Invested in America

December 8, 2014

Mr. Kevin M. O'Neill
Deputy Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: *Treatment of Certain Communications Involving Security-Based Swaps That May Be Purchased Only by Eligible Contract Participants*, Release No. 33-9643 (Sept. 8, 2014), 79 FR 54224 (Sept. 11, 2014) (File Number S7-09-14)

Dear Mr. O'Neill:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to comment on Rule 135d under the Securities Act of 1933, as amended (the "**Securities Act**"), which was proposed by the U.S. Securities and Exchange Commission (the "**Commission**") in the above-referenced proposing release (the "**Proposing Release**").

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") amended the definition of "security" under Section 2(a)(3) of the Securities Act to include security-based swaps ("**SBS**")[2] and

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Section 2(a)(17) of the Securities Act defines "security-based swap" by reference to the Commodity Exchange Act, which in turn refers to the definition in the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"). In general, under Section 3(a)(68) of the Exchange Act, a "security-based swap" means any agreement, contract, or transaction that is a "swap," as defined in the Commodity Exchange Act, and that is based on –

(i) an index that is a narrow-based security index (generally, an index based on nine or fewer components), including any interest therein or on the value thereof;

(ii) a single security or loan, including any interest therein or on the value thereof; or

(iii) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security

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amended Section 5 of the Securities Act ("**Section 5**") to add a new paragraph (e), providing that unless a registration statement under the Securities Act is in effect as to an SBS, "it shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell, offer to buy or purchase or sell" an SBS to any person who is not an eligible contract participant ("**ECP**") as defined in the Commodity Exchange Act.[3]

Under proposed Rule 135d, the publication or distribution of quotes relating to SBS that may be purchased only by ECPs, and are traded or processed on or through a trading system or platform that either is registered as a national securities exchange under Section 6(a) of the Exchange Act or as an SBS execution facility (a "**SEF**") under Section 3D(a) of the Exchange Act, or is exempt from registration as a SEF, would not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase such SBS or any guarantees of such SBS that are securities, for the purposes of the Section 5.

We previously submitted a comment letter[4] in response to the Commission's adoption of interim final rules[5] temporarily exempting uncleared SBS entered into between ECPs from certain provisions of the Securities Act and the Exchange Act, in which we explained that SBS dealers or their affiliates may publish and distribute research reports discussing SBS at the same time such dealers are transacting in the subject SBS. In view of the existence of this research, we explained why some SBS dealers may be prevented from relying on the exemption from Section 5 provided by Section 4(a)(2) of the Securities Act ("**Section 4(a)(2)**") when transacting SBS.[6]

Although the proposed rule does not provide a Section 5 exemption for SBS research, the Proposing Release indicated that the Commission is

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index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

[3] *See* Dodd-Frank Act, Section 768(a)(1) and (b).

[4] *See* Letter from Kenneth E. Bentsen, Jr., Exec. V.P., SIFMA, to Elizabeth M. Murphy, Sec'y, SEC (Dec. 21, 2012), *available at* http://www.sec.gov/comments/s7-26-11/s72611-6.pdf.

[5] *See Exemptions for Security-Based Swaps*, Release No. 33-9231 (July 1, 2011), 76 FR 40605 (July 11, 2011).

[6] Without a Section 4(a)(2) or other exemption from the registration requirements of the Securities Act, as the Commission noted in the Proposing Release, it may also be necessary for the Commission to promulgate an exception from the Trust Indenture Act of 1939 for SBS. *See* Proposing Release, 79 FR at 54233, text at n. 92.

considering whether a broader exclusion from the Securities Act definition of "offer" than simply for SBS price quotes would be appropriate. We believe it would be appropriate for the Commission to expand proposed Rule 135d in substantially the following manner:

> *For the purposes only of Section 5 of the Act (15 U.S.C. 77e), the publication or distribution of any communication described in paragraph (a) or paragraph (b) of this section shall not be deemed to constitute an offer, an offer to sell, or a solicitation of an offer to buy or purchase any security-based swap or any guarantee of such security-based swap that is a security:*
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> *(a) quotes relating to security-based swaps that may be purchased only by persons who are eligible contract participants (as defined in Section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1a(18))) and are traded or processed on or through a trading system or platform that either is registered as a national securities exchange under Section 6(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78f(a)) or as a security-based swap execution facility under Section 3D(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c–4(a)), or is exempt from registration as a security-based swap execution facility under Section 3D(a) of the Securities Exchange Act of 1934 pursuant to a rule, regulation, or order of the Commission; or*
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> *(b) research reports (as defined in Rule 139(d) (§ 230.139(d))) discussing security-based swaps that may be purchased only by persons who are eligible contract participants (as defined in Section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1a(18))).*

As discussed more fully below, expanding proposed Rule 135d in this manner would allow market participants to take advantage of the Section 4(a)(2) exemption from the registration requirements of Section 5 without requiring SBS dealers to limit the distribution of credit research to their existing ECP customers, a limitation that would deprive the broader market of the potentially useful information provided by such research. Because not all SBS transactions will be required to be traded on a trading system or platform registered (or exempt from registration) as a national securities exchange or SEF, a Rule 135d research exemption should not be limited only to SBS that are traded on such a system or platform. For instance, SBS that are not subject to a mandatory clearing requirement or that are not "available to trade" on a trading system or platform will continue to be traded over-the-counter.

We believe that expanding the exemption in proposed Rule 135d to cover research reports discussing SBS is needed not only to avoid unnecessary disruption to beneficial market practices involving the distribution of research reports discussing SBS, but also to implement Congressional intent as demonstrated in the Dodd-Frank Act, which contemplated that the SBS market would continue to operate on an unregistered basis among ECPs, and the Jumpstart Our Business Startups Act of 2012 (the "**JOBS Act**"), which expressed a clear preference for relaxing the prohibition on "general solicitation or general advertising"[7] ("**general solicitation**") in the context of transactions in which the only eligible investors are sophisticated market participants, as Congress judged ECPs to be in crafting new paragraph (e) under Section 5. A Securities Act-registered market in SBS does not currently exist and we are not seeking an exemption for research reports discussing SBS in the context of any transaction in which an SBS could be purchased by an investor that is not an ECP. Given the sophisticated character of ECPs, and the fact that Congress has already determined that SBS transactions involving ECPs (and *only* SBS transactions involving ECPs) may be carried out without registration under the Securities Act, we believe such an exemption is both in the public interest and consistent with the protection of investors.

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The Proposing Release made three observations in reference to our earlier letter, and then posed a series of questions about a Section 5 exemption for SBS research. We begin with addressing the Proposing Release's observations in order to give some context to our responses to the specific questions.

First, the Proposing Release observed that:

> *A commenter requested broader relief for SBS communications, but it did not provide us with sufficient information to understand why a broader treatment would be necessary. For example, the commenter only addressed one type of SBS – credit default swaps.* [8]

We focused on credit-default swaps ("**CDS**") in our December 21, 2012 letter because they are the most commonly discussed SBS in research reports. This is due to the large, liquid nature of the CDS market, with an estimated total notional amount of contracts outstanding of $19.5 trillion at June 30, 2014.[9]

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[7] *See* Rule 502(c) under the Securities Act.

[8] Proposing Release, 79 FR at 54232.

[9] Bank for International Settlements, Monetary and Economic Department, "Statistical release: OTC derivatives statistics at end-June 2014" (Nov. 2014), Table 4 at p. 18, *available at* http://www.bis.org/publ/otc_hy1411.pdf.

However, as discussed below,[10] research reports do also discuss other types of instruments that may be SBS.

In a typical cash-settled CDS transaction, one party (the purchaser) agrees to make periodic payments to the other party (the seller) until the maturity date, and the seller agrees to make a payment to the purchaser if a negative credit event occurs with respect to the underlying issuer or security. SBS dealers routinely act on both sides (as purchasers and sellers) of the CDS market. For example, a CDS purchaser can hedge against the risk of default on a bond by purchasing a CDS covering the bond and making periodic payments to the seller; if the issuer of the bond defaults on its obligations, the seller would pay the difference between the par value and the fair value of the bond to the purchaser. A CDS purchaser or seller can also use CDS for non-hedging purposes in order, for example, to speculate on changes in an issuer's credit quality on an absolute basis or on a relative basis compared to other issuers.

CDS are discussed in research reports published by fundamental credit analysts, who may use the CDS as one expression of a particular issuer's credit risk in comparison to the outstanding debt securities of that issuer or another issuer, and by credit strategists, who may use CDS to compare relative credit risk between different issuers. Market participants use information about CDS, including information discussed in CDS research reports, to inform investment decision-making in CDS as well as in the underlying issuers or securities. Information from the CDS market is recognized as providing valuable insight into the global credit markets generally. For example, in a 2010 White Paper providing an overview of the global credit derivatives market,[11] the Intercontinental Exchange observed that:

> "CDS . . . play a vital role in the provision of transparent, market-based information about credit conditions for bankers, policymakers, regulators, investors and other capital market stakeholders. CDS spreads have been shown to consistently produce timelier and more accurate assessments of credit conditions than rating agencies. While rating agencies are paid by an issuer and rating reviews can take weeks or months to complete, CDS trade continuously. Therefore, credit derivatives markets function as an important real-time signaling mechanism for market participants and observers."

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[10] *See* pp. 6, 20.

[11] Intercontinental Exchange, "Global Credit Derivatives Markets Overview: Evolution, Standardization and Clearing" (March 2010), *available at* https://www.theice.com/publicdocs/globalmarketfacts/docs/factsheets/ICE_CDS_White_Paper.pdf.

Similarly, in a December 2004 study on the function and importance of CDS,[12] the Deutsche Bundesbank observed that:

> "[T]he CDS market will play an increasingly important role as an indicator of credit risk developments. CDS are already fulfilling an important function with regard to price discovery in the credit markets. This fact is also expressed in their ability to clearly anticipate changes in rating agencies' assessments before they occur. Apart from additional indicators such as risk models for assessing default probabilities, CDS therefore make an important contribution to the early detection of financial risks."

In addition, a June 2012 report assessing the functioning of the CDS market and its role in the price formation process by the Board of the International Organization of Securities Commissions[13] concluded that:

> "Current research clearly shows that CDS lead the price discovery process on credit risk for private issuers . . . . [While] there is mixed evidence on the impact of CDS on the orderly functioning of the primary and secondary markets of the underlying bonds and on creditor incentives . . . the CDS market is found to have an important role in the price discovery process."

Given the broadly recognized usefulness of information provided by CDS market activity to price discovery and credit risk assessment, we believe the Commission should act affirmatively to ensure that research reports discussing CDS – including those produced by SBS dealers and their affiliates – are not required to be restricted in distribution solely to SBS dealers' existing ECP clients. As discussed below,[14] this would be the likely consequence of a decision declining to expand proposed Rule 135d as we suggest in this letter. And given that an SBS dealer can only transact with its customers who are also ECPs, there is no risk that a non-ECP investor can be induced to engage in an SBS transaction on the basis of research reports discussing SBS.

If the Commission is persuaded of the need to exempt SBS research from the Securities Act definition of "offer" in the context of SBS transactions, we do

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[12] Deutsche Bundesbank, "Credit default swaps – functions, importance and information content" (Dec. 2004), *available at* https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2004/2004_12_credit_default_swaps.pdf?__blob=publicationFile.

[13] The Board of the International Organization of Securities Commissions, "The Credit Default Swap Market: Report" (June 2012), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD385.pdf.

[14] *See* p. 25.

not believe that any such exemption should be limited to research reports discussing CDS. Research reports may also discuss other types of instruments and indices, such as total return swaps ("**TRS**"), CDS indices ("**CDX**"), TRS indices ("**TRX**") and options or other derivatives on credit, debt or equity instruments, which may be "securities" for Securities Act purposes depending on the nature of the underlying instrument or index. For example, a CDS or TRS on a "narrow based" CDX consisting of nine or fewer component securities would likely be an SBS, although a change to the composition of such an index could take it out of the Securities Act definition of "security" and make it a commodity for federal regulatory purposes. Although the federal regulatory framework for securities and commodities draws important distinctions between these different types of instruments, investors and research analysts treat them as competing investment opportunities, comparing one against the other without regard to regulatory classification.

A Section 5 exemption limited to research reports discussing CDS would also run against the approach taken by the Commission in its existing Section 5 safe harbors for research, Rules 137, 138 and 139 under the Securities Act (the "**Research Rules**"). The Research Rules do not distinguish between research reports on different types of securities, other than the broad distinction made in Rule 138 for non-convertible debt research in the context of an equity or equity-linked security offering, and vice versa. For example, under Rule 137, if the broker-dealer publishing the research is not participating in the offering, or under Rule 139, if the issuer requirements are met, it does not matter if the offering involves common stock, preferred stock, convertible debt, trust preferred securities, debt securities or a novel hybrid security. Nor does Rule 138 differentiate among the myriad types of equity and equity-linked securities, on the one hand, or non-convertible debt securities, on the other. In any case, the distinction made between equity and debt securities in Rule 138 is not based on whether or not a particular type of security is widely covered in research reports, but is based on the nature of the particular transaction proceeding in reliance upon the Rule 138 safe harbor and whether or not a research report involving a type of security that is not the subject of that offering should be deemed to be an "offer" in the context of that offering.

The approach taken in the Research Rules makes sense in view of the dynamic and evolving nature of the securities markets, in which new securities products are introduced on a regular basis. The Commission has never before considered it necessary to pass upon the application of the Research Rules on a security-by-security basis, and we see no reason to begin doing so in the context of SBS. As a result we do not believe there is Commission precedent, or any regulatory need, for limiting the availability of a research report exemption to the precise type of security discussed in the research report. And certainly, even if the Commission were to embark on this approach, it would seem odd to do so on the back of a group of securities that, by Congressional design, can only be invested in by sophisticated market participants. We believe the most appropriate factor for the Commission to consider in determining whether to grant a Section 5 exemption for SBS research is the nature of the transaction, not the nature of the security. We discuss in response to Question 9(a)(i) below why the nature of SBS transactions is such that a research exemption is justified.

Next, the Proposing Release observed that:

> *The commenter also did not provide sufficient information about the types and contents of such communications, the distribution methods and restrictions for such communications, or the basis for characterizing such communications as research in order for us to evaluate the appropriate treatment of such communications.*[15]

Research discussing SBS is not meaningfully different from any other type of securities research produced and distributed by broker-dealers and their affiliates in the ordinary course of business, and with which the Commission is already well familiar. Like research on other types of securities, a research report discussing SBS is, in the words of the Research Rules, "a written communication, as defined in Rule 405, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."[16]

Research reports discussing SBS include those produced and distributed by an SBS dealer's or dealer affiliate's research department, which are subject to the same policies and procedures as other equity or debt research produced by the firm's research department. SBS dealers implement various policies and procedures to prevent sales and trading personnel from exerting influence or control over research analysts in order to maintain the independence of research reports produced by a firm's research staff. Such policies include requiring evaluation of the performance and compensation of research analysts to be based on solely the quality of their research products and the usefulness to clients of such products, rather than on any direct feedback provided by sales and trading personnel. Many larger firms specifically prohibit sales and trading personnel from participating in the evaluation and compensation process for research personnel. Further, research policies and procedures typically prohibit analyst compensation from being tied to a particular recommendation, trading transaction or the amount of revenue earned by any trading business.

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[15] Proposing Release, 79 FR at 54232.

[16] *See* Rule 137(e), Rule 138(d) and Rule 139(d).

Research reports generally discuss SBS in the context of (i) providing an investment recommendation as to a specific SBS by offering fundamental views on the security or a relative value analysis against another security; (ii) referring to SBS, such as CDX and other indices, in connection with an analysis of credit markets or proposed credit trading strategies; or (iii) discussing one or more SBS, typically CDS, in the context of covering other securities of the related issuer as an indicator of the overall creditworthiness of such issuer. Examples of research reports discussing SBS are attached to this letter as Annex A.

Discussion of SBS is often embedded within general credit research, and credit analysts frequently discuss SBS in the context of more general analyses regarding credit markets, credit trading strategies or the creditworthiness of an issuer. For example, a November 2014 research report published by credit analysts provided that:

> "We are lowering our recommendation of [ABC], Inc. to an Underweight following the S&P downgrade to BB+ and Moody's placing the ratings under review for downgrade. We expect Moody's to downgrade in a short period of time. We expect spreads to widen even more, despite the severe widening we saw yesterday, with the potential Moody's action and S&P action last night. This is all a result of the large reserve claim charge for their [XYZ] unit disclosed in their earnings. CDS spreads could go to points up front while cash yields could go to the 6.5% range as investment grade holders exit the name.[ABC], Inc.'s 4.8% Note due 2024 was last offered yesterday at $92.96, 5.79% yield, 340bp spread while 5 year CDS was marked at 315/335bp and the 6.15% hybrids were offered at $72.50, or 7.47% yield to maturity."

In another recent example, a May 2014 research report on sovereign credit markets published by credit analysts noted that:

> "We reduced [MNO country] to neutral from overweight last month on less attractive valuation and potential volatility stemming from presidential elections in the coming months. The situation has not changed from the last month – both fundamentals and technicals remain supportive, and the [MNO country] sub-index has tightened marginally further vs. EM investment grade average . . . . Regarding the presidential elections coming up this month, we continue to believe President [S] will be re-elected, albeit only in the second round. We expect the market to price out any lingering risk of re-election failure, which would compromise policy continuity . . . . In relative value, the 19s continue to look expensive to the curve and also to CDS. We are biased to selling [MNO country] CDS basis trades although we see more attractive short basis trades elsewhere (with better liquidity)."

Like other types of securities research, SBS research is distributed by firms through a variety of different channels, which, depending on the particular firm, may include proprietary distribution platforms as well as third-party research aggregators, some of which are authorized to offer certain products to the public.[17] As a result, research discussing SBS is made accessible to existing clients of the distributing dealer, including clients that are not ECPs, and in some cases research discussing SBS can be accessed by the public generally. For the reasons mentioned above, given the broad informational value of activity in the SBS market, investors who have no interest in transacting in SBS, including investors who are not ECPs and therefore have no practical ability to transact in SBS, may nevertheless find SBS research useful in analyzing underlying issuers or securities. SBS research can assist these investors in making investment decisions by providing views on a market, a specific sector or an issuer. For instance, as CDS can be a leading indicator of the market's views on an issuer's creditworthiness, fixed-income investors have a general interest in research analysts' views regarding an issuer's CDS. SBS research also assists ECPs in determining pricing around CDS, including with respect to the relative value of a given CDS in relation to other securities in a market or sector.

While there is nothing new about SBS research itself, or the manner in which it is distributed, what is new is that before the Dodd-Frank Act, SBS transactions were explicitly outside the Commission's jurisdiction and therefore the Research Rules did not need to address research in the context of SBS transactions. Because SBS research practices developed under a Securities Act regime in which SBS were not "securities," the Commission has not previously needed to clarify the circumstances under which SBS research would not constitute an "offer" to sell the subject SBS for purposes of Section 2(a)(10) or Section 5 of the Securities Act or a general solicitation in the context of an unregistered private placement.

As discussed in more detail below,[18] Rule 137 is inapplicable to SBS transactions because it is limited in scope to registered offerings. Although Rules 138 and 139 apply to some specific forms of unregistered offerings, they do not apply to Section 4(a)(2) private placements, and SBS transactions do not comply with the covered forms of unregistered offerings, including transactions pursuant to Rule 144A under the Securities Act, which applies to resales of securities to

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[17] For example, research discussing SBS is available through services of Thomson Reuters. According to Thomson Reuters' public website, "on a subscription basis, Investext provides access to over 12 million reports from award-winning investment research analysts around the globe," *available at* http://thomsonreuters.com/products/financial-risk/01_205/thomsononecom-ib-embargoed-research.pdf. We are informed that subscribers to this service may access research reports that have been embargoed for a period of 7 to 15 days without providing certifications with respect to ECP status or status as a client of the institution distributing the research through the Investext platform.

[18] *See* pp. 21-22.

qualified institutional buyers ("**QIBs**") but not to primary issuances, or transactions pursuant to Regulation S under the Securities Act, which is available only for offshore transactions.

Finally, the Proposing Release observed that:

> *Further, the commenter did not explain whether SBS dealers engage in SBS transactions with their existing or prospective clients who receive or access such communications. In this regard, we note that the examples of such communications provided by the commenter appear to include buy/sell recommendations with respect to certain SBS. If the SBS dealers are entering into transactions involving such SBS, such communications may be issuer offering materials rather than research*.[19]

As we noted in our earlier letter, SBS dealers or their affiliates publish and distribute research discussing SBS in which they are, at the same time, transacting and available to transact. Absent this, it would not be necessary to seek Section 5 relief for SBS research. We do not believe that the distinction between "issuer offering materials" and "research" helps answer the question of whether SBS research should be exempted from Section 5, since, as discussed below,[20] it is because research could be considered "offering materials" that an exemption is needed in the first place.

As we discussed in our earlier letter, the SBS market features bilateral contracts privately negotiated between SBS dealers and sophisticated counterparties who must qualify as ECPs, with no secondary resale market. Unlike a "classical" securities offering where, post-sale, only one party owes continuing obligations to the other, when an SBS dealer and a counterparty enter into an SBS, each party to the contract continues to be exposed to the other party's credit risk (as explained above in our example of how a typical CDS works), which means that each party can be viewed as making an investment decision with respect to the other party. (This credit exposure also explains why one party to an SBS may require a guarantee of the other party's obligations under the SBS; since the SBS is a security, then the guarantee of a party's obligation under the SBS is also a security for Securities Act purposes.[21]) Therefore, if an SBS is a "security" for Securities Act purposes, then absent Commission guidance to the contrary, the dealer and the counterparty could each be viewed as offering and selling a security to the other.

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[19] Proposing Release, 79 FR at 54232 (footnote omitted).

[20] *See* pp. 17-18.

[21] *See* Securities Act Section 2(a)(1), which defines "security" as, *inter alia*, any "guarantee of" a security.

We do not believe, simply because SBS research may be published by a counterparty to an SBS transaction, that one should conclude that SBS research merits less of an exemption than research published by a participating underwriter in a classical securities offering, and indeed the Research Rules do not condition reliance on whether or not the broker-dealer is publishing research on itself or an affiliate.[22] There would not be a sturdy basis to make a distinction between those broker-dealers who are, and those who are not, affiliated with the issuer in the context of an exemption for research produced by broker-dealers participating in an offering, because a non-affiliated broker-dealer could have as much of an interest in the transaction as the issuer, if not more. This helps to explain why the Research Rules focus on the overall nature of the transaction, and not on the relationship between the author or distributor of the research and the issuer of the security. As noted above, we discuss in response to Question 9(a)(i) below why the nature of SBS transactions is such that a research exemption is justified.

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With this background, we turn below to the Commission's specific questions. (These questions appear in the Proposing Release as Questions 9(a) through (e); we have followed this numbering and have further broken down multi-part questions into their components.)

9(a)(i) *Should we specify that other types of written communications [besides SBS price quotes], such as communications that have been called research, regarding SBS, would not be considered offers for purposes of Section 5 of the Securities Act? If so, why?*

Yes. We believe an exemption from the definition of "offer", as such term is used in Section 5 of the Securities Act, is needed for SBS research because SBS research could otherwise be deemed to entail an "offer" of the subject SBS[23] which, if disseminated through means involving a general solicitation, would render unavailable the Section 5 exemption provided by Section 4(a)(2) as well as

[22] Because of the purpose of Rule 137, which exempts research issued by a broker-dealer that is not participating in a transaction, it is unlikely that Rule 137 would apply in the context of a broker-dealer's research on its own or affiliates' securities.

[23] *See, e.g., Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933,* Release No. 33-5101, 35 FR 18456 (Nov. 19, 1970) ("Information, opinions or recommendations by a broker-dealer about securities of an issuer proposing to register securities under the Securities Act of 1933 for a public offering or having securities so registered, may constitute an offer to sell such securities within the meaning of Sections 2(3) and 5 of that Act, particularly when the broker-dealer is to participate in the distribution as an underwriter or selling group member. Publishing such information may result in a violation of Section 5 of the Act.").

the safe harbors provided by Regulation D under the Securities Act (other than Rule 506(c) thereof).[24] The Section 5 safe harbors provided by Rule 144A and Regulation S under the Securities Act are not available for SBS transactions in the U.S. market, and the Rule 506(c) safe harbor, under the Commission's current proposal,[25] would require a substantial revision in order to make it work in the context of a bilateral SBS transaction as opposed to the classical securities offering for which it was designed. Registration of SBS transactions under Section 5 is not a viable alternative under the existing Securities Act registration regime, and research reports distributed via customary channels could also involve an illegal offer to the public under Section 5(e) once the interim final rule expires.[26] Therefore, unless SBS research is exempted from Section 5 in the context of SBS transactions, dealers would be required to restrict distribution of SBS research so that its dissemination does not constitute a general solicitation of the subject SBS. While this is possible, it is not necessary for the protection of investors, and would unnecessarily deprive market participants – including those who do not transact in SBS – of the useful perspectives provided by research reports that contain some discussion of SBS.

Section 4(a)(2). Activity that involves a "general solicitation or general advertising" can prevent reliance on the Section 4(a)(2) exemption.[27] As is customary, research reports discussing SBS often contain statements that could be construed as an "offer" to sell the subject SBS (as detailed in response to Questions 9(b)(i)-(ii) below) under the Commission's longstanding interpretations[28] and as discussed above[29] may be available to investors who are

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[24] *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415 (July 10, 2013), 78 FR 44771 (July 24, 2013) ("Section 4(a)(2) of the Securities Act exempts transactions by an issuer 'not involving any public offering.' An issuer relying on Section 4(a)(2) is restricted in its ability to make public communications to attract investors for its offering because public advertising is incompatible with a claim of exemption under Section 4(a)(2)." (footnote omitted)).

[25] *Amendments to Regulation D, Form D and Rule 156*, Release No. 33-9416 (July 10, 2013), 78 FR 44806 (July 24, 2013).

[26] *See Exemptions for Security-Based Swaps, supra* n. 5.

[27] *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, supra* n. 24.

[28] *See, e.g., In the Matter of Carl M. Loeb, Rhoades & Co.*, 38 SEC. 843 (1959) ("In permitting, but limiting the manner in which pre-effective written offers might be made, the Congress was concerned lest inadequate or misleading information be used in connection with the distribution of securities. We were directed to pursue a vigorous enforcement policy to prevent this from happening. In obedience to this mandate we have made clear our position that the statute prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, condition the public mind or arouse public interest in the particular

(…continued)

not ECPs via customary securities research report distribution channels. Therefore, research reports discussing SBS could potentially involve a general solicitation that would prevent reliance on the Section 4(a)(2) exemption.

To be certain, it is not necessarily the case that the publication of any particular research report discussing SBS would constitute a general solicitation that would foreclose the availability of the Section 4(a)(2) exemption for a particular SBS transaction. Instead, determining (i) whether or not a given research report discussing SBS contains statements that would be viewed as likely to "condition the public mind or arouse public interest in the particular securities"[30] and if so, (ii) whether the potential counterparty became interested in the particular SBS transaction through the publication of that "offer" or through some permissible means, would involve a time-consuming, fact-intensive judgment call. Given the downside risk in a conclusion that the Section 4(a)(2) exemption is available for the SBS transaction in question,[31] absent the relief requested in this letter, the SBS dealer may conclude for risk-mitigation purposes either to withhold or limit distribution of the research report discussing SBS in order to maintain flexibility to deal with all potential counterparties, or to decline to do business with the potential counterparty. Given that only ECPs currently participate in the SBS market, and non-ECPs may only engage in registered SBS transactions (a market that has not yet developed), we believe that it is unnecessary for the protection of investors to force SBS dealers to make this sort of choice in the service of a doctrine designed to protect the general public from "inadequate or misleading information [being] used in connection with the distribution of securities."[32]

Section 768(b) of the Dodd-Frank Act amended Section 5 of the Securities Act to add a new paragraph (d), which provides that the exemptions from Section 5 found in Sections 3 and 4 of the Securities Act are unavailable for any offer or

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(continued…)

securities." (footnotes omitted)) ; *Guidelines for the Release of Information by Issuers Whose Securities Are in Registration*, Release No. 33-5180, 36 FR 16506 (Aug. 16, 1971) ("[T]he publication of information and statements, and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer . . . .").

[29] *See* pp. 9-10.

[30] *In the Matter of Carl M. Loeb, Rhoades & Co*., *supra* n. 28.

[31] In addition to Commission enforcement risk, a counterparty would have a right to rescind the transaction under Section 12(a)(1) of the Securities Act if the transaction violated Section 5.

[32] *In the Matter of Carl M. Loeb, Rhoades & Co*., *supra* n. 28.

sale of an SBS to any person who is not an ECP. By limiting mandatory Securities Act registration to SBS transactions involving non-ECPs, Congress contemplated that the SBS market among ECPs could remain outside of the registration regime of Section 5 of the Securities Act. There is no indication in the Dodd-Frank Act text or legislative history that Congress intended to rein in or limit the publication and distribution of SBS research, which would be the practical consequence of declining to exclude research reports discussing SBS from the definition of "offer" in the context of SBS transactions.

The Commission need not be concerned that providing an exemption for research in the context of SBS transactions would leave it unable to police SBS research or other market practices in the event a broad public market in SBS develops, because the Commission could tailor the exemption only to transactions involving ECPs. The Commission could therefore defer action on how to adapt the Research Rules until such time (if ever) that a registered market in SBS develops. We believe that a research exemption for SBS transactions involving ECPs is needed to avoid unnecessary disruption to market practices, as well as to implement Congressional intent as demonstrated in the Dodd-Frank Act and the JOBS Act, as discussed in response to Question 9(a)(iv) below, and that such an exemption is therefore in the public interest. Given the sophisticated character of ECPs, and the fact that Congress has already determined that SBS transactions involving ECPs may be carried out without registration under the Securities Act, we believe such an exemption is consistent with the protection of investors.

Safe Harbors Provided by Rule 144A and Regulation S. Rule 144A is not available for SBS transactions because, as discussed above,[33] in an SBS transaction, each party obligates itself directly to the other party and there is no resale involved. As the Commission has noted, a Rule 144A offering involves a "primary offering of securities by an issuer to one or more financial intermediaries . . . followed by the resale of those securities by the initial purchasers to QIBs in reliance on Rule 144A."[34] Regulation S is not available because the SBS transactions we are concerned with take place in the United States.[35]

Safe Harbor Provided by Rule 506(c). Rule 506(c) under the Securities Act, which permits general solicitation in the context of a Regulation D private placement, would in theory be available for SBS transactions, although if this is the route the Commission prefers to take, it would be called on to modify

[33] *See* page 10.

[34] *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, supra* n. 24, 78 FR at 44773.

[35] *See* Regulation S, Rule 901.

Regulation D so that it can function in the context of an SBS transaction. For example, given the bilateral nature of SBS transactions, the Commission would need to explain whether the ECP investor is an "issuer" that is required to file a Form D, and would need to clarify the "issuing" ECP's liability to the "investor" dealer under the federal securities laws. The Commission would also need to determine how to modify the disqualification provisions set forth in proposed Rule 507 under the Securities Act[36] – which presumably were not intended by the Commission to disqualify investors themselves from participating in Regulation D offerings – in order to avoid preventing ECPs from transacting in SBS because of some past transgression by a predecessor or affiliated party, or because the ECP forgot to make a required filing. Requiring SBS transactions to be carried out under Rule 506(c) would also result in a dramatic increase in paperwork, for dealers and ECPs as well as Commission staff, as each SBS transaction involving a distinct dealer, counterparty, SBS and reference security, issuer or index would potentially be a separate "offering" and thus trigger a Form D filing. In addition, under proposed Rule 510T,[37] SBS dealers would be required to submit research reports discussing SBS to the Commission before distribution.

Like the Research Rules, which developed in the context of classical securities offerings and therefore did not need to account for the distinct structure of the SBS market, Regulation D, as currently in effect and as proposed to be amended, was developed to facilitate capital formation as carried out in a classical securities offering. While it may be possible to shoehorn the entire $19.5 trillion CDS market into procedures that were developed to facilitate small-business capital formation, we do not think the costs and inefficiencies of doing so, or the substantial work that the Commission would need to do in order to revise Regulation D so that it is workable in the SBS context, is justifiable when there is a simple and straightforward way that does not raise any substantial investor protection concerns for the Commission to address the concerns outlined in this letter.

Securities Act Registration. Registration of SBS transactions under the Securities Act, under the registration system as it now exists, is not practical, given the bilateral nature of SBS transactions. Each transaction could potentially require a separate registration statement with audited financial statements of both counterparties – the dealer and the ECP, and the costs of preparing such a registration statement could easily outweigh the expected benefits of the transaction. Even if the costs could be managed, the length and delay of staff review of SBS registration statements for individual SBS transactions would make it impractical for market participants to transact. Absent the Commission's

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[36] *See Amendments to Regulation D, Form D and Rule 156, supra* n. 25.

[37] *Id.*

development of a new registration regime tailored to the specifics of the SBS market (which would have the side-effect of opening up the SBS market to investors who do not qualify as ECPs), the market for SBS would simply move offshore.

Section 5(e). Research reports distributed via customary channels that reach non-ECPs could also involve an illegal offer to the public under Section 5(e). Without Securities Act registration, Section 5(e) makes it unlawful for any person to use the jurisdictional means to "offer to sell, offer to buy or purchase or sell" an SBS to any person who is not an eligible contract participant. Since a research report discussing SBS could involve an offer to sell the subject SBS, a Section 5 exemption for such research is needed to avoid mandating the exclusion from all credit research of discussions of SBS that could be considered "offers" for Section 5 purposes.

9(a)(ii) Please describe in detailwhat other types of communications should be covered by the rule.

Proposed Rule 135d should be expanded to provide a Section 5 exemption for research reports, as that term is defined in the Research Rules.

9(a)(iii) What characteristics do such communications have that would distinguish them from being offers of the SBS that are discussed in such communications?

As noted above,[38] it is the fact that research reports discussing SBS can be viewed as soliciting offers of the subject SBS that gives rise to the need for Section 5 relief in the context of SBS transactions. This is the same as research in transactions covered by the Research Rules, and is why the Research Rules were first adopted by the Commission.[39]

For example, under Rule 139, a broker-dealer could publish a research report recommending that its clients buy a security at the same time the broker-dealer is participating in a registered offering for the security. Absent Rule 139, the broker-dealer's research report would likely be considered an illegal prospectus for that offering. Likewise, absent the modification to proposed Rule 135d that we are requesting, the publication of a research report that highlights an SBS investment opportunity could be considered an offer, which made through an

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[38] *See* p. 11.

[39] *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Fling of a Registration Statement, supra* n. 23.

unrestricted channel, could be considered a general solicitation involving that SBS.[40]

9(a)(iv) If we should not treat such communications as offers for purposes of Section 5 of the Securities Act, what conditions should apply to the use of such communications?

We do not believe that any conditions are necessary for a Section 5 exemption for research reports discussing SBS in the context of an unregistered SBS transaction. The constraint imposed on such a transaction by the Securities Act – that the parties thereto qualify as ECPs – is sufficient to ensure that a Section 5 exemption is consistent with the protection of investors. This is consistent with Congressional intent as evidenced by the JOBS Act. Section 201(a)(1) of the JOBS Act directed the Commission to permit general solicitation in offerings made under Rule 506 of Regulation D, provided that all purchasers of the securities are accredited investors. Section 201(a)(2) of the JOBS Act directed the Commission to revise Rule 144A(d)(1) under the Securities Act to permit offers of securities pursuant to Rule 144A to persons other than QIBs, including by means of general solicitation, provided that the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs. Although SBS transactions are not conducted in accordance with the Rule 506 or Rule 144A safe harbors, Congressional policy underlying the elimination of the prohibition on general solicitation in both Rule 144A and Rule 506 transactions supports our view that SBS that are sold only to persons who are ECPs, who Congress has determined are sufficiently sophisticated not to need the protections of Securities Act registration, should be exempt from registration, regardless of whether the transaction involves a general solicitation – including a general solicitation in the form of SBS research.

9(b)(i) What specific types of information, opinions, and recommendations are included in such communications regarding the SBS and the underlying reference issuers and/or securities?

As demonstrated in the examples discussed below, research reports discussing SBS may (i) provide an investment recommendation as to a specific SBS by offering fundamental views on the security or a relative value analysis against another security; (ii) refer to SBS, such as CDX and other indices, in connection with an analysis of credit markets or proposed credit trading strategies;

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[40] *Securities Offering Reform,* Release No. 33-8591 (July 19, 2005), 70 FR 44722 (Aug. 3, 2005), at n. 380 (explaining that research can create general solicitation concerns in the context of a Rule 144A offering: "Where [a broker or dealer] distributes research about the issuer around the time of a Rule 144A transaction, questions arise regarding whether it may be viewed as making offers to persons that receive the research, including those who are not QIBs.").

and (iii) discuss one or more SBS, typically CDS, in the context of covering other securities of the related issuer as an indicator of the overall creditworthiness of such issuer.

9(b)(ii) Do such communications include strategies for buying or selling SBS?

Yes. Research reports discussing SBS may include strategies or recommendations for buying or selling SBS. The following are a few examples of such statements taken from research reports discussing SBS recently in the market:

> "In the index rally, single-name CDS has lagged, leaving the CDX IG index NAV in the 6-7bp range. We think there are long credit opportunities in select single-name CDS . . . ."
>
> "Trade Idea – Long HY TRS vs. Short IG TRS: [Short IG TRS] has outperformed [Long HY TRS] on a total and excess return basis this year given the rally in long-end rates and the material correction in HY spreads . . . we like this trade to position for our positive HY view coupled with limited further total return upside for IG at current yields."
>
> "We recommend investors to sell [BCD], Inc. 5-year CDS at 217 bps . . . [BCD], Inc. CDS is now at the widest in the most recent six-month period given the recent market sell-off."

9(b)(iii) Are such communications related to industries, entities, or particular offerings of SBS?

SBS research is not related to particular offerings of SBS except in the sense that an SBS dealer may hold itself out as willing to transact across the full spectrum of particular SBS products, such as CDS. SBS research may discuss specific entities by providing fundamental views on a specific underlying issuer or as a reference point for a more general view on the creditworthiness of the underlying issuer. SBS research may also discuss industry or sector analysis. The following are a few examples of such statements taken from research reports discussing SBS recently in the market:

> "We are raising our rating on [ABC] Corp. CDS to Overweight -30% from Underweight -30%, following Moody's revision this afternoon of the credit outlook of [ABC] Corp. to Stable from Negative."
>
> "Despite the improvement YoY [in segment operating income], [DEF] Co. lowered its 2014 outlook . . . . The stock is down -7% today, CDS is 10bp wider, and bonds are unchanged to down 3/4 of a point."

> "We are lowering our recommendation of [GHI], Inc. to an Underweight following the S&P downgrade . . . and Moody's placing the ratings under review for downgrade . . . . CDS spreads could go to points up front while cash yields could go to the 6.5% range as investment grade holders exit the name."

> "[P country]: Keep underweight. Keep long basis (23s vs. 10Y CDS) and enter outright long (5Y) CDS protection at the current level of 235bp."

> "[M country]: On a relative basis, we believe 10Y bonds are especially expensive and favor CDS and the long end of the curve. We recommended entering short 10Y basis via selling 10Y CDS vs. 23s . . . which was at the widest level of the past year as a result of cash outperformance."

> "The differential between the average of the three main [N sector companies'] CDS to the index after a strong 2Q earnings season . . . was 90bp, while currently the differential is about 60-70bps . . . . If [the companies in N sector] report a solid 3Q with refined or updated guidance numbers, we think the differential should increase."

9(b)(iv) Do such communications involve SBS other than credit default swaps?

As discussed above,[41] the most commonly discussed SBS in research reports are CDS. This is due to the large, liquid nature of the CDS market, with the most active names trading up to 100 contracts a week, each representing $5 million notional amount of credit exposure.[42] CDS are typically and routinely discussed in research reports published either by fundamental credit analysts, who may use the CDS as one expression of a particular issuer's credit risk in comparison to the outstanding debt securities of that issuer or another issuer, or by credit strategists, who may also use CDS to compare relative credit risk between different issuers. To a lesser degree, SBS research may also discuss other types of instruments and indices, such as TRS, CDX, TRX and options or other derivatives on credit, debt or equity instruments, which may be "securities" for Securities Act purposes depending on the nature of the underlying instrument or index.

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[41] *See* p. 4.

[42] *See* our December 21, 2012 letter, *supra* n. 4.

9(b)(v) Do such communications include information, opinions, or recommendations with respect to securities other than SBS or an analysis of securities other than SBS?

Yes. SBS research often includes information, opinions, recommendations or analysis on securities other than SBS. SBS research may discuss SBS relative to other securities as an indication of market conditions, relationships or relative value. The following are a few examples of such statements taken from research reports discussing SBS recently in the market:

> "Individual single-name CDS and baskets are less liquid than the indices, but more 'customized.' We like using this strategy to hedge exposure to highly specific exposures or risks."

> "We expect loan TRS not only to help address heavy demand for hedging loan market risk, but also to help investors improve cash management. TRS has some advantages over ETFs, including a reduction in both true market tracking error and the complexities associated with the difference in ETF and underlying loan settlements."

> "The CDX indices have outperformed, driven in part by superior liquidity in a healing market environment as well as a lack of rates headwinds that pose risks to the cash bond market . . . upcoming supply is likely forcing money managers to stay light and liquid, which benefits index flows and spreads."

> "Cash spreads fair, CDS better value . . . we think the [QRS] plc 5.2% '24s offered at a G-spread of 182bp are at an appropriate differential to the [JKL] plc 4.25% '24 subs and prefer buying the [CDE] plc 6% '23 subs at a G-Spread of 239bp. However, in CDS, [QRS] plc 5-year levels are more attractive . . . ."

9(b)(vi) Are such communications similar to or different from the research reports contemplated by Rules 137, 138 and 139 of the Securities Act? Please explain in detail. If different or if such communications regarding the SBS and the underlying reference issuers and/or securities do not satisfy the conditions of Rules 137, 138 or 139 of the Securities Act, please explain in detail why such communications should be treated differently from other communications under the Securities Act.

As discussed above,[43] research reports discussing SBS are not materially different from other kinds of securities research reports that the Commission is

[43] *See* p. 8.

well-acquainted with, including those dealt with by the Research Rules. Also as discussed above,[44] because SBS research practices developed under a regulatory regime in which SBS were not "securities" for purposes of the Securities Act, the Commission has not previously needed to clarify the circumstances under which research reports discussing SBS would not constitute an offer to sell the subject SBS for purposes of Section 2(a)(10) or Section 5 of the Securities Act or a general solicitation in the context of an unregistered private placement. As a result, although research reports discussing SBS would be encompassed by the definition of "research report" contained in the Research Rules,[45] none of these rules would provide an exemption in the context of an SBS transaction.

Therefore, the fact that the Commission's existing rules do not accommodate research in the context of an SBS transaction is not evidence of any doubt on the Commission's part over whether such research should be exempted from Section 5 – instead, it is evidence of the fact that the Commission never needed to address the issue before passage of the Dodd-Frank Act. We thus do not believe that SBS research should be treated differently from similar such communications under the Securities Act. Like the treatment of research under the Research Rules, we believe that research in the context of SBS transactions should be exempted from the definition of "offer" under the Securities Act, for the reasons discussed above.

Even if the Research Rules were expanded to cover Section 4(a)(2) private placements, such rules, as currently structured, would inhibit SBS research as it exists today, with SBS dealers or their affiliates publishing and distributing research discussing SBS in which they are, at the same time, transacting and available to transact. Rule 137 provides a safe harbor for research written by a dealer that is not participating in an offering of the subject security; this safe harbor would be inapplicable because SBS dealers regularly transact business in the same SBS that are covered by their research reports. Rule 138 provides a safe harbor for research written about a qualifying issuer's debt securities in the context of an offering of its equity securities, and vice versa; this safe harbor would be inapplicable because a research report discussing SBS may concern the SBS itself. Rule 139 allows for the publication and distribution of research on a security even by a dealer engaged in a transaction involving the security, but for issuer-specific reports the rule is limited in scope to securities of an issuer eligible to use Form S-3 or Form F-3 or, in the case of a non-U.S. company only, a foreign private issuer with equity securities trading on a designated offshore securities market or with a non-affiliated equity float of at least $700 million. Given the bilateral nature of an SBS transaction, it would be unclear whether to

[44] *See* p. 10.

[45] *See* p. 8.

apply Rule 139's issuer requirements to both the SBS dealer (or its public company parent) and to the counterparty (which would be a major hindrance to the usefulness of the safe harbor), or just to the dealer or its parent; or perhaps only to the issuer of the reference security (if any); or to some combination of these entities. The Commission's existing rules therefore will not accommodate ordinary-course research reports discussing SBS.

An exemption from Section 5 for SBS research would not be an expansion of existing Commission precedent, as the Commission has for decades relaxed the regulation of "offers" in order to prevent interference with customary research practices.[46] For instance, the Commission has recognized that even though research reports issued by broker-dealers or their affiliates may contain statements that could be construed as "offers" of the subject securities, the market benefit in permitting the publication of research, even when the broker-dealer may be actively involved in transactions in the subject securities, often may outweigh the potential harm.[47] Likewise, in the unregistered offering context, the Commission in 2005 expressed concern that the restrictions in "Rule 144A on offers to non-qualified institutional buyers and general solicitation have resulted in brokers and dealers unnecessarily withholding regularly published research."[48]

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[46] For example, in analyzing whether a research report would be viewed as a "solicitation" in the context of a Rule 144 sale, the Commission's staff provided guidance in 1978 to the effect that:

> "A broker may issue research reports concerning the issuer of the underlying securities of an option written by its client [covering restricted securities] during the time of such writing and through the time of exercise and delivery of the underlying securities, provided that (i) the reports are issued in the broker's regular course of business; (ii) such reports concerning the issuer have been previously issued by the broker; (iii) the broker receives no consideration from its client in regard to the issuance of such reports; and (iv) the reports are not issued for the purpose of facilitating any aspect of the client's transaction."

Dean Witter Reynolds Inc., SEC No-Action Letter (Oct. 16, 1978).

[47] *See, e.g.*, *Adoption of Rules Relating to Publication of Information and Delivery of Prospectus by Broker-Dealers Prior to or After the Filing of a Registration Statement Under the Securities Act of 1933*, *supra* n. 23 ("It is the purpose of the adopted rules to provide guidance to broker-dealers and to alleviate such requirements where it appears that the purposes and policies of the Act will not be prejudiced while assuring that persons engaged in the distribution of a registered offering and their customers will be supplied with the disclosure afforded by the statutory prospectus.").

[48] *Securities Offering Reform*, *supra* n. 40, 70 FR 44722 at n. 381 (footnotes omitted).

9(c)(i) With respect to communications that some commenters call research, what is the basis for characterizing those communications as research?

As described above,[49] SBS research fits well within the definition of "research report" contained in the Research Rules, since a research report discussing SBS is "a written communication, as defined in Rule 405, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."

9(c)(ii) Do SBS dealers enter into transactions involving the SBS that are the subject of the communications they publish or distribute? If so, why would the SBS dealers not be the issuers of such SBS for purposes of the Securities Act?

As discussed above,[50] SBS dealers regularly transact in SBS that are discussed in research reports. Absent clarification from the Commission to the contrary, it would appear that both the SBS dealer and the ECP counterparty could be considered an "issuer" in the SBS transaction.

9(c)(iii) If SBS dealers are the issuers of such SBS, why should the offering communications contained in those communications not be considered issuer offering materials?

As discussed above,[51] it is because SBS research could be deemed to be "issuer offering materials" that an exemption from the definition of "offer" is requested.

9(d) How are the communications disseminated and to whom are they made available? Are there any restrictions on who may access these communications? Can non-eligible contract participants access these communications?

As discussed above,[52] SBS research is distributed by firms through a variety of different channels, which, depending on the particular firm, may include proprietary distribution platforms as well as third-party research

[49] *See* p. 8.

[50] *See* p. 11.

[51] *See* p. 17.

[52] *See* pp. 9-10.

aggregators, some of which are authorized to offer certain products to the public.[53] As a result, research discussing SBS is made accessible to existing clients of the distributing dealer, including clients that are not ECPs, and in some cases research discussing SBS can be accessed by the public generally.

Discussions of SBS can appear in a variety of different types of research, and a firm may distribute different types of research in different ways, with different restrictions. For example, non-ECP private wealth management clients who do not receive certain types of debt research reports (such as fundamental research on high yield credit markets) due to customer suitability constraints will also not receive SBS research contained in such research reports. On the other hand, the same non-ECP client may receive research discussing SBS in other research reports that it is eligible for.

It would be challenging for firms to restrict access to research discussing SBS only to ECPs, as discussion of SBS is often embedded within general credit research, which is distributed to a broad range of clients. Thus, requiring firms to restrict SBS research to only ECPs would effectively require firms to restrict all credit research to ECPs, as there is no practical way to segregate analysis of SBS and other debt instruments in such research. If research discussing SBS were to be restricted to only ECPs, firms would need to either drop coverage (and other analysis and discussion) of SBS or produce separate reports to continue to provide retail clients with credit research. Producing and distributing two separate reports, and creating the controls necessary to ensure only ECPs have access to research reports discussing SBS, would be operationally difficult, costly and burdensome, as well as unnecessary in light of the fact that only ECPs are permitted to transact in SBS.

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[53] *See supra* n. 17.

9(e) Should we consider alternative approaches to address the commenters' concerns regarding the use of communications that the commenters characterize as research? For example, should we consider a rule that would provide as follows: An SBS dealer's publication or distribution of a written communication that includes information, opinions, or recommendations with respect to SBS or an analysis of SBS would be considered for purposes of Section 5 of the Securities Act not to constitute an offer of such SBS or any guarantees of such SBS that are securities if such written communication (i) does not include strategies for buying or selling SBS and (ii) is included in an issuer-specific or industry research report that also includes information, opinions, or recommendations with respect to or an analysis of different types of securities other than only SBS? Are there other alternative approaches that we should consider that may address the commenters' concerns regarding the effect that the publication or distribution of the communication may have on the availability of an exemption from the registration requirements of the Securities Act? If so, please provide detailed explanations.

The Commission does not condition the availability of the Research Rules on such requirements as not offering buy or sell recommendations, or including an analysis of multiple types of securities, and we do not see any rationale for doing so in the context of SBS transactions.

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We would be pleased to answer any additional questions the Commission or its staff may have with respect to the matters discussed in this letter, or to provide any additional information that would be helpful in analyzing the request set forth herein. Please feel free to contact the undersigned, or our counsel at Davis Polk & Wardwell LLP, Annette L. Nazareth at [redacted] or Joseph A. Hall at ([redacted]

Very truly yours,

Kyle Brandon
Managing Director
Securities Industry and Financial
Markets Association

Attachment: Annex A – Sample SBS Research Reports

cc: Hon. Mary Jo White, Chair
Hon. Luis A. Aguilar, Commissioner
Hon. Daniel M. Gallagher, Commissioner
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
Mr. Keith F. Higgins, Director, Division of Corporation Finance
Ms. Amy Starr, Chief, Office of Capital Markets Trends, Division of Corporation Finance
Mr. Andrew Schoeffler, Special Counsel, Office of Capital Markets Trends, Division of Corporation Finance

Annex A

Sample SBS Research Reports

Rating Change - Credit

High Grade | United States | Electric Utilities
15 July 2014

FirstEnergy Corp.: Raising CDS rating to Overweight-30%

Bank of America Merrill Lynch

Peter D. Quinn, CFA +1 646 855 8284
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Raising FE CDS to OW-30% from UW-30%

We are raising our rating on FirstEnergy Corp. CDS to Overweight-30% from Underweight-30%, following Moody's revision this afternoon of the credit outlook of FirstEnergy Corp. to Stable from Negative. Our Overweight-30% rating on FirstEnergy Corp.'s cash bonds remains unchanged.

CDS referencing FE's Baa3/BB+/BB+ bonds is in IG index

Our prior rating on FirstEnergy Corp. CDS of Underweight-30% reflected 1) our expectation that common sense would drop it from the investment grade CDX index, given the Baa3/BB+/BB+ credit ratings of its senior unsecured securities which CDS contracts reference (the bonds are in our and others' high yield, not investment grade, index), and 2) our expectation that there was a reasonable probability that Moody's might downgrade the Baa3 rating, following the conclusion of the Jersey Central Power & Light rate case which is still underway, which would make all three senior secured ratings high yield and leave little hope of remaining in the investment grade CDX index.

Moody's raises FirstEnergy outlook to stable from negative

However, this afternoon Moody's affirmed the Baa3 senior unsecured rating of FirstEnergy Corp. and revised the outlook to Stable from Negative. (Moody's also upgraded the ratings of six of FirstEnergy's utility subsidiaries: Metropolitan Edison, Monongahela Power, Ohio Edison, Pennsylvania Power, Potomac Edison and West Penn Power). The negative outlook had been in place since February 2013, reflecting headwinds facing FirstEnergy, including increased debt, weakened key financial metrics and reduced financial flexibility, driven by weak operating results at the competitive generation subsidiaries and the financial impact of Hurricane Sandy. Today's change of outlook "reflects a number of credit positive developments over the past year, including a refocus on regulated operations and transmission, an improving outlook for the merchant markets and strong capacity revenues in the next few years, a dividend reduction at FE and the upgrade of several of FE's utility subsidiaries. In addition, we expect FE's consolidated financial ratios to improve in 2015-16 to levels consistent with our expectations for its current Baa3 rating, such as CFO-pre WC to debt of 13-14%, CFO-pre WC interest coverage of about 3.5x, and retained cash flow to debt of about 10-11%,." Moody's said.

Index technicals play a key role

The primary risk to our revised rating is that FirstEnergy CDS (5 years: 103 bp, 10 tighter on the day) is dropped from the 125-member investment grade CDX index (5 years: 58 bp). Should that happen, we expect that investors who are naturally long the credit simply because it is in the high grade index, would unwind their long positions, thereby forcing FirstEnergy CDS levels out towards those of the high yield CDX index (5 years: 304 bp).

Exhibit 1: BofAML RelVal Recommendations

To Overweight-30% From Underweight-30%
FirstEnergy Corp. (CDS)
Overweight-30%
Cleveland Electric Illuminating FMBs
FirstEnergy Corp. (cash bonds)
Jersey Central Pow er & Light
Metropolitan Edison
Monongahela Pow er
Ohio Edison
Pennsylvania Electric
Toledo Edison (sec'd)
West Penn Pow er
Underweight 30%
Allegheny Energy Supply
Cleveland Electric Illuminating Notes
FES Bruce Mansfield
FirstEnergy Solutions

Source: BofA Merrill Lynch Global Research.

Refer to important disclosures on page 4 to 7. Analyst Certification on Page 2. Link to Definitions on page 2.

Link to Definitions

Credit

Click here for definitions of commonly used terms.

Analyst Certification

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Security pricing

Allegheny Energy Supply / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
5.75, Notes, USD, 2019:B	350	15-OCT-2019	Baa3/BBB-/WD	109.27	14-Jul-2014	3.78	209
6.75, Notes, USD, 2039:B	250	15-OCT-2039	Baa3/BBB-/WD	101.61	14-Jul-2014	6.62	407

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Bruce Mansfield / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
6.85, Pass-thru Certificate, USD, 2034:B	1,050	01-JUN-2034	Baa3/BBB-/N.A.	107.84	14-Jul-2014	5.74	320

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FirstEnergy Corp. / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
2.75, Senior Notes, USD, 2018:B	650	15-Mar-2018	Baa3/BB+/BB+	101.06	14-Jul-2014	2.44	122
4.25, Senior Notes, USD, 2023:B	850	15-Mar-2023	Baa3/BB+/BB+	99.50	14-Jul-2014	4.32	188
7.375, Senior Notes, USD, 2031:B	1,500	15-NOV-2031	Baa3/BB+/BB+	118.40	14-Jul-2014	5.69	261
Senior Unsecured, USD, Y5, CDS					15-Jul-2014		103

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FirstEnergy Solutions / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
6.05, Senior Notes, USD, 2021:B	332	15-AUG-2021	Baa3/BBB-/WD	110.62	14-Jul-2014	4.30	212
6.8, Senior Notes, USD, 2039:B	363	15-AUG-2039	Baa3/BBB-/WD	108.11	14-Jul-2014	6.16	286

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Jersey Central Power and Light Co. / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
5.625, Senior Notes, USD, 2016:B	300	01-MAY-2016	Baa2/BBB-/WD	107.65	14-Jul-2014	1.30	83
5.65, Senior Notes, USD, 2017:B	250	01-JUN-2017	Baa2/BBB-/WD	110.88	14-Jul-2014	1.76	81
7.35, Senior Notes, USD, 2019:B	300	01-FEB-2019	Baa2/BBB-/WD	120.42	14-Jul-2014	2.56	102
6.15, Senior Notes, USD, 2037:B	273	01-JUN-2037	Baa2/BBB-/WD	114.66	14-Jul-2014	5.06	181

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Monongahela Power / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
4.1, First Mortgage Bonds, USD, 2024:B	400	15-APR-2024	Baa1/BBB+/WD	105.43	14-Jul-2014	3.43	87
5.4, First Mortgage Bonds, USD, 2043:B	600	15-DEC-2043	Baa1/BBB+/WD	113.88	14-Jul-2014	4.53	118

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Ohio Edison Company / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
6.875, Senior Notes, USD, 2036:B	350	15-JUL-2036	Baa2/BBB-/WD	128.64	14-Jul-2014	4.76	153
8.25, First Mortgage Bonds, USD, 2038:B	275	15-OCT-2038	A3/BBB+/WD	153.78	14-Jul-2014	4.56	128

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Cleveland Electric Illuminating Co. / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
7.88, Secured Notes, USD, 2017:B	300	01-NOV-2017	Baa1/BBB+/WD	119.48	14-Jul-2014	1.77	66
8.875, First Mortgage Bonds, USD, 2018:B	300	15-NOV-2018	Baa1/BBB+/WD	126.48	14-Jul-2014	2.40	92
5.5, First Mortgage Bonds, USD, 2024:B	300	15-AUG-2024	Baa1/BBB+/WD	116.09	14-Jul-2014	3.58	96
5.95, Senior Notes, USD, 2036:B	300	15-DEC-2036	Baa3/BBB-/WD	113.00	14-Jul-2014	4.98	174

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Toledo Edison Co. / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
6.15, Senior Notes, USD, 2037:B	300	15-MAY-2037	Baa1/BBB/WD	120.31	14-Jul-2014	4.69	144

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West Penn Power / FE

Security	Amt (Millions)	Maturity date	Ratings Moody's/S&P/Fitch	Price	Price date	Yield (%)	Spread (bps)
5.95, First Mortgage Bonds, USD, 2017:B	275	15-Dec-2017	A3/BBB+/A-	112.71	14-Jul-2014	2.08	92

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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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Goodyear Tire & Rubber Co.

Earnings Review

High Yield Credit | United States | Automotive Tires
30 July 2014

2Q slight beat, but FY14 headwinds surface

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2Q14 slight beat

Goodyear reported 2Q14 revenue of $4,656mn, down -5% YoY and slightly below market consensus of $4,752mn. Adjusted EBITDA for the quarter was $601mn, slightly above market consensus of $596mn. Adjusted EPS of $0.80 was slightly above market consensus of $0.79. Lower revenue from non-tire businesses (most notably third-party chemical sales) more than offset higher revenue from higher tire unit volumes (+3% YoY at 40.6mn tires globally). While revenue was down, segment operating income was up 7% YoY, primarily on improvement in Europe, Middle East and Africa. Despite the improvement YoY, Goodyear lowered its 2014 outlook for price/mix vs. raw materials to "slightly negative" from "slightly positive." The stock is down -7% today, CDS is 10bp wider, and bonds are unchanged to down ¾ of a point.

Maintain OW-30%

We maintain our OW-30% on GT bonds and CDS. While Goodyear became less favorable on the price/mix vs. raw materials outlook this quarter, we note that gross leverage has remained around 3x since the downturn. In addition, the company has proactively addressed its pension and targets pension-adjusted leverage of 2.0-2.1x by 2016. On relative value, GT 6.5% 2021s are offered at a YTW of 4.5% to a March 2016 call, compared to AXL 5.125% 2019s at a YTW of 3.3% to a November 2015 call. GT 6.5% 2021s provide 120bp more yield for extending out by about four months longer than the AXL 5.125% 2019s' call date.

Gross leverage at 3.0x

Goodyear ended the quarter with gross leverage of 3.0x (net 2.3x), down sequentially from 3.2x (net 2.4x) at the end of 1Q14. Adjusted EBITDA for the quarter was $601mn (12.9% margin) after adjusting for rationalizations/asset write-offs/accelerated depreciation ($26mn), charges related to a closed facility in Europe ($10mn), net gains on asset sales ($5mn), and settlement of indirect tax claims ($9mn). This was slightly above market consensus of $596mn. Goodyear ended the quarter with total debt of $6,762mn and $1,637mn of cash and cash equivalents. In 2Q14, free cash flow from operations was $314mn, down from $357mn last year, largely explained by working capital being a use this year relative to a source last year.

2014-2016 targets reaffirmed, but 2014 outlook weaker

Goodyear left its 2014-2016 targets unchanged, but did provide a somewhat weaker 2014 outlook. Goodyear still expects global volume growth of 2-3% this year. However, the company lowered its price/mix vs. raw materials outlook to "slightly negative" from "slightly positive" due to headwinds in off-the-road and a lower than expected raw materials benefit. Goodyear targets annual positive free cash flow from operations in 2014 through 2016 and expects to bring pension-adjusted leverage to 2.0-2.1x by 2016.

Table 1: Ratings & Recommendations

Agency Ratings	Sr Unsecured
Mdys/S&P/Fitch	B1/B+/B
Outlooks	P/P/P
BofAML Credit Recommendations	
Bonds	OW-30%
CDS	OW-30%

Source: Moody's, S&P, Fitch, BofAML Global Research

Table 2: Pricing

Sr Unsecured	Price	YTW	Z-Spread
8.750% 2020	120.000	4.9%	291
6.500% 2021	107.500	4.5%	397
7.000% 2022	110.000	4.3%	324
CDS			250

Source: BofAML Global Research
Levels are offer side.

Refer to important disclosures on page 3 to 5. Analyst Certification on Page 2. Link to Definitions on page 2.

NA and EMEA margins rise, LA and APAC margins fall

North America revenue was down -7% YoY to $2.0bn due primarily to a decline in sales third-party chemical sales and lower price/mix. Tire unit volumes were up 3% YoY. Segment operating margin improved to 10.2% from 9.3% a year ago primarily driven by higher replacement tire volume.

Europe, Middle East and Africa revenue was about unchanged YoY at $1.6bn as a 3% increase in tire unit volume and favorable foreign currency translation was partially offset by unfavorable price/mix. Segment operating margin rose to 7.4% from 3.2% a year ago, primarily due to higher tire volume and cost reduction actions, including savings from the closure of a tire plant in Amiens, France.

Latin America revenue fell -8% YoY to $489mn, on a 2% decrease in tire unit volume and unfavorable foreign currency translation, partially offset by improved price/mix. Segment operating margin was 12.1%, down from 15.4% a year ago, primarily due to the effects of continuing challenges in the operating environment in Venezuela, inflationary cost increases, lower original equipment volume, and plant expansion costs in Brazil, partially offset by favorable price/mix.

Asia Pacific revenue was down -7% YoY to $543mn, as a 5% increase in tire unit volume was offset by unfavorable price/mix and unfavorable foreign currency translation. Segment operating margin was 14.0%, down from 15.6% a year ago, driven by weak market demand for off-the-road tires and unfavorable foreign currency translation.

Link to Definitions

Credit

Click here for definitions of commonly used terms.

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Opinion history

Goodyear Tire & Rubber Co. / GT

Company	Date^	Action	Recommendation
Goodyear Tire & Rubber Co. / GT	30-Jun-2013		Overweight-30%
Security	**Date^**	**Action**	**Recommendation**
6.5, Senior, USD, 2021:B	30-Jun-2013		Overweight-30%
7, Senior, USD, 2028:B	30-Jun-2013		Overweight-30%
5-Year CDS:CDS	30-Jun-2013		Overweight-30%

Table reflects credit opinion history as of previous business day's close. ^First date of recommendation within last 12 months. The BofA Merrill Lynch Credit Opinion key is contained below.
B=Bond; CS=Capital Security (Not including Equity Preferred); CDS=Credit Default Swap

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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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High Yield | Homebuilding
North America

Pulte Group (PHM) 3Q14 Earnings Recap

OK Quarter; Step Up in Shareholder Friendly Activity & Land Spend Concerning

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- **Citi's Take** — PHM reported in-line results, with deliveries down ~4% YoY and gross margins up sequentially (but down 60bp YoY). PHM also announced today a 60% increase in their quarterly dividend to $0.08 per share (from $0.05 per share) and an additional $750mm share buyback authorization.
- **Key 3Q14 Operating Stats** — see PHM model snapshot.
  - **Revenue:** $1.60B (+0.8% YoY) vs. our estimate $1.57B and consensus $1.58B
  - **Gross Margin (ex. interest):** 26.6% (+170bp YoY; -60bp QoQ)
  - **EBITDA**: $288mm vs. our estimate $270mm and consensus $289mm
  - **Deliveries (units):** -3.5% YoY to 4,646 vs. our estimate -3.2% YoY
  - **ASP:** $334k (+7.7% YoY) vs. our estimate $329k (+6.0% YoY). Centex ASPs were flat ($204k) while Pulte Homes ASPs +11% YoY ($410k) and Del Webb +6% ($322k)
  - **Mix:** 46% Pulte (vs. 45% 2Q14), 30% Del Webb (Active Adult segment; vs. 32% 2Q14), 24% Centex (First-time buyer segment; vs. 23% 2Q14)
  - **New Orders:** -0.1% YoY to 3,779 vs. our estimate +2.5%
  - **Cash:** $1,222mm (ex. $25mm unrestricted cash)
  - **Debt/Cap:** 27.8% (-30bp QoQ); Net Debt/Cap: 11.2% (-100bp QoQ)
- **Shareholder Friendly Moves:** Concurrent with the earnings release, PHM announced a 60% increase in its dividend + additional share repurchase authorization to $750 (PHM had $85mm existing authorization).
- **Credit Implications** — We maintain Marketweight on PHM due to improving industry fundamentals and solid balance sheet. We rate all PHM notes Neutral, noting we are concerned up step up in shareholder friendly activity and land spend. We think PHM (Ba1/BB+) CDS quoted at 155/170bp is fairly valued relative to DHI (Ba1/BB) at 153/168bp and TOL (Ba1/BB+) at 155/170bp. We think HOV CDS (523/543 bp) is attractive when north of 500bp given our expectation for a multi-year recovery in housing.

