Drilling into Energy's borrowing base

Bank of America Merrill Lynch

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High Yield Strategy
Global

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Take the long-term view

After endless reams of analysis on the topic over the last two years, the upcoming rate hike is likely to end up as the least-anticipated one in memory. The rates market is pricing in less than 30% chance of a Sept. move and less than 60% probability that the Fed moves at all this year. Given the range of plausible scenarios and their implications over the next month or two, we have more conviction on near-term HY volatility than in near-term direction. We prefer to take the long-term view here. which is primarily shaped by fundamentals. The health of HY balance sheets matters more than rates at this juncture and our continued modestly bearish outlook is predicated by fundamentals, liquidity and commodity concerns more than the risk of a general rise in rates.

What's next for HY Energy?

Over the last 21 months, we have been unwavering in our lack of enthusiasm for HY Energy paper. This fall's borrowing base redetermination will be crucial for distressed credits in the sector, while higher-quality names are likely to face the same issue next year. In this piece, we explain the purpose and process of redetermination. Additionally, we do not think the sector will be buoyed by a significant amount of M&A over the next few months, as this activity tends to occur during periods of strength, not distress. We also think BB paper is not as safe as many expect, as it is exposed to crowded positioning and the potential for BBB downgrades to HY creating pressure on existing BB paper. Finally, despite our caution, it's important to highlight that restructured debt and distressed exchanges will show high default rates in the sector, but may not be as detrimental to bond holders as the rates would suggest.

Flows: EX-US funds post outflows

Ex-US flows dominated the picture this week, with Emerging Markets again taking center stage with their third consecutive billion+ outflow. Retail investors pulled out $3bn from EM funds this week, which has put the last four-week total to -$10bn, rivaled only by the -$12bn during taper tantrum. Also registering outflows were non-US HY funds. which put up a -$1.1bn outflow, a decline from last week's -$2.5bn. US HY funds posted a small inflow. as ETF inflows balanced outflows from open-ended mutual funds.

Issuance: Down but not out

DM high yield issuance was light this week. as only one company issued new paper (Lindorff Group out of Europe), for a total of $250mn on the week. No new deals came out of the US. The muted issuance does not come as a surprise for the final week of an already light summer. August concluded with a total of $10.25bn in new issues, $9.8bn of which came out of the US. We expect this summer lull to end after Labor Day and for the primary market to pick up in September.

Performance: A HY relief rally

US HY enjoyed a bit of a relief rally this week, as commodity prices rebounded nearly 10% from last week's lows. At 0.5% total return, US HY was the best performer of the week. However, the rebound seemed exclusive to HY, as other risk assets such as equities cratered. S&P 500 continued its decline, returning -1.8% for the week, while EM equities generated -1.4%. Energy gained 1.2%, driving HY returns, while Materials didn't gain quite as much, at +0.7% returns.

Recent publications

Refer to important disclosures on page 14 to 15.
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The View From Above

Isn't it ironic

After endless reams of analysis on the topic over the last two years and even the eventual market acceptance of 'data-dependent' as the Fed's resting state, the upcoming rate hike is likely to end up as the least-anticipated one in memory. The rates market is pricing in less than 30% chance of a September move and less than 60% probability that the Fed moves at all this year. This is quite a contrast to the beginning of the last two hiking cycles, where the market was fully priced for the first hike a week before the respective FOMC meetings. Circumstances are also almost exactly the opposite of September 2013, when the market was primed for tapering but the Fed decided to wait.

At various times this year, we've written about the gap between market and Fed expectations and their respective thresholds for beginning the tightening cycle. More often than not, the market has been more dovish than the Fed in 2015. The rates market, in effect, views a September hike as a possible policy mistake. We've generally considered this scenario to be bad for risk assets, because it entails more volatility. Furthermore, if the market indeed sells off violently on a hike, while it may lower the probability of further Fed moves considerably, it is hard to give this scenario a positive spin, given what it implies about the underlying economy and growth prospects.

Global Viewpoint: Fed up: The rate hike and its market implications 06 September 2015

Take the long-term view on HY

A dovish Fed, with or without a hike, could be the catalyst for a relief rally in HY. If our Economists' base case plays out, i.e., the market stabilizes over next week and the Fed is able to hike without much disruption, we wouldn't expect too severe a reaction in high yield. Alternatively, if rates volatility increases, the months following a September hike could begin to see retail outflows from the asset class, particularly if higher-rated high yield paper begins to weaken with an increase in rates. The more concerning scenario for high yield is if the markets remain fragile and the Fed pushes off hiking until later this year. Although holding the zero bound for longer should be bullish for credit, in our view, fundamentals and global growth concerns would take centre stage in such a scenario.

Given the range of plausible scenarios and their implications over the next month or two, we have more conviction on near-term HY volatility than in the near-term direction of spreads. As we wrote last week, though, we'd fade any relief rally in HY.

We prefer to take the long-term view here and that view is primarily shaped by fundamentals. The health of HY balance sheets matters more than rates at this juncture of the credit cycle and our continued modestly bearish outlook is predicated by fundamentals, liquidity and commodity concerns more than the risk of a general rise in rates. The bigger story for high yield is likely further into the future, when corporates that were able access very cheap funding over the last several years are forced to refinance at much higher rates later this decade.

Drilling down to Energy's near-term issues

Over the last 21 months, we have been unwavering in our general lack of enthusiasm for the Energy sector, as the overbuilt nature of the industry and dependency on high oil prices and strong demand, particularly from what we believed to be a weak China, left us uncomfortable. And, in the winter, as some investors began to breathe a sigh of relief as WTI crept higher, believing that, by autumn, crude would be back in the $65-70bbl

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range, we warned that fall redetermination could be a trigger point for lower valuations and didn't trust in what we thought was potentially a faux recovery.

In particular, we pointed to this fall's and next spring's borrowing base redetermination as intriguing trigger points for the Energy space. As we near the end of the summer, we realize there are many myths and misunderstandings about how the borrowing base redeterminations work and why they are important. In this week's The HY Wire, we explain the purpose and process of redetermination, as the next 6-9 months will prove pivotal to the sector, and continue to reiterate our caution across all the commodity industries on the back of not only excess supply, but also because of a slowdown in global demand.

But before going into the basics of redetermination, we first feel compelled to discuss three separate but related thoughts. First, we do not think the sector will be buoyed by a significant amount of M&A over the next few months, as this activity tends to occur during periods of strength, not distress. Second, we think BB paper is not as safe as many expect, as this portion of the market is exposed to risk from crowded positioning and the potential for higher-quality BBB downgrades creating pressure on existing high-quality high yield. Third, despite our caution, we do think it's important to highlight that restructured debt and distressed exchanges will show default rates that are high in the sector, but perhaps not as detrimental to bond holders as the absolute default rates would suggest.

