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- **Latin America**
- **Europe**
Investment grade remained resilient while high yield struggled in Q4 2014. Signals of risk increased but the market is alive as issuance continues to increase and upgrades outpace downgrades.

Overview:

- **Overall credit markets continued to remain volatile in Q4 2014** – Plummeting oil prices as well as slower global growth sent markets moving sharply. Investment grade outperformed high yield as investors moved towards less risky assets.

- **Risk is re-priced upwards** – The fixed income markets re-priced risk upwards this quarter. Z-spreads increased throughout all sectors and ratings categories. Median equity market-based probabilities of default increased. Notably, the highest increase was in energy as oil prices dropped significantly.

- **Market Activity moved lower in Q4** – Market activity in the high yield space moved to its lowest levels for the year in December, led by utilities, telecom, and materials.

- **Issuance remains healthy but investors are mindful of risk** – Issuance increased in most investment grade ratings categories on a YoY basis. Investors are mindful of elevated risk levels as the percentage of covenants in new issuances have increased.

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MARKET TRENDS
NOTES:

- As of December 31st, the S&P U.S. Investment Grade and High Yield Corporate Bond Indices generated 1.36% and -1.47% in total return, respectively, underperforming the S&P 500® which rallied to finish Q4 up 4.93% in total return.

- As oil continued to plunge we saw a decline in the markets in early December. Approximately 15% of the high yield bond market is comprised of energy bonds, which led the decline in the overall index. As issues in Europe persist, we are observing more volatility and a flight to quality during performance in investment grade this quarter and throughout the year.

Source: S&P Capital IQ as of Jan 1, 2015.
NOTES:

• All z-spreads widened in Q4 of 2014 and risk increased due to concerns that global macro data would be softer than expected.

• The largest increase in Q4 was in energy from 1.65% to 2.18%.

• Consumer staples and materials ended the quarter with the lowest increase in yields.

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<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Total % Change</td>
<td>13.59%</td>
<td>8.40%</td>
<td>31.93%</td>
<td>14.55%</td>
<td>14.65%</td>
<td>14.03%</td>
<td>17.59%</td>
<td>12.98%</td>
<td>15.81%</td>
<td>16.33%</td>
</tr>
</tbody>
</table>

All spreads and yield curves are proprietary data developed from buy-side indicative quotes. All bonds are USD denominated.
Source: S&P Capital IQ as of Jan 1, 2015.
NOTES:

- There was a widening of z-spreads quarter over quarter throughout all ratings categories.
- Within the investment grade space we observed a parallel shift upward throughout the term structure.
- In high yield we saw a steepening in the BB curve, while the B curve flattened.

<table>
<thead>
<tr>
<th>bps Change QoQ</th>
<th>1Y</th>
<th>5Y</th>
<th>10Y</th>
<th>15Y</th>
<th>20Y</th>
<th>30Y</th>
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<tr>
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<td>4.00</td>
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<td>4.00</td>
<td>4.00</td>
<td>4.00</td>
<td>4.00</td>
</tr>
<tr>
<td>AA</td>
<td>5.55</td>
<td>5.55</td>
<td>5.55</td>
<td>5.55</td>
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<tr>
<td>A</td>
<td>16.11</td>
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<td>16.11</td>
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</tr>
<tr>
<td>BB</td>
<td>21.67</td>
<td>44.00</td>
<td>63.86</td>
<td>63.86</td>
<td>83.16</td>
<td>86.65</td>
</tr>
<tr>
<td>B</td>
<td>94.36</td>
<td>73.59</td>
<td>55.14</td>
<td>55.14</td>
<td>37.20</td>
<td>33.95</td>
</tr>
</tbody>
</table>

All spreads and yield curves are proprietary data developed from buy-side indicative quotes. All bonds are USD denominated. Source: S&P Capital IQ as of Jan 1, 2015.
NOTES:

• Market activity declined in Q4 for four consecutive months of decreasing activity in both the investment grade and high yield indices.

• On a QoQ basis, we saw the largest percentage declines in market activity for both high yield utilities and investment grade information technology.

Source: S&P Capital IQ as of Jan 1, 2015. **Market Activity Score (MAS)** is a derived analytic created to provide an indication of the level of trade and market activity associated with a given security. It is developed from a review of all available trades and quotes based on price staleness, number of quotes/market makers and trade data. It is scaled from 1 (high MAS) to 5 (low MAS).
NOTES:
- Q4 2014 saw more upgrades than downgrades, continuing the trend from Q3. However, the upgrade to downgrade ratio deteriorated as downgrades increased this quarter to 99 from 71. We see that more Ratings were on Negative Outlook than Positive Outlook (10% and 8%, respectively), while the majority of issuers remained Stable. This remains consistent with last quarter.

