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Earning Your Curve

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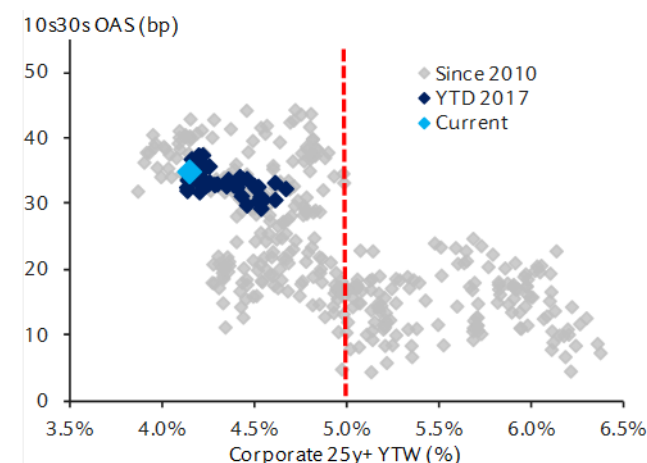
The Bloomberg Barclays Corporate Index OAS is roughly 3bp wider this week going into Thursday's trading session. If we end the week at current levels, it would mark just the seventh week over the past twelve months during which the index widened more than 1bp. Despite the compression broadly experienced with the steady grind tighter – spreads overall are 33bp tighter over the past twelve months – index level 10s30s curves have remained relatively stable, even as long-dated yields have come down (Figure 1).

However, this top-line stability masks a fairly wide dispersion in how sector curves have performed, with curves steepening in sectors that have increased leverage, such as communications and consumer cyclical, while deleveraging sector curves such as energy and consumer non-cyclical have flattened year-on-year (Figure 2). This suggests that there is room to pursue relative value among sectors and within individual curves even in the current low-volatility environment.

Longer term, we believe the shape of the 10s30s OAS curves should be driven in part by earnings volatility – with higher volatility leading to added risk of significant fundamental weakness, which should result in steeper 10s30s curves. Conversely, spread curves should be flatter for more stable businesses. To test this, we compare the historical volatility of quarterly growth over the prior year in operating income before depreciation for a universe of matched senior 10y and 30y debt for non-financial issuers. In general, BBB credits have higher earnings volatility and steeper 10s30s curves. At the index level, the 10s30s of the least volatile earnings quintile are roughly 10bp flatter than those of the most volatile quintile (Figure 3). This relationship is more pronounced within BBBs (among which the most volatile quintile 10s30s is around 12bp steeper than the least), although it holds for single-A issuers as well (with about a 6bp difference between the least volatile and the most volatile quintiles' 10s30s OAS).

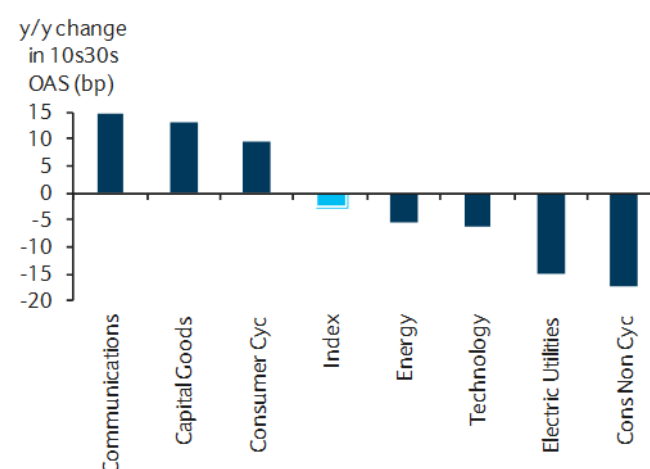
The relationship between earnings volatility and 10s30s curves holds at a sector level as well. The energy and communications curves remain the steepest in absolute terms. As our prior observations on earnings volatility would suggest, these two sectors have the highest historical earnings volatility, while sectors with lower volatility have flatter 10s30s curves (Figure 4).

FIGURE 1
Index-Level 10s30s Have Not Moved over the Past Year...



Source: Bloomberg Barclays Indices, Barclays Research

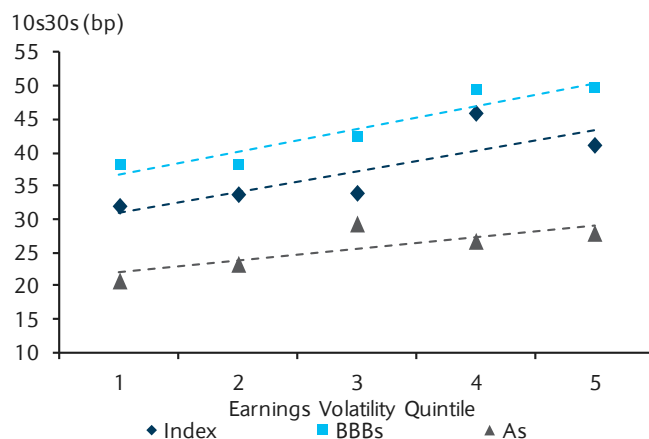
FIGURE 2
...Although Sector 10s30s Performance Is More Dispersed