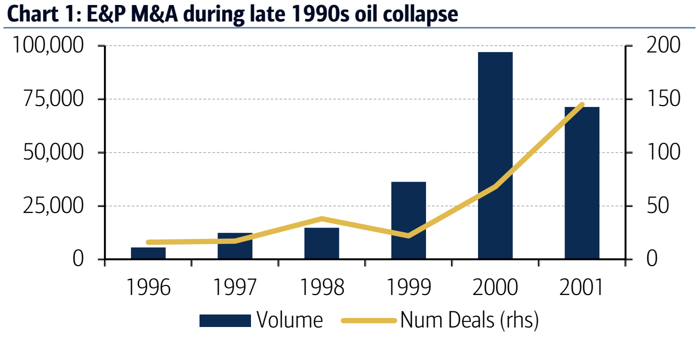
Don't expect a deluge of M&A

Although we do expect some M&A in the energy sector over the coming year, we don't think it will be enough to bolster valuations across the industry until oil prices begin to rise. As we look back in time at M&A waves, a common theme emerges: companies buy other companies when valuations are increasing, not decreasing.

Additionally, as specific sectors experience stress, typically all companies within the industry are feeling pressure to reduce costs, improve margins and survive. For this reason, M&A is often an unwise use of resources and capital, at least until fundamentals stabilize. In our opinion, higher-quality, large-cap energy companies would likely rather buy smaller producers out of bankruptcy or take advantage of asset sales rather than take the risk of overpaying during a period of substantial volatility and uncertainty.

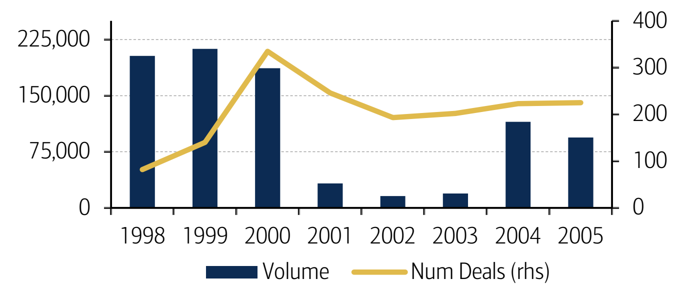
We, once again, look back to the late 1990s and early 2000s to see M&A activity in the energy sector when crude dropped by 50% and subsequently recovered, and in telecommunications, where M&A preceded stress and picked up again after a shake out of the sector.

Chart 1: E&P M&A during late 1990s oil collapse



Source: BofA Merrill Lynch Global Research
Note: 1998 Excludes Exxon/Mobil and BP Corp N American/BP PLC, 2 high grade mergers

Chart 2: Telecom M&A leading up to and following default wave



Source: BofA Merrill Lynch Global Research

In both these cases, M&A was virtually non-existent during periods of stress and defaults as investment-grade issuers and high-quality high yield players watched and waited before deploying much needed capital. In an industry like Energy, where oil price uncertainty could create longer-than-anticipated stress, we think M&A is likely to come later in the cycle.

No respite in BB energy

Additionally, hiding in Energy BBs may not be the answer to the current commodity rout. Lower-for-longer oil prices will create problems for these issuers, not just from a fundamental perspective, but also because of the threat of downgrades from the IG market. The total outstanding face of securities currently rated BBB- issued by IG Energy companies in developed markets is as large as $310bn. Of them, those currently on a negative outlook by at least one rating agency totals about $20bn and, on negative watch, another $4bn. $25bn may seem small relative to the IG index, but it's still a comparatively large number vs. the BB portion of the Energy index, which totals $100bn. Should some of these securities make a transition into HY, existing BB energy paper could feel pressure as investors sell out of them to buy higher-quality fallen angels.

Distressed exchange a good thing?

As we sit back and look at rising default rates in the energy sector and lower recovery values across all high yield, we frequently worry about the negative feedback loop from energy to the rest of risky high yield. Energy default rates have reached 7.5% on an equal-weighted LTM issuer basis (about 3.3% on a par-weighted basis), however, Distressed Exchanges have been a major contributor to them (5 of 14 Energy defaults in the last 12 months were DEs).

We have previously written about how the repeat default rate of issuers that undergo Distressed Exchanges is very high (~25%), as DEs help issuers unload their debt burden, but they hardly solve any of the real underlying problems that caused companies to reach the brink of default in the first place. There is certainly a case to be made that these exchanges then just prolong the time to the eventual bankruptcy, thereby eroding more asset value and lowering ultimate recoveries for investors. However, DEs in Energy might not be all doom and gloom, especially those that have resulted in the aftermath of an event-driven supply shock (such as now). The precious time that DEs buy for issuers facing such circumstances might just be enough for the problem causing the oil shock to dissipate (OPEC might decide to curtail supply or Chinese intervention may lift the Yuan). Moreover, in special situations where an exchange is done for equity, investors may benefit even more should commodity prices rebound. However, it's worth noting that our house call is for further Yuan devaluation and no significant upside to oil prices for the remainder of the year. But, should an Energy company's lifeline get extended by a year or two, it just might make it over the hump if oil prices rise.

Redetermination of borrowing base explained

Back in the late winter, we discussed that the looming spring redetermination was less important to the market than the fall and, as we come back after Labor Day and look critically at the market, we thought it would be a good idea to visit how redetermination works and why it's important. The oil and gas market is unique in that the sector is in constant need of capital. Given that oil is a fixed asset -- where wells are ultimately depleted -- energy companies need to constantly explore, discover and produce in order to maintain cash flow and earnings. And, as such, the sector faces a catch-22 proposition when trying to weather a significant down-turn in crude prices.

