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How Much More Room to Run?

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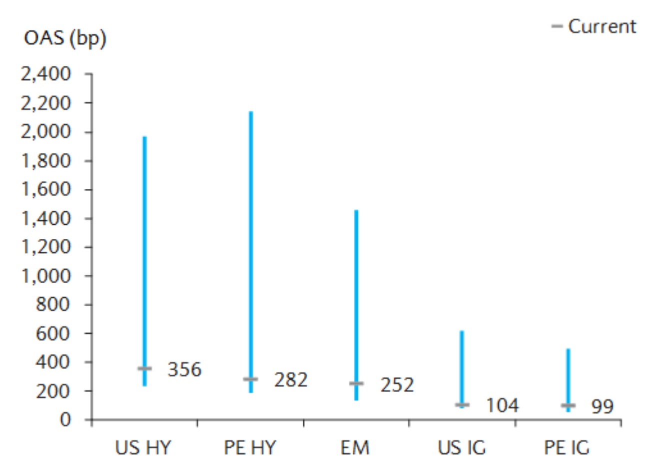
In last week's *US Credit Alpha*, our investment grade credit strategy colleagues examined the broader IG market valuation level with some historical context (see *Tighter and Tighter*) as the Investment Grade Credit Index finally broke through 100bp. The natural follow-up for us is how the US high yield market fares under a similar historical lens, incorporating both favorable and adverse adjustments to historical trading levels. But we come to some notably different conclusions for high yield that still back a modestly constructive stance.

Using History as Guide, What Could Support Tighter Spreads

To start, in Figure 1, we set the valuation stage by mapping the current range of valuations across the major US credit asset classes since the beginning of 2007. It is no surprise to see spreads across all assets quickly closing in on their 10-year tights. We are well aware that trading liquidity, market size, investor composition, price convexity, and duration differences complicate true comparisons across assets over time. But the chart simply reminds us of the dearth of "spready" alternatives available to fixed income asset managers today. Specific to US high yield, as we noted last week (see *No Accounting for Taste in Quality*), while the BB index as a percentage of the overall High Yield Index is through its 10-year average, Bs and CCCs still look to have room to compress along this metric.

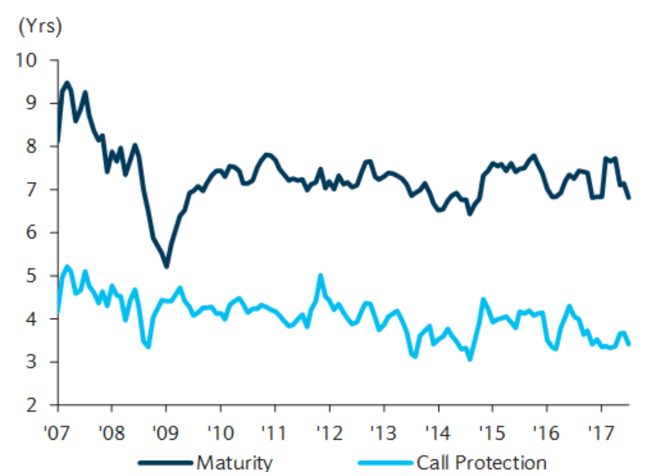
More important, in stark contrast to the changes in the investment grade market, the high yield market today is actually of higher quality (using purely ratings cohort as a proxy) and shorter duration relative to the opportunity set that existed at the historical tights. Those changes have recently been driven by fallen angel and default activity (a net positive for quality), a market structural trend toward shorter call protection in new issues (Figure 2), and a less robust M&A environment that has limited net new issuance since announced M&A peaked in 2015 (allowing the high yield market to roll down the curve). Adjusting the current index spread of 356bp for these differences results in an adjusted High Yield Index level of 390bp, almost 160bp wider than the 2007 tights and almost 70bp wider than the 2014 local tights (Figure 3).

