High Yield Strategy

The Price of Liquidity

Bank of America Merrill Lynch

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Risk appetite tested as the Fed disconnect is priced out

HY spreads remained stable earlier in the week around 370bps levels, however they were moving wider on Thrs as the risk appetite reversed. HYG was down 3/4s of a point between late Weds and early Thrs, easily reversing three weeks of earlier gains. The rates have awaken to an apparent disconnect between extreme performance in risk assets on one hand and a still-likely rate-cut priced into the fed funds futures. We wrote just last week that one of these sides must be wrong.

Within HY, the CCC edge over BBs have reached an impressive 200bps ytd in total return terms earlier this week, before giving up 20bps since then. This represents a material shift in CCC outperformance from as recently as late March, when their ytd return was in line with BBs. Despite the impressive move in the last few weeks, CCCs remain a material underperformer on a yoy basis, where they trail BBs by almost 400bps in total returns.

In sectors, energy and capital goods were the worst performing sectors this week, whereas cable and tech led things tighter. So far this year, the best performing sectors are energy, retail, and cable; and the laggards are telecoms, autos, and chemicals.

In technicals this week, a strong $4.3bn intake from calls/tenders was complemented by $2.7bn in coupons and $300mn in fund flows. On the other side of all this, the market absorbed $4.0bn in new issues, which came on the back of a $7.0bn last week – the strongest print in three months. Combined, issuance exceeded permanent sources of cash $11.1bn vs $4.6bn over the past two weeks, while coupons added another $2.8bn of transitory cash.

Going forward, we are looking at May as one of the seasonally strongest months for issuance, with our models pointing to $18.4bn in expected volume. In the meantime, calls/tenders are expected to come in at only $13bn for the month and they are particularly light next week, at only $1.3bn. Coupons are decent in May, at $7.6bn but next week again carries almost none. So the technicals could hit a bit of an air pocket in the next few sessions. Our readers can now track all this data live on our visualization page at https://rsch.baml.com/highyield_interactive

When the risk appetite turns abruptly, the question of liquidity always becomes paramount. What does it cost to win a bid when everyone is looking for one? How much more expensive to do so in size? What is the roundtrip cost of buying in a hot market and selling into a risk-off?

This topic has gained a particular importance in the aftermath of the Q4 meltdown and a subsequent extreme rebound in risk appetite. It was close to impossible to buy anything in late December and early January, when more than half of the price gain was realized. Similarly, the early stages of the selloff in Oct and Nov often felt bidless.

Here, we distill a few new key datapoints that may help shed some light on this critically important aspect of portfolio risk management.

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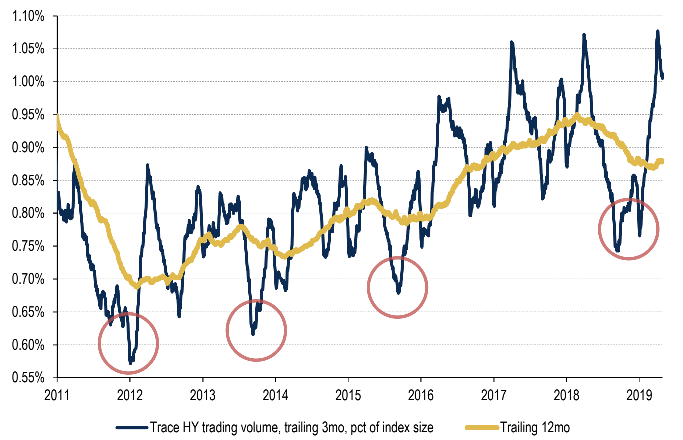
Have you noticed that liquidity always seem to vanish when you need it most? This seems to be one of its inherent attributes, as Figure 1 demonstrates. Here we plot Trace HY trading volumes, measured on a trailing 3mo basis, as a pct of market size. Overall trend appears to have continuously improved since hitting a cyclical bottom in late 2012, as measured by a longer-term 12mo average line.

