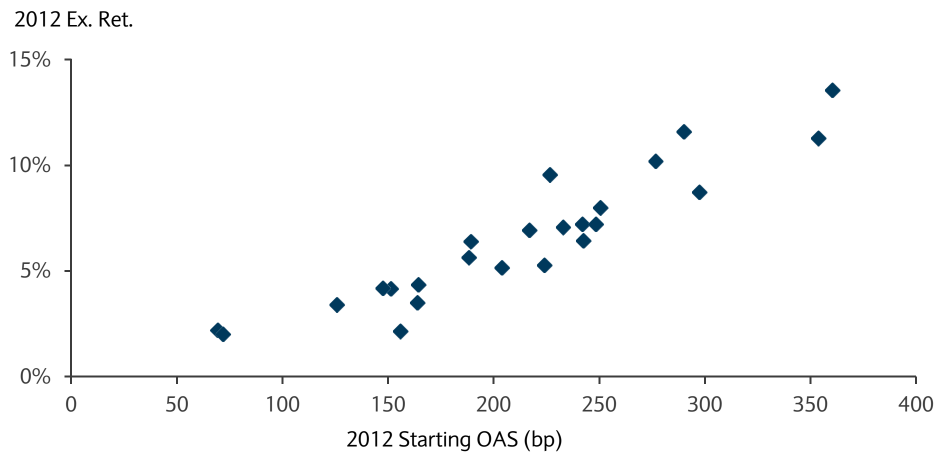
With relative value strategies likely to increase in importance (versus macro calls) in 2013, we view sector selection as a way for fund managers to differentiate their performance. Historically, starting spread has explained much of sector performance, especially in up years for the market. Of the five-widest sectors as we start the year, three – supermarkets, life insurance, and oilfield services – are rated Overweight by our fundamental team, making a strong case for them to be among 2013's best performers.

With macro risks from Europe abating and a positive outlook for U.S. economic growth, we expect relative value strategies to increase in importance versus macro calls in 2013. In that context, one way that fund managers should seek to generate alpha is sector selection. At the industry level, annual performance is strongly related to spread at the beginning of the year (Figure 1). Since the start of 2009, for example, starting spread explains almost 80% of sector-level excess return. The effect is strongest in the best years for credit markets, suggesting a simple explanation: higher beta sectors, which typically have comparatively wide spreads reflecting their greater risks, outperform when the market as a whole rises.

The relationship held in 2012, with the highest excess returns seen in the sectors that opened the year with the widest spreads. The top-performing sectors were life insurance (started 2013 as fourth widest sector), non-captive consumer finance (started as the widest), home construction (started as third widest), banking (started as fifth widest), and refining (started as tenth widest).

FIGURE 1

Sector-Level Performance Is Strongly Correlated to the Sector's Starting Spread



Source: Barclays Research

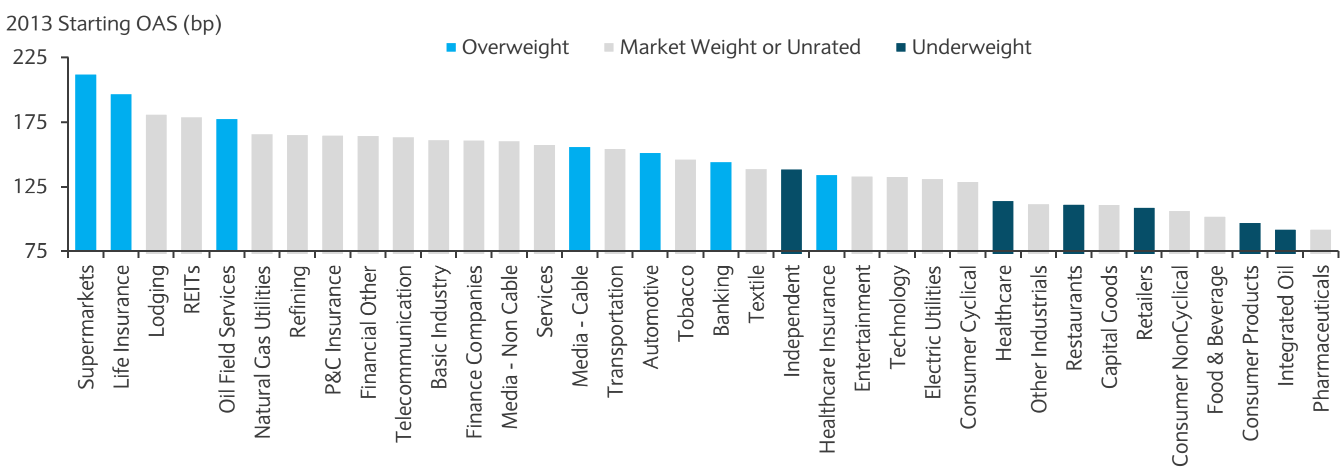
In 2013, we expect tightening of overall credit spreads (Global Credit Outlook 2013: A good bond is hard to find, December 2012) to drive positive excess returns for U.S. corporate credit. If that happens, we should once again see the strongest performances from the widest-trading sectors (Figure 2). Indeed, of the current five widest-trading sectors – supermarkets, life insurance, lodging, REITs, and oilfield services – three are rated Overweight by our fundamental analysts:

