The next default wave: Slow and low

High Yield Strategy | Global
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Bank of America Merrill Lynch

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Default wave to resemble late '90s, early '00s

We believe the next default cycle is likely to resemble that of the late 1990s and early 2000s, marked by two waves and in acute sectors. We envision a scenario where current distressed firms cause the default rate to rise in 2015 which, when coupled with a rise in treasury yields, leads 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 financing from 2010-2014. Additionally, with stringent rules around bank lending standards, significant existing covenant-lite issuance, and what we believe will be an increase in the size and scope of non-regulated lenders, the turn of this credit cycle may be one that in many ways is unlike any we have seen before. In particular, we envision an environment that is characterized by a lower default rate but an increased number of what we call 'zombie companies'.

Shake it off

We think last week's message from the Fed will prove to be bullish for high yield until year end and further reiterate our January 2014 call that the market should return 7-8% this year. We also revise our spread forecast back to our original estimate of 350bp. This represents 48bp of tightening from today's levels and a 2.10% 5 year per our rates strategist's year-end forecast.

Flows: Farewell flows, we barely knew thee

High yield funds saw another week of considerable outflows (-$3.2bn) fueled primarily by non-US funds, which reported outflows of $2.3bn. Within the US, high yield funds also saw outflows, though to a much lesser extent (-$898mn).

Issuance: Strong loan issuance driven by Burger King

Global high yield issuance was slower last week as 12 deals for a total of $5.4bn came to market. Nearly all of it came from the US while one deal came from Canada and none came out of Europe. However, global loan issuance was strong last week as $16.0bn was priced, much of which is attributable to Burger King's $6.75bn loan to fund its purchase of Tim Hortons.

Performance: Solid returns for equities and high yield

As the Fed maintained its dovish language during the September FOMC meeting, markets saw gains. The leading asset class was US equities, which added 1.25%, followed by CDX HY, which gained 0.59%. HY and IG cash were close behind, each adding 0.21% last week.

Convertibles: Supply is on a tear while performance lags

Global markets saw a bit of a pullback in the beginning of Sept. Month-to-date, the G300 global index is down 1.1% while the US has dropped 0.6%. New issuance volume has been very strong so far in Sept as globally we have seen a total of $10.2bn new supply. Of this, the US has seen the most issuance at $4.8bn.

Recent Publications

The High Yield Flow Report: Farewell flows, we barely knew thee 18 September 2014

The HY Wire: Ahead of the Fed 15 September 2014

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The View From Above

Shake it off

Last week was an important one for the bond market as the FOMC once again remained accommodative despite a broadly improving economy. Even with the dot plot suggesting a more hawkish Fed, Chair Yellen once again discounted the message and instead, in our economist's words, "tiptoed to the exit". This was positive for high yield bonds, as yield to worst dropped from 5.86% on the 16th (note this was about the same level as the high during this summer's selloff) to today's level of 5.79%. We think the message from the Fed will prove to be bullish for high yield until year end and further reiterate our January 2014 call that the market should return 7-8% this year. We also revise our spread forecast back to our original estimate of 350bp. This represents 48bp of tightening from today's levels and a 2.10% 5 year per our rates strategist's year-end forecast. As we have mentioned in the past, however, we believe the more important call is that the rise in rates from now until the end of 2014 will be absorbed by spread tightening in high yield. Whether that spread tightening is 20bp or 50bp is largely irrelevant in our view, as we feel more confident in high yield's reaction to rates than the level of rates themselves.

What strikes us as we write about last week's FOMC meeting and the trajectory for high yield into year-end are the remarkable similarities between the summer of 2014 and the summer of 2013. We highlight these below:

Summer Selloff: A summer selloff characterized by retail outflows and as much as 100bp of yield increase marked both 2013 and 2014.

Issuance Peaks: September 2013 and September 2014 were both abnormally large issuance months.

FOMC Anticipation: Both in 2013 and in 2014 the September FOMC meeting was highly anticipated for their potential policy shifts. In 2013, the taper was pushed off while in 2014, rate hikes have been shelved for another day.

Treasury Selloffs: In 2013, the 5y treasury increased 50bp from its pre-summer low of 0.9% on May 27th to the September FOMC level of 1.43%. In 2014, the 5y treasury increased nearly 35bp from its pre-summer low of 1.48% on May 27th to the September FOMC level of 1.83%.

High Yield Selloff: In 2013, high yield yield-to-worst increased 75bp from May 27th to the day of the FOMC meeting whereas during the same time in 2014, yield-to-worst has increased 70bp.

With this backdrop, we note that between September 18th 2013 and December 31st 2013, with the calendar overhang behind the market and with rates already significantly higher, high yield yield-to-worst declined 42bp while spreads tightened 67bp (the 5y increased 32bp). Interestingly, a 32bp increase in the 5y treasury would leave government bonds exactly at our rate strategist's year-end forecast while our estimate for spreads would closely mimic 2013. We believe the performance maybe slightly more muted this year as the exit of QE will likely have an impact on the market's ability to rally much more than 50bp, however we clearly believe the trajectory is lower in yield and spread from here until year end. Coupled with the fact that December and January tend to be strong months for the market, and we feel very confident in our total return forecast for 2014.

Table 1: 420 HY companies have reported

YoY Pct Change				QoQ Pct Change			
EBITDA	Debt	Rev	COGS	EBITDA	Debt	Rev	COGS
8.7	8.7	7.5	7.4	8.5	2.3	3.2	1.8

Source: BofA Merrill Lynch Global Research

Weekly Recap

420 high yield companies have reported Q2 earnings. On a year-over-year basis, EBITDA is up 8.7% while debt is up 8.7% and revenue has increased 7.5%. With just about all companies reporting, on a quarter-over-quarter basis, revenue growth has increased 3.2% while EBITDA growth has increased 8.5%. Since last Thursday, high yield spreads tightened 6bps from 403bps to 397bps while 5y rates decreased 1bp from 1.82% to 1.81%. In flows, US high yield funds saw outflows (-$898mn) as outflows from open-ended funds totaled $814mn and outflows from ETFs totaled $84mn. However, US investment grade funds reported another strong week of inflows, adding another $1.4bn. On a par weighted basis, 69% of our HY index is now trading inside a yield of 6%. US high yield issuance has fallen about $12bn behind last year's record pace as $5.3bn came to market this week in the US.

Default wave to resemble late '90s early '00s

The HY Wire: Pushing out the default cycle 21 October 2013

Relative Value Strategist: Let's talk defaults 23 September 2014

About a year ago we wrote a piece suggesting that defaults are unlikely to pick up meaningfully until late 2016 or early 2017 (see sidebar). However, in that publication, we did not discuss the catalyst to an increase in the default rate nor what we believe will be the set of circumstances surrounding a turn in credit conditions. In this piece we aim to highlight what we believe could be the course of events as it relates to the default cycle over the next several years. In our sister publication, the Relative Value Strategist (sidebar), we present our preferred trades to position for this next wave of defaults.

To begin with, we believe it is first necessary to discuss prior cycles, as one of our key projections is that the environment surrounding a pickup in defaults will likely have some similarities to past periods while at the same time will break the mold of what is a generally accepted during periods of corporate duress. In particular, we believe when defaults increase, the cycle is likely to resemble that of the late 1990s and early 2000s – with two waves and particularly acute in a handful of sectors. Also similar to the late 1990s, we expect this next cycle to be longer and lower than what we saw during the credit crisis. In fact, we expect that after an initial rise in bankruptcies next year, that the default rate remains modestly elevated (4-6%) despite decent US economic growth, and that the next leg higher will likely be a consequence of a US recession.

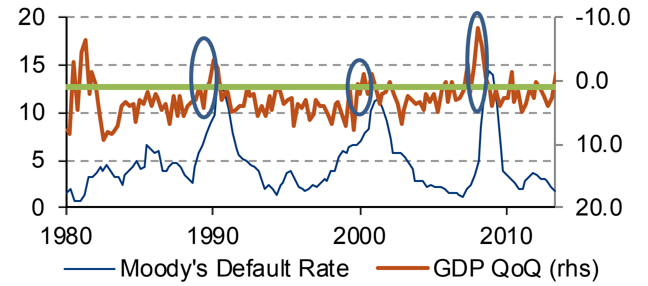
To this latter point, we believe that the era of corporate indulgence is likely to turn not because of a crack in the business cycle. Rather, we envision a likely scenario where current distressed firms cause the default rate to rise in 2015 which, when coupled with a rise in treasury yields, leads to a retail driven downturn in high yield bonds and a further unwillingness to lend to stretched corporates in 2016. This combination of events would not freeze capital markets, but rather would create a slow drain of liquidity from corporate issuers that were able to get financing from 2010-2014. Additionally, with stringent rules around bank lending standards, significant existing covenant-lite issuance, and what we believe will be an increase in the size and scope of non-regulated lenders, the turn of this credit cycle may be one that in many ways is unlike any we have seen before. In particular, we envision an environment that is characterized by a lower default rate but what we call "zombie companies" (firms trading around recovery, but not technically in default).

