

Don't Fear BB Duration

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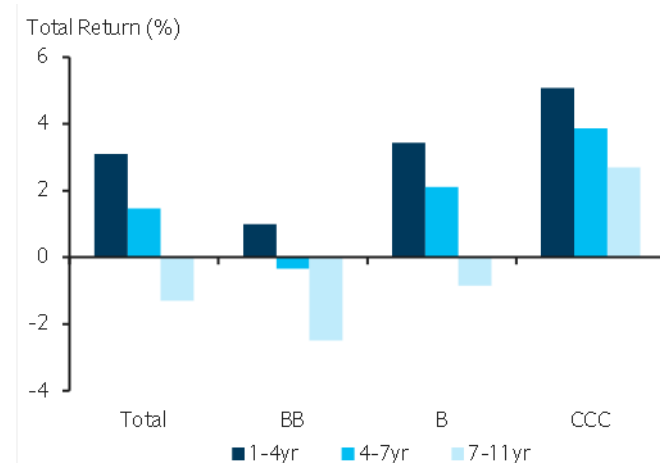
As previously discussed, year-to-date performance has been led by the lower rating buckets, with CCCs' total return of 410bp, outpacing -100bp and -156bp for BBs and Bs, respectively. This spread compression, coupled with the underperformance of longer-dated paper, has left many investors questioning whether BB rated credit is now cheap enough to increase allocations.

The high yield index OAS is unchanged for the year, while the CCC cohort has tightened nearly 50bbp. The price return of BBs has been down roughly 4 percentage points year-to-date, compared with down 58bp for CCCs. This can be explained partly by the longer duration of BBs (4.4 years, compared with 3.2 years for CCCs), as short-dated bonds have outperformed longer-dated bonds significantly across all ratings categories (Figure 1). But with BBs still underperforming in each category, this may not tell the whole story.

The outperformance of weaker-rated credits means that CCC valuations are tight relative to BBs in light of the recent historical relationship (Figure 2). Although a significant portion of this outperformance can be attributed to low default rates (see *Default, Dear Brutus, Is Not in Our Stars*) and sector weightings (energy represents an outsized portion of CCCs, as highlighted in *Drilling into CCC Energy*), the compression in spreads still suggests that BBs are cheap.

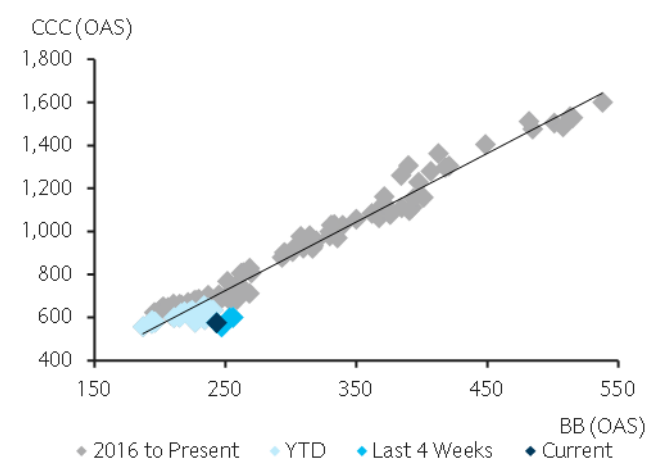
When examined specifically by duration, we find that longer-duration BBs appear cheap relative to similar-maturity BBBs. BB bonds with option-adjusted durations of less than five years trade in line with expectations relative to shorter BBBs (Figure 3). Conversely, longer-duration BBs trade roughly 60bp wide of their expected spread given the current level of BBBs with durations of more than five years.

FIGURE 1
Year-to-Date Total Return by Ratings and Maturity Bucket



Source: Bloomberg Barclays Indices

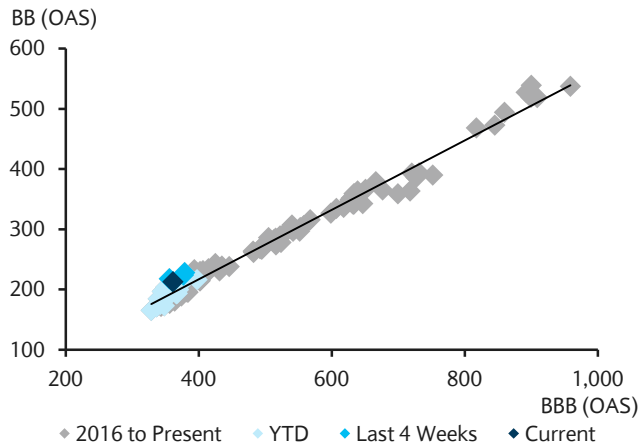
FIGURE 2
CCCs Look Rich Relative to BBs Given Year-to-Date Outperformance



