Previously published in the U.S. Credit Alpha
5 January 2018

A Walk down Sub-Carry Memory Lane

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In our 2018 US High Yield Credit Outlook, *Lower Highs*, we forecast total returns of 4.5-5.5%, given our view of a modest rates bear-flattening and benign defaults, but tight starting spreads and mixed effects from tax reform. Considering our tepid return expectations, we approach 2018 with an eye to how similar years played out historically. We identified four distinct years (2005, 2007, 2011, 2014) of returns that ranged from low to mid-single digits, similar to our forward view. While we are hesitant to rely purely on historical precedent, as each cycle is different, understanding how different segments of the market performed during each of these periods can be useful in framing the 2018 relative value picture and performance expectations.

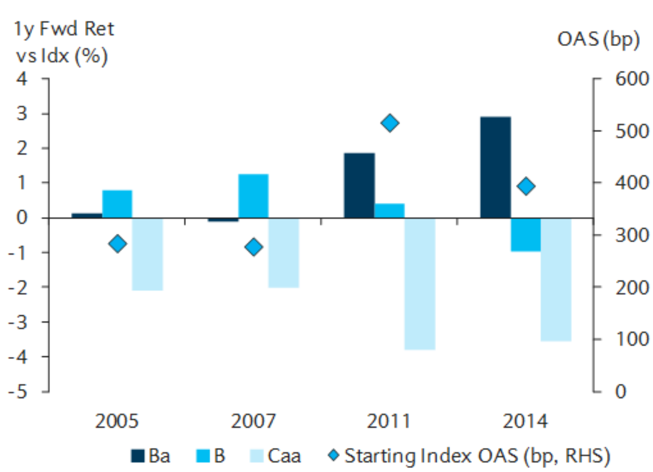
Preference for Higher Quality over Lower Quality

The performance of high yield in prior sub-carry periods supports our modest preference for higher quality in 2018. Figure 1 tracks the excess returns for each quality bucket relative to the index for each of the periods observed and, not surprisingly, shows that Bs and BBs consistently outperformed CCCs. Whlie we do not expect CCCs to underperform by nearly the same extent this year, limits on interest deductibility according to the revised tax code are a definite negative for lower-quality issuers, albeit to a lesser extent than the original standalone Senate proposal (see the Focus section for details).

The relative ranking of BBs and Bs has been less consistent during these periods. In 2005, a more aggressive and persistent Fed hiking path than we see for 2018, as well as an associated bear-flattening of the rates curve, weighed on BB performance. That outcome was exacerbated by lower starting spreads (Figure 1). While rates actually rallied in 2007, outsized exposure to financials produced a drag on BB returns that year.

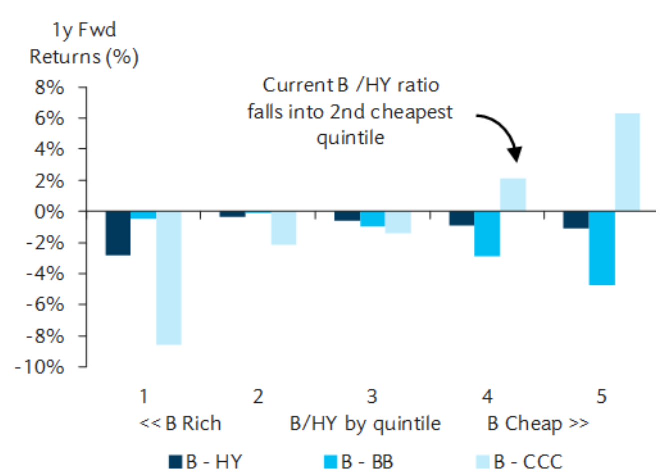
Despite the recent cheapening of Bs relative to BBs and our expectations of a rates bear-flattening, we expect modest underperformance of Bs with respect to BBs on an absolute basis and a more meaningful underperformance on a risk-adjusted basis. Our modest preference for higher quality is informed by a view that proactive deleveraging in higher-quality segments will help counterbalance the effects of a rates bear-flattening. The second

FIGURE 1
Relative Performance during Sampled Sub-Carry, Positive Return Periods



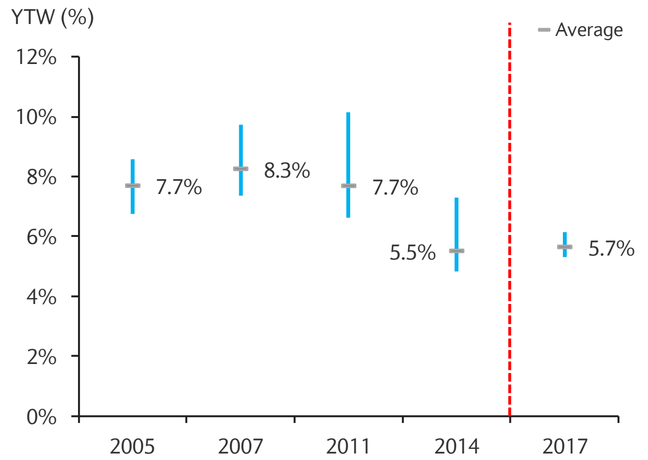
Source: Bloomberg Barclays Indices

FIGURE 2
Annualized Total Returns of Bs Relative to Other Segments, as a Function of the B/HY Ratio



