Previously published in the U.S. Credit Alpha
28 June 2019

Cuspy Credit Conundrum: Can CCCs Catch Up?

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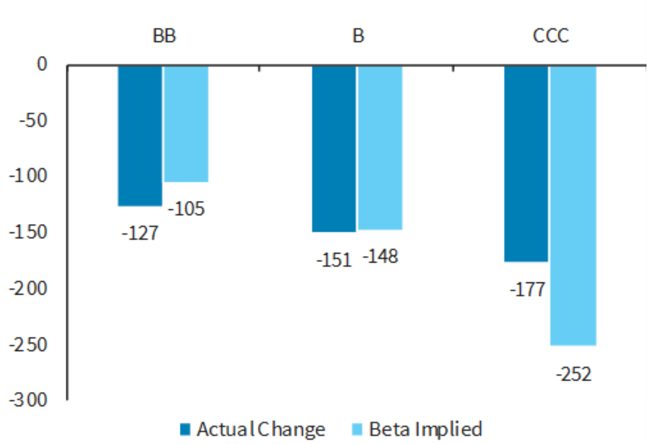
The first half of 2019 comes to a close as the start to what could be a banner year for the high yield market. Total returns for the index sit at 9.8%, the highest level through the first six months of the year since 2009. In terms of spread, the US High Yield Index has tightened more than 150bp thus far in 2019. As we have noted previously, this year's rally has been led by higher-quality credit. CCCs, on the other hand, have lagged their implied performance. While some of the underperformance is due to higher-quality credit's greater benefit from the rate move, CCCs spreads have tightened just 177bp year-to-date, relative to 252bp implied by the beta between CCCs and the US High Yield Index (Figure 1).

Investors are understandably cautious about CCC risk as we get further into an already-extended credit cycle and economic data indicate slowing growth around the globe. Breaking down CCC returns by sector helps isolate some of the underperformance of the cohort. Figure 2 shows the total return contribution of each sector for both the high yield index and the CCC index. The most notable difference has come from energy, which has been a 0.2% drag on returns for CCCs despite having a 1.0% contribution to US high yield returns. