The Fundamental Value in Sector Spreads

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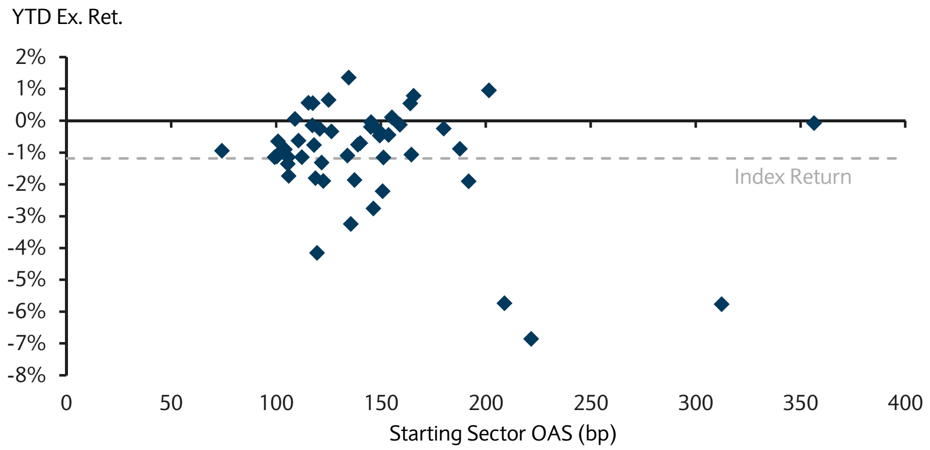
A starting point to find value among sectors is to consider what shifts in fundamental quality are implied by spread valuations. We compare industry-group spreads with the levels implied by their beta to the Corporate Index and frame the difference as the losses (or gains) that investors anticipate from near-term shifts in fundamentals and ratings. While many sectors are priced reasonably for what our analysts expect in the coming year, we think that office, healthcare, and apartment REITs are cheap (with more spread than needed to compensate for deterioration/downgrades) while retailers and integrated oil producers appear rich (valued for improvement/upgrades that are unlikely to appear).

The year-to-date performance of credit in 2015 has once again illustrated the value of correctly selecting sectors. While the US Corporate Index as a whole has produced a -1.3% excess return, the returns of various sectors have been much more dispersed, ranging from metals & mining's -6.85% to tobacco's +1.36%.

In the past, we have discussed the tendency for wider-trading sectors to outperform during periods of tightening markets (see, for example, *Sector Selection Update*). In contrast, when the Corporate Index widens, we expect to see an essentially random relationship between sector starting spreads and excess return. For the most part, 2015 has been consistent with historical experience (Figure 1), with a notable exception. Commodity-exposed sectors that started the year at the wide end of the spread range have widened even further, with metals & mining (-6.85%), oil field services (-5.76%), and midstream (-5.73%) the year's worst performing industries.

FIGURE 1

Returns for Most Sectors Have Been Typically Dispersed Given Index Widening; but Commodity Sectors Started Wide and Have Underperformed



Source: Barclays Research

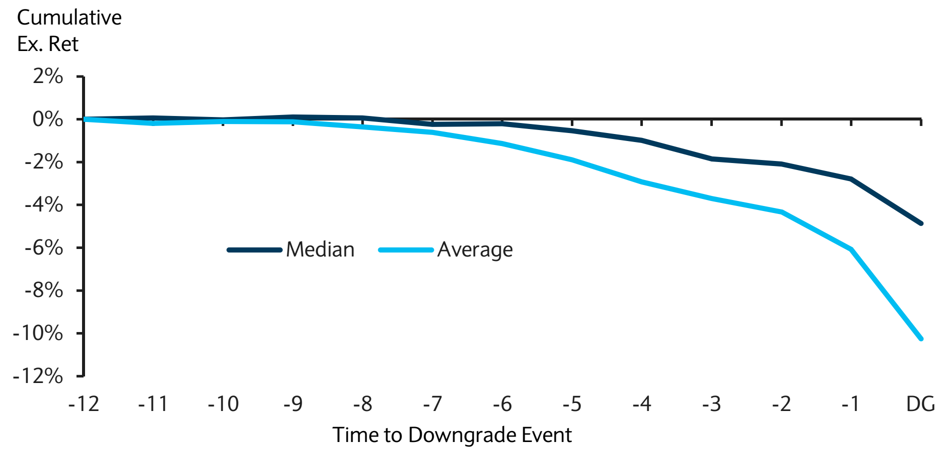
We still expect 20-25% of sectors to outperform the index strongly over the next year (see *Maintaining Balance*). But given this break with historical patterns, we think it makes sense to expand on the tools we use to evaluate which sectors are most likely to outperform.