- Supermarkets are rated an Overweight sector by retail analyst Priya Ohri-Gupta. In her view, a perfect storm of negative sentiment, combined with weaker profitability and idiosyncratic issues at some constituents, drove widening to previously unobserved levels. She sees a modest, but consistent, performance in 2012 as enough to support sector outperformance. See *Grocers: Carry into the New Year*, December 6, 2012, for further details.

- Life insurance is rated Overweight by insurance analyst Tom Walsh. He views sector performance as tied to the performance of higher-beta names and sees value in Genworth Financial Inc. (GNW, OW), American International Group Inc. (AIG, OW), and Prudential Financial Inc. (PRU, OW), three companies whose outperformance contributed to the industry's strong performance in 2012. See *Insurance Perspectives: How to Get It Right in 2013*, December 13, 2012, for further details.
- While investment grade lodging is not rated by our fundamental team, the sector has grown over the past year, with new issuance by Carnival (rated A3/BBB+), and Starwood entering the index as a rising star. As a subsector of consumer cyclicals, continued U.S. economic growth and general credit market tightening should be positive for the sector.
- The REITs sector is rated Market Weight by analyst Danish Agboatwala. Positives include relatively wide starting spreads (versus other sectors), constructive fundamentals, and demand technicals that create an opportunity for the sector to outperform in 2013 (as it has in each of the past several years). There are also reasons to be cautious, however, as valuations are already at multi-year tights versus indices, and the sector is susceptible to strong underperformance if macro risks flare or funding markets become more difficult. See *U.S. REIT Credit: Top Ideas and 2013 Outlook*, December 21, 2012, for details.
- Oilfield services is rated Overweight by energy analyst Harry Mateer. We expect outperformance as the sector works through a transition period in 2013. Oil-rig count should rise, and higher natural gas prices should also support the sector. In addition, we expect capital spending to be unchanged in North America and rise internationally. See the *Commodity Credit Outlook 2013: After the Boom*, December 19, 2012, for details.

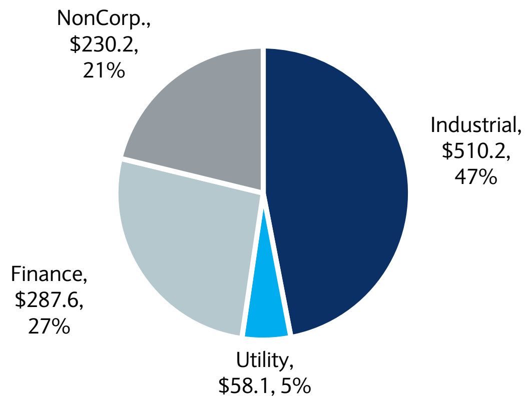
FIGURE 2

Wider Spreads Sectors Have More Overweights; Tighter Spread Sectors Have More Underweights



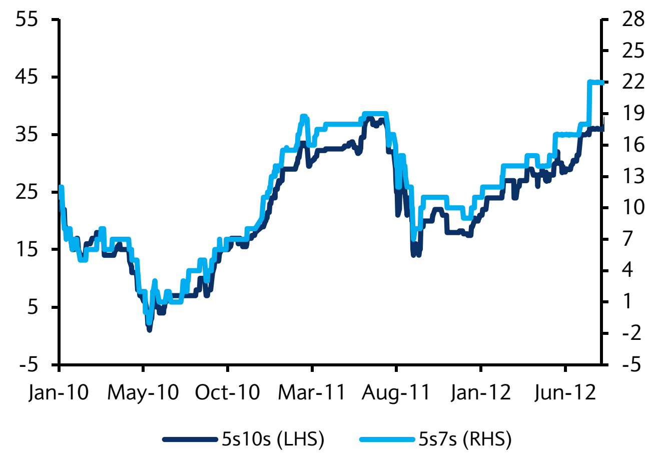
Note: Sectors with fewer than three issuers are omitted. Source: Barclays Research

