Credit Research
December 2013

# Global Credit Outlook 2014
# Spreads Carry Returns

PLEASE REFER TO THE LAST PAGE FOR ANALYST CERTIFICATION(S) AND IMPORTANT DISCLOSURES

# FOREWORD

2013 has been the calmest year in the credit markets since the start of the financial crisis. What passed for a risk flare this year – the volatility sparked by higher rates amid a fear of tapering – was both more muted and shorter-lived than the risk flares of any of the previous five years. While it is true that some asset classes, such as Municipals and Emerging Market Corporates, have not fully recovered from the sell-off in May and June, the bulk of developed market credit is back at the post-crisis tights despite the material increase in risk-free rates. Investors in these markets have generally been rewarded for taking incremental risk.

We expect more of the same in 2014. The advent of tapering and any associated rise in interest rates may again cause temporary bouts of volatility, but we do not foresee any major disruptions in the credit markets: credit quality remains high; we forecast another year of low default rates; and the major (known) sources of potential systemic risk have largely faded. That said, valuations are already high and the potential for spread tightening is limited in parts of the market. Excess returns in US Investment Grade, in particular, are likely to be muted, as we believe spreads in that market are close to a floor. Risk-adjusted returns are likely to be more compelling in High Yield, in Europe, and in select parts of EM.

We also see relative value opportunities across the credit markets. Our main sector call in the US and Europe is for the continued outperformance of financials. In the US, fundamentals away from financials have started to deteriorate. Eventually, this will become a macro concern, but for 2014 we expect the implications to be limited to an increase in single-name volatility, multiplying the opportunities for credit selection. In Europe, we expect the main source of outperformance to be driven by peripheral credits compressing versus the core.

The evolving regulatory environment will also remain a focus. Regulatory pressure on banks has resulted in improvements to their credit quality, but at the cost of a generic decline in liquidity. We expect more developments on this front over the next year, starting with the release of the Volcker rule later this month. The CDS market also faces an uncertain future, due in part to new regulatory provisions.

With more limited opportunities for broad-based tightening, carry will likely be a larger component of returns than in previous years. Balancing the top-down pressures from rising rates and changing regulations with bottom-up credit analysis will be key to driving performance. This publication brings together the expertise of our strategists and fundamental credit analysts across regions to give our perspective on these issues. We hope you find it useful in navigating the challenges of the year ahead.

Jeffrey Meli
Co-Head of FICC Research

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OVERVIEW

# Spreads carry returns

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com

**Macro tail risks have subsided, and the largest exogenous concerns for credit are the potential actions of the Fed and the prospect of higher interest rates. The focus for developed credit markets in 2014 will be the relationship between interest rates and spread changes. Over the course of the year, we still expect some spread compression, but it will likely be less than in previous rate spikes. We believe negative fund flows on initial rate moves may lead to short periods of rising rates and higher spreads, especially in retail-heavy asset classes such as municipals. With expectations for a more accommodating central bank and a greater improvement in growth, we expect Europe to outperform the US. Although we forecast modest releveraging from non-financial corporates (especially in the US), we generally prefer taking credit risk rather than duration risk. For emerging market corporates, we believe weaker growth will lead to increased credit differentiation and we would be more selective regarding riskier credits, especially in Asia. The longer-duration municipals market will likely produce negative total returns, but we believe high yield municipals represent attractive relative value, trading cheap to the high yield corporate market.**

## Seeking carry, not duration

The corporate credit market has spent the post-crisis period setting a myriad of records that have forced investors to re-examine traditional ways of analyzing the asset class. For most sectors, the largest returns on record came in 2009. Unprecedented low levels of risk-free rates led to numerous supply records in the US and EM in 2012, and the all-time lows in yields were breached in 2013. The one thing that remains far from the previous tights is spread. Dissipating macro concerns would seem to justify a lower generic risk premium as Europe has returned to growth (albeit barely), China appears to have averted a hard landing, and the US avoided default at the eleventh hour, again. However, the specter of eventually higher rates and new, more idiosyncratic risks has emerged and will color performance over the next 12 months. Chief among these concerns are the releveraging of non-financial corporates (especially in the US), slower growth in emerging markets and balance sheet stress for several high profile municipals. In addition, the premium for lower secondary market liquidity remains in an environment where regulatory changes are altering the behavior of banks and should limit the potential for spread compression to pre-crisis tights.

The general strategy of being long beta was effective in 2013, as it has been for most of the post-credit crisis period. Unless spreads can become the next metric to approach their high- (or, actually, low-) water mark, investors are left looking primarily at carry scenarios for excess returns in core credit markets. In general, we expect very modest tightening in spreads, which will only in part offset the expectation of higher risk-free rates. Therefore, while excess returns should be positive, total return prospects are bleak for higher quality bonds. With solid excess return forecasts and much better prospects with respect to total returns, we prefer high yield and leveraged loans to investment grade. This is consistent with an environment where we expect continued corporate releveraging but benign defaults rates of 2.0-2.5%. European balance sheets are still recovering from the prolonged recession, and as a result, the ECB looks set for a more expansionary policy relative to the Fed. A return to economic growth in Europe should lead to a further compression of the peripheral premium in some of the higher-spread credits. Our preference for European risk is also supported by better ratings, shorter duration, and a favorable supply/demand imbalance. In general, this highlights a theme running throughout this report; namely, that we would prefer taking some degree of credit risk over duration risk.

FIGURE 1

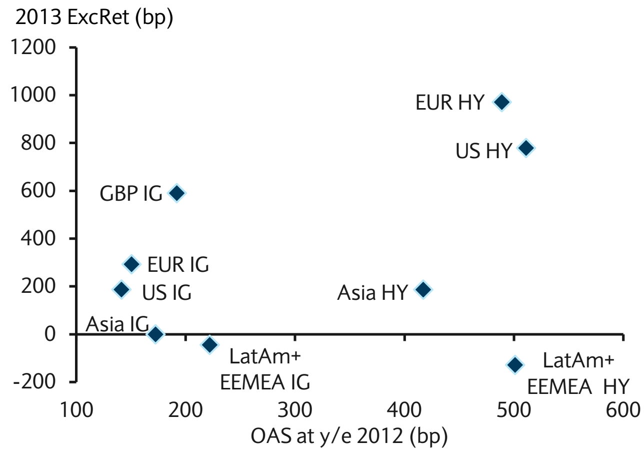
Key market themes and forecasts for 2014

| Market | Key theme(s) | Excess return forecast (bp) | Total return forecast (bp) |
|---|---|---|---|
| **Developed markets** | | | |
| US IG | Continuing improvements in bank fundamentals should lead to slight tightening in IG spreads. On the other hand, non-financial releveraging and a challenging liquidity environment are likely to put a floor on spreads at about the 115bp level. | 125-175 | (175)-(125) |
| EUR IG | Growth-driven spread compression should be led by peripheral and financial credits as euro area concerns continue to fade. Core non-financial credits are likely to perform in line with US credits of similar ratings. | 175-225 | (75)-(25) |
| GBP IG | Sterling is likely to produce the highest excess returns of any IG benchmark index next year thanks to its outsized credit duration. However, securities do not look particularly cheap and the exposure to our favoured areas of credit (peripherals and banks) is limited. | 250-350 | (50)-50 |
| Hybrids* | We expect financial capital securities to outperform, driven by a strong fundamental backdrop that supports moving down the capital structure. Bank Tier 1s also appear compelling relative to HY debt. Corporate hybrids look cheap relative to comparable credit sectors. | US:700-800<br>EU:1000-1200 | US:500-600<br>EU:850-1050 |
| US Municipals (tax-exempt) | Puerto Rico and Detroit will remain topical, but we expect munis to outperform Treasuries in 2014. Negative net supply and attractive valuations – particularly at the long end – will support the market, but a strong rally is not likely without a stabilization of fund flows. | 280-300 | (155)-(135) |
| US HY | Tighter spreads should only partially offset higher rates, with lower quality benefiting from its lower duration and higher carry. An increase in M&A and IPO activity would likely be a source of upside potential. | 500-600 | 300-400 |
| EUR HY | Growth-driven spread compression should fully offset the expected bear steepening in rate curves. Potential sources of outperformance include debut issuers, selected peripherals, and financials – all of which we prefer to duration extension for yield pickup. | 600-700 | 500-600 |
| US Lev Loan | With Libor floors in most loans and prices near par, we see very limited upside potential in 2014. That said, with duration risk a key concern across fixed income markets, loans should again prove to be a low-volatility source of carry. | 325-425 | 350-450 |
| EUR Lev Loan | With most of the market already at or above par, poor convexity limits potential upside in 2014. Meanwhile, CLO creation of €12-15bn should allow the institutional loan market to stabilize after shrinking for five consecutive years. | 375-475 | 400-500 |
| **Emerging markets** | | | |
| Asia IG | In an environment of low returns and a tepid growth outlook, we expect credit differentiation to increase. We suggest overweighting India and Korea while underweighting Indonesia. We recommend taking China exposure through Hong Kong and 'core' China SOEs. | 200-250 | (75)-(25) |
| LatAm + EEMEA IG | This is a bifurcated market, with EEMEA trading rich and LatAm trading cheap. Brazil is on a fundamentally negative path, but corporates reflect this already; we recommend adding Brazil risk. In EEMEA, Russia and GCC are more stable but IG valuations are relatively less compelling. | 450-500 | 250-300 |
| Asia HY | We are cautious overall on Asia credit and expect modest spread widening in high yield (~25bp). We recommend a neutral stance toward Chinese property and prefer Chinese industrials. | 350-400 | 225-275 |
| LatAm + EEMEA HY | We expect default rates to fall from the elevated levels of 2013 (>7% in LatAm HY). Carry alone should be a big buffer against rising UST yields. We prefer Dubai HY, some names in Russia such as VIP and short-dated steel, and a variety of names in LatAm across sectors. | 800-850 | 500-550 |

*Note: Hybrids returns are for PerpNC10 fixed to float T1 in the US and Tier 1s in Europe. Source: Barclays Research

FIGURE 2

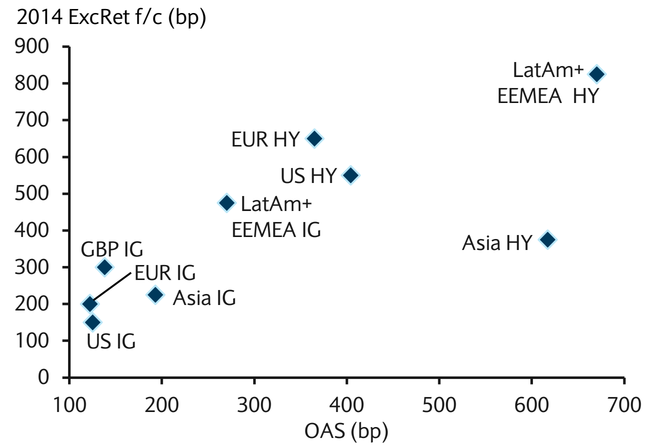
**2013 excess returns versus OAS at year-end 2012**




Note: Excess returns as of November 29, 2013. Source: Barclays Research

FIGURE 3

**2014 excess return forecasts versus current OAS**




Note: OAS levels as of November 29, 2013. Source: Barclays Research

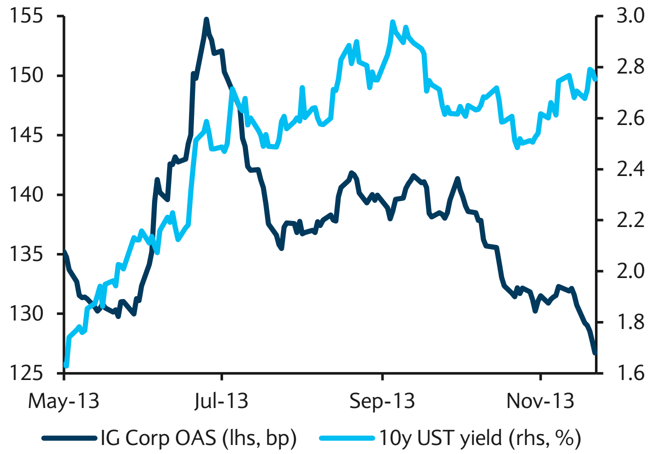
Releveraging should present opportunities from the short side for alpha in developed-market industrial credits. Financials look set to continue to deleverage, and therefore, we remain positively disposed to the sector even after it outperformed this year. We expect the greatest degree of credit differentiation in markets where the underlying fundamentals are less robust. Although we see some upside from elevated emerging market spreads, we do not believe performance will be uniform and prefer Latin America to Asia. Specifically, Fed tapering could have an outsized effect on economies with large current account deficits. The effect will initially be felt on sovereign spreads, but should follow through to corporates, especially in the banking sector. Likewise, higher rates represent a challenge for municipals, the asset class most reliant on fund flows. While excess returns should be positive because of modest ratio compression, negative total returns are still likely for the longest-duration asset class in our universe if our interest rate strategists' forecast of a 3.5% 10y Treasury yield comes to fruition.

## No great rotation, but prepare for short-term shocks

As other macro risks have dissipated, the flashpoint for fixed income markets has been the potential effect of Fed tapering and eventual rate increases. If rising rates in a stable economic environment are the chief concern, this should be a reasonably good environment for credit. Historical data for the US market show that traditional correlations between rate and spread changes have been -0.3 for investment grade and -0.6 for high yield. However, at various points in 2013, these correlations turned positive. The most notable was the selloff between May 2 and June 25, when 10y Treasury yields rose almost 100bp while investment grade spreads widened 20bp and high yield sold off 88bp. However, by the beginning of August, investment grade spreads were only a few basis points wider than they had been three months earlier, and high yield was off closer to 15bp (Figures 4 and 5).

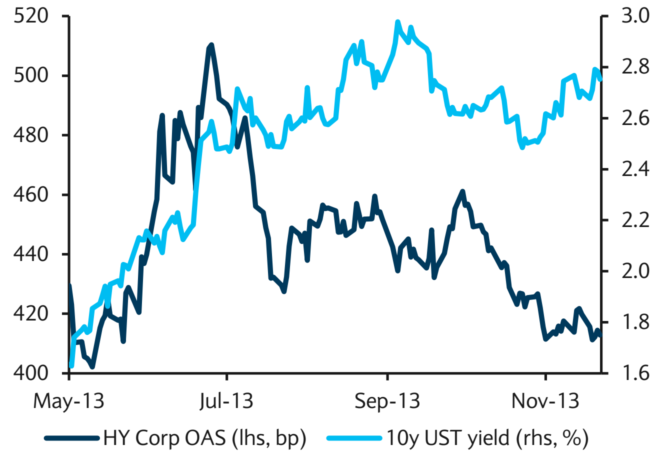
While the pain felt by long credit investors as they watched the market sell off sharply over a six-week period should not be understated, when we make our forecasts for the full year, we also keep in mind the medium-term performance, even after episodes of very high volatility. In early 2013, we detailed why we believed there would not be a massive rotation out of credit (*The Great Rotation: Myth or Reality?*, 1 February 2013). Using US data because of its robust spread history going back to the early 1990s, we find that every time there has been a rate increase of at least ~50bp over any period ranging from only a few months to a full year, excess returns have been positive. If we update the analysis using May 2 as the trough for rates this year and September 5 as the peak, the findings are consistent with the other 14 periods in our analysis, given that credit eked out slightly positive excess returns as carry offset a modest widening in spreads.

FIGURE 4
**US investment grade corporate OAS versus 10y UST yield**




Source: Barclays Research

FIGURE 5
**US high yield corporate OAS versus 10y UST yield**

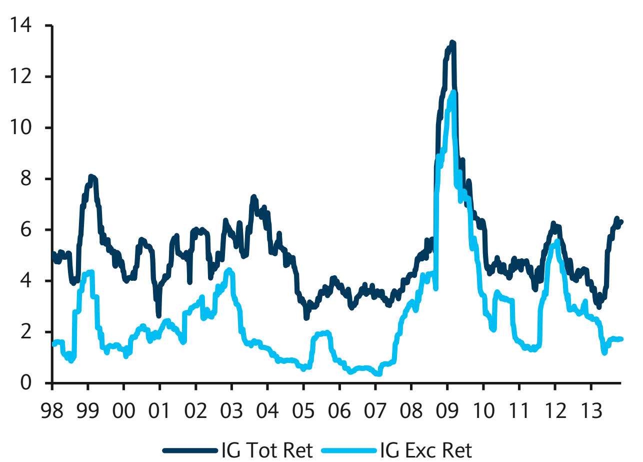



Source: Barclays Research

Our forecasts for 2014 are consistent with the historical analysis, but similar to 2013, they are at one extreme. In fact, while the positive excess return record held during the most recent rate rise, it was the only time in the 15 periods of rate increases that high yield spreads did not tighten and provide a boost to returns. We believe that over a full year, we will see some spread compression, but rates will be a drag on total returns. With European growth still on the upswing, the region should outperform the US as a result of greater spread tightening. While Fed tapering will be important for EM economies, we believe the bigger effect on spreads will be idiosyncratic risk, as spreads are elevated enough to absorb rate increases if underlying fundamentals improve. As we discuss later, it is not the sensitivity of spreads to rates that is the greatest cause for concern, but the timing of the taper with respect to a pickup in growth in EM, as the Fed will base its decision on US growth, not global data.

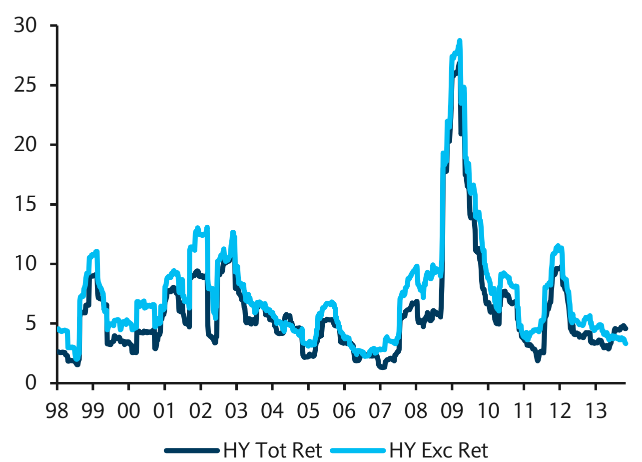
The greatest part of the volatility in credit total returns this year came from the move in rates. As Figures 6 and 7 show, the difference between total return and excess return volatility is as high as it has ever been. This highlights the fact that over the past 25 years (including the first 11 months of 2013), excess returns have exceeded total returns only four times for investment grade and five times for high yield.

FIGURE 6
**US investment grade annualized weekly return volatility (%)**




Source: Barclays Research

FIGURE 7
**US high yield annualized weekly return volatility (%)**

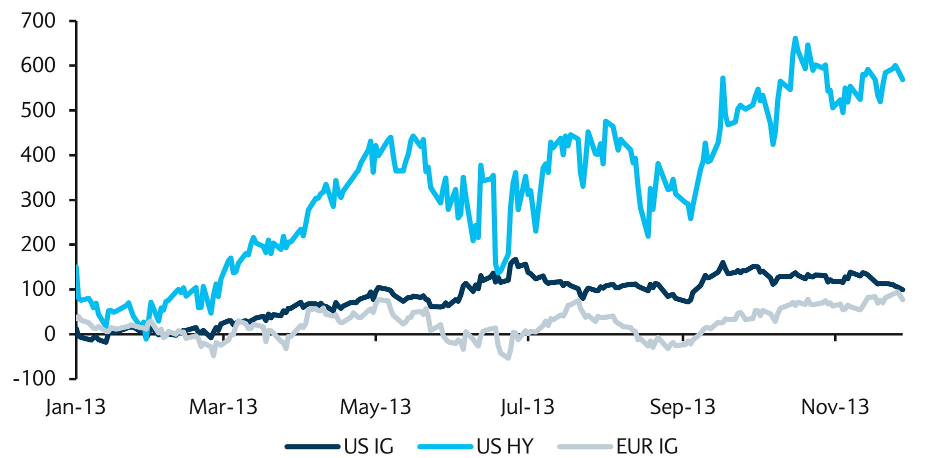



Source: Barclays Research

One method for coping with increased volatility from interest rate risk that we have advocated in the past is to use the derivatives market, instead of the cash market, to get long credit risk. Clearly, hedging rate risk can accomplish a similar goal with respect to interest rate duration, but there are other reasons to favor CDS in a strong market. The positive convexity of CDS was preferable to the US high yield cash market, which had more than 60% of bonds trading above their first call price in May, and the high-dollar-price US investment grade market, which peaked at $114. Since then, derivatives have outperformed massively, with HYCDX beating the High Yield Index excess returns by 569bp and IGCDX outperforming the Corporate Index excess returns by 99bp (Figure 8). As a result, the basis has become very negative, and we believe swapping from cash and into derivatives is only worthwhile in the US when there is clear upside in CDS compared with call-constrained bonds. For Europe, the move in the basis has been less extreme and the basis remains positive. iTraxx Main excess returns exceeded the Euro-Aggregate Corporate returns by only 77bp. Therefore, we believe there are more opportunities to move into derivatives in Europe than in the US.

FIGURE 8

**Year-to-date on-the-run CDX/iTraxx unfunded total returns minus cash excess returns (bp)**




Note: Data as of November 29, 2013. Source: Barclays Research

## Retail demand steals the headlines, but obscures the full picture

Before we address the fundamental factors that underpin our 2014 forecasts, it is important to understand the technicals related to fund flows. The fear of a deluge of retail outflows is core to the thesis of those that expect a great rotation out of fixed income. In the short term, mutual fund flows will continue to have an outsized effect on spreads, as was the case this summer, and will likely produce periods during which the correlation between rates and credit spreads turns positive again. Longer term, we believe institutional investors will be attracted to credit at higher yields, as returns should be superior to other fixed income assets because of the higher carry and stable fundamentals. However, the effect will not be uniform across the sectors and regions that we cover.

In our last quarterly publication, we looked at demand for credit markets globally and estimated the portion of each market that different types of investors owned (*Credit Market Outlook: Buyers for the retail sale*, 26 September 2013). The market that appears least well equipped to deal with shifting allocations from individuals is municipals, where two-thirds of the market is owned by households and mutual funds. The asset class is long duration and has produced the worst returns in our universe in 2013, as outflows have exceeded $50bn (Figure 9); flows have also been affected by headlines about Detroit and Puerto Rico.

We believe the ratio of municipals to Treasuries is approaching the point at which the asset class will look cheap on an absolute and certainly a tax-adjusted basis. However, if rates continue to rise, it is difficult to see flows reverse materially, and as a result, ratio compression should be modest.

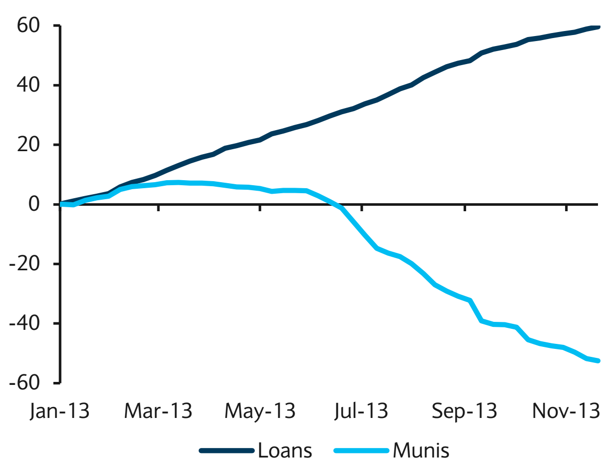
High yield has the next highest presence of retail investors (less than a quarter is dedicated high yield funds, but more than 40% when all retail sources of demand are included), and ETFs have established themselves in greater size than other parts of the credit markets. US high yield outflows were $20bn according to EPFR during the six weeks that spreads were wider beginning in May, but flows have rallied to be positive on the year (Figure 10). In Europe, flows have remained positive throughout the year, although cross ownership led to increased sensitivity to US and global fund flows. Despite concerns about rising rates, we do not expect a mass exodus from high yield funds in 2014. The shorter duration of the asset class and the higher carry should produce the best total returns in fixed income, which makes it an unlikely candidate for a massive reallocation.

Preferred stocks, with high retail participation, have also sold off as retail flows turned negative in May; investor redemptions have reduced the shares outstanding of PFF (the largest ETF of preferred stocks) by more than 23% over that period. However, further downside for preferred valuations from rising rates appears limited, in our view – in particular, we believe that the equilibrium level for yields is only about 50bp wider than current levels (in the 6.5-7.5% range) even in a significantly higher interest rate environment. Moreover, we expect retail demand to pick up as yields near 7% (at about 9% on a tax-equivalent basis accounting for their QDI-treatment), although a rapid/substantial increase in interest rates next year could exacerbate outflows.

Fund flows have been the highlight of the year for leveraged loans (Figure 9), as retail has grown from a high-single-digit to a high-teens portion of the US market over the past few years. Healthy CLO issuance has allowed this more stable source of demand to retain a ~50% market share as well. We expect rate concerns to keep technicals positive for floating-rate assets even if loans will not truly benefit from the first part of a rate move, since 80% contain a Libor floor that is over 100bp on average. While the negative convexity at current levels is concerning and lending standards are deteriorating, we still believe the positive flow dynamics should produce returns at least on par with US high yield and likely with lower volatility.

FIGURE 9

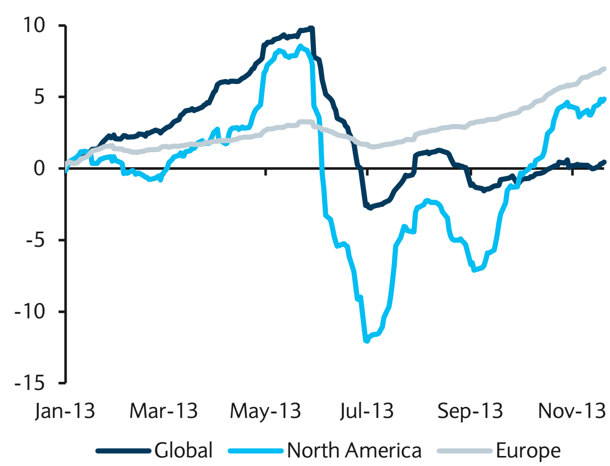
**Year-to-date cumulative municipal and loan fund flows ($bn)**




Source: Lipper, Barclays Research

FIGURE 10

**Year-to-date cumulative high yield fund flows ($bn)**




Source: EPFR, Barclays Research

For investment grade, retail is less than 20% of the market, and shifts in sentiment at insurance and pension accounts are much more important. We believe these investors will allocate toward credit as yields increase and provide a healthy dynamic over the medium term to offset any great rotation shift in retail due to potentially negative total returns. With respect to retail, we also note that allocation decisions among total return or aggregate benchmarked bond funds are the most important sources of demand. We saw a similar effect in emerging markets this year – many of these funds were overweight and subsequently pared those positions. We think it is unlikely that EM will receive an outsized allocation from non-traditional investors as long as the growth environment remains muted. Retail ownership of EM corporates has increased in the past few years, and as a result, the sector's sensitivity to flows continues to be high.

## Supply outlook is favorable in the markets we expect to outperform

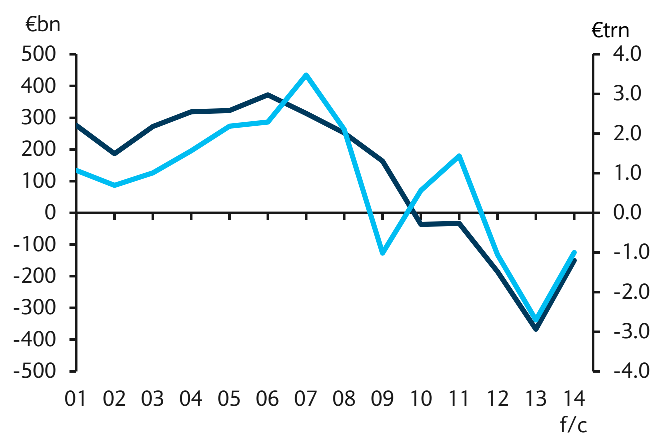
We discuss demand first because we believe it will be the more relevant driver of performance in 2014. This is because a large portion of supply has been related to refinancing in recent years and the lack of an M&A pipeline limits the risk of supply overhangs. The market may feel pressure from supply at certain times, such as the massive issuance in September, highlighted by the record deal from Verizon, but it is difficult to envision a situation in which arrangers are left holding significant committed deal risk in a fashion similar to 2008. Therefore, even in markets where we expect significant issuance, we believe a large portion of it will be opportunistic.

A lack of net supply can be a positive for certain markets. Our issuance forecast for European investment grade calls for a fifth consecutive year of negative net issuance driven by financials deleveraging (Figure 11). This is consistent with our overall positive view on financials and expectation for outperformance from Europe. Gross issuance from non-financials should be consistent with the record levels of 2012 and 2013. The catalyst is the refinancing of loans with bonds, as the European market is historically much more loan-heavy than the US market.

On the topic of refinancing loans with bonds, European high yield set a record for issuance in 2013 thanks to this trend. We expect a small pickup in gross issuance in 2014, but a healthier loan market due to increased CLO creation will likely slow the growth in high yield bond issuance.

FIGURE 11

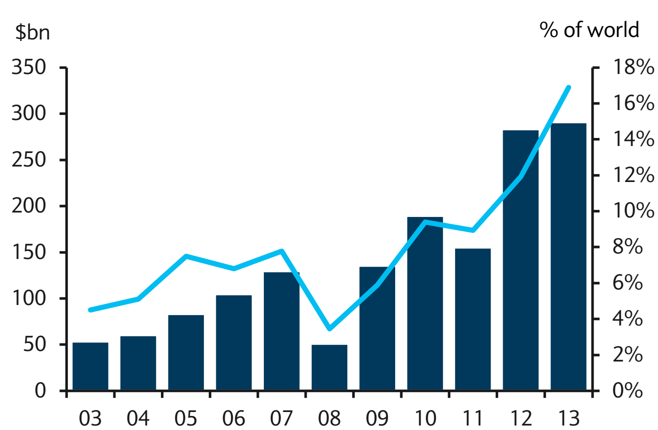
**European bank debt issuance and balance sheet trends**




Source: ECB, Barclays Research

FIGURE 12

**Global EM USD corporate and quasi sovereign issuance**




Source: Dealogic, Barclays Research

For emerging markets, 2013 supply should be just above last year's record number (Figure 12). In Asia, we expect only modest gross supply growth and lower net supply in 2014. For the rest of EM, we forecast a more pronounced pickup in issuance, but net supply similar to this year. While an increase in demand will be required to absorb the additional supply, we note that the EM corporate market has already expanded 67% since the end of 2011, to more than $900bn.

In the US, extremely low yields have led to an aggressive refinancing of the market in the past few years. The $49bn from Verizon showed the capacity of the market to digest issuance in greater size than anyone expected. That issue will likely push investment grade issuance past 2012 totals and establish a new record by a small margin. If FRNs are included, issuance is clearly at record levels. We expect 2014 fixed-rate issuance to be similar to 2013, but note that some of this could shift to FRNs. We view the shift towards more FRNs as positive, since it can help with demand if duration concerns remain elevated.

The desire for floating-rate paper will also play a big part in high yield issuance in 2014. We expect gross fixed-rate bond issuance to dip below $300bn as refinancing slows in general, but especially the refinancing of loans with bonds. This is because of a return to health of the leveraged loan market, which showed its first material growth in five years and finally surpassed the previous highs in par amount outstanding. This was chiefly because of a demand-driven issuance boom that was topped only by the LBO-driven deluge of 2007. From the standpoint of the supply/demand imbalance affecting 2014 returns, we believe the convergence of these two markets – as loans have become covenant-lite and bond non-call periods have shortened – should allow issuers that need to access the market to obtain financing wherever it is favorable.

Finally, we note that supply could be an offsetting factor for the lack of demand for municipals. This year, net supply was approximately negative $30bn in municipals, and we expect it to be negative again in 2014. While this was not enough to offset more than $50bn of outflows from municipal funds year to date, we expect outflows to slow and net negative supply to provide some support for the market.

FIGURE 13
**Gross supply forecasts**

| Market | 2013* supply | Record (Y/N) | 2014E supply | Y/Y growth |
|---|---|---|---|---|
| US IG | $1,120bn | Y | $1,030bn | -8% |
| EUR IG | €400bn | N | €420bn | +5% |
| GBP IG | £40bn | N | £43bn | +8% |
| US Municipals | $320bn | N | $270bn | -16% |
| US HY | $331bn | N | $270-295bn | -15% |
| EUR HY | €80bn | Y | €75-85bn | unch. |
| US Lev Loan (ex repricings) | $369bn | N | $340-360bn | -5% |
| US CLO | $88bn | N | $75-85bn | -8% |
| EUR Lev Loan (ex repricings) | €40bn | N | €40-50bn | +13% |
| EUR CLO | €8bn | N | €12-15bn | +69% |
| Asia | $123bn | Y | $120-130bn | +2% |
| LatAm + EEMEA | $160bn | Y | $191bn | +19% |

*2013 supply is annualized based on supply through late-November 2013. Source: Barclays Research

## Fundamentals will matter most when markets feel best

Somewhat paradoxically, credit selection mattered less as markets came under stress this year (Figure 14). This made sense considering that the period of stress was much more abbreviated than in the past few years, and the level of spread widening was also less extreme. Since we do not expect a substantial sell-off in 2014, we believe it will be more effective to position around potential single-name moves than the occasional macro-driven widening.

FIGURE 14

**US investment grade corporate index average constituent correlation**

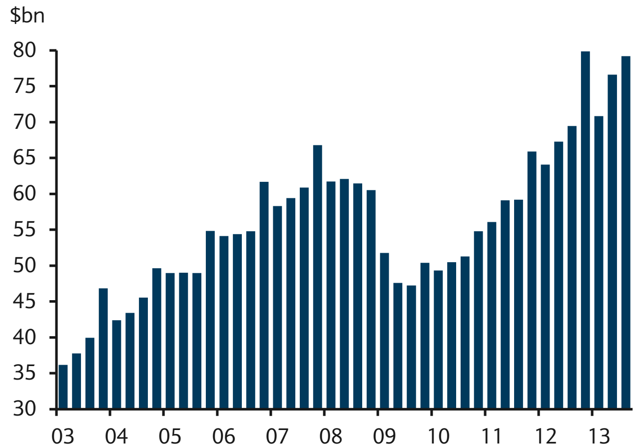

Note: Average correlation of weekly excess returns over a rolling 24-week period. Source: Barclays Research

As mentioned earlier, we prefer credit risk to duration risk. That does not mean that we would add risk in any sector with substantial yield. We believe that some sectors will be less subject to the whims of the market and more beholden to fundamentals. When we did our default outlooks, we noted that risks are concentrated in some secularly challenged industries, such as printing and publishing, retailers that face new sources of online competition, and natural resource companies with substantial negative free cash flow that could test their liquidity cushions over a two- to three-year horizon. However, very few of these sectors should see substantial defaults in 2013. We expect default rates to remain below 2.5% in the US in 2014, to trend toward that level in Europe, and do not expect a spike in defaults in EM similar to the 2013 experience in LatAm.

Our sector weightings are consistent with the themes of taking some degree of additional credit risk and avoiding areas that could experience releveraging, those that have limited upside or businesses with potential long-term structural challenges. In the US, this leads us to an underweight in high grade pharmaceuticals and technology, as well as high yield healthcare, paper, food, and aerospace & defense. In taking credit risk, it is necessary to find wider-spread sectors where we are comfortable with the credit risk. For the US, this includes overweights in high grade financials and autos and high yield retail and technology. In Europe, our key overweights are high grade banks and insurance. For industrials, we believe that the compression of the peripheral premium will be a source of outperformance. Finally, we believe it is attractive globally to move down the capital structure in industrials and financials when we are comfortable with the credit overall.

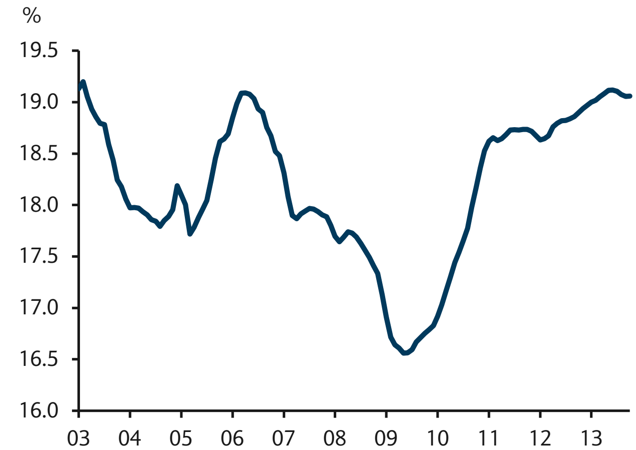
Apart from sector-specific concerns, the increase in leverage at US corporates is a trend that we are following closely. Overall leverage is approaching peak levels from the mid-2000s, and we expect share buybacks and dividends to remain high (Figure 15). M&A has taken longer to pick up than expected, but we should see additional deals, given that EBITDA

FIGURE 15
**S&P 500 quarterly dividends**




Source: S&P, Haver Analytics, Barclays Research

FIGURE 16
**S&P 500 ex-financials EBITDA margin**




Source: FactSet, Barclays Research

margins are the highest in a decade (Figure 16) and acquisitions provide opportunities for synergies. As a result, strategic buyers are likely to continue to outbid private equity, which means the increases in leverage should be more modest. For these less transformational increases in leverage, we believe there will be opportunities to generate alpha by getting long after the announcement has occurred. Verizon clearly provided the best example of a new issue discount that – despite the size of the acquisition – was a low-risk proposition because it had already operated the asset for a long time.

One factor that has alleviated increased leverage has been improving interest coverage as a result of refinancings at much lower coupons. This increase in coverage leveled off in 2013, and the potential for increased rates does not augur well for further improvement in this ratio. However, we believe there will be lasting effects from lower interest expense that should help to keep free cash flow positive even if growth slows.

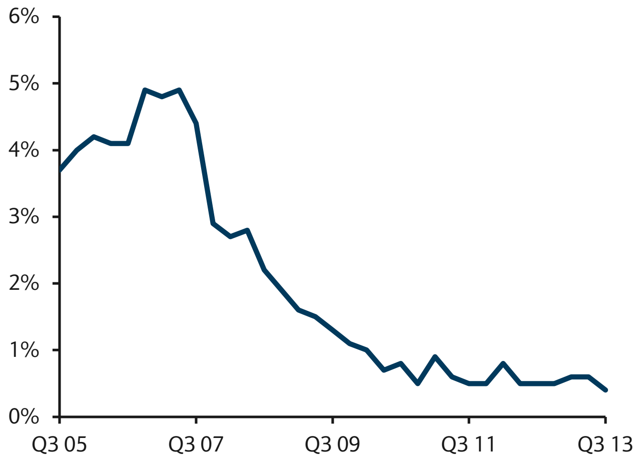
In EM fundamentals have deteriorated in 2013 and the prospects for 2014 have also dimmed. The growth differential between DM and EM is projected to be lower in 2014 than over the past few years. For many countries that have a large weight in the benchmarks (eg, Brazil and China), our economists project lower y/y growth. Political risks are also looming. More than one-third of the corporate bonds outstanding are in countries where elections are scheduled in 2014. At an individual corporate level, akin to developed market credits, EM corporates in general have increased their leverage by borrowing in their local currencies and offshore; the prospect of slower growth is likely to compound the effect of higher leverage on their credit profiles. Finally, with monetary policy in DM normalizing, flows into EM are likely to slow, exacerbating the challenges for countries with current account deficits. We have seen significant currency volatility over the course of 2013 and for companies with unhedged exposure, the feedback onto balance sheets can be rapid. Because of all these factors, we expect EM corporates to be choppy in 2014.

## Regulatory environment will continue to hamper liquidity

A major reason that we do not expect spreads to test their pre-crisis lows is the decrease in secondary market liquidity. We believe this is a factor across all of the regions we cover and use US data from TRACE to attempt to quantify the effect. Looking at trading volumes, the good news is that there are many more trades occurring today than before the crisis. However, those trades are much smaller and have failed to keep pace with the growth in the size of the credit market. As a result, the market's turnover ratio has decreased precipitously

FIGURE 17

**Percent of investment grade bonds with average trade size >$5mn**




Note: Based on universe of TRACE-eligible investment grade bonds.
Source: MarketAxess, Barclays Research

FIGURE 18

**Percent of high yield bonds with average trade size > $1mn**

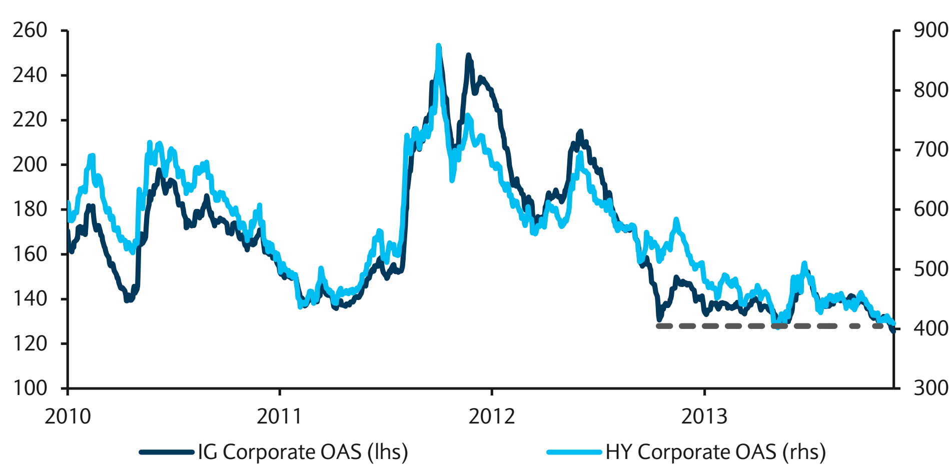

Note: Based on universe of TRACE-eligible high yield bonds.
Source: MarketAxess, Barclays Research

to ~75% (defined as TRACE trading volume/par amount of TRACE eligible bonds). The percentage of bonds in the investment grade market with an average trade size of more than $5mn has declined from 5% to less than 1% in the past six years (Figure 17), and the percentage of high yield bonds with average trade size above $1mn has dropped from ~40% in 2007 to ~20% today (Figure 18). The factors forcing these numbers lower, including increased use of electronic trading in investment grade and ETFs in high yield, are not all bad, but they hardly account for the entire decline.

Digging deeper into the data, we can compute the additional spread that might be required for today's lower-liquidity environment. We believe the analysis is most important for US investment grade, as that market until recently had shown an inability to break through the 130bp spread level in the post-crisis period (Figure 19). In our opinion, the decline in investment grade liquidity relative to the pre-crisis period is greater than in high yield. In addition to the above statistics, we note that the average block trade in investment grade above $5mn has declined 15% since the credit crisis, to just over $11mn, whereas in high yield, it is only slightly lower than in 2007, at $3.6mn. Based on bid-ask data that are used to

FIGURE 19

**U.S. Investment Grade Corporate index OAS and U.S. high Yield Corporate Index OAS (bp)**




Source: Barclays Research

calculate our Liquidity Cost Score, investment grade bid-ask has increased 3.5bp over that timeframe. With a duration of close to 7, this would increase the cost of an investment grade trade by 25bp and explains a good portion of the additional spread compensation that investors require today over the pre-crisis tights of ~80bp. Considering the difficulty investment grade spreads have had meaningfully piercing the post-crisis tights, we believe the concept of a floor that is related to the liquidity premium is most relevant in this market.

## The future effects of increased bank regulation are still uncertain

The well-documented decline in dealer inventory has been a large factor in decreased secondary market liquidity. The likelihood of a situation in which banks increase inventories materially in the near future is minimal, in our view. The next likely development will be the outlining of the Volcker Rule in the US. Whereas other jurisdictions have chosen to limit risk-taking through higher capital requirements, the US has sought to eliminate proprietary trading altogether. We hesitate to speculate about the effect of the Volcker Rule, given that the final draft should be published shortly. We believe banks have eliminated pure proprietary desks, and the risk is that the rule will be punitive enough to force banks to further reduce balance sheet and subsequently hurt secondary market liquidity.

We have spent a lot of time theorizing about the consequences of the different forms of regulation that banks now face. In our most recent report, *U.S. Banks: Intended and Unintended Consequences*, 7 October 2013, we attempt to marry the effects of risk-based capital rules, leverage ratios and potential minimum debt limitations. We believe the combination of these rules will intensify the focus on return on assets and how the assets are financed. The net effect of these rules should be most negative for lower-risk businesses that are asset intensive, such as repo, and should be supportive of maintaining trading operations in businesses that are not entirely illiquid. As this relates to the liquidity premium in the market, we think that these changes, in their current form, should not lead to a further deterioration of liquidity in credit.

Some of the new banking rules will also alter the supply landscape discussed above. The Federal Reserve is expected to issue a proposed rule in the next few months requiring the largest US banks to maintain a minimum amount of long-term unsecured debt issued by their holding companies. While most banks already have substantial senior debt outstanding, subordinated debt has historically been a relatively small proportion of holding company funding. Therefore, market debate has focused on whether these rules will include a minimum requirement for subordinated debt, or whether senior debt will be sufficient to meet the new mandate. If the proposed rule calls for subordinated debt of 3% or more of RWAs, the eight largest U.S. banks could need to issue more than $70bn of sub debt during a transition that should last through 2019.

Moving down the capital structure, new capital guidelines are altering the composition, if not the size, of the bank capital universe globally. In the US, banks are replacing trust preferreds, which are losing Tier 1 treatment under Basel III, with perpetual preferreds. We expect nearly $65bn of preferred supply over the next few years. In Europe, with CRD IV requiring non-common Tier 1 capital to have principal write-down or equity-conversion language, the new guidelines have led to the development of a contingent convertibles market. We believe the CoCo market could eventually be as large as €200bn as banks replace traditional Tier 1 hybrids with CRD IV-compliant securities.

## CDS market changes to accelerate in 2014

In the derivative market, we have a bit more clarity on what is required relative to the uncertainty on the Volcker Rule. The US and Europe regulations aim to achieve similar objectives (reduce counterparty risk and increase oversight and competitiveness), but they differ somewhat in scope, approach, and timing. Generally, European regulatory initiatives are proceeding at a slower pace, attributable to the many individual country regulators involved in the process. Although the goals are encouraging, the medium-term effect will likely be increased fragmentation, stifling of competition, potentially wider CDS spreads and reduced liquidity.

The costs of participating in the derivative market have increased significantly because of the need to build infrastructure, meet numerous reporting requirements and post extra collateral at the clearinghouse. The increase in margin requirements, although beneficial for reducing counterparty risk, will likely make it more costly to sell protection, which, all else equal, causes spreads to widen, with potential knock-on implications for funding costs for corporates.

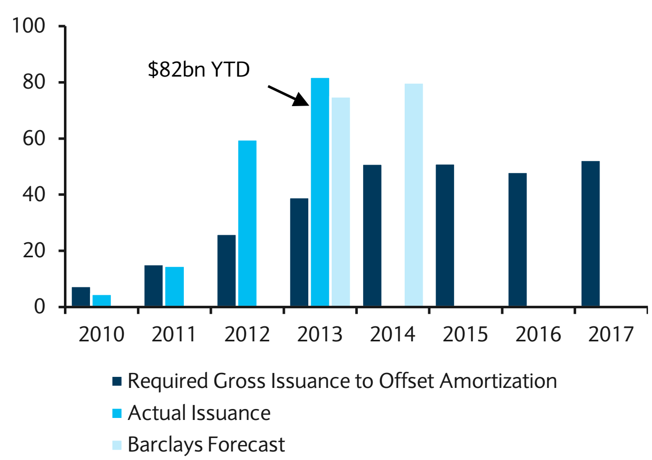
The liquid CDX and iTraxx indices are already cleared, whereas single-name CDS is only cleared for dealer-to-dealer trades, and mandatory clearing of single-name protection is not likely until later in 2014. Exchange trading under MiFID/R in Europe is not expected until the end of 2015 at the earliest, but in the US, exchange trading of indices under SEFs began very recently. This has caused some uncertainty in the market, as the cross-border implications of Dodd-Frank are far from clear.

Finally, we note that ISDA is rewriting CDS definitions with the goal of having a protocol to implement many of these changes ahead of the March CDS roll. There are specific changes designed to help with fungibility and make clearing easier, such as standard reference obligations and simplifying buckets for restructuring credit events. Other changes are based on events of the past 10 years that highlighted ambiguities in the 2003 ISDA Definitions. These include dealing with asset packages for bail-in credit events, as well as clarifying qualifying guarantees and succession events. We believe these are all positive changes as long as they are done in a way that does not change the economic effect of existing trades. The only downside could be that there will likely be different contract versions on certain credits, most notably subordinated financials. For more specifics, see *Credit Derivatives: ISDA 2014: November Update*, 22 November 2013.

### Leveraged loan regulatory hurdles to increase

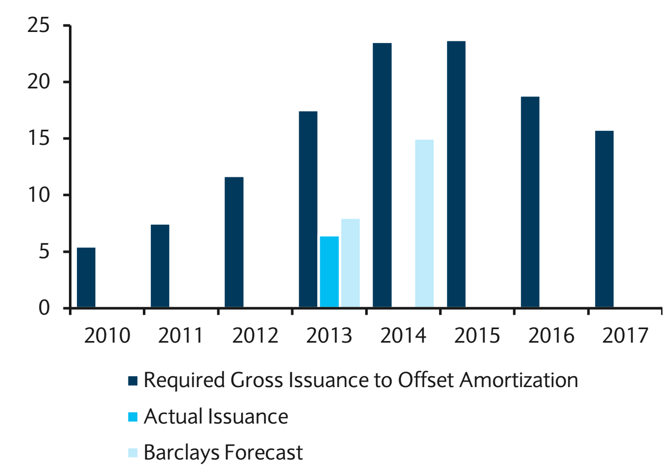
The leveraged loan market has been one of the greatest beneficiaries of the fear of duration among investors. It is hard to see retail flows reversing as long as rising rates remain a concern. The other boost to demand has come from increased CLO issuance in the US, which was the second-highest on record in 2013, with $82bn through November (Figure

FIGURE 20
**Historical, required, and forecast annual US CLO issuance ($bn)**




Source: Intex, Barclays Research

FIGURE 21
**Historical, required, and forecast annual European CLO issuance (€bn)**




Source: Intex, Barclays Research

20). Equity returns have become challenging, as AAAs remain in the 150bp context because of the lack of a dedicated buyer base. Earlier in the year, before the April 1 FDIC assessment rule that limited the ability of US banks to buy anything with highly leveraged loans as the underlying, spreads had reached 115bp.

One of the reasons that deals continue to print despite the prospect of modest equity returns is the specter that the window for issuance of non-Dodd-Frank-compliant deals is closing. Final risk-retention rules are likely to be published in early 2014 after the comment period on the most recent joint notice of proposed rulemaking closed at the end of October. Two years after the publication of the final rules, CLO managers will need to comply with the 5% risk-retention requirement. The exemption in the recent draft for CLO-eligible loans that are partially retained by banks is not helpful, in our opinion (see *US Loans & CLOs: No Exemptions*, 6 September 2013). Instead, without changes, the US market may begin to look a lot more like the European market, where Rule 122a is already in place. Despite a lack of product and more challenged credits, European CLO issuance has gone from non-existent in 2012 to €6.8bn in 2013, as managers found ways to retain the risk (Figure 21).

While the demand side has been the focus for the loan market, concerns on the supply side have increased recently. Lending standards have suffered, as is usually the case in a hot market where demand is outpacing supply. Although we do not think the consequences of covenant-lite loans will be dire over the long term (see *US Loans & CLOs: Can (and Should) the Cov-Lite Comeback Continue?*, 9 November 2013), investors would prefer fully covenanted loans and the potential amendment fees that come with them. Taking notice of these trends, several government agencies, including the Fed, the Treasury, and the FDIC, released Guidance on Leveraged Lending in March. The guidance discussed many aspects of the leveraged loan market, but specifically noted that a lack of covenant protections based on financial performance and total debt/EBITDA higher than 6x raises concerns for most industries. We do not expect any major changes in issuance trends in the near term, but at the margin, this could diminish leveraged loan supply and potentially increase the amount of secured bonds.

# US credit strategy

US HIGH GRADE STRATEGY

# Getting down to the spread floor

Jeffrey Meli
+1 212 412 2127
jeff.meli@barclays.com

Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com

Alex Gennis, CFA
+1 212 412 1370
alex.gennis@barclays.com

Ryan Preclaw, CFA
+1 212 412 2249
ryan.preclaw@barclays.com

Jigar Patel
+1 212 412 1161
jigar.n.patel@barclays.com

- **We forecast that the US Corporate Index will post 125-175bp in excess return and -1.75% to -1.25% in total return (based on our rates team's forecast) in 2014. This reflects a tightening in financials, whose fundamentals continue to improve relative to industrials, and a potential floor in spreads.**
- **IGCDX is unlikely to repeat its significant outperformance relative to cash excess returns in 2014. However, we think long positions in IGCDX can be an effective way for total return investors to generate carry in a rising rate environment without being exposed to a rate-driven sell-off in bonds. Negative basis trades and CDS curve trades should also remain attractive.**
- **Industrials' fundamentals are likely to continue deteriorating. Although we expect underlying operating performance to be near consensus (with EBITDA growth around 8%), companies are likely to issue enough debt to increase their leverage, and higher coupons on new issuance will start to pressure coverage.**
- **Financial firm fundamentals, particularly bank balance sheets, are likely to continue improving under ongoing regulatory pressure. Financials, which outperformed in 2013, are likely to do so again in 2014 (albeit more modestly).**
- **The demand picture for investment grade credit should remain supportive in 2014. Further increases in interest rates may lead to modest outflows from mutual funds, but we expect demand from institutional buyers – who tend to increase buying of credit at higher rates – to make up for any weakening in retail demand.**
- **We forecast \$1,030bn of gross investment grade issuance in 2014 (down 8% from this year's annualized level), which translates into \$522bn of net issuance (-22% y/y). The fall in net issuance should be positive for the market and help mitigate the effects of any mutual fund outflows. We expect banks and Yankees to post the biggest issuance drops.**

## 2014 performance outlook

Year to date in 2013, the US Corporate Index has tightened by about 16bp, generating excess returns of almost 200bp. This overall performance masks an underlying split between index components, with financial firms driving the gains and industrials and utilities stagnating. Industrials, which make up more than half of the index, have produced only 110bp of excess return on 5bp of spread tightening; financials, about one third of the index, have returned more than 320bp as spreads have tightened more than 35bp. Although financials started the year trading 20bp wider than industrials, the sharp relative move means that they are positioned to start 2014 trading almost 10bp inside (although they remain wider than the 35bp inside industrials that they averaged prior to 2008).

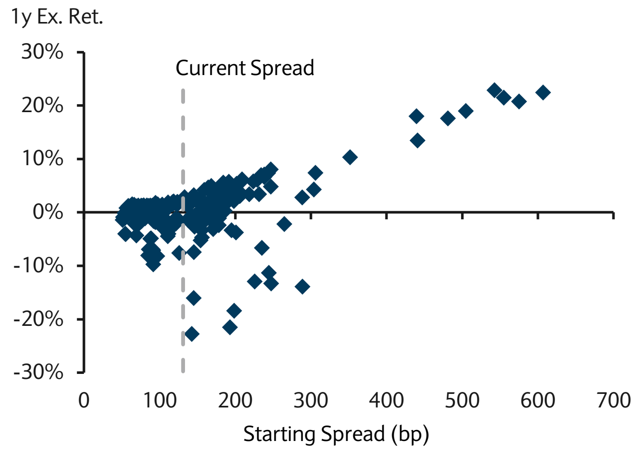
### US Corporate Index return forecast

Looking to 2014, we see the following factors driving US Corporate Index returns:

- **Starting spread** is among the most useful factors for forecasting excess returns (Figure 1). Assuming spreads will start the year at the current level of 125bp, we look at the historical context for 1y excess returns when the starting spread is 110-140bp (a wide enough range to offer about 30 examples). When the year has started in that range, the most likely outcome has been excess return performance near carry (Figure 2).

FIGURE 1

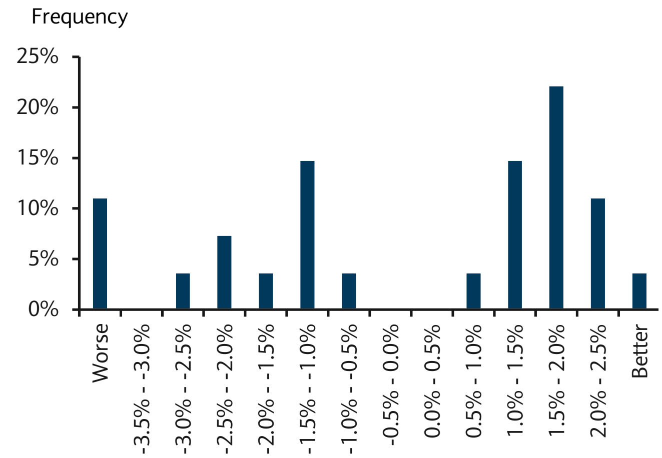
**US Corporate Index 1y excess return is influenced by starting spread**




Source: Barclays Research

FIGURE 2

**Starting with a spread of110-140bp, The US Corporate Index has generated positive 1y returns 55% of the time**




Source: Barclays Research

- **US GDP growth is set to accelerate.** A continued rally in other risk assets in the context of an improving economy could result in tightening pressure on aggregate spreads.
- **We expect financials to tighten by *c*.15bp versus industrials, driven by continuing improvements in bank fundamentals.** The financial-industrial basis is still 25bp off its pre-crisis average; however, we do not expect it to revert all the way back, given the deterioration in financials' ratings and a higher risk premium for subordinated debt. All else equal, we expect this to contribute 5bp of tightening to the US Corporate Index, given that financials comprise roughly one third of the overall index.
- **Non-financial spreads have limited potential to tighten.** We expect further deterioration in the fundamentals for industrial firms next year, with leverage already higher than 2007 levels. Both industrials and utilities have tightened by only 5bp YTD.
- **Structural changes have made it difficult for spreads to tighten beyond 115bp.** In *US Credit Alpha: Taking Apart the Spread Floor*, November 22, 2013, we concluded that OAS of 115bp could be somewhat of a floor for spreads unless liquidity improved, investor leverage increased, or perceptions of potential downside in investment grade credit changed markedly.
- **"Leakage" from index composition changes could act as a 15bp drag on excess returns.** Leakage occurs because of changes in index composition from the beginning to the end of the year (along with smaller contributions from convexity and technical factors). It has averaged -15bp a year of excess return when spreads are near current levels. To illustrate, consider a bond that starts the year at an OAS identical to the index, but defaults mid-year (and falls out of the index). If the rest of the constituents had unchanged spreads through the year, the start-of-year spread (which included the defaulted bond) is identical to the end-of-year spread (which does not include it). But the negative excess return as the bond moved toward default *is* included in the index's full-year performance, dragging the excess return below what we would expect based on the starting and ending spread.

Integrating those factors, we would set the low end of the range for excess returns at 125bp, which would suggest carry, plus some upside from financials tightening, flat industrials and utilities, less the drag from index leakage. We set the high end of the range at 175bp, comprising carry plus about 10bp of spread tightening (led by financials), partially offset by leakage. This amounts to -1.75 to -1.25% of total returns, assuming our house view on interest rates is realized.

*Risks to the forecast*

- There are many reasonable scenarios where returns could be positive but below the low end of our forecast range. Examples include financials improving less than expected, industrials giving back their small 2013 tightening, or disappointing US economic growth.

- Deteriorating non-financial fundamentals do not have a strong relationship with lower returns on the index level, but they are clearly a headwind (all else equal). If they take a sharper turn for the worse in 2014, it could put widening pressure on spreads.

- Investment grade credit returns are not smoothly distributed from starting spreads near current levels: in a narrow majority of years (55%) returns have been near carry, but in 45% of years returns have been negative, including a few years with sharply negative returns (Figure 2). The magnitude of the low-return years is such that the average return when spreads start at 110-140bp is slightly negative. We see no specific risks that could drive returns sharply negative in 2014, but it is in the nature of these risks to be unexpected.

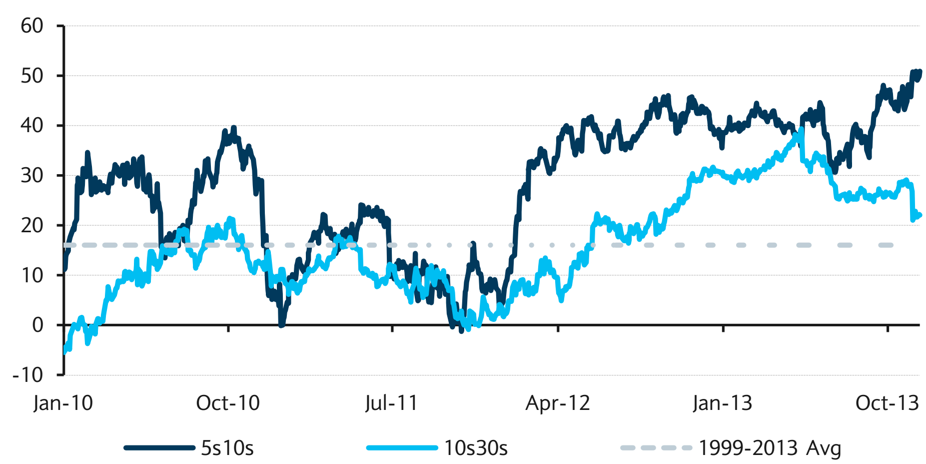
## Credit curves in a rising rate environment

We believe managing duration risk will be critical next year, with our rates strategists forecasting 10y Treasury yields to rise to 3.5% by Q4 14. On the one hand, given the limited room for spread compression, extending out the curve could help generate outperformance, given the higher carry of the long end; however, longer duration securities are also likely to have the weakest total returns in a rising rate environment.

Longer duration securities will obviously have worse total returns than the index in a rising rate environment but we expect them to outperform in excess returns terms. In particular, although we expect the overall effect of rising rates on investment grade spreads to be limited, data since mid-1993 show that higher Treasury yields generally lead to flatter spread curves as buyers of long-dated paper – mostly insurance and pension funds – tend to be more yield focused. Historically, this effect has been particularly marked in the 5s10s curve. However, the curve has not yet flattened despite the sell-off in Treasuries since May, as investors have generally shunned duration risk, given the sharp increase in rates. With the 5s10s curve at 50bp, close to its all-time steepest level, we believe demand for 10y

FIGURE 3

**Barclays US Corporate Index 5s10s and 10s30s OAS curves (bp)**




Source: Barclays Research

paper will pick up. Unlike the 5s10s curve, the 10s30s curve has flattened 15bp following the Treasury sell-off, but at about 20bp, it remains steeper than its average level since 1999. With rates forecast to rise in 2014, we expect the 10s30s curves to continue flattening. Therefore, we continue to see value in intermediate and long bonds despite their longer duration, especially for credits whose curves have lagged the recent flattening.

## CDS outlook

### IGCDX versus cash

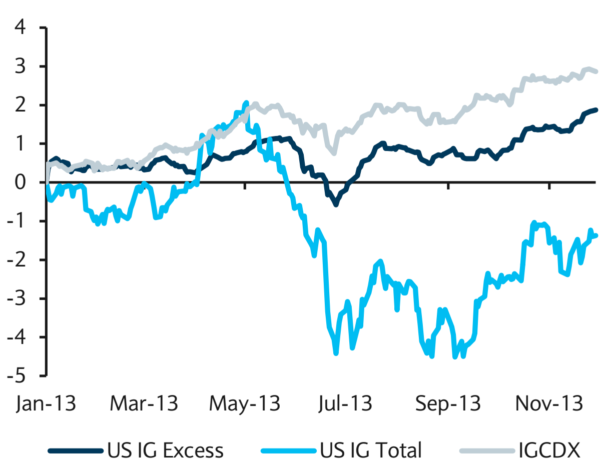
The 100bp move higher in 10y UST yields in 2013 certainly left its mark on the investment grade cash market, helping IGCDX outperform cash total returns for the first time in five years (Figure 4). IGCDX also outperformed cash excess returns, albeit by a smaller margin, as the approximately 43bp tightening in the on-the-run IGCDX index (Figure 5) far outpaced the 16bp tightening in the Corporate Index. The outperformance of IGCDX is all the more impressive, given that the index started the year at a much tighter spread level (95bp) than the Corporate Index (141bp), has a shorter duration, and does not include banks which were among the best performers this year.

The performance of IGCDX raises the question of how much further the index can tighten. As of November 29, 2013, the index was trading ~70bp. The all-time closing tight for the index is 29bp, reached in February 2007. Today's market lacks the prolific sellers of protection that characterized the 2006-07 period (synthetic CDOs, in particular), but it is benefiting from the extraordinary level of monetary policy accommodation, which is helping to contain volatility and keeping macro concerns at bay. If confidence in central bank policy remains high and Fed tapering gets pushed beyond March, spreads could continue to grind modestly tighter as the lack of a bid for protection is likely to persist. However, we do not expect IGCDX to return to the pre-crisis tights as we do not think the effect of monetary policy is commensurate with the exceptional liquidity created by synthetic CDOs in 2006-07.

From a relative value perspective, given their respective starting spread levels, we believe the significant outperformance of IGCDX relative to cash excess returns is unlikely to be repeated in 2014. However, with our rates strategists expecting 10y Treasury yields to rise by ~75bp by the end of 2014, we believe long positions in IGCDX can be an effective way for total return investors to generate carry in a rising rate environment without being exposed to a rate-driven sell-off in bonds.

FIGURE 4

**IGCDX versus cash returns, year-to-date (%)**




Note: Returns as of November 29, 2013. Source: Barclays Research

FIGURE 5

**IGCDX year-to-date spread performance by on-the-run index (bp)**


Source: Barclays Research

## Basis

Although the aggregate basis has consistently been negative for the past two years, it has become increasingly so throughout 2013 (Figure 6). At the start of the year, there were actually a number of opportunities in the investment grade market to switch out of cash and into CDS and pick up spread (or alternatively, to sell positive basis packages). These opportunities were concentrated in "story" credits, i.e., names where there were fundamental credit concerns or event risk speculation. As the year progressed, the positive basis in the majority of these credits largely disappeared, contributing to the significantly negative aggregate basis in the investment grade market today.

With the basis now in rare territory relative to the past two years (Figure 7), we now recommend seeking opportunities to switch out of CDS and into cash (or alternatively entering into negative basis trades) where there is a meaningful pick up in spread. Negative basis trades can be particularly attractive in names where there is concern about event risk.

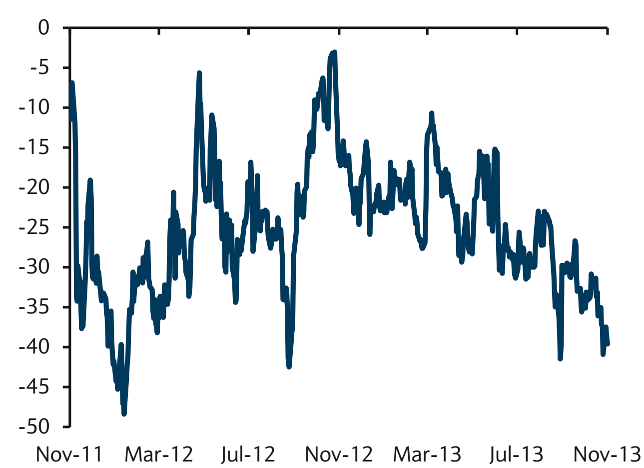
## Liquidity

Similar to 2012, index volumes remained relatively robust in 2013, with activity picking up in the second half of the year (Figure 8). IGCDX remains a liquid way to manage cash balances and to quickly gain exposure to diversified risk in the investment grade market. In contrast, concerns about single-name CDS liquidity persisted this year. Although the liquidity picture for index constituents and large financials remains intact, we do not expect liquidity for the broader market to improve until the regulatory uncertainty is resolved. Although the CFTC has largely implemented the provisions of Dodd-Frank as they apply to the indices, the market is still awaiting the final rule-making and implementation process for the single-name CDS market by the SEC. At the time of publication, the SEC had not yet published an updated timeline for their regulatory changes.

One reassuring data point with regard to single-name CDS liquidity is that for the vast majority of IGCDX constituents, liquidity in CDS tends to be greater than liquidity in cash. Figure 9 compares average weekly CDS and cash volumes for the two-month period prior to the last roll. Out of the 125 constituents, 97, or ~78%, had greater volume in CDS than in cash.

FIGURE 6

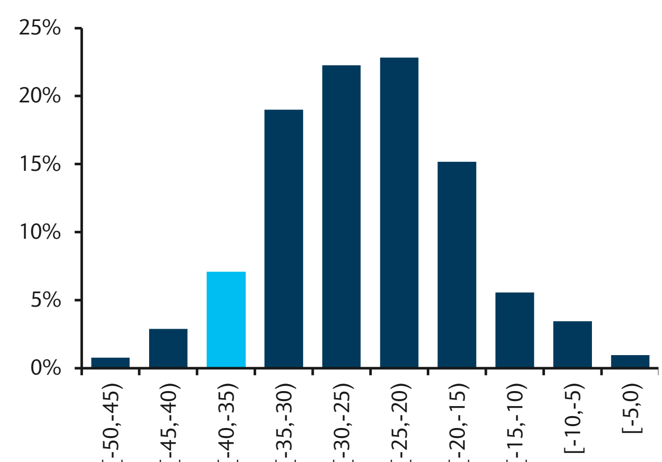
**IGCDX spread minus cash Libor OAS* (bp)**




* Note: Cash Libor-OAS calculated using the 1-10y, non-Yankee, non-bank senior bonds in the Barclays US Corporate Index. Source: Barclays Research

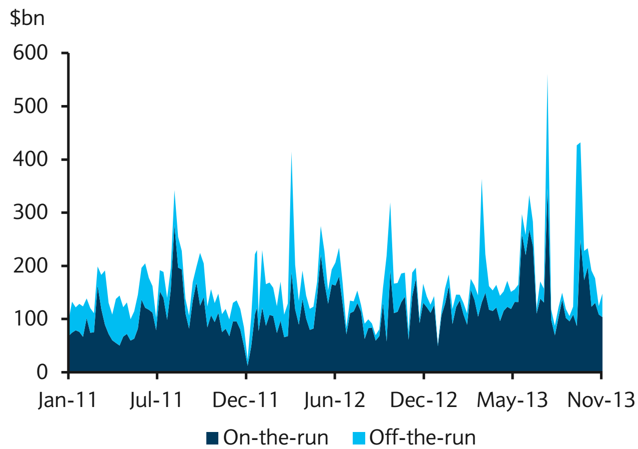
FIGURE 7

**Investment grade basis distribution**



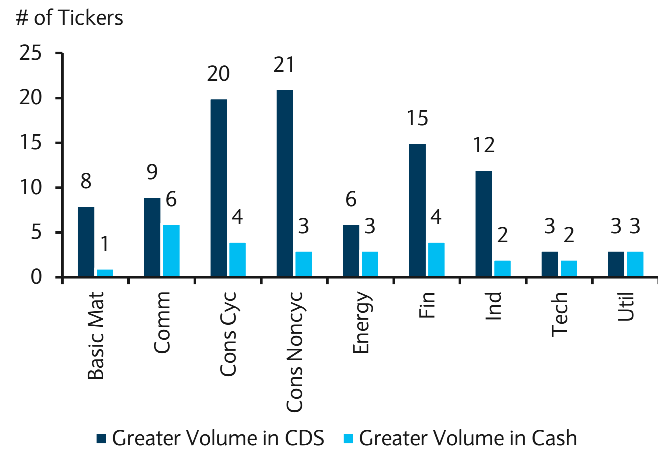

Note: Percentage distribution of daily values over the past two years. Source: Barclays Research

FIGURE 8
**Weekly IGCDX volumes**




Source: DTCC, Barclays Research

FIGURE 9
**Volume comparison of IGCDX constituents**




Source: DTCC, TRACE, Bloomberg, Barclays Research

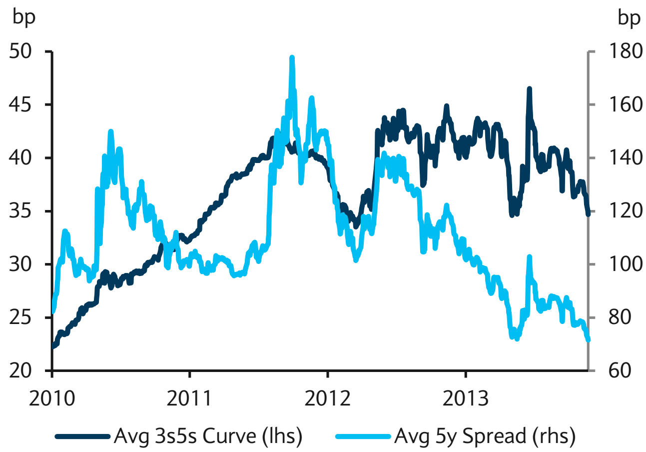
## Curves

In an environment where the overall upside potential for credit is likely to be limited, identifying opportunities to generate returns that have a more attractive risk-reward profile than being outright long or short will be essential to outperformance. We believe two such opportunities can be found in CDS curves. Average front-end CDS curves remain historically steep, with the very front end of the curve having outperformed in the post-crisis environment. Figure 10 shows the average 3s5s curve of current IGCDX constituents versus their average 5y spread. 3s5s curves steepened meaningfully from 2010 to mid-2012 and were rangebound for the next year, despite the rally in 5y spreads. Since mid-2013, curves have finally begun to flatten as 5y spreads have continued to rally. This change in behavior indicates to us that front-end spreads have likely hit a floor.

Although front-end curves on average have started to flatten, they remain historically steep, creating opportunities to sell 2y3y forward protection in names with stable credit fundamentals and benefit from positive rolldown and carry (a 2y3y forward is constructed by selling 5y protection and buying 3y protection of equal notional). The trade is effectively long 2y risk three years forward. The forward not only profits if the curve flattens, but also if the curve remains unchanged as the forward is a net long position. The forward has lower net duration than selling 5y CDS protection outright, which should provide greater protection in case spreads move wider.

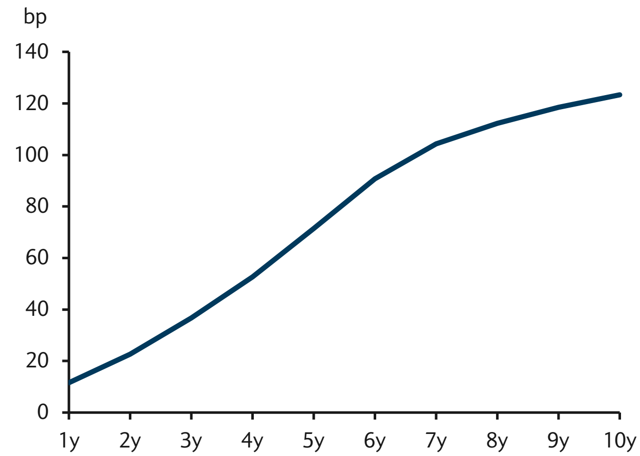
In names where there is some concern about a leveraging transaction, a 5s7s DV01-neutral steepener appears attractive. Figure 11 shows the average IGCDX constituent spread curve as of November 29, 2013. The curve is very steep up to the 6y point and then begins to flatten thereafter. For a number of index constituents, it is possible to put on a 5s7s DV01-neutral steepener that has positive rolldown and carry over a one-year period. The trade benefits from the less severe rolldown from the 7y point on the curve to the 6y point, and the relatively large rolldown from the 5y point to the 4y point. In our view, the steepener is more attractive than an outright short as it provides protection against a parallel shift tighter in the credit curve and generates positive carry even if the curve remains unchanged. The main drawback to the steepener is that it does have some default exposure, but historically significant leveraging transactions such as LBOs have had more of an effect on longer-term credit fundamentals than on near-term fundamentals. This is consistent with the steepening of credit curves that has typically occurred following LBOs.

FIGURE 10
**Average 3s5s curve and 5y spread of current IGCDX constituents**




Source: Barclays Research

FIGURE 11
**Average IGCDX constituent spread curve**




Source: Barclays Research

## Fundamentals

As 2013 nears its end, we have begun to see clear signs of deterioration in the fundamentals of non-financial investment-grade issuers. In contrast, financial credits continue to improve, a trend we expect to continue in 2014.

### Industrials

To develop our outlook for fundamentals, we first look at the underlying operating expectations for non-financial corporate issuers. Starting with the issuers in the US Credit Corporate ex Financials index, we focus on the subset that has been in the index for the past decade (to make comparisons across time more consistent).

As we detailed in US Credit Focus: *Weaker Fundamentals, Same Price*, we expect EBITDA to grow in line with consensus estimates (though we expect a different distribution, with higher sales growth and lower margins than consensus suggests). For index issuers, the median consensus expected 2014 EBITDA growth is about 8%. This would be a notable increase over 2013, for which the current expectation is for median EBITDA growth of about 4.5%.

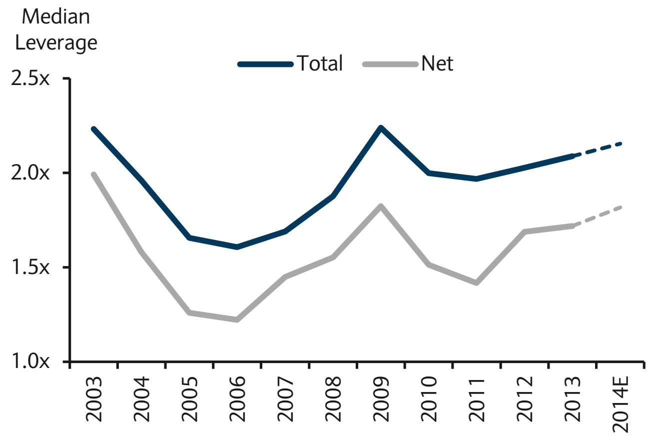
*Debt is likely to increase on continuing EBITDA growth*

The second component of our forecast is fundamental factors more under the control of management policies: how much debt companies are likely to add (or reduce) over the next year and how much cash they are likely to maintain on their balance sheets.

A number of factors drive investment grade corporates' issuance decisions. Using data from the past decade as the base for a bottom-up estimate, we have developed a model that forecasts the change in debt for individual issuers as a function of expected EBITDA growth and change in capital spending. The model has the following implications for 2014:

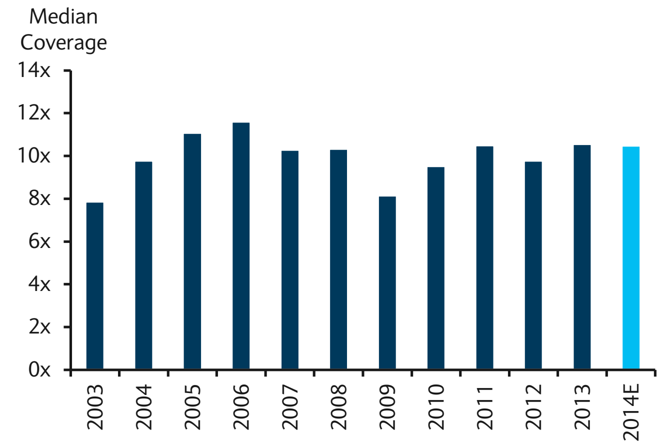
- On average, companies add just under $3 of debt over the next year for every $1 of projected EBITDA increase.
- Given that relationship between EBITDA and debt, we believe that in an otherwise improving economy (and absent macro risks that reward debt reduction), US Corporate Index issuer leverages trend toward 3x. This is well above the current level of just over 2x, giving plenty of room to continue increasing leverage.

FIGURE 12
**Our forecast is for the total leverage of non-financial corporates to increase again in 2014…**




Source: Factset, Barclays Research

FIGURE 13
**…While coverage deteriorates modestly**




Source: Factset, Barclays Research

- Capital spending is also a contributor to an increase in debt, with an additional $0.5 of new debt added for each incremental $1 of capital spending.

Using the model and consensus expectations for EBITDA growth, we forecast total debt issued by index issuers to rise by about 11% over the next year. This would be in line with 2013 (the amount outstanding in the US Credit Corporate index debt has grown 10.4% over the past 12 months) and imply a 0.07x increase in total leverage, about the same as last year (Figure 12). Assuming the average coupon of new issues matches the coupon of current debt (as we suggested was likely in our September 20, 2013, Credit Alpha: *Less and Less Covered*), the median coverage ratio would deteriorate very slightly (Figure 13).

One factor that has supported fundamentals since 2008 is firms holding increased amounts of cash. Even at a constant total leverage target, this gives companies lower net leverage and more balance sheet flexibility. Although total cash on balance sheets has continued to increase as a natural result of corporate growth, it has been falling as a proportion of total debt after peaking in 2011. Companies have also become increasingly dependent on short-term financing, with commercial paper balances recently rising above 2008 levels. We expect this trend to continue, returning cash (relative to debt) to 2009 levels and boosting net leverage by 0.1x to its highest level since 2009.

## Financials

In contrast to industrials, financial credits are continuing to improve their fundamental health. Banks and insurance companies, which make up the vast majority of the financial index, have significantly strengthened their balance sheets since the financial crisis, a trend we expect to continue in 2014.

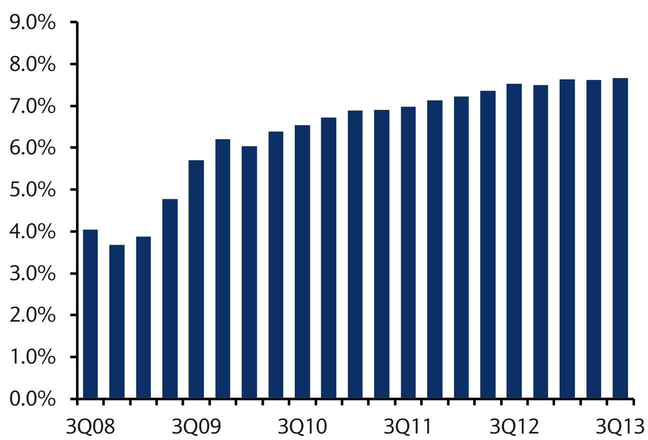
- **Banks:** Bank fundamentals have improved markedly over the past few years, and we expect them to remain strong in the medium term. Over the past five years, bank capital ratios have increased and liquidity and asset quality have improved. In particular, the 25 largest US banks have increased tangible common equity as a percentage of tangible assets to 7.7% from below 4% in late 2008 (Figure 14). In regard to asset quality, non-performing assets (NPAs) have fallen 53% from their peak in 2009 (Figure 15), and forward-looking indicators suggest continued improvement in the coming quarters. Importantly, unlike industrials, we do not expect the trend of strengthening fundamentals for banks to reverse. Stricter capital and liquidity requirements, many of which are being phased in over the next five years or so, limit their ability to re-leverage meaningfully in the medium term. Additionally, stricter risk-weightings make it more difficult for them to increase holdings of riskier assets without comparable increases in capital.

Regulatory changes have generally been positive for bank creditors, but regulatory and legal issues also pose risks. For example, the potential minimum debt requirement could be negative if it leads to a significant pickup in bank supply. However, we expect the structure of the rule to avoid requiring banks to increase their overall amount of debt outstanding. We do see potential for a minimum debt requirement to cause banks to increase subordinated debt issuance (with a corresponding decrease in senior issuance), which could create a negative technical in subordinated markets. A second headwind has been continued high litigation charges for the US banks. In recent weeks, the most prominent example of this risk has been JPMorgan's reported $13bn settlement with the US government over RMBS-related issues. Although the charges are large – and likely to continue for some time – we believe they are manageable in the context of existing reserves, current capitalization, and future earnings. Our bank analyst, Brian Monteleone, does not expect litigation risk to derail the favorable fundamental trends and remains Overweight US banks and finance companies.

- **Insurance:** Insurance fundamentals appear to be on a similar trajectory to those of banks. Life insurers are enjoying near record levels of capital and liquidity and we expect fundamentals to remain strong in the medium term given increased regulatory/rating agency scrutiny. Following the financial crisis, life insurers emerged with a level of self-discipline that resulted in stronger capital metrics, a better perspective on risk, and a healthy respect for the level of volatility in the capital markets. At the operating level, the industry's risk-based capital (RBC) ratio has been maintained in excess of 400%, a historically elevated level. From a liquidity perspective, the rating agencies have become more conservative and mandated 2x coverage of interest and upcoming debt maturities at the holding company level. In addition, operating trends in the P&C sector remain favorable, characterized by increasing premium rates and continued favorable reserve development. The challenging investing environment has been a blessing in disguise, as low rates have helped force pricing discipline on the sector.

FIGURE 14

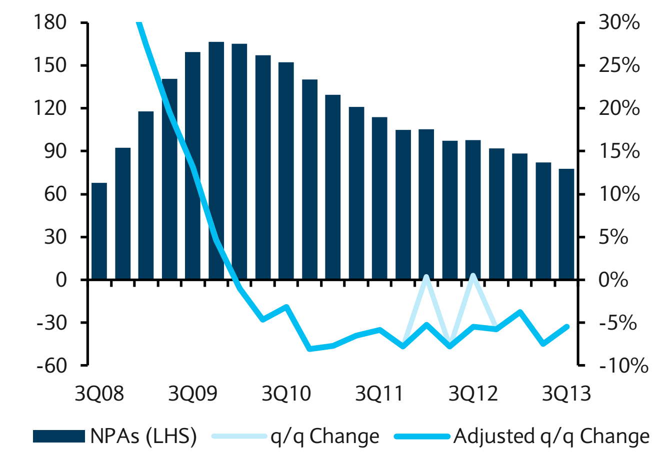
**Tangible common equity % tangible assets, 25 US bank aggregate (%)**




Source: Company reports, SNL, Barclays Research

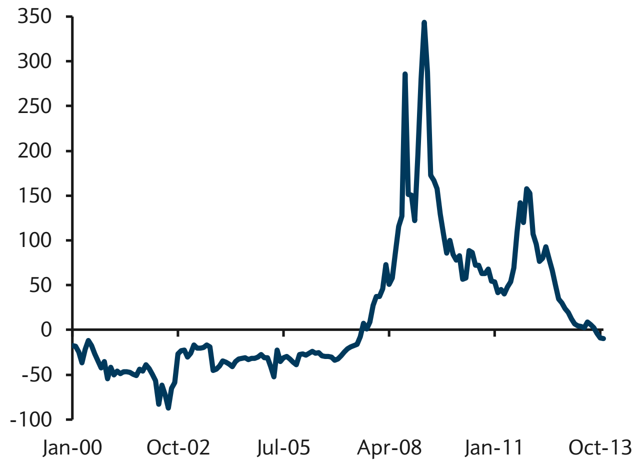
FIGURE 15

**Non-performing assets, 25 US bank aggregate ($bn)**



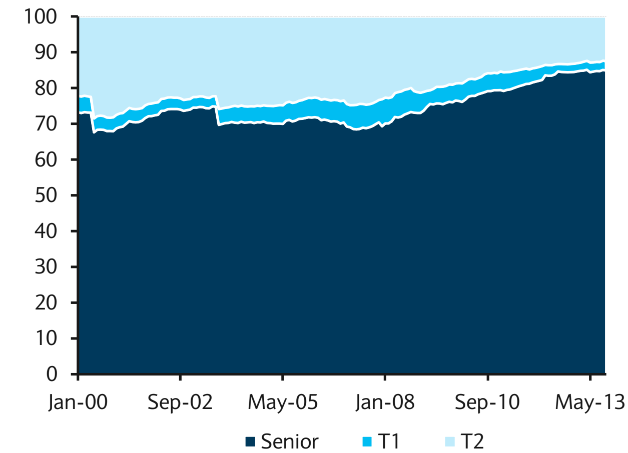

Source: Company reports, SNL, Barclays Research

FIGURE 16
**Financial – non-financial basis (bp)**




Source: Barclays Research

FIGURE 17
**Financial index composition by market value (%)**




Source: Barclays Research

The divergent fundamental trends between financials and industrials have been reflected in the tightening of the financial-industrial basis (Figure 16). After tightening for the past several years, that basis turned negative recently and is now at its most negative level since the financial crisis. Despite already trading inside of industrials, we think financials have further room to outperform.

The senior/sub composition of financials has also changed significantly since before the crisis, with the share of senior debt increasing. Currently, approximately 85% of the Financials Index is senior, 2.5% is Tier 1 capital, and 12.5% is Tier 2; in 2006, only 70% of the index was senior, with T1 and T2 capital making up 6% and 24% of the index, respectively (Figure 17). To adjust for changes in the percentage of subordinated debt in the index (which tends to trade wide of senior), we break down the financial-industrial basis into senior and sub components. The senior bank-industrial basis is 20bp off the pre-crisis averages, while the subordinated basis is still 50-60bp off pre-crisis levels. However, we believe that subordinated debt traded too tight pre-crisis; as a result, we think that it has only 15-25bp further to run. We expect 10-15bp of further compression from senior banks, but do not see a complete return to pre-crisis levels, given the deterioration in ratings since the crisis. In sum, we forecast *c.*15bp of tightening in the financial-industrial basis. We note that depending on its final form, the minimum debt requirement could lead to a rise in the share of subordinated debt in the index, which would cause the financial-industrial basis to be wider than if the ratio of sub to senior debt remained at current levels.

## Potential fallen angels

Ratings migration patterns have been balanced between upgrades and downgrades this year for the broader market and for companies crossing the investment grade/high yield threshold. M&A activity has comprised an increasing portion of fallen angels and rising stars – such as Dell, SLM, and Plains Exploration. We expect these trends to continue, given our expectation of a generally benign credit environment and of a pickup in M&A activity next year. Although the average spread gap between BB and BBB debt has shrunk recently and is now close to post-crisis tights, given our view that M&A activity will account for an increasing share of fallen angels, we expect outsized moves in certain credits that are downgraded to high yield. Thus, we think avoiding downgraded names will be increasingly important for outperformance, especially in a tight-spread environment. We forecast that approximately $30bn of investment grade non-financial debt and up to $8bn of European subordinated and some senior bank debt may be downgraded to high yield next year.

## Yankee credit outlook

Yankee non-financials have experienced mixed performance in 2013, tightening only 4bp year-to-date while the US Corporate Index tightened 6bp. Within the Yankee universe, performance has been sharply different based on geography: the USD bonds of European issuers tightened nearly 20bp, beating the US Corporate index but trailing the Euro equivalent, while non-European Yankees (about half the total) widened.

Looking to 2014, our European Credit Strategy team is expecting core European non-financial credit to perform similarly to US credit, with tightening of 0-10bp (see the European Investment Grade section for details). Given that only 5% of Yankees are issued by periphery-domiciled companies, we expect that Yankee performance will be similar to the European core and US markets, offering carry plus modest tightening potential. As peripheral issuers are concentrated within Telefonica (TELEFO), Iberdrola (IBESM), Enel (ENELIM), and ENI (ENIIM), we expect any outperformance to be more company specific than geographic.

For non-European Yankees, we believe performance is likely to be driven by regional, country, and sector factors. Canada and Australia account for almost half of non-European Yankees. Metals & mining names dominate Australia, and with the sector rated Market Weight by Harry Mateer (see fundamental section), we would expect performance in line with his views. Energy and metals are the most important sectors for Canada, potentially increasing the volatility of returns if oil prices move sharply in 2014.

## Considerations for sector selection

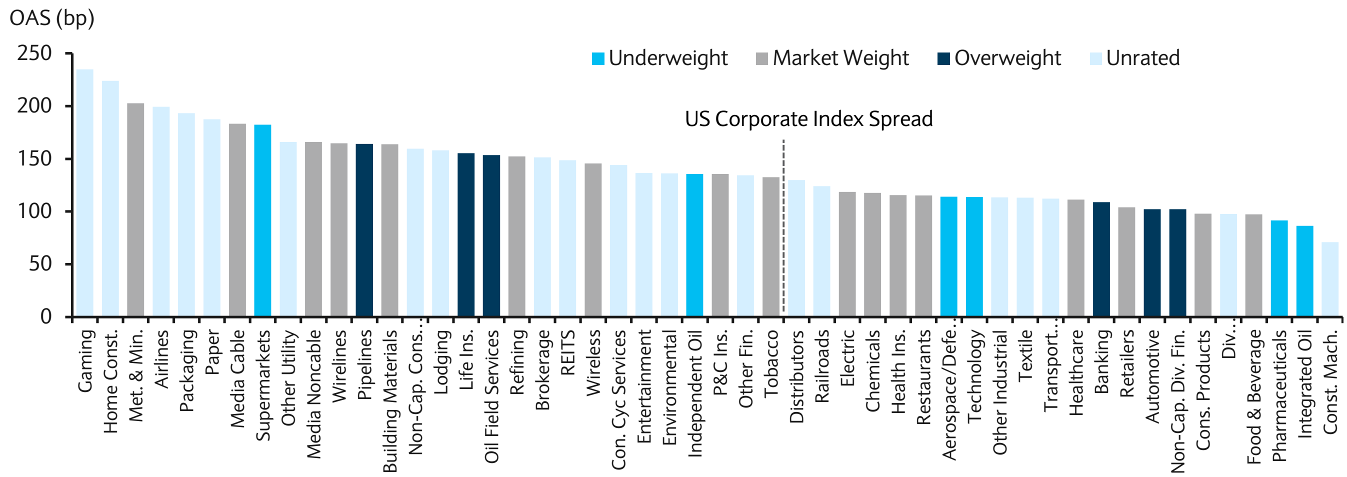
Given our expectation for modest excess returns from the index next year, we believe that sector selection is one of the most useful tools for investors to generate meaningful outperformance versus the index. In the Credit Alpha Focus: *Go Wide for Outperformance*, November 15, 2013, we found that the widest trading sectors have a tendency to beat the index, even after adjusting for their higher beta. Given the significance (both statistical and economic) of the relationship – 1bp of extra spread over the index has been worth 2bp of additional excess return, on average – we highlight several key considerations in picking the most promising sectors for 2014:

- Although the widest sectors tend to outperform, we do not see much concentration of underperformance in the narrowest sectors. The implication is that while investors should expect the widest sectors to beat the index, ones trading close to (or inside) the index spread could perform in line, beat, or lag the index in any year. Our fundamental analysts' recommendations are more evenly distributed now than they have been in the past, but relatively tight overweights (including banks, finance companies, and automotives) can still outperform, while wider underweights (such as supermarkets and independent oil producers) have room to underperform.

- Our model suggests that each of the five widest sectors could beat the index by more than 100bp this year. Of these sectors only one (metals and mining, Market Weight) is rated by our fundamental team (Figure 18). The two widest, gaming and home construction, are quite small, limiting their appeal for investment. On the other hand, airlines and packaging, along with paper (sixth widest), are all reasonably sized and may be a good place to look for outperformance in the coming year.

FIGURE 18

**Of the five widest sectors, only metals & mining (Market Weight) is rated by our fundamental team**




Source: Barclays Research

## M&A outlook

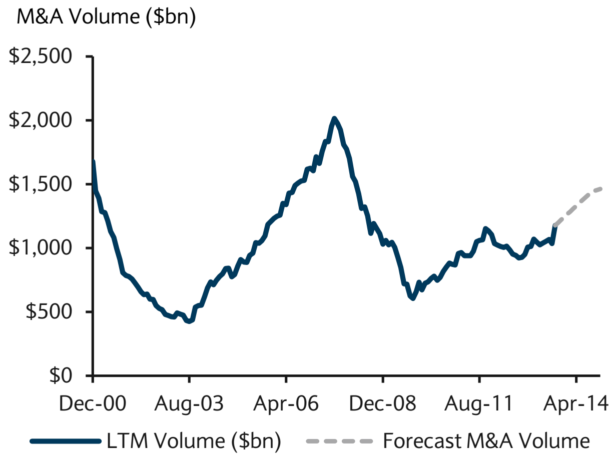
In *Back to the Future of M&A*, April 5, 2011, we introduced a model for forecasting aggregate M&A activity in the year ahead. The model uses changes in trailing VIX (a proxy for risk aversion) and current expectations of 1y forward GDP growth (a proxy for the degree of optimism about the economy) to forecast merger activity. In US Credit Alpha: *M&A Forecast Update*, we looked to 2014, with our model forecasting M&A volume to rise more than 20% (Figure 19). That would mean a ~$250bn increase in total deal volume (bringing it close to $1.5trn), but would still leave annual activity more than $650bn below the 2007 peak.

We see a number of factors supporting M&A:

- With VIX averaging less than 15 over the past year, down from an average of about 21 in 2012 and near 25 in 2011, we believe that stability in the markets has given managers more confidence when forecasting the costs and benefits of undertaking a transaction.
- Consensus 2014 GDP growth at 2.6% represents a rebound from 2013's pace, giving decision makers reason to believe operating leverage from deal-making will offer upside.
- The financing environment remains supportive relative to valuations. Although all-in yields on corporate bonds have risen by more than 50bp this year, the "M&A spread" (the difference between EBITDA/enterprise value and the average index yield) remains high compared with the prior peak of M&A deals in 2007 (Figure 20). Even as rates have risen, all-in yields remain more than 250bp lower than they were when deals peaked in 2007. At the same time, valuations are unexceptional – in 2007, the aggregate enterprise value of the S&P 500 was more than 13x forward EBITDA; now that same measure is just under 9.5x.

FIGURE 19

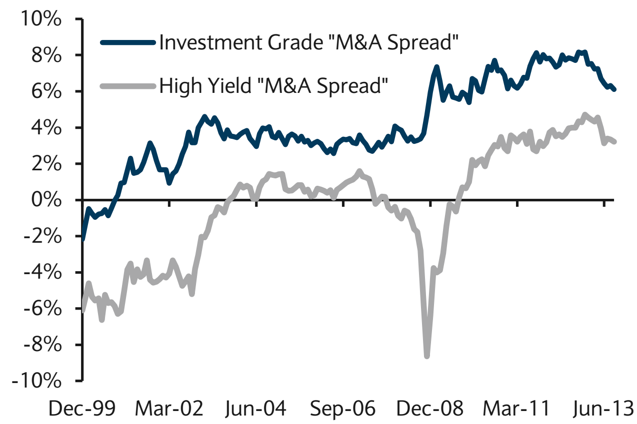
**M&A volumes are the highest since 2008, and our forecasting model suggests they will continue to rise**




Source: Bloomberg, Barclays Research

FIGURE 20

**Funding costs for M&A remain low relative to valuations, compared with the last M&A peak**




Note: M&A Spread is EBITDA/enterprise value of the Russell 3000 less yield to worst of the relevant credit index. Source: Bloomberg, Barclays Research

- **Verizon's (VZ) purchase of Vodafone's (VOD) minority stake in Verizon Wireless has demonstrated the potential for mega-deals.** Our expected increase in M&A volume could be met by only two Verizon-sized deals in the next year. Although these deals are rare given the limited number of very large firms (fewer than 40 companies in the Russell 3000 have EVs higher than $100bn), we believe managements at large companies have taken note of the market's capacity to absorb very large transactions.

Even with many reasons to expect growth in M&A, there is room for it to miss to the downside. We have seen macro events derail growth in deal volume, such as the 2011 spike in volatility associated with the European financial crisis. GDP growth in the US remains below trend, and slower-than-expected growth could also weigh on transaction growth. These caveats aside, we believe M&A volumes will continue to rise.

## Demand

We have not yet seen evidence of a "great rotation" away from investment grade credit and have not observed any meaningful shifts in ownership of the asset class (Figure 21). Even though fixed-income mutual funds had some of their largest outflows ever during this year's rate-driven selloff, flows into funds with investment grade corporate holdings are still significantly positive for the year. As a result, mutual fund holdings of the asset class increased slightly. Insurance and pension holdings declined slightly on a percentage basis; however, we believe the drift higher in yields is likely to lead to a pickup in demand from insurance companies and pension funds.

### Mutual funds

We estimate that mutual funds now hold a slightly higher portion of the investment grade corporate bond universe than a year ago. Although much has been made of the large outflows from bond funds following the sharp move in interest rates that began in May, net flows into investment grade corporate bond funds are significantly positive for the year. Even after the May-July outflows, year-to-date inflows are over $40bn (Figure 22).

Market participants tend to focus on flows for funds classified by Lipper as "Corporate – Investment Grade," but this category mainly comprises total return/agg type funds and contains very few dedicated investment grade corporate bond funds. In fact, less than a third of the assets in this fund category are investment grade corporates, with the rest made up of other fixed-income asset classes. Thus, we think investors should pay attention not only to flows into and out of total return/aggregate funds, but also to shifts in asset allocation by managers of these funds. Over the past year, the allocation to investment grade corporates within investment grade focused funds has declined by *c.*1.5%. However, this has been more than offset by an increase in AUM, leading to a slight rise in mutual funds' share of the asset class.

## Insurance and pension funds

Life insurance companies now hold a slightly lower percentage of the market, as they have not added enough of the asset class to keep up with the growth of this universe. That said, they remain by far the largest and most stable buyer of the asset class and, as we discussed in *The Great Rotation: Myth or Reality?* February 1, 2013, they tend to increase their allocations to credit at higher interest rates. We believe that the recent backup in Treasury yields is likely to have led to additional insurance buying and that further increases in rates could reinforce this trend. The significant flattening in 10s30s credit curves following the Treasury selloff points to increased buying by insurance companies, given that they are the primary buyers of long-dated credit.

Pension funds have also decreased their allocations to investment grade credit somewhat and shifted into higher-yielding assets, such as high yield credit and alternative investments, driven by their reach for yield to make up their funding shortfall. As part of the same trend, pension funds' shift from equities to fixed income appears to have ceased. However, similar to insurance companies, we believe pension funds may increase their buying of the asset class if Treasury yields continue to increase.

## Other buyers

We estimate that banks' allocation to investment grade corporates is largely unchanged from 12 months ago. Most investment grade corporate bond assets within banks – approximately $225bn – are reported as available-for-sale or held-to-maturity. A smaller

FIGURE 21

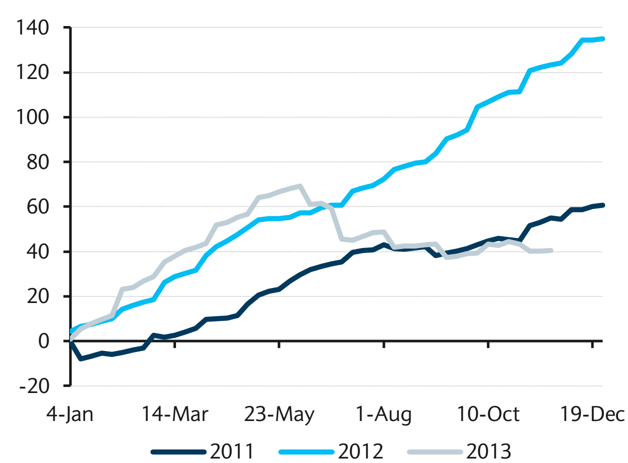
**Estimates of ownership of investment grade corporate bonds (% of total universe)**

| Category | Current estimates | 2012 estimates |
|---|---|---|
| Life insurance | 33-36% | 34-37% |
| P&C insurance | 6-8% | 6-8% |
| Pension funds | 13-15% | 15-17% |
| Mutual funds | 15-17% | 14-16% |
| Banks | 6-9% | 6-9% |
| Hedge funds | 2-4% | 1-3% |
| Other* | 15-20% | 15-20% |

Note: *Other includes endowments, foundations, sovereign wealth funds, offshore funds, and direct holdings by households. Source: Bloomberg, Federal Reserve, Lipper/Thomson Reuters, SNL Financial, EPFR, HFR, BarclayHedge, Barclays Research

FIGURE 22

**Cumulative investment grade corporate fund flows ($bn)**




Source: Lipper/Thomson Reuters, Barclays Research portion of the corporate bond holdings is held as a trading asset: inventory for the banks' market-making operations. However, even the amount of holdings in this category is likely to be significantly higher than the primary dealer net positions reported by the Fed – the number investors typically look at for dealer inventories – since the Fed provides a net number, while the analysis of holdings requires a gross figure.

We estimate that hedge funds now hold a slightly larger portion of the market than a year ago, primarily as a result of the large growth in AUM of hedge funds with a significant allocation to credit. While the high yield market is likely to have been a bigger beneficiary of this increase in AUM, certain parts of the investment grade market, such as subordinated financials, wider-spread or crossover credits, and event-risk names, are likely to have received some of the new hedge fund money as well.

## Supply forecast

We expect investment grade issuance to be above $1trn for the third consecutive year in 2014, albeit somewhat lower than this year's record volumes, which were skewed by Verizon's mega-deal (Figure 23). We forecast $1,030bn of gross fixed-rate issuance (-8% y/y), which translates to $522bn of net issuance (-22% y/y), with the greater decline in net issuance driven by an uptick in financial and non-corporate maturities. This fall should be positive for the market and help mitigate the effects of any potential mutual fund outflows. We expect the biggest drops in issuance in banks and Yankees.

2013 investment grade new issue volumes are on pace to set a new all-time record. So far, concerns about a potential slowdown in issuance caused by rising interest rates have not materialized. In fact, since Treasury yields began to rise in early May, monthly issuance totals have exceeded last year's totals in every month except June (Figure 24). Year-to-date fixed-rate issuance (including non-corporates) stands at $1,077bn. Annualizing this and adjusting for seasonal variation yields $1,120bn, $30bn above the 2012 total. While issuance was on pace with last year for most of 2013, Verizon's $49bn transaction led year-to-date supply to exceed last year's pace. Netting out the redemptions and tenders results in a net supply number of $610bn, slightly higher than 2012's $600bn.

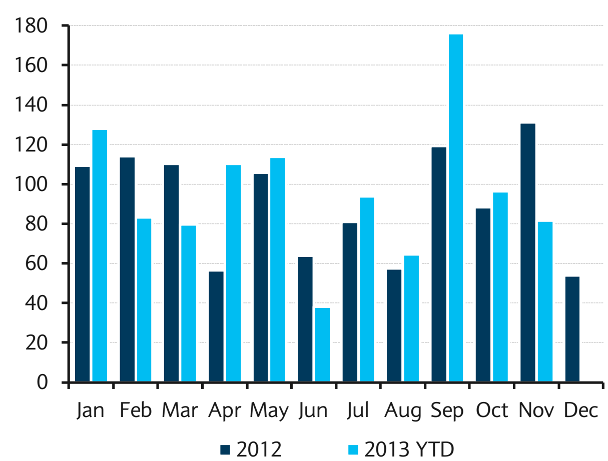
In terms of sector trends, non-financial corporate issuance is down approximately 10% from last year, financial issuance is close to unchanged, and non-corporate issuance is up

FIGURE 23
**2014 investment grade fixed-rate issuance forecast ($bn)**

| | 2014 maturities | 2013 issuance* | 2014 gross forecast | 2014 net forecast |
|---|---|---|---|---|
| Non-fin corp | 181 | 520 | 480 | 299 |
| Financials | 146 | 280 | 250 | 104 |
| Non-corporates | 181 | 320 | 300 | 119 |
| Total | 508 | 1,120 | 1,030 | 522 |

* Note: 2013 year-to-date issuance is annualized. All issuance data and forecasts are for debt eligible for the US Credit or US 144A indices, unless otherwise specified. Source: Barclays Research

FIGURE 24
**Investment grade issuance: 2012 versus 2013 ($bn)**




Source: Barclays Research

substantially. The increase in non-corporate issuance has been driven by foreign government funding agencies such as KFW, KBN, and CADES, as well as partially state-owned corporates such as Petrobras and Pemex. Another notable change has been the significant increase in floating-rate debt, with approximately 13% of total supply coming in FRN form this year, compared with 4% last year. The increase in FRN supply has been driven by increased demand from investors concerned about rising interest rates, a trend that we expect to persist.

Our forecast of slightly lower issuance next year is supported by several factors. First, we expect the share of FRN issuance (which is not index-eligible) to remain elevated and potentially increase further, given the higher demand for floating-rate product in a rising rate environment. Second, we expect issuers to rely more on shorter-dated funding and commercial paper, given the pressure to maintain net income margins in the face of rising rates and muted concerns about the ability to refinance debt in a low-volatility environment. Non-financial commercial paper balances are now above 2007/08 levels, as reliance on short-term funding has grown steadily post-crisis (Figure 25). With all-in yield curves close to their all-time steepest level (Figure 26) and interest rates expected to rise, companies may shift more of their funding toward shorter-dated debt and CP as a way to maintain net income margins. We also expect less Yankee issuance and issuance from foreign agencies and supranationals as a result of a narrowing cross-currency basis swap, which has decreased the relative attractiveness of issuing in USD. Finally, we expect pre-funding activity to slow somewhat next year, given several waves of opportunistic issuance as yields set new lows over the past two years.

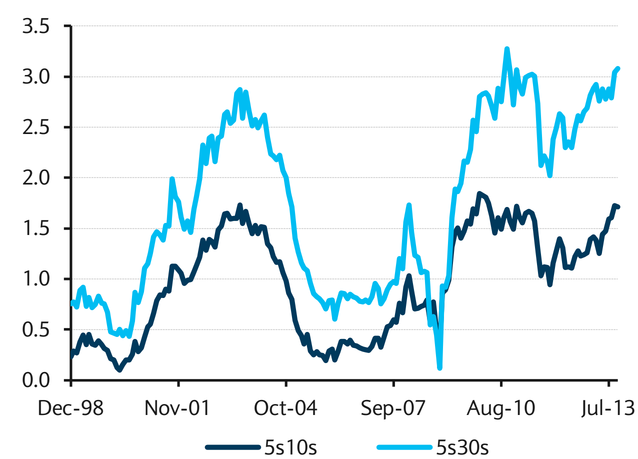
## 2014 non-financial US corporate issuance forecast: Top-down approach

The key components of our forecasts include near-term maturities, EBITDA growth, changes in leverage, and issuance from first-time issuers (Figure 27). As a starting point, we assume that all of next year's fixed-rate maturities – which are only slightly higher than this year's maturities – will be refinanced, which contributes $130bn to our top-down forecast for US non-financial issuance (Figure 28). Next, we assume that companies issue debt to keep up with growth in EBITDA, which we expect to be about 8% in 2014. This adds another ~$150bn of issuance. Our forecast for continued releveraging of .05-0.1x contributes another $110bn of net debt. Finally, we expect approximately $35bn of debt issuance from inaugural issuers – in line with this year's level.

FIGURE 25
**Non-financial domestic CP outstanding ($bn, SA)**


Source: Bloomberg, Barclays Research

FIGURE 26
**US Corporate Index 5s10s and 5s30s yield curves (%)**




Source: Barclays Research

Combining these factors results in a gross issuance forecast for US non-financial corporates of $425bn (10% higher than this year's annualized issuance) and a net forecast of $295bn (up 12% from this year). We also forecast issuance for US non-financials using a sector-level approach that is informed by our fundamental analysts (please see *2014 Investment Grade Issuance Forecast* for sector-level issuance forecasts). The sector level forecast yields a lower number of $295bn for gross issuance, but we believe that is biased downward because it does not explicitly account for potential issuance from M&A and inaugural issuers, and also does not cover the full universe of non-financial US corporates in our indices. As a result, our overall forecast for US non-financials is closer to our top-down number of $425bn.

Away from US non-financials, we expect fixed-rate bank issuance to be around 20% lower next year. We also expect Yankee issuance to decline, driven by a tightening in the cross-currency basis swap, a decreased need for currency diversification of funding, and moderating issuance needs for European corporates, given continuing deleveraging by European banks and the continuing need for balance sheet repair among European non-financials. Combining the different components of our forecast yields a total gross issuance number of $1,030bn for 2014.

FIGURE 27

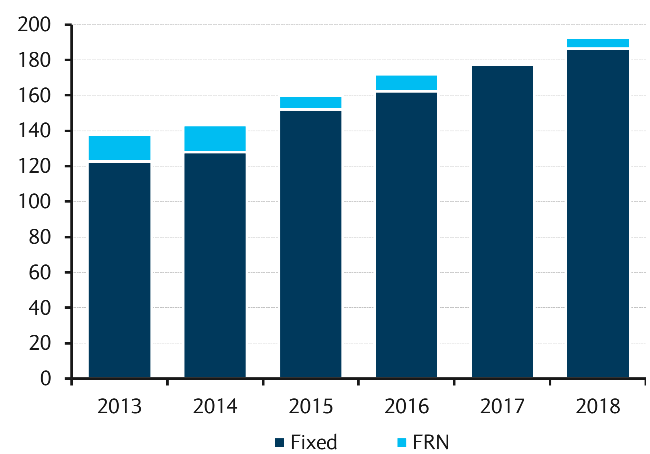
**Top-down forecast for 2014 US non-fin corp issuance**

| Source of debt issuance for 2014 | Amount ($bn) |
|---|---|
| Fixed redemptions | 130 |
| EBITDA growth for US non-fins | 150 |
| Increase in leverage for US non-fins | 110 |
| First-time issuers | 35 |
| Total gross issuance forecast | 425 |
| Net issuance forecast (gross – redemptions) | 295 |

Source: Barclays Research

FIGURE 28

**US non-financial corporate maturities ($bn)**




Source: Barclays Research

US HIGH YIELD STRATEGY

# Keep calm and earn carry

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com

Eric Gross
+1 212 412 7997
eric.gross@barclays.com

Jigar Patel
+1 212 412 1161
jigar.n.patel@barclays.com

Ellie Lan
+1 212 412 3038
ellie.lan@barclays.com

- **We expect total returns of 3-4% in 2014. Default losses should remain very low, but we anticipate that rates-driven price declines will eat into coupon returns. Incorporating our rates strategists' expectation of higher rates by the end of 4Q, we forecast excess returns of 5-6%.**

- **We forecast an issuer-weighted default rate of 2.0-2.5% for 2014, a slight decline from already-low levels. Uncertainty about the timing of potential defaults and/or restructurings of a few very large capital structures increases the range of outcomes for the par-weighted default rate, which we forecast as 1-3%.**

- **Tighter spreads should partially offset higher rates in 2014. While the historical rates/spread relationship suggests 80-100% absorption, we expect a more conservative 50% due to lower starting yields and the end of extraordinary Fed accommodation. Our base case forecast takes high yield spreads down to 350bp.**

- **Away from hedging rates directly, we favor managing duration by going down in quality, provided that the credit still produces positive free cash flow. While yield-to-call paper is an often-used alternative, we caution against bonds that are only barely call-constrained as part of such a strategy because of their significant extension risk.**

- **After diverging in 2012, the relationship between different parts of the high yield quality spectrum appears to have normalized; we believe total returns by quality will not differ materially from those implied by historical betas. However, given our outlook for low defaults, low credit volatility, low total returns, and higher rates, we continue to favor going down in quality to simultaneously pick up carry while shedding duration.**

- **We expect gross primary issuance of $270-295bn for 2014; net growth in par, accounting for redemptions and other refinancing transactions, should total $95-115bn. We believe refinancing volumes will be lower as yields creep higher due to rates. The trend of bond issuance to repay bank debt should also continue to wane. Growth in proceeds for M&A/LBO deals will partially offset the declines in refi activity, but proceeds for GCP/CapEx should be relatively flat. We believe strong equity markets will keep deal volumes for dividends and share repurchases relatively muted.**

- **We do not expect LBO volumes to return to 2005-07 levels, largely because of a lack of sponsor appetite to club together to buy very large companies, although the number of deals could still grow. Strong equity markets should support the increasing trend of IPOs, which should also produce some upside for companies with a credible path to an S-1 filing.**

- **Ratings migration appears relatively balanced, and we do not expect a large net flow from HY to IG next year. Furthermore, the Ba-Baa spread is near historical tights. That said, in a low return environment, we believe identifying rising stars before the upgrade event can help buttress performance.**

- **Derivatives are unlikely to repeat their significant outperformance of the cash market in 2014. However, we believe long positions via CDS will continue to be an effective way to manage duration and avoid the negative convexity of call-constrained bonds. Negative basis trades and forward long positions via CDS should also remain attractive.**

## Overview

Credit risk took a back seat to rate risk for most of 2013. Portfolio managers were forced to put significant effort into playing defense against a volatile Treasury market. Spread volatility was almost negligible away from the component related to rates (Figure 1), which broke from the normal negative correlation between rate and spread changes as the Fed struggled to communicate its QE exit strategy. While there are signs that the correlation has been normalizing of late (Figure 2), we believe the spread/rates relationship will be volatile through at least the first half of 2014 as further tapering headlines affect markets. Ultimately, however, we do expect the long-run negative correlation to re-establish itself once the path of rates becomes less driven by QE.

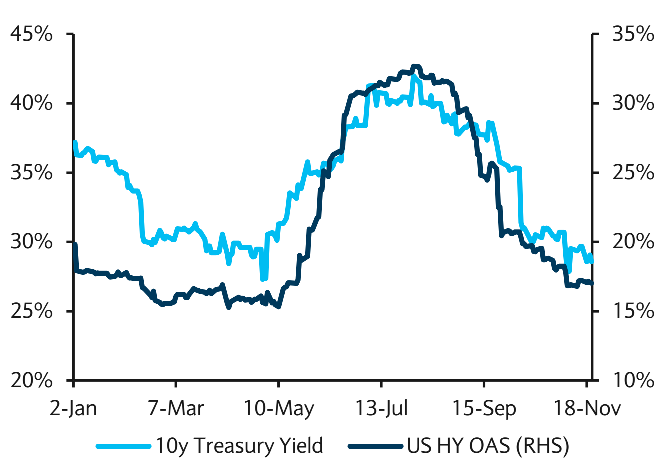
Despite the Fed-induced roller coaster ride in 2013, the market is on track for the dullest – and possibly the rarest – outcome in its 25-year history: a calendar-year coupon return (Figure 3). That said, returns by credit quality ranged widely, with the Ba Index underperforming its historical beta of 0.8x to US HY and the Caa Index outperforming versus its 1.4x beta (Figure 4). While differences in duration explain most of the year's extra dispersion in returns by quality, triple-C-rated bonds also owe part of their outperformance to the fact that they began the year somewhat dislocated to both the overall market and higher quality paper, and have since reverted to a more normal relationship (Figure 5).

