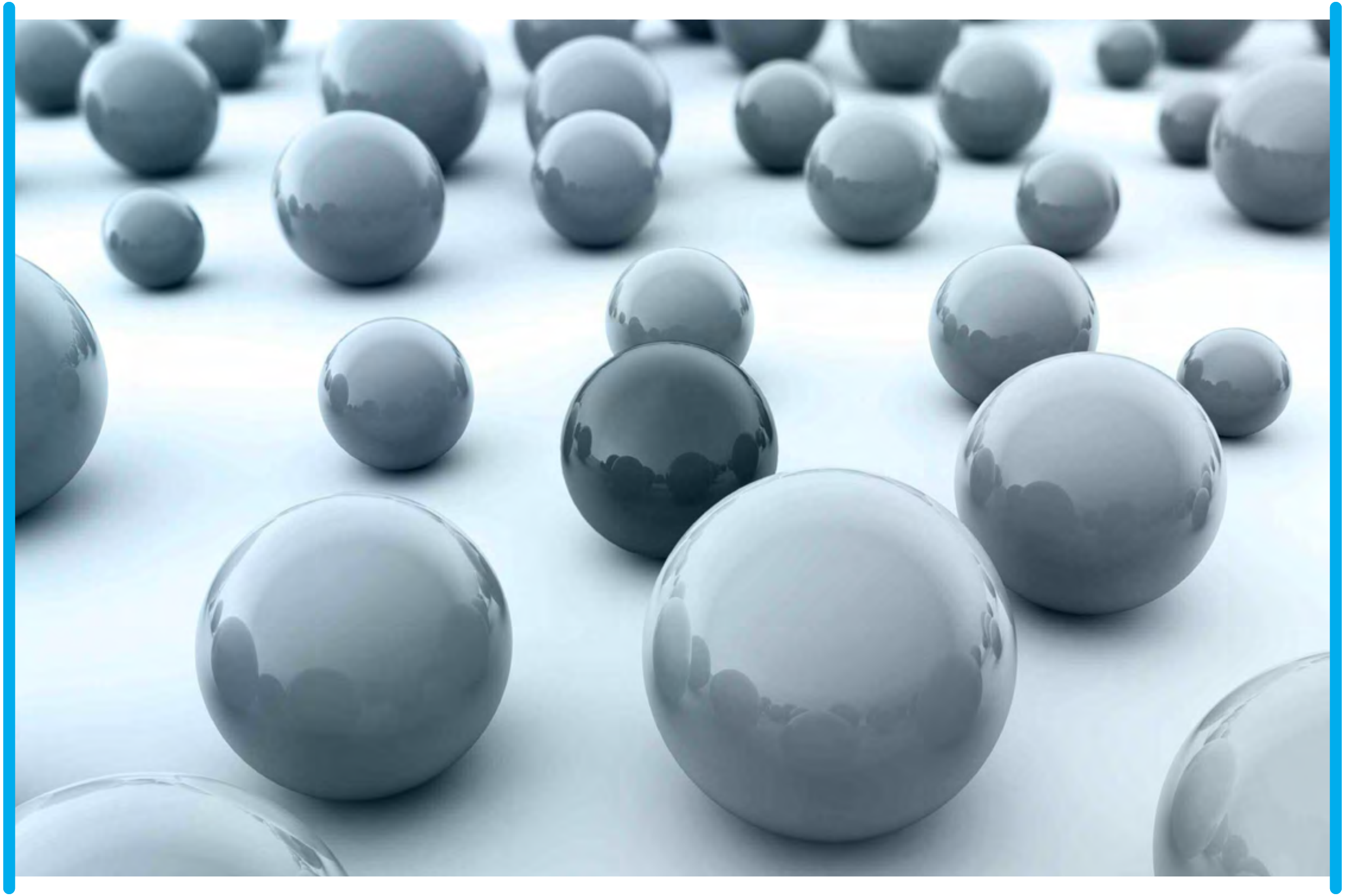
Credit Research
December 2012

Global Credit Outlook 2013

A good bond is hard to find



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FOREWORD

2012 has been a year of transition. The year began with wide spreads amid concerns about systemic risks, notably the European sovereign crisis. As we approach 2013, spreads are much closer to average levels across regions and credit quality, and investors' focus has shifted somewhat to fundamentals and idiosyncratic risks. This evolution occurred in fits and starts, with the most important catalysts coming from central banks. September was a key month – interventions by both the ECB (the announcement of the Outright Monetary Transactions program) and the Fed (QE3) came during a period of strong financial market conditions, at least relative to previous interventions. These aggressive policy maneuvers have disrupted, if not ended, the cycle of crisis/intervention that had dominated markets through the sovereign crisis.

We expect another year of positive excess returns in 2013. Ongoing support from central banks should translate into muted macro-led volatility, and the systemic risk premium should continue to be drained from the credit market. However, with tighter spreads, excess returns are likely to be lower than those achieved this year, and investors will be forced to seek outperformance in parts of the market that have lagged, such as BBBs in investment grade and CCCs in high yield.

Importantly, we expect the shift from macro, systemic risks into idiosyncratic, single-name volatility to continue. In the past few quarters correlation across credits has begun to decline. The lackluster economic backdrop, particularly in Europe, has started to weigh on results, evidenced by weak Q3 earnings, as well as credit ratings. Shareholder-friendly activity is likely to increase, as companies continue to take advantage of low yields. We also expect a rise in M&A activity, which should be neutral on average for credit investors, but will clearly contribute to differentiation across single names.

The fiscal cliff may turn out to be the major near-term exception to our view. We expect a solution to be reached that avoids a full-blown recession, and ascribe little importance to the cliff in our full-year forecasts. However, a market disruption of some kind could well be the catalyst to an eventual compromise. Given the aforementioned Fed and ECB programs, we believe any cliff-led volatility will be less severe than the sovereign-related episodes in 2010 and 2011, and would likely be a buying opportunity.

The need to move further out the risk curve to seek outperformance, combined with a potential rise in idiosyncratic single-name volatility, will translate into an environment in which a good bond is hard to find – the theme of our Global Credit Outlook for 2013. This publication brings together the expertise of our strategists and fundamental credit analysts across the regions, combining top-down views of the credit markets with bottom-up sector and issuer-specific analysis. More than in any other year since the start of the credit crisis, we expect both to play an essential role in performance for 2013. We hope you find this approach useful in helping you navigate what looks to be an increasingly idiosyncratic credit market in 2013.

Jeff Meli
Head of Credit Research

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OVERVIEW

A good bond is hard to find

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The actions of global central banks created a unique opportunity to take risk in 2H12. We believe these policies will continue in 2013 and therefore expect credit to remain the beneficiary of a global reach for yield. However, we think that most parts of the credit market are limited in terms of capital appreciation and, as a result, that credit has become more of an income asset class with a few notable high beta exceptions. Given limited opportunity for upside; modest global growth forecasts; macro concerns in the US, Europe, China, and the Middle East; and the potential for an increase in leverage from industrials, we believe most parts of the credit market will struggle to return much more than their coupon, but remain in favor relative to other even lower yielding fixed income assets. Throughout this publication, we focus on the aforementioned exceptions, which we believe will be the differentiating factors for performance in 2013.

What's left to rally in 2013?

2012 was a year of broken records in credit. Supply reached new heights in several markets, such as US IG and HY, Asia IG, and LatAm/EEMEA. Despite this influx of supply, technicals remained extremely robust. Yields declined to new all-time lows in much of the market, driven by both tighter spreads and the effect of central bank actions on risk-free rates. Many of these thresholds were broken in the fall as systemic concerns abated following the announcement of Outright Monetary Transactions (OMT) by the ECB in an effort to stem the European sovereign credit crisis. While performance was strong across the credit markets, the lowest credit quality parts underperformed, particularly on a beta-adjusted basis. This is not surprising, given the technical nature of the rally and ongoing concerns about global growth. We believe correctly assessing the parts of the market that have not fully participated in the rally will determine performance in 2013, and credit fundamentals will be the key driver, more than in any other period since the credit crisis.

The past two earnings seasons have provided a preview of how credit markets will trade in a low growth environment that is not overwhelmed by macro concerns. Correlation between regions and issuers has broken down, and companies that missed estimates were punished. With our economics team forecasting growth in 2013 of 0.1% in the euro area and 2.0% in the US, the environment is ripe for credit differentiation. While we believe the developments in the European periphery, the fiscal cliff in the US, and slowing growth in China will all have an effect on markets, we do not expect the swings to be as extreme as in the past few summers, thanks largely to the liquidity infusion provided by global central banks. Instead, we believe that investors will differentiate themselves by looking for the parts of the market that have lagged and taking a view on whether there are catalysts for change in 2013. While we address each of these topics in detail in their individual sections, Figure 1 summarizes key themes across markets.

One common theme that has developed over the past few years that we believe will remain and perhaps become more extreme is the premium for liquidity. This is in many ways driven by the changing regulatory environment. While many of the questions that we hoped to have answered by regulators have been delayed (especially concerning CDS), the dealer community has already shifted to smaller balance sheets that will be necessary regardless of the final rules. We review our expectations for the changing regulatory environment in 2013 and concentrate our recommended trading strategies on liquid instruments throughout this publication, as we do not expect this premium to shrink in the near future.

FIGURE 1

Key market themes and forecasts for 2013

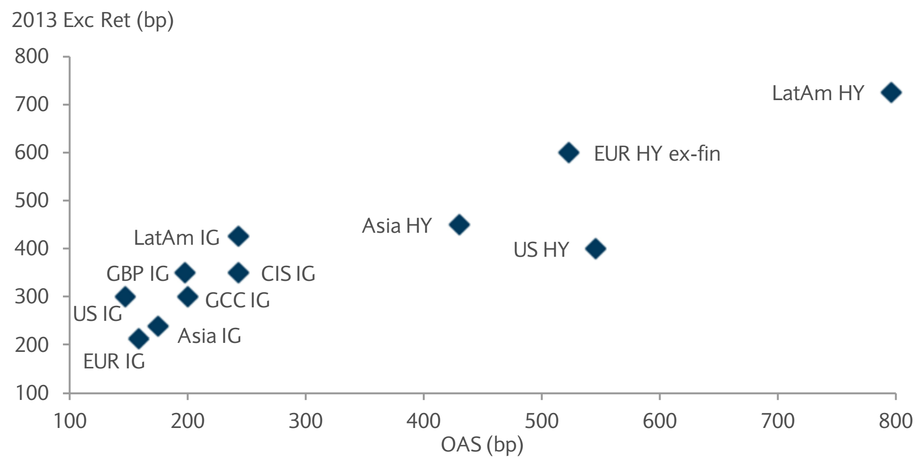
Market	Key question	Barclays answer	Excess return forecast (bp)	Total return forecast (bp)
Developed Markets				
US IG	Can financials tighten the gap vs. industrials?	Redemptions of subordinate financial bonds and improving bank balance sheets should allow financials to trade on top of industrials, where leverage metrics are now deteriorating.	300	425
EUR IG	Where are the opportunities in BBBs?	We are comfortable going down in ratings for industrials that should show stable credit metrics and find subordinated core financials a good source for yield.	200-225	125-150
GBP IG	Can GBP credit outperform EUR/USD indices for a second year?	The pickup in carry and spread duration of sterling credit over euro markets suggests that GBP markets will outperform again in 2013.	300-400	50-150
US Municipals (tax-exempt)	Can low-IG rated states improve their finances and get a ratings boost?	We believe that the November elections put California on the path for an upgrade and that it should outperform Illinois. Puerto Rico has upside potential if it is not downgraded to HY.	-	240
US HY	Will CCC returns finally catch up with their beta?	A substantial coupon pickup should offset growth concerns and the premium associated with less liquid CCCs, to produce returns in line with higher quality HY.	300-500	400-600
EUR HY ex-fin	Can peripherals hold onto recent gains?	The story should shift somewhat in 2013 as stronger peripherals become less volatile and concerns about cyclicals increase because of the poor growth environment.	600-800	550-750
US Lev Loan	Will the new issue CLO bid compensate for the deleveraging of older deals?	Loans are attractive from a relative value standpoint, but the recent rally has made CLO equity returns less appealing. AAA CLOs are cheap and should tighten to support issuance.	350-550	350-550
Emerging Markets				
Asia IG	Can China/Hong Kong bonds catch up with the rest of Asia beta-adjusted?	Strong institutional demand in the high BBB/single A segment and lower concerns about China growth should help these bonds catch up with the rest of Asia.	225-250	325-350
CIS IG*	Will issuance cause Russia to underperform?	The oil and gas sector is set for heavy supply, and we expect the 10y portion of the curve to underperform as a result.	350	450
LatAm IG	Will the senior/sub spread compress in LatAm banks?	We forecast Brazil growth rising from 1% in 2012 to 3% in 2013. NPLs have stabilized, and debt affordability metrics are sound. We like the sub debt of national champion banks like BANBRA.	425	550
GCC IG**	Will the geopolitical risk premium widen?	We expect periodic sell-offs, but as long as key infrastructure (eg, the Strait of Hormuz) is not disrupted, these should be contained and short lived.	300	400
Asia HY	Can Chinese property continue its stellar performance from 2012?	Spread compression for BBs is likely to be limited, but medium-sized B developers yielding 8-12% are likely to deliver returns well above the benchmarks.	400-500	500-600
LatAm HY	Will the global reach for yield finally extend to LatAm HY?	While returns should benefit from the substantial coupon, we think that fundamental weakness will cause the asset class to underperform its beta.	725	850

Note: *CIS is the Commonwealth of Independent States. **GCC is the Gulf Cooperation Council. Source: Barclays Research

Of the macro concerns we mentioned above, the fiscal cliff will likely dominate early in the year as a grand bargain does not appear imminent. This may diminish the typical positive January effect, but we expect a solution that will avoid recessionary concerns in the US early in the year. Potential downgrades to Spain and Italy are not our base case and represent some of the biggest risks to our returns forecasts in Europe. These concerns will likely persist throughout the year regardless of whether they come to fruition. Chinese economic data appear to have bottomed out and our macro outlook is consistent with our economics team view that Chinese GDP growth in 2013 should be similar to 2012. Finally, the biggest long term risk is obviously a change in central bank policies. At record low yields, total returns would be significantly exposed to any tightening policy. However, we do not think this will be a theme that credit investors need to be concerned with in 2013.

FIGURE 2

2013 excess return forecasts versus current OAS



Note: OAS levels as of November 30, 2012. Source: Barclays Research

Supply sets records, but demand rules

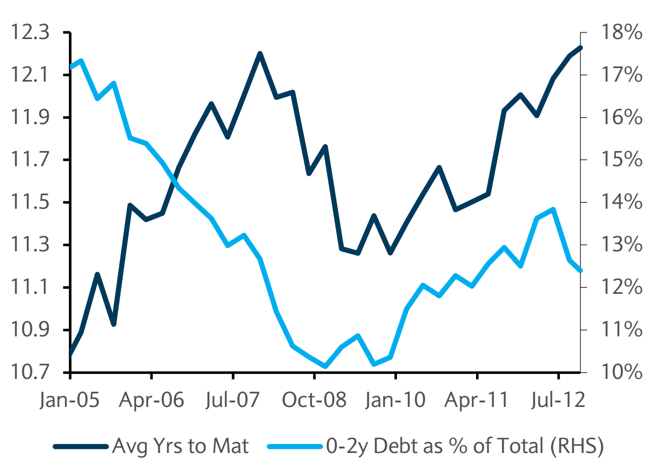
Supply not likely to eclipse 2012 records

Credit investors have always been focused on supply as a source of alpha and were generously rewarded in 2012. As we have shown in the past (see *High Yield New Issue: Where the Yankees Slump,* August 3, 2012), new issue is an effective means of outperforming, but in a hot market, new issue discounts disappear, the use of proceeds gets more aggressive, and supply eventually overwhelms the market. This occurred during the rally this fall, when new issue discounts turned to premiums in investment grade and dividend deals were a common occurrence in high yield.

In the US, investment grade and high yield set issuance records in 2012. As a result, the need for corporates to issue in 2013 has diminished. Investment grade companies have termed out their debt profiles, and the average number of years to maturity for issuers in our index has extended one year since the credit crisis (Figure 3). For high yield, the once-feared loan maturity wall of 2014 has diminished to less than $50bn, a decline of almost

FIGURE 3

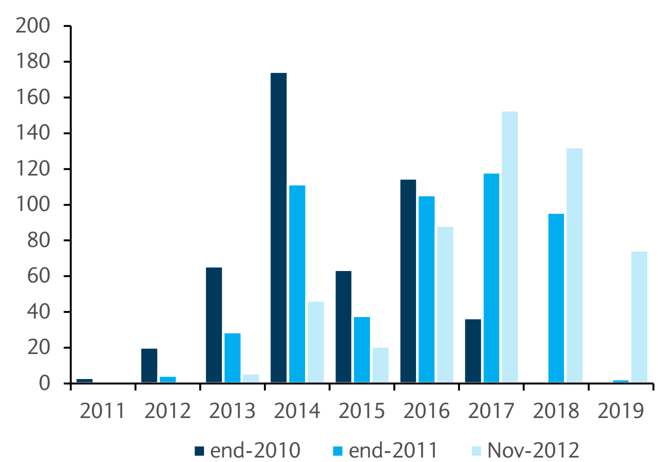
US investment grade company debt profile



Source: Capital IQ, Barclays Research

FIGURE 4

US leveraged loan maturities, $bn



Source: S&P LCD, Barclays Research

$100bn over the course of 2012 (Figure 4). The loan market grew for the first time since 2008, and the continuation of the bond-for-loan takeout trade was supportive enough to extend maturities for all but the most stressed issuers. Less need to issue does not mean that we will witness a substantial pullback in 2013 issuance from US credit markets. Rates remain historically low, industrials are increasing leverage, M&A looks set to increase, and private equity will be seeking a return on its investments through debt-financed dividends. With markets growing as well, we forecast modest declines in gross issuance for investment grade and high yield bonds of 8% and 14%, respectively.

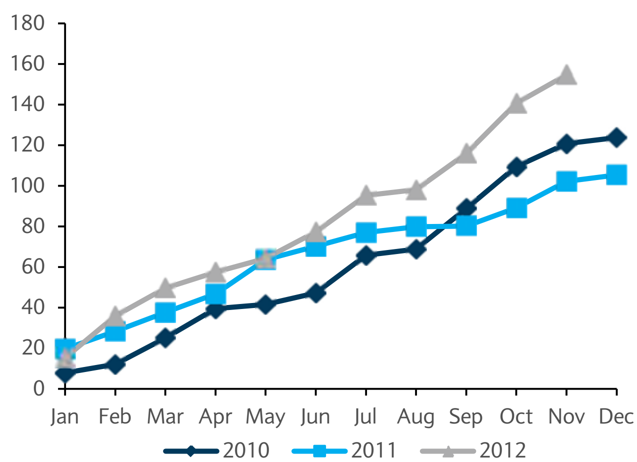
Emerging markets USD issuance has been climbing steadily from all regions and easily eclipsed previous records (Figure 5). Some of the issuance is supporting bond-for-loan takeouts, as the USD EM market is an avenue that was not accessible to many companies in the past. Growth also should lead to increased M&A issuance, and with a prevalence of property-related corporates in Asian high grade and high yield, opportunities for property development in Hong Kong/China will help dictate the pace of issuance in 2013. For LatAm and EEMEA, we believe that higher rated corporates are in a place similar to the US investment grade market and will issue opportunistically based on market conditions. For high yield in these regions, if the market closes for any prolonged period, there could be stress on certain issuers that have a much greater need to come to market in 2013.

For Europe, 2012 was not as much of a banner year for issuance as a result of the volatility throughout the summer. Net issuance for investment grade was negative as a result of deleveraging by financials and peripheral industrials (Figure 6). High yield issuance is similar to the previous record from 2010, but the size of the market has doubled since the beginning of 2010. To compensate for greater volatility in Europe, many issuers focused on the more stable US market, and Yankee issuance set a new record as a result of a huge increase from industrials. The more modest issuance from Europe in 2012 and the need to come to the US market highlight that supply has been less opportunistic and at times more of a necessity for certain European companies. The bond-to-loan trade is not nearly as complete in European leveraged finance as it is in the US, and BBB peripherals should be aggressive issuers if volatility remains subdued.

With less deleveraging from financials and the hope that a more stable macro environment will allow industrials to issue more in their native currency, we expect a modest increase in European supply in 2013. Financials should also be less of a drag on net issuance compared

FIGURE 5

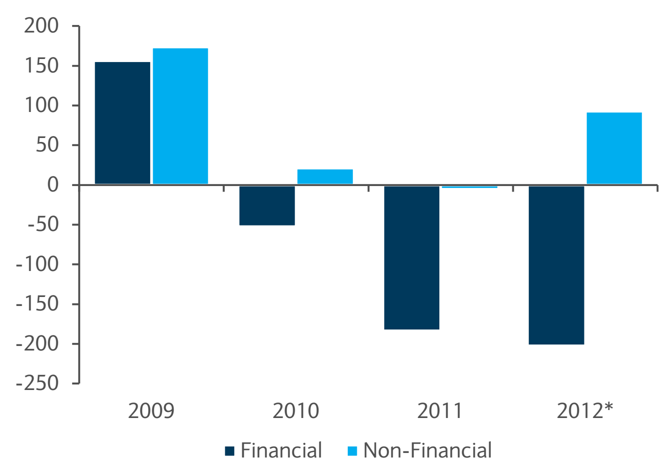
LatAm/EEMEA YTD gross supply, $bn



Source: Dealogic, Barclays Research

FIGURE 6

Euro-denominated net investment grade supply, EURbn



Note: *2012 supply is annualized based on supply through November 2012
Source: Dealogic, Barclays Research

with 2012 as a result of potential LTRO repayments and a new wave of contingent convertible debt instruments (CoCos) issued to meet new capital rules. We believe the CoCo market could grow from EUR19bn today to EUR400bn over time as Basel 3 gets fully implemented and think that there will be opportunities for those willing to sift through the documentation.

FIGURE 7

Gross supply forecasts

Market	2012* supply	Record	2013E supply	Y/Y growth
US IG	$1,080bn	Yes	$1,000bn	-8%
EUR IG	€445bn	No	€480bn	+8%
GBP IG	£48bn	No	£55bn	+16%
Asia IG	$94bn	Yes	$70-80bn	-20%
US Municipals	$371bn	No	$390bn	+5%
US HY	$335bn	Yes	$275-300bn	-14%
EUR HY	€37bn	No	€40bn	+8%
Asia HY	$24bn	No	$20-30bn	+5%
LatAm/EEMEA	$159bn	Yes	$128bn	-19%
US Lev Loan	$225bn	No	$225-250bn	+6%
US CLO	$50bn	No	$60-75bn	+35%

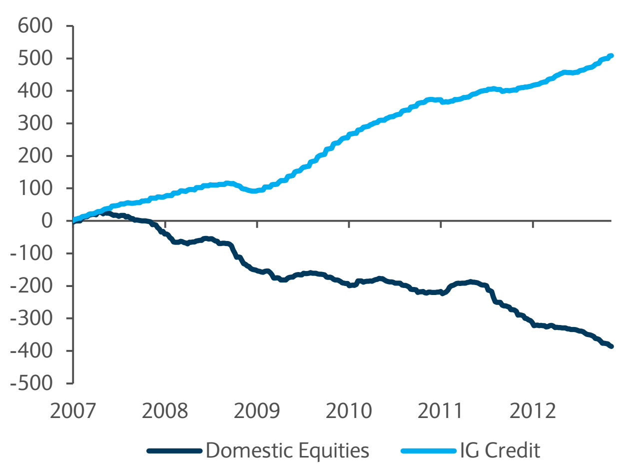
Note: *2012 supply is annualized based on supply through late-November 2012. Source: Barclays Research

Demand drives return forecasts

The primary market will remain an important source of performance in 2013, but we think forecasting general demand will have a much greater effect on overall credit returns. The post-credit crisis period has been defined by a shift in allocations toward fixed income spread product. The rush into credit has been supported by a preference away from the riskiest assets, such as equities (Figure 8), and a lack of available product in lower risk spread products, such as agency debt and mortgages (Figure 9). We do not expect any change in the stance of central banks, and as a result, we think credit will continue to benefit from a lack of supply in higher quality assets. While it is possible that bullish investors will shift to equities, where high dollar prices and call constraints do not limit upside, we do not believe the exodus from credit would be enough to affect valuations

FIGURE 8

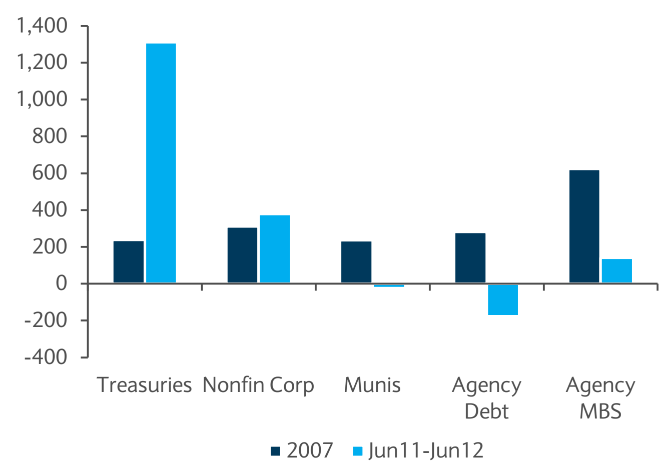
US equities and IG credit fund flows since 2007, $bn



Note: Excludes ETFs. Source: Lipper, Barclays Research

FIGURE 9

US credit market net borrowing by instrument, $bn



Source: Federal Reserve Flow of Funds, Haver Analytics, Barclays Research significantly. The exception would be if the move to equities is accompanied by a substantial rise in Treasury yields that could produce negative total returns for higher quality credit. However, our interest rate strategists expect a benign year for rates, and the current accommodative central bank policy makes us believe this downside risk is remote.

The shift into credit has occurred across most major constituents of the developed market investor base. Insurance has remained the steadiest owner of investment grade credit globally, pensions are allocating away from equity into credit, and the growth of corporate bond mutual funds has been the key catalyst for the growth of the market. In Asia and other emerging markets, corporate bonds are still in the developmental stage and we are witnessing a change in mandates from participants to include corporates in their portfolios. Local institutions that traditionally owned only developed market corporates are now, ironically, diversifying into EM issuers. In addition, we are seeing growth in EM benchmarked funds that have launched somewhat recently. With many of these strategies fairly nascent, we expect especially strong demand for high grade EM corporates in 2013 and, as a result, above market returns should follow.

Turning back to developed markets, we expect the key sources of demand mentioned above to remain positive in 2013, but to a lesser extent than in 2012. The key areas of focus will be pension funds and retail. As yields continue to set new all-time lows, we believe it is becoming harder for pension funds to shift out of equities and into credit. Public pensions face liability targets that now exceed the yield on every ratings category except CCC, and private pensions struggle with an increased burden from low discount rates. We do not expect these flows to reverse, but the pace of inflows should diminish. The bigger concern is retail, as significant flows into mutual funds and ETFs have been the biggest driver of supply and subsequent spread tightening, in our view. Investment grade mutual funds have experienced incredibly steady flows (only one week of outflows all year in the US and minimal outflows even at the height of European volatility this summer), and we expect inflows to continue as long as rates remain low.

Along with IG corporates, municipals have rallied recently as they represent another substitute for scarce low risk assets. For corporate investors, we believe that the taxable municipal market has room to compress versus the US Corporate Index as underlying fundamentals improve and returns receive a boost from the market's longer duration. In the larger tax-exempt market we remain positive as the uncertainty on tax rates related to the fiscal cliff has buoyed demand. Our forecast for solid returns is predicated on municipals retaining their tax exempt status in the 2013 budget process. Any significant changes or a lack of grandfathering existing securities could represent substantial downside.

In high yield, dedicated mutual funds are the largest portion of the market in the US and Europe. With core plus and income funds also looking for yield, retail represents close to half of the US market and one-third of the European market. However, the weakness in high yield flows amid only modest volatility this fall demonstrates that retail demand will likely be tempered if the market trades inside of 7% for extended periods. With the US market more call constrained than Europe, we believe it will produce slightly lower returns.

Some of the flows out of high yield in the US have gone to leveraged loans. After huge outflows following the Fed's announcement regarding an extended period of low interest rates in the summer of 2011, loans have made a comeback with the retail investor base in 2H12. We believe the record low yields for high yield were also a factor in these flows. With similar yields and capped upside in both asset classes, it is attractive to move up in the capital structure and shorten duration even if rising interest rates are a secondary concern. While the support of the retail base is helpful for leveraged loans, mutual funds own less than 15% of the market. Half of the institutional loan market is owned by CLOs, and we expect enough issuance next year to offset ~$40bn of amortization from the pre-credit crisis CLO base. This bid should make loans less volatile than high yield and produce returns in line with the current coupon.

Finally, for Europe, we note that the actions of the rating agencies could have a large effect on demand as well. While it is not our base case, if Spain and Italy were to be downgraded to high yield and all of the corporates eventually became sub-investment grade as well, the European high yield market would increase by ~75% ex-financials and almost double when including financials. Even though not all of the owners of these bonds would be forced to sell, we believe it would be hard for the current sources of demand immediately to absorb this paper. A downgrade is not our base case, but we factor in some probability in our projections and if this scenario does not materialize, then there should be some upside to our European forecasts as global investors that are underweight Europe reallocate back toward market weight.

It’s not just the flows; results will matter

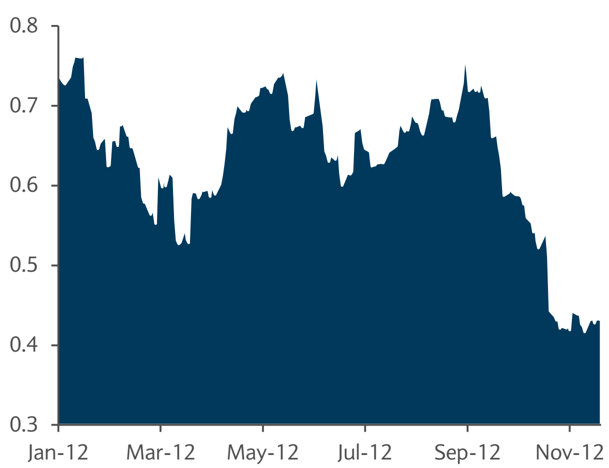
The high correlation across asset classes and within credit has forced portfolio managers to focus more on macro than micro over the past four years. Markets were generally either in risk-on or risk-off mode, and subsectors moved in that direction according to their beta. However, as tail risks decreased and corporate earnings disappointed in 2H12, we began to see greater differentiation (Figures 10 and 11). We believe this is a trend that will continue into 2013.

Relative performance should come increasingly from single-name credit calls, and sector positioning should also be more important than it has been in recent years. This year, the metals & mining sector produced the most volatility throughout the year, and we expect this to continue in 2013. We do not like the fundamentals for coal or steel, but recognizing the strong liquidity and already-elevated yields for most companies, it is difficult to have an Underweight rating on the sector.

While consumers have been fairly resilient considering the recession in Europe and slower growth in the US, we expect challenges for certain parts of the retail sector to subsist. We have an Underweight rating on retail in the US across investment grade and high yield, with mid-tier retailers and consumer electronics a particular concern. In Europe, we have concerns about cyclicals in general, with automotives a key Underweight. This contrasts to the US, where our

FIGURE 10

Rolling 60-day correlation of CDX IG and iTraxx Main spread changes



Source: Bloomberg, Barclays Research

FIGURE 11

US high yield/US investment grade corporate OAS ratio

Source: Barclays Research

positive view on Ford makes us comfortable with automotives. Performance in the technology sector has been disparate, as companies must react quickly to secular change. We have concerns about certain hardware producers that are facing these challenges, but are positive enough on other parts of the sector to rate it Market Weight.

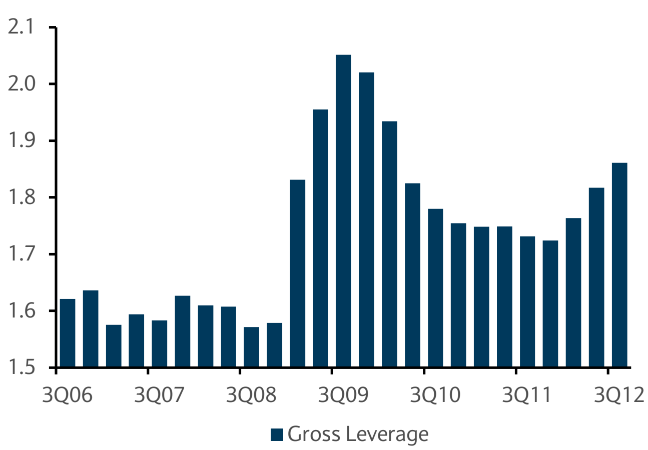
We believe that financials will be a key source of alpha in 2013. In the US, we expect financials to trade on top of industrials by the end of 2013 and have an Overweight rating on Life insurers. European core financial unsecured bonds are already trading in line with industrials and we are underweight many of the peripheral banks. However, we find value in the subordinated parts of the capital structure for core European banks and would look to add risk there. Senior/sub compression in banks is also a trade we like in Emerging Markets.

While financials may be deleveraging, the record low cost of debt could fuel releveraging for industrials. These concerns are more concentrated in the US, as the lower growth environment in Europe will probably keep aggressive issuance to a minimum. As shown in Figure 12, leverage for US investment grade corporates is back to early-2010 levels; and share buybacks and dividends, after falling sharply during the financial crisis, have since recovered to pre-crisis levels (Figure 13). In high yield, issuance for aggressive uses of proceeds such as LBOs, share repurchases, and dividends topped $30bn for the first time since 2008.

While we expect these trends to continue in 2013, we do not think they will approach the pace of the mid-2000s and believe that the trading implications are different regardless. In investment grade, we think it is important to consider rotating out of companies that are trading at tight levels and could increase their leverage target. AT&T is a recent example of a company that underperformed for this reason. However, the traditional trade of shorting low-spread names that could be subject to a bid from private equity is likely to be less effective. The leveraged finance market appears capable of supporting significant issuance, but we believe private equity is less likely to form consortiums that will lead to numerous large LBOs. In fact, with margins at all time highs, the names that have been reported in the press as possible LBO candidates have been stressed high yield issuers such as Best Buy and Supervalu, which would likely tighten if a deal were announced. If M&A in general increases, we believe that high yield companies will likely benefit and do not expect a substantial effect on the spreads of larger acquirers.

FIGURE 12

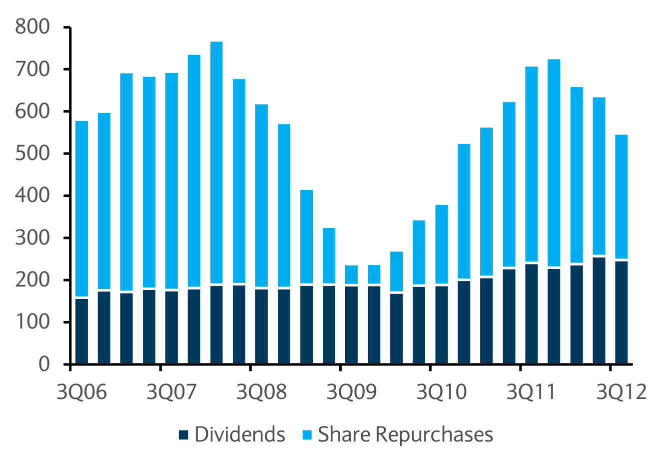
US non-financial investment grade gross leverage



Source: Capital IQ, Barclays Research

FIGURE 13

Shareholder-friendly activities of US non-financial investment grade companies, $bn



Note: Share repurchases and dividends are LTM median values for US non-financial companies in the Corporate Index. Source: Capital IQ, Barclays Research

Liquidity and regulation limit opportunities

Over the past year, many of the themes for our outlook have changed. One that has not is the more difficult trading liquidity in credit markets. The catalyst for diminished liquidity has been the well-publicized decrease in the size of dealer balance sheets following the credit crisis. In 2012, inventory levels bottomed out in July at a level not seen in the previous decade. A large portion of this decline has been due to changes in regulation that will persist for the foreseeable future. Basel 3 is a prime example, as capital charges on lower rated securities have become especially onerous for banks. In fact, this is part of our thesis on why illiquid CCC bonds will not catch up with the rest of the high yield market unless growth surprises materially to the upside. Regulatory changes have served as a catalyst for a renewed focus on ROE by bank equity investors. This has helped capital-inefficient securities lag the market as banks focus on the returns of risk-weighted assets and not solely on P&L.

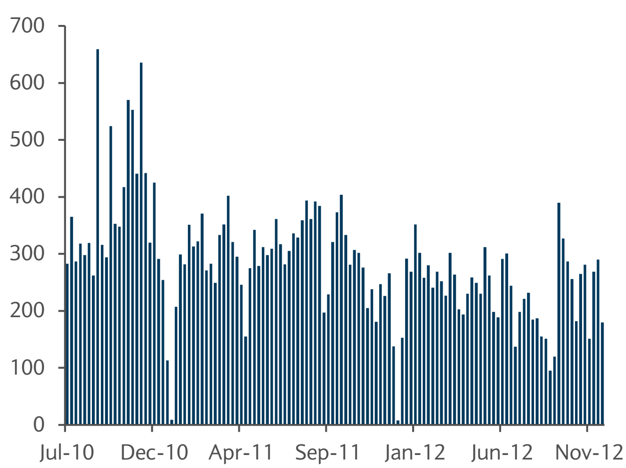
Perhaps as important as the rules to be implemented globally due to Basel 3 is uncertainty related to incomplete regulation at the local level. A year ago, we expected to have the final text of Dodd Frank in the US and CDS to be cleared and traded through swap execution facilities (SEFs). Neither of those occurred, and we believe uncertainty about the final language of the Volcker Rule has been another factor holding down dealer inventories.

CDS liquidity will get better, but probably not in 2013

We are more optimistic that we will get clarity on many of these items in 2013, but expect delays to occur once again. We laid out the most recent projected timelines in *Regulation Update,* July 13, 2012, and would highlight that completing the Dodd-Frank ISDA protocol by year-end is needed to trade CDX in 2013. Realistically, we believe that most investors will not be trading cleared single-name CDS on SEFs until very late in 2013. Unfortunately, this will likely cause current trends in CDS liquidity to persist. The number of credits trading $100mn+ per week has dropped precipitously, and trades are concentrated at the 5y point except in stressed credits (Figures 14 and 15). Once counterparty risk is eliminated and prices are widely disseminated, we believe that liquidity will begin to improve, especially at the 5y point. However, we think this will take time and is probably a 2014 event as the basis adjusts to entice marginal buyers and sellers of protection. Therefore, in 2013, we would focus on

FIGURE 14

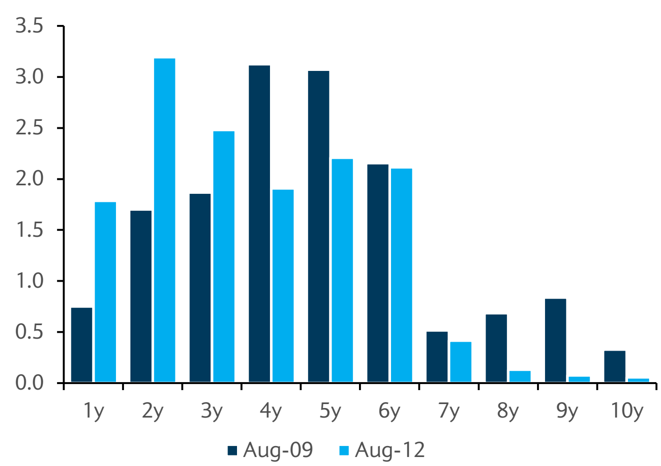
Number of single-name corporate CDS tickers with weekly volume > $100mn



Source: DTCC, Barclays Research

FIGURE 15

Maturity profile of single-name CDS, $trn notional



Source: DTCC, Barclays Research

trading 5y CDS on index names and look for opportunities in which the basis is skewed in either direction. Recently, the basis has turned more positive, and we would look to set longs in derivatives that do not face the same dollar price constraints as the cash market.

Europe is even further behind with respect to clearing, although a historical tendency to trade electronically should allow it to transition to a multi-dealer execution facility eventually. Where we have seen major changes in Europe in 2012 is the sovereign CDS market. Beginning November 1, sovereign CDS could only be bought to hedge government bonds or other exposures to a country or liabilities to a private entity in that country that is highly correlated with the value of government debt. Volumes in sovereign CDS remained strong going into November 1, but relative to corporate CDS volumes, there has been a decrease in sovereign CDS activity recently. This is partly confounded by the general risk-on sentiment since November 1 (sovereign CDS tends to be most active in a sell-off), but we do expect a decrease in activity of approximately 20% as a result of these changes. This is important because sovereigns represent 17 of the top 25 CDS names by volume.

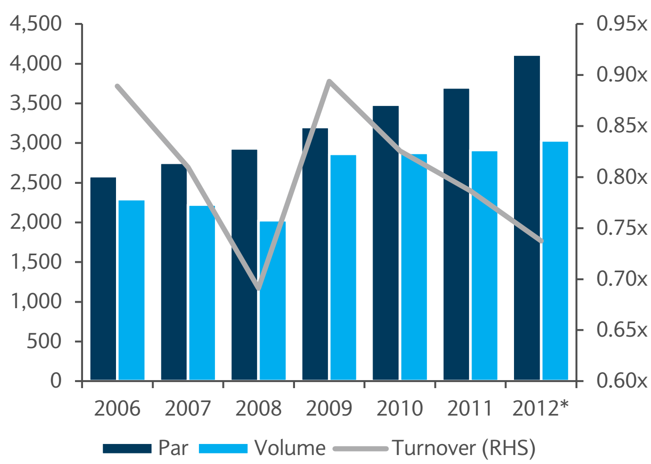
Cash volumes remain concentrated

The record year of issuance has provided a boost to trading that should produce overall volumes that marginally exceed 2011. Market turnover (calculated as TRACE volumes divided by par outstanding) is similar to the depressed level in 2011, at approximately 0.75x for investment grade and 1x for high yield (Figures 16 and 17). While this trend did not regress, the dominant issue remains concentration of those volumes. We focus most of our liquidity commentary on the US because of the better availability of TRACE data. The work we have done across regions indicates that the same concentration and bid ask issues are occurring in other areas as well. However, as emerging markets mature, there are greater prospects for improvement in volumes, although concentration is likely to persist.

With markets much less volatile than in 2H11, bid offer has declined slightly from late last year, although only to levels similar to early in 2011. The trend that concerns us most is not the level of liquidity, but the concentration. In investment grade, 34 tickers represent 50% of volumes, and in high yield, that universe is only slightly larger, at 48 tickers.

FIGURE 16

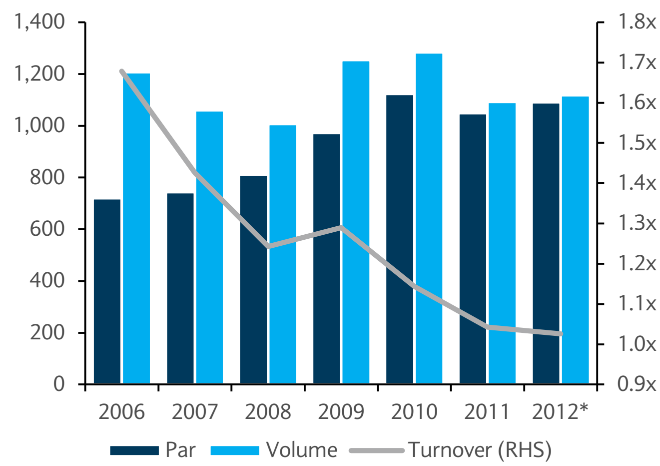
US investment grade size, volume, and turnover, $bn



Note: *2012 data are annualized based on volume through 3Q 2012.
Source: TRACE, MarketAxess, Barclays Research

FIGURE 17

US high yield size, volume, and turnover, $bn



Note: *2012 data are annualized based on volume through 3Q 2012.
Source: TRACE, MarketAxess, Barclays Research

One reason for the concentration in liquidity has been the rise of corporate credit ETFs with narrow benchmarks. In the US, the trend has been most pronounced in high yield, where AUM has increased from $20bn to more than $30bn in 2012. While this still represents only 3% of the market, the holdings are concentrated in the largest bonds, and as a result, these ETFs often own a mid- to high single-digits percentage of a given issue. With the promise of daily liquidity to investors and active trading in the underlying securities by arbitrageurs of the create/redeem process, the technical can be substantial. The two largest ETF benchmarks announced rule changes in 2H12 that leave us more optimistic that some of these concentration issues could abate in 2013.

Other markets have seen an increase in ETF AUM as well, although not enough to cause concentration issues. US IG corporate ETFs now own $53bn of bonds, and loan ETFs remain in their infancy with less than $1.5bn. In Europe, adoption of the ETF product has been slower, with only $13bn total AUM. Surprisingly, EM corporate investors have been more accepting of the product, as it was virtually non-existent a year ago and represents $8bn of demand today.

While ETFs are a new phenomenon that is worth monitoring, the key question for corporate bond liquidity remains unchanged. Will smaller dealer balance sheets be sufficient for the increased portion of the investor base that needs daily liquidity, including, most prominently, mutual funds and ETFs? Unfortunately, in the near future, we do not expect an increase in dealer balance sheets, which means that dealers are likely to use their limited inventories for the most liquid securities. Investors that wish to implement short-term market views will need to do so through the most liquid parts of the market. For example, the seven most liquid investment grade tickers are all financials, which makes that sector an ideal means of adjusting beta. This does not mean there is not a use for less liquid instruments, as we have observed a decrease in measures such as the premium for 144a bonds when the market is strong. We caution that the portion of a portfolio dedicated to these less liquid strategies must be sized according to the volatility of each investor's flows.

US credit strategy

US HIGH GRADE STRATEGY

Building on weaker foundations

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- **With 2012 on pace to achieve the second highest single-year excess returns of the past 20 years, we expect 2013 to post more modest results. In our base case, we forecast excess returns of 300bp for the Barclays US Corporate index, driven by its carry plus approximately 25bp of tightening. Given our rates strategists' expectation of unchanged 10y Treasury yields next year, this translates to a total return of 425bp.**

- **While deteriorating fundamentals and more aggressive leverage policies are likely to lead to limited upside for industrials, we see potential for outperformance in financials, with continuing improvement in fundamentals allowing them to trade flat to industrials.**

- **We expect more differentiated credit performance in 2013, as the potential effects of macro concerns – which have been a key driver of credit spreads in the past several years and have led to high correlations – are dampened by unprecedented levels of central bank support. Instead, differences in operating performance and balance sheet policies should increase the importance of sector and single-name selection. Furthermore, a pickup in M&A activity could add to differentiation in performance among credits.**

- **The demand picture for investment grade credit should remain supportive in 2013, in our view, driven largely by accommodative central bank policies that are pushing investors out along the risk curve and diminishing the probability of tail risk outcomes. Insurance should remain the steadiest (and largest) holder of the asset class, and mutual fund holdings of credit will likely continue to increase.**

- **We expect this year year's robust pace of new issue to persist in 2013, driven by record-low rates, increasing leverage of non-financials and the continuing trend of first-time issuers accessing the dollar market to take advantage of its strong demand technicals. We forecast $1trn of gross issuance next year, slightly below this year's annualized level, which translates to $565bn of net issuance. On a sector level, we expect financial and non-corporate issuance to increase slightly next year, but expect non-financial corporate issuance to decline from this year's record-high levels.**

2013 performance outlook

After a strong 2012, the US Corporate Index is on pace for its second-best performance since 1990, with year-to-date excess returns of 672bp. Heading into 2013, investment grade credit is poised to begin the year with spreads close to their 20-year average.

US Corporate Index return forecast

Looking back at 12-month excess returns when starting near current spreads, we see a pattern of performance clustering around two poles: either the index generates the coupon plus a small gain from tightening, or returns are negative (Figure 1). Notably, there have been no periods with significant outperformance, suggesting that tightening from this point will be modest and that excess returns will likely be lower in 2013 than in 2012.

We think credit is more likely to tighten than to widen over the next 12 months, supported by base-case US economic growth near 2%, European sovereign risks that have been dampened (for the moment, at least) by the ECB's policy stance, and investors that are being pushed out the risk curve in the US by the Fed (providing a strong demand technical).

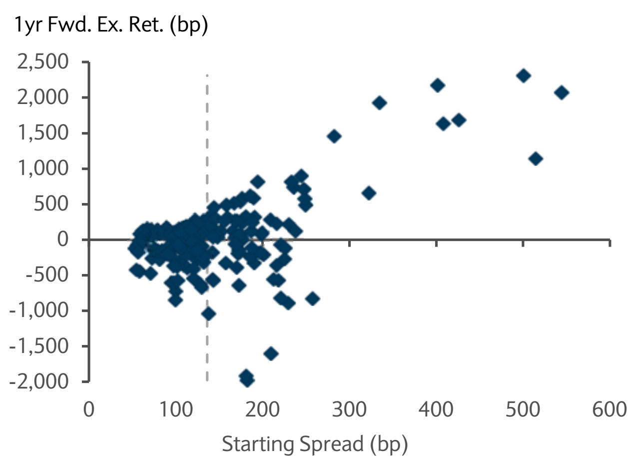
Non-financial fundamentals, which were on an improving path from the middle of 2009 through 2011, have weakened, and we believe they will continue to deteriorate. Although these fundamental trends should be a drag on performance, we expect the impact to occur on a credit-by-credit basis and be trumped in aggregate by investors' reach for yield. With that backdrop for our base case, we see no reason spreads should not retrace close to their 2012 tights. This suggests about 19bp of tightening for non-financials from current levels.

Financials, on the other hand, have improved their fundamentals, and we expect them to continue the trend in 2013. For instance, the Tier 1 common capital ratio for US banks has grown continuously since 2009 and is now at a post-crisis high of 10.75%, while nonperforming assets and net charge-offs have continued to fall. With financial spreads wide relative to historical levels, we favor financials over industrials.[1] We believe that financials could rally from the current financial-industrial basis of 23bp to trade flat to industrials (Figure 2). This would mean approximately 42bp of tightening in financial spreads.

Combining the above forecasts for financials and industrials, we expect the US Corporate Index to tighten ~25bp, to end the year with an OAS of ~120bp. The drag on index performance from fallen angels since the credit crisis has been minor because of the very small notional of these credits relative to the size of the index. While we expect downgrades to pick up somewhat next year, given our expectation for higher leverage, fallen angels are unlikely to total more than 1% of the index in 2013, in our view. After accounting for potential drag from credits that are downgraded to high yield and for the lower carry of new issues entering the index at lower yields than the index average, we expect the Corporate Index to generate excess returns of 300bp in 2013, a slightly above-average year. Given our rates strategists' expectation for unchanged Treasury yields in 2013, this translates to 425bp of total return.

FIGURE 1

From starting spreads near current levels, industrials have typically returned near coupons



Source: Barclays Research

FIGURE 2

Financials spreads remain wide of industrials, but the gap has been closing

Source: Barclays Research

[1] In this discussion, non-financials and industrials are used interchangeably and are both used to describe non-financial corporates in the index.

CDS market outlook

While we also expect CDS spreads to tighten next year, CDS is likely to continue to underperform cash, in our view, given a more steady ownership base of cash bonds and the fact that CDS is more often used to implement tactical shorts. Cash has outperformed CDS for most of the year, with the CDS-cash basis becoming less negative by more than 20bp since mid-September. The relative underperformance of CDS (on the index level) has also been due to differences in weighting between the CDX IG index and the cash index. CDX IG has higher concentrations of high-spread names that have experienced event risk or fundamental concerns (such as Pitney Bowes, CenturyLink, Hewlett-Packard, and Xerox). In addition, the CDX index does not include US banks, which have been among the strongest performers this year. Given our expectation for fundamental weakness in pockets of the non-financial universe and the outperformance of banks, we expect the CDX.IG index to remain more susceptible to widening from single-name news.

Key risk factors

In assessing the key risks to credit in 2013, we see potential for a shift from recent patterns. Over the past five years, macro factors have dominated the risk landscape – macro volatility led high correlation selloffs in each of those years. Some contingencies that could lead to a similar 2013 spread widening are readily apparently: a renewed European sovereign crisis, an Asia-led global economic slowdown, and the US fiscal cliff, supplemented by the always-tenuous situation in the Middle East. We note, however, that the sharpest macro-driven selloffs have tended to come in periods when central banks were withdrawing their support from the market. In our view, the current open-ended commitments from the Federal Reserve and the European Central Bank (ECB) should create a floor for macro downside in 2013. As long as central banks keep their supportive programs (and recession is avoided in the US), we are more concerned about risks that could increase volatility within the index. The resolution of the fiscal cliff is likely to result in major changes for some issuers and industries, and markets do not yet seem to have priced in the (as yet unknown) outcome; when the resolution becomes public knowledge, we may see a compressed period of sharp moves among the affected names. Shifting fundamentals are likely to increase the differentiation between improving and worsening stories. The rise in M&A volume should be credit neutral for the index as a whole, but it will increase volatility within the index as some credits benefit while others suffer.

After a long run in which the correct macro call has been the key to alpha generation, we may finally be entering a period when anticipating individual credit outcomes is the best source of outperformance.

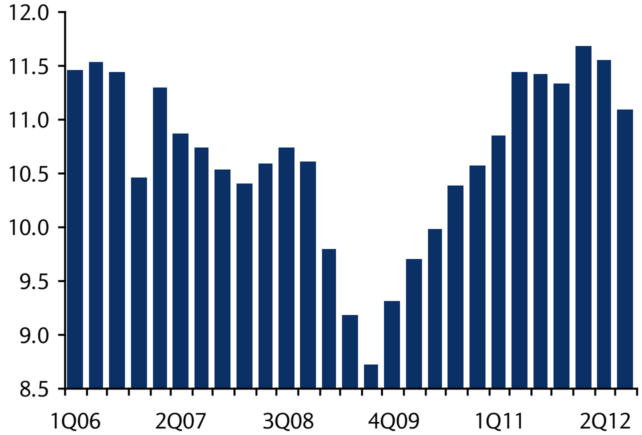
Industrials fundamentals – Weaker and weakening

Credit fundamentals of non-financial investment grade corporates peaked in 2011 and have begun to deteriorate over the past year. Leverage is up, and returns of cash to shareholders are increasing. We expect this trend to continue because of challenging equity returns, cheap debt, and declining top-line expectations, creating a drag on spread tightening in 2013.

While certain credit stories are weaker, we project that the overall effect on spreads over the next year will be relatively small. Low rates mean that interest coverage has not moved, and as firms replace higher-coupon old debt with lower-coupon new debt, they have more capacity to cover interest (Figure 3). Companies have termed out their capital structures and have a declining share of debt maturing in the near term, giving them more of a cushion for cash flows (Figure 4). However, in the longer term (if there is a recession or if firms come to depend excessively on low rates), individual credits could be setting up for significant underperformance.

FIGURE 3

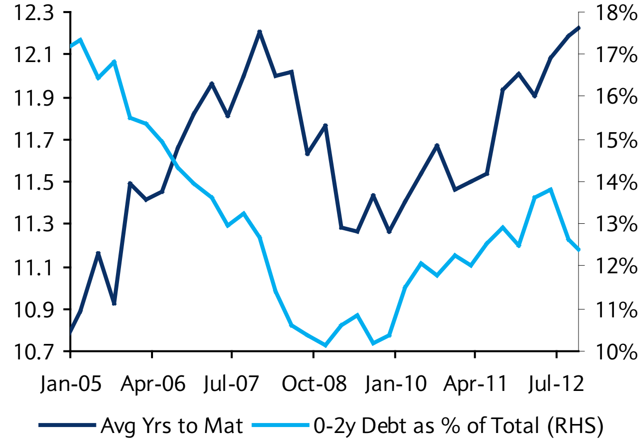
Median EBITDA/interest expense is close to pre-crisis levels despite higher leverage today



Source: Capital IQ, Barclays Research

FIGURE 4

Investment grade companies have extended their maturity profiles



Source: Capital IQ, Barclays Research

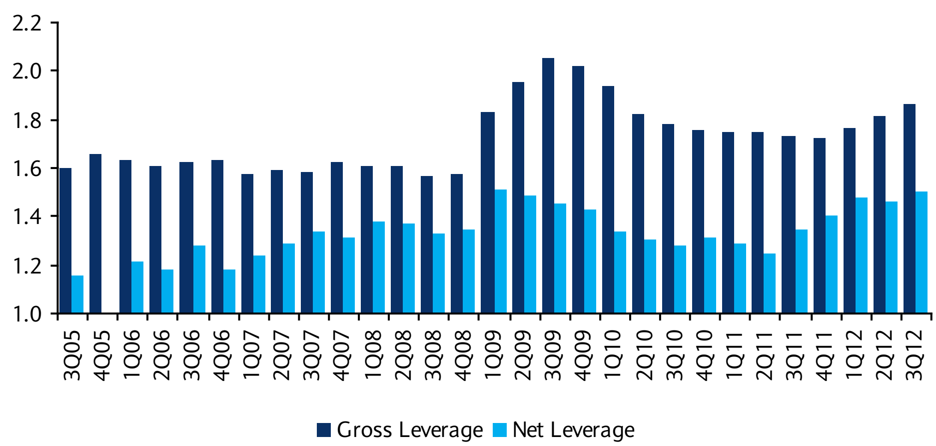
Index constituents' leverage hits mid-2009 levels and continues to rise

The leverage of investment grade companies[2] has increased through 2012 (Figure 5), reaching gross leverage of 1.86x and net leverage of 1.50x in 3Q12; both metrics are approaching levels last seen in early 2009. The move in leverage is broad, with approximately 60% of the companies in our sample increasing both total and net leverage over the past year. The following factors have contributed to higher leverage:

- Total debt has climbed as companies have issued far in excess of their refinancing needs. The record-breaking ~$800bn+ year-to-date gross corporate issuance in 2012 is more than $475bn higher than year-to-date matured debt.

FIGURE 5

Gross and net leverage for non-financial investment grade US corporates

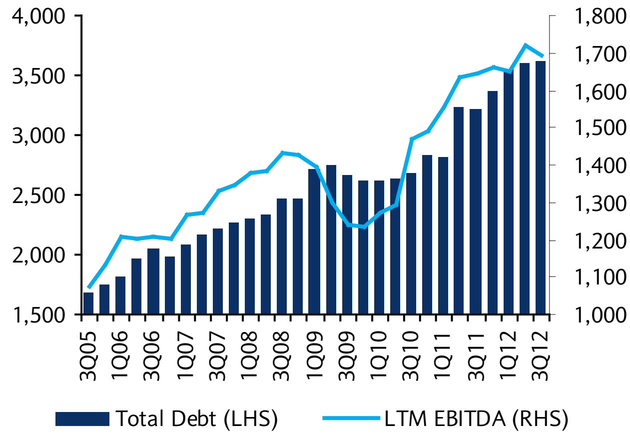


Source: Capital IQ, Barclays Research

[2] We evaluate the fundamentals of US industrial issuers by considering a set of corporations whose bonds are currently in the US Corporate Index. These 394 names represent ~82% of the issuers in the US Corporate ex Financial Index and ~86% of the index by par value. Unless otherwise specified, we use medians in order to mute the effect of large outliers.

FIGURE 6

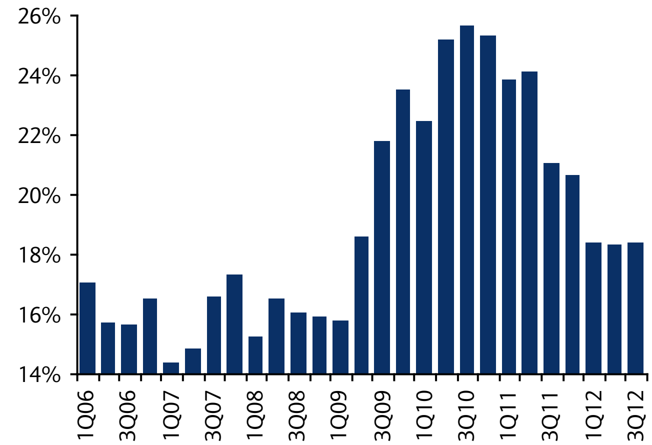
EBITDA growth has slowed while debt balances have continued to grow (medians, $mn)



Source: Capital IQ, Barclays Research

FIGURE 7

Cash as a percentage of total debt is significantly lower than its post-crisis peak



Source: Capital IQ, Barclays Research

- EBITDA growth has been slowing and recently turned negative – the median LTM EBITDA of investment grade corporates fell 1.5% q/q and is up only 3% y/y (Figure 6).
- While cash balances (as % of total debt) are still higher than they were pre-crisis, they have dropped from peak levels of approximately 25% in 2010 as balance sheet policies have become less conservative (Figure 7).

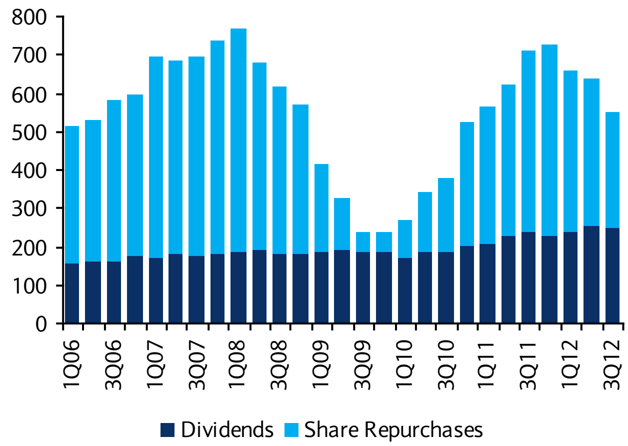
We expect the recent trend of increasing leverage to continue in 2013. Share buybacks and dividends fell sharply during the depths of the 2008 financial crisis, but have since recovered to slightly above pre-crisis levels (Figure 8). While the pace of returns has flattened – in our view, because of concerns about slowing economic growth – several factors suggest that returns to shareholders are likely to increase in 2013:

- Credit yields remain at historic lows, making it relatively cheaper to undertake shareholder-friendly activities than at any other period in recent memory.
- Implied volatility has seen its longest stretch at low levels since before 2008, driven at least in part by actions by the Federal Reserve and European Central Bank (ECB). If the central banks continue to contain volatility, management teams will become increasingly confident that aggressive capital structures will not be penalized by adverse macro events.
- Revenue and operating income outlooks have declined recently. While a worsening revenue outlook can make companies more cautious, it also adds pressure to find other ways to boost equity returns, as long as the change in outlook is relatively modest.
- Poor equity returns put pressure on companies to return cash to shareholders. More than 35% of the investment grade companies we use for historical comparisons had negative equity returns over the past year, and more than 20% have posted negative returns over the past three years (Figure 9).

Announced buyback plans have increased robustly this quarter, with QTD announcements already exceeding 3Q12 and 3Q11. We note that given the uncertainty about dividend tax policy next year, companies have increased the pace of special dividends, but are likely to prefer share repurchases as a way of returning cash to shareholders in 2013.

FIGURE 8

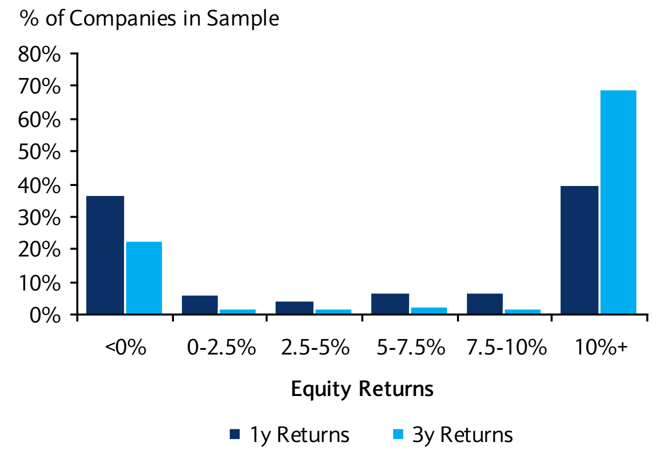
Returns to shareholders through share buybacks and dividends fell sharply during the financial crisis but have since rebounded ($mn)



Note: Share repurchases and dividends are LTM median values for US non-financial companies in the Corporate Index. Source: Capital IQ, Barclays Research

FIGURE 9

1y and 3y equity return distribution of companies in the sample



Source: Capital IQ, Barclays Research

For now, fundamentals are likely to weigh on spreads only moderately

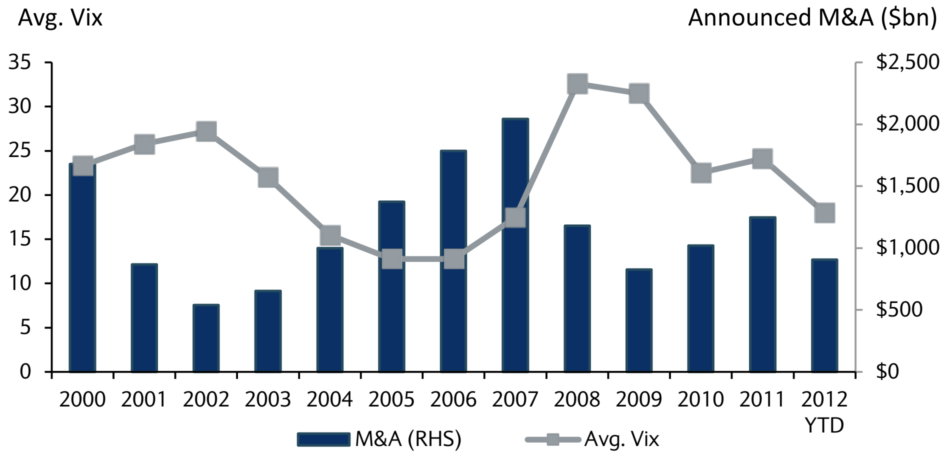
Although we expect only a modest effect on spreads from releveraging in 2013 (due to low debt costs and longer maturity profiles), we are more concerned about the potential spread impact beyond 2013. Low rates and supportive central banks appear to be in place for the foreseeable future, but they will end eventually. While we see few problems today, by the time rates rise, companies may have become too dependent on cheap money – it will be important to monitor credits and sectors for their reliance on short-term funding and potentially fragile financing vehicles. Even if rates were to remain low for the foreseeable future, a significant downturn in the economy could make higher leverage – which is not a major concern in the current environment - a source of anguish for investors.

M&A is likely to generate volatility among credits

With volatility in the midst of a sustained drop through 2012 – the VIX Index has averaged 18 this year, the lowest since 2007 (Figure 10) – we think that M&A could rebound sharply from its current $1.0trn annual pace. The forecast from our macro model of M&A activity has increased since we originally published it in the April 5, 2012, *US Credit Alpha: Back to the Future of M&A*. The model, which bases its forecast on trailing average VIX and forward expectations for GDP growth, now suggests that M&A growth will rise toward the pre-2008 average (closer to $1.5trn/year) by the end of 2013 (Figure 11). We see support for the move in the current run of low volatility, which has been sustained for longer than in any period since before 2008 – VIX has now been below 20 for six straight months and has not spiked above 30 in nearly a year. While an increase in risk aversion could easily derail deal growth (as appears to have happened in both 2010 and 2011), the reduction in risk of a European flare-up, the conclusion of the US presidential elections, and continuing wide spreads between asset cash flows and the cost of funding (more than 8% – near the 90th percentile since 1990) all support higher M&A. Indeed, M&A volumes have already begun to recover: 2012 M&A is still pacing behind 2011, but October had more than $200bn of deals announced, the busiest single month since July 2008.

FIGURE 10

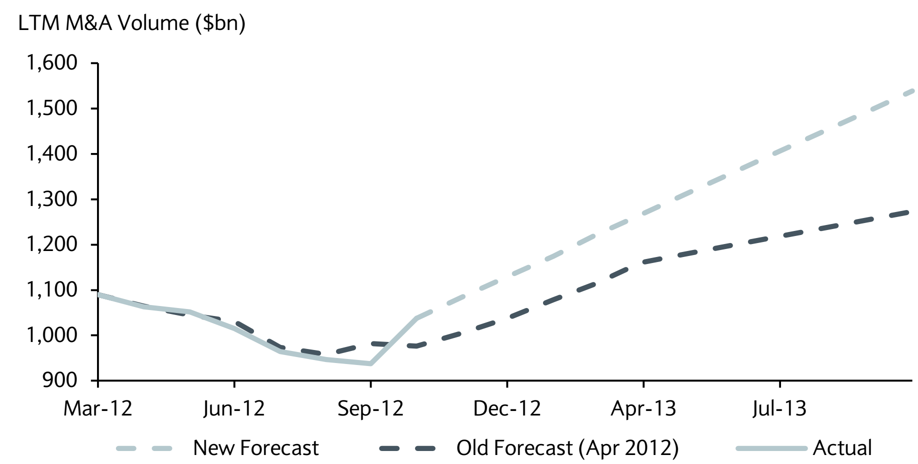
M&A volume tends to moves inversely with average volatility



Source: Bloomberg, Barclays Research

FIGURE11

M&A forecasts have risen since announced mergers jumped in October



Source: Bloomberg, Barclays Research

Because we view M&A as a neutral event, on average, for investment grade credit (see the November 12, 2010, *US Credit Alpha Focus: M&A: Mostly Harmless*, for details), we do not anticipate any aggregate effect on indices from higher deal activity. Nevertheless, for individual credits, the effect can be profound. The largest and the highest-rated companies typically see only very small effects from deals, but investors who own the bonds of smaller companies should consider whether they might be acquired or pursue an acquisition that would materially change their credit profiles. In our view, the most interesting opportunities are those in which companies could see meaningful upside if acquired.

Some developing themes that could help investors position for potential deals include:

- Issuers with few opportunities for organic growth, highlighted by the 0.06% average sales growth among S&P 500 companies in the 3Q12 earnings season.
- Companies with limited capacity for further internal expense reductions. While firms have cut costs effectively since 2009, raising margins to (or near) record levels, they will likely to need to seek economies of scale and scope to cut further.

- Secular industry changes are likely to force some consolidation among the affected firms as they seek to adapt.
- Leveraged buyouts may be a more realistic risk for investment grade names in 2013, with financing markets open to very large deals. Even with elevated risk, we retain our view that LBOs of investment grade firms will be isolated events because of greater selectivity among financial sponsors and elevated caution about multi-investor "club deals."

Some sectors could see larger upticks in activity this year:

- Investment grade diversified manufacturers are expected to increase sales by 1% less than other similarly rated industrials next year.
- Half of technology companies in the US Corporate Index have missed sales expectations, and some major firms experienced sharp deterioration in key businesses.
- Aerospace & defense firms are at risk from sequestration (or budget cuts in a fiscal cliff agreement), hurting firms' existing revenue opportunities. This could encourage large firms to pick up smaller (often high yield) rivals to bolster their businesses.
- Banks are likely to see further consolidation among smaller regionals seeking scale. High yield financials (whose high funding costs are a competitive burden) may be attractive to more traditional commercial banks struggling to grow loans.
- Life insurers face challenges from the low interest rate environment and may seek less capital-intensive revenue streams, particularly asset managers (for stable fee incomes).
- LBO interest has been most notable in retailers in 2012. We are skeptical about large deals involving firms for which the long-term viability of the model is in question, but the amount of press discussion suggests that a large LBO is a possibility in the sector.

Investment grade demand – As strong as ever

The demand picture for credit has been very supportive over the past year, driven largely by the same aggressive central bank policies that have increased companies' willingness to issue. Central banks are pushing investors out along the risk curve and diminishing the probability of tail risk outcomes, in our view. As such, we expect supply/demand technicals for credit to remain benign as long as accommodative central bank policies continue.

The biggest increase in demand for investment grade corporate bonds has come from mutual funds and ETFs, driven by extremely robust inflows over the past 12 months. We expect demand technicals to remain supportive, given that the other major holders of investment grade corporates – insurance companies and pension funds – tend to have steady allocations to credit and are likely to increase their buying when interest rates rise, making up for potential mutual fund outflows.

Mutual funds – Robust inflows continue

Domestic mutual funds and ETFs now hold approximately 14-16% of the universe, according to our estimates, up from approximately 12-14% this time last year. Investment grade ETFs have posted especially strong growth, capturing 22% of total flows into investment grade funds since 2011 while accounting for only 8% of assets. The largest investment grade-focused ETF – LQD – alone makes up nearly 4% of total investment grade corporate bond assets held by mutual funds and ETFs.

We expect strong flows into investment grade funds to persist, for the following reasons:

- Investment grade fund flows tend to be much less volatile than high yield and equity fund flows even during large selloffs. For example, during the market downturn in 2H11, investment grade fund outflows (relative to assets) were about one-sixth of those for high yield funds.
- More than 50% of credit's all-in yield now comes from spread (Figure 13), a near-historical high share and more than double the pre-crisis average. This means that investors can now more than double their yield by moving from Treasuries into corporate bonds.
- The new round of Fed purchases of agency MBS is likely to push some investors away from that asset class into other spread products, including corporate bonds.
- The Fed's latest commitment to keep rates low through mid-2015 ameliorates the risk that mutual fund flows into credit will turn negative in a rate-driven selloff.
- We expect the growth in credit ETFs to continue, because they are cheaper and more tax-efficient than mutual funds and more liquid than cash bonds.

Insurance companies – No major changes on the horizon

Life insurance companies are the single largest buyer of investment grade credit, holding 34-37% of the universe. They tend to employ a buy-and-hold strategy for their corporate bond holdings, limiting the volatility of flows from this buyer group. P&C insurers also have fairly stable holdings of corporate bonds, making up 6-8% of the universe.

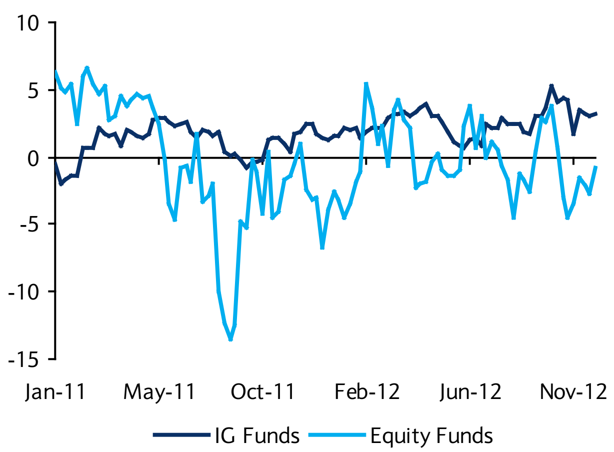
Federal Reserve Flow of Funds data show that life insurers pulled back slightly from buying corporate bonds in 2Q12, but we view this as a one-time move (Figure 14). We expect insurance flows into credit to move toward their long-run averages as insurers adjust the pricing of their products to reflect the lower yield environment. At the same time, the new round of Fed asset purchases is likely to boost the appeal of high grade corporate bonds relative to Treasuries and MBS.

Pension funds – Holding steady

We estimate that pension funds hold approximately 15-17% of the investment grade corporate universe, down slightly from prior years. Because pension funds have defined future liabilities, they tend to be more sensitive to levels of yields than to changes in yields, slowing their additions of corporate bond holdings since 1Q10.

FIGURE 12

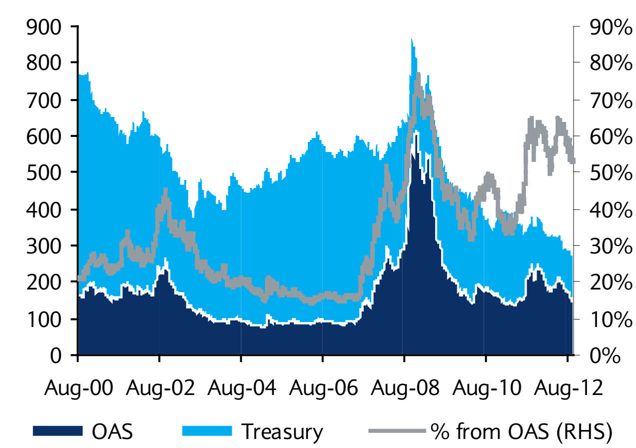
Fund flows into investment grade corporates and equities ($bn, four-week moving average)



Source: Lipper, Barclays Research

FIGURE 13

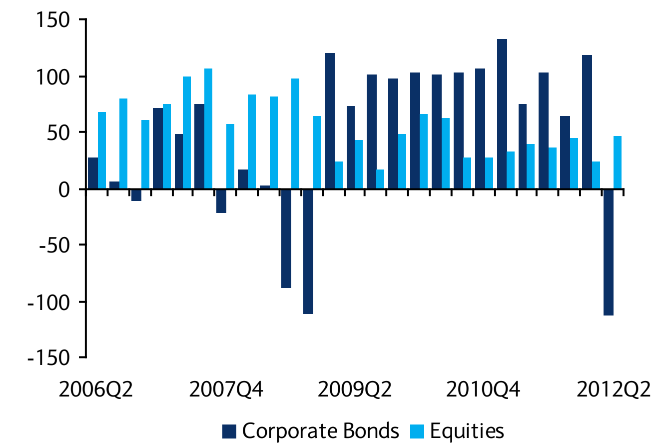
US Corporate Index: Contribution to YTW from spread and Treasury yield (bp)



Source: Barclays Research

FIGURE 14

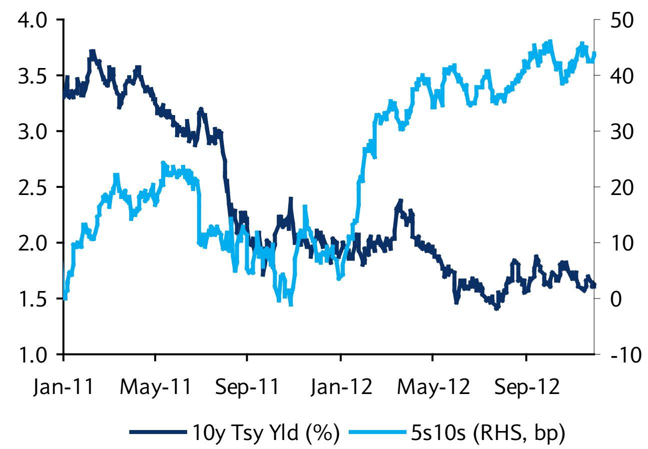
Life insurance flows into credit and equities ($bn)



Source: Federal Reserve, Barclays Research

FIGURE 15

Corporate Index 5s10s curves versus Treasury yields



Source: Barclays Research

Slowing demand for credit from pension funds has been evident in the shape of credit curves, with curves steepening significantly over the past 12 months as pension funds (large buyers of longer-dated credit) have been relatively less active (Figure 15). These yield-sensitive buyers have been more reluctant to participate in the long end at the prevailing low yields.

We expect pension fund buying of the asset class to remain muted until yields start to rise again. But we do not expect them to be outright sellers, given that many funds need to maintain a significant exposure to corporates to match their liabilities.

Supply forecast – Where there is demand, there is supply

We expect very strong investment grade issuance again in 2013 – only a touch below this year's record-breaking volumes (Figure 16). We forecast $1trn of gross issuance in 2013 (-8% y/y), $565bn of net issuance (-15% y/y). On a sector level, we expect financial and non-corporate issuance to be up slightly versus this year's annualized level, although non-financial corporate issuance should be slightly lower. Record low yields, strong demand technicals, and releveraging by many non-financial corporates should support new issue volumes in 2013.

FIGURE 16

2013 investment grade fixed-rate issuance forecast ($bn)

	2013 maturities	2012 issuance *	2013 issuance forecast	% change
Non-fin corporates	173	565	425	-25%
Financials	151	265	290	9%
Non-corporates	109	250	285	14%
Total	**433**	**1,080**	**1,000**	**-8%**

Note: Issuance eligible for the US Credit and the US 144A indices. * 2012 issuance is annualized based on issuance through November 30, 2012. Source: Barclays Research

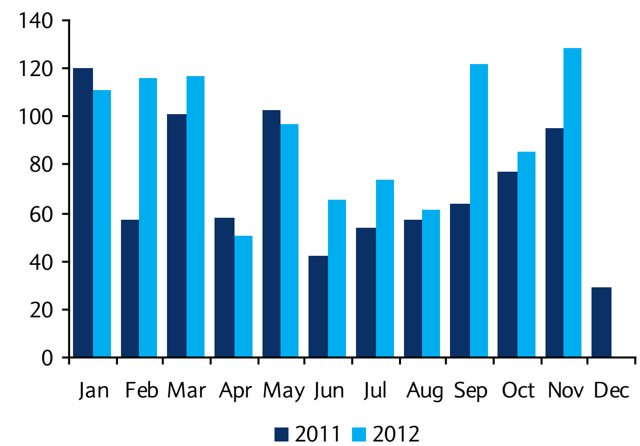
Following a slight pullback in 2011, this year's issuance has already set an all-time record, with more than $1.03trn of gross issuance as of November 30, 2012. New issue volumes are on pace to end 2012 at $1.08trn, more than 20% higher than last year's levels, with most of the increase coming from non-financial corporates (Figures 17 and 18). In net issuance terms, this translates to approximately $660bn, more than 35% higher than last year's level. Record-low yields that continued to decline for most of the year, very strong demand technicals, and extraordinary levels of central bank support brought issuers to the primary markets in droves this year. New issue volumes were also boosted by companies' pursuits of M&A activity and returns to shareholders to enhance equity returns in an environment of limited organic growth opportunities.

As in previous years, we forecast next year's issuance by combining a macro "top-down" approach and a sector-specific "bottom-up" approach. In the first approach, we use 2013 redemptions as a baseline and adjust that number to reflect the effect of various themes such as EBITDA growth and returns to shareholders. In the second approach, we forecast issuance for the various sectors in our universe using insights from our fundamental analysts (Please see 2013 *Supply Forecast: Where There Is Demand, There is Supply*, for details on sector-level issuance).

We begin our forecast by first examining next year's fixed-rate USD maturities, which total $435bn, approximately in line with 2012 maturities as of the end of 2011 (Figure 20). As a starting point, we assume that all of next year's maturing debt is refinanced (acknowledging that some 2013 maturities have already been prefunded). In addition to fixed-rate debt, a bit

FIGURE 17

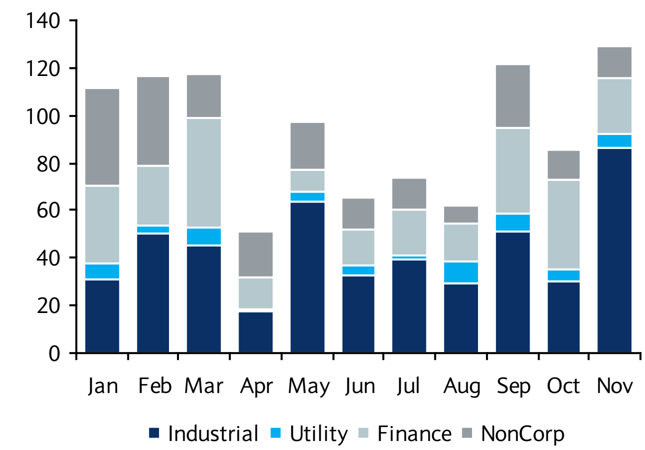
Fixed-rate investment grade issuance: 2011 vs 2012 ($bn)



Note: As of November 30, 2012. Source: Barclays Research

FIGURE 18

Monthly fixed-rate issuance by sector ($bn)



Note: As of November 30, 2012. Source: Barclays Research

FIGURE 19

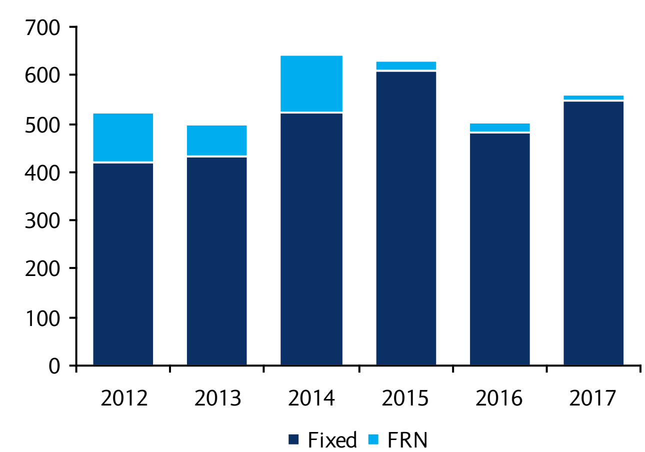
Top-down fixed-rate issuance forecast

Source of debt issuance for 2013	Amount ($bn)
Fixed redemptions	435
EBITDA growth	180
Increase in leverage	110
Prefunding and liability management	150
First-time issuers	125
2013 gross issuance forecast	1,000
2013 net issuance forecast	565

Source: Barclays Research

FIGURE 20

USD investment grade maturities ($bn)



Note: Based on debt in the US Credit, US 144A, and US FRN indices. 2012 maturities are as of the end of 2011. Source: Barclays Research under $70bn of FRN debt is maturing next year, a large part of it from banks. We assume that most FRN maturities will be refinanced in floating-rate form (and, thus, not counted in our supply forecast). As a result, the starting point for our 2013 issuance forecast is ~$435bn.

In addition to near-term redemptions, we see four main themes as the primary drivers of issuance: 1) EBITDA growth, 2) increasing debt-funded returns to shareholders in light of poor equity returns, 3) opportunistic pre-funding and the replacement of old high coupon debt with new debt through tenders and make-whole calls, and 4) first-time issuers accessing the market (Figure 19).

1. **EBITDA growth.** Consensus estimates suggest that 2013 EBITDA growth for US publicly listed non-financial companies (which represent about 70% of the whole universe of non-financials in the Credit and 144A Indices) will be in the high single digits. Assuming that leverage remains constant next year, net debt would have to increase by the same percentage as EBITDA next year. Applying this projection for debt growth to our whole non-financial corporate universe ($2.4trn of debt) results in $180bn of net debt to cover expected EBITDA growth, assuming that leverage remains constant.

2. **Continuing releveraging.** Given debt costs at historical lows and challenging equity returns, we expect companies to continue leveraging up slightly next year (see *High Grade, Higher Leverage* for details). As a result, we expect debt to grow in excess of EBITDA to fund increasing returns to shareholders and increasing levels of capex once the economy picks up. Furthermore, while we believe that organic growth prospects will be challenging next year, M&A volumes should pick up in 2013, further boosting issuance volumes, in our view (to the extent that investment grade companies with index-eligible debt buy high yield companies or smaller firms without index-eligible debt.) We believe that a rise in leverage by another 0.05x over the next year is a reasonably conservative estimate given recent trends. Using the total EBITDA for our subsample of public US-based companies of $1.57trn, a 0.05x increase in leverage implies an $80bn increase in debt. Scaling this up to reflect the entire non-financial universe results in another $110bn of net debt.

3. **Pre-funding and liability management exercises.** With all-in yields expected to remain near all-time lows, we expect companies to continue pre-funding next year to lock in record-low funding costs. Furthermore, 2014 and 2015 maturities are sizeable ($642bn and $630bn including FRNs, respectively) and are higher than forward maturities were two years ago, which could further encourage issuers to prefund (Figure 20).

   In addition to pre-funding, companies have been taking out higher-coupon debt with make-whole calls and tenders – a trend that we expect to continue. Recent examples of such transactions include AT&T's tender and exchange offer for up to $5bn of long-dated high-dollar price bonds and Verizon's $3.5bn tender offer, both occurring earlier this year. The incentive to undertake such transactions is particularly strong now, given extremely low yield levels and the significant difference between coupons of old and newly issued debt. For instance, 10y debt that was issued prior to 2010 has an average coupon of 6%, compared with 10y debt issued since July 2012, which has an average coupon of 2.95%. Year-to-date, approximately $70bn of investment grade debt has been tendered for. We believe that a similar amount of LME activity is likely next year. In sum, we believe that pre-funding and LME activity could contribute approximately $150bn of new issuance next year.

4. **First-time issuers accessing the investment grade debt market.** The investment grade universe has grown at an annual average pace of 11% since 1990. A significant part of this growth has come from first-time issuers (companies that have not previously had

debt in the US Credit or US 144A Indices); year-to-date, approximately 10% of total issuance (just under $100bn) has come from such issuers. Most came from outside the US, driven to the USD market by its low yield, greater stability relative to bond markets in other regions, favorable cross-currency basis swap levels, and large investor base. Unless the cross-currency basis swap moves dramatically to make USD funding less attractive, we have no reason to believe that the trend of first-time issuers accessing the USD corporate bond market will abate next year. We therefore expect another $125bn of issuance next year to be driven by first-time issuers.

In sum, our top-down approach results in a 2013 forecast of $565bn of net issuance. After adding 2013 maturities of $435bn, this translates to a gross issuance forecast of $1trn, 8% lower than this year's annualized level.

In addition to the top-down themes described above, we expect several other themes to affect next year's issuance. We expect bank issuance to be slightly higher next year, driven by an increase in the amount of unsecured funding in dollars from US and European banks. Yankee non-financial issuance is likely to be high again next year, driven by increased overall issuance from European companies if the sovereign debt situation in Europe continues to stabilize, as well as by the larger size and generally cheaper funding costs of the dollar market. Finally, we expect non-corporate issuance to increase next year also, driven by the scarcity value of many of the highest-rated foreign agencies and supranationals, as well as by growth in index-eligible taxable municipal and not-for-profit hospital issuance.

US HIGH YIELD STRATEGY

A clipped coupon

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- **We expect 4-6% total returns in 2013 as modest price declines and small default losses eat into coupon returns. Combining this view with our rates strategists' forecasts, high yield should produce excess returns of 3-5% for the year.**
- **Following a period of BB outperformance and CCC underperformance (risk-adjusted), the high yield market enters 2013 bifurcated in terms of yield and spread levels across the quality spectrum. While we do not expect the relationship between high quality and low quality yields to fully normalize, some compression should provide support to the lower end of the quality spectrum.**
- **Liquidity in the cash and derivatives markets will likely remain challenged in 2013. With dealer inventories depressed, we believe that volumes will continue to be abnormally concentrated in larger and more recently issued bonds. Similarly, until the dust settles on the regulatory front, we do not expect much improvement in CDS liquidity. We remain biased toward more liquid bonds and prefer CDX constituents in derivatives. We expect ETF-driven technicals in liquid bonds to become less acute by mid-2013 as rules for the JNK benchmark become less strict.**
- **We forecast an issuer-weighted default rate of 3.5% for 2013, in line with 2012. The par-weighted default rate should be 2.5-4.5%, depending largely on TXU.**
- **Recent trends in ratings migration suggest that fallen angels will outweigh rising stars in 2013. We forecast $20-30bn in rising stars and $35-45bn in fallen angels, adding $15-20bn in net supply to the high yield market.**
- **With top-line growth sluggish and internal cost-cutting opportunities largely exhausted, we expect a modest further pickup in M&A in 2013. LBO activity should increase slightly as well, with most deals resembling this year's mix of small takeouts, division carve-outs from larger companies, and operational turnaround stories.**
- **After a record year in 2012, we forecast gross high yield issuance of $275-300bn in 2013 ($110-130bn net of redemptions). Issuer incentives for refinancing remain in place, but simple mean reversion in volatility could slow issuance at times relative to this year's pace. Strategic transactions should gain share at the expense of loan-to-bond takeouts, which have largely run their course.**

Overview

The second half of 2011 was a period of near crisis-level volatility, but 2012 ushered in a period of relative calm. Tail risks associated with fears of a disorderly EMU breakup, initially moderated by the LTROs, were largely mitigated by the ECB's commitment to unlimited (albeit conditional) support of sovereign bonds through OMTs. Meanwhile, a sluggish domestic recovery paradoxically supported high yield demand. High yield benefited from its substantial coupon and mild default losses as investor demand shifted toward current income, similar to 2010. Furthermore, Fed policy action provided technical support by eliminating supply in more conservative asset classes. While performance since the announcement of QE3 has admittedly been lackluster – as other factors, such as weak 3Q earnings and post-election fiscal cliff concerns, have weighed on valuations – we expect the Fed's open-ended purchases of MBS to continue to translate into incremental demand for credit.

As demand for high yield rose this year, volatility collapsed (Figure 1), and with the exception of some volatility in May and into year-end, returns were nearly one-directional (Figure 2). While lower quality bonds outperformed in absolute terms, they underperformed in risk-adjusted terms, leading to tightly clustered returns across credit qualities. Through the end of November, the BB Index outperformed its historical market beta (0.8x) by 2.1%, and the CCC Index underperformed its beta (1.4x) by 3.6%. Yield/spread compression is to be expected in periods of overall market strength, but this outperformance of low beta led to the opposite pattern in 2012.

We believe high yield will continue to benefit from favorable demand technicals in 2013. Following a record supply year, the average coupon in high yield is only 34bp lower, at nearly 8%. This will attract investors seeking current income in what we expect to be a low-growth year, especially given a still-benign default outlook. However, returns for the upcoming year are, to some extent, held hostage by historically elevated valuations. Despite a spread (546bp) that is slightly inside of its long run average (~600bp), exceptionally low Treasury rates have taken the average yield of the US High Yield Index to 6.45%, or nearly 250bp inside of its 10y average. More important, however, this translates to an average price of $103.48, which means 39% of the market is trading at or above its next call price (Figure 3), leaving little room for upside in the better credits.

Nonetheless, this year's performance by quality has left the market bifurcated in terms of yields, leaving some areas where upside remains. Indeed, as Figure 4 illustrates, given the current market yield of 6.45%, we would expect the CCC/BB yield ratio to be closer to 1.6x, rather than its current 2.0x. While we do not expect the relationship to normalize fully, this dislocation supports our view that even in a slightly less-than-coupon year, some compression in this yield ratio should support CCC performance.

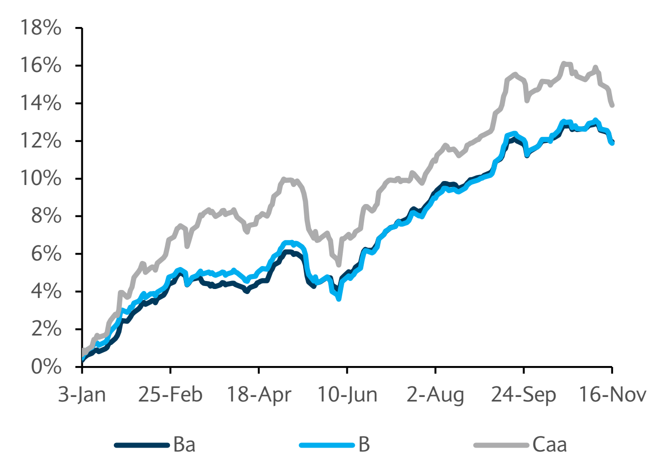
FIGURE 1

Annualized excess return volatility

Source: Barclays Research

FIGURE 2

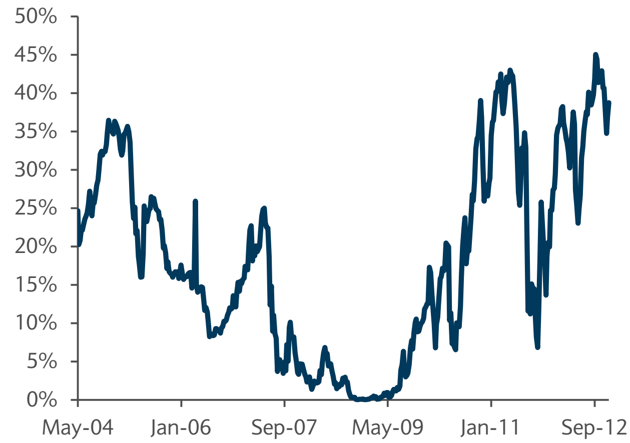
Year-to-date total return progression



Source: Barclays Research

FIGURE 3

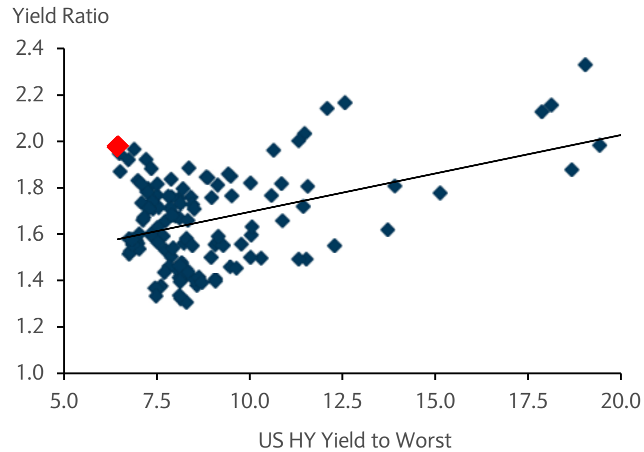
US HY percent trading above next call price



Source: Barclays Research

FIGURE 4

CCC/BB yield ratio vs US HY yield



Note: Ten years of monthly data. Source: Barclays Research

Forecasting returns

While high yield should continue to benefit from positive demand technicals next year, the scenarios that produce another year of double-digit returns require somewhat unrealistic assumptions, in our view. Assuming that valuations are unchanged between now and January 1, for 2013 returns to touch just 10%, we estimate that the index would have to reach an average price of $107, a spread of 465bp, and a yield of 5.35%. While we expect another year of significant refinancing activity, an average price of $107 is virtually impossible given the callable nature of high yield debt.

FIGURE 5

2013 total return scenario analysis

	Base case	Levels unchanged	Improved economy	Mild recession
10y Treasury	1.60%	1.67%	2.00%	1.25%
US HY OAS (bp)	620	546	490	850
US HY YTW	6.9%	6.5%	6.0%	8.9%
US HY price ($)	102.00	103.48	104.50	92.00
Coupon return	7.5%	7.5%	7.5%	7.5%
Default loss	-1.1%	-1.1%	-0.5%	-3.0%
Price return	-1.4%	0.0%	0.9%	-10.4%
Total Return	5.0%	6.4%	7.9%	-5.9%

Source: Barclays Research

Indeed, as we look to 2013, we see 4-6% as the most likely range for total returns, which would put excess returns at 3-5%. Naturally, different components of that return prediction have differing levels of predictability. Our starting point is the fixed coupon, which is currently slightly below 8%; while the coupon continues to decline as low yields attract opportunistic issuance, this component is by far the most predictable. Barring a recession (which we do not expect), default losses are the next easiest piece of the puzzle. As we describe in further detail below, default rates should remain below average next year, translating to losses of 1.0-1.5pts for the year. The last component is the price change for the non-defaulted part of the market, which encompasses spread changes and the effect of

Treasuries. While our rates strategists expect Treasuries to end the year essentially where they began, our baseline expectation is for a modest fall in price on slightly wider spreads.

Given a price of nearly $103.50, upside potential is limited if economic conditions improve, as can be seen by our 8% forecast in an improved economy (Figure 5). Moreover, the distribution of returns for next year is asymmetrically skewed to the downside, as the health of the US economy remains vulnerable to fiscal cliff negotiations and the European recession, among other risks.

Default risk

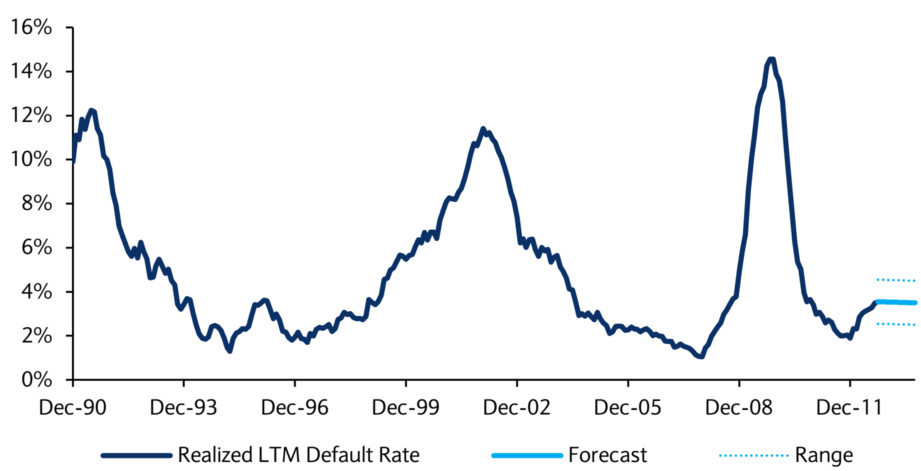
The high yield default rate is likely to remain subdued in 2013. As in prior years, we take a three-pronged approach to forecasting the default rate for the coming year, combining a top-down macro model, a bottom-up analysis of credits, and a ratings migration-based forecast; we arrive at a 2013 issuer-weighted default rate of 3.5%, or essentially unchanged from the most recent Moody's reading. Our expectations for the par-weighted default rate – which is more directly related to default losses for the aggregate market – are highly dependent on the future of TXU, the fourth-largest issuer in the US High Yield Index, and range between 2.5% and 4.5%.

Interestingly, our top-down model projects the lowest default rate (2.0-2.5%), while the ratings migration model is the highest (4.0-4.5%), with the bottom-up analysis estimate at 3-4%. The first model, which relies on the Fed lending survey and the price distribution of high yield bonds, effectively reflects the openness of the primary market and other price-based signals. Meanwhile, the ratings migration model, which relies on the relative rate of upgrade/downgrade from major credit ratings agencies, essentially captures the changing fundamental landscape. The rank-order of these three approaches is therefore unsurprising, given that 2012 was a year of looser lending standards, decreasing yields, record high issuance, and deteriorating credit statistics.

Recovery rates, the other key factor in evaluating expected losses to the asset class, are negatively correlated with the default rate, amplifying losses at the peak of the default cycle and making them less acute in low-default periods. Given our 3.5% default expectation for 2013 and the relationship between defaults and recoveries, we believe the aggregate unsecured recovery rate will be 40-50%.

FIGURE 6

Realized and forecast issuer-based default rate



Source: Moody's, Barclays Research

Event risk

It seems that every year since the recovery began in 2009, investors have looked for a significant pickup in strategic activity and then been slightly disappointed by the pace of deal flow. Certainly, the requisite financial conditions to support increased M&A and LBO activity appear to be in place. Issuer funding costs are near all-time lows, and asset yields, as measured by the ratio of EBITDA to enterprise value, remain reasonable. When the gap between funding costs and asset yields is large, there is a strong financial incentive for companies and/or equity sponsors to engage in debt-financed strategic activity. As Figure 7 shows, this gap is currently very elevated relative to historical norms, suggesting that the time may be ripe for strategic transactions to increase.

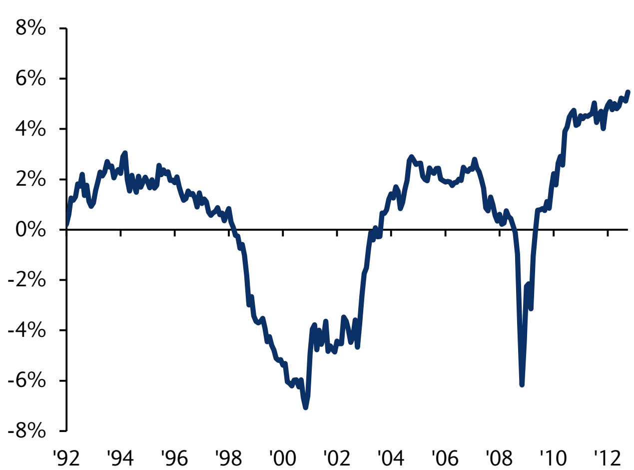
However, the same argument could have been made a year ago, or even as far back as late 2010, but as Figure 8 shows, the volume of high yield issuance supporting M&A and LBO transactions has not increased materially. We believe several factors are acting as inhibitors, including lingering European macro risks, tax rate uncertainty, and sluggish domestic growth. In addition, the upcoming implementation of Dodd-Frank and Basel III has made underwriters much more focused on risk-weighted assets, affecting their ability and willingness to tie up capital through larger financing commitments.

Despite these obstacles, a review of industry fundamentals leads us to conclude that strategic activity will pick up slightly in 2013. Our view is that strategic activity is likely to be a net positive for high yield investors next year, as high yield issuers are likely to become the acquisition targets of larger investment grade companies. In addition, recent headlines concerning Best Buy and Supervalu suggest that private equity may be shifting back to a more traditional model, acquiring troubled companies and making operational improvements rather than simply leveraging up a stream of steady cash flows. As we first described in *Strategic Thinking*, several factors have the potential to drive (or inhibit) deal flow next year, including:

- *Lack of organic growth opportunities* – After successfully repairing their balance sheets and reducing operating costs in the wake of the crisis, many management teams now find themselves confronting sluggish top-line growth and limited room for further internal cost savings. Acquisitions can potentially reignite growth while also providing the opportunity for synergy realization. In our view, industries likely to be affected include chemicals, consumer products, media, wireless, and wirelines.

FIGURE 7

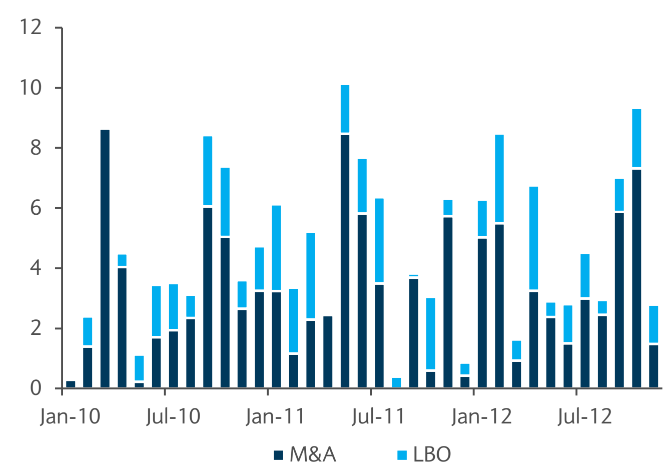
S&P500 (ex-fin/util) EBITDA/EV minus US High Yield Index yield-to-worst



Source: S&P Capital IQ, Barclays Research

FIGURE 8

Monthly high yield issuance with strategic use of proceeds ($bn)



Source: Barclays Research

- *Commodity prices* - The combination of high oil and low natural gas prices has been a driver of transaction volume in a number of industries in 2012, particularly those influenced by economies of scale in either the production or extraction of resources. M&A has been active in the energy sector and should remain so in 2013. Conversely, the fall in coal prices has curbed strategic activity in the metals and mining industries, a trend we expect to continue, as the challenging pricing environment looks set to persist.

- *The government effect: Regulatory changes versus budgetary uncertainty* - With Mitt Romney's threat to reverse the Patient Protection and Affordable Care Act now off the table, 2013 should be an active year for M&A in healthcare, as size and scale can help offset higher costs associated with regulatory compliance. Conversely, the lack of clarity about sequestration and the potential for significant cuts in defense spending are likely to inhibit deal flow in the aerospace & defense industry, at least initially. In the longer term, durably constrained defense spending under a Democratic administration is likely to drive industry consolidation, with smaller high yield companies potentially benefiting from being the acquisition targets of larger, investment grade rated industry leaders.

One final type of event risk that is more likely to be a net negative for investors is the potential increase in dividend deals. This trend gained steam during late summer and fall 2012 (see *In the Dividend Zone* for details), causing some widening of existing opco bonds in the days following the dividend deal announcements (see *Dividend Deals Weigh on Opco Debt*). With a number of senior unsecured bonds from post-crisis LBOs trading inside of 8%, holdco coupons of 11% or lower become feasible, creating a significant incentive for equity sponsors to tap the market.

