Global Credit Strategy

Does this credit rally still have legs?

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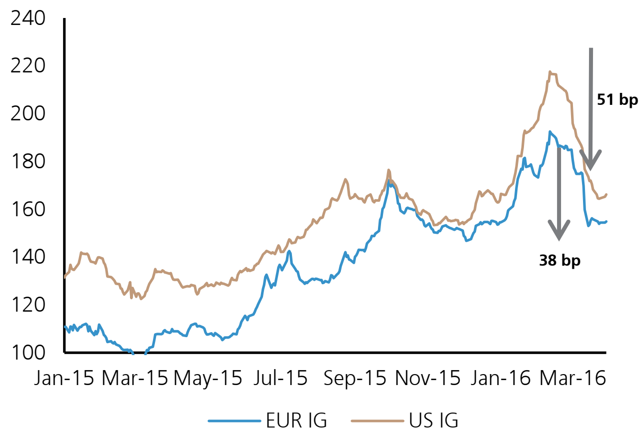
US: Neutral on Credit, but overweight high-quality, duration

Since January, credit investors have been rather unwillingly riding a stomach-churning rollercoaster of ups and downs. To the relief of many, the credit markets have caught a bid in recent weeks and stabilized. US IG spreads have tightened 51 bps and HY spreads have tightened 188bps since Feb 11th. However, our client meetings demonstrate a lack of conviction in the rally and where to best position for future gains. What is our view? We posit that US credit markets are modestly expensive at current levels for the next 3-6 months. However, we do not believe valuations are extreme, and hence we still argue for a neutral position in credit. However, structurally nothing has changed. Leverage is rising, lending standards are tightening, new high-yield issuance is anemic, and oil prices are the big wild-card. We thus strongly recommend an up-in-quality bias given these risk factors.

EU: Favour EU IG in run-up to ECB corp purchases; prefer EU HY to US HY

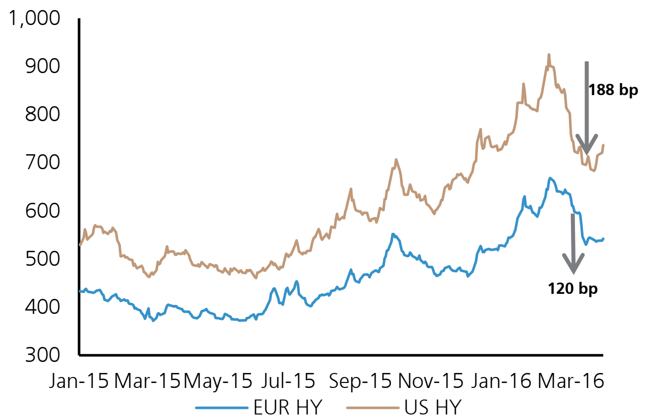
The EU Credit rally since Feb-16 has been underpinned by positive macro and economic data from the region, accommodating QE measures by the ECB, and technicals of a very strong primary pipeline which underscores the supply – demand imbalances in the market. We expect these factors to remain in play in the near term, especially as the ECB gets ready to add corporate paper to its asset purchasing program in 'late 2Q16'. Fund flows have been supporting this bias with EU IG and HY spreads tightening ~38bps and ~120bps respectively, and we believe spreads can grind somewhat further, but perhaps not to the levels of 12 months ago. This leads us to continue to favour EU Credit IG outright in the run up to ECB corporate purchases and favour EU HY relative to US HY over the near term. Adding IG non-bank corporate paper to the ECB's corporate purchase program has been a game changer to this asset class as we now have a marginal buyer with deep pockets for credit. In turn, this has led to interest in EU HY credit as investors search for yield. A few key risks to this scenario worth highlighting are a steep fall in oil prices, the uncertainty around BREXIT, US HY staging a gap downwards or disappointing economic data from Europe and/or China.

Figure 1: EU and US IG cash spreads



Source: UBS, Markit, Yieldbook

Figure 2: EU and US HY cash spreads

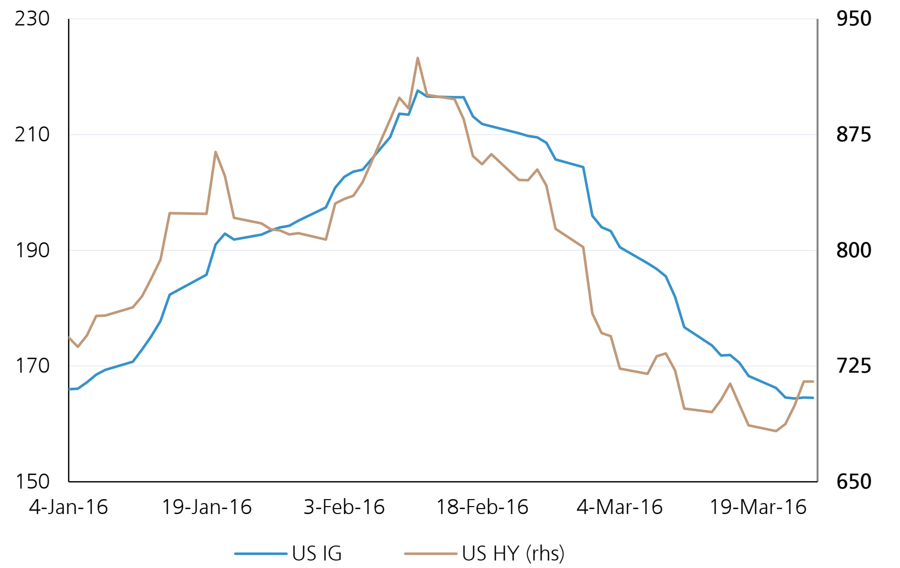


Source: UBS, Markit, Yieldbook

Does the US credit rally still have legs?

