U.S. CREDIT ALPHA

Credit Turns in a Clunker of a Week

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OVERVIEW

Credit Turns in a Clunker of a Week

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In the midst of a historical run, credit product finally showed some weakness, particularly in the derivative market, where IG widened 10bp and HY slid $2 ¼. Cash was considerably more resilient. The Credit Index's OAS held steady, while HY slipped ¼pt. The S&P 500 made back most of Monday's and Tuesday's losses, to close Thursday little changed this week but remains at 9-month high.

Credit valuations have improved significantly since March's bottom, producing equity-like returns that not even stocks have matched. Clearly, much of credit's upside has dissipated during this year's rally. Although we remain constructive on credit, given the rally we feel the universe of attractive credits has narrowed because of the economic backdrop and approaching seasonally challenging period. Consequently, we believe the most important investment decisions will be credit selection and relative value analysis. Credit's underperformance this week may be a direct result of investors' viewing relative value swing back to stock's advantage. Indeed, we have seen multiple surveys this week citing equity investors' bullish outlook.

The earnings season is slowing down, but there were a number of retail reports this week. Overall, results were solid, with Macy's, Wal-Mart, and Kohl's beating expectations. Although the latter raised 2009 guidance, the magnitude of the raise missed Street expectations. Furthermore Liz Claiborne revealed softer-than-expected numbers and was subsequently cut two notches by Moody's. High yield earnings continue to beat expectations. Of the 37 reporting companies we tracked this week, 20 surpassed estimates, versus only 10 misses. That is consistent with this season's established trend.

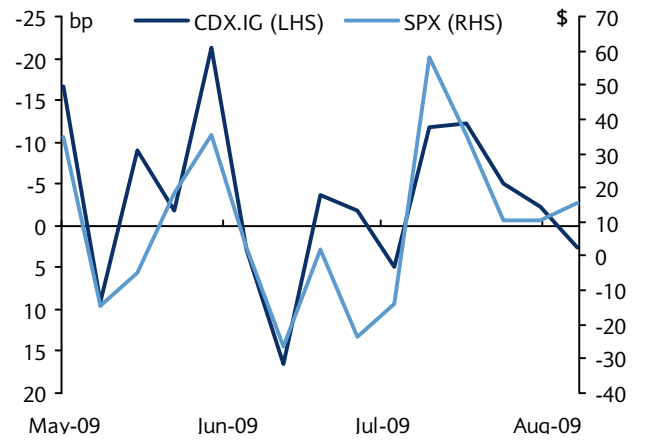
The high yield primary was unfazed by the secondary market's retreat. Issuers raised $7.6bn through Thursday's close, a 3-month high. Further illustrating the steady demand for speculative grade product were the upsizing of more than half the new deals and the placing of three $1bn bonds. In an unusual twist a new loan deal from Mediacom was launched to repay bonds (in conjunction with a new bond deal). So far this year it has generally been bonds used to repay loans.

Weekly Index Changes

	Thursday Close	Last Week Close	4-week Average
Credit Index (bp)	213	214	231
CDX.IG.12 (bp)	115	105	115
High-Yield Index ($ price)	86.29	86.62	84.46
CDX.HY.12 ($ price)	89.00	91.25	88.97
Leveraged Loan Index ($ price)	82.58	82.43	81.46
LCDX12 ($ price)	94.00	96.25	93.25

Note: CDX levels are mid-market and are not adjusted for defaults. Source: Barclays Capital

Figure 1. Week-over-week Change in CDX.IG vs SP 500



Source: Barclays Capital

Economic news was mixed. Data are increasingly pointing to a positive GDP growth in the US and euro zones for the first time in a year. Furthermore, the Fed is feeling more comfortable about letting its Treasury purchase program expire as expected in the fall. Offsetting these developments were a disappointing retail sales report, which fell 0.1% despite the Cash for Clunkers program, and initial jobless claims that unexpectedly jumped from last week.

In Europe the credit derivatives Determinations Committee ruled that the first Restructuring Credit Event occurred since CDS documents were changed in 2003. A press release concerning the extension of maturity of a private placement issued by Thomson SA caused the trigger. Thankfully the event occurred after almost all existing trades complied with the Small Bang protocol, thereby limiting the number of auctions. Technicals may still be significant across the curve because the deliverables are tightly held.

As mentioned above, we think credit relative value will play a large role in performance this fall. In this week's focus article, we review relative value between pari passu high and low dollar bonds. We identify the factors driving relative value and recommend which alternative offers the best value.

FOCUS

Dollars and Sense

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In the first seven months of 2009, the credit market experienced both a surge in issuance and a dramatic tightening in spreads. More than $560bn of fixed-rate investment grade corporate bonds have been issued so far this year, on pace for the largest issuance year ever. At this time last year, issuance was more than $100bn below the 2009 total, and we have already surpassed the full-year issuance levels from 2007. At the same time, spreads have rallied sharply. After peaking at 545bp in December 2008, the Credit Index has tightened more than 300bp, to 214bp. High yield credit has experienced similar trends, with an active new issue calendar and tightening spreads.

The active primary market during the first half, when spreads were at historical wides, has resulted in many issuers' having bonds with a variety of coupons and, thus, prices. In general, higher coupon bonds generate higher yields than bonds with lower coupons, as investors require additional compensation for investing in higher priced bonds, which have a larger percentage downside in a default. During the height of the sell-off, this relationship was particularly strong, as interest in limiting downside risk grew and investors required more incremental yield to risk the greater potential downside of higher priced securities. As spreads normalize, primary markets reopen, and default expectations recede, we expect investors to pay more attention to relative value opportunities within issuers' capital structures, including optimizing portfolios with respect to price.

Three factors determine the fair market yield difference between high and low coupon bonds: spread, tenor, and (anticipated) recovery. We briefly analyze each of these factors. In general, the yield difference between high and low coupon bonds should increase as spread and, thus, the likelihood of default increase. Although more muted, the effect of longer maturity is similar. Recovery is more nuanced. Low (anticipated) recovery bullet bonds should have small differences in yields, despite any difference in price, and in some cases, the higher price bond should actually yield less, because it generates higher current yield. However, the most common examples of low recovery bonds are hybrids, which are also callable, and the potential for a call (particularly a non-economic call) can affect the relative value assessment.

We examine several pairs of senior bonds from the same issuers. In some cases, such as CHK, F, M, and DOW, the higher priced bonds look more attractive. In others, such as LTD, EAC, and LEN, we recommend the lower priced bonds, as the yields of the higher coupon bonds do not adequately compensate for the difference in prices. That said, liquidity is limited in Lennar cash. In hybrids, there are several examples, such as MET and COF, in which the higher priced bonds are substantially more attractive than the lower priced bonds, as the difference in yields is too large given the low expected recovery of such subordinated debt.

Sensitivity to Credit Spread and Maturity

The fair market yield difference between high and low coupon bonds is determined by spread, tenor, and recovery. Spread is determined by the market, and tenor is simply a feature of a given bond. Recovery is uncertain—and has varied substantially across defaulted institutions throughout the current cycle. In this section, we examine how spread and maturity affect the fair compensation for increased dollar price, assuming a 40% recovery, before turning to the effects of recovery in the next section.

Initially, we focus on hypothetical bonds of different coupons and spreads to demonstrate the sensitivity of the relationship between yield and price to changes in credit spreads and tenor. We express the results as the required incremental yield to justify selling a low coupon, low price bond and buying a high coupon, high price bond.

- Spread: Higher spread credits require greater additional yield to compensate for higher coupons and prices than lower spread credits. Wider spreads indicate a higher likelihood of default and, thus, a greater chance that moving into a higher price security will result in a loss. For 10y bonds, an $80 asset should yield 25bp less than a par bond for a credit trading at 300bp. The difference increases to 65bp for a credit trading at 600bp (Figure 1). The difference is even starker for 30y bonds—the same move in price is worth 40bp for a 300bp credit and almost 100bp of yield for a 600bp credit.

- Tenor: Increasing tenor has similar but more muted implications for the sensitivity of yield to coupon. Longer-dated bonds require greater additional yield as coupon increases. For a 300bp credit, an increase in price from $80 to par corresponds to15bp more yield for a 30y than it does for a 10y (from 25bp to 40bp). The same comparison for a 600bp credit is 65bp and 100bp.

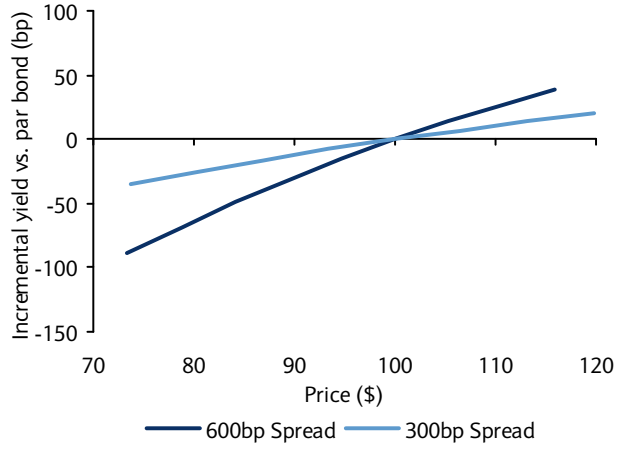
In all cases, the move from par to $120 requires less incremental yield than the move from $80 to par. This is because recovery value functions as a floor on price, and as a result, yield becomes more sensitive to changes in price as price approaches recovery. Part of this is due to our assumption of a fixed recovery—for distressed situations in which default is likely and recovery is highly uncertain, the approach we outline will be less reliable.

Computing Breakeven Recovery

For individual bond pairs—bonds issued by the same company with similar maturities but different coupons—we compute a "breakeven" expected recovery. This is the recovery at which investors should be indifferent between the two bonds. As seen below, if investors believe recovery will likely be less than the "breakeven," they should prefer the high dollar price bond, and vice versa.

