Previously published in the U.S. Credit Alpha
26 April 2019

There and Back Again with More Dispersion

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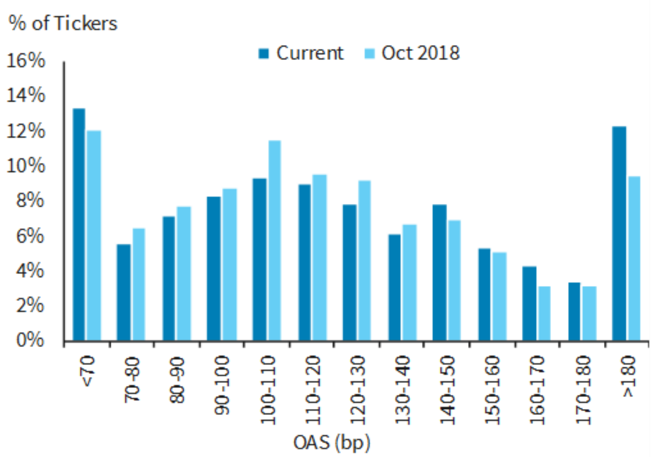
After reaching a multi-year wide of 157bp in the first days of January, the Bloomberg Barclays Corporate Index has tightened impressively through the start of 2019. Despite the strength of the rally, it has still taken nearly five months for the index to recover the spread widening experienced in the last two months of 2018, highlighting the severity of the sell-off in those trading sessions. Notably, the rally has been characterized by the outperformance of lower-duration, higher-quality issues throughout most of the year.

Indeed, even though index spreads are at levels similar to where they were six months ago, spread dispersion has increased meaningfully since last October. Figure 2 shows the number of tickers that traded in different spread ranges in October compared with now; the number of tickers in every range wider than 140bp has gone up, led by the widest bracket (tickers trading wide of 180bp), a cohort that has increased by 22 tickers. This emphasizes the underperformance of BBBs during this period – they clearly widened during the sell-off, but did not recover to the same extent as tighter-trading higher-quality debt. Although a number of these wide-trading issuers are smaller, less-liquid cap structures that likely take more time to re-price during a rally, a number of large BBB cap structures are, in fact, wider now than they were in October (including CVS, AbbVie, Ford, GM, GE, and Cigna)

Within BBBs, there has been a significant divergence in performance across sectors. Figure 2 looks at BBB spread per turn of net leverage across several broad sectors both in October and currently. We look at longer-dated debt - bonds maturing in at least seven years - as the effect of fundamental differences is likely to be less important in the front end. For net leverage, we use LTM EBITDA over net debt as of 3Q18 for the October levels and as of 4Q18 for current levels (the most recent backward-looking data available at each point). Compensation for leverage has declined for communications and energy, two sectors where leverage has been coming down for several large issuers and where deleveraging is expected to continue. In energy, deleveraging has been broad based and is evident in our numbers, with net leverage for the whole sector declining y/y (see *US Investment Grade Credit Metrics: Q4 18 Update*). Communications companies, on the other hand, have increased leverage on average, but some of the largest issuers in the sector have set deleveraging paths.

FIGURE 1

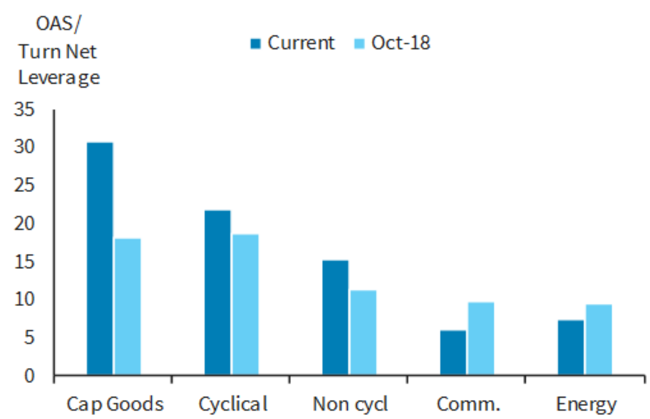
Single-Name Spread Dispersion Has Increased, Driven by BBB Underperformance…



Note: OAS for 7y+ debt only. Source: Bloomberg Barclays Indices, Barclays

FIGURE 2

…And within BBBs, Dispersion Has Increased Relative to Fundamentals



Note: OAS for 7y+ debt only. Source: Compustat, Bloomberg Barclays Indices, However, BBBs in the capital goods, consumer cyclical, and consumer non-cyclical sectors have seen spread compensation for leverage increase since October. The non-cyclical sector includes a number of large issuers that have recently increased leverage to fund acquisitions across the food & beverage, healthcare, pharmaceutical, and tobacco sub-sectors. While these sectors are traditionally more defensive, the increase in spread premium relative to fundamentals indicates to us that investors' concerns remain elevated. In cyclicals, fewer companies have increased debt burdens, but the sector is generally more exposed to broader economic weakness. Capital goods has more idiosyncratic risk; the increase in spread per turn of leverage is largely driven by GE. While these sectors do have elevated risks, they should be alleviated somewhat by the expectation that the economic cycle has been elongated by the Fed's dovish turn – for instance, our economics team revised its 2021 GDP growth expectation up to 2.0% from 1.6% earlier this year (see *March FOMC: We now see no hikes through 2020 on inflation tolerance*). Consequently, companies may have more time to deleverage or more broadly fix fundamentals than investors expected last year. This should be positive for valuations, particularly in the aforementioned sectors, since compensation for fundamental risk remains elevated.

