Revisiting Demand – Retail Leads the Way

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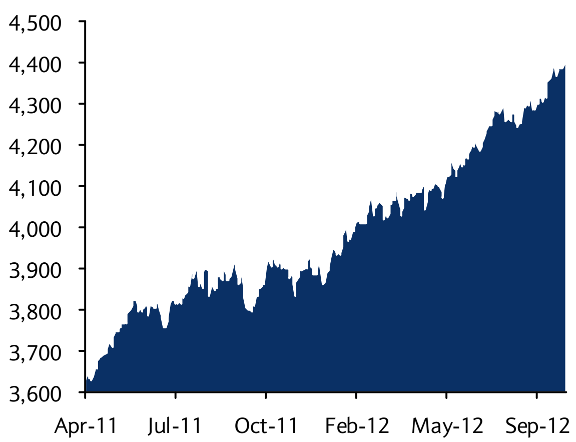
- **The demand picture for credit has been very supportive over the past year, driven largely by aggressive central bank actions around the world, which have pushed investors out along the risk curve and diminished the probability of tail risk outcomes, in our view. We expect supply/demand technicals 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. The main risk to fund flows, in our view, is a large rise in rates, which we do not expect in the near to medium term. 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.**
- **Accommodative Fed policy and low default rates have made high yield attractive. Investors have responded by increasing their allocation to the asset class, fueling growth. Retail investors have led the way, as demonstrated by the massive influx of funds into high yield mutual funds and ETFs.**
- **Somewhat surprisingly, the loan market investor base is little changed from last year, as resurgent CLO creation has offset legacy structure amortization and slow but steady inflows have allowed mutual funds to grow in step with the market.**

Investment Grade – As Strong as Ever

The investment grade corporate universe has continued to expand rapidly this year, growing by almost 15% in market value and 9% in amount outstanding since our last demand analysis, in September 2011 (Figure 1). The growth in the universe has been driven by this year's

Figure 1: Investment Grade Corporates Market Value ($bn)



Note: Based on the Barclays U.S. Corporate, U.S. 144A and U.S. FRN indices.
Source: Barclays Research

Figure 2: Estimates of Ownership of Investment Grade Corporate Bonds (% of Total Universe)

Category	Current Estimates	2011 Estimates
Life Insurance	34-37%	35-38%
P&C Insurance	6-8%	6-8%
Pension Funds	15-17%	16-18%
Domestic Mutual Funds	14-16%	12-14%
Banks	6-9%	6-9%
Hedge Funds	1-3%	1-3%
Other*	15-20%	15-20%

Note: *Other includes endowments and foundations, primary dealer inventories, sovereign wealth funds, offshore funds, and direct holdings by households.
Source: Federal Reserve, Lipper, Company Reports, SNL Financial, EPFR, HFR, BarclayHedge, Nacubo, Barclays Research

record-breaking new issue volumes, in addition to significant price appreciation. With just over two months of 2012 to go, investment grade issuance has already surpassed last year's total and is on track to break all-time records.

In the past 12 months, changes in allocations of investment grade corporate bonds across the major holders have been relatively modest, on our estimates. The one notable change has been the rise in the portion of the universe held by mutual funds and ETFs. Below, we detail some of the major trends in, and our outlook for, the ownership base of investment grade credit.

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. The growth in their holdings has been driven solely by the funds' increase in AUM on the back of persistently strong flows and has occurred even though multi-sector bond funds have marginally decreased their allocation to corporate bonds. In the past 12 months, taxable bond funds have lowered their allocation to investment grade corporates by about 2% in favor of other asset classes.

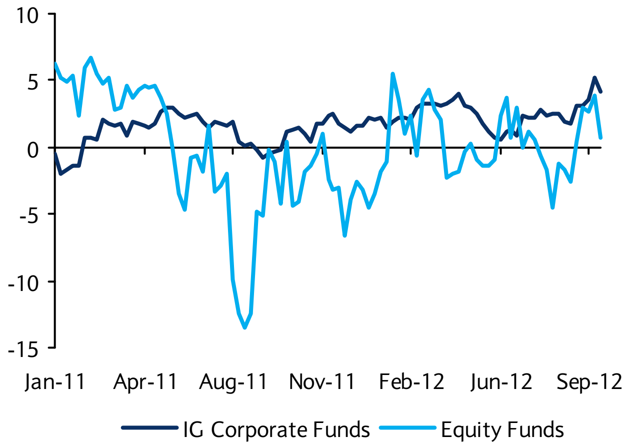
Fund flows into corporate bond funds have been extremely strong in the past 12 months, even during periods of risk-off sentiment. Year-to-date flows into investment grade bond funds total more than $106bn, with only one week of outflows all year. In comparison, inflows in all of 2011 were just over $60bn. The steady flows into credit funds stand in stark contrast to flows into equity funds (Figure 3), with outflows of over $25bn since January 2011, and high yield funds, which have also posted several weeks of significant outflows this year. Part of the reason for the steady inflows has been the decreasing interest rate environment and the Fed's commitment to keeping rates low for a protracted period, which has decreased investor concerns about negative total returns due to rate increases.

