Leveraging Complexity

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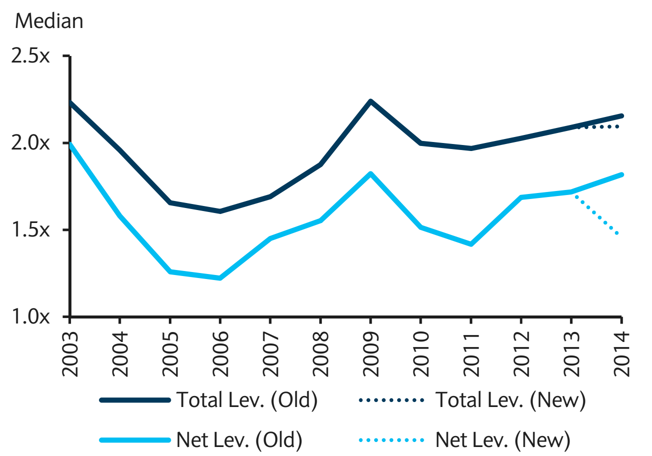
One of the most frequently asked questions we receive as strategists is "What is happening with the leverage of the index." For the past several years, our answer was simple: leverage was rising. When we last updated our view on fundamentals (see *U.S. Credit Alpha Focus: Weaker Fundamentals, Same Price*), we had seen leverage rise for several years and expected it to continue rising into 2014 (Figure 1). With most 2013 financial statements now filed, however, this rising trend appears to have halted, and we now see total leverage as closer to flat and net leverage as declining. As a result, we are taking the opportunity to change our answer to "it's complicated."

So what happened to our predicted increase in leverage? Although median 2013 EBITDA turned out lower than we expected at the time of our original forecast, median debt fell, and median cash rose, at an even faster pace (Figure 2). At least in part, these moves were driven by factors that were idiosyncratic to the constant universe of companies we used. For example, 2013 saw Abbott Labs (ABT) spin off AbbVie (ABBV). That moved ABT's leverage from above the median to below while taking almost $14bn of total debt out of our constant universe, because ABT stayed but ABBV did not.

This recent move highlights some of the trade-offs in the measure of index leverage we usually present:

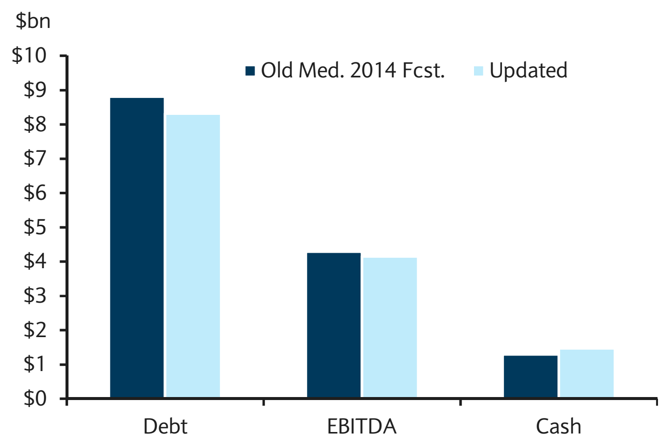
- We have typically used a fixed universe of firms that were in the U.S. Corporate ex. Financials Index for the entire period we consider. The main advantage of the constant universe is that it represents changes in the average tendencies of corporate behavior, which is the question we think investors are most frequently trying to address with the idea of index leverage. The disadvantage is that using a constant group of companies may bias our estimate relative to an index with constantly changing constituents. Figure 3 shows the difference between the median of our constant universe and the median of all the index constituents for which we have data. Since 2006, the constant universe's leverage has risen more than the total universe's (although both have risen in that time), suggesting an upward bias to our measure. At least part of that bias occurs because new index entrants that are excluded from that dataset tend to have lower leverage than

FIGURE 1
Median Total Leverage in Our Constant Universe Is Flatter Than We Expected, and Net Leverage Has Declined Notably



