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Tight and Tighter

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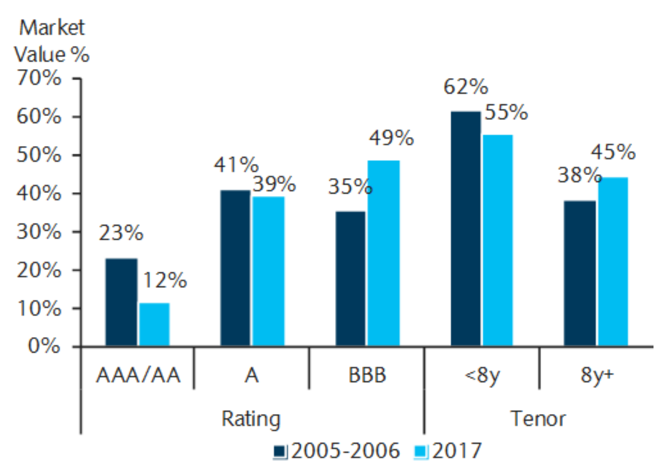
The Bloomberg Barclays Credit Index dropped below 100bp for the first time in nearly three years. Aside from a brief period in the summer of 2014, the index has not maintained a spread below its current level since the pre-crisis years of 2005-06. Over that period, the index composition has changed dramatically, with notable increases in the market value of lower-rated and longer-dated debt. The index market value weight of AAA/AA credit decreased over 10%, and debt with more than eight years to maturity increased over 6% (Figure 1). After we adjust for these differences at an index level, we find that spreads are less than 5bp off their average level for 2005-06, although they remain roughly 15bp off the tights (Figure 2).

Dissecting the index into financials and non-financials, the majority of rating deterioration has occurred in the former. While the term structure for financials remains consistent with pre-crisis levels, lower-rated debt nearly doubled its market value weight over the past decade (Figure 3). In particular, BBB rated debt comprised only 11% of financials' market value in 2005-06, while today BBBs are close to 40%, even though subordinated bank debt's share of financial market value has declined by 50% over the period. This rating migration partly explains the cheapness of financials currently relative to pre-crisis levels: from 2005 to 2006, the corporate index traded roughly 20bp wide of financial credit; that difference is about 4bp now.

However, even after adjusting for subordination and compositional differences, financials trade meaningfully wide of pre-crisis levels (Figure 4 compares senior financial spreads across different rating/maturity buckets between 2005-06 and now). This is driven partly by concerns about TLAC supply and the increase in USD-denominated European bank debt, which generally trades wider than US bank paper (see *Banking on Yankees Going into Summer*). That said, we see room for further compression in US bank spreads, especially as the TLAC technical abates (see *US Banks: 2Q17 Supply Update: Favorable Conditions Keep the Spigot Open*).

FIGURE 1

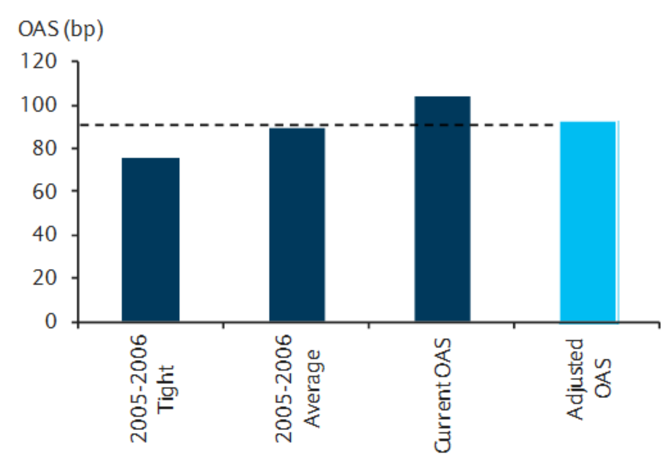
The Index Has Shifted to Lower-Quality, Longer-Dated Credit, Making Pre-crisis Comparisons Challenging