Duration risk

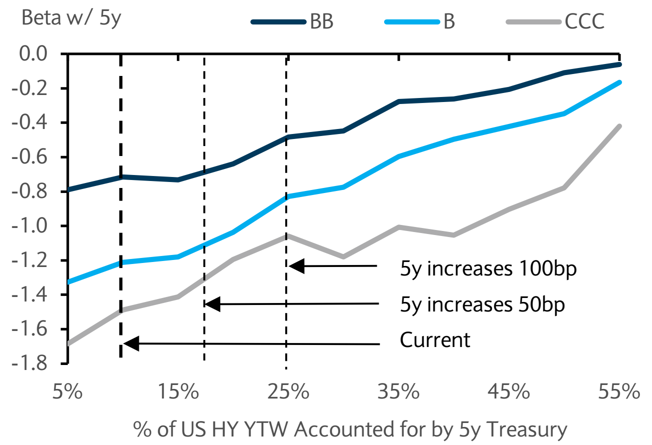
Recent Fed commentary continues to point toward sustained purchases of MBS and Treasury securities. Given an inflation rate that is within an acceptable range, the Fed is focused on its full employment mandate, and its open-market purchases across the curve suggest that rates are unlikely to increase for a while.

Despite this base case, it is clear that rate risk is asymmetrically skewed to the downside, given near record-low Treasury borrowing costs. Furthermore, following a 30-year period of declining rates, it is unclear what would happen to fixed income demand should the trend reverse for a sustained period.

Given the significant amount of spread cushion in the US HY Index yield, any increase in rates is unlikely to have much influence on prices, on average. Historically, the fraction of total yield coming from rates (or, conversely, from spread) is significantly correlated with the beta of spread changes to rate changes (Figure 9). At current levels – the 5y Treasury rate is 10% of all-in yield – we would expect rate increases to be fully absorbed by spread compression for the market overall. However, higher quality bonds, which tend to have longer duration, would likely underperform, especially in light of the deluge of very low-coupon refinancing in 2012.

FIGURE 9

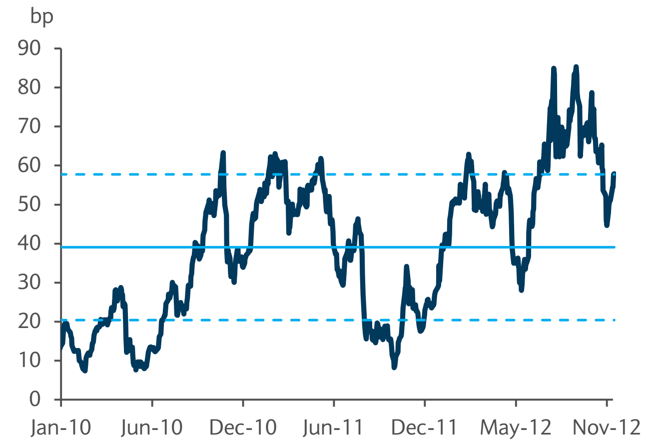
Beta of US HY OAS with 5y Treasury, by quality



Note: Monthly changes in months of increasing 5y Treasury rates.
Source: Barclays Research

FIGURE 10

US High Yield Index yield-to-maturity minus yield-to-worst



Source: Barclays Research

With the average bond in the US High Yield Index trading over $103, the more pertinent risk is negative convexity, in our view (Figure 10). In particular, the yield-to-call (YTC) part of the market is the most exposed to extension risk in a sell-off. However, we believe current income will be key in a period of low expected growth. In light of our expectations that there will be no more than a minor pullback in valuations, we view the trade-off between negative convexity and current income as worth examining.

An analysis of the ratio of YTC versus non-YTC yields and volatilities is telling, in our view. Naturally, yield-to-call bonds are typically lower vol because of their lower duration, but they also offer lower average yields. At current levels, YTC bonds yield nearly 80% of non-YTC bond yields. However, the ratio of volatilities for YTC and non-YTC bonds is about 0.6. This translates to more yield-per-unit-vol for YTC bonds (Figure 11). The difference in yield-per-unit-vol for these two segments of the market is a rough measure of the relative attractiveness of YTC bonds on a risk-adjusted basis. While Figure 12 shows that YTC bonds have been more attractive in the past, we believe they remain a compelling source of current income given that this measure is still positive.

FIGURE 11

Yield-to-volatility ratio of YTC and non-YTC bonds

Source: Barclays Research

FIGURE 12

Difference in yield-to-volatility ratio (YTC – non-YTC)

Source: Barclays Research

FIGURE 13

US. High Yield Index par and market value ($bn)

Source: Barclays Research

FIGURE 14

Estimated share of US high yield bond holdings

Category	2012	2011	Y/Y chg
HY mutual funds	22-25%	18-20%	+3%
IG/income funds	18-20%	18-20%	unch
CLOs/loan funds	2-4%	2-4%	unch
Offshore	5-8%	6-9%	-1%
Hedge funds	12-18%	12-18%	unch
Pension funds/sep accts	14-18%	15-20%	-1%
Insurance portfolios	8-12%	8-12%	unch
Other	4-7%	5-8%	-1%

Source: Bloomberg, Lipper, EPFR, HFR, SNL Financial, Barclays Research

Supply and demand

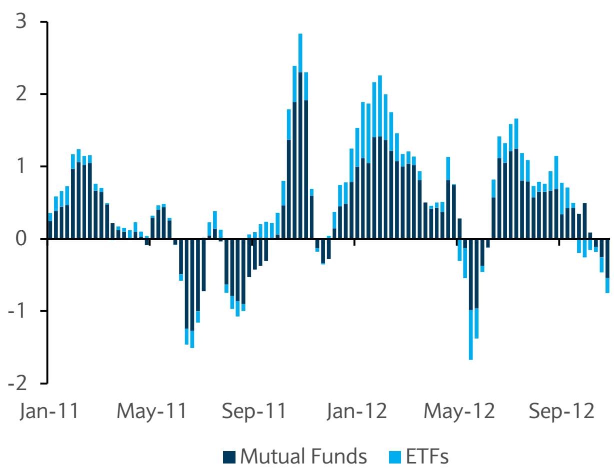
Demand

As we described in *Revisiting Demand – Retail Leads the Way*, the demand picture for credit has been very supportive in 2012, driven by aggressive central bank actions that have pushed investors out along the risk spectrum, to the benefit of high yield bond prices. Given the combination of ongoing asset purchases by the Federal Reserve and our expectation of reasonably low default rates, we expect demand technicals to remain supportive of high yield in 2013 as well. This should facilitate further growth in the US high yield bond market, which has averaged a nearly 12% annual gain in par amount over the past two decades and now exceeds $1trn in total size (Figure 13).

Breaking down the high yield market buyer base into its major investor types, we can see more clearly where this year's growth has come from. Figure 14 presents our most recent estimate of the share of US high yield notional outstanding held by each major asset pool, as well as the

FIGURE 15

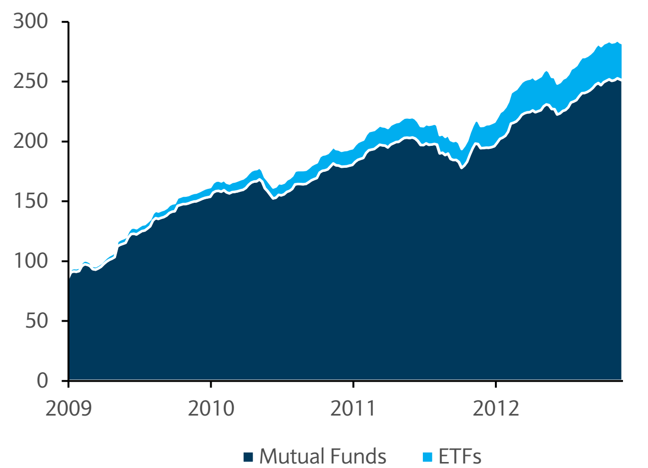
Four-week moving average of US high yield fund flows ($bn)



Source: Lipper US Fund Flows

FIGURE 16

Total AUM of US high yield mutual funds ($bn)



Source: Lipper US Fund Flows

change from our previous estimate from late 2011. We find that this year, most of the growth has come from high yield mutual funds and ETFs. Fund flows have been strong for most of 2012 (Figure 15), totaling more than $33bn as of late November. Combined with strong price appreciation, these flows have driven total AUM growth of more than $65bn this year (Figure 16), pushing the total mutual fund asset base to nearly $285bn. High yield ETFs (primarily HYG and JNK) account for approximately $10bn of the total AUM increase, off of a base of just $20bn at the end of 2011, for an impressive 50% growth rate in 2012.

We expect mutual fund and ETF growth to continue in 2013, as 2012's combination of reasonably low default rates and attractive yield relative to alternatives should continue to drive retail interest in high yield. Investment grade mutual funds are likely to keep their high yield allocations elevated as well, given the dearth of yield in high grade corporates. Provided rates remain low, however, other holders are unlikely to add material exposure in 2013 and may lose some market share as a result. Pension funds and separately managed accounts would likely become marginal buyers if a rates backup raised overall yields significantly, but they are finding it more difficult to shift allocation away from equities, given the low yield environment. Insurance portfolios would also be buyers at higher yields, although regulatory restrictions limit their ability to add sub-investment grade assets. Hedge fund interest is unlikely to pick up meaningfully next year, given the comparatively small amount of distressed assets available. With a lack of demand growth from these other sources, further growth in retail demand will be critical to offset what we expect will be robust supply.

Within the retail channel, the marked growth of high yield ETFs has raised investor awareness of their create/redeem process and the effect it can have on bonds that are part of ETF benchmark indices. Fortunately, changes are being implemented to ETF benchmarks that should reduce this technical. In May of this year, the Markit iBoxx USD Liquid High Yield Index (the benchmark for HYG) was broadened, causing it to increase in size by roughly 30%. Meanwhile, Barclays has announced changes to the eligibility rules for the US High Yield Very Liquid Index (Figure 17). The changes will significantly broaden the index, which is used as the benchmark for three high yield ETFs, including State Street's SPDR Barclays Capital High Yield Bond ETF (JNK). The implementation of these changes will begin on February 1, 2013, and will be phased in over six months. During that period, current index constituents will gradually decrease from 100% of the benchmark's market value to 48.5%, so more than half of current holdings will need to be sold between February and July of next year, creating some negative technical pressure. Conversely, new index constituents should see a positive technical as they are slowly added to the benchmark. In instances where individual issuers increase from having a single index VLI constituent to three, the premium associated with the existing index constituent should dissipate over time, potentially altering any current spread anomalies within the issuer's capital structure.

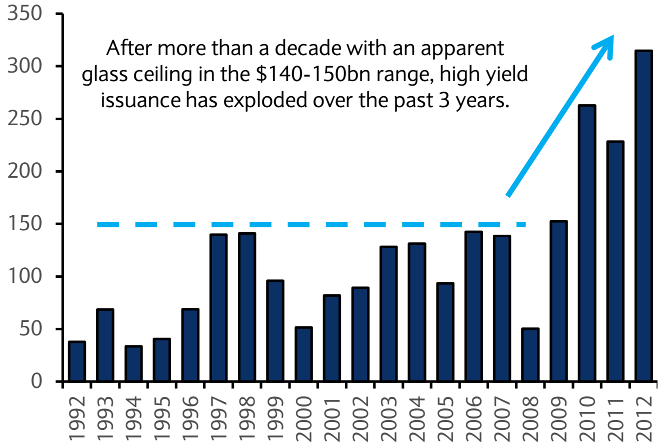
FIGURE 17

Upcoming eligibility rule changes for the Barclays US High Yield Very Liquid Index

	Old rule	New rule
Minimum issue size	$600mn	$500mn
Time since issue	Max 3 Yrs	Max 5 Yrs
Bonds per issuer	Max 1	Max 3
Issuer cap	n/a	2%
Total index par	$225bn	$465bn

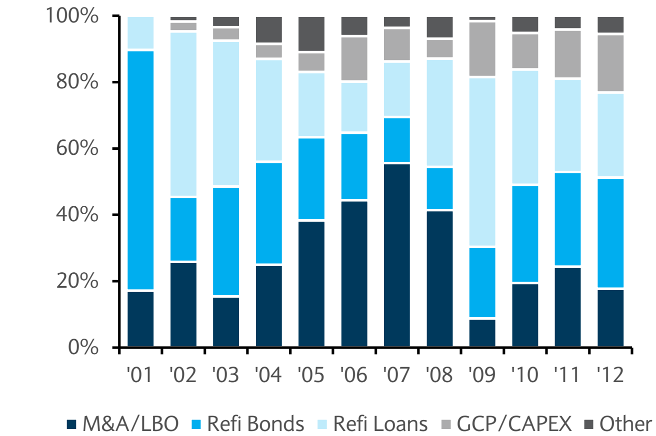
Source: Barclays Research

FIGURE 18
Annual high yield issuance ($bn)



Source: Barclays Research

FIGURE 19
Use of proceeds for US high yield bond issuance



Source: Barclays Research

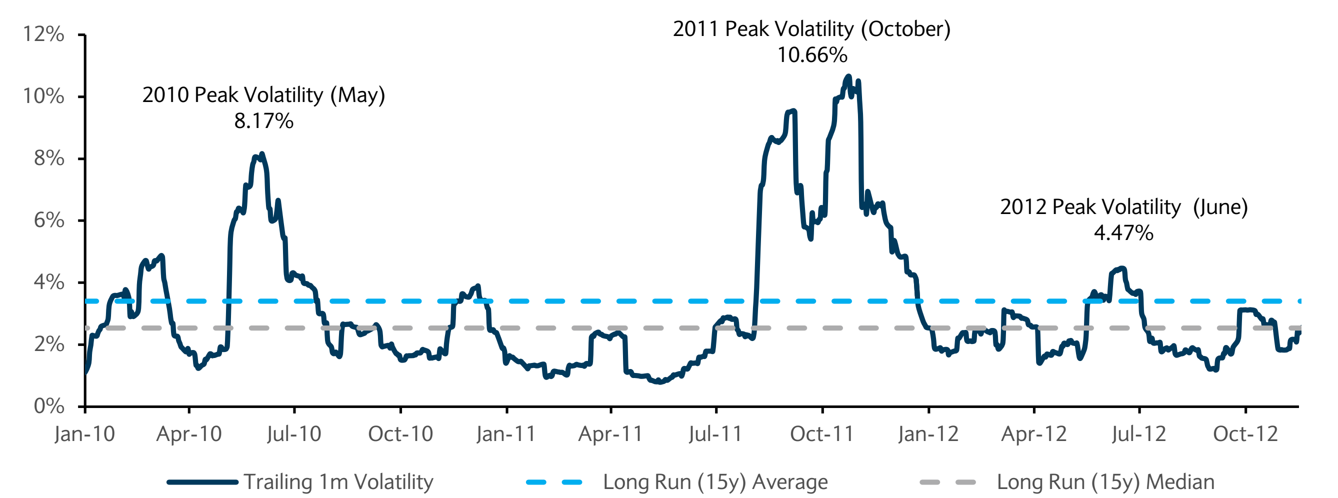
Supply

It has been a record year for US high yield supply, as issuers have responded to the all-time low yield environment. Through late November, a total of $312.9bn had priced (Figure 18), with three potentially active weeks still ahead before the late-December holiday shutdown. Not surprisingly, refinancing transactions accounted for more than half of the total (Figure 19). As we described in last year's *Global Credit Outlook*, three factors typically determine strength of issuance in any particular year:

1. The amount of debt that is maturing or losing call protection during the year (ie, the refinancing opportunity set).
2. Recent changes in yield levels, which provide an economic incentive for refinancing.
3. Secondary market volatility, which drives market access and issuer confidence.

All of these factors were favorable in 2012. In particular, volatility was down significantly from 2010 and 2011 and was below the long-run average for most of the year (Figure 20).

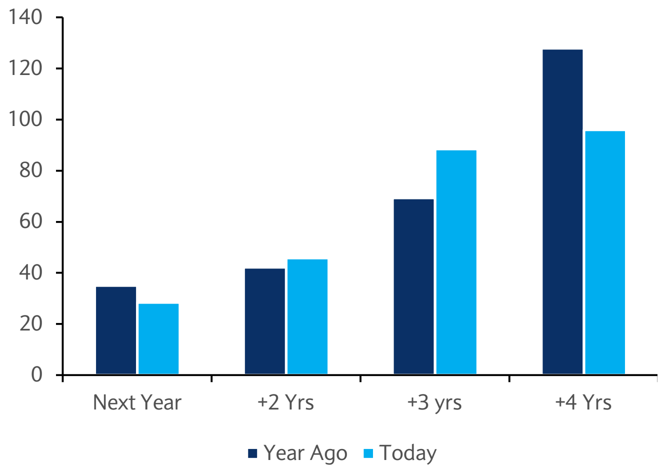
FIGURE 20
US high yield total return volatility



Note: Volatility is calculated as the standard deviation of trailing 22-day daily total returns, annualized. Source: Barclays Research

FIGURE 21

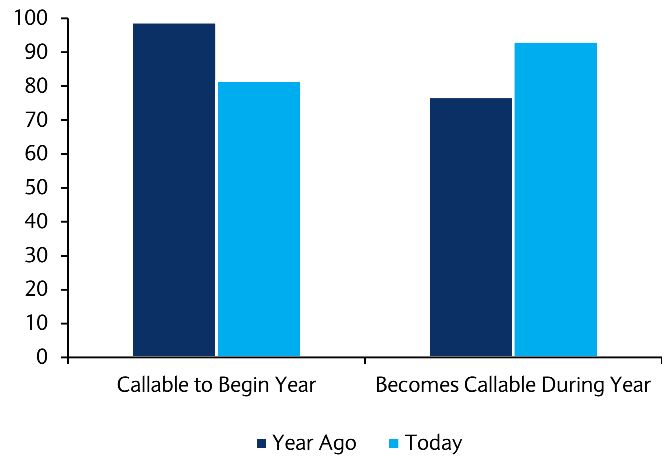
Par amount of US high yield bonds maturing ($bn)



Source: Barclays Research

FIGURE 22

Par amount of US high yield bonds callable during year ($bn)



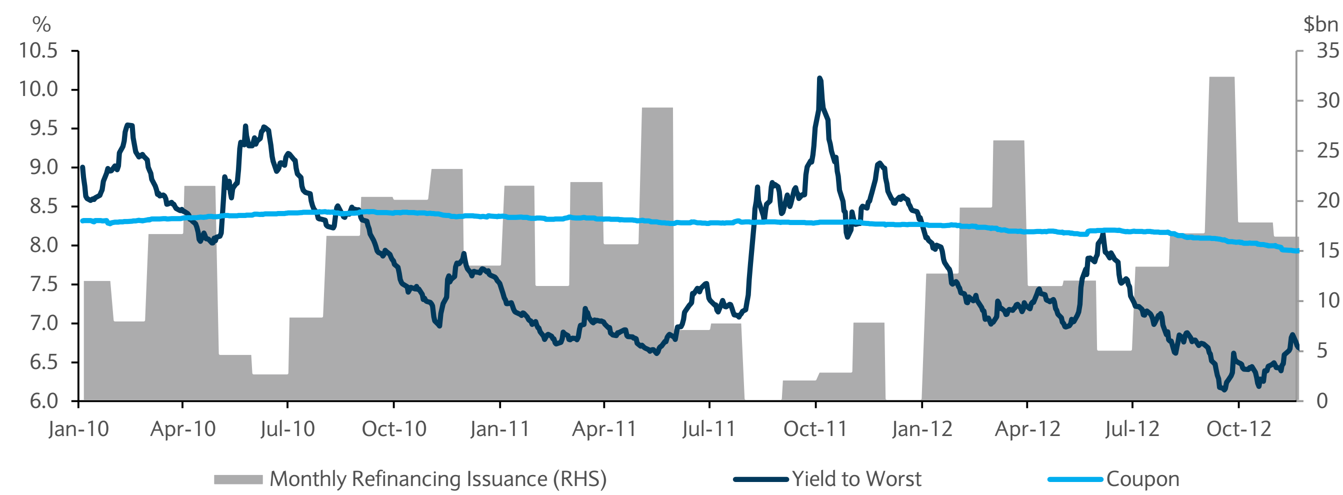
Source: Barclays Research

For 2013, the par amount of high yield bonds that are maturing (and presumably must be refinanced) in the coming year is fairly small, as it was at this time a year ago (Figure 21). More significantly for our supply projection, the par amount of bonds that will be callable at the beginning of 2013 is approximately $82bn, down from $99bn at the beginning of 2012. However, an additional $93bn in par will lose call protection during 2013, a larger amount than in 2012. Putting all of these figures together, we find the total refinancing opportunity set in 2013 to be roughly $210bn, almost identical to the year ago amount, suggesting that 2013 could be another big year for issuance.

Despite the extensive refinancing that has taken place in 2012, we believe a significant opportunity still exists for many issuers to lower their interest expense. Average yields have fallen 150bp year-to-date, but market-wide average coupon has been much slower to change, since only a fraction of the market is refinanced in any given year. As Figure 23 shows, refinancing issuance tends to be highest when there is a large gap between average coupon and average yield-to-worst. Assuming there are no sharp price moves prior to year-

FIGURE 23

US High Yield Index yield-to-worst and average coupon, with monthly high yield refinancing issuance



Source: Barclays Research

end, the high yield market will be heading into 2013 with a gap of ~140bp, from an average yield-to-worst of 6.5% and an average coupon of 7.9%. Historically, a difference of this magnitude has been sufficient to drive significant refinancing transaction volumes; we believe 2013 will be no exception.

The final key variable is volatility, and on this front we are slightly less sanguine. While we do not anticipate a return to the extremely elevated levels of volatility from 2H11, it feels a bit too optimistic to forecast a second consecutive year of very low volatility, even with the promise of continuous Fed intervention in the market. The tendency toward mean reversion suggests to us that 2013 is likely to be a bit bumpier than the past year, with periods of slower issuance when volatility rises. Putting these factors together, we believe US high yield issuance will be $275-300bn next year. Upside to that figure could come if volatility does, in fact, remain low for a second consecutive year, while a material backup in yields would likely lead to less refinancing and lower overall issuance.

FIGURE 24

2013 forecast issuance by use of proceeds

Use of proceeds	Gross issuance	Share of total
M&A	$45-55bn	16-18%
LBO	$20-25bn	7-9%
Repay bonds	$90-110bn	33-37%
Repay loans	$40-50bn	15-17%
GCP/Capex	$45-55bn	16-18%
Dividend	$15-20bn	5-7%
Other	$3-7bn	1-2%
Total	$275-300bn	100%

Source: Barclays Research

Figure 24 summarizes our expectations for 2013 use of proceeds. We expect M&A to gain share slightly, rising from this year's 13% to something closer to the 17% share achieved in 2011 (see *Strategic Thinking* for more detail on potential M&A activity by sector). LBO activity is likely to increase slightly as well, while still resembling this year's mix of smaller deals, division carve-outs from larger companies, and operational turnaround stories. Several impediments to larger, pre-crisis style LBOs remain, including reluctance by sponsors to write large equity checks, social issues related to legacy club deals, and banks' increased focus on capital ratios and risk-weighted asset metrics, which in some cases limit their appetite (or capacity) for large financing commitments. Straight bond refinancing transactions should once again make up roughly a third of total issuance, driven by the yield versus coupon gap referenced earlier. However, we expect a fairly material drop-off in loan-to-bond refinancing transactions, with share falling from 25% this year to perhaps 15-17% in 2013. Improved retail and CLO demand has allowed the leveraged loan market to return to growth, so issuers no longer need to issue secured bonds to repay loan debt. In fact, several have recently gone the other way, choosing to retire bond maturities by issuing new loans. Issuance in support of capital expenditures may decline slightly, particularly if fiscal cliff issues are not resolved prior to year-end. Finally, we expect the 2H12 rise in dividend deals to persist next year, slightly increasing the overall share of bond issuance that funnels cash back to equity holders.

Quality

In the context of a double-digit total return, quality has made a smaller difference in 2012 than one might normally expect. Through the end of November, CCCs have produced the highest total return at 15.99%, but significantly underperformed the 19+% expected return implied by their historical beta to the market. Meanwhile, year-to-date BB and single-B returns are virtually identical, at 13.52% and 13.92%, respectively, making higher quality the year-to-date outperformer on a beta-adjusted basis. The 2.5% range between the highest and lowest quality return is unusually tight for high yield, particularly in a strong return year.

After coming into 2012 wide of long-run averages, this year's strong rally has pushed spreads slightly to the tight side of historical averages (by 25-50bp) across all quality levels (Figure 25). Spread gaps between the major quality buckets within high yield (BB vs B vs CCC) are also close to normal, although the ratio of BB to BBB spreads (ie, the investment grade/high yield crossover threshold) is approximately 10% wider than usual, implying a slightly better-than-average potential reward for successfully identifying rising star candidates.

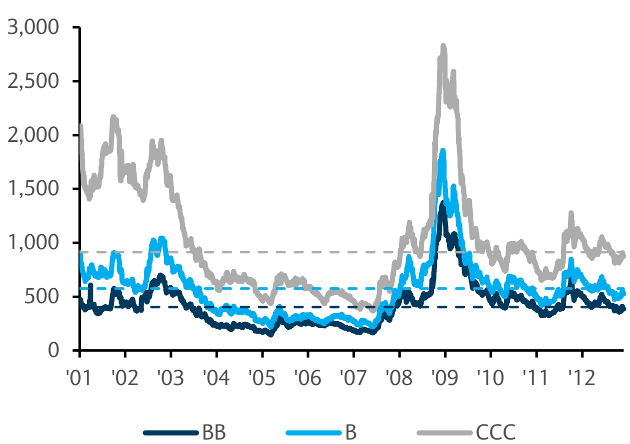
In general, with yields still close to all-time lows and nearly 40% of the market call constrained by high prices, we believe quality spreads are somewhat less applicable than usual as a relative valuation tool. With that in mind, we do not recommend materially deviating from market weight in quality terms heading into 2013. While our below-coupon return projection would normally imply that CCCs should underperform, we do not expect this to be the case next year, given that defaults are expected to remain below average, economic growth should be positive, and yield relationships imply that some compression could still take place. However, as always, CCC allocations should be carefully scrutinized. CCCs that have lagged this year's rally have tended to be smaller, less liquid issues, which could be difficult to offload in any material sell-off. As Figure 26 shows, the gap between larger, more recently issued CCCs (what we refer to as Go-Go's) and smaller, more seasoned CCCs (Slo-Go's) has steadily widened over the past three years, reflecting the rising liquidity premium in the cash market. On the other end of the quality spectrum, BBs should be the most resilient to the slight backup in spreads that we expect, but are also near all-time highs in call constraints, limiting their upside. As such, we prefer a market weight distribution, with the expectation that single name and sector selection will outweigh quality allocation in generating alpha in 2013.

Rising stars/fallen angels

Despite the recent downgrade of ArcelorMittal (MTNA), which became the seventh largest high yield issuer when it entered the US High Yield Index on December 1, rising stars look poised to outweigh fallen angels by par amount for the second consecutive year in 2012. Beyond the headline, however, the underlying trend in ratings migration momentum

FIGURE 25

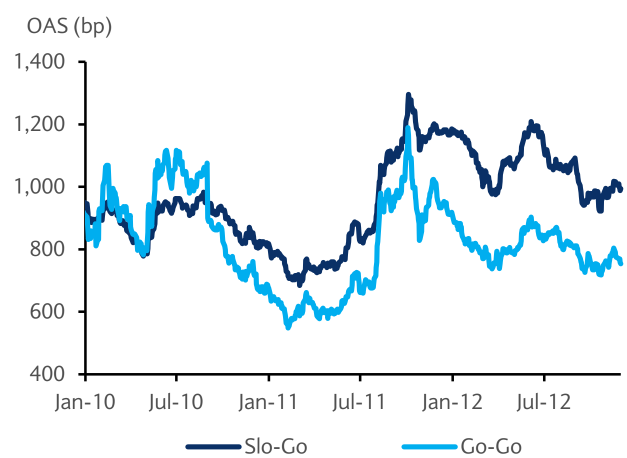
US high yield OAS by quality, with long-run average



Source: Barclays Research

FIGURE 26

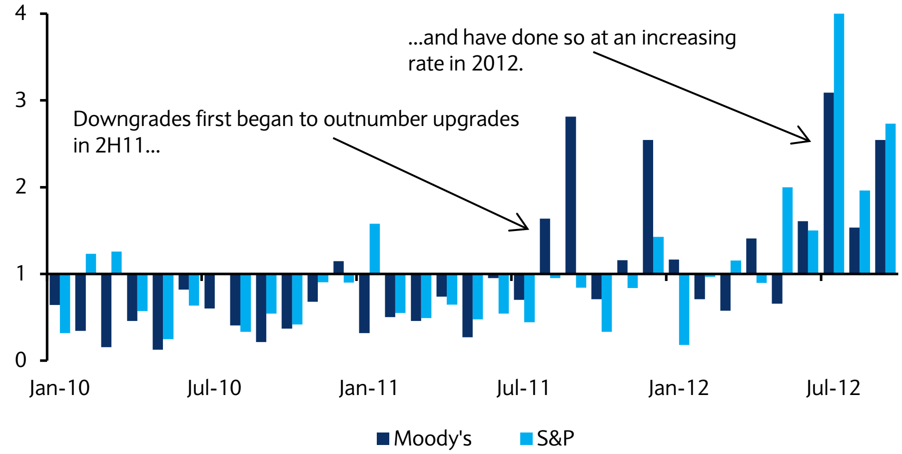
Average OAS of CCC rated Slo-Go and Go-Go bonds



Note: Slo-Go CCCs are at least 3 years past the issue date and max $250mn par. Go-Go CCCs are less than 3 years old and min $500mn par. Source: Barclays Research

FIGURE 27

Ratio of downgraded to upgraded bonds



Source: Moody's, S&P, Barclays Research

appears to have changed. In 2011, the improvement in credit metrics across the high yield market was broad based, allowing a large number of previously high yield issuers to achieve investment grade status. This year, a single issuer accounts for more than half of the rising star par amount: Ford, which became the single largest rising star of all time when it was upgraded by Moody's in May. Absent this single issuer, fallen angels would have outweighed rising stars significantly, even without the recent MTNA downgrade.

We are less optimistic that 2013 will produce a third consecutive win for rising stars. As Figure 27 shows, credit rating downgrades began to outnumber upgrades late in 2011, and this trend has accelerated in 2012 amid slow economic growth and signs of increasing appetite for leverage among issuers and investors alike. Since we do not expect any large issuer upgrades of Ford's magnitude next year, rising stars should fall from this year's ~$50bn to $20-30bn in 2013, while fallen angels are likely to be closer to $35-45bn, in line with longer-term averages (outside of crisis periods).

Derivatives

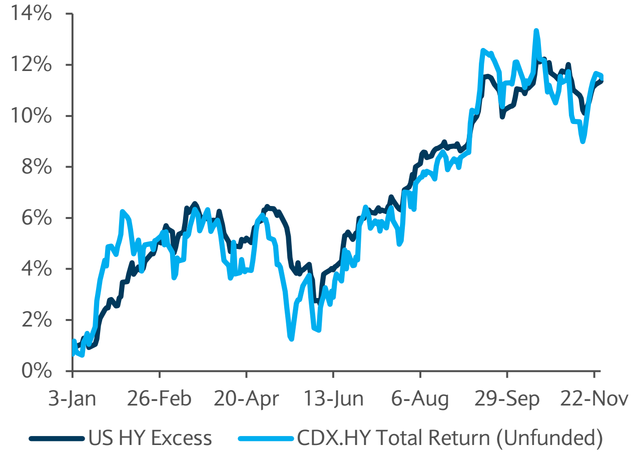
HYCDX versus cash

Excluding the 2008-09 crisis period, the high yield derivatives index has tracked the cash market well. Given that HYCDX is insensitive to interest rates, we generally compare its performance with the cash market excess return, and despite a few periods of divergence in the year, as of the end of November the two markets are almost exactly aligned (Figure 28). Barring another crisis, we expect HYCDX to continue to track cash excess returns well.

With ETF assets continuing to grow at a significant pace, it is worth examining their performance as cash substitutes as well. Using 2011 betas to our US High Yield Index (0.52 for JNK, 0.47 for HYG, 0.42 for HYCDX), we find that all three products were essentially equivalent in terms of performance in 2012. As Figure 30 shows, the relationship between the three products and the high yield cash market is strong, and all three performed as expected in large moves. Notably, the ETFs were superior at reducing portfolio volatility, at least in part because of their exposure to Treasuries, but all three hedged portfolios were similar in terms of their cumulative performance for the year (Figure 31). The main difference remains liquidity. ETF liquidity has improved as assets have grown, with about $2.5bn in traded market value in an average week. However, the HYCDX index still trades

FIGURE 28

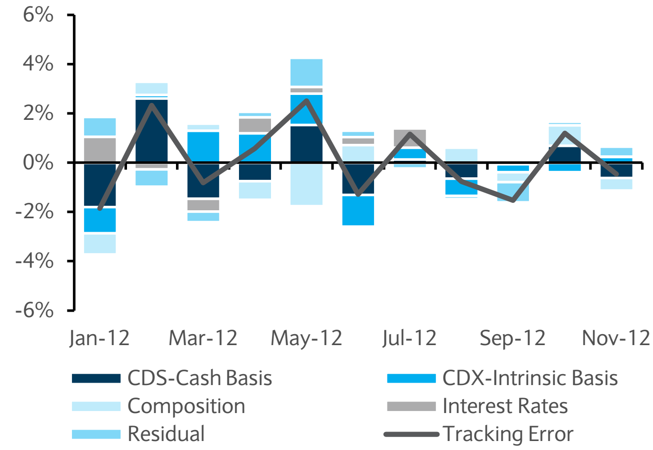
YTD HYCDX returns and US high yield excess returns



Source: Barclays Research

FIGURE 29

Components of HYCDX and US high yield tracking error



Source: Barclays Research

$18-20bn in notional in an average week, or 7-8x as much as the two largest ETFs combined. Thus, while HYCDX will never be perfectly in synch with the cash market, it remains the best choice for gaining liquid access to high yield returns, in our view, especially over a multi-month horizon.

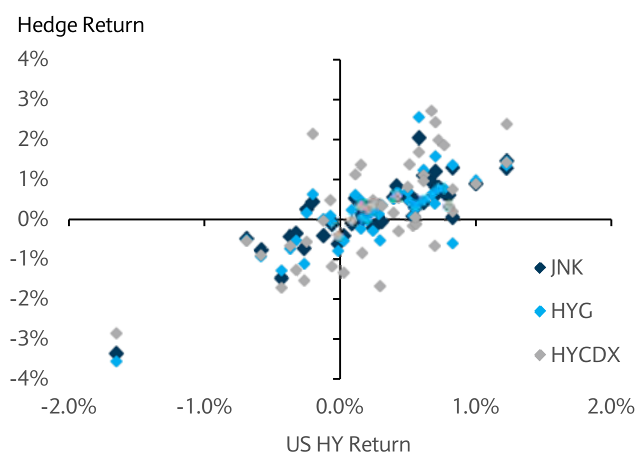
Liquidity

Continued regulatory uncertainty has depressed CDS volumes. As we discussed in *Regulation Update*, the process of rule-writing and implementing the Dodd-Frank Act and Volcker Rule continues. Until the dust settles, including full implementation of real-time reporting, clearing, and SEF trading, we do not expect much improvement in the liquidity environment. Given current progress, we do not think volumes will rebound materially before 2014.

Apart from a handful of exceptions, single-name liquidity remains concentrated in the constituents of on-the-run and recently off-the-run series of HYCDX, as shown in *Liquidity in CDS Markets*. Furthermore, the number of highly liquid names in single-name CDS

FIGURE 30

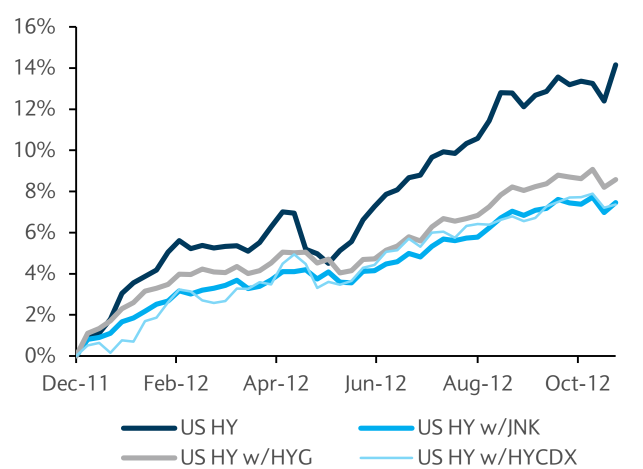
Weekly total returns – hedges versus US high yield



Source: Bloomberg, Barclays Research

FIGURE 31

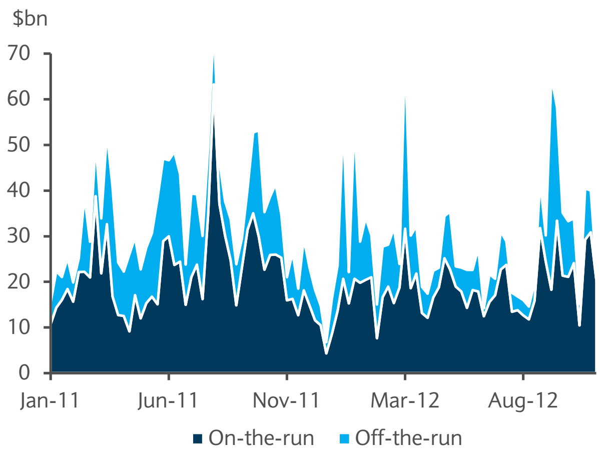
Cumulative 2012 hedged and unhedged returns



Source: Bloomberg, Barclays Research

FIGURE 32

Weekly HYCDX volumes



Source: DTCC

FIGURE 33

Ratio of HYCDX return volatility and US HY return volatility

Source: Barclays Research

continues to decline. On the other hand, traded volumes in the index have been more resilient (Figure 32). Admittedly, they are also lower y/y: in 2012, the on-the-run index traded an average of $17.7bn per week, while average weekly volumes in the same period in 2011 were $20.8bn. That said, higher volatility in 2011, especially in the summer months, drove significant volumes, which account for much of the y/y decline.

Despite the more brisk deterioration in single-name liquidity compared with the index, index arbitrage activity has managed to keep the CDX-Intrinsic basis in check. However, the resilience of index volumes has shown up in its volatility relative to the cash market. Indeed, while return volatility is lower in both cash and CDX following a solid performance year, the ratio of realized volatilities for the two markets is at its peak (Figure 33).

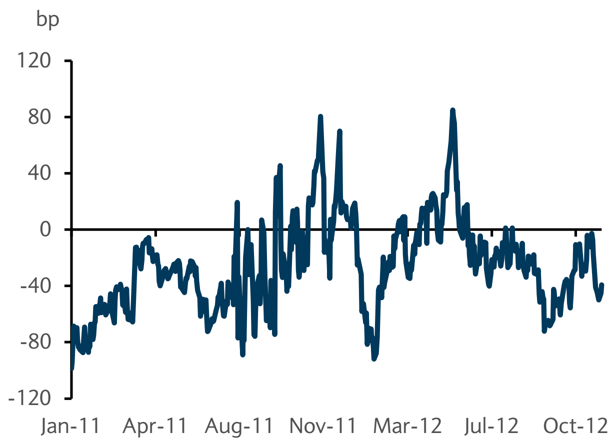
Basis

With volatility plummeting at the end of 2011, the CDX index led the way tighter in spreads, leaving the cash market looking cheap. The cash market corrected the dislocation over the first half of 2012, and a brief pullback in May made CDX extremely cheap for a few weeks. Since then, a period of relatively low volatility has kept the CDX-cash basis in a relatively tight range, and the current aggregate basis of about -45bp is essentially average relative to the past three-year history (Figure 34). For 2013, we do not expect a material divergence between HYCDX and cash market performance. However, tactical positioning in one or the other continues to make sense on a shorter horizon, as technicals and volatility cause these two markets to diverge periodically. Furthermore, with the cash market trading at more than $103, bullish investors will not get the performance they desire from call-constrained cash in their long views. For overweights trading above par, we recommend swapping out of cash and into a short protection position when a positive basis develops.

Although a few rolls have introduced some less-than-ideal constituents to the CDX index, arbitrage activity has kept the index from diverging too substantially from its intrinsic value. That said, the index spent a significant amount of 2012 trading rich to intrinsic, which is uncommon for the HY derivatives index (Figure 35). We believe the shift stems from CDX leading its less-liquid single-name constituents through a sustained period of market strength, rather than a more permanent, structural change.

FIGURE 34

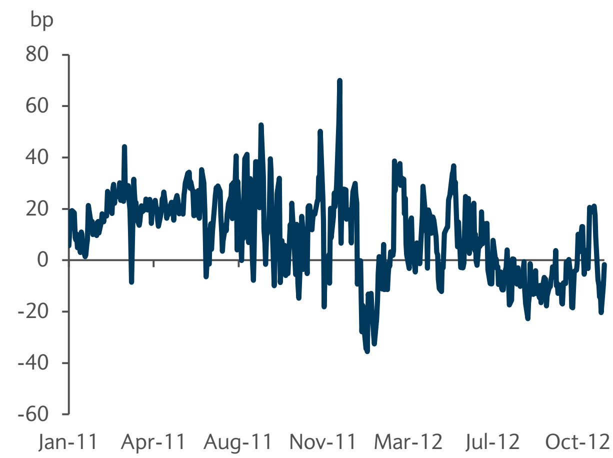
HYCDX spread minus US High Yield Index OAS



Source: Barclays Research

FIGURE 35

HYCDX traded spread minus HYCDX intrinsic spread



Source: Barclays Research

CDS curves

Visibility is limited with respect to CDS liquidity by tenor. Nonetheless, it is clear that activity remains concentrated at the 5y point. Certain regulations, such as the real-time dissemination of swap trade data, mandatory clearing, and SEF trading, have the potential to concentrate trade activity further, as highlighted in *Regulation Update*. Given the current delays in the regulatory process, we do not expect clearing and SEF trading to be mandated before the end of 2013, at the earliest.

Liquidity across the curve will therefore look much as it does today for most of 2013, in our opinion. That said, the nature of high yield credit makes the front end somewhat more liquid in general. Over the average five-year horizon, a significant share of the high yield universe either defaults (25-30%) or rises to investment-grade (5-8%), leading to natural supply and demand for shorter-dated protection. In turn, this makes high yield front-end curves tradable in "story" credits.

For next year, there are three main ways to take advantage of HY CDS, in our view:

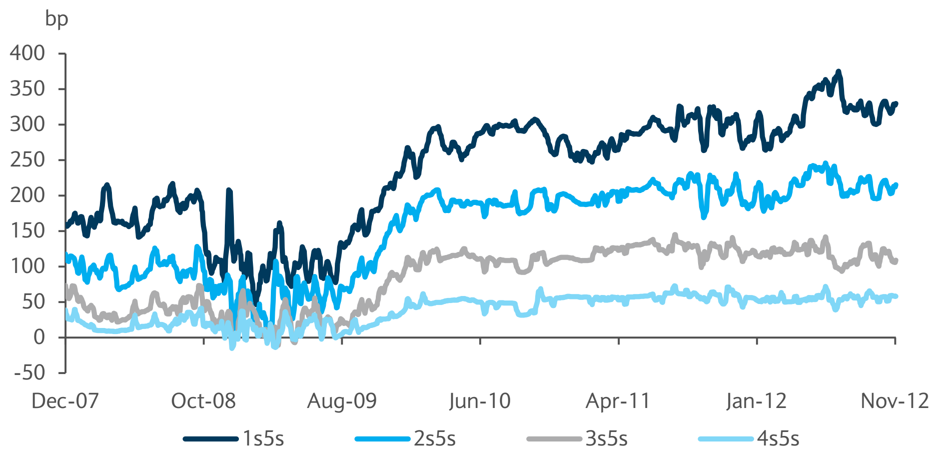
1. **Expressing a long view with a better convexity profile**: With high yield cash approaching its call-constrained peaks, negative convexity can limit upside, making CDS more appropriate to express a long credit view.

2. **DV01-neutral flatteners with positive carry:** Front-end curves have been very steep in aggregate in the post-crisis period (Figure 36). Further, for some credits, a DV01-neutral flattener can be positive carry (when accounting for roll-down and coupon). The flattener, in our view, should perform well in scenarios in which the curve remains unchanged (collect carry) or the curve flattens. The main risk to the position is if curves continue to steepen, but given their historically steep level, we view this as unlikely.

3. **Short-dated CDS:** As investors look for ways to shorten duration, selling short-dated CDS can be attractive when there is a positive basis, when bonds are negatively convex, or when there are no short-dated bonds. Liquidity is always an important consideration, but we expect it to be less of an issue for lower-rated credits where natural demand exists.

FIGURE 36

Average CDS curves for HYCDX constituents



Source: Barclays Research

US LEVERAGED LOANS AND CLOS

Sustainability at last

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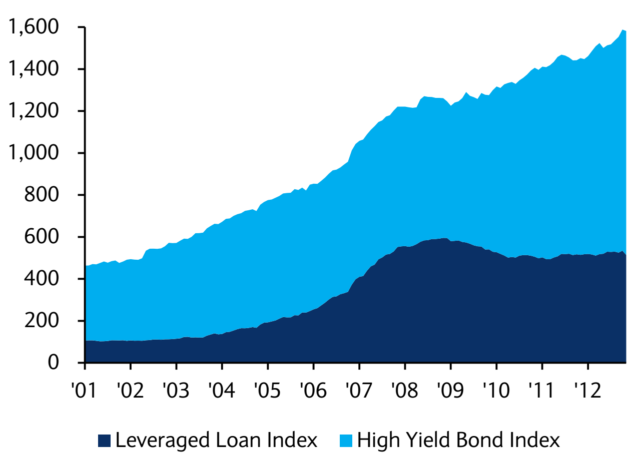
- **Barring a major move before year-end 2012, we expect US leveraged loans to provide total and excess returns of 3.5-5.5% in 2013. Despite index levels in the $97 range, we believe post-crisis price appreciation is largely complete, as 75% of the loan index now trades above $99. As such, any remaining pull-to-par is likely to be offset by repricing risk.**
- **Loan defaults should remain below the long-run average, at approximately 2.5-3.5% by issuer count, with the par default rate ranging anywhere from 2% to 5% depending on the timing of TXU's eventual resolution.**
- **Excluding repricings, we expect 2013 institutional loan issuance to be $225-250bn, the highest level since the 2008 financial crisis. Growth returned to the loan market in 2012 after a period of post-crisis shrinkage, and we expect this trend to continue as the retail and CLO demand channels provide support for increased issuance.**
- **We expect $60-75bn in new CLO creation in 2013, more than enough to offset the roughly $40bn in anticipated amortization of legacy deals. The window to place deals ahead of risk retention regulations creates an opportunity for issuers, while the superior spread of CLO liabilities relative to other structured products should help shore up demand despite heavy new issue volume.**
- **Individual credit selection will be critical for non-extended loans maturing in 2013-15, with a significant dispersion in prices and yields across pre-crisis LBO issuers. For extended tranches and post-crisis new issuance, the loan market is once again close to par and should produce a carry-driven return next year. On balance, we prefer to pick up yield through higher Libor floors, longer maturities, and looser covenants rather than by sacrificing issuer quality or adding leverage. Loans continue to offer solid value relative to high yield bonds, although repricing risk limits their upside.**

2012 was a watershed year in the US leveraged loan market. While notional growth continued in the high yield bond market following the 2008 financial crisis (Figure 1), the loan market contracted from early 2009 to mid-2011 (Figure 2), as the lack of loan demand

FIGURE 1

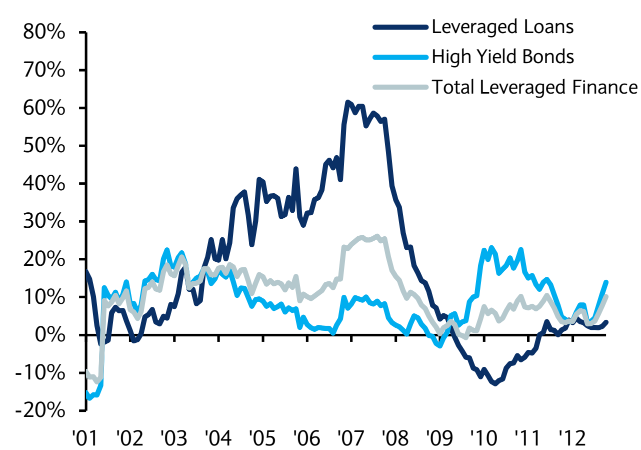
US leveraged finance par outstanding ($bn)



Source: Barclays Research

FIGURE 2

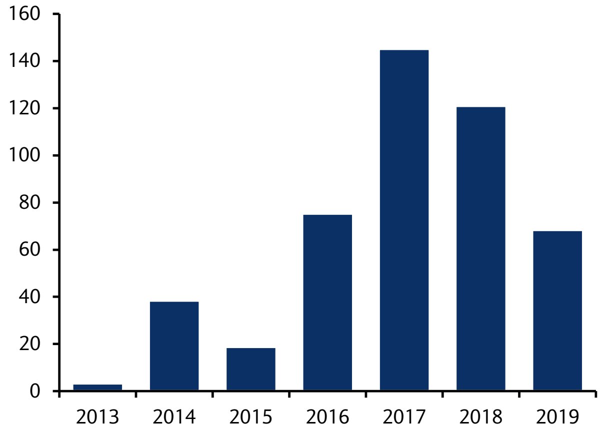
US leveraged finance y/y growth rate



Source: S&P LCD, Barclays Research

FIGURE 3

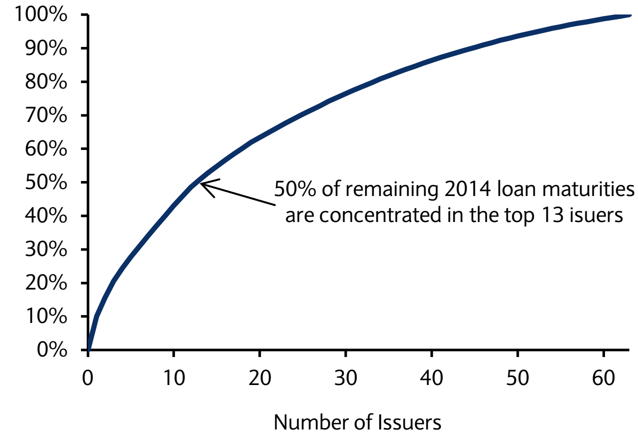
Leveraged loan maturities by year ($bn)



Source: S&P LCD, Barclays Research

FIGURE 4

Issuer concentration of 2014 maturities



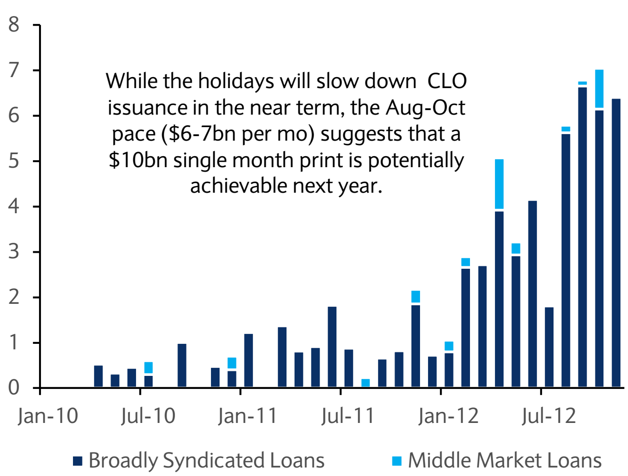
Source: S&P LCD, Barclays Research

forced many issuers to offer secured bonds instead. In the immediate aftermath of the recession, many market participants were apprehensive about the $200+bn 2014 maturity wall, fearing that a liquidity crisis would cause widespread defaults. As the maturity wall was slowly chipped away, investor concerns shifted to the diminishing structured bid, with fears that accelerating CLO amortization would put negative technical pressure on the cash loan market for several years. These concerns combined to make us fairly cautious on leveraged loans at this time last year, despite their attractive underlying fundamental value.

As the calendar turns from 2012 to 2013, it appears that both of these issues are well on their way to being resolved. The 2014 maturity wall is now less than $40bn (Figure 3) and is concentrated in a fairly small number of issuers (Figure 4), chiefly pre-crisis LBOs with idiosyncratic issues that have delayed refinancing. Similarly, the much-feared forced exit of CLOs has not materialized, as new CLO creation has accelerated throughout 2012 (Figure 5). Retail investors have also returned to the market, as evidenced by loan mutual fund flows, which have been strongly positive for most of 2012 after being sharply negative during 2H11 (Figure 6). The return of both retail and structured buyers has improved the technical picture considerably, putting leveraged loans back in the spotlight for 2013.

FIGURE 5

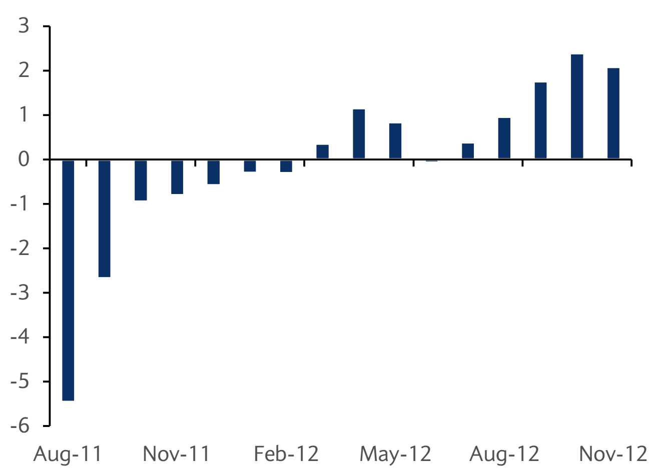
Post-crisis CLO creation by month ($bn)



Source: Creditflux, S&P LCD, Bloomberg, Barclays Research

FIGURE 6

Leveraged loan fund flows by month ($bn)



Source: Lipper US Fund Flows

A plateau in fundamentals

Leveraged loan issuer fundamentals appear to be reasonably stable in aggregate, although the pace of performance improvement has slowed considerably relative to the first few years of the recovery. According to S&P LCD, the rate of y/y revenue growth for issuers in the LSTA Leveraged Loan Index (LLI) has fallen from a post-crisis peak of +21% in 1Q11 to less than 10% in each of the past two quarters (Figure 7). EBITDA growth rates have followed a similar trajectory: after reaching a post-crisis peak of +24% in 3Q10, EBITDA growth has settled into a high-single to low-double digit range for much of the past year, falling to a post-crisis low of +9.3% in 3Q12. Given our expectation of continued below-trend economic growth in 2013, we do not expect a material reacceleration in EBITDA or revenue trends next year.

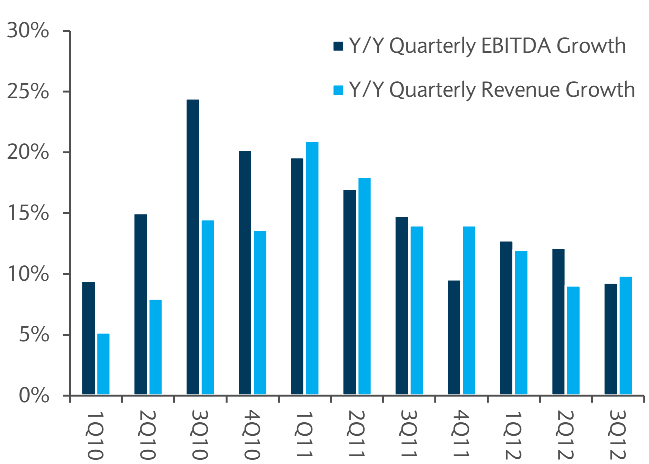
With issuance still robust and EBITDA growth slowing, leverage began to tick up modestly in 2012. S&P LCD reports that average total leverage for the LLI was 5.2x in 3Q12, up 0.3x from the post-crisis low of 4.9x in 4Q11. Fortunately, this slight increase has not yet affected aggregate credit ratings, suggesting that ratings agencies do not yet view it as worrisome. While high yield bond ratings have suffered in 2012 because of downgrades and heavy CCC issuance, leveraged loan ratings have remained largely flat in the BB-/B+ range (Figure 8). We believe the comparative stability of loan issuer credit ratings should persist in 2013, although some modest downside could come from further covenant-light issuance and a potential continuation of the recent pickup in leveraging transactions (LBOs and dividend deals).

Default risk

We forecast an issuer-weighted 2013 loan default rate of 2.5-3.5%. As noted in our *2013 Default Outlook*, various default models are sending somewhat divergent signals regarding 2013 default risk. Our top-down macro model, which combines a market signal with trends in C&I lending standards, indicates that defaults should ease somewhat from the current LTM rate of 3.4% for US speculative grade issuers (as of October month-end, published by Moody's). In contrast, our ratings migration model signals a slight uptick from this level in 2013, as the ratio of downgrades to upgrades has risen throughout 2012. Despite their directional differences, however, both models indicate that defaults should remain below the long-run average rate of 4.5% next year, consistent with market history, which suggests that defaults typically rise above this average only during recessions. Our bottom-up analysis of issuer fundamentals confirms this view and leads us to conclude that the leveraged loan issuer default rate will remain below the rate for high yield bonds, as has typically been the case historically (Figure 9).

FIGURE 7

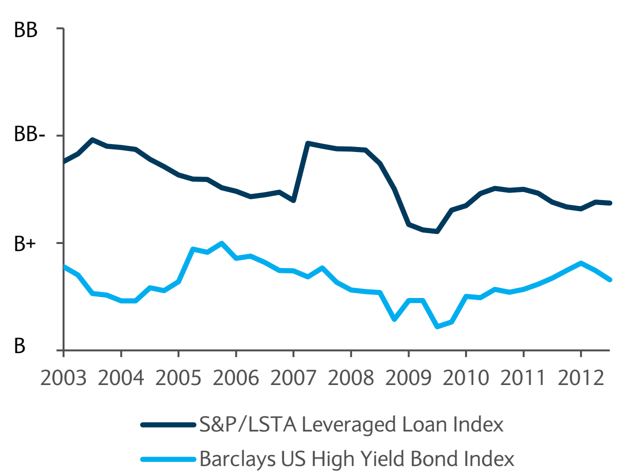
S&P/LSTA Loan Index revenue and EBITDA growth rates



Source: S&P LCD

FIGURE 8

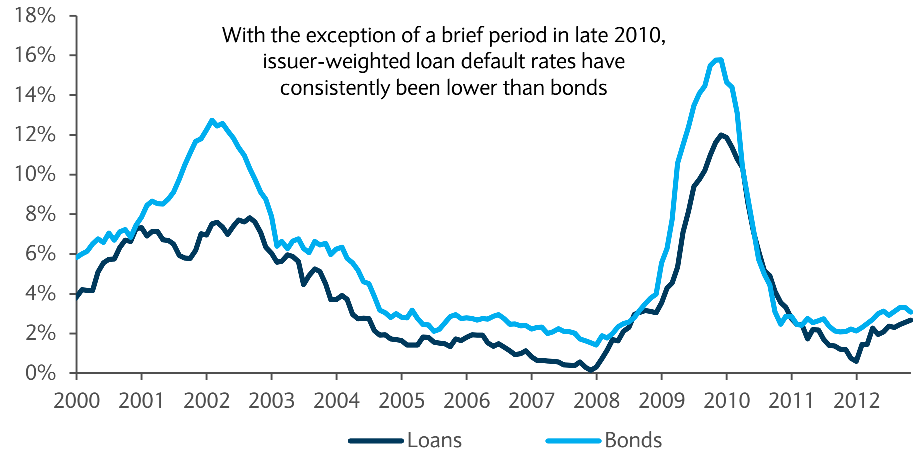
Weighted average credit rating for US leveraged loan and high yield bond indices



Source: S&P LCD

FIGURE 9

Issuer-weighted high yield bond and loan default rates



Source: Moody's Investor Services

From a par-weighted standpoint, most of the near-term default risk in the loan market is concentrated in the comparatively small number of issuers that have material 2014 maturities remaining. The timing of the ultimate resolution at TXU Corp., in particular, will have a large effect on 2013 and 2014 par-weighted loan default rates, although other issuers may also play a role. As Figure 10 shows, a significant fraction of remaining 2014 loans are trading at distressed prices, indicating that the market expects a relatively high default rate from this group. While we do not expect any maturity-driven distress to spread to the broader market, a spate of restructurings in close proximity could push the par-weighted loan default rate past the bond default rate for a short period.

FIGURE 10

Issuers with 2014 loan maturities trading below $90

Issuer	2014 loan balance	Average price
TXU Corp	3.8	67.28
Cengage Learning	2.1	77.40
GateHouse Media Operation Inc	1.2	36.22
R.H. Donnelley Corp	0.8	62.46
Penton Media Inc	0.6	87.50
Kik Custom Products Inc	0.6	85.96
Dex Media East LLC	0.5	64.07
Dex Media West LLC	0.5	66.81
Advanstar Communications Inc	0.5	81.07
Other Distressed Issuers	1.9	77.50
Total Below $90	**12.5**	**69.51**
Total Above $90	**25.3**	**97.66**

Source: Barclays Research

Relative value and return expectations

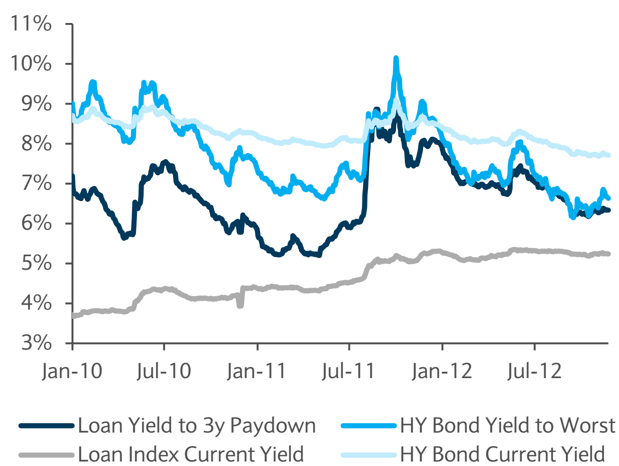
Our expectation for 2013 total and excess loan returns is 3.5-5.5%, slightly behind our forecast for high yield bonds, as loans' lower coupon is offset by their lower average starting price and slightly lower default expectations. Despite reported index levels in the $97 range, we believe post-crisis price appreciation is largely complete, as 75% of the loan index now trades above $99. As such, any remaining pull-to-par is likely to be offset by repricing risk, which would limit upside and leave a coupon-like return as the most likely outcome. With the exception of the heavily discounted loans that remain in the 2014/15 maturity bucket, leveraged loans are now essentially a carry-only market.

As we have highlighted periodically during the second half of 2012 (for example, see *Loans Ready for Pickup*, August 17, 2012), the fierce summer rally in high yield bonds pushed their yields down to a point at which they were comparable with leveraged loans (Figure 11), even though loans offered lower historical default rates and higher prospective recoveries. Initially, the relative drawback to loans was uncertainty in the technical picture, particularly the aforementioned concerns about legacy CLOs exiting reinvestment periods, but the demand outlook has brightened considerably. Figure 11 also shows that the current yields offered by the two markets continues to converge, as Libor floors and nominal spread increases on amend-and-extend transactions have gradually increased average loan coupons, while high yield bond coupons have fallen an average of 35bp in 2012 as issuers have aggressively refinanced callable high cost debt. Given the comparable yield, increasingly competitive income, and recent improvement in loan market technicals, we believe the leveraged loan market now offers strong risk-adjusted relative value.

Historically, the overlap between the leveraged loan and high yield bond investor bases has been limited, which may have inhibited investors' collective ability to capitalize on this year's diminished yield gap. For example, mutual funds and ETFs are a much bigger part of the bond market and typically have low cross-asset allocation limits (although many bond managers have recently been adding loan exposure, to the extent they are able). To the extent that insurance company portfolios include non-structured high yield assets, their allocation also skews heavily toward bonds rather than loans and has been slow to change over the past decade despite the loan market's growth. Hedge funds typically have the easiest time alternating between bonds and loans, but hold less than 20% of the total par outstanding in each market. The lack of easy substitution has no doubt contributed to the stickiness of the tight yield relationship, but recent fund flow trends suggest that marginal buyers have begun to favor the loan market.

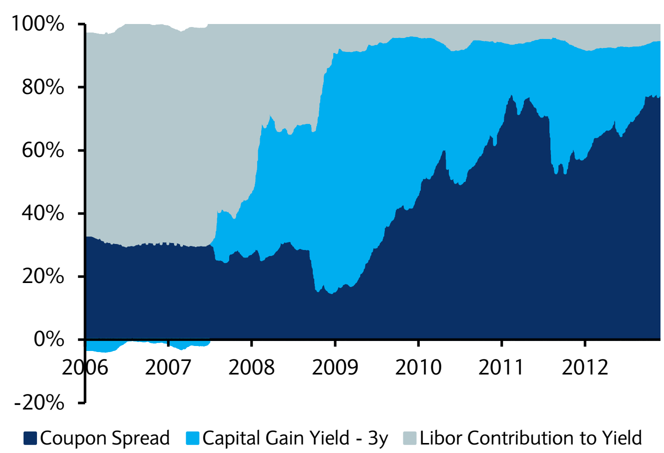
In a reversal of the relationship that existed before the 2008 financial crisis, loans also offer asymmetrically favorable exposure to future moves in interest rates. As we first described in *Yield Promise*, high yield bondholders benefited from falling Treasury yields during and after

FIGURE 11
Loan and bond index yields



Note: Loan index yield is calculated using a 3y pay-down assumption and is unswapped. Source: Barclays Research

FIGURE 12
Loan index yield decomposition



Source: Barclays Research

the recession that partially offset the abrupt spread widening. However, with yields now at historic lows, any such benefit in the future appears to be severely limited. In contrast, loan investors lost most of their income during the recession as Libor went from providing two-thirds of total coupon income to less than one-tenth (Figure 12). Today, nearly 80% of leveraged loan yield comes in the form of simple income from coupon spread. With Libor floors now present in well over half of the loan market (and virtually 100% of new issue), loan investors are largely insulated from downside rate movements while still standing to benefit if short rates eventually begin to rise.

Loan supply and demand

Demand holds the key

As described above, the 2H12 improvement in the technical backdrop for loans is an important development that has positioned the market for stability and even growth. Figure 13 provides our most recent estimate of the share of the leveraged loan market held by each investor type. The estimates are largely unchanged relative to a year ago, with the exception of legacy total return swaps (TRS), which are largely in runoff mode, causing their share to decline slightly y/y.

FIGURE 13

Estimated share of US leveraged loan market by buyer type

Category	Share of US leveraged loan market
CLOs	45-50%
Distressed/hedge funds	15-20%
Mutual funds (including ETFs)	12-15%
Legacy total return swaps	4-6%
Insurance portfolios (P&C, life)	3-5%
Other (banks, dealers, private lenders)	10-15%

Source: Bloomberg, Lipper US Fund Flows, EPFR, HFR, Barclays Research

More important than the precise shares held by each group is their potential capacity to contribute to overall demand growth in 2013. Unfortunately, several of the loan market's key investor types do not appear to be in a position to increase aggregate holdings. For example, hedge fund interest in loans is unlikely to grow materially until the aftermath of the next default cycle, at which point they will displace other holders that are reducing exposure to distressed assets. Meanwhile, insurance portfolio managers have limited capacity to add non-investment grade securities, banks and broker/dealers are increasingly sensitive to risk-weighted asset metrics, and a significant comeback in TRS does not appear imminent. Mutual funds are a source of potential growth, but with the Fed committed to keeping short rates low through at least 2014, we do not expect a near-term repeat of the major influx of new funds that occurred in 1H11 as investors positioned for the possibility of rate hikes.

This leaves CLOs as the key demand driver for the loan market, and on this front, recent trends are especially encouraging. Nearly $50bn in new CLOs has been printed through the end of November, more than double the most optimistic projections from a year ago. This was a crucial development for the cash loan market, because by the end of 2012, approximately $100bn in pre-crisis CLOs will have exited their reinvestment periods (Figure 14). By our calculations, slightly less than $30bn in new CLO creation was required this year in order to offset the effects of legacy CLO amortization (see *Net Neutral, For Now* for details about the calculation method and its assumptions). With actual CLO creation exceeding the required amount by close to $20bn so far, CLOs have been a key source of loan market growth in 2012, rather than a net negative as was widely feared a year ago.

As additional pre-crisis CLO reinvestment exits occur in the years ahead, the required amount of annual CLO creation will increase further, to a peak of approximately $45bn in 2014, before tapering off somewhat to an equilibrium of $30-40bn based on current market size (Figure 15). In the near term, the recent pace of CLO issuance suggests to us that a 2013 total of $60-75bn is achievable, potentially providing the cash loan market with another $25-40bn in net positive demand from the CLO investor base. Longer term, the picture is less clear, particularly given the uncertainty surrounding the potential effects of Dodd-Frank's risk retention regulations.

If you demand it, supply will come

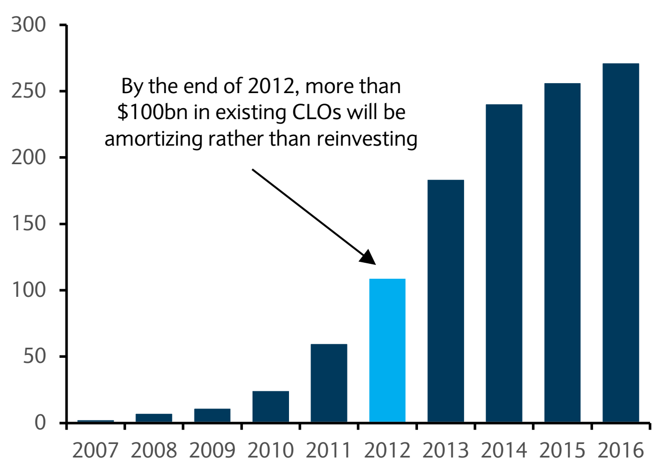
As this year has demonstrated, new supply will come to leveraged finance markets whenever spreads are reasonable, terms are issuer friendly, and volatility is low. All of these conditions have been true for the vast majority of 2012, and new loan supply has followed. Excluding straight repricing transactions, year-to-date institutional loan issuance exceeded $215bn at the end of November, easily the highest annual total since the 2008 financial crisis, with a busy December calendar still ahead.

Provided that the Federal Reserve's ongoing easing measures are able to restrain secondary market volatility in 2013, we expect another strong year for loan issuance, with total loan market proceeds of $225-250bn. Importantly, this would put total institutional loan supply much closer to our expectations for supply from the high yield bond market, as we believe the post-crisis trend of loans being refinanced by secured bond issuance has largely run its course. In fact, we have recently seen several examples of the opposite, as issuers choose to issue loans to retire higher coupon bonds and lower interest expense. Of next year's issuance total, releveraging transactions (LBOs and dividend deals) could reach $100bn, with an additional $50bn coming from strategic M&A activity and most of the rest being opportunistic refinancing transactions.

As we suggested at this time last year, loan issuers have sometimes made adjustments to their offerings to accommodate certain investor types. For example, as noted in *Calling for Better Protection*, very few loans are now offered without at least a $101 soft call, and the use of multi-year call structures and outright non-callable periods have increased relative to 2011. In addition, some issuers have shortened the maturity on new loan tranches to

FIGURE 14

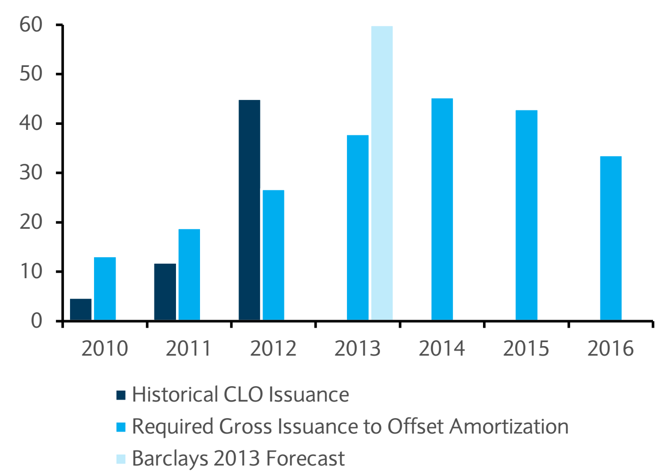
Notional amount of CLOs outside of reinvestment period ($bn)



Source: Intex, Barclays Research

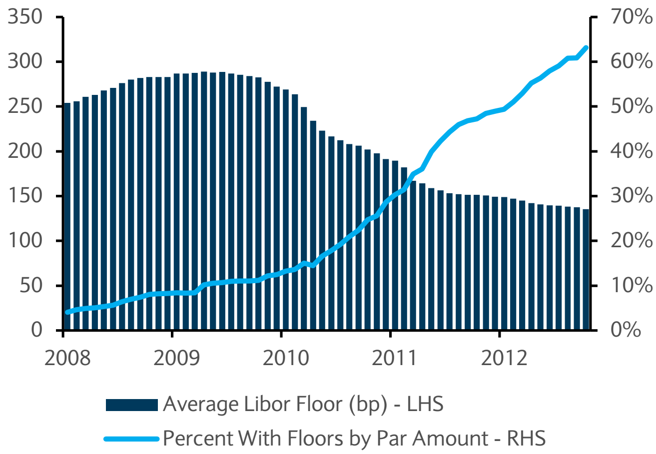
FIGURE 15

Historical, required, and forecast annual CLO issuance ($bn)



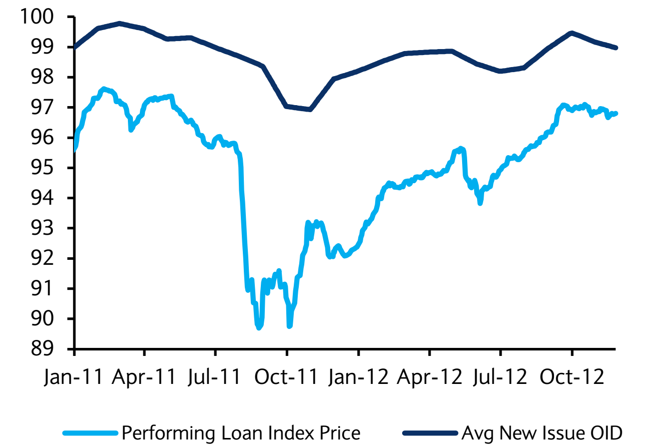
Source: Creditflux, S&P LCD, Bloomberg, Barclays Research

FIGURE 16
Libor floors in leveraged loans



Source: S&P LCD

FIGURE 17
Loan market OIDs and index prices

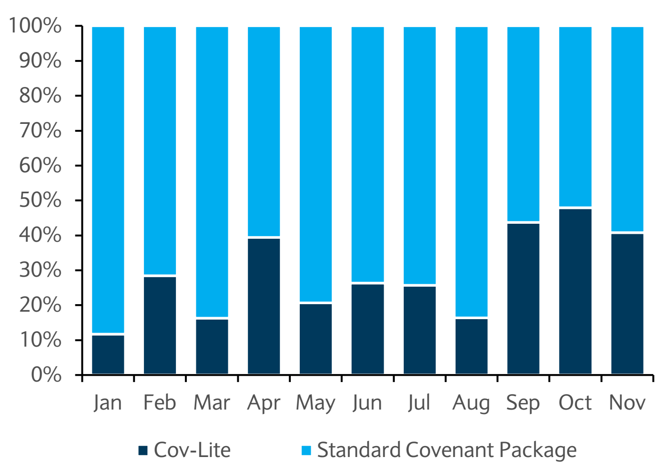


Source: Barclays Research

facilitate greater participation from CLO managers that need to remain in compliance with weighted-average life (WAL) tests. Libor floors continue to be included in virtually every new institutional loan tranche and are now present in nearly two-thirds of all leveraged loan par outstanding, while the average floor appears to be levelling off in the mid-130bp range (Figure 16). Meanwhile, original issue discounts (OIDs) have generally remained healthy throughout 2012 (other than at the September market peak), allowing new issue loan investors to capture some near-term upside (Figure 17). We expect all of these trends to continue next year, although we expect OIDs to be somewhat tighter, on average.

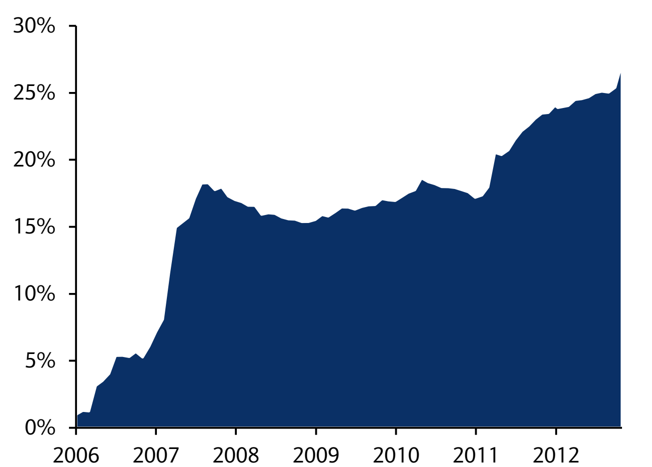
However, the primary market has been far from a one-way street, as issuers have also been rewarded in numerous ways as well. For example, investors have shown a renewed interest in second-lien offerings, which were scarce in the immediate aftermath of the financial crisis. As we noted in *Market Strength Pays (for) Dividends*, use of proceeds has also gotten more aggressive in 2H12, with leveraging transactions (LBOs and dividend deals) accounting for approximately $80bn of year-to-date supply. Finally, yield-seeking investors

FIGURE 18
Share of issuance by covenant type



Source: S&P LCD, Barclays Research

FIGURE 19
Cov-lite share of total loan par



Source: S&P LCD

have been increasingly willing to relax maintenance covenants in exchange for a pickup in spread. This trend gained steam in the latter half of 2012, with covenant-light (cov-lite) issuance exceeding 40% of the total every month starting in September (Figure 18), pushing the cov-lite market share to 27% of total institutional loan par outstanding (Figure 19). Most post-crisis CLOs have a 30-40% limit on cov-lite loans as a share of their total collateral pool, although Apollo recently printed a deal with a 70% limit and several other November deals had 45-50% limits. We believe additional CLO issuers will follow Apollo's lead in 2013, allowing the CLO market to facilitate the rising trend in cov-lite loan issuance.

Trends in CLOs

CLO 2.0

One byproduct of the extremely active CLO new issue calendar is that market conventions for post-crisis CLOs (commonly called CLO 2.0) have become clearly established. While there are still occasional exceptions, the overwhelming majority of 2012 vintage deals adhere to most or all of the norms in Figure 20. Other than cov-lite limits, all of the 2.0 conventions are tighter than they were for pre-crisis deals, with much greater standardization as well. With the exception of the potential for more deals with higher cov-lite limits, we expect these standards to persist into 2013 as well.

FIGURE 20

CLO market conventions: 2.0 vs. pre-crisis

Feature / Limit	2.0	Pre-Crisis
AAA % of Total Cap	62-65%	75%
Total Leverage	8-9x	12-13x
Minimum 1st Lien Loan Allocation	90%	80-90%
Maximum Cov-Lite Loan Allocation	40% (+)	n/a
Non-call Period Length	2 Years	4 Years
Reinvestment Period Length	4 Years	5y / 7y*
Final Maturity	10-12 Years	12-15 Years
Maximum WAL	7 Years	8-10 Years
Maximum CCC Rated Collateral	7.50%	7.5-10.0%

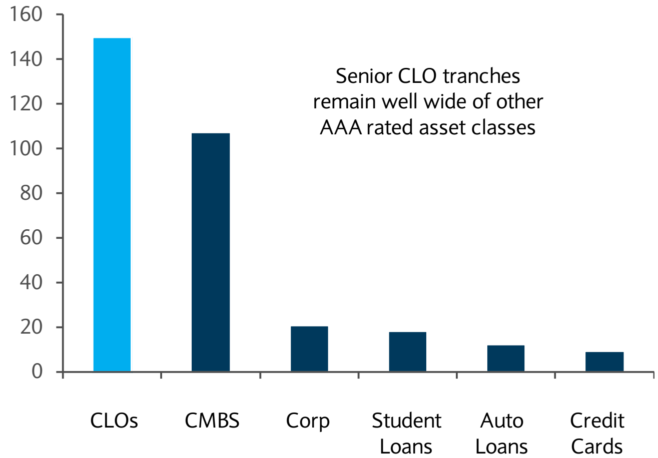
Note: 5-year reinvestment was common for 2003-05 deals, 7-year reinvestment became common in 2006-07.
Source: Creditflux, S&P LCD, Bloomberg, Barclays Research

The attractiveness of cash flow CLO arbitrage has ebbed and flowed throughout 2012, primarily because of the significant fluctuations in AAA coupons. After reaching a year-to-date low of L+130bp for several deals issued in late April, AAAs quickly backed up during the selloff in risk assets in May and never fully recovered, even as market conditions firmed again in late summer. Given the virtually non-existent yield in other AAA rated structured products (Figure 21), we expect new issue CLO liability spreads to improve in 2013, perhaps more so than collateral spreads. Over the course of the year, we expect new issue AAA spreads once again to approach the L+120 mark, as they did briefly in June 2011.

Secondary CLO spreads have predictably followed the general trend in risk assets throughout the year and as of late November were at post-crisis tights across all quality levels, although still well wide of pre-crisis levels (Figure 22). Relative to year-end 2011, AAAs were tighter by 70bp, AAs by 150bp, single-As by 200bp, BBBs by 275bp, and BBs by as much as 500bp, making 2012 a very good year for all classes of CLO investors. While this degree of tightening across the capital structure will almost certainly not be repeated in 2013, we believe the superior spread of CLO liabilities relative to other comparably rated assets should continue to attract new investor interest next year, so some modest further tightening in the secondary market should be in order as well.

FIGURE 21

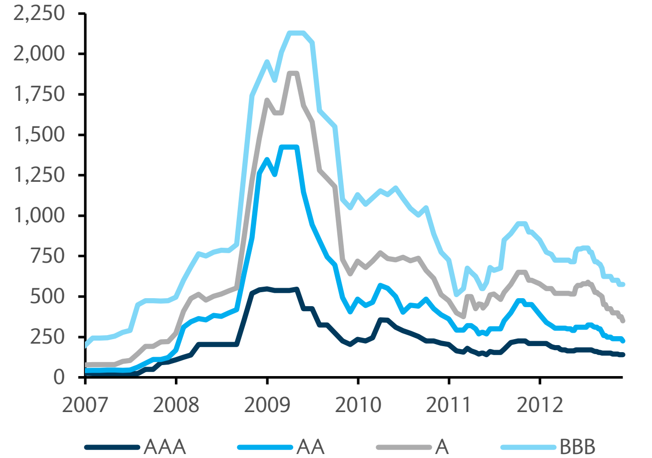
AAA structured product and corporate bond spreads (bp)



Source: Barclays Research

FIGURE 22

Secondary CLO spreads by quality (bp)



Source: Barclays Research

Regulation update

The potential effect of Dodd-Frank's risk retention rules on the CLO market has been heavily debated. Advocates of the legislation argue that requiring CLO managers to retain a 5% interest in their collateral pool (either in the form of a pro rata vertical slice of the capital structure, a horizontal slice of the first loss tranche, or potentially an L-shaped combination of the two) would force them to have "skin in the game," effectively aligning incentives with their investors. Opponents of the legislation's applicability to the CLO market argue that risk retention's purpose is to eliminate the dangerous incentives associated with an originate-to-distribute model, which does not apply to CLOs since the collateral manager is a third-party purchaser of loans rather than a direct provider of credit. To date, a final set of rules has not been enacted, and it will be an additional two years from the date of finalization before the rules are binding for new issuance, so deals launched in 2013 and 2014 (at least) will be unaffected. While the ultimate resolution and potential long-term effects of this issue remain unclear, in the near term at least, CLO managers have an incentive to bring deals to market before any new rules become binding, which further supports our belief that 2013 will be a busy year for CLO creation.

2013 trading themes

Credit selection in non-extended tranches

As described previously, the bulk of the leveraged loan market now trades close to par. The exception is in what remains of the 2014 and 2015 maturity buckets. In Figure 23, we show the maturity profile of the leveraged loan market, along with the average trading price for the loans maturing in each year. For maturities in 2016 and beyond, US leveraged loans have essentially returned to being a par market. However, the roughly $20bn in remaining 2015 maturities trades at an average dollar price of $96, while the ~$40bn in 2014 maturities barely averages $90. We believe the majority of 2013 price action will occur in these two groups, which together represent approximately 11% of loan universe by market value.

Cov-lites instead of lower issuer quality

With the outlook for 2013 economic growth not particularly improved from the muddle-through "new normal" that has characterized the post-crisis recovery, we remain wary of the most highly leveraged issuers with unsustainable capital structures. We also prefer to avoid turnaround stories for issuers attempting to manage rapid deterioration in their competitive position, or industries that are in secular decline (see our *2013 Default Outlook* for further details). Rather than attempting to catch falling knives, we prefer to add incremental yield at the margin by overweighting cov-lite loans, which proved surprisingly resilient during the recession, with a lower average default rate and higher average recovery than full covenant loans over the same period (Figure 24; also see *Can the Cov-Lite Comeback Continue*?). The lower default rate is not surprising, as the absence of maintenance covenants allows issuers to avoid a potential event of default long enough to benefit from a cyclical recovery. The higher recovery rate for cov-lite loans is less intuitive and appears to be conditional on other aspects of the issuers' capital structure. Specifically, in its comparison of cov-lite and full covenant first lien loan recovery rates, Moody's found that cov-lites tended to have a larger cushion of unsecured debt beneath them. In many cases, this unsecured debt bore the brunt of the default, often in the form of a distressed exchange, thereby buoying cov-lite loan recoveries. Our recommendation in favor of cov-lite loan exposure depends on these conditions being met by future issuers as well.

Bond-to-loan swaps for comparable yield and better security

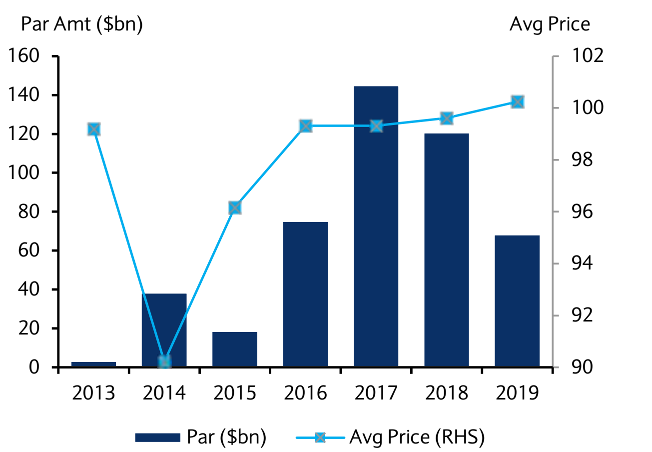
Last year at this time, we recommended swapping out of loans into secured bonds, finding the yield pickup to be especially worthwhile given the uncertain future for loan demand. Since then, as we have detailed previously, bonds have outperformed materially, to the point at which yields across the two assets classes are comparable, and many bonds find themselves call constrained with no further upside. Meanwhile, recent developments in the CLO market, as well as trends in loan mutual fund flows, have improved the loan market's technical picture considerably. Where possible, we now prefer swapping out of call-constrained bonds (secured or unsecured) and into extended loan tranches, to pick up (or at least maintain) yield while potentially moving up in the capital structure and gaining more favorable exposure to any eventual rise in interest rates.

Discounted CLO liabilities in amortizing legacy deals

Despite the rally in CLO liability spreads, discounted legacy tranches still exist, as pre-crisis coupons remain well below current market levels. Given the seemingly insatiable investor appetite for new CLOs, we expect managers and equity holders of amortizing legacy deals

FIGURE 23

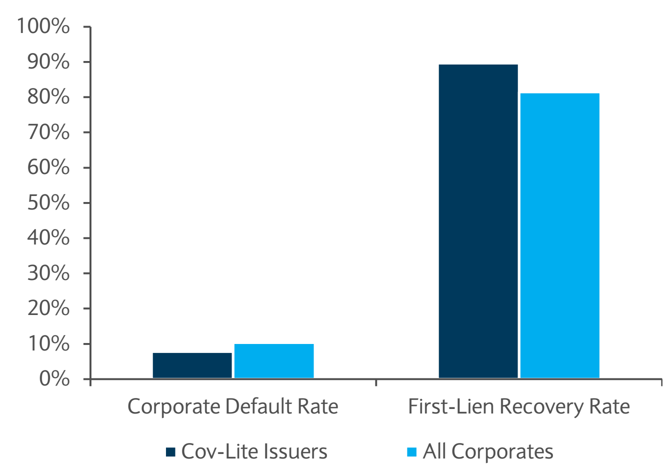
Par amount and average price by maturity year



Source: Barclays Research

FIGURE 24

Cumulative 2.5-year default and recovery rate comparison



Note: 2.5-year cumulative default rate based on a review of 104 issuers that originated covenant-lite loans between 2005 and 2007. Recovery comparison is based on 15 defaulted covenant-light issuers and 136 defaulted issuers with standard covenant packages. See Moody's "Covenant-Lite Defaults and Recoveries – Seeing Where it Hurts," June 7, 2011, for details. Source: Moody's Investor Services to use their call option aggressively as a way of rolling collateral pools forward and refreshing equity return profiles. Pre-crisis CLOs that have paid down more than half of their AAA tranches, or are more than 18 months past the end of their reinvestment period, are likely to be 2013 call candidates. Discounted mezzanine noteholders in such deals could realize considerable pull-to-par next year, helping to augment the lower carry relative to post-crisis tranches.

US MUNICIPAL CREDIT

The rally continues

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- **In our base case, tax exempt total returns will be roughly 240bp in 2013, reflecting a modest decline in AAA rated tax exempt yields and a flattening of the yield curve, with about 190bp of carry. This reflects our expectation for the ratio of 30y AAA rated tax-exempts to Treasuries to remain around 90% in 2013. We expect taxable municipal total returns to be approximately 900bp in 2013, on 550bp of excess returns, in part due to the relatively long duration of the Taxable Municipal Index. Our taxable return forecast is based on the Barclays Rates Strategy team's expectation of flat 5 and 10y Treasury rates (with a slight rally in 30y rates) and spread tightening in taxable municipals, owing to attractive relative value compared with corporates.**

- **The credit quality of state issuers is expected to continue to improve, as ongoing economic growth results in increased revenues. States enter FY13 with the least amount of aggregate budget deficits since the recession began in late 2007. State tax revenue collected has grown for ten consecutive quarters, with the most recent quarter showing 3.2% y/y growth.**

- **In our view, a major area of concern for municipal credit in 2013 remains at the local level. Property taxes declined in the first quarter of 2012, after having increased for the two prior quarters. Further stressing local credits, states have balanced their budgets through increased cuts in distributions to local governments. While we do not expect a large increase in municipal bankruptcies, the repeal of Public Act 4 in Michigan and the outcome of challenges to pension funding in Stockton and San Bernardino, California, may result in an increase in Chapter 9 filings.**

- **We expect issuance to increase 5% in 2013. Tax-exempt issuance should rise to $355bn, as the positive effect of low rates on current and advance refundings is balanced by a continuing reluctance to add debt to already leveraged balance sheets. Taxable issuance is forecast to be approximately $35bn, as low absolute rates continue to entice health care issuers, universities and others (such as issuers of pension obligation bonds) to enter the taxable municipal market.**

- **In terms of relative value, we continue to view taxable municipals as a favorable alternative to corporates, given the higher average quality, with the opportunity for spread pickup. We believe increased taxable issuance next year will remain supportive of the growth of the taxable municipal investor base. In tax-exempts, we believe that investor demand and expectations of higher tax rates will be a positive for muni bonds in the coming year, balanced by effects from potential changes to the muni exemption.**

- **The extreme scenario of a potential elimination of the muni tax exemption could result in all municipal bonds being immediately taxable or a grandfathering of current bonds (with the exemption eliminated for future issuance). While our forecasts assume the status quo, we believe investors should consider the possibility in the future of an outright elimination, particularly as many tax proposals thus far have been fairly silent on the issue of grandfathering.**

- **In 2013, we believe differentiation in investor performance will be driven by relative allocations to yieldier credits such as California, Illinois, Puerto Rico and tobacco. We believe that California paper offers attractive value versus IL and that Puerto Rico paper has potential for the most spread pickup versus both. Standard & Poor's has stated that failure to complete pension reform in the next few months will result in a downgrade of Puerto Rico's rating close to or into the non-investment grade**

category. The commonwealth's bonds already trade with a significant risk premium to lower investment grade levels. Successfully navigating the fiscal challenge would eliminate much of the uncertainty premium in the bonds and likely result in credit spread tightening.

Base case for 2013

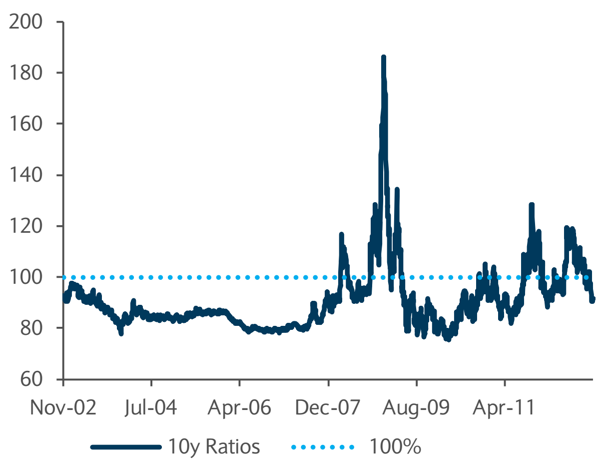
For tax-exempts in 2013, we expect roughly 240bp of total returns in the Barclays Municipal Index, versus about 800bp year-to-date in 2012 and 1070bp in 2011. This reflects about 190bp of yield carry and approximately 50bp in return from tightening (7bp decrease in average yields, with an adjusted duration of more than 6), bringing index yields to about 1.8% by FY13 end. Specifically, we expect very little change in the short part of the muni curve, coupled with a modest decrease in the 5s10s portion and up to 10bp of change in the long-end. Our expectation is for muni yield curves to continue to flatten, albeit at a slower pace versus 2012, reflecting quantitative easing in a low interest rate environment and a more modest pace of muni fund inflows.

For the Taxable Muni index in 2013, we forecast 900bp of total returns and about 550bp of excess returns. Our returns forecast would represent a slowdown from 2012; year-to-date in 2012, taxable munis have delivered 1300bp in total returns, on 790bp of excess returns. Our total returns forecast takes into account stimulus from quantitative easing and our rates team's expectation for unchanged 5 and 10y Treasury rates, coupled with a moderate (15-20bp) rally on the long end. Given that the taxable muni index has a fairly long duration (about 12), total returns will be boosted meaningfully by the treasury rally on the back end. Our excess returns forecast for 2013 reflects 190bp of spread carry and 30bp of spread tightening for the Taxable Municipal Index. Our forecast for spread tightening is consistent with expectations for US IG to tighten about 25bp, with taxable munis expected to tighten another 5bp. Furthermore, our forecast will be supported by some tightening in California bonds (roughly 12% of the index) and expansion of the taxable municipal investor base. We expect the Taxable Municipal Index to end 2013 with OAS of about 160bp.

Our base case entails fiscal cliff issues being deferred in December 2012 or dealt with in a manner that maintains current market dynamics. Following this, 2013 will involve comprehensive tax, spending and entitlement reform negotiations, with the expectation that actual reforms take effect in late 2013 or in 2014. While there are many permutations of potential outcomes, our forecast is based on the status quo, as any changes will likely not become clear until the end of next year.

FIGURE 1

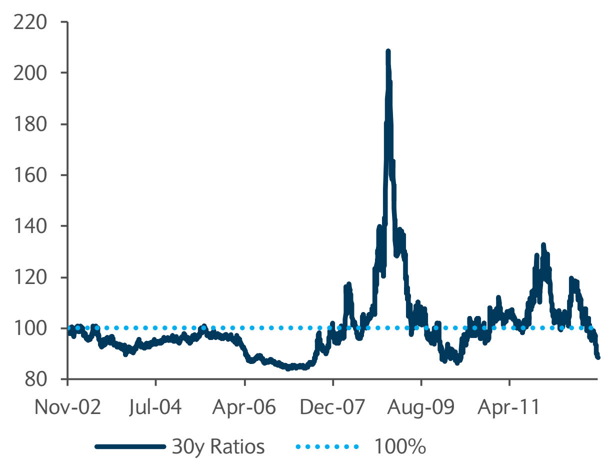
Ratio of 10y AAA Tax-Exempts to Treasuries, %



Source: Barclays Research

FIGURE 2

Ratio of 30y AAA Tax-Exempts to Treasuries, %



Source: Barclays Research

Our base case also factors in appetite for tax-exempts. Investors have signaled increased demand for tax exempt bonds, reflecting expectations for rising income taxes. This can be seen in recent muni ratio trends. Thirty-year ratios have moved below 100% (currently at 88%), after having spent most of 2012 well above 100% and averaging 100% for the past 10 years; similarly, 10y ratios have moved through 100% to their 10-year average of about 91% (Figures 1 and 2). Given the uncertainties of the aforementioned negotiations, investor behavior does not fundamentally change during the year, in our base case scenario. We would expect ratios to remain below 100%, assuming no changes to market expectations on tax status.

Factors that may cause deviations from the base case

Alternative scenarios include the failure of the fiscal cliff negotiations and a case in which meaningful reforms are implemented relatively soon in 2013. We believe failure of the fiscal cliff negotiations would likely result in stronger demand for tax-exempt municipals, owing to higher tax rates, counteracting effects from resulting governmental credit quality deterioration due to the predicted drag from a possible recession.

Another possibility involves serious discussions related to the elimination of the interest exemption on tax-exempt municipal bonds. If issuers believe in the high likelihood of an elimination of this exemption (with a grandfathering of existing bonds), there could be a dramatic increase in tax-exempt supply as issuers rush to take advantage of the expiring exemption. A level of supply that overwhelms demand would likely result in ratios moving higher as the market takes time to digest the robust issuance. However, we believe that the possibility that the muni tax exemption is not grandfathered is fairly high, for reasons discussed below.

Major themes that will drive the municipal market in 2013

In our view, five major themes will drive the municipal market in 2013: fiscal cliff and sequestration, tax reform, pensions, local credit issues (including potential Chapter 9 filings), and fund flows.

Fiscal cliff and sequestration

The fiscal cliff refers to several negative growth fiscal policies scheduled to occur on or about January 1, 2013. These fiscal policies are a mixture of tax increases, expiring tax cuts and government expenditure reductions mandated by sequestration, as described in Figure 3:

FIGURE 3

The size of the potential fiscal cliff in 2013

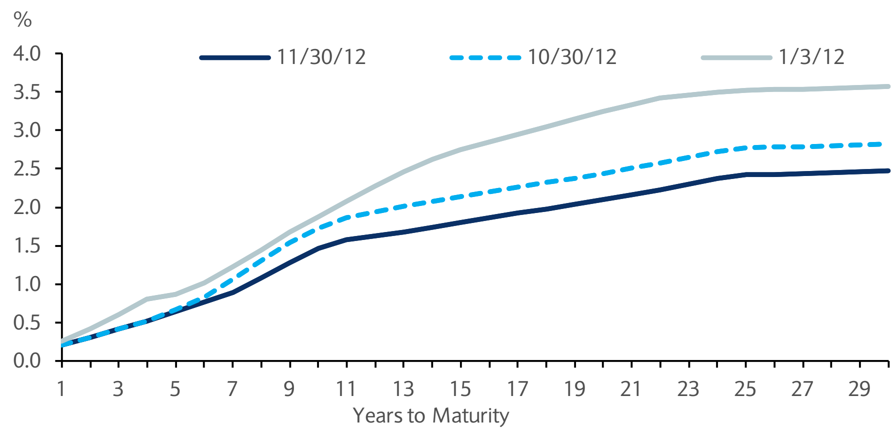
$bn	Current law
Payroll Tax Cut	-120
2001/2003 Tax Cuts (Lower/Middle Income)	-120
2001/2003 Tax Cuts ($250k+ Income/Estates)	-60
AMT	-100
Other expiring provisions	-75
Affordable Care Act	-25
Sequester Budget Cuts	-90
Emergency Unemp. Comp.	-30
Medicare payment rates	-10
ARRA spending	-20
Total	**-650**
% GDP	-4.1

Source: CBO, OMB, House Budget Committee, Treasury Department, Barclays Research

Year-to-date, the municipal market has rallied and the yield curve has flattened (Figure 4). The most recent movement has been due to investor expectations regarding tax rates. Market sentiment seems to be that taxes will be increasing and, therefore, the tax shield provided by the exemption of municipal bond interest is more valuable. If Congress and the president do not reach an agreement in December to forestall the $650bn in fiscal drag scheduled to occur on January 1, 2013, all taxpayers will be hit with higher rates. Any negotiated solution other than deferring the issue to next year is expected to result in some type of increased taxes.

FIGURE 4

Yield curve of AAA rated tax-exempts, %



Source: Barclays Research

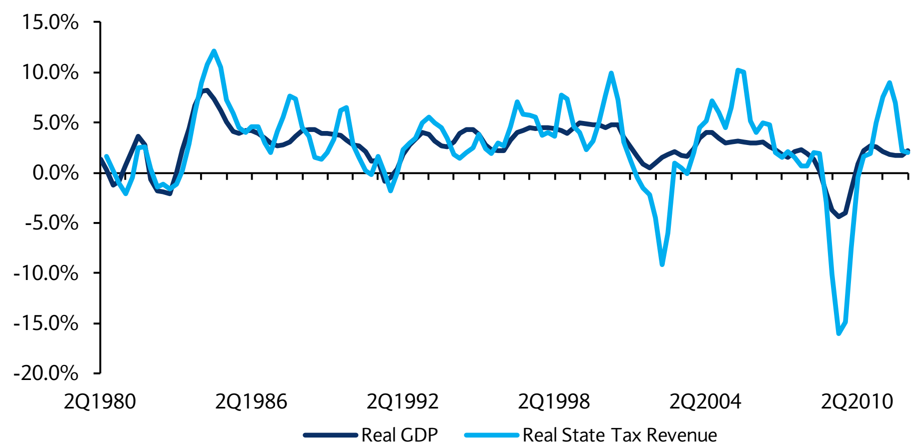
The fiscal cliff has both negative and positive implication for municipals. A first-order negative effect is the deterioration of municipal revenues from the expected economic slowdown. Governmental revenues are more volatile than the overall economy; thus, the effects of economic change on revenues are often greater than the magnitude of the economic change itself. Additionally, sequestration could further impair state and local credit quality, as the pain of the lost revenues is pushed to lower levels of government. Finally, some government expenditures are countercyclical, as the social safety net of government kicks in during periods of negative economic growth, increasing expenditures in times of declining revenues. On the positive side, the looming tax increases that accompany the fiscal cliff should make municipals more attractive. In our view, the two most important concerns for municipal credit under the fiscal cliff are the effects of spending cuts on state and local governments and the negative effects of a potential recession on municipal revenues.

On the first point, the sequestration cuts would affect many state government programs. According to the Federal Funds Information for States, roughly 18% of federal grant money flowing to the states will be subject to the sequester cuts. The types of programs affected include education, nutrition for low-income families and public housing. Defense cuts would hit employment in states such as Hawaii, where federal defense spending is roughly 15% of state GDP. Ultimately, these expenditure reductions will flow through state governments to the local level. State and local government budgets have been stretched thin and are struggling to adjust to the recent decline in revenues. Additional revenue cuts would add to these challenges at the local level, especially with state governments passing many of the cuts through to local governments.

More important than the sequester expenditure cuts would be the economic effects of hitting the fiscal cliff. Economists overwhelmingly agree that the net effect of hitting the fiscal cliff would be a U.S. economic slowdown. The Congressional Budget Office is projecting an overall economic decline of 0.5% in 2013 and an unemployment rate of 9%, if the full effect of the fiscal cliff is realized. As experienced in the most recent recession, municipal revenues are extremely sensitive to economic change, typically changing by a factor greater than the changes in the economy (Figure 5).

FIGURE 5

State tax revenues and the economy, change in real GDP and real revenues (2-quarter averages, %)



Source: Rockefeller Institute of Government, Barclays Research

In general, municipal governments have not fully emerged from the past recession and are vulnerable to economic shocks. An extrapolation of the economic sensitivity displayed in Figure 5 suggests that a new recession would affect government revenues meaningfully and result in credit stress. The section "Municipal Credit in 2013: States Improving; Local Credits Still under Stress" discusses this situation in more detail.

Tax reform

When comprehensive tax reform was last undertaken, in 1986, the municipal interest exemption was, for a time, negotiated away, before it was retained, though with significant limitations on the ability to issue tax-exempt bonds. This exemption is now subject to tax reform negotiations again. Political leaders agree that a comprehensive overhaul of the overly complicated tax code is needed. Thus, the question becomes whether the parties can find enough common ground to agree on significant reform. Importantly, the reduction or elimination of the exemption of municipal bond interest from taxation is an item that will be discussed by both parties as part of the solution. While it is difficult to predict where negotiations may lead, market participants should not be expecting a status quo outcome.

As mentioned previously, the municipal market has outperformed Treasuries since the November 6 elections, reflecting increased demand for municipals due to the expectation of higher taxes. However, there is a chance that the tax-advantaged status of munis is eliminated under comprehensive tax reform. Market action implies that investors assume taxes will increase, along with one of two things: 1) existing bonds will be grandfathered under the elimination scenario, or 2) bondholders have discounted the elimination scenario altogether.

A scenario involving the elimination of the tax advantage of municipal bonds has two paths: the outright elimination of the advantage, or a grandfathering of existing bonds with an all-taxable market for new issuance going forward (with or without a reconstituted Build America Bonds program). While many tax proposals over the past several years include the elimination scenario (Ryan Budget, The Deficit Commission, Bowles-Simpson, The "Gang of Six" Plan), none mention grandfathering existing municipal bonds. In fact, the stated goal of eliminating the tax-advantaged status of municipal bonds is to recover the "tax expenditure" (as the tax exemption of muni bond interest is known in federal budget and tax discussions) as part of a tax overhaul. We believe that investors should consider the possibility of an outright elimination.

The fact that all of these plans are silent on the issue of the treatment of existing investments may not be meaningful. After all, this would not be the first time that policymakers did not completely flesh out the full ramifications of proposals to the relatively esoteric municipal bond market. It is very likely that they have not considered the wealth or income effects of a retroactive taxation of interest on muni bonds. In our view, a fair number of retirement portfolios would be severely affected by retroactive taxation.

Policymakers will need to consider the balance between the destruction of wealth and negative income effects of an immediate elimination of the exemption versus the budgetary goal of eliminating the tax expenditure related to the municipal exemption.

An interesting market dynamic would be created if Congress were to eliminate the municipal exemption but grandfather existing bonds. As with Build America Bonds after the end of the program, grandfathering existing bonds would create a scarcity effect, in which the existing bonds with their remaining tax exempt status are in high demand and relatively low supply. The higher that tax rates eventually rise, the greater the scarcity value of the tax-exempt bonds.

Pensions

While there has been a steady drumbeat of ostensibly positive announcements regarding pension reform, most reforms have been rather narrow in scope and limited in dollar value compared with the massive scope of the problem. Earlier this year, Governmental Accounting Standards Board (GASB) approved accounting changes that will increase the measure of the unfunded liability for some pension plans; rating agencies are also changing their approach to the measurement and incorporation of pension funding status in ratings criteria. However, the issues facing pensions are more long term in nature. Each year of delay magnifies the challenges and renders solutions more costly. Additionally, the rapid escalation of required pension funding levels is creating a strain on governmental budgets, crowding out other state spending or programmatic priorities.