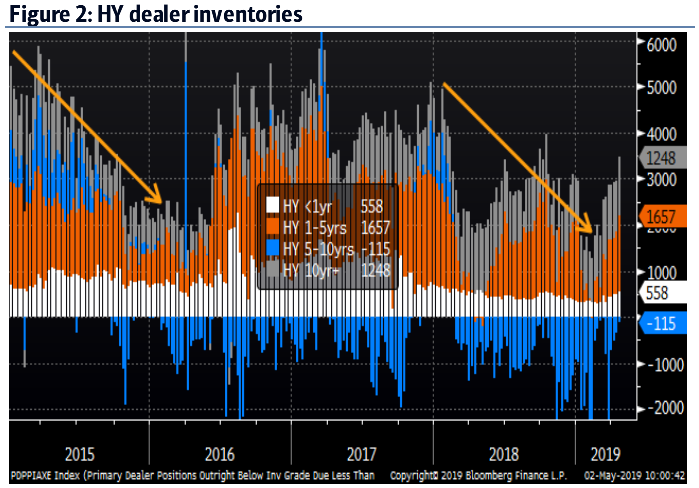
There are several distinct episodes of significant declines in trading activity, as we highlight on the chart. Interestingly, those appear to coincide with episodes of significant market stress, including the peak of EU sovereign debt crisis in late 2011/early 2012, the taper tantrum in mid-2013, the energy meltdown in late 2015, and the Q4 of 2018. While absolute levels differ, the striking similarity of setting local troughs in volumes is irrefutable.

Figure 1: Trace HY bond trading volumes, pct of market size



Source: BofA Merrill Lynch Global Research, NASD Trace

Figure 2: HY dealer inventories



Source: BofA Merrill Lynch Global Research, Federal Reserve, Bloomberg

The theory of low dealer inventories is not new, however what we think may still be an element of surprise in the fact that not only do dealers hold thin inventories when the market is stable, but they also tend to reduce them even further at times of market stress. Figure 2 goes on to show how this was the case in both 2015 and 2018 episodes. In other words, the problem of low inventories tends to be exacerbated by dealers lining up with other numerous sellers.

Figure 3: HY ETFs share trading volumes, pct of HY Trace bond volumes

Source: BofA Merrill Lynch Global Research

Figure 4: HYG premium/discount to NAV, vs average

Source: BofA Merrill Lynch Global Research

When investors cannot find required liquidity in the underlying bonds, they turn to other proxies. In recent years, HY ETFs have captured a growing share of portfolio trading volumes, as Figure 3 shows. Here we plot HY ETFs combined share trading volume, measured as a pct of underlying Trace HY bond trading volume. During the latest market meltdown in Q4, the share of such volume in ETFs has reached an all-time high, at over 25% of underlying, or about +15% to the previously established range. Recall that ETFs hold only 3% of HY AUM.

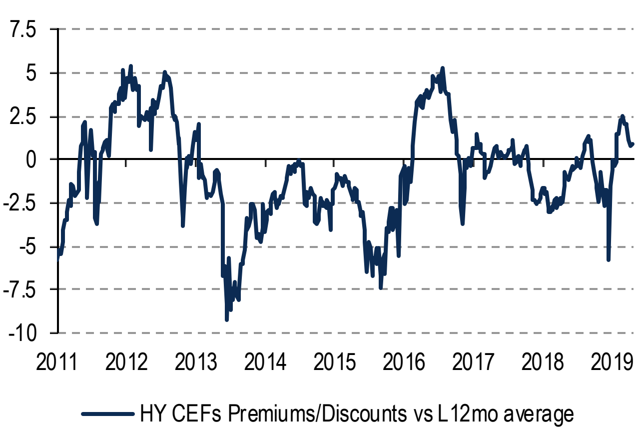
This does not appear to be an aberration, as the 2015 energy episode has seen a similarly impressive pickup in ETFs share of volume, from around 7% in early 2015 to 17% in early 2016.

When liquidity gets scarce, its price goes up – a natural outcome. Figure 4 shows one way to measure it in ETFs where we track their average premiums/discounts over time. Times of significant market stress are associated with above-average discounts in ETFs, ranging from 0.15pts in late 2015 to 0.25pts in late 2018. The opposite is true at times of strong risk appetite, where they flip to premiums, sometimes in excess of 0.25pts, as was the case in early 2016.

In other words, the whole roundtrip of liquidity cost – from the time most investors are looking for offers to the time when bids are hard to find – could range anywhere between 0.5pt to a full point. Recall, that we are discussing perhaps one of the most liquid instruments in the HY space, and so less liquid instruments must carry a greater cost of liquidity.