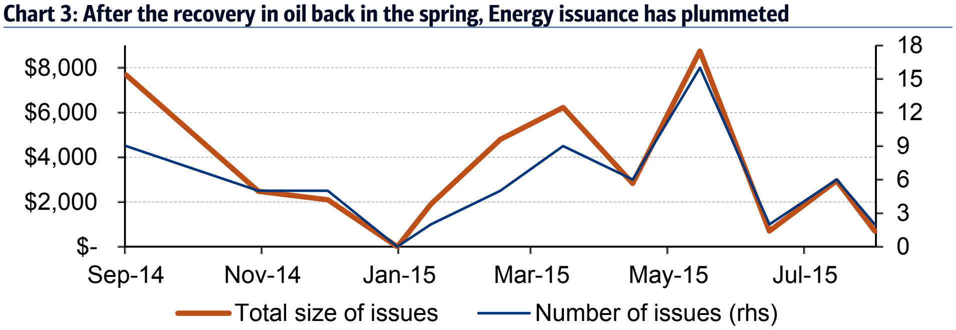
On the one hand, producers need to manage liquidity prudently, cut capex, and limit production in order to conserve cash and continue to make bond interest payments. On the other hand, they can't cut production too much, because they need cash flow to service existing debt. This creates a further problem of depleting oil reserves in existing wells that, when coupled with lower oil prices and a lack of new drilling, creates significantly lower collateral value to borrow against; i.e., the "borrowing base" banks determine to set credit lines.

The danger is that, if sustained for a significant period of time, the company effectively becomes like a home owner using HELOCs to fund first mortgage payments, where the value of the house starts to fall below the value of the loan. Only in an energy company's case, their house (the value of their wells and assets) is re-appraised ("redetermined") every six months -- typically around October 1st and then around March 1st. If the value of the assets has fallen below the drawn amount of credit at the time of redetermination, the company will need to make up the shortfall, known as the borrowing-base deficit. Therefore, the longer oil stays at depressed levels, the harder it becomes for cash flow generated by the depreciated asset to sufficiently pay back the gap in funding/asset value. Borrowing from Peter to pay Paul works when oil is at $100/bbl and low-rated energy companies can continue to explore for new assets. It doesn't work if oil prices remain depressed and funding begins to dry up like the wells themselves.

The problem has compounded over the last several months as oil has remained stubbornly low and capital markets have not been friendly to commodity issuers. This fall's redetermination of the borrowing base is going to be crucial, in particular, for distressed companies in the sector. Higher-quality issuers may have more room to maneuver this year, however; among the 59 E&P companies that our analysts track (representing 90% of E&P face value), only 20% have utilized greater than 50% of their borrowing base. However, as spending and, therefore, production is curtailed and if oil prices continue to remain depressed, we and our analysts think that next year's redetermination will likely be challenging for currently non-distressed issuers as well.

With the slump in crude continuing to hamper equity and credit valuations, the ability for bank lines to remain open is critical to the long-term health and survival of today's energy sector. As we have mentioned in previous pieces and above, today's environment is not unlike the late 1990s, when oil price volatility and steep drops in valuations (largely due, ironically, given the recent Chinese turmoil, to the Asian financial crisis) caused producers to become conservative with their liquidity -- an increasingly difficult process the longer commodity prices remain depressed.

Chart 3: After the recovery in oil back in the spring, Energy issuance has plummeted



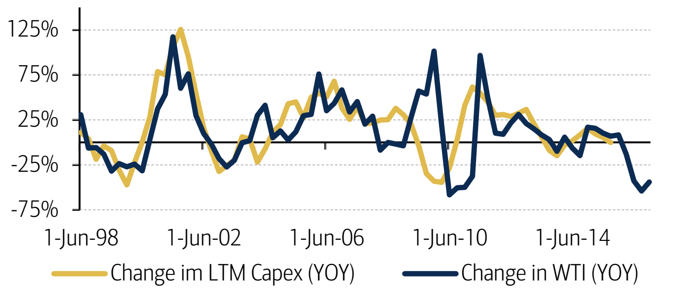
Source: BofA Merrill Lynch Global Research

How the borrowing base is determined

Every lender has a different set of criteria for determining the borrowing base. In fact, banks have teams of engineers to quantify the potential output of existing wells and future wells, while also using market-based data to determine the future value of oil. Because the borrower can draw down a predetermined credit line half a year into the future (prior to the next redetermination of the borrowing base), the lending institution will value the collateral six months from the date it is set, using a present value analysis for future potential production. This is an important point, as if the future production is not realized, discount rates change, or the futures curve/expectations for oil are depressed at the time of the next redetermination, the borrowing-base deficit mentioned above may need to be closed and the borrower could be forced to make principal pay-downs out of existing cash flow.

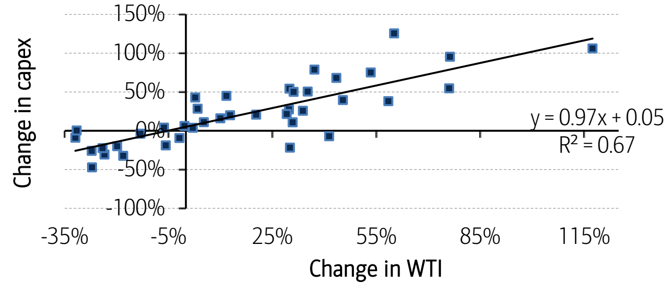
In the beginning of such an event, a borrower will typically cut capex to funnel cash toward paying down the loan. Chart 4, below, highlights capex declines in response to lower crude prices. Note that LTM capex tends to fall about six quarters after the decline in WTI, suggesting it takes a couple of quarters for companies to resort to cutting spending. This makes sense to us, as existing contracts and projects roll off and issuers wait to see if the increase/decrease in crude prices is long lasting. Given this historical relationship, based on the reaction of energy companies prior to the credit crisis, we would expect significant further declines in capex spending from current levels as the year wanes and redetermination begins to hinder cash flow.

Chart 4: LTM energy capex falls about 6 quarters following a move in WTI



Source: BofA Merrill Lynch Global Research

Chart 5: Up until the crisis, a 1% move in WTI led to a 1% move in capex



Source: BofA Merrill Lynch Global Research

However, if oil prices remain depressed for too long, this model is unsustainable, as an energy company needs new exploration and production in order to compensate for declining rates, increase the borrowing base itself, and to create the cash flow to pay back creditors. Given the possibility for a severe slowdown in global growth, a shift in Chinese policy from spending on infrastructure to the consumer, and the potential for further negative currency and supply headwinds (note the recent devaluation of currencies and their effect on crude prices, Iran supply coming online, etc.), we expect US oil and gas companies to have a hard time over the next couple of borrowing-base redetermination dates.

What's a distressed energy company to do?

There are several paths for an energy company to manage what will be a likely reduction in their borrowing base -- we believe some are viable options, while others are less so.