In our view, the main driver of the pension problem is the relatively high salaries of public employees compared with median family income. Secondary factors include the performance of pension fund assets, the number of employees covered under the plans, future cost of living adjustments and guaranteed wages at retirement. Governments and taxpayers bear most of the risk in these plans, while employees and retirees bear relatively limited risk. Many of the actual reforms taken to date fall short of adequately addressing these drivers.

Reforms such as moving new employees to defined contribution plans, adjusting the cost of living increases, increasing the retirement age and requiring employees to fund a larger portion of the annual contribution marginally reduce the unfunded liability. However, they do not address the major drivers: high salary levels and generous guaranteed retirement wage levels.

We addressed a full range of pension-related issues in *2H12 Municipal Outlook*, July 27, 2012. At the time, we discussed California Governor Brown's proposed pension reform. Since then, the ambitious plan that had the potential to eliminate approximately $60bn in unfunded liabilities (up to 50% of the total) has been significantly watered down to approximately $10bn in present value, due to concerns raised by public employee unions. This example illustrates the types of obstacles facing typical pension reform in the municipal market.

The pension discussions typically center on the large level of unfunded liabilities. However, a corollary issue is the pressure that the rapidly increasing annual pension funding requirements are imposing on already stressed municipal budgets. There are numerous examples of the Annual Required Contribution (ARC) for pensions doubling in the past five years. Pension payments are typically the fastest growing expense for municipalities. Municipal governments are feeling the sting of the pension problem in their annual budgets, as ARC payments are crowding out programmatic priorities.

Puerto Rico and Illinois

We believe that two of the more discussed credits in the market, Puerto Rico and Illinois, may see rating action this year, in part based on the level of action or inaction on their pension funding levels. On November 9, S&P issued a warning regarding its BBB/negative rating on Puerto Rico, stating that "delayed or insufficient action to adopt a pension reform package would result in a one-notch downgrade to our ratings in the next few months, with potential for additional deterioration within the next year." The agency's warning appears to be based on its review of the governor-elect's platform and public statements about the unfunded pension liabilities. We do not believe that such concern is warranted. While Mr. Garcia Padilla has stated a concern about cutting benefits for existing retirees, we believe this is a reasonable opening position for a governor-elect. During the transition hearings, representatives of his transition team have continually stated that they understand that the pension situation is the most serious fiscal challenge they face and must be dealt with in short order.

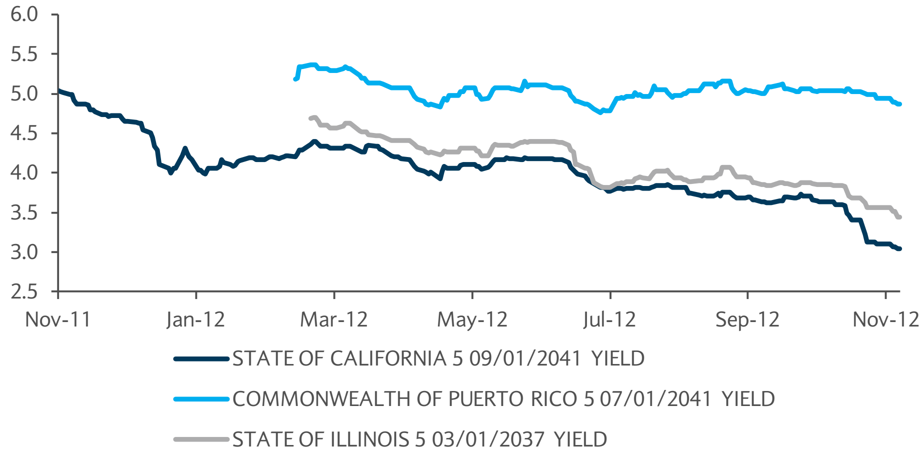
Regardless of whether S&P's concerns about the governor-elect's platform are well founded, the agency clearly expects real reform efforts in a very short period of time, or there is risk that it could downgrade the Commonwealth, potentially out of the investment grade category. Conversely, effectively addressing the pension issues would help stabilize the credit. PR 2041s are currently trading with a spread of 241bp above AAA rated tax-exempts, compared to Illinois 37s and California 41s ("A" rated states), which have spreads of 102bp and 58bp, respectively. Figure 6 shows the yield to worst of Puerto Rico GO's versus the lowest rated states (single-A California and Illinois); while CA and IL rallied after the November 6 elections, Puerto Rico lagged the rally.

In our view, the Commonwealth trades with a credit spread that reflects an uncertainty premium (given the lack of familiarity with the newly elected government) and downgrade risk. In fact, it may be argued that it trades as if it were a non-investment grade credit. We believe that effectively dealing with S&P's concerns regarding the commonwealth's pensions will result in spread compression, as some uncertainty and downgrade risk would be eliminated from the name.

For Illinois, S&P downgraded the state's rating in August and left its negative outlook in place, primarily owing to pension funding issues. We believe that rating agencies are disappointed with the state's lack of progress on pension reform during 2012 and could move to further downgrade the credit if progress on pensions and payables is not made early in 2013. While the pension funding situation is not the sole driver of potential rating action in Illinois (as it is in Puerto Rico), it is one of several key factors, and failure to achieve near-term progress would factor heavily in any rating action.

FIGURE 6

Puerto Rico GO versus Comps, yield to worst (%)



Source: Barclays Research

Local credit fundamentals

Federal and state governments have addressed, in part, some of their fiscal issues by decreasing disbursements to lower levels of government. This has added to the credit stress of these lower levels, which typically have less control over other revenues and expenses. California dodged a massive cut in school aid with the unexpected victory of Proposition 30, which introduced a temporary tax increase to balance the budget, rather than impose school aid cuts. State credits are rebounding faster than local ones, in part because states have cut disbursements (such as school aid) to local governments. We believe this gap between state and local credit quality will persist next year.

Rulings and expected rulings in the Jefferson County bankruptcy; the legal battle over pensions in the Stockton and San Bernardino bankruptcies; and the continued fiscal distress of local municipalities from Rhode Island to Pennsylvania, Michigan, California and isolated cases in between mean that local credit issues and bankruptcy filings will remain prominent on the municipal market news wire in 2013. The repeal of Public Act 4 in Michigan will likely add to the headlines, with much attention turning towards the City of Detroit.

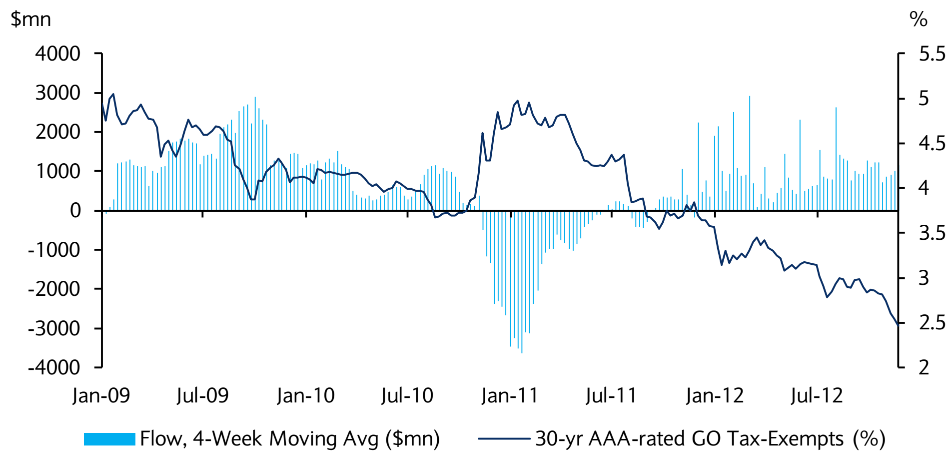
The credit fundamentals are discussed in more detail in the section entitled *Municipal Credit in 2013 - States Improving; Local Credits Still under Stress*.

Fund flows

Municipal fund flows remain a major theme for 2013. Figure 7 shows the relationship between fund flows and yields for AAA rated tax exempts, with inflows typically accompanying periods of lower muni yields and outflows corresponding to periods of higher yields. In 2012, municipal fund flows have been solidly positive every week thus far (except for the week of Hurricane Sandy), supporting the rally in muni yields. For 2013, we expect fund flows to remain positive (though they may moderate), continuing to support technicals in munis. For more details, please see "Supply Forecast and Redemptions Forecast" below.

FIGURE 7

Muni fund flows and 30y AAA rated tax-exempts



Source: Lipper, Barclays Research

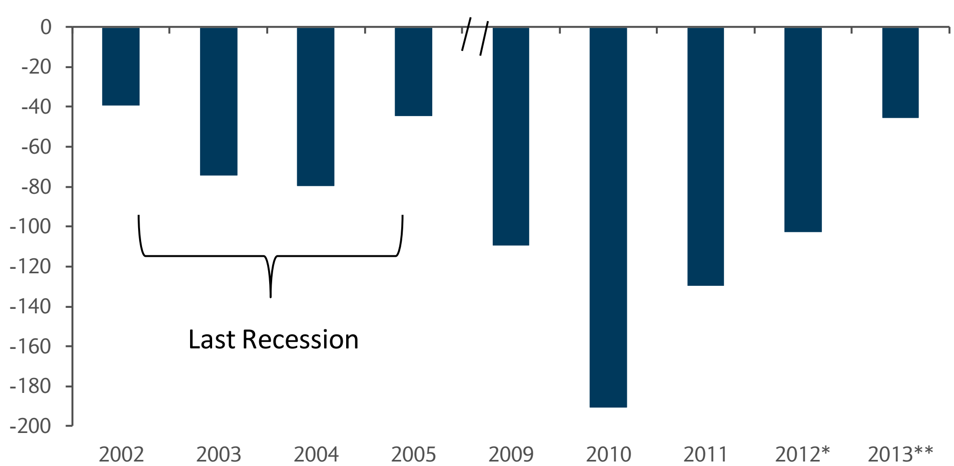
Municipal credit in 2013: States improving; local credits still under stress

Municipal governments have not fully emerged from the past recession. Total tax revenues have recently returned to pre-recession levels (not on a real basis), except for real estate taxes, which turned down again in the first quarter this year after two quarters of increases. However, the growth of municipal revenue has suffered recently. Demand for municipal spending continues to put pressure on state budgets. The states' response to this has been primarily to cut spending, with much of it coming from distributions to local governments.

States have generally returned to a state of stability, which would be strengthened by continued economic growth, even weak economic growth. As Figure 8 indicates, the overall budget deficit situation in FY13 is very similar to that in FY05, the last year of aggregate net budget deficits from the 2001-02 recession. However, clearly, the recent recession took a much larger toll on state budgets, as the peak deficit was over $180bn

FIGURE 8

State budget gaps, $bn



Note: *Reported to date; ** Preliminary. Source: Center for Budget and Policy Priorities, Barclays Research after the Great Recession, versus $80bn after the 2001-02 recession. Another indicator is that it took four budget years to climb back to surplus status after the 2001-02 recession. This time, we are five budget years into deficits after the Great Recession, and even though it appears as if states are about to turn to a net surplus position, it has taken longer than after the past recession.

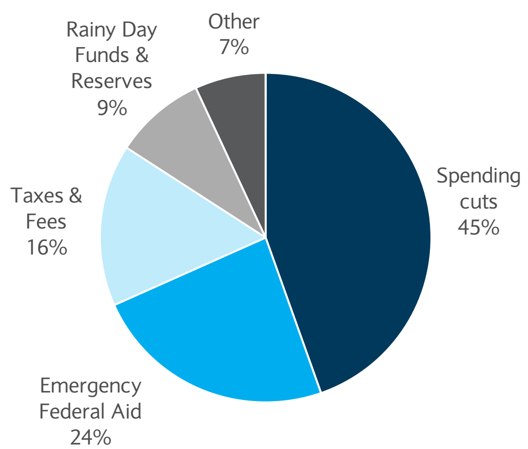
States used a number of fiscal tools to balance budgets in the aftermath of the recession. Figure 9 indicates that 45% of the aggregate budget closing measures during 2008-12 were from spending cuts, 24% from emergency financial aid (primarily ARRA funds) and 16% from increased revenues. Figure 10 shows that over time the mix of the measures changed as the 2012 budget deficits were closed primarily with spending cuts, which represented 76% of deficit closing activities. While these spending cuts were necessary for the states to meet their obligations to enact balanced budgets, many were made at the expense of local governments through cuts in education funding and social welfare programs that are shared by state and local governments.

According to the Census Bureau's Annual Survey of State Government Finance, states receive about 33% of their revenue from the federal government and pay a similar amount to local governments. Standard & Poor's calculated that 22% of state and local revenues were derived from federal support in FY09. Federal budget cuts typically avoid entitlement programs and mainly fall on discretionary programs that result in grants to state and local governments. Thus, the major share of budget cuts is passed through the governmental system to local levels of government.

We see continued credit stress at the local government level in 2013. It begins with the cuts in state aid described above. In addition, local governments rely on real estate taxes for a large portion of their funding, and such collections fell in 2012 after having recently turned positive, hurting the local government revenue picture. At the same time, expenses have continued to rise. The highly unionized workforces tend to have multi-year contracts with relatively generous inflation factors. Another factor causing fiscal problems for municipalities is the escalating fringe benefit costs. These are made up of insurance items such as health care premiums, pension contributions and OPEB costs. All of these benefit expenses are rapidly increasing at a time when governments need to find savings due to decreased revenues.

FIGURE 9

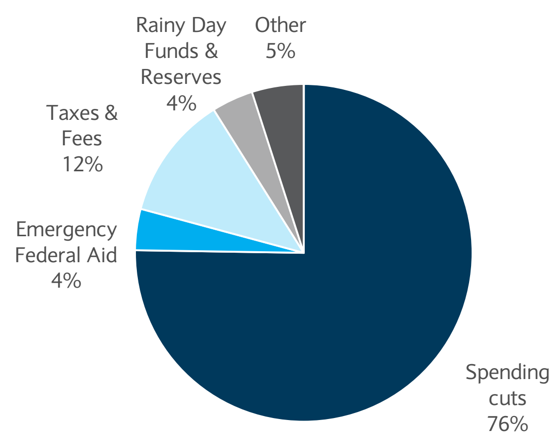
Budget deficit closing activities (FY08 to FY12)



Source: Center for Budget and Policy Priorities, Barclays Research

FIGURE 10

States relied mainly on spending cuts in FY12



Source: Center for Budget and Policy Priorities, Barclays Research

Chapter 9 filings

While we do not expect a material increase in Chapter 9 bankruptcy filings, we do think that several conditions may lead to the potential for more bankruptcy filings. The first was discussed at length in *Stockton, California Bankruptcy: Another Look* and has been reemphasized by the action of the City of San Bernadino in its bankruptcy case. The serious challenges to pension funding initiated by Assured Guaranty and National Public Finance Guaranty may lead to the ability to achieve significant pension restructurings in bankruptcy. If this becomes true, more municipalities with challenged fiscal conditions may be incentivized to file for Chapter 9 bankruptcy protection.

The issue of municipal pensions in bankruptcy has moved to the forefront in the San Bernardino bankruptcy, in which the city has taken the position that the automatic stay provides it the opportunity to relax its pension funding requirements as it develops its bankruptcy plan. CalPERS has filed for relief from the stay, arguing that under California law, pensions have statutory lien status and are therefore immutable and exempt from the automatic stay. While there is Supreme Court precedent that says that municipal pensions are not immutable, the statutory lien argument is a new consideration. If CalPERS is successful, the net effect would likely be fewer Chapter 9 filings, a weakened fundamental credit picture, and probable downgrades of many classes of California local municipal debt (leases, certificates of participation and perhaps even weaker GOs) as obligations to fund pensions become senior debt obligations. However, we continue to believe that there is little risk of this outcome.

A second condition is the repeal of Public Act 4 in Michigan. This law granted strong restructuring powers to a state-appointed receiver or emergency manager. The elimination of these powers relegates emergency managers to a relatively weak position, without the ability to restructure the fiscal affairs of a distressed municipality. The localized economic dislocation in Michigan arising from the recent decline in the auto manufacturing industry has led to a concentration of municipalities with severe fiscal stress. There were seven distressed municipalities (four cities and three school districts) operating under a state-appointed manager, and three additional ones in which the emergency manager powers were conferred on the municipal government through consent agreements.

The repeal of Public Act 4 has led to a high level of uncertainty regarding the state's ability to intervene and support distressed local credits. There is a legal argument over whether Public Act 4 replaced or added to the prior emergency manager statute, Public Act 72. Whether the prior law is effective or not, Public Act 4 was passed because Public Act 72 did not provide the fiscal options required to deal with the stress experienced by Michigan municipalities. Without the ability to bring new revenue to the table and now without the ability to restructure expenses, emergency managers are not empowered to provide solutions that will correct the problems with the more severely distressed municipalities. Therefore, the repeal of Public Act 4 could very well result in several Chapter 9 bankruptcy filings in Michigan.

2013 supply and redemptions forecast

We forecast $390bn of gross municipal supply in 2013, including $355bn in tax-exempt issuance and $35bn in taxable supply (please see the "Taxable Supply" section for a discussion of taxables classified as municipals versus those classified as corporates). We project $387bn in redemptions for the year. This brings our net supply forecast to about $3bn in 2013 (Figure 11).

FIGURE 11

Barclays 2013 supply and redemption forecast

	$bn
Tax-Exempt Total	355
Taxable Total	35
Gross Supply	390
Redemptions	387
Net Supply	3

Source: Barclays Research

Supply

Over the past decade, annual issuance averaged $386bn, with a peak of $433bn in 2010 and a trough of $288bn in 2011 (Figure 12). We expect 2013 issuance to be up slightly y/y from $371bn, reflecting the following considerations:

- The continued low interest rate environment should remain favorable for issuance, resulting in robust current refunding activity. Should current refunding activity be greater than expected, this would result in gross supply coming in above expectations, with minimal effects on net supply after redemptions.

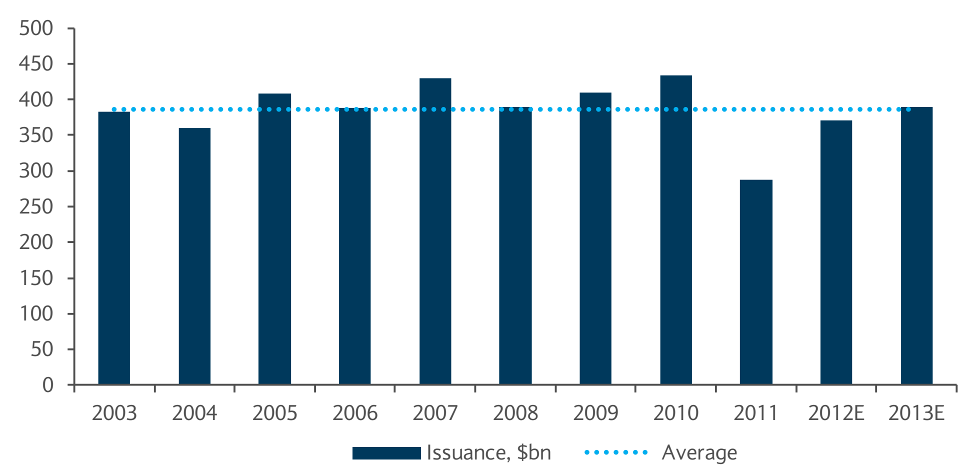
- Issuance related to advance refunding activity will likely pick up modestly, given that muni ratios are below 100%, alleviating potential negative arbitrage effects. Additionally, the passage of time should help alleviate a measure of negative arbitrage that may have existed in potential refunding escrows in 2012. As a result, some marginal refundings that did not take place in 2012 may now be economic.

- Municipal and infrastructure projects may be pulled forward, owing to the favorable interest rate environment and concerns about tax-exemption, which could bring about incremental supply.

- Issuers may be reluctant to add debt to already-leveraged balance sheets, which could offset some of the abovementioned factors.

FIGURE 12

Muni issuance, 2003-12; 2013E forecast ($bn)



Note: "2012E" includes our supply forecast expectations for the balance of 2012.
Source: Bond Buyer, Barclays Research

Taxable supply

For taxable issuance classified as municipal, we expect about $35bn of supply in 2013; we note that this does *not* include crossover issuance on the corporate side. Year-to-date in 2012, taxable issuance totaled about $30bn, with roughly $5bn of it eligible for the US Taxable Municipal Index and, by extension, the larger US Credit Index. In 2013, we expect index-eligible taxable issuance of $5-6bn, owing to relative ease of issuance compared with regulatory-intensive tax-exempt bonds and the continuing trend of tax-exempt entities opting to issue in US Credit Index-eligible format. Recall that this index requires a minimum CUSIP size of $250mn, and there is typically a yield premium for non-index transactions.

The BAB program educated a broader market on municipal credit. With rates at historic lows, more traditional muni borrowers are issuing in the taxable market, at times with a corporate classification. Higher education borrowers started issuing a relatively large amount of taxable debt in late 2011, carrying over into the first half of 2012, resulting in $850mn of US Credit index-eligible issuance year-to-date outside of the Taxable Municipal index. Not-for-profit health systems have issued over $4bn of index-eligible debt with a corporate designation in 2012 year-to-date. The attractiveness of the taxable market to these issuers is a function of the additional flexibility and ease of issuance in the taxable market, combined with low rates.

In 2013, for taxable municipal issuance classified as corporates, we expect roughly $1bn of issuance in higher education (private universities) and $6bn of index-eligible supply in not-for-profit hospitals, both upticks from 2012. Again, municipal issuance with a corporate classification would not be included in the US Taxable Municipal Index, although it will be eligible for the larger US Credit Index.

Demand

Redemptions (which we define as redemptions from current refundings, advanced refundings, and maturing bonds) are expected to total $387bn in 2013, compared with $279bn on average over the past 10 years. Redemptions have picked up in recent years, owing primarily to the low interest rate environment. For 2013, we expect estimates for redemptions from advanced refundings ($80bn) and maturing bonds ($146bn) to change only slightly over the course of the year, as these are generally set through prior market activity. Redemptions from current refunding activity should result in the greatest variation from our forecast (Figure 13),

FIGURE 13

2013 redemption estimates, $mn

Month	Current Refundings	Advance Refundings	Maturing Bonds	Total
Jan	12,384	4,760	10,718	27,863
Feb	9,302	6,352	11,108	26,761
Mar	11,660	4,838	8,025	24,523
Apr	14,030	2,802	7,728	24,560
May	15,066	5,430	10,455	30,950
June	16,263	14,884	17,872	49,019
July	17,751	13,608	20,238	51,596
Aug	13,749	8,453	14,832	37,034
Sep	13,051	3,566	10,101	26,719
Oct	13,323	5,117	10,391	28,831
Nov	11,969	3,821	9,853	25,643
Dec	12,456	6,520	14,699	33,675
Total	161,004	80,150	146,022	387,176

Note: Advance refundings and maturing bonds are obtained from IDC; current refundings are Barclays estimates.
Source: IDC, Barclays Research

For current refundings, we expect 2013 levels to rise from the $150mn+ this year. Our forecast is driven by issuance levels from ten years ago, given the 10y call features typical of many municipal bonds. Given that issuance in 2003 increased roughly 7% from 2002 levels and the current low interest rate environment, we expect redemptions from current refundings to total $161bn in 2013.

With coupon distributions expected to total well over $100bn in 2013, total proceeds that could be reinvested in 2013 may be as high as $500bn, potentially making 2013 yet another year of negative net supply. We acknowledge that not all coupon payments are reinvested by holders, particularly in light of the large retail presence in the muni market, as roughly 70% of the demand for municipals comes from individuals in the form of direct purchases and mutual funds.

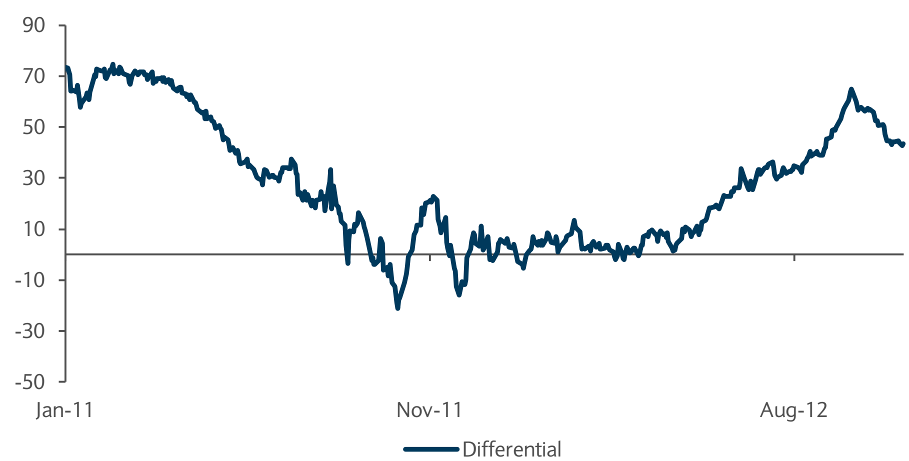
Setting aside the issue of coupon reinvestment, we believe that municipal fund flows will be able to digest net supply in 2013. Year-to-date in 2012, muni fund flows have totaled roughly $49bn, as flows have been robust and positive thus far, with the exception of the week of Hurricane Sandy, when they briefly experienced outflows. For 2013, we expect flows to remain positive, although the pace of inflows will likely moderate y/y. Given sustained monetary stimulus via variations of quantitative easing, muni fund flows will likely remain positive, absent an exogenous shock (i.e., from tax policy, interest rates, etc) that affects the market.

Relative Value

We continue to view taxable municipals as a favorable alternative to corporates, given the higher quality and opportunity for spread pickup. Currently, the taxable municipal index trades 44bp back of the Corporate Index, above the post-crisis average of 27bp. We see the opportunity for this differential to narrow, particularly owing to positive technicals and California (roughly 12% of the Taxable Municipal Index), which remains an upgrade candidate, in our view. Additionally, we believe increased taxable issuance next year is another positive that will likely remain supportive of the growth of the taxable municipal investor base.

FIGURE 14

Taxable municipals minus corporate OAS (bp)



Source: Barclays Research

Currently, the highest relative value may be found in intermediate taxable munis, which trade wide versus the Intermediate Corporate Index. Intermediate taxable munis trade about 44bp back of intermediate corporates, while long taxable munis are largely on top of the Long Corporate Index. However, given that there is only $16bn outstanding in the intermediate portion of the Taxable Muni Index, trades may be difficult to execute in this bucket. While no differential exists at the aggregate long indices level, this reflects the fact that long taxable munis are of higher credit quality (AA3/A1 for long taxable munis, versus A3/Baa1 for long corporates). Long taxable munis offer value versus corporates by rating bucket, particularly in the AA and A buckets, which trade about 44bp and 77bp behind the long corporate index counterparts. The BBB rating bucket is more limited in size and number of deals, with the bulk of this bucket comprised of Puerto Rico-related debt (PR GDB, PREPA, and PR Public Finance Corp). Such debt (such as PR GDB, which is considered essentially equal to the Commonwealth credit itself) could offer good value, for the reasons highlighted in earlier sections.

FIGURE 15

Taxable munis versus Corporate OAS, bp

Index	OAS (bp)	Index	OAS (bp)	Difference (bp)
US Taxable Muni Intermediate	172	US Credit Corp Intermediate	129	44
US Taxable Muni Long	193	US Long Credit Corp	193	0
AAA	121	AAA	96	25
AA	164	AA	119	44
A	237	A	160	77
BBB	340	BBB	240	100

Source: Barclays Research

Figure 16 shows select not-for-profit healthcare deals in the US Credit Corp Index that trade wide versus their respective corporate rating buckets. Admittedly, these are of longer duration than the overall sub-indices. However, deals such as Baptist Health and Partners Healthcare offer spread pickup of some 50-60bp, for only slightly longer duration than the Aa portion of the US Credit Corp Index. In the single-A category, Novant offers a spread pickup of more than 130bp, with a shorter duration. Given our 2013 forecast for an uptick of index-eligible supply in the not-for-profit healthcare sector, the coming year should offer additional opportunities for investors to increase exposure to high-quality names that offer good value.

FIGURE 16

Not-for-profit healthcare deals versus US Credit Corp Aa and single-A

Issuer	Ticker	Ratings	# of Issues	Par Outstanding ($mn)	Mod. Adj. Duration	OAS (bp)
US Credit Corp Aa		AA	308	294,103	6.6	76
Baptist Health South Florida	BAPTST	Aa2/AA/nr	1	250	7.4	137
Catholic Health Initiatives	CATMED	Aa3/AA-/AA-	3	1,500	12.4	128
Partners Healthcare System	PARHC	Aa2/AA/AA	1	250	7.5	122
US Credit Corp A		A	1,801	1,488,710	7.1	121
Kaiser Foundation Hospitals	KPERM	nr/A+/A+	2	1,000	13.6	137
Dignity Health	CATHHE	A3/nr/A	2	600	12.8	167
Novant Health Inc.	NOVANT	A1/A+/AA-	1	250	5.9	253

Source: Barclays Research

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European credit strategy

EUROPEAN HIGH GRADE

Tip-toeing along the ratings cliff

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- **In our base case, we forecast that our Euro Aggregate Corporate Index will generate 200-225bp of excess returns in 2013. This reflects our expectation of marginal spread tightening, sufficient to outweigh the drag from a continued flow of fallen angels.**
- **Given our constructive view and current valuations, we recommend overweight positions in Insurers, subordinated debt of "core" European Banks and corporate hybrids. We also recommend being overweight less cyclical, core BBB credits that we believe are likely to retain their investment grade ratings, and overweight 3-7y credit versus the "wings".**
- **Counterbalancing a policy-induced reach for spread, we expect credit metrics to remain under pressure given the downbeat outlook for growth in the eurozone. This implies an ongoing flow of fallen angels in 2013. A key downside risk to our outlook is the potential for Spain to be downgraded to mid/low BB, with the result that the majority of Spanish credits migrate to high yield indices.**
- **Therefore, we believe that the peripheral overhang will continue to be a key risk and that peripheral credit will remain a "range trade" in 2013. At current levels, we advocate being underweight peripheral credit. We also recommend underweight positions in tight and/or cyclical sectors such as: Autos; Chemicals; Oil & Gas; and Consumer Goods.**
- **Lastly, we note that, unlike in 2012, when the key positioning decisions were peripherals vs. non-peripherals and financials vs. non-financials, we believe investors will need to pull on multiple "levers" in order to meaningfully outperform benchmark indices in 2013.**

2012 returns in perspective

This year has seen euro credit generate exceptional returns, though in part this represents payback for the losses experienced in H2 2011. Through 30 November, year-to-date excess returns for our Euro Aggregate Corporate Index are 795bp, which would be the second highest annual returns on record after 2009. Total returns have also been strong, at 1248bp, reflecting the record-low interest rate environment and a moderation in credit concerns about the French sovereign[3]. As well as the exceptional outright performance, EUR credit outperformed versus USD (outright) and GBP (duration adjusted) credit.

This year's strong performance reflected a combination of valuations coming into 2012, and the outperformance of European credits trading at very wide levels (particularly peripheral names). Across the curve, 7-10y credit generated the highest returns, as the steepening of credit curves was overwhelmed by a general rally in spreads. Similarly, BBB credit outperformed other rating buckets as risk assets in general rallied.

At a sector level, Financials outperformed, given cheap valuations at the start of 2012, and the palliative effect of the ECB's two 3y LTRO operations. Combined with progress towards a banking union, restructuring of the Spanish banking system, and the potential for the ESM to be used to "break the feedback loop between banks and sovereigns" in the future, the

[3] Our benchmark Euro indices measure excess returns versus a weighted basket of Germany, France and Netherlands treasury bonds.

risks to this sector have been re-priced significantly (and reasonably, in our view) lower. Across non-financials, performance has been driven by exposure to peripherals, with Utilities and Telcos outperforming other non-financial sectors.

2013: Low benchmark rates, lower spreads, lower ratings

After several years of central banks pumping liquidity into financial markets, global interest rates sit at or near multi-decade lows, with credit market yields not far behind. Risk assets have responded positively to these actions – with near-zero nominal rates pushing investors out the risk spectrum, albeit begrudgingly. Our economists expect the easing bias of central banks to persist through 2013, and so this dynamic should continue over the next twelve months. Alongside continued net-negative issuance of unsecured corporate bonds, ongoing asset allocation shifts should underpin credit performance in our base case.

In bond markets, the flood of liquidity has allowed corporates to refinance their debt, term out maturities, reduce their financing costs and accumulate large liquidity buffers. In turn, this has pushed down corporate default rates, perpetuating the over-capacity prevalent across many sectors. The result has been a deterioration of credit metrics, accelerated by methodological and sovereign-driven downgrades. Thus, while we expect spreads to grind tighter in 2013, we also expect several credits to exit investment grade indices over this period and to underperform on their way out. In our view, portfolio managers will need to carefully navigate the BBB ratings space to outperform their benchmarks.

There are other risks to our outlook. In more positive macro scenarios, there is the potential for growth to surprise and Europe to make rapid progress towards lasting solutions for the structural challenges faced by the currency union. On the downside, risks include: a deeper recession in Europe; a slowdown in the US (potentially due to the “fiscal cliff”); a disorderly reversal in the recent asset allocation flows into credit; and tail-risks associated with the eurozone. Superficially, European investment grade credit remains overshadowed by many of the same issues the market was struggling with a year ago. It is still unclear how Europe will resolve the debt sustainability of Greece, Spain has yet to enter an official programme and is at risk of losing its investment grade status, and European growth remains depressed even in our base case.

But it is also undeniable that, inexorably, the eurozone has made progress towards building an institutional framework of the sort required if it is to survive in the medium term. The dialogue on peripheral Europe has moved to a more balanced discussion of both growth and fiscal retrenchment. The process of creating a banking union, under a single supervisor (SSM), has been instigated, with the potential for true risk-mutualisation at the end of the (long and winding) road. And the ECB has opened the door to acting as a lender of last resort to eurozone member states, albeit in the context of strong conditionality.

At the same time, investment grade indices have been “purged” of many high-beta, riskier securities including those from corporates in programme countries and many subordinated bank securities. In many ways, investment grade portfolios are exposed to fewer, albeit more binary, risks. In particular, the key *known* overhang for IG credit spreads is the risk of a mass downgrade of Spanish and/or (less likely) Italian credits to high yield.

Valuations and returns forecast

Investment grade credit is likely to enter 2013 at meaningfully tighter spread levels than those that prevailed at the beginning of 2012 and performance will lag this year’s returns as a result. Nevertheless, as laid out above, we believe that, against a backdrop of massive liquidity provision and a search for yield, credit spreads are likely to grind tighter over the next 12 months – albeit with intermittent bouts of volatility, continued negative ratings migration, and significant risk overhangs.

Based on our macro-driven model for index OAS (*European Credit Alpha*, 9 September 2011), we have outlined our expectations of spread performance in three scenarios: our baseline expectations; a more upbeat scenario in which growth surprises to the upside and credit conditions ease moderately; and a more negative scenario in which Spain is downgraded more severely, triggering a mass migration of Spanish credit to HY indices. In Figure 2 we transform these spread levels into raw excess returns forecasts for our Euro Aggregate Corporate Index, and various slices through ratings and the credit curve.

We highlight that in our "base case" scenario, we expect EUR IG spreads to end next year at c.130bp (ignoring meaningful changes to index composition), approximately 30bp tighter from recent levels. We expect approximately 15-20bp of tightening from Industrials, with more meaningful tightening likely to come from Financials and Utilities.

FIGURE 1

Macro model scenarios and returns

	30-Nov-12		Baseline	Faster Recovery	Growth-driven, Spain downgrade
GDP (%, yoy)	-0.6		0.1	1.0	-0.5
CPI (%, yoy)	2.5		1.8	2.5	1.7
V2X	16.6		20.0	18.0	35.0
Lending Standards	10		20	10	35

OAS (bp)	Observed (EoD)	Regression	Baseline	Faster Recovery	Growth-driven, Spain downgrade
Euro IG	159	190	130	122	205
Euro IG - Indu	130	140	110	102	180
Indu - AA	61	66	56	50	87
Indu - A	89	110	91	83	145
Indu - BBB	174	177	144	131	238

Note: * Lending standards are 1Q lagged. Source: Bloomberg, Barclays Research

FIGURE 2

Barclays Research 2013 excess returns forecasts, European Investment Grade credit

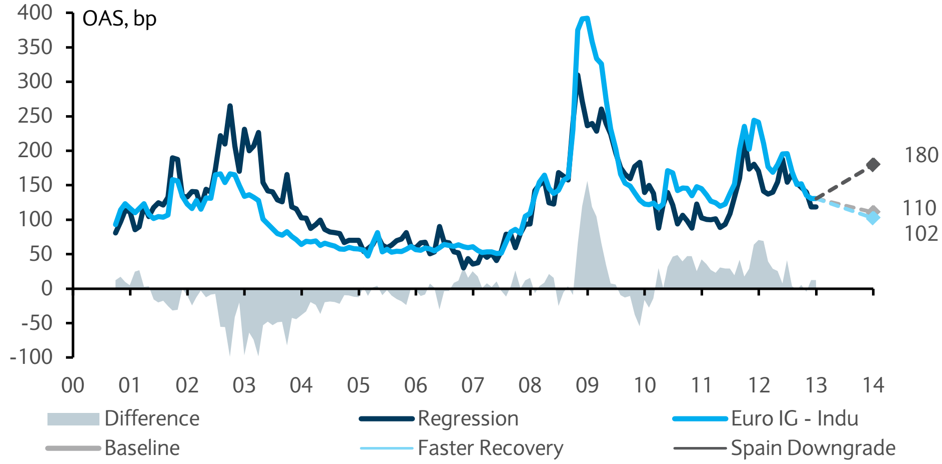
	Baseline	Faster Recovery		Baseline	Faster Recovery
EUR Corp	2.5%	2.8%			
EUR Industrials	2.2%	2.3%	Indu - 1-3y	1.2%	1.3%
			Indu - 3-5y	2.5%	2.7%
Indu - AA	0.8%	1.1%	Indu - 5-7yr	2.7%	3.0%
Indu - A	0.8%	1.2%	Indu - 7-10yr	2.2%	2.4%
Indu - BBB	3.0%	3.5%	Indu - 10-20yr	4.1%	3.3%

Source: Barclays Research

Adjusting these raw forecasts for the drag associated with fallen angels and other issues related to index survivorship, we forecast excess returns of 2.00-2.25% for the Euro Agg Corporate Index in 2013. In line with our overall theme of reaching for beta to investment grade credit, we note that our model suggests that BBB credit will significantly outperform better-rated securities in 2013. On the curve, returns are forecasted to be relatively evenly distributed across maturity buckets. With this in mind, we prefer the 3-5y and 5-7y areas of the curve on a risk/duration adjusted basis for 2013.

FIGURE 3

Barclays Research OAS model, Euro IG Industrials 2013 scenario analysis



Source: Barclays Research

The risks around our forecast are mixed and, in our view, different for total- and excess-return investors. We believe the risks to our excess returns forecast are relatively balanced, with stronger returns likely in an environment where either growth begins to improve or policy makers provide more stimuli while avoiding any of the most negative scenarios. The significant downside risks to our forecast are a potential downgrade of Spain and/or Italy to mid/low BB (leading to a broad migration of Spanish/Italian credit to high-yield) and the tail event of one or more countries exiting the eurozone. We note that our model-based forecast for spreads in the "Spain downgrade" scenario implies c.50bp of spread widening for IG Industrials, and slightly less widening from Financials and Utilities, which already look cheap to our models. That said, we would not be surprised to see those already-cheap sectors get even cheaper given their higher exposure to peripheral (in the case of Utilities) and systemic (in the case of Financials) risks, and such scenarios could also entail at least some peripheral credits being downgraded to high yield, which would further weigh on returns.

For total return investors, the risks appear more asymmetrical and differently distributed. For yields to continue falling, we believe that the current "goldilocks" environment of low growth and a continued, but critically unrealised, overhang of macro uncertainty needs to prevail. This could keep central banks easing, and benchmark interest-rates low, while allowing credit spreads to grind tighter as monetary policy suppresses the volatility of financial assets. In more upbeat scenarios, benchmark rates are likely to begin to price tighter monetary policy, pushing yields higher – though likely not at a sufficient rate to drive total returns deeply negative. Alternately, in the negative scenarios outlined above, we could see a sharp widening of credit spreads that would, likely, be only partially offset by a rally in government bonds – given yields that are already pressing against the zero bound.

Finally, some investors might argue that the valuation dynamics we have outlined so far are unsustainable. Indeed, central banks are arguably pushing down both credit spreads and interest rates, leading to what some might view as "unnaturally" low credit yields as money is forced into the asset class. While we have sympathy with these concerns over a longer time horizon, our global economics and rates research colleagues do not believe that central banks are likely to tighten policy in 2013, or even 2014. We thus believe the likelihood is that any duration-led sell-offs will be more moderate in nature, and a more significant sell-off will be a story for another day.

Fundamentals: Low growth, overcapacity and downgrades

Growth has been hard to find in Europe over the course of 2012. The most recent estimates put eurozone GDP at -0.6% y/y, albeit with a significant bifurcation between the southern and northern member states. Similarly, the UK economy had grown by only 0.1% y/y in Q3, and more generally global growth has disappointed this year. This has been reflected in the sluggish top-line and EBITDA growth of non-financial corporates, particularly those with a greater exposure to Southern Europe.

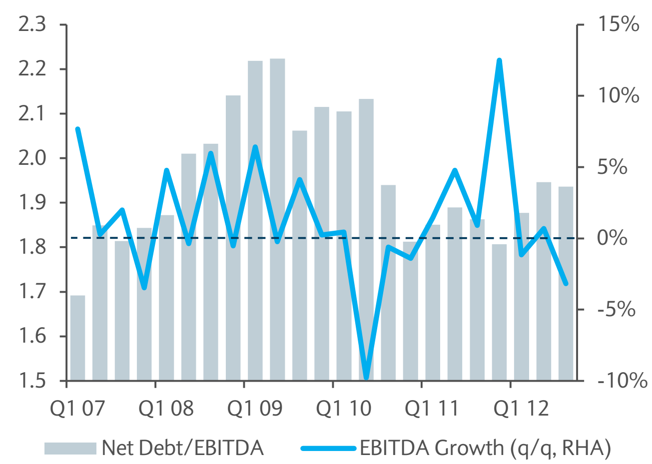
With Europe slipping back into recession after only nine quarters of growth, companies have struggled to de-leverage and de-risk their balance sheets. Stagnating EBITDA growth has begun to push up the leverage of many issuers, creating negative ratings pressure that has been augmented by sovereign downgrades (Figure 4). Despite this credit deterioration, funding pressures have been limited due to the exceptionally low cost and high availability of financing to European credit. For banks, this has primarily been from central banks: the ECB has made liquidity available in unlimited quantities and at ultra low interest rates. In contrast, bond markets have been the key source of inexpensive debt financing for non-financials, and companies issued record amounts of low-coupon debt (Figure 5).

The net result of this massive liquidity provision, both from central banks and from debt capital markets, has been to enable corporates to refinance maturing debt while also increasing the affordability (interest coverage) of leverage – at least in the near term. This has been a positive for bondholders, who have benefited both from the historic rally in bond prices and from the boost to issuers' balance sheets.

Long term, however, the lack of funding stress and the accompanying lack of pressure to rationalise underperforming assets have the potential to exacerbate existing fundamental challenges, as excess capacity continues to linger in many sectors. This is particularly an issue in those industries that are viewed as "strategic employers", as governments are more inclined to intervene with political pressure and/or industry subsidies. A classic example of a "strategic" employer is the auto industry. Comparing Europe, where no major auto manufacturer has yet failed (or been restructured), with the US, where both GM and Chrysler filed for bankruptcy, it is clear that Europe is behind the curve in reducing excess supply capacity (Figure 6). Unsurprisingly, our analysts' outlook on the European autos industry is bleak and many OEMs face negative ratings pressure. Similarly, metals and mining names have suffered this year given the overhang of global

FIGURE 4

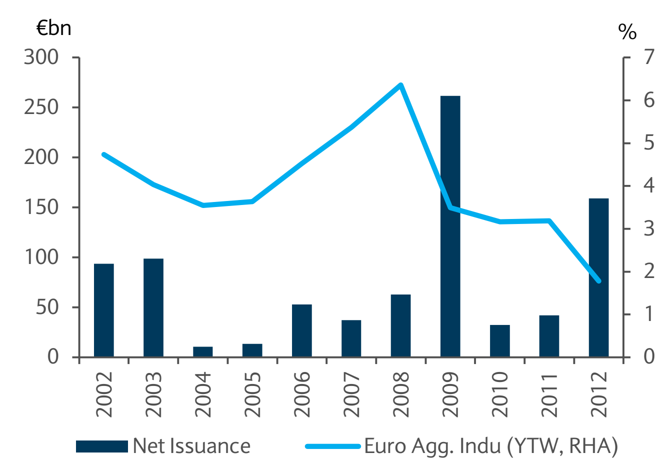
European non-financial EBITDA, Net debt/EBITDA trends



Source: Capital IQ, Barclays Research

FIGURE 5

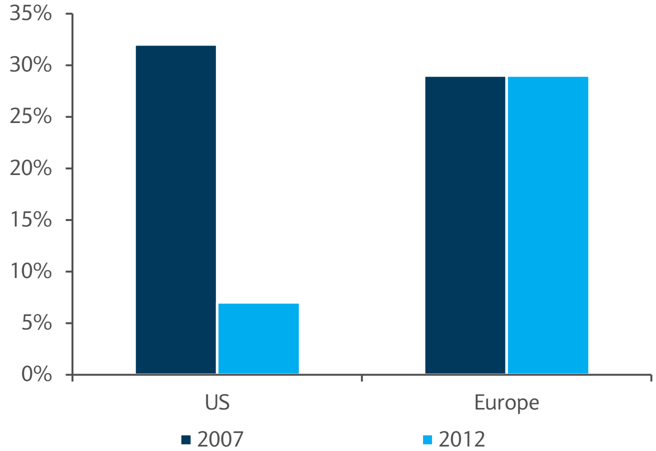
Euro non-financial net bond issuance, versus credit yields



Source: Dealogic, Barclays Research

FIGURE 6

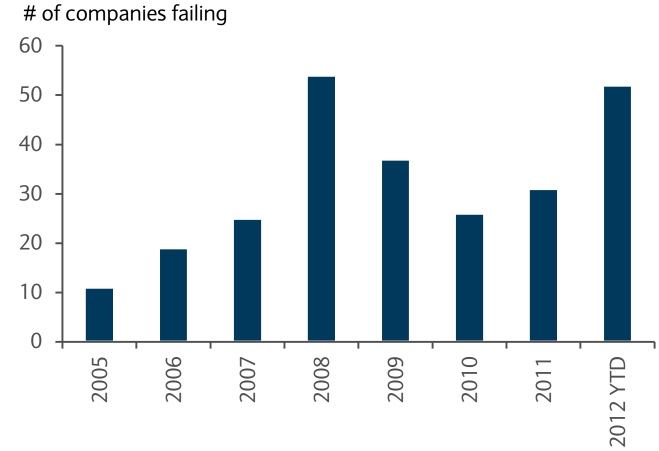
Auto industry excess capacity, US versus Europe



Source: Barclays Research

FIGURE 7

UK Retail store closures



Source: Centre for Retail Research

steel manufacturing capacity following the 2009/10 stimulus in China. Here too, in Europe, we note that the French government has intervened to prevent job losses. But not all areas have been so sheltered. In the UK, there have been record closures on the retail high street and so, while the cyclical outlook remains uninspiring it is clear that when growth does resume (our economists look for acceleration in H2 2013), those credits that have survived will face significantly less competition (Figure 7).

Negative ratings migrations are likely to persist

As we outlined in our 2013 fallen angels/rising stars update (*European Credit Alpha,* 23 November 2012), we expect 2013 to be another year in which downgrades significantly outnumber upgrades in Europe. This implies a continued flow of fallen angels, although in our base case we expect 2013 downgrades to lag the €60bn equivalent seen this year. Risks to this forecast are skewed towards more downgrades, in our view – principally due to the potential for several more rounds of sovereign-driven corporate down-rating.

The average rating decline of European credit in 2012 has been outsized both relative to history, and versus rating actions in the US credit market (Figure 9). In part, this reflects the economic performance of these regions, with the US posting firm, if unimpressive, growth while Europe fell back into recession. However, the larger driver of downgrades in Europe has clearly been the impact of sovereign downgrades on peripheral corporates.

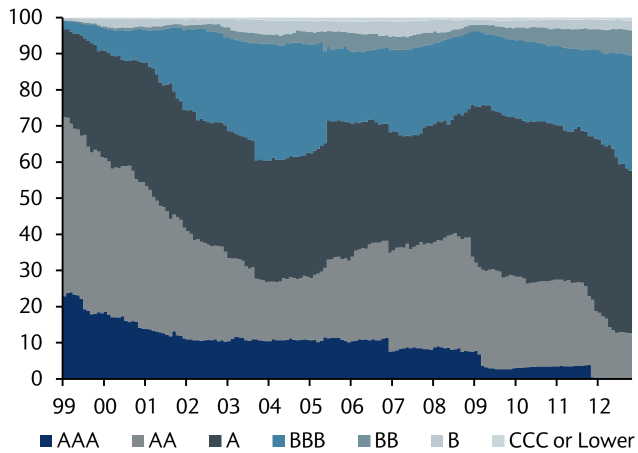
The third significant factor in 2012 fallen angel volumes has been methodological changes; for example, rating agencies have systematically lowered or removed the sovereign uplift that was previously incorporated into the ratings of many European issuers. This has been an especially significant driver of the re-rating of banks, particularly lower down the capital structure (ie, for capital securities).

In the context of these three drivers, we would make three observations regarding 2013:

- Methodological changes and the loss of the sovereign ratings uplift are largely behind us, and therefore unlikely to drive large volumes of downgrades in the near future.

FIGURE 8

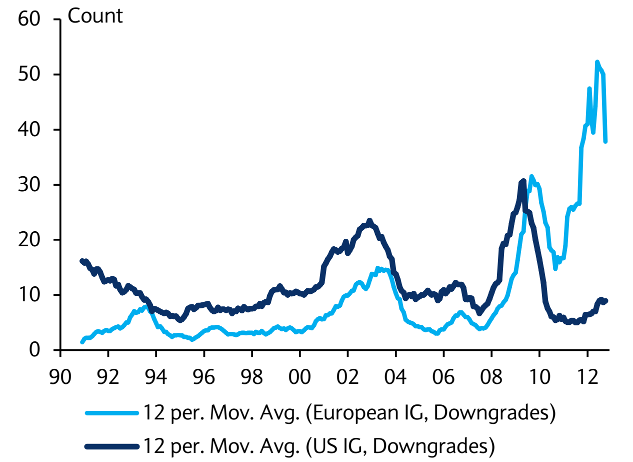
Pan European Corporate, Pan European High Yield Index rating trends



Source: Barclays Research

FIGURE 9

Moody's Investment Grade downgrade trends, Western Europe versus United States



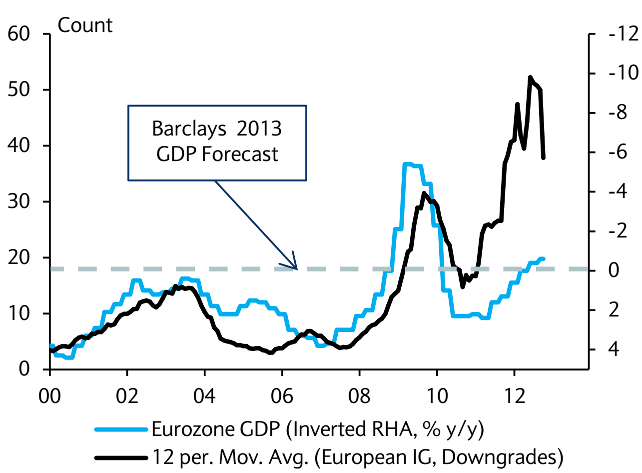
Source: Moody's Analytics

- The economic outlook for Europe remains poor, outright and relative to the US. In that context, downgrades are likely to continue at a significantly higher pace than seen pre-crisis, or even during the 2002/03 recession (Figure 10).
- The credit ratings of their sovereigns remain a key overhang for peripheral corporates. To the extent that the sovereign ratings ceiling is a "hard" one, and ratings pressure on sovereigns remains negative, there are significant downgrade risks – especially for IG rated Spanish and Italian issuers – and minimal chance of any upgrades in 2013.

The potential for a sovereign-driven fallen-angel surge is a clear overhang for the markets. That said, this is not our base case for 2013. We believe it is more likely that sovereign ratings will stabilise near or just below current levels. In this scenario, the government could move below investment grade, along with most financial institutions. However, we believe many non-financial issuers, including utilities and telecoms, could be left at low-BBB and therefore retain an investment grade rating on a 12-month horizon.

FIGURE 10

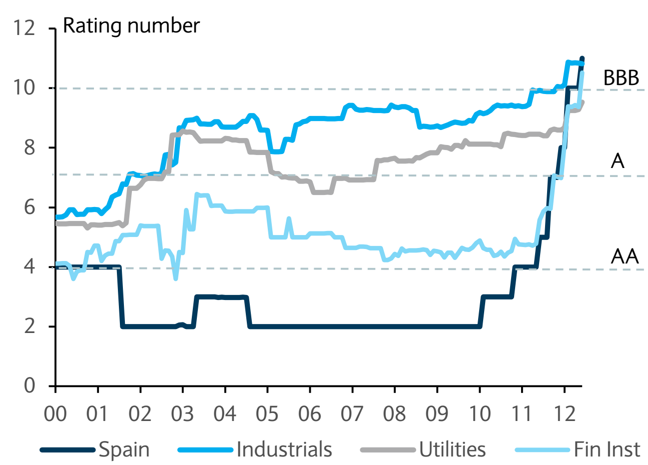
Western European IG downgrades versus GDP



Source: Moody's, Bloomberg, Barclays Research

FIGURE 11

Rating of Spanish sovereign versus Spanish credit



Source: Barclays Research

For rising stars, there are relatively fewer opportunities, not least because such credits would clearly be swimming against the tide. Rating agency data suggest that in the last cycle, upgrades peaked around 2004 – two-to-three years after the recession trough. On that basis, we are several years from a significant acceleration in rising star volumes.

We highlighted several of our top rising star/fallen angel candidates in the *European Credit Alpha*, 23 November 2012.

2013 supply outlook

This is an edited extract of European Credit Strategy: 2013 supply outlook, 4 December 2012

We expect gross, unsecured, investment grade issuance to accelerate to €480bn in 2013, from c.€445bn in 2012 (€430bn YTD). Our forecast is that €230bn of this will come from non-financial credits, representing a continued growth of the market and an ongoing loan-to-bond transition for European borrowers. This implies that net issuance will be negative for a fourth year, again driven by large redemptions by financials. We see risks as balanced; with upside risks in more positive scenarios offset by the potential for Spanish (or Italian) "national champions" to migrate to high yield.

FIGURE 12

Barclays unsecured, euro corporate issuance estimates

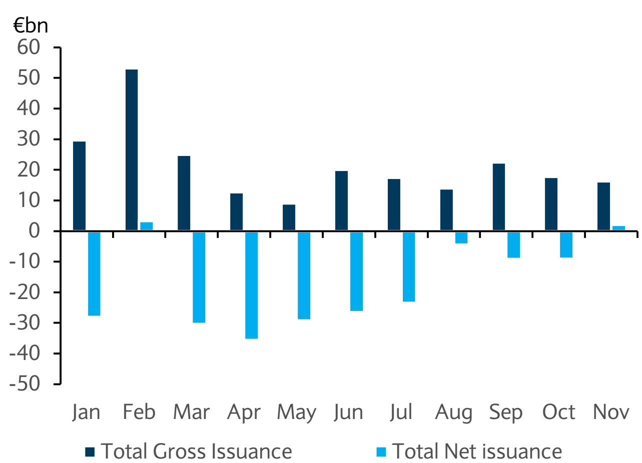
		2013			2012 YTD	
		Gross	Redemptions	Net	Gross	Net
EUR	Fin	250.0	371.4	-121.4	237.4	-189.8
	Non-Fin	230.0	139.1	90.9	191.6	92.9

Source: Dealogic, Barclays Research

On the financial side, we believe that the key drivers of deeply net-negative unsecured bank issuance have already begun to wane. Barring a further crisis, the ECB's balance sheet has likely peaked, as has the shift to secured funding via covered bonds. Thus, downwards pressure on issuance will need to be driven by shrinking liabilities (and to a lesser extent an increase in USD funding). More negatively, issuance could fall short of our mark if Spain is downgraded to sub-investment grade as the majority of Spanish banks would also migrate to high yield (and therefore, out of our issuance statistics) and debt capital markets would likely shut for at least some period of time.

FIGURE 13

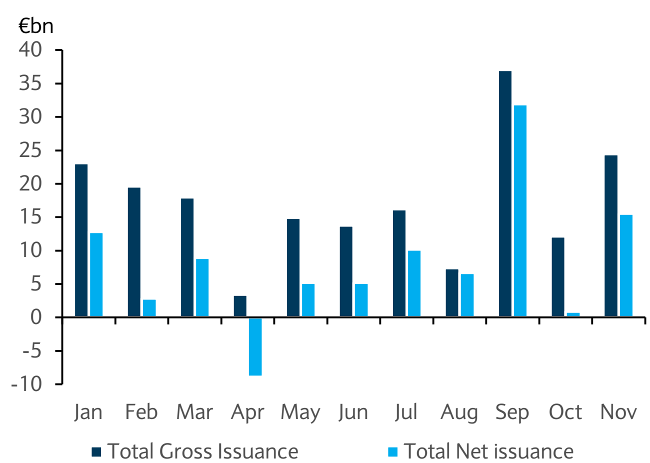
€-denominated, unsecured financial Issuance



Source: Dealogic, Barclays Research

FIGURE 14

€-denominated, financial issuance



Source: Dealogic, Barclays Research

On the non-financial side, we expect corporates to remain defensive and therefore look to maintain the significant liquidity positions they have accumulated since 2008/09. This implies that 2013 redemptions will be refinanced in full, along with a fraction of loan facilities as the loan-to-bond transition continues for investment grade European issuers. In more positive macro scenarios, there are significant upside risks to our forecast due to the potential for M&A and shareholder payouts to rise from severely depressed levels.

2013 demand outlook

Given historically low yields and the continued decline in the euro area savings rate, we would not be surprised to see the demand for European investment grade credit wane over the course of 2013, particularly in more positive scenarios. That said, we still expect flows to remain, on balance, net positive in 2013. In the near term, ultra-low benchmark rates and recent strong performance should encourage further investment flows into the asset class.

From a valuation perspective, yields on investment grade €-credit are at an all-time low and, while spreads are wide relative to pre-crisis levels, we are rapidly approaching the post-crisis tights (Figure 15). Despite these challenges, we expect demand for credit to be positive next year. First, allocations tend to trail performance and the strong returns from credit in 2012 are likely to generate some trailing demand. Further, the ultra-low level of "safe haven" benchmark interest rates and the dearth of perceived "safe" assets, particularly in the context of continued quantitative easing, make spread products look attractive for fixed-income investors, despite being near post-crisis tights. And with most global investors "underweight" Europe, significant progress towards a long-term resolution of peripheral Europe could prompt global investors to begin re-engaging with European risk assets.

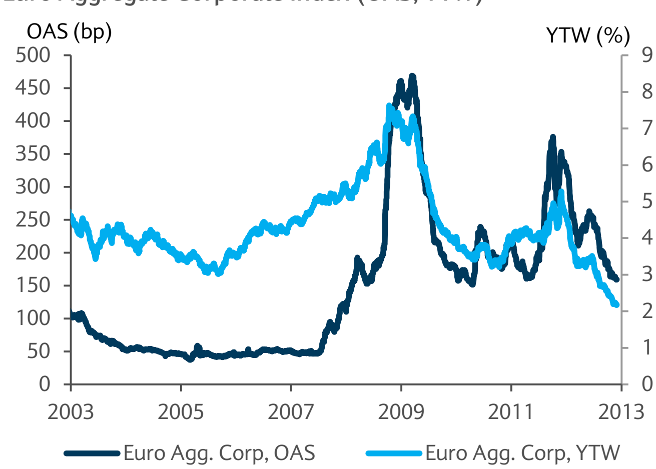
While our base case is for sustained demand in 2013, we must acknowledge the potential for longer-term downside to total returns related to broader investor reallocation out of "low beta" assets, including investment grade credit. As yet, we have seen little evidence of such reallocation and do not expect it to become a theme until 2014 at the earliest.

Peripheral credit

The demand for peripheral credit will be a particularly relevant and multi-faceted question in 2013. Following the spike in issuance in September, many benchmark Spanish and Italian issuers are now well funded through 2013, or beyond. In addition, most peripheral issuers are not heavily reliant upon non-domestic investors to refinance their debt as the majority of their bonds have already transferred to domestic holders.

FIGURE 15

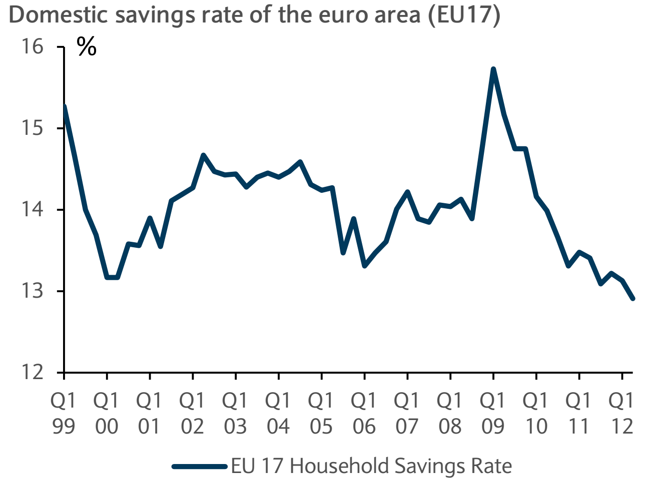
Euro Aggregate Corporate Index (OAS, YTW)



Source: Barclays Research

FIGURE 16

Domestic savings rate of the euro area (EU17)



Source: Eurostat

In our view, where they are able to retain investment grade ratings, we believe that demand will be sufficient to facilitate the relatively limited re-financing needs of Spanish and Italian issuers in 2013. At the same time, we do not expect non-domestic investors to significantly increase their exposures to peripheral credit until there are more meaningful resolutions to the underlying structural issues in Europe. Further, deterioration in the European situation that results in broad downgrades of this space to high yield would be a significant event for credit markets, as we have discussed previously (*European Credit Alpha*, 5 October 2012).

Positioning for 2013

Based on our model forecasts, as well as our overall market view, we remain constructive on European investment grade credit for 2013. That said, as we have highlighted previously, given the volatile range-trading that has characterised large periods of 2012, we believe that short-term tactical positioning will be a key alpha generator in 2013.

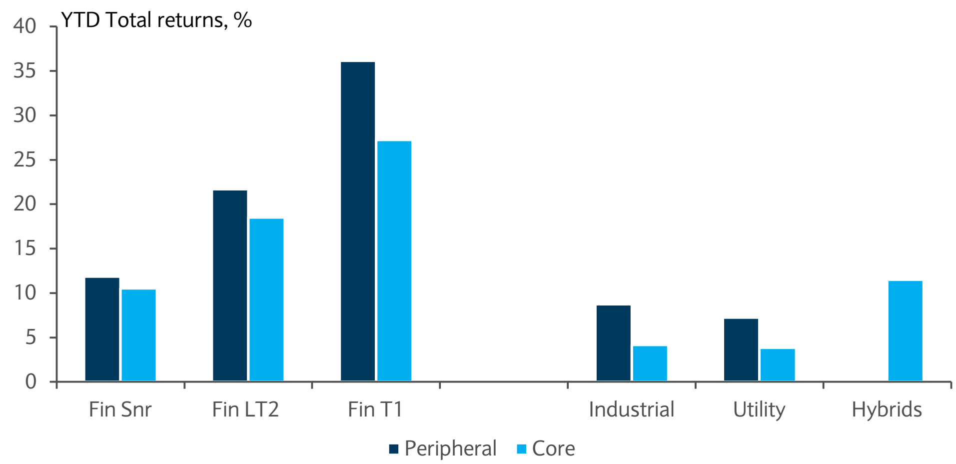
Further, we do not believe that positioning for 2013 is as simple as being "long-beta". In 2011 and 2012, the key drivers of relative performance were investor positioning along two axes: peripherals vs. core; and (sub) financials vs. non-financials (Figure 17). Given our positive returns forecast, we remain constructive on some high-beta parts of investment grade, in particular the subordinated instruments of core European credits. However, in our view this will not be the whole story for 2013.

Given the broad reshaping of investment grade indices, there is now too little peripheral and subordinated debt for investors to rely solely on these parts of their portfolio to express differentiated market views. Peripheral credit now comprises 15.4% of our benchmark index, while subordinated instruments make up just 10% of the index. Thus, even if we assume significant beta-driven outperformance by these sectors (in the context of our 200-225bp excess returns forecast), the impact on investor portfolio performance will be in the context of 20-30bp – even for very large positions (Figure 18). Potentially, similar outperformance could be achieved through curve positioning and credit selection in non-peripheral senior debt, but with significantly less exposure to downside tail-risk scenarios.

Indeed, given the high-beta/low-beta compression that has played out over the course of 2012, investors will need to pull on several "levers" at once to meaningfully outperform their benchmarks. As discussed above, we recommend that investors overweight the 3-5y and 5-

FIGURE 17

Index total returns, 2012 YTD (30 November 2012)



Source: Barclays Research

FIGURE 18

Performance scenarios, Euro Aggregate Corporate Index

	Weight	Out performance (bp)	Portfolio Overweight (0% = Benchmark) -50%	-25%	0%	25%	50%	75%	100%
Periph	15.4%	150	-11.6	-5.8	0.0	5.8	11.6	17.3	23.1
Sub	8.9%	400	-17.8	-8.9	0.0	8.9	17.8	26.6	35.5
Hybrid	0.9%	100	-0.4	-0.2	0.0	0.2	0.4	0.7	0.9
Core Senior	59.5%	25	-7.4	-3.7	0.0	3.7	7.4	11.1	14.9
Non-European	15.4%	25	-1.9	-1.0	0.0	1.0	1.9	2.9	3.8

Source: Barclays Research

7y parts of the curve, versus the wings, and overweight BBB credits we believe are likely to retain an investment grade rating on an 18-24 month horizon. We walk through other key recommendations in the following pages.

Peripherals vs. Core

Peripheral credits remain exposed to weak economic growth and substantial credit rating risk that is de-linked from the underlying credit story. This is particularly true in Spain, where there is the potential for a two-notch downgrade of the sovereign to transition almost all Spanish credits to High Yield indices. We have discussed this topic in significant detail (see: *Assessing risk/reward in peripheral credit*, 5 October 2012), and provide our summary recommendations here:

- Our base-case scenario remains one of "muddle through" in which downgrades of the Spanish sovereign are limited to one notch. In this case, the majority of Spanish banks will migrate to high yield (with the notable exception of Santander) but most Spanish non-financial credits retain investment grade ratings next year.
- In that base-case scenario, we would expect peripheral credit to outperform over the full year. That said, given the continuing overhangs, we believe peripheral credit will remain a "range trade". Thus, investors will need to actively trade the space to add alpha, reducing exposure as peripheral premia decline and becoming more constructive as valuations cheapen. With peripheral credit currently near the tight end of its 12-month range, we would enter the year with a moderate underweight and look to add as peripheral premia increase. We expect this to be a key tactical trade over the course of the year.
- We prefer Italian to Spanish risk in investment grade credit, given the relatively higher ratings of the Italian sovereign (Baa2/Neg, BBB+/Neg, A-/Neg) and stronger growth in that economy relative to Spain (Baa3-/Neg, BBB-/Neg, BBB/Neg).

Financials vs. Non Financials

With the bulk of bank rating changes likely behind us, and the majority of subordinated instruments already excluded from investment grade indices, we believe that investment grade financials will be a less volatile sector moving forward. Further, given the meaningful increase in capital ratios, reduced exposure to the periphery (of non peripheral banks), initial moves towards a banking union and (potentially) a supra-national back-stop in the form of the ESM, European banks is slowly becoming a less risky sector than it was a year ago.

That said, senior unsecured paper issued by core banks has performed well over the year to date, and now trades only slightly wide of non-financials (Figure 20). Further, as our bank analyst team has repeatedly highlighted, regulatory changes will, in the long term, push down on the recovery value of senior unsecured debt (due in particular to ring-fencing and bail-in legislation). Hence, we do not think that senior unsecured bank debt is particularly attractive and see limited room to outperform at current levels.

Instead, with subordinated instruments still offering a significant premium to senior bonds, we recommend investors move down the capital structure in the financials complex. Specifically, given our broader theme of sector right-sizing, we believe subordinated bank paper within those jurisdictions such as the US, UK and Switzerland, where balance-sheet reduction and capital ratio increases are more progressed, present attractive opportunities. In addition, we highlight that insurers continue to look cheap as a sector, particularly at the subordinated level, and are significantly less exposed to the sovereign risk issues that have plagued European banks over the past two and a half years. We thus recommend Overweights in the subordinated paper of "core" banks and European insurers. We discuss positioning in this space in more detail in the Global hybrids section.

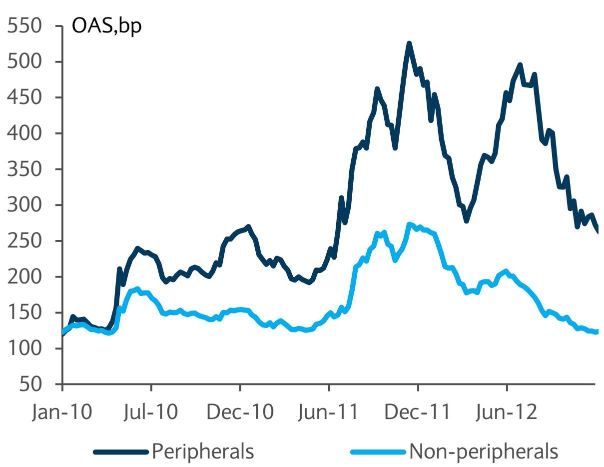
Lastly, we continue to believe investors should tread cautiously with respect to the peripheral banks – with the possible exception of covered bonds. With peripheral premia having declined in recent months, we believe investors should be underweight peripheral risk for now. While the Spanish banking system is on the (long) path to consolidation and right-sizing, fundamentals will likely remain under pressure in the near term. In addition, there is no ratings buffer versus the sovereign, and therefore there is a very reasonable chance that many of the senior securities issued by the Spanish banks will transition to high yield this year. In Italy, the sovereign-ratings buffer is considerably higher; however, that banking system has yet to forcefully address the rising NPLs and low coverage ratios. We thus also see ongoing risks in the Italian names as well.

Sector/rating positioning within non-financials

Within non-financials, we believe it is necessary to balance cyclicality, peripheral exposure, and current valuations in our credit sector recommendations. Given the growth outlook, we prefer taking exposure to less cyclical credits and those sectors/names where restructuring, consolidation and capacity reduction are already under way. Further, given our positive view on credit spreads, we have a general bias towards overweighting BBB credits within those sectors we favour and underweighting tight trading, low beta credits.

FIGURE 19

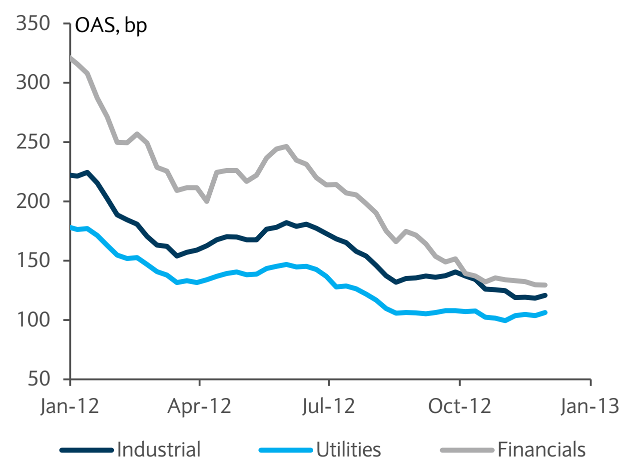
Peripheral European credit vs. core European credit



Note: Senior 3-7year bonds. Source: Barclays Research

FIGURE 20

Core European financials vs. core European non-financials



Note: Senior 3-7year bonds. Source: Barclays Research

In this context, we emphasise our analysts' Underweight sector ratings on Autos, Building Materials, Retail, and Consumer (relatively tight spread cyclical sectors), as well as the Underweights in Pharmaceuticals, Oil & Gas, Chemicals, and Diversified Manufacturing (tight trading, defensive sectors likely to underperform in our base case).

In addition, a theme of balancing peripheral exposure drives our sector ratings in the Telecom (Market Weight), Utilities (Market Weight), and Aerospace/Defence (Underweight) sectors. Heavy exposure to Finmeccanica drives the Underweight in Aero/Defence, while the Market Weights in Telecoms and Utilities balance relatively wide sector spreads against substantial peripheral exposures. We believe tactically trading the Telecoms and Utilities sectors will be key during the course of 2013.

Lastly, we also highlight that for some tight trading names in senior there is the potential to take more attractive subordinated exposure via hybrids. We have viewed the corporate hybrid space as an attractive part of the market for some time, and despite a strong rally we continue to believe the space represents reasonably attractive relative value. Please refer to our global hybrids section for more details.

Cash vs. CDS

CDS-Cash basis has been consistently positive through 2012 (Figure 22). Until the strong demand for cash credit breaks down, we expect this bias to continue, at least to some extent. That said, we expect the size of the basis to remain broadly directional, at least in the initial period of any move wider/tighter as the dynamic of cash investors adding/removing CDS hedges is likely to persist while the strong supply/demand technicals in the cash market provide a stabilising force there.

Thus, we believe investors should look to tactically trade the basis, selling (buying) basis when it moves to very positive (negative) levels versus history – particularly at times when we have a constructive (negative) tactical view. At current levels we recommend that investors who can sell basis do so, or rotate their longs into CDS, to benefit from the increased carry. Our measures of the CDS-cash basis are currently around +25bp for senior unsecured credit (for both financials and non-financials) versus the negative levels reached in January and the wides of c.+50bp/+75bp for non-financial/financials, respectively.

FIGURE 21

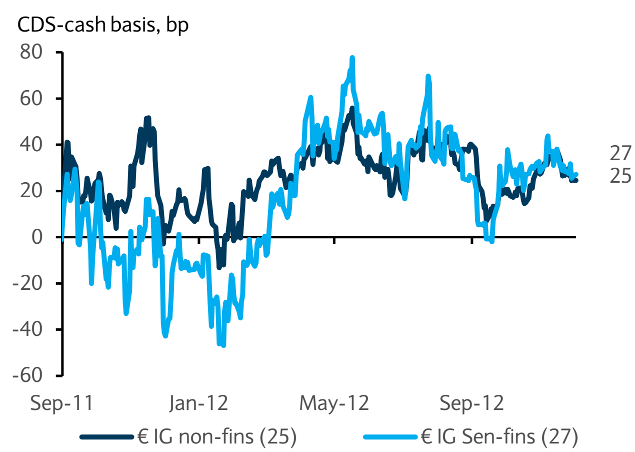
Non-financial, OAS by sector and rating (ex. peripheral)

	AA	A	BBB
Basic Industry		71.5	147.6
Capital Goods	56.6	81.2	156.6
Consumer Cyclical	66.0	86.6	195.1
Consumer Non-Cyclical	59.9	81.3	122.2
Energy	61.1	84.0	144.1
Technology	50.3	72.4	171.5
Transportation		123.9	166.6
Communications		100.9	138.6
Industrial Other		104.4	175.3
Utility		94.6	144.6

Note: As of 3 December 2012, Senior only. Source: Barclays Research

FIGURE 22

Euro unsecured, CDS-Cash basis



Source: Barclays Research

STERLING HIGH GRADE

More work, less payoff

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- **In our base case, we forecast that our Sterling Aggregate Corporate Index will generate 300-400bp of excess returns in 2013. This reflects our expectations of a marginal rally in credit spreads, led by the 7-10y part of the curve.**
- **Similar to Euro IG, we recommend investors take selective credit risk by positioning in Insurers, subordinated bank debt, corporate hybrids and BBB credits that are likely to retain investment grade ratings even in more negative growth scenarios.**
- **In our view, the pick-up in carry and spread duration of sterling credit over euro credit suggests that GBP indices will outperform again in 2013. Further, on a like-for-like measure, we still view sterling cash as cheap relative to euro equivalents and fair valued versus dollar markets.**
- **Finally, we note that in a downside scenario in which Spanish credit migrates to high yield (following a sovereign downgrade), sterling credit could outperform. Following the initial sell-off, which we would expect in such a scenario, high-quality, non-euro credit could be subject to a strong technical bid as investors recycle their cash into perceived "safe" assets.**

2012 perspectives

Sterling credit produced extraordinary returns in 2012, both in total and in excess of gilts. Through the end of November, the 2012 YTD total returns of our Sterling Agg Corporate Index stood at 1518bp, the most since its inception and ahead of the 1470bp returned in 2009. Excess returns are slightly lower, but still impressive, at 1135bp, the second-best after 2009 (1479bp). Indeed, sterling corporate excess returns outstripped those from EUR (795bp) and USD (672bp) credit, albeit due to the outsize duration of the sterling index.

Returns reflect several factors, including the wide levels at which spreads began the year and the long duration of the sterling index, which naturally makes returns more volatile and extreme in both "risk-on" and "risk-off" periods. That said, to some extent the duration "uplift" to returns has been muted by the steepening of both the yield and spread curves. Further, the tailwind of peripheral outperformance was a relatively minor driver of returns given their very low weighting in our benchmark sterling corporate index.

Across the curve, the 7-10y bucket produced the highest returns, as did BBB credit given the strong performance of risky assets. Across sectors, financials outperformed, led by their subordinated instruments. For non-financial sectors, Media and Transportation led, while Pharmaceuticals and Autos lagged.

Supply

This is an edited extract from 2013 Supply Outlook, 3 December 2012

Through end-November, 2012 gross issuance was £45.1bn up £10bn (30%) versus the same period in 2011. We expect gross sterling issuance to accelerate in 2013, led by non-financial issuers. This implies an even sharper pick-up in net issuance as we estimate 2013 redemptions will be £26.3bn, down sharply from £56.7bn in 2012.

FIGURE 1

2013 unsecured, sterling corporate issuance estimates

		2013			2012	
		Gross	Redemptions	Net	Gross	Net
GBP	Fin	20.0	18.2	1.8	17.5	-30.0
	Non-Fin	35.0	8.0	27.0	30.0	20.8

Source: Dealogic, Barclays Research

On the financial side, unsecured bank issuance is likely to remain limited, particularly from UK banks given the Bank of England's Funding for Lending Scheme. Further, UK building societies are likely to focus any debt issuance in the developing sterling covered bond market given the relative cost of funding. Instead, we are likely to see an ongoing flow of opportunistic deals from US, Scandinavian and Australasian issuers. We also expect a reasonable flow of non-bank financial supply from Housing Associations and Universities.

On the non-financial side, we expect issuance to remain high driven by the secular factors influencing European non-financial issuance. Further, we see several sterling-specific factors bolstering non-financial supply, including: demand for credit from retail and institutional investors; the need for highly rated securities against a backdrop of continued down-rating of global financial issuers; and a desire from issuers to term out their liabilities, given the receptiveness of sterling investors to multi-decade bonds from highly rated credits.

Non-financial issuance is likely to remain dominated by utilities (£6.7bn issued YTD), as the natural issuers of long-term liabilities. We would also expect some pick-up in issuance from Telcos, alongside other infrastructure-type names such as the major UK airports (BAA, for example, has regular funding needs). Pharmaceuticals may also come to the sterling market in 2013, and could find a positive reception given the dearth of very-highly rated names from other sectors; similar arguments apply to the Energy sector.

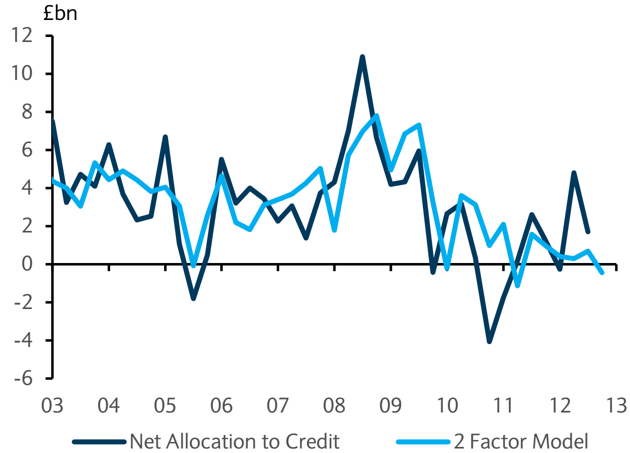
Demand

We have previously looked in detail at demand dynamics within the sterling credit markets and identified key drivers of asset allocation for each of the major investor bases ("Demand side economics", *European Credit Alpha*, 12 August 2011). In Figure 2 through Figure 5 we update our analysis, and present our forecasts through year-end.

With spreads approaching post-crisis lows and yields at all-time lows, we expect inflows to investment grade credit from life assurers and retail investors to fall next year. Indeed, we are likely to see at least one quarter of outflows from life assurers in 2013 (Figure 2) if yields remain near current levels. In contrast, pension fund and general insurance allocations are likely to be relatively strong unless we see a sharp fall in equities. Longer term, an increasing volume of assets will flow into the UK pension industry following the introduction of legislated employer pension contributions – this should support inflows into all asset classes, including credit.

FIGURE 2

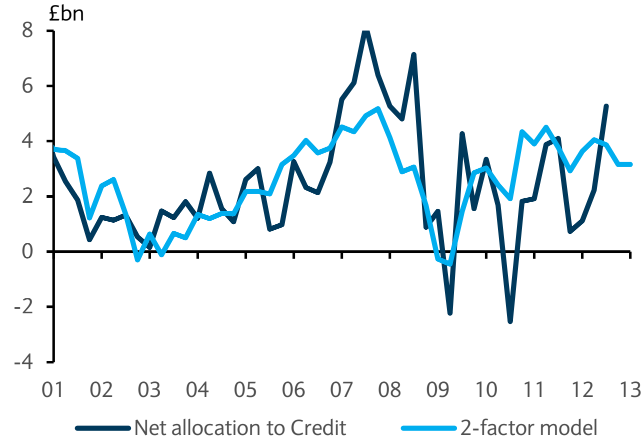
Quarterly allocations to £-credit, life assurers



Source: ONS, Barclays Research

FIGURE 3

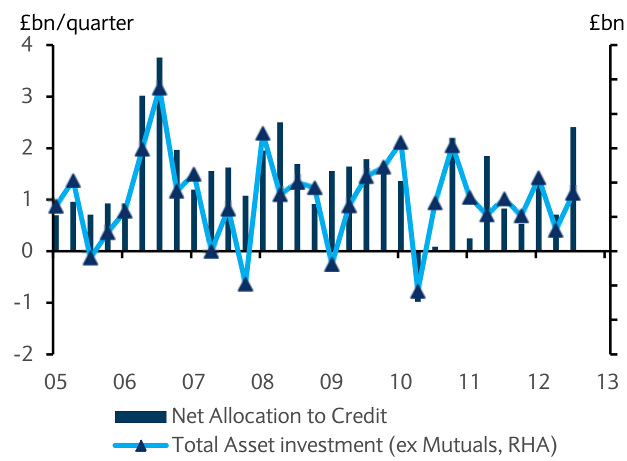
Quarterly allocations to £-credit, pension funds



Source: ONS, Barclays Research

FIGURE 4

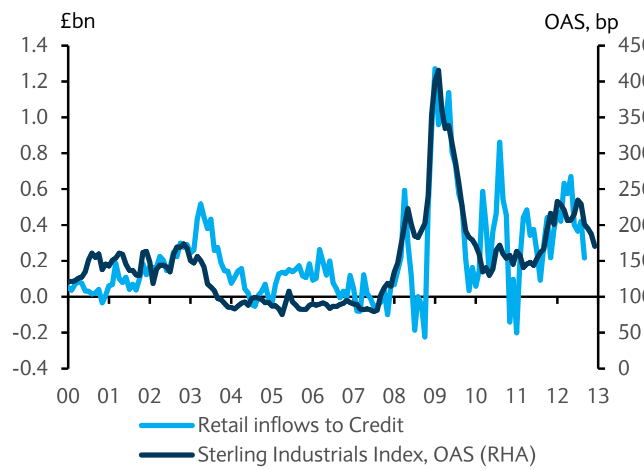
Quarterly allocations to £-credit, general assurers



Source: ONS, Barclays Research

FIGURE 5

Monthly allocations to £-credit, retail investors



Source: IMA, Barclays Research

Finally, we believe that in a scenario in which Spain is downgraded to mid/low BB and the bulk of Spanish credits follow the sovereign into high yield, sterling credit could find itself subject to unusual demand technicals. Given the size of Spanish credit across EUR, GBP and USD credit markets (c.$125bn total) a large volume of cash would eventually need to be re-cycled back into investment grade indices. Further, given that such an event would likely be accompanied by a general aversion to European and euro-denominated credit, demand for high-quality, non-EUR cash could cause a significant squeeze in the GBP credit market.

Valuations and Returns forecast

We have taken the same approach to our sterling credit returns forecast as outlined for euro credit, applying our macro-driven spread model to several economic scenarios. The implied returns for sterling credit in our base and upside scenarios are laid out below.

FIGURE 6

2013 raw excess returns forecasts, Sterling Aggregate Corporate Index

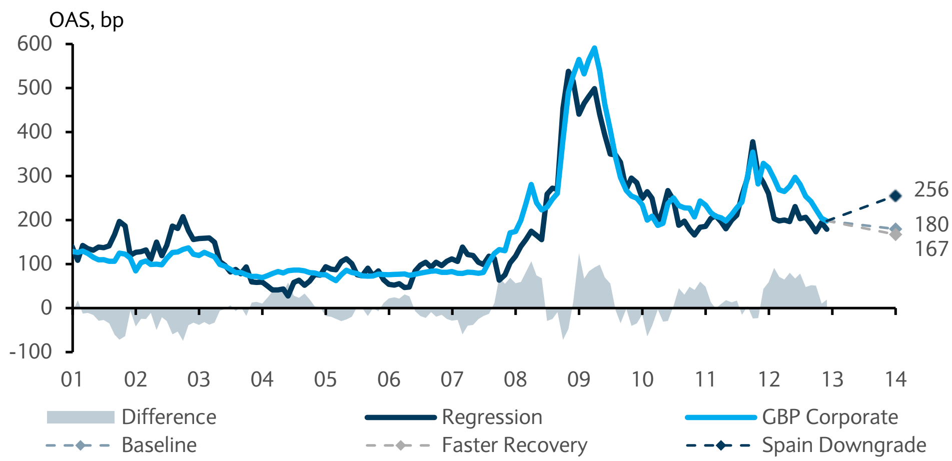
	Baseline	Faster Recovery		Baseline	Faster Recovery
GBP Corp	3.0%	4.7%	1-3y	2.2%	2.3%
GBP Non-Fins	2.4%	4.0%	3-5y	3.2%	3.4%
			5-7yr	3.1%	4.5%
AA	1.7%	2.1%	7-10yr	4.4%	6.8%
A	2.3%	3.1%	10-20yr	2.6%	4.9%
BBB	5.0%	7.6%	20yr+	2.6%	5.0%

Source: Barclays Research

Based on this analysis, we forecast 2013 excess returns of 300-400bp, driven by the BBB rating bucket. Higher-rated bonds are expected to generate returns in line with their current carry plus roll-down. Across the curve, we continue to highlight the 7-10y part of the curve as attractive, despite its strong performance over 2012. That said, we note that our rates team disfavours the 10y part of the gilt curve versus the wings; hence, this positioning may not be the best for total-return investors.

FIGURE 7

Barclays Research OAS model, 2013 scenario analysis



Source: Barclays Research

Unsurprisingly, we view the risk to this outlook as being broadly the same as those outlined for the euro credit markets. However, we would note that the sterling credit market is less exposed to peripheral credits than euro indices (15.2% vs 4.6%), and to Spanish credit in particular (4.6% vs 1.5%). Thus, we would expect it to outperform in scenarios where broad swathes of Spanish credit migrate to high yield indices. Further, we would expect the initial reaction of domestic investors to any rise in gilt yields to be buying from ALM and LDI investors, which should help keep a lid on credit yields in the near term. This should help to mitigate (at least in part) any risks associated with a significant rise in gilt yields.

Cross currency performance

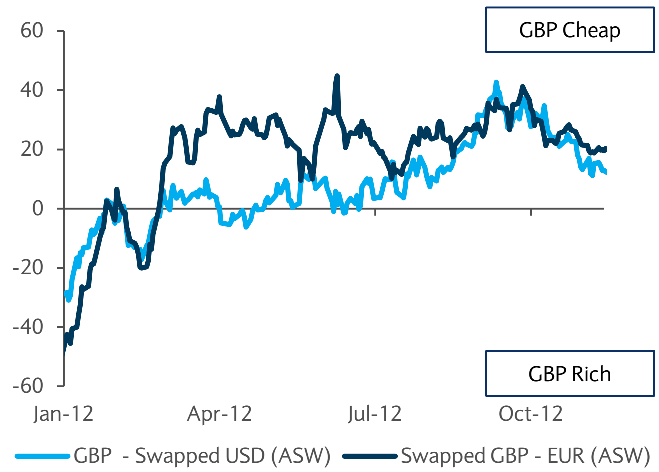
Given the significant outperformance of sterling credit over the past 12 months, it is fair to question whether it is at risk of underperforming in 2013. This is particularly relevant, given the sharp uptick in supply (both gross and net) that we expect for sterling markets, outright and relative to €- and $-unsecured.

We recently highlighted that we believe, despite the returns outperformance, that on a like-for-like basis sterling credit remains cheap relative to €-unsecured, and no worse than fair value relative to $-unsecured. This was a view we held across both non-financials, and senior unsecured bank paper (*European Credit Alpha,* 9 November 2012). While levels have adjusted somewhat since then, we believe that those arguments still hold (Figures 8 and 9).

Further, given our constructive outlook on credit spreads in general, the Sterling Aggregate Corporate index has several mechanical advantages over the Euro Aggregate Corporate Index, namely, longer duration (pushing up price returns from any spread compression) and higher carry, which is likely to make up a significantly larger share of returns in 2013 than it did in 2012. Thus, we are comfortable remaining overweight sterling credit versus euro indices for another year.

FIGURE 8

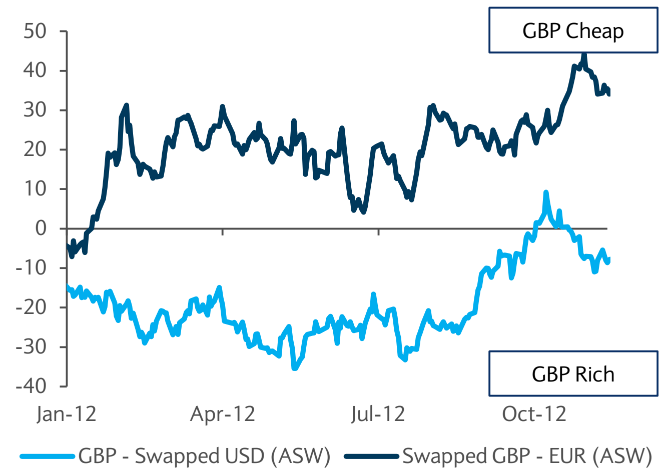
Cross currency relative value, Senior unsecured financials



Source: Barclays Research

FIGURE 9

Cross currency relative value, Senior non-financials



Source: Barclays Research

EUROPEAN HIGH YIELD STRATEGY

Rolling with the punches

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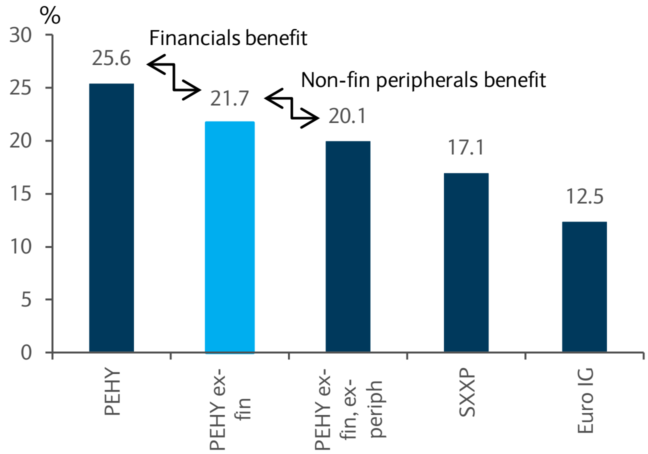
- **We expect European High Yield ex-financials to generate total returns of +5.5-7.5% in 2013.**
- **Strong demand dynamics should support returns again in 2013. Relative value remains attractive versus many other asset classes, and a continued amelioration of the peripheral crisis should further attract global demand.**
- **Euro HY default rates should tick slightly higher y/y, but end the year in the 2.5-3.5% range – relatively low considering the dour economic backdrop.**
- **A mass downgrade of Spanish/Italian corporates from IG to HY is a key risk; we do not expect this to occur in 2013, although it will probably remain a market overhang for much of the year.**
- **The peripheral concession should continue to decline, while pressure will likely build on many of the tighter trading cyclical names and sectors.**
- **We believe risk/reward is most attractive in single-Bs. We find it challenging to see European BBs outperform given their relatively high exposure to cyclical sectors/names. Austerity measures and weaker growth should weigh greatest on CCCs, which appear tight by most measures.**
- **Despite our expectation for a grind tighter in spreads, we remain relatively cautious on duration exposure, particularly in BBs, given their greater rate sensitivity.**
- **HY supply has credible potential to top 2012's record year; we look for 50-60bn euro-equivalent of new issuance (including USD issuance by European corporates), compared with 2012's YTD €54bn.**

More of a good thing

Our Pan European High Yield Index has posted an impressive +25.6% total return through 30 November – the second-best year on record and a stark reversal of 2011's -2.4%. Per Figure 1, the 3.9% YTD Index performance boost from financials (versus PEHY ex-fins) was much greater than the incremental return performance from non-financial peripherals (+1.6% to non-fin HY). The huge contribution from financials was a factor of both: 1) HY financials returns of +41% YTD; and 2) financials growing from 16% of the PEHY Index to 26% in 2012 (Figure 2). Non-fin peripheral credit performance should not be understated though. The average spread differential between peripheral and non-peripheral credit (non-financial) decreased from +313bp at the beginning of 2012 to roughly +100bp currently (Figure 3).

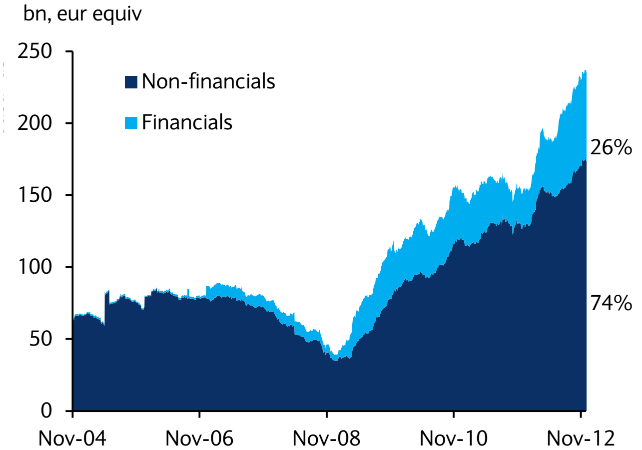
Outright valuations are much less attractive than a year ago, while the economic growth picture is arguably worse, especially in Europe. Macro uncertainty remains a major concern, although it has been partially alleviated by recent ECB policies (eg, OMT) and progress on Greece. Despite the fundamental challenges, the global search for yield continues, and European HY remains attractive versus other opportunities (Figure 4). Accordingly, we expect PEHY to perform well on a relative basis next year (+5.5-7.5% ex-fin total returns in FY13), although well behind 2012's standout year.

FIGURE 1
YTD 2012 total returns



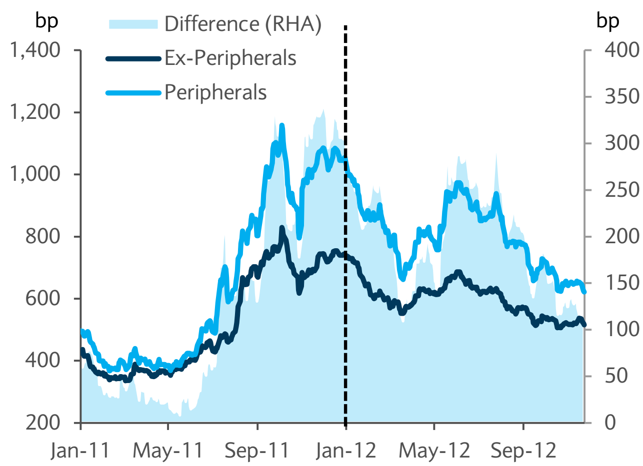
Source: Barclays Research

FIGURE 2
Pan Euro HY Index market value



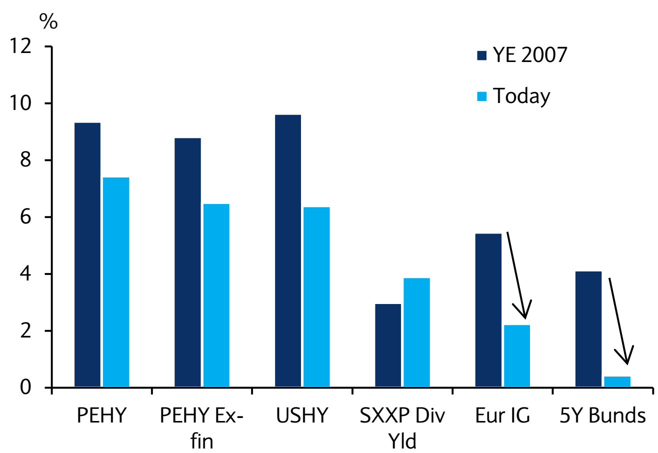
Source: Barclays Research

FIGURE 3
PEHY ex-fin OAS, peripheral vs non-peripherals



Note: Peripherals includes issuers in the PEHY ex-fins index whose country of domicile is Spain, Italy, Portugal or Greece. Source: Barclays Research

FIGURE 4
Relative yield levels



Source: Barclays Research

It may seem incongruous to expect positive HY returns when Europe is in/on the brink of recession. We believe European credit has experienced a breakdown in the typical relationship between the growth cycle and the credit cycle, largely traceable to the overwhelming central bank support from both the ECB and the US Federal Reserve. We note that it is in the late stage of the credit cycle where we historically have seen HY returns veer towards flat or even negative, on average. That said, despite the weak growth picture, with limited near-term maturities, lending conditions still only moderately tightening, default rates low, and central banks still very accommodative, we believe European credit has been bolstered into a tenuous "mid-cycle", with some room left for bond market upside. If central bank policies begin to lose efficacy and/or issuers become more aggressive around their balance sheets, we would become more concerned; however, we do not expect such scenarios to develop in the near term.

Demand technicals, a key driver of our returns forecast, should remain strong next year. A possible concern is a re-allocation into equities, which we do not expect to happen on a widespread basis in 2013. The potential for massive supply – both primary and via fallen angels – is a more worrisome risk. We believe that the primary market may post a second consecutive record year, driven by continued terming out of the maturity wall and more debut issuers transitioning funding from loans. This should be absorbable, particularly as significant reliance on the USD bond markets may continue.

While we do not expect a mass migration of Spanish and Italian fallen angels in 2013, this will likely remain a key market overhang. In the event that it does occur, the HY market could experience a near-complete transformation in relatively short order, which would likely drive spreads meaningfully wider as the prospects of absorbing such a large amount of paper are nothing short of daunting. More broadly, if the peripheral crisis really does return in force, the potential to see a disorderly reversal in flows out of HY is material, further exacerbating a market adjustment. For perspective, Lipper reported €3.4bn of fund outflows in June-Sept 2011, wiping out basically the entire H1 11 inflow. Again, while not our base case, nervousness around the sovereign situation can crystallise into outflows quickly and is obviously worth monitoring very closely.

Finally, lower yields and pockets of deteriorating fundamentals will render name selection more important in 2013. The year should be less of a beta trade in European HY, providing greater opportunities for fundamental analysis-based alpha generation. Underlying this view, again, is the expectation that central banks remain accommodative, inviting ongoing demand for yield and risk assets.

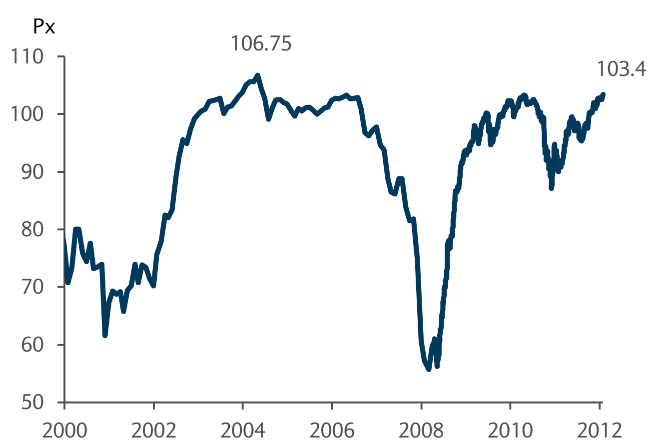
2013 total return forecast

We expect the PEHY ex-fin market to generate total returns in the +5.5-7.5% range in 2013. Our forecast is based on a sustained bid for yield, with continued slow (and likely choppy) progress on the European sovereign situation. Economic growth will likely stay challenged for at least H1 in northern Europe, and beyond in the periphery. Thus, fundamental improvement, on average, will likely not be impressive. However, demand for European HY should stay robust and arguably keep yields 'low' considering the macro backdrop – a scenario we think is sustainable for a prolonged period.

The current price of the PEHY ex-fin Index is ~103.4, and the YTW is at a record low of 6.3% (Figures 5 and 6). Risk/reward appears skewed to the downside on nearly every historical metric. Not surprisingly, our macro models, based on lending standards, GDP growth,

FIGURE 5

PEHY ex-fins historical average price



Source: Barclays Research

FIGURE 6

PEHY ex-fins historical YTW

Source: Barclays Research

FIGURE 7

Macro model return projections

	Unchanged	Baseline	Faster recovery	Growth-driven, Spain downgrade	System shock
PEHY industrials OAS (bp)	534	552	442	938	1486
PEHY industrials yield (%)	6.4	6.6	5.5	10.5	15.9
PEHY industrials price (pts)	103.5	102.9	106.5	90.1	72.1
Price return (%)	0.0	-0.6	3.0	-12.9	-30.3
Default loss (%)	1.9	1.9	1.6	2.6	2.6
2013 total return estimate (%)	4.5	3.9	7.9	-9.4	-27.5

Source: Barclays Research

inflation, and market volatility, suggest HY will be unchanged to even modestly wider in 2013, based on current conditions (see the Euro IG section of this Outlook for the inputs used). Assuming default rates stay in the +2.5-3.5% range, this implies +3.9-4.5% of total returns next year (Figure 7).

Nevertheless, and despite the fundamental backdrop, we believe the underlying demand trends will be incrementally supportive of HY spread tightening next year, arguably to a point where spreads do not fairly compensate investors for overall risk. But we think this kind of dynamic could persist for quite a while – possibly well over a year. If we assume the price of the Index returns to its historical peak, 106.75, with 3% defaults, 2013 returns would be roughly +8%, with spreads 110bp tighter to +415bp; the OAS traded in the mid-350s in February 2011, although yields were nearly 7% at that point.

Incorporating the current much lower all-in yields, we think it is reasonable to assume spreads grind 50-60bp tighter in 2013 given sustained demand, to an OAS of ~470bp and YTW of 5.75% (assuming risk free rates yields do not move materially). That implies a FY total return of roughly +6.4% (Figure 8); a FY13 total return range of +5.5-7.5% for PEHY ex-financials seems a reasonable base case to us.

FIGURE 8

PEHY ex-fins total return estimate for 2013

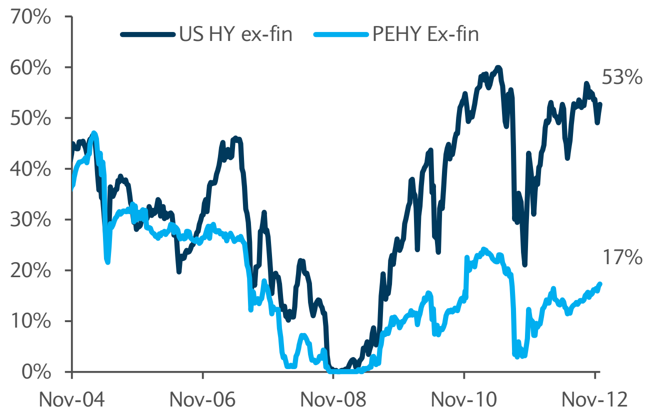
	Contribution
Today's yield	+6.3%
Estimated spread change	-60bp
Duration	3.3yr
Default loss	-1.9%
2013 total return estimate	+6.4%

Source: Barclays Research

That said, it is important to recognise the extent of potential downside risk at current levels. If eurozone progress reverses, the European economy stumbles, or there are significant sovereign downgrades, a significant correction could emerge. In Figure 7, our model suggests -9.4% to -28% return scenarios in some of the more draconian situations (-0.5% GDP growth, average V2X of 35% for the former; -3.0% GDP growth, average V2X of 50%, and 70% of banks net tightening lending standards for the latter). While not our base cases, the downside potential is material and needs to be incorporated into risk/reward measurements across portfolio positions.

FIGURE 9

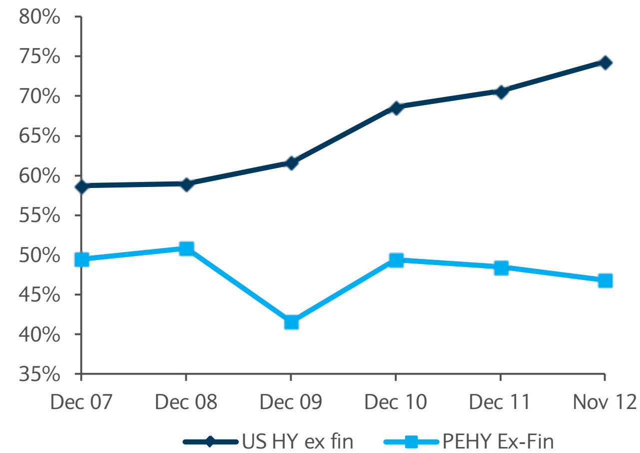
US HY ex-fin vs PEHY ex-fin, proportion of index where YTW<YTM



Source: Barclays Research

FIGURE 10

US HY ex-fin vs PEHY ex-fin, percent of index that is callable



Source: Bloomberg, Barclays Research

Finally, a key consideration at current yield levels is the degree to which call constraints can limit upside. Per Figure 9, this is becoming a meaningful issue for Euro HY, as ~17% of the market is at least to some degree pricing in the chance of a call (YTC<YTM); at this point, the actual number of bonds fully priced up to a 1% or 0% YTC is still very small. Nevertheless, while Figure 9 does not imply material call constraints as of yet, it does signal more limited upside and increasingly negative convexity. Yet, relative to US HY, Europe HY has a much less negatively convex profile; around half of the bonds in US HY are pricing in at least some degree of a call (and a significant portion is already call constrained).