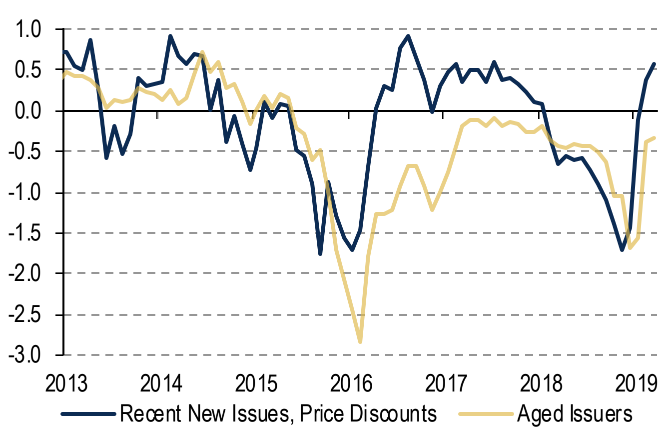
We find a confirmation to this in Figure 5, where we plot a similar timeseries of premiums/discounts on HY closed-end funds (CEFs). The latter tend to be smaller (most carry $500mn-$1bn in AUM compared to $10bn+ in largest ETFs. They also have no ability to create/redeem shares, which leads to a more constrained ability of market participants to arbitrage away the deviations from NAVs. Lastly, they trade less actively: even on peak days any given CEF is unlikely to trade in excess of $25-50mn. All of the above differences make them more like a bond than an ETF, when it comes to understanding their liquidity profiles.

Figure 5: HY closed-end funds premium/discount to NAV, vs average



Source: BofA Merrill Lynch Global Research

Figure 6: On-the-run/larger vs aged/smaller HY bond price discounts



Source: BofA Merrill Lynch Global Research

The range of premiums/discounts to NAVs is materially wider here, bottoming out at 5pts+ while reaching 2.5-5pts at the peaks. In other words, the whole roundtrip in liquidity costs here could be in excess of 5pts most of the time and as wide as 10pts if an investor happens to hit the exact trough and peak in a given episode. So the price of liquidity gets very expensive, once we step outside the most actively traded instruments.

Next, Figure 6 shows the price differentials in most liquid and on-the-run bonds priced within the last year (blue line) and compare them to those in less-liquid cap structures that have not accessed the market in more than a year (yellow line). We note that liquid bonds naturally lead in both the periods of market stress as well as rebounds. We can also observe that the differential in price discounts ranges 0.5-2pts at extremes, providing us with another way to assess the price of liquidity at times of meaningful market turns. Because this range measures *incremental cost of liquidity* for off-the-run bonds, it should be added to the liquidity costs for on-the-runs. While we do not have a direct way to measure those, we could safely assume those to be at least 0.5-1pt, using ETFs as a floor; realistically it is probably a bit higher in most cases. Thus overall cost of a roundtrip in liquidity conditions could be ranging from a 1pt to 3pts+.

Note that these estimates for roundtrip liquidity costs are different from a simple bid-ask spread, which we do not show here for a reason. We find that measure to be somewhat superficial, as it fails to capture the depth of a real commitment on either side of the trade. In other words, the level could be quoted at 1/4pt apart, but it may only work on a token size, and it may not work for another one right after that. For block trades, the quotes could shift materially and could even lose the other side of the bid-ask spread altogether. Again, we generally do not find the bid-ask data useful absent of a market depth context, which is almost always the case in the over-the-counter market for corporate bonds.

These findings should be used as an important input to managing the risk of HY portfolios. While the market appears orderly and accommodative to flows most of the time, operating at tight bid-ask spreads and complemented by well-functioning new issue and OWIC/BWIC channels, the depth of liquidity often drops meaningfully around market turns. Trading volumes usually set their local lows at the peak points of market stress and dealers tend to reduce whatever little inventory they had going into such episodes even further.

Investors turn to portfolio products in search for ways to manage risk in such environments, which they can find but only at a price. A round-trip in ETFs could face 0.5pt-1pt in liquidity-related costs, while less liquid closed-end funds sometimes see liquidity costs exceeding 5pts and even more at extremes. In bond pairs, our data suggests 1-3pts+ of liquidity cost should be assumed once the risk sentiment makes another 180.