The growth in investment grade ETFs has been especially notable, with flows into this segment making up more than 22% of total flows into investment grade funds since 2011, even though ETFs account for only 8% of investment grade fund 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 several reasons:

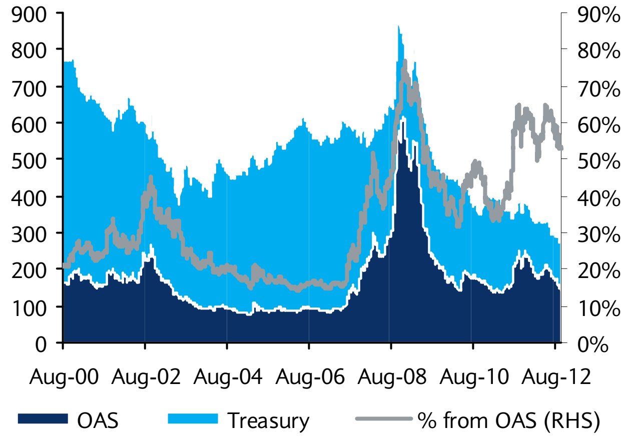
- Investment grade fund flows tend to be much less volatile than high yield and equity fund flows. Even during the marked selloff in 2H11, investment grade fund outflows totaled only 70bp of total fund assets. This is in contrast to high yield funds, where outflows equaled approximately 4.2% of high yield fund assets during that time.
- The current yield pickup of investment grade corporates over Treasuries is near historical highs, with more than 50% of credit's all-in yield coming from spread (Figure 4). That ratio is very close to the ex-crisis highs and more than twice as high as the pre-crisis average. This means that investors can more than double their yield by swapping from Treasuries to investment grade corporates.
- The new round of Fed purchases of agency MBS is likely to push some investors, including money managers, away from that asset class into other spread product, given that the Fed buying will significantly exceed net issuance of agency MBS. We think investment grade corporates are among the alternatives such investors may consider.
- As mentioned above, mutual fund flows into credit can turn negative when rates increase markedly. However, we believe that the Fed's latest commitment to keep rates low through mid 2015 should allay investors' fears of a rate-driven selloff and be supportive of flows in the medium term.

Figure 3: Fund Flows into Investment Grade Corporates and Equities ($bn, 4-week Moving Average)



Source: Lipper, Barclays Research

Figure 4: US Corporate Index: Contribution to YTW from Spread and Treasury Yield (bp)



Source: Barclays Research

- We expect the growth in credit ETFs to continue, as they provide a cheaper and more tax-efficient alternative to mutual funds and a more liquid alternative to buying cash bonds. Furthermore, LQD, the biggest investment grade corporate bond ETF, has had a relatively low tracking error versus its benchmark (iBoxx $ Liquid IG Index).

Insurance Companies – No Major Changes on the Horizon

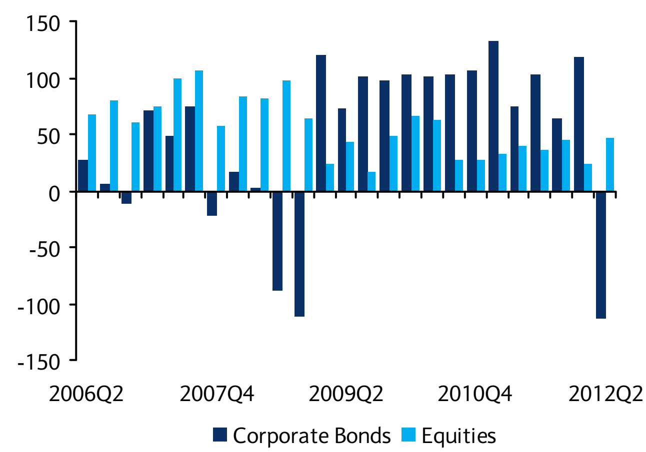
Life insurance companies are the single largest buyer of investment grade credit, holding 34-37% of the universe, based on our estimates, which is only slightly below their share of the asset class a year ago. Given that they tend to employ a buy-and-hold strategy for their corporate bond holdings, the volatility of flows from this buyer group tends to be limited. P&C insurers also tend to have fairly stable holdings of corporate bonds, although they hold a much smaller portion of the universe (6-8%).

Despite the historical stability of life insurance holdings of corporate bonds, Federal Reserve Flow of Funds data show that life insurers pulled back somewhat from buying corporate bonds in 2Q12, even though they were net buyers of corporate bonds in the preceding 12 months (Figure 5). However, we view this move as one-time in nature, rather than the start of a trend. The two factors that typically lead insurance companies to scale down their corporate bond holdings are large falls in Treasury yields and sudden selloffs in risky assets. Both occurred in 2Q12, with the OAS of the Corporate Index widening by 40bp and 10y Treasury yields falling by more than 50bp. 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 increase the attractiveness of high grade corporate bonds relative to Treasuries and MBS. Finally, aggressive action by the ECB has decreased the probability of tail risk outcomes that could lead to a major credit market sell-off, in our view. In the longer term, interest rate increases should lead to higher demand for corporates from insurance companies, which should more than offset the mutual outflows that may be precipitated by negative total returns from large rate increases.