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 2

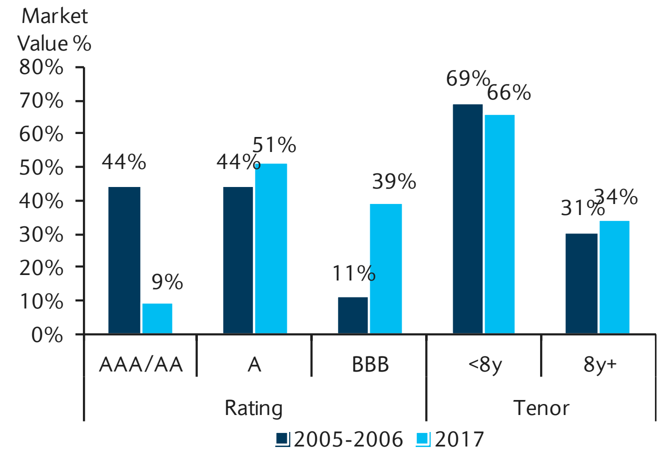
After Adjusting for These Changes, Spreads Appear in Line with Their Pre-crisis Average



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 3

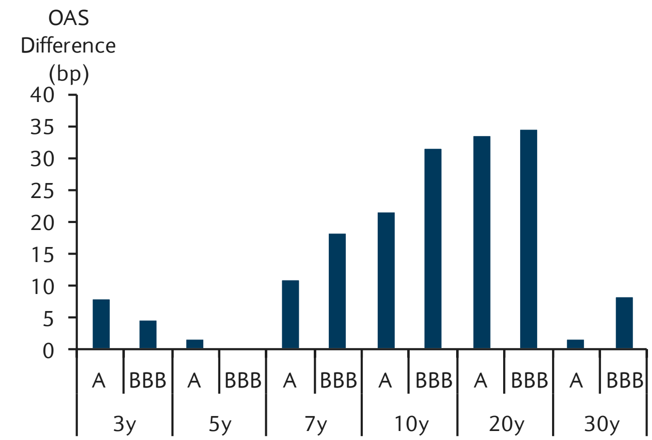
Financials Remain Heavily Weighted in the Front End, but Ratings Have Been Downgraded Significantly



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

Senior Financial Spreads across Ratings and Tenor Are Wide of Pre-crisis Levels



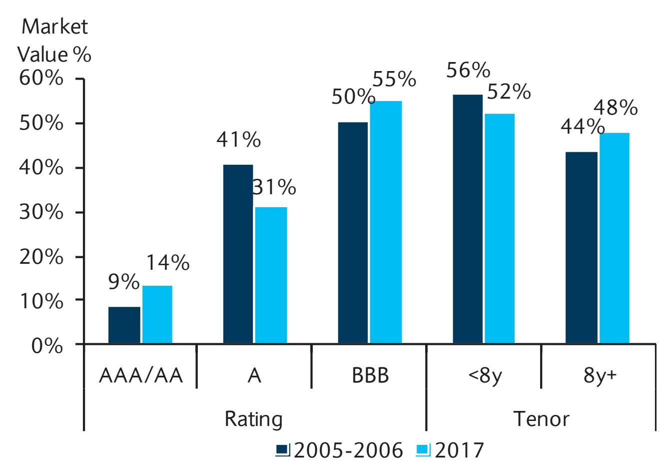
Source: Bloomberg Barclays Indices, Barclays Research

Industrials have largely seen a more balanced change in composition (Figure 5). While there has been an increase in BBB rated and 20-30y debt (the sector's market value share increased roughly 4% for each from 2005 to 2006), we also see added market value share in AA rated credit and bonds in the 1-3y maturity bucket (each increased more than 3% in the same period). Comparing valuations across the ratings/maturity buckets, A rated paper consistently trades through pre-crisis averages, while BBBs appear more in line or slightly wide, particularly for longer-dated paper. One part of the market that still offers substantial pickup versus 2005-06 spreads is BBB rated 20y debt (Figure 6).

Although we do not see an identifiable near-term catalyst for spread widening, we believe that investors should focus on pockets of the index where relative value looks somewhat attractive. Within the industrials sector, 7-20y BBBs stand out as attractive, trading materially wider than pre-crisis levels, unlike the rest of the industrials sector.

FIGURE 5

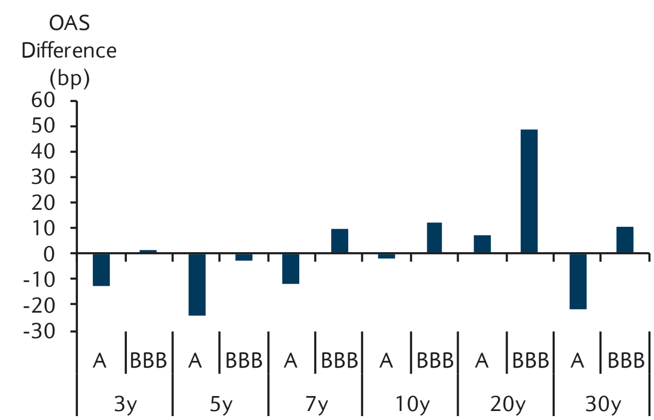
Industrial Composition Has Not Changed Materially



Source: Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 6

A Rated Spreads Are Tight of Pre-crisis Levels, while BBBs Are in Line or Slightly Wide



Source: Source: Bloomberg Barclays Indices, Barclays Research

CDS: Limited Room for Further Compression

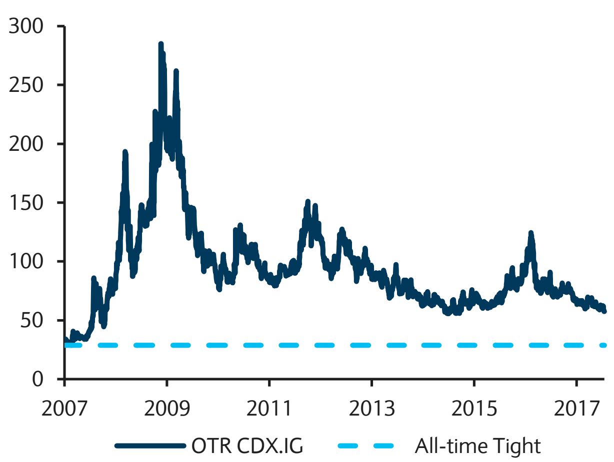
Similar to the performance in the cash market, spreads in the derivatives market have rallied, with CDX.IG now within 2bp of its post-crisis tight of 56bp in July 2014. While spreads now appear tight relative to post-crisis levels, they remain more than 28bp wide of the all-time tight of 28bp in February 2007 (Figure 7). At a high level, this would seem to indicate that there is potential for the index to rally further, particularly if the macro backdrop remains benign. But there are notable differences between the index today (IG28) and the index back then (IG7), which we believe, when taken together, make it unlikely that the index will compress meaningfully from current levels.

In 2007, the biggest factor driving spreads to very tight levels was the presence of synthetic CDOs, which were sizable sellers of protection. During that period, there was significant leverage available, which made it attractive to sell protection even at low absolute spread levels. At the time the index reached its all-time tight, more than half of index constituents were trading inside of 20bp (Figure 8). In contrast, today there is less leverage available for these trades, and structured credit is not a significant part of the market. Currently, only 10% of IG28 constituents trade inside of 20bp, and unless structured products (or similarly prolific sellers of protection) are meaningfully reintroduced to the market, we do not expect a large number of index constituents to trade at very tight levels. Another difference between the index today and the index in 2007 is quality. IG28 is of lower average quality than IG7 was back in 2007: Baa1 versus Baa1/A3.

While we do not believe that the index can tighten significantly from current levels, one factor, in particular, could support a further modest rally: the number of relatively wide-trading constituents in the index. As Figure 8 shows, 23% of IG28 constituents trade wider than 80bp. The majority of these credits are from the retail and energy sectors (16 of the 29 credits). While they are trading wide for a reason, meaningful fundamental improvement in these sectors could support index tightening. To put the potential effect on the index into context, if the retail and energy credits trading wider than 80bp tightened 25%, it would take the intrinsic spread of the index 5bp tighter.

FIGURE 7

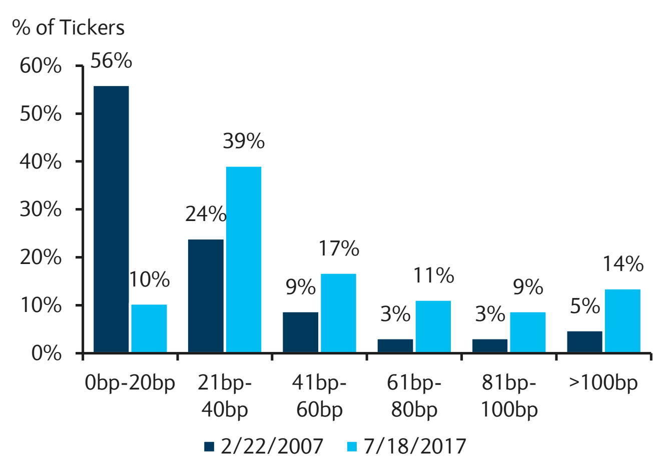
On-the-Run CDX.IG Spread (bp)