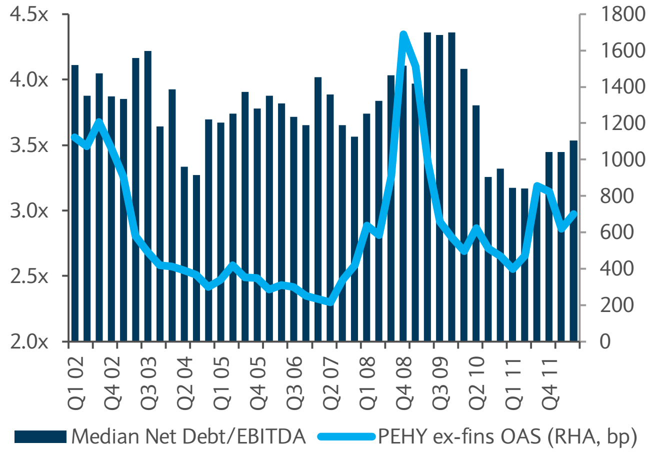
A partial driver of this divergence between the two markets is that, with more than €35bn of non-financial fallen angels over the past two years in Europe, the overall percentage of callable paper in the PEHY market has actually declined (Figure 10) as IG-issued bonds tend to not have hard call language. This contrasts to the US, where the proportion of callable paper continues to climb. So while call constraints are an increasing concern to watch, we believe the availability of non-callable paper in Europe not only allows for achieving our forecast returns, but even is a net positive from the demand side, relative to US HY.

Credit fundamentals

From a fundamental perspective, the PEHY market remains in reasonable shape. Per Figure 11, while median net leverage has crept up modestly over the past several quarters, it still remains below its historical average. Looking into 2013, we would expect issuers to remain mostly cautious in terms of significant re-leveraging strategies given the many uncertainties at the macro level. However, our expectation of continued top-line pressures implies that leverage will likely skew higher, rather than lower, over the next 12 months, although we would not expect it to return to 2002 or 2009 levels anytime soon. As discussed earlier, given significant policy support, we do not believe European HY is yet on the brink of the latter stages of the current credit cycle; on the aggregate level, balance sheet preservation and restrained growth likely allow for some further upside in valuations.

FIGURE 11

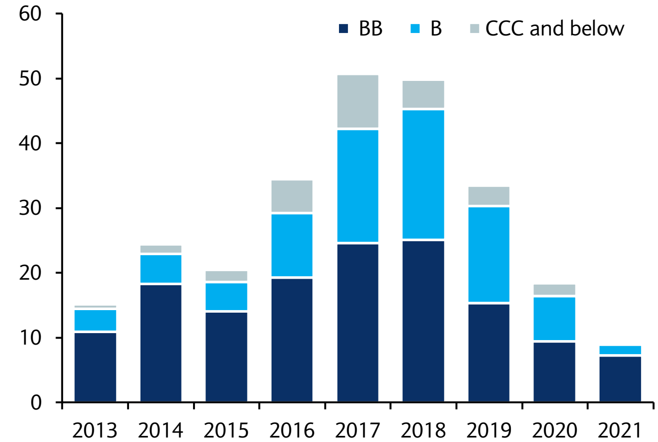
Median LTM net debt/EBITDA for PEHY ex-financials



Note: Based on constituents in the Barclays Pan European HY ex-fins index. Source: S&P Capital IQ, Barclays Research

FIGURE 12

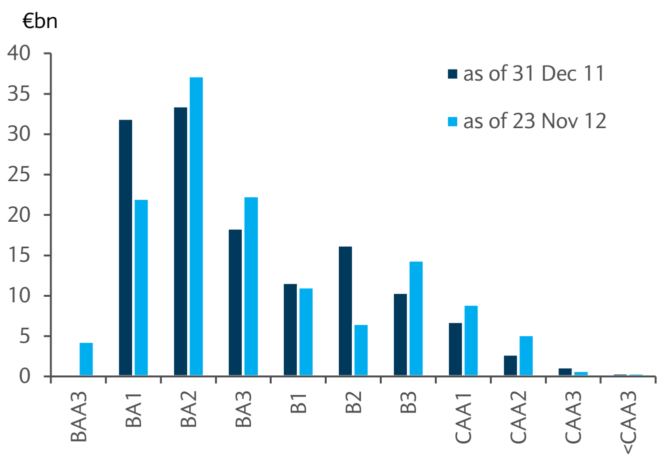
Maturity profile by quality, €bn equivalent



Note: Includes USD maturities. Source: Barclays Research

FIGURE 13

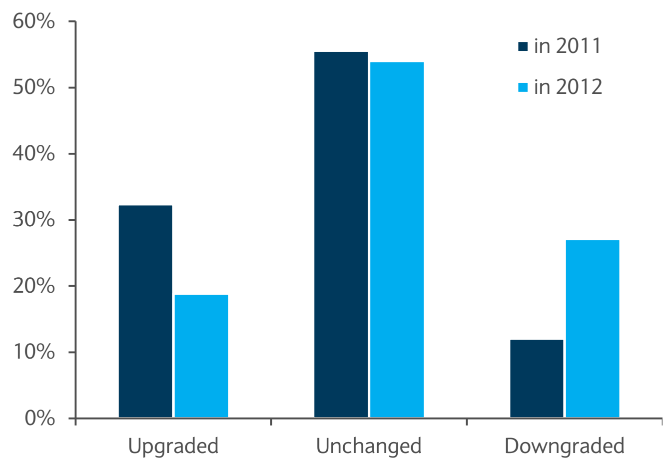
Beginning of 2012 PEHY ex-fins Index, 1 Jan vs current ratings distribution



Source: Barclays Research

FIGURE 14

Beginning of year PEHY ex-fins Index, net ratings moves that year



Source: Barclays Research

The upcoming maturity schedule in Figure12 highlights the relatively limited need for lower-quality issuers to refinance bonds in the near future. As we discuss in more detail later, low all-in yields may drive opportunistic primary deals across HY; again, though, we expect these to be relatively conservative with few instances of significant re-leveraging.

Despite only a modest erosion of fundamentals last year, 2012 saw a substantial deterioration of HY ratings (Figure 13). In 2011, 32% of the ex-fin beginning-of-year Index was upgraded during the year, while only 12% was downgraded. 2012 saw 19% upgraded, and a much larger 27% downgraded (Figure 14). We would expect 2013 to be more similar to 2012 than 2011. However, on the whole, we would expect the investor base to absorb these downgrades relatively well; there will be spots where performance does lag meaningfully on ratings deterioration, but likely only in the more extreme situations.

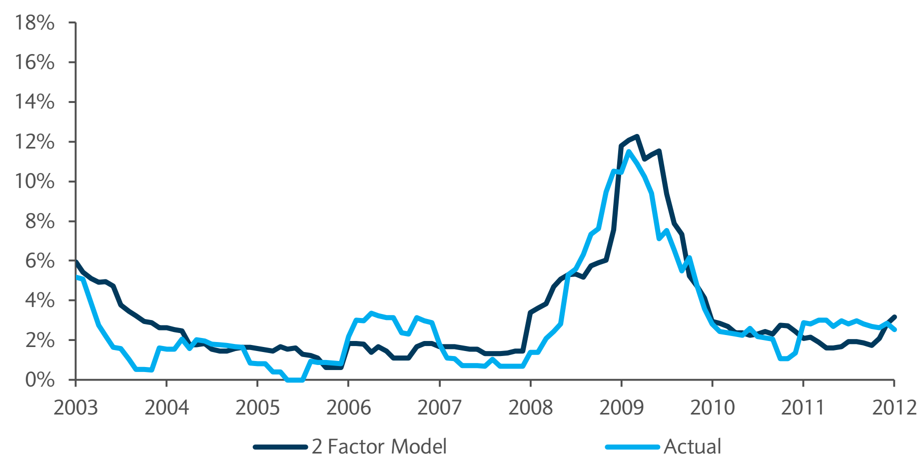
Default outlook

Extraordinary liquidity measures from central banks have helped to ease lending standards in 2012, keeping HY default rates low for the current economic conditions. In fact, despite the sovereign turmoil, European credit is enjoying lower default rates than US credit. Per Moody's, Europe has experienced eight non-financial corporate defaults, totalling $6.4bn of debt (including distressed exchanges) as of end-October; that has translated into an issuer-weighted trailing 12-month default rate of 2.5%. Looking ahead, we expect the issuer-weighted default rate in Europe to remain relatively low in 2013 at 2.5-3.5%.

For a top-down estimate, we use a model framework based on ECB lending standards and HY bond prices (% issuers trading below 70) to predict future default rates; we find both inputs highly correlated to default rates over time. Based on current market conditions, our model predicts a 2013 default rate of 2.5%. As we believe lending conditions may become more restrictive, we re-ran this last model with +20 lending conditions and 15% issuer distress (similar to what we saw the last time lending conditions were at +20); this implies a 2013 rate of 4.1% (Figure 16). We think the pressures on the banking system and ongoing macro risks make this latter scenario plausible.

FIGURE 15

Moody's TTM default rate vs two-factor model



Source: Moody's, ECB, Barclays Research

While estimating default rates from the issuer level up is challenging, doing so did not lead us to change our forecast materially from what our models predict. Likely one of the greatest risks is that more issuers buy back debt in the secondary market at 'distressed levels,' leading to distressed exchanges per the agencies. However, we will not endeavour to predict that potential, other than noting it as a clear risk. Accordingly, we think defaults should be in the 2.5-3.5% range in 2013 – likely modestly higher than today's rate, but still relatively low given the economic backdrop and fundamental challenges many companies in Europe are currently facing. We would expect a par-weighted default rate to be skewed to the lower part of the range given the recent increase in the number of BB-rated, large capital structures compared with single-B and triple-C issuers.

FIGURE 16

Default forecasts under different scenarios using two-factor model

	Lending standards (% net tightening)	% of issuers trading below 70	Issuer-weighted default rate forecast
Using current data	15	2.6%	2.6%
Best Case	10	2.0%	2.2%
Realistic 2013 inputs	20	15.0%	4.1%
Worst Case	30	25.0%	5.7%

Source: ECB, Moody's. Barclays Research

The elephant in the room

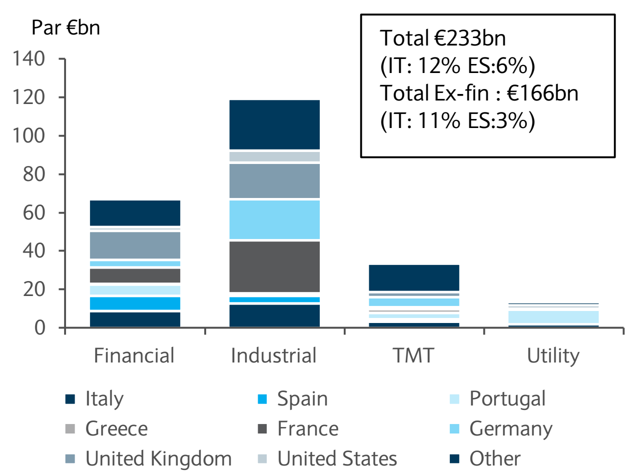
As highlighted earlier, one of the key risks to our 2013 forecast is a further deterioration in the peripheral crisis in Europe. The ratings risks for Spain and Italy are particularly concerning given the knock-on effects on sovereign-linked corporate ratings. In the event of a downgrade of Spain and/or Italy to mid or low double-B, most if not all currently IG-rated Spanish/Italian corporate paper would be pulled down to high yield. Any transition close to this scale would transform the HY market. Figures 17 and 18 contrast the current PEHY market with the (extreme) pro forma one where all IG-rated Spanish and Italian credits enter HY. Pro forma:

- the PEHY Index par value would increase from €233bn today to €436bn, or +87%;
- the PEHY ex-fins Index would increase from €166bn today to €293bn, or +76%; and
- Spanish- and Italian-domiciled credit would represent a huge 57% of the PEHY Index and 51% of the PEHY ex-fin Index, versus 18% and 14%, respectively, currently.

While this type of transformation is not our base case for 2013, its potential remains a clear overhang to the markets. We do not anticipate that this concern dissipates in the near future, particularly given the limited clarity and consistency out of the agencies in terms of Spain and Italy's ratings. That said, we think it is more plausible that sovereign ratings will stabilise near or just below current levels, with limited further sovereign-linked fallen angels

FIGURE 17

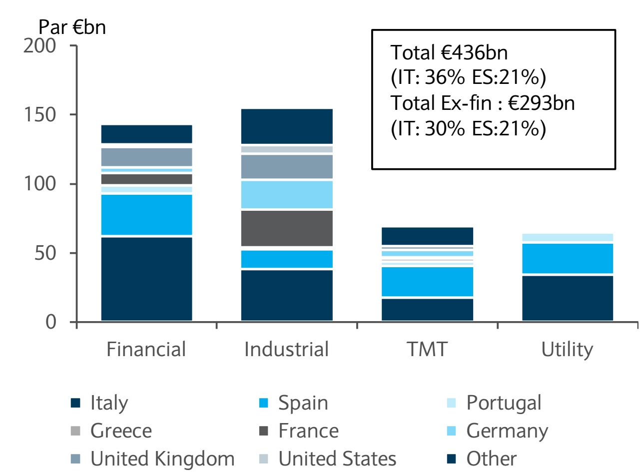
Current PEHY by sector and domicile



Note: Based on par values. Source: Barclays Research

FIGURE 18

Pro forma* PEHY by sector and domicile



Note: *Pro forma to include all currently-IG-rated Italian and Spanish corporate debt; based on par values. Source: Barclays Research in 2013. This latter scenario is clearly much more supportive of HY valuations given the sheer size of the possible downgrades, the question as to how they could be absorbed, and the broader market environment where Spain and/or Italy are driven to mid-BB (or below).

Strategies for outperformance

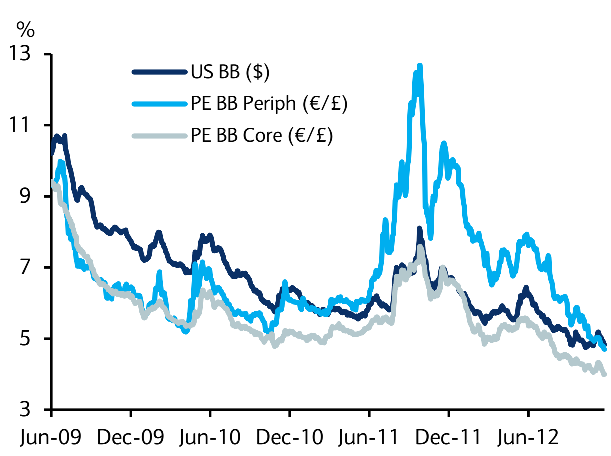
Quality

We continue to favour single-Bs to both BBs and CCCs. Per Figure 19, on a yield basis, core European BBs trade 83bp tight of US BBs, and peripheral BBs now trade 15bp inside of US BBs. We have a hard time justifying these relationships given the macro backdrop in Europe; we find it particularly challenging to see European BBs outperform further given their relatively high exposure to cyclical sectors/names such as the autos, the paper sector, Lafarge, ArcelorMittal, and others. The relationships in the single-B part of the market look more appropriately aligned (Figure 20), with US single-Bs the tightest; in contrast to BBs, single-Bs yields have not even returned to their 2011 lows. Additionally, on a fundamental basis, we favour many more single-Bs, particularly several of the consumer/retail names and some of the lower parts of the capital structures of the higher-quality TMT names.

Triple-Cs, generally, do not offer compelling risk/reward, in our opinion. We believe that austerity measures and weaker growth, especially in Europe, will continue to weigh on markets, particularly in H1 13, and that these pressures are not priced into CCC spreads. At a basic level, CCC spreads look tight to current Eurozone GDP (Figure 21); further, we have started to see a significant uptick in idiosyncratic shocks in this part of the market (re: CEDC, NSINO, IDEABB). We doubt investor support will remain particularly strong if such events continue. Also, while CCCs have been underperforming single-Bs despite the broader market rally in the past few months (Figure 22), we think this trend could continue for some time into next year. Into H2 13, however, we believe prospects for CCCs could improve, assuming defaults stay relatively low and economic growth prospects improve. There are, nevertheless, some CCC opportunities we find attractive on a risk/reward basis, such as the Ardagh PIKs, ONO subs, and House of Fraser '18s.

FIGURE 19

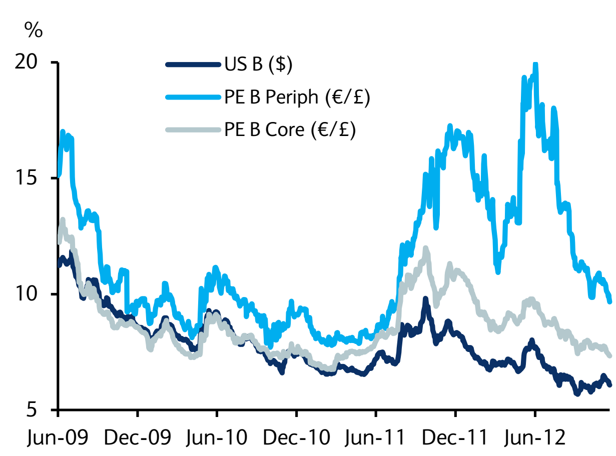
Double-B YTW, by geography



Source: Barclays Research

FIGURE 20

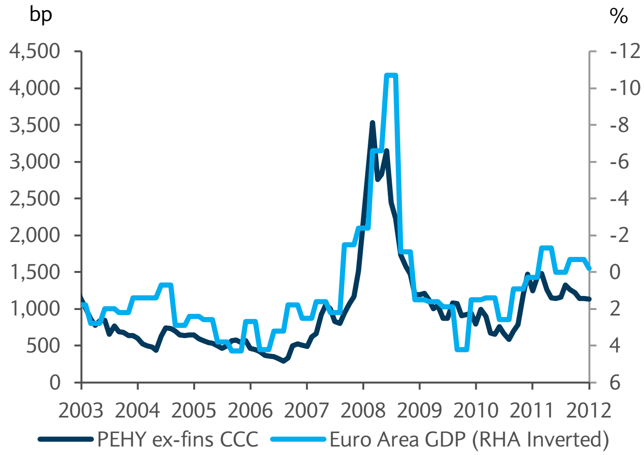
Single-B YTW, by geography



Source: Barclays Research

FIGURE 21

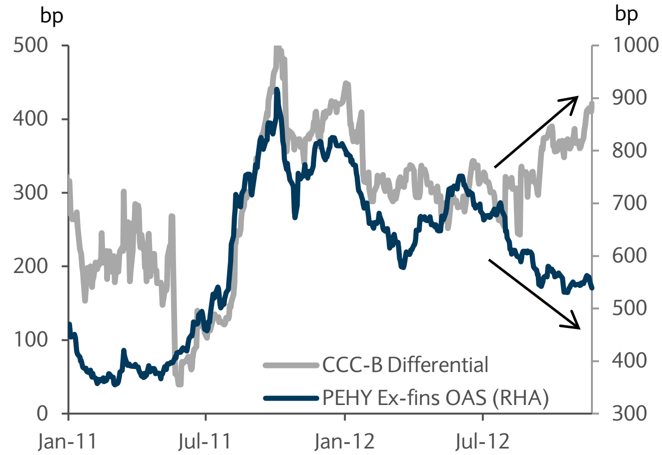
CCC OAS vs Euro area GDP



Source: Bloomberg, Barclays Research

FIGURE 22

CCCs – Bs, OAS differential, vs PEHY ex-fin OAS



Source: Barclays Research

Finally, within the ratings purview, we expect activity around the IG/HY credit cliff to remain robust in 2013. We refer readers to our *Credit Alpha*, 23 November 2012, for a more detailed analysis. In Figure 23, we highlight some of our analysts' possible fallen angels and rising stars over the next 18 months. Trading strategies around upgrades/downgrades can provide attractive opportunities, but frequently vary on a case-by-case analysis. Broadly, strategies of avoiding the fallen angels until they have actually fallen to HY, and building long positions to rising stars multiple months in advance of the final upgrades, tend to perform well.

Sectors

We believe the biggest sector-based calls in 2013 will be the cyclical ones: autos, building materials, paper, metals and mining, etc. Our concerns around most of these sectors are based on: 1) limited prospects for a medium-term reversal of challenged earnings trends; and 2) relatively tight valuations for especially the non-peripheral names, given that for most of this year they have benefitted from a 'core' flight to safety.

FIGURE 23

Reasonable potential for significant ratings transition in next ~18 months

Possible fallen angels		Possible rising stars	
Issuer	**HY eligible par (€ mm)**	**Issuer**	**IG eligible par (€ mm)**
A2A SpA	*	Continental AG	3,000
Banco Popolare (senior)	1,000	Edison SpA	1,800
Banque PSA	4,800	Fiat Industrial	2,200
DONG Energy (perp)	*	GKN	989
FGA Capital	1,000	HeidelbergCement	5,830
First Group	1,754	ITV	-
Finmeccanica	2,692	Jaguar Land Rover	1,238
KPN	10,960	TRW	-
Metro AG	2,850	Ziggo (unsecured)	1,209
ThyssenKrupp	4,000		
Total	**29,056**	**Total**	**16,266**

Note: *Bonds not eligible for Barclays HY indices because they are defined as Gov-Agency debt. Source: Barclays Research

Figure 24 highlights an interesting theme: peripheral outperformance compared with the cyclical auto sector over the past several months. While it may be a volatile trade, particularly depending on how the situation around Spain develops, we think the long (non-cyclical) peripheral/short cyclical trade will continue to perform in H1 13, as Europe slowly resolves the sovereign crisis. At the same time, we would expect more fundamental focus on the cyclical sectors, and their relatively tight levels (Figure 25) amid a recession.

Specifically, the large European auto makers, select paper, metal/mining, airline, and building material names do not appear to be pricing in much cyclical risk. On the other hand, we are relatively constructive on many of the HY retail names given their significant UK exposure. Lastly, the telecom/media sector looks cheap as highlighted in Figure 26, due mostly to the inclusion of WIND, ONO, and OTE; again, we think there will be room for particularly many non-cyclical peripherals to compress versus many of the aforementioned cyclicals.

Cash curves

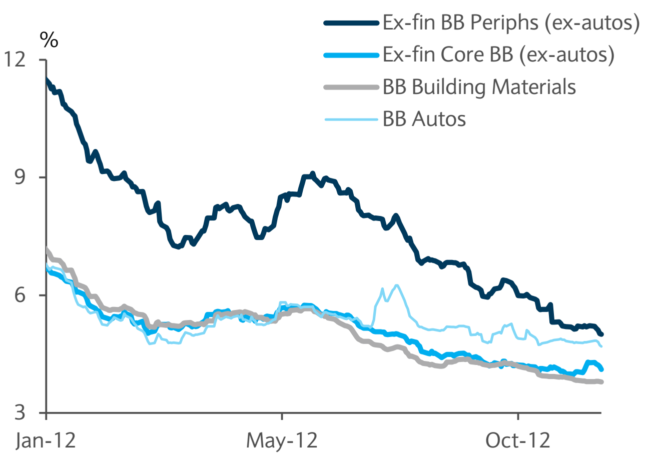
Despite our expectation for a grind tighter in spreads, we remain relatively cautious on duration from a risk/reward perspective. Longer-dated double-Bs are particularly susceptible to underperformance due to outright rich valuations and their relatively high sensitivity to rate moves compared with the rest of HY. Benchmark rates could spike meaningfully higher in a handful of scenarios, from growing inflation concerns to European debt mutualisation developments, likely to the detriment of longer-dated credit. Technicals for shorter-dated credit are more supportive, and thus we would recommend looking for yield down the quality spectrum (eg, shorter single-Bs) as opposed to out the maturity curve, for now.

Cash vs CDS

The CDS-cash basis in HY credit reached extremely positive levels earlier in the year, but has since corrected to near flat (Figure 26). The allocation decision between cash and CDS will depend on market conditions, but we believe opportunistically positioning longs in CDS, where possible, when the basis ticks positive, will be an attractive means of generating alpha during 2013. As we have experienced, large positive bases tend to revert, and CDS longs are an interesting means of working around call constraint issues in the cash market. However, we must note that volatility in HY CDS will likely be higher compared with cash given the relatively more supportive technical backdrop in the latter; thus, being tactical around this theme will be integral.

FIGURE 24

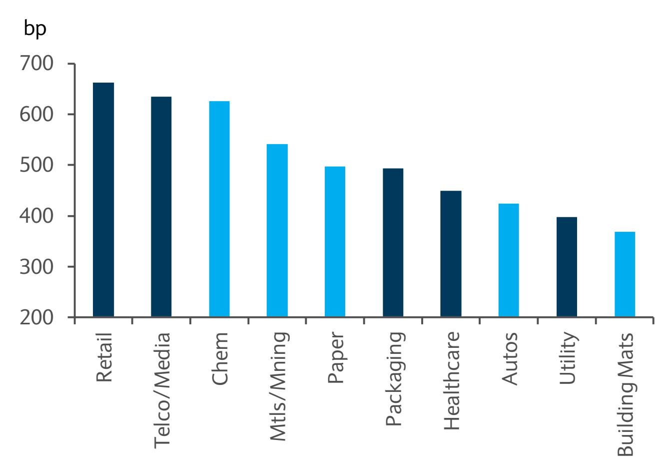
Select HY sector yields



Source: Barclays Research

FIGURE 25

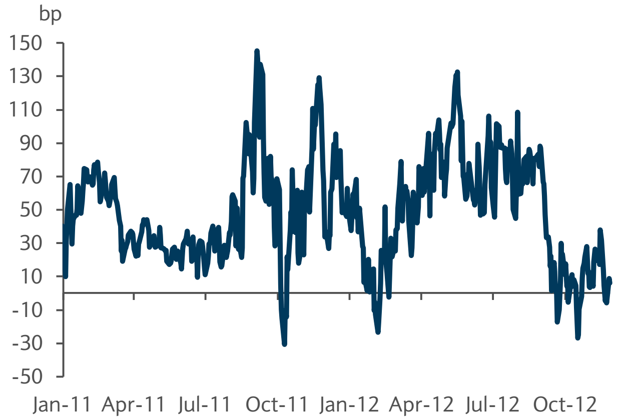
Sector OAS



Source: Barclays Research

FIGURE 26

Aggregate HY CDS-cash basis



Note Based on the difference between iTraxx Xover (roll adjusted spread) and the Barclays PEHY ex-fins index. Source: Bloomberg, Barclays Research

FIGURE 27

Secured vs unsecured spread relationship

Source: Barclays Research

Capital structure

In tandem with the rally this year, the secured/unsecured spread relationships in most non-financials have compressed meaningfully. The median OAS ratio of secured/unsecured in PEHY has dropped from over 1.5x in mid-2012 to ~1.3x, while the outright median spread differential has fallen to ~200bp. We think there is incrementally more room for this compression to run, but recommend being selective in evaluating yield pick-up and potential security take-outs. For example, we continue to advocate moving down the capital structure in Ardagh and ONO at current levels.

Financials

The majority of Euro HY benchmark investors continue to manage against an ex-financial benchmark. Nevertheless, as noted at the beginning of this section, HY financial performance was particularly strong in 2012, and we think select subordinated financial paper remains an interesting off-Index strategy for 2013. Security selection will remain paramount, but we highlight examples such as UK-bank LT2s and ECNs yielding 7-10%+, as well as many core-Europe T1s, as interesting relative value. Also, as the CoCo market continues to develop, it will likely provide more relatively attractive yield opportunities.

Supply: Vying for the new record

Our YTD Euro HY supply tally, which includes USD denominated bonds issued by European companies, stands at 53.9bn €-equivalent, ahead of the previous record of 51.5bn €-equivalent in 2010. Across all currencies, YTD supply is up 17% from 2011's 46bn €equivalent. We expect 2013 issuance in the €50-60bn range (Figure 28); this includes USD bonds issued by Euro companies. Excluding USD issues, PEHY issuance will likely be in the ~€40bn area. The macro backdrop will continue to be a significant driver of supply volumes, as well as underlying trends, next year. Sustained near-current, or even lower, all-in yield levels should be supportive of increased volumes given outright attractive funding levels. Historically, we have seen a significant correlation between yield levels and issuance volumes, and expect that to continue in 2013. Please see *2013 Supply Outlook* for a full analysis on our 2013 expectations.

FIGURE 28

FY13 PEHY supply estimate

	2013 estimates (€ equiv, bn)
Maturity refinancings/GCP	20 to 25
Funding called paper	5 to 10
Loan to bond/debut issuers	15 to 20
M&A, other	5 to 10
2013 FY PEHY new issuance estimate	**50 to 60**

Source: Barclays Research

Our estimates are based on top-down analyses and issuer-level inputs from our analysts.

Maturity refinancings

Despite a valiant effort by issuers to term out the refinancing wall, the steady flow of fallen angels this year has cancelled out much of their work (Figure 30). So the total 2013/2014 bond maturity wall remains similar in size to what it was a year ago, driving up our expectations for refi-based primary volumes to north of €20bn for 2013. Some maturities have been pre-funded or will be retired with cash, but we would expect issuers to be pro-active at taking out longer-dated maturities if the market remains open and attractive. We expect the most refi activity out of the auto sector, followed closely by some of the recent fallen angels with relatively large capital structures (general industrials and utilities).

Callable bonds

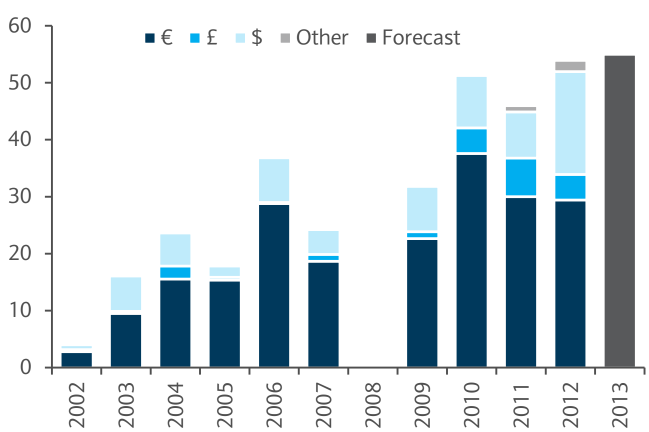
We expect €5-10bn of supply to fund the calling of outstanding bonds. Having combed through our research-covered names with our fundamental analysts, we estimate €5-8bn of reasonable potential calls that would likely require funding. Over the past two years, average call rates have been ~25% of callable paper. Roughly €40bn is up for call by the end of 2013, so €10bn makes senses from the top-down perspective as well, we think.

Loan-to-bond

We are looking for loan refinancings to contribute around 15-20bn €-equivalent of bond supply next year. While the two 3y LTROs postponed the urgency driving the loan-to-bond

FIGURE 29

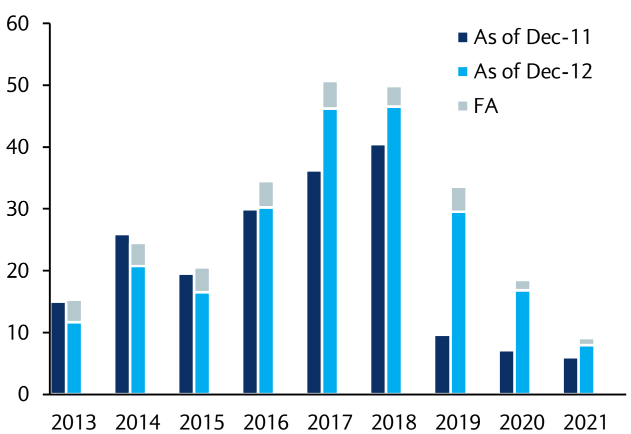
PEHY supply, by currency, €bn equiv



Source: Barclays Research

FIGURE 30

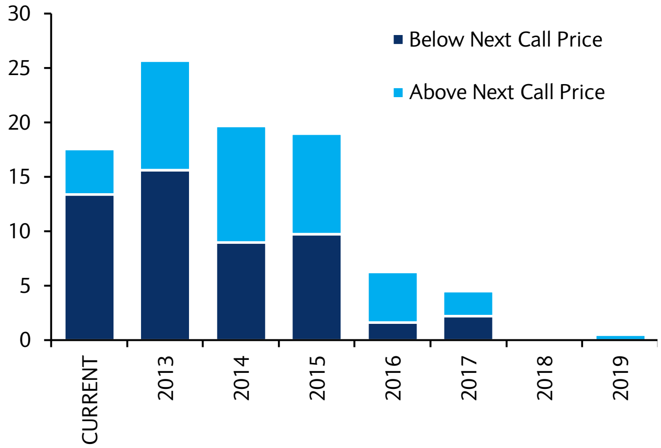
Maturity profile, including YTD fallen angels, €bn equiv



Note: Includes USD maturities. Source: Barclays Research

FIGURE 31

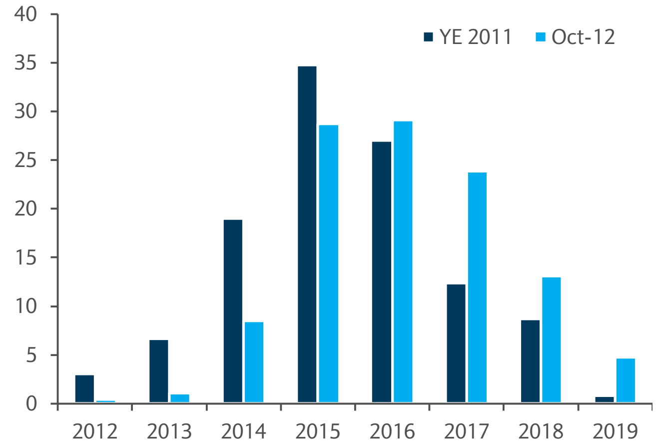
Total non-fin callable bonds by year of next call, €bn equiv



Note: Includes USD maturities. Source: Bloomberg, Barclays Research

FIGURE 32

ELLI maturity profile, €bn equiv



Source: S&P LCD, Barclays Research

trend in Europe, the transition to bond market financing was still a significant factor in 2012 supply. We think that the pressure on banks to delever will continue to build, furthering the pro rata loan market term-out trade. Despite the success of European issuers chipping away at the public loan market maturity wall (Figure 32), we believe focus will remain high on the 2014 and 2015 hurdles. The CLO market is showing signs of re-emergence in Europe; while this risks deterring institutional loan-to-bond trades, we would expect CLO progress to be relatively slow and not overwhelmingly detrimental to bond supply in 2013.

M&A

We estimate that M&A and LBO-related supply activity accounted for just over 15% of total issuance in 2012, or around 8bn €-equivalent. We think 2013 will see more M&A-driven issuance compared with 2012, but only modestly. We think a €5-10bn estimate for 2013 is reasonable, although again with potential upside risk to the range.

Demand: Strong, but waning

We believe demand for Euro HY remains broadly supportive into 2013, although moderated by 2012 performance (see *Credit Alpha*, 9 November 2012). The key themes we expect are outlined below.

1. Ongoing growth in the size of the market, furthering its proportional share of the global HY market and garnering increased global focus; Euro/sterling HY represents ~22% of the combined USD/€ HY bond market, up from ~12% in fall 2008 (Figure 34);

2. Accommodative global central bank policies pushing investors out the risk spectrum. Thus, despite outright low yield levels, relatively attractive HY valuations versus many other investment alternatives bode well for retail and institutional demand; and

3. Investment grade and international investors increasing exposure to HY, to manage negative ratings migrations and/or increase portfolio yield.

FIGURE 33

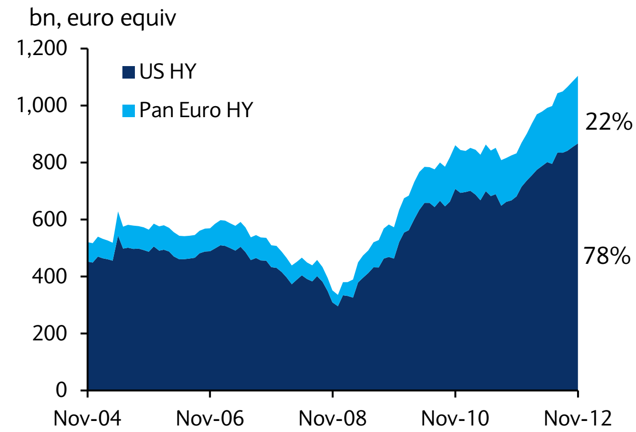
Estimated holders of PEHY corporate market

Investor base	% PEHY held
Mutual funds	~20%
UK insurance/pension funds	15-20%
Euro insurance/pension funds	15-20%
Hedge funds	15-20%
IG/Crossover funds	10-15%
CLOs	< 5%
Other	10-15%

Source: ECB, Intex, Lipper, UK ONS, Barclays Research

FIGURE 34

US and Pan Euro HY market sizes



Source: Barclays Research

There are downside risks to HY demand, however. A worse-than-anticipated shock to the economy could significantly hurt both retail and institutional demand for risk; the US fiscal cliff is key in the near term. Another protracted crisis with respect to the EU sovereign situation would likely limit risk taking and rekindle concerns of a mass wave of fallen angels.

Mutual funds

Based on Lipper data, we estimate HY mutual funds hold roughly 20% of the PEHY market. Dedicated €/£ HY funds had net assets of €24bn in the most recent data release. Global-dedicated HY funds totalled an additional €84bn; based on the approximate 20/80 split of the combined Euro/USD HY market, this suggests another ~€17bn of PEHY holdings by global funds. Anecdotally, the global HY funds have taken significant strides over the course of the year to get much closer to market weight Europe than they were at the beginning of 2012; as we do not get the impression many of the global funds are meaningfully overweight Europe, we believe the market is relatively well aligned with the 20/80 split. Accordingly, this suggests mutual funds holdings at ~€41bn, or 18% of PEHY.

We calculate that the primary Euro HY ETFs have net assets of about €2bn – up more than 100% y/y, but still a small portion of the overall market. While the ETF market may continue to grow in Europe, we would not expect a US-type growth trajectory any time soon.

It is worth highlighting the volatile nature of this source of HY demand. Much of this flow will likely be dominated by macroeconomic/Eurozone headlines, and could turn negative on an unexpected economic shock and/or equity market sell-off. In the other direction, continued improvement on the sovereign front, ongoing macro policy accommodation, and supportive equities should bolster demand from the retail side and support market growth.

Finally, the growth of globally-focused HY funds is a significant potential positive for demand for Euro HY. As discussed earlier, a lot of global money is still on the sidelines, cautious of the sovereign crisis in Europe, and waiting for more concrete steps before re-upping European allocations. We believe this is particularly true in PEHY.

UK and EU insurance companies and pension funds

Based on data from the UK ONS, we estimate that UK insurance and pension funds hold roughly £450bn of global corporates; more than half of this is GBP-denominated paper issued by UK corporates. Assuming 50% of the remainder is €-denominated, split proportionally IG/HY, we calculate UK insurance and pension funds hold somewhere around €40-45bn of PEHY debt, or 15-20% of the market. Euro insurance and pension funds hold a similar size, we believe. According to the ECB, holdings of non-fin Euro corporates are ~€200bn. With similar assumptions, this implies ~€35-40bn of non-fin debt. Financial holdings are more difficult to estimate, but we believe an extra €5bn of HY financial holdings is plausible, bringing Euro insurance/pension fund HY holdings to €40-45bn, 15-20% of the market.

We believe longer-term demand from insurance and pension funds will be resilient. Trends have been towards fixed income and away from equities over the past several years. Another long-term driver supportive of credit versus equity is the upcoming Solvency II implementation, whose QIS5 capital shocks are particularly punitive to equities. While IG bonds are treated better than HY in the regulation, we expect at least part of this disadvantage to be offset by the yield and diversification opportunities in HY.

Investment grade/crossover funds

Low yields and ongoing negative ratings trends have combined to increase the involvement of traditional investment grade and crossover funds in European HY credit over the past several years. Particularly with the growing market impact of sovereign-corporate rating linkages in many parts of the market, we are seeing a noteworthy trend of IG mandate changes to allow for increased exposure to HY credits, particularly fallen angel names. As the fallen angel tally likely grows, we would expect to see more IG managers looking for more flexibility to invest in HY names, particularly those with which they are familiar, to manage a negative ratings transition as well as to bolster portfolio performance. We estimate these funds hold roughly 10-15% of the PEHY market, the same proportion as last year despite the growth in the market.

Hedge funds, CLOs, other

Hedge funds remain active participants in the HY market. Especially with credit volatility around the IG/HY corporate (and sovereign) credit cliff, as well as higher yield opportunities in the growing HY financial space, we would expect hedge funds to maintain their share of the HY market in the 15-20% range, as we have estimated historically. While marginally higher y/y, demand from the CLO market has not picked up meaningfully, nor do we expect a surge in demand, given the state of the market and ongoing ends of investment periods. We continue to expect this part of the market to represent less than 5% of Euro HY. 'Other' demand sources of Euro HY corporates are banks/dealers, special non-European/UK real money carve-outs, and other investors. Pressures on banks to shrink their balance sheets will keep sustained demand limited there, but international investors will likely continue to become more interested in Europe as the market develops. We think this 'Other' part of the market accounts for roughly 10-15% of PEHY holdings, but with the potential to increase materially.

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Global hybrid capital strategy

GLOBAL HYBRID OUTLOOK

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The preferred path to outperformance

US banks and insurance

- **Key recommendations. We expect bank hybrids to outperform senior debt, on an absolute and a beta-adjusted basis, given the wide senior-hybrid basis, improving bank fundamentals and a macro backdrop supportive of higher beta assets. We recommend expressing this view using fixed-to-float structures with high back-end coupons, given their limited extension risk. While recently issued fixed-for-life securities are slightly cheaper on a yield-to-call basis, their coupon structure exposes them to significant rates risk.**

- **Supply.** The technical backdrop should also be broadly supportive of hybrid valuations. While we expect perpetual preferred supply to remain elevated in 2013, net issuance should be fairly small, with TruPS redemptions likely to continue.

- **Dividend tax risk.** Potential changes to dividend tax rates pose a key risk to the preferred market. Although we believe that a marginal increase in dividend tax rates (our base case) is unlikely to affect valuations meaningfully, a complete elimination of the tax advantage of dividends could lead to a significant sell-off in the preferred market.

- **Insurance hybrids.** The senior-hybrid basis in insurers also appears attractive, and subordinated valuations should be supported by a strong fundamental backdrop. However, we remain mindful of the extension risk of lower coupon securities and favor longer non-call/higher coupon hybrids, which have limited extension risk.

European banks and insurance

- **Key recommendations. Financial subordinated debt is set to outperform senior credit in our baseline scenario. In bank hybrids, we like being long high-coupon callable LT2s and T1s with attractive pick-up over bullet LT2s, versus low-coupon securities that are at risk of extension and offer low pick-up versus LT2s.**

- **Liability management.** Rationales have shifted and improved valuations now reduce the incentive for conducting sub LMEs; however, the ongoing need to build capital buffers should ensure that banks continue to identify securities to tender or exchange.

- **Issuer calls.** A shift toward economically driven calls is accelerating. Extension risk is likely to remain a key theme going into 2013.

- **Supply.** The new-style Basel III-compliant hybrid issuance is likely to pick up in 2013, while the old-style hybrid space looks set to shrink further, driven mainly by upcoming calls.

- **CoCos.** The CoCo market is starting to take shape, although more clarity is necessary on what the "right" CoCo structure is, how to value CoCos in a consistent framework and if there is a sufficient investor base.

European corporate hybrids

- **Key recommendations. Corporate hybrids continue to look attractive relative to matched senior bonds and the broader senior non-financials universe. However, given the recent strong outperformance, we would be more selective in picking names.**

- **Issuer calls.** The way the bonds are structured around the call dates will be increasingly important for valuations as the large batch of first calls in 2015 approaches. We continue to think that the bonds are likely to be called on an economic basis, with the loss of equity content after the first call date in the recent new issues likely being a particularly strong incentive to call.

- **Rating methodology risk.** S&P's proposed methodology change regarding assigning equity content to corporate hybrids creates downside risk for affected securities.

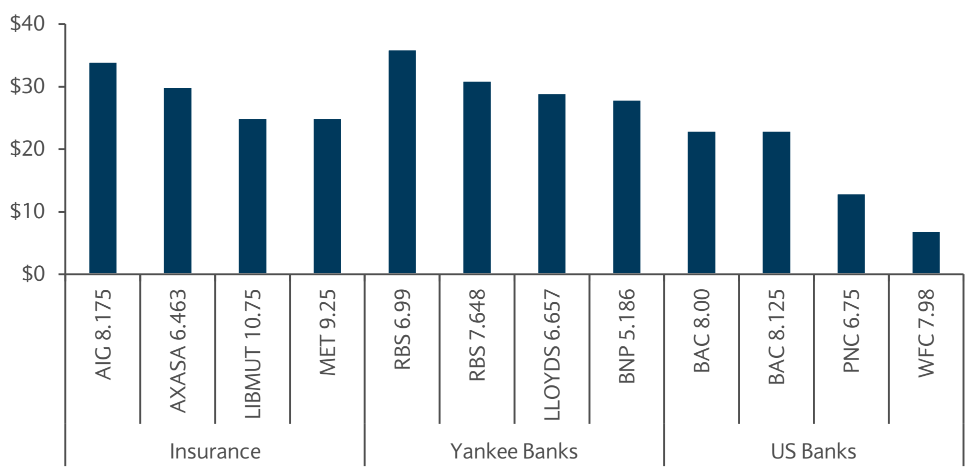
US banks and insurance

Financials have led the tightening in credit year-to-date with the Fed's quantitative easing program pushing investors down the risk spectrum and the announcement of the ECB's OMT lowering tail risk in Europe. Valuations down the capital structure have been further supported by the redemption of nearly $36bn of trust preferreds, which has led to a significant shrinking of the hybrid space. As a result, hybrids have substantially outperformed senior debt with PGF, an ETF of retail preferreds, returning nearly 21% YTD (total return), compared with about 14% from senior financials.

Within the preferred space, higher beta securities have outperformed. Yankee bank hybrids are among the best performers, with select RBS and Lloyds securities rallying more than 30pts (Figure 1). AIG and AXASA hybrids are also up about 30pts. BAC hybrids have led the rally among US money-center banks, increasing more than 20pts.

FIGURE 1

YTD price change of select hybrid securities



Source: Barclays Research

US bank preferreds: More room to rally

Despite the sharp rally this year, we believe bank hybrids have further room to outperform senior parts of the capital structure, on an absolute and a beta-adjusted basis in 2013, and recommend long positions in high coupon fixed-to-float securities.

- The macro backdrop for risk assets remains attractive, with the Fed committed to boosting economic growth by supporting asset prices and tail risk in Europe likely to remain low following the announcement of the OMT. Even though global growth continues to show signs of weakness and fiscal cliff concerns in the US remain, we expect strong central bank policy intervention to drive valuations higher next year.

- At the same time, subordinated spreads are likely to be supported by strong bank fundamentals, as banks continue to build capital and liquidity and asset quality has improved. A strong fundamental backdrop would keep the risk of dividend deferrals low in the medium term, although recently proposed regulatory changes have increased deferral risk during future periods of banking sector stress, in our view.
- The technical backdrop also remains favorable. Despite the pickup in preferred supply, net issuance of bank hybrids was negative this year, driven by nearly $36bn of TruPS redemptions. While we expect bank preferred supply to remain elevated in 2013, a significant portion of this should be offset by continued trust preferred calls.
- However, structure selection will be key. In particular, while we find fixed-to-float preferreds attractive, the fixed-for-life coupon structure of many recently issued securities causes them to have negative convexity to rates. Therefore, we recommend swapping out of the latter and into fixed-to-float preferreds.
- Changes to dividend tax rates are a key risk for the preferred market. A marginal increase should not affect valuations much; however, in the unlikely case that the tax advantage of dividends is completely eliminated, it could lead to a significant decline in preferred valuations (particularly for securities with high retail ownership).

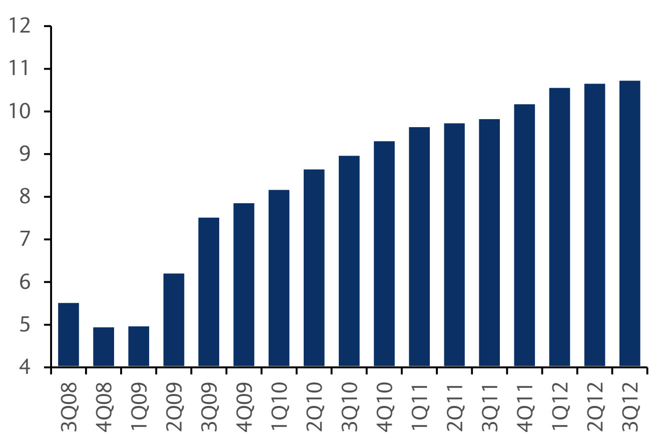
Bank fundamentals remain strong

Bank fundamentals continued to improve in 2012, a trend we expect to be sustained in 2013. The improvements happened along three key dimensions:

1. **Capital:** Bank Tier 1 capital ratios continued to increase, with the aggregate ratio now at 10.75%, up 5.8% from the 2009 crisis lows (Figure 2). With Basel III capital requirements being phased in over the next few years, we expect aggregate capital ratios to continue to rise in the medium term.
2. **Liquidity profiles:** U.S. banks have benefited from $1.7trn in new deposit funding since 1Q09, pushing the ratio of loans versus deposits to a 17-year low.
3. **Asset quality**: Asset quality has consistently improved since 2009, as non-performing assets (NPAs) and net charge-offs have fallen from crisis highs (Figure 3). Improvement in delinquencies and NPA in-flows, along with positive management commentary, suggest this trend will continue in 2013.

FIGURE 2

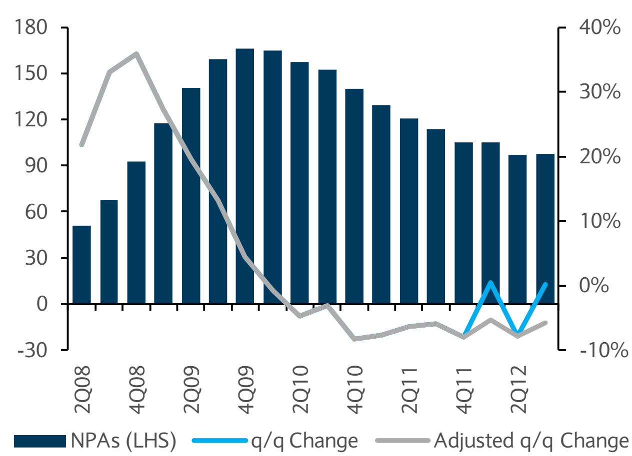
Basel I Tier 1 common capital ratios (%)



Source: Company reports, Barclays Research

FIGURE 3

Non-performing assets ($bn)



Note: Constituents include the banks in the Credit Research 25-Bank Aggregate.
Source: Company reports, Barclays Research

With bank fundamentals continuing to improve, we believe that coupon deferral risk will remain low in the medium term. Although new capital requirements have raised the likelihood of mandatory deferrals if banks face severe distress, deferrals are unlikely over the next few years, given banks' strong capitalization ratios, in our view.

Under existing law, banks that fall below the minimum capital requirement (below 4% T1 capital) face a number of restrictions designed to raise capital, including a prohibition on preferred dividends. New capital regulations, part of the Dodd-Frank Act, propose a more stringent constraint, incorporating a higher minimum capital requirement (eventually 4.5% Tier 1 Common) and an additional capital conservation buffer[4] above this amount (Figure 4). Under the proposed rules, banks would face restrictions on capital distributions upon breaking into the buffer zone (ie, below 7.0%), even if capital levels are above the 4.5% minimum.[5] This could lead to coupon cancellations and even force extensions beyond the first call date; based on the wording of restricted capital distributions, all discretionary dividend payments on Tier 1 and Tier 2 securities (if applicable) and the discretionary repurchase/redemption of these securities could be blocked (please see *Turn-offs for Preferreds, 22 June 2012,* for more details).

FIGURE 4

Capital distribution restrictions as of 2019

Capital Conservation Buffer (as % of RWA)	Maximum Payout Ratio (as % of eligible retained income)
Greater than 2.5%	No payout ratio limitation applies
1.875-2.5%	60%
1.25-1.875%	40%
0.625-1.25%	20%
Less than or equal to 0.625%	0%

Note: Capital conservation buffer will be phased in gradually from 2016 through 2019. Source: Federal Reserve

With banks operating at Tier 1 common ratios well in excess of the trigger levels, we believe that mandatory deferrals are fairly unlikely in the medium term. Nevertheless, the proposed capital restrictions increase the likelihood of coupon deferrals during periods of stress over a longer timeframe, in our view. Even though we expect the risk of optional deferrals to remain low, the mandatory deferral provisions included in the proposed rule could force preferred dividends to be shut off for banks under severe duress.

Technicals remain supportive as TruPS redemptions continue

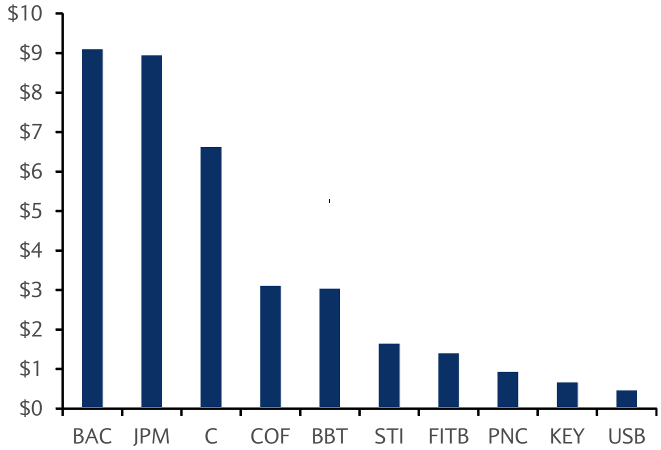
The hybrid universe has undergone a significant transformation following the release of the notice of proposed rulemaking (NPR) in June this year. With the tier 1 treatment of TruPS being phased out under the Dodd-Frank Act, many issuers used the release of the NPR as the trigger for regulatory par calls embedded in these securities. Indeed, since June, banks have exercised calls – either regulatory or natural – on nearly $36bn of TruPS. BAC and JPM have called about $9bn of these securities each, while Citi redeemed another $6.3bn (Figure 5).

[4] The capital conservation buffer is defined as the lowest of the bank's 1) common equity tier 1 capital ratio minus its minimum common equity tier 1 capital ratio; 2) tier 1 capital ratio minus its minimum tier 1 capital ratio; and 3) total capital ratio minus its minimum total capital ratio.

[5] Additional requirements would be applied to systemically important financial institutions under the SIFI buffer.

FIGURE 5

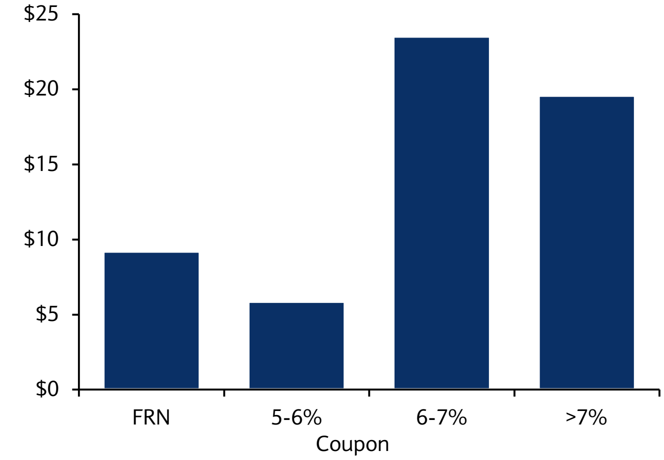
TruPS redemptions by bank ($bn)



Source: Barclays Research

FIGURE 6

Outstanding TruPS by coupon ($bn)



Source: Barclays Research

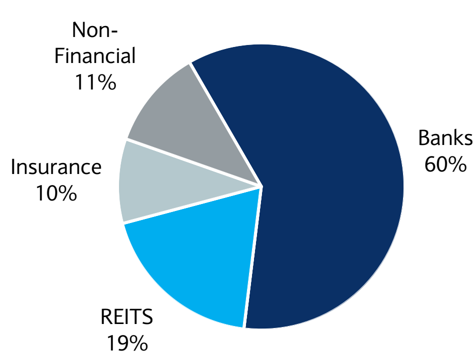
We expect TruPS redemptions to continue for the rest of the year and into 2013. More than $58bn of TruPS are still outstanding, a significant fraction with coupons over 6% (Figure 6). We believe these securities are fairly expensive for the issuers, given the low interest rate environment and the limited need for Tier 2 capital, and are likely to be redeemed.

Preferred Issuance Has Picked Up

After remaining low for most of the pre-crisis period, hybrid supply picked up significantly in 2012, driven by new capital requirements, historically low yields and strong investor demand. YTD, nearly $33bn of hybrids have been issued, almost completely offsetting the $36bn of TruPS redemption. However, with banks accounting for only 60% of issuance (Figure 7), net supply of bank preferreds was significantly negative, providing support to valuations in this space. Most issuance this year has been in the form of fixed-for-life $25 par securities. Figure 8 shows the breakdown of recent preferred deals by form of issuance and coupon structure. Nearly 79% of the 2012 supply has come in the retail market ($25 par preferreds), while 65% of securities have fixed-for-life coupons.

FIGURE 7

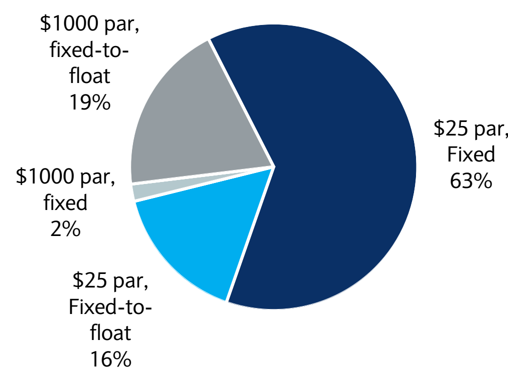
2012 hybrid issuance breakdown by sector



Source: Bloomberg, Barclays Research

FIGURE 8

2012 hybrid issuance breakdown by structure



Source: Bloomberg, Barclays Research

We expect net issuance of bank preferreds to remain low in 2013, with TruPS redemptions offsetting a substantial portion of bank preferred supply. Non-cumulative perpetual preferreds continue to count as Tier 1 capital under the new guidelines and we expect banks to use these structures to fill the 1.5% of RWAs bucket assigned to non-common Tier 1. Based on banks' combined RWA, we estimate that the US bank preferred market could grow to about $145bn, implying net supply of nearly $80bn of preferreds over the next few years. Figure 9 lists the potential room for preferred capital for select banks. With capitalization ratios well in excess of regulatory requirements, most institutions have limited need for more capital in the near term. That said, we expect them to continue to opportunistically tap the preferred market to monetize the strong demand and historically low yields. Similar to this year, a significant portion of the supply is likely to come in the retail market.

FIGURE 9

Room for non-common Tier 1 capital for select banks

	Est. Q4 2014 RWA ($bn)	Total Room for Preferreds* ($mn)	Preferreds Outstanding ($mn)	Potential Medium-Term Issuance ($mn)
JPM	$1,779	$ 26,691	$ 9,058	$ 17,633
C	$1,209	$ 18,140	$ 1,812	$ 16,328
BAC	$1,610	$ 24,154	$ 15,843	$ 8,311
WFC	$1,204	$ 18,058	$ 11,972	$ 6,086
MS	$425	$ 6,371	$ 1,508	$ 4,863
GECC	$505	$ 7,572	$ 4,000	$ 3,572
GS	$578	$ 8,674	$ 5,700	$ 2,974
COF	$247	$ 3,705	$ 875	$ 2,830
STI	$155	$ 2,324	$ 275	$ 2,049
AXP	$136	$ 2,040	$ 0	$ 2,040

*Equal to 1.5% of RWA. Source: SNL, Barclays Research

Valuations are attractive, but recently issued preferreds have rates risk

As discussed above, a significant portion of the new issuance has come in the form of fixed-for-life securities (Figure 10 lists select new deals). While the yield to call of these preferreds is attractive, low absolute coupons and the fixed-for-life coupon structure exposes them to significant extension risk if Treasury yields increase. The risk-reward profile of these securities does not appear attractive; their upside is capped by the call option, but they could sell off significantly in a rising rate environment.

FIGURE 10

Select recently issued fixed-for-life preferreds

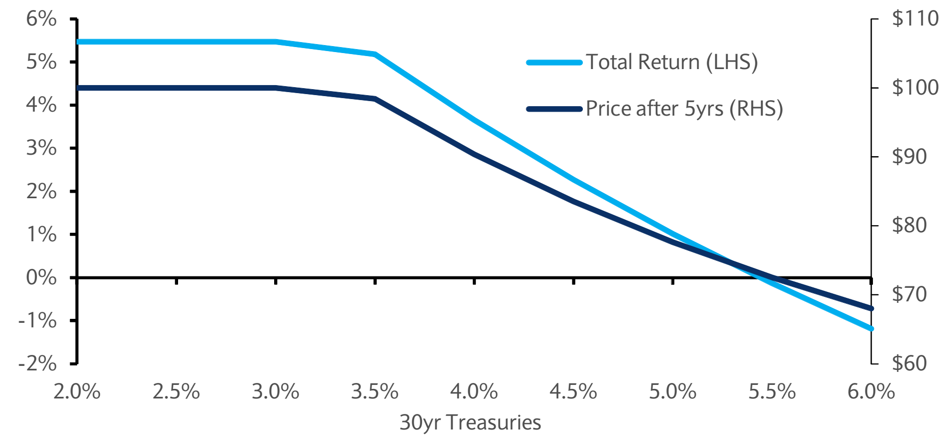
Issuance Date	Ticker	Div	First Call	Amount Outstanding ($mn)	Price	Yield to Call
Jul-12	BBT E	5.625%	Aug-17	$1,150	$25.5	5.3%
Aug-12	JPM D	5.500%	Sep-17	$1,258	$25.0	5.5%
Aug-12	COF P	6.00%	Sep-17	$875	$25.0	6.1%
Aug-12	WFC N	5.200%	Sep-17	$750	$25.0	5.1%
Oct-12	GS I	5.950%	Nov-17	$850	$24.8	6.3%

Note: All securities are $25 par. Source: Bloomberg, Barclays Research

For instance, Figure 11 estimates the annualized rate of return for JPM Ds over a five-year holding period in different rate environments. If Treasury yields stay near current levels, we would expect these securities to return c.5.5%. However, even a marginal increase in Treasury yields would increase extension risk and lower the expected return. For instance, if 30y yields increase to 4%, we estimate the price of JPM Ds will drop 10pts, as they are priced to extend.

FIGURE 11

5-year expected rate of return for JPM Ds



Source: Barclays Research

While our rates strategists do not expect rates to rise in the near term, the risk/reward profile of the fixed-for-life preferreds is not compelling. Consequently, we prefer fixed-to-float securities that have a more balanced profile and the give-up in yield versus fixed-for-life securities is fairly small (Figure 12). For instance, a swap out of JPM Ds and into the 7.90s involves giving up about 40bp in yield-to-call terms. However, the higher coupon of the 7.9s means that they benefit more from the DRD treatment. Indeed, we estimate that in DRD-equivalent terms, the swap allows investors to pick up about 20bp in yield.

FIGURE 12

JPM Ds to 7.9s swap

	Call Date	Back-End Coupon	Price	Annualized Yield to Call	DRD-equivalent Yield to Call*
JPM 7.9	Apr-18	L+347bp	$ 113.0	5.1%	8.0%
JPM Ds ($25 par)	Sep-17	5.50%	$ 25.0	5.5%	7.8%

*Assumes 70% exclusion rate and 35% marginal tax rate. Source: Barclays Research

Given their limited interest rate risk, our best picks in the US bank hybrid space are fixed-to-float structures with high back-end coupons (Figure 13 lists select $1000 par securities), which are first callable in 5-10 years and yield about 5% to the first call date. These securities appear cheap in spread terms, trading 200-350bp wider than corresponding senior bonds. In addition, given the wide back-end coupon of these preferreds, we expect them to be called on the first call date, barring a significant worsening in credit quality.

FIGURE 13

Select fixed-to-float preferreds

	First Call Date	Back-End Coupon	Price	Yield to Call	Hybrid Spread (bp)	Snr-Hybrid Basis (bp)
JPM 7.9	Apr-18	L+347 bp	$ 113.0	5.1%	441	318
WFC 7.98	Mar-18	L+377 bp	$ 115.5	4.6%	396	347
C 5.95	Jan-23	L+406.8 bp	$ 102.3	5.6%	403	254
GE 6.25	Dec-22	L+470.4 bp	$ 108.0	5.2%	360	233
PNC 6.75	Aug-21	L+367.8 bp	$ 113.0	4.9%	353	249

Source: Barclays Research

The two $25-par ALLY preferreds also have a fixed to float structure with very high back-end coupons (Figure 14). Both securities have rallied meaningfully this year: YTD, the As and Bs are up 32% and 39%, respectively. Despite the rally, they are among the highest yielding securities in the preferred space. The company appears to have made significant progress on the fundamental side with the bankruptcy filing of ResCap and the announced sale of international assets. Consequently, even though valuations may remain volatile, we continue to see value in these preferreds and recommend staying long.

FIGURE 14

ALLY retail preferreds

	First Call Date	Backend Coupon	Price	Yield to Call	Hybrid Spread (bp)	Snr-Hybrid Basis (bp)
ALLY A	Feb-16	L+578.5 bp	$ 26.1	6.8%	645	338
ALLY B	May-16	L+624.3 bp	$ 25.5	8.0%	761	454

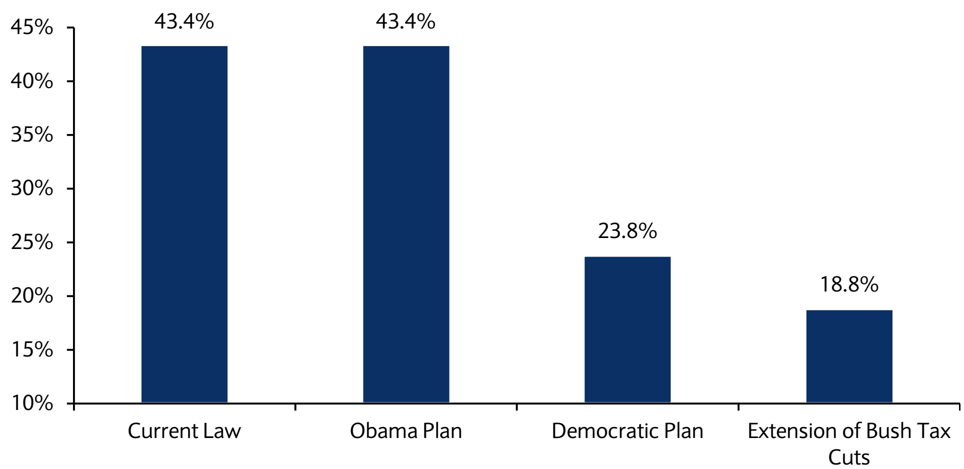
Source: Barclays Research

Tax risk is key

Aside from interest rate risk, which can be managed by swapping into fixed to float securities, we believe potential changes to dividend tax policy pose the biggest risk to the preferreds market. In particular, lower dividend tax rates, part of the Bush tax cuts, are scheduled to expire at the end of 2012. Subsequently, under current law, dividends will be taxed as regular income, potentially leading to a nearly three-fold increase in maximum dividend tax rates (from 15% to 43.4%) after accounting for the 3.8% Medicare tax (Figure 15). Under the Obama plan, dividends will also be taxed as income, but only for the top two tax brackets. The Democratic budget plan is more benign, but even that would raise dividend tax rates from 15% to 23.8%.

FIGURE 15

Maximum dividend tax rates* in 2013



Note: * Maximum tax rate in 2013 will be even higher if the Pease limitation is reinstated. Source: Barclays Research

The tax-advantaged nature of preferred dividends is an important driver of demand for preferred stocks. Any increase in dividend taxes or change in tax policy that lowers the relative tax advantage of preferreds could therefore weaken demand. That said, a minor increase in dividend tax rates (similar to that under the Democratic plan/extension of the Bush tax cuts) is unlikely to have meaningful implications for preferred valuations, for two reasons:

1) The recently proposed changes in tax policy will only affect tax rates for retail holders of preferreds. Corporate buyers of these securities, which form a significant portion of the demand, will continue to benefit from the DRD treatment.

2) Despite rallying meaningfully year-to-date, preferred yields appear attractive compared with other parts of the credit market, even before accounting for their tax benefit. In particular, as discussed above, preferred spreads appear wide relative to senior debt. Combined with the lack of high yielding opportunities in other parts of the credit market, this should limit any sell-off in case of dividend tax increases, in our view.

We believe that a marginal increase in dividend tax rates is the most likely outcome and do not expect hybrid valuations to be affected meaningfully. That said, in the unlikely scenario that the preferential treatment of dividends is completely eliminated – which will happen under current law and the Obama plan – preferreds could be exposed to significant downside. For a preferred yielding 6%, the beneficial tax treatment of dividends adds about 1.8% to yield, resulting in a tax-equivalent yield of about 7.8%.[6] If preferreds lose their tax advantage completely, we would expect yields to back up about 1% (corresponding to 5-10pts of downside, depending on the duration of the security), or half of the tax benefit, with the sell-off being partially mitigated by corporate demand and overall cheap valuations. In such a scenario, we would expect retail securities with high retail ownership – including non-US preferreds and some recently issued preferred stocks – to have the most downside.

Diminished retail demand for preferreds could also alter the form of preferred issuance over the next few years. As discussed earlier, we expect a significant portion of preferred supply to come in the retail market. However, elimination of the tax advantage of preferreds for retail holders would likely lead banks to bring more issuance in the form of $1000-par preferreds targeted to institutional investors.

Insurance hybrids

Despite the rally in insurance hybrids, we believe that the senior-hybrid basis appears attractive. Subordinated valuations should also be supported by a strong fundamental backdrop. The P&C sector remains fundamentally sound, as strong balance sheets and enhanced risk management, particularly for catastrophe losses, have served the sector well even in the face of substantial industry losses. Life insurers, while more exposed to capital markets volatility than their P&C brethren, benefit from strong capital and liquidity positions and reasonable leverage. Operating capital is at historical highs, with RBC ratios generally in excess of 400%. Holding company liquidity is also historically strong, covering debt service and short-term maturities on average by 2x.

However, many insurance hybrids were issued in 2006-07 and have low back-end coupons, exposing them to significant extension risk. In Figure 16, we list a few hybrids with tight reset spreads. While they have an attractive yield to call, the spread pickup over senior debt does not appear compelling, assuming extension.

- We recommend swapping out of the two LNC hybrids, ALL 6.125s and XL 6.5s and into securities with lower extension risk (see discussion below).
- While the senior-hybrid basis for GNW 6.15s is also tight, our insurance analyst, Tom Walsh, rates the credit overweight, and we view the 6.15s as an attractive high beta long.
- The XLIT preferreds appear cheap, having a better yield to call and yield to worst than the XL 6.5s. The pickup over senior debt is also attractive even assuming extension.

[6] For a preferred trading at par. Assumes 15% dividend tax rate and 35% income tax rate.

FIGURE 16

Select low coupon insurance hybrids

					To Worst		
	Call Date	Backend Coupon	Price	Yield to Call	Yield	Spread (bp)	Snr/Hybrid Basis (bp)
ALL 6.125	May-17	3mL+193.5 bp	$ 104.0	5.1%	4.9%	234	113
LNC 6.05	Apr-17	3mL+204 bp	$ 99.0	6.3%	5.2%	240	47
LNC 7	May-16	3mL+235.75 bp	$ 102.5	6.2%	5.3%	252	59
GNW 6.15	Nov-16	3mL+200.25 bp	$ 68.0	17.7%	7.7%	486	14
XL 6.5	Apr-17	3mL+245.75 bp	$ 91.0	9.0%	6.1%	334	129
XLIT	Currently Callable	3mL+312 bp	$ 78.0	10.3%*	7.2%	440	235

*To April 2017 (the first call date of the 6.5s). Source: Barclays Research

In Figure 17, we highlight select insurance hybrids with longer non-call periods and/or high back-end coupons, as a result of which they have minimal extension risk, in our view. While absolute yields are low, these securities are cheap on a spread basis, trading 175-300bp behind senior debt. The senior-hybrid basis is particularly wide for CB 6.375s and MET 10.75s. Further, while the basis is tighter for AIG and PRU hybrids, we are fundamentally overweight these credits and believe that the hybrids offer an attractive way to express a high beta long on these names.

FIGURE 17

Insurance hybrids with lower extension risk

	Call Date	Back- End Coupon	Price	Yield to Call	Hybrid Spread (bp)	Snr Hybrid Basis (bp)
AIG 8.175	May-38	3mL+419.5 bp	$ 125.0	6.2%	364	188
ALL 6.5	May-37	3mL+212 bp	$ 106.5	6.0%	347	226
CB 6.375	Apr-17	3mL+225 bp	$ 108.0	4.3%	380	320
HIG 8.125	Jun-18	3mL+460.25 bp	$ 116.0	4.8%	406	218
LIBMUT 10.75	Jun-38	3mL+712 bp	$ 149.0	6.7%	414	173
MET 10.75	Aug-34	3mL+754.8 bp	$ 152.0	6.3%	394	277
PRU 8.875	Jun-18	3mL+500 bp	$ 123.0	4.2%	344	194
PRU 5.875	Sep-22	3mL+417.5 bp	$ 104.0	5.3%	378	228

Source: Barclays Research

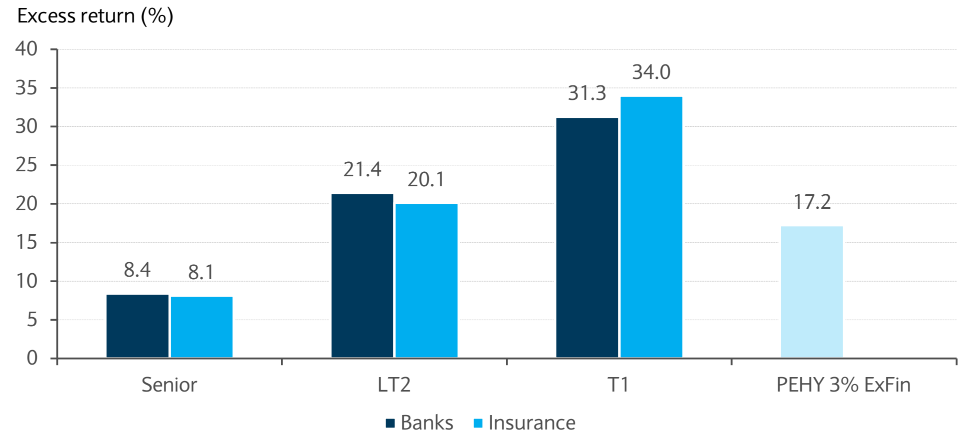
European bank and insurance hybrids

Valuations – Room for further outperformance

Subordinated bank paper has performed very strongly so far this year with T1 and LT2 returning 31.3% and 21.4% (excess return), respectively, which compares to 8.4% and 17.2% on bank senior debt and HY debt (based on Barclays PEHY 3% Ex-Fin index), respectively (Figure 18). Insurance hybrids performed strongly as well, roughly in line with bank capital.

FIGURE 18

2012 YTD performance across bank and insurance capital structures vs comps



Note: "Senior", "LT2" and "T1" refer to subindices of Barclays Euro Aggregate. Source: Barclays Research

After a period of such strong returns, the question is how much room is left for further performance. Looking at the path of average spreads across bank capital structures in Figure 19 is quite revealing.

- Senior financials have rallied to the tights last seen before the market sell-off in April 2011. This, combined with historically low yields, suggests to us that senior debt offers relatively limited upside going forward.

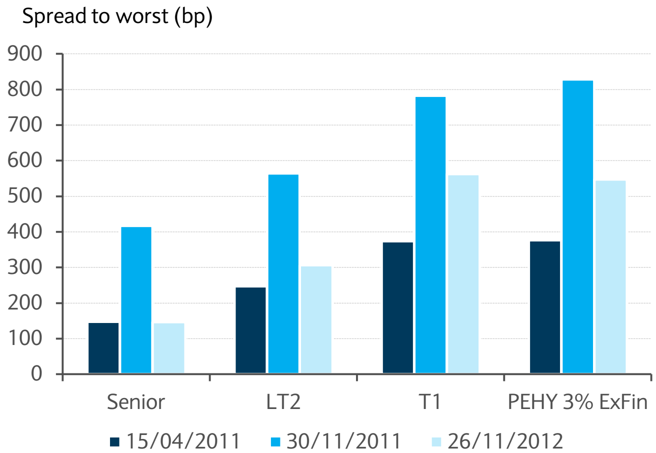
- At the same time, LT2s and T1s remain elevated versus the 2011 tights, still offering ~60bp and ~190bp pick-up in z-spread-to-worst versus the tights, respectively. This fits into the general theme of high-beta credit lagging low-beta in this year's rally. Given the more challenging fundamental and macro outlook currently versus that prevailing in early 2011, we believe some premium in subordinated spreads is justified, particularly given the subordination and issuer-friendly structural features embedded in these securities. However, should our baseline scenario of moderate positive excess returns in 2013 be realized (discussed in detail in the IG section of this report), LT2s and T1s would materially outperform higher-quality credit.

- As we show in Figure 20, insurance credit is priced roughly in line with bank capital across senior, LT2 and T1, suggesting that subordinated debt in this sector also offers attractive return potential compared with senior.

- T1s have been tracking non-financial HY credit in spread-to-worst terms, with both sectors now trading at ~550bp to worst – both still about 200bp away from 2011 tights. Given that the vast majority of T1s currently trade with issuer calls "out of the money" (93% of the bonds in our sample), the effective duration in this sector is significantly higher than in European HY credit (PEHY 3% Ex-Fin index has an average duration of

FIGURE 19

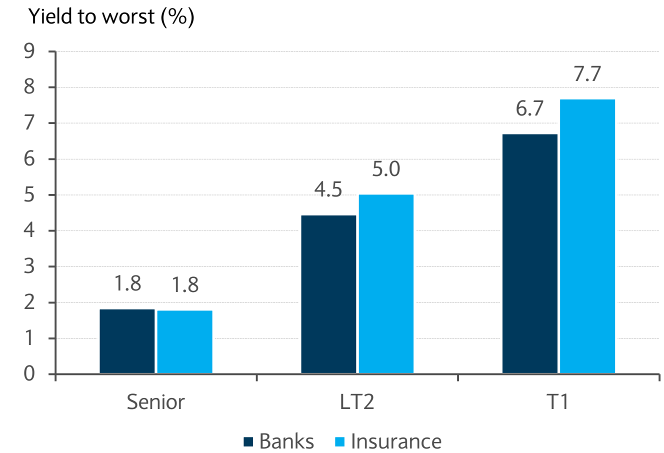
Bank capital – performance since April 2011 versus comps



Note: "Senior" – average spread of bank senior unsecured bonds in Barclays Euro Aggregate. "LT2" and "T1" – average spread of LT2 and T1 securities based on samples of actively traded securities. "PEHY 3% Ex-Fin" – average spread on the index Barclays index of the same name. Source: Barclays Research

FIGURE 20

Yield-to-worst across capital structure in Banks and Insurance



Source: Barclays Research

3.8), where 20% of the bonds included in the index already trade with calls "in the money". This suggests to us that the convexity profile in the T1 complex appears more attractive, with the average price of bonds in our actively traded universe at 90 versus the 103 average price for our PE HY index (ex-fins).

Top themes going into 2013

While we continue to believe that the subordinated financials space has room to outperform, we think investors should be mindful of the key risk concerns in the sector and position accordingly. We think that sovereign-related risk, risk of calls/LMEs, regulatory calls, balance sheet fundamentals and primary issuance are the key drivers that investors should be assessing when considering the value in bank and insurance capital going into 2013.

Macro risk – sovereign-related risks remain substantial

Given the high beta nature of financial hybrids, the macro risks in Europe are likely to continue to be a primary driver of performance in the asset class. The risk overhangs on this front are two-fold. First, the sovereign crisis in Europe continues along a winding path, albeit with the Euro-wide contagion risks at least somewhat reduced by the ECB OMT programme "put". That said, the systemic risk could potentially flare up again subject to the progress on keeping Greece within the Troika programme and the ability of the policymakers to maintain market access for Spain and Italy. In addition, one of the more predictable side-effects of the ongoing fiscal consolidation across Europe is a very weak macroeconomic backdrop, which is expected to continue weighing on credit fundamentals.

In our baseline scenario for 2013, we expect broader market spreads to grind marginally tighter on expectation of a shallow recession in Europe, Spain entering a programme in Q1 (activating ECB OMT purchases), the US fiscal cliff being resolved via partial measures and Greece staying in the Eurozone through year-end (after receiving a new programme). In that scenario, given still subdued valuations relative to senior, we would expect financial hybrids to be one of the key sources of outperformance in 2013. We thus believe the subordinated instruments of "core" European banks and insurers will be important drivers of outperformance in 2013. At the same time, given our expectations for ongoing volatility, we believe investors should generally remain cautious with respect to peripheral bank subordinated paper.

LMEs – a cushion to valuations for non-distressed names

European banks have taken out ~€18bn of sub bonds in 2012 to date versus ~€31bn in 2011. The LMEs in 2011 were focussed entirely on sub debt, while in 2012 senior debt LMEs have become more prevalent. Rationales have shifted and improved valuations now reduce the incentive for conducting sub LMEs; however, the ongoing need to build capital buffers should ensure that banks continue to identify securities to tender or exchange going into 2013.

From a valuation perspective, we believe that for non-distressed names LMEs provide a cushion to valuations in a negative scenario (we would expect further LMEs if bond prices fall to attractive levels). That said, it is important to keep in mind that more coercive LMEs have driven, and we believe could continue to drive, the realisation of credit losses in more distressed names (here, the recapitalisation programme for the distressed Spanish banks currently in progress is one example).

For a more detailed analysis, see *Liability management - understanding the rationale*, 20 September 2012.

Calls – a shift towards economic calls accelerates

In addition, banks have continued to actively manage the composition of their capital in 2012, with one of the key themes being an accelerating shift toward pure economic criteria when evaluating call options on subordinated debt. Most recently the trend was confirmed by LMEs announced by BBVA and Intesa (see *Subordinated call options go unexercised*, 2 November 2012). In October, BBVA announced a cash tender offer for LT2s, along which the bank announced that decisions to exercise calls on subordinated instruments in the future would be made on an economic basis. This was followed by Intesa's announcement of an exchange offer for selected LT2s. Not only did Intesa highlight that it did not consider it appropriate to maintain a call-all policy on subordinated debt instruments under current market conditions, but it went even further by removing the call feature from the bonds altogether.

This is a continuation of a trend that picked up in 2011, when Santander announced an exchange in which the bank offered to take out selected callable LT2s effectively below market prices and stated that call decisions in the future would be made on an economic basis. Although the activities which have effectively constituted bond extensions have been focussed on LT2s so far, we think that the shift towards economically-driven call decisions is a broader phenomenon and is likely to affect T1s as well, given that, at current valuations, the economic incentives to call in that part of the capital structure in many cases are even less attractive.

That said, by no means do we suggest that all European banks will stop exercising uneconomic calls in the near future. Many banks continue to appear committed to reputational first calls (mainly the high-quality, non-peripheral banks) and this has come through in the valuations of callable vs non-callable LT2s. That said, we would expect issuers to monitor the market's reaction to BBVA's and Intesa's recent moves, focussing in particular on their impact on the banks' cost of funding. In the end, the example of the US banks shows that economically-driven calls by strong banks can be acceptable.

In that context, we recommend that investors switch out of rich callable LT2s and T1s, ie, bonds where the market-implied value of the call is high relative to the economic value of the call (from the issuer's perspective) and move into bonds where the market-implied value of the call is low.

More precisely, generally we would avoid LT2s and T1s with calls trading "out of the money" that are pricing high likelihood of calls (we assume that a call is "in-the-money" if the bond is trading with a z-spread-to-worst tighter than the back-end spread, because in that case – if the bond was callable now – the issuer would likely be able to refinance the bond at a rate lower than the back-end spread). The easiest way to identify such bonds, in our view, is to screen for those trading out-of-the-money (z-spread-to-worst trading wide versus the back-end spread) and which offer little pick-up in yield-to-perpetuity (for T1s) or yield-to-maturity (for callable LT2s) versus the yield on bullet LT2s from the same issuer.

At the same time, we would focus longs in two categories of callable bank subs: 1) bonds with relatively high back-end spreads in which the call is "deep in-the-money" (z-spread-to-worst trading inside the back-end spread) and a decision to call would likely be economical even if the market volatility persists; and 2) bonds where there is little likelihood of a call being priced (and thus little downside if calls are not exercised). Among these bonds we prefer those that offer the best pick-up in yield-to-worst versus yield on bullet LT2 from the same issuer.

Notably, at current levels, only 28% of callable LT2s and 7% of T1s (in the sample of actively traded securities that we track) trade with the call options "in-the-money". This is because most of the outstanding bonds were issued before the crisis, with back-end spreads very low relative to prevailing market spreads. At the same time, many of these bonds continue to price in materially positive reputational value in the calls (ie, LT2s trading "to call" versus non-callable bonds and T1s with out-of-the-money calls trading relatively tight to LT2s, see Figure 22). While this reflects the fact that most of the core banks have continued to redeem all of their bonds coming up for first calls, we think that recent actions by BBVA and Intesa have increased the risk of negative re-pricing.

Lastly, as we move closer to the start of the Basel III phase-in period in Europe, we believe investors will need to become increasingly mindful of regulatory capital call provisions embedded in existing bank capital securities, a topic we expect to expand upon in future publications.

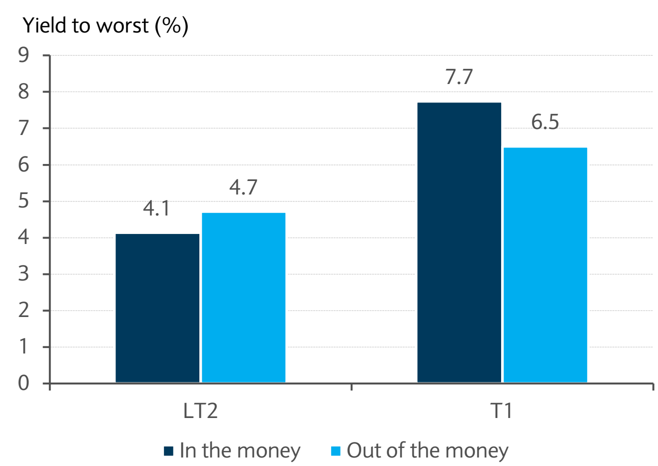
For more detail on this analysis and recommendations, see *Subordinated call options go unexercised*, 2 November 2012.

Fundamentals – balance sheets improving

Overall, our Bank analysts continue to be cautious on the sector from a fundamental perspective, highlighting that capital, liquidity, and funding improvements continue to be offset by ongoing asset quality deterioration. On the capital front, Core Tier 1 ratios have

FIGURE 21

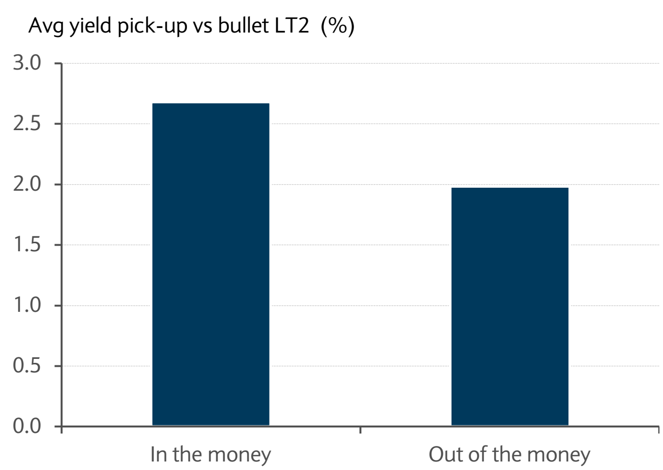
Bank capital average yields by moneyness



Source: Barclays Research

FIGURE 22

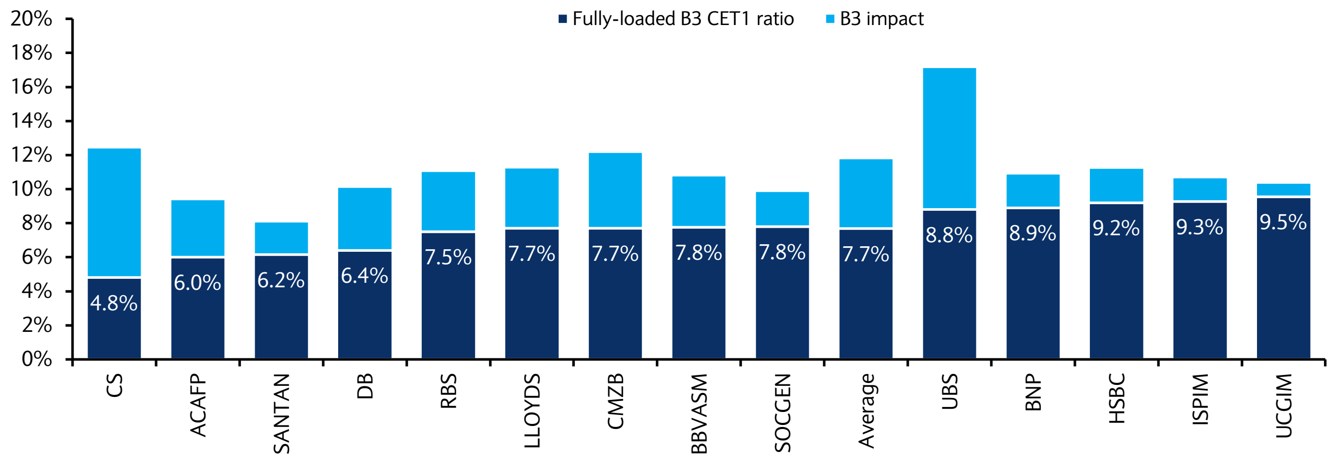
T1 yield pick-up vs bullet LT2s by moneyness



Source: Barclays Research

FIGURE 23

Fully-loaded Basel III core Tier 1 ratio and impact (Q2 '12)



Source: Company reports, Barclays Research

climbed to new records in 2012, although the fully-loaded Basel III ratios still have room to improve (Figure 23). This suggests that banks will likely continue to move toward increasing the ratios, which on balance should be supportive for bank capital valuations in our view.

For further details, see *As balance sheets improve, bondholder protection deteriorates*, November 2012.

Supply – Basel III compliant issuance to pick up

European banks have continued to make progress on building capital ratios in 2012, however on a fully-loaded Basel III basis there is still material room for improvement. We expect that RWA reductions and retained earnings will remain the key avenues for increasing capital ratios in the near term, with Basel III compliant capital instruments becoming a more important factor over time.

That said, we expect the new-style Basel III compliant hybrid issuance to pick up in 2013. In particular, we would not be surprised to see a meaningful increase in issuance of Tier 2 CoCos, driven by Swiss and UK banks, and possibly the Nordics. Moreover, the market should finally open up for Additional T1 capital (ie, T1 CoCos) towards H2 2013, assuming that the final version of CRD IV is published in H1 2013. Up to now, the issuance in this space has been stifled by the lack of clarity around the final structure of new non-common T1 capital.

On the redemptions front, we expect ongoing shrinkage in the old style hybrid space, driven mainly by upcoming calls (~€12bn in LT2s, ~€0.6bn in UT2 and ~€25bn for T1). However, the process may slow down relative to previous years given: 1) the ongoing shift towards economically-driven calls; and 2) a slow down in sub debt exchanges/tenders following large LMEs in 2011 and 2012, as well as the substantially improved valuations post this year's rally.

In the insurance sub space we would expect the run rate to remain close to the levels seen in H2 12, with issuance focussed in T2 paper, driven by refinancing needs and opportunistic capital management exercises. In the longer term, we would expect a more meaningful pick-up in issuance as the clarity around the Solvency II requirements increases.

CoCos – the market taking shape

In 2012 we have seen nearly €8bn of new CoCo issuance, which brought the size of this fledgling asset class to almost €20bn. Although quite limited in size for now, we believe the issuance trend is likely to pick up as banks continue to adjust their capital to the new regulations. Indeed, our Banks analysts estimate the potential size of the asset class in Europe at almost €400bn (€300bn in T1 CoCos, €50bn T2 CoCos from UK and Nordic banks and €37bn CoCos from Swiss banks; see *CoCos, a structural evolution - part 1*, 20 November 2012).

We think there are three basic questions that have to be addressed before CoCos as an asset class can truly start to grow.

- **What is the right structure for the CoCos?** It is still unclear what the right structure for CoCos should be. The CoCos issued so far have come to the market with a full spectrum of structural features, with the key differences lying in the conversion type (principal write-down versus conversion into equity), the mechanics of conversion trigger (various capital-ratio trigger thresholds; additionally complicated by varying methods of calculating the capital ratio) and inclusion (or not) of a viability trigger. Lack of specific guidance on these issues from the regulators is not helpful in answering these questions, but at least provides an opportunity for the market to find the right solution for all stakeholders. Although we will defer on predicting which format will ultimately prevail, looking at recently issued CoCos, one trend that appears to be clear at present is a move towards instruments with principal write-down versus securities convertible into equity. Overall, we would expect some stabilisation in the structure as CoCo issuance picks up into 2013.

- **How to value the CoCos in a consistent framework?** The wide variety of novel structural features in existing CoCos poses a significant challenge to assessing fair or relative value of these securities. The key difficulty lies in estimating the value of the conversion feature. The recent shift in issuance toward instruments with fixed principal write-down simplifies the task by eliminating the uncertainty around the recovery in conversion scenario, but assessing the likelihood of triggers – critical to evaluating the value in the bond - remains problematic.

- **Is there a sufficient investor base to absorb CoCo issuance?** Investing in CoCos may be problematic for many traditional bank capital investors mainly because: 1) CoCos are not eligible for inclusion in credit indices at the moment; 2) the novel structures make valuation difficult; and 3) many fixed income investors are not mandated to hold paper convertible into equity (although this may not be an issue if future issuance shifts entirely into CoCos with fixed principal write-down). That said, high participation in the recent CoCo deals indicates that these drawbacks are unlikely to deter investors as long as the issuers are ready to provide sufficient compensation.

Corporate hybrids

Valuations – corporate hybrids still offer value

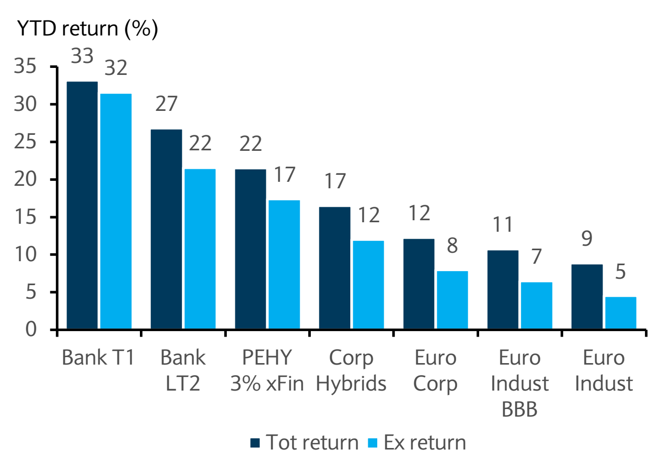
Corporate hybrids have been catching up with matched senior debt, but the spread gap remains wide (Figure 25**).** The relative value gap between corporate hybrids and matched senior debt has been compressing since September 2012; however, it still seems extreme and we see at least a few strong arguments to support this thesis. First, with hybrids paying ~350bp on average and senior offering only ~55bp, the hybrid-senior spread differential at 300bp appears very high. Second, the rating differential of 2-3 notches between the average hybrid (BBB-/BBB) and average matched senior bond (BBB+/A-) would imply an OAS spread differential of ~100bp given where A- and BBB senior non-financial cash currently trades. This contrasts quite significantly with the hybrid-senior average differential of 300bp mentioned above. We believe that this more than compensates for the liquidity and structural risk embedded in the hybrids.

Corporate hybrids have been catching up with the matched basket of equities (Figure 26). It makes sense from a fundamental perspective to look at hybrid valuations relative to equities, given that hybrids sit between senior debt and equity in the capital structure, share many features with equity (coupon deferral, perpetual or very long-dated) and the cash flows are structurally linked to the extent that all hybrids have either a dividend pusher or stopper. In practice, the relationship is confirmed by a high correlation between hybrid and equity performance, as shown in the chart. Very strong performance in corporate hybrids in September-October 2012 coupled with the weakness in matched equities have brought the valuations between the two parts of the capital structure back in line.

Corporate hybrids look somewhat wide versus the Industrials BBB sub-index (Figure 27**).** We also think that comparison against Industrial BBBs sub-index provides a useful reference point for hybrid valuations. Corporate hybrids appear wide relative to Industrial BBBs on a spread basis. The average OAS spread for hybrids is currently at ~350bp, while Industrial BBBs in Barclays Euro-Aggregate index pay 175bp. The current average spread differential between hybrids and equally rated non-financial senior debt, at 175bp, in our view, provides more than enough compensation for the risks we currently see in this asset class.

FIGURE 24

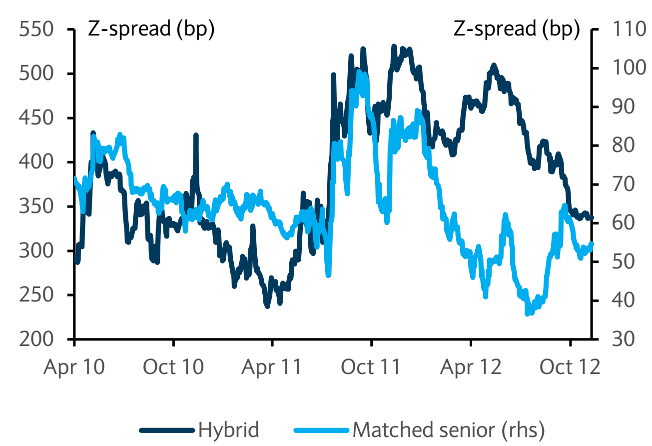
YTD returns across asset classes



Source: Barclays Research

FIGURE 25

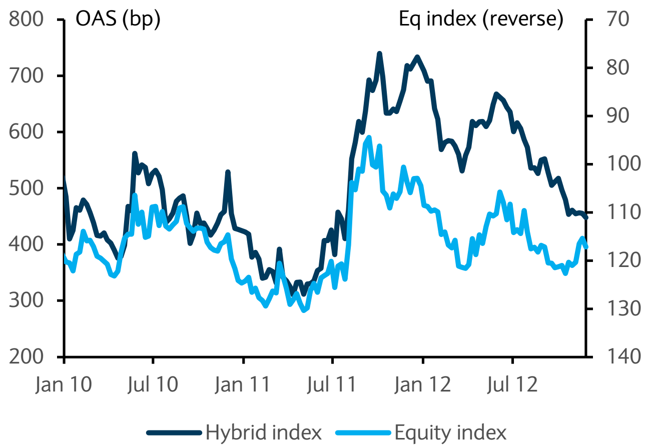
Hybrids catching up with matched senior debt



Note: Average hybrid spread excludes LTOIM and WIEAV.
Source: Barclays Research

FIGURE 26

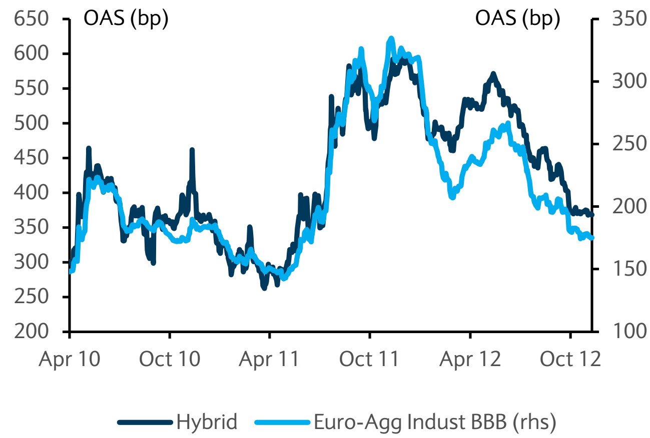
Hybrids catching up with matched equities



Note: The equity index was calculated based on the average return of the stocks of the names that have tradable equity (SIEGR, LINGR, HENKEL, BAYNGR, SZUGR, BGGRP, SOLBBB, OMVAV, DGFP, SSELN, RWE, ENBW, SEVFP, REXLN, ORGAU, STOAU, LTOIM, WIEAV), weighted by the current size of hybrid issuance outstanding. The equity-matched hybrid index was calculated as an average hybrid spread for names that have tradable equity. Source: Bloomberg, Barclays Research

FIGURE 27

Hybrids still look cheap relative to Industrial BBBs



Note: Average hybrid spread excludes LTOIM and WIEAV.
Source: Barclays Research

From a slightly different angle, the 350bp average spread on hybrids is close to the average spread on senior non-financial BB credit. We would argue that investors would be better served holding hybrid capital of the defensive-by-nature utility and industrial IG names rather than the fallen angel names that dominate in the BB bucket of the high yield market.

Top themes going into 2013

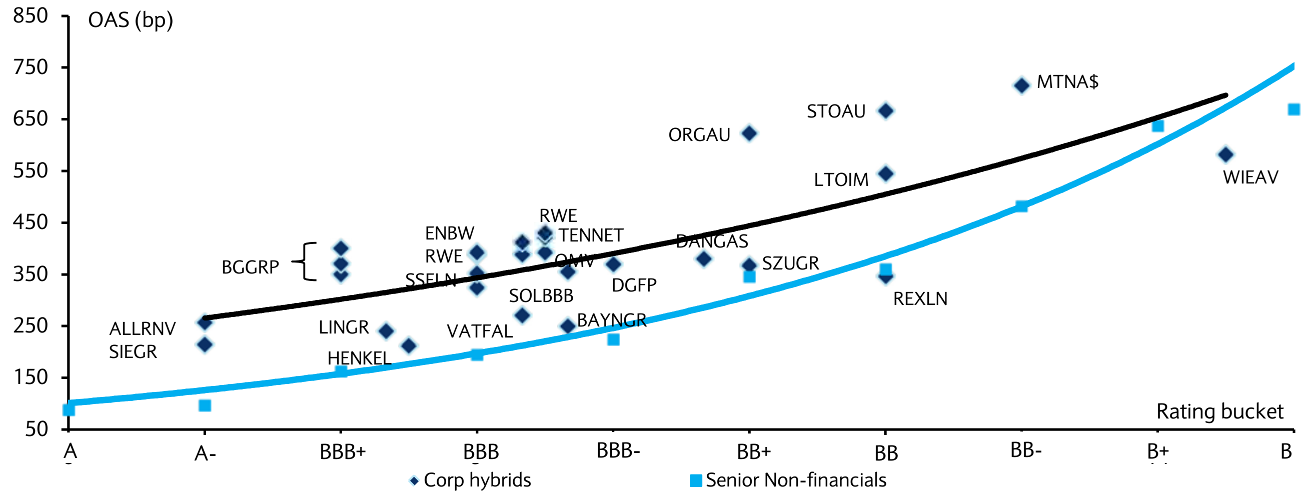
The key themes driving performance in corporate hybrids in 2013 in our view include, macro risk, fundamentals, call likelihoods, rating methodology risk and issuance. The same macro risks to those discussed in the European bank and insurance hybrids section apply to corporate hybrids, so we jump straight into the discussion of the other themes.

Fundamentals

In the current market environment, company fundamentals are, in our view, the second most important valuation factor in corporate hybrids after the macro developments in Europe. We think that fundamentals have a larger impact on valuations than structural bond features as long as the call dates are still far off, which is the case for most of the hybrids, and the issuer is not in distress, which also applies to the majority of names in the space - in this case the mechanics of coupon deferral would likely dominate.

In Figure 28 we overlay the average OAS spreads for non-financial issuers across rating buckets (light-blue line). Interestingly, a curve fitted to the hybrids spread-rating scatter (black line) is in line with the senior non-financials curve (blue line with markers), but shifted upwards by ~175bp – broadly in line with the 175bp spread premium in hybrids relative to the Industrial BBBs sub-index in Figure 27. We think a spread-rating screen like this provides a useful first step in the relative value analysis in corporate hybrids.

FIGURE 28
Spread versus rating



Note: Pricing indicative as of 12 Sep. OAS refers to option-adjusted spread to call. Ratings shown reflect the averages of Moody's, S&P and Fitch ratings.
Source: Barclays Research

Issuer calls

One of the key themes corporate hybrid investors have been focusing on is the issuer call feature. We are still more than two years away from the first large batch of calls scheduled for 2015 (10 out of 32 bonds that we track), but the way the bonds are structured around the call dates (step-ups, equity credit treatment, replacement capital covenants) will be increasingly important for the valuations as we get closer to that period. The first call date on LINGR 6 '13, in July 2013, should be an important test for the market.

The decision to call or extend a corporate hybrid will likely be driven to a large extent by the economics of the outcomes. With the recent rally in rates, a majority of the bonds in our corporate hybrid universe are now trading above par. However, given that all of the bonds have coupon resets based on rates current at the time of the call, only the prevailing credit spread will be relevant to the call decision from a purely economic perspective (the bond will be trading above par at the call date and the call decision will be economically attractive if the spread at which the issuer can refinance the hybrid in the market at the call date is below the reset spread and vice versa). We highlight a few key points based on this analysis.

- Three-quarters of the issuer calls are currently in the money.
- Calls in all but one (ORGAU 7.875% '18) of the names that have issued hybrids recently are currently in-the-money. This, in our view, is an effect of a combination of two factors: 1) the recent hybrids were issued amid high market volatility and consequently, came to the market with historically high coupon reset spreads; and 2) the hybrid structures issued over the past year lose equity credit treatment at S&P after the first call dates under the current rating methodology. We think that – assuming no significant changes to S&P hybrid methodology - both of these factors will continue to provide strong support for the high likelihood of calls in these securities.
- Not surprisingly, many of the older structures, ie, issued before 2011, are now out of the money. The main reason is that those securities were issued at spreads that are low relative to currently elevated levels. These securities would require further normalisation of the European credit market for the calls to move in-the-money.

Is the hybrid a binding constraint on the issuer's credit rating? In addition to gauging the likelihood of calls based on current valuations and structural features of the bonds, it is also useful to think about the extent to which the issuer needs the hybrid to maintain an efficient funding profile. Corporates typically issue hybrids in order to minimize the impact of increased funding needs on senior ratings, but avoid the high cost and dilution effect of equity financing. To get an idea of whether the hybrid on the balance sheet is a "binding constraint" for the senior rating, it is useful to look at what the key rating-sensitive credit metrics look like against the targets set by S&P and Moody's, assuming that the issuer: 1) keeps the hybrid on the balance sheet; 2) replaces the hybrid by issuing senior debt; or 3) replaces it with equity.

We would argue that whenever FFO/Debt or RCF/Debt after refinancing hybrid debt with senior debt or – almost equivalently – paying it down with cash ("Hybrid refi'd with senior" in the table) is below, or close to, the bottom of the range indicated by the agency, this likely means that the issuer needs the hybrid to achieve the target and is thus less likely to redeem it in the near/medium term. Clearly, this does not mean that the issuer will not call the bond to refinance it with another hybrid; however, we would expect that most of the situations in which the issuer has to issue a hybrid to maintain ratings would coincide with the periods when the call on existing hybrids is not attractive economically (eg, the recent new SSELN hybrid issuance in € and $).