With the average price of the US High Yield Index at $103.63, call constraints would appear to be a concern once again, given that 40% of the market is trading above its next call price. Indeed, coming into 2013 the high yield market was deeply call-constrained (Figure 6), seriously limiting upside. However, for better or for worse, we believe call constraints will not be the limiting factor in 2014. Instead, we expect spreads to only partially absorb the higher rates expected by our rates strategy team, taking overall prices lower, actually making the market less call-constrained in the process.

Overall, we believe high yield credit will be resilient and provide solid excess return compensation, but rates headwinds will hamper total returns. In contrast to last year, no relative value dislocations are apparent to us today in terms of different quality buckets; however, we expect the higher carry and spread cushion of lower-rated bonds to be the driver of better total returns in another year of low credit risk and high rate volatility. On the other hand, longer duration paper, which has understandably been out of favor due to higher perceived rate risks, could outperform if the Fed materially delays tapering; while this is a distinct risk, it is not our base case expectation.

FIGURE 1

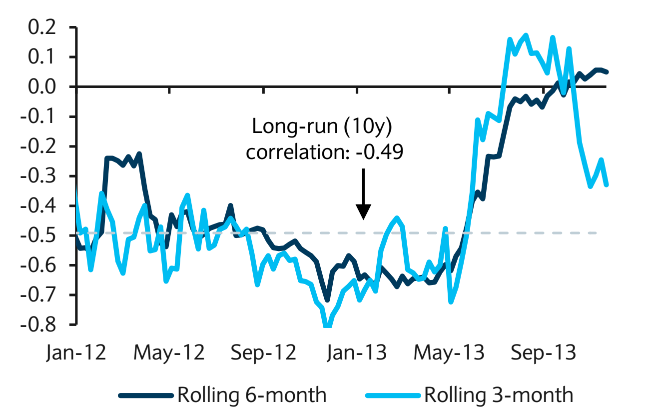
**US HY spread volatility and 5y Treasury yield volatility**




Source: Barclays Research

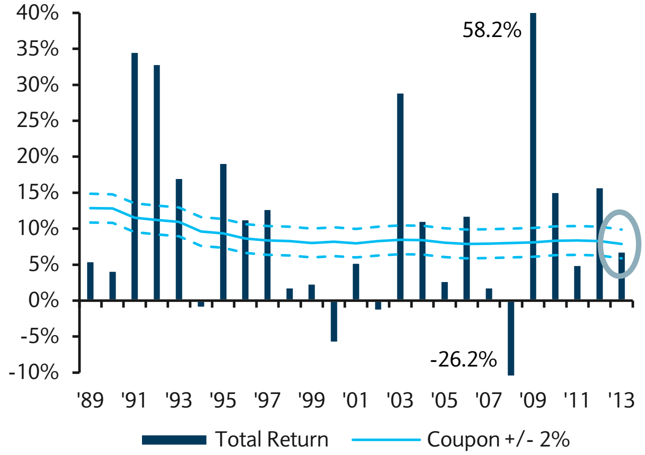
FIGURE 2

**Correlation of US HY OAS and 5y Treasury yield**



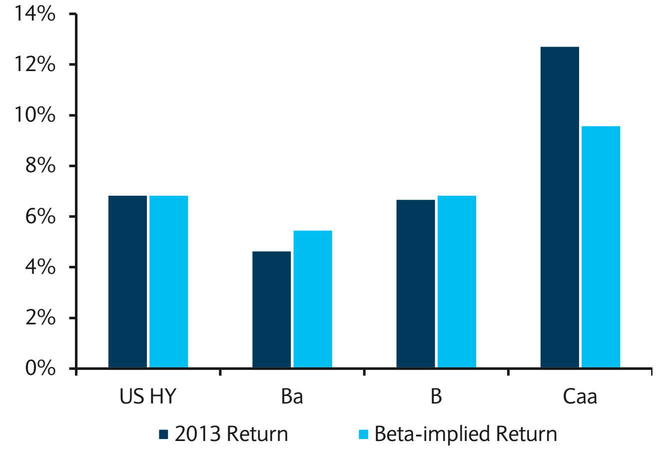

Note: Correlation of weekly changes. Source: Barclays Research

FIGURE 3
**Annual total returns versus starting coupon**




Source: Barclays Research

FIGURE 4
**Realized versus long-run beta-implied returns**

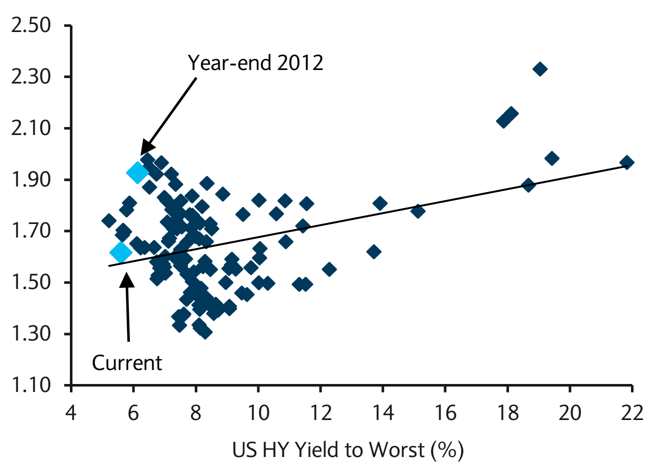



Source: Barclays Research

## Forecasting returns

We expect spreads to tighten next year, partially offsetting the significant increase in rates (+113bp 5y; +76bp 10y) forecast by our rates strategists. Specifically, our base case scenario is for spreads to compress to 350bp, which from current levels equates to a spread-to-rates beta of -0.48. Importantly, we note that this amount of rates absorption is significantly lower than history would suggest. Indeed, going back monthly to 1993, the beta of OAS changes to changes in the 5y Treasury has been -1.03 in months of increasing rates. Further, the sensitivity of OAS to rates has historically been very dependent on the spread cushion (Figure 7), and in periods where the spread cushion – as measured as the OAS as a percentage of all-in yield – was similar to its current value (72%) it also absorbed a little more than 100% of rates moves, on average. However, we believe the current situation is not well captured by the historical data. Indeed, market expectations of a prolonged period of higher rates, starting from an environment of ultra-low yields supported by extraordinarily accommodative Fed policy, could be prone to larger than normal fund outflows, and warrants some caution. For that reason, we believe a beta closer to -0.5 is a more reasonable expectation.

FIGURE 5
**Caa-to-Ba yield ratio vs US HY yield**

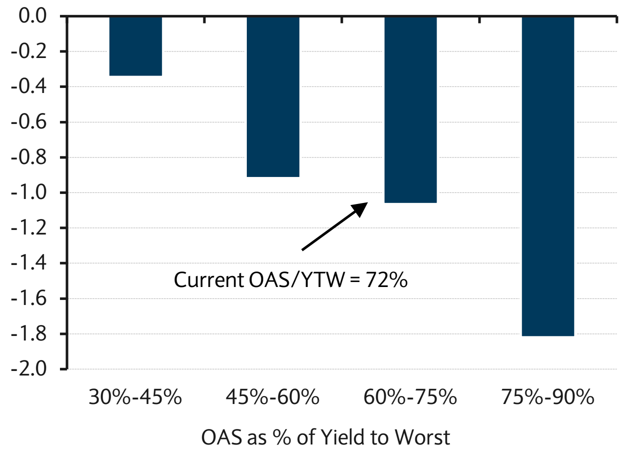



Note: Ten years of monthly yield data. Source: Barclays Research

FIGURE 6
**Percent of US HY trading above its next call price**

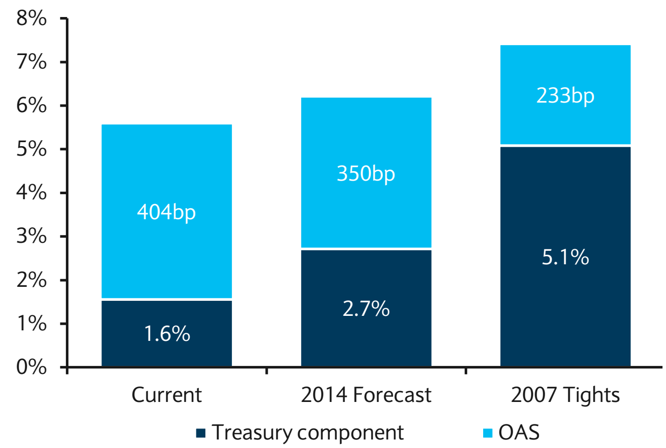

Source: Barclays Research

FIGURE 7
**Beta of US HY OAS with 5y Treasury**




Source: Barclays Research

FIGURE 8
**Current and forecast breakdown of US HY yield-to-worst**




Source: Barclays Research

Thus, we believe that next year will mark the beginning of a shift towards an environment of higher yields and tighter spreads. Under our base case scenario, year-end spread (350bp) and yield (6.2%) will be within 120bp of the levels reached at the spread tights in 2007 (Figure 8). This produces total return for the high yield market of 3-4% and an excess return of 5-6% (Figure 9).

FIGURE 9
**2014 total and excess return scenario analysis**

| | Current level | Base case | Bull case | Bear case |
|---|---|---|---|---|
| 5y Treasury | 1.37% | 2.50% | 3.00% | 1.25% |
| *y/y change (bp)* | | *113* | *163* | *-12* |
| US HY OAS (bp) | 404 | 350 | 275 | 600 |
| *y/y change (bp)* | | *-54* | *-129* | *196* |
| *Implied beta of OAS to 5y Tsy* | | *-0.48* | *-0.79* | *-16.20* |
| US HY YTW | 5.6% | 6.2% | 5.9% | 7.4% |
| *y/y change* | | *0.6%* | *0.3%* | *1.8%* |
| US HY price | 103.63 | 100.98 | 102.07 | 96.09 |
| *y/y change* | | *-2.65* | *-1.56* | *-7.54* |
| **Return components** | | | | |
| Coupon return | | 7.0% | 7.0% | 7.0% |
| Default losses | | (1.2%) | (0.6%) | (3.4%) |
| Price return | | (2.5%) | (1.5%) | (6.8%) |
| **Total return** | | 3.4% | 5.0% | (3.2%) |
| **Excess return** | | 5.3% | 9.4% | (7.4%) |

Source: Barclays Research

## Duration risk

Rates and spreads should, in theory, be negatively correlated. Spreads narrow as economic conditions improve, while an improving economic backdrop is typically associated with rising rates. The reverse is true, in general, in an environment of deteriorating economic conditions. The experience in 2013 was, of course, very different. While spreads ended up tightening by more than rates backed up, the correlation and beta turned sharply positive over shorter intervals.

Historical correlation and beta of spreads and rates are telling, and the mid-year sell-off in both rates and spreads has clearly shown up in the metrics. Looking at months of rising rates in the post-crisis period (2010-today), the correlation is considerably less negative than over a longer period (Figure 10).

FIGURE 10

**Correlation and Beta of US HY OAS changes and 5y Treasury changes**

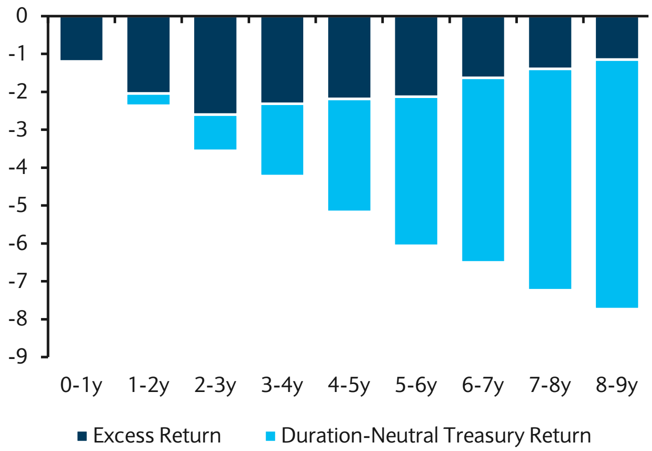
| | Correlation | | | | Beta of OAS and rates | | | | Effective duration multiplier | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | US HY | Ba | B | Caa | US HY | Ba | B | Caa | US HY | Ba | B | Caa |
| *All months* | | | | | | | | | | | | |
| Oct 93 - Oct 13 | -48% | -46% | -49% | -40% | -1.2 | -0.8 | -1.2 | -1.6 | -0.2 | 0.2 | -0.2 | -0.6 |
| Oct 03 - Oct 13 | -49% | -48% | -48% | -45% | -1.6 | -1.2 | -1.5 | -2.2 | -0.6 | -0.2 | -0.5 | -1.2 |
| Jan 97 - Dec 07 | -60% | -56% | -57% | -43% | -1.1 | -0.8 | -1.2 | -1.5 | -0.1 | 0.2 | -0.2 | -0.5 |
| Jan 04 - Dec 06 | -52% | -39% | -52% | -44% | -0.6 | -0.4 | -0.7 | -0.9 | 0.4 | 0.6 | 0.3 | 0.1 |
| Jan 10 - Oct 13 | -38% | -37% | -36% | -40% | -1.0 | -0.8 | -1.0 | -1.6 | 0.0 | 0.2 | 0.0 | -0.6 |
| *Rising rate months* | | | | | | | | | | | | |
| Oct 93 - Oct 13 | -35% | -33% | -38% | -28% | -1.0 | -0.7 | -1.2 | -1.5 | 0.0 | 0.3 | -0.2 | -0.5 |
| Oct 03 - Oct 13 | -41% | -37% | -44% | -35% | -1.6 | -1.0 | -1.7 | -2.3 | -0.6 | 0.0 | -0.7 | -1.3 |
| Jan 97 - Dec 07 | -47% | -42% | -47% | -33% | -1.0 | -0.8 | -1.2 | -1.3 | 0.0 | 0.2 | -0.2 | -0.3 |
| Jan 04 - Dec 06 | -48% | -35% | -52% | -46% | -0.8 | -0.5 | -1.0 | -1.3 | 0.2 | 0.5 | 0.0 | -0.3 |
| Jan 10 - Oct 13 | -8% | -3% | -6% | -12% | -0.3 | -0.1 | -0.2 | -0.6 | 0.7 | 0.9 | 0.8 | 0.4 |
| *Falling rate months* | | | | | | | | | | | | |
| Oct 93 - Oct 13 | -40% | -40% | -37% | -36% | -1.6 | -1.2 | -1.6 | -2.5 | -0.6 | -0.2 | -0.6 | -1.5 |
| Oct 03 - Oct 13 | -45% | -46% | -38% | -42% | -2.4 | -1.9 | -2.0 | -3.3 | -1.4 | -0.9 | -1.0 | -2.3 |
| Jan 97 - Dec 07 | -54% | -52% | -48% | -41% | -1.5 | -1.1 | -1.7 | -2.4 | -0.5 | -0.1 | -0.7 | -1.4 |
| Jan 04 - Dec 06 | -64% | -42% | -56% | -42% | -1.4 | -0.9 | -1.3 | -2.0 | -0.4 | 0.1 | -0.3 | -1.0 |
| Jan 10 - Oct 13 | -60% | -60% | -59% | -59% | -3.0 | -2.5 | -2.9 | -4.1 | -2.0 | -1.5 | -1.9 | -3.1 |

Source: Barclays Research

We expect tapering headlines to continue to move rates and risky asset markets in 2014, and we believe it is likely that we will once again experience periods of positive correlation. It is therefore understandable for high yield managers to be cautious about their duration risk. The historical record should provide some comfort, however. As Figure 10 shows, the beta over long periods (the first three rows are 20-year, 10-year, and pre-crisis 10-year periods, respectively) is -1.0x or lower in rising rate months. While the January 2004 to December 2006 period admittedly corresponds to an era of rising leverage and liquidity, it also corresponds to a similar starting spread and a prolonged rise in rates; during that period, spreads offset a big part of the moves in rates, but the high yield market still experienced a -0.8x beta to 5y Treasuries.

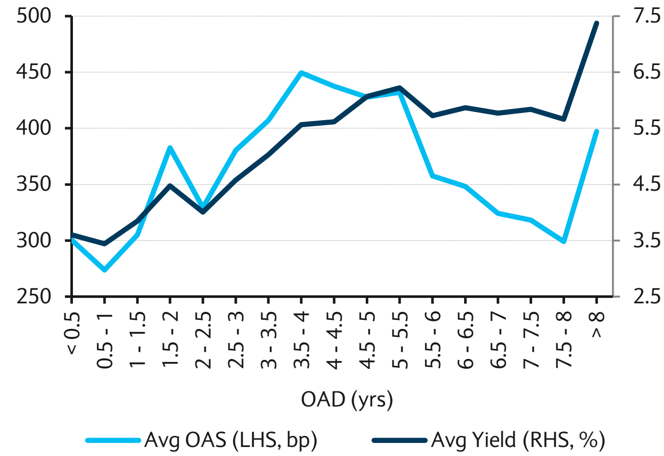
Looking to 2014, a few caveats skew our view towards a more conservative beta. First, we appear to be on the threshold of what most expect to be a prolonged rise in rates, but from a lower all-in yield than previously experienced. Second, the catalyst for the turn in rates is the end of extraordinary measures to stoke growth, which have distorted risky asset valuations in ways that are difficult to quantify. Third, there is much less appetite today for the use of increased leverage by investors of the magnitude experienced in 2004-06. Because of these caveats, our baseline assumption is that spreads will absorb a more modest 50% of rates increases in 2014.

FIGURE 11
**Total return breakdown in May 2 to June 24 sell-off**




Source: Barclays Research

FIGURE 12
**Spread and yield by duration bucket**




Source: Barclays Research

Away from hedging rates directly, which most high yield investors do not (or cannot) do, there are a few choices for managing duration risk. As Figure 10 shows, going down in quality provides a consistently lower empirical duration, as higher spread cushions absorb a greater fraction of rates moves. Yield-to-call paper is another alternative, although we caution against bonds that are only barely call-constrained as part of such a strategy. As many learned in the May-June sell-off, these bonds have significant extension risk, making them more likely to underperform (Figure 11).

Finally, we believe the September meeting of the FOMC sent a strong signal that the Fed is much more concerned about the risk of derailing the recovery by pulling back too soon than the risk of being accommodative for too long. Given this, and future Fed chairman Yellen's support of "optimal control", we believe there is a non-negligible probability of further delays to tapering, an outcome which would support taking more duration risk. Investors who can hedge rates (or are more sanguine with respect to duration) need not go far out the curve to pick up spread. In fact, the spread curve peaks around the 4y OAD point (Figure 12), which corresponds approximately to the 6-7y maturity point.

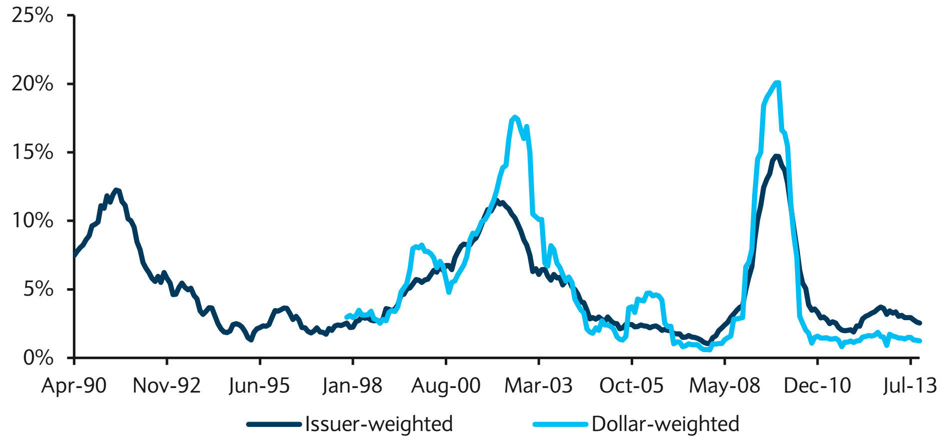
## Default risk

We do not expect the high yield issuer default rate to pick up in 2014, and in fact, we see potential for it to drop slightly from already-low levels (2.5% as of end of October) to 2.0-2.5%. Uncertainty about the timing of potential defaults and/or restructurings of a few very large capital structures increases the range of outcomes for the par-weighted default rate, which we forecast as 1-3%.

As we have done in the past, we combined the results of three different methodologies to arrive at our forecast: a model based on macro variables, a model calibrated to ratings trends, and a bottom-up analysis of credits. The three approaches come remarkably close this year. The macro model, which combines C&I lending standards and the percentage of bonds trading below $70 to predict defaults, produces a 2.3% forecast, while the ratings-based model forecasts a 2.9% issuer-weighted default rate seven months out. Our bottom-up review of the default risk of credits in the high yield cash index made it clear that – despite a few challenging stories – the list of names that face a material risk of default or restructuring before the end of 2014 is quite short. On an issuer-weighted basis, the bottom-up analysis points to a 2.0-2.5% default rate.

FIGURE 13

**Trailing 12m issuer-weighted and dollar-weighted default rates**




Source: Moody's

We expect the par-weighted default rate also to be low, but the range of outcomes hinges on the outcome of a small number of very large capital structures, hence the broader 1-3% forecast range. Specifically, with Energy Future Competitive Holdings (TXU) having made its November 1 interest payment, the timing of a possible restructuring is likely to be pushed into 2014. Furthermore, Clear Channel's recently proposed exchange offer – which we expect will count in the Moody's speculative grade default rate, and which is set to expire on December 23 – could extend into 2014. Meanwhile, Caesars Entertainment is another company with an elevated risk of offering a distressed exchange, although the timing remains unclear.

## Event risk

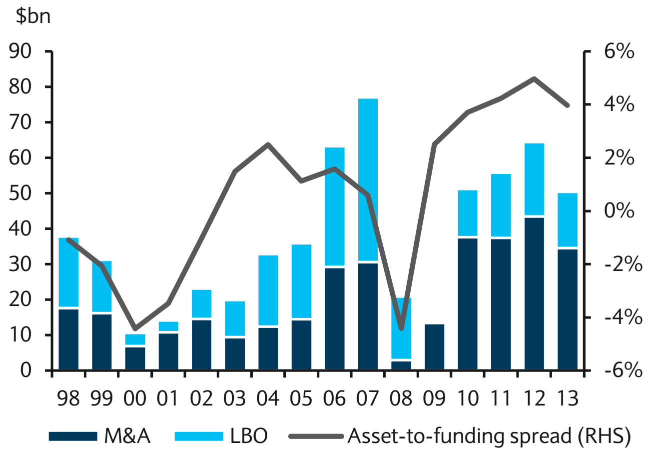
The financial conditions for M&A and LBO activity have been attractive for several years, and while LBO volumes have not come close to those reached over 2005-07, primary market proceeds for M&A have been significant. Specifically, we track the gap between asset yields and funding costs: when the spread between them is high companies and private equity sponsors have a strong economic incentive to use cheap funding to acquire companies for their comparatively high asset yields (Figure 14).

We believe 2014 is poised for further growth in M&A volumes. We do not expect LBO volumes to return to 2005-2007 levels, largely due to a lack of sponsor appetite to club together to buy very large companies, although the number of deals could still grow. However, increasing GDP growth forecasts and a prolonged period of low market volatility have, in our view, made it possible for corporate management teams to gain confidence in growth forecasts for their own and their targets' financials.

M&A activity is generally a positive for high yield issuers. Notwithstanding the recent stories about a potential Charter Communications acquisition of Time Warner Cable,[1] high yield companies are often the targets of larger, more stable, sometimes investment grade-rated companies. While improved credit metrics are certainly a benefit, significant upside comes (even after accounting for potential equity claws) from the acquirer tendering for the target's bonds; change of control puts can also be a source of upside for high yield investors when the target's debt trades at a sufficient discount.

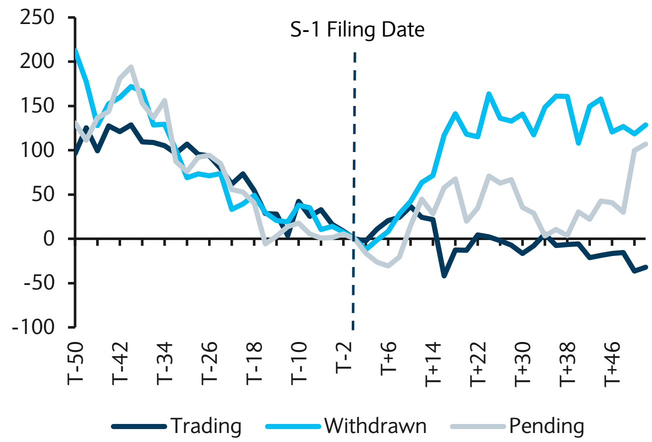
[1] "Charter Is Arranging $25 Billion in Debt for Time Warner Cable Bid," *Wall Street Journal*, November 27 2013.

FIGURE 14
**USD-denominated high yield supply for M&A and LBO, versus S&P 500 asset-funding spread**




Note: Asset-funding spread calculated as median S&P500 EBITDA/EV (ex-financials and utilities) minus US HY yield-to-worst. Source: Barclays Research

FIGURE 15
**Spread performance relative to US High Yield Index around the S-1 filing date (bp)**




Source: Bloomberg, Barclays Research

Another potential source of significant alpha in what we expect will be a low-return year is IPOs. Of the companies taken private between 2002 and 2007, several hundred remain in private hands. Within this large pool of potential exit candidates, those that have a credible path to filing an S-1 can significantly outperform the high yield market. Indeed, those that have pursued IPOs thus far have seen their bonds tighten about 150bp versus the US High Yield Index in the year leading up to the initial S-1 filing (Figure 15). Importantly, however, outperformance has historically unwound for companies that ultimately withdraw their S-1 or have a planned use of equity proceeds other than to repay debt.

## Supply and demand

The pipeline of bridged high yield bond deals remains negligible compared with pre-crisis levels. While there were some very large LBO transactions in 2013, including Dell and Heinz, these were special circumstances, and the calendar of leveraged deals for early 2014 is fairly sparse. The lack of these transactions is mostly due to diminished sponsor activity, in our opinion, as the demand picture remains favorable for issuers. Despite significant retail outflows during the summer, mutual fund flows are now positive for the year and participated in the 11% growth of the High Yield Index this year. The significant retail ownership discussed below can make high yield more volatile in times of market stress. We expect periods of outflows around rate flares, but the lowest duration and highest coupon among fixed income products should keep flows positive in 2014.

### Demand

Retail holdings of high yield credit have decreased somewhat in the past 12 months, led by dedicated high yield funds, which have given up about 3% of their share of the high yield market (Figure 16). Significant outflows on the retail front have largely been attributable to duration concerns, which had been relatively mild until they flared up with rates in early May. While dedicated funds have seen some erosion in demand, growth rates for retail funds focused on income generation and the investment grade market have kept pace with the growth in overall high yield assets, and they still hold 18-21% of the overall credit market, by our estimates. We believe the investment grade/income fund segment of the retail market has likely shifted its allocation slightly toward equities and high yield at the expense of investment grade corporate debt, due to a combination of ultra-low yields and higher duration risk in the latter. Secondary sources of retail demand, such as loan funds and offshore funds, have seen strong growth in their asset bases in the past year. However, in both cases, the absolute increases were not sufficient to materially affect their share of high yield market ownership.

FIGURE 16
**Estimated share of US high yield bond holdings**

| Category | 2013 | 2012 | Y/Y Chg |
|---|---|---|---|
| HY mutual funds and ETFs | 19-22% | 22-25% | -3.0% |
| IG/income funds | 18-21% | 18-20% | unch |
| CLOs/loan funds | 2-4% | 2-4% | unch |
| Offshore funds | 5-8% | 5-8% | unch |
| Hedge funds | 16-22% | 12-18% | +4.0% |
| Pension funds/Sep accts | 13-17% | 14-18% | -1.0% |
| Insurance portfolios | 11-15% | 8-12% | +3.0% |
| Other | 1-4% | 4-7% | -3.0% |

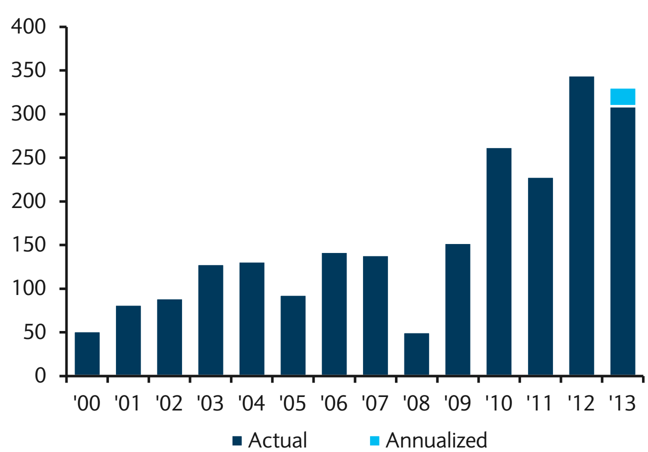
Source: Bloomberg, Lipper, EPFR, HFR, SNL Financial, Barclays Research

The decline in retail demand has been balanced by an increase in hedge fund and insurance holdings. We estimate that hedge funds hold $220-290bn in high yield (accounting for leverage), or 16-22% of the market. The increase in market share for hedge funds of 4% y/y is a result of AUM growth and not necessarily an asset allocation decision. The relative scarcity of yield across fixed income assets has pushed insurance portfolios further down the quality spectrum over the past year. An analysis of portfolio holdings of the largest insurers shows that segment of the market growing significantly faster than the overall market. We estimate that insurers now hold $135-185bn in US high yield assets, or 11-15% of the market, for a 3% increase in share over the past year. While insurers may be comfortable with the incremental credit risk, further increases may be difficult due to the higher risk weighting of non-investment grade debt.

## Supply

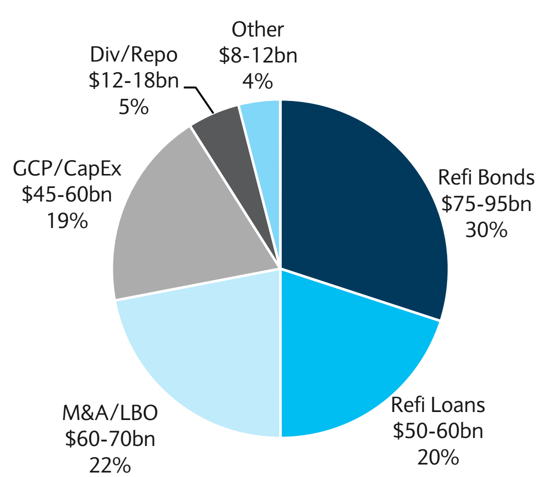
With yields hitting all-time lows, the primary market has been robust again this year, pricing nearly $309bn thus far in 2013. Accounting for typical seasonality patterns, the remainder of the year should amount to roughly 7% of the full-year total, implying an annualized run rate of

FIGURE 17
**Annual high yield issuance ($bn)**




Source: Barclays Research

FIGURE 18
**Expected breakdown of 2014 issuance by use of proceeds**




Source: Barclays Research

$331bn (Figure 17). This amount, if realized, would put 2013 just $14bn shy of the record set in 2012 – no surprise given that 1Q13 was the largest quarter of supply on record ($100.2bn), and September 2013 was only $170mn shy of the largest month ever (September 2012, $46.8bn).

A continuation of the low yield environment witnessed in 2012 kept volumes elevated across different uses of proceeds. With yields never climbing above 7% this year and averaging less than 6%, issuers used about a third of this year's proceeds to refinance existing bonds and an additional 25% to repay bank debt. M&A and LBO volumes were more moderate than we expected, accounting for about 17% of the total, and a similar amount was used for CapEx and general corporate purposes

We forecast gross issuance of $270-295bn for 2014 (Figure 18). We anticipate lower refinancing volumes ($75-95bn), driven by slightly higher average yields and a continued decline in bond issuance to repay bank debt ($50-60bn). These declines should be offset partially by increased M&A/LBO volumes ($60-70bn), but we expect issuance for GCP/CapEx to be relatively flat y/y at $45-60bn. Strong equity markets should keep high yield issuance to pay dividends and repurchase shares relatively muted at $12-18bn. We anticipate net growth in par, accounting for redemptions and other transactions, of $95-115bn.

Looking to next year, we re-examine the factors that we believe will contribute to issuance volume:

- ***The refinancing opportunity set.*** The total amount of debt set to mature in the next twelve months, combined with the amount of debt that is now callable or will be callable during that period, is about 8% higher than it was a year ago, creating a significant opportunity for refinancing activity in 2014. Despite this, we expect refinancing activity to decrease slightly next year as higher Treasury rates take average secondary yields up. A delay in tapering is certainly a risk to this view, as it could cause rates to remain low and refinancing activity to be well supported.

- ***Secondary yields relative to average coupons.*** Secondary yields remain very low relative to the average coupon (160bp difference). However, while we expect spreads to absorb some of the increase in rates expected by our rates strategists, we believe yields will be higher on average in 2014, making call options less valuable.

- ***Asset yields relative to financing yields.*** While M&A volumes were somewhat lower than expected this year despite high asset-to-financing spreads, we continue to expect a pickup. We believe issuance to finance M&A and LBOs will account for a quarter of the 2014 total, a 20% increase in volume from 2013.

- ***The primary market for loans.*** While the high yield market continues to grow, we expect the decline in net bond-for-loan volumes – due to strong demand for loans driven by an aversion to duration risk and resurgence in CLO issuance – to be a significant drag on overall high yield issuance. Changes in guidance from regulators on leveraged lending could be a risk to this view, but it is too early to determine the extent to which the guidelines will lead to a change in the financing mix between loans and secured bonds for highly leveraged credits.

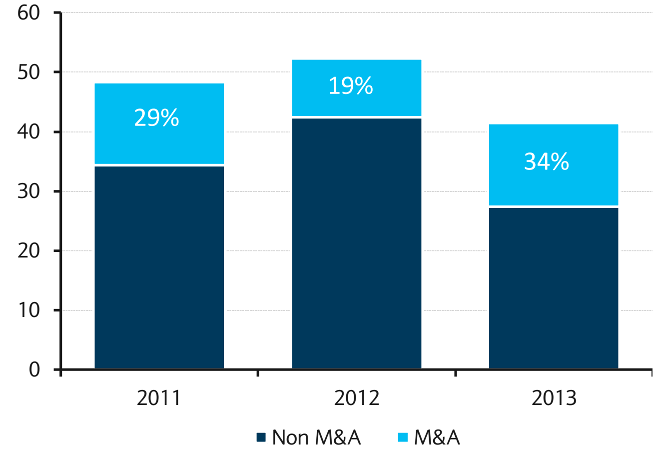
## Quality

Returns in 2013 were very dependent on quality. The lower end of the ratings spectrum outperformed significantly, with Caa-rated bonds up 12.75% through the end of November. That equates to 1.86x the 6.87% market return, materially higher than the 1.40x historical long-run beta. On the flipside, higher quality underperformed in 2013. Ba-rated bonds were

FIGURE 19
**Difference between Ba and Baa OAS**


Source: Barclays Research

FIGURE 20
**Rising star volumes: M&A versus non-M&A related ($bn)**




Source: Bloomberg, Barclays Research

up 4.67% over the same period, for a total return beta of 0.68x, compared with a long-run beta of 0.80x.

While much of the relative performance can be explained by differences in carry and duration, the dispersion in excess of beta-implied returns is due to a reversion to a more normal relationship between triple-C's and double-B's (see Figure 5). Indeed, if the Caa/Ba yield ratio had remained 1.9x instead of normalizing to 1.6x, total returns by quality would have been essentially in line with their betas this year.

Caa-rated bond spreads are admittedly a little further through their medians and averages in absolute terms than Ba- and B-rated paper. However, the different quality buckets do not appear dislocated in relative terms today: yield and spread ratios are very near their long-run averages and medians. We therefore have no reason to believe that total returns will differ materially from what their historical betas would imply. That said, given our outlook for low defaults, low credit volatility, low total returns, and higher rates, we continue to favor going down in quality to pick up more carry while shedding duration.

## Rising stars

We expect ratings migration trends to remain fairly balanced next year and see approximately $33bn of high yield debt potentially reaching investment grade. Admittedly, the upside to an upgrade is optically low. The OAS difference between Ba and Baa debt is now approximately 132bp – close to the post-crisis tights, down 53bp from a year ago and 123bp from two years ago (Figure 19). Also, upgrade candidates are typically recognized well in advance by investors and ratings agencies. However, the upgrade event can be significantly more meaningful than these averages for the issuer in question, especially if it is driven by M&A, which has caused an increasing share of upgrades (Figure 20). Further, in past studies we have found that the six months prior to the upgrade generate average outperformance of 1-2% (relative to the Ba Index), and the upgrade event itself produces average outperformance of 1.5% in the five days following the upgrade (relative to the Baa Index).

Given our low total return forecast for 2014, identifying rising stars early can therefore prove to be an important source of outperformance. We believe the ten credits in the top part of Figure 21 have a higher than average likelihood of achieving investment grade ratings in the next 18 months; the second section of the table includes credits that we believe have good longer-term prospects of reaching investment grade.

FIGURE 21
Rising star candidates

| Ticker | Issuer name | Par ($mn) | % of US HY | Moody's | S&P | Fitch |
|---|---|---|---|---|---|---|
| *High yield issuers with potential to reach investment grade in the next 18 months* | | | | | | |
| AIG | International Lease Finance | 11,050 | 0.92% | BA3 | BBB- | BB |
| GM | General Motors Co | 4,500 | 0.38% | BA1 | BB+ | BB+ |
| CLR | Continental Resources | 4,400 | 0.37% | BA2 | BBB- | NR |
| CNH | Case New Holland | 4,102 | 0.34% | BA1 | BB+ | NR |
| FMEGR | Fresenius Medical Care | 3,050 | 0.26% | BA2 | BB+ | NR |
| TOL | Toll Brothers | 1,770 | 0.15% | BA1 | BB+ | BBB- |
| PSD | Puget Energy | 1,650 | 0.14% | BA1 (+) | BB+ | NR |
| RKT | Rock-Tenn | 1,449 | 0.12% | BA1 | BBB- | NR |
| AN | AutoNation | 750 | 0.06% | BAA3 | BB+ | NR |
| NVE | NV Energy | 315 | 0.03% | BAA3 | BB+ (+) | BB+ (+) |
| *High yield issuers with longer-term prospects of achieving investment grade ratings* | | | | | | |
| STZ | Constellation Brands | 4,050 | 0.34% | BA1 | BB+ | BB+ |
| MWE | MarkWest Energy | 3,030 | 0.25% | BA3 | BB | BB |
| ACMP | Access Midstream | 2,900 | 0.24% | BA3 | BB | NR |
| NCX | Nova Chemicals | 850 | 0.07% | BA2 | BB+ | BB+ |

Source: Barclays Research

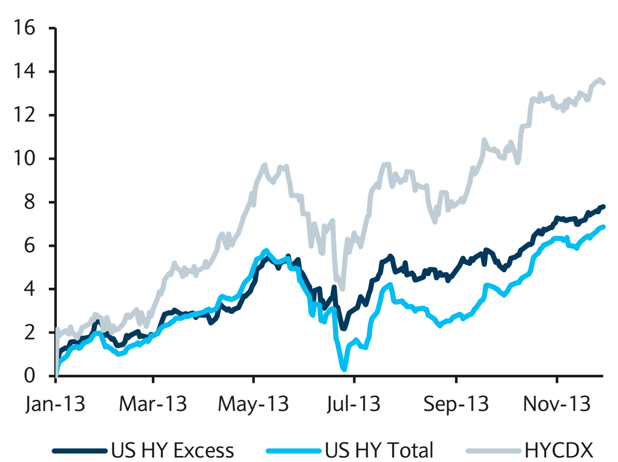
## Derivatives

### Performance versus cash

The high yield market experienced significant divergence between CDS and cash performance in 2013. As of November 29, the on-the-run HYCDX index had returned 13.48%, nearly double the 6.87% total return of the US High Yield Index (Figure 22). The move in rates has generally been cited as the reason for the underperformance of cash, but the direct impact of the rate move was rather limited: cash total returns only lagged excess returns by ~90bp.

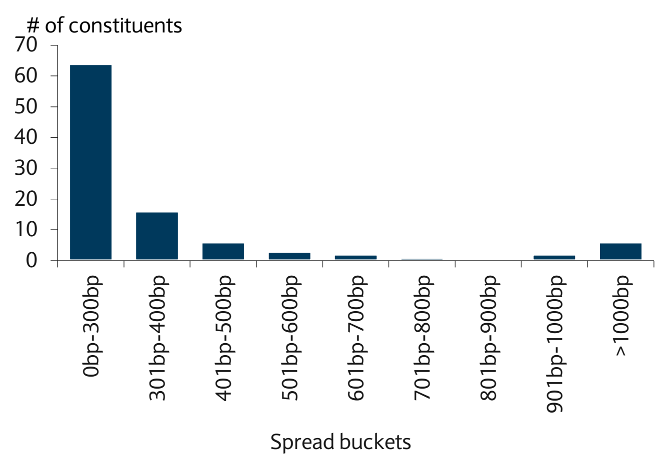
More likely, the rate move helped increase investor aversion to duration risk. And with the upside in the cash market being capped by call constraints for most of the year, expressing longs via CDS became increasingly attractive. Further support for the derivative market

FIGURE 22
HYCDX versus cash returns, year-to-date (%)




Note: Returns as of November 29, 2013. Source: Barclays Research

FIGURE 23
HYCDX S21 constituent spread distribution




Note: Data as of November 29, 2013. Source: Barclays Research came from the reduced need for hedges as a result of diminished macro concerns. Looking ahead, given the tight level of CDS spreads (Figure 23), we believe the significant outperformance of CDX relative to cash excess returns is unlikely to be repeated in 2014.

## Basis

2013 presented a number of opportunities to switch out of cash and into CDS to pick up spread (see *The Derivative Advantage*, July 19, 2013). The CDS-cash basis was positive at the start of the year and turned positive again in June during the rate spike. But the subsequent outperformance of derivatives has taken the CDS-cash basis into relatively rare territory versus the past two years (Figures 24 and 25).

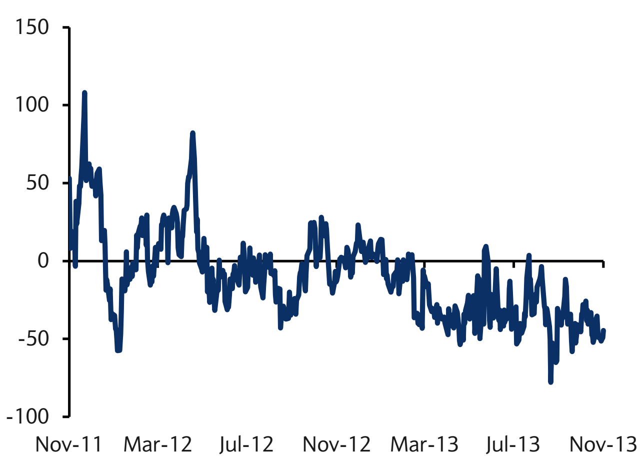
With the basis having become increasingly negative, we recommend looking for opportunities to switch out of CDS and into cash (or alternatively entering into negative basis trades) where there is a meaningful pick up in spread. But switches out of call-constrained bonds and into CDS where there is a minimal give-up in spread are also attractive as a way to minimize exposure to negative convexity. In general, we believe investors will need to maintain a more tactical approach in 2014– i.e., take advantage of valuation differences between the cash and CDS market as they arise and be willing to switch between the two markets when the spread pickup is attractive and liquidity is sufficient. In particular, periods of elevated macro concerns (such as June-July 2013) have historically led to a more positive basis, and such periods can be an opportunity to sell CDS protection.

## Liquidity

Similar to 2012, index volumes remained relatively robust in 2013, with activity picking up in the second half of the year (Figure 26). HYCDX remains a liquid way to manage cash balances and to quickly gain exposure to diversified risk in the high yield market. In contrast, concerns about single-name CDS liquidity persisted this year. Although HYCDX index constituents remain fairly liquid on average, liquidity for the broader market continues to be hampered by regulatory uncertainty. While the CFTC has largely implemented the provisions of Dodd-Frank as they apply to the indices, the market is still awaiting the final rule-making and implementation process for the single-name CDS market by the SEC. We believe it is unlikely that liquidity for the broader single-name CDS market will improve until there is greater clarity on the regulatory front.

FIGURE 24

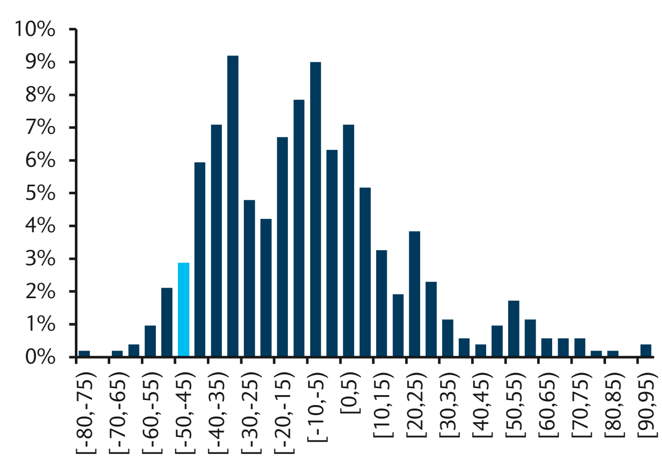
**HYCDX spread minus cash benchmark OAS (bp)**




Note: Cash benchmark is the Barclays US High Yield Very Liquid Original Index. Source: Barclays Research

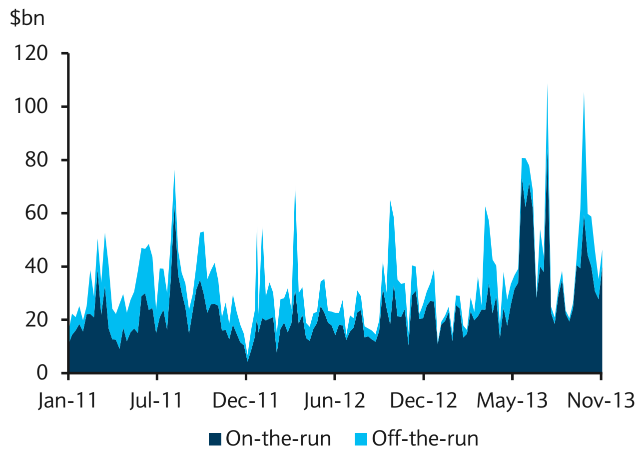
FIGURE 25

**High yield basis distribution**



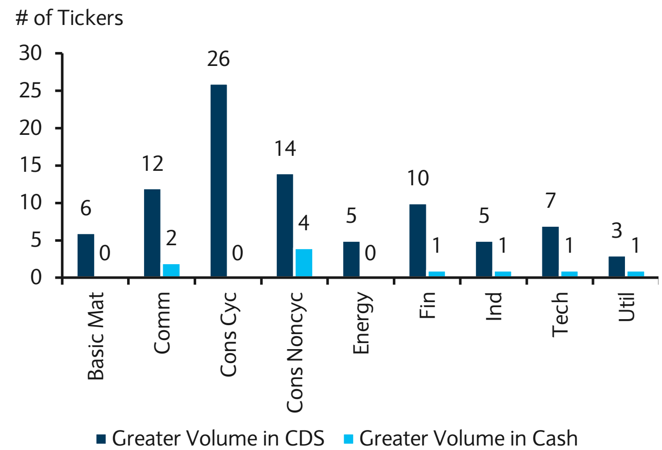

Note: Percentage distribution of daily values over the past two years. Cash benchmark is the Barclays US High Yield Very Liquid Original Index. Source: Barclays Research

FIGURE 26
**Weekly HYCDX volumes**




Source: DTCC, Barclays Research

FIGURE 27
**Volume comparison of HYCDX constituents**




Source: DTCC, TRACE, Bloomberg, Barclays Research

However, one reassuring data point with regards to single-name CDS liquidity is that for the overwhelming majority of HYCDX constituents, liquidity in CDS tends to be greater than liquidity in cash. Figure 27 compares average weekly CDS and cash volumes for the two-month period prior to the last roll. Out of the 98 constituents for which both DTCC and TRACE data were available, 88 constituents, or ~90%, had greater volume in CDS than in cash.

With the majority of HYCDX constituents having greater liquidity in CDS than in cash, CDS can be an efficient way to increase or reduce exposure to a particular credit. In addition, CDS can be utilized to gain exposure to maturities for which a particular credit may not currently have any debt outstanding.

## Curves

Although activity in the CDS market remains concentrated in the on-the-run 5y contract, the inherent nature of the high yield market (i.e., shorter debt maturities and changing perceptions of default risk for individual credits) lends itself to greater activity at the front-end of CDS curves. As a result, curve trades can offer opportunities to express views on relative valuations at different points on the curve.

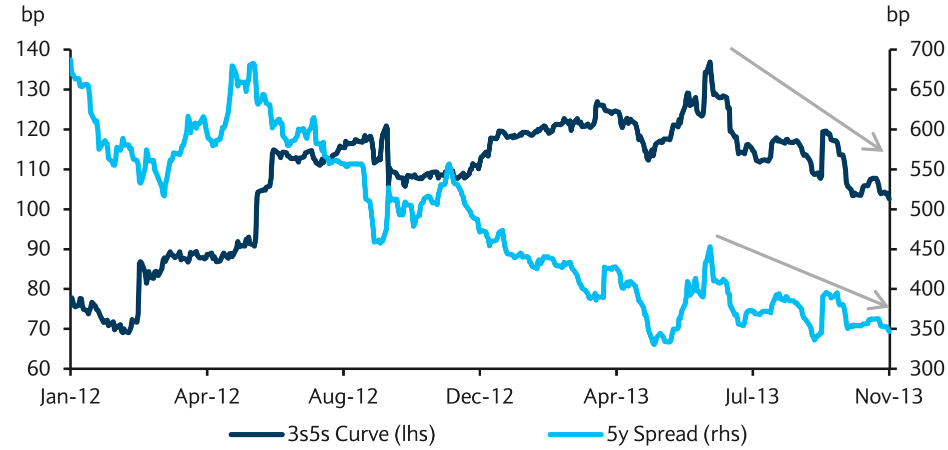
One particular part of the curve that has received much attention of late has been the 3s5s curve. On average, 3s5s CDS curves had been steepening for the better part of the past two years as spreads rallied (Figure 28). Intuitively, this made sense as front-end spreads should benefit disproportionately from reduced macro concerns and accommodative primary markets. However, it now appears that the rally in front-end spreads may have reached a floor. In the middle of 2013, as the HYCDX 5y spread rallied through 400bp, the 3s5s intrinsic curve flattened, which is a significant departure from the prior relationship.

In our view, this change in behavior can be attributed to the relative tightness of CDS spreads. With front-end spreads having rallied significantly over the past year, further upside appears particularly limited at the front end of the curve. This has created an opportunity for 5y spreads to outperform over the past several months, resulting in flatter curves. If macro concerns remain contained, we would expect curves to continue to flatten.

Although front-end CDS curves have started to flatten, they remain historically steep, creating opportunities to either put on DV01-neutral flatteners (in cases where there is some credit concern) or to sell forward protection (i.e., put on notional-neutral flatteners) and earn positive carry and rolldown. The DV01-neutral flattener earns less carry than selling forward protection but affords greater protection against a parallel shift wider in CDS spreads.

FIGURE 28

**HYCDX 3s5s intrinsic curve versus 5y intrinsic spread**




Source: Barclays Research

US LEVERAGED LOANS & CLOS

# The best offense is a good defense

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com

Eric Gross
+1 212 412 7997
eric.gross@barclays.com

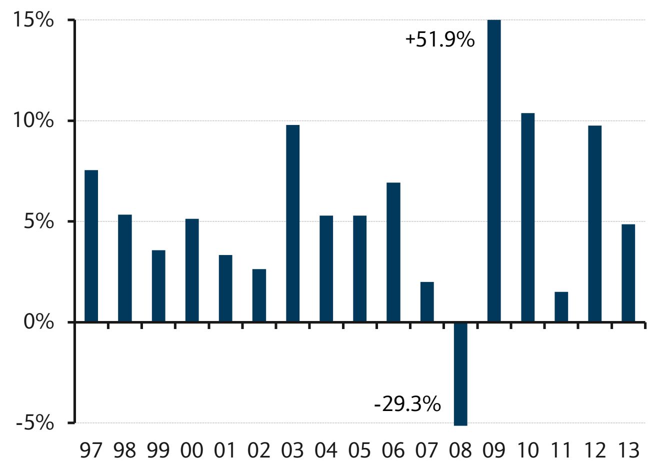
Ellie Lan
+212 412 3038
ellie.lan@barclays.com

- **We forecast total returns of 3.5-4.5% and excess returns of 3.25-4.25% for loans in 2014. We anticipate that the average price of loans will end the year relatively unchanged, but foresee some erosion of carry returns from repricings and nominal default losses.**
- **We believe defaults could be even less frequent in 2014 than they were in 2013. Specifically, we think that loans will see the same default rates as high yield next year: 2.0-2.5% on an issuer-weighted basis and 1-3% on a par-weighted basis.**
- **We anticipate another year of solid loan issuance, with $340-360bn in total supply excluding repricings. With a significant share of loan proceeds going toward relatively aggressive purposes, changes in guidance from regulators on leveraged lending could prove to be a significant downside risk to this forecast.**
- **CLO issuance has been strong, and we expect $75-85bn in 2014, a total similar to 2013. The structure of CLOs has already changed to reflect the higher proportion of covenant-lite loan issuance, and we see further changes to reinvestment periods and call periods as likely in advance of risk retention.**

## Overview

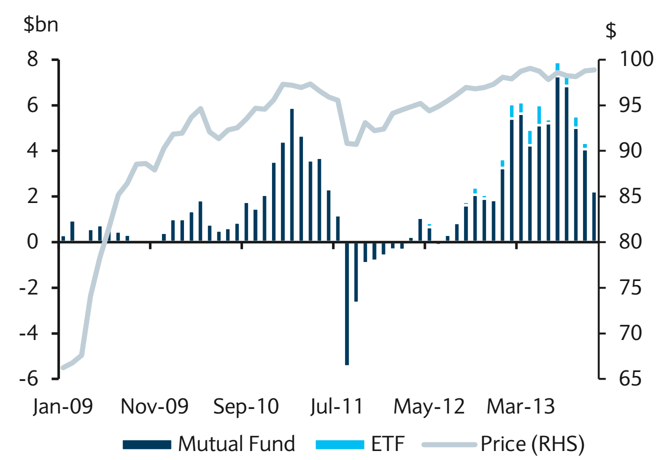
Loans have performed relatively well in absolute terms in 2013 (+4.76% through the end of November) and should end the year with a return only slightly below the asset class's historical average of 5.4% (Figure 1). While this outcome is in line with what we expected coming into the year, one might still be forgiven for being surprised when considering the unprecedented appetite for loan product from retail funds this year (Figure 2). However, loans had very little room to run, with price appreciation capped by negative convexity. Indeed, the Barclays US High Yield Performing Loans Index began the year at $97.29, although, given that more than 75% of loans were trading over $99 and a small contingent of distressed mid-2000s LBO loans were dragging down the average, even that level was misleadingly low. Today, the average loan in the index is at $98.84, more than 84% trade above $99, and the price is much less distorted by distressed loans.

FIGURE 1
**Annual returns of S&P/LSTA performing loan index**



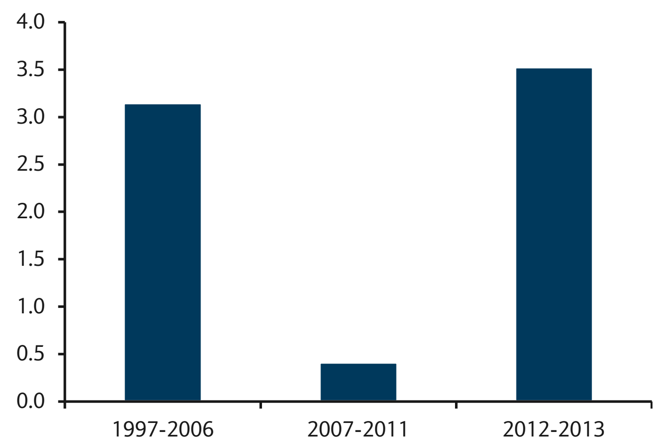

Source: S&P LCD

FIGURE 2
**Fund flows vs Barclays US performing loan index price**



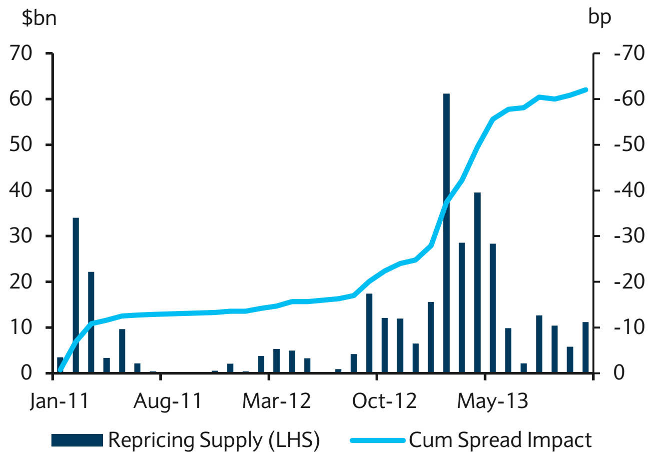

Source: Lipper, Barclays Research

FIGURE 3
**Ratio of annualized total returns and annualized volatility**




Note: Monthly returns of the S&P/LSTA performing loan index. Source: S&P LCD

FIGURE 4
**Repricings and their effect on nominal spread since 2011**



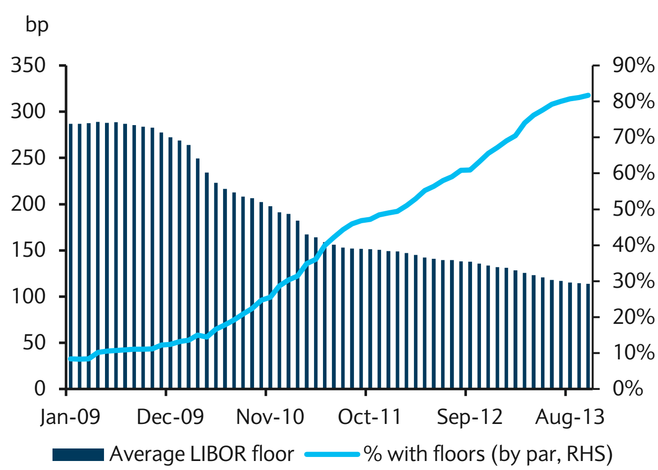

Source: S&P LCD, Barclays Research

While the absolute performance of loans was good last year, the risk-adjusted performance was exceptional. In fact, loans appear to have returned to their pre-crisis status quo of moderate return on almost negligible volatility (Figure 3). Given the consensus expectation of reduced Fed purchases of MBS and Treasuries next year, and the corresponding effect on rates, we believe demand for loans will remain robust, keeping volatility in check. That said, while price upside was limited in 2013, it appears non-existent today, virtually capping total return potential at carry.

## Return expectations

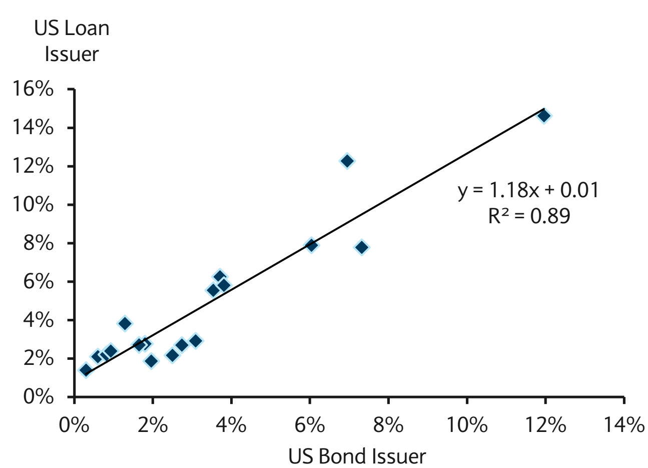
We forecast total returns of 3.5-4.5% and excess returns of 3.25-4.25% for loans in 2014. With a nominal spread (including the effect of Libor floors) of about L+440bp, Libor of 24bp, and an index near par, carry returns are, straightforwardly, about 4.6%. Default losses, which we expect to be very low, only nominally affect the estimate; repricings, however, may have a more significant effect. We estimate that repricings have shaved a cumulative 62bp off nominal spreads over the past three years (Figure 4). Indeed, with $225bn in repricings in 2013 and an average coupon decrease of 93bp, the drag from repricings has

FIGURE 5
**Average Libor floor and percent of loans with floors**




Source: S&P LCD

FIGURE 6
**US loan issuer versus US bond issuer default rates**




Note: Annual LTM rate at year-end, beginning in December 1997, except for most recent data (September 2013). Source: Moody's been about 40bp in 2013 alone. We anticipate strong demand on the back of tapering headlines and further repricing volumes to erode coupon income again next year. However, the average change in coupon is likely to be considerably lower than 93bp given current levels, and we therefore expect an overall drag from repricings on loan carry income of at most 15-20bp.

Importantly, we do not expect the floating component of coupons to have much sway on returns in 2014. While the messaging from the Fed on the timing of a pullback from quantitative easing has arguably been confusing, it is very clear that it intends to keep the front end of the rates curve low for some time still. Furthermore, with more than 80% of loans carrying Libor floors, an average floor of about 115bp (Figure 5), and Libor at 24bp, the carry income from loans is, for all intents and purposes, fixed for now. We note that although Libor floor loans technically have duration, the loan market has not responded to rates like a typical fixed-rate asset, largely because of the positive relationship between loan fund flows and changes in rates. We do not expect this relationship to change in 2014, which should support loan returns while the rest of fixed income endures its more traditional relationship with duration.  Longer term as rates rise and loan investors do not receive the full benefit due to Libor floors, we have concerns that flows could slow with better absolute yields across fixed income.

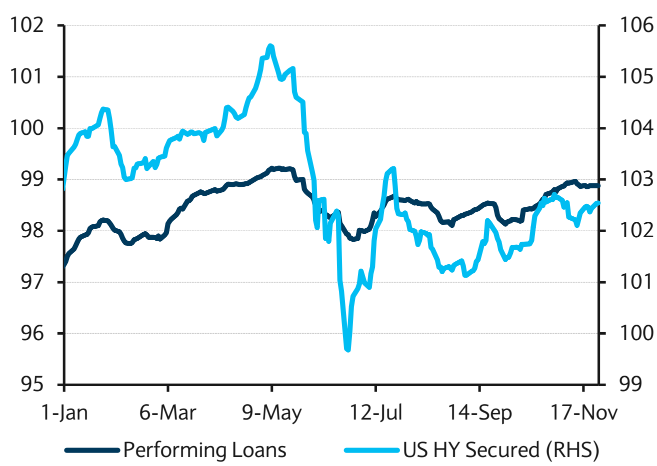
The range of potential total returns next year will be mainly governed by the only remaining factor: price. Our base case expectation is for the index to end the year at approximately the same level as today, hence our carry-like return forecast. That said, with most loans pre-payable at par, the range of index prices at year-end is admittedly skewed to the downside. Should the Fed materially delay tapering, for instance, we could see a significant shift in allocations back towards bonds, sending prices and returns a few points lower. While we cannot dismiss this risk altogether, we do not believe it is the most likely outcome.

## Default risk

As discussed in the US high yield section, we do not expect default rates to pick up in 2014, and, further, we see potential for defaults to be even less frequent than they were this year. Specifically, we forecast a high yield issuer-weighted default rate of 2.0-2.5% and a par-weighted default rate of 1-3%. While the loan market has lower average credit quality than high yield and a somewhat more leveraged issuer base, we believe our high yield forecasts can be readily extended to the loan asset class this year. We believe the difference in the two default rates to be nominal in 2014 for two reasons:

FIGURE 7

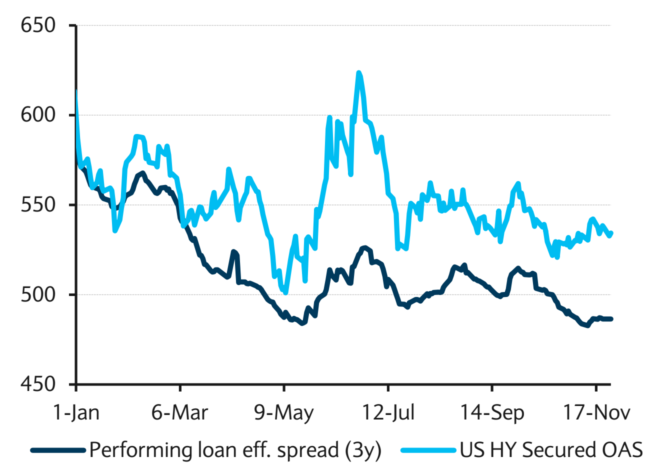
**Historical price of performing loans and secured bonds**




Source: Barclays Research

FIGURE 8

**Relative value – loans versus secured high yield bonds**




Source: Barclays Research

- While Figure 6 shows that annual US loan default rates are roughly 1.2x those of US bonds, the beta drops to about 1.0x when excluding higher default rate years (over 5% for US high yield bond issuers).
- On a more qualitative level, the high yield and leveraged loan markets have become significantly more intertwined through the primary markets in recent years, making their fates more highly correlated.

### Relative value

Although the upside to owning loans has essentially disappeared, the value proposition of carry with a lower beta than even secured high yield and minimal duration risk is pretty compelling. Figures 7 and 8 illustrate this point very well, in our view. The first compares the historical price series of the US Performing Loans index with that of the US High Yield Secured index. We note that while the two series are on separate axes, both axes span a $7 range, showing the extent to which Fed policy drove volatility in bonds while loans valuations remained firm. Meanwhile, the second chart shows that while these two indices offered the same spread entering the year, investors can now pick up about 50bp more in secured paper, compensating for the increase in perceived duration risks.

An investment in loans instead of secured bonds is therefore a defensive strategy that protects against Fed tapering headlines and the corresponding rates increases at the cost of 50bp of foregone spread. As we detailed in the US High Yield section, we believe high yield bonds will absorb approximately 50% of rates increases next year. Secured paper is lower duration (3.3 vs 4.2 for US HY) and higher spread (534bp vs 413bp for US HY) on average, making it likely to absorb at least that much. Thus, with our rates strategists expecting 2y and 5y rates up 62bp and 113bp, respectively, from current levels, the relative value between secured bonds and loans appears very fairly priced from a duration risk perspective, in our view.

## Supply and demand

### Demand

While duration risk has been a concern for several years, the level of market anxiety reached fever pitch this year, substantially benefitting the loan asset class due to its floating rate nature. A surge in demand, especially from the retail buyer base, helped drive the par amount of loans in the S&P/LSTA Leveraged Loan index up 22.3% to $673bn in the year through November.

FIGURE 9
**Estimated share of US leveraged loan holdings**

| Category | 2013 | 2012 | Y/Y Chg |
|---|---|---|---|
| US/European CLOs | 46-52% | 46-52% | unch |
| High yield/distressed/hedge funds | 14-19% | 15-20% | -1.0% |
| Mutual funds (open, closed, ETFs) | 16-19% | 12-15% | +4.0% |
| Total return swaps (TRS) | 4-6% | 5-7% | -1.0% |
| Insurance (P&C & life) | 3-5% | 3-5% | unch |
| Other (banks, dealers, private lenders) | 8-13% | 10-15% | -2.0% |

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

CLO creation has accelerated since 2011, and year-to-date issuance of $82bn has already far exceeded our estimates of legacy vehicle amortisation. The corresponding growth in CLO assets has generally kept pace with the broader loan market, making their share of the asset class unchanged year-over-year at 46-52% (Figure 9). Notably, although CLO creation has been robust this year, it has slowed somewhat since an FDIC rule change on April 1 that made it more expensive for banks to hold AAA tranches. Further, as currently written, risk retention rules present long-term risks to CLO creation; that said, they could lead to a pull-forward of deals in the near term. Ultimately, as risk retention takes its toll on CLO issuance, other sources of loan demand will become more important, but with the rules not taking effect until 2016 at the earliest, we do not anticipate a large shift in the buyer base next year.

While the demand picture for CLOs is a mix of near-term positives and medium-to-long-term uncertainty, retail demand has been more clear-cut. Inflows into loan retail funds have been remarkably strong, averaging more than $925mn per week in the past 75 weeks, without a single outflow week, and surging to $1.5bn per week in the May-to-August rates sell-off. In the process, retail loan funds have grown their asset base a staggering 94% year-to-date. They currently hold $100-120bn in US loans, by our estimates, or 17-20% of that market, for a 4% increase in share since last year.

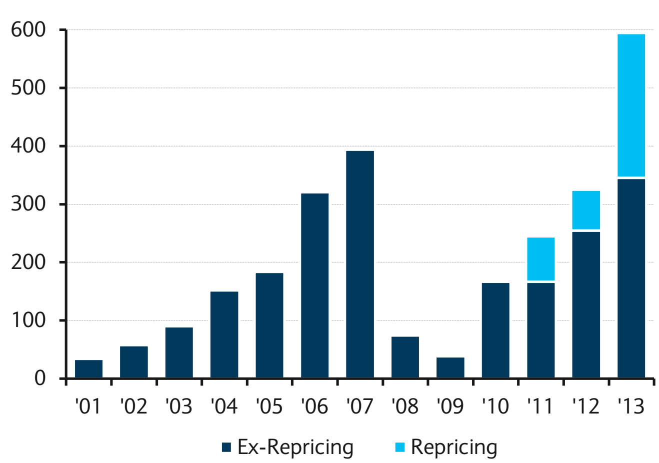
Away from CLOs and retail funds, we believe high yield, distressed, and hedge fund managers' ownership of loans declined about 1% as a result of the May-June rates sell-off and subsequent outflows. With loan fund flows remaining positive throughout the summer, this did not cause a major market disruption. Finally, we believe the size of the total return swap market is essentially unchanged y/y, which translates to a slight loss in share (-1%) relative to the significant growth in the asset class.

## Supply

The primary market for loans has been extremely robust for issuers this year. At $595bn, the overall volume of deals including repricings is already more than 50% higher than the record set in 2007; excluding repricings, 2013 will end the year as the second largest on record, having reached $345bn year-to-date, compared with a 2007 peak of $394bn (Figure 10). Perhaps the strongest signal of loan primary market health is the increase in loan-for-bond refinancing activity, a stark reversal from the earlier years of the post-crisis period (Figure 11). We expect the main contributors to primary market strength – relatively low credit volatility, elevated rates volatility, and resurgent CLO issuance – to persist in 2014, supporting another year of very high loan supply.

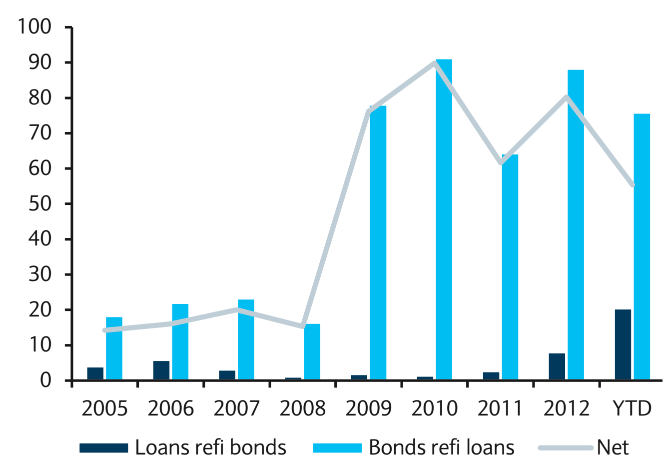
Our forecasts for 2014 are in line with where we expect to end this year, at $340-360bn in total supply excluding repricings. Changes in guidance from regulators on leveraged lending could be a significant downside risk to this forecast. While it is too early to determine the extent to which the guidelines will lead to a slowdown in loan issuance, it is worth noting

FIGURE 10
**Annual loan supply ($bn)**



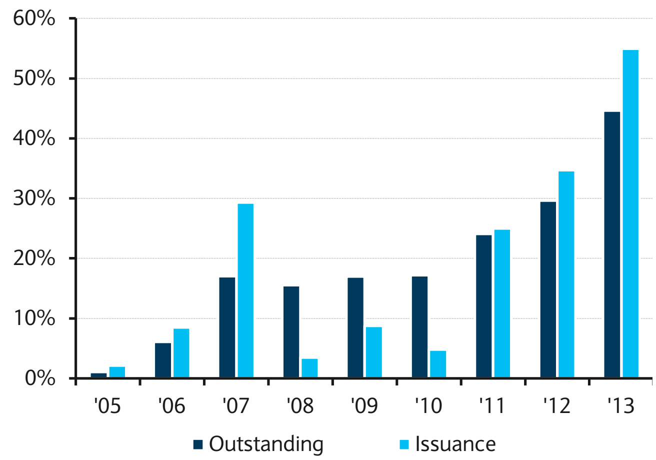

Source: Barclays Research

FIGURE 11
**Bond-for-loan and loan-for-bond refinancing activity**



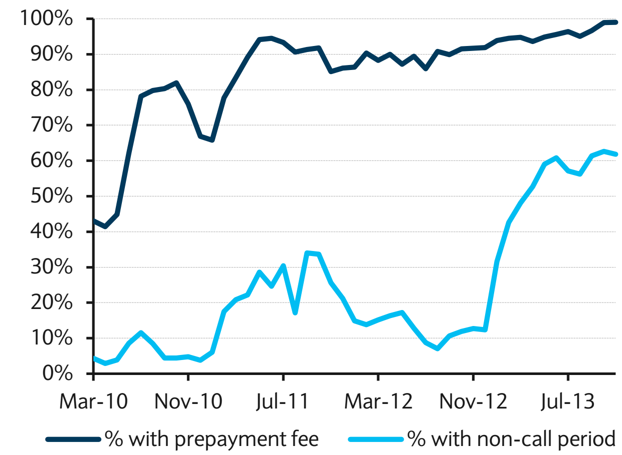

Source: S&P LCD, Barclays Research

FIGURE 12
**Covenant-lite % of loans outstanding and loan issuance**




Source: S&P LCD

FIGURE 13
**New issue call protection**

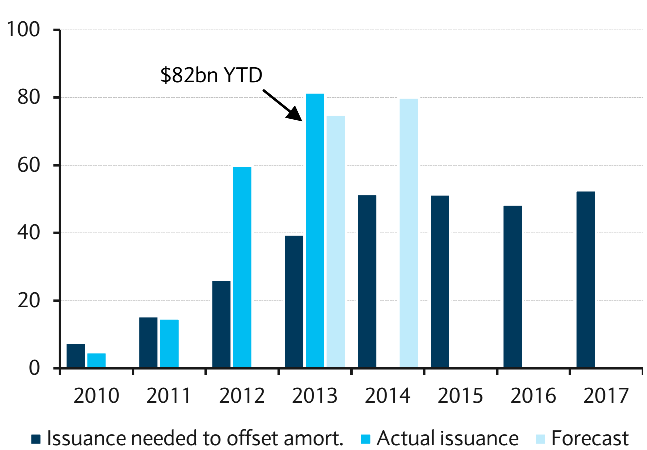



Note: 3m moving average. Source: S&P LCD

that a significant share of loan proceeds tend to be used for purposes that increase leverage; in the past four years, M&A, LBO, and dividend deals have accounted for 50-60% of total volumes ex-repricing.

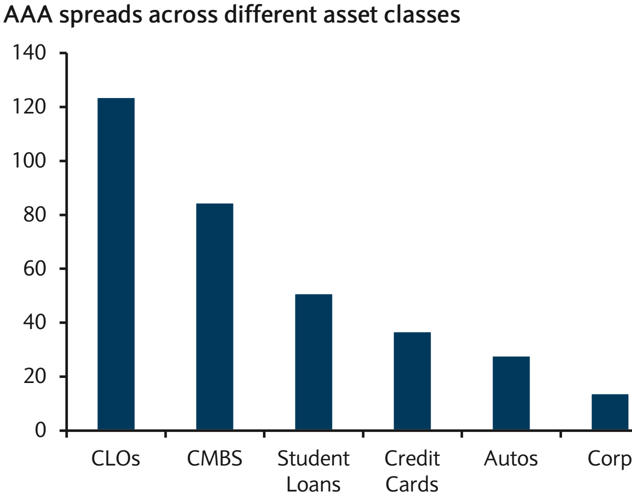
We believe repricing waves are also likely next year. We have found a few factors to be helpful in predicting repricing volumes, including strong fund flows, higher average prices, and declining spreads. While significant non-repricing volume could help keep spreads from grinding too quickly, other factors point to a heightened risk of repricings in the first half of the year. Repricings are certainly a concern for loan investors and covenant-lite issuance has quickly become the norm (Figure 12), but the structure of loan deals has not been entirely issuer friendly this year. Indeed, investors have increasingly demanded prepayment fees, to the extent that they are basically ubiquitous in new deals. Even more encouraging for investors is the growing presence of non-call periods, which were in as much as 60% of deals in recent months, up from 10-15% at the beginning of the year (Figure 13), a trend that we expect to persist into 2014 as the loan market competes with the bond market for product.

FIGURE 14
**Issuance needed to offset amortization vs actual, forecast**




Source: Intex, Barclays Research

FIGURE 15
**AAA spreads across different asset classes**




Source: Barclays Research

## CLO trends

### Positive net issuance for now

CLO issuance has come very close to our expectations in 2013, with $82bn in new deals printing thus far in 2013, despite a few less-than-favorable developments. First, an FDIC rule change on April 1 made it more expensive for banks to hold AAA tranches, contributing to secondary AAA spreads moving about 20bp wider this year; primary AAA spreads have correspondingly trended wider, with the most recent deals printing AAAs near L+150bp. Meanwhile, collateral spreads have declined slightly, with the average coupon on the performing loans index down 33bp. The net effect is that potential equity tranche returns have been squeezed. Deal flow has not slowed much yet, partly because of a need to get loan collateral out of warehouses that have been building for several months. As a result, issuance has far outpaced the roughly $40bn amount needed to offset legacy structure amortisation this year (Figure 14).

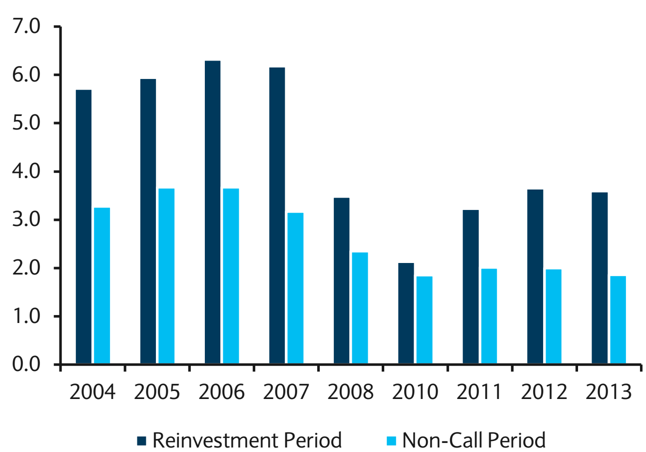
Looking forward to 2014, we believe CLO issuance will be similar to this year's total and expect $75-85bn. AAA spreads look very cheap to us, but could remain wide relative to other AAA assets because of their lack of liquidity (Figure 15). However, we believe CLO managers will look to grow the consistent stream of management fees that CLOs produce with non-recourse leverage, supporting further issuance next year. In fact, while risk retention poses questions for 2016 and beyond, we believe it could pull forward CLO issuance.

### A shifting structure

One gauge of this pull-forward behavior is the non-call period on new deals, which has hovered around two years since 2010 (Figure 16) but we believe the non-call period could decline to allow new vehicles to be refinanced before the rules takes effect. Similarly, we would not be surprised to see reinvestment periods lengthen as the deadline for risk retention approaches, with CLO managers incentivized to push harder to protect management fees.

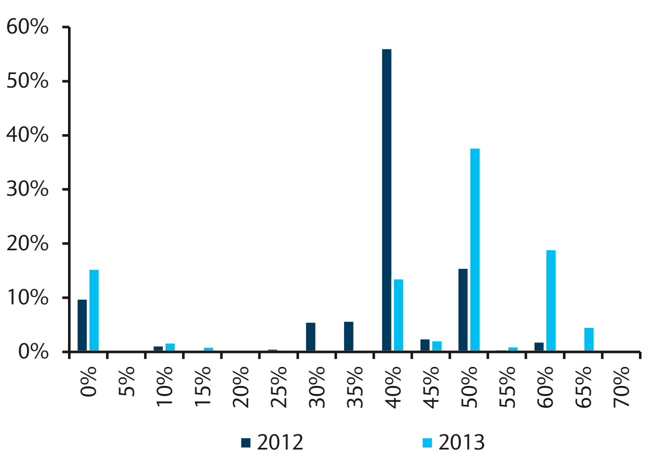
While changes to call periods and reinvestment periods are a possibility, changes in the covenant-lite buckets for new deals are already ongoing. As Figure 12 shows, loan supply continues to be skewed towards covenant-lite, representing 55% of year-to-date issuance. CLO managers have clearly taken notice of this trend, and structures have come with more

FIGURE 16
**CLO reinvestment and non-call periods**




Source: S&P LCD

FIGURE 17
**CLO covenant-lite bucket size by vintage year**




Source: S&P LCD

relaxed caps on cov-lites this year. While the majority of structures printed in 2012 came with a 40% cap, a 50% cap has become most common and deals have printed with limits up to 70% (Figure 17). We believe it will be increasingly difficult for new structures to come to market with highly restrictive cov-lite caps due to the changing nature of the loan universe, and therefore expect this trend to continue into 2014.

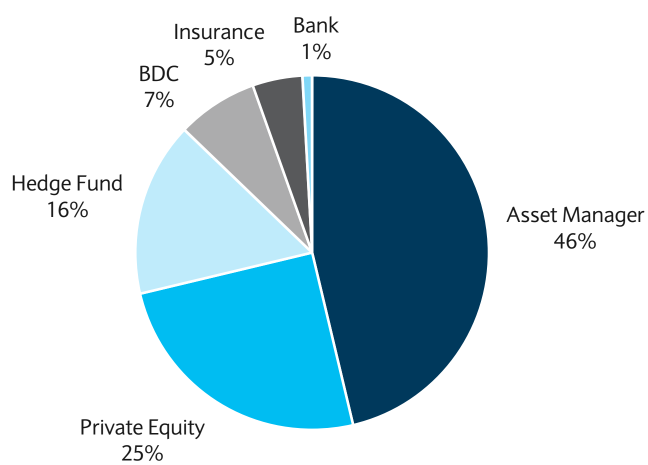
## An uncertain future

Risk retention rules from the Dodd-Frank Act cloud the longer-term outlook for CLOs. Following extensive comments, revisions to the proposed rules offered an exemption to CLO managers holding 5% of the structure if the underwriters of the CLO collateral hold a 5% stake of the loans themselves, among other restrictions. Unfortunately, we do not believe that the exemption is practicable since it places an unrealistic burden on banks, and we therefore do not see it having any appreciable effect on the negative technicals that loom once the rule comes into effect.

As a result, we think that whenever the rules go into effect, a substantial proportion of current CLO managers will be shut out of the market if they do not raise significant capital, and the industry will therefore continue to see consolidation and shifts in manager market share (Figure 18). Admittedly, a significant part of the close-to 50% of issuance from asset managers post-crisis could disappear under the new regime. However, a major change compared with the pre-crisis CLO market has been an increase in the presence of investors with dedicated capital, including private equity, hedge funds, and business development companies (BDCs). Assuming that the final risk retention rules are not overly punitive for managers that hold horizontal equity slices, these participants are likely to remain a big part of the market. Private equity has been a major consolidator in the sector in recent years and has represented a quarter of new issuance. In a market where opportunities have been more difficult to come by in their primary business lines, we believe private equity firms and hedge funds will continue to favor the fee income generated by CLO management. This business also comes with significant economies of scale as managers issue multiple deals. Therefore, while we share longer-term concerns about the shifting investor base in loans, we believe there will be enough managers with dedicated capital to keep CLOs among the top holders of leveraged loans.

FIGURE 18

**Post-crisis CLO manager market share**




Source: Barclays Research

US MUNICIPAL CREDIT STRATEGY

# Navigating a more difficult terrain

Thomas Weyl
+1 212 526 0751
thomas.weyl@barclays.com

Sarah Xue
+1 212 526 0790
sarah.xue@barclays.com

Ming Zhang, CFA
+1 212 528 7055
ming.zhang@barclays.com

- **We project total returns of -145bp in 2014 for the Barclays Municipal Index. Our expectations are driven primarily by rising interest rates; carry on the index; and the expected outperformance of munis relative to Treasuries, especially at the long end. For taxable munis, we expect -175bp of total returns – with 200bp of excess return – for the Barclays Taxable Municipal Index, as we once again expect higher interest rates to counteract modest spread tightening.**

- **While we expect munis to outperform Treasuries, a lot of challenges remain, and the municipal market could be choppy in the next year. A lot will depend on fund flows and the supply/redemptions dynamic. The latter should be supportive, but a strong rally is not likely without a stabilization of fund flows. We think that it will be difficult for fund flows to stabilize until the Fed starts to taper. The muni market could react adversely in the early stages, but we think that outflows will reverse – similar to the 2005 experience – as valuations likely become attractive and the benefit of tax exemptions increases with rising rates.**

- **The retail-dominated muni market was prone to headline risk in 2013, and we believe that this will prevail in 2014. Specific areas to watch include creditor negotiations and settlements during the Detroit bankruptcy; Puerto Rico's liquidity and market access; the pension deficit problem in Illinois; and the far-reaching effects of underfunded pension/OPEB liabilities for local municipal credits.**

- **We expect 2014 issuance to decline 16% y/y, to $270bn. We believe the most meaningful driver of this potential decline will be less current and advanced refunding activity, which will likely be constrained amid an evolving higher-rate environment. We project a 10% decline y/y in taxable issuance; our projection reflects the relative advantage of issuing in the less regulatory-intensive taxable market, offset by the expected upward drift in rates.**

- **In the tax-exempt market, we see value in long bonds given the underperformance of longer-duration municipal bonds and a steep muni curve. We expect the muni curve to flatten next year, in line with expectations in the Treasuries market. We also think that the A-rated portion of the index looks attractive at current levels given its underperformance this year, as well as improving municipal credit quality. On a sector basis, we believe the following sectors offer relative value: hospital, IDR/PCR, transportation, and water and sewer. Finally, muni HY looks attractive versus US HY, with the ratio of the former to the latter at 119%, an all-time high.**

- **On the taxable side, we see value in intermediate taxable munis and the power sector within long taxables. In our view, the relationship between intermediate taxable munis and intermediate credit appears somewhat dislocated currently, with the differential between the two indices well off May 2012 tights. We believe that spreads in power bonds look attractive versus the utilities sector on the corporate side and that the former still has room to run.**

## 2014 performance outlook

We project total returns of -145bp in 2014 for the Barclays Municipal Index. Our expectations are driven by three major factors: 1) Barclays 2014 rates forecast; 3) likely carry on the index; and 3) expected outperformance of munis relative to Treasuries, especially at the long end. The largest driver of returns next year is the projected rise in interest rates. Barclays' rates strategists project 10y and 30y yields to increase to 3.50% and 4.40% by year-end 2014, respectively. We expect this dynamic to drag down total returns by approximately 600bp, as the average duration of the Muni Index is relatively long at 8.4. Yield carry is the second-largest component; we forecast a carry of approximately 310bp in 2014 based on current index yields. The final component is our belief that long munis will outperform Treasuries, mitigating some of the effects of expected higher interest rates. Specifically, we expect muni ratios at the long end to compress to the 100% area – from 108% – providing approximately 145bp of total returns. Altogether, 2014 will likely be another down year for munis, given interest rate expectations, but they should outperform Treasuries in this environment.

As we contemplate the taper and rising interest rates, as well as continued municipal mutual fund outflows – approximately $60bn have left muni funds, or 11% of assets, since March 2013 – it is hard to see the light at the end of the tunnel. However, some positive signs, on a relative basis, have already emerged, and history suggests that munis will typically outperform Treasuries in rising rate environments as well as in periods of Fed tightening. Looking at the last 20y+, we find that, with very few exceptions, the muni curve tends to flatten and muni ratios tend to compress when the Fed tightens or rates rise (Figure 1). Here, the exceptions were the Fed tightening in June 1999-May 2000 and the rising interest rates environment in October 2010-February 2011. We would argue that those are unique time periods. In 1999-2000, economic growth was robust and equities were soaring to record highs. Many investors pulled money out of bond funds and other sources and funnelled them into equities, as the PE ratio on the S&P 500 index reached a frothy 30x; muni fund outflows reached close to 10%. While in late 2010 to early 2011, the municipal market was under duress due to (what turned out to be unwarranted) concerns about defaults and the downgrade of the tobacco sector during a lull in QE. In this instance, outflows were also significant, totalling slightly over 10%.

FIGURE 1

**Muni curve and ratio changes during Fed tightening and rising interest rate environments**

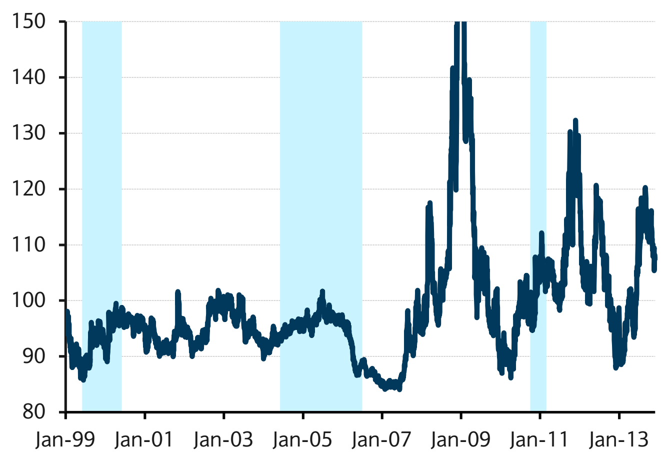
| Date | Treasury 10s30s curve (bp) | MMD 10s30s curve (bp) | 10y muni ratio (%) | 30y muni ratio (%) |
|---|---|---|---|---|
| **Fed tightening** | | | | |
| Feb 94 - Feb 95 | -37 | -15 | -3 | -2 |
| Jun 99 - May 00 | -50 | 14 | 0 | 9 |
| Jun 04 - Jun 06 | -63 | -57 | -5 | -5 |
| **Rising rate environments** | | | | |
| Sep 93 - Nov 94 | -54 | -5 | -6 | -2 |
| Jan 96 - Jun 96 | -25 | -10 | -5 | -4 |
| Oct 98 - Jan 00 | -63 | -5 | -16 | -10 |
| Nov 01 - Apr 02 | -20 | -26 | -7 | -10 |
| Jun 03 - Sep 03 | -33 | -31 | -5 | -6 |
| Mar 04 - Jun 04 | -29 | -10 | -3 | -1 |
| Jun 05 - Jun 06 | -26 | -35 | -7 | -12 |
| Mar 08 - Jun 08 | -43 | -37 | -22 | -17 |
| Dec 08 - Jun 09 | 32 | -9 | -85 | -96 |
| Nov 09 - Apr 10 | -14 | -44 | -9 | -16 |
| Oct 10 - Feb 11 | -32 | 17 | -6 | 5 |
| Sep 11 - Oct 11 | -2 | -13 | -12 | -13 |
| Jan 12 - Mar 12 | -3 | -28 | 3 | -8 |
| Jul 12 - Sep 12 | 15 | -5 | -12 | -14 |

Source: Bloomberg, Barclays Research

While there are a lot of similarities between those two periods and today – including a strong equities market, concerns about certain municipal credits, and significant outflows – there are some key differentiating factors. Most importantly, we believe the supply/redemptions technical that has helped the market in the past few months will once again be supportive next year. We estimate that redemptions will outpace supply by $30-40bn this year – which has helped to alleviate the effect of outflows. Also important, munis, especially long munis, are relatively attractive; the muni curve remains steep, and 30y muni ratios are still above 100%. The slope of the 10s30s part of the curve is around 150bp compared with just 100bp at the beginning of 2013 (Figure 2). In contrast, the 10s30s curve at the beginning of 1999-2000 was just 50bp, and it was near the tight of the year when the Fed began raising rates. When rates began rising in late 2010, the 10s30s curve was steeper, at 137bp, and continued to steepen as idiosyncratic issues drove a muni sell-off. Further, the 30y muni ratio – at 108% – offers considerable value relative to Treasuries (Figure 3). By contrast, the 30y muni ratio was around 95% in late-2010 and mid-1999. With respect to concerns about investors withdrawing funds from munis to invest in equities, we think 2008 is fresh enough in investors' mind that we will not see the re-allocation witnessed around the turn of the century. During June 1999-May 2000, fund flows into equities totalled $220bn, or 7% of assets. In comparison, fund flows into equities have totalled approximately $170bn since May 2013, or around 2.5% of assets.

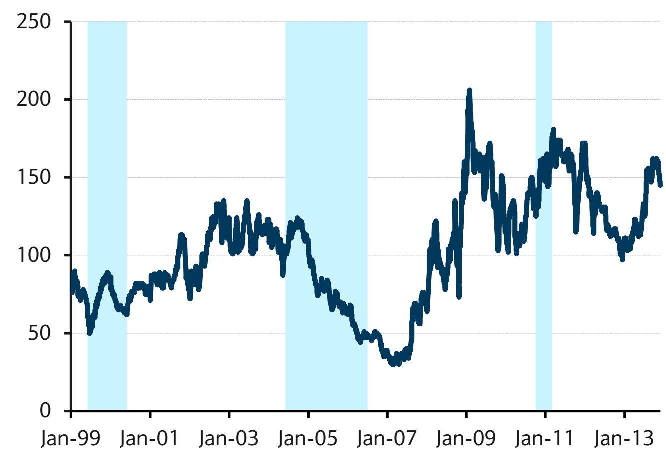
We think that a comparison with 2004-06 is more interesting, and perhaps more appropriate. There were many similarities between the two periods including: 1) both economies were undergoing a stimulus-driven recovery, although the early 2000s recovery was more robust; 2) both markets were expecting/experiencing Fed tightening; 3) munis were attractive, particularly long munis; and 4) muni mutual funds faced significant outflows, but flows reversed in the middle of the Fed tightening during the mid-2000s. Interestingly, the outcome of the 2004-06 bout of Fed tightening was positive for the muni market from a relative perspective. In our view, the current municipal market could have a similar experience. We think that the biggest takeaway is that fund outflows could reverse even as the Fed is tightening, if munis are attractive. From April 2004 to August 2004, muni fund outflows totalled $12bn, or 4% of assets, as the Fed started raising rates. However, fund flows started returning as munis became more attractive, even as the Fed continued to raise rates through to June 2006.

FIGURE 2
**30y tax-exempt muni ratios (%)**




Source: Barclays Research

FIGURE 3
**10s30s AAA-rated tax-exempt GO yield curve slope (bp)**




Source: Barclays Research

We think that the supply/demand dynamic will be supportive for the market, but a strong rally is not likely without a stabilization of fund flows. To that end, we think that clarity on Fed policy would be a major step. Currently, the market is itching to react to any data that could point to a tapering of Fed asset purchases. Thus, we think that it will be difficult for fund flows to stabilize until after the Fed starts paring back QE. In the early stages of tapering, we think that the muni market will react adversely, similar to the experience when the Fed tightened in June 2004. However, as valuations become attractive and the benefits of tax exemptions increase with rising rates, fund flows will likely return to the muni market, setting up a scenario where munis can outperform. In such a case, long muni ratios could reasonably compress to the 100% area, if not even further. In our view, 10y and 5y muni ratios have limited room to compress given current levels – 97% and 85%, respectively. However, we acknowledge that these ratios could compress as shorter dated muni yields generally do not rise as much as Treasury yields in a rising rate environment (but we offer the caveat that in the current environment, short muni yields may rise more in line with short Treasury yields as the muni curve is steep).

Our returns projections face downside and upside risks. One of the major risks is investors' reaction to the Fed tapering asset purchases. In recent efforts, the Fed has strongly argued that the end of QE is not tantamount to tightening policy. If investors accept this argument, we could see positive fund flows return sooner than anticipated, providing a lift to the muni market. The market will then have its sights set on rate hikes, which many participants expect in 2015, although a dovish Fed under chairman nominee Janet Yellen should ease concerns of a hasty tightening. In our opinion, it is unlikely that investors will take this view, especially as the financial markets remain sensitive to new economic data points and Fed releases. On the downside, there is a possibility that fund flows do not recover as quickly as we anticipate, if investors quickly focus their attention on a potential rate hike in 2015 after the Fed ends QE. We are mindful of this, but we believe that fund flows will return if munis remain attractive even if Fed tightening is on the way, similar to the environment in 2005.

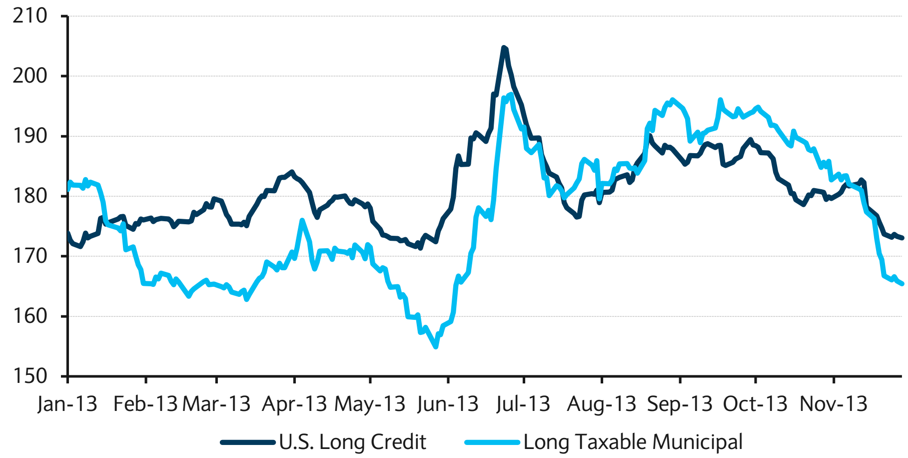
Higher-than-expected supply and headline risk could also blow our total return forecast off course. In 2014, we expect issuance to decline 16% y/y to $270bn. In our view, higher rates will severely constrain current and advance refunding activities, while new money supply will be stable y/y. Although the likelihood is low, supply could exceed our expectations if the market experiences a pull-forward of new money issuance in the face of rising rates and concerns about the potential for tax reform. In addition to tax reform, there are several key issues that can readily grab headlines and shake investor confidence, which is something that is both hard to predict and to discount. Specific areas to watch include: creditor negotiations and settlements during the Detroit bankruptcy; Puerto Rico's liquidity and market access; the pension deficit problem in Illinois; and the far-reaching effects of underfunded pension/OPEB liabilities for local municipal credits.

## Taxable returns

For 2014, we project -175bp of total returns for the Barclays Taxable Municipal Index as we expect higher interest rates to drag down returns. Year-to-date, the taxable index has generated excess returns of 240bp, which is solid in comparison with the U.S. Credit Index (136bp). For next year, we forecast excess returns of approximately 200bp, driven mostly by 175bp of spread carry and 0-5bp of spread tightening, in line with the performance expectations of U.S. investment grade credit. With the long portion of the taxable muni index now trading 8bp through long U.S. Credit, compared with as much as 10bp wide at the beginning of the year, we see limited room for the taxable index to rally on a relative basis (Figure 4). Any outperformance will likely be driven by intermediate taxables, which are considerably wider than their corporate counterparts. However, intermediate bonds are a small and illiquid portion of the taxable index, and names such as Puerto Rico and Illinois are disproportionately represented.

FIGURE 4

**Long taxable municipal versus US long credit OAS (bp)**




Source: Barclays Research

## Key municipal issues

### Tax reform

The spectre of tax reform has faded from investor confidence for much of 2013. Prospects for tax reform have been discounted, as market attention was focused on other events in Washington – specifically, the government shutdown in October. However, both Houses of Congress are still working on tax reform packages; which may include measures to reduce or eliminate the tax exemption of interest on municipal bonds. In our view, tax reform that could affect the municipal exemption will be proposed during 2014, although actual tax reform legislation is unlikely.

A large and influential group of legislators from both parties agree that a comprehensive overhaul of the overly complicated tax code is needed. Currently, the fundamental challenge facing comprehensive tax reform is whether the parties can find enough common ground to agree on significant reform. Both parties approach the subject with the intent of reducing the economic drag from our inefficient tax code. However, there is extreme disagreement on whether tax reform should be revenue neutral or, if it should raise additional revenues to fund government programs. Ultimately, these irreconcilable objectives, coupled with the increasing partisan mistrust, suggest significant uncertainty around whether tax reform of any substance can be achieved by Congress.

### Headline risk

2013 has shown that headline risk is a critical factor in a retail-dominated asset class such as municipals. All fixed income markets performed poorly after the tapering discussion began in May. However, for most fixed income markets, the volatility settled fairly soon after the tapering discussion began. The sole outlier was the municipal market, as concerns about Detroit's proposed debt restructuring led to concerns regarding its bankruptcy filing. Post-Detroit's bankruptcy filing, the attention turned to Chicago and soon thereafter, Puerto Rico. The latter has been besieged by a relentless storm of negative media articles since late August. The net effect of this media attention on the municipal bond market has been the longest sustained period of mutual fund outflows on record, resulting in the largest dollar amount of outflows ever. As we write this Outlook, net negative flows for 2013 are $53bn, including gross outflows of $61bn since outflows began in March.

We believe headline risk in 2014 could come from the following areas:

- Bankruptcies;
- Puerto Rico;
- Illinois; and
- Pensions and OPEB

*Bankruptcies – Jefferson County, Stockton, and Detroit*

We expect little headline risk to arise from the Jefferson County and Stockton bankruptcies, as the former recently had its plan of adjustment confirmed and Stockton is moving toward plan confirmation. In Stockton's case, there is a fairly small risk that the plan may not be confirmed. The city has settled with all of its creditors except one. The non-settling creditor could argue that the treatment of creditors under the plan is not equitable, while the city could argue that settlements with each creditor group were based on the value of the underlying security (for bond deals) and therefore is allowable. Investors expect that the judge will find that the plan does not unfairly discriminate.

The Detroit bankruptcy will likely be in the headlines for much of 2014. On December 3, 2013, the court ruled that Detroit was deemed eligible for Chapter 9 bankruptcy protection. Following this ruling, we would expect the case to move towards negotiations on a plan of adjustment. During this period, various issues may arise, including, for example the valuation and utility of municipal assets such as the art collection. Ultimately, we would expect the city to reach settlements with its creditors as Stockton did. There has never been a cramdown of creditors in a Chapter 9 – a plan such as the original restructuring plan prepared by the city has numerous problems that may hinder the path to plan confirmation, unless there are creditor settlements (similar to what occurred with Stockton). In the Stockton case, confirmation was made more likely by the voter approval of a tax hike, which extended some share of the burden to the residents combined; all creditors settled and there was only one holdout. In general, a confirmation outcome is more likely with only one holdout rather than multiple holdouts claiming disparate treatment. This could provide Detroit with the incentive to reach settlement with all of its creditors. This will be no simple task, given the public comments of many of the creditor groups such as the unions.

*Puerto Rico*

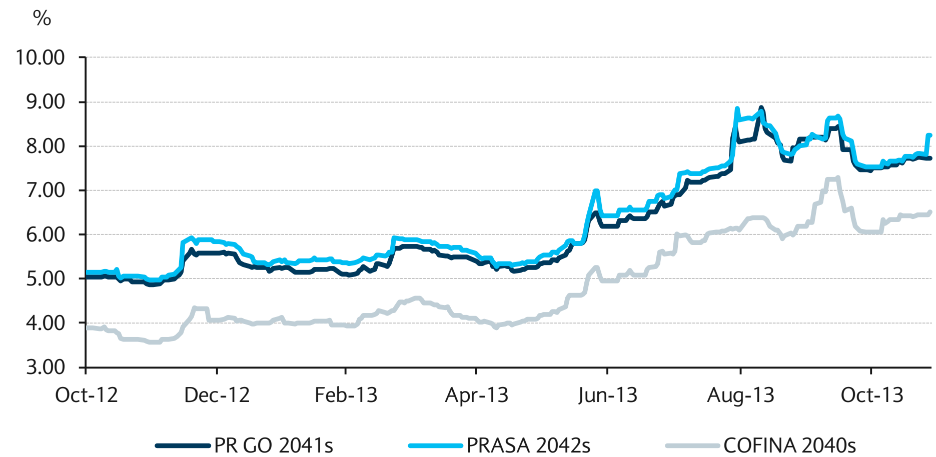
Puerto Rico dominated headlines for most of 2013, starting in January, when the market became aware that the commonwealth had a widening budget deficit. We believe that the commonwealth will likely retain a similar level of market attention during 2014. Specifically, we believe all eyes will be on the commonwealth in early January and February, as market participants look to interim revenue measures as a guide to the status of the 2014 budget. There will also be market interest regarding the timing of commonwealth bond issues. As of early December, it appears that the anticipated $0.5-1.2bn in deficit financing will not occur before the end of 2013. While the commonwealth has stated that it can wait out market conditions and even defer borrowing until next fiscal year (given its sources of liquidity), market participants question this assertion.

The various ratings of the commonwealth entities border on non-investment grade, with two negative outlooks and one watch negative. Thus, downgrade risk to non-investment grade is fairly high. Fitch has recently warned that lack of market access could have negative rating consequences. The rating agency has signaled that it is closest to downgrading the commonwealth, while S&P has evidenced a constructive two–year outlook and rating philosophy. Market participants will be intently watching for rating action.

The question of market access for Puerto Rico is interesting. Conversations with investors have led us to believe that the commonwealth does have market access and could sell a sizable amount of debt. The major issue for the commonwealth is the interest cost of such debt currently. This cost would be at levels reflective of a liquidity squeeze in the municipal market, likely exacerbated by concerns over the fundamental credit position of Puerto Rico. It appears as if the commonwealth would rather wait out the negative fund flows in the market and potentially issue bonds at more favorable rates when flows turn positive. Figure 5 shows yield levels for benchmark Puerto Rico bonds.

FIGURE 5

**Select Puerto Rico bonds, YTW (%)**




Source: Barclays Research

The recent Jefferson County bond deal is an example of one of the risks commonly mentioned in the Puerto Rico situation: the question of market access if the commonwealth is downgraded to a non-investment grade level. Although Jefferson County carried one investment grade rating, investors looked past that rating and the transaction sold at prices indicative of municipal high yield or non-investment grade levels. This transaction was the first time a municipal government has sold debt while in bankruptcy and is the first large, if not only, debt issue sold for a non-investment grade municipality. Judging by this bond sale, we believe that market access does not seem to be an issue of rating alone, but will hinge on various factors.

### *Illinois*

Illinois' pension deficit and general fund payables problems have led to much concern over the state. Pension issues continue to fester as political leaders propose fixes that either run short of what is needed or do not reach requisite political consensus. Moody's has indicated that significant further deterioration in the unfunded liability could cause ratings to go down; in June, S&P stated that lack of meaningful pension reform and further budgetary stress could result in ratings pressure. Legislative leaders from each party recently announced that a pension reform plan has been reached. As of early December, the legislature had passed the bill, and the governor promised to sign, although there still appears to be significant organized opposition. Illinois is currently the lowest-rated state and, in our view, risk for a downgrade remains if the pension reform plan is found to be deficient or is struck down in court.

### *Pensions and OPEB*

The Detroit bankruptcy filing has shined the spotlight on retiree (OPEB) healthcare obligations, highlighting these as a fiscal issue equally as important as the much-discussed government pension problem. The most significant issue with the healthcare liability is that it is predominantly unfunded, with the entire annual obligation generally met on a pay-as-you-go (Paygo) basis. For the most part, these liabilities are long-term issues. However, the rapid increase in the recognition of the liability is causing a crowding out issue in government budgets. In some cases, the annual expense is doubling in as little as four years. We are concerned that the growing annual expenditures for these two items may cause fiscal problems in isolated local credits throughout the country.

### Municipal credit quality

Away from the examples addressed above, overall municipal credit quality is actually improving due to modestly increasing revenues. Economic growth, even if slow, is generally a positive for municipal revenues, albeit with a lag. According to the Nelson A. Rockefeller Institute of Government, total state tax collections have been growing for over three years, although levels have not reached the pre-recession peaks of 2008. Revenue increases have also been recorded at the local level, though the increases remain generally weak due to the slow rebound in real estate-related tax revenue.

Going forward, the largest issue regarding municipal credit quality will be the increasing payments required to meet retiree obligations: pensions and health care. From a ratings standpoint, the trend of downgrades outnumbering upgrades continues, as local governments continue to adjust to declining state distributions. Interestingly, municipal defaults are occurring at the slowest pace since 2008, according to Municipal Market Advisors. However, idiosyncratic risk remains, as shown by the Detroit bankruptcy filing, and the numerous media headlines about Puerto Rico.

## 2014 supply and redemptions forecasts

We forecast $270bn of gross municipal supply in 2014, including $240bn in tax-exempt issuance and $30bn in taxable supply. We project $302bn of redemptions for the year, with roughly $281bn in tax-exempt and $21bn in taxable redemptions. This translates into a net supply forecast of about -$32bn in 2014, including -$41bn of tax-exempt and $9bn in taxable net supply (Figure 6).

FIGURE 6
**Barclays 2014 supply and redemption forecasts**

| | ($bn) |
|---|---|
| Tax-exempt supply | 240 |
| Taxable supply | 30 |
| Gross supply | 270 |
| Tax-exempt redemptions | 281 |
| Taxable redemptions | 21 |
| Total redemptions | 302 |
| **Net supply** | **-32** |

Source: Barclays Research

The taxable supply numbers above refer only to debt issued with a municipal CUSIP. Muni deals sold with a corporate CUSIP are not included in the regular supply forecast; they are discussed separately below. We make the distinction as traditional muni supply databases (i.e., SDC) do not count deals sold with a corporate CUSIP in aggregate muni volumes.

### Gross supply

Post-Build America Bond (BAB) era, annual muni issuance has been either in line with or below the 10-year mean of $376bn (Figure 7). Given the likely upward drift in interest rates next year, we expect 2014 supply to be down 16% y/y on the following considerations.

- **Current refundings**: A higher interest rate environment would be a significant overhang on current refunding activity. We saw evidence of this in 2013, when 30y Treasuries sold off more than 100bp from May-August and current refundings declined 5-15% in 2H versus 1H. In the prior period, when 30y Treasuries backed up more than 100bp (October 2010 to February 2011), current refundings declined about 15% in the four months afterwards. In 2014, we expect current refunding activity to remain pressured, particularly as Treasury yields likely continue to rise.

- **Advanced refundings**: In 2014, we believe advance refunding activity will decline meaningfully y/y. With 30y AAA muni yields currently above 4% and likely to drift higher next year, refunding economics for deals issued in recent years are less attractive. Additionally, we believe that advance refunding transactions may be constrained by negative arbitrage effects. In general, as part of an advance refunding transaction, the differential between muni yields and Treasury yields affects the ability to structure an efficient escrow. A higher differential could result in a very inefficiently structured escrow, which may lead to negative arbitrage and overwhelm transactional savings. Long muni bonds are currently spread more than 100bp over Treasuries, while they were trading just 30bp behind Treasuries at this time last year. This higher differential y/y could increase the risk of negative arbitrage in 2014 and limit pre-refundings.

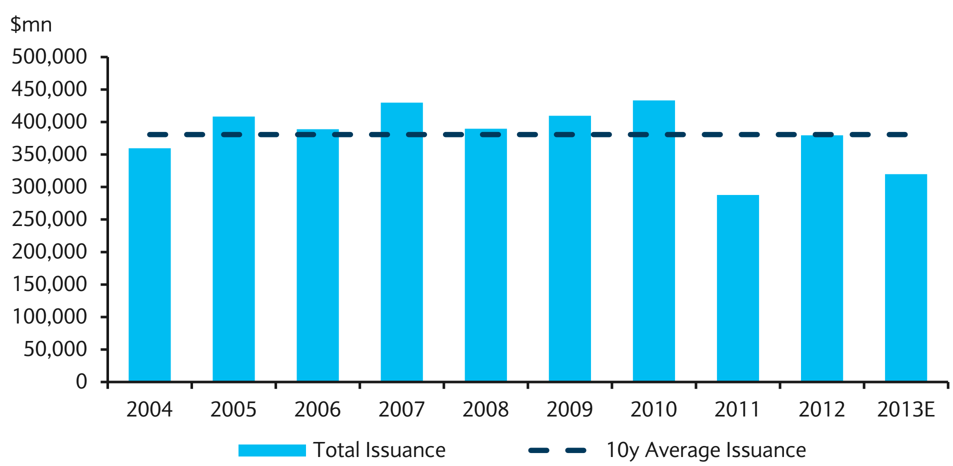
- **New money**: We believe that 2014 new money supply will be unchanged y/y. Our belief reflects the fact that various major issuers having been fairly quiet on the issuance front for a while, counterbalanced by a higher interest rate environment.

- **Tax exemption**: Concerns about the status of tax exemption and the ultimate outcome of tax reform may result in a pull-forward of issuance, although we believe this effect would be minor.

We caveat that should rates sell off more than expected, issuance would decline meaningfully versus our projections, particularly for current and advance refundings.

FIGURE 7

**Annual muni issuance (2004-13E) versus average**




Source: Bond Buyer, Barclays Research

### *Taxable supply*

For taxable issuance sold with a muni ticker, we expect about $30bn of supply in 2014. Year-to-date in 2013, taxable issuance totalled about $32bn, with roughly $5bn of it eligible for the US Taxable Muni Index and, by extension, the larger US Credit Index. In 2014, we expect index-eligible taxable issuance of $4-5bn. This forecast reflects the advantage of issuing in the less regulatory-intensive taxable market compared with the tax-exempt bonds and issuers' awareness of the benefits of issuing in taxable muni index eligible size (CUSIP size of at least $250mn), and could be partly offset by any overhang from a higher rate environment.

For taxable issuance sold with a corporate ticker, we expect roughly $2-3bn of US Credit index eligible issuance in the higher education sector and $3-4bn of supply in not-for-profit hospitals. As a reminder, muni issuance with a corporate ticker would not be included in the taxable muni index, although it could be eligible for the broader US Credit Index, assuming it satisfies index rules.

## Reinvestment capital

We expect redemptions (which we define as redemptions from current refundings, advanced refundings, and maturing bonds) to total $302bn in 2014. As always, we expect estimates for redemptions from advanced refundings ($69bn) and maturing bonds ($152bn) to change only slightly over the year, as these are generally set through prior market activity. Redemptions from current refunding activity should result in the greatest variation from our forecast (Figure 8).

FIGURE 8
**2014E redemptions**

| ($mn) | Current refundings | Advance refundings | Maturing bonds | Total |
|---|---|---|---|---|
| Jan | 5,942 | 4,920 | 10,783 | 21,645 |
| Feb | 4,568 | 6,848 | 11,283 | 22,699 |
| Mar | 5,646 | 4,152 | 9,091 | 18,889 |
| Apr | 6,764 | 4,381 | 8,797 | 19,942 |
| May | 7,366 | 5,361 | 10,118 | 22,845 |
| June | 8,465 | 8,020 | 14,858 | 31,342 |
| July | 8,882 | 8,859 | 19,567 | 37,307 |
| Aug | 6,789 | 9,336 | 20,443 | 36,567 |
| Sep | 6,275 | 2,665 | 9,797 | 18,737 |
| Oct | 6,438 | 4,514 | 11,181 | 22,133 |
| Nov | 6,593 | 3,794 | 10,679 | 21,066 |
| Dec | 6,497 | 6,408 | 15,671 | 28,576 |
| **Total estimated redemptions** | **80,224** | **69,258** | **152,267** | **301,749** |
| Tax exempt | 75,009 | 68,018 | 138,035 | 281,062 |
| Taxable | 5,215 | 1,240 | 14,232 | 20,687 |

Source: IDC, Barclays Research

For current refundings, we expect 2014 levels to decrease from the $110bn+ this year. Our forecast is driven by issuance levels from 10 years ago, given the 10y call features typical of many muni bonds. Given that 2004 supply declined 6% from 2003 levels and the higher interest rate environment, we expect redemptions from current refundings to total $80bn in 2014.

Overall, we expect tax-exempt redemptions to account for about 90% of redemptions in the coming year, in line with post-BAB norms.

### *Coupon distributions*

We expect coupon distributions to total well over $170bn in 2014, bringing total potential reinvestment proceeds to as much as $475bn. Not all coupon payments are reinvested by holders, however. More than 70% of demand for the muni debt comes from retail (either household or mutual funds, Figure 9); a major portion of retail includes buyers (such as retirees) who spend rather than automatically reinvest all coupon distributions. Nonetheless, even though not entirely reinvested, coupon payments will be another driver of negative net supply in 2014.