Source: Barclays Research

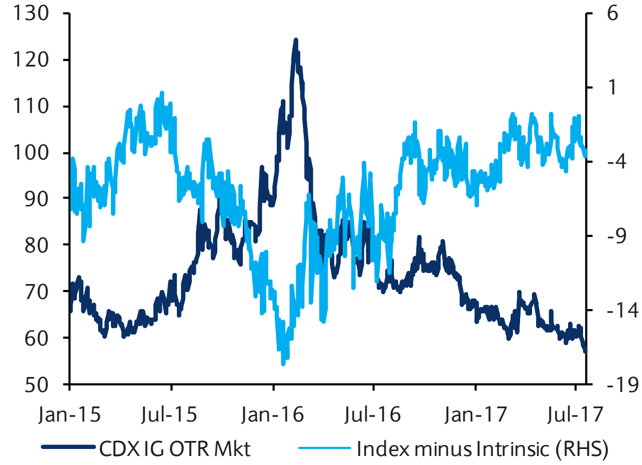
FIGURE 8

CDX.IG Constituent Spread Distribution



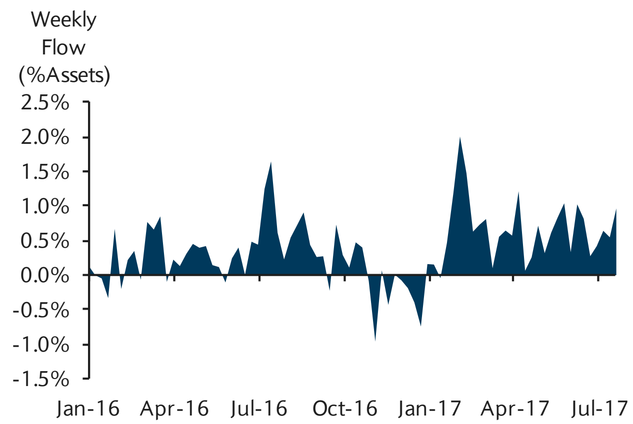
Source: Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



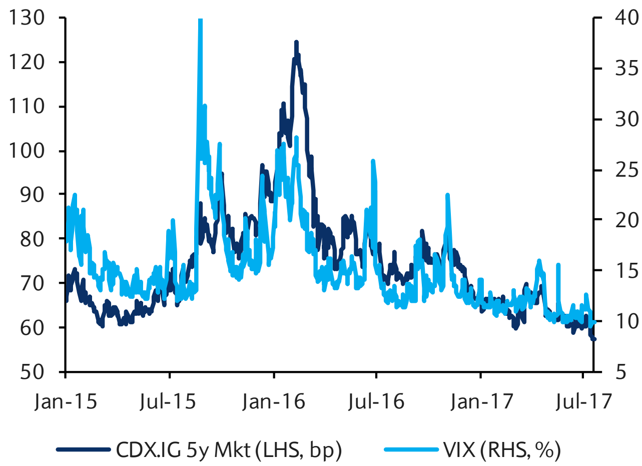
Source: Barclays Research

EPFR Weekly Investment Grade Corporate Fund Flows



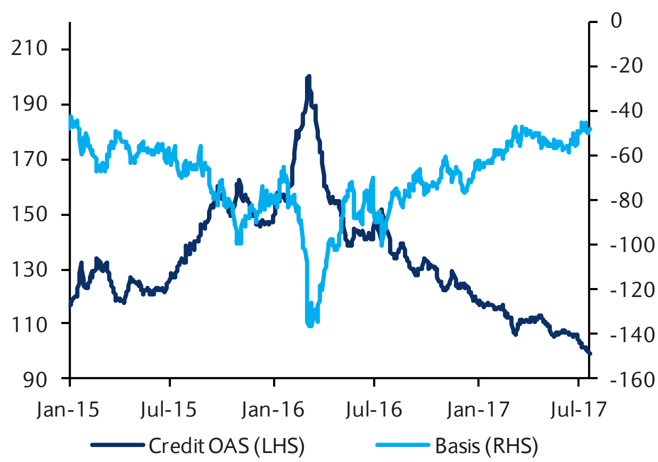
Source: EPFR, Barclays Research

CDX.IG versus VIX



Source: Markit, Barclays Research

CDS-Cash Basis (bp)



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

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