Source: Bloomberg Barclays Indices

FIGURE 3

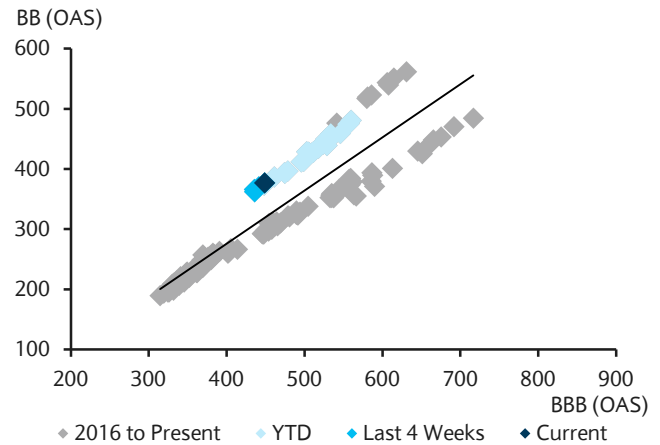
Shorter Duration BBs Are Trading in Line with the Broader High Yield Index...



Source: Bloomberg Barclays Indices

FIGURE 4

...But Longer Duration BBs Look Cheap



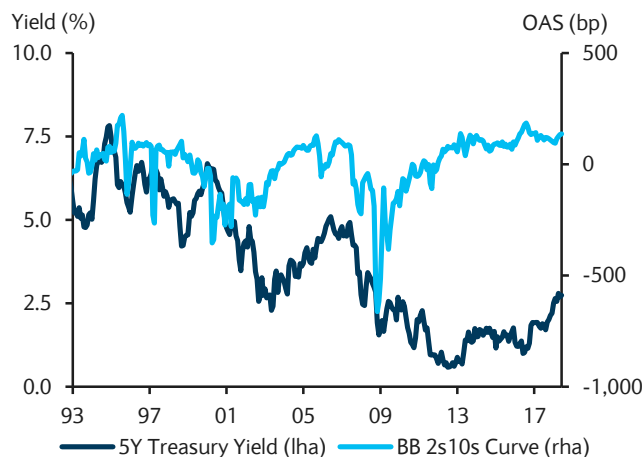
Source: Bloomberg Barclays Indices

Despite the relative cheapness of long-dated BB paper, many investors are cautious of curve steepness because of rising rates. That said, the BB spread curve (as represented by BB 2s10s) is currently steeper than during other periods of rising rates (Figure 5). We find similar results when we compare with flattening rates curves (Figure 6), with the current BB 2s10s steepness above peaks reached in prior periods of flat Treasury 2s10s. In addition, long-dated BBs have outperformed short-dated BBs toward the end of recent periods of rising rates and flatter rates curves, such as 1999 and 2004-05.

In addition, the relationship between BB-rated bonds and the equity markets points to the relative cheapness of BBs. As seen in Figure 5, BB spreads are wide compared with the S&P 500, implying relative cheapness in the credit bucket. The same cohort is also cheap relative to the Russell 2000 when viewed in the same manner. As we have outlined previously ([Choose Your Beta Wisely](#)), these equity indices are not perfect comparisons (in part because of quality and sector differences) for the US high yield market, but we believe this could make this segment of the market more attractive to asset allocators.

FIGURE 5

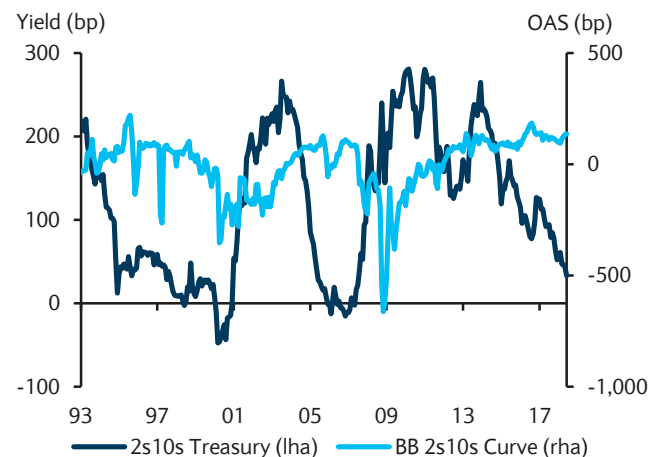
BB 2s10s Steepness Has Not Been Driven by Rising Rates...