Year-to-Date 2012 Fixed Investment Grade Supply ($bn)



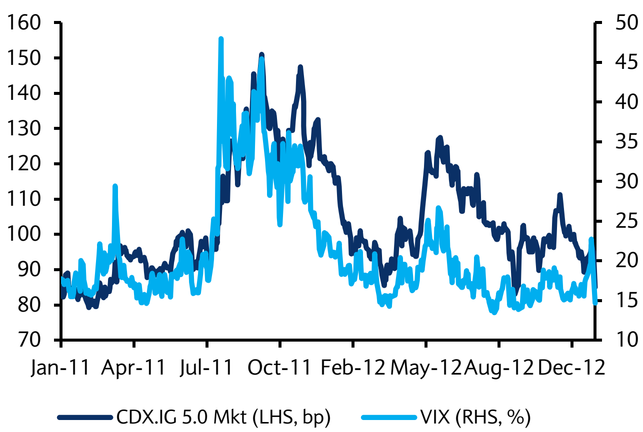
Note: Levels on this page as of Wednesday close. Source: Barclays Research

On-the-Run CDX.IG Curve (bp)



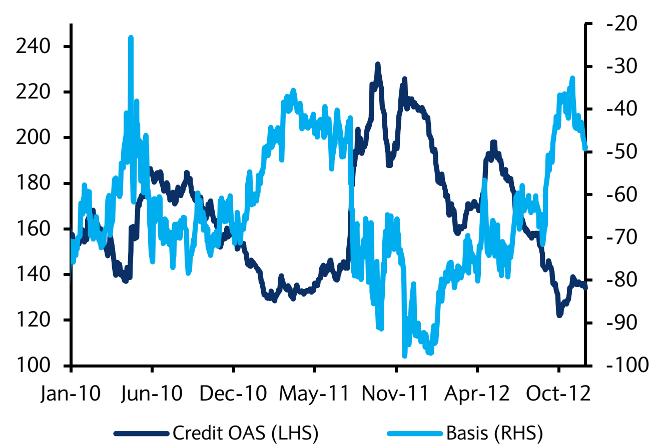
Source: Barclays Research

CDX.IG versus VIX



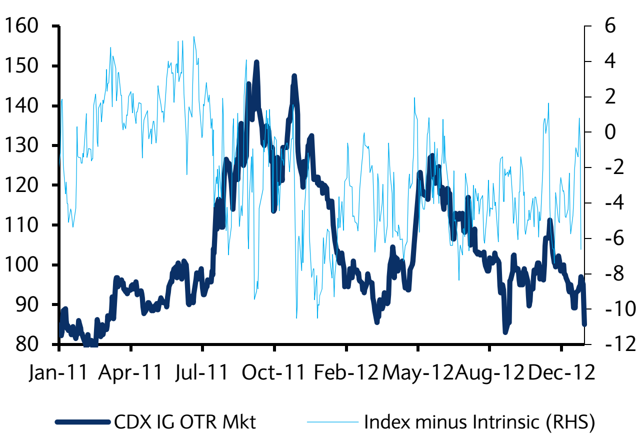
Source: Markit, Barclays Research

CDS-Cash Basis (bp)



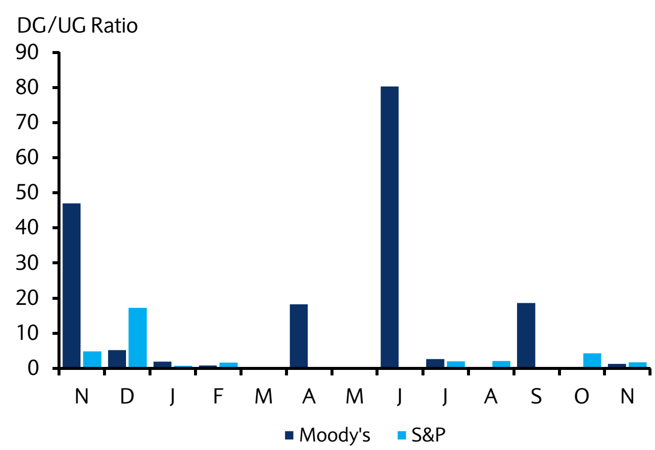
Note: Basis defined as CDX.IG spread – corporate Libor OAS. Source: Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



Source: Barclays Research

Par Downgrade/Upgrade Ratio



Source: Barclays Research

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