FIGURE 1
Few Spready Alternatives to US High Yield in a Global Fixed Income Context



Source: Bloomberg Barclays Indices. Range indicated from January 2007 to present

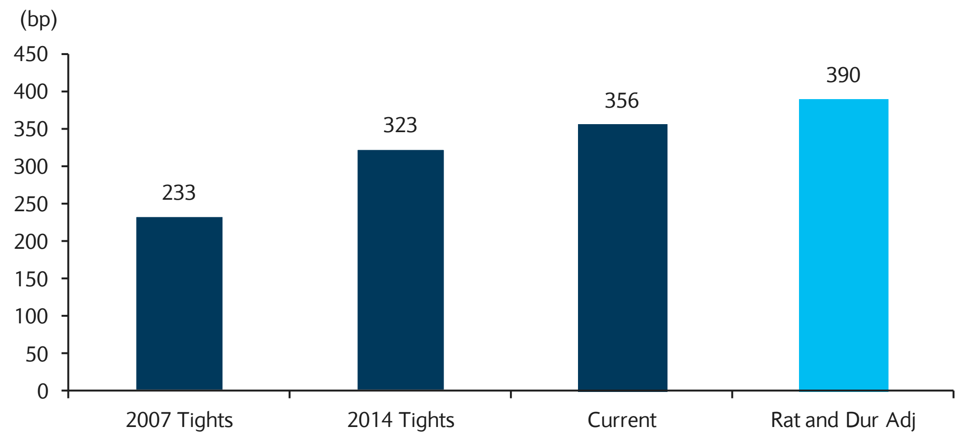
FIGURE 2
Duration of High Yield Issuance Has Shortened Significantly, and Call Protection Is Near the Lows



Source: Bloomberg Barclays Indices

FIGURE 3

Today's High Yield Market Is Shorter in Duration and Higher in Quality, Resulting in an Even Wider Adjusted Spread



Source: Bloomberg Barclays Indices

Next, while we all debate how far along we are in the economic and credit cycles, we think it is important to acknowledge that the commodity sectors broadly (approximately 14% of the par-weighted risk in the US High Yield Index) have already undergone a reasonable amount of credit repair after the 2015-16 stresses. That recovery would have typically occurred in the early stages of a broader credit cycle. Energy companies and miners, in particular, have spent a good portion of the past 18 months selling assets, "equitizing" balance sheets, repaying debt, and enjoying a fall in leverage courtesy of a recovery in underlying commodity prices. We believe it is difficult to argue that the high yield credit market is uniformly "late cycle" across sectors. As a result, we find reasonable scope and rationale for high yield credit spreads to move tighter from here, despite the fact that all-in-yields are closer to historic lows than spreads are to their tights.

What's the Pushback?

Nonetheless, there is reasonable pushback to the above supportive points that we share with some investors. First, fallen angel activity has a mixed effect on our assessment. While many of the fallen angels have landed as BBs, improving the optical quality of the high yield market, as noted above, those same fallen angels lack the typical protections for creditors traditionally found in a standard high yield covenant package. It is difficult to quantify how much a less uniform set of covenants in high yield resulting from fallen angel activity should be worth in spread terms. But investors are right to highlight the divide that should be reflected as some incremental compensation at the index level.

Next, one could argue that there should be a floor on how tight spreads can go just as a function of the prevailing interest rate environment. While US high yield spreads today are wider than historical tights, all-in yields clearly are not. Historically low fixed income yields may not matter as much for the investment grade market, where excess returns are the prevailing performance. Meanwhile, high yield is clearly considered more of a total return asset class, with higher direct retail investor participation (and equities serving as a competing asset allocation). Today's low all-in yields leave total returns vulnerable to shrinking breakeven moves higher in UST yields. Furthermore, coupons in a high yield portfolio have traditionally generated income to buffer principal losses through defaults that will undoubtedly occur in every high yield portfolio. But historically, low coupons and yields have served as a hurdle to how tight spreads can go, in light of the need for income to offset principal losses in the next default cycle.