Conference Call Highlights

- **Capital Allocation & Leverage:** Concurrent with the earnings release, PHM announced a 60% increase in its dividend + additional share repurchase authorization to $750 (PHM had $85mm existing authorization). Shareholder rewards will be of greater priority going forward, both via dividend (yield target of 2-3%) and ongoing stock buybacks. PHM sees keeping gross leverage in 30-40% range, but may go outside for M&A.

- **Land Spend:** 3Q land spend was $525mm ($1.25B YTD). PHM expects to spend closer to $1.8B for FY14 than $2.0B guided for, but expects FY15 land spend of $2.4B. Spending is divided roughly 50-50 on land acquisition and development (vs. 2/3 and 1/3, respectively, two years ago). Mgmt. said they don't want to be land heavy this time around, and refuted claims they are chasing land.

- **M&A:** PHM announced that on 8/25/14 they had acquired certain real estate assets from Dominion Homes, including control of ~8.2k lots and the assumption of 622 homes in backlog. 3Q14 results included 64 orders and 86 deliveries from 33 communities. Management mentioned they remain focused on M&A opportunities, which they view as land transactions.

- **Community Count:** 600, including 33 Dominion communities. Ex that, 567 communities (in line with guidance of 560-580 communities).

- **Regions:** Florida and Carolinas were particularly strong; Midwest was generally steady; Southwest (Phoenix, Las Vegas) and Southern CA improving; continued slow demand on the East coast; Texas easing from "unsustainable" conditions; increased volatility in Northern CA.

- **Margin Pressure:** Gross margins were down YoY due to acquisition accounting from the purchase of Dominion in August (ongoing hit of 20-30bp for the next 2-3 quarters) + unexpected legacy close-out costs + mix shift (more lower-margin Centex and fewer higher-margin Del Webb closings coming through)

- **FHFA:** Mgmt. is encouraged by comments made this week (10/20/14) by Director Mel Watt at the MBA Annual Convention to develop guidelines for mortgages with LTVs of 95-97%, given tight mortgage availability especially for first-time homebuyers.

- **Labor Shortages:** Similar to many 2Q calls, PHM reported ongoing tightness in the labor market. They expect some delays in closings as a result of shortages, but that it is more pronounced among the smaller builders.

- **Related Research**

  – **10/23/14:** Pultegroup Inc (PHM) - 3Q14 EBIT Inline. Relative to Consensus, Closings & Net Orders 2% % 5%, Light, Respectively, While Backlog 6% Better

  – **10/22/14:** HY Homebuilder Preview: 3Q/4Q14

Figure 1. PHM Model Snapshot: 3Q14

	12/31/10 2010A	12/31/11 2011A	12/31/12 2012A	12/31/13 2013A	9/30/13 3Q13	12/31/13 4Q13	3/31/14 1Q14	6/30/14 2Q14	9/30/14 3Q14	3Q14E
Rating (Moody's/S&P)	(B1/BB-)	(B1/BB-)	(B1/BB-)	(B1/BB-)	(Ba3/BB)	(Ba3/BB)	(Ba3/BB)	(Ba2/BB+)	(Ba1/BB+)	(Ba1/BB+)
Concensus Estimate										$1,583
Revenue	$4,569	$4,137	$4,846	$5,680	$1,582	$1,655	$1,119	$1,286	$1,595	$1,567
YoY Growth	*11.9%*	*(9.5%)*	*17.1%*	*17.2%*	*21.5%*	*5.6%*	*(3.8%)*	*0.5%*	*0.8%*	*(1.0%)*
Homebuilding Revenue	$4,448	$4,034	$4,685	$5,539	$1,548	$1,625	$1,094	$1,255	$1,561	$1,542
YoY Growth	*12.1%*	*(9.3%)*	*16.2%*	*18.2%*	*23.3%*	*7.0%*	*(2.8%)*	*(0.0%)*	*2.8%*	*1.5%*
Mortgage Finance Revenue	$122	$103	$161	$141	$34	$30	$25	$31	$33	$25
YoY Growth	*3.3%*	*(15.3%)*	*56.1%*	*(12.4%)*	*(27.4%)*	*(37.4%)*	*(32.5%)*	*(20.7%)*	*(2.6%)*	*(27.2%)*
Adjusted EBITDA	$220	$237	$542	$897	$266	$312	$183	$222	$288	$270
Margin	*4.8%*	*5.7%*	*11.2%*	*15.8%*	*16.8%*	*18.8%*	*16.4%*	*17.3%*	*18.1%*	*17.2%*
Net New Orders (units)	15,148	15,215	19,039	18,197	3,781	3,214	4,863	4,778	3,779	3,876
YoY Growth	*6.8%*	*0.4%*	*25.1%*	*(4.4%)*	*-16.8%*	*-18.1%*	*-6.5%*	*-2.2%*	*-0.1%*	*2.5%*
Deliveries (units)	17,095	15,275	16,505	15,654	4,817	4,964	3,436	3,798	4,646	4,662
YoY Growth	*13.9%*	*(10.6%)*	*8.1%*	*(5.2%)*	*9.0%*	*-3.7%*	*-10.4%*	*-8.5%*	*-3.5%*	*-3.2%*
Average Price ($ '000)	$258.5	$258.6	$275.8	$290.8	$310.0	$305.0	$317.0	$328.0	$334.0	$328.6
YoY Growth	*0.3%*	*0.0%*	*6.6%*	*5.4%*	*9.1%*	*6.3%*	*10.4%*	*11.7%*	*7.7%*	*6.0%*
Backlog (units)	3,984	3,924	6,458	7,560	7,522	5,772	7,199	8,179	7,312	7,393
YoY Growth	*(32.8%)*	*(1.5%)*	*64.6%*	*17.1%*	*-2.1%*	*-10.6%*	*-8.0%*	*-4.4%*	*-2.8%*	*-1.7%*
Unrestricted Cash	1,471	1,083	1,405	1,580	1,350	1,580	1,268	1,171	1,222	
Secured Debt	0	0	0	0	0	0	0	0	0	
Other Debt	3,392	3,088	2,510	2,058	2,057	2,058	1,814	1,816	1,817	
Total Debt	$3,392	$3,088	$2,510	$2,058	$2,057	$2,058	$1,814	$1,816	$1,817	
Credit Statistics										
Net HB B/S Debt / LTM EBITDA	0.0x	0.0x	0.0x	0.0x	0.9x	0.5x	0.6x	0.7x	0.6x	
Total HB Debt / Cap	61.4%	61.4%	53.4%	30.7%	31.9%	30.7%	28.0%	28.1%	27.8%	
Net HB B/S Debt / Cap	0.0%	0.0%	0.0%	0.0%	13.6%	9.3%	10.5%	12.2%	11.2%	
Inventory / Net Debt	2.5x	2.4x	4.1x	9.8x	5.5x	8.3x	7.4x	7.7x	7.8x	

Source: Citi Research, Company Filings

Appendix A-1

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D.R. Horton Inc (DHI) — Issuer Portfolio Weighting and Issue Rating History
High Yield Credit Research
Analyst: James P Finnerty

Issuer		Issue				
Weighting	Date	Coupon	Description	Maturity	Rating	Date
MW	19-Oct-12	6.875%	Sr Nts	01-May-13	Neutral (2)	19-Oct-12
					NC	07-Jun-13
		6.125%	Sr Nts	15-Jan-14	Neutral (2)	19-Oct-12
					NC	21-Jul-14
		2.000%	Sr Nts	15-May-14	Neutral (2)	19-Oct-12
					NC	21-Jul-14
		5.625%	Sr Nts	15-Sep-14	Neutral (2)	19-Oct-12
					NC	17-Oct-14
		5.250%	Sr Nts	15-Feb-15	Neutral (2)	19-Oct-12
		5.625%	Sr Nts	15-Jan-16	Neutral (2)	19-Oct-12
		6.500%	Sr Nts	15-Apr-16	Neutral (2)	19-Oct-12
		4.750%	Sr Nts	15-May-17	Neutral (2)	19-Oct-12
		4.375%	Sr Nts	15-Sep-22	Neutral (2)	19-Oct-12
		4.750%	Sr Nts	15-Feb-23	Neutral (2)	26-Mar-13

Coupon	Description	Maturity	Rating	Date
3.625%	Sr Nts	15-Feb-18	Neutral (2)	26-Mar-13
5.750%	Sr Nts	15-Aug-23	Neutral (2)	27-Jan-14
3.750%	Sr Nts	01-Mar-19	Neutral (2)	15-Apr-14

Hovnanian Enterprises Inc (HOV) — Issuer Portfolio Weighting and Issue Rating History
High Yield Credit Research
Analyst: James P Finnerty

Issuer		Issue				
Weighting	Date	Coupon	Description	Maturity	Rating	Date
OW	19-Oct-12	10.625%	1st Lien Nts	15-Oct-16	Neutral (2)	19-Oct-12
					NC	01-Nov-12
		7.250%	1st Lien Nts	15-Oct-20	Buy (1)	19-Oct-12
		2.000%	1st Lien Nts	01-Nov-21	Neutral (2)	19-Oct-12
		5.000%	1st Lien Nts	01-Nov-21	Neutral (2)	19-Oct-12
		9.125%	2nd Lien Nts	15-Nov-20	Buy (1)	19-Oct-12
		6.500%	Sr Nts	15-Jan-14	Neutral (2)	19-Oct-12
					NC	10-Jan-14
		6.375%	Sr Nts	15-Dec-14	Neutral (2)	19-Oct-12
					NC	10-Jan-14
		6.250%	Sr Nts	15-Jan-15	Neutral (2)	19-Oct-12
					NC	21-Jul-14
		11.875%	Sr Nts	15-Oct-15	Neutral (2)	19-Oct-12
		6.250%	Sr Nts	15-Jan-16	Neutral (2)	19-Oct-12
		7.500%	Sr Nts	15-May-16	Neutral (2)	19-Oct-12
		8.625%	Sr Nts	15-Jan-17	Neutral (2)	19-Oct-12
		6.000%	Sr Amort Nts	01-Dec-17	Neutral (2)	19-Oct-12
		7.000%	Sr Nts	15-Jan-19	Buy (1)	27-Jan-14

PulteGroup Inc (PHM) — Issuer Portfolio Weighting and Issue Rating History
High Yield Credit Research
Analyst: James P Finnerty

Issuer		Issue				
Weighting	Date	Coupon	Description	Maturity	Rating	Date
UW	19-Oct-12	6.250%	Sr Nts	15-Feb-13	Neutral (2)	19-Oct-12
MW	27-Jan-14				NC	26-Dec-12
		5.125%	Sr Nts	01-Oct-13	Neutral (2)	19-Oct-12
					NC	26-Dec-12
		5.250%	Sr Nts	15-Jan-14	Neutral (2)	19-Oct-12
					NC	07-Jun-13
		5.700%	Sr Nts	15-May-14	Neutral (2)	19-Oct-12
					NC	07-Jun-13
		5.200%	Sr Nts	15-Feb-15	Neutral (2)	19-Oct-12
					NC	21-Jul-14
		5.250%	Sr Nts	15-Jun-15	Neutral (2)	19-Oct-12
		6.500%	Sr Nts	01-May-16	Sell (3)	19-Oct-12
					Neutral (2)	03-Feb-14
		7.625%	Sr Nts	15-Oct-17	Neutral (2)	19-Oct-12
		7.875%	Sr Nts	15-Jun-32	Neutral (2)	19-Oct-12
		6.375%	Sr Nts	15-May-33	Neutral (2)	19-Oct-12
		6.000%	Sr Nts	15-Feb-35	Neutral (2)	19-Oct-12

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17 October 2014 │ 14 pages

High Yield
North America

Speculative Grade Credit Weekly

Changing Recommendations for a Changing Backdrop

- **180-Degree Turn**: What a difference a day makes. The markets cheered Fed President Bullard's comments Thursday morning, thus ending a prolonged losing streak. With the change in tone, we upgrade our view on high yield to neutral and recommend investors use the strength to position their portfolios for the medium term.
- **Which Recommendations Have Changed?** First, we reverse our preference for loans over bonds. While the view has served us well over the past few months, we now expect bonds to outperform loans. Second, we've recommended avoiding the belly of the high yield curve (i.e. 3-5y) but now expect more dovish Fed forecasts to benefit this segment.
- **Which Recommendations Haven't Changed?** As we stated last week, we continue to prefer to move up in quality and underweight triple-C exposure.

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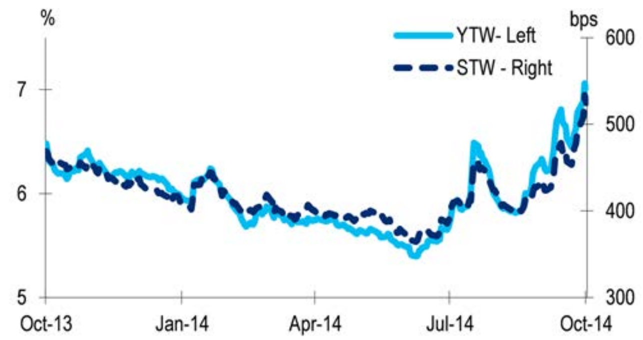
High Yield Market Recap

	Yesterday's Close		Weekly Change		8-Week Average	
	Price	Spread	Price	Spread	Price	Spread
CDX HY 23	104.96	388	-0.18	4	104.98	388
Citi High Yield Market	100.06	525	-0.86	33	102.73	440
BB Index	102.95	385	-0.50	25	104.77	321
B Index	100.87	550	-0.96	36	103.66	459
CCC Index	89.33	930	-1.72	61	94.44	772
Citi Lev Loan Tracker	96.24	419	-0.94	24	97.82	382
Capped Tracker	96.90	416	-0.94	23	98.44	380
CDX IG 23	101.29	74	-0.11	2	101.44	71
Citi US BIG Corporate	109.70	121	0.42	7	108.92	106
BBB Index	110.16	159	0.34	9	109.75	140
S&P 500	1862.76		-43.37		1972.30	

Source: Citi Research

Citi High Yield Market Index, Yield-to-Worst and Spread-to-Worst



Source: Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

That Was Then, This is Now

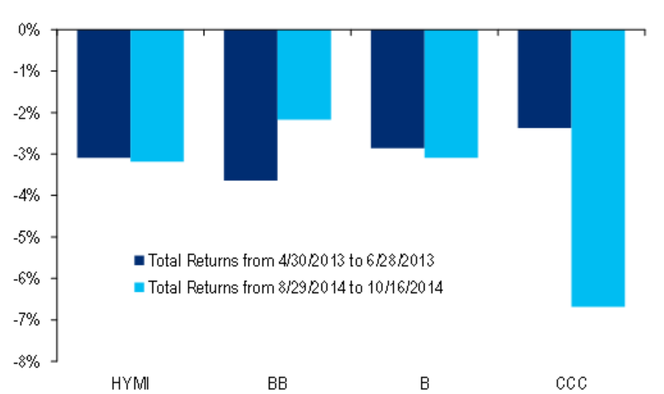
Be careful what you wish for. Back in late spring the market was very quiet and risky assets marched steadily higher in the face of ominously escalating Russian tensions, the rise of ISIS in the Middle East, an overthrow of the Thai government and Brazil's perplexing collapse in the World Cup. We wondered what could disrupt the momentum.

Although high yield led the initial selloff in July, the market has been reasonably resilient recently given the extraordinary upheaval in other asset classes. Admittedly, the price on the High Yield Market Index temporarily slipped below par this week for the first time since mid-2012, but most high yield bonds have held in reasonably well with pain concentrated in certain sectors and in low-quality paper. Through Thursday, double-B credits are down $0.5 in October, versus the $3.5 plunge across the triple-C segment.

This is in stark contrast to last spring's taper tantrum when everything in high yield suffered deep losses. In fact, double-B bonds fell more in May and June 2013 than triple-C bonds. Since Labor Day 2014, triple-C credits have registered losses nearly triple those of double-B credits.

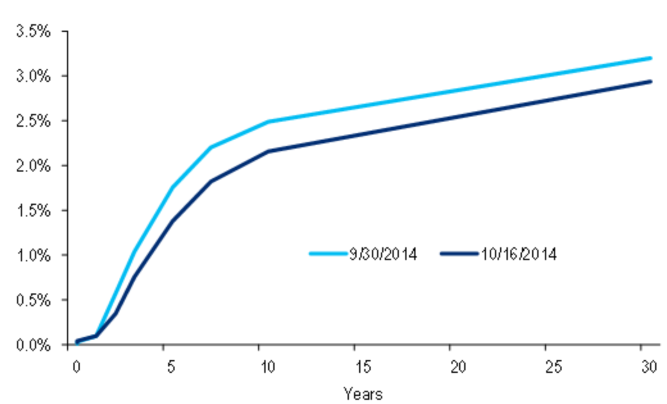
Of course the current environment in September/October is considerably different now than it was last May/June. Treasury yields have moved in the opposite direction to how they moved last spring. This week, the 10-year Treasury yield plummeted to a 16-month low while the 2-year yield fell to an 8-month low. Even with conditions changing by Friday, yields remain subdued relative to recent history.

Recent Selloff Mostly Concentrated in CCC-segment Whereas Losses Were Evenly Distributed During Taper Tantrum



Source: Citi Research, Yield Book

The Treasury Curve has Evolved over the Past Month, Causing Some Recommendation Changes



Source: Citi Research, Bloomberg

Considering how much the rate backdrop has changed, we thought it was a good time to refresh some recommendations we've made recently. We see the shifting Treasury curve as providing valuable information for speculative-grade investors. Last week we mentioned that the minutes from the latest FOMC meeting should be positive for long-duration double-B paper. We continue to believe that. The plunge in 2-year yields mentioned above reflects market expectations of a more dovish Fed which will influence high yield valuations.

As we detail below, we believe the developments mentioned in the prior paragraph will be good for high yield bonds over leveraged loans and we expect short-term high yield bonds (i.e. 3-5y) to benefit from more dovish rate hike forecasts. The one view we have not changed, however, is our underweight to triple-C credits. Although the CCC-Rated Index has lagged the BB/B-Rated Index by 5% since we lowered our triple-C rating to underweight in mid-April, we believe this relationship will widen further over the medium term.

Market View

What a difference a few words and a few minutes make? Fed President Bullard's comments Thursday morning about potentially delaying QE's end helped reverse the market's 6-week decline. It was just three months ago President Bullard said the Fed was "closer to its goals than during most of the past 50 years." This represents quite a reversal, one that should be respected not so much because it will result in a change in policy[1] but rather because of how the market responds. The change in high yield's tone from early Thursday morning to Friday morning was quite striking.

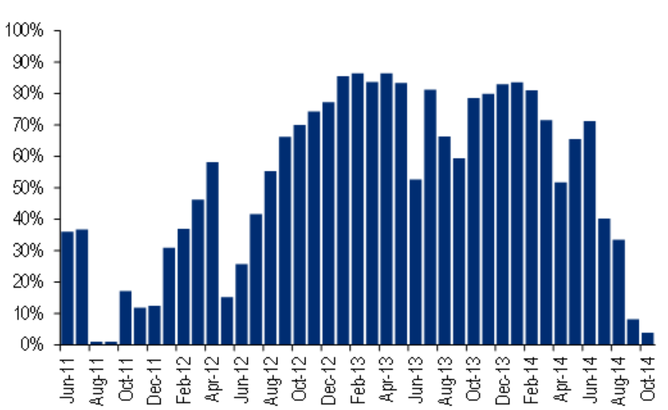
As a result, we move to a neutral stance and recommend investors focus on using the current strength to reposition their portfolios. We summarize two recommendation changes below.

High Yield over Loans

Leveraged loans have outperformed high yield bonds since the late June peak by almost 200bp. At the time, we believed a bear flattening curve would benefit the loan market (because it reflected near-term rate hikes), but we now expect high-quality high yield to outperform loans. We base this view on three factors. First the difference in yield between high yield bonds and loans are at post-taper wides. In addition, given the Treasury rally, the difference in spreads is even greater than the difference in yields. Secondly, considering the shifting Treasury curve mentioned above, we forecast assets with interest-rate duration to outperform over the medium term. Lastly, the Treasury rally leaves loan retail at risk of accelerating outflows.

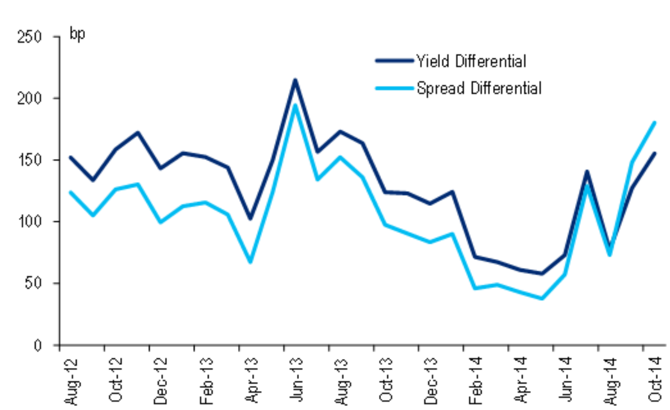
One factor that will help loans is that more loans trade below par than at any time since late 2011. As we've stated in the past, when evaluating relative value between loans and bonds it's important to consider the value of the call option imbedded in loans. In other words, a discount price on leveraged loans partially offsets the three factors underpinning our preference for high yield. Despite this factor, we still believe loans need to reprice wider in order to be competitive with high yield.

Percent of Loans Trading Above Par Drops to 2011 Low



Source: Citi Research, Citi Leveraged Loan Tracker

Yield and Spread Differentials Between HY and Loans are at Post Taper Tantrum Wides



Source: Citi Research, Yield Book, Based on non-distressed issuers with both loans and bonds outstanding, loan yields assume 3-year takeout

[1] A *Wall Street Journal* blog on Friday mentioned Bullard's "limited" influence among "actual Fed policy makers."

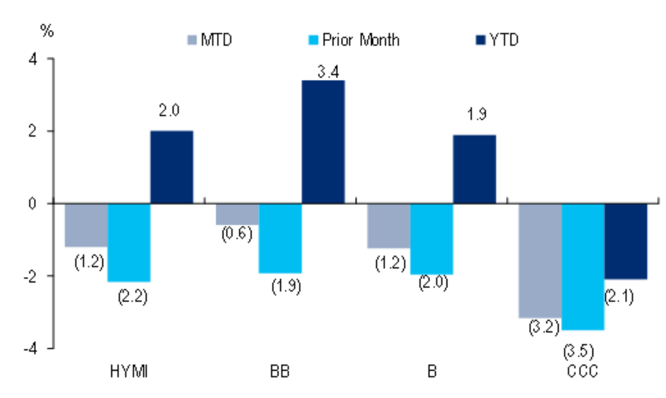
Fill Up in the Belly of Curve

Within high yield, we believe high yield bonds in the belly of the curve (i.e. 3-5y) offer solid risk-reward. These bonds were attractive to investors over the past couple of years because short-term Treasury rates were so low. Since August, however, this segment fell out of favor as investors began to price in Fed rate hikes in 2015. We anticipate these bonds will be attractive again as the high yield market reflects a more dovish Fed.

HY Performance Review (As of Thursday)

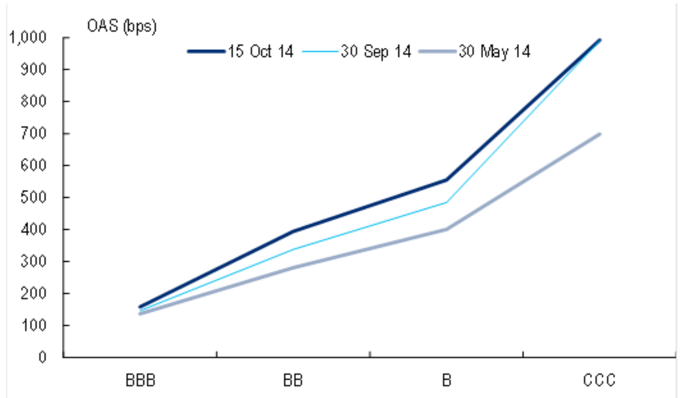
- Citi's High Yield Market Index spread widened 33bp this week through Thursday, with price down $0.86. The index price temporarily dipped below par for the first time since mid-2012 during Tuesday trading. High yield across rating buckets is down month-to-date, with triple-Cs leading the sell-off (-3.20%).
- All high yield sectors have negative returns month to date, with energy (-3.26%) and basic materials (-2.72%) leading the decline.
- The last five days have seen estimated client net buying of $1.5bn, most of that in the BB bucket.

Index MTD Total Returns



Source: Citi Research

HY Risk Curve



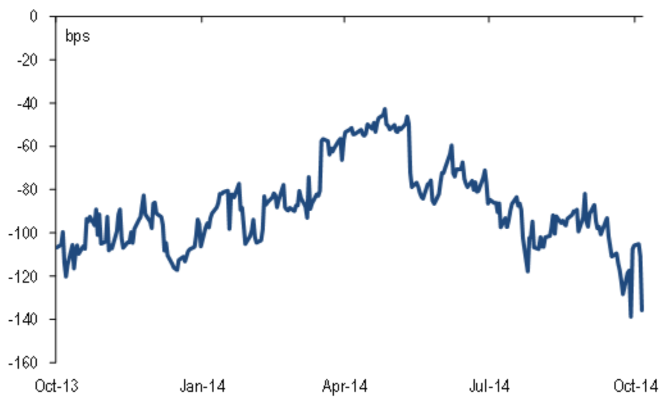
Source: Citi Research

Cash Performance by Sector

Sector	YTW(%)	MTD(%)	YTD(%)	Sector	YTW(%)	MTD(%)	YTD(%)
Auto	4.95	-0.20	4.04	Media	7.45	-0.80	3.60
Basic	8.02	-2.72	-2.52	PaperPack	6.19	-0.20	3.71
Build	5.79	-0.19	3.22	Power	5.88	-0.64	4.81
Consumer	6.40	-0.41	2.65	Retail	7.72	-0.81	1.50
Energy	7.07	-3.26	0.17	Service	7.15	-1.00	1.60
Finance	5.50	-0.25	3.31	Technology	6.41	-1.16	4.45
Health	5.81	-0.29	3.76	Telcab	5.92	-0.65	3.17
Leisure	8.88	-1.66	-3.85	Transport	5.80	-0.23	5.84
Manufact	5.72	-0.05	2.19	HYMI	6.56	-1.21	2.00

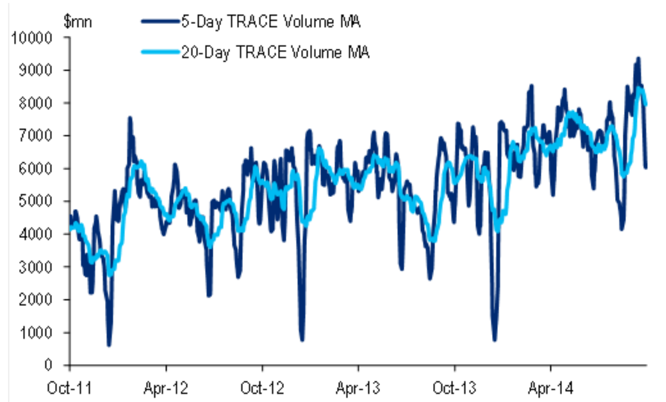
Source: Citi Research

Basis (CDX – Cash)



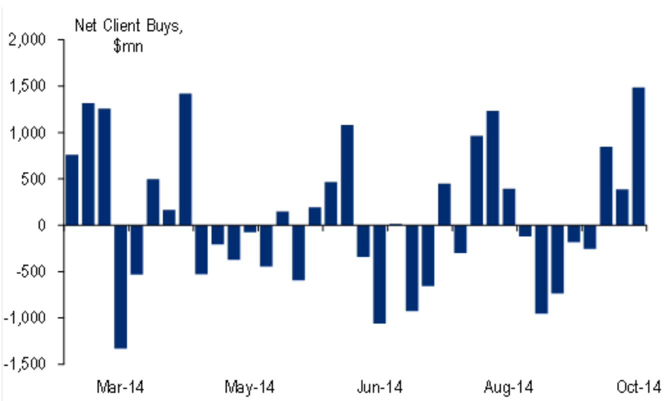
Source: Citi Research, Bloomberg

HY Bonds Traded Volume, 5-Day and 20-Day Moving Averages



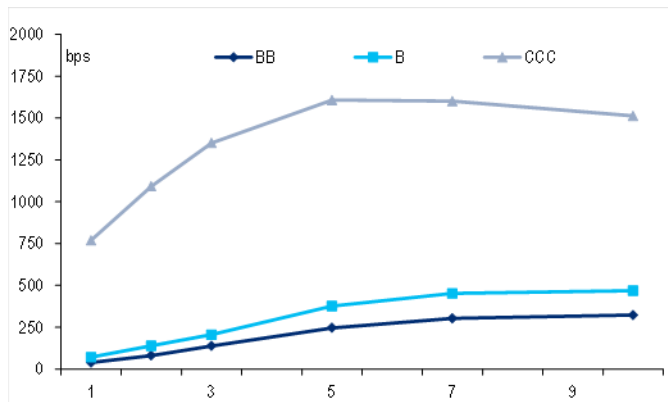
Source: Citi Research, Bloomberg

Weekly Estimated Positioning



Source: Citi Research, TRACE, includes only Dealer-Client trades

Median High Yield CDS by Rating



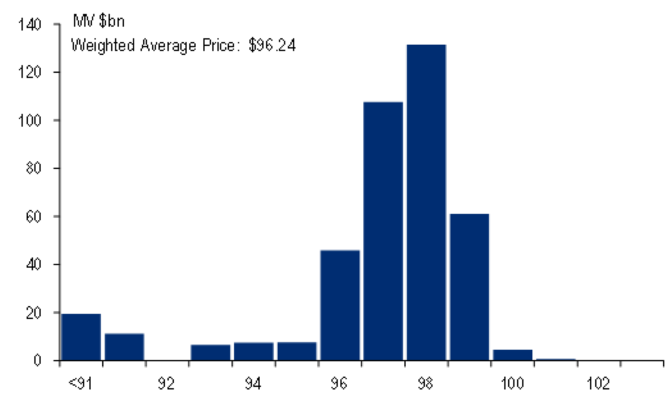
Source: Citi Research

A-27

Leveraged Loan Tracker (As of Thursday)

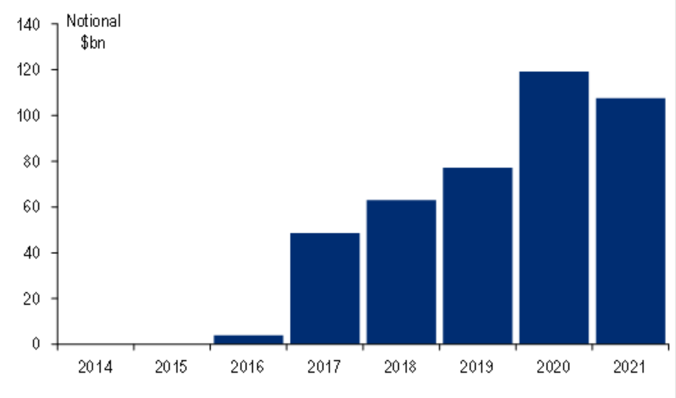
- Loans in the Capped and Uncapped Tracker decreased $0.94 in price since last Friday, with month-to-date return dropping to -0.92% and -1.00% respectively. 2nd-lien Tracker performed the worst, down $1.21 (-1.37% MTD return).
- Power and energy suffered another massive loss this week, down 3.3% and 2.5% respectively, lagging all other sectors. The other sectors returned between -0.42% and -1.53%.

Loan Price Distribution



Source: Citi Research

Maturity Wall



Source: Citi Research, Note: Maturity wall of the loans in the Leveraged Loan Tracker.

Leveraged Loan Tracker, Weighted Average Price and Discount Margin*

Source: Citi Research , * On 4/29, we removed defaulted loan issuers from our discount margin calculations, accounting for the drop in DM seen above

Leveraged Loan Tracker Capped and Uncapped Total Returns by Sector

	Uncapped							Capped						
	Current			Month-to-Date		Year-to-Date		Current			Month-to-Date		Year-to-Date	
	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change	Market Value	Price	Spread	Total Return	Spread Change	Total Return	Spread Change
All Loans	$400,843	96.24	419	-1.00%	30	0.63%	-34	$373,856	96.90	416	-0.92%	30	0.41%	14
Auto Mfg/Vehicle Parts	3.04%	98.65	373	-0.42%	21	1.39%	60	3.26%	98.65	373	-0.42%	21	1.39%	60
Basic Materials	4.90%	96.97	419	-1.14%	36	-0.67%	69	5.26%	96.97	421	-1.14%	38	-0.67%	71
Building/Bldg Products	2.20%	97.48	381	-1.11%	28	-0.14%	26	2.36%	97.48	382	-1.11%	28	-0.14%	26
Consumer Products	5.23%	95.68	368	-0.75%	20	-0.78%	58	4.45%	94.99	389	-0.88%	25	-1.03%	66
Energy	2.49%	94.40	570	-2.50%	87	-2.20%	107	2.67%	94.40	574	-2.50%	90	-2.20%	111
Finance	3.64%	97.93	384	-0.52%	20	0.67%	20	3.90%	97.93	384	-0.52%	20	0.67%	20
Healthcare	12.88%	98.41	359	-0.51%	18	0.76%	29	13.48%	98.39	359	-0.51%	18	0.75%	29
Leisure & Gaming	8.78%	95.90	502	-1.53%	54	-0.65%	119	8.57%	96.34	475	-1.38%	52	-0.38%	90
Manufacturing	4.25%	97.24	398	-0.98%	28	0.32%	54	4.38%	97.23	399	-0.97%	28	0.32%	55
Media & Entertainment	6.75%	96.27	508	-1.28%	40	2.73%	-123	6.77%	96.50	490	-1.12%	37	2.77%	-133
Paper & Packaging	1.15%	97.69	349	-0.54%	19	0.47%	-21	1.23%	97.69	349	-0.54%	19	0.47%	-21
Power	4.15%	78.18	332	-3.30%	27	4.26%	-1235	2.49%	85.34	332	-2.25%	27	1.87%	-611
Retail	12.71%	97.51	415	-0.70%	20	0.63%	26	12.76%	97.45	419	-0.70%	22	0.62%	30
Service	6.94%	96.54	482	-1.03%	31	-0.65%	100	7.43%	96.54	496	-1.03%	45	-0.65%	114
Technology	10.68%	97.73	412	-0.74%	23	0.48%	26	10.35%	97.71	413	-0.77%	25	0.40%	26
Telecom & Cable	8.78%	97.82	394	-0.68%	23	0.64%	33	9.11%	97.82	396	-0.68%	23	0.64%	35
Transportation	1.44%	97.29	370	-1.00%	35	-0.62%	58	1.54%	97.29	370	-1.00%	35	-0.62%	58

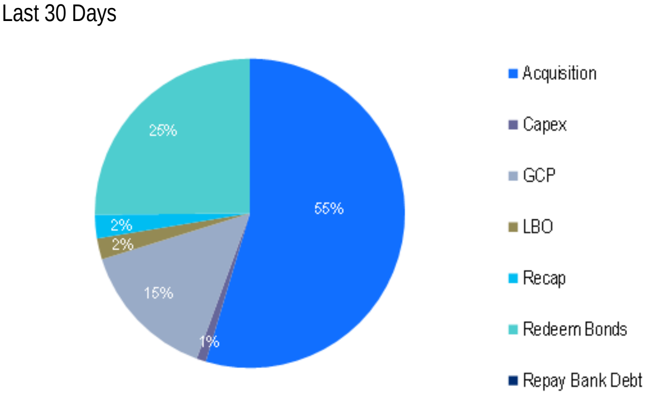
Source: Citi Research, Markit

Issuance Tracker (As of Thursday)

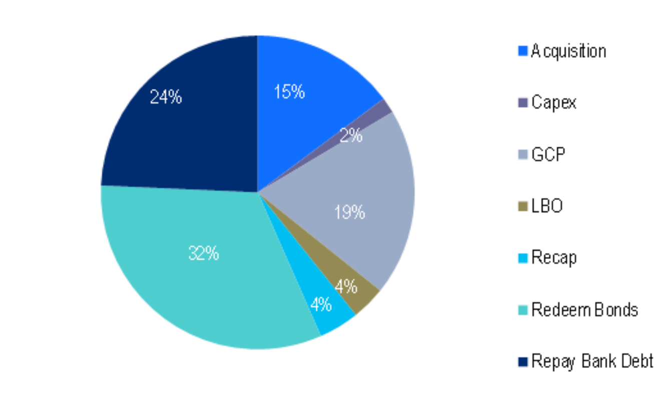
- This week saw no high yield issuance, with YTD issuance at $264bn.
- New issues launched in the week of October 9th rose an average of $1.35 this week, bucking the trend in secondary market performance.
- Over half of the new issuance proceeds were used for acquisitions in the last 30 days, compared to 15% over the last 5 years.

Breakdown of Issuance by Use of Proceeds

Last 30 Days



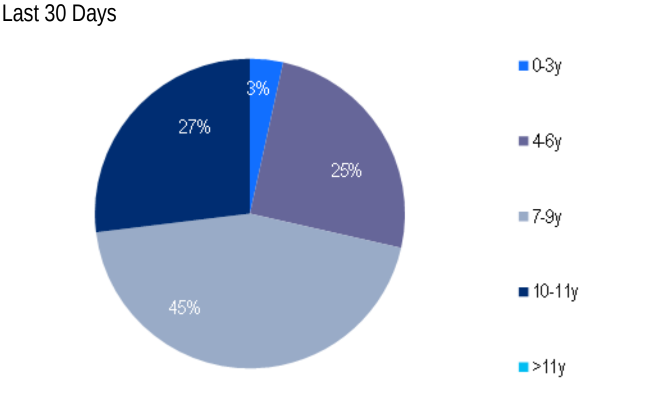
Last 5 Years



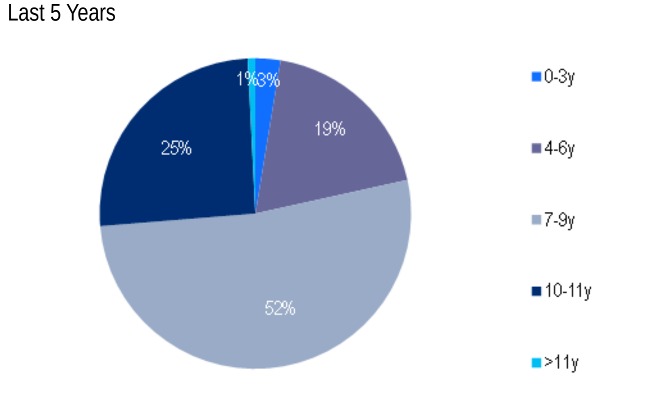
Source: Citi Research, proceeds weighted by par.

Breakdown of Issuance by Maturity Buckets

Last 30 Days

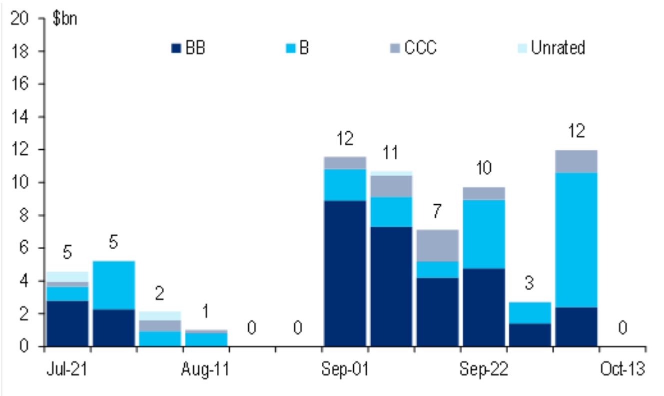


Last 5 Years



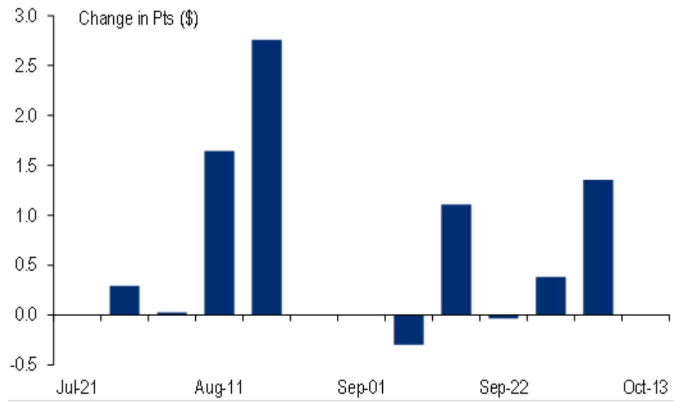
Source: Citi Research, proceeds weighted by par.

Weekly Issuance by Rating



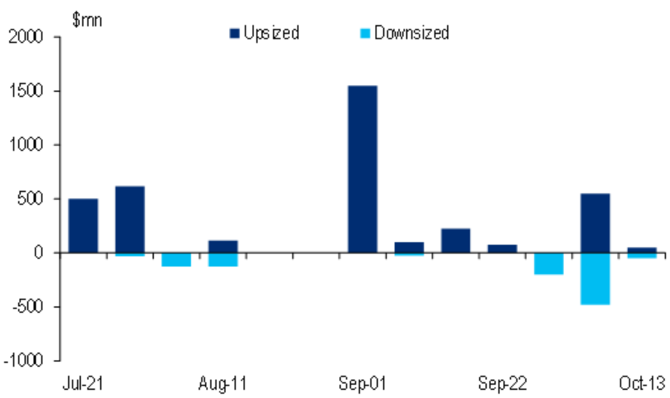
Note: USD denominated issuance only, week starting Monday. Source: Citi Research.

Performance of New Issues (Avg Change in Pts, Par Weighted)



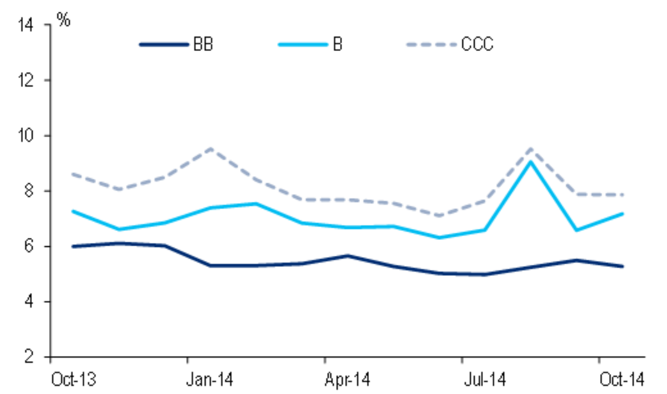
Source: Citi Research, Note: Represents the performance of new issues the week following issue date (through Thursday).

Weekly Upsized/Downsized



Source: Citi Research, week starting Monday.

Weighted Average Coupon by Rating



Source: Citi Research, week starting Monday.

Appendix A-1

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Emerging Markets | Credit Sovereigns | Trade Recommendation | Date 9 May 2014

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EM Sovereign Credit Strategy Update (May 2014)

The following is a compendium of views on sovereign credit strategy, largely based upon the May 2014 Emerging Markets Monthly report. We also use this compendium to replace the EM Sovereign Credit Weekly for this week.

Sovereign Credit: Keeping an eye on the ball

EM performance this year has been solid – led by sovereign credit. While UST has helped, EM credit has outperformed not only US IG but also HY. Differentiation has been a key feature of the market during the past month, with Ukraine and Russia selling off sharply, while the rest of the market continued to perform relatively well.

This underlying positive performance of EM credit is evidence of market participants' acknowledgement of the improving global macro-economic backdrop and has also been supported by improving technicals, with fund flows turning positive on a sustained basis (particularly for hard currency funds) and with a significant proportion of the issuance for the year already completed.

On country selection, we returned from our recent trip to Venezuela more convinced that country-specifics bode for additional outperformance, and are also overweight Colombia. We see long protection in Russia as a more cost-effective expression of our bearish view on Russia and Ukraine and believe Brazil spreads are now too tight. We also hold cash curve steepener recommendations in Turkey, South Africa, the Philippines, and PDVSA, and generally favor short basis (especially in Turkey and Brazil).

Argentina: Neutral. Favour long global bonds, especially the Pars.

Brazil: Underweight. Maintain short basis via 10Y CDS vs. 23s.

Colombia: Move back to overweight from neutral to balance underweight in Brazil. Favour CDS over bonds.

Mexico: Neutral. Continue to see better potential in Pemex via switching to Pemex 45s from UMS 45s. Look to enter short basis.

Peru: Remain neutral.

Venezuela: Overweight. Hold long PDVSA 14s. Favour PDVSA 17Ns and Venezuela 19s. Position for further curve dis-inversion via PDV 17N vs. 35s.

Hungary: Neutral. Valuation looks tight, but both fundamentals and technicals are supportive.

Russia: Keep underweight. Keep long basis (23s vs. 10Y CDS) and enter outright long (5Y) CDS protection at the current level of 235bp.

South Africa: Stay neutral. Hold cash curve steepener of 25s vs. 41s.

Turkey: Stay neutral. Hold 10s30s cash curve steepener, and enter 10Y CDS vs. 43s.

Ukraine: Remain neutral. Favor shorter end of the curve.

Indonesia: Remain neutral. Tactical buy 5Y CDS. Close our long 23Ns vs. 5Y CDS basis trade.

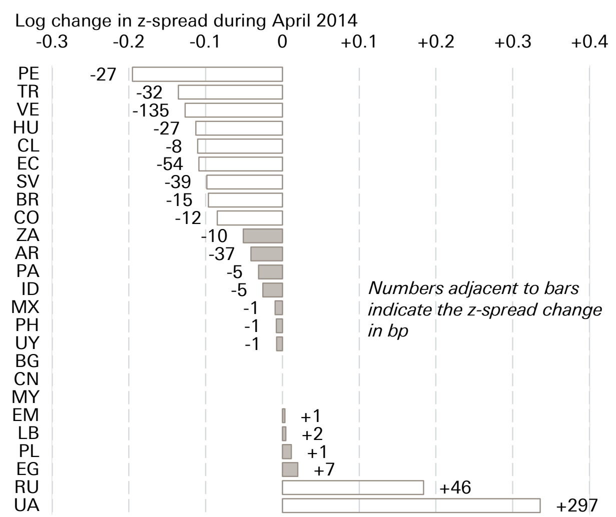
Thailand: Remain neutral. Buy 5Y Thai CDS outright or vs. MALAY 5Y.

EM Sovereign Credit Strategy Update – May 2014

Market Overview: Keeping an eye on the ball

For the majority of the past month the aggregate spread of EM sovereign credit (eg as indicated by the EMBI Global Diversified) has remained in a tight 10bp range. This was in stark contrast to the previous two months which saw a 70bp rally. However, this apparent 'inaction' is somewhat misleading. Differentiation has been a key feature of the market during the past month, with Ukraine and Russia selling off sharply, while the rest of the market continued to perform relatively well. This is clearly evident in the following chart, which shows that the spreads across a significant number of countries tightened by around 10%+ over the month.

Diverse performance of EM credit in April

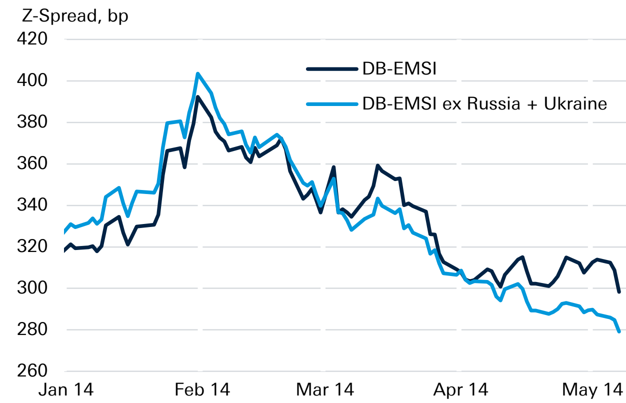


Source: Deutsche Bank

Furthermore, stripping out Russia and Ukraine from the overall index (in this case we use our own market benchmark index, the DB-EMSI) we see that the rally which began at the start of February was only slightly tempered in April.

This underlying positive performance of EM credit is evidence of market participants' acknowledgement of the improving global macro-economic backdrop (as discussed earlier) and has also been supported by improving technicals, with fund flows turning positive on a sustained basis (particularly for hard currency funds) and with a significant proportion of the issuance for the year already completed.

Ex Russia and Ukraine, the market rally continued in April



Source: Deutsche Bank

Where do we go from here? Continuing to focus on the market ex-Russia and Ukraine, we find that the recent rally has taken the spread back to the level it was at in mid-May last year, just before the sharp sell-off. This might suggest that there is little room to rally further, but it is important to consider the extent to which DM credit has tightened since then (partly on the back of improving global growth prospects). Using our usual measure of BBB EM vs. BBB DM credits, (but stripping Russia from the EM index) we find EM to be 30bp wider than global BBB. A year ago it was 30bp tighter. The remaining cheapness is probably justified by the negative rating migration trend among EM credits and this should begin to constrain the extent to which EM can continue to tighten, but while technicals remain strong (and contagion from Ukraine/Russia is limited), the core of EM will likely remain well supported.

With respect to Russia and Ukraine, we continue to believe that the best way to position is with a neutral exposure to Ukraine and an underweight position on Russia. We are not convinced that the recent statements by President Putin (such as calling for the postponement of the referenda in the Eastern regions of Ukraine) signal a decisive de-escalation. Indeed, we use the opportunity of the squeeze in CDS to recommend[1] outright buying of protection on Russia (in addition to our underweight recommendation).

Summary of recommendations:

- Overweights: Colombia, Venezuela

[1] See EM Daily – May 8th "Russia/Ukraine: Fade the squeeze"

- Underweights: Russia, Brazil
- Basis trades: Long basis in Russia (23s v 10Y), short basis in Brazil (10Y v 23s)
- Curve trades: Steepeners in Turkey (sell 10Y CDS vs 43s), South Africa (25s v 41s) and Venezuela (PDV17N v 35s)
- Other: In Mexico, switch to Pemex 45s from UMS 45s.

Country Views and Recommendations

ARGENTINA

- Neutral
- Favour long global bonds, especially the Pars. Constructive on warrants but await better entry levels

Over the past month, the outperformance of Argentina seemed to have stalled with spreads virtually unchanged. Indeed, as we pointed out in our last Monthly, the scope for continued rally in the near term had become more limited as most of the good news was already priced in given the still unresolved legal situation and that policy responses had been inconsistent. Despite recent, further market-friendly policy developments, such as the announcement of plans to introduce subsidy cuts in electricity, prudent wage agreements, progress in the Paris club negotiations, etc., our economists warn of the risk of overconfidence by the government on the back of stabilization of the currency and fx reserves and impatience with the ongoing economic adjustment, and recent inclination of backtracking reflected in the cut of 200bp on open market operations. Overall, we hold the same view as last month in that the potential for further spread tightening is limited though we continue to see value in the carry.

We also continue to favour the global bonds at the long end of the curve, especially the Pars which has cheapened vs. the Discounts recently. We believe the local law curve will be facing significant amount of supplies following the recent approval of compensation agreement with Repsol on YPF expropriation. Specifically, Repsol will receive USD5bn nominal amount of local law bonds, including USD500mm Bonar X, USD1250mm of (local law) Discount 33s, and USD3,250bn of a new Bonar 2024s[2]. Repsol has suggested it would monetize the bonds within a couple of years, but there is likely a risk that this is front-loaded, if market conditions are conducive.

Finally, we remain constructive on GDP warrants as they offer the most leveraged exposure to the better growth prospect in the future, but we await more attractive entry levels for taking a long position (the current level of 7.25; target entry level: 6.6).

BRAZIL

- Underweight
- Maintain short basis via 10Y CDS vs. 23s

The Brazil sub-index has tightened by a further 25bp since the end of March, now trading at -15bp vs. the EM investment grade average compared with +30bp at the end of January, which was the peak of Brazil's underperformance. In our view, this level of valuation is not sufficient to compensate for the risk of continued deterioration of fundamentals characterized by stagflation, worsening BoP, deteriorating fiscal quality, and a challenging policy outlook before and after the elections.

Our baseline projection regarding the election remains that President Rousseff will be re-elected, but only with a tighter race and in the second round. Her popularity will likely continue to decline in the polls, due to the unfavourable economic cycle, as well as an energy crisis, an expected congressional investigation, and difficulties in hosting the World Cup, but probably not enough to derail her chance for re-election, or bring Lula back to replace her as the PT candidate. This dynamic will likely represent an unfavourable scenario for the market, as the PT will likely run the campaign with a strong populist appeal, which will probably not help improve the market's perception about a Rousseff second term.

Based on this assessment, we expected the complacency in the market to be priced out and hence recommended reducing exposure to Brazil back to underweight on May 5[3] (see *Trade Recommendation – Brazil: reduce to underweight and favour short basis* for more details).

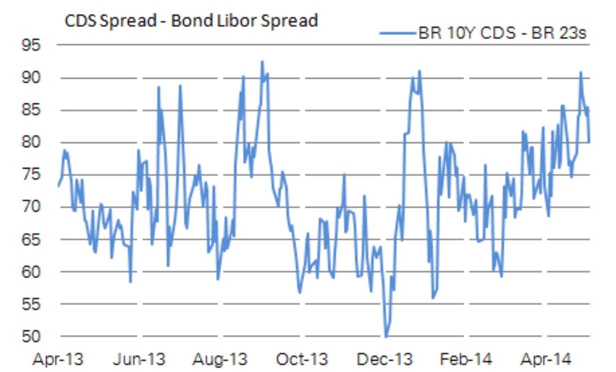
On a relative basis, we believe 10Y bonds are especially expensive and favour CDS and the long end of the curve. We recommended entering short 10Y basis via selling 10Y CDS vs. 23s (entry: 85bp; target: 68bp; stop: 100bp), which was at the widest level of the past year as a result of cash outperformance.

[2] In addition, if within 90 days of settlement the market value of these bonds fall under USD4.7bn, there will be additional bonds totaling up to USD 1.0bn in nominal amount awarded to Repsol (in Boden 15s, Bonar 17s, and Bonar 24s) to plug in the gap.

[3] We covered our long-standing underweight recommendation in January and have been neutral since.

Finally, for our existing relative value recommendations in Brazil, we hold dv01-neutral 5s10s curve flatteners (entered at 58bp, current 53bp, target 45bp, stop 70bp). In addition, we recommend taking profit in the switch from 3% 19s to 7.875% 19s on Petrobras (entry: 60bp; current: 46bp), but maintaining switching from 20s to 23s on BNDES (entry: 55bp; current: 48bp; target: 10bp).

10Y basis in Brazil has been retracing from 1Y wide levels



Source: Deutsche Bank

COLOMBIA

- Move back to overweight from neutral to balance underweight in Brazil
- Favour CDS over bonds

We reduced Colombia to neutral from overweight last month on less attractive valuation and potential volatility stemmed from presidential elections in the coming months. The situation has not changed from the last month- - both fundamentals and technicals remain supportive, and the Colombia sub-index has tightened marginally further vs. EM investment grade average (though offering unimpressive total returns given its relatively low yield). However, Colombia remains our favoured LatAm low beta curve, and in order to balance our underweight position in Brazil, we would move Colombia back to overweight. The main risk to our view is potential volatility of political origin stemmed from presidential campaigns.

Regarding the presidential elections coming up this month, we continue to believe President Santos will be re-elected, albeit only in the second round. We expect the market to price out any lingering risk of re-election failure, which would compromise policy continuity (especially regarding peace negotiations with FARC).

In relative value, the 19s continue to look expensive to the curve and also to CDS. We are biased to selling Brazilian CDS basis trades although we see more attractive short basis trades elsewhere (with better liquidity).

MEXICO

- Stay neutral
- Continue to see better potential in Pemex via switching to Pemex 45s from UMS 45s. Look to enter short basis

Mexico has been underperforming EM investment grade peers during the past three months due to unattractive carry. Solid fundamentals notwithstanding, this trend will likely continue, in our view, given the positive tone in the market outside Russia and Ukraine. However, even though a market-weight exposure to Mexico is punitive in terms of carry, we should increasingly value the defensive feature Mexico bonds offer after the strong performance of EM credits over the past three months, leaving the scope for further outperformance more limited. In addition, with over 70bp yield pickup, Pemex bonds – which are part of the EMBI benchmarks – offer more attractive exposure in lieu of UMS bonds, making the carry of the overall Mexican complex more attractive.

In terms of economic and policy outlook, our economist maintains the view that downside risks to economic activity appears limited going forward, and we expect growth to pick up later in the year. The process in approving the secondary laws related to structured reforms has generally gone slower than expected, with much uncertainty regarding the timing of the secondary laws on telecommunications and energy reforms, but we still expect them to be passed by September. Broadly, the basis underpinning Mexico's medium-term credit improvement remains intact.

In terms of asset selection, we continue to favour Pemex, especially at the long end of the curve, over UMS, at the current spread differential of 77bp. The slope of the UMS curve (10s30s) remains the flattest among LatAm low-beta curves but we find more attractive steepeners elsewhere, such as the Philippines and Turkey. Finally, CDS/bond basis is at the top end of the range, and we will look to enter short basis trades on the curve – at better entry levels.

PERU

- Remain neutral.

Since the end of April, Peru has retraced its previous outperformance on unfavourable valuation. Indeed, the Peru sub-index, despite having one of the longest average duration in EM, was trading 35bp tighter than the EM investment grade average. Now at -20bp, the relative valuation has improved, though Peru still should not be favourably allocated in a market with a positive tone and low volatility. We therefore remain neutral on Peru, and continue to favour Colombia over Peru given the latter's weaker external account and higher sensitivity to metal prices, reflected in its deteriorating terms of trade due to falling Copper prices over the past few months. We favour the long end of the curve (especially the 37s) as Peru 10s30s is the steepest among LatAm low beta curves.

VENEZUELA

– Overweight. Hold long PDVSA 14s. Favour PDVSA 17Ns and Venezuela 19s. Position for further curve dis-inversion via PDV 17N vs. 35s.

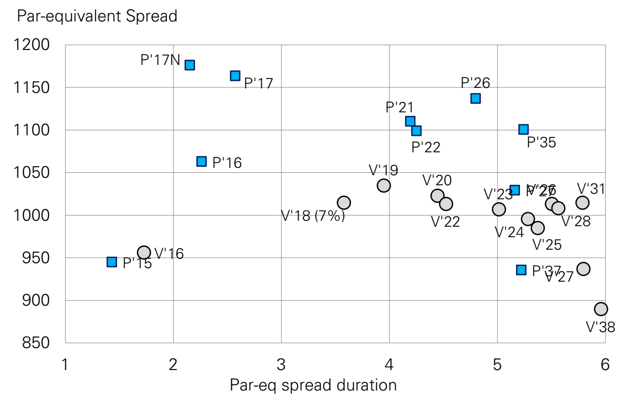
As suggested in *EM Daily of Monday April 28th*, we came back from our investor trip to Venezuela with mixed – but on balance positive – feelings about current policy dynamics (also see special report *Venezuela: the Value of Opportunistic Adjustment* published on 28-April-14 and also included in this Monthly for more details).

While the risk-reward of a long position has clearly become less attractive after the recent rally and positioning has likely gotten heavy, valuation remains attractive vs. the overall EM index (still almost 700bp above the overall EM index, see first chart below), and especially vs. the global high-yield index (at +600bp, in comparison with past 5Y average of 500bp). With the improved risk sentiment towards EM assets recently, we believe an overweight exposure to the Venezuelan complex should be more appropriate at this juncture. However, the extent of recent outperformance, uncertainties over further policy directions and increased positioning suggest one should keep the overweight small at the moment and look to increase on weakness.

We would continue to hold long PDV 14s (to maturity), which we believe PDVSA will pay in full in dollars. We see no justification for PDVSA to consider "bolivarizing" this bond from the perspective of its re-financing ability – it is simply not necessary and it would compromise its debt re-financing and investment strategy if that occurred. Our view was in a way enhanced through our conversations with PDVSA's financial executives during the trip.

We expect continued dis-inversion of the curves and hence retain our preference of the 3-5Y sector. On the sovereign curve, our previously favoured 18s have outperformed; we would now extend to the 19s, which we expect to follow the recent path of rolling down the curve of the 18s and to outperform in spread terms.

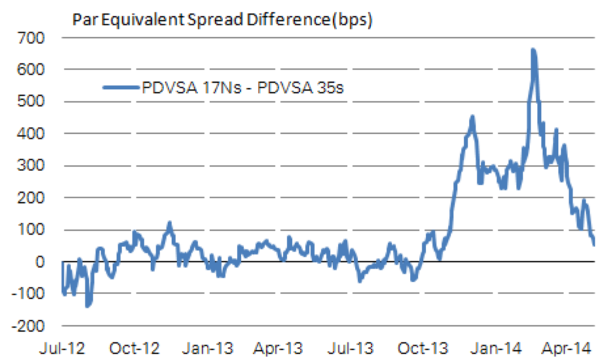
Venezuela and PDVSA curves remain inverted – PDV 17Ns and VEN 19s offer the best valuation



Source: Deutsche Bank

On PDVSA, expected issuance of bolivar-dollar bonds (likely at the long end of the curve) will likely not have a material impact on the performance of the bonds in the near term as the new bonds will only gradually be sold to international markets (just like the 26s). Meanwhile, we believe the potential liability management transactions by PDVSA discussed above will benefit the PDV 15s through 17s, especially the 17Ns, which begin amortizing in 2015 with three equal repayments. We therefore favour the 17Ns, which also offer the widest par-equivalent spreads, and also recommend par-equivalent spread dv01-neutral curve steepeners of 17Ns vs. 35s (entry: 175bp; current: 60bp; extended target: 0bp; tightened stop:100bp).

We expect PDV 17Ns to eventually trade through PDV 35s



Source: Deutsche Bank

RUSSIA

- Keep underweight
- Keep long basis (23s vs. 10Y CDS) and enter outright long (5Y) CDS protection at the current level of 235bp

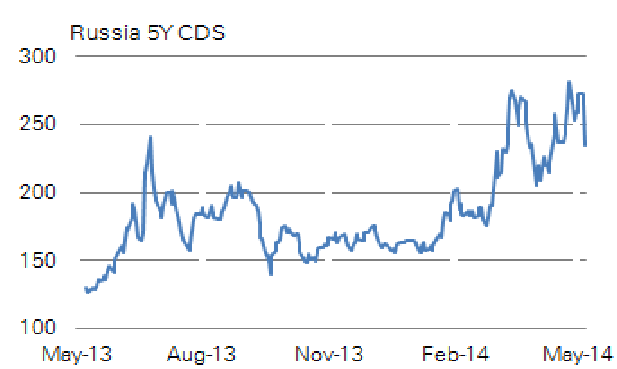
While retaining underweight on Russia in our last Monthly, we were worried about the risk of re-escalation in the Ukraine crisis as we approach the May 25 presidential election in Ukraine. Unfortunately, such a scenario materialized, with intensifying violence in eastern Ukraine and an expansion of sanctions on Russia imposed by the US and EU. Elevated geopolitical risks are accompanied by declining growth, higher inflation, accelerated capital outflows, weaker currency, and a credit ratings downgrade. S&P downgraded Russia's credit rating to BBB- from BBB with a negative outlook, citing "the risk of a marked deterioration in external financing" as well as risks associated with Russia's economic growth prospects. We also expect both Moody's and Fitch to likely follow suit in July when they conduct their scheduled reviews, especially Moody's which had already put Russia on watch for downgrade from its current Baa1 rating.

The tensions eased on Wednesday (May 7) after President Putin rendered a more conciliatory statement, expressing support of the Presidential election in Ukraine and calling for a postponement of the referenda called by separatists. He also stated that some Russian troops had been withdrawn from the border. However, some may see this as merely confirming that the crisis will be chronic, rather than critical. The latest move could also be a tactical play by Putin in a long game of trying to ensure that Russia retains significant economic and political influence over Ukraine. It will be key to see how Kiev and the West respond to this latest move. Initial indications from Kiev and Washington suggest that they are unconvinced and if – as seems likely – the Ukrainian government continues its military operation to regain control in Eastern Ukraine this could create the pretext for Russia to 're-escalate' the situation, overtly – or perhaps more probably, covertly. The May 9 Victory Day celebrations create an imminent potential flash point.

Last month we recommended looking to enter long 5Y CDS, but the rapid deterioration in the situation meant that our suggested entry level remained elusive, until now. With 5Y CDS squeezing sharply down toward 235bp we now see an asymmetric risk profile, with risk tilted towards upside in spreads. We therefore recommend entering long 5Y CDS position as a defensive trade (current: 235bp; target: 280bp; stop: 200bp).

On 30-April-14 (see *EM Sovereign Credit Weekly*) we recommended re-entering long basis in Russia via 23s vs. 10Y CDS (entry: +6bp; current: +23bp; target: +30bp; stop: -10bp), and will keep this position. Russia basis has moved to the opposite directions than the general market trend as real money investors scrambled to reduce their exposure to Russia on the recent re-escalation of the crisis in Ukraine. We see the balance of risk on Russian basis still to the upside as the risk of re-escalation will likely induce renewed demand for protections, while real money positioning has likely significantly lightened

We see an asymmetric risk profile in Russia 5Y CDS levels



Source: Deutsche Bank

UKRAINE

- Remain neutral
- Favour shorter end of the curve

In Ukraine, the risk scenario we envisioned in our last Monthly of a re-escalation of unrest in the Eastern Ukraine materialized. Tensions have eased somewhat following Putin's remarks, but we continue to see downside risk after the squeeze on Wednesday. However, we continue to use our underweight recommendation on Russia to express our core view on the direction of the geopolitical crisis, and hence stay neutral Ukraine at the moment – the high yields of Ukrainian bonds and strong external financial support should help limit the downside.

We favor the shorter end of the curve on a relative basis as a conservative asset allocation strategy. The IMF support should limit default risk over the near term and yet the way the curve is currently priced (with bonds from 2Y-10Y priced in a very narrow 85-86 range) suggests a high probability of default, but with a high recovery value. If the situation deteriorates once again, losses (in price terms) on short-dated bonds are unlikely to be greater than those on long-dated bonds, and yet if there were to be a significant improvement, short-end bonds should benefit relatively more.