Default cycles have always responded to business cycles

Typically past credit cycles have been characterized by exogenous shocks causing companies with weak balance sheets and stretched capital structures to default on their bonds. In each scenario, these shocks have led to restrictive lending conditions and an inability for risky corporate issuers to roll over existing debt. For example the last cycle was marked by a severe leverage/bank/credit/housing crisis that led to lower economic growth and subsequent defaults. In the early part of the decade an excessive build out of telecom companies, the tech bubble and corporate scandals caused a pickup in bankruptcy filings. In the early 1990s, the S&L crisis and an oil shock led to the end of a real estate bubble and a default wave. What is of particular interest is that in all of these scenarios GDP growth fell below 1% (qoq) before defaults picked up.

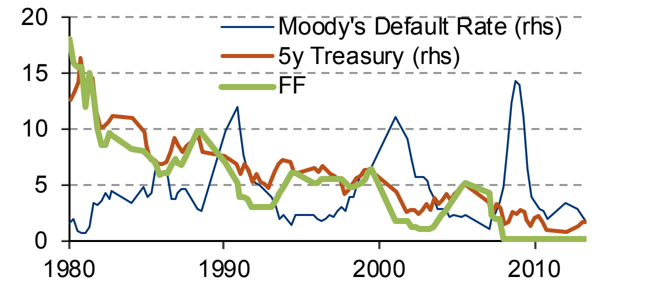
Also of note is that generally speaking, defaults don't pick up while interest rates are increasing (notwithstanding the first round of defaults in the late 1990s – a topic we'll discuss more below). Given the fact that the economy was already headed in a downward trajectory during past cycles, the Fed typically has already started cutting rates and treasury yields have declined by the time defaults increase substantially.

Chart 1: Lower GDP leads defaults



Source: BofA Merrill Lynch Global Research
Note: GDP QoQ is on a reverse scale

Chart 2: Generally rates fall during a default wave



Source: BofA Merrill Lynch Global Research

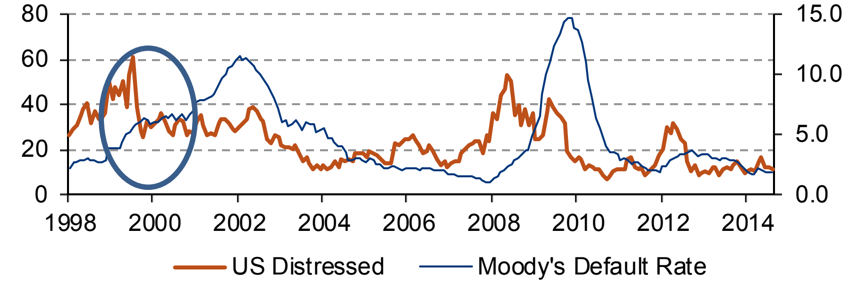
The exception: CLECs

Over the last 34 years, the only time we have seen rates increase in the beginning of a default cycle was between June 1999 and June 2000. During this time, quarterly GDP growth was vacillating between nearly 1% and 8% but the newly created competitive local exchange carriers (CLECs) following *The Telecommunications Act of 1996* drove defaults higher. During the mid-1990s capital markets were wide open and new high yield companies were welcomed with open arms. Between 1996 and 1999, $82bn of high yield debt was issued to help fund the CLECs entry into the service provider business. Subsequently, as expansion without revenue growth eroded returns and caused cash flow problems, financing dried up, causing a default wave despite solid GDP growth and rising rates.

Party like its 1999

This situation could bear some resemblance to what we expect to see in 2015 and 2016. In the below chart we see that in 1999 defaults of stressed names caused the default rate of the overall market to increase. Despite a subsequent drop in the default rate of these issuers, however, the overall default rate remained modestly elevated at about 5.5% for 2 years before picking up again substantially in 2001. What is extraordinary about this period is that the defaults of distressed companies didn't immediately lead to a spike in the overall default rate like during the last crisis. This is in large part because the overall economy was strong; the initial spike was caused by companies already in trouble, while the slow bleed that followed was due to shaky balance sheets after an aggressive telecom infrastructure build during the mid-1990s.

Chart 3: US distressed default rate leads market default rate



Source: BofA Merrill Lynch Global Research

Contrast this default pattern with what we expect to see over the next two years. The distressed defaults of the 1990s could be today's well known troubled retail names, rather than the worst-off CLECs, and are likely to fall into bankruptcy despite strong economic growth. The effect of the increase in defaults will likely be met at first with an air of inevitability. After all, most investors now expect that RadioShack, Sears, JC Penny and others will experience serious headwinds as going concerns in the relatively near future. To this end, we believe the first couple of defaults are unlikely to shake the market substantially. However, we do fear that as 2 bankruptcies turns to 3, and 3 to 4, that the headlines of the events will begin to scare retail investors in particular. Although this process may take 6, 9 or even 12 months, as the default rate begins to tick higher, rates begin to increase and total returns are lackluster, we believe retail investors will begin to put pressure on high yield, affecting both the secondary and primary markets.

As mentioned above, we don't believe this potential weakness leads to a rash of defaults and expect non-retail investors to support the market at first. However, we also believe fatigue will eventually set in as large institutions become more discerning of the new issue market. As 2015 turns to 2016, rates are higher and retail is less interested in the asset class as the carry trade slowly unwinds itself, we believe the institutional buyer base will be less willing to lend or extend credit to companies that haven't shown a clear ability to grow or generate positive free cash flow. In particular first-time issuers or those issuers that first came to market over the last several years could represent a problem during this time. We are most concerned with CLEC-type companies: those issuers who have recently come to market with little to no financial information available, no Wall Street analyst coverage, and negative free-cash flow.

In our view, it is a combination of events that will lead to the increase in defaults, and a first sign among them is the response of retail investors to deteriorating credit quality. This summer's selloff, in our view, provides an interesting case-study of the impact retail can have to the market, and so we discuss below some of the troubling signs from the July 2014 market malaise.

Summer 2014: Canary in the coal mine?

This summer's selloff was one we labeled "The Big Sleep"[1]. Despite a yield backup of 100bp, generally speaking the market was very calm during the largely retail driven selloff. In fact, we argued that the weakness was not routed in any fundamental change in credit quality, but rather because of negative headlines, geopolitical risk and flows following returns. To this end, we recommended that clients leg into long positions when the market was trading at its widest levels.

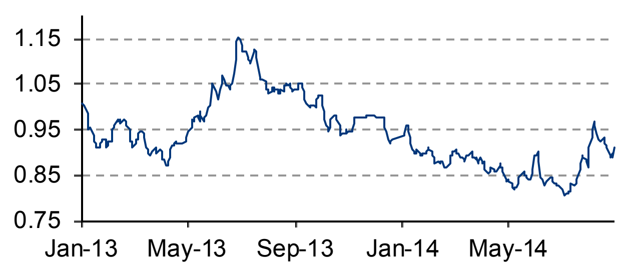
[1] The Big Sleep was a 1946 film starring Lauren Bacall- a reference we used following her death this summer

However, we would also argue that the market malaise highlighted vulnerabilities in high yield: Vulnerabilities that could significantly hurt investors and corporate entities should the circumstances surrounding the next retail driven outflow be routed in credit quality concerns rather than due to headlines and unjustified fear.

Glass half full

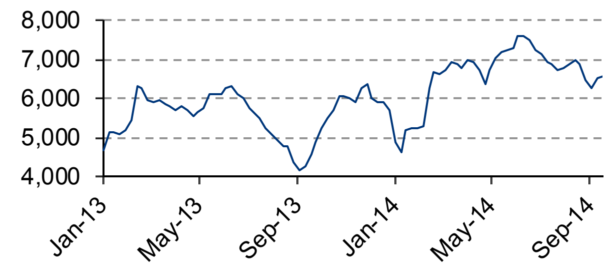
For those who want to view this past summer's events in a positive light, we point to the general lack of panic in the market during the swoon. In fact, bid/ask, in points, increased to beginning of the year levels, but remained well below the recent highs seen during the taper tantrum. Additionally, TRACE volumes remained strong throughout the summer, confirming the chatter we heard of good two-way flow during the widening.

Chart 4: Bid/ask increased to beginning of year levels…



Source: BofA Merrill Lynch Global Research

Chart 5: …while TRACE volumes only marginally declined



Source: BofA Merrill Lynch Global Research

Institutional investors seemed to take comfort in the idea that the selloff was driven by retail with no change in fundamentals, and that despite diminished dealer balance sheets the market was able to absorb the event with little panic. In fact, large institutional buyers were waiting in the wings to buy bonds as yields approached 6%, creating a floor to the yield increase.