Pension Funds – Holding Steady

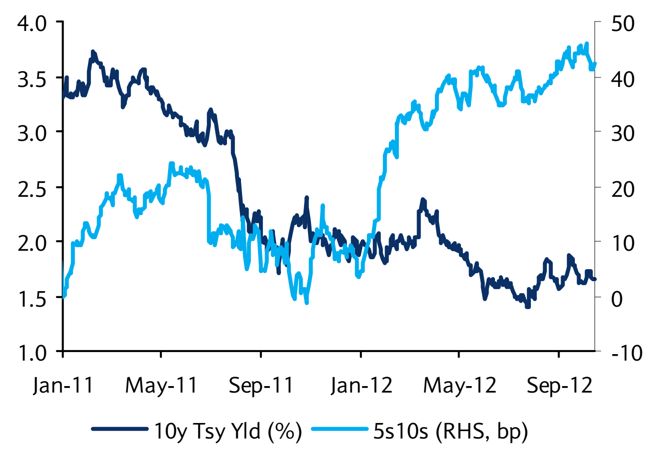
According to our estimates, the investment grade corporate bond holdings of pension funds have increased slightly in the past 12 months, but not enough to offset the growth of the corporate bond universe. Thus, the percentage of corporates held by pension funds has

Figure 5: Life Insurance Flows into Credit and Equities ($bn)



Source: Federal Reserve, Barclays Research

Figure 6: Corporate Index 5s10s Curves versus Treasury Yields



Source: Federal Reserve, Barclays Research

declined somewhat. We estimate that pension funds hold approximately 15-17% of the investment grade corporate universe. Since pension funds have defined future liabilities, they tend to be more sensitive to levels of yields rather than changes in yields. According to the Federal Reserve Flow of Funds data, flows into corporate bonds have been near zero or negative since 1Q10, likely caused by the low yields of the past two years.

Slowing demand for credit from pension funds has also been evident in the shape of credit curves. Since pension funds (and insurance companies) are large buyers of longer-dated credit, their buying patterns have a meaningful effect on the shape of credit curves. Curves have steepened significantly over the past 12 months, and 5s10s credit curves are now near their all-time steepest levels, while 10s30s curves are as steep as they have been post-crisis. The steepening has occurred in tandem with a drop in Treasury yields, as yield-sensitive buyers have been more reluctant to participate in the long end at such low yield levels.

We expect pension fund buying of the asset class to remain muted until yields start to rise again. However, we do not expect them to be outright sellers, given that many funds discount their plan liabilities using investment grade corporate rates and will thus need to maintain a significant exposure to corporates to match their liabilities.

Other Buyers

Other major holders of investment grade corporate bonds include banks, hedge funds, endowments and foundations, primary dealers, sovereign wealth funds, foreign mutual funds, and households in the U.S. and abroad.

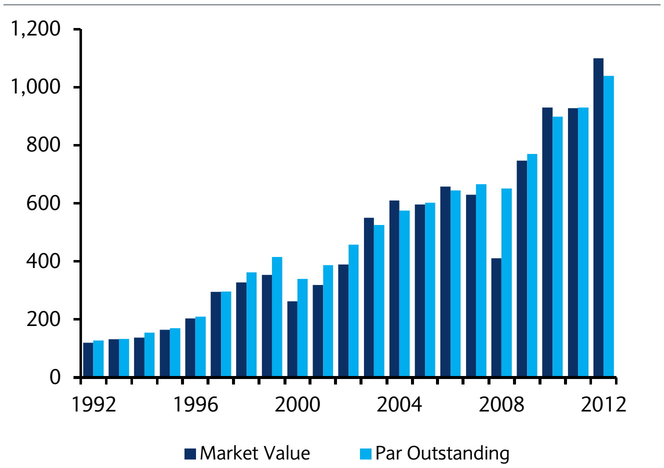
- We estimate that banks hold approximately 6-9% of investment grade corporate bonds. This includes holdings in banks' held-to-maturity, available-for-sale, and trading accounts, but excludes the corporate bonds held by primary dealers, which we discuss below. According to regulatory filings, U.S. banks boosted their exposure to U.S. corporate bonds slightly between 2Q11 and 2Q12, but their share of the overall universe has not changed.
- According to our estimates, hedge funds hold approximately the same percentage of the universe as they did last year – 1-3%. Hedge funds' asset allocation tends to be fairly volatile; however, because they hold such a small percentage of the overall universe, their effect on overall demand is limited.

- We estimate that endowments and foundations hold 1-2% of the universe and that their allocation to corporate bonds and fixed income in general has declined somewhat in the past year. We believe that has been due to the continuing drop in yields, which made the asset class less attractive in terms of its ability to generate a return sufficient to meet required spending rates.
- Primary dealers' holdings of corporate bonds have continued to decline, dropping by approximately 25% in the past 12 months, and are now only $10bn away from all-time lows. We estimate that primary dealer holdings account for a bit less than 1% of the overall universe and do not expect their holdings to rise meaningfully any time soon, given recent regulatory changes. As a result, we expect liquidity to remain challenging and spread volatility elevated.
- We estimate that sovereign wealth funds, offshore mutual funds, and foreign and domestic households hold another 15-20% of the investment grade corporate bond universe. There is very limited transparency on holdings by these other categories, making it difficult to analyze changes in buying patterns. That said, Federal Reserve Flow of Funds data show that corporate and foreign bond holdings by the household and rest of world categories have fallen somewhat over the past year, suggesting that the share of the universe held by these investors is toward the lower end of our estimated range.