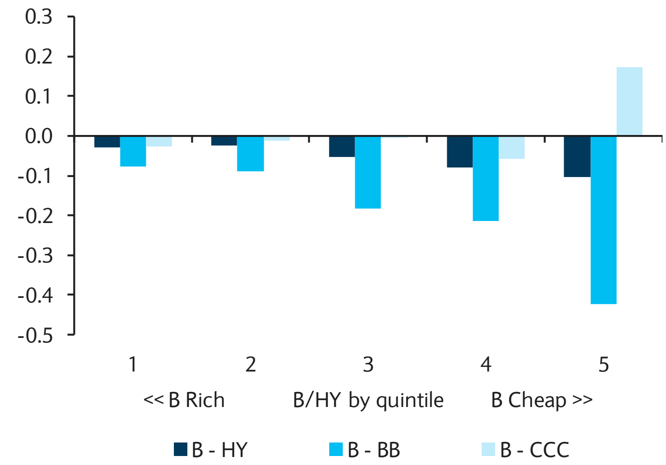
Source: Bloomberg Barclays Indices

FIGURE 3
Ranges in Yield-to-Worst in Sub-Carry Return Environments and 2017



Source: Bloomberg Barclays Indices

FIGURE 4
Sharpe Ratio of Bs Relative to Other Segments, as a Function of the B/HY Ratio



Source: Bloomberg Barclays Indices

reason for our preference is the relationship between starting B valuations and forward returns. Figure 2 ranks the average differential in one-year forward performance of Bs relative to other parts of the market by quintiles of the starting B to HY spread ratio, which we use as a proxy of relative richness/cheapness of Bs. As shown, BBs have managed to outperform even when Bs have been historically wide. And while challenged by tight valuations and high call constraints, a more modest BB outperformance is, in our view, warranted for these reasons.

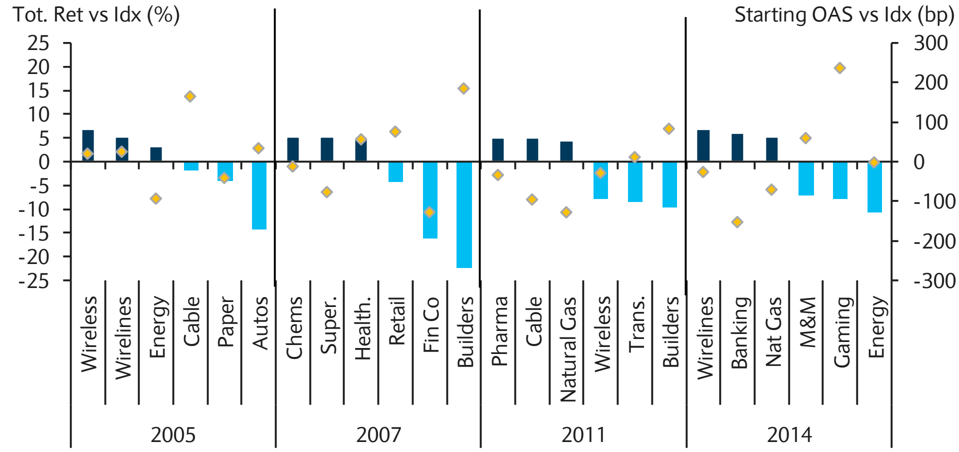
We expect more meaningful underperformance of Bs relative to BBs on a risk-adjusted basis, especially if volatility returns to the levels of other sub-carry periods (Figure 3). The ranges of the market YTW in 2005, 2007, 2011, and 2014 were markedly wider than that in the above-carry year of 2017. So while we do not see the ingredients for a climb in volatility akin to 2007 (the eve of the financial crisis) or 2011 (Euro-sovereign worries), we believe Bs will underperform should the high yield market volatility simply climb from 2017's subdued levels. Figure 4 shows that they have consistently underperformed on Sharpe ratio, the level of cheapness/ richness notwithstanding. And we would expect this trend to continue, as the implications of tax reform are mixed for B issuers, while a clear positive for the vast majority of BB (and higher-rated) issuers.

No Discernible Sector Patterns in Sub-Carry Return Environments

Finally, an analysis of relative sector performance over the sampled sub-carry return periods reveals less distinct patterns. Figure 5 ranks the top three best- and worst-performing sectors in the index for each of these periods and the starting spreads for each sector relative to the index. The worst-performing sectors were driven by a few specific narratives (OEM auto downgrades from investment grade in 2005, fincos and builders in 2007, and energy in 2014) despite higher starting spreads. Our takeaway is that starting spreads, while a useful barometer for sector performance for other sectors in similar periods, display no clear relationship with forward returns for sectors that end up performing the best and worst in sub-carry return environments (see *Sector Opportunities Widespread*). Today, retail, wirelines, media, and supermarkets are four such sectors that trade meaningfully wide of the index but are rated Underweight by our fundamental analysts, since risks of structural deterioration outweigh the benefit from wider starting valuations.