S&P Ratings Services View:
- Mostly stable North American credit conditions could suffer in 2015 from a repricing of credit risk in fixed income markets.
- The U.S. recovery continues to build, with the country's labor market in particular showing signs of strength, while high consumer leverage and low oil prices will limit Canada’s growth prospects.

The Market Derived Signal (MDS) is a quantitative analytic that uses Credit Default Swaps (CDS) to facilitate the interpretation of how the CDS markets generally view the credit quality of well-known firms and sovereigns. It aims to capture the market’s sentiment regarding an entity’s perceived credit risk. One of the objectives of the MDS is to identify where market sentiment may differ from the issuer credit rating. CDS spreads are used to compute the difference between an entity’s actual spread and expected spread for a given rating. Universe is all companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.

**NOTES:**
- The CDS market sentiment has flipped in two sectors. The average CDS score is now higher than the S&P Rating for consumer staples and lower than the S&P Rating for materials.
- Energy has seen the strongest negative movement in CDS vs. S&P Rating from last quarter.
- Overall, the CDS market views 5 of the 10 sectors with better perceived credit quality than their current S&P Ratings, with the highest positive notch difference coming from industrials and utilities, respectively.

### S&P Rating vs. CDS MDS Value

<table>
<thead>
<tr>
<th>S&amp;P Rating</th>
<th>CDS MDS</th>
<th>Value</th>
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<tbody>
<tr>
<td>AAA</td>
<td>aaa</td>
<td>23</td>
</tr>
<tr>
<td>AA+</td>
<td>aa+</td>
<td>22</td>
</tr>
<tr>
<td>AA</td>
<td>aa</td>
<td>21</td>
</tr>
<tr>
<td>AA-</td>
<td>aa-</td>
<td>20</td>
</tr>
<tr>
<td>A+</td>
<td>a+</td>
<td>19</td>
</tr>
<tr>
<td>A</td>
<td>a</td>
<td>18</td>
</tr>
<tr>
<td>A-</td>
<td>a-</td>
<td>17</td>
</tr>
<tr>
<td>BBB+</td>
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<td>16</td>
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<tr>
<td>BBB</td>
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<td>BBB-</td>
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<td>BB</td>
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<td>B+</td>
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<td>B-</td>
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<td>CCC+</td>
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<td>1</td>
</tr>
<tr>
<td>NR</td>
<td>nr</td>
<td>0</td>
</tr>
</tbody>
</table>

### CDS Market Sentiment By Sector

![CDS Market Sentiment By Sector](chart)

The Market Derived Signal (MDS) is a quantitative analytic that uses Credit Default Swaps (CDS) to facilitate the interpretation of how the CDS markets generally view the credit quality of well-known firms and sovereigns. It aims to capture the market’s sentiment regarding an entity’s perceived credit risk. One of the objectives of the MDS is to identify where market sentiment may differ from the issuer credit rating. CDS spreads are used to compute the difference between an entity’s actual spread and expected spread for a given rating. Universe is all companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.
NOTES:

• We have highlighted companies with some of the biggest divergences between their S&P Rating and their CDS Market Derived Signal in red. This provides us with a list of firms whose market sentiment is significantly different than its Rating. As shown by the blue circles, the vast majority of firms were scored +/- 3 notches from their Credit Rating.

• We notice that the CDS market has more bullish outliers than bearish, especially in the lower end of the investment grade spectrum. We see a strong concentration of BBB companies priced in the CDS market with aa risk profiles.

• Some new names to the list this quarter include Capital One Bank, Marsh & McLennan, and Safeway.

The Market Derived Signal (MDS) is a quantitative analytic that uses Credit Default Swaps (CDS) to facilitate the interpretation of how the CDS markets generally view the credit quality of well-known firms and sovereigns. It aims to capture the market’s sentiment regarding an entity’s perceived credit risk. One of the objectives of the MDS is to identify where market sentiment may differ from the issuer credit rating. CDS spreads are used to compute the difference between an entity’s actual spread and expected spread for a given rating. Universe is all companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.
S&P Capital IQ’s proprietary probability of default (PD) model, ‘Market Signals’, is a unique analytical model which provides daily changing, 1-year forward looking PDs of publicly listed companies based on a cutting-edge econometric framework. Universe is all companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.
S&P Capital IQ’s proprietary probability of default (PD) model, ‘PD Model Fundamentals’, provides an innovative approach to assessing potential default that separates credit risk into two components—financial risk and business risk. The PDs are applicable for any public or private company and provide a short- to mid-term view of credit risk. They are based purely on fundamental data—financial ratios and macro factors— and are updated when new financials are released or there is some change in the macro factors. Universe is all companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.