High Yield – The River Becomes a Flood

As we noted out in last year's *On Demand*, mutual fund flows are by far the most visible source of demand information for high yield corporate bonds. As such, they tend to receive a disproportionate share of investor attention as a proxy for overall market sentiment. While at some points in the past this focus on fund flows has arguably been a bit overdone, in 2012 it has been justified, in our view, as robust inflows have been the primary driver during a period of very strong market growth. During the roughly 13 months since our last demand piece, the Barclays U.S. High Yield Index has grown by more than $100mn by par amount, from $930bn to $1.04trn today. Coupled with seven points of price appreciation over the same period, this growth has pushed the market value of the index to almost $1.1trn, by far an all-time high for the high yield market (Figure 7). In this update to last year's analysis, we once again examine the various sources of high yield demand (Figure 8), note how they have changed y/y, and consider the outlook for demand in 2013.

Figure 7: U.S. High Yield Index Par and Market Value ($bn)



Source: Barclays Research

Figure 8: Estimated Share of U.S. 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
CLO's / 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

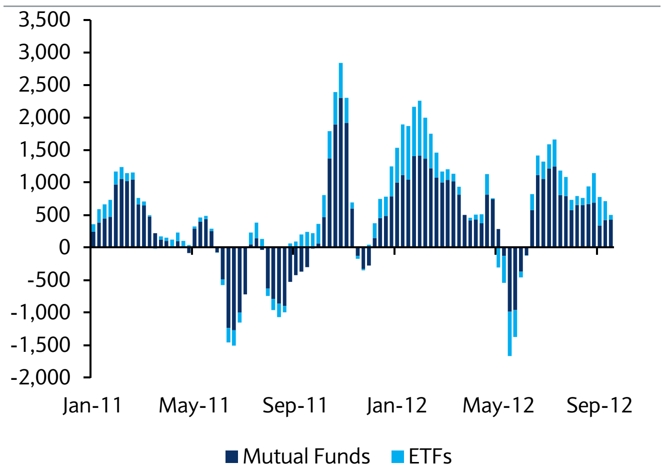
Retail Holdings - Fund Flows Tell True Tales in 2012

High yield mutual funds have been the primary beneficiaries of high yield's status as one of the last available investment opportunities offering anything more than a low single-digit yield. According to Lipper data, the aggregate AUM of U.S. high yield mutual funds has risen from $170bn a year ago to $244bn today, a y/y par value increase of 36% (adjusted for price appreciation) that easily outpaces the market's overall growth rate of just under 12%. As a result, high yield mutual funds have picked up approximately 3% share and now comprise the single largest source of high yield demand, at nearly a quarter of the market. For comparison, as recently as late 2008, high yield mutual funds were as low as fourth in total share, trailing investment grade mutual funds (which were more established at that time), hedge funds, and pension funds. High yield ETFs (primarily JNK and HYG) have led the way, having roughly doubled in size since this time last year.

As Figure 9 shows, much of the growth in high yield mutual funds and ETFs has come in the form of fund inflows, which have been strongly positive for most of the year (apart from a few weeks in May prior to the Fed's announcement that Operation Twist would be extended). Year-to-date net inflows stand at $36.3bn, breaking the previous record of $32.7bn set in 2009 during the early stages of the recovery. Since our last demand update, in September 2011, the total inflow figure is approximately $45bn, against roughly $20bn in coupon payments distributed to mutual fund managers over the period. Netting the two, we find that at least $25bn in new retail money entered the asset class (reinvested coupon distributions are counted as inflows). As we have noted in the past, there is a strong concurrent relationship between fund flows and returns volatility, as well as a mild predictive relationship when flows are lagged (i.e., flows tend to chase returns, not drive them). As Figure 10 shows, returns volatility has been much lower on average this year than in 2011, clearing the path for the record inflows that followed. Given that volatility has generally been subdued during periods of active Fed intervention, we expect high yield inflows to remain positive during the coming months as the Fed pursues additional asset purchases.

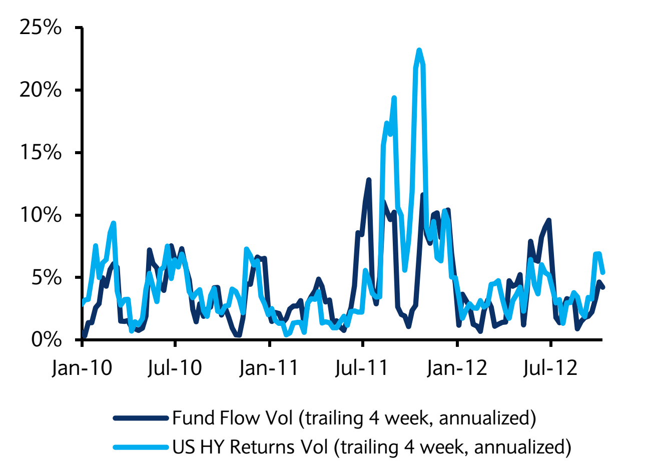
Unlike last year, investment grade and income mutual fund holdings of high yield debt have not outpaced overall high yield market growth so far in 2012. At first, this seems counter-intuitive, given the strong investment grade fund flows, as well as ample anecdotal evidence