To build a more rigorous framework that allows us to integrate our analyst's views about each sector, we start by estimating what kinds of future fundamental shifts are implied by the spread for each sector:

- The starting point is long-term beta estimates (in this case, we use five-year trailing beta).
- We then compare the sector spread with the level suggested by beta and the index OAS. We believe that when a sector is trading at a different level from its beta-adjusted spread, it indicates that investors are demanding compensation for a different risk trajectory than the broader market. If spreads are wider than the beta-implied level, investors are requiring compensation for deteriorating fundamentals or downgrade risks that could make the sector riskier; if they are trading tighter, investors are being compensated for improvements or upgrades.

FIGURE 2

Excluding 2008-09, the Average Falling Angel Has Returned -10% in the Year Leading Up to the Downgrade that Removes It from the Index



Source: Barclays Research

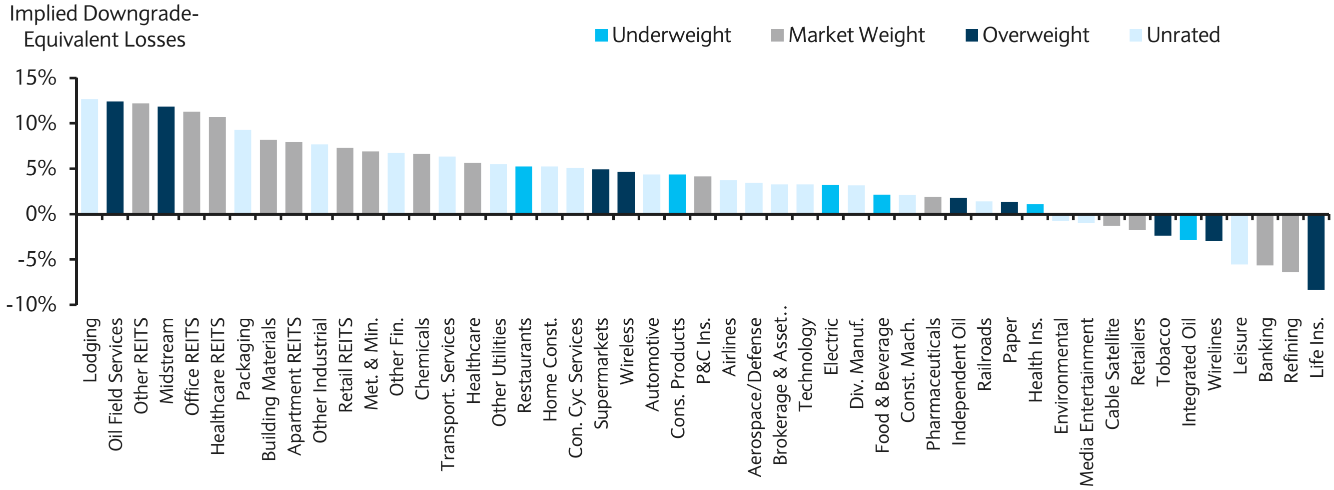
- Finally, to increase the comparability with how our fundamental analysts look at sectors, we calibrate the surplus (or deficit) spread into a simple metric: what net percentage of the sector can be downgraded from investment grade to high yield (in market value) and still be absorbed by the extra carry (Figure 2 shows the average 12-month impact of an issuer downgrade from investment grade to high yield).