### NOTES:
- Fundamentals improved over the fourth quarter with 7 out of 10 sectors showing stronger credit quality.
- PD Fundamentals showed the largest year-over-year credit improvement in the telecom sector. Contrary to the market view, energy has shown fundamental improvements, but we will await the effects of oil prices as they flow through to the balance sheets of these firms.
- Consumer discretionary had the largest increase in its PD. The companies with the highest risk levels in this sector are American Media and The Gymboree Corporation, respectively.

### Fundamental Implied Default Risk By Sector

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</tr>
</thead>
<tbody>
<tr>
<td>13 Q4</td>
<td>0.80%</td>
<td>0.43%</td>
<td>0.42%</td>
<td>0.13%</td>
<td>0.33%</td>
<td>0.60%</td>
<td>0.47%</td>
<td>0.55%</td>
<td>0.75%</td>
<td>0.22%</td>
</tr>
<tr>
<td>14 Q4</td>
<td>0.88%</td>
<td>0.40%</td>
<td>0.36%</td>
<td>0.13%</td>
<td>0.34%</td>
<td>0.53%</td>
<td>0.42%</td>
<td>0.60%</td>
<td>0.62%</td>
<td>0.21%</td>
</tr>
<tr>
<td>% Change</td>
<td>9.31%</td>
<td>-6.00%</td>
<td>-15.44%</td>
<td>-3.03%</td>
<td>1.20%</td>
<td>-11.07%</td>
<td>-11.22%</td>
<td>8.18%</td>
<td>-17.16%</td>
<td>-5.19%</td>
</tr>
</tbody>
</table>
NOTES:
• We have highlighted companies with some of the biggest divergences between their S&P Rating and their CreditModel (CM) Score, which is purely quantitative, in red. This provides us with a list of firms with fundamental attributes that make them positive or negative outliers. As shown by the blue circles, the vast majority of firms were scored +/- 3 notches from their Credit Rating.
• Within the universe we observed a higher distribution of companies with higher CM Scores than Ratings.
• Companies that are new on the list this quarter include Pilgrim’s Pride Corporation and Mitsubishi International Corporation.

The model output is a stable credit score, which is expressed in the well-known nomenclature of S&P Ratings but in lower case letters, such as bbb, in order to indicate that this score is the outcome of a purely quantitative model. CreditModel Score is trained on ratings, rather than on default data, which helps CreditModel generate a long-term stable view of credit risk that is aligned with a ratings process. Source: S&P Capital IQ as of Jan 1, 2015.
FINANCIAL RATIO TRENDS
NOTES:

- Capital expenditures remained flat YoY but increased slightly from last quarter within investment grade. High yield was higher YoY but lower QoQ.

- EBITDA/Interest Coverage levels have ticked up for both high yield and investment grade issuers as margins continue to grow. At the same time, interest payments remain low due to lower borrowing costs.

- Total debt on balance sheets continues to rise as companies take advantage of lower interest rates in an effort to keep cost of capital down.

Universe is all non-financial companies that have an S&P Long-Term Local Rating, primary headquarters in the US or Canada, and an S&P Capital IQ sector classification. Source: S&P Capital IQ as of Jan 1, 2015.
ISSUANCE TRENDS
Issuance was mainly higher in Q4 for investment grade categories, with the exception of AAA, and lower for all high yield issues.

One of the biggest issuers this quarter was Medtronic issuing over $17 billion in debt.
## Issuance Trends By Security Type

### NOTES:

- Issuance in bonds and notes increased in Q4 2014 vs. Q4 2013 as companies continued to take advantage of low interest rates.

- Convertibles saw significant declines, which may reflect less confidence in the strength of the equity markets and a desire for more yield.

Issuers are public and private companies globally that issue in USD debt in U.S. bond markets. Securities include bonds, convertibles, notes and MTNs. Amounts are aggregated by Date of Issuance. All values in $ billions. Source: S&P Capital IQ as of Jan 1, 2015.

<table>
<thead>
<tr>
<th>Security Type</th>
<th>Q4 2013</th>
<th>Q4 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$17.25</td>
<td>$32.28</td>
</tr>
<tr>
<td>Convertibles</td>
<td>$23.18</td>
<td>$6.76</td>
</tr>
<tr>
<td>Notes</td>
<td>$383.19</td>
<td>$414.11</td>
</tr>
</tbody>
</table>
NOTES:

- The graph represents the percentage of companies with each type of covenant within new high yield issuance.

- We have observed an increase in covenants in Q4 2014 as uncertainty and risk begins to increase. Investors’ protection levels have risen as well.

- The fixed charge covenant increased from 15.4% of issuance in Q3 to 22.6% of issuance in Q4.

Universe includes all high yield corporate debt issuance that is denominated in USD.
Source: S&P Capital IQ as of Jan 1, 2015.
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