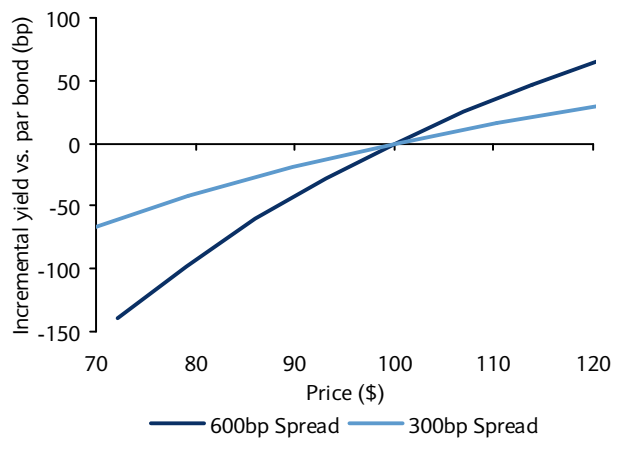
We compute breakeven recovery using our BCDS method. This is equivalent to computing the default probabilities that correctly price a par bond and applying them to high and low coupon bonds to determine the fair yield of each. We apply this method across a range of

Figure 1A: Change in Yield for 10y Bonds of Different Prices



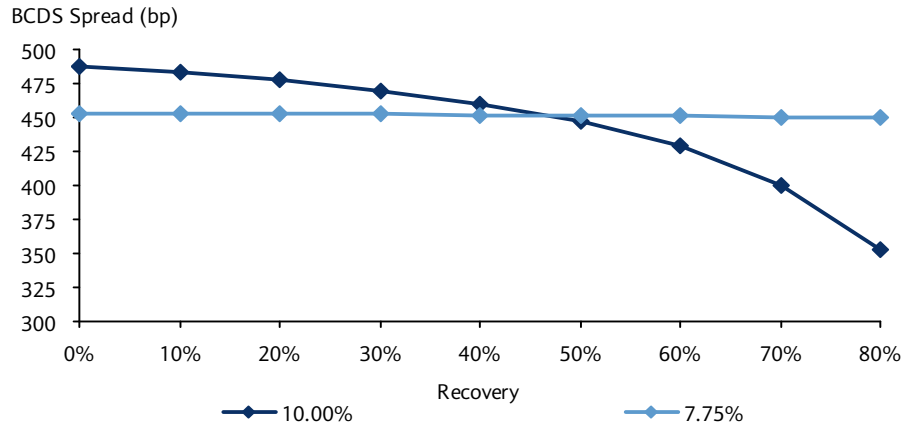
Assumes a 40% recovery. Source: Barclays Capital.

Figure 1B: Change in Yield for 30y Bonds of Different Prices



Assumes a 40% recovery. Source: Barclays Capital.

Figure 2: BCDS across Recovery Rates for PXP Indicates a Breakeven Recovery of 45%



Source: Barclays Capital

recoveries in order to find the level at which the yield difference between the two bonds appropriately accounts for the difference in their coupons.

As an example, we consider the 10% 2016 and 7.75% 2015 PXP bonds (Figure 2). The BCDS of the two bonds are equal at a recovery of 45%. This is the breakeven recovery. Investors should prefer the bond with the higher BCDS, which is the 7.75% bond, for recoveries above breakeven. Investors who expect that recovery will be below 45% should prefer the 10% bond.

We apply this method to a group of investment grade and high yield bond pairs with similar maturities (Figure 3). We prefer the high coupon bonds of CHK, F, M, and DOW. These have high breakeven recoveries, indicating that the incremental yield more than compensates for the higher dollar price. Ford is a particularly interesting case: the 8s were issued with a much deeper discount than the 12s. As a result, the 12s could have less downside in a high recovery default (i.e., close to par recovery).

Figure 3: Analysis of Select Bond Pairs Reveals Potential Opportunities

Name	High Coupon	Yield (%)	Low Coupon	Yield (%)	Breakeven Recovery	Recommendation
CHK	9.5% 2015	7.9	6.875% 2016	7.7	82%	High $
EAC	9.5% 2016	8.7	6.0% 2015	8.8	0%	Low $
EP	12.0% 2013	8.1	6.875% 2014	7.2	65%	--
HAWK	10.5% 2014	8.2	7.875% 2015	7.9	58%	--
KWK	11.75% 2016	9.4	9.125% 2019	9.4	50%	--
PXP	10.0% 2016	8.1	7.75% 2015	7.8	45%	--
F	12.0% 2015	10.7	8.0% 2014	9.9	NA	High $
LEN	12.25% 2017	9.6	6.5% 2016	9.0	20%	Low $
RAD	10.375% 2016	10.8	7.5% 2017	10.1	38%	--
RCL	11.875% 2015	11.2	7.25% 2016	10.6	24%	--
M	8.875% 2015	8.1	5.9% 2016	7.5	65%	High $
LTD	8.5% 2019	8.3	6.9% 2017	8.5	NA	Low $
JCP	7.95% 2017	7.5	5.75% 2018	6.9	40%	--
IP	9.375% 2019	7.5	7.5% 2021	7.5	25%	--
C	8.125% 2039	8.2	6.875% 2038	8.0	24%	--
DOW	8.55% 2019	7.5	5.7% 2018	7.0	55%	High $
BAC	7.625% 2019	6.2	5.65% 2018	6.2	18%	--

Source: Barclays Capital

On the other hand, we prefer the lower priced bonds of LTD, EAC and LEN, for which we would expect recovery to be above the breakeven level, limiting the downside of the low price bonds. Limited's low dollar bond yields more and therefore is preferred to the high dollar bond. EAC's high dollar bond is also trading only a couple of points below the next call price, thereby capping upside from current values. In addition, we note that Lennar has limited liquidity in cash. For companies with fairly priced bonds, we believe there is no systematic mispricing between the bonds with different coupons, and our investment recommendation is more directional. Bullish investors should prefer the higher yielding, higher priced bond, whereas more cautious investors should prefer the lower priced bond.

Moving Down the Capital Structure—Hybrid Capital

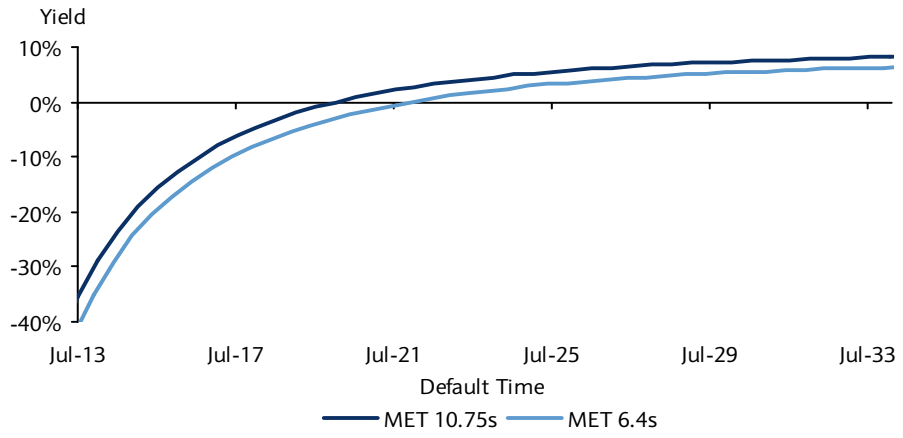
One major difference between hybrids and more senior bonds is recovery. Whereas recovery is uncertain but generically positive for senior debt, we expect hybrid recoveries to be close to (or equal to) zero. As a result, the concept of breakeven recovery is not relevant.

In fact, with a recovery close to zero, the main reason to prefer low coupon, low price bonds is no longer valid—both bonds will lose 100% of invested principal in the event of a default. In addition, the high coupon bond generates a larger cash-on-cash yield, assuming that the yield to worst (YTW) is not substantially below that of the low coupon bond. Higher cash-on-cash yields results in higher total returns if the issuer defaults. This is because less of the returns are due to pull-to-par (in fact, pull-to-par actually reduces the returns of premium bonds) and more are due to coupon payments, which, once made, are no longer exposed to default risk.

Consider two MET hybrids as an example: the MET 6.4% 2036 hybrids and the new issue MET 10.75% 2039s. The 6.4% bonds currently yield 8.4% at a $79 price. The 10.75% bonds yield 9.5% at a price of $112. We compare the total returns of each bond for different default scenarios in Figure 4.

In each case the 10.75% bond generates higher total returns because of the higher cash-on-cash yield—9.6%, compared with 8.1% for the 6.4% notes. In addition, the bond generates higher returns if there is no default because of its higher yield. As a result, the price we estimate using our BCDS approach, assuming 0% recovery, is $128, substantially above its current price.

Figure 4: Total Returns of Two MET Hybrids Indicate a Preference for the 10.75%



Source: Barclays Capital

Hybrids are also exposed to deferral and extension risks, which have not been factored into this analysis. For the MET bonds, in particular, this is less relevant because they are pari passu (and, thus, must be deferred simultaneously) and both have similarly long-dated calls (2036 and 2039). However, these risks must be considered when comparing other hybrids. Figure 5 lists several pairs of hybrids for which we believe the high coupon bonds are cheap.

Figure 5: Higher Coupon Hybrids Look Attractive

					Estimates Based on Lower Price Bond		
	Coupon	Mid Price	YTW	Current Yield	Fair Value	YTW	Current Yield
MET	6.4%	$ 79.0	8.4%	8.1%			
MET	10.75%	$ 112.0	9.5%	9.6%	$ 127.8	8.2%	8.4%
COF	6.745%	$ 74.0	9.3%	9.1%			
COF	10.25%	$ 104.5	9.8%	9.8%	$ 111.7	9.1%	9.2%
LIBMUT	7.8%	$ 68.0	11.7%	11.5%			
LIBMUT	10.75%	$ 90.0	12.0%	11.9%	$ 92.9	11.6%	11.6%

Source: Barclays Capital

INVESTMENT GRADE

Deleveraging, TLGP, and Other Recession Tales

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Derivative spreads weakened during the week, as some of macroeconomic data—notably retail sales and jobless claims—came in worse than expected. CDX IG12 closed Thursday at 115bp, 11bp weaker on the week. Cash spreads were modestly tighter: the Barclays Capital Credit Index closed Thursday at 212bp, 2bp tighter on the week.