FIGURE 9

**Share of muni bond holdings, %**

| | Percentage of total | | | |
|---|---|---|---|---|
| **Category** | **2013** | **2012** | **2011** | **2010** |
| Individuals/households | 44.3 | 44.6 | 48.6 | 49.7 |
| Mutual funds [1] | 28.2 | 28.6 | 26.6 | 26.5 |
| Banks [2] | 11.1 | 10.6 | 8.9 | 7.9 |
| Insurance [3] | 12.4 | 12.4 | 12.2 | 12.2 |
| Other [4] | 4.0 | 3.9 | 3.7 | 3.7 |

Note: Numbers in this figure may not add up exactly to 100% due to rounding error. (1) Includes mutual funds, money market funds, close-end funds, and exchange traded funds. (2) Includes commercial banks, savings institutions, and brokers and dealers. (3) Includes property-casualty and life insurance companies. (4) Includes nonfinancial corporate business, nonfinancial noncorporate business, state and local governments and retirement funds, government-sponsored enterprises, and foreign holders. Source: Federal Reserve Flow of Funds, SIFMA, Barclays Research

## Demand

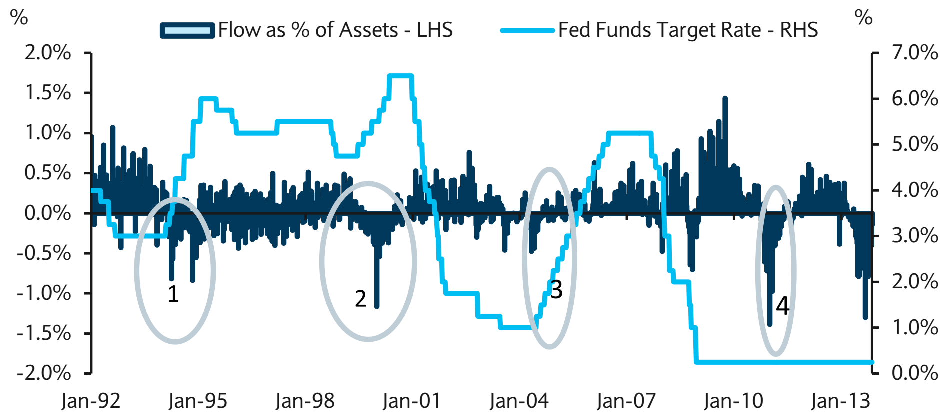
### *Fund flows*

As the muni market primarily consists of retail holders, mutual fund flows are crucial to the overall 2014 demand outlook. In 2013, fund flows were a large net negative (roughly -$53bn year-to-date). Inflows in the early part of the year turned to outflows following fears of Fed tapering, exacerbated by idiosyncratic events in the muni market such as the Detroit bankruptcy. As we have discussed above, we think that it will be difficult for fund flows to stabilize until after the Fed begins tapering asset purchases. In the early stages, the muni market will likely react adversely, similar to periods when the Fed hiked interest rates. However, we believe that outflows can reverse even in the face of additional tightening as long as munis are attractive.

Figure 10 shows muni fund flows from 1992-present. The circles represent prior periods when rates sold off significantly and funds experienced meaningful outflows. Circles 1-3 (pre-crisis) were accompanied immediately by sustained hikes in the fed funds target rate; circle 4 (post-crisis) was accompanied by idiosyncratic events in the muni market, (i.e., media headline predictions of a high volume of muni defaults and the downgrade of tobacco credits to high yield in 2011). We have previously argued that a potential tapering of Fed asset purchases is akin to the pre-crisis rate hike “shocks” in circles 1-3. Based on the limited historical data, during the pre-crisis period, we see that fund outflows mostly ended at or before the end of Fed rate hikes. Notably, fund outflows managed to reverse in 2005 in the middle of the mid-2000s Fed tightening. In our view, this historical trend is encouraging for flows in 2014.

FIGURE 10

**Muni mutual fund flows versus 30y AAA tax-exempt yields**




Source: Lipper, Barclays Research

*Banks*

Two rules under Basel III are of note, although we do not expect them to meaningfully affect bank demand for munis in the near term. Under one rule, the largest banks must account for any price movements in investments held in their available-for-sale (AFS) portfolios; in a rising rate environment, banks would have to account for price declines in AFS holdings, thereby reducing their reported regulatory capital levels. Under a second rule, revenue debt would maintain at its risk-weight of 50% and GOs would retain a weight of 20%; banks would continue to hold 2.5x as much capital against revenue debt versus GOs, despite arguments from industry participants (including SIFMA) for more equal treatment of the two. These rules are effective from January 1, 2014, for the largest banks, with other banking organizations required to comply a year later.

In our view, these rules will likely not result in meaningful change in the pace of bank buying of muni assets. The first rule applies to all securities, and not just munis; to the extent that banks need to buffer against losses, they may choose to move to higher quality securities, shorten duration, or raise more capital. On the second rule, even though revenue bonds continue to have a higher risk weighting than GOs, munis as a whole continue to have a low risk weighting relative to other securities.

Another issue is the recent Fed proposal for liquidity requirements at affected banks. Under the proposal, regulators have designated high quality liquid assets (HQLA) that can be used to satisfy liquidity coverage ratios; however, munis would not qualify as HQLA. Affected institutions would be phased in to the requirement and would be expected to maintain an LCR of 80% as of January 1, 2015, 90%, as of January 1, 2016, and 100% as of January 1, 2017. It appears that many banking institutions already do not classify munis as "liquid," and as such, the negative effects of this proposal on the muni market may be muted at best.

*Insurance*

As a percentage of total amount outstanding in the muni market, insurance holdings of muni bonds have remained stable at approximately 12% over the past eight years. Within the insurance category, P&C holdings of munis are 2.5x that of life insurance companies. We attribute this largely to the relative disincentive of life insurers (compared with P&C insurers) to invest in tax-exempt instruments, based on proration provisions and rules from the federal tax code. However, in recent months, we believe there have been increased instances of life insurance companies looking towards the muni asset class for asset-liability matching purposes, owing to the attractive relative value in munis at present. Overall, we do not expect insurers' share of total muni holdings to change meaningfully in 2014.

## Positioning within munis

### Tax-exempt

*Value in long bonds*

Amid the summer sell-off in the municipal market, investors often shunned bonds with longer maturities, fearing higher interest rates. As a result, the muni curve steepened considerably in 2H13 (Figures 11 and 12). As we have discussed above, we believe that the curve will flatten next year, making longer bonds relatively more attractive. Barclays U.S. rates strategists are projecting a modest bear flattening in the Treasury curve. They expect 5y Treasury yields to reach 2.50% in 2014, up around 110bp from current levels. The projected rate rise is more moderate at other points of the curve; 10y and 30y yields are expected to reach 3.50% and 4.40%, up around 75bp and 60bp, respectively. For more details, see *Global Rates Outlook 2014: Grinding Higher*, November 21, 2013. The muni curve tends to flatten along with Treasuries in rising rate environments. Although the flattening in munis is often more modest, we think the opposite could happen for a couple of reasons: 1) the long part of the market has underperformed materially with longer muni ratios above 100%; and 2) the muni curve is historically steep, offering more room for the curve to flatten. The long-end has started to perform better as the slope of the 10s30s curve has compressed 15bp to 145bp. However, the main driver is the underperformance of the 10y, as the 5s10s curve continues to steepen. We would be nervous about adding exposure at the front end of the curve given that the relationship between 5y munis and 5y Treasuries is relatively tight. In addition, Barclays' rates strategists believe that the 5-10y portion of the curve is likely the most sensitive to changes in Fed policy.

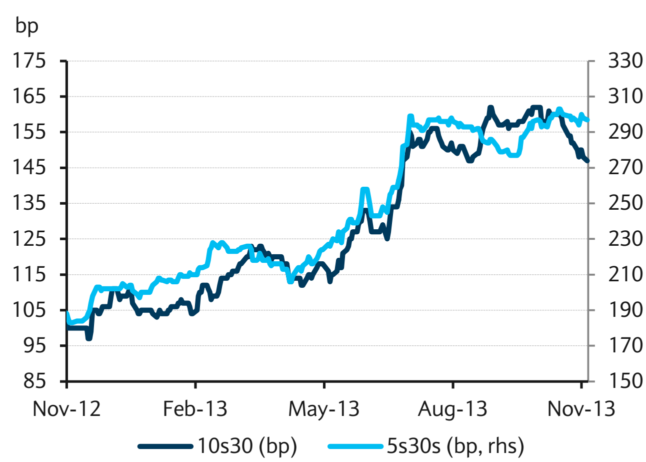
*Value in A-rated bonds*

We think that there is value in the lower-quality portions of the Barclays Municipal Index – particularly in the A-rated portion – as AAs have outperformed. As of late November, the differential between the AA-rated and AAA-rated parts of the index was 53bp, up just 14bp from the post-crisis low reached earlier in 2013. By contrast, the A-rated part of the index has measurably underperformed, especially in the past few months (Figure 13). The A-AA differential expanded ~30bp to 86bp; excluding Puerto Rico-related credits, which had a modest effect, the differential increased ~25bp to 79bp. The underperformance is in line with the post-crisis experience, as the A-AA differential has a tendency to widen as rates rise, but we think it is overdone. In the past couple of months, A-rated bonds have underperformed other portions of the index, even as the muni market has performed relatively well. Excluding

FIGURE 11
**5s10s AAA-rated tax-exempt GO yield curve (bp)**


Source: Barclays Research

FIGURE 12
**5s10s and 10s30s AAA-rated tax-exempt GO yield curve**




Source: Barclays Research

FIGURE 13
**AAA-AA and AA-A yield differentials (bp) – Muni Index excluding Puerto Rico**


Source: Barclays Research

FIGURE 14
**BBB-A yield differential (bp) – Muni Index excluding Puerto Rico**


Source: Barclays Research

Puerto Rico-related credits – which have an outsized effect on the yield of the BBB part of the index – the yield differential between the A- and BBB-rated portions compressed ~10bp. Similarly, the spread between AAs and AAAs started compressing in September and has compressed 6bp so far. Furthermore, we think that improving municipal credit quality, as discussed above, could lead to spread tightening.

*Sector positioning*

In Figure 15, we re-introduce our muni cross-sector relative value heat map. The heat map tool offers a quick way to glean potential relative value opportunities in the tax-exempt municipal space. The table, designed to be read horizontally, delineates yield relationships between various sectors in the Barclays Municipal Index. We rely on yield-to-worst differentials as a measure of value, which is normalized using a percentage scale. For example, if a sector is trading at a yield that is demonstrably above its historical relationship relative to the broader market or another sector – over a one-year period in this case – it potentially offers relative value. Using a specific example, the hospital sector is trading at a relatively wide level compared with the broader muni market, or the Barclays Muni Index, as well as the vast majority of other sectors. Currently, the YTW differential between the hospital sector and the muni index is 111bp – near the wides of the year (112bp) and nearly 30bp off the tight in May – corresponding to a score of 96%. While we believe this is a useful tool, we emphasize that this is a starting point for further credit analysis.

Based on the heat map and our views on sector fundamentals, the following sectors look attractive:

- **Hospital** – The yield differential between hospitals and the Municipal Index was 111bp or 96% of the LTM range. In our view, the fundamentals of the sector have not changed materially, and we think that hospitals, or systems with strong market shares, or those that provide high acuity services, could differentiate themselves.

- **IDR/PCR** – The sector has rallied in the past couple of months and outperformed the Municipal Index. Nevertheless, it still trades at more than 120% of the yield on the U.S. corporate index, offering cross-asset relative value. Given that many of the bonds in IDR/PCR are issued by the same credits as those in the corporate market, we think there is more room for the sector to run. For more details, see *Pockets of Opportunities*, August 22, 2013.

- **Transportation** – The sector trades at a yield of 3.42%, or 35bp wide of the muni index. While it is near the wides of the year (37bp), the differential is just 13bp off of the tight of the year (22bp), suggesting that there is limited room to tighten. Still, many of the larger issuers are strong credits that are the very definition of essential services. In addition, we think these credits will perform well as the economy recovers. Furthermore, many of the bonds in the sector are special revenue bonds which offer strong protection in periods of distress, as demonstrated by the Detroit water and sewer bonds.

- **Water and sewer** – The sector has outperformed the broader muni market in the past few months, but we still believe there is value in the sector. For a more in-depth treatment, see *Water & Sewer: Stable but Not Risk-Free*, October 30, 2013.

## HY munis

With yields on the muni HY index at 6.64% and corporate HY at 5.60%, the ratio of Muni HY to corporate HY is at 119%, an all-time high (Figure 16). This ratio has expanded after the May/June rate sell-off, as HY corporates have rallied while yields for HY munis have remained elevated. In our view, HY munis look attractive, given current ratios. While the increase in ratios reflects the duration differences between muni HY versus HY corporates, we note that HY munis are of higher average credit quality (BA3/B1 versus B1/B2) and are tax-exempt. Figure 17 shows the ratio of muni HY to long HY corporates. After adjusting for duration, HY munis still look appealing, as the ratio of HY munis to long HY corporates are well off their 10-year lows.

FIGURE 15
**Municipal cross-sector relative value heat map**

| Percentile of 1y Range | Muni | GO | State GO | Local GO | Rev. | Elec | Hosp | Hsg | IDR/PCR | Trans. | Ed | Wtr/Swr | Res. | Lease | SPT |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Municipal Index | - | 98 | 92 | 79 | 7 | 7 | 4 | 79 | 37 | 12 | 20 | 30 | 79 | 21 | 58 |
| GO Index | 2 | - | 63 | 36 | 2 | 2 | 3 | 74 | 18 | 7 | 5 | 13 | 78 | 2 | 18 |
| State GO | 8 | 37 | - | 37 | 8 | 7 | 3 | 74 | 18 | 9 | 9 | 16 | 70 | 2 | 23 |
| Local GO | 21 | 64 | 63 | - | 1 | 0 | 3 | 73 | 18 | 8 | 4 | 17 | 78 | 14 | 29 |
| Revenue Index | 93 | 98 | 92 | 99 | - | 36 | 6 | 81 | 58 | 27 | 36 | 47 | 83 | 59 | 89 |
| Electric | 93 | 98 | 93 | 100 | 64 | - | 27 | 85 | 61 | 58 | 57 | 65 | 83 | 61 | 90 |
| Hospital | 96 | 97 | 97 | 97 | 94 | 73 | - | 86 | 95 | 98 | 96 | 92 | 87 | 77 | 93 |
| Housing | 21 | 26 | 26 | 27 | 19 | 15 | 14 | - | 20 | 18 | 21 | 22 | 41 | 15 | 20 |
| IDR/PCR | 63 | 82 | 82 | 82 | 42 | 39 | 5 | 80 | - | 36 | 51 | 42 | 78 | 50 | 58 |
| Transportation | 88 | 93 | 91 | 92 | 73 | 42 | 2 | 82 | 64 | - | 55 | 60 | 81 | 61 | 85 |
| Education | 80 | 95 | 91 | 96 | 64 | 43 | 4 | 79 | 49 | 45 | - | 41 | 84 | 62 | 80 |
| Water/Sewer | 70 | 87 | 84 | 83 | 53 | 35 | 8 | 78 | 58 | 40 | 59 | - | 86 | 59 | 69 |
| Resource | 21 | 22 | 30 | 22 | 17 | 17 | 13 | 59 | 22 | 19 | 16 | 14 | - | 6 | 20 |
| Leasing | 79 | 98 | 98 | 86 | 41 | 39 | 23 | 85 | 50 | 39 | 38 | 41 | 94 | - | 76 |
| Special Tax | 42 | 82 | 77 | 71 | 11 | 10 | 7 | 80 | 42 | 15 | 20 | 31 | 80 | 24 | - |

Note: As of November 29, 2013. This table should be read horizontally. Light blue shading represents relatively tight (25th percentile threshold) relationships, and gray shading with bolded text represents relatively wide (75th percentile threshold) relationships. Figures indicate the percentile at which the current YTW differential between the two sectors stands relative to the LTM range. For example, hospital minus the municipal index is at the 96th percentile of the LTM differential range, so hospital is relatively wide versus the broader muni market. State GO minus the municipal index is at the 8th percentile of the LTM differential range, so the state GO sector is relatively tight versus the broader muni market. Source: Barclays Research

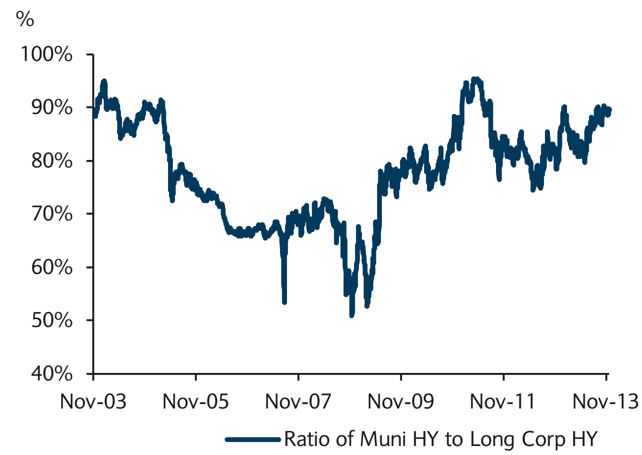
FIGURE 16

**Ratio of muni HY to corp HY (YTW ratio, %)**


Source: Barclays Research

FIGURE 17

**Ratio of muni HY to long corp HY (YTW ratio, %)**




Source: Barclays Research

When we drill down on the muni HY index, no particular sector stands out as being the sole driver of the recent underperformance. Figure 18 shows the current YTW and as a percentage of LTM ranges for individual sectors in the HY muni index. With the exception of the local GO category, YTW for all categories stand at more than 70% of their LTM ranges.

FIGURE 18

**Categories in muni HY**

| Sector | Min YTW | Max YTW | Current YTW | % of LTM Range |
|---|---|---|---|---|
| State | 4.37 | 6.10 | 5.89 | 88% |
| Local | 4.64 | 8.25 | 4.84 | 5% |
| Education | 4.81 | 6.43 | 6.29 | 91% |
| Hospital | 4.57 | 6.21 | 6.17 | 98% |
| Housing | 5.30 | 6.48 | 6.28 | 84% |
| Power | 4.23 | 6.40 | 6.13 | 87% |
| Resource recovery | 5.33 | 9.50 | 8.90 | 86% |
| Transportation | 3.56 | 6.08 | 5.93 | 94% |
| Water & sewer | 3.96 | 7.59 | 7.08 | 86% |
| Leasing | 5.24 | 7.40 | 7.12 | 87% |
| Special tax | 5.05 | 6.12 | 5.79 | 69% |
| IDR/PCR ex-tobacco | 5.36 | 7.54 | 6.89 | 70% |
| Tobacco | 6.01 | 8.03 | 7.57 | 77% |

Note: Based on an LTM (last 12 months) timeframe. % of LTM range = (current YTW – min YTW) / (max YTW – min YTW). Source: Barclays Research

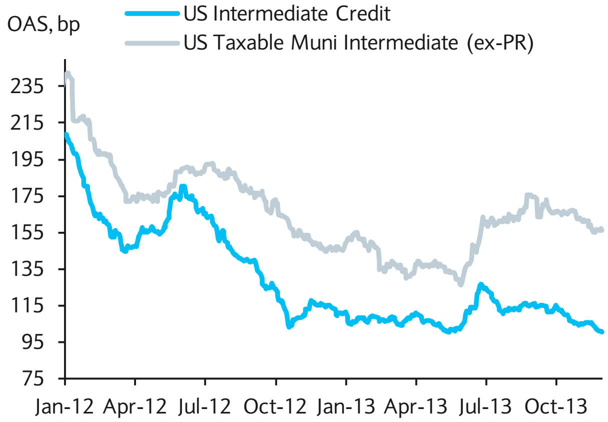
## Taxable munis

### *Intermediates offer value*

Given the potential higher rate environment next year, investors skittish about long duration assets may wish to consider intermediate taxable munis. We acknowledge that offerings in the intermediate taxable muni space are somewhat more limited. However, in our view, the relationship between intermediate taxable munis and intermediate credit appears somewhat dislocated currently. Figure 19 shows intermediate taxable munis (excluding Puerto Rico-related credits) against the intermediate credit index. Here, the intermediate taxable muni index (ex-PR) trades 56bp behind the US Credit Intermediate index. This 56bp differential is at

FIGURE 19

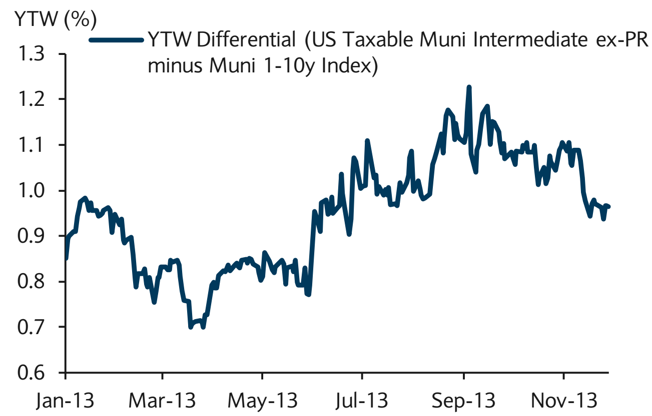
**Intermediate Taxable Munis (ex-PR) and US Credit Intermediate Index, OAS (bp)**




Source: Barclays Research

FIGURE 20

**US Taxable Muni Intermediate ex-PR minus Muni 1-10y Index, YTW Differential (%)**




Source: Barclays Research

its post-January 2012 wides, well off the tight of about 6bp in May 2012. This suggests that intermediate taxable munis represent good relative value at current levels, in light of their higher ratings (A1/A2 for taxable munis ex-PR, versus A2/A3 for intermediate credit).

On a YTW basis, intermediate taxable munis (ex-PR) offer 96bp of pickup versus the tax-exempt Municipal 1-10y Index. This differential is 26bp away from the year-to-date tight of 70bp, suggesting that intermediate taxable munis offer some value versus their tax-exempt peers as well (Figure 20).

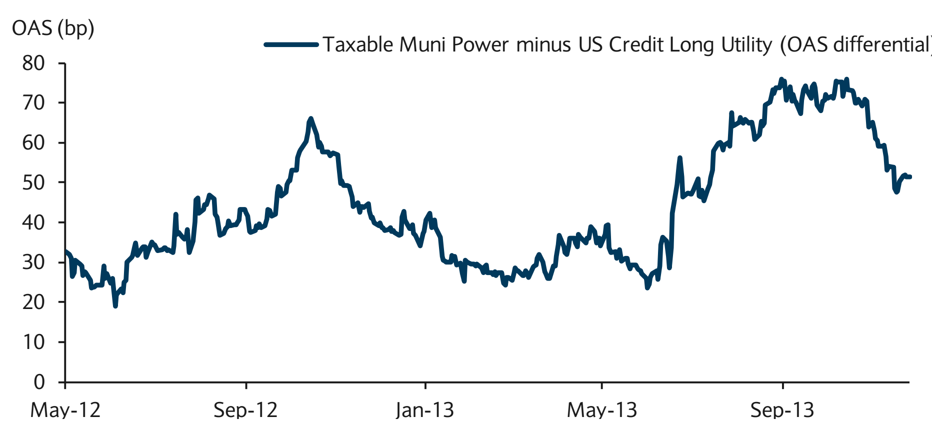
*Choose wisely within long taxable munis*

Overall, upside/downside in long taxable munis has become less attractive in recent months, given potentially higher rates next year and the fact that spreads have rallied meaningfully. Certain sectors, however, may still see meaningful spread compression, which should help offset effects from higher Treasury yields. Investors familiar with corporate financial analysis may wish to consider the taxable muni power sector, which offers spread pickup versus the utilities sector on the corporate side.

Figure 21 shows the spread differential between taxable muni power index and the long portion of the US Credit Utilities. The former trades wide of the latter, despite being of higher credit quality (AA3/A1 versus A3/BAA1). Though the spread differential between the two is away from recent wides, we believe power bonds still have room to run versus corporate utilities.

FIGURE 21

**Taxable Muni Power (AA3/A1) minus US Credit Long Utilities (A3/BAA1) – OAS differential**




Source: Barclays Research

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# European credit strategy

EUROPEAN HIGH GRADE STRATEGY

# More room to play catch up

Zoso Davies
+44 (0)20 7773 5815
zoso.davies@barclays.com

Ioannis Kallianiotis
+44 (0)20 7773 0158
ioannis.kallianiotis2@barclays.com

- **We forecast that our Euro Aggregate Corporate Index will generate 175-225bp of excess returns next year. This reflects our expectation of index spreads tightening c.20bp over the course of 2014, with a significant slowdown in fallen angel volumes. We see €-IG credit outperforming USD markets as Europe closes the growth gap.**
- **Overlaying the forecasts for government bond yields from our Rates analysts, we expect €- IG credit yields to move higher next year, offsetting the carry and roll-down available to total return investors. We forecast total returns of -75bp to -25bp.**
- **Uncertainty in our forecasts is unusually high. Europe is entering a period of low inflation that is unprecedented in developed markets and presents serious challenges to market forecasters and policymakers. That said, we see the downside as capped by the potential for the ECB to undertake asset purchases if inflation falls further.**
- **We are more confident in the technical backdrop for €-IG. Our supply forecasts imply a fifth consecutive year of negative net supply, again driven by European banks. While retail funds in Europe have had small outflows, which we expect to continue, we believe that demand for credit from institutional investors will rise as interest rates and equity valuations move higher.**
- **Given our generally constructive view, we favour wide-trading, high-beta credit. In particular, we expect peripheral credit to outperform, given more attractive valuations and the potential for compression against core credits as systemic risk falls further.**
- **We also favour European banks over other sectors. In our view, they now have the most robust, and heavily scrutinised, balance sheets in Europe. While the AQR is seen as an overhang to the sector, it is likely to drive capital ratios higher – positive for creditors in the medium term. We do not expect losses for subordinated bondholders at any of the banks in our fundamental analysts' coverage universe.**

## 2013 performance

Through the end of November, excess returns for our Euro Aggregate Corporate Index were 293bp. If December excess returns are slightly positive, then 2013 will become the third-highest excess returns year after 2009 and 2012. Total returns have been a fraction weaker, standing at 281bp, as the move higher in bund yields offset their carry and roll-down.

2013 returns have reflected several key strategic themes: a positive environment for excess returns; a more challenging total returns backdrop; and selective beta compression. High beta (BBB and peripheral) credits outperformed, while the 3-5y part of the curve generated the highest returns as curves continued to steepen.

Utilities was the best performing sector, driven by its high spread duration and outsized exposure to peripheral credits; it is now the sector most exposed to peripheral Europe. Financials also outperformed the broader index, driven by subordinated instruments and exposure to peripheral credits. At the other end of the performance spectrum, core non-financial credit lagged, but every sector has generated positive excess returns in 2014, reflecting the broad-based performance of European risk assets.

## 2014 outlook: Finding the demand for Europe

**Our outlook for European credit is built on three pillars: the closing differential between European and global growth; continued easy monetary policy; and the stabilisation of European balance sheets. We believe that the net result of these developments will be an outperformance of European assets as demand for exposure to the euro area grows.**

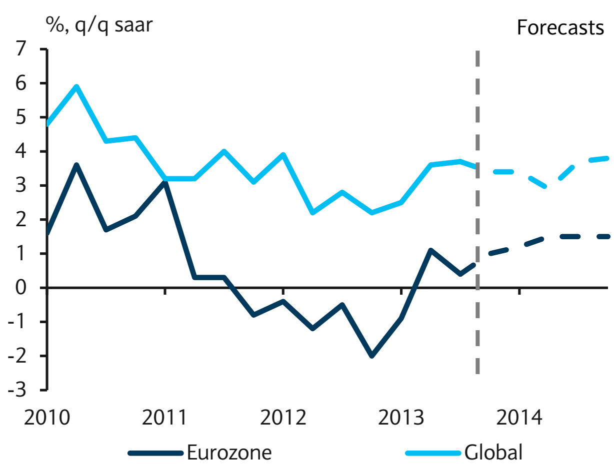
The euro area exited recession in Q2 13 and our economists expect it to stage a slow, but persistent, recovery; they forecast that growth will reach 1.5% (y/y) in Q4 14. While the headline growth number is somewhat mundane, and risks are to the downside, the differential between global growth and euro area growth should fall about a third (Figure 1). Overall, this sets a backdrop that is supportive of taking exposure to European risk, both outright and relative to the rest of the world. We forecast that index spreads will tighten 15-20bp in 2014.

That said, the recovery in Europe is likely to be atypical, given the growth composition that the euro area is targeting. In particular, looking at the components of our economists' GDP forecasts, we note the importance of investment (i.e., capex, Figure 2). Consumption, both public and private, is likely to remain weak as governments continue to lower their deficits (albeit more slowly) and households struggle with extremely subdued wage growth, in nominal and in real terms (Figure 3). This has important investment implications.

First, it suggests that some conventionally cyclical sectors (such as retail and autos) that sell their products and services within Europe will not enjoy the usual tailwind for operating performance over the next 12-18 months, as domestic demand remains weak. On the cost side, European corporates should benefit from internal devaluation and structural reforms in southern Europe, but credits that generate significant revenues outside of the euro area are likely to outperform those whose sales are focused within the single market.

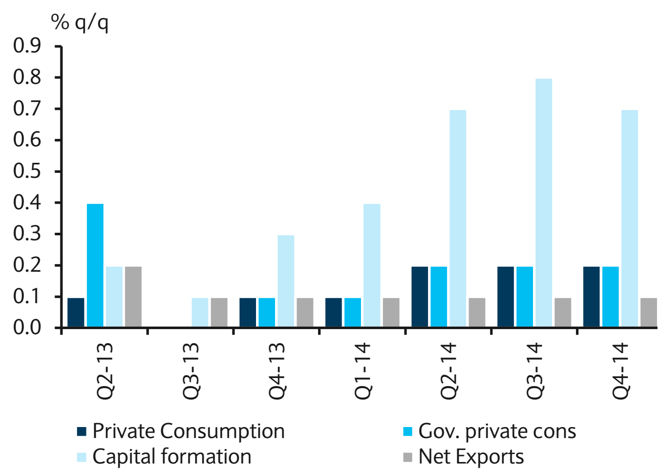
Second, if European growth becomes more dependent on global demand (as the euro area targets a large current account surplus, Figure 4), then it will also become more exposed to emerging markets volatility. Indeed, the performance of European credits in global markets was a key theme in Q3 earnings and we expect it to be an ongoing source of operational volatility in 2014. Over the medium term, European credits with exposure to growth in EM are likely to see superior revenue growth, but at the expense of increased volatility and headline risk. In this context, the strength of the euro is also likely to be a focus for markets in 2014 and could become a driver of monetary policy in the euro area.

FIGURE 1
**Global growth trends**




Source: Barclays Research

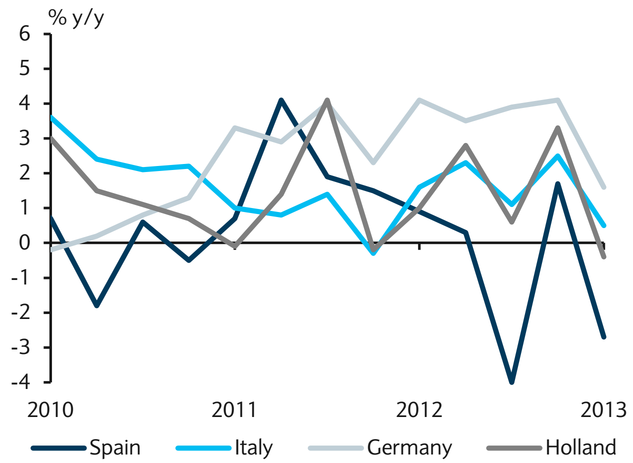
FIGURE 2
**Euro area growth components, with forecasts**




Note: Shows growth by sector, not pp contribution to overall growth
Source: ECB, Barclays Research

FIGURE 3

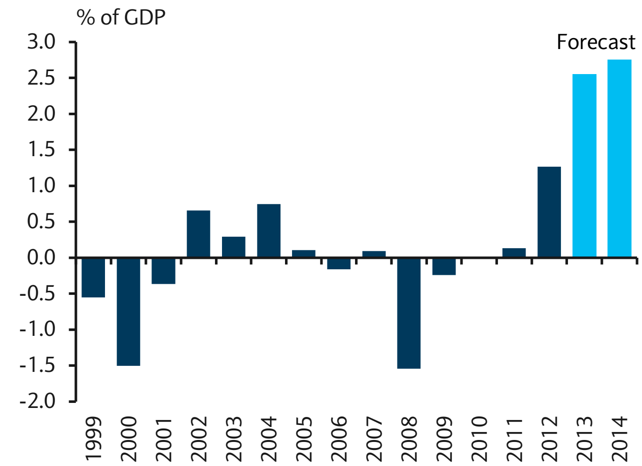
**Euro area nominal wage growth by country**




Source: Eurostat, Barclays Research

FIGURE 4

**Euro area current account**




Source: Barclays Research

## Deflation risk poses challenges to many

**In previous years, we have relied on our macroeconomic model of credit spreads to forecast excess returns in Europe. This approach is challenged by the extremely low inflation that the euro area is likely to experience over the next two years. At the same time, the inflation outlook is likely to shape monetary policy in Europe and, hence, the outlook for interest rates. A persistently strong euro is a key risk to our outlook.**

In *European Credit Alpha*, 9 September 2011, we set out an approach to macroeconomic modelling of credit spreads at the index level. This has subsequently been the foundation of our returns forecasts as we applied our model to various market scenarios. In 2014, we face a new challenge, in that our economists expect extremely low inflation for the next two years (1.2% y/y in Q4 14), despite their forecasts for accelerating real growth. Given the linear modelling approach we have historically taken, this combination of economic inputs returns an unrealistically tight index spread at the end of 2014. In essence, our model views low inflation as positive for spreads and very low inflation as even better. In contrast, we are less sure that extremely low inflation signals a fertile risk-taking environment.

To adjust for this, we have updated our macro model by adding a measure for inflation expectations, which were relatively stable through the crisis but have been falling recently. The results of this new model, along with our economist's macroeconomic forecasts and the resulting excess returns forecasts, are shown in Figures 5 and 6.

FIGURE 5

**Barclays Research 2014 excess returns forecasts, Euro Aggregate Corporate Index**

| | Baseline scenario | Upside scenario | | Baseline scenario | Upside scenario |
|---|---|---|---|---|---|
| EUR Corp | 1.9% | 2.6% | | | |
| EUR Industrials | 1.4% | 2.2% | Indu - 1-3y | 0.8% | 1.1% |
| | | | Indu - 3-5y | 1.5% | 2.3% |
| Indu - AA | 1.2% | 1.7% | Indu - 5-7y | 1.9% | 2.9% |
| Indu - A | 1.3% | 1.9% | Indu - 7-10y | 1.8% | 3.2% |
| Indu - BBB | 1.8% | 2.8% | Indu - 10-20y | 1.2% | 1.2% |

Source: Barclays Research

FIGURE 6

Macroeconomic scenario analysis and index spread analysis

| | Baseline | Faster Recovery | Downside |
|---|---|---|---|
| GDP (yoy) | 1.5 | 1.7 | 1.0 |
| CPI (yoy) | 1.2 | 1.5 | 1.0 |
| V2X | 16.0 | 14.0 | 18.0 |
| Lending Standards* | 3.0 | 0.0 | 5.0 |

| OAS | Regression | Baseline | Faster Recovery | Downside |
|---|---|---|---|---|
| Euro IG | 122 | 104 | 85 | 147 |
| Euro IG - Indu | 106 | 95 | 78 | 128 |
| Indu - AA | 63 | 51 | 42 | 68 |
| Indu - A | 80 | 70 | 58 | 95 |
| Indu - BBB | 133 | 125 | 101 | 169 |

*Lagged 1 quarter. Source: Barclays Research

Within our forecasting framework, the expected spread tightening is driven by an improved growth outlook for Europe, coupled with persistently low inflation and no significant rise in volatility. We see industrials tightening c.10bp as the macroeconomic conditions push EBITDA growth higher and managements remain creditor friendly. Taking into account the likely outperformance of peripheral names, this suggests that core non-financial debt would tighten a measly 0-10bp, in line with US non-financial credit. In our base case, financials are likely to compress against non-financials; we forecast that the Financials index will tighten c.30bp next year, led by subordinated and peripheral securities.

## Low inflation also challenge for the ECB, but Q€ is an upside risk for credit

Persistently low inflation is not just a headache for our macroeconomic model, it also poses serious policy challenges for the ECB on several fronts. In recognition of this, the ECB cut the interest rate on its refinancing operations by 25bp in November and has articulated that it is prepared to ease further.

Our economists do not expect any further policy action from the ECB until 2014. In their view, current policy focus is on improving credit provision in the euro area (*Preserving a safety margin against deflationary risk*, 22 November 2013). In our view, this is an area where the EIB/EIF and EC will need to take the lead, as liquidity provision is not the best tool for addressing the balance sheet constraints that are depressing credit growth in Europe (see *Assessing credit conditions in Europe*, 8 November 2013).

However, if inflation remains weak (or falls further), the ECB could look to ease policy. We agree with our economists that lowering the deposit rate into negative territory is unlikely to have much inflationary effect and would be a drag on core European banks (and, hence, could actually weaken credit growth in the near term). Similarly, while further liquidity operations may offset the passive tightening of money market conditions, European banks are not liquidity constrained and are therefore unlikely to participate aggressively, unless an economic subsidy is embedded in the operation.

Our economists believe that given these issues, the next step for the ECB could be an asset purchase programme. *We believe that the announcement of "Q€", while likely only in the context of weak economic performance, would have significant implications for European risk assets and would provide a major tailwind to credit performance.*

Our analysis suggests that asset purchases by the Fed and Bank of England supported risk assets by dampening market volatility, rather than a mechanism specific to asset purchases (*Spot the QE*, 13 September 2013). In Europe, though, we believe that an asset purchase programme from the ECB would have the additional effect of reducing the risk of a potential return of the euro crisis (and redenomination risk premia). This could trigger global capital inflows to Europe (in particular, peripheral markets) and, hence, trigger a significant rally.

Although an announcement of "Q€" would not mechanically adjust our returns forecasts, we believe it would drive a significant peripheral-core compression and push returns higher. Indeed, the ECB may be able to underpin European risk markets simply by discussing the potential for asset purchases – as occurred with OMT. That said, if economic data remained very weak following an announcement of "Q€", then we would expect credit spreads to give back their initial gains over a longer horizon.

## The risk of a persistently strong euro

In the context of a structural current account surplus, very low inflation in Europe is also a serious risk to our FX team's forecast of a weaker euro. Their call is based on divergent monetary policy at the Fed (preparing to taper) and the ECB (considering further ways to ease), which seems likely in the short term. Longer term, however, low inflation and a large current account surplus could result in persistent euro strength (similar to Japan from 1990 to 2010). This would create downside risks to our economists' growth forecasts and inject negative translation effects into corporate earnings (Figure 7).

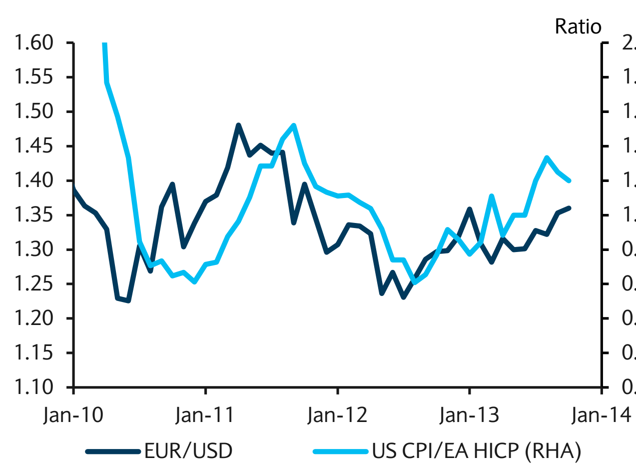
## Despite the prospects for looser monetary policy, yields are likely to rise

While looser monetary policy and subdued inflation suggest that government bond yields will remain low for longer in Europe, our rates team question the ability of the ECB to de-link yields in Europe from the US (where the Fed is expected to taper asset purchases in 2014). With UST-EGB spreads already near their historical wides, they believe that government bond yields are likely to trend higher next year, despite the loosening bias of the ECB and downside risks to the outlook for growth and inflation in Europe.

They forecast yields moving 40-80bp higher across the curve over the next 12-15 months, more than the 15-20bp of spread tightening that we estimate for €-IG corporate spreads (Figure 8). If both sets of forecasts are realised, credit yields will be 25-60bp higher by year-end, resulting in total returns of -0.75% to -0.25% in 2014.

FIGURE 7

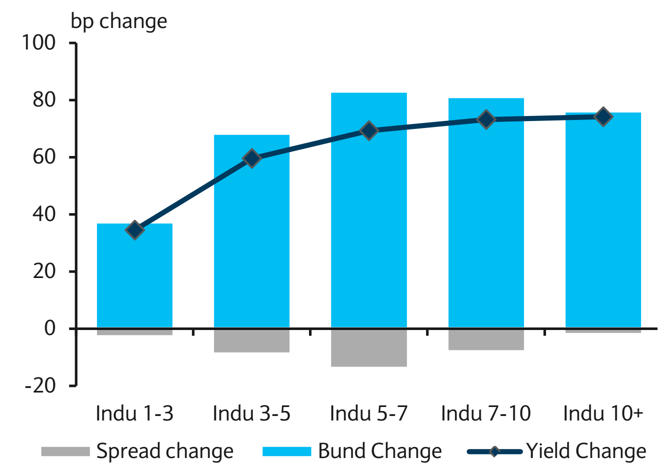
**EUR/USD performance versus relative inflation rates**




Source: Bloomberg, Barclays Research

FIGURE 8

**Spread and interest rate change forecasts, full-year 2014**




Source: Barclays Research

## Systemic risk should continue to fall: Overweight peripherals

**Peripheral credit has outperformed in 2013, reflecting wide spreads at the start of the year and a high beta to the market. We expect further outperformance in 2014, given our constructive outlook for credit and given that these credits continue to trade at a premium to core credits. This should be supported by the continued fall in systemic risk and stabilisation of euro area sovereign credit ratings."**

**Our bullish outlook for credit implies high-carry, high-beta securities will outperform.** Peripherals continue to trade wide of core credits (Figure 9) and with a beta of greater than one (though the beta of peripheral credit to the index has been falling since the beginning of the year). Mechanically, this implies that they should outperform the index in a year when we expect excess returns to be positive.

**Peripheral credits can compress against similarly rated core credits.** In our view, fair value for IG rated peripherals is between core credits of the same rating and core credits rated one notch lower, reflecting the potential (but not certainty) of a sovereign-driven ratings downgrade. That implies room for compression. Indeed, the sovereign premium could fall further if rating linkages are loosened. On 19 November, S&P revised its approach to coupling the credit ratings of corporates and sovereigns; as a result, the rating agency put Santander and Edison SPA on CreditWatch positive.

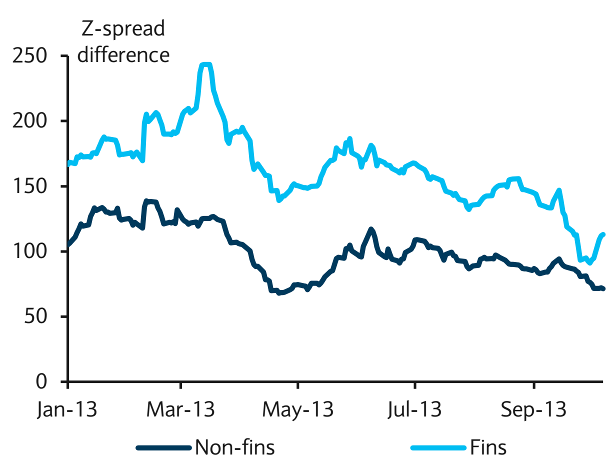
**In IG non-financials, we believe that operational trends are the greater risk to ratings.** In our view, the optimal way to invest in IG non-financial peripheral credit is to focus on issuers with strong fundamentals rated Baa2 or higher. We would still avoid peripheral credits that are operationally challenged. In financials, we recommend positioning for the peripheral/core compression in senior bank debt, where the premium for peripheral risk is the most attractive on a risk-adjusted basis.

**Positioning is favourable**: Though hard to measure, many European real-money investors likely remain underweight peripheral credits – positions that they have held for some time. If the outlook for peripheral Europe continues to improve, there could be shifts in portfolio positioning to reduce these underweights. That would result in significant demand for peripheral credits. Another potential trigger for this portfolio rebalancing, as discussed above, would be the announcement of "Q€" by the ECB.

*For further discussion, see Peripheral vision, 25 October 2013*

FIGURE 9

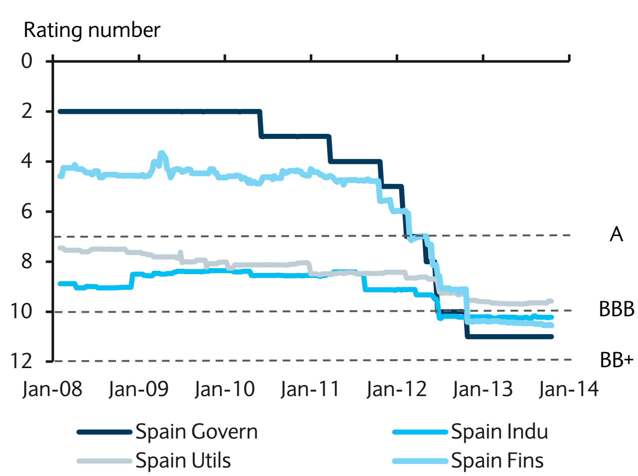
**Senior €-IG credit, peripheral versus non-peripheral**




Source: Barclays Research

FIGURE 10

**Peripheral credit rating trends**




Source: Barclays Research

## Financials have the best balance sheets: Overweight banks

**We believe that banks have some of the most heavily scrutinised balance sheets in Europe. With regulators pushing for further improvements in transparency and capital ratios, we see further upside for bank creditors. In contrast, the repair of non-financial balance sheets has only just begun; hence, execution risk in these sectors is elevated.**

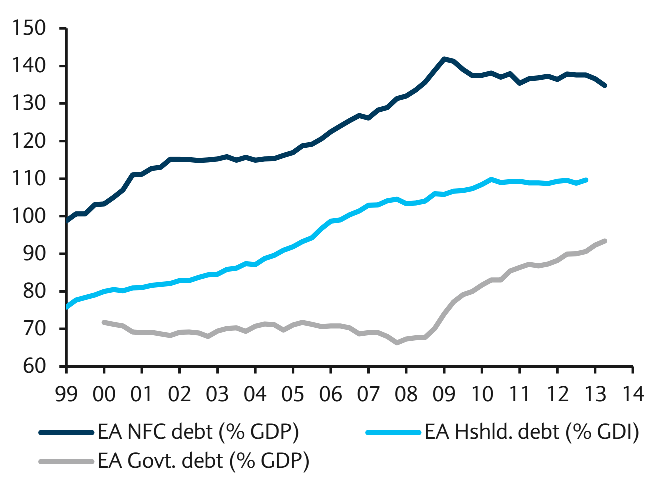
**There has been little to no balance sheet de-leveraging in Europe.** While European "de-leveraging" has been a talking point since 2008, in reality government and household debt has continued to rise throughout the global financial and euro area crises (Figure 11). Private non-financial corporation (PNFCs) leverage has been almost flat. In part, this reflects the stagnation in nominal GDP that the euro area has suffered, demonstrating the difficulty in de-leveraging in a low-growth, disinflationary environment.

**The banking system is one area where balance sheets have tangibly improved.** As highlighted by our bank analysts, blue-chip European banks continue to increase their capital ratios (which are now measured along multiple axes) and their terminal targets for capitalisation have risen. Banks are becoming safer, less leveraged credits and this trend is likely to continue, rather than reverse, given the current approach from regulators. While extremely unsophisticated, the ratio of bank capital and reserves to total assets shows the progress banks have made in recent years (Figure 12).

**For creditors, AQR risks are to the upside.** While the AQR has become the focal point for European bank investors, we struggle to construct a plausible scenario that is negative for bondholders. Banks will be given time to fill any capital shortfalls identified; indeed, they could begin pre-announcing yet-more ambitious capital targets in Q1 14, which would be positive for bondholders. At the same time, the AQR will provide unprecedented oversight of European bank balance sheets. The risk of large capital shortfalls that result in losses for subordinated bondholders seems low and limited to small banks that have little publically traded debt. Hence, the risk to broader markets is also low, in our view; if spreads were to move wider as a result of the AQR, we would see that as a buying opportunity.

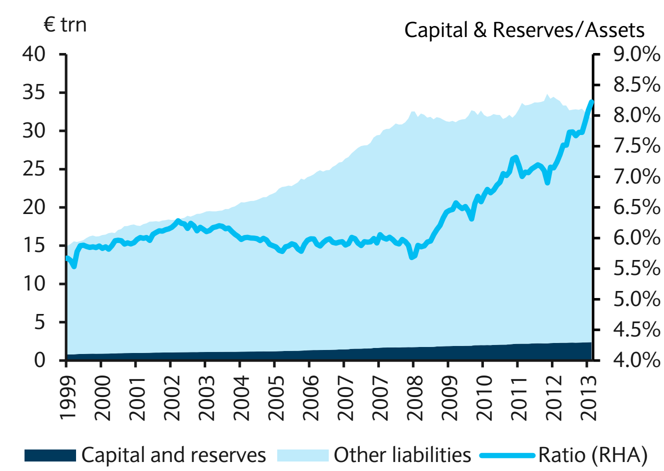
**Valuations versus non-financials justify Overweight positioning.** Given the relative health of balance sheets, upside risk from the AQR, our constructive view on peripheral credit and on legacy bank capital instruments, we believe the bank sector will outperform in 2014. The Financials index currently trades c.30bp wide to industrials and we expect this to compress to c.10bp by the end of 2014.

FIGURE 11
**Euro area leverage trends, by sector**




Source: Eurostat

FIGURE 12
**Euro area bank assets, capital and reserves**




Source: ECB Barclays Research

## Non-financial balance sheets are more mixed

**Downgrades should slow in 2014.** Corporates in Europe have taken drastic measures in an attempt to preserve investment grade ratings. Across names and sectors, there has been a series of dividend cuts, equity raises, asset sales and (more recently) issuance of corporate hybrids. We believe that these have generally been successful in stabilising IG ratings (with a few notable exceptions). However, leverage remains elevated (Figure 13).

**Upgrades are far away**. European credit has suffered an unprecedented re-rating over the past three years, with a significant deterioration in credit quality (Figure 14). In our view, upgrades are unlikely to occur in significant numbers until there is a pickup in the organic growth of earnings in Europe. This is a H2 14 story, in our view. Further, aside from the recent cyclical pressures, we believe that several sectors (e.g., autos, paper, generation-focused utilities, high street retailers) face secular headwinds that have yet to be addressed.

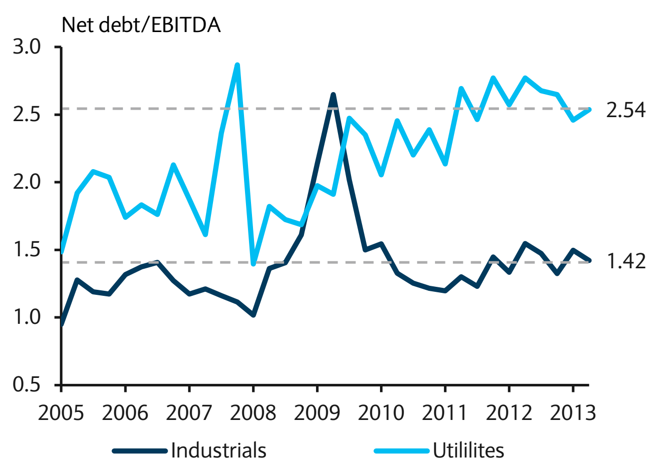
**Overweights in banks and peripherals dominate our recommendations in the remaining sectors**. With banks making up 38.2% of our benchmark Euro Aggregate Corporate index, there is limited room for further Overweight recommendations in other sectors. We are also overweight Insurance (which remains one of the widest trading sectors) and Media Cable (a low duration, high spread sector weighted towards the secured debt of high yield issuers).

**Underweights are concentrated in tight-trading sectors with limited upside**. Given the improving economic backdrop, we expect the large majority of issuers to see improving operational trends; however, for many of the non-peripheral issuers, this is already priced in. Indeed, the mathematical reality is that it will be extremely difficult for tight-trading sectors to generate the 175-225bp of excess returns we target at the index level. For example, for a name trading at 80bp and an average duration of 5 years, spreads would need to tighten 25bp to generate returns in line with the broader index.

**Our sector recommendations leave us long European credit**. We are Overweight 43% of the Corporate index and Underweight 27% of the Corporate index (Figure 15), i.e., net long European credit. These asymmetric recommendations are possible because our ratings are versus the broader Pan European Credit index, which includes non-corporate credit and trades at tighter spreads than the Euro Corporate index. We expect corporate credit to outperform government-related sectors next year.

FIGURE 13

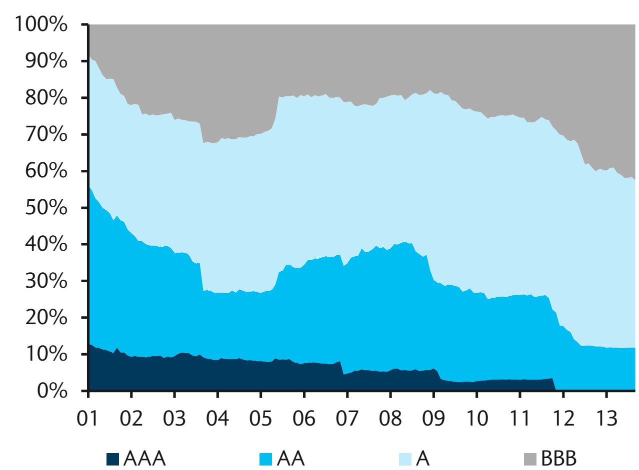
**European non-financial leverage**




Source: Factset, Barclays Research

FIGURE 14

**Euro Aggregate Corporate Index, rating trends**




Source: Barclays Research

FIGURE 15
**Index sector ratings**

| Sector | Peripheral Exposure | EM Exposure | Sub | Index Weight | OAS | Duration | Rating | Sector Rating |
|---|---|---|---|---|---|---|---|---|
| Pharmaceuticals | 0% | 0% | 0% | 2.51 | 66 | 4.16 | 5.6 | UW* |
| Restaurants | 0% | 0% | 0% | 0.12 | 74 | 7.19 | 7.0 | UW* |
| Aerospace/Defense | 0% | 0% | 0% | 0.30 | 76 | 4.33 | 7.7 | UW |
| Food and Beverage | 0% | 0% | 0% | 2.65 | 85 | 4.93 | 8.3 | UW* |
| Automotive | 1% | 0% | 3% | 5.58 | 89 | 3.92 | 8.1 | UW |
| Consumer Products | 13% | 0% | 12% | 0.95 | 90 | 5.23 | 6.6 | UW |
| Technology | 0% | 0% | 0% | 0.62 | 90 | 7.66 | 6.5 | UW* |
| Tobacco | 3% | 0% | 0% | 1.29 | 91 | 5.05 | 8.2 | UW* |
| Retailers | 0% | 0% | 0% | 0.37 | 92 | 6.36 | 8.0 | UW |
| Chemicals | 0% | 0% | 14% | 2.19 | 101 | 4.27 | 8.1 | UW |
| Diversified Manufacturing | 0% | 3% | 4% | 1.78 | 102 | 4.61 | 8.0 | UW |
| Construction Machinery | 0% | 0% | 8% | 0.51 | 106 | 4.46 | 8.5 | UW* |
| Supermarkets | 0% | 0% | 0% | 2.10 | 107 | 4.67 | 9.7 | UW* |
| Finance Companies | 3% | 0% | 12% | 2.55 | 109 | 4.17 | 6.4 | MW* |
| Energy | 38% | 0% | 5% | 3.69 | 112 | 4.98 | 7.1 | UW |
| Building Materials | 11% | 0% | 0% | 1.41 | 113 | 4.74 | 9.5 | UW |
| Other Financial | 0% | 0% | 11% | 0.46 | 120 | 4.01 | 8.0 | UW* |
| Wirelines | 22% | 1% | 0% | 6.62 | 120 | 5.48 | 9.2 | MW** |
| Media Noncable | 0% | 0% | 0% | 1.43 | 121 | 4.76 | 9.7 | MW* |
| Paper | 0% | 0% | 0% | 0.17 | 123 | 4.95 | 10.0 | UW* |
| **Total** | **14%** | **1%** | **12%** | **100.00** | **124** | **4.54** | **8.0** | |
| Metals and Mining | 0% | 7% | 0% | 1.91 | 125 | 5.06 | 8.8 | MW* |
| Transportation | 36% | 0% | 0% | 3.03 | 127 | 5.05 | 9.5 | MW* |
| Healthcare | 0% | 0% | 0% | 0.03 | 128 | 2.20 | 11.0 | MW* |
| Consumer Cyc Services | 21% | 0% | 0% | 0.74 | 129 | 4.15 | 9.8 | MW* |
| REITS | 0% | 0% | 0% | 1.73 | 130 | 4.73 | 8.8 | MW* |
| Brokerage | 0% | 0% | 0% | 0.19 | 131 | 2.30 | 9.0 | MW* |
| Banking | 12% | 0% | 19% | 37.99 | 131 | 4.14 | 7.3 | OW |
| Utility | 46% | 1% | 6% | 9.68 | 132 | 4.94 | 9.0 | MW |
| Wireless | 0% | 44% | 11% | 1.12 | 138 | 4.89 | 8.1 | MW** |
| Packaging | 0% | 0% | 0% | 0.07 | 143 | 5.97 | 10.0 | UW* |
| Lodging | 0% | 0% | 0% | 0.10 | 147 | 4.15 | 11.0 | MW* |
| Other Industrial | 0% | 0% | 14% | 0.91 | 151 | 4.21 | 8.3 | MW* |
| Insurance | 13% | 0% | 61% | 4.93 | 205 | 4.81 | 8.0 | OW |
| Media Cable | 0% | 0% | 0% | 0.25 | 255 | 2.97 | 10.6 | OW* |

*No analyst sector coverage
**Covered as Telecommunications
Source: Barclays Research

## M&A risks are subdued

**Rising equity valuations and improving credit conditions suggest that M&A and LBO activity will rise modestly in Europe. Current equity valuations appear to make European credits attractive targets for US companies, fuelling cross-border transactions that have been a net positive for European credit quality year-to-date. However, we believe that this will be overtaken by less creditor-friendly activity over the course of 2014.**

**We expect European M&A activity to pick up over the next 12-18 months** as funding conditions continue to improve and equity valuations rise. Our analysis of M&A volumes suggests that equity valuations (of the acquirer) and the availability of funding are the key drivers of M&A volumes, for both intra-Europe and 'inbound' transactions (non-European companies acquiring assets from European corporates). These factors point to a rise in M&A activity in Europe in 2014.

**Credit-positive disposal activity by European credits is likely to decline** as a share of overall M&A activity. With corporates focused on stabilising their ratings in 2013, only c.4% of this year's M&A activity has resulted from European corporates' acquiring non-European assets (Figure 17). In contrast, 46% of corporate actions have involved the sale of assets by a European entity to a non-European party. In 2014, we expect this mix to re-balance towards more credit-neutral activity and intra-European transactions.

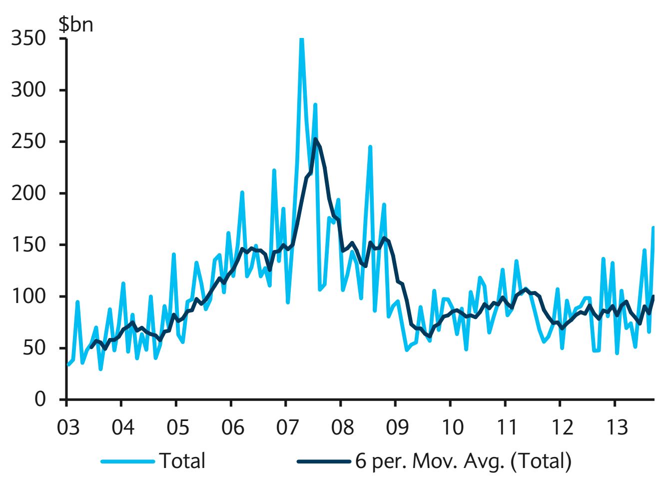
**We do not expect European corporates to pursue aggressive leveraging transactions,** given that credit ratings in Europe are only now stabilising and that the repair of non-financial balance sheets is far from complete. In our view, a greater proportion of positive ratings actions and/or rating outlooks is required before there is a broad-based increase in European M&A. Financial balance sheets are much better capitalised than they were pre-crisis, but this is unlikely to be reversed, given the new regulatory environment.

**Companies are less likely to de-leverage via shareholders**. Indeed, the rise in corporate hybrid issuance (and subordinated issuance by financials) indicates that focus is already shifting away from equity transactions. History suggests that secondary equity raises will plateau or decline in the next 1-2 years, to be replaced by IPO activity.

*For further discussion, see The event horizon, 20 September 2013.*

FIGURE 16

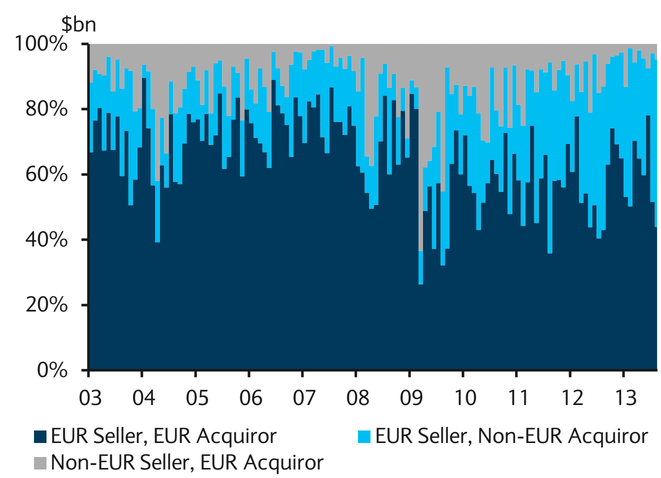
**Monthly M&A activity involving European corporates**




Source: Dealogic, Barclays Research

FIGURE 17

**M&A activity split by aquisitor/divestor**




Source: Dealogic, Barclays Research

## Positive technicals: Supply is likely to be weak…

**We expect gross, €-denominated investment grade issuance to reach €420bn in 2014, up from an estimated €400bn this year. A more meaningful acceleration seems unlikely, given the regulatory pressure on banks to keep their balance sheets constrained and the need for non-financials to improve their credit metrics. Our forecasts imply a fifth consecutive year of net negative issuance, again driven by financials.**

FIGURE 18
Barclays 2014 investment grade corporate issuance forecasts, €bn

| | | 2014 (est) | | | 2013 (est) | |
|---|---|---|---|---|---|---|
| | | Gross | Redemptions | Net | Gross | Net |
| EUR | Fin | 210 | 336 | -126 | 195 | -180 |
| | Non-Fin | 210 | 155 | 55 | 205 | 65 |

Source: Dealogic, Barclays Research

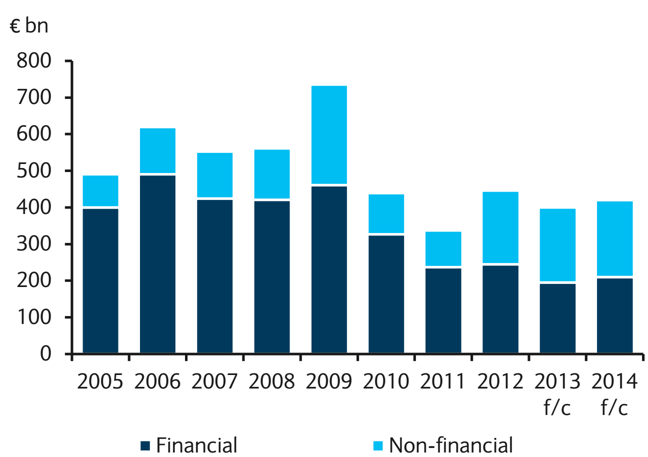
**We expect gross €-denominated investment grade issuance to reach €420bn in 2014**, up from a disappointing €400bn (estimated) this year. A more meaningful acceleration in issuance seems unlikely, given the regulatory pressure on banks to keep their balance sheets constrained and the need for non-financials to improve their credit metrics.

**A fifth year of net negative financial supply.** European banks remain under pressure to increase their capital base and reduce leverage ratios. Given that unsecured funding is a tool for leveraging the balance sheet, the environment seems ripe for net negative issuance as European banks continue to right-size balance sheets. Continued de-leveraging also implies that issuance will be relatively more focused on capital instruments, versus senior debt.

**The loan to bond shift will decline as a driver of non-financial €-IG issuance** over the next few years, as loan redemptions have already fallen (or been pushed back) significantly. Indeed, 2014 looks like a nadir for maturities even before we adjust for facilities that have already been refinanced or extended. Hence, while we expect non-financial issuers to grow in importance in the €-IG market, an extremely unchallenging redemption profile in 2014 is likely to lean against any marked acceleration. Instead, we are looking for 2014 supply to be similar to 2013 in both gross and net terms.

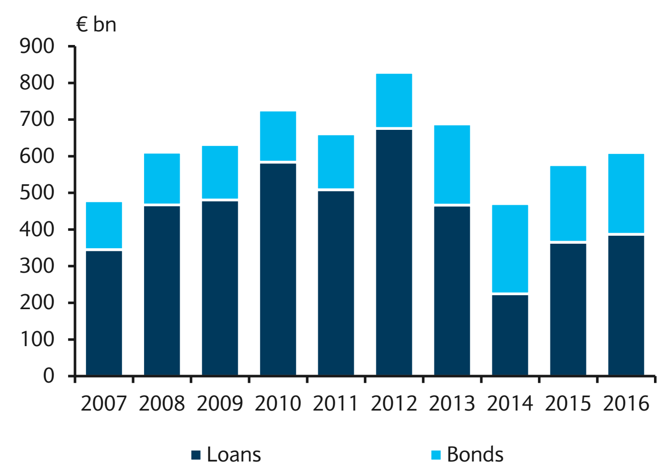
*For further discussion, see 2014 Supply outlook, 4 October 2013.*

FIGURE 19
Gross €-IG issuance




Source: Dealogic, Barclays Research

FIGURE 20
European non-financial redemptions – Loan & Bonds




Note: Values in €-equivalents at signing. Source: Dealogic, Barclays Research

## … with demand underpinned by institutional investors

**Year-to-date, investment grade credit funds have suffered small outflows in Europe, while institutional investors appear to be raising their allocations to credit as interest rates and equity valuations rise. This rotation of ownership away from retail and towards institutional investors will be an ongoing theme in Europe, in our view.**

**European retail funds had limited outflows this year**. Despite the volatility in interest rates this summer, outflows amounted to just c.€2.1bn (1.82% of AUM) for euro-denominated funds (Figure 21). For context, we estimate that these are less than the coupon payments that funds received over this period (year through end-August). Further, European fund flows data are a poor reflection of the retail and private money invested in Europe. We estimate that only about 32% of the "retail money" in European credit is actually invested via funds; the remainder, we believe, resides in private banks and credit investment vehicles such as fixed maturity funds.

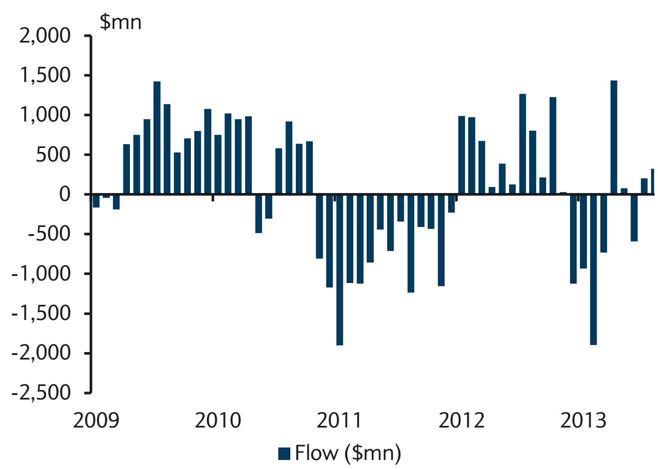
**Private investors continued to allocate capital to fixed income through Q3**, in particular into non-financial and government debt and away from financials (Figure 22). Even in Q2, when interest rates were rising, private investors added to their fixed income exposure. Investment in government securities rose in all quarters, which we attribute to increased allocation to Spanish and Italian government debt over this period. Hence, the broader data set supports our view that the risk of very large outflows from €-IG credit is limited.

**We expect institutional investors to remain net buyers of IG bonds**. Based on ECB data, it appears that institutional investors were net buyers of corporate credit in mainland Europe. As the dominant owners of €-IG credit (c.60% of the market), we believe that this is a more important driver of demand than retail funds. Balance sheet data show that holdings of non-financial and MFI (bank) debt rose 3% in Q1, well in excess of the 0.55% total returns of our benchmark index over that period. There were also gains in the holdings of government debt (+3%), which likely reflects a move to more market weight holdings of Spanish and Italian government paper at the start of this year.

**The recently agreed Solvency II standards will be positive for credit**. Recent progress on the regulatory front suggests that Solvency II is likely to come into force in 2016. Finalised regulation could begin to influence asset allocation from the start of 2014.

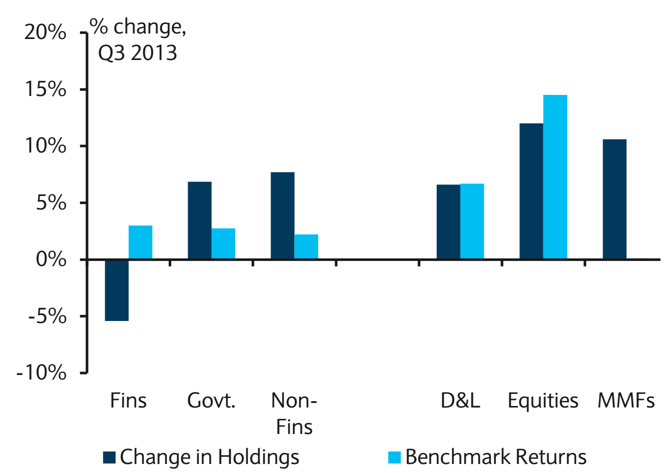
*For further discussion, see Tracking the demand, 27 September 2013*

FIGURE 21
**Inflows to euro-denominated corporate bond funds**




Source: EPFR

FIGURE 22
**European investment fund assets, YTD 2013 changes**




Source: D&L – Deposits and Loans. Source: ECB, Barclays Research

FIGURE 23

**Estimated holding of EUR-denominated investment grade credit and covered bond**

| | Euro Area Issuers | | | |
|---|---|---|---|---|
| | Non-Fin | Fin | ROTW | Total |
| EA Investment Funds | 40% | 36% | 4% | 27% |
| EA Insurance | 35% | 55% | 60% | 52% |
| EA Pension Funds | 5% | 7% | 8% | 7% |
| Other | 20% | 2% | 28% | 14% |
| EA Investment Funds (€bn) | 187 | 354 | 29 | 571 |
| EA Insurance (€bn) | 164 | 543 | 391 | 1,098 |
| EA Pension Funds (€bn) | 21 | 71 | 51 | 143 |
| Other (€bn) | 94 | 19 | 184 | 296 |
| | | | | 2,109 |

Note: % reflects percentage holding of that asset class (column). Source: ECB, EIOPA, Barclays Research

## Managing duration risk: Overweight 5y credit

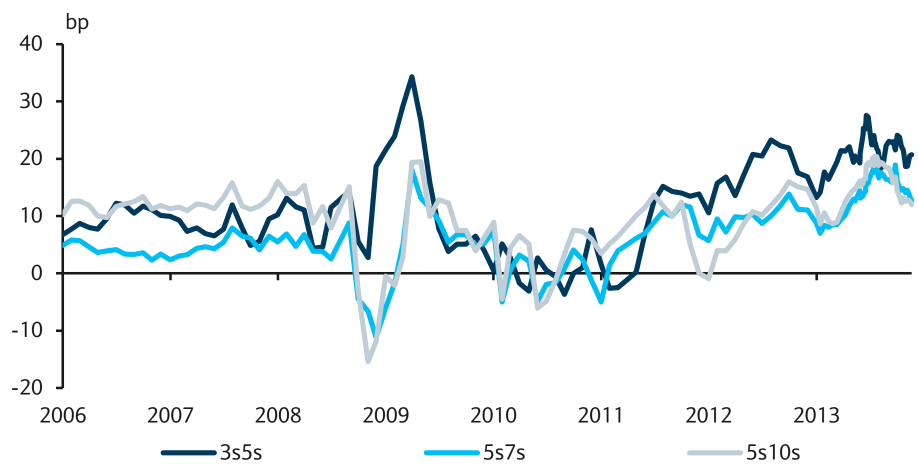
**Given the divergent outlook for credit spreads and government bond yields, we prefer to take credit risk over duration risk. That said, we believe this is already a consensus view and yield curves are already very steep. With this in mind, we believe it makes sense to add credit duration selectively where forwards are attractive.**

**Curves remain steep**. Measuring cash curves using our preferred technique, we note that curves remain near their all-time highs in steepness (Figure 24). This presents attractive opportunities to add longer-dated credit selectively when taking into account the pickup in carry and returns from rolling down the curve.

**We see value in the 5y point** over the 3y point, as we believe this is the best balance of duration risk and credit returns. Looking at our expectations for credit yield changes (Figure 8) and our excess returns forecasts across the curve (Figure 5), we believe that the 5y area of the curve will generate the best returns in 2014. This also tallies with our measure of curve steepness: the 3s5s for credit still appear steep, implying that investors are well compensated for extending along this part of the curve (Figure 24).

FIGURE 24

**€-IG credit curves remain steep on a historical basis**




Source: Barclays Research

STERLING HIGH GRADE STRATEGY

# Paying the duration piper

Zoso Davies
+44 (0)20 7773 5815
zoso.davies@barclays.com

Ioannis Kallianiotis
+44 (0)20 7773 0158
ioannis.kallianiotis2@barclays.com

- **We forecast that our Sterling Aggregate Corporate Index will generate 250-350bp of excess returns. This reflects our expectation of the index OAS tightening 10-15bp in 2014 and a significant slowdown in Fallen Angel volumes. The small exposure to financials and peripheral credits in our GBP index will limit the room for outperformance, despite its large credit duration.**
- **Overlaying the forecasts for government bond yields from our Rates analysts, we expect £-IG credit yields to move significantly higher next year – offsetting the carry and roll-down available to total return investors. Our forecasts imply total returns of -50 to +50bp, with losses at the long end of the credit curve.**
- **The technical backdrop for £-IG will be less supportive than for €-IG. Our forecasts imply positive net-supply driven by non-financials. That said, we believe demand should be sufficient to absorb issuance. While £-bond funds have seen outflows, which we expect to continue, we believe that demand for credit from institutional investors will rise as interest rates and equity valuations move higher.**
- **Given our generally constructive view on European credit, we favour wide-trading, high-beta sectors. In particular, we expect peripheral credit and sub-financials to outperform. The low weight of these areas in £-indices mean performance will need to come from spread tightening at the ultra-long end of sterling credit curves.**
- **The independence vote in Scotland is likely to gain some attention as the polling date approaches. A yes vote is likely to inject volatility into UK credits (particularly utilities and financials), as well as the underlying Gilt market – a potential double-whammy for £-denominated UK corporate bonds.**

## 2013 performance

While not matching the extraordinary returns of 2012, our Sterling Agg Corporate Index has generated strong returns (both in total and in excess of gilts) in 2013. Through the end of November, excess returns stood at 583bp. As such, sterling corporate excess returns are set to beat both EUR (293bp) and USD credit (187bp), in line with our expectations that sterling will outperform this year. Total returns are lower, at 254bp, as rising gilt yields have offset their carry and roll-down, pushing the return of Gilts negative for the calendar year.

Across the curve, the 15+ year bucket has produced the highest excess returns, along with BBB credit given the strong performance of risky assets. Among sectors, Financials have outperformed Non-financials, led by the strong performance of subordinated instruments. This contrasts with the Euro indices where Utilities (which are much more heavily weighted towards peripheral credit in the €-indices) are the best performing of the broad sectors. Within the Industrial space, Transportation and Electric Utilities were the top performers, while Communications and Consumer non-cyclical have lagged.

## 2014: Better than Gilts, but not much else

**While inflation in the UK is falling, unlike in Europe it is doing so from above the central bank's inflation target. As such, we are not expecting the UK's economic situation to move "out of sample" and we stick to our previous methodology for forecasting spreads (and thus returns) at the end of 2014.**

In *European Credit Alpha,* 9 September 2011, we laid out an approach to macro-economic modelling of credit spreads at the index level. Based on this approach and our economists' baseline forecast for 2014, we forecast 250-350bp of excess returns in 2014, weighted towards BBB credits. This represents around 15bp of tightening at the index level, with BBB credit tightening 20-30bp and higher-rated bonds rallying significantly less. As in the €-IG space, we expect Financials to outperform the broader index, led by subordinated debt.

FIGURE 1

Barclays Research 2014 excess returns forecasts, Sterling Aggregate Corporate Index

| | Baseline | Slower growth | | Baseline | Slower growth |
|---|---|---|---|---|---|
| GBP Corp | 3.3% | 1.9% | 1-3y | 2.0% | 1.4% |
| GBP Non-Fins | 2.9% | 1.9% | 3-5y | 2.6% | 1.9% |
| | | | 5-7y | 4.1% | 2.7% |
| AA | 1.1% | -0.1% | 7-10y | 4.0% | 2.2% |
| A | 2.2% | 0.2% | 10-20y | 3.1% | 1.4% |
| BBB | 4.4% | 1.8% | 20y+ | 3.6% | 2.2% |

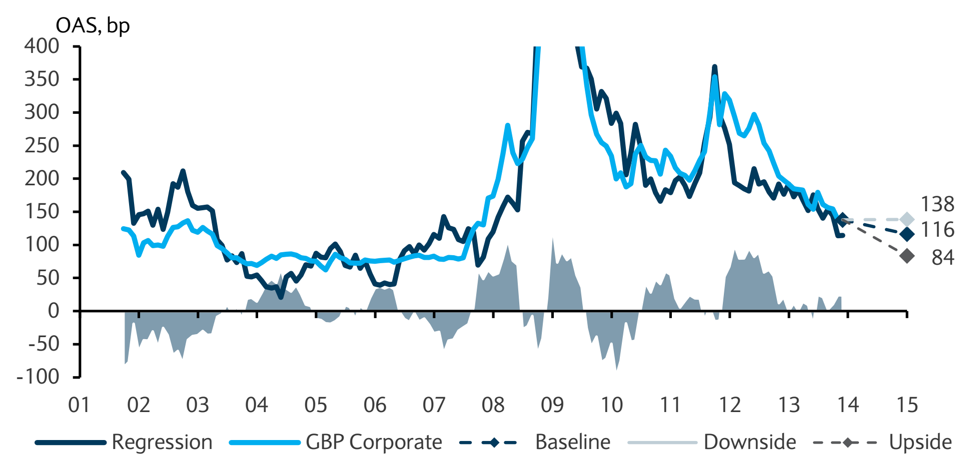
Source: Barclays Research

### Positioning on the curve

Given the duration of the sterling corporate bond market (OAD 7.79), positioning along the curve is particularly important for investors. In the €-IG space, we specifically like to exploit the steepness of credit curves (both spread and yield curves) by selectively extending in the 3-5 year area. In sterling, we believe that the same area of the curve offers the best risk-reward for total return focused £-IG investors given the attractive roll-down that is available. For excess return investors, our forecasts highlight the 5-7y bucket as likely to generate the highest credit returns.

FIGURE 2

Sterling Aggregate Corporate index, historical OAS versus model and forecasts




Source: Barclays Research

## Supply to rise slowly, from subdued levels

**We forecast £42.5bn of gross £-IG issuance in 2014, slightly up from an expected £40bn this year. The increase is likely to come from non-financials, with financial issuance still weak due to the very limited funding needs of UK banks and building societies. Credit provision in the UK remains extremely subdued on a net-basis and is likely to accelerate slowly.**

FIGURE 3

**Barclays 2014 investment grade corporate issuance forecasts, £bn**

| | | 2014 (est) | | | 2013 (est) | |
|---|---|---|---|---|---|---|
| | | Gross | Redemptions | Net | Gross | Net |
| GBP | Fin | 17.5 | 17.2 | 0.4 | 17.5 | -0.3 |
| | Non-Fin | 25.0 | 7.9 | 17.1 | 22.5 | 14.5 |

Source: Dealogic, Barclays Research

The outlook for financial £-IG issuance is essentially unchanged from last year. Among the domestic banks, there appears to be limited appetite to fund in the senior unsecured market. Indeed, UK banks have recently been guided to reduce their liquidity buffers and to focus on leverage (rather than capitalisation) ratios. The effect of both of these regulatory drives will be downward pressure on the size of bank balance sheets during 2014.

Non-financial supply has been disappointing this year, relative to our forecasts coming into 2013. In part, this reflected the cheapness of sterling credit relative to other currencies for most of 2013. With sterling valuations now richer than they have been for some time, we expect to see a brisk start to 2014, with good supply from non-domestics. We expect TMT, Utilities and Transportation names to dominate issuance volumes with other sectors likely to see a small amount of refinancing activity and opportunistic supply from non-UK issuers.

*For a more detailed discussion, refer to 2014 Supply outlook, 4 October 2013.*

## Institutional demand to take over from retail investors

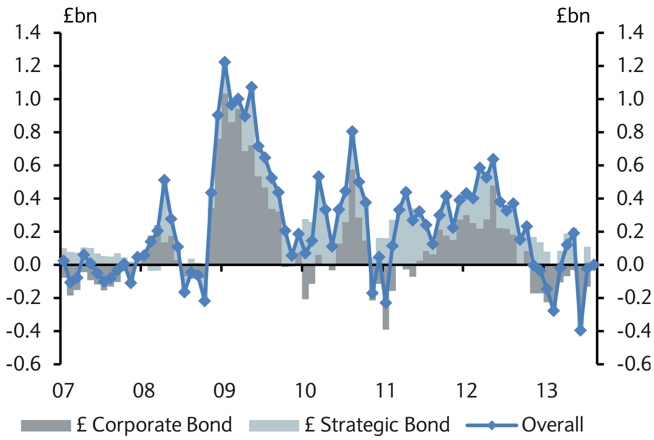
Similar to €-denominated funds, sterling funds saw outflows up to the end of August, but these amounted to just c.£550mn (0.65% of AUM, Figure 4). For context, we estimate that these outflows are less than the coupon-payments that funds received over this period (year to date, through end August). Our analysis suggests that retail flows are dominated by past performance and, based on historical relationships, inflows to credit funds may recover moderately in Q4. Beyond that, we expect retail inflows to remain weak in 2014 – with retail investors likely to favour equities. This is based on our total returns outlook for £-IG credit: we forecast total returns of c.0.0% in 2014 versus the 17% total returns our equity team forecast for the FTSE 100 (*Valuing Europe*, 8 November 2013).

In line with our outlook for the EUR market, we expect institutional investors to remain net buyers of £-IG credit. ONS data reveal that in the UK, institutional investors bought £4.2bn of credit in the first half of 2013, as credit allocations recovered from their lows of Q4 2012 (Figure 5). Our analysis suggests that rising yields and equity valuations led to increased credit investment by insurers and pension funds, respectively – a theme that appears to have played out in 2013 and we anticipate continuing in 2014.

*For a more detailed discussion, refer to Tracking the demand, 27 September 2013.*

FIGURE 4

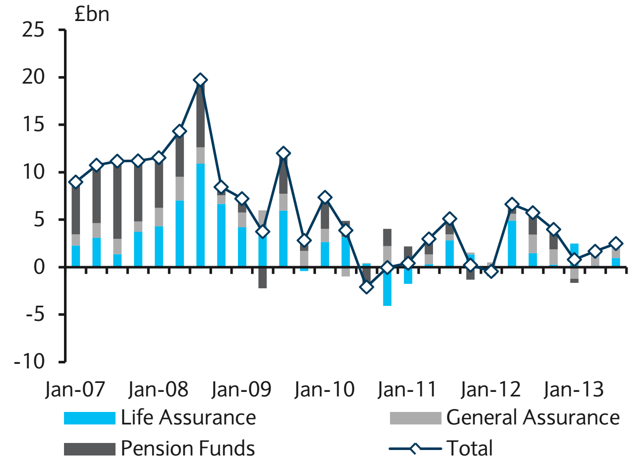
**Retail inflows to sterling-denominated credit funds**




Source: IMA, Barclays Research

FIGURE 5

**UK institutional investor net allocations to credit**




Source: ONS, Barclays Research

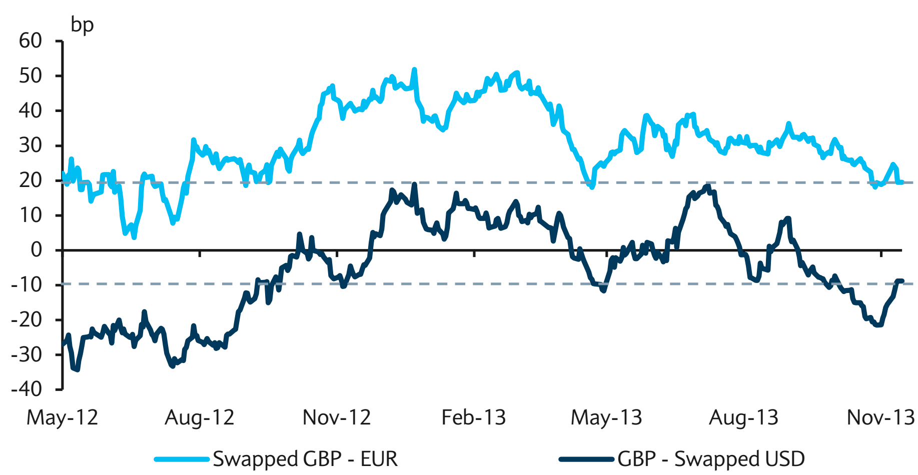
## Cross-currency performance

Following its strong outperformance in October and November, we dropped our Overweight portfolio recommendation on £-credit (versus €-credit) and moved to a more neutral stance (*European Credit Alpha*, 15 November 2013). We carry this into 2014 as valuations have not moved enough to justify significant positioning, in our view (Figure 6). We think the current discount of £-IG to €-IG is fair given the relative liquidity of the two markets.

This might seem at odds with our relative returns forecasts (where we have £-IG generating higher returns than both €- and $-IG). However, the excess returns advantage we forecast for sterling credit reflects the extremely high duration of the index rather than fundamental valuations. Indeed, until recently we argued that, in investment grade credit, both European currencies traded rich relative to the dollar market (*European Credit Alpha* 15 November). However, valuations have already begun to normalise and we now view the risk-reward as fair across all three currencies; what opportunities still exist are more idiosyncratic.

FIGURE 6

**Relative value of £-credit versus equivalent €- and $-bonds**




Source: Bloomberg, Barclays Research

## Scottish independence: The only certainty is uncertainty

**The Scottish referendum on independence, to be held on 18 September 2014, could be either the biggest event in the UK's constitutional history for several hundred years or a damp squib. It is not yet clear to us what the most likely outcome is, nor what form of "independence" might emerge. However, a yes vote would inject significant uncertainty into the future of UK companies and the Gilt market – a potential double whammy for £-denominated corporate bonds.**

**We believe market impact will depend on polls nearer to the vote.** Current polls appear to signal that full independence will be rejected by the Scottish voters. If this remains the case throughout 2014, then Scotland's referendum could be a "non-event" for financial markets. However, signs that the Scottish public plan to vote in favour of independence would bring to the fore the numerous questions that remain unanswered.

**Apportionment of government debt could create uncertainty for Gilts.** If Scotland opts for independence, it is unclear what portion of the UK's government debt it would inherit and how that might occur. As the "risk free" benchmark against which £-denominated credit is priced, uncertainty over the potential division of the UK government's debt would likely result in volatility, which could hurt the functioning of corporate debt markets.

**Primary markets are likely to be the first point of stress.** If the probability of a yes vote rises, this is likely to weigh heavily on sterling credit primary markets given the number of economic uncertainties that would exist for sterling fixed income securities.

**In the scenario of Scottish secession, companies with operations in Scotland could be affected in many ways** including: possible redenomination of revenue streams; change of tax regimes; ratings caps; and the need to re-organise business units to reflect new national borders. UK banks and several of the UK utilities are most exposed, in our view. In particular, issuers that predominantly operate in Scotland may face caps on their rating depending on the future rating of an independent Scotland. Companies headquartered in Scotland would also face significant operation risks if the new nation were not a member of the EU – which could restrict corporate access to the single market.

**Size of "Scottish risk" hard to quantify ex ante**: We note that we cannot identify Scottish credits in our credit indices, as potential candidates are currently considered to be "UK risk". This is likely to change in the scenario of an independent Scotland, but precisely how would depend on operational exposures, among other considerations. We believe that the number of directly affected credits is likely to be small.

**Bond markets are aware of the risks, but appear to pay little compensation.** We note that there are already securities (PFI bonds) that include clauses for the possible creation of a "New Scottish Currency", suggesting that the market is aware of the potential outcomes of the independence referendum. Nevertheless, with £-IG trading at the recent tights versus other currencies, there does not appear to be much risk premium for a market unfriendly outcome from the vote. This leaves room for underperformance if uncertainty rises.

**The implications for €-IG credit are limited**. We believe potential disruptions are likely to be focused in the sterling markets. We do not think this is likely to spill-over into the €-IG markets, though the risk is for increased agitation for independence from euro area regions, such as Catalunia, which have also called for independence recently.

EUROPEAN HIGH YIELD & LEVERAGED LOAN STRATEGY

# Still in the sweet spot

Mike Kessler
+44 (0)20 7773 7232
michael.kessler@barclays.com

Darpan Harar
+44 (0)20 7773 1694
darpan.harar@barclays.com

- **European high yield's combination of reasonable spreads, very low duration, and falling default risk (thanks to the return of growth) should continue to attract capital from global investors, fostering a supportive demand environment in 2014.**
- **We forecast high yield total returns of 5-6% including financials (4.5-5.5% ex fins), with excess returns of 6-7% (5.5-6.5% ex fins), as growth-driven spread compression should offset the anticipated backup in rates.**
- **European leveraged loans should deliver total returns of 4-5%, as poor convexity limits upside despite the demand for floating rate products produced by a rising rate environment.**
- **Driven by their superior carry, lower duration, and higher beta to a tightening market, single-Bs should outperform BBs by approximately 200bp in index terms. Investors can capture further lower-quality performance upside via debut issuer premiums, which are often recouped by investors prior to month-end index entry.**
- **CCC performance will remain idiosyncratic, but collectively they should outperform once again in absolute terms, as they have in every year of the post-credit crisis period save 2011.**
- **We forecast default rates to fall further as growth accelerates modestly, while central banks remain extremely accommodative by historical standards. We expect a 1.5-2.5% default rate for bonds, and a 2.5-3.5% rate for loans.**
- **We believe the peripheral premium will shrink further in 2014, driven by the improving economic outlook, although the outperformance of peripheral credits will be lower than it has been over the past two years.**
- **High yield financials should be a source of outperformance in 2014, including senior unsecured bonds from peripheral banking names as well as subordinated parts of core European bank capital structures.**
- **Among non-financial sectors, we see the potential for outperformance in electric utilities, gaming, retailers, transportation services, and wireless.**
- **Credit derivatives, including single-name CDS and the iTraxx Crossover index, are likely to outperform cash for the second year in a row, thanks to lower rate exposure and a better convexity profile. Changing ISDA definitions and decisions around protocols could temporarily affect liquidity in certain names, but are unlikely to fundamentally alter the economics of existing trades.**
- **We forecast high yield bond supply of €75-85bn, most likely a third straight annual record, although the pace of growth should slow somewhat as fewer loan issuers are forced into the bond market. Much of the supply will be opportunistic, and should not materially weigh on spreads.**
- **Despite binding risk retention regulations, new CLO creation should accelerate to €12-15bn, allowing the institutional loan market to stabilize after shrinking for five consecutive years. Leveraged loan supply should be €40-50bn, excluding repricing transactions, driven by a gradual, growth-driven pickup in M&A and LBO activity.**

## Returning to growth, but with lower returns

### It's been a good couple of years, but is there anything left for 2014?

On 8 December 2011, the ECB issued a *press release* announcing a pair of three-year "longer-term refinancing operations" (LTROs). Their intent was to improve liquidity in the European financial system, which was becoming increasingly paralyzed by the unfolding sovereign debt crisis. The benefits of this decision were not immediately apparent to market participants; the Barclays Pan Euro High Yield Index closed 8bp wider that day in OAS terms, and widened an additional 30bp over the ensuing week before rallying marginally into year-end. With index OAS at 883bp as of 31 December 2011, the market was still pricing in elevated defaults and a non-trivial risk of a European breakup going into 2012.

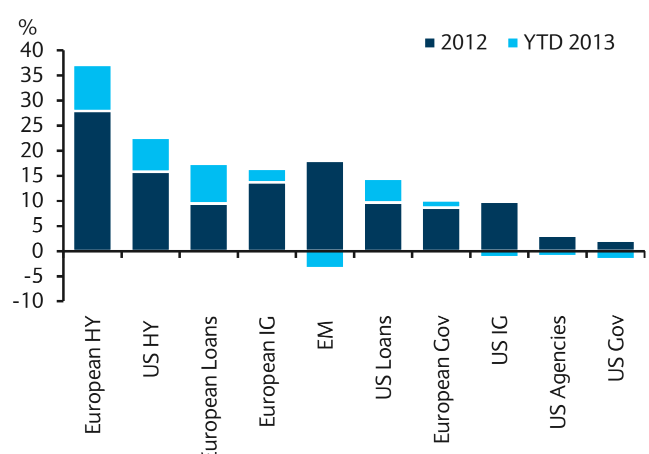
Over the longer term, however, the two LTROs in combination with the OMT announcement and various other central bank actions have improved liquidity, helped to curtail systemic risk, and delivered impressive returns to European high yield investors. After a currency-hedged total return of 27.9% in 2012 (23.7% excluding financials), the cash market has followed up with a 9.5% return over the first 11 months of 2013 (8.4% ex-fins). With a cumulative 23-month return of 37.4%, European high yield has been the single best performing fixed income asset class in the world over that period (Figure 1).

With such stellar performance in the rear-view mirror, it is reasonable to wonder whether there is anything left in the tank for 2014. As we enter the new year, cash market spreads are likely to be 350-360bp, given current levels of 364bp (360bp ex-fins) along with our expectations of a modest grind tighter into year-end. For reference purposes, the previous post-crisis tights in non-financial spreads occurred in March 2011, reaching a low of 354bp before concerns about European sovereign risk began to spread beyond Greece and into the wider periphery (Figure 2). As such, any meaningful tightening in 2014 would take spreads to levels that haven't been reached since mid-2007.

We believe such a breakthrough is possible. By the end of 2014, Europe will be six years removed from the credit crisis, and three years removed from the height of the peripheral sovereign crisis, and (we expect) seven quarters removed from recession. Moreover, we expect the ECB's asset quality review to show an increasingly resilient financial system. Despite these improvements, however, the long and challenging road to a full economic recovery also suggests that the ECB should remain extremely accommodative by historical

FIGURE 1

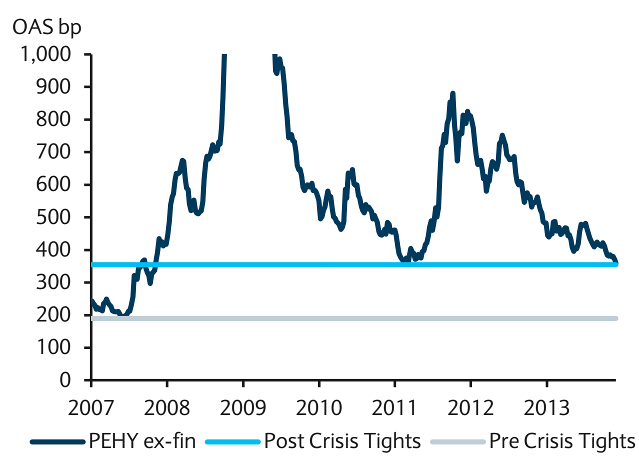
**2012-13 total returns by fixed income asset class**




Note: Returns in local currency. Source: S&P LCD, Barclays Research

FIGURE 2

**Pan-Euro High Yield ex-fins Index OAS (bp)**




Source: Barclays Research

standards. We believe this combination of an improved economic outlook, receding systemic risk premia, and supportive monetary policies should be sufficient to push high yield spreads to new post-crisis lows.

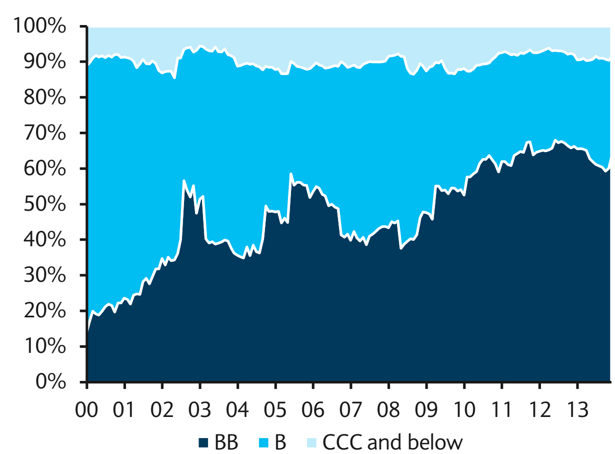
### Our 2014 outlook for high yield spreads and total returns

As described in a preceding section of this report, our outlook for European investment grade credit spreads is based on a macro model that incorporates the expected rate of economic growth, inflation, volatility, and the net change in lending standards. Driven primarily by our economists' forecast of 1.5% y/y GDP growth for the euro area, our investment grade colleagues expect 15-20bp of net tightening in IG spreads next year. Over the long run (10+ years), the historical beta of changes in high yield spreads to changes in IG spreads has been slightly above four. When applied to our IG forecast, this would imply 60-80bp of spread tightening for high yield.

However, we are cautious about applying long run HY/IG spread betas to the current environment, for two reasons. First, the quality distributions of the two markets have converged over the years, as IG has become increasingly BBB heavy because of ratings downgrades, while high yield has become dominated by BBs because of the prevalence of large fallen angels (Figure 3). Second, high dollar prices have pushed a large portion of the high yield market above its next call price (Figure 4), which puts something of a cap on further upside and hinders the ability of high yield to rally in synch with IG credit. Indeed, these two limitations have been factors in 2013 as well, which helps to explain why high yield's beta to IG spread changes has been closer to 2.5 this year. Applying this lower, more context-sensitive beta to our IG spread forecast implies high yield spread tightening of 40-50bp in 2014. This would push average spreads into the 310-320bp range, or 30-40bp inside previous post-crisis tights.

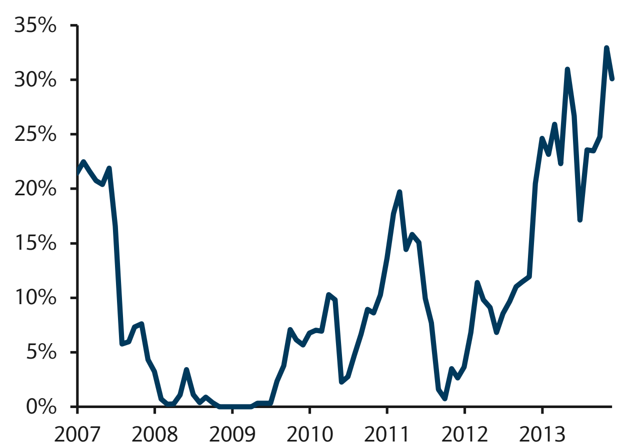
Translating this spread tightening into a total returns forecast requires taking a view on rates. For this purpose, we rely on the recently published forecasts from our colleagues in interest rate strategy, which imply a backup in 3.3y (duration matched to index) Bund yields of approximately 55bp (Figure 5, also see *Global Rates Outlook 2014: Grinding Higher*, 21 November 2013, for details). With roughly an equal amount of expected rate backup and spread tightening, overall price levels should be largely consistent, suggesting that today's average index yield of 4.8% is a good starting point for next year's returns. Upside relative to the starting yield will come from occasional tender offers, sub-optimal exercise of issuer call

FIGURE 3
**High yield market share by quality**



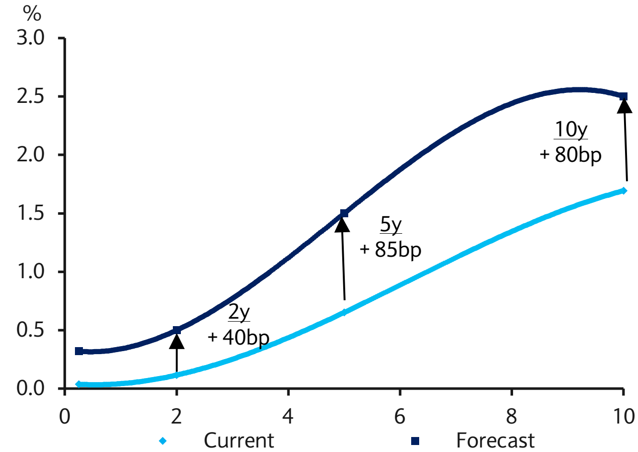

Note: Based on the PEHY ex-fins index. Source: Barclays Research

FIGURE 4
**High yield non-financials trading above next call price (%)**



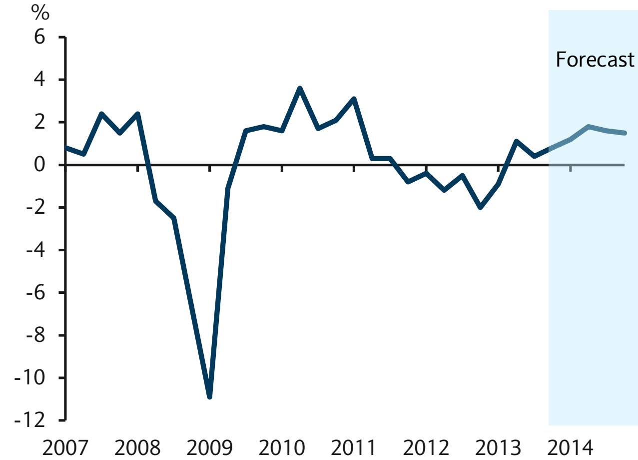

Source: Barclays Research

FIGURE 5
**Bund yield curve: current and 2014 year-end forecast**




Source: Bloomberg, Barclays Research

FIGURE 6
**European quarterly GDP growth with 2014 forecasts**




Source: Bloomberg, Barclays Research

options, recapture of new issue concessions, and incremental carry from lower rated issuance, offset by a small amount of drag from defaults (see the ensuing section on default risk for further details).

Considering all of these factors, we arrive at a total returns forecast for the unconstrained Pan-Euro High Yield Index of 5-6% (4.5-5.5% excluding financials). While this would be the lowest total return since 2011, it nevertheless compares favourably with expectations for most fixed income asset classes next year, thanks to European high yield's extremely low duration. The anticipated backup in bund and sterling rates is expected to reduce total returns by only 100bp, suggesting that high yield's excess returns should be in the 6-7% range (5.5-6.5% ex-fins).

### Alternate scenarios for total return

Relative to our base case expectation of 5-6% total returns, we think the primary source of upside would come from a less dramatic increase in underlying rates. In our view, it is possible to envision a scenario in which European economic growth of 1-1.5% provides sufficient impetus for spread tightening, while central bank activity (in particular, a heavy emphasis on forward guidance at the Fed, ECB, and BoE) succeeds in keeping rates relatively well anchored until growth accelerates more dramatically. In this scenario, global developed market rates could remain low across the board.

Alternatively, it is also possible that the correlation between Bunds and Treasuries could decline, as a stronger US recovery and tapering of the Fed's asset purchase program drives US rates higher, while a slower (but still positive) recovery and aggressive ECB support keeps Bund rates near current levels. Either of these outcomes would remove at least some of the rates drag from our outlook, bringing total and excess returns more in line at 6-7%. Upside beyond these levels becomes increasingly difficult to envision, as it would most likely require a significant acceleration of growth combined with a benign rate outlook. Therefore, we view a repeat of this year's high single- to low double-digit returns as extremely unlikely.

Conversely, we believe the primary source of downside to our base case would most likely come from faltering European economic growth, rather than the acceleration our economists currently expect (Figure 6). With rates already near historic lows, a significant deterioration in the growth outlook would almost certainly precipitate spread widening that would not be fully offset by any decline in underlying rates. While we do not believe a growth slowdown, or even a return to outright recession, would cause a dramatic rise in near-term default risk, it would almost certainly push spreads wider, resulting in a below-coupon return. In an extreme downside scenario, growing signs of deflation could reignite more systemic concerns about peripheral sovereign solvency and financial system stability, pushing total returns into negative territory. While we view this outcome as unlikely, the somewhat tenuous nature of the recovery means it cannot be dismissed entirely.

## Returns by quality

Translating our outlook for index-level returns into returns across ratings buckets requires us to make one final assumption: quality betas. Historically, the spread betas of BBs, Bs, and CCCs to changes in overall index spreads have been roughly 0.75, 1.2, and 1.9, respectively. However, as was the case with overall HY/IG spread betas, changes in index composition and the increased prevalence of call constraints for lower quality levels have caused betas partially to converge. As such, we use betas of 0.85, 1.1, and 1.6 to translate our expected index-level spread changes into quality-specific outcomes for 2014. The results are summarized in Figure 7.

Not surprisingly, the combination of a relatively bearish rate forecast plus a constructive outlook on economic growth and spreads results in an expectation of fairly significant outperformance for the lower quality buckets, at least on an outright basis. This is the result of progressively shorter duration exposure as credit quality declines, along with a progressively higher beta to changes in overall index spreads. Roughly speaking, these two factors combine to produce an incremental 2% in total returns expectation for each full step down across the ratings spectrum. Given our general preference for taking credit exposure over rates exposure, we therefore recommend that investors take an underweight position in BBs relative to their roughly two-thirds market share, and a corresponding overweight in lower quality to the extent that is consistent with their mandate and/or portfolio limits.

However, this recommendation does require a few caveats. First, as always, CCC performance is likely to be highly idiosyncratic, given its relatively small overall size and lack of diversification. CCCs have outperformed in absolute terms in 2013 (Figure 8), with lower than usual volatility (Figure 9), but have underperformed their long-run historical beta as call constraints have limited upside (54% of CCCs are trading to their next call). Second, referring back to the alternative scenarios from our overall market forecast, we believe the primary source of potential upside in total returns is from a more benign outcome for underlying rates, which would disproportionately benefit BBs relative to the expectations in Figure 7. Conversely, our downside return scenarios chiefly involve disappointing economic growth, widening spreads, and potentially (at the unlikely extreme) the return of systemic risk premia to the market. These outcomes would disproportionately harm lower quality (especially CCCs) relative to our base case outlook. In sum, the risks to our quality outlook are clearly asymmetric, and investors that hold different views regarding next year's rates outlook or European GDP growth prospects should adjust their quality allocations accordingly.

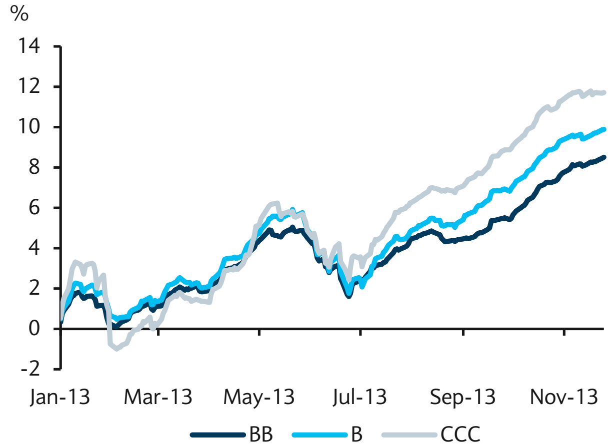
FIGURE 7
**Total return forecasts by quality**

| Credit Ratings Bucket | Basic Stats | | Option-Adjusted Spread (bp) | | | Yield to Worst (%) | | | Total Return (%) |
|---|---|---|---|---|---|---|---|---|---|
| | Market Value (%) | Duration | Current | Forecast | Change | Current | Forecast | Change | |
| BB | 64.9 | 3.6 | 285 | 230-240 | (45-55) | 3.91 | 4.0-4.1 | 0.1-0.2 | 3.0-4.0 |
| B | 25.8 | 2.9 | 453 | 390-400 | (55-65) | 5.40 | 5.2-5.3 | (0.1-0.2) | 5.5-6.5 |
| CCC | 8.0 | 2.5 | 579 | 485-500 | (80-95) | 6.73 | 6.1-6.3 | (0.4-0.6) | 7.5-8.5 |

Note: Based on the Barclays Pan European HY index. Source: Barclays Research

FIGURE 8

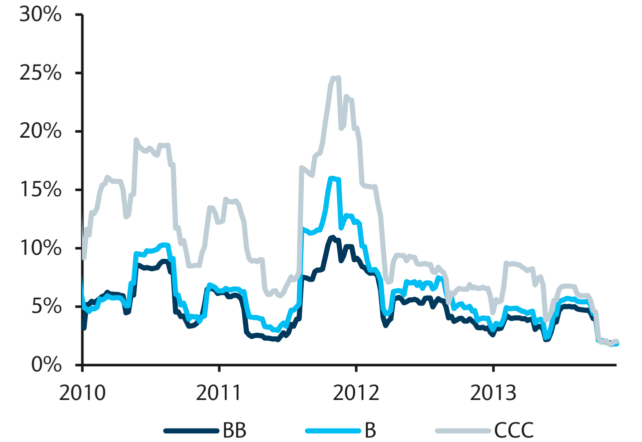
**YTD total returns by quality**




Source: Barclays Research

FIGURE 9

**Trailing three-month total returns volatility by quality**



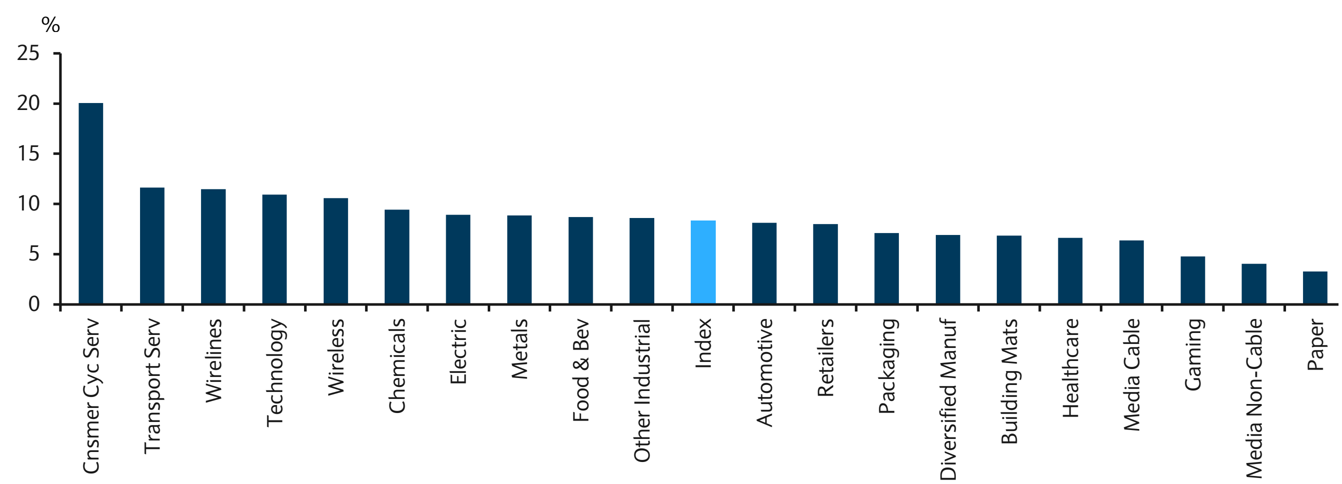

Source: Barclays Research

## Sector selection grows in importance

With 2014 total returns expected to be in the mid-single digit range and quality spreads having compressed significantly over the past two years, we believe one of the most important sources of relative performance next year will be in sector selection. Unlike returns across quality levels, which we expect to vary by only 200bp next year, sector by sector returns can diverge significantly even in years where the overall market return is close to coupon. As Figure 10 shows, 2013 has been no exception, with five sectors delivering double-digit YTD total returns through the end of November, including consumer cyclical services at nearly 20%. At the other end of the spectrum, several sectors have lagged the market significantly, including noncable media, gaming, and paper, all of which have delivered total returns of just 3-5%. Given that some high yield sectors are highly concentrated in just a few issuers, we expect performance dispersion of a similar magnitude in 2014, offering significant opportunities for outperformance.

FIGURE 10

**YTD total returns for non-financial sectors representing at least 1.5% of the Pan Euro High Yield Index by market value**




Source: Barclays Research

FIGURE 11

**European high yield sector comparison and ratings**

| | Basic stats | | | | Strategy considerations | | | | Valuation | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Industry | Total Par (€bn) | YTW | OAS | OAD | % Constrained | Ratings Profile | Duration | % Periph | Raw OAS | Adj OAS | Rating |
| Aerospace/Defense | 3.5 | 4.54 | 333 | 5.7 | 18.5% | High | Long | 63.1% | -32 | 35 | UW |
| Automotive | 30.2 | 3.37 | 290 | 3.0 | 17.8% | Medium | Medium | 40.9% | -75 | -30 | UW |
| Banking | 53.8 | 5.77 | 375 | 3.3 | 2.6% | Medium | Medium | 49.6% | 11 | 15 | OW* |
| Building Materials | 17.1 | 3.29 | 268 | 3.6 | 4.0% | High | Medium | 12.5% | -97 | -24 | UW |
| Chemicals | 6.4 | 3.28 | 284 | 2.5 | 52.1% | Low | Short | 0.0% | -81 | -103 | UW |
| Construction Machinery | 2.4 | 3.93 | 351 | 2.5 | 56.5% | Medium | Short | 53.1% | -14 | 19 | MW* |
| Consumer Cyclical Services | 4.8 | 5.53 | 491 | 2.8 | 55.0% | Low | Medium | 35.7% | 126 | -36 | MW* |
| Consumer Products | 3.2 | 6.48 | 563 | 2.9 | 62.7% | Low | Medium | 15.0% | 198 | -4 | MW |
| Diversified Manufacturing | 9.2 | 3.14 | 272 | 2.8 | 40.0% | Medium | Medium | 0.0% | -93 | -28 | UW |
| Electric | 11.5 | 3.96 | 323 | 3.8 | 10.7% | High | Medium | 81.0% | -42 | 50 | OW |
| Food And Beverage | 6.1 | 3.94 | 332 | 2.4 | 68.4% | Medium | Short | 8.2% | -33 | -24 | MW |
| Gaming | 4.1 | 10.44 | 897 | 2.5 | 45.6% | Low | Short | 30.8% | 532 | 174 | OW |
| Healthcare | 7.5 | 4.94 | 402 | 3.4 | 28.4% | Medium | Medium | 2.7% | 37 | 4 | MW* |
| Media Cable | 17.8 | 4.91 | 397 | 3.5 | 65.6% | Low | Medium | 8.7% | 32 | 10 | MW |
| Metals And Mining | 3.7 | 3.61 | 314 | 3.0 | 22.8% | High | Medium | 7.5% | -51 | 13 | UW |
| Packaging | 7.8 | 4.72 | 411 | 2.3 | 59.8% | Low | Short | 41.1% | 47 | -26 | MW* |
| Paper | 4.3 | 5.59 | 478 | 3.5 | 36.9% | Medium | Medium | 34.0% | 113 | 54 | UW* |
| Retailers | 5.2 | 6.92 | 544 | 4.1 | 38.0% | Low | Long | 0.0% | 180 | 33 | OW |
| Technology | 2.4 | 4.76 | 414 | 3.3 | 20.8% | Low | Medium | 0.0% | 50 | -26 | MW* |
| Transportation Services | 7.5 | 5.55 | 480 | 3.0 | 42.5% | Low | Medium | 24.8% | 116 | 36 | OW* |
| Wireless | 8.4 | 4.91 | 460 | 1.3 | 90.8% | Low | Short | 43.8% | 95 | 44 | OW |
| Wirelines | 28.9 | 4.38 | 324 | 4.1 | 1.2% | High | Long | 87.5% | -41 | 12 | MW |

% Constrained: the percent of total par that is currently trading to its next call from a yield-to-worst standpoint (i.e., YTW calculation references the next call price).
Ratings profile: weighted average credit agency rating. High = at least one notch better than overall index; Low = at least one notch worse than overall index.
Duration: weighted average option-adjusted duration. Long = at least ¾ year longer than overall index; Short = at least ¾ year shorter than overall index.
% Peripheral: the percent of total par that is from credits domiciled in European peripheral countries.
Raw OAS Relative Valuation: Sector OAS minus Pan Euro HY Ex-Fin Index OAS
Adj OAS Relative Valuation: Sector OAS minus a quality- and duration-equivalent benchmark OAS.
*-Note: Sector ratings with an asterisk denote strategy recommendations – these sectors are not rated by Barclays fundamental credit research analysts.
Source: Barclays Research

In considering sector selection, we note that a number of factors are relevant, including fundamental economics, the potential for M&A, issuer concentration, overall quality profile, starting valuations, duration exposure, the presence or absence of call constraints, and aggregate peripheral exposure. These factors are summarized, along with basic index statistics and our ratings for the major sectors in European high yield in Figure 11.

