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A Rising Tide Could Lift These Boats

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In August, we looked at the market through the lens of a new macro framework (see *US Credit Focus: Macro Credit Framework: Let's Be Reasonable* for details). Given that we appeared to be in a state of steady economic growth, we anticipated about a 70% chance of positive returns over the forward six-month period, with expected returns revolving around carry.

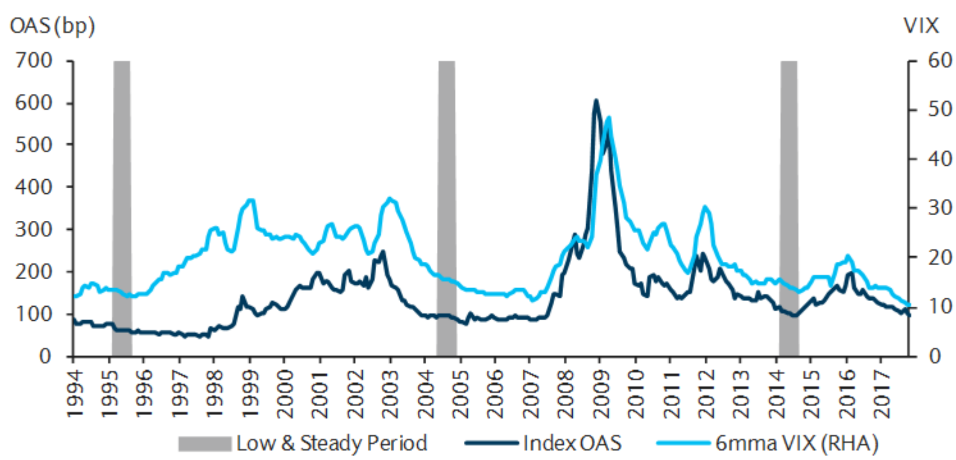
Even with the index rally to inside 100bp of OAS, we think that carry-like positive returns remain the best forecast for the market, because the economic situation remains solid. But with aggregate spreads now so tight – BBB OAS is lower than about 90% of the time since the Bloomberg Barclays Indices began – it is more difficult to find situations that offer absolute upside. To see where we should focus our search for those opportunities, we identified three periods in the past when spreads and volatility were already low and continued to grind lower for the subsequent six months (Figure 1). Then we looked at which combination of circumstances for particular credits was associated with the most compelling upside.

We start with valuation. Because we think that credit valuations are a good proxy for forward-looking beta, if the market does see upside over the next six months, we should expect wider-trading names to post absolute outperformance. Figure 2 shows that during the tight-spread periods we consider, the most absolute upside was posted by issuers trading 2-3x wider than the index spread. Figure 3 shows that this range also had a comparatively high concentration of situations that produced 2x the index return or higher.

Narrowing our consideration set to issuers that trade 2-3x wider than the index gives us a limited set of situations to consider. We lay these out in Figure 4. A few observations about these companies:

- We know, from their spreads relative to the index, that they were viewed as among the riskier investments available in credit at each period.
- Despite the obvious risks, many of them posted strong performances, and almost all produced positive returns. For example, within this set, 88% had positive returns over the subsequent six months, even better than the 85% rate of positive returns for all index members.

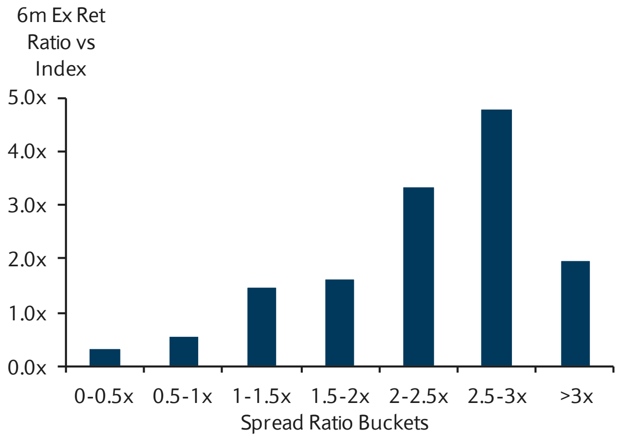
FIGURE 1
Past Periods of Low Spread Rallies