Since January, credit investors have been rather unwillingly riding a stomach-churning rollercoaster of ups and downs. To the relief of many, the credit markets have caught a bid in recent weeks and stabilized. US IG spreads have tightened 51 bps (218 to 166) and HY spreads have tightened 188bps (925 to 736) since Feb 11th. This has finally allowed investors to exhale for the first time this year. However, as clients survey the landscape (and the damage), uncertainty still reigns supreme. Client meetings demonstrate a clear lack of conviction in the rally and how to best position. What is our view? As we will detail below, we posit that US credit markets are modestly expensive at current levels for the next 3-6 months. However, we do not believe valuations are extreme; there is still room for further spread tightening of 65-70bps in HY and 10bps in IG in an upside scenario. Hence, we still argue for a neutral position in credit tactically. However, structurally nothing has changed. Leverage is rising, lending standards are tightening, new high-yield issuance is anemic, and oil prices are the big wild-card. We thus strongly recommend an up-in-quality bias given these risk factors.

Figure 3: US IG vs. HY Spreads



Source: UBS, Yieldbook

Duration and Commodities Boost Credit Returns

Total returns for US credit markets are firm year-to-date with US investment grade returns of 3.3% and US high-yield returns of 2.9%. What are the drivers of these positive returns? **First, duration exposure has been richly rewarded.** 10+ year maturity US high-grade corporates have returned +6.1% YTD vs. only +2.4% for 3-7 year corporates (Figure 4). This has been due to extra rate duration, as changes in credit spreads have been effectively nil across tenors. This has worked well for one of our key calls in 2016 to overweight long-duration, A-rated credit.

Second, a bounce-back in commodity prices and risk appetite has allowed commodity and other beaten down sectors to rebound. The best performing sectors in high-grade YTD are Miners (+10%), Gas Pipelines (+7%) and Cable/Media (+5%), while 2015 stalwarts in the banking (+1%) and REIT (+2%) sectors have lagged the index. For US high-yield, it is a similar story: Miners,

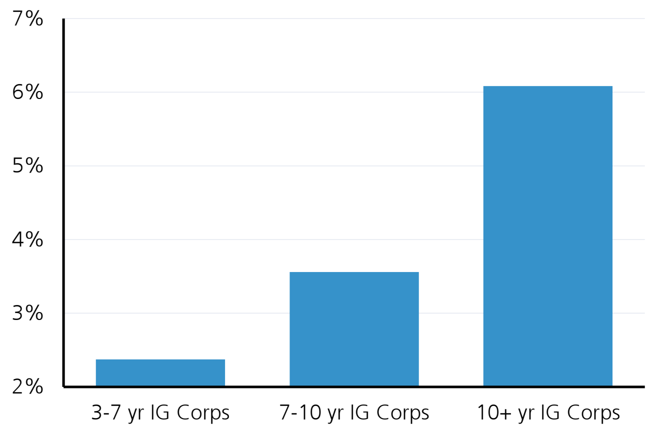
(+11%), Retail Stores (+7%), Gas Pipelines (+6%) have surged while home-builders (+1%) and banks have underperformed (+2%), in a direct contrast to 2015 performance.

What is the staying power of these drivers? First, we like our long duration call on high-quality credit. Any hawkish sentiment from the Fed is likely to keep long-end Treasury yields subdued. Second, even a controlled and modest steepening of the Treasury yield curve from higher inflation and better growth would draw in US pensions and insurance companies looking to hit yield bogeys, tightening credit spreads going forward. And our bias for A-rated names severely mitigates the future risk of fallen angels in an economic downturn[1].

On commodity sectors, we are wary of further outperformance, especially in high-yield names. The recent bounce in commodity prices has been large, with short-covering playing a large role in both oil and industrial metals. WTI oil is currently $38, not far below our commodity's team forecast of $41 by June 2016. And the potential for bank revolver reviews in April to sharply curtail liquidity for HY energy firms is large. Fed dovishness weakening the dollar and stabilizing data out of China do provide some support to commodity prices, but not enough to move the needle for underwater high-yield firms. We would recommend that investors look for opportunities to take gains in energy and mining names. We still project default rates of 15-20% for each sector in 2016 (vs. Moody's forecasts of 9% for energy and 14% for miners).

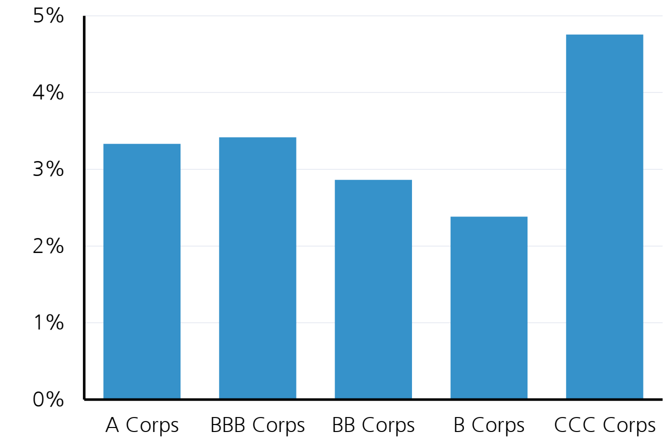
Lastly, a word on banks. We do acknowledge that our over-weight on high-grade US banks has failed to bear fruit, as recession risks spiked early in 2016 along with an unwind of a crowded long trade. While recession risks have subsided and provided support to the market, they have not disappeared[2]. Hence, while we maintain our over-weight on US banks, we recognize that bank spreads may not outperform to the extent necessary to erase the underperformance earlier this year. We will be watching forward recession risks and real-estate related NPLs to gauge whether our overweight is still correct.