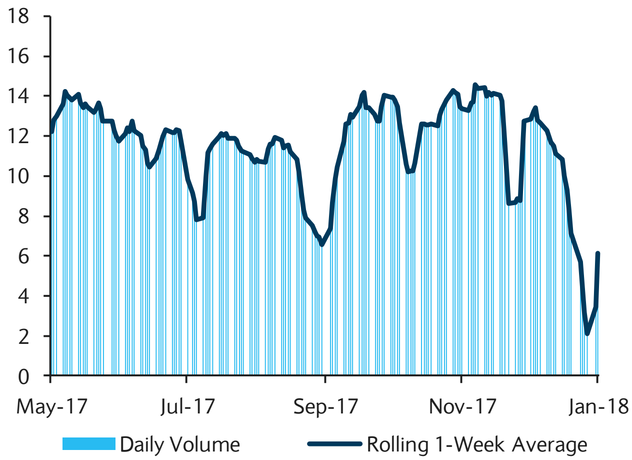
FIGURE 5

Sector Performance during Sampled Sub-Carry, Positive-Return Periods



Note: Yellow diamonds reflect the difference in sector spreads and the index OAS on the right-hand-side axis.
Source: Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)

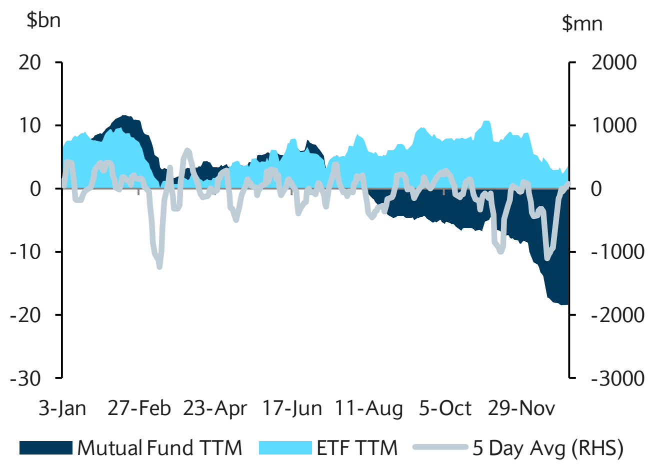


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

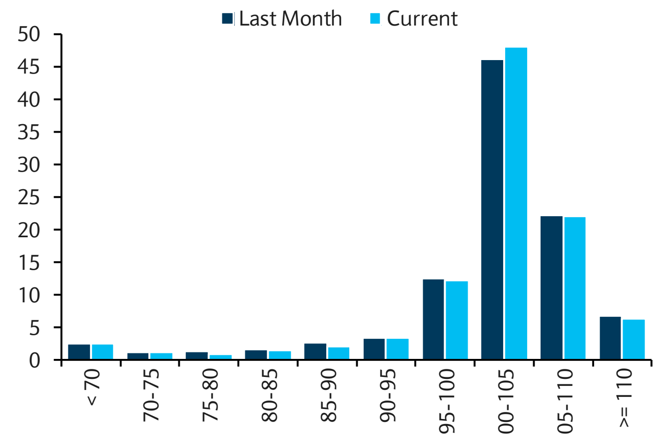
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs (YTD)



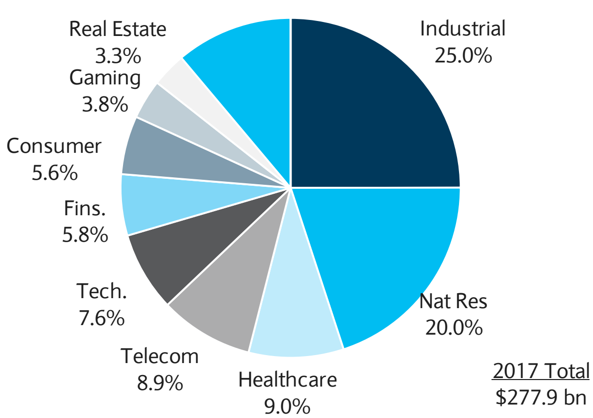
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



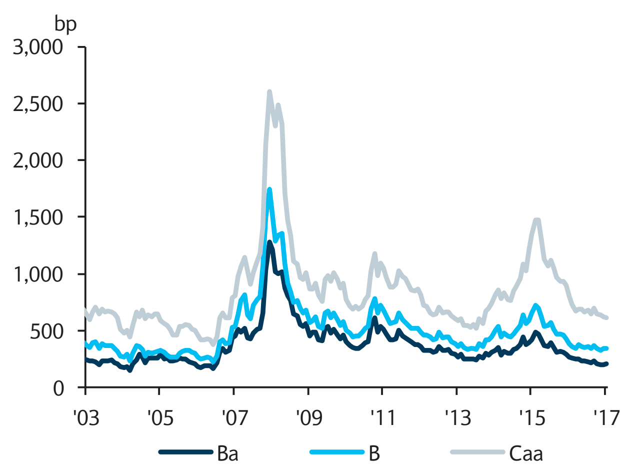
Source: Barclays Research

High Yield Supply by Sector (YTD)



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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