## Sector overweights

*Banking* – Bonds in the high yield banking sector generally fall into one of two groups: senior unsecured bonds from a few peripheral banks, and subordinated instruments (including hybrid capital) from a broad selection of banks that carry investment grade senior unsecured credit ratings. In aggregate, the banking sector carries above average yield and spread despite its average quality and duration profile, while offering significant exposure to the shrinking peripheral premium. As banking analyst Jonathan Glionna recently noted in *Three-dimensional capital*, 25 November 2013, the increased focus on total capital ratio, the CET1 ratio, and the leverage ratio should further the ongoing balance sheet improvement at European banks. See also the global hybrid capital section of this publication for further details on our outlook for financial hybrids.

*Electric Utilities* – A call on high yield utilities effectively comes down to a call on Electricidade de Portugal (ELEPOR), which represents 60% of the sector by par amount. As our fundamental analyst Tom Southon recently noted in *EDP - Deleveraging commitment reaffirmed*, 1 November 2013, Q3 results demonstrated that management is committed to keeping the company on its deleveraging trajectory. Even beyond ELEPOR, the sector offers additional exposure to the shrinking peripheral premium through other credits, which we believe will be a source of outperformance in 2014.

*Gaming* – The performance of CODERE has caused the gaming sector to be one of the worst performers in 2013. However, with the story there having largely played out, the focus in 2014 will be on other credits. Even after CODERE is excluded, gaming trades more than 120bp wide of the index in raw OAS terms, and close to 80bp wide on a quality- and duration-adjusted basis. With outsized peripheral exposure on top of a lower-than-average credit rating profile, this is a high beta sector that should deliver above-average total returns in the context of a tightening overall market.

*Retail* – Although longer than average in duration and lacking peripheral exposure, this sector carries above average spread relative to its quality and duration profile, as investors have been sceptical of any durable improvement in consumer spending habits. We believe this sector stands to benefit from the improved consumer confidence that should eventually accompany multiple consecutive quarters of economic growth. Fundamental analyst Karine Elias is particularly positive on names such as New Look, House of Fraser, SMCP, and Maisons du Monde, as she details in *Shopping for fall/winter trends*, 4 October 2013.

*Transportation Services* – Unlike several of the sectors referenced above, transportation is highly diversified, containing 15 different credits. Although many are not covered by our fundamental analysts, we favour the sector's superior carry, reasonable duration, and cyclical exposure to an improving economic outlook.

*Wireless* – Despite its extremely short average duration, owing in part to a large number of bonds trading to near-term calls, the wireless sector still carries above-average yield and spread thanks to its lower credit ratings profile. Three credits dominate the wireless index: Matterhorn Mobile, Sunrise Communications, and Wind Telecomunicazioni. Fundamental analyst Dan Rekrut is constructive on all three.

## Sector underweights

*Aerospace/Defense* – This sector comes down to a call on Finmeccanica, which represents 63% of total par (the rest comes from Bombardier). Fundamental analyst Darren Hook just downgraded the credit to underweight, and it remains on negative outlook at both Moody's and Fitch (see *Guidance cut to trigger a sharp fall in valuations*, 8 November 2013, for details).

*Automotive* – As the largest non-financial sector in European high yield, automotive contains a number of our largest individual credits, including Peugeot, Renault, and Schaeffler. Driven by expectations of a cyclical recovery in auto sales, the sector already trades tight on both an absolute and quality/duration-adjusted basis. Moreover, average fleet age is much lower in Europe than in the US, suggesting that a real rebound in sales could still be at least a year or two away.

*Building materials* – As another large sector dominated by fallen angels, the performance of building materials will largely be driven by the outcome for Lafarge and HeidelbergCement. Both credits suffered as 2013 evolved from their outsized exposure to emerging markets (Lafarge and Heidelberg, with the later especially impacted by its exposure to Indonesia) as currency devaluations caused by rising US rates had translational and economic implications. Given our outlook for benchmark rates and E/M growth prospects in 2014, we expect these challenges to persist, driving underperformance for the sector.

*Chemicals* – Although the sector is shorter in duration and lower in quality than the index overall, its combination of high call constraints (>50% of total par is trading to its next call), zero peripheral exposure, and tight spreads on both a raw and adjusted basis suggests that chemicals will have difficulty keeping pace with the market next year. Fundamental analyst Tom Southon continues to like Kerling (see *Maintain Overweight, despite Phase II review*, 11 November 2013), but at less than one-eighth of the sector by par amount, it is unlikely to carry enough weight to drive the overall result.

*Diversified manufacturing* – This sector carries no peripheral exposure, above average call constraints, and tight spreads, providing a combination of below average carry and limited upside in price terms. The largest issuer is ThyssenKrupp, which carries an underweight from fundamental analyst Darren Hook as it struggles to affect a turnaround in operating performance (see *ThyssenKrupp (TKAGR): Three steps forward; two strategic steps back*, 03 December 2013, for details).

*Metals and Mining* – As a higher quality sector trading tight to the index, metals and mining is likely to suffer in a rising rate environment. Moreover, the sector's largest credit is ArcelorMittal, which remains on negative outlook at Moody's and S&P and carries an underweight rating from fundamental analyst Darren Hook despite supportive Q3 results (see *Positive momentum in H2 confirmed*, 7 November 2013, for details).

*Paper* – Although this sector offers above-average spread in both raw and quality/duration neutral terms, we believe top-line industry pressures are likely to lead to further ratings downgrades in 2014. Paper has been the worst performing sector in 2013, a trend we expect to continue until significant capacity rationalization is achieved.

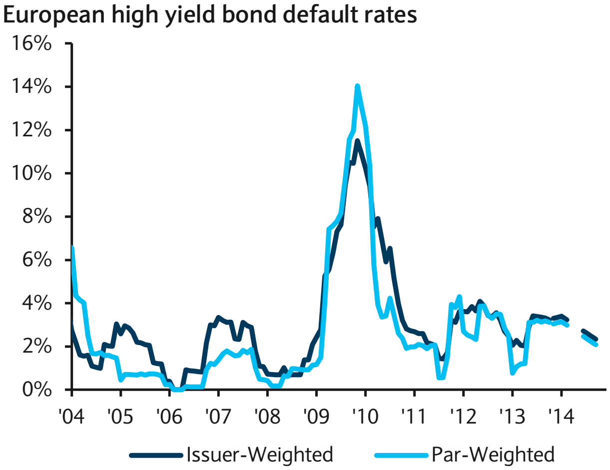
## Defaults are not a key risk for 2014

In both our quality and sector outlooks above, we have recommended increasing exposure to lower quality credits as an appropriate strategy for next year. Underlying this view is our belief that default risk should remain relatively subdued in 2014. Ongoing central bank support should keep refinancing markets open, buying time for highly leveraged credits as they await the benefits of gradually improving economic growth.

As we detailed in our *2014 European high yield default outlook*, 15 November 2013, we take a mosaic approach to analysing European high yield default risk for 2014 by combining three distinct forms of analysis: a macro model using both economic and market signals, a

FIGURE 12

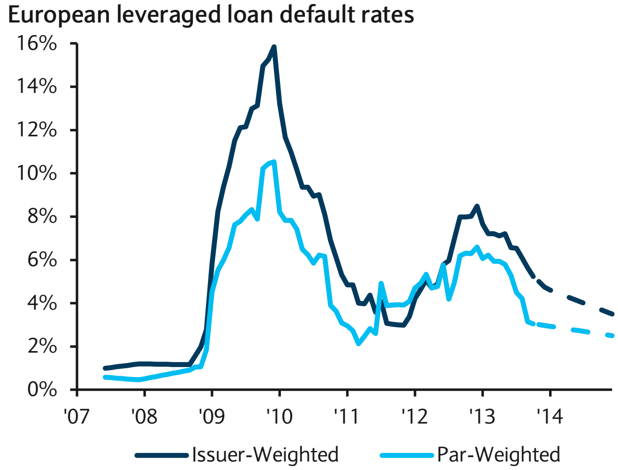
**European high yield bond default rates**




Source: Moody's Investor Services, Barclays Research

FIGURE 13

**European leveraged loan default rates**

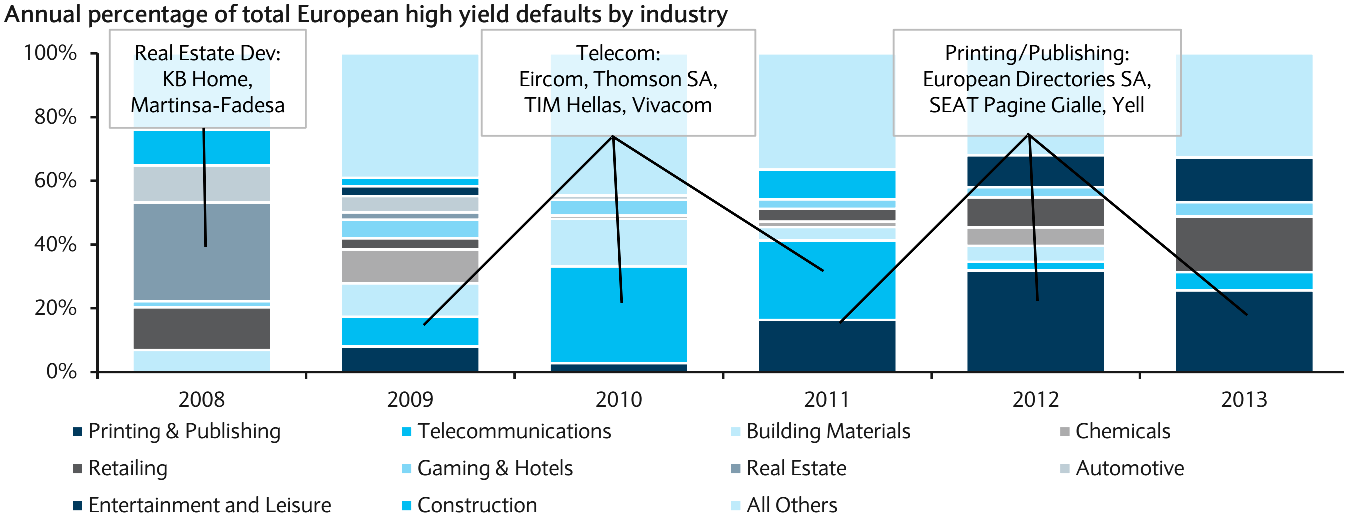



Source: S&P Capital IQ LCD European Leveraged Loan Index, Barclays Research ratings-driven model using aggregate measures of agency actions, and a bottom-up review of stressed credits with input from our fundamental credit analysts. From these three inputs, we derive the following forecasts and key insights:

- Our forecast for the 2014 European high yield issuer-weighted bond default rate is 1.5-2.5%. The par-weighted bond default rate should be similar.
- Our forecast for the leveraged loan default rates is 2.5-3.5%, with the issuer-weighted rate towards the higher end of the range, and the par-weighted rate towards the lower end. Improvements in banks' capital positions should gradually increase their ability to jettison non-performing assets, leaving some of the more troubled smaller loan issuers with few refinancing alternatives.
- The key macroeconomic factors driving our relatively benign default outlook are the persistence and mild acceleration of European economic growth, ongoing loose monetary policy, and loosening lending standards.
- While still useful, we believe market-based metrics such as average index price or quantity of issuers trading at distressed levels currently have lower-than-normal explanatory power for predicting default rates. Central bank stimulus has arguably been more supportive for asset prices than for the real economy, partially altering the relationship between market prices and credit fundamentals. Not surprisingly, market spread-implied default rates are currently extremely low.
- Aggregate ratings migration trends are improving, providing another signal that default rates are likely to decline in the months ahead. However, ratings-based models tend to lose predictive power beyond a six-month time horizon, so we use them primarily to complement our macro and bottom-up approaches.
- At the fundamental level, idiosyncratic default risk appears to be mostly absent from European high yield. Unlike the US, there is limited overhang in Europe from large pre-crisis LBOs or other over-leveraged structures that could drive an increase in defaults in the absence of a more systemic deterioration in credit.
- While new issuance has skewed towards lower quality and aggressive deal features in 2013, we believe macroeconomic factors will largely prevent recent new issuers from defaulting in 2014. However, the increase in B rated debut issuers and also the pickup in PIK dividend deals are likely to contribute to higher default rates in Europe over time.

FIGURE 14

**Annual percentage of total European high yield defaults by industry**




Source: S&P Capital IQ LCD, Barclays Research

- An industry breakdown (Figure 14) shows clear patterns of default concentrations, including real estate development leading up to the 2008 credit crisis, overleveraged telecoms in its aftermath, and more recently a pickup in retail and print media defaults as technology changes alter consumers' shopping and media consumption habits. While the outlook for retail sales is slowly improving, excess capacity in the paper sector suggests that the recent concentration of defaults in that area could persist.

## Peripheral risks (and premiums) are still falling

Our sector recommendations also characterize peripheral exposure as a positive, rather than as a source of incremental risk. In particular, the outsized peripheral exposure of electric utilities and wireless is a factor in their overweight ratings, while our underweights in building materials, chemicals, diversified manufacturing, and metals & mining are driven at least in part by the lack of peripheral credits in these sectors. As we described in *Peripheral vision*, we expect the systemic components of peripheral premium to fall further in 2014, delivering incremental outperformance.

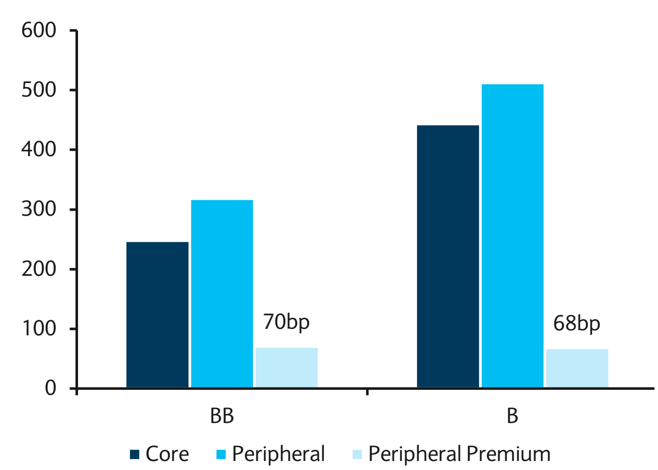
That said, the upside in peripheral credits is becoming more limited following two years of consistent spread compression. The beta of peripherals to the broader market, currently 1.2 on a 60-day trailing basis, has declined considerably relative to 2012, when it averaged almost exactly 2.0 (Figure 15). Following the downgrade of Telecom Italia, the peripheral premium is fairly evenly distributed across the major quality buckets, after previously being more concentrated in single-Bs. On a ratings-matched basis, the peripheral premium for single-Bs is now 68bp, while BBs stand at 70bp on average (Figure 16).

More importantly from a strategy perspective, the premium is also differently distributed across credit curves for the higher and lower quality parts of the market. For BBs, the premium is reasonably uniform beyond the three-year point on the duration curve (Figure 17), while for single-Bs peripherals tend to pay more at the front of the curve (Figure 18). We believe this reflects investor uncertainty regarding the ability of lower quality peripherals to refinance upcoming maturities. This reluctance is somewhat misplaced, in our view, given that the high yield primary market has been increasingly accommodative to peripheral credits over the past two years. Indeed, an issuer's peripheral status no longer has meaningful explanatory power with regards to all-in new issue yields, while peripheral issuance volumes have risen to an all-time record this year. We recommend positioning to take advantage of further peripheral refi trades in 2014.

FIGURE 15
**Rolling 60-day beta of peripherals to Pan-Euro high yield**

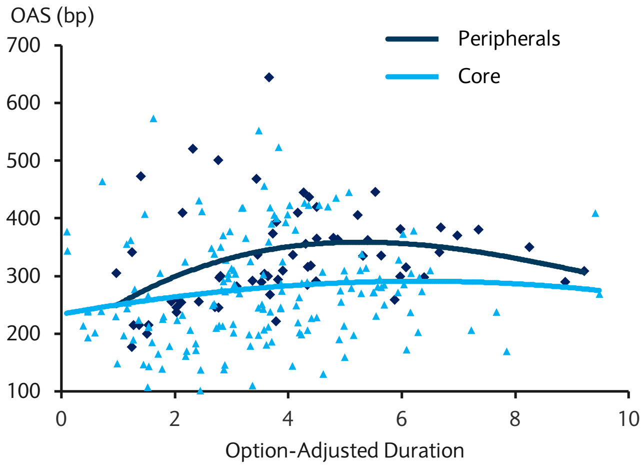

Source: Barclays Research

FIGURE 16
**Average OAS by quality, peripheral vs. core (bp)**



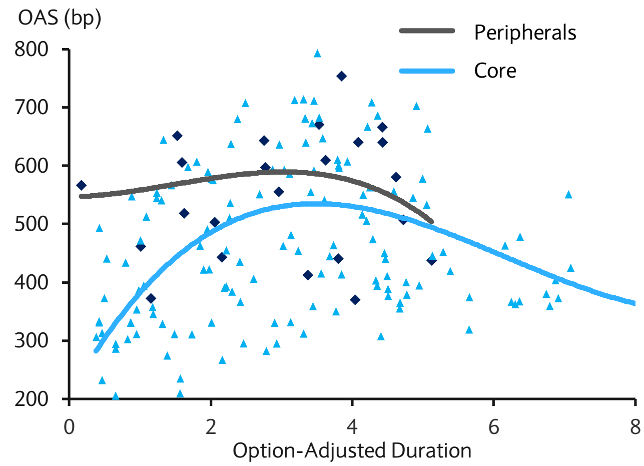

Source: Barclays Research

FIGURE 17
**BB rated peripheral and core aggregate credit curves**




Source: Barclays Research

FIGURE 18
**B rated peripheral and core aggregate credit curves**



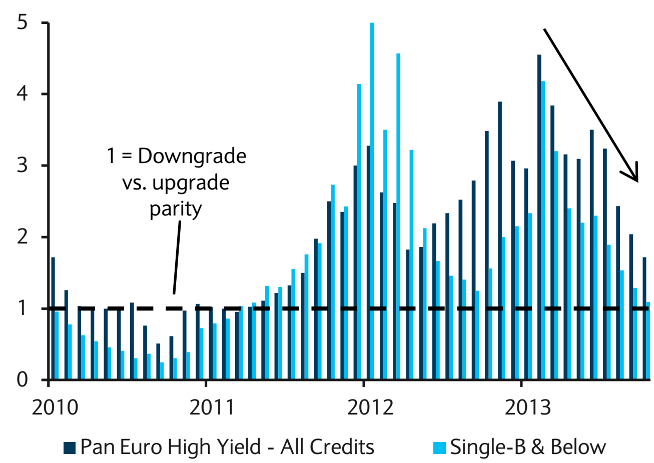

Source: Barclays Research

## The risk of mass downgrades also appears contained

In *Global Credit Outlook 2013*, while downplaying its likelihood, we labelled the risk of mass sovereign-linked downgrades of Italian or Spanish corporates to high yield as "the elephant in the room." Fortunately, that potentially very challenging outcome did not come to pass in 2013, and in our view, it is increasingly unlikely to do so next year either. Rather, as we noted in our *2014 rising star/fallen angel outlook*, 11 October 2013, we believe the key theme for ratings actions next year will be the re-coupling of ratings and growth, as sovereign linkages and other factors diminish in importance.

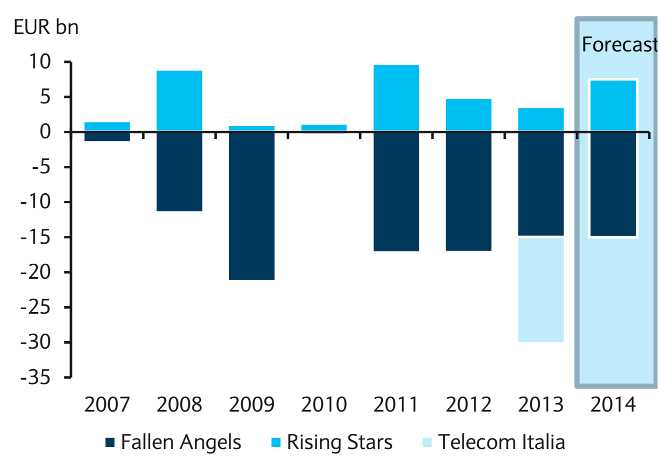
Based solely on rating agency outlooks, the opportunity for 2014 fallen angels appears to be much larger than for rising stars. For non-financial corporates, the total amount of debt with a Ba1 index rating that is on positive outlook and/or upgrade review/watch at one or more agencies is just €7bn. By comparison, the total amount of Baa3 index debt with a negative outlook or downgrade review/watch is €99bn. However, many of these negative outlooks are the result of methodological linkages with the agencies' outlook for the associated sovereign.

FIGURE 19
**Six-month trailing downgrade-to-upgrade ratio in high yield**




Source: Moody's Investor Services, Barclays Research

FIGURE 20
**Non-financial fallen angels and rising stars (with 2014 est.)**




Source: Barclays Research

We believe ratings agency actions, in the form of actual upgrades and downgrades, are a more meaningful signal of credit quality trends. In that regard, the outlook has improved considerably: the trailing six-month downgrade-to-upgrade ratio has fallen consistently throughout 2013 and now stands closer to parity than at any point since H1 11 (Figure 19).

Fallen angels have outweighed rising stars for both financials and non-financials in each of the past six years, with a total €268bn in fallen angels against €60bn in rising stars from 2008-13 (a 4.5:1 ratio). We believe that the ratio in 2014 should not be nearly as severe, reflecting our expectation of a re-coupling of GDP and credit ratings, along with the generally improved economic outlook for Europe. After augmenting agency outlooks with the views of our own fundamental analysts, we expect €10-20bn in non-financial fallen angels next year. Conversely, we expect €5-10bn in non-financial rising stars, most likely including some credits that are not currently at the cusp of investment grade but that will ascend multiple notches due to M&A activity.

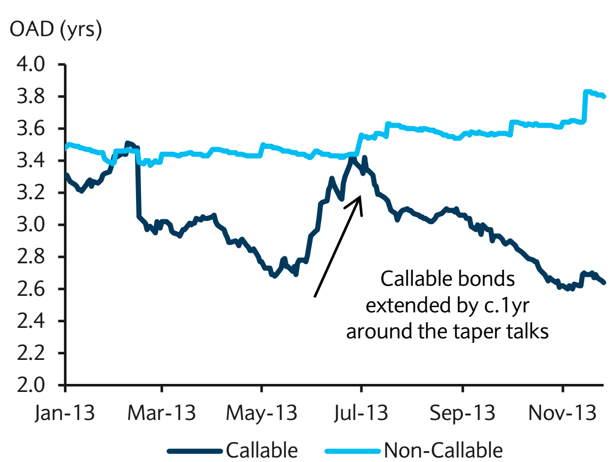
If realized, these totals would push the fallen angel to rising star ratio to approximately 2:1, making 2014 potentially the most balanced year across the IG/HY threshold since 2007 (Figure 20). In any case, we do not expect a deluge of downgraded peripheral credits to overwhelm the high yield market in 2014, as was widely feared a year or two ago. Moreover, the market's reasonably muted reaction (so far) to the recent downgrade of Telecom Italia is very encouraging, and suggests that even very large fallen angels can be absorbed provided they are flagged sufficiently far in advance.

## The key risk to manage in 2014 is duration

If our rates team's forecast is correct, duration exposure is the primary risk that fixed income investors will need to manage in 2014. Fortunately, European high yield's very low duration keeps this risk at manageable levels, and the traditionally negative correlation between rates and spreads provides some cushion. Given central banks' increasing focus on using forward guidance as a policy tool, we do not expect a repeat of the scenario that took place in May/June, where a somewhat disorderly rate backup was exacerbated by spread widening. Moreover, our recommendation to underweight BBs will naturally reduce investors' duration exposure.

FIGURE 21

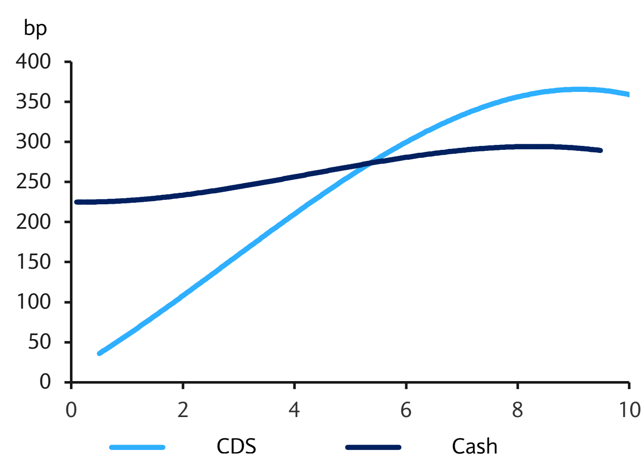
**Duration of callable and non-callable bonds**




Source: Barclays Research

FIGURE 22

**Aggregate CDS and cash curves for BB rated credits**




Source: Barclays Research

Beyond that step, we believe that investors can also mitigate their duration risks by rotating into CDS, for several reasons. First, bullet CDS does not have the same direct exposure to rates as cash bonds. Second, given its superior convexity profile, CDS can normally be expected to outperform call-constrained bonds in an upside (ie, spread tightening) scenario, while also overcoming extension risk in a downside (ie, rate sell-off) scenario. Call-constrained bonds, while nominally of short duration, can contain material extension risk in the event of a rate-driven selloff, increasing downside exposure when it is least desired. This exact scenario unfolded earlier this year, as the duration of the callable part of our market went from 2.7 to 3.4 over the span of just a few weeks when many bonds abruptly extended past their next call date (Figure 21), while the duration of bullet bonds held steady. While bonds that are deeply call constrained are not particularly at risk of extending in our base case scenario for next year, investors should consider swapping out of bonds that are on the cusp of call constraints, where convexity is at its worst, and into either short-dated bullets or CDS.

We also recommend that investors capitalize on the divergence between CDS and cash curves to reduce exposure to long-end rates. CDS curves are materially steeper than cash curves for BB rated credits, which are the primary source of long-end rate exposure in our market (Figure 22). Given the current steepness of CDS curves relative to cash, investors can benefit from superior roll-down by expressing longs via CDS. Moreover, as we highlighted in *Dodging duration*, 15 November 2013, there are several cases where investors can pick up spread by switching out of long-dated cash and into five-year CDS, despite the fact that CDS-cash basis has already compressed meaningfully this year.

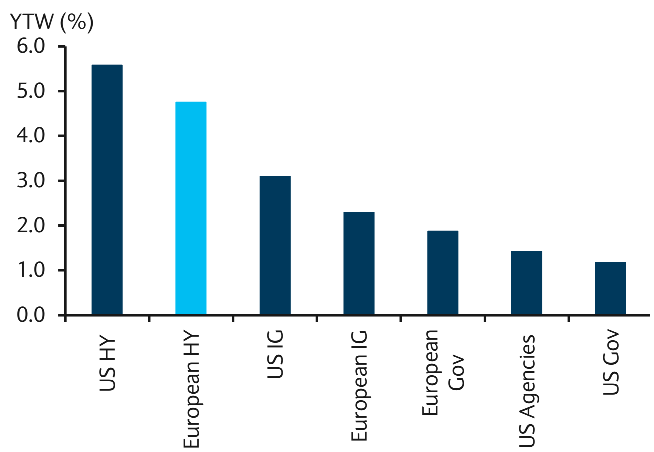
## Strong demand will be met by opportunistic supply

### Still in the sweet spot

We believe European high yield continues to occupy something of a sweet spot in a world that is increasingly duration-averse, yet still yield-seeking. Among major fixed income asset classes, only the US high yield market offers materially higher all-in yields, owing to its lower average quality profile and a higher underlying rate component (Figure 23). Meanwhile, European high yield is by far the lowest duration fixed income asset class, at barely more than three years on average (Figure 24). The return of economic growth and the associated decline in systemic risk has provided the “third leg” of the stool, in the form of an improving outlook for fundamentals.

FIGURE 23

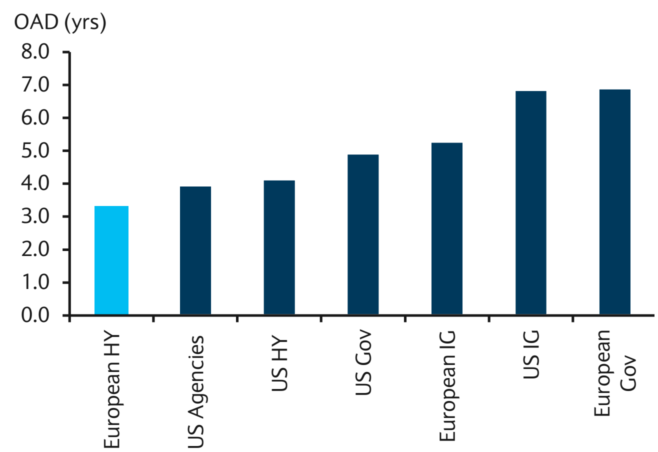
**Average yield to worst for various fixed income asset classes**




Source: Barclays Research

FIGURE 24

**Average duration for various fixed income asset classes**




Source: Barclays Research

FIGURE 25

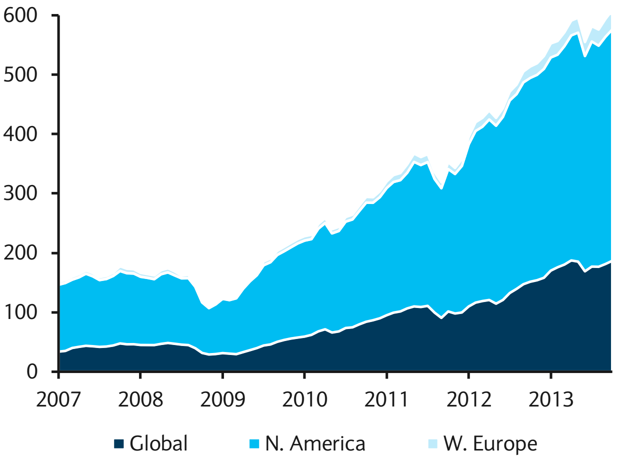
**Estimated Pan-Euro high yield market share by buyer type**

| Investor type | % of market held |
|---|---|
| Retail* | 25-30% |
| UK Insurance and Pension Funds | 10-15% |
| EU Insurance and Pension Funds | 15-20% |
| IG Funds | 10-15% |
| Hedge Funds | 15-25% |
| CLO | <5% |
| Other | 5-10% |

Source: Barclays Research

FIGURE 26

**High yield mutual fund AUM by region ($bn)**




Source: EPFR Global, Barclays Research

This powerful combination has caused a surge in demand for European high yield in 2013, particularly from retail buyers which collectively hold the largest share of the market, and are also growing the fastest (Figure 25). We expect these advantages to persist in 2014, suggesting that the market should continue to benefit from a firm technical backdrop. In particular, as we described in *A tale of two markets*, 27 September 2013, high yield managers with global mandates appear to be increasing their aggregate allocation to European high yield, after having been consistently underweight over the past few years. EPFR Global reports that this buyer base has nearly $200bn in total AUM, dwarfing the size of dedicated European retail funds (Figure 26). As a result, comparatively small changes in global funds' allocations to Europe can produce significant marginal demand in absolute terms.

## 2014 supply: opportunistic and issuer-friendly, but not onerous

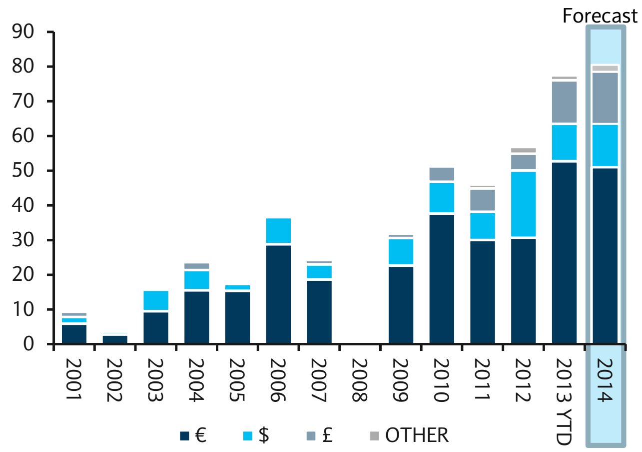
2013 has been a second consecutive record supply year for European high yield, as low volatility has kept primary markets open all year, with the exception of a few weeks in June when rate volatility caused a brief soft spot in the new issue calendar. Even that episode was ultimately encouraging, however, as the majority of affected deals re-emerged just a few weeks later as conditions quickly improved. We expect 2014 to be broadly similar, as central banks' emphasis on forward guidance should help to keep a lid on volatility even as the Fed takes the first steps towards eventual policy normalisation.

As we described in our *2014 supply forecasts*, 4 October 2013, we expect approximately 75-85bn EUR-equivalent in gross high yield bond issuance, including €45-55bn in euro, £10-15 in sterling, and $15-20bn in dollars (Figure 27). The higher end of this forecast would represent only a slight y/y increase relative to 2013, which we expect will finish at approximately €80bn. While an increase in callable debt (Figure 28) and an expected pick-up in M&A and LBOs appear poised to drive supply growth, a potential deceleration in the bond-for-loan take-out trade, driven by renewed demand from resurgent new CLO creation, causes us to temper our expectations.

As was the case in 2013, we do not expect this large influx of supply to weigh on spreads next year, because little if any of it will be forced. Two years of accommodative primary markets have provided issuers with an ample refinancing window, resulting in an aggregate maturity profile that features very few near-term hurdles. We believe the main focus for issuers in 2014 will be on continuing to optimize interest costs. With rates ticking higher, issuers with higher coupon callable debt will continue to execute refinancing transactions, even for debt with several years remaining before maturity.

FIGURE 27

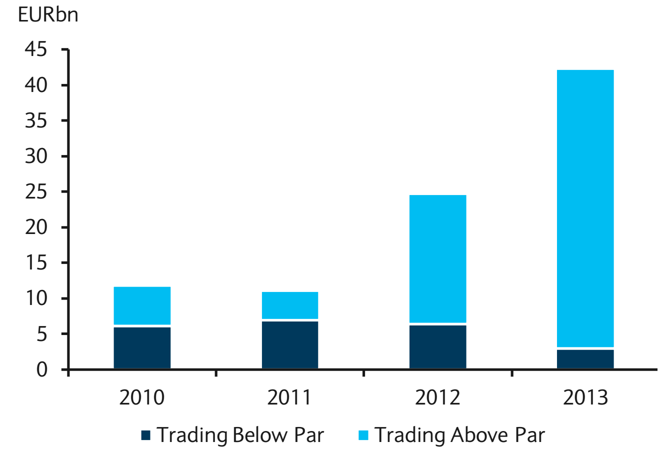
**Annual European high yield issuance by currency (€bn)**




Source: Barclays Research

FIGURE 28

**Index eligible debt callable within the next calendar year**




Note: The bar shows the amount of debt currently callable or callable within the next calendar year at each year end. Source: Bloomberg, Barclays Research

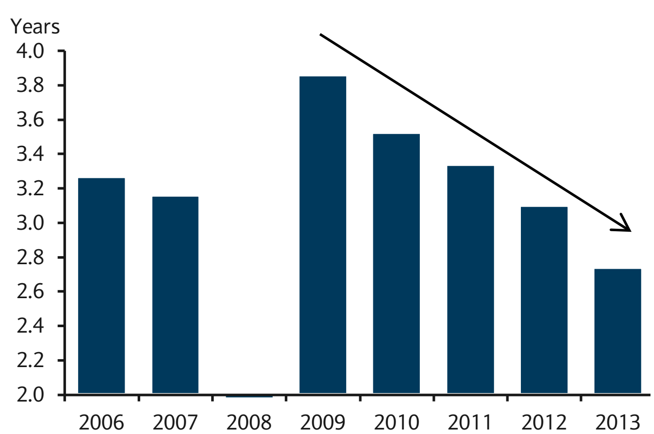
Meanwhile, equity sponsors will continue trying to preserve their operating and financial flexibility, with an eye towards eventual exits. Although improved relative to the past few years, IPO markets in Europe have not yet become sufficiently accommodating to allow sponsors to execute widespread exits from their pre-crisis investments. As a result, sponsor-to-sponsor transactions have been common in Europe, a trend which has given rise to shorter non-call periods (Figure 29) and the contentious issue of portability clauses. Strong demand for European credit has also allowed sponsors to extract dividends while they wait for exit opportunities, a dynamic that has resulted in the largest share of dividend deals since 2006 (Figure 30). These aggressive deal features should persist in 2014, and may contribute to a marginally higher default rate over time, but we do not expect any such consequences to manifest themselves in the near term.

## Debut issuers improve diversity while offering a yield concession

The record pace of high yield bond issuance in 2013 has been boosted by the appearance of numerous debut issuers in the market. In some cases, these credits are entirely new to leveraged finance, but more often they are only new to the bond market because of shifts in their financing mix. This continued influx of new names has had several beneficial effects.

FIGURE 29

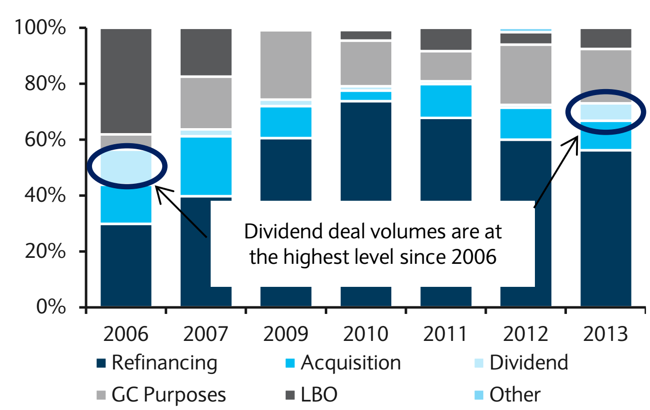
**Average non-call period by year of issue**




Source: Barclays Research

FIGURE 30

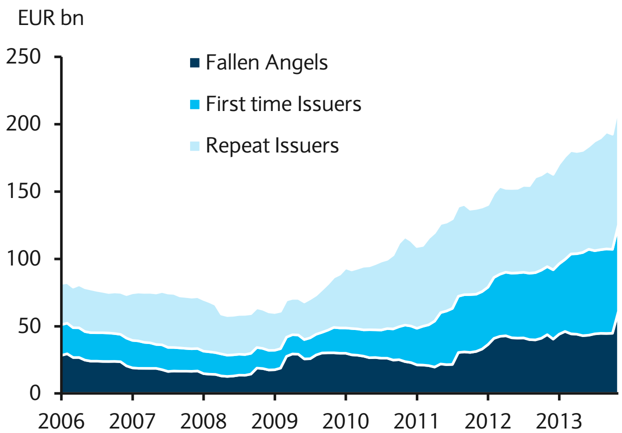
**New issue use of proceeds**




Source: Barclays Research

FIGURE 31

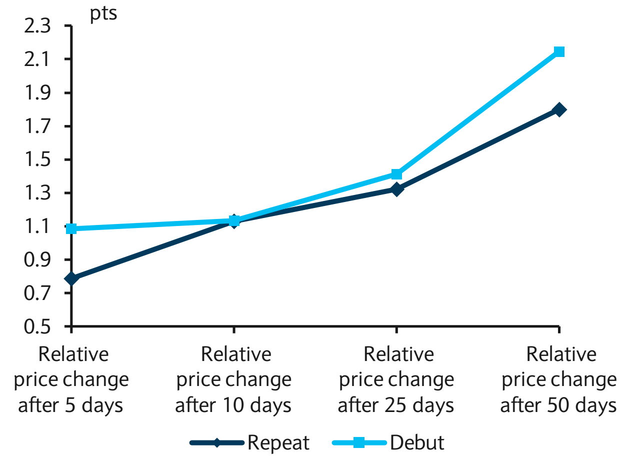
**European high yield par outstanding by issuer type**




Note debut issuers defined on a bond basis. If a bond is issued from a debut issuer then it is counted as a "first time issue" for the remainder of existence. When re-issuing it is classified as a repeat issuer. Source: Barclays Research

FIGURE 32

**Debut and repeat issuer relative performance**




Note: Graph shows the average relative price change versus a quality adjusted index. Source: Barclays Research

First, it has been a meaningful driver of high yield bond market growth (Figure 31). So far this year, 75 debut issuers have accessed the high yield primary market, pricing 28.8bn EUR-equivalent in new debt, representing 37% of total YTD issuance. Further, the continuous addition of new credits has helped reduce concentration concerns by increasing issuer diversity in the high yield market (although large fallen angels like Telecom Italia continue to have an opposing effect). Debut issuers tend to be lower rated (usually single-B) compared with the broader cash market, helping to fill out a quality profile that has historically been dominated by BB names.

In addition to providing diversification benefits, debut issuers also typically offer a significant yield premium to compensate bond investors for their unfamiliarity. After controlling for various factors that normally contribute to new issue yield, including peripheral exposure, rating, overall index yield at the time of issuance, size, and callability, we find that debut issuers have provided a statistically significant average yield premium of 1.2% over the past two years (See: *Debut offerings shine brightly*, 6 September 2013). A portion of this yield premium is recouped in relatively short order by investors, as debut issues have outperformed the market on average by more than a point in the first week after issuance, and by more than two points over a 10-week period (Figure 32). While the pace of debuts could slow a bit next year as the loan market approaches self-sufficiency, we believe investors will continue to have opportunities to harvest this premium, provided they can invest the necessary time to learn new credits.

## Crossing currencies and borders

### US versus Europe – tactical relative value

With global high yield managers increasingly focused on Europe, the evolving relative value between Europe and the US continues to be topical. After trading cheap for the past several years, "European premium" compressed significantly in 2013, as peripheral sovereign risks abated and growth finally emerged. Europe is now only 14bp wider than the US on a quality adjusted spread basis compared to over 200bp at the start of 2012 (Figure 33). While this relationship may not be completely justified fundamentally given Europe's slower growth rate and more fragmented financial system, the attractiveness of Europe's less daunting rate exposure is such that this newfound spread parity is most likely sustainable.

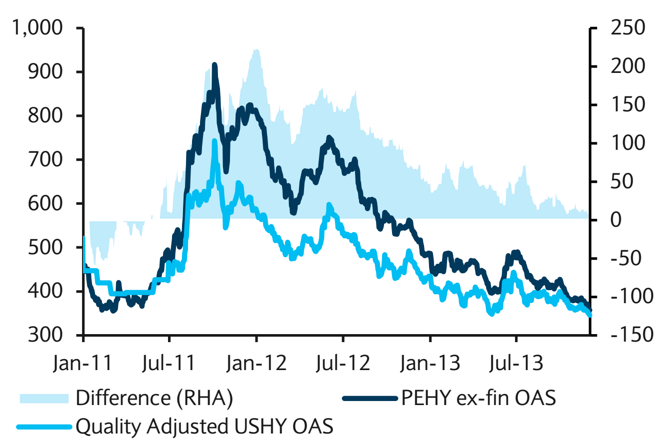
Given that the two markets are broadly trading flat to one another, we believe investors need to be increasingly tactical around allocating across the two geographies. Interestingly, the overall "in line" relationship breaks down at a more granular level. Dissecting the two markets by quality, we find that European Bs still trade roughly 75bp cheap to the US on a spread basis, while European BBs trade approximately 25bp inside. The stark difference across quality buckets suggests that US investors are duration averse, but still wary of lower quality European credit. The potential for US investors to pick up spread by moving into European single-Bs further supports our positioning recommendation in favour of an overweight in lower quality.

On an all-in yield basis, the relative moves in benchmark rates across the two regions have left US high yield trading cheap to Europe (Figure 35). Given that many European credits issue in both markets, investors have recently had opportunities to pick up yield by moving from the euro- to the dollar-denominated security, while keeping duration broadly constant. While this trade does not change underlying credit exposure, it does change exposure to rates, which we expect to rise more quickly in the US, potentially undermining the yield advantage. In our view, US vs. European relative value will need to be managed tactically in 2014, as cross-border volatility is likely to make each market relatively more or less attractive at various points throughout the year. For example, as we highlighted in *Swaps for avoiding ETF-driven volatility*, large swings in US fund flows, along with the ETF share create/redeem process, can drive significant volatility in ETF bonds (Figure 34), causing temporary dislocations within cross-border issuer cap structures.

## Overweight sterling HY

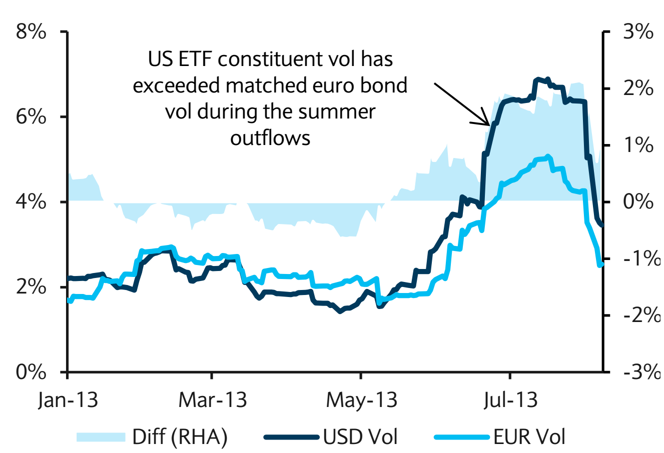
Sterling-denominated issuance has been a large growth area for the European high yield market. As a proportion of the overall Pan Euro HY ex-fins index, sterling currently represents over 15% by market value, compared with just 11% at the start of the year. We recommend that investors take an overweight position in sterling-denominated high yield, for several reasons. First, sterling continues to trade cheap relative to euro-denominated high yield on a quality-adjusted basis, primarily as compensation for the market's relatively lower liquidity (Figure 36). Given our overall constructive outlook for credit in 2014, we believe it is worthwhile selectively moving down in liquidity to capture this additional spread.

FIGURE 33
**Quality-adjusted time series of Europe vs. US**




Note: Based on the ex-financials index. Source: Barclays Research

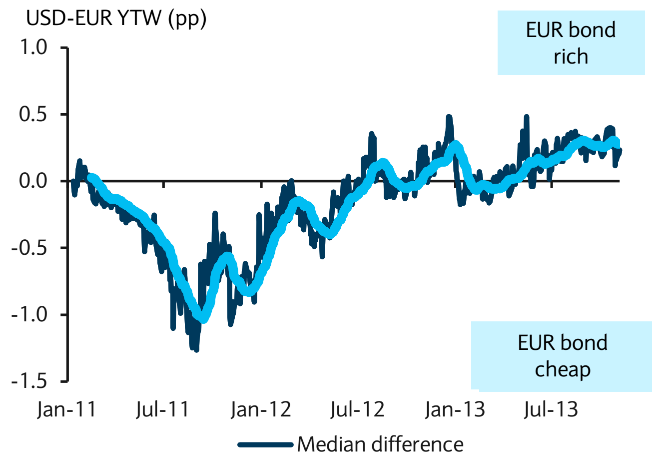
FIGURE 34
**ETF-eligible bonds are susceptible to greater volatility**




Source: Barclays Research

FIGURE 35

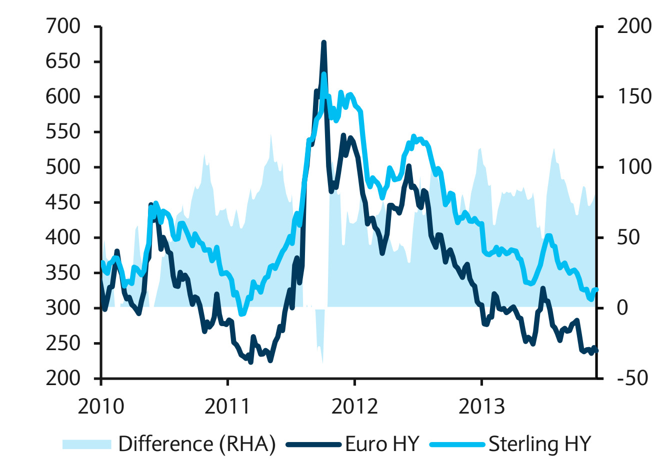
**Cross-border issuer US versus Europe relative value**




Source: Barclays Research

FIGURE 36

**Sterling versus euro BB spreads (bp)**




Note: Based on L-OAS Source: Barclays Research

Looking beyond the liquidity premium, the sterling high yield universe is also concentrated in names with favourable fundamental outlooks (UK retail, VMED, TTMTIN, etc.), due in part to their exposure to a UK economy that is improving more quickly than the European continent overall. That said, a consequence of this better growth outlook is a slightly greater exposure to duration risk in sterling bonds. Our rates strategists expect further gilt underperformance in 2014 versus the bund, given the different points in the interest rate cycle of the two central banks. While this could potentially weigh on sterling high yield total returns, FX is likely to provide a natural hedge. Overall, we believe that there is sufficient spread premium in sterling bonds to offset the forecast differences in underlying rate moves.

## European leveraged loans: looking up at last

As we noted in *2014 supply forecasts*, 4 October 2013, next year could be a watershed moment for the European leveraged loan market, as the gradual resurgence of new collateralised loan obligation (CLO) creation allows the loan market to finally stop shrinking. As was the case in the US, the absence of new European CLOs in the wake of the credit crisis caused a significant demand gap that was ultimately filled by bond investors. In the US, this situation lasted for approximately three years, until dramatic growth in CLO creation turned the tables in 2012. Meanwhile, 2013 marks the fifth consecutive year of falling European institutional loan par outstanding, as the bond market has continued to offer an alternate source of financing to formerly loan-only issuers (Figure 37).

On a more positive note, the availability of bond financing has almost certainly helped to curtail loan default risk, providing issuers (and their lenders) with breathing room to weather the twin crises and survive to see 2013's turn in the economic cycle. As a result, the formerly daunting loan maturity wall is now well laddered, with very few remaining maturities over the next 24 months (Figure 38).

With near-term liquidity in reasonable shape for most issuers, and default rates falling, our attention turns to the longer-term health and viability of the market. On this front we are cautiously optimistic that the trough in loan demand and par amount is essentially at hand. Driven by gradually increasing new CLO creation and some amount of crossover demand from bond managers (subject to regulatory constraints that prevent a full scale retail invasion of the space), we believe 2014 will be the year in which the loan market achieves self sufficiency and par stabilization, potentially positioning it for growth in 2015 and beyond.

Excluding repricings, we expect 40-50bn EUR-equivalent in gross institutional leveraged loan issuance next year, of which 70-75% should be in euro, 20-25% in sterling, and c.5% in other currencies. Close to half of the gross volume should be loan-for-loan refinancings, with most of the remainder split between LBOs, M&A, and the occasional dividend deal. While still nowhere near US levels, repricing activity has emerged in Europe this year as well, with approximately €9.8bn in loans having their coupon shaved so far in 2013. Firm market conditions would likely bring a similar amount or more next year.

## Appealing relative value, but capped upside

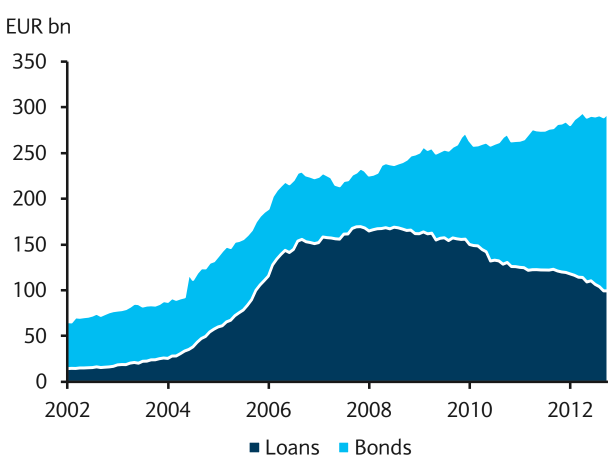
As we highlighted in *Loan approval*, 1 November 2013, European leveraged loans offer several advantages that could be especially appealing in the context of the rising rate environment we expect in 2014. Beyond the obvious duration advantages associated with floating rate instruments, loans typically offer significantly lower volatility, particularly during periods of market stress. Unlike bonds, which are widely held by retail managers that must provide daily liquidity to their end investors, roughly 70% of European institutional loans are held within CLO collateral pools, which have committed long-term financing.

Finally, loans currently look attractive relative to bonds from a valuation standpoint. Figure 39 shows average three-year discount margins (3y DM) for BB rated loans and average option-adjusted spreads (OAS) for BB rated bonds (the single-B comparison chart is similar). At both quality levels, loans currently provide nearly 100bp more spread on average relative to comparably rated bonds. Loans also offer superior downside protection given a median starting price of 99.50 versus 106.00 for bonds in the Barclays Pan-Euro High Yield ex-Fin index, along with higher expected recoveries.

Offsetting these advantages, however, are two key factors that limit loans' potential. First, the loan market's liquidity is lower than what high yield investors are accustomed to in the bond market, which can inhibit cross-asset demand. Perhaps more importantly, the combination of limited (or non-existent) call protection and high trading prices exposes loan spreads to repricing risk. As our US colleagues detail elsewhere in this report, more than half of the US loan market has repriced over the past three years, removing more than 60bp in overall market spread in the process. With nearly half of European loans having bid side marks above par (Figure 40), there is real potential for a pickup in European repricings in the context of a general move tighter in spreads. As a result, European leveraged loans should deliver total returns of 4-5%, as poor convexity limits upside despite the increase in demand for floating rate product produced by a rising rate environment.

FIGURE 37

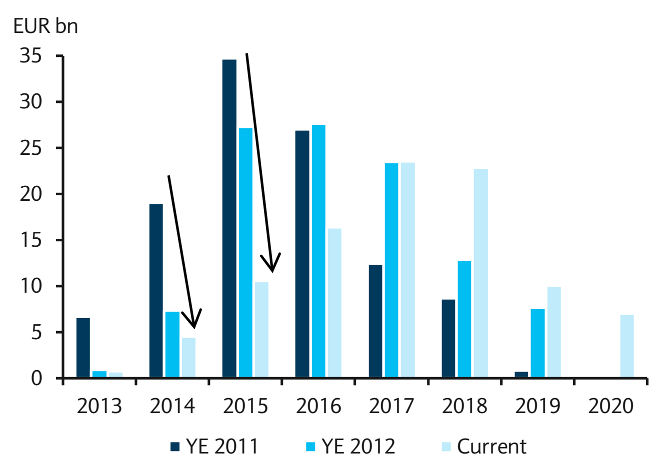
**European high yield bond and loan index par outstanding**




Source: S&P LCD, Barclays Research

FIGURE 38

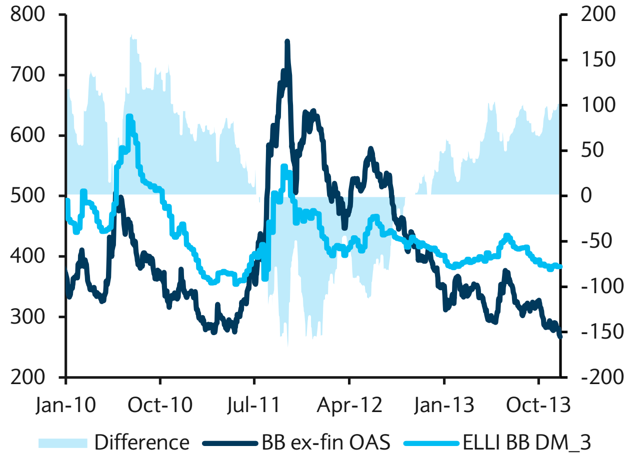
**European leveraged loan index maturity wall**




Source: S&P LCD

FIGURE 39

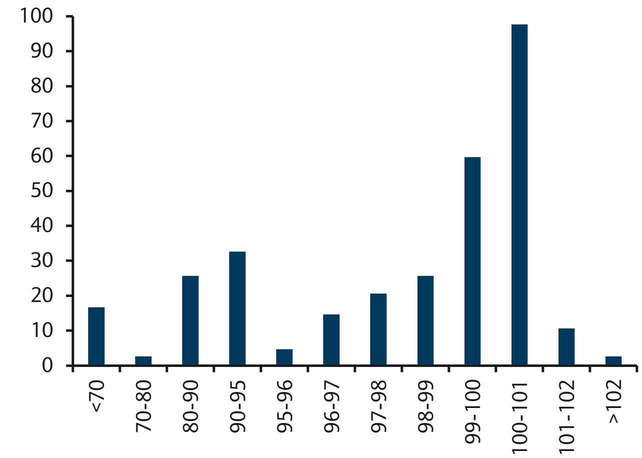
BB rated loan (3y DM) and bond (OAS) spreads (bp)




Source: S&P LCD, Barclays Research

FIGURE 40

European loan index price distribution by loan count




Source: Barclays Research

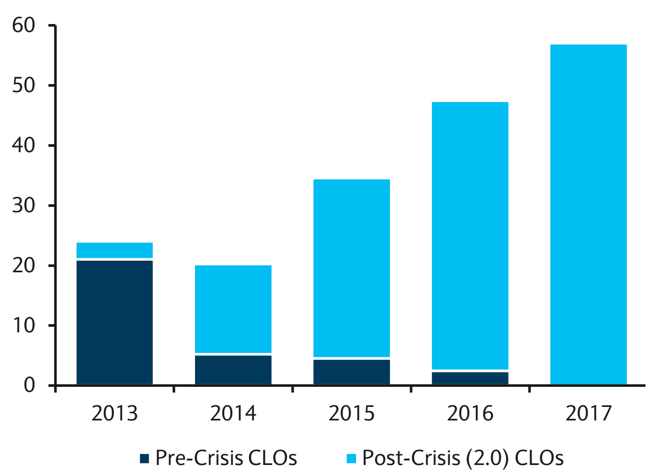
## European CLOs: this year a whisper, next year a shout?

As mentioned above, the four year post-crisis hiatus on new European CLO creation was the primary factor behind the c.35% decline in institutional leveraged loan par outstanding from 2009 through 2012. Fortunately, CLO issuance has restarted this year, with nearly €7bn priced through the end of November. With the full-year 2013 total likely to be in the €7-8bn range despite virtually nothing pricing in the first three months (Cairn CLO III was the only Q1 deal), and a large stable of arrangers competing for market share, we anticipate further growth in new CLO creation next year, to a total of €12-15bn. Growth beyond these levels will be challenging to achieve, given the 5% risk retention requirement that is already binding in Europe.

The timing of this resurgence is welcome, because 2013 represents the peak of pre-crisis reinvestment period exits. By the end of this year, barely €20bn in pre-crisis deals will still be in reinvestment, and by the end of next year this number will drop to less than €3bn. In fact, at some point next year, there will be more CLO 2.0s in reinvestment than pre-crisis deals, and thereafter the reinvestment capacity of the European CLO universe will depend almost entirely on the pace of new issuance. Figure 41 presents one possible path of reinvestment

FIGURE 41

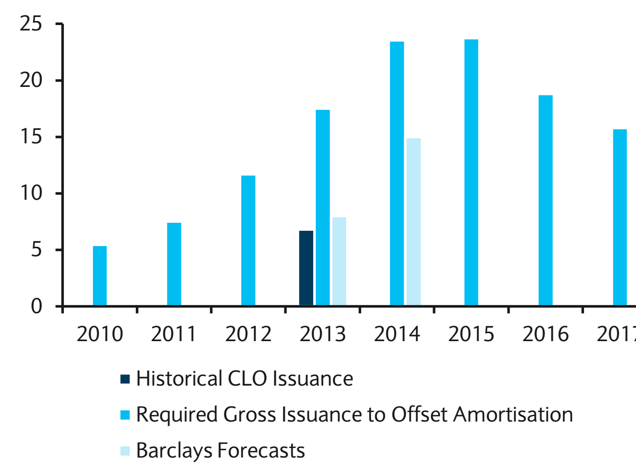
Estimated par amount of CLOs in reinvestment period (€bn)




Source: Intex, Barclays Research

FIGURE 42

Historical and projected CLO issuance versus the amount required to offset amortization of existing structures (€bn)




Source: Intex, Barclays Research

capacity growth, based on an assumption of €12-15bn in new CLO creation per year and a standardized four-year reinvestment period. More rapid issuance growth over the next few years would lead to a correspondingly larger increase in total reinvestment capacity by 2017, at which point this year's crop of deals would themselves begin to run off.

Unfortunately, even €15bn in gross new CLO issuance next year will be insufficient to fully offset the expected pace of legacy amortisation. Using an assumed paydown rate of 25% (slower than the average annual collateral repayment rate of 35% to account for some limited forms of post-reinvestment flexibility), we believe that legacy amortization rates will peak at nearly €18bn per year in 2014-15. If we further assume that 25% of new issue volume represents refinancing of existing asset pools, thus providing no new demand to the loan market, gross CLO issuance would need to reach nearly €24bn next year in order to completely offset amortisation (Figure 42). With risk retention regulations firmly in place, we do not believe an acceleration of this magnitude will occur in 2014, meaning CLO par outstanding will continue shrinking for at least one more year.

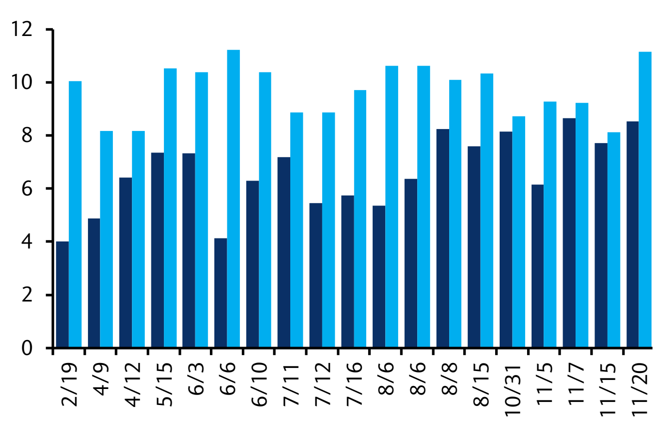
## European CLO 2.0 increasingly resembles US CLO 2.0

While both the US and European new issue markets have been designated "CLO 2.0", there were some important differences when the European market first reopened in early 2013. The first several deals that came to market featured very low leverage – less than 6x on average for CLOs that priced during the first half of the year, compared to 9.4x for US deals during the same period. While CLO leverage is still lower in Europe (St. Paul's CLO III from ICG represents the peak so far at 8.6x), the trend is clearly upward, averaging nearly 8x across the five European deals that have priced in Q4 (Figure 43).

The trend in weighted average European CLO liability spreads is also upward, although at a much more gentle pace, owing to the fact that European spreads were never particularly tight to begin with. Recent European deals have printed AAA coupons at Euribor + 140bp, which is significantly inside the US Q4 average of Libor + 147bp. Slightly wider mezzanine spreads in Europe have kept overall weight average liability spreads comparable to the US (Figure 44). With the leverage gap narrowing and liabilities close to in line, the economics of US and European CLO capital structures are quickly converging.

FIGURE 43

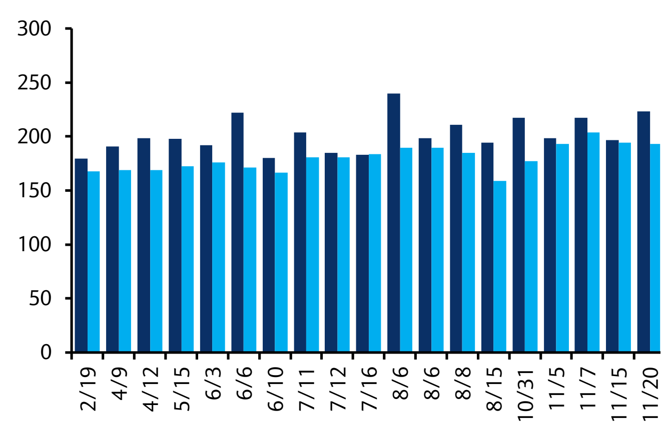
**Turns of leverage to equity in 2013 European CLOs, with the nearest US CLO chronologically**




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

FIGURE 44

**Weighted average liability spreads in 2013 European CLOs, with the nearest US CLO chronologically**




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

On the asset side of the balance sheet, however, meaningful differences still persist. On a like-for-like quality basis, European leveraged loans continue to trade at a healthy spread premium to the US market (16bp for BB rated loans, 44bp for single-Bs), primarily as compensation for their lower liquidity. With increasingly similar liability structures and better collateral spreads, prospective CLO equity returns appear to be marginally higher in Europe at the moment than in the US (although both markets offer lower equity returns relative to historical levels). Meanwhile, collateral buckets in Europe are much different than in the US, reflecting divergences in the underlying loan markets. For example, bond buckets in Europe are often as large as 40%, while US deals are typically 3.5% or 5%. Conversely, the covenant-light (cov-lite) buckets that are often 40% or 50% in the US are usually absent entirely from European CLOs, as the ability (so far) of European investors to avoid the cov-lite loan trend makes explicit limits unnecessary.

# Global hybrid capital strategy

GLOBAL HYBRID OUTLOOK

# New capital, new opportunities

**US Credit Strategy**
Shobhit Gupta
+1 212 412 2056
shobhit.gupta@barclays.com

**European Credit Strategy**
Dominik Winnicki
+44 (0)20 3134 9716
dominik.winnicki@barclays.com

James Simmonds
+44 (0) 20 3134 9554
james.simmonds@barclays.com

## US banks and insurance

- **While preferreds sold off in 2013 as Treasury yields increased, further downside appears limited. We believe that the equilibrium level for preferred yields is only about 50bp wider than current levels even in a significantly higher interest rate environment.**
- **Managing duration risk will be critical in 2014. We recommend buying recently issued perpNC10 fixed-to-float preferreds, which have limited extension risk and should be able to absorb most of rates move expected next year. However, many fixed-for-life securities still appear rich and could fall further in a rising rate environment.**
- **We expect US bank preferred supply of $15-20bn in 2014. Additionally, a significant portion of European bank CoCo issuance is likely to come in USD. After shrinking for three years, the universe of US bank capital securities is likely to grow in 2014.**
- **We believe the most attractive hybrids in the insurance space are the recently issued 40NC10 fixed-to-float hybrids with wide reset coupons that limit their extension risk. Hybrids with 30y non-call periods also appear attractive on a Treasury-hedged basis.**

## European banks and insurance

- **We expect European bank T1s and LT2s to generate 8.5-10.5% and 2-3.5%, respectively, in total returns in 2014.**
- **We prefer T1s and LT2s over senior unsecured bank credit. We recommend positioning for further performance in bank capital via French high-coupon T1s, select short-call T1s and CoCos.**
- **We think that further peripheral/core compression is likely to be one of the sources of value in 2014.**
- **We expect European insurance hybrids to return 7-9% in 2014 (in total return terms). We maintain our call to take advantage of still-attractive valuations and a positive fundamental outlook in the Insurance sector via longs in hybrids. We think there is still value in the perps-dated sub compression trade.**

## European corporates

- **We forecast 2014 total returns of 4-5.5% for European corporate hybrids.**
- **We think corporate hybrids generally look cheap relative to comparable credit sectors, including matched senior debt, bank LT2s, peripheral non-financials and HY credit.**
- **As the economic cycle in Europe finally turns, there should be an increasing proportion of new hybrids issued to fund growth capex and acquisitions and relatively less issuance driven purely by weakening ratings.**
- **We expect the vast majority of the short-call hybrids to be called despite adverse economics in some cases. Exceptions are possible in names that face material deterioration in fundamentals.**

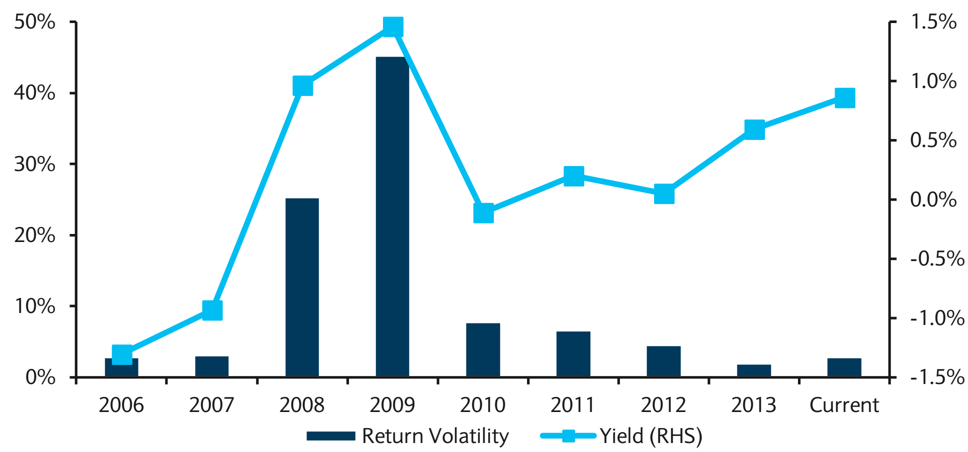
## Hybrids versus credit universe

The unique structure of hybrids means that they have a very different risk profile than the traditional corporate bond universe. Hybrids are deeply subordinated securities that combine features of debt and equity. Many of them are perpetual (with initial non-call periods of 5-10 years) and have deferrable coupons, and CoCos issued by European banks can be written down/converted to equity. Even after adjusting for differences in recovery and deferral risks, we believe hybrids appear cheap relative to senior debt in the US and Europe. In excess return terms, we expect hybrids to outperform senior debt on an absolute- and beta-adjusted basis. With the bulk of the hybrid universe comprising bank securities, strengthening fundamentals should support valuations down the capital structure.

As hybrid yields have backed up with the Treasury sell-off, comparisons with lower-rated segments of the credit market have also become compelling from a total return perspective. In the US, bank preferreds appear attractive compared with high yield bonds, as the S&P preferred stock index (average rating BB+) yields[2] almost 1% more than BBs in the HY index. Preferred valuations have typically been more volatile than BBs, explaining part of their cheapness; however, the difference in return volatility has gradually declined to pre-crisis levels after rising during 2008-09. Even as volatility has normalized, yields have not, considering preferreds traded through BBs prior to the crisis (Figure 1).

FIGURE 1

**Average difference in return volatility* and yield** between preferreds and BBs**




Note: *Annualized based on trailing 6m daily total returns. ** Current yield. Source: Barclays Research

While we remain comfortable with the credit risk in preferreds, these securities have significant duration risk, owing to their perpetual nature. With interest rates expected to rise in 2014 as the Fed begins to taper asset purchases, managing duration risk remains critical. We recommend buying recently issued perpNC10 fixed-to-float preferreds to protect against this risk. These securities yield 6.5-7.0% to the first call date and have limited downside, in our view, if rates were to rise moderately. Indeed, we expect these securities to generate 5-6% of total returns in 2014, higher than our base case forecast of 3-4% total return for HY.

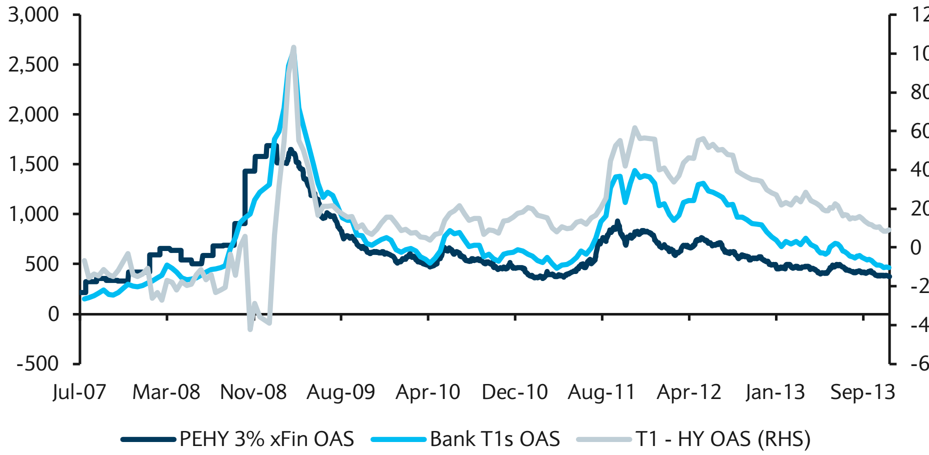
The basis between European bank Tier 1s (average rating BB+) and high yield debt has continued to compress this year, although the former still yield about 90bp more (Figure 2). Prior to the crisis, Tier 1s traded through high yield, suggesting there is further room for compression in the basis. Tier 1 valuations are likely to be supported by strong fundamentals of core European banks, as capital ratios have risen and asset quality has

[2] In current yield terms.

improved. Further, with traditional Tier 1s losing capital treatment, we expect many of them to be redeemed in the medium term, lowering their effective duration. Therefore, adjusted for credit and duration risk, hybrids still appear attractive compared with HY.

FIGURE 2

**European bank hybrids still trade wide of high yield debt (bp)**




Source: Barclays Research

Compared with traditional hybrids, European bank CoCos – with explicit write-down/equity conversion language – have a worse structure from the investor's perspective and are lower rated. Further, with a more limited buyer base, CoCo valuations are likely to be more volatile and could come under pressure from a significant pickup in supply. That said, USD-denominated Tier 1 CoCos yield 7-8%, in line with CCC bonds in the HY index (which yield 7.5%). Relative to the latter, CoCos are more subordinated in the capital structure and have conversion risk; however, we believe this is more than offset by better underlying fundamentals of core European banks than generic CCC credits. Therefore, we believe Tier 1 CoCos offer an attractive alternative. In particular, we recommend buying CoCos with high back-end coupons and near-term call dates, owing to their limited duration and extension risk.

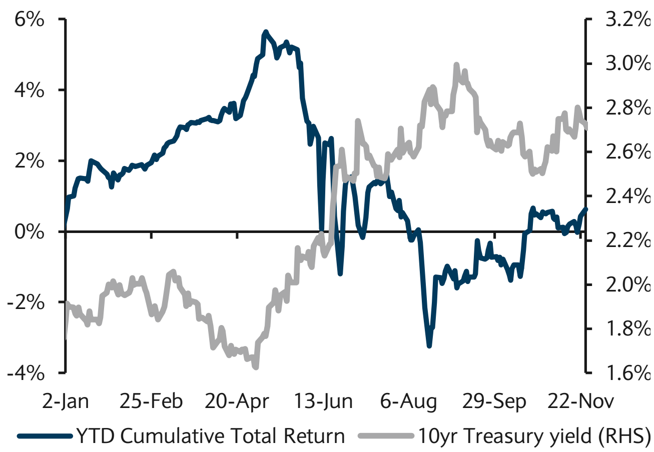
## US bank hybrids

Preferreds staged a significant rally to begin the year, with the S&P preferred stock index returning more than 5% through mid-May (Figure 3). With 10y yields dropping to about 1.6%, a reach for yield, combined with a strong fundamental backdrop, drove the rally. Retail inflows into preferred funds remained strong, with the shares outstanding of PFF, an ETF of preferred stocks, growing more than 12% through mid-May. However, since May, as concerns about Fed tapering of asset purchases have led Treasury yields to rise, preferreds have sold off significantly. Recently issued retail fixed-for-life securities are down about 20pts on average. 10y non-call fixed to float preferreds have fared slightly better but are still down 9pts, while older vintage securities callable in the next 4-5 years are only about 3pts lower (Figure 4).

Not surprisingly, the sensitivity of preferred valuations to interest rates has increased meaningfully since May. Prior to the rates sell-off, preferreds had a low positive correlation with rates – as Treasury yields increased, valuations improved, with both being driven essentially by broader macroeconomic conditions, in our view (Figure 5). Since May 2013, the correlation between preferreds prices and rates has become negative – preferred prices drop when rates increase – and the relationship has become stronger (R-squared has increased from 11% to 55%). The average empirical duration of PFF (which includes many near-term callable securities) has been about 5.7, although the duration of some of the recently issued fixed-for-life securities has been much higher (11-17).

FIGURE 3

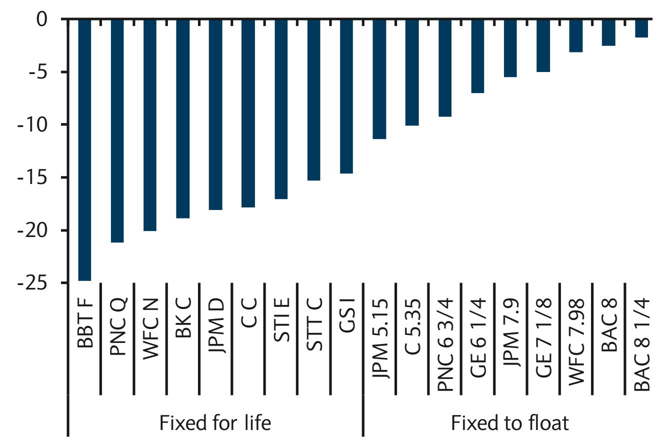
**Preferreds underperformed as Treasuries have sold off**




Source: Bloomberg, Barclays Research

FIGURE 4

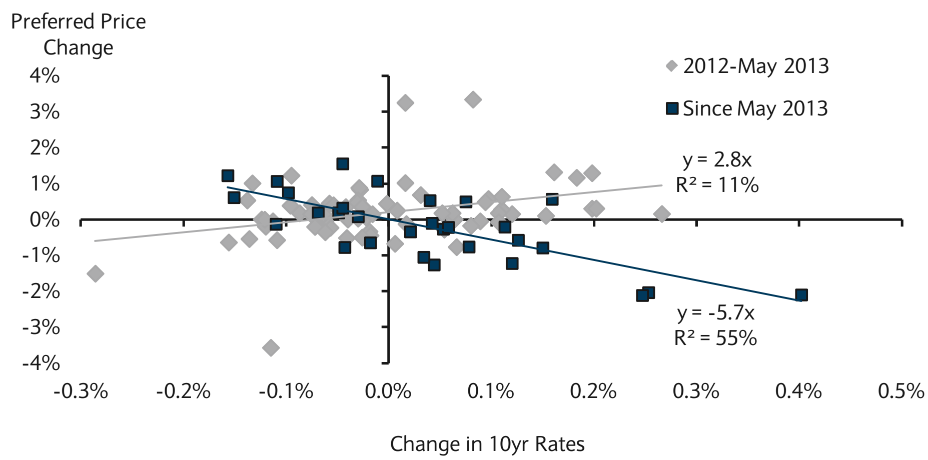
**Price change of select preferreds since May 1 (pts)**




Source: Bloomberg, Barclays Research

FIGURE 5

**Preferred duration has changed significantly since May**




Source: Barclays Research

## 2014 outlook: Preferred valuations near a bottom

Given the high empirical duration of preferreds in the rates sell-off, the exposure to further moves in Treasury yields remains a key concern, with the Fed likely to begin tapering asset purchases in 2014. However, with preferred yields already 6-7%, further downside is limited in our view. In particular, we believe that the equilibrium level for yields is only about 50bp wider than current levels even in a significantly higher interest rate environment.

This view is premised on preferred valuations during 2005-06: with issuance picking up only in the mid-2000s, we believe this period is appropriate for estimating preferred valuations in a high and rising rate environment. Overall, credit spreads were much tighter in 2005-06 (the US corporate OAS was, on average, 90bp) but interest rates were higher, with 10y yields at 4.0-5.3%. During this period, preferred yields were 6-7%. While bank fundamentals have consistently improved since the credit crisis and appear much stronger than in 2005-06, the overhang of issuance, concerns about the changing buyer base and generic aversion to duration risk could weigh on valuations. Consequently, we believe preferreds could trade wide of the pre-crisis range; specifically, we expect yields to settle about 50bp back of the 2005-06 levels implying a yield range of 6.5-7.5%.

With many parts of the preferred market already trading in this range, this view implies that further increases in Treasury yields will be offset to a large extent by tightening in preferred spreads. While there is no precedent for a negative correlation between hybrids spreads and rates in a rising rate environment – spreads prior to the crisis were too tight, leaving little room for further compression when rates rose – this view is based on the spread and rates relationship in the high yield market. Similar to hybrids, the high yield buyer base tends to be more yield/total-return focused, which has historically led to a negative correlation between high yield spreads and rates.

Compression in preferred spreads is also likely to be supported by their fairly wide levels. In particular, 10y senior spreads for the six largest banks are 110-150bp. Assuming 40% recovery for senior and 0% for preferreds, the ratio of preferred to senior spreads should be 1.7x. The risk premium for other preferred features, such as non-cumulative coupon deferrals and no maturity, tends to be more variable and dependent on broader risk appetite. However, given banks' strong fundamentals, we expect this premium to be less than 50bp for most credits. Therefore, we estimate that the fair level of preferred spreads is 240-310bp (Figure 6). This has different implications for different parts of the market.

FIGURE 6

**Estimating fair preferred spreads**

| | Spread (bp) |
|---|---|
| Range of 10y senior spreads for six largest banks | 110-150 |
| Premium for worse recovery | 80-110 |
| Premium for deferral risk/perpetual nature | 50 |
| Estimated fair preferred spread | 240-310 |

Source: Barclays Research

- **Fixed-to-float securities**: Many fixed-to-float preferreds already trade in our expected yield range and appear attractive, in our view. With the exception of the GECC hybrids (which are much higher rated), the perpNC10 securities in Figure 7 yield 6.5-7.0% when priced to the call date and 7-8% on a yield-to-perp basis. Given their wide spread levels – these securities trade at 350-400bp to the first call date, nearly 2.5-3.0x senior spreads – we believe that tightening in spreads should offset most of any further increase in Treasury yields.

  Assuming our house view on Treasury yields is realized –our rates strategists forecast 10y yields to increase to 3.5% by Q4 14 – we expect yields on these preferreds to back up 10-20bp, with the rest of rates move being absorbed by a compression in spreads. This corresponds to a total return of 5-6% for the year.

FIGURE 7

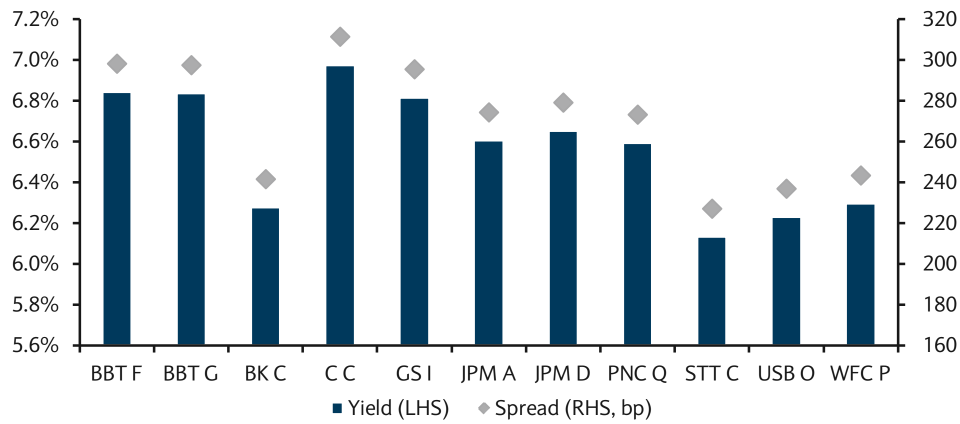
**Select perpNC10 fixed-to-float preferred securities**

| | | | | Priced to call | | Priced to perpetuity | |
|---|---|---|---|---|---|---|---|
| Security | Next call date | Reset spread | Price | Yield | Spread (bp) | Yield | Spread (bp)* |
| BAC 5.2 | Jun-23 | L + 313.5bp | $91.0 | 6.5% | 386 | 7.1% | 320 |
| C 5.35 | May-23 | L + 346.6bp | $89.8 | 6.8% | 423 | 7.4% | 354 |
| C 5.95 | Jan-23 | L + 406.8bp | $94.5 | 6.8% | 429 | 7.7% | 382 |
| C K** | Nov-23 | L+413bp | $100.3 | 6.9% | 412 | 7.7% | 382 |
| GECC 5.25 | Jun-23 | L + 296.7bp | $95.0 | 5.9% | 338 | 6.7% | 286 |
| GECC 6.25 | Dec-22 | L + 470.4bp | $104.5 | 5.6% | 314 | 7.4% | 357 |
| GS J** | May-23 | L+364bp | $90.8 | 6.9% | 419 | 7.5% | 364 |
| JPM 6 | Aug-23 | L + 330bp | $97.5 | 6.4% | 368 | 7.1% | 320 |
| JPM 5.15 | May-23 | L + 325bp | $90.8 | 6.5% | 387 | 7.1% | 326 |
| WFC Q** | Sep-23 | L + 309bp | $96.2 | 6.4% | 359 | 7.0% | 309 |

* Over 30y Treasuries. **$25 par securities; price based on $100 notional. Source: Barclays Research

- **Fixed-for-life securities**: Despite the significant sell-off in fixed-for-life preferreds since May, we believe they appear rich compared with the fixed-to-float securities highlighted above. The former have a longer duration, in our view (given their low coupons, we expect them to be extended well beyond their first call date) and yield less than the fixed-to-floats on a yield-to-perpetuity basis (Figure 8). Therefore, we believe that the fixed-for-life preferreds could be exposed to further downside in a rising rate environment – assuming yields stabilize around 7%, prices could be 5-10pt lower.

FIGURE 8
**Valuation of select $25-par preferreds**




Source: Barclays Research

## Higher capital is key fundamental protection for preferreds

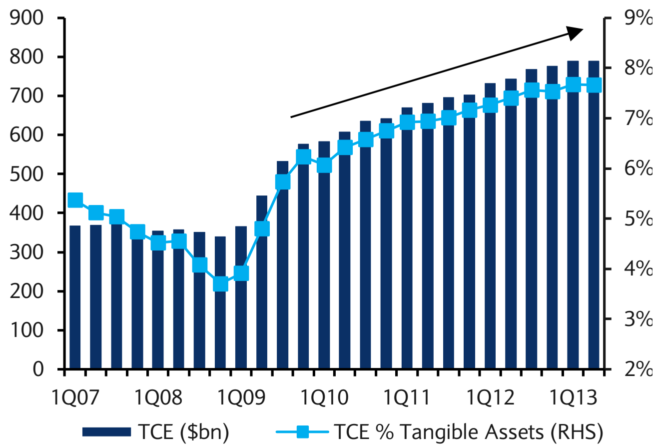
The US banking sector has experienced a dramatic improvement in capital, liquidity, asset quality, and risk appetite since the pre-crisis period. In light of these improvements, we have an Overweight rating on the sector and expect senior spreads to tighten, reflecting positive fundamental trends. This should provide support for tighter preferred levels.

In aggregate, the 25 largest US banks have increased tangible common equity as a percentage of tangible assets to 7.7%, from 5.4% in Q1 07 (Figure 9). On a bank-by-bank basis, this has represented a significant increase in the absolute amount of common equity (that is subordinated to preferred stock). For example, Citigroup's tangible common equity base amounted to only $64bn heading into the crisis (as of Q1 07), fell to a low in the low-$50bn range in late 2008, but has since risen to $142bn – more than 2x the pre-crisis run rate (Figure 10). Admittedly, the asset base for many of these names has risen due to crisis-period mergers and post-crisis deposit inflows, but the increase in capital has still clearly outstripped the increase in assets or risk.

Further, we believe that more stringent regulations mean that the fundamental improvements – higher capital ratios, better liquidity – are unlikely to be reversed in the medium term. The Basel III capital standards have increased capital requirements to such a degree that banks will not be able to re-leverage meaningfully in better economic times. Yes, they will gradually optimize risk allocation under this new capital constraint (or any other constraint that regulators impose), but we believe that this larger base of common capital represents a significant improvement from before the crisis and a meaningful buffer that should limit the likelihood of preferred losses.

FIGURE 9

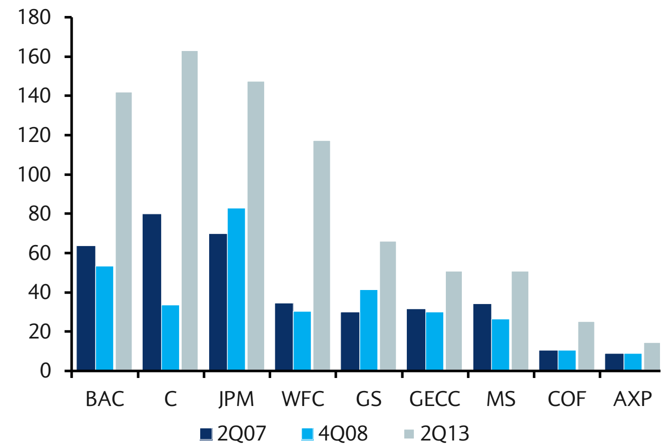
Aggregate tangible common equity, 25 US bank aggregate




Source: Company reports, SNL, Barclays Research

FIGURE 10

Tangible common equity by firm ($bn)




Source: Company reports, SNL, Barclays Research

## Can demand keep up with supply?

The universe of bank capital securities continues to evolve as banks adapt to the new capital guidelines. As they replace TruPS with perpetual preferreds, the ability of the buyer base to absorb the significant supply remains a key risk, in our view.

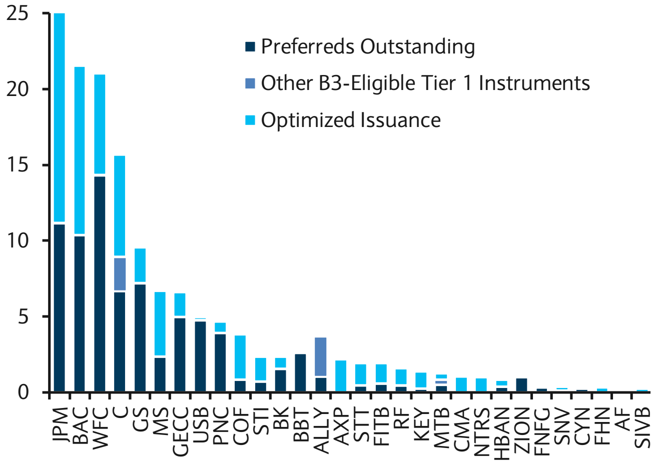
### *Supply*

Basel III capital rules encourage US banks to issue non-cumulative preferreds in an amount equal to 1.5% of risk-weighted assets (RWAs), as the lowest-cost means to fulfill the non-common portion of Tier 1 capital requirements. US banks have responded by issuing about $40bn in preferreds since 2011, with $19bn in 2013. However, continuing the trend from the past two years, net supply of US bank securities was once again negative this year, owing to more than $24bn of redemptions (of which nearly $14bn were TruPS).

For 2014, most of the larger issuers have significant room for further issuance under the upcoming regulatory regime (Figure 11). We expect the current ~$80bn US preferred market to increase to $145bn by the time the new capital rules are fully phased in (2018). Of the $65bn of US bank preferred supply expected through the end of 2018, we believe $15-20bn could come in 2014. Importantly, after shrinking for the past three years, the US bank hybrid universe is likely to grow in 2014 as the pace of TruPS calls/buybacks slows meaningfully. In addition, we expect European banks to issue about €40bn of capital securities in 2014, a substantial portion of which is likely to be in USD.

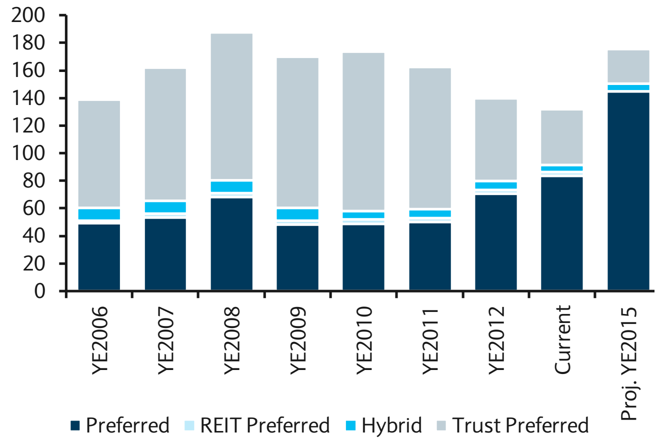
While the preferred universe will be growing, we do not expect the US bank hybrid market to exceed 2008 levels, when $110bn of TruPS and $70bn of preferreds resulted in $180bn of total hybrids. Instead, we expect the mix of securities to shift from TruPS to perpetual preferreds (Figure 12).

FIGURE 11
**Potential room for preferred issuance in bank capital structures ($bn)**




Source: Barclays Research

FIGURE 12
**US bank and finance company capital securities outstanding ($bn)**




Source: Barclays Research

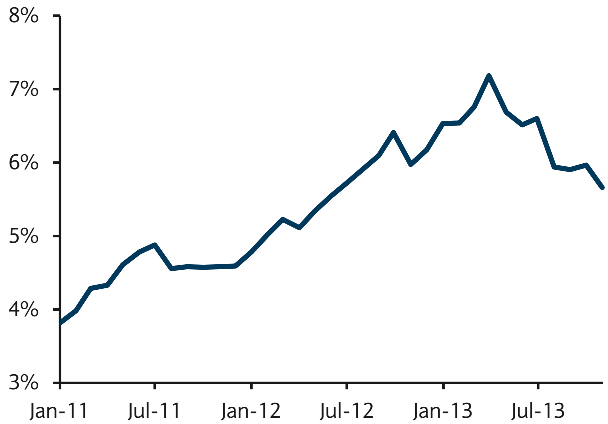
*Demand*

Even though the overall bank capital universe will not surpass 2008 levels, in our view, the shift in the mix of bank hybrids has important implications for demand. Insurance companies were large buyers of TruPS during the pre-crisis years, as these securities' final maturity and cumulative coupon features, index eligibility, investment grade rating, and spread pickup made them attractive investments. TruPS price volatility during the financial crisis led some insurers to exit the asset class, and many have not yet returned. Furthermore, preferreds have no final maturity date, are not index eligible, and are generally not investment grade rated, making them less attractive to this investor group.

Retail and high yield investors have stepped in to fill the gap created by some of the lost demand. The market capitalization of PFF grew from less than 4% of the S&P preferred stock index in 2011 to more than 7% earlier this year (Figure 13). However, retail flows have been negative lately: investor redemptions have reduced PFF's shares outstanding by more than 23% since May amid increased aversion to duration risk (Figure 14). With preferred yields nearing 7% (about 9% on a tax-equivalent basis accounting for the QDI-treatment), we expect retail investors to return to the space, although a rapid/substantial increase in interest rates next year could exacerbate retail outflows.

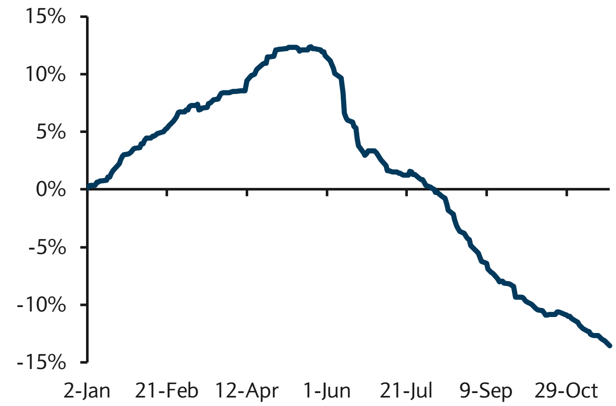
The demand for bank hybrids from HY investors has also picked up, as valuations appear compelling relative to the traditional HY universe. For instance, benchmark perpNC10 preferreds, rated BB or better, yield 6.5-7%, much higher than the 4.7% yield of the BB index. These securities do have a longer duration than the index, but we believe that is more that offset by strong US bank fundamentals.

FIGURE 13
**PFF market cap as % of S&P Preferred Stock Index**




Source: Bloomberg, Barclays Research

FIGURE 14
**YTD change in PFF shares outstanding**

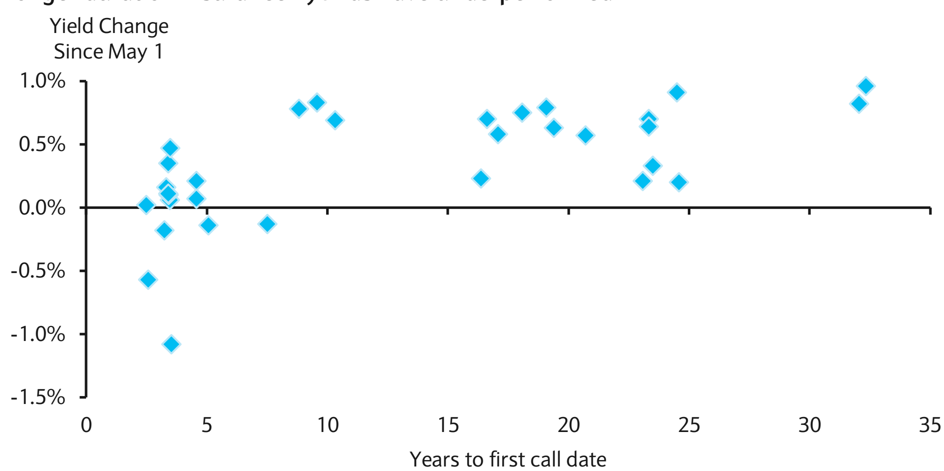



Source: Bloomberg, Barclays Research

## US insurance

Insurance hybrids have dropped in price since May as interest rates have risen, even as the tightening in spreads has absorbed some of the move in rates. The securities are about 5pts lower on average over that period. Increasing aversion to duration has caused longer non-call hybrids to underperform: on average, the yield of securities with less than 5 years to the first call date is unchanged, compared with the nearly 55bp increase in yield for hybrids with longer non-call periods (Figure 15).

FIGURE 15
**Longer duration insurance hybrids have underperformed**




Source: Barclays Research

As evidenced in the recent rate move, hybrids with near-term call dates have lower interest rate risk, as they are priced to be redeemed on the first call date. However, many of these have relatively low back-end coupons and could be extended beyond the first call date. While the hybrids generally offer a substantial spread pickup over senior debt, even when priced to maturity, their payoff profiles are negatively convex; the upside is capped in a rally but they have significant downside if spreads widen. Of the securities listed in Figure 16, we believe ALL 6.125s, LNC 6.05s and 7s have the worst payoff profiles, owing to their low YTC and tight reset coupons relative to senior spreads. Hybrids with lower extension risk trade at a tighter spread when priced to the first call date, but have better risk/reward profiles, in our view. In particular, we believe HIG 8.125s, PRU 8.875s and the two ZURNVX hybrids appear attractive.

FIGURE 16

**Near-term callable insurance hybrids**

| Security | Call date | Back-end coupon | Price | To first call date | | To maturity | |
|---|---|---|---|---|---|---|---|
| | | | | Yield | Spread | Yield | Spread |
| ALL 6.125 | May-17 | L+193.5 bp | $105.0 | 4.6% | 381 bp | 5.9% | 204 bp |
| CB 6.375 | Apr-17 | L+225 bp | $109.0 | 3.5% | 283 bp | 5.9% | 208 bp |
| GNW 6.15 | Nov-16 | L+200.25 bp | $90.5 | 9.9% | 938 bp | 6.9% | 307 bp |
| HIG 8.125 | Jun-18 | L+460.25 bp | $117.0 | 4.0% | 283 bp | 7.3% | 346 bp |
| HIG 6.505 | Feb-17 | L+212.5 bp | $97.0 | 7.6% | 693 bp | 6.6% | 275 bp |
| LIBMUT 7 | Mar-17 | L+290.5 bp | $103.0 | 6.0% | 531 bp | 6.9% | 308 bp |
| LNC 6.05 | Apr-17 | L+204 bp | $101.0 | 5.7% | 501 bp | 6.2% | 238 bp |
| LNC 7 | May-16 | L+235.75 bp | $103.5 | 5.5% | 506 bp | 6.3% | 248 bp |
| PRU 8.875 | Jun-18 | L+500 bp | $122.0 | 3.6% | 242 bp | 7.4% | 353 bp |
| XL 6.5 | Apr-17 | L+245.75 bp | $99.3 | 6.7% | 604 bp | 6.8% | 289 bp |
| ZURNVX 6.45 | Jun-16 | L+200 bp | $108.5 | 3.0% | 254 bp | 5.7% | 184 bp |
| ZURNVX 6.5 | May-17 | L+228.5 bp | $107.0 | 4.3% | 357 bp | 6.1% | 222 bp |

Source: Barclays Research

The longer non-call securities have minimal extension risk but obviously a longer duration. These securities appear cheap on a spread basis, although we recommend hedging their interest rate exposure (Figure 17). The ALL 6.5s and MET 7.875s offer the highest spread pickup over senior debt.

We believe the most attractive hybrids in the insurance space are the recently issued 40NC10 fixed-to-float hybrids with wide reset coupons, owing to their limited extension risk. Further, their interest rate duration is lower than 30y non-call securities, as the former switch into floating coupons after 10 years. We believe the ALL 5.1s ($25 par) and PRU 5.625s appear attractive, trading 3.1x and 2.8x wider than corresponding senior debt, respectively.

FIGURE 17

**Longer non-call insurance hybrids**

| Security | Call date | Back-end spread | Price | Yield to call | Hybrid spread | Comp. snr spread | Hybrid/snr spread ratio |
|---|---|---|---|---|---|---|---|
| Hybrids with long con-call periods | | | | | | | |
| AIG 8.175 | May-38 | L+419.5 bp | $ 121.0 | 6.5% | 290 bp | 168 bp | 1.7 |
| ALL 6.5 | May-37 | L+212 bp | $ 106.0 | 6.0% | 252 bp | 90 bp | 2.8 |
| LIBMUT 10.75 | Jun-38 | L+712 bp | $ 152.0 | 6.5% | 293 bp | 193 bp | 1.5 |
| LIBMUT 7.8 | Mar-37* | L+357.6bp | $ 110.0 | 6.9% | 343 bp | 193 bp | 1.8 |
| MET 10.75 | Aug-34 | 10.75%** | $ 149.3 | 6.4% | 306 bp | 113 bp | 2.7 |
| MET 6.4 | Dec-31 | 6.4%** | $ 103.5 | 6.1% | 286 bp | 113 bp | 2.5 |
| MET 7.875 | Dec-32 | 7.875%** | $ 115.5 | 6.4% | 318 bp | 113 bp | 2.8 |
| Recently issued perpNC10 hybrids | | | | | | | |
| ALL 5.1*** | Jan-23 | L+316.5 bp | $ 97.0 | 5.6% | 288 bp | 94 bp | 3.1 |
| ALL 5.75 | Aug-23 | L+293.8 bp | $ 102.5 | 5.4% | 274 bp | 94 bp | 2.9 |
| PRU 5.2 | Mar-24 | L+304 bp | $ 97.0 | 5.6% | 284 bp | 110 bp | 2.6 |
| PRU 5.625 | Jun-23 | L+392 bp | $ 99.0 | 5.8% | 311 bp | 110 bp | 2.8 |
| PRU 5.875 | Sep-22 | L+417.5 bp | $ 102.3 | 5.5% | 310 bp | 110 bp | 2.8 |

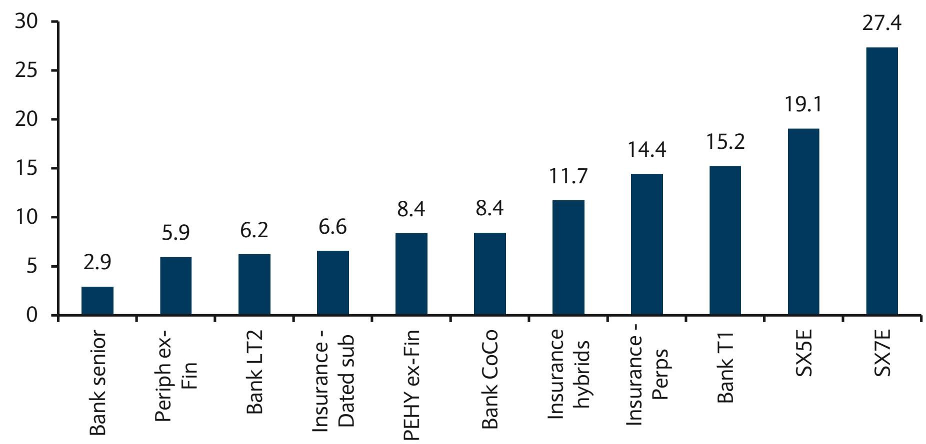
Note: *Scheduled maturity. **Coupon to scheduled maturity; it switches to floating if the bond is extended beyond that date. *** $25 par. Source: Barclays Research

## European bank hybrids

With a total return of 15.2%, European bank hybrids have had the strongest performance among the higher-beta parts of the European credit market so far in 2013 (Figure 18). This was driven by names that started the year with heavily discounted prices, including discount perps, low back-end securities with near-term calls and some of the peripheral T1s. CoCos came second, with a total return of 8.4%, led by the UK bank issues. Finally, bank LT2s clocked in at 6.2%, lower than Pan-Euro High HY Index but slightly more than corporate hybrids and peripheral ex-financials. As in the case of T1s, the performance in LT2s was driven by high-low beta compression, with the total return strongly correlated with the spread level at the beginning of the year.

FIGURE 18

**Bank capital versus other high beta sectors, YTD total returns, %**



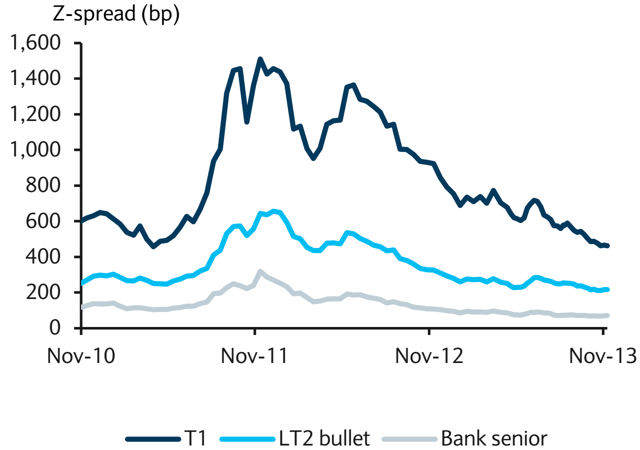

Source: Bloomberg, Barclays Research

While subordinated spreads have compressed relative to senior debt in absolute terms (Figure 19), the T1/senior and LT2/senior spread ratios have remained historically high for most of 2013 (Figure 20). The ratios started to decrease when the market rebounded in July but are still well above 2010-11 levels, and we see room for further compression in 2014.

Subordinated valuations are likely to be supported by a strong fundamental backdrop. As Q3 earnings indicated capital ratios continue to improve, with the Core Tier 1 ratio rising to its highest on record at 12.7%. We expect them to continue to increase, driven primarily by more stringent regulatory requirements. Asset quality has been mixed, with an ongoing negative trend in Spain and Italy, but we expect this to stabilise in 2014, with a slight chance of improvement. Profitability remains weak: in Q3, return on equity was poor in the banking sector, marred by fines, low FICC trading volumes, and cost-reduction programmes, although this is more of an equity concern for now, in our view.

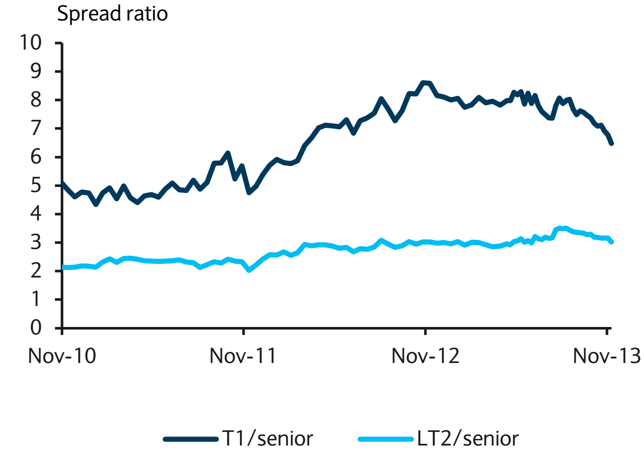
The technical backdrop for traditional Tier 1s is also positive, with negative net supply as banks continue to replace old-style hybrids with CoCos. Wider-spread segments also provide significant spread cushion against rising rates, while the tighter-spread paper appears to be nearing the spread floor.

FIGURE 19
Spread performance across banks' capital structures




Source: Barclays Research

FIGURE 20
Hybrid/senior spreads finally started to compress in August




Source: Barclays Research

## 2014 return forecast and key themes

Given our expectation for compression in subordinate spreads versus senior debt, we expect T1s and LT2s to generate total returns of 8-11.5% and 2-3.5%, respectively (Figure 21). We base the forecast on an assumption that senior unsecured bank debt spreads tighten c.15bp by the end of 2014 (in line with our mid-point forecast of 20bp tightening in the average IG spread) and a compression in T1/senior and LT2/senior spread ratios from 6.5x and 3x to 4.75-5.75x and 2.5-3x at the end of 2014 (the ratio ranges prevailing in 2011-12). While an overall forecast is helpful for those looking to allocate to the sector, we think high performance dispersion will remain.

FIGURE 21
Total and excess return forecasts for T1s and LT2s

| | Current | | Expected change | | | Expected return | |
|---|---|---|---|---|---|---|---|
| | Spread (bp) | Yield (%) | Spread (bp) | Rate (bp) | Yield (%) | Excess (%) | Total (%) |
| T1 | 463 | 5.6 | 150-200 tighter | 65 higher | 0.7-1.5 lower | 10-12 | 8.5-10.5 |
| LT2 | 216 | 3.7 | 50-75 tighter | 80 higher | 0-0.3 higher | 5-6.5 | 2-3.5 |

Note: We assumed average durations in T1s and LT2s of 3.8 and 5.8, respectively. Based on this, we assume 66bp and 80bp moves up in rates for T1s and LT2s, respectively, implied from our Rates Strategy team's view on rates at the end of 2014. Source: Barclays Research

We recommend positioning for further performance in bank capital via French high-coupon T1s, select short-call T1s and CoCos.

- **French high coupon T1s.** The cheapness in French bank Tier 1s has been an ongoing theme in the European Tier 1 market over the past few months. Although the bonds have put in a good performance over the summer, we still view the ACAFP and SOCGEN T1s as offering the best risk/reward balance in the broader T1 space, thanks to relatively high yields, very low extension risk and strong fundamentals (for more details, please see *European hybrids: High-low beta compression to continue*, 18 October 2013).

- **Short-call T1s.** Among the T1s with short-term calls, we see the best value in high-coupon securities and those issued by very strong banks. We view the upside/ downside as unfavourable in low back-end short-call T1s, despite the high likelihood that they will be called. For more details, please see *European hybrids: Positioning in short-call bank T1s*, 15 November 2013.

- **CoCos.** We believe that CoCos offer an attractive spread pick-up over corresponding non-convertible T1 and T2 securities. CoCos with shorter non-call periods (up to 5y) and high back-end coupons (that are likely to be redeemed on the first call date) look particularly attractive. By the time the CoCo space grows enough to make the non-default conversion scenarios more than a negligible risk, these securities would be near their first call dates and have limited credit exposure. Their key risk, in our view, is still a relatively small buyer base, which leads to limited liquidity and increased volatility (for more details, please see *European hybrids: CoCos – Refining the relative value approach,* 19 September 2013).

## Supply forecast

We forecast issuance in the bank hybrid space of about €40bn in 2014 (Figure 22), with the supply split into three types of securities: AT1 CoCos, LT2 CoCos and non-CoCo LT2s. However, net issuance is likely to be flat, with about €39bn of redemption of traditional capital securities.

The AT1 CoCo issuance will likely be driven by banks' willingness to maximise the proportion of CoCos within the Basel 3 minimum of 1.5% of RWAs for AT1 instruments. While they could meet this requirement with common equity, they would likely favour CoCos as a cheaper form of capital. The first AT1 CoCos have been issued this year in Europe, as a result of more clarity regarding the EU and national-level capital requirements.

Tier 2 CoCos issuance is likely to continue to come from the Swiss banks (we estimate the potential size of this market at €37bn), where regulators require CoCos as part of the solvency requirement, and potentially from the UK and the Nordic countries (potential size of about €50bn). In addition, there may be more T2 CoCo issuance aimed at supporting credit ratings, an example being the recent ACAFP LT2 CoCo. We expect more non-CoCo issuance in jurisdictions where CoCos are not required by the regulators.

On redemptions, €39bn of bonds are callable or mature in 2014 and we think most of these securities will be redeemed. Notably, the outlook for calls has improved substantially since last year following further improvement in the bank debt valuations and the EBA's clarification in July that T1s containing step-ups would not qualify as T2 capital after the step-up.

In addition, we expect more redemptions via tenders and exchanges as banks continue to adjust the capital structures to the new regulatory requirements, but this theme should be more limited compared with the LME activity over the past three years.

For more details, please see *2014 supply forecasts*, 4 October 2013.

FIGURE 22

**Current total outstanding and projected issuance (€bn)**

| | Outstanding (as of Q3 2013) | Expected gross issuance 2014 | Expected redemptions 2014 | Expected net issuance 2014 |
|---|---|---|---|---|
| Financials | 554 | 50 | 44 | 6 |
| Banks | 454 | 40 | 39 | 1 |
| Old style | 425 | 0 | 39 | -39 |
| - LT2 | 246 | 0 | 13 | -13 |
| - UT2 | 27 | 0 | 2 | -2 |
| - T1 | 152 | 0 | 25 | -25 |
| New style* | 29 | 40 | 0 | 40 |
| Insurance | 99 | 10 | 5 | 5 |
| Dated sub | 46 | 6 | 2 | 4 |
| Perp | 53 | 4 | 3** | 1 |
| Corporate hybrids | 66 | 15 | 3 | 12 |

Note: * Includes non-CoCo T2s. ** There is €5bn insurance perps coming up for calls in 2014, but €1.5bn of that is Aegon's perps, which the company has been indicating would be extended. Source: Dealogic, Barclays Research

## Themes to watch in 2014

### *Hybrid calls*

The rise in hybrid bond extensions has been among the main themes in the bank capital sector since the beginning of the crisis. This dynamic has now started to reverse, evidenced by a drop in the proportion of bonds not being called on the first call date this year (Figure 23 and 24). This is a natural consequence of the recovery in fundamentals and valuations and the phase-out/disqualification from capital treatment of old-style securities under new regulatory rules starting to take effect. Both factors have generally improved the call economics.

Another key theme during the crisis has been the shift away from the reputation-driven "call-all" approach towards an economically driven capital management. Recently, this dynamic has also stalled, with no "new" banks declaring plans to call on an economic basis.[3] It is unlikely that any of the banks that stated the intention to call on economic basis would reverse this policy shift in the foreseeable future.

Looking at European bank T1s coming up for calls in the next 2.5 years, we find that of 29 securities in our sample, 22 are highly likely to be called on the first call dates. In most cases, our view is based on 1) the expectation that the banks that used to "call all" securities will stick to this policy and/or 2) the presence of coupon step-up, although we also expect the high-coupon non-steps to be taken out.

We discussed our views on short-call T1s in detail in *European hybrids: Positioning in short-call bank T1s*, 15 November 2013.

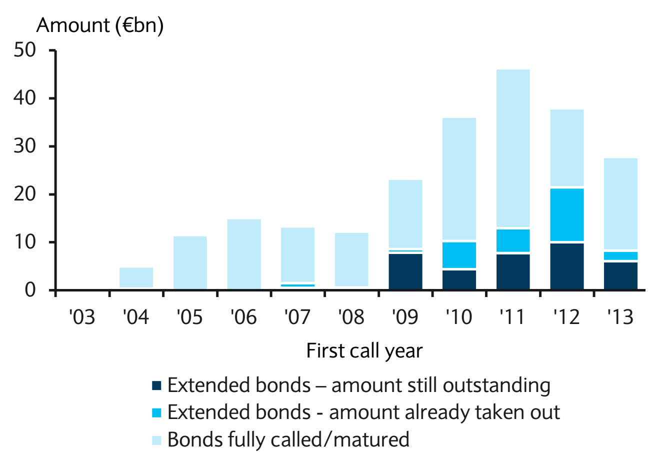
### *Peripheral/core compression*

Peripheral/core relative value remains a key theme in the bank space and we think that positioning for further compression is likely to be one of the sources of value in 2014.

So far in 2013, peripherals have materially compressed versus core in seniors and T1s, with the average spread differential dropping from c.170bp to 90bp and from c.225bp to c.150bp, respectively. Somewhat surprisingly, this has not really happened in the LT2 space, with the peripheral-core spread differential trading range-bound over the past 10 months and remaining relatively unchanged year-to-date, despite a material tightening in spreads overall.

FIGURE 23

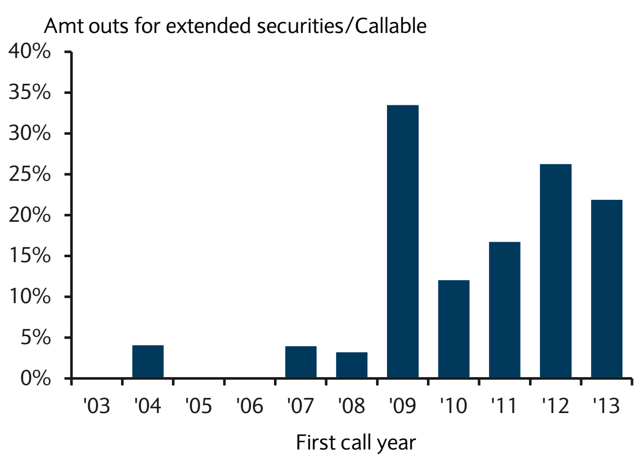
**How much of the bonds that became callable are still outstanding?**




Source: Barclays Research

FIGURE 24

**Proportion of callable securities that were extended**



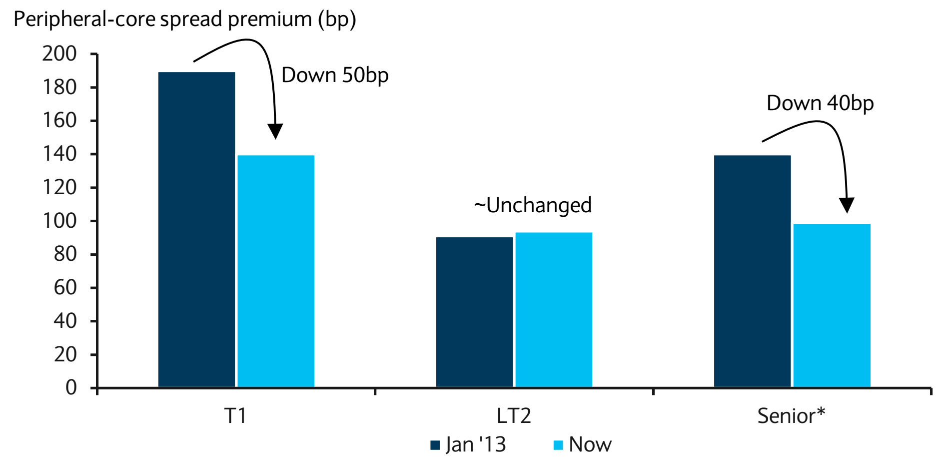

Source: Barclays Research

[3] INTNED is one exception, given that in the recent LME (6 November), the bank stated that call decisions will be based on economics. However, this announcement was not a surprise, given that the bank has been extending most of its bonds throughout the crisis and its capital management remains under close scrutiny of the European Commission.