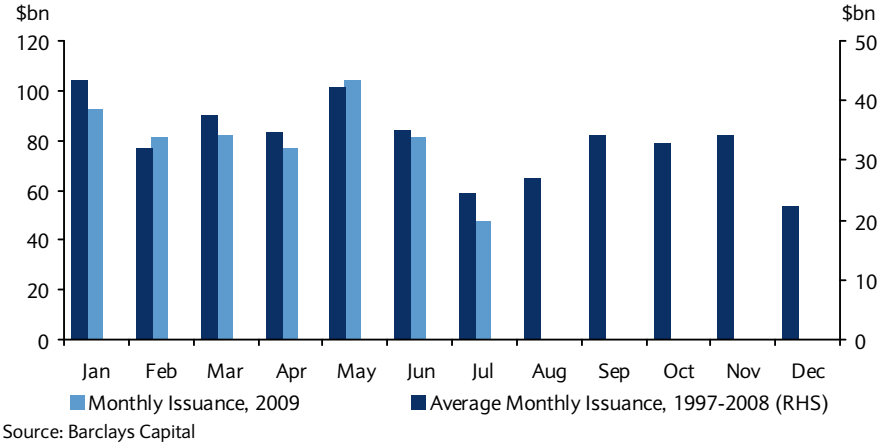
After a series of record supply months in 1H09, the pace of investment grade issuance in 2H09 has slowed. However, this decline in issuance is broadly in line with the seasonality historically observed in the investment grade primary market (Figure 1). Comparing the dip in issuance in July 2009 (plotted on the left axis) with historical average issuance (plotted on the right axis), we see that the reduced supply is consistent with a lighter issuance calendar during July and August. At a sector level, while industrial and utility issuance remains relatively robust, financial issuance remains subdued by historical standards. Year-to-date, total fixed-rate investment grade issuance (not guaranteed by the government) stands at $604bn, compared with $551bn during the same period in 2008. By contrast, year-to-date non-government-guaranteed financial issuance stands at $118bn, compared with $175bn during the same period in 2008.

In the focus article *The Future of Bank Debt*, we indicated that despite replacing wholesale funding with deposits and TLGP debt, large banks are likely to allow debt maturities to roll off as they continue to focus on deleveraging until debt concentrations decline to more manageable levels. Consistent with this view, issuance of index-eligible (Barclays Capital Credit and FRN Indices) senior debt by the seven largest domestic financial issuers (GECC, BAC, JPM, GS, WFC, C, and MS) from January to July 2009 totaled only $37bn, while corresponding debt maturities totaled $63bn.

Given the likely termination of the TLGP on October 31, 2009, we believe that further issuance under this program will be limited. Some issuers (e.g., General Electric Capital) have also announced that that they will no longer issue government-guaranteed debt.

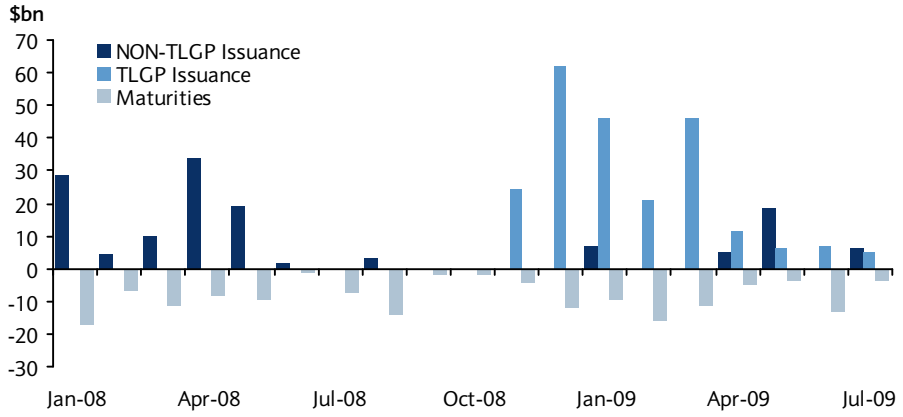
As such, total TLGP debt for most issuers will likely be maintained at current levels. We now try to assess the effects of TLGP debt on the liability/funding picture for the largest financial issuers.

Figure 1: Dip in 2H09 Fixed-Rate Investment Grade Issuance Is in Line with Historical Trends



Source: Barclays Capital

Figure 2: Senior Debt Issuance versus Maturities for the Seven Largest U.S. Financial Issuers



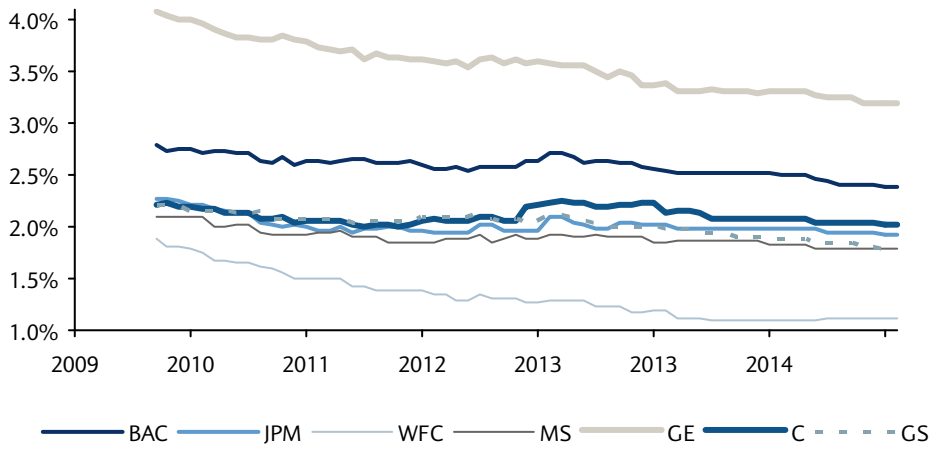
Source: Barclays Capital. Note: Includes debt eligible for the Barclays Capital Credit and FRN Indices from seven issuers: GECC, BAC, JPM, GS, WFC, C, and MS

The seven credits mentioned above issued a total of about $86bn of TLGP debt in November-December 2008. However, this issuance occurred after a period of significantly reduced supply in 2H08, when total senior debt maturities exceeded issuance by about $38bn (Figure 2). Furthermore, these seven issuers reduced their commercial paper outstanding by about $49bn during 2H08. Thus, funds raised through the TLGP in 2H08 were almost fully offset by maturity roll-offs and the reduction in commercial paper during the period. During January-July 2009, total TLGP issuance for the seven issuers stood at $142bn. During this period, senior debt maturities exceeded issuance by about $26bn and commercial paper outstanding declined by about $64bn. Thus, about $90bn of the $142bn of TLGP issuance in the first seven months of 2009 was offset by maturity roll-offs and reduction in commercial paper, leaving about $52bn of excess funding through the TLGP, for the seven issuers.

With about $47bn of upcoming senior debt maturities during August-December 2009, we believe that the excess funding under TLGP during 2009 completely offsets the need to issue further senior debt, assuming no further reduction in commercial paper or changes in deposit-based funding. We believe, however, that these issuers will continue to access the markets during the remainder of 2009, as they have done so far during the year, so as to stay relevant to their investor base and to manage overall liability profiles across the capital structure. However, this issuance is likely to remain materially below the $42bn of senior debt maturities during August-December 2009. Based on issuance patterns seen in 1H09 ($31bn of senior debt issued against about $59bn of maturities), we estimate that issuance in the near term will likely equal about one half of upcoming maturities. This is also consistent with plans announced by GE in July 2009 for issuance of about $95-100bn of debt against maturities of $218-233bn from 2009 to 2012.

With this assumption regarding potential issuance of senior debt, we revisit the medium-term index concentration estimates that we calculated in *The Future of Bank Debt*. Given the size and maturity profile of outstanding TLGP debt, it is important to consider the effect that any refinancing of the TLGP debt will have on overall senior debt concentration. We project index concentrations assuming that 30% of maturing TLGP debt and 50% of maturing non-government-guaranteed debt will be refinanced through issuance of new senior debt (Figure 3).

Figure 3: Estimated Credit + FRN Index Concentrations Assuming That 30% of TLGP and 50% of Non-TLGP Senior Debt Is Refinanced

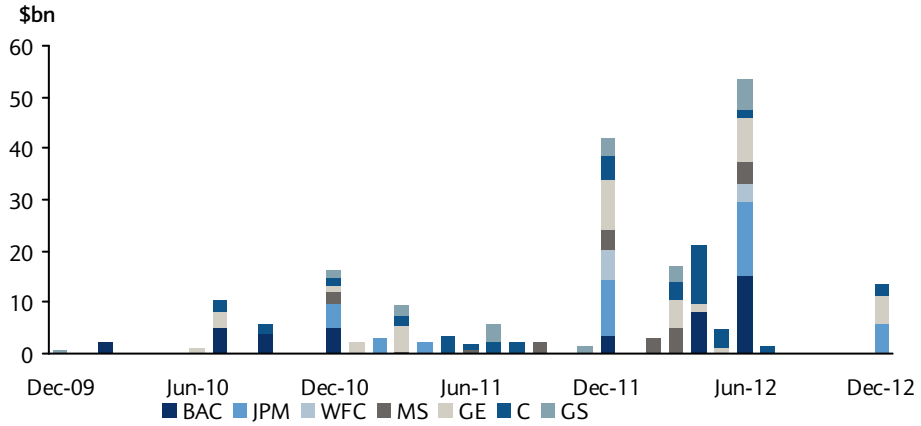


Source: Barclays Capital. Note: Amount outstanding for other issuers in the index is assumed to remain constant for the purpose of this analysis.

While index concentrations for GE and WFC are projected to decrease materially by 2014 (by more than 0.75% of overall index outstanding) under this assumption, the reduction in debt for other issuers is limited (less than 0.45% of overall index outstanding) by potential new issuance to refinance TLGP debt maturities. With a significant part of the TLGP maturities concentrated in 2H11 and 1H12, outstanding debt from these issuers could potentially increase briefly before subsiding again. In particular, December 2011 and June 2012 are heavy maturity months for this group of issuers, with more than $40bn and $50bn, respectively, of TLGP debt maturing. How these issuers deal with the TLGP debt roll-off will, therefore, have a significant effect on index concentration levels and, consequently, debt valuations.

