SOCIETE GENERALE
Cross Asset Research

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Credit Strategy Outlook 2016

Climbing the wall of worry

Head of EM & Credit Research

Guy Stear
(33) 1 42 13 63 99
guy.stear@sgcib.com

Head of European Credit Strategy

Juan Esteban Valencia
(33) 1 56 37 36 83
juan.valencia@sgcib.com

Head of US Credit Strategy

Kevin McCarthy
(212) 278 7027
kevin.mccarthy@sgcib.com

Head of Asian Credit Strategy

Imtiaz Shefuddin
(65) 6326 7817
imtiaz.shefuddin@sgcib.com

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- Defaults are the biggest challenge for credit next year, but we think they will be seen in emerging markets more than in US high yield.
- Despite defaults, excess returns on global credit could reach 2% in 2016.
- Add beta to European credit portfolios by adding subordinated financials.
- As dispersion remains high, credit selection may matter more than beta in non-financials.

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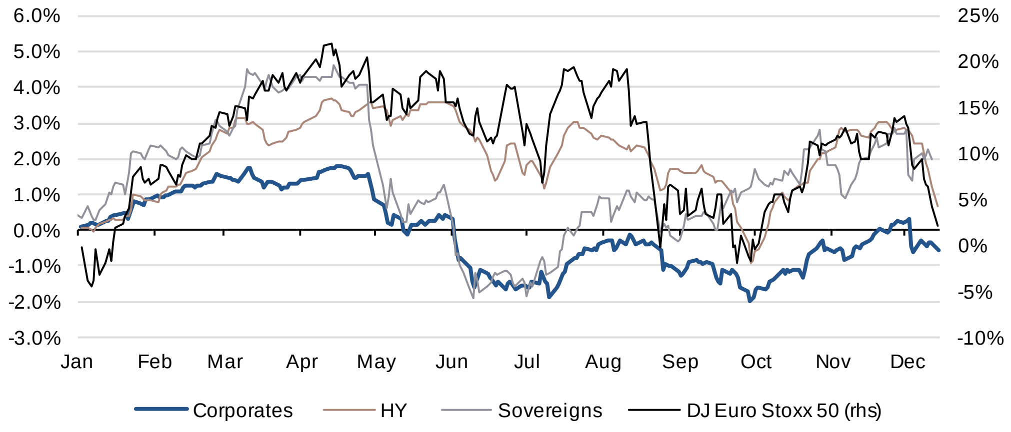
Executive comment

In 2015, global credit markets felt like a cold and forbidding place. European investment grade, which was supposed to be a defensive haven made even more defensive by the ECB, ended up seeing the sharpest percentage widening in spreads, while European high yield markets turned in the best percentage performance of any sector. And despite all the worries surrounding emerging markets, EM high yield did best of all in total returns. Nothing worked out quite as anyone expected.

IG remains in negative territory, all others very volatile



Source: www.markit.com, Bloomberg, SG Cross Asset Research/Credit

Like the climber scaling the wall of ice on our cover, credit investors will have to get past some further worries next year. This year they looked nervously ahead to defaults; next year these defaults will almost certainly occur. They may not come quite where investors expect, however. The most distressed prices are in the US high yield energy sector, and oil prices have indeed kept falling (though our commodity strategists expect them to bounce soon). For us, however, emerging market companies remain a bigger worry. Prices in this sector anticipate relatively few defaults, even though the history of non-performing loans in emerging markets is a fearsome one. In "Deeper into the Vortex," our EM strategists explain why emerging market currencies are likely to fall further still in 2016, and this will only add to pressure on the emerging market corporations who have borrowed in dollars. Investors are not just worried about defaults at companies, however; they are also worried about a lack of liquidity among investors. Trading conditions are tight, and the decision by US high yield funds, Third Avenue Management and Stone Lion Capital, to suspend redemptions has raised further jitters about what might happen if a lot of investors head for the exits.

Yet if these worries are surmounted, then the view from the top of the credit mountain at the end of 2016 could be surprisingly good. Credit has advantages: though US issuers may be eager to take advantage of the low yields on offer in the European markets, their European counterparts are still managing balance sheets very defensively. The ECB continues to add liquidity to the European markets, and European insurance companies need the extra yield that credit can provide. Finally, the widening in spreads seen over 2015 has made break-evens more attractive. As a result, we expect excess credit returns to be better in 2016 than they were in 2015, with global credit markets generating an excess return over benchmarks of some 2%. While European IG markets should provide the best risk/return, the biggest opportunity may be overweighting the US vs EM in H1, and then reversing the positions in the second half of the year.

At this point of the cycle, security selection matters at least as much as beta, if not more, so our analysts have helped us with a detailed summary of the issues to focus on in their sectors, and a list of the names to buy and to avoid. Financials remain our preferred sector within Europe once again this year, and we recommend adding beta to portfolios through bank AT1 issues, holdco LT2 bonds, and Spanish or UK banks. We also like subordinated insurance bonds from issuers such as Axa or Aviva. Dispersion rose amongst the non-financial names in H2, and is likely to remain high next year, so picking the right issuers will matter more than beta in non-financials next year. Our analysts are bullish on selected names in the auto and air transport sectors, but investors need to be careful with the rich valuations on offer in many of the industrial sectors. Though utilities have become more defensive, they may face further ratings downgrades next year, and telecoms could offer better opportunities despite having to fight to keep revenue at current levels.

Summary of views

<table>
<tr><th></th><th>Comment</th><th>Highlights in bullet points</th></tr>
<tr><td>Macro credit view</td><td>ECB and Fed on different paths: There are many issues to deal with next year on the Macro front, including Chinese (and global) economic growth, commodity prices including oil, metals, and different raw materials, trends in the different emerging markets and rising concern over US HY to name a few. All these factors are likely to be drivers of the credit markets through 2016 but we think the bigger impact will come from the diverging policies of the ECB and the Fed. Both central banks will be moving in opposite directions with the former easing further and the latter tightening its monetary policy. This will have an impact on rates (sovereign bond yields) and credit spreads (US corporates will be releveraging earlier and faster than eurozone corporates). We believe the divergence will continue to increase with eurozone assets yielding less and less and US assets yielding more and more. At some point the decoupling will stop as arbitrage opportunities arise but the timing is as always difficult to judge.</td><td>Fundamentals
World economic growth to improve from 2.8% (2015f) to 3.1%, with the US and eurozone offsetting Chinese slowdown.
Eurozone to grow at 1.6% with inflation rising to 1.1%.
UST 10y yield to rise to 2.25% and differential with 10y Bund yield to rise to 1.85%.
EUR/USD to reach parity by the end of 2016.
Balance sheet discipline stays strong in eurozone but US releveraging more aggressively.
Upgrades and downgrades to remain broadly balanced through the year.
Low defaults in eurozone (2.5%) but rising (although still manageable) in the US and EM combined (4%).</td></tr>
<tr><td>Corporate cash market</td><td>High beta and double-Bs but US IG looking increasingly attractive: The ultra-low yield environment in the eurozone is set to continue in 2016 as the ECB has committed to extending QE until March 2017 (for now) and this means that the bid for credit will remain strong as the hunt for yield intensifies. We believe the higher beta sectors are the best option as anything low beta, highly rated and low yielding has very low breakevens, leaving investors with no room for error. We prefer the higher beta names and bonds, including sub financials, corporate hybrids, crossover names and double-B rated companies. We expect to see euro IG returns around 1.5%, with HY faring better at around 6-7%. However, we believe US IG will become increasingly attractive as rates and spreads adjust to the Fed rate hikes and releveraging. The yield differential between US IG and euro IG should increase making the case for US IG particularly strong in H2 2016. The same is not true for US HY where we see difficult times ahead with clear concerns over the energy sector and rising defaults.</td><td>Take risk to generate performance
Keep beta slightly above 1 to benefit from spread tightening.
5yr to 10yr area to post the strongest performance but longer end should remain volatile with benchmark yields rising.
BBBs attractive vs Single As in IG.
BBB/BBs space to offer the most attractive risk/reward profile.
Single Bs and CCCs are likely to be exposed to difficulties in US HY.
AT1, LT2 and Sub insurance to outperform senior bank and senior insurance debt.</td></tr>
<tr><td>Synthetics market</td><td>iTraxx indices to benefit from equities and/or cash: The correlation between synthetic indices and equity markets has weakened through the year and the former have been much less volatile than the latter even if the iTraxx indices continue to look at equities for direction. Additionally, the synthetic indices have been slowly outperforming cash, in a tightening or widening environment. As we move into 2016 we expect to see the iTraxx indices continue to creep tighter, looking for support from either equities or cash. We believe default rates will remain low in the eurozone and expect to see an ongoing hunt for yield. This should translate into a moderate tightening in the Main contracts with the X-Over outperforming, and a better performance from the financial baskets.</td><td>Some compression room still left
Sell X-Over vs Main – target 3.6x
Sell iTraxx Sub fins vs Senior fins
Sell Senior Fins vs Main – target 0.85x</td></tr>
<tr><td>New issue markets</td><td>More overseas issuance and another big year for the euro market: 2015 saw a very large increase in issuance by non-eurozone corporates and we expect the trend to continue in 2016 as the euro market becomes increasingly mature, broad and deep, making it a very attractive funding alternative. US corporates were the biggest users of the euro markets for the first time in history in 2015 and we believe they will be even more active in 2016. And corporates from other jurisdictions are likely to follow suit. After all, funding costs in euros are set to remain extremely low, and the markets also add a funding diversification dimension. IG should test the €250bn level again, which, added to lower redemptions, means an even higher net issuance figure. But we don’t expect this on its own to put much pressure on spreads. After all, we expect a new marginal buyer with deep pockets, and we also expect some sovereign bond investors to give a very good look at credit. Overall, it should be a more dynamic market and hopefully we’ll see a better balance between supply and demand.</td><td>New issue forecasts 2016<table><tr><th>Sector</th><th>2014</th><th>2015*</th><th>2016 Forecast</th></tr><tr><td>Non Fin Corps</td><td>€223.9bn</td><td>€245.8bn</td><td>€250bn</td></tr><tr><td>HY Corps</td><td>€76.9bn</td><td>€66.8bn</td><td>€80bn</td></tr><tr><td>Hybrids</td><td>€28.6bn</td><td>€25.6bn</td><td>€25bn</td></tr><tr><td>Senior Fins</td><td>€146.24bn</td><td>€149.6bn</td><td>€160bn</td></tr><tr><td>Subordinated</td><td>€54.5bn</td><td>€44.7bn</td><td>€60bn</td></tr></table>*to Dec 11</td></tr>
</table>

Source: SG Cross Asset Research

Top views 2016

Top views

Sector	Company	Recommendation	Comment
Banks	UK Sen Holdco	**Overweight**	Brexit risk is offset by higher earnings, and holdco risk is too cheap.
	Santander	**Overweight**	Latam risk is overestimated by the markets.
	Holdco Tier 2	**Overweight**	No riskier than Opco Tier 2, but the market doesn't price it that way.
	German Senior	**Underweight**	Prices need to fall to reflect the subordination risk.
	Nordic Senior	**Underweight**	High quality, but very expensive indeed.
Insurance	Axa and Aviva	**Overweight**	Axa's capitalisation underestimated, and Aviva Solvency II fears overdone
	Swiss Re	**Overweight**	Best of the low beta peers
	Allianz	**Underweight**	Take profits on tight valuations
	Zurich	**Underweight**	Could have poor news on reserving
Consumer	Accor	**Overweight**	Sector consolidation is ongoing but we expect a company to preserve ratings
	Rallye	**Underweight**	Clear potential for a negative feedback loop stemming from Casino
Industrials	Glencore	**Overweight**	Cheap value way to get exposure to improving commodity markets
	Solvay	**Overweight**	Potential downgrades in the price, and Cytec acquisition makes sense
	LafargeHolcim	**Underweight**	Cyclical BBB with integration and EM risk that trades too tight
	Bayer	**Underweight**	Still worried about the prospect of M&A
	Alstom	**Underweight**	Ratings at risk depending on how debt reduction progresses
Autos	PSA	**Overweight**	Deleveraging and hopes of ratings improvement to tighten spreads
	Schaeffler	**Overweight**	Balance sheet metrics to improve
	BMW	**Underweight**	At risk of more competition in China
	Volkswagen	**Underweight**	Still too unpredictable, though high beta makes it alluring
Air & Aerospace	Ryanair	**Overweight**	Pricey, but worth it
	Airbus	**Overweight**	Strong civil exposure makes it appealing
	Bombardier	**Underweight**	Cash burn and C-Seriess worries could lead to downgrades
	AF-KLM	**Underweight**	Competition from low cost and Middle-East airlines not priced in
Utilities	Enel	**Overweight**	Attractively prices vs peers, even if deleveraging should slow
	Statkraft AS	**Underweight**	Capital situation less solid after Norwegian government wants more dividends
	RWE	**Underweight**	Restructuring poses problems for debt holders
Telecom	KPN	**Overweight**	Best value in the sector, particularly in 4-6yr maturities
	TEF	**Overweight**	Attractive spreads vs large IG Telcom peers, with risks overestimated
	Swiss HY	**Overweight**	Improving operating trends leaves room for outperformance
	AT&T	**Underweight**	Execution risk on DirecTV purchase not priced in at the long end

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Sector positioning

We expect market conditions will remain challenging in 2016 as the ultra-low yield environment is set to stay. That means returns will likely remain low and gains will be laboured throughout the year. Market beta should continue to dominate but given the extremely low yields, breakevens are currently tiny and there is almost no room for error. Avoiding the significant underperformers will be paramount in 2016 as idiosyncratic risk is on the rise, although we acknowledge this is easier said than done. We recommend keeping a high level of diversification but also to know very well the names investors buy as, through periods of high volatility (there are always some in any given year), investors may find themselves forced holders of the bonds.

Sector Allocation

		Sector	View	Comment
Synthetic		Financials	Long risk	The financial baskets have outperformed the corporate indices in the past few years at a slow but constant pace and we expect them to extend that trend through 2016. Financials are arguably much more solid and safer than prior to the 2007 crisis although spreads remain much wider than back then. We don't expect them to reach pre-2007 levels any time soon but we believe they still have some room to recover.
		Non-financials	Neutral	We expect the iTraxx Main to gain some ground through 2016, but we believe it will be the clear underperformer among the family of synthetic indices. We expect the hunt for yield to intensify as the ultra-low yield environment remains and in that respect we believe we'll see more spread compression with the X-Over index outperforming the Main.
Cash IG	Curves	1-3y 3-5y 5-7y 7-10y 10y+	Neutral Neutral Overweight Overweight Underweight	We expect to see a moderate spread tightening next year; hence we want to keep duration slightly above the index. Additionally, we also expect secondary liquidity conditions to remain challenging and believe investors will continue to use the new issues as the preferred route to add credit risk. This ties in well with our desire to have a slightly higher duration and we prefer to overweight the 5-10y maturity buckets, which is where we believe we'll see the most issuance.
	Ratings	AAA AA A BBB	Underweight Underweight Neutral Overweight	We recommend having exposure to the higher yielding assets, as we believe the low beta, low yielding bonds and names will offer tiny breakevens that leave no room for error. Therefore, we recommend an overweight position in triple-B rated bonds as we believe they offer strong capital preservation at the best available yields. Additionally, this is where we believe most new issuance will come from as has been the case in the past couple of years.
	Sectors	Financials Non-financials	Overweight Neutral	The banking sector has progressed strongly in recent years and is now showing very good health. In that sense, we would argue that banks in general, are now safer than they were prior to the 2007 crisis. However spreads are much wider than back then and, while we don't expect spreads across the capital structure to reach even the average levels pre-crisis, we believe they have still ample room to improve, particularly as we expect to see moderate issuance levels in both senior and sub space. At the same time, we prefer to keep a neutral stance on non-financials. We expect spreads to improve, but acknowledge that many offer very low yields and leave no margin for error, something highlighted by the recent VW troubles. However, we continue to like the corporate hybrids and prefer to remain overweight the sector.
	Financials	Senior LT2 Sub insurance	Neutral Overweigh Overweight	We believe the financials sector will continue to improve in 2016 as the recovery continues. However, we prefer to overweight the subordinated paper where we still see decent yields and spreads, while we prefer to maintain a neutral position in senior bonds which we see as very safe but very low yielding despite what remain wide spreads.
	Corps	Autos Consumers Industrials TMT Utilities	Neutral Underweight Underweight Neutral Neutral	Non-financial sectors struggled through 2015 given the low level of yields and breakevens at a time of rising idiosyncratic risk. Next year some trends remain the same so we prefer to keep a neutral or underweight position in the different sectors. We expect consumers and several of the industrial subsectors in particular to remain under pressure. We see more M&A activity, weaker ratings and some pressure coming from EM corporates among others. The continued low yields remain a worry although we continue to favor corporate hybrids.
Cash HY	Off index	BB B CCC	Overweight Neutral Underweight	We expect moderate GDP growth in the eurozone and this should prove beneficial for HY companies. We continue to like double-B rated bonds as, in our view, they offer the most attractive risk/reward profile, with high yields for a very manageable increase in the default rate. Single-Bs and triple-Cs remain exposed in our view, particularly to contagion from a volatile (and more vulnerable) US HY market.

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2015: A year of two halves

Lessons to take away from 2015

Global credit markets had a difficult 2015. Table 1 shows the performance across four geographies and two rating classes, and highlights how the excess return over governments was negative or zero for five of the seven subgroups. Only European high-yield (HY) and, even more surprisingly, HY EM bonds in dollars managed to outperform similarly dated government bonds.

Table 1: Where did the returns go?

	Excess return	Total return	Median spd.	Spd chg.	Median yld	Yld chg.	Median durat.
US ex EM (IG)	-0.5%	-0.3%	158bp	31bp	4.0%	0.4%	6.6
Euro (IG)	-0.8%	-0.4%	125bp	40bp	1.6%	0.1%	5.0
GBP (IG)	0.0%	1.4%	157bp	20bp	3.7%	0.2%	7.8
EM in USD (IG)	-0.1%	0.5%	255bp	48bp	4.6%	0.5%	5.1
US incl EM (HY)	-1.8%	-2.5%	421bp	94bp	6.3%	1.2%	6.3
Euro HY (HY)	2.6%	2.6%	421bp	6bp	4.3%	0.0%	3.4
EM in USD (HY)	5.5%	5.8%	748bp	52bp	9.3%	0.5%	3.5

Source: SG Cross Asset Research

Total returns including government bonds were only marginally less depressing. US and European investment-grade (IG) bonds as a group lost money; US HY lost even more. IG sterling bonds eked out small gains, but once again EUR-denominated and EM USD-denominated HY were the best performers.

What went wrong for credit markets? Chart 1 shows the percentage change in spreads over 2015 in the US IG and HY indices, plotted against the closest oil futures (shown in brown, in reverse). The correlation is hardly perfect, but the fall in oil prices from $60/bbl to $40/bbl over the summer coincided with a widening in spreads in both the IG and HY markets. Chart 2 shows the percentage change in the European IG and HY markets. Note first that while European IG spreads widened more in percentage terms than US spreads, European HY spreads widened much less than US spreads (and were all but unchanged on the year).

Chart 1. Falling oil pushes spreads wider in the US

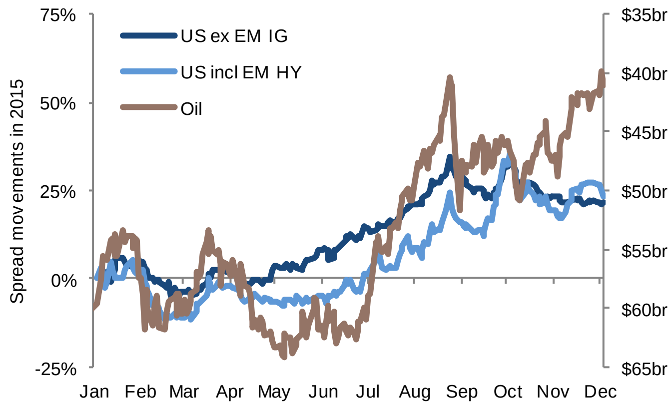
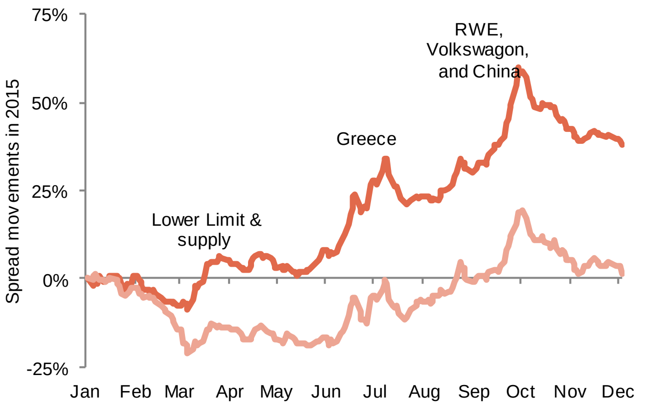


Chart 2. Europe suffers in three waves



Source: www.markit.com, Bloomberg, SG Cross Asset Research

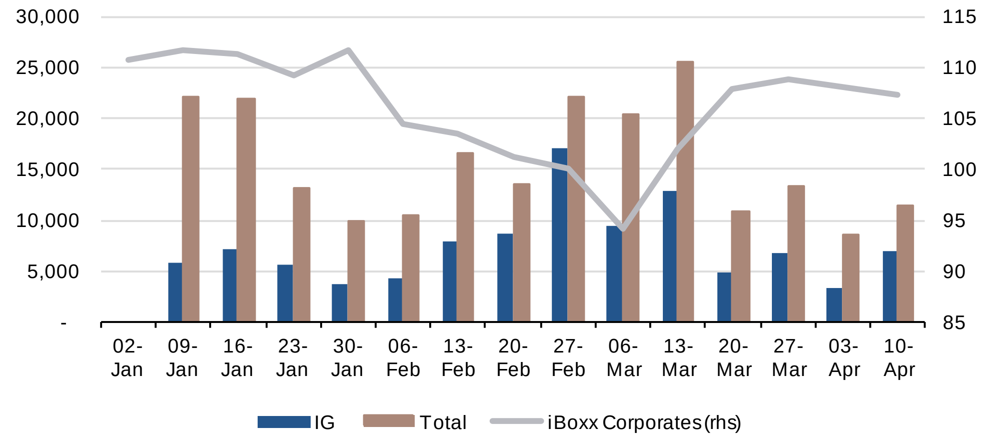
Second, the European widening took place in three waves.

ECB and the lower limit problem

The ECB started its QE program, purchasing €60bn of sovereign bonds a month in March, but investors had already positioned for it. The 10-year Bund yield hit a low of 7bp by mid-April, down from 54bp at the start of the year, and German government bond yields went negative out to the 9Y area of the curve. The IG yield as measured by the iBoxx Corporates index dropped from 1.35% at end 2014 to a record low of 1.02% by mid-March, and this created a lower limit problem, as we discussed in "A corporate is not a custodian," with investors refusing to buy corporates with a negative yield.

At the same time, low yields encouraged corporates to issue in the EUR-denominated market. Chart 3 shows the huge increase in supply in late February and early March, which ultimately led to some indigestion in the IG market.

Chart 3. Spreads weaken on sustained heavy issuance volumes



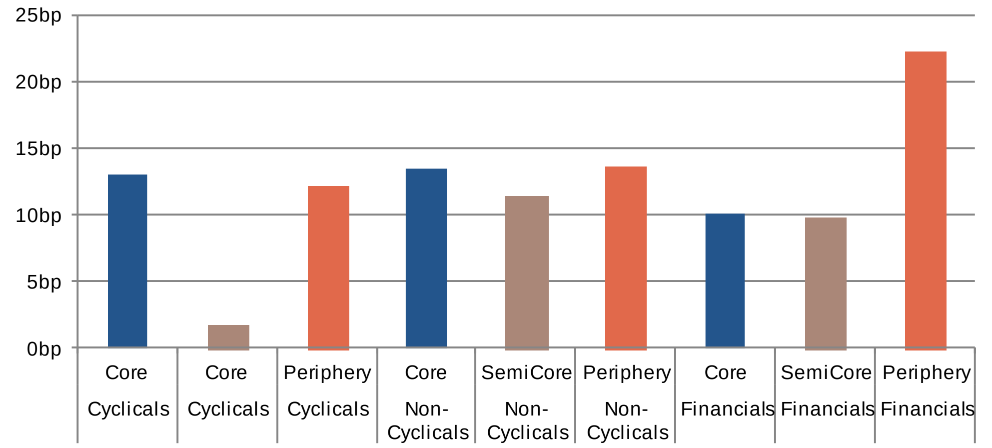
Source: www.markit.com, SG Cross Asset Research/Credit

The second half of February and first half of March saw a total of €48bn issued in IG, which matched the €48.5bn seen in January 2009, the strongest month ever in the history of the European IG market. But back then, the markets were reopening following Lehman's bankruptcy and corporates were ready for anything in order to secure funding. The average maturity was just six years and the average coupon was 6.3%. Fast forward to February-March 2015, and we had a similar amount issued in just four weeks. But the high volumes came after months and months of heavy issuance (€224bn in 2014, €194bn in 2013 and €188bn in 2012), and the average coupon was just 1.3% and the average maturity was 9.5 years.

Greece and the financial sector

The second problem for the market was Greece, which drove cash spreads wider between the start of June and mid-July. During this period, peripheral bonds suffered relative to core or semi-core bonds, but not in every industry sector. Chart 4 shows the widening in CDS spreads by sector over this period and illustrates that while peripheral cyclical and non-cyclicals performed very similarly to core cyclical and non-cyclicals, peripheral financials sharply underperformed. Consanguinity was back.

Chart 4. Greece leads to pressure on peripheral financials more than anything else



Source: Bloomberg, SG Cross Asset Research/Credit

China and idiosyncratic risk

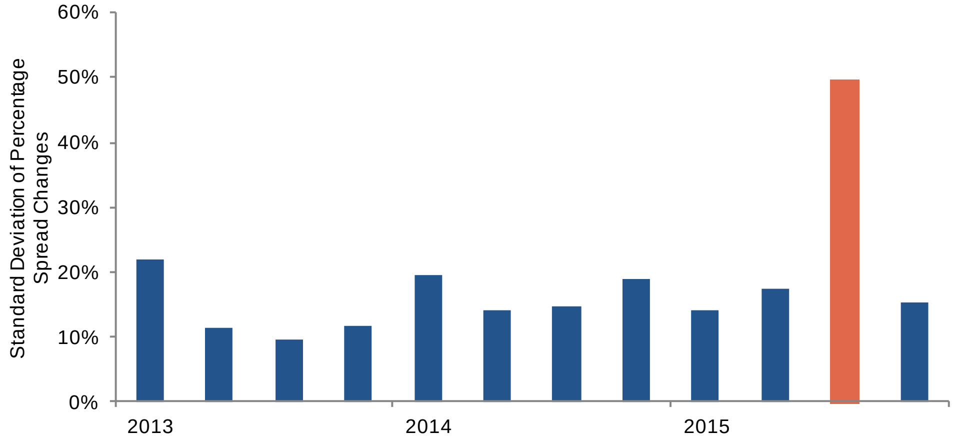
However, Greece was not the only macro threat to the markets. Through the summer it became clear that China's economy was slowing. This mattered for Europe, as automakers there generated up to a third of their revenue in China in 2014, which also provided one-eighth of European luxury goods companies' revenue.

Heavy issuance was also a factor in the weak tone of the fall, when IG saw €26bn issued in just two weeks – an even higher pace than seen back in the February-March period, or in January 2009.

Then in September, the damage to Europe started to come from within. **VW** widened sharply as the company admitted to cheating to pass the emission tests in the US. **RWE** came under pressure on the back of deteriorating credit metrics and nuclear liabilities, although the company had sufficient provisions to cover these, as our Utilities analyst explained here. **Glencore** suffered from falling commodity prices amid the Chinese slowdown. Even though it announced a comprehensive plan to reduce net debt by end 2016 in early September, the market fears that the company cannot keep its Baa2/BBB ratings and could be downgraded to high yield. **Anglo American** bonds suffered a similar widening.

The issues at Volkswagen, German utilities and commodity companies caused an almost unprecedented rise in idiosyncratic risk. Idiosyncratic risk can be seen as the dispersion, or standard deviation, of performances, and Chart 5 measures this by showing the standard deviation of percentage changes in spreads from the companies in the iTraxx CDS indices back to 2013. Q3 of this year stands out as a record.

Chart 5. Much more dispersion apparent

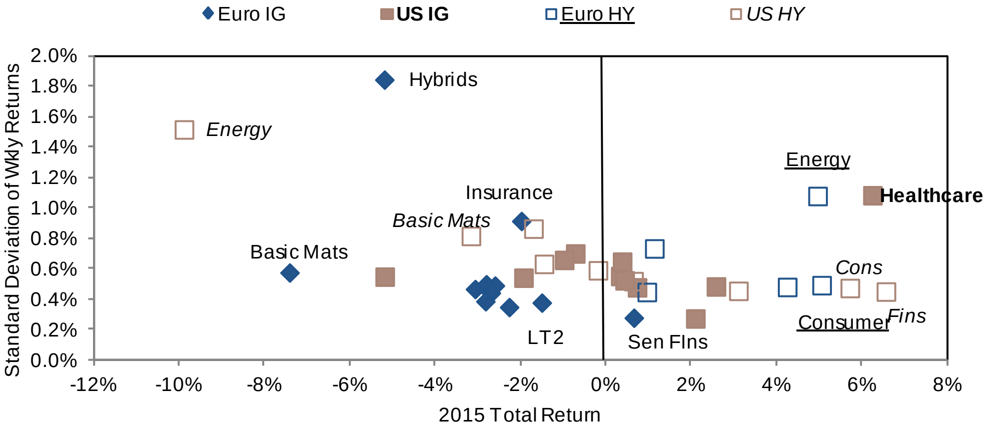


Source: Bloomberg, SG Cross Asset Research/Credit

There was also a very significant dispersion between sectors. Chart 6 shows the performance of industrial subsectors across four asset classes – EUR-denominated IG (blue diamonds) and HY (empty blue squares); USD-denominated IG (brown squares) and HY (empty brown squares). Several points stand out.