Figure 4: YTD US IG Total Returns by tenor



Source: UBS, Yieldbook

Figure 5: YTD Total Returns by Credit Rating



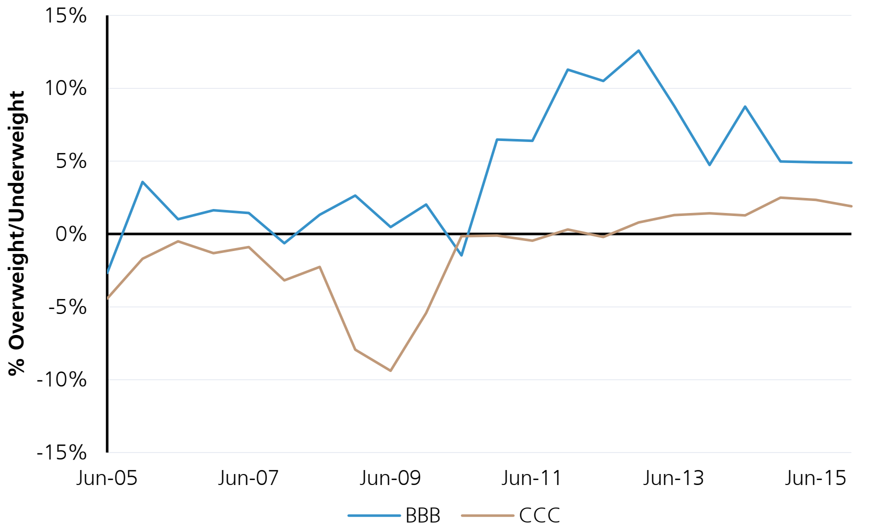
Source: UBS, Yieldbook

[1] 2016 US IG Outlook: How The Dominos Will Fall?, S. Caprio, 14-Jan-16
[2] The Long and Short of Recession Probabilities, S. Caprio, 03-Mar-16

Low beta trades have worked well, apart from CCCs

Has our desire to overweight high-quality securities worked? Generally yes, albeit with caveats (Figure 5). In US IG, A-rated (+3.3%) and BBB-rated (+3.4%) total returns are effectively tied YTD, though after stripping out commodity sectors, A-rated ex-commodity firms are winning outright (3.52% vs. BBB ex-commodity of 3.13%). In HY, BB's (+2.9%) are beating B's (+2.4%) as well. It is CCC returns (+4.8%) that are the largest outlier to our high quality bias. However, as Figure 6 below illustrates, investor positioning in CCCs is still crowded relative to history, in a hangover from a Fed-induced binge for yield. A similar story is depicted for BBB-rated credits. If we are correct that the credit cycle is in the later innings[3], these crowded trades will begin to unwind before too long. **Do not be tempted to chase higher returns in low-quality credits.**

Figure 6: Institutional and Retail Funds remain overweight low-quality credit*



Source: UBS, Yieldbook, eVestment, *through Dec-2015

Credit is modestly expensive, though not extreme tactically

Do we think the current credit rally has legs going forward for the market in general? And how far could it run? **While the prospect for further gains is real, the markets have become modestly expensive**. Current high-yield spreads sit at 736bps and high-grade spreads sit at 166bps. These are both lower than our year-end targets of 825bps for US high-yield, and 180bps for US high-grade.

On a more tactical 6 month view, we tackle this question by using our fundamental fair-value high-yield credit model[4], which suggests that high-yield spreads should be 632 bps in 6 months. However, given our model is likely not the best gauge of significant commodity related default risk, we believe comparing it to ex-commodity spreads is more sensible for valuation purposes. **Via this measure, ex-commodity spreads of 606bps are 26bps expensive.** This is modestly rich, but well within the 1 standard deviation bound of 92bps from which market spreads have deviated from model estimates in the past.

[3] US high yield outlook: What is the fate of $1tn in stressed credit?, M. Mish, 03-Dec-2015
[4] Interactive IG Spread, HY Spread and HY Default Forecasts, S. Caprio, 01-Mar-2016