Overall, we believe that the deleveraging process begun by the largest financial issuers will continue to support financial sector spreads in the near term. In the medium term, however, we remain cautious about the effects of the potential withdrawal of government support for the financial sector, as well as the refinancing/paydown of debt issued under the TLGP.

Figure 4: TLGP Debt Maturities for the Seven Largest U.S. Financial Issuers

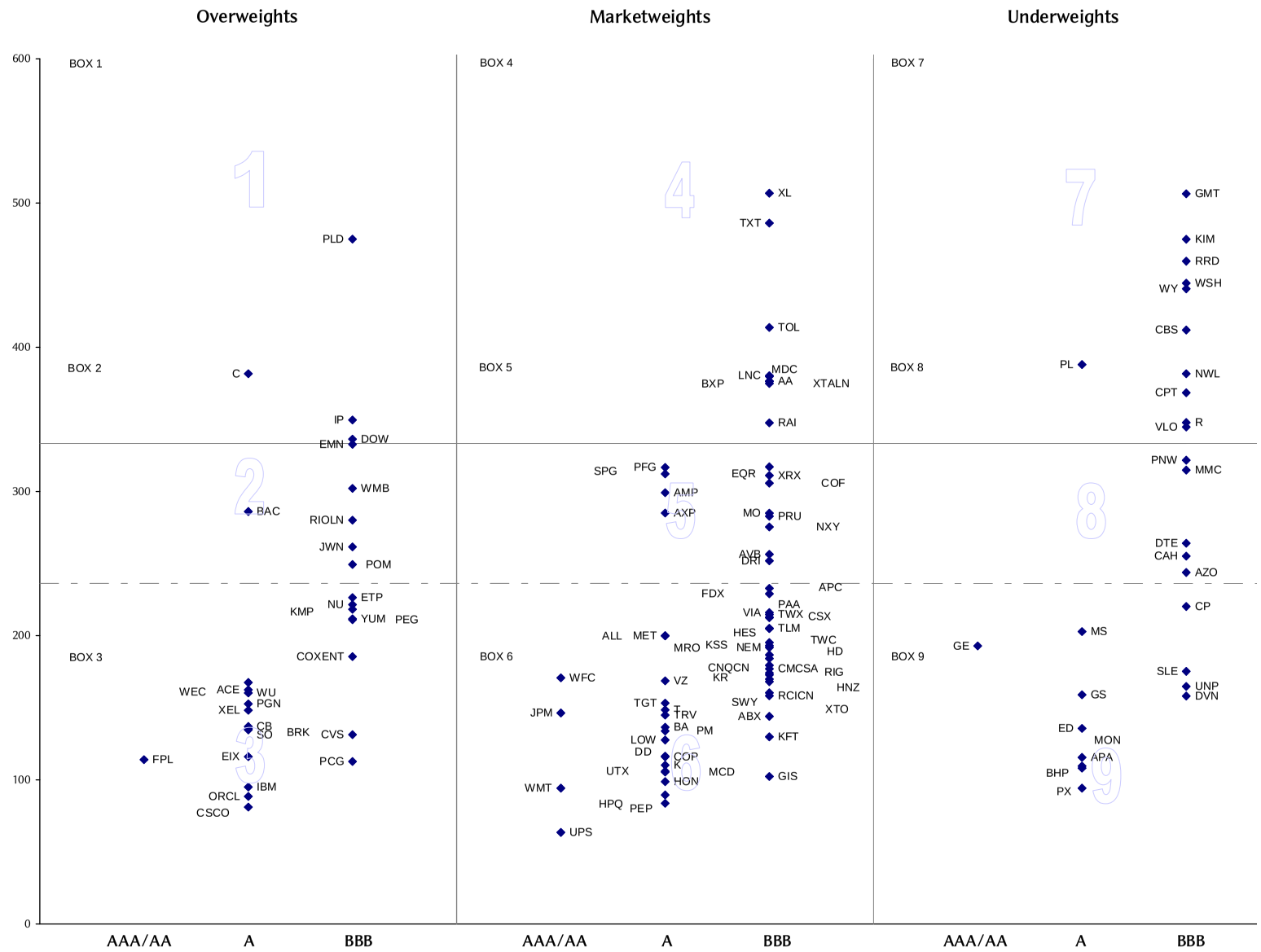


Source: Barclays Capital

Figure 5: Sector Relative Value Monitor

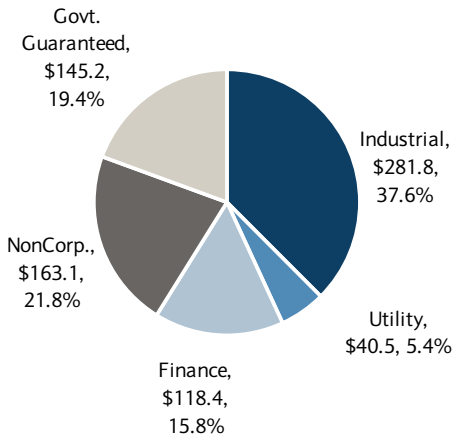
Note: Dashed line represents the average OAS for the Barclays Capital US Corporate Index. Levels as of August 13, 2009. Source: Barclays Capital

Figure 6: Issuer Relative Value Monitor



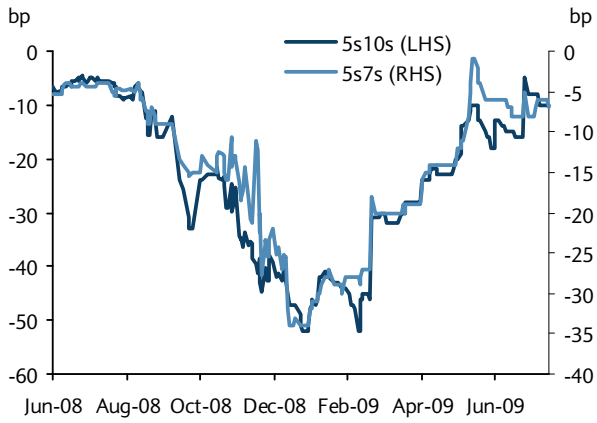
Note: Dashed line represents the average OAS for the senior unsecured bonds in the Barclays Capital U.S. Corporate Index. Levels as of August 13, 2009.
This table does not represent our full coverage universe. A full list of ratings can be found on our research website. Source: Barclays Capital

YTD2009 Fixed IG Supply



Source: Barclays Capital

CDX.IG Curve

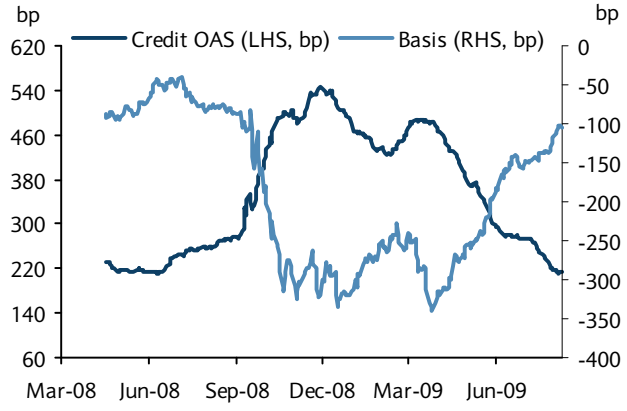


Note: A portion of the significant steepening in CDX.IG curve levels on March 20, 2009, is attributable to the roll from Series 11 to Series 12. Source: Barclays Capital

CDX.IG versus VIX

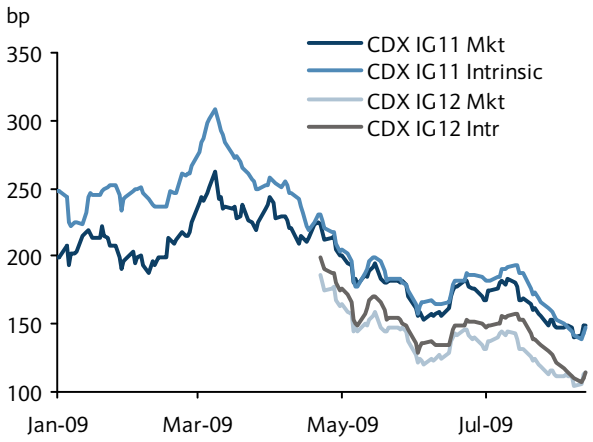
Note: A portion of the significant tightening in CDX.IG on March 20, 2009, is attributable to the roll from Series 11 to Series 12. Source: Markit, Barclays Capital

Basis



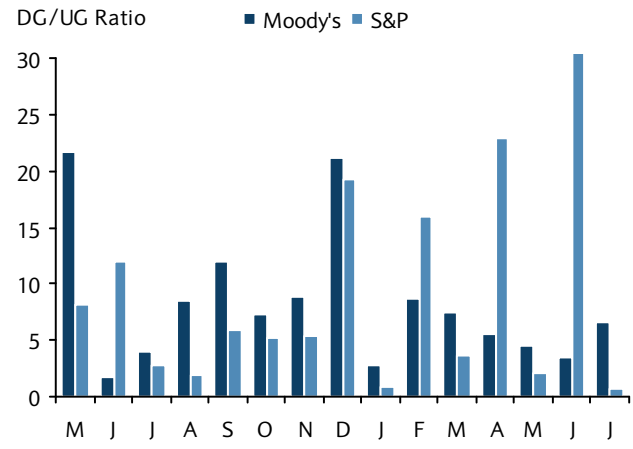
Basis defined as CDX.IG OTR spread - corporate Libor OAS. Source: Barclays Capital

CDX.IG Mkt vs. Intrinsic



Source: Barclays Capital

Par Downgrade/Upgrade Ratio



Source: Moody's, S&P, Barclays Capital. Note: The S&P ratio for June 2009 was 9.35.