In Europe, the volatility of HY and IG has been similar, but all HY sectors have performed better than IG sectors. Generally the most volatile IG sectors (like hybrids) fared poorly, though building materials turned in the worst performance of all.

Chart 6. Sectors diverge significantly

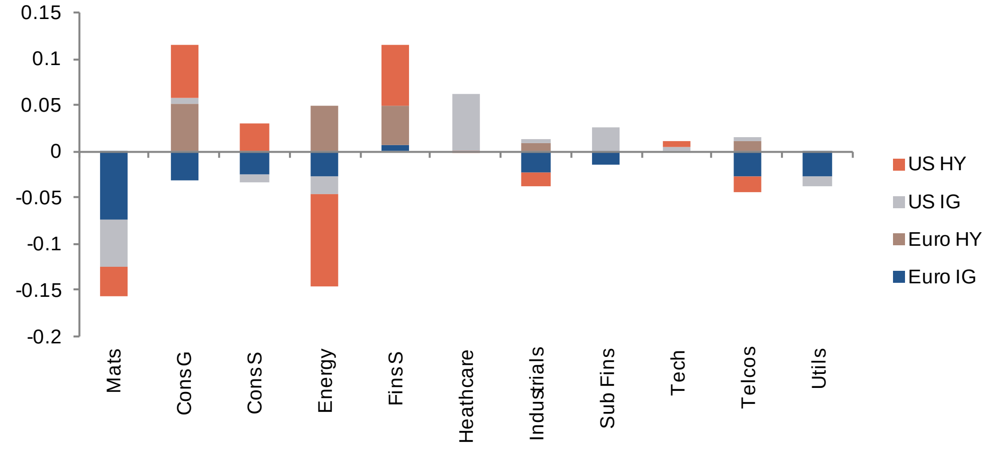


Source: www.markit.com, SG Cross Asset Research/Credit

In the US, the poor performance of HY bonds is due to the energy sector (which also suffered in 2014). By contrast, both the financial and the consumer sectors did well in the US HY market.

One of the striking things about the chart is that the industry factors were uneven across the markets. Chart 7 makes this clearer by showing just the performances of the industry factors in all four markets. In sectors like basic materials, bonds did badly whether they were high-grade or high-yield, and denominated in euros or in dollars. Conversely, financials did well; energy did relatively poorly, and consumer goods did relatively well. But then there were sectors like telecoms or industrials where there was no clear trend across the markets.

Chart 7. Sectors diverge significantly



Source: www.markit.com, SG Cross Asset Research/Credit

Four themes for the year to come

Which 2015 trends will continue to drive credit markets in 2016, and what will be the new themes? To outperform their indices next year, we think investors need to concentrate on four themes.

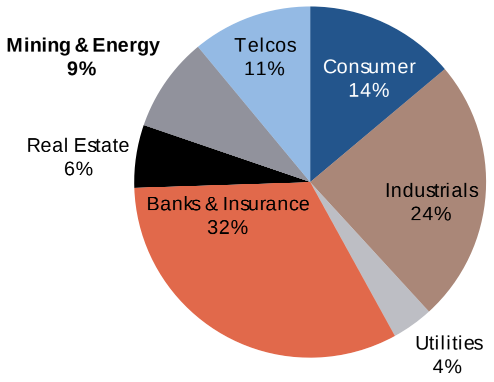
- **Defaults:** Always a key topic for credit investors, 2015 was about rising default expectations due to falling commodity prices. The next year will be about whether the defaults actually happen.
- **Supply and balance sheet management:** Supply was a recurrent theme in 2015 and will continue to be one next year. European companies may be at the trough of their leverage cycle, and we expect more US issuers to tap the European market in 2015. One of the other important questions (yet again) is how bank regulation will affect issuance.
- **Monetary policy and the need for yield:** Low interest rates have fuelled demand for credit globally in recent years. With the Fed now looking to hike rates, this will have less of an impact in the US – but EUR-denominated investors' need for yield is still pressing, and could be aggravated by even easier monetary policy from the ECB.
- **The tail risk of an EM crisis.** European credit investors consider economic risk a much bigger threat than political risk. We still think they are wrong, and would prefer to tilt portfolios towards Core Europe.

How far will defaults rise?

Moody's anticipates a gentle rise in defaults next year, with US speculative grade defaults expected to climb from 2.76% to 3.77%, while European defaults rise from 2.36% to 2.67%. However the HY bond market in the US is considerably more pessimistic, with about 7% of the market trading under a cash price of 50%. Concerns focus on commodity companies. Oil and gas sector companies trading under 50% make up almost 4% of the index, and bankruptcies in this sector alone would drive the default level to above Moody's figures.

Commodities matter because they have become a much bigger part of global credit markets. As Chart 8 shows, commodities now account for 9% of global credit markets, with most exposure being in the emerging markets (both IG and HY) and the beleaguered HY markets.

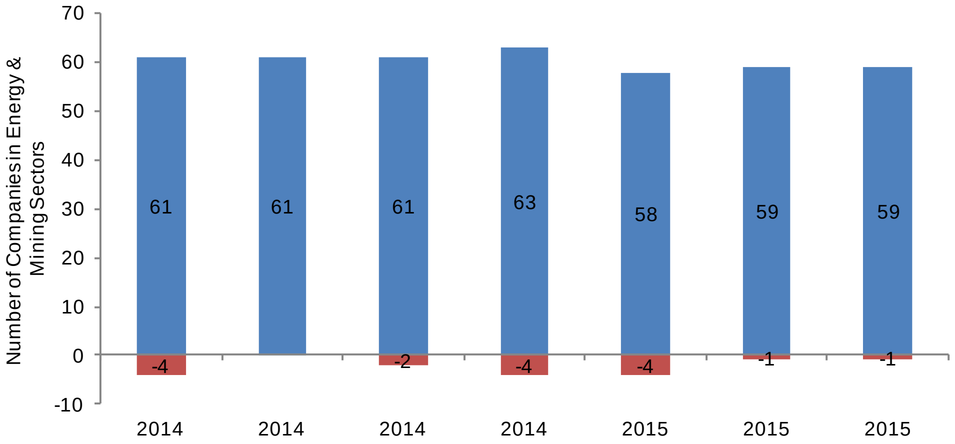
Chart 8. Commodities and bigger part of the global credit markets



Source: SG Cross Asset Research

But despite the concerns, there are at least three pieces of good news for the US commodity sector. First, even though operating cash flow for the sector has fallen around 33% from its mid-2014 peak, almost all companies are still generating operating cash. Chart 9 shows the number of companies in the US energy sector (both HY and IG) reporting positive (blue) and negative (red) cash flows over the past seven quarters. Though oil prices have fallen this year, fewer companies reported operating cash losses.

Chart 9. Number of companies with negative operating cash flow has declined



Source: SG Cross Asset Research

Second, the immediate liquidity needs of companies are not that pressing. Chart 10 shows the percentage of companies with a quick ratio (current assets divided by current liabilities) over one. Before oil prices started falling, when liquidity conditions were easy, only one quarter of the companies in the universe had enough cash on the balance sheet to finance next year's debt. Now that number has risen to around 50%. The improvement is partially due to a relatively small amount of refinancing in 2016, however. Chart 11 shows that the refinancing need is only $6bn in 2016, but it rises precipitously in 2017, 2018, and 2019.

Chart 10. Better quick ratios in the industry…

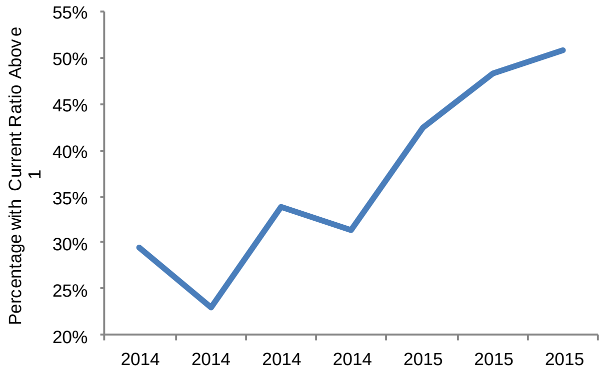
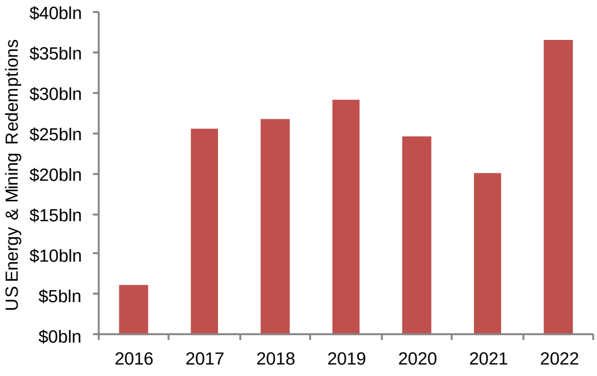


Chart 11. … but redemptions rise in 2017. Beware.



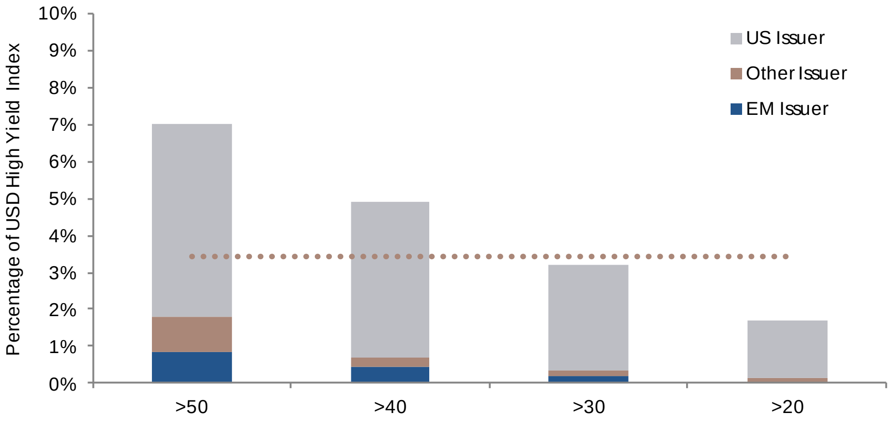
Source: SG Cross Asset Research

Finally, our commodity strategists are bullish on prices next year. In their 2016 Commodities Review, "Rebalancing," our commodity strategists see a gentle rise in oil prices next year, with Brent seen rising from $45/bbl to $60/bbl (or some 15% above the forwards). By 2020, Brent is seen climbing back to $75/bbl, so the medium-term outlook is sanguine. The outlook for some basic materials is more worrying, since coal is expected to climb only from $45/t to $56/t, and then $64/t; however most industrial metals are expected to rise by well over 10%, with copper, for example, seen climbing 20% over the next 12 months.

Also, the US energy and mining companies have extended the life of their debt, and face only $5bn worth of bond redemptions this year (concentrated in H2). As Chart 11 shows, however, redemptions rise quite sharply in 2017, 2018 and 2019, so the sector will need refinancing over this period.

It may be, then, that investors are more concerned than they should be with the immediate threat of defaults in the US energy sector. However, they could be too optimistic about the prospect of defaults in emerging markets. Chart 12 compares the cash prices of bonds in the HY universe by the region of the issuer. The dotted line is Moody's default forecasts.

Chart 12. Fewer EM issuers than US or other country issuers trade at distressed levels

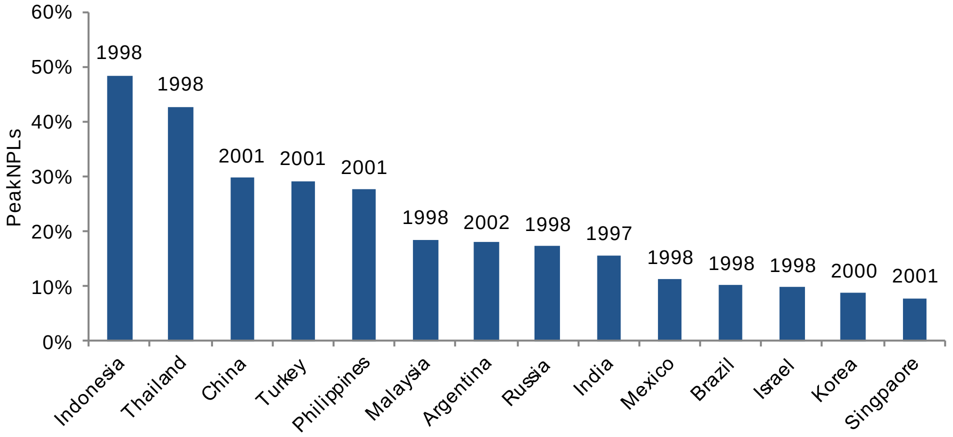


Source: SG Cross Asset Research

While around 7.5% of US-issuer HY bonds trade below 50%, the percentage falls to 5.8% for EM issuers, and around 6.4% for non-US and non-EM issuers. Investors clearly have a good deal of faith in the EM issuers to pay their debts. Is this faith warranted?

Historical precedents are not encouraging. The hard-currency-denominated EM corporate bond market hardly existed five years ago, so historic default data is not much use; a good proxy, however, is non-performing loans (NPLs). The chart below shows the level and the date at which NPLs peaked for a range of EM countries. Several countries have seen peak NPLs of well over 10%.

Chart 13. NPLs in EM countries



Source: SG Cross Asset Research

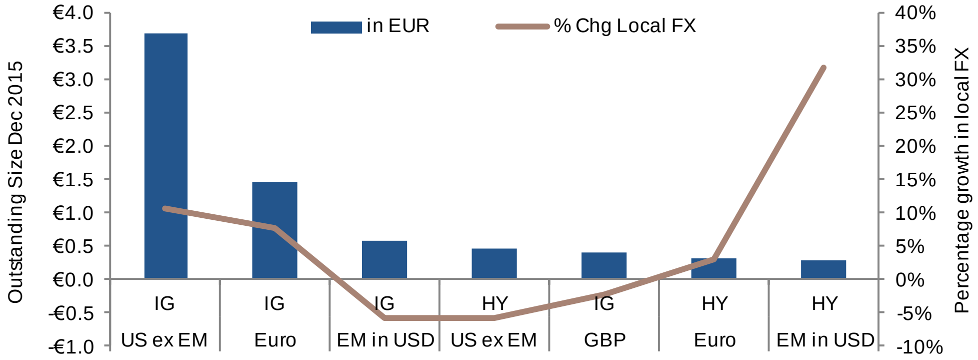
In their 2016 outlook, "Deeper into the Vortex," our EM colleagues have written about the threat facing EM governments and corporate. Their expectation that currencies will continue to drop next year means that credit quality is likely to continue to worsen, even if commodity prices rebound. We expect EM defaults to rise to 6% next year as a result. By contrast, we think that the rest of the US HY sector should see defaults of less than 4% – and with higher recovery rates than on EM debt. In "Defaults: A question for 2016," we highlight the top down regression models that we have used to forecast defaults.

Will the supply juggernaut roll on?

Supply is a complicated topic, and in the second section of this report we give it the attention it deserves. Here we focus on how supply might impact secondary market spreads.

Since the inception of the single currency the euro IG credit market has been growing at a strong pace, averaging 15.5% growth on an annual basis. The market stalled from 2009 to 2013 but has since continued to grow, mostly on the back of a strong showing by non-financials. Chart 14 below compares the credit markets in euros, sorted by size (in blue), and shows the percentage increase in the market this year in local currency terms (in brown). The growth of the IG sectors in both the US and Europe has been much bigger than the growth of the smaller high yield markets. While the EM IG market appears to have shrunk, this is really because of downgrades which have boosted the size of the EM HY market.

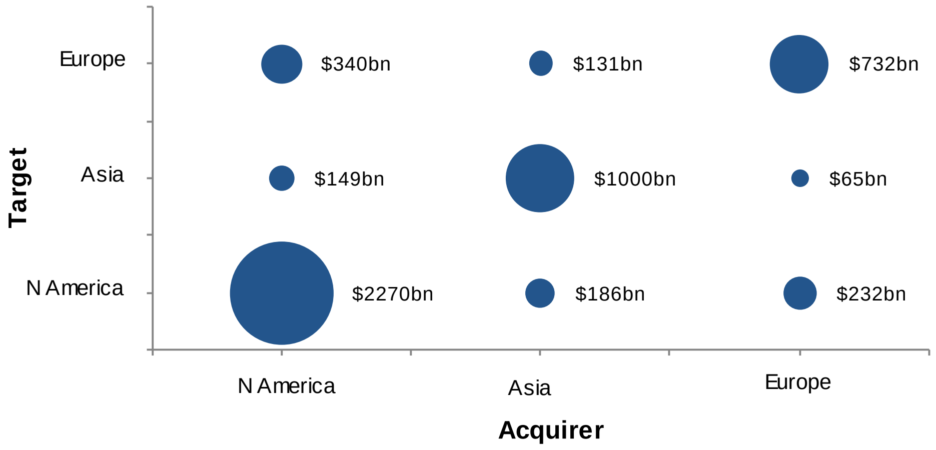
Chart 14. iBoxx Corporates size



Source: www.markit.com, SG Cross Asset Research/Credit

We expect the IG markets to continue to grow next year for two reasons. First, we expect to see more M&A, primarily in the North American market. Chart 15 shows the total amount of deals done based on targets and acquirers, and highlights three times as much intra-Americas deal-making as intra-Europe deal-making. Moreover both US and Asian companies are buying more European companies than European companies are buying businesses elsewhere.

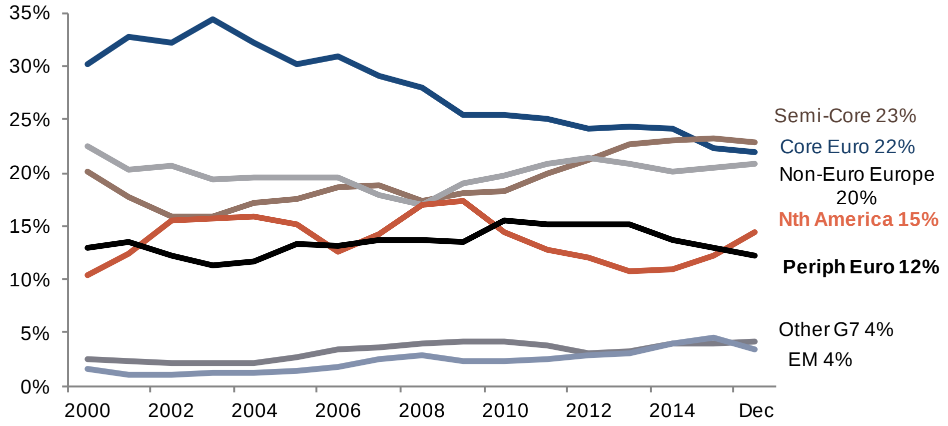
Chart 15. M&A three times as big between North American companies as between Europeans



Source: SG Cross Asset Research

Cross-border deal-making can still affect European ratings, of course, and US companies may finance US deals in the euro markets. The other trend that is likely to continue this year is US issuance in Europe. Chart 16 shows the percentage of North American issuers in the iBoxx index has risen from 10% in mid 2014 to 15% by December 2015; we expect the figure to reach 18% by the end of 2016. Low European yields are one reason why US issuers are choosing to come to Europe, though on a swapped-back basis the funding advantage evaporates. The other reason is access to multiple markets, with global issuers putting a premium on being able to tap different pools of investors.

Chart 16. North American membership of Euro indices almost back to 2009 peaks



Source: SG Cross Asset Research

High supply in both the US and European investment grade markets is likely to weigh on spreads, just as it did at times this year. The increase in US issuers in the European market is likely to increase the correlation between the US and European investment grade markets as well.

Will low interest rates still be Europe’s trump card?

One of the most important issues credit markets will face next year is the divergence in monetary policies at the Fed and the ECB. Our economists expect the Fed to hike rates in December and embark on a slow tightening process. In contrast the ECB has already extended its QE program to March 2016, cut the deposit rate by a further 10bp and stands ready to more if needed. With the falling oil prices, inflationary pressures are likely to remain low and keep the ECB on its toes.

In their 2016 Outlook, “The butterfly effect,” our rate strategists anticipate a slow rise in US 10yr yields, and an even slower rise in European bond yields. European credit’s technical advantage is not so much in where rates are going, however, but rather in where they are now. Our shortfall model compares the yield target for domestic insurers (which is a weighted average of bond yields over the past eight years) with current yields. Given the passage of time, and our rate colleagues’ forecasts, we think the European shortfall will shrink next year, but will still be around 135bp by yearend. By contrast the US shortfall has already disappeared, and as bond yields rise but targets stay relatively flat, demand for credit amongst dollar-based investors may fall.

Chart 17. European yield shortfall around 135bp by yearend

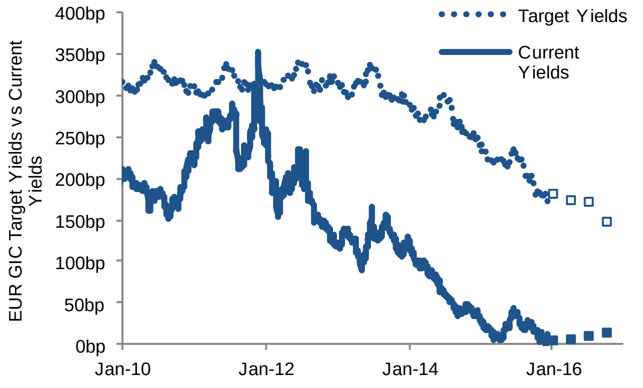
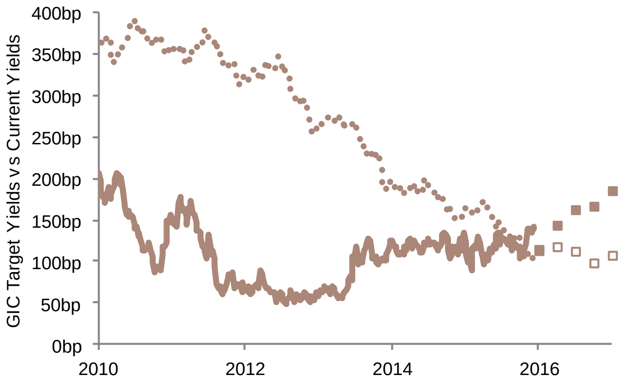


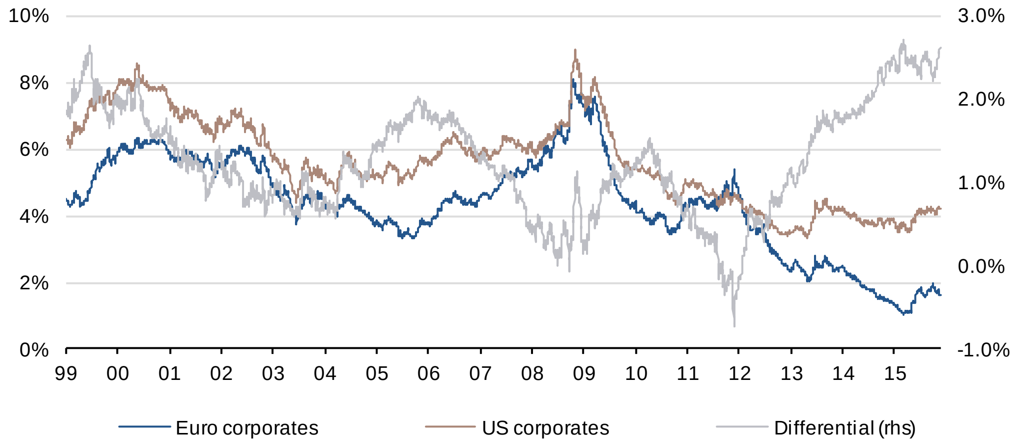
Chart 18. European yield shortfall around 135bp by yearend



Source: SG Cross Asset Research

The question is whether European investors will move across the Atlantic to cover their yield shortfall. This was one of the investment themes in late 2014 and early 2015 as European yields plummeted. Chart 19 shows how the yield differential between US and European IG credit has never been so high.

Chart 19. Euro and US IG yield differential



Source: www.markit.com, SG Cross Asset Research/Credit

The big risk on the strategy, however, is on the currency. Generally investors opting for this strategy have covered the risk with short-term forwards. Such forwards are cheap to buy at the moment, but the risk is that they will get considerably more expensive as US and European short rates diverge. Indeed the forecasts from our economists imply that forward covering will cost around 2.5% by 2018, wiping out the yield advantage.

Cash spread forecasts

Chart 20 shows our forecast for global credit spreads over the next four quarters. Broadly we see markets tightening into the end of H1, thanks to seasonal factors and some better news on US earnings than the market currently expects. Fears should return in the second half, however, leading to a general widening in spreads.

Chart 20. SG's global credit spread forecasts

Source: SG Cross Asset Research

Table 2 breaks these forecasts down by major geographical sector.

Table 2: European outperforms US and

	US ex EM IG	Euro IG	GBP IG	EM in USD IG	US incl EM HY	Euro HY HY	EM in USD HY	Global
Q4 15	170bp	145bp	170bp	250bp	500bp	465bp	800bp	233bp
Q1 16	160bp	135bp	160bp	275bp	485bp	450bp	825bp	227bp
Q2 16	145bp	120bp	150bp	275bp	495bp	420bp	780bp	213bp
Q3 16	155bp	120bp	160bp	250bp	525bp	420bp	750bp	217bp
Q4 16	175bp	130bp	160bp	250bp	575bp	460bp	750bp	235bp

Source: SG Cross Asset Research

The following table shows the EUR IG sectors forecasts:

2016 spread forecasts

	Corp	Autos	Utilities	Telcos	Indust	Retail	Senior Banks	LT2	T1	Sub Ins
Current Spd	**151bp**	**166bp**	**148bp**	**152bp**	**119bp**	**147bp**	**104bp**	**209bp**	**258bp**	**355bp**
December 2015	145bp	159bp	140bp	147bp	114bp	144bp	100bp	194bp	238bp	335bp
March 2016	135bp	150bp	130bp	137bp	108bp	140bp	88bp	165bp	210bp	295bp
June 2016	121bp	140bp	120bp	128bp	100bp	130bp	77bp	138bp	185bp	260bp
Sep 2016	121bp	140bp	120bp	130bp	102bp	135bp	72bp	128bp	180bp	245bp
Dec 2016	129bp	150bp	130bp	138bp	112bp	140bp	72bp	125bp	180bp	235bp

Source: www.makit.com, SG Cross Asset Research/Credit

The following trends are worth noting:

- We expect European spreads to move back towards their recent widest gaps with the US. The IG spread should move to 45bp; the HY spread should move to a new peak, at 115bp.
- We expect EM markets to underperform the US in percentage terms, at least in the IG sector. We expect the ratio of EM to US IG to rise from under 1.5x to almost 2x by mid-year.
- We expect the ratio of HY spreads to IG spreads to widen on both sides of the Atlantic, though the move should be stronger in the US.

Performance will depend on carry and capital gains or losses but, at least for the high yield markets, we will also need to subtract defaults (and take account of the expected loss). As noted in the text above, we expect defaults in the EM high yield market to rise towards 8% next year, though we think US domestic high yield defaults are likely to be only slightly over 3%, and European defaults should be between 2% and 3%. We also factor in a 1% default rate in investment grade EM. Losses given default should be higher in EM than in the US or European markets for two reasons. First, as noted in the text above, many US names already trade at deeply distressed levels (we measure the loss given default from current prices, not from par). Second, the legal regime is more creditor-friendly in the US than in the EM countries.

Chart 21 gives our performance forecasts for the markets quarter by quarter. The total return by end 2016 is shown above the bars; the projected volatility (based on the standard deviation of performances) is given below the bars. Chart 22 shows a simple risk/return measure, dividing the performance by the projected volatility.

Chart 21. Performances by quarter

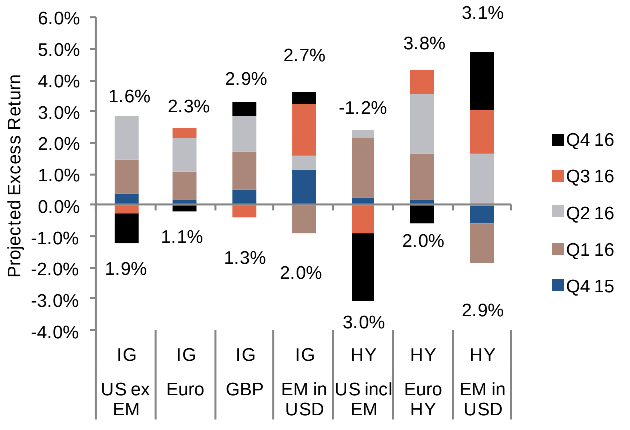
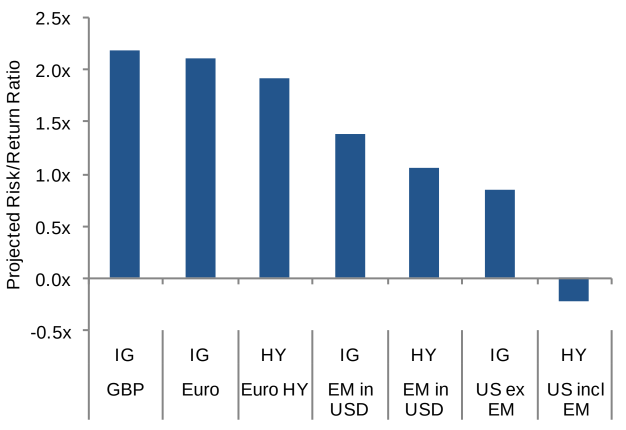


Chart 22. Best Risk/Return ratios



Source: SG Cross Asset Research/Credit

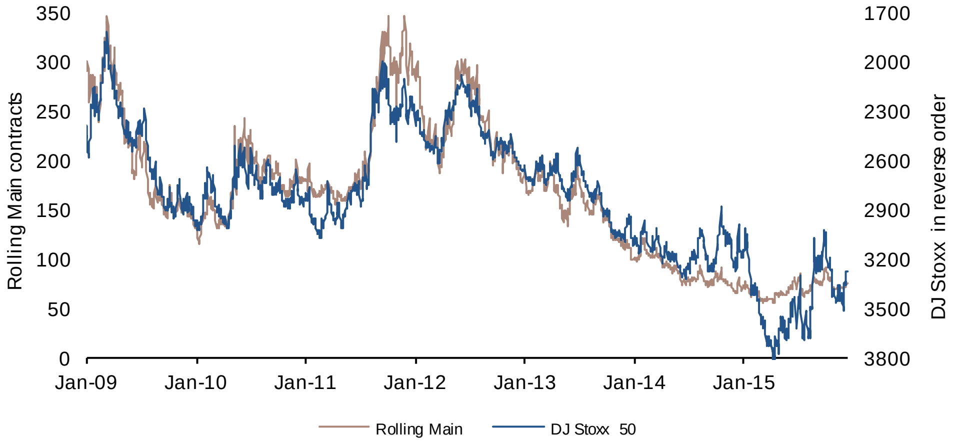
The sterling market comes out surprisingly well on this measure, but the European IG market comes out a close second, and European HY makes it into third place. By contrast the US markets look poised for another year of disappointing returns.

iTraxx forecast

The iTraxx indices remain the risk proxy in credit and as such they have not only been highly correlated to equities, but to the cash market as well. However, the recent volatility, and the rise in equity markets have weakened the correlations and there are other inputs that can affect the iTraxx indices like the price of oil and sovereign bond volatility. To a large extent it is a natural reaction as the markets become increasingly linked. However, we can see that the very strong correlation between the iTraxx and equity markets weakened in the second half of last year and this process continued through 2015.