On a risk-adjusted basis, the average peripheral-core premium looks much higher in seniors than in LT2 or T1s: a 100bp average peripheral-core pickup in senior unsecured looks high versus 90bp in LT2s and 140bp in T1s if we take into account the materially higher risk of impairments in the sub debt (Figure 25).

FIGURE 25

**On a risk-adjusted basis, the average peripheral premium is the highest in senior debt**




Source: Barclays Research

On that basis, we recommend positioning for the peripheral/core compression in senior bank debt, where the premium for peripheral risk is by far the most attractive on a risk-adjusted basis. In sub debt, we think it is better to position for compression in LT2s, given that in this sector, the premium has not compressed this year, despite a material tightening in Spain and Italy spreads, and it now looks more attractive on a risk-adjusted basis than in T1s. For details on our view of peripheral/core relative value in bank debt, please see *Peripheral vision*, 25 October 2013.

### *CoCos*

**Divergence in structures, convergence in valuations.** The CoCo structures have continued to evolve in 2013, driven by global capital rules, but also by local regulatory demands and rating agency requirements. Notably, recent issues reveal a growing divergence in CoCo structures, rather than the progressive convergence that most investors had hoped for. While there are many moving parts, we believe that for AT1 CoCos perpNC5 structures with fixed-to-float coupons, CT1/PONV triggers and equity conversion language are likely to appeal to both regulators and investors. Despite the growing diversity in the structures and difficulties in valuation cited by many investors, current market prices indicate that the bonds are priced consistently. The key valuation factor is the amount of capital cushion above the CoCo trigger.

We discussed the growing diversity of the CoCo universe and our valuation framework in *European Banks: CoCo Handbook*, 19 September 2013.

**Demand for CoCos to increase.** The growth of the CoCo asset class continues to be hindered by its exclusion from major fixed-income indices. As our Index Research colleagues explained in *Technical note: Eligibility of contingent convertible capital securities*, 4 March 2011, CoCos with regulatory capital-driven triggers – those with equity conversion and those with principal write-down – are not eligible for Barclays bond indices. However, we think that factors including the increased pace of new CoCo issuance in 2014, the large potential size of the asset class and the replacement of old-style bank capital securities with CoCos are likely to lead to a pickup in demand.

*Regulation*

Following formal adoption of CRD IV and CRR by the European Council in June 2013 with the implementation date set for 1 January 2014, the regulatory landscape from the hybrid capital perspective is now relatively clear. That said, it is important to keep an eye on the EBA Single Rulebook Q&A process, which continues to provide more clarity on technical implementation details of CRD/R; the tax treatment of AT1 CoCos in jurisdictions in which the treatment is not entirely clear (France) and those where AT1 CoCos are not tax-deductible (Germany, the Netherlands); and BCBS's consultation on the eligibility of AT1 capital for the calculation of leverage ratios.

## European insurance hybrids

Insurance hybrids have performed strongly so far in 2013, showing exceptional resilience to market shocks (eg, the taper-talk sell-off) compared with other higher beta credit sectors, particularly bank capital. The sector recorded a total return of 11.7% (Figure 18), split into 14.4% for perpetual hybrids (just slightly less than bank T1s) and 6.6% for dated subs (broadly in line with bank LT2 performance). Unsurprisingly, the performance was driven primarily by the securities that started the year with the lower prices and higher spreads.

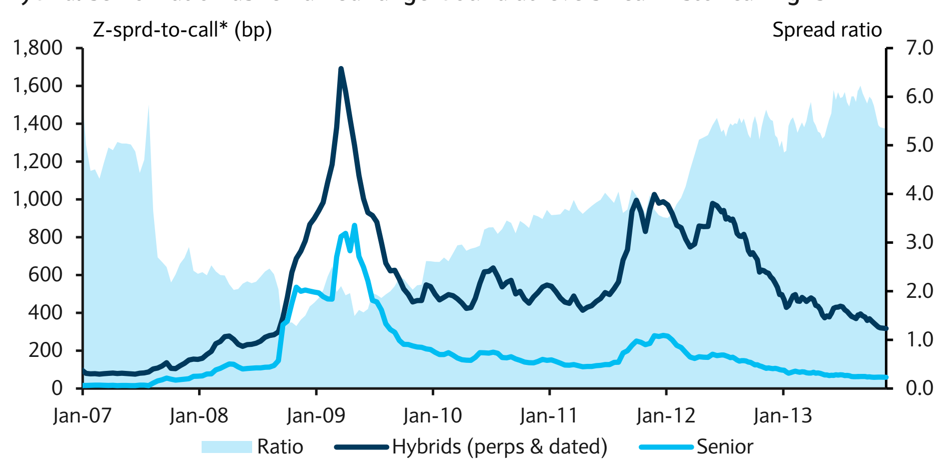
Despite a compression in the sub-senior spread differential, the insurance hybrid/senior ratio has remained range-bound at levels near its historical highs (Figure 26). This signals to us that insurance senior debt looks increasingly tight versus hybrids and that the upside/downside in hybrids has improved even further relative to that in seniors.

At the same time, the fundamental backdrop remains supportive of the sector. The key fundamental trends that transpired in the Q3 13 results for European insurers were low combined ratios, strong earnings, improved solvency, and declining leverage (see *European Insurance: More of the same*, 14 November 2013). If growth in the eurozone gains momentum in 2014, we would expect strong earnings to continue in the sector. With no significant changes in regulation expected next year, capital ratios should stay near current levels. Our analysts have an Overweight recommendation on the sector.

We maintain our call to take advantage of still-attractive valuations and a positive fundamental outlook in the Insurance sector via longs in the hybrids.

FIGURE 26

**Hybrid/senior ratio has remained range-bound at levels near historical highs**




Note: Hybrids represents the average spread of a basket of 104 actively traded insurer perps and dated subs. *We use z-spread-to-worst for the following perps: CCAMA €6.298, CCAMA €4.375, FRIPRO £6.875, FRIPRO £6.292, PEALLN £6.5864 and RLMI 6.125; these securities price in high risk of extension, in our view. Source: Barclays Research

## 2014 return forecast

Given our expectation for compression in sub spreads versus senior debt, we expect insurance hybrids to generate total return of 7-9% (Figure 27). We base the forecast on an assumption of 10bp tightening in senior unsecured insurance debt spreads in 2014 and a compression in sub/senior spread ratio from 5.5x down to 3.5-4.5x at the end of 2014 (the ratio range prevailing in 2011).

FIGURE 27

**Total and excess return forecasts for perps and dated subs**

| | Current | | Expected change | | | Expected return | |
|---|---|---|---|---|---|---|---|
| | Spread (bp) | Yield (%) | Spread (bp) | Rate (bp) | Yield (%) | Excess (%) | Total (%) |
| Insurance hybrids | 346 | 4.8 | 120-170 tighter | 80 higher | 0.4-0.9 lower | 9.5-11.5 | 7-9 |

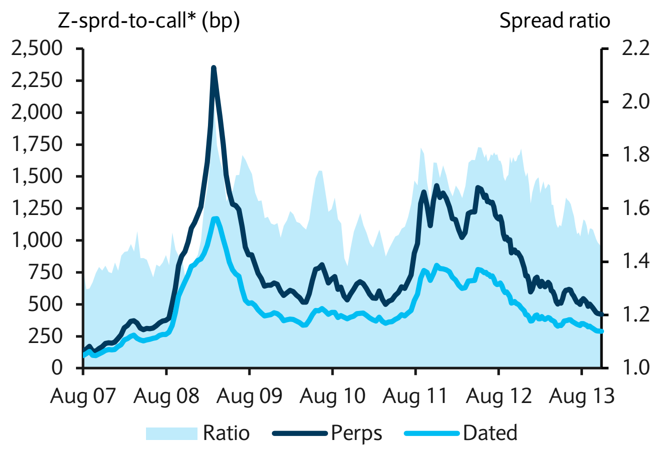
Note: We assumed an average duration in insurance hybrids of 4.8. Given the ~5y average duration of the insurance hybrids bond basket, we assume an 80bp move up in rates based on our Rates Strategy team's view on 5y rates at the end of 2014. Source: Barclays Research

Following a substantial compression in insurance perps versus dated subs (Figure 28), we still see an extra premium of 50-60bp in perps (after adjusting for differences in composition and the structural risk of the perps and dated subs in our baskets). We think that to some extent, this reflects the higher risk of non-calls in perps, given that they have much lower back-end spreads on average, which makes the extensions more economical on the margin. That said, we think that overall the risk of extensions in insurance perps is very low and does not justify the size of the extra premium: insurers' call/extension decisions over the past seven years suggest the majority of issuers have been calling the securities regardless of the economics and continued to do so even at the height of the financial crisis. On that basis, we think there is still value in the perps-dated sub compression trade.

Within the dated sub space, the old-style securities (issued pre-crisis) have continued to trade more or less in line with new-style bonds (Solvency 2 compliant T2 securities issued since 2010, Figure 29). There have been very modest signs of the new-old style spread decompression - a dynamic that we think is likely to prevail as the old-style bucket benefits from sliding down the curve and being gradually replaced with new-style securities.

FIGURE 28

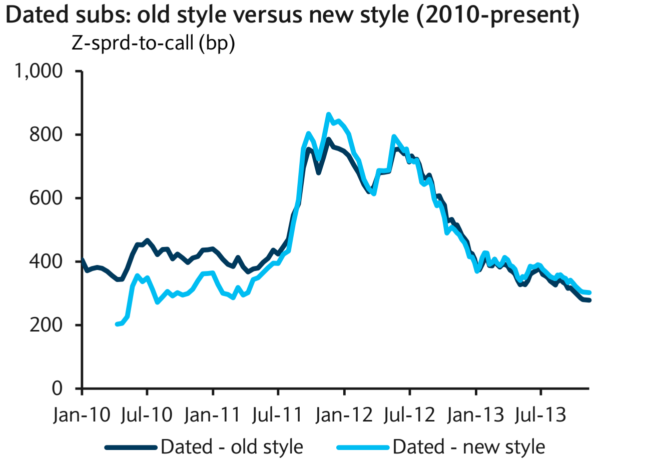
**Perps versus dated subs (2006-present)**




Note: *Perps* and *Dated* are based on baskets of 45 and 59 actively traded insurer perps and dated subs, respectively. *We use z-spread-to-worst for the following perps: CCAMA €6.298, CCAMA €4.375, FRIPRO £6.875, FRIPRO £6.292, PEALLN £6.5864 and RLMI 6.125 - these securities price in high risk of extension in our view. Source: Barclays Research

FIGURE 29

**Dated subs: old style versus new style (2010-present)**




Note: *Dated -old-style* and *Dated - new style* are based on baskets of 24 and 35 actively traded insurer old-style and new-style dated subs, respectively. Source: Barclays Research

FIGURE 30

**New-style insurance sub structures**

| | Tier 3 | Tier 2 | Tier 1 |
|---|---|---|---|
| Maturity | 3y or NC3 | 10y or 10NC5 | PerpNC5 or 30NC5 |
| Step-up | Yes - "limited" – y3 | Yes - "limited" – y10 | No |
| Interest deferral | MCR breach - cumulative | SCR breach - cumulative | Optional – non-cumulative SCR breach – Non-cumulative |
| Dividend pusher/stopper | Yes / Yes | Yes / Yes | No / No |
| Maturity lock-in | SCR breach | SCR breach | N/a (perpetual) / SCR-breach (dated) |
| Subordination | Subordinated to senior | Subordinated to Senior | Subordinated to Senior, Tier 3 and Tier 2 |
| Writedown / share conversion | - | - | Capital ≤ 75% SCR or (b) Capital ≤ MCR |
| Tax / regulatory call | If before y 3, only if funded with new Tier 3 (or higher) capital | If before y 5, only if funded with new Tier 2 (or higher) capital | If before y 5, only if funded with new Tier 1 capital |
| Amortisation | - | - | - |

Note: MCR – Minimum Capital Requirement, SCR – Solvency Capital Requirement. Source: Barclays Research

### Supply forecast

We estimate €3bn of net supply from European insurers in 2014 (Figure 22), which reflects €10bn of gross issuance offsetting €7bn of redemptions. Following a surge in new-style T2 issuance over the past three years, we expect dated subordinated debt supply to be driven primarily by refinancing in 2014. The introduction of Solvency 2 is encouraging insurers to hold more and higher quality capital. Although the implementation date for Solvency 2 is not until 2016, insurers have been issuing eligible subordinated debt with enhanced loss absorption features and retiring old-style debt, which will eventually no longer qualify as Solvency 2 capital. This pattern will likely continue in 2014. That said, the issuance of Tier 1 perpetual debt is unlikely to pick up until the regulatory requirements for this type of capital are clarified.

### Themes to watch in 2014

*Regulation*

The pace of regulatory change in the insurance space remains slow, but we believe the pace will pick up. Solvency 2 is expected to come into force on 1 January 2016. A high level provisional agreement of the Omnibus 2 Directive was reached on 13 November 2013 by the European Parliament, the European Commission and the EU council. The agreement included a final conclusion on provisions of the long-term guarantee package. The Directive will now be subject to a final approval from the European Council and a plenary vote by the European Parliament, currently expected to take place on 3 February 2014, before it can be approved into European legislation.

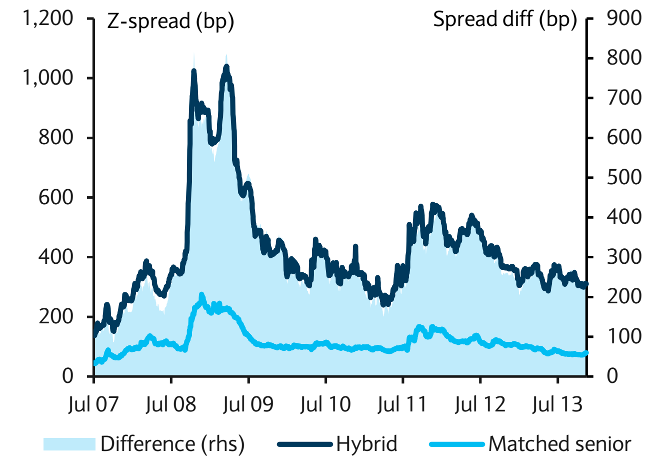
Official publication of the Level II text, which will fix most of the technical applications of the Solvency 2 framework, could follow later in 2014. Most of the basic features of Solvency 2 eligible capital securities, notably Tier 2, seem to be clear and insurers have been issuing these Solvency 2 compliant Tier 2s since 2010. Tier 1 structures require further clarification at the EU and local level, including tax treatment. We summarize the main capital securities in Figure 30.

## European corporate hybrids

Corporate hybrids returned 6.1% so far in 2013 (Figure 18). As in the case of bank and insurance hybrids, the key determinant of the year-to-date performance has been the spread at the beginning of the year, highlighting the systemic nature of the price action.

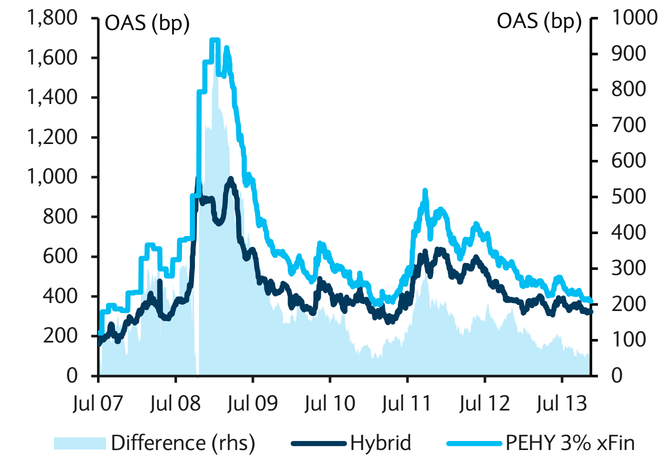
At 6.1% total return, corporate hybrids come in line with bank LT2s and peripheral ex-financials. What we find surprising in this context is that corporate hybrids started the year at a significantly higher average spread of 360bp, versus 295bp and 276bp in LT2s and peripheral non-fins, respectively, but tightened only 50bp versus 85bp in LT2s and 55bp in

FIGURE 31
**Corporate hybrids versus matched senior debt**




Source: Barclays Research

FIGURE 32
**HY-hybrids spread differential almost back to pre-crisis levels**




Source: Barclays Research

peripheral non-fins. At this point, corporate hybrids not only offer better carry but also have more room for further spread performance, and given that all three sectors have similar average ratings (BBB/BBB-), we see significantly more value in corporate hybrids.

More broadly, corporate hybrids are the only sector that remains materially wide of the 2011 tights compared with all other higher beta credit sectors (even after adjusting for the large amount of new corporate hybrid issuance in 2013). This is evident in various cross-sector comparisons. For example, the average hybrid-senior premium is still in excess of 200bp, well above the pre-crisis 100-150bp (Figure 31). Furthermore, hybrids appear wide relative to HY credit (PEHY 3% ex-Fin), given that the HY index has compressed substantially towards our hybrid basket, even though in absolute terms the spreads are still well off the pre-crisis levels (Figure 32). A spread gap of 50bp appears tight if we consider that on average, corporate hybrids are rated BBB/BBB-, versus an average of BB-/B+ for the HY index (both the index and our hybrid basket have an average duration of about 4.0).

Disappointing performance in corporate hybrids thus far can to some extent be explained by the riskier structure of the bonds (coupon deferral language in corporate hybrids) and exceptionally large amount of issuance in 2013. That said, we continue to think that deferral risk is very low in the sector and that potential downside is mitigated by the cumulative nature of the deferral features. As for the supply/demand technical, we think it is likely to moderate in 2014, with smaller new issuance (as we discuss below) and growing demand as investors get more familiar with the sector and the hunt for excess returns intensifies.

**2014 return forecast.** We forecast a total return of 4-5.5% (Figure 33). The corporate hybrid average spread remains 70bp wide of the tights of early 2011. As we mentioned earlier, this is in stark contrast to other high-beta credit sectors, which in most cases are near or through those tights. Hence, for our 2014 returns forecast, we think it is reasonable to assume as a base case that the average spread reaches +/-20bp around the 2011 tights (a 50-90bp tightening).

FIGURE 33
**Total and excess return forecasts for corporate hybrids**

| | Current | | Expected change | | | Expected return | |
|---|---|---|---|---|---|---|---|
| | Spread (bp) | Yield (%) | Spread (bp) | Rate (bp) | Yield (%) | Excess (%) | Total (%) |
| Corp hybrid | 310 | 4.4 | 50-90 tighter | 65 higher | 0.3 lower - 0.2 higher | 5-6.5 | 4-5.5 |

Note: We assumed an average duration in corporate hybrids of 4.1. Given the ~4y average duration of the corporate hybrids bond basket, we assume a 65bp move up in rates based on our Rates Strategy team's view on 4y rates at the end of 2014. Source: Barclays Research

## Supply forecast

Corporate hybrids have clearly been in a sweet spot in terms of primary activity in 2013, as the market more than doubled in size. We think that the key ingredients that drove the expansion in hybrid issuance in 2012-13 are still in place, albeit to a lesser extent. A number of capital-intensive corporates remain under rating pressure, owing to weak profitability. Also, we are still in a relatively low rates environment in which investors are attracted by the yield pickup offered by the hybrids on one hand and hybrids remain a relatively cost-effective capital/ funding instrument from the issuer's perspective on the other.

While we find it difficult to put a number on likely 2014 issuance in this still-dynamic market, we think it is fair to assume that it may exceed the pre-crisis average of c.€7bn, but it may not reach the record-breaking €29bn+ in 2013 so far. In Figure 22, we use €15bn for 2014 as our initial estimate.

## Themes to watch in 2014

### *Shift in issuance from rating protection to funding growth*

As the economic cycle in Europe finally turns, there should be an increasing proportion of new hybrids issued to fund growth capex and acquisitions and relatively less issuance driven purely by weakening ratings. As we show in Figure 34, issuance in the past three years was skewed towards the purely ratings-driven issuance; this makes sense, given the large number of capital-intensive corporates facing ratings pressure due to weak profitability amid the recession in Europe. Recently, though, there has been more growth-motivated issuance; we expect this trend to continue into 2014.

### *Hybrid calls*

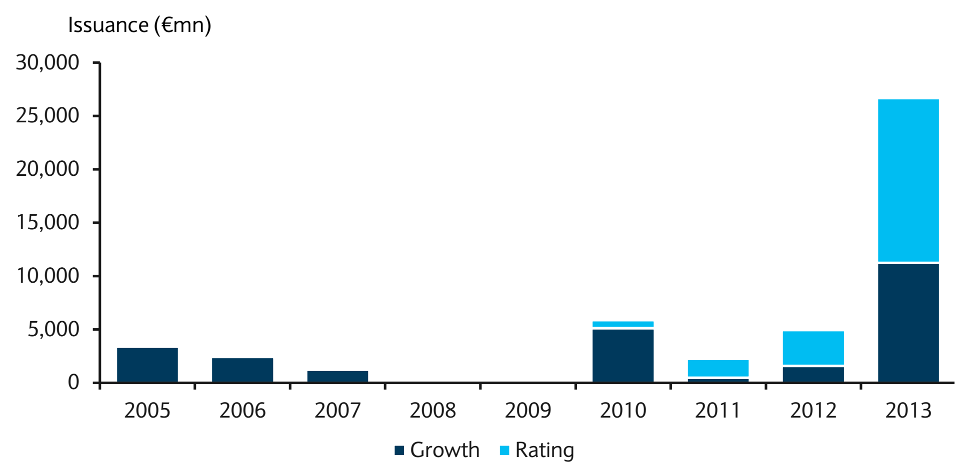
About 30% of the actively traded corporate hybrid universe comprises bonds with calls coming up in the next three years. We think that it makes sense to look at these securities separately from other hybrids, given the relative strength of the structural technical created by the call feature.

We expect the vast majority of the short-call hybrids to be called, despite adverse economics in some cases. Exceptions are possible in names that face material deterioration fundamentals, but this risk currently appears to be material only for the RWE 4.625 perp.

That said, similar to European bank T1s, the upside/downside potential in short-call hybrids is less attractive than in longer-dated perps, and we prefer moving out the curve.

FIGURE 34

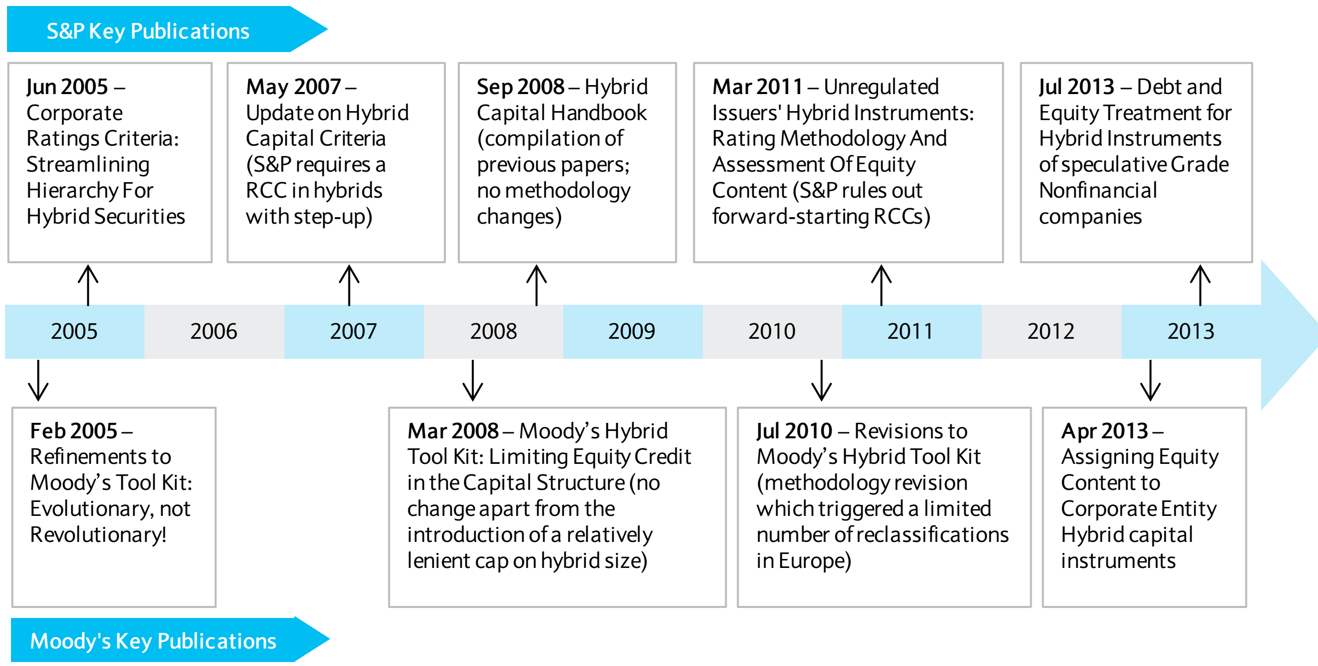
**Comparing ratings- and growth-driven issuance**




Source: Barclays Research

FIGURE 35

**Timeline of rating methodology changes in the past nine years**




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

### *Rating methodology risk*

Rating methodology risk has been one of the big themes of 2013 in the corporate hybrid sector. Moody's and S&P modified their methodologies, and select corporate hybrids have had substantial price volatility driven by the resulting bond documentation events. Clearly, investors now have to pay more attention to bond language in this sector.

The methodology changes are hard to predict. In the past nine years, there were nine material changes. One source of comfort is that the previous methodology changes either affected a small number of bonds or – if they affected a broader part of the market – the existing securities were grandfathered.

### *Peripheral/core split blurred by idiosyncrasies*

Further reduction in the risk premium in the peripheral names should provide a source of additional performance in corporate hybrids in 2014. We estimate the average spread premium for peripheral domicile in corporate hybrids at c.80bp. We also find that the peripheral premium varies substantially by name. This makes sense, given that the corporate hybrid space is generally characterised by the more idiosyncratic nature of the price action, especially after a wave of new issuance in 2013, which brought about a large number of names that are facing rating pressures driven by weak operating performance (as opposed to being driven by the contagion from the sovereign crisis).

# Asian credit strategy

ASIA CREDIT STRATEGY

# Slim pickings

Krishna Hegde, CFA
+65 6308 2979
krishna.hegde@barclays.com

Avanti Save
+65 6308 3116
avanti.save@barclays.com

- **We believe returns on Asia credit will be smaller than what the beta to US credit would suggest. We project Asia high grade spreads to be roughly unchanged over the course of 2014 and the sector to generate ~200-250bp of excess returns. We expect a mild spread widening in Asia high yield (of ~25bp), leading to an excess return forecast of ~350-400bp, which translates into a total return forecast of 2.25-2.75%.**

- **In an environment of anaemic returns and a tepid growth outlook, we expect credit differentiation to increase further in 2014. In high grade, we suggest overweighting India and Korea while underweighting Indonesia. With issuance from Chinese corporates remaining high, we expect concentration concerns to come to the surface. We recommend taking China exposure through Hong Kong and 'Core' China SOEs. In high yield, we recommend a neutral stance towards Chinese property and prefer Chinese industrials.**

- **We believe demand for Asian credit will improve in 2014. This is likely to come from within the region, especially for high grade bonds. However, we do not expect a return to the heady days of Q1-Q2 13, when a combination of strategic and tactical allocations from outside Asia helped drive spreads to multi-year tights. The demand picture for sovereigns and high quality corporates/financials is likely to be stronger, supported by banks and official institutions.**

- **We forecast gross issuance will total USD120-130bn in 2014, broadly in line with volumes in 2013. On a net basis, however, we expect supply to be lower, c.USD75-80bn. We expect issuance to be again dominated by Chinese issuers and the Korean proportion of the index to continue to shrink. In our view, the Chinese SOE segment is set to expand further in sectors such as construction, insurance, asset management, banks and gas utilities.**

## Return projections: More differentiation but limited returns

Return prospects for 2014 are dim compared with other credit asset classes that trade with a similar spread range. We forecast Asia credit to generate total returns of 0-50bp (Barclays expects the 10y US Treasury to be at 3.5% by end Q4 14). We believe returns on Asia credit will be smaller than what the beta to US credit suggests and project Asia high grade spreads to be roughly unchanged over the course of 2014. As a result, we expect the sector to generate ~200-250bp of excess returns (negative total returns of 25-75bp).

In line with our cautious bias, we expect a mild spread widening in high yield (of ~25bp), although it has the benefit of a large carry (current OAS 613bp). After allowing for some losses due to potential defaults, we arrive at an excess return forecast of 350-400bp, which translates into a total return forecast of 2.25-2.75%.

Across Asia credit, we are projecting an environment of anaemic return generation. We believe increasing differentiation will be a key theme and credit selection will drive outperformance in 2014. From a portfolio construction perspective, in high grade, our preferred sectors are at either end of the spread continuum making it akin to a barbell. In high grade, we suggest overweighting India and Korea while underweighting Indonesia. We recommend taking China exposure through Hong Kong and China SOEs in strategic sectors such as oil & gas. In high yield, we recommend a neutral stance towards Chinese property and prefer Chinese industrials.

The typical negative correlation between rates (US Treasury yields) and Asian credit spreads broke down in mid-2013 amidst a sharp upward move in rates. We believe the spread widening that occurred in parallel with the rate move was due to a combination of factors:

- Skewed positioning, with investors finding themselves longer duration than they wanted to be in a scenario of altered rates expectations;
- Outflows from emerging market bond funds and cross-over investors (including aggregate benchmarked funds) reducing their EM positions; and
- A negative feedback loop whereby outflows in local currency bond/equity markets and FX depreciation led to tighter monetary policy and expectations of lower growth.

We expect the correlation between rates and Asian credit spreads to return to the pre-May 2013 levels, but the beta is likely to be lower. In other words, an increase in rates is likely to result in a slight compression in credit spreads. This effect is likely to be most pronounced in segments like Korean policy banks that have global institutional sponsorship. For the rest of Asia credit, we expect other factors like supply/concentration risk (for Chinese credits) and fundamental headwinds (most other high grade corporates) to offset the salutary effect of higher US Treasury yields.

## Key macro themes

### Developed market monetary policy normalisation

The normalisation of monetary policy in the US poses a headwind for Asia credit. We see several implications. Fund flows from Global/EM investors to EM/Asia credit will likely be smaller. As a result, liquidity is likely to tighten and ultimately corporate balance sheets will also be affected as the cost of borrowing/financing begins to rise. A confluence of these factors may lead to a re-pricing of the EM Asia risk premium for global investors.

### China – reforms following the Third Plenum

The reform blueprint that emerged from the Third Plenum in November has areas that could affect Asian credit. At a macro level, we think it is important to keep an eye on the implementation of these reforms and any indications of the future roadmap.

Specific areas to keep an eye on through 2014:

A. Market-based resource pricing for sectors like water, electricity and oil & gas and any dilution of the market power of SOEs in these areas.

B. Changes to local government financing and any aspect that reduces the risk perception around the local government debt buildup.

C. Land reform that alters the supply/pricing of land for property development.

D. SOE restructuring that changes the perception/likelihood of state support in cases of potential stress.

E. Financial sector reform that results in higher onshore rates and funding costs.

F. Environmental protection measures that increase costs and/or reduce overcapacity.

### Adjustment to potential growth for countries in Asia

Through 2013, growth estimates for Asia and EM were cut, and the market is likely to start questioning estimates of potential medium-term growth. We believe downward revisions are possible as the effect from easy global monetary policy (and associated fund flows) on investment and consumption activity is reassessed. We are already seeing signs of this: Bank

Indonesia's assessment of the country's potential growth rate has fallen from 6.9% in mid-2012 to 6.5% in November 2013. A deeper and systematic reassessment of potential growth levels could feed into the ratings trajectory and affect flows (portfolio and FDI) into these countries.

### Political risks in India/Indonesia and Thailand

India and Indonesia, which together account for over 20% of the index by market value terms, have national elections in 2014. Parliamentary elections are expected to be held in April in Indonesia, followed by presidential elections in mid-July. India elections are expected to be held by May/June. These will be closely watched, given the challenges the countries have been facing on growth, currency moves and widening current accounts. The uptick in political noise in Thailand has the potential to become a source of concern. We think an uptick in political noise in Q1/Q2 or even an early election in 2014 can not be ruled out.

Our spread and return forecasts do not take into account any positive surprises out of the elections being held in Asia next year. If a post-election government in India and/or Indonesia announces a credible reform roadmap, we could see a material tightening of spreads for the sovereign bonds of these countries.

## Positioning: Country selection key in high grade

### High grade

*High beta: India versus Indonesia*

We favour India credit, for several reasons:

- *Economic fundamentals*: India's current account deficit is narrowing rapidly, while in Indonesia our economists expect the current account to stabilise only in 2014; India's rebuilding of foreign reserves has been supported by sticky inflows (such as foreign currency deposits), while Indonesia has rebuilt reserves by portfolio inflows and onshore short-dated term deposits; Indonesia has significant foreign currency borrowing needs in 2014.
- *Technicals:* We believe most market participants have lower-than-benchmark positions in India. Furthermore, key participants in Indonesia credit are EM/global investors and we expect demand from this segment to be softer on a year-on-year basis. Indonesia has higher foreign currency borrowing needs in 2014.
- *Valuations*: India credit offers better volatility adjusted carry, quoted 114bp wider than the high grade benchmark and 120bp wider than Indonesia. In addition, the duration for India credit is significantly shorter than for Indonesia's (India: 4.5, Indonesia: 7.6)

Another favourable development for India is S&P's reaffirmation of its sovereign rating at BBB- Neg on 7 November. We interpret S&P's comments as providing comfort on current ratings through at least mid-2014, which effectively rules out a downgrade before the national elections due in May 2014.

*China versus Hong Kong*

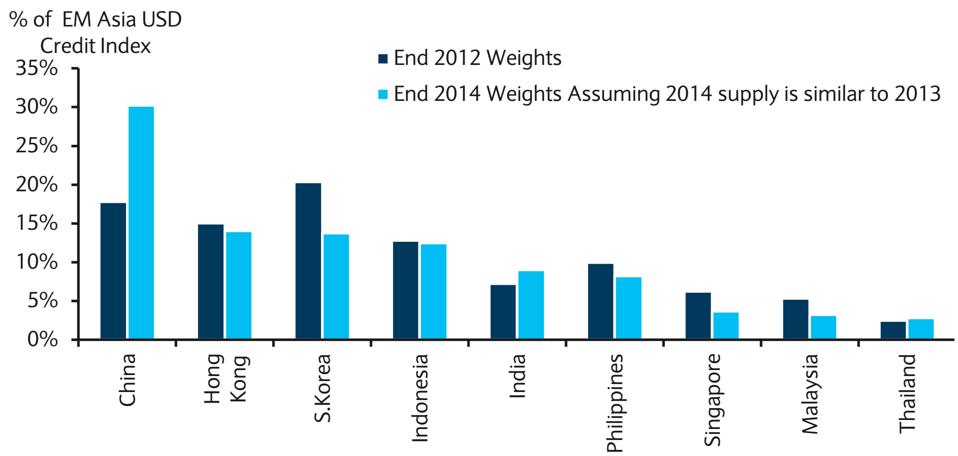
Given our expectation of supply from China, we believe spreads in aggregate will remain range bound. As a result of the surge of issuance from China credit, the performance of Asia credit is increasingly dominated by China risks. In high grade, Chinese corporates constitute 26% of the Asia index, while Chinese property makes up 30% of Asia high yield. Our supply forecasts indicate an expectation for issuance from China to remain high in 2014, further increasing the concentration of China credits in the benchmark. For example, if 2014 issuance volumes and mix are similar to 2013, bonds from China would constitute over 30% of Asian credit at end-2014, versus 18% at the start of 2013.

A return of macro concerns regarding China would likely lead to sustained underperformance of the China complex, as investors would look to limit exposure to the segment, like US financials in 2009 or Italy in 2012. A benign outlook is likely to drive continued supply. As a result, we think the risk/reward of being overweight China high grade as a complex is negatively asymmetric.

We expect increased spread differentiation between core and tertiary SOEs because growing supply from tertiary/secondary SOEs should cap spread compression and the government's plans to reform SOEs, move to a market-based resource allocation, and move to a 'state investment company' model, will likely increase rating divergence. Therefore, we recommend taking China exposure via Hong Kong entities and holding core SOEs, which benefit from global sponsorship. Within the Hong Kong complex, we think the property sector may experience volatility due to potentially rising headline risks (regarding the effect of rising rates and a potential property price correction).

FIGURE 1

**Weights of countries in index assuming supply pattern is similar in 2014**




Source: Barclays Research

### Chinese SOEs: Scope for more differentiation

Policy discussions in China point to reforms in areas spanning financial liberalisation, factor prices, administrative controls, monopolies and income distribution, all of which ultimately filter down to how state-owned enterprises (SOEs) are managed. Comments by officials indicate that the thrust will be a move towards more market-orientated mechanisms across the economy.

Initially at least, the structural reforms are likely to lead to a deterioration in the credit metrics of many SOEs. This is likely to result in a higher risk premium and lower credit ratings, as has already been seen with the likes of Metallurgical Corporation of China and Yanzhou Coal. Further out, if the structural reform process gathers momentum, we believe markets will need to re-assess the bulk of SOEs on the basis of being standalone commercial entities, with the government being an active shareholder, rather than a backstop/safety net. Assumptions of a government backstop were recently challenged in the financial services industry. With respect to China, we argue that a shift in implied government support is not inconceivable over 3-5 years. In such a period, the government could accomplish a shift from the current structure of deep linkages between all SOEs and the state to a more differentiated structure wherein only strategic SOEs retain a high level of government engagement. For the other SOEs, the government would restrict itself to being an active shareholder.

We classify SOEs into three broad categories.

- **Core**: Central SOEs are strategically important, control natural resources nationwide and employ large numbers of people. They control significant domestic market shares and are the vehicles used for offshore M&A in the relevant sector. On a standalone basis, their business profiles are strong. Credit ratings are BBB or higher on a standalone basis.

- **Secondary**: Central and provincial/local SOEs operate in strategic or competitive sectors. They are dependent on the government for concessions and contracts, such as long-term contracts for gas, and they also benefit from their SOE status for access to financing. Most of them have strong market shares in their business or areas of operation. Credit ratings are in the BBB range on a standalone basis. Some issuers may face the risk of divestment or changes in regulated prices.

- **Tertiary**: SOEs operate in strategic or competitive sectors but depend heavily on the government for contracts, concessions and preferential tax treatments. There is a high dependence on SOE status to access financing. Business viability is also dependent on government contracts/support. Thus, there is a high level of SOE and local government interdependence. Credit ratings are mid-BB or higher on a standalone basis. Some issuers may face risk of divestment, changes in regulated prices, and lower government support during reform process.

### *Low beta: Korea versus Philippines*

We prefer Korea to Philippines:

- *Technicals*: We see increasing demand for Korean debt from developed market investors (US credit and rates), which should ensure that technicals remain robust. Global bank demand for high-quality liquid assets should also favour Korea. The Philippines will likely see continued demand from onshore investors but with US Treasuries expected to be volatile, we think these participants will prefer lower duration product.

- *Valuations*: Korea is quoted 28bp tighter than the Philippines. Even then, we favour Korea for the 5-6 notches higher rating and shorter duration (Korea: 3.7; Philippines: 8.3).

### High yield

*China property versus China industrials*

We recommend a neutral stance on China property and prefer industrials. A neutral stance on property is appropriate, in our view:

- *Fundamentals*: The credit profiles of many developers look to have peaked. A benign market and policy outlook suggest that developers are likely to continue to replenish land banks opportunistically, which could take priority over deleveraging; material land acquisitions could raise execution and financial risks, especially for smaller developers or those that are highly leveraged. We also expect construction spend to increase in 2014 as developers bring on stream the land they acquired in the past 6–9 months.
- *Technicals*: Bond supply should pick up due to business and refinancing needs. Furthermore, we believe the property sector is a consensus long because of the size and performance of the sector.
- *Valuations*: Bond prices largely reflect the expected benign policy outlook for the sector. In contrast, we think the industrial segment's credit metrics will continue to stabilise and positioning remains favourable, which should allow for bond supply to be absorbed.

## Demand dynamics: In-region demand should help

**We believe demand for Asian credit will recover in 2014, led again by in-region demand, especially for high grade bonds. However, we do not expect a return to the heady days of Q1-Q2 13, when a combination of strategic and tactical allocations from abroad and in-region demand provided a solid technical. The demand picture for sovereigns and high quality corporates/financials is likely to be stronger, supported by banks and official institutions.**

**High grade**: We believe demand technicals are most favourable for high grade credit, owing to a deepening of the institutional investor base. Growth in Asian life insurance companies' assets should continue to support demand for longer-dated investment grade corporates. In addition, the expected slower loan growth in Asian banks and the need for high-quality liquid assets to manage liquidity are likely to boost demand at the front end of the investment grade curve.

**High yield**: Incremental demand for high yield corporate bonds is likely to be more challenged. Private banks are likely to deploy a larger portion of their incremental funds to equities or developed markets. We do not expect Asian credit funds to get the same traction as before, following 2013 performance and headwinds from likely interest higher rates. A pocket of strength is likely to be demand from Chinese investors (retail and institutional), typically for Chinese HY bonds.

**Global asset allocation/crossover** demand is unlikely to increase, given the prospects of Fed tapering and a renewed focus on the challenges for EM.

FIGURE 2

**Expected demand changes for Asia sovereigns/quasi-sovereigns**

| Investor base | Driver of flows | Changes expected in 2014 | Overall view for 2014 vs 2013 |
|---|---|---|---|
| Global institutional fixed income investors | 1. Ongoing structural allocations to EM assets<br>2. Relative value of Asian sovereigns vs LatAm/EEMEA | 1. Institutional strategic allocations (such as European/UK pension and insurance) into EM to continue, but at a slower pace than in 2013. Furthermore, after the volatility in mid-2013, we expect allocation decisions to be slower<br>2. Relative value considerations may put Asia at a disadvantage | ⬅➡ |
| Global EM sov/quasi-sov benchmarked retail funds | 1. Fund flows and structural demand for EM assets from retail investors<br>2. Relative value of Asian sovereigns vs LatAm/EEMEA | 1. Following weak performance in 2013, we expect retail demand to be lower<br>2. Number of new fund launches is likely to slow, with possible upside from Japan | ⬅➡ |
| Domestic (pan-Asia) buyers | 1. Bank buying to match USD liabilities – eg, dollar deposits<br>2. Retail buyers stretching for yield, rotating out of local-currency bonds into USD debt, especially where local-currency government bond yields remain low | 1. Philippine banks to continue to buy ROP bonds. As spreads for ROPs shrink, we expect this group gradually to expand mandates to high grade corporates and reduce holdings of ROPs<br>2. If investment-led loan demand in Indonesia slows, banks with ample USD liquidity are likely to park those funds in INDON bonds. The sovereign's potential onshore USD bond issuance could siphon some demand away from INDON bonds | ⬆ |
| Insurance companies | 1. Investors focused on all-in yields for asset-liability matching purposes | 1. Continued participation if yields increase either because of spread widening or rates selling off<br>2. On average, insurance assets in the region are growing faster than domestic bond markets, which encourages diversification offshore<br>3. Following the sell-off in local-currency bonds, we expect some companies to increase allocations to the local-currency space | ⬆ |
| Official institutions | 1. Reserve investment to get spread | 1. Countries where current account surpluses remain robust (eg, Korea) are likely to continue to invest in this sector | ⬅➡ |
| Asia credit benchmarked | 1. Significant portion of benchmark, so need to take exposure based on expected returns | 1. Participation to be opportunistic | ⬅➡ |
| Hedge funds – credit and global multi-asset | 1. Opportunistic, especially in the high yield sector<br>2. Event-driven (eg, inflation, politics, foreign exchange) | 1. Participation to be opportunistic | ⬅➡ |

Source: Barclays Research

FIGURE 3
**Expected demand changes for Asia corporates/financials**

| Investor base | Driver of flows | Changes expected in 2014 | Overall view for 2014 vs 2013 |
|---|---|---|---|
| Institutional allocation from global insurers and pensions | 1. Strategic allocation to Asia/EM<br>2. Diversification away from US/Europe | 1. Allocations to Asia/EM are likely to slow from the Q1-Q2 13 pace. A larger share of new allocations is likely to be directed to high grade corporates<br>2. US and European institutions investing directly are likely to continue to prefer Asian issuers that are in global credit benchmarks. Asian bonds with a 144a tranche should benefit more than Reg S bonds | ⇔ |
| EM corporate benchmarked retail funds | 1. Strategic allocation to EM assets<br>2. Shift in allocations away from EM sovereigns toward corporates<br>3. Relative value | 1. Flows likely to be softer than in 2013 because new fund launches are likely to slow, given their performance in 2013 | ⇔ |
| Asia credit benchmarked mutual funds (retail) | 1. Stretch for yield – rotating out of local-currency debt into USD debt, especially where spreads on local-currency government bonds are tight<br>2. Cross-currency basis swaps rising, which makes swapped yields more attractive | 1. Taiwan: Expect continued allocations towards Asia IG and HY<br>2. Japan: Mandates towards Asia credit to increase, especially from retail. Pickup in demand for Asia high grade from pensions<br>3. Others (Malaysia, Thailand, Korea): Low local yields likely to push fund managers to invest in USD bonds, especially if cross-currency basis swaps rise. We expect demand for Asia high grade from Malaysia and Thailand, but the pace of incremental allocations may slow. On the other hand, Korea is likely to see continued onshore demand | ⇓ |
| Asia credit benchmarked institutional allocations | 1. Cross-currency basis swaps rising, which makes swapped yields more attractive<br>2. Diversification | 1. Japan: Mandates to Asia credit likely to increase, with an emphasis on investment grade and non-China segments<br>2. US, Europe, Asia official institution asset allocation: strategic allocation into Asia credit to continue | ⇑ |
| Asian insurance companies | 1. Oriented towards all-in yields for asset-liability matching<br>2. Cross-currency basis swaps rising, which makes swapped yields more attractive than government bonds in some markets | 1. We expect increased participation in long-dated high grade corporates, especially from Taiwan. Overseas holdings have been increasing. We expect increased allocations to Asia and further movement down the ratings spectrum<br>2. Insurers from Thailand, Hong Kong, Korea and, potentially, China likely to buy USD quasi-sovereign and high grade bonds as AUM grows faster than local-currency bond markets. Diversification away from home-country bonds expected in Korea and Thailand | ⇑ |
| Commercial banks – treasury desks | 1. Generate returns on deposits (especially foreign-currency) or park USD liquidity | 1. Chinese banks to continue buying Chinese SOE credit. For Hong Kong and Singapore banks, loan growth is being driven by Chinese demand. If it slows, incremental deposit growth could be deployed in the bond market, given tepid home market conditions<br>2. Philippine banks gradually to expand mandates to high grade corporates, offering wider spreads than ROP bonds<br>3. Korean banks also likely to buy more bonds as loan growth continues to slow<br>4. Asia credit offers a greater positive spread, with the cost of senior funding for US and European banks decreasing<br>5. The move towards implementation of Basel III Liquidity Coverage Ratio rules should boost single-A and above corporates in jurisdictions where these are part of High Quality Liquid Assets | ⇑ |
| Hedge funds | 1. Opportunistic and relative value<br>2. Event-driven (eg, M&A, earnings) | 1. Given current valuations, multi-asset funds are unlikely to allocate more to credit. They likely will wait for dislocations, as they did in mid-2013 | ⇔ |
| Private banks | 1. Pool of assets continues to grow<br>2. Allocations to credit vs equity are a theme<br>3. Access and availability of leverage enhances yields on high grade bonds | Demand to be modest in 2014<br>Key drivers: 1) rising US Treasury yields will likely dampen potential total returns; 2) the leverage private banks offer to clients is likely to be reduced; 3) alternative asset classes (eg, equities, DM credit) could siphon off some allocations to Asia credit; 4) regulatory scrutiny on hybrid structures marketed to clients is likely to curb demand for these products | ⇓ |

Source: Barclays Research

## Supply dynamics: Another year, another record

**We forecast gross issuance will total USD120-130bn in 2014, broadly in line with volumes in 2013. On a net basis, however, we expect supply to be lower, c.USD75-80bn. We expect issuance to be again dominated by Chinese issuers and the Korean proportion of the index to continue to shrink. In our view, the Chinese SOE segment is set to expand further in sectors such as construction, insurance, asset management, banks and gas utilities.**

Overall, our supply expectations indicate that the pace of issuance growth will slow compared with the past few years. given the current market size. We believe front-loaded supply will be met with nearly USD25bn of redemptions in H1 14 (Figure 5).

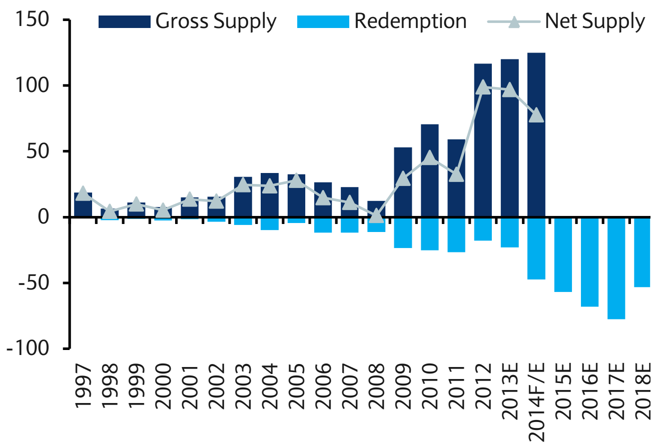
**High grade**: We expect the Chinese SOE segment to expand further. Chinese banks/ insurance companies are also likely to tap the bond market. Most of this expected issuance will be net positive, given that there is very little Chinese high grade debt maturing over 2014-15. On the other hand, Korea has significant redemptions scheduled for the coming two years, but we do not expect supply to pick up, largely because Korean issuers will likely continue their trend of diversifying their funding sources (including currencies). Added to this is the increasing demand for Korean debt among developed market investors, which should ensure that technicals for Korean credit remain robust.

India credit will grow at a modest pace, in our view, partly driven by the official encouragement for government-owned corporates to borrow offshore. However, we do not expect a supply surge from this segment because Indian issuers continue to receive favourable funding costs in the loan market.

**High yield:** This will likely be used for a broad variety of purposes, spanning refinancing maturities, pre-funding calls, boosting liquidity and funding growth/expansion. We expect Chinese developers and industrials to look to refinance upcoming calls. In addition, we think Chinese developers are keen to rebuild their land banks and will remain opportunistic towards raising funds for such expansion. Chinese industrials that have benefited from the stabilisation of Chinese growth are likely to be keen to raise funds for expansion/diversification of their funding, especially as onshore borrowing costs have been trending higher; and maiden issuers with relatively weak metrics are likely to consider SBLC structures to reduce funding costs. Indonesian supply is likely to be limited and concentrated in the property sector. We expect supply from frontier markets such as Sri Lanka to pick up further, given tighter onshore liquidity and a general policy thrust.

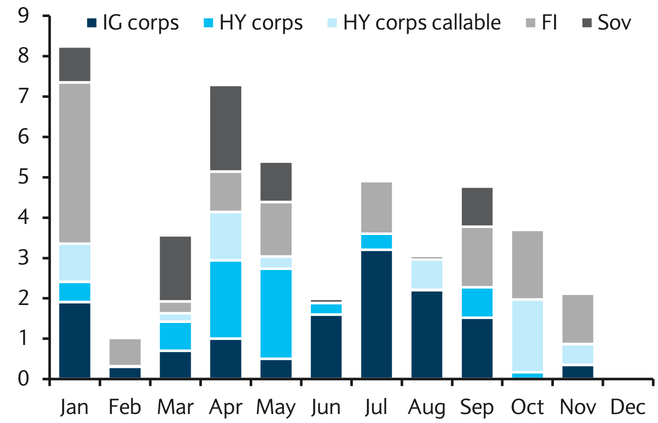
**Sovereigns**: We expect Indonesia to be the largest gross issuer. We also view Korea and Thailand as potential candidates, though they should remain sensitive to pricing. High yield sovereigns such as Sri Lanka are likely to continue to be regular issuers.

FIGURE 4
Asia credit issuance profile (USD bn)




Source: Barclays Research

FIGURE 5
Monthly redemptions in 2014 (USD bn)




Source: Barclays Research

### No dearth of maiden issuance

Focussing on countries with tightening banking system liquidity, we use a number of screens to identify potential maiden issuance.

*China*

**Methodology**: We screen all Hong Kong-listed Chinese companies to identify sectors comprising existing USD or CNH bond issuers. We narrow down the issuers to eliminate small companies. We then overlay data on loan maturities and whether the company is a large onshore issuer.

**Result**: (1) We think there is potential for maiden issuance from some Chinese property developers, especially medium-sized developers that are listed in Hong Kong. (2) Within the Chinese SOE segment, we think companies in construction, insurance, asset management, banks and gas utilities could be potential maiden issuers. These sectors are under-represented in the USD bond universe and continue to have significant expansion/capex needs. We think these companies will continue to use the keepwell deed and deed of equity interest purchase undertaking to support bond issuance from offshore subsidiaries.

*Philippines*

Philippines corporate issuance has picked up in the past eighteen months. We believe this trend is likely to continue as large conglomerates (especially property, retail, gaming, utilities) look to diversify funding sources.

*Indonesia, Vietnam, Sri Lanka*

Finally, we expect Indonesian high yield corporates primarily in the property sector to be issuers in 2014. We also expect maiden issuance from frontier markets such as Sri Lanka and Vietnam to pick up further, given the tighter onshore liquidity and policy thrust in the former.

FIGURE 6

**Drivers of borrowing for 2014**

| Drivers of borrowing | High grade corporates | High yield corporates | Financials | Sovereigns |
|---|---|---|---|---|
| **Debt redemptions/maturities** | | | | |
| USD bond maturities | 1. Scheduled USD maturities in 2014 (USD13bn) and 2015 (USD20bn) are dominated by Korean corporates followed by Hong Kong.<br>2. We expect corporates to refinance and pre-fund USD bond and foreign currency loan maturities in the USD debt market to take advantage of still low UST yields and to lock in long tenor funding.<br>3. Korean corporates have been diversifying the currency of their borrowing. As we expect this trend to continue, even though redemptions are high we do no expect all to be refinanced in the USD bond market. | 1. Total USD maturities in 2014 (USD13bn) and 2015 (USD12bn) are dominated by Chinese corporates (including bonds up for call).<br>2. We expect most Chinese developers to refinance/prefund maturities/calls. Issuers in this bucket include Agile, Country Garden, Evergrande, KWG Properties, Road King and Shimao<br>3. Chinese industrials are also likely to be opportunistic to refinance calls if all-in yields are favourable.<br>4. Indonesian corporate maturities are modest. We believe strong issuers like Adaro may tap the market but weaker names like Bumi Resources are unlikely to have USD bond market access. | 1. In 2013 and 2014 senior financials' debt maturing will total around USD13bn and USD21bn respectively.<br>2. In 2013, the bulk of maturities will be from Korean banks, followed by Singaporean banks (subdebt). We believe Singaporean banks are likely to tap the SGD market for refinancing given the lack of SGD paper and stable retail demand.<br>3. In 2014, maturities will again be dominated by Korea. But Indian banks maturities are also set to pick up in 2015 (c.USD4.6bn). | 1. Total USD bond maturities of USD7.5-8bn in 2014. Most maturities are from Indonesia and Korea.<br>2. We expect both of these countries to refinance in the bond market. |
| CNH bond maturities | 1. Nearly USD8bn of CNH bonds will mature in 2014. We believe some of this could be refinanced in USD markets because a portion of these issuers also have USD bonds outstanding and the USD market may offer longer tenors/sizes. | | N/A | N/A |
| Other foreign currency maturities | 1. Foreign currency borrowing (except USD and CNH) is limited among corporates. Significant upcoming redemptions include Hutchison Whampoa (EUR bonds in 2015), HK Land (SGD bonds in 2015) and POSCO (samurai bond in 2014) | | 1. Most foreign currency (except USD and CNH) redemptions is from financials in Korea and India. We expect Korean issuers to continue to diversify their funding currency profiles. Indian bank bonds issued in SGD and CHF will start coming up for redemption from 2015. We believe some of this debt could be refinancing in the loan or USD bond market. | 1. China has EUR1bn of bonds maturing in 2014. However, we do not expect this debt to be refinanced. |
| Others (incl loans, entrusted/trust loans) | 1. Hong Kong based companies like Wharf, Noble, Sun Hung Kai, Henderson have large loans due in 2014/15. We believe part of this debt will be refinanced in the bond market. We also think Chinese companies like Citic Pacific and Sinochem (see Corporate Outlook section) are likely to follow this trend. | | N/A | 1. Sri Lanka is likely to refinance external debt (maturities/payments amount to roughly USD500mn). |

| Drivers of borrowing | High grade corporates | High yield corporates | Financials | Sovereigns |
|---|---|---|---|---|
| **Business operations** | | | | |
| Capex and operations | 1 .**Korea gencos**: Capital spending at Korea Electric Power and the six Korean gencos (KHNP, KEWSPO, KOWEPO, KOSPO, KOSEPW and KOMIPO) will remain high over the coming years, given the need to improve reserve margins. Specifically, KEPCO has a capex program of c.KRW74trn between 2013 and 2016.<br>2 .**Oil and gas**: Capex levels are also elevated in this sector, as companies look to increase their medium-term production targets (PTTEP, KNOC, Chinese oil and gas). Gas utilities: Chinese gas utilities generally have ambitious capex plans to support growth in natural gas consumption.<br>3 .**Hong Kong properties**: We believe companies with improved financial flexibility could be opportunistic in land bank acquisitions (eg, Sino Land, Hang Lung Properties). | 1 .**Indonesia**: We think capex/operational funding needs will be lower at coal producers but higher at industrials (such as property). Several IPPs (including STAREN, CIKLIS, and possibly Jababeka) may consider new power plants, and property companies may look to replenish their land banks.<br>2 .**Chinese industrials**: We do not expect these corporates to embark on aggressive growth plans in 2014. However, with the stabilisation of economic growth in China, we expect capex needs gradually to pick up, especially for construction related companies. Companies with relatively high short-term funding needs are also likely to consider SBLC structures.<br>3 .**Chinese developers**: As most developers are in a land acquisition phase, they are likely to raise funds to expand their land banks.<br>4 .**Philippines corporates**: We expect this segment incrementally to tap the USD market to fund capex/expansion plans onshore. | 1. Over the years, liquidity has tightened in most countries (except Korea), and we believe a withdrawal of global liquidity (Fed tapering) will put further pressure on system liquidity. We expect banks to tap wholesale borrowing to ease some of their liquidity constraints. In particular, liquidity is tightening in Singapore, Hong Kong, Indonesia and Sri Lanka. | 1. Higher funding needs: We see countries with shrinking current account surpluses, softening portfolio flows, and/or a need to build reserves as potential sovereign issuers.<br>2. Borrowing mix shifts: If portfolio flows from the local bond markets reverse, sovereigns are likely to shift their borrowing mix to more offshore bonds. |
| **Event risk/capital structure** | | | | |
| M&A | 1. **O&G**: We expect the major Chinese oil and gas companies, ONGC, PTTEP and KNOC, to remain acquisitive, specifically in purchasing stakes in production joint ventures.<br>2. **Gas utilities**: The Chinese gas distribution companies are keen to expand their networks, which could involve further stake-building and vertical integration activities, given the government's push towards higher gas penetration.<br>3. **Conglomerates**: Key development would be Hutchison group's acquisition and disposal activities along with its organizational repositioning. | | 1 .We expect banks (Singapore, Malaysia) to remain acquisitive and believe banking sector consolidation will remain a theme. To the extent that banks have capital buffers, debt can be used to fund M&A activity. | N/A |
| Others (policy, regulatory capital) | 1 .Government support for pricing reforms in the energy sector (higher gas prices, adjustments to refined product prices) would improve profitability, while the development of the clean energy sector should drive further investments. | | 1. The introduction of Basel III regulations across the region means old-style capital instruments lose capital credit; therefore, we think banks are likely to boost their Tier 1 and Tier 2 capital by issuing loss-absorbing capital instruments. | N/A |

Source: Barclays Research

## Fundamentals are moderating

**We expect credit metrics to continue to moderate across Asia, but believe companies in most segments have sufficient buffers to prevent rating downgrades. Although leverage is likely to increase, debt service remains manageable, given cash balances and favourable financing costs in recent years. We expect the rating agencies and market participants to re-evaluate tertiary/secondary Chinese SOEs based on their fundamentals and see several candidates that are vulnerable to credit quality erosion.**

**High grade corporates**: We expect credit metrics to weaken in 2014, driven by softening economic growth and continued M&A and investment. However, we believe most companies have sufficient ratings headroom and are likely to remain flexible in their investment programs and undertaking acquisitions. Some low-mid BBB issuers with less ratings headroom will continue to face a trade-off between pursuing growth and defending their ratings.

**High yield corporates**: China high yield benefited from stabilisation in the country in 2013. We believe Chinese developers' credit profiles have peaked and expect a slight deterioration in 2014, driven by increasing appetite to build land banks and potential policy measures in select cities. Coal producers' earnings will likely remain weak and performance driven by their ability to lower costs and maintain adequate liquidity.

**Financials**: Fundamentals appear to have peaked. We expect credit metrics to moderate and would not rule out deterioration at some banks. Asset quality is likely to weaken, albeit from a strong base, as economic growth slows. Korean banks are likely to be the most defensive and Indian banks' fundamentals to remain under pressure.

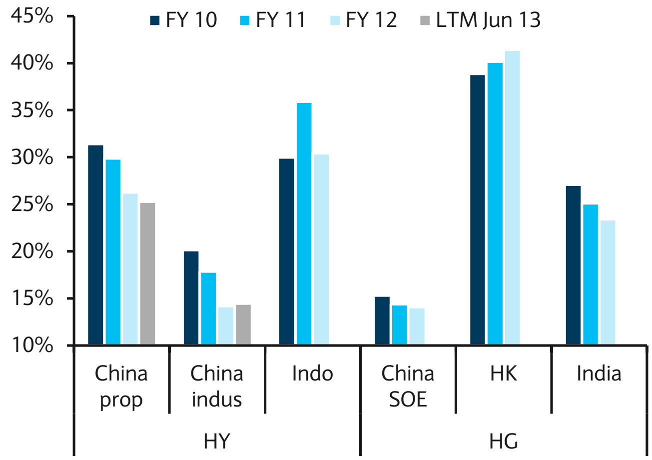
### Factor 1: Softening economic growth in EM Asia

Overall, margins are likely to moderate for most Asian corporates. Economic growth in China is expected to stabilise next year. Even then, revenues for high yield companies involved in coal, industrial machinery, steel and metals will likely remain soft, and focus will remain on keeping costs low, destocking, shortening the cash-conversion cycle and scaling back discretionary capex. Coal producers remain a weak spot; we believe Indonesian producers are better positioned, given their low costs and adequate liquidity. We expect earnings at Indonesian and Chinese property developers to grow, albeit at a slower rate. In both countries, government policies to moderate property prices increases will weigh on the pace of demand growth.

In high grade, moderating economic growth will likely cap potential revenue gains, and we expect margins to be broadly flat or slightly lower y/y. In particular, miners, industrial materials, property/retail and telcos are likely to see EBITDA margins narrow. Government policies and ongoing reforms should remain the key drivers of earnings prospects and credit quality among Chinese SOEs. In India, we expect government policies with respect to fuel subsidies and under-recoveries to continue to affect the quasi-sovereign refiners (Indian Oil, Bharat Petroleum, Hindustan Petroleum) and upstream companies (ONGC, Oil India, GAIL India).

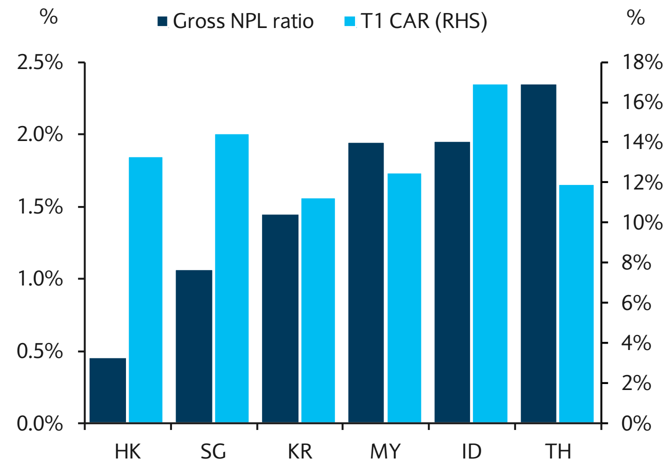
Asia banks are also likely to experience a gradual turn in the credit cycle, which would lead to pressure on asset quality. Banks have grown their loan books at a healthy pace over the past few years (Figure 8), and this could lead to an uptick in NPLs and credit costs as portfolios season. Furthermore, treasury income is likely to decline as local currency government bond yields rise.

FIGURE 7
**Trend EBITDA margin (median) has been shrinking for corporates**




Source: Company financials, Barclays Research

FIGURE 8
**Banks' NPL and capital ratios**



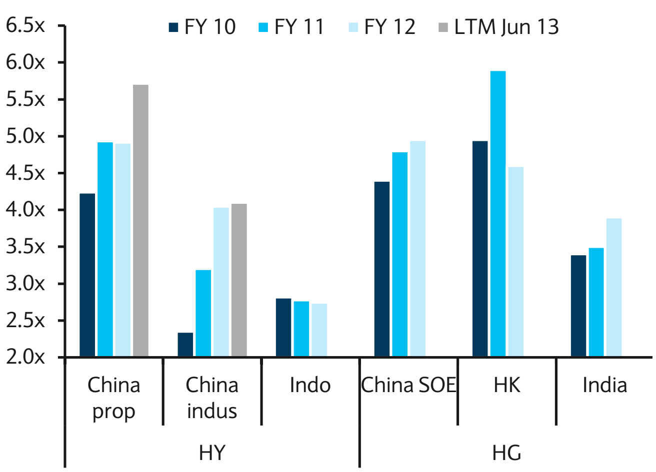

Source: Company financials, CEIC, Barclays Research

## Factor 2: Financing conditions to tighten, in terms of borrowing costs and availability of funds

Although leverage has risen at most Asian corporates, debt service remains manageable because of favourable financing costs in recent years. This should mitigate significant pressure on most corporates' fundamentals in 2014, even as EBITDA growth slows. We see only a handful of high yield issuers with significant near-term risk arising from a high proportion of short-term debt and weak liquidity, including Glorious Property and Hidili. In addition, credit fundamentals at some Chinese high yield developers and high grade corporates may deteriorate as they turn to debt-funded growth (eg, land acquisitions).

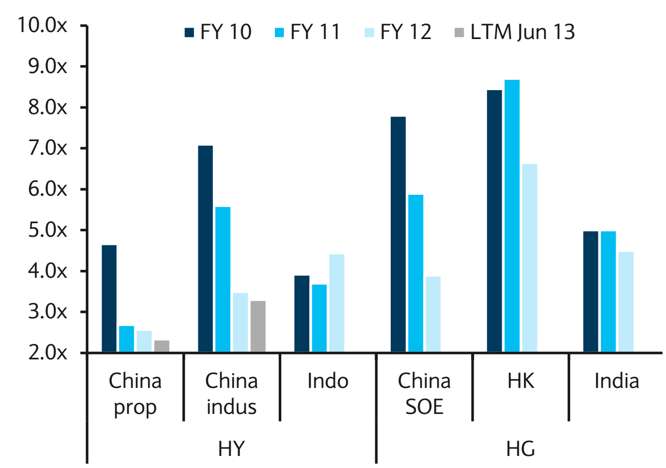
Trends in loan-to-deposit ratios for key countries in the region indicate that banking liquidity has tightened meaningfully in the funding centres, Hong Kong and Singapore, and in Indonesia. As a result, NIMs could come under pressure, especially in Hong Kong, as competition for deposits increases.

FIGURE 9
**Asian corporate debt leverage has risen (debt/EBITDA, median)…**




Source: Company financials, Barclays Research

FIGURE 10
**… but interest coverage is manageable (EBITDA/gross interest, median)**




Source: Company financials, Barclays Research

In 2014, we expect continued divergence of the availability of funds for Chinese corporates, as onshore banks are likely to ration funds incrementally. Also, we believe issuers able to access funding from Taiwanese, Japanese or Middle Eastern banks will continue to receive favourable borrowing rates.

## Factor 3: Weakening EM currencies

We believe FX risk arising from IDR depreciation is manageable for most Indonesian corporate issuers. Coal and utility issuers have natural hedges from their cash generation and debt service costs. Also, the larger property companies have hedged their USD bond principal so the impact will be mitigated on earnings even though balance sheets will likely deteriorate. Indonesian industrials appear exposed, given their lack of hedging and the mismatch between their cash flows and debt service costs. However, most still have large USD cash deposits from recent bond issues, which could be utilised for interest payments in the near term.

Weaker currencies by themselves are unlikely to have an adverse effect on the asset quality of Asian banks, since most have been prudent with regard to permitting unhedged FX exposure among their clients.

In Figure 11, we list companies that we think will face earnings volatility on adverse movement in their local currency. We have not included those where currency depreciation has implications for the debt position, given that those names do not have upcoming maturities and have sufficient USD cash deposits

FIGURE 11

**Companies vulnerable to currencies moves***

| Company | Comments |
|---|---|
| Gajah Tunggal | IDR depreciation affects Gajah's operations (c.70% of operating costs are in USD) and debt servicing ability. The risk is partly mitigated by export sales (c.30% of total sales). The company is able to pass on most cost increases to customers, although with a three- to six-month lag. |
| Indian oil-marketing companies (HPCL, BPCL, IOC) | The credit quality of OMCs is driven by the level of under-recoveries – a function of the INR's relative strength, crude oil prices and recent price deregulation. |
| Indian upstream companies (Reliance, ONGC) | INR weakness provides some upside due to these firms' USD-based earnings streams from oil and gas products. Nonetheless, there are several offsetting factors, especially for ONGC. As ONGC pays about 30% of the cost of domestic fuel subsidies, any increase in under-recoveries diminishes its gains from a weaker INR. |
| Japfa Comfeed | The company generates substantially all of its sales in IDR, but the majority of its costs are for imported raw materials. Historically, the company has been able to pass on its cost increases to customers, albeit with some time lag. |

Note: * Issuers whose near-term credit profiles are likely to be adversely affected by depreciation of their domestic currency. Source: Barclays Research

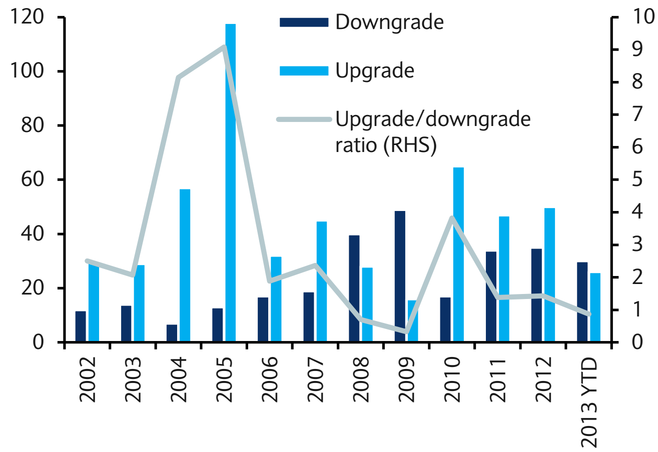
## Ratings trajectory has turned

The ratings trajectory in Asia credit has turned: fewer upgrades and a modest number of downgrades (Figure 12). We believe this trend will continue into 2014 and that Indian Overseas Bank, Syndicate Bank and Chong Hing Bank look like potential fallen angel candidates in 2014

We expect increased divergence in credit ratings among Chinese SOEs. With two fallen angels in this segment in 2013, we expect the rating agencies and market participants to re-evaluate tertiary/secondary SOEs based on their fundamentals. Chinese SOEs whose ratings could face potential pressure due to weak credit metrics include China Merchants Holdings International (CMHI; due to the challenging operating environment and growing competition), China Railway Group (CHRAIL), Sinochem HK, Bright Food (due to rising

FIGURE 12

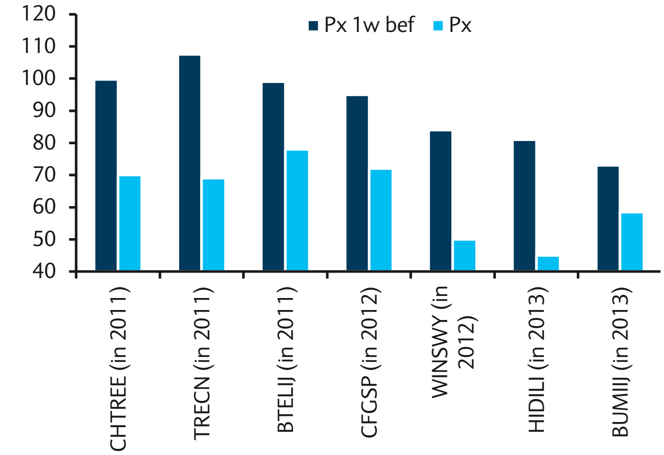
Number of downgrades has increased




Note: Asia ex-Japan, Australia and New Zealand. Individual issuer actions (not notches). Source: S&P, Barclays Research

FIGURE 13

Bonds whose price fell at least 20% w/w




Source: Barclays Research

competition), China State Construction International Holdings Limited (CHCONS), Aluminium Corp of China Limited (Chalco; due to the weak operating environment and overcapacity) and Shenzhen International Holdings (SZIH). In Korea, Hyundai Steel's Baa3 rating is on Watch Negative at Moody's (S&P: BBB- Stb). According to Bloomberg, a potential merger with Hyundai Hysco (no credit rating) could improve the financial profile of the combined entities, helped by Hysco's position in the cold-rolled steel sector.

Estimating default rates in Asia is challenging, as most situations are idiosyncratic. Data covering the past four years show that bonds of issuers that have become distressed have mostly experienced a sharp price drop (10-20%) in one week, rather than a gradual decline, which suggests the market did not anticipate significant deterioration in the credit.

## Trading strategy: Mind the liquidity shifts

**With trading volumes in Asia becoming more volatile and liquidity more concentrated in new issues, we think fund managers are likely to respond by keeping cash levels higher than pre-May 2013 to prepare for potentially more volatile fund flows. Furthermore, we think spread volatility is likely to increase for the most liquid names in the triple-B segment, especially as participants use the same subset of issues for cash management and tactical positioning.**

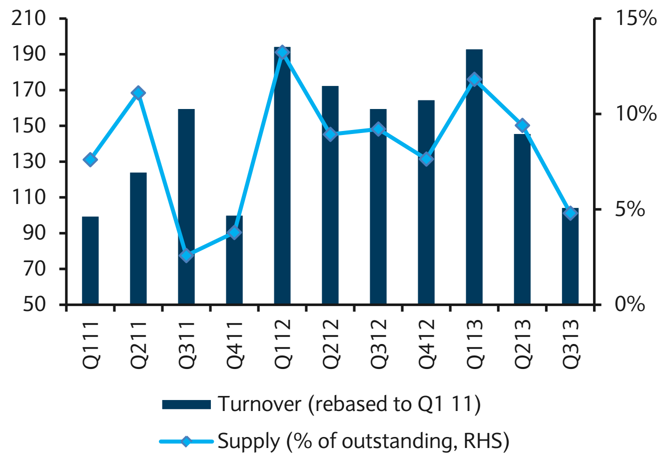
1. Liquidity (trading volumes) deteriorates rapidly in a widening-spread environment or when issuance slows down (Figure 14);

2. The number of names traded falls sharply in conjunction with deteriorating volumes, which suggests that most liquidity flows to a small subset of issuers; and

3. The average trade size shrinks during such periods.

FIGURE 14

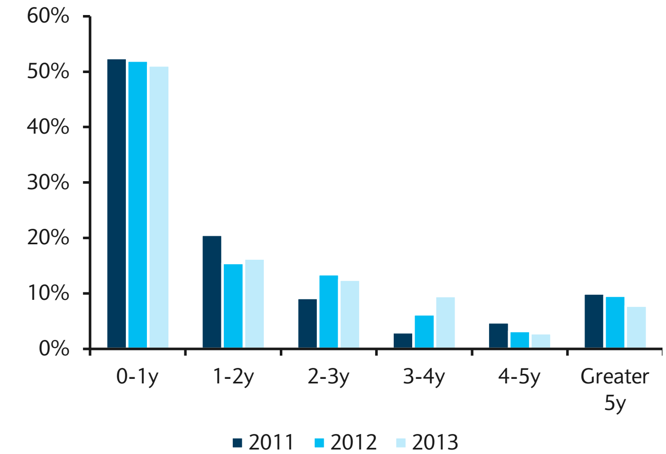
**Trading volume is closely linked to issuance in Asia credit**




Source: Barclays Research

FIGURE 15

**Trading volume is highest in the first year of bond issuance**




Source: Barclays Research

# Latin America and Emerging Europe and Middle East credit strategy

LATIN AMERICA, EMERGING EUROPE & MIDDLE EAST CREDIT STRATEGY

# Re-emerging markets

Aziz Sunderji
+1 212 412 2218
aziz.sunderji@barclays.com

Andrew Abramczyk
+1 212 412 1162
Andrew.Abramczyk@barclays.com

- **This has been a tough year for EM corporate investors; we think 2014 will be better. In particular, the reaction of EM spreads to Fed tapering should be more muted.**
- **We identify five themes and accompanying trades that we hope will help guide asset allocation decisions in 2014: better returns with more differentiation, preparing for higher UST yields, a growing asset class but not a bubble, bank regulation, and the shifting investor base.**
- **We forecast 2014 total returns for LatAm & EEMEA corporate credit of 3.5%. Our favourite sectors are, in Russia, quasi sovereign bank senior bonds and the energy sector; and in LatAm, bank LT2 bonds, select high yield bonds, pulp & paper, and drill ships.**

## 2014 Forecasts: Better returns, more differentiation

### It has been a tough year…

This year has not been a good one for the asset class. The average EM corporate fund lost almost 2% in total returns, though this was substantially better than the (longer-duration) EM sovereign market (Figure 1), which dropped more than 6%, and is also a reasonable recovery from the low-water mark of roughly -6% hit this summer. But these results are a painful falloff from last year's return of 18%, and a severe underperformance versus developed market corporate credit (+9% in European high yield, +7% in US high yield, +3% in European high grade, -1.5% in US high grade). Poor relative performance was exacerbated by a rising default rate, particularly in Latin America, where defaults rose to more than 7%; the worst level since the credit crisis.

It has consequently been a tough year for EM corporate fund managers. Most EM funds, particularly those that manage more retail than institutional money, saw substantial outflows. In fact, these outflows continue today, although at a more moderate pace than over the summer (Figure 2).

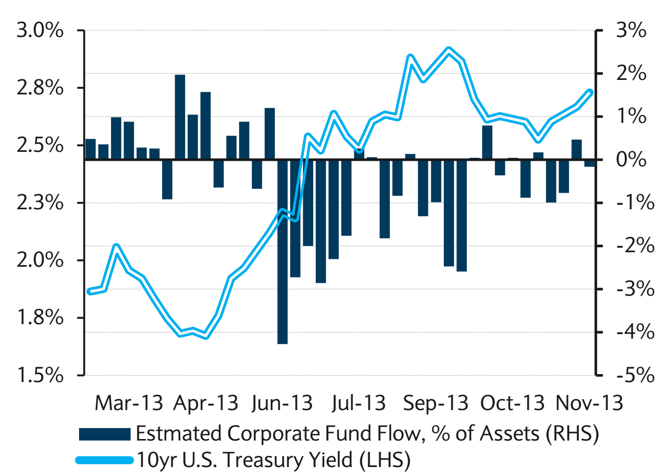
FIGURE 1
**In almost every region, on a maturity-matched basis, sovereigns underperformed their domiciled corporates**

2013 total returns, ranked by best to worst, worst performing asset highlighted

| | Total | Sovereign | Corporates |
|---|---|---|---|
| S.Korea | -0.6 | | -0.6 |
| UAE | -1.6 | | -1.6 |
| Russia | -2.3 | -7.1 | -1.8 |
| Chile | -3.0 | -5.0 | -2.6 |
| China | -3.1 | | -3.1 |
| Qatar | -3.3 | -3.8 | -3.1 |
| India | -4.1 | | -4.1 |
| Mexico | -4.5 | -5.8 | -4.1 |
| **Total** | **-5.0** | **-7.6** | **-4.1** |
| Colombia | -6.6 | -8.2 | -5.4 |
| Brazil | -7.0 | -10.3 | -6.4 |
| S.Africa | -8.2 | -8.7 | -7.5 |
| Turkey | -8.5 | -9.1 | -8.2 |
| Indonesia | -10.3 | -10.3 | -10.0 |
| Venezuela | -11.7 | -12.8 | -9.6 |

Note: 7-12y bonds only. Includes HY Source: Barclays Research

FIGURE 2
**EM corporate fund outflows coincided with rising UST yields; we expect retail money to continue to exit**




Source: Bloomberg, Barclays Research

## …but 2014 should be better

We expect 2014 to be a better year, and our return forecast of 3-4% is significantly higher than what we perceive to be the consensus forecast.

FIGURE 3

**LatAm & EEMEA: We think 3-4% total returns are achievable, if not beatable, in 2014**

| | IG | HY | Total |
|---|---|---|---|
| Current spread | 275 | 675 | 390 |
| Forecast spread change | -40 | -90 | -50 |
| Losses from defaults (bp) | 0 | -220 | -60 |
| Excess return forecast | 475 | 825 | 575 |
| **Total return forecast** | **275** | **525** | **350** |

Source: Barclays Research

Our relatively sanguine forecast reflects our expectation that the weaker domestic macroeconomic and external environment for EM will be overshadowed by the search for spread generated by rising UST yields. Given the substantial discount on EM assets compared with those in developed markets – and little evidence of systemic and/or severe deterioration in EM corporate fundamentals – we believe this will lead to inflows into EM corporates. These inflows should come particularly from institutional investors, leading to positive returns for the asset class. At the same time, performance should be more differentiated: in our view, asset allocation will be more important in 2014 than it has been for the past few years. Figures 6 and 7 show our key sectoral recommendations.

Our favourite segments are LatAm bank LT2 bonds, Russian quasi-sovereign bank senior bonds, Russian energy, select LatAm high yield bonds (across sectors), LatAm pulp & paper, and LatAm drill ships. We hold a negative view on LatAm senior banks (primarily the short end), Russian bank subordinated bonds, LatAm steel, Russian steel, Russian non-energy/non-financial quasi sovereigns, Ukraine corporates, and LatAm miners. We hold a neutral view on all other sectors we cover, including Brazil quasi sovereign senior banks, LatAm energy, Turkish banks (across the cap structure), GCC banks (across the cap structure), Kazakh quasi sovereigns, Russian telecoms, Brazil infrastructure, and Dubai credit.

## Corporates to outperform sovereigns, high yield to outperform high grade

We think LatAm & EEMEA corporates will outperform their underlying sovereigns in 2014, driven by a number of factors including higher carry and better fundamental momentum. Moreover, if the consensus strategy in 2014 is to go down in credit quality to hedge rising UST yields, but without buying fundamentally weak credits, we believe low BBBs and high yield EM corporates offer far superior opportunities for diversification than EM sovereigns (in global EM, 7 sovereigns trade above 300bp but below 700bp, while 44 quasis and 155 corporates trade in this range).

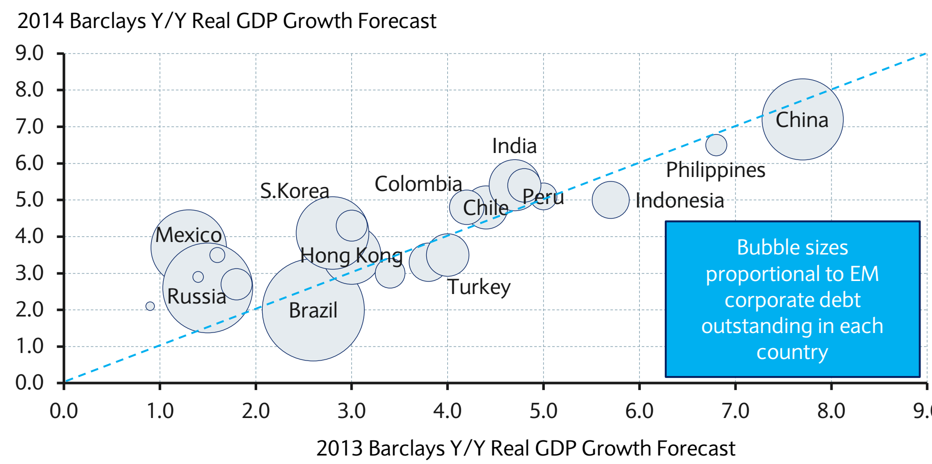
As Figure 1 shows, this corporate outperformance is indeed what occurred in 2013: at the index level, the differences between the corporate and sovereign indices (the corporate index has a lower representation of underperforming regions and a shorter duration than the sovereign index) led corporates to outperform, but even on a country-matched, quality-matched (all HG credit), and tenor-matched (only 7-12y bonds) basis, EM corporates produced higher excess and total returns than their sovereigns. Moreover, this is not just because of the higher carry on EM corporates – spread widening was also lower for corporates (ie, corporates outperformed in absolute terms and even more so on a beta-adjusted basis).

We do not think this outperformance means EM corporates are now 'rich'. We continue to argue that the outperformance of EM corporates vs their sovereigns in 2013 merely brings the relative relationship between the two asset classes to the long-run norm, after corporates were unusually cheap in late 2012 (see *LatAm and EEMEA Corporate Credit Strategy: The long view on Brazil and Russia corporate versus sovereign valuations*, October 3 2013).

We also expect HY to outperform HG again in 2014 as investors use higher spread bonds to offset losses from rising UST yields. We expect default rates to subside after a bad year in 2013 as growth accelerates (Figure 4). Despite the rise in defaults, in 2013 HY still outperformed HG; although spread widening was more severe in HY, the higher carry was more than enough to offset the spread widening.

FIGURE 4

**Growth should accelerate next year across most EM countries that host large corporate bond markets – Brazil is a notable outlier, but we think this is mostly priced in**




Source: Barclays Research

Figure 5 presents what we think are the key statistics that corporate investors should consider as they formulate their 2014 strategies. Dark blue boxes highlight negative aspects (e.g., slow growth, high debt, tight valuations, etc.), light blue boxes highlight positive ones.

FIGURE 5

**Key indicators for major LatAm & EEMEA countries: Dark/light boxes highlight negative/positive aspects**

| | Latin America | | | | | Emerging EMEA | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Brazil | Mexico | Chile | Colom | Peru | Russia | Turkey | Abu Dh. | Dubai | Qatar |
| **ECONOMY** | | | | | | | | | | |
| Barclays 2014 GDP forecast (% y/y) | 2.00 | 3.70 | 4.80 | 4.80 | 5.10 | 2.60 | 3.30 | 3.6 | | 5.1 |
| vs. consensus | -0.45 | 0.00 | 0.60 | 0.30 | -0.90 | -0.20 | -0.70 | 0.00 | | 0.00 |
| vs. 2013 | -0.60 | 2.40 | 0.40 | 0.60 | 0.10 | 1.10 | -0.40 | -0.50 | | 0.10 |
| Openness (trade as % of GDP) | 21 | 64 | 59 | 32 | 45 | 43 | 49 | 169 | | n/a |
| Food % of Exports | 32 | 6 | 19 | 11 | 21 | 3 | 11 | 1 | | 0 |
| Raw Agriculture % of Exports | 4 | 0 | 5 | 2 | 1 | 2 | 0 | 0 | | 0 |
| Fuel % of Exports | 11 | 14 | 1 | 68 | 14 | 70 | 5 | 65 | | 75 |
| Manufactured good % of Exports | 35 | 74 | 14 | 17 | 14 | 14 | 78 | 4 | | 5 |
| Ore & Metal % of Exports | 16 | 4 | 61 | 1 | 50 | 4 | 4 | 1 | | 1 |
| Non-Fuel Commodities % of Exports | 52 | 10 | 85 | 14 | 72 | 9 | 15 | 2 | | 1 |
| **VULNERABILITY** | | | | | | | | | | |
| External Debt (Gross, Public and Private) | 14 | 29 | 43 | 22 | 30 | 31 | 43 | | | |
| Current account +FDI | 0.6 | -1.9 | -2.3 | -0.1 | 2.6 | 3.8 | -4.9 | | | |
| Reserves / external debt | 118 | 70 | 35 | 46 | | 77 | 30 | | | |
| 3m average inflation (% y/y) | 7 | 4 | 2 | 2 | 3 | 7 | 8 | | | |
| Real policy rate | -2.5 | -0.1 | 3.0 | 1.0 | 1.0 | -1.4 | -2.5 | | | |
| EOY '14 FX forecast / % change | -6% | 3% | 0% | 0% | -2% | 0% | -4% | | | |
| Growth correlation with China** | 55% | 34% | 30% | 64% | 49% | 36% | 43% | | | |
| Growth correlation with USA** | 17% | 39% | 40% | 32% | 5% | 37% | 45% | | | |
| Growth correlation with Europe** | 59% | 76% | 65% | 48% | 31% | 90% | 59% | | | |
| Policy changes to prep for tapering | -1 | +1 | | | | +1 | 0 | | | |
| **FISCAL SOUNDNESS** | | | | | | | | | | |
| Gross Gen. Govt. Debt / GDP (%) | 69 | 46 | 13 | 32 | 17 | 15 | 35 | | | |
| 2014 Govt Balance (% of GDP) | -3.2 | -4.1 | -0.2 | -0.7 | 0.3 | -0.3 | -2.3 | | | |
| 2014 Barclays fiscal strength score | 4.25 | 5.5 | 6.5 | 5.75 | 6.25 | 7.25 | 5 | | | |
| vs. 2013 | -0.75 | -0.25 | 0.25 | 0 | -0.5 | -0.25 | 0 | | | |
| 2013 World Bank governance score | 5 | 5 | 8 | 4 | 4 | 3 | 5 | | | |
| **BOND SUPPLY** | | | | | | | | | | |
| F/C sovereign issuance net of maturities (USD bn) | 2 | 10 | 0 | 0 | 1 | 6 | 2 | 0 | 1 | 0 |
| Non financial redemptions (USD bn) | 1 | 2 | 1 | 0 | 0 | 6 | 0 | 4 | | 2 |
| Financials redemptions (USD bn) | 6 | 0 | 2 | 0 | 0 | 4 | 1 | 7 | | 1 |
| **BANKING SYSTEM** | | | | | | | | | | |
| System NPL (most recent, %) | 3.4 | 2.7 | 2.2 | 3.0 | 2.1 | 6.3 | 2.8 | 7.2 | | 1.9 |
| Change from one year ago (%) | -2.5 | 0.2 | -0.1 | 1.3 | | 1.7 | -0.2 | | | -0.1 |
| System LDR (most recent, %) | 141 | 101 | 118 | 101 | 102 | 101 | 110 | 93 | | 106 |
| IIF lending standards index (regional) | 47 | 47 | 47 | 47 | 47 | 48 | 48 | 49 | | 49 |
| 2014 forecast credit growth (%) | 13 | 13 | 9 | 15 | 18 | 19 | 17 | 10 | | 10 |
| Change from 2013 (%) | -2 | 2 | -2 | 0 | | 3 | -8 | 1 | | 0 |
| **VALUATIONS** | | | | | | | | | | |
| Moody's rating*** | Baa2 | Baa1 | Aa3 | Baa3 (*+) | Baa2 (*+) | Baa1 | Baa3 | Aa2 | NR | Aa2 |
| S&P rating*** | BBB (*-) | BBB (*+) | AA- | BBB | BBB+ | BBB | BBB+ | AA | NR | AA |
| Fitch rating*** | BBB | BBB+ | A+ | BBB- (*+) | BBB+ | BBB | BBB- | AA | NR | NR |
| Sovereign 10y spread: cash bond | 208 | 129 | 66 | 141 | 147 | 167 | 206 | 65 | 236 | 121 |
| Sovereign 10y spread: CDS | 250 | 149 | 112 | 174 | 183 | 228 | 246 | 75 | 268 | 103 |
| Sovereign basis (CDS - cash) | 42 | 20 | 46 | 33 | 36 | 61 | 40 | 10 | 32 | -18 |
| Avg non financial spread (all ratings) | 310 | 215 | 230 | 270 | 280 | 275 | 345 | 160 | 260 | 170 |
| HG corps - Sov CDS spread (bp) | 60 | 66 | 118 | 96 | 97 | 47 | 99 | 85 | | 67 |
| HG corps / Sov ratio | 1.2x | 1.4x | 2.1x | 1.6x | 1.5x | 1.2x | 1.4x | 2.1x | 1.0x | 1.7x |
| Dislocation vs. post-crisis avg | 35 | 0 | 10 | 25 | 10 | -50 | | -70 | | -25 |
| Senior 10y financials (incl. quasis) | 329 | 238 | 200 | 324 | 278 | 318 | 381 | 222 | | 152 |
| Senior banks - Sov CDS spread (bp) | 79 | 89 | 88 | 150 | 95 | 90 | 135 | | | 49 |
| Senior banks / Sov CDS spread ratio | 1.3x | 1.6x | 1.8x | 1.9x | 1.5x | 1.4x | 1.5x | | | 1.5x |
| LT2 financials (incl. quasis) | 403 | 345 | | 375 | 376 | 358 | 485 | | | |
| LT2 - senior spread | 324 | 256 | | 225 | 281 | 268 | 350 | | | -49 |
| LT2 / senior ratio | 1.2x | 1.4x | | 1.2x | 1.4x | 1.1x | 1.3x | | | 0.0x |
| HY corporates (ex CCCs) | 650 | 535 | | 435 | | 435 | 410 | | | |

Notes: *Growth correlations measured from 2000-present. **Colored boxes denote rating watch up/down. ***Based on consensus

Source: Bloomberg, World Bank, IMF, Moody's, S&P, Fitch, Country central banks/governments, Dealogic, Barclays Research

# Asset allocation: Financials

FIGURE 6
**Financial sectors**

| LONG | NEUTRAL | SHORT |
|---|---|---|
| **LatAm Banks Lower Tier II Bonds**<br>LT2 bonds should benefit from scarcity value as they are grandfathered in terms of contributing to Basel III capital requirements. Sub/senior relationships are relatively decompressed. Some systems like Mexico are very well capitalized and are Basel III 'fully-loaded' compliant already. Our top picks are BBVASM, BCP, and BANBRA. We are less positive on Colombian names in sub debt (though positive in seniors). | **Brazil Quasi Sovereign Banks Senior Bonds**<br>Brazilian quasi-sovereign banks have expanded more rapidly than private sector peers, leading to concerns about asset quality in an environment of slow growth and risks to unemployment. That said, valuations look rewarding: after substantial underperformance, CAIXBR 2017 bonds are a rare 3y BBB 100% quasi sovereign trading at over 350bp. | **LatAm Banks Senior Bonds**<br>LatAm senior banks have generally outperformed global peers this year, from a lower spread to begin with. This outperformance has been concentrated at the front end: LatAm 5/10 curves are now much steeper than elsewhere. That said, BCOLO 10y seniors look compelling. |
| **Russian Quasi Sovereign Banks Senior Bonds**<br>Russian quasi-sovereign senior banks continue to offer relatively compelling spread versus global similar-quality peers. Given regulator pressure to increase capital, and amid some pressure on asset quality, we prefer banks that have the ability to generate capital organically and/or have strong shareholder support. | **Turkish Banks (full capital structure)**<br>We perceive Turkish banks as well run and generally fundamentally sound. However, the tight valuations of the senior bonds to the sovereign (in ratio terms) reflect the macro risks here - for investors who like Turkey, we think the sovereign bonds are more compelling than the banks. That said, we like short-dated quasis like HALKBK, which mitigate some of the macro risks because of low duration, and trade relatively cheap to the sovereign. | **Russian Bank (including quasis) Subordinated Bonds**<br>We believe regulatory pressure to increase capital amid a slower growth environment, and the implementation of Basel III, will cause substantial issuance here. In particular, we see greater risk of subordinated issuance in Russia because of weaker capital (eg, compared to LatAm banks), and also because of the unique implementation of Basel III in Russia, which allows for 4% of the total 10% in total capital to come from subordinated debt. Sub banks are tight to seniors. |
| | **GCC Banks (full capital structure)**<br>Rich valuations are justified given strong local support, ample liquidity and good fundamentals, underpinned by a favourable operating environment and government spending. Less geo-political risk is also a positive, especially for UAE banks that benefit from growing trade between Iran and the rest of the world. Our favourite names within the sector are DIB 17s, DIB 49 perps, Al Khaleeji 18s, and ADCB 23 callables. | |

Source: Barclays Research

# Asset Allocation: Non-Financials

FIGURE 7

**Non-financial sectors**

| LONG | NEUTRAL | SHORT |
|---|---|---|
| **LatAm High Yield/High Spread IG - Select names**<br>We expect the LatAm HY default rate to fall after the sharp spike in 2013. Valuations are attractive: LatAm high yield credits trade wider than HY in every other region. Our top picks are DLLTD 20, CEMEX, PRECN, OIBRBZ, HYPEBZ, JAVER, TONON, and USJ. | **Kazakh Quasi Sovereigns**<br>Fair valuations given the lack of sovereign paper. Upside rating potential but technical difficulties in the Kashagan field holding this back. Potential issuance from KMG in late 2014 given the early January 2015 maturity. Kazakh Rail could issue given its big capex program. | **Russian Steel**<br>Challenging sector outlook given weak pricing. Russian steels are integrated; falling iron ore prices could flatten cost curve and lower finished steel prices. Still, some Russian producers are cutting costs; maturities manageable given solid liquidity. Preferred bonds are CHMFRU 17s/18s, Evraz 17s and TMK 18s for high carry/compensation for fundamentals. |
| **LatAm Pulp & Paper - Select names**<br>We prefer Brazilian producers over Chilean. Continuing weak BRL should cushion the effect of lower pulp prices. Our top picks here are Fibria (abstaining from increasing capex) and Suzano (benefits from higher volumes from its new paper mill). | **Russian Telecoms**<br>We are comfortable with VIP, and also MTS given moderate leverage and strong cash flow. Risk of rising competition and the planned refi of Wind debt is an overhang on VIP. MTS is fundamentally IG but its rating is constrained by a dominant shareholder. | **LatAm Steel**<br>LatAm steels names like GGBRBZ and CSNABZ trade wider than global steel peers, and have underperformed some Russian peers like CHMFRU in the 10y segment YTD. However, the sector outlook remains very challenging given weak pricing trends, warranting a continuing cautious view on the entire sector. |
| **LatAm drill ships**<br>SCHAHN and ODEBRE are at the wide end of historical valuations versus PETBRA, and offer some of the widest spreads in global investment grade corporate credit. Investors are being compensated generously for potential volatility and concerns about shareholder support. | **Brazil Infrastructure**<br>Although these are some of the most positive fundamental stories in Brazil and will likely be less affected by a potential sovereign downgrade, they have outperformed throughout 2013 and with ODBR and VOTO trading 40bp tighter to the avg Brazil BBB, are no longer attractive longs. | **LatAm Mining**<br>Challenging outlook for sector given weak outlook for iron ore prices. We prefer credits offering additional spread for similar fundamental risk: MEXGEN over SCCO, and SAMMIN over VALEBZ. |
| **Russian Oil & Gas**<br>Our 2014 Brent f/c of 105 $/bbl means cash flow stays strong vs planned capex. Leverage is moderate. Issuance risk from any Gazprom China export contract or sector M&A. Gazprom exports to Europe are strong, but risks from customer desire to diversify. Top pick is Gazprom Neft 23s; trades wide to peers/sov; has low leverage, access to new assets in Russia. | **Dubai Credit**<br>With spreads close to record tight levels, we prefer HY over HG. We like DHCOG's 17s and MAF's Perps (we think these will be called in 2018). We see little value left in Dubai's real estate credits. All corporates should get a boost from the Expo, but we believe hospitality and retail credits, with smaller cap-ex needs, will benefit the most. | **Russian Non-Financial Quasi Sovereigns/Transport**<br>Concerns about change in government policy towards quasi-sovereigns in an environment of slower growth and higher-than-desired inflation (including tariff freezes), and potential privatizations (Rurail, Sovcomflot). |
| | **LatAm Oil & Gas**<br>Our WTI forecast is 99 $/bbl at EOY '14 (+7%). PETBRA, ECOPET, PEMEX are fair value vs sovereigns, but PETBRA 21 is cheap on the curve. PACRUB 19s is cheap vs ECOPET and should tighten. At ~400s over USTs, PRECN '19 trades near weaker global peers. | **Ukraine Corporates**<br>Spreads driven by sov developments and interconnectedness. Fragile economic/political situation raises growth concerns. Risks to iron ore/steel prices in 2014. On an RV basis prefer the export-focused corps, especially 2016 bonds of Ferrexpo (moderate leverage, strong export coverage of interest). |

Source: Barclays Research

## Prepare for higher US Treasury yields

A critical underpinning of our optimistic view is that credit spreads will not react to rising UST yields in the way they did in 2013. Figure 8 sets out the key elements of our house view on US rates.

FIGURE 8

**The Barclays interest rate view: What EM corporate investors should know**

### US interest rates: Grinding higher

Our US interest rate strategists forecast the US 10y Treasury yield at 3.5% by end-2014, 20bp higher than the forwards are pricing. They expect the Fed to begin tapering asset purchases in March 2014 and for that process to be concluded within six months. Unemployment should reach the Fed's threshold of 6.5% by end-2014, at which time core PCE will be 2.1% (far above consensus and Fed forecasts) – this sets the stage for the Fed to hike in mid-2015 (roughly six months ahead of forward pricing). As 2014 draws to a close, the curve should bear-flatten in anticipation of this hike.

This view is motivated in part by expectations of stronger US data: the wealth effect should cause higher consumption, fiscal retrenchment is receding into the past (e.g., payroll tax hike), there is upside risk to business investment, and housing should slow but still contribute to positive growth.

Most important, the jobs market is improving. This should help the growth picture but is particularly meaningful since the Fed continues to emphasize the importance of the labour market in its reaction function. There has been no indication that a change in the Fed chair will alter this focus.

EM corporate investors should be cognizant that the volatile policy environment has caused substantial discrepancies between forecast rates 1y ahead and realized rates 1y later (on average in the post crisis era, these have diverged by 1.2%). Adding this range of uncertainty to our view (Figure 9) poses modest downside risk but very substantial upside risk. Investors should prepare their portfolios for higher rates, and, moreover, for the risk of substantially higher rates.

Note: for further details on our interest rate outlook, see *Global Rates Outlook 2014: Grinding higher*, 21 Nov 2013.
Source: Barclays Research.

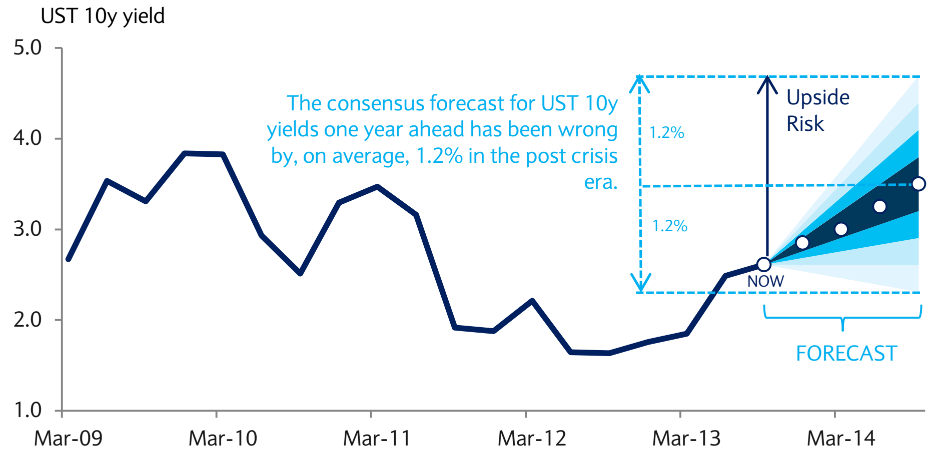
Although we expect rates to be 75bp higher over the coming year – ie, a move not dissimilar to what we observed in 2013 – this move will take place over 12 months, rather than two. The slower pace of the selloff should be much less disruptive for EM, not least because bond carry will have time to accrue, offsetting losses from the UST component.

Moreover, the starting conditions are much more benign today than in May 2013, when the UST selloff began. Not only have policymakers had time to adapt (some have used this time more effectively than others), but also flows are more balanced ('crossover' investors' substantial longs have been pulled back). Expectations for Fed policy have shifted; we think investors will not be blindsided the way they were this year.

Finally, UST yields will likely be rising for different reasons – the abrupt selloff this year was not to the result of stronger fundamentals in the economy, but of an expected removal of stimulus. To the extent that the Fed remains 'data dependent', we believe future selloffs in the UST curve will be 'good', ie, coinciding with stronger US growth. As long as EM growth also recovers, as we expect it to, we believe a more normal relationship between USTs and EM credit spreads (ie, a negative beta) can reassert itself.

FIGURE 9

**Substantially more upside risk to UST yields, even considering high level of uncertainty**




Source: Bloomberg, Barclays Research

## Trades that protect against higher UST yields

Below, we recommend a number of specific trades that investors can use to protect against the reality of higher UST yields.

### *Buy higher-yielding bonds*

In 2013, the overall move in corporate bond yields (ie, the combined effect of spread widening and UST rates rising) was sufficiently muted that the higher carry on HY bonds offset their widening and led to better performance than in IG. We forecast that in 2014 spreads will tighten, or the widening will be so moderate as to be more than compensated for by carry (at least in HY). In either case, we recommend that investors overweight HY and underweight IG.

FIGURE 10

**Even assuming the positive correlation between credit spreads and USTs seen last summer, USTs would need to rise by 135bp before HY begins to underperform IG**

| | Calculation | Result |
|---|---|---|
| A | Global EM: average investment grade spread (bp) | 233 |
| B | Global EM: average high yield spread (bp) | 645 |
| C= A-B | Difference in spread carry | 412 |
| D | Average EM corporate (IG/HY combined) duration | 5.2 |
| E = C/D | Breakeven yield widening (bp) | 79 |
| F | Summer 2013: IG beta to UST yields | 0.6x |
| G | Summer 2013: HY beta to UST yields | 1.2x |
| H = G-F | Difference in HY versus IG betas to USTs | 0.6x |
| I=E/H | UST move which achieves the breakeven shown in row E (bp) | 135 |

Note: We assume HY and HG have the same durations; in reality, HY is lower duration and our model here is therefore conservative. Source: Barclays Research.

As shown in Figure 10, whether or not credit spreads revert to being negatively correlated with USTs, in all but the most bearish outcomes for UST yields, HY will outperform IG. Taking into account the much higher carry on HY, at the index duration of 5.2, the breakeven spread widening between the two is 79bp – ie, HY credit would have to widen by 79bp more than IG to begin to underperform.

Even if spreads remain positively correlated with UST yields, we think this outcome is unlikely. Using betas observed this past summer (arguably a worst-case scenario), high yield credit would widen by 1.2bp for every 1bp selloff in USTs, and IG credit would widen by 0.6bp. Even under these circumstances, given the much higher carry on high yield, it would take USTs selling off by 135bp (ie, much more than we forecast) for HY widening to breach this 79bp breakeven.

The risk to this view is that credit spread widening occurs for non-UST related reasons, for example, because of credit quality deterioration. We think this outcome is unlikely as EM default rates are declining, not rising.

*Buy floating-rate notes*

We think bonds with floating rate coupons should weather a higher UST yield environment particularly well. Indeed, US loans (floating rate instruments) performed very well this year, seeing large inflows amid higher UST yields, even when US high yield bond funds were seeing outflows. The fact that we cannot detect any meaningful outperformance in the (small) universe of EM corporate floating rate bonds suggests to us that this is an interesting trade, particularly for investors whose mandates prevent them from shorting rates outright. Figure 11 lists some of the largest FRNs in the LatAm & EEMEA universe.

## A growing asset class, not a bubble

We are often asked, particularly by non-EM dedicated investors, whether record-breaking issuance from EM corporates could be a sign of a bubble in the asset class. We firmly believe this is not the case. First, this is a global phenomenon: EM corporates are issuing record amounts of debt, but so are US companies. Second, there is no evidence of fundamental deterioration: leverage is rising, but only modestly, as should be expected at this phase of the economic cycle. Third, this is nothing new: the proportion of global corporate debt being issued by companies located in EM countries rose this year, but it has risen in all but 3 years in the past 11.

FIGURE 11

**Major floating rate notes in the LatAm & EEMEA corporate bond universe**

| Ticker | Description | Amount Outstanding | Coupon | Maturity Date | Price | Yield to Worst | OAS | OAD | Index Rating | Country |
|---|---|---|---|---|---|---|---|---|---|---|
| PETBRA | PETROBRAS | 1,500,000 | 2.38 | 1/15/2019 | 97.5 | 2.9 | 273 | 0.10 | BAA2 | Brazil |
| PETBRA | PETROBRAS | 1,000,000 | 1.86 | 5/20/2016 | 99.25 | 2.2 | 199 | 0.24 | BAA2 | Brazil |
| BRADES | BANCO BRADESCO SA | 850,000 | 2.34 | 5/16/2014 | 100.1 | 2.1 | 200 | 0.23 | BAA2 | Brazil |
| CEMEX | CEMEX SA DE CV | 800,000 | 5.25 | 9/30/2015 | 103 | 3.7 | 348 | 0.11 | B1 | Mexico |
| AMXLMM | AMERICA MOVIL | 750,000 | 1.26 | 9/12/2016 | 100.1 | 1.2 | 100 | 0.05 | A2 | Mexico |
| QNBK | QNB FINANCE LTD | 750,000 | 1.49 | 10/31/2016 | 100.4 | 1.7 | 117 | 0.18 | A1 | Qatar |
| TEVA | TEVA PHARMACEUTICAL | 500,000 | 0.75 | 3/21/2014 | 100.0 | 0.5 | 38 | 0.07 | A3 | Israel |
| CEMEX | CEMEX SA DE CV | 500,000 | 4.99 | 10/15/2018 | 104.5 | 5.1 | 382 | 0.20 | B1 | Mexico |
| PEMEX | PETROLEOS MEXICANOS | 498,570 | 2.27 | 7/18/2018 | 103.1 | 1.5 | 136 | 0.23 | BAA1 | Mexico |
| SANT | SANTANDER CHILE SA | 494,700 | 1.84 | 1/19/2016 | 99.3 | 2.2 | 198 | 0.15 | A1 | Chile |
| GULINT | GULF INTL BANK | 360,998 | 1.45 | 9/30/2015 | 96 | 8.5 | 0 | 0.00 | BAA1 | Bahrain |

Source: Barclays Research

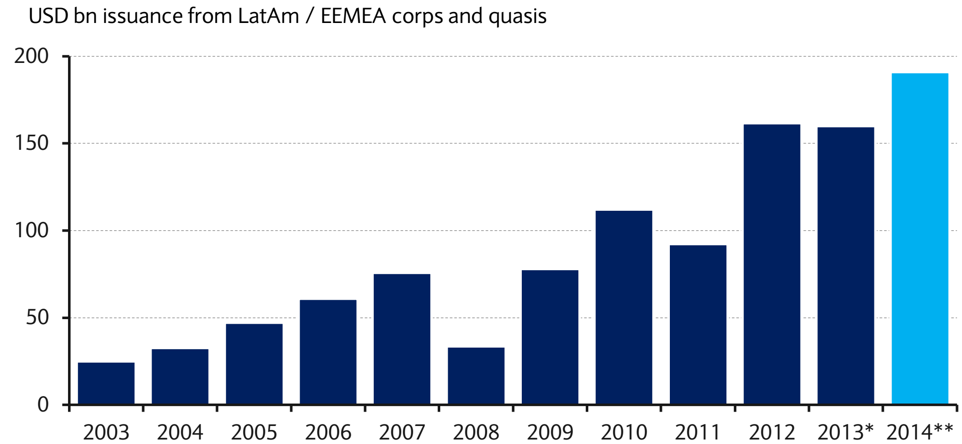
In our view, record issuance is not a sign of a bubbling market; it is the sign of a market in the midst of long-run, secular growth. Twenty percent of global corporate issuance this year was from EM – a record proportion, but still too low – EM economies account for almost half of global GDP. EM corporates and quasi sovereigns account for only 10% of our USD corporate index. Thus, we think investors should prepare for many more years of record-breaking issuance from EM corporates.

## What to expect in 2014

- **We forecast $191bn of combined LatAm/EEMEA corporate/quasi sovereign gross supply.** For comparison, gross issuance in 2012 was $162bn. At the current run rate, 2013 should post a similar figure (YTD through November 2013 is ~$145bn, which annualizes to ~$160bn, USD denominated issuance only).
- **Risk free yield curve and cross-currency basis swap differentials are making non-USD hard currency funding cheaper than USD funding; companies will likely issue a larger portion of debt in non-USD currencies (like CHF, EUR, JPY and GBP).**
- **More issuance, especially from banks, is set to be in floating-rate coupon format.** This is partly to take advantage of investor demand for floaters in a rising UST yield environment.
- **Of the $191bn in forecast 2014 issuance, we expect $81bn in gross issuance from EEMEA and $110bn from Latin America.** This includes refinancing of $26bn in EEMEA and $17bn of LatAm debt maturing in 2014.
- **More subordinated issuance, especially new-style Basel III-compliant, loss absorbing bonds, is expected.** Banks have begun to lose capital relief for non-loss-absorbing sub debt. Meanwhile, capital adequacy rules are being tightened. Russian regulation allows greater scope for debt issuance to fulfil capital requirements; subordinated 'new style' issuance could reach $65bn, although this will be spread over years. We also see upside risk to our LatAm bank issuance forecast in particular, as other banks may opt to follow Santander Brazil's recently announced plan to issue subordinated debt to replace cash as paid-in capital. We prefer LT2 'old style' bonds that should benefit from increasing scarcity and do not allow loss absorption.
- **A slower pace of growth of the senior debt market.** Bank credit growth is positive but decelerating in most regions. Senior debt issuance should also be positive, but the growth rate slower than in prior years.
- **Local issuance surge unlikely.** Local debt markets are too illiquid to capture meaningful sponsorship from international investors, and few EM countries outside Asia have domestic savings bases big enough to support a vibrant local-currency corporate bond market. This should change in time, but 2014 will not, in our view, be an inflection point.
- **EM will continue to take a larger share of global corporate issuance.** If the recent run rate is maintained, the proportion of global corporate issuance coming from EM countries could exceed 20% in 2014. LatAm and EEMEA should account for more than half of this.
- **Over the past two years, more than four of every five dollars of dollar-denominated EM bond issuance has come from corporates and quasi-sovereigns, rather than sovereigns.** We do not expect this proportion to change in 2014.

FIGURE 12

Our LatAm/EEMEA issuance forecast in historical context




Note: *2013 annualized. **2014 forecast. Source: Dealogic, Barclays Research

## Issuance forecast method

Our estimate of next year's issuance includes the following:

- **11% EBITDA growth multiplied by the estimated current base of $420bn non-financial company debt outstanding to keep leverage constant.** 11% is the weighted average Bloomberg consensus 2014 earnings growth forecast for a representative EM corporate bond portfolio.

- **0.25x increase in non-financial corporate leverage.** The average ratio of gross debt to EBITDA for 50 emerging market companies is about 2.3x – our forecasts account for an increase in issuance commensurate with gross leverage increasing to 2.55x. For comparison, gross debt to EBITDA for the U.S. investment grade and high yield indices are about 2.5x and 4.6x, respectively.

- **10% asset growth multiplied by the estimated current base of $260bn financial company debt outstanding.** EM credit growth is positive but decelerating. Bank issuance should increase, though at a slower rate than historically. There is upside risk to this forecast from rising subordinated bond issuance.

- **Refinancing $43bn of 2014 maturities.** We estimate near-term maturities based on a search of all Latin American and EEMEA dollar corporate debt outstanding. The total breaks down by region as $26bn in EEMEA maturities and $17bn in Latin America. We forecast that all of these will be rolled over.

- **$30bn of debt offerings from first-time issuers.** This estimate is in line with historical levels. In 2013 so far there has been US$24bn of debut issuance in LatAm and EEMEA, vs $36bn in 2012.