Rating methodology risk - a tail risk for the asset class

S&P recently published a request for comments (RFC) on the proposed methodology change regarding assigning "high" equity content to corporate hybrids (see *Request For Comment: Criteria: Assigning "High" Equity Content To Corporate Hybrid Capital Instruments*, S&P, 14 November 2012).

The RFC states: "Standard & Poor's is proposing to update its hybrid capital methodology for determining the equity content of certain corporate hybrid capital instruments, i.e., the degree to which these instruments are included in our measures of capital for issuers, especially those classified as having "high" equity content. Under the proposal, we would no longer assign "high" equity content to a hybrid capital instrument issued by a corporate issuer that has:

- A stated or effective maturity;
- Any step-up coupon feature or equivalent financial incentive to redeem; or
- With certain exceptions, any type of call option within 10 years of the issue date."

No grandfathering. Contrary to some of the previous S&P hybrid methodology changes, this one would likely be applied to existing issues (no grandfathering), given that the RFC mentions "approximately 10 hybrids could be affected" and the issuer ratings of "up to three entities could be affected".

This suggests that the hybrid bonds in our universe currently with high content, ie, DANGAS 7.75, STOAU 8.25% and ORGAU 7.875%, could lose "high" equity content, because all have calls within 10 yrs since issuance, although they would still qualify for the "intermediate" equity content under current rules, unless these rules are also modified. We would note here, that the RFC also asks market participants if a presence of a contractual replacement capital covenant (RCC; the covenant requires that the bond is refinanced via an issue of capital of the same or better quality) would be enough to ensure sufficient permanence of the bond for it to qualify for the "high" equity content bucket (assuming all other requirements for this classification are met). If S&P decides that this is the case, STOAU 8.25% and DANGAS 7.75% could retain "high" equity content, given that these securities have RCC language starting at issuance.

Securities with "intermediate" equity content could potentially be affected. In our view potentially much more importantly, the RFC asks market participants if they "think the permanence analysis should be the same for "high" and "intermediate" equity content, i.e., that the criteria should not assess instruments with a stated or effective maturity as having "intermediate" equity content." As it stands now, "the proposal does not affect the eligibility for "intermediate" equity content of corporate hybrid capital instruments with a stated or effective maturity". All corporate hybrids issued in our universe since mid 2011 have effective maturity and are currently classified in the "intermediate" equity content bucket. Any change to the hybrid methodology that would reclassify those securities to the "minimal" equity content bucket would be a major negative for the valuations of the affected securities, given that all of these securities have rating event call language, which allows most of the issuers to redeem the bonds at 101% of par if their equity content is reduced. Based on recent comments from S&P, we do not expect this to become an issue in the near term. That said, we do believe investors must remain watchful for any signs of change on this front.

Issuance – more of the same?

2012 has seen €5.8bn in new hybrid issuance to date, bringing the size of the market to ~€36bn. All new issuance (ArcelorMittal, SSE, RWE, BG Group, EnBW) has been in the "new" format where the bonds have a 100bp step-up in year 25 or 27 with an intent-based, but not contractually binding, RCC. Most notably, these securities are typically structured to receive intermediate (50%) equity treatment at S&P until the first call date, but lose this treatment thereafter. This is a continuation of a trend initiated with the issue of ORGAU 7⅞ '17 in June 2011 – the first € hybrid covered by S&P's 2011 hybrid rating methodology.

After the well-flagged recent new hybrid issuance from RWE, SSELN and BGGRP, the sources of new issuance are now less clear. Vattenfall, National Grid, Veolia and Repsol are the only corporates that have been indicating plans to issue new hybrids, as far as we are aware. That said, we expect continued issuance in 2013, primarily from many of the seasoned hybrid issuers, with a few new issuers potentially entering the market.

Asian credit strategy

ASIA STRATEGY

China stabilisation to drive returns

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- **We expect Asia IG excess returns of 225-250bp in 2013, with carry being the main driver. We expect Asia HY to generate 5-6% of total returns, with the spread compression being eroded by defaults.**
- **With Asian bond markets growing faster than other regions' and relative liquidity improving, given constraints in developed markets, the liquidity premium demanded for Asian bonds is also likely to narrow.**
- **In high grade, we expect spread compression in the China-Hong Kong complex to be the biggest driver of excess returns, with stabilisation of growth in China and a subsequent re-rating of that segment being the key drivers. In high yield corporates, we maintain our overweight rating on Chinese real estate and recommend reaching down into single-Bs to generate returns.**
- **The sovereign segment of high yield trades at levels tighter than many investment grade corporates and these spreads need to compress significantly just to match the returns of the benchmark. So we recommend switching out of sovereigns into quasi-sovereigns/corporates.**
- **Incremental inflows in 2013 will mostly be targeted at corporates. Key drivers are likely to be strategic allocations to Asian/EM corporates and demand from domestic investors in Asia who previously focused on local-currency government bonds. Reduced demand from retail/private banks, due either to a sell-off in rates or strong performance by equity markets, is a key risk for BBB/not rated segments of the market where institutional support is limited.**
- **We forecast 2013 gross supply to be USD90-100bn (net supply of USD70-80bn), compared with USD115bn in 2012 YTD and USD59bn in 2011. Supply will likely be dominated by high grade, with high yield focussed on refinancing.**

Returns to be significantly lower

We forecast Asia IG excess returns of 225-250bp in 2013. Returns will be driven by carry (Spread on Nov 30: 175bp) and spread tightening (10-15bp). Given that our rates strategists expect 5y and 10y rates to be flat between now and end-2013, we expect Asia IG total returns to be approximately 325-350bp in 2013.

Our view of a 10-15bp compression in Asia IG is based on the expectation that inflows into credit in general and high grade EM/Asian credit in particular will continue in 2013, though they could less than they were in 2012. We expect US/Western European institutional investors to increase strategic allocations into EM corporates next year, driven by the tight valuations in EM sovereigns and the fast-paced growth in EM corporates. Within Asia, we expect institutions and retail increasingly to look at the G3 corporate bond market as a source of extra return, given the low all-in yields available in local currency fixed income product. In this regard, our highest conviction view is to be overweight the HK & China complex, which accounts for one-third of the spread duration of Asian high grade credit. A key risk to our view is a sustained rally in equities, accompanied by a sharp rise in risk-free rates, both of which would likely diminish/reverse private bank demand for investment grade corporates.

We expect Asia HY to generate 5-6% of total returns and forecast excess returns to be 4-5% for 2013. Given the current spread of ~430bp, carry is likely to be the most significant component of total returns. We look for 20-25bp of spread compression, built on the view that Chinese HY property can continue to compress significantly while HY sovereigns have limited upside potential. Projecting a default rate on Asian HY is challenging, given the small set of issuers and the nature of defaults. 2.5% of Asian HY is trading at a price of less than 85, and assuming over two-thirds of these default, returns would be diminished by 1%. Combining the effects of carry, spread compression, movement in rates and losses due to defaults, a 5-6% total return expectation looks to be appropriate.

Prefer corporates to sovereigns, investment grade to high yield

We expect credit markets to be helped by positive technicals and a benign fundamental backdrop, but the upside will be capped by the low level of spreads and yields. In this scenario, carry is likely to be the largest component of excess returns.

In high grade, we expect the China-Hong Kong complex to be the biggest driver of excess returns. The stabilisation of growth in China and a subsequent rerating of that segment are likely to compress the discount of Chinese credits to other Asian/global peers. India has the potential to generate significant returns if proposed government policy changes are executed nearly perfectly and the overhang of a sovereign ratings downgrade fades. Absent conviction on the policy front, we recommend keeping an overweight until February 2013 and reassessing exposure based on the tone of policy and the 2013 budget.

We project high yield will generate significantly higher excess returns than high grade, but in our view, they will not be sufficient, given the beta of high yield. The sovereign segment of high yield offers spreads that in many cases are tighter than investment grade corporates, and as shown in Figure 1, these spreads need to compress significantly just to match the returns of the benchmark. More than 50% of the callable high yield corporate bonds are trading above their next call price (versus 14% in June 2012 and 12% in December 2011). In this segment, like the sovereign/quasi-sovereign segment, we expect returns to be limited largely to carry. Although bonds trading below $85 account for less than 3% of total market value, they account for almost 10% of the spread duration. While these issues have the potential to generate significant total returns, given the corporate governance overhang at many of these companies, they have become “un-investable” for large segments of investors.

Overall, we recommend switching out of sovereigns into corporate credit and quasi-sovereigns. We expect fund offerings to move away from sovereign-only mandates to corporate mandates and flexible EM aggregate-type mandates.

FIGURE 1

Sovereign yields need to compress significantly to generate excess returns similar to corporates

	HY Corporates	HY Sovereigns	IG Corporates	IG Sovereigns
OAS	620	174	187	152
OAD	3.96	8.31	5.15	6.78
	If HY corporate spreads are unchanged in three months, HY sovereigns need to compress at least 13.4bp to provide the same excess return. At current spreads, this implies compression of 8% for HY sovereigns		If IG corporate spreads are unchanged in three months, IG sovereigns need to compress at least 1.3bp to provide the same excess return. At current spreads, this implies compression of 1% for IG sovereigns	

Source: Barclays Research

FIGURE 2

Corporates are cheaper than sovereigns even after the 2012 rally (OAS bp)

Source: Barclays Research

Recommended positioning for 2013

By Geography

High Grade

1. Indonesia

- Benign fundamentals and supportive technicals will sustain Indonesia's appeal through Q2 13. In H2, we recommend that investors reassess their exposure, given that headlines about the presidential election in 2014 are likely to increase. In our view, the emergence of a reform oriented front-runner would help to assuage concerns on this front.

2. China/Hong Kong

- Lower concerns about a potential sharp decline in growth and/or better-than-expected growth would drive the outperformance of Chinese/Hong Kong credits; however, supply from Chinese SOEs could cap upside potential.
- We are comfortable with a slightly above-benchmark exposure to the China complex. We would avoid some of the tertiary SOEs, which we think are most at risk of rating downgrades due to an adverse operating environment.

3. India

- If sovereign rating is not downgraded, spreads could settle about 30bp tighter, but a downgrade by two agencies would likely push spreads 70-80bp wider. Given the recent headlines on policy, our view is that the chance of both agencies downgrading is about 20%, while there is a 50% chance that both retain their current rating.
- We think rating downgrades (by Fitch, S&P or both) will depend on the economic data and policy developments in the coming months – areas over which the government does not have complete control. Any rating agency action would only occur in late Q1 or Q2 13, after the budget presentation.
- We are comfortable with an above-benchmark exposure to Indian bonds in the near term (until February 2013), given wider spreads, but would look to adjust to neutral ahead of the budget.

4. Korea

- For benchmarked Asia credit investors, an underweight stance is appropriate, given that spread levels are significantly tighter than the benchmark. Korean bonds are more attractive for US investors, since they give a spread pickup over their benchmark but for Asia-benchmarked investors, we believe there is better value in other parts of the market.

High Yield	
1. Sovereigns and quasi-sovereigns	• Versus the Asia credit benchmark, given absolute spread levels, we think an underweight stance is appropriate.
2. Chinese property	• For 2013, we recommend increasing exposure to medium-sized B-rated developers yielding 8-12%. • A benign macro economic outlook, prudent financial management and still-attractive yields should drive performance. • While we do not see sector-specific downside risks, it is worth noting that significant leverage has been deployed by private bank clients in this sector. Therefore, tighter-spread names will be more vulnerable to potential leverage unwinding, because we think private bank clients are more likely to raise cash by selling the best performers than to realise losses on other positions. • We think the appetite to rebuild land banks and obtain cheaper offshore funding is also likely to pick up in H2 13. We maintain our overweight view on the sector.
3. Indonesia coal HY	• Without a significant bounce in coal prices, credit metrics for these companies are likely to remain under pressure. We recommend opportunistic exposure at lower levels on the expectation that event risk in the Bakrie complex will ultimately subside
4. Chinese industrials	• Recent Chinese activity data show signs of a stabilisation in growth. We suggest positioning to ride the economic/business cycle – cement companies should see the first-round effects of growth stabilising in China.

By rating buckets

- BBB-rated and not-rated credits with investment grade metrics offer best risk/reward. High yield credits in the BB segment have richened versus BBB and not rated bonds. Therefore, we recommend maintaining only selective exposure to BB credits. Select single-Bs across Chinese real estate and Indonesian coal offer better risk/return.

Along the curve

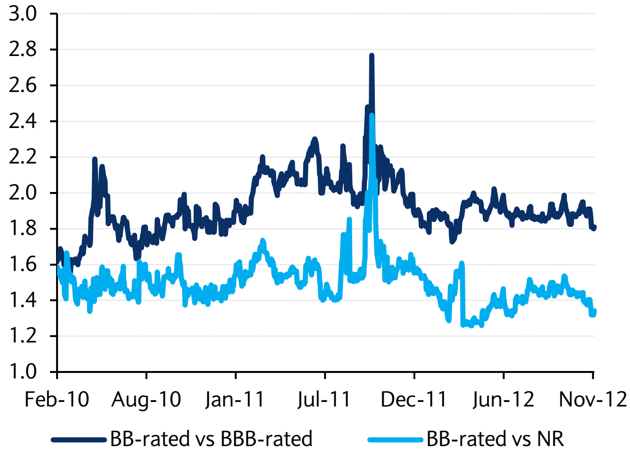
- Expect investment grade credit curves to continue to flatten with long-dated bonds outperforming. Our view is based on the expectation that allocations to corporates will intensify in 2013 and that regional insurance companies' (from Taiwan, China, Thailand and Korea) investments in corporate credit will grow.
- For Indian financials, we continue to like the front end of the curve (including 2016s). These bonds offer carry and given the short tenor should be less vulnerable on a MTM basis to any weakness on credit rating concerns.

Along the capital structure

- We recommend investors move down the capital structure to generate yield rather than move down the credit spectrum.
- Switch from BB-rated Chinese real estate bonds into corporate hybrids (eg, Cheung Kong Infrastructure and Hutchison Whampoa perps).
- LT2 bonds also offer attractive yields compared with BB rated credits. In addition to the value proposition, we think the structural demand for old-style subordinated debt is likely to intensify in 2013, given the scarcity of such structures.

FIGURE 3

BB rated have richened vs BBB rated and not rated



Source: Barclays Research

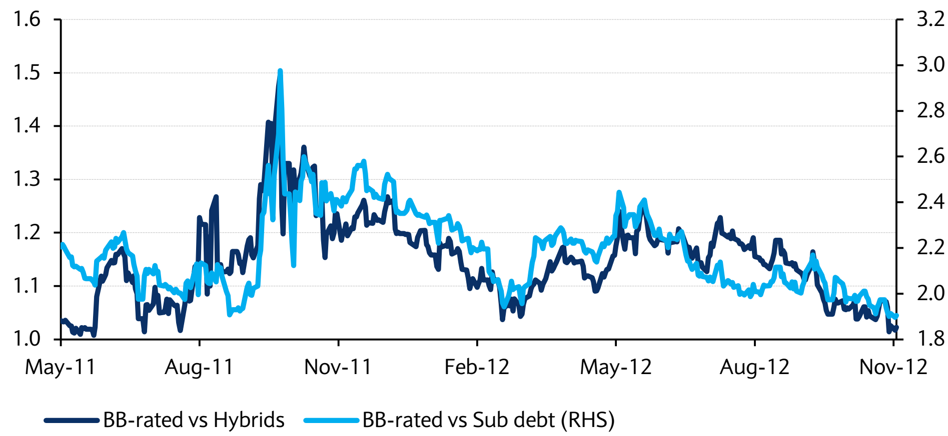
FIGURE 4

BBB credits still look cheap vs A rated

Source: Barclays Research

FIGURE 5

BB-rated credit vs corporate hybrids and bank sub-debt



Source: Barclays Research

Macro themes for 2013

China growth stabilising

Recent data are in line with our economists' expectation that Chinese GDP growth will stabilise at 7.5-8.0%. Stabilising and/or better-than-expected growth will continue to lead to unwinds of China tail-risk hedges and drive spread compression for cash bonds, in our view. Following the Communist Party Congress, we do not expect a large stimulus programme. We expect the government to introduce some investment projects, eg, to promote urbanisation and service sector and regional development. Implementation of major new policies will probably have to wait until at least the Third Plenum of the Central Committee, which will be held about a year from now.

Looming concerns about India's sovereign ratings

We think rating downgrades (by Fitch/S&P/both) will likely be dependent upon the path of data and policy over the coming months – areas over which the government does not have complete control. Any rating agency action would occur only in late Q1 or Q2, after the budget presentation.

If downgrades do not occur, then spreads could settle about 30bp tighter than current levels, whereas downgrades by two agencies would likely push spreads 70-80bp wider.

Interconnectivity of offshore and local currency corporate bond markets

In 2013, we expect increased interconnectivity between the offshore and local-currency corporate bond markets. Onshore investors' (retail, insurance companies, pension funds) demand for USD bonds is likely to intensify next year in a stretch for yield, given the compression in local-currency government bond yields. In addition, local-currency corporate bond markets are not deep enough to absorb the growing demand. This demand dynamic will be a function of cross-currency basis swaps and the growth of onshore corporate bond markets. In 2013, typical USD investors will have to pay more attention to cross-currency basis swaps (especially in Malaysia, Korea, Thailand, Singapore) and central bank policy rates to gauge magnitude and timing of demand for bonds.

Supply dynamics will also be increasingly affected by the liquidity of local-currency markets. Two factors worth considering are that banking system liquidity is improving across the region and an uptick in corporate bond issuance in China (CNY-denominated) can provide alternative funding platform for corporates.

Relative changes in liquidity favour Asia

With Asian bond markets growing faster than other regions' bond markets, there has been an increase in the number of investors participating. Furthermore, many global investors who were previously involved in Asia have chosen to establish a physical presence in the region, usually starting with investment analysts followed in quick succession by an ability to execute transactions. Also, institutions from within the region (Thai, Korean, Taiwanese insurers; Chinese banks; Japanese asset managers) have become more prominent participants. As a result, liquidity in bonds during Asian trading hours has increased significantly. The improvement in liquidity has come at the expense of Asian bonds' liquidity during US trading hours. With more US based-investors preferring to trade Asian bonds during the Asia morning, we think the shift has crossed an inflection point, and the trend is likely to accelerate in 2013.

In addition, with the liquidity of corporate bonds in US and Europe declining significantly – driven partially by regulatory constraints – the gap between liquidity in Asia and developed markets has compressed. As a result, the liquidity premium demanded for Asian bonds is also likely to narrow over time.

Demand drivers – local demand to be the swing factor in 2013

Based on the drivers of flows across the different investor bases, we believe incremental inflows in 2013 will be most robust in the corporate segment. The key factors influencing these inflows will be:

- Strategic allocations to Asian/EM corporates, given rapid growth and a sense that the market has reached a "critical mass" that justifies allocations; and
- Low government bond yields in many countries, including Korea, Thailand and Malaysia, which will push domestic investors who previously focused on government bonds to take exposure to offshore bonds to generate yield.

Below, we enumerate the key investor bases, drivers of allocation decisions and the changes we expect in 2013. Where possible, we use end-investors making allocation decisions rather than channels like money managers.

FIGURE 6

Expected demand changes for Asia sovereigns

Investor base	Driver of flows	Changes expected in 2013	Overall view for 2013 vs 2012
Global institutional fixed income investors	1. Structural shift to EM assets 2. Relative value of Asian sovereigns versus LatAm/EEMEA	1. Strategic allocations by institutional investors (eg, European/UK pensions and insurers) into EM will continue, but more slowly than in 2012 2. Relative value considerations may put Asia at a disadvantage	↓
Global EM sov/quasi-sov benchmarked retail funds	1. Structural demand for EM assets from retail investors following solid performance (compared with other credit assets and equities) 2. Relative value of Asian sovereigns versus LatAm/EEMEA	1. Scope for growth in ETF assets, albeit at a slower pace. Total ETF assets tracking Asian sovereigns amount to ~2.5% of the amount outstanding; for US HY, that figure stands at 4-5%	↔
Domestic (pan-Asia) buyers	1. Bank buying to match USD liabilities (eg, USD deposits) 2. Retail buyers stretching for yield, rotating out of local-currency bonds into USD debt – especially given rate cuts and low yields on local-currency government bonds	1. Philippine banks to continue to buy ROP bonds. We expect this group to gradually expand mandates to corporates into high grade 2. If investment-led loan demand slows in Indonesia, banks with ample USD liquidity are likely to park the funds in INDON bonds 3. Interest from retail investors to grow via domestic trust banks and Singapore- and Hong Kong-based private banks	↑
Insurance	1. Investors focused on all-in yields for asset-liability matching	1. Participation likely to increase if yields rise because of spread widening or a sell-off in rates	↑
Asia credit benchmarked investors	1. Relatively low volatility and significant composition of benchmark	1. Participation likely to be opportunistic; would increase as a defensive measure if market environment deteriorates	↔
Leveraged funds – credit and global multi-asset	1. Opportunistic especially in the high yield segment 2. Event driven – eg, developments in inflation, politics, foreign exchange	1. Interest in buying/selling Indonesia to grow as we head closer to the presidential elections in 2014	↔

Source: Barclays Research

FIGURE 7

Expected demand changes for Asia High Grade

Investor base	Driver of flows	Changes expected in 2013	Overall view for 2013 vs 2012
Institutional allocation from insurers and pensions	1. Strategic shift towards Asia/EM corporates 2. Diversification from US/Europe corporates	1. Institutional investors are more knowledgeable about the EM corporate segment and are likely to consider incorporating these credits into asset allocations, but not yet as a part of their strategic benchmarks 2. A larger proportion of new allocations is likely to be directed to high grade corporates, given valuations of EM sovereigns and the growth/track record of the EM corporate segment	↑
EM corporate benchmarked retail funds	1. Strategic allocation to EM assets 2. Shift in allocations to EM corporates from EM sovereigns 3. Relative value	1. Flows likely to be higher than in 2012 since a number of new funds were launched this year and returns have been very strong even as yields remain better than comparable assets 2. EM corporate funds are now being raised in a larger number of markets than previously	↑
Asia credit benchmarked mutual funds	1. Stretch for yield – rotating out of local-currency debt into USD debt – especially given rate cuts and low yields on local-currency government bonds 2. Cross-currency basis swaps rising, which makes swapped yields more attractive 3. Strong performance in 2012	1. Taiwan: Expect more allocations towards Asia IG and HY 2. Japan: Mandates towards Asia HY to increase 3. Others: Low local yields will push fund managers to invest in USD-denominated bonds, especially if cross-currency basis swaps rise. Malaysian, Korean fund managers are potential candidates. We find that most Malaysian managers have the flexibility to hold up to 30% of their NAV in foreign bonds	↑
Asian official institutions' allocations	1. Strategic allocation to Asia 2. Diversification from Europe	1. Official institutions that do not have EM/Asia in their strategic benchmarks are likely to start allocating to the region	↑
Asian insurance companies	1. Oriented towards all-in yields for asset-liability matching 2. Cross-currency basis swaps rising, which makes swapped yields more attractive than government bonds	1. Expect participation in long-dated high grade corporates, especially from Taiwanese insurers 2. Insurers from Thailand, Hong Kong, Korea and, potentially, China likely to buy quasi-sovereign/high grade bonds of issuers from their home country	↑
Commercial bank treasury desks	1. Generate returns on deposits (especially foreign currency) or park USD liquidity raised through bond issuance	1. Chinese banks to buy Chinese SOE credit on USD deposit accumulation. USD deposit accumulation is a function of appreciation expectations, with two-way USD/CNY movement leading to higher USD accumulation 2. Philippine banks to gradually expand mandates to high grade corporates offering higher spread than ROP bonds 3. Indian banks will continue to buy other Indian bank bonds as a way to deploy USD liquidity temporarily 4. Banks from Singapore and Europe to be more active since the decline in their wholesale funding costs has been greater than the compression in corporate bond spreads and credit growth has been anaemic.	↑
Leveraged funds (eg, Asian credit, global multi-asset global credit)	1. Opportunistic and relative value 2. Event driven, such as M&A, earnings	1. Expect interest to remain stable	↔
Private banks	1. Assets continue to grow 2. Allocating to credit instead of equities remains a theme 3. Access to leverage enhances yields on high grade bonds	1. Becoming an important participant in the market. Issuers in the region (and globally, especially European financials) to target these investors 2. More leverage to be applied to high grade corporates, including those that are not rated by credit agencies.	↓

Source: Barclays Research

FIGURE 8

Expected demand changes for Asia High Yield

Investor base	Driver of flows	Changes expected in 2013	Overall view for 2013 vs 2012
EM corporate benchmarked mandates	1. Strategic allocation to Asia/EM 2. Relative value between high grade/high yield	1. Increased allocation to high yield as a result of stretch for yield 2. Pickup in EM high yield-dedicated mandates	⬆
Asia HY-dedicated mutual funds	1. Low all-in yields in other segments of fixed income 2. Rangebound equity markets	1. Increase in Asia HY-dedicated funds in Japan, Taiwan and the rest of Asia given strong performance in 2012 – provided HY bond supply picks up	⬆
Private banks – leveraged/ unleveraged	1. Pool of assets continues to grow 2. Allocation to credit instead of equities remains a theme 3. Willing to use leverage to invest in high yield bonds, since tighter spreads on high grade bonds makes leveraged returns there less attractive	1. Expect clients to leverage high yield bonds more aggressively in order to generate double-digit returns 2. Lack of significant defaults is also likely to make leverage easier to obtain	⬆
Leveraged funds – Asian credit and distressed	1. Opportunistic and relative value 2. Event driven (eg, M&A, earnings)	1. Pool of very high yielding bonds is shrinking globally. Stressed segments of Asian credit offer high yields but complexities of the workout process and jurisdiction create hurdles for participation. Expect demand to be in line with 2012	⬅➡

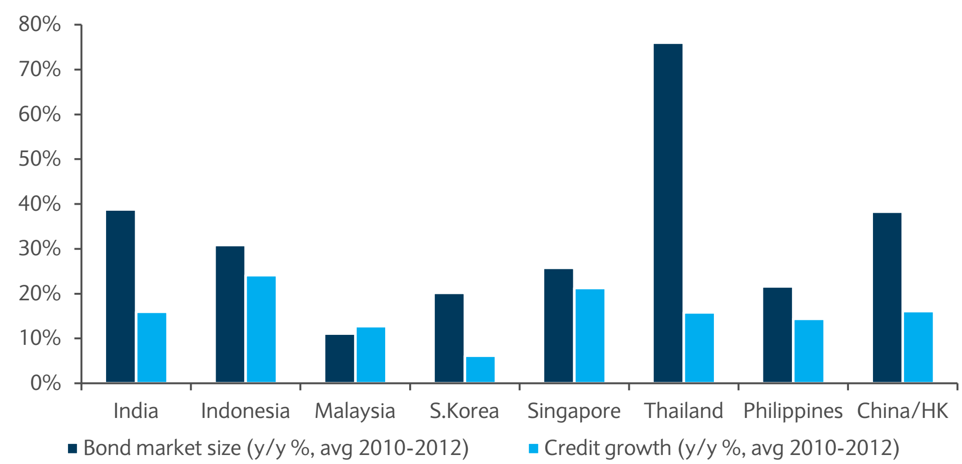
Source: Barclays Research

Supply slightly lower

We forecast 2013 gross supply to be USD90-100bn (net supply of USD70-80bn) compared with USD115bn in 2012 YTD and USD59bn in 2011. Asian credit has grown rapidly in past three years owing to net issuance and increasing allocations to the asset class. Net supply of Asian bonds has outpaced credit growth in most countries in the region. However, we do not expect this trend to continue, especially considering the deepening of local-currency bond markets underway in many parts of Asia. We expect a lower gross supply in 2013 than in 2012.

FIGURE 9

Bond market growth has outpaced credit growth



Source: Barclays Research

Asian corporates: More maiden issuance in 2013

We believe issuance in 2013 will be dominated by high grade issuers. High yield supply, in our view, will be focused on refinancing, and an increase in issuance will be contingent on the outlook for the Chinese economy/financing costs in China. High yield supply (including maiden issuance) should rise in 2H13 if China's macro picture improves significantly.

High grade corporates

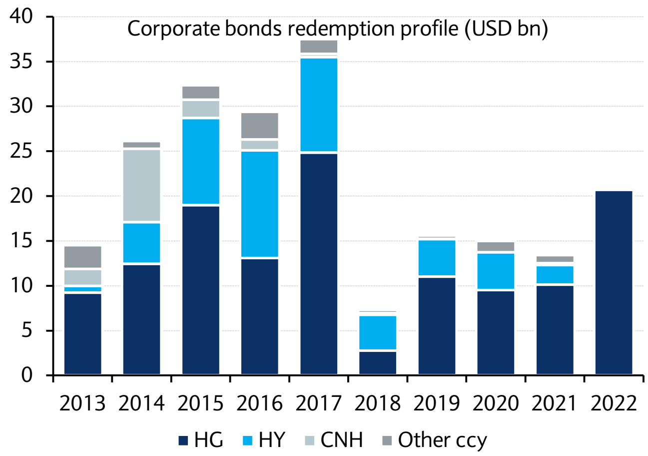
- Issuance will be dominated by Hong Kong, China and Indian corporates. The key themes driving issuance will be: 1) M&A activity; 2) loan-to-bond migration; and 3) changes in regulations making offshore borrowing easier and cheaper.
- Issuance from India will pick up in 2013 from the oil and gas, and utility sectors.
- A significant portion of the CNH bond universe is redeemable in 2014. Refinancing in CNH depends on demand, which is tied to the outlook for the CNY – if the outlook for subdued appreciation remains unchanged, larger corporates may tap the USD market opportunistically to refinance or pre-fund CNH bond maturities.
- High grade corporates will continue to diversify their funding currencies. In particular, as US corporate bond issuance in the JPY tapers off, Korean corporates will continue to shift issuance from the USD market to the JPY bond market. The SGD-denominated bond market has also grown rapidly this year, and we believe Hong Kong developers, and Malaysian and Singaporean companies will remain opportunistic issuers in this space. Supply will be a function of cross-currency basis swaps and demand.

High yield corporates

- We expect issuance to be mainly for refinancing. However if China's macro outlook improves, supply could pick up in 2H13.
- **Indonesia**: We think net supply will be low. We expect corporates to conduct tender offers or bond exchanges for upcoming calls
- **China**: We think supply will be mainly for refinancing or driven by onshore borrowing restrictions. Modest issuance is possible from smaller- and medium-sized property developers, in our view, especially from companies that want to expand their land banks. First-time issuers may also take advantage of market conditions to tap a new funding source and term out debt. The cement sector is likely to see maiden issuance if government policies continue to restrict onshore lending to these firms.
- **CNH market**: We expect larger corporates to opportunistically tap the USD market to refinance or pre-fund CNH bond maturities. Some CNH redemptions are also likely to be refinanced in the SGD market, in our view.

FIGURE 10

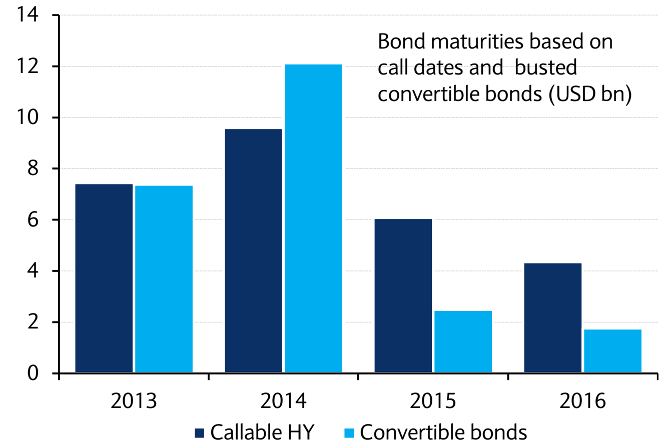
HY corporate bond maturities are relatively low in 2013



Source: Bloomberg, CMU, Barclays Research

FIGURE 11

But there are a significant number of busted convertible bonds and calls on high yield corporate bonds



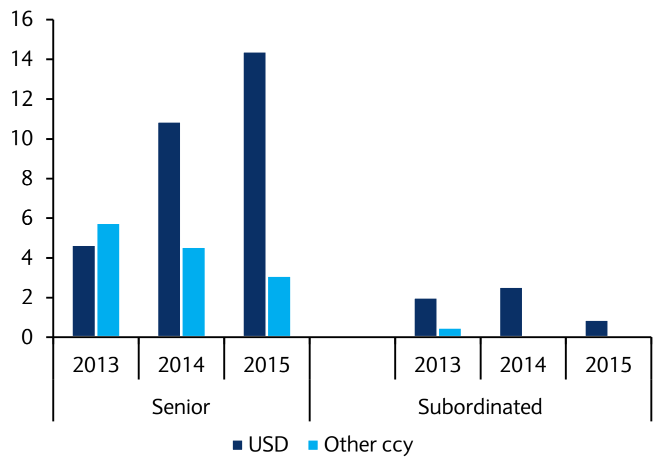
Source: Bloomberg, Barclays Research

Asian financials: Subordinated debt issuance to pick up in 2013

- We expect net supply from Asian financials. Refinancing will not be the key driver – banks will be borrowers to fund loan growth and M&A. Maiden issuance is likely from Thailand, Indonesia, Mongolia and Sri Lanka, in our view, where loan demand is solid.
- **Korea**: Net supply will be flat or lower y/y, although Korean banks account for most of senior debt that matures in 2013. Korean banks have diversified their funding currencies, and we expect some of the USD maturities to be refinanced in the JPY market.
- **India**: Indian banks will be small net issuers next year, in our view. Maiden issuance from financing arms of utilities or infrastructure companies is also likely following the loosening of restrictions on external commercial borrowings.
- **Debt funded M&A and expansion**: Malaysian and Singaporean banks, such as Maybank and DBS, will be potential issuers of senior debt to fund M&A and growth
- **Regulation driven**: While Basel III regulations on the Net Stable Funding Ratio do not come into force for a few years, we expect the shift in banks' – notably those from Hong Kong, Thailand and Malaysia – business mix to drive a need for USD funding.
- **Subordinated debt**: The introduction of Basel III regulations across the region means old-style capital instruments lose capital credit; therefore, banks are likely to boost their Tier 1 and Tier 2 capital by issuing loss-absorbing capital instruments. We expect subordinated bond issuance from Hong Kong banks, given their low capital levels.

FIGURE 12

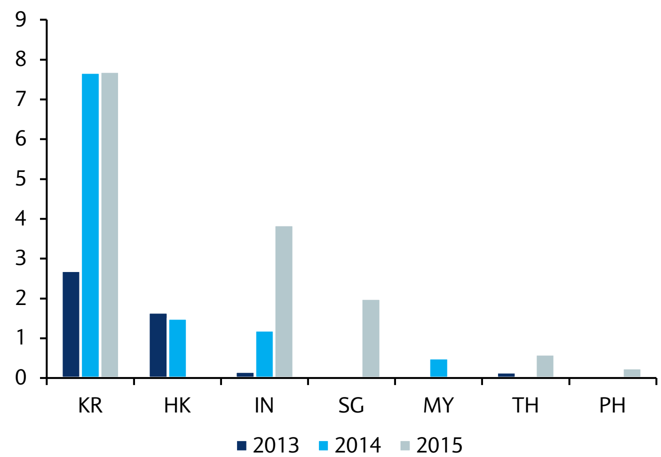
Financials face low maturities in 2013 (USD bn)



Source: Bloomberg, Barclays Research

FIGURE 13

Senior bank bond maturities are mainly in Korea (USD bn)



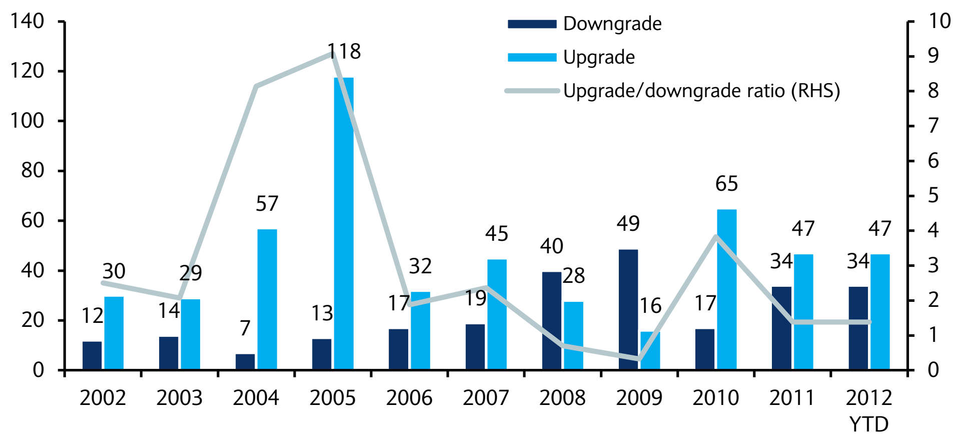
Source: Bloomberg, Barclays Research

Fundamental outlook

We expect credit metrics in Asia to weaken slightly during 2013, largely due to a lower-growth economic environment. The deterioration in fundamentals will be more pronounced in cyclicals geared towards Chinese industrial demand.

FIGURE 14

Ratings upgrade/downgrade ratio



Note: Counted by individual issuer actions and not notches. Asia ex-Japan. Source: S&P, Barclays Research

Corporates: Fundamentals to moderate

High grade

Overall, we expect the credit metrics of high grade corporates to moderate during 2013, largely due to a lower-growth economic environment, elevated capex outlays and M&A. Corporates have improved their balance sheets (cash levels, capex flexibility, tapped/setup alternative sources for capital raise) in the years following the global financial crisis, creating headroom to tackle challenges arising from changes in the economic outlook.

FIGURE 14

High grade corporate fundamental outlook

	Revenue growth	Margins	M&A appetite	Gearing/ leverage	Liquidity position
O&G					
2012 (vs prev year)	↔	↓	↑	↑	↓
2013 outlook	↔	↔	↑	↑	↔
Utilities					
2012 (vs prev year)	↑	↓	↑	↑	↓
2013 outlook	↑	↔	↔	↑	↔
Telcos					
2012 (vs prev year)	↑	↓	↔	↑	↔
2013 outlook	↔	↓	↔	↔	↔
Mining					
2012 (vs prev year)	↓	↓	↑	↑	↓
2013 outlook	↓	↓	↑	↑	↔
HK Property					
2012 (vs prev year)	↓	↑	↑	↑	↔
2013 outlook	↔	↔	↑	↑	↔
HK Diversified					
2012 (vs prev year)	↑	↓	↔	↑	↔
2013 outlook	↔	↔	↔	↔	↔
Steel					
2012 (vs prev year)	↓	↓	↑	↑	↔
2013 outlook	↓	↓	↑	↑	↔

Source: Barclays Research

High yield

We expect the credit metrics of high yield issuers to be more bifurcated. Chinese credits are likely to report better results in 2013 on of the country's improved economic outlook, easing liquidity and base effects. Indonesian coal will remain under pressure. Fundamentals of China property developers, Indonesian industrials/utilities and some Philippine corporates will stabilise or improve.

Asian banks: Credit cycle turning but comfortable overall

As growth sags in Asia, we believe the credit cycle will gradually turn, leading to pressures on asset quality. Furthermore, unlike most of their global peers, Asian banks have grown their loan books at a healthy clip over the past couple of years, and we expect this could lead to further upticks in NPLs and credit costs as portfolios season. This is especially true in Thailand, in our view, where credit growth has outstripped GDP growth. In addition, the loan mix at the Asian banks has changed since 2008, and the ultimate impact of changes in asset quality is unknown. In particular, Singaporean and Hong Kong banks have increased their focus on overseas lending to boost earnings, reflecting their extremely competitive and mature home markets. The overseas books are likely to season at a time of slower economic growth, and we expect an uptick in credit costs.

FIGURE 15

Bank sector fundamental outlook

	Earnings	Asset quality	Funding/liquidity	Capital
Australia				
2012 (vs prev year)	↓	↔	↔	↔
2013 outlook	↓	↓	↔	↔
Hong Kong				
2012 (vs prev year)	↑	↔	↑	↑
2013 outlook	↓	↓	↔	↑
India				
FY12 (vs prev year)	↑	↓	↔	↔
FY13 outlook	↓	↓	↔	↔
Korea				
2012 (vs prev year)	↓	↓	↔	↔
2013 outlook	↓	↓	↔	↔
Malaysia				
2012 (vs prev year)	↑	↔	↔	↔
2013 outlook	↔	↓	↔	↑
Singapore				
2012 (vs prev year)	↑	↔	↔	↔
2013 outlook	↔	↓	↔	↔
Thailand				
2012 (vs prev year)	↑	↓	↑	↔
2013 outlook	↑	↓	↔	↔

Source: Barclays Research

CDS Market Trends

Over the course of 2012, liquidity in single-name Asian CDS has migrated further towards the most liquid portions of the market. Average weekly trading volumes for China, Korea and Indonesia were higher in 2012 than in 2011, whereas for most other issuers, y/y volumes declined. At an index level, a key change was that liquidity was better in iTraxx Asia IG than in iTraxx Australia, a reversal from previous years. In Japan, given the significant spread widening and global investor focus, a large number of credits have had y/y increases in average trading volumes.

We believe Asian sovereign CDS will remain actively traded in 2013, with a steady supply of protection from credit-linked notes. Liquidity is likely to be limited to the 5y and, to an extent, 3y points.

In terms of trading opportunities, we believe the best opportunity for the basis is in the Philippines sovereign. Cash bonds trade significantly inside of CDS, given the bid from onshore banks and global sovereign funds. We recommend moving from 10y cash to 5y CDS to pick up ~15bp while trimming duration.

Our other core recommendation would be to trade the range in Korea and China. We believe Korea sovereign CDS should ultimately settle inside the China sovereign, and periodic dislocations are an opportunity to enter into a convergence trade.

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Latin America and Emerging Europe, Middle East and Africa credit strategy

LATIN AMERICA, EMERGING EUROPE & MIDDLE EAST CREDIT STRATEGY

Flowing into the mainstream

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- **EM corporates look set to perform in line with developed market corporates in 2013, although they should outperform EM sovereigns given their higher beta and carry.**
- **Regional performance will hinge on many things that are tough to predict: for Latin America, soft commodity prices and Brazilian growth; for Russia, oil, privatizations, and supply; and for GCC, geopolitics.**
- **We have more conviction about performance by credit quality. We think high grade will outperform high yield on a risk-adjusted basis (although high yield should outperform marginally in absolute terms, driven by incremental EM inflows going overwhelmingly to high grade credit. By contrast, high yield is not benefiting from these tailwinds and is also more exposed to fundamental deterioration.**
- **The major threat to high grade EM corporate bonds is rising Treasury yields, but Barclays' forecasts suggest this is something to be concerned about in 2014, not 2013.**

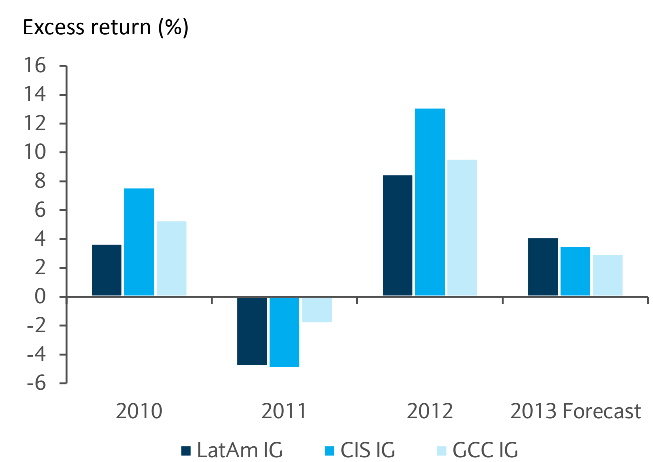
Weaker fundamentals, but demand strong

The tailwinds behind EM corporate credit for most of the past decade – cheap valuations and upwardly migrating sovereigns – have died down.

But as the asset class moves toward the developed market mainstream, it is increasingly benefiting from new, different tailwinds. Most important among these is increased demand from non-traditional EM corporate investors, including investors fleeing deterioration in their home asset classes (European institutional investors, most prominently) and investors being forced out of their asset classes by low real yields (US corporate and EM sovereign investors, among others).

FIGURE 1

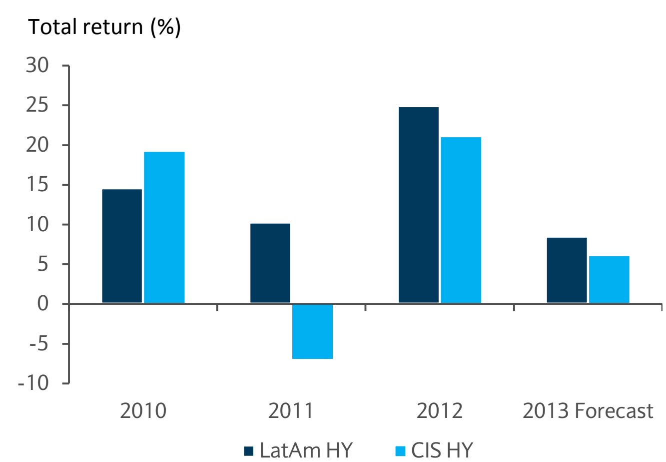
Modest spread tightening should cause high grade EM credit to produce small positive excess returns



Source: Barclays Research

FIGURE 2

High yield fundamentals are weaker, especially in LatAm, and may not produce much higher returns than high grade



Source: Barclays Research

We believe these factors will persist in 2013. European QE (OMT) will do little to arrest weak economic growth and negative ratings migration in Europe, but it will, along with policies undertaken by central banks around the world, continue to depress real yields. The hunt for yield will continue; so should inflows to EM corporates.

Against these positives there is a more pernicious trend: corporates globally are starting to releverage, downgrades outnumber upgrades, and earnings are mixed. Fundamentals are not in freefall, but they are in decline in many geographies and regions.

Year in review

How times have changed: Onward and upward with EM corporates

Returns and issuance statistics understate the development of the emerging market corporate asset class in 2012 – specifically, the increase in accessibility. We highlight two developments that signal the maturation of EM corporates.

- As of last December, there was no way to take ETF exposure to EM corporates. In 2012, six new ETFs that invest solely in EM corporates were launched.
- 2012 also saw the launch of the LatAm CDX corporate and the iTraxx CEEMEA corporate indices – the first CDS indices composed solely of EM corporates and quasi-sovereigns. Should these indices succeed in garnering liquidity, they could become viable hedging tools for EM corporate bond portfolios. (Figure 3)

A good year for almost all EM funds

Global EM corporate funds generally did well this year. The average fund return was just over 16% (total) with a standard deviation of just 2.7% – compared with last year's average performance of 2.0% with a standard deviation of 4.6%. The LatAm/EEMEA portion of the global EM corporate universe was no exception; our bespoke index composed of LatAm and EEMEA corporates and quasi-sovereigns (high grade and high yield) produced a total return of 14.55%.

This was well in excess of our 2012 forecast of only 6-8% total returns for LatAm/EEMEA, which we formulated in December 2011. What went wrong? Or rather, what went so unexpectedly right? Though growth slowed and fundamentals deteriorated (as we expected), central banks were much more aggressive and proactive than we envisioned. Indeed, continuing extraordinary monetary policy support is a major driver of our more sanguine 2013 view.

FIGURE 3

The new corporate CDS indices (highlighted, among peer indices) have struggled with liquidity

Index (untranched)	Avg. wkly volume since Sep 20 ($mn)	Gross notional outstanding ($mn)	Net notional Ooutstanding ($mn)
CDX.NA.IG.S19	122,099	427,513	65,001
ITRAXX EUROPE S18	98,099	350,855	39,952
CDX.NA.HY.S19	23,241	91,065	18,564
ITRAXX EUROPE CROSSOVER S18	24,417	77,418	11,123
CDX.EM.S18	1,828	11,862	3,666
ITRAXX SOVX CEEMEA S8	1,559	11,599	1,288
ITRAXX CEEMEA S18	490	3,789	985
CDX.LATAM.CORP.18	118	879	297
ITRAXX SOVX W. EUROPE S8*	40	110	57

Note: * iTraxx Western Europe has been affected by the sovereign naked short ban. Source: DTCC, Barclays Research

FIGURE 4

In 2012, EM corporate funds saw less differentiated and higher performance than in 2011

Source: Bloomberg, EPFR, Morningstar, Lipper

What to expect in 2013

Like other credit asset classes around the world, LatAm/EEMEA corporate bonds (referred to from here onward as "EM corporates," although our colleagues write separately on Asia) will in 2013 be caught between enormously supportive monetary policy and somewhat weaker fundamentals. Importantly, unlike at the end of 2011, spreads are not unusually wide today – in fact, high grade credit is back at the tights of 2011. Within this framework, we make the following predictions for 2013.

Better risk-adjusted returns in high grade than high yield

We expected high grade bonds to outperform high yield on a risk-adjusted basis this year, for several reasons: new mandates, especially from European funds seeing institutional inflows, were going exclusively to high grade credit (not high yield). QE would benefit high grade securities because of their attractive relative yields and arguable substitutability for "riskless" developed market government bonds (which are either artificially pinned at unrewarding levels or have deteriorated in credit quality). Meanwhile, corporate fundamentals were deteriorating, affecting high yield companies in particular, and the primary market was less open for them. Importantly, relative valuations were not yet reflecting this.

In our view, 2013 will see a stabilization of the relative cheapening of high yield to high grade credit. Some of the drivers of this year's decompression still exist (mandates going to HG, the effect of QE), but fundamental metrics for high yield companies are arguably stabilizing at weaker levels (see Figure 12 – we analyze LatAm[7] here because it constitutes the bulk of the LatAm/EEMEA HY segment). Moreover, although we would not entirely rule out a credit event in 2013, maturities are extremely low, particularly in LatAm. Therefore, our base case is that investors collect their coupon in high yield, with limited erosion of returns due to defaults, but that – given weak fundamentals – spreads do not meaningfully compress versus high grade, even though LatAm high yield is the cheapest global HY asset class.

[7] The LatAm high yield market is split between the 'haves', trading at close to 6% yields, and the 'have nots,' trading above 10%. It is this latter category to which we are referring here, primarily.

FIGURE 5

Our return forecasts for 2013: Modest but positive

	Index Characteristics			2013 Forecasts	
	Coupon	YTW	OAS	Excess Return	Total Return
High Grade					
GCC HG	5.2%	2.8%	200bp	300bp	400bp
CIS IG	5.7%	3.3%	243bp	350bp	450bp
LatAm IG	5.6%	3.7%	243bp	425bp	550bp
High Yield					
CIS HY	7.5%	5.9%	515bp	475bp	600bp
LatAm HY	8.0%	9.0%	796bp	725bp	850bp

Note: We assume 100-125bp (depending on duration) of UST returns in our total returns. Source: Barclays Research

EM vs DM: We expect EM to beta-adjusted perform in line with developed market credit, outperform EM sovereigns

If our assumptions about 2013 are correct, EM corporates will perform in line with their historical beta to developed market corporates. An eruption of systemic risk with the potential to cause EM to underperform seems less likely in 2013 than it did at the beginning of 2012, given global central banks' commitment to dampening volatility through QE. At the same time, EM valuations are not cheap enough versus developed markets to offer the potential for substantial outperformance, either (Figure 9).

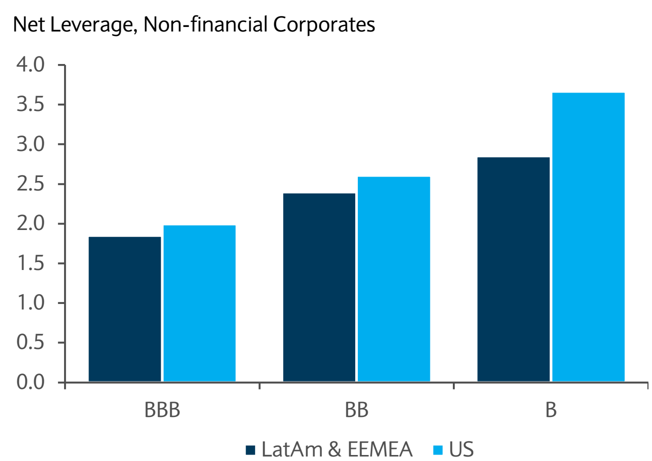
We see opportunities for developed market investors to generate alpha in EM, but we do not expect the asset class as a whole to outperform or underperform DM credit in terms of risk-adjusted returns.

Sectoral preferences: A mixed bag

Figure 10 summarizes our view on the globally comparable sectors.

FIGURE 6

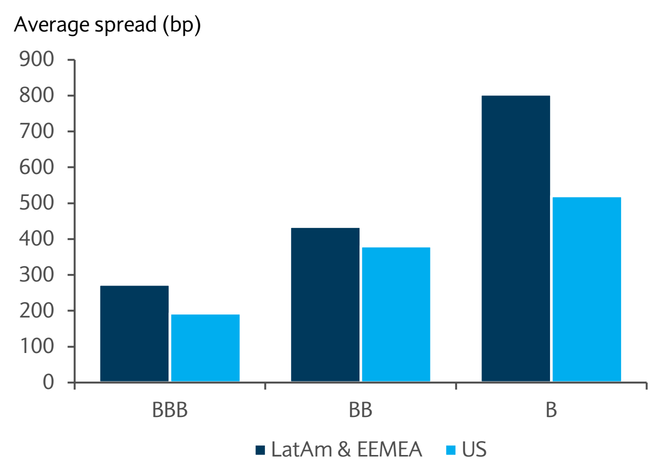
EM corporates are slightly less leveraged at each rating…



Source: CapIQ, Barclays Research

FIGURE 7

…but pay more credit spread than US credit at each rating



Source: Barclays Research

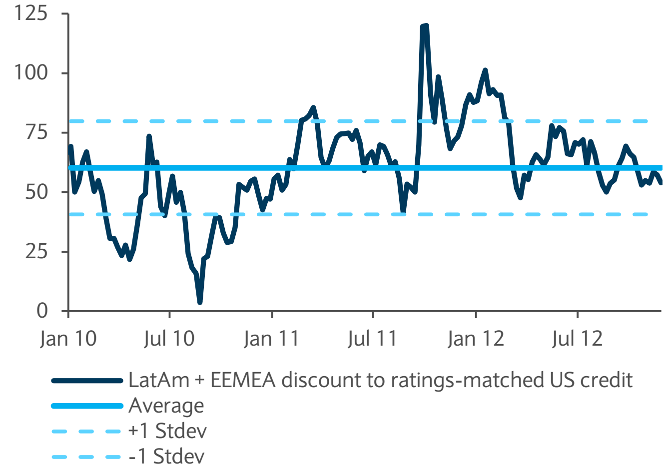
FIGURE 8

LatAm and EEMEA corporates and quasis rallied for most of the year, interrupted only by a contained spring correction

Source: Barclays Research

FIGURE 9

LatAm/EEMEA credit converged back to its typical discount to US credit of similar quality



Source: Barclays Research

Fundamentals

Leverage trends

During 2012, fundamentals weakened for corporates globally. The evidence of this is not as pronounced in EM for IG companies (where net leverage has been broadly stable) as in HY (particularly in Latam), where leverage spiked (although our sample size is small and the time series is therefore volatile).

FIGURE 10

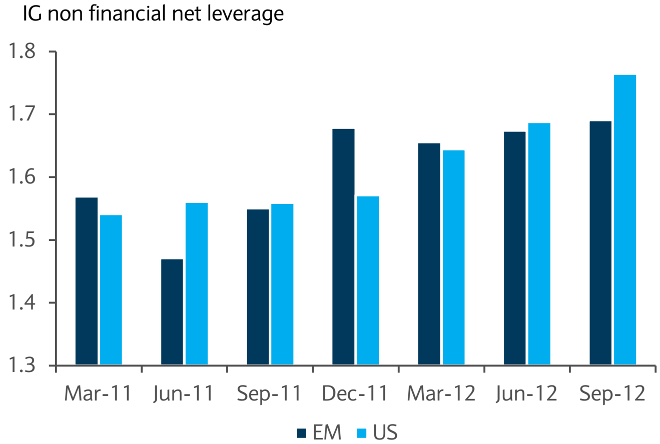
Sectors that are comparable across LatAm/EEMEA and our view

Sector	Preferred region	Comments
Oil & Gas	Mixed	We expect GAZPRU to be a moderate issuer in 2013; the short end of its curve is attractive ahead of potential issuance from Russian peers or those in other regions, such as PETBRA (which could become more compelling in 2013 after any potential issuance comes to market). Amongst tight-trading names (PEMEX, ECOPET, KMG, Dolphin), we think Dolphin offers the most value.
Telecoms	LatAm & GCC	In the GCC region, telecoms curves are steep in the 0-5y portion, we recommend short end there versus spread peers in the tenor, such as AMXLMM (which offers value in the belly of the curve instead). In higher beta names, we prefer Brasil Telecom to MTS.
Steel	CIS	The sector globally is troubled by oversupply, but producers in CIS offer better value than their LatAm peers. In BBBs, the Russian credit NLMK has lower net leverage (~1.8x) and offers a 80bp spread pickup over LatAm names such as GGBRBZ (~2.6x current). In the BB segment, the Russian credit CHMFRU has lower net leverage (1.7x), enough cash to cover maturities until end-2013, and its 2017 bond trades 70bp wider than the 2020 bond from LatAm issuer CSNABZ, which is substantially more leveraged (3x and rising).
Senior banks	CIS	Russian banks trade wider than LatAm and Turkey peers, even after adjusting for Russia's higher sovereign spread. For example, quasi-sovereign Sberbank provides an 80bp pickup over its nearest LatAm peer Banbra and 60bp over non-quasi Turkish banks Garanti and Akbank. Some of this discount is due to recent heavy issuance, but we expect lighter external issuance from CIS banks in 2013 as balance sheet expansion slows, which should decrease the spread premium of CIS IG banks over other EM IG debt.
Subordinated banks	LatAm	The senior/sub spread in Latin American banks (100bp) is substantially wider than in Russia (35bp) and the US (65bp), even for quasi-sovereign national market leaders such as BANBRA. Though LatAm LT2 coupons are deferrable (but cumulative), we believe the deferral probability in a well-capitalized bank such as BANBRA is low. The 2012 relative underperformance in LatAm subs was due partly to a period of heavy supply (banks rushed to issue Basel II paper), which is now coming to a close, and to rising NPLs earlier this year, which have now stabilized. We also like the SEC-registered bonds that are eligible for our Barclays US Corp Aggregate Index, such as the Bancolombia subordinated 6.125% 2020s and 5.125% 2022s.

Source: Barclays Research

FIGURE 11

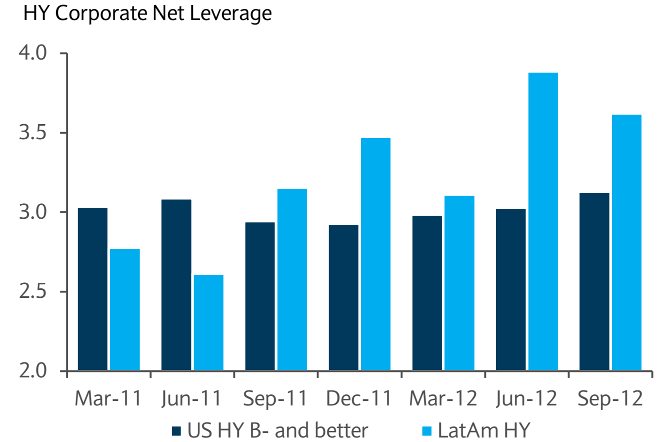
EM and US IG leverage is gradually rising



Source: Capital IQ, Barclays Research

FIGURE 12

LatAm HY leverage has soared but could now stabilize



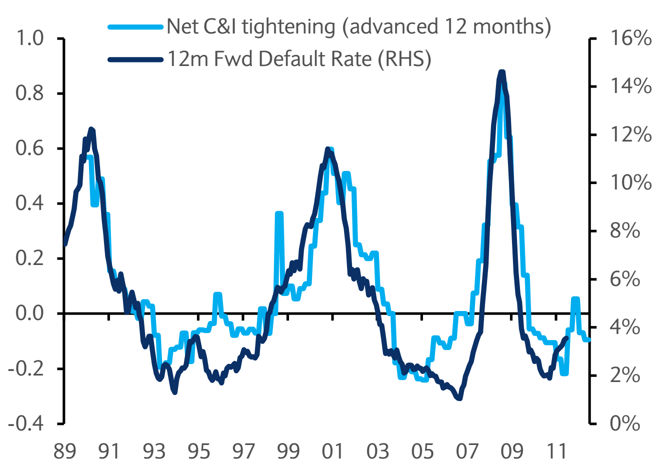
Source: Capital IQ, Barclays Research

The path forward for defaults

At the end of 2011, we forecast a sharp uptick in global high yield defaults; one of the drivers for this view was the tightening in bank lending standards seen at the end of 2011. Indeed, lending standards are, in our view, one of the best leading indicators for high yield defaults. This forecast materialized, but we now believe that defaults will stabilize: lending standards have fallen back into loosening territory in the US (Figure 13) and are moving in that direction throughout the EM world (Figure 14). That said, we believe liquidity will be a growing concern for EM investors throughout 2013 – the primary market is not wide open for EM HY issuers like it is in the US; should tepid volumes persist into 2013, we believe that investors will start paying more attention to looming redemptions, which are mostly concentrated in EEMEA (Figure 17).

FIGURE 13

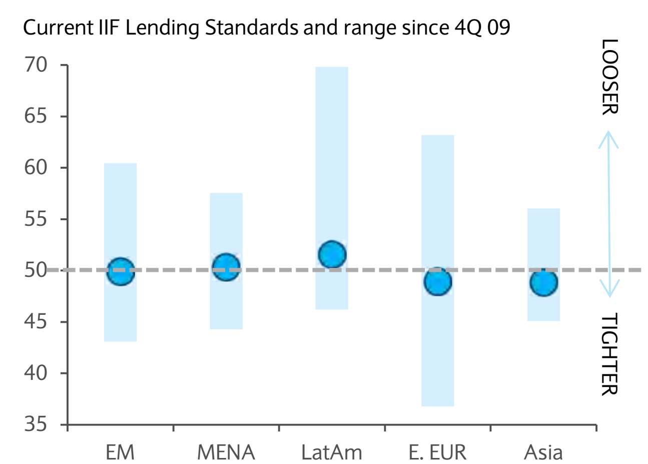
Lending standards are the best leading indicator for global high yield default rates – they suggest stable defaults



Source: Federal Reserve, Moody's, Barclays Research

FIGURE 14

Lending standards are now moving into loosening territory across EM



Source: IIF, Barclays Research

FIGURE 15

Potential fallen angels: Positioning correctly in BBB- bonds will likely be a key driver of performance in 2013

Issuer	Moody's	S&P	Fitch	Z-spread	Factors on which downgrade or stabilization hinges
Low IG bonds with higher likelihood of downgrade to HY					
CSN	Ba1	BBB-	BBB-	345bp	Ability to slow rising leverage until steel oversupply abates, M&A risk
Eletrobras	Baa2 (NEG)	BBB	BBB	297bp	Brazil gov't's willingness to provide funding support to the company
Cencosud	Baa3 (NEG)	N/A	BBB- /*-	331bp	Dropping leverage[1] to ~3.5x by YE13 via equity sale/debt reduction
Braskem	Baa3 (NEG)	BBB-	BBB- (NEG)	326bp	Stopping trend of weaker operating results and increasing leverage
Low IG bonds with a lower likelihood of downgrade to HY					
TNK-BP	Baa2 /*-	BBB- /*+	BBB- /*-	275bp	Rights of bondholders following the planned sale of the company[2]
Brasil Foods	Baa3	BBB-	BBB- (NEG)	303bp	Ability to improve margins and take leverage back to ~2.5x
Oi	Baa3 (NEG)	BBB-	BBB	380bp	Ability to drop leverage via asset sales and better operating trends

Note: [1] Lease-adjusted leverage. [2]Fitch does not currently anticipate a downgrade, but Watch Negative remains, given uncertainties about the rights of bondholders following the planned sale of the company. Spread shown for benchmark 10y bond. Source: Bloomberg, Barclays Research

Potential fallen angels

In 2011 and 2012, investors were able to generate alpha by targeting rising stars – companies moving from high yield to high grade. As the credit cycle turns, we believe that 2013 will be the year in which making the right moves in BBB-s and avoiding the names that fall to HY (we believe there will be several) pays off. Figure 15 shows some of the names that we believe are at risk of becoming fallen angels; we divide these into high risk and lower risk, although a move to HY cannot be ruled out for any.

FIGURE 16

Our LatAm/EEMEA 2013 issuance forecast calls for a modest decline in supply

Consideration	Amount
2013 redemptions	$18bn
EBITDA growth	$69bn
Debut issuance	$26bn
Increase in leverage for IG issuers	$15bn
2013 gross issuance	$128bn
Year over year change from 2012 gross issuance	-17%
2013 Redemptions	$18bn
2013 net issuance	$110bn
Year over year change from 2012 net issuance	-15%

Source: Dealogic, Barclays Research

Technicals

Supply forecast

2012 was a banner year for LatAm/EEMEA corporate USD issuance ($155bn YTD), surpassing the prior annual record set in 2010 ($124bn). Primary market conditions were supported by global central bank actions, particularly the Fed's announcement of QE3 in September (Figure 18). We expect primary markets to remain supportive in 2013, leading to a strong but not record-breaking year of USD-denominated gross supply totaling about $128bn. To arrive at this forecast, we use a top-down model based on redemptions, projected organic growth and a small increase in leverage for IG issuers, and likely issuance from maiden USD issuers. We reconcile this with our analyst bottom-up expectations (Figure 20).

FIGURE 17

Top 10 LatAm/EEMEA USD redemptions in 2013: 70% from Russia

TICKER	Amount outstanding	Coupon	Maturity	Amount	Country of risk
GAZPRU	1,750,000,000	9.625%	3/1/2013	1,750,000,000	Russia
KZOKZ	1,400,000,000	8.375%	7/2/2013	1,400,000,000	Kazakhstan
TAQAUH	995,000,000	6.6%	8/1/2013	995,000,000	Abu Dhabi (UAE)
VIP	800,647,000	8.375%	4/30/2013	800,647,000	Russia
RSHB	646,582,000	7.175%	5/16/2013	646,582,000	Russia
TMENRU	600,000,000	7.5%	3/13/2013	600,000,000	Russia
TNEFT	600,000,000	7.7%	8/7/2013	600,000,000	Russia
CSNABZ	550,000,000	9.75%	12/16/2013	550,000,000	Brazil
CHMFRU	543,552,000	9.75%	7/29/2013	543,552,000	Russia
EVRAZ	533,873,000	8.875%	4/24/2013	533,873,000	Russia

Source: Dealogic, Barclays Research

Redemptions

EM corporates have surged in size only since 2010, so near-term maturities remain extremely limited (especially in Latin America). Nevertheless, some large redemptions loom in 2013, concentrated primarily in Russia.

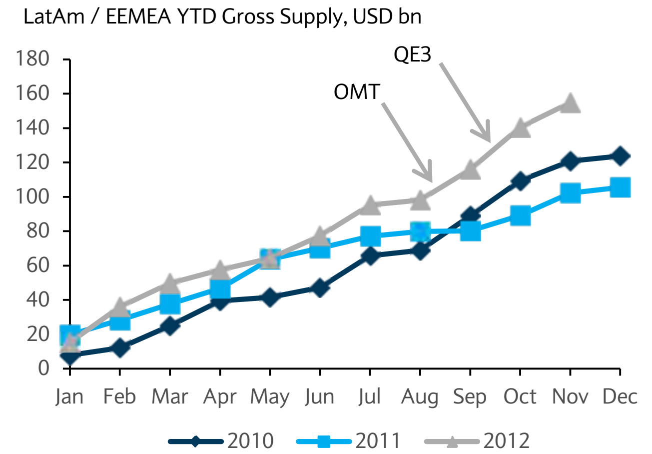
2012 recap

EM corporate issuance in the first half of 2012 was broadly in line with 2010/11 levels. However, following the ECB press conference announcing the OMT program in August and the FOMC statement announcing QE3 in September, EM corporate primary market activity picked up significantly. Issuance in 2H was particularly strong for HY issuers, which had been underrepresented in the primary market earlier in the year, but nevertheless the entirety of the increase in issuance this year was driven by high grade credit (Figure 19). Despite the record-breaking year, EM corporate issuance as a proportion of global corporate issuance was essentially flat y/y, as other major corporate bond markets also experienced record or near-record years of issuance.

2012 YTD gross supply has significantly exceeded our forecast ($113bn). In 2013, we expect primary markets to continue to remain wide open for IG issuers but for issuance to be more challenging for HY issuers; new institutional mandates for EM corporate bond investment, particularly in Europe, are predominantly confined to the investment grade universe. That said, redemptions are so low that we do not expect widespread liquidity squeezes, even for high yield companies.

FIGURE 18

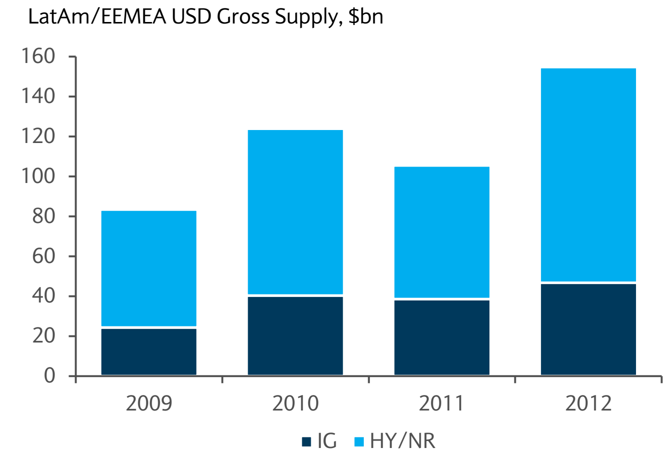
Issuance was super-charged by central bank action…



Source: Dealogic, Barclays Research

FIGURE 19

…although this boosted high grade only and not high yield



Source: Dealogic, Barclays Research

FIGURE 20

Issuance forecast by sector

Sector	2012 USD Supply ($bn)	2013 Up/Down	Comment
Latin America			
Oil & Gas	17.8	Flat	We expect Petrobras and Pemex to be sizeable issuers again in 2013, with refi activity and some net issuance. Smaller issuers such as Pacific Rubiales and OGX are less likely to issue in 2013.
Metals & Mining	9.5	Down slightly	LatAm miners had high issuance 2012, with sinking prices (of most base metals, but particularly iron ore) coinciding with high capex plans. We expect relatively lower issuance in 2013, as both of these effects should be weaker
Homebuilders	1.3	Down sharply	The large issuers priced a good deal of debt in 2012, and 2013 will start off with a market that may not be wide open for all issuers. The sector also needs to deleverage, leading us to believe issuance will be significantly down vs. 2012
Telecom	7.8	Down slightly	We expect some refinancing activity but relatively low net issuance, even from large issuers. America Movil will likely be aiming to deleverage slightly in 2013 and may be a small negative net issuer. Maiden 2012 issuers are unlikely to be active in 2013.
Pulp/Paper	1.0	Flat to Up	Pulp & Paper is one sector that may have increased issuance in 2013, as benchmark issuers did not tap USD markets for the most part in 2012. Fibria and Suzano could issue in benchmark size in 2013, given supportive market conditions.
Consumer/Retail	4.8	Flat	Larger issuers such as Bimbo and Cencosud got a lot done in 2012 and are unlikely to continue to issue in size in 2013. Smaller, idiosyncratic issuers with good stories may access the USD market in 2013, leading to total supply that is flat to slightly down vs. 2012
Banks	29.9	Uncertain	Regulatory uncertainty due to Basel III implementation in Brazil makes 2013 fairly unpredictable for LatAm banks. Additionally, large banks essentially maxed out their issuance needs in 2012, so the amount and makeup of 2013 issuance is very uncertain.
CIS			
Oil & Gas	8.5	Up	Gazprom dominated CIS corporate issuance in 2012 with c.$4bn of new bonds (including Gazprom Neft). We expect it to continue to refinance maturing eurobond debt ($4bn in 2013 and $4.5bn in 2014), while peers such as KMG have also signaled an intention to return to market in the near future.
Metals & Mining	2.7	Up	Russian steel and mining firms actively targeted the market for refinancing in 2012, a trend we expect to be repeated in 2013, given maturing bonds of Evraz and Severstal in 2013 and 2014. We would also not be surprised if Metalloinvest issues a second bond, given the significant short-term finance recently raised to fund the purchase of its own shares, or Alrosa, given significant amounts of short-term debt.

Sector	2012 USD Supply ($bn)	2013 Up/Down	Comment
Telecoms	0.5	Up	There was little issuance in 2012 from Russian telecoms, aside from the new 2019 eurobond from MTS's parent, Sistema. VIP has an $800mn bond maturing in April 2013, and selected bonds in the Wind capital structure become callable, so we would not be surprised if VIP is again in the market in 2013.
Banks	25	Down	We expect slower debt issuance for Russian banks, as capital constraints are forcing them to slow balance sheet growth. However, historically low yields will likely lure them at least to replace maturing debt (c.$10bn in 2013). We expect a slight increase in Kazakh banks (from nothing in 2012), mainly to refinance maturing debt. In the Ukraine, we expect banks to remain in deleveraging mode.
GCC			
Dubai corporates	2.6	Flat to down	We expect Dubai corporate issuance to remain subdued, although a revival of the real estate development sector could lead to an upward surprise. DEWA's sukuk refinancing is expected in Q1.
Abu Dhabi corporates	6.5	Up	We expect supply from the major quasi-sovereigns (IPIC, Mubadala and Taqa), especially as issuance was below expectations this year and 2014 is a fairly heavy maturity year as 2009 5y issues come due. We look for an increase in project finance transactions.
Qatar corporates	0.0	Up	While we expect issuance to continue to be heavy in Qatar, the majority should come at the sovereign level and the banking sector.
Banks	12.9	Flat	2012 had strong issuance, which could be repeated in 2013, possibly including more BBB and BB names. Banks could look to issue sub debt and Tier 1 capital, encouraged by the positive reception for ADIBUH Tier 1s.

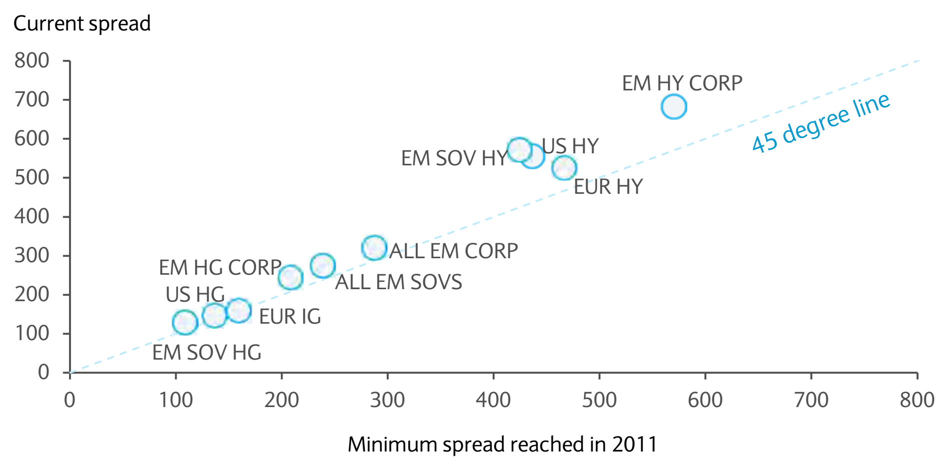
Source: Barclays Research

Valuations

Unlike at the end of 2011, EM valuations today are not unusually wide, versus either developed market credit or EM sovereigns. EM HY is the asset class with the furthest to retrace to return to 2011 tight levels, but this is entirely in line with the pattern seen in global credit: higher beta asset classes have underperformed. In other words, EM HY's cheapness is a function of its beta rather than idiosyncratic underperformance driven by specific factors.

FIGURE 21

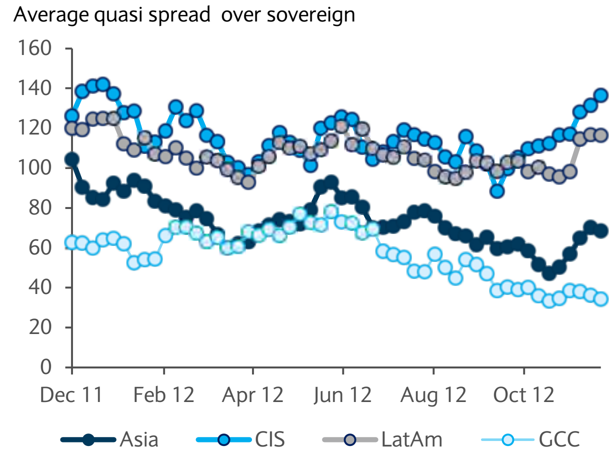
LatAm/EEMEA corporates (labeled EM corp) conformed to the broader trend in global credit – higher beta assets underperformed and are further off 2011 tights than low betas



Source: Barclays Research

FIGURE 22

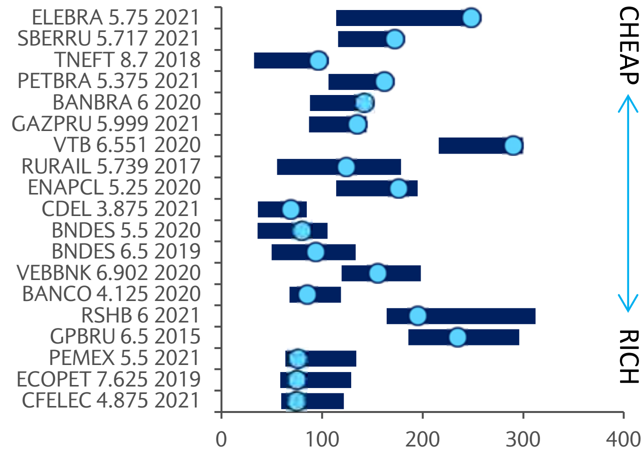
Asian and GCC quasis have richened versus their maturity-matched sovereigns; Russia and LatAm have cheapened



Source: Barclays Research

FIGURE 23

LatAm and Russia quasis: Spread to sovereign shown (range and current difference) ranked by normalized cheapness



Source: Barclays Research

Quasi valuations versus sovereigns

We monitor quasi-sovereign valuations closely through our *Global EM Quasi Sovereign Monitor*. LatAm and EEMEA today present much more compelling opportunities for moving from sovereigns into quasi-sovereigns than do Asia or GCC. This is especially remarkable in Russia, where corporates trade in a tight bunch – in that market, some of the most compelling opportunities are in banks, such as SBERRU and VTB. ELEBRA is the cheapest quasi-sovereign in Latin America (for good reason, see *We believe Eletrobras bonds still have significant room to underperform*, November 21), although PETBRA – a stable credit, in our view – is also at the wide end of its range versus Brazil.

US sector outlooks

US HIGH GRADE AEROSPACE & DEFENSE – MARKET WEIGHT

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Key recommendations

Boeing (OW). We recommend selling 5y CDS (55/60bp). We favor Boeing to other defense contractors because of its diverse earnings across commercial aerospace (60% of revenue) and defense (40% of revenue). We expect increased production of its 787 Dreamliner aircraft during 2013 to help to offset declining US defense spending.

Northrop Grumman (MW), Raytheon (MW), and General Dynamics (UW). We recommend buying 5y CDS on Northrop Grumman (53/58bp), Raytheon (53/58bp), and General Dynamics (48/53bp). We are generally cautious on the defense industry over the near term because of rich valuations and uncertainty about future defense spending. We believe that trading levels are pricing in a low probability that sequestration will be implemented or that future defense budgets will face increasing headwinds.

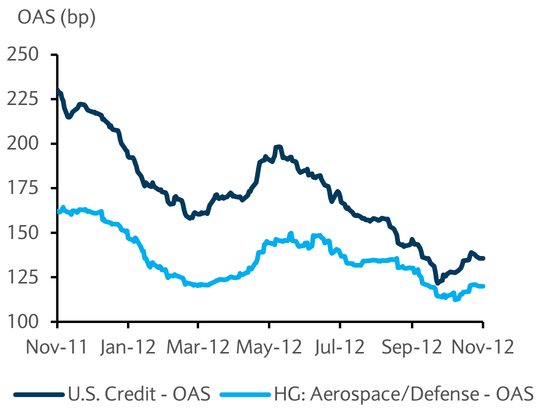
Sector outlook

Defense spending in 2013 will face increasing headwinds – with or without the implementation of sequestration. The FY13 baseline budget request from the Pentagon was $525bn. However, the Budget Control Act mandates automatic spending cuts (sequestration) of $1.2trn over the next decade, beginning in January 2013, with half coming from the US Department of Defense. Under this sequestration scenario, reductions to the defense budget are expected to reach $55bn/year over the next decade, bringing the FY13 baseline down to $470bn. However, given the severity of the cuts and the potential impact on national security, we believe Congress will adjust the mechanics of the Budget Control Act during the current lame duck session. Ultimately, we believe that the size of the national debt and increased focus on deficit reduction will force the defense department to reduce budgets. No agency will be immune to cuts. Defense primes will have less revenue opportunities as a consequence.

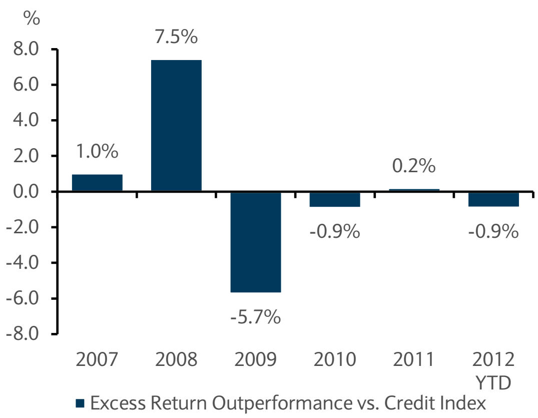
The outlook for large commercial aerospace is more constructive, although business jets remain challenged. Global air traffic has been healthy in 2012 and is expected to improve in 2013 (+5.0% y/y), particularly in China (+9.5% y/y) and Asia-Pacific (+6.3% y/y). OEM backlogs remain strong and should lead to healthy profits in 2013. The aftermarket segment was under pressure in 2H12, but should improve y/y in 2013. We are cautious on the business jet market, as the global economic recovery has not been strong enough to support new demand.

Strong balance sheets and liquidity will continue to provide credit support in 2013. However, the expected slowdown in top-line growth in FY13 could lead to more aggressive shareholder-friendly initiatives to help boost profitability.

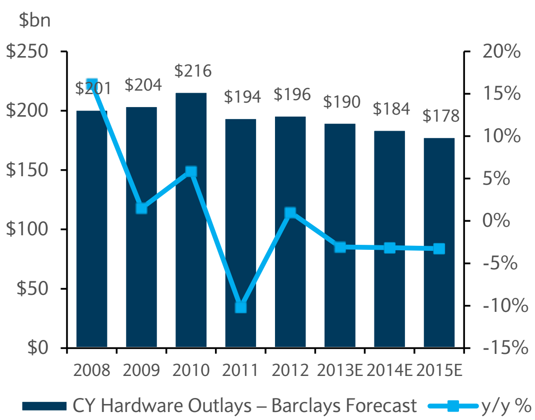
HG Aerospace & Defense OAS vs. HG Credit Index



HG Aerospace & Defense Excess Return vs. HG Credit Index



DoD Hardware Outlays Estimates – Calendar Year



Source: OMB, CSBA , DoD, Barclays Research

US HIGH GRADE BANKS – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on US banks. The positive fundamental trends that began in early 2010 – namely, improving capital, liquidity, and asset quality – remain in place. However, this fundamental strength is tempered by continued policy and macroeconomic uncertainty in the U.S. and abroad. Furthermore, bank spreads have outperformed dramatically since the end of 2011, leaving the sector at multi-year tights and less compelling from a yield perspective. We believe the balance of fundamental strength and sector risks leaves modest room for further tightening versus industrials.

We prefer the wider trading money-center banks and selectively moving down the capital structure to obtain yield. On an issuer-by-issuer basis, we see value in large, well-diversified names such as Citigroup (Overweight), which continue to trade substantially wide to the sector average despite fundamental improvements. Separately, across the sector, we see value in subordinated debt, particularly at the bank level, while we recommend moving out of fixed-for-life perpetual preferreds and into fixed-to-float structures.

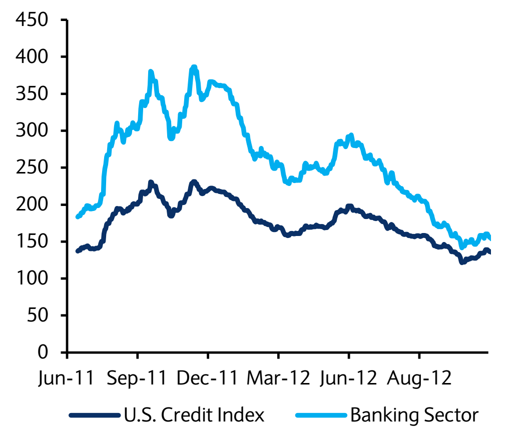
Sector outlook

We expect positive fundamental trends to continue in 2013. Despite likely increases in dividends and share buybacks post-CCAR, capital should continue to rise from already high levels in preparation for Basel III regulation. Liquidity will benefit from expected robust deposit balances. Asset quality should benefit from resilient post-crisis tailwinds, especially if home price indices demonstrate positive y/y change. Regulatory and litigation developments are likely to remain significant, but manageable.

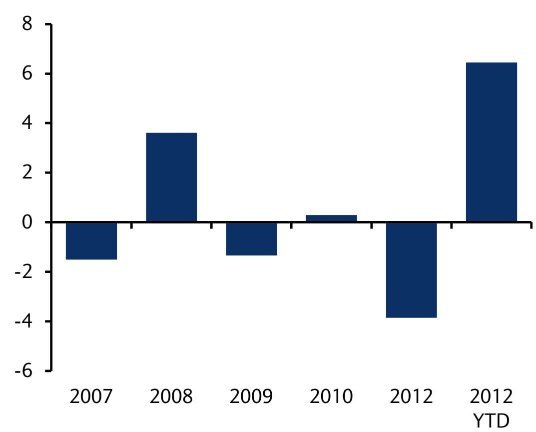
We forecast $70bn of index eligible supply in 2013 for the U.S. banks in the credit index. Over the past four years, U.S. banks have been negative net issuers across currencies, but positive in USD fixed-rate debt. 2013 should again result in positive net supply for USD fixed rated index-eligible securities (ie, new issuance > $59bn maturities) but net negative supply as banks limit non-index-eligible floating rate and non-USD issuance.

Will U.S. and European bank spreads remain highly correlated? We think yes. Last year, we noted the strong correlation between European and U.S. bank spreads that developed in 2Q11 and carried through the 2011 widening trend. While spreads reversed course and tightened for most of 2012, the strong relationship between U.S. and European names persisted. For 2013, we expect this correlation to continue, as investors remain focused on macro and political events that affect banks globally.

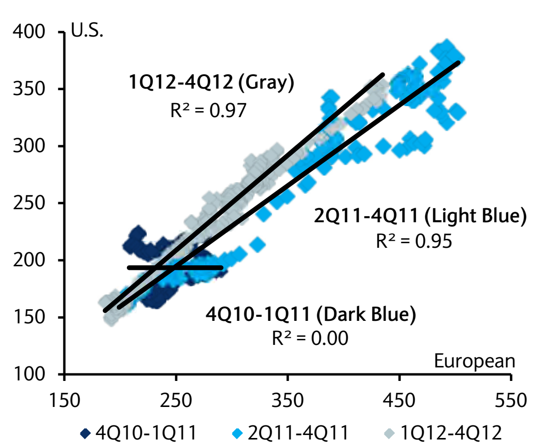
US Banks OAS versus US Credit Index



US Banks excess return versus US Credit Index



Europe vs. U.S. Bank, Broker, and Finance Company Index OAS



Source: Barclays Research

US HIGH GRADE BUILDING MATERIALS (NOT RATED)/ HIGH YIELD BUILDING MATERIALS (UNDERWEIGHT)

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Key recommendations

USG Corp. (MW). We recommend buying the 6.3% notes due '16 ($103/104). We believe valuations will continue to improve as housing fundamentals recover further in 2013. Growth in housing starts due to the low levels of housing inventory across the US will be a positive driver of USG's operating trends. We expect drywall demand in the Northeast to rise due to rebuilding efforts following Hurricane Sandy.

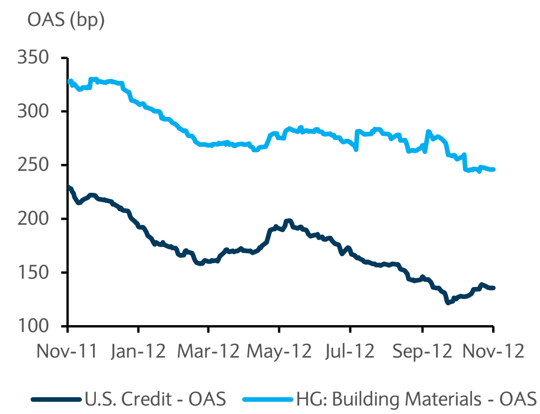
Mohawk Industries (MW). We recommend buying 5y CDS (130/140bp). We expect Mohawk's operational performance to improve in 2013 as home prices rise and housing starts continue to recover. However, we believe valuations are rich and prefer to be long higher-quality homebuilders, such as Toll Brothers (125/135bp), which trades slightly inside of Mohawk.

Sector outlook

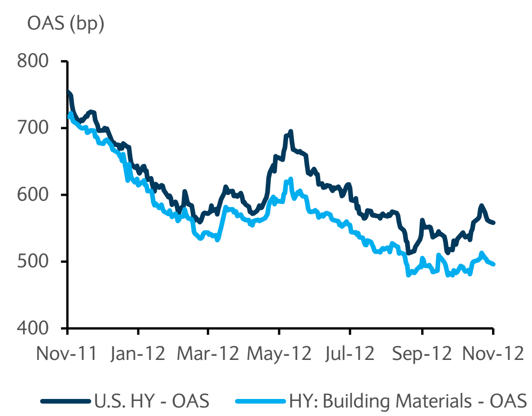
US housing recovery should gain traction in 2013 following a solid 2012. For building materials companies, two key drivers of operational performance will trend more positively in 2013. First, housing starts are expected to rise at a healthy pace due to a low degree of new and existing home inventory (4.8 and 5.4 months, respectively). Barclays economics expects 1.0mn housing starts in 2013, reaching a high of 1.05mn (SAAR) in 4Q13. While 1.0mn starts would remain below the long-term average of 1.2mn, it would represent a rise of 12% above the 2012 peak of 894k. Second, a key driver of remodelling activity is home price appreciation. Continued home price appreciation will reduce the number of homeowners that are underwater on their mortgages and increase the potential for discretionary home renovations (ie, kitchen and bath remodels). Barclays economics expects home prices to rise 3.5% y/y in 2013.

The operational performance of building materials companies lagged the homebuilders in 2012, but we expect this dynamic to improve in 2013. Building material companies with high exposure to new construction will continue to report solid demand growth, as housing starts improve in 2013. Companies with exposure to more discretionary products, such as cabinets, should see a modest uptick in demand, as home prices rise and as more borrowers are no longer underwater on loans.

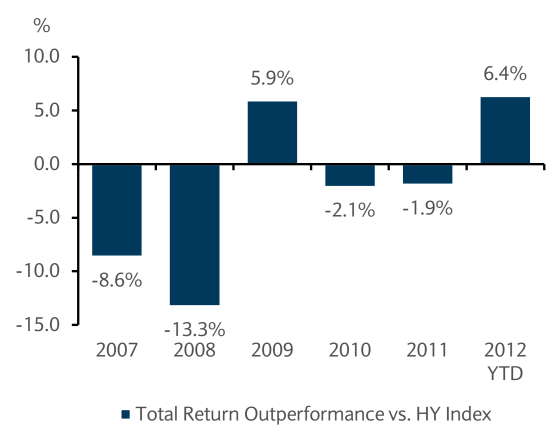
HG Building Materials OAS vs. HG Credit Index



HY Building Materials OAS vs. HY Index



HY Building Materials Total Return vs. HY Index



Source: Barclays Research

US HIGH GRADE CABLE & MEDIA – OVERWEIGHT/MARKET WEIGHT

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Key recommendations

We recommend an Overweight position on the HG Cable sector. We continue to view the sector as defensive and think credit fundamentals will remain resilient in a macro slow down. We prefer cable to satellite and have Overweight ratings on Comcast, Time Warner Cable, and Cox Communications.

We recommend a Market Weight position on the HG Media/Entertainment sector. While advertising fundamentals and balance sheets remain steady, tight spread levels offer limited room for outperformance. Our sole Overweight in Entertainment is NBC, which we believe has room to compress, given the 20-25bp discount to CMCSA.

Sector outlook

Advertising – healthy, but decelerating. We expect underlying ad trends to remain healthy, but to show deceleration y/y due to tougher comps (Olympics/political) and cautious spending by businesses. We estimate US ad growth of 1.5% (3% ex-Olympics/political), including national cable TV, up 6%, and newspapers, down 8%.

Affiliate fees – content still rules. We expect the proliferation of content across multiple platforms (mobile, tablets, etc) and the renewal of digital agreements to help cable networks sustain their impressive affiliate revenue streams. We expect a mid- to high-single-digit rise in MSOs' programming costs, which should pressure video margins.

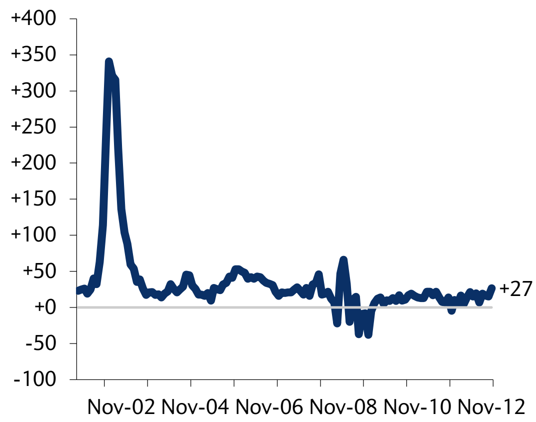
Subscriber trends – We expect similar trends to 2012 with cable winning the lion's share of broadband net adds. Video competition is expected to remain intense, with DirecTV, in particular, likely to see slowing growth. While cord cutting/cloud video remains a longer-term threat, we do not expect any near-term impact.

Event risk. Several pending and potential transactions could result in spread volatility. Key items of note include: 1) a potential DTV acquisition of GVT or a widely speculated[1] (eg, Bloomberg) merger with DISH; 2) NWSA's publishing/entertainment split; 3) a possible CBS Outdoor conversion to a REIT or a spin; 4) potential CLEC M&A by cable MSOs following the FCC's forbearance of restrictions; 5) Scripps' buy-in of Tribune's remaining stake in Food Network; 6) M&A at international cable networks, with TWX[2] and DISCA[3] reportedly evaluating assets.

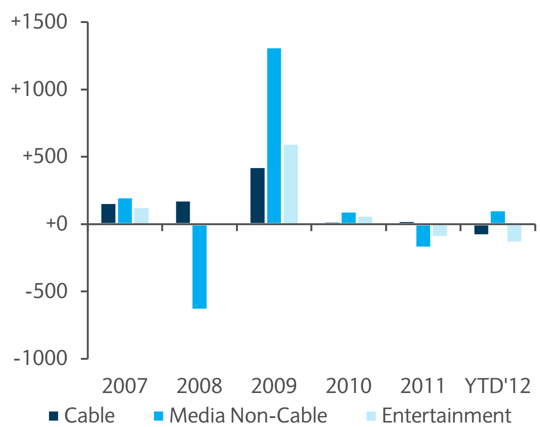
Aggressive shareholder repurchases to continue We expect cable/media credits to maintain their aggressive share buyback programs. However, we expect most to be funded with free cash flow. Three notable exceptions are DTV, TWC, and DISCA which will buy back shares in excess of FCF.

[1] 'Dish Rises on DirecTV Merger Talk as Customer Growth Stalls', Bloomberg, November 2012.
[2] Time Warner eyes LatAm and Europe opportunities, Financial Times, Nov 6, 2012.
[3] ProSieben Said to Choose Three Bidders for Nordic Unit, Bloomberg, Oct 31, 2012.

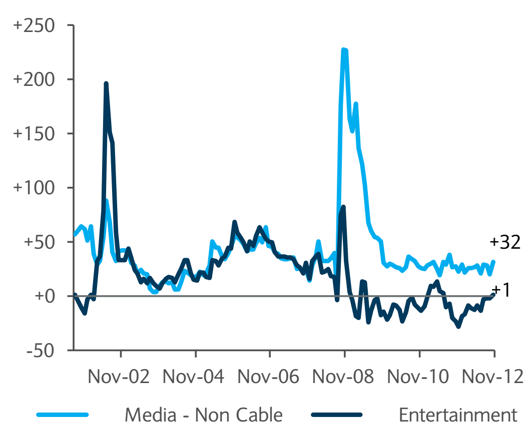
HG Cable Sector OAS versus US Credit Index



IG Cable/Media excess return vs US Credit Index



HG Media/Entertainment OAS vs US Credit Index



Source: Barclays Research. As of November 30, 2012

US HIGH GRADE ELECTRIC UTILITIES – MARKET WEIGHT

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Key recommendations

Buy MidAmerican Energy Holdings (MIDAM, OW) 6 1/8% due 4/1/36 bonds, quoted at +130. MidAmerican benefits from its diversified regulated electric utility and natural gas pipeline businesses, constructive regulatory support, limited exposure to unregulated generation, improving financial metrics, and access to credit support from its parent, Berkshire Hathaway. We expect any future M&A activity and renewable energy investments to be managed so as to maintain credit quality.

Buy CMS Energy Corp (CMS, OW) 5.05% due 3/15/22 bonds, quoted at +190. With an attractive regulated utility subsidiary, a supportive regulatory environment in MI, and improving financial metrics, we think the CMS holdco credit will likely achieve investment grade ratings over the next 12-18 months.

Sector outlook

Our Market Weight sector rating reflects relatively tight spreads and our expectations of stable credit quality and performance by regulated utilities, and gradually declining credit quality and weaker performance by diversified holding companies and unregulated generating companies. We expect the sector to return to its historical trading correlation with the US Credit Index in 2013.

Impact of US elections. We continue to expect the EPA to proceed with several new regulations affecting mainly coal-fired power plants, potentially raising environmental capex requirements and the number of early coal plant retirements. We also expect the administration to continue to encourage renewable energy development and energy efficiency investment.

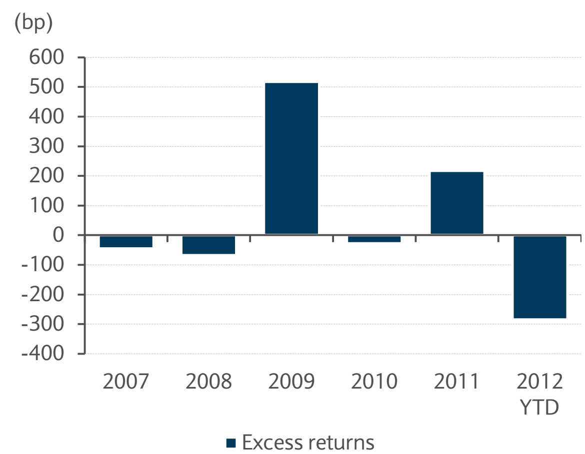
Hurricane Sandy's impact on infrastructure in the Northeast. The assessment by various commissions of the preparation and response measures of the electric utilities affected by Hurricane Sandy is still underway, but we expect the companies in our coverage universe largely to recover their costs using deferrals of O&M expenses and rate case filings for capital expenditures. Storm response reviews may lead to new requirements to enhance preventive measures, strengthen response capabilities, and/or harden infrastructure.

Other challenges. Slow economic growth, stagnant electricity sales, and continued low natural gas and power prices are increasing nervousness about unregulated generation, especially from Moody's. Event risk remains relatively low, in our view. We see limited new M&A activity, modest dividend increases, and limited share buybacks.

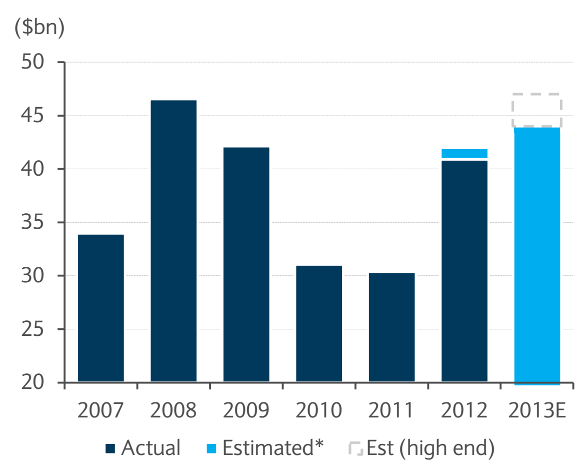
Robust 2013 issuance expected. We expect another active year in 2013, with $44-47bn in new issuance, up from an expected $41-42bn in 2012. The expected y/y growth is driven by slightly higher maturities, 5-10% higher capex, and the elimination of bonus depreciation (bonus depreciation was 50% in 2012).

US Electric Utilities versus US Credit Index OAS

US Electric Utilities minus US Credit Index



New Issuance ($bn)



Note: YTD through November 30, 2012, *Expected issuance through year-end 2012, and 2013 estimated issuance (lower-end). Source: Bloomberg, Barclays Research, Barclays POINT

US HIGH GRADE ENERGY AND PIPELINES – UNDERWEIGHT

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Key recommendations

Independent E&P: short Devon (DVN, MW) and Canadian Natural Resources (CNQCN, MW); long Anadarko (APC, MW), EOG Resources (EOG, MW) and Marathon Oil Corporation (MRO, MW)

Refining: 10s-30s curve flatteners

Oil Field Service: long Transocean (RIG, OW), Schlumberger (SLB, NR) and Cameron (CAM, NR); short Nabors (NBR, UW)

Pipelines: long El Paso Pipeline (EPB, OW); short Williams Partners (WPZ, UW) and Enbridge Energy (EEP, NR)

Sector outlook

The independent E&P sector is valued in the middle of its 3y range relative to U.S. Credit. Although we expect soft natural gas prices to be less of a factor than in 2012, we expect many producers to outspend cash flow, and credit metrics are unlikely to improve, which will weigh on performance. We are Underweight the E&P sector.

The integrated sector remains defensive, but we do not expect credit quality to improve from current levels and valuations are in the middle of the 3y range. For integrateds to outperform, we believe the broader market would need to widen and energy prices would need to climb. We are Underweight the integrated sector.

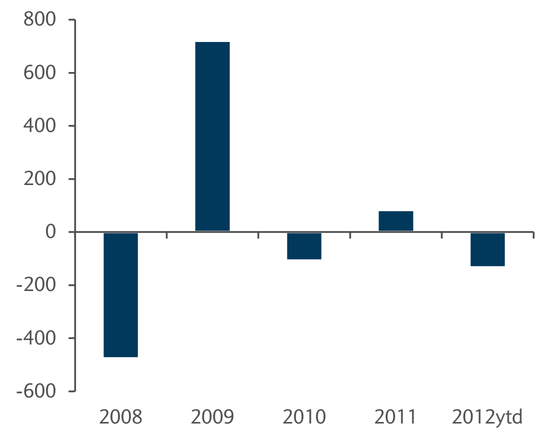
The refining sector has been on a remarkable run of outperformance since 2009, and spreads remain wide to the tights that were reached in 2007. Volatility remains an ever-present threat, and we expect global downstream capacity to continue to rise. That said, we believe U.S. crude oil differentials will remain wide versus global benchmarks, which will support domestic refining profitability. We are Market Weight refining.

The oil field service sector is wide to its 3y average differential versus U.S. Credit. The sector's wide spread is largely driven by Weatherford (WFT, MW) and RIG, which comprise 35% of the sector's market value. Although the sector could generate attractive carry, we do not expect much fundamental improvement, with dayrates already high for drilling companies and capital spending already elevated on the part of E&P customers. We are Market Weight oil field services.

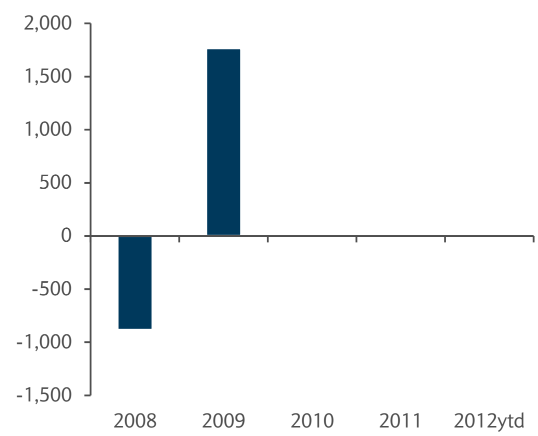
The pipelines sector essentially performed in line with U.S. Credit in each of the past three years and is trading in line with its average differential versus the broader market. We expect sector fundamentals to deteriorate slightly in 2013, as lower NGL prices are fully absorbed when hedges roll off. Nevertheless, we believe that E&P drilling activity will remain robust and M&A is unlikely to be a major spread driver due to an abundance of organic growth projects. We expect pipelines to perform in line with the broader market for a fourth consecutive year.

Energy & Pipelines minus U.S. Credit Index (OAS)

Energy Excess Returns minus U.S. Credit (bp)



Pipelines Excess Returns minus U.S. Credit (bp)



Source: Barclays Research

US HIGH GRADE FOOD & BEVERAGE (MARKET WEIGHT), CONSUMER PRODUCTS (UNDERWEIGHT), AND TOBACCO (MARKET WEIGHT)

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Key recommendations

We recommend a Market Weight position in the food & beverage sector. Fundamental drivers are expected to take the forefront as event risk moderates. Relative value, while looking more compelling versus the index and industrials, should be viewed idiosyncratically. We prefer credits that will likely focus on deleveraging and operational improvement.

Overall, we have a Market Weight rating for tobacco. Sector valuation has cheapened since July driven by Altria (Underweight) and recent new issue. The more benign litigation environment has also supported a defensive valuation, but we see limited potential for outperformance versus the market given current levels compared with other BBBs. For investors wanting exposure to the sector, we suggest Lorillard and Reynolds (Market Weight) given compression potential.

In consumer products, we remain Underweight, supported by similar ratings for P&G and Avon, where we continue to see downside risk to ratings, sooner for the latter.

Sector outlook

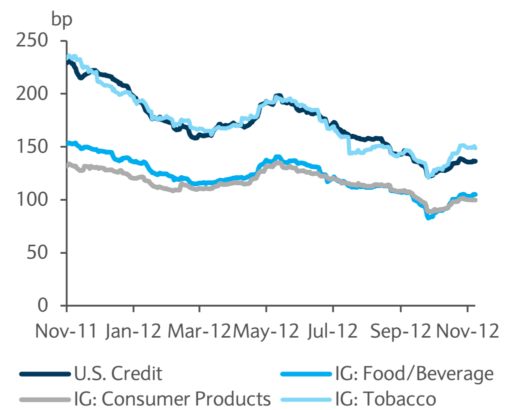
After a year of M&A, we expect deleveraging to be a focus in 2013. Credits for which debt reduction is likely to be key include Kellogg (Market Weight), ConAgra, SABMiller, Molson Coors, and Anheuser-Busch InBev.