For example, during the financial crisis, many energy companies and their lenders decided to extend maturities, hoping to realize a rebound in the price of oil that would increase borrowing bases and not create shortfalls. In 2008, when the banks were already inundated with non-performing loans, this made sense for both parties. We think it will be less relevant today, given the scrutiny of bank balance sheets and the lack of tolerance for high-risk loans. Coupled with the possibility that lower oil prices are here for the foreseeable future, and we believe banks this fall and next spring will be less and less likely to amend terms with borrowers.

Another potential option would be for issuers to sell assets if they can obtain a value above the borrowing base. Higher-quality, large-cap companies may have the appetite to mop up these assets. However, this strategy depends on oil prices stabilizing to encourage these companies to step in and also perhaps some improvement in the prospects for the commodity in order to bring in feasible valuations for the assets.

Perhaps a more relevant path forward for energy companies today is to monetize current hedges or lock in hedges above the banks October price deck (the price that banks use to value reserves). In order to value future reserves using the above PV analysis, a lender needs to forecast their expectations for future crude prices. Banks will likely be conservative with their future estimates, creating lower borrowing bases for producers. However, if the company can or has locked in higher prices in the future than the banks price deck assumptions, the borrowing base can be increased.

Weekly Recap

As of Sep 4, nearly all high yield names have reported their Q2 earnings. On a year-over-year basis, EBITDA is down 40%, while debt is up 7.5% and revenue has decreased

4.8%. EBITDA adjusted for one-time items was a lot more benign, coming in at -0.6%. Excluding energy names, year-over-year EBITDA decreased 10%, debt was up 5.3%, and revenue declined 1%. In the last one week, high yield spreads have remained roughly flat, while 5y rates have decline 7bps. US high yield funds saw small inflows, while non-US funds witnessed an exodus last week. US high yield issuance is now roughly in line with last year's pace, as issuance slowed down significantly through the summer.

Table 1: HY issuer fundamentals

YoY Pct Change				YoY Pct Change, Ex Energy			
EBITDA	Debt	Rev	COGS	EBITDA	Debt	Rev	COGS
-40.3	7.5	-4.8	-6.7	-10.2	5.3	-0.9	-2.2

Source: BofA Merrill Lynch Global Research

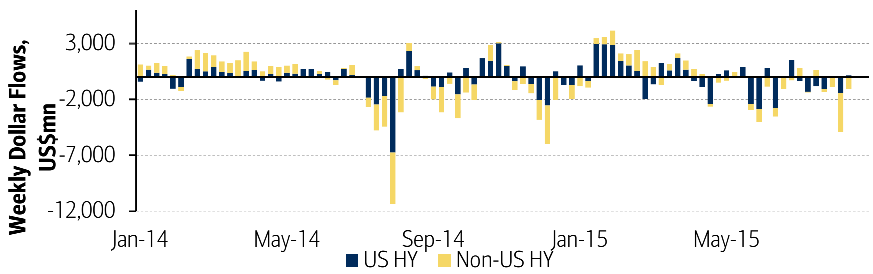
Flows

This is an excerpt from our recently published report: The High Yield Flow Report: Ex-US funds post outflows 03 September 2015

Ex-US flows dominated the picture this week, with Emerging Markets again taking center stage with their third consecutive billion+ outflow. Retail investors pulled out $3bn from EM funds this week, which has put the last four-week total to -$10bn, rivaled only by the -$12bn during taper tantrum. The relatively weak economic data coming out of China is weighing on Emerging Markets because, not only do EM countries export to China, but they also compete with it for US market share. Weak Chinese domestic demand along with the recent Yuan devaluation is spelling trouble for these countries on both accounts. Also registering outflows were non-US HY funds, which put up a -$1.1bn outflow, a decline from last week's -$2.5bn.

US HY funds posted a small inflow, as ETF inflows balanced outflows from open-ended mutual funds. Also returning to inflows was US IG, which attracted $1.2bn. Equities saw +$5bn flowing in. Commodity funds gave back some of the inflows of the month, registering -$430mn in outflows. Loans, the worst-performing asset class this year in terms of % of AUM added, saw another -$440mn leave the asset class. Loan funds have underperformed this year on the back of the diminishing potential of rate increases. It also doesn't help that most of these securities won't truly float in the near term, due to their embedded LIBOR floors.

Chart 6: Global HY flows distributed between US-domiciled and non US-domiciled funds



Source: BofA Merrill Lynch Global Research, EPFR Global

New Issue Roundup

Bonds

DM high yield issuance was light this week, as only one company issued new paper (Lindorff Group out of Europe), for a total of $256mn on the week. No new deals came out of the US. The muted issuance does not come as a surprise for the final week of an already light summer. August concluded with a total of $10.25bn in new issues, $9.8bn of which came out of the US. We expect this summer lull to end after Labor Day and for the primary market to pick up in September.

Year-to-date in developed markets, we stand at $246.3bn in primary deals, about $30bn behind last year's pace. For comparison, last year at this time, we had seen $278bn of issuance in the developed markets. US issuance, which recently was ahead of last year's pace, has now caught up after slowing down over the summer. Europe remains $40bn behind. A further analysis shows that approximately half of the issuance YTD was rated B, while 34% was BB and 15% was CCC. This distribution is almost identical to that of last year's, as, recently, we have seen the most issuance in the B-bucket. Finally, 86% of the deals YTD have been private placements, 30% with reg rights and 56% without reg rights. Private placements have consistently outpaced public deals.

Table 2: DM issuance summary ($bn)

	DM	United States	Europe	BB	B	CCC/NR
WTD Sep 04	0.3	0.0	0.3	0.0	0.3	0.0
Wk Aug 28	0.0	0.0	0.0	0.0	0.0	0.0
Wk Aug 21	1.3	0.9	0.0	0.5	0.4	0.4
Wk Aug 14	4.6	4.6	0.0	1.1	3.5	0.0
MTD Sep	0.3	0.0	0.3	0.0	0.3	0.0
August	10.3	9.8	0.1	2.3	5.8	2.2
July	18.3	7.4	6.4	7.2	8.6	2.4
June	27.7	20.9	6.6	8.1	13.8	5.8
YTD 2015	246.3	167.3	63.1	82.2	128.1	36.0
YTD 2014	278.0	164.4	103.3	87.5	143.6	47.0
2014	376.0	238.8	119.5	129.9	186.8	59.2
2013	378.3	270.3	91.5	128.8	172.4	77.2
2012	365.7	280.5	65.5	103.6	198.3	63.8