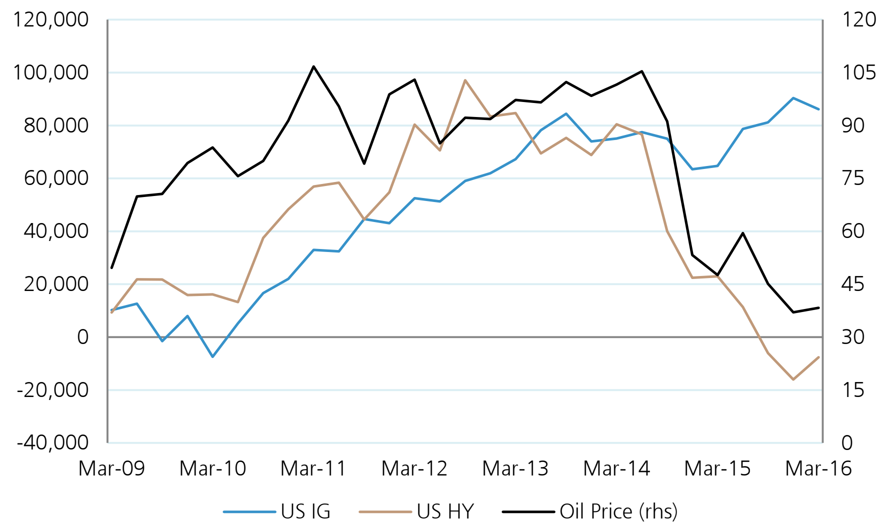
This provides some context for further upside. It would not be surprising to see HY spreads tighten roughly 65-70 bps in a good (though not best case) scenario, though this requires oil prices to rally in our view. If our model is correct, we would expect HY spreads to widen 26bps over the next 6 months (though to be clear, there will be bouts of volatility around this estimate)[5].

For high-grade, this analysis holds as well. While two weeks ago[6], we flagged that high-grade spreads had room to catch up to high-yield, current levels are roughly in line after strong outperformance. This argues that high-grade spreads are now modestly expensive as well. Based on our HY parameters above, we could see roughly 10bps of potential further spread tightening in an upside scenario. Our base case would be 5bps of IG spread widening over the next 6 months.

Structurally, the HY rally is not sound

However, the reasons behind the recent credit rally give us room for pause, particularly in high-yield. Rising oil prices have created a technical bid for the market, which is not sustainable without further increases in oil. On the former, one can see clearly in Figure 7 how high-yield flows have moved in lock-step with oil prices since they began falling in mid-2014, while high-grade demand has remained resilient. US high-yield remains largely a bet on oil prices, while high-grade has more staying power due to new inflows from abroad.

Figure 7: US IG and HY Cumulative Flows ($mn) vs. oil prices (since March 2009)



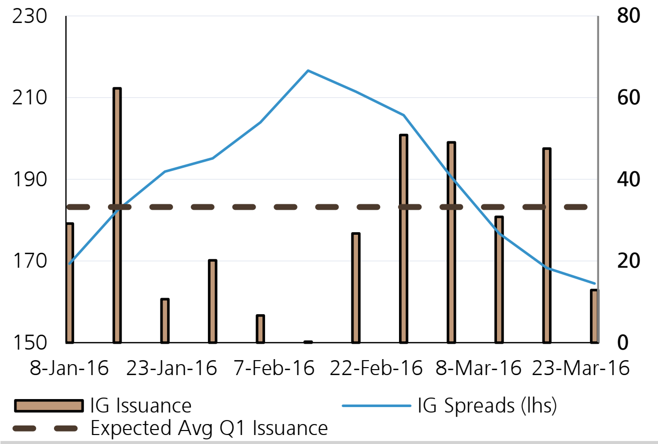
Source: UBS, eVestment, Lipper

In addition, high yield spread tightening has occurred with anemic primary market issuance. Hence, the main theme is rising oil prices + new fund inflows + limited supply = higher prices. However, this is not solving fundamental credit risk and re-financing issues that will creep up on this market over the next several years[7]. Figures 8 & 9 below detail weekly high-grade and high-yield spreads vs. weekly issuance respectively. The dotted line is the average weekly issuance one would expect based on seasonal factors from our interactive issuance model and total AUM outstanding[8]. One can see how high-grade spreads have continued to

[5] Assuming annualized default rates of 3% for ex-commodities and 30% recovery rates
[6] Will Super Mario and the ECB power-up US, S. Caprio, 15-Mar-2016
[7] US high yield: quantifying the downside risk in this cycle, M. Mish, 16-Mar-2016
[8] Interactive IG and HY Gross Issuance Forecast Model, S. Caprio, 30-Mar-2016

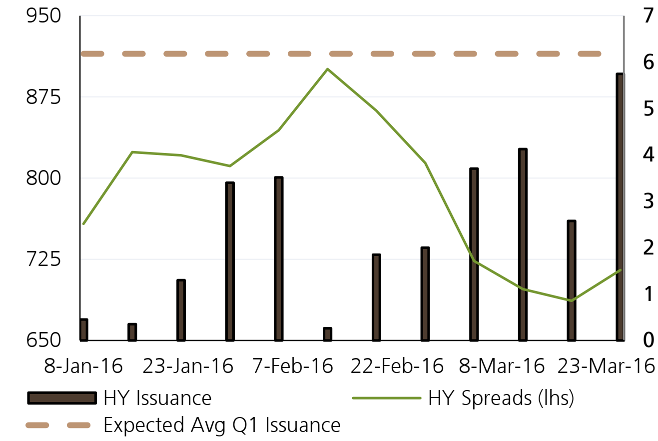
tighten despite above-average weekly supply hitting the markets, which is a positive signal for US IG that robust demand exists for new paper. **In contrast, HY issuance has remained tepid; it has been below average in almost every week of 2016.** The recent $5.6bn Western Digital deal may change that fact for this week, but one week does not make a trend. Current primary market conditions are not healthy for high-yield.