TURKEY

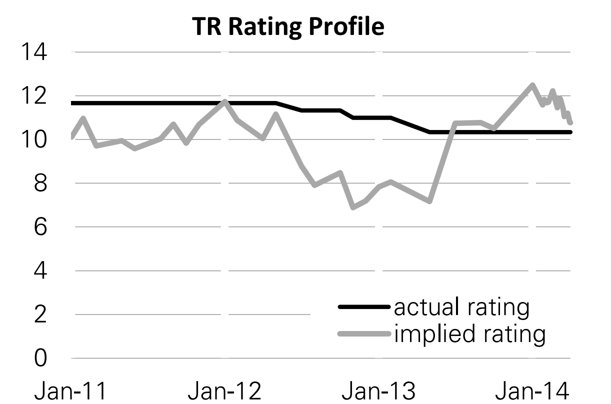
- Stay neutral
- Hold 10s30s cash curve steepener, and enter 10Y CDS vs. 43s

Since AKP's local election victory on March 30, the Turkish sub-index has tightened by 60bp vs. EM investment grade average and is currently trading at +60bp over. The strong recovery of Turkish credit spread has brought the relative valuation of Turkey so much closer to the levels prior to May 2013.

Indeed, the much less attractive valuation can also be seen from the perspective of market implied credit rating vs. actual rating. Fitch has recently affirmed Turkey's credit rating (BBB-) and stable outlook. Moody's (Baa2) revised its outlook lower to Negative from Stable on April 11, while maintaining its credit rating at Baa3. S&P currently hold a BB+(u) with negative outlook and is due to review its rating on May 23, but we believe it will likely keep the rating at the current level. Market pricing is now implying an average rating between BB+ and BBB-, pretty much consistent with its actual rating (see graph below), leaving little cushion against any deterioration of its credit quality, which is currently on a deterioration path in our view.

Domestic political risks are probably now mostly priced though the upcoming (end-May) anniversary of the Gezi Park protests and later on the presidential elections scheduled for this summer could create some volatility. The economy has shown some resilience in the face of political turbulence, weaker capital flows, and higher interest rates, but the risk for CBT to continue easing in spite of the higher than expected inflations is high. This will put the bank's credibility to test once again, and at the same time, could also bring the current account deficit back into the spotlight, casting doubts on Turkey's macro adjustment to reduce its external vulnerability.

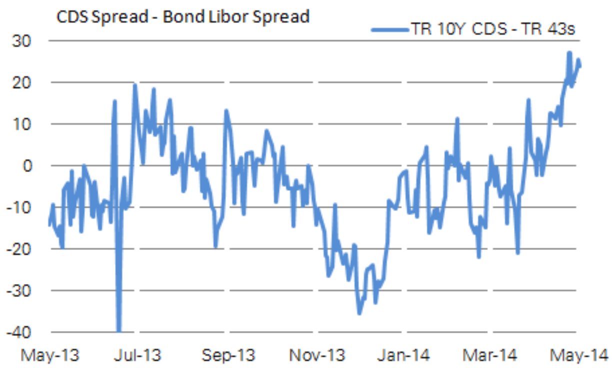
Market pricing on Turkey is in line with its actual rating



Source: Deutsche Bank

While keeping a neutral position, we favor the 10Y sector of the curve vs. the long end and also favor CDS over cash. Our previous steepener recommendation (22Ns vs. 41s) has moved in our favor and we recommend taking profit on that position, the curve slope measured by other bond pairs remains flatter than comparables. In our April 30 *EM Sovereign Credit Weekly*, we also recommended short basis via 10Y CDS vs. 23s as basis had moved beyond the levels justified by the historical relationships thanks in part to flows of money redirected from exposure to the CIS regions. Overall, combining our view of curve being too flat and basis being too wide, we now recommend also selling 10Y CDS vs. 43s (current: 23bp; target: -5bp; stop: 35bp)

Curve steepener via selling 10Y CDS vs. 30Y bonds offers attractive entry levels



Source: Deutsche Bank

HUNGARY

– Remain neutral. Valuation looks tight, but both fundamentals and technicals are supportive

The Hungary sub-index has outperformed the EM benchmark by about 20bp over the past month, following the general market rally which saw higher yielding credits generally outperforming. We see the balance of risk being slightly to the downside with the 10Y spread now comparable to the average level of EM investment grade credits, while there is limited potential for Hungary to be upgraded to investment grade in the near term. On the other hand, we also think the valuation is broadly justified by fundamentals, with strong economic recovery and subdued inflation, and improving fiscal and external accounts. On the negative side, policy risk remains as Fidesz – which won a supermajority in last month's general elections – is expected to continue with its populist and interventionist policies, potentially deterring foreign investment.

Technical conditions in terms of supply/demand are supportive, with more than USD3.0bln redemptions scheduled during the remainder of the year and at most USD1.5bn Eurobonds still to be sold according to AKK's original plan, but in fact AKK recently announced that further Eurobond issuance may not be needed this year if there is strong demand for forint-denominated government bonds. We believe the change of instrument from the two-week NBH bill to a two-week deposit facility will indeed likely attract higher demand in forint government bonds and bills, especially from non-residents.

We continue to favor long end of the curve (41s) at the moment as the REPHUN curve is still very steep in comparison with peers with similar spread levels.

SOUTH AFRICA

– Stay neutral

– Hold cash curve steepener of 25s vs. 41s

South Africa was one of the best performers in EM during Q1, but has slightly underperformed the EM investment grade average since the end of March. We believe the recent weaker than expected growth numbers, proximity to national elections, and ongoing strikes in the mining sector have weighed on the market. The recent performance was also in line with the view we expressed in last Monthly that the previous rally had become a little excessive. On the positive side, the macro adjustment to reduce external vulnerability remains on track from a longer term perspective, in our view, even though our economist has recently revised her forecasts on the current account deficit slightly wider for the year (from -4% to -4.2%). We believe S&P will likely downgrade South Africa's credit rating in June (from BBB to BBB-), but this has been widely expected. On the technical side, South Africa has yet to issue this year and will likely come to the market within the next couple of months - we project USD 1.5bn issuance in Eurobonds in 2014 and it will be due to repay about USD1bn in June.

Overall, risk seems balanced and we retain a neutral view on the credit. 10s30s in South Africa has steepened somewhat but remains one of the flattest in EM, with the long 41s looking expensive. We hold the cash curve steepener of long 25s vs. 41s for further steepening of the curve (current: -14bp; target: -20bp).

INDONESIA

– Remain neutral.

– Tactical Buy 5Y CDS

– Close our Long 23Ns vs. 5Y CDS basis trade

INDON curve, in our view, remains increasingly vulnerable to the potential slippage in positive hype over forthcoming presidential elections given the unexpectedly mixed news flow relating to Jokowi's popularity ratings and the quality of his political agenda. Additionally, the market is expecting somewhat sizeable new supply by the country's large SOEs, including Pertamina, PLN and PGN that have been mentioned in the press. INDON cash curve has been the main beneficiary of US and European accounts brining their Asia exposure to "market-weight" from UW. Combining valuations vs. the fundamentals, we continue to believe that INDON 5Y CDS is overvalued and Asian investors are predominantly overweight Indonesia risk these days.

Although we acknowledge that the spreads could be supported should July elections not disappoint market expectations of Jokowi becoming a president, it is still difficult in our view to justify fundamentally INDON 5Y CDS spreads fully converging with those of Brazil. This is already becoming evident from Brazil CDS spreads outperforming those of INDON and now trading ~15bp tighter vs. ~7bp differential a month ago. Our economists still expect Indonesia's trade balance figures to deteriorate materially by end 1H14, which we believe will result in spread widening.

We continue to be buyers of INDON 5Y CDS (currently at 161bp). Our target remains 200bp, but we lower our stop level by 10bp to 150bp and we believe that the strong technical support by non-Asian accounts to CDS is bound to reverse in near future. Key risks: better than expected economic data, IDR appreciation, spike in global coal and nickel, positive rating action.

We also had a long basis trade in Indonesia (Long 23Ns vs. 5Y CDS) which has by now nearly reached an average level (start:-51bps; current:-30bps; target: -25bps) and we believe it makes sense to close it out before fully reaching the target. In our view, the incremental move to reach the target is relatively small considering the gain that this trade has achieved thus far.

THAILAND

- Stay neutral
- Buy 5Y Thai CDS outright or vs. MALAY 5Y

Thailand presents us with a busy political calendar coupled with the looming 1Q GDP announcement. Both are most likely to bring negative news to the market. Today Constitutional Court effectively removed Yingluck Shinawatra from the office ruling that she abused her position by transferring a top security official, constituting the abuse of power. The current Commerce Minister will step into PM's role. The court's decision clearly deepens the nation's political crisis creating a doubt that her remaining cabinet is able to be a going concern until at least a new round of general elections that is scheduled for 20-Jul-14 (elections in Feb-14 were deemed void). We could also expect a potential escalation of pro-government protesters' activity. This development does not provide any optimism to the soon-expected 1Q 2014 GDP announcement, in our view, – DB expects Thai economy to have contracted 1.5% yoy (while FY14 GDP growth is being downgraded by 100bp to 2.5% yoy). Additionally, Asian Development Bank warned recently that GDP growth may dip below 2% this year should a functioning government not be installed by the end of 3Q. We continue to recommend Buying THAI 5Y CDS (~124bp) vs. MALAY 5Y CDS (~96bp) as we expect the former to underperform and the spread differential to reach ~50bp in the near term (stop at 15bp). The trade has moved 4bp in our favor over the past week. Risks to this recommendation: economic data surprising on the upside with political tensions decelerating in Thailand, stagnation of fiscal reforms Malaysia coupled with aggressive new issuance.

Recent Publications

- EM Monthly: Keeping an eye on the ball (May-14)
- Trade Recommendation – Brazil: Reduce to underweight and favour short basis
- Trade Recommendation – EM Sovereign Credit Weekly - Improving sentiment and technicals (30-Apr-14)
- Special Report – Venezuela: The Value of Opportunistic Adjustment (30-Apr-14)
- EM Debt: Technicals Monitor (Apr – 14)
- EM Monthly: Biding time for growth (Apr-14)
- Trade Recommendation – EM Sovereign Credit Weekly - Still a range-bound environemnt (8-Apr-14)
- Trade Recommendation - Turkey: Enter cash curve steepener
- Trade Recommendation – EM Sovereign Credit Weekly - A quarter of remarkable turnaround (1-Apr-14)
- EM Debt: Technicals Monitor (Mar – 14)
- Trade Recommendation – EM Sovereign Credit Weekly (25-Mar-14)
- Trade Recommendation – EM Sovereign Credit Strategy Update (March 2014)
- Trade Recommendation - Argentina: Favour Pars; look to enter long Warrants
- EM Monthly: Limiting Contagion (Mar-14)
- Special Report: Sovereign Credit in 2014: Back in the Black
- Special Report: Introducing EM Sovereign Credit Snapshot (19-July-13)

See Appendix for a list of our trade recommendations and their performance.

Appendix: New, Open, and recently Closed Trade Recommendations

Status	Country	Trade	Weights	Initiation	Last Action	Last Action Date	Metric	Entry	Stop	Current/ Close	Target
New	Russia	Long 5y CDS	Outright	7-May-14	Initiation		CDS Spd	234	200	226	280
New	Turkey	Sell 10Y CDS vs. TR 43s	Dv01-neutral	7-May-14	Initiation		Libor Spd	24	35	23	-5
New	Brazil	Sell 10Y CDS vs. 23s	Dv01-neutral	2-May-14	Initiation		Libor Spd	85	100	76	68
Open	Turkey	Sell 10Y CDS vs. TR 24s	Dv01-neutral	29-Apr-14	Initiation		Par-eq Spd	37	50	27	15
Open	Russia	Long 23s vs 10Y CDS	Dv01-neutral	29-Apr-14	Initiation		Libor Spd	6	-10	23	30
Open	Venezuela	Long 19s	Outright	25-Apr-14	Initiation		Price	82	75	84.0	90
Open	PDVSA	Long 17Ns	Outright	25-Apr-14	Initiation		Price	90	84	92.3	98
Open	PDVSA	Long 17Ns vs. 35s curve steepener	Dv01-neutral	25-Apr-14	Chg target/stop	7-May-14	Par-eq Spd	182	100	60	0
Open	Philippines	Switch to 26s from 34s	Dv01-neutral	24-Mar-14	Initiation		Par-eq Spd	-6	10	-3	-30
Open	South Africa	Long 25s vs 41s curve steepener	Dv01-neutral	12-Feb-14	Initiation		Libor Spd	-2	8	-14	-20
Open	Mexico	Switch to Pemex 45s from UMS 45s	Dv01-neutral	12-Feb-14	Initiation		Libor Spd	82	95	79	60
Open	Brazil	5s10s CDS curve flattener	Dv01-neutral	12-Feb-14	Initiation		CDS Spd	58	70	54	45
Open	Brazil	Switch to BNDES 23s from 20s	Dv01-neutral	12-Feb-14	Initiation		Libor Spd	55	65	48	10
Open	Argentina	2s5s CDS flattener	Notional-neutral	15-Aug-13	Initiation		Upfront	6	12	5	2
Open	PDVSA	Long 14s	Outright	13-Jun-13	Chg target/stop	20-Jun-13	Price	96	90	98.4	100
Closed	Brazil	Switch to Petrobras 7.875% 19s from 3% 19s	Dv01-neutral	12-Feb-14	Profit before target	7-May-14	Par-eq Spd	59	75	46	20
Closed	Indonesia	Long 23Ns vs 5Y CDS	Dv01-neutral	7-Apr-14	Profit before target	5-May-14	Libor Spd	-51	-65	-30	-25
Closed	Turkey	Switch to 22N from 23s	Dv01-neutral	23-Jul-13	Profit at target	5-May-14	Libor Spd	24	40	4	5
Closed	Poland	Switch from 19s to 22s	Dv01-neutral	12-Mar-14	Loss (at stop)	24-Apr-14	Par-eq Spd	40	40	42	20
Closed	Russia	Long 23s vs 10Y CDS	Dv01-neutral	10-Apr-14	Loss (at stop)	21-Apr-14	Libor Spd	26	20	18	40
Closed	Turkey	Long 22Ns vs 41s curve steepener	Dv01-neutral	2-Apr-14	Profit before target	16-Apr-14	Par-eq Spd	-21	-10	-37	-40
Closed	Venezuela	Sell 5Y CDS vs. VE 24s	Dv01-neutral	12-Mar-14	Profit at target	7-Apr-14	Par-eq Spd	179	200	3	0
Closed	Indonesia	Long 44s vs. 24s curve flatener	Dv01-neutral	24-Mar-14	Profit before target	7-Apr-14	Par-eq Spd	60	75	39	30

Only currently open and trade closed within the past month are included
The metric for relative value trades is the different difference between the Long asset and Short asset, in basis points
The metric is in points if price is used
Trades with metric close to target/stop have their current levels and target/stop highlighted in italic/bold

Source: Deutsche Bank

Appendix 1

Important Disclosures

Additional information available upon request

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Risks to Fixed Income Positions

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Emerging Markets | Credit Sovereigns | Trade Recommendation | Date 26 September 2014

EM Sovereign Credit Weekly - Differentiation and Relative Value

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Sovereign Credit: differentiation and relative value

EM skepticism and renewed HY outflows are weighing on EM credit. However, some idiosyncratic elements have improved over the near term (Russia and Venezuela) and we see pockets of values in differentiation and relative value.

Technicals: supportive supply/demand balance but weak sentiment

The technicals are a mixed picture for sovereign credit, but still moderately supportive, given steady monthly repayments ahead and a historic high annual issuance completion rate at this point. However, fund flows remain muted without a clear trend.

We introduce a new indicator based on *non-dealers' net long protection positions via CDX.EM,* to gauge investors' sentiment. Currently, this indicator shows a weakening of the sentiment.

Russia: short-term de-escalation and long-term instability

We tactically covered underweight on Russia on 23 September following a series of de-escalatory developments, which are likely to keep the situation relatively quiet through the Ukraine Rada elections, but we continue to hold a cautious view on the crisis and Russia's economic fundamentals over a longer term. Focusing on relative value on the Russia curve, we hold cash curve steepeners (22s vs. 42s) and look to enter 2s5s CDS curve steepeners.

Venezuela: cover underweight and focus on RV

We tactically covered underweight yesterday as bonds prices continued to bounce from recent lows and we believe the adjustment in the exchange agreement announced yesterday is a small step in the right direction. Our bearish view on the macroeconomic outlook and policy direction nevertheless prevent us from going overweight at this point.

We see a number of relative value opportunities, including **switching to PDVSA 17s from Venezuela 22s (*new trade*)**, switching to 23s from 20s and 27s on the sovereign curve, and keeping short basis (5Y CDS vs. 22s).

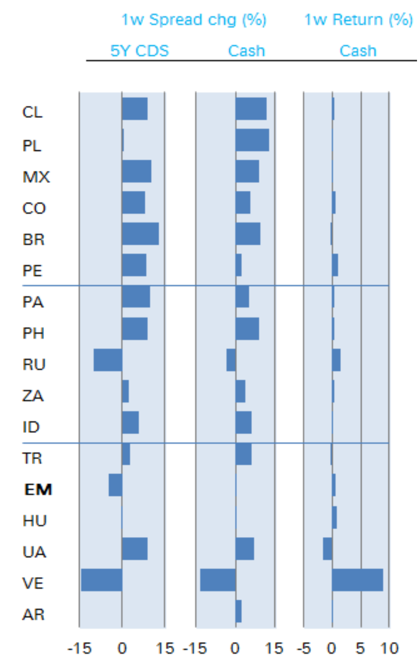
Argentina: improved prospect on local law bonds

A recent hearing transcript at the District Court reveals Judge Griesa's understanding that the local law bonds "are different" from the exchange bonds. While this seems to improve the chance for the local law bonds to be "carved out" from the injunction, risk remains. The hearing scheduled for today may offer further clarity.

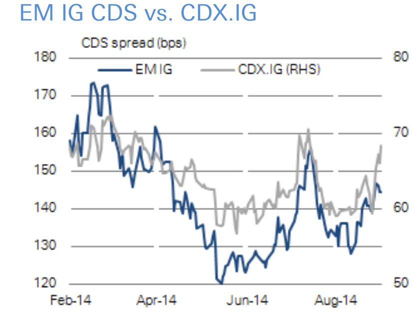
Asia credit update

Pelabuhan Indonesia III Persero (Pelindo III) has priced its inaugural USD-denominated bond yesterday. The new USD bond was priced at FV, but risks are to the downside. Within the Indonesia complex, mid-term positive catalysts would be more in Pertamina's and PLN's favor in the form of fuel subsidy reforms, in our view.

Weekly performance (as of 25-Sep-14)



EM IG CDS vs. CDX.IG



Source: Deutsche Bank

EM Sovereign Credit Strategy Weekly – Differentiation and relative value

Market Overview – Differentiation and relative value

There has been a bout of risk-off in the market, triggered by global growth concerns, dollar strength, lower commodity prices, and weaker equities. A Chinese official's remark at the G20 meeting sent a signal to the rest of the world that they should accept the reality of downward pressure on its growth, and this did not help the slumping commodity prices. Indeed, seasonal adjustment in the Chinese numbers aside, the prospect of reduced demand from China and liquidity reduction from the Fed in the quarters ahead are weighing on EM, which has now little to offer beyond carry – an unconvincing proposition when volatility increases. Lower equity prices and renewed outflows from HY also didn't help. So once again, EM's vulnerability regains focus, and EM skeptics are gathering strength.

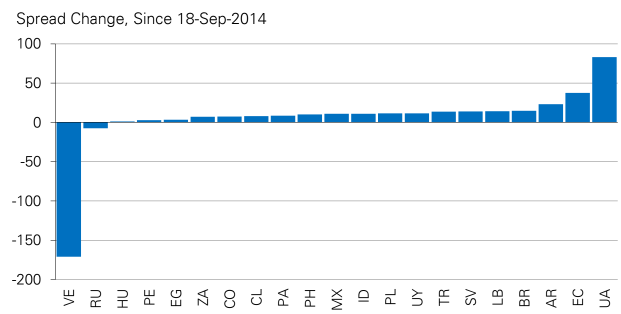
Idiosyncratic risks also featured heavily in a few markets during the past week, with mixed impacts – Brazil (negative) on a change of momentum in election polls, Russia (positive) on a series of short-term de-escalation developments, and Venezuela (positive) on bottom-bouncing flows and new fx measures, to name a few.

To our comfort, core rates dynamics are far from disruptive; EM valuation does not look stretched – spreads are generally quite tight, but EM sovereign BBBs are still trading at +30bp over their core market counterparts. Finally, yield-seeking remains strong as seen in the high levels of oversubscription rates in the recent primary markets. We therefore do not see enough reasons to be overly pessimistic at the moment, despite weaker sentiments as reflected in funds flows and some other indicators (more on this below), and we believe differentiation and relative value will continue to offer pockets of value.

In this *Weekly*, we focus on Venezuela, where we tactically covered underweight and we discuss a few relative value opportunities; on Argentina, as we reach another important point especially pertinent to the local law bonds; and on Russia, where we tactically covered underweight earlier this week. We also provide a quick update on technicals. Finally, on Asia credit, we focus on the new Indonesian quasi-sovereign bonds from Pelindo III.

Over the past week, Venezuela led the performance chart with recovery from recent routs, followed by Russia. Meanwhile, Ukraine continued to widen on default concerns (we expect no credit events this year). Argentina and Brazil were also notable underperforms. Most other credits have been spreads moderately widen during the week.

DB-EMSI sub-index spread changes over the past week



Source: Deutsche Bank

Technicals update

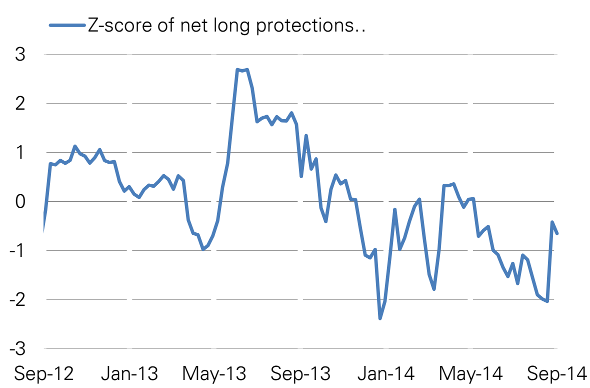
The technicals are a mixed picture for sovereign credit, but still moderately supportive, given steady monthly repayments ahead and a historic high annual issuance completion rate at this point. However, EM hard currency fund flows remain muted without a clear trend. Institutional funds within the EPFR survey continues to take in fresh money but the retail funds flows remain weak. See our September 2014 edition of EM *Debt: Technicals Monitor* for a more detailed presentation on the various technical aspects.

In the same report, we also introduce a new indicator based on *non-dealers' net long protection positions via CDX.EM*[1] to gauge investors' sentiment. This indicator

[1] The data is reported by DTCC on weekly basis. DTCC reports non-dealers total positions in long and short protections in the CDX.EM indices. We combine the data for on-the-run index and the past four off-the-run indices. We first express the net long protection positions (initially in dollars) as % of total gross positions to neutralize the effect of change in overall market size, and then use the z-score of this data as the indicator.

has sharply increased over the past two weeks (see chart below), corroborating a cautious tone by EM investors. Note that most of the time EM investors are net sellers of protection via CDX.EM, as the index has been used more as a vehicle to go long risk or manage beta in the portfolio rather than a means of hedging. So a sharp rise in this indicator – caused by either a sharp reduction of net long risk positions or, if the net position is long protection, a sharp increase of net long protection positions – likely reflects the risk sentiment of investors to a certain extent. Just like funds flows, this is at best a concurrent (or even lagging) indicator. However, if looked at in conjunction with other measures, it may still provide a useful number for gauging inventors' sentiment. Currently, this indicator shows a weakening of the sentiment.

A sharp reduction in net short protection positions through CDX.EM



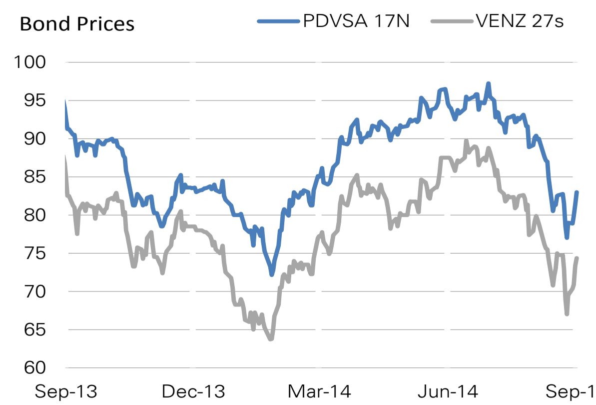
Source: Deutsche Bank

Venezuela: tactically cover underweight and focus on RV

Venezuelan bonds have bounced pretty strongly from the recent lows as the market continued to price out the imminent default concerns (the "Haussmann risk premium") and was further supported by the announced law change to allow PDVSA to sell a portion of its contributions to FONDEN at "any of the official exchange rates". While not as significant as the headlines suggested, this nevertheless led to a partial devaluation and represented a small step in the right direction, and should help improve the fiscal conditions of the government and narrow the gap between official rate and the parallel market rate.

While we retained our bearish view on the outlook for macroeconomic conditions and policy direction of the country, we felt it appropriate to tactically cover our existing underweight position, which we last night (see *EM Daily*). This policy tweak – while far from sufficient if no further measures are unveiled – will likely at least help halt further slides in the bond prices over the near term, while the yields look very attractive for investors at the moment. On the other hand, our bearish view on the medium-term fundamentals and investors' lack of trust in the policy makers make us feel constrained in moving to overweight.

Recent price moves of PDVSA 17Ns and Venezuela 27s



Source: Deutsche Bank

Other risk factors over the near term that should be closely watched include:

- Further clarity on government's decision on whether it will sell CITGO. President Maduro showed some ambiguity on this in his recent UN remarks;
- Potential ICSID award to ConocoPhillips in its arbitration case against the Republic – the tribunal had ruled on the merit of the case last year and is expected to issue the amount of award in the coming months. A number that is larger than expected (such as double digit or high single digit) would likely create negative sentiment for the market. Recently, the ICSID ruling awarded Gold Reserves Inc in its arbitration case against the Republic USD740m, about 1/3 of what the claimant demanded (USD2.1bn). This may suggest the ruling on Conoco case will likely be much smaller than the headline claim of USD30bn. It is also worth noting that the enforcement of an award is not usual, and it would typically take between 2 to 4 years, and settlements have been the normal way out. The risk of the Republic having to make an immediate disbursement upon the announcement of award is minimal.

- Potential ICSID ruling on ExxonMobil in its arbitration case – on merit only (i.e. whether Venezuela violated the Bilateral Investment Treaty) but not on the amount of award to the claimant. Note that on this matter recent news headlines on Bloomberg appear somewhat misleading. The amount would actually take about another year to come out judging from the experience in Conoco case.

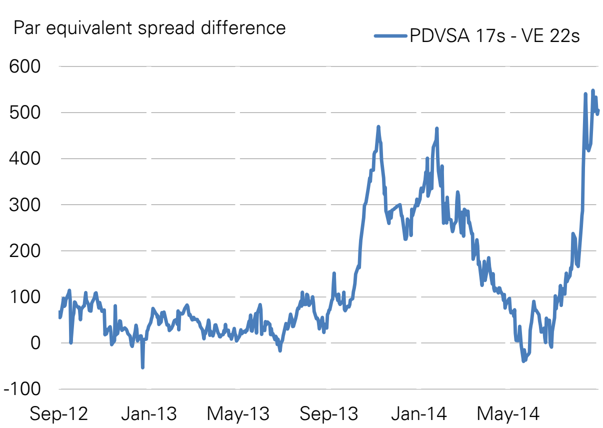
While covering underweight, we see a number of relative value opportunities on the curves.

Favor PDVSA bonds over sovereign bonds on tactical basis

The recent positive momentum will likely fuel some additional recovery of PDVSA bonds vs. their sovereign counterparts. In our view, the most attractive switch is from Venezuela 20s or 22s (still rich to the curve) to PDVSA 17s (which have underperformed adjacent bonds). The position is quote directional; hence it is a bullish trade. But we expect PDVSA bonds – especially the ones at the shorter end of the curve – to generally outperform their sovereign counterparts as long as spreads do not move significantly wider.

We recommend switching from Venezuela 22s to PDVSA 17s at the current par-equivalent spread differential of 500bp, target 250bp, risk 600bp.

PDVSA 17s to recover some lost ground vs. Venezuela 22s

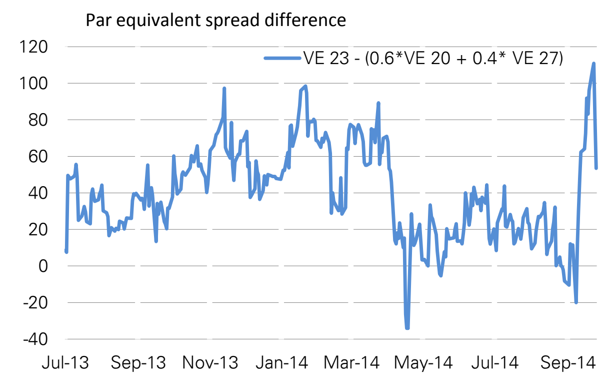


Source: Deutsche Bank

Switch to the 23s from the wings on the sovereign curve

We recommended this trade yesterday – see *Trade Recommendation – Venezuela: the 23s cheap to the wings* for more details. As a summary, we recommend switching to the 23s, which are significantly cheap to the curve, from a combination of 20s and 27s. A switch from a number of other bonds could also be considered.

Venezuela 23s vs. 40% 27s and 60% 20s, par-equivalent spread differential

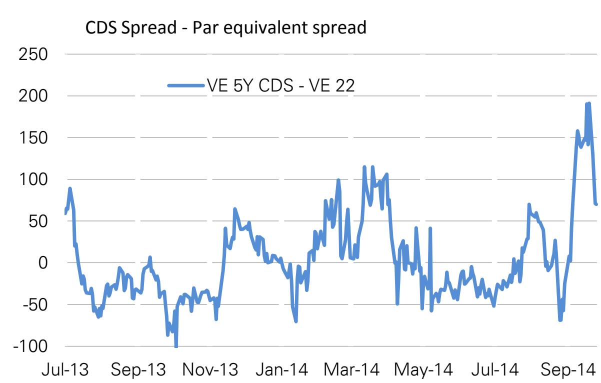


Source: Deutsche Bank

Stay short basis

Our short basis recommendation of selling 5Y CDS vs. 22s on expectation of market pricing out imminent default risk has moved in our favor (entry: 150bp; current: 100bp; target: 0bp), but we see potential for the basis to tighten further.

5Y CDS vs. Venezuela 22s (par-equivalent spread differential)



Source: Deutsche Bank

Russia/Ukraine: short-term de-escalation but long-term instability

Recent signs of de-escalation in the Russia/Ukraine crisis warranted a reconsideration of our recommendations – on a tactical basis only.

Consequently, we tactically covered our underweight recommendation on 22 September (see *EM Daily*).

Following the buffer zone agreement reached by the contract group in Minsk on 20 September, which will likely reinforce the current "cease-fire" at least through the 26 October Rada election in Ukraine, NATO yesterday confirmed decreasing level of violence and "a significant pullback of Russian conventional forces", according to Bloomberg reports. These followed a series of earlier de-escalatory developments, including the adoption of set of laws by Ukrainian Rada on 16 September to grant autonomy to the Donbass region for 3 years and amnesty to those engaged in the conflict, while postponing until end-2015 the full implementation of EU integration. In our view, while all these laws would improve the prospect of cease-fire over the near term, it still clearly falls short of Russia's aim of some sort of "federalization" in Ukraine's political structure to keep it under Russia's sphere of influence in terms of diplomatic policy and geopolitical orientation. President Poroskenko's near-term priority may enhance his political standing through the elections, but the prospect of him gaining enough political capital to find a middle ground with Russia remains highly uncertain. We remain skeptical.

Recent developments seem to point to relative calm in the conflict – albeit likely with sporadic, low-level violence – over the near term, providing room for the ruble and credit spreads to recover. Accordingly, we tactically covered our underweight position in Russia (see EM Daily of 24 September). Over a longer term, however, we continue to see reasons to be strategically underweight and reduce on strength because the conflict will likely persist given the fundamental differences and the wide gap between the positions taken by the different parties, while the economic conditions continue to deteriorate.

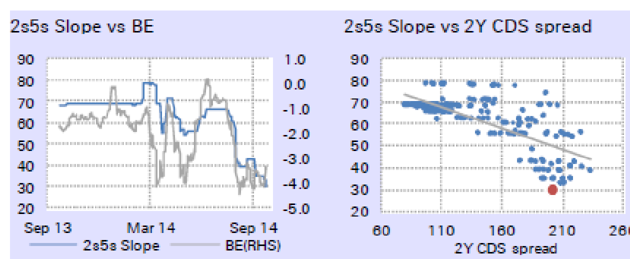
We remain neutral on Ukraine credit – we believe the near-term payments (including Nafto 14s) will be covered with official support but a debt restructuring and/or substantially more official support will be unavoidable within the next couple of years.

Russia CDS curve: look for steepener opportunities

Russia CDS curve has dramatically bear-flattened ever since the crisis began earlier this year when Russia annexed Crimea. The flattening has gone way beyond a normal bear-flattening given that many believe the crisis would be a temporary one and hence resort to shorter dated CDS for their hedging need. While 5Y levels reflect the macro fundamentals, the shorter dated ones were more heavily influenced by technicals as both investors and dealers look for shorter dated and relatively less expensive protections. 2s5s, for example, flattened from around 70bp in February to 30bp today – a 40bp flattening. 5Y CDS, on the other hand, has recovered almost about half the widening since February, and is only about 40bp wider today compared to February levels.

Given the tactically improved view over the near term, the slope of CDS curve may have a chance to normalize, and the 4bp per month breakeven as measure of steady-state return in dv01-neutral 2s5s steepeners make the risk/reward of such a position look even more asymmetric. However, the current flows in which dealers still have a sizeable demand in short dated CDS for risk management purposes mean such trade is still a bit premature. It would likely take a significantly positive headline to drive the curve steeper at this stage. So for now, we would just put it in our "watch list" and look to enter CDS curve steepeners once technicals improve or the crisis situation changes.

Russia 2s5s CDS curve looks excessively flat; dv01-neutral steepener has attractive breakeven of 4bp per month.



Source: Deutsche Bank

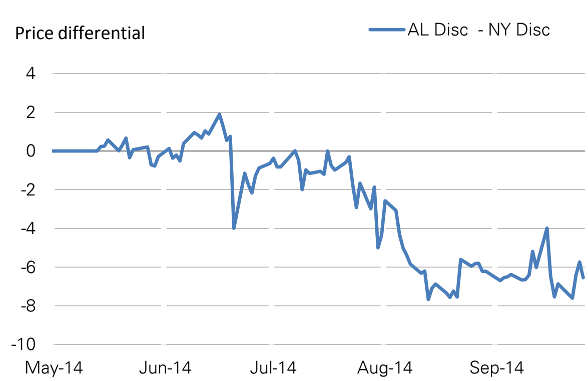
Argentina: improved prospects on local law bonds

In a hearing on 19 September 2014 when only Citibank lawyers were present at the District Court, Judge Griesa apparently acknowledged his understanding that local law bonds should be "treated differently". During this conversation Judge Griesa said "It was my view ... that the Argentine law bonds issued in Argentina, payable in Argentina, subject to Argentine law, are different from the bonds subject to the 23 February order. And whether they're payable externally or not, the factors I've talked about make them different. Now, if the Court has the responsibility of dealing with any issue about the payment due in Argentina 30 September or 31 December, etc., then that will have to emerge from requests to the Court and briefing to the Court as necessary...". Responding to that request, Citibank filed its request on Monday, 22 September, repeating all the arguments previously presented to the court of appeal, the most relevant of which is that these bonds are not "external indebtedness" pursuant to the exchange bonds documents (i.e., the explicit exclusions of "Domestic Foreign Currency Indebtedness", or DFCI). Judge Griesa has tentatively scheduled a hearing for Friday (today).

Based on this, there seems to be an improved chance for Judge Griesa to allow the payments of local law bonds to be processed in the future. However, it remains in the hands of Judge Griesa – while he understands these bonds "are different", it does not mean he will be treat term differently in connection with the injunctive order. Argentina's ongoing efforts to alter bond payments mechanism to skirt around the order would certainly complicate this matter.

However, if Judge Griesa indeed rules that local law bonds will be out of reach from the 23 February order, it will most likely fuel a strong recovery of the local law bonds, which have so far significantly underperformed relative to the global bonds. Interestingly, a main downside risk stems from that, to our surprise, the new Citibank filing seems to have broadened the universe of bonds under debate to all local law bonds (not just the Discounts and the Pars), so if the Judge rules against this it could result in a wider range of default. One other possibility is for the Judge to allow another one-time payment on the Pars due at the end of this month without a final decision this time.

Local law Discounts would recover vs. global bonds *if* the Court gives green light



Source: Deutsche Bank

Asia credit update

Indonesia: Pelindo III new USD bond is at FV, but risks are to the downside

Pelabuhan Indonesia III Persero (Pelindo III) has priced its inaugural USD-denominated bond yesterday. The company managed to print USD500m under RegS and 144a formats with the final maturity in 2024. The final yield at the time of pricing was set 30bp lower vs. the initial guidance. According to Bloomberg, the deal managed to attract orders in excess of USD6bn with the majority of those coming from US asset managers, thanks to the bond's inclusion into the EMBI index and 144a leg.

We acknowledge the great deal of interest towards Indonesia sovereign and quasi-sovereign complex of late from outside of Asia. The investor attention is largely stemming from Jokowi's victory during the presidential elections in July. At the same time, we believe that the markets are giving too much credit to such a political event and are pricing in the future potentially positive developments in Indo's economy too much upfront. We also believe that the tightening of final yield guidance by Pelindo was too aggressive considering that Indo quasis' bonds are trading at the historic tights while the market is feeling wobbly due to the flood of new issues and we expect more USD supply from Indo quasis by end-2014. Pelindo has materially stepped up its capex in the past six months, taking its FCF into red and depleting cash reserves to three-year lows. The new bond will stretch its cash metrics even further and total debt will exceed its annual revenues. In our view, PGN would then look relatively stronger than Pelindo. However, given inferior liquidity features of PGNIJ '24 we believe Pelindo '24 should be trading flat vs. PGN '24. We'd caution investors on greater downside risks to Pelindo's spreads as it already trades at ~57bp vs. INDON '24 (the historic tights vs. quasi Indo peers) and mid-term positive catalysts would be in Pertamina's and PLN's favor in the form of fuel subsidy reforms. Initiate on PLBIII 4.875% USD500m notes due 2024 with a HOLD. .

Recent Publications

- Trade Recommendation – Venezuela: the 23s cheap to the wings
- Trade Recommendation – EM Sovereign Credit Weekly (19-Sep-14)
- Special Report – Venezuela: Implications of the CITGO sale and ICSID awards
- Trade Recommendation – EM Sovereign Credit Weekly (12-Sep-14)

- Trade Recommendation – Venezuela: enter short basis
- Trade Recommendation – EM Sovereign Credit Weekly (4-Sep-14)
- Trade Recommendation –Venezuela: cut to underweight after changes in economic team
- Trade Recommendation – EM Sovereign Credit Weekly (13-Aug-14)
- Trade Recommendation – Argentina: downside risk to recovery value in CDS auction
- Trade Recommendation – EM Sovereign Credit Weekly (29-Jul-14)
- Trade Recommendation – EM Sovereign Credit Strategy Update (July 2014)
- Special Report: Argentina: Flirting with default while aiming at resolution
- EM Monthly: Picking up dimes (Jul-14)
- Special Report: Sovereign Credit in 2014: Back in the Black
- Special Report: Introducing EM Sovereign Credit Snapshot (19-July-13)

See Appendix for a list of our trade recommendations and their performance.

Appendix: New, Open, and recently Closed Trade Recommendations

Status	Country	Trade	Weights	Initiation	Last Action	Last Action Date	Metric	Entry	Stop	Current/ Close	Target
New	PDVSA/Venezuela	Long PDVSA 17s vs. VE 22s	Dv01-neutral	25-Sep-14	Initiation		Par-eq Spd	505	600	505	250
New	Venezuela	Long 23s vs. (20s and 27s)	1 / 0.6 / 0.4	24-Sep-14	Initiation		Par-eq Spd	78	130	53	20
Open	Uruguay	Long 45s vs. 24s	Dv01-neutral	18-Sep-14	Initiation		Par-eq Spd	71	80	71	50
Open	Russia	Long 22s vs. 42s	Dv01-neutral	18-Sep-14	Initiation		Libor Spd	-4	3	-6	-25
Open	Venezuela	Sell 5Y CDS vs. VE 22s	Dv01-neutral	10-Sep-14	Initiation		Par-eq Spd	153	200	70	0
Open	PDVSA	Long PDVSA 37s	Outright	10-Sep-14	Initiation		Price	50.6	45.0	52.4	60
Open	PDVSA	Long PDVSA 15s	Outright	10-Sep-14	Initiation		Price	84.8	80.0	88.9	100
Open	Brazil	Buy BR 5Y CDS vs. CO 5Y CDS	Dv01-neutral	10-Sep-14	Initiation		Libor Spd	50	40	63	70
Open	Turkey	Sell 10Y CDS vs. TR 25s	Dv01-neutral	10-Sep-14	Initiation		Libor Spd	33	50	13	-5
Open	South Africa	Long 41s vs. 25s	Dv01-neutral	3-Sep-14	Initiation		Libor Spd	27	38	17	8
Open	Poland	Long 24s vs. 19s	Dv01-neutral	3-Sep-14	Initiation		Libor Spd	49	60	46	25
Open	Argentina	Short USD Discounts	Outright	31-Jul-14	Initiation		Price	90.0	95.0	87.5	75
Open	Hungary	Switch to 23s from 21s	Dv01-neutral	16-Jul-14	Initiation		Libor Spd	16	25	8	0
Closed	Russia	Long RU 30s vs. RU 5Y CDS	Dv01-neutral	3-Sep-14	Profit at target	12-Sep-14	Libor Spd	-39	-50	-20	-20
Closed	Turkey	Sell 10Y CDS vs. TR 43s	Dv01-neutral	7-May-14	Unwind	10-Sep-14	Libor Spd	24	35	25	-5
Closed	PDVSA	Long 26s vs. 17s	Par-eq dv01-neutral	3-Sep-14	Profit at target	8-Sep-14	Par-eq Spd	-182	-50	-414	-350
Closed	PDVSA	Long 15s	Outright	11-Jun-14	Loss (at stop)	5-Sep-14	Price	94.7	90.0	88.8	100
Closed	PDVSA	Long 17Ns vs. 35s curve steepener	Dv01-neutral	17-Jul-14	Loss (at stop)	2-Sep-14	Par-eq Spd	104	150	185	-50
Closed	Brazil	5s10s CDS curve flattener	Dv01-neutral	12-Feb-14	Unwind	3-Sep-14	CDS Spd	58	70	60	45
Closed	PDVSA	Long 24s	Outright	11-Jun-14	Loss (at stop)	22-Aug-14	Price	64.5	60.0	58.5	75
Closed	Venezuela	Long VE 22s	Outright	16-Jul-14	Loss (at stop)	12-Aug-14	Price	104.4	100	98.2	110
Closed	Russia	Switch to 30s from 19s	Dv01-neutral	16-Jul-14	Profit at target	8-Aug-14	Libor Spd	83	115	38	40
Closed	Philippines	Switch to 26s from 34s	Dv01-neutral	24-Mar-14	Profit at target	7-Aug-14	Par-eq Spd	-6	10	-29	-30

Only currently open and trade closed within the past month are included
The metric for relative value trades is the different difference between the Long asset and Short asset, in basis points
The metric is in points if price is used
Trades with metric close to target/stop have their current levels and target/stop highlighted in italic/bold

Source: Deutsche Bank

The authors of this report would like to acknowledge the collaboration by Salil Rajpal and Jayanth Gupta, employees of Evalueserve, a third-party provider to Deutsche Bank of offshore support services.

Appendix 1

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US Fixed Income Weekly

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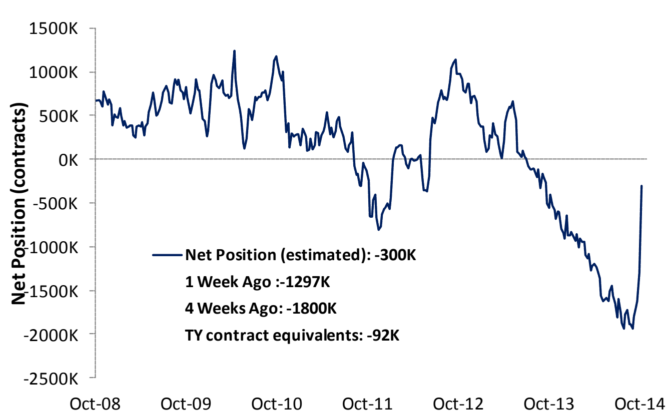
- We think the 5y sector will be sticky at current yield levels or even lower, while we expect a modest steepening of 5s10s achieved via higher 10y yields. Our end of year forecast for the 10y Treasury remains at 2.35%. A twist of 5s10s from current levels will keep the 5y5y rate within the bottom of the 3.25%-3.75% range in the short run, while allowing markets to price out the Fed until 2016 and potentially lower the lower the terminal cyclical rate.
- There is an investor debate around whether we should ignore recent events and focus on familiar themes of US recovery (risk on), if anything helped by low oil and a delayed Fed and at worst being slightly more cognoscent of European growth worries VERSUS a more profound concern for the limits of global QE all around and the existential threat of deflation. We all have our biases but for now we think it is best to think about the markets trading between the two extremes based on policy maker actions and data. Event risk will therefore be high. Weaker than expected inflation, disappointing Euro PMIs, harsh AQR results coupled with a complacent Fed and policy inertia in Europe will squarely get us back into risk off mode.
- That said by contrast the longer the Fed is seen to push out normalization, the more time there is for the US recovery to be a better one and the more healing time Europe has even in the context of bumbling policy.

3m Eurodollars futures spec net positions – with estimate of current (end week 10/17)



Source: CFTC and *Deutsche Bank*

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2014 Outlook Recommendations

	Trade Detail	Rationale	Risks	Opened	Entry	Current	P/L
Treasury RV	Buy 10y Treasuries vs 5s and 30s	10s have underperformed on the curve since May, and appear cheap on fly	Further sell-off in Treasuries, led by a steeper 5s/10s curve	12/6/13	+17 bp	+5 bp (Closed on 6/25)	+1,123k
Option	1y 3s10s conditional bearish flattener for zero premium: Buy 1y3y + 25 bp payer, sell DV01 weighted 1y10y +41.5 bp payer for zero premium.	The curve should bear flatten as soon the Fed tapers and front end sells off	Curve steepens as rates rise	12/6/13	+213 bp	+145 bp	+18k
Swaps RV	Receive 3y1y/2y1y rate spread at 108 bp	Curve slope is near its historic levels; curve is likely to flatten in both sell-off or rally	Curve steepens	12/6/13	+108 bp	+81bp	+69k
Option	Dual digital option on 5s and 10s: Buy a 6m dual digital that pays out if 5s > 2% & 10s< 3.50%, offer 17% (6:1 leverage)	Curve flattens beyond the current forwards; adding additional leverage by shorting the correlation between 5y and 10y rates	Either of the two conditions is not true at expiration; maximum loss is premium outlay	12/6/13			
Option	Contingent curve cap: Buy 6M 5s10s ATMF curve caps subject to 10s < 3.50%, 5.25c offer, a 40% discount to vanilla at 9c	Front-end of the curve remains anchored, limited sell off in 10s	Curve flattens	12/6/13			
Option	Receiver spreads: Buy $100mm 2y2y ATMF/25 bp receiver spreads at 28 bp	Macro data disappoints, curve bull flattens	Rates rise as recovery strengthens	12/6/13	+28 bp	+35 bp	+80k
Option	Contingent payers: Buy 1y30y ATMF payers subject to 5s< ATMF+50 bp at 259 bp, a 57% discount to vanilla	Rate hikes unbundled from taper, long end sells off while 5y remains anchored	Curve flattens	12/6/13			
Option	Curve caps: Buy 1y single reset, ATMF 5s30s curve cap at 21.5 bp	Economic recovery disappoints and curve remains steep	Curve flattens	12/6/13	+22 bp	+1 bp	-190k
Inflation	Long-end US real rates vs long-dated Europe real rates: Buy 2041 US TIPS vs sell 2040 OATei	Long dated real rates in the US appear cheap to those in Europe, especially France	Further sell-off in long dated US rates relative to Europe	12/6/13	+40 bp	+50 bp(Closed on 9/25)	+3,382k
Inflation	Buy 2023 TIPS vs. 7/2019 and 1/2025 TIPS on ASW	The intermediate sector in inflation markets is cheap relative to the wings	Further cheapening of the belly in inflation markets relative to the wings	12/6/13	+38 bp	+19 bp	+1,502k
US Credit	Underweight high-yield into Taper	HY spreads should widen upon the onset of the taper	Tapers gets delayed	12/6/13			

Other Current Recommendations

	Trade Detail	Rationale	Risks	Opened	Entry	Current	P/L
Treasury RV	Short ultra long futures vs 30s	Ultra long futures are rich	Ultra continue to richen	6/12/14	+12 bp	+11 bp	+13k
Agencies	Buy long-dated GSE debt: Buy $100mm FNMA 6.625 11/30s vs. T 5.325 2/31s	Legislative momentum of Johnson-Crapo on GSE reform is credit bullish for long-dated GSE debt.	Reform bill stalls in Congress or language on government guarantee modified.	3/14/14	+48 bp	+45 bp	+864k
Muni	Receive $100m 3y3y SIFMA ratio at 78.2%. (Sorid)	Attractive roll down profile	Further ratio curve steepening	4/25/13	78.2%	77.7%	+447k
Option	1X2 1Y 5Y5Y ATMF/41 receiver spreads costless	Lon-end rallies on premature or fast rate hikes (policy mistake)	Rally below the breakevens; unlimited downside	9/26/14			
Option	Conditional bull steepeners: Sell $32.8mn 3M10Y ATMF receivers vs. buy $100mn 3M3Y ATMF receivers at net takeout 1c	Front-end gets re-priced in a delayed Fed hike	Curve bull flattens; unlimited downside	9/26/14			
Option	Buy 1X2 3M3Y ATMF/13.5bp receiver spreads for zero net cost	Short-term risk off and short covering	Rally below the breakevens; unlimited downside	9/26/14			
Option	Sell $100mn 3M5Y straddles vs. buy $100mn 3M5Y 22bp OTM payers for net takeout of 100c.	No big changes in vol near term	Rates rally	9/19/14			
Option	Buy $100mn 6M 2y1y 25bp OTM MC payers vs. Sell 100mn 1Y 4Y1Y 45bp OTM MC payers at zero net cost	Curve flattens on a hawkish FOMC	Curve bear steepens	9/12/14			
Option	Sell $100mn 6M5Y ATMF vs. buy $200mn 6M5Y 30bp OTM payers at zero net cost	Skew trades rich in a sell-off	Rates sell off half-way and stay there till the expiry	9/12/14			
Option	Buy $1bn 6M 5s/10s ATMF/15 curve cap spread vs. sell $1bn 6M 5s/10s 5bp OTM curve floor at zero net cost	Curve steepens as the market converges to Fed	Curve flattens beyond the floor strike; unlimited downside	9/5/14			
Option	Buy $1,000mm 6m single reset cap on CMS10-CMS5 strike 89bp for 9.75c	Carry pays for option, repriced fed suggests 5y outperformance	Curve flattening, max loss premium	5/20/14	+9 bp	+1 bp	-773k
Option	Sell $100mn 1Y2Y ATMF receivers vs. buy $40mn 1Y5Y 22bp OTM receivers at zero net cost	5s lead the way in a rally as rate hikes are taken out	Bull steepening in 2s/5s	10/3/13	0 bp	0 bp	+7k
Option	Buy $100mn 2Y2Y ATMF receivers vs. sell $22.7mn 2Y10Y ATMF receivers for the net takeout of $55K	Trend growth and low inflation limit the rise of long rates	Recessionary mode with bull flattening of forwards	10/3/13	-6 bp	-88 bp	-812k
Option	Payer spreads: Sell $500mn 2Y2Y 92bp OTM payers vs. buy $50mn 2Y30Y 25bp OTM payers at zero net cost	Vol differential is favorable for initiating a positive carry bear steepening trade	Bear flattening of the curve	1/2/14	+2 bp	-9 bp	-118k
Option	Mid-curve payer: Sell $100mn 1Y 5Y5Y ATMF mid-curve payers vs. buy $200mn 1Y2Y ATMF payers for the net takeout of 28c	5Y5Y has a limited upside while 1Y2Y could see significant repricing due to adjustments of monetary policy	Bear steepeners	3/14/14	-18¢	19¢	+375k

Other Current Recommendations Cont'd

	Trade Detail	Rationale	Risks	Opened	Entry	Current	P/L
Inflation Swaps	Long 2y2y inflation swap	2y2y inflation looks attractive on historical basis	Forward inflation falls	10/3/14	+2.1 bp		
Swaps Rv	Receive $208.2mm 6m5y rate versus pay $292.9mm 10y5y rate	15y par rate rich, 6m5y exposed to repricing Fed with positive carry	Curve flattenening	5/20/14	+219 bp	+187 bp	-3,270k
Swaps Rv	Receive $1,023.4mm 2y1y rate versus pay $1,002.7mm 1y1y rate	Positive carry look at repricing Fed	Curve steepening	5/20/14	+95 bp	+80 bp	+1,336k
Swaps Rv	Receive $1,023.4mm 2y1y rate versus pay $431.2mm 1y1y rate and $597mm 3y1y rate	Further rally via Fed delay benefits 2y1y rate	2y1y underperformance	5/20/14	-10 bp	-5 bp	+349k
Swaps Rv	Forward steepener: Receive fixed on $115.71 mm 1y10, pay fixed on $54.85 mm 1y30y	Slope of 10s30s too flat given level of 10y Rate	Long en flattening	3/28/14	+45 bp	+54 bp	+419k
Swaps Rv	Forward fly: Pay fixed on $298.6 mm 10y5y versus receive fixed on $72.9 mm 5y5y and $257.6 mm 15y5y	5y rate, 10y forward is historically rich versus 5y rate, 5y forward and 5y rate, 15yfoward	Further 10y5y outperformance	4/29/14	+22 bp	+19 bp	-788k
Cross Market	Buy $10m each of SPNTAB 2.95% 3/16; SPABOL 2.625% 5/16; DNBNOR 2.90% 3/16 on ASW. (Sorid)	Risk-on retightening of covered bonds in stable rates regime	Bank credit underperforms; Eurozone credit crunch; Widening in a rate sell-off	7/25/13	+25 bp +37 bp +31 bp	+11 bp +26 bp +23 bp	-539k
Cross Market	US-Europe spread tightener: Buy €80.4mm 1y10y ATMF payers vs. $116mm+15bp payers for zero premium	US/Europe spread near historical highs	Further US led sell-off	1/24/14	+118 bp	+126 bp	-50k
Cross Market	US-Europe spread tightener: Receive fixed in $244 mm USD 5y5y rate vs. pay fixed on €165.8mm EUR 5y5y rate	US recovery disappoints	Spread widens	1/24/14	+127 bp	+151 bp	-11k

P/L as of 10/16/2014 prices.

We started tracking the performance of our trade recommendations on June 18, 2010. This table shows our current open recommendations; a table of our closed positions is in the back of this publication. Both tables will be a regular feature in the Weekly. Performance numbers are based on trader end-of-day marks, and do not include bid/offer spreads or transaction costs. We consider the relevant benchmark for our trades to be a zero position, given the leveraged or generally market neutral aspects of these trades. Historical performance is not a guarantee of future performance

Source: Deutsche Bank

United States

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US Overview

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- There is an investor debate around whether we should ignore recent events and focus on familiar themes of US recovery (risk on), if anything helped by low oil and a delayed Fed and at worst being slightly more cognizant of European growth worries VERSUS a more profound concern for the limits of global QE all around and the existential threat of deflation. We all have our biases but for now we think it is best to think about the markets trading between the two extremes based on policy maker actions and data. Event risk will therefore be high. Weaker than expected inflation, disappointing Euro PMIs, harsh AQR results coupled with a complacent Fed and policy inertia in Europe will squarely get us back into risk off mode.
- That said by contrast the longer the Fed is seen to push out normalization, the more time there is for the US recovery to be a better one and the more healing time Europe has even in the context of bumbling policy.
- Empirically, the fiscal channel appears to have been far more effective in increasing growth relative to trend than decreases in private sector net lending. In Europe, the data suggest that fiscal action has been constrained from fully offsetting increases in private sector net lending.

The New Trading Regime

The debate now is what if any legacy do the recent violent and, in some cases, unprecedented market moves leave. Treasury yields have reclaimed the majority of their weekly declines; some rate vol measures have cut in half their gains while the VIX has almost returned to October 10 levels along with SPX itself. Cash credit indices remain a little wider although again off their wides. In Europe the story is broadly similar. Bunds having almost touched 70 bps back at 86 bps (vs. 89 bps October 10[t]), SX5E largely recovered although peripheral spreads are still wider. Importantly some markets have not returned to previous levels -- notably Eurodollars where, although off their extremes, Fed expectations have clearly been pushed back at least one meeting.

There seem to be two camps around this would be “legacy”. The optimistic camp is that really nothing much has changed except the markets were reminded of the real weak links in the global economy, i.e. Europe. After the Draghi euphoria “we will do everything it takes”, reality has set in that a) they can't do what it takes not because of what they can do but because of what it takes and b) even what they do has its limitations, most obviously around the public qe uncertainty but even around the extent of beggar thy neighbor weak euro policy. Fundamentally though the US recovery remains largely orthogonal to Europe. So while the Fed may duck and weave around Euro currency weakness and global disinflation, US inc. is sound. The issue is still not if they normalize rates but when. Normalizing from 2016 doesn't mean much compared with 2015 from a big picture perspective, not withstanding those prior 1 million + net short spec positions that were forced to cover.

The pessimistic camp can readily embrace the same Europe outlook but is less prepared to be so sanguine about US inc's island of prosperity. QE won't work in Europe, even if they did it wholeheartedly, because it never worked in the US. It largely raised asset prices without stimulating new credit demand that would have put the US recovery on a clearer self sustaining track to full employment and higher inflation. Equity valuations are highly dependent on the trajectory for inflation expectations and even if earnings are stable now, valuations are vulnerable around the end of qe. A reversal of inflation expectations threatens a much deeper risk off that might infect business and consumer confidence. Merely delaying the Fed a year isn't the issue. The issue is with the very ability to countenance rate normalization amid the existential threat of global deflation.

We think appreciating this tug of war may prove to be the best guide to market volatility into year end. It will also provide the right kind of framework for discounting policy action. We don't think either camp is so obviously correct that the other can be ignored. At the very least it also suggests that there is some longevity to the recent "new risk off and then "partially" on phase. i.e. we do not think it appropriate to assume that the recent risk off should be readily reversed, with a return to risk asset highs and tights. At least not until there is better clarity from European policy makers. We also think it is important that the Fed emphasizes the free risk asset "put option" with some form of commitment to delayed tightening, perhaps even including an extension of QE.

Specifically what is critical is clarity over whether the ECB really will do public QE and, partly subject to that whether there is any commitment to fiscal stimulus as a backup jumpstart to structural reforms. Fiscal is more important and, if anything, a better trade off if public sector qe is too much. Unfortunately we doubt there is clarity anytime soon on either so that risk remains vulnerable to data (PMIs this week) as well as the AQR results on October 26.

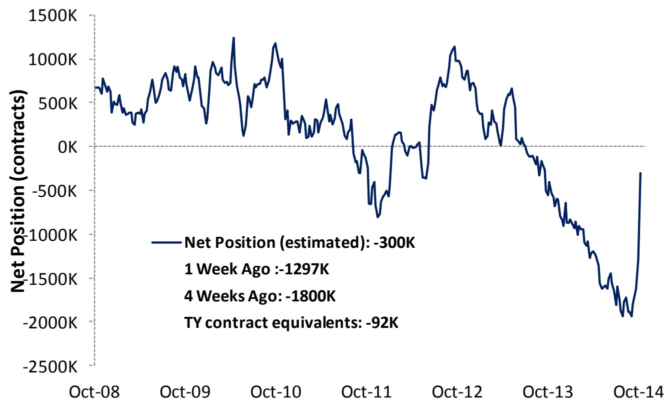
Below we analyse in more detail some of the issues surrounding fiscal easing in Europe compared with the US in the context of its efficacy in boosting demand. It is very clear that US fiscal is a very effective means of boosting growth, conditional on a private sector in deleveraging mode. In Europe the private sector is empirically that much more important. It might be precisely because of the fiscal straightjacket that this has been the case and a proper fiscal response could relieve the private sector. It could also be consistent with recognizing the limits to fiscal stimulus effectiveness and redoubling efforts on private sector credit relief – perhaps even some bank regulatory relief. One thing for sure, though, there is little room to expect nothing but at best, for now, Europe muddles along with very low nominal growth and persistent worries for debt sustainability.

Which brings us to the US and the Fed. To our minds it is clear the Fed is drawing a line in the sand (along with US Treasury) as to how far Europe might expect to rely on a weaker currency as a relief mechanism. Yes, the US recovery is clearly more entrenched and different monetary policy trajectories warrant a tendency towards a stronger dollar. But equally there are limits. As we have highlighted persistently the US recovery is not bad but nor is it particularly good. In particular it has a mature profit cycle. It relies on low wages not high prices as productivity is low. Thank you Tarullo and yes, Yellen recognized this in her inequality speech. This means it needs to be nurtured and not derailed by foreign elements like exported “excess” disinflation from Europe. The Fed wants markets to be more data dependent and for that reason it is still reasonable that QE ends as envisaged, despite Bullard. But we think the risk on-off pull will be with us for a while. Taper delay would be a big positive for risk and 5s10s can steepen further though probably more bearishly. Front eurodollars though would be more firmly locked down. To the extent that the Fed fails to embrace a more cautious approach to normalization and, especially, if the data slacks (worst, a disappointing CPI print) then clearly rates can sharply rally again. Our logic remains that absent assertive policy action from either Europe or the Fed, bouts of risk off can easily dominate around disappointing data.

Whether or not these bouts are as extreme as we’ve recently seen depends to a large extent on the weight of positions. Our positioning metrics give some comfort that risk is more balanced now – less extremely contrite about the world being a beautiful place. The most dramatic position adjustment has been in Eurodollars. While we don’t have the latest CFTC data at the time of writing and anyway it would not capture data after Tuesday, October 14, if we assume the collapse in open interest was all due to short spec positions being closed, we think there may only be about -300k net spec short positions still outstanding. This is down from a peak of -1.8 m and -1.3 m only 10 days ago. Last week we suggested these shorts were vulnerable and the violence of the move has clearly forced, in our view, a healthier equilibrium in rate expectations. We suspect the Fed will essentially endorse this and over time what remains of rate hike expectations in 2015 will be pushed into 2016.

We note however that there is a residual bearish rump that while acceding to a delayed rate normalization believes that any delay must be offset by a still more aggressive trajectory. We wholeheartedly disagree with this logic. For a start, the logic of the delay is to buy more time for the US recovery to become a better recovery. It also is designed to secure the recovery and stem the rise in the dollar that might otherwise undermine it. None of that is achieved if we double up rate expectations in 2016. Or at least, doubling up expectations requires much clearer evidence of stronger data going forward. In addition we continue to emphasize the Fed doesn’t need to rush to neutral. Neutral is a mere 10 meetings away at 25 bps. Taking their time over a two year cycle doesn’t seem unreasonable.

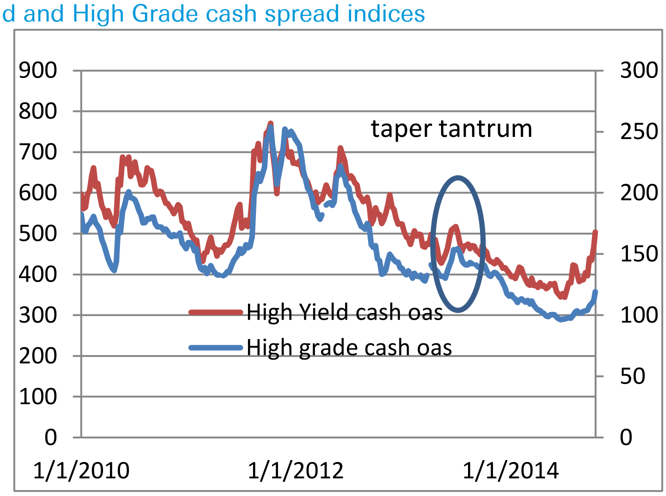
3m Eurodollars futures spec net positions – with estimate of current (end week 10/17)



Source: Deutsche Bank

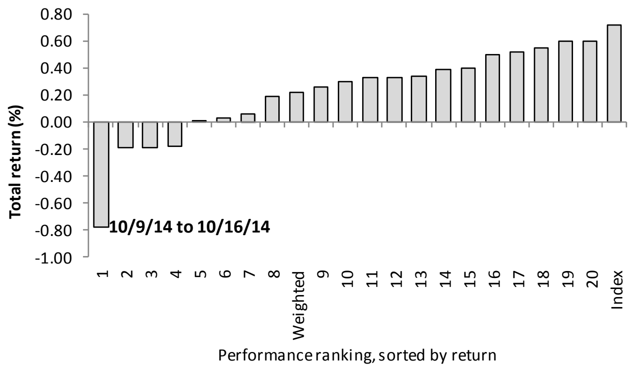
The other big positioning issue we think still, is with real money asset managers. Overall duration hasn't shifted very much according to money manager surveys while based on the top 20 money manager returns we can still see the heavy exposure to credit and implied underweight to rate. In the violent rally and credit spread widening, every money manager underperformed with average weighted underperformance being around 50 bps. There was also some partial recovery later in the week. Our rolling beta analysis of the first principal component on excess returns suggests that IG exposure is dominant in excess returns. Given the relative stability of IG spreads in the risk off, we suspect that real money used alternative hedging vehicles to risk rather than test the dealers' liquidity provision. This probably explains the sharp rise in the VIX and gamma rate vol. HY spreads note did test and bounce from their taper tantrum highs as feared (520-ish on cash OAS DB index) while high grade hardly came close (taper tantrum wides 150 bp cash oas). Going forward if we are right that we may continue to be rocked back and forth between the optimistic and pessimistic camps, we think spreads can stay volatile not least because positioning seems to still be much the same i.e. long credit, underweight Treasuries amid "strong" hands with a bias to hedge opportunistically when vol or VIX looks cheap.