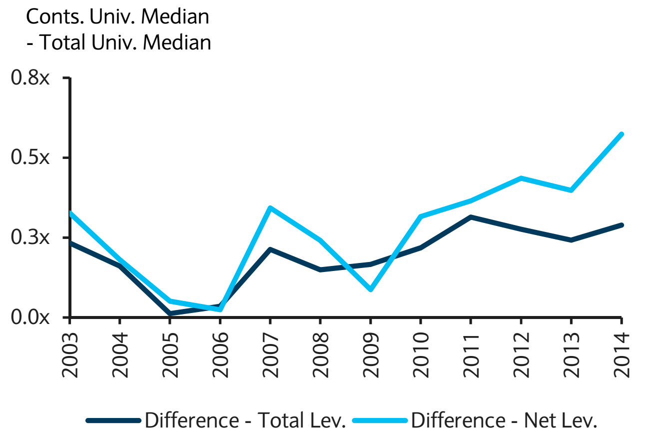
Source: Factset, Barclays Research

FIGURE 2
Net Leverage Has Declined Because of a



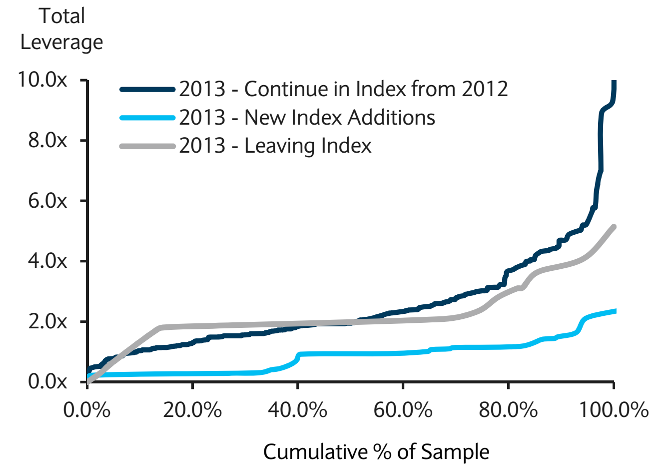
Source: Factset, Barclays Research

FIGURE 3
The Constant Universe Median Has Risen More over Time Than the Median of the Broader Universe



Source: Factset, Barclays Research

FIGURE 4
New Index Entrants Tend to Have Lower Leverage Than Incumbents or Exiting Issuers



Source: Factset, Barclays Research

the firms already in the index (Figure 4), because index additions are much more heavily weighted toward inaugural issuers than rising stars. In the past several years, this has been compounded by first-time issuers such as Apple (AAPL) and Google (GOOG), which carry high cash balances relative to other firms that issue debt.

- We use the median as the measure of central tendency because it is less sensitive to the tails, which tend to move around more dramatically than is representative of the index. The disadvantage of using the median is that it does not reflect investor exposures, which are weighted by the market value of debt outstanding. Figures 5 and 6 show leverage by cumulative index weight. Although it is complicated, with leverage higher in some ranges but lower in others, in general the 2013 curve is below the 2012 curve. Weighting by index exposure, the average of both both total and net leverage declined from the end of 2012 to the end of 2013.

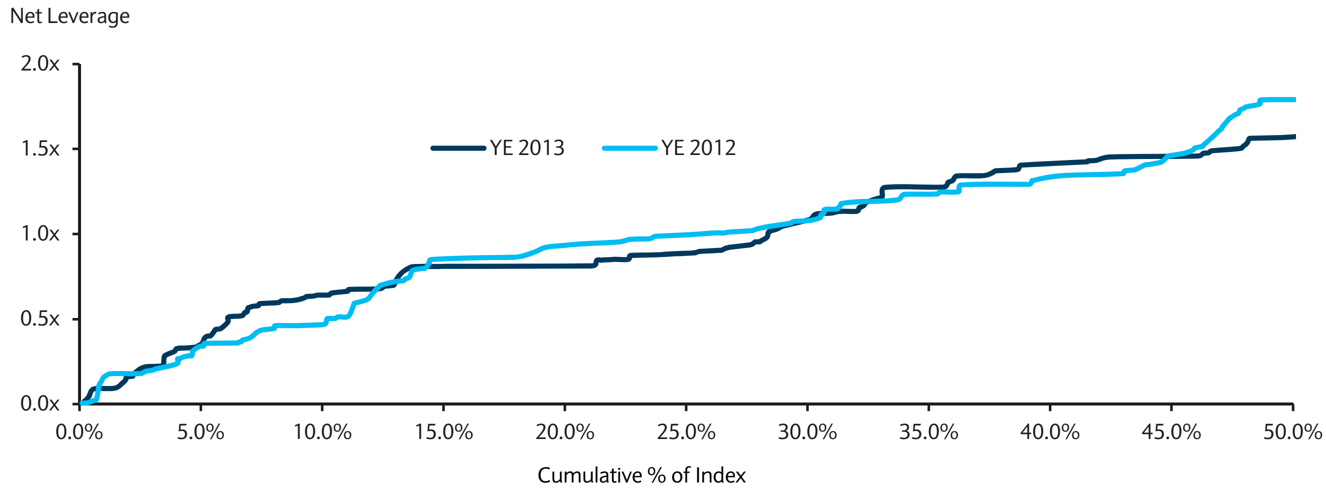
- We have measured leverage as the latest reported debt divided by the consensus forward EBITDA, to smooth out short-term swings in results that are generally disregarded by the market. But this means that our sample is biased toward the large, public companies for which estimate data are available.