Source: Bloomberg Barclays Indices, Bloomberg

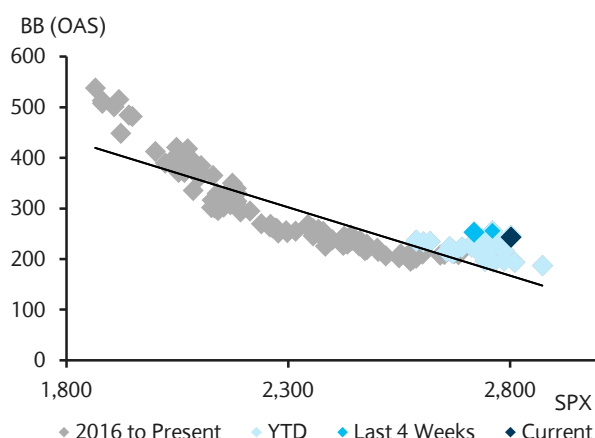
FIGURE 6

...or by Treasury Curve Flattening



Source: Bloomberg Barclays Indices, Bloomberg

FIGURE 7

BB-Rated Bonds Look Cheap Relative to the S&P 500

Source: Bloomberg Barclays Indices, Bloomberg

FIGURE 8

Longer-Maturity BBs Have Widened Year-to-Date

Years to Maturity	Current OAS (bp)	Start of Year OAS (bp)	YTD Change (bp)
All BB	236	211	25
<2	141	149	-9
2-4	188	174	14
4-6	223	199	24
6-9	247	213	34
8-11	281	237	44
>11	338	300	39

Source: Bloomberg Barclays Indices

As a result of the year-to-date underperformance of both longer-duration and higher-quality credit, long-dated BBs now appear cheap and should outperform if rate increases are less extreme and the rate curve does not invert. Figure 9 highlights select longer-duration BB bonds that are rated Overweight by our fundamental analysts and have underperformed this year.

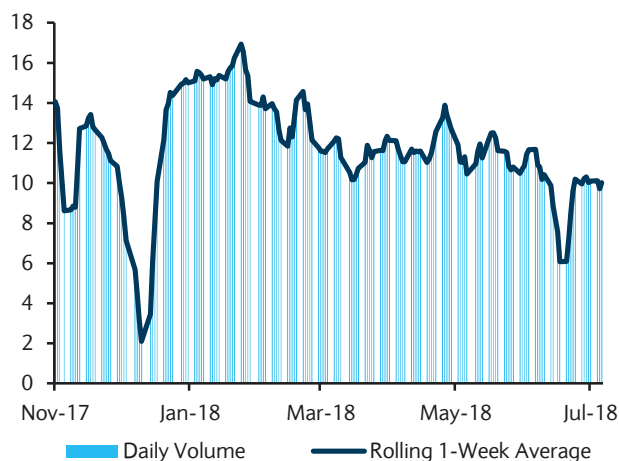
FIGURE 9

Select Overweight Longer-Duration BB Credits

Ticker	Coupon	Maturity Date	OAD	Spread (bp)	YTD Spread Change (bp)	Index Rating	Sector	Analyst
CC	5.375	5/15/2027	7	291	49	BB-	Chemicals	Brian Lalli
CHTR	5.125	5/1/2027	6	280	7	BB	Cable & Satellite	Vince Foley
CHTR	5.000	2/1/2028	6	281	9	BB	Cable & Satellite	Vince Foley
HBI	4.875	5/15/2026	6	236	28	BB-	Retailers	Hale Holden
LW	4.875	11/1/2026	5	188	40	BB-	Food and Beverage	Hale Holden
NGLS	5.375	2/1/2027	5	248	16	BB-	Midstream	Paul Chambers
NGLS	5.000	1/15/2028	7	268	32	BB-	Midstream	Paul Chambers
PPC	5.875	9/30/2027	6	373	97	BB-	Food and Beverage	Hale Holden
ST	5.625	11/1/2024	5	206	50	BB-	Technology	Jeff Harlib
ST	5.000	10/1/2025	6	210	40	BB-	Technology	Jeff Harlib

Source: Bloomberg Barclays Live, Barclays Research

High Yield Average Institutional Trade Volume (\$bn)



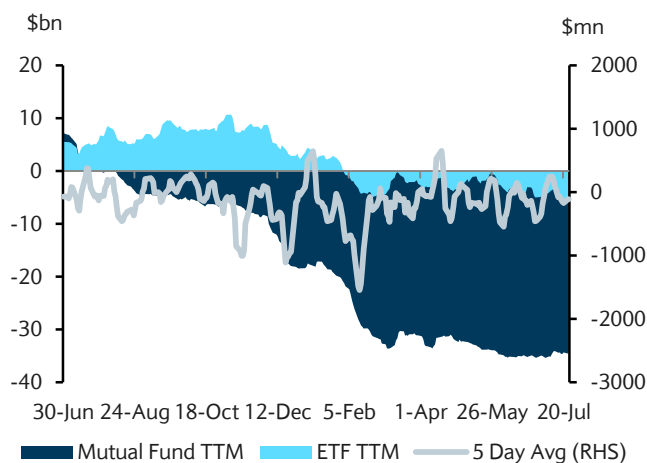
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