High Yield and High Grade cash spread indices



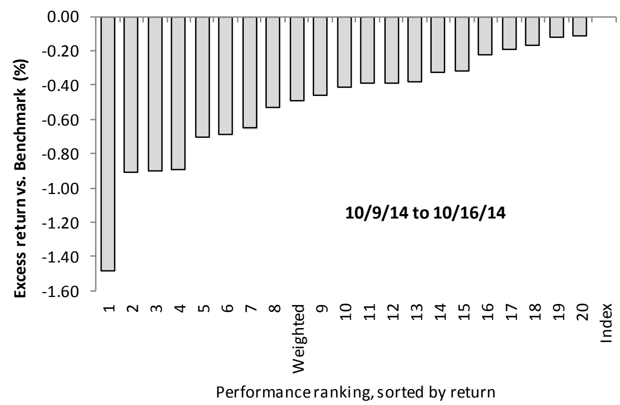
Source: Haver and Deutsche Bank

Last one-week return



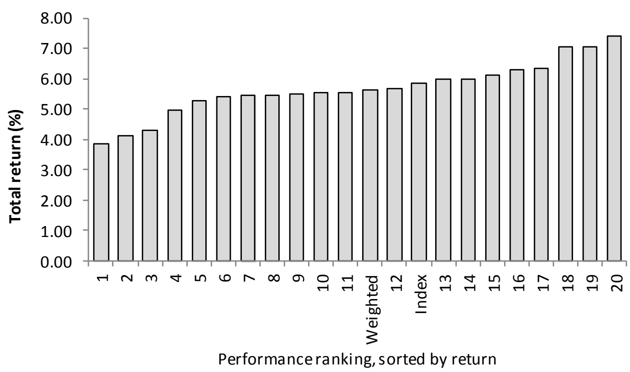
Source: Deutsche Bank

Last one-week excess return over index



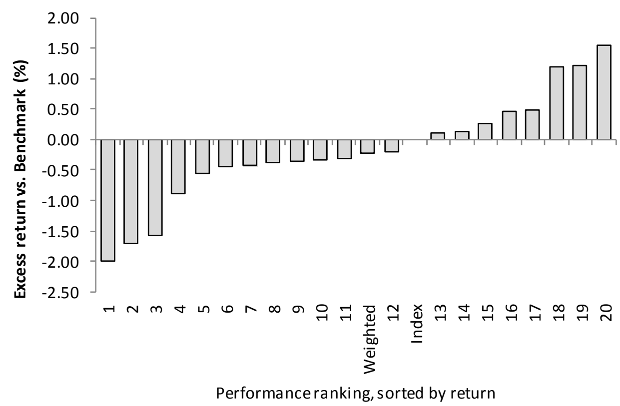
Source: Deutsche Bank

Year-to-date return



Source: Deutsche Bank

Year-to-date excess return over index



Source: Deutsche Bank

Fiscal alternatives for accommodation?

Much has been made of central bank divergence, and ECB President Draghi has amplified expectations that ECB and Fed policy will move in different directions for some time. This was the rationale between rate divergence trades and strength in the dollar. We have been skeptical of this argument vis-à-vis Europe for two reasons. First, ECB purchases of public sector assets remain quite politically contentious. Second, Fed rate hikes in an environment of a static accommodative stance in Europe or further easing portend for a stronger dollar and additional downward pressure on US inflation. We think investors will be well served to consider the scenario whereby the Fed doesn't tighten – at least not in 2015 as has been the consensus expectation – and the ECB does not ease beyond the tLTROs and its current plans for asset purchases.

This is not to say that nothing will be done to support growth in Europe. There remain fiscal alternatives, and although these are also contentious politically, it is possible that they are less so than public sector asset purchases. Moreover, it is possible that fiscal measures might be more effective than public sector QE.

Evidence from the last 15-20 years suggests that the cyclical element of growth is more responsive to changes in the structural deficit than to changes in private sector net lending. We would argue this is clearly the case in the US and perhaps more subtly so within the Eurozone. To illustrate this we looked at annual changes in the real output gap as a function of changes in structural public sector deficits and changes to private sector net lending. For the US, we used CBO estimates of the real output gap, while for Europe we used IMF estimates. In the US we used CBO budget estimates without automatic stabilizers for the structural deficit, while in Europe we used the European Commission's net lending series adjusted for cyclical elements, expressed as a percentage of trend GDP. For both the US and Europe, we used private sector net lending as a percentage of nominal GDP. In both cases the regression intercepts were not statistically significant and results are given with the intercept forced to zero.

US: changes in cyclical growth as function of changes in structural fiscal deficit and private sector net lending

	Coefficients	Standard Error	t Stat
Structural Deficit	0.641	0.11	5.94
Private sector net lending as % GDP	-0.062	0.05	-1.28
Adj R^2	0.667		

Source: Deutsche Bank

In the US, the sensitivities are as one would expect: an increase in the structural fiscal deficit results in higher growth relative to potential, and an increase in private sector net lending (savings) slows growth relative to trend. The structural fiscal variable is strongly significant, while the private sector net lending variable is not. Moreover, the coefficient of the structural deficit variable is far larger in magnitude than for the private sector variable.

In our view the results suggest a limited efficacy of QE in that QE would affect private sector investment (lowering net lending) by lowering the cost of capital to very attractive levels. While the sign of the coefficient is consistent with this, the magnitude and (lack of) significance during a historical period which includes Fed QE suggests limited observed impact.

Europe: changes in cyclical growth as function of changes in structural fiscal deficit and private sector net lending

	Coefficients	Standard Error	t Stat
Structural Deficit	0.52	0.32	1.59
PrivSec net Lending % GDP	-0.87	0.16	-5.53
Adj R^2	0.65		

Source: Deutsche Bank

In Europe the results are somewhat different, but we think suggest a similar interpretation. The coefficient signs are again consistent with intuition; a higher structural deficit increases growth relative to trend, and higher private sector net lending (saving) reduces growth relative to trend. In Europe, however, the structural deficit isn't statistically significant, while private sector net lending is significant and larger in absolute value than the structural deficit variable.

One can square the circle here by noting the differences in the political and fiscal infrastructure in Europe versus the US. Throughout the crisis Europe has been constrained by limits on excessive deficits, so in this light the statistical result of less responsiveness to structural deficits and more to the private sector is no surprise. We would argue that because of these constraints, fiscal policy was unable to sufficiently offset the decline in private demand, so the effect of increases in private sector net savings predominate in the analysis. The implication is that some agreement for a temporary fiscal "relent" might enable fiscal policy to provide a tailwind to growth relative to trend, if political obstacles make public sector asset purchases a non-starter.

United States

Rates
Gov. Bonds & Swaps

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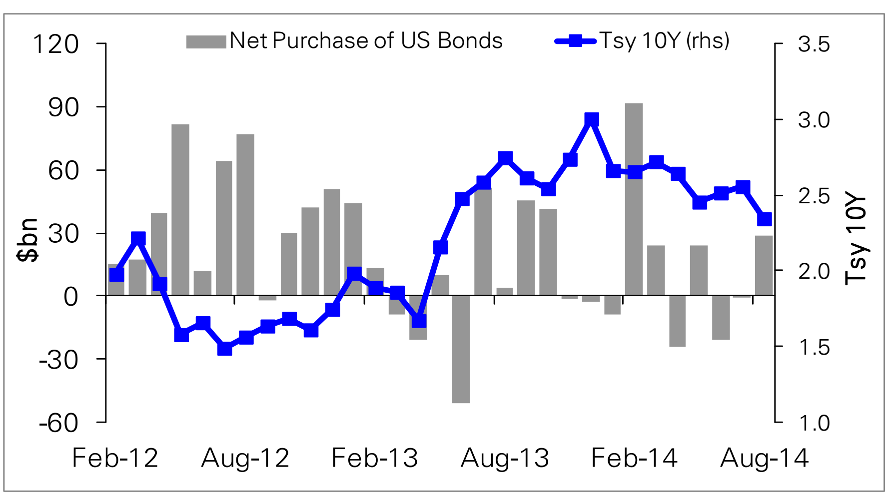
Treasuries

- Foreign investors purchased $26 billion of long-term Treasuries in August. Latin America was the largest buyer with $15 billion of investments whereas Asia and Europe added $13 billion and $10 billion, respectively.
- Net foreign purchases of long-term Treasuries have totaled $133 billion so far this year. Foreigners divested $31 billion of securities in the first eight months last year; they added $368 billion of paper during the same period in 2012.
- Treasury two-year floaters have been well received by investors since their introduction in January 2014. We analyze auction data and total return performance. Treasury auction allotment figures show that foreign investors have been a consistent demand source for floaters at auctions this year.

Foreign Treasury purchases rebound in August

Foreign investors purchased a net $29 billion long term U.S. Treasury, agency and corporate bonds in August, the most since February. August's additions were preceded by net reductions of $21 billion in June and a small $0.4 billion in July. Asia based investors led the purchases in August with $18 billion in investments, followed by those in UK and the Latin America who added, respectively, $16 billion and $14 billion of securities. Europe ex-UK however offloaded $13 billion of securities, taking its net divestments to $68 billion since the beginning of the year.

Foreign purchases of US bonds by month, vs. 10Y yield level

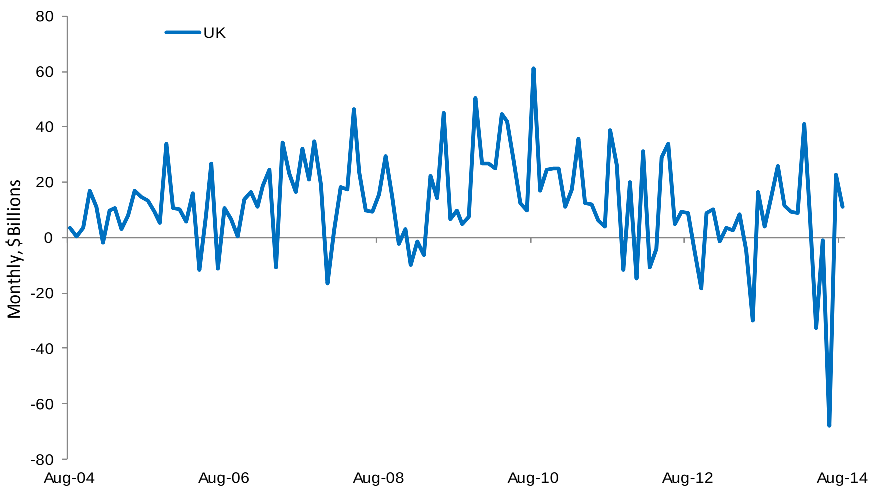


Source: US Treasury; Deutsche Bank

In Treasuries, Latin America was the largest buyer of notes and bonds, adding $15 billion of securities during the month. Asia purchased $13 billion of paper as well, offsetting its net divestments in July. Europe was a net buyer of $10 billion of securities for the second straight month. However, investors based in

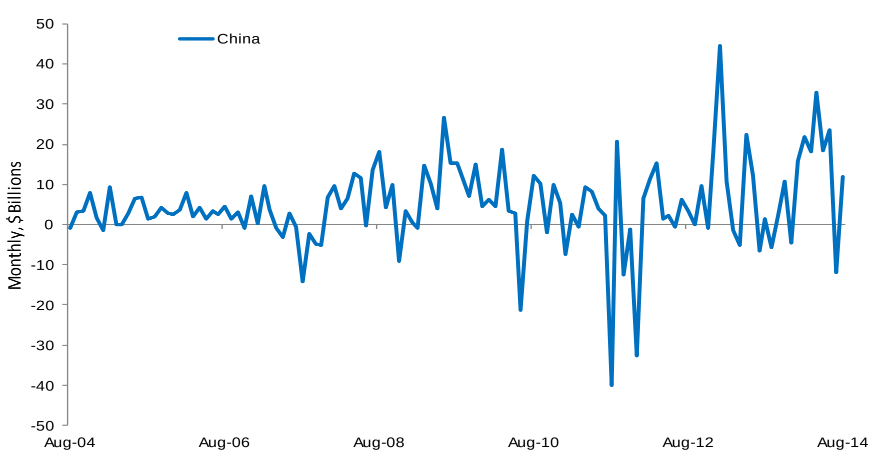
Canada offloaded $9 billion. Overall, the net foreign investments totaled $26 billion in August, of which $4 billion were attributed to foreign official institutions.

UK's net purchase of Treasury notes and bonds



Source: U.S Treasury Department

China's net purchase of Treasury notes and bonds



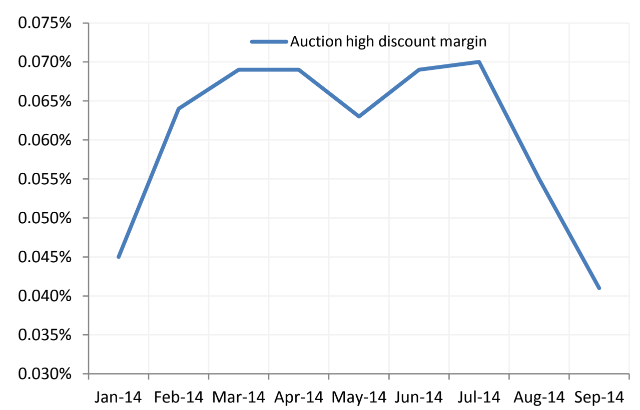
Source: U.S Treasury Department

Foreigners were net buyers of $10 billion in agency and mortgage-backed securities in August. Europe led the purchases with $5 billion of investments whereas the Asia was a close second at $4 billion. However, they divested $7 billion from the corporate paper for the second consecutive month.

Treasury floaters update

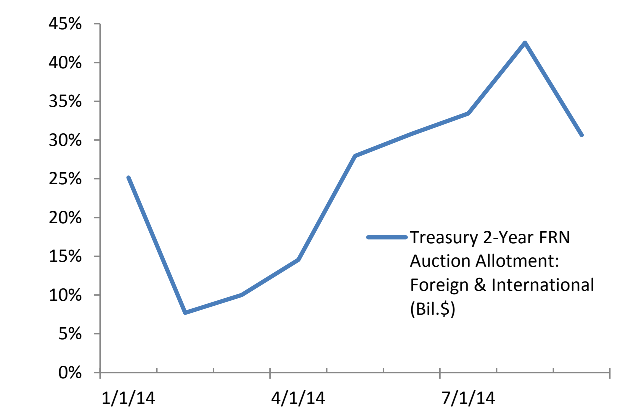
Treasury two-year floaters have been well received by investors since their January introduction. In the September auction, $13bn floaters were sold at a high discount margin of 0.041%, the lowest on record. Indirect bidders made up 54% of the purchase, an indication that client demand for these securities remains strong. Treasury auction allotment figures show that foreign investors have been a consistent demand source for floaters at auctions this year.

Record low discount margin at the last FRN auction



Source: Treasury and Deutsche Bank

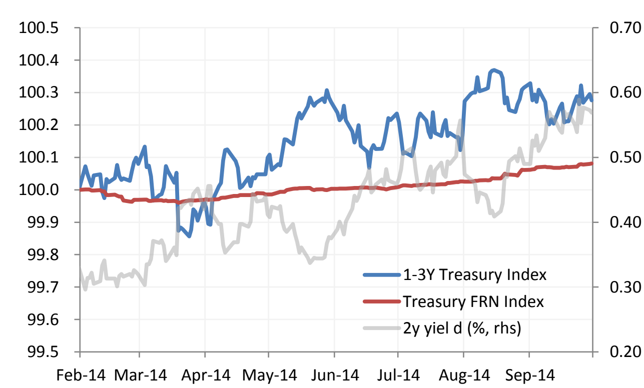
Foreign investor allotments



Source: Treasury and Deutsche Bank

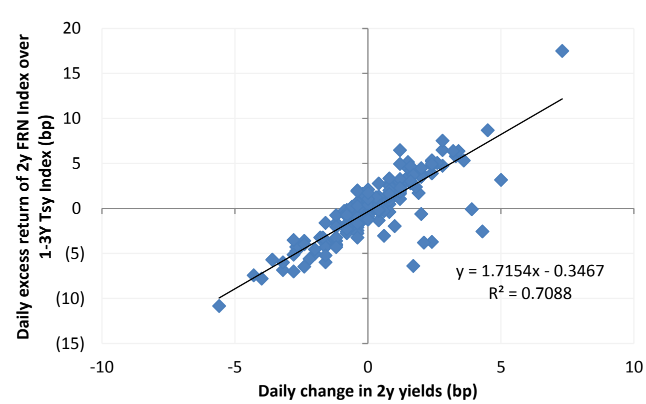
Despite the increase in short rates this year, on a total return basis 2y floaters have underperformed 2y fixed coupon notes. The Bloomberg Treasury Floating Rate Bond Index returned 0.08% from January 31 through September 30, compared to a 0.28% return on the Treasury 1-3 Year Index. The underperformance is not a surprise, given the higher yield and longer duration on the Treasury 1-3 Year Index, whereas floaters are considered a short term investment vehicle.

Treasury floater and 1-3y fixed coupon indexes vs. 2y yields



Source: Bloomberg Finance LP and Deutsche Bank

Regression of floater vs. fixed excess returns on daily 2y yield changes



Source: Bloomberg Finance LP and Deutsche Bank

A regression[1] of the difference in daily returns by these two indexes on daily 2y yield changes suggests that for 2y floating and 2y fixed coupon notes to return the same to investors, yields in the 2y sector would have to rise by 0.21bp per day, or 37bp total, between February 2014 and September 2014. 2y yields increased just 25bp during this period.

[1] The regression has a constant of -0.37% and a beta coefficient of 0.017%, the former can be interpreted as the opportunity cost of unearned carry from holding floaters versus fixed rate note, and the latter implies the percentage excess return over a fixed rate note portfolio for every basis point rise in yields.

Two-year floating rate note (FRN) auction allotments

Settle Date	Total (less Fed)	Federal Reserve		Dealers and Brokers		Investment Funds		Foreign and International		Other	
	$bn	$bn	%*	$bn	%	$bn		$bn	$bn	%*	$bn
1 Yr Avg	*14*	*0*	*0%*	*7.9*	*58%*	*1.8*	*13.2%*	*3.4*	*24.8%*	*0.5*	*4.0%*
9/26/2014	**13**	**0.0**	**0%**	**5.9**	**46%**	**0.1**	**0.6%**	**4.0**	**30.6%**	**3.0**	**23.2%**
8/29/2014	13	0.0	0%	6.9	53%	0.4	3.5%	5.5	42.6%	0.1	0.6%
7/31/2014	15	0.0	0%	8.6	57%	0.9	6.1%	5.0	33.4%	0.5	3.4%
6/27/2014	13	0.0	0%	7.8	60%	1.2	8.9%	4.0	30.8%	0.1	0.5%
5/30/2014	13	0.0	0%	7.6	58%	1.5	11.5%	3.6	28.0%	0.3	2.3%
4/30/2014	15	0.0	0%	9.8	65%	2.5	16.5%	2.2	14.5%	0.5	3.5%
3/28/2014	13	0.0	0%	8.7	67%	2.9	22.7%	1.3	10.0%	0.0	0.1%
2/28/2014	13	0.0	0%	7.8	60%	4.0	30.8%	1.0	7.7%	0.2	1.3%

** Percentage as of total less Fed SOMA*
Source: US Treasury and Deutsche Bank

Fed buyback

Next week's three buyback operations are worth about $4 billion in notional and $3 billion in ten-year equivalents. Monday and Tuesday's operations are targeted at the 4.8-5.75 and 7-10 year sectors of the curve whereas the 5.8-7 year segment will be in focus on Thursday.

Fed buyback schedule for October 20-24

Date	Operation type	Maturity range		Expected par ($bn)	Avg. Duration	Avg. DV01	10yr Equiv ($bn)	Sub/cover (Last 4 avg)
20-Oct	Treasury	7/31/2019	6/30/2020	1.125	4.85	5.16	0.65	5.14
21-Oct	Treasury	11/15/2021	8/15/2024	1.550	7.30	8.15	1.42	3.13
23-Oct	Treasury	7/31/2020	9/30/2021	1.500	5.80	6.32	1.06	3.70
	Total			4.18	6.08	6.69	3.13	

Source: Deutsche Bank, New York Fed.

United States

Rates
Gov. Bonds & Swaps
Rates Volatility

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Derivatives

- Vol has returned to the markets with the last week's developments likely to set the template for future market corrections. The unprecedented realized move in rates, about seven standard deviations intraday, has been to a large extent a function of positioning and is unlikely to resurface with the same force.
- The most troubling fact after the last week is the transient nature of the entire episode. Only two days after the event, we were seeing attempts to undo the correction -- as if the market is using this as an opportunity to reload on the same trades that led to it. Such a quick reversal of volatility spike reaffirms both our concerns that such episodes are likely to resurface in the near term, as well as our conviction that risky assets would be the epicenter of future turbulence.
- While at these vol levels it might be tempting to go back to selling strangles and reload on risky assets, an outright gamma short could be premature as the market could experience additional turbulence in the near term. We believe that selling vol in an RV context or though contingent structures is a safer option. We recommend the following vol trades:
- **Sell $195mn 3M5Y vs. buy $100mn 3M10Y straddles at zero cost.**
- **Sell $100mn 6M5Y vs. buy $100mn 18M5Y straddles, offer 184c**
- In rates, our core position is bull steepeners in 5s/10s. This is the mode that could persist beyond 2014. We would express this view through contingent curve caps:
- **6M 5s/10s ATMF curve cap subject to 5Y CMS < Fwd-25bp (at expiry), offer 4.5c, a 58% discount to vanilla at 10.75bp**
- The repricing of risky assets might not be over yet. In the near-term, accommodative Fed and delayed rate hikes is a bull stepener with reduced vol and a possible rebound in risky assets. A delayed response or non-dovish rhetoric, on the other hand, could trigger another leg of risk off trade and further sell off in risky assets lower, which might rebound only after that. The following trades capture the two scenarios:
- **3M SPX ATM (1890) call subject to 5s < Fwd-10bp at expiry, offer 1.00%, a 70% discount to vanilla at 3.25%**
- **3M SPX ATM (1890) call subject to KO at 1950 (103%) during the first month, offer 1.15%, a 66% discount to vanilla at 3.25%**

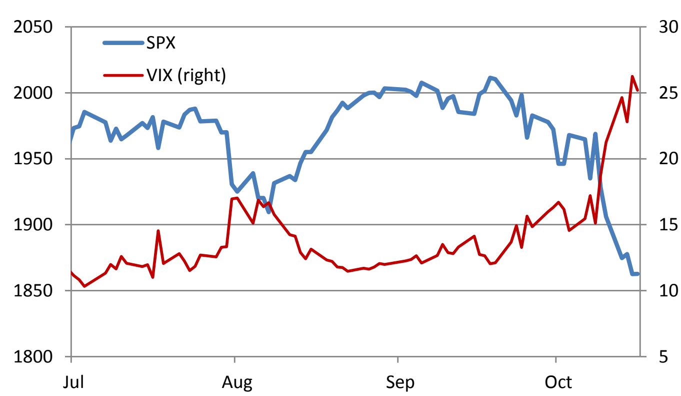
Everything is moving, but nothing is changing

Vol has returned to the markets with the last week's developments likely to set the template for future market corrections. For rates, the magnitude of realized move was unprecedented. Large daily swings, in excess of 20bp, used to be a regular occurrence 10-15 year ago, but this was primarily an effect of negative convexity of the market. This time around, the magnitude of the move, although not surprising in the context of market positioning, has caused a temporary sense of panic. What made things especially uncomfortable was the large intraday whipsaw. Rates led the way with as much as 35bp rally in the morning trading hours (about 7-sigma move), and closing only 6bp lower for the day. In contrast, max S&P move remain within two standard deviations. Such a large whipsaw made it very uncomfortable for liquidity providers which largely distorted the pricing. To put things in perspective, for the current market calibrated to 3M10Y vol around 4.5bp/day a 35bp daily move exceeds seven standard deviations. In units of 2001-2005 markets, when 3M10Y was trading north of 8+bp/day, this would correspond to a 50+bp move. For comparison, the largest one-day move in rates has been a 47bp rally in 10Y UST on 18-Mar-2009.

The discomfort caused by such an outlier is something that is justified in the context of existing market complacency. Low volatility and excessive determinism, fostered by the Fed transparency, created positions which became vulnerable to minor instabilities. A buildup of rates shorts, which have seen a capitulation in the last week, has been partly "subsidized" by the dollar strength, which in itself began to expose vulnerability of the US economy to deflationary risks and further reduced a likelihood of rate hikes.

While weakness in Europe and anticipation of policy response there was encouraging for the US shorts, it went against the equity market's pricing as ECB disappointed. The explosion of vol across the board was announced by the dramatic rise in VIX, which started gradually in mid-September from 12% reaching 15% by the end of the month, and soared to 26% in the second week of October. This was largely a function of both market complacency and caution of equity investors. With S&P on the way to new highs as of late August, the risk/reward profile looked like a high probability of small gains and a low probability of big losses. This meant a long equity position overlaid with OTM puts. At the same time, high degree of complacency encouraged short gamma as a carry position with multiple implementations either through VIX puts or futures. This made both street short convexity in a sell off and investors short VIX and when equities sold off and street hedging exacerbated the move, the first leg of rise in VIX was multiplied by short covering of VIX positions. All of this was helped by strong USD and weakness in Europe together with less optimistic outlook in the US. At the end, what had been the strongest points for US equities, (e.g. growth prospects, liquidity and response to accommodation), turned out to be their biggest curse. The need to deleverage meant that losses would have to be covered by the best performers, which meant either credit or equities, but, because of relatively pore liquidity, equities had to pay the price. In fact, in the metric of different risk premia, reaction of credit has been relatively mild. Compared to the move in VIX, IG widening has been twice as strong as post-2008 history suggests.

Figure 1: S&P and VIX: a perfect storm

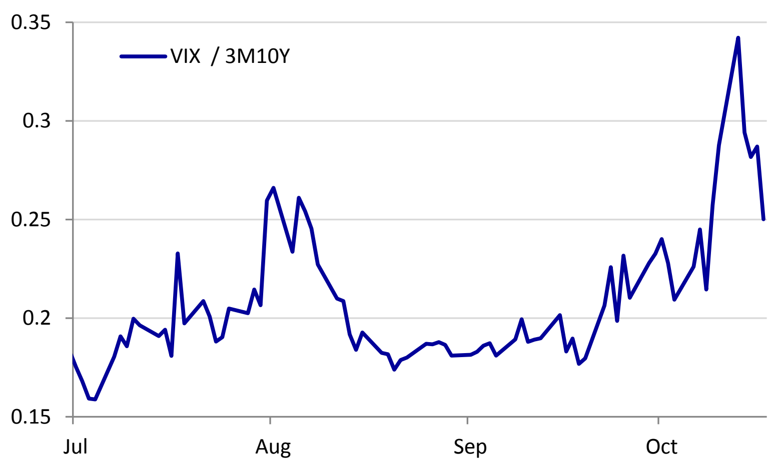


Source: Deutsche Bank

Extremely low volatility has been one of the main concerns of the Fed. In our view, their intention was to shake things up so that risky assets reprice close to fundamentals, but not to shake them up too much, as one sided positioning could trigger possible liquidity problems and cause positive feedback in the market. The absence of particular theme on Wednesday suggested that volatility has reached uncomfortable levels and that its further rise could be counterproductive. It is not unlikely to see an effort on the Fed side to smooth things out if we see further turbulence.

To a large extent, last week's rise in rates vol reflects the magnitude of realized move due to capitulation of the shorts. Open interest indicates that about 2/3 of this trade is done, so, we do not expect to see another leg of vol increase. Risky assets, opn the other hand are potential source of risk. For some time, our contention has been that return of volatility would take place through risky assets. This is what happened this time, as equities vol led the way. Fig 2 shows the recent history of the ratio between VIX and rates vol.

Figure 2: Equity vs. rates vol



Source: Deutsche Bank

Perhaps the most troubling fact after the last week is the transient nature of the entire episode. Only two days after the event, we were seeing attempts to undo the correction -- as if the market is using this as an opportunity to reload on the same trades that led to it. Such a quick disappearance of the spike in volatility reaffirms both our concerns that such episodes are likely to resurface in the near term, as well as our conviction that risky assets would be the epicenter of future turbulence.

Trades: Go faster, but go where?

While at these vol levels it might be tempting to go back to selling strangles and reload on risky assets, an outright gamma short could be premature as the market could experience additional turbulence in the near term. We are not against fading the last week's turbulence, but would exercise caution in this context. We believe that selling vol in an RV context or though contingent structures is a safer option.

Vol

If rates vol spikes again in sympathy to risky assets vol and another episode of the risk off trade, it is unlikely to see a move of the same magnitude in the belly as most of positions have been cleared there. In the near term, rebuilding of rates short is unlikely, especially of the magnitude that led to the last week's unwinds. At current levels, we would finance a long gamma position in 10Y tenors through short 5Y gamma:

- **Sell $195mn 3M5Y vs. buy $100mn 3M10Y straddles at zero cost.**

If the market recovers in the sense that sentiment returns to pre-October correction, but rate hikes are pushed into 2016, 5Y gamma could remained somewhat constrained while bid for forward vol in the belly would resurface with calendar spreads opening up. Current pricing offers attractive entry levels for this trade:

- **Sell $100mn 6M5Y vs. buy $100mn 18M5Y straddles, offer 184c**

Both trades are vulnerable to unilateral rise in 5Y gamma with potentially unlimited downside.

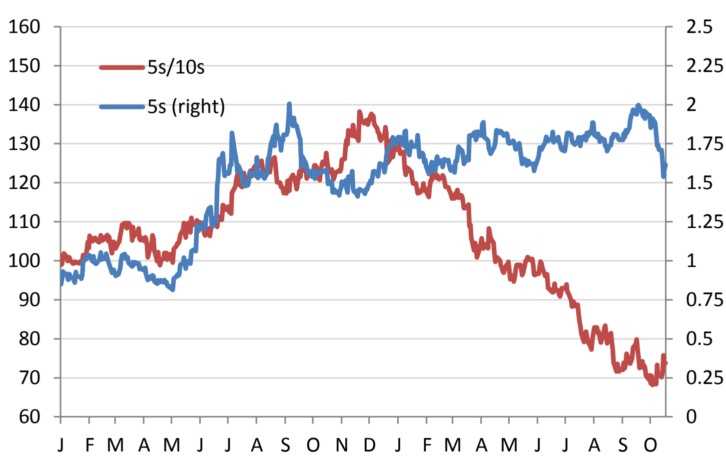
Rates, risky assets and curve modes

Going forward, the strategies are likely to be a function of the policy response and any unconditional trades remain risky. In rates, our core position is 5s/10s steepener. With the unwind of shorts on the Eurodollar strip and repricing of delayed rate hikes, the belly is likely to outperform with 5Y UST ending up below 1.25% if rate hikes are pushed into 2016, while 10s could stay at current levels or even rebound higher. This is the mode that could persist beyond 2014. We would express this view through contingent curve caps:

- **6M 5s/10s ATMF curve cap subject to 5Y CMS < Fwd-25bp (at expiry), offer 4.5c, a 58% discount to vanilla at 10.75bp**

Ref. fwd 66.25bp, 6M5Y fwd 1.89%. The barrier at 1.64% reflects the view that 5s would return to their pre-taper-tantrum levels, Fig 3.

Figure 3: 5Y swaps rate and 5s/10s since 2013



Source: Deutsche Bank

The repricing of risky assets might not be over yet. In the near-term, accommodative Fed and delayed rate hikes is a bull stepener with reduced vol and a possible rebound in risky assets. A delayed response or non-dovish rhetoric, on the other hand, could trigger another leg of risk off trade and further sell off in risky assets lower, which might rebound only after that. If there is a forced deleveraging, it is likely that risky assets will "finance" that process as they have had the most impressive gains in the last year. Given the liquidity problems in credit, equities might be the first frontier in that process, which should be bearish for stocks and supportive for vol. So, while the word “rebound” of risky assets is in both scenarios, the initial conditions would be very different. We recommend two trades that capture these two policy response modes.

Dovish: Equities rise while Fed hikes are pushed out (Contingent equity calls)

- **3M SPX ATM (1890) call subject to 5s < Fwd-10bp at expiry, offer 1.00%, a 70% discount to vanilla at 3.25%**

Hawkish: Equities decline before they bounce back (Up & out calls)

- **3M SPX ATM (1890) call subject to KO at 1950 (103%) during the first month, offer 1.15%, a 66% discount to vanilla at 3.25%**

Both trades are offered at a substantial discount to vanilla. Even when combined to proxy for an “unconditional” strategy (equities rebound one way or another), at total price of 2.15%, they still look attractive relative to vanilla at 3.35%. All trades have a limited downside with maximum losses equal to the options premium.

United States

Rates
Gov. Bonds & Swaps
Inflation
Rates Volatility

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Inflation-Linked

- Treasury will issue additional $7 billion February 2044 TIPS through a second reopening auction on Thursday, October 23. Customers took down 67.9% of the supply in June this year. Except the auction in October 2013, which came through 2.3bp, recent 30-year bond TIPS auctions since 2011 have tailed.
- We believe bond TIPS are cheap on a relative value basis, and the 10s/30s breakeven curve has room to steepen.
- We analyze the latest ten-year TIPS auction allotment data.

Auction preview: 30-year TIPS, re-opening

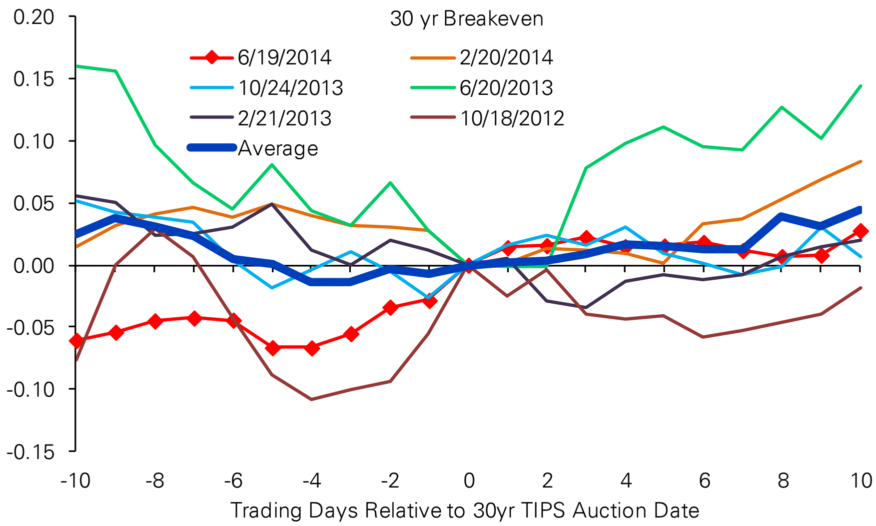
The Treasury will issue additional $7 billion February 2044 TIPS through a second reopening auction on Thursday. Customers took down a solid 67.9% in June this year. The indirect bidder takedown was good in the last four auctions except for the one in last October, in which indirect bidders bought 45% of supply versus their one-year average of 53.7%. The direct bidder participation however was just the opposite as it was strong in October but weak in the other three. The opening auction this year had a weak bid-to-cover ratio of 2.34 (average 2.62) while the last auction was strongly bid (2.76). Except the one in October 2013, which came through by 2.3bps, every auction since 2011 has tailed. We believe bond TIPS are cheap on a relative value basis, and the 10s/30s breakeven curve has room to steepen.

30-year TIPS auction statistics

	Size ($bn)	Primary Dealers	Direct Bidders	Indirect Bidders	Cover Ratio	Stop-out Yield	1PM WI Bid	BP Tail
1yr Avg	*$7.67*	*35.5%*	*10.8%*	*53.7%*	*2.62*			*1.0*
Jun-14	**$7.00**	**32.1%**	**8.2%**	**59.7%**	**2.76**	**1.116**	**1.082**	**3.4**
Feb-14	$9.00	38.5%	4.9%	56.5%	2.34	1.495	1.475	2.0
Oct-13	$7.00	35.9%	19.1%	45.0%	2.76	1.330	1.353	-2.3
Jun-13	$7.00	38.9%	0.4%	60.8%	2.48	1.420	1.390	3.0
Feb-13	$9.00	31.6%	14.0%	54.5%	2.47	0.639	0.620	2.1
Oct-12	$7.00	37.7%	13.2%	49.1%	2.82	0.479	0.485	0.1
Jun-12	$7.00	37.6%	28.1%	34.3%	2.64	0.520	0.495	2.5
Feb-12	$9.00	45.8%	13.6%	40.6%	2.46	0.770	0.695	7.5
Oct-11	$7.00	30.2%	26.7%	43.2%	3.06	0.999	1.050	-5.1
Jun-11	$7.00	50.5%	26.1%	23.3%	3.02	1.744	1.788	-4.4
Feb-11	$9.00	41.2%	3.6%	55.2%	2.54	2.190	2.214	-2.4
Aug-10	$7.00	33.1%	28.0%	38.9%	2.78	1.768	1.783	-1.5

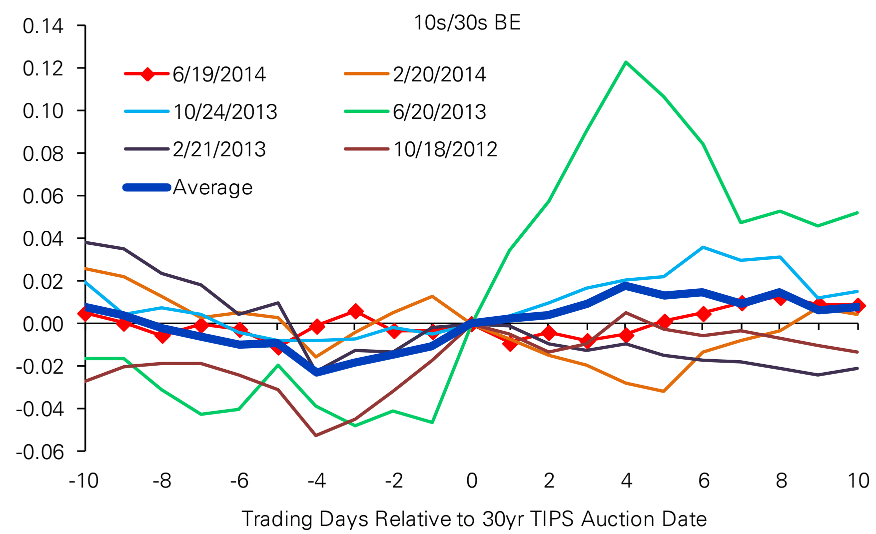
Source: US Treasury and Deutsche Bank

30y TIPS breakevens around auctions



Source: Deutsche Bank, Bloomberg Finance LP

10s/30s breakevens around auctions



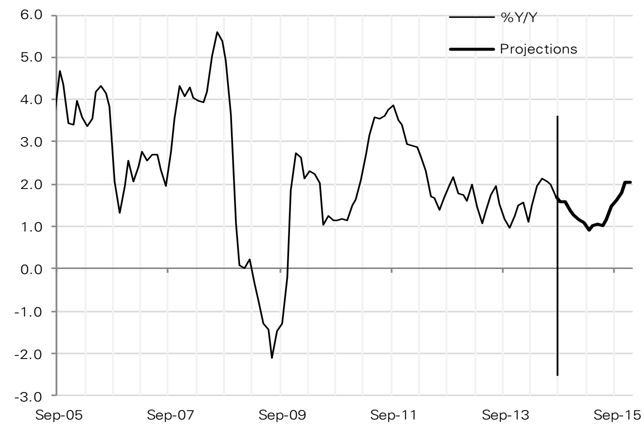
Source: Deutsche Bank, Bloomberg Finance LP

CPI preview: Soft patch likely to continue in September

We expect the headline CPI index to change little in September, as the Bureau of Labor Statistics (BLS) reports the inflation data on Wednesday, October 22. On year-on-year basis this would translate to 1.6% gain in the Index, down from 1.7% increase in the previous month.

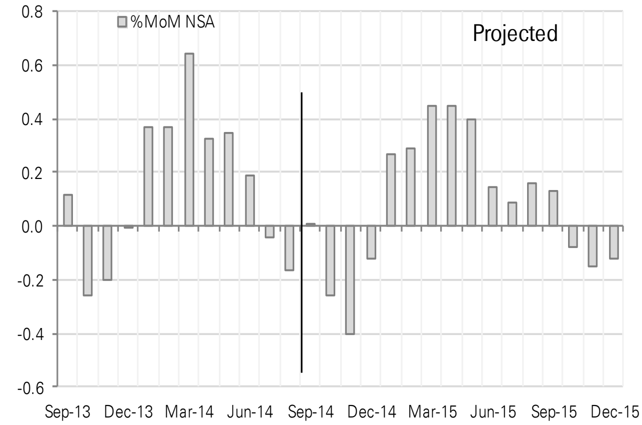
Falling gasoline prices and the subdued food inflation is likely to keep the headline under pressure in coming months. Strong dollar should keep the commodities inflation soft. However, the trend in rent and owner's equivalent rent prices remains strong and is expected to keep the services inflation supported. Core CPI should remain in the 1.7% to 1.8% range until July 2015 and then could finally pick up towards 2% in the second half of 2015.

US CPI-U NSA y/y, actual and forecast



Source: Bureau of Labor Statistic, Deutsche Bank and Bloomberg Finance LP.

MoM CPI-U, actual and forecast (non-seasonally-adjusted)



Source: Bureau of Labor Statistic, Deutsche Bank and Bloomberg Finance LP.

Allotments update: Ten-year TIPS

In the September ten-year TIPS re-opening auction, the foreign and international investor allotment share fell to 12.4%, the lowest since March 2013, from 17.8% in July and compares with its one-year average of 20%. The allotment share to investment funds however increased slightly to 44.7% and remained above the average 41.4% for the third straight month. The combined share allotted to the two investor classes was down to 57.1% from the about average 61.4% in July.

Ten-year TIPS auction allotments

Settle Date	Total (less Fed)	Federal Reserve		Dealers and Brokers		Investment Funds		Foreign and International		Other	
	$bn	$bn	%*	$bn	%	$bn		$bn	$bn	%*	$bn
1 Yr Avg	*14*	*0*	*0%*	*5.2*	*38%*	*5.7*	*41.4%*	*2.7*	*20.0%*	*0.1*	*0.4%*
9/30/2014	**13**	**0.0**	**0%**	**5.5**	**43%**	**5.8**	**44.7%**	**1.6**	**12.4%**	**0.0**	**0.3%**
7/31/2014	15	0.0	0%	5.7	38%	6.5	43.5%	2.7	17.8%	0.1	0.5%
5/30/2014	13	0.0	0%	3.6	28%	7.1	54.4%	2.3	17.6%	0.0	0.2%
3/31/2014	13	0.0	0%	5.9	46%	4.3	33.4%	2.7	20.5%	0.1	0.4%
1/31/2014	15	0.0	0%	6.2	42%	6.0	39.9%	2.7	18.0%	0.1	0.5%
11/29/2013	13	0.0	0%	4.4	34%	4.2	32.4%	4.4	33.7%	0.0	0.2%
9/30/2013	13	0.0	0%	6.1	47%	4.6	35.8%	2.2	16.8%	0.1	0.5%
7/31/2013	15	0.0	0%	5.3	36%	5.8	38.6%	3.7	24.9%	0.1	0.8%
5/31/2013	13	0.0	0%	4.3	33%	5.9	45.2%	2.7	21.1%	0.1	0.5%
3/28/2013	13	0.0	0%	5.8	44%	6.0	46.0%	1.2	9.5%	0.0	0.1%
1/31/2013	15	0.0	0%	5.5	37%	8.0	53.4%	1.5	9.8%	0.1	0.3%
11/30/2012	13	0.0	0%	5.7	44%	6.3	48.3%	1.0	7.8%	0.1	0.4%

** Percentage as of total less Fed SOMA*
Source: US Treasury and Deutsche Bank

Europe

Rates
Gov. Bonds & Swaps
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Rates Volatility

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Bond Market Strategy

- The market volatility stopped us out of out of the long BTP 5y earlier this week (entry 1.03% stop at 1.2%), and we exit the corresponding hedges EUR10s30s flattener, receiver spreads in EUR3m30Y and long US breakeven vs. euro. The recent market moves present both some opportunities and some threats
- From an *opportunistic* perspective, USD breakevens, rates gamma and European equities have overreacted relative to IG credit and conventional metrics of financial market stresses such as swap spreads. The spike in gamma offers opportunities to enter conditional bearish positions in the front-end of the US curve and conditional bullish position in the front-end of the EUR curve
- In Europe, the dynamics in the periphery are likely to dominate the price action. Despite recent market volatility, there are important structural differences which should prevent a repeat of 2011-12. However, political risk in Greece remains high and is unlikely to be resolved soon
- From a medium-term perspective we should be mindful about the *threat* of a tightening of credit conditions in the Eurozone if the market stresses worsen further in a lasting fashion

Threats and opportunities

The market volatility stopped us out of out of the long BTP 5y earlier this week (entry 1.03% stop at 1.2%), and we exit the corresponding hedges EUR10s30s flattener, receiver spreads in EUR3m30Y and long US breakeven vs. euro. The recent market moves present both some opportunities and some threats.

First from an *opportunistic* perspective, we search for market dislocations across asset classes. The aim of the exercise is to identify those assets which have either over or under reacted in the latest moves. This scanning exercise suggests that USD breakevens, rates gamma and European equities have overreacted relative to IG credit and conventional metrics of financial market stresses (such as asset swaps). The spike in gamma offers opportunities to enter conditional bearish positions in the front-end of the US curve and conditional bullish position in the front-end of the EUR curve. This analysis also supports our constructive view on USD breakevens.

In the US, the data remains broadly consistent with a resilient growth trajectory. In the context of a Fed which has ratcheted up its dovish rhetoric, the curve remains too flat given the level of front-end rates. We continue to recommend USD5s10s steepeners with a beta weighted short position in the front-end of the curve. In Europe, the dynamics in the periphery is likely to dominate the price action. Despite the recent market volatility, there are important differences today relative to the height of the Eurozone crisis in 2011-12. From a strategic perspective, we remain constructive on Italy and Spain as the fiscal & current account position and reduced non-resident ownership should ensure that they are more resilient today, especially in the context of an ECB which is more pro-active. However, political risk in Greece remains high. Given that Greece is now running a primary budget surplus and the vast majority of the redemptions in the coming years are due to the Troika there is an increased risk of political brinkmanship.

Finally, from a macro perspective, the easing of credit conditions was one of the positives for the Eurozone economy. We should be mindful about the *threat* of a tightening of credit conditions if the market stresses worsen further in a lasting fashion.

Market dislocations – monetizing new opportunities

This week has been marked by an extreme volatility across asset classes and by an increase in most stress indicators. However the market response to the spike in risk aversion has not been homogeneous. We build a stress monitor for an extensive list of assets (see below). The stress indicator for each asset corresponds to the position of the current asset price relative to its past level at the peak of the EU crisis in Q4 2011 and relative to its level at the time of the June ECB meeting before the drop in commodity prices. A stress indicator around 100% means that the asset is roughly as depressed as it was back in Q4 2011, a stress indicator around 0% means that the asset price is very close to the price observed this June before the start of the risk-off environment.

Stress monitor

Assets	Today	Peak EU crisis Q4-11	June-14 ECB meeting	Stress indicator
EUR 5Y5Y BE	1.76	1.95	2.12	208%
USD 5Y5Y BE (Fed measure)	2.25	2.24	2.44	92%
EUR 30y vol slope (3M vs 2Y expiry)	11.62	23.33	(8.31)	63%
USD 30y vol slope (3M vs 2Y expiry)	9.90	28.25	(13.40)	56%
Treasury 10Y yield	2.15	1.82	2.60	58%
Italy FTSE MIB	18,083.1	14,244	22,472	53%
V2X (Eurostoxx vol)	31.5	50.4	13.1	49%
VIX (S&P vol)	25.1	40.8	11.2	47%
European Bank stocks	130.0	97.8	160.8	49%
UST 5Y ASW	20.3	35.3	8.0	45%
USD 3M30Y gamma	87.7	135.8	61.2	36%
Eurostoxx 50	2,874.7	2,091.1	3,305.3	35%
US 10Y real yield	0.25	0.04	0.38	38%
EUR 3M30Y gamma	68.4	126.9	45.6	28%
Itraxx X-Over - EU HY CDS 5Y	401.1	874.4	218.6	28%
CVIX (FX vol)	8.0	14.6	5.5	27%
Libor/OIS 2Y2Y basis	25.77	39.00	19.95	31%
EURUSD 2Y2Y Xccy basis swap	13.75	34.75	6.50	26%
OAT Bund spread	44.24	82.92	32.21	24%
Libor/OIS 5Y basis	23.34	39.00	18.48	24%
Euribor/Eonia 2Y2Y basis	20.50	32.60	17.00	22%
CDS EU Sub Financials 5Y	176.9	550.7	85.1	20%
US CDX IG	74	148	57	18%
EURUSD 5Y Xccy basis swap	13.3	43.0	6.8	18%
BTP Bund spread	175.93	376.8	132.55	18%
US CDX HY	398	867	297	18%
US Libor/OIS 3M basis (4th IMM)	19.5	51.0	13.1	17%
Bund ASW	27.5	74.9	18.2	16%
Libor/OIS 2Y basis	18.62	47.01	14.47	13%
Itraxx Main - EU IG CDS 5Y	75.6	208.4	56.5	13%
EURUSD 2Y Xccy basis swap	14.3	63.8	8.0	11%
Euribor/Eonia 5Y basis	19.05	38.70	16.90	10%
JPYAUD exchange rate	1.07	1.36	1.04	10%
Bono Bund spread	139.5	337.2	119.6	9%
Euribor/Eonia 3M basis (4th IMM)	17.0	44.0	14.4	9%
Spain 5Y CDS	90.3	390.3	61.6	9%
Italy 5Y CDS	116.9	486.3	81.8	9%
CDS EU Senior Financials 5Y	74.9	296.4	57.6	7%
Bobl ASW	33.8	83.5	31.1	5%
France 5Y CDS	44.0	200.0	35.9	5%
Schatz ASW	28.7	88.0	26.4	4%
Euribor/Eonia 2Y basis	15.60	51.20	15.40	1%
German 2Y-30Y ASW slope	20.01	72.3	28.25	-19%

Source: Deutsche Bank

Some key messages and trading opportunities emerge from the table

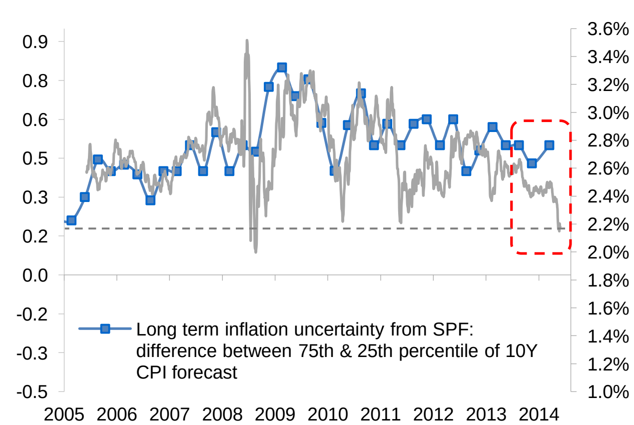
a) **Long-term inflation expectations are particularly depressed** in EUR and USD, not only relative to where they were at the peak of the EU crisis but also relative to other asset classes.

Trade implication: **we maintain our long TIPS 5Y5Y breakeven** as an asymmetrical normalization trade. Any delay in policy normalization triggered by a persistent risk-off mode or by the recent commodity-driven disinflation should lead to a gradual recovery in long term inflation expectations. Conversely, a return to a risk-on mode in a context of good domestic data should naturally help the normalization of the inflation risk premium and 5Y5Y breakeven.

b) **The rates gamma spike has been remarkable**, outright and relative to intermediate expiries. While this gamma spike has been felt across the USD curve, the EUR gamma spike has mostly been concentrated at the long end in EUR between the 10Y and 30Y sector.

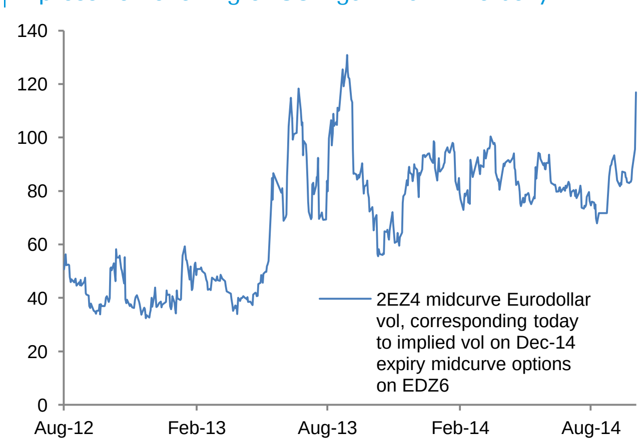
Trade implication: **We recommend monetizing the rich volatility by selling it in a midcurve put ratio 1x2 on EDZ6 (expiry Dec-14)** to gain a cheap and asymmetrical bearish position in the belly of the USD curve. The money market curve is now pricing in a first hike in Dec-15 and only 75bp of rate hikes in 2016, so that the Dec-16 target rate is now seen at 1.25, The underlying midcurve vol is close to historically high levels following this week's spike in realized vol while EDZ6 is back towards pre-QE taper levels. At the time of writing, ref EDZ6 98.375, buy 1 2EZ4 put at 98.375 for 17cts and sell 2 2EZ4 puts at 98.125 for 7cts per put and a net cost of 3cts. Leverage ratio of 8:1. Max payoff at expiry of 25cts is achieved if EDZ6 reaches 1.875% (which would be consistent with a delay of the rate hike cycle from June-15 to Sept-15 at a pace of 25bp per quarter). The trade makes money as long as the sell-off does not push EDZ6 beyond 2.1%.The trade should capture roughly a 1.25%/1.75% range on FFZ6. Alternatively one can also enter the 2EZ4 put ratio 1x2 98.25/98.00 for also ~3cts and capture a positive payoff range of 1.75%/2.25% on EDZ6 and 1.375%/1.875% on FFZ6.

Cheapness of TIPS 5Y5Y BE



Source: Deutsche Bank

Impressive richening of USD gamma in the belly

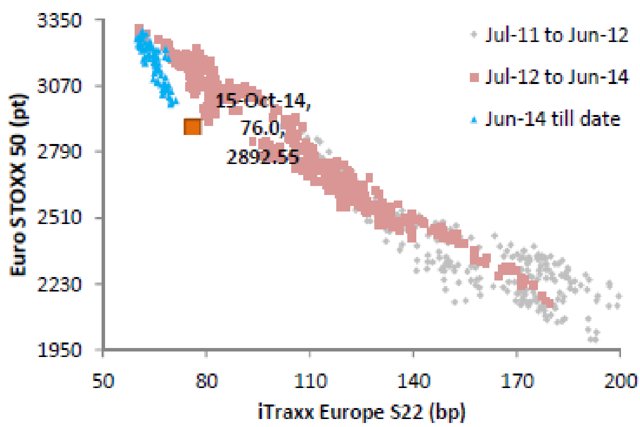


Source: Deutsche Bank

c) **European equity indices embed a much deeper level of stress than European synthetic credit indices**. The correction experienced on the Eurostoxx 50 has been more acute than the widening of spread on EUR 5Y Itraxx Main. Based on the historical relationship between the Eurostoxx and Itraxx, the Itraxx Main looks particularly tight relative to the level of European equities. Moreover, Eurostoxx implied vol remains expensive relative to Itraxx Main implied vol.

Trade implication**: We favor 17-Dec-2014 expiry payers on Itraxx Europe S22 rather than 19-Dec-2014 expiry put on Eurostoxx 50** to hedge further deterioration of the risk environment. The historical analysis suggests that the Eurostoxx 50 has moved on average with a beta of 8 relative to Itraxx (droping 80 ticks for a 10bp widening of 5y Itraxx main) while the option market (expiry Dec-14) is implying a beta closer to 13. An ATMF Dec-14 expiry payer on Itraxx Europe S22 is cheaper than the equivalent position in an ATMF Dec-14 expiry put on Eurostoxx 50 by nearly 40%. Beyond the cheapness of credit vol vs. equity vol, the underlying Itraxx index trades ~15bp rich against the level of Eurostoxx 50.

iTraxx Main is too tight relative to Eurostoxx



Source: Deutsche Bank

Some short-term stresses, but it ain't 2011

The recent market pressure on Italy and Spain and the renewed political risk in Greece could seem all like déjà-vu with a repeat of the 2010-2012 Eurozone sovereign debt crisis. The low growth and inflation environment has revived concerns about the debt sustainability for Italy. Indeed, if we assume that current conditions persist in a "Japanification" scenario, with nominal GDP growth of 1.2%, primary balance unchanged from the 2013 level at 2.2% of GDP and an average interest rate on debt of 4%, Italian debt/GDP ratio will not stabilize and remain on an upward trajectory rising by about 1.5% per year. While this creates a long-term debt sustainability issue, the experience of Japan itself suggests that a favourable net external debt position is more relevant than the fiscal dynamics as long as there is no domestic capital flight. With this in mind, there are some important differences today relative to 2010-2012.

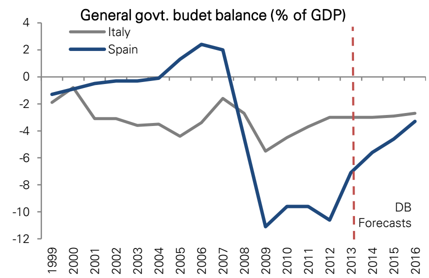
First, the fiscal balance and hence the net new issuance of debt by the governments have stabilized or improved. In 2010, Italy was running a 4.5% deficit vs. 3% in 2013. Second, there has already been a de-risking of non-domestic investors which was initially accommodated by the ECB support via the SMP and the first LTROs. Since, there has been some increase in the non-domestic ownership of government debt, but the share remains low and we estimate it to be below 30% in Italy after adjusting for the SMP and domestic ownership via funds domiciled outside of Italy. This compares to a level of more than 50% in 2010. Third, current account balances have turned from deficits into surplus implying that the Italian economy does not require additional external funding (i.e. that its reliance on non-domestic investors can be further reduced). Fourth, the capitalization levels of banks are much higher and preparations to clear the upcoming AQR and the stress tests should reduce the vulnerability of the sovereign via the financial sector. Last but not least, the ECB has already in place a TLTRO and soon to be launched private asset purchase programmes (both of which are likely to benefit disproportionately the periphery). If the success of these programs in a low yield environment is doubtful, they will automatically become more relevant in a situation of further stress. Moreover, the ECB's willingness to expand its balance sheet with more aggressive easing should also increase if the recent developments result in a significant tightening of credit conditions.

In short, relative to 2010, budget deficits are smaller, current accounts are positive, non-domestic ownership is lower, banks are better capitalized, the ECB has liquidity and asset purchase programmes in place and Draghi has repeatedly suggested that it is willing to do more if necessary. The situation in Spain is not dissimilar with the caveat that the net international investor position, i.e. the cumulative current account balances in Spain is a lot more negative which would imply that overall Spain remains more vulnerable to a change in sentiment from the international investor community. However, the improved growth outlook as a result of the structural reforms should help to offset some of these concerns.

Taken together, these factors suggest a more robust position of Italy and Spain today than in 2010, which should make large scale sell-off less likely to be persistent in the medium term as long as there is no domestic capital flight. This remains a risk, but the threshold of political and economic stresses is likely to be higher than what we are witnessing at present. Deposit outflows from peripheral countries would be one way to monitor this risk. Note that even in 2010-2012 there were no meaningful deposit outflows from Italy.

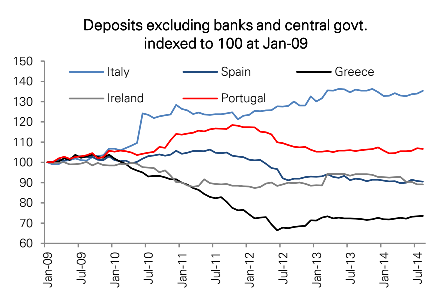
However, there is still scope for some market volatility for several reasons. First, being long the periphery has been a fairly consensus trade and recent positions could be vulnerable especially if the increase in market volatility could generate forced selling. Second, while spreads today are broadly similar to 2010, the lower absolute level of yields makes the investment less attractive given the increase in volatility. Third, the ECB may be reluctant to cross the government QE Rubicon without being pushed by the market. Finally, the increased risk of brinkmanship in Greece could keep political risk high.

Budget balances have stabilized/improved since 2011-12



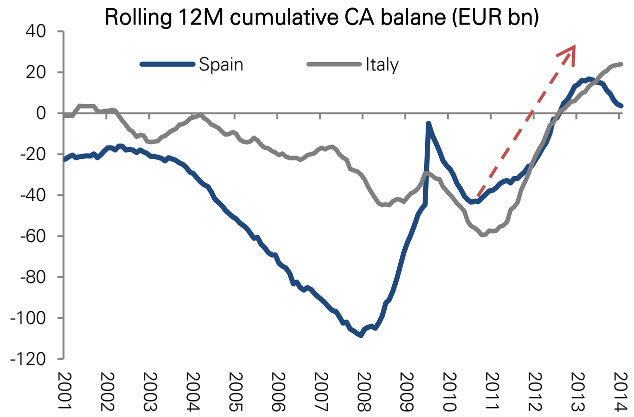
Source: Deutsche Bank, Haver Analytics

Deposit flows need to be closely monitored



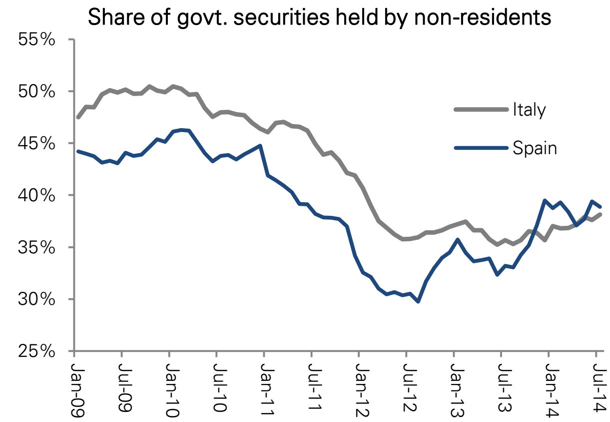
Source: Deutsche Bank, Haver Analytics

Italy and Spain are in current account surplus rather than deficit



Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics

Non-resident holdings in Italy and Spain are lower now than in 2011



Source: Deutsche Bank, Haver Analytics

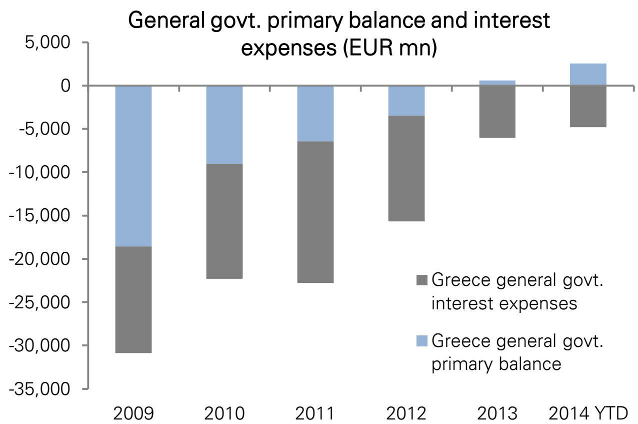
Greece Update

The ‘gap’ move lower in Greek government bond prices over the last couple of weeks is largely the market coming to terms with the political risk on the horizon which is unlikely to be resolved any time soon. In the presidential elections, to be held in Feb 2015, the current government would need to obtain approval of 180 MPs. Failure by the current government to get its candidate elected as the President will lead to an automatic dissolution of the parliament and calling of fresh elections. In the vote of confidence held last week the government received the support of 155 MPs implying that it would be short by around 25 in February. In order to get the necessary support and prevent elections the government is looking to exit a full Troika programme and opt for an ECCL (Enhanced Conditions Credit Line) while the main opposition party Syrzia is campaigning that it would obtain debt relief from the Troika if it came to power.

Even before the recent sell-off, significant reliance on market funding rather than extending the Troika programme was likely to be economically sub-optimal. The latest sell-off is likely to make it even more difficult for the Greek government to fund in the market although political reasons might still necessitate an attempt at a sub-optimal outcome.

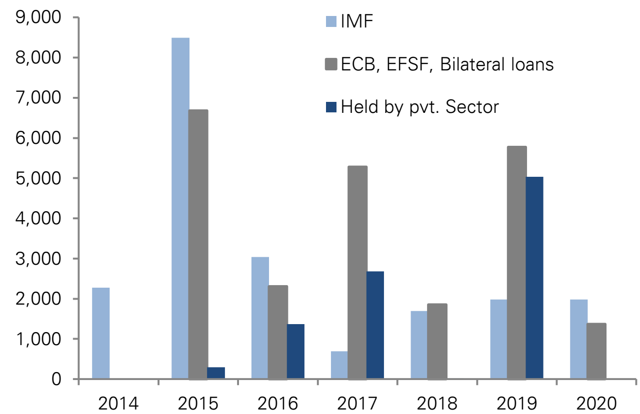
Irrespective of the political configuration following the Presidential elections there is clearly some concern that the next Troika review and any subsequent negotiations with the Troika would be more contentious given the stall in the reform process. From the Greek perspective, with the government in a comfortable primary surplus and no debt held by private sectors maturing over the next few years there is the clear risk of brinkmanship. From the perspective of the Troika, with Greek debt repayments over the next few years primarily implying the Troika paying itself there could be more reasons for the Troika to be conciliatory rather than confrontational. However, the political situation does imply that we could be in for a rather ‘messy’ few months.