Glass half empty

The glass half empty crowd will note their concern that the market could sell off nearly 100bp despite no change to fundamentals. When one further considers that retail funds constitute 25% of the total market, it can become unsettling that a shift in sentiment from this investor base can have such a large impact on yields. In many ways, we believe it could be argued that this summer's weakness, despite not a significant volatility event accompanied with broad-based fear, was in spirit more violent than last year's taper tantrum. The absolute repricing was significant while participation in the selloff was limited largely to retail funds. We wonder what this means for the market when credit quality does in fact begin to erode or when anxiety is more pervasive within the entire high yield community; retail and institutional alike. Without a strong backstop, we can envision a slow and long weakening that is ultimately much more significant than the one we realized this summer. Coupled with higher rates, this could have a real, meaningful impact to borrowing costs later in 2015 and into 2016, in our opinion.

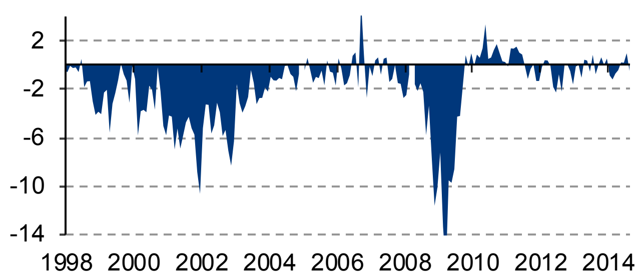
Our main concern, more specifically, stems from the dramatic increase and apparent easing of standards within the new issue market and first time issuers in particular, a topic we discuss more below. Similar to the CLECs of the late 1990s, we see a significant amount of this first time issuance concentrated in a few sectors, among issuers with negative free cash flow and little financial history available. However, we also note that much of this issuance is unlikely to default all at once and that the overall quality of the entire high yield market is strong.

This, in our view, is what will contribute to our "wave one" of defaults… marked by a rise in bankruptcies but defined by a slow and low rate for perhaps the next couple of years.

Quality seems OK, but can change quickly

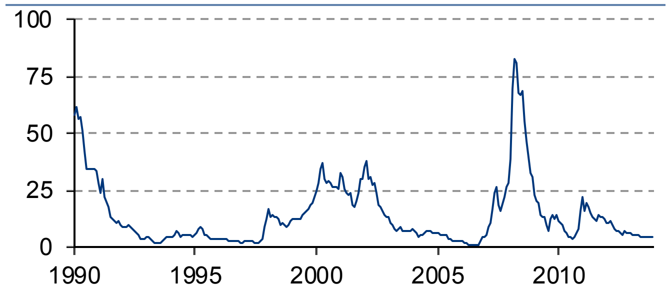
As mentioned above today we see little sign of a drop in ratings within our overall index. Chart 6 shows that the rating migration rate for US HY is virtually flat, meaning there are just as many upgrades as downgrades within our index on a monthly basis, while Chart 7 shows that the distress ratio (the percentage of issues within our index trading above 1000bp) is at post crisis lows. However, we also note that there is very little leading quality to these figures, and that both can turn for the worse with little warning. Still, in combination with strong balance sheets the lack of credit deterioration gives us comfort heading into the end of 2014 and the beginning of 2015, despite being cautious about the medium to long-term outlook.

Chart 6: Monthly rating migration rate



Source: BofA Merrill Lynch Global Research

Chart 7: Distress ratio



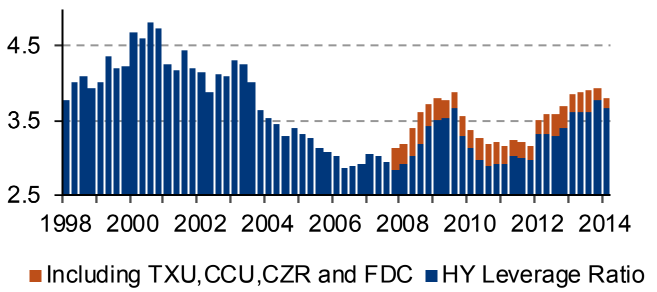
Source: BofA Merrill Lynch Global Research

Easy come, easy go

The difficulty in forecasting the next cycle resides in the fact that balance sheets today appear to be in pristine shape. In our view, it is undeniable that the Fed's easy money policy over the last several years helped turn the US economy while putting an abrupt halt to a default wave that was particularly deep and swift. However, with the depression of interest rates - not only in the US, but globally as well - central banks have incentivized carry trades that we believe will continue to unwind throughout next year. This is likely to have an impact on high yield borrowing costs for several years to come.

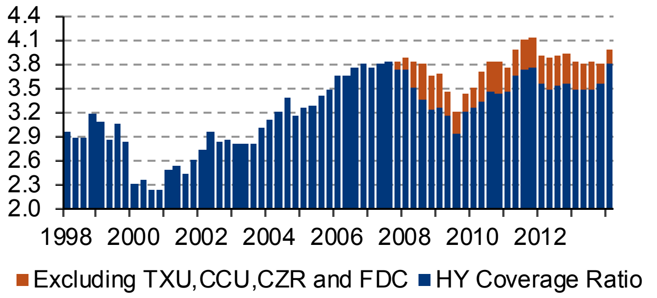
However, the cheap financing available over the last 5 years has left high yield corporate balance sheets in arguably in the best shape ever over the last 30 years. In particular, despite releveraging (Chart 8), interest coverage is at all-time highs (Chart 9), signaling that the ability for corporates to service even increasing debt loads has never been better. In fact, if all US high yield companies were to instantaneously re-finance 100% of their debt at a rate 150bp higher than today's levels, with no EBITDA growth, interest coverage would still be 3x. Clearly this is an extreme example as all companies don't refinance all debt at once and EBITDA growth has been in the high single digits recently.

Chart 8: Leverage of US HY is up, but below early decade levels



Source: BofA Merrill Lynch Global Research

Chart 9: Interest coverage is near all-time highs



Source: BofA Merrill Lynch Global Research

For this reason, we believe a sharp increase to double digit default rates is still far into the future and will likely have to be accompanied by a US recession. However, buried in the index are smaller issuers, many of whom are first time issuers in the credit market. These companies, in our opinion, pose a risk to investors, yet are unlikely to cause a deterioration of the entire market such that the default rate spikes to double digit levels. Instead, these issuers are likely to create a slow, drawn out cycle where lackluster returns and mid-single digit defaults define the market for several years to come.

With lower total returns and some credit risk re-instituted into the market, we would expect retail outflows to put pressure on pricing in high yield. Coupled with an environment where banks may struggle to issue loans to higher leveraged companies (greater than 6x), we envision an environment where more corporations tap non-regulated entities for capital, perhaps leading to even weaker lending terms and higher levered companies. Although defaults may not immediately increase to the heights we saw in the early 2000s, let alone during 2007, effectively we could be ushering in an era of zombie companies that trade as if in default, though technically survive as going concerns.

Zombie Apocalypse: Cov-lite and non-regulated lenders

We have written in the past about cov-lite issuance and the fact that cov-lite loans have a lower cumulative default rate than traditional loans as the ability to have financial flexibility seems to help during times of distress. However, given new Fed and OCC letters to the large, regulated US investment banks about their lending practices and restrictions on leverage (in particular, those issuers with leveraged greater than 6x), we believe cov-lite issuance could prove to be a problem in years to come as new deals are pushed off to non-regulated lenders.

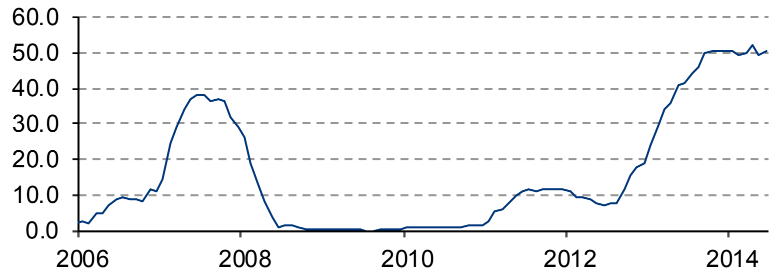
We envision an environment where stressed companies turn to non-regulated entities to complete deals that would traditionally be underwritten by the large investment banks. Many of these deals may be small club deals arranged by private equity firms or hedge funds. Others may be loan to own deals while yet more may be fully syndicated to investors. However, we believe these lenders are likely to be more predatory than their regulated counterparts - potentially layering more debt than the business model can withstand or with higher rates than would otherwise be desirable. PE firms currently have over $400bn[2] in dry powder and have shown their willingness and desire to build capital market franchises while boutique shops outside of the purview of the Fed and OCC have increased substantially. In fact, according to league tables from Bloomberg, in 2007 41 companies underwrote leveraged loan deals while year-to-date 87 different firms

[2] http://www.pegcc.org/education/pe-by-the-numbers/

have underwritten deals. Of the 87 different firms, a large number fall outside the scope of the OCC and the Fed. For example, Jeffries and KKR are two firms that combined have underwritten more than $10bn in leveraged loans so far in 2014 and S&P Capital IQ LCD estimate that 83% of total middle market volume was from non-bank lenders in 2013, up from 71% in 2011.