We see several opportunities for investors to move into credits that we are constructive on at elevated spread levels relative to fundamentals. Given our expectation that spreads should continue to grind tighter in the near term, led by lower-quality debt, we highlight BBBs that are rated Overweight by Barclays' fundamental analysts and that trade wider per turn of leverage than they did in October in Figure 3 below.

FIGURE 3

BBBs with Increased OAS per Turn of Net Leverage since October

Ticker	Rating	Sector	OAS (bp)*	Change Since October	
				Net Leverage	OAS (bp)*
GE	BBB+	Capital Goods	256	-1.0x	72
MO	BBB	Consumer Non-Cyclical	227	0.1x	70
LOW	BBB+	Consumer Cyclical	142	0.1x	43
ABBV	BBB	Consumer Non-Cyclical	191	-0.1x	24

* OAS for 7y+ debt only.

Source: Bloomberg Barclays Indices

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Materially Mentioned Issuers/Bonds

ABBVIE INC, Overweight, A/CD/CE/D/J/K/L/M
Valuation Methodology: AbbVie's capital structure has realized tremendous selling pressure since mid-July, around the time that a proposed rule regarding the elimination of a safe harbor for drug rebates was submitted to the Office of Management and Budget (OMB) for review. Since then, the relationship between ABBV and AMGN has materially diverged, now trading 28bp apart versus a one-year trailing average differential of just 9bp (ABBV 47s versus AMGN 48s since ABBV 48s were only issued a few months ago, Figure 11). Although we believe this wider relationship is more appropriate given our preference for more diversified portfolios in the current high-volatility operating environment (which Amgen has on both a therapeutic and product-level), using our fair value target for AMGN (ie, 45bp back of PFE in the long-end or G+145), we believe ABBV long bonds should trade at roughly G+175, suggesting 25bp of upside from current levels.
Risks that May Impede Achievement of the Rating: If AbbVie imminently announces a large debt-funded acquisition, which would run counter to commentary from CEO Rick Gonzales during the company's Q3 earnings call, credit valuations would likely come under significant pressure. Alternatively, if the settlements already reached with various biosimilar manufacturers come under FTC scrutiny, bonds could experience a sharp sell-off.
Representative Bond: ABBV 3.2 05/14/26 (USD 96.51, 24-Apr-2019)

ALTRIA GROUP INC, Overweight, A/CD/CE/D/J/K/L/M
Valuation Methodology: We raise Altria to Overweight (from Underweight) primarily driven by compelling valuation.
We also think the company has done a better job of addressing some of the concerns that have risen among investors since it announced the JUUL acquisition, and we expect this to further stabilize sentiment in the sector more broadly, particularly as additional details continue to be provided to the investment community.
Risks that May Impede Achievement of the Rating: *Increased regulatory or tax risk
*Increased litigation risk
*Shifting consumer trend risk
*IQOS device not approved by FDA
*Increased leverage from potential M&A activity
Representative Bond: MO 2 5/8 09/16/26 (USD 91.63, 24-Apr-2019)

GE CAPITAL INTERNATIONAL FUNDING CO UNLIMITED CO, Overweight, CD/D/E/J/K/L/M/N
Valuation Methodology: We expect a series of positive events, including further details regarding GE Capital's runoff long-term care business, guidance on the turnaround for GE's Power segment and FCF, potential LME and operational improvement to drive spread compression in GE Capital's credit spreads, leading it to outperform the finance companies index.
Risks that May Impede Achievement of the Rating: GE may experience headwinds for longer than expected – and, hence, weaker cash flow generation dragged by Power segment and there is execution risk involved in the planned divestiture of assets and deleveraging plan.
Representative Bond: GE 2.342 11/15/20 (USD 98.59, 24-Apr-2019)

Representative Bond: GE 3.373 11/15/25 (USD 97.07, 24-Apr-2019)
Representative Bond: GE 4.418 11/15/35 (USD 91.75, 24-Apr-2019)
Representative Bond: GE 5 PERP (USD 92.63, 24-Apr-2019)

LOWE'S COS INC, Overweight, A/CD/CE/D/J/K/L/M
Valuation Methodology: We rate Lowe's Overweight (from Market Weight) given attractive valuation across most of the curve, with levels cheap to our fair value. We recognize that the company has to continue demonstrating that its initiatives will result in a more effective competitive position for the company. While the company's discussion around 4Q18 and early 1Q19 suggest some early developments in this direction, it could take another one to two quarters for investors to become fully comfortable with management's ability to turn things around. That said, if this is the case, we would expect the bonds to be trading more in line with our fair value at that time.
Risks that May Impede Achievement of the Rating: * Operations improvement later than expected
* A deviation from stated financial policy
* A shift in the housing backdrop and/or macro environment that results in an adverse effect on operational performance
Representative Bond: LOW 2 1/2 04/15/26 (USD 94.51, 24-Apr-2019)

All pricing information is indicative only. Prices are sourced from Refinitiv as of the last available closing price at the time of production of the research report, unless another time and source is indicated.

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Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

Market Weight (MW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
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Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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