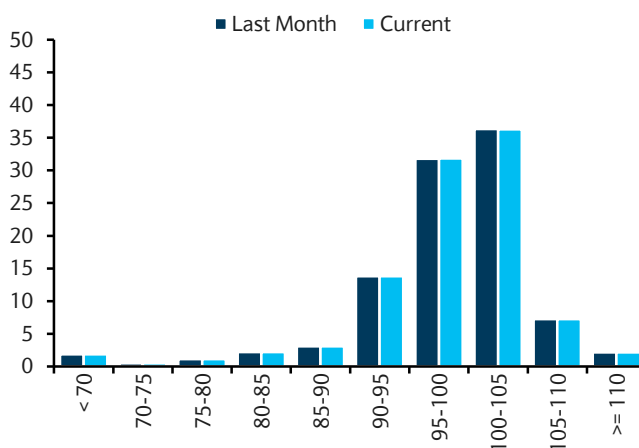
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



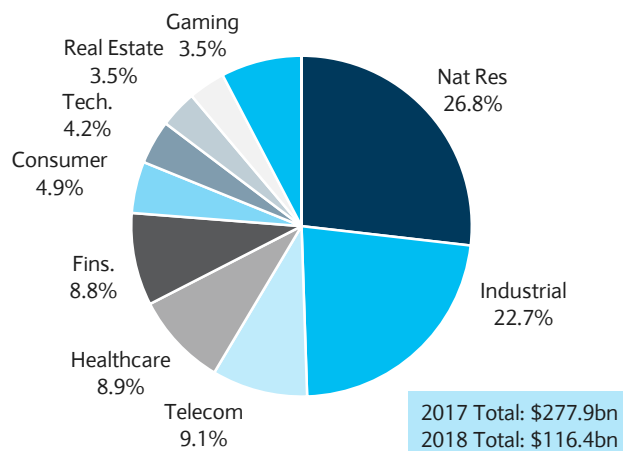
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



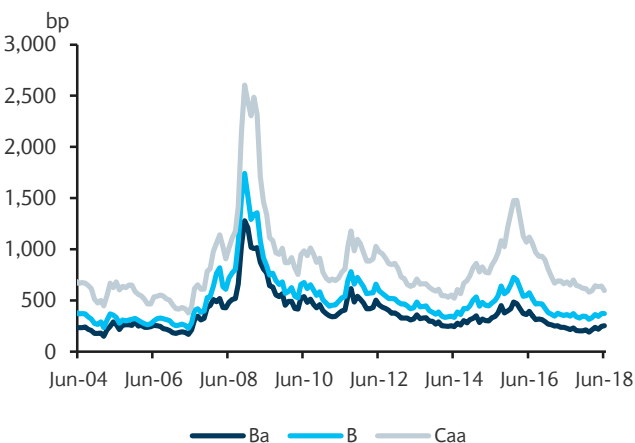
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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CHTR 5 1/8 05/01/27, Overweight (USD 94.50, 24-Jul-2018)

CHEMOURS CO/THE, A/CD/CE/D/E/J/K/L/M/N

CC 5 3/8 05/15/27, Overweight (USD 96.75, 24-Jul-2018)

HANESBRANDS INC, CD/CE/D/J/K/L/M/N

HBI 4 7/8 05/15/26, Overweight (USD 97.13, 24-Jul-2018)

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LW 4 7/8 11/01/26, Overweight (USD 98.50, 24-Jul-2018)

PILGRIM'S PRIDE CORP, A/CD/CE/D/E/J/K/L/M/N

PPC 5 7/8 09/30/27, Overweight (USD 93.50, 24-Jul-2018)

SENSATA TECHNOLOGIES BV, CD/D/J/K/L/M/N

ST 5 10/01/25, Overweight (USD 99.63, 24-Jul-2018)

ST 5 5/8 11/01/24, Overweight (USD 103.00, 24-Jul-2018)

TARGA RESOURCES PARTNERS LP / TARGA RESOURCES PARTNERS FINANCE CORP, A/CD/D/E/J/K/L/M

NGLS 5 01/15/28, Overweight (USD 94.25, 24-Jul-2018)

NGLS 5 3/8 02/01/27, Overweight (USD 98.00, 24-Jul-2018)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

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