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 2

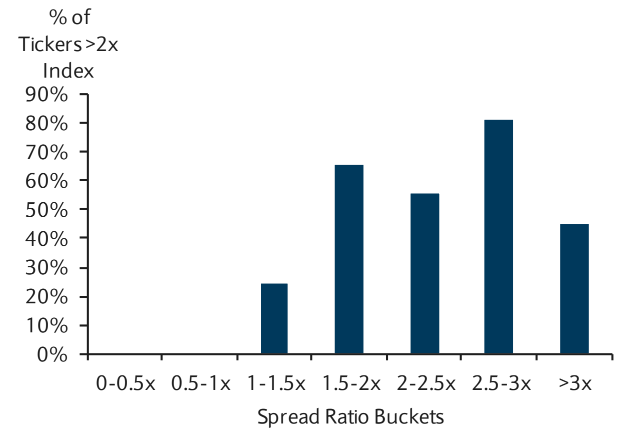
Average Excess Return (as Multiple of Index Excess Return) by Starting Spread Relative to the Index



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 3

Percentage of Tickers in Starting Spread Ranges with at Least 2x Index Excess Returns after Six Months



Source: Bloomberg Barclays Indices, Barclays Research

A review of the details for each company in the 2-3x index spread group shows that they were all facing some kind of meaningful challenge at the time, including weak fundamentals, difficult industry trends, or one-off business problems. The themes that emerge from looking at those difficulties can help indicate which current companies have the most promising opportunities.

FIGURE 4

Wide-Trading Issuer Performance in Past Low Spread Rallies

1995				2004				2014			
Name	Spread	Spread Ratio	6m Excess Return (bp)	Name	Spread	Spread Ratio	6m Excess Return (bp)	Name	Spread	Spread Ratio	6m Excess Return (bp)
Index	**66**	**1**	**75**	**Index**	**99**	**1.0**	**131**	**Index**	**109**	**1.0**	**95**
UAUA	243	3.7	694	UAUA	644	6.5	-357	CLF	337	3.1	-119
TWX	192	2.9	617	INTEL	396	4.0	-388	KCN	330	3.0	383
RAI	171	2.6	-15	PETBRA	374	3.8	922	WMB	313	2.9	569
AMR	167	2.6	329	AMBEV	369	3.7	1074	SCCO	290	2.7	745
CMCSA	161	2.4	303	CZN	367	3.7	209	ATI	289	2.6	477
FE	161	2.4	117	DALR	353	3.6	86	CTL	280	2.6	275
UBS	156	2.4	329	AMR	311	3.2	286	NEM	275	2.5	772
KSE	155	2.4	117	CAL	311	3.2	165	MDC	262	2.4	142
KMRT	139	2.1	12	EDS	260	2.6	252	SASOL	260	2.4	625
				MO	250	2.5	457	MWV	255	2.3	545
				HTZ	238	2.4	255	OHI	251	2.3	311
				F	195	2.0	117	QVCN	251	2.3	407
				GM	193	2.0	-85	EMBRBZ	250	2.3	304
								AVP	245	2.2	32
								BCOLO	241	2.2	444
								JBL	238	2.2	344
								VALEBZ	236	2.2	465
								OC	233	2.1	470
								AA	233	2.1	30
								LDOS	231	2.1	-208
								KPN	224	2.1	510
								UFS	223	2.0	174
								ABXCN	221	2.0	485
								UU	219	2.0	407
								TACN	219	2.0	115

Source: Bloomberg Barclays Indices, Barclays Research

Themes

Rising Stars Still Rising

Recent rising stars that remain relatively wider than the average for investment grade. The most notable group was in 2004, associated with upgrades of emerging market companies. The current crop is more closely linked to recovery from turmoil in energy.

- Previously: PETBRA, AMBEV in 2004
- Now: ECACN, CVECN

Idiosyncratic Difficulties in a Stable Industry

These are issuers that experienced company-specific problems. These could be operational (falling sales or weaker margins), event-driven (significant asset impairment), or reputational (some business controversy). Each of these tends to be unique, and the current group is facing downgrade risks from conditions that are more specific for each company than a wider trend in their industries.

- Previously: AMR, KMART, KSE, in 1995; CAL in 2004; EMBRBZ, KPN in 2014
- Now: VALEBZ, VIA, KPN, LM

Commodity Producers Facing Low Underlying Prices

Companies that produce commodities that have been stressed by low prices for the goods they sell. These names tend to see tightening valuations when spreads rally from tight levels.

- Previously: CLF, KCN, WMB, SCCO in 2014
- Now: HES, VALEBZ, CVECN, ECACN, APC, PAA, ETP, ENLK

Structural Issues That Are Not Immediately Fatal

Companies that are in industries facing structural changes that may put their businesses at risk, but where there is little immediate risk of a total collapse. These companies can remain stressed for some time, but generally have long runways despite their difficulties.