Figure 9: High Yield Mutual Fund and ETF Fund Flows ($mn)



Note: Figures represent 4-week moving average of flows from all funds, including weekly and monthly reporters. Source: Lipper U.S. Fund Flows

Figure 10: High Yield Fund Flow and Total Return Volatility



Note: Volatility figures represent the annualized trailing four-week standard deviation of total returns and fund flows as a % of total assets.
Source: Lipper U.S. Fund Flows, Barclays Research

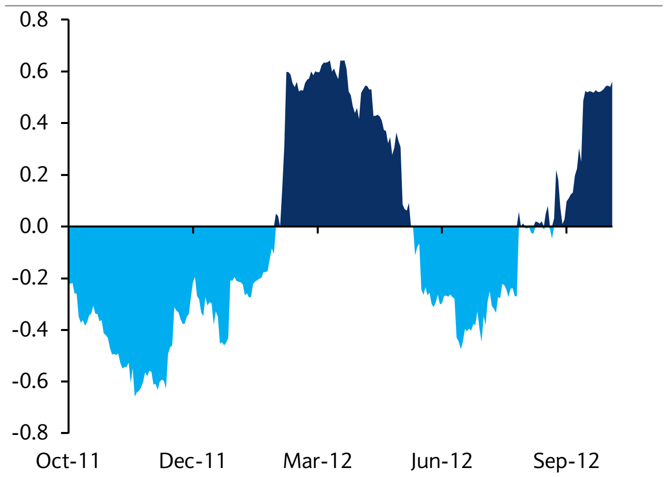
of higher quality managers increasing their high yield allocations in pursuit of better returns. However, two less obvious factors have tempered these increases somewhat. First, as mentioned above, investment grade and income fund managers have slightly lowered their allocation to corporate bonds overall since last year, in favor of government debt. Second, much of Ford's $27bn in outstanding bond debt was already held in investment grade portfolios when the Moody's upgrade took place in May. The upgrade of such a large issuer acted as a de facto shift away from their high yield allocation, as the holdings were generally retained after the upgrade rather than replaced with other high yield bonds. Netting these effects, we find investment grade managers' aggregate high yield holdings to be a shade under $200bn, against an overall asset base of some $3.25trn, for an average high yield allocation of around 5% of total assets. Given their absolute size, higher quality fund managers will continue to be an important source of demand for high yield assets, and the longer the current low yield environment persists, the more high grade managers may be tempted to increase their allocations to high yield in search of higher relative and absolute performance (provided the default outlook remains benign, of course). An increase of even 0.5% in average allocation from investment grade managers would make a material difference in the high yield demand picture, particularly given that high grade funds are also experiencing robust inflows. Any incremental demand would disproportionately affect higher quality levels within high yield. As such, we believe the BB/BBB spread gap, which is currently near its long-run average when normalized for spread levels, is likely to tighten gradually as long as the low yield environment persists.

Other sources of retail demand for high yield include loan mutual funds ($30-40bn in high yield bond holdings) and offshore funds ($60-70bn), both of which are small in absolute terms and appear to have lagged the growth rate of the overall market. With loan mutual fund flows fairly muted given the outlook for short rates, asset growth has been modest, and the incremental contribution to high yield demand has been immaterial. Offshore funds also appear to have been small net buyers of high yield assets in 2012, but at a pace that lagged overall market growth, causing their estimated share to slip by approximately 1%. As we noted in *Carried Out*, May 25, 2012, volatility in the Brazilian *real* versus U.S. dollar exchange rate (Figure 11) has contributed to a decline in the popularity of offshore fund vehicles that add a currency overlay on top of U.S. high yield portfolios. Until global growth concerns subside, ongoing FX volatility is likely to act as an inhibitor to growth in offshore holdings of U.S. high yield corporate bonds.

Figure 11: BRL/USD Exchange Rate

Source: Bloomberg

Figure 12: Rolling 30-Day Correlation Between HFR Macro Index and Barclays U.S. High Yield Total Returns Index



Source: HFR, Bloomberg, Barclays Research

Institutions – Holding the Line, but Not Redrawing It Just Yet

Despite yields that would once have been considered wholly unappealing, hedge funds have continued to show interest in high yield this year, particularly as risk appetite has returned to the market in recent weeks. The aggregate AUM of fixed income corporate bond relative value funds (as reported by HFR) has remained fairly constant y/y, and some recent marginal buying appears to be coming from macro fund managers, who rotate in and out of U.S. high yield in the context of a dynamic asset allocation process. As Figure 12 shows, the correlation between macro hedge fund returns (as reported by HFR) and the Barclays U.S. High Yield Index is now significantly positive, after having been sharply negative in the autumn of 2011 amid a prolonged bout of macro-driven risk aversion. However, macro hedge fund exposure to high yield is often taken synthetically, so the sharp swing in correlation does not necessarily imply a large increase in actual cash bond holdings. As a result, our estimate of hedge fund holdings of high yield corporate bonds has risen only to $135-155bn, growth that has kept hedge funds' market share constant in the mid-teens. On a cautionary note, hedge fund positioning appears to suggest that high yield is exposed to the effects of a macro fund exodus (real or synthetic) should risk appetite suddenly wane, and the market is a long way from yields at which hedge funds typically begin providing support on an absolute basis (10% or higher).