Event risk is a concern, but decreasingly so. Bolt-on M&A activity could support additional issuance for credits such as Campbell, Coca-Cola Enterprises, and Heinz (Market Weight), where management has indicated the possibility. Post-separation M&A could be a factor for credits such as Mondelez (Market Weight), Beam (Market Weight), and Hillshire Brands.

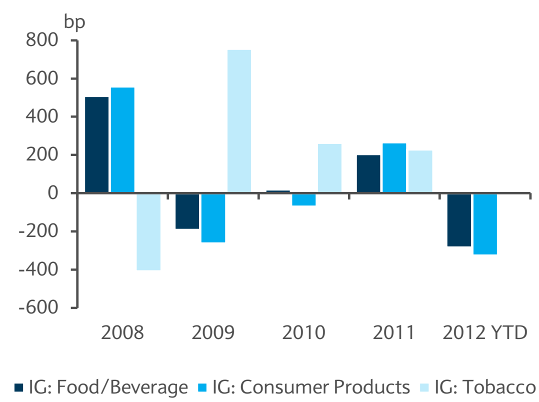
We expect the benign litigation environment to continue for tobacco. Companies in the sector are expected to look for opportunities to expand their businesses as cigarette volume declines persist. Across the sector, we see limited M&A and ratings risk.

We forecast $37-40bn of supply in 2013 across food, beverage, consumer products and tobacco. This is predicated on refinancing of $24bn, as well as incremental debt issuance to support ongoing share repurchase activity and a modest amount of M&A-related issuance, in addition to new debt issuance to support ConAgra's acquisition of Ralcorp.

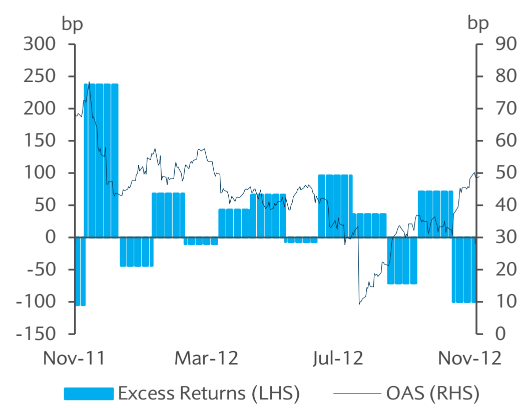
US Consumer OAS versus US Credit Index



US Consumer excess returns versus US Credit Index



Domestic Tobacco excess returns and OAS versus US Credit Index



Source: Barclays Research

US HIGH GRADE PHARMACEUTICALS (MARKET WEIGHT), HEALTHCARE (UNDERWEIGHT), AND HEALTH INSURANCE (OVERWEIGHT)

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Key recommendations

We recommend swapping out of GILD 41s (T+130/120bp, NR) into AMGN 42s (T+160/150bp, OW). This reflects 1) limited revenue visibility in GILD beyond 2020; 2) an expected stabilisation in AMGN's capital structure and ratings; and 3) the limited likelihood of issuance from AMGN.

Swap out of ESRX 17s (T+95/85bp, NR) into HSP 17s (T+130/120bp, NR). Our recommendation reflects 1) a stabilisation in HSP's credit profile over the past few months; 2) the risk of ESRX adopting a more shareholder-friendly capital allocation strategy; and 3) the similarity in the ratings and leverage levels of the companies.

Swap out of ESRX 16s (YTW of 1.3%) into MYL 20s (YTC of 2.0%, run to a 3y maturity, NR). After the upgrade to IG, MYL unsecured notes should trade at levels similar to other low BBB entities such as ESRX or WPI (MW).

Sector outlook

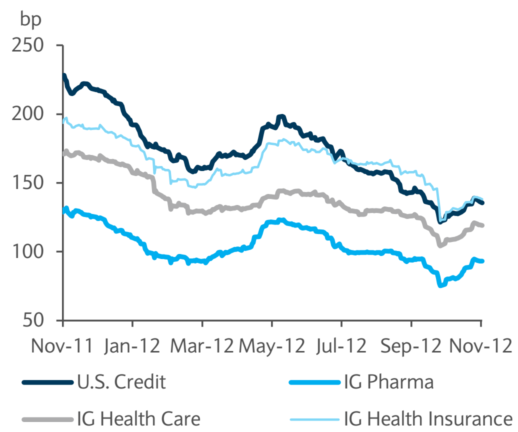
Market weight on IG Pharmaceuticals: The IG pharmaceuticals sector has historically traded at a premium to the IG credit index, reflecting the sector's defensiveness and higher ratings. With most US-based issuers having completed large strategic initiatives in FY12, such as spin-offs, asset sales, acquisitions, and large buyback programs, we expect the credit profiles of pharmaceutical companies to remain stable in FY13.

Overweight on Managed Care: A significant amount of debt issuance related to funding large M&A transactions has caused the managed care sector to underperform the IG Credit Index in FY12. With most large companies likely to be in a de-leveraging mode, we would expect the sector to outperform the broader markets in FY13. Our recommendation also reflects the favorable longer-term growth prospects for the sector, which would be driven by the implementation of PPACA, and the sector's increasing participation in Medicare and Medicaid. However, we expect some benefit of membership growth to be offset by moderation in operating margins.

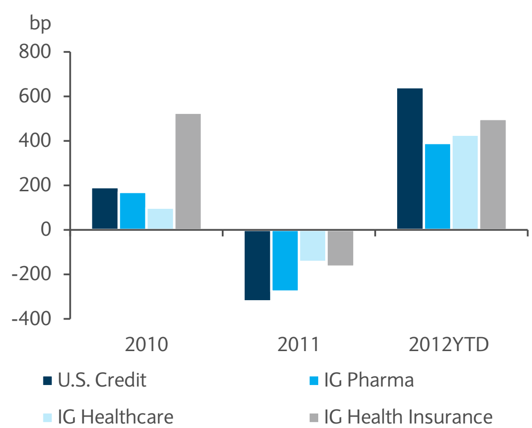
Underweight on the Healthcare sector: Our recommendation reflects possibility of a number of companies facing weak organic growth prospects and/or underperforming equities resorting to shareholder-friendly actions. Given attractive debt costs, we also expect companies to operate their businesses at higher leverage levels, which could result in pressure on ratings and drive additional issuance.

Issuance activity likely to moderate from FY12 levels: The HC sector has issued a significant amount of unsecured debt in FY12 to fund acquisitions and buybacks. With most large companies having completed big transactions in FY12, we expect more modest issuance in FY13.

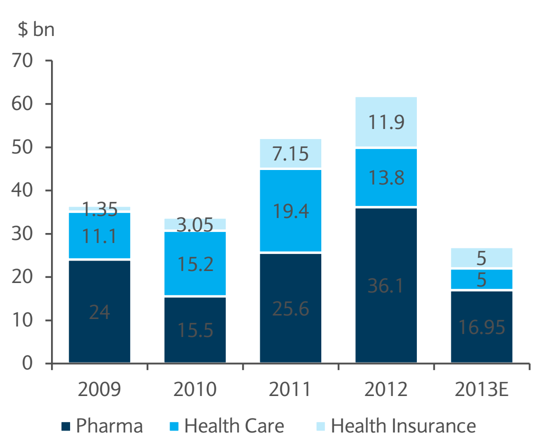
US Credit Index vs. IG Healthcare Sectors – OAS



U.S. Credit vs. IG Healthcare – Excess Returns



Issuance Expectations



Source: Barclays Research

US HIGH GRADE/HIGH YIELD HOMEBUILDERS – MARKET WEIGHT

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Key recommendations

Hovnanian Enterprises (MW). We recommend selling 5y CDS (8½/9½pts). Event risk for Hovnanian Enterprises has diminished materially over the past 12 months. A series of changes to its capital structure has reduced fixed costs, and improving gross margins should allow the company to return to profitability in 2013. Its land banking relationship with GSO Capital Partners should also allow the company to take advantage of the housing recovery without eroding its liquidity.

Standard Pacific (OW). We recommend selling 5y CDS (300/315bp). Recent spread widening following solid 3Q12 results presents an attractive entry point. The company's operational improvement has been impressive, and the credit is well positioned for stronger results in 2013. Standard Pacific has been among the most consistent homebuilders in terms of reporting operating profitability.

Pair Trade: Hovnanian Enterprises (MW) vs. Beazer Homes USA (MW). We recommend selling 5y CDS on Hovnanian Enterprises (8½/9½pts) versus buying CDS on Beazer Homes (3¾/4¾pts). Beazer Homes lagged peers operationally in 2012, and this is likely to continue in 2013. Beazer Homes remains unprofitable (FY12: -$135.6mn net income) and its gross margins are the lowest in the sector (FY12: 11.6%). Increased land investment in 2013 will likely erode liquidity ($487.8mn). We believe that over the coming 12 months Hovnanian Enterprises and Beazer Homes should trade flat in 5y CDS.

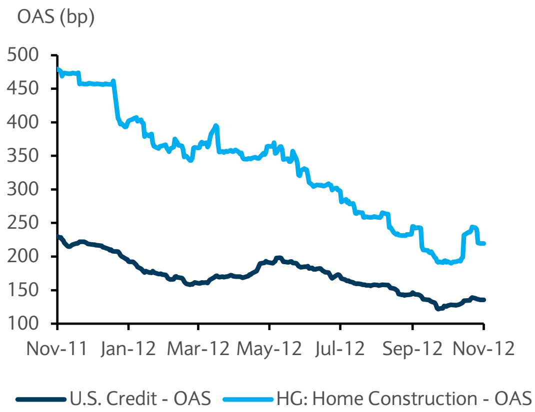
Sector outlook

US housing recovery should gain traction in 2013 following encouraging growth in 2012. Below-average inventory (existing homes: 5.4 months; new homes: 4.8 months), attractive affordability, and improved sentiment (NAHB future sales: 53) support further improvement in housing demand. Housing starts should rise at a healthy pace in 2013 (Barclays economic forecast: 1.0mn) and home prices should continue to firm (Barclays forecast: +3.5% y/y).

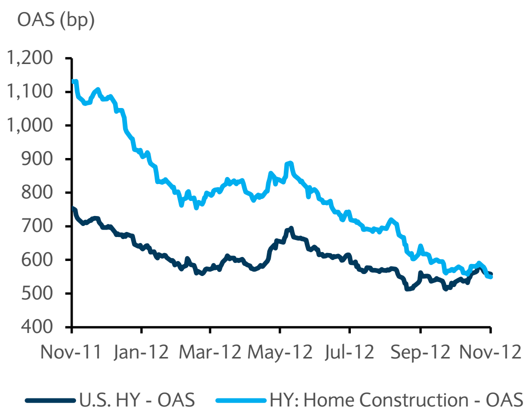
The focus of homebuilders in 2013 will be less about demand growth and more about profitability. We expect the spring selling season to be successful; however, the y/y improvement will likely be lower than 2012 due to the challenging comps. Most builders have been profitable since mid-2012, as new land purchases and increased demand have led to expanding gross margins and prices. Improving profitability will be key as the housing market continues to recover.

Liquidity will remain a credit positive, but decline from peak levels. Following several years of contraction, homebuilders are focused on achieving profitable growth. We expect land purchases and development activity to be the primary use of cash during FY13.

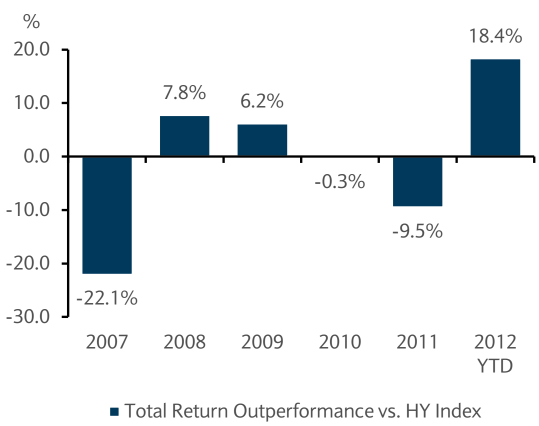
HG Home Construction OAS vs. HG Credit Index



HY Home Construction OAS vs. HY Index



HY Home Construction Total Return vs. HY Index



Source: Barclays Research

US HIGH GRADE INSURANCE (LIFE) – OVERWEIGHT

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Key recommendations

We are upgrading our recommendation to Overweight from a Market Weight position on US Life Insurers. Our sector rating now aligns with our Overweight recommendation on higher beta names. Sector performance is heavily tied to higher beta names such as AIG (AIG, OW), Genworth (GNW, OW), and Hartford (HIG, MW). As macro volatility waned in 2012, spreads rallied, and the Life sector is now 75bp cheap to US Credit, in from 170bp at the beginning of the year. The sector traded as tight as 20bp back of US Credit pre-crisis. Since we expect manageable volatility 2013 against a backdrop of low interest rates, less economic uncertainty, and a weak but improving jobs picture, we return to a more bullish stance.

We prefer high beta names that have reduced idiosyncratic risk.

- AIG's 3Q12 results, in our view, were indicative of a lower volatility credit story. We see fair value roughly 30bp through current levels.
- GNW continues to consider strategic alternatives, but its commitment to holding company liquidity and leverage are positive for creditors. The potential for a downgrade to HY remains, but is priced in with benchmark bonds quoted +500bp on a g-spread basis.
- HIG continues to take a bondholder-friendly approach to restructuring its life operations. As clarity improves on the use of proceeds from asset sales, capital management, and earnings momentum, we suspect that spreads versus peers will collapse.

Sector outlook

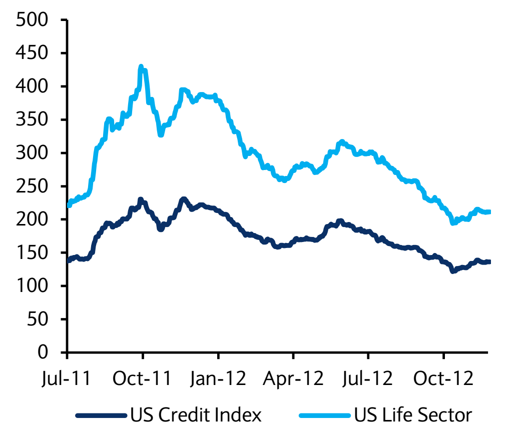
Capital and liquidity are sector strengths. Operating capital is at historical highs, as large cap life insurers maintain RBC in excess of 400%. Holding company liquidity is also historically strong, covering debt service and short-term maturities on average by 2x, driven in part by rating agency expectations. Financial leverage* remains conservative at 23-27% for most life insurers.

Headwind from interest rates. Low interest rates will continue to grind on the sector's earnings as the effect on reinvestment rates, driven in part by QE3 and the adverse effect on reserves and intangibles, will make double-digit ROEs difficult to achieve. We do not view low rates as a regulatory capital issue, given the industry's current RBC health.

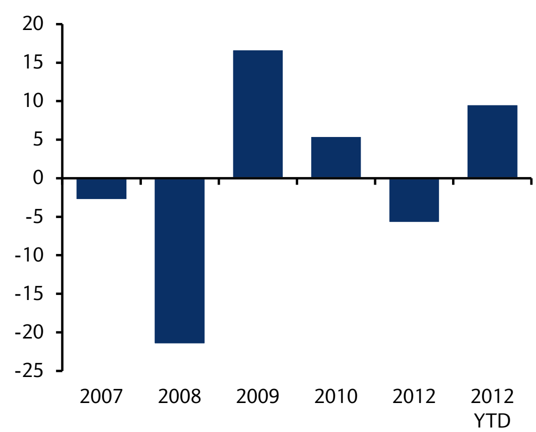
Pricing and benefit changes a short-term hedge. The life sector has raised prices and is adopting product features reflective of the more difficult operating environment. However, the benefit of these actions is finite. Still, capital management continues to provide a near-term ROE buffer. Our ROE forecast for 2013 is 11.7% (10.8% excl AFL).

* Financial debt+preferreds/total capital less AOCI

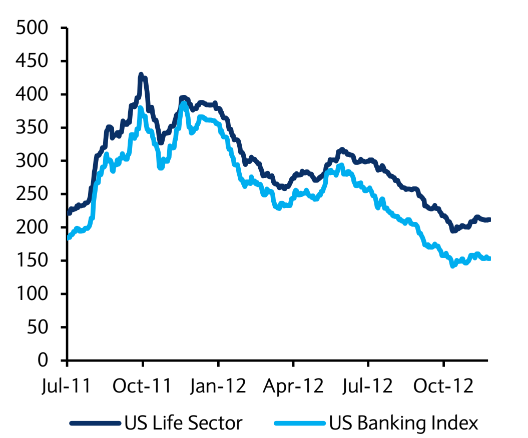
US Life Insurance OAS versus US Credit Index



US Life Ins. excess return versus US Credit Index



US Life Ins. OAS versus US Bank OAS



Source: Barclays Research

US HIGH GRADE INSURANCE (PROPERTY/CASUALTY) – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on US P&C Insurers. The sector remains defensive as low capital market exposure creates a safe haven during periods of volatility. Sector OAS was +169bp at month-end, 32bp wide of the US Credit Index. The P&C index has traded as tight as 10bp inside US Credit in the past year, arguing for potential upside if volatility re-emerges. If that does not materialize, the sector OAS will likely remain rangebound within 100bp of current levels.

We prefer CNA (CNA, OW)/brokers and avoid tighter-trading blue chips. CNA has demonstrated material improvements in recent years and maintains one of the most conservative balance sheets in the industry. CNA 2021s are at least 80bp cheap to ACE (ACE, MW), Chubb (CB, UW), and Travelers (TRV, MW), leaving room for roughly 25bp of compression. Industry blue chips including ACE, Allstate (ALL, MW), CB, and TRV have posted good results of late and have strong balance sheets, which we believe are fully priced in. Insurance brokers should continue to benefit from the positive premium rate environment, allowing for sustained organic growth and margin expansion. With a limited need for capital, broker ROEs have outperformed the P&C sector over time.

Sector outlook

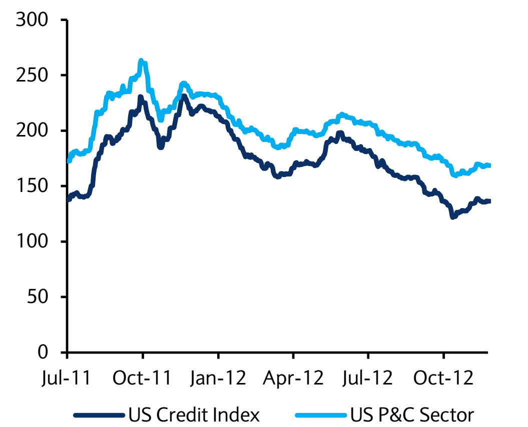
Strong capital. Industry operating leverage remains conservative at 0.8x, providing a capital buffer against volatility from severe weather claims. Although Hurricane Sandy claims may exceed industry estimates, we do not expect them to materially detract from the sector's strong capital position.

Positive rate environment continues. P&C insurers have reported several consecutive quarters of premium rate increases. With insured loss estimates as high as $25bn for Hurricane Sandy claims, we expect that positive pricing momentum will continue in personal lines. Commercial lines are more dependent on investment income, so persistently low interest rates should sustain premium rate tailwinds.

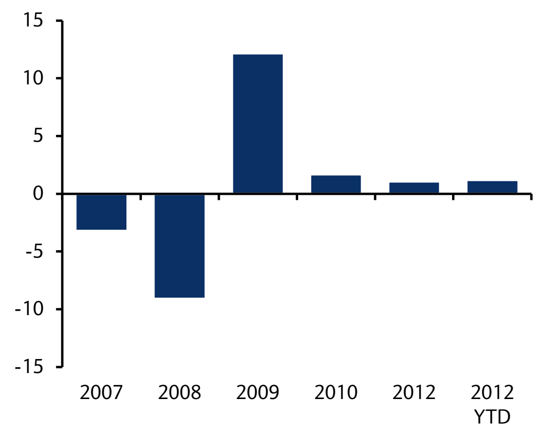
Earnings headwinds constrain ROE potential. We expect that low operating leverage, waning reserve releases, and lower reinvestment yields will combine to constrain sector returns. We believe only industry leaders such as ALL, CB, and TRV will be able to achieve double-digit ROEs over the near term (4Q12 notwithstanding).

Weather is a source of volatility. P&C insurers remain exposed to high severity losses from large weather events. Although we believe this risk is well managed in general through modelling and reinsurance protection, it has been a source of earnings volatility in recent years. Hurricane Sandy highlights this risk, which we expect will have a material earnings effect in 4Q12, but not impair capital.

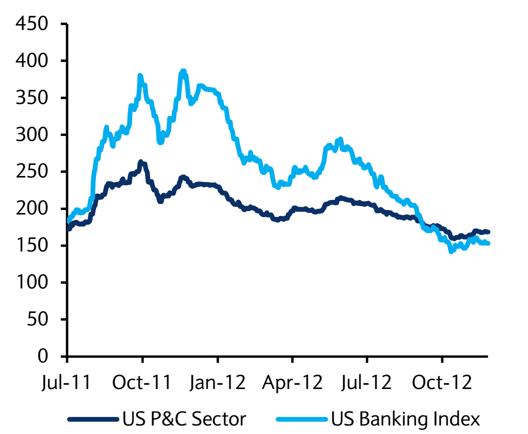
US P&C Insurance OAS versus US Credit Index



US P&C Insurance excess return versus US Credit Index



US P&C Insurance versus US Bank OAS



Source: Barclays Research

US HIGH GRADE METALS & MINING – MARKET WEIGHT

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Key recommendations

Long: Teck Resources (TCKBCN, MW) and BHP's (MW) Petrohawk notes.

Short: Nucor (NUE, UW), Alcoa (AA, UW) and Cliffs Natural (CLF, NR).

Sector outlook

2013 is unlikely to be the year in which the metals and mining sector outperforms the broader market. With China's future demand for commodities still uncertain, uneven global economic growth, and potential downward ratings pressure on certain issuers, we expect many investors to remain negatively biased toward the sector.

That said, pro forma for the departure of ArcelorMittal from the investment grade index, spreads are at their 3y wides relative to U.S. Credit and investors should, in our view, have some exposure to the sector, given its carry potential. Although we do not expect fundamental improvement, companies are beginning to signal a greater commitment to capital discipline and are right-sizing capital spending programs for the "new normal" of slower Chinese growth.

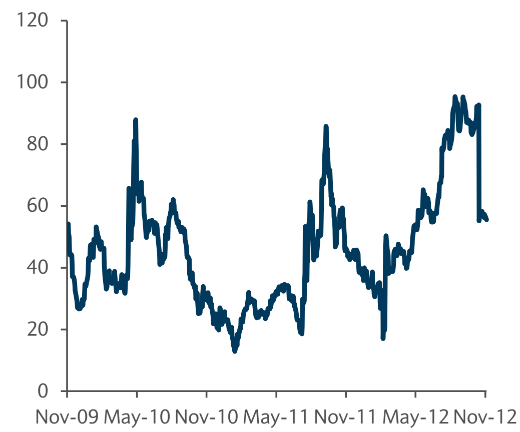
We believe that investors should build to a Market Weight position by concentrating exposure in select BBB credits with diversified business profiles and/or low-cost copper production. Despite the tempting levels of certain low-BBB issuers, we believe that ratings risk is real and spreads do have downside.

New iron ore capacity is likely to pressure prices and could threaten the prevailing view that a floor exists at $100-120/mt. Although iron ore prices recovered rather quickly from their late summer swoon, we believe that new capacity from low-cost producers will add volumes during the next several years and shift the supply curve down. The larger question, in our opinion, is the timing of when this shift will happen.

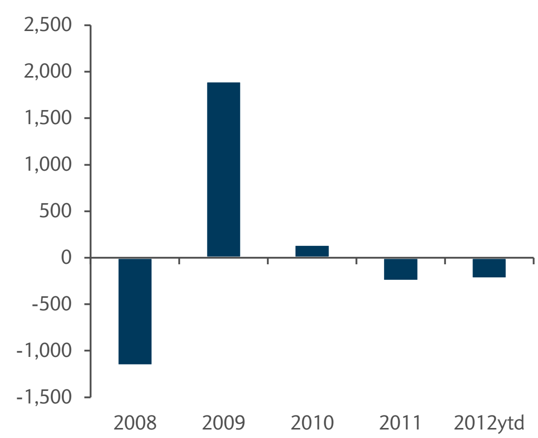
Aluminum's supply-demand surplus is expected to grow in 2013, and we expect continued pressure on prices. Although being bearish aluminum is a consensus view, it is nonetheless supported by significant production in China with little evidence of curtailments.

Copper's supply-demand deficit is expected to shrink in 2013, but higher production should still be offset by increased demand.

Metals & Mining minus U.S. Credit (OAS, bp)



Metals & Mining minus U.S. Credit (excess returns, bp)



Source: Barclays Research

US HIGH GRADE REITS – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on US REITs. We remain constructive on fundamentals as the commercial real estate sector continues to recover and REIT balance sheets are in the strongest shape in years. However, we view spread levels, which are near multi-year tights, as appropriately priced. The sector remains susceptible to macro and idiosyncratic risks (fiscal cliff, capital market access) and has historically exhibited a high-beta to market sell-offs.

We recommend an Underweight in Equity Residential and AvalonBay, given relatively tight spreads and a material deterioration of credit metrics following the Archstone transaction, at potentially the peak in the multi-family cycle.

We recommend that investors favor defensive REIT credits with strong balance sheets and access to capital. We remain Overweight on Boston Properties and Kilroy Realty but recommend that investors take advantage of the recent rally to swap out of Duke Realty (MW) and Brandywine (MW).

Sector outlook

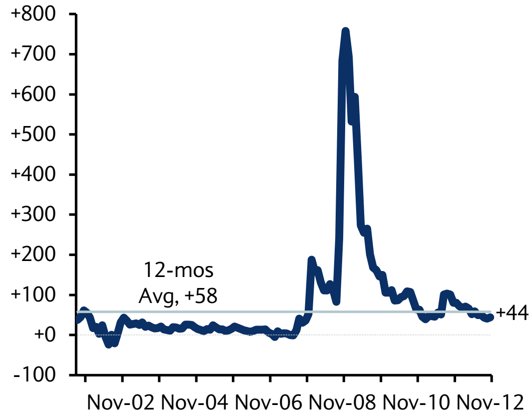
Credit metrics to show improvement in 2013, albeit slower than prior years, as issuers reduce leverage to meet targets, fund M&A in a largely credit-neutral manner (equity issuance/JVs), take advantage of low-rates to bolster liquidity, and asset quality continues to improve.

We forecast $18-20bn of index eligible REIT supply in 2013, which includes refinancing of ~$8bn of maturities through 1Q14. The biggest swing factor to our estimate is M&A-related issuance, which may see a surge, particularly for healthcare and from the recent Archstone deal.

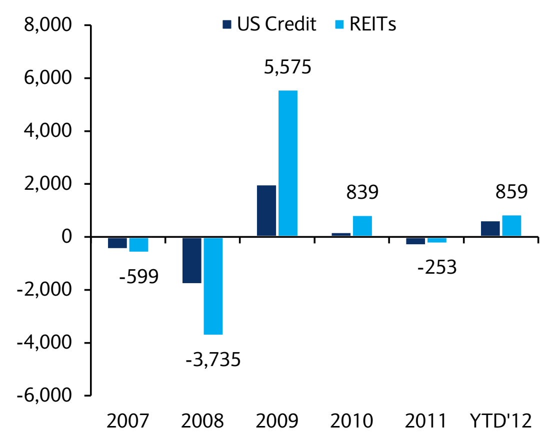
Commercial real estate should broadly experience a further recovery, driven, in part, by favorable supply dynamics. However, we expect it to be varied by property type and markets. Our subsector outlooks are:

- **Multi-family – Stable but decelerating.** Fundamentals should remain solid, yet will show further deceleration, given rising supply, slowing rent growth, and real estate tax pressure.
- **Office – Stagnating recovery.** The uneven recovery should heavily favor CBD (versus suburban) and in tech-/energy-driven markets. Modest supply will support fundamentals; however, macro (job growth) and fiscal spending cuts (DC) remain key overhangs.
- **Retail:** Mall/outlet fundamentals remain solid and bolstered by non-existent supply. Large international M&A/development remains a key risk. Shopping center REITs will benefit from portfolio repositioning, low supply, and improved consumer spending, but face tough comps. Small tenants should continue to rebound.
- **Industrial:** Improving housing markets should boost demand, which, combined with low vacancies in key markets, should result in improvements in occupancy and rents. Rent spreads should turn positive in 2013, albeit only modestly. Speculative developments should resume in high growth markets.

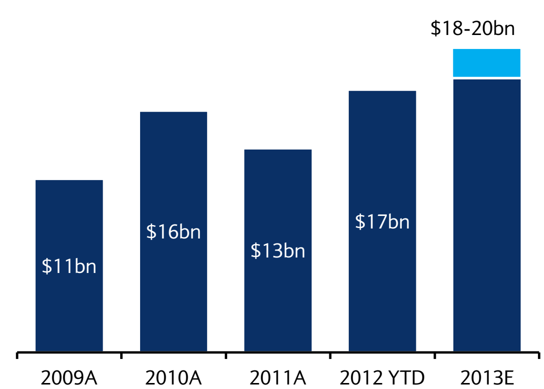
US REITs OAS versus US Credit Index (bp)



REITs Excess Return versus US Credit Index (bp)



U.S. REIT Issuance Volumes ($bn)



Source: Barclays Research. As of November 30th , 2012

US HIGH GRADE RETAIL, RESTAURANTS (UNDERWEIGHT) AND SUPERMARKETS (OVERWEIGHT)

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Key recommendations

We lower our rating on retail to Underweight (from Market Weight) supported by a similar rating on Lowe's, Target, and Kohl's.

We continue to rate supermarkets Overweight, driven by cheap valuation, which we expect to compress on modest, but consistent operational improvement.

Restaurant fundamentals have weakened of late with softening sales trends. We expect this to be a key issue with sector performance likely to lag until operations and the global macro backdrop improve.

We recommend credits that offer consistency in terms of operational performance and financial policy while trading at reasonable valuations. In this regard, we prefer Home Depot (Market Weight) in retail and Kroger (Market Weight) in grocers. We also see room for credits such as Gap and Delhaize to continue compressing toward BBB comps given positive ratings and operational momentum in the case of Gap and attractive valuation and ratings cushion at Delhaize.

Sector outlook

The retail sector is valued for its quality bias, and we continue to expect this to be the case in the event of market volatility. Sentiment for retail names could also benefit from potential preference for domestic credits, given limited international exposure. However, during non-volatile times, technicals will be increasingly important, affecting curve relationships as well as CDS performance.

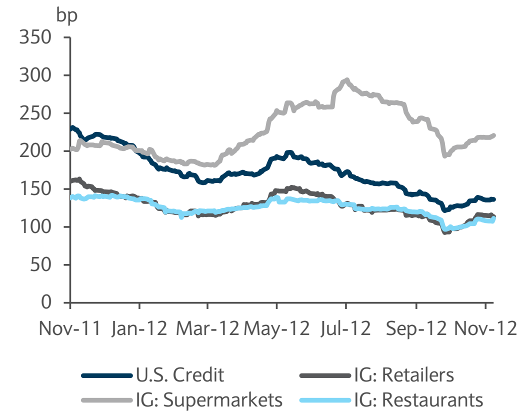
Event and ratings risk is heightened in the sector, given LBO headlines for IG retail names such as Staples and Advance Auto.[1] This is likely to add pressure until clarity is gleaned on whether such transactions will occur. In the case of cuspy credits such as Safeway (Market Weight), the coming year will be crucial from a ratings and deleveraging perspective.

Shareholder-friendly uses of cash are likely to persist, which may place some downward pressure on ratings. We have seen credits such as Kohl's and Lowe's decrease the amount of cash cushion and add leverage in order to support larger share buybacks. We continue to see room for select issuers to use the balance sheet flexibility provided by lower ratings, although the need for commercial paper access is a limiting factor.

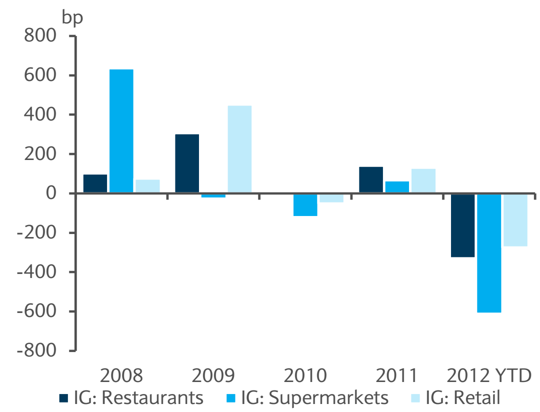
We forecast $16-17bn of supply in 2013 across retail, grocers, and restaurants. This would be roughly in line with issuance in 2012 and assumes that companies such as Lowe's and Kohl's continue to add incremental leverage to support buybacks and credits such as Home Depot and CVS operate closer to their leverage objectives. M&A is forecast to have a modest effect on the sector.

[1] Staples Seen Reversing Romney Deal after Record Value," Bloomberg October 8, 2012. "Advance Auto Takeover Seen as Value Meets Record Age," Bloomberg, November 13, 2012.

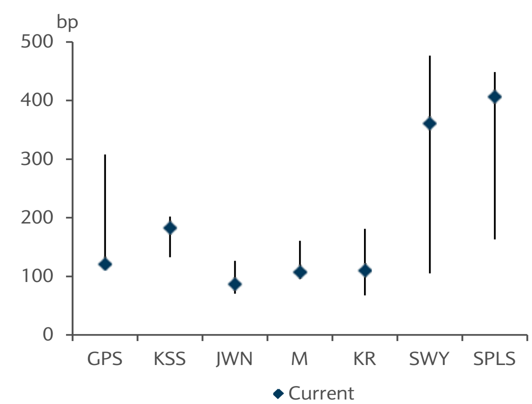
US Retail OAS versus US Credit Index



US Retail excess returns versus US Credit Index



Select IG Retail CDS performance (LTM ranges)



Source: Barclays Research

US HIGH GRADE TECHNOLOGY – MARKET WEIGHT

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Key recommendations

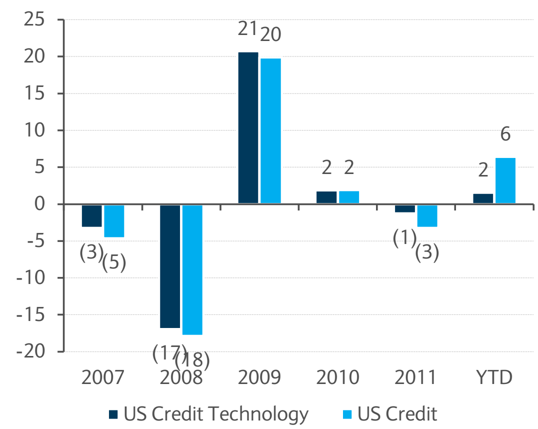
We are retaining our Market Weight recommendation on Technology. While we remain positive on many of the names in the sector, Dell (MW), Xerox (MW), and Hewlett-Packard (UW) together account for 19.8% of the Technology Index, and we expect all three to remain under pressure as secular hardware pressure accelerates in 2013.

Within the sector, we retain core Underweight ratings on Hewlett-Packard and Western Union. For different reasons, we think both stories could continue to get meaningful worse. We remain Overweight rated on Agilent, Arrow, Cisco, and Corning and Market Weight rated on IBM and Oracle.

On an OAS basis, the IG Technology index is trading 5bp cheap to the US Credit Index, which is a three-year wide and compares with a tight of 72bp through (December 2011).

US Technology OAS versus US Credit Index

US Technology and Credit Index excess return



Source: Barclays Research

Sector outlook

For 2013, we expect a rebound in some key tech markets, including software, storage, networking, and mobility, with software and services segments likely to remain highly defensive. The Barclays economics team estimates global GDP growth at 3.4% in 2013, and we expect IT spending to outpace global GDP growth modestly. However, the outlook is highly dependent on a benign resolution to the US fiscal cliff and sequestration issues.

We do, however, expect continued pressure on hardware segments such as PCs and printers, which face both secular and cyclical headwinds that are only likely to accelerate in 2013. Specifically, we expect worldwide printer shipments to decline 6% in 2013, with PC sales likely down 4% y/y. We expect this to continue to have a negative effect on Lexmark, Hewlett-Packard, Xerox, and Dell and, to a lesser extent, the larger IG semi-conductor credits (Applied Materials (NR), Texas Instruments (NR), and Analog Devices (NR)), as well as Microsoft (MW).

Year-to-date, the technology sector has had $28.5bn in new issuance, compared with $42.6bn in 2011 (a large percentage of which reflected HPQ issuance). In 2013, maturities in the sector total only $15.9bn (IBM, HPQ, and ORCL account for a large component of maturities – notable, given that ORCL has already prefunded its). However, given the outlook for low rates, still reduced global GDP growth, and the lack of clarity on federal budgetary plans, we think tech companies will consider increasing core leverage ratios/targets and an active M&A pipeline, which is likely to drive issuance levels similar to 2012's.

US HIGH GRADE TELECOM – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on the domestic telecom sector, which reflects our Market Weight rating on AT&T (T), Verizon (VZ), and American Tower and our Overweight rating on CenturyLink.

We remain Market Weight on AT&T but recommend reducing exposure to off-the-run notes ahead of an estimated $25-30bn in issuance over the next three years to support its investment program (Project Velocity) and share buybacks. We expect the supply to remain an overhang as AT&T is already the largest non-financial corporate issuer in the Credit index (1.4% of index).

CenturyLink, which is one of the cheapest names in the index, will be the critical driver of sector performance, in our view. We remain Overweight with a preference for the 10y notes and expect spreads to benefit from the resolution of Moody's negative outlook early next year. We believe an affirmation could act as a catalyst for compression as a potential downgrade has prevented broader HY investor buying and, at the same time, limited the IG buyer base appetite for the name.

Sector outlook

Wireless – More of the same. We expect AT&T and Verizon to maintain their dominance in post-paid over the near term as their first-mover advantage in LTE bears fruit. However, the industry as a whole should experience slowing subscriber growth as penetration levels approach saturation. Nevertheless, growing smartphone penetration and tiered/family data plans should support healthy ARPU growth.

Wireless consolidation. We expect consolidation to be a recurring theme, particularly given the T-Mobile USA/MetroPCS merger, Softbank's investment in Sprint, and DISH's focus on a wireless offering. However, we do not expect AT&T or Verizon to have an active role in the industry consolidation over the medium term.

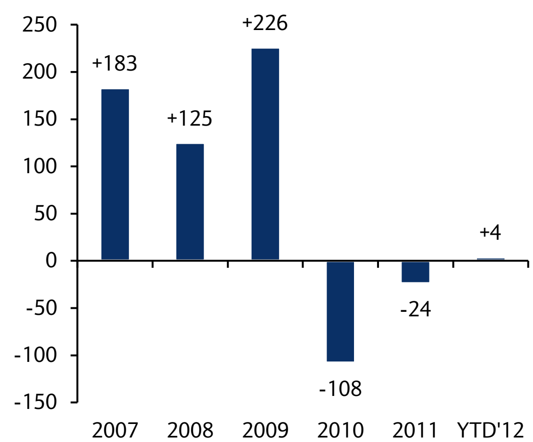
Wireline – Investment phase. We expect moderating top-line declines for wireline telecoms as softer enterprise demand is offset by improving consumer growth and strategic services, particularly across fiber footprints. DSL adds will remain pressured from higher-speed cable offerings and broader availability of LTE. AT&T should benefit from its expanded U-verse/enhanced-DSL footprints, but margins will likely compress due to the higher investments.

Towers – Secular growth intact. We view towers as the best-positioned subsector, benefiting from LTE upgrade cycles and higher international penetration. However, potential for large M&A remains a concern.

We estimate $16-17bn in sector issuance in 2013, mostly to refinance maturities and for AT&T's investment plan. The largest swing factor is potential liability management exercises similar to T's and VZ's.

HG Telecom OAS versus US Credit Index (bp)

HG Telecom Excess Return versus Credit Index



Top Issuers in US Telecom Index

Ticker	% of Telecom Index	% of US Credit Index
T	27.3%	1.4%
VZ (inc VZW)	23.2%	1.2%
VOD	7.8%	0.4%
AMXLMM	7.0%	0.4%
CTL	6.9%	0.3%
TELEFO	5.8%	0.3%
FRTEL	4.6%	0.2%

Source: Barclays Research

US HIGH YIELD AEROSPACE AND DEFENSE – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position in US HY Aerospace and Defense. The sector currently trades right on top of the index, and we expect strong balance sheets and solid free cash flow to offset potential budgetary/macro weakness for many of the manufacturers in this space. Commercial aerospace fundamentals appear to be holding strong, which we think will justify a continuation of tight spreads in that sub-sector. While concerns about sequestration and DoD budget cuts persist, we think a deal to avert devastating cuts will be reached. Additionally, we do not see many of our HY defense names as prime sequestration targets to begin with.

We recommend investors gravitate towards names with better cash flow profiles and higher quality of earnings (think of BE Aerospace and TransDigm as core holdings). We think these should trade at least 100bp through names such as Bombardier and Spirit Aerosystems, whose cash flow has been constrained and earnings have come under pressure. Investors with greater risk tolerance may also consider the Dyncorp 10.375s, which are currently yielding ~14% for a company generating solid free cash flow and paying down debt (though significant exposure to overseas contingency operations is a risk).

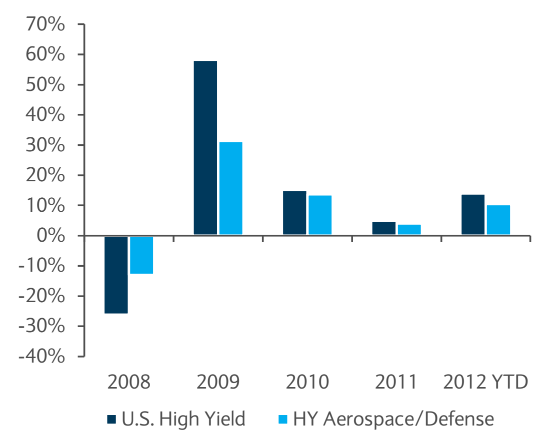
Sector outlook

Commercial aerospace fundamentals appear to be holding steady, buoyed by strong backlogs at Airbus and Boeing. Demand for these aircraft should hold at least for the near to intermediate term as airlines continue to refresh fleets with newer, more fuel-efficient aircraft. Our counterparts in equity research are calling for 4.8% increase in air traffic in 2012, followed by another 5% in 2013.

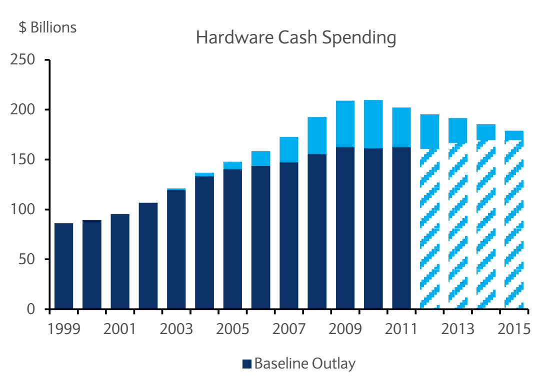
On the defense front, sequestration is the elephant in the room that will need to be dealt with in relatively short order. In our view, Democrats are likely to bend a bit as it pertains to defense spending cuts as they work with Republicans towards broader spending/tax reform. Additionally, as we look across our high yield defense universe, we do not see many companies that stand out as prime sequestration targets. Those that could be exposed to cuts appear to have clean balance sheets and the ability to generate decent free cash flow, which should help credit metrics remain solid (ie, Alliant Techsystems and Oshkosh).

US HY Aero/Defense OAS versus US HY Index

US Aero/Defense total return versus US HY Index



Barclays Equity Research DoD Budget Forecast



Source: Barclays Research

US HIGH GRADE AUTOMOTIVE (OVERWEIGHT) / HIGH YIELD AUTOMOTIVE (NOT RATED)

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Key recommendations

Ford Motor Co. (OW). We maintain our Overweight rating on Ford Motor Co. and recommend selling 5y CDS (220/230bp). We expect Ford to report strong results in 4Q12, and the company is well positioned for profitable growth in 2013. Its North American operations will remain the primary driver of profitability; however, its European operations should begin to stabilize in 2013 and its South American operations should contribute to profitability. With European restructuring initiatives now in place, focus should return to the strength of Ford's North America franchise. We believe Ford CDS should compress toward other investment grade automotive comps, including Johnson Controls (145/155bp).

General Motors (NR). We recommend selling 5y CDS (330/350bp). We are more comfortable with General Motors' valuations now that: 1) 3Q12 earnings are behind us; 2) European restructuring initiatives have been announced; and 3) loan hedging related to its increased secured credit facility has abated. Given the expected strength in its North American operations in 2013, we believe valuations are attractive, particularly 110bp wide of Ford Motor Co.

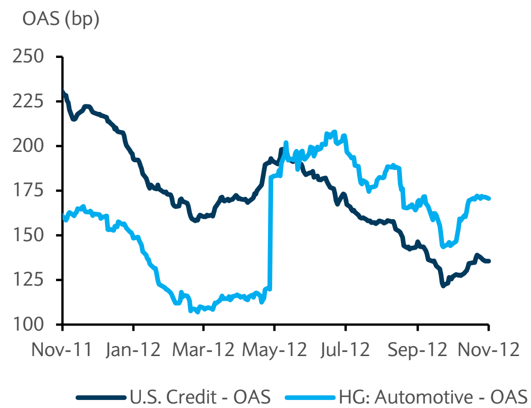
Sector outlook

The outlook for North American auto sales remains positive. Light vehicle sales have reached 14.0mn units in 11 of the past 12 months. Significant pent-up demand, an aging vehicle fleet, cheap automotive financing, and replacement needs following Hurricane Sandy should keep SAAR elevated for the near-to-intermediate term. Barclays equity research expects light vehicle SAAR to reach 14.5mn units (+13% y/y) in 2012 and rise to 15.5mn units (+7% y/y) in 2013.

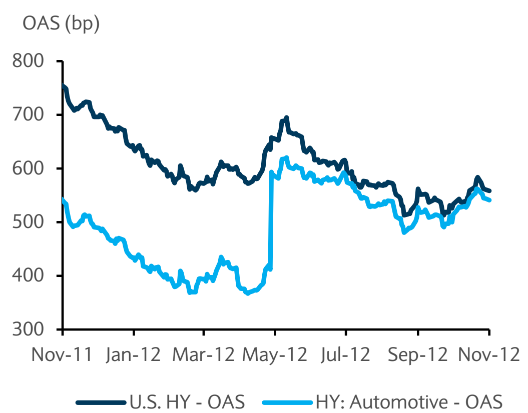
Light vehicle production in North America should rise in 2013 with solid demand, while European production will likely weaken further due to overcapacity. IHS Automotive expects North American light vehicle production to reach 15.6mn units in 2013, up 1.8% y/y. IHS forecasts for 2013 have improved 840k since January. Overcapacity in Europe will continue to plague the industry. For 2013 IHS expects production to decline 1.8%, to 18.7mn units. Production estimates for 2013 have been cut by 965k since January. Europe represents 23% of LTM revenue at Ford and 15% at GM.

Ratings for Ford and GM will remain stable in 2013. We expect Ford and GM to report strong profitability and maintain robust liquidity in 2013. However, we believe GM is unlikely to be upgraded to investment grade in 2013 before operations in Europe have stabilized and progress toward breakeven begins to materialize. We do not expect S&P to upgrade Ford to investment grade until at least late 2013.

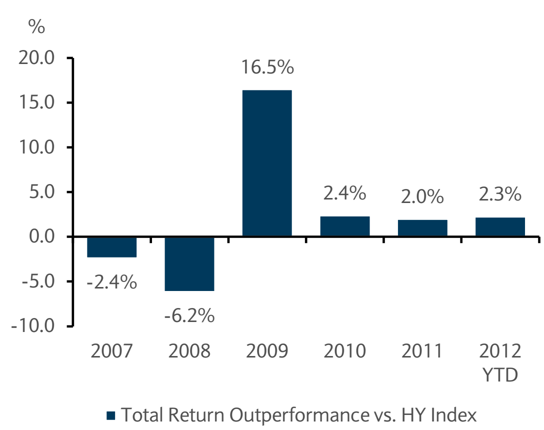
HG Automotive OAS vs. HG Credit Index



HY Automotive OAS vs. HY Index



HY Automotive Total Return vs. HY Index



Source: Barclays Research

US HIGH YIELD CABLE & SATELLITE – MARKET WEIGHT

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Key recommendations

We rate the US cable and satellite sector Market Weight. Given that cable began 2012 at relatively tight trading levels as a high quality sector, it has underperformed in the past year amid strong HY returns. The cable sector (4.80% YTW) now trades 165bp inside of the HY Index, versus 254bp inside at the beginning of the year. However, we remain cautious on fundamental trends. We believe deleveraging will remain limited in 2013 and expect operating cash flow to be largely directed towards capital investment and shareholder returns, with minimal debt reduction. However, with some room for spread compression, and given expectations for lower HY returns in 2013 (4-6% Barclays Capital HY Strategy target), we expect cable returns to be broadly in line next year.

We prefer Charter and Cablevision senior bonds following recent underperformance. Cablevision and Charter bonds have lagged the market in late 2012, as recently weaker free cash flow reflected the network investments each company is making. While we do not expect meaningful deleveraging, we believe each offers compelling spreads versus BBs. Charter 6.5% notes due 2021 currently trade 13bp inside the BB index, versus 90bp inside at the beginning of the year (and as recently as August). CSC Holdings 6.75% notes due 2021 currently trade 15bp wide of BBs, after starting 2012 97bp inside of BBs.

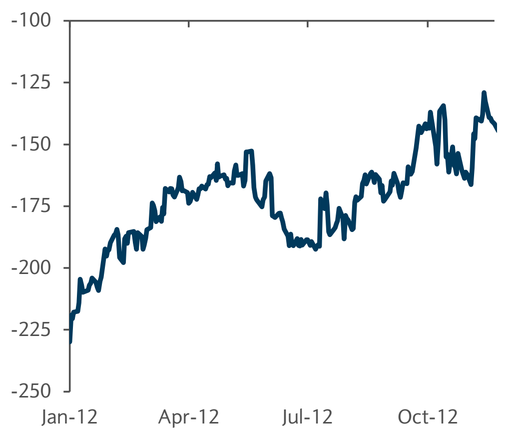
Sector outlook

We expect limited improvement in balance sheet metrics in 2013, as EBITDA growth and free cash flow will be affected by network investments and efforts to improve customer trends. Acquisition and retention costs should continue to pressure margins, and we expect ARPU increases merely to cover the continued escalation in programming costs, at best.

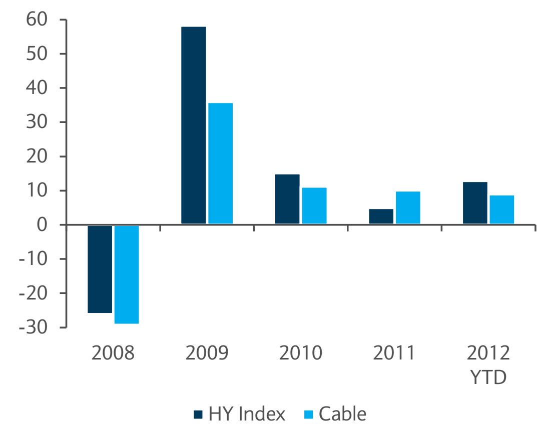
Subscriber trends should continue to improve in 2013, with fewer video net losses (13.0% improvement y/y for the nine months ended September 30) and continued growth in higher value broadband net additions (up 14.5% y/y in 2012). Strong customer trends should continue to come at a steep cost; in 2012, margins fell y/y at Charter, Cablevision and DISH and were roughly flat at Mediacom and Cequel.

We remain constructive on FSS sector trends. Top-line growth has slowed in 2012 but should be bolstered by solid demand from key markets, such as Latin America. Cutbacks in military spending and increased use of fiber in Africa are concerns for 2013. However, long-term contractual revenues and healthy backlogs provide good visibility and stable cash flow. Recent satellite launches should augment top-line growth and drive free cash flow generation through EBITDA expansion and a scaling back of capex as launch schedules wind down.

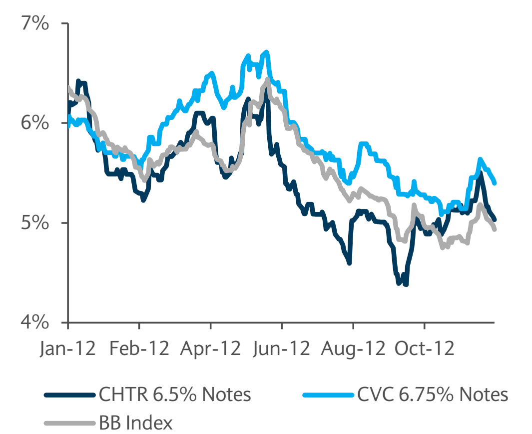
HY cable OAS versus High Yield Index



High yield cable total returns



Charter and Cablevision versus BB Index (YTW)



Source: Barclays Research

US HIGH YIELD CHEMICALS – MARKET WEIGHT

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Key recommendations

We continue to recommend a Market Weight position in US high yield chemicals. Following moderate outperformance in YTD12, we maintain our Market Weight rating for the HY chemicals sector for 2013. Fundamentals have only improved over the past 12-18 months as management teams have focused on deleveraging and maintaining significant liquidity positions in light of still-weak macroeconomic trends. While additional tightening may be difficult given high dollar prices/call constraints, we expect the sector to perform in line (at a minimum), as strong balance sheets and y/y improvement in EBITDA trends highlight the underlying credit strength for a majority of the sector.

We remain positive on higher-rated issues. Despite limited upside in many of these issues (LYB, HUN, NCX, CE), we would remain better positioned in higher quality credits into 2013 (strong EBITDA/FCF, focus on deleveraging) and expect these names to outperform if the historically tight high yield market trades off on any signs of macroeconomic weakness.

Sector outlook

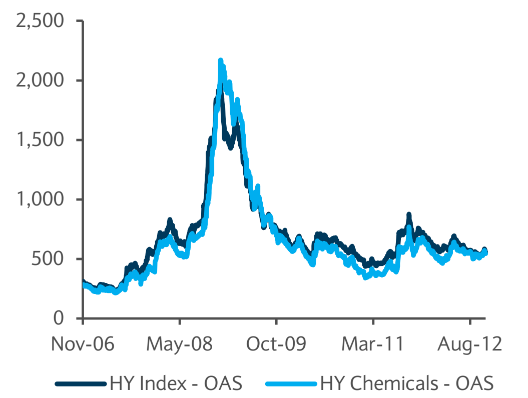
Balance sheet metrics should improve further in 2013 as EBITDA trends move higher y/y (macroeconomic improvement, cost cutting benefits) and liquidity remains strong. We expect management teams to remain conservative toward aggressive releveraging transactions.

M&A is likely to remain a key sector theme as global petrochemical producers seek (inorganic) growth and increased specialty chemical exposure while global GDP trends remain depressed. Even as the market became more bullish on sector trends in 2012, current market valuations could present opportunities to purchase strategic assets relatively cheaply and generate returns on capital (low rates, cheap financing) well in excess of those achievable on a standalone basis.

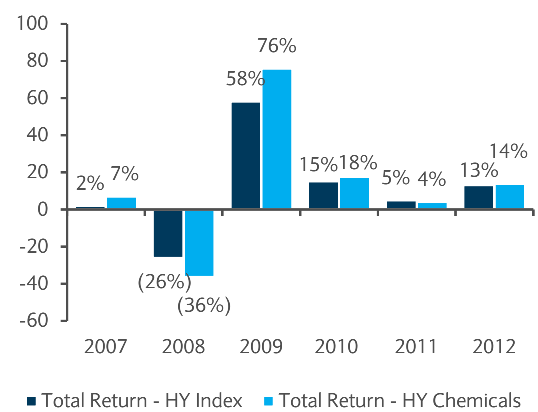
New issues will be a key focus in 1Q13, with financings anticipated for the proposed merger activity for Georgia Gulf-PPG, DuPont Coatings-Carlyle, PolyOne-Spartech (Barclays acting as financial advisor for these three transactions), and TPC Group-First Reserve. In addition, as we saw this year, we would expect issuers to remain opportunistic about early refinancings assuming that rates remain low into 2013.

The global economic direction still presents risks, so it is important to be mindful of key economic indicators such as industrial production, housing starts, global auto production, and the macro trends for both the European and Asian (and, in particular, Chinese) economies. That said, we believe credit fundamentals are strong enough to weather any volatility in 2013.

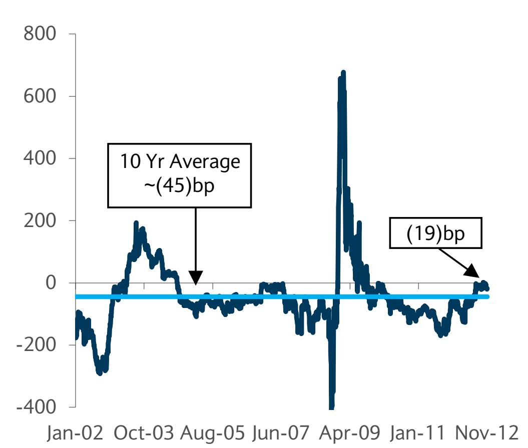
US HY Chemicals OAS versus US HY Index



US HY Chemicals return versus US HY Index



Historical spread, US HY Chemicals versus US HY Index



Source: Barclays Research

US HIGH YIELD CONSUMER PRODUCTS – MARKET WEIGHT

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Key recommendations

Our Market Weight view of the consumer products space is based on the reasonable free cash flow characteristics of most operators; sluggish, but slightly higher y/y; consumer spending trends; and the reasonable implied enterprise value cushions enjoyed by many credits. These factors are tempered by intense competitive dynamics in many product segments, continued pressures on discretionary consumer spending, and limited pricing power in most categories.

Sector outlook

In our view, consumer product company sales trends are likely to remain sluggish in CY13, as mixed macroeconomic trends persist and a highly value conscious consumer will remain highly price sensitive. That said, sales trends are likely to vary materially across various categories. Competitive intensity remains elevated, and is likely to continue into CY13.

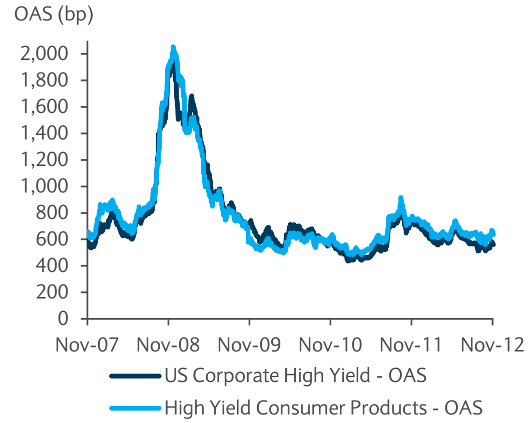
Raw material cost inflation appears reasonably benign, for a change, although transportation and Asian sourcing costs continue to face upward pressure.

EBITDA trends are likely to remain mixed overall but generally under some downward pressure, in our view, and dependent on pricing and cost dynamics in sub-sectors. However, balance sheets are for the most part in reasonable shape, in our view, considering the significant refinancing activity over the past two years.

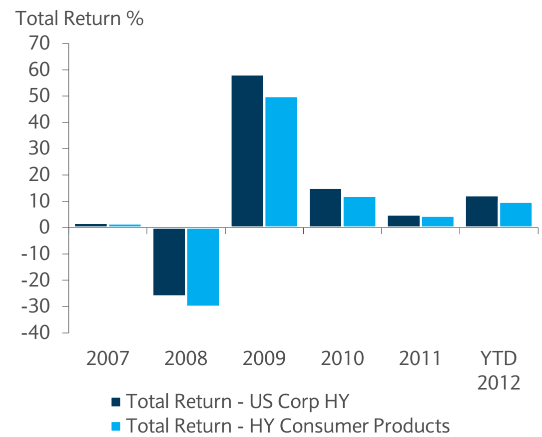
The slight uptick in M&A activity at healthy EV multiples over the past year could continue in CY13, as operators search for cost savings avenues, and financial sponsors have ample dry powder.

We believe that investors should consider accumulating core holding bonds on relative weakness, including those of Easton Bell (Market Weight), Elizabeth Arden (Overweight), Prestige (Market Weight), Libbey (Market Weight), and Jarden (Market Weight). Visant bank debt (7.7% YTM, 3.8x net leverage) appears well oversold. Short duration investors should consider Easton Bell and Jarden 2016-2018 bonds, in our view.

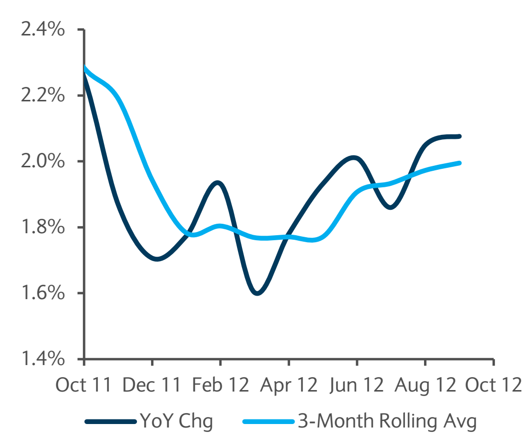
Consumer Products Index OAS versus HY Index



Consumer Products total returns versus HY Index



Consumer Spending (% Change y/y)



Source: BEA, Bloomberg, Barclays Research

US HIGH YIELD ELECTRIC UTILITIES – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position in US high yield utilities. The key themes of 2012 – notably the direction of natural gas prices and investor perception about the timing and ultimate impact of EPA-mandated shutdowns – will be topical again in 2013. While the independent power production (IPP) market has stabilized somewhat as gas prices approach $4/mmbtu, power prices are still near trough levels, and declining hedge profiles remain a risk to profitability in 2013-14. Solid balance sheets and liquidity positions offset these operational headwinds, but sector performance will likely track natural gas prices (and, in turn, power forwards) throughout 2013.

We prefer credits with exposure to the Texas/ERCOT market in the near term. It is tough to point to any truly positive sector trends in the absence of plant shutdowns or materially higher natural gas prices, but the Texas market dynamics should benefit existing operators. With tightening supply/demand and potentially record summer weather (as seen in 2011), the public utility commission (PUCT) has shown that it is willing to discuss regulatory solutions to move prices higher and encourage operators to install new capacity. This trend will benefit both NRG and Calpine as existing operators, and as such, we are positive on both names heading into 2013 (albeit with limited upside given tight trading levels).

Sector outlook

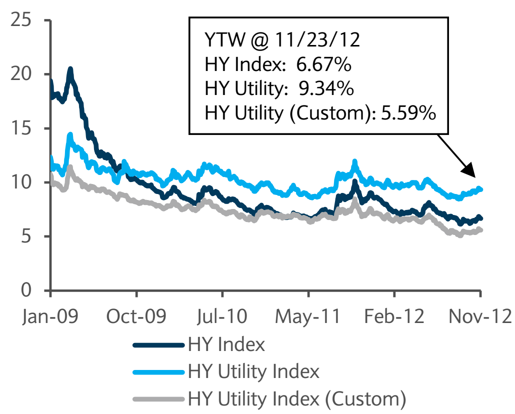
Natural gas upside above $4-5/mmbtu is likely muted, as lower coal-to-gas switching and increased supply will offset any demand increases. For a sector ultimately tied to natural gas, we expect the focus to be on the near-term direction of weather, storage, and rig counts as investors attempt to gauge the trends for forward power prices.

All eyes will be on Texas as the PUCT works through key reform measures to encourage new plant installation. With reserve margins continuing to tighten, the state will need to find a way, either through higher price caps or a capacity market, to provide an incentive for new builds to address the issue of resource adequacy as industrial demand increases.

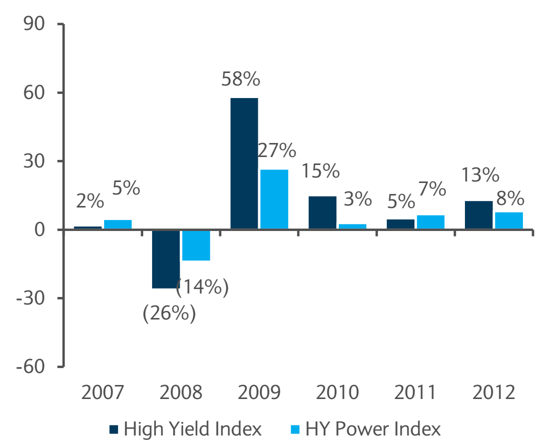
GenOn and NRG merger will be a key focus, with investors weighing the benefits of increased scale and significant synergies with the continued weakness in wholesale coal generation for the next few years.

Balance sheets continue to improve as management teams recognize the difficult operating environment facing the industry for the next few years. Both NRG and CPN produce solid free cash flow annually, and we expect a somewhat balanced stance toward capital allocation despite management teams' disposition to be shareholder friendly.

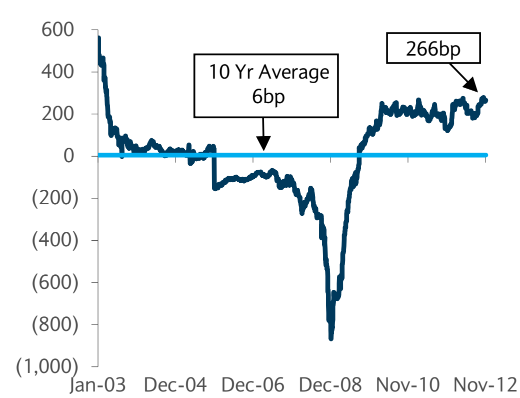
US HY Utilities versus US HY Index (YTW%)



US HY Utilities returns versus US HY Index



Historical spread, US HY Utilities versus US HY Index



Source: Barclays Research. Custom HY Utilities index excludes DYN, TXU and EIX tickers.

US HIGH YIELD ENERGY & PIPELINES – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on US HY Energy. In 2012, HY Energy bonds have lagged the market, returning 9.0% through November, well below the 14.0% return posted by the high yield market. Weak natural gas prices and outsized new issuance have weighed on spreads through the year. While we expect a ~30% lift in average U.S. natural gas prices in 2013, continued strong new issuance and flat y/y oil prices will likely lead to market returns, in our view.

Our top picks include a trio of E&P credits: EP Energy, Samson Resources and SandRidge Energy. The former two are LBOs completed in the past year, and the latter a credit that could undergo a transformative divestiture with the possible sale of its Permian assets. All three are well hedged, with hedges covering ~80% of 2013 oil and natural gas production for EP Energy and Samson, and ~100% of SandRidge's oil production.

Sector outlook

High Yield energy trades cheap to historical average. The energy sector trades about 12bp through the High Yield Index, compared with a 10-year average of ~103bp. While oil prices remain supportive and leverage is generally stable, poor technicals on continued strong new issue supply could keep a lid on outperformance. New issuance in energy and pipelines has totaled $55bn year-to-date (~18% of the market), surpassing last year's total of $32bn and the 2010 high of $34bn (see the third chart).

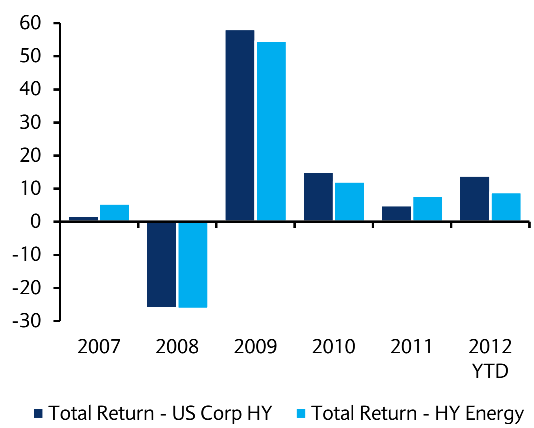
In our view, the sector is supported by strong asset coverage, hedging that provides downside protection, stable leverage, and oil prices that buffer weak gas prices. Risks include an economic slowdown, low natural gas prices, labor pressures, and, for many shale producers, negative free cash flow.

From a fundamental perspective, we forecast 2013 WTI oil and Henry Hub natural gas prices will average $90/bbl and $3.50/mmbtu, respectively. Oil prices will likely be supported by limited spare capacity, geopolitical risk, and a return of demand growth from China and India. However, demand trends in North America and Europe, where 42% of global demand is sourced, could limit upside. Natural gas prices are mired in oversupply amid associated gas related to profitable liquids-rich drilling, though normal winter weather could provide demand support compared with last winter.

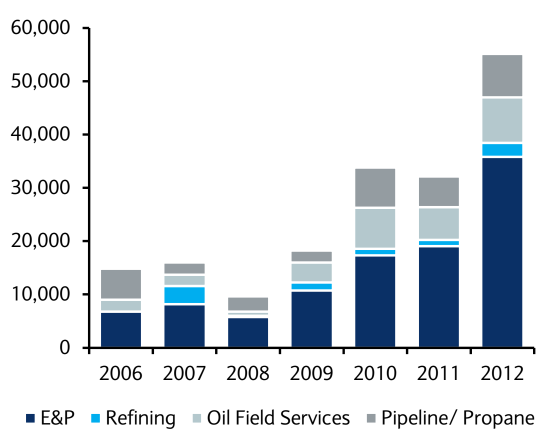
Sector themes likely in 2013: strong economics for oil to continue favoring liquids vs. gas drilling, robust M&A (and possible LBO) activity and poor technicals on new issue supply. We remain cautious on domestic oilfield service providers, as well as unhedged natural gas producers.

High Yield Energy Spreads

High Yield Energy Returns



High Yield Energy New Issuance ($mn)



Source: Barclays Research

US HIGH YIELD FOOD/BEVERAGE – MARKET WEIGHT

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Key recommendations

Our Market Weight view of the HY food and beverage space is based on the strong free cash flow characteristics of most operators; healthy implied enterprise value cushions within packaged food; and sluggish, albeit nearly flattish, EBITDA trends; partly offset by intense competitive pressures, high consumer sensitivity to pricing, pockets of cost inflation within the protein space, and the sector's below-average YTW (5.6%).

Sector outlook

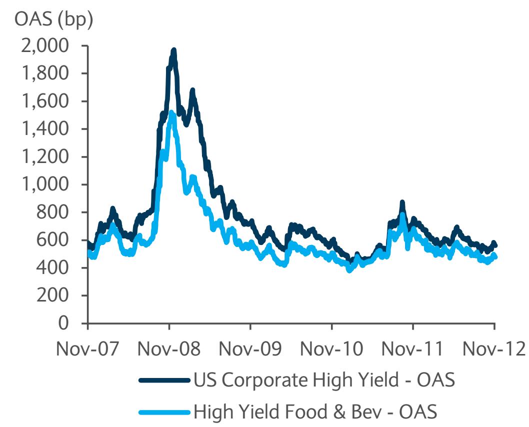
Volume declines have become less pronounced in packaged food, as pricing gains have moderated in the space. We expect this dynamic to continue in CY13, leading to flattish volumes and minimal pricing. We see potential for promotional intensity to rise in some categories, leaving diversified packaged food operators better positioned.

Cost inflation has moderated for most packaged-food operators (despite higher grain costs), and is likely to continue to gradually moderate in CY13. In our view, EBITDA trends in the packaged food space face manageable y/y comparisons in 1H13, and are likely to trend modestly higher y/y through a combination of less onerous cost inflation and slightly better volume trends. M&A activity has recently picked up in the space, and is likely to keep rising as some operators seek cost savings and revenue-growth opportunities.

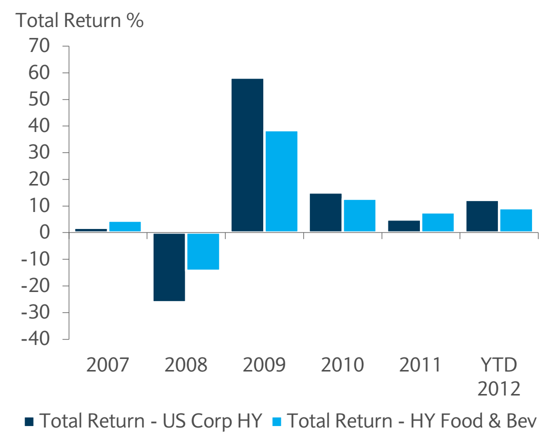
Within meat processing space, operating trends are likely to diverge across various proteins, Poultry processing margins look set to improve sequentially in 1H13, and y/y in 2H13, reflecting reasonable production discipline. On the other hand, beef processing margins are poised to remain under meaningful pressure, as cattle availability will likely trend 5-7% lower y/y, placing downward pressure on margins. Meanwhile, pork processing margins are likely to remain within historical normalized ranges.

We maintain our Overweight rating on Pilgrim's Pride, reflecting well above average YTW of 8.0%, expectations for reasonable EBITDA in FY13 leading to 3.0x leverage, significant asset base, and strong market position, partly offset by continued exposure to volatile grain costs. Separately, we believe investors should take advantage of periodic market dislocations to accumulate core holding packaged food bonds, including Pinnacle Foods (Market Weight), Smithfield Foods (Market Weight), and Del Monte Foods (Market Weight).

Food & Bev Index OAS versus High Yield Index



Food & Bev Index total return vs. High Yield Index



Source: Barclays Research

US HIGH YIELD HEALTHCARE – MARKET WEIGHT

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Key recommendations

Hospital companies appear fairly valued. Valuations appear to reflect the expected upside from coverage expansion associated with the implementation of PPACA. A delay in the timeline could, however, be a negative for the hospitals.

Overweight position in Gentiva (OW) 11.5%, 2018 (12.7% YTW); our rating reflects the company's solid free cash flow generation ability, good earnings performance over the past few quarters, improved equity cushion, and strong liquidity position.

Add exposure to select HY pharmaceutical names. We recommend adding exposure to Warner Chilcott (WCRX, NR). Current valuations – 7.75% 2018 trading at 6.2% YTW, versus 4.8% for the Ba part of the HY Index – appear to be overlooking the company's solid free cash flow generation and modest leverage levels relative to peers.

Sector outlook

We recommend a Market Weight position in HY Healthcare. In the near term, we expect an increase in volatility in valuations of HY healthcare credits, given uncertainties around the composition of the package that would be used to address the fiscal cliff. While a package that involves significant entitlement reform – Medicare and Medicaid – and/or one that pushes back the implementation of PPACA would be negative for most participants, a package that relies heavily on revenue increases should be benign for the healthcare sector. With the HY healthcare sector currently trading at a lower premium (28bp) versus the HY market relative to historical average (61bp), this uncertainty appears to have been fairly priced into valuations.

Operating fundamentals should largely remain sound in 2013, despite muted volumes, with incremental benefit from the implementation of PPACA expected in 2014. PPACA should drive expansion of coverage, benefiting hospitals, ASCs and providers with high uncompensated care (such as emergency service providers).

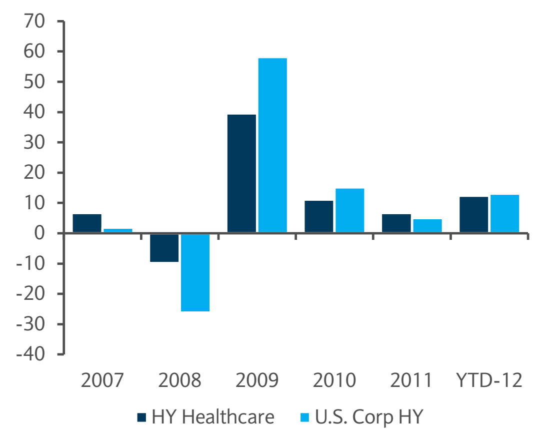
The role of the managed care sector in government programs is expected to increase significantly. Such involvement, driven by fiscal pressures, should drive significant changes in how healthcare gets paid for.

Pharmaceutical companies should be a safe haven. HY Pharma should be fairly immune to structural changes in the healthcare system; credit investors should, in our view, allocate additional capital to these companies, given their solid cash flow generation ability, modest leverage levels, and access to emerging markets.

Issuance to be driven by acquisitions/dividend recapitalisations, with most companies having used benign capital markets for refinancing near-term maturities. The pursuit for scale is expected to drive further consolidation and is likely a source of issuance (particularly in the facilities subsectors).

HY Healthcare OAS versus U.S. Corp HY Index and B US HY Index

HY Healthcare total return versus U.S. Corp HY Index



Source: Barclays Research

US HIGH YIELD INDUSTRIALS – UNDERWEIGHT

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Key recommendations

We have an Underweight rating on US HY Industrials. We believe that with Diversified Manufacturing and Construction Machinery trading at ~5.30% and 5.25% YTW, respectively, versus the US High Yield Index at approximately, 6.45%, there is little to no room for error within our industrial universe in 2013. In addition, we think fundamentals are less positive/clear heading into 2013 than they were heading into 2012 and thus do not like the risk/reward right now for many of the industrial credits we follow.

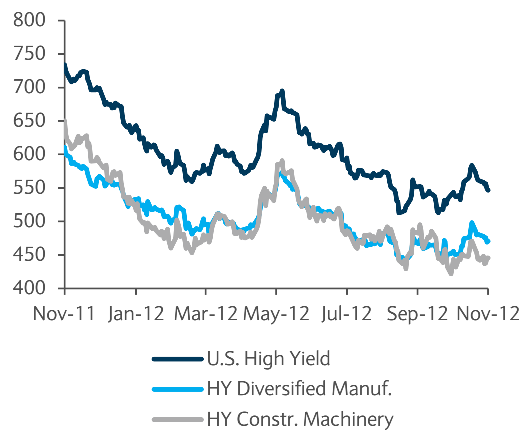
We think Manitowoc (MTW) bonds continue to trade too tight for their credit metrics. MTW is still 5.5x leveraged and third-quarter earnings were a bit light to our expectations. Similarly, Rexnord (RXN) bonds trading at 4.24% on the offer side appear to price in very little downside risk and/or fundamental weakness in 2013. We concede that both MTW and RXN along with most of the industrial credits we follow remain focused on improving profitability/cash generation and debt repayment but at these tight trading levels, we think even a small deterioration in fundamentals could have the sector underperforming the index.

Sector outlook

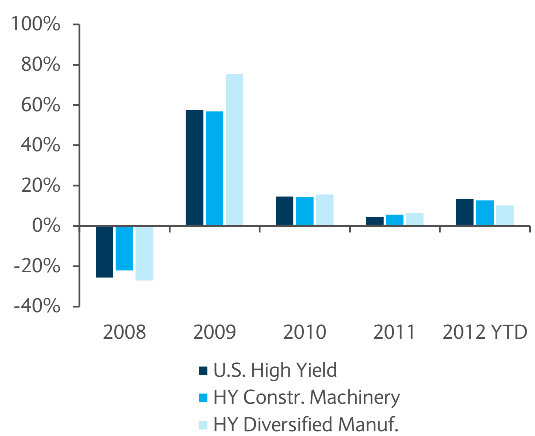
We are currently modeling 2013 with a continuation of the slow North American economic recovery we have seen in 2012. That said, we have begun to see evidence of cracks in that recovery after a pretty solid 1H12. At the individual credit level, second- and third-quarter earnings showed a meaningful slowdown in top-line growth for some names. Examples of this include Terex (TEX) y/y revenue growth slowing to just 1% in 3Q12 while Tomkins (PINFOR) had core organic sales down 2.3% versus the prior year. Most companies have cited continued weakness in Europe and slowing growth in Asia/China as the primary reasons for weaker growth.

From a more macro level, data have been inconsistent at best over the past few months. After a solid first five months of the year in which the ISM manufacturing index was consistently in the 52-54 range (>50 signals expansion), we saw June, July, and August readings of less than 50, signalling manufacturing contraction. September and October came in at 51.5 and 51.7, respectively, only to see levels drop below 50 again with a November reading of 49.5. Things could be worse, however, as they are in Europe where the November PMI came in at 45.8. Companies with meaningful exposure to Europe include Manitowoc (~22% of revenue), Rexel (~55%), Terex (~27%), and Tomkins (~23%).

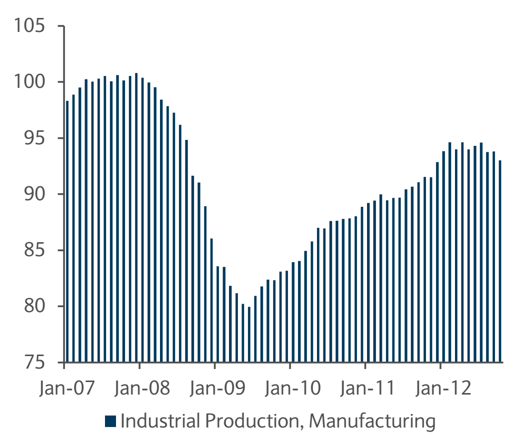
US HY Industrials OAS versus US HY Index



US HY Industrials total return versus US HY Index



US Industrial Production, Manufacturing



Source: Barclays Research

US HIGH YIELD MEDIA & ENTERTAINMENT – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on US HY Media (7.55% YTW, ex CCMO 6.88%). We expect fundamentals to remain stable with upside tied to stronger economic growth. 2H13 will present tougher comps for broadcasters, but we expect bonds to hang on through the cyclical downturn. Print and publishing credits should continue to face challenging fundamentals, which could lead to volatility. The group's largest issuer is CCMO, which is still in a volatile position, and sector performance is likely to be affected by developments at the company.

We recommend Clear Channel Outdoor (CCO). We like the 7.625% sub notes (OW) and believe the incremental yield (7.8% vs. 6.25% for Barclays B index) more than compensates for the risk of being tied to the parent. We also like the 6.5% senior notes (MW) as a more defensive holding with favourable relative value against other ad-based media.

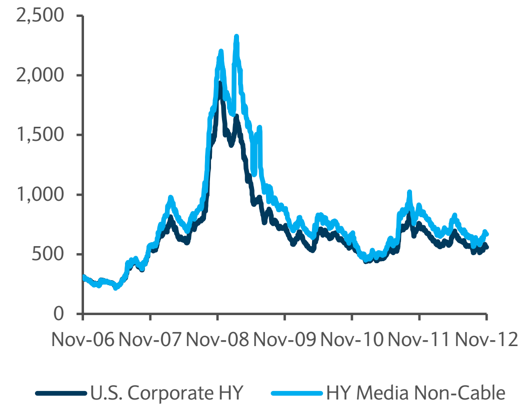
We continue to recommend Univision (UVN) senior notes (OW). We expect Univision to have a solid 2013 with good television growth, higher digital revenues and better radio performance. We also believe unsecured bonds look cheap trading flat to highly levered Cumulus (CMLS, NR), which has a much worse growth profile.

Despite more difficult comps, we continue to recommend TV bonds. In addition to better operating results in 2012, the strong HY market allowed many operators to refinance, extend maturities and lower interest expense. We think investors should look to pick up yield in Gray (GTN, OW) and Nexstar (NXST, NR), compared to higher quality peers LIN Media (TVL, MW), Sinclair (SBGI, MW), and Allbritton (ALLBRI, NR). Many of these are smaller issues, so investors may need to own a basket of these names.

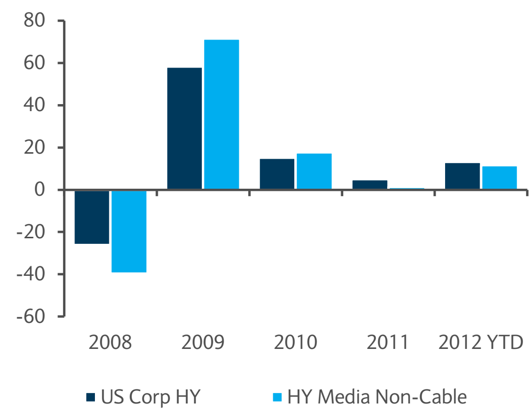
Sector outlook

The quadrennial hangover. With 2012 almost complete, the election and Olympics appear to have delivered on their promise for significant increases in advertising. Thus, advertising growth will likely slow in 2013. In addition, our economists forecast another year of slower economic growth, which should also keep advertising growth in check. However, we would note that a continued rebound in the housing market and its positive effect on the consumer could improve fortunes of ad-based media. The amount of M&A transactions in 2012 exceeded our expectations, and this trend could continue in 2013, with favourable debt markets and more of the 2005-7 deals looking to change hands. Auto spending continues to be a critical driver of traditional media spending. We believe auto advertising spending could increase again in 2013, with Barclays Equity research expecting a healthy 7% increase in auto sales (see *November U.S. Autos Tune-Up/3Q Review)*. Growth should slow from 2012, however, given the tougher comp (sales are estimated to jump 14% in 2012).

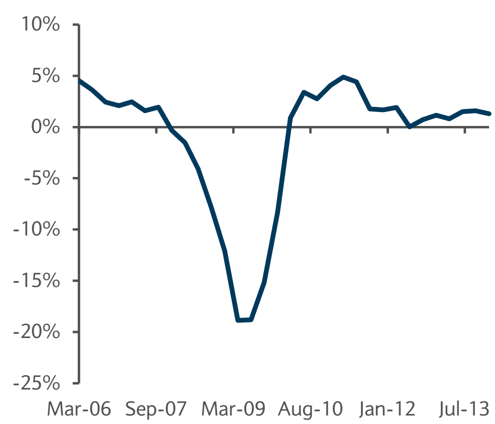
HY Media Non-Cable OAS versus US HY Index



HY Media Non-Cable total return versus US HY Index (%)



US advertising spend growth (historical and estimated)



Source: Magna, Barclays Research

US HIGH YIELD METALS AND MINING – MARKET WEIGHT

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Key recommendations

We have a Market Weight rating on US High Yield Metals and Mining. We recommend investors look to stay shorter-dated (Fortescue bonds) or secured (AK Steel) where possible. We like Novelis, Consol Energy, and Steel Dynamics as less volatile core holdings. Investors who build a portfolio around those names can sprinkle in some higher risk, higher reward bonds like the recently issued Arch Coal 9.875s of 2019.

Our neutral view is the result of a still very cautious fundamental outlook coupled with the sector now trading ~100bp wide of the broader high yield market. In addition, as we look across the space, many of the most fundamentally exposed credits have built up huge liquidity balances and eased covenant pressure, pushing potential negative credit events well into the future (AK Steel, Arch Coal, Alpha Natural Resources). That said, the sector's fate is tied to commodity prices (most notably steel, iron ore, and met coal), which have become more volatile and harder to predict. Weakness in Europe, slowing Asian growth, and a less-than-robust North American recovery are likely to keep these commodity prices low in 2013 leading to worsening credit metrics across the sector. The market appears content to dismiss weak earnings in 2013; however, any realization that commodity weakness will persist, could lead to further downside.

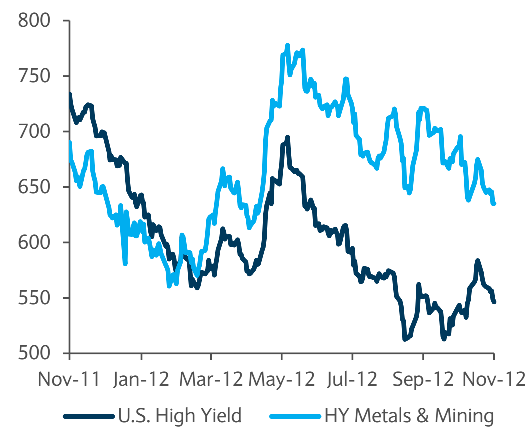
In our view, commodity intense credits, such as coal and steel producers, should consistently trade wide to say a plain vanilla industrial manufacturer given the greater volatility. Even if coal/steel fundamentals begin to improve in 2013, we would expect many of our metals and mining names to continue to trade wide to the index as the market more thoroughly prices for the sector's uncertainty.

Sector outlook

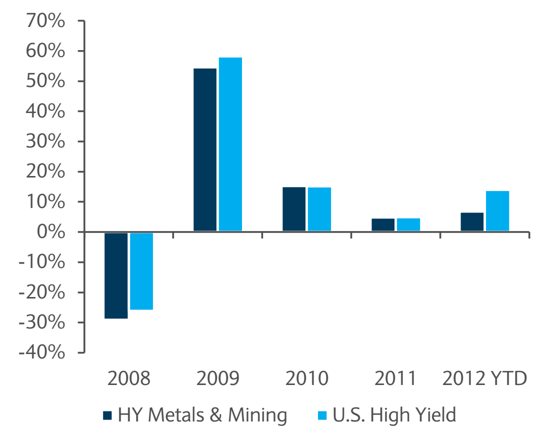
We see leverage increasing in 2013 for many of our high yield metals and mining companies. This trend will be most pronounced with coal producers owing to lower production volume and weak thermal/met prices. Spot met coal prices have come up off their bottom of roughly $140/tonne (FOB Australia) in mid-September to ~$160/tonne today. However, even at today's higher prices, most US met coal producers will struggle to make money and will see depressed EBITDA and higher leverage. In addition, we note that at least one coal price source (Platts) has US met coal trading at a discount to similar quality Australian product (negative news for ANR and WLT).

Steel fundamentals remain weak given a sluggish North American construction market. Moreover, continued weakness in Europe and slowing steel demand from China are putting pressure on global steel prices, making it difficult for US producers to raise prices. We do not expect significant changes to this market in 2013.

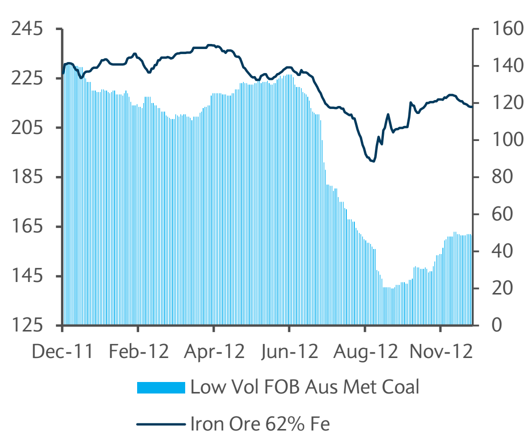
US HY Metals & Mining OAS versus US HY Index



US HY Metals & Mining total return versus US HY Index



Low Vol Met Coal & 62% Fe Iron Ore Spot Prices



Source: Barclays Research

US HIGH YIELD PAPER (UNDERWEIGHT)/ US HIGH YIELD PACKAGING (MARKET WEIGHT)

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Key recommendations

Overweight Berry Plastics 9 ¾% senior notes due 2021 ($112, 6.8% YTW). After the IPO, leverage is ~5x with a longer-term goal of 2-4x. Solid execution and over $200mn of PF annual free cash flow support continued credit improvement.

Sector outlook

Paper: With weak global macroeconomic trends and secular weakness in certain grades (i.e., newsprint, uncoated and coated freesheet), paper/paperboard demand trends for U.S. producers continue to be weak. Producer capacity discipline, including machine closures and production downtime, however, has kept inventories at fairly low levels and input costs have been stable/moderating. The prospects for pricing improvement remain mixed, with the most recent containerboard/box price increase expected to be realized, pulp prices moving higher, but coated paper and newsprint pricing expected to be challenged due to secular demand declines. Wood products prices (particularly OSB) have benefitted from improved housing starts and tight inventories; however, capacity restarts could be a potential risk to the continued improved pricing trend.

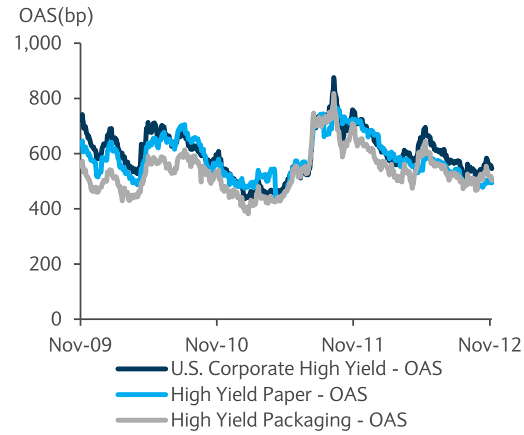
Packaging: Demand even from the traditionally stable food/beverage/ consumer sectors has been weak (partly reflecting food inflation), restraining volume growth for many companies. Domestic beer consumption has outperformed carbonated soft drinks. European weakness has affected companies with high exposure including O-I (glass) and Ardagh (metal). CMAI projects fairly stable resin prices in 2013.

There remain several refinancing candidates across the sector, including debt issues in Appleton, Ball, Berry Plastics, Boise, Inc., Crown, Graphic Packaging, and Longview Fibre.

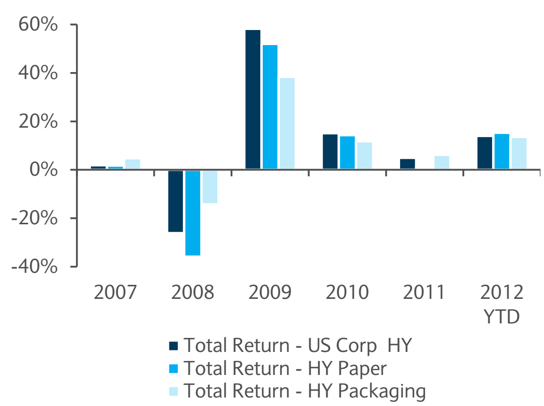
Year-to-date through November 30, the HY paper index has returned 15.3%, while the HY packaging index (with Reynolds comprising 48% of the index) has returned 13.6%, compared with 14.0% for the HY Corporate index.

At a YTW of 6.06% vs.6.45% for the HY Corporate Index, given the low yield and challenging industry fundamentals, we recommend an Underweight for the HY Paper Sector. At a YTW of 5.90% vs. 6.45% for the HY Corporate Index, we recommend a Market Weight for the HY Packaging sector.

Historical OAS



Historical and 2012 YTD (11/30/12) Total Return



Top 10 Constituents of the HY Paper and HY Packaging Indices

Issuer	% of HY Paper Index	Issuer	% of HY Packaging Index
Weyerhaeuser	20%	Reynolds Group	48%
Rock-Tenn	9%	Ball	8%
Sappi	8%	Sealed Air	8%
UPM-Kymmene	7%	Ardagh	8%
Verso Paper	6%	Berry Plastics	6%
Stora Enso	5%	Crown	5%
Cascades	4%	Owens-Illinois	3%
Graphic	4%	BWAY	2%
Boise Inc	4%	Greif	2%
Smurfit Kappa	4%	Silgan	2%
Top 10	**70%**	**Top 10**	**92%**

Source: Barclays Research

US HIGH YIELD RESTAURANTS – UNDERWEIGHT

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Key recommendations

Our Underweight view of the HY restaurant space is based on the favorable same-store sales trends in the QSR sector; modestly positive, yet slowing, same- store sales in casual dining; and reasonable M&A activity at healthy EV multiples. However, we maintain a cautious stance within the restaurant space, reflecting recent signs of same-store sales slowdown in casual dining, likely meaningful protein cost inflation in CY13, and historical vulnerability to a potential pullback in discretionary consumer spending. Furthermore, the YTW of the sector (6.7%) is in line with the overall market (6.7%), and appears unappetizing relative to a potentially choppy industry environment.

Sector outlook

The quick service restaurant segment has enjoyed favorable same-store sales in recent periods, a trend that is likely to continue in CY13, in our view. QSR same-store sales gains are partly driven through a combination of more affordable prices (than casual dining), meaningful improvement in snack, breakfast, and beverage day-parts, and less discounting than in CY10. That said, price discipline needs to improve in order to offset rising protein costs. While competitive intensity can flare up at any time in the QSR sector, we prefer the QSR segment over the casual dining segment going into CY13.

Casual dining sales have recently slowed, and face difficult y/y comparisons in 1Q13, in our view. Casual dining sales remain vulnerable to any discernable pullback in discretionary consumer spending, as well as elevated consumer sensitivity to pricing. Fully leveraged casual dining restaurant chains without solid free cash flow and/or reasonable value menu offerings are particularly vulnerable to a potential weakness in discretionary consumer spending as well as macroeconomic trends.

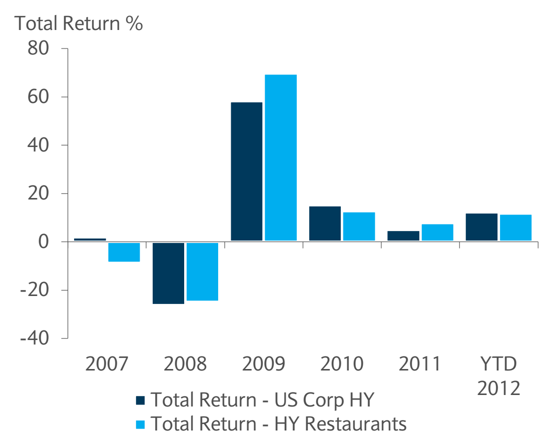
Beef, chicken, and dairy costs are likely to pose meaningful cost headwinds in CY13, and will likely require some degree of pricing. We believe beef and poultry costs could rise in the 5-8% range in CY13. Operators have become accustomed to gradually managing through periods of cost inflation through menu engineering. Furthermore, private equity sponsors have been active in the restaurant space over the past two years, providing reasonable EV support.

Restaurant operators will have to start planning for the onset of higher healthcare benefit costs in 2014, which will likely not be helpful to investor sentiment late in CY13.

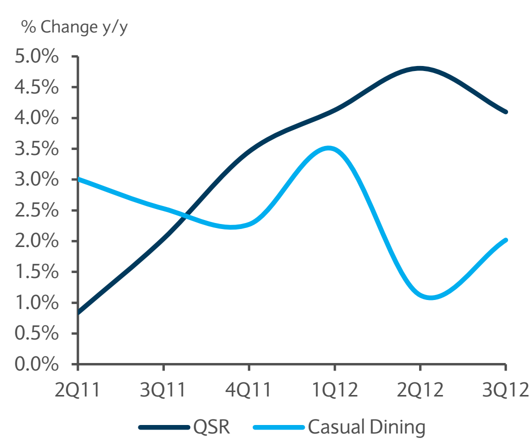
Core holdings in the HY restaurant space remain DINE senior notes (Market Weight) and Burger King senior notes (Market Weight), in our view, given their highly franchised business models, healthy free cash flow profiles and solid EV multiples. We believe that investors (particularly short-duration funds) should consider accumulating DINE and BKC bonds on relative weakness. We prefer the QSR segment over casual dining. Within casual dining segment, we prefer Landry's bonds (Not Rated) over Logan's (Market Weight) and PF Chang's bonds (Not Rated), until there are signs of improved category and company specific sales traction.

Restaurants Index OAS versus HY Index

Restaurant Index total returns versus HY Index



Same-Store Sales Trends



Source: Company documents, Barclays Research

US HIGH YIELD RETAIL – UNDERWEIGHT

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Key recommendations

We continue to have an Underweight rating on the US HY retail sector. We think the combination of lackluster GDP growth, uncertainty about taxes (fiscal cliff), and continued releveraging of the sector will limit performance.

The HY retail benchmark is 10bp behind the HY Index, compared with a three-year wide of 30bp (January 2012) and tight of 100bp (October 2010). The top five components of the HY Retail index, which account for 50% of the index, are Limited (14.5%), Rite Aid (13%), Toys "R" Us (8.8%), J.C. Penney (7%), and Claire's Stores (7%). Within the group, Limited is our only Overweight rated name, and we retain Underweights in JCP and large portions of the CLE, RAD, and TOY capital structures.

Sector outlook

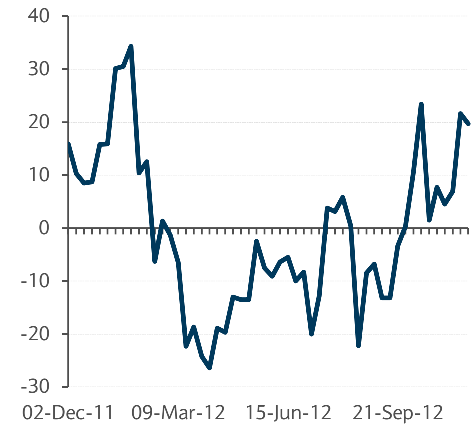
Solid back-to-school sales and a longer-than-typical holiday sales calendar should act as positives in calendar 4Q. However, we remain cautious regarding the effect that fiscal cliff negotiations could have on consumer spending. Overall, we estimate 2012 holiday comps up 2.0-2.5% (versus +4.1% in 2011).

We think event risk remains high in the sector, with SUPERVALU, Best Buy, Staples, Sears, and J.C. Penney all having been subject to press speculation regarding M&A options. In addition, sponsor exits will remain dependent on a healthy equity market (which also requires a fiscal cliff soft landing).

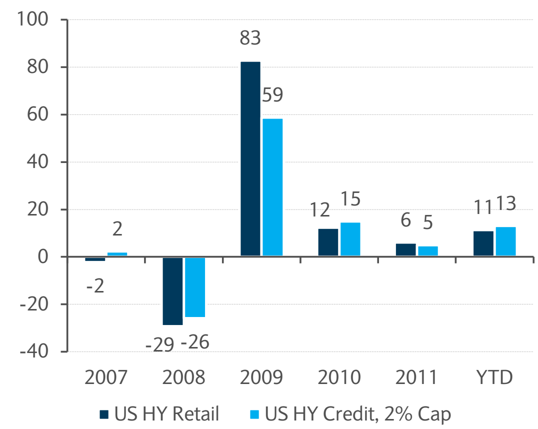
We believe the reliance on mobile phone sales by Best Buy, RadioShack, and to a lesser extent Sears will cause further pressure in 2013 as the carriers move toward subscriber retention from an acquisition model. We also expect continued pressure on traditional grocers from Wal-Mart's pricing investments and neighborhood market build-outs.

We expect continued migration between the "haves" and "have nots" in the sector. In additional to structural considerations, we think an omni-channel retail approach will increasingly become important, and over time, chains with larger footprints may have to shrink store sizes and migrate toward greater online distribution.

US Retail OAS versus US Credit Index



US Retail and HY Credit Index total return



Source: Barclays Research

US HIGH YIELD TECHNOLOGY – MARKET WEIGHT

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Key recommendations

Overweight First Data 8¼% second-lien notes ($99.875, 8.27% YTW) and 8¾% second-lien notes ($101.625, 8.40% YTW). For 2013, we expect a modest EBITDA improvement. Leveraged at a manageable 6.5x, we believe the second-lien notes provide solid yield/return potential with only moderate risk.

Overweight Infor/Lawson 9 3/8% senior notes ($110.25, 7.03% YTW). Notwithstanding top-line constraints from European weakness, currency and soft IT spending, performance should be resilient with high recurring revenues/cash flow. We expect solid execution in FY13 and ~$250mn of free cash flow with longer-term IPO potential.

Sector outlook

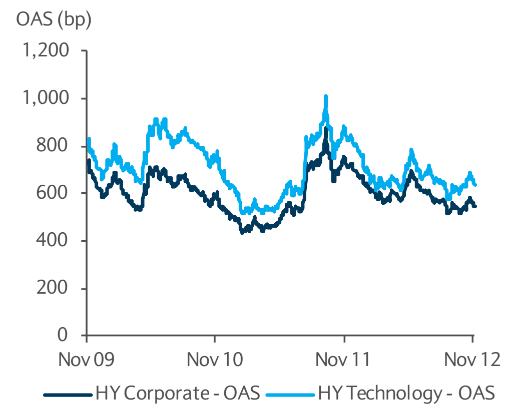
Overall, technology sector industry fundamentals are weak. End demand trends are soft across end markets including technology-specific end markets, as well as broader consumer/industrial/automotive markets. Key end markets including communication/networking and computing (which are particularly difficult with secular shifts to smartphones/tablets) remain difficult. Corporate investment/IT spending trends weakened in mid-late 2012, with spending decisions deferred in the wake of economic (tax and budgetary) uncertainty. The semiconductor sector has also been challenged, with a short-lived upturn in 2Q12 followed by anemic demand/revenue trends into late 2012. On the positive side, the supply chain has been disciplined, avoiding significant inventory building, and further top-line pressure.

In addition to semiconductors, companies exposed to computing (i.e., AMD), enterprise IT spending (i.e., Avaya), and carrier spending (i.e., Alcatel-Lucent), have been hit particularly hard, with company-specific issues exacerbating weak performance trends. The performance of software/services companies with high recurring revenues and greater revenue stability have been resilient with performance trends holding up well. These companies include First Data, GXS, IDC, Iron Mountain, TransUnion, Infor/Lawson, and SunGard.

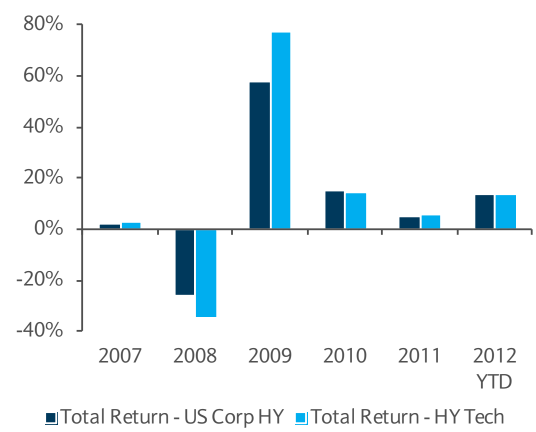
Year-to-date through November 30, 2012, the HY technology index has returned 13.7%, underperforming the HY Corporate Index by ~30bp. However, sector performance has been highly variable with outperformers including First Data and Ceridian and underperformers including Alcatel-Lucent, AMD, and Avaya.

While technology fundamentals are weak entering 2013, the HY Tech Index YTW (7.29%) is 84bp above the HY Corporate Index YTW (6.45%). While we are generally defensive on near-term fundamentals, focused on credits with solid performance, healthy free cash flow, and manageable leverage, we will continue to evaluate credit/performance turnaround stories offering favorable risk/reward.

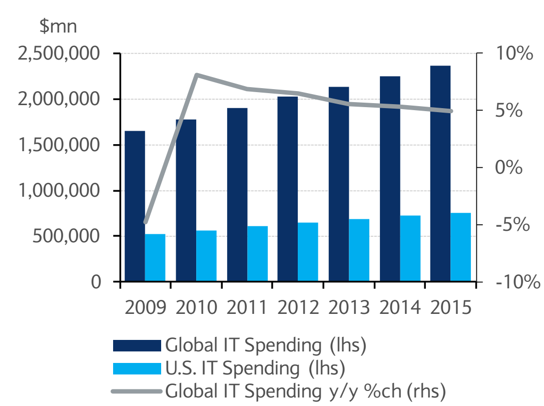
Tech Index OAS versus High Yield Index



Tech Index Total Returns versus High Yield Index



Global IT Spending 2009-2015E



Source: Barclays Research

US HIGH YIELD TELECOM – MARKET WEIGHT

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Key recommendations

We rate the US telecom sector Market Weight. It trades 31bp inside of the High Yield Index, after trading 65bp wide of the index at the start of the year, primarily due to strength in the wireless subsector. Wireless currently trades 20bp inside of the HY Index, versus 135bp wide of the index in January. Wirelines also outperformed the broader market this year, albeit with more moderate tightening (currently 48bp inside the HY Index versus 35bp in January).

Sector outlook

We expect wireless M&A to drive relative performance in 2012, given pending deals announced and a continued trend in wireless consolidation. In 2013, key strategic events include the regulatory review of T-Mobile USA's proposed merger with MetroPCS, Softbank's pending acquisition of a majority stake in Sprint, Clearwire funding, DISH Network's wireless plans, Leap's strategic review, and the PCS H-Block auction. Smaller, tuck-in deals (such as Sprint's acquisition of certain markets from US Cellular) could present further opportunities to strengthen spectrum holdings as well.