HIGH YIELD

Supply Powers Back In

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The high yield market pared some of its gains this week, underperforming equities, which ended flat through Thursday's close. The CDX.HY12 lost 2 ¼pts, while the U.S. High Yield index shed a more moderate ⅓pt, taking the indices to $89.00 and $86.29, respectively. For the year, though, high yield cash remains substantially better than the S&P, with year-to-date total returns of 40.7%, versus returns of 13.9% for the equity benchmark.

Supply picked up in a big way this week, as issuers tapped the market for $8.0bn in high yield debt, a weekly pace not seen since May of this year. In addition, twelve of the nineteen deals priced through Thursday were upsized from their original amounts. Notable issuers included Sprint Nextel, which priced a $1.3bn 8.375% senior note issue due 2017, upsized from $500mn. DISH DBS and Case New Holland sold $1.0bn each, while Ball Corp came to market for two separate issues totaling $700mn, upsized from $650mn.

Second-quarter earnings season continues, with reports coming predominantly from the food, media & entertainment, and packaging sectors. Broadly, the tone of the 2Q releases was a bit softer than in the first few weeks of the season, but positive earnings surprises still outnumbered negative twenty to ten, with an additional seven companies coming generally in line with estimates. Georgia-Pacific posted a solid performance, beating pre-announced EBITDA by a substantial margin while generating strong free cash flow. Meanwhile, Clear Channel's 2Q results were weak overall, but expenses were managed well, driving EBITDA above expectations.

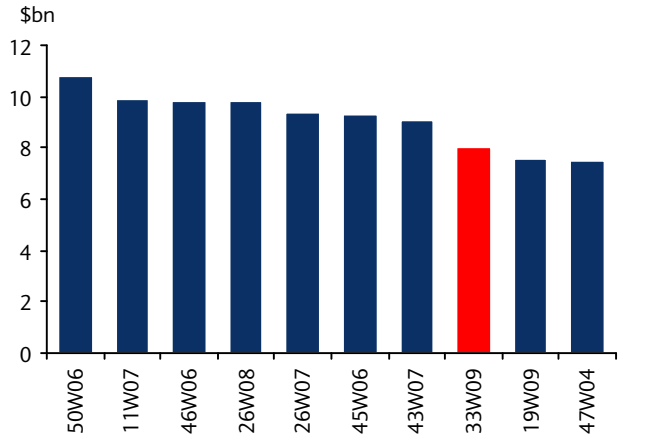
In other company news, Fitch upgraded DirecTV's corporate family rating to BBB- on Wednesday. The company is also rated BBB- by S&P, and DirecTV debt will therefore no longer be eligible for the U.S. High Yield index. At $3.4bn, DTV was the thirty-fourth largest issuer in the U.S. High Yield index. All three DTV issues should be eligible to transfer to the U.S. Credit Index at month-end. DirecTV joins a very short list, as fallen angels have outnumbered rising stars by a factor of 20 this year.

Figure 2: Cash and CDS Movers

High Yield Cash					
Best	**Px**	**Chg**	**Worst**	**Px**	**Chg**
BPOP 6.564 '34	56.00	+19.6	CNB 7.114 '12	0.50	-9.5
BC 5 '11	99.50	+16.0	TAKFUJ 9.2 '11	50.00	-6.0
MWV 7.35 '17	96.94	+8.3	INEGRP 8.5 '16	44.50	-5.5
High Yield CDS					
Best	5y	Chg	Worst	5y	Chg
AXL	38.5	-9.5	F	18.5	+5.0
CCU	60.0	-7.0	UVN	29.0	+4.0
H	47.0	-3.0	THC	9.3	+3.8

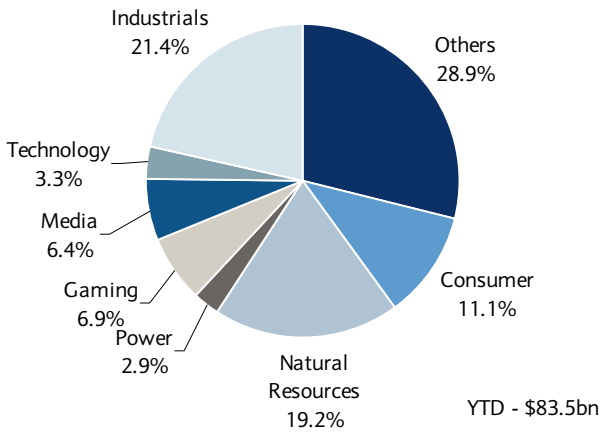
Source: Barclays Capital

Figure 2: Top-10 Weeks in High Yield Issuance



Source: Barclays Capital

High Yield 2009—Supply by Sector



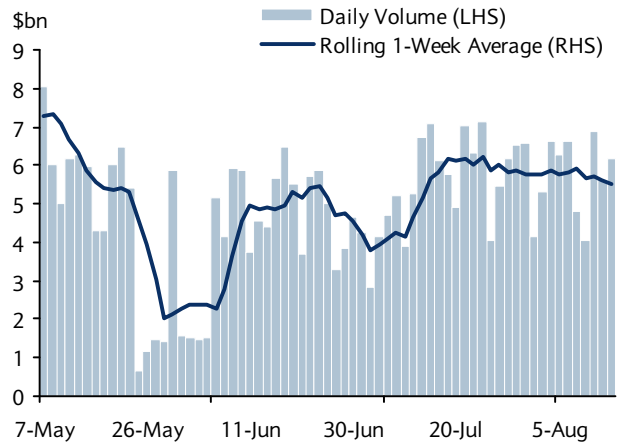
Source: Barclays Capital

Top CDX Index Names by Net CDS Outstanding

	Notional Outstanding ($bn)		Change – Week Ending 8/7/09 ($mn)	
	Gross	Net	Gross	Net
Limited Brands	28.8	2.5	374.9	(48.5)
Radian Group	37.2	2.5	1,224.1	59.5
Lennar	39.9	2.5	493.9	(11.3)
Clear Channel	30.3	2.4	1,010.2	62.9
Sprint Nextel	30.6	2.2	372.9	(4.0)
Radioshack	21.0	2.2	332.7	34.1
Temple-Inland	27.4	2.1	303.1	(33.3)
Gannett	28.5	2.1	958.0	13.3
Tyson Foods	23.8	2.1	550.7	98.3
Harrah's	29.9	1.8	644.5	(33.1)

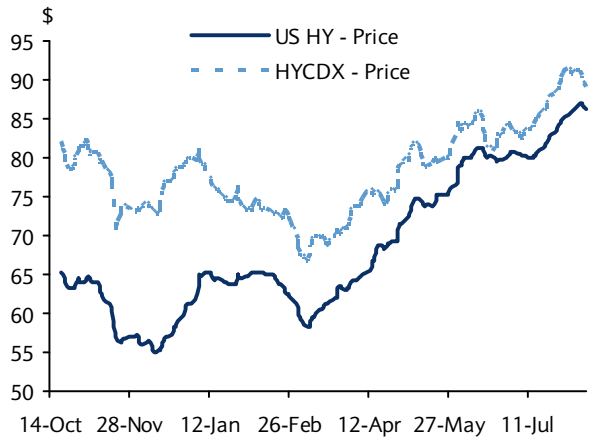
Source: DTCC

High Yield Average Institutional Trade Volume



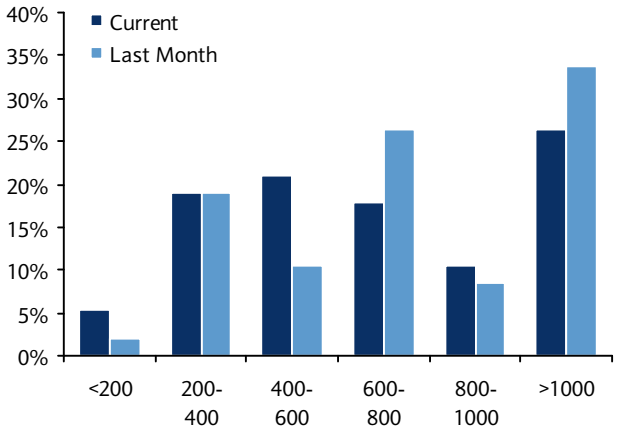
Source: Trace, Barclays Capital

OTR HYCDX versus U.S. High Yield Index



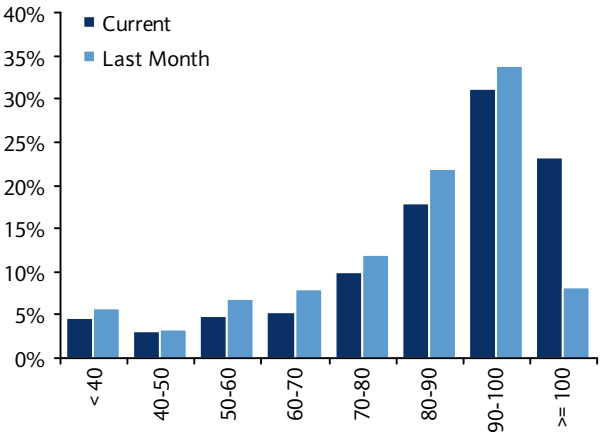
Source: Barclays Capital

On-the-Run HYCDX Spread Distribution



Note: Excludes defaults.
Source: Barclays Capital

High Yield Index Price Distribution by Par Value (%)



Source: Barclays Capital

LEVERAGED LOANS

Chipping Away at the Maturity Wall

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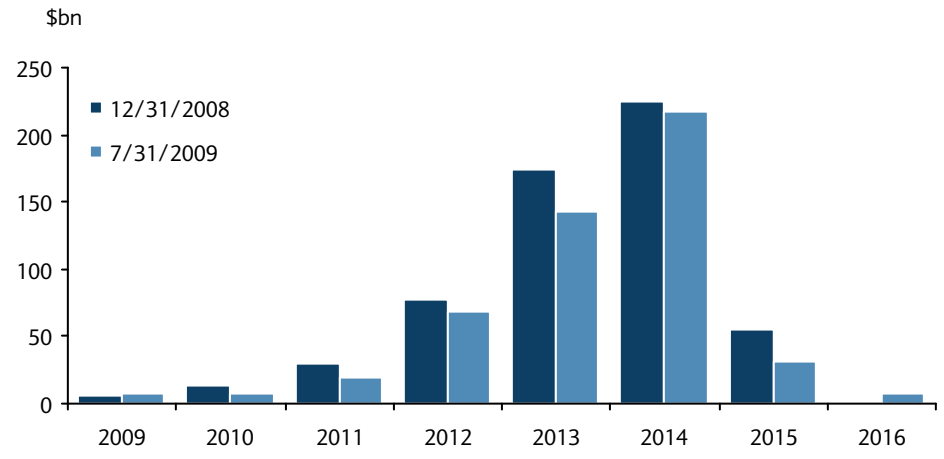
In a down week for credit, LCDX 12 dropped 2pts, to $94. The LCDX/HY12 relationship remained at approximately 5pts. We expect that relationship to diverge even further if the market softens. One potential boost could come from a lower near-term probability of default for some of the riskier credits exclusively in the LCDX. Oshkosh issued equity last week to repay loans, Michaels Stores launched an amendment to begin addressing its future loan maturities, and Capital Automotive revised its proposed amendment to comply with investor requests.

