

## Long Loan Opportunities

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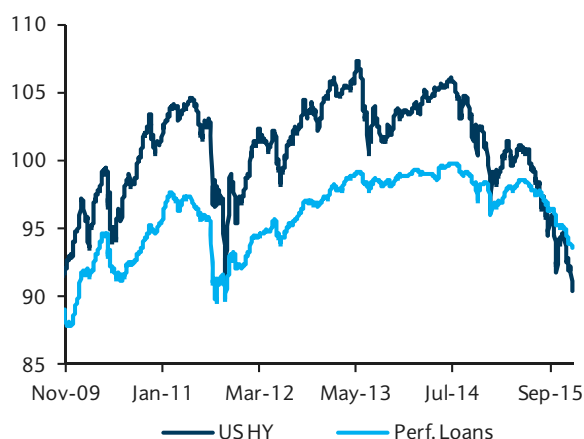
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The weakness in the leveraged finance markets intensified this week, in tandem with the sell-off in commodities. Through Wednesday, high yield total returns fell to below -3.3% on the year, and the average bond price fell to \$90.49, its lowest level since 2009. Similarly, the loan market fell to multi-year lows, as the Performing Loans Index reached a trough of \$93.51 last seen in 2012 (Figure 1). Despite the current weakness, we are broadly constructive on the high yield and loan markets as we look ahead to 2016, as detailed in the [Global Credit Outlook](#). Specifically, we forecast a year of outperformance for loans, at 500-600bp of total returns, versus 400-500bp for high yield, and think that loan investors will likely benefit from the rare price upside that is currently available in a solid economic environment.

In concert with this theme, we revisit the current relative value picture for loans and high yield. As a reminder, our preferred method of comparing the markets is with an “effective yield” measure that combines current yield and a pull-to-par component. In addition, we adjust for differences in rating compositions by applying the market weights of BBs and Bs in the Loan Index to the High Yield Index (see [Relatively Well Valued](#) for more details). As seen in Figure 2, high yield looked significantly more attractive than loans immediately after the August sell-off, with the effective yield gap exceeding 150bp. Since then, however, the weakness in the loan market has closed the gap between the two. We also note that the gap between the two markets is narrower when rate swaps are incorporated in the calculation, which is a rate-insensitive way of looking at relative value between the markets. That said, loan investors do not typically use swaps, but may still benefit from a rise in short-term rates above 1% floor levels in the near future as the Fed begins its hiking cycle.

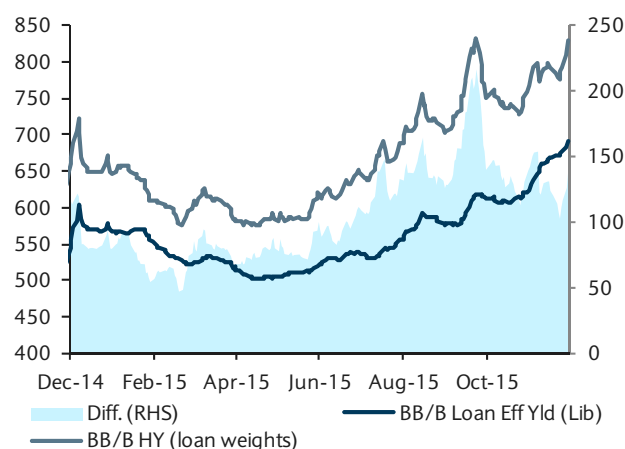
To position opportunistically for another volatile year, we present two ways of capitalizing on the currently wide loan market with intra-capital structure trades. The first is swaps out of bonds and into loans, and we present such opportunities on a duration-matched basis in Figure 4. The table is sorted by differences in effective yields between bonds and loans. There are a few instances where the loans actually have a higher effective yield than the bonds, but for the most part we recommend trades where moving up in the capital structure leads to very little give-up in yield and actually allows investors to take out price. This highlights the better convexity of the loan market compared with its historical lack of upside when it trades near par. If markets move lower, these swaps should be very effective, and in a rally, we do not expect returns to be substantially different.