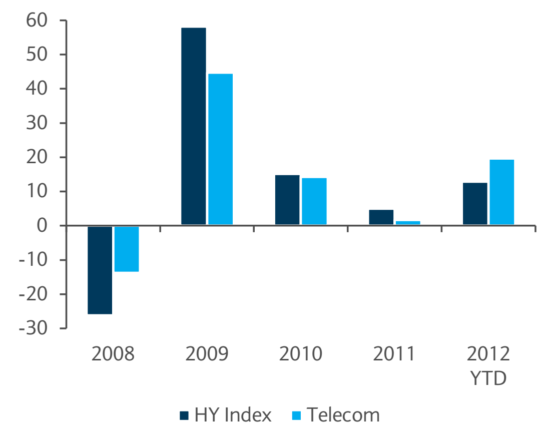
Sprint will remain a key driver for returns in 2013, at 30.4% of the HY Telecom Index. Sprint began the year as 28.6% of the index, and as the top performer within our coverage, drove the sector's outperformance (19.7% total return YTD for the Telecom index) this year. While Sprint continues to face execution risk in Network Vision, the Softbank transaction allows some margin for error and greater financial flexibility. We expect the deal, if approved, to bolster ratings (on review for upgrade/watch positive at Moody's, S&P and Fitch) and drive net leverage substantially lower, depending on potential uses of cash.

Wireless operating trends continue to reflect a more saturated market, as gross additions decline and customer retention is paramount. Central to this issue in 2013 will be the market position of T-Mobile, which is refocused on the US market with its purchase of MetroPCS and planned LTE network investment. We believe that Sprint gross adds have benefitted in recent quarters from exceptionally high churn at T-Mobile (postpaid churn >2%, prepaid churn >6%); improved network experience at T-Mobile could bolster customer retention, limiting potential share gains for Sprint.

We expect operating trends in wireline telecom to be broadly consistent with 2012, including increased pressure on residential DSL net adds from higher-speed cable modem offers. Consumer net losses accelerated this year at Windstream, offset by strength in its Enterprise business. Frontier was able to reduce residential subscriber losses in 2012 off a weak 2011 base, with customers continuing to fall in the high single-digit percentage range.

HY telecom OAS versus High Yield Index

High yield telecom total returns



Sprint 6.9% notes: spread versus HY index (OAS)

Source: Company reports, Barclays Research

European sector outlooks

EUROPEAN HIGH GRADE AUTOS – UNDERWEIGHT

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Key recommendations

We recommend an Underweight position on HG EUR Autos. Volkswagen (UW), Daimler (UW) and BMW (MW) account for 63% of the Autos HG index. Although these issuers are perceived as fundamental safe havens, current valuations are too tight and do not offer sufficient risk premium given the current weak fundamental outlook in Europe and technical risk coming from non-abated primary issuance that affects secondary valuations (bond issuance net of redemption across all currencies of USD19bn at VW YTD, USD12bn at DAI and USD2bn at BMW).

We favour RCI Banque bonds, Valeo '17 and '18, FCE '17 (EUR and GBP). Although we expect Banque PSA to migrate into HY territory by end 2013, we remain Market Weight owing to attractive valuations and large bond redemptions as new bonds will be state guaranteed.

Sector outlook

We expect global demand for passenger vehicles to be up by 2% y/y in 2013 but EU27+EFTA to be down by 3.5% y/y (US +4.6%, Japan -12.1%, Brazil +4%, Russia +4%, India +10% and China +6.8%).

Weak European business confidence is likely to translate into weaker sales of European light commercial vehicles, which we see declining by 5.9% y/y in 2013 (-9.8% in 2012). In addition, it could put some pressure on corporate fleet sales that tend to be significant in Germany (60-70% of premium vehicle sales for BMW, DAI and VW).

We see 2013 global truck sales rising by 3.8% y/y (Europe flat, US + 9.7%, Japan -1.8%, Brazil +14.8%, and China -0.1%).

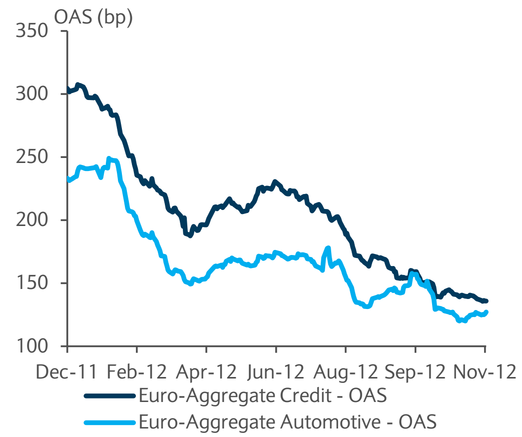
Residual values have been stable in 2012, but could be under rising pressure in 2013 should demand in Germany weaken beyond our baseline scenario (-3.2% y/y). The German Big 3 OEMs have the largest operating lease exposure in Europe.

Free cash flows of HG Autos should remain positive in 2013 though lower y/y due to weaker EBITDA generation, likely negative working capital and still high R&D and capex on the back of tightening CO2 emission rules and expanding capacities in emerging countries.

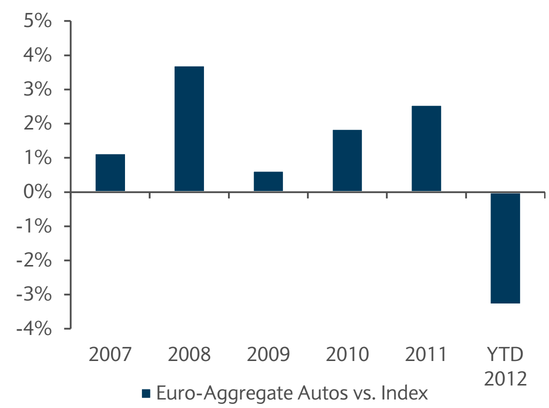
We believe that credit ratings of companies within our HG coverage are likely to stabilise at best in 2012. Banque PSA and FGA Capital are potential candidates for the high yield category. In a bearish scenario (euro area GDP at -2%, car sales down by 8.3% in Europe and down by 4.6% globally), we could see up to a one-notch cut across the HG Autos.

We expect 2013 bond issuance in European HG Autos at USD70-84bn across all currencies (USD103bn YTD 2012) of which EUR24-29bn in euros (EUR31bn YTD 2012).

HG EUR Autos OAS versus HG EUR Credit Index



HG EUR Autos excess returns versus HG EUR Credit Index



Euro area unemployment rate vs. European car registrations

Source: Barclays Research

EUROPEAN HIGH GRADE BANKS – UNDERWEIGHT

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Key recommendations

UK banks. We expect UK banks, such as Royal Bank of Scotland and Lloyds, to continue to demonstrate balance sheet improvements, as capital ratios grow and non-core portfolios decline. Still, we recommend Market Weight positions in RBS and Lloyds because senior spreads have tightened and are now fair value. We still see compelling value in RBS LT2 and Lloyds ECNs.

Swiss banks. We see value in LT2 securities from UBS and Credit Suisse because of the robust capital base being built beneath them, in reaction to super-equivalent capital requirements, and the high probability of the securities being called at the first call date.

German banks. We recommend a Market Weight position in Deutsche Bank in recognition of stable fundamentals and fair valuation. We remain Underweight on Commerzbank given its slow restructuring progress and weakening asset quality.

French banks. We have Market Weight recommendations on BNP, Societe Generale, and Credit Agricole based on lower balance sheet risk, as short-term debt has been reduced, capital ratios have been improved, and peripheral sovereign exposure has been lessened. Valuations constrain our recommendations from being more bullish.

Spanish banks. We expect the restructuring of the Spanish banking system to continue, with the latest developments being a request for €39bn of external aid and the imposition of principal losses on subordinated bondholders. We are Underweight Santander and BBVA.

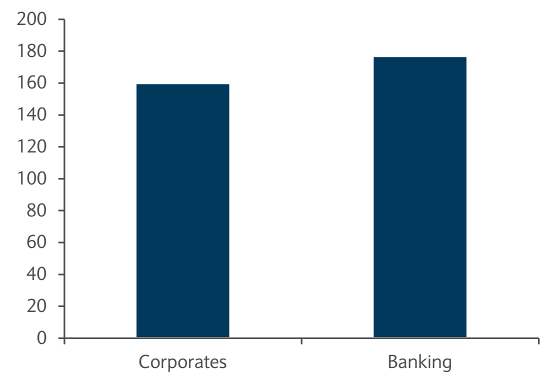
Italian banks. We recognise the capital improvement at Italian banks but remain cautious given continued asset quality deterioration, with stability in bad loan ratios still at least two quarters away. Our recommendations on Intesa Sanpaolo and Unicredit are Underweight.

Sector outlook

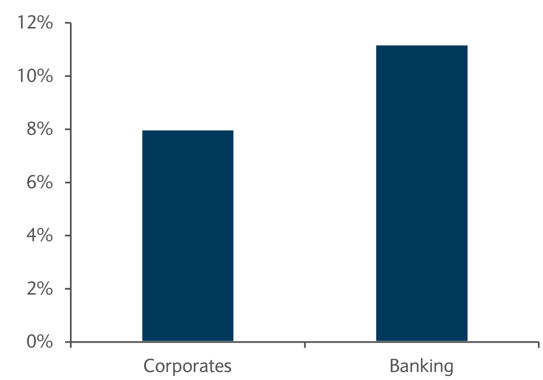
We expect European bank balance sheets to continue to improve. Core Tier 1 ratios have reached a new high at almost 12%, and we expect the multi-year improvement in capital ratios to be sustained in 2013. In addition, we expect banks to continue to hold elevated amounts of cash and central bank-eligible securities, demonstrating a strong liquidity position. The outlook for market-based funding remains challenging, but we expect that to continue to be offset by exceptional support from the ECB. Loan quality is our key balance sheet concern, particularly in Southern Europe where stabilisation remains elusive.

Bondholder protection will continue to erode. In 2013, we expect the bail-in framework to advance, increasing downside risk for unsecured bondholders. In addition, asset encumbrance will continue to grow, furthering the structural subordination of unsecured debt.

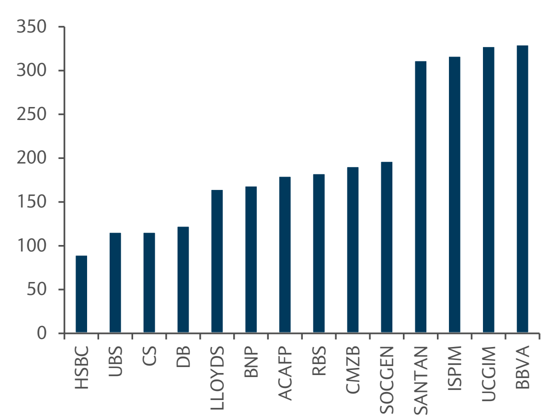
European bank OAS versus Credit Index, bp



European bank excess returns versus Credit Index



European bank 5y CDS, bp



Source: Barclays Research

EUROPEAN HIGH GRADE BASIC MATERIALS – UNDERWEIGHT*

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Key recommendations

***Market Weight Metals & Mining; Underweight Chemicals**. We have supported a cautious approach towards steel, and accordingly view Metals & Mining as better positioned to outperform, following the exit of ArcelorMittal from the HG indices in November. Our Underweight on Chemicals reflects expensive valuations and M&A risk.

We support an Underweight on MTNA, given near-term ratings risk.

- **Preference for short end**, such as the $'15s, given our assumption that management will act to bolster liquidity in early 2013.
- **Preference for $'39s vs. hybrid**: Similar yield, which does not reflect the seniority of the $'39s.

Buy CLNVX €'17s (OW) and basis package: With ratings under pressure, an S&P downgrade would see the coupon step up, which should more than compensate for spread widening. We view Clariant as migrating to a stronger business profile with ratings upside, over the longer term.

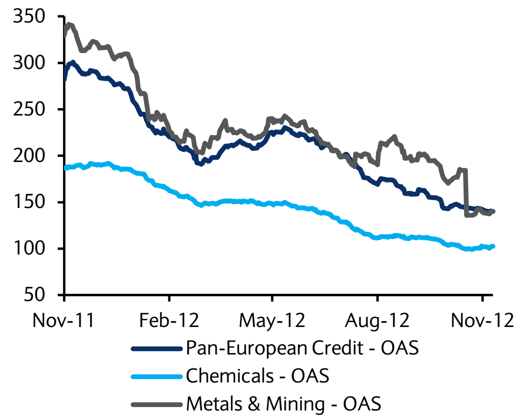
Buy AKZANA (UW) CDS: Based on its exposure to cyclical markets, ratings risk and the poor quality of cash flow.

Sector outlook

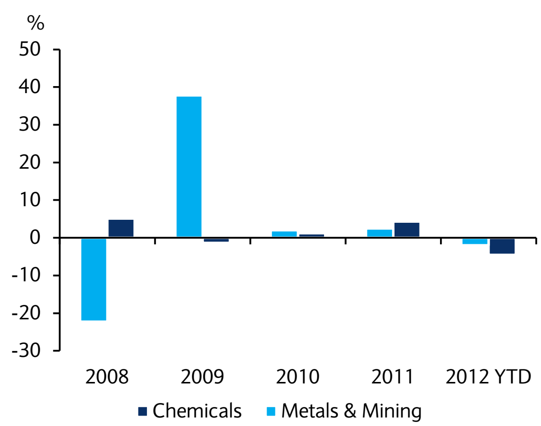
Steel sector fundamentals to remain challenging: We expect a further decline in demand in Europe. While Chinese demand is expected to improve, we do not anticipate a sizeable ramp up in stimulus measures. Resolution of the 'fiscal cliff' could serve as a positive support for the US steel and broader metals & mining sector. Assuming Chinese steel demand firms up, then iron ore pricing should be supported at current levels. The WSA forecasts a 3.2% rise in global apparent steel use in 2013, but we see downside risks to the EU27 (+2.4%) and South America (+ 6.3%) forecasts in particular. We expect the sector's focus to remain on disposals, cash flow and liquidity, but expect ArcelorMittal's ratings to fall further in the absence of a material operating recovery and large disposals in H1 13.

Chemicals: Following a lacklustre demand backdrop in 2012, weighed down by a contraction in Europe and challenging comps, we see scope for a modest level of volume growth in 2013, driven by emerging markets and the US. We see input cost inflation as remaining relatively modest, albeit overall profitability may be vulnerable to management's pursuit of market share in key emerging markets. We highlight that the sector has substantial exposure to the construction and auto sectors, both of which are expected to remain under significant pressure in Europe. Given an assumption of a relatively benign industry backdrop, we see scope for M&A activity to accelerate and would be particularly cautious towards names such as Bayer, BASF and Syngenta. We see scope for negative ratings actions on Akzo Nobel and Clariant in H1 13.

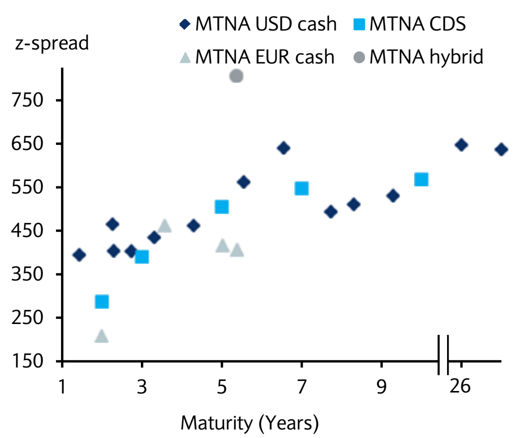
Metals & Mining and Chemicals versus EUR Credit Index



Excess returns performance versus the EUR Credit Index



MTNA cash & CDS scatter



Source: Barclays Research

EUROPEAN HIGH GRADE CONSUMER PRODUCTS – UNDERWEIGHT

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Key recommendations

Pernod (OW) is our top pick in the beverage space. We expect Pernod to continue outperforming its peers in organic sales and profit growth, supported by its high exposure to EM and the fast-growing brown spirits category. We think its strong deleveraging momentum (4.4x in FY11 to 3.8x at FY12) and cash flow generation is set to continue and note the company has ruled out substantial M&A in the near term.

Preference for BAT (OW) over IMT (MW) in tobacco. We see greater room for margin expansion at BAT vs. IMT and prefer the former's more diversified and EM-skewed geographical profile, which makes it more resilient vs. Plain Packaging roll-outs relative to IMT. We think BAT USD cash looks particularly cheap across the consumer space and recommend switching out of DGELN $'17s or '22s into BATSLN $'17s or 22s.

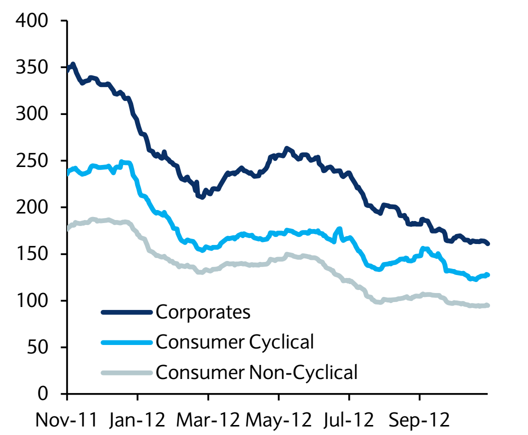
Sector outlook

M&A continues to be active in the beverage sector. Consolidation of the more fragmented spirits industry looks set to continue as companies, such as Diageo, look to fill portfolio gaps and build route-to-market in high-growth countries (however, Pernod has ruled out substantial acquisitions). The more consolidated brewing industry has also seen a step-up in competition for assets, particularly as emerging market brewing assets become scarcer, as seen in the record high multiples being paid in recent deals (HEIANA for APB at c.20x trailing EV/EBITDA).

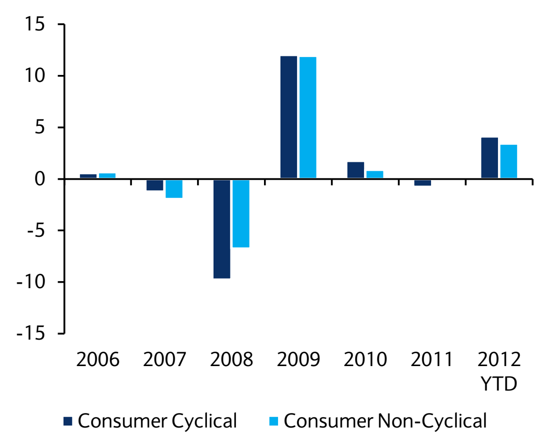
Regulatory risks ongoing. An increase in excise taxes and regulatory restrictions on alcohol and tobacco products continues to be a key theme in certain markets. While these risks are mitigated to some degree by the strong geographical diversification of most large consumer product companies, certain companies with more concentrated exposures remain more vulnerable. For example, Carlsberg's key Russian market (c.41% of EBIT at Q3 12 LTM), recently underwent a marketing and kiosk sale ban and a potential PET ban remains a possibility. Imperial Tobacco, similarly, faces a regulatory overhang in its important UK market (c.20% of adj. op. profits), which could potentially implement Plain Packaging legislation.

Strong brands and innovation to support sales growth. While the demand environment remains sluggish, particularly in developed markets, strong brands, premium products and innovation should support positive price/mix amidst weakening volumes.

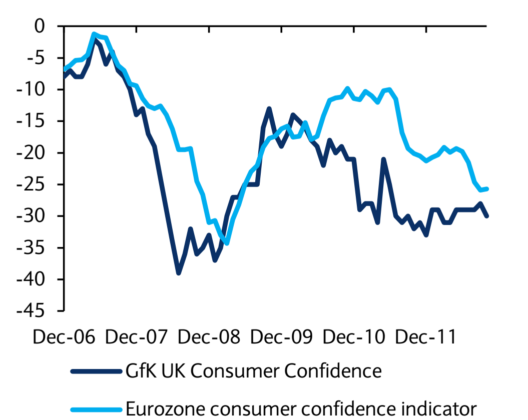
Consumer OAS versus Corporate index (bp)



Excess returns performance versus index (%)



Consumer confidence indexes



Source: GfK, Eurostat, Barclays Research

EUROPEAN HIGH GRADE GENERAL INDUSTRIALS – UNDERWEIGHT*

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Key recommendations

***Reflects our Underweight ratings on Building Materials, Aerospace & Defence and Diversified Manufacturing.** We highlight that the recommendation for Aerospace & Defence is driven by Finmeccanica (c.52% of the index).

Switch out of LGFP (UW) into HEIGR (OW): We prefer the latter's more defensive geographical exposure and view it as better positioned to regain IG ratings over the medium to longer term, at this juncture.

Preference for CRHID (OW) over SGOFP (UW): Reflects CRH's higher exposure to US construction and the passage of a supportive Federal highway bill. We remain cautious of St Gobain's high exposure to Europe, with ratings vulnerable to a downgrade to Baa3/BBB- in H1 13.

FNCIM (UW): Reduce exposure given near-term ratings risk. Preference for $ bonds, given their structural seniority in relation to DRS assets.

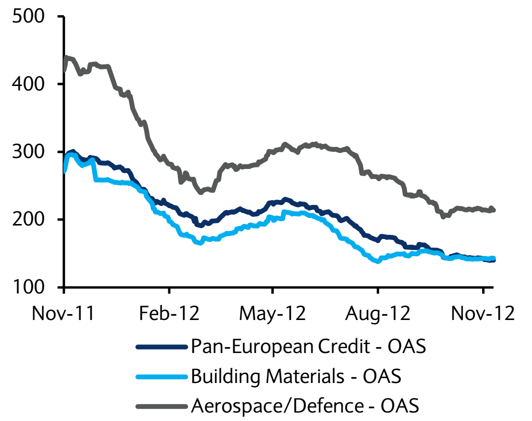
Sector outlook

Building Materials outlook mixed: We expect a low to mid single-digit rise in volumes and a mid to high single-digit rise in EBITDA for our coverage names. This assumes a small volume decline in Europe offset by growth in emerging markets and the US, as well as cost savings. Further declines in European infrastructure spending remain a key risk, while margins could be vulnerable to energy cost inflation and new supply in key emerging markets, depending on the strength of demand. We view Italcementi, Saint Gobain and Lafarge ratings as vulnerable in the near term, in the absence of a material improvement in credit metrics.

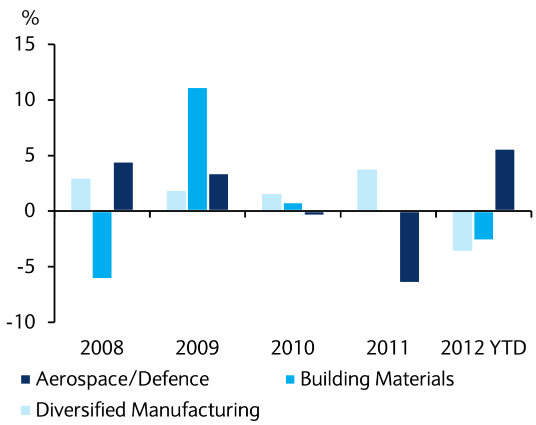
Defence outlook uncertain: A key risk to industry prospects remains the US budget. Following the re-election of President Obama, we assume a mid single-digit cut in the baseline budget, but that a materially more painful permanent implementation of sequestration will be avoided. Meanwhile, an escalation in the sovereign debt crisis could lead to further austerity-driven cuts in European budgets. While diversification strategies into new defence markets and civil segments continue to be pursued, we also see scope for major alliances to be considered, with BAE a likely key market focus following its aborted merger with EADS.

Capital goods still reliant on emerging markets: A focus on high-growth markets and a weak euro has supported a solid order flow, helping to offset weakness in Europe. However, we continue to see longer-term risks to infrastructure/transport spending in Europe and to pricing and cash flow, given increasing competition in emerging markets. We see scope for rising M&A, given generally solid balance sheets, with the likes of Siemens, ABB and Schneider best positioned. Of our coverage names, we view ThyssenKrupp and Alstom as most vulnerable to downside ratings risk in 2013.

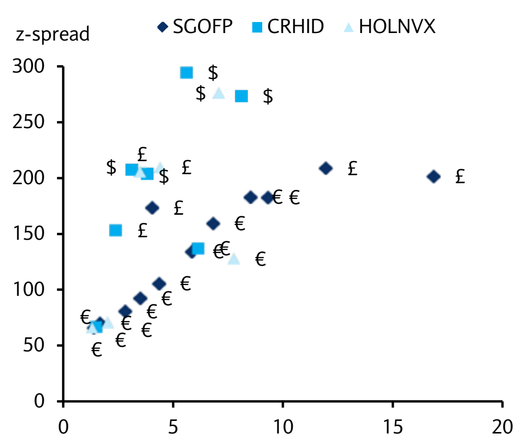
Building Materials and Aerospace/Defence versus EUR Credit Index



Excess returns performance versus the EUR Credit Index



SGOFP, CRHID & HOLNVX cross currency scatter



Source: Barclays Research

EUROPEAN HIGH GRADE INSURANCE – OVERWEIGHT

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Key recommendations

We recommend Overweight positions in Allianz and Zurich. These large composite insurers offer earnings diversity, manageable leverage, strong debt service coverage, and attractive valuation. We specifically recommend Allianz 5.75s of 2041 and Zurich 7.5% of 2039.

Prefer AXA to Aviva and Generali. Among the insurers we cover, AXA, Aviva, and Generali have the highest spreads, making them potential candidates for outperformance in 2013. We prefer AXA (Overweight), because of the company's diversity, resilient life returns, and attractive valuation. We recommend a Market Weight position in Generali, largely due to peripheral sovereign exposure, and in Aviva, as the company progresses through its strategic repositioning.

We recommend Overweight positions in Reinsurers. Swiss Re, Hannover Re, and Munich Re are among the strongest credits in the sector, in our view, given low leverage, minimal peripheral sovereign exposure, and sound catastrophe risk management. We recommend buying Tier 1 from these issuers, including Swiss Re £6.3024% perpetuals and Hannover Re 5% perpetuals.

Stay Market Weight life insurers. We recommend Market Weight positions in Prudential Plc, Aegon, Legal & General, and Old Mutual as low interest rates constrain growth and profitability.

Sector outlook

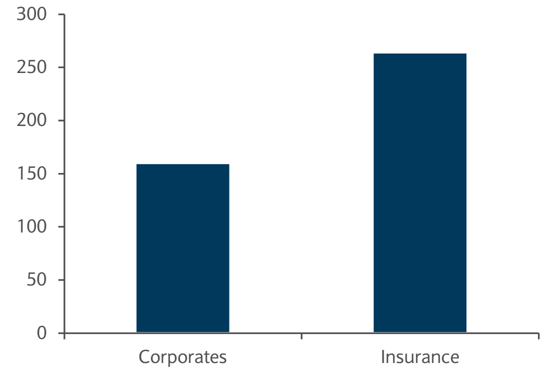
Refinancing risk is limited. We view stability of funding to be a differentiating factor for insurers compared with other financial institutions. With 75% of the unsecured debt of the insurers we cover having more than five years remaining until maturity, the sector faces limited refinancing risk.

Debt burdens are modest. We expect the average financial leverage of the insurers we cover to fall modestly in 2013, from 27% to 25%. This manageable debt burden will result in EBIT coverage ratios of greater than 8x, on average, by our calculations. Insurers that we believe will continue to report particularly low leverage include Old Mutual, Munich Re, and Hannover Re.

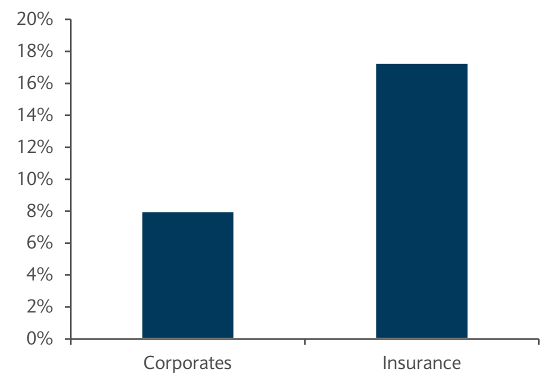
Catastrophe risk is manageable. 2012 was a benign year for catastrophe claims for European insurers, following exceptional large losses in 2011. With the outlook for catastrophes in 2013 obviously uncertain, we take comfort in the demonstrated resiliency of the industry to this risk.

Lower for longer is a challenge. We expect interest rates to remain low in 2013, which will continue to pressure insurance growth and profitability, principally in the life insurance segment.

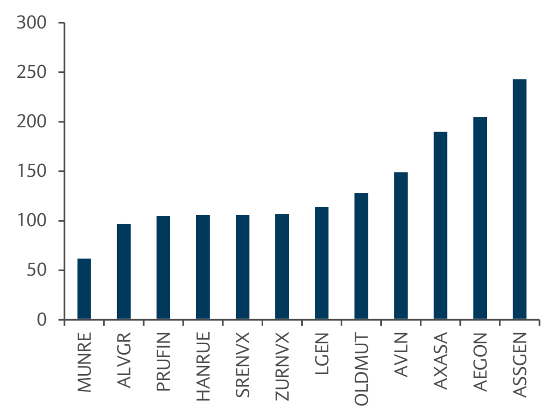
European insurance OAS versus Credit Index, bp



European insurance excess returns versus Credit Index, 2012 YTD



European insurance 5y CDS, bp



Source: Barclays Research

EUROPEAN HIGH GRADE MEDIA – MARKET WEIGHT

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Key recommendations

Our preferred names are ITV (OW) and UBM (OW): ITV continues to successfully execute its strategy, has a net cash position and improved its balance of non-advertising/international revenue streams via its production business. ITV's ratings are on a positive outlook, but we highlight investors should be aware of a possible step down in the £'17s if HG ratings are granted. UBM continues to deliver solid results, reduce leverage and refocus its business on higher-margin/growth areas.

Our least preferred name is Wolters Kluwer (UW). Wolters Kluwer continues to operate with relatively high levels of leverage for its BBB+ rating (2.8x) and growth remains muted. Management expects Europe to remain difficult in 2013, which could leave it vulnerable to weakening or encourage M&A in faster-growth targets.

Sector outlook

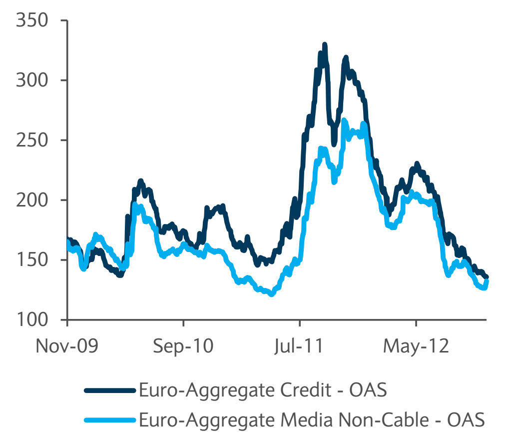
Cyclicality is a concern for investors given continued macroeconomic uncertainty and the exposure of the sector to advertising trends. However, in general, we believe that the sector is better positioned than in 2009 following a period of balance sheet strengthening.

For more cyclically exposed sub-sectors such as the advertising agencies (WPP (MW) and Publicis (UW)), signs of weakness in advertising had begun to feed through in Q3 and downwards guidance was a feature. Along with a lack of quadrennial events in 2013, we believe continued macroeconomic weakness could increase investor caution although geographical diversification and active portfolio management does provide some protection. With visibility on advertising relatively low, subscription/contract-based businesses such as fixed satellite operator SES (MW) could become more attractive if volatility elsewhere increases. For the professional publishers (Pearson (UW), Reed Elsevier (UW) and Wolters Kluwer), which also benefit from better visibility, exposure to corporate and public sector spending is a feature and we highlight that a sustained economic slowdown could see pressure growing at these traditionally late cyclical sectors.

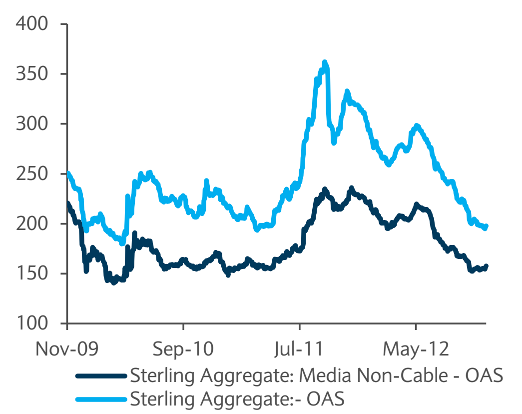
We highlight that with strengthened balance sheets comes increased M&A risk, although we generally expect bolt-on M&A given strategies from a number of issuers to expand footprints in emerging or better growth markets (such as digital).

In terms of relative value, the Media sector has remained in relatively good health and the index trades at 132bp (157bp in GBP). Given low operational visibility in more cyclical segments, and likely caution if macroeconomic weakness persists, we do not think spreads at these levels will outperform the European credit index at 135bp (197bp in GBP).

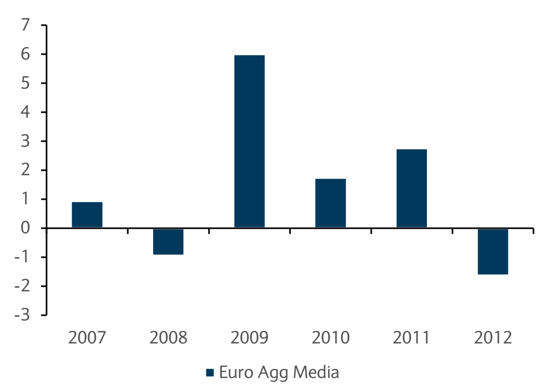
Euro Media OAS vs Index



GBP Media OAS vs Index



Euro Media excess returns performance to index



Source: Barclays Research

EUROPEAN HIGH GRADE OIL & GAS – UNDERWEIGHT

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Key recommendations

We expect sound sector fundamentals to persist into 2013, with a sustained high oil price and asset disposals supporting leverage. However, while fundamentals are generally sound, core spreads offer limited upside versus the indices and sovereign-linked names could produce meaningful volatility.

Overweight BP. At current levels, we would expect BP cash and CDS to compress versus its 'AA' peers, with spreads likely performing post a final Macondo settlement/upgrade of BP's credit rating.

Underweight Repsol. Current valuations remain tight versus the last six months. Execution risk around the LNG disposal and Spain-related pressures are our key concerns. 5y CDS remains vulnerable on the back of Crossover Index arbitrage.

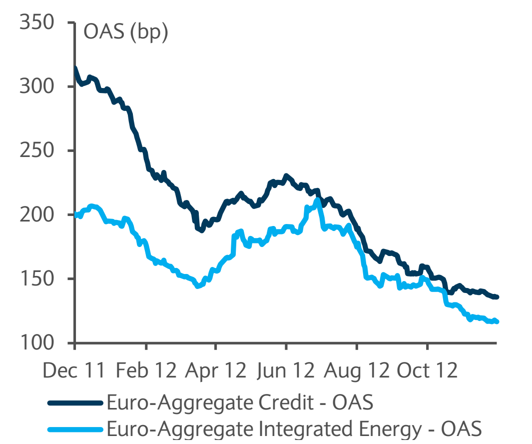
Sector outlook

Disposals will likely improve balance sheet metrics. Total, Statoil, Shell and OMV already have low 9M 12 leverage for their current ratings, supported by the high oil price. We expect disposals to boost metrics for those names more weakly placed (BP; TNK BP in H1 13), ENI (Snam by end-H1 13, and potentially Galp in 2013), BG Group (capital release programme increased to USD7.6bn by end-2013) and Repsol (LNG Assets; possible announcement before end-2012). Moreover, most names continue to have active portfolio rationalisation programmes and will likely continue to re-deploy proceeds upstream.

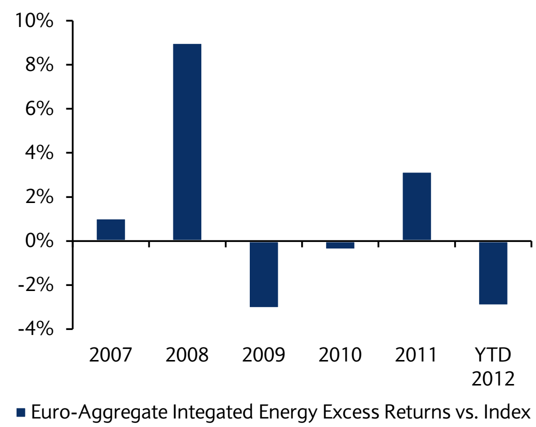
Production growth likely to be challenged in 2013, but higher oil price to support E&P earnings. BG Group, BP and OMV have already guided for production stability in 2013, with Statoil expecting lower production owing to disposals. E&P earnings are likely to benefit from a higher average Brent oil price in 2013 (Barclays forecast: $125/bbl vs. $113/bbl in 2012). Geopolitical risks (eg, an Iran nuclear standoff), in addition to limited spare capacity in the oil market, means more potential upside than downside risk to the oil price vs. 2012. Issuers such as Shell, with exposure to weaker regional oil pricing (WTI), will not, in our view, see the full benefit of higher headline Brent prices.

Downstream operations in 2013 vulnerable to rising oil price; LNG fundamentals robust. While for BP, Total and Shell, downstream performance helped to beat consensus in Q3, the expected increase in oil price should impair refining conditions and profitability. Efficiency drives in downstream and exits from unprofitable refineries are likely to continue. Opportunities to redirect LNG supplies to Asia from North America will remain in 2013, given depressed North American natural gas prices and higher EM Asia growth (Barclays forecast: +6.5% in 2013 vs. +6.1% in 2012).

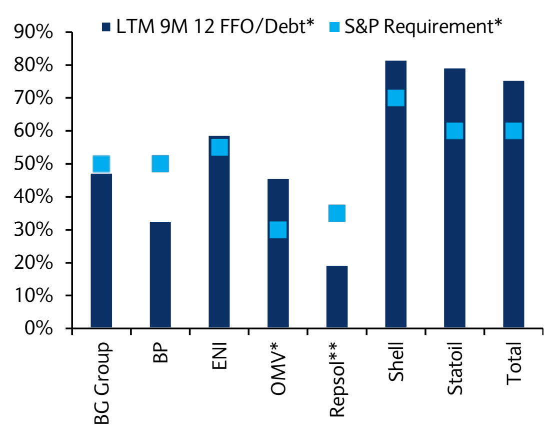
EUR Integrated Energy OAS versus EUR Credit Index



EUR Integrated Energy excess returns versus EUR Credit Index



Leverage LTM 9M 12 vs. requirements



Note:*RCF/Debt for OMV (Moody's), **Repsol ex. YPF & Gas Nat
Source: S&P, Moody's, Barclays Research

EUROPEAN HIGH GRADE RETAIL – UNDERWEIGHT

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Key recommendations

Underweight Metro. Metro remains one of the most exposed names in our coverage to the deteriorating macroeconomic conditions in Europe given its significant reliance on the region (95.4% of sales) and exposure to peripheral countries (c.12% of sales). We continue to see execution risk in Metro's key segments, as its cash and carry and consumer electronics businesses continue to experience margin pressure. € cash still looks tight as it trades with positive basis (c.100bp) - more than double the average of other European retailers.

Switch out of Carrefour into Casino in cash and CDS. Carrefour's recent asset disposals have weakened its geographical profile, putting more emphasis on its underperforming French business. We continue to favour Casino given its better FCF generation, lower reliance on the declining hypermarket format and greater exposure to high-growth international markets, such as LatAm and Asia.

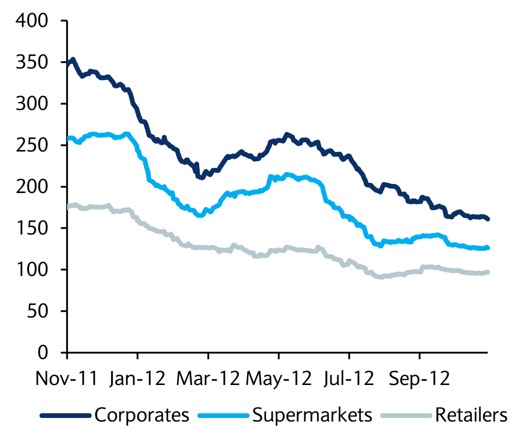
Sector outlook

European backdrop continues to deteriorate. Metro's recent profit warning on 5 Oct signalled that the pace of deterioration in Europe has accelerated. European retailers, in 2013, will likely continue to be weighed down by weak consumer spending, high unemployment levels and austerity programmes, with non-food retail sales particularly vulnerable. We remain particularly cautious on names with material exposure to peripheral European countries (namely Carrefour and Metro, which generate c.17% and c.12% of sales from peripheral countries respectively) given the especially sharp deterioration of trends in the region.

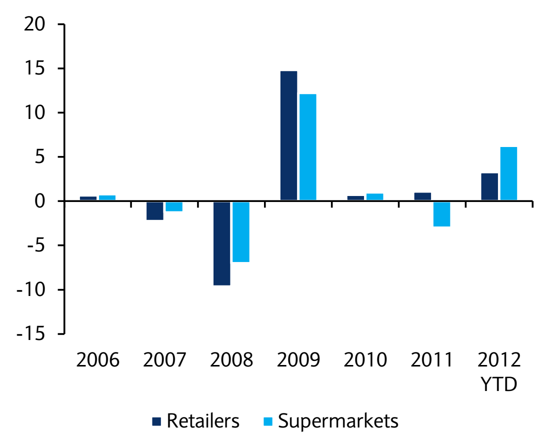
Asset disposals likely to continue. Difficult trading conditions and the depletion of cost-cutting programmes have put pressure on European retailers to find alternative ways to defend their credit profiles. We expect a number of asset disposals to materialise in 2013, specifically as more troubled retailers, such as Metro and Carrefour seek to dispose of non-core assets to shore up their balance sheets. Elsewhere in the sector, we expect Casino to continue its disciplined approach to asset disposal/capital raising targets and would expect a monetisation of Ahold's 60% stake of ICA.

UK retail. Although we expect UK retail to outperform EUR retail on better consumer spending and easier comparables, we see limited scope for spread upside given shareholder return policies. We remain cautious on Next on the back of weak Q3 trends (Retail stores underperforming and Online growth slowing) and expect Sainsbury to remain vulnerable to further potential LBO speculation, which first arose in unconfirmed press reports, (dealReporter, *Financial Times*, 7 September).

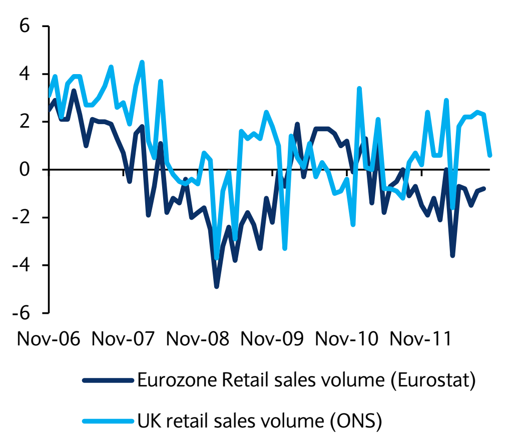
Retail OAS vs. the HG Corporate Index (bp)



Excess returns performance versus the Index (%)



Retail sales, % y/y change



Source: ONS, Eurostat, Barclays Research

EUROPEAN HIGH GRADE TELECOMS – MARKET WEIGHT

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Key recommendations

Within the Telecoms sector, our preferred names are TeliaSonera (OW) and Telecom Italia (OW): Telia has not been immune to operational pressure but low peripheral exposure and geographic diversification has limited spread volatility. We expect a focus on deleveraging to continue, aided by partial divestments/disposals (Megafon, KCell, Yoigo) and a defined cost-cutting plan. Telecom Italia's spreads continue to have a significant peripheral premium, and domestic operations remain pressured, but management continues to reduce debt/leverage, showing strong strategy execution.

We believe underperformance will come from BT Group (UW) and KPN (UW). BT has been offsetting revenue weakness with cost control, but limited geographic diversification and exposure to corporate/government spending via Global Services are not reflected in relatively tight spreads. KPN's operations are pressured, net leverage has been diverging from management's targets and with an upcoming spectrum auction/potential for a new market entrant, we believe KPN will underperform.

Sector outlook

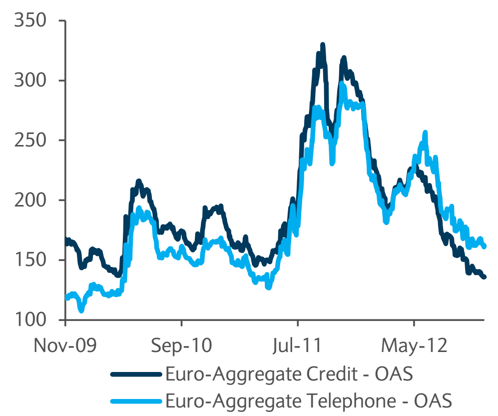
The uncertain macroeconomic outlook has increased spread volatility for issuers exposed to the peripheral markets. Evidence of operational pressure is becoming more widespread but while the telecom sector faces challenges, we believe it is fundamentally resilient, with management teams increasingly focused on balance sheet/bondholder protection, evidenced by dividend cuts from a number of issuers.

However, some operators are choosing to invest defensively in networks and commercial costs to attract/retain customers. We view such strategies as sensible, but visibility over the beneficial result is limited and has a near-term cash impact.

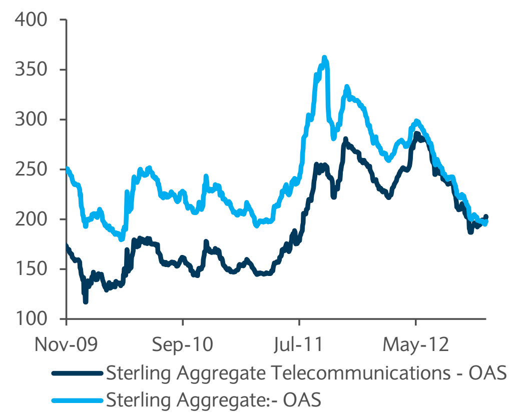
M&A has been largely focused on the divestment of assets by weaker operators to improve leverage and liquidity. We expect this trend to continue but note that buyers could increasingly be more difficult to come by, constrained by regulation or resources. In the event that macroeconomic weakness persists, investors will closely follow the degree to which operators are exhausting their cash-generative levers.

The HG telecoms sector trades at 162bp (202bp in GBP), against the credit index at 135bp (197bp in GBP). A fundamentally resilient model is balanced by the sector's sovereign exposure and continued competitive/regulatory pressure, driving our Market Weight recommendation.

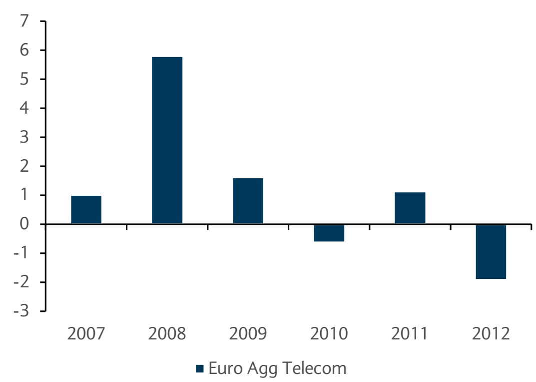
Euro Telecom OAS versus Index



Sterling Telecom OAS versus Index



Euro-Telecom excess returns – Performance to Index.



Source: Barclays Research

EUROPEAN HIGH GRADE UTILITIES – MARKET WEIGHT

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Key recommendations

We recommend a Market Weight position on European Utilities. In our view, challenging conditions for thermal generators from weak power demand, low margins and load factors are pressuring business risk profiles. This is before taking into account the 2013 carbon allowance auctioning, and the ongoing pressures renewables expansion is placing on the traditional merit order and peak prices. While financial risks are supported by strong liquidity, de-leveraging remains difficult and we see more potential for core names to fall into the 'BBB' range. Away from sovereign risk, regulated utilities should benefit from stable credit profiles, although a number of adverse changes in the UK could be meaningful. Overlaying the above with sovereign risk, we see potential for further HY names, particularly in Spain. While we note that the sector trades cheap to the European credit index, further sovereign downgrades in peripheral Europe could be a material source of underperformance.

Our top picks include EDF-controlled Edison (OW), which we expect to be upgraded to HG by Fitch and S&P. We are cautious on Spain and thus continue to have a negative view on Spanish utilities as the risk of cuts to sub-IG remains significant and likely not priced in.

Sector outlook

Business risks rising. We believe ongoing pressures on generation and supply activities, combined with limited profitability in mid-stream activities, notwithstanding any benefits from contract renegotiations, are continuing to erode profitability. In addition regulatory changes are pressuring network utilities' financial and business risk profiles.

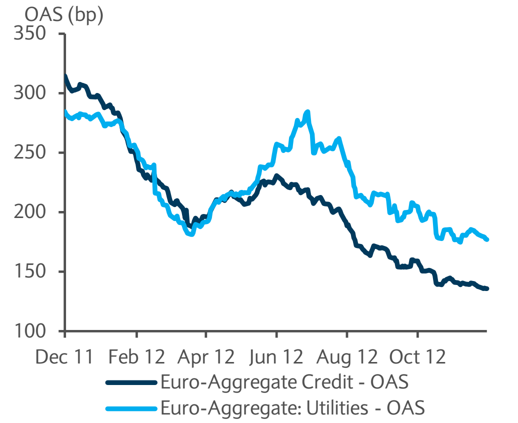
Leverage reduction challenging on earnings momentum alone. For the majority of the sector leverage is either stabilising or deteriorating. With earnings pressures for integrateds continuing, self-help measures will likely be required to reduce debt. Therefore, owing to more challenging business conditions, we see ongoing downside rating risks.

Liquidity remains solid but issuance likely to remain high. In our view, a distinguished sector feature is the strength of liquidity. We have limited liquidity concerns into 2013 and expect c.EUR40bn of issuance.

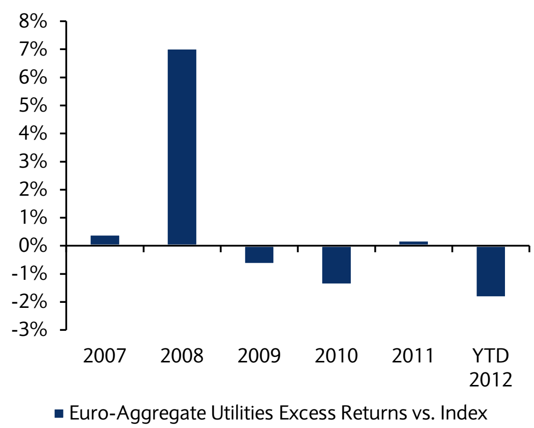
Core remains tight and not overly attractive. For names in the core space, we expect spreads to be tight for fundamental risk (ie, of further cuts into the 'BBB' range).

Peripheral utilities will remain a key spread driver. Accounting for 45% of the European Utilities Index, the performance of peripheral utilities will be a key spread driver. We see ongoing downside risk related to poor macroeconomic conditions and fiscal or regulatory measures. Further, substantial downside risk may emerge on sovereign-related rating cuts.

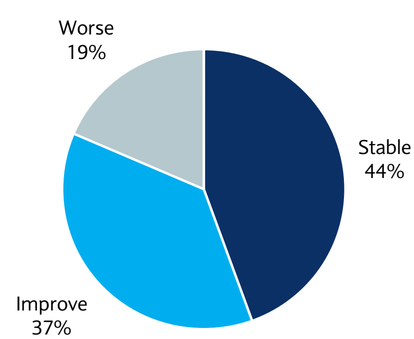
EUR Utilities OAS vs EUR Credit Index



EUR Utilities Excess Returns vs EUR Credit Index



FY13 leverage expectations



Note: The percentage of names in European Utilities we expect to see improved/stable/worsened leverage in FY 13 vs FY 12.
Source: Barclays Research

EUROPEAN HIGH YIELD/CROSSOVER AIRLINES – UNDERWEIGHT

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Key recommendations

We recommend an Underweight position on European Airlines due to expensive valuations versus the Pan-European HY Credit Index (although we note that Air France is not in the Airlines Index as it does not hold a credit rating) given expectations of rising and volatile fuel prices and a weak macroeconomic outlook.

We have a Market Weight rating on British Airways GBP 8.75% '16 (6.1% yield). We view BA's credit rating outlook as solid for a BB like issuer.

We have an Underweight rating on Air France '14 and '16 bonds due to expensive valuations. We regard the issuer as being in line with a mid-to-high single B rated company, with bond yields of c.2.5% and c.4.9%, respectively, which are expensive versus peers.

We have an Underweight on Lufthansa '14s and '16s given expensive bond valuations (yields of 1.7% and 2.3%) despite being in the Barclays HY Index. We recommend buying protection in 5y CDS given current tight valuations and a lack of upside given volatile fuel prices.

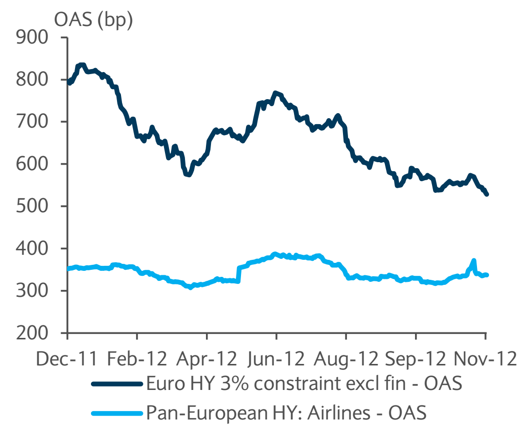
Sector outlook

We expect high fuel prices to be a source of downside risk, despite hedging. Earnings are vulnerable to a higher average Brent oil price in 2013 (Barclays forecast: \$125/bbl vs \$113/bbl in 2012) as the fuel bill accounts for c.30% of operational costs. Geopolitical risks (eg, an Iran nuclear standoff), in addition to limited spare capacity in the oil market, mean more potential upside risk than downside to the oil price vs 2012. Nevertheless, we note that Air France and IAG expect a fuel bill in 2013 that is unchanged versus 2012.

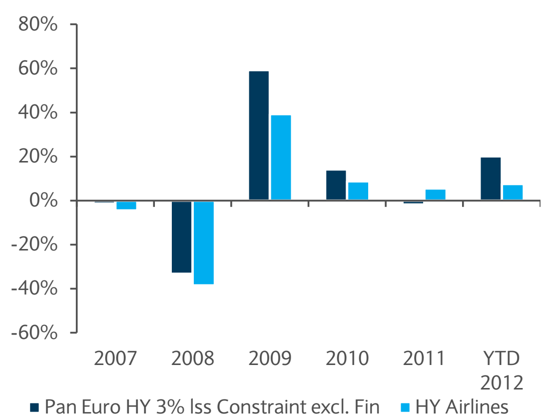
Soft macroeconomic conditions make top-line growth challenging. So far, the resilience of revenues to the continued downward trend in European economic growth has been positive. Nevertheless, we note that a combination of weakening business confidence, a continued deterioration in seat mix and stalling global trade will maintain pressure on earnings. IATA expects the 2013 EBIT margin for European airlines at 0.5% (-0.1% in 2012).

Restructuring to reduce costs designed to support earnings through 2015. IAG has the most challenging restructuring at Iberia (cash burn of EUR1.7mn per day in Q3 12). BA is involved in the restructuring of BMI, which made its first positive contribution to the group in September. Air France will see EUR280mn in cost savings in H2 12 to help achieve guidance of a better H2 12 than H2 11. Lufthansa's SCORE programme has yet to make a visible mark on earnings; its EUR280mn in contributions from SCORE restructuring has been more than offset by fuel, fees and personnel costs.

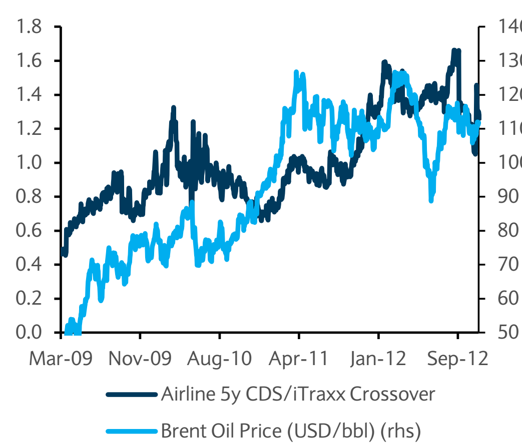
European Airline OAS versus the PE HY 3% excl Financials Index



Total return versus the PE HY 3% excl Financials Index



European Airline CDS performance vs oil price



Source: Barclays Research

EUROPEAN HIGH YIELD AUTOS – UNDERWEIGHT

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Key recommendations

We recommend an Underweight position on HY EUR Autos due to weak fundamental outlooks at companies with a large contribution to the index such as Peugeot, Fiat and to a lesser extent Faurecia, while valuations in the more solid HY Autos companies tend to trade tight versus other cyclical sectors.

We favour bonds of JLR, FIIM and Continental, and Fiat's bonds issued before January 2011 as they benefit from the guarantee of FIIM. We hold a Market Weight stance on Banque PSA and FGA Capital; we believe these could migrate into HY territory in 2013, while valuations already trade at fair level versus high BB Autos. We remain Underweight Peugeot, Renault, Faurecia, and Fiat's bonds issued after January 2011.

Sector outlook

We expect global demand for passenger vehicles to be up 2% y/y in 2013 but EU27+EFTA to be down 3.5% y/y (US +4.6%, Japan -12.1%, Brazil +4%, Russia +4%, India +10% and China +6.8%). Sales in France and Italy, where Peugeot, Renault and Fiat are most exposed, are expected to decline by 6.2% y/y and 3.2% y/y, respectively.

We expect European vehicle production to decline by 11% y/y in Q1 13 and to be down 3% in Q2 12 (down 5.8% in FY 13), which should affect Faurecia and to a lesser extent Continental, Schaeffler and GKN. Global production is expected to be down 5% y/y in Q1 13 and up 0.2% for the full-year 2013.

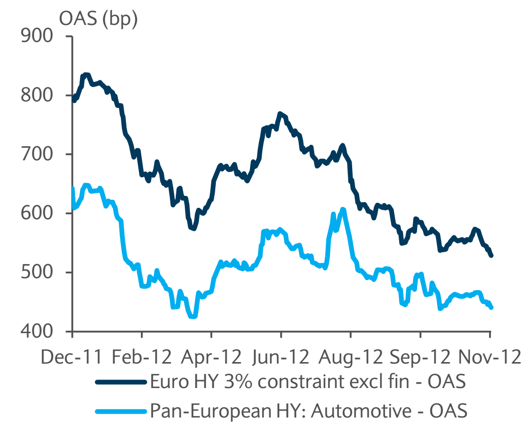
Net pricing continues to affect European operating margins on the back of rising consumer incentives and significant overcapacity (c.25%), which we do not expect to reduce before 2014.

Free cash flows to remain negative in 2013 at Peugeot, Faurecia and Fiat excluding Chrysler. Meanwhile, other HY European Autos are likely to see a significant decline in FCF due to weaker EBITDA generation, likely negative working capital and still high R&D and capex as well as cash restructuring charges.

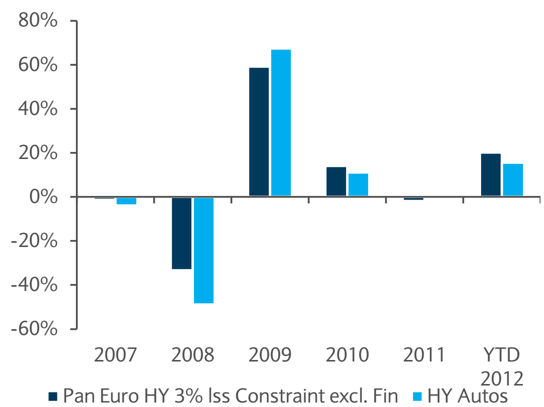
We expect 2013 bond issuance in European HY Autos at USD11-17bn across all currencies (USD24bn YTD 2012), of which EUR6-9bn would be in euros (EUR6.5bn YTD 2012) including from Banque PSA.

We see Banque PSA and FGA Capital as potential fallen angels in 2013, while Fiat Industrial could return to HG by end 2013. Should Schaeffler further reduce its holding in Continental to de-leverage the upper deck, we should also see Continental return to HG by year end. In a bearish scenario (euro area GDP -2%, car sales -8.3% in Europe and -4.6% globally), we could see up to two notches cut across the sector. Peugeot, Faurecia and Fiat are the most vulnerable, in our view.

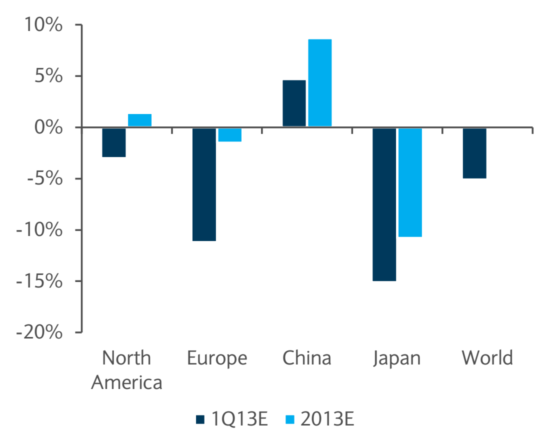
HY EUR Autos OAS versus HY EUR Credit Index



HY EUR Autos excess return versus HY EUR Credit Index



Vehicle production estimates



Source: HIS, Barclays Research

EUROPEAN HIGH YIELD PAPER & PACKAGING

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Key recommendations

Buy 5y NSINO protection. We remain negative on Norske Skog's operational outlook as ongoing macro uncertainties weigh on domestic demand, particularly in Europe and Australasia. With the company facing challenging y/y comparables in Q4 12 and its RCF covenants grinding tighter on a quarterly basis, we see scope for a potential covenant breach in H1 13, which is typically a cash burning half.

Preference for UPM (OW) over Stora (UW). We believe Stora is more vulnerable to rating downgrades over the near term given its commitment to a material ramp-up in investment (capex in 2013 could exceed €1bn vs UPM's budgeted level of €500mn) at a time when credit metrics are already below the requirements for ratings. Across the curve, we prefer the UPMKYM $'18s and the £'17s and support selling UPM protection versus buying Stora protection.

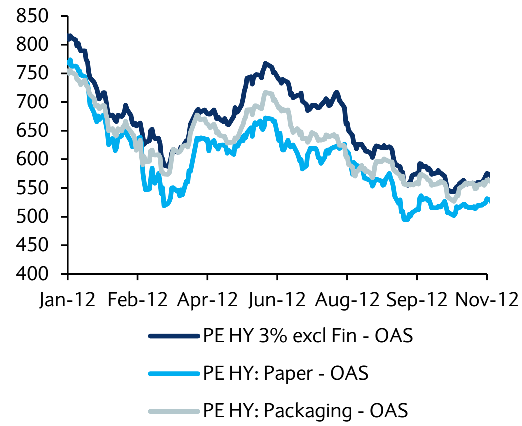
Overweight Ardagh Packaging 7.375% 2017 secured notes and 11.125% 2018 PIK notes. We remain positive on Ardagh, favouring its good operational visibility, relatively resilient end markets and solid PF liquidity with no near-term maturities. We believe Ardagh benefits from a near-term positive catalyst with management targeting an IPO in the US in early 2013, market conditions permitting. In our view, a portion of the PIKs could be redeemed in the event of an IPO, so as to comply with the 3.5x loan-to-value ratio in the PIK documentation.

Sector outlook

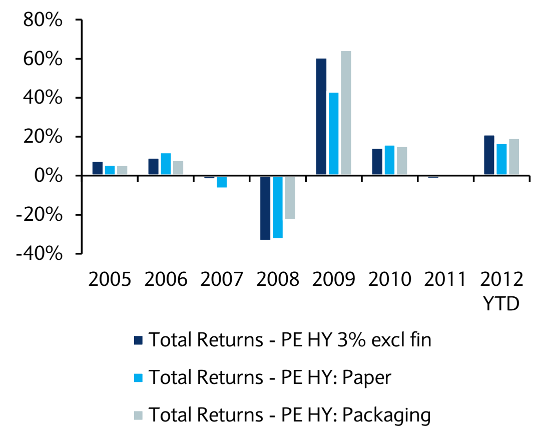
Muted operational outlook for the paper sector. Despite our expectation for a relatively benign cost environment in 2013, European paper operators still face various challenges. These include depressed domestic deliveries due to the subdued macro climate, further cost reductions to restore margins to sustainable levels and a need for capacity curtailments as the structural decline of the industry continues to gain pace, particularly in the newsprint segment where there is significant overcapacity. While a number of producers have announced price increases for Q1 13, we expect these to be met with a certain degree of customer resistance, particularly in newsprint, given current demand trends. Despite the difficult trading conditions, however, we note the lack of near-term maturities in the paper space.

A more resilient performance expected in the packaging sector. Given the sector's exposure to largely defensive food and beverage end markets, we expect a relatively stable FY 13 operating result from the majority of our names, despite ongoing macro headwinds. As such, we remain broadly constructive on the sector as a whole and expect some margin recovery, driven by cost reduction efforts and reasonably stable raw material costs. We highlight Clondalkin as the only name in the space facing a 2013/14 refinancing need.

Sector OAS versus PE HY 3% excl fins index



Total returns versus PE HY 3% excl fins index



Source: Barclays Research

EUROPEAN HIGH YIELD CONSUMER PRODUCTS & RETAIL

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Key recommendations

Overweight House of Fraser: We expect earnings momentum to improve heading into the Christmas season and we remain confident in management's ability to beat current estimates of c.£60mn for FY 13 EBITDA. We see leverage falling to 5.8x by year end on strong EBITDA and improved FCF and expect LFL sales to outperform.

Overweight Bakkavor: We see more upside from the expected equity injection (£15mn) by the owners by year end (YE), as well as the sale of Bakkavor's French and Spanish businesses, which should reduce net leverage by c.0.3x to 4.7x by YE, on our estimates. We remain comfortable with current earnings momentum, boosted by LFL growth rates in the mid-to-high single digits and improvements in margins of c.50bp (observed over Q3 12).

Underweight Refresco: Despite improved earnings in Q3, boosted mainly by the better weather, we remain cautious on the underlying operations given the decline in volumes, lack of visibility on business wins and volatility in sales. We continue to think that investors are not adequately compensated, given the higher leverage and appetite for M&A. We see better value in Ontex senior notes and Bakkavor.

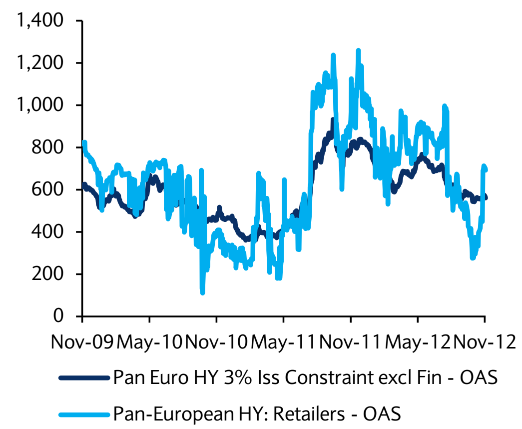
Sector outlook

UK retail: Although trading conditions are likely to remain challenging for some time, we expect growth in real consumer spending to translate into improved earnings trends for UK retailers. We favour companies with leading market shares, operating levers and ample cash balances – our top picks are HOUSF, Phones4u and Matalan. We think that UK retail will outperform European and South African retail and see more upside from Christmas trading, especially for HOUSF and Matalan. Although there could be an increase in dividend payments (within baskets) for DFS and potentially Phones4u, we expect the latter to be coupled with debt buybacks and still expect overall leverage ratios to improve y/y.

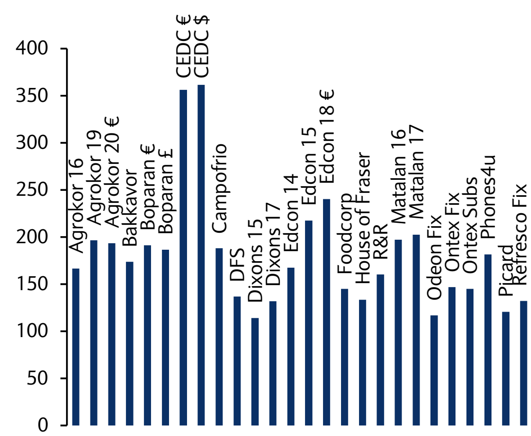
Food/Beverages: Although raw materials are up y/y as a result of the droughts in the US affecting corn and soya meal and the poor weather in Europe affecting vegetable prices, we do not expect inflation to be as severe as in FY 11. We expect food producers to show y/y improvement in margins. We continue to favour companies with high LFL volume growth and strong operational leverage – our top picks are Bakkavor and Ontex, followed by R&R. We continue to favour Bakkavor over Refresco, as we view Refresco's bonds as too rich given its high leverage (5.2x). We expect a surge in M&A activity in the food space in 2013.

SA corporates: Given the weaker Rand, we would expect SA issuers to reduce their overall exposure to EUR/USD-denominated debt and expect more Rand issuance from Peermont and Edcon. We favour Edcon 14s and 15s over the 18s, and we remain positive on FDCSJ and on Peermont.

Sector OAS versus the PE HY excl Fin index



Average spread/turn (FY12E net leverage)



UK 3-month average clothing y/y sales growth (%)

Source: ONS, Barclays Research

EUROPEAN HIGH YIELD GENERAL INDUSTRIALS & TRANSPORTATION

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Key recommendations

Kerling – Overweight 10.625% senior secured notes. Kerling underperformed the chemicals sector significantly in 2012, reflecting a weak backdrop for European PVC and a number of operational one-offs. Although we do not expect a material improvement in demand conditions, synergies from the LVM acquisition and other cost cutting initiatives should see earnings normalise over the course of 2013 and underpin a recovery in the bonds, in our view.

Befesa Zinc – Overweight 8.875% senior secured notes. We continue to view Befesa as one of the more resilient credits in the "cyclical" space. The recent shift in capex strategy, away from Spain and into Turkey and South Korea, will add geographic diversification and help protect utilisation rates at its existing Spanish plant. Despite recent price appreciation, we still think BEZINC offers good value relative to other cyclicals and we view the discount to first call as incrementally positive, given the number of call-constrained comparables.

Europcar – Underweight EC Finance 9.750% senior secured notes. Although Europcar's near-term liquidity concerns were addressed by the refinancing earlier this year, its capital structure remains over-levered, in our view. The senior secured notes have appreciated in line with other higher-beta credits and now trade nearly 4pts above the Aug '14 call, offering little upside from current levels. Furthermore, despite their structural seniority, at c.35pts above their 12-month low, historical trading suggests the notes would be vulnerable to market weakness. Any further improvement in company fundamentals is best captured in the EUROCA holdco debt, in our view.

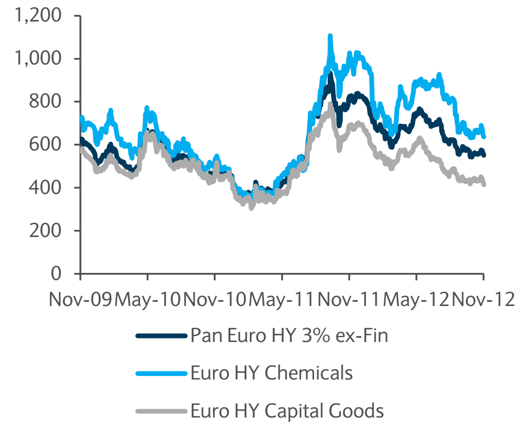
Sector outlook

Muted demand outlook, but inventories remain light. We expect the weak macro backdrop to continue into 2013, but note that light inventories, as suggested by anecdotal evidence, leave the more cyclical sectors favourably geared to any signs of improvement. In the near term, self-help measures will be the primary source of credit improvement.

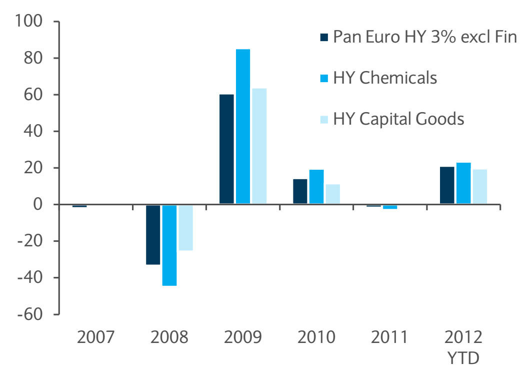
European Chemicals facing a tough comp in H1 13. Within chemicals, we expect a similar pattern to last year, with seasonality favouring H1. However, we note the particularly strong re-stocking activity in early 2012 is likely to represent a challenging comp for the European-based issuers.

Refi risk greatly reduced. A number of issuers termed out maturities in 2012, most notably INEOS and Europcar, leaving minimal near-term refinancing risk for 2013. ATU is the main exception, where the entire capital structure matures in 2014. In this regard, we do not expect a solution until late-2013, leaving the bonds highly sensitive to overall market sentiment in the near term.

Euro Industrial OAS vs Index



Total returns vs Index



Source: Barclays Research

EUROPEAN HIGH YIELD TELECOM, MEDIA & TECHNOLOGY

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Key recommendations

Within the European HY TMT sector, we maintain our Overweight recommendation on the Wind senior secured and subordinated notes. Our view is based on current yields, our belief that the company will continue to perform in line with our expectations and that support from VimpelCom (100.0% owner) will be evident as we move closer to the 2013 call dates (of the Wind capital structure).

Relative value analysis will also continue to play an important role in 2013. Given the fact that there are more than 40 individual bond issues across the senior secured and subordinated portions of the nine cable issuers in the European Cable sector, opportunities to take out cash points reduce leverage while maintaining/potentially increasing yield will continue to exist. Our current Overweight recommendations include UPC 6.375% and 6.625% and the Ziggo 8.000% subordinated notes, to name a few. We maintain our Underweight recommendation across the bonds in the Telenet capital structure, based on concerns regarding shareholder-friendly practices and higher leverage.

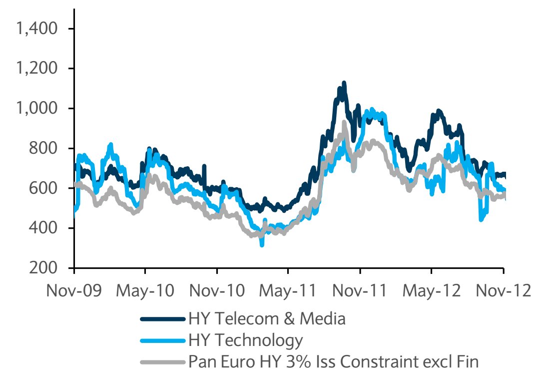
Sector outlook

Continued operational and financial growth for some operators, including Kabel Deutschland, Telenet, UPC, Virgin Media and Ziggo, as a result of higher customers and increased average revenue per user (ARPU). We do note that this growth will come at a cost, and expect capital expenditure levels to remain high.

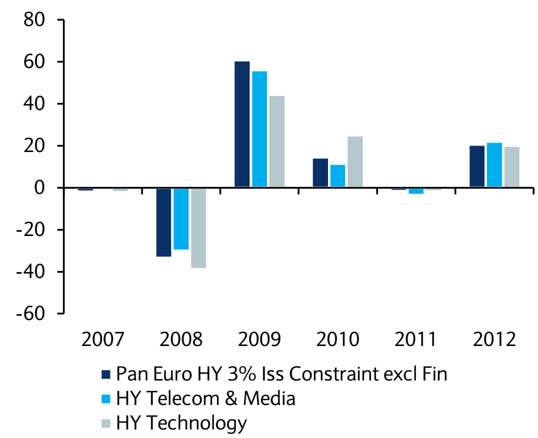
Lower growth rates from cable operators, including ComHem, Numericable (Not Rated) and Ono. This is due to those operators having operations in mature/highly penetrated markets, or limited scope for increased prices due to macroeconomic circumstances.

There are several bonds that become callable and could be refinanced at favourable rates in 2013. Based on our calculations, there is €10.5bn (equivalent, of which over half comes from the Wind capital structure) of European HY TMT bonds that become callable in 2013. As we have seen with Virgin Media, companies with high fixed coupon debt (trading at tight yields) could look to refinance where possible should market conditions allow (also benefit from the extension of maturity profiles). That said, a refinancing of the callable debt within Ono and Numericable structures is a lower probability, given current trading levels. The refinancing of Wind debt (VimpelCom, does not expect this process to be completed until 2014, market dependent) and the CETV (49.9% owned by Time Warner) 11.625% (OW) could depend on parental support. Lastly, refinancing in names including Matterhorn (Not Rated) and Sunrise will be market dependent, in our opinion.

Euro Telecom OAS versus Index



Total Returns versus the PEHY 3% excl. Financials



Asia-Pacific sector outlooks

AUSTRALIAN BANKS – UNDERWEIGHT

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Key recommendations

We hold an Underweight rating on the big four Australian banks. Although fundamentals remain solid, tight valuations for their senior bonds and a weaker outlook for growth in Australia will limit performance relative to the benchmark, in our view. That said, we like the old-style Lower Tier 2 bonds of the Australian banks, given the eventual scarcity value when Basel III begins in 2013. In particular, we like the ANZ 3.45 22c17s and the WSTP 3.625 23c18s.

Sector outlook

We expect balance sheet metrics to continue to broadly improve in 2013. Continued muted loan growth coupled with strong deposit growth should result in further improvements in the Australian banks' funding profiles. Capital positions should also strengthen in line with relatively healthy organic capital generation. In our view, the Australian banks will seek to further build their capital buffers despite capital ratios largely meeting the targets stated by their regulator APRA.

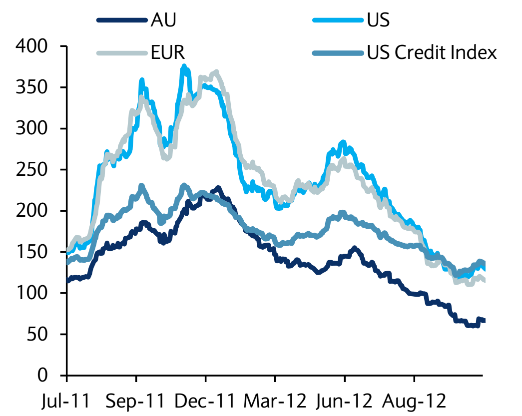
Earnings will remain under pressure. We think achieving net interest income growth will be challenging in 2013, given the subdued credit environment and pressure on NIMs in a rate-cutting cycle.

Asset quality may weaken slightly. In our opinion, credit costs will pick up from current low levels due to the lagged impact of stresses in the non-mining sectors of the Australian economy. We think any increase in impaired loans is more likely to be driven by corporates rather than households.

Measured expansion in Asia. Aside from ANZ, which has had a clear Asia expansion strategy for a while, we believe sluggish domestic growth will spur the other Australian banks to focus on building their activities in Asia.

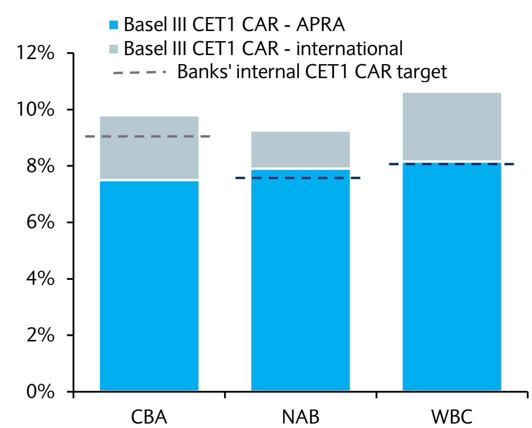
Senior unsecured issuance to decline. Although the big four banks are generally guiding for similar funding tasks as in previous years, we think senior unsecured issuance in 2013 could decline if deposit growth continues to fully fund loan growth. This should support technicals for the banks' senior bonds.

OAS of senior bonds (bp)



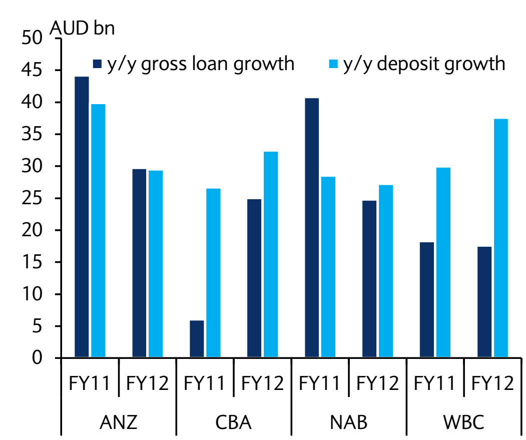
Note: As of 29 November 2012. Source: Barclays Research

CET1 CAR versus internal targets



Source: Company data, Barclays Research

Deposit growth has outpaced loan growth



Source: Banks, Barclays Research

ASIA NON-JAPAN BANKS

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Key recommendations

We recommend being overweight old-style Tier 2 bonds. With the implementation of Basel III, we expect subdebt supply in 2013 to be Basel III compliant (ie, instruments will contain loss-absorption features). This will eventually create scarcity value for the old-style Tier 2 bonds, of which about USD19bn are outstanding. We therefore expect positive technical support for these bonds. In particular, we like the Singaporean bank LT2s (DBSSP 3.625 22c17s, OCBCSP 3.15 23c18s, UOBSP 2.875 22c17s). We think these bonds also look attractive from a senior/sub ratio perspective.

We have an Underweight rating on the Korean banks given tight valuations relative to their benchmark. We believe the Indian banks, in particular the smaller state-owned banks, offer value in the near-term. That said, we acknowledge that sovereign downgrade risks are non-negligible and investors should reassess positioning closer to the FY14 budget. We estimate that a sovereign downgrade by two agencies could result in a 70-80bp of widening in Indian bank spreads.

Sector outlook

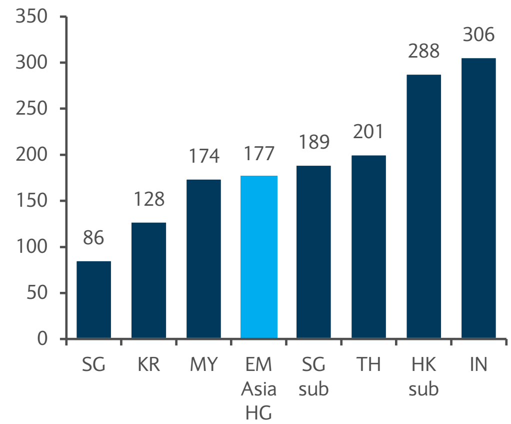
We expect fundamentals to remain broadly stable. The bottoming out of growth in China should be supportive for growth in the region and in turn banks' fundamentals. However, earnings could falter as NIMs remain under pressure in the low interest rate environment. NPLs could also creep up from current low levels. as loan books season but we expect overall credit costs to remain manageable relative to earnings.

Capital management activities likely to increase. Although most Asian banking systems look comfortably placed to meet Basel III requirements, we expect banks to be more conscious of the need to optimize capital. In particular, we think some banks may dispose of non-strategic minority investments. Risk-weight optimization is also likely to increase. For example, despite its healthy capital ratios, DBS has alluded to the potential for further improvement as it improves its capital computation process.

We expect supply of Basel III compliant instruments to commence. There are few USD subdebt redemptions in 2013 but we believe Hong Kong and Singaporean banks could be potential issuers. In our view, banks with sufficient onshore liquidity (eg, in Malaysia, Thailand) may opt to issue subdebt in local currencies.

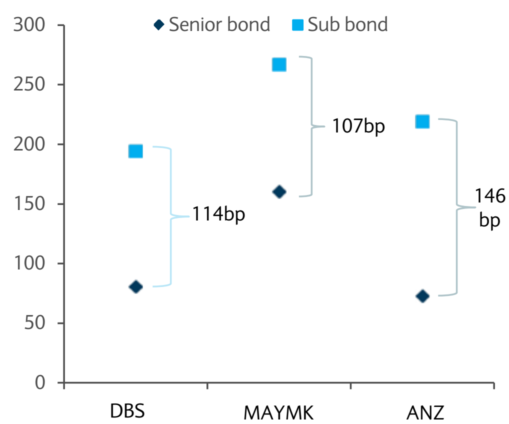
Covered bond supply could pick up, depending on the timing of relevant legislation. The *Financial Times* reported that a bill on covered bond issuance in Korea is due to go before parliament in December. The Monetary Authority of Singapore also issued a consultation paper for covered bonds in March 2012.

OAS: Banks versus EM Asia USD High Grade Index



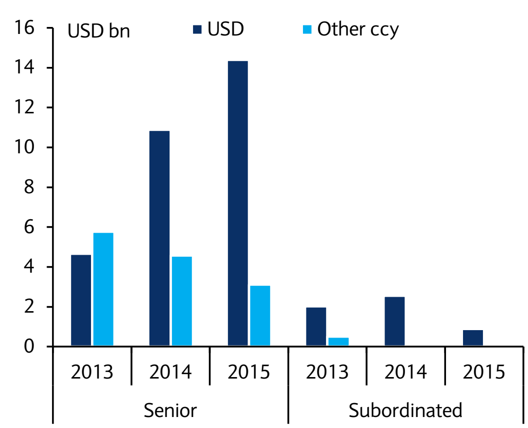
Source: Barclays Research

OAS: Old-style Tier 2s versus seniors



Note: As of 29 November 2012. Source: Barclays Research

Bond redemptions



Source: Bloomberg, Barclays Research

ASIAN HIGH GRADE DIVERSIFIED INDUSTRIALS – OVERWEIGHT

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Key recommendations

Overweight Swire Properties (A2/A- Stb). We expect the group's diversified investment properties portfolio (13.5mn sq ft in Hong Kong and 5mn sq ft in China) and positive rental reversions to sustain its stable earnings momentum. Its retail rental space (17% of investment portfolio in Hong Kong and c.58% in China) is also relatively more resilient to macro challenges compared with the office rental market.

Market Weight Hutchison (A3/A- Neg). We expect Hutchison's credit profile to remain firmly supported by its diversified business portfolio. While M&A risks persist, we expect management to maintain a prudent acquisition approach with a focus on value-creating utilities/telecom assets. Further down the ratings curve, the HUWHY and CKI hybrids could present attractive long opportunities versus the senior bonds.

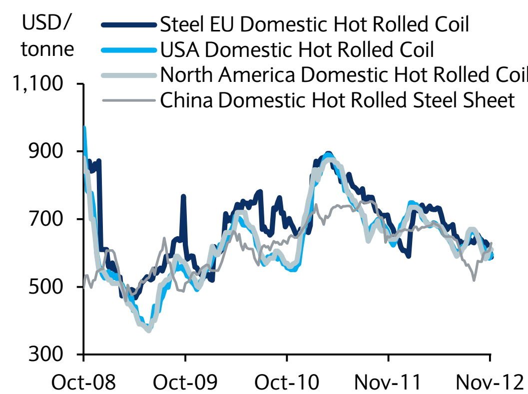
Sector outlook

Steel industry remains under pressure from overcapacity and low demand growth. Over the next 12 months, we expect the slow growth conditions in major economies and excess capacity to keep steel pricing weak. Nonetheless, subdued economic growth will also restrain any sharp rebound in iron ore and coking coal prices – a positive for steelmakers. A key risk to credit quality is the strategy of backward integration by steel producers – acquisition of iron ore assets helps to secure access to the raw material. We think any significant debt-funded acquisitions of iron ore assets, however, would likely weigh negatively on the credit metrics of the steel industry, which are already being stretched by low steel prices.

Hong Kong property companies. We think the property cooling measures (ie, supply-side increase, extra duties for non-local buyers) will lead to lower sales volumes and softer prices over the near term. However, the property companies are supported by their investment property businesses as well as low supply in the Hong Kong primary and secondary markets. We also expect certain companies (Sino Land, Hang Lung) to use their financial flexibility to replenish their land banks.

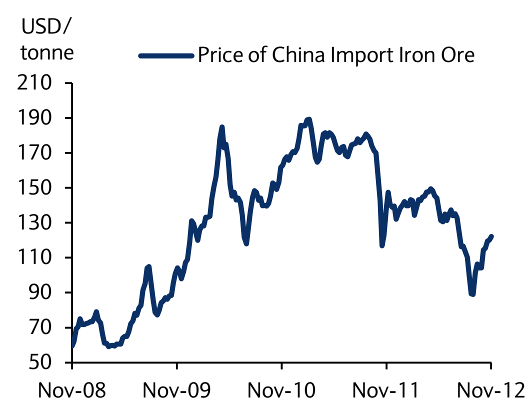
Hong Kong conglomerates – resilience underpinned by diversified business and geographical coverage. We expect Hutchison to maintain a stable credit profile, helped by respectable performances of its many business segments and its financial policy of keeping its net debt/capital at less than 25% (1H12: 22.8%). Additionally, Hutchison's debt maturity profile has been strengthened through active bond issuance in 2012 (USD5bn and EUR2bn). We expect Hutchison to remain receptive to opportunistic acquisitions, specifically to enhance its infrastructure/utilities and telecom business.

Global steel prices



Source: Bloomberg

Iron ore price



Note: Iron ore fines 62% Fe spot (CFR Tianjin port).
Source: Bloomberg

Private domestic property price indices in Hong Kong

Note: Rating and Valuation Department of Hong Kong. 1999 = 100.
Source: Barclays Research

ASIAN HIGH GRADE RESOURCES – MARKET WEIGHT

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Key recommendations

Overweight Reliance Industries (Baa2 Stb/BBB Pos). While its bonds have performed well over the last year, we think Reliance's credit profile remains underpinned by its strong balance sheet position and portfolio of integrated upstream, refining and petrochemicals operations.

Market Weight the Chinese and Thailand oil and gas companies (CNOOC, PTT PCL, PTTEP, PTTGC). Despite M&A risk at CNOOC, its credit ratings remain strongly supported by Chinese government ownership, business scale and its strong liquidity position. For the Thai oil and gas companies, we view their credit profiles as being supported by links to the government and steady operational performances.

Sector outlook

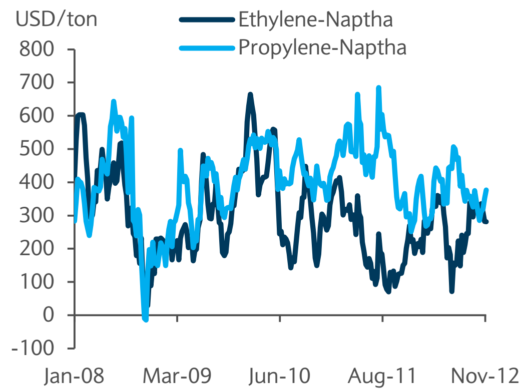
M&A growth agenda remains in place as Asian oil and gas companies look to boost reserves and production levels. We saw several M&A transactions this year (ie, CNOOC and Curtis LNG project; Sinopec and the 50% stake in Talisman's UK North Sea assets). Some deals (CNOOC-Nexen; Petronas-Progress) are also under regulatory review in Canada. We expect the three major Chinese oil and gas companies, KNOC, Woodside Petroleum and Reliance Industries to be open to further M&A activities in 2013.

High crude oil prices afoot. We expect crude oil prices to remain above USD100/bbl, a positive for upstream companies (CNOOC, PTTEP) but a headwind to those downstream, specifically petrochemicals and refining. Barclays commodity team forecasts an average 2013 WTI crude oil price of USD115/bbl and Brent of USD125/bbl.

Stronger petrochemical demand. With the stabilisation of growth in China, we expect some y/y improvement in petrochemical demand in 2013 and consequently, the headwind on margins could ease. Within the petrochemical industry, cost structure competitiveness is driven by feedstock. Petrochemical plants that depend on high-cost naphtha feedstock, particularly in China, are disadvantaged by elevated crude oil prices. In contrast, the margins of gas-based petrochemicals producers such as PTTGC are less vulnerable to crude oil prices.

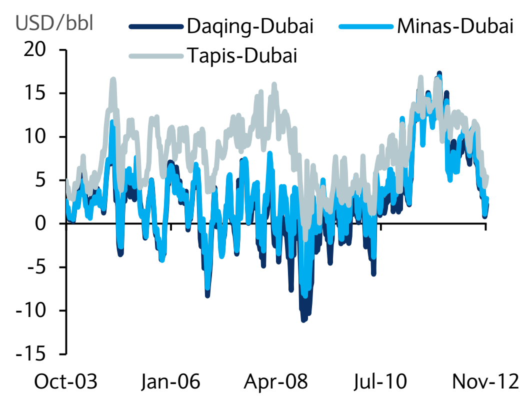
Government policies a key factor. Government controls on refined product prices cap the profitability of Asian oil and gas companies. We expect some pricing reform moves this year. In China, reform would be a positive, and we note that pilot programs have been initiated in Guangdong and Guangxi. In India, we expect fuel subsidies to remain elevated, along with under-recoveries. As such, the leverage levels of government-linked Indian oil and gas companies will remain high due to the time lag in subsidy reimbursement.

Olefin-Naphta spread



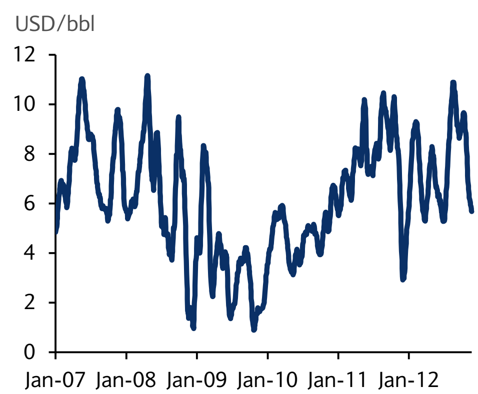
Note: Olefins include ethylene and propylene.
Source: Barclays Research

Oil spread prices between Asia and Dubai



Note: Crude oil spot price in China (Daqing), Indonesia (Minas) and Malaysia (Tapis). Prices are shown on a weekly basis.
Source: Bloomberg

Reuters Singapore Dubai crack spread



Source: Barclays Research

ASIAN HIGH GRADE TELECOMS – UNDERWEIGHT

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Key recommendations

Underweight HKT Trust & HKT Limited (Baa2/BBB Stb); the unrated PCCW 5.75% '22s look more attractive: While we do not see any major directional catalysts for HKT Trust & Limited bonds, we think spread levels offer little value for a mid BBB credit. We think the much wider-spread PCCW '22s provides attractive compensation for the absence of a credit rating and structural subordination.

Underweight SK Telecom (A3 Neg/A- Stb): Its credit profile is vulnerable to high capex and elevated operating costs (aggressive marketing), albeit these are mitigated in part by its strong domestic market share and scope for higher returns from its LTE investments.

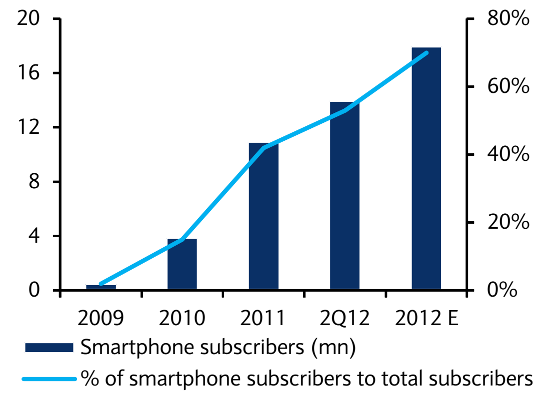
Sector outlook

Margin improvement unlikely: Given the aggressive marketing initiatives in South Korea to gain LTE subscribers, we do not see much meaningful margin improvement over the coming 12 months. The tariff discounts imposed by the regulator Korean Communications Commission are also likely to restrain the potential for better margins.

Capex programs drag on financial profiles, but set to fall in 2013: Recently, SK Telecom raised its planned capex for 2012 by KRW500mn to KRW2.8trn (USD2.55bn) due to faster-than-expected growth in LTE subscribers (7mn expected by end-2012 versus the original expectation of 5mn) – the increase comprised KRW300bn for multi-carrier base stations and KRW200bn for LTE capacity. Management guided that 2013 capex will be lower y/y, reflecting the pull-forward of capex into 2012. Telekom Malaysia has also maintained a relatively high capex program – estimated capex of MYR2.6bn for 2012 (2011: MYR2.56bn) – and over the next 7 years plans to spend MYR6.5bn on HSBB (high speed broadband internet). This suggests that capex will moderate after the initial HSBB roll-out.

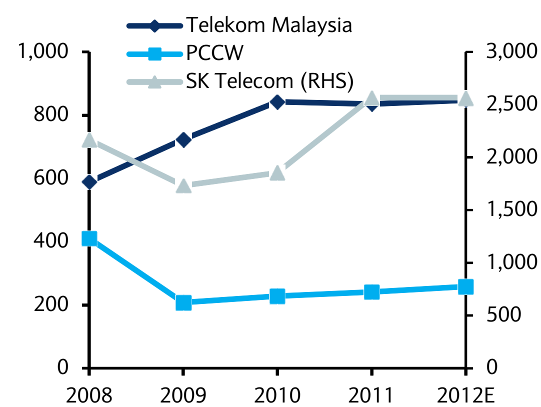
High market share provides stability in a competitive industry: While we expect competition to remain stiff, the major telcos benefit from strong market share positions. SKT is Korea's leading wireless operator with a market share above 50% (KT Corp 31.5%, LG Uplus 18%) and the second leading operator in broadband internet through its 50.6%-owned SK Broadband (market share of c.24% vs KT Corp's 44%). Telekom Malaysia has a domestic market share of more than 95% in fixed-line telecommunications and fixed broadband. With the Malaysian government likely to allocate LTE licenses in 2013, the high-speed data segment will see more competition, albeit higher data volume along with growth of smartphone use should help Malaysian telecom providers. HKT also has a strong 68% share in its domestic broadband market and a 62% share in its fixed-line market.

SKT smartphone subscribers



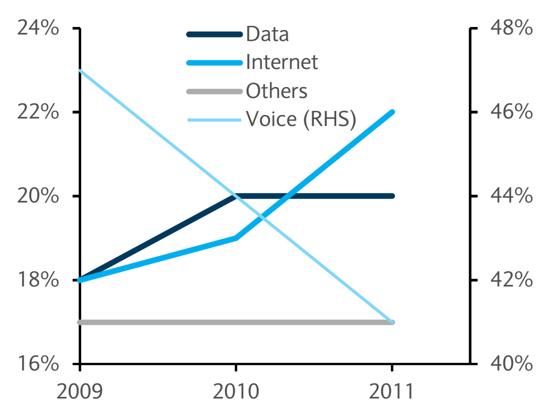
Source: Company presentation

Capex (USD mn)



Source: Company reports

Telekom Malaysia – revenue contribution by segment



Note: Growth of the contribution from internet revenue versus the decline in voice. Source: Barclays Research

ASIAN HIGH GRADE UTILITIES – MARKET WEIGHT

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Key recommendations

Overweight China Resources Gas (Baa1/BBB+ Stb), Market Weight Beijing Enterprises Holdings (Ba1 Stb/A- Stb): The credit profiles of these two gas distribution companies are well-supported by growth trends in gas consumption, diversified end-markets, stable gas supply and their SOE status. High capex and acquisition risks are partly mitigated by a willingness to raise equity capital – China Resources Gas raised HKD2.7bn through a share placement in November 2012.

Underweight Korea Electric Power, KEPCO (A1/A+ Stb): A significant capex program, margins that remain under pressure from tariff controls and high operating costs (particularly during disruptions to nuclear power generation) are downside risks to its credit profile.

Sector outlook

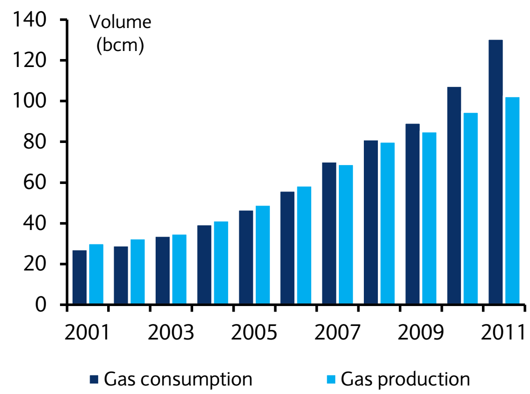
Mixed margin outlook: Recent tariff increases (+4.9% in August 2012) in South Korea are still insufficient to offset higher input costs and, consequently, we expect margin weakness to persist for KEPCO. The disruption to nuclear power generation (parts replacement, plant shutdown) is also raising the group's operating costs. In China, lower coal prices should be helpful for the utilities sector and we expect some recovery in power consumption growth in 2013 following the recent lows in September 2012.

No respite from high capex: We expect the utilities sector to maintain its high capex levels. In South Korea, targeted future capacity is 86.3GW by 2016 and 105.3GW by 2024 (vs 2011 capacity: 67GW). Cumulative capex planned by KEPCO/gencos over 2013-16 is KRW77trn. In India, NTPC targets to reach a capacity of 75GW by 2017 and 128GW by 2032. Its current capacity is c.39.2GW (18.5% of India's total installed capacity) and it has c.16.6GW of capacity under construction. NTPC budgets INR1.5trn (c.USD28bn) of capex for its current and planned capacity expansion, which it says will be debt funded.

Active issuance pipeline: Given the high capex requirements to fund capacity growth, we expect the utilities, especially those in South Korea and India, to be potential issuers in 2013.

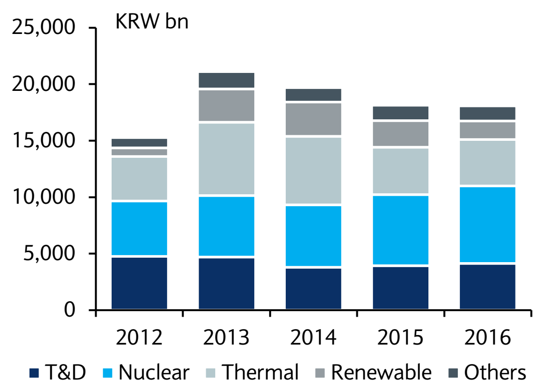
Government policies not to be overlooked: In China, we expect the gas utilities to benefit from the government's plan to reach natural gas self-sufficiency of 25% by 2017. We expect China Resources Gas and Beijing Enterprises Holdings to remain keen on expanding their city gas distribution networks through JVs, acquisitions and organic growth. In India, we expect the tripartite agreement (between state government, central government and the RBI) to remain supportive in ensuring payments by state electricity utilities to NTPC.

Consumption/production of natural gas in China



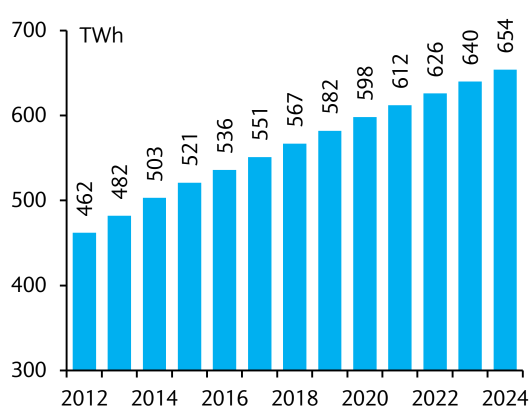
Source: BP Statistical Review of World Energy 2012

Capex projections for KEPCO and the 6 gencos



Note: T&D = transmission and distribution.
Source: Company reports

Electricity demand forecasts, South Korea



Source: Company reports, KOWEPO

ASIAN HIGH YIELD DIVERSIFIED INDUSTRIALS NORTH ASIA – MARKET WEIGHT

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Key recommendations

Overweight West China Cement '16s. Although we have a cautious view of WESCHI's credit profile, due to its aggressive liquidity management, we believe bond valuations more than compensate for the risk. The company's liquidity position has improved since June, while cement demand appears to have picked up in October as China's rail projects restarted. WESCHI also raised cement prices by CNY10-20/tonne (4-8%) in November, which, if sustained, should be supportive of improved earnings in 2013. We expect stable to improving credit metrics on improved EBITDA as a result.

Seek out the laggards. A combination of stable to improving operating and credit profiles, better access to liquidity and expectations of muted USD bond supply is likely to support risk-taking in 2013. We recommend looking for value among the laggards, especially corporates that are likely to benefit from infrastructure and rail projects that are adequately financed.

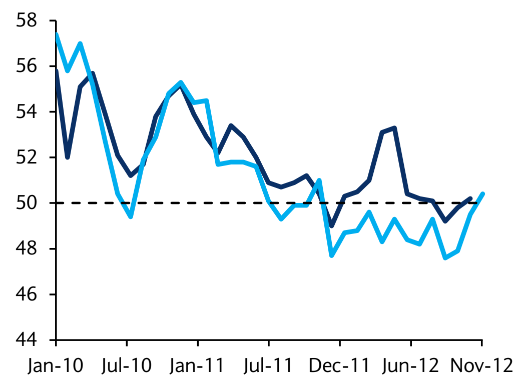
Sector outlook

Rising tide starts to lift boats. Signs that China's GDP had bottomed in 3Q12, as well as low base effects, are reflected in our expectations of a modest improvement in 1H13 demand, with further acceleration in 2H13. Credit profiles will likely remain weak, although we expect debt metrics to stabilise or marginally improve on higher earnings. We think cement producers will report stronger earnings, as average selling prices have also started rising.

Liquidity pressure easing, as Chinese corporates are increasingly able to obtain domestic and/or offshore bank funding, often at lower rates than their bond yields. Shanshui Cement indicated that it is able to borrow domestically at 6%. In November, Fufeng signed a 3y USD150mn amortising loan at L+400bp with all-in cost of 460bp at the top, compared with a bond yield of 8%. Even liquidity-challenged Hidili was able to obtain domestic trust financing at 10% for three years, compared with bond yields of 19%.

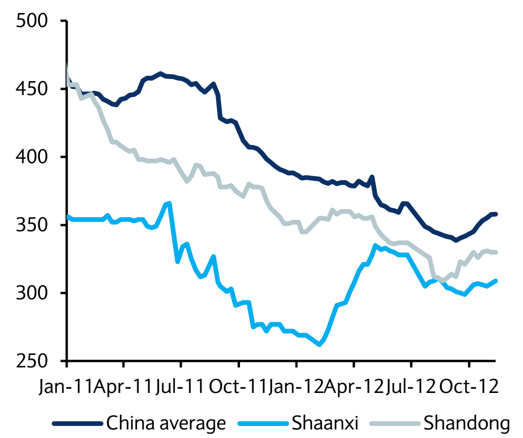
USD bond supply will likely be muted, due to the increasing access to domestic funding. We think USD issuance in 2013 will be limited to corporates looking for size or tenor, as well as those that are not able to access domestic funding due to government restrictions against long-term bank lending to certain sectors such as cement. That said, supply prospects may improve during the year if expectations of CNY appreciation are rekindled.

China manufacturing PMI



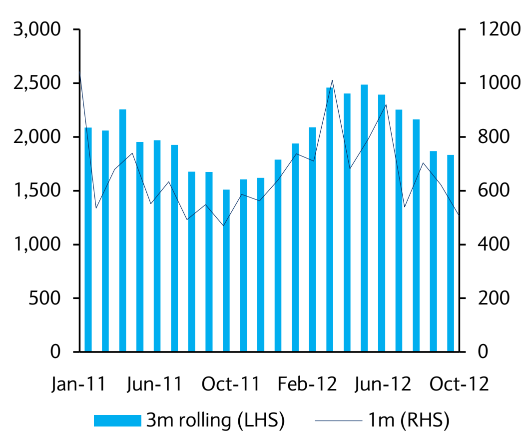
Source: Bloomberg, Markit

China's cement prices (CNY/tonne)



Source: chinacement.net

China's monthly new loans (CNY bn)



Source: Bloomberg, chinacement.net, Barclays Research

ASIAN HIGH YIELD DIVERSIFIED INDUSTRIALS SOUTH ASIA – OVERWEIGHT

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Key recommendations

Buy Gajah Tunggal '14s (Overweight; B3/B). We think the 2014 bonds are likely to be called by mid-2013 as Gajah looks to get rid of the restrictive covenants in order to finance its plant expansion. We view the yield of over 7% on the '14s as relatively attractive for the likely short average life. Assuming the bonds are not called, the step-up in coupon to 10.25% in July will also improve the bonds' carry. We view Gajah as an improving credit in the near term.