Our fear is that as more non-regulated lenders extend increasing amounts of credit to risky borrowers, existing debt holders are likely to come out on the bottom given current loose covenants. We note in Chart 10 that as a percentage of market size, 50% of all loan issuance was cov-lite over the last 12 months. Where this could prove to be a problem is as borrowers who issued loans in the last several years need to come back to the market, non-regulated lenders may have the ability to hurt existing holders of the debt by being a lender of last resort. We see this potential as a consequence of higher rates, lower retail and institutional demand given quality and return concerns, and increased bank regulation. This is yet another reason why the default rate may not increase dramatically over the next couple of years while zombie companies displace defaulted entities.

Chart 10: Cov-Lite Loan Issuance, Pct of Market Size (12mo)



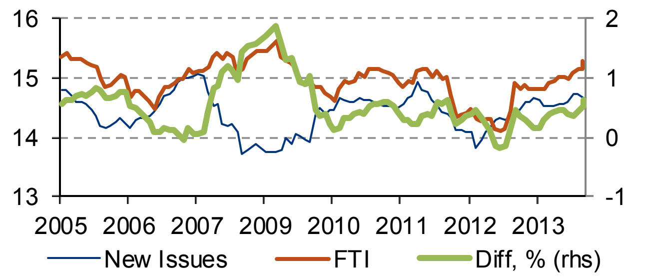
Source: BofA Merrill Lynch Global Research

In addition to cov-lite issuance and the impact non-regulated entities may have on borrowing in the future, we are have also become increasingly concerned about the quality of issuance over the last several years- both among first time issuers as well as all new issues in general.

First concern, first time issuers

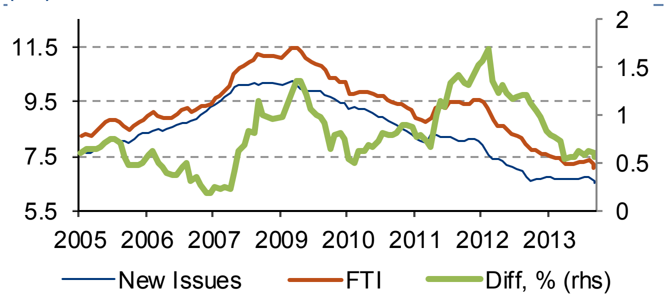
Since 2009 over 600 companies have issued debt for the first time. Though in isolation we don't think this is a cause for alarm, when coupled with the decrease in quality and coupon of these issuers relative to past periods as well as the lack of transparency surrounding company fundamentals, we believe these issuers can be the driving force behind a long, slow beginning to the next default wave. Chart 11 below shows that the average rating of first time issuers has decreased relative to all new issues over the last couple of years (the higher the numeric rating, the worse the quality) while Chart 12 highlights the drop in coupon of first time issuers relative to all new issues.

Chart 11: First Time Issuers' (FTI) quality has decreased relative to all new issues



Source: BofA Merrill Lynch Global Research

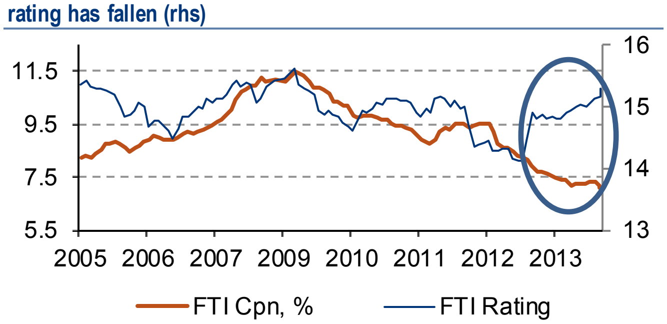
Chart 12: LTM Average coupon has fallen more for First Time Issuers (FTI) than all new issues



Source: BofA Merrill Lynch Global Research

Even more dramatic is to look at the decrease in first time issuer's coupons relative to the increase in numeric rating in Chart 13. As the quality of first time issuers has declined so has coupon, a phenomenon that is inconsistent with any other period over the last decade. What is most concerning about all of these statistics is that the number of issuers that have a history of financial statements available (in Bloomberg) at the time of their issuance has plummeted (Chart 14). This suggests to us that investors have not been able to perform the necessary homework to justify lending to many of these companies. So far in 2014, just 8% of all first time issuers have financial statements in Bloomberg prior to issuance.

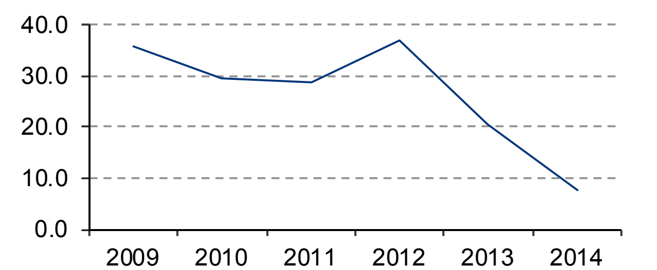
Chart 13: As First Time Issuers' (FTI) coupons have decreased, their rating has fallen (rhs)



Source: BofA Merrill Lynch Global Research

Note: a higher numerical rating, the worse the quality

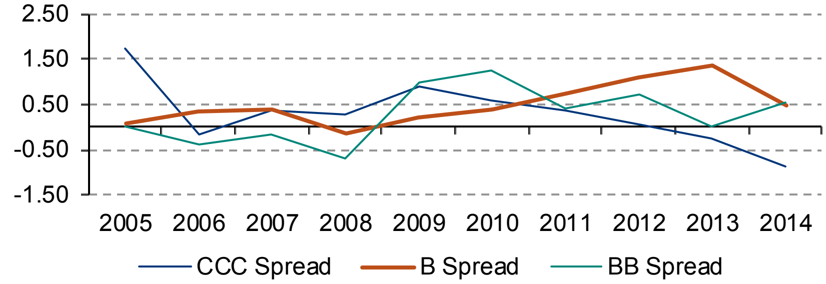
Chart 14: % of first time issuers with financial statements in Bloomberg prior to issuance



Source: BofA Merrill Lynch Global Research

Within our set of first time issuers we further breakdown the cohort by rating. Our findings suggest that CCC first time issuers have been pricing tight to all triple C new issue paper while the market currently demands a premium for first time single B and double B issuers (Chart 11). The low coupons of first time CCC issuers bode well for the immediate future of these companies. The lower interest expenses, in our view, will further prolong the credit cycle until the first wave of highly distressed companies noted above realize their eventual demise. However, as investors become more critical of lending terms and as rates increase throughout 2015, we also believe such low financing could prove detrimental when these companies need to refinance existing debt in 2016 and 2017 from given what appears to be relatively weak credit fundamentals.

Chart 15: Spread between first time issuers coupon and all new issue coupons



Source: BofA Merrill Lynch Global Research

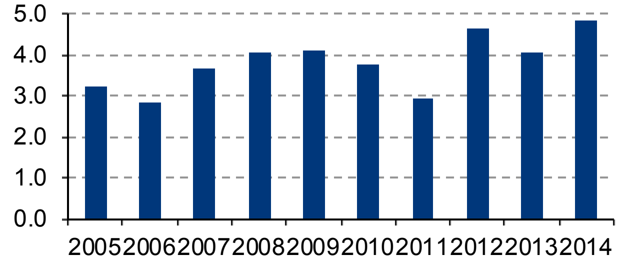
Deteriorating fundamentals of first time issuers

Based on the information we do have about first time issuers, we are also concerned about their fundamentals. Free cash flow among first time issuers is seems to be very poor. Over 40% (66 out of 162) of all first time issuers since the crisis where we have data have negative free cash flow. Filtering on this universe, we see 15 of these issuers are currently rated triple C, all but one has been issued since 2010 and 13 of the 15 are Energy names. 43 of the issuers with negative free cash flow are rated single B, and of these issuers, 21 are energy names. While we believe many of these first time issuers will be targets for M&A in 2015 we also believe that many will find it difficult to survive rising rates, heightened fundamental scrutiny and tighter bank regulations.

However, first time issuers are not our only concern when it comes to new issuance as the entire new issue market has become lower quality based on fundamentals. For example, since 2004 net leverage for all new issues has increased to nearly 5x, well above the average leverage of our index of 3.8x.

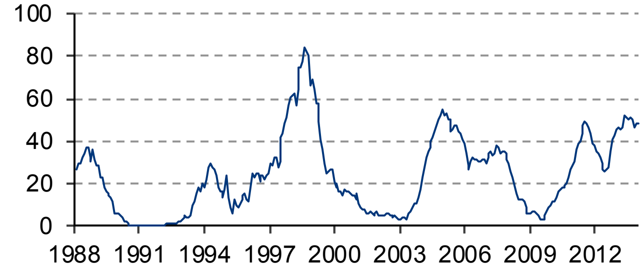
Additionally, triple C issuance has increased substantially since the crisis, as the last 12 months of CCC issuance is equal to nearly 50% of all the CCC issuance currently outstanding. What worries us is that in a period where rates rise and credit quality concerns are more at the fore of investors' minds, that many of these issuers will find it difficult to tap the bond market.