Figure 8: US IG is rallying with above-average issuance



Source: UBS, Bloomberg

Figure 9: US HY rallies, but Issuance isn't following



Source: UBS, S&P LCD

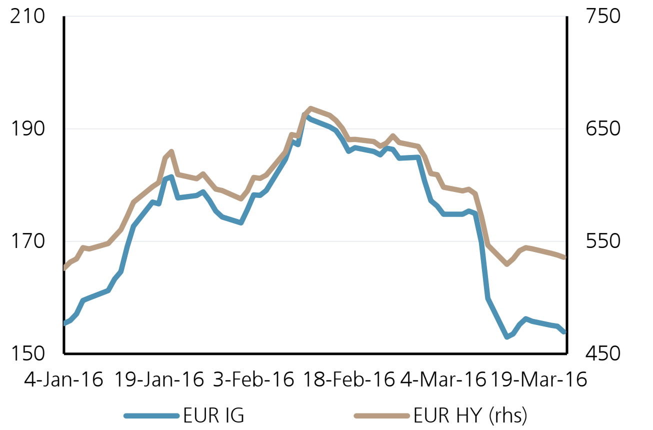
The bid for yield vs. credit risk

There is a clear divide taking shape in credit. **The bid for yield is lifting high-grade, while credit risk is thwarting high-yield. How will we know if the bid for yield or credit risk will win this tug of war?** In the short-run, it is impossible to abstract away our discussion from oil prices. Oil prices will continue to drive near-term inflows and outflows from the asset class. But away from oil, we will be watching several key data points. The bid for yield theme will gain credence if high-yield issuance picks up in coming months, particularly for those lower-quality issuers rated B & CCC. On the flip side, if lending conditions continue to deteriorate from banks (such as the Q1 Fed Senior Loan Officer Survey released in May), and non-banks (such as the monthly CMI Index of Trade Credit, whose March survey should be released March 31st) and corporate earnings continue to fall through 1H '16, we fear that credit risk will begin to encroach on B and possibly even BB-rated firms as the year progresses.

Does the EU credit rally still have legs?

Since February, credit has rallied along with other asset classes in fixed income. EU IG and HY spreads are 38bps and 120bps tighter respectively with Main and XO 53bps and 185bps tighter from Feb 11 (Figure 10). Fundamentally, the near-term backdrop in Europe should remain supportive with positive EUR macro data alongside accommodating monetary policy by the ECB. The supply-demand imbalance is probably more the cause of recent deals printing in the primary market than the fundamental environment. Fund flows into the region have been supporting this bias, and the constructive mosaic appears circular. In the near term run up to ECB corporate purchases, we expect EU spreads to compress from here, albeit small compared to the past six weeks. On the back of this, we continue to favour EU IG outright, and prefer EU HY to US HY based on technicals and macro backdrop in the near term.

Figure 10:European Spreads (bps)



Source: UBS, Yieldbook, Markit

Figure 11: Primary Issuance (in billions)

Gross Issuance	Q3'15	% Chg Y/Y	Q4'15	% Chg Y/Y	YTD '16	%Chg Y/Y
US IG	295	33%	276	4%	345	0%
US HY	40	-42%	36	-41%	30	-66%
EU IG	70	-13%	69	-22%	150	-8%
EU HY	23	38%	5	-53%	7	-75%

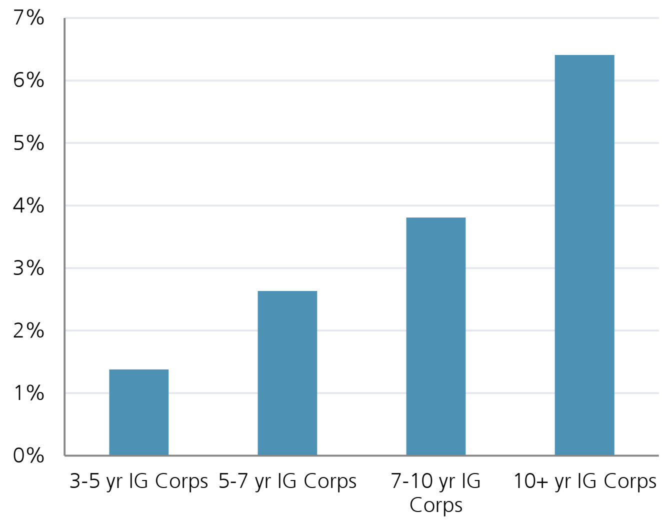
Source: UBS, Bloomberg, S&P LCD; Amounts in Local Currency

ECB boosts returns and primary issuance in March

The week after the ECB announced its additional QE measures, EUR credit markets had its largest ever primary issuance at ~€30bn. As a reminder, the ECB stated it will include non-bank investment grade corporate bonds as part of their asset purchasing programme, which is expected to begin 'towards the end of 2Q16'. We would not be surprised to see March 2016 set a new month's record for primary issuance in Europe IG non financials. Granted, a large chunk was taken by AB InBev at €13bn, and three borrowers comprised almost half of March's total issuance. To date, we have seen over €40bn printed already this month.

