

Fuller Cushions in Low-Quality Short Duration

Update: This publication has been updated to add important conflict of interest disclosures for one or more of the companies that are the subject of this report.

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com
BCI, US

Rizwan Hussain
+1 212 412 7997
riz.hussain@barclays.com
BCI, US

Arvind Kumar
+1 646 333 1184
arvind.kumar4@barclays.com
BCI, US

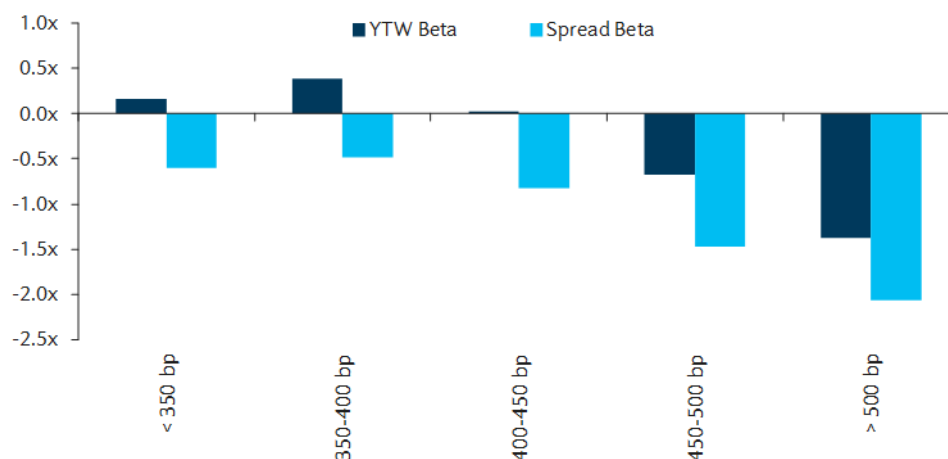
The impending start of Fed balance sheet normalization, a pickup in certain inflation measures, uncertainty about the next Fed chief nomination, and the potential for growing budget deficits as a result of the administration's current tax reform proposal have all conspired to propel both Treasury yields and swaption volatility off their recent lows. More recent, stability has been positive for high yield credit, however, with approximately \$2.9bn of inflows to high yield funds (per Lipper data) over the four weeks ending October 11. Those flows have helped drive the US High Yield Index to near year-to-date tightness. However, the relationship between changes in risk-free spreads and the shape of the Treasury curve and the implications for credit spreads across duration and quality over the medium term can be complex and invites further study.

To start, history shows that spread reactions to moves in risk-free yields are themselves a function of spread levels. Figure 1 displays the betas of simple regressions using five years of data over various levels of prevailing index spreads. The yield to worst beta captures the betas of regression of the yield changes in the Ba/B US high yield index and 5y US Treasuries.¹ The spread beta similarly tracks weekly spread changes versus Treasuries. Simply put, spread betas of -1.0x or greater indicate spread moves that fully offset the underlying changes in risk-free yields. That threshold is observed for the 450-500bp and >500bp index spread regimes. At tighter spreads, moves wider or tighter have not consistently offset the underlying move in Treasuries.

So while the data confirm intuition that spread tightening has helped absorb moves higher in Treasury yields, particularly when index spreads have been wider, where along the duration spectrum should investors focus? In a previous report (*Lift the Barbell, Trim the Belly*), we concluded that a duration barbell strategy was the most effective way to position for the bear flattening that our interest rate strategy team expects (*Stormy Weather Ahead*). Currently, it forecasts that 2y UST yields will increase by approximately 40bp, to 1.90%, by 3Q18, with 10y USTs largely pegged at current levels around 2.40%.

FIGURE 1

Ability of Spreads to Counterbalance UST Yield Changes Depends on the Starting Level of Spreads

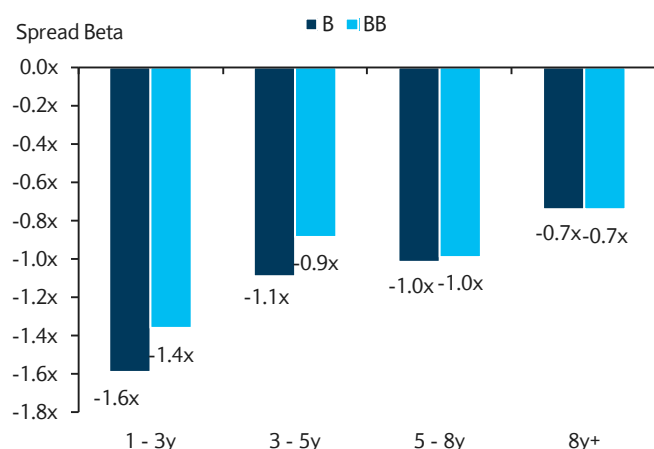


Source: Bloomberg Barclays Indices

¹ We have not considered CCC risk generally, as we consider idiosyncratic credit developments for this rating cohort to be more relevant than risk-free yield changes and associated spread moves in driving dollar prices and returns.