The following chart shows that the iTraxx Main has tracked the DJ Stoxx 50 extremely closely but that this relationship has weakened as the credit index has become much more stable than the equity index. We've mentioned before that while there is no limit as to how much the equity index can rise (at least theoretically), there is a limit as to how much the iTraxx index can tighten. As it improves, every basis point that it tightens makes the next one harder.

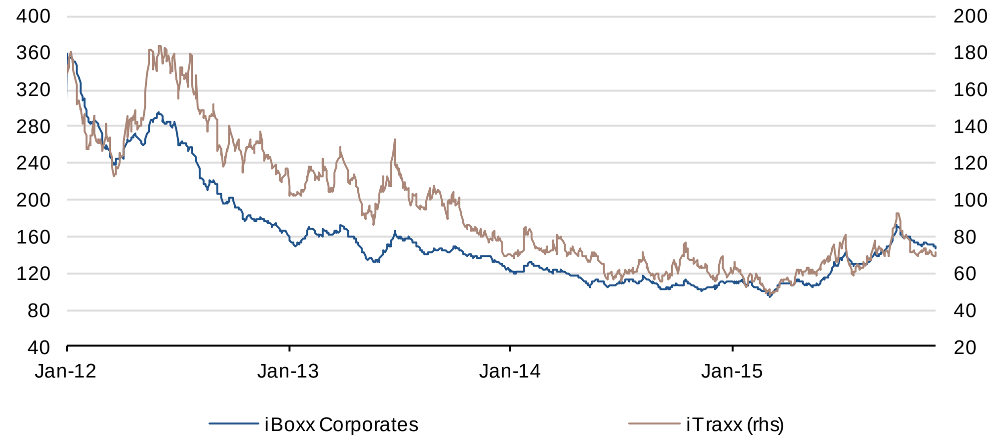
Chart 23. iTraxx Main and DJ Stoxx 50



Source: Bloomberg, SG Cross Asset Research/Credit

But as we see below in chart 24, the iTraxx index has been very stable when the equity market sells off sharply, largely anchored by the resilient performance of the cash markets. Nevertheless, the iTraxx Main has slowly outperformed the cash index in the past few years and this trend continued throughout 2015.

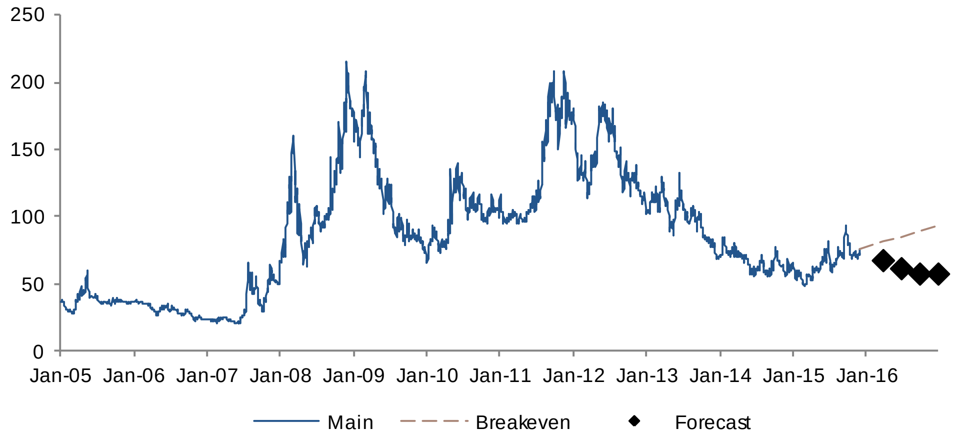
Chart 24. Cash and iTraxx



Source: www.markit.com, Bloomberg, SG Cross Asset Research/Credit

In summary, the iTraxx index is more volatile but continuously outperforms in a tightening environment, but is more resilient when cash spreads widen. We expect this trend to continue next year. In our view, the iTraxx indices will take support from the equities or cash markets, whichever is performing the better; we expect a moderate tightening throughout the year.

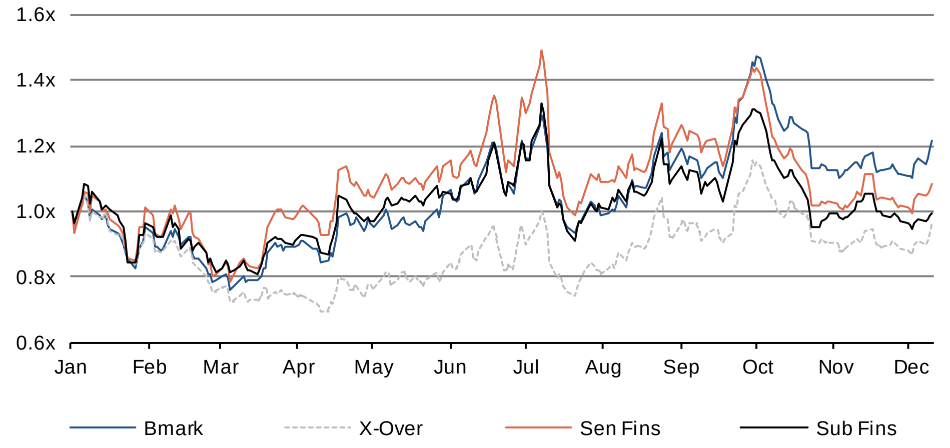
Chart 25. iTraxx Main forecasts



Source: www.markit.com, Bloomberg, SG Cross Asset Research/Credit

However, we expect the iTraxx Main to be the laggard next year as we expect further spread compression. This has been an ongoing issue this year although compression has been relatively tame. But, as we can see in the chart below, the indices moved in tandem in the first months of the year and then started diverging with the X-Over index outperforming all others. We note that the financial baskets also outperformed the indices with the higher yielding sub financials edging out the senior financials.

Chart 26. iTraxx indices relative performance



Source: www.markit.com, Bloomberg, SG Cross Asset Research/Credit

We believe that spread compression will continue next year as the hunt for yield intensifies on the back of the ECB's QE. This means the X-Over should outperform the Main and the Sub financials should outperform the Senior financials. We also expect the senior financials to outperform the Main further as the financial sector continues to improve in general versus the non-financials.

The following table shows our forecasts for the different iTraxx indices.

On the run S24 forecasts

	Europe	X-Over	Senior	Subordinated
Current S24 Spd*	77bp	317bp	73bp	148bp
March 2016 Forecasts	68bp	270bp	65bp	125bp
3m Breakeven	*81bp*	*341bp*	*78bp*	*158bp*
June 2016 Forecasts	62bp	240bp	58bp	110bp
6m Breakeven	*85bp*	*361bp*	*81bp*	*166bp*
Sep 2016 Forecasts	58bp	220bp	52bp	95bp
9m Breakeven	*89bp*	*380bp*	*85bp*	*174bp*
Dec 2016 Forecasts	58bp	210bp	50bp	90bp
12m Breakeven	*93bp*	*400bp*	*89bp*	*182bp*

*Dec10
Source: SG Cross Asset Research/Credit

As we mentioned above, the European speculative default rate remains low (2.36%) and is expected to rise gently in the next 12 months (2.67%), according to Moody's. We set our forecasts a touch lower at 2.5%, but as usual, the iTraxx indices are pricing much higher levels of default rates a year from now than current or expected levels. Currently the Main index is pricing 1.1% of defaults in IG a year from now, and 5.7% cumulative defaults in five years. Moody's puts the 5-year accrued default rate in IG at 1.33% for the period 1998 to 2013. The X-Over index implies a default rate of 4.8% a year from now and a 5-year cumulative rate of 22%, which is much more in line with Moody's figure for the 5-year accrued speculative rate at 22.3%. However, it is important to note the HY universe that Moody's rates is much weaker than the 85 members of the X-Over index which have the easiest access to capital markets.

Chart 27. Main and 1y implied default rate

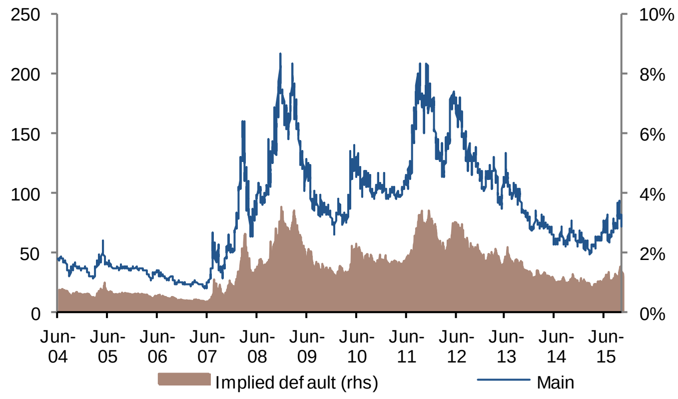
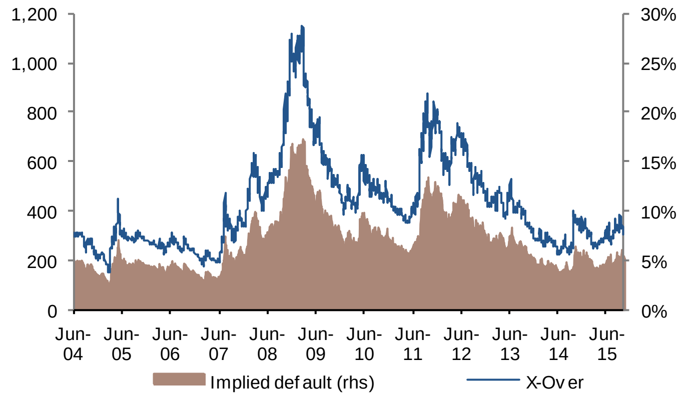


Chart 28. X-Over and 1y implied default rate



Source: Bloomberg, SG Cross Asset Research/Credit

The following table shows how both the different Main and X-Over series have performed through time. We take the premiums earned and subtract the losses incurred by actual defaults, taking into account the established recovery values (Abengoa's default, which has not taken place yet, will have an impact on the X-Over series 17 to 21). All series up until now have posted a positive P&L which highlights how high the implied defaults continue to be.

P&L iTraxx indices

	Main						X-Over						
Series	Initial spread	Implied cumulative default rate 5y	Number of Credit events	Actual def rate	Premiums	Total	Initial spread	Implied cumulative default rate 5y	Number of Credit events	Actual def rate	Losses	Premiums	Total
1	44	3.90%	0	0.00%	221,945	221,945	301	23.25%	0	0.00%	-	1,507,345	1,507,345
2	33	2.88%	1	0.80%	167,155	147,793	266	21.01%	0	0.00%	-	1,330,180	1,330,180
3	37	3.21%	1	0.80%	184,094	164,731	238	19.00%	0	0.00%	-	1,190,000	1,190,000
4	39	3.36%	1	0.80%	193,185	173,823	310	24.00%	2	4.88%	465,181	1,528,093	1,062,913
5	36	3.00%	1	0.80%	177,777	158,415	290	22.70%	2	4.35%	415,192	1,430,522	1,015,330
6	30	2.54%	1	0.80%	149,231	129,869	282	22.00%	3	6.52%	602,876	1,372,216	769,340
7	26	2.20%	1	0.80%	128,600	109,238	241	19.24%	5	9.80%	834,501	1,162,162	327,661
8	38	3.20%	0	0.00%	187,915	187,915	317	24.50%	6	11.76%	878,153	1,505,316	627,163
9	132	11.00%	0	0.00%	661,590	661,590	594	40.00%	6	11.76%	878,107	2,807,669	1,929,562
10	121	10.00%	0	0.00%	602,735	602,735	593	41.00%	6	11.76%	851,433	2,794,275	1,942,842
11	172	14.00%	0	0.00%	857,610	857,610	928	56.00%	4	8.89%	539,843	4,496,877	3,957,034
12	85	7.20%	0	0.00%	423,750	423,750	603	41.00%	3	5.88%	454,120	2,932,509	2,478,389
13	82	7.00%	0	0.00%	412,160	412,160	460	33.50%	3	5.88%	450,416	2,223,512	1,773,096
14	111	9.20%	0	0.00%	555,060	555,060	511	36.40%	3	6.00%	450,416	2,468,578	2,018,162
15	102	8.50%	0	0.00%	508,915	508,915	374	28.22%	1	2.50%	88,208	1,860,014	1,595,391
16	185	14.80%	0	0.00%	741,600	741,600	795	49.93%	1	2.50%	88,208	3,165,849	2,989,433
17	114	9.60%	0	0.00%	456,340	456,340	557	38.90%	1	2.00%	88,208	2,214,229	1,949,605
18	128	10.12%	0	0.00%	383,769	383,769	528	35.60%	1	2.00%	88,208	1,573,799	1,397,384
19	119	9.37%	0	0.00%	355,536	355,536	477	32.80%	1	2.00%	88,208	1,427,135	1,250,719
20	99	7.50%	0	0.00%	198,944	198,944	395	27.50%	0	0.00%	-	790,038	790,038
21	81	6.20%	0	0.00%	161,580	161,580	308	21.85%	0	0.00%	-	616,726	616,726
22	65	6.20%	0	0.00%	65,334	65,334	335	21.85%	1	0.00%	-	335,043	335,043
23	57	6.20%	0	0.00%	56,659	56,659	266	21.85%	0	0.00%	-	265,774	335,043

Source: SG Cross Asset Research/Credit

New issue forecasts: 2016 continues to grow

The market has been growing strongly over the past few years and 2015 was no exception. All major market segments continued to grow with the exception of the senior financials sector, which continues to see a reduction that is well offset by other markets. Next year the scheduled redemptions should remain stable or fall further but we expect even higher levels of issuance, resulting in an increase in net issuance. However, we expect these new amounts to be absorbed by the market, particularly as the ECB's QE program will continue to put pressure on sovereign bond investors to find paper and as we believe many will turn to the credit markets for answers.

Issuance figures

	2015 ytd	2015 Redemptions	2015 (F)	Net ytd	2016 Redemptions	2016 Forecast
IG	€240bn	€123bn	€250bn	€117bn	€128bn	€250bn
HY	€65bn	€21bn	€80bn	€45bn	€21bn	€80bn
Sen Fins	€147bn	€251bn	€150bn	-€104bn	€182bn	€160bn
Sub Fins	€45bn	€41bn	€60bn	€4bn	€21bn	€60bn

Source: SG Cross Asset Research/Credit

IG volumes to hit €250bn and remain at record levels

The IG market has experienced uninterrupted growth over the past four years, with 2015 volumes hitting over €245.8bn+ as of 10 December. We expect the total for the year to be close to the €251.5bn record of 2009. Redemptions will remain broadly stable which means net issuance should hit €100bn+ for the second year running.

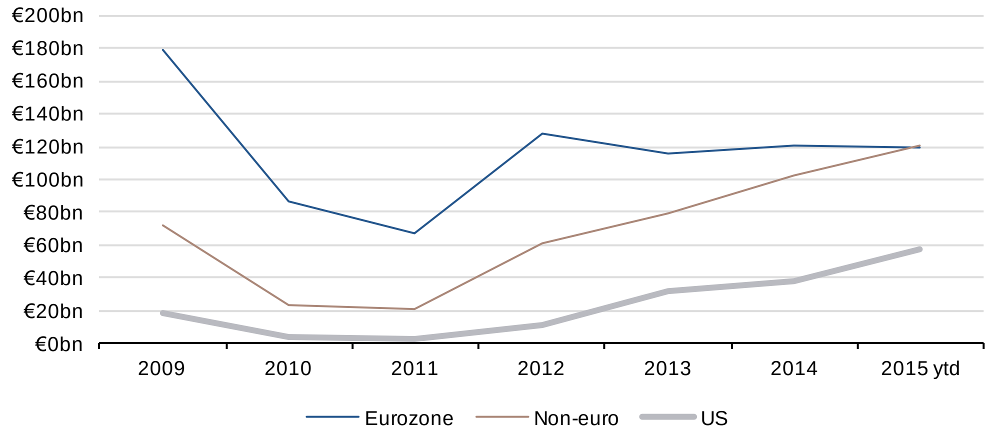
IG Non-financial Corporate Supply 2001-2015: Fixed and Floating

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015ytd
January	23,385	22,688	24,850	11,532	9,750	11,225	9,802	7,825	48,500	12,600	12,600	19,500	20,778	22,350	22,363
February	12,004	9,780	19,640	4,562	4,520	11,135	11,235	5,120	33,550	6,888	5,850	15,200	9,470	17,600	37,785
March	23,607	17,365	3,930	9,130	8,645	10,435	17,275	10,275	33,100	23,100	9,050	19,250	25,005	24,850	36,675
April	18,909	15,971	15,565	6,291	4,115	6,145	8,125	17,840	17,550	8,700	3,635	3,330	16,805	11,100	26,850
May	21,682	22,197	16,221	14,486	6,875	17,600	17,055	19,455	35,900	1,258	14,700	14,200	14,750	19,250	25,610
June	21,211	12,038	24,026	10,617	19,865	11,580	17,600	14,165	19,125	8,675	4,220	12,850	13,250	23,365	8,900
July	23,280	4,825	13,037	13,013	2,300	5,100	3,300	6,190	12,115	5,259	6,400	14,650	17,550	11,170	9,525
August	4,265	2,168	1,325	722	1,500	5,450	2,000	10,925	3,475	500	0	7,400	8,350	3,050	4,150
September	6,543	9,849	18,443	13,755	6,550	13,567	12,825	7,100	26,200	17,170	6,700	38,225	21,000	31,750	28,259
October	17,126	3,119	12,715	6,332	4,500	12,880	13,315	3,650	9,550	13,057	12,550	12,860	15,080	15,200	14,340
November	21,488	9,126	10,987	7,109	15,925	18,880	6,320	23,050	9,800	11,750	7,950	24,300	24,331	37,830	26,625
December	6,661	7,258	4,538	3,350	2,665	2,140	4,400	7,875	2,625	1,000	6,450	6,500	11,180	6,450	4,760
Total	200,161	136,384	165,277	100,899	87,210	126,137	123,252	133,470	251,490	109,957	90,105	188,265	194,169	223,965	245,841

Source: SG Cross Asset Research/Credit

A year ago we expected eurozone issuers to slow down somewhat and non-eurozone issuers to pick up the slack. But eurozone issuers did not slow down at all and are currently posting similar levels of issuance to last year's €121bn while non-eurozone issuers increased their levels of participation in the euro market, particularly US corporates. In fact eurozone issuers have been raising on average around €120bn per year while non eurozone issuers have been increasing the amounts raised in the euro markets as we can see in chart 29 below.

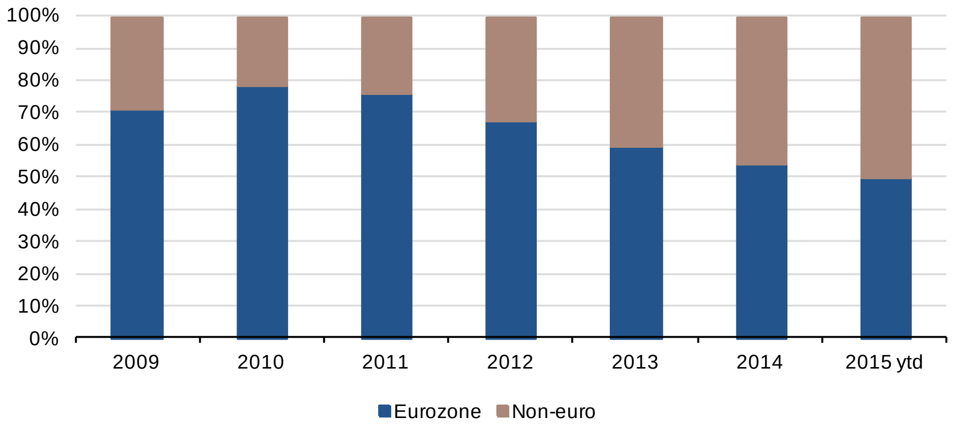
Chart 29. Non-eurozone issuance has been rising since 2011



Source: SG Cross Asset Research/Credit

2015 is the first year in which non-eurozone corporates issuance has represented more than eurozone issuance. Towards the end of the year, however, eurozone issuance has caught up and currently the figure is almost evenly split (currently it is 49.72%/50.28%).

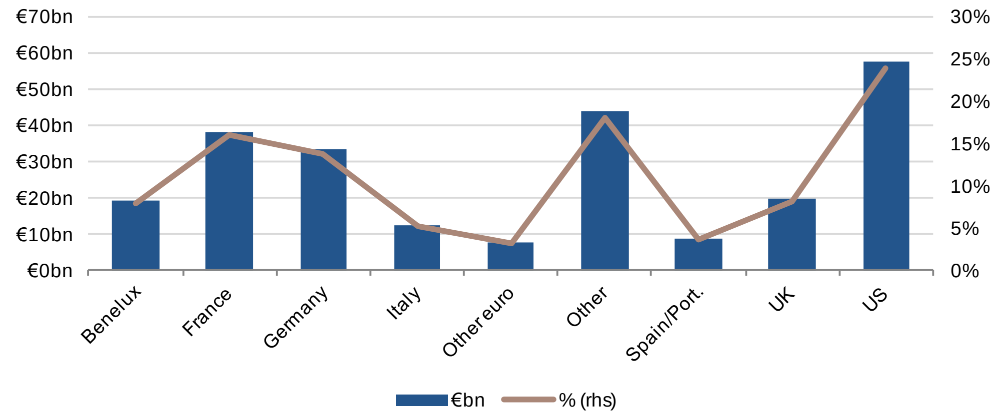
Chart 30. Eurozone and non-eurozone issuance is evenly split



Source: SG Cross Asset Research/Credit

US corporates are ending the year as the most active in the euro markets, dethroning French corporates which have traditionally been the heaviest users of the euro capital markets. Interestingly, other non-eurozone corporates combined (Canada, China, Australia, Switzerland, etc) posted stronger volumes than France, showing that it is not only US corporates that have decided to take advantage of the lower yields and greater funding diversification that the euro market offers.

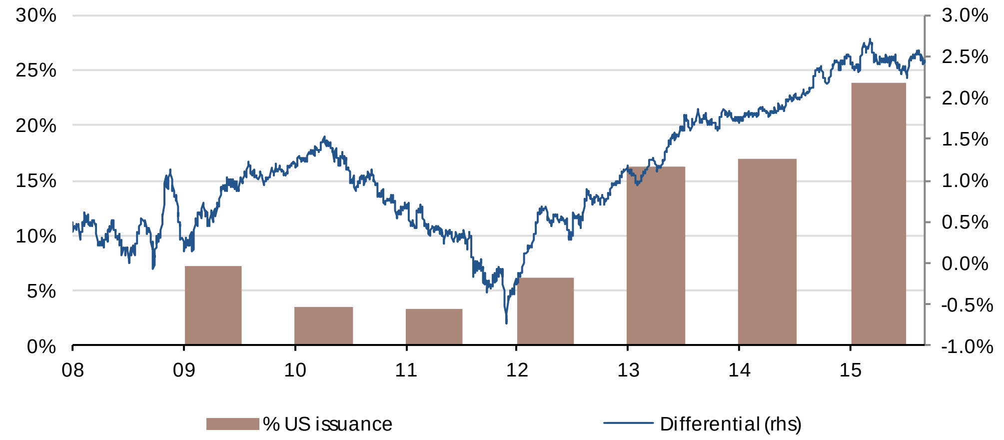
Chart 31. US corporates are well ahead



Source: SG Cross Asset Research/Credit

In the following chart we see that US corporates issuance has been growing at the same time as the yield differential between the US IG and the EUR IG indices has been diverging. In our view, the yield differential is likely to remain high or even rise further as US corporates releverage at a faster rate (given the leading position of the US in the economic cycle) and also as a reaction to the Fed's tightening policy. In contrast we expect the EUR IG yield to drop further as credit spreads tighten and sovereign yields remain stable to lower as the ECB continues its QE program for longer.

Chart 32. US/EUR yield differential and US issuance as a percentage of euro issuance



Source: SG Cross Asset Research/Credit

We note that the 10-year UST-Bund yield differential continued to increase this year, rising from 163bp to 177bp currently (reaching as high as 190bp in March), while the euro depreciated from $1.21 at the beginning of the year to $1.05 currently. Both trends are making the euro markets increasingly attractive and are likely to continue. Our rates strategists expect the 10y UST-Bund yield differential to rise to 180bp by the end of the year (please see: FI Outlook 2016 - The butterfly effect), with the euro falling to parity with the USD.

Chart 33. UST – EUR term structures

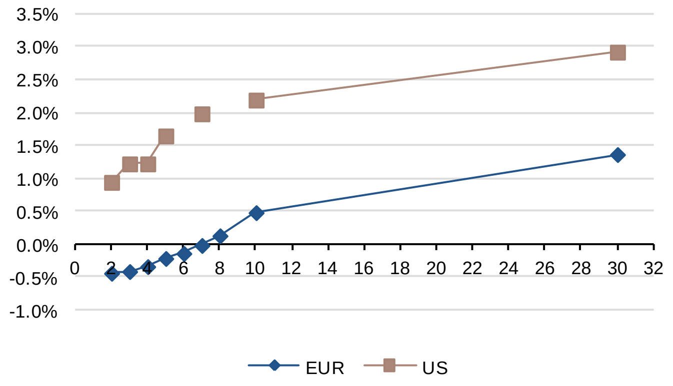
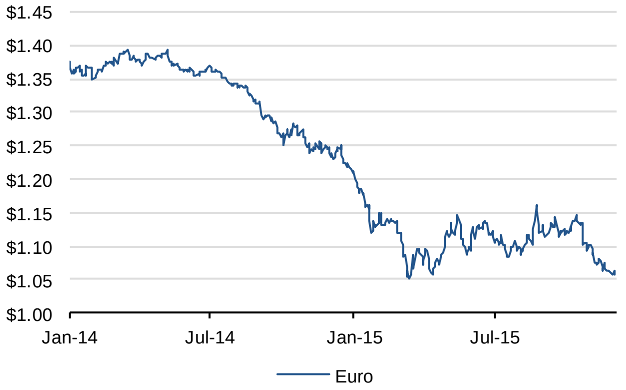


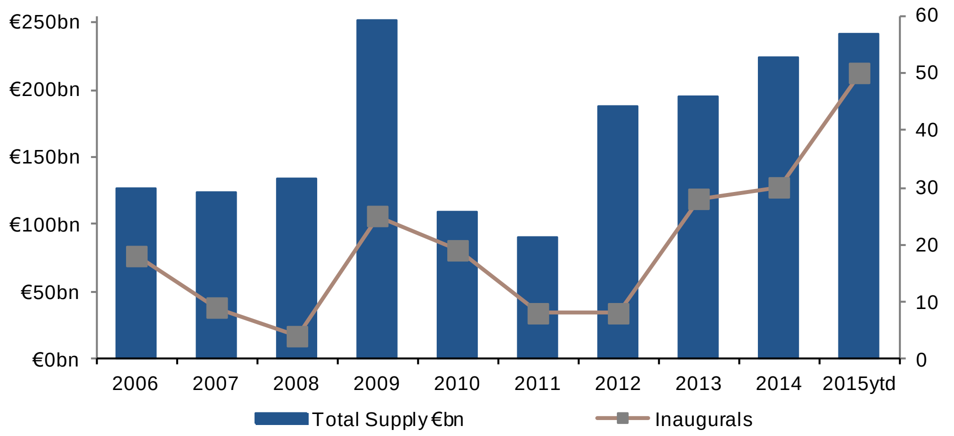
Chart 34. Euro depreciated through 2015



Source: Bloomberg, SG Cross Asset Research/Credit

Another interesting statistic is that this year we had 50 inaugural deals, the record so far for the euro IG market. Of the 50 new deals (at the time of writing), 36 came from non-eurozone corporates and 15 of those were US companies. We expect to see a high number of inaugurals next year as more US and other non-eurozone companies test the euro markets.

Chart 35. Issuance and number of inaugurals



Source: SG Cross Asset Research/Credit

Another trend we saw this year was a slight shortening of maturities. Last year the 10y+ bucket was extremely active and represented 25% of all issuance. That figure came down in 2015 to 22% currently, but it was well above 25% earlier in the year. However, we expect most bonds to come with maturities between 5-10y in 2016.