Source: BofA Merrill Lynch Global Research

Table 3: New issue breakdown by week, last 3 months

		Ratings				Currency (US$mn equivalents)				Seniority			Deal Type		
	Total	BB	B	CCC	NR	USD	EUR	GBP	CAD	Secured	Senior	Sub	144a w RR	144a w/o RR	Public
5/22/2015	4,826	2,000	2,356	470		4,720	106			806	4,020		906	2,220	1,700
5/29/2015	10,058	4,864	4,473	720		8,975	1,083			4,055	6,003		1,283	6,275	2,500
6/5/2015	11,105	3,450	4,655	3,000		9,840	1,181	84		1,074	9,431	600	5,100	5,671	334
6/12/2015	5,705	1,080	3,734	891		1,835	2,469	1,401		3,141	2,139	425	2,321	3,159	225
6/19/2015	3,472	1,000	1,922	550		3,000	255			472	3,000		1,650	1,472	350
6/26/2015	6,364	2,600	2,920	724	120	5,655	709			335	6,029		1,050	3,314	2,000
7/3/2015	1,085		600	485		1,085					1,085		600	485	
7/10/2015	200	200				200					200			200	
7/17/2015	4,175	1,600	2,200	375		4,175					4,175		1,275	1,150	1,750
7/24/2015	10,708	5,437	4,159	1,112		3,305	6,528	875		3,507	7,201		2,366	8,342	
7/31/2015	3,191		2,271	920		2,480		711		1,096	2,095		273	2,917	
8/7/2015	4,342	700	1,832	1,810		4,270	72			1,282	3,060		1,407	2,935	
8/14/2015	4,600	1,100	3,500			4,600				500	4,100			4,300	300
8/21/2015	1,315	500	425	390		1,315					1,315		815		500
9/4/2015	256		256				256			256			33	223	

Source: BofA Merrill Lynch Global Research

There was only one new offering this week. Lindorff Group, a privately-held credit management services company out of Europe, issued $256mn senior secured notes in a two-tranche deal in Euros. The first tranche has $223mn face value due 2020, while the second is a $33mn portion maturing in 2021. Proceeds from the deal will be used to refinance their currently outstanding bank debt.

The largest deal for the month of August was $1.2bn senior secured bonds issued by First Data Corporation. These were 5 3/8% 2023 bonds with a B1 rating used for refinancing purposes. The only other $1bn+ deal in August was a $1.125bn issuance by Jaguar Holding Co. The bonds are senior unsecured with a CCC rating and 8-year maturity. Proceeds from the deal will be used in combination with a senior secured credit facility to redeem $575mn outstanding debt and to issue a shareholder dividend.

Table 4: New issues from August 28th – September 4th

Pricing Dt	Name	Size ($)	Snr	Cpn	Maturity	Price	Yield	Moody's	S&P	Type	Sector	Region
9/3/2015	Lock AS/ Lock Lower (Lindorff)	33	Sr Sec Nts	7.00	15-Aug-21	0.00	0.00	B2	BB-	144A w/RR	Diversified Finan Serv	Europe
9/3/2015	SLock AS/ Lock Lower (Lindorff)	223	Sr Sec Nts	5.48	15-Aug-20	0.00	0.00	B2	BB-	144A for Life	Diversified Finan Serv	Europe

Source: BofA Merrill Lynch Global Research

Loans

Global loan issuance still remains muted as no new deals came to market this week. This marks the second week in a row with no new issuance and rounds out a particularly dry month for loan supply. During the month of August, only 30 loans were issued, for a total of $9.4bn new money brought to the market. Breaking August's new supply down further, 52% of new issuers were B-rated, 46% were BB-rated, and just 2% were CCC-rated. Additionally, 21 of the 30 new deals launched were used for acquisition or LBO purposes, underlining a particularly heavy year for M&A activity. At the single name level, the largest deal in August was a $1.2bn unsecured, covenant-lite issuance by JBS LLC. Proceeds from this loan will be used to pay for the acquisition of Cargill Pork. The loan pays Libor+300bps.

Table 5: Global loan issuance over time ($bn)

	Global	BB	B	CCC/NR	Cov lite	2nd lien
WTD Sep 4	0.0	0.0	0.0	0.0	0.0	0.0
Wk Aug 28	0.0	0.0	0.0	0.0	0.0	0.0
Wk Aug 21	0.2	0.0	0.1	0.0	0.0	0.0
Wk Aug 14	2.8	1.7	1.1	0.0	2.3	0.0
MTD Sep	0.0	0.0	0.0	0.0	0.0	0.0
Aug	9.4	4.7	4.5	0.2	8.2	0.2
July	37.6	10.8	24.3	2.5	26.9	2.4
June	29.7	11.7	16.3	1.7	18.7	1.5
YTD 2015	187.9	78.9	100.2	8.8	129.0	8.4
YTD 2014	291.1	83.7	165.1	42.4	205.2	29.1
2014	379.4	109.5	218.3	51.6	267.1	36.6
2013	454.9	152.8	261.7	40.4	279.1	28.9
2012	295.3	105.0	161.9	28.4	97.5	17.2

Source: BofA Merrill Lynch Global Research, S&P LCD

Table 6: New issue breakdown by month, last 3 months

		Ratings						
	Total	BB	B	CCC	NR	TLb	2nd Lien	Cov Lite
05/29/2015	2,954	126	2,396	432		2,522	432	2,077
06/05/2015	7,007	2,648	4,100	259		6,748	259	5,483
06/12/2015	11,065	4,015	6,015	1,035		9,930	1,035	5,405
06/19/2015	7,778	2,520	4,913	345		7,603	175	5,285
06/26/2015	3,810	2,486	1,299	25		3,785	25	2,550
07/03/2015	650		650			650		650
07/10/2015	2,883	1,068	1,571	245		2,538	345	1,816
07/17/2015	10,390	2,700	6,855	835		9,555	835	9,970
07/24/2015	15,537	5,425	9,267	845		14,867	670	9,222
07/31/2015	8,184	1,620	5,999	565		7,619	565	5,261
08/07/2015	6,498	2,987	3,306	205		6,256	242	5,851
08/14/2015	2,755	1,700	1,055			2,755		2,255
08/21/2015	155	45	110			155		45
08/28/2015								
09/04/2015								

Source: BofA Merrill Lynch Global Research, S&P LCD

The second-largest loan issuance in August was Hudson's Bay Company's $1.1bn, 7-year term loan B. The BB-rated, covenant-lite issuance will be used to acquire Galeria Kaufhof, an owner and operator of department stores. Hudson's Bay newest deal pays Libor+375bp (100bp floor).