FIGURE 13

**USD Corporate Bond Issuance Forecast, $bn**

| | EEMEA | LatAm |
|---|---|---|
| Non-Financial Issuance from Earnings Growth | $15 | $31 |
| Non-Financial Issuance from Leveraging | $15 | $31 |
| Financial Issuance | $15 | $11 |
| Near Term Maturities | $26 | $17 |
| Offerings from Debut Issuers | $9 | $21 |
| Estimated 2014 Corporate Bond Issuance | $81 | $110 |

Source: Barclays Research

EM corporates still constitute a nascent asset class and therefore near-term redemptions are small compared to the amount of issuance we expect. That said, 2014 has a much higher tally of redemptions ($43bn) compared with this year ($18bn).

EEMEA has more overall redemptions than LatAm ($26bn versus $17bn). However, in EEMEA the majority of these are high grade ($16bn) and not high yield ($11bn), compared with LatAm where investment grade redemptions ($6bn) are roughly half the size of high yield redemptions ($11bn). In both regions, financials account for half of IG redemptions. The largest 2014 maturity by far will be the $3bn PDVSA 9.4% bond.

FIGURE 14

**LatAm 2013 issuance versus 2014 redemptions**

| | 2013 issuance | 2014 redemptions |
|---|---|---|
| Investment Grade | 47 | 6 |
| *of which financials* | 8 | 3 |
| High Yield | 22 | 11 |
| Total | 69 | 17 |

Source: issuance from Dealogic, redemptions from Bloomberg

FIGURE 15

**EEMEA 2013 issuance versus 2014 redemptions**

| | 2013 issuance | 2014 redemptions |
|---|---|---|
| Investment Grade | 44 | 16 |
| *of which financials* | 15 | 8 |
| High Yield | 22 | 11 |
| Total | 66 | 26 |

Source: issuance from Dealogic, redemptions from Bloomberg

FIGURE 16

**Largest 10 2014 redemptions in LatAm**

| Bond | Maturity date | Amt ($mn) |
|---|---|---|
| PDVSA 4.9 | 10/28/2014 | 3000 |
| SANBBZ 2.35185 | 3/18/2014 | 1200 |
| BRADES 2.3632 | 5/16/2014 | 850 |
| AMXLMM 5.5 | 3/1/2014 | 795 |
| CDEL 4.75 | 10/15/2014 | 500 |
| PETBRA 7.75 | 9/15/2014 | 398 |
| PEMEX 7.375 | 12/15/2014 | 363 |
| ENRSIS 7.375 | 1/15/2014 | 348 |
| BANBRA 8.5 | 9/20/2014 | 300 |
| BANSAF 3.5 | 5/16/2014 | 300 |

Source: Bloomberg

FIGURE 17

**Largest 10 2014 redemptions in EEMEA**

| Bond | Maturity date | Amt ($mn) |
|---|---|---|
| TNEFT 5.67 | 3/5/2014 | 1300 |
| MUBAUH 5.75 | 5/6/2014 | 1250 |
| ALDAR 10.75 | 5/27/2014 | 1250 |
| GAZPRU 8.125 | 7/31/2014 | 1250 |
| TAQAUH 4.75 | 9/15/2014 | 1200 |
| RASGAS 5.5 | 9/30/2014 | 1115 |
| RSHB 9 | 6/11/2014 | 1000 |
| TDICUH 6.5 | 7/2/2014 | 1000 |
| ADCBUH 4.75 | 10/8/2014 | 1000 |
| TDICUH 4.949 | 10/21/2014 | 1000 |

Source: Bloomberg

## Banks: arriving in Basel at different speeds, from different places: Implications for subordinated debt

Emerging market banks are – with few exceptions – better capitalized and more profitable than their developed market peers. But as the external environment becomes less supportive, EM economic growth slows, and credit growth decelerates, EM banks are becoming a more heterogeneous lot.

The overarching theme for the entire sector, globally, is the adoption of Basel III standards for capital (liquidity standards are, for the most part, still in the works). Figure 18 examines how Basel III is being implemented in the various regions.

FIGURE 18

**Basel III implementation in major LatAm & EEMEA banking systems**

| Basel III regulations common to all jurisdictions | | |
|---|---|---|
| **Basel III guidelines** | | A tangible common equity component of 4.5% of RWA. Minimum T1 capital of 6%, total capital of 8%, a preservation buffer of 2.5%, and a countercyclical buffer of up to 2.5%. This adds to a total BIS ratio of up to 13%. Basel III contains a number of liquidity-based rules, but EM regulators have not yet announced how these will be implemented. No LatAm or EEMEA banks have been designated as globally systemically important financial institutions (SIFIs), though Santander and BBVA parents have. |
| **Basel III definitions** | | T1 and T2 instruments must be loss absorbing, with the trigger for loss-taking defined by local regulators. Existing debt capital instruments' contribution to capital will be phased out over a 10y horizon that began in 2013. The countercyclical buffer will be imposed within a range of 0-2.5%, comprising common equity, when authorities judge that credit growth is resulting in an unacceptable buildup of systematic risk. |
| **Aspects of Basel III regulation that are being implemented differently across regions** | | |
| **What is the status of Basel III implementation?** | Brazil | Brazilian banks are on track to adopt Basel III regulations according to the BIS-recommended schedule. Loss-absorbing T1 paper (CoCos) have been issued by BANBRA. |
| | Mexico | Mexican banks already meet B3 'fully loaded' capital requirements. No instruments have yet been issued under the new rules. |
| | Russia | Russian banks are on track to adopt Basel III regulations according to the BIS-recommended schedule. 6 banks have issued T2 Basel III-compliant instruments. |
| **What is the trigger for loss absorption on Basel III subordinated debt instruments?** | Brazil | The trigger for loss absorption in T1 instruments is 5.125% of CET1, and for T2 instruments, 4.5% of CET1. The regulator has the power to convert into equity or write-down the securities at its discretion. |
| | Mexico | The trigger for loss absorption in T1 instruments is 5.125% of CET1, and for T2 instruments, 4.5% of CET1. The regulator cannot write down of convert securities to equity unless stated in the bond indenture. |
| | Russia | The trigger for loss absorption in T1 instruments is 5.5% of CET1, and for T2 instruments, 2% of CET1. The regulator has the power to convert into equity or write-down the securities at its discretion. |
| **What are the unique aspects of Basel III implementation in the region?** | Brazil | Brazilian banks are allowed to classify deferred tax assets as T1 equity even though this is not consistent with B3 rules. The quasi sovereign banks are also allowed to classify government bonds as capital. Holdings of government bonds accrue a 0% risk weight, unlike in other systems outside Latin America. It is noteworthy that Brazil's central bank has proposed a depositor preference regulation, which would 'bail in' senior unsecured debt before depositors take losses - this is rare amongst EM banking systems (Colombia has this feature already). |
| | Mexico | Holdings of government bonds accrue a 0% risk weight, unlike in other systems outside Latin America. Banks must be listed on the Mexican stock exchange to issue Basel III-compliant debt instruments. |
| | Russia | Russia is unique in implementing its own set of capital requirements; these differ from those set out by the Basel committee: common equity must be 5% of RWA (vs. 4.5% elsewhere), and total capital must be 10% (vs. 8% elsewhere).The critical idiosyncrasy of Russian implementation of Basel III is that, unlike other systems, LT2 bonds can count toward 4% of RWA (vs 2% in most other systems). |

Source: Barclays Research

## What are the implications for investors?

### *Avoid new-style instruments*

Overall, we recommend avoiding new-style subordinated bank debt at current valuations. We do not believe the risk of conversion/principal write down of new-style debt is adequately reflected in valuations compared to old-style debt. Moreover, we believe a substantial proportion of new-style debt was bought by retail investors; such investors are likely shifting away from fixed income in favour of equities as interest rates rise. Although the transfer of holdership of Basel III bonds from the retail to the institutional base will happen, it will likely do so only at cheaper valuations. Our view is more sanguine for developed market CoCos, but in EM, the unstable sponsorship and relatively unattractive valuations versus DM peers keeps us more cautious (see *EM Banks: In Russia, we choose old-style*, Oct 31 2013, and *EM Banks: Brazilian CoCos - Are you ready?* Aug 28 2013).

We are particularly negative on potential performance on new-style Russian subordinated debt. Although the BIS schedule for implementation is generous, Russian banks capital computations are more affected than other systems because of more stringent RWA measurements, and this could lead to a deluge of supply. Moreover, Russian banks are relatively less capitalized vs regulatory minimums than banks elsewhere.

Performance may be somewhat better in LatAm new-style subs: Basel III implementation is less material for Brazilian banks because the major material changes have been mitigated by either grandfathering or an option to compute existing hybrid instruments as core equity tier I capital (particularly important for Banco do Brasil), and because Brazilian banks are relatively well-capitalized already. We therefore do not expect the surge in new-style debt issuance that we do in Russia. But the discretionary nature of the PONV trigger (vs Mexico) and the weakness of capital quality in some state-owned banks like BNDES (government bonds count toward core equity T1 capital) are distinct negatives. Moreover, from a valuations perspective, we do not think Basel III compliant sub debt issued by BANBRA is attractive compared with European peers.

### *Old-style instruments: One of our favourite segments, especially in Mexico*

Old-style capital instruments are among our favourite segments in LatAm and EEMEA corporate credit. We believe they offer one way of picking up spread without sacrificing credit quality, they benefit from issuance of more subordinated (Basel III-compliant) instruments, and as they can no longer be issued, benefit from 'scarcity value'.

In particular, we are very positive on Mexican LT2 banks. Mexican banks– unlike those in other systems – are already compliant with Basel III 'fully loaded' capital guidelines, and in fact satisfy these requirements with core equity alone (even after applying a conservative risk-weight to government bonds). Furthermore, Mexican regulation has an early alert mechanism that aims to solve capital adequacy issues at much higher levels than the limits established by Basel III. The old-style LT2 bonds of BBVA Bancomer (6.5% 2021) are among our favourite bonds in LatAm & EEMEA.

Although not as compelling as BBVASM, other LT2 bank bonds in LatAm also make sense to us. In Brazil, we like the BANBRA 5.875% 2022s and the ITAU 6.2% 2021, and in Peru, the BCP 6.125% 2026s.

We are less positive on Russia here. We favour LT2 old-style bonds over new-style, but our overall preference is for other regions in the subordinated space given tight sub/senior valuations in Russia, the low CET1 trigger making new-style LT2 debt less protective of the rest of the cap structure, and the high level of T2 rather than T1 debt in the measurement of total capital (though the larger quantity of total capital is a positive). We favour banks that are well capitalized/highly profitable/have strong shareholder backing, but overall in Russia prefer senior debt.

In Turkey, given the prevailing macro risks, and cheap valuations relative to global peers but not vs the sovereign, our top recommendation is a very cautious one – the short-dated senior quasi sovereign risk of HALKBK 4.875% 2017s. The Turkish senior 5/10 curve is the flattest in EM and we do not think investors are paid for going out along the curve.

## The changing investor base: Institutions matter

We think many investors are concerned that demand for EM corporate issuance will be weak and that companies will have difficulty funding themselves, and/or that clearing levels for secondary trading will be much higher than today's levels.

### Non mutual fund/ETF money should be relatively sticky

Although the heyday of demand for EM corporate assets has likely passed, we think some of the worst concerns here may be overstated. Investors have focused on the retail flows, which have been negative for most of the second half of 2013, but this ignores the composition of the buyer base for EM corporates. We estimate that – at most – $200bn of EM corporate debt is held in mutual funds and ETFs (including EM sovereign, EM broad, global fixed income, and developed market corporate funds). Since the size of the asset class is more than $1.5trn, this leaves $1.2trn held outside funds and ETFs.

We think this non-mutual fund buyer base consists primarily of institutions (insurance companies, pension funds, sovereign wealth funds, endowments, etc) and that this investor base will be "sticky" in its EM corporate holdings in 2014, primarily because it is already under-allocated in terms of corporate exposures to EM and because the valuation gap between EM and DM is unusually large today, even in the relatively safe high-quality high-grade segment.

### Mutual fund outflows could continue; watch out for retail money leaving

This is not to say mutual fund flows should be ignored. The volatility of their in/outflows, their mark to market nature, and their benchmarking leads them to turn over their portfolios more frequently than non-fund investors. However, this is not a homogenous group – both EM (corporate, sovereign, and broad funds) and DM funds hold EM corporates – and each has a different institutional versus retail component. We see both upside and downside here.

*Source of further upside for EM corporate demand: Crossover institutional accounts*

In our view, DM funds, have already reduced their EM exposure and, on a 12-month basis, if EM spreads are tested against rising UST yields and pass that test (ie, are stable/compress), these investors could add.

FIGURE 19

**We see upside for demand for EM corporates from DM funds – what have they historically owned in EM?**

| European Funds (all Hard Currency) | European Funds (only USD) | US Funds (only USD) |
|---|---|---|
| SBIIN 4.50 11/30/15 € | VIP 7.748 02/02/21 | PETBRA 3.875% 01/27/16 |
| VOTORA 5.25 04/28/17 € | AIA 1.75 03/13/18 | SANBBZ 4.25% 01/14/16 |
| BANBRA 4.50 01/20/16 € | MUBAUH 3.75 04/20/16 | CEMEX 9.5% 12/14/16 |
| PEMEX 6.375 08/05/16 € | ALFARU 7.875 09/25/17 | MEX 5.625% 01/15/17 |
| RURAIL 7.487 03/25/31 £ | PETBRA 3.00 01/15/19 | DLLTD 8.25% 09/30/20 |
| BNDES 4.125 09/15/17 € | METINV 8.75 02/14/18 | TEVA Float 11/08/13 |
| GAZPRU 8.125 02/04/15 € | ALRSRU 7.75 11/03/20 | PETBRA 5.375% 01/27/21 |
| VIP 7.748 02/02/21 $ | VIP 9.125 04/30/18 | NIHD 7.5% 04/01/21 |
| OIBRBZ 5.125 12/15/17 € | VIP 7.504 03/01/22 | BBVASM 6.5% 03/10/21 |
| PEMEX 8.25 06/02/22 £ | EVRAZ 7.40 04/24/17 | SBIN 4.5% 07/27/15 |

Source: Bloomberg, Barclays Research

This need not be the base case expectation, but does present some upside risk. Specifically, we think high grade funds are most likely to be net adders in EM corporates because they are most exposed to the effect of rising UST yields (and need to add spread product) and because they are more captive in fixed income and have less ability within their mandates to rotate into even more protective asset classes like equities (though loans and munis could also compete with EM corporates for these flows). We think investors should consider longs in EM corporate bonds historically owned by DM funds.

### *Source of further downside for EM corporate demand: Retail investors*

On the other hand, retail mandates (especially in EM) are likely to continue to reduce their EM corporate allocations, driven by the impact of rising yields on fixed income total returns. Meanwhile, EM equities – which have posted persistent outflows for years – are now cheap by most conventional valuation metrics. They should be more protective against rising UST yields and will likely take a substantial proportion of those flows (or, if EM growth remains weak, DM equities could see those flows). We recommend investors lighten allocations in areas that have historically been supported by retail investors. There are a number of ways of triangulating on what is owned by retail, but we focused on the trades originating from private banks that we see through our electronic platform:

- **Basel III capital bonds/Tier 1 bank bonds:** BANBRA 6.25%/9.25% perpetual, ADIBUH 6.375% perpetual, SBERRU 5.25% 2023.
- **Turkish banks, especially 10y subordinated notes:** YKBNK 5.5% 2022, VAKBN 6% 2022, and ISCTR 6% 2022.

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# US sector outlooks

# US HIGH GRADE AEROSPACE & DEFENSE – UNDERWEIGHT

Vincent W. Foley
+1 212 412 7943
vincent.foley@barclays.com

Keith Byrne
+1 212 412 7938
keith.byrne@barclays.com

## Key recommendations

**We remain cautious on the HG Aerospace & Defense sector heading into 2014.** Spreads in 5y CDS have grinded to multi-year tights following successive beat-and-raise quarters in 2013, with concerns about sequestration seemingly dissipating from valuations. However, while the financial effect of sequestration may have been overstated for FY13, the defense primes still face potential headwinds related to spending cuts in FY14. As investors recognize that the overhang has been pushed forward, not eliminated, we expect a correction in trading levels.

**We are downgrading our sector rating to Underweight from Market Weight.** We recommend buying 5y CDS on Raytheon (MW, 22/27bp), Northrop Grumman (MW, 22/27bp), General Dynamics (UW, 24/29bp), Lockheed Martin (MW, 27/32bp), and Boeing (MW, 32/37bp). These defense primes are at 12-month tights, despite the uncertainty surrounding future declines in DoD spending. We believe there is limited downside to a short position in these credits at current rich valuations.

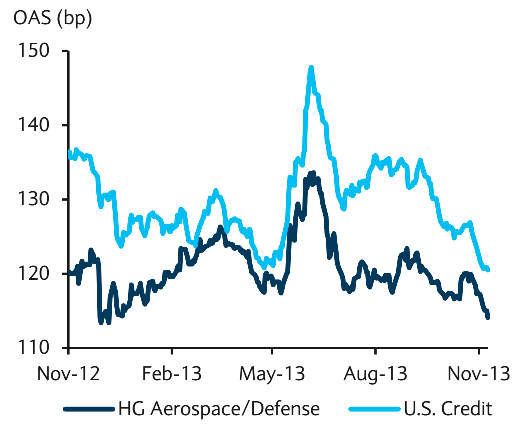
## Sector outlook

**Defense spending in 2014 will continue to face headwinds related to the sequester and broader budgetary concerns.** Federal budget cuts have not derailed the year-to-date performance of the defense primes, due partly to strong backlogs and longer-cycle businesses, which are relatively insulated from the Pentagon's spending reductions over a shorter horizon. However, the effect of sequestration on FY14 results appears less certain. The Federal government is operating under a continuing resolution until mid-January, and another round of required cuts ($20bn) must be adopted unless the law is adjusted in 2014. Barclays equity research forecasts defense hardware outlays to decrease ~9% y/y in 2014, following an estimated ~5% y/y decline in 2013. We believe that the prospect of better-than-expected DoD budgetary outcomes and an uptick in contract opportunities is limited by the size of the national debt and renewed focus on deficit reduction, which will likely again come to the political forefront during another debt ceiling debate in 1Q14.

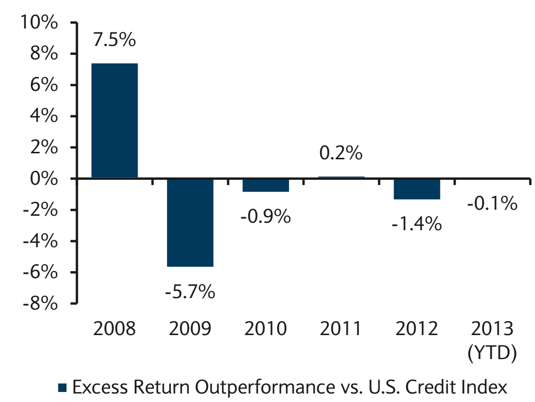
**The large commercial aerospace outlook remains positive, while the outlook for business jets is more challenged.** Global air traffic has been healthy for the past several years and is expected to improve further in 2014 (+4.7% y/y), particularly in China (+11.0% y/y) and Asia (+5.8% y/y). Backlogs for the OEMs remain strong (Boeing commercial backlog: $344bn) and should lead to healthy profits in 2014 and beyond. We are cautious on the business jet market, as weak global economic recovery has led to only modest new demand.

**The A&D industry should continue to maintain strong balance sheets; however, more sluggish revenue growth is likely to lead to increased shareholder-friendly behavior in 2014.** Credit profiles could be pressured as free cash flow slows and liquidity positions moderate. However, ratings should remain intact for FY14.

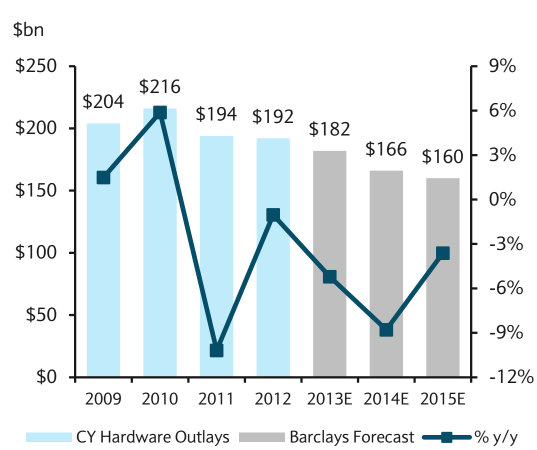
HG Aerospace & Defense OAS vs. HG Credit Index




HG Aerospace & Defense Excess Return vs. HG Credit Index




DoD Hardware Outlays Estimates – Calendar Year




Source: OMB, CSBA, DoD, Barclays Research

# US HIGH GRADE AUTOMOTIVE – OVERWEIGHT / HIGH YIELD AUTOMOTIVE – NOT RATED

Vincent W. Foley
+1 212 412 7943
vincent.foley@barclays.com

Keith Byrne
+1 212 412 7938
keith.byrne@barclays.com

## Key recommendations

**Ford Motor Co. (OW).** We maintain our Overweight rating on Ford Motor Co., as the company's strong fundamentals remain intact and could drive further rating upgrades. Ford's North America segment continues to show strong volume growth and profitability, and its international operations have reported incremental improvement in recent quarters. Ford has lowered its breakeven in Europe, due to restructuring efforts and inflecting demand, while its South America segment is benefitting from initiatives to replace legacy products with newer models across the dealer network. Though Ford 5y protection (110/115bp) has rallied to all-time tights, we continue to believe that CDS spreads should compress further to other BBB industrials, such as Whirlpool (90/95bp) and Johnson Controls (60/65bp).

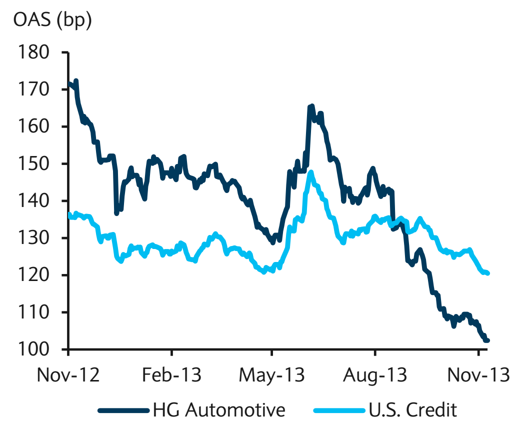
**General Motors (OW).** We maintain our Overweight rating on GM's 3.5% senior unsecured debt due 2018 and its 4.875% senior unsecured debt due 2023. We believe valuations in 5y CDS (160/170bp) are attractive for selling protection. After achieving an investment grade rating from Moody's in September, GM is now awaiting upgrades from Fitch and S&P, both of which recently raised their outlooks to Positive. The revisions mainly reflect an improvement in automotive volume and profitability in North America, a stabilization of the company's European operations, and a general strengthening of its global product portfolio and balance sheet. In our view, continued progress in these areas could lead to upgrades by S&P and Fitch in 2014, along with further spread compression toward Ford in cash and CDS.

## Sector outlook

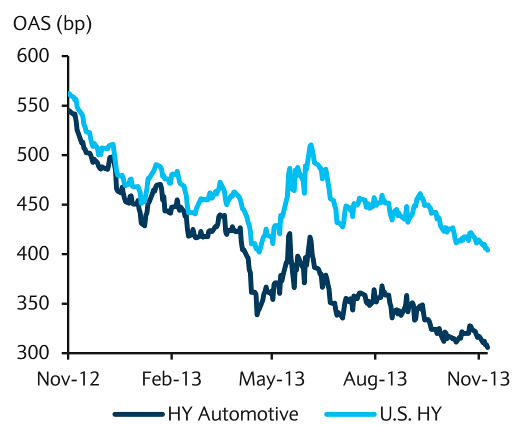
**The outlook for North American auto sales remains positive for 2014 following a strong 2013.** Light vehicle sales have tracked at 15.8mn units over the trailing six months, reaching a peak of 16.4mn units in November. Significant pent-up demand, an aging vehicle fleet, and cheap automotive financing should keep light vehicle SAAR elevated for the near to intermediate term. Barclays equity research expects light vehicle SAAR to reach 15.6mn units (+8.0% y/y) in 2013 and rise a more modest 3.8% y/y, to 16.2mn units, in 2014.

**Light vehicle production in North America should rise in 2014 amid solid demand, while European production will likely remain in recovery mode.** IHS Automotive expects North American light vehicle production to reach 16.8mn units in 2014, up 3.9% y/y. In Europe, the supply overhang has begun to ease as a result of OEM restructuring initiatives and stabilizing consumer demand. IHS expects production to rise 2.9% in 2014, to 19.7mn units. Europe represents 19.7% and 13.5% of LTM revenue at Ford and GM, respectively. Stabilization of the European auto industry would be a key driver of positive rating actions.

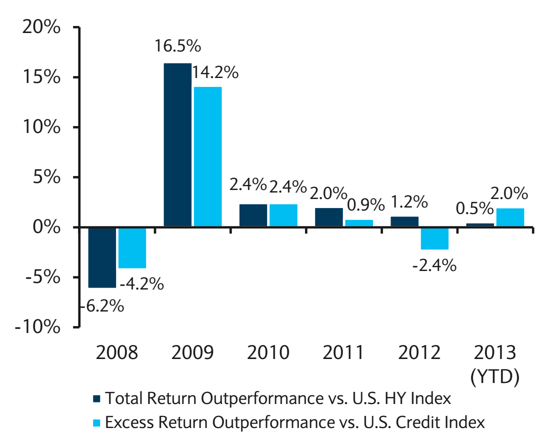
**HG Automotive OAS vs. HG Credit Index**




**HY Automotive OAS vs. HY Index**




**HG Automotive excess return vs. HG Credit Index**
**HY Automotive total return vs. HY Index**




Source: Barclays Research

# US HIGH GRADE BANKS – OVERWEIGHT

Brian Monteleone
+1 212 412 5184
brian.monteleone@barclays.com

Conor Pigott
+1 212 412 3441
conor.pigott@barclays.com

## Key recommendations

**We recommend an Overweight position on US banks**. Banks posted a very strong 2013 year-to-date. After starting 2013 at 13bp wide to the index, banks traded 12bp through as of late November (given a 50bp July-November rally in bank spreads). We view this tightening as the combined result of improved fundamentals, lower market volatility, and a shift to more non-financial drivers of general volatility. While banks are now at their post-crisis tights versus the index, we believe there is further room for tightening. We expect banks to maintain and improve upon fundamental strength, exhibit a declining beta to the market, and justify tighter spreads to the index. Furthermore, after adjusting for duration and issuer-domicile, the U.S. banks-industrials basis is tighter than reported figures suggest (bottom right figure), underlying our expectation for 10-20bp of further banking sector outperformance.

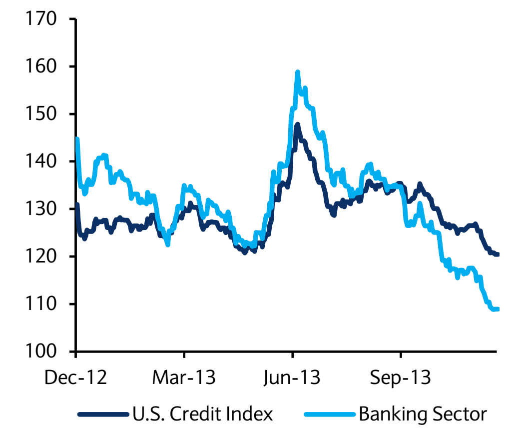
**We prefer the wider trading moneycenter banks and selectively moving down the capital structure.** On an issuer-by-issuer basis, we see value in Bank of America, Goldman Sachs, and Morgan Stanley (each Overweight), which continue to trade wide to the sector average despite steady improvement. Across the sector, we are cautious on subordinated debt given potential regulatory-driven issuance, and see value only where subordinated spreads are at least 1.5x senior. In preferred stock, we recommend moving out of fixed-for-life securities and into fixed-to-float structures to take advantage of a substantial spread pick-up to subordinated debt while also managing rate risk.

## Sector outlook

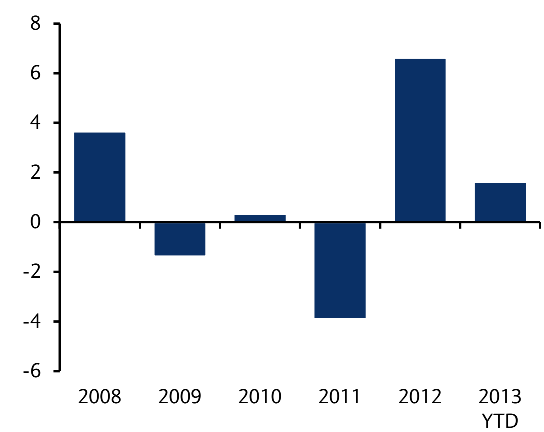
**We expect positive fundamental trends to continue in 2014.** Banks remain in a historically strong fundamental position. Capital is at modern-era highs, liquidity remains substantially higher than projected stress scenario outflows, and asset quality has normalized across most loan types. More importantly, new regulations will force banks to maintain elevated capital and liquidity, and even further improve in certain cases. Asset quality also looks set to further strengthen, as the recent crisis experience keeps underwriting standards relatively strict and low early-stage delinquencies imply further improvement in 2014.

**Regulations to remain a focus.** The Federal Reserve plans to issue a proposed rule in the next few months requiring the largest U.S. banks to maintain a minimum amount of long-term unsecured debt issued out of their holding companies. While most banks already have substantial senior debt outstanding, subordinated debt has historically been a relatively small proportion of holding company funding. If the proposed rule calls for subordinated debt of 3% of RWAs or higher, then the eight largest U.S. banks could need to issue over $70bn of sub-debt, likely over a transitional period through 2019.

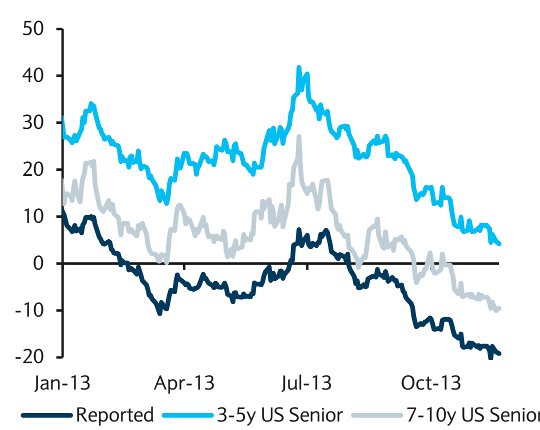
**US Banks OAS versus US Credit Index, bp**




**US Banks excess return versus US Credit Index, %**




**Duration- and Domicile-Adjusted U.S. Banks-Industrials Basis, bp**




Source: Barclays Research

# US HIGH GRADE CABLE & TELECOM – MARKET WEIGHT/MARKET WEIGHT

Danish Agboatwala
+1 212 412 2573
danish.agboatwala@barclays.com

Parth Shah
+1 212 412 2079
parth.shah@barclays.com

## Key recommendations

**We lower our rating on HG Cable-Satellite to Market Weight.** While sector valuations are cheap to historical averages (OAS: 63bp cheap to the US Credit index; 3y average: 22bp), they could be pressured by a media-discussed sale or break-up of Time Warner Cable* (~27% of index, Underweight). In a CHTR-led buyout/ break-up, existing TWC bonds could travel to Charter and have meaningful downside. We remain Overweight on Cox and Comcast, as we believe their participation would be limited to select assets sales, with relatively modest credit effects. Please see *Cable M&A: TWC in the Spotlight* and *Revisiting Cable Consolidation Scenarios and Credit Implications* for further details.

**We keep a Market Weight rating for domestic Telecom.** Event risk remains a concern, with AT&T (22% weighting; Underweight) likely to pursue a European acquisition (see *AT&T: Downgrade to Underweight*). Nevertheless, this is balanced by a deleveraging focus at VZ and AMT.

## Sector outlook

**M&A: Special situations overhang.** Fundamentals should (again) take a backseat to ongoing special situations including: 1) whether AT&T enters Europe; 2) TWC sale or break-up scenarios; 3) further wireless consolidation (DISH, T-Mobile, Sprint, etc.); and 4) potential Tower sales.

**Wireless: Competition, spectrum, capital intensity focal points.** T-Mobile's 'un-carrier' strategy has affected share dynamics, and we expect competition to further intensify. We expect carriers to maintain elevated capital intensity to boost service quality and to look to bolster spectrum holdings, particularly at upcoming auctions.

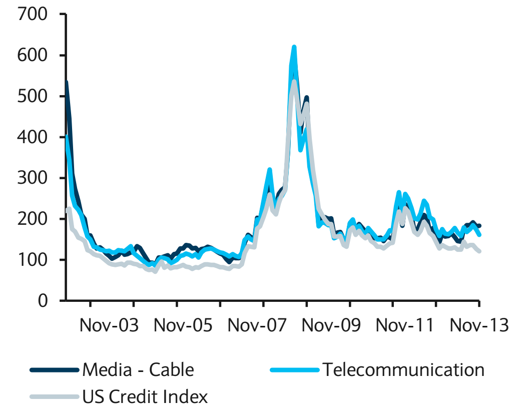
**Wireline: Enterprise sluggishness offset by consumer.** Enterprise growth will remain challenged due to macro/political factors, which have delayed spending. However, consumer is a bright spot with RBOCs taking share in PayTV through fiber-based offerings (U-Verse and FiOS).

**Cable: Underlying fundamentals stable**. Excluding consolidation fears, fundamentals remain stable due to improving video losses, further gains in broadband and commercial and ARPU gains offsetting programming cost pressures. 2014 will also benefit from political advertising.

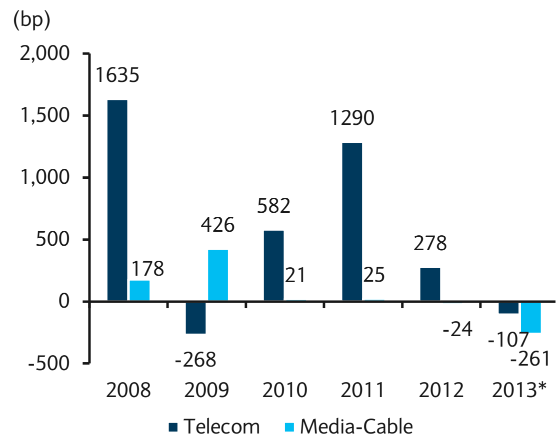
**Towers: Secular growth intact, but deleveraging focus.** We remain bullish on the tower secular growth story (capacity needs, network densification, VoLTE, spectrum deployment, etc.). However, the focus will be on deleveraging for AMT (we expect it to hit its 3-5x target by 2015) and the potential for further asset purchases.

Note: * "Charter said to raise $25 billion to acquire Time Warner Cable," Bloomberg, November 28, 2013.

**HG Cable & Telecom OAS vs US Credit Index, bp**




**HG Cable & Telecom excess return vs. US Credit Index, bp**




**Top issuers in Telecom & Cable Indices**

| Ticker | % of Telecom Index | % of Media-Cable Index | % of US Credit Index |
|---|---|---|---|
| VZ (inc VZW) | 37.7% | | 1.9% |
| T | 22.3% | | 1.1% |
| VOD | 7.9% | | 0.4% |
| TELEFO | 6.6% | | 0.3% |
| AMXLMM | 6.1% | | 0.3% |
| CMCSA | | 51.8% | 0.9% |
| TWC | | 27.0% | 0.5% |
| DTV | | 20.0% | 0.3% |

Note: As of November 29, 2013. Source: Barclays Research, POINT

# US HIGH GRADE CHEMICALS – MARKET WEIGHT

Brian Lalli
+1 212 412 5255
brian.lalli@barclays.com

## Key recommendations

**2013 performance a mixed bag.** Performance over the past year has been mixed, with lower-rated BBB credit outperformance helping to offset the weakness related primarily to 1) shareholder activism (DuPont, DD; Eastman, EMN; Air Products, APD) and 2) global potash volatility (Mosaic, MOS; Potash, POT). Strength out of the US Gulf Coast producers helped buoy excess returns, with LyondellBasell (LYB), Methanex (MXCN) and Westlake (WLK) the top three performers YTD.

**We maintain our Market Weight recommendation for 2014,** with our expectation that solid industry fundamentals (USGC cost advantage, leverage to global economic improvement) will offset the continued risk of shareholder activism/returns. Ratings upside across the sector is likely capped, but we see downside as similarly limited given solid balance sheets and lower pension obligations y/y. While we do not expect any single significant leveraging event, we remain mindful of event risk for names like DOW, DD and EMN and, as such, would be better positioned in LYB (Overweight) given conservative leverage and strong FCF.

## Sector outlook

**Shareholder activism is clearly in focus** but the impact for each credit is an unknown. While DD announced a spin-off of its Performance Chemicals business following Trian Advisers taking a stake, EMN saw Jana Partners come and go without any specific actions. We continue to monitor the situations at CF Industries and APD to determine the appropriate spread impact if something is announced, but the uncertainty related to sector activism will likely persist into next year.

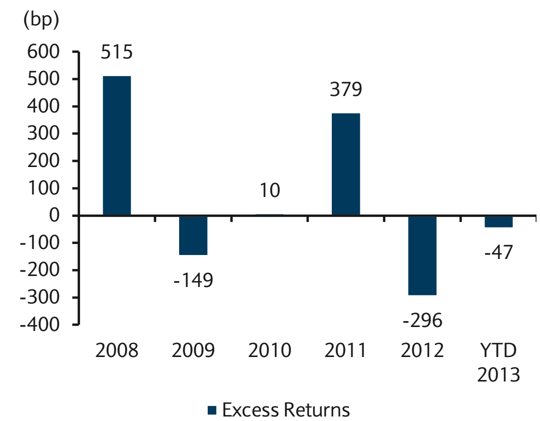
**M&A seems to be here to stay** as global producers seek (inorganic) growth and increased specialty chemical exposure, while global GDP trends remain depressed. Even as the market became more bullish on sector trends in 2012-13, current market valuations could present opportunities to purchase strategic assets relatively cheaply and generate returns on capital (low rates, cheap financing). The continued theme of asset sales and portfolio optimization will likely remain in the headlines in 2014 (DOW).

**Is deleveraging still important?** Given management's focus on shareholder value, it feels like the answer broadly is no. Certain issuers may still look to gross deleverage (DD, ECL), but we expect more deals focused on releveraging for either buybacks or M&A given low rates.

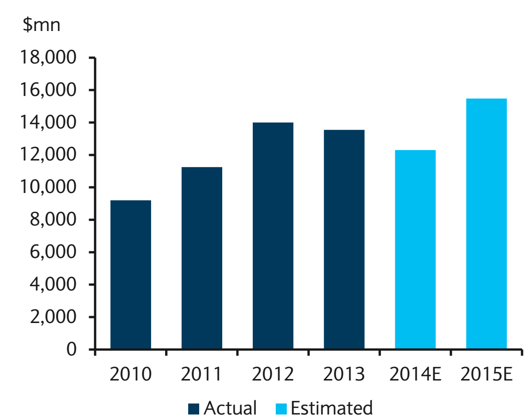
**Growth ultimately hinges on the economy,** so we will be focused on macro trends out of North America, Europe and Asia as we develop our view on EBITDA trends for 2014-15. We believe we have hit bottom, but we would expect 2014 to exhibit still-depressed growth, limiting upside for EBITDA and FCF. If gross leverage moves higher and we hit another patch of weakness, sector performance could suffer.

US Chemicals versus US Credit Index OAS


US Chemicals minus US Credit Index




New issuance – Historical and estimates




Source: Barclays Research

# US HIGH GRADE ELECTRIC UTILITIES – MARKET WEIGHT

Yung Chuan "Y.C." Koh
+1 212 412 3796
yc.koh@barclays.com

Brittany Chen
+1 212 412 3841
brittany.chen@barclays.com

## Key recommendations

**Buy Puget Energy (PSD, OW) 6.5% due 2020 bonds, quoted at T+145, G+210 mid.** We expect PSD cash spreads to continue to compress, helped by a potential near-term full IG rating by both Moody's and S&P (Ba1 review for upgrade/BBB- stable; S&P placed the previous BB+ holdco cash ratings on watch positive on November 26, and upgraded it to BBB- a week later on December 3), constructive regulatory developments in Washington state (multi-year rate plan/rate increases, and revenue decoupling that went into effect in July 2013), and the desire to achieve and maintain IG holdco cash ratings.

**Buy Ohio Power (AEP, OW) 5.85% due 2035 bonds, quoted at T+126, G+149 mid.** The separation of the generation business from the utility, expected by year-end 2013, should lower Ohio Power's business risks. We expect cash spreads to continue to converge with other low-A rated unsecured opco bonds such as D/VEPCO and ED/CECONY (mid G-spreads quoted in the low/mid-80s).

## Sector outlook

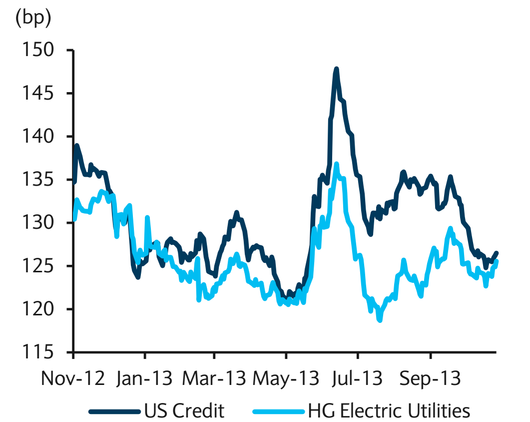
**Our Market Weight sector rating reflects relatively tight spreads and our expectations of stable credit quality and performance by regulated utilities, partly offset by another active primary issuance calendar and some gradual stabilization in the credit quality of unregulated gencos (helped by cost-cutting/support from parents).** We expect the sector to continue to track its historical trading correlation with the US Credit Index in 2014.

**Continued shift to regulated investments.** We expect competitive power markets outside ERCOT to remain challenging, and regulated investments and cost management to remain a focus especially for diversified utilities. We would not be surprised to see additional generation asset/unregulated generation portfolio rebalancing by companies or in certain states (e.g., Ohio, with separation of generation assets from utilities) and RTOs (shuts, divestitures).

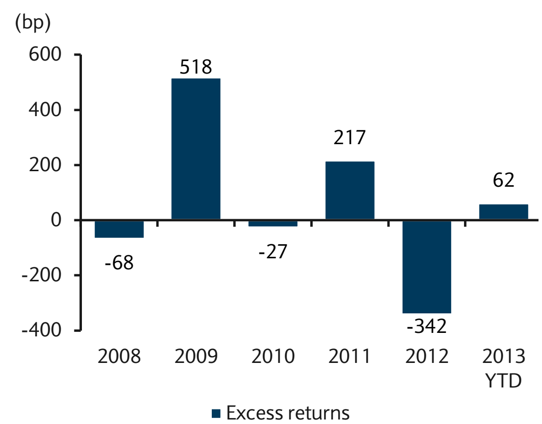
**Soft demand environment to persist.** We believe the backdrop of rising interest rates, tepid economic growth, flattish electricity sales, modestly declining capex, and low natural gas/power prices could drive a pick-up in M&A activity and the exploration of alternative financing structures (e.g., MLP/yieldco) in 2014.

**Active but slightly lower 2014 issuance expected.** We expect another active year in 2014, with $41-47bn in new issuance, down from an expected $47-48bn in 2013. The y/y decline is driven by lower maturities, 2-6% lower capex, and offset by the elimination of bonus depreciation (bonus depreciation was 50% in 2013, expected to be 0% in 2014).

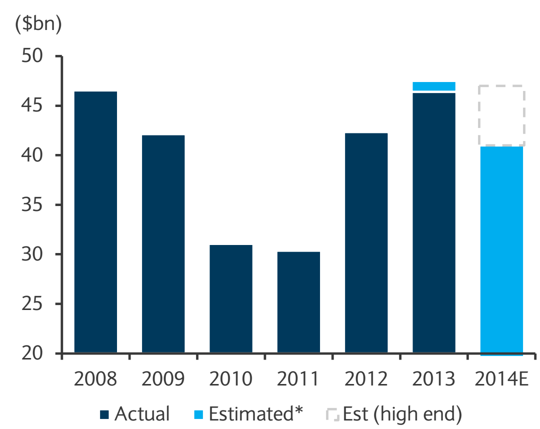
US Electric Utilities versus US Credit Index OAS




US Electric Utilities minus US Credit Index




New Issuance ($bn)




Note: YTD through November 29, 2013, *Expected issuance through year-end 2013, and 2014 estimated issuance (lower-end). Source: Bloomberg, Barclays POINT, Barclays Research

# US HIGH GRADE ENERGY AND PIPELINES: INDEPENDENT E&P – MARKET WEIGHT, INTEGRATED – UNDERWEIGHT, REFINING – MARKET WEIGHT, OIL FIELD SERVICE – OVERWEIGHT, PIPELINES – OVERWEIGHT

Harry Mateer
+1 212 412 7903
harry.mateer@barclays.com

Greggory Price
+1 212 412 7905
greggory.price@barclays.com

## Key recommendations

**Independent E&P**: long Continental (CLR, OW); pair longs in low-cost oil producers with shorts in high-cost producers (*link*)

**Refining:** buy Valero (VLO, MW) 5y CDS, sell IG CDX

**Pipelines:** long DCP Midstream Partners (DPM, OW)

## Sector outlook

**The independent E&P sector is valued toward the wide end of its 3y range relative to the U.S. Credit Index.** Natural gas prices remain low and we think that oil prices are vulnerable because of rising North American supply, but management teams have proven adept at mitigating negative free cash flow with asset sales and are still generating strong returns on their drilling programs. In our opinion, a key risk remains further shareholder activism, although companies are becoming more proactive in confronting the threat. We see scope for 5bp of tightening at the sector level and 180bp of excess return. We raise E&P to Market Weight from Underweight.

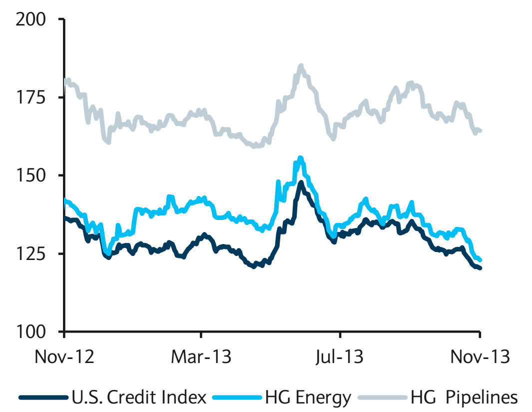
**We expect another year of underperformance for the integrated sector.** For integrateds to outperform, we believe that the broader market would need to widen and energy prices would need to climb. We expect roughly 90bp of excess return from the integrateds and remain Underweight.

**Although volatility picked up in 2013, the refining sector is still on track to register another year of outperformance.** In 2014, we expect that crude oil differentials will remain wider than historical levels and support sector cash flows, but spreads are tight to the 3y average differential and we expect management focus to remain on shareholder returns. We expect 125bp of excess return and remain Market Weight.

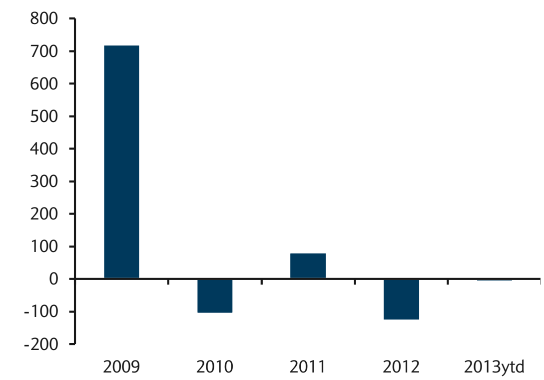
**The oil field service sector is no longer wide to its 3y average versus U.S. Credit, but we see scope for modest sector tightening and 200bp of excess return.** In our view, the sector's focus is squarely on enhancing shareholder value, but there is a greater representation of higher-quality companies than in the past and the higher-beta credits have lower event risk in the near term. We remain Overweight.

**The pipelines sector is on track to slightly outperform the U.S. Credit Index in 2013, and we see scope for another year of outperformance in 2014.** In our view, the key risks for the MLP sector in 2014 will be the potential for lower oil prices, higher interest rates and increased M&A, which we expect to come back into favor because of slowing organic spending. Although we expect that interest rates will rise, we anticipate that they will remain well below the level that we expect to trigger fundamental deterioration for MLPs. In 2014, we anticipate 210bp of excess return and remain Overweight.

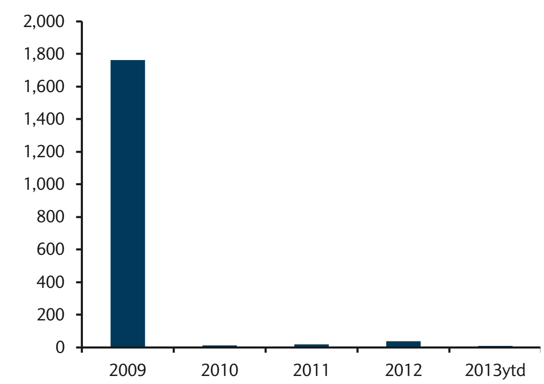
Sector and Index OAS (bp)




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




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




Source: Barclays Research

# US HIGH GRADE FINANCE COMPANIES – OVERWEIGHT

Brian Monteleone
+1 212 412 5184
brian.monteleone@barclays.com

Conor Pigott
+1 212 412 3441
conor.pigott@barclays.com

## Key recommendations

**We recommend an Overweight position on US finance companies.** Finance companies have benefited from increasingly open financing markets and a significant improvement in asset quality (especially among commercial borrowers). These trends appear likely to continue in the near term, leading us to expect stable/modestly improving sector fundamentals in 2014 and guiding our sector recommendation. Like the banks, finance company spreads are now at their post-crisis tights to the index (13bp through vs. 31bp wide to index at YE12). Nonetheless, we believe there is further room for tightening given the positive fundamental outlook, declining sector beta, and a shift to increasingly non-financial drivers of market volatility.

**We are Overweight GECC.** Given sector concentration in GECC (see below for more detail), our Overweight rating on the credit drives our overall sector view. We believe GECC's unique relationship to a large diversified industrial parent provides substantial support to the finance company's already improved standalone credit profile. Given our expectation for GECC to remain part of GE Co. for the foreseeable future, we believe there is further room for spreads to tighten, especially in intermediate and long-end.

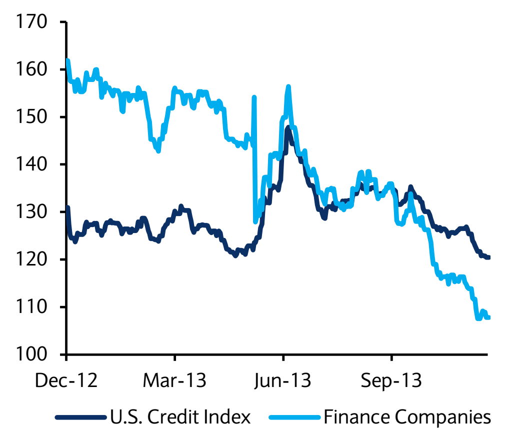
**We also find a number of smaller issuers attractive.** For example, debt recently issued by business development corporations (BDCs) looks cheap at current levels. The two 2013 BDC deals are currently among the widest trading U.S. bank, broker, and finance company bonds in the IG index, despite low leverage (capped at 1x), strong tailwinds in commercial lending, and stable BBB ratings.

## Sector outlook

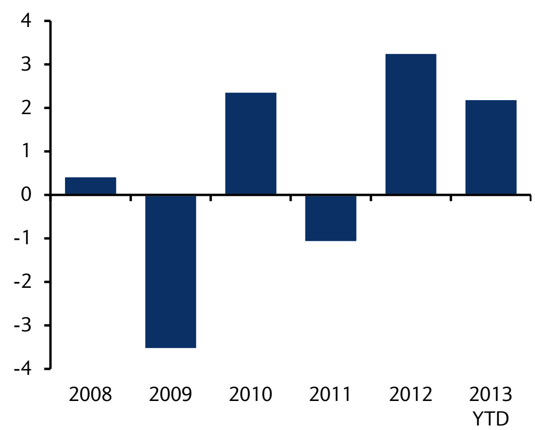
**High GECC concentration will persist.** Currently, GECC constitutes the vast majority of sector outstandings at 84% of market value. This is up from only 77% at YE12, given the migration of SLM Corp into HY this spring. While GECC has indicated that it will be a negative net issuer in 2013, this should only modestly reduce ticker concentration.

**But new issuers and rising stars could gradually diversify sector.** We expect BDCs, air lessors, and other high yield rising stars to gradually constitute a higher portion of sector bonds. In 2013, two new BDC issuers, in Ares Capital Corp. (ARCC) and Prospect Capital Corp. (PSEC), brought deals and we expect peers could soon follow. Also, this year Air Lease (AL) became the first post-crisis air lessor in the IG index, and we expect the company to increase issuance. Finally, over the next 1-3 years we expect large HY financials, such as CIT and ILFC (each with roughly $12bn outstanding), to obtain upgrades to IG.

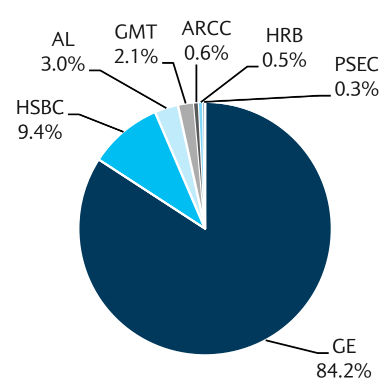
US Finance Companies OAS versus US Credit Index, bp




US Finance Companies excess return versus US Credit Index, %




Amount Outstanding by Issuer, % of Sector




Source: Barclays Research

# US HIGH GRADE FOOD & BEVERAGE – MARKET WEIGHT, CONSUMER PRODUCTS – MARKET WEIGHT, TOBACCO – MARKET WEIGHT

Priya Ohri-Gupta, CFA
+1 212 412 3759
priya.ohrigupta@barclays.com

Kacie Overlander
+1 212 412 2077
kacie.overlander@barclays.com

## Key recommendations

With flat 10s30s relationships across BBB food (ConAgra, General Mills, and Campbell), we recommend investors shorten duration to intermediates. From a valuation standpoint, our preference is for Kraft and Campbell, both of which are Market Weight.

In our view, ag names such as Cargill and ADM (both NR) offer investors single-A credit quality while trading at levels in line with mid- to high-BBB food.

We are Underweight Avon as we believe that heightened ratings pressure could result in the credit moving to high yield in the absence of rapid fundamental improvement. We are Overweight Newell Rubbermaid as we see 30bp of upside potential in current cash levels on the back of ratings improvement to mid-BBB.

Within tobacco, we continue to see the greatest upside potential in Lorillard (Overweight), supported by ongoing efforts to diversify the product portfolio and organically expand its geographic footprint. In our view, menthol-related headlines should be limited, with FDA actions likely to have a fairly long timeline. We see fair value for Lorillard as about 40bp back of Altria (Market Weight).

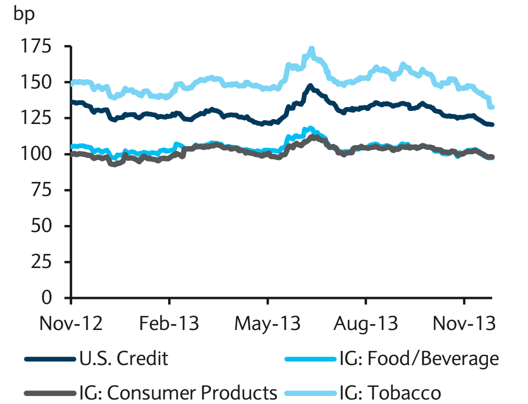
## Sector outlook

**We are Market Weight Food & Beverage**. Volume growth is forecast to be modest in the coming year with consumers highly value conscious and shopping closer to need. In our view, M&A will largely focus on bolt-ons with a propensity for some sector consolidation given a weaker top-line outlook. In the absence of this, FCF will likely be directed toward shareholder returns.

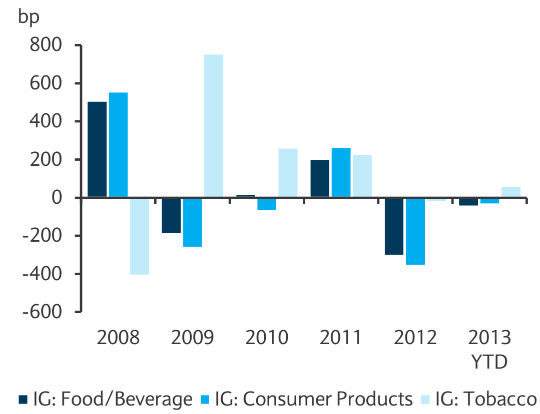
**We move Consumer Products to Market Weight** (from Underweight). In our view, there is modest ratings pressure to constituents (with the exception of Avon), which should limit downside. While M&A activity is also forecast to consist of bolt-ons, we see room for balance sheet usage to support shareholder returns, specifically buybacks.

**We move to a Market Weight rating on the Tobacco sector** (from Overweight) in light of recent strength from the domestic manufacturers, which comprise 62% of the sector. Key drivers for the sector include e-cigarette growth, MSA dispute settlements, shareholder returns, and a benign litigation environment.

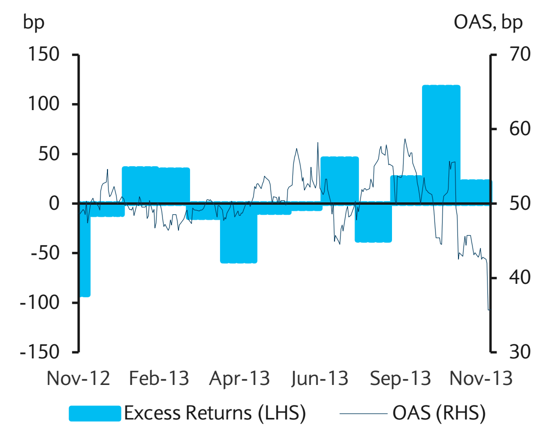
**US Food/Beverage, Consumer, and Tobacco OAS versus US Credit Index**




**US Food/Beverage, Consumer, and Tobacco excess returns versus US Credit Index**




**Domestic Tobacco excess returns and OAS versus US Credit Index**




Source: Barclays Research

# US HIGH GRADE PHARMACEUTICALS – UNDERWEIGHT, HEALTHCARE – MARKET WEIGHT, HEALTH INSURANCE – MARKET WEIGHT


Shubhomoy Mukherjee
+1 212 412 5245
shubhomoy.mukherjee@barclays.com

Audra Stundziaite
+1 212 412 1731
audra.stundziaite@barclays.com

Kyle Stockmal
+1 212 412 1772
kyle.stockmal@barclays.com


## Key recommendations

**Add to Laboratory Corp. of America Holdings 2023s (T+151bp G-spread, NR)** to reflect: 1) attractive valuations vs. other mid- to low BBB healthcare credits; 2) good operational performance and conservative financial policies; and 3) downside protection from event risk given the 101 COC control and the bonds trading below par ($97.72).

**Add exposure to Quest Diagnostics 5.75% 40s (T+221bp G-spread, NR)** to reflect: 1) upside potential if the company is able to deliver on its restructuring initiative; and 2) downside protection from event risk given the 101 change of control feature and the bonds trading below par ($98.8).

**Add exposure to Cigna (22s at T+127bp G-spread, OW)** to reflect: 1) positive outlooks by all three agencies and rating upgrades by S&P that realign CI's rating with AET; 2) strong operational performance aided by diversified operating portfolio; and 3) reduction in earnings volatility due to reinsurance transaction with Berkshire Hathaway.

**Reduce exposure to Pfizer (2023s at T+86bp G-spread, UW).** To reflect: 1) reduced scale and diversity due to potential separation of the company; 2) unknown capital structures and financial policies; and 3) unknown placement of existing bonds.

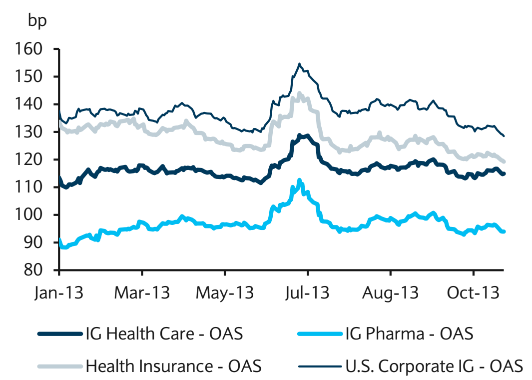
## Sector outlook

**Market Weight IG Healthcare:** Upside potential given current valuations appears limited (13bp discount vs. consumer non-cyclicals to reflect one-notch rating diff.). After a year of consolidation in life science and distributors space (TMO/LIFE, MCK/Celesio) we expect the companies to focus on integrating these transactions and paying-down debt. We recommend that investors add exposure through new issues at modest concessions from current levels.

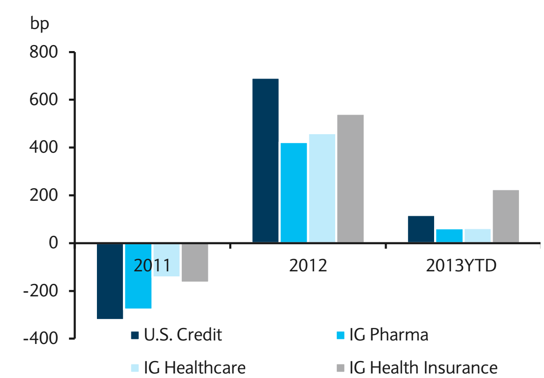
**Market Weight Managed Care:** We think the managed care valuations fairly reflect one-notch rating differential between the sector and consumer non-cyclicals (13bp discount). We believe that near-term earnings and ratings upside from the start of healthcare reform will be limited due to limited managed care participation in exchanges and continuous margin pressure in the Medicare Advantage business.

**Underweight IG Pharmaceuticals:** Valuations of the IG Pharmaceutical Index (12bp premium vs. consumer non-cyclicals) do not reflect expected rating migration downward due to event risks: debt-funded M&A, buybacks, and restructurings. We expect these corporate actions to be driven by big pharmaceutical companies' need to offset earning declines after patent losses on blockbuster products and attempts by generic makers to expand into higher-margin specialty areas.

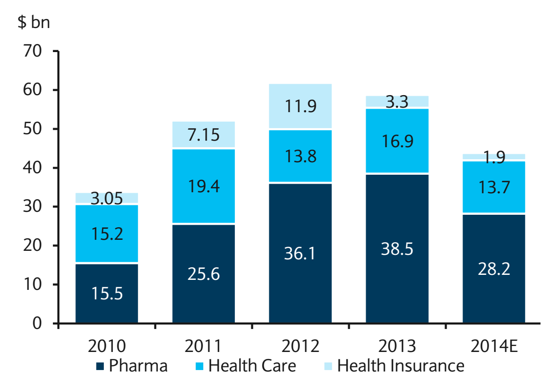
US Credit Index vs. IG Healthcare Sectors – OAS




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




Issuance Expectations




Source: Barclays Live, Barclays Research

# US HIGH GRADE/HIGH YIELD HOMEBUILDERS – MARKET WEIGHT

Vincent W. Foley
+1 212 412 7943
vincent.foley@barclays.com

Keith Byrne
+1 212 412 7938
keith.byrne@barclays.com

## Key recommendations

**We recommend selling 5y CDS on Toll Brothers (OW, 162/172bp) outright or as a pair trade against buying protection on D.R. Horton (MW, 193/203bp).** The rise in mortgage rates that is expected once the Fed begins tapering (or hints at beginning) should disproportionately affect volume, pricing, and gross margins at D.R. Horton (entry-level focus) relative to Toll Brothers (luxury focus). The basis between the credits, currently 31bp, should begin to decompress once mortgage rates begin to climb. The wide of this relationship over the past two years has been 60bp. We view Toll Brothers' recent purchase of Shapell Homes as a longer-term positive, as it favorably positions the credit in the land-constrained California market. Toll's operating fundamentals should prove more resilient amid rising rates.

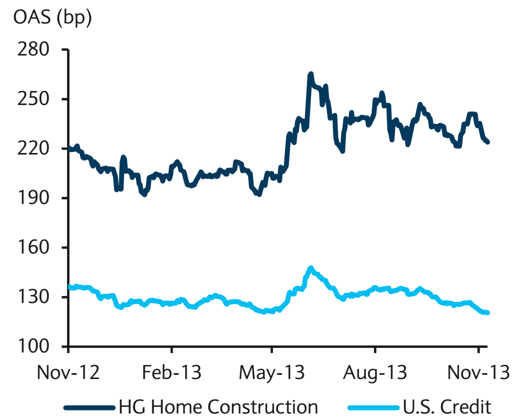
**We recommend selling 5y CDS on Standard Pacific (OW, 240/250bp).** Standard Pacific is among the higher-quality builders in our coverage universe, given its consistent profitability (LTM EBITDA: $307mn) and industry-leading gross margin (31.2%). The company is well positioned in the attractive California marketplace, and its buyers are more insulated from higher rates, given an above-average selling price ($420k). We believe the company will maintain its top-tier gross margin profile in 2014.

## Sector outlook

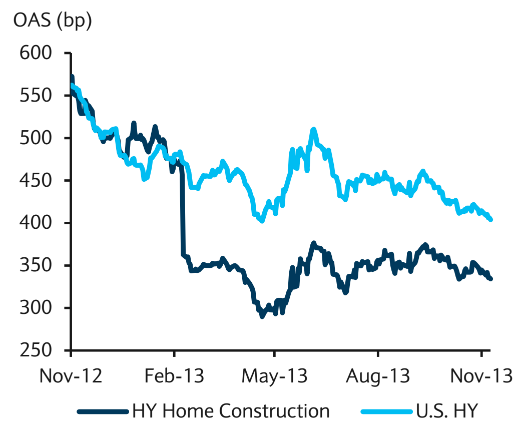
**Despite the rising rate environment and its negative effect on homebuyer demand, we expect the US housing recovery to sustain momentum in 2014, albeit at a slower pace.** More favorable employment trends, increased mortgage availability, and lean housing inventory (both NHS and EHS supply stands at roughly 5.0 months, vs. the historical equilibrium of 5.5-6.0 months) should support broader housing fundamentals in 2014. However, the higher cost of mortgage funding is likely to weigh on the trajectory of demand and potentially lead to a moderation of home price increases later in 2014, particularly for those homebuilders focused on rate-sensitive entry-level buyers. Barclays economics forecasts housing starts to reach 1.24mn (SAAR) in 4Q14 and home prices to rise 7-8% in 2014, following 9-10% improvement in FY13.

**Homebuilders will likely continue to focus on margin expansion over volume improvement in 2014.** While we expect y/y improvement in sales during the spring selling season (+10%), the trajectory of improvement should be more modest relative to the past several years, as comps have become tougher and mortgage funding has become more expensive. Maximizing gross margins has been a key focus in 2013, and we expect this dynamic to remain intact in 2014. However, a moderation of home price appreciation in FY14 due to higher rates could limit gross margin expansion for some homebuilders.

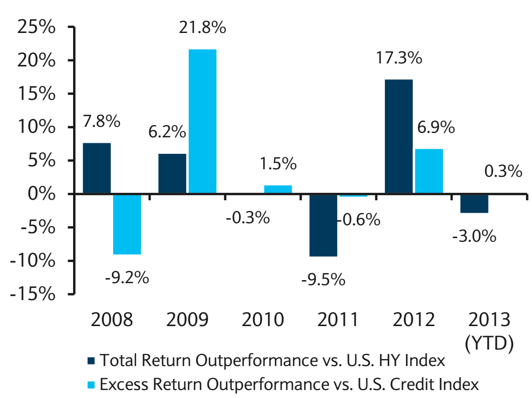
HG Home Construction OAS vs. HG Credit Index




HY Home Construction OAS vs. HY Index




HG Home Construction Excess Return vs. HG Credit Index; HY Home Construction Total Return vs. HY Index




Source: Barclays Research

# US HIGH GRADE LIFE INSURANCE – OVERWEIGHT

Thomas C. Walsh
+1 212 412 3129
thomas.walsh@barclays.com

Peter Troisi
+1 212 412 3695
peter.troisi@barclays.com

## Key recommendations

**We remain Overweight the US Life Insurance sector.** Despite a strong credit performance from the life sector in 2013, we remain Overweight. Life insurance sector OAS is +155bp, or 35bp behind US Credit. With interest rates poised to increase in 2014 as QE begins to taper, we expect a favorable top- and bottom-line effect. Namely, higher investment income should drive better core profitability and higher returns. Lower volatility (VIX) has been a cornerstone of the sector's performance to date, as the VIX has been range-bound despite tapering expectations. That said, we believe the industry is better equipped to handle a spike in volatility given the reduction in risk on the balance sheet and strong parent liquidity. Accordingly, we see value in the sector at current levels.

**We prefer high beta names that have reduced idiosyncratic risk.** Genworth (GNW, OW) maintains its sharp focus on capital and liquidity, with a clear path to the repayment of upcoming debt maturities. We believe investors will continue to gain comfort as GNW's operating track record develops, which should push spreads tighter. We see at least 25bp of upside potential for GNW 2023s. Also, we favor ING US (VOYA, OW), which has demonstrated meaningful progress in reducing enterprise risk. In addition, the business mix is well positioned to benefit from favorable market dynamics. At 40bp back of LNC 2023s, we see 15bp of upside potential for VOYA 2022s.

## Sector outlook

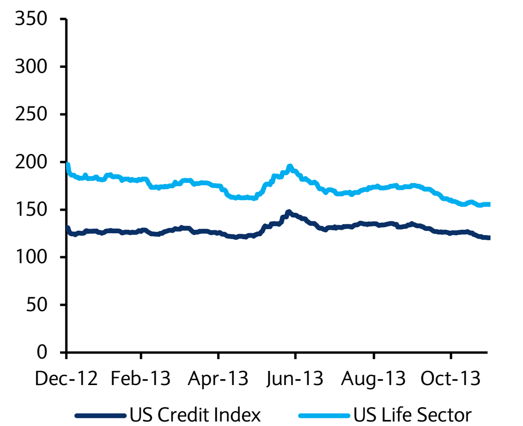
**Capital and liquidity are sector strengths**. Operating capital is at historical highs, as large cap life insurers maintain RBC in excess of 400%. Holding company liquidity is also historically strong, covering debt service, and short-term maturities on average by 2x, driven in part by rating agency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

**Higher rates will be a lift.** The Barclays Rates Strategy forecast is for the 10y UST yield to rise by roughly 65bp to 3.5% in 2014. The expected rise in rates from tapering of QE in 2014 should drive higher new money rates for life insurers, a key lift to sector earnings. Higher rates also place less strain on assumptions embedded in life insurer balance sheets, namely policy intangibles and reserves.

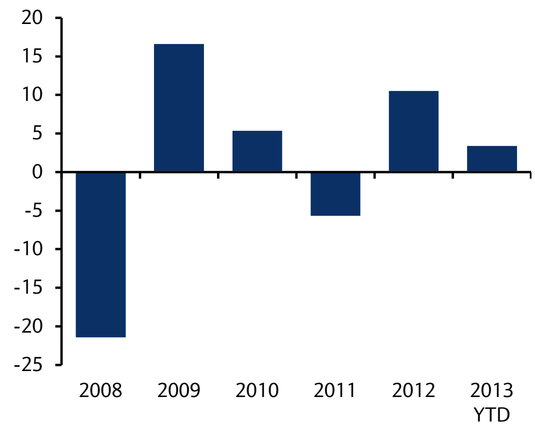
**Pricing and benefit changes a short-term hedge.** The life sector has raised prices and is adopting product features reflective of the more difficult operating environment. However, the benefit of these actions is finite. Capital management continues to provide a near-term ROE buffer. Our ROE forecast for 2014 is 12%.

Note: *Financial debt+preferreds/total capital less AOCI

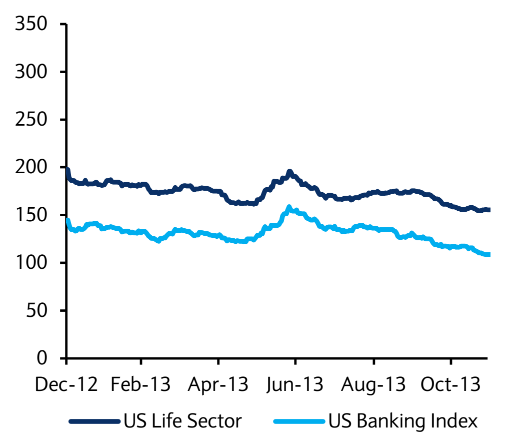
US Life Insurance OAS versus US Credit Index, bp




US Life Ins. excess return versus US Credit Index, %




US Life Ins. OAS versus US Bank OAS, bp




Source: Barclays Research

# US HIGH GRADE PROPERTY/CASUALTY INSURANCE – MARKET WEIGHT

Thomas C. Walsh
+1 212 412 3129
thomas.walsh@barclays.com

Peter Troisi
+1 212 412 3695
peter.troisi@barclays.com

## Key recommendations

**We recommend a Market Weight position on US P&C Insurers.** The P&C sector remains farily valued at +136bp, or 15bp behind the US Credit Index. The sector generated strong earnings in 3Q13, reflecting the benign Atlantic hurricane season and the earn-through of several quarters of premium increases. Capital remains at historically high levels, shaping a core foundation for the sector. P&C insurance remains defensive as low capital market exposure creates a safe haven during periods of volatility. The current spread differential between P&C and US Credit of 15bp is equal to the average YTD 2013. With fundamentals intact going into 2014, we maintain our Market Weight rating.

**We prefer insurance brokers over tighter-trading blue chips.** We remain OW AON and Marsh (MMC) as they offer an attractive risk/return profile relative to underwriters. Aside from a less capital intensive business, brokers offer more operating stability than P&C insurers. At roughly 45bp back of the average g-spread of comparable P&C bonds, we see 20bp of upside. Aside from brokers, we are OW CNA Financial (CNA). CNA has demonstrated material improvements in recent years and maintains one of the most conservative balance sheets in the industry. CNA 2021s are roughly 70bp cheap to blue-chips peers, leaving room for at least 15bp of compression, in our view. Industry blue chips including ACE (MW), Allstate (MW), Chubb (UW), and Travelers (MW) continue to demonstrate improved underlying performance and strong capital, which appear fully priced into valuations.

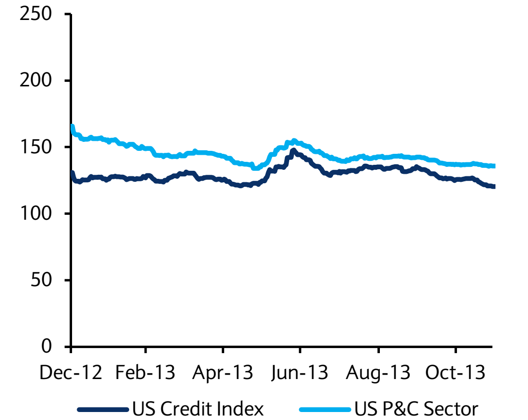
## Sector outlook

**Strong capital.** The P&C industry, including the Bermuda subset, remains flush with capital. The combination of solid pricing dynamics, driven in large part by low interest rates and continued risk discipline, and a light U.S. hurricane season finds the industry's capital position in solid shape going into 2014. Industry operating leverage has remained conservative in the 0.8x range. We attribute a healthy respect for financial volatility as well as continued discipline with respect to risk modelling as factors that will keep capital discipline high .

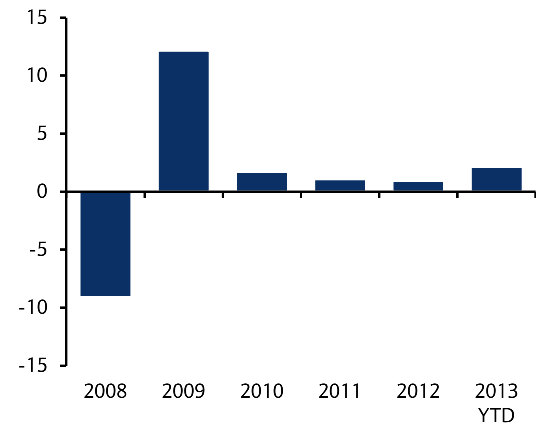
**Positive rate environment continues.** P&C insurers continue to report premium rate increases, continuing a multi-year trend. As a result, the sector has shown incremental improvement in core underwriting margins. This has translated into higher ROEs, which were low/mid-teens for blue-chip carriers in 3Q13. Given the sector's strong capital position, we expect rate pressure on short-tail lines in 2014. Long-tail lines are more dependent on investment income, hence we expect operating discipline to carry on for at least the first half of next year.

**Weather is a source of volatility.** P&C insurers remain exposed to weather events. Although we believe this risk is well managed in general through modelling and reinsurance protection, it has been a source of earnings volatility in recent years.

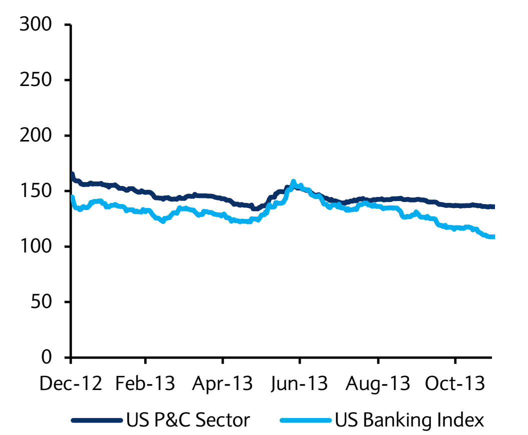
US P&C Insurance OAS versus US Credit Index, bp




US P&C Insurance excess return versus US Credit Index, %




US P&C Insurance versus US Bank OAS, bp




Source: Barclays Research

# US HIGH GRADE MEDIA & ENTERTAINMENT – MARKET WEIGHT

Danish Agboatwala
+1 212 412 2573
danish.agboatwala@barclays.com

Parth Shah
+1 212 412 2079
parth.shah@barclays.com

## Key recommendations

**We recommend a Market Weight position in the HG Media & Entertainment sector.** The fundamental outlook for the sector remains bright, with advertising trends healthy and expected growth in affiliate fees from renewals, syndication, and SVOD agreements. Although we expect shareholder returns to accelerate, this has been fairly well telegraphed, and we view the potential for further event risk or re-leveraging as relatively low.

Nevertheless, we believe spreads adequately reflect this and see limited room for outperformance. The Media-Non Cable and Entertainment sectors are trading 45bp and 16bp behind the US Credit Index, respectively on an OAS basis.

Our preferred sector picks are the ad agencies, Omnicom (OW), and IPG (MW). We remain comfortable with the ad agency model, view underlying trends as healthy, think both credits could have rating upside, and view the discount (25-50bp) to the rest of the Media credits as attractive. Within the large cap names, FOXA remains our sole Overweight.

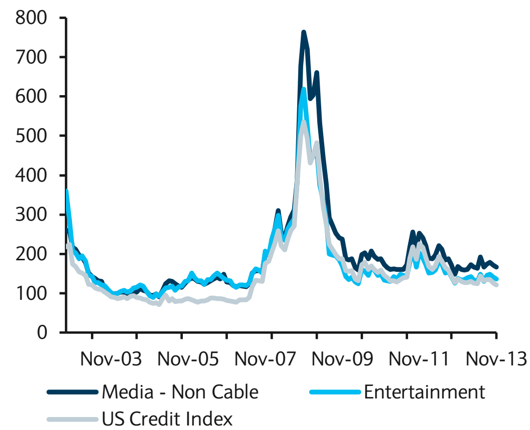
## Sector outlook

**Relatively low event/re-leveraging risk.** While the sector has had its fair share of event risk (leverage target increases, spin-offs), we believe the outlook for further credit surprises is relatively benign. CBS is an exception – it has indicated that it will "relook" at its leverage ratios following the outdoor spin. Nevertheless, our base case is an increase in leverage to 2.5x (~1.8x currently; 2x PF for outdoor spin), consistent with its current mid-BBB rating.

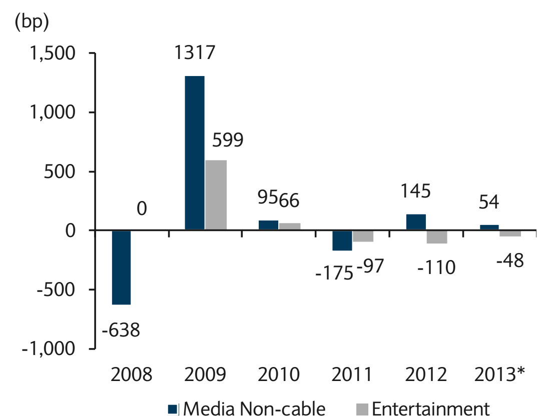
**Shareholder returns to accelerate, but well telegraphed.** We expect media credits to continue their active pace of buybacks; however, following recent announcements and increased authorizations (eg, CBS, FOXA, VIA, DIS), we believe most of this has been well telegraphed and do not expect any shocks.

**Fundamental outlook bright.** We expect sustained fundamental strength in 2014. Ratings have been broadly resilient, advertising growth should accelerate because of improving macro drivers and the political year, and affiliate fee growth should remain solid given recent renewals, syndication, and SVOD deals. Finally, while we expect continued debate on upcoming threats to the pay-TV ecosystem (Aereo, cord-cutters, smaller bundles), we do not view this as a near-term concern.

HG Media & Entertainment Sector OAS vs US Credit, bp




HG Media Non-Cable excess return vs US Credit Index, bp




Note: As of November 29, 2013. Source: Barclays Research

# US HIGH GRADE METALS & MINING – MARKET WEIGHT

Harry Mateer
+1 212 412 7903
harry.mateer@barclays.com

Greggory Price
+1 212 412 7905
greggory.price@barclays.com

## Key recommendations

**Long: Alcoa** (AA, MW), Barrick (ABXCN, OW), Freeport (FCX, OW) and Glencore Xstrata (GLENLN, OW).

**Short: BH**P Billiton (BHP, UW), Cliffs Natural (CLF, UW), Newmont (NEM, UW), Rio Tinto (RIOLN, UW), Teck (TCKBCN, MW).

## Sector outlook

**The investment grade metals and mining sector is on track to underperform the U.S. Credit Index for the third consecutive year.** Since 2010, the differential between the metals sector and the broader market has been a series of wider wides and wider tights. In 2014, we expect spreads to widen slightly, by 3bp for the entire sector, but carry will offset the widening and generate excess returns of 175bp. Although this is at the high end of our strategy team's excess return estimate for the market, we remain Market Weight in light of the significant downside risks that could still materialize.

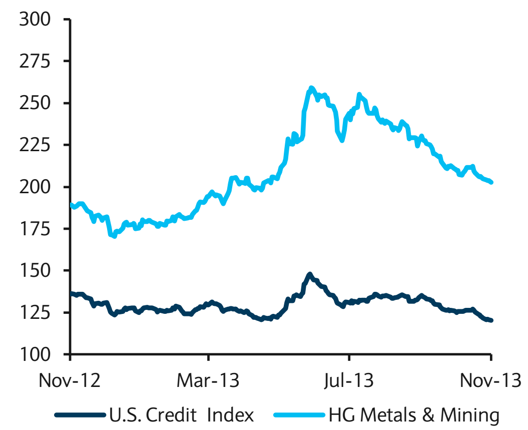
**Performance could come from some unlikely places.** In 2013, the two best performers as of November 22, 2013 – Alcoa (AA, MW) and Cliffs (CLF, UW) – were arguably consensus shorts heading into the year. In our opinion, AA could repeat as an outperformer as its ratings prove stickier than expected, but CLF remains exposed to iron ore prices that we think are vulnerable to supply-driven declines. Admittedly, iron ore prices surprised to the upside in 2013, but we continue to estimate that excess supply will push prices lower in 2014.

**As a key positive, many management teams are defensive in light of the uncertain commodity outlook, which is skewing their financial policies toward bondholder-friendly initiatives.** Unlike other industrial sectors, which are at risk of debt-financed M&A and/or LBOs, we see limited risk of leveraging actions in the metals sector.

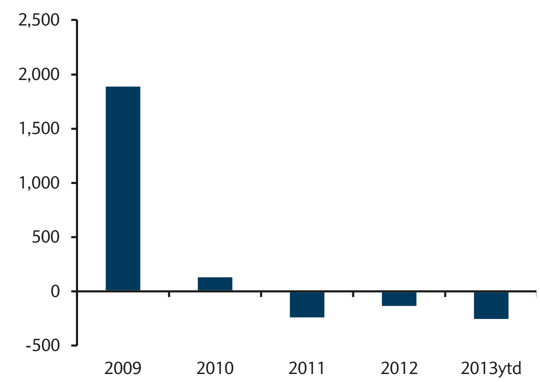
**As China goes, so goes the sector.** Consistent with our view in September 2013 (*link*), improved data from China were short-lived and recent data points are signaling a renewed slowdown in growth heading into 2014. Somewhat mitigating this for bonds is the cheaper starting point for spreads relative to early 2013.

**The gold producers could be the key for the entire sector.** In our opinion, overall metals and mining sentiment appears to be driven, in part, by gold prices and the performance of the liquid gold producers, Barrick (ABXCN) and Newmont (NEM). Based on our estimates, gold prices falling to $1,100/oz are factored into spreads, but below that level, there is valuation and ratings downside. We are Overweight ABXCN and Underweight NEM in cash, but think that both companies are wide in 5y CDS.

**Sector and Index OAS, bp**




**Metals & Mining minus U.S. Credit (excess returns, bp**




Source: Barclays Research

# US HIGH GRADE RETAIL – MARKET WEIGHT, RESTAURANTS – MARKET WEIGHT, SUPERMARKETS – UNDERWEIGHT

Priya Ohri-Gupta, CFA
+1 212 412 3759
priya.ohrigupta@barclays.com

Kacie Overlander
+1 212 412 2077
kacie.overlander@barclays.com

## Key recommendations

**Our top picks within retail include CVS (Overweight), Macy's (Overweight), and Home Depot (Market Weight).** We think that CVS is positioned well in the evolving healthcare backdrop with a balanced offering consisting of its retail and PBM businesses along with MinuteClinic. Macy's is an improving ratings story that continues to demonstrate an ability to execute against a less than robust industry backdrop with a consistent financial policy view. Home Depot is best positioned in our view to continue benefiting from an improving housing and macro backdrop.

**In Restaurants, we recommend investors begin to add exposure selectively in Darden (Market Weight) and YUM (Not Rated).** While ongoing activist-related headlines are likely to prevent meaningful compression at Darden near term, current levels are pricing in a fair amount of downside. Once there is clarity regarding potential actions that could be credit neutral/positive, we think there may be room for upside. With regard to YUM, we look for signs of sustained improvement at KFC China before taking a more constructive view.

**Within Grocers, we remain Underweight Safeway and recommend selling cash and buying CDS** given the heightened ratings risk in the credit. In our view, fundamental underperformance, coupled with activist involvement and reports of LBO interest*, support levels that are more in line with BB credit.

## Sector outlook

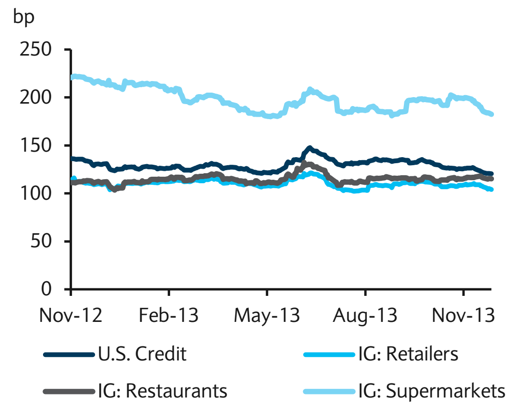
**Given recent single-name rating revisions, we are moving to a Market Weight rating (from Underweight) on the Retail sector**. In addition, the sector is approaching the recent wides relative to the Index, which in our view supports a more neutral positioning. Key drivers of sector performance in 2014 are expected to include macro improvement coupled with refinement of omni-channel offerings as new issue is likely to support shareholder returns. We anticipate a very aggressive holiday period, with gross margin compression forecast across the space.

**We revise our sector rating on Restaurants to Market Weight (from Underweight).** While the sector is trading near the 5y wides to the Credit Index, we think meaningful tightening will depend on the resolution of idiosyncratic issues at sector constituents, namely Darden and YUM.

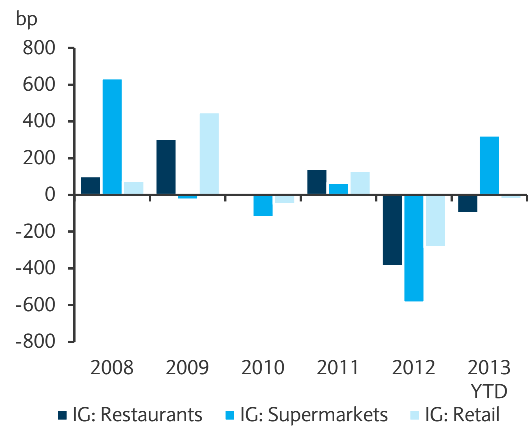
**We remain Underweight Grocers and expect the sector to underperform benchmarks modestly until investors can regain comfort in sector constituents,** namely Safeway, given the LBO overhang and fundamental underperformance.

* Exclusive: Cerberus, others explore deal for Safeway – sources" Reuters, October 22, 2013.

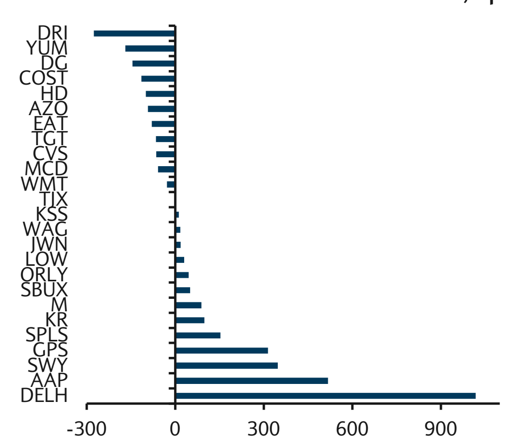
US Retail, Restaurants, and Supermarkets OAS versus US Credit Index




US Retail, Restaurants, and Supermarkets excess returns versus US Credit Index




YTD Excess Returns versus US Credit Index, bp




Source: Barclays Research

# US HIGH GRADE TECHNOLOGY – UNDERWEIGHT

Danish Agboatwala
+1 212 412 2573
danish.agboatwala@barclays.com

Parth Shah
+1 212 412 2079
parth.shah@barclays.com

## Key recommendations

**We are lowering our rating on HG Technology to Underweight.** With the sector already biased toward higher quality (~60% are A-rated) and sector valuation OAS already 7bp inside the US Credit index, we see little room for outperformance. Although we do not expect credit metrics to worsen, we also see no specific catalyst for improvement. Beyond balance sheet fundamentals, we think the balance of risk in the sector is to the downside. Forward outlooks have worsened recently on secular (eg, Print/PC, Cloud) and cyclical headwinds (eg, emerging markets). Robust equity cushions should make aggregate sector spreads insensitive to a modest deterioration in operating results, but the lower starting spread and limited fundamental upside potential should cause the sector to trail the broader credit universe in 2014.

**Top Picks.** Within the BBB credits, we see value in ARW, which remains among the cheapest names in the sector and which we think should benefit from the reach for yield. We remain bullish on FIS, which still has room to compress, despite recent outperformance, in our view. Among the higher-quality names, our top picks are Intel, Corning and Oracle. Despite some near-term headwinds, we view their credit profiles as strong and the discount to "blue-chip" tech names as attractive.

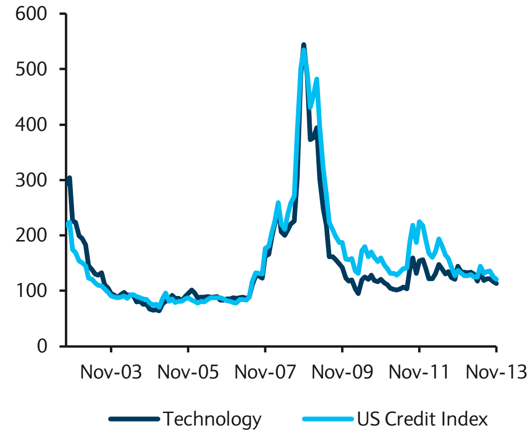
## Sector outlook

**Fundamental outlook mixed:** IT spending will likely remain muted as a result of US federal spending issues, macro slowdowns in key emerging markets (eg, China), and broader adoption of cloud-based platforms. We recommend a cautious stance on credits with outsized exposure to secularly challenged segments (PCs, servers, printing). Our equity counterparts forecast 2014 PC units down 8% and printer units down 3%, despite easier comps. We prefer names that are well aligned with structural tailwinds, including Mobility, Cloud (eg, SaaS, SDN), Big Data, and Payments (eg, FIS, FISV).

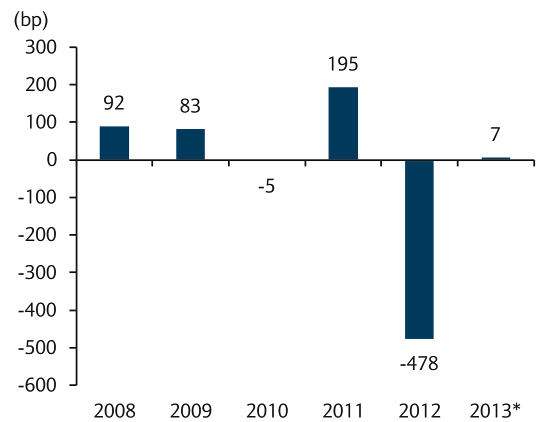
**Despite shareholder focus, balance sheet metrics remain healthy:** The technology sector is in the midst of a (re)leveraging cycle, with inaugural issuers funding shareholder returns (eg, Apple, EMC) and seasoned issuers growing balance sheets to support equity valuations (eg, IBM, ALTR). Nevertheless, the sector remains underleveraged relative to other industrial sectors, has significant cash holdings (albeit largely offshore), and an ample equity cushion, which provides downside protection.

**Issuance volumes likely to moderate:** We forecast 2014 sector issuance of $35bn, below the $50bn YTD, which has been skewed by Apple's mega-deal. Although maturities of ~$24bn are relatively modest, focus on shareholder returns and precedent transactions will likely attract inaugural issuers. Tax laws remain a swing factor, with Senator Max Baucus recently proposing a temporary tax repatriation window that could reduce financing needs.

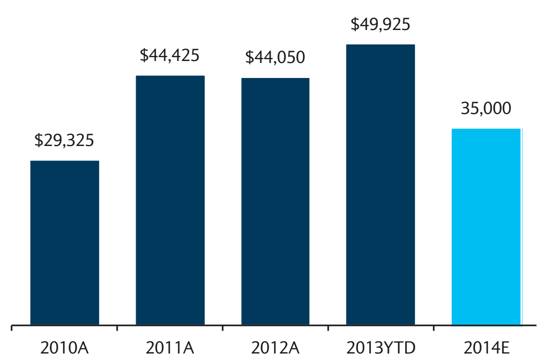
US Technology OAS versus US Credit Index, bp




US Technology Excess Return vs Credit Index




US HG Technology Issuance Trends, $mn




Note: * 2013 YTD as of December 3, 2013. Source: Barclays Research

# US HIGH YIELD AEROSPACE AND DEFENSE – UNDERWEIGHT

Matthew Vittorioso
+1 212 412 1378
matthew.vittorioso@barclays.com

Oscar Bate
+1 212 412 3732
oscar.bate@barclays.com

## Key recommendations

**We have an Underweight rating on US HY Aerospace & Defense.** The sector trades just wide of the HY index, at 5.98% YTW, but if we adjust for the two highest-yielding names in the sector, Alion and Altegrity, the index actually yields just 5.35%. We think it makes sense to look at the index, excluding those names as they have bonds trading at 46% and 30% YTW, respectively, which meaningfully skews the data. In general, we believe the Aerospace and Defense index trades fairly tight, with the highest-quality names (eg, BEAV) yielding less than 5% YTW and the riskier names (eg, BBDBCN) trading at levels that do not necessarily reflect their risk profile. Furthermore, Bombardier debt currently accounts for ~21% of the Aerospace & Defense index. Given our Underweight rating on the credit and the fact that it is easily the largest issuer in the sector, the rest of the index would have to significantly outperform to justify anything but an Underweight sector rating.

**We continue to suggest moving into names with better cash flow profiles and a higher quality of earnings and recommend swapping out of the Bombardier 5.75% '22s (UW) into the Transdigm 5.5% '20s (MW).** At roughly even yield, we think Transdigm looks attractive, given its free cash flow profile, asset coverage and business model. Bombardier has solid liquidity, but it will burn cash in 2014 as it works through multiple development programs, notably the C-series.

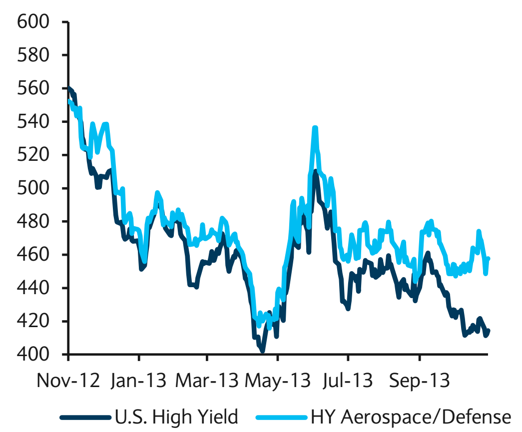
**The defense services industry has been under pressure this year as budget pressure limits new programs and customers look to increase competition in existing work.** That said, we are starting to see value in this niche of the sector as trading levels have come down. We think the Wyle 10.5% notes look attractive, yielding 11.1% at a 98 offer, for a company that has strong liquidity and is generating solid free cash flow. We also like the TASC term loan (L+325, 1.25% floor) yielding 8.25% at a 95 offer for first-lien paper.

## Sector outlook

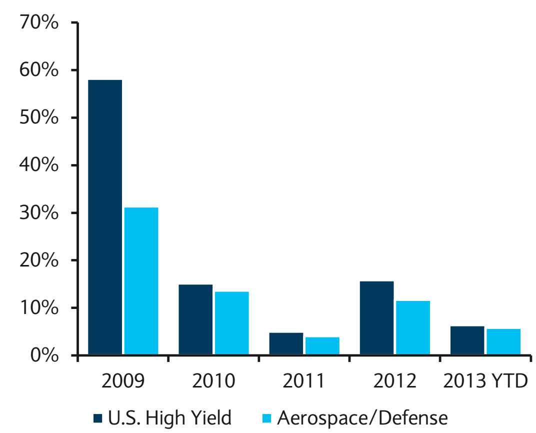
**Commercial aerospace fundamentals appear to be holding steady, buoyed by strong backlogs at Airbus and Boeing.** Demand for these aircraft should hold, at least for the near to intermediate term, as airlines continue to refresh fleets with newer, more fuel-efficient aircraft.

**In defense, sequestration continues to weigh on the top line even as the government shutdown and debt ceiling fears stole recent headlines.** Based on what we have seen in 3Q13 earnings, the government shutdown had a modest impact on revenue but slowed payments, thereby affecting working capital and free cash flow. Investors appear hopeful that the January and February dates for funding the government and increasing the debt ceiling will prove less eventful; however, we believe some caution is warranted, given the government's recent track record.

US HY Aerospace & Defense OAS versus US HY Index, bp




US Aero & Defense total return versus US HY Index




Source: Barclays Research

# US HIGH YIELD CABLE & SATELLITE – UNDERWEIGHT

Keith Hanauer
+1 212 412 5956
keith.hanauer@barclays.com

Luke Labella
+1 212 412 5677
luke.labella@barclays.com

## Key recommendations

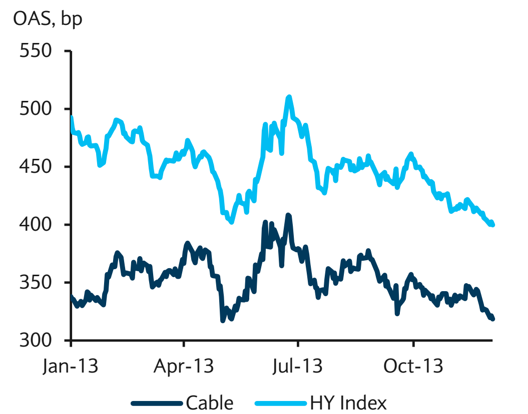
**We rate the US Cable & Satellite sector Underweight.** M&A continues to weigh on high yield cable credits, most notably Charter (23% of the index). See our recent note *here* for more details. Given the potential for substantial incremental supply, with a new deal concession and presumably the opportunity to buy HY Cable debt at more attractive rates, we recommend maintaining low exposure to Cable. While we expect that a pro forma CHTR/TWC credit could trade well, it would not necessarily be captured in index performance immediately (any IG debt downgraded or new debt issued would not be included in index returns until the end of the applicable month).

Given that the Cable sector began 2013 at approximately the same absolute levels as it trades currently, it has underperformed (3.59% YTD total return) high yield returns of 6.87% in the past year. Although the sector now trades 78bp inside of the HY Index, compared with 155bp inside at the beginning of the year, we remain cautious about M&A and think that the Cable Index could underperform regardless, given its long duration, high quality, and relatively low yields amid a broader trend of the reach for yield.

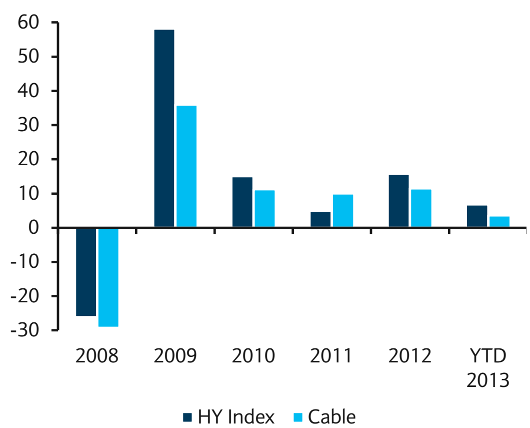
**We prefer Intelsat bonds, given the stability and predictability of cash flows and the company's focus on gradual deleveraging.** We continue to believe that the Intelsat Jackson bonds offer compelling value versus HY Cable & Satellite peers. We prefer the Jackson layer of the structure, as it screens well versus similarly leveraged peers Dish (DISH) and Cablevision (CVC), although we acknowledge that the Luxembourg notes could continue to benefit from the reach for yield. Intelsat's cautious outlook for 2014 does not materially alter our view of its strong cash flow profile. We continue to expect the company to deleverage gradually as low capital spending boosts free cash flow through a period of minimal growth in the next few years.

**We believe that Mediacom offers compelling value at current levels as EBITDA growth continues and the balance sheet deleverages progressively toward the ~5x target.** Mediacom is often overlooked given its lack of scale and less-liquid bonds. The company has invested in its network, with DOCSIS 3.0 covering the vast majority of its footprint, backbone network, and power investments, and all-digital conversion is expected by next year. This sets the stage for a potential improvement in its EBITDA growth trajectory, with relatively low competition from competitive fiber (~10% overlap, mostly U-Verse). Furthermore, as large-scale consolidation plays out in the near term, smaller operators such as Mediacom could benefit from the increased attention on M&A, potentially providing upside to the bonds.

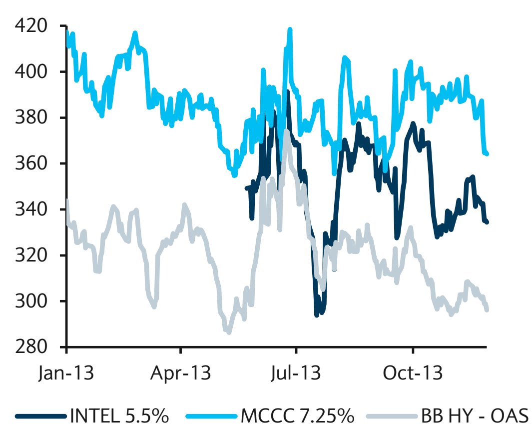
HY Cable OAS versus High Yield Index




High Yield Cable total returns versus the HY Index, %




Intelsat and Mediacom versus BB Index, OAS, bp




Source: Barclays Research

# US HIGH YIELD CHEMICALS – MARKET WEIGHT

Brian Lalli
+1 212 412 5255
brian.lalli@barclays.com

## Key recommendations

**We continue to recommend a Market Weight position in US High Yield Chemicals for 2014.** Following moderate outperformance in YTD13, we maintain our Market Weight rating for the HY Chemicals sector for 2014. While the sector's lower weighted duration/quality would seemingly position it for outperformance again in 2014, our cautious view about the near-term prospects for Momentive/Hexion (MOMENT/HXN), coupled with rate/duration risk across the BB peer group, likely limits sector upside next year. Overall, we maintain our constructive view on fundamentals for 2014, as strong balance sheets and y/y improvement in EBITDA trends highlight the underlying credit strength for a majority of the sector.

**Top Picks.** While we are broadly avoiding the longer-duration, rate-sensitive securities, we remain positive on Axiall (AXLL, Overweight) given strong EBITDA/FCF and the significant equity cushion. We also like NOVA Chemicals (NCX, Market Weight) given ratings upside. For higher-yield names, we still advise accounts stay in the senior layers of the HXN/MOMENT (Market Weight) structures given our cautious view heading into 2014.

## Sector outlook

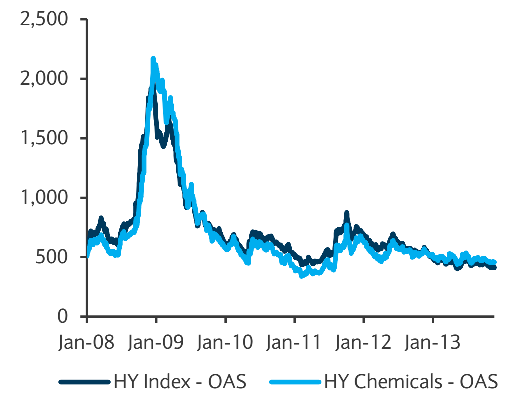
**We are still watching the global economy,** given its importance for top-line results. Commentary points to trends now stabilizing near the bottom, but a tepid recovery in North America, coupled with weak trends in Europe and consumer-focused growth in Asia, paints a picture of only modest y/y growth across the industry in 2014.

**Strategic activity should remain robust** as shareholder value creation becomes more important in 2014. We expect 1H14 deals for both Ashland (ASH) and Tronox (TROX), given management commentary, and could see the announcements on portfolio optimization at both Dow (DOW) and DuPont (DD) creating additional opportunities through acquisitions or sponsor-driven M&A financing.

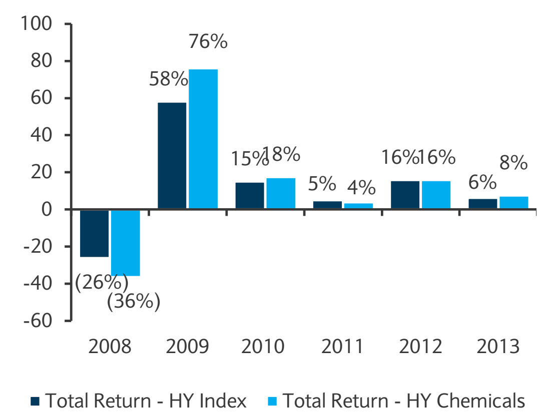
**There will be a focus on shareholder returns** as management teams look to reward shareholders for their patience over the past three to four years. Increased dividends and share repurchase authorizations have become increasingly popular across the BB- and B-rated credits we cover, and we would expect future cash generation (both FCF and asset sale proceeds) to be directed in higher percentages to shareholders.

**IG upgrades unlikely in 2014**, meaning the opportunity for BB-rated outperformance driven by spread tightening will likely be limited. These credits remain solid core holdings given underlying fundamentals, but the shift away from deleveraging to shareholder returns and M&A may delay ratings upgrades until 2015-16 at the earliest.

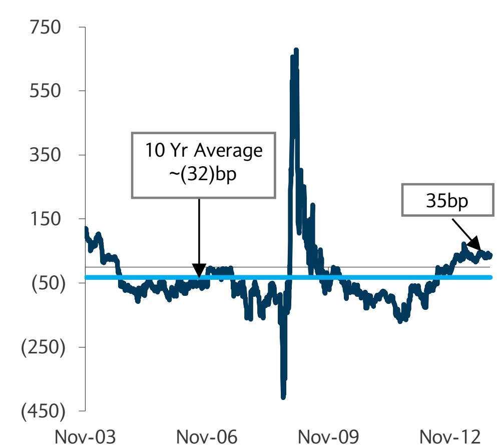
US HY Chemicals OAS versus US HY Index, bp




US HY Chemicals return versus US HY Index




Historical spread, US HY Chemicals versus US HY Index




Source: Barclays Research

# US HIGH YIELD CONSUMER PRODUCTS – OVERWEIGHT

Hale Holden
+1 212 412 1524
hale.holden@barclays.com

Jamie Robins, CFA
+1 212 412 3817
jamie.d.robins@barclays.com

## Key recommendations

**We upgrade our rating on the Consumer Products sector to Overweight from Market Weight.** The sector fits all the buckets we think will drive outperformance, including skewed lower in quality (B and CCC), shorter duration, wide to the HY index, and potential for positive event risk related to sponsor exits.

**We maintain our Overweight rating on Visant**, which is among our top picks given the potential for the structure to be refinanced by end-2015, if the American Achievement transaction closes. We continue to view Sun Products favorably and believe the company will be able to compete against P&G's new mid-priced Tide. Finally, we remain bullish on Serta Simmons. Our primary Underweights include Acco Brands and Central Garden and Pet Co.

## Sector outlook

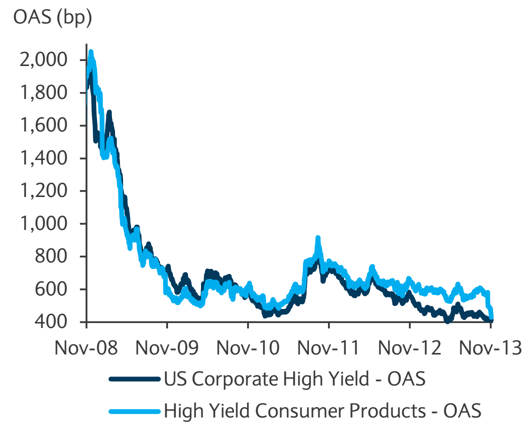
**We expect a moderate gain in consumer product sales as the economic environment improves.** Barclays Economics team expects the impact of the Affordable Care Act to shift to a modest fiscal boost in 2014 from a drag in 2013 and currently estimates 2014 GDP growth of 2.4% up from an estimated 1.7% in 2013. With last year's payroll tax increase being lapped, fewer (hopefully) budget disruptions in DC, and lower gas prices, we expect a steady-state consumer spending environment.

Like this year, raw materials cost increases are likely to be reasonably benign and, in some cases, improving, which should help offset the select segments that face near-term pricing pressure (eg, laundry detergent). As a result we expect a modest y/y improvement in EBITDA trends next year.

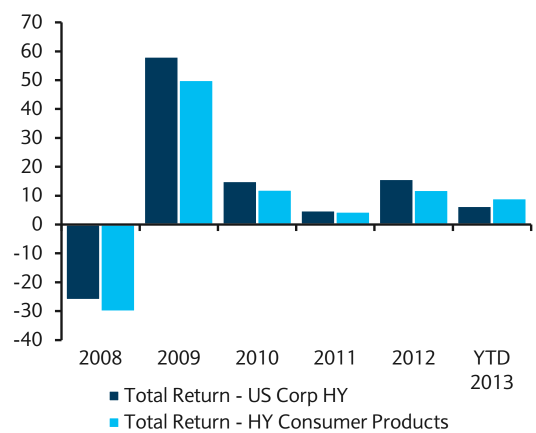
We believe issuers representing 7.5-8.0% of the index could be candidates for sponsor exits.

Barclays Economics team forecasts new and existing home sales will continue to grow in 2014, climbing 22% and 4%, respectfully, on a seasonally adjusted and annualized basis in 4Q14. We expect the continued recovery of the US housing market to support sales growth for mattress manufacturers Tempur Sealy (Market Weight) and Serta Simmons (Not Rated), as well as Spectrum Brands (Market Weight) through its hardware and home improvement division.

**Consumer Products Index OAS versus HY Index**




**Consumer Products total returns versus HY Index, %**




Source: Barclays Research

# US HIGH YIELD ENERGY & PIPELINES – MARKET WEIGHT

Gary Stromberg
+1 212 412 7608
gary.stromberg@barclays.com

Jaci Bernstein
+1 212 412 5966
Jaci.bernstein@barclays.com

## Key recommendations

**We are downgrading our sector view on HY Energy to Market Weight from Overweight.** The downgrade reflects lower 2014 WTI oil prices, increasing shareholder activism, longer sector duration, and continued robust new issue supply. We expect 3-4% returns in HY Energy in 2014, about flat compared with the market.

**The market value of HY Energy & Pipelines totals $186bn, or ~15% of the total market, up from just 5% in 2000.** We believe that the growth in new issue and size of the sector has contributed to HY Energy's underperformance in four of the past seven years. In 2013, HY Energy bonds have thus far performed in line with the market, returning 6.7% through November, reflecting supportive oil prices, offset by healthy new issue supply and the sector's relatively longer duration.

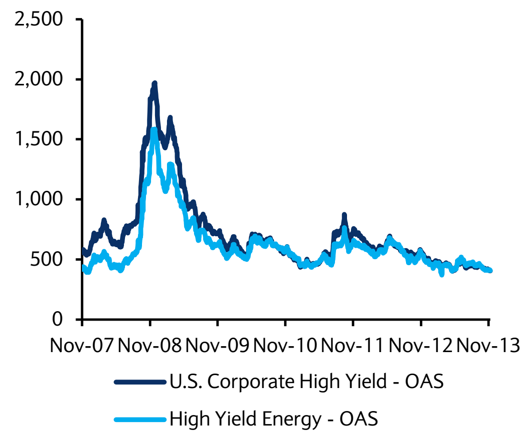
**Our top trade ideas in the 300bp, 400bp, 500bp spread ranges: Buy Access Midstream Partners (ACMP) and sell Targa Resources Partners (NGLS) (MW); buy MEG Energy (MEGCN) (OW) and sell Denbury Resources (DNR) (MW); buy SandRidge (SD) (MW) and sell Linn Energy (LINE) (MW).** We believe ACMP could have a quicker path to investment grade ratings given its stronger growth trajectory. We would be buyers of MEGCN on oil price weakness given its solid liquidity, comprehensive crude marketing strategy, and strong organic growth profile. Finally, over the near term we prefer SD bonds versus LINE given Linn's high pro forma revolver balance and the potential for HY new issuance.

## Sector outlook

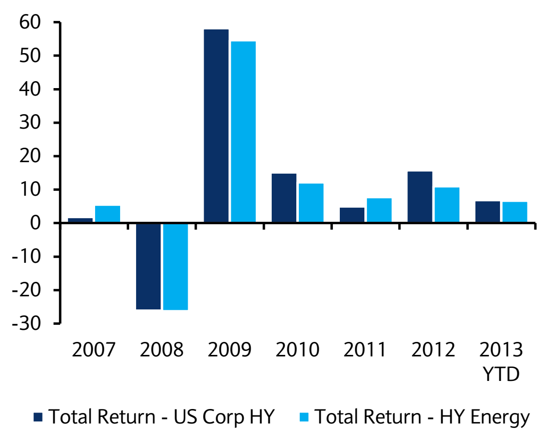
**High yield energy trades rich to its 10-year average, but cheap relative to the market.** The energy sector trades at an OAS of 408bp, compared with a 10-year average of 467bp. However, the HY Energy sector trades at roughly even spread versus the HY market, compared with a 10-year average that has been 95 through. In general, we continue to think the sector is supported by strong asset coverage, hedging that provides downside protection, and mostly stable leverage.

However, there are several headwinds in the sector that could limit 2014 returns, in our view. **First, we believe WTI oil prices will average $90/bbl in 2014, about 8% below 2013**, as continued US oil production growth, and modestly weaker Chinese demand, weigh on prices. Second, while not all **shareholder activism** is negative for creditors, we believe the recent uptick could be a harbinger of more to come. **New issue supply** may continue to surprise on the upside given capital needs for shale resource development in the E&P and midstream space. Finally, HY Energy & Pipelines is one of the tightest sectors in the market, **and has a ~10% longer duration,** which could limit price return in a rising rate environment.

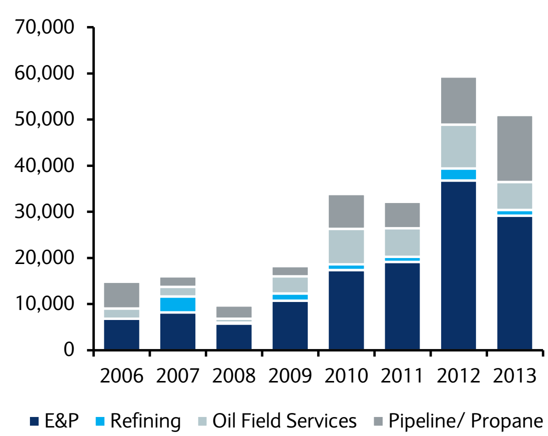
US HY Energy OAS versus US HY Index, bp




US HY Energy total return versus US HY Index, %




High Yield Energy New Issuance, $mn




Source: Barclays Research

# US HIGH YIELD FINANCIALS – MARKET WEIGHT

Brian Monteleone
+1 212 412 5184
brian.monteleone@barclays.com

Conor Pigott
+1 212 412 3441
conor.pigott@barclays.com

## Key recommendations

**We move to Market Weight from Overweight on US HY Banking and HY Finance Companies.** The sectors posted a very strong 2013, with HY banking and HY finance companies tightening 16bp versus the index in aggregate. Outperformance in 2014 appears less likely, with the sectors currently trading through the index by 150bp and 85bp, respectively. We expect HY financials to perform more in line with the index in 2014, given a backdrop of rising rates and the sectors' higher duration and lower starting yields on the one hand, balanced against positive fundamental and ratings trajectories on the other.