Greece govt. primary surplus could make negotiations more noisy



Source: Deutsche Bank, Haver Analytics

Maturity profile of Greek debt (excluding bills) over the next few years (EUR mn)

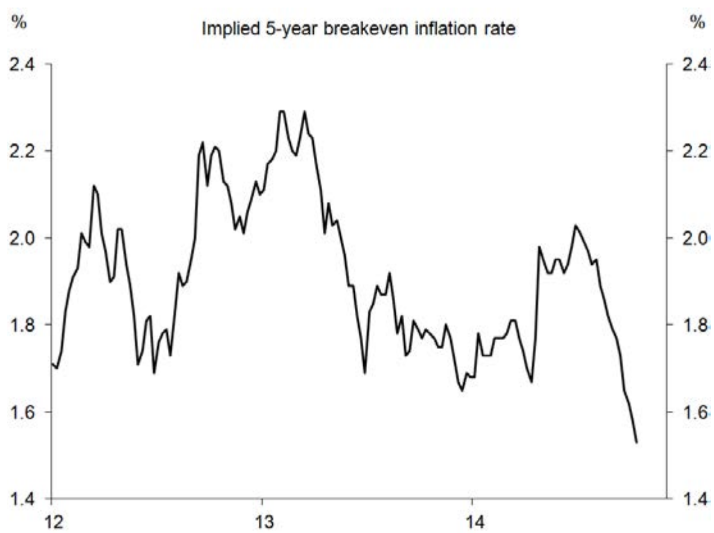


Source: Deutsche Bank, EFSF, IMF, Bloomberg Finance LP

Economics

Summary: Over the last three months, inflation has fallen significantly, rekindling fears of deflation. Moreover, the fact that energy prices have collapsed—in part because of a stronger dollar—has caused the breakeven inflation rate to roll over. In turn, financial markets have pushed out the timing of Fed tightening and substantially reduced expectations for the terminal fed funds rate. Our analysis shows that core inflation is likely to trend higher over time, led by higher services prices. Goods prices have been soft, but there is little evidence to suggest they are likely to turn sharply lower. Finally, the dollar needs to appreciate significantly further to have any noticeable impact on core inflation.

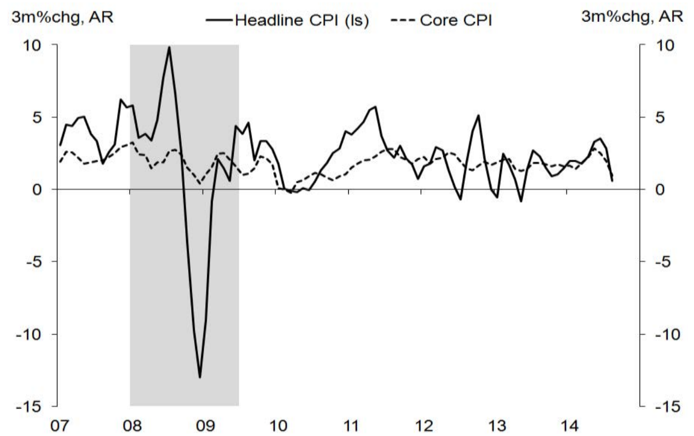
Inflation expectations have declined dramatically over the past 5 months



Source: FRB, Haver Analytics & DB Global Markets Research

We focus on the consumer price index (CPI) because it is timelier than the personal consumption expenditures (PCE) deflator and does not get revised. Moreover, the correlation between the growth rates in the two series is around 0.90 so generally, the trend in the PCE deflator mirrors the trend in the CPI. September CPI data will be released next Wednesday. Over the last three months, the annualized change in headline CPI has been just 0.6%. This is down from a 3%-plus rate as recently as June. The pattern is the same for the core CPI. Over the last three months, the annualized change in the core CPI is up 1.0%. This is down from a near 3% rate as recently as May. However, as we can see from the chart on the following page, the three-month rates of change can be quite volatile. The last time both measures of inflation were growing under 1% over a three-month period was in June 2010. At that time, the headline rate was flat, and the core was up just 0.9%. However, within nine months of those lows, the three-month annualized changes improved to 4.7% and 2.0%, respectively. Therefore, we need to be mindful that gyrations in inflation are the norm not the exception. There are compelling reasons why core inflation should trend higher over time.

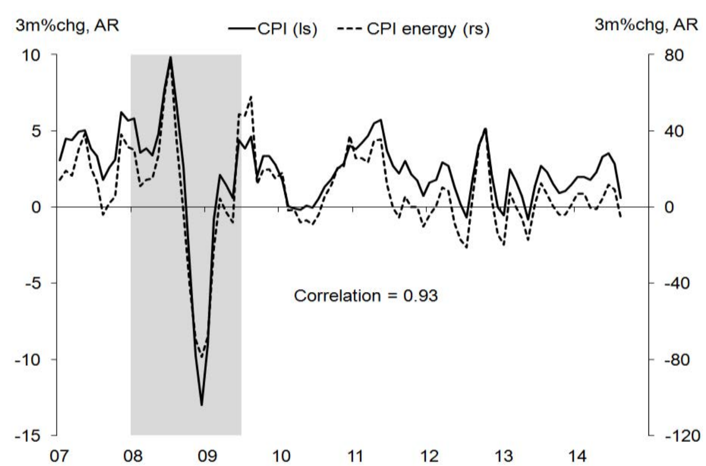
Short-term movements in inflation are extremely volatile



Source: BLS, Haver Analytics & DB Global Markets Research

In the near term, headline CPI will continue to be dominated by energy prices. However, the trend in core CPI will be determined primarily by the trend in service prices rather than goods prices because the former have a much larger weight at 75% compared to just 25% for the latter. Over the last three months, the growth rate in core CPI has noticeably slowed, but we believe this is payback from elevated readings earlier this year. For example, in May the three-month annualized change in the core was 2.8% but over the last three months, the growth rate has slowed to 1.0%. The year-over-year change in core services within the CPI has been consistently running well in excess of 2%, and as we discuss below, this trend should accelerate over time.

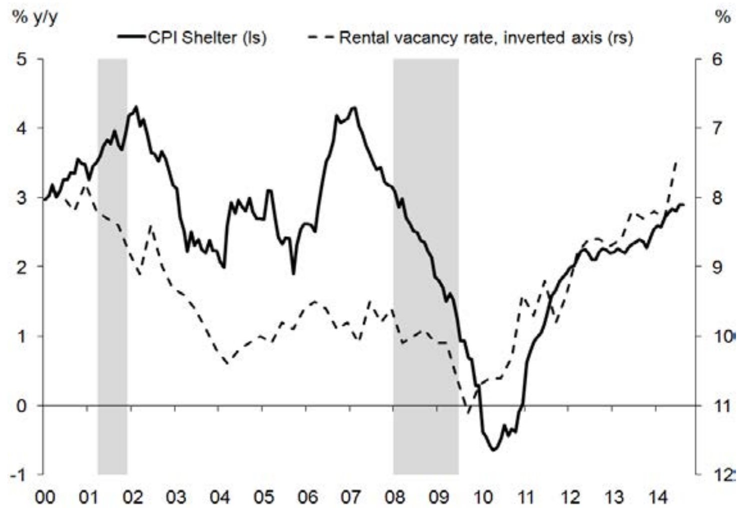
Swings in energy prices are likely to continue to dominate headline CPI



Source: BLS, Haver Analytics & DB Global Markets Research

Core CPI is dominated by housing. Shelter accounts for 42% of the core CPI, and its growth rate continues to rise because of lack of available housing supply. This is most evident from the nationwide rental vacancy rate, which fell to 7.5% in Q2 (the latest available data) to its lowest reading since Q1 2007. Based on the current vacancy rate, the growth rate in shelter costs, currently running at 2.9% over the last 12 months, should approach 4% over the next year. This alone would add 50 basis points (bps) to the underlying rate of core inflation. A tightening labor market should also put upward pressure on other categories within the services sector such as education, medical care and recreation. In general, when the job market strengthens, the prices of services tend to increase, reflecting the fact that labor is the key input in service sector production.

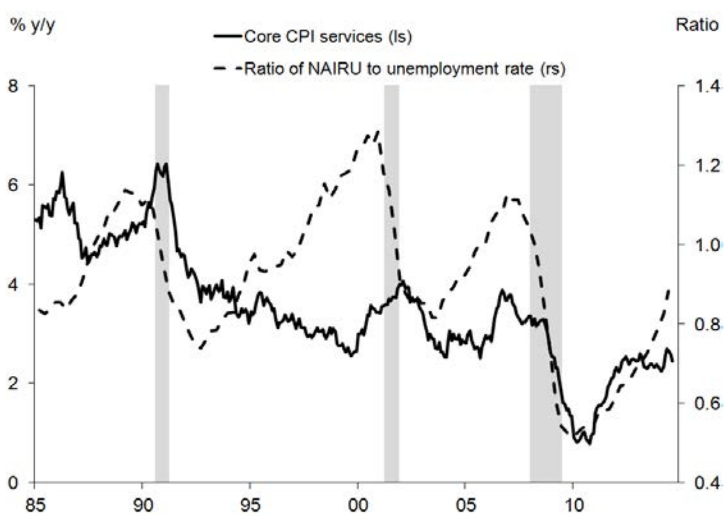
The plunge in the rental vacancy rate points to larger gains in shelter costs



Source: BLS, Haver Analytics & DB Global Markets Research

As shown in the chart below, price trends within the services sector increase when the unemployment rate approaches the non-accelerating inflation rate of unemployment (NAIRU). While NAIRU is not known until after the fact, our research has found that cost pressures build when the unemployment rate falls below 6%. At present, we are at 5.9% and poised to head substantially lower over the next few quarters given record low readings on initial jobless claims.[2]

A tightening labor market should push service prices higher over time



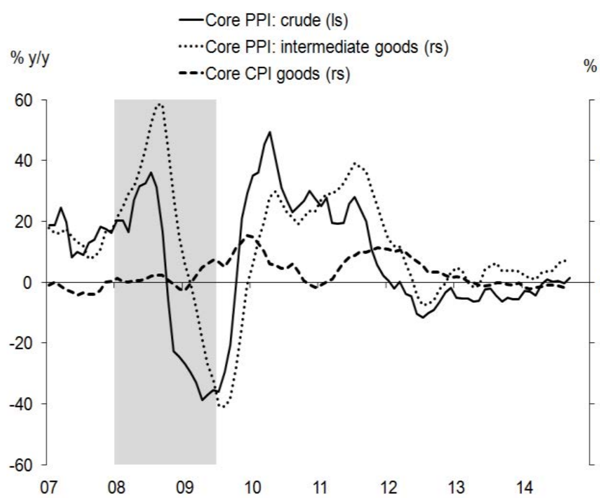
Source: BLS, Haver Analytics & DB Global Markets Research

Whither goods prices? While services prices are set to accelerate, the price of goods continues to decline at a relatively steady -0.4% year-over-year rate. For goods prices to weigh further on core inflation, prices would have to decline at an even faster pace. However, the data suggest this scenario is unlikely. This is apparent from the earlier stages of processing within the producer price index (PPI), which measures inflation in the wholesale sector. Price trends in the wholesale sector often foreshadow the trends in the retail sector. More

[2] "How low does unemployment have to go before compensation accelerates?" US Economics Weekly October 10, 2014.

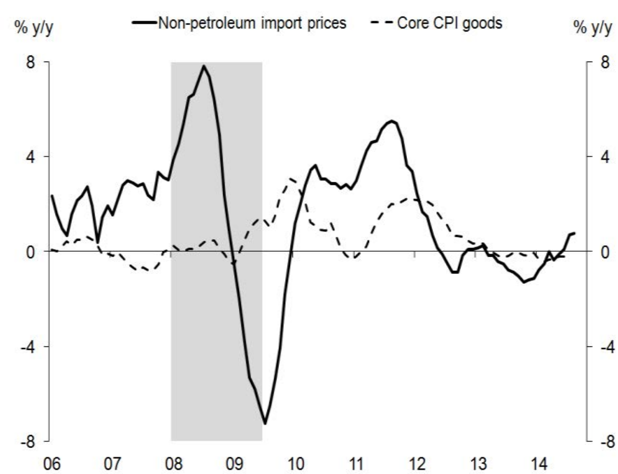
specifically, changes in core crude prices tend to lead the trend in core intermediate prices, which in turn tend to lead changes in core CPI goods prices. This is illustrated in the chart below. While the growth rates in core crude and core intermediate prices are only slightly positive, they are nonetheless running at their highest pace in over two years. This suggests the rate of deflation in the retail goods sector is unlikely to pickup in any meaningful way. What about the dollar?

The earlier stages of processing do not show any pipeline deflation



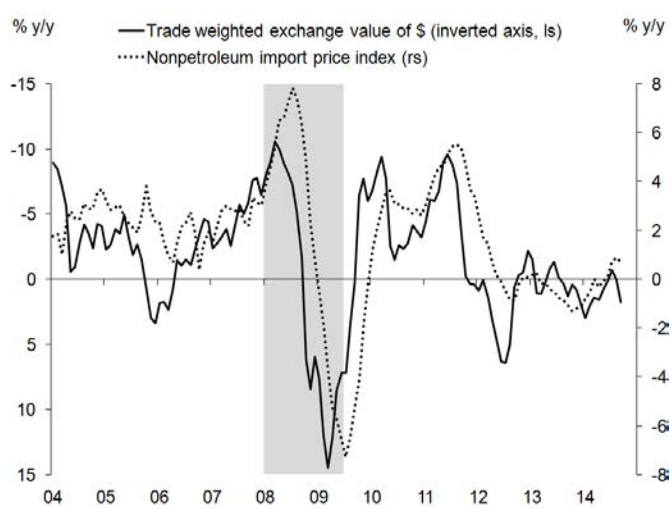
Source: BLS, Haver Analytics & DB Global Markets Research

Core CPI goods prices are down slightly compared to a year ago



Source: BLS, Haver Analytics & DB Global Markets Research

The real broad trade-weighted dollar is up only modestly from its record low



Source: BLS, Haver Analytics & DB Global Markets Research

The dollar has had a negligible impact on import prices thus far. Financial markets and some monetary policymakers, in particular New York Fed President Dudley and Governor Fischer, are worried about a strengthening dollar and its potential to put further downward pressure on goods prices through lower import prices. At the moment, the rise in the dollar has had little discernible impact on goods inflation. This is evident in the chart on the previous page. The reason for this is simple: In inflation-adjusted broad trade-weighted terms, the dollar has not increased that much. In point of fact, the real broad trade-weighted dollar is up less than 2% over the last 12 months and is up just under 8% from its all-time record low set more than three years ago in July 2011. This should have little impact on nonpetroleum import prices, which are currently rising at nearly a 1% year-over-year rate. But what if the dollar strengthens significantly further?

According to our calculations, every one percentage point increase in the trade-weighted dollar reduces non-petroleum import prices by 60 bps, which in turn lowers core goods prices by 15 bps. However, the effect on the overall core CPI is less given the fact that the weight of goods prices is two-thirds smaller than the weight of services prices in the core CPI. Thus, the impact turns out to be just 4 bps, which is negligible.

What is the bottom line? Above-trend economic activity will further weigh on unemployment, which will put further upward pressure on services prices. This means that unless pipeline inflation pressures moderate or the real, broad trade-weighted dollar appreciates significantly, core inflation should grind higher in the months ahead, notwithstanding normal intra-year gyrations.

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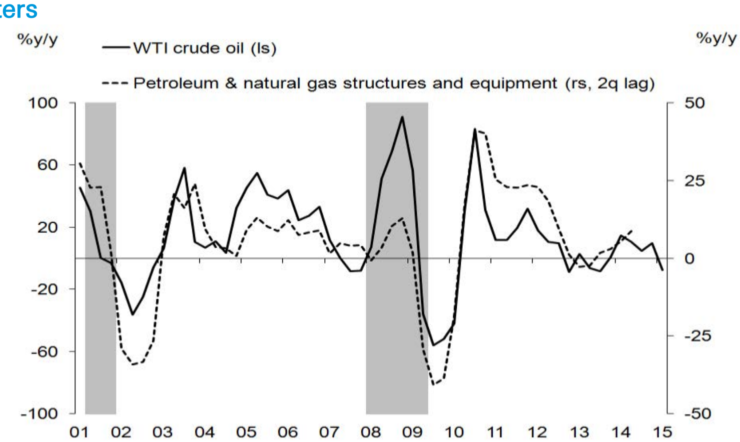
Lower energy prices will not sink capex

Summary: Financial market participants are fretting the impact of falling energy prices on capital expenditures within the energy sector. In our view, these fears are overblown as oil- and gas-related investment is only about 10% of total nonresidential investment in equipment and structures, which is where business spending is captured in the GDP accounts. In total, business investment accounts for roughly 9% of real GDP. Hence, while energy-related capital spending could slow if oil prices remain depressed for a significant period of time, this may be worth only a tenth or two on inflation-adjusted output growth, which is not very much. In fact, as we recently highlighted, the positive effects from a boost to consumer spending should more than outweigh any negative impact from lower capital expenditures.

Oil and gas investment is only a small portion of overall capex. As the chart below illustrates, oil and gas capex is highly correlated with oil prices. The latter tends to lead the former by approximately two quarters. This makes sense because as prices rise, more expensive production becomes economically viable so firms invest in equipment to extract oil, and vice versa when prices decline. Since the lag between oil prices and capex spending is substantial, producers would have to anticipate a sustained downtrend in crude prices to meaningfully curtail investment. At around $80 per barrel, WTI crude prices are down 20% compared to a year ago. Given the aforementioned relationship between prices and energy-related capital expenditures, this would imply a roughly 8% year-over-year decline in oil and gas capex. In turn, this would subtract a little less than a tenth from real GDP.

Crude oil prices tend to lead the trend in oil & gas capital spending by two quarters



Source: EIA, BEA, Haver Analytics & Deutsche Bank

In general, the outlook for business spending remains constructive because outside of energy, capacity constraints are beginning to develop. For example, the capacity utilization rate of durable goods manufacturing is currently 77.6%, which is about half of a percentage point above its long-term average. Typically, as capacity utilization rises, companies need to invest in order to keep pace with rising demand and depreciating equipment. Moreover, the capital expenditures outlook in the Philadelphia Fed survey, which is highly correlated with capex spending in the GDP accounts, remains at an elevated level. In short, we highly doubt lower energy costs will be a negative for the US economy.

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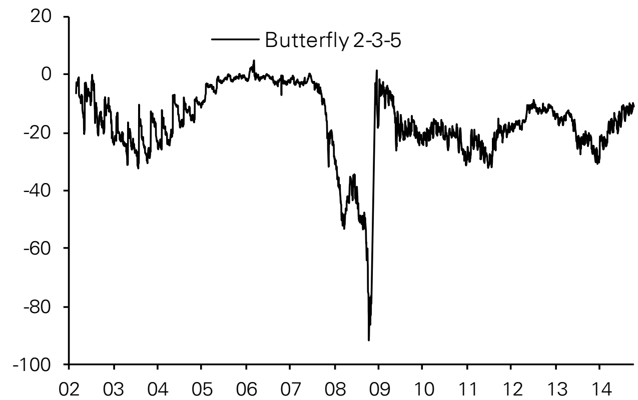
Chart Pack

DB Treasury Yield Forecasts

	2Y	5Y	10Y	30Y
2014 H2	0.50	1.40	2.35	3.05
2015 H1	0.95	1.70	2.60	3.25
2015 H2	1.55	2.25	2.80	3.30

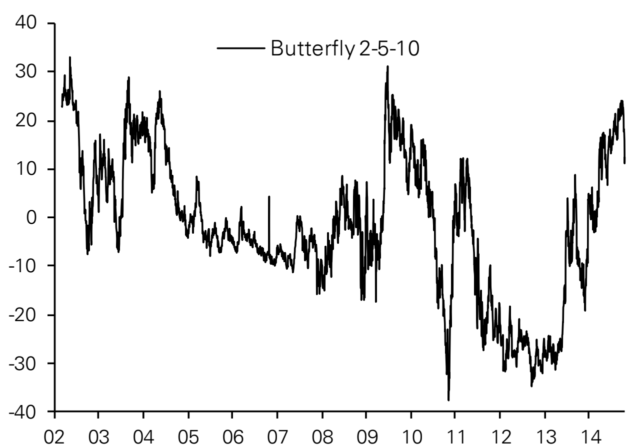
Source: Deutsche Bank
Note: Forecasts reflect expectations for end-of-period.

2-3-5 butterfly, 50/50 weight, long bullet



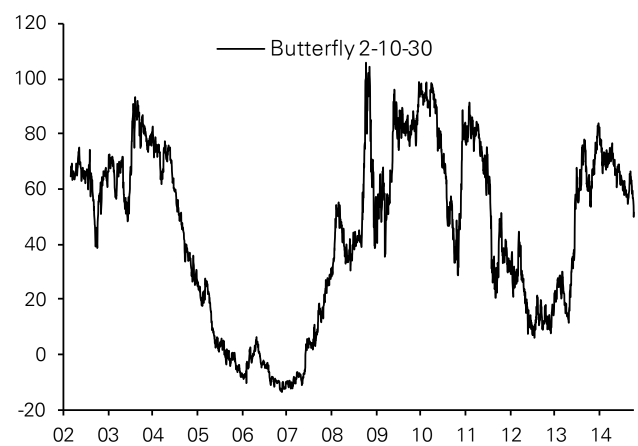
Source: Deutsche Bank

2-5-10 butterfly, 50/50 weight, long bullet



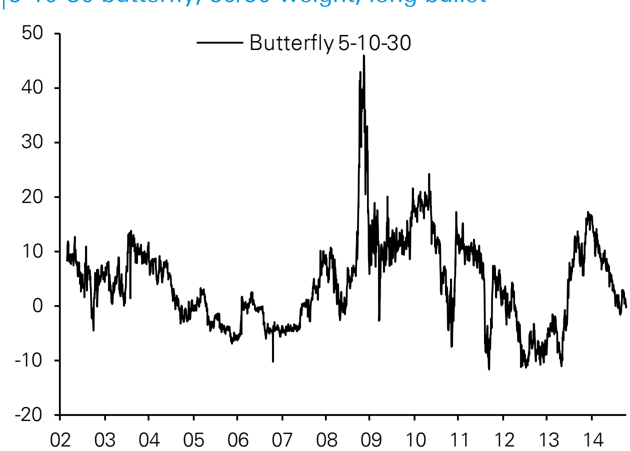
Source: Deutsche Bank

2-10-30 butterfly, 50/50 weight, long bullet



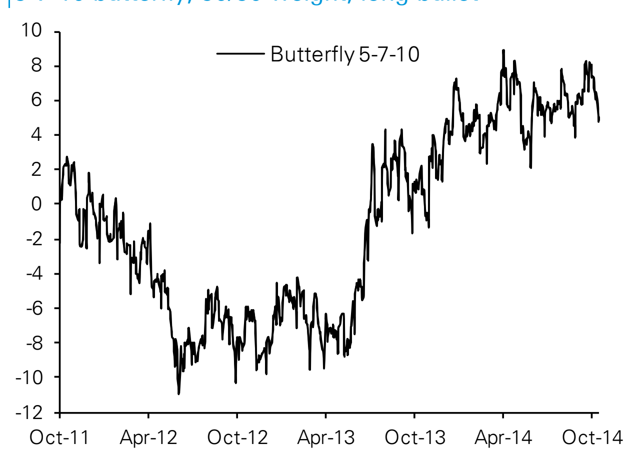
Source: Deutsche Bank

5-10-30 butterfly, 50/50 weight, long bullet



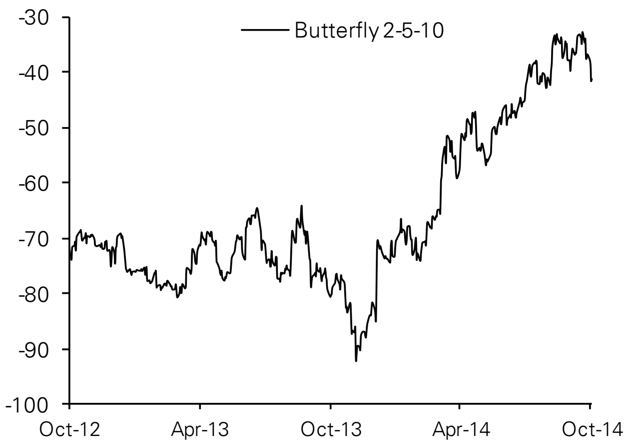
Source: Deutsche Bank

5-7-10 butterfly, 50/50 weight, long bullet



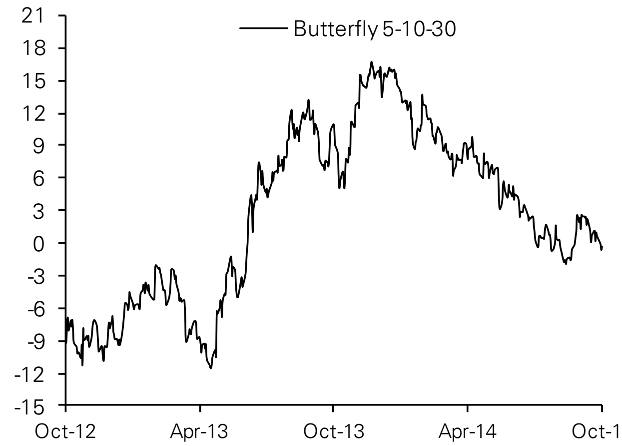
Source: Deutsche Bank

2-5-10 butterfly (PCA 20.34% and 79.66% risk on the wings)



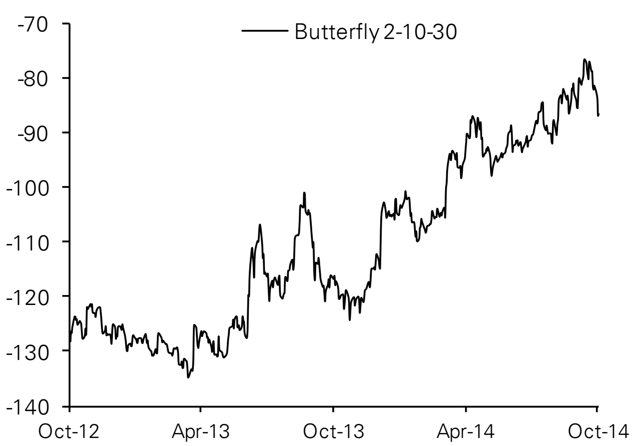
Source: Deutsche Bank

5-10-30 butterfly (PCA 49.78% and 50.22% risk on the wings)



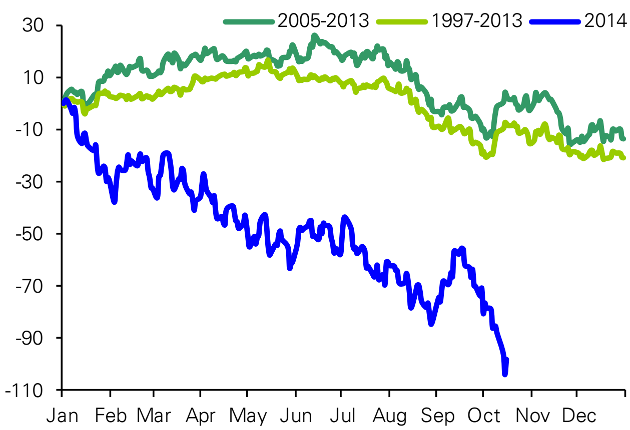
Source: Deutsche Bank

2-10-30 butterfly (PCA -3.22% and 103.22% risk on the wings)



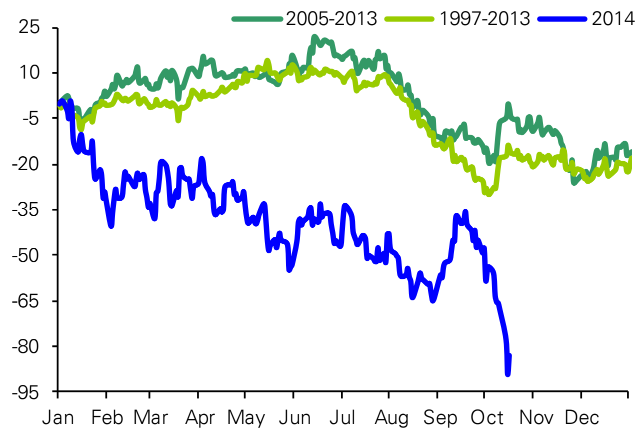
Source: Deutsche Bank

30Y Treasury yield seasonals (Change since Jan-1)



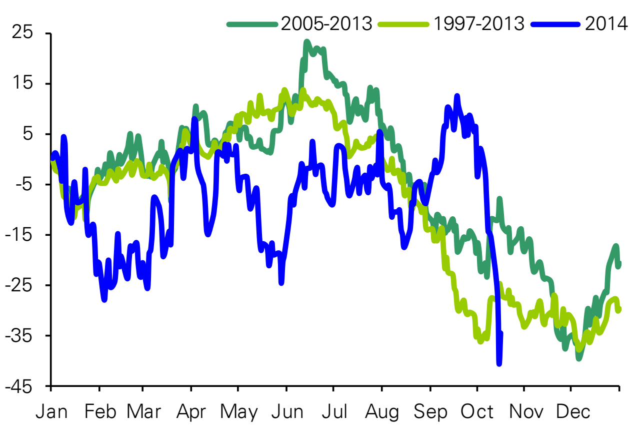
Source: Deutsche Bank

10Y Treasury yield seasonals (Change since Jan-1)



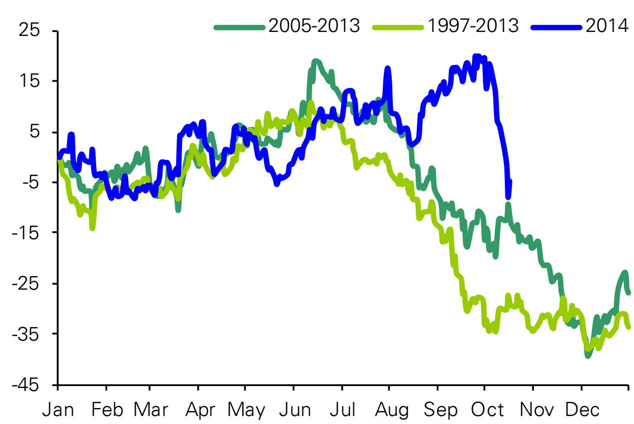
Source: Deutsche Bank

5Y Treasury yield seasonals (Change since Jan-1)



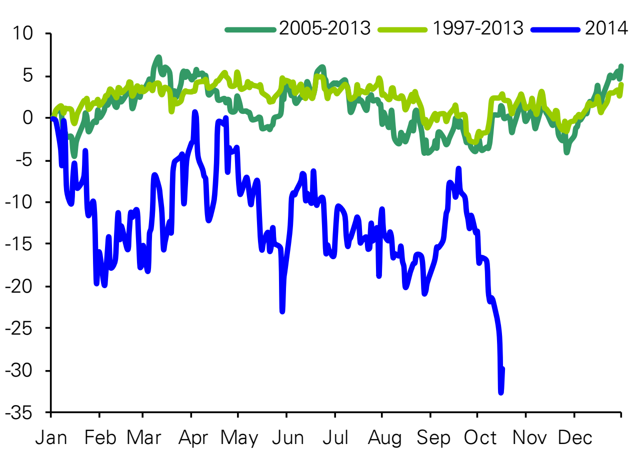
Source: Deutsche Bank

2Y Treasury yield seasonals (Change since Jan-1)



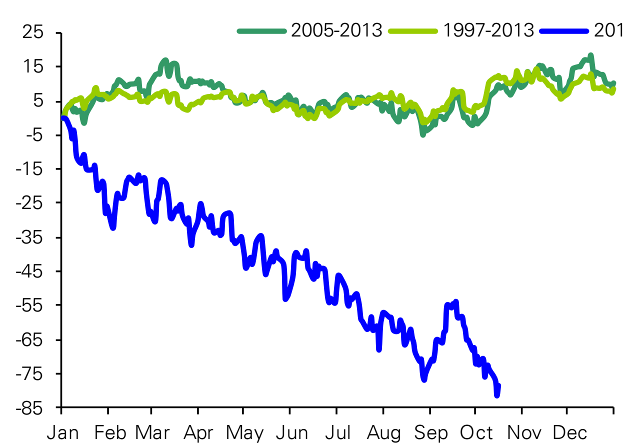
Source: Deutsche Bank

2Y/5Y slope seasonals (Change since Jan-1)



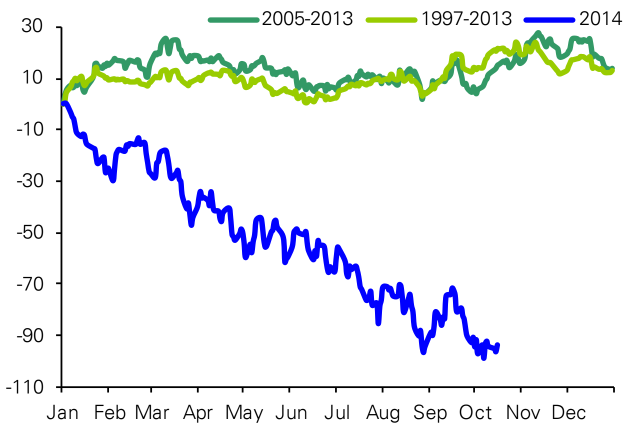
Source: Deutsche Bank

2Y/10Y slope seasonals (Change since Jan-1)



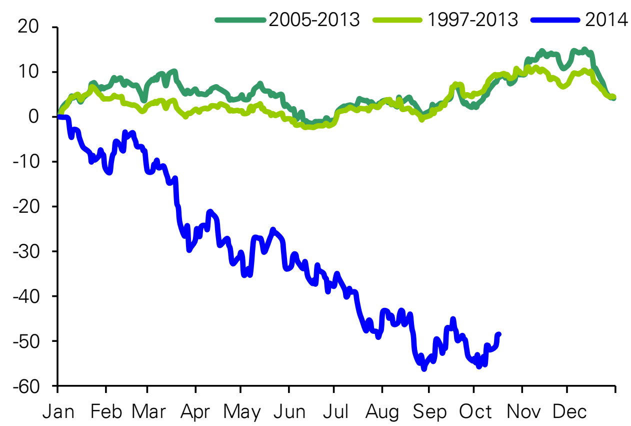
Source: Deutsche Bank

2Y/30Y slope seasonals (Change since Jan-1)



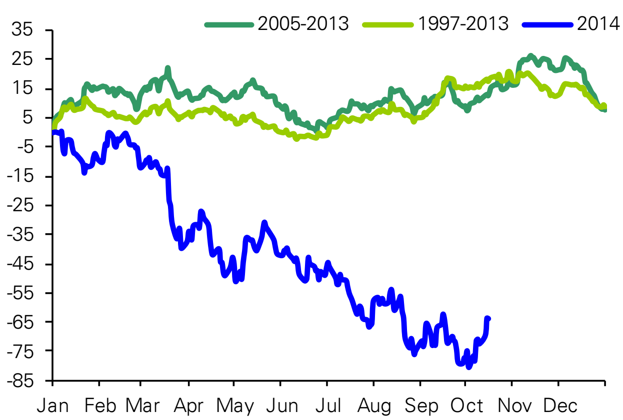
Source: Deutsche Bank

5Y/10Y slope seasonals (Change since Jan-1)



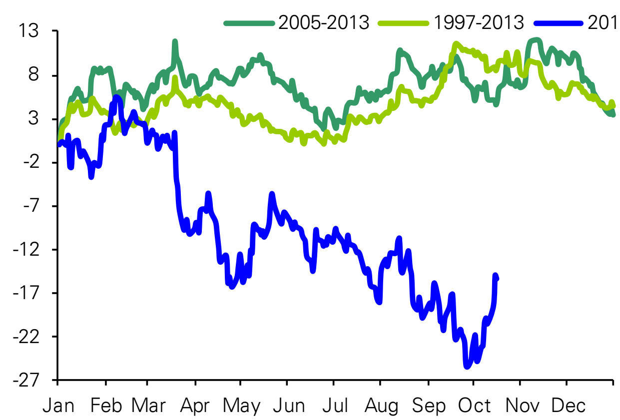
Source: Deutsche Bank

5Y/30Y slope seasonals (Change since Jan-1)



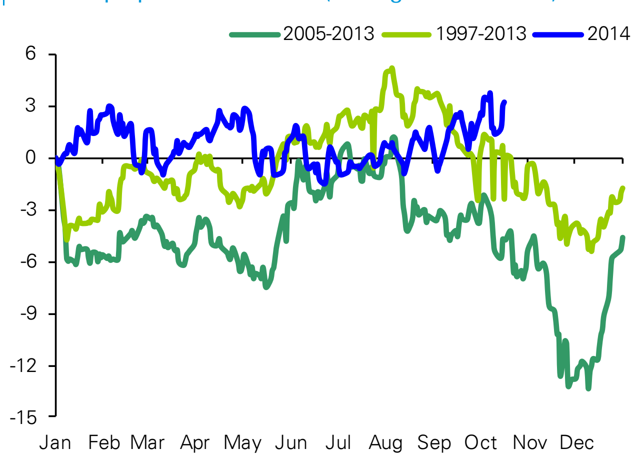
Source: Deutsche Bank

10Y/30Y slope seasonals (Change since Jan-1)



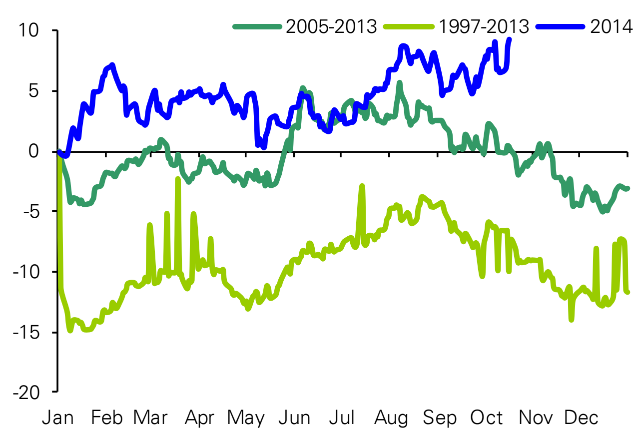
Source: Deutsche Bank

30Y swap spread seasonals (Change since Jan-1)



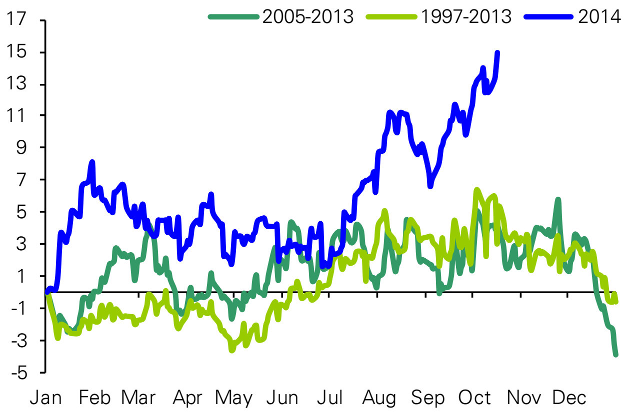
Source: Deutsche Bank

10Y swap spread seasonals (Change since Jan-1)



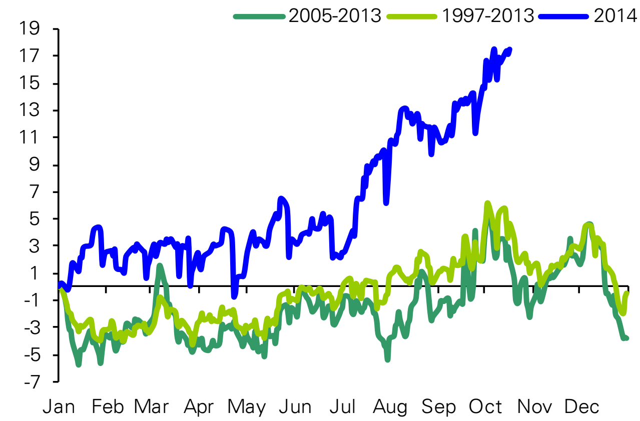
Source: Deutsche Bank

5Y swap spread seasonals (Change since Jan-1)



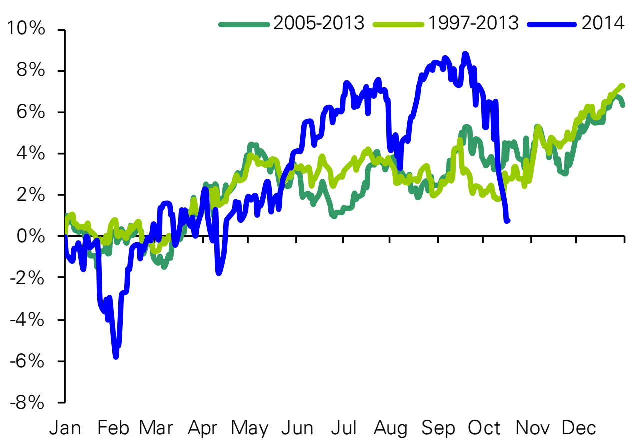
Source: Deutsche Bank

2Y swap spread seasonals (Change since Jan-1)



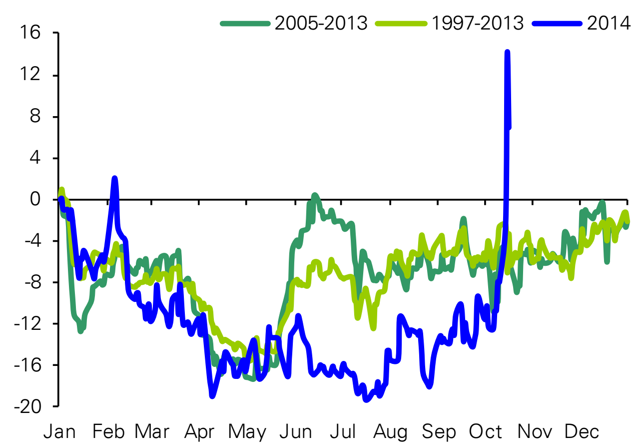
Source: Deutsche Bank

S&P Index seasonals (Change since Dec-31)



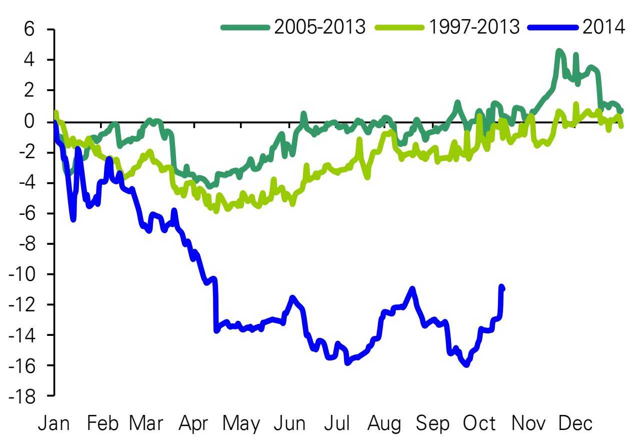
Source: Deutsche Bank

3M10Y Implied vol seasonals (Change since Dec-31)



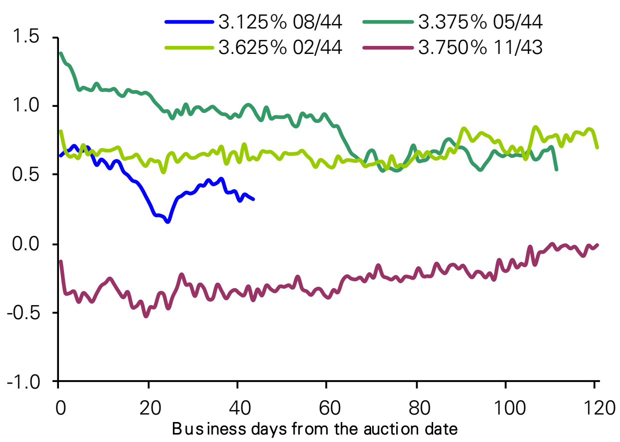
Source: Deutsche Bank

5Y10Y Implied vol seasonals (Change since Dec-31)



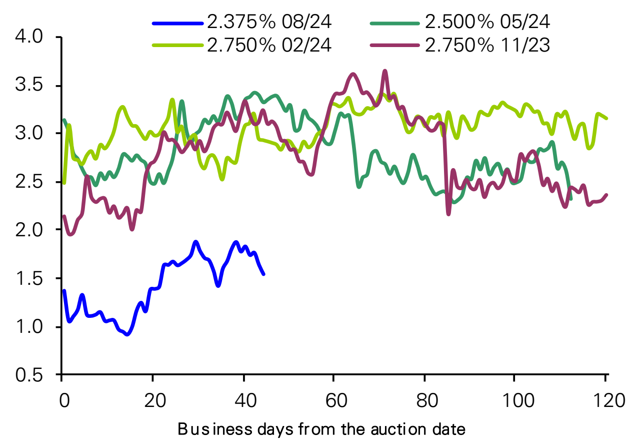
Source: Deutsche Bank

30Y Treasury roll business days from auction



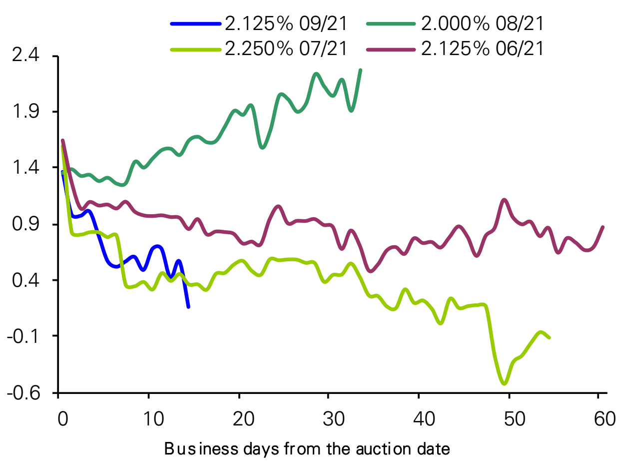
Source: Deutsche Bank

10Y Treasury roll business days from auction



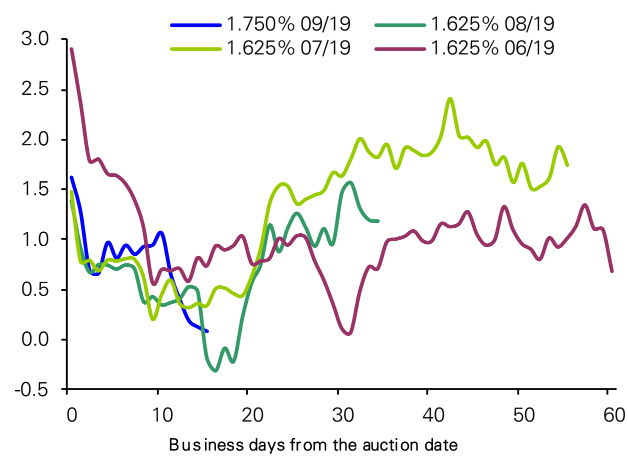
Source: Deutsche Bank

7Y Treasury roll business days from auction



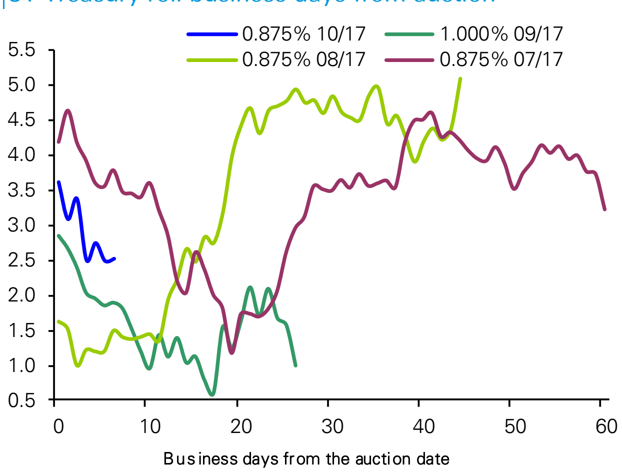
Source: Deutsche Bank

5Y Treasury roll business days from auction



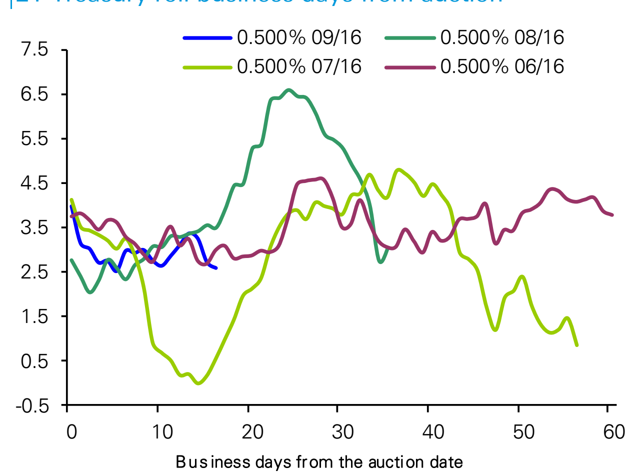
Source: Deutsche Bank

3Y Treasury roll business days from auction



Source: Deutsche Bank

2Y Treasury roll business days from auction



Source: Deutsche Bank

Top 15 USD Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	3M 1Y2Y	25.4	31.6	0.8	59	-3.1	0.1	0.7	1.1	4.2
2	6M 1Y2Y	19.6	28.5	0.7	56	-3.1	0.2	0.6	1.1	4.5
3	3M 1Y3Y	33.0	48.3	0.7	60	-2.3	0.1	0.5	0.9	3.9
4	1Y 1Y2Y	11.5	20.4	0.6	45	-1.8	0.1	0.6	1.0	4.6
5	6M 1Y3Y	21.6	42.3	0.5	48	-2.3	0.1	0.5	0.9	4.0
6	3M 1Y5Y	28.5	64.3	0.4	55	-1.9	-0.1	0.4	0.8	4.2
7	3M 2Y3Y	7.6	18.5	0.4	55	-1.9	-0.3	0.3	0.8	3.0
8	3M 1Y7Y	20.9	68.8	0.3	54	-1.8	-0.3	0.2	0.6	4.3
9	1Y 1Y3Y	8.6	31.3	0.3	35	-1.8	-0.1	0.5	0.9	3.4
10	6M 1Y5Y	12.5	58.4	0.2	39	-1.9	-0.2	0.4	0.7	3.9
11	3M 1Y10Y	12.0	72.9	0.2	53	-1.9	-0.3	0.1	0.5	4.2
12	6M 2Y3Y	2.0	16.1	0.1	40	-1.7	-0.3	0.4	0.8	3.2
13	3M 2Y5Y	3.1	39.0	0.1	48	-1.8	-0.4	0.1	0.6	3.6
14	6M 1Y7Y	3.5	65.0	0.1	38	-1.7	-0.3	0.2	0.5	3.5
15	6M 1Y10Y	-5.4	70.8	-0.1	36	-1.7	-0.4	0.1	0.4	3.1

Source: Deutsche Bank

Top 15 USD Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	1Y 3Y30Y	50.8	64.3	0.8	65	-0.6	0.2	0.6	1.0	1.6
2	1Y 2Y30Y	53.7	69.3	0.8	69	-0.9	0.0	0.5	0.9	1.5
3	1Y 3Y25Y	48.7	63.1	0.8	64	-0.6	0.1	0.5	1.0	1.6
4	1Y 3Y20Y	46.0	60.2	0.8	64	-0.6	0.1	0.5	1.0	1.6
5	1Y 2Y25Y	51.7	68.4	0.8	69	-0.9	0.0	0.4	0.8	1.5
6	1Y 25Y30Y	2.1	2.8	0.8	67	-1.6	0.2	0.5	0.8	1.6
7	1Y 10Y15Y	9.0	12.1	0.7	56	-0.1	0.2	0.6	0.9	1.3
8	1Y 2Y20Y	48.9	66.1	0.7	69	-0.9	0.0	0.4	0.8	1.5
9	1Y 3Y15Y	41.0	55.4	0.7	65	-0.7	0.1	0.5	0.9	1.6
10	1Y 10Y12Y	4.3	5.8	0.7	47	-0.8	0.2	0.8	0.9	1.8
11	1Y 12Y15Y	4.8	6.5	0.7	48	-0.1	0.4	0.8	0.9	1.3
12	1Y 10Y20Y	14.0	19.2	0.7	57	-0.1	0.3	0.6	0.9	1.3
13	3M 25Y30Y	2.4	3.3	0.7	72	-3.2	0.2	0.4	0.8	4.5
14	1Y 5Y30Y	37.4	52.2	0.7	61	-0.3	0.3	0.6	1.0	1.6
15	1Y 10Y30Y	18.8	26.3	0.7	58	-0.1	0.3	0.6	0.8	1.3

Source: Deutsche Bank

Top 15 EUR Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	1Y 2Y3Y	4.2	6.6	0.6	81	-1.2	-0.4	0.1	0.5	1.5
2	1Y 1Y5Y	12.9	22.9	0.6	74	-1.8	-0.4	0.1	0.6	2.6
3	1Y 2Y5Y	9.5	17.3	0.5	87	-1.1	-0.4	0.1	0.4	1.3
4	1Y 1Y7Y	16.1	31.2	0.5	81	-1.5	-0.5	0.1	0.4	2.4
5	6M 2Y3Y	4.1	7.9	0.5	69	-1.7	-0.4	0.1	0.7	2.4
6	3M 2Y3Y	3.7	7.3	0.5	67	-2.0	-0.4	0.2	0.7	3.7
7	1Y 3Y5Y	5.3	11.1	0.5	91	-1.0	-0.4	0.0	0.2	1.0
8	6M 2Y5Y	9.9	20.9	0.5	72	-1.5	-0.4	0.1	0.5	1.8
9	1Y 2Y7Y	12.7	27.0	0.5	91	-1.0	-0.4	0.0	0.3	1.1
10	1Y 1Y3Y	7.6	16.2	0.5	65	-2.0	-0.4	0.2	0.7	3.3
11	6M 3Y5Y	5.8	13.4	0.4	81	-1.2	-0.4	0.0	0.4	1.2
12	6M 1Y5Y	12.7	29.4	0.4	65	-2.3	-0.6	0.1	0.7	3.2
13	6M 2Y7Y	13.5	31.7	0.4	76	-1.4	-0.5	0.0	0.4	1.6
14	6M 1Y7Y	16.3	38.3	0.4	69	-2.1	-0.6	0.1	0.6	2.9
15	3M 2Y5Y	9.1	22.8	0.4	69	-1.8	-0.5	0.1	0.6	3.0

Source: Deutsche Bank

Top 15 EUR Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	1Y 10Y20Y	9.7	14.1	0.7	63	-0.1	0.3	0.5	0.8	1.1
2	1Y 10Y25Y	12.1	17.9	0.7	64	-0.1	0.3	0.5	0.8	1.1
3	1Y 15Y20Y	3.9	5.9	0.7	79	0.0	0.3	0.5	0.6	0.9
4	1Y 10Y15Y	5.7	8.8	0.7	58	-0.2	0.2	0.5	0.8	1.1
5	1Y 10Y30Y	13.3	20.5	0.6	67	-0.1	0.3	0.5	0.7	1.1
6	1Y 15Y25Y	6.3	9.9	0.6	77	0.0	0.4	0.5	0.6	1.0
7	1Y 15Y30Y	7.5	12.8	0.6	79	0.0	0.3	0.4	0.6	1.1
8	1Y 20Y25Y	2.4	4.4	0.5	82	0.0	0.3	0.4	0.5	1.1
9	1Y 7Y30Y	15.3	28.4	0.5	49	-0.2	0.2	0.5	0.8	1.2
10	1Y 7Y25Y	14.1	26.2	0.5	48	-0.2	0.2	0.6	0.8	1.2
11	6M 10Y25Y	11.9	22.5	0.5	47	0.0	0.3	0.6	0.8	1.2
12	6M 10Y20Y	9.5	18.2	0.5	46	0.0	0.3	0.6	0.8	1.2
13	6M 15Y25Y	6.3	12.2	0.5	53	0.0	0.3	0.5	0.7	1.1
14	6M 15Y20Y	3.9	7.6	0.5	52	0.0	0.3	0.5	0.7	1.1
15	6M 10Y30Y	13.1	25.7	0.5	48	-0.1	0.3	0.5	0.7	1.1

Source: Deutsche Bank

Top 15 JPY Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	6M 2Y5Y	7.0	9.4	0.7	90	-1.8	0.1	0.5	0.7	1.6
2	3M 3Y5Y	4.5	6.2	0.7	86	-1.5	0.0	0.4	0.6	3.0
3	6M 3Y5Y	4.6	6.4	0.7	86	-1.5	0.1	0.4	0.6	1.8
4	1Y 2Y5Y	7.0	10.2	0.7	83	-1.6	0.1	0.4	0.6	1.2
5	6M 1Y5Y	8.6	13.1	0.7	65	-2.0	0.3	0.6	0.7	1.9
6	1Y 2Y3Y	2.4	3.7	0.7	87	-1.4	0.1	0.5	0.6	1.0
7	3M 2Y5Y	7.0	10.7	0.6	74	-1.5	0.1	0.4	0.7	2.4
8	6M 2Y7Y	10.5	16.6	0.6	80	-1.8	0.1	0.4	0.6	1.5
9	1Y 3Y5Y	4.6	7.2	0.6	74	-1.4	0.0	0.4	0.6	1.2
10	3M 3Y7Y	8.2	13.1	0.6	84	-1.8	0.0	0.4	0.6	2.1
11	1Y 2Y7Y	10.2	16.3	0.6	83	-1.6	0.1	0.4	0.6	1.1
12	3M 2Y7Y	10.6	17.2	0.6	76	-1.8	0.1	0.4	0.6	2.0
13	3M 1Y5Y	8.6	14.0	0.6	60	-1.7	0.2	0.5	0.8	2.3
14	6M 1Y7Y	12.1	19.9	0.6	65	-2.1	0.3	0.5	0.7	1.8
15	6M 2Y3Y	2.4	3.9	0.6	69	-1.7	0.2	0.5	0.6	1.7

Source: Deutsche Bank

Top 15 JPY Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	3M 15Y20Y	2.7	3.2	0.8	65	-3.8	0.5	0.7	1.0	2.4
2	6M 15Y20Y	2.9	4.3	0.7	45	-1.3	0.5	0.7	1.0	1.9
3	1Y 15Y20Y	3.1	4.6	0.7	36	-0.3	0.6	0.8	1.0	1.6
4	6M 10Y20Y	2.1	7.5	0.3	17	-0.6	0.4	0.6	0.9	1.9
5	1Y 10Y20Y	2.6	9.3	0.3	13	-0.3	0.5	0.7	0.9	1.5
6	3M 10Y20Y	1.7	6.3	0.3	18	-1.2	0.4	0.6	0.9	2.7
7	6M 15Y30Y	6.7	113.4	0.1	1	-0.5	0.1	0.4	0.9	1.8
8	1Y 15Y30Y	6.8	127.8	0.1	0	-0.3	0.1	0.4	0.9	1.4
9	1Y 7Y20Y	0.7	13.6	0.1	2	-0.3	0.2	0.4	0.8	1.7
10	6M 10Y30Y	5.9	115.9	0.1	1	-0.6	0.2	0.4	0.9	1.8
11	3M 15Y30Y	6.6	132.0	0.0	2	-1.3	0.1	0.3	0.9	2.4
12	1Y 10Y30Y	6.3	130.7	0.0	1	-0.4	0.2	0.4	0.9	1.5
13	3M 10Y30Y	5.6	134.6	0.0	2	-0.9	0.1	0.3	0.9	2.4
14	6M 20Y30Y	3.7	110.0	0.0	1	-0.5	0.1	0.3	0.7	1.4
15	1Y 7Y30Y	4.4	136.3	0.0	1	-0.2	0.1	0.4	0.8	1.6

Source: Deutsche Bank

Carry is calculated for next 3 months and shown in annualized form.

Volatility is calculated as 1m realized for CAD and extracted from swaptions prices for other currencies.

Percentile statistics are calculated from a 10 year history.

Top 15 CAD Flatteners

Rank	Trade	1y Carry	Rlzd. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	3M 2Y3Y	8.5	12.0	0.7	88	-2.3	-0.4	0.1	0.5	1.5
2	6M 2Y3Y	8.5	13.5	0.6	90	-2.5	-0.4	0.0	0.4	1.3
3	1Y 1Y3Y	22.9	36.3	0.6	81	-3.4	-0.2	0.1	0.5	2.5
4	1Y 1Y2Y	16.7	27.3	0.6	71	-4.7	-0.2	0.3	0.7	3.5
5	1Y 1Y5Y	24.5	42.6	0.6	86	-2.4	-0.3	0.1	0.3	1.7
6	1Y 1Y7Y	24.1	44.7	0.5	88	-2.2	-0.3	0.0	0.3	1.5
7	6M 1Y7Y	17.6	33.6	0.5	70	-4.1	-0.6	0.1	0.6	3.5
8	6M 2Y5Y	11.7	25.2	0.5	91	-2.5	-0.4	0.0	0.2	1.2
9	6M 1Y5Y	17.4	37.8	0.5	64	-5.1	-0.5	0.2	0.7	4.3
10	6M 1Y3Y	14.3	31.2	0.5	56	-8.8	-0.4	0.3	1.1	6.7
11	3M 2Y5Y	11.2	24.9	0.5	88	-2.6	-0.4	0.0	0.3	1.3
12	6M 1Y10Y	14.6	33.4	0.4	73	-3.3	-0.6	0.0	0.5	2.7
13	1Y 1Y10Y	20.6	48.0	0.4	89	-1.9	-0.4	0.0	0.2	1.1
14	6M 2Y7Y	11.8	27.9	0.4	89	-2.5	-0.4	-0.1	0.2	1.1
15	3M 2Y7Y	11.0	26.2	0.4	86	-2.8	-0.5	0.0	0.3	1.4

Source: Deutsche Bank

Top 15 CAD Steepeners

Rank	Trade	1y Carry	Rlzd. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	3M 10Y20Y	10.7	8.9	1.2	94	-2.1	0.3	0.7	1.0	2.3
2	3M 15Y20Y	4.6	4.0	1.1	95	-0.5	0.3	0.5	0.8	4.1
3	3M 10Y25Y	12.9	11.6	1.1	94	-1.7	0.3	0.6	0.9	2.1
4	3M 10Y15Y	6.2	5.7	1.1	95	-3.7	0.2	0.5	0.8	3.1
5	3M 10Y30Y	14.2	13.7	1.0	97	-1.3	0.3	0.6	0.7	2.3
6	6M 15Y20Y	4.4	4.4	1.0	90	-0.2	0.2	0.5	0.7	1.5
7	6M 10Y20Y	10.4	10.5	1.0	81	-1.0	0.3	0.7	0.9	1.7
8	3M 7Y20Y	13.7	14.0	1.0	84	-1.1	0.2	0.5	0.9	1.8
9	3M 7Y25Y	15.9	16.3	1.0	88	-1.1	0.2	0.6	0.8	1.7
10	3M 15Y25Y	6.8	7.0	1.0	96	-0.6	0.3	0.5	0.7	3.1
11	3M 7Y30Y	17.2	18.3	0.9	92	-1.2	0.2	0.5	0.8	1.8
12	1Y 10Y20Y	10.7	11.5	0.9	83	-0.5	0.3	0.6	0.8	1.5
13	6M 10Y25Y	12.4	13.7	0.9	81	-0.8	0.3	0.6	0.8	1.5
14	1Y 15Y20Y	4.5	5.0	0.9	87	0.0	0.3	0.5	0.7	1.4
15	6M 7Y20Y	13.4	15.2	0.9	77	-0.5	0.2	0.6	0.8	1.7

Source: Deutsche Bank

Top 15 AUD Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	3M 3Y5Y	33.0	26.7	1.2	98	-1.4	-0.7	-0.3	0.3	1.8
2	3M 2Y5Y	54.5	49.3	1.1	99	-1.2	-0.4	0.2	0.5	1.4
3	3M 2Y7Y	53.9	64.4	0.8	99	-0.9	-0.3	0.1	0.3	1.0
4	1Y 2Y3Y	16.6	21.9	0.8	92	-1.3	0.0	0.3	0.6	1.1
5	3M 2Y10Y	52.4	73.9	0.7	99	-0.7	-0.3	0.0	0.2	0.9
6	6M 2Y5Y	33.4	47.5	0.7	99	-1.1	-0.3	0.1	0.3	0.8
7	6M 2Y3Y	20.8	30.2	0.7	79	-1.0	0.1	0.4	0.6	1.5
8	3M 3Y7Y	32.4	48.9	0.7	98	-0.8	-0.4	-0.1	0.1	1.0
9	3M 1Y5Y	61.8	95.8	0.6	73	-1.3	-0.2	0.4	0.7	1.4
10	3M 1Y7Y	61.1	101.8	0.6	79	-1.2	-0.2	0.3	0.6	1.3
11	3M 2Y3Y	21.6	37.1	0.6	79	-0.9	0.1	0.3	0.5	1.3
12	3M 1Y10Y	59.6	106.3	0.6	85	-1.1	-0.2	0.2	0.5	1.1
13	3M 3Y10Y	30.8	61.7	0.5	99	-0.7	-0.3	-0.1	0.0	0.8
14	6M 1Y5Y	40.8	82.3	0.5	80	-1.1	-0.2	0.3	0.5	1.0
15	6M 2Y7Y	31.3	67.6	0.5	99	-0.8	-0.3	0.0	0.2	0.5

Source: Deutsche Bank

Top 15 AUD Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	1Y 5Y10Y	6.5	44.0	0.1	42	0.0	0.1	0.2	0.2	0.5
2	1Y 7Y10Y	2.6	18.3	0.1	43	-0.1	0.1	0.2	0.3	0.5
3	1Y 5Y7Y	3.9	27.9	0.1	43	-0.2	0.1	0.2	0.2	0.4
4	6M 7Y10Y	2.3	19.2	0.1	42	-0.2	0.1	0.1	0.2	0.5
5	6M 5Y10Y	4.4	44.0	0.1	34	-0.1	0.1	0.1	0.2	0.5
6	3M 7Y10Y	1.5	17.2	0.1	37	-0.4	0.1	0.1	0.2	0.7
7	6M 5Y7Y	2.1	27.6	0.1	30	-0.4	0.1	0.1	0.2	0.4
8	1Y 3Y10Y	4.8	76.7	0.1	2	0.0	0.1	0.2	0.3	0.5
9	3M 5Y10Y	2.1	39.5	0.1	28	-0.5	0.0	0.1	0.2	0.7
10	1Y 3Y7Y	2.1	62.1	0.0	2	-0.1	0.2	0.2	0.3	0.6
11	3M 5Y7Y	0.6	25.4	0.0	27	-1.0	0.0	0.1	0.2	0.6
12	1Y 3Y5Y	-1.8	36.6	0.0	2	-0.1	0.2	0.3	0.4	0.8
13	6M 3Y10Y	-8.2	69.8	-0.1	1	-0.2	0.1	0.2	0.3	0.5
14	3M 1Y2Y	-7.2	60.7	-0.1	69	-1.6	-0.5	-0.4	0.0	1.1
15	6M 1Y2Y	-7.4	58.7	-0.1	65	-0.8	-0.3	-0.2	0.1	0.8

Source: Deutsche Bank

Top 15 GBP Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	1Y 1Y2Y	-1.4	16.6	-0.1	22	-1.2	0.0	0.2	0.5	2.5
2	6M 1Y2Y	-1.9	19.9	-0.1	10	-0.9	0.1	0.3	0.7	3.4
3	3M 2Y3Y	-2.2	19.6	-0.1	45	-5.2	-0.5	0.0	0.5	2.0
4	3M 1Y3Y	-4.6	38.1	-0.1	11	-0.8	0.2	0.5	0.9	4.0
5	3M 1Y2Y	-2.4	19.8	-0.1	2	-0.7	0.2	0.6	1.3	9.8
6	6M 1Y3Y	-5.4	31.6	-0.2	16	-1.1	0.0	0.3	0.7	3.4
7	6M 25Y30Y	-1.5	7.9	-0.2	44	-1.6	-0.2	-0.1	0.0	0.2
8	3M 25Y30Y	-1.5	8.0	-0.2	42	-0.8	-0.2	-0.1	0.0	0.2
9	3M 1Y5Y	-11.8	59.6	-0.2	16	-1.1	0.0	0.4	0.8	3.4
10	1Y 25Y30Y	-1.4	7.0	-0.2	36	-1.0	-0.3	-0.1	0.0	0.2
11	3M 2Y5Y	-9.3	42.0	-0.2	42	-4.7	-0.5	-0.1	0.4	1.6
12	1Y 1Y3Y	-5.4	24.0	-0.2	23	-1.2	-0.2	0.2	0.5	2.0
13	6M 20Y30Y	-3.8	15.8	-0.2	48	-2.0	-0.3	-0.2	0.0	0.2
14	3M 20Y30Y	-3.9	16.1	-0.2	46	-1.0	-0.3	-0.2	0.0	0.2
15	6M 1Y5Y	-12.8	49.6	-0.3	21	-1.3	-0.2	0.3	0.6	2.9

Source: Deutsche Bank

Top 15 GBP Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percentile	Min	25th	Median	75th	Max
1	1Y 2Y25Y	34.8	50.7	0.7	69	-0.5	0.0	0.2	0.9	2.1
2	1Y 2Y20Y	32.5	47.6	0.7	69	-0.5	0.0	0.2	0.9	2.0
3	1Y 3Y20Y	28.5	42.2	0.7	67	-0.4	0.0	0.2	0.9	2.0
4	1Y 2Y30Y	36.2	53.9	0.7	69	-0.4	0.0	0.2	0.8	2.2
5	1Y 3Y25Y	30.7	46.1	0.7	67	-0.4	0.0	0.2	0.9	2.0
6	6M 2Y25Y	35.0	52.7	0.7	70	-0.8	0.0	0.2	0.9	3.8
7	6M 2Y30Y	36.5	55.5	0.7	70	-0.7	0.0	0.2	0.8	3.7
8	6M 2Y20Y	32.7	49.9	0.7	70	-0.8	-0.1	0.2	0.8	3.8
9	3M 2Y30Y	35.3	54.6	0.6	73	-0.9	0.0	0.2	0.7	6.5
10	1Y 3Y30Y	32.1	50.0	0.6	66	-0.4	0.0	0.2	0.9	2.0
11	3M 2Y25Y	33.8	52.7	0.6	72	-0.9	-0.1	0.2	0.7	6.3
12	6M 3Y20Y	29.1	45.6	0.6	69	-0.6	0.0	0.2	0.9	3.7
13	1Y 3Y15Y	24.6	38.7	0.6	68	-0.4	0.0	0.2	0.9	2.0
14	1Y 10Y15Y	6.6	10.5	0.6	51	-0.3	0.1	0.6	0.9	2.0
15	6M 3Y25Y	31.5	49.7	0.6	68	-0.6	0.0	0.2	0.9	3.6

Source: Deutsche Bank

Carry is calculated for next 3 months and shown in annualized form.

