

# High Yield Strategy

## Signs of Capital Misallocation in Sectors

Bank of America  
Merrill Lynch



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

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

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

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

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

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

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

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

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

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

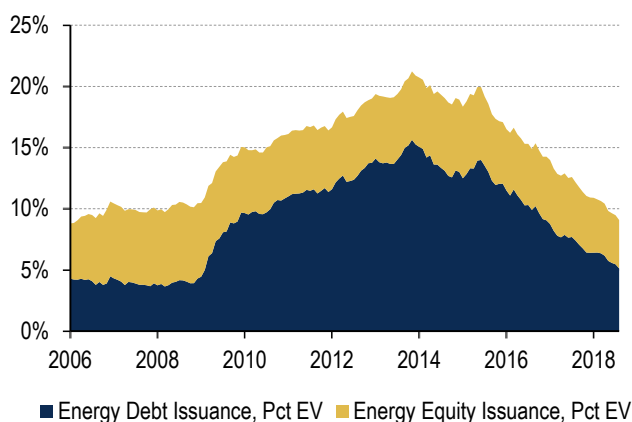
This does not mean that the current cycle cannot turn here – we view trade barriers as the fastest shortcut from where we are (solid economic growth) to an unwarranted contraction. Barring such an unfortunate outcome – and our base case remains that such an outcome is going to be eventually avoided –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

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

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

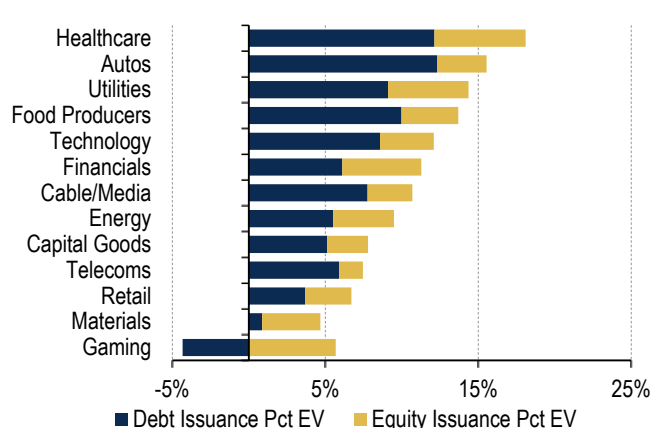
Figure 1 shows how these developments played out most recently in energy, where the shale revolution in 2006-2009 led to a significant increase in new capital being raised. At its peak in early 2015, the sector was running a 5-year cumulative tab of \$650bn in new net debt and equity capital formation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

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



Source: BofA Merrill Lynch Global Research

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



Source: BofA Merrill Lynch Global Research

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

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

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

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

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

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

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

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