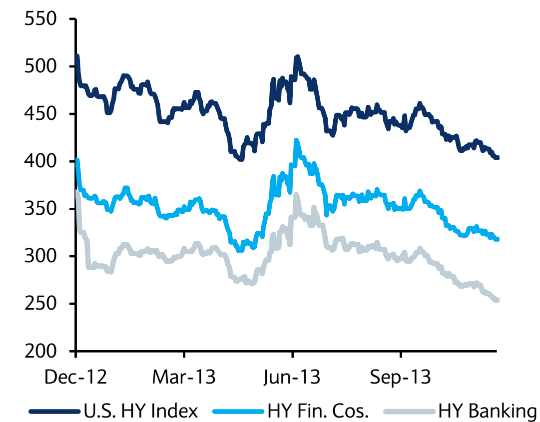
**Within the two sectors, we are Overweight Sallie Mae and Market Weight CIT and ILFC.** We recommend an Overweight position in Sallie Mae given our confidence in cash flows over the medium term. We prefer SLMA 5-10y bonds given curve steepness. We remain Market Weight on CIT and ILFC, but we see value in these names as well. We believe a highly capitalized CIT represents attractive value versus IG names in the short-end of the curve, at roughly 2.5-3.5x IG spreads. In ILFC, we believe a potential IPO could lead to an upgrade to IG over the course of the next two years, faster than market expectations. We continue to see value down the capital structure, including the ILFC E-CAPS and SLM FRN preferred.

## Sector outlook

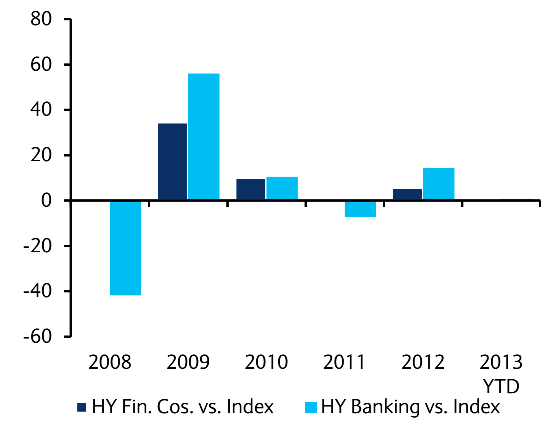
**Positive, long-term shifts in funding profile.** Most, if not all, of the HY financials experienced a high degree of liquidity stress in the 2007-2009 period. In response, these companies have reduced unsecured debt exposure and increased more stable sources of funding, such as deposits (bottom right figure). Remaining unsecured debt balances have been refinanced into longer-term maturities (most notably by CIT, Sallie Mae, and Springleaf). Finally, over the course of 2012-13, ABS markets have opened to more types of collateral and at a lower cost. From a credit perspective, this improved access to funding represents a material positive and the dramatic shift in funding sources constitutes a key difference versus the companies' profiles in the pre-crisis period.

**Transformational activity remains a focus for the sector.** A number of companies in the sector remain in a period of post-crisis transition. For example: Springleaf recently completed an IPO this fall. ILFC is in the process of a sale/IPO. Sallie Mae is splitting into two businesses. Ally is continuing to repay its U.S. government investment and is moving toward a longer-term private shareholder base. Mortgage servicers are in a period of rapid balance sheet growth by portfolio acquisition. Generally, we believe this transformational activity will serve as a positive catalyst in 2014, but investors should consider this on a company-by-company basis.

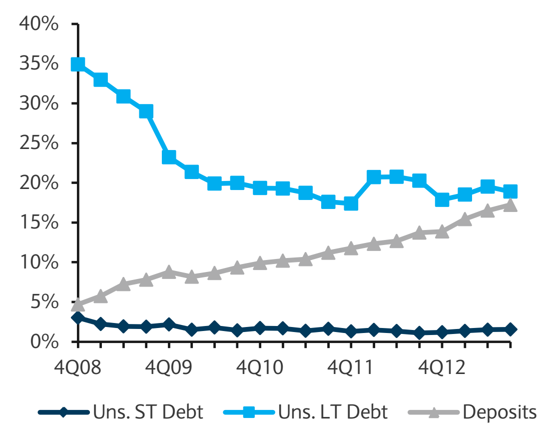
US HY Financials OAS versus US HY Index, bp




US HY Financials total return versus US HY Index, %




Aggregate Liabilities by type, % of total




Note: Includes Ally, CIT, ILFC, Sallie Mae, iStar, and Springleaf.
Source: Barclays Research

# US HIGH YIELD FOOD/BEVERAGE – UNDERWEIGHT

Hale Holden
+1 212 412 1524
hale.holden@barclays.com

Jamie Robins, CFA
+1 212 412 3817
jamie.d.robins@barclays.com

## Key recommendations

**We lower our rating on the HY Food & Beverage sector to Underweight from Market Weight.** The Food & Beverage sector hits all the boxes that we think could drive underperformance: it trades at a premium to the index, it is longer in duration, and it is more heavily weighted to BBs. In terms of fundamentals, we expect M&A/consolidation to continue and promotional activity to increase, pressuring margins.

## Sector outlook

**The Food & Beverage index is trading 46bp through the HY Index, compared with an LTM range of 96bp through (in June) and 27bp through (January).** We think the sector sets up well to underperform, as it is viewed as a safe sector in what has become a risk-on market. In addition, we expect aggressive M&A, with all companies we cover highlighting active pipelines.

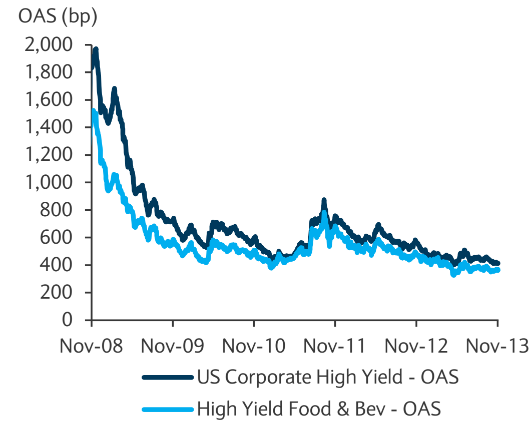
We believe pricing investments have accelerated recently while volume remains relatively flat. Combined with concerns around the recent reductions in SNAP benefits, this could continue to drive softer results and below-average growth into the first half of 2014.

Nielsen data for the four weeks ended 26 Oct 13 showed branded sales down 150bp y/y, with price/mix off 90bp and volume down 50bp. Private label continues to be a strength. We are more constructive on near-term protein trends (Bumble Bee, JBS, Pilgrim's Pride, and Smithfield Foods), given improved export demand and more balanced domestic supply/demand.

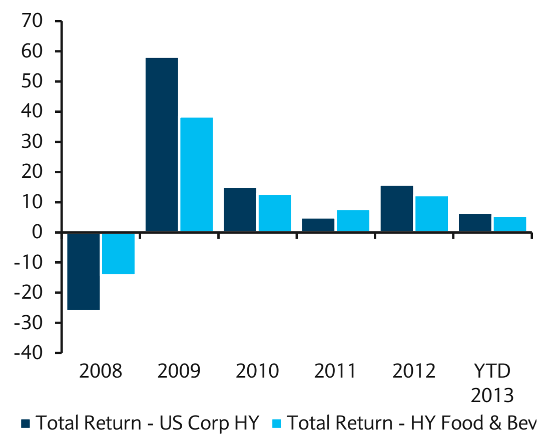
**We retain our Overweight rating on JBS USA** and highlight that the company targets mid- to low-3x leverage by end-2014 (versus over 6x at the start of this year). **We also remain Overweight Constellation Brands** given the company's longer-term (2015-16) potential to achieve investment grade ratings. **We also have an Overweight rating on Michael Foods** given valuations and attractive operating metrics.

**We expect a heavy level of M&A in packaged food, with Post (Rating Suspended), B&G Foods (Market Weight), Pinnacle Foods (Market Weight), Treehouse Foods (Not Rated), and Del Monte (Market Weight) all highlighting the potential for further M&A** – likely associated with additional primary issuance, in our view – over the near term.

**Food & Beverage Index OAS versus High Yield Index**




**Food & Beverage Index total return vs High Yield Index, %**




Source: Barclays Research

# US HIGH YIELD GAMING – MARKET WEIGHT

Kateryna Kukuruza
+ 1 212 412 7647
kat.kukuruza@barclays.com

## Key recommendations

**We are Overweight all the bonds in Pinnacle Entertainment's capital structure,** given our forecast for cash flow generation and material deleveraging after closing the Ameristar acquisition in August 2013.

**We maintain a Market Weight rating on Boyd Gaming (BYD), although we are Overweight the Peninsula Gaming (PENGAM) bonds (8.375% of 2018)** in that structure, given our view that Boyd intends to include that subsidiary in its restricted group.

Given a favorable capital markets environment, we think there are opportunities for several companies to call outstanding higher coupon debt and issue at lower levels. **We think Marina District Finance (BORGAT) 9.875% due 2018 (OW), BYD 9.125% due 2018 (MW), Isle of Capri (ISLE) 7.75% due 2019 (MW), and BYD/PENGAM 8.375% due 2018 (OW) are attractive for yield to call investors.**

## Sector outlook

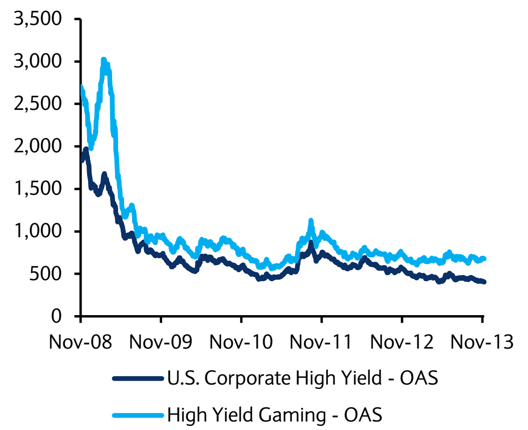
The High Yield Gaming sector trades ~270bp wide of the High Yield market, cheap compared with the past 10-year average of 122bp wide. However, excluding Caesars (NR) (which accounts for ~31% of the HY Gaming Index and remains volatile), the sector trades ~15bp through the market, rich compared with the past 10-year average of 46bp wide.

Casinos on the Las Vegas Strip have diversified revenues away from the casino floor, with a larger proportion of revenue coming from the room segment, driven largely by group and convention customers. While overall visitor volumes have reached a new high in Las Vegas, convention attendance remains well below the 2008 peak. However, **improving confidence, along with management commentary expecting an overall strong 2014 booking calendar, should lead to continued RevPAR growth on the Las Vegas Strip, in our view.**

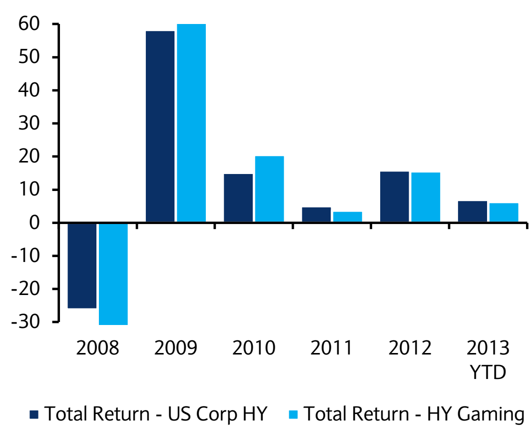
Regional supply continues to increase in the gaming industry, although most recently opened casinos have underperformed expectations. We believe the underperformance is due to the relatively high level of penetration in the gaming industry, as new entrants have cannibalized other properties. **We are cautious on operators that have high exposure to regions with forecasted additional supply and favor multi-property/multi-jurisdictional operators.**

**We believe the gaming sector is supported by multiple factors over the long term**: 1) regulations –some states limit the number of licenses that will be awarded; 2) location – geography/proximity remains critical to success; 3) barriers to entry – high upfront construction costs and lead time to build ; 4) consumer trends – gaming is widespread as ~34% of all Americans visited a casino in 2012; and 5) cash flow generation – the sector as a whole is largely FCF positive, due to relatively low levels of maintenance capex.

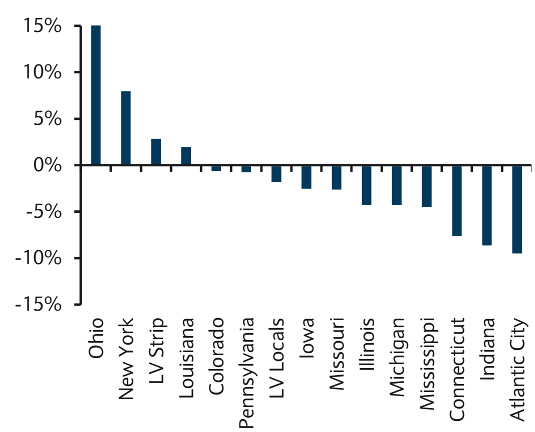
US HY Gaming OAS versus US HY Index, bp




US HY Gaming total return versus US HY Index, %




YTD Gaming Revenues by Market




Note: Gaming Revenues as of October. Maximum amount shown is 15% to enable visual comparisons. Ohio revenues are up 250% y/y. Source: Barclays Research

# US HIGH YIELD HEALTHCARE – UNDERWEIGHT

Shubhomoy Mukherjee
+1 212 412 5245
shubhomoy.mukherjee@barclays.com

Audra Stundziaite
+1 212 412 1731
audra.stundziaite@barclays.com

Kyle Stockmal
+1 212 412 1772
kyle.stockmal@barclays.com

## Key recommendations

**Overweight on Gentiva (11.5%, 2018 (9.7% YTW).** In our view, current valuations do not reflect that Gentiva might refinance these notes on the first call date, in August 2014. Other credit positives: strategic benefits of the Harden acquisition; solid cash flow generation ability; near-term visibility on the reimbursement environment for the home health and hospice sectors.

**Reduce exposure to Community Health (CYH) Senior Notes.** In our view, current valuations (Z spread of 480bp on the 7.125%, 2020) do not reflect the expected rise in leverage associated with the HMA acquisition (5.8x pro forma) or adequate concession for the debt we expect CYH to issue to fund the deal.

**Add exposure to Fresenius Medical Care.** We see Fresenius Medical Care as a potential rising star, given its scale and size and its conservative financial policies, which we view as comparable with those of other low-BBB rated healthcare companies (eg Mylan, Actavis).

## Sector outlook

**Underweight HY Healthcare.** The current valuation of the Healthcare Index (32bp premium to the HY Index) does not seem to reflect the uncertainties for providers created by structural changes under way in the US healthcare sector. We recognise that some of the premium reflects the lower duration of the HC index (3.7 years) versus the HY Index (4.2 years), but we expect new issuance in FY2014 to bring the HC sector's duration into line with that of the HY market.

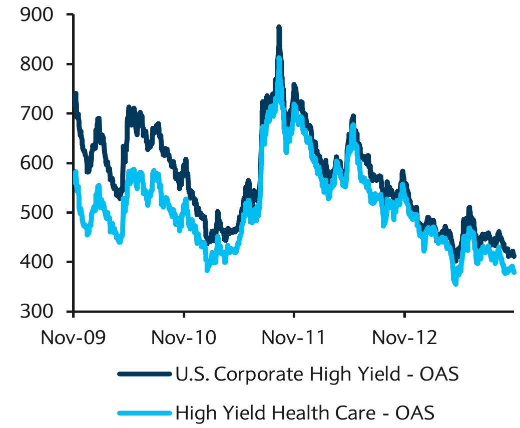
**Structural changes create longer-term uncertainties.** The healthcare sector is undergoing structural change driven by: increased intervention by managed care companies in managing healthcare risk; the implementation of healthcare reform; the shift from a fee for service to a payment for performance reimbursement paradigm; and rising consumer engagement.

**Upside from healthcare reform for providers is likely to undershoot expectations.** Lower than expected enrolment in Federal exchanges and limited participation by Republican states in Medicaid expansion should result in lower upside from healthcare reform than initially expected. We expect the implementation of healthcare reform to result in a 3-4% EBITDA benefit for hospitals in FY2014 (vs 5-6% previously).

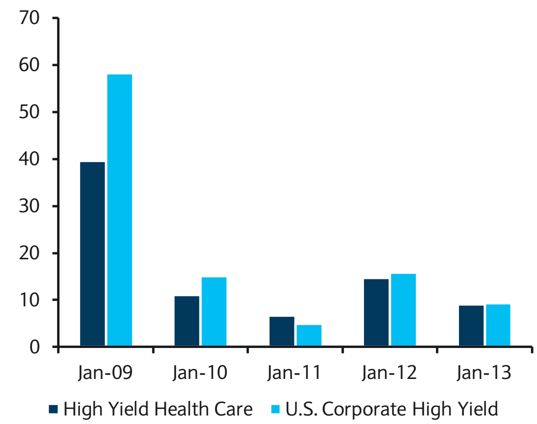
**Significant issuance expected.** We expect at least $20bn of HY issuance in the sector in FY2014, driven by refinancing of YTC paper and the financing of announced M&A transactions (CYH/HMA).

**Buoyant equity markets should allow monetisation of sponsor interests.** The recent rally in healthcare sector stocks has led to a meaningful expansion of EV/EBITDA multiples, giving sponsors an attractive opportunity to monetize some of their investments.

**HY Healthcare OAS versus US Corp HY Index, bp**




**HY Healthcare total return versus US Corp HY Index, %**




Source: Barclays Research

# US HIGH YIELD INDUSTRIALS – UNDERWEIGHT

Matthew Vittorioso
+1 212 412 1378
matthew.vittorioso@barclays.com

Oscar Bate
+1 212 412 3732
oscar.bate@barclays.com

## Key recommendations

**We have an Underweight rating on US HY Industrials.** We believe that with Diversified Manufacturing and Construction Machinery trading at ~4.81% and 4.15% YTW, respectively, versus the US High Yield Index at approximately, 5.60%, the sector looks rich and presents more downside than upside risk in 2014. Fundamentals have improved modestly in the past year and look reasonable as we head into 2014, but valuations are not particularly attractive for many of the industrial credits we follow.

**We think recently issued LBO paper in the Industrial sector trades at the rich end of fair value and already prices in improving credit profiles in 2014.** With companies such as Accudyne and Gardner Denver leveraged in the 7x neighborhood but yielding just 6.25-6.75%, we think upside is limited. At current levels, we believe Accudyne offers the best value of the bunch given its geographical and end-market diversification, but we generally remain cautious about reaching for yield in the sector. Outside of those two names, longer-dated bonds of the largest issuers in our index (United Rentals, CNH, Terex, Manitowoc) generally trade at or well inside the broader HY index.

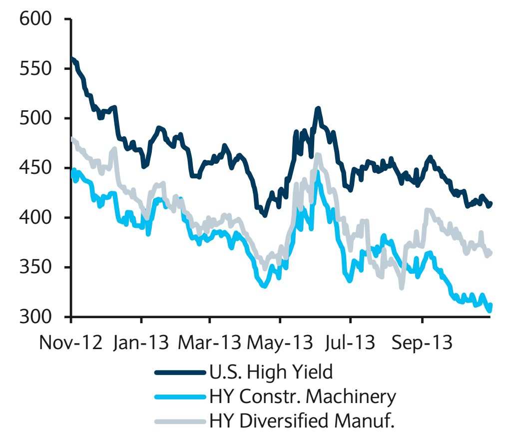
**With unsecured bonds in the sector trading tight, we recommend looking at a few of the higher-yielding secured term loans as a way to move up in credit quality for only a modest give-up in spread.** For instance, we suggest swapping out of the Park Ohio (PKOH) 8.125% 2021 notes or the Terex (TEX) 6.5% 2020 notes into the Rexnord term loan (L+300, 1% floor). Versus PKOH, the Rexnord loan offers a similar yield (~5.1% with the curve) and security and moves investors into a much larger company with a superior cash flow profile. Versus TEX, investors pick up yield/spread and security while moving into a credit with a much more stable earnings/cash flow profile over a full cycle.

## Sector outlook

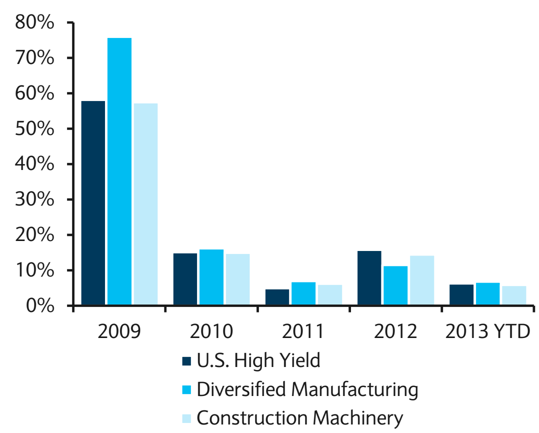
**In 2014, we expect a continuation of the slow North American economic recovery that has occurred throughout 2013.** At the individual credit level, second- and third-quarter earnings were generally in line with expectations. A common theme in management commentary was that inquiry was positive, but persistent market uncertainty is weighing on actual orders. Not surprisingly, companies have also cited continued weakness in Europe and slowing growth in Asia/China as drags on corporate growth.

**At a macro level, data have been reasonably positive over the past few months.** On a year-to-date basis, there has been just one ISM manufacturing index reading that indicated economic contraction, and that occurred in May. After hovering in the low 50s throughout much of 2013, the ISM has printed above 55 in the last five readings, recently topping out at 57.3 (>50 signals expansion).

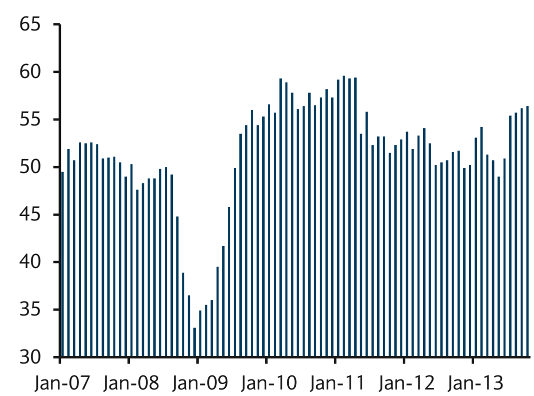
US HY Industrials OAS versus US HY Index, bp




US HY Industrials total return versus US HY Index, %




US ISM Manufacturing PMI




Source: Institute for Supply Management, Barclays Research

# US HIGH YIELD METALS AND MINING – MARKET WEIGHT

Matthew Vittorioso
+1 212 412 1378
matthew.vittorioso@barclays.com

Oscar Bate
+1 212 412 3732
oscar.bate@barclays.com

## Key recommendations

**We have a Market Weight rating on US High Yield Metals & Mining.** Despite our still very cautious fundamental outlook on the bulk of the underlying commodities included in the Metals & Mining index, we maintain our Market Weight sector rating. The sector now trades ~65bp wide of the broader high yield market, and we feel the additional yield helps justify the incremental risk. Many of the most fundamentally exposed credits have built up significant liquidity, amended maintenance covenants and refinanced near-term maturities to help push potential negative credit events well into the future (eg, AK Steel, Arch Coal, Alpha Natural Resources).

The sector's fate remains tied to commodity prices (most notably steel, iron ore, and met coal), which have become more volatile and harder to forecast. Softness in Europe, uncertainty about Asian growth, and a tepid North American recovery are likely to keep these commodity prices low in 2014, maintaining challenged credit metrics across the sector, most notably in coal. The market appears content to dismiss weak earnings in 2014; however, any realization that commodity price weakness will persist, could lead to further downside.

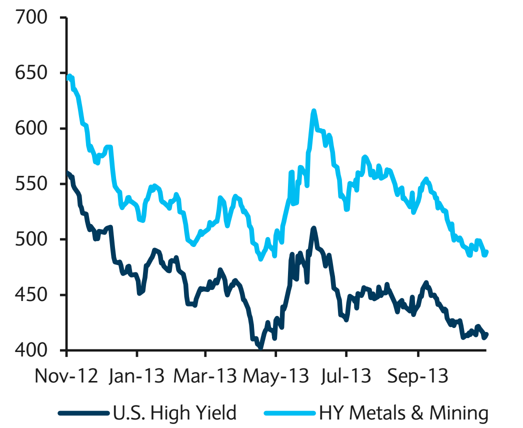
We recommend positioning in higher-quality credits and in companies with clean balance sheets that are best situated to weather a decline in underlying commodity prices. Accordingly, we continue to view names such as Steel Dynamics (STLD) and Fortescue (FMGAU) as core holdings. We recently downgraded some Fortescue bonds to Market Weight from Overweight following tightening, but we think the company's credit profile continues to improve, warranting a market weight position. We continue to recommend an underweight allocation to Alpha Natural Resources' bonds, given its exposure to weak met coal prices and stressed balance sheet.

## Sector outlook

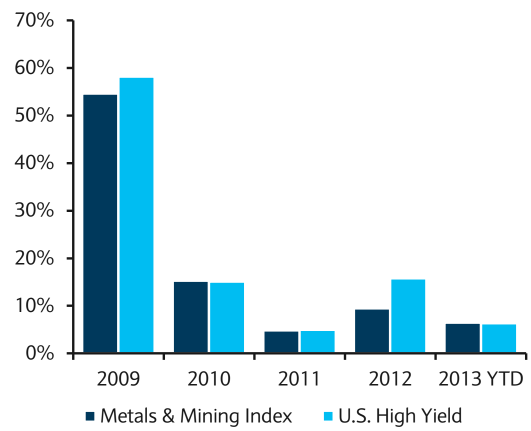
**We see leverage increasing in 1H14 for many of our high yield metals and mining companies.** This trend should be most pronounced among coal producers owing to lower production volume and weak thermal/met prices. The met coal benchmark has risen from its bottom of \$145/tonne (FOB Australia) in 3Q to \$152/tonne in 4Q. However, even at the higher 4Q benchmark, most US met coal producers will burn significant amounts of cash, and experience depressed EBITDA and higher leverage.

Steel fundamentals remain soft in the absence of a rebound in the North American nonresidential construction market. Although US producers have recently had success in raising prices, we expect the spread between US and Chinese prices to open the door for competition from Chinese imports.

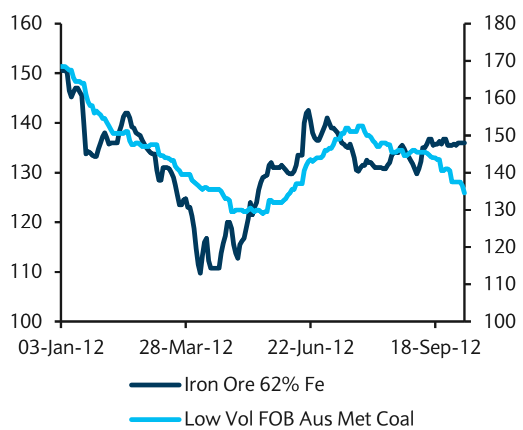
US HY Metals & Mining OAS versus US HY Index, bp




US HY Metals & Mining total return versus US HY Index




Low vol met coal & 62% Fe iron ore spot prices, \$/mt




Source: Platts, Barclays Research

# US HIGH YIELD PAPER – UNDERWEIGHT/US HIGH YIELD PACKAGING – MARKET WEIGHT

Jeff Harlib
+1 212 412 6952
jeffrey.harlib@barclays.com

## Key recommendations

**Overweight Reynolds 9% ($107.13, 5.60%), 9 7/8% ($111, 5.79%), and 8 ¼% senior notes ($104.13, 7.28%).** Partly driven by improvement at Graham, Reynolds has posted two quarters of y/y improvement in performance. We expect over $300mn of free cash flow this year. Acquisition activity has slowed, and management is focused on deleveraging.

## Sector outlook

**Paper:** Grade pricing diverged in 2013, with strength in pulp (particularly NBSK) and containerboard, while secularly challenged grades (ie, newsprint, uncoated freesheet, coated paper) suffered price declines. After peaking at very high levels in March-April 2013, wood product prices fell sharply, but have been more stable in 2H13. There were some notable consolidation transactions this year, including Packaging Corp of America's acquisition of Boise Inc, LPX and Ainsworth combining to form the leading North American OSB producer, and Weyerhaeuser's purchase of Longview Timber Holdings.

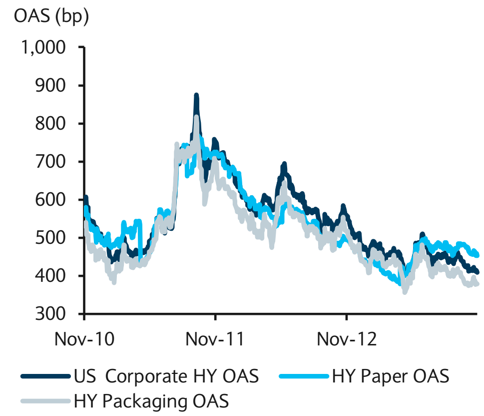
Heading into 2014, due to aggressive capacity reductions (mainly at International Paper), uncoated freesheet pricing prospects appear favorable. While producers have been disciplined to date, this year's significant additions to recycled linerboard capacity remain a risk for containerboard fundamentals. Rated Ba1 by Moody's, RockTenn is a candidate for upgrade to IG in 2014.

**Packaging:** Demand trends in the packaging sector have been soft, with continued weakness in carbonated soft drinks (traditional beverage cans) and food service. Resin prices have been uneven, benefiting packagers when they eased earlier in 2013, but becoming more of a headwind recently. There was some M&A activity, with Crown acquiring Spanish food can maker Mivisa, and Ardagh attempting (with FTC objections) to acquire Saint-Gobain's North American glass business, Verallia.

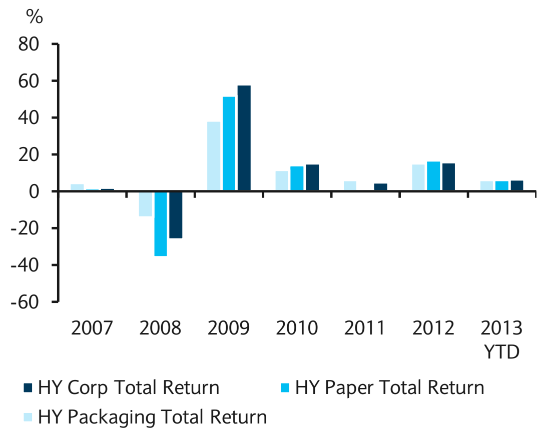
Through November 29, the HY paper index had returned 6.55% YTD, and the HY packaging index (with Reynolds comprising 44% of the index) 6.63%, compared with 6.87% for the HY Corporate index.

At an OAS of 459bp for the Paper Index versus 404bp for the HY Corporate Index, we have an Underweight rating on the HY Paper sector. At an OAS of 368bp, we have a Market Weight rating on the HY Packaging sector, but we note our Overweight rating on Reynolds' senior unsecured notes.

### US HY Paper OAS versus US HY Corporate Index




### US HY Paper total return versus US HY Index




### Top 10 constituents of the HY Paper and HY Packaging indices

| Issuer | % of HY Paper Index | Issuer | % of HY Packaging Index |
|---|---|---|---|
| Rock-Tenn | 11% | Reynolds Group | 44% |
| Sappi | 10% | Ardagh | 11% |
| UPM-Kymmene | 9% | Ball | 9% |
| Verso Paper | 8% | Sealed Air | 8% |
| Stora Enso | 6% | Crown | 6% |
| Cascades | 6% | Berry Plastics | 4% |
| Graphic Packaging | 5% | Owens-Illinois | 3% |
| Clearwater Paper | 5% | Silgan | 2% |
| Norbord | 5% | Exopack | 2% |
| Resolute Forest | 5% | Greif | 2% |
| Top 10 | 71% | Top 10 | 90% |

Source: Barclays Research

# US HIGH YIELD RETAIL – OVERWEIGHT

Hale Holden
+1 212 412 1524
hale.holden@barclays.com

Jamie Robins, CFA
+1 212 412 3817
jamie.d.robins@barclays.com

## Key recommendations

**We revise our rating on the US HY retail sector to Overweight from Underweight**. Although we maintain our UW rating on the three widest-trading names (JCP, TOY, and GYMB), collectively they account for only 11.6% of the index.

**The HY retail benchmark is 47bp cheap to the HY Index, which compares with the 12-month range of 35bp through (in May) to 61bp behind (November 13)**, and it is well wide of the three-mean level of 2bp wide. The Top 5 components account for 46% of the index and include LTD (13.9%), RAD (8.7%), CLE (7.0%), MIK (5.9%), and JCP (5.7%). Within this group we rate only JCP Underweight. Finally, we believe issuers that account for up to 16.3% of the index are candidates for a sponsor exit in 2014.

## Sector outlook

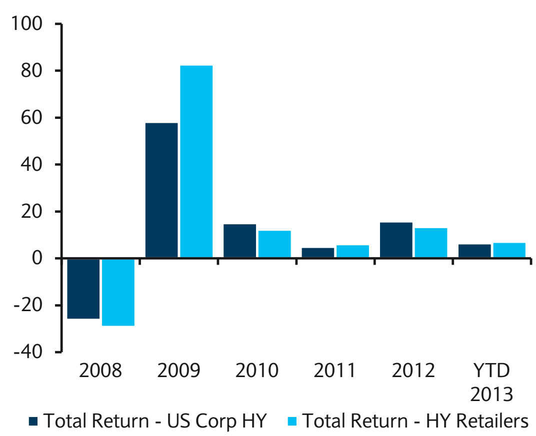
**Barclays Economics team expects the impact of the Affordable Care Act to shift to a modest fiscal boost in 2014 from a drag in 2013**, and it estimates 2014 GDP growth at 2.4%, up from an estimated 1.7% in 2013. With last year's payroll tax increase being lapped and fewer (hopefully) budget disruptions in DC, we expect a relatively benign, steady-state consumer spending environment. Although we have low expectations for Q4 13 holiday spending, it sets an easier y/y comparison bar for 2014. We forecast Q4 13 holiday comps will be up 1.5-2.0%, compared with 2.5-3.0% in 2012.

**In 2014, we expect the retail sector's slow-moving "car crashes" to continue to deteriorate and maintain our Underweight rating on JC Penney, Toys 'R' Us, and RadioShack**. Gymboree also remains a core UW, and we expect continued weakness in Sears' sales (but keep our Market Weight on its second liens, given asset coverage). Finally, we expect sponsor exits to accelerate and become more prevalent than dividend deals.

**Our key Overweights for 2014 are: 1) PVH Corp; 2) Sally Beauty; 3) the Quiksilver 2020s; 4) QVC; 5) Bon-Ton; and 6) the Claire's Stores first-lien 6.125% 2020s**.

US Retail OAS versus US HY Corporate Index


US Retail and HY Credit Index total return, %




Source: Barclays Research

# US HIGH YIELD TECHNOLOGY – OVERWEIGHT

Jeff Harlib
+1 212 412 6952
jeffrey.harlib@barclays.com

## Key recommendations

**Overweight Alcatel-Lucent 6 ¾% ($101.25, 6.45%) and 8 7/8% ($109.75, 6.31%) senior notes due 2020.** Aggressive refinancings, including a rights offering, have cleaned up debt maturities through 2015, and pro forma cash exceeds €5bn. Performance is showing early benefits from Shift Plan, with the top line exceeding expectations. Senior note issues are structurally senior to other Lucent bonds (with subsidiary guarantees).

**Overweight First Data 8 ¼% ($106.88, 6.56% due 2021) and 8 ¾% ($107.13, 7.02% due 2022) second-lien notes.** With 6.4x second-lien leverage, there is adequate valuation coverage of second-lien debt. We note that FDC had not used $400-500mn of available second-lien capacity for its recent refinancing transactions.

**Overweight Travelport 13 7/8% ($106.25, 8.05%) and L+8 5/8% ($99.38, 9.61%) senior PIK notes due 2016.** The company is executing well on new products and growth initiatives, and we expect mid-single-digit growth in revenues and EBITDA in 2014. These and other debt securities are good refinancing candidates on or before their August 2014 call dates.

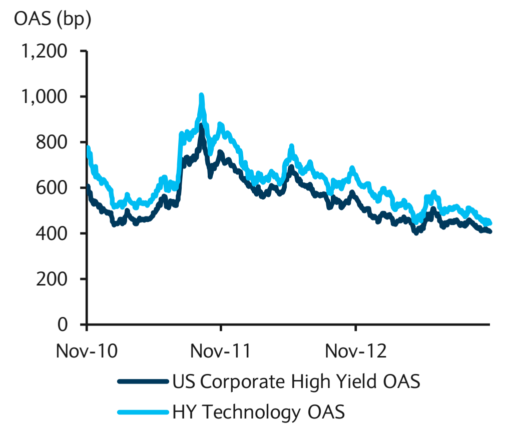
## Sector outlook

**Overall, technology sector industry fundamentals remain soft.** End-demand trends are weak overall as we finish 2013. IT spending trends remain lackluster, and 4Q guidance from EMS companies and semiconductor companies was below expectations. While PC market declines have moderated, the demand outlook remains weak and smartphone demand has slowed. On the positive side, carrier spending trends are somewhat better, with particular strength in North American wireless, and improved economic performance in 2014 should benefit IT spending trends. Given high recurring/maintenance revenues, the software sector continues to be resilient.

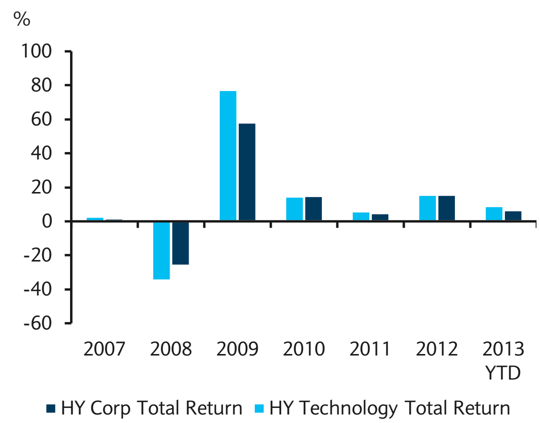
Year-to-date through November 29, 2013, the HY technology index has returned 9.3%, outperforming the HY Corporate Index by ~240bp. Notable outperformers include AMD, Alcatel-Lucent, Avaya, First Data and Freescale. Notable underperformers include Flextronics, Iron Mountain, and Nuance.

At an OAS of 437bp (versus 404bp for the HY Corporate Index), we believe potential spread compression is more limited. However, we maintain an Overweight rating on the sector based on the expected outperformance of several larger issuers including First Data and Alcatel-Lucent.

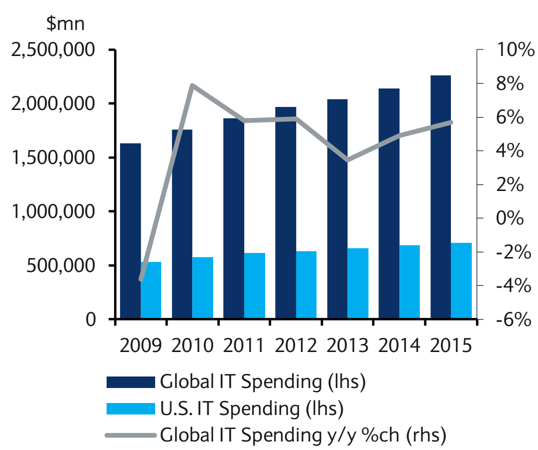
Tech Index OAS versus High Yield Index




Tech Index total returns versus High Yield Index




Global IT spending 2009-15E




Source: Barclays Research

# US HIGH YIELD TELECOM – MARKET WEIGHT

Keith Hanauer
+1 212 412 5956
keith.hanauer@barclays.com

Luke Labella
+1 212 412 5677
luke.labella@barclays.com

## Key recommendations

**We rate the US Telecom sector Market Weight.** The sector trades 25bp inside of the High Yield Index, after trading 78bp through the index at the start of the year, primarily because of weakness in the wireless subsector. Wireless currently trades 22bp inside of the HY Index, versus 103bp through the index in January. Wirelines are roughly flat with the market, starting the year 40bp inside of the HY Index and currently trading 30bp inside of the broader market.

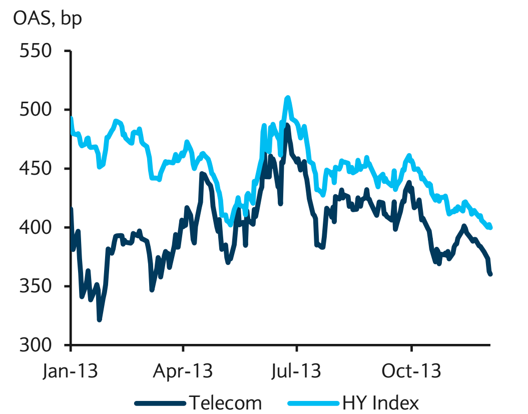
## Sector outlook

**We expect wireless issuance to continue to drive relative performance in 2014**. We think that wireless has underperformed partly because of technical pressures in the sector. Between Sprint's $6.5bn issuance, T-Mobile's $5.6bn (DT notes) and $2.0bn (potential spectrum purchase funding) bond deals, and Verizon's $49bn deal, there has been an ample supply of telecom bonds in the back half of 2013. Looking ahead to 2014, we expect concerns about persistent issuance to continue to weigh on spreads.

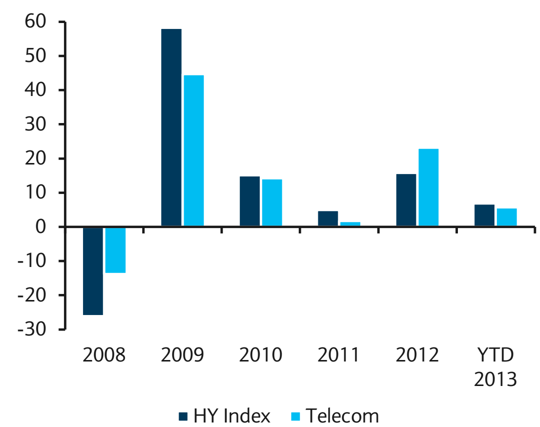
**Sprint will remain a key driver for returns in 2014,** at 26.1% of the HY Telecom Index. Sprint spreads look somewhat attractive, trading ~10bp wider (versus the high yield market) to pre-Softbank levels. However, we remain cautious given our view that Sprint is not fully funded and could come back to the market in the near term, potentially close in size to its previous benchmark offering. The supply concerns could be mitigated somewhat if the company lines up substantial vendor financing, although this remains uncertain. Given our cautious stance on supply, we see better value in the guaranteed layer of the structure, with 4.5x less leverage and only a ~50bp give-up in yield. T-Mobile bonds also offer compelling spread, 50bp wide of the BB index. We project that T-Mobile is adequately funded, including piecemeal acquisitions of low band spectrum. The company has indicated that it is unlikely Deutsche Telekom will sell its remaining $5.6bn in notes to the market until the reset features kick in, starting in April 2015.

**We expect operating trends in wireline telecom to be broadly consistent with 2013,** including increased pressure on residential DSL net adds from higher-speed cable modem offers. Frontier has been able to increase broadband net adds in recent quarters, although the use of third-party marketing could lead to high churn in 2014, and we note that EBITDA continues to decline in the mid-single digits. Windstream and CenturyLink were each forced to lower guidance in 2013, although we remain more constructive on their revenue mix, which is skewed more heavily toward enterprise and other lines of business that are growing. Among the three, we prefer Windstream and continue to believe that the credit should trade ~50bp inside Frontier.

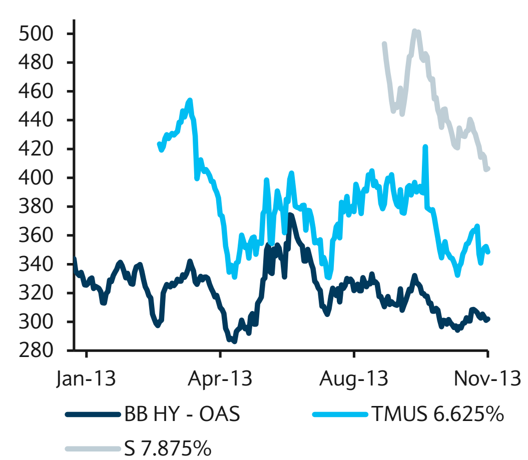
US HY Telecom OAS versus High Yield Index




US High Yield Telecom total returns, %




Sprint and T-Mobile versus BB Index, OAS, bp




Source: Company reports, Barclays Research

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# European sector outlooks

# EUROPEAN HIGH GRADE AUTOS – UNDERWEIGHT

Christophe Boulanger
+44 (0) 20 3555 1984
christophe.boulanger@barclays.com

Sophie Lim
+44 (0) 20 3134 4256
sophie.lim@barclays.com

## Key recommendations

**We recommend an Underweight position on HG EUR Autos** as current valuations are too tight compared to the HG Pan European index, given we see stabilisation in credit metrics and continued technical risk coming from non-abated primary issuance from the Financial Services units of the carmakers that affects secondary valuations. Volkswagen (UW), Daimler (UW) and BMW (MW) account for around 60% of the Autos HG index

We are Overweight FGA Capital due to wide valuations and strong support from its 50% shareholder, Credit Agricole SA. We also consider the USD 2019 of Continental to offer best value within the Continental curve. We are Market Weight RCI Banque, Valeo, and Volvo and Underweight all other companies.

## Sector outlook

**We expect global demand for passenger vehicles to rise by 3.4% y/y in 2014 with EU27+EFTA to bottom out and be up 1.5% y/y** (US +3.8%, Japan -1.4% and China +8%). The small rebound in Europe reflects our expectations of renewed GDP growth though the unemployment rate is unlikely to start reducing before 2015, which, combined with a young European car fleet of less than nine years old, should trigger a small uptick in replacement demand. By comparison, the US car fleet stands at c.11 years. The ongoing government scrapping scheme in Spain will artificially support vehicle sales in 2014, which could translate into a pay back in 2015 if the macroeconomic rebound is not sufficient to reverse significantly the unemployment rate curve.

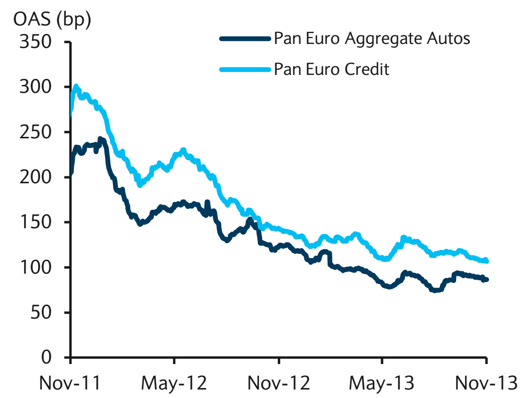
**The rebound in European business confidence is likely to translate into a return to moderate growth for European light commercial vehicle registrations,** which we see increasing by 3% y/y in 2014 (-10% in 2013 and -12% in 2012).

**We forecast 2014 global truck sales to rise by 7% y/y** (Europe +5%, US + 4%, Brazil +5%, and China +9%).

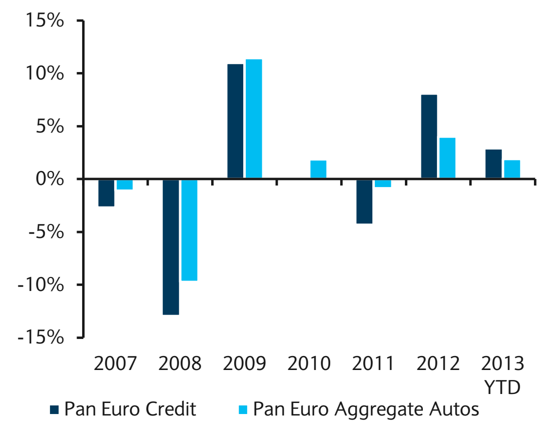
**Free cash flows of HG Autos should remain positive in 2014 but flat at best y/y** due to a still weak pricing environment, no significant improvement in the product mix, still high R&D and capex on the back of tightening CO2 emission rules and expanding capacities in emerging countries.

**We believe that the credit ratings of the companies within our HG coverage universe are likely to stabilise in 2014.** CNH Industrial and Renault SA are two potential candidates to migrate from High Yield to High Grade in the coming 12-18 months. Continental AG could also be upgraded to flat BBB in 2014 on the back of further de-leverage at Schaeffler.

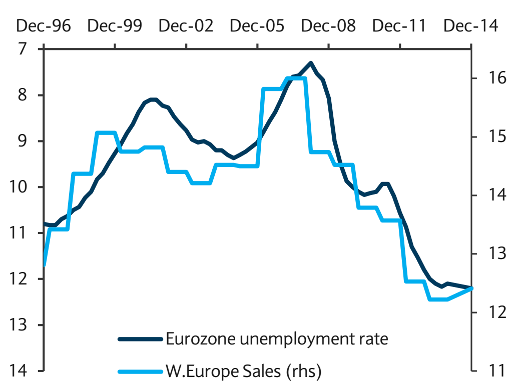
**Pan EUR HG Autos OAS versus Pan EUR HG Credit Index**




**Pan EUR HG Autos excess returns versus Pan EUR HG Credit Index**




**Euro area unemployment rate versus European car registrations**




Source: Barclays Research

# EUROPEAN HIGH YIELD/CROSSOVER AIRLINES – UNDERWEIGHT

Christophe Boulanger
+44 (0) 20 3555 1984
christophe.boulanger@barclays.com

Sophie Lim
+44 (0) 20 3134 4256
sophie.lim@barclays.com

## Key recommendations

**We recommend an Underweight position on European Airlines** due to expensive valuations versus the Pan-European HY Credit Index (although we note that Air France is not in the Airlines Index as it does not hold a credit rating) and given our expectations of volatile fuel prices, FX headwinds and a small rebound in the macroeconomic outlook in Europe where European airlines continue to hold most of their traffic.

**We have a Market Weight rating on British Airways GBP 8.75% '16** due to a still solid credit rating outlook and still fair yield for a low BB-like company. See *IAG Improving margins, operating profit guidance for FY13*, 11 November 2013.

**We have an Underweight rating on Air France '16 and a Market Weight rating on Air France '18.** We regard the issuer as being in line with a mid-to-high single B-rated company. We recommend a CDS flattener where we sell 5yr CDS and buy 2yr CDS, as we think there is potential for an orphanage event in April 2016. See *Air France – Looking to contain costs as net leverage ratios improve*, 31 October 2013.

**We have an Underweight on Lufthansa'16** as we believe it trades tight, especially when compared with our HY Pan European index and our HY Autos index. We regard Lufthansa 5yr CDS as trading at a fair level. See *Lufthansa - Tight valuations, we remain underweight*, 1 November 2013.

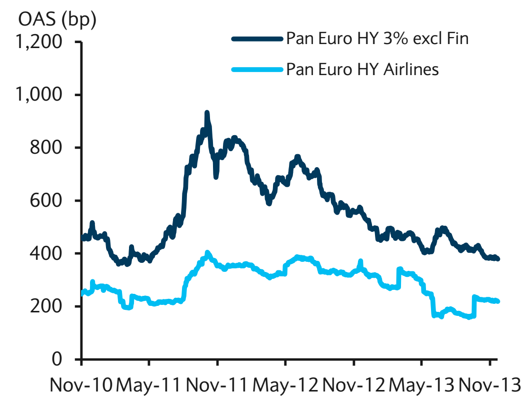
## Sector outlook

**We expect lower fuel prices in 2014 but FX volatility could be a source of downside risk, despite hedging.** While recent low Brent prices have been positive for airlines (fuel bill accounts for c.30% of operational costs), they are still affected by the high volatility in oil prices.

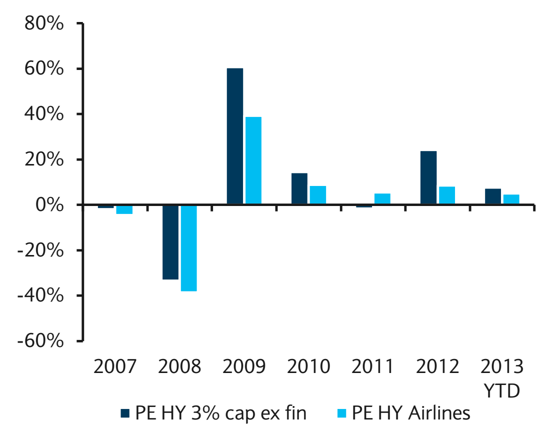
Another potential headwind could be a weak euro. Our colleagues in FX Research expect EUR/USD to be 1.30 in six months, falling to 1.27 in 12 months, compared with an average of 1.32 for the last 12 months).

**Passenger business should remain strong while the cargo business will remain challenging.** Business conditions should improve in 2014. The main headwinds in 2013 should soften in 2014 with oil prices expected to stabilise, world trade growth rising above 5% and passenger traffic set to grow further (IATA expects revenues per passenger kilometre to grow by 5% y/y in 2014 in Europe compared with +4% in 2013), especially in emerging economies, which were weaker than expected in 2013. IATA expects a 2014 EBIT margin for European airlines at 1.9% (vs. 1.3% in 2013 and 0.7% in 2012).

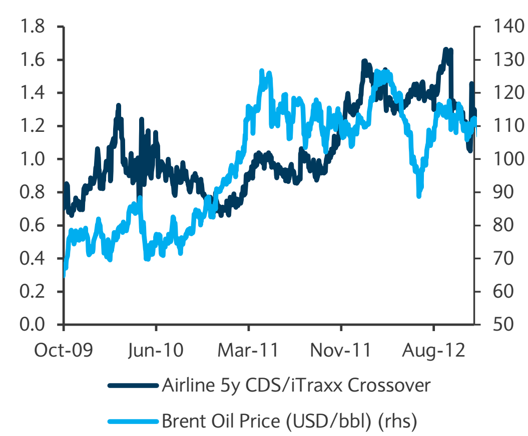
**European Airline OAS versus the PE HY 3% excl Financials Index**




**Total return versus the PE HY 3% excl Financials Index**




**European Airline CDS performance versus oil price**




Source: Barclays Research

# EUROPEAN HIGH GRADE BANKS – OVERWEIGHT

Jonathan Glionna
+44 (0) 20 3555 1992
jonathan.glionna@barclays.com

Christy Hajiloizou
+44 (0) 20 3134 2992
christy.hajiloizou@barclays.com

Yulia di Mambro
+44 (0) 20 7773 4295
yulia.dimambro@barclays.com

## Key recommendations

**Overweight Lloyds and Market Weight Royal Bank of Scotland.** With its stronger capital position today, fewer headwinds to profitability, on-track privatisation process, and a lower risk profile, we prefer Lloyds (Overweight) to RBS (Market Weight) among the domestic UK banks. While the decision to not create an external bad bank through a legal split and higher capital targets are credit-positive, RBS continues to face challenges in the near term, such as a substantial loss in Q4 as it takes £4-4.5bn of additional provisions.

**Overweight Spanish banks and Underweight Italian banks.** We believe Spanish banks are well prepared for the ECB's 2014 comprehensive assessment following the restructuring of the Spanish banking system completed in 2012. Conversely, we believe a reserve and capital deficiency will be revealed within the Italian banking system. We have Overweight ratings on Santander and BBVA and Underweight ratings on Intesa Sanpaolo and Unicredit.

**Overweight BNP and Societe Generale.** BNP and Societe Generale have been reporting strong financial performance characterised by robust profits, ample capital, and repaired funding profiles. We see value in these two large French banks, particularly in Tier 1, and rate them Overweight.

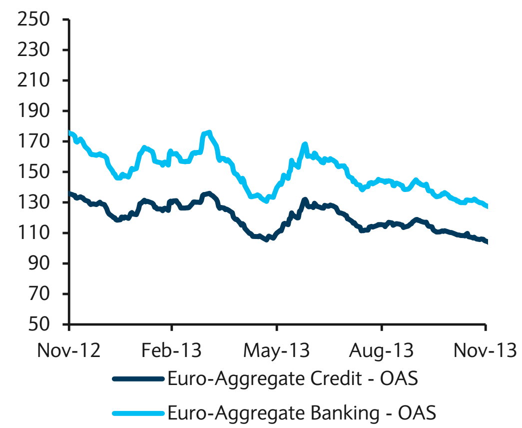
## Sector outlook

**Fundamental outlook characterised by better capital, even as profits decline.** One of the most positive trends for bank fundamentals is persistently increasing capital ratios. This process, driven by regulatory pressure, has resulted in the average CT1 ratio reaching a record high of 12.7% and the average fully loaded Basel 3 CET1 ratio already surpassing the 2019 minimum of 9.5%. This, coupled with deteriorating profitability, has lowered the sector's return on equity, with the average just 3% in Q3 13. We believe capital ratios will continue to improve throughout 2014.

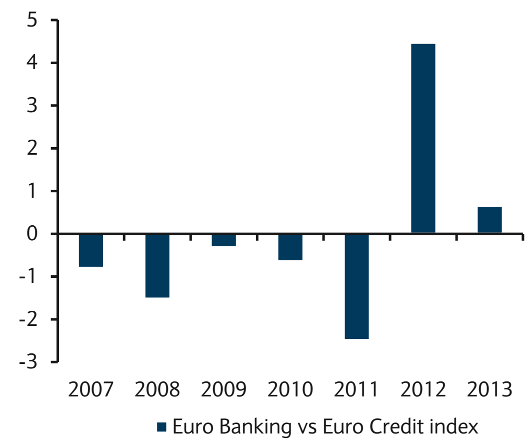
**Valuation restrains outperformance.** Despite our opinion that capital will continue to improve for European banks, potential outperformance is limited at many banks due to tight spreads. Among these we include UBS, Credit Suisse, HSBC, and Deutsche Bank.

**We expect the CoCo market to continue to grow.** With senior bank bonds at an average OAS of 106bp and an average yield-to-maturity of 1.6%, we recommend searching for value in other parts of the capital structure. Specifically, we believe the CoCo market will present opportunities in 2014, as the product continues to grow. We estimate the CoCo market, which is currently €35bn, will grow to more than €200bn, with issuance focused in the high-yielding AT1 structure.

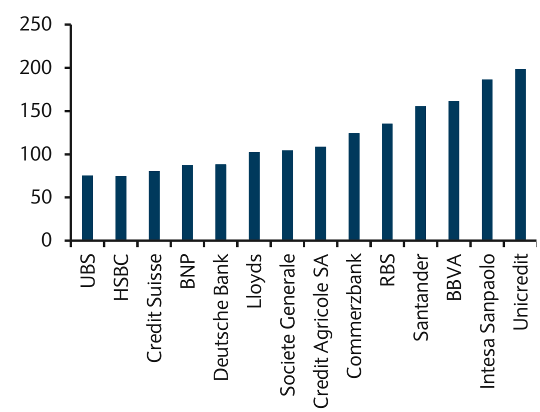
European bank OAS versus Credit Index, bp




European bank excess returns versus Credit Index, %




European bank 5y CDS, bp




Source: Barclays Research

# EUROPEAN HIGH GRADE/CROSSOVER BASIC MATERIALS – UNDERWEIGHT*

Darren Hook
+44 (0) 20 7773 8970
darren.hook@barclays.com

Nick Macdonald
+44 (0) 20 7773 6725
nick.macdonald@barclays.com

## Key recommendations

*** Market Weight Metals & Mining; Underweight Chemicals**. We view HG Metals & Mining as positioned for a stable performance, which takes into account our Overweight rating in GLENLN. Our Underweight on Chemicals reflects expensive valuations and M&A risk.

**Sell MTNA CDS:** We consider MTNA CDS as an option to fund shorts in high-yield names, such as ThyssenKrupp (UW cash) and Lafarge (UW cash). We believe current levels adequately compensate investors for the risk of a downgrade to BB.

**GLENLN (OW)**: Preference for $s. Our rating is based on the near-term prospect of a Las Bambas sale, its diversified business profile, a demonstrated commitment to solid IG ratings and potential to pick up spread vs. the index.

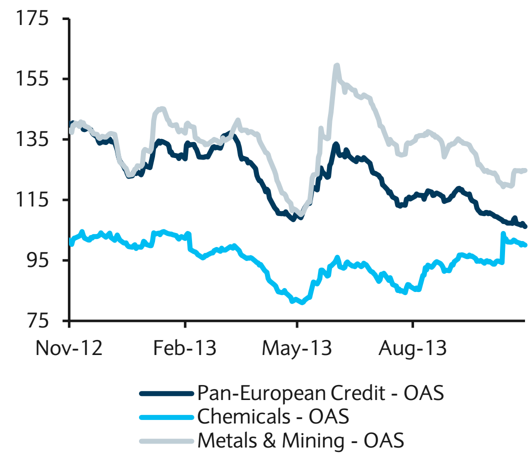
**Buy CLNVX €'17s (MW); Sell LXSGR (UW):** CLNVX has strengthened its business profile following the successful restructuring of its portfolio, which positions it for ratings upside longer term. We see scope for a further, albeit more modest, convergence of spreads towards LXSGR levels.

## Sector outlook

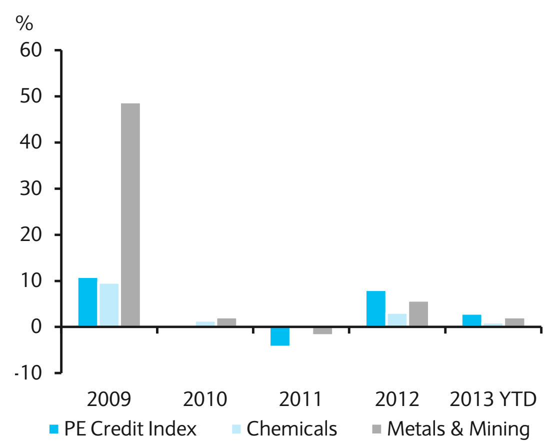
**Steel sector trends improving, but overcapacity limits upside:** Global apparent steel use is expected to rise by 3.3% in 2014 (source: WSA), which we view as achievable, albeit we see downside risks to the LatAm forecast (+5%). We expect European steel demand to grow by 3%, and anticipate similar growth in the US helped by continued auto strength, improving construction activity and expansion in manufacturing. Chinese growth is expected to slow substantially next year, declining to 3% from this year's estimated rate of 6%. On the back of this trend and rising supply, we expect the iron ore price to decline to an average of $100/mt from its current level $135/mt, which will particularly affect integrated steel players, such as MTNA (UW). Investment across the mining and steel sectors will be constrained beyond the current projects committed to and we expect the focus to remain on disposals, cash flow and liquidity. While earnings momentum looks solid into Q1, we caution that MTNA's ratings could fall should steel's earnings recovery stall.

**Chemicals:** We expect a low-to-mid single-digit level of organic volume growth across the various industry segments in 2014. We see input cost inflation as relatively muted, albeit a more challenging environment in EM could hold back margin improvement. The sector has substantial exposure to the construction and auto sectors, both of which we expect to register low single-digit growth in Europe. This, together with cost-saving initiatives, should drive an above sector average recovery in earnings at Lanxess (UW) and Akzo Nobel (MW). Given a relatively benign industry backdrop, we see scope for M&A activity to remain a key risk for the sector and would be particularly cautious towards names, such as Bayer (UW) and Merck KGaA (OW). We see scope for negative ratings actions on LXSGR in H1 14.

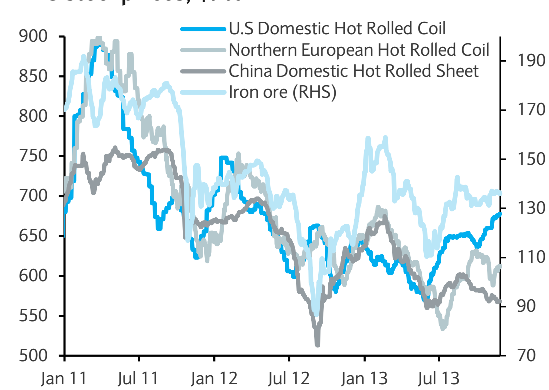
Metals & Mining and Chemicals versus the PE Credit Index, bp




Excess returns versus the PE Credit Index




HRC steel prices, $/ton




Source: Barclays Research

# EUROPEAN HIGH GRADE RETAIL/CONSUMER PRODUCTS – UNDERWEIGHT

Karine Elias
+44 (0) 20 7773 7060
karine.elias@barclays.com

## Key recommendations

**Preference for M&S (MW) over Metro (UW).** We view fair value in CDS between Metro and M&S (ex any LBO overhang on M&S) as roughly flat. We continue to prefer M&S over Metro on a fundamental basis. Our view is based on the ongoing pressure on Metro's key Cash and Carry and Consumer Electronics segments, its weakly-placed credit metrics and the better overall consumer environment in the UK versus Europe. Risks to our recommendation would include potential asset sales or a partial IPO of Metro's Russian operations.

**Compression trade Pernod (MW) vs. Carlsberg (UW).** We see fair value at 0 to -5bp (with Pernod trading tighter) despite Pernod's lower rating by one notch and higher leverage by c.1x. Our view is based on the incrementally negative trading conditions in Carlsberg's key Russian market (c.35% of EBIT), and our expectation for Carlsberg spreads to remain vulnerable to continued M&A risk. We still view Pernod's deleveraging trajectory very favourably. Also, we highlight that while the company has said bolt-on acquisitions remain a possibility, it has ruled out substantial acquisitions over the next 1-2 years.

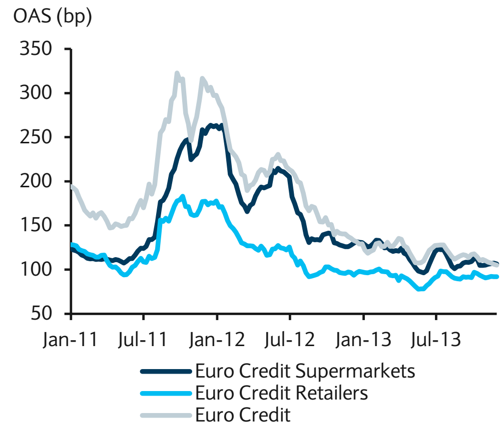
## Sector outlook

**EM slowdown.** The slowdown in EM regions has been a key theme across consumer credits, resulting in each of the beverage credits under our coverage missing expectations in the most recent calendar Q3 period. For the brewers, Russia's greater-than-expected deterioration was the main driver; whereas spirits were adversely affected by FX-related destocking in Asia/LatAm, and weaker underlying trading in China due to government policy tightening. That said, the reaction of spreads to weaker earnings has been muted: cost cuts are expected to provide support for brewers, while comparables are easing for spirits.

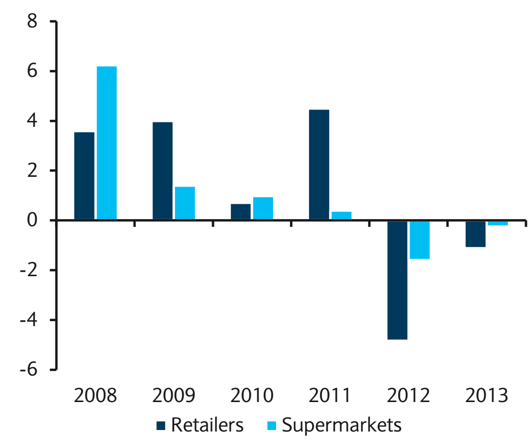
**Turnaround programmes.** Self help and retrenching was a major theme in 2013 among food retailers, with a plethora of asset disposals from non-core or uncompetitive assets from companies such as, Carrefour (UW), Tesco (MW), Metro, and Ahold (MW), as well as a new hybrid issue from Casino (MW). Attention now turns to their ability to turnaround their operations. We think this will continue to be a long, drawn-out process, especially as convenience competition heats up in the UK, as independents and discounters continue to gain market share in France, and as earnings remain challenging in Southern Europe.

**Valuation likely to hamper further outperformance.** Despite our constructive view on earning trends (albeit back-ended to 2H 14) as inflation remains benign, we retain an Underweight rating on the consumer and retail sectors due to valuation, which we believe limits outperformance in most cases. Among our Underweight ratings, Carrefour and Metro are trading at all-time tights (sub-100bp).

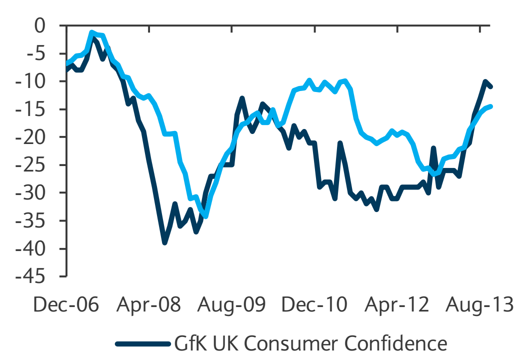
Retail OAS versus the HG Corporate Index




Excess returns performance versus the Index, %




UK versus eurozone consumer confidence




Source: ONS, Eurostat, Barclays Research

# EUROPEAN HIGH GRADE/CROSSOVER GENERAL INDUSTRIALS – UNDERWEIGHT*

Darren Hook
+44 (0) 20 7773 8970
darren.hook@barclays.com

Nick Macdonald
+44 (0) 20 7773 6725
nick.macdonald@barclays.com

## Key recommendations

***Reflects our Underweight ratings on Building Materials, Aerospace & Defence and Diversified Manufacturing.**

**TKAGR (UW):** We view current deleveraging initiatives as inadequate to stabilise ratings. Cash trades expensively versus Ba1-rated industrial names. In anticipation of strengthened liquidity following deleveraging initiatives; we prefer the €'16s across the curve.

**Preference for CRHID (OW) over HOLNVX (UW):** This reflects CRH's higher exposure to US construction and improving trends in European construction, as well as the more attractive valuation in $s. Lower earnings visibility in emerging markets combined with expensive valuations supports our Underweight in Holcim.

**ALOFP (UW):** Reflects ratings risk. Metrics are weakly placed, while the €1-2bn disposal plan is not enough to stabilise IG ratings, in our view.

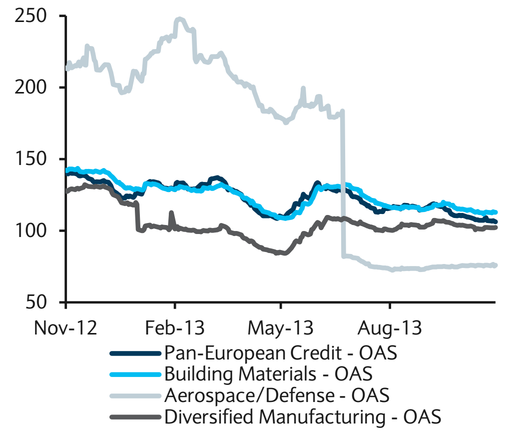
## Sector outlook

**Building Materials outlook mixed:** We expect a low-to-mid single-digit rise in volumes and a mid-to-high single-digit rise in EBITDA for our coverage names. This assumes a low single-digit organic volume rise in Europe and faster growth in the US, driven by residential, with non-residential prospects likely to be still held back by weak infrastructure spending, as well as further cost savings. Earnings prospects in EM appear relatively uncertain into 1H 14, given currency weakness, inflationary pressures and slowing growth in key construction markets, including India, Indonesia and, to a lesser extent, Brazil. We view Lafarge's ratings as vulnerable in 2014, in the absence of a recovery in MEA and Europe.

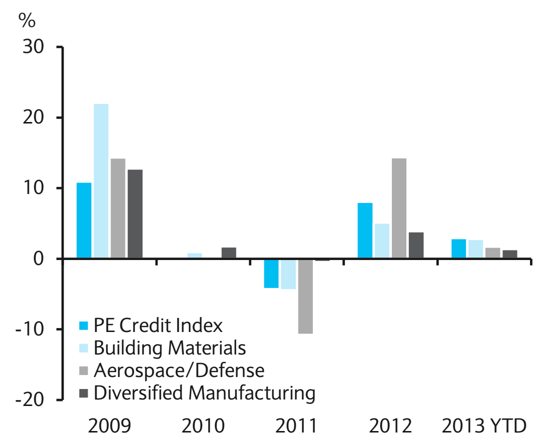
**Capital goods likely to benefit from improved investment trends in Europe, but prospects in emerging markets are more uncertain**: A recovery in non-construction investment of 3% should support growth in the euro area, albeit prospects will vary by segment, with utility investment expected to remain relatively weak. We see scope for EM order growth to disappoint, given the headwinds of weaker currencies and slower growth, with the risk of rising competition pressuring pricing and cash flow. We expect the sector to remain actively engaged in M&A. Of our coverage names, we view TKAGR and ALOFP as most vulnerable to downside ratings risk in 2014.

**Sequestration continues to overhang prospects in defence:** We note the impact of sequestration will be more fully felt across US defence in 2014, in the absence of a political consensus being reached. Meanwhile, any escalation in the sovereign debt crisis could lead to further austerity-driven cuts in European budgets, with developments in Italy a particular area of focus. The sharp drop in the Aerospace/Defence index spread earlier this year reflected Finmeccanica's exit from HG indices.

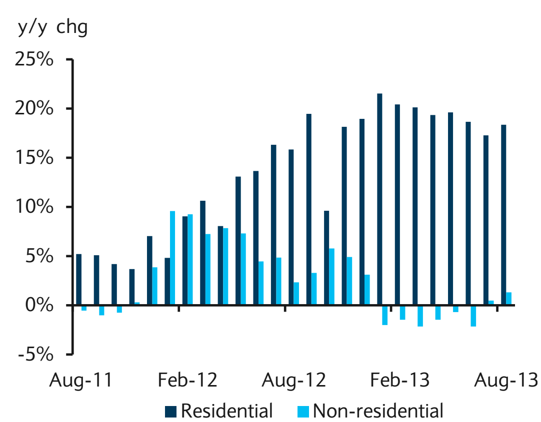
Building Materials, Aerospace/Defence and Diversified Manufacturing versus PE Credit Index, bp




Excess returns versus the PE Credit Index




Value of new construction put in place in the US




Source: U.S. Census Bureau, Barclays Research

# EUROPEAN HIGH GRADE INSURANCE – OVERWEIGHT

Christy Hajiloizou
+44 (0) 20 3134 2992
christy.hajiloizou@barclays.com

Jonathan Glionna
+44 (0) 20 3555 1992
jonathan.glionna@barclays.com

Yulia Di Mambro
+44 (0) 20 7773 4295
yulia.dimambro@barclays.com

## Key recommendations

**We recommend Overweight positions in Allianz and Zurich**. These large composite insurers offer earnings diversity, manageable leverage, strong debt service coverage, and attractive valuation. AXA also exhibits many of these trends but our rating is Market Weight on valuation grounds following a strong 2013.

**Selectively more positive on life insurers.** Lower-for-longer interest rates remain challenging for life insurers in Europe. However, we recommend an Overweight position in Aegon to benefit from its large exposure to the US and as a way to express a view on higher interest rates. We also recommend an Overweight in Legal & General due to its superior fundamentals in the UK. We recommend Market Weight positions in Prudential Plc and Old Mutual, as emerging market volatility remains relevant.

**Aviva and Generali will likely continue to restructure successfully**. We recommend a Market Weight position in Generali due to valuation following strong performance in 2013 and ratings risk related to peripheral exposure. We also recommend a Market Weight position in Aviva on valuation grounds and because it has a long way to go to complete its strategic repositioning.

**We recommend Overweight positions in Reinsurers**. Swiss Re, Hannover Re, and Munich Re are among the strongest credits in the sector, in our view, given low leverage, minimal peripheral sovereign exposure, and sound catastrophe risk management. We believe the perpetual securities offer the best value.

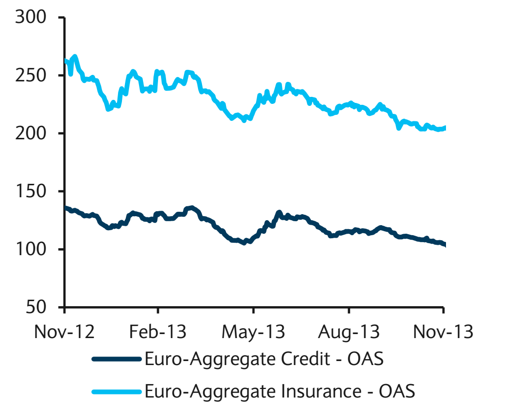
## Sector outlook

**Solvency 2 development could trigger new hybrid issuance.** We think there will be progress in Solvency 2 regulations during 2014, including further clarity on eligible capital structures, notably Tier 1 instruments. We expect supply in hybrid instruments to grow.

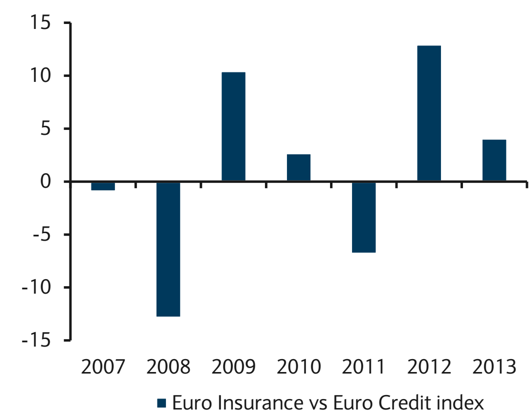
**Shareholder returns to pick up.** We expect a growing trend in some insurers to return excess capital to shareholders in 2014 through special dividends, share buybacks and higher payout ratios. Swiss Re, Munich Re, Hannover Re and Allianz are the likeliest candidates but we do not envisage this compromising capital levels.

**Interest rate challenges continue.** We expect interest rates in Europe to remain low in 2014, which would continue to pressure insurance growth and profitability, principally in the life insurance segment.

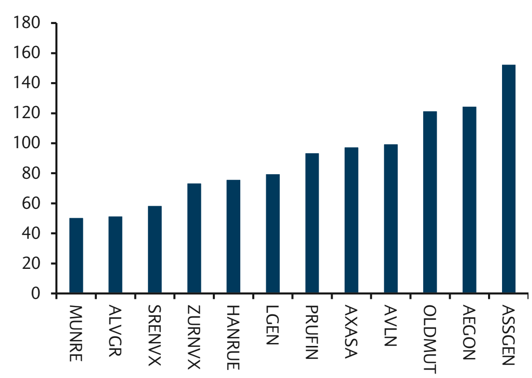
**European insurance OAS versus Credit Index, bp**




**European insurance excess returns versus Credit Index, %**




**European insurance 5y CDS, bp**




Source: Barclays Research

# EUROPEAN HIGH GRADE MEDIA – MARKET WEIGHT

Daniel Rekrut
+44 (0) 20 7773 5980
daniel.rekrut@barclays.com

Jonathan Horner
+44 (0) 20 7773 5286
jonathan.m.horner@barclays.com

## Key recommendations

**We like exposure to WPP (MW):** WPP reported Q3 like-for-like revenue growth of 5% y/y and continues to expect above-industry revenue growth and margin expansion. The company remains cautious with its balance sheet, targeting small- to medium-sized acquisitions. Operationally, the business is robust, and our Market Weight rating is driven by already relatively tight spreads. However, good geographical diversification and exposure to improving cyclical momentum could provide upside compared with more defensive media peers, if positive trends continue. Therefore, we like exposure to WPP going in to 2014.

**Tight-trading, less-cyclical sub-sectors likely to underperform:** The professional publishers (Reed Elsevier, Pearson and Wolters Kluwer; all UW) generally continue to deliver consistent results, but trading levels already reflect defensive trends, in our opinion. Publishers' spreads were pressured in February 2013, following the takeover of Virgin Media (as the market considered potential LBO targets-outlined in a 12 February Bloomberg report), which highlighted the downside risk at tight trading levels.

## Sector outlook

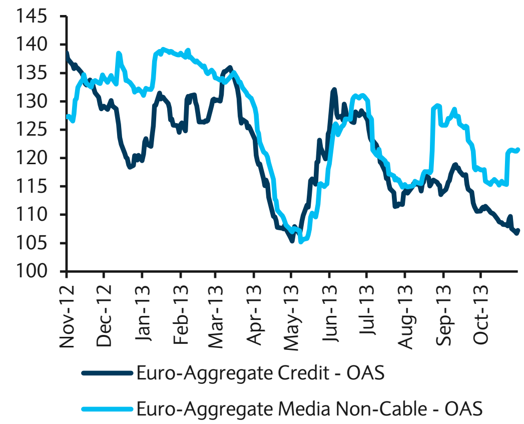
Our economists forecast global GDP to grow by 3.4% y/y in 2014 compared with 2.9% y/y expected in 2013. Similarly, media buyers expect global advertising growth to trend up y/y in 2014. Signs of continued macroeconomic recovery support positive sentiment towards the media sector, but we are market weight in the context of relatively tight trading levels following robust operational performances in 2013.

For more cyclical and advertising-exposed sub-sectors, such as the advertising agencies/broadcasters, 2013 saw good operational trends and caution in maintaining balance sheet strength despite improving macroeconomic conditions, which provides comfort. For more defensive sub-sectors, such as the professional publishers, consistent operations remain a positive feature, but significant near-term positive catalysts are hard to envisage at current trading levels.

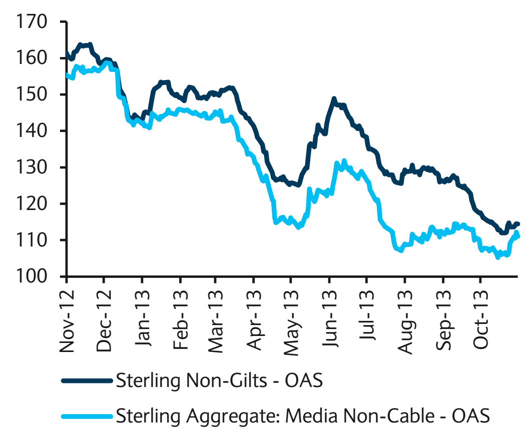
The improving macro environment and strengthened balance sheets since 2009 increase the risk of larger-scale M&A, in our opinion. However, we generally expect bolt-on acquisitions, given the prevalence of strategies designed to expand footprints into faster-growth markets, such as digital or EM.

In terms of relative value, the EUR Media non-cable index has an OAS of 120bp, compared with the EUR aggregate credit index at 106bp. In GBP, the Media index trades at 113bp, which is slightly tight to the GBP non-gilts credit index at 114bp.

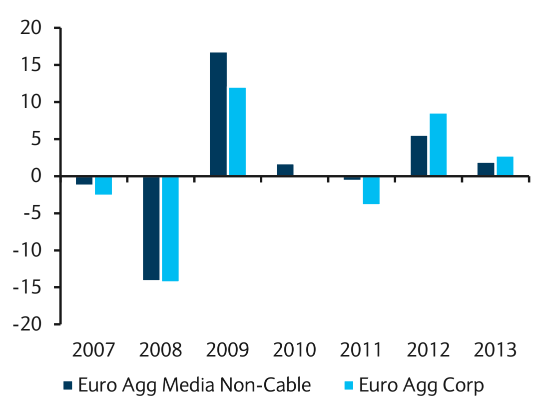
EUR Media OAS versus index, bp




GBP Media OAS versus index, bp




EUR Media excess returns performance to index, %




Source: Barclays Research

# EUROPEAN HIGH GRADE OIL & GAS – UNDERWEIGHT

Tom Southon
+44 (0) 20 7773 6918
tom.southon@barclays.com

Srinjoy Banerjee
+44 (0) 20 7773 7755
srinjoy.banerjee@barclays.com

## Key recommendations

**Overweight ENI.** We think that ENI has ample room to compress towards core 'A' bracket integrated energy names (BG Group, OMV, BP) that trade 35-30bp tighter. Potential catalysts for spread tightening include further disposals and earnings recovery.

**Overweight BP.** We think BP's current cash and CDS levels price in a gross negligence finding for the Gulf of Mexico oil spill, and see c.20bp of spread tightening in the event of a "not grossly negligent" finding and eventual upgrades to the 'AA' range. We expect a ruling on whether BP was grossly negligent or not by year end.

**Market Weight Repsol.** We think that current valuations already price in a likely one-notch upgrade next year with Repsol trading inline with Gas Natural (O/W).

## Sector outlook

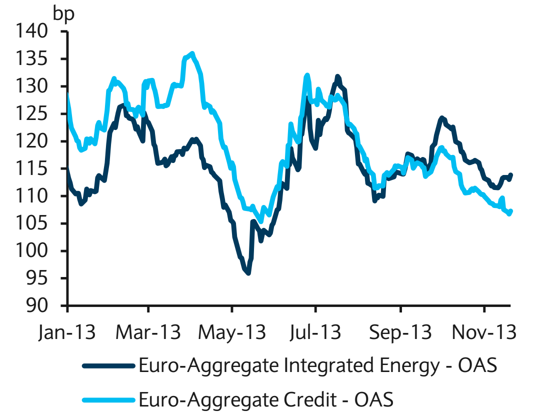
**Cash flow recovery will be driven by production growth.** We think 2014 will be a year of cash flow recovery for the integrated O&G space after a challenging 2013. The key driver will be major upstream projects coming online, offsetting the geopolitical disruptions seen in 2013 and helping to restore metrics. For example, while ENI was forced to downgrade its 2013 production guidance (now expected to be down y/y) owing to theft, sabotage and flooding in Nigeria and disruptions in Libya, management still target >4% CAGR for 2012-16, reflecting start-ups across Africa, Russia, Kazakhstan and Venezuela. Consensus expects >5% y/y improvement in EBITDA in 2014 across the European Integrateds, with BG Group (+14%) and ENI (+14%) expected to see most improvement.

**We expect the oil price to be supportive.** Barclays' forecast is for Brent oil price to remain range bound (USD100-120/bbl) in 2014 (vs. USD 108.5/bbl in 2013), referencing that the political climate in producer countries (eg, Libya, Nigeria and Egypt) remains fragile.

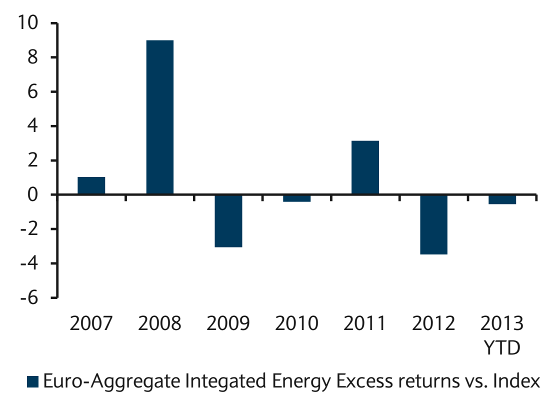
**Disposals a popular way of returning cash to shareholders.** During the Q3 results season, we saw ENI and BP stress their intention to press ahead with share buy backs. Both issuers have large disposal plans to fund the return of cash (BP announced a new USD10bn programme) in order to maintain gearing ratios.

**Underweight due to unattractive valuations.** Despite our expectation of operational improvement in 2014 versus 2013, we note that most of the sector has unappealing valuations (Total (MW), Shell (MW), BG Group (UW), OMV (UW)) compared with the credit index with limited scope for excess return outperformance next year, in our view.

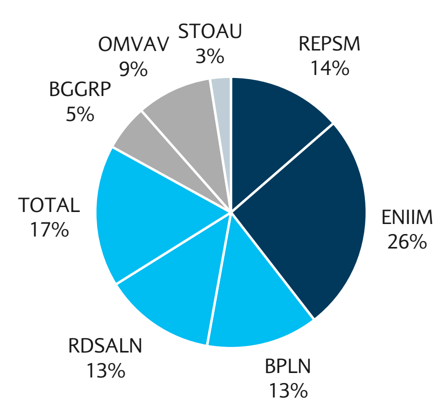
**EUR Integrated Energy OAS versus EUR Credit Index**




**EUR Integrated Energy excess returns versus EUR Credit Index, %**




**Barclays HG Integrated Energy Index**




Note: (Colour blocks going clockwise) – Peripherals, Oil Majors, Mid-Caps, Other Source: Barclays Research

# EUROPEAN HIGH GRADE TELECOMS – MARKET WEIGHT

Daniel Rekrut
+44 (0) 20 7773 5980
daniel.rekrut@barclays.com

Jonathan Horner
+44 (0) 20 7773 5286
jonathan.m.horner@barclays.com

## Key recommendations

**For peripheral exposure, we highlight Telefonica's (Market Weight) debt reduction:** At its last results (Q3) Telefonica had reduced its net debt to €46,101mn, which is below its full-year target of €47,000mn one quarter early. Furthermore, accounting for post-Q3 closing events, it has reduced debt by €13,676mn since June 2012. Telefonica continues to make progress, although pressure persists domestically. Spreads are at LTM tights, but still display a peripheral premium. For investors seeking exposure to peripheral Europe, we believe Telefonica is an attractive option.

**We believe Orange (Underweight) will continue to underperform peers:** Orange has had a difficult 2013, with Q3 EBITDA down 7% y/y and we are yet to see signs of group-level stabilisation. Management stated that 2014 will be a year of transition, and domestic mobile, in particular, remains difficult. Despite this, 5y CDS spreads are at LTM tights, and we see few near-term positive catalysts.

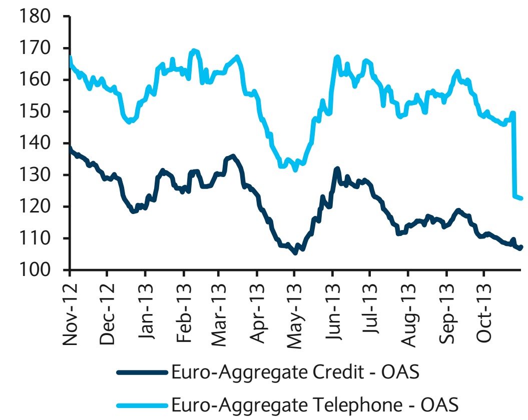
## Sector outlook

We expect trends to remain challenging in 2014. Telecom operators continue to experience top line pressures from regulation, competition and the weak macroeconomic environment. EBITDA and cash flows are in part defended by cost cutting/non-core asset sales, but dampened by the weaker top line and increased investment (capex/marketing costs) for the benefit of commercial positioning.

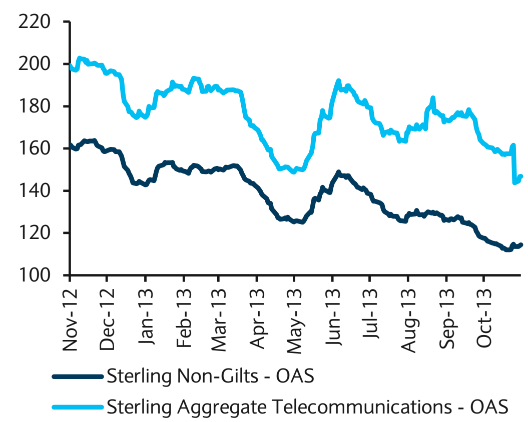
The telecom model continues to show its relatively defensive nature and the benefit of scale. The most-pressured issuers are successfully executing inorganic options to bolster balance sheets or to create flexibility to invest. We have seen hybrid issuance from Telecom Italia, KPN and Telekom Austria. In addition, KPN completed a capital raise and announced the sale of a core asset to help reduce debt. The success of these operators in generating liquidity from inorganic sources shows the benefits of scale, but we continue to highlight that for some, limited options remain. With many operators investing defensively, we believe operational pressure will remain a feature in the sector, with any potential benefits of such investment unlikely to show until later in the year. In terms of M&A, the majority of issuers under our coverage remain more focused on disposals than large-scale acquisitions, but we could see increased interest around in-market consolidation or acquisitions to bolster convergent offerings.

The HG telecoms sector trades at 120bp (147bp in GBP), against the credit index at 106bp (114bp in GBP). Competitive/regulatory pressures and increased investment levels are counterbalanced by balance sheet focus, spreads that are already wide to index levels and improved sentiment around the periphery to which the telecom index has exposure. This drives our Market Weight recommendation.

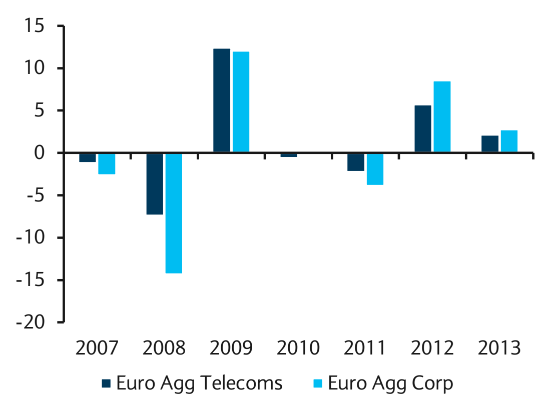
**EUR Telecom OAS versus index, bp**




**GBP Telecom OAS versus index, bp**




**EUR Telecom excess returns – performance versus index (2013 YTD), %**




Source: Barclays Research

# EUROPEAN HIGH GRADE UTILITIES – MARKET WEIGHT

Tom Southon
+44 (0) 20 7773 6918
tom.southon@barclays.com

Srinjoy Banerjee
+44 (0) 20 7773 7755
srinjoy.banerjee@barclays.com

## Key recommendations

**Overweight Iberdrola.** We see improving credit metrics in 2014, in spite of the impact of the Spanish energy reforms, with Iberdrola benefitting from tariff deficit securitisations (€1.6bn still on the balance sheet) and €0.8bn of disposals to be executed next year. We anticipate 10-15bp of spread compression.

**Overweight Gas Natural.** We see a clear commitment to balance future expansion with balance sheet prudence over the medium term; management target current leverage (3.0x) as a ceiling going forwards. We also welcomed the visibility into potential earnings through to 2015-17 in the first strategy update since 2010 during the Q3 results. We see at least 30bp of tightening at the longer end of EUR cash.

**Overweight ESB.** ESB (and its owner, the Irish state) continues to prioritise sustaining a minimum BBB+ rating. We think Ireland's positive sovereign story (the only peripheral sovereign on positive outlook and likely to transition smoothly out of the bailout programme) will support ESB spread performance. We target 20bp of tightening in EUR cash.

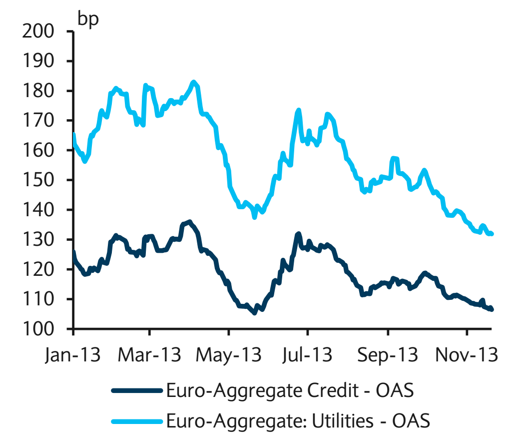
**Underweight RWE.** We expect that RWE's 2014 guidance and suggestion that net leverage will remain above 3.5x in the medium term (we think above 4.0x in 2014) is cause for negative rating action in the coming weeks (negative outlook/Credit Watch negative) with a downgrade likely early next year. We think the EUR FC '15 hybrids are most vulnerable to negative rating action, and have the real possibility of extension risk (to 2020). We see 5pts of downside risk from current levels.

## Sector outlook

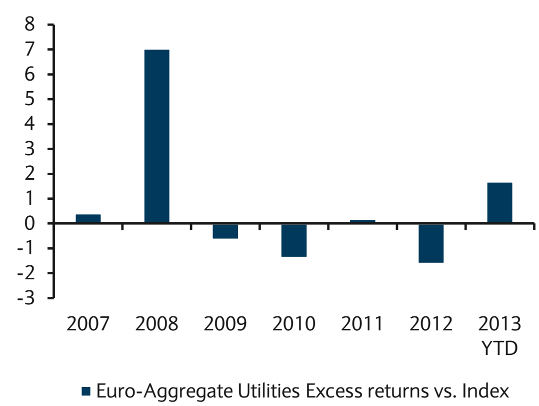
**Constructive on peripheral utilities.** In spite of recent spread outperformance versus core utilities, we anticipate mid to high BBB-rated utilities will continue to grind tighter. We are more comfortable with peripheral sovereign ratings which cap those of peripheral utilities given our house view of an economic recovery in Europe in H2 13/H1 14. On a fundamental level, peripheral utilities have continued with their efforts to deleverage and improve liquidity. We think there is still scope for peripheral utilities to grind in, with mid BBB-rated peripheral utilities trading c.50bp wide of mid BBB-rated core utilities (30bp for high BBB).

**Bearish on core utilities.** We expect heightened political and financial risk for core utilities in 2014. Questions concerning the affordability of electricity for UK consumers has led to suggestions of political invention, including price freezes from 2015. In Germany, power prices remain depressed owing to continued renewable capacity increases. We see earnings declines and increasing leverage in 2014 for German utilities as a result.

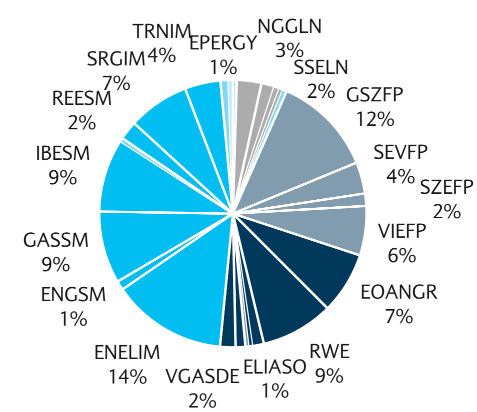
**EUR Utilities OAS versus EUR Credit Index**




**EUR Utilities Excess Returns vs. Index, %**




**HG Barclays European Utility Index**




Note: Colours clockwise: UK, France, Germany, Peripheral (Italy/Spain), Emerging Europe Source: Barclays Research

# EUROPEAN HIGH YIELD AUTOS – UNDERWEIGHT

Christophe Boulanger
+44 (0) 20 3555 1984
christophe.boulanger@barclays.com

Sophie Lim
+44 (0) 20 3134 4256
sophie.lim@barclays.com

## Key recommendations

**We recommend an Underweight position on HY EUR Autos** due to tight valuations compared to the HY Pan European index and still weak, though slightly improving, operating performance. Potential candidates to migrate from High Yield to High Grade in the next 12-18 months include, in order of likelihood, CNH Industrial and Renault SA.

**We are Overweight TTMTIN 5.625% 23, Fiat 7.75% 16, 7% 17, 7.375% 18, 6.625 18 and 6.75% 19**. We remain Underweight Peugeot beyond 2015 maturity as we expect the company to keep generating negative free cash flow in FY14 that could result in further credit rating pressure (Market Weight all bonds of Banque PSA and Market Weight Peugeot up to 2015 maturity). Also we remain Underweight Renault, Faurecia 16, Fiat 6.375% 16, CNHI 15, Chrysler 19, TTMTIN 18 (GBP and USD) and 21and Schaeffler 6.75% 17 and 4.25% 18. We are Market Weight all the other bonds within our Autos HY universe.

## Sector outlook

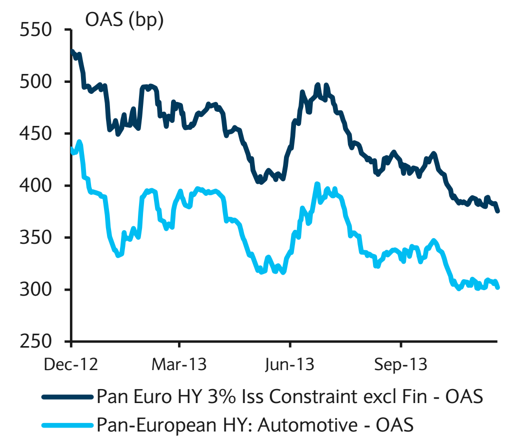
**We expect global demand for passenger vehicles to rise by 3.4% y/y in 2014 with EU27+EFTA to bottom out and rise by 1.5% y/y** (US +3.8%, Japan -1.4% and China +8%). The small rebound in Europe reflects our expectations of renewed GDP growth though the unemployment rate is unlikely to start falling before 2015, which combined with a young European car fleet of less than nine years old, should trigger only a small uptick in replacement demand. By comparison, the US car fleet stands at c.11 years old. The ongoing government scrapping scheme in Spain will artificially support vehicle sales in 2014, which could translate into a pay back in 2015 if the macroeconomic rebound is not sufficient to reverse significantly the unemployment rate curve.

**The rebound in European business confidence is likely to translate into a return to moderate growth for European light commercial vehicle registrations**, which we see increasing by 3% y/y in 2014 (-10% in 2013 and -12% in 2012).

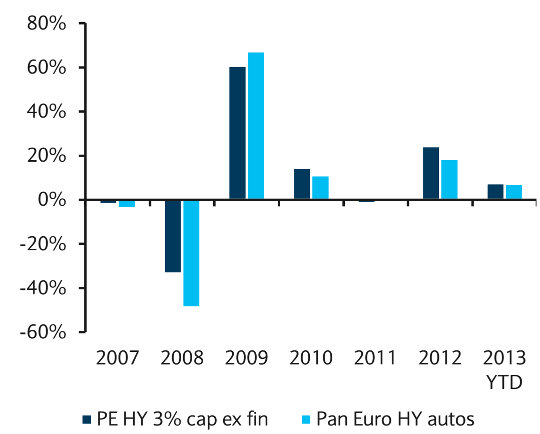
**In 2014 we expect global light vehicle production to be up by 4% y/y with Europe to rise by 2% y/y,** which should benefit all suppliers within our coverage universe. Global suppliers, such as Schaeffler, should benefit the most. Faurecia remains more exposed to European demand.

**HY European Autos excluding Peugeot are likely to report breakeven to small positive FY14 free cash flow at best** due to a weak net pricing (high consumer incentives in Europe) and a rebound in demand that remains low compared to existing excess capacity (over 30% in Europe).

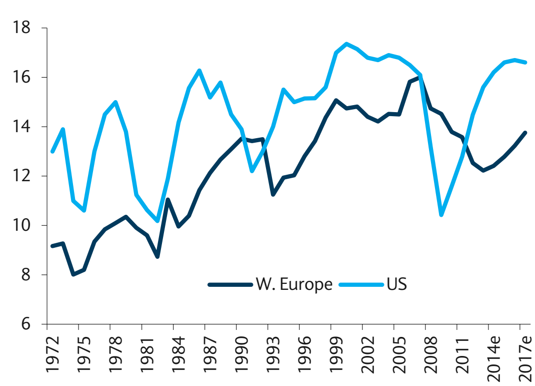
Pan EUR HY Credit Index OAS versus Pan EUR HY Autos Index OAS




Pan EUR HY Credit Index Total Return versus Pan EUR HY Autos Index




Unit sales: EU27+EFTA versus US, mn




Source: IHS, Barclays Research

# EUROPEAN HIGH YIELD CONSUMER PRODUCTS – MARKET WEIGHT

Karine Elias
+44 (0) 20 7773 7060
karine.elias@barclays.com

## Key recommendations

**Bakkavor (OW) remains our top pick in the Food space.** We think Bakkavor has demonstrated a sound business model and high-quality execution, absorbing an unprecedented £30mn in raw material inflation in FY 11 and dealing effectively with the horsemeat scandal. Despite its higher net leverage (4.9x), we remain comfortable with its steady FCF profile and view the credit as stable. We favour the 2020 notes and see fair value vs. the 2018 notes at 60bp vs. 110bp currently. We expect Bakkavor to outperform the rest of the market due to its leading market share, strong product pipeline and operating leverage. We estimate FY 13 net leverage at 4.7x and FY 14 at 4.4x.

**Preference for Findus (OW) over Boparan (MW) in Food**. We recommend a switch out of Boparan (£/EUR) '18s into Findus (£/EUR) '18s. Investors can pick up 2.5pts in cash and c.2.0% in extra yield, while improving their security/seniority position and maintaining a similar duration. Although Boparan's ratings are stronger, we remain comfortable with Findus's positioning within its ratings bucket and think that a 100-150bp spread differential adequately compensates for the weaker rating.

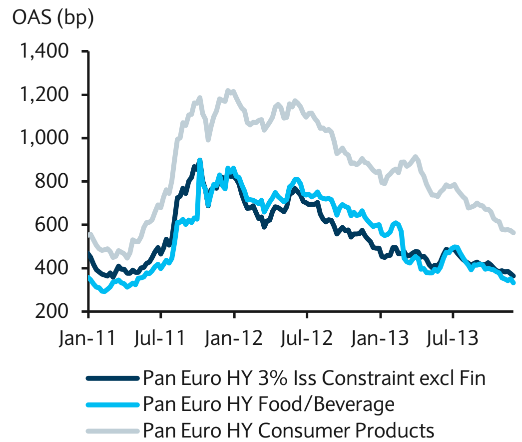
## Sector outlook

We maintain our Market Weight rating on the European HY Food/Beverage sector, mainly reflecting the call-constrained nature of the majority of its constituents and relatively tight levels vs. the EU HY index, with OAS for the Food/Beverage sector at 332bp vs. 364bp for the Index. The outperformance is also likely due to the limited supply in Food in contrast to other sectors such as Retail, with only a handful of new issues from Findus, and some supply from existing issuers such as, Ontex (tap), R&R (PIK toggle), Bakkavor and Picard.

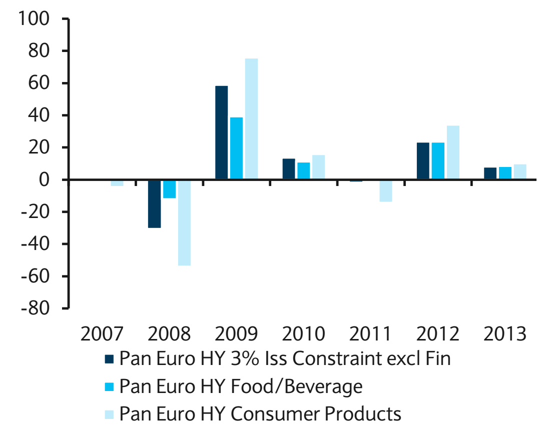
**Inflation remains manageable.** Our outlook on inflation remains benign, and despite recent rises in the prices of milk and cheese, we do not expect inflation to be as severe as in FY 11. We expect food producers to show y/y improvement in margins. We continue to favour companies with high LFL volume growth and strong operational leverage – our top picks are Findus, Bakkavor and Ontex, followed by R&R. Lastly, we expect rising M&A activity in FY14, as suggested by Boparan's acquisition of Vion's Red Meat and Poultry business in the UK, Refresco's acquisition of Gerber and Ontex's acquisition of Serenity.

**Horsemeat issue – muted impact on overall consumption.** Although sales of ready-made meals containing meat were negatively affected by the horsemeat issues and fell by 40% in Q1, most food producers, such as Bakkavor, Boparan and Findus, have seen sales recover since March, with the exception of Picard. That said, we think the scandal has raised concerns about sourcing, which has led to a pick-up in meat and protein prices.

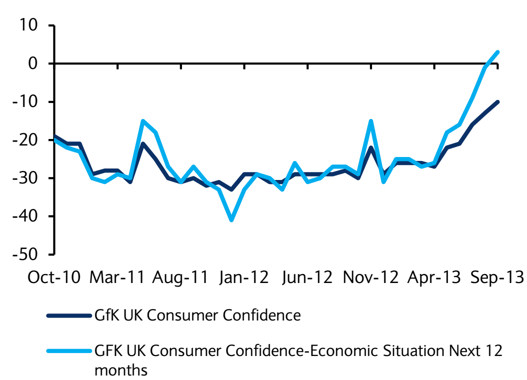
**Consumer OAS versus Corporate index**




**Total returns performance versus index, %**




**Consumer confidence indices**




Source: GfK, Eurostat, Barclays Research

# EUROPEAN HIGH YIELD GENERAL INDUSTRIALS & TRANSPORTATION

Tom Southon
+44 (0) 20 7773 6918
tom.southon@barclays.com

Srinjoy Banerjee
+44 (0) 20 7773 7755
srinjoy.banerjee@barclays.com

## Key recommendations

**INEOS – Overweight € 6.5% 2018 senior notes.** We remain positive on INEOS's fundamental outlook, and expect O&P North America to continue to underpin the group's earnings over the medium term. In addition, we view the transfer of the Grangemouth plant out of the restricted group as credit positive, and expect that the main underperforming product grades (nitriles, butadiene) will be early beneficiaries of any recovery in European and Asian demand in 2014. Across the capital structure, we currently favour the € 6.5% senior notes and have recently upgraded our rating on these to Overweight from Market Weight.

**Europcar – Overweight the 9.375% 2018's, Underweight the 11.5% 2017's.** Europcar's better-than-expected Q3 13 results and upgraded cost plan should leave the group well placed to look at refinancing options over the course of next year. We continue to think this could include an IPO of the business, which would increase financial flexibility further and represents the group's only option to refinance the 11.5% notes (111.5 IPO call). We continue to favour the 2018 9.375% notes and we maintain our Overweight rating on them. However, we recently downgraded the 11.5% 2017s to Underweight given recent price appreciation and our view that the possibility of an IPO at some point in 2014 has increased.

**Kerling – Overweight 10.625% senior secured notes.** We continue to view Kerling's proposed JV with Solvay as materially credit positive and, despite being subject to a Phase II review, highly likely to complete. Therefore, our base case remains that the 10.625% senior secured notes are called at some point next year or early 2015 and we maintain our Overweight rating.

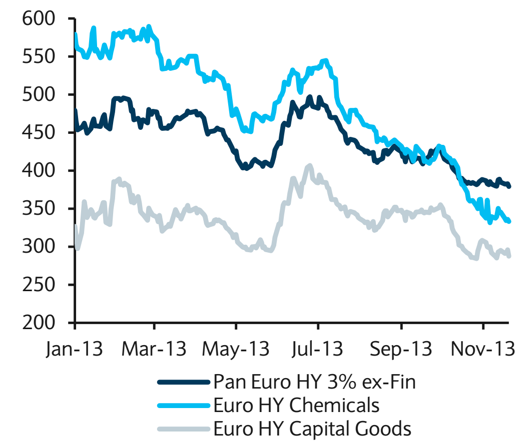
## Sector outlook

**Cost-reduction plans starting to bear fruit**. We expect 2014 to represent another year of relatively low growth, and see cost-reduction plans as a key earnings driver in 2014. In particular, Europcar, Styrolution, INEOS (O&P Europe) and Kerling all have meaningful self-help tailwinds into next year.

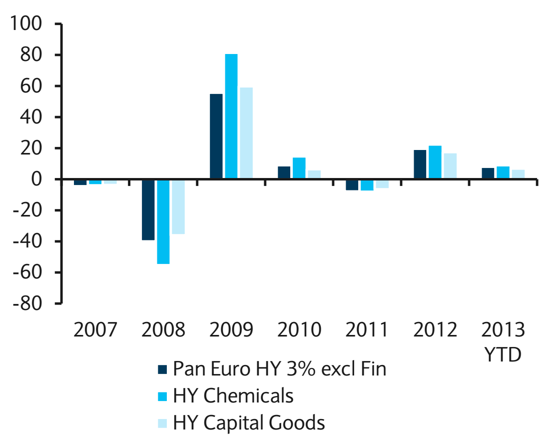
**Opportunistic refinancing to continue.** Within the sector, we see INEOS, Europcar, Kerling, Styrolution and Orion Engineered Carbons as potential refinancing candidates in 2014, with bonds becoming callable and likely favourable economics.

**Exit events starting to become a possibility.** While ISS is reportedly considering an IPO in H1 (Reuters: 21 November, unconfirmed), we also think it is possible that BASF's exit from Styrolution could happen in H2 14. Additionally, Europcar could revisit plans to list as a means to reducing funding costs.

Euro Industrial OAS versus Index, bp




Total returns versus Index, %




Source: Barclays Research

# EUROPEAN HIGH YIELD RETAIL – OVERWEIGHT

Karine Elias
+44 (0) 20 7773 7060
karine.elias@barclays.com

## Key recommendations

**New Look (OW).** New Look reported Q2 results that were well ahead of our expectations, with sales and EBITDA showing continued improvement and LTM EBITDA improving from £195mn in Q1 to £206mn in Q2 . With the refinancing recently completed and H1 results largely in line with guidance despite the unseasonal weather in October, we continue to see scope for earnings to support spreads and see fair value for New Look £18s at 50bp versus Matalan £16s.

**Matalan 17s (UW):** Although our medium-term thesis is unchanged, we are cautious on earnings momentum over the next two quarters given the volatility in LFL sales across the sector, especially in the context of the various initiatives being implemented (pricing review, roll-out of Sports stores format, single-stock projects and Click & Collect). We see fair value at 250-300bp wider versus Takko 19s.

**Switch out of DFS (OW) into Maison du Monde (OW):** Investors can pick up c.4.25pts in cash and c.3.7% in extra yield while maintaining a similar security/seniority position, and ratings, extending duration by two years, and gaining exposure to improving growth prospects and an implied equity cushion. We view Q1 13 results as a better entry point for DFS, given our forecast for weaker Q1 earnings.

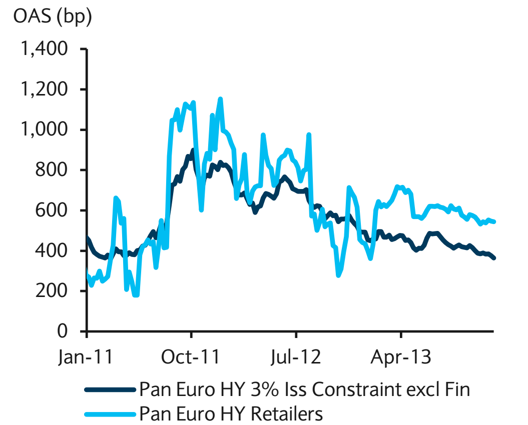
## Sector outlook

We maintain our Overweight rating on the Pan-European (PE) HY Retail index. The sector remains among the highest yielding in the PE HY Index (currently quoted at 6.92% YTW and 544 OAS compared with the PE HY 3% ex fin index at 4.38% YTW and 364 OAS) despite having performed inline with the index over the past 12 months (total returns LTM of 10.32%, versus 10.66% for the overall PE HY 3% ex-fin index).

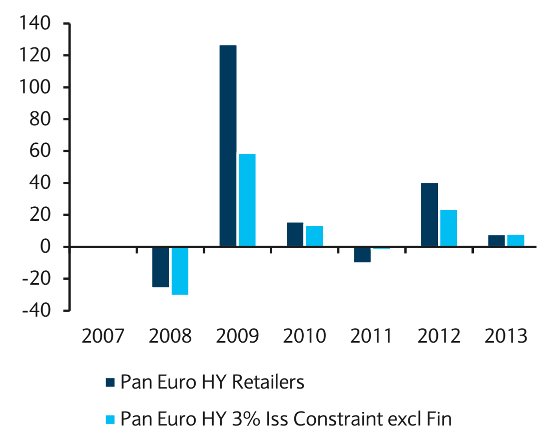
**UK retail:** Echoing comments made by our equity colleagues in their report, *Is there further upside remaining*, 4 September 2013, we believe that a UK economic recovery has been predominantly priced in. In our view, the rising tide that lifts all ships has already occurred and investors' focus should now be on the retailers that can actually deliver against rising expectations. Interestingly, we note that most of the upside to earnings has been driven by improvements in margins resulting from lower mark-downs and/or better stock management, while LFL performance remains volatile. In the context of the unpredictable British weather, we are more bullish on retailers with a "real story" and an ability to drive sale growth through: 1) range expansions; 2) up-selling and cross-selling; and 3) international expansion.

**Top picks & pans:** Our top picks remain New Look (OW) and House of Fraser (OW), as we remain bullish on both companies' "retail story". We remain cautious on Matalan (UW 17s) given the higher execution risk, scope for further guidance downgrade on the back of the unseasonal weather in October.

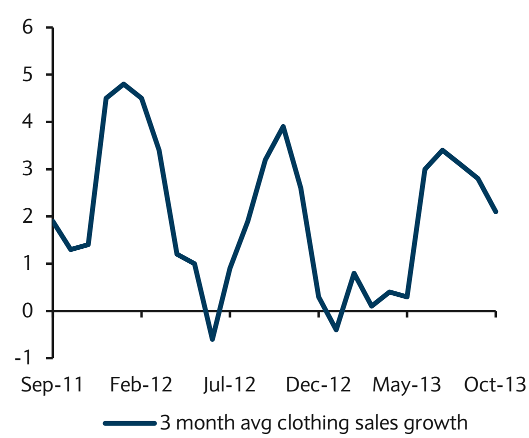
**Sector OAS versus the PE HY excl Fin index**




**Total returns performance versus index, %**




**UK 3-month average clothing y/y sales growth, %**




Source: ONS, Barclays Research

# EUROPEAN HIGH YIELD TELECOM, MEDIA & TECHNOLOGY – MARKET WEIGHT

Daniel Rekrut
+44 (0) 20 7773 5980
daniel.rekrut@barclays.com

Jonathan Horner
+44 (0) 20 7773 5286
jonathan.m.horner@barclays.com

## Key recommendations

**We remain comfortable with the fundamental and operational profiles of European HY TMT issuers in the majority of situations.** Given this favourable opinion, we have Overweight ratings on the subordinated portions of the Ono (10.875%, 11.125%), UPC (6.375%, 6.750%), Matterhorn (9.000%) and Sunrise (8.750%) capital structures given the higher yields these securities offer. Alternatively, for capital structures in which investors receive limited additional yield in the subordinated notes, we recommend staying in the senior secured notes. Therefore, we have Overweight ratings on UnityMedia (5.500%, 5.750%, 5.125%, 5.625%) and Wind (7.375%, 7.250%, 6.500%).