- Previously: RAI in 1995; MO in 2004
- Now: PBI, STX, FIBRBZ, M, BBBY

Stressful Corporate Events

Firms where corporate events – restructurings, mergers, spin-offs, or other similar moves – have put the credit under stress. These tend to be transient situations that are resolved, one way or another, within our six-month performance window.

- Previously: TWX and CMCSA
- Now: JWN

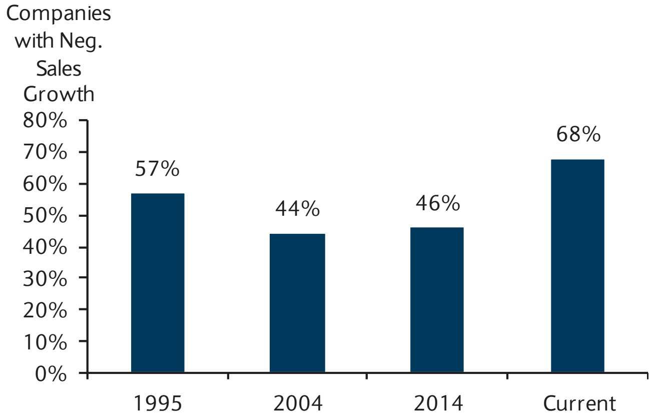
The Exceptions: Names Where Things Could Worsen Sharply

Despite the probability that many of the firms we have identified would outperform in a rally, there are notable exceptions. In general, these have experience a discrete event – a sharp move toward default or a credit-worsening corporate event.

- Previously: UAUA (1995 and 2004), INTEL and GM in 2004 CLF in 2014
- Now: JWN, M, CTL, TEVA

FIGURE 5

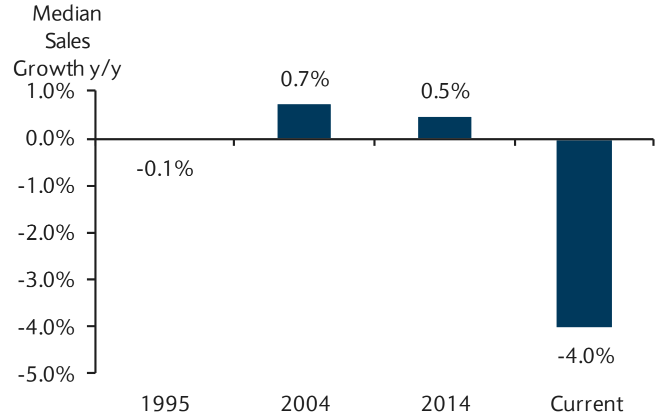
Percent of Companies with Negative Year-on-Year Sales Growth for Each Cohort



Source: Factset, Bloomberg Barclays indices, Barclays Research

FIGURE 6

Median Year-on-Year Sales Growth for Each Cohort



Source: Factset, Bloomberg Barclays indices, Barclays Research

We sound an additional note of caution about extending past experience to the current cohort. In general, these are companies that are under some kind of strain, but the present group appears to be more operationally strained than we have seen in the past. In particular, this cohort has seen much worse sales growth – in the past, only half of the 2-3x index spread names had posted negative sales growth in the prior year, now that percentage is above two-thirds. Furthermore, the median sales growth of the current cohort is much lower (Figures 5 and 6).

Appendix: Names That Are Currently at Least 2x Wide of the Index

FIGURE 7

Names That Currently Trade at Least 2x Index OAS

Name	OAS	OAS Ratio	Market Value ($bn)	Analyst Rating
Index	**95**	**1**	**5,121**	-
BBBY	294	3.1	1.4	-
M	274	2.9	5.0	Underweight
CTL	265	2.8	1.9	-
HES	254	2.7	6.4	Market Weight
PBI	249	2.6	2.5	-
STX	230	2.4	5.1	Market Weight
SBRA	226	2.4	1.0	-
VIA	215	2.3	9.6	Market Weight
VALEBZ	212	2.2	14.9	Overweight
CVECN	206	2.2	8.0	Market Weight
KPN	200	2.1	1.4	Underweight
ECACN	197	2.1	4.8	Overweight
FIBRBZ	196	2.1	1.4	Underweight
OHI	196	2.1	3.5	-
JWN	190	2.0	2.7	Underweight

Name	OAS	OAS Ratio	Market Value ($bn)	Analyst Rating
TEVA	190	2.0	16.0	Underweight
APC	188	2.0	11.7	Market Weight
LM	188	2.0	1.1	-
PAA	187	2.0	9.2	Market Weight
ADNA	187	2.0	1.6	Market Weight
ETP	187	2.0	26.2	Market Weight
ENLK	186	2.0	3.6	Market Weight

Source: Bloomberg Barclays Indices, Barclays Research

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