Volatility is calculated as 1m realized for CAD and extracted from swaptions prices for other currencies.

Percentile statistics are calculated from a 10 year history

Top 15 CHF Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	6M 3Y5Y	7.3	8.3	0.9	91	-0.7	-0.3	0.1	0.5	1.5
2	6M 2Y5Y	10.6	12.9	0.8	89	-0.9	-0.3	0.2	0.6	1.4
3	1Y 3Y5Y	6.3	8.1	0.8	92	-1.0	-0.4	0.0	0.4	1.2
4	3M 3Y5Y	7.4	9.7	0.8	86	-0.8	-0.3	0.1	0.6	2.3
5	1Y 2Y5Y	9.9	13.0	0.8	90	-0.8	-0.4	0.1	0.5	1.1
6	3M 2Y5Y	10.2	14.7	0.7	81	-1.1	-0.3	0.2	0.6	3.7
7	1Y 2Y3Y	3.5	5.4	0.6	87	-0.8	-0.2	0.2	0.5	1.2
8	6M 2Y3Y	3.3	5.1	0.6	81	-1.3	-0.2	0.2	0.5	1.7
9	6M 2Y7Y	12.5	19.7	0.6	88	-1.0	-0.4	0.1	0.5	1.4
10	6M 3Y7Y	9.2	15.3	0.6	90	-0.9	-0.5	0.0	0.4	1.4
11	3M 3Y7Y	10.2	16.9	0.6	85	-1.0	-0.3	0.0	0.5	2.6
12	3M 2Y7Y	12.9	21.8	0.6	83	-1.2	-0.4	0.1	0.5	2.0
13	1Y 2Y7Y	10.9	18.9	0.6	90	-0.9	-0.5	0.0	0.3	1.0
14	1Y 3Y7Y	7.4	14.4	0.5	92	-1.0	-0.6	-0.1	0.2	1.0
15	3M 2Y3Y	2.7	6.0	0.5	75	-1.7	-0.2	0.2	0.5	1.6

Source: Deutsche Bank

Top 15 CHF Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	1Y 7Y10Y	1.4	8.1	0.2	18	0.0	0.4	0.6	0.9	1.6
2	6M 7Y10Y	0.7	10.5	0.1	15	-0.1	0.4	0.6	0.9	1.4
3	3M 7Y10Y	0.5	12.4	0.0	10	-0.1	0.1	0.3	0.7	1.6
4	1Y 5Y10Y	0.4	14.7	0.0	7	-0.1	0.2	0.6	0.8	1.3
5	6M 5Y10Y	-1.3	17.9	-0.1	3	-0.4	0.1	0.5	0.8	1.4
6	3M 5Y10Y	-2.2	21.1	-0.1	5	-0.9	0.1	0.4	0.8	1.5
7	1Y 5Y7Y	-1.0	6.9	-0.1	8	-0.6	0.0	0.4	0.6	1.0
8	6M 5Y7Y	-1.9	7.8	-0.2	12	-1.0	-0.1	0.3	0.6	1.2
9	1Y 3Y10Y	-6.0	22.0	-0.3	7	-0.6	0.0	0.3	0.7	1.1
10	3M 5Y7Y	-2.7	9.1	-0.3	13	-1.6	-0.1	0.1	0.3	1.3
11	3M 3Y10Y	-9.7	28.2	-0.3	14	-1.6	-0.2	0.1	0.6	1.1
12	6M 3Y10Y	-8.6	25.0	-0.3	9	-1.0	-0.1	0.1	0.6	1.1
13	1Y 2Y10Y	-9.5	26.2	-0.4	8	-0.7	-0.2	0.1	0.6	1.0
14	3M 2Y10Y	-12.4	32.8	-0.4	17	-1.6	-0.3	0.0	0.5	1.2
15	6M 2Y10Y	-11.9	29.2	-0.4	12	-1.1	-0.3	0.0	0.6	1.1

Source: Deutsche Bank

Top 15 SEK Flatteners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	1Y 1Y3Y	96.7	19.2	5.0	78	-4.9	-1.1	2.2	4.8	9.5
2	1Y 1Y5Y	115.1	25.9	4.4	79	-4.3	-1.3	1.6	4.0	7.6
3	1Y 1Y7Y	119.9	30.0	4.0	80	-4.2	-1.6	1.2	3.5	6.8
4	1Y 1Y10Y	119.5	33.8	3.5	78	-4.5	-1.8	0.9	3.1	6.3
5	1Y 3Y5Y	18.4	8.6	2.1	87	-4.1	-1.7	-0.2	1.5	3.2
6	1Y 3Y7Y	23.3	14.1	1.7	87	-4.5	-2.0	-0.5	1.1	2.5
7	1Y 3Y10Y	22.9	18.7	1.2	87	-4.7	-2.1	-0.8	0.7	2.0
8	1Y 5Y7Y	4.9	6.6	0.7	97	-3.5	-1.7	-0.8	0.1	1.0
9	6M 3Y5Y	5.5	13.5	0.4	66	-2.8	-1.5	-0.4	0.8	2.9
10	1Y 5Y10Y	4.5	11.3	0.4	97	-4.2	-2.0	-1.2	-0.2	0.8
11	3M 3Y5Y	5.0	14.6	0.3	68	-3.2	-1.2	-0.3	0.8	2.6
12	6M 3Y7Y	4.8	21.2	0.2	70	-3.5	-1.9	-0.7	0.5	2.4
13	3M 3Y7Y	4.7	23.9	0.2	69	-3.5	-1.7	-0.7	0.5	2.1
14	6M 3Y10Y	0.2	25.7	0.0	73	-3.9	-2.1	-1.0	0.1	1.9
15	3M 3Y10Y	-0.2	28.5	0.0	73	-3.4	-2.0	-0.9	0.2	1.6

Source: Deutsche Bank

Top 15 SEK Steepeners

Rank	Trade	1y Carry	Imp. Vol	Ratio	Percent	Min	25th	Median	75th	Max
1	3M 1Y7Y	455.6	55.6	8.2	73	-12.5	1.7	4.6	8.5	14.9
2	3M 1Y10Y	460.5	56.7	8.1	72	-12.5	1.9	4.7	8.9	15.0
3	3M 1Y5Y	455.3	56.3	8.1	71	-12.2	1.6	4.6	8.9	14.6
4	3M 1Y3Y	460.3	57.8	8.0	66	-11.8	1.1	5.4	9.9	21.1
5	6M 1Y3Y	138.5	33.9	4.1	77	-12.5	1.2	2.1	3.8	8.1
6	6M 1Y5Y	133.0	34.7	3.8	82	-12.5	1.0	1.7	2.9	6.9
7	6M 1Y7Y	133.7	35.7	3.7	81	-11.9	1.0	1.6	3.0	6.6
8	6M 1Y10Y	138.3	37.7	3.7	80	-11.3	1.1	1.8	3.1	6.3
9	3M 7Y10Y	4.9	5.4	0.9	32	-0.9	0.7	1.3	1.9	3.8
10	6M 7Y10Y	4.6	5.5	0.8	29	-0.7	0.7	1.4	2.0	4.3
11	6M 5Y10Y	5.3	13.8	0.4	24	-1.0	0.4	1.2	2.2	4.0
12	3M 5Y10Y	5.2	15.9	0.3	22	-1.2	0.4	1.2	2.1	3.4
13	1Y 7Y10Y	0.4	5.3	0.1	4	-0.7	0.6	1.3	2.0	4.6
14	6M 5Y7Y	0.7	9.2	0.1	23	-1.1	0.2	1.0	1.9	3.9
15	3M 5Y7Y	0.3	11.0	0.0	23	-1.3	0.1	1.0	1.8	3.1

Source: Deutsche Bank

Spread of Swap Spreads Trades

Trade	Current Carry	Current Level	Percentile	Min	25th	Median	75th
2Y3Y	-2.05	-2.3	7	-4.2	-1.6	-0.8	-0.3
2Y5Y	-1.48	-6.9	7	-9.8	-4.6	-0.9	0.8
2Y7Y	-1.86	-12.8	5	-16.3	-6.6	-2.6	1.5
2Y10Y	-1.05	-11.2	6	-13.2	-7.2	-3.2	-0.4
2Y30Y	-2.51	-25.6	25	-37.8	-25.9	-19.4	-14.8
3Y5Y	0.57	-4.6	9	-8.2	-2.9	-0.5	1.3
3Y7Y	0.19	-10.5	7	-15.3	-5.1	-1.9	2.0
3Y10Y	1.00	-8.8	10	-12.3	-6.3	-1.9	0.3
3Y30Y	-0.46	-23.3	30	-37.1	-25.8	-18.3	-13.8
5Y7Y	-0.38	-5.9	4	-7.7	-2.5	-1.1	0.8
5Y10Y	0.42	-4.2	25	-10.7	-3.9	-1.0	1.0
5Y30Y	-1.03	-18.7	39	-38.3	-27.8	-17.2	-11.2
7Y10Y	0.80	1.6	63	-9.5	-5.1	-0.6	3.3
7Y30Y	-0.65	-12.8	59	-38.1	-27.5	-16.0	-9.2
10Y30Y	-1.45	-14.4	58	-30.7	-21.6	-15.6	-12.7

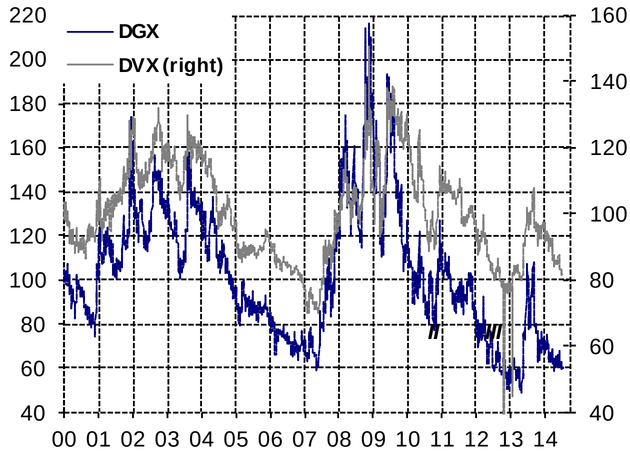
Source: Deutsche Bank

Values as of Oct 9th 2014

Tenor	Repo	Spot Swap Spread	1M Fwd. Swap Spread
2	15.00	25.9	28.3
3	16.00	23.6	23.9
5	7.50	19.0	19.9
7	9.50	13.1	13.6
10	2.50	14.7	16.0
30	11.50	0.3	0.1

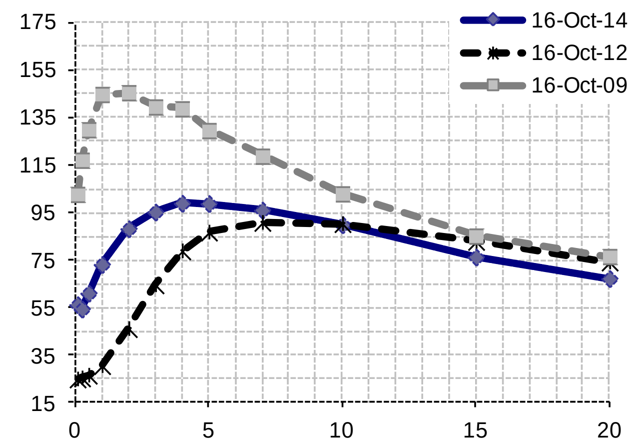
Source: Deutsche Bank

DGX and DVX across different market regimes



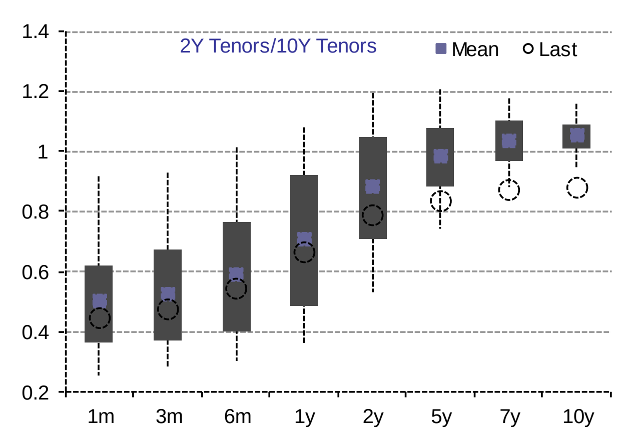
Source: Deutsche Bank

Term structure of 2Y vol



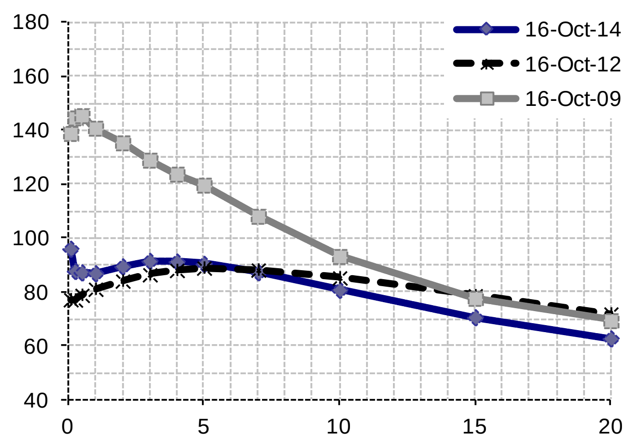
Source: Deutsche Bank

Ratios of 2Y to 10Y tenors (quartiles, 5-year history)



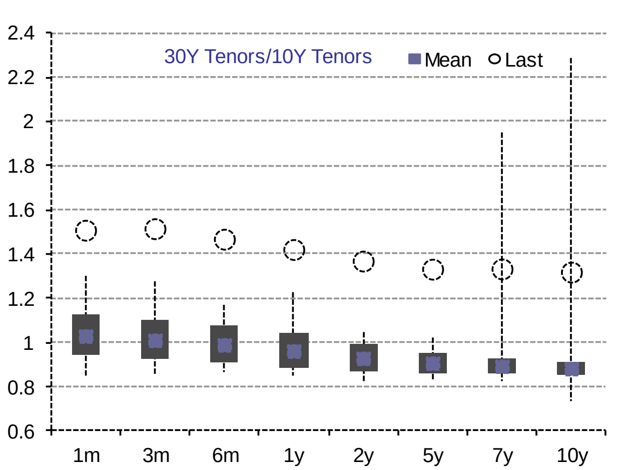
Source: Deutsche Bank

Term structure of 10Y vol



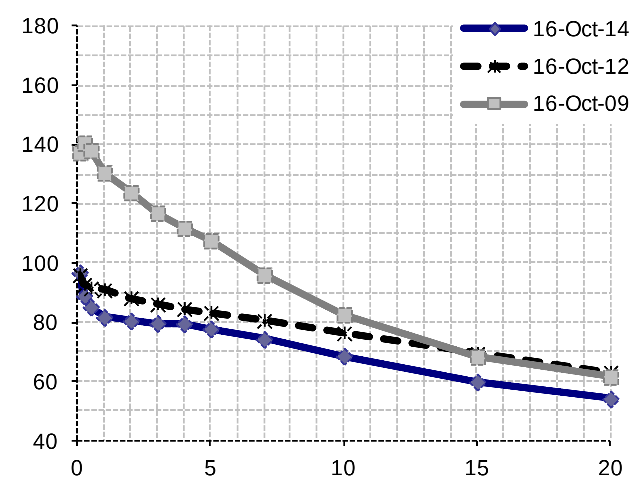
Source: Deutsche Bank

Ratios of 30Y to 10Y tenors (quartiles, 5-year history)



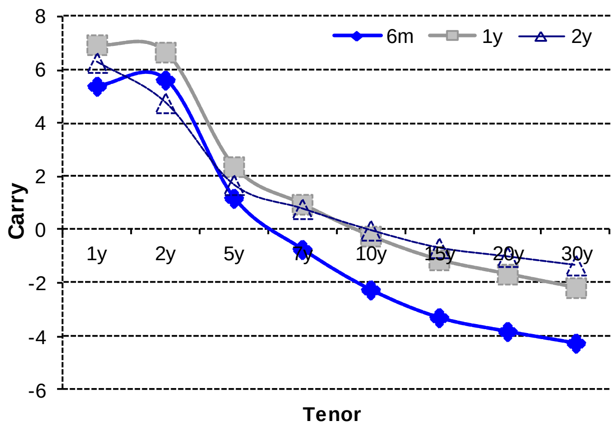
Source: Deutsche Bank

Term structure of 30Y vol



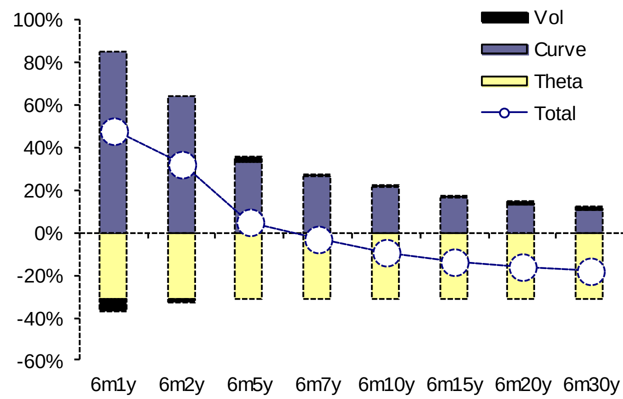
Source: Deutsche Bank

3M carry across different expiries (ATMF receivers)



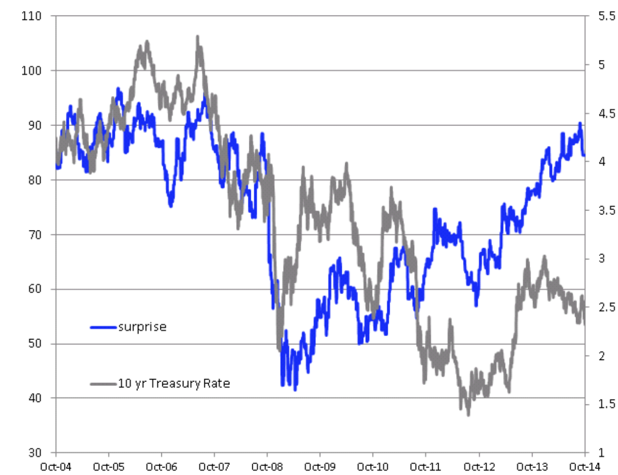
Source: Deutsche Bank

Breakdown of 3M carry for 6M expiries (% premium)



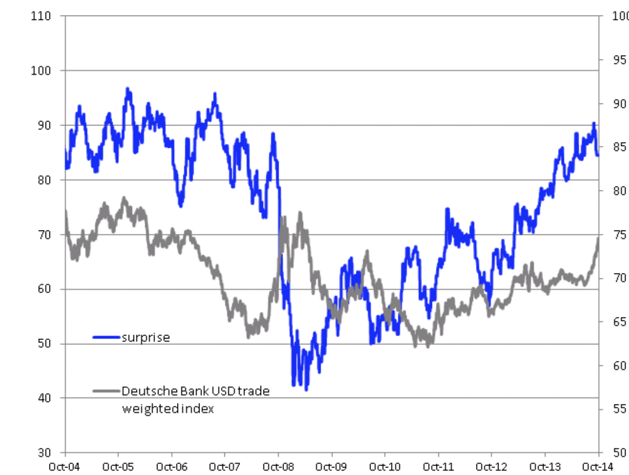
Source: Deutsche Bank

US surprise index: 10Y Treasury yield



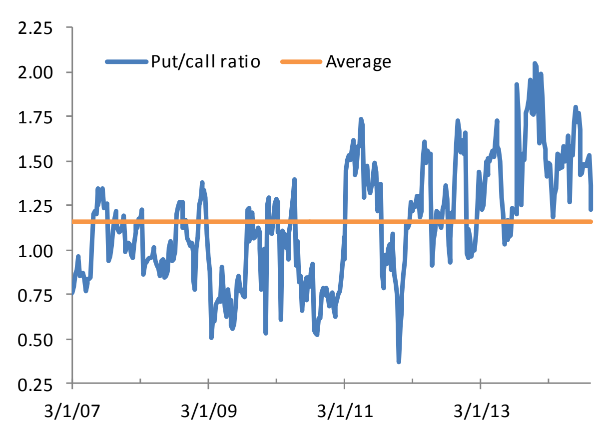
Source: Deutsche Bank

Trade weighted dollar surprise index



Source: Deutsche Bank

Combined put/call ratio in Treasury futures



Source: Deutsche Bank and CME Group

US Treasury Coupon Auction Calendar

Ticker/Coupon/Maturity	Date	Tap/New Issue	Size
TII 1.375% 2/44	Thursday, October 23	Tap	7bln

US Economics & Events Calendar

	Event	DB Forecast
Tue, Oct 21 2014	Existing Home Sales	5.10M
Wed, Oct 22 2014	CPI Price	
	• Total	+0.1%
	• Core	+0.2%
Thu, Oct 23 2014	Leading Economic Indicators	+0.8%
	2 Yr FRN Announcement	$15B
	2 Yr Note Announcement	$29B
	5 Yr Note Announcement	$35B
	7 Yr Note Announcement	$29B
Fri, Oct 24 2014	New Home Sales	510k

European Economics & Events Calendar

Date	Economic Releases	Political Events	Bond Redemption/Supply
Oct 20	Portugal: Current Account Balance Germany: PPI YoY Italy: Industrial Sales WDA YoY Eurozone: ECB Current Account SA	Germany: Schaeuble, Sapin, Gabriel, Macron Brief Reporters in Berlin Eurozone: ECB's Coeure Speaks at OMFIF Policy Group Roundtable in London	Germany: AUCT - EU Auction of 1.873m Ph.3 EUAs (Spot Market) EEX France to Sell Bills
Oct 21	Greece: Current Account Balance Eurozone: Govt Debt/GDP Ratio	Germany: Merkel, Telekom's Hoettges Attend Annual IT Summit in Hamburg Eurozone: EU General Affairs Ministers Hold Meeting in Luxembourg	Germany: AUCT - EU Auction of 1.873m Ph.3 EUAs (Spot Market) EEX
Oct 22	Ireland: Property Prices YoY	Portugal: Bank of Portugal's Neves at Conference on Portuguese Economy	Germany to Sell EUR2 Bln 2.5% 2046 Bonds (DE0001102341)
Oct 23	Spain: Unemployment Rate Germany: Markit/BME Germany Composite PMI France: Markit France Composite PMI Ireland: PPI YoY Eurozone: Markit Eurozone Composite PMI	Eurozone: EU Leaders Hold Summit in Brussels	Germany: AUCT - EU Auction of 1.873m Ph.3 EUAs (Spot Market) EEX
Oct 24	Spain: PPI YoY Portugal Releases Year-to-Date Budget Report Germany: Import Price Index YoY France: Jobseekers Net Change Italy: Consumer Confidence Index	Eurozone: ECB's Praet Speaks in Milan	Germany: AUCT - Germany Auction of 2.352m Ph.3 EUAs (Spot Market) EEX

Total/excess return forecasts in HY, IG, leveraged loans

	HY	IG	5yr Trsy	10yr Trsy
Spreads/Yields				
Current	410	115	150	285
Target	360	95	250	385
Change	-50	-20	100	100
	Normal HY vs IG Beta = 4:1			
Duration	4.6	6.5	4.8	8.5
Change in Yield	50	80	100	100
Change in Price	-230	-520	-480	-850
Current Yield	698	428		
Current Price	106.0	107.5		
Default Rate	1.5	0.0		
Recovery	40	--		
Credit Loss	-93	0		
Price Return	-3.1	-4.8		
Total Return	**3.9**	**-0.6**		
Excess Return	**7.2**	**3.8**		
Using DB rate forecasts:			200	325
Price Return	-0.9	-1.2		
Total Return	6.1	3.1		
Excess Return	7.0	3.9		

	Loans	2yr Trsy
Spreads/Yields		
Current	490	30
Target	450	50
Predicted Change	-40	20
Rate Duration	2.0	
Spread Duration	2.7	
Avg Par Coupon	440	
Libor/Tsy Change	20	
Total Change in Yield	-20	
Repricings	-50	
Capital Gain	18	
Current Yield	446	
Default Rate	1.5	
Price	98.7	
Credit Loss	36	
Total Return	**4.3**	

Source: Deutsche Bank

Closed Trade Recommendations

	Trade Detail	Rationale	Risks	Opened	Entry	Closed	Exit	P/L
Agencies	Switch into 10Y $SSA vs. US GSEs: Buy $50m BNG 2.5 Jan-23 on ASW / Sell FHLMC 2.375 Jan-22	Decline in agency market liquidity and uncertainty over housing finance reform may pressure GSEs to underperform $SSAs. BNG offers a more geographically diverse funding base with an equivalent AA+ rating and a similar spread volatility.	Renewed Eurozone risk, increased dollar funding demand from Europe, increased government support for US GSEs.	1/24/14	+30bp	6/11/14	+19 bp	+523k
Agencies	Buy $50m FNMA 0.875% 8/28/14 vs selling duration matched Treasury / Sell $50m FHLMC 4/17/15 vs buying duration matched Treasury	3s are tight to 2s vs Treasuries	Spread curve flattening or inversion	3/15/12	-2.7 bp	1/23/14	+2.3 bp	-56k
Inflation	Long 10yr TIPS breakevens vs 5yr and 30yr TIPS breakevens	10yr breakevens look cheap ahead of supply	10yr breakevens underperform	5/16/14	+6 bp	9/25/14	+6 bp	-120k
Inflation	Long 30yr TIPS breakevens vs 10yr TIPS breakevens	10s-30s breakeven curve is too flat	10yr breakevens outperform	6/12/14	+8 bp	7/23/14	+12 bp	+171k
Inflation	Long 5yr TIPS breakevens	We favor short-dated TIPS for near-term carry. We like the cheap and liquid 0.125s of 4/2019.	Decline in energy prices or inflation expectations	6/12/14	+200bp	9/16/14	+182 bp	-1,240k
Inflation	Long 5yr TIPS breakevens	5yr breakevens are cheap	Large decline in energy prices or 5yr Treasuries rally	4/11/14	+195bp	6/12/14	+206 bp	**+2,184k**
Inflation	Long 10yr TIPS breakevens vs 30yr TIPS breakevens	10s-30s breakeven curve has room to flatten	30yr breakevens outperform	1/24/14	+18bp	6/12/14	+11 bp	**+1,387k**
Inflation	Long 10yr TIPS breakevens vs. 5yr TIPS breakevens	5s-10s breakeven curve has room to steepen	5yr breakevens outperform	3/20/14	+12bp	4/7/14	+16 bp	+100k
Inflation	Long 10yr TIPS breakevens vs 5yr TIPS breakevens	5s-10s breakeven curve has room to steepen	5yr breakevens outperform	2/10/14	+11bp	3/6/14	+9 bp	-151k
Treasury RV	Sell classic bond futures CTD (6.125 Aug29s) against Aug22s and Aug42s	Classic bond futures close to 1.5 standard deviations rich versus 10s and 30s	Continuing outperformance of classic bond futures	10/7/13	+13bp	8/12/14	+7 bp	-404k
Treasury RV	Take profits on the 2026-2029 bonds. (Li)	2026-2029 bonds have outperformed recently and look rich to 10s and 30s	2026-2029 bonds continue to cheapen	9/17/13	+11 bp	8/12/14	+7 bp	-226k
Treasury RV	Long 10s vs 5s and 30s	10s look cheap on the curve	10s continue to cheapen	9/12/13	+26 bp	7/7/14	+14 bp	+364k
Treasury RV	Short WN vs 10s and 30s	Ultra long futures are rich	Ultra continue to richen	4/25/14	+65bp	5/01/14	+68 bp	+221k

Source: Deutsche Bank

Closed Trade Recommendations Cont'd

	Trade Detail	Rationale	Risks	Opened	Entry	Closed	Exit	P/L
Option	Buy 2y10y 25/75/115 payer ladder at zero net cost.	Positive carry bearish rates positioning	Higher gamma; rates rally	4/5/13	0 bp	10/9/14	+92 bp	+991k
Option	Buy $342m 18m3y ATMF+25bp payer and sell $113m 18m10y ATMF+57.5bp payer. (Kocic)	Fed tapers in 2013	Curve steepens and rates rise	5/16/13	+147 bp	10/9/14	+127 bp	+539k
Option	Buy $207mm 3m5y receiver ATMF - 25 bp, sell 207mm 3m5y receiver ATMF - 50 bp at 16.75 bp premium	High payout ratio for exposure to delayed Fed	Market sell off, max loss net premium	5/20/14	+17 bp	8/19/14	+0 bp	-339k
Option	Sell 3M10Y 50bp wide strangles for 116bp	EM uncertainties subside	Rates rally further in risk-off	2/6/14	-116bp	5/6/14	0 bp	+1,188k
Option	Quiet bulls: Buy $100mn 6M10Y atmf/25 receiver spreads financed with $100mn 52bp OTM 6M10Y payers at zero net cost (Kocic)	Fade the sell off if data does not align with the optimism already embedded in the curve	Vulnerable to sell off beyond breakevens with potentially unlimited losses	9/11/13	0 bp	3/11/14	+223.9k	+2354k
Option	Aggressive quiet bulls: Buy $100mn 6M10Y atmf/25 receiver spread financed by $184mn 60bp OTM 6M5Y payers at zero net cost	Fade the sell off if data does not align with the optimism already embedded in the curve	Vulnerable to sell off beyond breakevens with potentially unlimited losses	9/11/13	0 bp	3/11/14	+223.9k	+2352k
Option	Short-dated payer spreads on 5y rate: Buy 3m5y +25/+50 payer spreads at 20.5 bp (6:1 leverage)	Economic healing continues and 5y rates rise	Recovery frustrates and/or rates do not pick-up	12/6/13	+20.5 bp	3/6/14	0 bp	-186k
Option	Buy $880mn 1Y 5s/30s ATMF curve caps vs. sell $100mn 6m10Y 11bp OTM payers at net zero cost. (Kocic)	The risk of weak data and/or more aggressive forward guidance becomes a 5s/30s steepener, while slowdown of growth puts an upper limit on the 10Y sector	Short term flattening sell off	9/13/13	0 bp	3/14/14	+229 bp	+2441k
Cross Market	Receive 158m 1y5y EUR and pay 773m 1y1y EU. (Sparks)	ECB cuts the depo rate further	Forward curve steepens	5/16/13	+84 bp	5/16/14	+55 bp	+2,963
Cross Market	Receive 3y1y JPY and pay 1y1y JPY (Sparks)	Recent sell-off in Japan	US rate outperforms	5/16/13	+44 bp	4/22/14	+8 bp	+4,575k

Source: Deutsche Bank
Performance numbers are based on trader end-of-day marks, and do not include bid/offer spreads or transaction costs. We consider the relevant benchmark for our trades to be a zero position, given the leveraged or generally market neutral aspects of these trades. Historical performance is not a guarantee of future performance."

Appendix 1

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COMMENT

HCA Holdings, Inc.

Credit Research

Sell HCA 5-year or basket of hospital CDS against index into 3Q

OUTPERFORM/IN-LINE
HEALTHCARE PROVIDERS - HY
COVERAGE VIEW: ATTRACTIVE

Recommendation

We recommend investors to **sell HCA 5-year CDS at 217bps.** We continue to see the current differential to CYH/THC, at 70-80bps, as too tight given the historic differential is closer to the 90-130bp range. Additionally, HCA CDS is now at the wides in the most recent six-month period given the recent market sell-off. See charts inside report. We see two potential catalysts for tightening: (1) A potential ratings upgrade as HCA is currently on positive outlook at both Moody's and S&P. We do not think HCA having the same corporate family rating (CFR) as CYH at S&P and the same as THC at Moody's makes sense given more than two turns of total leverage differential and much better FCF generation. (2) HCA may pre-release strong 3Q results in mid-October as it did last year. In five out of the last six quarters, HCA pre-released strong results. Comments from peers at recent investor conferences suggest that volume and mix improvements in 2Q have continued into 3Q. While UHS stated at one of the conferences that some of the volume may be due to pent-up demand, CYH stated it does not think there has been a lot of pent-up demand in 2Q and that Medicaid expansion should continue to benefit 3Q. Additionally, CYH stated that September "is probably the best month in the quarter." THC stated that in-patient volumes so far through August continue to be strong and consistent with the trends seen in 2Q.

For a hedged trade, investors can also **sell a basket of hospital CDS (HCA, CYH and THC) against buying the index** into 3Q earnings. A strong pre-release from HCA could cause peer CDS to rally as well. The differential between the average of the three main hospital CDS to the index after a strong 2Q earnings season in early August was 90bp, while currently the differential is about 60-70 bps. See chart inside report. If hospitals report a solid 3Q with refined or updated guidance numbers, we think the differential to the index should increase.

Risks to our view

HCA could potentially complete a large acquisition like peers CYH and THC did. However, we would not expect leverage to increase more than an immaterial amount for any acquisition or dividend due to the scale of the company (LTM $7bn of EBITDA).

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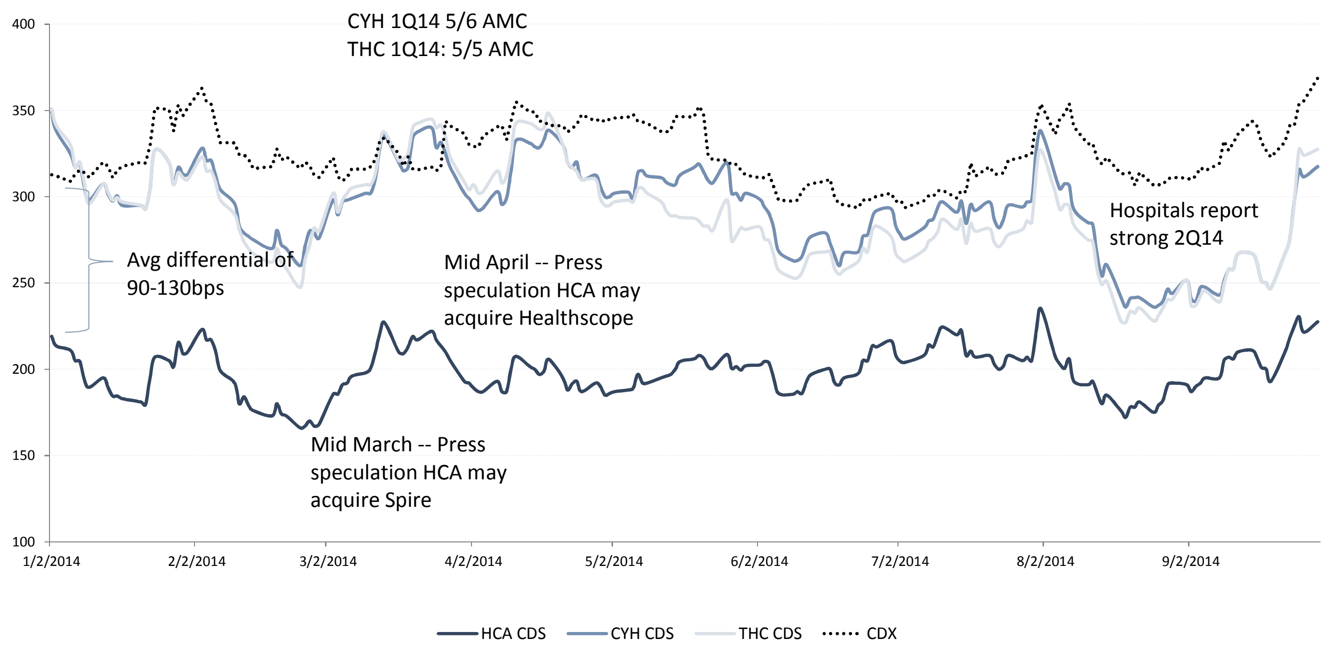
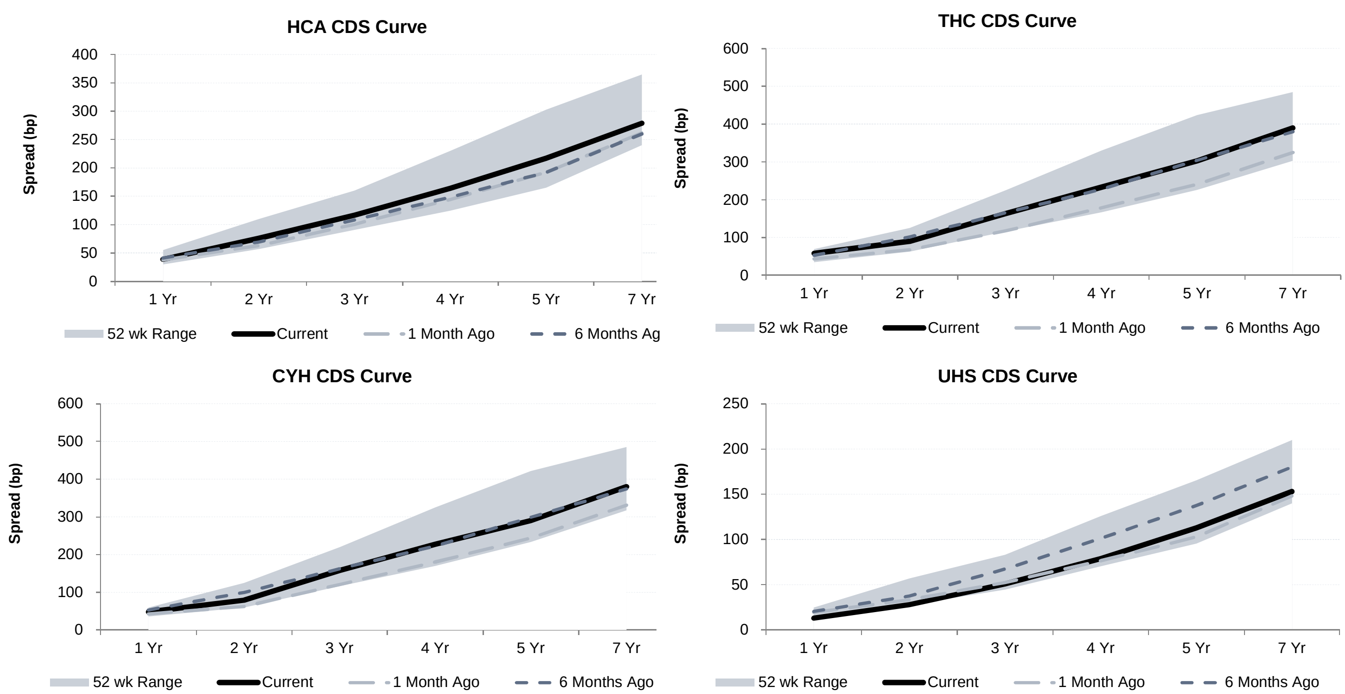
Hospital CDS relative value

Exhibit 1: Hospital CDS vs. overall index



Source: Bloomberg.

Exhibit 2: Hospital CDS curves



Source: Bloomberg.

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July 1, 2014

COMPANY UPDATE

Standard Chartered

In-Line

Credit Research

Negative earnings: cash spreads fair, CDS better value

Earnings negative, but balance sheet remains solid

Despite negative earnings news late last week and subsequent spread widening, we are reiterating our IL rating on STANLN as spreads are at fair value versus European peers under coverage. The group has among the highest relative exposures to EM and Asia of all covered banks, and investor concerns continue about the bank's ability to improve revenues in the current macro environment.

We think the STANLN 5.2% '24s offered at a G-spread of 182bp are at an appropriate differential to the HSBC 4.25% '24 subs (at a G-spread of 137bp) and prefer buying the RBS 6% '23 subs at a G-spread of 239bp. However, in CDS, STANLN 5-year levels are more attractive, and we would be comfortable selling senior CDS at 79bp, flat to RBS and 13bp wider than BACR (IL).

We think it will be difficult for STANLN to outperform in the short term, despite recent widening, due to (1) weak markets revenues (expected to be down by 20% yoy in 1H14), (2) new guidance for lower yoy earnings for FY2014, (3) an increase in impairments (up by high-teens percentage in 1H14), and (4) ongoing concern about results from India, Korea and Singapore, as well as increased investor questions about the group's China exposures.

On the positive side, these earnings concerns are offset by continued balance sheet strength, with a fully-loaded B3 CET1 ratio of 11.2% and a CRDIV leverage ratio of 4.7% at the end of 2013. Despite higher impairments, asset quality remains solid to date, with an NPL ratio of 1.7% for FY2013. Nevertheless, STANLN remains one of the banks under coverage with most exposure to EM, with around 72% of its loan portfolio in Asia. Given ongoing investor concern about economic uncertainty in some regions, volatility in spreads could continue in the medium term.

We are also changing our benchmark security to the 5.2% '24 sub notes and will no longer rate the 3.2% '16 seniors.

EUROPEAN BANKS - IG
COVERAGE VIEW: ATTRACTIVE

Key risks to our view

Risks to the upside: EM risks subside and investors focus on balance sheet strength rather than earnings weakness, low debt issuance.

Risks to the downside: Additional EM concerns and/or execution risk from the new group strategy could cause higher volatility in spreads.

Benchmark bond

Ticker	GS Rating	Amount Outstanding ($mn)	Coupon (%)	Maturity	Issue Rating	Offer price	YTW	G-Spread (bp)
STANLN	IL	1,000	5.200	26-Jan-24	A3/A-	106.9	4.3%	182

Goldman Sachs Global Investment Research.

5 year CDS

	5yr CDS
Senior	79/83
Sub	105/113

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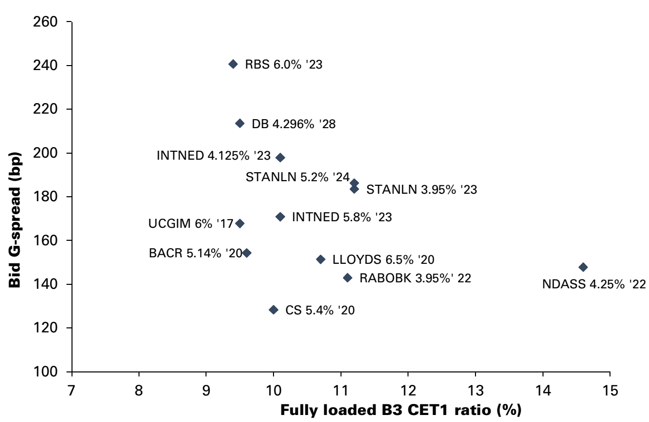
Key takeaways – announcement of weak 1H14 results

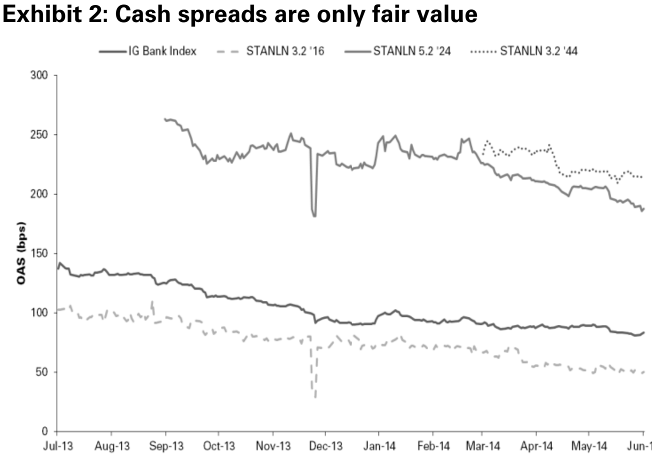
- All yoy comparisons exclude the impacts of the UK Bank Levy, Own Credit Adjustment, and the impairment of goodwill with respect to Korea.
- Group income for 1H2014 is expected to be down by a mid-single digit percentage yoy. On a constant currency basis, group income fell by a low single-digit percentage. Despite growth in China and Africa, the lower revenues were largely fueled by weaker performance in India, Korea and Singapore.
- On a segment basis, income for Transaction Banking is expected to be down by low single-digit percentages, Financial Markets will fall by 20% yoy, and Corporate Finance is expected to be broadly flat. Income for Wealth Management is expected to be up by mid single-digit percentages, Retail Products is expected to be down in the mid single-digit percentages, and Principal Finance is expected to be down by over 10% yoy.
- Costs are expected to be "slightly higher" yoy on continued investment, higher salaries, and regulatory and compliance costs.
- Loan impairments are expected to rise by high-teens percentages yoy. Asset quality remains good, but management "remains watchful" in India and of commodity exposures.
- Other impairments include around $75mn from the re-valuation of "certain strategic investments."
- Group operating profit is therefore expected to have fallen by around 20% yoy.
- Customer loans and advances should have risen by a low single-digit percentage from the end of 2013. Balance sheet growth remains muted as property cooling measures have been implemented across several Asian markets and management has been controlling low-return RWAs.
- Basel 3 RWAs will have risen by mid single-digit percentages from the end of 2013, largely owing to the introduction of regulatory changes to risk models. Organic RWA growth is expected to be largely offset by "very good progress" on RWA management initiatives.

Exhibit 1: Prefer RBS or INTNED over STANLN



Source: Bloomberg, Goldman Sachs Global Investment Research. All capital ratios as of 1Q14, expect STANLN and RABOBK as of FY13

Exhibit 2: Cash spreads are only fair value



Source: Yield Book, Goldman Sachs Global Investment Research.

Exhibit 3: Financial snapshot
In USD million

Key Figures	2011	2012	2013
Income Statement			
Net interest income	10,153	11,010	11,156
Net fee & commission income	4,046	4,121	4,101
Financial transactions income	2,645	2,748	2,514
Other income	793	1,192	1,006
Total operating income	**17,637**	**19,071**	**18,777**
Operating expenses	(9,917)	(10,896)	(10,193)
Pre-provision, pre-tax operating profit	7,720	8,175	8,584
Provisioning charges	(1,019)	(1,415)	(2,746)
Associate income	74	116	226
Pre-tax profits from continued operations	6,775	6,876	6,064
Net income	4,933	4,985	4,200
Net income attributed to equity shareholders	**4,748**	**4,786**	**3,989**
Balance Sheet			
Total assets	592,686	631,208	674,380
Total liabilities	551,311	585,153	627,539
Total equity (including minority interests)	41,375	46,055	46,841
Gross loans	341,061	356,344	385,731
Net loans	332,771	347,435	374,410
Reserves	2,734	3,157	3,547
Non performing loans	4,183	5,538	6,479
Deposits	381,022	409,301	424,583
Income ratios			
NIM	2.3%	2.2%	2.1%
Net interest income/net revenues	57.6%	57.7%	59.4%
Net fee & commission income/net revenues	22.9%	21.6%	21.8%
Net trading income/net revenues	15.0%	14.4%	13.4%
Cost/net revenues ratio (efficiency)	56.2%	57.1%	54.3%
			21.8%
Lending & asset quality			
Net loans/total assets	56.1%	55.0%	55.5%
NPL ratio	1.2%	1.6%	1.7%
Reserve ratio	0.8%	0.9%	0.9%
NPL coverage	65.4%	57.0%	54.7%
Capital adequacy			
Risk weighted assets	270,510	301,861	322,251
Tier 1 core capital ratio	11.8%	11.7%	11.8%
Tier 1 capital ratio	13.7%	13.4%	13.1%
Total capital ratio	17.6%	17.4%	18.0%
Proforma CRD IV CET1 end point basis	-	-	11.2%
Funding & liquidity			
Deposits/Total liabilities	69.1%	69.9%	67.7%
Deposit growth	13.6%	7.4%	3.7%
Loans/ Deposit ratio	76.6%	73.9%	75.7%

Source: Company filings, Goldman Sachs Global Investment Research.

Disclosure Appendix

Reg AC

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Morgan Stanley

October 31, 2014

Credit Companion

Weekly Market Thoughts and Strategy

Credit Lagging

Credit has lagged equities in the healing, and within credit, investment grade is lagging high yield. Why? In our view, it is driven by liquidity, the low level of rates, and the considerable calendar for expected supply. Rates headwinds keep liability-driven investment dollars on the sideline, even though the long-run trend for LDI is quite constructive. Low rates coupled with the funding of strategic M&A are driving the calendar, and we point out that the derivative indices have rallied much more than cash (and more in line with equities), as they benefit from better liquidity and a lack of rate risk. (**See pages 3-5**)

Our Credit View – Global Central Bank Policy Cuts Both Ways

The bear-flattening of the US Treasury curve post-Fed is not an ideal backdrop for IG credit, but as the Fed ends QE, additional stimulus in Japan and Europe will ultimately motivate flows into US assets. Indeed, global central bank policy cuts both ways. Importantly, on a near-term horizon, our IG credit models are now back to fair value after having pointed rich. The drivers have been better growth relative to expectations, along with a healing in volatility. We remain OW on a longer-term horizon for both IG and HY. (**See page 4**)

Screening for Opportunities

We recently became more positive on the Consumer sector in US IG, reflecting better entry points and a strong macro backdrop that should benefit this sector, and we provide screens for single-name Consumer opportunities. Separately, with the rally in CDX causing CDS to lag, we also highlight opportunities to sell protection across sectors. (**See pages 5-9**)

Client Feedback

Perhaps it was the World Series, but more investors are putting a time line on the remaining length of the current credit cycle, with “7th inning” and 1 to 2 years being common. Energy has become the focus sector of this cycle, and most investors are cautious and concerned about credit fundamentals if this is the new regime in oil prices. In terms of credit asset allocation, adding to HY has been a common theme, as has global flows into the US market. Finally, hedging is topical as investors learn lessons from the recent correction and consider again systematic processes. (**See page 10**)

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Dashboard | Recent Research

Recent Research From US Credit Strategy

- Credit Derivatives Insights: iBoxx TRS – Liquidity Emerges
- Credit Continuum: Raising the Consumer Sector to Overweight
- Leveraged Finance Insights: EUR Not as Cheap as US
- Credit Continuum: The BBBest Part of the Quality Curve
- Credit Continuum: Long-End Beta
- Leveraged Finance Insights: Buy High Yield
- Municipal Strategy Playbook: Running Out the Clock
- Credit Companion: CDX IG23 and CDX HY23 Roll
- Muni Monthly Dashboard: September: Munis Flatten Out
- Credit Derivatives Insights: 2014 ISDA Credit Derivative Definitions
- Credit Investor Election Guide: Studying for Midterms
- Credit Continuum: Supplementary Supply
- Morgan Stanley Back to School: Credit Markets Pedal Through the Cycle
- Muni Monthly Dashboard: August: Munis Carry On
- Leveraged Finance Insights: 2Q Fundamental Review
- Credit Continuum: Rationalizing the Resilience
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- Muni Monthly Dashboard: July: Munis in Summerland
- US Credit Strategy: Where Are We in the Credit Cycle?

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Presentations

- Credit Strategy Playbook: Cycle Turn or Cyclical Opportunity?
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- Leveraged Finance Chartbook

Credit Strategy Flagships

- Credit Derivatives Handbook

Other Recent Morgan Stanley Research & Highlights

- Global Strategy Outlook: Investing in an Out-of-Sync World
- Back-to-School Global Macro Outlook: Lower but Longer

Market Thoughts and Strategy | **Investment Grade Is Lagging, But at Fair Value Now**

Investment Grade Lagging in the Healing: Credit has lagged equities in the healing, and within credit, investment grade is lagging high yield. US cash investment grade markets have traded in a 96-121 bp range over the past 3 months. At 118 bp today, spreads are only 3bp (or 12% of the range) tighter than the wides. By contrast, US HY, at 460 bp, is roughly half way in between the 3 month tights (400 bp) and wides (533 bp), and the S&P 500 has rallied back from the 1862 low to an intra-day level that matches all-time highs.

Why Is IG Lagging? Consider Rates: In our view, it is driven by the low level of rates, with the 10 year currently closer to the 3-month lows of 2.14% vs. the highs of 2.62%. Rates headwinds keep liability-driven investment dollars on the sidelines, even though the long-run trend for LDI is quite constructive. In particular, with the 30-year Treasury still hovering near 3%, nearly 100 bp lower than year-end levels, all-in yields for most 30-year opportunities are well below the 5% yield bogey.

Why Is IG Lagging? Consider Liquidity & Supply: Furthermore, an strong expected supply calendar for November, driven in part by strategic M&A and the low rate environment, is contributing to the lag in IG performance of late, as investors prepare by keeping portfolios light and cash and CDX positions larger. Derivative indices further benefit from a liquidity advantage as well.

Our US IG View: We are overweight US IG on a one-year horizon with a spread target of 98bp and 2.6% excess return from here. Importantly, on a near-term horizon, our models are now back to fair value after having pointed rich. The drivers have been better growth relative to expectations, and a healing in volatility.

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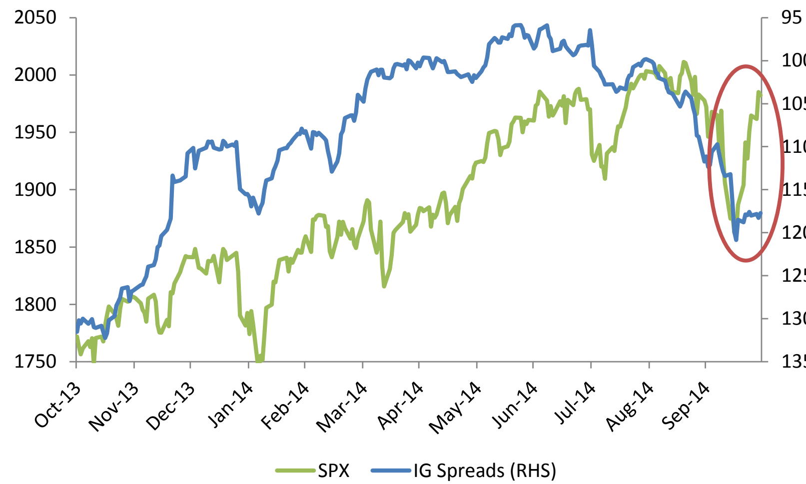
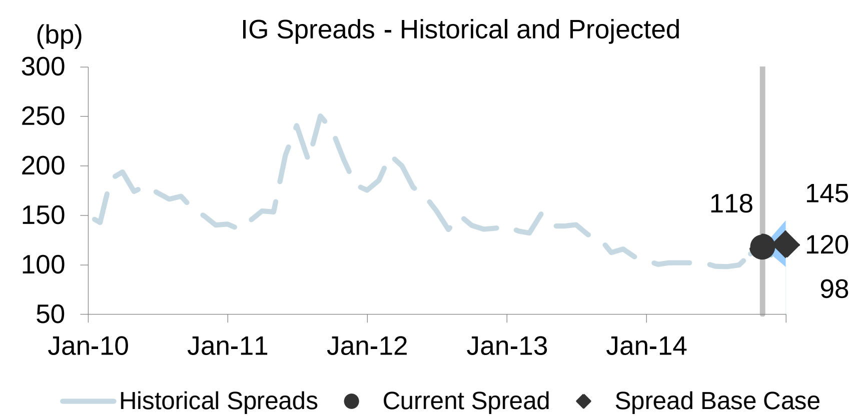
US IG Has Lagged the S&P 500 Since the Sell-off



Source: Morgan Stanley Research, Bloomberg, Yieldbook

IG Credit Valuations: At Fair Value on a 3M Basis



Source: Morgan Stanley Research, Bloomberg, Yieldbook

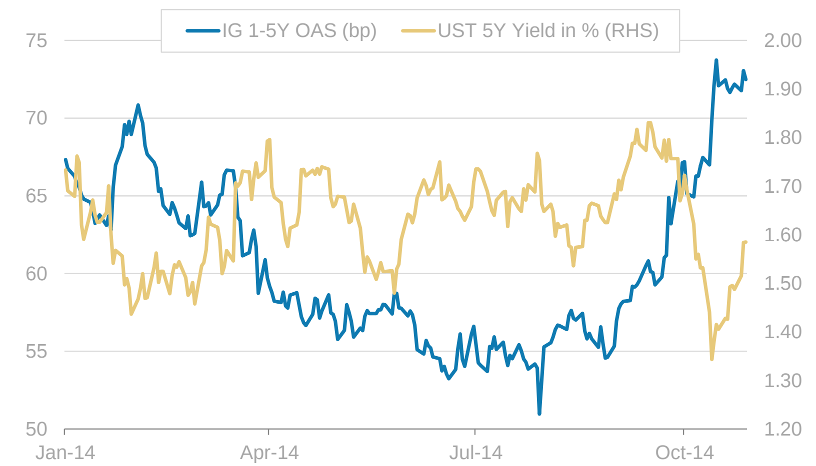
Market Thoughts and Strategy | A More Hawkish Fed, But the ECB & BOJ Do Matter

The Fed and BOJ: The October FOMC resulted in a more hawkish tone out of the Fed. Though they retained the "considerable time" language, they acknowledged that labor market underutilization is gradually diminishing, despite the potential for lower inflation data in the near-term given significantly lower energy prices. However the tone from Japan is far more dovish, with more stimulus from the BOJ as well as an important rebalancing of the GPIF.

What Does This Mean for Credit? Post-Fed, we had a significant bear flattening of the Treasury curve, which we believe is negative for credit. It pressures the front-end of credit markets, and though we have a long way to go to get a truly flat curve, this part of the IG market offers little upside in spread terms, with the ultimate risk of outflows as short-term rates normalize and funds move back to where they came. The lack of a sell-off in the 30-year bond also keeps LDI flows muted. But we must balance a slightly more hawkish Fed with a dovish BOJ and ECB, all of which could support global flows into US credit markets.

3Q Earnings: 363 S&P 500 companies have reported. Earnings have grown by 10% so far, led by Materials, Telecom, and Health Care. Revenues have grown by 3.8%. Earnings have beaten expectations by 5.5%, led by Materials, Energy and Financials. However, revenues are flat to expectations.

5Y Treasuries Have Retraced Half of the Rally from August



Source: Morgan Stanley Research estimates, Bloomberg, Yieldbook

The Front-end of the IG Market Is Rich

Spreads	Current	10yr Lows	Average	Percentile
IG Corp Index	118	82	106	41%
1-3Y	61	41	71	27%
3-5Y	83	60	90	26%
5-7Y	118	79	109	37%
7-10Y	132	80	113	39%
10+Y	170	112	137	51%

Source: Morgan Stanley Research estimates, Yieldbook

Market Thoughts and Strategy | CDX Has Outperformed, Watch Single-Names Next

CDX Indices Outperform: The CDX indices have outperformed, driven in part by superior liquidity in a healing market environment as well as a lack of rates headwinds that pose risks to the cash bond market. In short, indices have traded more with equities, and we also note that upcoming supply is likely forcing money managers to keep stay light and liquid, which benefits index flows and spreads.

Single-Name CDS Lags: In the index rally, single-name CDS has lagged, leaving the CDX IG index NAV in the 6-7bp range. We think there are long credit opportunities in select single-name CDS, see our summary on the right.

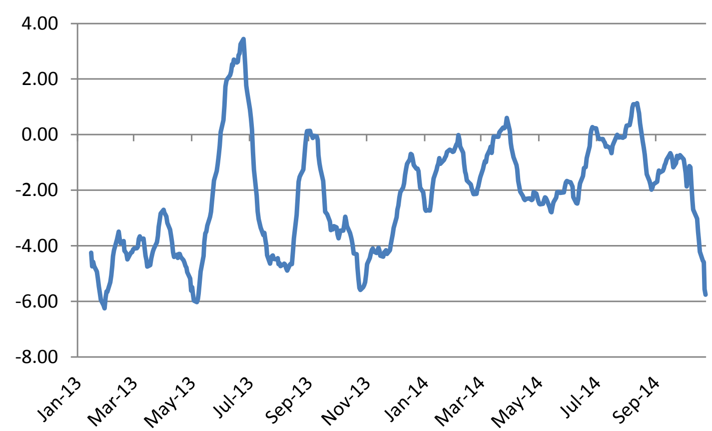
Volatility: With markets healing, we had a very big drop in implied volatility for CDX options. CDX IG price volatility fell to 1.4% from 2.1%, spread volatility fell to 46% from 62%. CDX IG vol is now cheap by 13% in spread vol, and 0.4% in price vol relative to iTraxx Main. We like buying upside receivers in CDX IG, funded by selling downside payers. CDX HY fell back to single-digit vol, 9.2% from 11.6%.

Single Name CDS Underperformers

Ticker	5Y CDS	Change (since Aug 25)	Change (since Jul 3)	Similar Maturity Bond OAS
AVP	383	135	142	379
TECK	207	82	73	185
WFT	151	64	68	137
ABX	182	73	51	142
DVN	95	39	50	76
FCX	148	46	43	149
F	120	28	32	128
NEM	163	69	32	157
DRI	194	44	26	167
HAL	50	16	20	69
VLO	97	17	18	95
BRK	57	12	14	43

Source: Morgan Stanley Research, Yieldbook Note: As of 10/30/2014

CDX IG – Index to NAV Skew



Source: Morgan Stanley Research

US IG Credit | Consumer Sector Screen

More Positive on Consumer Sector

A week ago we raised our view on the Consumer sector to overweight (see: *Raising the Consumer Sector to Overweight*). The rationale for this move is largely macro in nature, given an improvement in the labor market, lower oil prices, and the resultant pick up in consumer sentiment.

This week we present a list of bonds worth looking at in the sector, and we screen for positive EBITDA growth, positive FCF, and attractive spread / leverage. We look at both older bonds, as well as those issued in 2014.