Table 7: Top 10 new issues July, August, September

Launch Dt	Issuer	Deal Name	Deal Size ($)	New Inst. Money ($)	Moody's	S&P	Asset Backed	Cov Lite	Proceeds	Sector	Region
7/20/2015	Charter Communications Inc	Charter Comm (8/15)	3800	3800	Ba1	BBB-	No	No	Acquisition	Cable	North America
7/22/2015	Asurion LLC	Asurion (TL 8/15)	2725	2725	Ba3	B	No	Yes	Repurchase equity	Insurance	North America
7/24/2015	Pharmaceutical Product Development Inc	Pharmaceutical Product (TL 8/15)	2575	2575	B1	B	No	Yes	Dividend	Services & Leasing	North America
7/14/2015	Ascena Retail	Ascena Retail (TL 8/15)	1800	1800	Ba2	BB+	No	Yes	Acquisition	Retail	North America
7/29/2015	Party City Holdings Inc	Party City (TL 8/15)	1340	1340	B1	B	No	Yes	Refinancing	Retail	North America
7/15/2015	Alliant Insurance Services Inc	Alliant Insurance (TL 8/15)	1340	1340	B2	B	No	Yes	LBO	Insurance	North America
8/10/2015	JBS USA LLC	JBS USA (9/15)	1200	1200	Ba1	BB+	No	Yes	Acquisition	Food & Beverage	North America
7/30/2015	EMI Music Publishing	EMI Music (8/15)	1170	1120	Ba3	BB-	No	No	Dividend	Film	North America
7/15/2015	AlixPartners LLC	AlixPartners (TL 8/15)	1100	1100	B2	B+	No	Yes	Dividend	Services & Leasing	North America
8/4/2015	Hudson's Bay Company	Hudson's Bay (9/15)	1085	1085	B1	BB	No	Yes	Acquisition	Retail	North America

Source: BofA Merrill Lynch Global Research, S&P LCD

Performance Summary

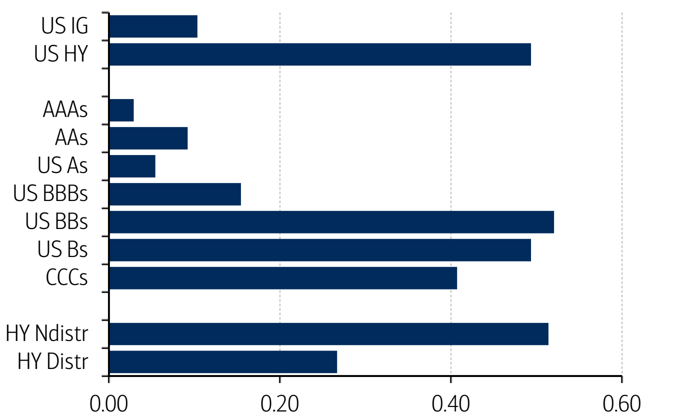
US HY enjoyed a bit of a relief rally this week, as commodity prices rallied nearly 10% from last week's lows. At 0.5% total return, US HY was the best performer of the week, something we haven't seen in a while. However, the rebound seemed exclusive to HY, as other risk assets such as equities cratered. S&P 500 continued its decline, registering a -1.8% return for the week, while EM equities generated losses of 1.4%. Within HY, Energy led the baton gaining 1.2% after the selloff last week. Materials didn't quite rebound all that much, but were still in the green, at +0.7%. Telecommunications and Utilities were some of the other sectors in the lead. Amongst ratings, the picture painted was not one of a true risk rally. Better-quality names led the gains. BBs outperformed all else, at 0.5%. Investors still seemed wary of credit concerns, as distressed issuers rallied only half as much as the non-distressed names.

Table 8: Total returns across asset classes

Ticker	Name	WoW (%)	MTD (%)	YTD (%)
SPX	S&P 500	-1.84	-1.07	-5.23
MXEF	EM Eqty	-1.43	-2.11	-16.19
CDXHY	CDX.HY	-0.84	-0.31	-0.88
G0QI	TIPs	-0.49	-0.54	-0.94
CDXIG	CDX.IG	-0.12	0.00	-0.14
EMIB	EM IG	-0.07	-0.07	0.67
GA05	5yr TRSY	0.01	0.27	2.13
U0A0	Municipals	0.01	-0.05	1.07
M0A0	Mortgages	0.03	0.10	1.04
HE00	EU HY	0.04	-0.02	1.99
C0A0	US IG	0.10	0.20	-0.39
LCDI/ALL	Lev Loans	0.11	0.01	2.11
EMHB	EM HY	0.13	-0.41	3.97
EMGB	EM Govts	0.13	-0.23	0.56
H0A0	US HY	0.49	0.20	0.27

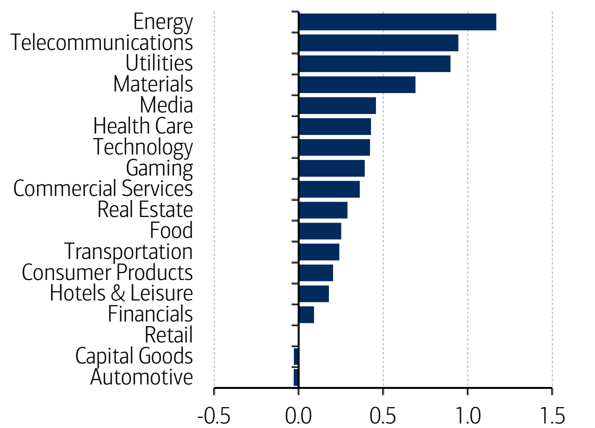
Source: BofA Merrill Lynch Global Research

Chart 7: Segment and rating returns, week-on-week (WoW)



Source: BofA Merrill Lynch Global Research

Chart 8: Sector returns, week-on-week (WoW)



Source: BofA Merrill Lynch Global Research

Top performers

Top securities of this week were dominated by Energy. BB names, in particular, gained the most in this week's HY rally. Better-quality issuers like RIG, WPX, Range Resources, CHK and Whiting all made the cut, as oil rallied to $45 post breaching into the $30 handle last week. Peabody was another big gainer, with its bonds gaining 4 points, on average, and one of the largest traded capital structures with a combined notional of at least ~$150mn traded. Only three non-commodity issuers made it to the top 30 -- Sprint, Claire's Stores, and JC Penney.