Chart 36. Maturity distribution 2014

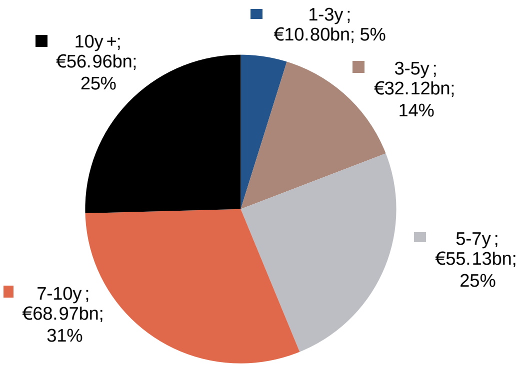
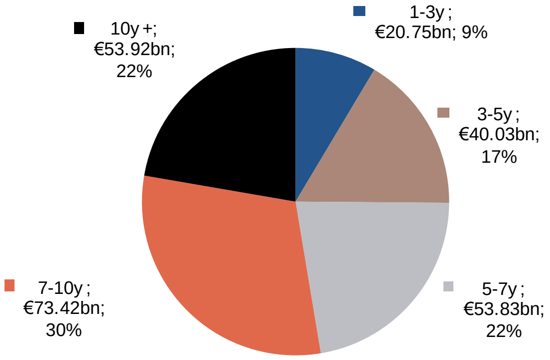


Chart 37. Maturity distribution 2015



Source: SG Cross Asset Research/Credit

Finally, this year we had a very even distribution across rating categories, particularly as many highly rated US corporates came to the euro markets. It is difficult to model how many of those will come next year but we suspect that a bigger number of US and other non-eurozone corporates will continue to make active use of the euro markets and we should see a relatively uniform distribution among rating categories.

Chart 38. Ratings distribution 2014

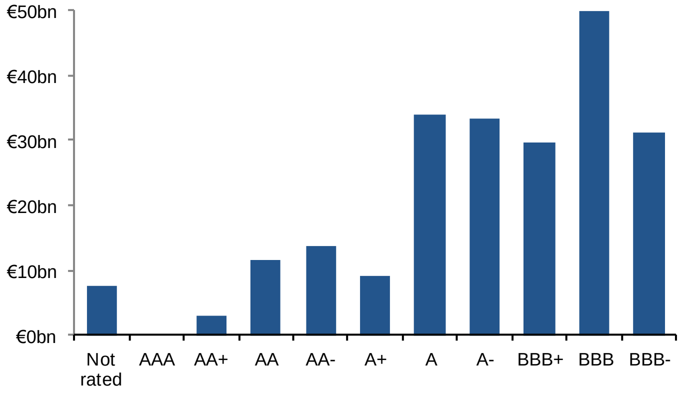
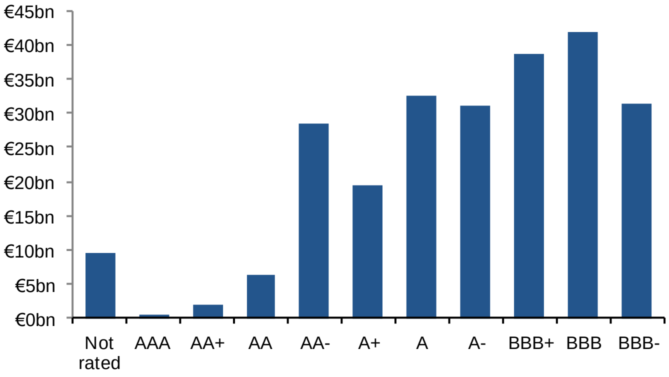


Chart 39. Ratings distribution 2015



Source: SG Cross Asset Research/Credit

HY to hit €80bn and set a new record

The HY market started 2015 with a bang, but is ending with a whimper. Volumes in the first seven months of the year stood at €55bn, but since the summer they are only €10bn at the time of writing and the market will miss our €80bn forecast. Investors have become more reluctant as different news stories have emerged, including problems with retailers (started in 2014), then some emerging market bonds (Brazilian names for instance), and most recently Abengoa's troubles; clearly there are concerns over the health of many sectors and issuers. However, as defaults are set to remain low, and the ultra-low yield environment is expected to continue through next year, we expect to see slightly heavier new issue activity, and the market should end around the €80bn level. clearly there are concerns over the health of many sectors and issuers. However, as defaults are set to remain low, and the ultra-low yield environment will continue through next year, we expect to see slightly heavier new issue activity and the market should end around the €80bn level.

HY supply

EUR (m)	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
January	535	2,422	3,673	4,445	0	275	5,190	2,775	1,493	5,760	5,580	6,630
February	990	1,385	1,568	2,724	0	0	200	1,957	5,027	5,600	4,520	8,497
March	1,080	1,960	1,965	1,352	0	400	4,953	9,013	4,525	8,480	10,045	14,214
April	3,863	1,303	5,124	4,552	0	400	6,264	4,143	1,550	5,480	12,896	12,940
May	2,146	260	2,875	4,878	0	1,212	810	5,770	1,672	7,358	6,345	1,945
June	1,910	985	160	6,595	0	650	2,395	2,345	850	1,768	12,061	4,300
July	661	1,270	385	998	0	3,375	3,871	3,125	1,615	7,427	7,732	7,030
August	0	500	1,553	0	0	0	640	0	973	1,115	1,053	1,100
September	1,215	1,880	1,265	0	0	3,629	5,650	700	6,944	9,901	7,215	2,435
October	1,110	300	4,592	0	0	7,000	7,117	100	2,835	5,255	2,575	2,539
November	1,110	965	3,225	0	0	6,680	4,187	637	2,800	8,575	3,546	2,750
December	530	1,300	2,765	0	0	2,915	600		1,655	2,255	3,015	2,460
Total	15,150	14,530	29,150	25,544	0	26,536	41,876	30,565	31,938	68,973	76,582	66,840

Source: SG Cross Asset Research/Credit

The strong volumes in Q1 pushed the market to grow further and hit a peak in April as it reached €344bn of notional outstanding. But then issuance volumes dropped, and many bonds were dropped as their maturities fell below one year while others were upgraded to IG status (Renault bonds for instance). The index size has shrunk slightly since April, particularly double-Bs (rising stars are double-B in most cases) while others remained largely unchanged. Still the market is showing good growth still, ending with a notional outstanding of €327bn, up from €308bn at the end of 2014.

Chart 40. HY size by rating

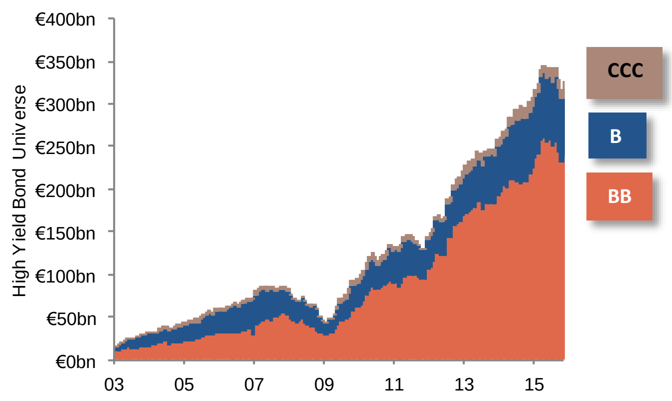
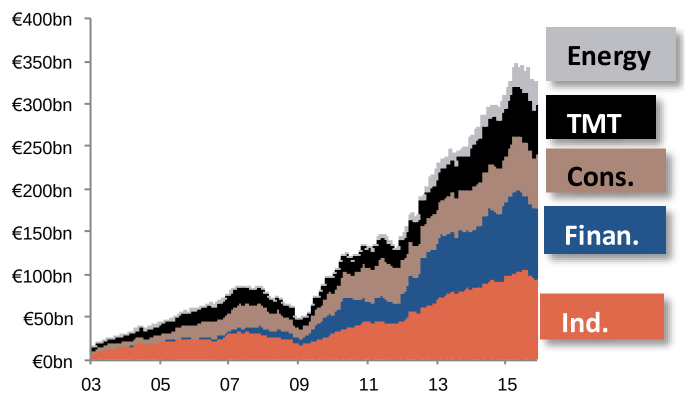


Chart 41. HY size by industry

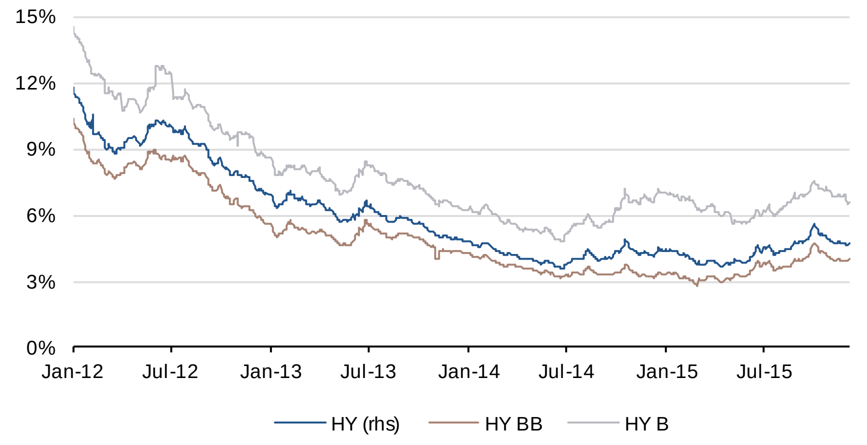


Source: www.markit.com, SG Cross Asset Research/Credit

Looking at the industry sizes we can see that industrials and financials are down slightly on the year while Consumers and Energy are up 15% and 75% respectively, mostly as a result of fallen angels.

But independently of the changes in composition of the index (fallen angels/rising stars) we believe the market will be receptive of new deals, particularly double-B rated bonds as the current ultra-low yield environment exacerbates the hunt for yield. In the chart below we can see how HY in general is currently yielding over 4.5% with double-Bs yielding 4%. This is towards the low end of the range but more than twice what IG yields currently (1.7%) and much more than what any sovereign bond yields. Furthermore, the risk of default for double-B rated bonds remains very manageable in the current ultra-low yield environment and we expect most issuance next year to come from this segment of the market.

Chart 42. HY, double-B and single-B yields evolution



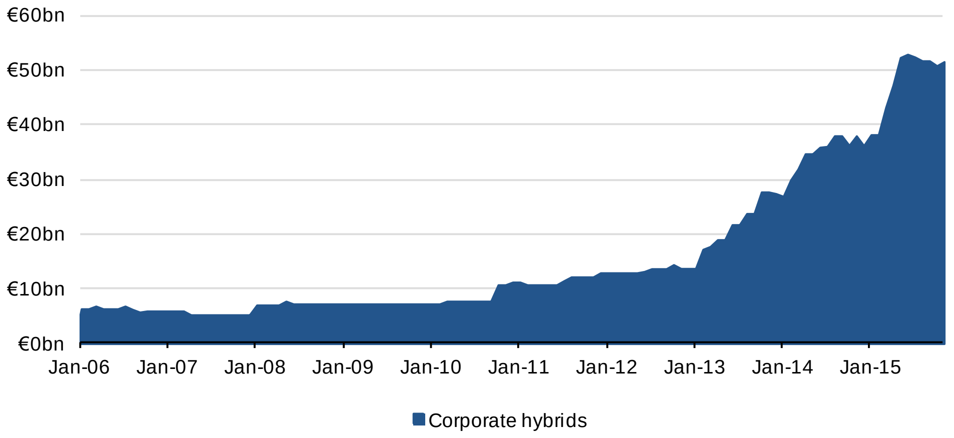
Source: www.markit.com, SG Cross Asset Research/Credit

Single-Bs offer a much better yield, currently at 6.55% and triple-Cs even better at almost 12%. However, we believe the market will be much more weary of the weaker HY names following the recent developments that continue to stack up (retailers, energy companies, some EM names, Abengoa and others) and we believe that investors will be more strict with single-B and triple-C rated deals in general.

Corporate hybrids to stabilise around €25bn

The sector continued to grow in 2015 with a total of €25.6bn issued (€18.25bn in IG and €7.35bn in HY) at the time of writing, not too far from our €30bn forecast. Recently S&P lowered the equity content on 28 hybrids but we don't expect this to affect issuance volumes next year. In IG the size of the market has already grown to €51.7bn from €36.3bn at the end of last year.

Chart 43. Corporate hybrids growth



Source: www.markit.com, SG Cross Asset Research/Credit

We expect the growth rate to continue as companies continue to make use of corporate hybrids as an integral part of their capital structure. We expect to see issuance on the back of more M&A deals as well as the usual credit rating support, capex funding and pension funding.

Senior Financials at cruise speed should hit €160bn

In recent years bank issuance has been fairly stable at around €120bn-€150bn, much lower that the levels we saw in the years before Lehman's collapse. Banks have been reducing their balance sheets and have less need to issue heavy volumes. Additionally European banks have other sources of funding, like covered bonds and, in the past few years, TLTRO operations.

Senior financial supply 2003-2015, euros only, billions (fixed and floating)

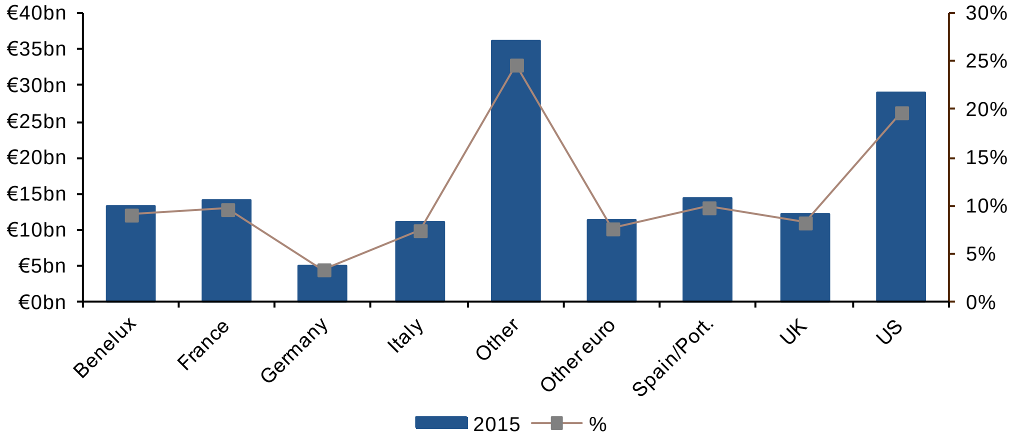
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
January	29.1	38.1	54.7	48.2	90.5	17.8	11.3	34.2	26.4	24.0	30.0	23.2	33.94
February	17.5	29.6	27.6	43.2	42.5	15.8	4.1	14.6	19.8	21.9	4.3	11.0	7.60
March	19.0	26.9	31.2	49.2	42.4	15.8	8.3	20.7	17.8	10.8	7.3	24.2	19.30
April	20.7	23.6	20.3	18.8	23.2	41.7	23.0	6.0	20.1	0.6	9.2	10.4	11.35
May	24.4	25.6	22.7	31.8	47.5	38.8	18.8	0.7	20.1	1.3	9.6	15.8	15.57
June	25.5	29.7	42.4	22.7	32.7	28.7	14.2	10.3	6.0	8.3	0.4	17.8	5.68
July	22.0	30.8	10.9	15.0	12.7	12.3	12.6	18.7	1.3	8.5	9.7	1.8	10.13
August	7.0	7.4	14.4	11.0	6.9	21.8	10.6	4.5	0.0	10.2	9.9	5.1	3.27
September	25.2	46.3	19.0	41.2	11.0	7.3	13.0	21.7	2.5	10.0	6.2	15.0	16.61
October	28.1	17.6	17.3	47.0	16.2	0.0	10.5	15.3	8.0	11.3	9.9	6.5	11.52
November	13.2	25.9	23.5	34.0	3.7	0.0	18.2	6.6	1.2	12.3	19.4	14.6	10.43
December	6.8	9.0	12.1	6.9	0.0	4.6	7.5	0.5	0.0	1.3	5.0	1.0	4.18
Total	239	311	296	369	329	205	152	154	123	120.26	120.65	146.24	149.58

Source: SG Cross Asset Research/Credit

We believe we'll see slightly better volumes next year, with senior financial issuance hitting €160bn, slightly less than the scheduled redemptions (€180bn including Fix coupon bonds, FRNS and bonds above €100m). This means another year of a shrinking universe although the pool is stabilising.

As is the case with the IG market, we believe non-eurozone banks will be heavy users of the euro capital markets, like they were this year. US banks were the most active this year, representing 20% of all issuance. Other non-eurozone jurisdictions combined were even more active (Switzerland 11.6%, Canada 7%, Australia 4%, Japan 2.2%). Given the anticipated low level of yields, we expect foreign banks to continue diversifying their funding sources and use the euro market extensively.

Chart 44. Issuance by jurisdiction



Source: SG Cross Asset Research/Credit

Sub Financials to hit €60bn

Sub financial issuance has been buoyant in recent years although it hasn't reached the record levels seen pre-2007. But as regulatory rules became clearer we've seen stronger volumes in 2014 and the first half of 2015, keeping the market dynamic even if this year volumes dropped after the summer, in line with all other markets. Still activity improved in November and we expect activity to remain very healthy in 2016, surpassing the volumes of the past two years and settling at around €60bn.

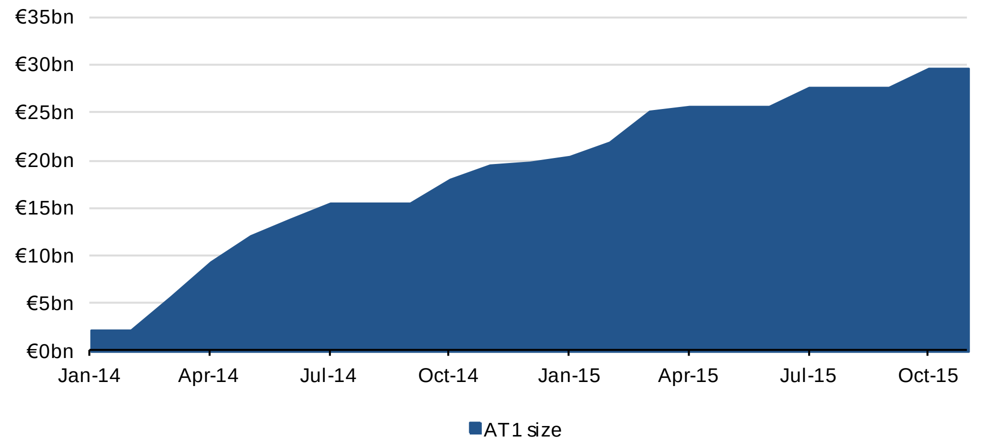
Financial SUB supply 2001-2015

€m	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
January	3,180	4,390	2,580	3,365	3,550	7,100	6,300	3,250	0	0	500	0	1,000	1,500	4,317
February	5,520	1,430	600	4,427	4,450	6,510	6,900	1,800	0	1,000	400	1,250	0	6,250	8,900
March	4,860	4,880	2,950	5,420	5,790	10,375	6,550	2,350	0	3,500	5,204	2,150	3,150	8,030	6,900
April	2,980	4,070	5,360	1,450	4,820	2,600	2,350	6,550	0	2,300	2,378	0	0	4,950	1,750
May	2,780	1,230	2,410	1,150	5,270	6,500	11,600	6,375	2,000	0	500	0	1,000	9,850	1,931
June	4,170	3,910	2,870	6,650	10,235	6,595	5,155	3,050	1,750	1,650	0	0	0	3,950	6,000
July	2,730	1,040	1,250	3,675	1,250	3,740	1,550	0	1,425	4,000	0	2,250	3,400	1,000	1,832
August	850	700	550	425	1,550	1,550	0	1,000	2,300	500	0	500	0	0	0
September	2,280	1,140	5,650	10,985	9,995	13,000	6,250	1,450	4,500	4,100	0	1,750	6,446	9,250	4,450
October	3,610	2,810	6,180	4,880	4,800	5,300	5,800	0	3,350	4,700	0	3,250	5,500	2,250	2,270
November	4,600	2,740	3,750	4,600	6,750	3,300	750	0	1,870	1,750	0	1,750	750	5,400	5,000
December	750	4,630	1,560	2,020	3,960	3,700	1,200	0	0	200	0	1,750	2,300	2,050	1,350
Total	38,310	32,970	35,710	49,047	62,420	70,270	54,405	25,825	17,195	23,700	8,981	14,650	23,546	54,480	44,700

Source: SG Cross Asset Research/Credit

However, we don't expect record years, just a healthy increase in T2 issuance, helped partly by AT1 CoCo issuance. This year we've had just €10bn (in euros only), slightly down from last year's €13.2bn and we believe next year we'll see a similar €10bn issued in euros to maintain the same rate of growth.

Chart 45. AT1 CoCos growth stabilising



Source: www.markit.com, SG Cross Asset Research/Credit

US credit outlook

US credit: Mediocre 2016 with a solid H1 giving way to a likely H2 setback

After a weak performance this year (IG c,-100bp excess returns), we believe **2016 is set to be a better but still-challenging year for the credit market**. We expect returns to be modest for both excess and total returns. **Our base case is for a modest widening in spreads (IG +5bp), translating to 157bp of positive excess returns** (Exhibit 1). Given our rates team's forecast for moderately rising Treasury yields, total return prospects are biased to be a bit more subdued, estimated to register +0.9% in our base case. Factoring in a 'bull' (spread tightening: -45bp) and 'bear' (+105bp) scenario with 50%/25%/25% weightings results in +76bp of excess returns.

Ex. 2: View of path dependent spreads – stronger H1 / weaker H2

2016 Spread Forecasts:

	IG		HY	
Tsy	**Spread**	**YTD Chg**	**Spread**	**YTD Chg**
Start	170		625	
Q1	**160**	***-10***	**610**	***-15***
Q2	**145**	***-25***	**620**	***-5***
Q3	**155**	***-15***	**650**	***+25***
Q4	**175**	***+5***	**700**	***+75***

Source: SG Cross Asset Research/US Credit

Path dependency: A tale of two halves

We see plenty of reasons to be constructive on credit, but also many concerns percolating under the surface. As a result, we advocate starting the year with a ***modest overweight*** given our view that **effective Fed policy/communication, combined with supportive fundamentals and technicals, should hold sway early on to influence a favourable H1 2016.** Nonetheless, we anticipate **shifting to a *modest underweight* late in Q2,** since we project a challenging 2H as enough negatives materialize to hinder credit market tone. Fed policy is poised to be a primary driver of sentiment shifts throughout the year. The unfolding handling of diverging global central bank trends – US tightening running against the tide of easing tendencies from Europe, Japan and China, is likely to get more difficult as the year progresses. Additionally, slow global growth, robust issuance, idiosyncratic risk, rising balance sheet leverage and uncertainty regarding the November presidential election could all conspire to put a damper on credit performance, leading to spread widening in H2 2016 (Exhibit 2).

Ex. 1: 2016 Outlook: Modest excess return prospects with total returns at risk to rate rise

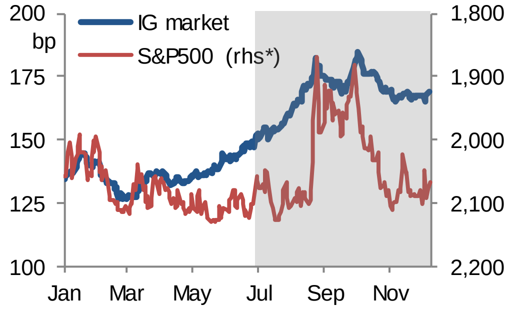
	Current Spread	Scenarios:	Base (50%)	Bull (25%)	Bear (25%)	*Weighted (100%)*
IG Spreads (bp)	**170**		**175**	**125**	**275**	
Excess Returns (bp)			**+157**	**+486**	**-497**	***+76***
*Total Returns (%)**			*+0.90*	*+4.30*	*(5.60)*	*+0.13*

Source: SG Cross Asset Research/US Credit * Incorporates SG rates forecast.

Out with the old: goodbye to a difficult 2015

The year is closing out on a cautious tone for credit. After a range-bound H1, a meaningful Q3 setback was followed by a moderate improvement so far during Q4, leaving IG spreads up about +35bp YTD to 170bp. Disappointingly, **credit has significantly lagged the flat performance for equities this past year** (Exhibit 3a: S&P500 -0.3% YTD). But on a longer-term perspective, 2015's IG market setback is really quite modest (Exhibit 3b). With the setback, the 'good news' is that wider spreads improve the carry situation and provide more room for spread compression (excess returns) – if not for the overall market, at least for alpha opportunities due to astute sector and credit selection.

Ex. 3a: 2015 was a difficult year for credit, as IG spreads lagged equities during a H2 setback...



Source: SG Cross Asset Research/US Credit, Bloomberg *Inverted axis*

Ex. 3b: ... which is nonetheless a quite modest pullback in a longer-term perspective

Source: SG Cross Asset Research/US Credit, Bloomberg

Constructive start to 2016 poised to fall victim to rising risks (the '*buts'*)

We expect 2016 to get off to a favourable start, with credit apt to benefit from the typical stepped-up investor risk appetites entering the New Year. Our view is that a 'good, not great' backdrop should hold up to produce excess returns during H1 before fading with rising risks and uncertainties during H2. As a result, we point to several tangible positives for credit, including better valuations due to 2015 widening, a still-solid fundamental outlook and supportive market technicals. However, **we also see many '*buts*' that could materialize as the year progresses**, ultimately eroding the positive backdrop and weighing on investor sentiment during H2 2016. We do not expect the *'buts'* to play out in dramatic fashion, but the increased threat of these adverse developments will start to weigh on credit valuations.

We give some general thoughts on this **path dependency for three catalysts for credit during 2016: Fed policy, fundamentals and technicals**.

Fed policy to be acceptable early on...

We expect this week's FOMC decision to set the tone for a solid start to 2016. With a Fed hike now widely expected (implied market probability ~76%) and well-telegraphed by Fed members, we believe that recent market weakness is setting up for a bit of a 'relief rally' on the FOMC news – as long as the delivery is well packaged. Fed transparency and communication are key ingredients for a smooth and favorable market reaction. The FOMC statement is likely to convey that the economic backdrop is strong enough to be ready for a higher fed funds rate, and our economists believe the statement could also include some text that points to gradual tightening that is poised to be highly data-dependent and still accommodative. Even if the statement does not add a dovish tone toward the path of Fed hikes, Chair Janet Yellen is likely to stress a preference for gradual tightening while monitoring the strength of economic data during her press conference. Our view is that Yellen will once again succeed with communication that effectively assuages market concerns regarding a possible monetary policy mistake.

But, the honeymoon for Fed liftoff is unlikely to last the whole year. Our economists forecast three additional 25bp hikes for 2016. With four of the eight 2016 FOMC meetings having press conferences and economic projections (more likely for hike announcements), that leaves one of the press conference meetings to pass on hiking (if our economists are correct). As a result, we see the potential for a perceived policy hiccup as the year progresses

– which meeting to pass on among the March, June, September and December meetings? Given the onus on data dependency, passing in March could help sentiment in H1, while passing at later meetings could add to uncertainty regarding the strength of the economy as the tightening cycle progresses. The bottom line is we see greater risk to Fed policy as the year progresses.

Exhibit 4: SG GDP forecasts (%)

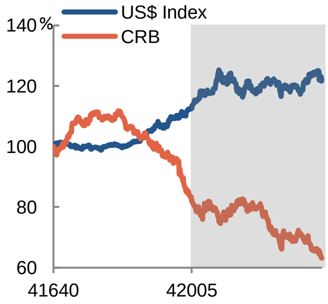
Country	2015	2016
US	2.5	**2.8**
Euro area	1.5	**1.6**
Germany	1.7	**1.8**
France	1.2	**1.4**
Italy	0.8	**1.2**
Spain	3.1	**2.5**
UK	2.5	**2.0**
China	6.9	**6.0**
Japan	0.8	**1.7**

Source: SGCIB

Fundamental outlook is solid for credit...

Our economists project that growth for the US economy will remain moderately above trend, registering credit-friendly 2.8% GDP growth during 2016 (above the 2.5% consensus estimate). This would amount to a modest uptick from the expected 2.5% in 2015 and significantly above the GDP growth rates for Europe and Japan (Exhibit 4). Although SG economists view the US economy as maturing, they still see the credit cycle as far from over. With a view that the US is about 65% through the cycle, their projection is that the next recession does not occur until H2 2018. Additionally, the SG view is for a solid employment backdrop (4.5% unemployment rate for end-2016) and well behaved inflation (1.8%). And expectations are currently favourable for S&P500 earnings growth, as analysts estimate c.7% EPS growth (7.1% overall; 7.4% ex-energy) vs a flat 2015 (-0.4%; 6.5%), which should be aided by easier yoy comparables for energy companies given that the oil downdraft will be more than a year long entering 2016.

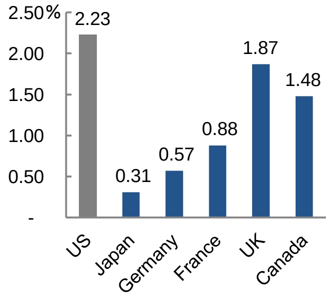
Ex. 5: Diverging fortunes: USD strength vs commodity selloff



Source: SG Cross Asset Research/US Credit, Bloomberg

<u>But</u> global developments could ultimately put a dent in the fundamental outlook. Although prospects for US growth appear to be decent for credit metrics, global weaknesses could impact the picture. In contrast to the Fed, central banks in Europe, Japan and China are all apt to expand their accommodation initiatives – but will they be able to do enough or not make a policy mistake? We view EM as a potential pressure point for sentiment. As we saw in August, China can be a primary wildcard to sentiment for risk assets. SG economists project below-consensus 6% GDP growth for China. Should China have a bumpy or harder landing, then the already adverse commodity story could fall victim to another leg down, accentuated by any further USD gains (Exhibit 5) given diverging central bank policies. The result for credit could be further turmoil for the energy and metals & mining sectors, particularly for the HY market, where default rates could accelerate. Moody's currently projects a moderate increase in US HY defaults, from 2.8% currently to 3.8% late in 2016. However, their pessimistic forecast is over 13%. Should the EM commodity story falter, then investors would start pricing in greater HY default risk, which would spill over into IG commodity sectors and the overall IG market. Add to the mix a potential Fed policy mistake and re-leveraging initiatives, and the fundamental situation could come into question.