Positioning recommendations

After a 200bps outperformance in CCCs vs BBs in the last few weeks, we think a good share of that trade is done, leaving some moderate room for the melt-up to continue. BBs are trading 74bps away from BBBs, close to their all-time tights, whereas CCCs still have 100bps to go to historical averages vs BBs and 200bps to go to last year tights.

While we thought this melt-up was inevitable a few weeks ago, we also continue to believe it has slim chances of surviving beyond the next few weeks to a couple of months. The risk-reward is just too poor in our mind for this late stage of the credit cycle to be scratching the bottom of the barrel. As such, we remain predisposed to recommend reducing CCC risk into any further potential strength in this space.

Overall HY spread has been bumping along 375bps level for three weeks now, after spending the previous six weeks around 400bps. We think the last leg of a melt-up could take us to 350bps or even below, a level we expect to be hard to defend and maintain. We continue to target 450bps as a risk-neutral level over the next few months, once the current episode of extreme technicals passes.

We still like US HY over EM HY here after 125bps outperformance in the former since mid-March. On the other hand, we like the risk-reward in EU over US HY in light of 300bps of FX hedging benefit for US-domiciled investors.

In sectors, energy underperformed the rest of HY by 50bps in total returns over the past week, alongside the oil slumping $5/bbl. We recommended reducing earlier overweight in energy over the past few weeks (here and here), and remain indifferent to current levels in both oil and energy HY spreads for the moment.

An underweight in HY utilities we recommended in late March added another 10bps to its performance this week, currently tracking +88bps in total return since inception. We still like this positioning.

Our recommendation to underweight single-B retail last week faced a setback in performance as the segment proceeded to outperform broader single-Bs by 20bps in total returns since then. However other view on this positioning has not changed and in fact had improved a bit as a result of an adverse price move.

Market recap

DM USD HY spreads have stabilized around 370bps since mid-April. The 2bps tightening for the week delivered moderate positive total return of 0.16% and excess return of 0.06%. In qualities, CCCs slightly lagged BBs for the first time since late March, falling behind higher quality by 5bps in total return.

Most of the sectors tightened for the week, led by cable (ATCNA, SFRFP, CSCHLD), healthcare (CNC, BHCCN, DVA), and technology (DELL). On the other side of the performance spectrum, energy (CRC, WFT, PACD) widened.

In technicals, we have seen a moderate $2.7bn coupon this week, with very little scheduled for next week ($67mn). A relatively heavy coupon of $4bn is coming our way the week of May 17th. Calls/maturities came in at $4.3bn this week and we expect the pace to slow down, with $1.3bn expected for the next week and $1.8bn for the week of May 17th. After the very active last week, primary market has $1.2bn priced this week, a somewhat slow pace for what is historically one of the busiest months of the year. YTD, $74bn of gross issuance is still exceeded by $66bn of calls/maturities and $17bn of retail flows.

Rating actions were quiet for the week with concentration in relatively high quality issuers. Charles River Laboratories was downgraded by S&P to BB+ from BBB- on acquisition. The downgrade reflects the issuer's delayed deleveraging trajectory and more aggressive financial policy. CRL's $500mn senior unsecured debt is already in the HY index, which is unaffected by this rating action.

Figure 1: Rating agency HY actions in the past week

Company Name	Agency		New	Old	Country	Industry	Total Debt
Goodyear Tire & Rubber Co/The	Moody's	▼	Ba3	Ba2	US	Autos	7,376
Ensco Rowan plc	S&P	▼	B-	B- *+	GB	Energy	5,010
Rite Aid Corp	S&P	▼	B-	B	US	Retail	3,495
Charles River Laboratories International Inc	S&P	▼	BB+	BBB- *-	US	Healthcare	1,668
Popular Inc	Fitch	▲	BB	BB-	PR	Financials	1,377
Eldorado Gold Corp	Moody's	▼	B3	B2	CA	Materials	603
Cumberland Farms Inc	Moody's	▲	Ba3	B1	US	Retail	

Source: BofA Merrill Lynch Global Research, Fitch, Moody's, S&P

Korea April final exports fell 2% yoy with -4.5% yoy reported in terms of exports to China. This represents a fifth consecutive month of negative yoy prints, although the trough appears to have been set in February.

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