It is important to note that we do not necessarily anticipate actual downgrades in those sectors. Instead, this is convenient shorthand to consistently compare, in valuation terms, what our analysts expect from sector fundamentals. For example, if our model suggests that a sector's spread implies compensation for 1% of its market value being downgraded to high yield, this could also be consistent with an analyst expectation that 4% of the bonds will be downgraded one notch from A- to BBB+ (an event which is about one-fourth as severe as a downgrade to high yield). Also, the anticipated weakness does not necessarily have to be ratings specific. It could simply be compensation for fundamentals deteriorating in equivalency to ratings notches, even if no downgrades actually occur

Figure 3 shows each sector in the Corporate Index and its corresponding implied downgrade percentage. Comparing each sector with our analysts' views gives an impression of whether the implied compensation is greater than, less than, or in line with expected losses.

FIGURE 3

Many Sector Valuations Imply Significant Net Downgrades or Deterioration in Fundamentals



Source: Barclays Research

Sectors Trading Cheap, Offering More Spread than Needed to Compensate for Expected Fundamental Shifts

Office, healthcare, and apartment REITs are among the highest in terms of implied downgrades, with both implying more than 10% of the market value moving toward a downgrade. But analyst Peter Troisi sees their situation as stable, with office vacancies improving and demographic trends providing tailwinds for residential apartments. See *REITs: Fundamental Update and 3Q Preview* for details.

Sectors Offering Reasonable Spread Compensation for Expected Fundamental Shifts

Oil field services and midstream are among the widest sectors in the index and are pricing in among the largest implied fundamental deteriorations. Analyst Harry Mateer rates the sectors Overweight, but views the excess spread as reasonable compensation given the fundamental headwinds still facing the sectors.

Paper trades 60bp wider than the overall index because of its lower average rating. Despite that, we see an industry where consolidation, conservative balance sheet management, and balanced capital allocations mean that it is not unusually risky (see analyst Brian Lalli's report *HG Paper: Initiating Coverage at Overweight*). Despite modest expected credit risk, spreads are currently implying a small amount of deterioration in quality.

Wirelines are toward the tighter end of the spectrum in terms of excess compensation, consistent with their position as a stable and highly rated sector. The spread is implying net upgrades (or a slight improvement in average credit quality). We see this as consistent with the fundamental outlook, with the biggest participants committed to deleveraging. Given how mobile data services have benefited from shifts in consumer usage and the low likelihood of a new entrant, the lack of compensation appears to be in line with trends. For details, see TMT analyst Sandeep Gupta's report, *Metamorphosis Everywhere: Initiating Coverage on Telecom at Overweight and Cable/Satellite at Market Weight*.

Life insurers remain stable, with challenges from low rates and FX balanced by strong capital and double-digit returns on equity in the industry. See *Insurance Perspectives: Third-Quarter 2015 Earnings Outlook* for details.

Banks now trade at levels consistent with expected upgrades or fundamental improvement. While the near-term ratings risk is downward, we see that as a well-anticipated technical change as ratings agencies adjust their methodologies for bank debt. Analyst Brian Monteleone expects a continued improvement in fundamentals, with asset quality continuing to improve and capital growing faster than balance sheets. See *U.S. Banks: 3Q15 Earnings Preview: Lackluster Results* for details.

P&C Insurers are priced for modest downgrades, or a deterioration in fundamentals. The level appears consistent with the challenges facing the sector, including slowing premium increases and expected weaker reserve releases. See Tom Walsh's note, *Insurance Perspectives: Third-Quarter 2015 Earnings Outlook*, for details.

Sectors Trading Rich, Offering Less Spread than Needed to Compensate for Expected Fundamental Shifts

Retailers appear to be priced for net upgrades, while the risks appear to be more weighted toward deterioration. The sector is still facing technological disruption risk, and many of the major companies are seeing near-term weakness in credit from business restructuring, M&A, or other operational and competitive issues.

Integrated oil producers are priced to imply net upgrades. While energy analyst Harry Mateer does not see them facing widespread downgrade risks, given the continued weakness in the energy sector, they appear to be undercompensating investors for even the beta risk they represent.

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