Consumer Sector Screen - 2014 Issued Bonds

Ticker	CUSIP	Issue Date	Maturity	Bond Size	Industry Group	Moody's	S&P	OAS 10/29/14	FCF ($mm)	EBITDA YoY	Leverage	Spread / Leverage
CVS	126650CE8	8/12/2014	8/12/2019	850	Retail Stores	Baa1	BBB+	82	394	2%	1.27x	64.4
CVS	126650CF5	8/12/2014	8/12/2024	650	Retail Stores	Baa1	BBB+	112	394	2%	1.27x	87.9
HD	437076BF8	6/12/2014	3/15/2045	1000	Retail Stores	A2	A	115	1700	7%	1.24x	93.1
HD	437076BE1	6/12/2014	6/15/2019	1000	Retail Stores	A2	A	58	1700	7%	1.24x	46.9
KR	501044CY5	1/30/2014	2/1/2024	500	Retail Stores	Baa2	BBB	132	504	44%	1.73x	76.3
M	55616XAL1	5/23/2014	6/1/2024	500	Retail Stores	Baa2	BBB+	142	225	0%	1.86x	76.5
MCD	58013MES9	6/9/2014	6/10/2024	500	Restaurants	A2	A	99	897	0%	1.49x	66.5
MJN	582839AG1	5/13/2014	6/1/2044	500	Food Processors	Baa1	BBB	157	75	2%	1.86x	84.3
MDLZ	609207AB1	1/16/2014	2/1/2024	1750	Food Processors	Baa1	BBB-	138	547	16%	3.42x	40.4
MDLZ	609207AA3	1/16/2014	2/1/2019	850	Food Processors	Baa1	BBB-	90	547	16%	3.42x	26.3
JWN	655664AR1	6/6/2014	1/15/2044	666	Retail Stores	Baa1	A-	143	108	3%	1.71x	83.7
PEP	713448CM8	2/28/2014	3/1/2024	1250	Beverage/Bottling	A1	A-	99	1925	2%	2.62x	37.7
PEP	713448CL0	2/28/2014	2/22/2017	750	Beverage/Bottling	A1	A-	31	1925	2%	2.62x	11.8
TJX	872539AA9	6/5/2014	6/15/2021	750	Retail Stores	A3	A+	93	272	3%	0.34x	275.3
WMT	931142DP5	4/22/2014	4/22/2024	1500	Retail Stores	Aa2	AA	75	3259	0%	1.56x	47.9
WMT	931142DQ3	4/22/2014	4/22/2044	1000	Retail Stores	Aa2	AA	111	3259	0%	1.56x	71.0
WMT	931142DN0	4/22/2014	4/21/2017	500	Retail Stores	Aa2	AA	26	3259	0%	1.56x	16.6

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Source: Morgan Stanley Research, Yieldbook, Bloomberg. Note: FCF and Leverage as of Q2 2014

US IG Credit | Consumer Sector Screen

Consumer Sector Screen - Legacy Bonds

Ticker	CUSIP	Issue Date	Maturity	Bond Size	Industry Group	Moody's	S&P	OAS 10/29/14	FCF ($mm)	EBITDA YoY	Leverage	Spread / Leverage
KO	191216BE9	11/1/2013	11/1/2023	1500	Beverage/Bottling	Aa3	AA	82	2823	3%	3.07x	26.7
KO	191216AZ3	3/5/2013	4/1/2023	750	Beverage/Bottling	Aa3	AA	79	2823	3%	3.07x	25.7
COST	22160KAD7	12/7/2012	12/7/2015	1200	Retail Stores	A1	A+	56	266	0%	1.23x	45.6
COST	22160KAF2	12/7/2012	12/15/2019	1200	Retail Stores	A1	A+	50	266	0%	1.23x	40.7
CVS	126650BR0	9/11/2009	9/15/2039	734	Retail Stores	Baa1	BBB+	180	394	2%	1.27x	141.3
CVS	126650CD0	12/5/2013	12/5/2043	750	Retail Stores	Baa1	BBB+	147	394	2%	1.27x	115.4
CVS	126650CC2	12/5/2013	12/5/2023	1250	Retail Stores	Baa1	BBB+	109	394	2%	1.27x	85.5
HD	437076AV4	3/31/2011	4/1/2041	1000	Retail Stores	A2	A	145	1700	7%	1.24x	117.3
HD	437076AS1	12/19/2006	12/16/2036	3000	Retail Stores	A2	A	143	1700	7%	1.24x	115.7
HD	437076BB7	9/10/2013	9/10/2018	1150	Retail Stores	A2	A	38	1700	7%	1.24x	30.7
HST	44107TAK2	2/4/2011	11/1/2020	500	Lodging	Baa3	BBB	207	278	5%	3.16x	65.5
HST	44107TAM8	1/11/2012	6/15/2019	500	Lodging	Baa3	BBB	155	278	5%	3.16x	49.0
KMB	494368BC6	7/30/2007	8/1/2037	700	Consumer	A2	A	147	661	11%	1.73x	85.0
KRFT	50076QAR7	1/14/2013	1/26/2039	877	Food Processors	Baa2	BBB	219	279	25%	2.20x	99.4
KRFT	50076QAN6	1/14/2013	2/9/2040	787	Food Processors	Baa2	BBB	209	279	25%	2.20x	94.9
KR	501044CS8	7/25/2013	8/1/2023	600	Retail Stores	Baa2	BBB	131	504	44%	1.73x	75.7
KR	501044CX7	12/23/2013	1/15/2021	700	Retail Stores	Baa2	BBB	111	504	44%	1.73x	64.2
LOW	548661CP0	9/11/2007	9/15/2037	500	Retail Stores	A3	A-	162	1184	11%	1.64x	98.5
LOW	548661CJ4	10/6/2005	10/15/2035	500	Retail Stores	A3	A-	155	1184	11%	1.64x	94.3
M	55616XAH0	11/20/2012	2/15/2023	750	Retail Stores	Baa2	BBB+	132	225	0%	1.86x	71.1
M	314275AC2	3/12/2007	3/15/2037	500	Retail Stores	Baa2	BBB+	203	225	0%	1.86x	109.4

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Source: Morgan Stanley Research, Yieldbook, Bloomberg. Note: FCF and Leverage as of Q2 2014

US IG Credit | Consumer Sector Screen

Consumer Sector Screen - Legacy Bonds

Ticker	CUSIP	Issue Date	Maturity	Bond Size	Industry Group	Moody's	S&P	OAS 10/29/14	FCF ($mm)	EBITDA YoY	Leverage	Spread / Leverage
MCD	58013MEC4	10/18/2007	10/15/2037	850	Restaurants	A2	A	171	897	0%	1.49x	114.9
MCD	58013MEF7	2/29/2008	3/1/2038	750	Restaurants	A2	A	169	897	0%	1.49x	113.6
MDLZ	50075NAZ7	2/8/2010	2/9/2040	2212	Food Processors	Baa1	BBB-	193	547	16%	3.42x	56.5
MDLZ	50075NBA1	2/8/2010	2/10/2020	1383	Food Processors	Baa1	BBB-	97	547	16%	3.42x	28.4
NWL	651229AK2	8/10/2010	8/15/2020	550	Consumer	Baa3	BBB-	178	61	2%	2.54x	69.9
NKE	654106AD5	4/26/2013	5/1/2043	500	Textiles / Apparel	A1	AA-	91	119	12%	0.34x	266.9
NKE	654106AC7	4/26/2013	5/1/2023	500	Textiles / Apparel	A1	AA-	67	119	12%	0.34x	196.5
JWN	655664AK6	12/3/2007	1/15/2018	650	Retail Stores	Baa1	A-	84	108	3%	1.71x	49.2
PEP	713448BP2	1/14/2010	1/15/2040	1000	Beverage/Bottling	A1	A-	160	1925	2%	2.62x	61.0
PEP	713448BS6	10/26/2010	11/1/2040	750	Beverage/Bottling	A1	A-	151	1925	2%	2.62x	57.6
PM	718172AP4	3/20/2012	3/20/2042	700	Tobacco	A2	A	146	2453	1%	2.07x	70.7
PM	718172AM1	11/15/2011	11/15/2041	750	Tobacco	A2	A	145	2453	1%	2.07x	70.2
PG	742718DF3	3/5/2007	3/5/2037	1400	Consumer	Aa3	AA-	122	2366	12%	1.76x	69.5
PG	742718EB1	8/13/2013	8/15/2023	1000	Consumer	Aa3	AA-	72	2366	12%	1.76x	41.0
PG	742718DY2	2/6/2012	2/6/2022	1000	Consumer	Aa3	AA-	51	2366	12%	1.76x	29.1
WAG	931422AK5	9/13/2012	9/15/2042	500	Retail Stores	Baa2	BBB	185	877	4%	1.03x	179.9
WAG	931422AH2	9/13/2012	9/15/2022	1200	Retail Stores	Baa2	BBB	137	877	4%	1.03x	133.2
WMT	931142CB7	8/31/2005	9/1/2035	2500	Retail Stores	Aa2	AA	135	3259	0%	1.56x	86.3
WMT	931142CY7		10/25/2040	1250	Retail Stores	Aa2	AA	130	3259	0%	1.56x	83.1

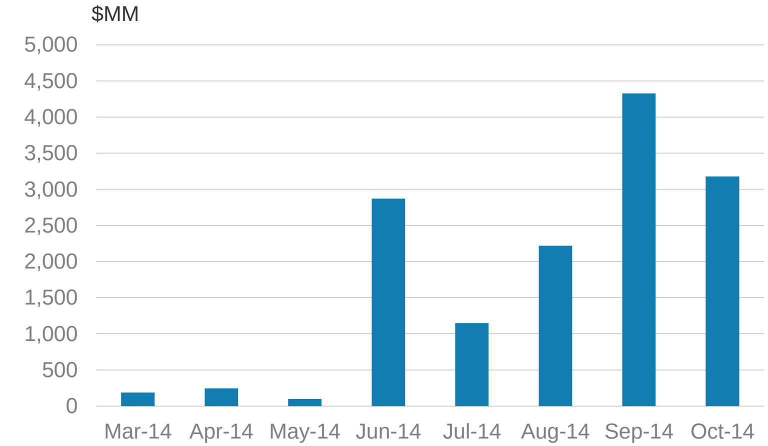
Source: Morgan Stanley Research, Yieldbook, Bloomberg. Note: FCF and Leverage as of Q2 2014

US Credit | TRS – Liquidity Emerges

TRS Opportunities: We provide a detailed update on Total Return Swaps (TRS) linked to the iBoxx bond indices in a recent research (iBoxx TRS - Liquidity Emerges).

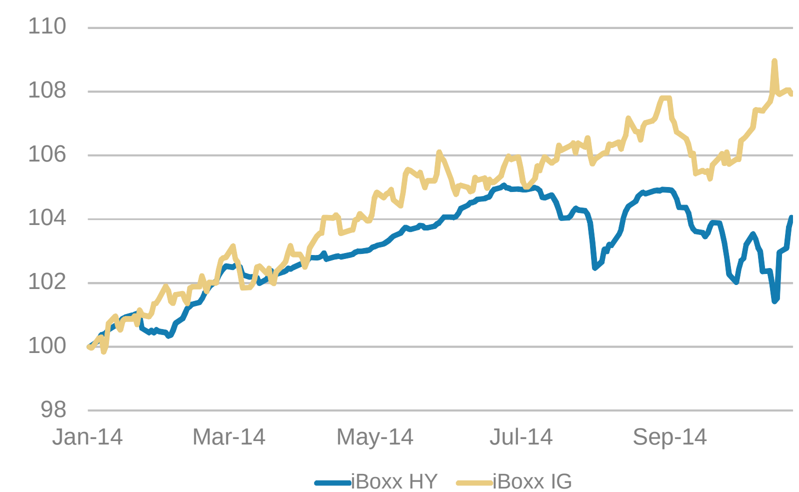
- **Credit and Fund Flow Volatility:** Macro and policy uncertainties, along with a challenging corporate bond liquidity profile have led to significant fund flow volatility in the US credit markets. The high yield and loan markets have had net outflows this year, in particular with many negative weeks starting this past summer, while investment grade has shown much more strength and consistency. This fund flow environment has generated much interest in portfolio solutions like TRS to aid both cash management and hedging against outflows.
- **The TRS Liquidity Landscape:** Based on data over the past five months, average reported iBoxx TRS volumes have been $2.5Bn per month across all indices, a conservative estimate in our view. Further, the volumes in HY are now converging towards those of the largest ETFs and in loans the pick-up has been reasonable given the nascent stages of the product.
- **Fragmentation and a Long History**: There has been a long history of credit portfolio trading innovations, with CDS indices clearly being the most popularly adopted instrument. However, as investors seek solutions that directly reference bond indices, ETFs (cash) and TRS (swap) are now the natural alternatives.
- **Trade Idea – Long HY TRS vs. Short IG TRS**: IG has outperformed HY on a total and excess return basis this year given the rally in long-end rates and the material correction in HY spreads. With the spread valuation entry-point attractive across both markets, we like this trade to position for our positive HY view coupled with limited further total return upside for IG at current yields.

TRS Volumes Have Surged This Summer



Source: Morgan Stanley Research estimates, Bloomberg, Yieldbook

iBoxx IG vs. HY



Source: Morgan Stanley Research, iBoxx

US Credit | What Have We Learned from Investors Recently?

The Credit Cycle: Perhaps it was because of the World Series, but more investors are putting a time line on the remaining length of the current credit cycle. We heard descriptions like 7th inning and 1 to 2 years left. Within IG, most investors do not see a tremendous amount of upside. GDP growth forecasts remain in the 2-3% range which supports a credit carry trade.

Energy Is the Risk Sector of this Cycle: Every cycle has one, and it has become increasingly clear that Energy has become this cycle's risk contributor. Most investors are cautious and concerned about credit fundamentals if this is the new regime in oil prices, with a significant portion of Capex concentrated in this sector, and a plethora of negative FCF stories. Our investor conversations have ranged from waiting for even better valuations to running even weaker oil scenarios.

Financials: Financials continue to be the safe haven sector with a bit of beta, and most are overweight risk here. The opinion on subordinate financials is finally more balanced after liquidity induced underperformance of late, but subs remain a significant reach for yield trade.

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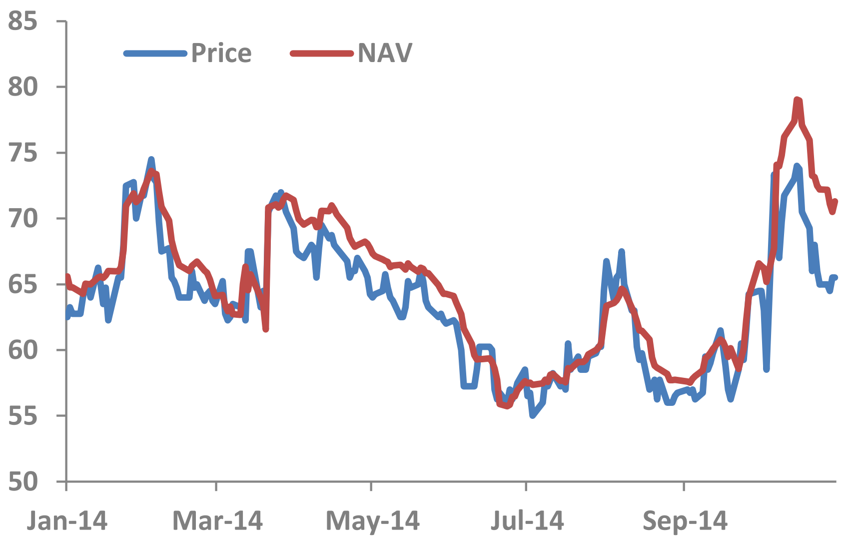
Credit Asset Allocation: Multi-asset portfolio flows are increasingly important to the US credit markets, given both the size and nimble behavior of such funds. Conversations with multi-asset portfolio managers of late suggest a preference for US credit in general over other regions, and US HY in particular, with many adding during the peak of the weakness. And even in traditional credit portfolios, the view is that ECB and BOJ QE will also support additional flows into USD credit as global investors hunt for yield.

Hedging Lessons Learned: The recent two risk-off periods have raised the specter of credit portfolio hedging, and we have worked with many investors on identifying what the best performing hedges would have been, and how best to hedge going forward. There continues to be interest in using the iBoxx TRS products for such purposes, especially in HY and Loans.

Hedging as a Business Model: While many credit hedgers do so on a tactical or opportunistic basis, hedging can also be part of a longer-term business planning. We recently presented at the RISK USA 2014 conference in New York to an audience of risk professionals seeking to understand how to implement hedging into the credit investing culture, much like it is in equities. Here is our presentation (Hedging Credit Risk - A Tour Through the Tools).

US IG Credit | Weekly Performance

CDX IG Is Rich to NAV



Source: Morgan Stanley Research

Derivatives

Over the past several weeks we have seen the IG / HY ratio come down from its highs to 5.4x, but still above a fair value implied by the intrinsic levels of 4.8x. After trading very closely for much of this year, CDX IG is now 6bps rich to NAV and we highlight some single name opportunities on slide 5.

US IG Returns and Price Performance

US IG credit has lagged in the healing since the selloff and has been flat on the week to close again at 118bps. On an excess return basis, we are slightly positive on the year with 0.39% in excess returns after losing -0.28% in October. The environment in 2014 has been very good for US IG total returns, and YTD we are up 6.86% after gaining 1.18% this month. However US HY and the S&P 500 have outperformed IG over the past two weeks, and have risen to 4.3% and 9.7% in total returns, respectively.

Sector Performance

Sector performance this week was mixed, although the range between the best and worst performing sectors was less than 3bps. Basics was the best performing, and tightened 1.4bps while TMT underperformed with 1.2bps of widening. Utilities is the only sector to still be tighter on a YTD basis, and all other sectors are wider led by Healthcare and Energy at 17.4bps and 16.7bps respectively.

Curve Performance

All parts of the credit curve are still in negative excess return territory for October. The long end has underperformed the most and excess returns are -0.55% for the month and -1.04% for the year, making it the only part of the credit curve to have negative excess returns on the year. The intermediate 3-7Y and 7-10Y part of the curve has performed the best YTD, with 1.16% and 1.18% of excess returns, respectively, for 2014.

Market Metrics

US IG Credit Weekly Update | Global Corporate Credit Snapshot

US Credit

US IG Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
US IG	96	**118**	132	108	60%		22	14
CDX IG	55	**66**	75	64	55%		11	9
AA	58	**74**	77	64	82%		16	4
A	79	**98**	105	88	75%		20	6
BBB	127	**155**	181	146	52%		28	26
1-3Y	41	**60**	64	51	80%		18	4
3-7Y	74	**96**	118	90	50%		22	22
7-10Y	109	**133**	160	126	47%		24	27
10Y+	145	**171**	181	157	71%		26	10
Finance	87	**106**	122	100	54%		19	16
Industrial	98	**123**	135	111	69%		25	11
Utility	104	**124**	148	117	45%		20	25

US HY Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
US HY	364	**460**	533	418	57%		96	73
CDX HY	291	**352**	398	329	57%		61	46
BB	260	**324**	396	303	48%		65	71
B	376	**486**	559	431	60%		110	73
CCC	644	**851**	930	712	72%		207	79

US Muni Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
BABS	143	**158**	211	161	21%		15	53
MCDX	66	**82**	146	97	20%		16	64

Europe and Asia Credit

EU IG Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
iTraxx Main	55	**68**	85	69	42%		13	17
EU IG	79	**85**	108	90	21%		6	23
EU Non-Fin	74	**78**	98	83	16%		4	20
EU Financial	86	**96**	121	102	28%		10	25
EU Fin Senior	54	**54**	83	67	1%		0	29
iTraxx Fin Senior	56	**70**	121	80	21%		13	51
iTraxx Fin Sub	75	**163**	186	123	79%		88	23

EU HY Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
Xover	219	**364**	403	281	79%		145	39
EU HY	325	**417**	447	364	75%		92	31
EU HY BB	241	**293**	320	269	66%		52	27
EU HY BB	478	**623**	654	537	82%		145	31
EU HY CCC	775	**979**	1001	872	90%		203	22

Asia Credit	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
Asia Blended	232	**255**	295	259	36%		23	40
Asia IG	167	**184**	221	188	31%		17	38
Asia HY	447	**510**	557	494	58%		63	46

Indices	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	Above Tights	Below Wides
S&P	1742	**1995**	2011	1889	94%		253	17
VIX	10	**15**	26	14	26%		4	12
STOXX 600	310	**331**	350	333	52%		21	19
VDAX	11	**17**	24	15	52%		7	6

Source: Morgan Stanley, Bloomberg, the Yield Book, iBoxx

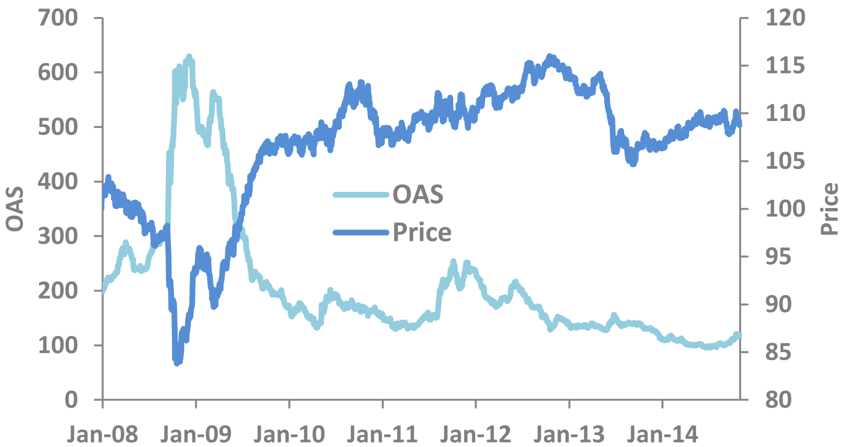
Note: S&P 500, STOXX 600, VIX and VDAX refer to index levels. All others refer to spread levels. The green shades represent one standard deviation above and below the mean. The dot represents current level, and line represents mean.

US IG Credit Weekly Update | US IG Corporate Credit Market Snapshot

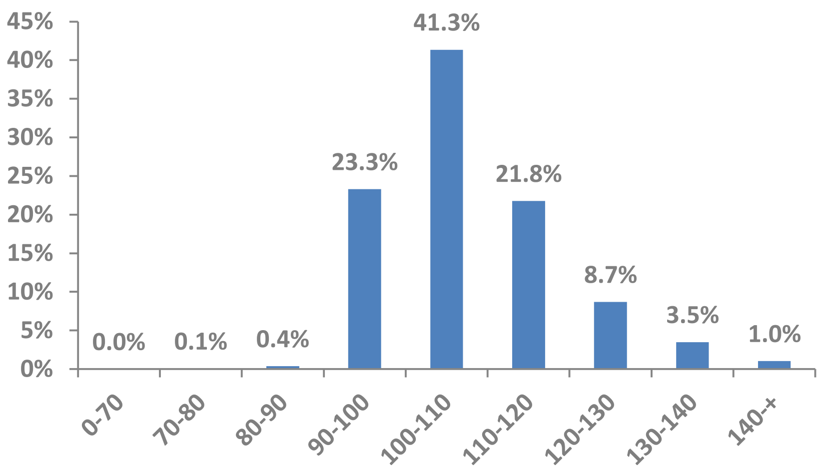
US IG Corporate Credit Performance Snapshot

	Spreads				Change		
	YE 2013	Last Month	Last Week	Current	1w	MTD	YTD
Spread	112.5	111.1	117.6	117.8	0.3	6.7	5.3
Price	106.3	108.1	109.1	108.8	-0.3	0.7	2.5
Yield	3.2	3.1	2.9	3.0	0.0	-0.1	-0.3
Duration	6.6	6.9	7.0	6.9	0.0	0.1	0.4

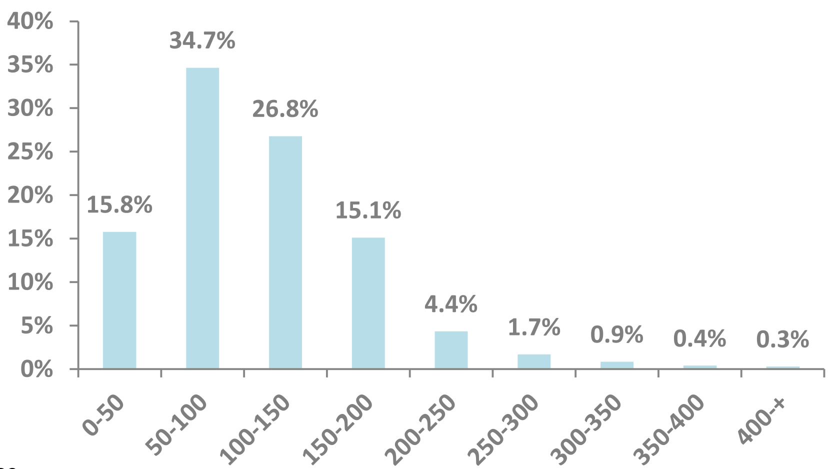
US IG Corporate Credit Price vs. Spread



Price Distribution of US IG Corporate Credit



Spread Distribution of US IG Corporate Credit



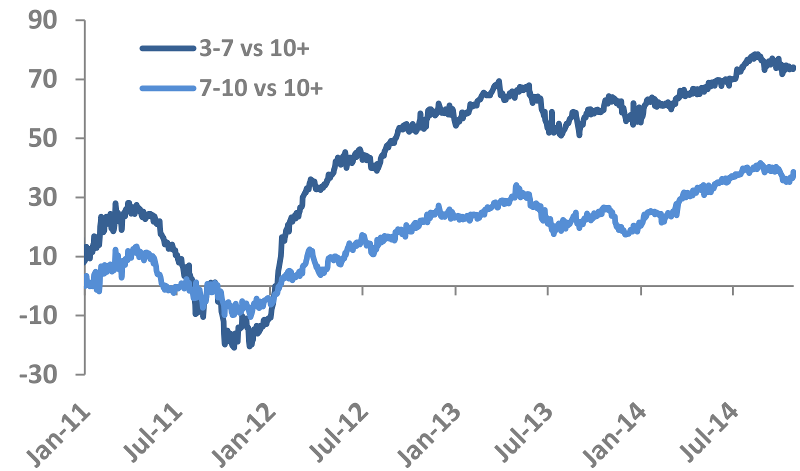
Source: Yieldbook, Morgan Stanley Research

US IG Credit Weekly Update | Curve Performance

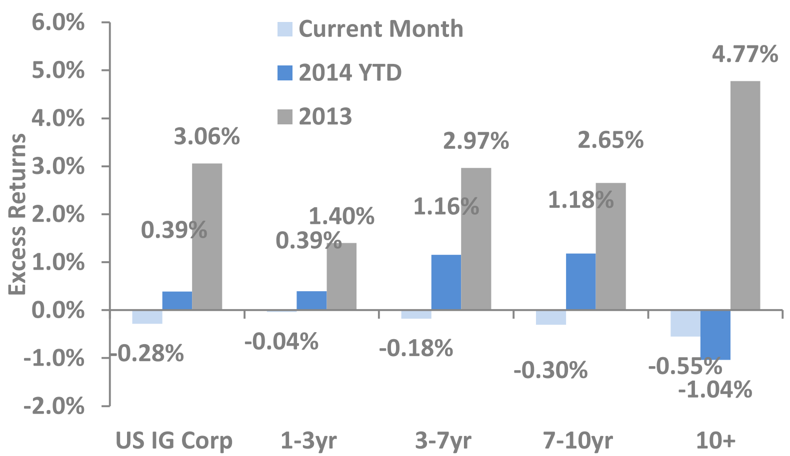
Performance Across the Curve

	YE 2013	Last Month	Last Week	Current	1w	MTD	YTD
Spreads							
IG Index	112.5	111.1	117.6	117.8	0.3	6.7	5.3
1-3yr	54.2	55.3	61.0	59.7	-1.3	4.4	5.5
3-7yr	99.4	88.6	96.0	96.3	0.2	7.7	-3.1
7-10yr	135.1	126.0	132.7	133.1	0.4	7.1	-2.1
10+yr	155.5	165.6	169.6	170.9	1.3	5.3	15.3
Prices							
IG Index	106.3	108.1	109.1	108.8	-0.3	0.7	2.5
1-3yr	104.7	104.0	104.5	104.4	-0.1	0.3	-0.4
3-7yr	109.6	108.5	109.0	108.7	-0.3	0.3	-0.9
7-10yr	99.5	101.5	102.7	102.4	-0.3	0.9	2.9
10+yr	108.9	115.7	117.4	117.1	-0.3	1.4	8.2

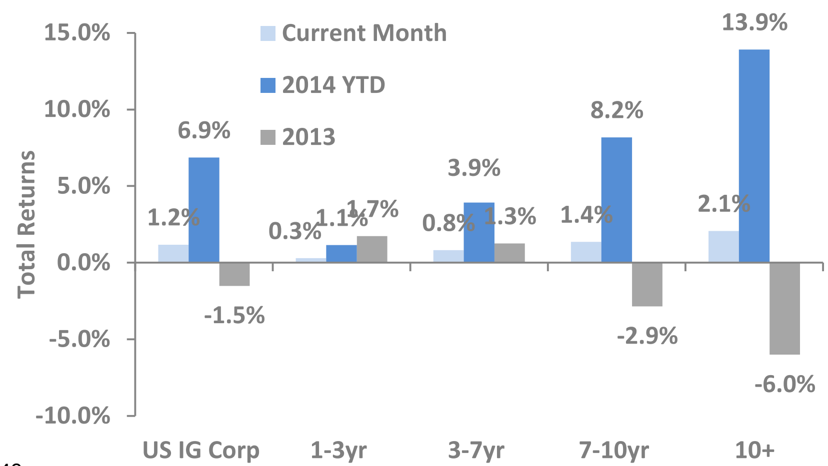
Curve Relative Value



Monthly Excess Returns



Monthly Total Returns



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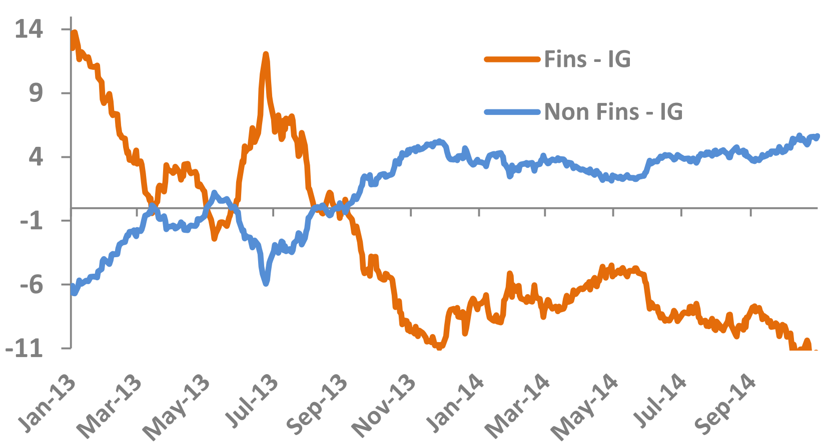
Source: Yieldbook, Morgan Stanley Research

US IG Credit Weekly Update | Sector Performance

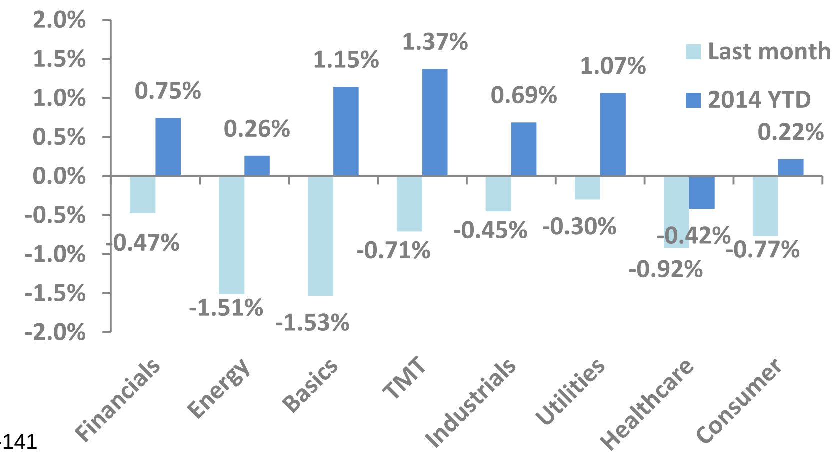
Sector Summary - Spreads and Performance

	Spreads					Change					Valuations	
	YE 2012	YE 2013	9/30/2014	Last Week	Current	1w	MTD	YTD	Spread to IG (YE13)	Spread to IG (today)	5Y	LTM
IG Market	139.8	112.5	111.1	117.6	117.8	0.3	6.7	5.3	n/a	n/a		
Basics	163.9	155.1	154.2	165.3	163.9	-1.4	9.7	8.8	43	46		
Consumer	116.6	100.1	104.3	109.7	109.7	0.0	5.5	9.6	-12	-8		
Energy	148.0	135.1	141.5	150.8	151.9	1.1	10.4	16.7	23	34		
Financials	153.2	105.0	101.7	106.1	106.1	-0.1	4.4	1.1	-8	-12		
Healthcare	94.7	83.8	94.7	100.5	101.2	0.7	6.5	17.4	-29	-17		
Industrials	131.2	101.6	98.2	105.0	104.7	-0.2	6.5	3.2	-11	-13		
TMT	146.5	126.4	117.1	125.8	127.0	1.2	9.9	0.6	14	9		
Utilities	130.1	110.0	101.6	106.2	106.2	0.0	4.6	-3.7	-3	-12		

Financials vs. Non-Financials: Spread to IG



Monthly Excess Returns



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Source: Yieldbook, Morgan Stanley Research
Note: YTD in Total and Excess Return charts contains up to the previous month's ending.

US IG Credit Weekly Update | US IG Corporate Volumes (TRACE)

TRACE TFLO – Weekly Volumes (Sector)

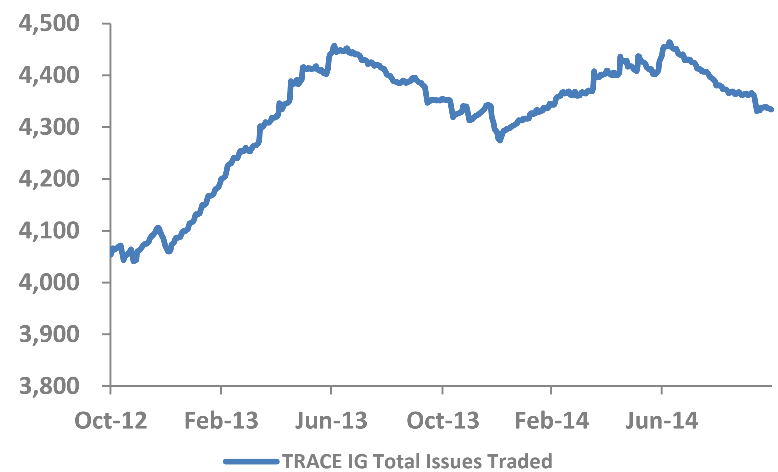
Sector	Total Volume ($M)	Volume (% of Total)	Dealer to Client ($M) Buys ($M)	Sells ($M)	Net	Dealer to Dealer ($M) Volume ($M)	Dealer as % of Total
Total	81,167	100.0%	30,383	32,165	- 1,782	18,618	22.9%
Financials	26,951	33.2%	10,048	10,698	- 651	6,205	23.0%
Communications	9,558	11.8%	3,498	3,646	- 148	2,414	25.3%
Energy	12,833	15.8%	4,837	4,975	- 139	3,021	23.5%
Materials	6,484	8.0%	2,275	2,414	- 139	1,795	27.7%
Consumer Staples	4,993	6.2%	1,894	2,064	- 170	1,035	20.7%
Consumer Discreti	6,186	7.6%	2,370	2,558	- 188	1,259	20.4%
Health Care	4,726	5.8%	1,785	2,001	- 216	940	19.9%
Technology	3,372	4.2%	1,184	1,303	- 118	885	26.2%
Industrials	3,658	4.5%	1,452	1,524	- 72	682	18.7%
Utilities	2,405	3.0%	1,040	982	58	383	15.9%

6M Rolling TRACE IG Volume ($M)

TRACE TFLO – Weekly Volumes (Maturity)

Sector	Total Volume ($M)	Volume (% of Total)	Dealer to Client ($M) Buys ($M)	Sells ($M)	Net	Dealer to Dealer ($M) Volume ($M)	Dealer as % of Total
Total	81,614	100.0%	30,584	32,370	- 1,786	18,660	22.9%
0 -1 yr	5,721	7.0%	2,502	2,355	147	864	15.1%
1 -3 yr	11,231	13.8%	4,216	4,995	- 779	2,020	18.0%
3 -7 yr	25,648	31.4%	9,326	10,509	- 1,183	5,813	22.7%
7 -12 yr	22,870	28.0%	8,360	8,570	- 210	5,939	26.0%
> 12 yr	16,100	19.7%	6,157	5,930	227	4,012	24.9%
Matured	46	0.1%	23	12	12	11	23.0%

6M Rolling TRACE IG Total Issues Traded



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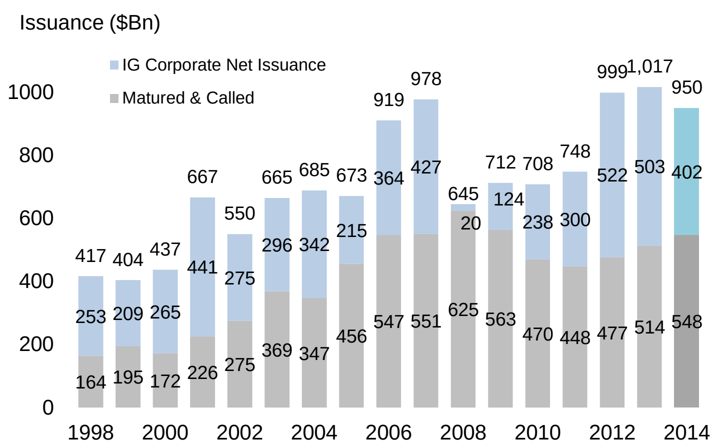
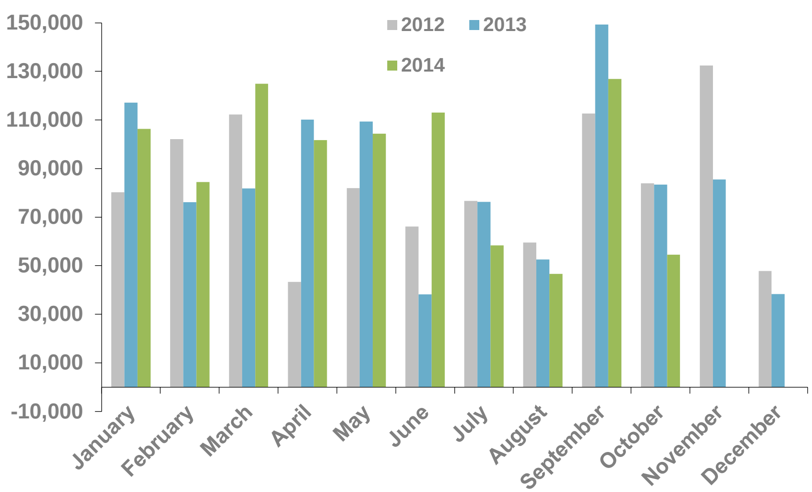
Source: Bloomberg, Morgan Stanley Research

US IG Credit Weekly Update | US Investment Grade Corporate Supply

US Investment Grade Annual Gross and Net Issuance



US Investment Grade Monthly Gross New Issuance



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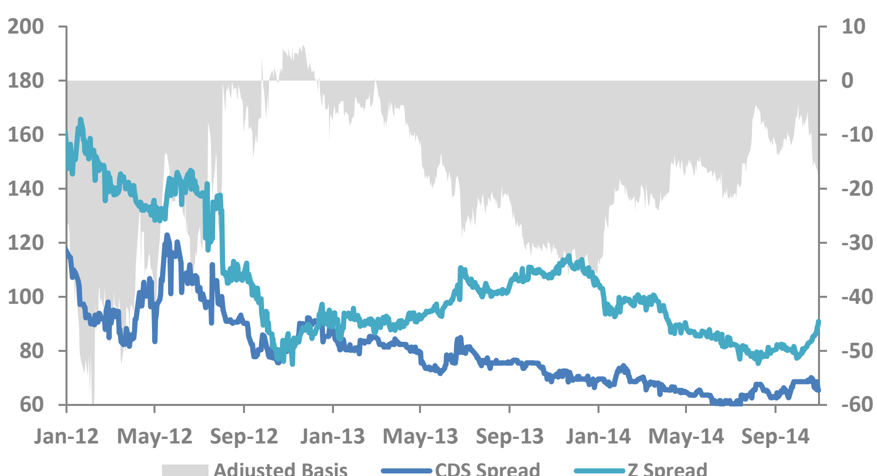
New Issuance Breakdown $mm				
Sectors	**2013**		**2014 YTD**	
Financials	439,595	41.1%	464,941	51.6%
Basics	50,879	4.8%	21,738	2.4%
Consumer	98,051	9.2%	54,390	6.0%
Energy	125,064	11.7%	89,138	9.9%
Healthcare	54,559	5.1%	43,413	4.8%
Industrials	76,598	7.2%	64,262	7.1%
TMT	137,601	12.9%	88,507	9.8%
Utilities	58,825	5.5%	43,654	4.8%
Unknown / Other	27,346	2.6%	31,156	3.5%
Yankee				
USA	707,369	66.2%	571,825	63.5%
Yankee	361,149	33.8%	329,375	36.5%
Coupon				
Fixed	909,829	85.1%	770,401	85.5%
Floating	155,812	14.6%	121,632	13.5%
Unknown	2,877	0.3%	9,167	1.0%
Maturity Bucket				
0-5yrs	483,416	45.2%	419,405	46.5%
6-10yrs	356,147	33.3%	281,675	31.3%
11-30yrs	175,685	16.4%	135,072	15.0%
31+yrs	14,109	1.3%	15,692	1.7%
N/A / unknown	39,162	3.7%	49,357	5.5%
Credit Quality (S&P Rating)				
AAA	12,150	1.1%	6,772	0.8%
AA	146,278	13.7%	95,910	10.6%
A	353,578	33.1%	332,277	36.9%
BBB	300,645	28.1%	218,105	24.2%
BB and below	39,545	3.7%	24,420	2.7%
Unknown / NR	216,322	20.2%	223,716	24.8%
	1,068,518		**901,200**	

Source: Dealogic, Thomson Financial, Morgan Stanley Research
Note: * Morgan Stanley Research Projected Gross and Net Issuance for 2014. New issuance breakdown is up to month end last month

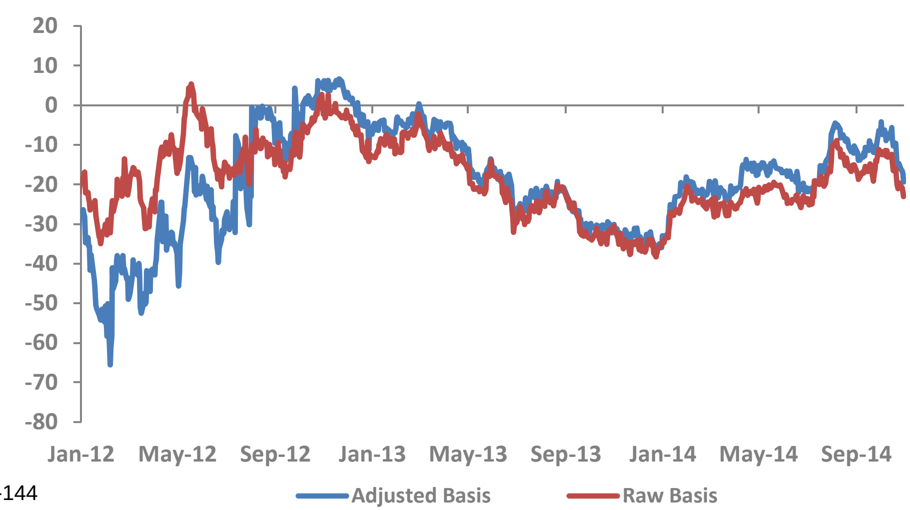
US IG Credit Weekly Update | **US IG Cash CDS Basis**

Adjusted Basis by Sector	1Y Tights	Current	1Y Wides	1Y Avg	1Y% Range	1Y Range	YE 2013	Last Week	1 Y Ago	Above Tights	Below Wides
Healthcare	-56	**-34**	-18	-32	58%		-49	-30	-43	23	16
Consumer Discretionary	-68	**-36**	-13	-34	58%		-57	-26	-49	32	23
5Y	-38	**-19**	-4	-19	55%		-33	-16	-30	18	15
Financial: Banks	-62	**-43**	8	-16	27%		-8	-33	-13	19	52
Financial: Non-Banks	-28	**-18**	1	-15	35%		-22	-15	-19	10	19
Basics	-42	**-11**	6	-16	64%		-38	-15	-19	31	17
Information Technology	-39	**-15**	-1	-15	63%		-30	-13	-27	24	14
Utilities	-32	**-10**	2	-15	64%		-28	-9	-12	21	12
Consumer Staples	-44	**-22**	1	-18	50%		-33	-16	-29	22	23
Industrials	-43	**-13**	8	-13	60%		-36	-12	-30	30	20
Energy	-54	**-21**	1	-26	60%		-45	-17	-41	33	22
Telecommunications	-48	**-12**	71	-12	30%		-36	-8	-24	36	83

US IG Cash CDS Basis



Adjusted vs. Raw Basis



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Source: Morgan Stanley Research

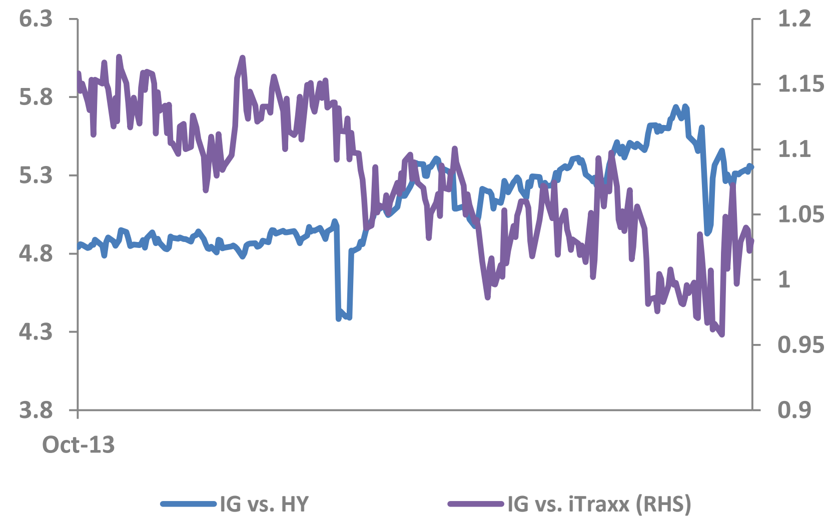
US IG Credit Weekly Update | CDX Performance

CDX IG vs. CDX HY

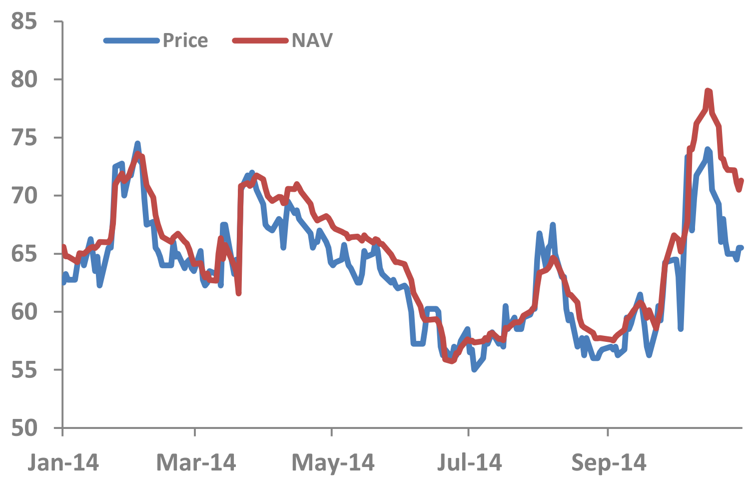
Index Summary - Spreads and NAV

	Levels				Change		
	YE 2013	9/30/14	Last Week	Current	1w	MTD	YTD
CDX IG	62.3	64.4	66.0	65.8	-0.2	1.4	3.6
CDX HY	305.6	354.1	350.5	352.3	1.8	-1.8	46.7
iTraxx Main	70.1	62.6	67.0	67.8	0.8	5.2	-2.3
iTraxx Xover	286.0	257.0	353.3	364.1	10.7	107.0	78.1
IG NAV	65.6	66.6	72.5	71.3	-1.2	4.7	5.7
HY NAV	312.1	340.2	343.9	344.9	1.0	4.7	32.8
HY / IG ratio	4.91	5.50	5.31	5.35	0.05	-0.14	0.44
iTraxx / IG ratio	1.13	0.97	1.01	1.03	0.02	0.06	-0.10
Fair Value (HY / IG)	4.76	5.11	4.74	4.84	0.09	-0.27	0.08

Ratios: CDX IG vs. CDX HY | CDX IG vs. iTraxx



CDX IG 5Y Price vs. NAV



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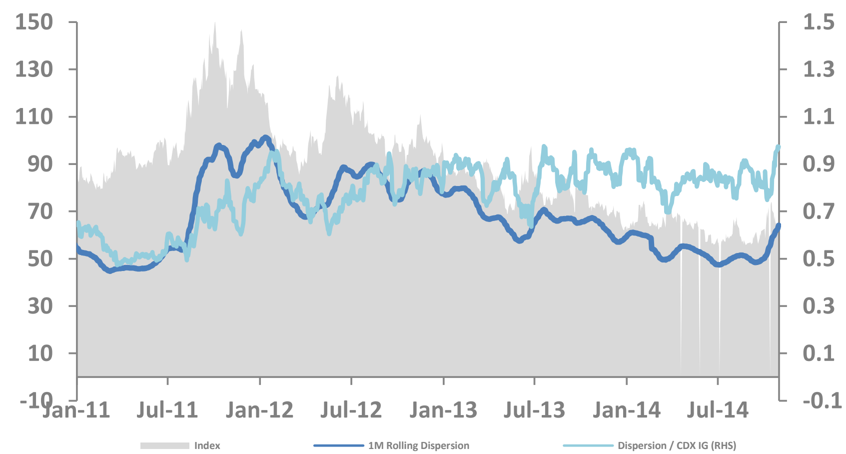
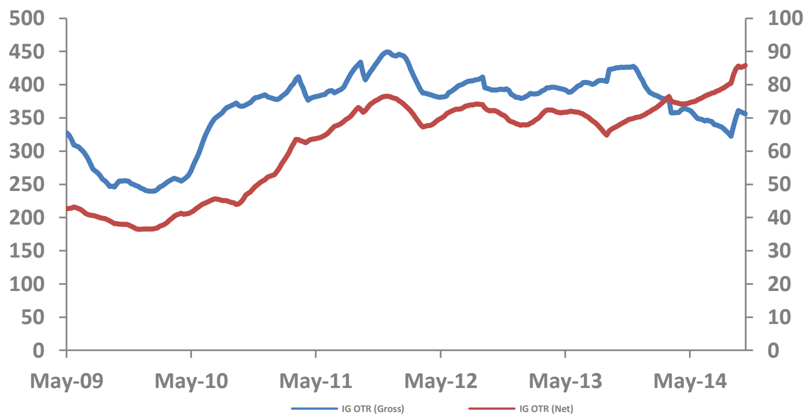
CDX IG Dispersion



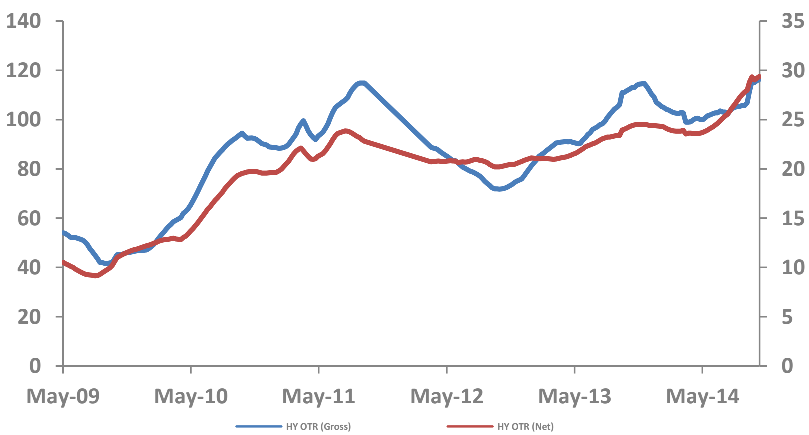
Source: Bloomberg, Morgan Stanley Research

US IG Credit Weekly Update | CDX Technicals – DTCC

IG OTR Gross and Net Notional ($Bn)



HY OTR Gross and Net Notionals ($Bn)



All Credit Products by Customer and Breakout Type

All Credit Products (Gross Notional $Bn)	Dealer		Non-Dealer / Cust.		Total	
	Current	1Y Ago	Current	1Y Ago	Current	1Y Ago
Dealer	8,761	12,350	4,131	4,823	12,892	17,173
Non-Dealer / Cust.	4,002	4,766	976	469	4,978	5,235
Total	12,763	17,116	5,108	5,292	17,870	22,407

CDS Credit Products (Gross Notional $Bn)	Dealer		Non-Dealer / Cust.		Total	
	Current	1Y Ago	Current	1Y Ago	Current	1Y Ago
Dealer	5,750	7,980	1,727	1,867	7,476	9,847
Non-Dealer / Cust.	1,729	1,884	15	16	1,744	1,900
Total	7,478	9,864	1,742	1,883	9,220	11,747

CDX Credit Products (Gross Notional $Bn)	Dealer		Non-Dealer / Cust.		Total	
	Current	1Y Ago	Current	1Y Ago	Current	1Y Ago
Dealer	2,320	3,337	2,313	2,877	4,634	6,214
Non-Dealer / Cust.	2,196	2,822	961	452	3,157	3,274
Total	4,516	6,158	3,275	3,329	7,791	9,488

CDT Credit Products (Gross Notional $Bn)	Dealer		Non-Dealer / Cust.		Total	
	Current	1Y Ago	Current	1Y Ago	Current	1Y Ago
Dealer	691	1,032	91	79	782	1,112
Non-Dealer / Cust.	77	61	0	0	77	61
Total	768	1,093	91	79	859	1,172

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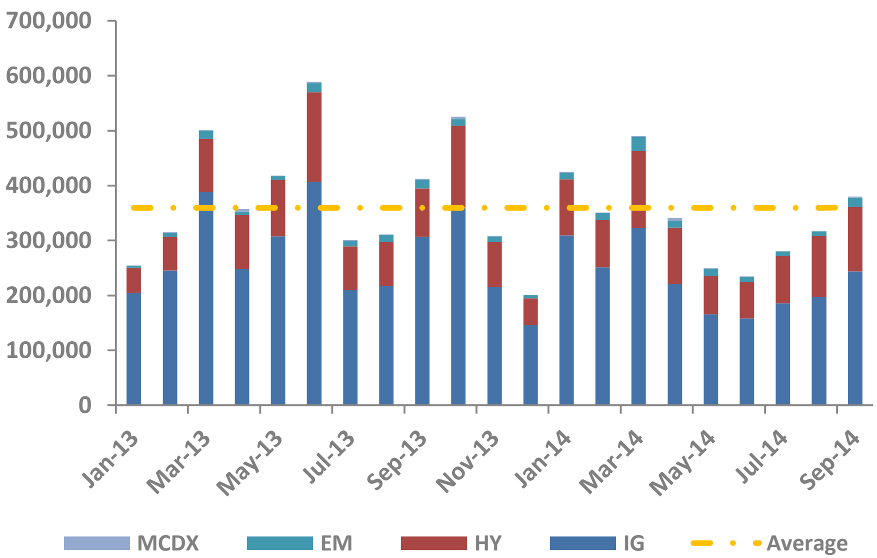
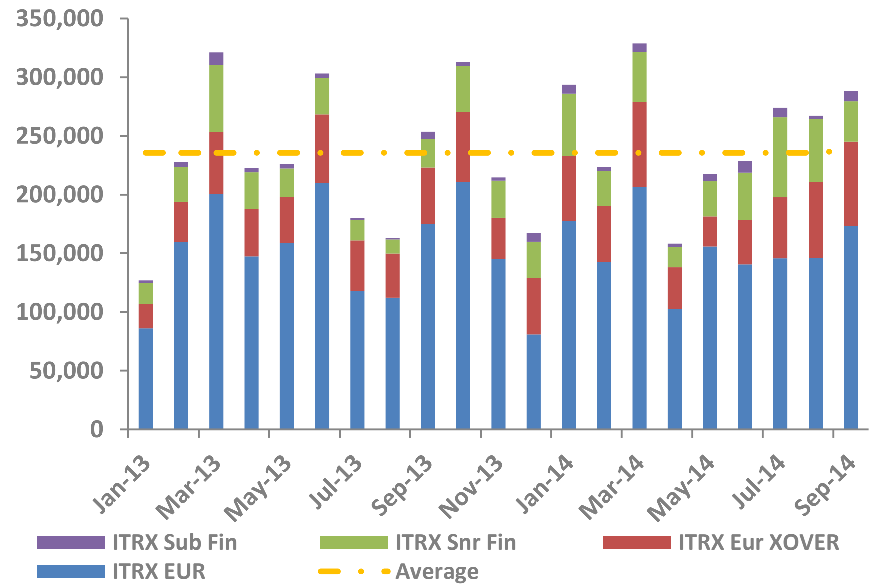
Source: DTCC, Morgan Stanley Research

US IG Credit Weekly Update | CDX Technicals – SDR

SDR Trading Volumes by Product (USD $Bn)



SDR Trading Volumes by Product (EUR $Bn)



SDR Trading Volumes by Product ($Bn)

	USD				EUR			
	IG	HY	EM	MCDX	ITRX EUR	ITRX Eur Xover	ITRX Snr Fin	ITRX Sub Fin
Mar-14	323,155	139,422	25,884	1,767	206,502	72,432	42,471	7,516
Apr-14	220,763	102,589	12,977	4,510	102,777	35,387	17,267	2,868
May-14	165,590	70,473	12,990	1,206	155,854	25,504	30,075	6,015
Jun-14	157,967	66,690	9,590	678	140,532	37,850	40,380	9,681
Jul-14	185,337	86,187	8,908	500	145,790	52,070	68,024	8,190
Aug-14	197,170	111,141	8,491	982	145,907	64,862	53,805	2,621
Sep-14	243,845	117,473	16,942	2,065	173,316	71,929	34,156	8,970

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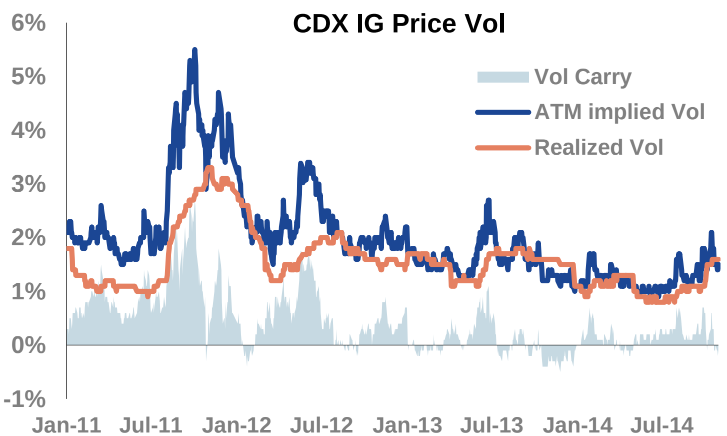
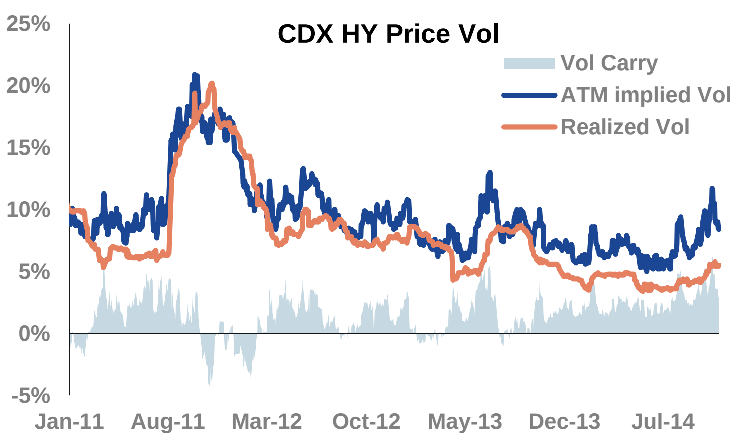
Source: Bloomberg, Morgan Stanley Research

US IG Credit Weekly Update | **CDX Volatility**

CDX IG Price Volatility Historical



CDX HY Price Volatility Historical



Source: Morgan Stanley Research

Credit Options Statistics

	Spreads					Change		
	YE 2012	YE 2013	9/30	Last Week	Current	1w	MTD	YTD
CDX IG								
Index (spread)	**97**	**63**	**65**	**66.5**	**66**	**-0.5**	**1**	**3**
Implied Vol (spread)	50.0%	38.0%	59.0%	50.0%	49.0%	-1.0%	-10.0%	11.0%
Realized Vol (spread)	34.0%	33.0%	41.0%	46.0%	46.0%	0.0%	5.0%	13.0%
Vol Carry (spread)	16.0%	5.0%	18.0%	4.0%	3.0%	-1.0%	-15.0%	-2.0%
Implied Vol (price)	2.2%	1.1%	1.8%	1.5%	1.5%	0.0%	-0.3%	0.4%
Realized Vol (price)	1.5%	1.1%	1.1%	1.6%	1.6%	0.0%	0.5%	0.5%
Vol Carry (price)	0.7%	0.0%	0.6%	-0.1%	-0.1%	0.0%	-0.7%	-0.1%
Upside skew (price)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Downside skew (price)	0.6%	0.2%	0.6%	0.4%	0.5%	0.1%	-0.1%	0.3%
CDX HY								
Index (spread)	**488**	**310**	**358**	**352**	**354**	**2**	**-4**	**44**
Index (price)	**102.4**	**108.4**	**105.9**	**106.6**	**106.5**	**-0.10**	**0.63**	**-1.88**
Implied Vol (price)	10.7%	5.9%	9.3%	8.9%	8.6%	-0.3%	-0.7%	2.7%
Realized Vol (price)	7.8%	4.4%	4.7%	5.5%	5.5%	0.0%	0.8%	1.1%
Vol Carry (price)	2.9%	1.5%	4.7%	3.5%	3.1%	-0.4%	-1.6%	1.6%
Upside skew (price)	0.3%	0.2%	0.8%	0.9%	1.4%	0.5%	0.6%	1.2%
Downside skew (price)	1.3%	1.8%	1.4%	1.7%	1.9%	0.2%	0.5%	0.1%
iTraxx Main								
Index (spread)	**117**	**70**	**62.5**	**67**	**67.75**	**0.75**	**5.25**	**-2.25**
Implied Vol (spread)	48.0%	42.0%	59.0%	59.0%	59.0%	0.0%	0.0%	17.0%
Realized Vol (spread)	33.0%	34.0%	48.0%	55.0%	55.0%	0.0%	7.0%	21.0%
Vol Carry (spread)	14.0%	8.0%	11.0%	4.0%	3.0%	-1%	-8.0%	-5.0%
Implied Vol (price)	2.5%	1.4%	1.7%	1.8%	1.8%	0.0%	0.1%	0.4%
Realized Vol (price)	1.9%	1.3%	1.4%	1.8%	1.8%	0.0%	0.4%	0.5%
Vol Carry (price)	0.6%	0.0%	0.3%	0.1%	0.1%	0.0%	-0.2%	0.1%
Upside skew (price)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Downside skew (price)	0.6%	0.3%	0.4%	0.4%	0.4%	0.0%	0.0%	0.1%

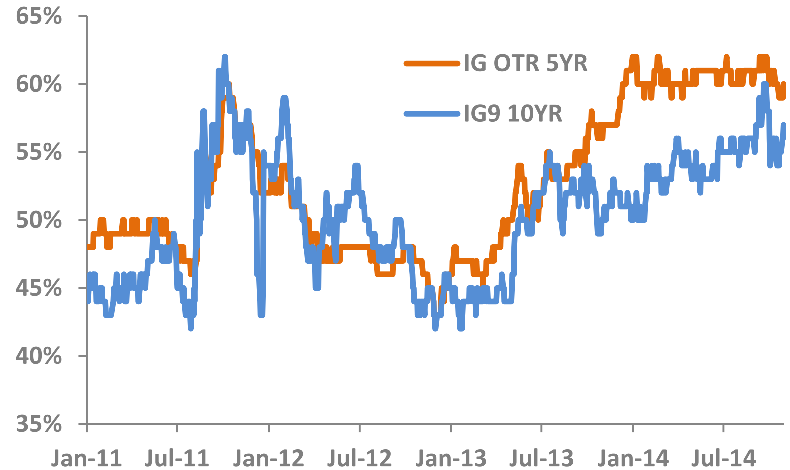
Note: Current CDX HY values based on the V2 index after accounting for defaults. Older values are based on the on-the-run index as of that given date.

US IG Credit Weekly Update | CDX IG Tranche Performance

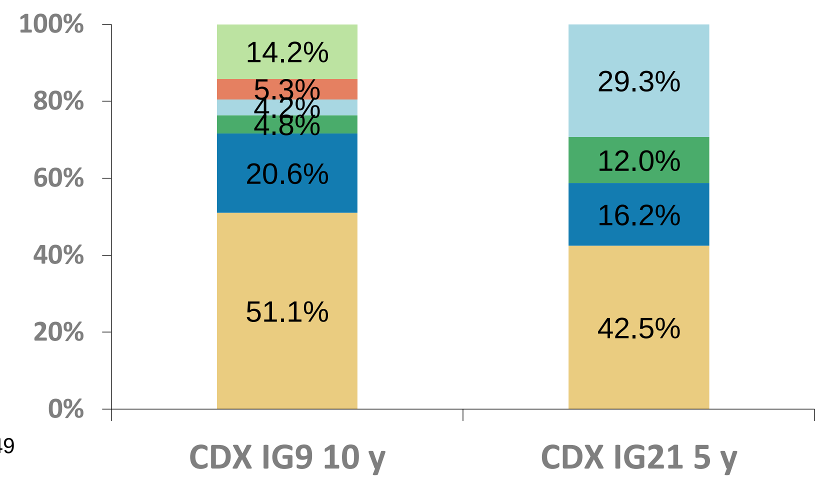
Tranche Performance

	Spreads					Change		
	YE 2012	YE 2013	Sep-14	Last Week	Current	1w	MTD	YTD
CDX IG OTR 5yr (pricing)								
Index	**95**	**63**	**57**	**51**	**51**	**0**	**-6**	**-12**
0-3%	39.0%	15.0%	13.0%	11.0%	11.0%	0.0%	-2.0%	-4.0%
3-7%	481	263	247	208	209	1	-38	-54
7-15%	182	108	84	77	76	-1	-8	-32
15-100%	31	25	21	18	17	-1	-4	-8
CDX IG9 10yr (pricing)								
Index	**123**	**63**	**60**	**55**	**54**	**-1**	**-6**	**-9**
0-3%	68.0%	32.0%	25.0%	24.0%	23.0%	-1.0%	-2.0%	-9.0%
3-7%	888	328	335	287	273	-14	-62	-55
7-10%	450	153	108	87	83	-4	-25	-70
10-15%	192	61	47	44	44	0	-3	-17
15-30%	75	27	24	19	18	-1	-6	-9
30-100%	21	13	12	10	11	1	-1	-2
CDX HY OTR 5yr (pricing)								
Index	**488**	**312**	**339**	**307**	**295**	**-12**	**-44**	**-17**
0-15%	62.0%	41.0%	45.0%	42.0%	40.0%	-2.0%	-5.0%	-1.0%
15-25%	688	438	459	391	377	-14	-82	-61
25-35%	386	221	203	167	151	-16	-52	-70
35-100%	155	74	68	53	50	-3	-18	-24

Equity Tranche Correlation



Current CDX IG Risk Allocation



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Source: Morgan Stanley Research

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Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1113**	**35%**	**353**	**40%**	**32%**
Equal-weight/Hold	**1390**	**44%**	**410**	**47%**	**29%**
Not-Rated/Hold	**109**	**3%**	**21**	**2%**	**19%**
Underweight/Sell	**575**	**18%**	**96**	**11%**	**17%**
Total	**3,187**		**880**		

For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight, Not-Rated and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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Morgan Stanley

October 2014

Risk USA 2014 Conference

Hedging Credit Risk – A Tour Through the Tools

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All information is as of October 16, 2014, unless otherwise indicated.