Beyond that, there are many more complications: changes in behavior among incumbent issuers, the characteristics of new issuers, industry composition, and trends in default expectations all weigh on the question of what aggregate leverage means for index investors. And that is even before we consider how those factors are compensated by spreads.

So what do we conclude about index leverage? With median total leverage near flat and median net leverage down, and both total and net leverage lower when weighted by index exposure, the upward trend has halted, at least for the moment.

FIGURE 5

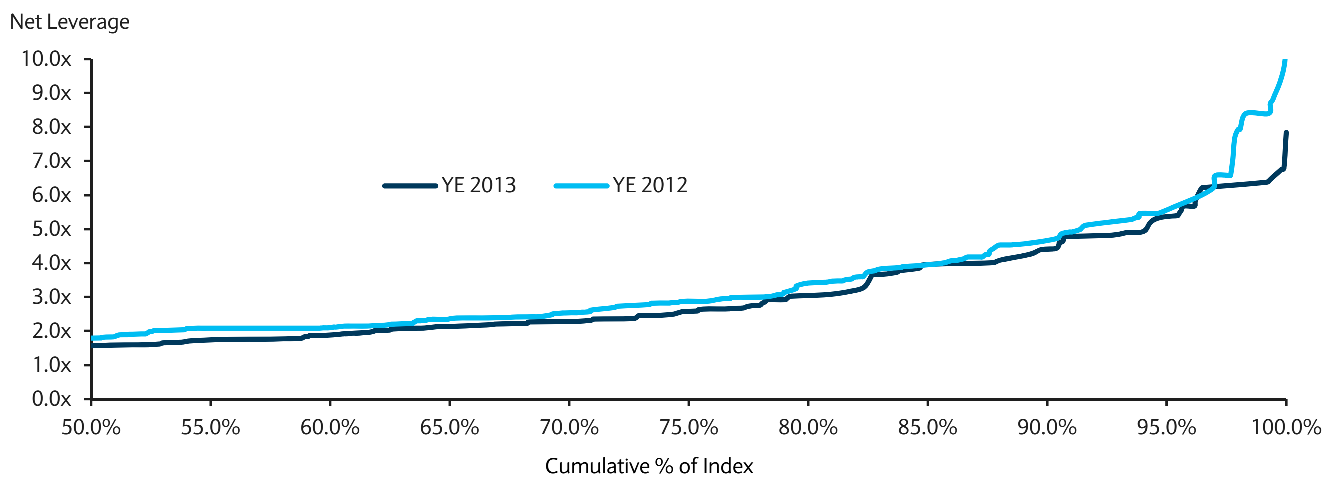
At the Less Leveraged End of the U.S. Corporate Ex. Financials Index (as Measured by Market Value Outstanding), the Leverage Trend Is Mixed…



Source:Factset, Barclays Research

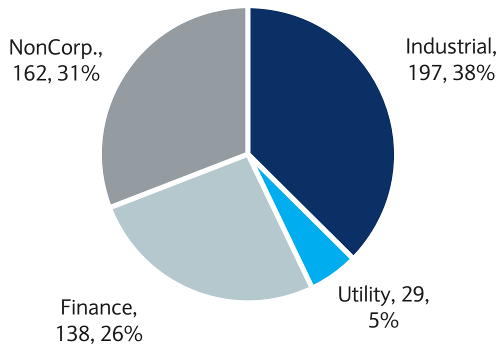
FIGURE 6

…But Investor Exposure to Leverage Has Clearly Declined Y/Y at the More Leveraged End of the Index



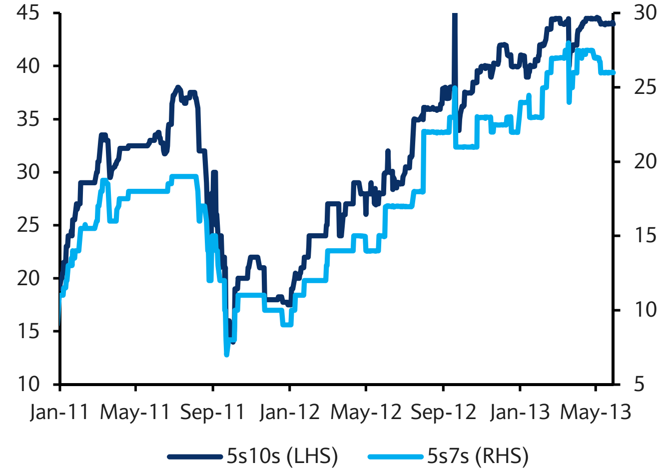
Source: Factset, Barclays Research

Year-to-Date 2013 Fixed Investment Grade Supply ($bn)



