Sector Selection Update

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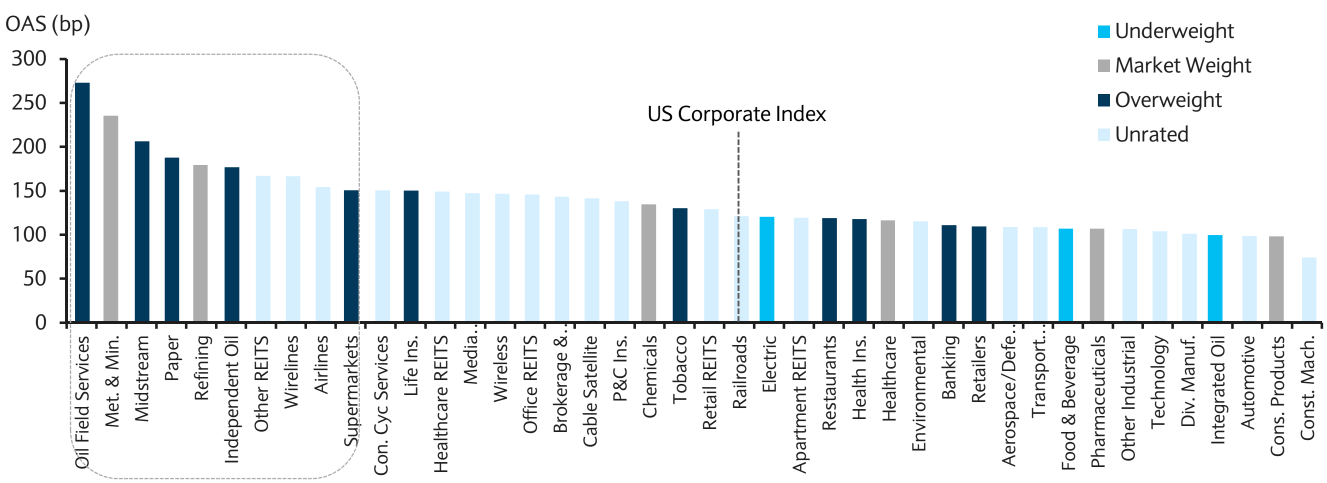
The U.S. Corporate Index has posted an excess return of about 30bp year-to-date, broadly in line with our view for moderately positive returns in 2015, but slightly below the 175-225bp pace we projected in the *2015 Global Credit Outlook*, December 5, 2014. While we expect about 10-15bp of tightening by year-end and, as a result, excess returns to pick up and move closer to our forecast range, we continue to see even more upside from relative value opportunities, particularly in sector selection strategies.

As we have discussed previously, the widest-trading sectors in any given period tend to outperform the index by 100-200bp over the following 12 months (see *Systematically Selecting Securities to Simulate Sectors*, September 12, 2014, for more details). Figure 1 highlights the widest trading sectors at present, which are composed primarily of energy and commodity sectors. In our view, a good strategy would be to increase exposure to out-of-favor sectors that we are fundamentally constructive on; in that regard, we believe midstream, independent oil, paper, and supermarkets look particularly attractive. Conversely, reducing exposure to tight-trading sectors that we are fundamentally Underweight, such as integrated oil and food & beverage, also appears compelling.

Admittedly, such a strategy requires taking a larger position in oil credits. However, we do not believe that buying the widest sectors is necessarily taking a view on oil. Instead, it is taking a view that investment grade companies tend to perform adequately even when facing difficult market conditions and that adequate operating performance plus spreads much wider than the index leads to outperformance. The lower leverage, larger size, and enhanced balance sheet flexibility of investment grade oil companies, for example, make them more capable than high yield companies of producing positive cash flows even at low, sustained oil prices. While we are constructive on investment grade energy (especially midstream and independent E&P), we remain Underweight high yield E&P and oil field services, as low oil prices are likely to pressure operating fundamentals and leverage significantly (*High Yield Energy 2015 Outlook*, January 14, 2015).