Ex. 6: US rates (10Y) are among the highest in the developed world

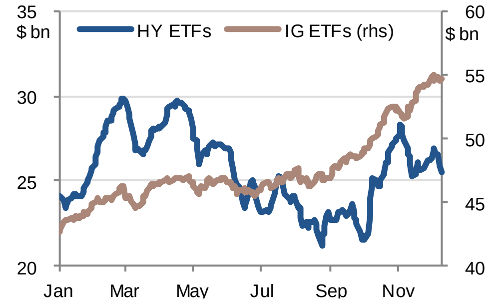


Source: SG Cross Asset Research/US Credit, Bloomberg

Technical situation reflects investor demand for credit...

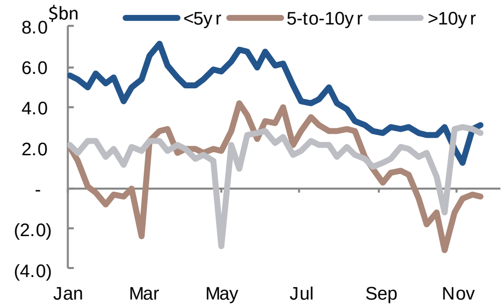
Although mutual fund flow data turned uneven and negative during H2 2015, ETF flows have remained positive for IG credit (Exhibit 7a). Institutional accounts continue to have cash to spend, as evidenced by solid demand for another record-breaking IG supply calendar of $1.3tn. And global investors are poised to continue to be active in the US IG market given its status as not only the largest and most liquid credit market with extensive breadth across names and sectors, but also due to US fixed income yielding among the highest rates in the developed world (Exhibit 6).

Ex. 7a: ETF flows remain positive for IG



Source: SG Cross Asset Research/US Credit, Bloomberg

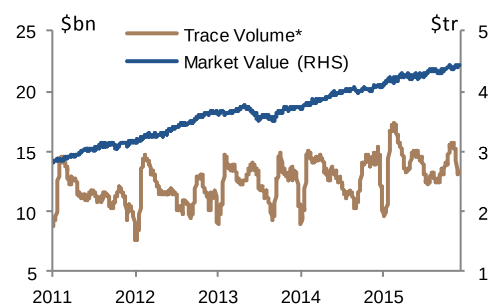
Ex. 7b: Dealer credit positions remain light



Source: SG Cross Asset Research/US Credit, Bloomberg

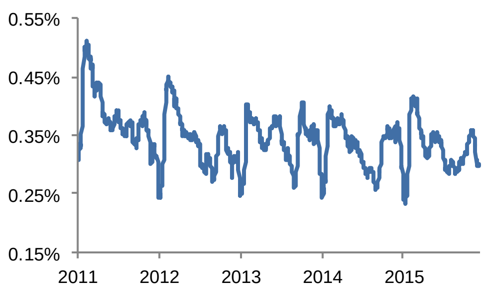
<u>But</u>, tourist investors could get antsy and trading liquidity may falter further. Faster money and retail investors could prove more apt to abandon credit should sentiment and total returns take a hit from widening spreads and/or rising rates due to Fed policy or global turmoil. Liquidity has proven challenging, as investors see significant difficulty in transacting sizeable bond positions. Although daily trading volumes have edged higher for the IG cash market this year (Exhibit 8a), this dynamic is misleading. Looking at trading volumes adjusted for a growing market size reveals that the trend has stagnated this year (Exhibit 8b). And when one considers the dominance of newly issued benchmark bonds among trading volume, the *real* liquidity for secondary bonds is actually deteriorating. Add to the mix increasingly light dealer inventories (Exhibit 7b) and you have another concern for investors who may want to take a step back should markets come under pressure.

Ex. 8a: IG trade volumes edge higher in 2015



Source: SG Cross Asset Research/US Credit, Bloomberg * 20D moving average of Trace data.

Ex. 8b: Stagnant when adjust for market size



Source: SG Cross Asset Research/US Credit, Bloomberg * Daily volume as % of IG market size.

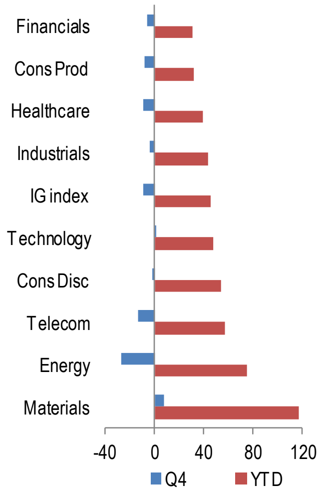
Should investors start the year overweight?

Yes, but a Moderate OW for H1

Credit performance is biased to be quite path-dependent during 2016. To start the year, we advocate a *moderate overweight* to IG credit. December has been volatile, but hope for the seasonal improvement that typically follows through into January should get a boost when the Fed dispels some uncertainty by finally establishing liftoff next week. Investors who want to take a more aggressive stance to start the year should look to scale back to a moderate OW by late January. January performance often starts to fade mid-month once: 1) investor risk appetites have ramped up; 2) an active supply calendar occupies much of the available investor cash; and 3) Q4 earnings season is in full swing.

As stated earlier, our longer-term view for 2016 is that H1 should generate the lion's share of excess returns. Therefore, we anticipate beginning a shift to an *underweight* stance in early June, locking in H1 gains ahead of the mid-month Fed meeting, with deference to our view that Fed policy could be a catalyst for a more defensive tone in H2.

Ex. 9: Q4 and YTD sector moves



Source: SG Cross Asset Research/US Credit, Bloomberg

Given a bias for a stronger H1 2016 in the context of a year when overall return prospects are likely to be modest, investors need to also focus on relative value strategies to supplement portfolio performance. This environment lends itself to 'Four Cs' for boosting returns: 1) **Credit selection**: overweighting/underweighting sectors and names (e.g. our November 2 *USCC*: GM over F; AAPL over IBM; and HD over WMT); 2) **Carry**: adding select higher-yielding assets; 3) **Compression**: concentrating on bonds with stronger spread tightening potential; and 4) **Curve**: positioning to benefit from favourable roll-down and technicals. And the stepped-up volatility over the past several months is contributing to dislocations that represent emerging relative value opportunities for investors. In 2016, we believe a further search for prudent sources of added yield in a low-yield, slow-growth world lends itself to favourable performance from astute relative value positioning. In addition to name selection, we see **distinct opportunities via sector views and curve positioning**.

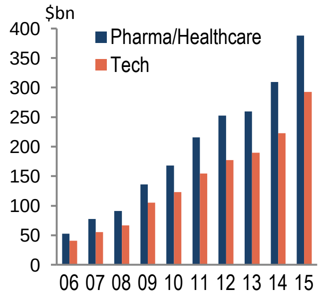
Some sector views and thoughts: Choppy and defensive markets this year have exhibited meaningful differentiation for credit. As a result, decompression trends have played out across ratings (Exhibit 10a) and, more importantly, across sectors where YTD sector spread moves have varied significantly (Exhibit 9), with the commodity sectors (materials and energy) unsurprisingly being the distinct underperformers.

Heading into 2016, we once again expect sector weightings to be an important theme. Traditionally, getting the call right on financials has been vital to performance given the sector's size, liquidity and spread. But since the credit crisis, the yield advantage for financials has disappeared and reversed to trade tight and correlated to the overall IG market (Exhibit 10b), overweighting/underweighting the banks sets up as less vital for 2016. That said, we continue to **view the banks favourably (OW) as having reverted back to being a modestly more defensive sector that offers carry-plus performance** given more conservative business strategies amid stepped-up regulations. For 2016, adding spread with selective down-in-capital-structure and Yankee bank opportunities should be a focus for overweighting the sector.

To start 2016, we advocate a **neutral stance to the commodity sectors**, energy and metals & mining. At this stage, these high-spread/high-beta assets are too risky to apply an aggressive stance. Their high carry and 'risk' of snapback rallies dictates that an underweight posture is inappropriate, while the potential volatility also convinces us not to be overweight either. They start the year as 'show me' sectors, where substantive and sustainable turns for the better in commodities are needed before we would shift views. Also, the HY commodity sectors need to show signs of weathering the storm with moderate defaults during H1 2016. As such, any added exposure should be relegated to higher quality names that have been more resilient to the commodity volatility. Regarding oil, our commodity team sees 2016 as a rebalancing year in which crude should eventually trend higher during H2. However, oversupply is poised to keep the contango situation for WTI futures a nagging negative for sentiment.

Among the higher-spread sectors, we would **overweight telecom,** where the two major players (VZ and T) provide ample liquidity and carry for names with consistent track records

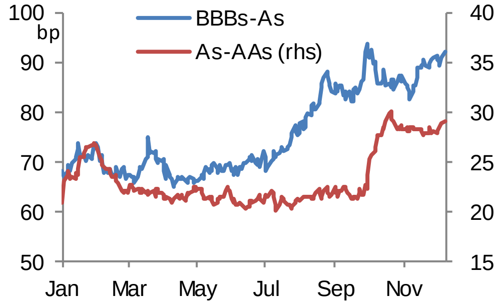
Ex. 11: Pharma/healthcare and tech sectors have surged in size within the IG credit market



Source: SG Cross Asset Research/US Credit, Bloomberg

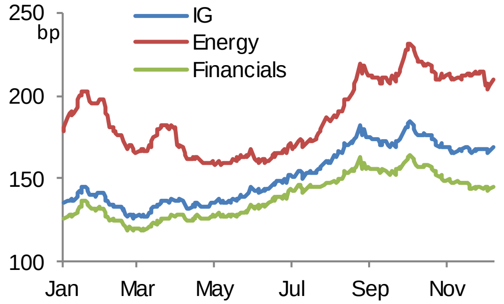
for executing on business strategies. Our two **mid-beta overweight sectors are technology and pharma/healthcare**. These sectors have grown substantially in importance to the IG market (Exhibit 11: approaching $700bn combined), offering favourable spread and liquidity for names with maturing businesses that nonetheless maintain enough size and growth to adequately support more leverage. On the other hand, we see too little spread compensation for sectors with meaningful idiosyncratic risk potential: **Underweight stance to consumer products and industrials** with EM/China exposure risk.

Ex. 10a: YTD decompression by ratings



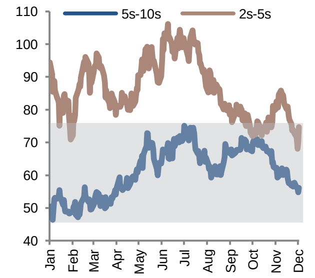
Source: SG Cross Asset Research/US Credit, Bloomberg

Ex. 10b: Diverging sector performance YTD



Source: SG Cross Asset Research/US Credit, Bloomberg

Ex. 13: The 5s-10s Treasury slope has had a flattening trend in the past two months, still 10bp above YTD low



Source: SG Cross Asset Research/US Credit

Curve positioning: 10Y opportunities on the back of Fed liftoff. With Fed liftoff likely this week, we see new considerations emerging for credit curve positioning. Examining 10Y Treasury rates around the prior three Fed liftoffs (in 2004, 1999 and 1994), Exhibit 12a shows that yields tend to move higher ahead of liftoff, with direction being less certain immediately after liftoff and during the early phases of the tightening cycle. That said, the general trend is for flatter Treasury curves (Exhibit 12b, 5s10s flattening). This year, the front end of the Treasury curve has come under pressure with the 2Y Treasury yield backing up meaningfully since mid-October (+40bp) to its highest level in over five years, contributing to a bear-flattening trend. Exhibit 13 details the trend for Treasury slopes during 2015, with both 5s10s and 2s5s curves flattening meaningfully over recent months. With this in mind and a much-anticipated rate hike expected at the upcoming FOMC meeting, our rates strategists believe yields at the front end of the curve will continue to migrate higher, promoting a moderate flattening trend as we move through 2016 (SG forecast: 5s10s +50bp at end-2016).

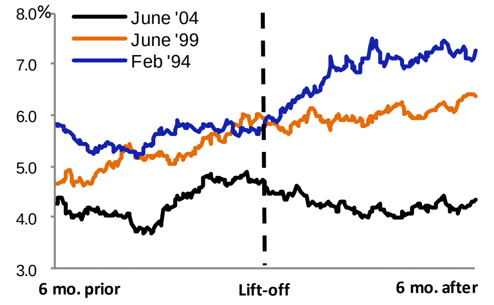
Ex. 14: Attractive 10Y bonds with steep 5s10s slopes

	10-yr	5s-10s Slope	
Ticker	Spread	Abs.	Adj.*
Telco			
VZ	136	+61	*+51*
Tech			
AAPL	81	+50	*+42*
INTC	98	+49	*+45*
Pharma/Healthcare			
ABBV	148	+48	*+40*
CELG	162	+49	*+45*

Source: SG Cross Asset Research/US Credit, Bloomberg * Adjusted for G-spreads. *All levels are indicative only.*

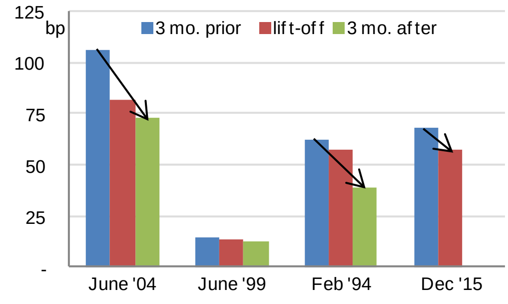
With a bias for a modest progression higher in Treasury rates, we continue to advocate a neutral duration posture for credit portfolios. And the potential for a flattening trend argues for exploring positioning in the 10Y portion of credit curves. Rising front-end rates could influence investors to take a step back from technically tight short corporate paper while higher rates and a flatter curve may continue to convince investors to be cautious to long duration 30Y exposure. As a result, **we see relative value emerging for the 10Y area of select steep corporate curves**. With the belly of the curve poised to benefit, we believe investors should move some 5Y and 30Y money into solid 10Y benchmarks for credits that have steep curves, with a focus on names from our overweight sectors with adusted 5s10s curves of at least +40bp and yield pickups north of 100bp (Exhibit 14: Telecom, Tech and Pharma/Healthcare).

Ex. 12a: 10Y Treasury during last three Fed liftoff periods



Source: SG Cross Asset Research, Bloomberg

Ex. 12b: Tsy 5s10s flattening during Fed liftoff periods



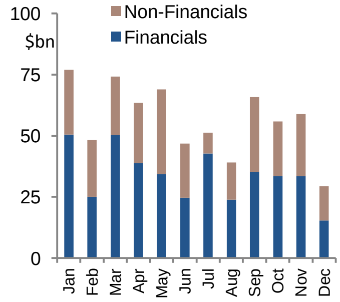
Source: SG Cross Asset Research, Bloomberg

For the balance of the report, we delve into three themes to monitor in 2016: Supply, leverage and rate risk.

Will IG supply be robust?

Yes, we forecast another $1tn+ year (-5% vs 2015)

Ex. 16: 2016 IG maturity schedule



Source: SG Cross Asset Research/US Credit, Bloomberg

Ex. 17: US credit taking advantage of issuance opportunities in EUR: EUR- denominated issuance in 2015

Ticker	Name	Amt Issued (€mm)
KO	*Coca-Cola*	8,500
GS	*Goldman Sachs*	6,300
JPM	*JPMorgan*	5,800
WFC	*Wells Fargo*	5,500
GE	*General Electric*	3,150
BRK	*Berkshire Hathaway*	3,000
BAC	*Bank of America*	2,750
T	*AT&T*	2,500
LLY	*Eli Lilly*	2,100
MCD	*McDonald's*	2,000
MDLZ	*Mondelez Intl*	2,000

Source: SG Cross Asset Research/US Credit, Bloomberg

We expect 2016 to be another active year for IG supply. **Our forecast is for a modest reduction from 2015's record-setting very rapid pace, -5% (c.$1,275bn)**. It is hard to envision a significant issuance slowdown, as the typical trend is for a growing economy and a constructive credit backdrop to be accompanied by an increasing supply calendar (Exhibit 15a, 2009 boosted by guaranteed bank debt). We expect a strong start to 2016, as Q1 supply is typically quite active, supported by significant domestic and Yankee bank issuance. That said, issuance is poised to be tone-dependent, with a bias for a lighter calendar should risk assets come under pressure to start the year.

Some of the factors that should keep issuance strong in 2016 (plus one modest drag):

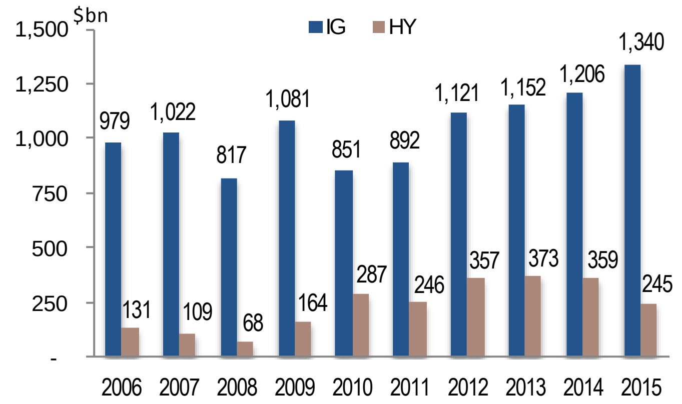
+ Refinancing needs are poised to provide a consistent impetus for companies to come to market with new deals. Part of the story over the past couple of years is a view that supply totals were boosted by 'bringing forward' issuance needs due to the combination of concern over higher rates and opportunistic issuance at historically low all-in yields. Given still-low rates and expectations for rising rates, we expect this trend to be in play again this year, particularly in H1, which is typically strong anyway (Exhibit 15b).

+ Banks should remain active with an added boost this year due to TLAC issuance needs. Admittedly, there is a long runway for meeting the requirements, but banks are apt to start issuing in the coming year to begin ramping up.

+ M&A/re-leveraging activity is the primary wildcard that could actually push the 2016 supply tally above the 2015 record when considering the very substantial pace of M&A, as well as the significant amount of share buybacks. *(Note: We size up this dynamic in the next section.)*

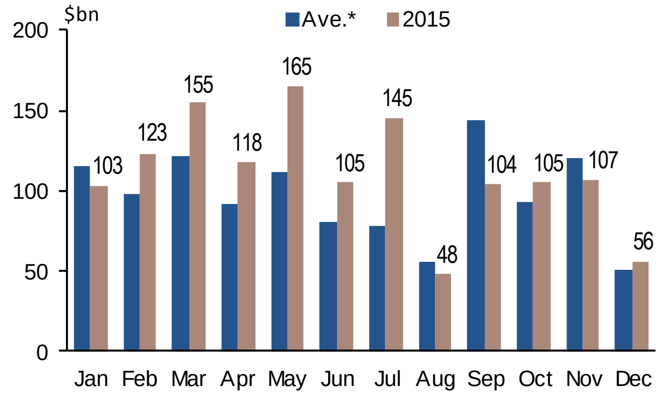
- EUR-denominated issuance by US companies is a trend that gained momentum this year, with US companies tapping European credit markets for over €80bn of issuance (up from c.€60bn in 2014), led by well-known, higher-quality benchmark names (Exhibit 17). We expect this trend to remain strong in 2016, as diverging central bank policy is poised to make EUR issuance an attractive option as US Treasury rates should remain well above Bunds (10Y difference at 164bp), enabling companies with international operations to match issuance with non-USD cash flows.

Ex. 15a: Annual IG issuance has continued to ramp higher



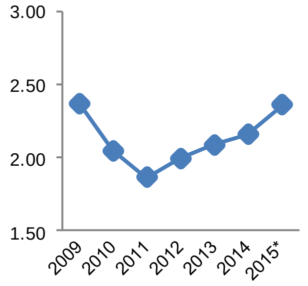
Source: SG Cross Asset Research/US Credit, Bloomberg

Ex. 15b: Seasonality favours an active Q1 IG calendar



Source: SG Cross Asset Research/US Credit, Bloomberg * Average of prior 3 years.

Ex. 18: Leverage creeping higher



Source: SG Cross Asset Research/US Credit, Bloomberg * LTM

Ex. 19: 2015's mega deals with M&A-related deals shaded

Issue Date	Ticker	Size
3/3	ACT	$ 21,000
4/23	T	$ 17,500
5/5	ABBV	$ 16,700
12/9	V	$ 16,000
7/9	CHTR	$ 15,500
7/13	CVS	$ 15,000
9/30	HPE	$ 14,600
10/29	MSFT	$ 13,000
2/9	MSFT	$ 10,750
7/20	UNH	$ 10,500
9/9	GILD	$ 10,000
6/23	HNZ	$ 10,000
5/6	RDSALN	$ 10,000
4/28	ORCL	$ 10,000
5/13	QCOM	$ 10,000

Source: SG Cross Asset Research/US Credit, Bloomberg

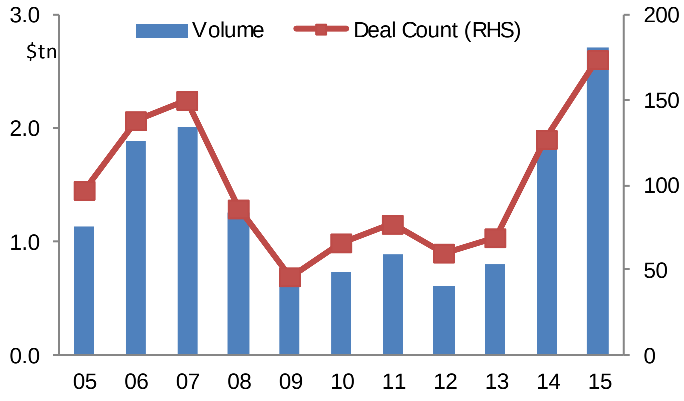
Will re-leveraging weigh on credit?

Yes, to an extent as the year progresses, but primarily as an idiosyncratic risk concern

The US economy is expected to grow more strongly than most of the other developed economies, but being later in the credit cycle means that corporate leverage is apt to continue creeping higher in 2016 (Exhibit 18). A slower growth global backdrop is poised to keep some companies cautious regarding large capex. Instead, companies may decide to use balance sheet flexibility to pursue re-leveraging initiatives, with M&A and share buybacks being quite prominent.

M&A activity has climbed to a record this year (Exhibit 19a), with another megadeal announced in the chemical space on Friday, Dow and DuPont confirming a merger agreement to combine (c.$130bn together) then split into three independent companies focused on agriculture, material science and specialty products businesses. Of note, **activist investors,** including Third Point and Trian Fund Management, played a hand in the tie-up. Regarding corporate supply, M&A deals have been a significant contributor to IG issuance this year with $275bn in bonds issued to help fund deals, representing over 20% of total supply and up dramatically from a run rate of nearly $100bn in the prior three years. Of note, in a year dominated by jumbo deals, the six largest were M&A financing-related (Exhibit 19). These deals have also helped diversification efforts, as many large benchmark deals are coming from new names in the IG space (e.g. $16bn from Visa last week). **In 2016, we expect M&A bond deals to once again be featured prominently, especially given a significant backlog of large announced M&A deals that will be closing in the coming months (Exhibit 20b).**

Ex. 20a: M&A surges to a record this year



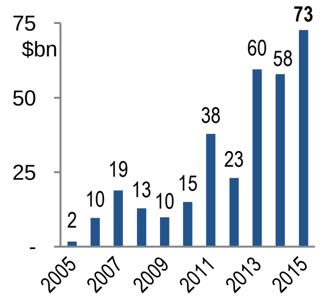
Source: SG Cross Asset Research/US Credit, Bloomberg

Ex. 20b: Large (>$15bn) pending M&A deals.

Announce Date	Acquirer Name	Target Name	Transaction Value ($bn)
11/23/15	Allergan	Pfizer	**$183.7**
10/13/15	Anheuser-Busch	SABMiller	**$120.5**
4/8/15	Royal Dutch Shell	BG Group	**$79.3**
10/12/15	Dell	EMC	**$63.5**
9/28/15	Energy Transfer Equity	Williams Cos	**$58.1**
7/24/15	Anthem	Cigna	**$50.4**
7/27/15	Teva Pharmaceutical	Generic Biz (AGN)	**$40.5**
8/10/15	Berkshire Hathaway	Precision Castparts	**$35.7**
5/28/15	Avago Technologies	Broadcom	**$29.8**
7/3/15	Aetna	Humana	**$28.9**
12/15/14	BT Group	EE Ltd	**$19.6**
10/27/15	Walgreen Boots	Rite Aid	**$16.7**
10/21/15	Western Digital	SanDisk	**$15.9**

Source: SG Cross Asset Research/US Credit, Bloomberg

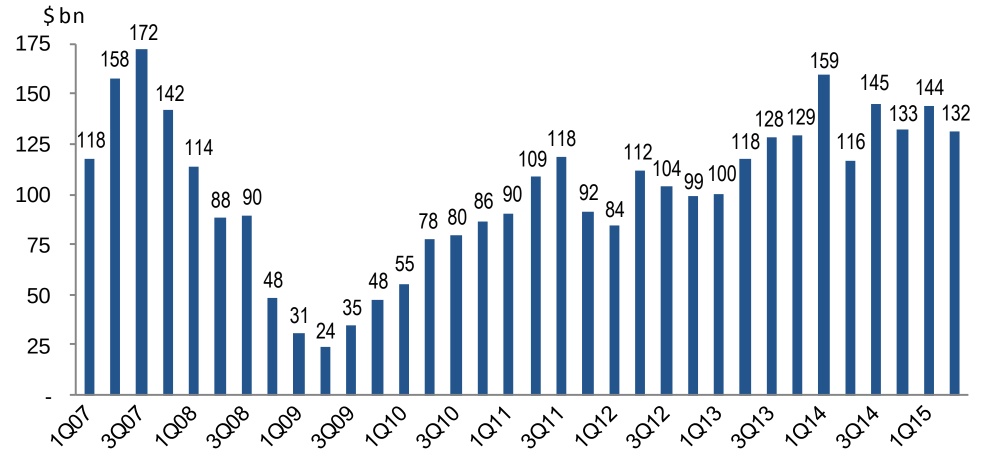
Ex. 21: Bonds issued for share buybacks (annual)



Source: SG Cross Asset Research/US Credit, Bloomberg

Share buybacks remain another part of the re-leveraging story, as companies have been quite active in deciding to reward shareholders, often using debt financing. We believe credit investors need to be vigilant regarding identifying what companies could be more susceptible to becoming too aggressive on shareholder initiatives. Companies that have weak balance sheets and underperforming equities may be susceptible to gravitate toward greater shareholder initiatives – **led by management or by pressure from activist investors**. Stock buybacks are poised to be one avenue for rewarding shareholders. The amount of completed share buybacks by S&P 500 companies has trended meaningfully higher over the past few years, with over $100bn for ten straight quarters (Exhibit 22). Additionally, companies are issuing more bonds that explicitly identify share buybacks as a use of proceeds, with almost $120bn of bonds issued over the past two years (Exhibit 10b). For most companies with solid fundamentals, this can be a healthy activity, but investors will need to monitor whether laggards with suspect balance sheets start to aggressively pursue shareholder initiatives in 2015.

Exhibit 22: Completed share buybacks remain prominent and consistent (S&P 500, quarterly).



Source: SG Cross Asset Research/US Credit, S&P

Should higher rates be feared?

Not really, history supports spread tightening.

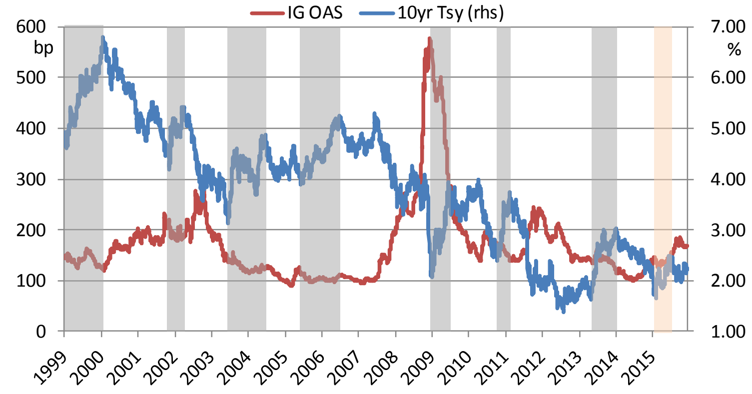
Ex. 23: SG view is for a move higher for Treasury rates in 2016.

		2016 Forecasts:	
Tsy	**Current**	**Q2**	**Q4**
2yr	0.93	**1.15**	**1.45**
5yr	1.64	**2.00**	**2.25**
10yr	2.22	**2.55**	**2.75**
30yr	2.97	**3.25**	**3.35**
2s-5s	*72*	***85***	***80***
5s-10s	*57*	***55***	***50***
10s-30s	*76*	***70***	***60***

Source: SG CIB

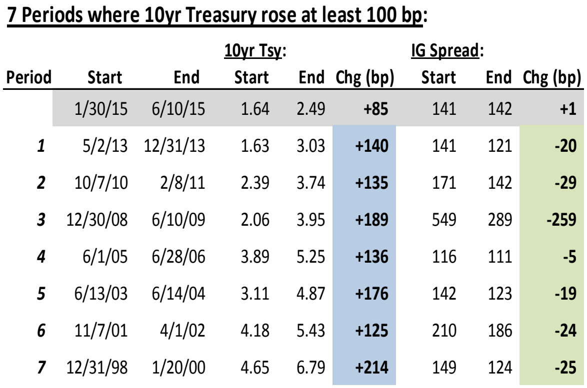
Given an outlook for further fed funds hikes as part of a tightening phase in 2016, most Street forecasts are for meaningfully higher Treasury rates. SG's rates team projects a migration higher with the 10Y Treasury ending 2016 at 2.75% (Exhibit 23). Importantly, the history of substantial increases in rates actually supports spread tightening. Exhibit 24a details IG spreads and 10Y Treasury rates over the past 17 years. An examination of the seven instances when 10Y yields increased by more than 100bp (Exhibit 24b) reveals that in each instance IG spreads actually tightened, meaningfully in several of the cases. Although history does not always repeat, we do believe that if 2016 has reasonably solid economic growth, which is a major contributor to higher rates (without significantly higher inflation), then the accompanying favourable fundamental backdrop for corporations should again support spread tightening. Of note, the 85bp rate backup earlier this year was accompanied by a virtually flat market (+1bp).