According to the most recent Federal Reserve Flow of Funds data, the total corporate bond holdings of public and private pension funds have remained relatively constant y/y. Granularity regarding the high yield versus investment grade allocation of pension funds is difficult to come by, but anecdotal evidence suggests that pension managers have increased their allocation to high yield marginally this year in search of better nominal returns. However, it appears that the increase has been insufficient to overcome the lack of overall growth in corporate bond holdings, causing pension funds' aggregate share of the high yield market to slip by roughly 1%, even as nominal holdings rose slightly. We estimate total pension holdings of high yield at roughly $145-165bn, out of approximately $770bn in reported pension holdings of corporate and foreign bonds and nearly $9.4trn in total assets. Similar to investment grade mutual funds, pension funds are so massive that even small changes in corporate bond allocations could make for a material increase in demand.

Finally, insurance portfolios (P&C and life) appear gradually to be replacing their unwanted holdings of downgraded structured products with high yield bonds, such that their aggregate share of the high yield market is holding steady. We now estimate insurance holdings of high yield corporates at $100-120bn, up 10-15% from 2011, keeping their share of the overall market at around 10%. As we noted last year, our analysis of pension portfolios turned up numerous holdings of structured products that were downgraded in the wake of the 2008 financial crisis, particularly the formerly investment grade tranches of private-label RMBS. Natural runoff has also reduced these holdings over time, affording insurance portfolio managers with a few opportunities to add high yield assets while remaining within their regulatory restrictions. Still, the illiquid nature of legacy structured holdings should continue to make this a gradual process, leading us to conclude that growth in line with the market is probably the best we can hope for from insurance buyers over the next several years.

The Road Ahead

Today's high yield market finds itself in favor because of the combination of lower-than-average volatility, a benign near-term default outlook, and a dearth of better alternatives in a yield-starved world. But present conditions are no guarantee of future results. Nearly two-thirds of the asset base is held by mutual funds, hedge funds, and offshore vehicles, all of which tend to be highly pro-cyclical sources of demand. High yield's remarkable growth remains dependent on positive GDP growth and an accommodative Fed to help tamp down volatility. Fortunately, both of those things appear to be on offer for the foreseeable future. As such, the flood of flows is likely to continue into 2013, and market growth along with it.

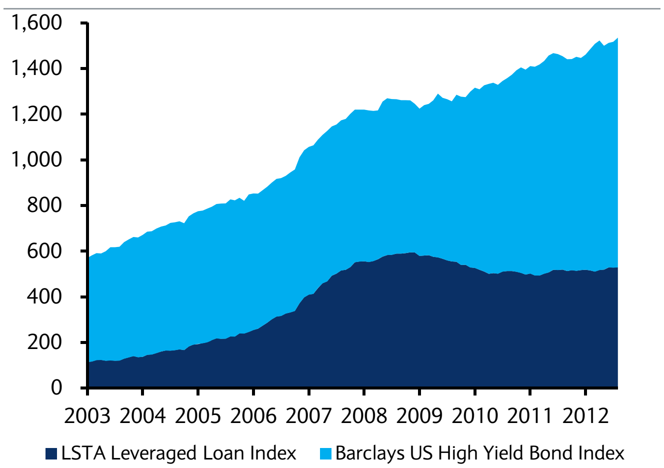
Leveraged Loans – Steady as She Goes

In last year's *On Demand*, we noted the oncoming acceleration in pre-crisis CLOs exiting their reinvestment periods, as well as the associated unfavorable demand technical for the institutional loan market. As the title "Demanding a New Home" suggested, many market participants felt that the existing investor base would be insufficient to handle issuers' refinancing needs. Notional growth had just barely returned to the leveraged loan market, after it shed more than $100bn in institutional par amount between late 2008 and early 2011. Much of this declining loan balance was refinanced in the bond market as secured paper, as the total size of the U.S. leveraged finance market returned to its pre-crisis growth trend even as the loan market continued to shrink in 2009 and 2010 (Figure 13). Many market participants came to view secured bond investors as the key to a soft landing for the then-daunting 2013-15 loan maturity wall. Fortunately, the slow but steady increase in institutional loan demand that began in the summer of 2011 has persisted in 2012. Thanks to this demand growth, total par amount in the LSTA Leveraged Loan Index has risen approximately 3% since the publication of last year's demand update, and loan primary market activity is currently robust amid issuer-friendly market conditions. Our analysis suggests that the loan market investor base is little changed from last year, as resurgent CLO creation has offset legacy structure amortization and slow but steady inflows have allowed mutual funds to grow in step with the market. As a result, we keep our market share estimates unchanged from last year (Figure 14).