FIGURE 2

Historically, Short-Dated Spreads Have Shown Significant Cushion against Rates...

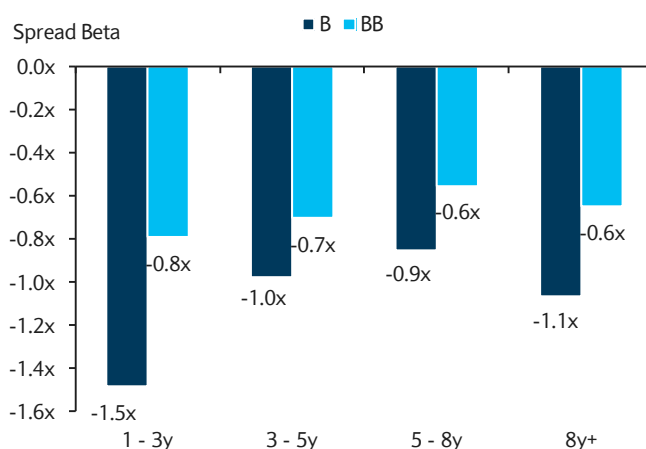


Note: Spread beta measured by regressing weekly spread changes of each duration bucket to yield changes of a representative Treasury bond.

Source: Bloomberg Barclays Indices

FIGURE 3

Restricting the Data to Periods with Spread Levels Similar to Today's, BBs Are Much Less Able to Absorb Yield Changes in Treasuries across Duration Buckets, Particularly for 1-3y



Note: We consider periods when BB spreads were 175-225bp to calculate the BB spread betas (current level of 203bp). To calculate B spread betas, we consider periods when Bs traded between 300 and 350bp (current level of 332bp).

Source: Bloomberg Barclays Indices

With that barbell preference in mind, Figure 2 shows how spread betas vary along the maturity spectrum. Should investors reach for spread through duration or credit quality? Over the past five years, short-duration spread changes (in the 1-3y bucket) have more than offset rate moves, as indicated by spread betas of -1.6x and -1.4x for Bs and BBs, respectively. Betas in the 3-5y duration bucket show a modest preference for Bs (ie, spread betas larger than -1.0x), while spread betas of less than -1.0x for the 8y+ duration bucket suggest avoiding it, all else equal, if investors are simply looking to offset risk-free yield increases with spread tightening.

What if we restrict the observation to periods when B and BB spreads were similar to today's levels? Figure 3 shows that the spread betas of BBs across duration buckets are uniformly below -1.0x, and underlying risk-free yield moves are not fully offset by equal or greater opposing spread moves. Again, focusing on the shortest duration bucket, BBs have shown a relative poor ability to absorb moves in short-dated rates in spread regimes similar to today's (spread beta of -0.8x); considering heightened extension risk in BBs relative to Bs, we remain more cautious on this part of the market (please see [Upside-Down BBs](#)). Meanwhile, single-B short-dated spreads still offset more than 1.5x of underlying rate moves.

Rolling up our conclusions from above, we reiterate our preference for short-duration (1-3y) single-B risk for investors who are looking to offset anticipated increases in UST yields with credit spread tightening. Figure 4 presents securities rated Overweight by our fundamental analysts that fit these duration and rating criteria. Some of these credits could also benefit from positive event risk or other drivers, such as potential liability management exercises or sufficient debt service runways, but we believe that they are all attractive short-duration candidates to add to credit portfolios.

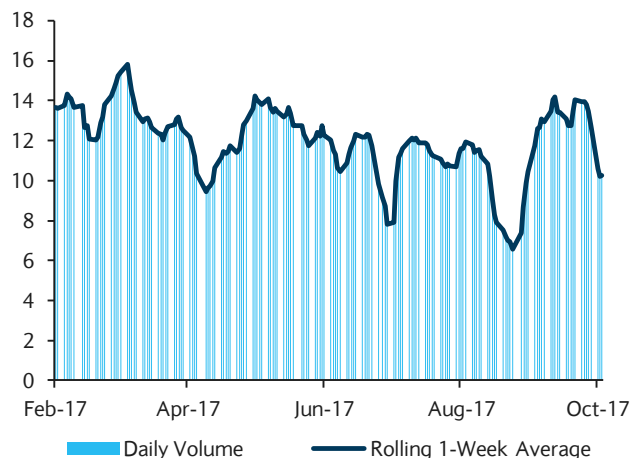
FIGURE 4

Short-Duration Single-Bs Rated Overweight

Ticker	Security	Amount Outs. (\$mn)	Index Rating	Price (\$)	Yield to Worst (%)	OAS (bp)
OAS	6.875s of 2022	937	B3	101.1	6.24	431
OAS	6.5s of 2021	396	B3	100.7	6.13	419
NE	4.9s of 2020	168	B2	97.0	6.08	437
DYN	7.375s of 2022	1750	B3	105.2	5.5	353
HBMCN	7.25s of 2023	400	B3	106.5	5.3	326
TLN	4.625s of 2019	208	B3	99.1	5.19	363
AKS	7.5s of 2023	380	B1	108.7	4.38	267
ARGID	7.25s of 2024	1650	B3	109.9	4.1	233
S	7s of 2020	1500	B2	109.5	3.47	183