Chart 16: Net leverage of US high yield new issues, yearly



Source: BofA Merrill Lynch Global Research

Chart 17: % of CCC issuers tapping primary mkt (12mo)



Source: BofA Merrill Lynch Global Research

Though we don't expect defaults to increase sharply over night, we do believe that in 2015 we will see a tick up in bankruptcies. We envision an environment where several of the weaker distressed names are unable to access the primary market however also see a macro landscape that continues to be supportive to rising rates. This combination will likely lead to less support from retail investors as credit quality concerns and lackluster total returns drive ETF and mutual fund buyers to reduce exposure.

In 2016 and 2017 we believe the default rate will approach mid-single digits as many of the weaker issuers that came to market in the post-crisis period begin to find it difficult to refinance or issue new debt. With increased regulation we believe the large investment banks will be forced to pull back financing activities leaving non-regulated lenders to fill the void. Coupled with the high degree of cov-lite issuance over the last several years, we believe 2016 and 2017 could usher in a period of zombie companies and a default rate that continues to be well below double digit levels until such a time that the overall US economy succumbs to another downturn. In this way, we believe the next default cycle is likely to resemble that of the late 1990s and early 2000s, marked by 2 waves and in acute sectors.

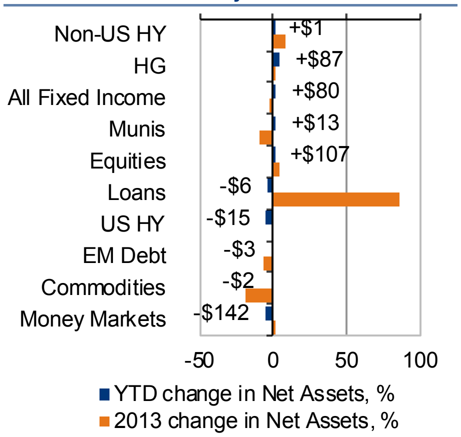
Flows

This is an excerpt from last night: The High Yield Flow Report: Farewell flows, we barely knew thee 18 September 2014

High yield funds saw another week of considerable outflows (-$3.2bn) fueled primarily by non-US funds, which reported outflows of $2.3bn. Within the US, high yield funds also saw outflows, though to a much lesser extent (-$898mn). Last week's US outflow was almost entirely driven by open-ended funds (-$814mn) while ETFs lost only $84mn. High yield was not the only asset class to report outflows last week—loans declined $646mn, commodities lost $60mn, and munis lost $34mn.

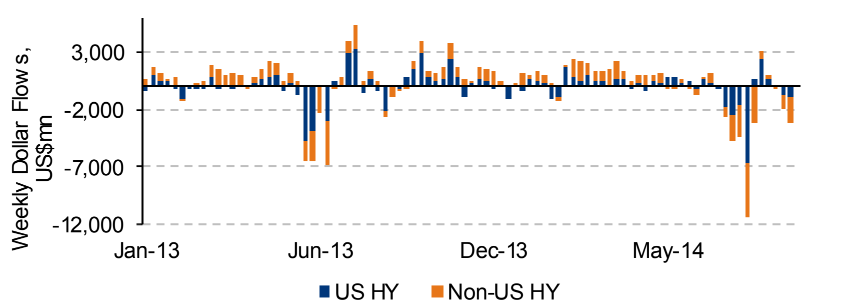
Equity funds saw the largest inflow last week as nearly $10bn entered the asset class. Additionally, US investment grade continued its inflow streak as another $1.4bn flowed into IG funds. This is the 34th consecutive week of inflows for the asset class. Finally, EM debt reported inflows of $128mn as inflows into hard currency funds (+$181mn) and blended currency funds (+$135mn) offset outflows from local currency funds (-$188mn).

Chart 18: Annual flows by asset class



Source: BofA Merrill Lynch Global Research, EPFR Global

Chart 19: 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 slower last week as 12 deals for a total of $5.4bn came to market. Nearly all of it came from the US while one deal came from Canada and none came out of Europe. Of the $5.4bn issued last week, $2.0bn was rated BB, $1.6bn was B, and the remaining $1.8bn was CCC or not rated. Month-to-date, we have seen a total of $29.2bn come to market in September. Year-to-date we now stand at $296.4bn, still ahead of last year's pace. For comparison, last year at this time we had seen $276.6bn of issuance globally. As we've noted in the past, Europe is outpacing its 2013 volume while the US is behind.

Table 2: Global issuance over time ($bn)

	Global	United States	Europe	BB	B	CCC/NR
WTD Sep 19	5.4	5.3	0.0	2.0	1.6	1.8
Wk Sep 12	12.2	8.9	1.9	7.5	2.7	2.0
Wk Sep 05	11.6	11.6	0.0	8.1	2.7	0.9
Wk Aug 29	0.0	0.0	0.0	0.0	0.0	0.0
MTD Sep	29.2	25.7	1.9	17.6	6.9	4.7
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
June	45.4	24.0	20.2	11.0	25.1	9.3
YTD 2014	296.4	179.4	105.2	97.0	147.9	51.5
YTD 2013	276.6	191.7	72.5	90.9	129.2	56.5
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 37% of new issues were rated BB, while 30% were B, and 33% were CCC. In terms of seniority, 86% of new issues were senior unsecured last week while the remaining 14% were secured. Finally, about 93% of deals last week were private placements, 41% with reg rights and 52% without reg rights. Private placements have consistently outpaced public deals this year.

Table 3: New issue 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
06/06/2014	6,410	750	3,999	1,661		4,820	1,361		229	800	4,340	1,270	2,251	3,139	1,020
06/13/2014	12,506	575	8,634	2,214	1,083	9,040	2,621	297	275	2,979	9,527		4,867	4,569	3,070
06/20/2014	8,466		6,768	1,293	405	5,875	2,448			4,698	3,768		2,098	6,068	300
06/27/2014	15,570	8,826	4,895	1,849		8,010	6,505	985	70	7,320	8,050	200	3,909	11,211	450
07/04/2014	5,789	821	3,175	1,280	513	4,455	821	513		825	4,964		3,171	2,105	513
07/11/2014	11,433	2,180	9,253			6,780	2,512	2,141		3,163	8,270		1,064	4,817	5,552
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	5,441	2,000	1,636	1,805		5,305			136	766	4,675		2,200	2,841	400

Source: BofA Merrill Lynch Global Research

At the single name level the largest last week was the $1.6bn two-part offering from AECOM Technology Corporation. The first tranche pays a 5.875% coupon and matures in 2024, and the second tranche pays a 5.75% coupon and matures in 2022. Proceeds from the offering will be used to repay outstanding debt and to fund the cash consideration of its proposed acquisition of URS Corp. Other large deals last week include the $800mn offering from Acosta Holdco and the $750mn offering from American Airlines.

Table 4: New issues September 12th – September 18th

Pricing Dt	Name	Size ($)	Snr	Cpn	Maturity	Price	Yield	Moody's	S&P	Type	Sector	Region
9/18/2014	Simmons Foods Inc	415	Sr Sec Nts	7.88	1-Oct-21	100.00	7.88	Caa1	CCC+	144A for Life	Food	United States
9/18/2014	SFX Entertainment Inc	65	Sr Sec Nts	9.63	1-Feb-19	100.00	9.63	Caa1	B-	144A for Life	Commercial Services	United States
9/18/2014	Anixter Inc	400	Sr Nts	5.13	1-Oct-21	100.00	5.13	Ba3	BB	SEC	Electrical Compo&Equip	United States
9/18/2014	American Airlines Group Inc	750	Sr Nts	5.50	1-Oct-19	100.00	5.50	B3	B-	144A for Life	Airlines	United States
9/17/2014	Onex York Acquisition Corp	270	Sr Nts	8.50	1-Oct-22	100.00	8.50	Caa2	CCC+	144A for Life	Insurance	United States
9/17/2014	Noralta Lodge Ltd	136	Sr Sec Nts	7.50	24-Sep-19	99.49	7.63	NR	B	144A for Life	Lodging	Canada
9/17/2014	JAC Products Inc	150	Sr Sec Nts	11.50	1-Oct-19	100.00	11.50	B3	B	144A for Life	Miscellaneous Manufactur	United States
9/17/2014	AECOM Technology Corporation	800	Sr Nts	5.88	15-Oct-24	100.00	5.88	Ba3	BB-	144A w/RR	Engineering&Construction	United States
9/17/2014	AECOM Technology Corporation	800	Sr Nts	5.75	15-Oct-22	100.00	5.75		BB-	144A w/RR	Engineering&Construction	United States
9/16/2014	CBS Outdoor Americas Capital LLC/ Capital Corporation	450	Sr Nts	5.88	15-Mar-25	100.00	5.88	B1	BB-	144A w/RR	Advertising	United States
9/16/2014	CBS Outdoor Americas Capital LLC/ Capital Corporation	150	Sr Nts	5.25	15-Feb-22	99.50	5.33	B1	BB-	144A w/RR	Advertising	United States
9/15/2014	RCN Telecom Services Inc	105	Sr Nts	8.50	15-Aug-20	102.00	8.00	Caa1	CCC+	144A for Life	Media	United States
9/15/2014	Ply Gem Industries inc.	150	Sr Nts	6.50	1-Feb-22	93.25	7.72	Caa1	CCC+	144A for Life	Building Materials	United States
9/15/2014	Acosta Holdco Inc (Anna Merger Sub t/b/ merged w & into)	800	Sr Nts	7.75	1-Oct-22	100.00	7.75	Caa1	CCC+	144A for Life	Commercial Services	United States
9/12/2014	Whitewave Foods Company	500	Sr Nts	5.38	1-Oct-22	100.00	5.38	B1	BB-	SEC	Food	United States

Source: BofA Merrill Lynch Global Research

Loans

Global loan issuance was strong last week as $16.0bn was priced. Most of the new supply, about $10.1bn was B-rated, while $2.6bn was BB-rated and $3.3bn was CCC or not rated. Cov-lite issuance totaled $13.0bn and 2nd lien issuance totaled $0.9bn. Month-to-date, we've seen a total of $34.1bn come to market while year-to-date we have seen a total of $326.6bn. Last year at this time, we had already seen $355.8bn of new loan supply.