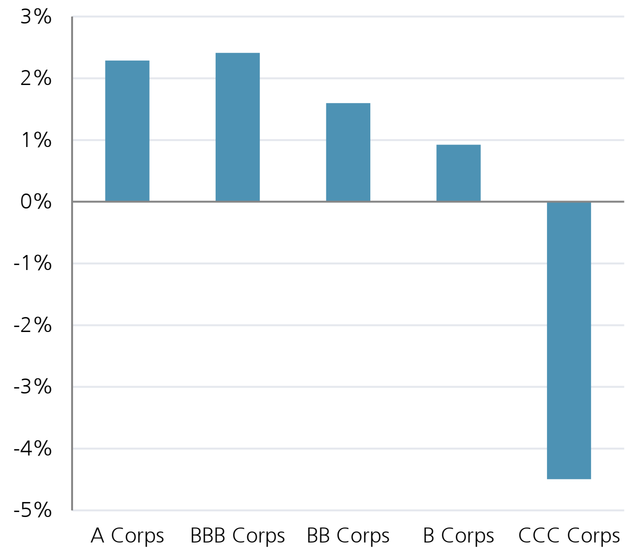
YTD Total returns for EU credit markets are solid at 2.42% and 1.25% for IG and HY respectively fuelled by the ECB announcements. The commodity rally has also helped boost returns, more so in the US over Europe. We see this remaining firm for the next several weeks until the finer details of the ECB plan come to fruition. The closer we get to this actionable date with detailed disclosed purchases, the quicker this positive sentiment should fade to neutral.

Figure 12: YTD EU IG Total Returns by tenor



Source: UBS, Markit

Figure 13: YTD Total Returns by Credit Rating



Source: UBS, Markit

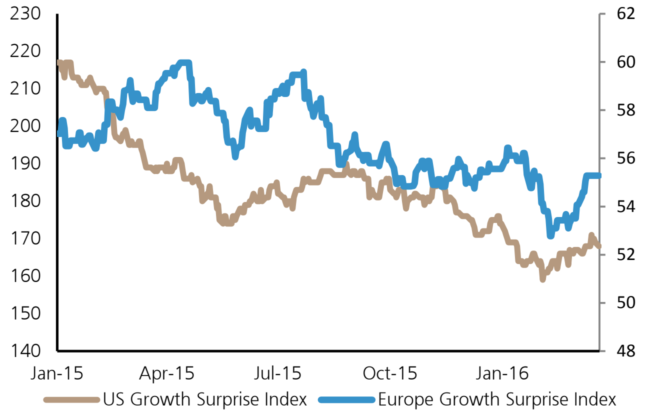
IG spreads are 70bp now and were 50bp at this time last year. However, there are several reasons why we are in a better place than we were in March 2015.

- ECB has announced its Corporate Sector Purchase Programme to start at the end of 2Q16
- EUR economic data is improving rather than trending downwards in both the US and Europe
- Oil has staged a 60% rally since February which has been positive for US HY and risky assets in general. This is providing investor comfort that oil prices may have turned the corner for the foreseeable future.

Duration has worked very well in the IG names (Figure 12). CCC Corps are the outlier which is comprised of bank subordinated paper, basic materials and consumer goods & service issuers (Figure 13). CCC bonds comprise <5% of the EU HY index, which is partly why their negative returns have not overtly affected the overall HY return.

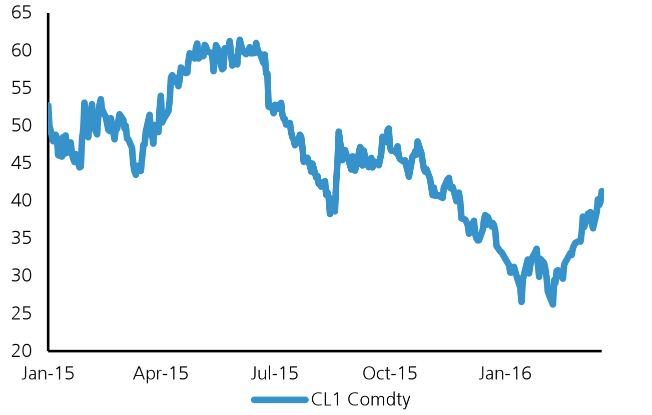
At this time last year, we were in a downward trend in economic data. Both the US and Europe were seeing their economic data surprise on the downside. This trend continued during 2015, but in February, both the US and Europe reversed course, with the turnaround in Europe becoming particularly strong (Figure 14). The recent Ifo print for Germany and composite PMI numbers for Europe are an example of this improvement. Oil, growth surprises, and Europe and US credit and equity markets all turned positive in mid-February.

Figure 14: US and Eurozone growth surprises.



Source: Bloomberg, UBS

Figure 15: WTI oil price.



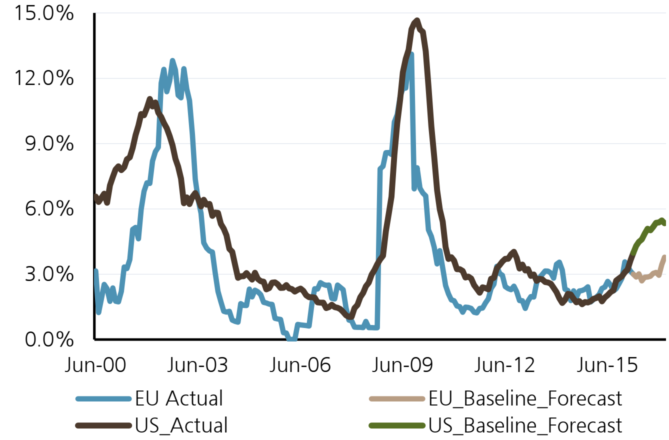
Source: Bloomberg, UBS

Since last March, the BoJ has announced further stimulus, the Fed has turned dovish and the ECB has expanded its QE purchases, a new TLTRO programme and its Corporate Sector Purchase Programme. The CSPP has created a very strong boost to sentiment and caused a flurry of inflows into corporate credit. In fact, despite the fact that the ECB will only buy non-Bank IG bonds, the main beneficiary in ETF flows has been European HY credit. If effect, the ECB has put investors in the position where they are looking to extend credit maturities or move further down the credit curve. Primary markets have taken advantage as IG issuers printed a record week at over €30bn in March, ahead of the ECB buying which is expected to being in 'late 2Q16'. This small window should remain open for the next few weeks and then abate. The large AB Inbev deal was on the back of M&A activity versus the normal 'general corporate purposes'.