Amend-to-extend proposals were prominent once again this week, as a number of the credits we highlighted in our July 31 article, "Loans: Amend and Extend," proposed amendments. West Corp announced an amend-to-extend after failing to gain permission to issue secured debt in June. Jarden is seeking to extend $600mn of loans to 2015 from 2012. Michaels' amendment was slightly different, as it sought permission to issue new bonds or loans as long as the proceeds repaid loans. West Corp and Jarden were up modestly despite the weaker market, and Michaels loans jumped 5pts on the news. Following Cedar Fair's extension of 54% of its term loan this week, $13.9bn of loans have been extended year-to-date.

In a departure from the ordinary, Mediacom issued loans to repay bonds this week. The cable service provider issued bonds as well, but the cost of capital was less on the L+350 TL even with a 2% LIBOR floor and 1.5pt discount compared with the notes, which were priced to yield 9.5%. The loan was upsized from $200mn to $300mn, and a portion of the proceeds, along with a portion of the bond issue proceeds, will be used to retire $500mn of bonds. The new term loan traded above par on the break.

Figure 1: Loan Maturity Wall Evolution



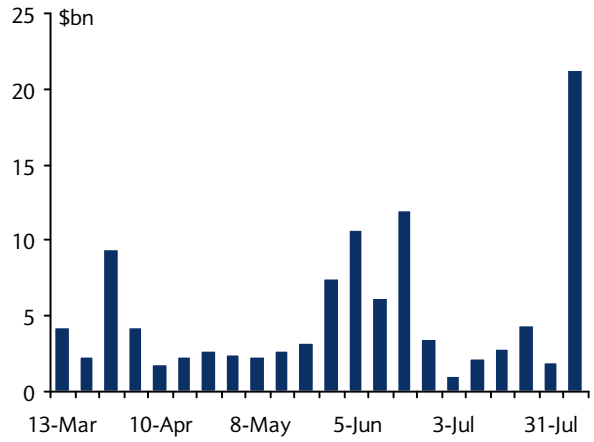
Source: Barclays Capital, S&P LCD

Weekly Leveraged Loan New Issue Volume

Leveraged Loan	# of Deals	Amt ($mn)
Institutional Launched Volume	8	1,670
Forward Calendar of Institutional T/Ls	7	3,380
Year-to-Date Institutional Loans*	44	14,060

Source: S&P LCD and S&P/LSTA Leveraged Loan Index, Barclays Capital

New Trade Volume in LCDX Indices

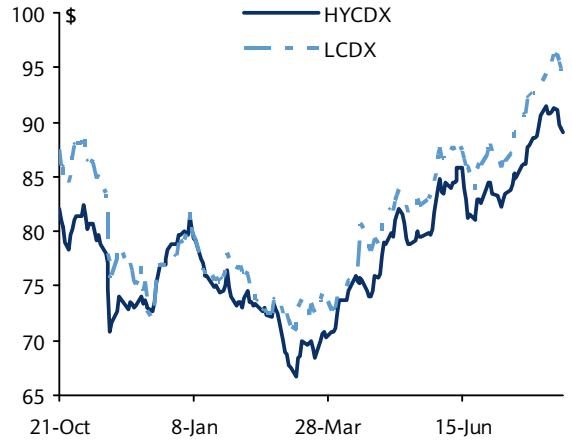


Source: DTCC

OTR LCDX Historical Spreads

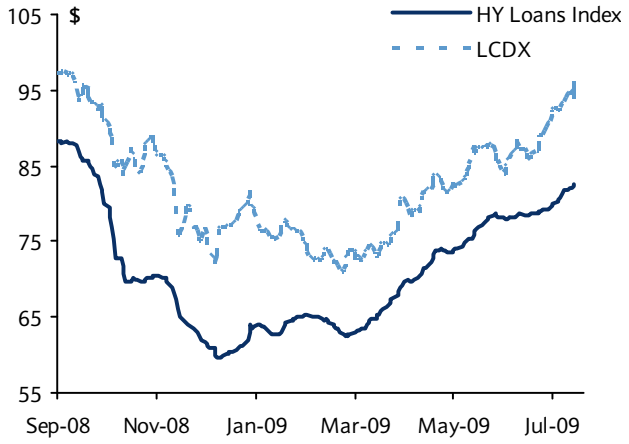
Current market assumes 55% recovery on LCDX.
Source: Barclays Capital

OTR HYCDX vs. LCDX



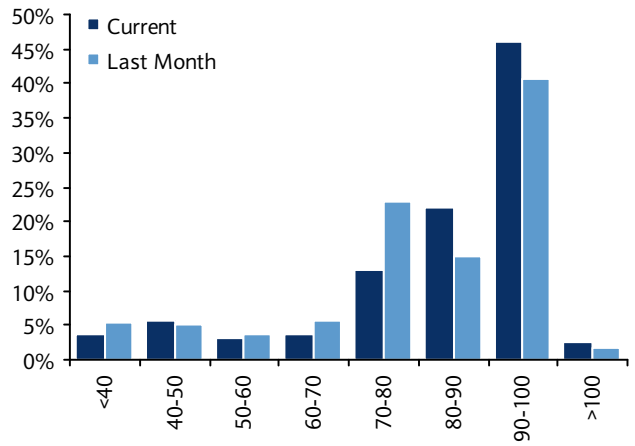
Source: Barclays Capital

OTR LCDX versus Loan Index Price History



Source: Barclays Capital

Loan Index Price Distribution by Par



Source: Barclays Capital

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Unwinds of long super senior positions have led to a widening in the 5y IG.9 super senior tranche and caused the super senior basis to widen to about 9bp. We believe this is still not enough to compensate investors for the default risk they are exposed to in a full capital structure trade. In our opinion the fair value of the basis should be about 10bp and the basis would probably have to trade wider for investors to put on the trade. In credit options, we recommend buying 1x2 December payers and funding the cost by selling OTM receivers. We show that investors can enhance their payoff profile significantly compared with a regular costless 1x2 payer by taking exposure to significant tightening from current levels, which we believe is unlikely.

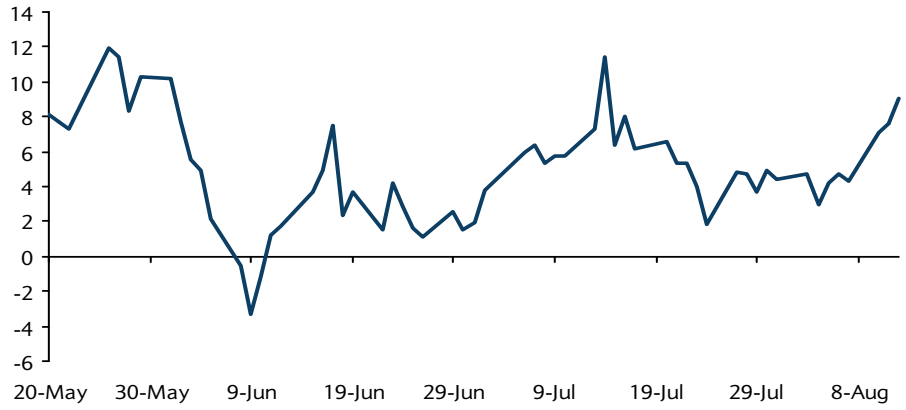
5y IG.9 Super Senior Basis Not Wide Enough, but Getting There

Super senior spreads have widened on a delta-adjusted basis, as investors have been unwinding long positions to monetize gains on the back of the index rally over the summer. As a result, 5y IG.9 super senior spreads are now trading at a 9bp premium to model-implied levels.

Super senior spreads trading wide to model-implied levels is not uncommon. Since May 2009, super senior spreads have traded at a premium to their tranche-implied levels. The average spread premium has been 5bp, with a range of -3.3 to 11.9 bp (Figure 1).

Figure 2 shows indicative tranche and index levels and durations as of August 12. Implied super senior levels (in all-running spreads) are at about 17bp, while actual super senior levels are at about 26bp.

Figure 1: 5y IG.9 Actual-Implied Super Senior Basis



Source: Barclays Capital

Figure 2: Indicative Prices and Durations for 5y IG.9 Tranches on August 12

	0-3%	3-7%	7-10%	10-15%	15-30%	30-100%	Ref
Bid Price	70.0	25.88	1.25	3.75	-1.47	-2.43	165
Offer Price	70.5	26.38	1.50	4.00	-1.37	-2.33	
Duration	1.56	2.68	3.07	3.21	3.28	3.22	3.15

Source: Barclays Capital

Figure 3: Percent Default Needed For IG.9 to Break Even on Its Basis (20% Recovery)

	Now	One Year Later	Two Year Later
Breakeven Default Level	1.9%	2.7%	4.6%

Source: Barclays Capital

Investors have monetized the basis in the past by selling protection on all the tranches and buying protection on the index (full capital structure trade). Under the current setup, a full capital structure trade would result in an upfront payment of 2.12pts and a positive annual running coupon of 80bp.

It makes sense for a positive basis to exist between actual and implied super senior levels because full capital structure trades are implicitly long credit and investors must be compensated for it. They are long credit because tranches pay a higher coupon (500bp/100bp) compared with the index (60bp). As a result, when defaults occur, net coupon payments on the trade decrease. This makes the trade sensitive to front-loaded defaults.