CLOs – The Elephant in the Room Is Alive and Well

A year ago, the biggest risk to loan market stability appeared to be CLOs, as more and more pre-crisis deals were exiting their reinvestment periods (Figure 15) and, thus, were unable to participate in refinancing transactions that materially extended maturities. Meanwhile, the CLO primary market had only recently begun to stir, with just $13bn in new structures priced through 3Q11. As we described in *Net Neutral for Now*, (July 27, 2012), new CLO creation needed to reach nearly $30bn this year and rise to more than $45bn by 2014 just to offset the amortization of legacy structures and allow CLOs to retain their existing holdings of cash

Figure 13: U.S. Leveraged Finance Par Amounts ($bn)



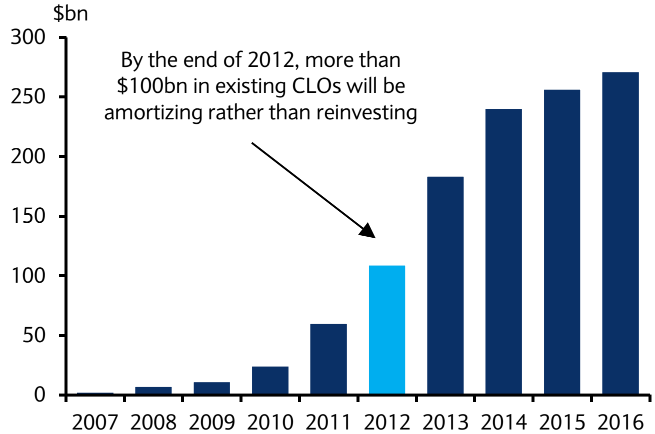
Source: Barclays Research

Figure 14: Estimated Share of U.S. Leveraged Loan Holdings

Category	% of Total Universe Held
U.S./European CLOs	46-52%
High Yield/Distressed/Hedge Funds	15-20%
Mutual Funds (Open, Closed, ETFs)	12-15%
Total Return Swaps (TRS)	5-7%
Insurance (P&C & Life)	3-5%
Other (Banks, Dealers, Private Lenders)	10-15%

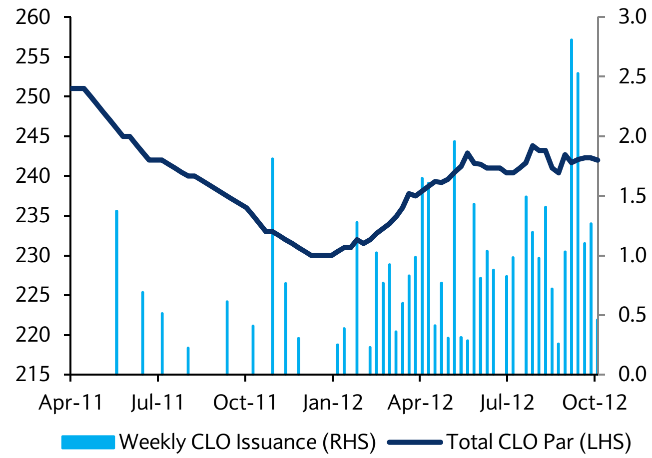
Source: Bloomberg, Lipper U.S. Fund Flows, EPFR, HFR, Barclays Research

Figure 15 : Par Amount of CLOs Outside Reinvestment by Year



Source: Intex, Barclays Research

Figure 16: CLO Total Par Outstanding and Weekly Issuance ($bn)



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

loans. CLO managers have been able to meet and exceed that threshold this year, issuing $37bn in new deals with more than two months remaining on the calendar. The acceleration of new deal creation reversed the decline in total CLO par outstanding in the early part of this year (Figure 16), allowing CLOs to become small net buyers of cash loans. As a result, total CLO par outstanding has grown by approximately 2.5% since last year's demand report was published, very close to the overall growth rate of the cash loan market, allowing their share to hold steady. As was the case last year, CLOs appear to hold slightly less than half of the total amount of U.S. leveraged loans currently outstanding. With the pipeline for further CLO creation looking robust at close to $8bn and spreads continuing to grind tighter across the capital structure, we are optimistic that CLOs can continue to be a small net buyer of loans next year, provided that a material increase in risk aversion does not reappear.