**Relative value analysis will also continue to play an important role in 2014.** Given that there are more than 52 individual bond issues across the senior secured, subordinated and PIK portions of the eleven issuers in the European Cable sector, opportunities to take out cash points and reduce leverage while maintaining/potentially increasing yield will continue to exist. These same opportunities exist within mobile and fixed line operators, although to a lesser extent.

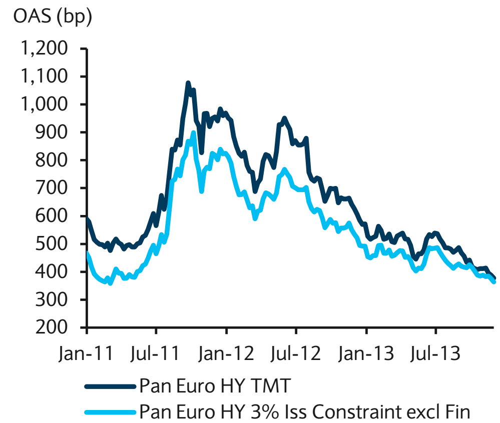
## Sector outlook

**Consolidation continues to support spreads and valuations in the sector, specifically within the cable segment.** Names with public equity, including Numericable, Telenet and Ziggo, trade at EV/EBITDA levels of over 10.0x. Additionally, during 2013, Vodafone purchased Kabel Deutschland for 12.1x LTM EBITDA and Liberty Global purchased Virgin Media for 8.8x LTM EBITDA. We believe potential consolidation will remain an important factor of spreads through 2014. Organically, we expect cable operators to experience continued growth, mobile operators to see some signs of stabilisation and continued pressure on fixed line operators.

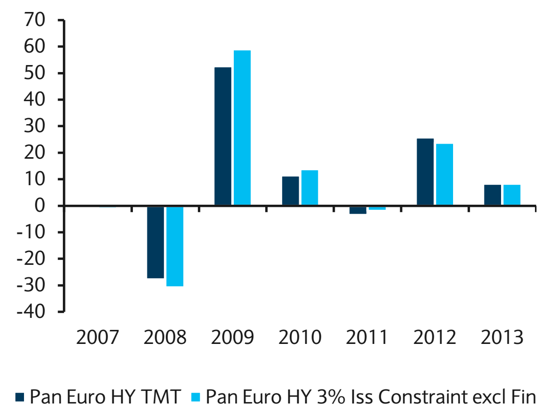
**There are several bonds that become callable and could be refinanced at favourable rates in 2014.** Based on our calculations, there are more than €20.0bn (equivalent) of European HY TMT notes that are either currently callable or become callable during 2014. We believe that several issuers will refinance debt where possible to capitalise on favourable credit conditions. Furthermore, we calculate approximately €4.0bn (equivalent) of notes that mature during 2014. Given these factors, we expect significant issuance in the European HY TMT sector over the coming year.

**Fallen angels/incumbent issuers continue to provide trading opportunities.** Names including Telecom Italia, and OTE are now included in the European HY index. We believe these names will continue to provide interesting trading opportunities given their varied capital structures. Alternatively, we see limited scope, if any, for the existing European HY TMT issuers to move into the investment grade rating category.

Pan Euro HY TMT OAS versus Index




Total returns versus the PEHY 3% excl. Financials, %



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# Asia-Pacific sector outlooks

# AUSTRALIAN BANKS – MARKET WEIGHT

Krishna Hegde
+65 6308 2979
krishna.hegde@barclays.com

Lyris Koh
+65 6308 3595
lyris.koh@barclays.com

## Key recommendations

**We have Market Weight ratings on the big four Australian banks – ANZ, CBA, NAB and WSTP.** While valuations of their senior bonds are tight relative to their benchmark, we do not see any catalyst for underperformance in 2014. Fundamentals of the banks remain sound, and we expect technicals in the USD senior space to remain supported by banks' issuance of covered bonds.

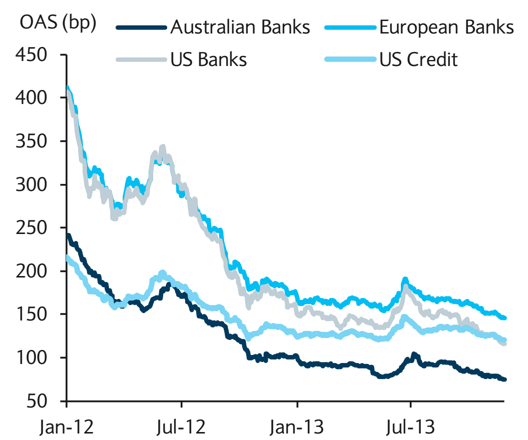
## Sector outlook

**Fundamentals to remain stable.** Despite our economists' forecast for weaker economic growth in 2014, we expect bank fundamentals to remain broadly steady. Overall, we expect profitability to stay healthy, supported by continued low credit costs and muted (albeit still positive) credit growth. Some banks have expressed optimism that improved business confidence could lead to a pickup in business credit growth. While we are less optimistic, this could be a potential tailwind for earnings in 2014. We expect banks to remain focused on cost control, but given that cost to income ratios are already relatively low, we do not expect a further significant boost to bottom lines as a result.

**Domestic Systemically Important Bank capital buffers in focus.** In its annual report, APRA said it intends to publish the key elements of its D-SIB methodology by end-2013 and expects the framework to be implemented from 2016. Local media have reported that the capital charge may be 1.0-1.5pp. Given the healthy organic capital generation capacity of the Australian banks, we believe they will be able to meet the D-SIB charge comfortably. In addition, banks have the flexibility of raising capital through their dividend reinvestment programmes and/or lowering their dividends.

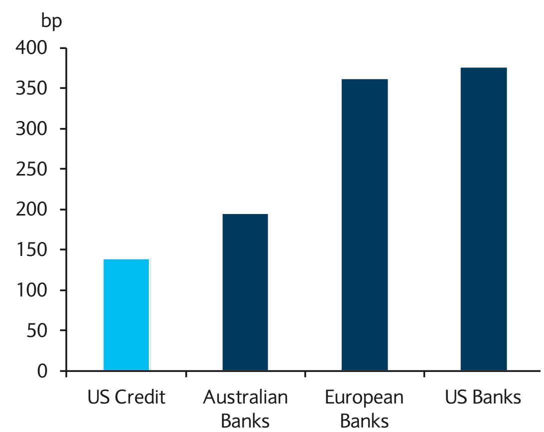
**Concerns about housing bubble to continue.** Housing prices in Australia have climbed, spurring concerns about housing bubbles and the associated asset quality risks for Australian banks. While we agree that trends in the housing sector require close monitoring, given banks' relatively large exposures to mortgages and the low interest rate environment in Australia, we do not expect mortgage NPLs to climb significantly in 2014. Mortgage credit growth has not been especially strong in Australia, and loan-to-value ratios are comfortable. In a survey conducted earlier this year, APRA also found that Australian banks generally followed good practices in evaluating the loan serviceability of borrowers during the housing loan approval process (*APRA Insight - Issue 2 2013*).

### OAS of bonds



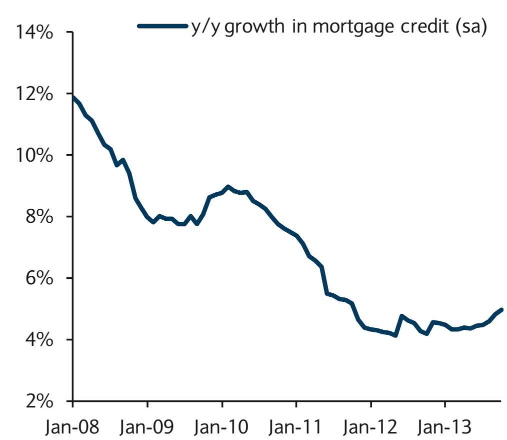

Note: As of 29 November 2012. OAS is for index comprising major banks. Source: Barclays Research

### Excess returns




Note: As of 29 November 2013. Excess Return is for index comprising major banks. Source: Barclays Research

### Mortgage credit growth




Source: RBA, Barclays Research

# ASIA NON-JAPAN BANKS – MARKET WEIGHT

Lyris Koh
+65 6308 3595
Lyris.koh@barclays.com

Krishna Hegde
+65 6308 2979
krishna.hegde@barclays.com

## Key recommendations

We recommend a barbell approach to positioning in the Asian banks senior space. In particular, we see value in Korean financials. While spreads of the Korean banks are tighter than the benchmark, we think they offer good risk-adjusted returns, given their defensive nature. We prefer the policy banks to the commercial banks, as we think spreads on the former could tighten on demand from US investors, as well as buying for banks' High Quality Liquid Assets pool.

With S&P almost ruling out a downgrade of India's rating before the national elections, we think selected Indian banks offer good carry, notwithstanding the ongoing deterioration in fundamentals. However, following IDBI's downgrade by S&P, we think there is increased downgrade risk for the smaller state-owned banks. Our top pick in the Indian banks space is ICICI Bank (Overweight).

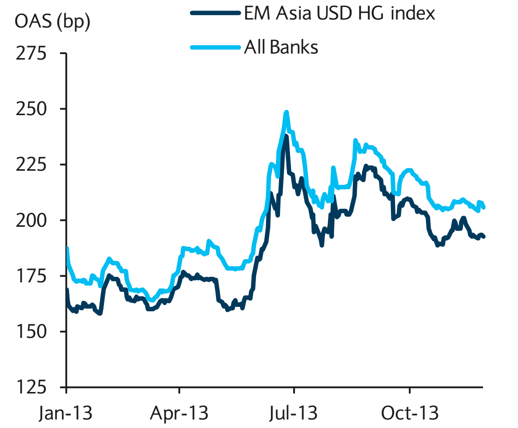
## Sector outlook

**We expect fundamentals to be stable to slightly weaker in 2014.** With liquidity expected to tighten across the region as Fed tapering commences, we think loan growth is likely to slow across most banking systems. Earnings growth momentum should consequently moderate, in our view, especially given that NIMs are unlikely to show significant improvements until interest rates rise. Asset quality has been relatively resilient but we do not see scope for further improvement, as NPL ratios are at the lows for most banks. Indeed, we think the bias is for NPLs to increase as loan books season following years of robust loan growth.

**Increased focus on capital management.** We believe most Asian banks have gained comfort with the rules of the Basel III capital regime and will increasingly focus on optimising their capital structures, especially as greater proportions of Basel II instruments are phased out over the coming years. Consequently, we expect the exercise of call options (where possible and economically sensible), tenders and bond exchanges to pick up. We also expect issuance of Basel III T1 and T2 bonds to increase in 2014. In our view, Singaporean banks are potential issuers. Indian banks (eg SBI, IDBI) have also expressed interest in issuing bank capital instruments. Following ICBCAS's and CINDBK's Basel III LT2 issuance, we expect some of the smaller banks (BNKEA, DAHSIN) to follow.

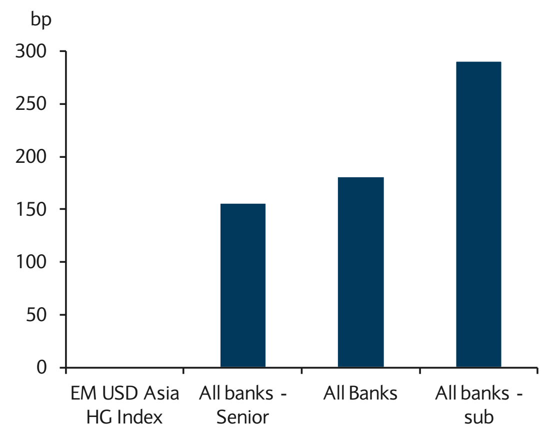
**Attention will turn from Basel III capital to liquidity rules.** With the Basel III capital rules in place across most Asian banking systems, we expect regulators' and, consequently, banks' focus to turn towards the liquidity rules. Several regulators (eg MAS, HKMA) have released consultation papers regarding the implementation of the liquidity rules and we expect final guidelines to be issued in 2014.

**OAS: Banks versus EM Asia USD High Grade Index**



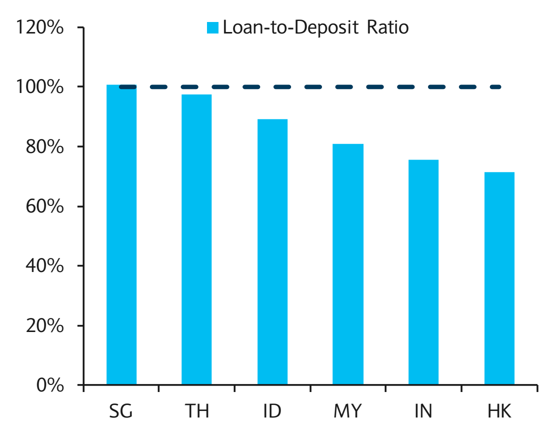

Note: As of 29 November 2013. Source: Barclays Research

**Excess Return: Banks versus EM Asia USD High Grade Index**




Note: As of 29 November 2013. Source: Barclays Research

**Liquidity likely to tighten in 2014**




Note: Data till end-October (except for Thailand and Indonesia). Source: Central banks, Barclays Research

# ASIAN HIGH GRADE DIVERSIFIED INDUSTRIALS – UNDERWEIGHT

Justin Ong
+65 6308 2155
justin.ong@barclays.com

Eugene Tham
+65 6308 3180
eugene.x.tham@barclays.com

## Key recommendations

**Overweight China Railway Construction Corporation (A3/A- Stb), Market Weight Hutchison (A3/A-/A- Stb).** We expect CRCC to maintain its A3/A- ratings and to benefit from its high contract backlog and government-driven railway investment. The Hutchison cash complex should be well supported by the group's diversified portfolio and steady operating results. The HUWHY hybrids may provide attractive spread upside, subject to the evolution of the group's M&A and divestment activities.

**Underweight POSCO (Baa2 Stb/BBB+ Neg/BBB+ Neg) and Hyundai Motor (Baa1/BBB+/BBB+ Stb).** Moody's rating downgrade on POSCO was in line with our expectation: POSCO continues to be weakly positioned in the high-BBB rating, and the steel market remains operationally challenging. While Hyundai Motor's operating margin and performance remain solid compared with its global peers, we view the spread level as far too tight for the relatively weak domestic market, currency risks (stronger KRW) and competitive environment.

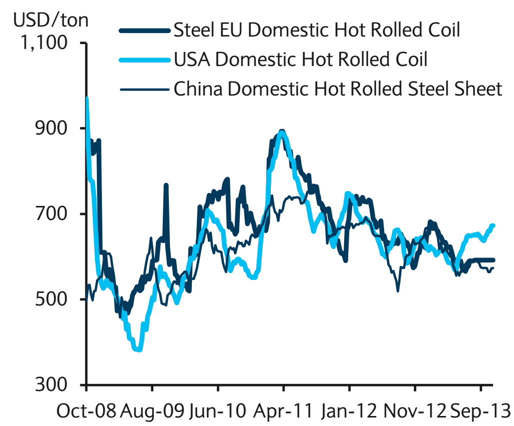
## Sector outlook

**Steel industry continues to have oversupply and weak demand growth.** The State Council of China is pushing to reduce the country's steel production capacity by 80mtpa (vs 2012 domestic level: 708mtpa, global level: 1,510mtpa). The cut is higher than the 48mtpa target (by 2015) set by the Ministry of Industry and Information Technology. For effective execution, the government needs to overcome various headwinds, especially the potential resistance from local governments. As for input costs, the iron ore price could weaken due to higher production capacity from Australia, though the decline could be marginal as producers adjust their supply to maintain profitability.

**Hong Kong property sector: soft outlook ahead.** The property cooling measures (additional stamp duties for non-local buyers, higher home supply, LTV adjustments, longer presales period) will pressure property prices and sales volume. Barclays equity analysts expect residential prices to decline 30% by end-2015 (more negative than consensus estimates), aggravated by weak household income growth and higher interest rates. While we think the investment property portfolio will generate stable income and partly mitigate the effect of the weaker property development business on credit ratings, the softer property outlook will still weigh on investor sentiment.

**Hong Kong conglomerates: diversified portfolio supports ratings but acquisitions and divestments will drive credit quality.** While we expect Hutchison to maintain a solid credit profile, it would hinge on a balance of steady operating performance, disciplined M&A and the outcome of its strategic review for its Watson retail unit, which may lead to some divestment.

### Global steel prices




Source: Bloomberg

### China iron ore prices


Note: Iron ore fines 62% Fe spot (CFR Tianjin port).
Source: Bloomberg

### Private domestic property price indices in Hong Kong


Note: Rating and Valuation Department of Hong Kong. 1999 = 100.
Source: Barclays Research

# ASIAN HIGH GRADE RESOURCES – OVERWEIGHT

Justin Ong
+65 6308 2155
justin.ong@barclays.com

Eugene Tham
+65 6308 3180
eugene.x.tham@barclays.com

## Key recommendations

**Overweight Reliance Industries (Baa2 Stb/BBB+ Neg/BBB- Stb) and ONGIN (Baa2 Stb/BBB- Neg).** We expect RILIN and ONGC to maintain their stable credit profiles, albeit the latter will likely be more volatile, given the overhang of the sovereign ratings. Nonetheless, we expect these upstream companies to benefit from the proposed gas price increase in 2014, and their products are largely denominated in USD dollars.

**Overweight CNOOC (Aa3/AA-/A+ Stb).** CNOOC continues to be our preferred Chinese oil and gas company, given the strength of the Chinese government support and its strong cash generation capability, as well as its more diversified portfolio following the acquisition of Nexen.

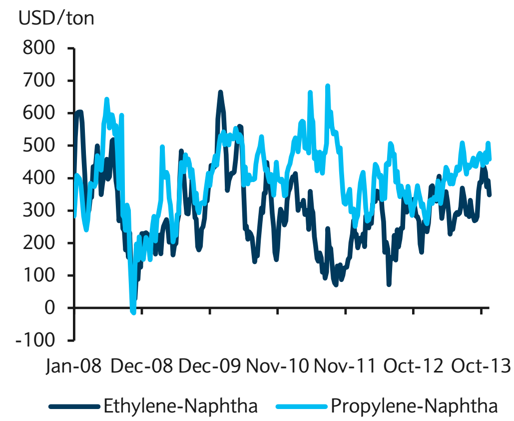
## Sector outlook

**M&A and high capex will drive bond supply.** We expect the oil and gas companies to look for more acquisition opportunities to secure energy resources, though deal sizes could be somewhat smaller than those over the past 12 months (CNOOC's acquisition of Nexen for c.USD14.8bn, CNPC's acquisition of an 8.4% stake in the Kashagan project for c.USD5bn). For high-risk investments that require high development costs, companies will likely continue to prefer participating through joint ventures. For certain companies, there could be selective disposals of downstream refining operations (Harvest in Canada) as KNOC, for example, seeks to reduce its leverage level and focus on improving the profitability of its existing upstream portfolio.

**Petrochemical demand to improve y/y in 2014,** assuming that global economic outlook remains steady. Companies are still investing in higher olefin and aromatics capacity, so the margin evolution (olefin-naphtha and the aromatics-naphtha spread) would depend on the scale of capacity additions, utilization rates and feedstock costs. PTTGC will continue to benefit from the domestically produced gas-based feedstock from its parent, PTT PCL.

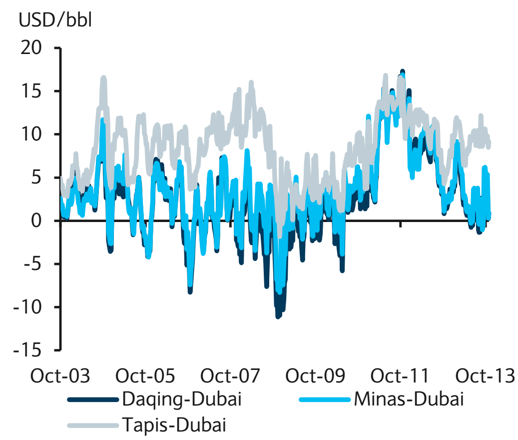
**Government policies a key factor.** In India, the government has proposed doubling the gas price (currently USD4.2mmbtu) from April 2014, which would be positive for the upstream companies. The deregulation of domestic diesel prices and further progress in phasing out diesel subsidies would improve India's fiscal position. In China, there may be some incremental reforms in energy price controls and government efforts to draw in private investments to the energy sector. The JV between China and Russia is positive for the Chinese oil and gas companies, especially CNPC. Higher oil imports from Russia would increase the profitability of CNPC, while the JV to develop the Taas Yuryakh oil field (East Siberia) should diversify its portfolio. Barclays expects an average WTI crude oil price of USD96.5/bbl in 2014 and average Brent crude price of USD104.8/bbl.

**Olefin-Naphtha spread**



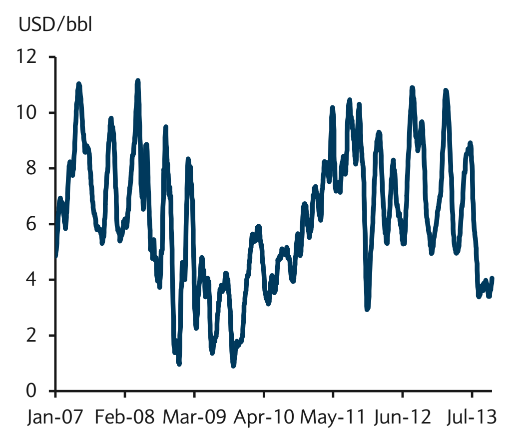

Note: Olefins include ethylene and propylene.
Source: Barclays Research

**Oil spread prices between Asia and Dubai**




Note: Crude oil spot price in China (Daqing), Indonesia (Minas) and Malaysia (Tapis). Prices are shown on a weekly basis.
Source: Bloomberg

**Reuters Singapore-Dubai crack spread**




Source: Reuters, Barclays Research

# ASIAN HIGH GRADE TELECOMS AND MEDIA– MARKET WEIGHT

Justin Ong
+65 6308 2155
justin.ong@barclays.com

Eugene Tham
+65 6308 3180
eugene.x.tham@barclays.com

## Key recommendations

**Market Weight HKT Trust & HKT Limited (Baa2/BBB Stb) with a preference for the unrated PCCW 5.75% '22s.** We expect HKT Trust/HKT Limited to deliver steady operating results through 2014, helped by its strong positions in the HK fixed line and broadband market. We continue to view the unrated PCCW '22s (guaranteed by the parent PCCW Ltd.) as the most attractive in the PCCW/HKT cash complex on valuation grounds.

**Buy Tencent '18s (Not Rated, Baa1 Pos/A- Stb).** In our view, the Tencent '18s look relatively attractive for what we view as a low-single A credit. We expect the Tencent '18s to trade 5-10bp wide of the Baidu '18s (Not Rated, A3/A Stb), reflecting converging credit quality between the two companies. We expect Tencent to demonstrate progress in mobile monetisation in 2014 and record stable revenue growth, underpinned by its strong games and social network revenues and driven by further diversification into the e-commerce business.

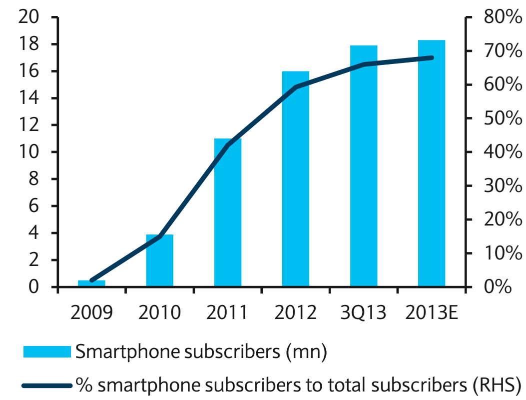
## Sector outlook

**Regulatory oversight on competitive matters.** The competitive environment, especially in the LTE segment in South Korea, has been partly mitigated by the Korean Communications Commission's (KCC) action to rein in the excessive subsidy policies of mobile operators. KCC could impose further penalties and temporary bans on subscriber acquisitions by operators that violate the KCC regulation. In Hong Kong, the Communications Authority will auction a third of mobile spectrum in 4Q14 to reallocate spectrum when existing licenses expire in October 2016; this is credit negative, due to the scope for further cash outflow.

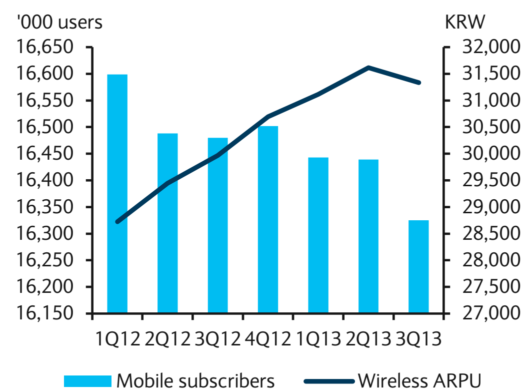
**Capex spending will ease.** In South Korea, the three major operators (SKT, KT, LGU) should see their capex needs moderate following their recent LTE investments.

**Strong credit quality, but watch the acquisition risks.** Acquisition risks will likely be the main headwind, as we expect Baidu and Tencent to invest heavily in the mobile internet sector. Nevertheless, we take comfort in their strong credit profiles and relatively prudent approach in target selection and M&A financing. The monetisation potential from their mobile platforms provides optimism, despite increasing competition, and we would look for a stable track record of consistent revenue generation from their mobile businesses in the next 12-18 months. We expect margins to remain stable for both Baidu and Tencent, as margin compression from intensifying competition would likely offset improved margin contributions from their mobile businesses.

**SKT smartphone subscribers**

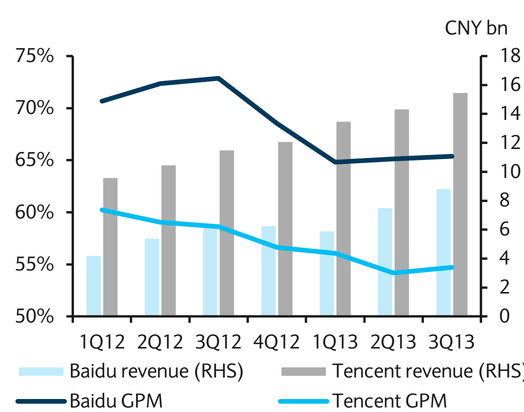



**KT Corp's wireless ARPU growth turning negative q/q**




Source: KT Corp company reports

**Baidu and Tencent – profit margins decline but remain strong**




Source: Company reports, Barclays Research

# ASIAN HIGH GRADE UTILITIES – MARKET WEIGHT

Justin Ong
+65 6308 2155
justin.ong@barclays.com

Eugene Tham
+65 6308 3180
eugene.x.tham@barclays.com

## Key recommendations

**Neutral on Chinese gas distribution companies.** China Resources Gas (Baa1/BBB+ Stb), Beijing Enterprises Holdings (Baa1 Stb/A- CW Neg) and ENN Energy (Baa3 Stb/BBB- Stb/BBB Pos), with a preference for the XINAOG '21s. We expect the major Chinese gas distribution companies to benefit from government policies expanding gas consumption in China, albeit the high capex needs and acquisitive activities are the key risks to credit quality. In our view, the XINAOG '21s offer attractive spread upside for a stable Baa3/BBB- credit.

**Korea utilities: prefer Korea Gas (MW) versus KEPCO (UW) and its thermal gencos.** While the Korean quasi-sovereigns continue to face heavy capex needs and high operating costs, we view Korea Gas as relatively more attractive, given its deleveraging activities (share placement) and the government's plan to pull back the growth of nuclear power; this would sustain the importance of LNG in South Korea's energy mix.

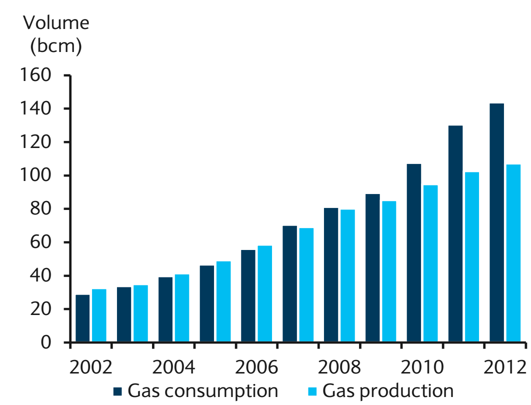
## Sector outlook

**Margin performance depends on tariff and input costs.** Gas distribution companies are largely able to pass through the higher cost of the city-gate prices for natural gas to their commercial and industrial end-users. Over time, the National Development and Reform Commission (NDRC) of China will likely extend the price adjustment to the residential segment. In Korea, the higher dependence on expensive LNG imports due to slower growth in nuclear power should weigh on the margins. Positively, the Korean government authorized a 5.4% average tariff hike in November, helpful for KEPCO's margins.

**High capex to persist.** In South Korea, KEPCO plans to raise its generation capacity to 86.3GW by 2016 and 105GW by 2024 (end-2012: 69.5GW). Between 2013 and 2016, KEPCO plans to spend over KRW74trn in capex. We also expect the Chinese gas distribution companies to maintain their relatively high capex program, given their medium-term growth targets. Beijing Enterprises Holdings plans to increase its sales volume to 15bcm by 2015 (2012: 7.94bcm) and CR Gas intends to achieve gas sales volume of 20bcm (FY12: 9.3bcm).

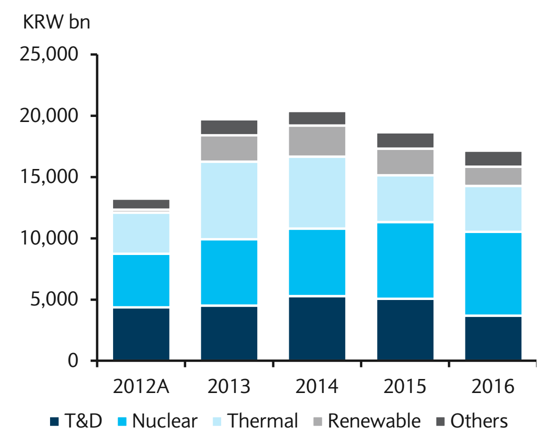
**Government policies continue to dominate.** In China, government policies to support natural gas and other clean energy sectors (wind, hydropower, solar) will likely drive investments in these areas. We expect the major gas distribution companies to remain keen on growing their gas distribution networks. In South Korea, the government has scaled back its growth plans for nuclear power generation, due to public safety concerns and the scandal over substandard parts in nuclear plants. The Energy Ministry recently said that nuclear will account for c.29% of the energy mix by 2035, instead of the original c.41% target (FY12: 20.7GW, c.25% mix). The Korean government has been pushing state-owned companies to reduce their leverage. Accordingly, KEPCO will sell its stakes in certain entities (KEPCO Engineering, LG UPlus) and real estate to reduce debt.

### Consumption/production of natural gas in China



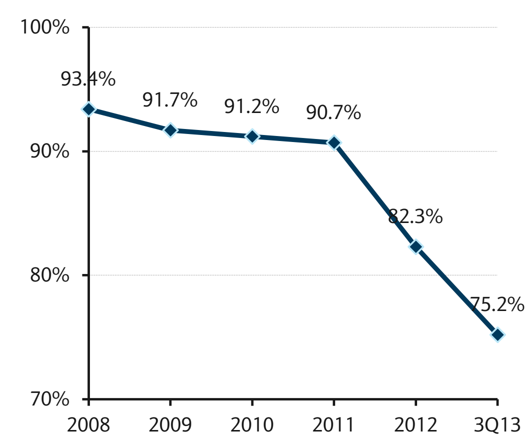

Source: BP Statistical Review of World Energy 2013

### Capex projections for KEPCO and the 6 gencos




Note: T&D = transmission and distribution.
Source: Company reports

### Nuclear capacity factor, South Korea




Note: The decline in nuclear capacity factor in 3Q13 was due to higher maintenance days, largely related to the replacement of substandard parts. Source: Company reports, KHNP

# ASIA HIGH YIELD DIVERSIFIED INDUSTRIALS NORTH ASIA – OVERWEIGHT

Jit Ming Tan
+65 6308 3210
jitming.tan@barclays.com

## Key recommendations

**Carry on.** Sector valuations look fair, and we see limited scope for material capital gains. We expect 2014 sector returns to be mainly carry-driven. We believe outperformance is likely to come from selective risk-taking among the laggards and through primary participation. Technicals are supportive as we think institutional investors are under-invested in the sector. In addition, a material number of bonds are short-dated, with maturities of two to three years. Overall, we expect the sector to outperform the broader EM Asia HY Corporate index on its still high carry and supportive technicals.

**Overweight the laggards.** We have Overweight ratings on the Hyva '16s, the CITIC Pacific 8.625% perpetuals and the Shanshui '17s. These bonds have materially outperformed in recent months. While we do not expect yields to compress significantly in 2014, we believe they continue to offer attractive carry relative to their peers. We also remain comfortable with their credit profiles despite high leverage, especially in the case of Hyva and CITIC Pacific.

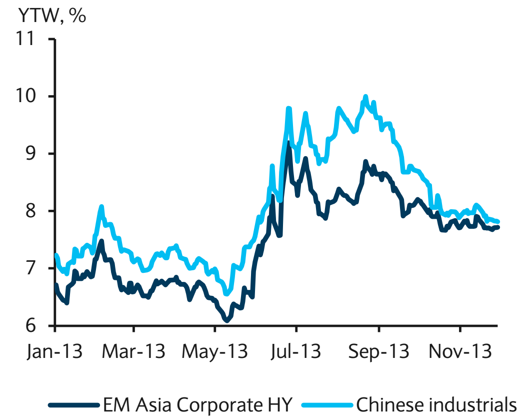
## Sector outlook

**Stable outlook.** Barclays forecasts China's GDP to grow 7.2% in 2014, compared with the consensus expectation of 7.5%. Consistent with our macro forecast, we expect mid-single digit EBITDA growth for Chinese industrial corporates under our coverage. Chinese corporates are mostly cautious on the outlook and have curtailed capex plans due to expectations of flat prices and margins, concerns over funding availability and lack of policy clarity from the government. We think this caution will result in stable credit profiles in 2014.

**Liquidity pressure easing.** Chinese industrial corporates generally reported improved liquidity on lower working capital in 1H13. We expect liquidity to strengthen further in 2014 as industrial corporates keep capex plans in check and strive to reduce working capital. In addition, notwithstanding tight onshore liquidity conditions, Chinese corporates have been able to obtain alternative funding offshore. Fufeng and Fosun both issued convertible notes in November while Hilong completed a syndicated loan in September after failing to issue in the USD bond market in June 2013.

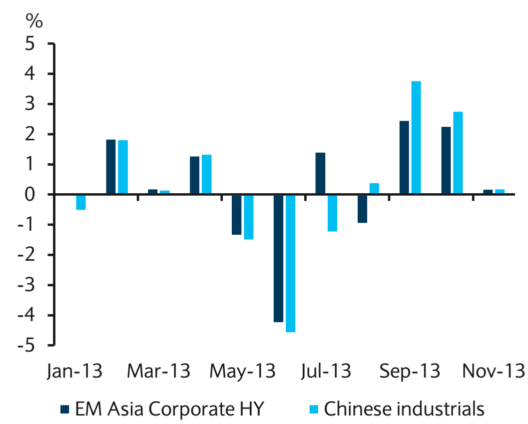
**Supply to pick up.** A combination of rising domestic interest rates, potential refinancing of callable bonds and likely greater policy clarity from the government could prompt more Chinese corporates to access to the USD bond market. At the same time, we believe price expectations of corporates and investors are converging again after the risk-off in the summer of 2013. We expect bond issuance to increase in 2014. In the absence of significant fund inflows, we expect investors to be selective and disciplined towards issuers.

**Sector still yields more than index**



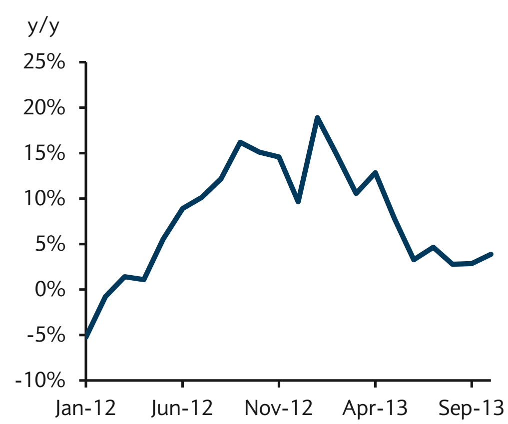

Source: Barclays Research

**Total returns have improved since summer**




Source: Barclays Research

**China: new loan growth, 12m rolling average y/y**




Source: Barclays Research

# ASIA HIGH YIELD DIVERSIFIED INDUSTRIALS SOUTH ASIA – MARKET WEIGHT

Erly Witoyo
+65 6308 3011
erly.witoyo@barclays.com

## Key recommendations

**Buy Multipolar '18s (Not Rated; B+/B+).** We expect the credit to benefit from strong consumption growth in Indonesia. The bonds look cheap compared with other 'B' Indonesian corporates. This partly reflects higher structural subordination risk given the holdco bond issue. However, we expect this concern to ease as dividend flows from subsidiaries increase. The bonds also provide attractive carry.

## Sector outlook

**Property.** Industry growth is likely to slow significantly in 2014, in our opinion. Recent rate hikes and home lending restrictions will impact demand and limit ASP growth. Issuers also expect fewer project launches in 2014 due to a slowing market. Long-term fundamentals for the sector remain robust, nonetheless. We expect rising urbanisation and land shortages, especially in the Greater Jakarta region, to drive demand over the medium term.

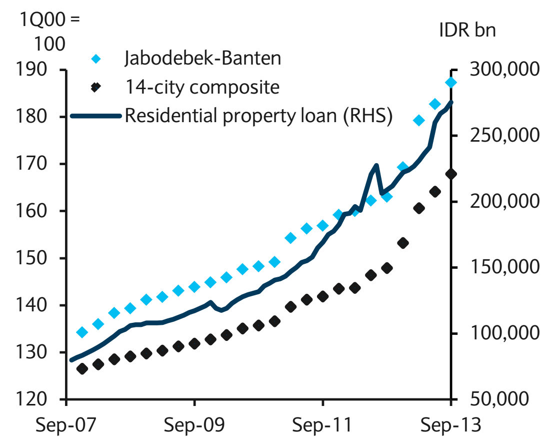
**Consumer sector.** We are positive in near-term consumer demand given Indonesia's rapidly growing middle class. Election-related spending should also boost household consumption in 1H14, which should benefit issuers like Japfa and Multipolar. Bhakti is also likely to post higher earnings in 2014 as ad spending normally increases in an election year.

**Tyre.** The IDR depreciation will increase operating and financing costs for Indonesian tyre producers. Historically, companies likely Gajah Tunggal have passed on higher costs to customers. Increased competition in the domestic market, however, will likely limit this ability. We expect continued growth in the domestic replacement tyre market, although this will be partly offset by weaker export sales.

**IDR depreciation.** The near-term impact from IDR depreciation is limited for most issuers. They do not have large USD repayment needs over the next 12 months. Additionally, most maintain a large USD cash balance from recent bond issues, which can be utilised to service USD financing costs. Companies that have USD operating costs face the highest risk from a weak IDR. This includes Gajah Tunggal and Japfa.

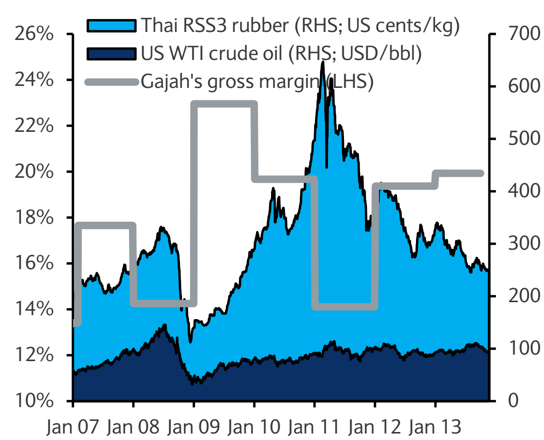
**Limited supply risk.** Bond technicals should remain favorable in the near term as new issuance is likely to be limited. A slowing growth outlook, weak IDR, and high hedging costs are likely to reduce the appeal of issuing USD bonds. Weaker credits with limited access to bank lending, may opportunistically come to the market.

**Indonesian property – The end of rapid growth?**



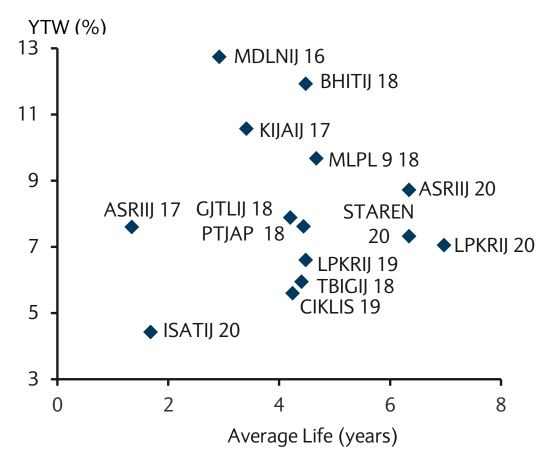

Source: Bank Indonesia, Bloomberg, Barclays Research

**Tyre – Low rubber prices a boost to profit margin**




Source: Bloomberg, Barclays Research

**Indonesian industrials – RV comparison**




Source: Barclays Research

# ASIA HIGH YIELD RESOURCES – MARKET WEIGHT

Erly Witoyo
+65 6308 3011
erly.witoyo@barclays.com

Jit Ming Tan
+65 6308 3210
Jitming.tan@barclays.com

## Key recommendations

**Buy Vedanta '21s (Overweight; Ba3/BB-/BB).** The bonds trade wide versus similar-rated peers. We believe Vedanta's credit profile has significantly improved following the completion of its corporate restructuring, which pushed down USD5.9bn of debt from the holdco to a key subsidiary Sesa Sterlite. We expect further deleveraging in 2HFY14 as free cash flow is likely to be positive on higher earnings and lower capex.

**Buy MIEHOL '18s (Overweight NR/B+/B both Stb).** We expect the independent E&P operator to report 6% y/y revenue and EBITDA growth in 2014, although leverage will rise due to debt-funded capex. The MIEHOL '18s remain one of the wider Chinese HY corporate bonds and we believe there is scope for yields to compress 20-30bp.

## Sector outlook

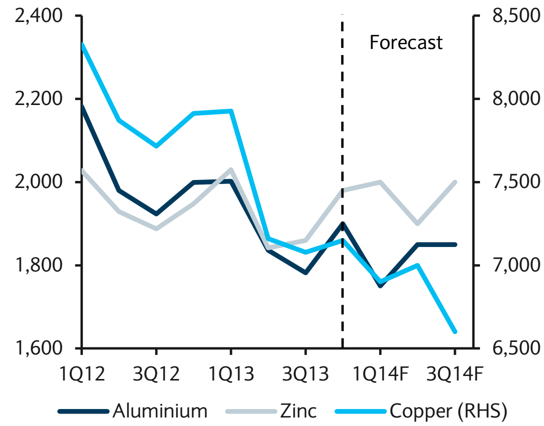
**Neutral sector outlook.** While China's economic growth is expected to slow in 2014, we believe most commodity prices are likely to be flat to slightly higher in the near term. Production rationing has resulted in more balanced demand and supply fundamentals. Most issuers in the sector are likely to report stronger earnings in 2014 on higher production. Increased capex, however, means limited improvement in near-term credit profiles.

**Base metals.** We have mixed-views on the near-term outlook for base metals. Copper prices are expected to continue sliding in 2014 on oversupply. Zinc may see a slight rebound on strong demand growth. Aluminium is likely to trade range-bound – high inventory levels are likely to decline as producers undertake supply rationing. Overall, these trends bode well for Vedanta as zinc generates most of its earnings among the three metals. The company should also see a boost from production expansion at its oil and metals units. Assuming Vedanta does not undertake a significant debt-funded acquisition, we expect further improvement in its credit profile.

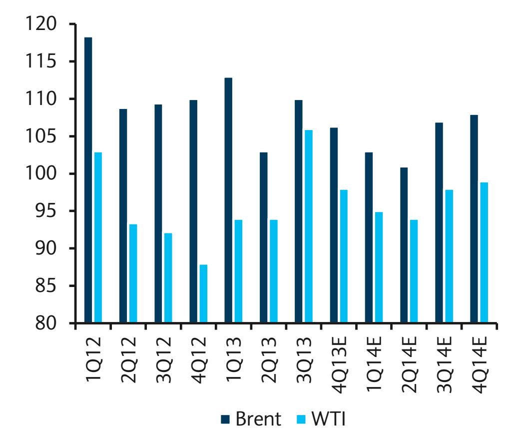
**Oil and gas.** Barclays forecasts Brent will average USD105/bbl in 2014, versus 2013 estimate of USD108/bbl. We expect independent upstream operators to report mid-single digit EBITDA growth on volume growth, partly offset by higher lifting costs. Chinese oil field service (OFS) companies should see more activity as the country increasingly taps unconventional and/or tight energy assets to boost production. We expect earnings growth to be offset by rising leverage as Chinese OSF invests in new technology.

**Supply risk.** Bond issuances in 2014 will likely be for debt refinancing needs, including USD bonds (Citic Resources, MIE). Resources companies may also opportunistically issue for business expansion.

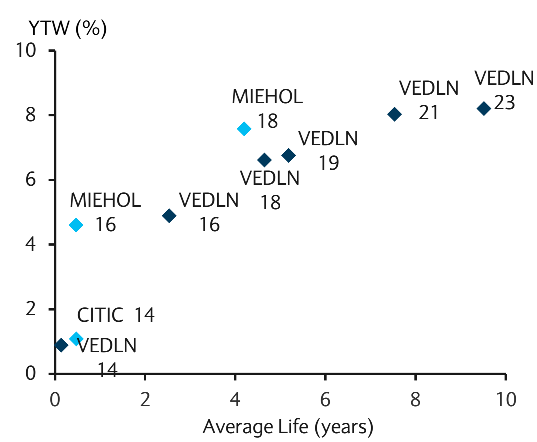
Base metals – a mixed bag




Barclays Brent and WTI forecasts (USD/bbl)




Asian HY resources compared




Source for all charts: Bloomberg, Barclays Research

# ASIA HIGH YIELD INDONESIAN COAL – OVERWEIGHT

Erly Witoyo
+65 6308 3011
erly.witoyo@barclays.com

## Key recommendations

We have an Overweight rating on the Indonesian thermal coal sector. We believe the worst is over for the sector. Near-term price recovery, along with higher production and lower costs, should support credit improvements for most issuers.

We see significant event-driven upside potential for the bonds of Berau Coal ('15s OW, '17s MW) and Bumi Resources (OW). A successful separation of Berau's parent (Bumi plc) from the Bakrie group would likely improve investors' perception of Berau's corporate governance. For Bumi Resources, a successful debt-to-equity swap with China Investment Corp (CIC) would ease refinancing concerns. Based on carry alone, the Berau '15s and Bumi Resources' bonds should outperform the Barclays Asian HY corporates index. Our Underweight rating on Indika's '18s and '23s reflects tight valuations and expected deterioration in its credit profile in the near term.

## Sector outlook

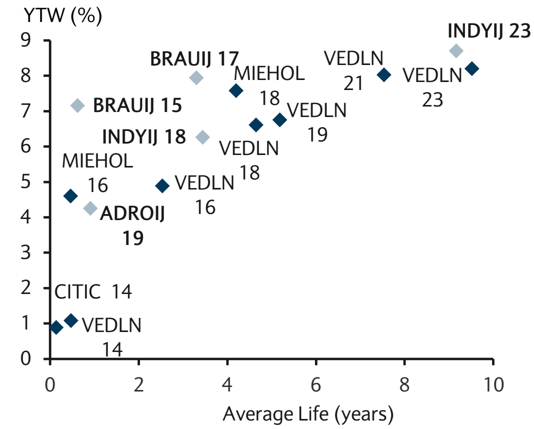
**ASP rebound in 2014.** A modest rebound in coal prices in 2014 should support sector earnings. Coal prices seem to have troughed in 3Q13, with a slow but healthy bounce since then. While the increases are partly due to seasonal factors, we believe they also reflects improved supply fundamentals as smaller and less efficient mines are closing on losses. Higher production and lower costs should also support near-term earnings growth for Indonesian issuers in the near term.

**Stronger debt metrics.** We expect a turnaround in credit metrics after two years of deterioration (see graph). Apart from higher earnings, we may see lower debt levels in 2014 if issuers remain prudent in their capital spending. Only Bumi Resources seems to face downgrade risks over the next 12 months. S&P indicated it may lower its ratings on Bumi Resources to SD upon the completion of its debt-to-equity swap with CIC. The ratings agency views the swap as a distressed debt exchange.

**Robust liquidity.** Most issuers have strong liquidity positions with cash comfortably covering short-term debt. Cash buffers provide some mitigation against the risk of another coal price decline, in our view. Bumi Resources is the exception. It had only USD57mn of cash versus short-term debt of USD893mn at end-3Q13. However, we believe its recent swap agreement with CIC should address this risk, as the deal will reduce its short-term debt by USD600mn and increase its financial flexibility.

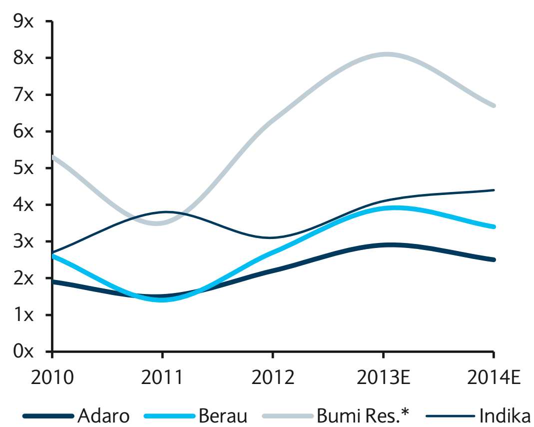
**Bond issues for refi needs.** New issuance in 2014 will likely be for refinancing of existing bonds, in our view. We see a high likelihood of Berau Coal refinancing its 2015 bonds for cost savings. However, this is only likely after a successful completion of its parent's separation from the Bakrie group. In our view, Adaro is also likely to call its bonds in October 2014. These bonds look expensive in comparison with the company's other debts.

### Indonesian coal vs Asian HY resources



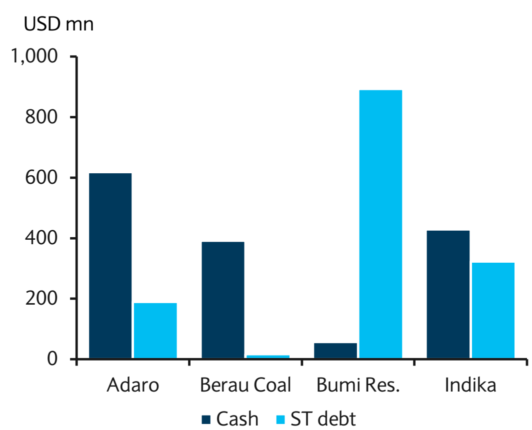

Source: Barclays Research

### Credit metrics to slightly improve in 2014




Note: * Assumes a successful debt to equity swap with CIC.
Source: Company data, Barclays Research

### Robust liquidity positions for most




Note: 3Q13 data. Source: Company data, Barclays Research

# CHINESE HIGH YIELD REAL ESTATE – MARKET WEIGHT

Christina Chiow
+65 6308 3214
christina.chiow@barclays.com

## Key recommendations

**After months of outperformance, the high yield Chinese real estate sector underperformed the EM Asia HY index in September and October. We maintain a neutral stance on the sector. In our view, sector valuations largely price in a benign policy and market outlook. We think the credit profiles of many developers have peaked, with some bond supply likely for business needs and refinancing needs.** We continue to like China Overseas Land (OW) and China Resources Land (OW) in the high grade space, and Country Garden (OW '14s, '15s, '17s, '18s, MW '21s & '23s) and Shimao (OW '17s, '18s, UW '20s) in high yield, given their strong execution and financial prudence. We also like Guangzhou R&F (OW '16s & '20s) for its prudent growth management and we expect Kaisa (OW '17s, '18s & '20s) to continue to unlock value from its urban redevelopment projects. We remain sceptical towards developers that had weak (negative) sales growth against a market backdrop of strong property sales in 2013.

## Sector outlook

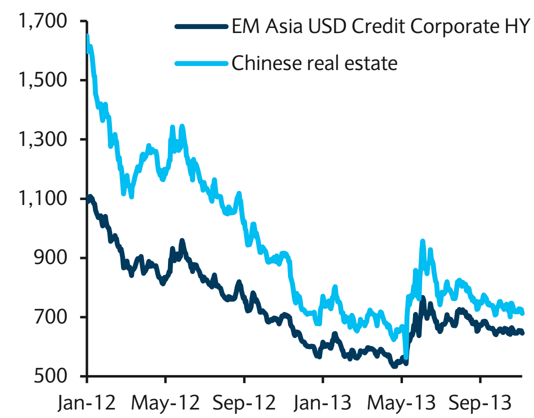
**2014 sales to slow after a robust 2013.** In 10M 13, nationwide sales rose 32.6% y/y to CNY5.2trn, on GFA growth of 22.3% y/y and price growth of 8% y/y. This reflects pent-up demand after a weak 1H 12 and the lack of excessive curbs. For 2014, our equity team forecasts a growth of 7.2% y/y. See *China Property: Coming of age*, 12 Nov 2013. The details of the Third Plenum also lead us to believe there is now more importance placed on steady growth.

**Market forces more than administrative controls likely to drive markets.** The details of the Third Plenum stressed the expanded role of market forces in resource allocation. This suggests administrative controls on property are likely to weaken gradually. Aside from policy headwinds such as property taxes in select cities, a broad regulatory tightening seems unlikely.

**Credit profiles of many developers have peaked.** A benign policy and market outlook suggest a continuation of land replenishment, which could take priority over deleveraging. But material land acquisitions could raise execution and financial risks, especially for smaller developers or developers that are highly leveraged. We also expect construction spend to increase in 2014 as developers bring on-stream the land they acquired in the past 6–9 months.

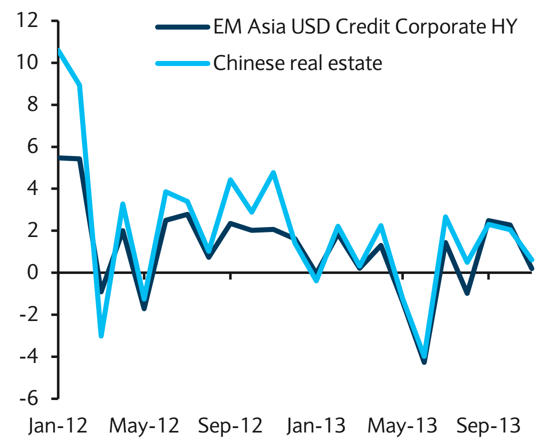
**Adequate liquidity and access to financing.** Developers shored up liquidity over the past 18–24 months, through sales and debt. This should position the sector on a stable footing. Access to the offshore debt markets (bonds and loans) should not be an issue for existing issuers. Developments in the domestic capital market may also provide a renewed funding source.

OAS, bp



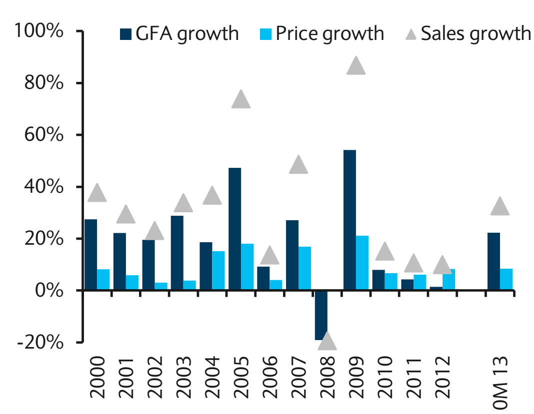

Source: Barclays Research

Total return, %




Source: Barclays Research

Property sales to slow after a robust 2013




Source: CEIC, Barclays Research

# Emerging Europe and Middle East sector outlooks

# RUSSIA/CIS INVESTMENT GRADE

Stella Cridge
+44 (0)20 3134 9618
stella.cridge@barclays.com

## Key recommendations

**In 2014, we expect issuance risk to be a theme for the Russia BBB segment**. The potential announcement of a gas export contract with China following years of discussion (see Bloomberg, 25 November 2013) could raise issuance risk for Gazprom in 2014, while Rosneft's sizeable refinancing needs linger still. However, at c.100-120bp wide of the Russia sovereign in 10yr, Russian BBBs are not overly expensive despite a resilient performance in 2013. Selected bonds still hold value given the still strong fundamental profiles of many benchmark issuers.

**Our top pick is Gazprom Neft 23s which trade wide to peers and c.125bp wide of the sovereign**. This is on account of the company's strong fundamental profile including low leverage and privileged access to new assets in Russia, following its recent visit to the market. We also like Lukoil 22s and Gazprom 22s. We would also monitor the market for any opportunities to add exposure via primary issuance.

## Sector outlook

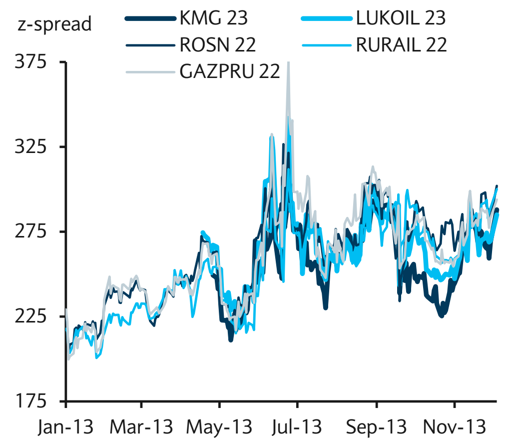
**Oil price outlook supportive of IG credit.** Russian and Kazakh corporate credit continues to be highly dependent on the oil price. Overall, our commodities team expects the Brent price to be slightly lower in 2014 at $105/bbl as non-OPEC supply growth is on track to exceed demand growth. However, in this scenario, both Russian and Kazakh sovereign and corporate credit would remain well underpinned.

**A Gazprom export contract with China could be a turning point for the Russian IG market.** Following years of negotiations, Gazprom repeatedly stated in 2013 that it is close to signing a gas export agreement with China. Such a project would bring a positive transformation of its business profile, but also require significant investments in export infrastructure (c$50bn). Gazprom could draw on both cash flow and borrowing to fund the investment, which could signal a rise in bond issuance and pressure on secondary spreads.

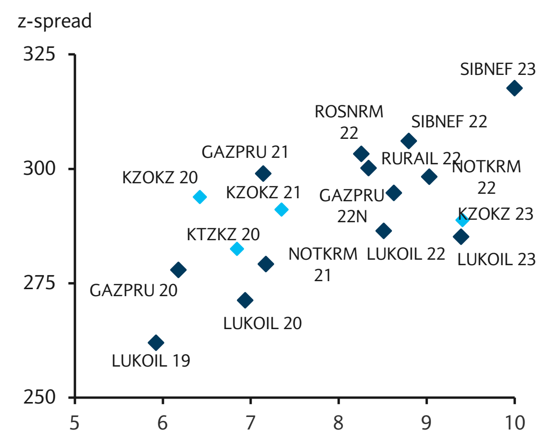
**Weak growth puts pressures on Russia quasi-sovereigns.** Amid weaker growth and higher-than-desired inflation, new demands were placed on quasi-sovereigns in 2013 including tariff freezes and higher dividend requirements. We think Russian Rail will remain exposed to these developments in 2014 given its greater domestic focus than peers.

**Kazakh growth remains robust, privatisation risks re-emerge.** The outlook for the Kazakh economy remains robust and quasi-sovereign bonds well supported given the lack of sovereign paper. However, recent news (Bloomberg, 15 November 2013) that the government may sell a stake in KMG within 1-2 years brings privatisation risk back on the agenda. Otherwise, we would not be surprised if KTZ visited the market in 2014 to fund its sizeable investment programme. We also expect KMG to refinance its $1.5bn, January 2015 eurobond ahead of schedule.

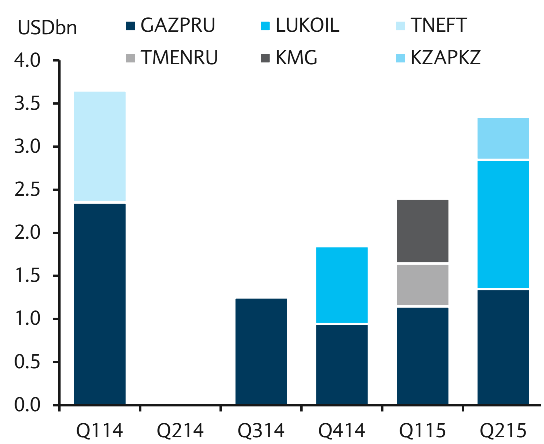
CIS investment grade spread history




CIS investment grade scatter (5-10y segment)




CIS IG Eurobond maturity profile (Q1 14-Q2 15)




Source: Bloomberg, Barclays Research

# RUSSIA HIGH YIELD

Stella Cridge
+44 (0)20 3134 9618
stella.cridge@barclays.com

## Key recommendations

**Russian telecoms continue to offer good value given their defensive profiles and moderate leverage, despite the risks of rising competition we see in 2014.** Despite VIP's still-present refinancing risks, we value its strong free cash flow, and VIP 22s and 23s offer the best value on the curve (430-450bp z-spread), trading wide to similarly-levered steel names, which still face a challenging industry outlook. The high cash price MTS 20s also offer value at 50-70bp wide of IG bonds.

**We see further downside risks to steel prices in 2014; however, pockets of value still exist in Russian steel, in our view.** We think Severstal can comfortably refinance upcoming debt given its solid credit profile, and its 2017 and 2018 bonds offer defensive exposure within the sector (c350bp in z-spread). We are also comfortable holding Evraz 17s and TMK 18s for high carry given the c.180-200bp discount to Severstal and NLMK, which we think prices in their higher leverage, although spread tightening is only likely when industry and idiosyncratic trends turn more positive.

## Sector outlook

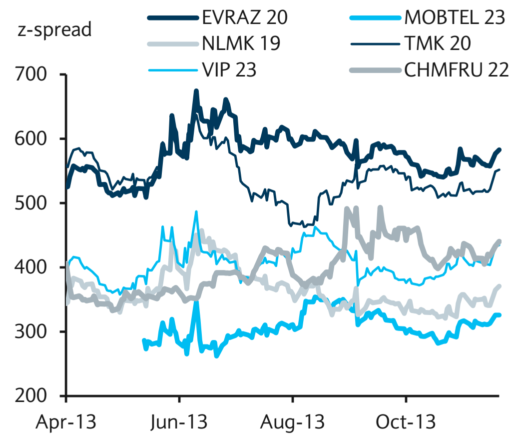
**Further downside risks to steel prices in 2014.** We remain concerned about the outlook for iron ore prices given that c.10% of the current seaborne market is likely to come onstream in 2014 and 2015. We see a risk that lower iron ore prices could pass through to finished steel prices, and depress earnings further. Positively, the liquidity position of Russian steel companies remains generally solid, and issuers such as Severstal and NLMK have moderate leverage within the global context.

**Russian steel demand remains solid, room to cut capex.** Steel demand grew in 2013, driven by increased demand from the construction sector. The outlook also remains robust, driven by the investment programmes of large state-owned companies, such as Russian Railways. Due to their low-cost position, producers also have flexibility to reduce capex further in the event of further price pressure.

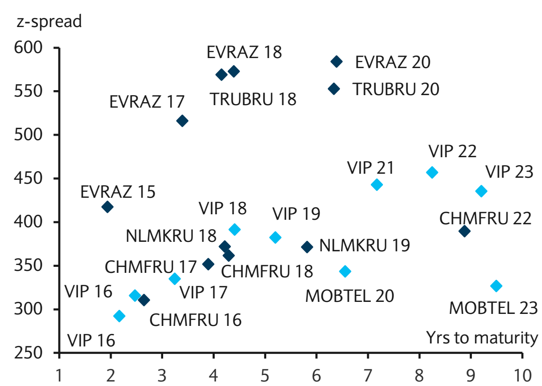
**Increasing competitive pressure likely in Russian telecoms.** Competitive pressure in the Russian market could rise in 2014 as mobile number portability becomes available and as Rostelecom rolls out mobile services in Moscow. Comments from Rostelecom's CEO also suggest a new mobile joint venture between Rostelecom and Tele2 could be formed (Bloomberg, 22 Nov 2013), adding another competitive dimension. Execution risk remains, however, and MTS, VimpelCom and Megafon all currently benefit from extensive network coverage and strong brand value.

**Refinancing remains the key theme for VimpelCom.** VimpelCom still plans to refinance the debt of its Italian subsidiary, Wind, although to date it has refrained from giving any timeline for the event. We think this could be done, in part, in 2014, and hence see issuance risk for VIP.

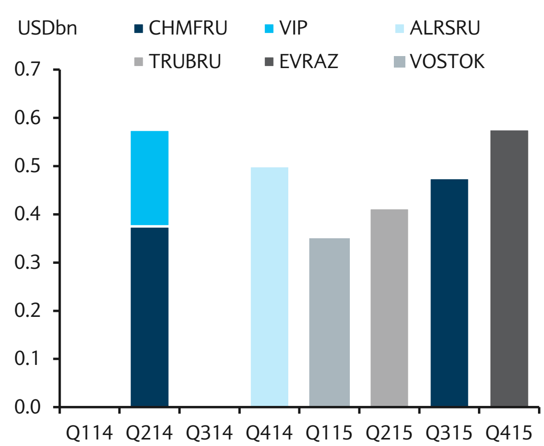
Russia high yield spread history




Russia high yield scatter




Russia high yield bond maturity profile (2014/15)




Note: Includes TMK 2015 convertible bond and Severstal 2017 convertible bond to its put date.
Source: Bloomberg, Barclays Research

# UKRAINE CORPORATES

Stella Cridge
+44 (0)20 3134 9618
stella.cridge@barclays.com

## Key recommendations

**Trading levels for Ukraine corporate bonds continue to be driven by sovereign developments and interconnectedness, while the economic and political situation in the country remains fragile.** Given the ongoing economic challenges, our sovereign analysts recommend an underweight position in Ukraine sovereign credit. However, given their more constructive view on very short-dated sovereign bonds (those due in 2014), on a relative value basis among corporates we prefer the 2016 bonds of Ferrexpo (11.1% offer yield). Ferrexpo has demonstrated an ability to obtain new financing in a challenging sovereign environment, leverage is moderate, and export revenues comfortably cover interest expense. The outlook for the global iron ore supply/demand balance remains challenging, however, and is a key risk to monitor into early 2014.

## Sector outlook

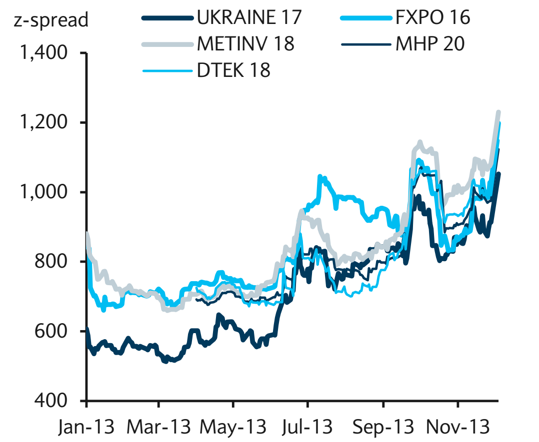
**Ukraine corporates proved their ability to fund in a challenging sovereign environment.** In November 2013, both Metinvest and Ferrexpo attracted new funds as part of their ongoing refinancing efforts. Ferrexpo put in place a $300mn forward start facility to extend its existing $420mn trade finance facility (maturing in September 2016) out to 2018. Similarly, Metinvest arranged a $300mn 5yr PXF facility with a group of international banks with an 18-month grace period. This highlights the ability of the major exporters in Ukraine to refinance in a challenging sovereign environment, and eases refinancing risk.

**Bond tenders have lightened near-term refinancing needs.** Following the tender of DTEK and MHP in 2013 for their 2015 bonds, the eurobond maturity profile of Ukraine corporates is relatively light. Given the still moderate leverage profile of all four corporates under coverage, we think they should be able to continue to refinance upcoming debt in the near term, although sovereign volatility remains a clear risk. We think Metinvest could come to the market in late 2014 in order to refinance its $500mn, May 2015 maturity.

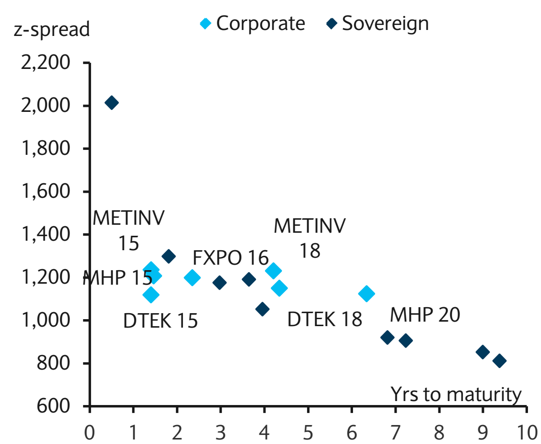
**Risks remain in trade relations with Russia**. Failure to sign an EU Association Agreement has eased the risk of a trade-related dispute with Russia. However, given pressures on profitability within Russian steel and ongoing discussion of support measures, we continue to see some risks for Metinvest given its exposure to the Russian steel market.

**Fundamental challenges remain.** Fundamental pressures have risen over the past year for the four Ukraine corporates under coverage, and are likely to remain a concern in 2014. The pricing environment in global steel remains depressed due to persistent overcapacity, and the upcoming supply increase in iron ore presents downside risks to prices. DTEK continues to have limited pricing power within the Ukraine market as energy prices remain a highly sensitive issue. MHP earnings, however, should benefit from positive tailwinds as the company continues to expand poultry capacity.

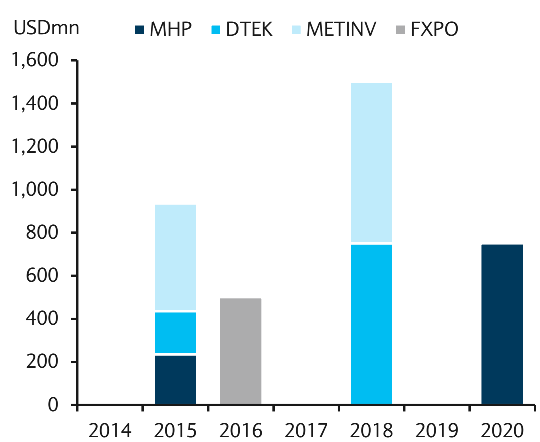
### Ukraine corporate spread history




### Ukraine corporate cash scatter




### Ukraine corporate Eurobond maturity profile




Note: Only the four issuers under coverage are included. Source: Bloomberg, Barclays Research

# DUBAI CORPORATES

Bayina Bashtaeva
+44 (0)20 7773-7428
bayina.bashtaeva@barclays.com

## Key recommendations

Dubai credit could see some positive effects from the recently announced successful Expo bid. However, with most spreads close to record tight levels, we focus on opportunities around idiosyncratic drivers and relative mispricings.

**We recommend buying DHCOG's 2017**. Dubai Group's (DHCOG's sister-company) restructuring still appears to be weighing on the spreads, but we believe DHCOG is adequately ring fenced. We expect DHCOG to see significant benefits from the Expo and from the potential sale of some telecom assets. We believe that proceeds from asset sales would be used to repay its 2017 bonds.

**We recommend buying MAF's 7.125% Perps**. MAF perps provide an attractive risk/return profile, in our view. The higher yield is explained by the bond's subordination and perpetuity features. However, we believe both are more than compensated by MAF's high quality asset base and high recurring revenues. Also, we think that MAF has a strong incentive to call the bonds in 2018. Therefore, MAF's perp is essentially a 5y bond, offering a YTW of c.7.0%, the highest in the Dubai credit universe.

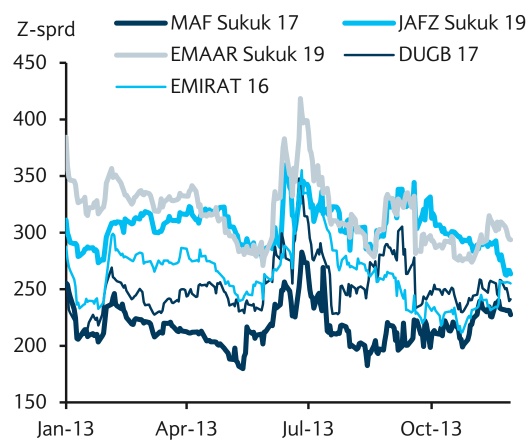
## Sector outlook

The Expo should provide a strong boost to corporate earnings in the short to medium term; however, its magnitude will vary among sectors and companies. We believe the main beneficiaries would be DHCOG, Emirates Airline, Jafza, MAF, and DEWA. Emaar and DP World should also see a positive impact, but likely with a need for higher capex.

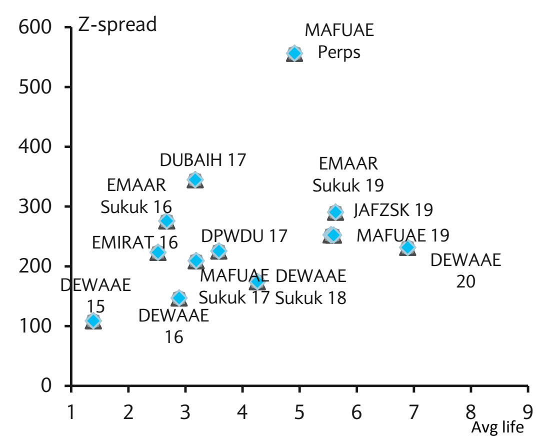
The successful Expo bid could further boost short-term sentiment for Dubai credit. However, the still-high levels of indebtedness remain a lingering systemic risk and could cap further upside. According to statements made by Sheik Ahmed Al Maktoum, Dubai needs to spend $8.1bn to build necessary infrastructure for the Expo. Although some of it could be financed at the government level, we believe the lion's share of debt financing would come from GREs.

We estimate that, at present, Dubai's government and its corporates (excluding banks) have about $103bn of FX debt, up about $13bn from our adjusted estimate at 3Q12. We believe the increased support from Abu Dhabi will facilitate the rollover of $20bn of bailout debt due in 2014. Under this scenario, Dubai's debt profile looks more evenly distributed, with an estimated $5bn of debt due in 2014. Therefore, Dubai Inc's refinancing risks are less acute and imminent compared with 2009; however, we note further debt increases could eventually expose Dubai to any post-Expo growth moderations.

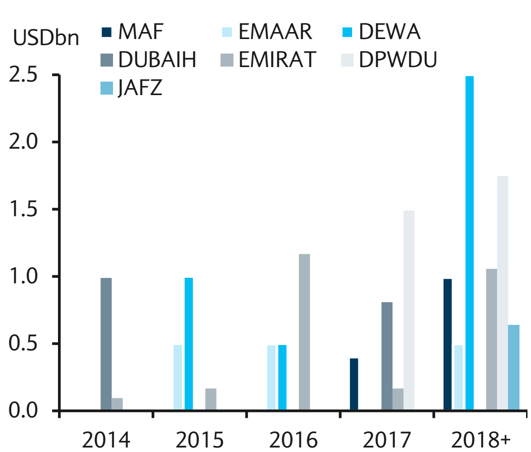
Dubai corporate spread history




Dubai corporate scatter




Dubai bond maturity profile




Note: In the scatter chart, MAF Perp is shown at is first call date (in Oct-18). Source: Company reports, Barclays Research.

# GCC BANKS

Antoine Yacoub
+971 4 36 21038
antoine.yacoub@barclays.com

## Key recommendations

**We recommend a neutral position on GCC banks credit as we think they have limited room to outperform – given their generally rich valuations, already reflecting their robust credit profiles.** However, we believe that the GCC bonds continue to offer a good level of defensiveness in times of global market volatility given ample bank liquidity profiles and good overall fundamentals. The latter remain underpinned by a favourable operating environment and generous government spending. In addition, the recent agreement between Iran and the West should contribute to less geo-political risks. This could, in the long term, benefit some GCC banking systems, such as the UAE, should we see a gradual rebound in trade between Iran and the ROW.

Our favourable name within the sector are DIB 17s (yielding 3.15%), DIB 49 (6.8%) perps, Al Khaliji 18s (3.37%), ADCB 23 callable (5.73%). All are supported by good fundamentals and are, in our view, attractively priced relative to peers.

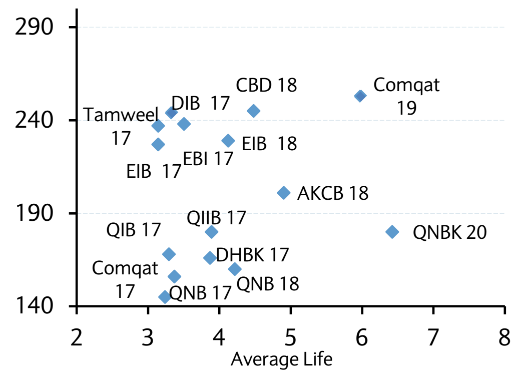
## Sector outlook

**Funding/liquidity:** GCC banks' funding profiles have improved or at least reamined steady in 2013 as reflected by decreasing LDRs in almost all GCC banking systems. The most noticeable improvements occurred in UAE and Qatar where rapid customer deposit growth (boosted by large government and GRE cash placements) and moderate credit growth (of around 8-9%) have helped banks enhance their funding bases, with LDRs down to 92.7% in the UAE and 105% in Qatar. We expect funding levels to remain largely unchanged in 2014 thanks to moderate credit growth. GCC banks continue to enjoy ease of access to market funding (as reflected by the stong, multi-format issuance seen this year) and at favourable pricing.

**Asset quality:** We expect GCC bank's asset quality profiles to remain largely steady in 2014 thanks to a stable operating environment, moderate credit growth, and by their adoption of tight underwriting standards adopted in recent years. In the UAE, the burgeoning trade and hospitality sectors in Dubai, as well as a recovering real-estate sector, will continue to lower default levels and help UAE banks reduce their NPL ratios, which reached an average of 7.2% in Sep 2013, but which we expect to continue to decrease in 2014, to below 7% level.

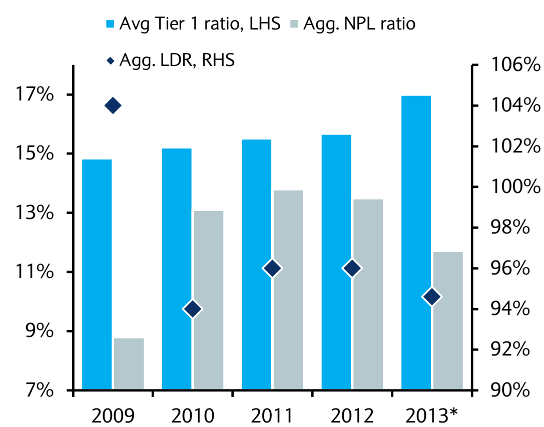
**Capital:** GCC banks' capital ratios already surpass the Basel III minimum capital thresholds due to be implemented from 2015 onwards. Moreover, we expect GCC central banks to maintain stricter regulatory capital requirements than Basel III rules as current local regulatory requirements already exceed Basel II rules (ie, min Basel II tier 1 ratio and CAR of 4% and 8%, compared with current minimum GCC regulatory requirements of 8% and 12%, respectively). Some Banks in UAE have issued tier 1 debt to enhance their tier 1 ratios, a trend likely to be seen in Qatar and perhaps among other GCC banks, particularly those which exhibit lower core capital than peers.

**Dubai and Qatar banks: senior bonds z-spreads (bp)**



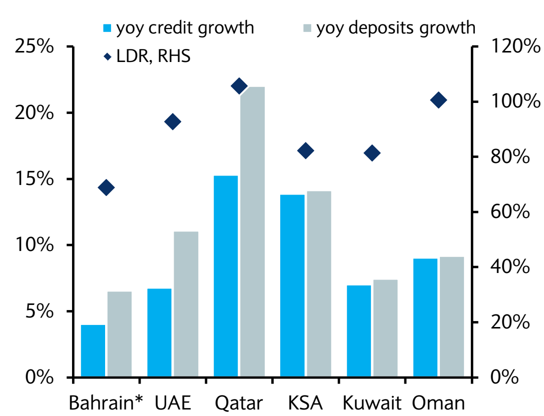

Source: Barclays Research

**Dubai banks: fundamentals maintain an improving trend**




Source: GCC central banks, Barclays Research. * As of Sep 2013

**GCC banks: loans and deposits growth (Sep-13)**




*includes retail banks only. Source: GCC central banks, Barclays Research

# TURKISH BANKS

Antoine Yacoub
+971 4 36 21038
antoine.yacoub@barclays.com

## Key recommendations

**We take a cautious view on Turkish banks' credit given the increasing challenges facing the sector and tight valuations after recent outperformance.** Despite weakening capital and funding in 2013, Turkish banks' fundamentals still compare well to the rest of EM. However, the sector is facing increasing challenges, both domestic (currency depreciation/fluctuation and the outcome of upcoming elections) and external (fed tapering). Fed tapering could take its toll on large foreign corporates/banks borrowing and could negatively impact credit growth, profitability and asset quality. Also, ballooning credit growth seen in recent years carries risk of credit seasoning, which we think could be triggered by further currency weakness, a substantial drop in credit growth and increased lending rates.

Our cautious view on the senior bond space also translates into the high-beta Turkish subs. Our favourite pick remains Halkbank '17s, which is among the cheaper quasis vs. sovs in EM. The bank maintains the strongest funding profile in the sector with an LDR of 97.6%, which provides comfort in times of tight global funding conditions.

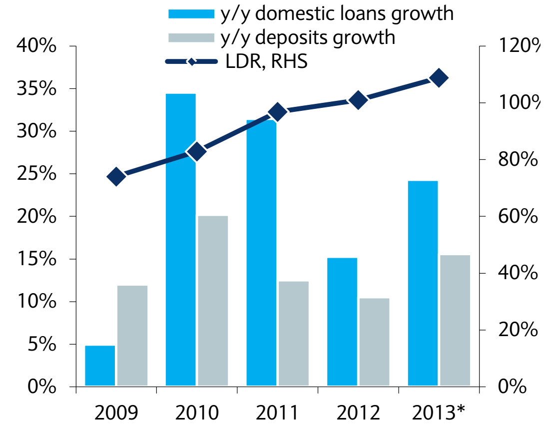
## Sector outlook

**Asset quality:** A fluctuating/depreciating currency seems not to have had a noticeable effect on asset quality so far in 2013, but could take start pressuring foreign currency (FC) loan books in Q1 onwards, particularly if TRY depreciates further. Though, we expect any asset quality weakness to remain manageable (NPL ratio in the 3-3.6% range) given decent employment conditions (unemployment rate remaining in single digits), resilient exports and a robust tourism sector. Moreover, FC loans are only to the corporate and SME sectors (no retail banking involved) which generally have FC cash flows and in some cases hedge their FX loans.

**Funding:** Banking system LDR have increased significantly during 2013 as a result of rapid credit growth outpacing deposit growth. We expect moderate credit growth in 2014 to arrest or at least slow down LDR increases. However, the key challenge to bank funding remains the large net interbank borrowing which increased to TRY160bn in 2013; this borrowing is owed largely to foreign banks and could be negatively affected by potential Fed tapering. This could then increase funding costs further during 2014 and push Turkish banks to curb loan growth.

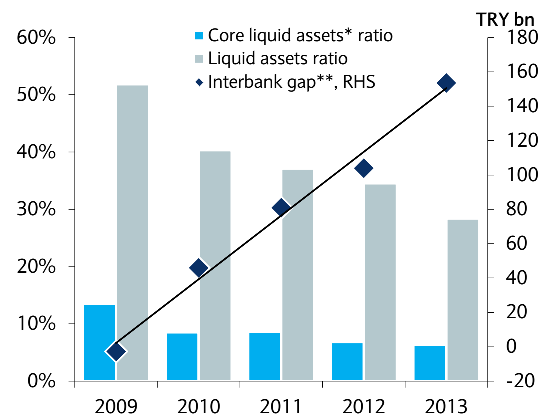
**Capital:** Capital levels have continued to decrease in 2013 as a result of a strong loan growth and re-pricing of AFS securities/currency depreciation during Q2 and Q3 2013. We expect Basel III rules implementation in 2014 to have a very minimal impact on banks' capital indicators, while slowing risk-weighted assets growth could help stabilise banks capital profiles, with Agg. CAR likely to remain around 15% and tier 1 ratio above 11%.

Loan growth continues to outpace growth



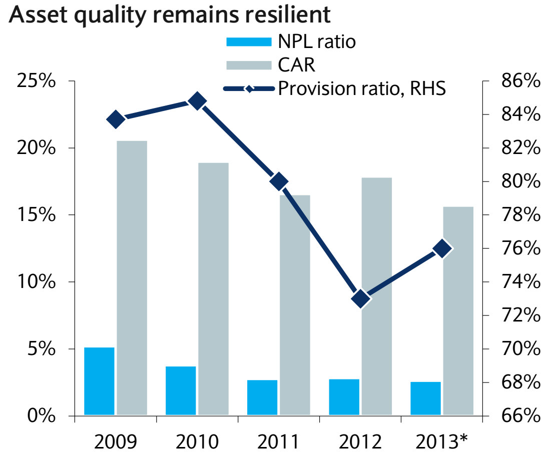

*As of Oct 2013. Source: Turkey BRSA, Barclays Research.

Funding continues to tighten with interbank net borrowing growing




* Core liquid assets include cash and due from banks.
** Interbank gap = due to bank – due from bank. Source: Turkey BRSA, Barclays Research.

Asset quality remains resilient




* As of Sep 2013 Source: Barclays Research

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# Latin America sector outlooks

# LATIN AMERICA FINANCIAL INSTITUTIONS

Anibal Valdes
+1 212 412 3419
anibal.valdes@barclays.com

## Key recommendations

**Among Latin American banks, our top pick is BBVASM subs.** We recommend buying BBVASM 21s subordinated bonds, as they trade 112bp to their senior debt; this is adequate compensation for the subordination in the capital structure due to expected stable fundamental trends for 2014 and the lack of supply due to regulatory changes, in our view. Thus, we expect BBVASM sub/senior spread to compress to 50bp.

**Macro and regulatory changes could weigh on large Brazilian bank bonds.** Within large Brazilian banks, we recommend BANBRA 22s sub bonds, although we believe regulatory and macro risks are not fully priced in. We would feel comfortable buying Brazilian banks' sub debt 40- 50bp back of BBVASM subs.

## Sector outlook

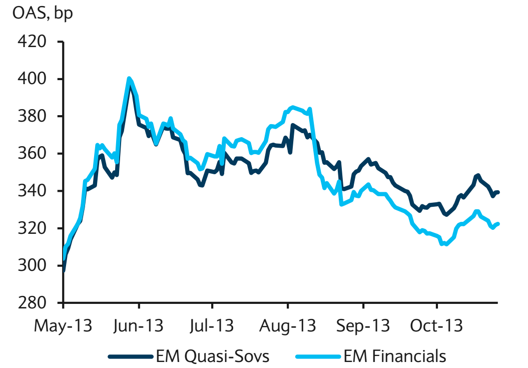
**Brazil: Focus on economic and regulatory trends.** In terms of results, we do not expect 2014 to be that different from 2013. We expect margins to stabilize, NPLs to remain at historical lows, y/y loan growth to fall to 13% from 16% in 2013, and continued focus on costs while fees and insurance continue their good growth momentum. However, we expect a sovereign downgrade in early 2014, in addition to the introduction of a Resolution Framework, to weigh on SIFI bonds.

**Mexico: Asset quality should improve, while loan growth should accelerate**. We expect the Mexican economy to gain dynamism during 2014, when higher economic growth should have a positive effect on asset quality and loan growth. In addition, BBVASM bond valuations should benefit from a lack of supply, as under Basel III capital rules, banks have to be listed to issue subordinated and junior subordinated debt.

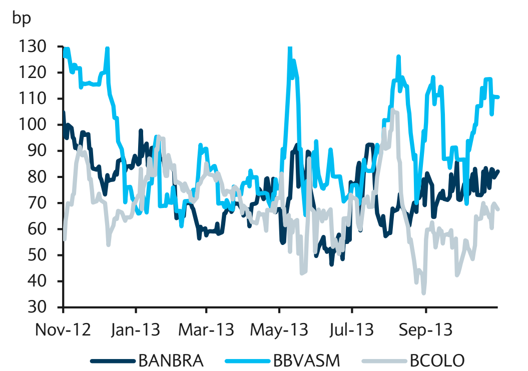
**Colombian and Peruvian Banks: Inorganic vs. organic growth.** After several acquisitions outside Colombia, during 2014 Colombian banks face the challenge of successfully integrating the operations, which could add additional pressures on costs. In addition, while asset quality is expected to remain stable, continued pressure on margins and an expected deceleration on loan growth should further pressure results. Peruvian banks should continue to benefit from high levels of economic growth and ample room for credit penetration. Although the banking system is highly vulnerable to a sustained and sharp PEN depreciation against the dollar, we expect the PEN to remain stable against the USD during 2014.

**We estimate total issuance of $11bn:** Upside risks to our call are Basel III compliant sub and subordinated debt issued by Brazilian banks.

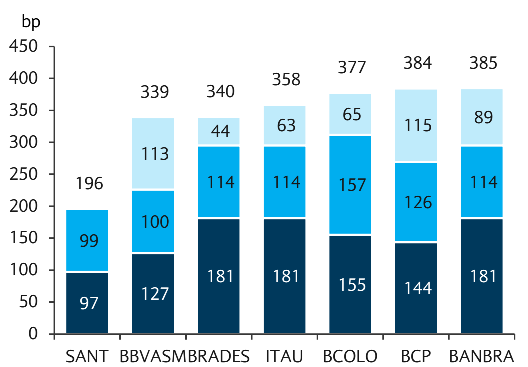
### EM Financials versus EM Quasi-corps




### LatAm banks sub/senior spread




### LatAm structural premium




Source: Barclays Research

# LATIN AMERICA OIL AND GAS AND PETROCHEMICALS

Christopher Buck
+1 212 412 3418
christopher.buck@barclays.com

## Key recommendations

**Quasi-sovereign oil and gas bonds have little room to compress:** Pemex and Ecopetrol are trading inside 100bp relative to their respective sovereigns. While reform in Mexico is positive and Ecopetrol remains a solid credit, bonds are within our expectations of 75-100bp relative to their respective sovereigns, thus leaving little room for additional compression. We were disappointed with the recent Petrobras fuel price announcement and see little value in Petrobras bonds relative to the sovereign, though we still have a preference for 21s along the curve. Pressure on the Brazil sovereign is also a risk for Petrobras bonds.

**In HY oil and gas, we like short-dated PRECN bonds.** Pacific Rubiales new 2019s are indicated 190bp wide to Ecopetrol 18; we believe this is cheap and the right levels is 125bp. OGX remains highly uncertain, given the murky nature of Brazil's bankruptcy process, limited liquidity, and lack of clarity on the future of Tubarau Martelo. We do not recommend OGX bonds even at current levels in the single digits. We also believe OSX bonds are expensive.

**In petrochemicals, we prefer Alpek**: After the recent outperformance of Braskem, we shift our preference back to Alpek. Despite difficult earnings, we favour the company's conservative strategy to Mexichem's aggressive growth. We believe Alpek bonds should trade 30-50bp tight to Mexichem and 60-75bp tight to Braskem.

## Sector outlook

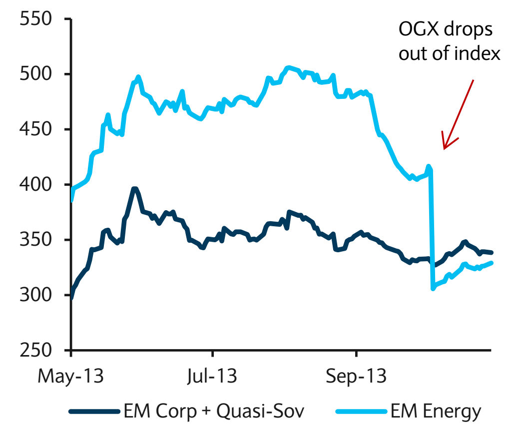
**The race for production growth.** The big national oil companies of Latin America are spending aggressively in an effort to grow production. Pemex and Petrobras should see mild production growth in 2014 and, more importantly, provide more clarity on the trajectory for 2015 and beyond. Ecopetrol and Pacific Rubiales are under pressure to improve reserves and production, which will be key drivers.

**Government policy to play a key role:** Reform continues to progress in Mexico and final details will be important in 2014. We remain optimistic that progressive reform will materialize, though it could disappoint the market. We also expect Petrobras to achieve an automatic price increase mechanism, though it remains unclear how progressive it will be; we would expect a more progressive reform to result in positive reaction for bonds.

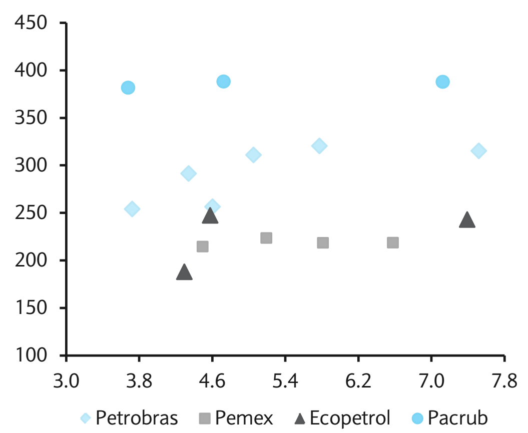
**Significant supply is likely again from Petrobras and Pemex:** Both companies need to fund their cash flow gaps. We expect at least $10-15bn in USD issuance from Petrobras and more than $5bn from Pemex. Ecopetrol and Pacific Rubiales funded themselves in 2013, and additional debt is unlikely in 2014.

**OGX and OSX remain highly uncertain:** The bankruptcy processes and future of Tubarao Martelo will determine the path for bonds.

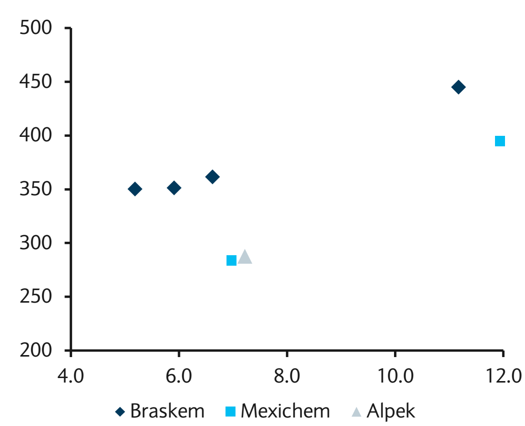
**EM energy vs EM Corp + Quasi-Sov (OAS)**




**The short end of PRECN looks cheap (OAS, duration)**




**Alpek should trade at a premium to Mexichem**




Source: Barclays Research

# LATIN AMERICA TELECOM AND MEDIA

Christopher Buck
+1 212 412 3418
christopher.buck@barclays.com

## Key recommendations

**In IG, we prefer Oi bonds.** Oi delivered important sequential improvement in 3Q13. Many challenges remain, given the company's elevated leverage and cash flow challenges, but management is focused on improving these metrics, goals that are well aligned with creditor interests. We believe the probability of a downgrade has decreased and are constructive on bonds at current prices. In the case of AMX, we expect uncertainty about M&A to prevent a significant rally but believe leverage will come down in 4Q13, providing space for mild upside potential.

**We see further downside for NIHD.** We believe NIHD is significantly over-leveraged and, despite its strong liquidity position, its debt load is unsustainable. We expect continued pressure on bonds, particularly those with high dollar prices. Axtel bonds have room to perform well in 2014, but management will have to deliver revenue growth for this to materialize. Digicel continues to perform well, but offers little relative value, in our view.

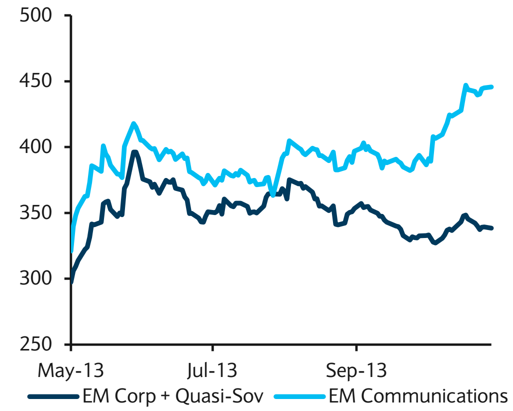
## Sector outlook

**Consolidation in Brazil:** After years of fierce competition, it appears consolidation could materialize in Brazil. Significant press speculation about a possible break-up of TIM and the merger of Oi and Portel could alter the landscape.

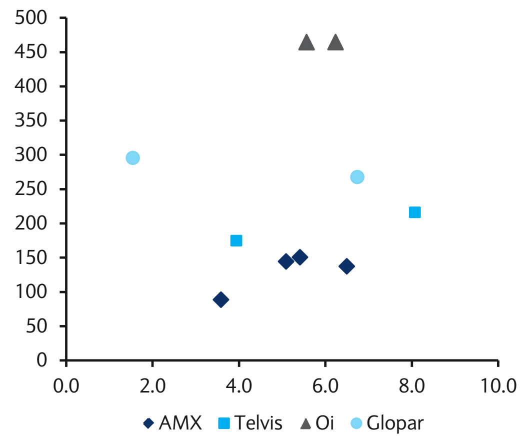
**Reform details in Mexico**: Mexico's congress passed wide-reaching reform in 2013 that sets out key pillars, but the market is anxiously awaiting the secondary legislation during 1H14. While we expect the ultimate changes to materialize slowly, the final rules have the potential to move the market.

**Significant investment to continue**: The capital demands of the telecom industry remain high. We expect all LatAm carriers to continue to invest heavily to improve quality and expand services. Wireless data and high-speed fixed line broadband/pay TV remain key initiatives for most telecoms in LatAm. In the mobile segment, we expect fierce competition for post-paid and high data customers to continue. In fixed line, companies from Oi to Axtel will likely continue to expand their high quality fiber offerings and triple play bundles. We expect this to result in further stabilization of line disconnections and improvement in overall fixed-line revenues.

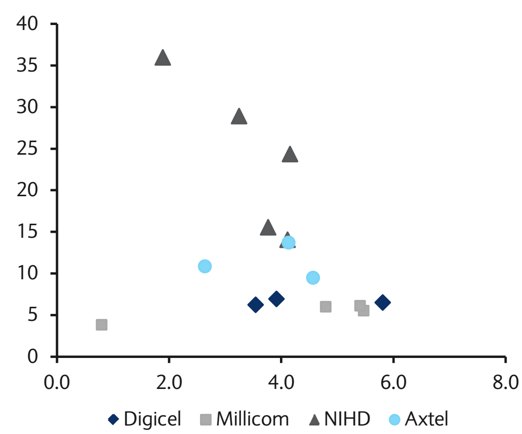
EM Corp + Quasi-Sov vs EM Communications (OAS)




In IG Oi and Glopar Perps look cheap (OAS)




NIHD bonds trade at high yields but we remain bearish (YTW %)




Source: Regulators, Barclays Research

# LATIN AMERICA CONSUMER PRODUCTS AND RETAIL

Autumn Graham
+1 212 412 3417
autumn.graham@barclays.com

## Key recommendations

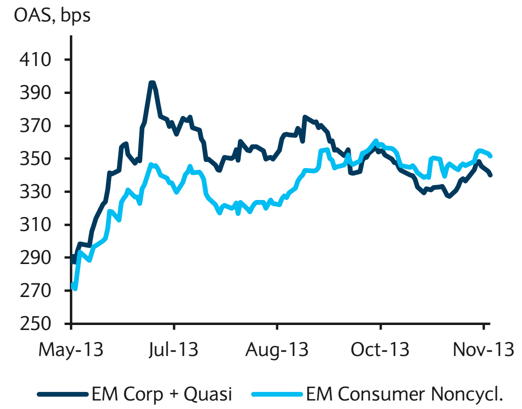
**In the consumer sector, most bonds are fairly valued: BRF '22s (BFRSBZ) are relatively cheap, and Sigma bonds face positive catalysts if our base case materializes.** Sigma is on negative watch by two rating agencies and negative outlook by the third, as it plans its debt-funded tender for 100% of the Spanish processed meat company, Campofrio. Although the results of the tender and Sigma's potential IPO are risks, our base case is that Sigma is able to price an IPO and return leverage to historical levels. While SIGMA bonds have partially recovered after selling off ~60bp on the announcement, we think bonds should benefit if our base case materializes and the credit is taken off negative watch. We are positive on the fundamental outlook for Hypermarcas (HYPEBZ) and Bimbo (BIMBOA) but believe these bonds have only limited upside potential considering good performance by HYPEBZ bonds and tight absolute levels on BIMBOA bonds.

## Sector outlook

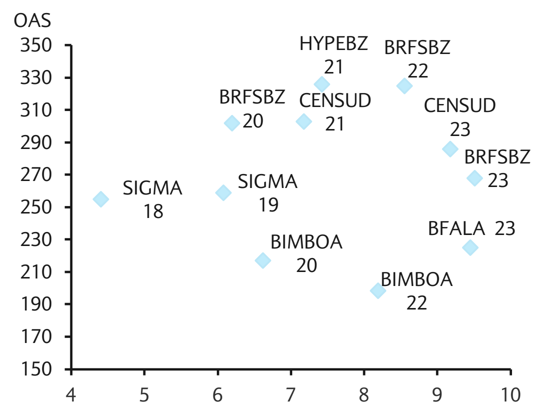
**Most consumer retail companies under our coverage reported improving leverage in 2013** (see bottom figure). The largest improvement came from Cencosud as it raised equity and sold assets to maintain its investment grade rating after its Carrefour acquisition late last year. The most significant deterioration came from Automotores Gildemeister, which showed slowing top-line growth, shrinking margins, and cash burn related to selling Hyundai cars in Chile and Peru.

**As leverage improves, M&A activity heats up.** Most consumer/retail companies are managing their balance sheets prudently and considering carefully whether to expand or consolidate. With five of six companies reporting flat or improved leverage, M&A activity has increased toward the end of 2013. Sigma has announced a tender for 100% of Campofrio, BRF has stated that it is looking for growth opportunities in international markets, and Grupo Bimbo is said to have bid for the Canadian Maple Leaf Bakery business (source: *Bloomberg*, November 20, 2013). Cencosud is still in the process of consolidation after acquiring Carrefour in Colombia, along with a number of smaller acquisitions, late last year. In contrast, Arcos Dorados, which experienced challenging operating conditions and was in the minority of companies to report rising leverage in 2013, is pulling back on store openings.

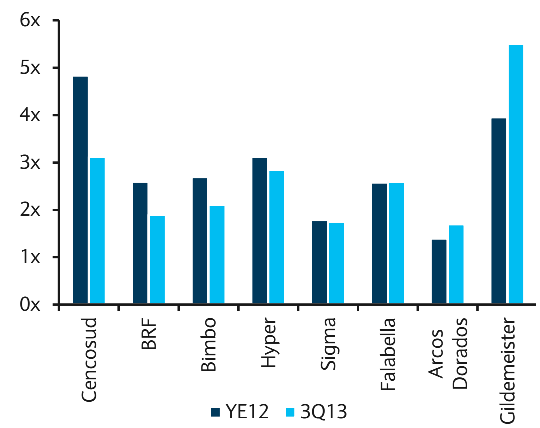
**EM Consumer Noncyclical vs EM Corp+Quasi Indexes**




**LatAm Consumer Retail**




**Net debt/EBITDA metrics have mostly improved across consumer/retail companies in 2013**




Source: Company reports, Barclays Research

# LATIN AMERICA BASIC MATERIALS

Autumn Graham
+1 212 412 3417
autumn.graham@barclays.com

## Key recommendations

**In the pulp sector, we favour Brazilian pulp producers over Chilean.** Barclays forecasts for a continued weak BRL into 2014 should cushion the effect of pulp price weakness; Fibria (FIBRBZ) is currently abstaining from increasing capex; while Suzano's (SUZANO) cash generation should benefit, particularly in 2H14, from higher volumes from its new pulp mill. Of the Chilean pulp/paper producers, we prefer Celulosa Arauco (CELARA) over CMPC (CMPCCI), given our expectations for rising leverage at CMPC from high capex spending on its $2.1bn pulp mill project.

**In the mining sector, we prefer credits offering additional spread for similar fundamental risk.** Vale has outperformed other Brazilian benchmark corporates, as well as its closest LatAm mining peer, SCCO. We believe VALEBZ bonds are about fair value in the near term, but face downside risks in 2014, when we expect iron ore prices to soften. Lesser-known, less liquid credits underperformed in the sell-off this year, and we believe bonds such as MexGen 32s (c.140bp wide to SCCO 22s in YTAL terms) and SAMMIN 23s (when more than 75bp wide to VALEBZ 22s) provide attractive additional compensation for similar risk to their respective benchmarks (SCCO and VALEBZ).

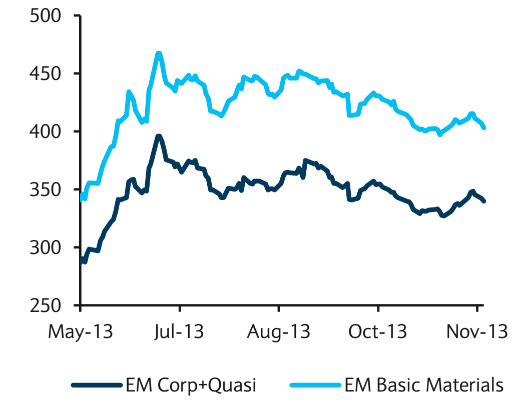
**Cemex remains a core holding.** We believe Cemex will continue to deleverage in 2014 as the US business continues to rebound and Mexico improves. While near-term valuations are not particularly attractive, we still see medium-term value.

## Sector outlook

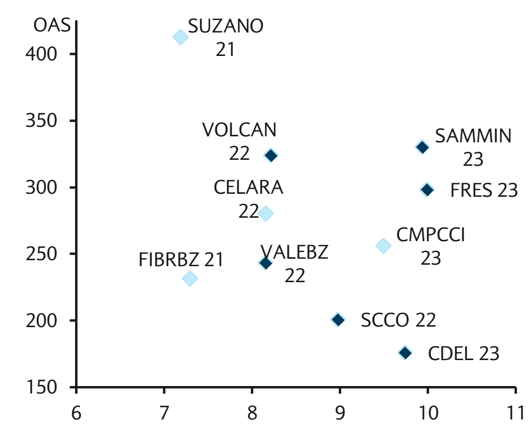
**Further BRL weakness to cushion Brazilian pulp producers**. Spot BRL levels are approximately 18% higher than 2012 average BRL/USD. Barclays forecasts that the BRL will stay around current levels, providing Brazilian pulp producers (Fibria and Suzano) a meaningful cushion against falling pulp prices. Pulp prices can fall to $600 (from $770 current) with a 2.45 BRL/USD (Barclays 1y forecast), and realized pulp prices in BRL terms will only be back to 2012 average levels.

**More weakening expected across relevant commodity prices in 2014.** Barclays commodity teams expects silver and copper prices to continue falling in the coming year, with 2014 estimates for silver 17.7% lower and copper 7.9% lower than 2013 estimates. Consensus iron ore forecasts also have iron ore falling to $119, or 12% lower than the YTD 2013 average price. Hardwood pulp prices are also expected to go lower in 2014, as a total of 4.3MT (equivalent to c.15% of the total hardwood market) of new hardwood pulp capacity ramps up in 2013-14 from three major LatAm projects.

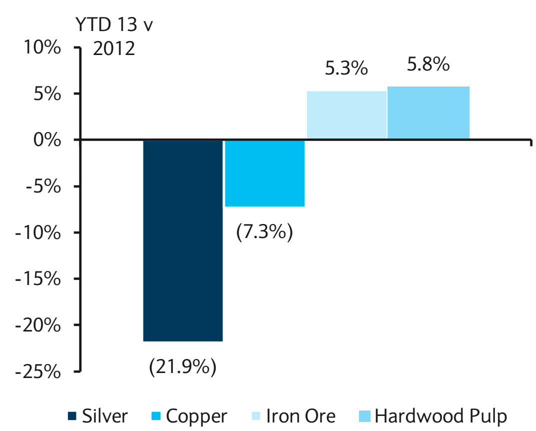
**EM Basic Materials vs EM Corp & Quasi Index (OAS)**




**LatAm Basic Materials**




**Commodity price performance YTD 2013 v 2012**



**Analyst Certification**

We, Jeffrey Meli, Bradley Rogoff, CFA, Alex Gennis, CFA, Shobhit Gupta, Jigar Patel, Ryan Preclaw, CFA, Eric Gross, Ellie Lan, Thomas Weyl, Sarah Xue, Ming Zhang, Zoso Davies, Ioannis Kallianiotis, Darpan Harar, Mike Kessler, James Simmonds, Dominik Winnicki, Krishna Hegde, CFA, Avanti Save, Andrew Abramczyk, Aziz Sunderji, Keith Byrne, Vincent Foley, Brian Monteleone, Conor Pigott, Danish Agboatwala, Parth Shah, Brian Lalli, Brittany Chen, Yung Chuan Koh, Harry Mateer, Greggory Price, Priya Ohri-Gupta, CFA, Kacie Overlander, Shubhomoy Mukherjee, Kyle Stockmal, Audra Stundziaite, Peter Troisi, Thomas Walsh, Oscar Bate, Matthew Vittorioso, Keith Hanauer, Luke Labella, Hale Holden, Benjamin Robins, Jaclyn Bernstein, Gary Stromberg, Kateryna Kukuruza, Jeff Harlib, Christophe Boulanger, Sophie Lim, Yulia Di Mambro, Jonathan Glionna, Christy Hajiloizou, Darren Hook, CFA, Nick Macdonald, Karine Elias, Jonathan Horner, Daniel Rekrut, Srinjoy Banerjee, Tom Southon, Lyris Koh, Justin Ong, Eugene Tham, Jit Ming Tan, CFA, Erly Witoyo, Christina Chiow, CFA, Stella Cridge, Bayina Bashtaeva, Antoine Yacoub, Anibal Valdes, Christopher Buck and Autumn Graham, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

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One of the analysts on the coverage team owns the common stock of Home Depot.

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# RESEARCH CONTACTS


**Jeffrey Meli**
Co-Head of FICC Research
+1 212 412 2127
jeff.meli@barclays.com

**Bradley Rogoff, CFA**
Head of Credit Strategy
+1 212 412 7921
bradley.rogoff@barclays.com

**Thomas C. Walsh**
Head of Fundamental Credit Research/ Insurance (HG)
+1 212 412 3129
thomas.walsh@barclays.com

**United States**

**Gary Stromberg**
Head of US High Yield Fundamental Research / Energy & Pipelines (HY)
+1 212 412 7608
gary.stromberg@barclays.com

**Danish Agboatwala**
Telecom, Media & Entertainment (HG)
+1 212 412 2573
danish.agboatwala@barclays.com

**Vincent Foley, Jr.**
Aerospace & Defense (HG)/Manufacturing (HG)/ Homebuilders & Building Products (HG/HY)/ Autos/Autoparts (HG/HY)
+1 212 412 7943
vincent.foley@barclays.com

**Eric Gross**
High Yield Credit Strategy
+1 212 412 7997
eric.gross@barclays.com

**Shobhit Gupta**
Investment Grade Credit Strategy
+1 212 412 2056
shobhit.gupta@barclays.com

**Keith Hanauer**
Telecom, Cable & Satellite (HY)
+1 212 412 5956
keith.hanauer@barclays.com

**Jeff Harlib**
Technology, Paper & Packaging (HY)
+1 212 412 6952
jeffrey.harlib@barclays.com

**Hale Holden**
Consumer Products/Food, Beverage & Tobacco/Retail & Supermarkets (HY)
+1 212 412 1524
hale.holden@barclays.com

**Yung Chuan "Y.C." Koh**
Electric Utilities (HG)
+1 212 412 3796
yc.koh@barclays.com

**Kateryna Kukuruza**
Gaming (HY)
+1 212 412 7647
kat.kukuruza@barclays.com

**Brian Lalli**
Chemicals (HG/HY)
+1 212 412 5255
brian.lalli@barclays.com

**Harry Mateer**
Energy & Basic Industries (HG)
+1 212 412 7903
harry.mateer@barclays.com

**Brian Monteleone, CFA**
Banks, Brokers, Finance (HG/HY)
+1 212 412 5184
brian.monteleone@barclays.com

**Shubhomoy Mukherjee**
Pharmaceuticals/Healthcare (HG/HY)
+1 212 412 5245
shubhomoy.mukherjee@barclays.com

**Priya Ohri-Gupta**
Food, Beverage & Tobacco, Consumer Products, Retail , Restaurants (HG)
+1212 412 3759
priya.ohrigupta@barclays.com

**Jigar Patel**
Credit Strategy
+ 1 212 412 1161
jigar.n.patel@barclays.com

**Ryan Preclaw, CFA**
Investment Grade Credit Strategy
+1 212 526 3083
ryan.preclaw@barclays.com

**Peter Troisi**
Insurance (HY)
+ 1 212 412 3695
peter.troisi@barclays.com

**Matthew Vittorioso, CFA**
Aerospace & Defense (HY), Transportation (HG), Industrials (HY), Metals & Mining (HY)
+1 212 412 1378
matthew.vittorioso@barclays.com

**Thomas Weyl**
Municipal Credit
+ 1 212 526 0751
thomas.weyl@barclays.com

**Europe**

**Daniel Rekrut**
Head of European Fundamental Credit Research
Telecom, Media, Technology (HG/HY)
+44 (0)20 7773 5980
daniel.rekrut@barclays.com

**Søren Willemann**
Head of European Credit Strategy
+44 (0) 20 7773 9983
soren.willemann@barclays.com

**Christophe Boulanger**
Autos, Airlines (HG/HY)
+44 (0)20 3555 1984
christophe.boulanger@barclays.com

**Zoso Davies**
Investment Grade Credit Strategy
+44 (0)20 7773 5815
zoso.davies@barclays.com

**Karine Elias**
Consumer & Retail (HG/HY)
+44 (0) 20 7773 7060
karine.elias@barclays.com

**Jonathan Glionna, CFA**
Head of Global Bank Credit Research
Banks, Insurance (HG)
+44 (0)20 3555 1992
jonathan.glionna@barclays.com

**Christy Hajiloizou**
Banks, Insurance(HG)
+44 (0)20 3134 2992
christy.hajiloizou@barclays.com

**Darren Hook**
Industrials (HG/HY)
+44 (0)20 7773 8970
darren.hook@barclays.com

**Mike Kessler**
High Yield Credit Strategy
+44 (0)20 7773 7232
michael.kessler@barclays.com

**Thomas Southon**
Utilities & Oil/Gas (HG/HY), Industrials (HY)
+44 (0)20 7773 6918
thomas.southon@ barclays.com

**Dominik Winnicki**
Credit Strategy
+44 (0)20 3134 9716
dominik.winnicki@barclays.com

**Asia-Pacific**

**David Fernandez**
Head of FICC Research, Asia Pacific
+65 6308 3518
david.fernandez@barclays.com

**Krishna Hegde, CFA**
Head of Asia Credit Research
+65 6308 2979
**krishna.hegde@barclays.com**

**Christina Chiow**
Chinese Real Estate (HY); Industrials (HG)
+65 6308 3214
christina.chiow@barclays.com

**Lyris Koh**
Financial Institutions
+65 6308 3595
lyris.koh@barclays.com

**Justin Ong**
Industrials; Oil & Gas and Utilities (HG)
+65 6308 2155
justin.ong@barclays.com

**Avanti Save**
Credit Strategy
+65 6308 3116
avanti.save@barclays.com

**Jit Ming Tan**
N. Asia Industrials and Resources (HY)
+65 6308 3210
jitming.tan@barclays.com

**Erly Witoyo**
S.E. Asia Industrials and Resources (HY)
+65 6308 3011
erly.witoyo@barclays.com

**Emerging Markets**

**Christopher Buck**
Head of LatAm Corporate Credit Research
Media & Telecom, Oil & Gas, Basic Materials
+1 212 412 3418
christopher.buck@barclays.com

**Andreas Kolbe**
Head of EEMEA Credit Research
Sovereign Credit Strategy
+ 44 (0) 20 313 43134
andreas.kolbe@barclays.com

**Bayina Bashtaeva**
Dubai Corporates (EEMEA)
+ 44 (0) 20 7773 7428
bayina.bashtaeva@barclays.com

**Stella Cridge**
CIS Corporates (EEMEA)
+44 (0)20 3134 9618
stella.cridge@barclays.com

**Autumn Graham**
Consumer/Retail, Homebuilders, Pulp/Paper, Mining (LATAM)
+1 212 412 3417
autumn.graham@barclays.com

**Aziz Sunderji**
EEMEA/LatAm Corporate Credit Strategy
+1 212 412 2218
aziz.sunderji@barclays.com

**Anibal Valdes**
Financials (LATAM)
+ 1 212 412 3419
anibal.valdes@barclays.com

**Antoine Yacoub**
MENA/Turkey Financials (EEMEA)
+971 43621038
antoine.yacoub@barclays.com