Table 9: Top 10 performers Aug 27th – Sep 3rd

Issue	Rating	Price	Yield (%)	ZSpread	Px Change	Px Change (%)	Volume
BTU 6.5 '20	CCC1	29.25	40.50	3899	3.7	14.6	32
BTU 6.25 '21	CCC1	28.31	35.67	3399	3.5	14.1	51
BTU 6 '18	CCC1	35.99	46.31	4513	4.4	13.9	61
EXXI 7.5 '21	CCC2	20.92	48.51	4692	2.0	10.5	27
RIG 7 '28	BB1	64.96	12.59	1039	5.2	8.7	9
WTI 8.5 '19	CCC1	50.50	32.00	3069	3.6	7.7	27
WPX 6 '22	BB2	89.79	8.08	630	5.4	6.4	14
MEMP 6.88 '22	CCC1	64.02	15.56	1377	3.4	5.6	13
RRC 5 '22	BB2	94.91	5.90	405	4.7	5.2	14
SD 7.5 '21	C	29.31	40.34	3880	1.4	4.9	20

Source: BofA Merrill Lynch Global Research

Bottom performers

The worst performer of the week was Halcon Resources 8.875% 2021 bonds, which dropped 12 points in value after announcing they will exchange $1.57 billion of their unsecured bonds for $1.02 billion of third-lien debt (see Rating Actions). They had previously exchanged $250mn of their debt back in April. Some of the non-energy names included Navistar, Navient and technology issuers such as AMD and Sungard systems. Telecoms also featured in the list with Frontier and Equinix.

Table 10: Bottom 10 performers Aug 27th – Sep 3rd

Issue	Rating	Price	Yield (%)	ZSpread	Px Change	Px Change (%)	Volume
HKUS 8.88 '21	CCC3	34.50	37.41	3581	-11.8	-25.4	34
LINE 8.63 '20	B3	38.07	38.17	3674	-6.6	-14.8	56
VTG 7.13 '23	CCC3	39.74	25.45	2362	-6.7	-14.5	19
LINE 6.25 '19	B3	35.66	38.49	3711	-5.9	-14.2	26
VTG 7.5 '19	CCC3	40.34	36.45	3508	-6.4	-13.7	53
LINE 6.5 '19	B3	40.60	37.49	3624	-3.7	-8.3	39
DNR 4.63 '23	BB3	65.86	11.29	932	-1.7	-2.5	21
NAV 8.25 '21	CCC2	84.89	11.77	1006	-2.1	-2.5	28
FGP 8.63 '20	B3	99.12	8.84	736	-1.9	-1.8	6
NAVI 5.88 '24	BB2	83.51	8.51	643	-1.4	-1.6	14

Source: BofA Merrill Lynch Global Research

Rating Actions

Last week saw a limited number of ratings actions on high yield issuers, with only 21 changes made by Moody's or S&P. Downgrades outnumbered upgrades by a ratio of 3:1, and there were several initiations and drops. There were no rising stars or fallen angels for the week. One notable change was S&P's downgrade of Halcon Resources Corp to Selective Default after the company announced it will exchange $1.57 billion of their unsecured bonds for $1.02 billion of third-lien debt. This is the second distressed exchange for the company, which initially exchanged out $250mn of its bonds in April. The crude oil producer is one of several companies this year to suffer from the oil supply glut.

Amongst other issuers, Moody's downgraded Clayton Williams Energy from B3 to Caa1, although their outlook remains stable. Clayton Williams, an E&P company, is having trouble keeping margins high this year, as commodities continue their 12-month decline. Another noteworthy downgrade was Moody's lowering of Tronox Ltd from BB to BB-. In response to the downgrade, the chemicals manufacturing corporation reaffirmed their commitment to reducing leverage and continuing current dividend payments.

There were only three ratings improvements on the week. One noticeable upgrade was S&P's change of Isle of Capri Casinos from B to B+. The ratings agency said its upgrade is in response to the company's operating performance exceeding their expectations for CY2015. In addition, S&P expects that Isle's EBITDA will grow modestly and that their leverage ratio will fall to the mid-4x area in fiscal 2017.

Table 11: List of ratings changes August 28th – September 4th

Date	Action	Company Name	Rating Type	Agency	Curr Rtg	Last Rtg
09/01/2015	Downgrade	Tronox Ltd	LT Local Issuer Credit	S&P	BB-	BB
09/02/2015	Downgrade	Michael Baker Holdings LLC	Senior Unsecured Debt	Moody's	Caa2	Caa1
09/02/2015	Downgrade	Michael Baker International LLC	Senior Secured Debt	Moody's	B2	B1
09/03/2015	Downgrade	Clayton Williams Energy Inc	Senior Unsecured Debt	Moody's	Caa1	B3
09/03/2015	Downgrade	TPC Group Inc	LT Local Issuer Credit	S&P	B-	B
09/04/2015	Downgrade	Aleris International Inc	Senior Unsecured Debt	Moody's	B3	B2
09/04/2015	Downgrade	Basic Energy Services Inc	Senior Unsecured Debt	Moody's	Caa2	B2
09/04/2015	Downgrade	NGPL PipeCo LLC	LT Local Issuer Credit	S&P	CCC-	CCC
09/01/2015	Initiated	GNY Custom Insurance Co	LT Local Issuer Credit	S&P	A-	
09/01/2015	Initiated	Greater New York Mutual Insurance Co	LT Local Issuer Credit	S&P	A-	NR
09/01/2015	Initiated	Informatica Corp	LT Local Issuer Credit	S&P	B	
09/01/2015	Initiated	Insurance Co of Greater NY	LT Local Issuer Credit	S&P	A-	NR
09/01/2015	Initiated	Strathmore Insurance Co	LT Local Issuer Credit	S&P	A-	NR
08/31/2015	Upgrade	CVR Refining LP	LT Local Issuer Credit	S&P	BB-	B+
08/31/2015	Upgrade	Wolverine World Wide Inc	LT Local Issuer Credit	S&P	BB+	BB
09/04/2015	Upgrade	Isle of Capri Casinos Inc	LT Local Issuer Credit	S&P	B+	B
09/03/2015	Dropped	Coyote Logistics LLC	LT Local Issuer Credit	S&P	NR	A+
09/04/2015	Dropped	Harvard Drug Group LLC/The	LT Local Issuer Credit	S&P	NR	A-
09/04/2015	Dropped	Knoll Inc	LT Local Issuer Credit	S&P	NR	BB
08/28/2015	Default	Halcon Resources Corp	LT Local Issuer Credit	S&P	SD	B-

Source: BofA Merrill Lynch Global Research

Relative Value

Cash v. CDS

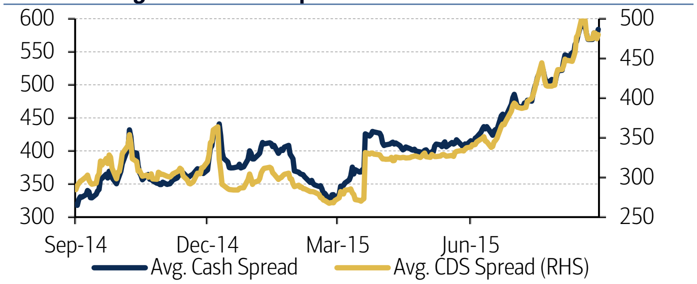
Cash indices outperformed CDX indices over the week (Table 12). CDX HY widened by 18bp compared to 10bp of tightening for our HY cash index. In the IG space, CDX saw 2bp of widening while cash tightened 2bp. The average basis for CDX HY issuers we track, however, fell to -104bp.