FIGURE 1  
High Yield and Loan Index Prices



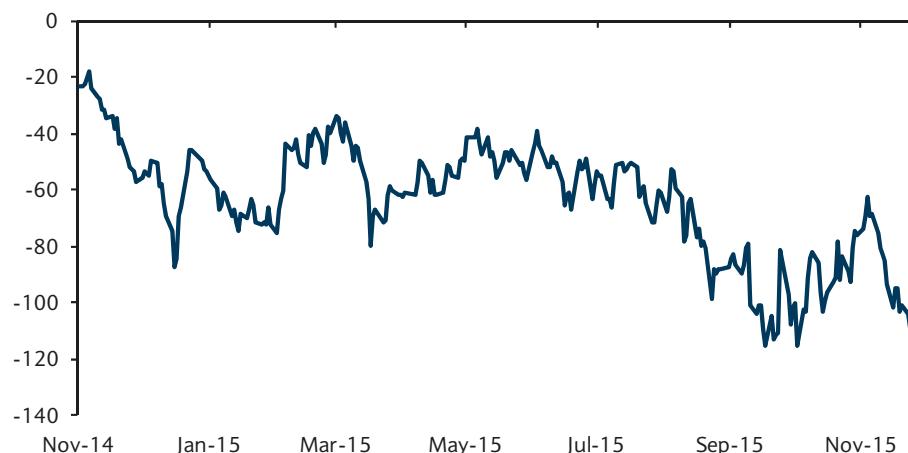
Source: Barclays Research

FIGURE 2  
Effective Yields for BB/B Bonds and Loans (bp)



Source: Barclays Research

FIGURE 3  
Matched High Yield CDS-Cash Basis (bp)



Note: Calculated using 76 constituents of HY25. Source: Barclays Research

Investors anticipating a continuation of credit market weakness in the near term can opt for loan-CDS pairs that offer a significant positive basis in order to get short unsecured risk. The cash-CDS basis has become increasingly negative over the past year (Figure 3), and as we discussed in the *Outlook*, we struggle to find a good reason for the persistent dislocation between HY CDX and its constituents. We recognize there are fewer basis-focused accounts in the market today (and therefore less of a regulating mechanism for the basis). And with the CDX skew currently very rich, there is likely tightening pressure on single-name CDS from reverse arb accounts that are looking to capture the difference in valuation between the index and its underlying constituents. But these factors cannot justify why in some cases unsecured CDS trades inside of secured obligations in the same capital structure. We believe this represents an opportunity to own downside protection and still earn a significant amount of spread with long loan-short CDS pairs. We present such pairs in Figure 5 – they are sorted by carry, defined as the difference between the loan spread-to-maturity and the maturity-matched CDS level. We note that the table shows the spread differences on a notional-neutral basis, which can be adjusted depending on specific credit views.

FIGURE 4

## Swaps into Loans and out of Bonds

Bond									Loan				Differences				
Issuer	Ticker	Cpn (%)	Mat Date	Redeem	Par (\$mn)	Rating	Price (\$)	Eff.Yield (%)	Facility	Cpn (%)	Mat Date	Rating	Par (\$mn)	Price	Eff. Yield (%)	Price (\$)	Eff. Yield (%)
Safeway	ALBLLC	5.00	Aug-19	Aug-19	269	CCC+	99.50	5.16	TL B2	5.51	Aug-21	BB-	3,880	99.50	5.71	0.00	-0.54
Safeway	ALBLLC	5.00	Aug-19	Aug-19	269	CCC+	99.50	5.16	TL B4	5.39	Mar-19	BB-	1,427	99.46	5.60	0.04	-0.44
Virgin Media	VMED	5.38	Apr-21	Apr-19	900	BB-	103.75	4.06	TL F	3.51	Jun-23	BB-	1,855	98.90	3.92	4.85	0.14
Schaeffler	SHAEFF	4.75	May-21	May-19	850	BB-	101.50	4.24	TL B	4.26	May-20	BB-	590	100.88	3.93	0.62	0.31
Fortescue	FMGAU	8.25	Nov-19	Nov-19	577	B+	80.50	15.35	TL B	4.26	Jun-19	BB+	4,851	77.75	15.02	2.75	0.33
First Data	FDC	5.38	Aug-23	Aug-20	1,210	BB	102.25	4.78	TL	4.09	Jun-22	BB	725	99.50	4.28	2.75	0.50
Ineos	INEGRP	5.88	Feb-19	Feb-19	590	B-	99.50	6.06	TL B	3.76	Dec-20	BB-	886	96.63	5.06	2.88	1.01
Zebra Tech	ZBRA	7.25	Oct-22	Oct-20	1,050	B+	103.75	6.22	TL B	4.76	Sep-21	BB+	2,050	100.20	4.68	3.55	1.53

Note: Loan coupons include benefit of Libor floors. Swapped yields are interpolated based on each loan's effective maturity. Source: Barclays Research