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 3

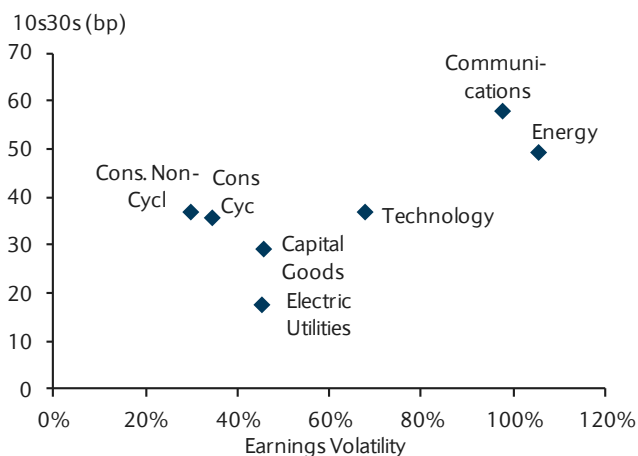
Average Historical 10s30s OAS by Earnings Volatility Quintile



Source: Compustat, Bloomberg Barclays Indices, Barclays Research

FIGURE 4

Median Current 10s30s OAS versus Historical Earnings Volatility for Major Sectors



Source: Compustat, Bloomberg Barclays Indices, Barclays Research

Overall, while 10s30s credit curves appear somewhat flat for the level of long-dated corporate bond yields, we believe this is driven partly by the influx of demand from Asian life insurance companies, which typically have lower yield bogeys than their US counterparts. While, on the whole, we believe that 30y debt valuations are fair relative to 10y debt, from a ratings perspective, BBB 10s30s curves are historically steep, trading at the steepest levels relative to the index looking back to 2000 (Figure 5). Conversely, single-A curves are relatively flat to the index.

FIGURE 5

Average 10s30s OAS for Senior Non-Financials



Source: Bloomberg Barclays Indices, Barclays Research

Consequently, we favor flatteners among steep BBB curves in sectors with relatively low earnings volatility and steepeners among flat single-A curves with relatively high earnings volatility. Figures 6 and 7 present our screen of select flattener trades in BBBs and steepener trades in As. In addition to looking at issuer curves from a valuation perspective, we also include a filter for historical earnings volatility:

1. For BBBs, we screen for liquid 10s30s flatteners among issuers with below-the-median BBB earnings volatility whose curves have steepened the most year-to-date. We exclude issuers with Underweight ratings from our fundamental analysts.

2. For As, we screen for liquid 10s30s steepeners among issuers with above-the-median single-A earnings volatility whose curves have flattened the most year-to-date. We exclude issuers with Overweight ratings from our fundamental analysts.

FIGURE 6

Sell 10y and Buy 30y BBBs in Steep Issuer Curves with Lower Earnings Volatility

Ticker	10y Bond	10y OAS (bp)	30y Bond	30y OAS (bp)	10s30s
SYN	3.3s of 26	91	4.85s of 45	139	47
LMT	3.55s of 26	76	4.07s of 42	121	45
LH	3.6s of 27	119	4.7s of 45	163	44

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 7

Sell 30y and Buy 10y Single As in Flat Issuer Curves with Higher Earnings Volatility

Ticker	10y Bond	10y OAS (bp)	30y Bond	30y OAS (bp)	10s30s
MA	2.95s of 26	60	3.8s of 46	88	28
NKE	2.95s of 26	60	3.8s of 46	91	31

Source: Bloomberg Barclays Indices, Barclays Research

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LH 4.7 02/01/45 (USD 105.69, 08-Nov-2017)

LOCKHEED MARTIN CORP, CD/CE/D/E/J/K/L/M/N

LMT 3.55 01/15/26 (USD 104.21, 08-Nov-2017)

LMT 4.07 12/15/42 (USD 103.50, 08-Nov-2017)

MASTERCARD INC, A/CD/CE/D/E/J/K/L/M/N

MA 2.95 11/21/26 (USD 100.10, 08-Nov-2017)

MA 3.8 11/21/46 (USD 103.74, 08-Nov-2017)

NIKE INC, CD/CE/D/J/K/L/M/N

NKE 2 3/8 11/01/26 (USD 95.37, 08-Nov-2017)

NKE 3 3/8 11/01/46 (USD 94.40, 08-Nov-2017)

SYSCO CORP, A/CD/CE/D/J/K/L/N

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SYY 4.85 10/01/45 (USD 112.73, 08-Nov-2017)

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