Retail Demand Settles Down after a Tumultuous 2011

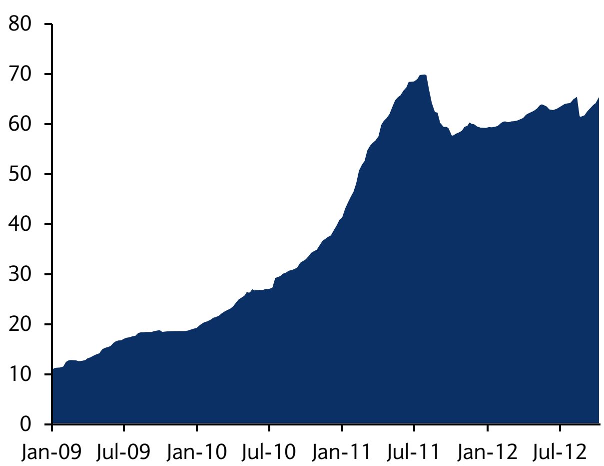
As we reported last year, loan mutual funds were considered a candidate to replace the shrinking CLO bid in early 2011, when loan fund flows were robust amid general investor sentiment that rates were likely to rise. The Fed's summer 2011 pronouncement that rates would remain on hold through mid-2014 (subsequently extended to 2015) put an end to the loan fund euphoria, and massive outflows followed, cutting assets by 15% in just a few months (Figure 17). It was in the midst of this exodus that our demand piece was written, and at the time there seemed little reason to expect a retail buyer comeback. Fortunately, loan flows stabilized once the "rate risk" crowd had fully departed. Week by week, small positive flows into the asset class have allowed it to grow by roughly 3.5% y/y in notional terms, with price appreciation adding another few percentage points to AUM. This slow but steady single-digit growth has kept mutual funds' share of the market at a relatively constant 12-15%. Given the Fed's clearly communicated intentions regarding interest rates, we do not expect a resumption of large inflows into loan mutual funds and ETFs in 2013, but given loans' compelling value relative to high yield bonds (comparable yields, better security, and asymmetrical rate exposure thanks to Libor floors), a continuation of smaller yet steady inflows appears likely. Overall, we find it encouraging that, like CLOs, mutual funds now constitute a small net buyer of cash loans, providing further stability to an increasingly self-sufficient loan market.

Other Sources: Is a 5% Current Yield Enough?

Beyond CLOs and loan mutual funds, other material holders of U.S. leveraged loans include high yield funds, distressed funds, hedge funds, insurance portfolios, banks and broker/dealers, and investors gaining exposure through total return swaps (TRS). As we detailed in *Loans Ready for Pickup* (August 17, 2012), loan yields are competitive with high yield bonds at nearly all quality levels when calculated to a three-year average takeout. This seemingly better risk-adjusted yield could entice cross-market investors, including hedge funds, high yield bond funds, and insurance companies, to consider increasing their allocation to loans while lightening their high yield bond holdings. However, we believe two factors make this comparison more challenging, preventing the bond-to-loan swap from being executed on a large scale. First, the recent rally has exposed the much weaker call protection in the loan product, as another repricing wave has recently gained steam (see *Repricing Reboot* for details). Many managers feel somewhat less comfortable with calculated loan yields given the possibility of having 50-100bp skimmed off by repricing whenever market conditions firm. Second, while the calculated loan yield to an assumed takeout is indeed comparable with the yield-to-worst in the bond market, the loan market's current yield of 5.2% lags the bond market by roughly 2.5 percentage points (Figure 18). In a yield-starved world, income-oriented investors may hesitate to sacrifice this much carry, even with the greater security provided by loans' superior position in the capital structure. Nevertheless, anecdotal evidence suggests that high yield bond funds and hedge funds have increased their loan exposure at the margin, so while we leave our market share estimates unchanged relative to last year's update, we acknowledge that the aggregate loan holdings of high yield, distressed, and hedge funds is likely to be closer to the top end of our 15-20% range.

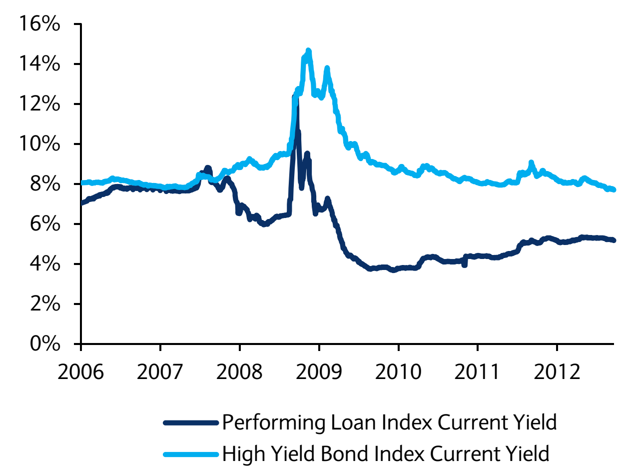
Finally, with banks and broker/dealers still managing down exposure to risky assets ahead of Dodd-Frank implementation and TRS generally in runoff with no sign of a significant comeback, we find it difficult to be optimistic that significant incremental loan demand will come from any of these other sources. If anything, both are likely to remain closer to the lower end of our published ranges, having surrendered some share to bond and hedge funds at the margin that they are unlikely to reclaim. Furthermore, we expect retail demand, as reflected by mutual fund and ETF inflows, to be steady but unspectacular next year. In the end, loan demand in 2013 is likely to be mainly a function of CLO creation. Trends on

Figure 17: Loan Mutual Fund AUM, Including ETFs ($bn)



Source: Lipper US Fund Flows

Figure 18: Current Yields: Leveraged Loans versus High Yield Bonds



Source: Barclays Research

that front are encouraging, and CLO liability tranches remain the best source of yield relative to their credit ratings, suggesting the potential for further tightening . Given current momentum, we are cautiously optimistic that the 2013 hurdle of ~$40bn in required CLO creation can be cleared, maybe with a bit of room to spare, allowing the institutional loan market to continue on its current path of slow, but steady, growth.

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