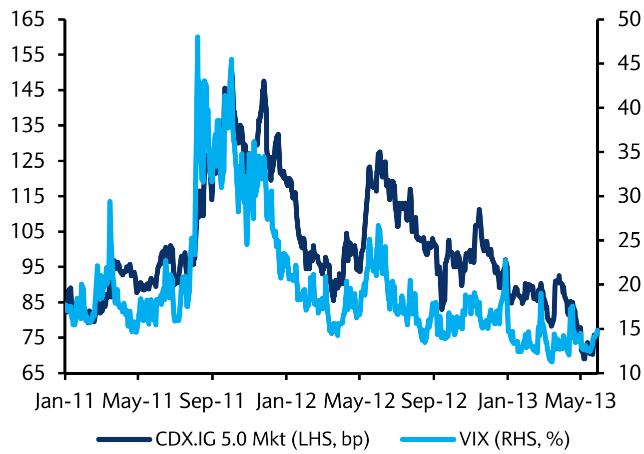
Note: Levels on this page as of Wednesday close. Source: Barclays Research

On-the-Run CDX.IG Curve (bp)



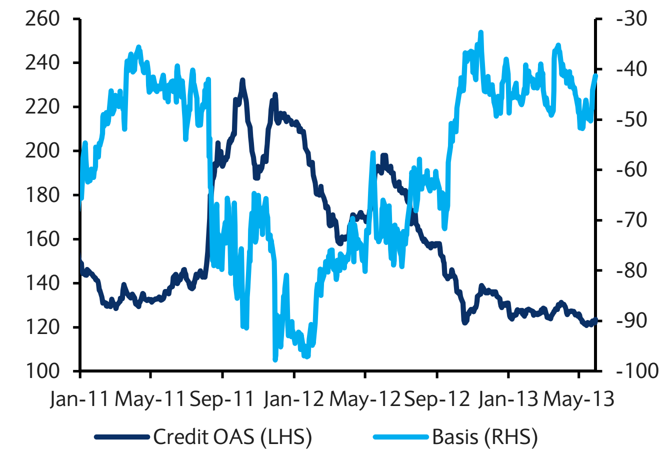
Source: Barclays Research

CDX.IG versus VIX



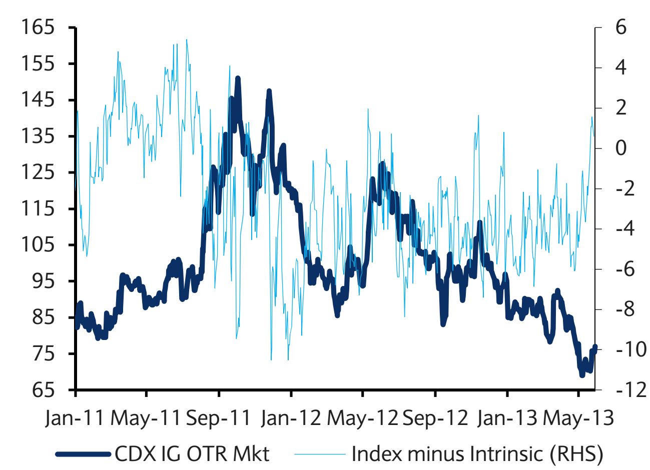
Source: Markit, Barclays Research

CDS-Cash Basis (bp)



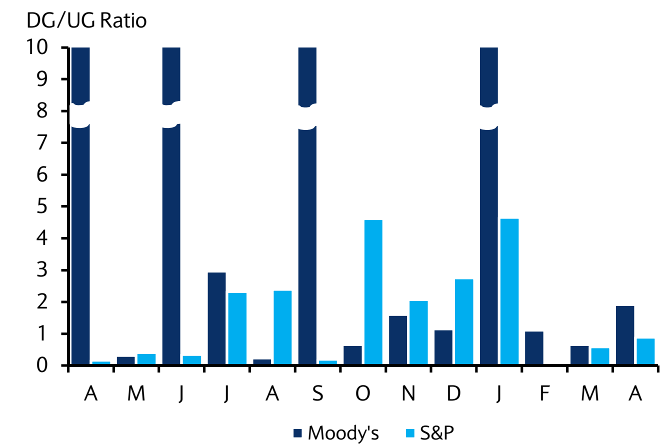
Note: Basis defined as CDX.IG spread – corporate Libor OAS.
Source: Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



Source: Barclays Research

Par Downgrade/Upgrade Ratio



Note: Broken bars indicate a value of greater than 10x. Source: Barclays Research

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