

BBBs versus BBs: Basis Point Break

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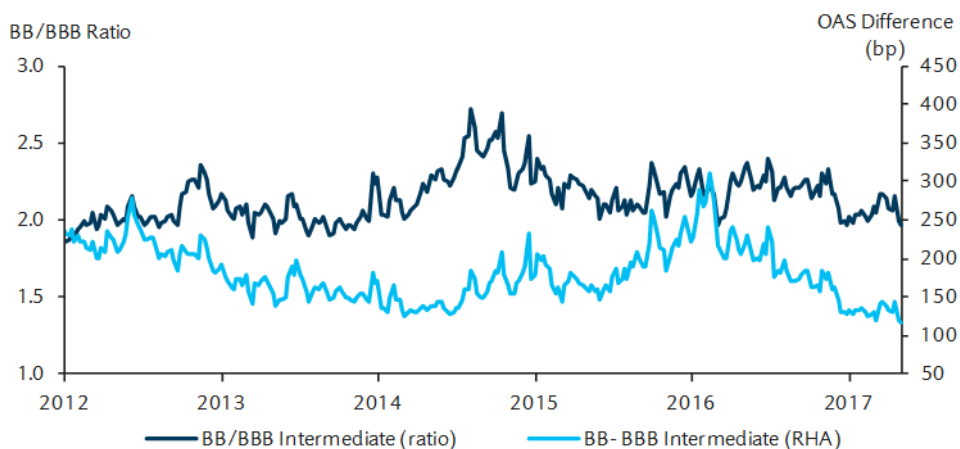
The BB-BBB basis has compressed materially in the past year. While the overall spread rally is the biggest driver of the move, the increase in interest rates also explains a good deal of the variation. We deconstruct the effect of Treasuries on credit spreads across the quality scale, focusing on securities that lie on the borderline between BBBs and BBs. Despite apparently stretched spread valuations, we find that BB spreads can continue to benefit more than BBBs from rising rates. As such, we do not believe that high yield investors should look for opportunities within the investment grade universe. For investment grade investors, the implication is that moving into wider-trading BBBs offers not only better spread carry but also higher potential upside from spread tightening if rates rise.

Mostly a Beta and Rates Story

Amid the broad rally in credit spreads since February 2016, the BB-BBB basis has compressed meaningfully. Even after adjusting for differences in duration by examining <10y BBBs, BBs have outperformed by more than 100bp during that time, which in turn has brought the basis near multi-year tights (Figure 1). This outcome is obviously driven in part by overall tight spread levels; however, the BB/BBB ratio is also trading near the lows of the relationship.

FIGURE 1

BB Spread versus BBB Intermediate (<10y) Spread Ratio and Difference

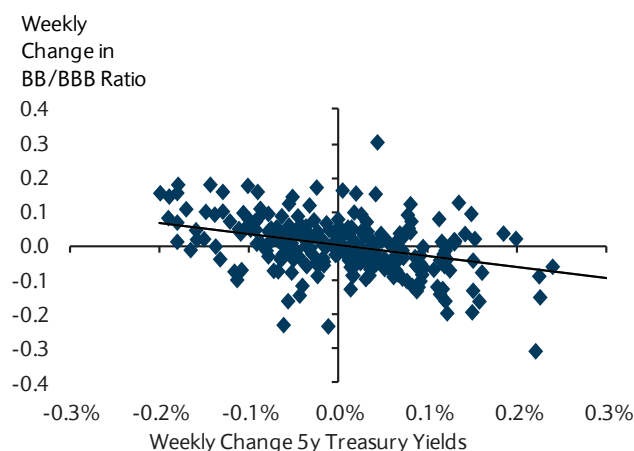


Source: Bloomberg Barclays Indices, Barclays Research

The significant rally in BBs relative to BBBs has raised concerns about whether the BB-BBB basis can compress further or if it is too tight. Indeed, we believe there is room for compression in the basis and expect BBs to outperform BBBs. Further outperformance could be driven in part by a sell-off in Treasuries, as implied by the relationship between the BB/BBB spread ratio and 5y Treasury yields shown in Figure 2. As yields increase, the ratio compresses, which is in line with our prior observations.¹

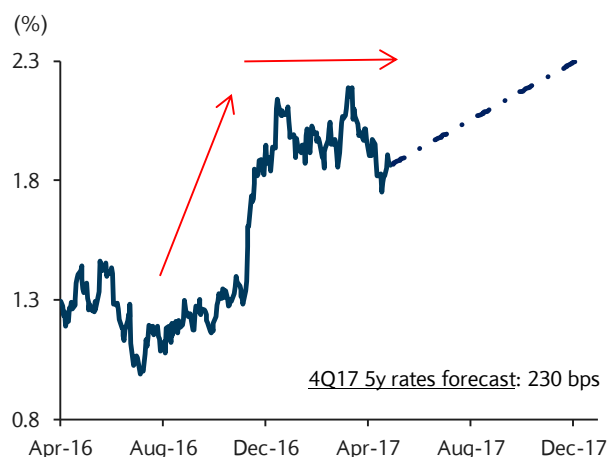
¹ Please see the *Long if It, in Short*, May 22, 2015; *Take a Hike without Breaking a Sweat*, March 13, 2015; *Do the Shift and Twist*, October 17, 2014.