In addition to a larger oil allocation, the widest sectors strategy inherently involves increasing beta exposure to the index. However, as we have noted before, the widest sectors have positive

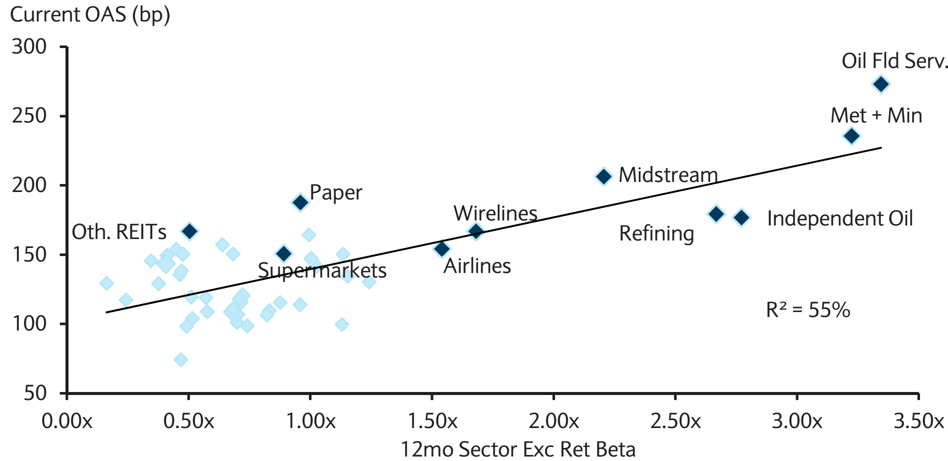
FIGURE 1
Widest Sectors Are Dominated by Energy and Commodities



Note: Only sectors with a market share above 0.2% are included. Source: Barclays Research

FIGURE 2

Widest Sectors Tend to Trade Wider than Beta-Implied Levels



Note: Ten widest sectors with a market share above 0.2% of the index are highlighted in dark blue.
Source: Barclays Research

convexity, meaning that they tend to outperform by more than their beta implies during market rallies, but underperform by less than their beta during sell-offs; as a result, the widest-sectors strategy outperforms even on a risk-adjusted basis (*Go Wide for Outperformance*, November 15, 2013).

Figure 2 compares the realized 12-month excess return beta of each sector with current spread levels. Of the ten widest sectors, seven trade wide of beta-implied levels (based on the above linear relationship). In fact, with an average beta of 2x, fair spread compensation for owning the ten widest sectors (based on beta exposure) would be around 175bp, 15bp below the actual average of 190bp. The spread differential is even larger for the five widest sectors (average beta 2.5x), which trade 22bp above beta-implied levels (216bp versus 194bp). This analysis is more relevant for low- to mid-beta sectors (since there are relatively few sectors with betas greater than 1.5x). In this light, the spread compensation offered by supermarkets and paper looks especially appealing, given that both sectors have a beta of less than one.

Ultimately, given our view that investment grade spreads are likely to tighten from current levels (or at least remain range-bound), we believe wide sectors should outperform by year-end, owing to their high beta and high spread carry. We highlight the most attractive sectors, in our view, below.

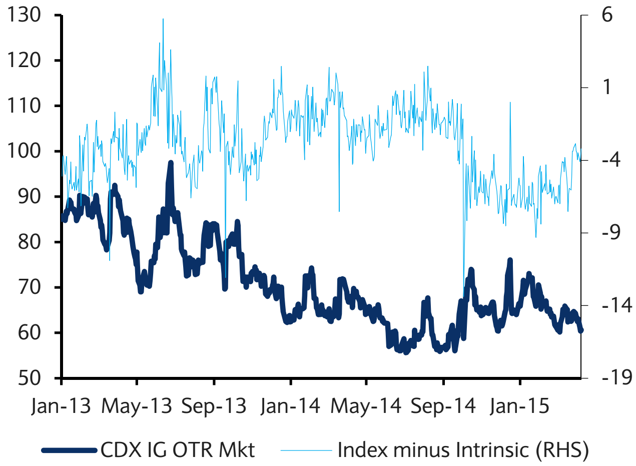
- **Paper:** The paper sector offers approximately 60bp of spread pickup over the broader U.S. Credit Index. Despite its lower ratings (relative to the index), the industry exhibits consistent end-market demand and a high degree of consolidation, which have historically provided stability to the sector. Overall, our fundamental analysts think the combination of spread pickup and low volatility will lead to outperformance in 2015 and have initiated coverage at Overweight (*HG Paper: Initiating Coverage at Overweight*).

- **Independent E&P**: We have an Overweight rating on the investment grade E&P sector, with spreads versus the U.S. Credit index remaining near the wide end of the 20-year range. At the top of the energy value chain, we expect the upstream producers in our coverage universe to exercise significant flexibility in their capital spending and cost structures in the coming months in an effort to limit outspending cash flow as commodity prices remain weak. Credit metrics will invariably deteriorate for the majority of the credits in the sector, but in aggregate, we believe spreads can outperform with commodity price stability as opposed to needing materially higher prices.