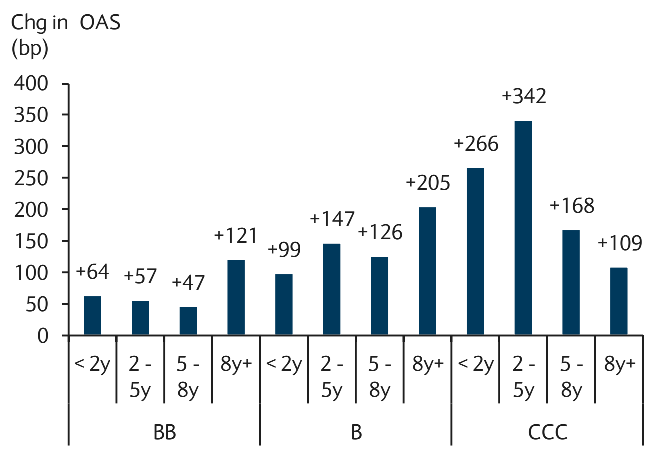
Breaking Down the Historical Comparison across Quality and Duration

In Figure 4, we show the difference of index spreads in various maturity buckets across rating cohorts versus the all-time spread tights, set in 2007. With the exception of longer-dated CCCs (itself a relatively small sample set), it confirms that credit quality curves have steepened over time, despite an accommodative primary market that has allowed stressed issuers to come to market over the past several years. It also confirms our thoughts from last week, that Bs and CCCs look to be more attractive new money allocation buckets than high dollar price, call-constrained BBs.

Figure 5 provides some detail on our earlier observation that the High Yield Index duration has shortened over time. Market value representation in the High Yield Index of two-year and shorter risk has increased across all ratings cohorts, while 8+ year risk has decreased across all cohorts. These two observations lead us to conclude that short-dated Bs and CCCs are an interesting opportunity space today for investors looking to add risk.

FIGURE 4

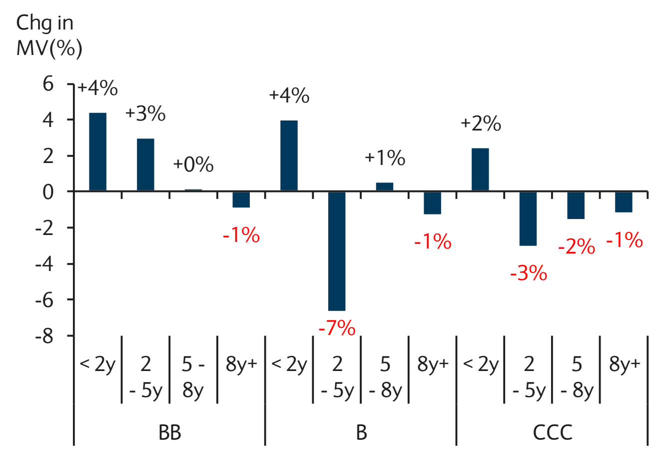
A Steeper Credit Curve and Wider Spreads across All Maturity Cohorts Compared with the 2007 All-Time Tights



Source: Bloomberg Barclays Indices

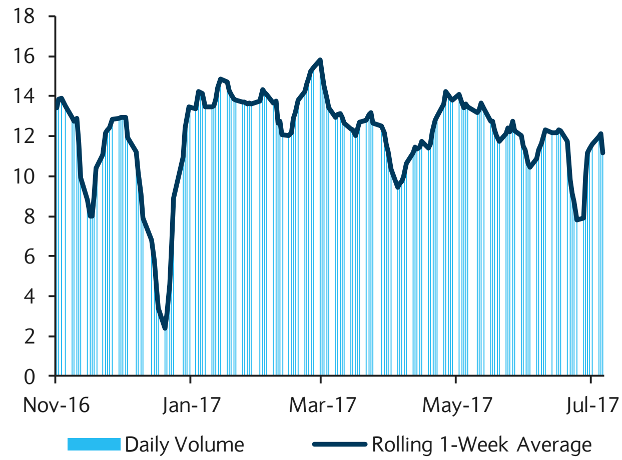
FIGURE 5

Risk Has Migrated to Short Maturities, Consistent with the Shortening of the High Yield Index Duration



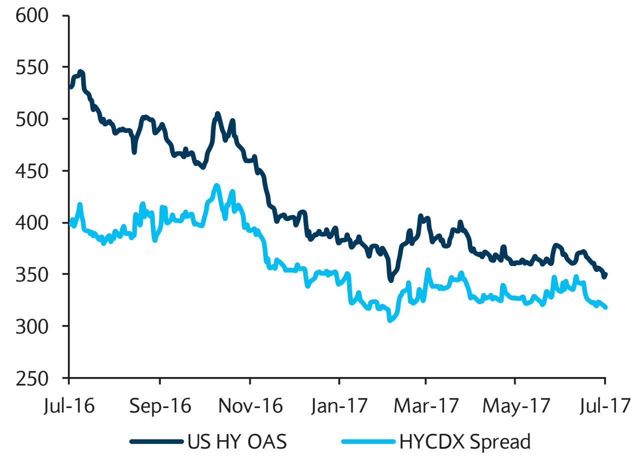
Source: Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)