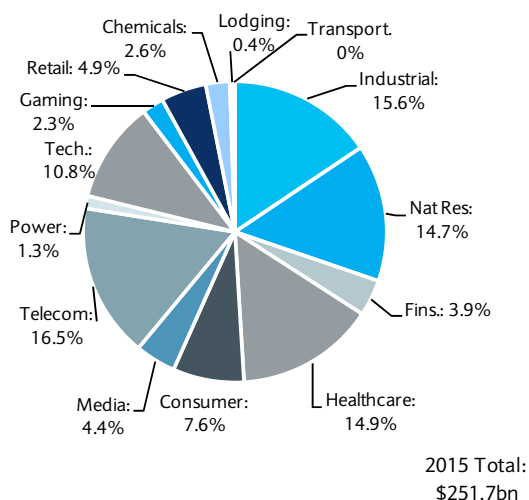
FIGURE 5

## Loans and CDS Packages with Positive Carry

Issuer	Mat. Date	Facility	S&P Rating	Par (\$mn)	Mat. (yrs)	Price (\$)	All-in Spread (bp)	Spread to Mat. (bp)	5y CDS (bp)	Matched CDS (bp)	Carry (bp)
Sabre	Feb-19	TL B	B+	1,726	3.2	99.53	400	384	212	120	264
First Data	Mar-18	TL B1	BB	4,600	2.3	99.10	L+350	393	348	137	256
Level 3	Aug-19	TL B3	BB	815	3.6	99.93	400	369	189	121	248
Level 3	Jan-20	TL B4	BB	1,796	4.1	99.92	400	369	189	144	225
First Data	Sep-18	TL B1	BB	1,008	2.8	99.15	L+350	384	348	172	212
Boyd Gaming	Aug-20	TL B	BB-	731	4.7	99.70	400	375	249	232	142
Community Health	Dec-18	TL F	BB	1,692	3.1	98.28	L+325	388	555	292	97

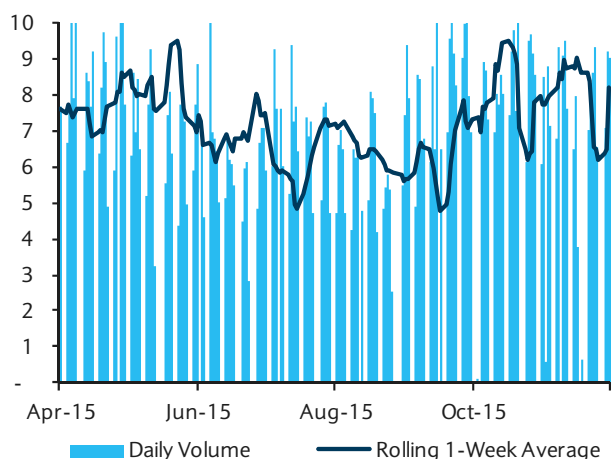
Note: \*All-in-spreads show the "L+" if there is no Libor floor and show the all-in-spread including the Libor floor otherwise. Matched-maturity CDS spreads are interpolated. Source: Barclays Research

## High Yield Supply by Sector – 2015 Breakdown



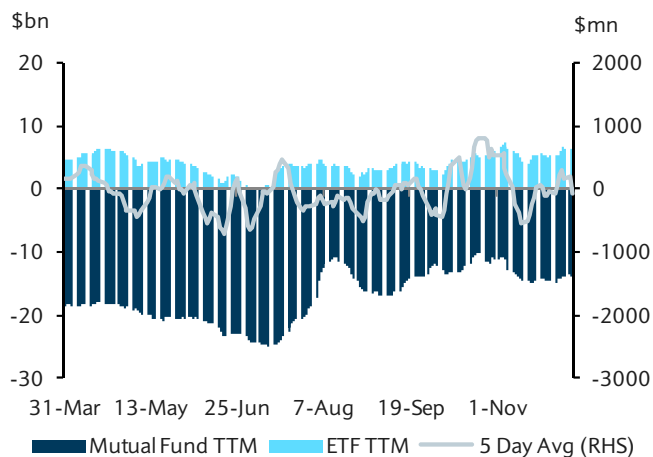
Source: Barclays Research

## High Yield Average Institutional Trade Volume (\$bn)



Source: FINRA TRACE

## Flows to High Yield Mutual Funds and ETFs



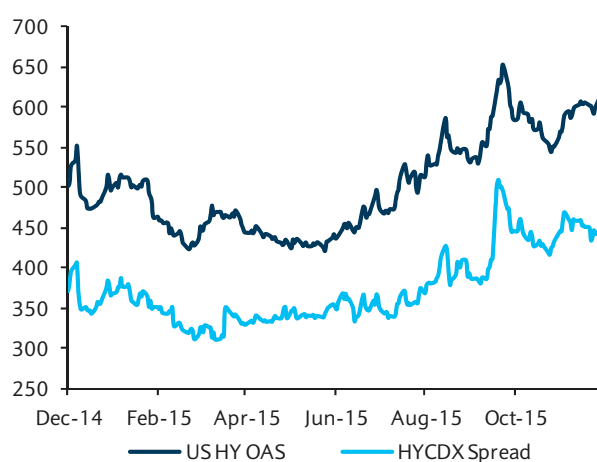
Note: Daily reporters only. Source: EPFR

## Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding (\$bn)		Volume – Week Ending 12/04/15 (\$mn)
	Gross	Net	Gross
Chesapeake	9.4	1.0	402.3
IHeart Comm.	14.1	0.8	257.3
Avon	10.3	0.7	192.6
U.S. Steel	7.8	0.8	174.2
Ally Financial	11.2	0.8	153.6
Centurylink	10.1	0.8	143.6
Beazer Homes	6.6	0.7	130.0
McClatchy	7.3	0.4	106.5
AK Steel	4.5	0.3	91.9
KB Home	6.7	0.6	88.3

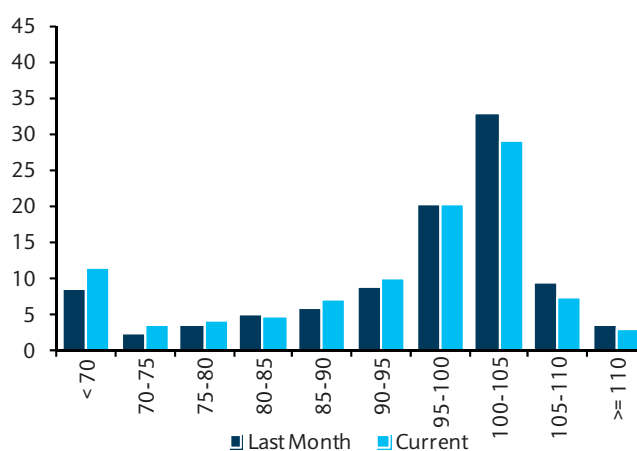
Source: DTCC

## On-the-Run HYCDX versus US High Yield Index (bp)



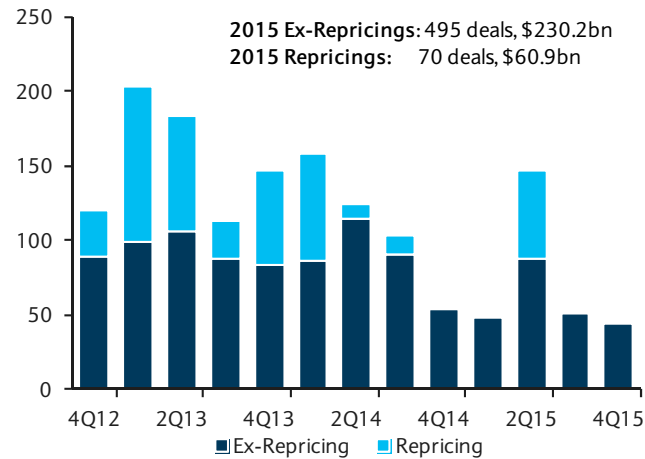
Source: Barclays Research

## High Yield Index Price Distribution by Par (%)



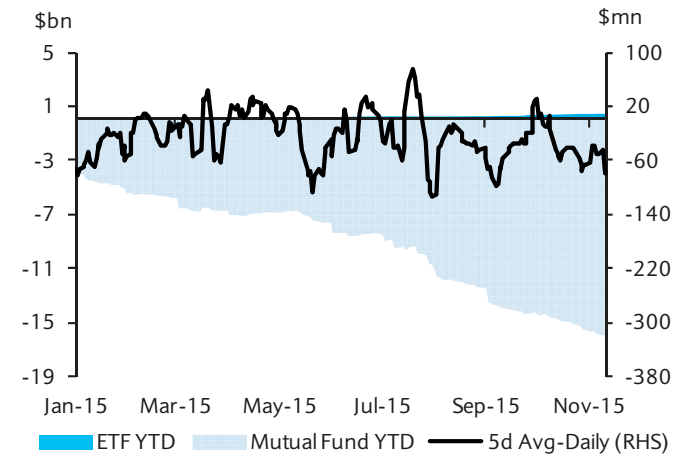
Source: Barclays Research

### Quarterly Institutional Leveraged Loan Issuance (\$bn)



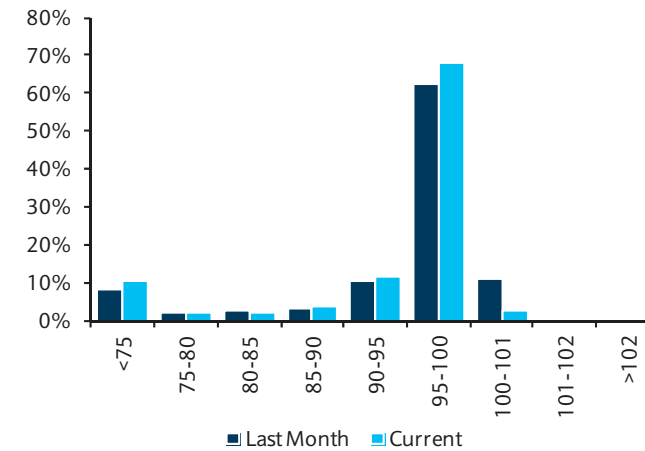