Ex. 24a: Over the past 17 years, the seven periods of rising rates have been accompanied by spread *tightening* for the IG corporate market



Source: SG Cross Asset Research, Bloomberg

Ex. 24b: Rate and spread details for the periods when 10Y Treasury rates backed up by more than 100bp



7 Periods where 10yr Treasury rose at least 100 bp:

			10yr Tsy:			**IG Spread:**		
Period	**Start**	**End**	**Start**	**End**	**Chg (bp)**	**Start**	**End**	**Chg (bp)**
	1/30/15	6/10/15	1.64	2.49	**+85**	141	142	**+1**
1	5/2/13	12/31/13	1.63	3.03	**+140**	141	121	**-20**
2	10/7/10	2/8/11	2.39	3.74	**+135**	171	142	**-29**
3	12/30/08	6/10/09	2.06	3.95	**+189**	549	289	**-259**
4	6/1/05	6/28/06	3.89	5.25	**+136**	116	111	**-5**
5	6/13/03	6/14/04	3.11	4.87	**+176**	142	123	**-19**
6	11/7/01	4/1/02	4.18	5.43	**+125**	210	186	**-24**
7	12/31/98	1/20/00	4.65	6.79	**+214**	149	124	**-25**

Source: SG Cross Asset Research, Bloomberg

Financial Sectors

Banks: embrace boring

Paul Fenner-Leitão, CFA (Head)
(44) 20 7676 7132
paul.fenner-leitao@sgcib.com

Jean Luc Lepreux (Banks)
(33) 1 42 14 88 17
jean-luc.lepreux@sgcib.com

Natacha Blackman (Banks)
(44) 20 7676 6169
natacha.blackman@sgcib.com

Brajesh Kumar, CFA (Banks)
(91) 80 2809 5034
brajesh.kumar@sgcib.com

Harjesh Bawa
(91) 80 3087 8112
harjesh.bawa@sgcib.com

Banks will become boring in 2016, and this is good news for credit investors. We think continued improvements in regulatory capital, a slow recovery in pre-provision profitability and tentative signs that regulators are becoming a little less unfriendly on topics like TLAC, UK bank leverage requirements and Spanish DTA arrangements should all make the banking sector even more appealing. Net supply in senior EUR-denominated issues should be negative again this year, which will provide technical support. We recommend overweight positions in subordinated paper, including AT1, where mandates allow. Our favourite geographies are the UK, Ireland, Switzerland and the Netherlands.

Fundamental Themes: Four for the year ahead

Weak profitability: The ECB's QE will tighten margins and shift revenue from interest income to fee income as depositors see higher returns in riskier – managed – assets. Besides the negative impact this may have on bank funding and liquidity, it increases the risk that banks lose customers who seek other products. Overall, ROE's will remain subdued in 2016, in the 5-12% range after tax, barely covering the cost of bank capital.

Better asset quality: We think 2016 will cement the improvement in post-crisis asset quality, including in Italy, where NPLs have remained stubbornly high.

From CET1 to loss-absorbing capacity: Authorities are showing signs of becoming less hawkish on bank capital requirements. There are some clear examples where capital has yet to be built up (such as DB, BNP, Santander & BBVA), but CET1 standards are now well into the 11-13% target range. So the focus is evolving from CET1 alone to a more holistic view of liabilities that can be written-down easily on resolution, i.e. when a bank is no longer viable. This shifts the emphasis to building secondary Tier 2, senior holding company debt and other TLAC/MREL eligible buffers.

The end of the litigation curse? The last of the big US RMBS settlements are (probably) likely to come during 2016. Key banks at risk include Barclays, DB, CS, UBS and RBS

Supply: Less is still more in EUR

In the second section of this report, we show how senior financial EUR-denominated redemptions (from global issuers, banks, insurers) will fall from €210bn in 2015 to €180bn in 2016. This implies that net negative supply in senior should fall to -€10bn, from -€36bn. We estimate net sub supply at €40bn, based on €60bn in gross supply and €20bn in redemptions. These figures are for supply in EUR only and for all financial institutions globally; the table below shows our forecasts for European bank issuance in all currencies.

Tier 2 for MREL/TLAC is a question: We expect a total of €315bn in total European bank bond issuance in 2016. This is up 5% from the expected €298bn in 2015 (see table for summary). We base our estimates on historical Dealogic information and factor in our expectations for 2016, including asset growth, evolving regulatory requirements and investor appetite for bank debt.

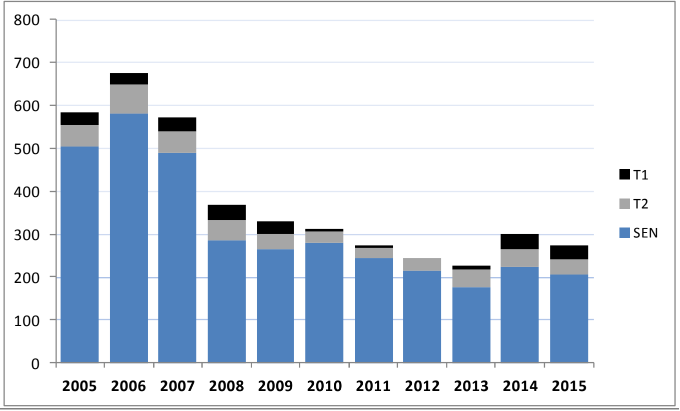
European Bank supply expectations, all currencies

EUR equiv bn	2015e	2016e	2016e by ccy EUR	 USD	 GBP	 Other
Sen Opco	196	175	109	38	7	22
Sen Holdco	26	53	18	31	2	2
Tier 2	37	45	23	18	0	3
AT1	39	42	10	20	3	9
Bank total	**298**	**315**	161	107	12	35

Source: SG Cross Asset Research/Credit, Dealogic

The bank team estimates are for European banks issuing in benchmark size in any major currency. For Tier 2, we estimate issuance of €45b equivalent in 2016, up from this year's €37b. Clarity around GSIB TLAC requirements (and the MREL 2016 phase-in) should encourage more French and Spanish issuance to cover deficits by issuing more Tier 2 (see TLAC deficits here).

European bank supply (any currency)



Source: SG Cross Asset Research/Credit, Dealogic

However, the French banks were already over-represented in Tier 2 issuance in 2015 (50% in terms of number of issues), meaning the yoy delta may not be as significant as might otherwise have been the case. The hope of insolvency law change to make senior debt TLAC-eligible (leading to less Tier 2 requirement, as in Germany and Italy, may also encourage issuers to hold off). So for us, the net result may be greater Tier 2 issuance, but not a major change. Remember that 2015 actually saw less Tier 2 supply than consensus expectations. As for AT1, we are also expecting a small increase to €42b, premised, in part, on what we perceive to be a fairly welcoming investor base for the product. We think 2014 and 2015 have provided ample evidence of strong appetite for new AT1 issues – from strong and weak stories alike. We think annual supply of c.€40bn (across currencies, maturities) is digestible.

A lot more Holdco paper: We think the major difference in supply patterns for 2016 over 2015 will be the start of senior bank holding company paper emerging as a major new issue product. We think holdco senior issuance could double to €53bn (driven by UK and Swiss banks) and replace some opco issuance. As a result of this uptick in holdco issuance, we expect opco supply to decline from €196bn to €175bn. **The net result of this shift among some banks from opco to holdco, over time, will be a lower rating for the senior financials sub-section of the indices.**

Positioning: Country themes and high-beta structures

Stick to quality, low-maintenance credits: We would be overweight banks in countries like the UK, Ireland, Switzerland and the Netherlands, where economies are recovering, banks are still deleveraging, regulators are strict and spreads do not yet fully reflect recent positive developments. Brexit risks pose a bit of a problem for UK bank exposure, but we think the balance of risk/reward still favours an overweight here. We also like Spain – particularly the two big banks Santander and BBVA – though we recognised that taking positions in these banks exposes investors to EM risk. Our EM strategists do not think the worst is over for the sector, as they explain in their 2016 outlook, "Deeper into the Vortex."

Underweight Nordics, second tier Italians, Germans: We expect bonds to underperform given full valuation, a lack of fundamental improvements on the horizon and under-compensated exogenous risks. We think Italian and German senior bond prices have yet to fully reflect the subordination proposals (see our views here). Investors in Italy are likely to see additional volatility in the wake of the ongoing resolution of the four failed banks. In Nordic Banks – Safe haven status over-played, we emphasised that the high quality of local banks is more than reflected in bond prices and investors should look elsewhere. Our preferred name in the region is Danske.

Bank holco offers value: Notwithstanding the expectation that issuance will rise substantially in 2016, we like bank holding company paper, since we think investors get over-compensated for the risk. The investment case is different between holdco senior and Tier 2. In senior, we think holdco bonds are certainly riskier than opco paper. However, the risk of holdco UK paper, say, should ultimately be no more than Italian or German bank paper, which is in the process of being subordinated in order to become TLAC/MREL eligible. Yet UK senior bank holdco paper is trading at a significant discount. At the Tier 2 level, holdco paper is of very similar risk to opco paper. If the holdco only exists to own the bank subsidiary, then trouble at the bank is the only way the holdco will get into trouble itself – so for regulatory capital, the likelihood (and extent) of loss is very similar.

Go for beta: Just as in 2015, we expect AT1 and Tier 2 to outperform senior debt in 2016. The year will see the formal introduction of bail-in legislation for senior debt across the EU, which should start to weigh on senior spreads. We also think investors and rating agencies will worry about the risk that senior unsecured bondholders may end up being further (statutorily) subordinated (in claim) across Europe (as is already proposed in Germany & Italy). As a result, spreads between senior and subordinated bonds are likely to compress.

We are fans of the AT1 market in particular, and have been active in recommending strategic positioning, as well as tactical trades. We explain why we like the sector and provide some of our latest thoughts here. We think the sector stands to perform well against other credit products again in 2016, and we think there are ways of effectively positioning for the attractive carry (beta) while also minimising downside risk through security selection (alpha).

SG view on European bank positioning

Level	View	Spread direction	Issuance prospects
Senior Opco	**Market Weight**	**Flat**	Less than 2015
Senior Holdco	**Market Weight**	**Flat**	A lot more
Tier 2	**Overweight**	**Flat**	A little more
AT1	**Overweight**	**Tighter**	Similar to 2015

Source: SG Cross Asset Research/Credit

Summary view of our bank likes/dislikes

	Like	Dislike
Senior	CS €1.25% 22 (holdco) BACR €1.5% 22 (holdco) BKIR €1.25% 20	CS €1.375% 22 (opco) BACR €4.875% 19 (opco) NDASS €3.25% 22
Tier 2	RBS €3.625% 24/19 UBS €4.75% (T2 CoCo) RBIAV €4.5% 25/20 BACR €2.625% 25	STANLN €3.125 24 KBC €2.375% 24/19 BNP €2.375% 25
AT1	ACAFP €6.5% call 21 RBS $7.5% call 20 UBS $7.125% call 20 DANBNK €5.75% call 20	DB €6% call 22 BNP €6.125% call 22 DNB $5.75% call 20 NDASS $5.25% call 19

Insurance: Enter Solvency II

Rötger Franz
(44) 20 7676 7167
rotger.franz@sgcib.com

After an almost 20-year marathon, issuers and regulators are finally ready for Solvency II. Despite all the preparation; there is still scope for surprises. The regulators' application of the new rules is definitely not uniform, and discounting reserves remains controversial, particularly in the UK. Moreover, Europe's new common supervisory framework will require more harmonisation in the years to come. Nonetheless, we do not think Solvency II will boost supply this year, and we recommend buying CNP, Generali, Axa and Aviva.

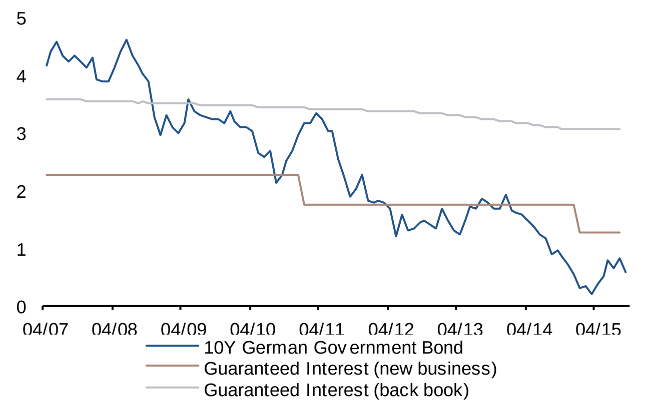
Fundamental themes: Plus ca change…

The unappealing life business: Fundamentally, old issues prevail in the individual subsectors. Life insurers are still competing with one another for bigger pieces of the same pie, but with little hope of a rate increase big enough to make the European traditional life business a safe proposition once again, insurers are increasingly focusing on the protection and unit-linked businesses. But it is not only continental Europe that is causing trouble, as regulatory changes in the UK and US are also reducing margins, and emerging markets are also causing concern.

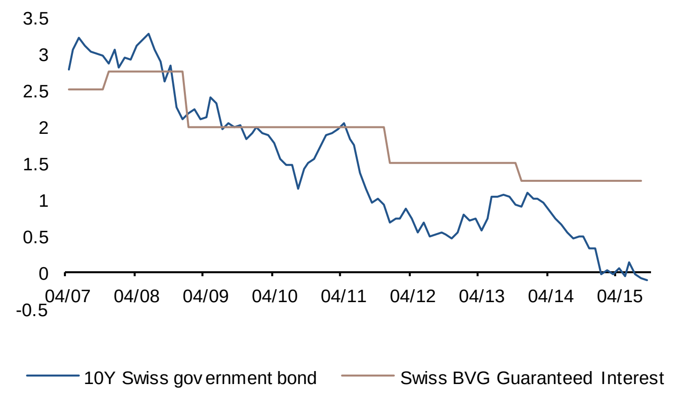
Germany, Holland and Switzerland remain the most toxic life insurance markets, in our view. While sales of guaranteed business have fallen sharply in recent years, local insurers are still sitting on sizeable back books, which are weighing on their longer-term credit quality. While we still believe the interest rate exposure is manageable for the major insurers, there could be some negative headline risk if the solvency of small and mid-cap players is squeezed.

The average guarantee on the back book of German and Swiss life insurers is still marginally above 3.0% (above the levels suggested by our strategists' model for the whole of Europe, which appears in the second section of this report). Across the market the average is declining by less than 10bp per year as old books with guarantees of up to 4.0% slowly run off.

Life insurance guarantees – Germany (%)



Life insurance guarantees – Switzerland (%)



Source: SG Cross Asset Research/Credit

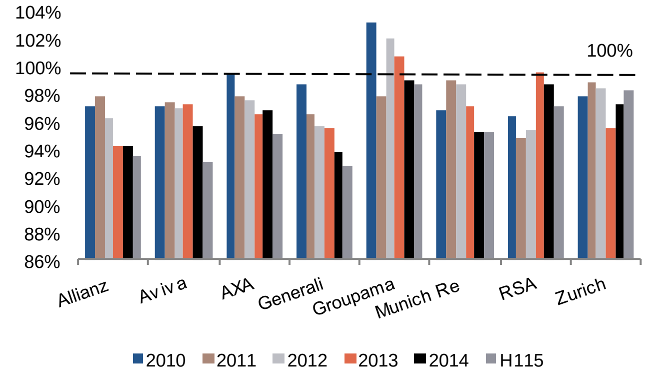
Changing the business mix: New business disclosures by the insurers we cover show a strong decline in the ratio of traditional sales to other business. The numbers are biased, however, as good equity performance has made unit-linked sales soar even though we doubt whether any of these players gained market share in unit-linked business over the past few years. A reversal of stock markets could make new business drop quickly again.

In our universe, Allianz, Munich Re, AXA, Generali and Zurich are most exposed to traditional guaranteed business in continental Europe. Zurich already stopped selling such business several years ago and is more advanced than peers in running-off the back book. Munich Re recently announced that it will completely withdraw from selling such policies after having reduced its domestic traditional sales to less than 50% of total new business over the last couple of years. Similarly, Allianz already generates 53% of its domestic retail sales and 31% of its domestic corporate sales with innovative guarantees of around 0.8% on average. Interestingly, Allianz has said goodbye to mean reversion and no longer assumes interest rates will recover. They are now underwriting only hedgeable guarantees.

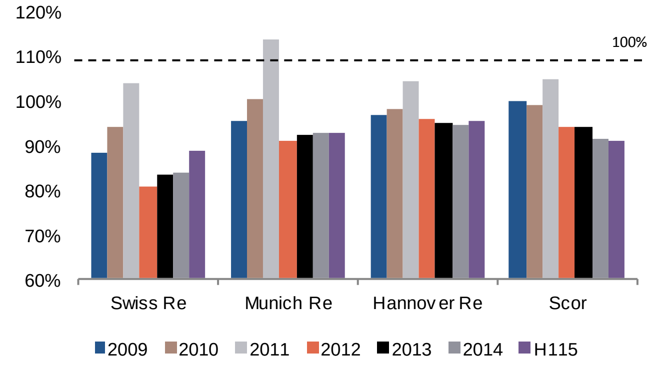
UK has its own challenges: Could UK players be better placed in this environment? UK life insurers stopped selling guarantees almost two decades ago after the collapse of Equitable Life. But it is not all about guarantees. UK life insurers remain under fire from politics, and we expect their business models to change fundamentally over the next few years. In 2014, the announcement of the liberalisation of annuities caused a sharp drop in sales. In 2015, further challenges await, as the UK chancellor is discussing the potential removal of upfront tax relief on pensions to create a regime where ISA-type investments dominate. Payments into this new pension class would be out of the fully taxed income, squeezing margins further for insurers such as Prudential, Aviva, Legal&General and Standard Life, and intensifying the integration of the local life and asset management markets.

P&C a better option: The P&C business still offers a potential escape route from the pressures in the life business: Insurers like Generali still intend to expand the share of P&C business in the group, although this is a long-term process. Top-line growth in the major mature markets in Europe and the US remains subdued, as underwriting discipline prevails. Emerging markets have driven premium growth in recent years. An EM crisis could flatten overall growth, though sales in these countries are usually just a moderate portion of total premium income. The good news is that in both P&C and life, a drop in EM GDP could be offset by higher insurance penetration (i.e. premiums as a percentage of GDP), which tends to rise alongside GDP per capita. Amongst the emerging markets, Turkey is causing the most concern. Regulatory changes and intense competition have kept combined ratios well above 100% for most firms, and we expect a full recovery to take several years.

Combined ratio (primary insurance)



Combined ratio (reinsurance)



Source: SG Cross Asset Research/Credit

Globally, combined ratios are still in the mid-90s for most players, which remain profitable despite falling rates in some markets. Rates in commercial and industrial lines are under pressure in France and Italy, while Germany and the US are holding up well. We expect P&C to generate high underwriting profits in 2016 unless catastrophe losses and large man-made losses exceed the long-term average.

Paradoxically, more non-life focused or pure non-life insurers, like Zurich, RSA and Groupama, are still underperforming their peers' underwriting results. In our view, however, this is due to deep-rooted issues at the individual companies rather than the state of the market. In our view, Groupama's tight pricing makes its bottom line vulnerable to adverse events, while Zurich and RSA still have issues on reserves. Zurich once again issued a profit warning due to an increase in reserves of $300m, mostly for US auto liabilities and US contractor guarantee business (see our note here). RSA is still undergoing a strategic refocusing.

Heterogeneity in reinsurance rates: Feedback from the negotiations for the 2016 reinsurance business renewals suggests that market continues to soften. Yet the market cycle appears more fragmented than it has in the past. Events in 2011 and 2012 were mostly concentrated to Asia/Pacific and North America, while central Europe, and Germany in particular, had its worst year in history in 2013 and therefore trails the cycle in other markets. The recent increase in large man-made losses has increased rates in some property-related businesses. Casualty lines are still solid, while the hard primary insurance markets in the US and Germany have had a positive effect on the reinsurance market.

In years past, reinsurers would have reacted to the divergence in the markets by withdrawing capacity from the softest lines and thereby reducing top-line premium income. However, this is not currently happening, with only Munich Re suffering lower revenues. Hannover Re and Scor are both much smaller than the two market leaders, and more flexible at reallocating capacity between lines of business and geographies. Data from the January 2015 renewals and the subsequent renewal dates show that a relatively large portion of business was cancelled, but this was offset by new business. This might also indicate some flight to quality among primary insurers, as the capitalisation of more aggressively pricing small and mid-cap reinsurers is being slowly depleted. There has been a slight change across the industry towards a higher share of proportional business, where rates are following the primary market, which is not as soft as the reinsurance market. But as rates are still profitable in the non-proportional market, we do not expect this to be sustainable.

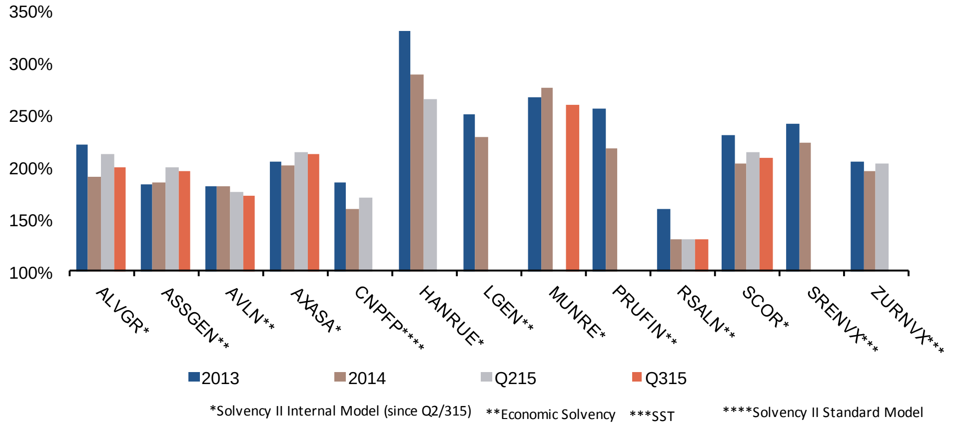
For 2016, we see more potential for a volume decline at Swiss Re and Munich Re, and possibly some stagnation at Hannover Re and Scor, as the market softens and underwriting results decline slightly among all reinsurers in our universe.

Supply: Down again this year

The economic solvency and Solvency II ratios of the insurers in our universe recovered a bit in Q2 and Q3 2015, thanks mostly to higher interest rates. The picture is somewhat biased, however, as many insurers do not publish interim solvency ratios, and model changes requested by regulators had a material impact.

No negative Solvency surprises so far: There were no negative surprises in H2 2015, as Hannover Re, Scor, AXA, Allianz and Munich Re published their final Solvency II ratios. All are well within the comfort zone, which we see starting at 160%, and we do not expect any of them to come to the market for regulatory reasons. Most remaining insurers publish Economic Solvency Ratios, and CNP publishes a Solvency II ratio according to the Solvency II Standard Model. However, some uncertainty remains in the UK, where published Economic Solvency ratios could materially differ from the final Solvency II ratios, which have yet to be disclosed. There are also questions about Groupama, which we view as the weakest name in our universe. That is not to say that Groupama, Standard Life or the Society of Lloyd's have disclosed any of these ratios.

Solvency II/Economic Solvency/SST Ratios



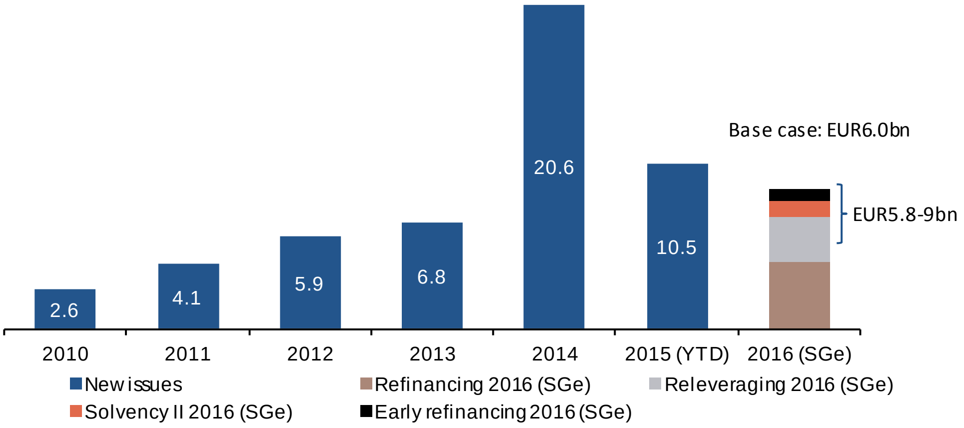
Source: SG Cross Asset Research/Credit

But some may need to top up reserves: Reserve releases have declined in reinsurance, though we see this not just as an sign of depleting reserve redundancies, but also as a reflection of lower catastrophe losses as some players smooth underwriting results. In the primary insurance sub-sector, the picture is more varied due to one-off changes in reserves, and both RSA and Zurich showed reserve deficiencies. We believe both have thinner reserves than peers, and while RSA has already addressed issues following multiple reserve reviews, we believe further action may be warranted at Zurich.

Not much releveraging: The deleveraging of the recent years has come to an end, in our view. By contrast, we see little incentive to re-leverage now, as top-line growth is limited and M&A activity remains subdued. Only Zurich announced that it will increase leverage. Hence, new issue activity will be mostly to refinance old legacy sub debt that is up for call in 2016-17, but we would not rule out some Solvency II-driven new issues in the UK.

Leads to a further decline in supply: In total, we should expect new issues between EUR5.8-9.0bn and GBP1.2-3.1bn in 2016. Our base case is EUR6.0bn at the lower end of the range for the issues in EUR and GBP1.8bn of new issuance, allowing for Zurich's moderate re-leveraging and one benchmark-size Solvency II-related deal in sterling. We note that this forecast is for our coverage universe. We expect insurers to continue to prefer Tier 2 paper. So far, we have seen no new Solvency II-compliant Tier1 issuance, and a first Tier 1 issue in 2016 would come as a surprise to us, but we do not fully rule out this possibility.

New Issues (€bn)



Source: SG Cross Asset Research/Credit

Positioning: As in banks, go for beta

We maintain our view that high-beta names in our universe remain most attractive. In particular, CNP and Generali paper remains structurally undervalued while still offering a reasonable yield for the inherent asset risk of primary (life) insurance companies. We like CNP for the implicit shareholder support from its government-owned shareholders, which is not factored in pricing. Generali paper has yet to receive sufficient appreciation for its balance sheet recovery, in our view.

The two As – Axa and Aviva: Opportunistically, we recommend select AXA and Aviva paper, which recently underperformed and look attractive to us relative to peers. AXA's capitalisation relative to other players, such as Allianz or Zurich, tends to be underestimated, even when taking into account that AXA, unlike peers, issues through the non-operating holding company. Aviva has delivered on its recovery plan, but its Tier 2 paper weakened recently thanks to some Solvency II concerns, which believe are overblown. Among the low-beta alternatives, we see very few opportunities given the tight valuations of reinsurance paper and the idiosyncratic issues of Zurich and RSA. In this context, Swiss Re paper is the most attractive relative to low-beta peers, in our view.

Stick with the start of the alphabet: We are more nervous about possible negative newsflow from Zurich regarding its reserving and believe the lack of a new permanent CEO adds to the uncertainty. Following Zurich's announced re-leveraging and plans to issue up to $3.0bn of additional sub debt, we recommended selling Zurich paper. We also recommend taking profit at Allianz given its tight valuation despite higher fundamental volatility than peers. Hannover Re paper is now the tightest reinsurer in our universe, which no longer reflects its capitalisation relative to peers. Although we believe that the issuer's fundamentals are strong, we currently see more value in other reinsurers.

Top picks and pans

Buy	ASW Spread	Sell	ASW Spread
Aviva 6.125% 43-23	323bp	Allianz 3.375% perp	289bp
Aviva 3.875% 44-24	300bp	Aviva 6.875% 38-18	222bp
Aviva 3.375% 45-25	292bp	Hannover Re 5.75% 40-20	222bp
AXA 6.211% perp	243bp	Hannover Re 5% 43-23	220bp
AXA 3.875% perp	318bp	Zurich 7.5% 39-19	235bp
CNP 4.75% perp	331bp	Zurich 4.25% 43-23	240bp
CNP 4% perp	375bp		
CNP 6% 40-20	332bp		
CNP 6.875% 41-21	353bp		
CNP 4.25% 45-25	348bp		
Generali 5.479% perp	314bp		
Generali 4.596% perp	405bp		
Generali 10.125% 42-22	458bp		
Generali 7.75% 42-22	413bp		
Generali 5.5% 47-27	398bp		
Swiss Re 2.6% perp	258bp		

Source: SG Cross Asset Research/Credit

Cyclical Sectors

Retail and Consumer

Simon Cowie
(44) 20 7676 7152
simon.cowie@sgcib.com

Subsectors will face very different challenges in 2016. UK food retailers may lose even more market share to discounters and price deflations, while non-food retail spending should be buoyed by low unemployment and rising real incomes. In France, we expect rising domestic earnings from Casino and Carrefour, and also think that although retail spending may be weak in Q4 after the Paris atrocity it should return in 2016. The falls in commodity prices which boosted consumer businesses this year should not be repeated next year, while in brewing the main risks are bond issuance linked to the acquisition of SAB-Miller by AB-Inbev, and potential brand sales most likely to Carlsberg (and to a lesser degree Heineken). Our top pick for 2016 is Accor while we recommend avoiding Rallye despite the latest positive news on Casino's de-leveraging plans.

Fundamental themes: UK food retail and EM are the principal challenges

Clouds lingering over UK food retail... The competitive pressures in UK food retail we outlined in our 2015 Outlook have not gone away. Kantar data for the 12 weeks to 6 December reveal still meaningful deflation at 2%, Aldi/Lidl market share gains of 140bp, and the biggest market share losers being Tesco (-110bp), and Asda (-50bp). This is reflected in 2015 CDS performance. While there has been limited change yoy at **Sainsbury/Morrison,** this is not the case at **Tesco**. In addition to UK sales weakness, Tesco also disappointed in its balance sheet repair (a halt to asset sales and no rights issue to date), which has led to wider spreads over H215 - 5yr CDS at 330bp is up 130bp yoy. We continue to like **Carrefour** for its exposure to an improving domestic market and earnings recovery in Spain / Italy.