- **Midstream:** Given an expectation for a muted (at best) oil price recovery in coming years, our fundamental analysts expect aggregate volumes in the U.S. to remain robust in the near term. As a result, they believe that midstream infrastructure will still be needed in order to provide takeaway options for producers in certain basins (most notably the Marcellus). They expect volume growth to slow, which will likely lead to M&A, but have not found M&A to be a significant catalyst for underperformance in the past. They remain Overweight the sector and continue to see value with spreads trading at the seventy-seventh percentile of their LTM range versus the U.S. Credit Index.

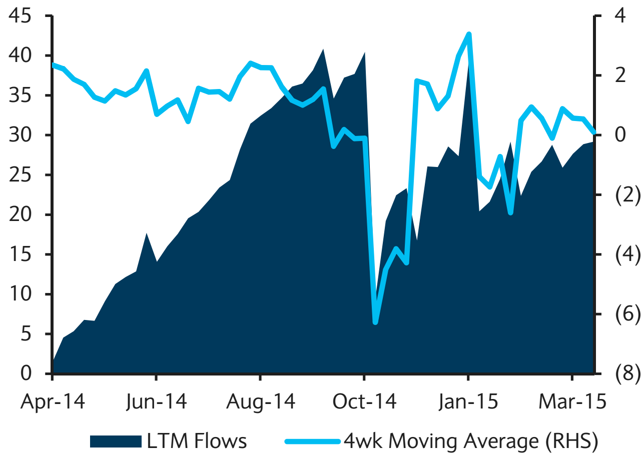
- **Supermarkets**: Our fundamental analysts are Overweight the supermarkets sector because of strong fundamentals. In their view, grocers should be more immune to some of the headwinds being faced by food manufacturers due to their diversified offerings, which enable better fit with changing consumer preferences and higher-margin private label and organic/natural offerings. As a result, the sector serves as an alternative to sectors with more headline risk, such as food & beverage. Supermarkets currently offer 30bp of spread pickup over the U.S. Credit Index.

CDX.IG OTR Market versus Intrinsic (bp)



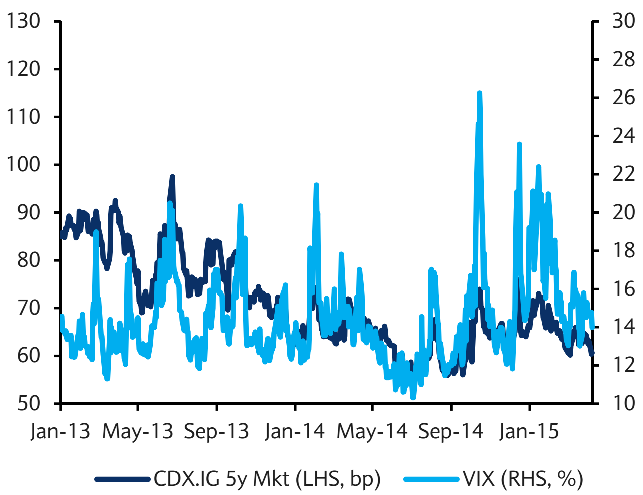
Source: Barclays Research

Investment Grade Fund Flows ($bn)



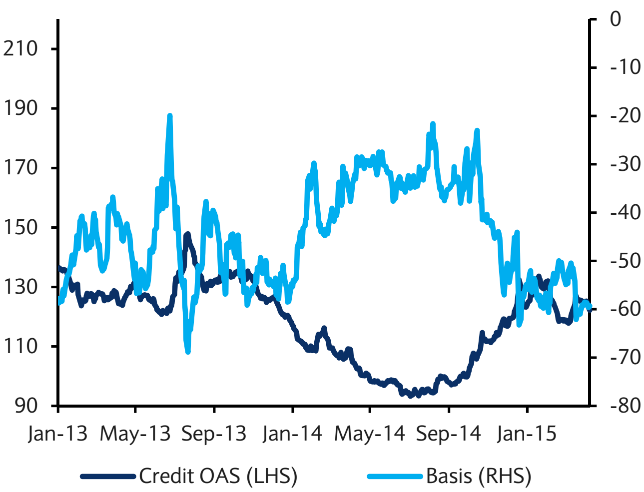
Source: Lipper/Thomson Reuters, Barclays Research

CDX.IG versus VIX



Source: Markit, Barclays Research

CDS-Cash Basis (bp)



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

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