HY issuance has piggy-backed on this over exuberant tone as issuance paper printed €1.2bn the same week with YTD HY issuance at ~€5bn. This is still markedly down from the same point last year at ~€35bn. We are still looking for clarity on the details of the purchasing plan (if any constraints on size, tenor, issuer, etc), but we assume they will follow the capital key proportion which is already in place. Under this scenario, we see issuers in Germany benefitting over those in France and the Netherlands. Given the small pool of assets that are actually available to purchase, we feel the positive tone may become muted as the ECB fully publishes the list of corporate bonds purchased, as it may be smaller than envisioned, coupled with positioning ahead of the purchase start date. For more information on the ECB corporate purchases, please see our report ECB Corporate Credit Purchases, K. Middlemiss, 15-Mar-2016.

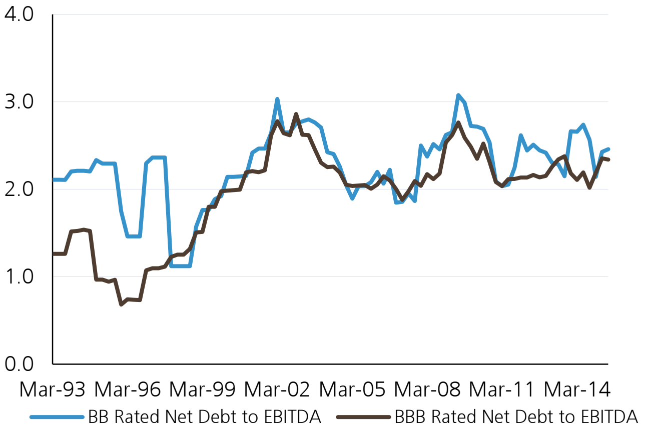
Tactically, we prefer EU HY vs US HY. Fundamentally, EU HY is comprised of better rated issuers than its US counterparts with BB and BBB issuers hugging Net leverage ~2.5x (Figure 17). Currently BB rated bonds comprise over 70% of total AUM in the EU HY index. This is a very different picture in the US, where BB bonds comprise 47% of the US HY index. At the same time CCC bonds in the US comprise 16% in the US HY index, versus <3% in EU HY. The default rate projection for EU speculative grade issuers is muted versus its US counterparts (Figure 16). We also believe the extended ECB QE program will have investors looking further down the ratings scale into the BB range in Europe for yielding paper to boost demand.

Figure 16: Trailing 12-Month Issuer-Weighted Spec-Grade Default Rates



Source: UBS, Moody's

Figure 17: Median Net Debt to EBITDA, by Rating for European Companies



Source: UBS, Worldscope

Models suggest Europe should outperform

Our high yield model forecast for Europe expects that the rally will continue over the next 6 months based on fundamentals (Figure 18). Here the direction of the key input to this model is crucial, namely lending conditions. In the US we use the SLO survey (tightening in small company C&I loans) whereas for Europe we use the ECB lending survey. These have been diverging: the ECB survey has remained easy whereas the US SLO survey has shown tightening. In addition, EUR banks are much more bullish on the EUR economy than US banks are on the US economy, a real first since the financial crisis (Figure 19).

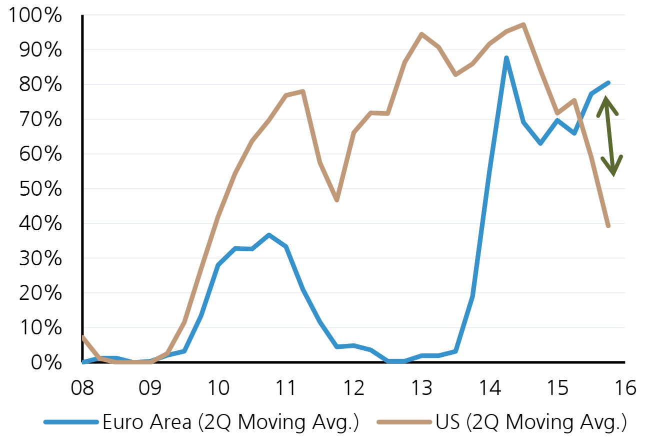
We do not expect EUR HY to decouple from US HY; however, our EUR & US spread estimates (US estimates detailed in prior section) provide confidence that EUR HY will relatively outperform US HY. In April we will get the next print for the ECB lending survey and if this remains easy, it should continue to support this thesis.