Non food retail mixed... The bright spot in the UK has been non-food where we expect 2016 demand to remain firm. However with low market shares in many products, especially clothing and accessories we believe that each retailer has the ability to materially out/underperform – name picking is key, which has been most apparent in high yield where asymmetric risks have again been made clear in 2015. In addition, while micro factors tend to dominate this is not the case during periods of significant economic contraction and currency weakness, both of which are a significant operating drag at **Casino Electronics** in Brazil and **Metro** in Russia. For the latter, a key credit support this year was the sale of Kaufhof department stores, and for the former it was the re-organisation of portfolio holdings and proposals for 2016 de-leverage.

Commodity prices unlikely to get any better for food producers: Food and drink producers benefitted from global franchises and falling commodity prices in 2015. We would not expect input costs to be as supportive in 2016.

M&A the main risk with drink producers: In brewing and spirits, we regard M&A and potential pressure on spreads from bond issuance to be the greatest risks. In the proposed acquisition of SAB-Miller by AB-Inbev the bank/bond funding mix is unknown, but nonetheless, it would seem quite possible that the current record $49bn bond issuance from Verizon in 2013 could be broken next year. In addition, with AB-Inbev explicitly exploring the sale of the Peroni and Grolsch brands, and Carlsberg the more likely buyer (with Heineken less so), in our view there is no shortage of potential bond issuance. We consider Carlsberg the more likely buyer as they have expressed interest in acquiring Italian brands, while Heineken could face competition issues.

Supply: Driven by the consumer sector

Redemptions another supply driver: In addition to the brewers, various other issuers have bond redemptions through 2016 and could therefore issue into the bond market in coming months. There is very little in retail, perhaps EUR1bn+ from Carrefour SA, far more in consumer, with likely activity from Philip Morris International (c.€2.25bn), Imperial Tobacco (c.€2bn), Pernod (c.€1.2bn), and Diageo (c.€1.25bn).

Positioning:

Buy Accor 2021 and 2023 bonds: Accor management has clearly structured the FRHI transaction to minimise the impact on its credit metrics to maintain its IG credit rating. This is unlikely to be the end of sector consolidation but with €2.3bn of bonds outstanding with a 125bp coupon step on any Rating downgrade, we expect a balanced focus at Accor, including ratings preservation. The company guides for 2015 EBIT of €655m-675m, although since the Paris attacks the outcome has likely shifted from the top to the bottom end of the range, in our view. Even the latter would represent EBIT growth of c.9% for 2015. We have a Stable credit opinion and recommendation to Buy the 09/2023 bonds at 101.75/YTW 2.12%/Z+152, and 02/2021 bonds at 104.75/YTW 1.65%/Z+140.

Hold Casino senior bonds, Sell 5yr protection: For Casino, the weakness in the Brazilian economy of the Brazilian real and electronics earnings is well flagged. However, we consider the 2016 de-leveraging plans announced 15 December to be a significant boost to credit investors. We now regard 5yr CDS levels as too high at c.285 mid versus the May 2021 bonds at c.Z+175, with the duration-adjusted basis at c.120bp. In our view Casino is now an IG credit where there is a clear path and a strong incentive (125bp coupon step-up in most of its senior bonds as well as Rallye impact) to manage debt protection metrics in line with current ratings and significantly reduce holding company leverage. There are also early signs of a domestic earnings recovery. The latter is part demonstrated by Q3 LFL sales gains. We firmly believe that Casino will continue to pay a dividend to support Rallye, but we also maintain a base case that in the event the Casino share price leads to funding problems at Rallye it would be extremely difficult to alter the current Rallye-Casino corporate structure.

Sell Rallye 2021 bonds and Buy 5yr protection: Rallye should be able to avoid a near term liquidity crunch, as there are c.€1.9bn of committed unutilised bank facilities with likely reasonable headroom over the two financial covenants at end-2015. However, there is still clear potential for a negative feedback loop around the Casino share price, bond prices, commercial paper access and the maturity of the €389m, 4 November 2016 bonds.

Rallye has benefited directly from Casino's de-leverage announcement, since as of 16 December it triggered an 8% share price rise and indirectly gained from greater certainty over the Casino dividend. In our model, Rallye asset cover (i.e. the reverse of LTV) has recovered to 1.03x versus a low of 0.92x on Monday 14 December. However, it is extremely sensitive to Casino share price weakness, for whatever reason, and with 2021 bonds at c.92/YTW 5.8%/Z+548 and 5yr CDS at c.800 mid, we question the extent of current bond market access. We also fear that CP investors may choose to exit, triggering a likely draw-down on secured, over-collateralised bank facilities which would subordinate bondholders. Bonds are senior unsecured obligations, with no upstream guarantees from Casino. We note that CP of €390m at end-2014 peaked at €692m on 11 September, but has since fallen back to €391m. Some CP investors also have the option of buying the 2016 bonds for a material pick-up in yield of perhaps 300bp.

Building Materials

Philippe Landroit, CFA
(44) 207 676 7136
philippe.landroit@sgcib.com

In 2015, the continued weak operating environment was largely overshadowed by significant M&A in Europe. Notable events included the completion of the LafargeHolcim merger, the agreed acquisition of Italcementi by HeidelbergCement, the acquisition of Lafarge/Holcim assets and C.R. Laurence Co. by CRH, and the completion of the Verallia sale by Saint-Gobain. We expect modest deleveraging in 2016 and believe the two main themes will be emerging markets, where deteriorating economies are creating pricing pressure, and, again, M&A (with divestments from LafargeHolcim and HeidelbergCement/Italcementi). We expect HeidelbergCement to be an active issuer due to refinancing of the Italcementi deal, while LafargeHolcim should come to the market for refinancing and liability management. We are buyers of protection on LHNVX, sellers of HOLNVX/LHNVX bonds and buyers of LGFP legacy bonds

Fundamental themes: Beware of emerging markets

US still improving, Europe gradually recovering, some emerging markets weakening: We expect the US construction market to remain solid in 2016, led by the residential and non-residential segments (cement volumes and prices +4%) and the West European market to gradually recover (+2-3%) with the UK again solid (volumes +5%), Spain recovering further (volumes +8%), Germany flat, and a slight pickup in France due to an increase in housing starts (+3%) after a weak 2015 (-7%). Lastly, some emerging markets will be weakening further in 2016 (lower volumes in Brazil, China and Russia; lower prices in Nigeria and Egypt) while others should recover or stabilise after a difficult 2015 (India and Indonesia).

Modest credit metrics improvements in 2016: We anticipate high single-digit EBITDA growth in 2016, driven by higher volumes/prices and synergies more than offsetting cost inflation and negative FX effects, with some margin expansion. Organic deleveraging will continue to be modest, but we expect asset sales to make a meaningful contribution to debt reduction in 2016.

M&A still a major theme: The focus will be on the integration process at LafargeHolcim given the rocky start to the merger (change in CEO and CFO), as well as asset sales. LafargeHolcim targets asset divestments of CHF3.5bn in 2016 (including India), and HeidelbergCement is committed to raising EUR1bn from the sale of assets (non-core or overlapping geographies) to help fund the Italcementi deal (closing expected in H2 2016). Saint-Gobain remains confident that it will complete the acquisition of a controlling stake Sika in 2016.

Supply: M&A the driver

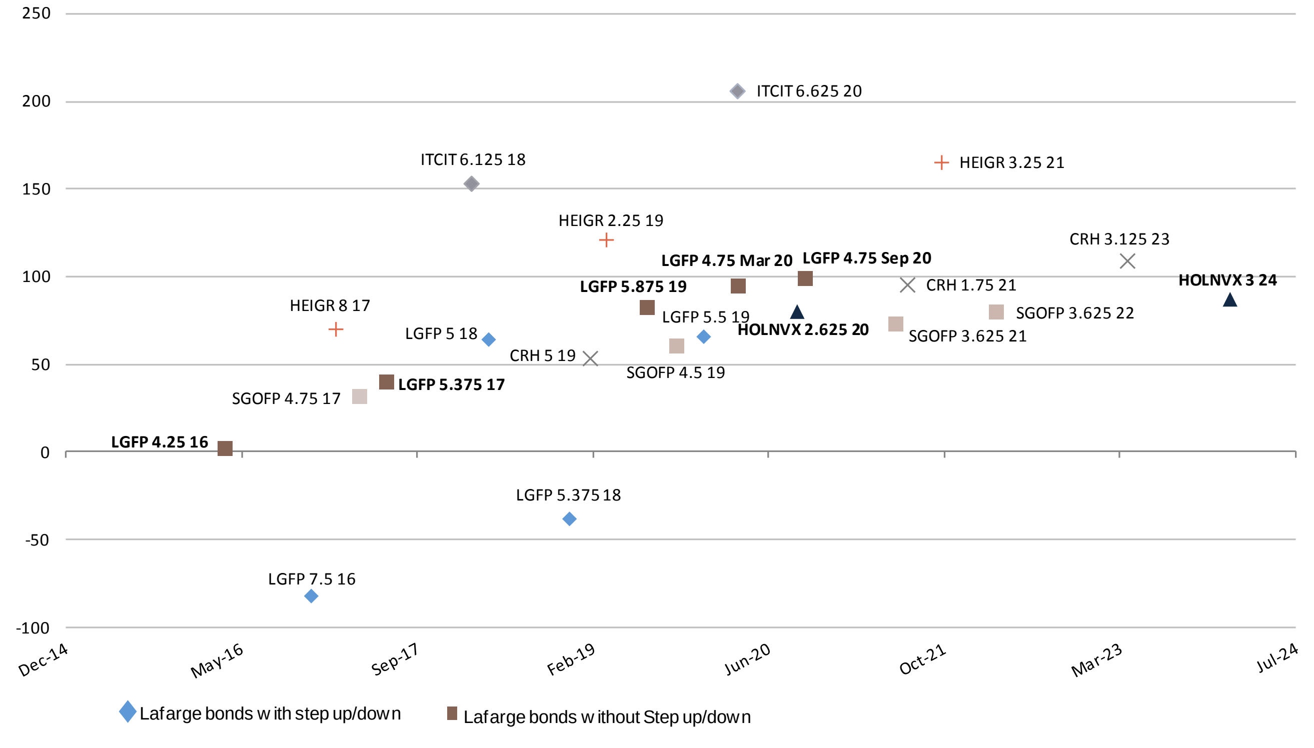
HeidelbergCement and LafargeHolcim likely to be active bond issuers: We forecast EUR5bn in bond issuance from the names we cover (vs EUR1.5bn in 2015). The main drivers will be M&A and liability management exercises, in our view. HeidelbergCement has guided for EUR2.5bn of bond issuance to refinance the acquisition of Italcementi. In addition, we expect LafargeHolcim to issue new bonds and use some of the asset sale proceeds to continue buying back some of the Lafarge SA bonds still outstanding.

Positioning: Avoid rich cyclicals

Buy LGFP 5% 2018, 5.875% 2019 and 2020: We have a Buy recommendation on some LGFP legacy bonds (5% 2018, 5.875% 2019, 2020) given the supportive technicals (likely additional bond buybacks, lack of new issuance out of Lafarge SA).

Buy LHNVX CDS, Sell HOLNVX/LHNVX 2020, 2024: In our view, LafargeHolcim is a cyclical BBB credit with limited rating headroom, low earnings visibility, significant EM exposure (c.70% of EBITDA) and integration risk. As such, the LHNVX 5Y CDS should trade at least 20bp wider than current levels. We have a Sell recommendation on HOLNVX/LHNVX bonds due to supply risk and tight valuations vs CDS.

Relative value, building materials



Source: SG Cross Asset Research

Metals & Mining

Philippe Landroit, CFA
(44) 207 676 7136
philippe.landroit@sgcib.com

Conditions in the steel and commodity markets took a turn for the worse in 2015. In 2016, SG's outlook for base metals is moderately bullish compared with current prices amid the extended price drops and announced production cuts, but there remain considerable downside risks from the slowdown in China and sharply lower production costs. In steel, we expect prices to remain depressed into Q1 and start recovering from Q2. For most commodities, average prices in 2016 will be lower than in 2015, and credit metrics will deteriorate (or stay weak in steel) despite declining operating costs, capex/dividend cuts and planned asset sales. Under SG commodity price forecasts, we expect most names under our coverage to lose at least one rating notch in 2016. We anticipate a lot less bond issuance across the metals & mining sector in 2016. Current valuations price in multi-notch downgrades, which is disconnected from fundamentals, in our view. Glencore is our top pick (Sell CDS, Buy cash).

Fundamental themes: Weak commodity prices lead to downgrades

Outlook for base metals/bulk commodity prices: SG's outlook for base metals in 2016 is moderately bullish compared with current prices amid the extended price drops and announced production cuts. Our commodity strategists see copper prices averaging $5,125/t in 2016, vs $5,540/t in 2015 and the spot of c.$4,600/t. However, there remain considerable downside risks from the slowdown in China and sharply lower production costs. In SG view, Zinc and nickel prices should fare better than copper prices. We see iron ore prices averaging $45/t in 2016, vs $40/t spot and $57/t YTD, with the yoy decline reflecting lower Chinese iron ore demand and rising supply. See SG Commodities Review for a comprehensive discussion on commodity prices.

Outlook for steel prices: We expect steel prices to remain depressed into Q1 2016 and to start recovering from Q2 on seasonally stronger demand, Chinese mill closures (many Chinese steelmakers are currently generating negative EBITDA) and likely anti-dumping duties in the US (almost certain) and possibly in Europe, which will primarily target Chinese exporters. See SG Commodities Review for a comprehensive discussion on steel prices.

Rating downgrades likely across the board in 2016; liquidity positions generally strong: For most commodities, average prices will be lower than in 2015, and credit metrics will deteriorate (or stay weak in steel) despite declining operating costs, capex/dividend cuts and planned asset sales. Under SG commodity price forecasts, we expect most names under our coverage to lose at least one rating notch in 2016: BHP Billiton to mid-A, Glencore to low BBB, Anglo American to high BB and ArcelorMittal to low BB. We believe ThyssenKrupp's credit metrics will be well positioned within its current ratings (Ba1/BB). Even if leverage deteriorates, we expect liquidity positions to remain generally strong. ArcelorMittal's covenant headroom under its undrawn credit facilities will tighten in 2016, but we see no risk of a covenant breach (leverage to peak at 3.8x, vs 4.25x covenant).

Focus to be on asset sales; large-scale M&A cannot be ruled out: With the sector in deleveraging mode, asset disposals will be a key focus in 2016. Glencore and Anglo American will be the most active sellers of assets, albeit Anglo's asset sale plan bears the highest execution risk. For more detail on asset disposal strategies, please refer to our recent notes on Glencore and Anglo American. Given depressed equity valuations and the appetite for acquisitions of some miners (e.g. Rio Tinto), we cannot rule out large-scale M&A, as it may be cheaper to buy assets than to build from scratch.

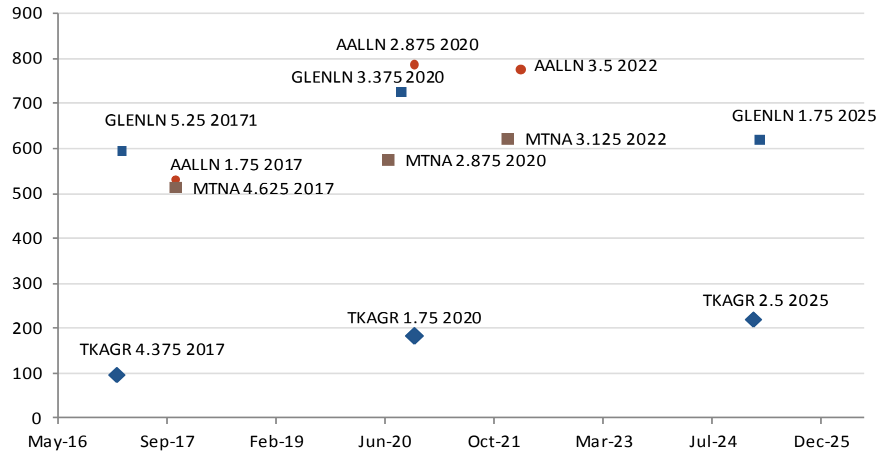
Supply: Less of it

Bond issuance likely to decline significantly yoy: Metals & mining companies were active bond issuers in 2015, placing EUR9bn of paper, of which EUR4bn came from BHP Billiton (including EUR2bn in hybrids). Given wide credit spreads and strong liquidity positions, we expect EUR-denominated bond issuance to drop significantly in 2016 to EUR4bn.

Positioning: Buy value

Sell Glencore 5Y CDS and buy cash bonds: Current valuations price in a multi-notch downgrade to non-IG, which we do not expect given the group's ability to reduce debt levels further should commodity prices continue to fall, a strong liquidity position, a credible asset-divestment programme and a stable cash flow contribution from the marketing business.

Relative value, metals & mining



Source: SG Cross Asset Research/Equity

Engineering/Capital Equipment

Bob Buhr
(44) 20 7676 6454
bob.buhr@sgcib.com

We expect credit stability in this sector despite an improving but still desultory economic outlook, especially given the negative impact lower oil prices are having on a significant industry customer base, especially in North America. In general, we believe that market conditions will remain challenging. Both North America and China could remain weak markets in 2016, leaving Europe as the only bright spot. However, we expect the currency advantage to remain in place for exporters. In addition, the ongoing restructuring in the industry has continued to boost margins, which should help preserve credit stability.

Fundamental themes: Weak demand

Demand growth for industrial equipment is expected to be weak in the US and Asia, but somewhat more positive in Europe. In general, short-cycle sectors, such as general manufacturing and transportation, will probably perform better than long-cycle sectors, such as power and energy, particularly oil patch-related sectors. In fact, we see increasing concerns about excess capacity in the power sector, which is likely to have negative margin implications for companies with exposure in this area. It is not all negative, of course — auto-related businesses continue to do well, given expectations of persistently strong auto demand in North America and improving outlooks in Europe and Asia. The residential construction industry also appears to be steadily recovering in North America, although infrastructure activity remains weak.

Acceleration in M&A? After a relatively (and surprisingly) quiet 2015, we expect some further consolidation moves in the sector, especially in weaker areas, such as oilfield services. Our expectation that Siemens could become more aggressive in M&A in 2015 proved unfounded. Nonetheless, we still believe Siemens is the most likely acquirer in the sector following its summer 2015 closing of the Dresser-Rand acquisition, largely because of its sheer financial firepower and the recent completion of its €4bn share buyback program. We also note its current portfolio optimization efforts, which cojuld expand its interests in the Digital Factory and Energy areas, although we note that the new transportation-only Alstom could also become a consolidator in the rail sector. Credit profiles should remain stable, with reasonably strong liquidity positions) and ample access to financing.

Positioning: Underweight

Hold on most things: We have no outright Buys in the sector, since everything seems fully valued. We retain Hold recommendations on ABB, KION Group, Schneider and Siemens.

Buy Alstom 5Y CDS: In January, we moved to a Stable credit opinion on Alstom (Baa POS/BBB- Negative) in expectation of some improvement in its credit profile following the close of the sale of its power business to GE in 2015 (which closed on 2 November). However, Alstom's bond and CDS spreads are already trading at high-BBB levels, and we do not expect its ratings to mirror this. In fact, we still have the curious split in rating agency views – Moody's and S&P have essentially the same ratings on the company, but radically different outlooks. We believe there is still a possibility that Alstom's ratings go to HY at S&P, depending on the scope of the company's debt reduction. The company has already announced a share buyback of up to €3.2bn, a level we believe S&P may find to be in line with the current credit profile. It remains unclear at present how Alstom intends to reduce its debt load. We remain Buyers of Alstom CDS.

Chemicals & Pharmaceuticals

Bob Buhr
(44) 20 7676 6454
bob.buhr@sgcib.com

Despite weak growth and competition from overseas, we expect the chemical sector to maintain its credit quality in 2015, although increasing M&A activity has stressed some credit profiles (Solvay) and raised strategic questions about others (Bayer). Pharmaceuticals companies are less likely to do so, given their weak pipelines, pressure from generics and regulations, and willingness to buy growth. Our top pick is Solvay; we would avoid GSK and Bayer (although we have a Buy on the Bayer hybrids).

Fundamental themes: Weak demand encourages mergers

Chemical industry faces weak growth in Europe: The European chemical industry will remain under pressure in 2016 from flat volumes and uncertain pricing in its main market – Europe – and will only be able to partially offset this with modestly improved sales in North America and Asia. Since Q1 2015, when the industry began to derive a substantial cost advantage from the declining euro, this advantage has been offset by persistent weak European demand. In fact, deflation risks have actually been increasing in a number of product categories where oil-derived naphtha is the principal feedstock.

Still, credit quality remains solid on average, and we believe that most European companies will weather this weakness, in part from improvements to company business profiles over the past several years. In fact, we believe that, despite challenging conditions, EBITDA will continue to rise in the sector, providing some stability from companies where leverage may rise as a result of steady M&A activity. Moreover, the longer-term positive trends in a number of chemical sectors – agricultural chemicals and fertilisers, nutrition, composite materials and industrial gasses – remain intact, although some (nutrition and industrial gasses) have seen weakness in current demand conditions.

European chemical companies at risk from competitors elsewhere: However, European chemical producers remain at risk from a feedstock and energy cost disadvantage to their US and Middle East competitors over the medium term, and these risks are materialising rapidly. In fact, while the gap between lower-cost, gas-based ethylene products, particularly upstream products, in the US and elsewhere has been diminishing somewhat from substantially lower oil prices in 2015, this gap remains. Moreover, significant new Middle Eastern and US shale-gas-based capacity is set to come on stream, increasing expected pricing pressures in a number of product categories. Over the past five years, while volumes and prices have declined modestly, operating margins have remained relatively flat. Much of the growth that the industry has experienced is associated with generally strong Chinese demand, but even this appears to be weakening at present, and Chinese companies are taking an increasing share of their domestic markets.

M&A still a theme: We continue to see interest in portfolio realignment amongst the chemical companies, with M&A continuing at a steady pace during 2015, in some instances to the extent of potentially impairing ratings. Both Solvay and DSM are currently under review for possible downgrades, in part from added leverage associated with M&A in the past several years, and Air Liquide has only recently been placed under review because of M&A as well. We note that a large amount of this activity has been concentrated in industrial gasses, primarily in the large and growing US market. We suspect this will taper off in 2016, largely from the lack of available M&A targets.

Pharmaceuticals sector in a more difficult position: We retain our underweight and negative outlook on the pharmaceuticals/healthcare industry. Business profiles will remain challenged by pipeline issues, although we saw some improvement here in 2015, increased generic cometition, and reduced government subsidies. Balance sheets are also at risk from the continued enthusiasm for rewarding shareholders. And ratings may be jeopardised by continued M&A activity.

Positioning: Watch for M&A and ratings changes

Buy Solvay: Given our solid views on the chemical sector, we remain sellers of Solvay CDS, and buyers of Solvay's 5.425% and 4.199% perps. We believe that potential downgrades by S&P and Fitch are already factored in current prices. We believe the Cytec acquisition, while increasing debt, has a sound strategic rationale.

Avoid Bayer and GSK: We remain buyers of Bayer and GSK CDS, and sellers of Bayer and GSK Eurobonds. Despite current stable outlooks, we believe GSK remains at risk for further long-term downgrades. And while Bayer's announced disposal of its industrial chemical business was expected, we remain concerned about the scope of the company's M&A ambitions. In general, we see little upside to either bonds or CDS at current levels in the pharmaceuticals sector. In chemicals, we remain neutral on Air Liquide paper, but note that we recently moved to a negative credit opinion on Air Liquide. We do not expect a significant price reaction to Air Liquide's M&A activity, given the name's status as a premier defensive holding.

Autos & Airlines

Pierre Bergeron
(33) 1 42 13 89 15
pierre.bergeron@sgcib.com

The auto industry is likely to remain supported by solid car sales and strong financial fundamentals in 2016, while we expect growing revenues and earnings in European airlines, with higher passenger traffic, lower fuel expenses and cost cutting through restructuring. While Volkswagen Group is likely to remain under pressure from diesel scandal in 2016, BMW profitability should remain under pressure from the tougher competitive environment in its highly profitable Chinese markets.

Fundamental themes: Improving earnings leads to ratings upgrades

Decent auto sales, more than decent margins: The recovery in operating performance in recent years has improved profitability and cash flow generation despite a rise in investment to support new product sales. As result, all major carmakers apart from FCA reported net industrial cash positions at end June 2015. We expect more good news in the sector in 2016.

A recovery in sales in southern Europe, and further growth in North America and China, should more than offset persistent weakness in Russia and LatAm. This should further help margins, which will also be boosted by falling raw material prices in our view.

Auto ratings to improve: On the back of these improvements in fundamentals, we are looking for positive rating actions in 2016, particularly for PSA and Schaeffler, which are moving slowly back towards IG status. By contrast, ratings for Volkswagen Group may remain under pressure due to the uncertain cost of diesel engine test frauds.

M&A a minor theme: After Gruppo Antolin's acquisition of Magna Interiors and the purchase of TRW by ZF, we think Continental AG could make some small acquisitions next year after the purchases of Veyance in 2014 and Elektrobit in 2015. FCA might also purchase an initial stake in General Motors to create synergies in R&D and the production process.

Rising air traffic in some regions: IATA expects global airline passenger traffic to increase again next year. The fastest growth is expected to come in Asia and Middle East destinations, reflecting economic and demographic growth in those markets, with Europe and North America growing more slowly.

And restructuring to cut airlines' costs: Almost all major European airlines have published restructuring plans (AF-KLM: Perform 2020, Lufthansa: SCORE, etc) to reduce operating costs. We also expect low-cost airlines' profitability to improve in 2016, supported by growing passenger traffic, persistently low fuel prices and cost cutting. This improving profitability should boost airline issuers' credit metrics.

Supply: Less of it

Solid cash flow generation and net industrial cash positions at most issuers (except FCA) are likely to limit volumes of new bond issues from the carmakers' industrial units. By contrast, their captive finance units will remain active in the primary markets to support group vehicles sales. The strongest area of growth is likely to come from new issues by HY issuers, which we expect to sell bonds in order to refinance bank loans.

Positioning: Watch for M&A and rating changes

Volkswagen and BMW: Volkswagen Group is likely to remain under pressure from the diesel scandal next year. Consolidated operating results and free cash flow could well be negative, and the uncertainty surrounding the yet to be disclosed global cost of VW's diesel scandal could exert additional pressure on the group's ratings. BMW's profitability may also be threatened by tougher competition in the highly profitable Chinese markets.

Deleveraging to help PSA and others: We expect an operating and financial recovery at PSA to translate into rating upgrades and tighter spreads in 2016. We recommend buying Peugeot vs Renault. Deleveraging should continue in some of the smaller names in the sector as well. We see lower levels of leverage at Faurecia, not only because of strong cash flow, but also because of the recently announced conversion of the outstanding €250m convertible bond issue into equity. The IPO of Schaeffler Group's operating unit and its industrial unit restructuring should also improve balance sheet metrics. While small debt-funded acquisitions are always a possibility at Valeo, solid operating cash flow normally leads to lower leverage. And the situation is similar at Europcar, which should see continued improvement in leverage after the 2015 IPO.

CNHI and Aston Martin face operating challenges: CNHI's credit metrics are likely to remain under pressure due to both the weak state of the agricultural equipment market in the face of low agricultural prices and a negative currency effect. Aston Martin's recurrent negative free cash flow and ambitious investment program should continue to worsen its credit profile in 2016. We do not expect Daimler to meaningfully increase its 5% stake in Aston Martin.

And too much leverage and Gruppo Antolin and ZF: The credit profiles of both of these companies worsened after their debt-financed acquisitions last year. Deleveraging may start in 2016 through positive cash flow generation, but in the absence of assets disposals or capital increases (which we do not expect), the pace will be slow.

Buy Ryanair vs IAG: Though Ryanair's spreads are tight, the excellent fundamentals and balance sheet discipline justify the valuation. By contrast, IAG may face some challenges this year in integrating Aer Lingus, which it acquired in 2015.

And avoid AF-KLM: While financial debt is higher than peers, the operating performance of the carrier should be challenged by tough competition from low-cost and Middle East airlines. Falling jet fuel prices and growing passenger traffic may partially offset these challenges, but not enough to make the investment story appealing just yet.

Aerospace and Defence

Bob Buhr
(44) 20 7676 6454
bob.buhr@sgcib.com

Rising revenues and management's reluctance to increase dividends should continue to improve credit metrics in the aerospace sector. By contrast, the sector's fundamentals remain challenging, although recent events in the Middle East may change this trend. We continue to recommend selling Bombardier bonds and buying protection on BAE systems.

Fundamental themes: better airlines, better plane sales

Air traffic growth supports aerospace revenues: The growth in passenger traffic noted in the airlines sector above should also continue to support the civil aerospace sector in 2016. Airlines continue to place orders for new, more fuel-efficient aircraft, and we expect this trend to continue, although at a reduced level given the drop in aviation fuel costs over the year. Though we expect some slowdown in civil aircraft deliveries, order backlogs at Airbus and Boeing remain very high. In fact, Airbus's backlog is at a record level.

Spending remains high too: We expected high capex levels to continue through 2015, and they did. We see no change in this trend in 2016, which will consume a considerable portion of cash flows. For credit investors, this does have the advantage of limiting management's temptation to pursue share buybacks, as we have seen with BAE Systems.

Defence sector faces more challenges: In contrast, we see negative credit trends persisting in the defence sector, where we see further pressure on national defence budgets. To counter this, we expect some increased M&A activity, including potential cross-border transactions. Defence budgets in Europe will remain under pressure, as they will in the US, although budgets in the UK and US appear to be flat for the next two years, and this trend is being somewhat offset by increased defence spending elsewhere in the world. Nonetheless, it has to be said that the events of 2015 in the Middle East may result in a return to higher levels of defence spending, particularly in the US.