FIGURE 2

Rising Rates Contribute to BB-BBB Compression

Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 3

Barclays Forecasts a Further Increase in 5y UST Yields

Source: Bloomberg

Rate sensitivity varies with the level of spreads, and high yield debt with wider spreads is able to absorb a much larger portion of any back-up in rates. Indeed, sharp post-election rate moves partly drove the compression between BBBs and BBs tighter, notwithstanding the broad-based outperformance of higher beta. With our rates analysts expecting 5y Treasury yields to increase about 50bp, to 2.3% (Figure 3), we believe it is worth re-assessing BB and BBB relative value opportunities more thoroughly.

Positioning for Higher Rates

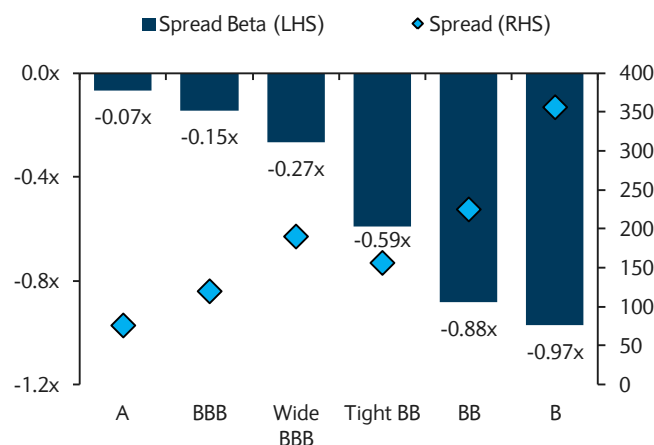
On the surface, the beta-led rally has made the relative value of BBs less compelling in comparison with BBBs, leading some high yield investors to explore up-in-quality trades. That said, higher rates can continue to drive the BB-BBB basis tighter for the aforementioned reasons.

In order to estimate the room for further compression in the BB-BBB basis assuming higher risk-free yields, we look at the spread beta to Treasury yield of the different rating buckets. This is estimated by regressing weekly changes in spreads against changes in the 5y Treasury rate over the past five years. We restrict maturities to 10 years or less in order to control for differences in duration exposures across quality.

- The analysis confirms that lower-rated debt with wider spreads provides extra cushion against a back-up in rates. Indeed, the spread beta to Treasuries for BBB debt is $-0.1x$ (ie, the BBB spread absorb only about 10% of the move in Treasury yields), compared with $-0.9x$ for BBs and $-1.0x$ for Bs (Figure 4).
- We also estimate the spread beta for the widest-trading BBBs and the tightest BB bucket. The wide-BBB bucket has an average spread that is about 40bp wider than the tight-BB bucket. Despite this, the BBB bucket still has a lower spread beta than the BBs. In our view, this discrepancy can be reconciled by noting the differences in buyer base and market pricing conventions; investment grade bonds are typically quoted as a spread to Treasury, while high yield bonds are quoted on price.

FIGURE 4

Spread Beta and Implied Excess Returns for Wide BBBs and Tight BBs



Note: We restrict maturities to 10 years to control for differences in duration exposures across quality. Spread beta is calculated relative to the 5y Treasury using weekly data for the past five years. Source: Bloomberg Barclays Indices

FIGURE 5

BB-BBB Basis Under Different Interest Rate Scenarios

5y Tsy Yield Increase (bp)	BB-BBB Basis (bp)	BB/BBB Ratio
Current	116bp	1.97x
+25bp	98bp	1.84x
+50bp	79bp	1.70x

Note: We consider duration matched BB/BBB universes. Source: Bloomberg Barclays Indices, Barclays Research

The spread beta allows us to estimate the potential move in the BB-BBB basis from a further move higher in Treasury yields. Assuming that 5y yield increases 50bp, we estimate that the basis could compress nearly 35bp, with the ratio decreasing to 1.7x (Figure 5).

Combining our view that higher beta credit should continue to generate solid returns through year-end with expectations for higher rates at the five-year point of the Treasury curve, we do not believe that the up-in-quality trade is justified for high yield investors. The implication of the above analysis for investment grade investors is that the widest trading BBBs not only benefit from higher spread carry, but also have higher potential upside from spread tightening driven by a move higher in rates. As such, Figure 6 highlights select swaps out of BBBs into wider trading BBBs, allowing investors to pick up roughly 40bp on average.