Table 5: Global loan issuance over time ($bn)

	Global	BB	B	CCC/NR	Cov lite	2nd lien
WTD Sep 19	16.0	2.6	10.1	3.3	13.0	0.9
Wk Sep 12	11.5	4.3	5.3	1.9	8.0	0.9
Wk Sep 05	6.6	3.2	3.0	0.4	6.2	0.8
Wk Aug 29	0.2	0.0	0.0	0.2	0.0	0.0
MTD Sep	34.1	10.1	18.4	5.6	27.2	2.6
August	7.3	0.7	6.0	0.6	3.5	0.1
July	43.7	13.5	24.1	6.1	31.6	5.1
June	43.9	10.8	25.4	7.7	30.4	5.5
YTD 2014	326.6	93.8	183.7	49.2	233.3	32.1
YTD 2013	355.8	116.3	208.6	30.8	212.2	21.4
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 this week's new supply down further, about 63% of new issues were B-rated, 16% were BB-rated, 4% were CCC-rated, and 17% were not rated. 81% of new supply this week was cov-lite, while about 94% of new issuance was term-loan B and about 6% was 2nd lien.

Table 6: New issues breakdown by week, last 3 months

	Total	Ratings BB	B	CCC	NR	TLb	2nd Lien	Cov Lite
06/13/2014	14,042	3,090	8,840	1,662	450	12,560	1,482	9,627
06/20/2014	7,878	300	5,109	1,219	1,250	6,659	1,219	6,216
06/27/2014	3,870	900	2,195	450	325	2,920	950	3,395
07/04/2014	4,258	870	1,800	760	828	3,498	760	3,430
07/11/2014	11,807	1,345	8,551	1,445	466	10,225	1,582	7,819
07/18/2014	12,400	3,000	7,028	1,517	855	9,883	2,517	11,574
07/25/2014	6,701	630	5,156	275	640	6,131	570	4,916
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	195				195	165	30	
09/05/2014	6,578	3,188	2,970	300	120	5,783	795	6,203
09/12/2014	11,521	4,250	5,346	750	1,175	10,576	945	7,986
09/19/2014	16,008	2,640	10,068	585	2,715	15,108	900	12,995

Source: BofA Merrill Lynch Global Research

At the single-name level, the largest deal this week was the $6.75bn senior secured offering from Burger King Worldwide. The loan is priced to yield 350bps above Libor. Proceeds from the deal are going to be used to fund the acquisition of Tim Hortons. Other large loan deals this week include the $2.25bn offering from Pilot Travel Centers LLC and the $2.0bn offering from Zebra Technologies.

Table 7: Top 10 largest new issues September 12th – September 18th

Launch Dt	Issuer	Deal Name	Deal Size ($)	New Institutional Money ($)	Moody's	S&P	Asset Backed	Cov Lite	Proceeds	Sector	Region
9/15/2014	Burger King Worldwide	Burger King (TL 10/14)	6750	6750	B1	B+	No	Yes	Acquisition	Restaurants	United States
9/18/2014	Pilot Travel Centers LLC	Pilot Travel (10/14)	4450	2250	NR	NR	No	No	Dividend	Retail	United States
9/18/2014	Zebra Technologies Corp	Zebra Technologies (TL 10/14)	2000	2000	Ba2	BB+	No	Yes	Acquisition	Computers & Electronics	United States
9/17/2014	Micro Focus	Micro Focus (TL 10/14)	1850	1850	B1	BB-	No	Yes	Acquisition	Computers & Electronics	Europe
9/15/2014	Berlin Packaging	Berlin Packaging (TL 10/14)	545	545	B2	B	No	Yes	LBO	Metals & Mining	United States
9/18/2014	Halyard Health Inc	Halyard Health (10/14)	640	390	Ba2	BB	No	No	Acquisition	Healthcare	United States
9/12/2014	Flavors Holdings	Flavors (10/14)	415	365	B2	B	No	No	Acquisition	Food & Beverage	United States
9/16/2014	Answers Corporation	Answers (TL 10/14)	320	320	B1	B	No	Yes	LBO	Computers & Electronics	United States
9/16/2014	Victory Capital Management Inc	Victory Capital (TL 10/14)	310	310	B2	BB-	No	Yes	Acquisition	Services & Leasing	United States
9/17/2014	Callon Petroleum Co	Callon Petroleum (2nd Lien 10/14)	275	275	NR	NR	No	Yes	Acquisition	Oil & Gas	United States

Source: BofA Merrill Lynch Global Research

Table 8: Total returns across asset classes

Ticker	Name	WTD (%)	MTD (%)	YTD (%)
MXEF	EM Eqty	-0.72	-3.12	5.11
G0QI	TIPs	-0.60	-2.79	4.10
EMHB	EM HY	-0.36	-0.90	5.86
EMGB	EM Govts	-0.30	-1.33	8.23
GA05	5yr TRSY	0.00	-0.85	1.43
LCDI/ALL	Lev Loans	0.07	-0.12	2.60
EMIB	EM IG	0.08	-0.63	6.30
HE00	EU HY	0.10	0.07	5.73
U0A0	Municipals	0.14	-0.27	7.89
CDXIG	CDX.IG	0.19	0.06	1.28
M0A0	Mortgages	0.20	-0.47	3.87
C0A0	US IG	0.21	-1.39	5.84
H0A0	US HY	0.21	-0.88	4.90
CDXHY	CDX.HY	0.59	-0.32	1.96
SPX	S&P 500	1.25	0.35	8.77

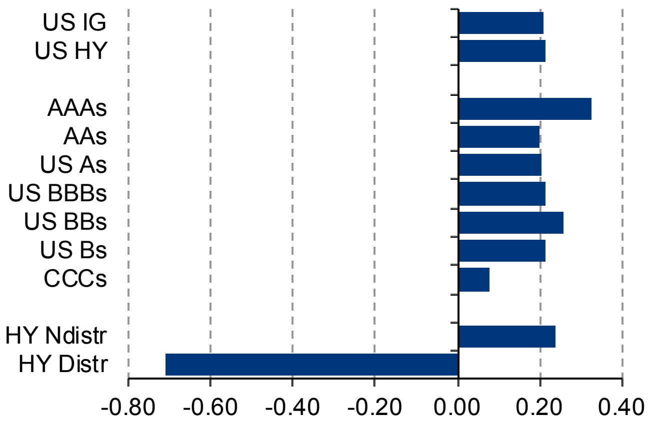
Source: BofA Merrill Lynch Global Research

Performance Summary

As the Fed maintained its dovish language during the September FOMC meeting, markets saw gains. The leading asset class was US equities, which added 1.25%, followed by CDX HY, which gained 0.59%. HY and IG cash were close behind, each adding 0.21% last week. Leveraged loans increased 0.07% while 5y treasuries were flat on week. Underperformers include EM equities (-0.72%), TIPs (-0.60%), and EM HY (-0.36%).

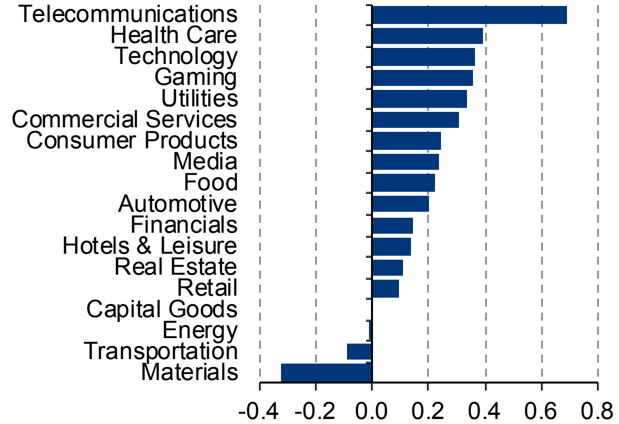
Amongst HY rating buckets, BBs were the best performers at +0.26% last week, while Bs added 0.22% and CCCs gained 0.8%. However, the best rating bucket overall was AAAs, which increased 0.33%. On sectors, Telecoms were the best performers (+0.69%) followed by Health Care (+0.39%), while Materials (-0.33%), Transportation (-0.09%), Energy (-0.01%), and Capital Goods (-0.01%) all underperformed.