Positioning: Buy big

Buy Airbus: We retain our Sell on Airbus (A2/A/A-) CDS largely on account of its strong civil exposure and increasingly balanced portfolio. We are neutral on Finmeccanica (Baa3/BBB-/BBB-) CDS, as we believe possible rating upgrades on the back of the sale of the transport business and resulting debt reduction is already priced in the CDS and bonds.

Sell BAE and Bombardier: We retain our negative opinion on BAE, with a Buy rating on the CDS, on the back of concerns that the company's ratings will come under increased pressure (in fact, they already have: both S&P and Fitch moved to negative outlooks in 2015.) We also note that nearly all of BAE's debt is USD-denominated. We remain sellers of Bombardier Eurobonds on the back of concerns about continued cash burn associated with the development of the CSeries aircraft. We note that BOMB's near-term liquidity will benefit from the recent $1bn investment from the Province of Quebec; nonetheless, this will not necessarily preserve the company's credit metrics, and we do not preclude further rating agency downgrades.

Non-Cyclical Sectors


Paul Vickars
(44) 20 7762 4180
paul.vickars@sgcib.com

Utilities

The utilities sector continues to offer both good news and bad to credit investors. On the one hand, cash flow in the sector has become considerably more predictable in the past five years, and though LatAm exposure is a bugbear for some, it affects the sector less than many think, in our view. The bigger challenges are the stubbornly high level of leverage, which creates scope for a further extension of the rating downgrade trend. Supply should be in line with last year's levels, and we recommend buying Enel bonds, though we would avoid both Statkraft issues and RWE bonds.

Fundamental themes: Defensive appeal despite LatAm exposure

Sector offers defensive appeal: The utility sector has become significantly more defensive since the start of the decade, with the proportion of EBITDA derived from generation and commodity-exposed assets falling from roughly 75% to about 45% today. Meanwhile, the proportion of EBITDA derived from regulated assets has increased to c.45%, while a further c.10% is now derived from quasi-regulated renewable assets. Regulated assets may have experienced steady growth and renewables may have grown exponentially from a low starting point, but the main driver of this trend has been the decline of traditional generation after years of falling power prices. The overall EBITDA base of the sector has in fact fallen from c.€125bn to c.€110bn, but we expect this to stabilise as power prices in markets such as Germany and the Nordics approach floor levels.

LatAm exposure lower than feared: LatAm accounts for a relatively low 7-9% of sector EBITDA, but varies significantly by company with Gas Natural deriving 34% of EBITDA from the region in 2014, while the equivalent figures for Enel, EDP and Engie are 20%, 17% and 13%, respectively. Once seen as an attractive means of achieving growth and diversifying away from the declining European market, LatAm exposure has now become a source of concern due to lower commodity prices, depreciating currencies and country-specific economic risks. These concerns are valid, yet we note that c.50% of the sector's LatAm EBITDA is from regulated assets, while generation assets are often supported by long-term contracts and/or have 'dollarised' tariffs. Our equity analysts therefore estimate that 10% depreciation in LatAm currencies would only impact sector EPS by a relatively modest 2.6%, although this would rise to 8% if the 'dollarisation' of tariffs was abandoned.

Power prices may be reaching a floor: Power prices in the key German market have more than halved, from over €60/MWh in 2011 to below €30/MWh, due to a combination of weak demand, rising supply from renewables and lower commodity prices. German 1Y forward power prices have fallen 20% to €28.5/MWh over the past year, but may now be reaching a floor, which we estimate at €24/MWh based on the cash breakeven of new lignite plants. The Nordic power market has been the worst performer over the past year, with 1Y forward prices down 40% to €18.5/MWh due to favourable hydro conditions (as hydro generation accounts for around 50% of the Nordic market). While electricity generators typically hedge a large proportion of their output up to three years forward, the prices at which they can renew these hedges are declining in line with 1Y forward prices, meaning they offer less earnings protection.

The three most relevant commodities for power prices are coal, CO2 and gas. Coal prices have been under pressure since 2011, first because US shale gas displaced domestic coal, and more recently because of reduced Chinese demand and over-capacity. CO2 market prices have risen steadily from a low of under €4/t in 2013 to the current level of over €8/t, as the approval of the Market Stability Reserve has addressed some of the structural defects of the market. However, CO2 prices remain substantially below the >€20/t seen in 2011 and well below the levels required to rebalance the generation mix away from coal towards gas. Clean dark spreads (the gross margins between the cost of coal plus the cost of carbon allowances and the cost of power) remain positive, while clean spark spreads (the gross margin between the cost of gas plus carbon allowances and the cost of power) are still negative. Gas prices continue to decline and exert negative pressure on power prices due to a combination of weak European GDP, lower demand from electricity generators due to negative clean spark spreads, lower global LNG prices and the fact that a significant proportion of the market is still linked to oil prices.

Leverage still stubbornly high: As EBITDA has contracted due to a lower contribution from generation, the utilities sector has typically responded by cutting net debt through a combination of asset disposals, cost cutting and cash preservation. This has seen reported net debt/EBITDA leverage for the sector as a whole decrease from 2.8x in 2012 to 2.7x in 2013 and 2.6x in 2014. As the potential for net debt reduction diminishes, however, we expect leverage to stabilise for 2015 and into 2016. While the sector has been able to reduce reported net debt, adjusted net debt levels remain stubbornly high, as pension, nuclear and mining provisions have risen due to falling real interest rates. We estimate that adjusted net leverage for the sector has actually increased, from 3.7x in 2012 to 3.8x in 2013 and 3.9x in 2014, and see little scope for this to decrease without a material increase in real interest rates, regardless of what other actions the utilities take to reduce reported net debt.

Renewed pressure on credit ratings: The financial and sovereign crises saw the sector's average credit rating decline by around two notches to BBB+ over 2007-13. As these crises passed, credit quality stabilised to the point that there were only three upgrades and three downgrades in the whole of 2014 (from S&P, Moody's or Fitch). However, 2015 has seen a further deterioration in average credit quality, with 13 downgrades and only four upgrades YTD. All four of the upgrades were from peripheral utilities (two for Red Electrica, one each for EDP and ESB) although only two of them were directly linked to sovereign upgrades (Red Electrica and ESB). Of the 13 downgrades, seven were driven by corporate restructuring (three for EON, four for Fortum) in response to changing energy market conditions, and the remaining six downgrades were driven largely by exposure to low power prices (two for RWE and EDF, one for CEZ and Vattenfall). As both of these trends remain in place, and with sovereign-linked upgrades looking less likely, we expect credit quality to remain under modest pressure in 2016.

Supply: More of the same

Sustained bond issuance: We expect bond and hybrid issuance for 2015 to be close to the €30bn level seen for 2014, based on €28n of issuance YTD and around €1bn of maturities due in December. Cumulative new issuance for 2015 was trending well below 2014 levels through to Q3, until EDF's $4.75bn multi-tranche issue in October brought it back in line. Of note in 2015 has been a significant reduction in hybrid issuance, which has fallen to c.€5bn equivalent, from c.€11bn in 2014 and c.€20bn in 2013. This not only reflects the inevitable slowdown since the hybrid market took off in 2013 and the fact that some issuers are close to their hybrid limits, but also the fact that hybrids have become more expensive relative to senior bonds in 2015, with the yield premium widening from c.2% at the start of the year to c.2.5%.

For 2016, we expect bond and hybrid issuance to be sustained at c.€28bn based on debt maturities and hybrid calls of €28bn for the year and broadly neutral free cash flow available for debt reduction. We expect around half of the issuance to come from the top three issuers EDF (€6bn), Enel (€5bn) and Engie (€4bn), with opportunistic issuance from other, less frequent issuers. The aggregate liquidity position of the sector remains robust, with cash balances of €125bn being sufficient to cover debt maturities through 2018, while including available credit lines of €100bn pushes this further out to 2021.

Positioning: More of the same

Enel offers attractive valuations: Although a renewed emphasis on growth should slow the pace of deleveraging in the medium term, we think the bonds are trading wide to peers like Iberdrola. We recommend buying the 4.875% 2020 bond and selling the 5Y CDS as a result.

Sell RWE Bonds: Though equity holders have been enthused by the company's restructuring plans, bondholders have been more wary, and rightly so. We have a Sell recommendation on the bonds, as we believe the structural risks to the new setup outweigh the advantages. See "Breaking up may be difficult for the bondholders" for more on the risks with the structure.

Sell Statkraft AS: With the Norwegian government reneging on its dividend reduction, the capital situation at Statkraft looks less solid than previously. The company may have the financial flexibility to pay the dividend by cutting discretionary capex, but the timing is poor, given the fall in power prices. We recommend selling SAS as a result. This is also our equity colleagues' least favourite name in the sector.

TMT


Robert H Jaeger, CFA
(44) 20 7676 7023
robert.jaeger@sgcib.com


Priya Viswanathan, CFA
(91) 80 2803 7458
priya.viswanathan@sgcib.com


Mehul Kumar
(91) 80 28 02 49 23
mehul.kumar@sgcib.com

The European telecom and cable sectors will continue to converge in 2016, but further easing of competitive pressures should keep revenues and EBITDA stable. We view IG telecom operators as well positioned to achieve or maintain their targeted credit profiles, even as moderate M&A continues. We forecast a stable year for HY cable companies, although HY telecoms are likely to see another year of mixed performance.

Fundamental themes: Better credit ratios despite margin challenges

Revenue declines to decelerate: The dire revenue trends of recent years in the telecom sector are slowly improving. In 2016, we expect revenues to be stable yoy, with a decline of no more than 1-2%, although FX translation could pose a risk for some names, such as Telecom Italia and DT. Key supports for the top line include accelerating mobile data revenue growth driven by 4G and further progress with bundled offerings, in turn aided by more progress with fibre deployments. We think these growth drivers will largely offset structural challenges in traditional voice (fixed/mobile) and competitive pressures.

Margins still mixed, however: We expect EBITDA to benefit from improved revenues. All the same, increases in certain costs aimed at driving growth, such as content and opex, could lead to persistent margin pressures into 2016, even if some of the cost increase is offset by continued savings and operating efficiency measures.

Diverse capex trends have little impact on cash flow: Given the focus on network quality to drive differentiation, we expect network investments to remain high for operators such as Telecom Italia (TI), Telefonica (TEF) and Vodafone. Nonetheless, good traction to date on subscriber upgrades leaves us comfortable with operators' ability to obtain returns on network investments. Low interest rates should keep interest expense falling even as high liquidity levels at firms such as KPN and Telefonica could lead to debt repayments. Overall, we expect cash flow profiles to remain strong in 2016.

Improved credit metrics: Further improvement in EBITDA and solid cash flow profiles should allow telecom operators to improve balance sheets and credit metrics in 2016. We also expect telecom operators with high leverage relative to targeted ratings (such as TEF) to sell assets. Vodafone's and TI's ratings could come under pressure, however, given our expectation of little deleveraging in 2016.

M&A to continue at a moderate pace: We expect convergence to continue to drive M&A activity in 2016, although failed deals (such as Vodafone/Liberty Global and Altice/Bouygues), the tougher regulatory environment in general and fewer consolidation pockets could moderate the pace of deal-making versus recent years. We still see some pockets of deal-making in select markets and areas such as content assets. We expect this activity to persist, especially around key players like DT, America Movil, Liberty Global and Altice.

Supply: Still a US flavour

Issuance driven by redemptions and investment plans: We forecast €20bn of EUR issuance from the TMT sector, with €16.5bn from telecom operators. Debt maturities at large European issuers like DT, Vodafone, TI and BT will be sizeable this year. Moreover, we expect a third of the telecom operator issuance to come from non-European issuers like AT&T, Verizon and America Movil for spectrum/investment and refinancing needs. The divergence expected in European and US interest rates anticipated by our rates colleagues could encourage other US TMT names to tap the EUR primary markets as well. However, we expect limited M&A-driven issues (except for BT's EE funding). Given the ability to maintain existing ratings through hybrid issues, we expect European players to continue to use them to fund M&A. In the HY telecom and cable sector, we expect issuance to be driven by M&A and by refinancing using callable debt in order to reduce interest expense.

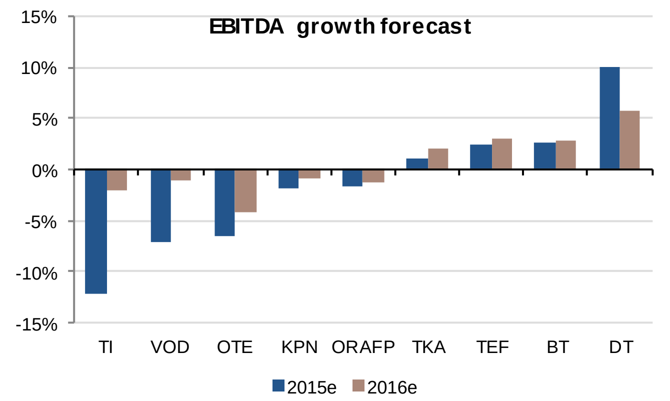
Positioning: Buy Europe over the US

Buy KPN and TEF: We think KPN continues to offer the best value in the sector, especially at the longer end of the curve, where we recommend buying the 2022 and 2024s. With lower leverage after the E-Plus sale last year, optionality related to its TEF-D stake and a stabilising operating performance, we see a good basis for outperformance in 2016. We also have a Buy recommendation on TEF bonds, including the EUR 4.71% 2020, 3.961% 2021 and 3.987% 2023 bonds given the increased spread differential versus large IG telecom peers. We think current spread levels price in too high of a deal risk premium in relation to the closing of the sale of O2 UK to Hutch.

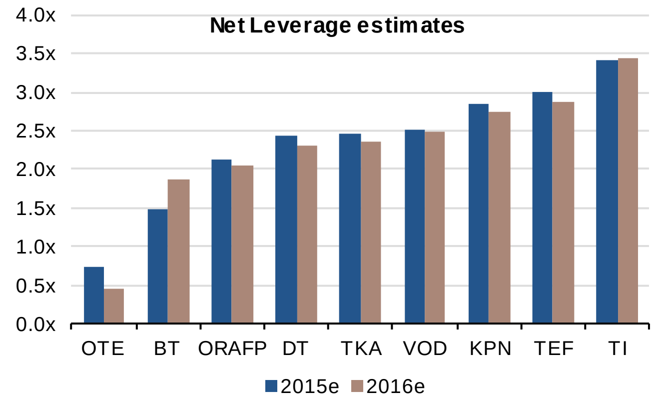
Sell AT&T: We have a Sell on the longer-dated AT&T EUR bond issues (2029s, 32s, 34s, 35s) given execution risk around the acquisition of pay-TV satellite company DirecTV. With the satellite pay-TV business more exposed to the cord-cutting theme in the US, we think execution risk around the deal is not adequately priced in at the longer end of the AT&T EUR curve.

In HY, buy Swiss: In HY cable/telecom, we continue to have a favourable view of Swiss mobile market dynamics, with Buy recommendations on the SUNCOM CHF 2022s, MATTER CHF/EUR secured, and EUR unsecured bonds. Despite some headwinds for both operators in H1, operating performance showed a recovering trend in Q3 that we expect to continue into 2016, leaving room for the bonds of both issuers to outperform. We also have a Buy on the Wind 7% 2021 bond. As is the case with TEF, we think this issue prices in too much deal risk related to the Wind/Hutch merger.

Estimated EBITDA yoy growth, select telecoms



Flat to declining leverage, select telecoms



Source: SG Cross Asset Research, Credit

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APPENDIX

ANALYST CERTIFICATION

The following named research analyst(s) hereby certifies or certify that (i) the views expressed in the research report accurately reflect his or her or their personal views about any and all of the subject securities or issuers and (ii) no part of his or her or their compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed in this report: **Guy Stear, Juan Valencia, Kevin McCarthy, Imtiaz Shefuddin, Paul Fenner-Leitão, CFA, Rotger Franz, Simon Cowie, Philippe Landroit, CFA, Bob Buhr, Pierre Bergeron, Paul Vickars, Robert Jaeger, CFA**

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SG CREDIT RESEARCH RATINGS

SG credit research may contain both a credit opinion of the company and market recommendations on individual bonds issued by the company and/or its Credit Default Swap.

Credit Opinion:
POSITIVE: Indicates expectations of a general improvement of the issuer's credit quality over the next six to twelve months, with credit quality expected to be materially stronger by the end of the designated time horizon.
STABLE: Indicates expectations of a generally stable trend in the issuer's credit quality over the next six to twelve months, with credit quality expected to be essentially unchanged by the end of the designated time horizon.
NEGATIVE: Indicates expectations of a general deterioration of the issuer's credit quality over the next six to twelve months, with the credit quality expected to be materially weaker by the end of the designated time horizon.

Individual Bond recommendations:
BUY: Indicates likely to outperform its iBoxx subsector by 5% or more
HOLD: Indicates likely to be within 5% of the performance of its iBoxx subsector
SELL: Indicates likely to underperform its iBoxx subsector by 5% or more

Individual CDS recommendations:
SG Credit research evaluates its expectation of how the 5 year CDS is going to perform vis-à-vis its sector.
SELL: CDS spreads should outperform its iTraxx sector performance
NEUTRAL: CDS spreads should perform in line with its iTraxx sector performance
BUY: CDS spreads should underperform its iTraxx sector performance

Sector weightings:
OVERWEIGHT: Sector spread should outperform its iBoxx corporate index
NEUTRAL: Sector spread should perform in line with its iBoxx corporate index
UNDERWEIGHT: Sector spread should underperform its iBoxx corporate index

EXPLANATION OF CREDIT RATINGS

U.S. Credit Research does not currently maintain ratings or credit opinions on individual companies. Trade ideas may be short term in nature and may not necessarily represent a fundamental view on the issuer.

All pricing information included in this report is as of market close, unless otherwise stated.

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IMPORTANT DISCLOSURES

Abengoa	SG acted as a joint bookrunner in Abengoa's high yield bond issue (EUR, 15/04/2020).
Accor	SG acted as dealer manager in Accor's tender offer (FR0011274026 and FR0011452291), and as joint bookrunner in the new bond issue (EUR, 8yr).
Accor	SG acted as financial advisor to Accor for the disposal of hotel assets to Orbis.
Air France-KLM	SG acted as passive bookrunner in Air France KLM 's tap bond issue (6.25% Perp NC Oct-2020).
Air Liquide	SG provided advisory services to Air Liquide
Airbus Group	SG acted as Sole Global Coordinator & Joint Bookrunner in Airbus' convertible bond issue (7yr).
Allianz SE	SG acted as a co lead manager in Allianz' bond issue
Alstom	SG holds between 5% and 10% of Alstom.
Alstom	SG is dealer manager in Alstom's public share buy-back offer (OPRA)
Altice NV	SG acted as a joint bookrunner in Neptune Finco Corp's high yield bond issue (issuing vehicle of Altice/Cablevision) to fund Altice's purchase of Cablevision.
Altice NV	SG acted as underwriter of bridge facilities and joint bookrunner in Altice HY bond issue in the context of the acquisition of Portugal Telecom's assets.
ArcelorMittal	SG acted as a joint-bookrunner in Arcelormittal's bond issue (7yr).
Barclays	SG acted as co-manager in Barclays's bond issue (EUR, 1.25bn, 2.625%)

Barclays	SG acted as joint bookrunner for Barclay's bond issue (3y GBP covered bond)
Bayer AG	SG acted as a joint bookrunner in Bayer's hybrid bond issue
BHP Billiton plc	SG acted as passive joint bookrunner in BHP Billiton's bond issue (EUR, 5yr, 7.5yr, 15yr).
BNP Paribas	SG acted as joint bookrunner in BNPP's bond issue (EUR, 10yr).
Boeing	SG acted as co-manager in Boeing's bond issue (USD, 5yr, 7yr,10yr)
Boeing	SG acted as co-manager in Boeing's bond issues (10y, 20y, 30y)
Bombardier	SG acted as joint bookrunner in Bombardier's high yield bond issue (USD, 3.5NCL).
BT Group	SG acted as a mandated lead arranger in BT's acquisition of EE
Carrefour	SG acted as Global Coorodinator and Joint bookrunner in Carrefour's disposal of treasury shares.
Carrefour	SG acted as joint bookrunner in Carrefour Banque's bond issue (EUR, 5yr).
Casino	SG acted as a joint bookrunner in Casino's bond issue (10 year)
CEZ	SG is acting as a Dealer Manager in CEZ's Tender Offer on Bonds (ISIN US157214AA57 / XS0764313614 / XS0521158500).
Credit Suisse	SG acted as joint lead manager and joint bookrunner in Credit Suisse's capital increase
Credit Suisse	SG acted as co-manager in Credit Suisse's bond issue (7y).
Danske Bank	SG acted as Joint-Lead Managers in Danske Bank's bond issue (5yr EUR).
Danske Bank	SG acted as Joint-Lead Managers in Danske Bank's bond issue (7yr EUR).
Deutsche Bank AG	SG acted as co-manager in Deutsche Bank's bond issue (EUR, 2.75%, 17/02/2025).
EDF	SG is acting as financial advisor in the potential acquisition of Areva NP by EDF.
Energias de Portugal	SG acted as joint bookrunner in EDP's bond issue.
Engie	SG acted as a lead structuring advisor in Engie's bond tender offer.
Engie	SG acted as passive joint bookrunner in GDF Suez's bond issue.
Engie	SG acted as joint dealer manager in GDF SUEZ's tender offer (targeting some 10/2017, 02/2021, 07/2022, 10/2022, 02/2023 bonds).
Europcar	SG acted as Joint Global Coordinators in Europcar's IPO.
Europcar	SG acted as joint bookrunner in Europcar's bond issue (7yr Senior Sub).
Faurecia	SG acted as a global coordinator in Faurecia's high yield bond tap.
Faurecia	SG acted as global coordinator in Faurecia's bond issue (7y).
FCA	SG acted as co-manager in Fiat Chrysler Automobiles' bond issue (Senior, USD, 5NCL, 8NCL).
FCA	SG acted as senior manager in Fiat Chrysler Automotive's mandatory convertible bond issue (USD 2yr)..
Finmeccanica	SG acted as joint global coordinator in Finmeccanica's tender offer (XS0423814119, XS0999654873, XS0458887030, XS0861828407, XS0182242247)
Ford Motor Co	SG acted as a joint bookrunner in Ford Motor's bond issue (5y-10y tap).
Ford Motor Co	SG acted as a joint bookrunner in Ford Motor's bond issue.
Ford Motor Co	SG acted as co-manager in Ford Motor Co's bond issue
Gas Natural SDG	SG acted as joint bookrunner in Gas Natural's hybrid bond issue
General Electric	SG acted as joint lead manager in General Electric's bonds issue (EUR,5;8;12 yr).
General Electric	SG acted as co-manager in General Electric Capital's bond issue (EUR, 5/7yr)
General Motors	SG acted as a co-manager in General Motors' bond issue.
Glencore	SG acted as bookrunner in Glencore Xstrata's bond issue (USD).
Groupama	SG acted as joint bookrunner in the Veolia Environnement's block trade sold by Groupama.
Holcim	SG acted as financial advisor to Holcim in the merger with Lafarge.
Holding d'Infrastructure de Transport	SG acted for Holding d'Infrastructures de Transport as joint bookrunner in their tap on ISIN XS1111108673 & joint dealer manager in their tender offer on ISIN XS0602534637.
Iberdrola	SG acted as joint dealer manager in the tender offer of outstanding ACS exchangeable bonds into Iberdrola (EUR 721.1M 2.625% 2018 & EUR 405.6M 1.625% 2019).
IBM	SG acted as passive bookrunner in IBM's bond issue (7yr, GBP).
Lafarge	SG is dealer manager of the squeeze-out initiated by LafargeHolcim on Lafarge's shares, following the public exchange offer.
Lafarge	SG acted as financial advisor to Holcim in the merger with Lafarge.
LEG Immobilien AG	SG acted as joint bookrunner in LEG Immobilien's capital raising.
Marathon Oil	SG acted as co-manager in Marathon Oil Corp's bond issue
Matterhorn Mobile SA	SG acted as passive bookrunner in Matterhorm Telecom's high yield bond issues (CHF 7y, EUR 7y, EUR 7y, EUR 8y).
Metro AG	SG acted as sole bookrunner in Haniel's ABB on Metro.
Metro AG	SG acted as joint bookrunner on Metro's bond issue (10y benchmark).
Peugeot Citroen PSA	SG acted as financial advisor to Peugeot SA for the partnership between Banque PSA Finance and Santader Consumer Finance
Philip Morris International	SG acted as joint bookrunner in Philip Morris's bonds issue (USD, 2yr, 10yr)
Prudential	SG acted as joint bookrunners in Prudential Plc's bond issue (3yr)
Rio Tinto	SG acted as joint bookrunner in Rio Tinto's bond issue (USD 10y benchmark).
Royal Bank of Scotland	SG acted as co-manager in RBS's bond issue (USD)
SABMiller	SG is acting as joint mandated lead arranger & bookrunner with Anheuser-Busch InBev for the financing of the acquistion of SABMiller.
Santander	SG is acting as joint lead manager in Abbey National Treasury's bond issue (5y EUR benchmark).
Santander	SG acted as Joint Lead Manager in Santander Consumer Finance's bond issue (5yr EUR)
Santander	SG acted as financial advisor to Peugeot SA for the partnership between Banque PSA Finance and Santander Consumer Finance
Santander	SG acted as joint bookrunner in Santander's bond issue (7yr).
Schneider	SG acted as joint bookrunner in Schneider Electric's bond issue (EUR, 8yr).
Telecom Italia Spa	SG acted as joint dealer manager in Telecom Italia's tender offers.
Telecom Italia Spa	SG acted as joint dealer manager in Telecom Italia's tender offer and joint bookrunners in the company's issue (8yr).
Telefonica SA	SG acted as joint bookrunners in Telefonica's rights issue.
Telefonica SA	SG acted as joint bookrunner in Telefonica's hybrid bond issue
UBS AG	SG acted as joint lead manager in UBS's Tier 1 bond issue (USD)
UBS AG	SG acted as co-manager in UBS's bond issue (5 yr)
UBS AG	SG acted as a co-manager in UBS bond issue (2y FRN, 3y FXD).
Verallia	SG acted as joint bookrunner in Verallia's high yield bond issue (Senior, EUR, 7yr, 8yr).
Vodafone	SG acted as joint bookrunner in Vodafone's bond issue (EUR, Senior, 5yr)
Volkswagen (Pref.)	SG acted as joint bookrunner in Volkswagen's bond issue
Volkswagen (Pref.)	SG acted as joint bookrunner in Volkswagen's bond issue (triple tranche bond: 3.5y, 8y, 15y).
LafargeHolcim	SG is dealer manager of the squeeze-out initiated by LafargeHolcim on Lafarge's shares, following the public exchange offer.
LafargeHolcim	SG acted Joint Structuring Advisors & Joint Dealer Managers in Lafarge's bond buy-backs (ISINs: XS0235605853, XS0434974217, XS0307005545, XS0501648371, XS0562783034, XS0801954867, XS0473114543, XS0215159731, XS0975113498, XS0430665108, XS0158276708).

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executive officer or director of SG and/ or its affiliates is a director and/or officer of Vodafone.
SG and its affiliates beneficially own 1% or more of any class of common equity of Air France-KLM, Alstom, Assic Generali spa, BNP Paribas, Engie, Telefonica SA, Vodafone.
SG or its affiliates expect to receive or intend to seek compensation for investment banking services in the next 3 months from Abengoa, Accor, Air France-KLM, Air Liquide, Airbus Group, Allianz SE, Alstom, Altice NV, ArcelorMittal, Aviva, Axa, BBVA, BNP Paribas, BT Group, Barclays, Bombardier, Bouygues, CEZ, CNP Assurances, CRH PLC, Carrefour, Daimler, Deutsche Telekom, EDF, Enel, Energias de Portugal, Engie, FCA, Faurecia, General Electric, Glencore, Groupama, Imperial Tobacco, LEG Immobilien AG, Lafarge, LafargeHolcim, Legal & General, Metro AG, Pernod Ricard, Peugeot Citroen PSA, Philip Morris International, Premier Oil, RWE, Rallye SA, Renault, Royal Bank of Scotland, Saint-Gobain, Santander, Schneider, Telefonica SA, Tesco, UBS AG, Valeo, Volkswagen (Pref.).
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Global Head of Research
Patrick Legland
(33) 1 42 13 97 79
patrick.legland@sgcib.com

CROSS ASSET RESEARCH – CREDIT GROUP

Head of Credit Research
Guy Stear
(33) 1 42 13 63 99
guy.stear@sgcib.com

Financials

Paul Fenner-Leitão, CFA (Head)
(44) 20 7676 7132
paul.fenner-leitao@sgcib.com

Jean Luc Lepreux (Banks)
(33) 1 42 14 88 17
jean-luc.lepreux@sgcib.com

Natacha Blackman (Banks)
(44) 20 7676 6169
natacha.blackman@sgcib.com

Brajesh Kumar, CFA (Banks)
(91) 80 2809 5034
brajesh.kumar@sgcib.com

Harjesh Bawa
(91) 80 3087 8112
harjesh.bawa@sgcib.com

Rötger Franz (Insurance)
(44) 20 7676 7167
rotger.franz@sgcib.com

Auto & Transportation

Pierre Bergeron
(33) 1 42 13 89 15
pierre.bergeron@sgcib.com

Retail, Consumer & Leisure

Simon Cowie
(44) 20 7676 7152
simon.cowie@sgcib.com

Simon Desrumaux
(44) 20 77 62 59 17
simon.desrumaux@sgcib.com

Industrials

Bob Buhr
(44) 20 7676 6454
bob.buhr@sgcib.com

Philippe Landroit, CFA
(44) 20 7676 7136
philippe.landroit@sgcib.com

Telecom & Media

Robert H Jaeger, CFA
(44) 20 7676 7023
robert.jaeger@sgcib.com

Priya Viswanathan, CFA
(91) 80 2803 7458
priya.viswanathan@sgcib.com

Utilities & Energy

Paul Vickars
(44) 20 7762 4180
paul.vickars@sgcib.com

Global Head of Credit Strategy
Guy Stear
(33) 1 42 13 63 99
guy.stear@sgcib.com

European Head of Credit Strategy
Juan Esteban Valencia
(33) 1 56 37 36 83
juan.valencia@sgcib.com