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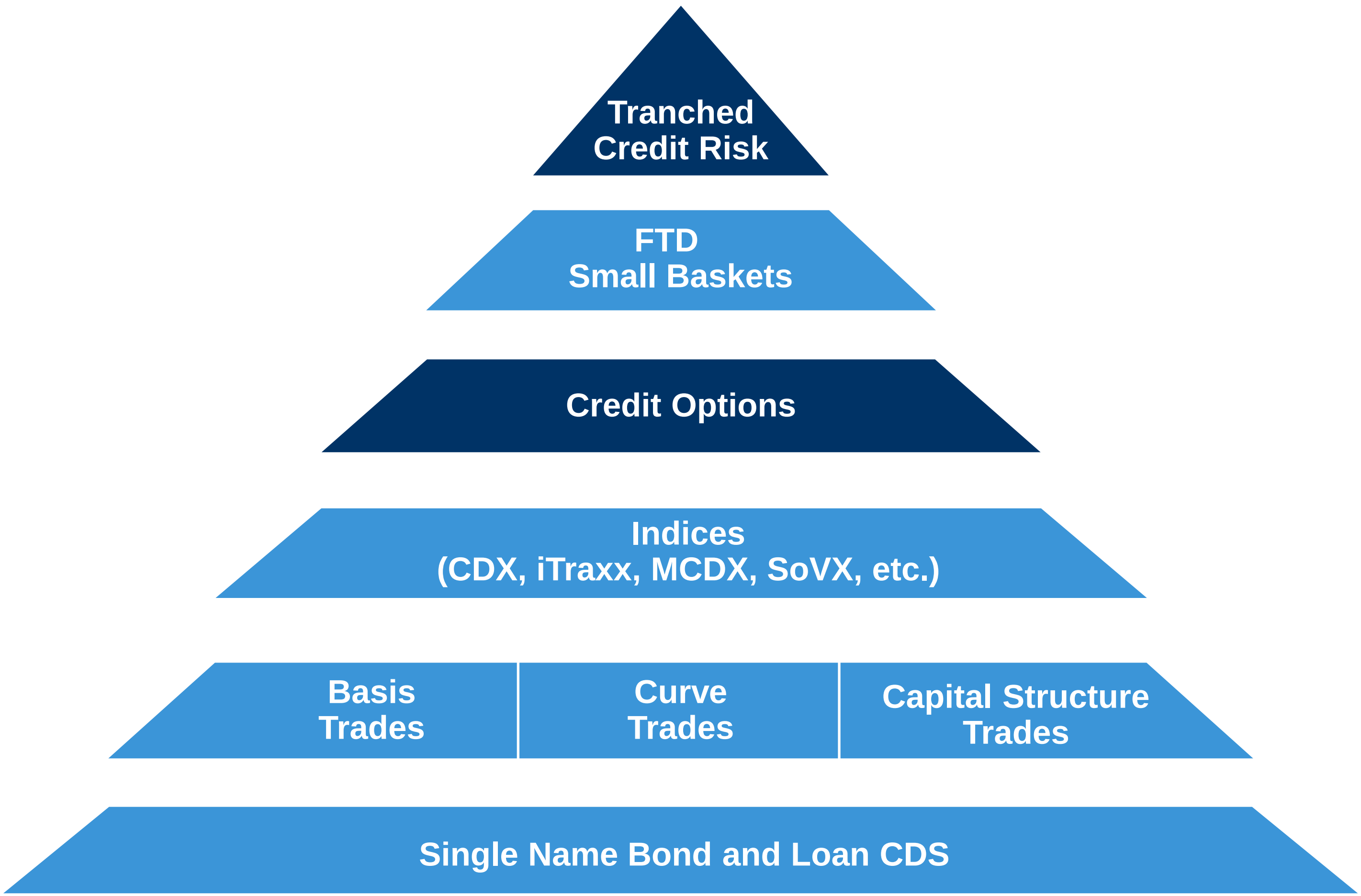
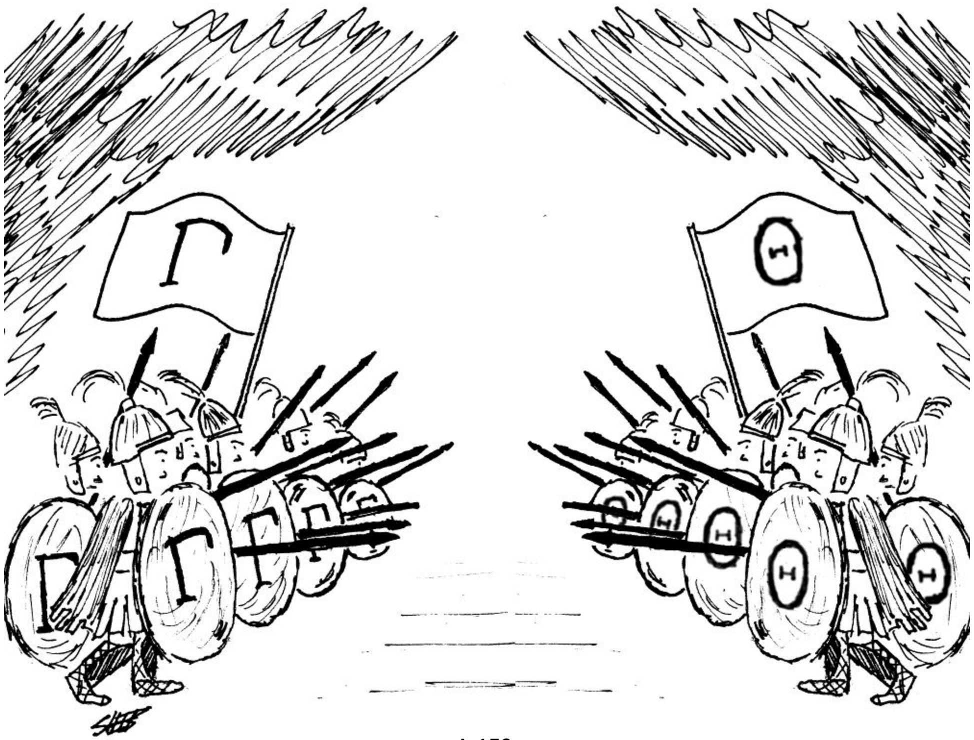
Hedging in Credit Markets – Overview

- Credit Derivatives Landscape
- Credit Options Market
- Market for Tranched Credit Risk
- Review of the Performance of Systematic Hedging Strategies
- iBoxx TRS – The Market's Newest Credit Hedging Tools

The Credit Derivatives Landscape



Credit Options



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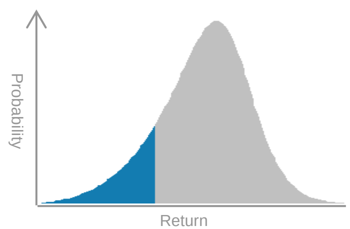
Three Basic Options Strategies

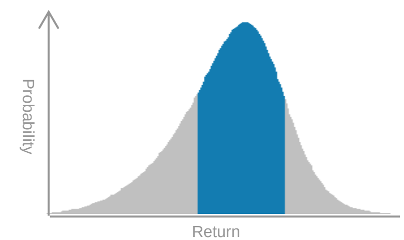
Hedging

A primary motivation for many new options users, advantage of a capped downside profile. Manage the natural negative convexity of credit.

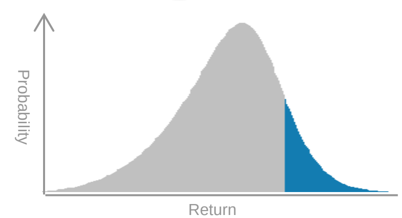


Yield

Monetize high levels of volatility to add additional yield to credit portfolios, similar to a callable bond.



3 Basic Options Strategies



Express directional views and "cover" an underweight credit position.

Upside

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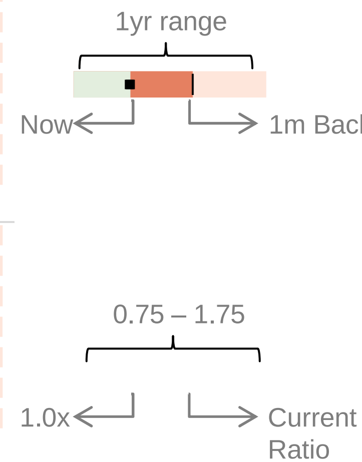
Credit Option Hedging Strategies Summary

Strategy	Building Blocks	Comments
Payers	Buy payer outright	▪ Most basic strategy. Unlimited upside if bearish scenario materializes. Benefits from rising volatility. Relatively expensive compared to alternatives. Ideal when volatility is low and spreads are tight.
Payer Spreads	Buy an ATM payer and sell a further OTM payer	▪ Less expensive than the payer but capped upside in a sell-off and limited exposure to volatility. Popular when volatility is slightly high, skew is steep and spreads are wide. Use when payers are expensive and investor only needs to hedge a modest downside or near tail scenario. ▪ Ideal for investors new to options due to relatively low cost, capped downside and muted volatility exposure
Risk Reversal	Buy payer outright and sell OTM receiver	▪ Cheaper than payers and in some cases cheaper than put spreads as well. Retains full upside in the scenario spreads widen unlike the payer spreads. ▪ For lower cost while retaining unlimited upside, investor is taking on the risk of spreads tightening substantially by selling OTM receiver.
Payer Spread Collar	Buy payer spreads and sell OTM receiver	▪ Payer Spread Collars are the cheapest of the strategies above as investor is selling both an OTM receiver and the OTM payer to fund the ATM payer. The negatives are that upside is capped if spreads widen a lot, and investor is still exposed to the risk of spreads tightening substantially.
Sell 1x2 Payer Spread	Sell 1 ATM payer and buy 2 OTM payers	▪ Trade costs very little if spreads tighten a lot and has unlimited upside for extreme widening of spreads but suffers the most if spreads widen modestly. ▪ Trade is long volatility from a MTM perspective but loses potency as time passes. Trade is ideal if spreads are tight and volatility are very low and investor view is that when spreads widen, they will spike rather than grind wider.
Buy Payer Ladder	Buy 1 ATM payer, sell 1 OTM payer and 1 Deep OTM payer	▪ This is the opposite of selling a 1x2 Payer Spread. Trade benefits most from a modest and gradual widening in spreads. However, the trade is short volatility, and a sharp and extreme widening in spreads hurts the trade most. Value in the trade accretes as time passes. Trade is ideal when spreads are already wide, volatility is very high and skew steep. The Payer Ladder is a more cautious form of the 1x2 Payer Spread by spreading out the strikes sold.
Covered Short	Sell OTM payer against Index short	▪ Covered shorts make sense when implied volatility is extreme and spreads are already quite wide.

Source: Morgan Stanley Research

Cross Asset Volatility Monitor

Index	Spot		Implied Vol 3m		Vol Skew 3m		Term Structure (3m-1y)		IV3m/RV1m Ratio	
	Now	Δ1m on 1yr Range	Now	Δ1m on 1yr Range	Now	Δ1m on 1yr Range	Now	Δ1m on 1yr Range	Now	scale 0.5 to 1.75
Equities										
S&P 500	1,969		13.5%		6.0%		-2.6%		1.03	
Nasdaq100	4,041		15.5%		4.4%		-2.2%		0.98	
Russell 2000	1,097		19.4%		4.3%		-1.9%		1.15	
Eurostoxx 50	3,053		17.6%		4.2%		-0.9%		1.11	
DAX	8,995		17.0%		3.9%		-1.5%		1.35	
FTSE 100	6,482		13.4%		5.4%		-1.3%		1.22	
Nikkei	15,596		18.5%		1.9%		-0.7%		1.26	
HSI	23,263		16.0%		1.7%		-1.4%		1.21	
MSCI EM	999		18.3%		3.7%		-2.6%		1.02	
G10 FX										
JPYUSD	108.1		7.8%		-0.7%		-0.5%		0.96	
GBPUSD	1.62		6.3%		0.7%		-0.7%		0.93	
EURUSD	1.27		6.8%		0.8%		-0.6%		0.87	
AUDUSD	0.88		9.4%		1.6%		-0.4%		0.85	
CADUSD	0.90		7.2%		1.0%		-0.5%		0.88	
NOKUSD	0.16		7.7%		0.8%		-0.8%		0.76	
SEKUSD	0.14		7.8%		0.8%		-0.7%		0.82	
Rates										
US10y	2.47		69		9		-10		1.22	
EU10y	1.11		44		16		-6		1.01	
UK10y	2.35		62		3		-11		1.11	
JP10y	0.62		24		-		-5		1.28	
US5y	1.74		*68*		16		*-13*		1.24	
EU5y	0.45		*28*		21		*-8*		0.89	
UK5y	1.82		*64*		9		*-12*		1.14	
Credit										
CDX IG	67		35		17.7%				0.79	
iTraxx Main	67		39		7.8%				1.02	
iTraxx XOver	349		181		9.9%				0.56	
CDX HY	338		9.0%		2.3%				1.46	



Notes: Colour coding is meant to imply what's in the price. A sea of green on the dashboard implies equities have risen a lot, FX up versus USD, rates wider, credit spreads tighter. Options skew for stocks 90-110 skew, for FX 25 delta risk reversal and credit 130-80 skew. Credit vol (except CDX HY) is normalised vol, similar to rates. Source: Bloomberg, Morgan Stanley Research

Where Is the Credit Option Market Relative to Equities?

Pillar 1 – Risk Management and Return Enhancement

From a directional perspective, options are most useful for either risk management or return enhancement.

***This is where we are in credit markets now*.**

Pillar 2 – Volatility as an Asset Class

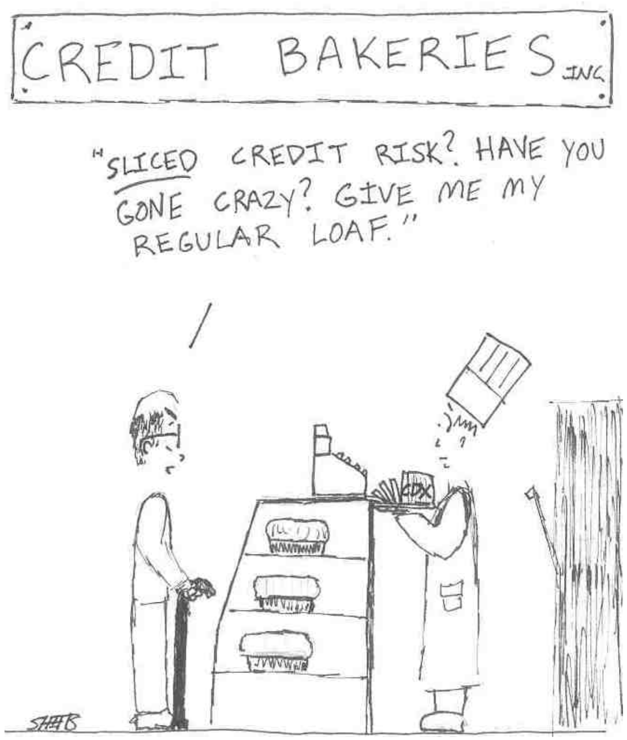
When traded actively, options can create isolated exposure to portfolio characteristics like volatility, correlation, the passage of time, dividends, and interest rates.

Three classes of investors with some overlap

Close monitoring of them can provide valuable information on the technical structure of markets and the potential future direction of asset prices.

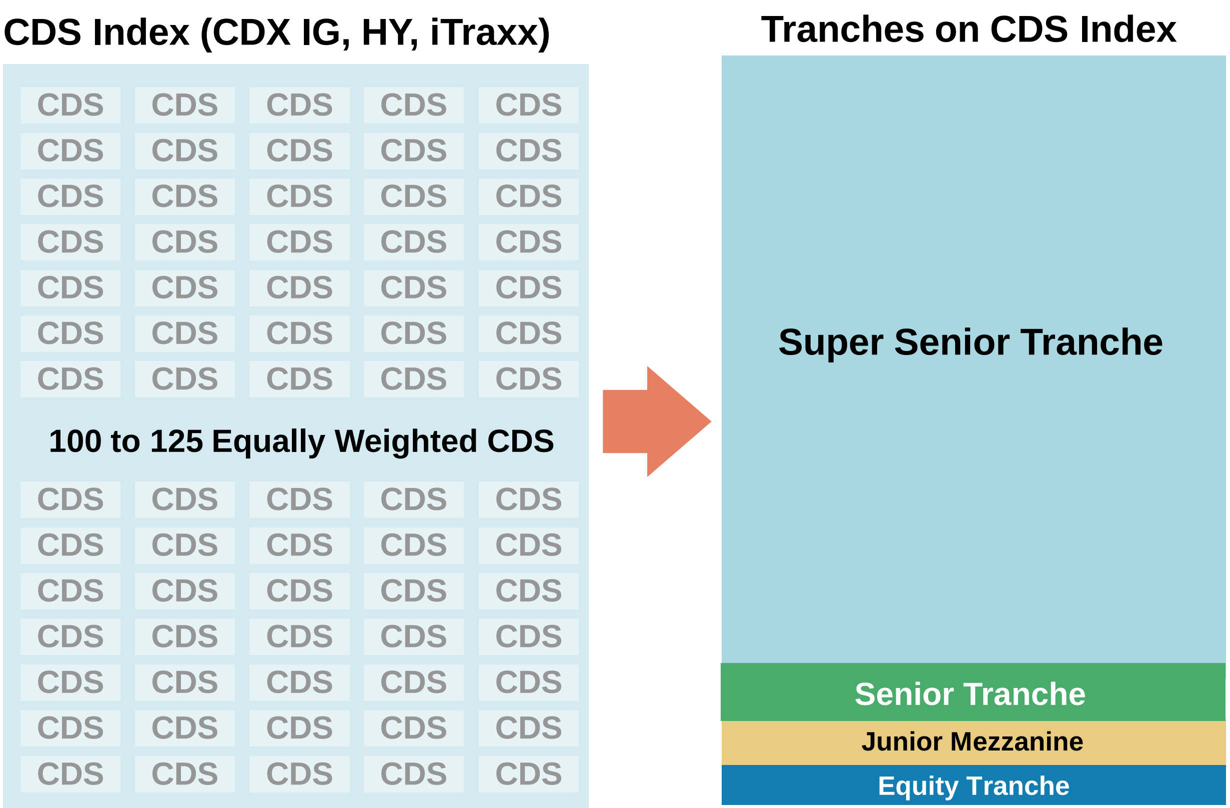
Pillar 3 – Derivatives as a Market Barometer

Options on Credit Losses – Tranched Credit Risk



What Is a Credit Derivatives Index Tranche?

Index tranches represent "slices" of risk exposure to losses on a given index



Source: Morgan Stanley Research

- **Equity.** Also called the first loss tranche, this is the most levered and widest spread tranche. With no subordination, this tranche will experience losses immediately if there are defaults in the underlying portfolio.
- **Mezzanine.** Mezzanine tranches offer less spread than equity tranches, in return for some subordination offering a buffer against the first several losses in the portfolio.
- **Senior and Super Senior.** Senior tranches trade the tightest and can be de-levered with regards to the underlying index. Chance of experiencing actual principal losses in these tranches is extremely remote.

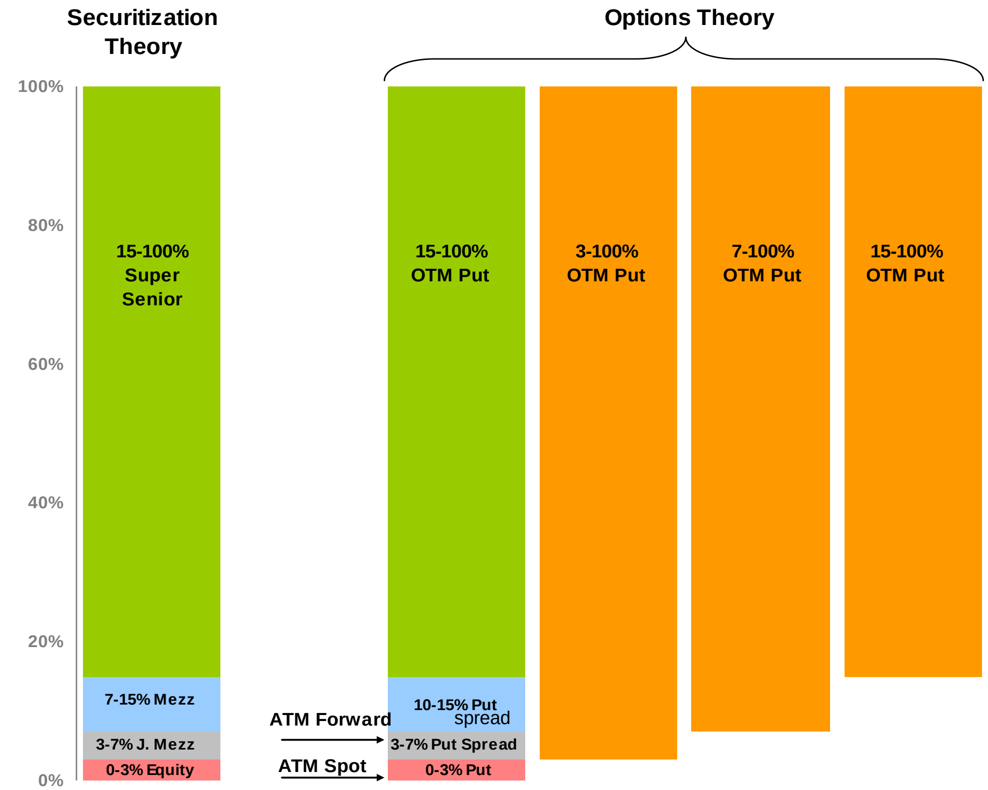
Index Tranches Are Options on Defaults and Losses

We can think of credit tranches as outright puts and put-spreads on credit losses from default

Moneyness: If we do not expect any losses in a portfolio, then a 0% attachment point would be an ATM put, and the 3% attachment point could be considered an OTM put. But given risk-neutral pricing, the markets imply some amount of credit losses on the index, termed *expected losses.*

Spot vs. forward moneyness: If we consider the entire index an ATM put on a spot basis, then any X%-100% tranche would be considered an OTM put. On a forward default basis, we can consider the market implied expected loss point as the ATM point. Thus a tranche that attaches below and detaches above the expected loss point would be a forward ATM put. Any tranche below this point would be an ITM forward put, and any tranche above this point would still be an OTM put.

CDX IG Tranches – Options on Losses



Source: Morgan Stanley Research

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Systematic Credit Hedging

Credit Hedging Landscape: Who Are Credit Hedgers?

Small Tail Focused Hedgers (Size = Large)

Investors who focus on small tails in investment grade and high yield credit in both the US and Europe perhaps comprise the largest segment of the market. This community is opportunistic and will hedge when it feels it necessary or when it sees value. Some take more of a buy-and-hold approach, while others can manage their options portfolios very actively. We have seen more focus of late on tranches in this community, especially at times when credit volatility becomes high and investors look for further convexity opportunities through rises in market correlation or actual idiosyncratic events.

Natural and Systematic Hedgers (Size = Medium)

Natural hedgers generally have business models that demand regular hedging, including the management of risks from loan books and counterparty exposures over both short- and long-term periods, and they tend to take very systematic approaches as well. There is also a medium-sized community of banks who engage in first-loss protection hedging that can provide important regulatory capital relief to lending portfolios.

Long-Term and Large Tail Hedgers (Size = Medium)

Many investors in this category are looking for a lock-in-the-drawer type long-term hedge that costs little and doesn’t require much day-to-day management. This is also a community that is more likely to invest in third-party tail risk funds. While they use credit options, the lack of a well-developed longer maturity market is a deterrent, as is high volatility which has impacted their equity hedges as well. Within credit options, this community will focus on far OTM strikes, thereby owning skew. The longer-duration and far OTM nature of tranche hedges are appealing as well, and are in many ways a more natural fit, and activity here has increased.

Yield Generators (Size = Medium)

This community of participants are not hedgers and are generally not inclined to spend premium on option or tranche strategies, as they tend to focus on relative return versus benchmarks and their peer groups. Instead, they look for opportunities to monetize excessive market volatility through the sale of options and have effectively translated their capabilities in rates, FX and equities into credit. Flows from this community are important to balance the large community of hedgers, and the market would welcome more yield generators for this reason.

Cross-Asset Hedgers (Size = Small)

This growing community of investors is increasingly active in options, and to some degree tranches, to identify the cheapest hedge or yield idea across equities, credit, rates, currencies, and commodities. They can play an important role in balancing the technicals between markets, and have often engaged in credit vs. equity hedging themes (i.e., selling options in one market to fund the purchase of options in another).

The Credit Hedging Budget: How Much to Pay?

Having a hedging budget can be helpful when narrowing down the range of hedging strategies. Deciding a hedging budget is an iterative process – a function of the portfolio being hedged and its yield, how much of a contribution is desired from the hedges and the current cost of sourcing hedges.

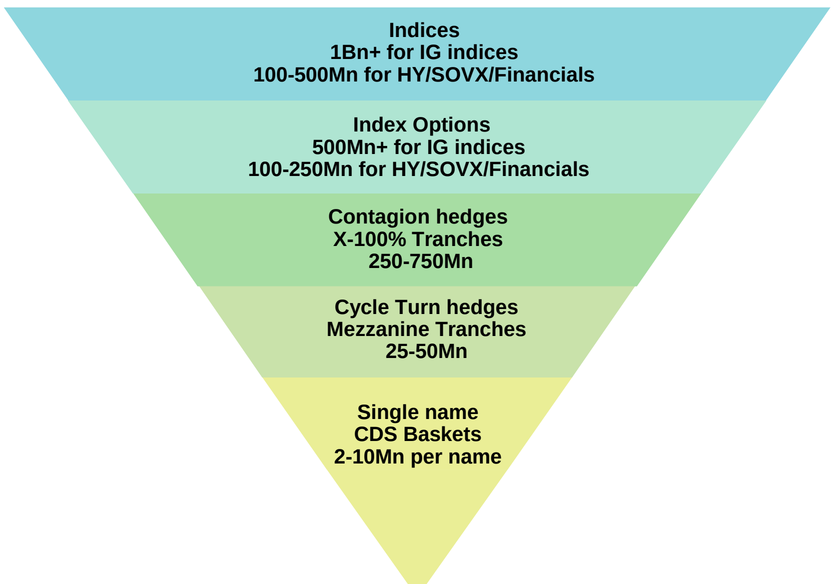
- We generally target payout ratios of **3.5x or higher** for hedging strategies in normal environments. Thus for every $1 spent on hedging, we would expect a payoff of about $3-6 if the hedged scenario materializes.
- During market dislocations, we drop this target payout to **2.0x-2.5x.**
- Increasing the budget can facilitate the purchase of hedges with unlimited upside, whereas with a more limited budget, investors may have to settle for strategies with capped upside.
- Assuming the hedges are successful and the hedging budget generates 3.0x leverage, that can translate into 2% in hedge P&L for IG portfolio and 4.5-.7.5% for HY portfolios. We emphasize setting guidelines on constructing a hedging budget, and remaining adaptable as the market changes.

The Hedging Instruments: Single Name CDS, Indices, Options and Tranches

Three things drive the choice of instrument:

- **Liquidity**
- **Correlation to hedged assets**
- **Cost vs. convexity**

Hedger's Liquidity Pyramid – Typical Trade Sizes



Credit indices: CDS indices, of which there are over 20 globally, remain the most liquid way to express a portfolio view in credit. The drawback is that the exposure is linear, meaning that the investor can lose money if the market improves, and hedging can be expensive if risk premium is already in the price.

Index options: Increasing liquidity, asymmetric payoffs and the ability to customize payouts define maximum costs at trade inception all have attracted investors to options for hedging. However, these are still very short-dated instruments, with expiries in the 3m–6m range.

Credit tranches: Tranches are designed to express a view on defaults and risk premiums separately. Their long-dated nature makes them ideal when uncertain about the timeframe of events being hedged. These are also relatively liquid, and can vary in cost depending on the strategy. Unlike options these do have more than capped downside if the market improves.

Single-name CDS and baskets: Individual single-name CDS and baskets are less liquid than the indices, but more "customized". We like using this strategy to hedge exposure to highly specific exposures or risks.

Beyond Delta One: Options vs. Tranches As Hedges

Options as a hedge

- An investor who buys a put or payer is long the "option" to buy protection at a pre-determined price (strike). The probability of this option being in the money at expiry is between 0% and 100%, which is roughly equivalent to the option's delta.
- The investor also owns protection from any defaults that occurred up through the option expiry.
- **Time decay is a big factor in an option hedge**, and an OTM option loses value at an accelerating rate as expiry approaches.

Tranches as a hedge

- An investor who buys tranche protection is short the market with 100% certainty, much like simply owning CDX protection.
- The tranching defines the payoff for scenarios where there are actual losses from default, and the delta of the tranche estimates how much the tranche price will move with respect to small price changes in the underlying index/portfolio. A tranche that is ATM in terms of expected defaults will have the highest delta.
- **The biggest concern for tranches is the ongoing carry involved**, unlike an option strategy where the payment occurs only once upfront.
- In tranches, while the time decay is less severe (unless maturity is less than a year or so), the longer the investor waits for the market widening, the more expensive the hedge.

If we think of an option in the context of a tranche, then the put buyer's best case scenario is being long 0-100% protection at an attractive price (at expiry) relative to the then market price of that protection. There is no additional leverage to the market in the form of default exposure.

Options vs. Tranches: A Comparison

Tranches and options each have their merits and drawbacks, including:

- the impact of time decay
- the timing of the scenario hedged
- the cost involved
- the delta to the underlying index if the hedged scenario does materialize
- how much negative MTM an investor is willing to tolerate should the market actually improve

Options Hedges

	ATM Put	OTM Put	ATM Put Spread	Put Spread Collar*	Bearish Risk Reversal**
Absolute Cost	High	Medium	Medium	Low	Medium
Downside	Limited	Limited	Limited	Unlimited	Unlimited
Upside	Unlimited	Unlimited	Limited	Limited	Unlimited
MTM Impact of..					
Spread Direction (Delta)	High	Medium	Medium	High	High
Magnitude of Spread Change (Gamma)	High	Medium	Medium	Low	High
Implied Volatility (Vega)	High	High	Low	Medium	Low
Volatility Skew	Low	Medium	High	High	High
Time Decay (Theta)	High	Medium	Medium	Low	High

Tranches Hedges

	Equity Tranche	Junior Mezzanine	Senior	Super Senior	X-100
Absolute Cost	High	High	Medium	Low	Medium
Downside	High	Medium	Medium	Low	Low
Upside	Full Writedown	Full Writedown	Medium	Low	Medium
MTM Impact of..					
Increase in Systemic Risk	Low	Low	Medium	High	High
Increase in Tail Risk	High	Medium	Low	Low	Medium
Implied Correlation	High	n/a	n/a	n/a	High
Correlation Skew	n/a	High	High	High	n/a
Time Decay (Theta)	High	High	Medium	Medium	Low

Notes: *Buy ATM Payer, Sell OTM Payer and OTM Receiver
**Buy OTM Payer, Sell OTM Receiver
"n/a" implies that the correlation impact on tranche performance depends on other factors

The First Step: Defining Hedge Scenarios

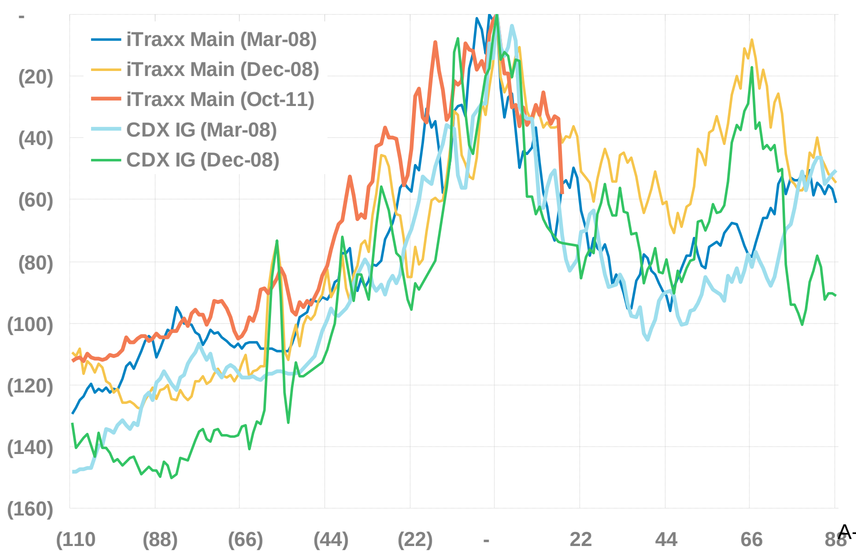
Hedging for a Large Tail Scenario

We find it useful to look at past credit sell-offs to assess the extent and pace of bear market credit spread deterioration. For the moment, we ignore the basis between cash and CDS. For CDS indices specifically, we have a more limited history than the broader credit market, but the examples we have show roughly the same intensity and trajectory as the underlying credit market for various market declines.

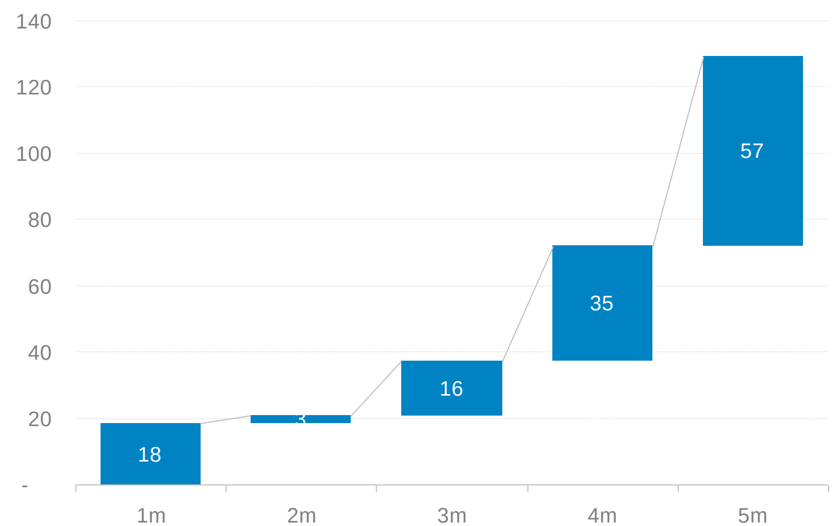
For investment grade indices a large tail scenario seems to be about 130bp of widening over five months from trough to peak, with the bulk of this in the two months preceding the peak (illustrated below).

In high yield indices, the equivalent move is around 400-600bp over a five-month period with nearly 300bp of that in the 4-8 weeks before the peak.

Historical Examples of IG Large Tail Moves



An Average Large Tail Widening in IG



The First Step: Defining Hedge Scenarios

Hedging for a Small Tail Scenario

In investment grade indices, smaller tail scenarios are more frequent and involve 30-65bp move in a 1-3 month timeframe with the bulk of this occurring in the 4-6 weeks prior to the peak.

In high yield indices, a small tail is a move of about 150-300bp with a similar timeframe.

Small Tail Hedging: Options work better

The easiest way to hedge a small tail is by using options, which would involve buying a rather expensive ATM or close to ATM payer, coupled with a short call for a **risk reversal**, or OTM put to make a **put spread**, to cheapen the cost.

Hedging for small tail scenarios is more challenging in tranches, as spread impact on individual tranches is less clear in smaller spread-widening scenarios, and the cheapest hedges can have little convexity in a moderate sell-off.

iTraxx Main Small Tail Moves

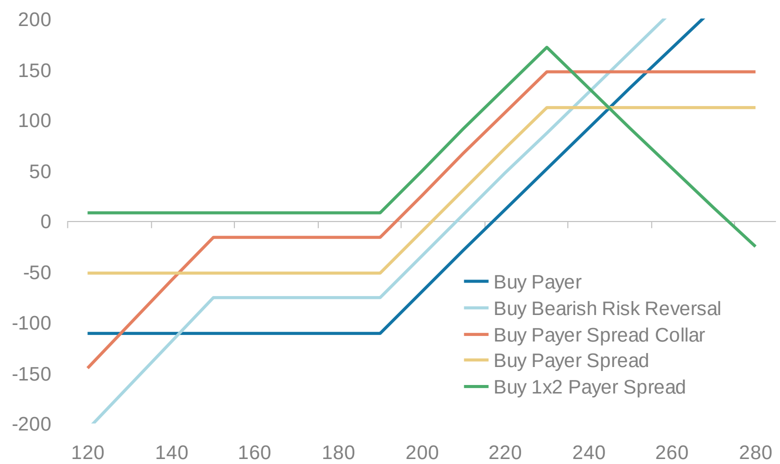
Start	End	Time Months	Spread Move
3/7/2005	5/17/2005	2.37	32
6/4/2007	7/30/2007	1.87	46
10/11/2007	11/21/2007	1.37	35
5/19/2008	7/8/2008	1.67	45
2/9/2009	3/9/2009	0.93	63
1/11/2010	2/8/2010	0.93	29
3/17/2010	6/8/2010	2.77	66
		1.70	**45**

CDX IG Small Tail Moves

Start	End	Time Months	Spread Move
3/8/2005	5/17/2005	2.33	36
6/5/2007	8/3/2007	1.97	47
4/15/2010	6/9/2010	1.83	50
7/4/2011	10/3/2011	3.03	61
		2.29	**49**

The Second Step: Choosing a Hedging Strategy

Option Hedging Strategies



In options, the simplest strategy (but most expensive) is the **outright payer**, a trade with capped downside and unlimited upside if spreads widen dramatically.

One way to cheapen the cost of an outright payer is by selling a further OTM payer to make **a payer spread**. These are cheaper than payers, but don't have the unlimited upside.

Another way to cheapen a payer is to sell an OTM receiver in a **bearish risk reversal**. These have the advantage of unlimited upside when spreads widen, but also have unlimited downside in a rally.

Payer spread collars are the cheapest in a range-bound market, capping the upside if spreads widen but also taking the risk of a significant tightening of spreads.

Tranche Hedging Strategies

For tranches, the investor can think of hedges as falling into one of two broad categories.

Systemic tranche hedges

These should protect the underlying portfolio when the market widens rapidly due to systemic risk concerns but not individual corporate issues. These include the standard super senior tranche, or X-100% tranches which combine the super senior with any number of the tranches beneath it.

These all performed well going into the credit crisis, when systemic risk was rising. These trades are generally done outright (no-delta) with an annualized cost of under 100bps, depending on the attachment used and when the trade was implemented. These tranches usually have a delta of less than one, which rises as markets widen.

Cyclical tranche hedges

These should protect the portfolio from more idiosyncratic risk, or actual corporate defaults, and include buying protection on equity tranches. Because equity protection is very expensive, most investors prefer mezzanine tranches, which can widen considerably with a default, given the loss of subordination. Typically these types of hedges are paired with a light delta long on the index to reduce cost. These trades work best when there is an expectation of actual defaults and the underlying index has some risky tail names.

The Third Step: Monitoring the Hedge – A Guide to Our Methodology

To evaluate various hedging strategies across options and tranches, we evaluated each as though they were implemented on a systematic basis. We then assessed their impact across three variables as follows:

P&L Impact

This metric shows the average monthly return of systematically using the hedging strategy. A negative number indicates that the hedging overlay had a cost to the hedging investor during the period evaluated. Conversely, a positive number implies the hedging strategy added to the P&L on average over the period. This number is presented as a monthly cost (or revenue), averaged over the period.

Volatility Reduction

Here we show the % decline in volatility of the hedged portfolio when evaluated in comparison to the unhedged portfolio. Thus if the unhedged portfolio has an annualized volatility of 10% and the hedged portfolio has an annualized volatility of 5%, that is a 50% reduction in the portfolio volatility when a hedge is implemented.

Drawdown Reduction

In this metric, we show the % change in the performance of the worst month of the hedged portfolio over the worst month of the unhedged portfolio. So for example, if the worst month for the unhedged portfolio was March 2009 in which the unhedged portfolio had a return of -3%, and the worst month for the hedged portfolio was June 2009 with -1.5% return, the drawdown reduction is 50%.

The Third Step: Monitoring the Hedge – Investment Grade Options

Systematic Hedging with Options: Payers Consistently Reduce Volatility

In our analysis, we assume the investor rolls the option hedges a month before expiry, rather than holding them to expiry. We can conclude that systematically hedging with options has been cost effective, volatility reducing, and loss protecting, across a variety of options strategies.

Cost: The cost of implementing the systematic hedge program has been less than 15bp over the course of two years

Volatility reduction: Any of the options hedging strategies helped significantly reduce the volatility of the underlying portfolio by 15% to as much as 60%

Drawdown reduction: Furthermore, the hedged portfolio experienced a similar 15% to 60% reduction in the max drawdown (difference of max monthly loss with a hedge in place vs without).

We can further parse the results and conclude that for investment grade, **"expensive" strategies such as ATM payers look better than most other strategies** in terms of both volatility reduction and drawdown reduction

iTraxx Main Jan-08 to Dec 09	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
ATM Payer	-15	-43%	-35%
OTM Payer	-15	-32%	-25%
OTM RR	-18	-46%	-41%
PS	-13	-15%	-6%
PSC	-16	-34%	-24%
1 X 2 payer	-8	-19%	-17%

iTraxx Main Jan-10 to Sep 11	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
ATM Payer	3	-66%	-65%
OTM Payer	-1	-46%	-54%
OTM RR	1	-55%	-59%
PS	-3	-17%	-15%
PSC	-2	-26%	-23%
1 X 2 payer	-1	-27%	-39%

CDX IG Options Jan-10 to Sep 11	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
ATM Payer	-4	-27%	-47%
OTM Payer	-6	-23%	-35%
OTM RR	-8	-21%	-33%
PS	-9	-15%	-12%
PSC	-11	-14%	-14%
1 X 2 payer	-2	-11%	-23%

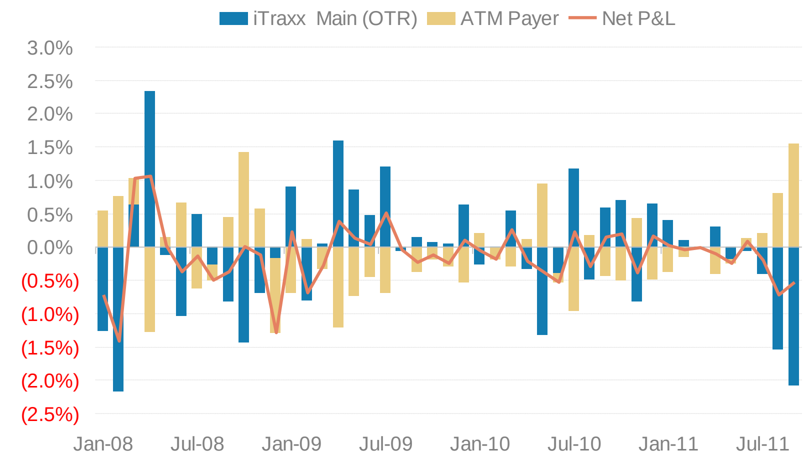
The Third Step: Monitoring the Hedge – High Yield Options

High Yield: Collared Strategies. While outright payers perform best for investment grade, in high yield, strategies that sell away upside have performed well, though we caution that this analysis was performed in a post credit crisis period, in which valuations and volatility have been dislocated. With implied volatility generally trading at a significant premium to realized, outright payers have not performed as well.

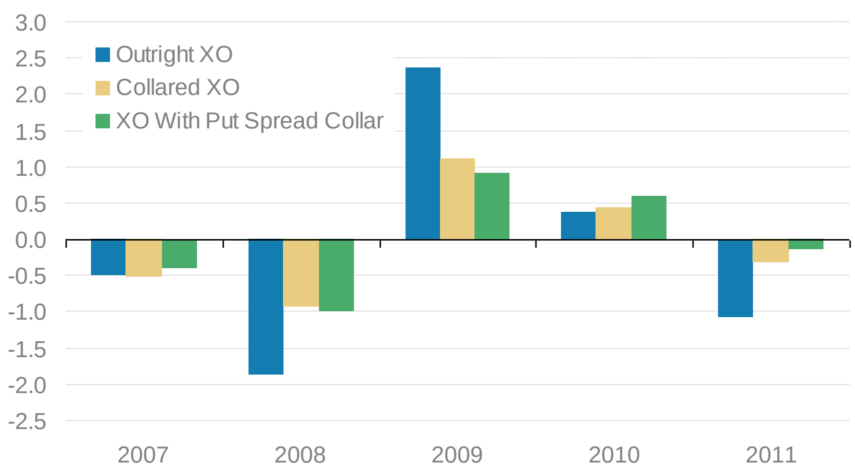
Put spread collars and risk reversals that do not take an outright long volatility view have worked well. From a MTM perspective, put spread collars benefit from lower volatility and time decay as expiry approaches.

Collared strategies are popular as systematic hedges in equity markets for the same reasons. Given HY market pricing today this congruence in the two markets makes sense to us.

Investment Grade: Use Systematic ATM Payers



European High Yield: Collared Strategies Have Resulted in Superior Sharpe Ratios



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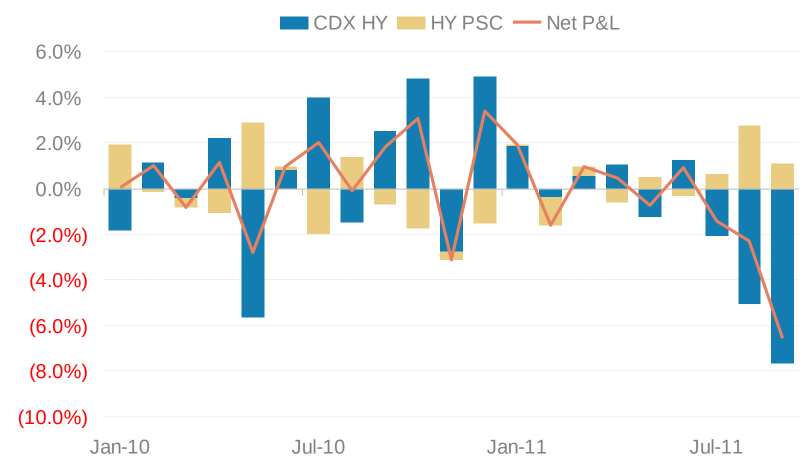
US High Yield: Collared Strategies Have Worked Well



The Third Step: Monitoring the Hedge – CDX IG Tranches

Systematic Hedging with CDX Tranches: Senior and X-100% Strategies Consistently Reduce Volatility

Tranches can be used to fine-tune views to account for default correlation, portfolio dispersion and tail risk.

Index tranches are an important liquidity point in the corporate credit landscape in part due to their potential for outsized returns at different points in the cycle, but also because they are among the few "lock-in-the drawer" longer-duration instruments available in the credit markets.

We look at tranches purely from a hedging perspective to examine how different parts of the capital structure would have performed as hedges during the last several years.

For systematic hedging, **very senior tranches, as well as some X-100% tranches** with mid-level attachment points can be cost effective, portfolio volatility reducing and loss-protecting hedges.

Intuitively, this makes a great deal of sense to us, because these tranches are very much akin to puts (OTM would be 30-100% or 22-100%, ATM would be the lower attaching X-100% tranches) and put spreads (15-30%, 12-22%,etc.)

CDX Tranches Jan 06 to Sep 07	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
7-100% (No Delta)	1	-39%	-55%
30-100% (No Delta)	0	-33%	-37%
15-30% (No Delta)	2	-49%	-79%
3-7% (Delta Scaled)	1	-59%	-73%
7-10% (Delta Scaled)	3	-39%	-49%
10-15% (Delta Scaled)	-3	38%	34%
15-30% (Delta Scaled)	9	49%	-70%

CDX Tranches Jan-08 to Dec 09	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
7-100% (No Delta)	-3	-37%	-45%
30-100% (No Delta)	-2	-27%	-41%
15-30% (No Delta)	-8	-33%	-44%
3-7% (Delta Scaled)	12	77%	75%
7-10% (Delta Scaled)	14	27%	21%
10-15% (Delta Scaled)	16	22%	-20%
15-30% (Delta Scaled)	1	-24%	-44%

CDX Tranches Jan-10 to Sep-11	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
7-100% (No Delta)	-1	-39%	-45%
30-100% (No Delta)	-1	-16%	-16%
15-30% (No Delta)	3	-51%	-61%
3-7% (Delta Scaled)	-4	3%	-37%
7-10% (Delta Scaled)	0	-29%	-63%
10-15% (Delta Scaled)	-2	-30%	-51%
15-30% (Delta Scaled)	-1	-45%	-49%

The Third Step: Monitoring the Hedge – iTraxx Main Tranches

Systematic Hedging with CDX Tranches: Senior and X-100% Strategies Consistently Reduce Volatility

In iTraxx, like CDX IG, super senior tranches would have performed very well as part of a broader systematic hedging program prior to 2010.

In other trades however, tranche hedges in iTraxx performed rather differently from CDX IG. In CDX IG, junior tranches would have added considerable cost if not implemented on a very strategic basis, while in iTraxx, they would have still been volatility reducing and with relatively low impact on overall P&L

Interestingly, many iTraxx tranche hedges would have been volatility reducing and loss reducing throughout the more recent European stress. This would have come at varying levels of cost however.

iTraxx Tranches Jan 06 to Sep 07	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
6-100% (No Delta)	1	-32%	-43%
22-100% (no Delta)	0	-22%	-27%
12-22% (No Delta)	2	-59%	-79%
3-6% (Delta Scaled)	-3	-54%	-58%
6-9% (Delta Scaled)	1	-55%	-80%
9-12% (Delta Scaled)	4	-37%	-87%
12-22% (Delta Scaled)	7	1%	-90%

iTraxx Main Jan 08 to Dec-09	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
6-100% (No Delta)	0	-55%	-61%
22-100% (no Delta)	-1	-41%	-50%
12-22% (No Delta)	0	-44%	-41%
3-6% (Delta Scaled)	3	-19%	-35%
6-9% (Delta Scaled)	8	-50%	-64%
9-12% (Delta Scaled)	3	-50%	-72%
12-22% (Delta Scaled)	-2	-36%	-19%

iTraxx Tranches Jan 10 to Sep 11	P&L Impact	Volatility Reduction	Max Monthly Drawdown Reduction
6-100% (No Delta)	10	-57%	-56%
22-100% (no Delta)	4	-34%	-30%
12-22% (No Delta)	25	-50%	-76%
3-6% (Delta Scaled)	17	-60%	-69%
6-9% (Delta Scaled)	17	-63%	-76%
9-12% (Delta Scaled)	18	-69%	-77%
12-22% (Delta Scaled)	18	-61%	-74%

The Third Step: Monitoring the Hedge – Tranche Strategies

Senior tranche shorts: Systematic hedging

When hedging for systemic or contagion risk, senior and super senior tranches can be ideal, given the cost and convexity profile. These tranches are more "option like" in their return profile, and can be thought of as deep OTM puts, but on defaults rather than spreads.

On an annualized basis, a super senior tranche usually costs much less than most OTM puts, yet can offer decent payoffs if systemic fears manage to push risk up the capital structure, as we saw in late 2008.

If the systemic scenario does not materialize, these usually have limited downside, both in terms of carry and MTM.

Junior tranche shorts: Tactical hedging

For environments where systemic risk is expected to be low, spreads are generally low, yet there is risk of a few names widening dramatically or even defaulting, junior tranches are appealing tools for hedging.

To illustrate, we look at tranche performance in mid-2005, when the US autos were downgraded, causing fears of potential defaults in names from that sector, despite an overall robust credit market.

They key is determining the ATM tranche, and then shorting it on a delta adjusted basis to reduce the cost, since the cost of being wrong for too long can be a drag on eventual returns

We also like these shorts for turns in the cycle. When it appears that credit may be headed for a downturn, but before defaults happen, the junior mezzanine tranche can be an effective hedge.

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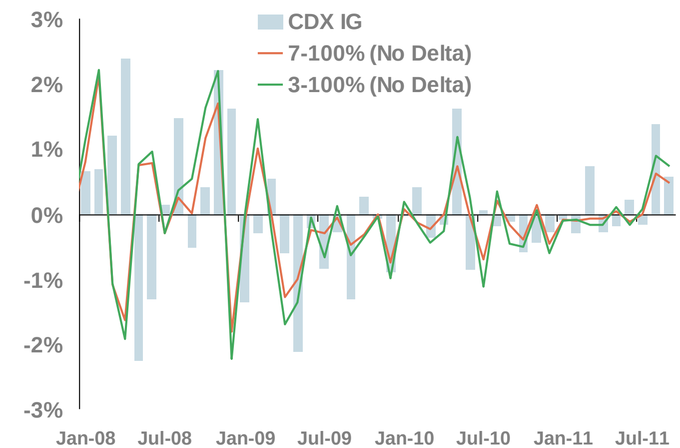
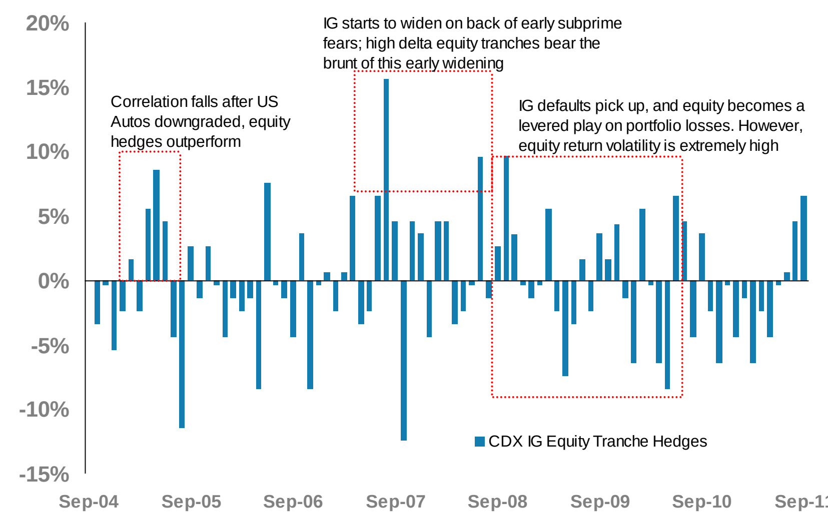
X-100% Credit Hedging Has Good Performance



Equity Tranche Hedge Performance



iBoxx Total Return Swaps (TRS)

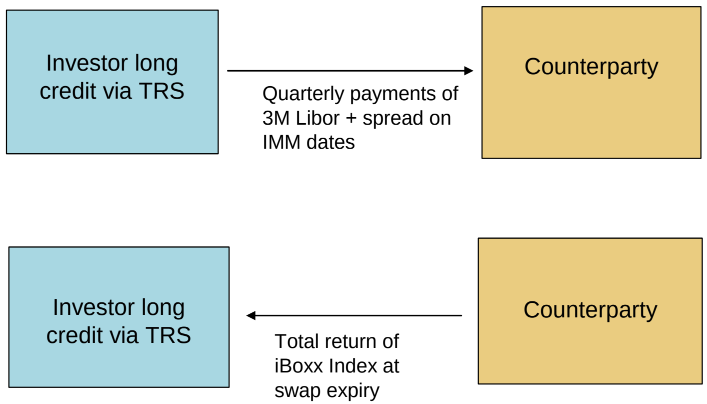
iBoxx TRS | Introducing Markit iBoxx Total Return Swaps

Standardized TRS contracts bridge the gap between derivatives and cash products by providing unfunded returns based on a cash index. The benefits are scalability (like a derivative) and lower tracking error relative to CDS indices and ETFs.

In terms of cash flow, a total return swap consists of two legs: (1) a funding leg and (2) a total return leg. The cashflows on the funding leg will be paid quarterly on standard IMM dates, similar to an interest rate swap. If the contract is initiated between these dates, the investor pays an accrued funding amount.

The index fixing at the maturity of the trade is based on the closing level as of the maturity date of the contract. An investor who is long credit exposure will "pay" a funding leg quarterly and "receive" a total return leg at the expiry of the trade (which could result in a payment if the return is negative).

Total Return Swap Mechanics



Source: Morgan Stanley Research

iBoxx TRS | Portfolio Credit Exposure Via Three Index Products: A Comparison

Comparison of Total Return Swaps, ETFs and CDS Indices

	Total Return Swap	ETF	CDS Indices
Exposure	Total return of specified bond index with no tracking error.	Total return of specified bond index with tracking error (NAV) and premium/discount differentials.	Credit return of specified index with NAV differentials.
Rationale	Gain unfunded long/short exposure to specific bond index with no tracking error. Can act as a cash substitute, a strategic/tactical reallocation tool or a portable alpha strategy.	Gain cash exposure to a replicating bond portfolio with the option to exchange for the actual bonds. No derivatives counterparty exposure.	Gain unfunded long/short exposure to the pure credit premium using the market's most liquid instruments. Can easily trade single names against indices as well as overlaying options/tranches.
Funding	Unfunded with financing cost on floating leg and daily MTM posted as per ISDA.	Fully funded	Unfunded with daily MTM posted as per ISDA.
Cash flows (Long)	Pay funding cost quarterly, receive total return at swap maturity.	Pay full value upfront, receive monthly dividends, receive full value upon sale.	Receive quarterly premiums, pay/receive an upfront, pay par – recovery on any single-name defaults
Cash flows (Short)	Receive funding cost quarterly, pay total return at swap maturity.	Borrow shares to sell and buy back later on.	Pay quarterly premiums, receive/pay an upfront, receive par – recovery on any single-name defaults.
Counterparty	Swap counterparty	None	Swap counterparty
Key Advantages	Unfunded, no tracking error to index, and shorter swap maturities mean no exit cost, if TRS held to maturity.	Cash instrument for those with derivatives limitations, exchange traded, exchangeable into bonds.	Unfunded, best market liquidity and depth, credit only exposure, can overlay with options and tranches.
Key Disadvantages	Unproven market liquidity and fixed indices that may not match benchmarks.	Two sources of tracking error (discount/premium to NAV), difficulty borrowing to go short, management fees.	Basis risk to cash portfolios and portfolio mismatch.

Source: Morgan Stanley Research, Markit, Yieldbook, Bloomberg

iBoxx TRS | TRS Cashflows: An Example

One key advantage of using total return swaps is that if held to maturity, the end investor has to bear the bid-offer cost only at the entry point. At the expiry of the trade, there is no additional cost involved since settlement is simply based on the observed index level at that expiry. To illustrate the cashflows involved in a total return swap, we look at a hypothetical trade where the investor takes long credit exposure.

Example 1: The investor goes long 100MM of 1-year total return swaps of the iBoxx index with the initial index ref at 190, with a funding of 3M Libor + 20 bp. If the ending period index level is 195, the total return is simply calculated by (195 – 190)/190, which works out to 2.631%. Assuming 3-month Libor remains unchanged at today's level (0.4875%).

Example 2: In this example, we use the same starting values as the previous example, but assume that the index falls in value to 185 at trade expiry. In this case the total return is (185-190)/190, which works out to -2.631%. Since the total return is negative, the investor has to pay out on the index leg at maturity.

Cashflows Assuming Index Moves from 190 to 195, Libor Unchanged (Notional = $100 MM)

	Funding Leg	Index Leg
Sep-12	(171,875)	
Dec-12	(171,875)	
Mar-13	(171,875)	
Jun-13	(171,875)	2,631,579
Net	(687,500)	2,631,579

Source: Morgan Stanley Research

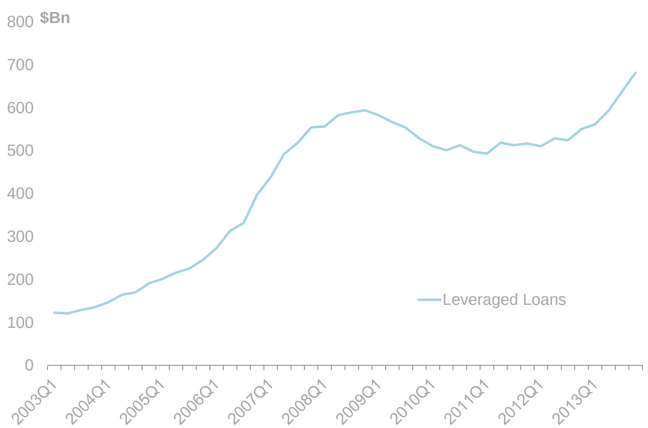
Cashflows Assuming Index Moves from 190 to 185, Libor Unchanged (Notional = $100 MM)

	Funding Leg	Index Leg
Sep-12	(171,875)	
Dec-12	(171,875)	
Mar-13	(171,875)	
Jun-13	(171,875)	(2,631,579)
Net	(687,500)	(2,631,579)

Source: Morgan Stanley Research

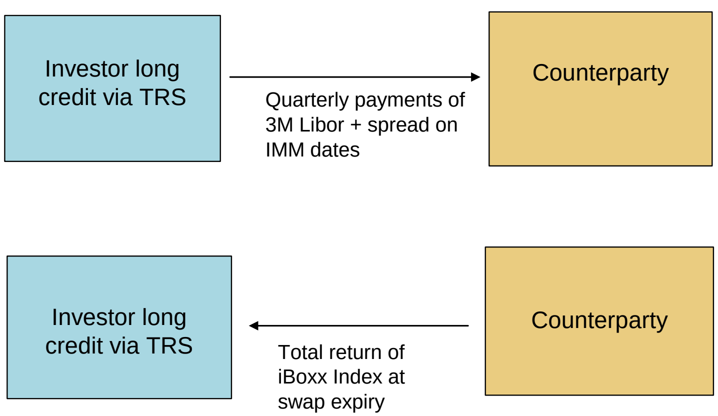
iBoxx Loan TRS | **Introducing iBoxx Loan TRS**

Size of the Leveraged Loan Market



Source: S&P LCD, Morgan Stanley Research

Mechanics of a Total Return Swap



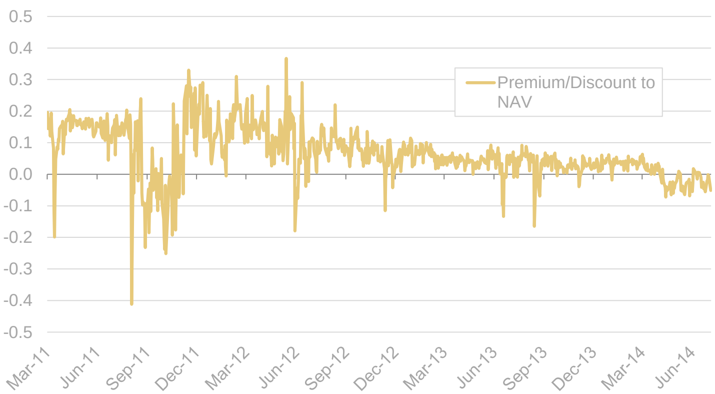
Source: Morgan Stanley Research

The Loan Market Needs Tools: Leveraged loans have seen robust demand over the past few years, driven by growth in overall credit demand, attractive valuations, the floating rate structure, and a revitalized CLO market. At the same time, risk-management-tool liquidity has dried up, an unfortunate outcome given the potential risks in this sector of the credit markets. Markit has recently extended its suite of total return swaps (TRS) to include leveraged loans, a welcome addition, in our view.

What Is the Rationale for Trading TRS? We expect loan TRS not only to help address heavy demand for hedging loan market risk, but also to help investors improve cash management. TRS has some advantages over ETFs, including a reduction in both true market tracking error and the complexities associated with the difference in ETF and underlying loan settlements.

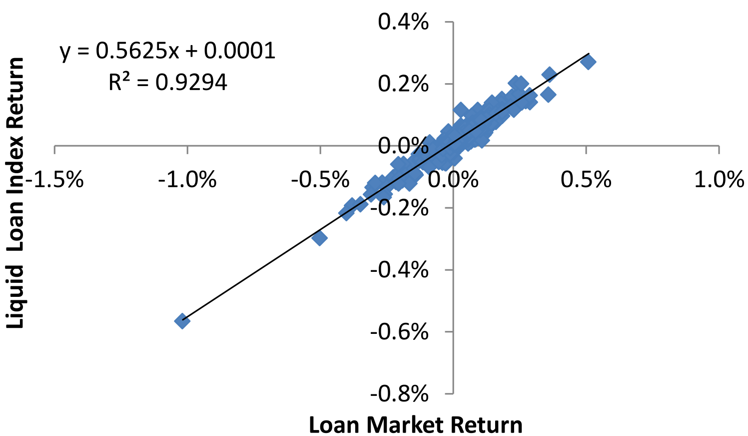
iBoxx Loan TRS | **iBoxx Loan TRS vs. ETFs**

Loan ETF Tracking Error



Source: Bloomberg

Liquid Loan Index Returns versus Loan Market (2012-2014)



Source: Morgan Stanley Research, Markit

Loan TRS offers several advantages relative to ETFs.

- ETFs can be hard to short
- ETFs generally show some tracking error versus the underlying securities. Further, the difference in settlement mechanics between ETF shares and underlying loans creates a basis risk. This could amplify the tracking error in an environment of outflows given the cashflow mismatch.
- Investors have to pay management fees and transaction costs when buying and selling ETF shares. With the loan TRS, bid-offer spread only has to be paid at contract initiation as the settlement happens at mid.

Disadvantages of the Loan TRS

- The underlying index is fixed and may not match investor holdings.
- The Liquid Leveraged Loan index covers just 25% of the market and is less likely to be used as a benchmark. However, our analysis shows that it does track the broader market fairly well.
- Liquidity in unproven. But the iBoxx HY index has seen a significant pick-up in flows over time, with over $3Bn traded over the past 3 months.

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(as of September 30, 2014)

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Total	**3,187**		**880**		

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