Chart 20: Segment and rating returns, week-to-date



Source: BofA Merrill Lynch Global Research

Chart 21: Sector returns, week-to-date



Source: BofA Merrill Lynch Global Research

Rating Actions

Ratings actions on high yield issuers last week included a fairly equal amount of upgrades and downgrades, a variety of initations, two drops, and a default. On upgrades, both Moody's and S&P lifted Carrizo Oil & Gas, the former from B3 to B2 and the latter from B to B+. S&P cited increased growth assumptions for oil production and reserves in 2015 as the reason for the upgrade, while Moody's noted the company's more diversified and balanced oil and gas production profile. Last week also saw a rising star as S&P raised Rockwood Specialties Group Inc from BB+ to BBB-. The ratings agency said the upgrade reflects their view that the company's financial risk profile will strengthen given it will successfully sell its titanium dioxide business.

On downgrades, S&P dropped CITGO Petroleum Corp from B to B-. Because S&P downgraded its parent, Venezuela's national oil company (PDVSA), it had to lower CITGO's rating as per their methodology. However, it is worth noting that S&P pointed out that there could be scenarios in which PDVSA could incur financial distress bit CITGO would remain unscathed. This week also saw a fallen angel as Moody's lowered Hillenbrand Inc from Baa3 to Ba1. Moody's cited their expectation for less predictability in cash flow and operational risk from acquisitions as the reason for the downgrade.

Finally, we saw one default this week. S&P put Waterford Gaming LLC in default after it failed to repay the outstanding principal balance on its 8.625% senior notes that matured on September 15th. Moody's still lists the name as Ca.

Table 9: Ratings actions on HY issuers

Date	Action	Company Name	Rating Type	Agency	Curr Rtg	Last Rtg
9/12/2014	Upgrade	Geo Group Inc/The	Senior Unsecured Debt	Moody's	Ba3	B1
9/12/2014	Upgrade	Hornbeck Offshore Services Inc	LT Local Issuer Credit	S&P	BB-	B+
9/15/2014	Upgrade	Carrizo Oil & Gas Inc	Senior Unsecured Debt	Moody's	B2	B3
9/15/2014	Upgrade	Ply Gem Industries Inc	Senior Unsecured Debt	Moody's	Caa1	Caa2
9/16/2014	Upgrade	Carrizo Oil & Gas Inc	LT Local Issuer Credit	S&P	B+	B
9/16/2014	**Upgrade**	**Rockwood Specialties Group Inc**	**LT Local Issuer Credit**	**S&P**	**BBB-**	**BB+**
9/18/2014	Upgrade	Auxilium Pharmaceuticals Inc	LT Local Issuer Credit	S&P	CCC+	CCC
9/18/2014	Upgrade	OCI Beaumont LLC	LT Local Issuer Credit	S&P	B	B-
9/19/2014	Upgrade	American Media Inc	LT Local Issuer Credit	S&P	CCC	SD
9/16/2014	Initiated	GameStop Corp	Senior Unsecured Debt	Moody's	Ba1	WR
9/16/2014	Initiated	Jac Holding Corp	Senior Secured Debt	Moody's	B3	
9/16/2014	Initiated	GameStop Corp	LT Local Issuer Credit	S&P	BB+	NR
9/16/2014	Initiated	Jac Holding Corp	LT Local Issuer Credit	S&P	B	

Table 9: Ratings actions on HY issuers

Date	Action	Company Name	Rating Type	Agency	Curr Rtg	Last Rtg
9/16/2014	Initiated	Victory Energy Corp	LT Local Issuer Credit	S&P	BB-	
9/16/2014	Initiated	Zebra Technologies Corp	LT Local Issuer Credit	S&P	BB-	
9/17/2014	Initiated	Zebra Technologies Corp	Senior Unsecured Debt	Moody's	B2	
9/17/2014	Initiated	Answers Corp	LT Local Issuer Credit	S&P	B	
9/17/2014	Initiated	Halyard Health Inc	LT Local Issuer Credit	S&P	BB	
9/18/2014	Initiated	American Airlines Group Inc	Senior Unsecured Debt	Moody's	B3	WR
9/18/2014	Initiated	Halyard Health Inc	Senior Unsecured Debt	Moody's	B2	
9/18/2014	Initiated	RSP Permian Inc	Senior Unsecured Debt	Moody's	B3	
9/18/2014	Initiated	RSP Permian Inc	LT Local Issuer Credit	S&P	B+	
9/15/2014	**Downgrade**	**Hillenbrand Inc**	**Senior Unsecured Debt**	**Moody's**	**Ba1**	**Baa3**
9/15/2014	Downgrade	Road Infrastructure Investment LLC	LT Local Issuer Credit	S&P	B-	B
9/15/2014	Downgrade	Sequa Corp	LT Local Issuer Credit	S&P	B-	B
9/16/2014	Downgrade	NII Capital Corp	Senior Unsecured Debt	Moody's	C	Caa3
9/16/2014	Downgrade	Associated Asphalt Partners LLC	LT Local Issuer Credit	S&P	B	B+
9/18/2014	Downgrade	Waterford Gaming LLC	Senior Unsecured Debt	Moody's	Ca	Caa3
9/18/2014	Downgrade	CITGO Petroleum Corp	LT Local Issuer Credit	S&P	B-	B
9/18/2014	Downgrade	US Investigations Services LLC	LT Local Issuer Credit	S&P	CCC-	CCC+
9/15/2014	Dropped	JHCI Acquisition Inc	LT Local Issuer Credit	S&P	NR	B-
9/17/2014	Dropped	SkillSoft Ltd	LT Local Issuer Credit	S&P	NR	B-
9/16/2014	Default	Waterford Gaming LLC	LT Local Issuer Credit	S&P	D	CC

Source: BofA Merrill Lynch Global Research

Table 10: CDX vs. ML Cash Indices

Index	Spread	1W-Chng	1M-Chng	3M-Chng
CDX IG	56	-4	-2	0
HG Cash	113	-1	0	5
CDX HY	323	-13	8	27
HY Cash	397	-6	12	58

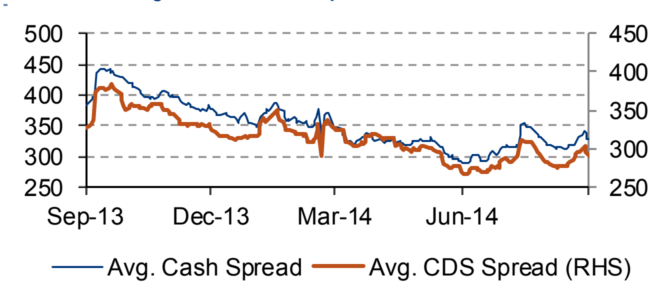
Source: BofA Merrill Lynch Global Research, 5y spreads for CDX, OAS for cash

Relative Value

Cash v. CDS

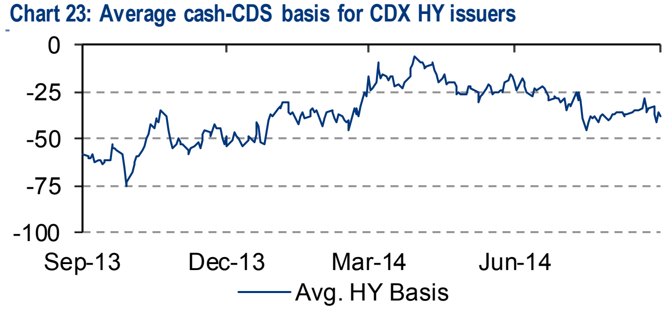
CDS indices tightened more than cash over the week (Table 10). CDX HY tightened 13bps while our HY cash index, in contrast, was 6bps tighter. The average cash-CDS basis for the CDX HY issuers we track became more negative (Chart 23). The average basis now stands at -38bps, 4bps lower over the week.

Chart 22: 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 23: 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

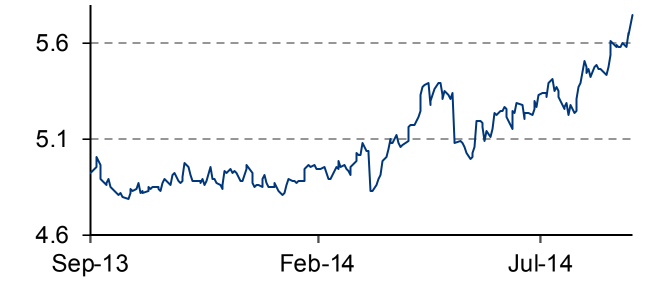
CDS indices were tighter on the week overall (Table 11). IG tightened 4bps, Main tightened 3bps, HY 13bps, and XO 15bps. The ratio between HY and IG increased during the past week and now stands at 5.75 (Chart 24). The XO-HY spread difference declined 1bp from -93bps to -94bps (Chart 25).