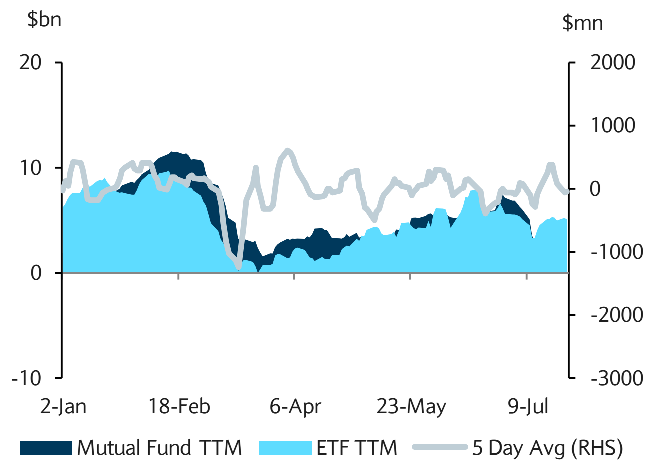
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)



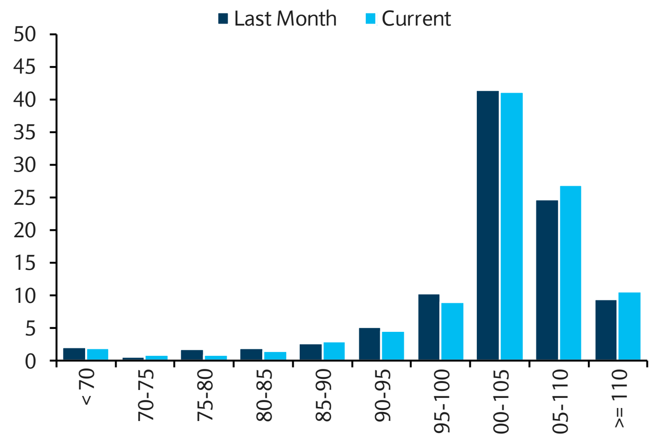
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



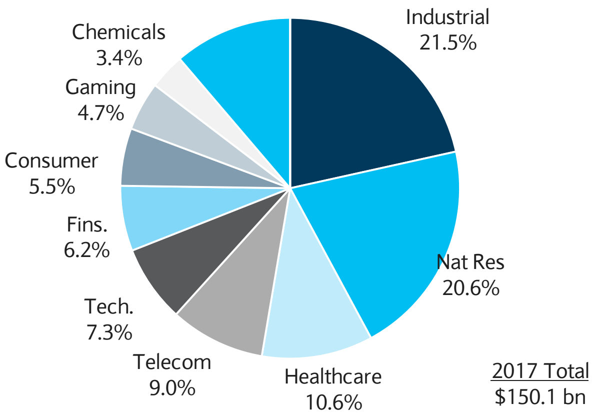
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



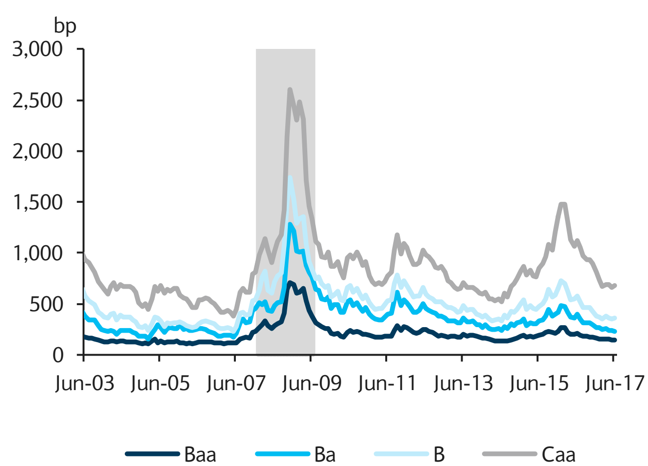
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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