FIGURE 6

Swaps into BBB Bonds with Higher Spread Beta to Treasuries

Sell Bond 1				Buy Bond 2				Bond 2 - Bond 1	
Ticker	Bond	Price	OAS	Ticker	Bond	Price	OAS	Price Diff	OAS Diff
KMI	3.5s of 23	100.3	135	ENBL	3.9s of 24	98.2	204	-2.1	69
AGN	3.85s of 24	102.8	124	MYL	3.95s of 26	98.5	185	-4.2	61
NBL	3.9s of 24	102.5	132	MRO	3.85s of 25	98.7	180	-3.8	48
PSXP	3.55s of 26	97.0	164	ENBL	4.4s of 27	99.7	211	2.7	48
WPZ	4s of 25	102.0	148	ENLK	4.85s of 26	104.7	194	2.7	46
PXD	4.45s of 26	106.6	129	APC	5.55s of 26	111.3	174	4.7	45
WPZ	4.5s of 23	105.5	144	ENLK	4.4s of 24	102.3	187	-3.2	43
JEF	5.125s of 23	107.8	160	LUK	5.5s of 23	107.5	196	-0.3	35
PXD	3.95s of 22	105.2	92	DVN	3.25s of 22	100.7	119	-4.5	26
PXD	3.45s of 21	103.0	94	APC	4.85s of 21	107.4	111	4.4	17
VLP	4.375s of 26	102.8	171	WES	4.65s of 26	104.2	181	1.4	10
BWP	4.95s of 24	106.6	173	ENLK	4.15s of 25	100.6	183	-6.0	9
ETP	9.7s of 19	112.9	125	ENLK	2.7s of 19	100.1	131	-12.8	6

Source: Bloomberg Barclays Indices, Barclays Research

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Materially Mentioned Issuers/Bonds

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AGN 3.85 06/15/24 (USD 102.70, 03-May-2017)

ANADARKO PETROLEUM CORP, A/CD/CE/D/J/K/L/M/N

APC 4.85 03/15/21 (USD 107.45, 03-May-2017)

APC 5.55 03/15/26 (USD 111.30, 03-May-2017)

BOARDWALK PIPELINES LP, A/CD/D/E/J/K/L/M/N

BWP 4.95 12/15/24 (USD 106.52, 03-May-2017)

DEVON ENERGY CORP, CD/CE/D/GE/J/K/L/M

DVN 3 1/4 05/15/22 (USD 100.62, 03-May-2017)

ENABLE MIDSTREAM PARTNERS LP, A/CD/CE/D/J/K/L/M

ENBL 3.9 05/15/24 (USD 98.20, 03-May-2017)

ENBL 4.4 03/15/27 (USD 99.69, 03-May-2017)

ENERGY TRANSFER LP, CD/D/J/K/L/M

ETP 9.7 03/15/19 (USD 112.99, 03-May-2017)

ENLINK MIDSTREAM PARTNERS LP, CD/CE/J/K/M

ENLK 2.7 04/01/19 (USD 100.13, 03-May-2017)

ENLK 4.15 06/01/25 (USD 100.50, 03-May-2017)

ENLK 4.4 04/01/24 (USD 102.13, 03-May-2017)

ENLK 4.85 07/15/26 (USD 104.75, 03-May-2017)

JEFFERIES GROUP LLC, CD/J/K/M

JEF 5 1/8 01/20/23 (USD 107.71, 03-May-2017)

KINDER MORGAN ENERGY PARTNERS LP, CD/D/GE/J/K/L/M

KMI 3 1/2 09/01/23 (USD 99.56, 03-May-2017)

LEUCADIA NATIONAL CORP, CD/CE/J/K/M

LUK 5 1/2 10/18/23 (USD 106.87, 03-May-2017)

MARATHON OIL CORP, CD/CE/J

MRO 3.85 06/01/25 (USD 99.00, 03-May-2017)

MYLAN NV, CD/CE/J/K/M/N

MYL 3.95 06/15/26 (USD 98.20, 03-May-2017)

NOBLE ENERGY INC, A/CD/CE/D/E/GE/J/K/L/M

NBL 3.9 11/15/24 (USD 102.50, 03-May-2017)

PHILLIPS 66 PARTNERS LP, A/CD/CE/D/E/J/K/L/M/N

PSXP 3.55 10/01/26 (USD 96.81, 03-May-2017)

PIONEER NATURAL RESOURCES CO, CD/CE/J/K/M

PXD 3.45 01/15/21 (USD 103.05, 03-May-2017)

PXD 3.95 07/15/22 (USD 105.24, 03-May-2017)

PXD 4.45 01/15/26 (USD 106.60, 03-May-2017)

VALERO ENERGY PARTNERS LP, A/CD/CE/D/J/K/L/M

VLP 4 3/8 12/15/26 (USD 102.89, 03-May-2017)

WESTERN GAS PARTNERS LP, A/CD/CE/D/J/K/L/M/N

WES 4.65 07/01/26 (USD 104.32, 03-May-2017)

WILLIAMS PARTNERS LP, CD/CE/D/E/J/K/L/M

WPZ 4 09/15/25 (USD 102.21, 03-May-2017)

WPZ 4 1/2 11/15/23 (USD 105.63, 03-May-2017)

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