Note: We consider bonds with durations of 1-3 years. Source: Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume (\$bn)



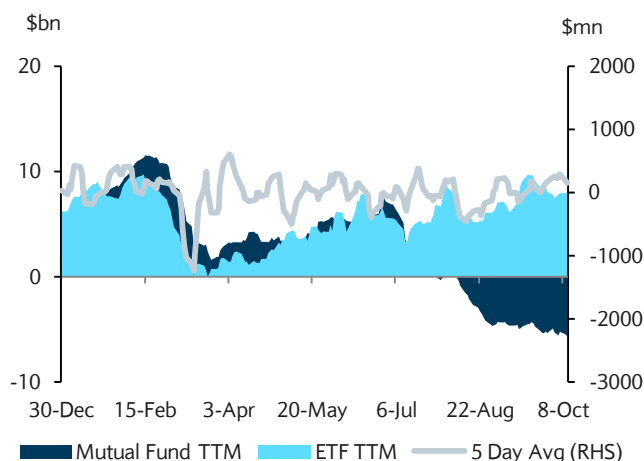
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



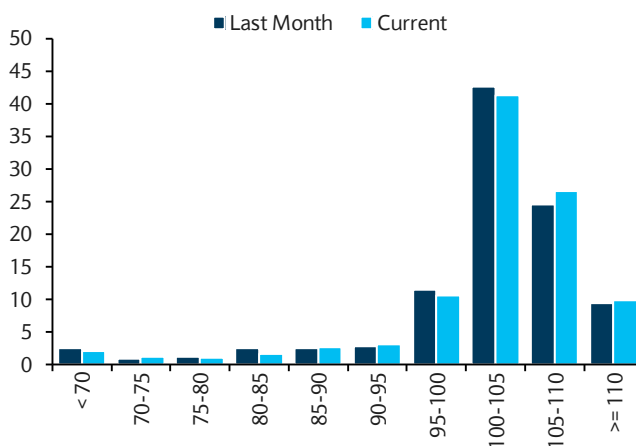
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs (YTD)



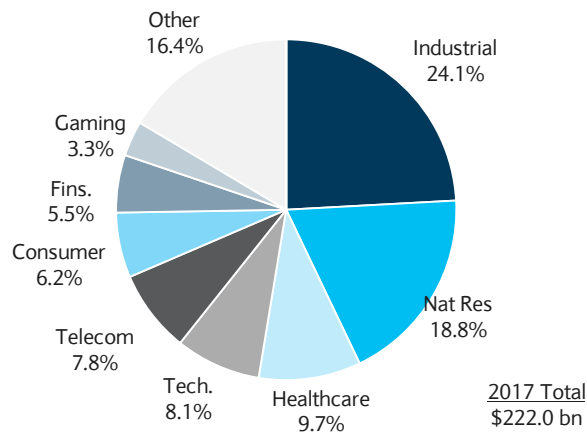
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



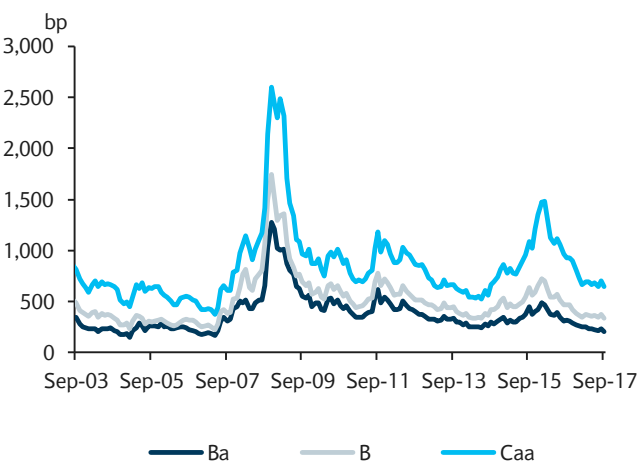
Source: Barclays Research

High Yield Supply by Sector (YTD)



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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ARGID 7 1/4 05/15/24, Overweight (USD 109.50, 11-Oct-2017)

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OAS 6.5 11/01/2021, Overweight (USD 101.13, 11-Oct-2017)

OAS 6 7/8 03/15/22, Overweight (USD 101.50, 11-Oct-2017)

SPRINT COMMUNICATIONS INC, CD/D/J/K/L/M/N

S 7 08/15/20, Overweight (USD 109.50, 11-Oct-2017)

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TLN 5 1/8 07/15/19, Overweight (USD 100.00, 11-Oct-2017)

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