How wide must the basis be in order to compensate investors fairly for this long credit position? Figure 3 shows the percentage of the index that would need to default in different points in time (assuming 20% recovery) for the trade to break even on its current basis. At 20% recovery, the percentage of index defaults increases from 1.9% immediate defaults to 4.6% defaults in two years. These results imply that we would need the equity to be wiped out and the 3-7% tranche to be 25% impaired after two years for the trade to break even. At higher recovery rates, the level of index defaults required to break even would increase.

Are these default levels high or low relative to levels implied from the underlying index constituents? At current basis levels, we think the trade offers a little bit less than fair value for the credit risk that investors assume in the position. We say this because expected loss levels on the 5y IG.9 index after two years are at about 4.1% based on underlying CDS spreads of the index constituents. These loss levels exceed the breakeven expected loss on the trade of 3.7% (4.6% x 80%).

In order for the trade to break even at the index-expected losses, we believe that the super senior tranche would have to trade at a premium of about 10bp to its implied levels. For this to occur, tranches would have to continue to widen. If all the widening were to occur in the equity tranche, we estimate that equity could widen by another 0.8pts. If all the widening were to occur in the 3-7% tranche, we estimate that the tranche could widen by another 0.5pts. Alternatively, super senior levels would need to widen by another 1bp.

Historically, we find that the basis tends to collapse once it reaches about 11bp. The basis reached those levels on May 22 and June 14. On both occasions, the basis collapsed below

Figure 4: Delta-Adjusted Performance of 5y IG.9 Tranches One Week after Super Senior Basis Reaches about 11bp

	Basis	Index	0-3%	3-7%	7-10%	10-15%	15-30%	30-100%
26-May	11.9	166	70.4	34.0	5.4	7.3	0.0	-1.7
4-Jun	5.0	150	64.3	22.5	0.0	3.3	0.0	-1.7
Delta-Adjusted Returns (pts)			5.4	8.9	2.9	2.3	-0.8	-0.6
14-Jul	11.4	196	71.4	34.4	8.5	6.6	-0.5	-2.1
23-Jul	4.1	180	70.5	27.0	3.8	4.3	-0.9	-2.1
Delta-Adjusted Returns (pts)			1.0	5.8	2.6	1.4	-0.3	-0.5

Source: Barclays Capital

5bp levels over the next week. The index rallied during the same period. Figure 4 shows the delta-adjusted returns over the next week across the tranches. We find that the collapse in the basis was driven mostly by tightening in the 0-15% portion of the capital structure. Super senior spreads actually widened on a delta-adjusted basis.

Although instances of wide basis have been limited since May, the data suggest that investors who wish to monetize the basis should consider putting on the full capital structure trade or sell delta-hedged protection on 0-15% tranches. Selling outright super senior protection is also sensible, although investors will need to have a bullish view on the index.

December 120-170 1x2 Payer Spread Funded by 90 Receiver

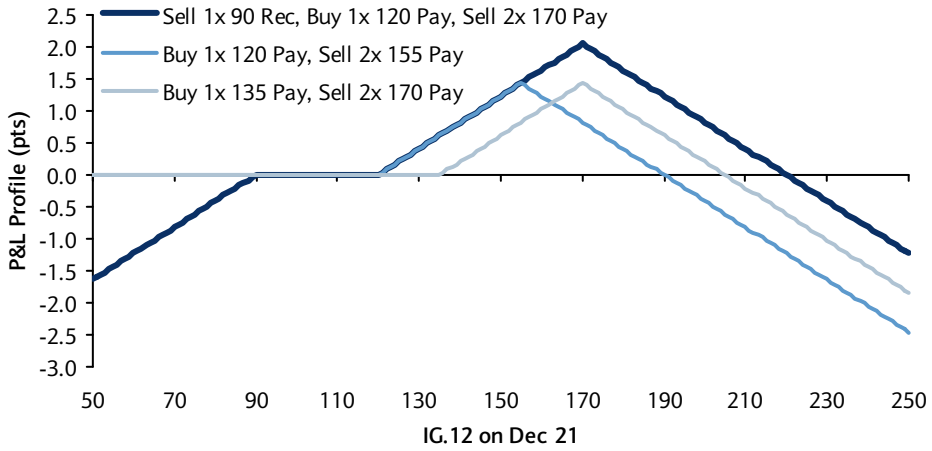
For bearish investors, we have been recommending costless December 1x2 payer trades. This week, in order to improve the breakeven range and maximum P&L potential, we outline an enhancement to these trades by selling OTM receivers.

In "How Tight Can the CDX IG Go?" *U.S. Credit Alpha*, July 31, 2009, we argued that in the medium term, IG.12 index spreads are unlikely to rally past 90bp unless there is a substantial improvement in the macroeconomic environment. Therefore, investors can sell 90 December receivers and use the upfront premium received to fund 1x2 payer trades.

In particular, we recommend buying 120-170 strike 1x2 December payer and selling 1x 90 December receiver. The trade is costless at inception. Figure 5 plots the payoff profile of the trade at expiry compared with two traditional costless 1x2 payers. Investors can enhance their upside profile by taking the risk of IG.12 spread tightening below 90bp.

For instance, an investor can buy 120-155 1x2 payer. Although the trade would generate positive P&L at expiry from immediate widening from the current levels, the main trade-off is a relatively low upper breakeven level. It is possible to improve this level by using more OTM strikes (e.g., 135-170 1x2 payer), but the investor would be giving up the benefit of the first 20-25bp widening of spreads from current levels.

Figure 5: P&L Profile for Costless 1x2 December Payers at Expiry Date



Source: Barclays Capital

Ideally, we would prefer to use 120 and 170 for lower and upper strikes of the 1x2 payer, respectively, but this would not be costless anymore. We recommend selling 1x 90 strike receiver to fund this cost. Constructed this way, the trade would generate positive P&L if spreads stay between 120bp and 220bp on December 21. It would be flat between 90bp and 120bp and would lose money only if spreads widen beyond 220 or tighten below 90bp. The maximum potential P&L is 2pts if spreads are at 170bp at expiry.

Market Recap

Thomson Restructuring Credit Event

ISDA determined that a restructuring credit event occurred for Thomson SA on August 12. The Thomson restructuring is the first restructuring credit event that will be settled under the terms of the restructuring supplement published by ISDA on July 27 and implemented via the "Small Bang" protocol. After the list of deliverable obligations is published by ISDA, CDS participants can choose to trigger their CDS contracts.

According to S&P, 261 tranches from 183 rated U.S. bespoke CDOs have exposure to Thomson SA. Bespoke maturities with exposure to Thomson would typically have maturities over the next five years. Since bespoke auctions tend to occur 45-90 calendar days after the CDS auctions, correlation desks generally buy bonds on or after the CDS auction date to hedge their long protection exposure through bespokes.

In Thomson's case, the lack of a sufficient number of deliverables in the 0-2.5 year maturity bucket (only about 25% of the bonds outstanding mature before December 2012) could make it difficult for bespoke desks to source the bonds. For longer maturities, this is less of a concern.

Loans Continue to Amend and Extend

The loan extension theme continues to develop. Since our focus article, "Loans - Amend and Extend," in *U.S. Credit Alpha*, July 31, 2009, some of the names that we identified as potential extension candidates have already extended their loans and/or broadly restructured their capital structure. These names include Jarden, Penn National Gaming, West Corp, and Michaels Stores. In most cases, both bonds and loans have rallied on the back of the restructuring news.

Synthetic Tranches and Credit Options

The IG.9 index ref levels decreased 3bp, 4bp and 5bp in the 5y, 7y and 10y tenors, respectively. Despite the muted moves in the index, on a delta-adjusted basis, junior tranches widened significantly. The 3-7% tranche across the tenors underperformed the most, with an average w/w P&L of -5.0%.

The HY.10 index ref levels decreased 0.75pts, 1pt, and 1.75pts in the 3y, 5y, and 7y tenors, respectively. The delta-adjusted tranche moves were muted in the 3y and 7y tenors. In 5y, the delta-hedged w/w P&L of the 15-25% tranche was 1.7%.

The LCDX.10 index ref levels increased 0.25pts in the 3y and 5y tenors. Equity has tightened in the 3y tenor but widened in the 5y. The 3y 8-12% tranche underperformed the most, with a w/w P&L of -3.3%.

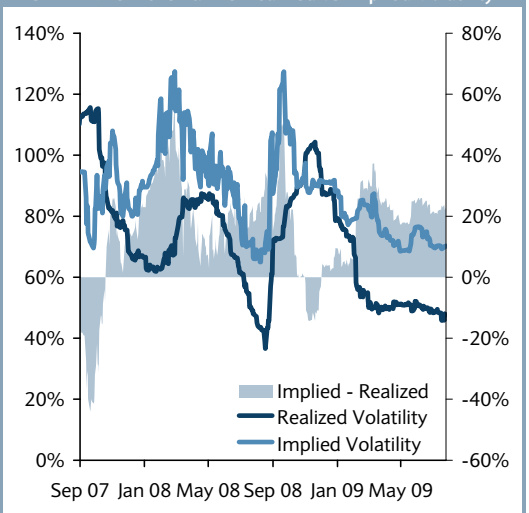
In IG index options, implied volatility increased slightly during the past week. 3m implied volatility increased 1.1%, to 70.3%, while 3m realized volatility increased 0.3%, to 46.4%. The

risk premium, which we define as the basis between the implied and realized volatility levels, increased 0.8%, to 23.9%. The term structure of implied volatility normalized, with the 3m-1m implied volatility basis increasing to -0.8% from -1.7%. The implied volatility skew steepened. The implied volatility basis between 115% and 85% normalized strikes (assuming that the ATM strike is 100%) increased to 1.9% from 0.3%.