Figure 18: High yield model forecasts for US and Europe over 6m horizon

Estimated EU HY spread forecast (6M ahead, bp)	462
Spread today (bp)	539
Forecast Tightening	-77

Source: UBS, Markit

Figure 19: % of banks that eased standards based on their economic outlook

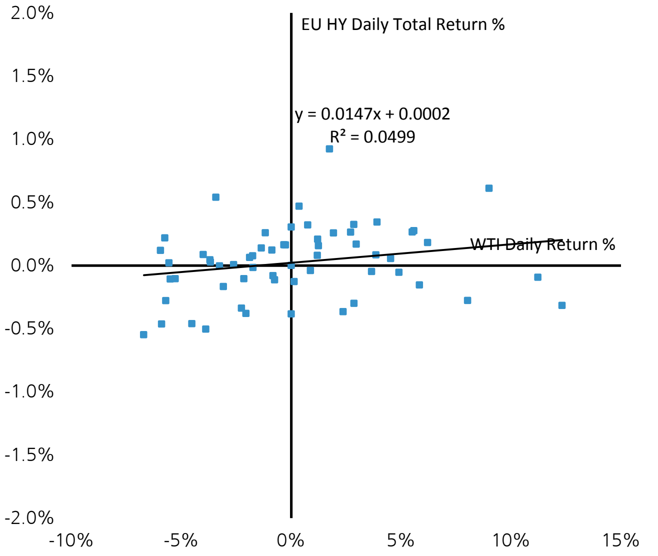


Source: UBS, ECB, Haver, Markit. ECB BLS Corp. CS represents the net % of banks easing/tightening credit condition versus the previous quarter (-ve = easing)

Oil and Europe outperformance vs US

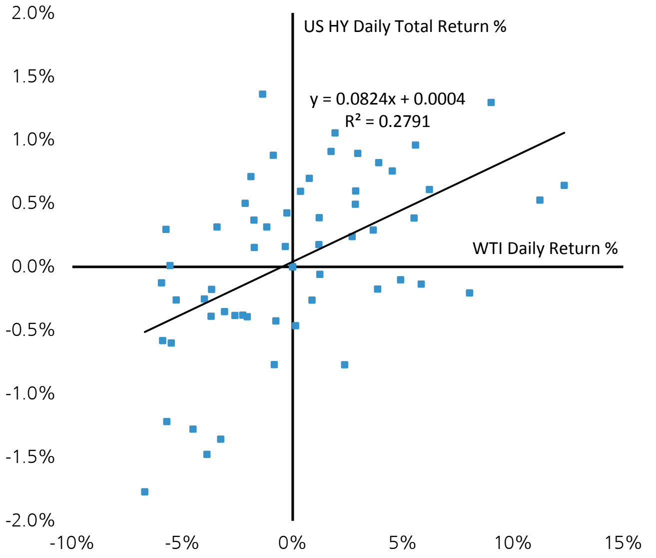
As we have noted previously the exposure of European HY is significantly lower than US HY. This fact is reflected in credit total returns where US HY has a very significant correlation to oil whereas European HY does not (correlation 53% vs 22% (see Figure 20 and Figure 21). The beta of European HY total return outperformance to oil return is 6%. This means that if the price of oil falls by 10% European HY will outperform by 0.6%.

Figure 20: European high yield total return correlation (year to date) to WTI is low…



Source: Bloomberg, UBS

Figure 21: … whereas US HY correlation is high.



Source: Bloomberg, UBS

A risk to our overweight in European HY vs US HY is therefore that the oil price will rally strongly in which case credit fundamentals would be drowned out by the effect of oil. However, taking the oil futures curve and our UBS oil forecast implies that neither the market nor our oil analysts expect a strong rise in the price of oil from here.

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UBS Global Credit Strategy and Research: Rating Definitions
UBS ranks potential investment opportunities within non-government fixed income markets and sectors.

<table>
<tr><th colspan="7">Issuer Ratings</th></tr>
<tr><th></th><th>UBS Terminology</th><th>Rating Category[1]</th><th>Time Horizon</th><th>Definition</th><th>Coverage[2]</th><th>IB Services[3]</th></tr>
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<tr><td>Stable</td><td>Hold</td><td>73%</td><td>46%</td></tr>
<tr><td>Negative</td><td>Sell</td><td>24%</td><td>37%</td></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="3">Credit Rating</td><td>AAA, AA, A (+/-)</td><td colspan="2" rowspan="3">Up to 12 months</td><td colspan="3" rowspan="3">UBS' assessment of a company's creditworthiness. Credit Ratings are only used in the evaluation of Swiss corporates.</td></tr>
<tr><td>BBB, BB, B (+/-)</td></tr>
<tr><td>CCC, CC, C (+/-)</td></tr>
<tr><th colspan="7">Security Recommendations</th></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="3">Bond Recommendation</td><td>Outperform</td><td colspan="2" rowspan="3">Up to 3 months</td><td colspan="3" rowspan="3">A corporate bond's expected relative performance versus a defined reference</td></tr>
<tr><td>Marketperform</td></tr>
<tr><td>Underperform</td></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="2">CDS Recommendation</td><td>Buy Protection</td><td colspan="2" rowspan="2">Up to 3 months</td><td colspan="3" rowspan="2">Recommendation to hedge a company's creditworthiness</td></tr>
<tr><td>Sell Protection</td></tr>
</table>

Note: Bond recommendations may be defined as 'Tactical', as in Tactical Outperform or Tactical Underperform, where there is a near term catalyst(s) taken into account.
The UBS credit rating may be modified by the addition of a plus (+) or minus (-) sign where applicable to show relative standing within the major categories.
Source: UBS. Rating allocations are as of 31 December 2015.
1.To satisfy regulatory requirements, we assign Buy, Hold and Sell in our Credit Outlook ratings distribution table for our Issuer Rating system.
2.Percentage of companies under coverage globally within this rating category.
3.Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

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