Source: S&P LCD, Barclays Research

### Flows to Loan Mutual Funds and ETFs



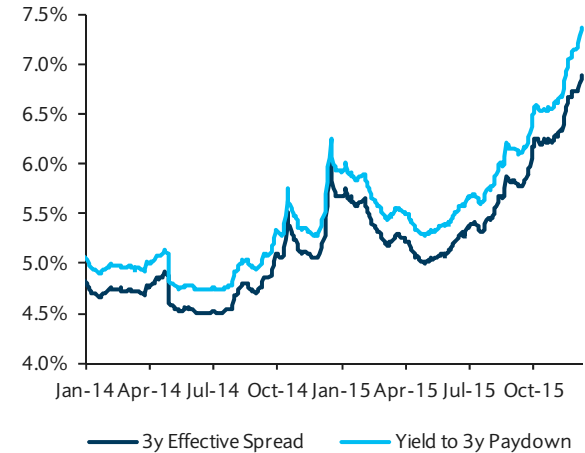
Note: Five-day average includes only flows of daily reporters. Source: EPFR

### Loan Index Price Distribution by Par



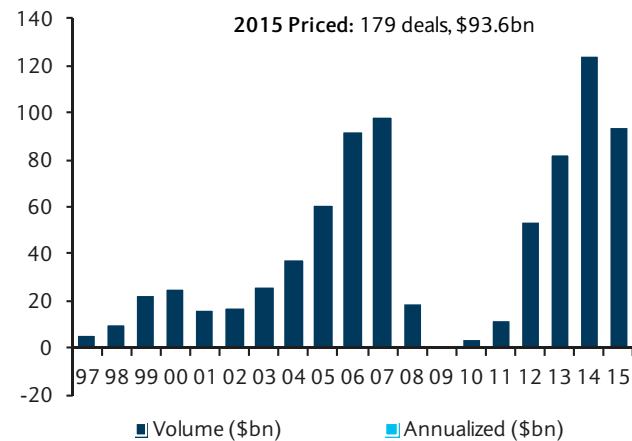
Source: Barclays Research

### Barclays Performing Loan Index Yield and Spread



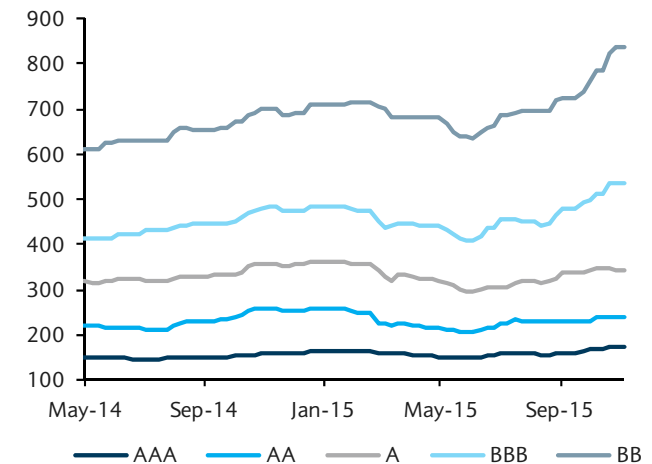
Note: Yield and spread calculation assumes a three-year paydown period, amortizing any premium or discount to par accordingly. Source: Barclays Research

### Annual CLO Issuance



Source: S&P LCD, Creditflux

### US CLO 2.0 Spread Performance by Rating (bp)



Note: Spread data from BWIC levels. Source: Moody's, Intex, Barclays Research

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