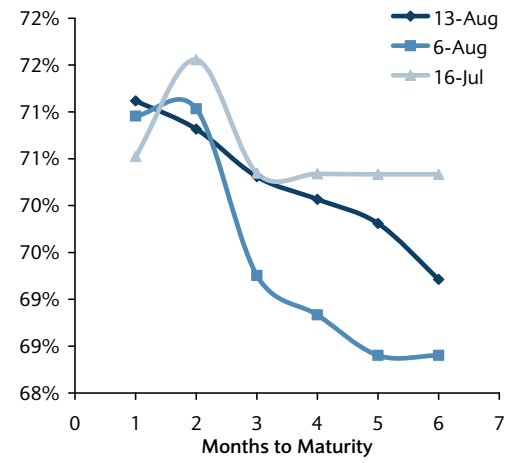
	Tranche	Bid	Offer	Delta	Weekly Level Change	Weekly Delta Adjusted Return	Monthly Level Change	Monthly Delta Adjusted Return
5y CDX.IG.9	Index	162			-3		-30	
	0-3%	70.00	70.25	1.5	2.00	-2.1%	-2.63	1.3%
	3-7%	26.38	26.63	4.4	4.25	-4.5%	-7.25	3.2%
	7-10%	0.88	1.13	4.0	-0.38	0.1%	-6.38	2.3%
	10-15%	3.38	3.63	2.2	-0.63	0.5%	-2.13	0.1%
	15-30%	-1.50	-1.40	0.8	-0.56	0.5%	-0.68	-0.1%
	30-100%	-2.52	-2.42	0.6	-0.12	0.0%	-0.29	-0.3%
7y CDX.IG.9	Index	153			-4		-28	
	0-3%	76.13	76.63	1.1	3.00	-3.1%	0.00	-1.2%
	3-7%	33.75	34.25	3.4	4.75	-5.2%	-5.50	1.5%
	7-10%	5.88	6.13	3.7	-0.25	-0.4%	-7.75	2.9%
	10-15%	8.00	8.50	2.5	-0.25	-0.1%	-3.75	0.9%
	15-30%	-1.32	-1.16	1.1	-0.56	0.4%	-1.10	0.0%
	30-100%	-3.58	-3.42	0.7	-0.36	0.2%	-0.70	-0.2%
10y CDX.IG.9	Index	135			-5		-24	
	0-3%	78.00	78.50	0.8	2.75	-2.9%	-0.38	-0.7%
	3-7%	36.75	37.25	2.6	4.63	-5.3%	-5.00	1.3%
	7-10%	9.25	9.75	3.4	-0.38	-0.7%	-8.50	3.1%
	10-15%	11.50	12.00	2.5	-0.13	-0.5%	-4.00	0.8%
	15-30%	-1.32	-1.08	1.2	-0.70	0.4%	-1.33	-0.2%
	30-100%	-5.05	-4.85	0.7	-0.55	0.3%	-1.00	-0.2%
3y CDX.HY.10	Index	96.75			-0.75		4.25	
	0-10%							
	10-15%	87.00	88.50	1.0	0.25	0.4%	-4.75	2.6%
	15-25%	34.50	36.00	3.5	2.00	0.2%	-13.75	1.6%
	25-35%	2.00	3.50	1.9	1.25	0.2%	-8.75	-0.1%
	35-100%	135	165	0.6	20	0.1%	-85	-1.3%
5y CDX.HY.10	Index	93.25			-1		4.5	
	0-10%							
	10-15%	93.00	94.50	0.4	0.75	-0.5%	-2.25	1.4%
	15-25%	57.00	58.50	2.0	0.25	1.7%	-10.25	3.7%
	25-35%	15.00	16.50	1.9	2.25	-0.4%	-7.75	-0.3%
	35-100%	280	305	0.9	28	0.1%	-63	-2.3%
7y CDX.HY.10	Index	91.75			-1.75		4	
	0-10%							
	10-15%	95.00	98.00	0.2	-0.25	0.5%	-1.25	0.7%
	15-25%	62.50	65.50	1.5	2.50	0.0%	-7.00	2.5%
	25-35%	26.00	29.00	1.8	3.00	0.0%	-6.50	0.3%
	35-100%	325	375	0.9	53	-0.4%	-45	-2.2%
3y LCDX.10	Index	97.25			0.25		7.25	
	0-5%							
	5-8%	4.25	5.75	0.2	0.75	0.7%	3.88	2.9%
	8-12%	47.75	49.25	5.0	-2.75	-3.3%	18.25	-3.1%
	12-15%	86.25	87.75	3.7	0.75	0.0%	24.00	1.0%
	15-100%	105.75	106.75	0.8	0.50	0.4%	5.75	-1.1%
5y LCDX.10	Index	92.75			0.25		6.75	
	0-5%							
	5-8%	2.00	3.50	0.1	-0.25	-0.3%	1.63	1.0%
	8-12%	23.75	25.25	1.8	-0.25	-0.6%	4.25	-5.1%
	12-15%	54.75	56.25	2.6	0.50	0.1%	12.00	-2.2%
	15-100%	105.50	106.50	1.1	0.00	-0.3%	6.25	-1.6%

	Strike	Type	Price	Imp Vol		Strike	Type	Price	Imp Vol
Swaption Sep-09 IG.12 Ref = 114	100	REC	15	68.4%	Swaption Dec-09 IG.12 Ref = 114	100	REC	35	68.2%
	110	REC	32	69.8%		110	REC	54	69.7%
	110	PAY	61	69.8%		120	REC	75	70.1%
	120	PAY	41	70.3%		120	PAY	91	70.1%
	130	PAY	26	71.2%		130	PAY	74	70.1%
	140	PAY	18	73.7%		140	PAY	61	71.2%
						150	PAY	52	73.3%

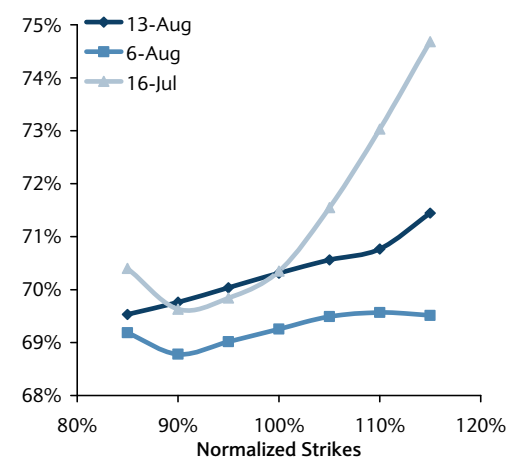
3m ATM On-the-run IG Realized vs Implied Volatility



Term Structure of Implied Volatility for ATM IG Options



Normalized Volatility Skew of 3m On-the-run IG Options



Note: W/w changes constitute the difference in market closing levels between August 6, 2009, and August 13, 2009. M/m changes constitute the difference in levels between July 16, 2009, and August 13, 2009. Source: Barclays Capital

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Explanation of the High Grade Sector Weighting System
Overweight: Expected six-month excess return of the sector exceeds the six-month expected excess return of the Barclays Capital U.S. Credit Index or Pan-European Credit Index, as applicable.
Market Weight: Expected six-month excess return of the sector is in line with the six-month expected excess return of the Barclays Capital U.S. Credit Index or Pan-European Credit Index, as applicable.
Underweight: Expected six-month excess return of the sector is below the six-month expected excess return of the Barclays Capital U.S. Credit Index or Pan-European Credit Index, as applicable.

Explanation of the High Grade Research Rating System
The High Grade Research rating system is based on the analyst's view of the expected excess returns over a six-month period of the issuer's index-eligible corporate debt securities relative to the Barclays Capital U.S. Credit Index or Pan-European Credit Index, as applicable.
Overweight: The analyst expects the issuer's index-eligible corporate bonds to provide positive excess returns relative to the Barclays Capital U.S. Credit Index or the Pan-European Credit Index over the next six months.
Market Weight: The analyst expects the issuer's index-eligible corporate bonds to provide excess returns in line with the Barclays Capital U.S. Credit Index or the Pan-European Credit Index over the next six months.
Underweight: The analyst expects the issuer's index-eligible corporate bonds to provide negative excess returns relative to the Barclays Capital U.S. Credit Index or the Pan-European Credit Index over the next six months.
Not Rated (NR): An issuer which has not been assigned a formal rating.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where Barclays Capital is acting in an advisory capacity in a merger or strategic transaction involving the company.

Explanation of the High Yield Sector Weighting System
Overweight: Expected six-month total return of the sector exceeds the six-month expected total return of the Barclays Capital U.S. High Yield 2% Issuer Capped Credit Index, or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.
Market Weight: Expected six-month total return of the sector is in line with the six-month expected total return of the Barclays Capital U.S. High Yield 2% Issuer Capped Credit Index or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.
Underweight: Expected six-month total return of the sector is below the six-month expected total return of the Barclays Capital U.S. High Yield 2% Issuer Capped Credit Index or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.

Explanation of the High Yield Research Rating System
The High Yield Research team employs a relative return based rating system that, depending on the company under analysis, may be applied to either some or all of the company's debt securities, bank loans, or other instruments. Please review the latest report on a company to ascertain the application of the rating system to that company.
Overweight: The analyst expects the six-month total return of the rated debt security or instrument to exceed the six-month expected total return of the Barclays Capital U.S. 2% Issuer Capped High Yield Credit Index or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.
Market Weight: The analyst expects the six-month total return of the rated debt security or instrument to be in line with the six-month expected total return of the Barclays Capital U.S. 2% Issuer Capped High Yield Credit Index or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.
Underweight: The analyst expects the six-month total return of the rated debt security or instrument to be below the six-month expected total return of the Barclays Capital U.S. 2% Issuer Capped High Yield Credit Index or the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, as applicable.
Not Rated (NR): An issuer which has not been assigned a formal rating.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where Barclays Capital is acting in an advisory capacity in a merger or strategic transaction involving the company.

Analyst Certification(s)
We, Ashish Shah, Jeffrey Meli, Bradley Rogoff, Madhur Duggar, Gautam Kakodkar, Hari Manappattil, Shobhit Gupta, Michael H Anderson, Batur Bicer, Matthew Mish and Eric Gross, 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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On September 20, 2008, Barclays Capital Inc. acquired Lehman Brothers' North American investment banking, capital markets, and private investment management businesses. Historical and current disclosure information is provided via the two sources listed below.
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