Table 12: CDX vs. ML Cash Indices

Index	Spread	1W-Chng	1M-Chng	3M-Chng
CDX IG	83	2	8	15
HG Cash	168	-2	10	30
CDX HY	410	18	34	55
HY Cash	570	-10	25	124

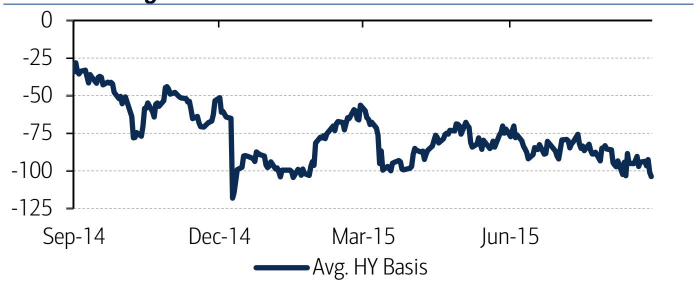
Source: BofA Merrill Lynch Global Research, 5y spreads for CDX, OAS for cash

Chart 9: Average cash and CDS spreads for CDX HY issuers



Source: BofA Merrill Lynch Global Research, Average spreads for a selection of issuers in the On The Run CDX HY index.

Chart 10: Average cash-CDS basis for CDX HY issuers



Source: BofA Merrill Lynch Global Research, Average basis for a selection of issuers in the On The Run CDX HY index.

CDS Indices

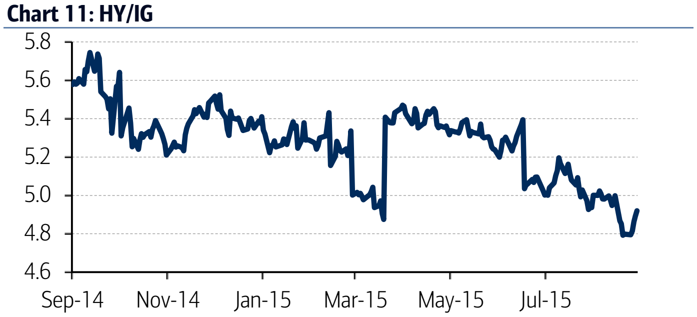
CDS indices in the US and Europe widened over the week (Table 13). Single-names outperformed index performance as skews increased 2bp to stand at -3bp by the end of the week. The HY/IG spread ratio increased and is currently 4.92, off its YTD low from the prior week (Chart 11). The XO-HY spread was little changed at -71bp, a modest 2bp decline from last week (Chart 12).

Table 13: CDS Indices – spread, intrinsic and skew

Index	Index	5y Spread	1W-Chng	1M-Chng	3M-Chng	5y Intrinsic	1W-Chng	1M-Chng	3M-Chng	Skew	1W-Chng	1M-Chng
CDX.NA.IG	CDX IG	83	2	8	15	86	0	5	18	-3	2	3
CDX.NA.HY	CDX HY	410	18	34	55	395	3	28	55	16	14	7
iTraxx Europe	iTraxx Main	73	1	7	3	76	1	8	11	-3	0	-2
iTraxx Europe Crossover	iTraxx XO	338	15	30	24	358	17	44	58	-21	-2	-14

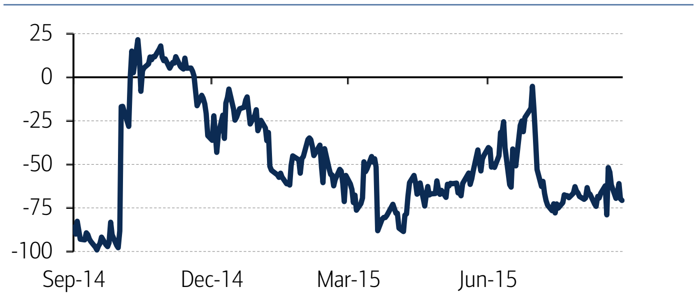
Source: BofA Merrill Lynch Global Research

Chart 11: HY/IG



Source: BofA Merrill Lynch Global Research

Chart 12: XO-HY

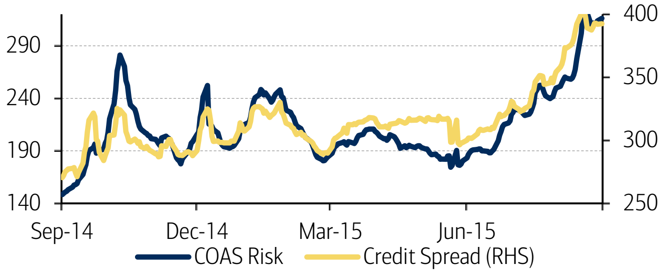


Source: BofA Merrill Lynch Global Research

Credit vs. Equities

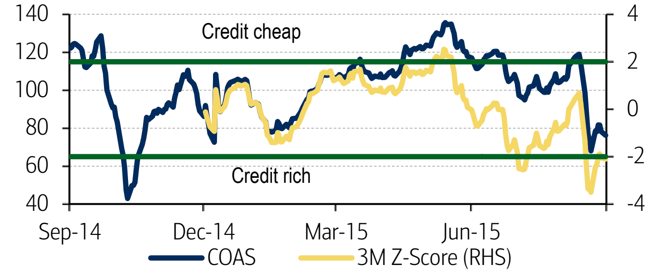
Average HY spread and equity implied credit risk widened by 5bp and 7bp, respectively, on the week (Chart 13). The US HY COAS 3m z-score increased to -2.1 from -2.44, indicating that credit continues to trade rich to what the equity markets imply (Chart 14).

Chart 13: US HY COAS Risk vs. Spread



Source: BofA Merrill Lynch Global Research

Chart 14: US HY COAS & Z-Score



Source: BofA Merrill Lynch Global Research

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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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