Table 11: 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	56	-4	-2	0	60	-1	0	4	-3	-3	-1	-4
CDX HY	323	-13	8	27	311	-1	10	31	12	-13	-2	-5
iTraxx Main	57	-3	-4	-2	55	-1	-5	0	1	-2	2	-2
iTraxx XO	229	-15	-22	3	232	-5	-16	17	-3	-10	-7	-14

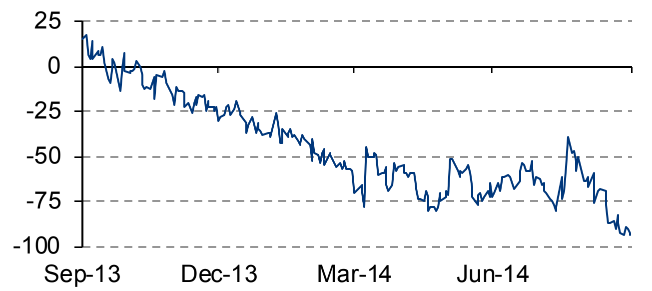
Source: BofA Merrill Lynch Global Research

Chart 24: HY/IG



Source: BofA Merrill Lynch Global Research

Chart 25: XO-HY

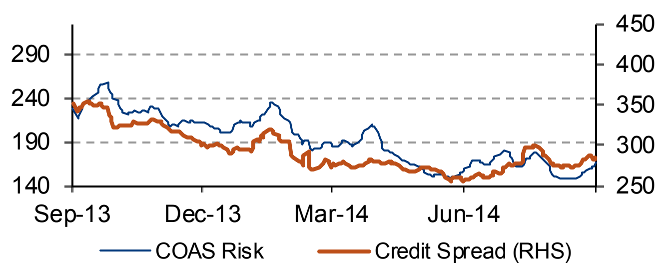


Source: BofA Merrill Lynch Global Research

Credit v. Equities

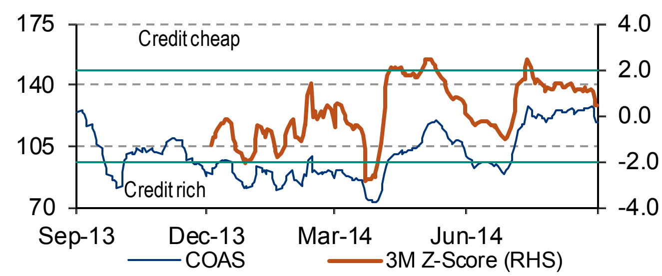
Average spread for our HY universe widened 2bps compared to a 10bps rise in the equity implied credit risk (Chart 26). The US HY COAS value declined 8bps over the week and its 3m z-score is now +0.42 indicating that credit is for the most part fairly valued relative to equity. However, the trend has been richening (Chart 27).

Chart 26: US HY COAS Risk vs. Spread



Source: BofA Merrill Lynch Global Research

Chart 27: US HY COAS & Z-Score



Source: BofA Merrill Lynch Global Research

CLOs

Market View

This is an excerpt from our recently published: CLO Weekly: Factors Affecting CLO Equity Returns 21 September 2014

US secondary activity was moderate this week with BWIC volumes totalling about $630mn split somewhat evenly between 1.0 and 2.0/3.0 deals. Bids for 2.0s have moved slightly weaker over the past couple of weeks but demand for 1.0s and especially shorter-WAL notes remained strong as both real and fast money continued to search for shorter cash flows. Trading in the 2.0 space remained choppy, tiered by manager and quality. Overall, US spreads were unchanged over the week.

The primary market in the US saw five additional deals price this week including GSO/Blackstone's $564mn Thacher Park CLO, Aegon's $461mn Cedar Funding IV, CSAM's $1,023mn Atrium XI as well as Carlyle's $571mn Carlyle Global Market Strategies CLO 2014-4. Of these, GSO/Blackstone's deal was reported to have priced at 147, 220, 305, 420 and 630bp, Cedar Funding IV priced at 150, 220, 340, 430 and 630bp while Carlyle 2014-4 priced at 150, 245, 315, 430, 640 and 775bp. Year-to-date, total issuance in the US is now close to hitting $90bn. We look for about $110bn in total for all of 2014. No deals priced in Europe this week.

As shorter-WAL legacy US deals continue to roll down the curve, we expect them to continue to perform well until year-end. The slow growth recovery thus far has kept the Fed in dovish mode and this suggests to us that the broad theme of reaching for yields will continue to make sense. As the front end of a duration barbell, we continue to like CLOs and we dismiss talk of a bubble in CLOs and high yield debt. Capital is simply being allocated to corporate debt and away from the formerly dominant residential mortgage market because of all the post-crisis challenges lenders had collecting on mortgage debt. We expect $110 billion of CLO issuance this year, with roughly 60% of it rated AAA; 2014 high yield loan and bond issuance should total $450 billion and $230 billion, respectively. These sound big by historic CLO and HY standards, but they pale in comparison to pre-crisis mortgage volumes: over a 7-year period from 2001-2007, annual mortgage production averaged $2.9 trillion per year, a multiple of 4x this year's elevated CLO and HY numbers. In 2014, total mortgage production will be lucky to reach $1 trillion; in 2015, mortgage production is likely to be even lower.

Convertibles

A September selloff

Global markets saw a bit of a pullback in the beginning of September due to ongoing geopolitical tensions in the Middle East and in Ukraine, disappointing data out of China, and fears of Fed hawkishness during the September FOMC meeting. However, the past few days brought some reprieve as China announced new stimulus policies and the Fed maintained its dovishness. All of this considered, global convertibles have declined so far during September. Month-to-date, the G300 global index is down 1.1% USD as the US has dropped 0.6% USD, Japan has lost 2.9% USD, Europe has declined 1.9% USD, and Asia has fallen 1.2% USD. Year-to-date, the picture is positive for the US (+9.5% USD) and Asia (+4.5% USD), though negative for Japan (-3.1% USD) and Europe (-4.8% USD).

Table 12: Global issuance summary

	US	Europe	Asia	Japan	Total
Sep MTD					
Issuance	4.8	4.1	0.9	0.5	10.2
Redemptions	1.5	0.5	0.6	0.0	2.5
Net	3.2	3.6	0.4	0.5	7.7
2014 YTD					
Issuance	33.9	21.1	11.2	5.4	71.6
Redemptions	33.3	13.3	9.5	2.4	58.6
Net	0.5	7.8	1.7	3.0	13.0
To Year End					
Maturities	5.6	3.9	2.1	0.8	12.4
Exp Redemp	5.9	0.3	0.8	0.0	7.0
Total	11.4	4.2	2.9	0.8	19.4

Source: BofA Merrill Lynch Global Research

Table 13: Global performance based on the G300 Global Convertible Index

Index Name	Sep '14 USD	Sep '14 EUR	Sep '14 JPY	Sep '14 LOC	YTD USD	YTD EUR	YTD JPY	YTD LOC	Code
G300	-1.1%	1.4%	3.7%	-0.3%	4.5%	12.1%	8.4%	6.2%	VG00
G300 (ex US)	-1.8%	0.8%	3.0%	0.1%	-2.0%	5.2%	1.6%	2.0%	VG2I
G300 (ex Japan)	-1.0%	1.5%	3.8%	-0.4%	4.9%	12.6%	8.8%	6.6%	VGXJ
US	-0.6%	1.9%	4.2%	-0.6%	9.5%	17.5%	13.6%	9.5%	VR10
Japan	-2.9%	-0.4%	1.9%	1.3%	-3.1%	3.9%	0.4%	-0.2%	VR20
Europe	-1.9%	0.6%	2.9%	0.3%	-4.8%	2.2%	-1.3%	1.0%	VR30
Asia ex-Japan	-1.2%	1.4%	3.7%	-1.0%	4.5%	12.1%	8.4%	4.5%	VR40
Emerging Markets	-1.3%	1.3%	3.6%	-0.5%	3.3%	10.9%	7.1%	5.4%	VEMG

Source: BofA Merrill Lynch Global Research

Supply is on a tear

New issuance volume has been very strong so far in September as globally we have seen a total of $10.2bn new supply during the first few weeks of the month. To put that into perspective, September is the second largest month so far this year (behind June when $15.7bn was issued) and we still have about a week to go. On regions, the US has seen the most issuance with $4.8bn, much of which is from the massive $1.8bn Twitter offering. Notably, due to both strong issuance and few redemptions, net supply for the US on an annual basis reached positive territory (+$0.5bn) for the first time this year. Behind the US is Europe, which has brought $4.1bn of new supply to market, followed by Asia (+$0.9bn), and Japan (+$0.5bn).

Link to Definitions

Credit

Click here for definitions of commonly used terms.

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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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