Buy Alam Sutera '17s (Not Rated; B2/B). The company's credit metrics looks robust for its mid-B ratings. This raises the likelihood of a ratings upgrade in the next six months, in our view. We believe the strong industry fundamentals should support further earnings growth in the near term. The bonds' high cash price suggests upside is limited. Nonetheless, we think the running yield of close to 10% is attractive for an improving credit.

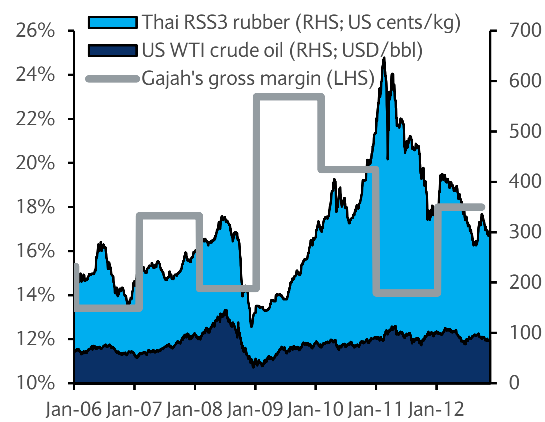
Sector outlook

Tyre. We remain positive on the outlook for the tyre sector. Profitability should benefit from expected low rubber prices. Domestic tyre demand will also remain robust, in our view. Replacement tyre demand should benefit from the robust vehicle sales growth of the past few years. This should offset a potential slow down in sales to the OEM market. We think Gajah Tunggal's credit profile is likely to be stable to improving in the near term. We expect cash flow growth, although we think the company may take on more debt to fund its plant expansion. New funding, however, would only likely come after a successful refinancing of the 2014 bonds.

Property. We believe the credit strength of Indonesian property developers should benefit from robust industry fundamentals in the near term. Healthy economic growth and growing mortgage financing by banks will further spur demand for residential and industrial properties, in our view. Average land prices should continue to rise, albeit at a slowing rate. We think these factors should support stronger cash flows for the developers in 2013. The key sector risk is an aggressive expansion requiring additional financing needs. We see this as the biggest risk for Jababeka given its relatively low cash position.

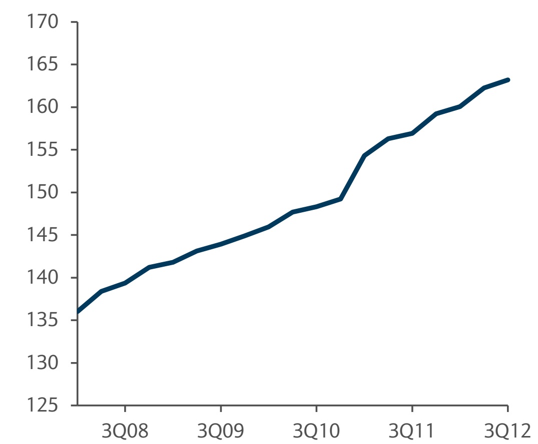
Limited supply risk. Bank loans will remain the preferred financing source for Indonesian corporates in the near term, in our view. Weaker credits, which may not have strong access to bank lending, may opportunistically raise financing through offshore bonds. In the near term, we think Gajah is likely to issue bonds to refinance existing paper. We may also see more issuances from property companies to fund land acquisitions. Indonesian regulations prevent developers from using bank loans for land purchases.

Low rubber price is positive for tyre producers



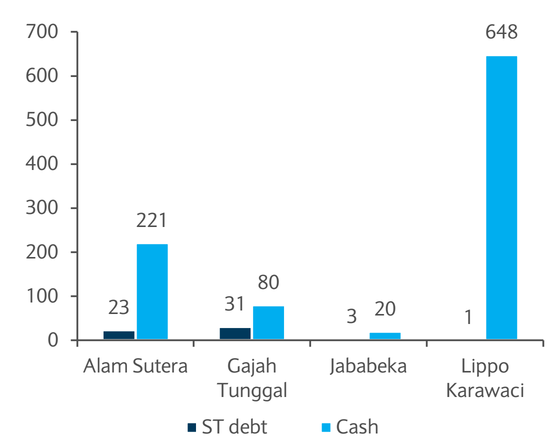
Source: Bloomberg, Barclays Research

Greater Jakarta residential property index



Note 1Q2000 = 100. Source: Bank Indonesia, Barclays Research

Issuers have strong liquidity positions (USD mn)



Note: 3Q12 data except Lippo Karawaci (2Q12).
Source: Barclays Research

ASIAN HIGH YIELD RESOURCES – MARKET WEIGHT

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Key recommendations

Buy Vedanta '18s (Overweight; Ba3/BB/BB). We expect the bonds to outperform the Asian Corporate HY market on carry. Vedanta is an improving credit, in our view. An increase in base metal and oil prices, and in production volumes should support stronger cash flow in the near term. Furthermore, we believe its debt profile should significantly improve, assuming completion of its proposed corporate restructuring.

Sector outlook

Positive sector outlook. The operating environment for the resources sector is generally positive. An improved demand outlook, partly on the expectation of pro-growth policies in China, should support a better pricing environment. We expect cash flow growth among the issuers, although for some, this may be offset by aggressive growth plans.

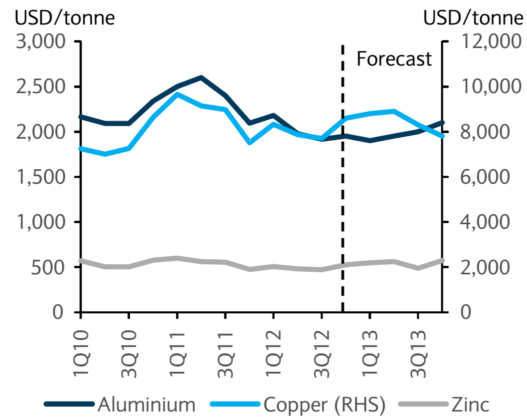
Base metals. We are cautiously optimistic on the base metals markets. With most sectors still facing supply surpluses, demand will shape the near-term price profile. Our expectation of an economic stimulus in China in early 2013 bodes well for metal demand. We believe the improvement in sector fundamentals, along with production expansion, will support cash flow growth and credit improvement for Vedanta. A bigger potential credit driver, however, is growth in its oil and gas business and the completion of its business restructuring.

Oil and gas. Barclays forecasts Brent will average USD125/bbl in 2013, 9% above our 2012 estimate, on strong EM demand and supply constraints. Combined with volume growth, we expect high yield Asian upstream operators to report low- to mid-teen earnings growth. Debt-funded M&A remains the key credit risk in 2013. We expect credit profiles to deteriorate but ratios to remain adequate for current ratings.

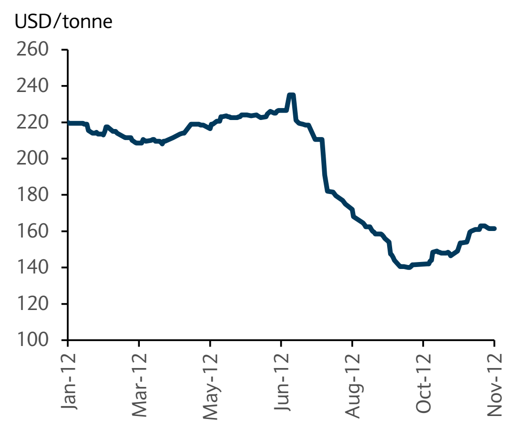
Coking coal. The coking coal market is past the worst, in our view. The near-term recovery is likely to be limited, however, with price rises of only 10-15% from current levels. We expect 2013 ASPs to be lower than 2012. On such a weak recovery, we do not envisage a significant improvement in the credit profiles of coking coal companies in Asia. Of the issuers, we are most concerned about Hidili, given its weak liquidity position and our expectation of continued low production next year.

Supply risk. We could see increased bond issuance in the near term, as improved demand for resources could trigger a more aggressive expansion by issuers. Vedanta may also issue bonds to refinance bank loans that were taken to fund its acquisition in oil-and-gas subsidiary Cairn India. We think this would most likely take place at subsidiary Sesa Sterlite following completion of the group's restructuring.

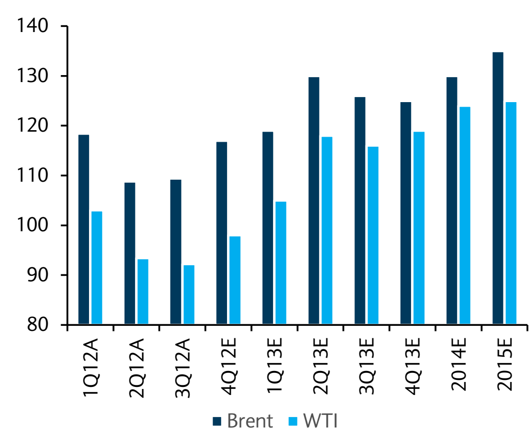
Base metal prices to recover slightly in 2013



Coking coal – past the worst, but still vulnerable



Barclays Brent and WTI forecasts (USD/bbl)



Source for all charts: Bloomberg, Barclays Research

ASIAN HIGH YIELD INDONESIAN COAL – UNDERWEIGHT

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Key recommendations

We have an Underweight rating on the Indonesian coal sector. Overall credit profiles are likely to weaken as earnings pressure intensifies on lower average selling prices. We do not expect significant debt reduction in the near term. Except for Bumi Resources, liquidity positions in the sector are relatively robust, which should provide a decent buffer against any temporary cash flow weaknesses.

We have an Underweight rating on the Adaro '19s (Ba1/BB+ both Stb) on tight valuations. Our Overweight rating on the Bumi Resources (B1 Neg/B+ CW Neg) reflects expected upside in the bonds on the resolution of shareholding issues in early-2013.

Sector outlook

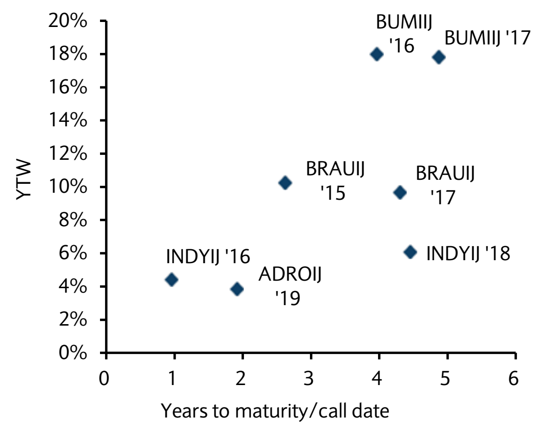
Lower ASP in 2013. Earnings are likely to be slightly weaker in 2013 on lower average selling prices. Indonesian thermal coal prices are coming off their lows. However, when producers sign annual fixed price contracts in early-2013, the coal price is likely to be much lower versus the 2012 contracts. We expect lower prices to be partly offset by increased coal production. Most producers are targeting an increase of c.10% y/y. Steps taken to lower cost may also help to ease near-term earnings pressure. Barclays' commodity team expects the Newcastle coal price to average USD94/tonne in 2013 compared with our forecast of USD96/tonne in 2012.

Weaker debt metrics. We expect lower earnings to translate into slightly weaker credit metrics in 2013 (see graph). We do not expect significant debt reduction next year as issuers' free cash flows are likely to be negative despite attempts to cut capital spending. Maturing debt in 2013 will likely be refinanced through new debt funding to maintain a strong liquidity position, in our view. Overall, we think ratings are likely to be stable in the near term. However, Berau Coal and Bumi both face event risk that could have a negative impact on their ratings.

Robust liquidity. Most issuers have sufficient liquidity for near-term debt repayment and to buffer any potential cash flow declines, in our view. The only exception is Bumi Resources, which has close to USD750mn of debt maturing next year. We see near-term default risk as low, nonetheless. If needed, we think the company can sell assets and liquidate investments to repay debt.

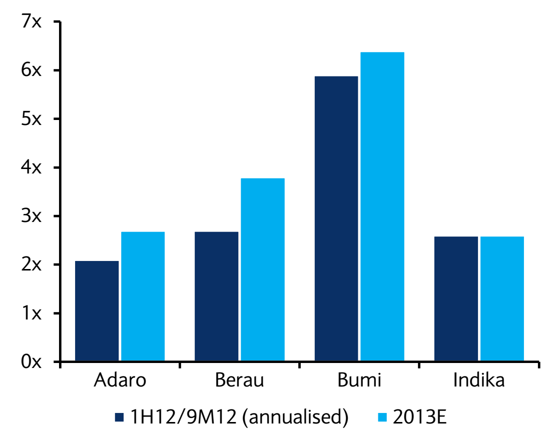
Low supply risk. New issuance in 2013 will likely be for refinancing of existing bonds, in our view. We see a high likelihood of Indika refinancing its 2016 bonds when it becomes callable in Nov 2013. We think Adaro may also opportunistically refinance its 2019 bonds (callable in 2014) through a bond exchange. Apart from bond refinancing, we expect other funding needs to be largely met through bank loans.

Indonesian coal producers compared



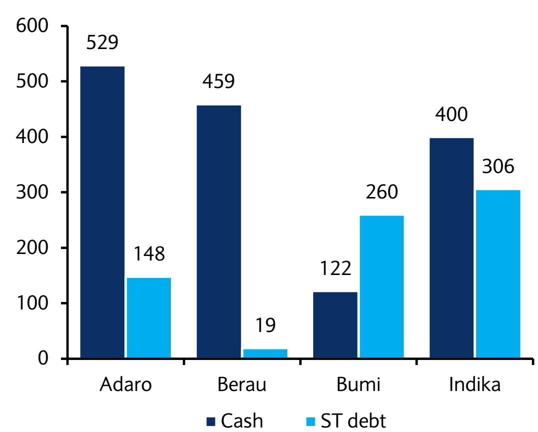
Source: Barclays Research

Credit metrics to slightly deteriorate in 2013



Source: Company data, Barclays Research

Robust liquidity position for most (USD mn)



Note: 3Q12 data for Adaro and Berau Coal; 2Q12 data for Bumi Resources and Indika. Does not include short-term investments.
Source: Company data, Barclays Research

CHINESE HIGH YIELD REAL ESTATE – OVERWEIGHT

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Key recommendations

We have maintained our sector overweight since April but recommend trimming exposure on BB rated, large developers such as Longfor '16s (Market Weight), Agile '17s (old and new, Market Weight) and raising exposure to the B rated, medium-sized developers yielding 8-12% such as KWG (Overweight), Guangzhou R&F '16s (Overweight) and Kaisa (Overweight). We believe stability has returned to the property market. Combined with a benign macro economic outlook and more prudent financial management, this will likely drive bond outperformance. While valuations compressed significantly in 2012, the sector still offers better risk/reward than other high yield ones in Asia. We remain comfortable on sector credit fundamentals.

Sector outlook

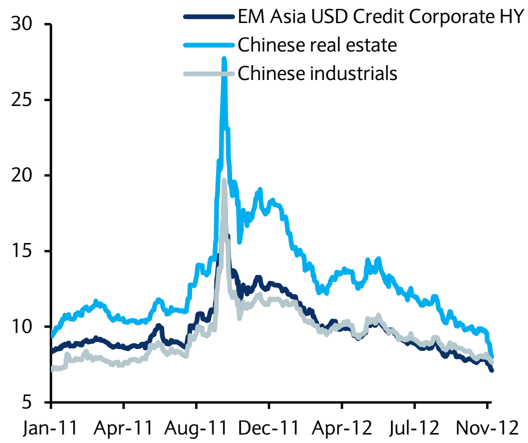
Stability has returned. It has been two years since the start of home purchase restrictions (HPRs) over 40 Chinese cities. Speculative demand has been taken out of the market, and end-user home demand, which was previously amplified by regulatory measures, is now more stable as the market has become accustomed to these measures. From a credit perspective, we are cautiously optimistic on the outlook for 2013 and expect modest price growth in 2013.

Regulatory measures here to stay but unlikely to get worse. A new round of harsh austerity measures is unlikely. While property sales and land markets have improved, they have yet to show extreme exuberance. Developers' overall tone remains pretty cautious and selective. At the same time, positivity on the sector is likely to be a result of a spill-over from monetary loosening in the general economy and other related industries, rather than targeting at the property sector.

Onshore and offshore financial markets providing lifelines. The cash collection cycle from onshore mortgage banks has reverted to normal, ie, 6-8 weeks. Onshore construction loans are also accessible at a slightly lower premium to the PBoC rate for most developers. Meanwhile, interest rates on trust loans have declined, although the availability of funding means developers are less likely to use this option in the near term. The offshore bond market is now open to the sector, with more marginal or maiden issuers likely to come to market. Offshore banks are also now more wiling to provide offshore loans to higher quality developers.

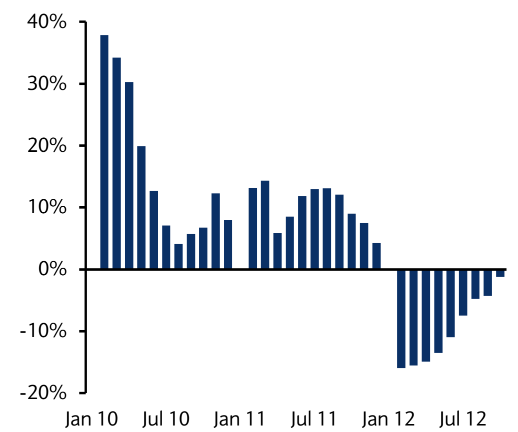
Robust bond supply. We expect bond supply from developers to be robust in 2013. This is potentially driven by increased land acquisitions; A-share China incorporated developers using structures similar to Gemdale; refinancing needs in 2H 13 and 2014 and; the callability of some bonds in 2H 13. But given stable to improving credit fundamentals and strong bond market technicals, we do not see this as a material risk.

Yield by sector (%)



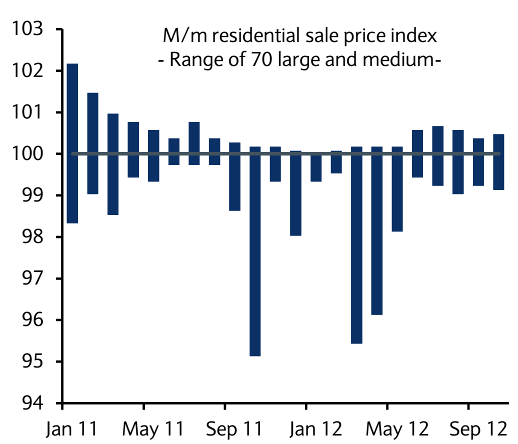
Source: Barclays Research

Volume stabilizing, YTD gross floor area (%, y/y)



Source: CEIC, NBS

Less volatility in property prices



Source: CEIC, Barclays Research

ASIAN HIGH YIELD TELECOMS & UTILITIES – MARKET WEIGHT

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Key recommendations

Overweight Bakrie Telecom '15s. Improvements to earnings and credit metrics appear to be on track, although liquidity remains weak. We think these improvements are supportive of a higher bond valuation, although issues at the broader Bakrie Group will continue to weigh on the BTELIJ '15 bonds in the near-term. But bond valuations offer a significant margin of safety; we estimate >13% YTM in a hypothetical restructuring scenario with 50% haircuts to principal and coupon, and a 5y tenor extension.

Sector outlook

Riding the data wave. Rising data penetration is seen driving earnings growth for Indonesian telcos. The *Jakarta Post* reported that smartphone penetration is only 10% in Indonesia. However, the country is already the second largest Blackberry, Facebook and Twitter market globally, according to PT Telkom; Indosat reported its 3Q12 data usage grew 60% y/y. Capex may rise as operators cope with the growth in data demand.

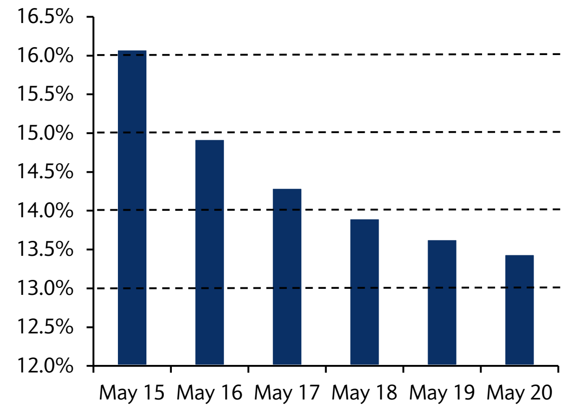
Tower sale and leaseback to continue. We expect Indonesian telcos to continue monetising their tower assets in order to raise shareholder returns, deleverage and fund capex. Credit profiles should be stable or marginally improve as a result. We think tower operators may issue USD bonds to fund such purchases. For example, the parent of tower operator Protelindo is seeking shareholder approval for Protelindo to sell USD750mn of bonds.

Consolidation hopes remain elevated, despite continued disappointment. Telecom markets can usually only support 3-4 operators due to high capex and scale economies. Indonesia's CDMA market looks ripe for consolidation, although it appears that Telkom Flexi has no interest to do so nor Bakrie Telecom the financial wherewithal to acquire smaller operators.

Constructive on pay-TV fundamentals. A low penetration rate (c.6%) and strong economic growth will continue to drive pay-TV expansion with industry sales likely to rise close to 30% y/y. We expect industry profitability to further improve as subscribers rise.

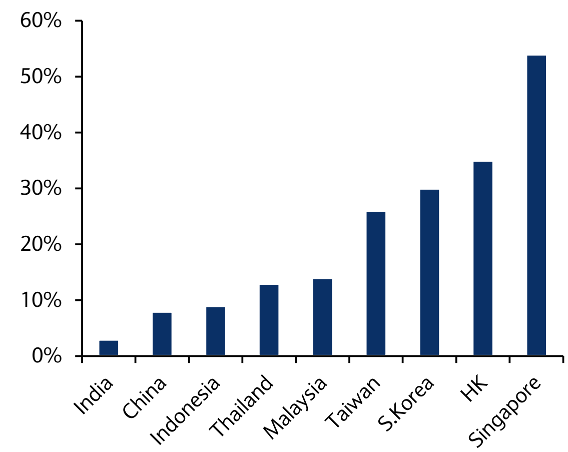
Positive outlook for IPPs; bonds' upside capped. Cikarang and Star Energy's fixed price contracts should ensure earnings will at least remain stable in the near term. Earnings growth will likely continue for Cikarang as demand from industrial customers is likely to rise on increased investments. Upside on bonds by both issuers, however, looks limited. The Cikarang '19s (Underweight) are among the tightest yielding Indonesian corporate paper. We expect Star Energy (Market Weight) to call its bonds in early-2013. The price of the bonds largely reflects this expectation.

BTELIJ '15s YTM assuming 50% haircut to principal and coupon under various tenor extension scenarios



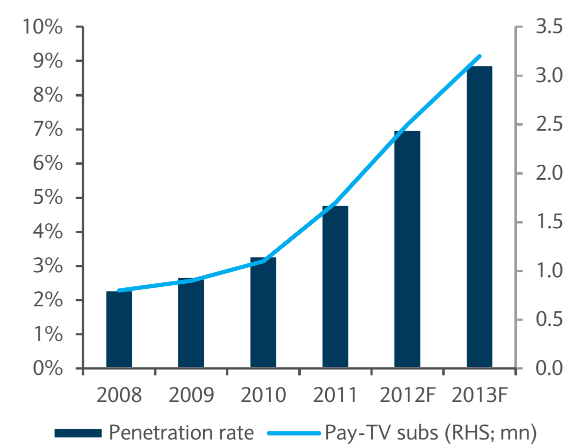
Source: Barclays Research

2011 smartphone penetration in Asia



Source: TomiAhonen Consulting 2011

Indonesian pay-TV sector – strong growth expected



Source: MPA, Barclays Research

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Emerging Europe, Middle East and Africa sector outlooks

CIS OIL AND GAS & QUASI-SOVEREIGNS

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Key recommendations

We recommend taking exposure at the short end of the Russian quasi-sovereign curve via Gazprom 16s and 18s. Issuance risk among Russian corporates in 2013 may put pressure on longer-dated spreads, and investors can take advantage of the flatness of the Gazprom curve, which trades relatively wide to both its own sovereign and quasi-sovereign peers. **We also see good value in Russian Rail 2017 bonds**, which have scarcity and diversification value and benefit from the group's solid fundamental profile.

New issuance may provide a better entry point for KMG. The outlook for the Kazakh economy remains robust and bonds well supported due to a lack of sovereign paper. However, KMG has hinted that new issuance is on the horizon in 2013, which may offer a better entry point. We see better value in DOLNRG 21s over KMG 20s and 21s at current levels.

Sector outlook

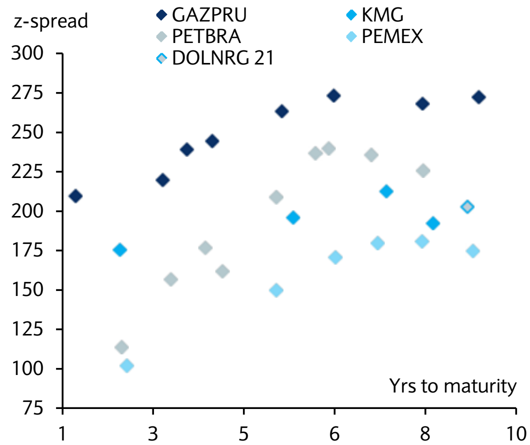
Privatisation continues to be a theme, as the Russian government is considering a 5% stake sale in Russian Railways in 2013, as well as stakes in others such as Sovcomflot. We expect state support for quasi-sovereign entities to remain high, although technical risk is an overhang for Rurail and Sovcomflot, given the inclusion of USD bonds in selected sovereign indices. Sovcomflot also remains vulnerable due to weak industry conditions, with shipping rates falling again in H2 12. In Kazakhstan, a part-stake sale of Intergas's parent, KazTransGas, appears to be on the agenda in 2013 and could lead to technical risks for Intergas bonds.

The oil and gas pricing outlook continues to be solid. Our house forecast is for Brent to rise to $125/bbl in 2013 from an average of $113/bbl in 2012 and for European gas hub prices also to trend higher (+9% y/y) as new regulations for coal put upward pressure on gas demand and pricing. While Gazprom long-term contract prices remain under pressure, we see this outlook for hub as cushioning downside price and volume risks for the company.

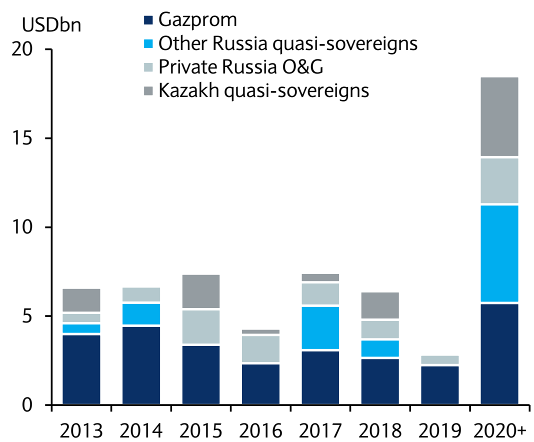
Maturities remain light but issuance risk remains amidst consolidation in oil and gas. We expect Gazprom to tap the market only for refinancing, and cash flow remains strong across the sector. However, wider issuance risk across the Russian oil & gas sector is likely to remain an overhang into 2013, and we also expect Russian Rail to seek new issues to fund capex spending.

Loan participation notes are set to be included in the Barclays Global Aggregate index from beginning of the second quarter in 2013. Bonds to be added include Gazprom, Sberbank, VTB and VEB, among others. We see this as a marginal positive for such bonds, given that this change is likely to attract additional investment flows.

CIS quasi-sovereigns versus peers



Eurobond maturity profile – CIS IG/quasi-sov.



Barclays Global Aggregate Index eligible bonds

Ticker	Issuer	# of bonds	Mkt value ($bn)
GAZPRU	Gazprom	17	22.7
MOSCOW	City of Moscow	1	0.6
NVTKRM	Novatek	2	1.4
RSHB	Russ. Agricult. Bank	5	4.7
RURAIL	Russian Railways	2	2.8
SBERRU	Sberbank	5	5.9
TNEFT	Transneft	1	1.3
VEBBNK	Veb Finance	5	5.6
VTB	VTB Bank	6	7.4
Total		**44**	**52.4**

Note: Please see *Index Announcement: Index Changes Resulting from Barclays Annual Index Governance Review*, 5 November 2012. Source: Barclays Research

CIS METALS AND MINING

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Key recommendations

We see further downside risks to the CIS metals and mining sector and prefer to take HY exposure via telecoms. There is a risk that earnings will disappoint and lead to further underperformance, and the fundamental outlook for the steel sector remains sombre.

NLMK and Severstal provide the most defensive mining exposure, given relatively low leverage (c1.7x net). We also think Russian steel offers good value relative to global peers. Evraz bonds have already priced in the industry weakness significantly and currently trade at two-year wides (c.150-190bp in 5y) to Severstal and VIP, although they could underperform, given their higher beta.

Sector outlook

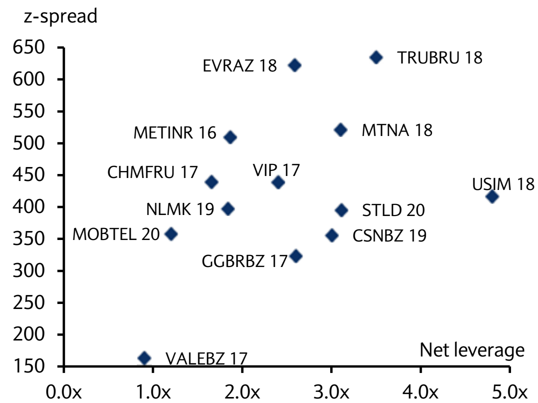
Industry trends points to a cautious outlook. The global steel sector remains plagued by overcapacity, and although recent price falls appear to have bottomed out, the demand outlook remains sombre given weak global growth trends and Russian steel firms have guided to a cautious outlook for 2013. Positively, the World Steel Association forecasts relatively stronger 3.9% growth in CIS steel consumption, versus only 3.2% globally, which should compliment the increased focus on domestic rather than export markets among Russian firms.

Russian firms more resilient than peers. Due to their position on the cost curve, Russian operators remain relatively resilient in the global context. Producers are likely to reduce capex to the maintenance level in order to deliver at least neutral cash flow generation. Nevertheless, free cash flow is likely to be limited, leverage will continue to rise given the reporting lag, and the liquidity position of Russian firms is weaker than global peers relative to short-term debt.

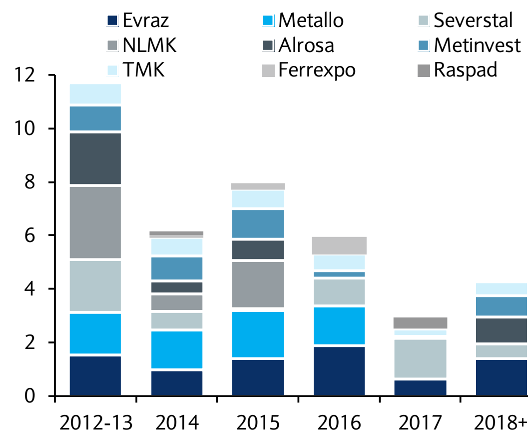
Little headroom to increase debt load or conduct M&A. Supply is to be limited to opportunistic issues addressing refinancing and/or liability management exercises. Given the cautious outlook and focus on organic growth, sizeable M&A seems unlikely. Divestment by global competitors, however, may increase the appetite for those with a stronger liquidity position or historically aggressive M&A background.

Sovereign factors more important for bonds of Ukrainian metals & mining companies. Our sovereign strategists hold an underweight recommendation on Ukraine. Although recent Eurobond issues have eased immediate liquidity concerns, the divisive political environment is not supportive of unpopular economic reforms and prospects of a resumption of IMF support remain uncertain. Positively, the steel/mining sector is export-oriented and set to benefit from the currency devaluation we expect in 2013, but sector headwinds remain.

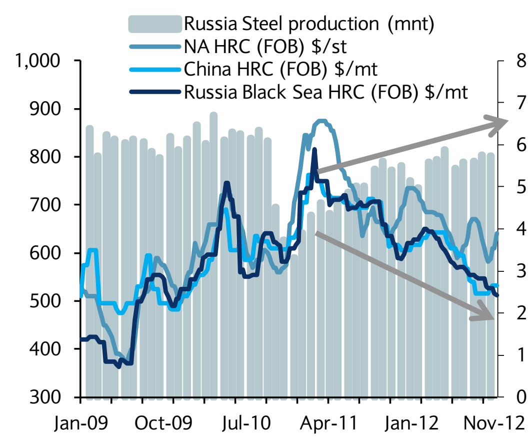
Russian metals & mining bonds trade cheap to peers, but absolute downside risk remains



Debt maturities schedule as last reported ($ bn)



Steel production growth remains vulnerable as spread between price and cost diminishes



Source: Company reports, Bloomberg, WSA, Barclays Research

RUSSIAN TELECOMS

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Key recommendations

We prefer to take high yield exposure in Russia via telecoms, rather than steel. Telecoms operators deliver solid free cash flow and exhibit low earnings volatility, while weak industry conditions could lead to further underperformance of issuers in the steel/mining sector.

Vimpelcom '17 is our preferred bond, given the 200bp pickup over investment grade bonds, 4.5y maturity and well-known refinancing risks in relation to Wind. Our base case is that VIP seeks to refinance debt at Wind and highlight the Overweight recommendation of our high yield colleagues on the Wind senior secured and subordinated notes (see page 211). We also recommend a switch from Severstal '16s and '17s into VIP '17s.

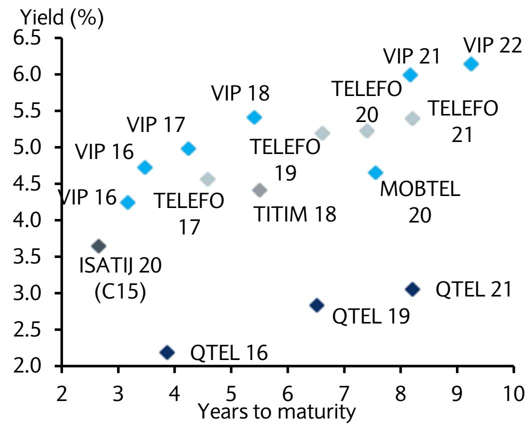
Sector outlook

Defensive sector with attractive bond yields. Our equity colleagues project fairly stable EBITDA for VIP and MTS, which we think is positive news for bondholders. While they see limited real growth in earnings, operators continue to generate free cash flow and have made progress on improving margins, driven by reduced dealer commissions. The expect steady FCF growth between 2012 and 2014 for VIP and MTS, from c.$2bn to $2.7bn and from c.$1.4bn to $2.0bn, respectively. As a result, net leverage should meaningfully improve for Vimpelcom by 2014 to c.2.1x (FY12: 2.5x) and remain low for MTS at 1.1x (FY12: 1.3x).

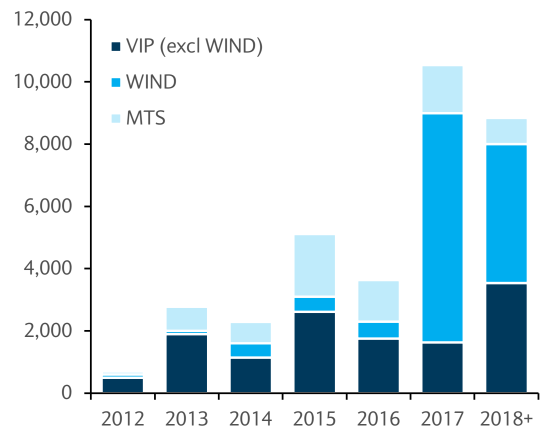
Debt maturities and refinancing. 2013 is the crunch year for Vimpelcom as bonds of its Italian subsidiary, Wind, become callable. Management has indicated its intention to address the capital structure in 2013 and 2014, and our base case is that VIP refinances debt at Wind, perhaps via new Wind bonds with a Vimpelcom guarantee, lowering interest costs across the group while limiting technical pressure on Vimpelcom's own curve. This could raise ratings risk for VIP, although Moody's and S&P see the long-term benefits of such refinancing and group leverage would remain unchanged. Vimpelcom also has $800mn of Eurobonds maturing in April 2013, which it may choose to refinance in the bond market.

Outlining risks on earnings. CIS telco operators cover a vast territory, and most regions are highly saturated with operators seeing mid-single-digit growth. Russian operators have, on average, achieved a 3pp y/y increase to 24% of value-added services in revenue, of which the fastest growing component was mobile internet, although a meaningful offset to flattening voice revenue is likely to take some time. Also, planned MTR cuts affecting WIND could particularly weigh on VIP performance. However, the market position and profitability of existing operations remain strong, providing a cushion to these challenges.

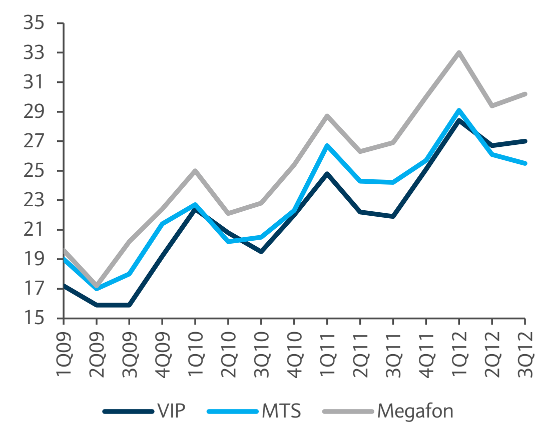
CIS Telecoms offers attractive yield among peers



Debt maturities schedule as of 9M2012 (USD mn)



Russia mobile-data revenue as percentage, %



Source: Barclays Research

DUBAI QUASI-SOVEREIGNS

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Key recommendations

Dubai BBBs are the most attractive of the GCC corporate universe, in our view. MAF, DP World and DEWA have solid stand-alone fundamentals, excellent liquidity positions, reduced reliance on external funding and strong technical support, as well as diversification opportunity away from euro area and other macro risks.

We recommend DUBAIH and JAFZ bonds in the Dubai high yield space. We believe that the Dubai property sector offers some interesting opportunities. While DHCOG has some legacy issues, and most importantly does carry more refinancing risk than Emaar, we do not believe a 230bps differential is justified. **We continue to view DHCOG as the most attractive name in Dubai from a risk-return perspective.** We would also **switch out of Emaar 19s into JAFZ 19s** (both sukuk) as we believe JAFZ's paper offers better structure as well as the good fundamental profile and simple, lower-risk business model, despite the company's higher leverage.

Sector outlook

Dubai Inc. restructuring is nearing completion with the repayment or refinancing of the "stressed" capital market debt of DIFCI, JAFZ and DUBAIH and loan restructurings of Drydocks, Limitless and Dubai Holdings during 2012. Importantly, no Dubai Inc. capital market debt was restructured through this process.

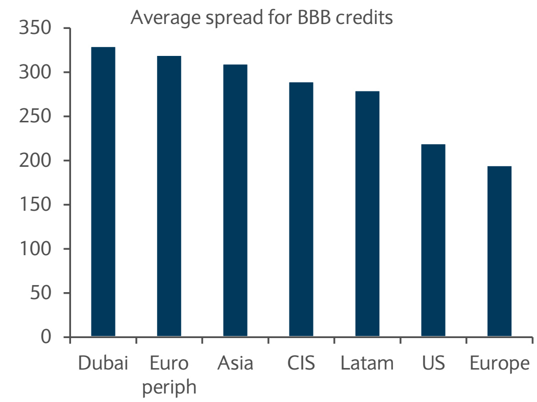
The 2013 and 2014 Dubai Inc. maturity schedule is light, with only c.$3.5bn of bonds maturing in 2013 (almost exclusively local currency) and c.$3bn in 2014. Foreign currency bank debt due in the two years totals $5.5bn and $1.7bn, respectively (this excludes the $20bn support package from the UAE central bank and Abu Dhabi banks, which we expect to be extended).

Dubai's economy is expected to grow 4.5% in 2012, according to upwardly revised projections by the Dubai Economic Council, driven by strong trade and tourism sectors. With most of Dubai Inc's corporate bond issuers coming from the trade, hospitality and property sectors, they are the key beneficiaries of the above trends.

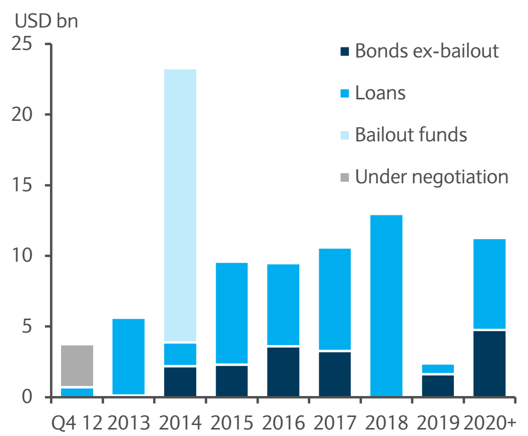
Improved technical picture, in addition to the decline in the absolute amount of borrowing. We have seen a shift towards local markets as the most important source of funding, suggesting a more stable funding base. GCC corporates in general have the lowest correlation with global macro drivers of all EM issuers, which partly reflects this trend.

Scarcity value increasing given limited supply from Dubai based issuers.

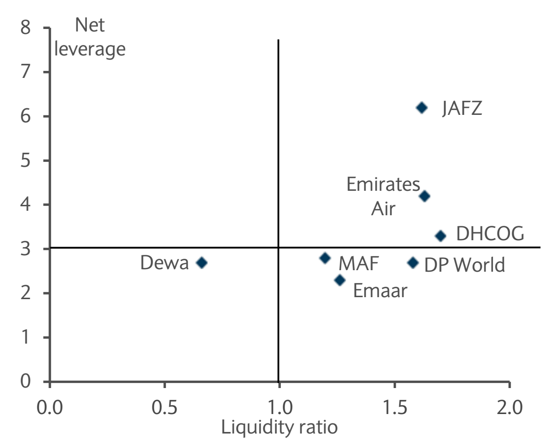
Dubai BBBs are attractive versus other regions



Dubai debt restructuring addressed



Solid fundamental picture



Source: Barclays Research

ABU DHABI QUASI-SOVEREIGNS

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Key recommendations

In the high-quality quasi-sovereign sectors, we think that room for further spread compression is limited and that absolute spread levels make the risk/reward profile tilted to the downside.

Dolphin Energy remains our favoured name in the sector based on its strong fundamental profile and project finance structure. **We prefer Mubadala to IPIC and Taqa,** given the relatively small pick-up that the latter names offer compared to recent history and Mubadala's arguably closer links to the sovereign.

We continue to view **Aldar** as an attractive short-dated hold to maturity trade. The Aldar 14s offer a potential 200bps pick-up versus the TDIC 14s.

Sector outlook

Abu Dhabi quasi-sovereigns' credit quality is fully reliant on government support given the weak stand-alone fundamentals of the issuers. To illustrate the latter, we estimate negative cash generation for the five biggest Abu Dhabi Inc. bond issuers of -$62bn for the 2008 – 2012 period. Notably, Abu Dhabi Inc. entities (including banks and the government) have issued c.$43bn of bonds in the same period, which have been one of the major sources of funding the spending.

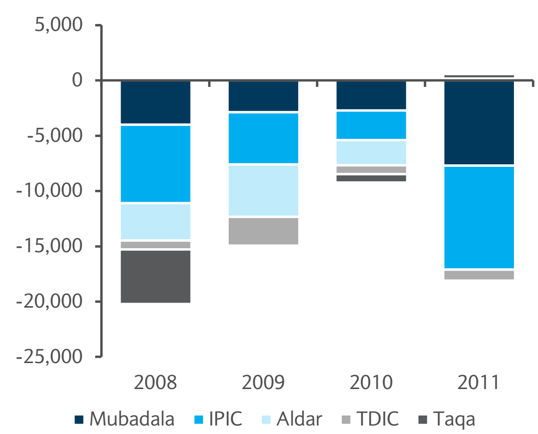
The Abu Dhabi government seems torn between its desire to control spending on one hand and stimulate economic growth, especially in the non-hydrocarbon sector, on the other. The Abu Dhabi department of Economic Development recently downgraded its growth expectations for 2012 to 3.9% from 4.5-5%.

The perceived likelihood of government support has increased over the past year after the government stepped in to support Aldar, the weakest member of Abu Dhabi Inc, by committing a total of c.$10bn of funds, thereby setting an important precedent. This has led to convergence in the trading levels between the Abu Dhabi quasi-sovereigns.

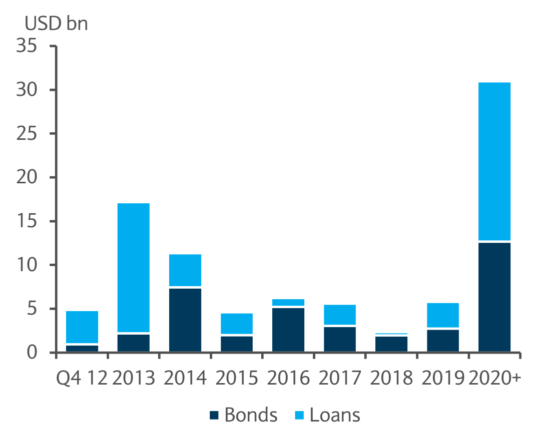
Current high oil prices leave little doubt about the government's ability to support the corporate sector. Our commodity analysts forecast Brent at $125/bl in 2013 and a rise to above $180/bl before the end of the decade. If their expectations are met, there is little to be concerned about with regards to the Abu Dhabi's quasi-sovereigns, in our view.

Abu Dhabi quasi-sovereign issuers' bond spreads have converged

Abu Dhabi Inc. corporates' negative cash flow



Non-bank FC market debt maturity profile



Source: Barclays Research

QATAR QUASI-SOVEREIGNS

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Key recommendations

We see little value in Qatari quasi-sovereigns at current levels. We prefer the corporate sector, and particularly **Rasgas**, to the sovereign for several reasons including proximity to the cash, stronger technicals and lower supply risk. We think the Rasgas 2019 bullet paper offers the best value on the curve.

Sector outlook

We view the gas market as the most important driver for Qatar Inc. Our commodities team expects the global LNG market to become increasingly tight over the near term, as demand increases faster globally than supply additions come online, thus pushing spot LNG prices up. The main risks to Qatar and Rasgas in this tightening environment relate to: 1) contract renegotiations given the difference between US Henry Hub, European and Asian pricing; and 2) faster-than-expected commissioning of liquefaction terminals, reversing the tightening demand/supply balance earlier than expected.

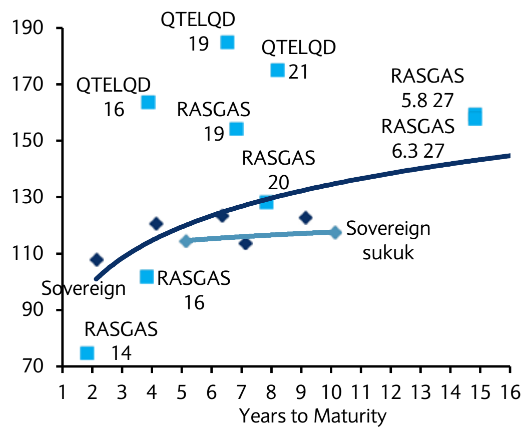
Regarding the first point, Edison announced in September that it won an arbitration case against Rasgas and the award will have a EUR450mn positive effect on its EBITDA. The obvious danger is that this sets a precedent for other customers of Rasgas to follow. In the short term, we do not expect these developments to have significant impact on Rasgas' bond prices given the low gas price break-evens and bondholders' priority position in the cash waterfall. In addition, while these are significant amounts their materiality reduces in the context of Rasgas' overall cash generation. However, they do highlight the downside risk to Qatar's long-term gas revenues, in our view.

We think that as of 2015-16, as the gas market returns to a loosening mode, the issue of pricing will become more important for Qatar to manage.

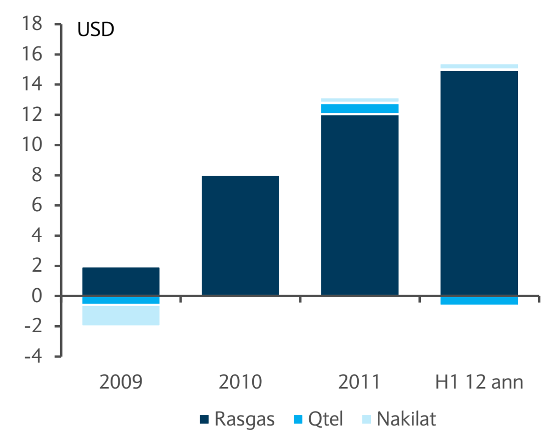
Qatar's effort to diversify away from hydrocarbons has created different challenges, as highlighted in Qatar Credit: Pressure points, 20 August 2012. As Qatar has progressed with its growth and diversification strategy, financing challenges are coming to the fore more forcefully. Recent expansion in credit to the public sector has severely tightened liquidity conditions in the local banking system, leaving few options for Qatar other than increasing its reliance on capital markets to finance its growth and diversification strategy both at home and abroad. Against this background, we believe Qatar is likely to further increase its efforts to access external financing, thus exposing itself to potentially disruptive market risk factors.

While we expect significant issuance out of Qatar in 2013 and beyond, we believe the majority of this will remain concentrated at sovereign level and the banking sector.

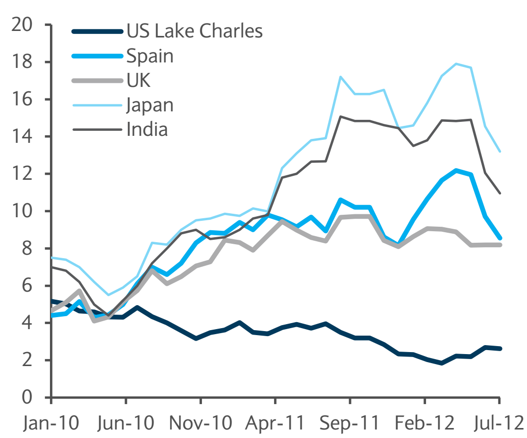
Qatar bond universe



Qatar Inc. issuers' cash generation



Future LNG price trends are key for the Qatar economy



Source: Barclays Research

CIS INVESTMENT GRADE BANKS

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Key recommendations

We see value in CIS IG financials, especially for investors looking for the highest yield among EM IG credits. CIS IG financials are mainly quasi-sovereign and policy banks of Russia and Kazakhstan. Their credit fundamentals remain solid, backed by the strong financial position of sovereigns and relatively strong growth rates of domestic economies. 2012 evidenced substantial debt supply from Russian IG banks, which we think will change in 2013 as loan growth moderates.

We recommend the bonds VTB, Gazprombank and Bank of Moscow as the highest yielding instruments in CIS IG space, trading 300-500bp in z-spreads, or more than 250bp over sovereign. **We also see value in Sberbank,** trading 150-200bp over sovereign and providing exposure to the strongest credit fundamentally among CIS financials. We also think the limited trading liquidity of DBKAZ bonds does not justify their 130bp spread premium to other Kazakh quasi-sovereign credits in the long end.

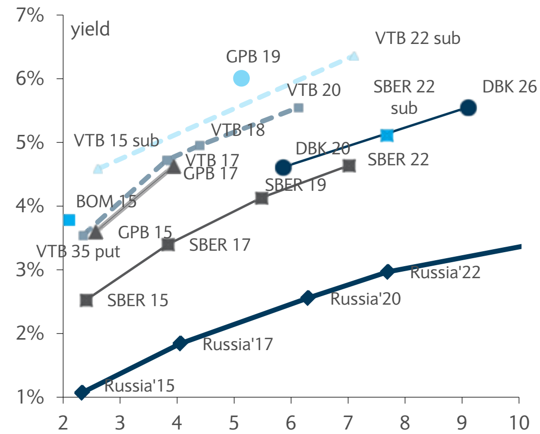
Sector outlook

State support is the key strength factor for CIS IG banks, and it remains intact. Both Kazakh and Russian state are net beneficiaries of strong oil price environment, with roughly balanced budgets, low debt and strong sovereign cushions. Sovereign balance sheet strength translates directly into the credit strengths of policy bank credits. For Russian quasi-sovereign banks that are on the privatisation list, state support is warranted by their systemic scale for the banking sector and the economy, in our opinion.

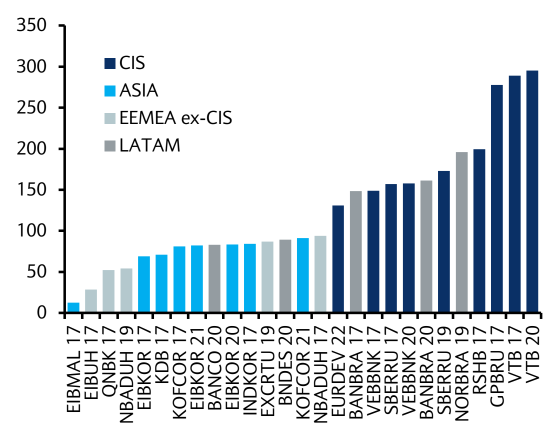
Slower debt issuance by Russian banks possible in 2013 (versus c.USD24bn YTD at Nov-12). We expect a slowdown in organic and non-organic expansion. The proximity of current capital to the required minimum, together with further regulatory changes in capital/RWA regulation, will force banks to moderate lending. In our view, 2013 loan growth at 15-18% (versus 20-25% y/y in 2012) can be mostly funded with domestic deposits, as positive real saving rates and potential improvements in cross-border capital flows should be supportive of deposit growth at likely above 15% y/y next year.

However, supply risk does not disappear completely as historically low yields will lure the banks to at least replace maturing debt (c.USD10bn in 2013). The need in Tier-1/Tier-2 capital will also make banks borrow from external markets, given the limitations for subdebt issuance domestically. At the same time, starting from 2013, new subdebt will have less credit protection due to a required non-viability loss absorption clause. In our opinion, this will gradually result in the scarcity value of currently outstanding subdebt.

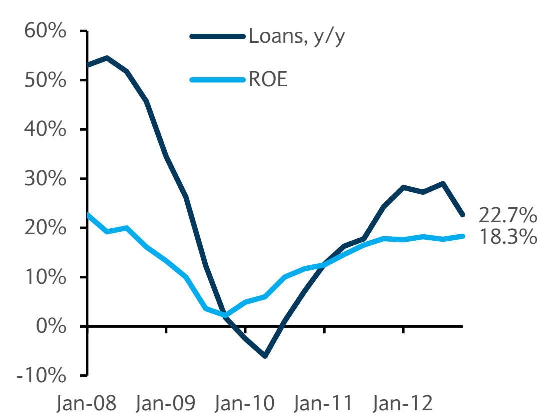
Selected bonds of CIS IG banks



Spread to sovereign of EM quasi-sovereign banks



Slower lending will slow supply from RU banks



Source: Bloomberg, Barclays Research

CIS HIGH YIELD BANKS

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Key recommendations

Russia's Alfa-Bank and domestic retail-focussed banks remain our favoured credits among CIS HY financials. The positive momentum in Alfa-Bank's credit continues. We believe it could be upgraded to IG, while the already strong financial position of Alfa's shareholders looks set to be boosted further by the sale of its stake in TNK-BP. The re-rating of Alfa's credit can result in 100bp spread tightening, in our view. We see value in the bonds of Russian Standard Bank (RSB) and Home Credit and Finance Bank (HCFB), which offer yields of 8-10.5%. The changes in regulation of consumer finance banking should eventually result in more balanced growth of the specialised lenders and restore their equity cushions, in our opinion.

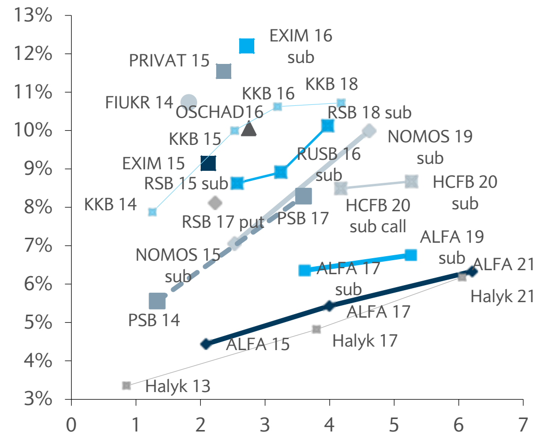
We recommend selling Ukrainian bank credit in light of increasing UAH devaluation pressure, very tight domestic liquidity conditions, a continuing decline in the NBU's FX reserves and weak economic growth. Since June, Ukrainian banks' debt has tightened more than 300bp in spreads, moving very close to where similar and higher-rated Russian/Kazakh bank bonds trade now.

Sector outlook

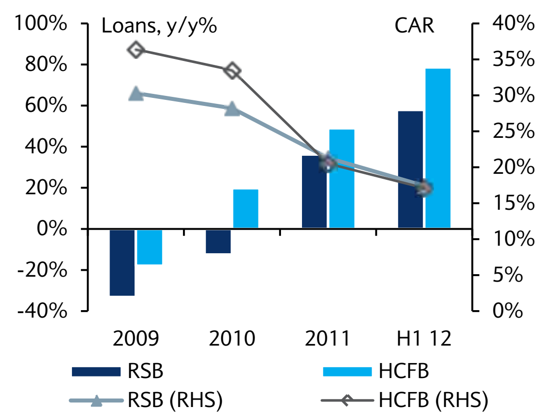
Russian consumer finance industry fundamentals remain strong, but rapid lending growth has raised concerns recently. We think higher domestic requirements to provisioning and risk weightings on unsecured consumer loans from 2013 should force specialised banks to eventually lift their CAR level by 200-400bp under Basel I. Relatively strong earning power (25-40% ROE) should allow banks to recapitalise internally, in our opinion. However, this will require banks to moderate their aggressive loan growth and dividend policies. Slowed borrowing also seems likely given the availability and healthy dynamics of domestic retail deposits, which has gradually turned into the key resource for consumer finance banks (LDR at 105% for RSB and 127% for HCFB at H1 12).

UAH devaluation pressure is growing, challenging domestic banking sector asset quality and funding, similar to 2008-09 trends. About 37% of total loans to domestic economy remain FX-denominated, and their quality is unlikely to remain resilient to the UAH decline, in our opinion. The growing expectations of a UAH slide have already been limiting local currency deposit growth and pushed interbank rates to their highest post-crisis level. At the same time, decreased FX reserves mean that any systemic support from NBU can be limited this time around.

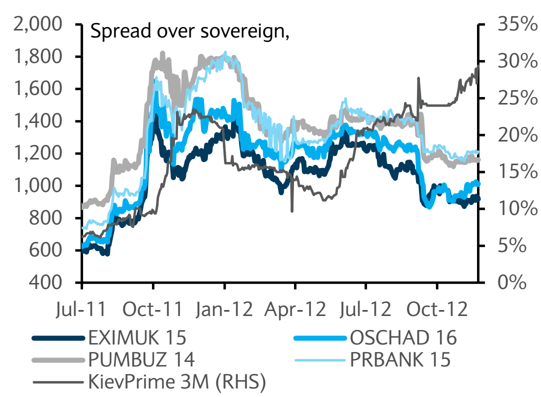
Selected bonds of CIS HY banks



Slower consumer lending to restore banks' equity



Ukrainian bank spreads tighten, while domestic liquidity deteriorates meaningfully



Source: Bank reports, Bloomberg, Barclays Research

GCC BANKS

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Key recommendations

We recommend a neutral position on GCC bank senior bonds. While we believe the sector screens cheap relative to other high grade EM banks such as Korean banks, strong debt issuance supply in 2012, as well as high regional geopolitical risks could limit bonds near-term price upside, in our view.

However, we think some bonds such as Burgan '20s subs (yielding 5.6%), Tamweel '17s (3.9%), NBAD '16s AED convertible (3.9%) and ADIB '18s tier 1 sukuk (5.5%) still offer value relative to peers and to senior debt/sukuks issued by same name/guarantor.

Sector outlook

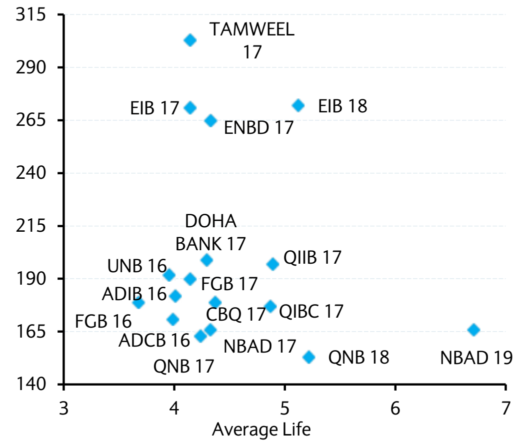
Funding/liquidity: We expect GCC banks' funding profiles to remain generally unchanged during 2013. Saudi, Kuwaiti and Bahrani banks will likely retain comfortable funding profiles as reflected by loan-to-deposit ratios (LDR) well below 100%. UAE and Oman LDRs are likely to be 95-102%. Qatari banks' funding stories will depend on government appetite for credit. A repeat of 2012, when loan growth outpaced deposit growth, could lead to further funding strains, particulary as banks increase exposures to market funds/interbank deposits (with the latter reaching about 34% of liabilities).

Asset quality: We expect Saudi, Qatar and Omani banks' 2013 aggregated NPL ratios to remain low thanks to a stable operating environment and strong credit expansion. Bahraini and Kuwait banks' asset quality performance, on the other hand, will largely depend on the evolution of political events in both countries, as well as the amount of government spending. In the UAE, the completion of most large corporate debt restructurings, the AED10bn fund set up by government to bail out distressed UAE national borrowers and the rebound in key Dubai economic sectors should help lower asset quality pressures during 2013 (helping stabilise the system NPL ratio at close to 8%).

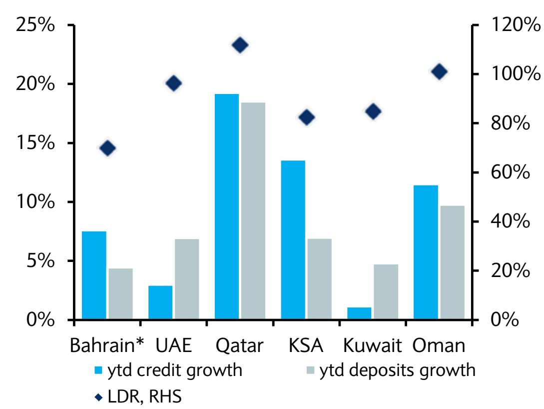
Capital: Most, if not all, GCC banks' capital ratios already surpass the Basel III minimum capital thresholds due to be implemented in 2015. Moreover, we expect GCC central banks to maintain stricter regulatory capital requirements than Basel III rules as current local regulatory requirements already exceed Basel II rules (ie, min Basel II tier 1 ratio and CAR of 4% and 8%, compared with current minimum GCC regulatory requirements of 8% and 12%, respectively).

We expect GCC bank debt issuance to remain strong. The prevailing low credit spreads could encourage more GCC banks to tap debt capital markets in 2013. We expect more BBB and BB rated institutions to issue bonds/sukuk, while current issuers could issue T1/T2 (particularly after ADIB T1's strong reception) or bonds with longer maturities.

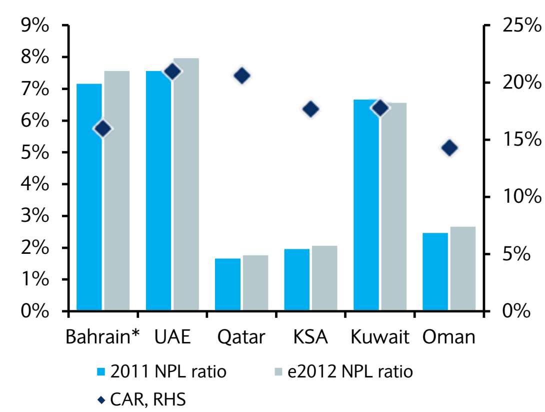
GCC banks' senior bonds/sukuk z-spreads (bp)



GCC banks' loans and deposits growth (Sep-12)



GCC banks' asset quality and capital indicators



*includes retail banks only. Source: GCC central banks, Barclays Research

TURKISH BANKS

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Key recommendations

We think that some Turkish banks bonds still offer some value but watch out for the strong supply expected for 2013. Despite the strong bonds performance during 2012, some Turkish bond spreads may have further room to tighten in the near term given further upgrade expectations and the related broadening of Turkey's investor base. We think strong international cash inflow into that universe is likely to continue.

However, within the EM IG space, we think Turkish banks spreads are getting closer to those of Brazilian banks and are starting to look expensive relative to Russian banks. We believe the strong Turkish bank debt supply expected for 2013 (which could significantly exceed that of 2012 of about USD9bn) could eventually constrain bonds' price upside over the course of 2013.

Our favourite picks are Vakifbank '17s and Halkbank '17s. Both trade at attractive levels relative to peers, are underpinned by good credit profiles and benefit directly from the sovereign upgrade given their majority government ownership.

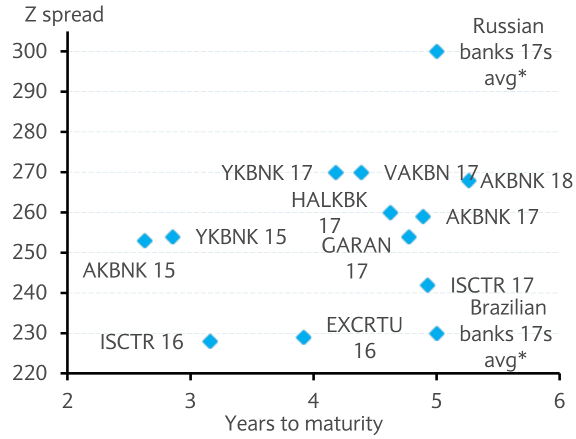
Sector outlook

Asset quality: The Turkish banking system NPL ratio, having reached 3% in 2012, is likely to continue its 'slow ascent' during 2013 driven by loan book seasoning. However, we expect the stable operating environment (underpinned by low unemployment levels) and active impaired loan write-offs to keep aggregated banks' NPL ratios within good norms during 2013 (at 3-3.5%).

Funding: We expect moderate credit growth in 2013 to keep Turkish banks' loan-to-customer deposit ratios steady. The key challenge to funding remains their large interbank exposure (namely owed to foreign banks), which could be affected by external factors such as more aggressive EU banks deleveraging/potential LTRO pull-out. Strong debt issuance and moderate business growth in 2012 have helped banks arrest the growth in 'due to foreign banks' and extend their liabilities' maturities. We expect this trend to continue in 2013, particularly if market conditions remain attractive.

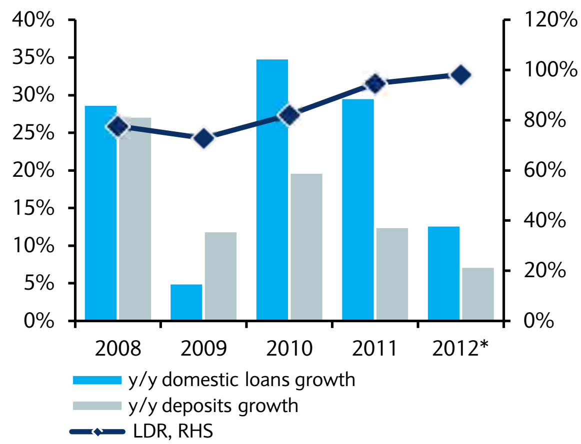
Capital: Basel II rules implementation in 2012 had a modest effect on banks' capital adequacy ratios, while slowing credit growth during the year helped banks maintain steady capital bases. We expect little change in capital level during 2013, with commercial banks' CAR likely to remain at about 15.5%, aided by the strong internal capital generation as well as moderate business growth. Moreover, more Turkish banks could tap the subordinated debt market if conditions remain attractive. This will allow them to enhance CAR further as well as their long-term funding bases.

Turkish banks' senior bonds Z-spreads (bp)



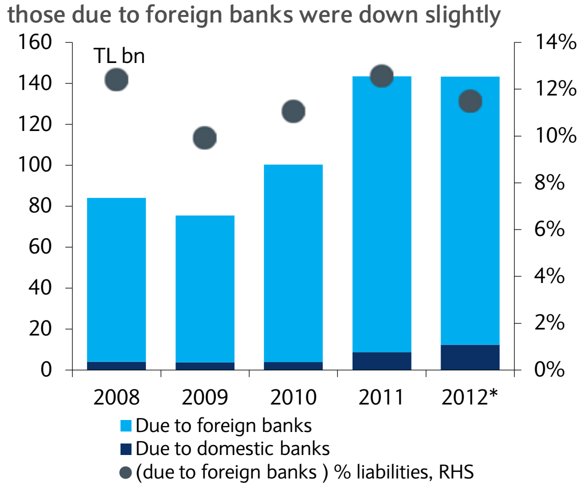
Note: *IG banks rated BBB/BBB+

Credit growth has halved during 2012 and the banking system's LDR is stabilising



* As of 30 September 2012

Interbank exposures steady throughout 2012 while those due to foreign banks were down slightly



* As of 30 September 2012 Source: Barclays Research

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Latin America sector outlooks

LATIN AMERICA FINANCIAL INSTITUTIONS – BRAZIL

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Key recommendations

We recommend subordinated debt issued by large cap Brazilian banks. We find this debt the most attractive as it trades 100bp wide to senior debt, and, in our view, this is more than adequate compensation for the subordination in the capital structure.

We favour Banco do Brasil, Itau Unibanco and Bradesco; specifically, we recommend Banbra 22s, Itau 22s and Bradesco 21s. These are the three largest Brazilians banks in terms of assets, with strong market share, and are well positioned to capture the Brazilian economy's growth and improved outlook for 2013. The federal-owned Banco do Brazil is our favourite name as is trades only 20bp tight to private-owned banks Itau Unibanco and Bradesco.

Sector outlook

Much improved economic growth outlook for 2013. For 2013, the Brazilian economy is forecasted to grow 4.1% compared to the lackluster 1.5% expected for 2012. This should help maintain unemployment at historically low levels, and we should observe an increase in real wages as the annual rate of inflation stays under control at 5.5%. Under these conditions banks should perform well, leading subordinated spreads to compress towards senior debt as investors focus on fundamental factors such as capital levels, asset quality and funding.

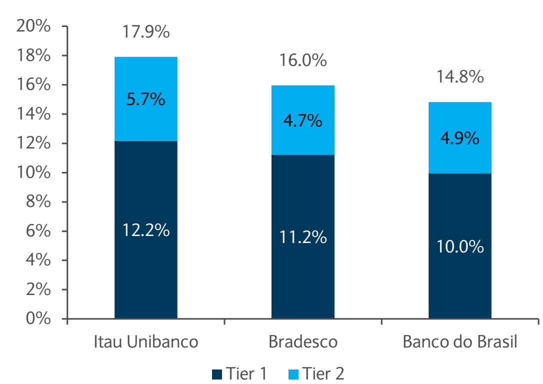
Well positioned for Basel III adoption. Basel III is expected to be implemented in Brazil beginning on January 1, 2013. We find large cap Brazilian banks well positioned for its adoption as Brazilian regulation is stricter in terms of capital requirements than Basel II (Brazilian minimum BIS ratio is 11.0% compared to the minimum BIS of 8.0% of Basel II and Basel III until 2015). **Nonperforming assets seem to have stabilized.** During 2012 non-performing assets have taken longer to stabilize than expected. Early delinquency rates for individuals most recent data show signs of improvement, while those of corporates have remained stable since May. We expect the improvement trend to continue during 4Q12 and be prolonged in 2013.

Supply outlook for 2013. During 2012 large cap Brazilian banks have issued as much Tier 2 Capital debt as possible since Basel III rules for Tier 1 Capital and Tier 2 Capital debt instruments are much stricter than Basel II rules, making them in theory more expensive. Basel III rules are expected to start on January 1, 2013 but the Central Bank of Brasil has not yet released the final rules; until then, it will be hard to predict supply for 2013.

EM Index vs. Brazilian Banks Sub.

Brazilian Banks Sub vs. US Financial BBB Index

Brazilian banks capital structure



Source: Barclays Research

LATIN AMERICA METALS AND MINING

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Key recommendations

In the mining sector, we prefer exposure to copper over iron ore and would express this through swapping out of Vale long bonds into SCCO long bonds. The Vale 10s-30s curve has recently flattened to c.55bp, while SCCO has steepened to c.120, and the SCCO long end still trades wide to Vale.

We remain cautious on the whole of the LatAm steel sector and find better value elsewhere (e.g., Votorantim and Odebrecht, two credits offering similar spreads but a much clearer short- and medium-term outlook; see "Latin America Real Estate, Cement and Infrastructure" section for details). However, within the steel sector, our order of preference is Usiminas followed by Gerdau (given the amount of deleveraging we are expecting as EBITDA should improve), while we are negative on CSN (increasing leverage).

Sector outlook

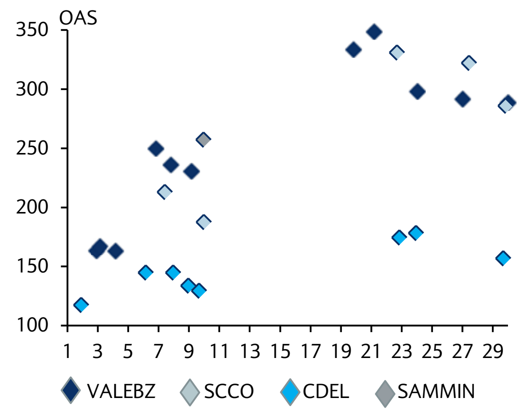
2012 has been a year of heavy issuance for miners as sinking metal prices coincided with heavy capex budgets. Bond issuance for the three largest LatAm mining issuers – Codelco, SCCO, and Vale – was 6x the amount issued in 2011 at $8.2bn. New issuers Volcan and Samarco added $1.6bn in issuance to the LatAm mining space as well.

After steep price declines, iron ore market participants concede that "exuberant prices belong to the past".[1] Base metals fell from 2011 highs, as global activity slowed and China growth decelerated. Copper prices are down 10% y/y, while iron ore is down a much steeper 23% y/y. Barclays 2013 estimates for copper and iron ore reflect the divergent performances this year: Barclays 2013 copper price forecast is 6% higher than current prices at $3.83/lb, and only 4% lower than 2011's prices. This compares to our forecast of c.$120-130 for 2013 iron ore prices, which is c.25% lower than 2011 average prices.

The outlook for the steel market remains difficult given large global oversupply and sluggish demand. **For flat-steel** (mainly CSN and Usiminas), despite our expectation for demand growth and government measures to reduce import competition, we expect pricing power to remain quite limited, driven by fierce domestic competition (evidenced by 3Q12 results), rising supply (Gerdau's new HRC line), and the political cost of price increases (government threats to eliminate tariffs). **For long-steel**, the competitive landscape is somewhat more positive (better demand trends and lower competition), but recent price increases limit room for additional ones. Gerdau stands to benefit the most from a potential additional BRL devaluation (FX translation effect of its US sub and better ability to pass-through USD-denominated costs to final prices).

[1]"Vale CFO says 'Exuberant Prices Belong to the Past" Bloomberg, November 21, 2012.

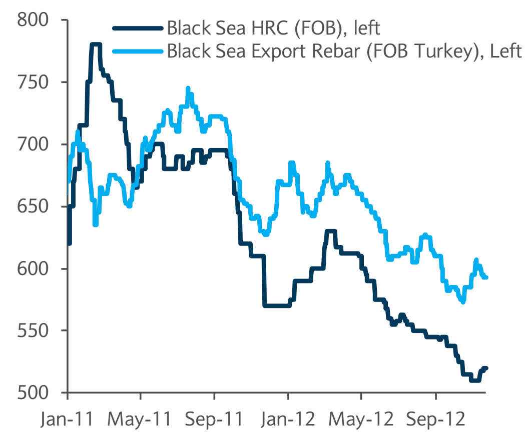
LatAm mining curves (OAS vs tenor)



Usiminas should deleverage the most in 2013

	Z-spread (bp)	Net leverage 3Q12	4Q12E	4Q13E	EBITDA 2013 (BRLmn) Barclays	Consensus	Barclays/ Consensus
Gerdau'21s	293	2.6x	2.7x	2.0x	5,542	5,995	-8%
Usiminas'18s	404	4.8x	4.4x	2.7x	1,610	1,999	-19%
CSN'20s	359	3.0x	3.5x	3.8x	4,736	5,782	-18%

Major steel price benchmarks in a difficult spot



Source: Barclays Research

LATIN AMERICA OIL AND GAS

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Key recommendations

We see room for selective tightening in IG bonds. We expect Petrobras once again to be the largest issuer in LatAm in 2013. Its $7bn of issuance in February 2012 led to several months of lacklustre performance, though the short end outperformed as the curve steepened. We expect a similar trend in 2013, though we see the '17s as offering more value. We expect progress on reform to be a positive catalyst for Pemex in 2013. Pemex must also prove it can start to increase production in 2013.

In HY, we still think it is too early to make a fundamental call on OGX. The ultimate level of flow rates at Tubarau Martelo will not be known until 2014, though more information about preliminary testing could move the market. The performance of new wells in the Tubarao Azul field could also be a catalyst for bonds in either direction. Pacific Rubiales appears to have a clear path to further production increases, and we expect the company and bonds to do well in 2013.

We like drillship bonds due to: 1) sole first-lien on valuable assets; 2) strong indentures with waterfalls and reserve accounts; 3) lease contracts that should produce stable revenue from a strong counterparty (mostly Petrobras); and 4) low to no contract renewal risk. We would continue to trade the space, as liquidity may allow, owning ODEBRE'21s and QGOGBZ'18s at flat yield to average life (after adjusting for the Treasuries curve based each bond's average life) spreads to each other and SCHAHN'22s some 75bp wide to ODEBRE'21s (due mainly to weaker insurance policies). We think OSX'18s are very attractive at current yield levels (6.7%), given low funding risk for construction of the asset and the large equity collateralization (30% now, 50% by 3Q12).

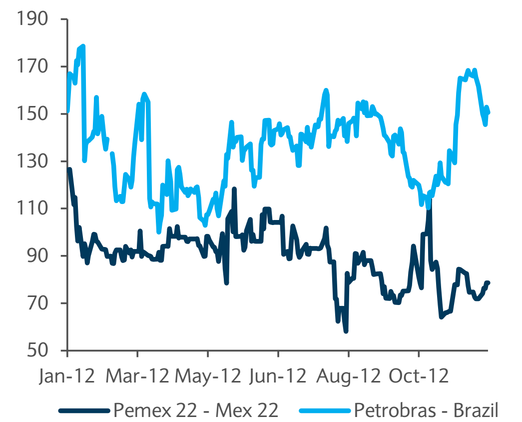
Sector outlook

Latin E&P companies remain in a dynamic period of growth. The big national oil companies are in the midst of huge expansion plans, with the hopes of surging production over the next five years. Combined with younger/smaller companies with huge potential, the region is poised to become a significant exporter of crude. We expect 2013 to be another year of investment and ground work with marginal increases in production, which should be more significant in 2014 and beyond.

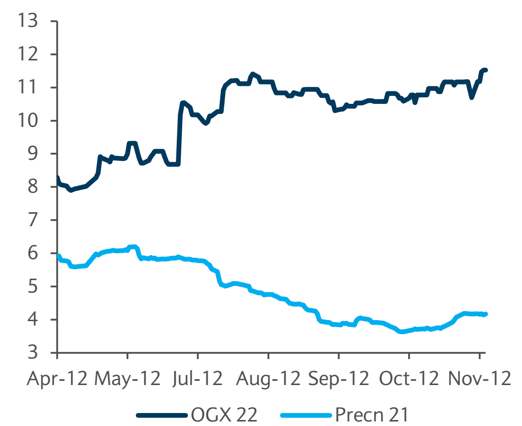
Reform agenda to play a key roll in Mexico. Reform was an important theme of the recent presidential election, and we believe the likelihood of meaningful reform has increased.

Significant supply is likely from Petrobras and Pemex, which both need to fund their capex plans. Higher gas prices in Brazil are likely, in our view, and would help Petrobras, but at least $10bn in issuance is still likely. We expect OGX to sell forward oil during the year, but additional debt is unlikely.

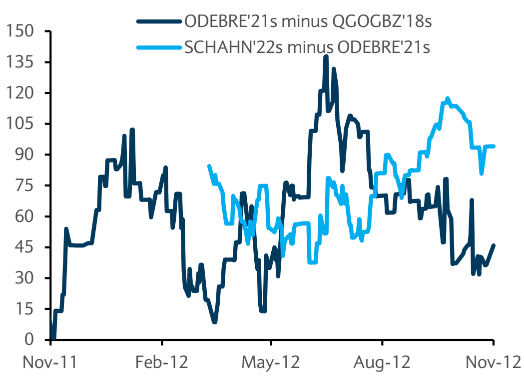
Pemex and Petrobras relative to sovereign (difference bp)



Pacific Rubiales has performed well, while OGX spreads remain elevated (YTW %)



Yield-to-average-life history (bp)



Source: Barclays Research

LATIN AMERICA TELECOM & MEDIA

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Key recommendations

In IG, we prefer Oi bonds. While Oi has not overcome all of its challenges, it has shown clear progress on its turnaround plan. We expect this to continue in 2013, which is not priced into the market. Oi offers attractive carry and upside potential over the medium and long term. We prefer Oi bonds over Colombia Telecom. AMX remain a core holding, and we would buy on dips. The company is unlikely to be overly aggressive in Europe and remains clearly committed to its rating – we expect deleveraging over the next several quarters and therefore see some, albeit limited, room for outperformance.

Axtel risk is still being undervalued by the market, but we would stay away from NIHD. The market continues to misprice Axtel risk, in our view. A final agreement regarding asset sales and resolution of the Supreme Court case should add clarity to the situation, and we see significant upside potential. We expect NIHD to continue to disappoint: 3G should prove lacklustre; our question is, how bad will it get? Digicel continues to perform well, but offers little relative value, in our view.

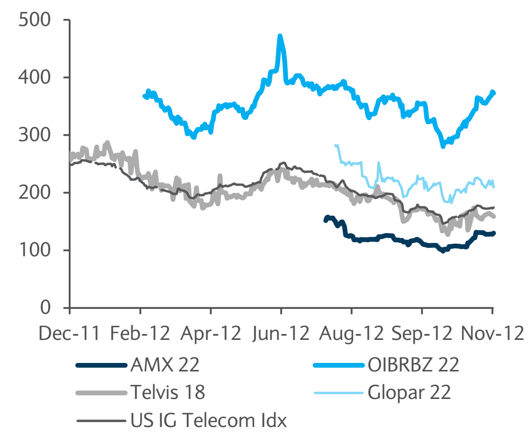
Sector outlook

Push toward data to continue. Wireless data and high-speed fixed line broadband/pay TV remain key initiatives for most telecoms in LatAm. In the **mobile segment,** fierce competition for post-paid and high data customers will continue, though Anatel's policing of network quality may inhibit aggressive pricing if networks are unable to handle additional capacity. **In fixed line**, companies from Oi to Axtel will likely continue to expand their high quality fiber offerings and triple play bundles. We expect this to result in further stabilization of line disconnections and improvement in overall fixed line revenues. All of these initiatives are capital intensive.

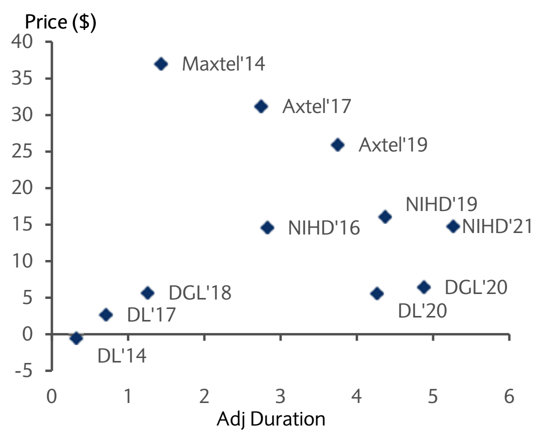
Regulation will continue to change the landscape. Anatel has already announced changes in the regulatory framework in Brazil, focusing on the reduction of mobile termination rates, billing, network sharing and quality metrics. In Mexico, the outcome of the supreme court case involving Axtel, as well as other competition initiatives, could further alter the landscape.

Supply: We expect big cap companies such as AMX and Oi to continue refinancing, though leverage should be on a downward path for both, limiting net issuance. For smaller companies, refinancing is likely for 2014 bonds, including Alestra and Columbus International, though question marks remain in the case of Maxcom. We also believe Axtel is likely to engage in liability management, but this will likely result in net deleveraging and fewer bonds outstanding.

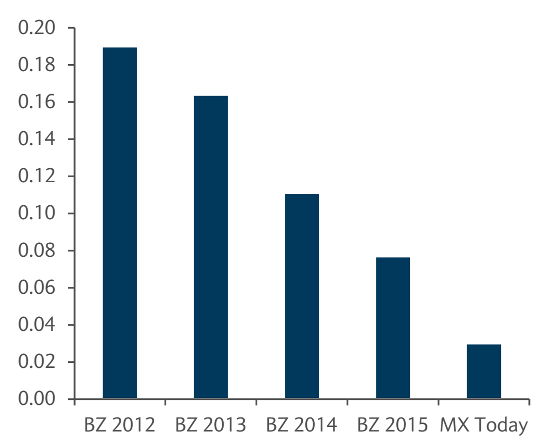
LatAm IG Telecom performance vs. US



HY performance has varied widely



MTR in Brazil versus Mexico



Source: Regulators, Barclays Research

LATIN AMERICA REAL ESTATE, CEMENT, AND INFRASTRUCTURE

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Key recommendations

We remain constructive on Cemex, and favour the 19, 20s and 22s. Given the significant liability management milestones of 2012 and the improving outlook for the US business, we believe Cemex bonds have further room to perform in the short and medium term. The company will likely remain active in the market moving forward and bonds still offer attractive yield pick up. **At current levels, we favour Cemex over ICA** as we expect ICA's leverage to continue moving higher in 2013 and investors to be disappointed by the incremental EBITDA of ICA's concession projects currently under construction.

In the current context of "muddling through", we think Homex currently offers the best tactical risk/reward among Mexican homebuilders. Homex has worked on shrinking its land inventory for over two years, and we think it will continue its efforts to be conservative. Geo appears the best able to sell its homes to Infonavit clients (a critical source of demand), but bonds appear to be pricing in very good results already. Homex bonds are rich to Urbi but do not carry the same downside risk, in our view.

In high grade, we favour Odebrecht and Votorantim (we think fair z-spread difference between them is north of 50bp). Besides the good prospects for infrastructure spending in Latam, Odebrecht has a backlog equivalent to approximately three years of revenues, with stable EBITDA margins, and close to zero net debt. Meanwhile, Votorantim's liquidity is quite comfortable and we expect leverage to have peaked in 3Q. The company's large exposure to the cement market in Brazil should maintain its defensive nature in the medium term.

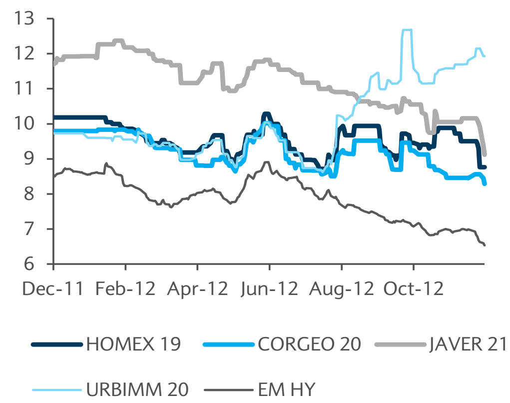
Sector outlook

Struggling from massive working capital investments and cash drain, homebuilders are likely to slow or shrink top-line growth in coming quarters as they seek to address these challenges. Despite an increased subsidy budget and a strong macro backdrop in Mexico, homebuilder results have demonstrated idiosyncratic issues facing the industry.

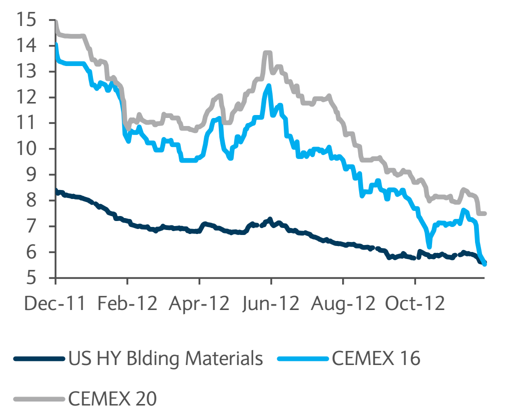
Challenges vary, but no builder is trouble-free. In our view, Homex needs to demonstrate its ability to sell down high inventory levels, Geo to reduce investments going into the seasonally weak 1H13, Javer to sell homes in its areas, and Urbi to reduce receivables.

The improving outlook for the US and Mexican cement markets should benefit Cemex. We expect moderate to continued improvement in the US housing market, which is likely to provide Cemex with positive growth, and which, combined with the ramping up of new government projects in Mexico, should offset weak markets in the EU.

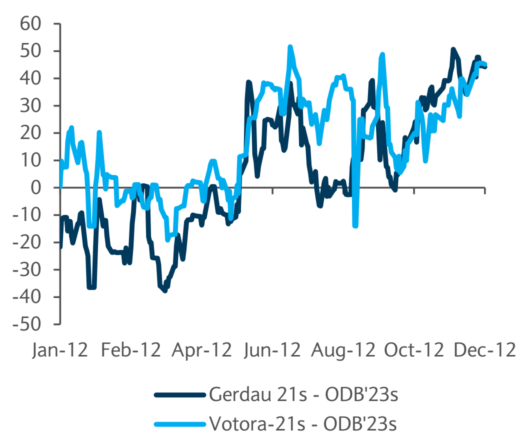
Mexican homebuilders versus EM HY (ytw %)



Cemex versus US HY Building Materials (ytw %)



Trading at tights, but we still prefer ODB bonds (z-spread difference, bp)



Source: Barclays Research

LATIN AMERICA AGRICULTURAL COMMODITIES

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Key recommendations

In proteins, we continue to favour exposure to the Brazilian cattle cycle and avoid exposure to grain-dependent proteins (chicken/US beef and pork). We much prefer Minerva over JBS given the balance of risks and current bond yields and prefer to avoid Marfrig altogether even at current levels, as too many uncertainties remain regarding operational turnaround and refinancing risk.

We are negative on sugar producers given the slow downward trend in international sugar prices due to rising global surpluses (absent adverse weather conditions). GVO has so far been helped by the weaker BRL offsetting lower international sugar prices, but has disappointed on capex and FCF, so we are no longer expecting deleveraging for 2012-13. A more sustained fall in sugar prices and/or BRL appreciation would put the company at significant risk given its high leverage, so we recommend trimming exposure.

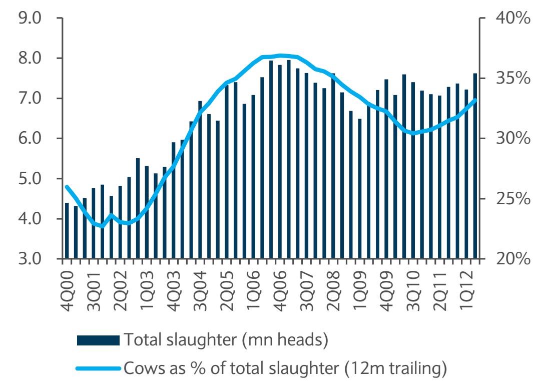
Sector outlook

Brazil Beef: Rising cattle supply should keep domestic cattle prices (i.e., approximately 80% of industry COGS) capped. Meanwhile, beef pricing power remains favourable as: 1) domestic demand is strong, 2) Brazil's exports have become even more competitive following this year's large BRL depreciation, and 3) higher chicken prices favour additional beef price increases. Weather patterns can always pose a significant short-term risk for regionally concentrated players such as Minerva, but the next drought season in Brazil does not start until late 3Q13. **US Beef:** A record low herd size coupled with high grain prices, which are negatively affecting feedlot output volumes, bring uncertainty to cattle supply at least through 1H13. Comments by JBS suggest lack of industry discipline and lower plant utilization rates for 2013.

US Chicken: For 3Q12, we estimate only results for the month of September reflect the rise in grain prices that began in June, so more COGS deterioration should be expected. In the US, leading indicators suggest supply discipline is being maintained for now, which leaves a reasonable chance that chicken pricing power may improve in early 2013 and could offset some of the COGS deterioration in the pipeline.

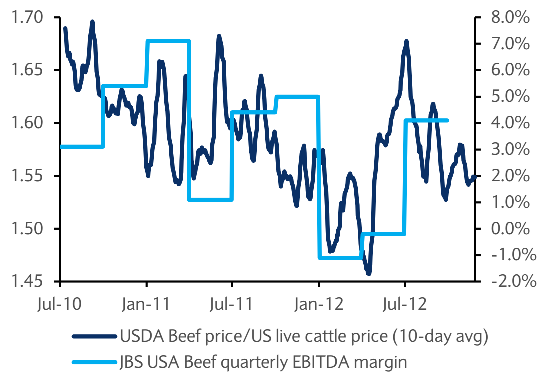
Sugar: After three difficult harvests (08/09 to 10/11), world markets have turned to a significant surplus in 2011/12 and 2012/13. Weather patterns affecting supply have been key to sugar prices, and an eventual good weather year in the major production areas (especially Brazil and India) should push international prices substantially lower for a significant period of time. We would not count on a weakening BRL to continue to offset lower international sugar prices. A potential increase in Brazilian fuel prices by Petrobras and/or an increase in the required domestic ethanol mix would be positive for GVO.

Growing cattle supply in Brazil



Source: IBGE

JBS USA beef margins should move lower



Source: Bloomberg, company reports

Sugar market fundamentals

	08/09	09/10	10/11	11/12E	12/13E
Global production (mn tons)	149.8	156.9	164.0	172.8	175.1
Global consumption (mn tons)	158.8	160.0	163.1	167.1	170.3
Balance	(9.0)	(3.1)	0.9	5.7	4.8
Total stocks	41.0	37.9	38.8	44.5	49.3
Weeks of consumption	13.4	12.3	12.4	13.8	15.1
Annual average prices (cent/lb)	14.9	20.8	28.2	23.0	

Source: Barclays Commodity Research

Note: International marketing year for sugar runs from October to September; Brazil runs May to April.

LATIN AMERICA PAPER AND PULP

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Key recommendations

In the pulp sector, we think Fibria bonds hold the most value, despite the rally. Fibria management remains committed to attaining investment grade status, and plans to gradually reduce debt through internally generated cash for the next one to two years. The company plans to call bonds upon achieving IG status. Although IG will take time, and Fibria is the most-exposed player to potentially weakening hardwood pulp prices, we think the company's discipline in refraining from initiating its own pulp expansion project sets the credit apart. FIBRBZ 20s and 21s are callable in 2015 and 2016, respectively. FIBRBZ 20s and 21s both trade at c.4.9% YTW, compared with BBB-rated CSN 15s at 3.16% and BBB+ rated Vale 15s at 2%.

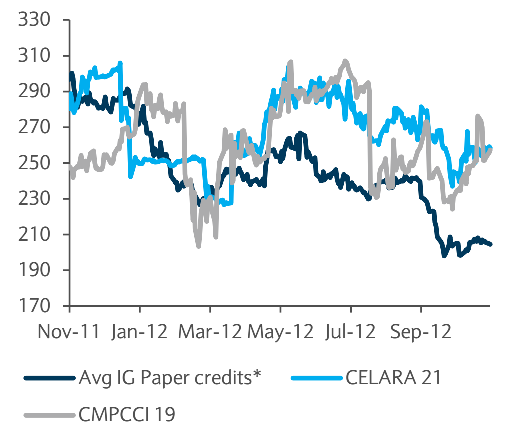
Sector outlook

New hardwood pulp supply to hit the market in 2013. Supply from the El Dorado project is expected to come online in 2013, adding 1.5mn tons capacity to the market. Barclays expects pulp prices to stay relatively flat to current levels into 1H13, and then come under pressure in 2H13 due to new supply. Additional new hardwood pulp supply may then continue to pressure prices down to the low $700 range in 2014.

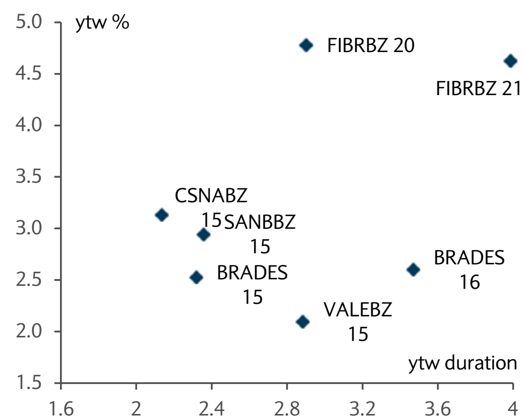
Weak BRL should continue to help Brazil pulp producers in 2013. Despite US$-denominated pulp prices weakening 8% in 2012, pulp prices in BRL are averaging 7% higher than last year due to a weaker BRL (see bottom figure), helping Brazil pulp producers to cover primarily BR$-denominated costs with a healthy margin. We expect this weaker exchange rate to continue softening the effect of weaker US$-denominated pulp prices, with the Barclays forecasts for the BRL to appreciate only c. 7% in a year.

Chilean pulp and forestry producers show high leverage for investment grade-rated companies, and we would expect CMPC and/or Arauco to take action to address high leverage metrics in 2013. CMPC reported two quarters of leverage higher than 2.5x, breaching its internal financial policy and prompting management to consider measures to comply with the policy within the next 24 months. Arauco was downgraded one notch due to more aggressive financial metrics than in the past. Arauco's 1.3mn-ton pulp mill JV will only begin to help EBITDA after the mill starts up toward year-end 2013.

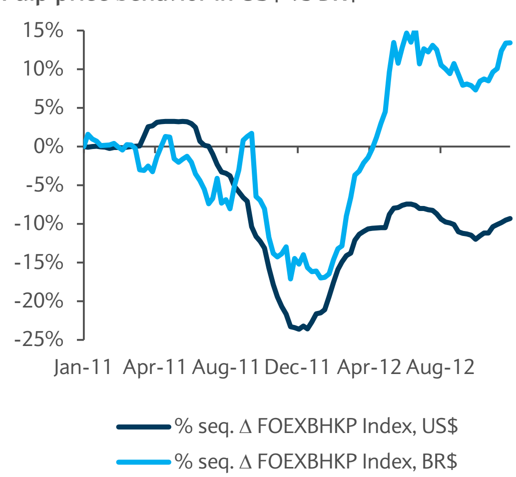
Chilean pulp producers trade in line with Chile peers, but underperformed IG paper names



Fibria bonds vs BBB– and BBB Brazil credits



Pulp price behavior in US$ vs BR$



Note: *Avg IG Paper credits are comprised of GP 5.4 '20s, PCL 4.7 '21s, IP 7.5 '21s, UFS 10.75 '17s. Source: Bloomberg, Barclays Research

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Analyst Certification

We, Jeffrey Meli, Bradley Rogoff, Alex Gennis, Shobhit Gupta, Ryan Preclaw, Eric Gross, Mike Kessler, Thomas Weyl, Sarah Xue, Zoso Davies, Sherif Hamid, Ioannis Kallianiotis, Darpan Harar, Neil Seyffert, Dominik Winnicki, Krishna Hegde, CFA, Avanti Save, Justin Luther, Aziz Sunderji, Vincent Foley, Cedric Morris, Brian Monteleone, Conor Pigott, Danish Agboatwala, Parth Shah, Jim Asselstine, Yung Chuan Koh, Harry Mateer, Priya Ohri-Gupta, CFA, Shubhomoy Mukherjee, Stacey Schroeder, Audra Stundziaite, Peter Troisi, Thomas Walsh, Hale Holden, Jonathan Kahnowitz, Oscar Bate, Matthew Vittorioso, Keith Hanauer, Brian Lalli, Benjamin Robins, Reza Vahabzadeh, Gary Stromberg, Andrew Finkelstein, Asif Khaja, Jeff Harlib, Tom Libretto, CFA, Srinjoy Banerjee, Christophe Boulanger, Jonathan Glionna, Christy Hajiloizou, Miguel Angel Hernandez, CFA, Darren Hook, CFA, Nick Macdonald, Karine Elias, Kelvin Heng, Jonathan Horner, Daniel Rekrut, Emmanuel Owusu-Darkwa, Eriko Lavinia Miyazaki-Ross, Tom Southon, Lyris Koh, Justin Ong, Jit Ming Tan, CFA, Erly Witoyo, Christina Chiow, CFA, Stella Cridge, Golib Zohidov, Milena Ianeva, Stanislav Ponomarenko, Antoine Yacoub, Anibal Valdes, Ivan Fernandes, CFA, Autumn Graham and Christopher Buck, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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The Corporate and Investment Banking division of Barclays is providing investment banking services to the Republic of Turkey on the privatisation of Turk Telekomunikasyon AS.

The Corporate and Investment Banking Division of Barclays is providing investment banking services to Cassa di Risparmio di Asti SpA in connection with its potential acquisition of Cassa di Risparmio di Biella e Vercelli SpA from Banca Monte Dei Paschi Di Siena SpA. The ratings, price targets and estimates on Banca Monte Dei Paschi Di Siena SpA issued by the firm's Research Department do not incorporate this potential transaction.

The Corporate and Investment Banking Division of Barclays has provided investment banking services to BZ WBK in relation to the merger with Kredyt Bank SA.

The Corporate and Investment Banking division of Barclays is providing investment banking services to the Committee for Internal Control and Governance of Telecom Italia Spa on a potential transaction involving its fixed-line network in Italy.

The Corporate and Investment Banking division of Barclays is providing investment banking services to Co-Operative Group Ltd on the potential acquisition of 632 branches from Lloyds Banking Group PLC. Ratings, estimates and price targets (as applicable) on Lloyds Banking Group PLC previously issued by the firm's Research Department do not incorporate this potential transaction.

The Corporate and Investment Banking Division of Barclays is acting as a Co-Dealer Manager to AT&T (T) on the potential exchange offer targeting 17 outstanding series of notes.

The Corporate and Investment Banking division of Barclays is providing investment banking services to Computer Sciences Corp. in the potential sale of certain credit services business assets and operations from CSC Credit Services (a subsidiary of Computer Sciences Corp.) to Equifax Information Services LLC (a subsidiary of Equifax Inc.). The rating, price target and estimates on Computer Sciences Corp. and Equifax Inc. issued by the Firm's Research Department have been temporarily suspended due to Barclays' role in this potential transaction.
The Corporate and Investment Banking division of Barclays is providing investment banking services to MassMutual in its acquisition of the retirement plans business from The Hartford Financial Services Group (HIG). The rating, price target and estimates (as applicable) on The Hartford Financial Services Group do not incorporate the potential transaction

The Corporate and Investment Banking division of Barclays is providing investment banking services to BG Group PLC in connection with the sale of certain interests in Queensland Curtis LNG to China National Offshore Oil Corporation (CNOOC). The effects of this transaction has not been incorporated into the analysts views due to Barclays role in this potential transaction.

The Corporate and Investment Banking Division of Barclays Bank PLC is acting as corporate broker to National Grid Plc.

The Corporate and Investment Banking division of Barclays is providing investment banking services to Anheuser-Busch InBev on the takeover of Grupo Modelo, S.A.B. de C.V. All ratings, estimates and price targets (as applicable) on Anheuser-Busch InBev and Grupo Modelo, S.A.B. de C.V previously issued by the firm's Research Department have been temporarily suspended due to Barclays role in this potential transaction

The Corporate and Investment Banking division of Barclays is providing investment banking services to Plains Exploration & Production Company (PXP) in the potential sale to Freeport-McMoRan Copper & Gold Inc. (FCX). The rating, price target and estimates on Freeport-McMoRan Copper & Gold Inc., Plains Exploration & Production Company, and McMoRan Exploration Co. (MMR) issued by the Firm's Research Department have been temporarily suspended due to Barclays' role in this potential transaction.

The Corporate and Investment Banking division of Barclays is providing investment banking services to General Motors Financial and General Motors in the proposed acquisition of Ally Financial's international business. The ratings, price targets and estimates on General Motors do not reflect this potential transaction.

The Corporate and Investment Banking division of Barclays is providing investment banking services to Georgia Gulf Corporation (GGC) in the potential merger with PPG Industries' (PPG) commodity chemicals business. All ratings, price targets and estimates (as applicable) on Georgia Gulf and PPG Industries issued by the Firm's Research Department have been temporarily suspended due to Barclays' role in the potential transaction.

The Corporate and Investment Banking division of Barclays is providing financial services to Spartech Corp (SEH) in its announced acquisition by PolyOne Corporation (POL). The rating, price target and estimates (as applicable) on PolyOne have been temporarily suspended due to Barclays' role in the proposed transaction.

The Corporate and Investment Banking Division of Barclays Bank PLC is acting as corporate broker to BHP Billiton Plc

The Corporate and Investment Banking division of Barclays is providing investment banking services to The Geo Group (GEO) in its potential Real Estate Investment Trust (REIT) conversion.

Explanation of the Barclays Research High Grade Sector Weighting System

Overweight: Expected six-month excess return of the sector exceeds the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Market Weight: Expected six-month excess return of the sector is in line with the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Underweight: Expected six-month excess return of the sector is below the six-month expected excess return of the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index, as applicable.

Explanation of the Barclays Research High Grade Credit Rating System

The High Grade Credit rating system is based on the analyst's view of the expected excess returns over a six-month period of the issuer's index-eligible corporate debt securities relative to the Barclays U.S. Credit Index, the Pan-European Credit Index or the EM Asia USD High Grade Credit Index, as applicable.

Overweight: The analyst expects the issuer's index-eligible corporate bonds to provide positive excess returns relative to the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Market Weight: The analyst expects the issuer's index-eligible corporate bonds to provide excess returns in line with the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Underweight: The analyst expects the issuer's index-eligible corporate bonds to provide negative excess returns relative to the Barclays U.S. Credit Index, the Pan-European Credit Index, or the EM Asia USD High Grade Credit Index over the next six months.

Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Corporate and Investment Banking division of Barclays is acting in an advisory capacity in a merger or strategic transaction involving the company.

Coverage Suspended (CS): Coverage of this issuer has been temporarily suspended.

Not Rated (NR): An issuer which has not been assigned a formal rating.

For Australia issuers, the ratings are relative to the Barclays U.S. Credit Index or Pan-European Credit Index, as applicable.

Explanation of the Barclays Research High Yield Sector Weighting System

Overweight: Expected six-month total return of the sector exceeds the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Market Weight: Expected six-month total return of the sector is in line with the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Underweight: Expected six-month total return of the sector is below the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Explanation of the Barclays Research High Yield Credit Rating System

The High Yield Credit Research team employs a relative return based rating system that, depending on the company under analysis, may be applied to either some or all of the company's debt securities, bank loans, or other instruments. Please review the latest report on a company to ascertain the application of the rating system to that company.

Overweight: The analyst expects the six-month total return of the rated debt security or instrument to exceed the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Market Weight: The analyst expects the six-month total return of the rated debt security or instrument to be in line with the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Underweight: The analyst expects the six-month total return of the rated debt security or instrument to be below the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Corporate and Investment Banking division of Barclays is acting in an advisory capacity in a merger or strategic transaction involving the company.

Coverage Suspended (CS): Coverage of this issuer has been temporarily suspended.

Not Rated (NR): An issuer which has not been assigned a formal rating.

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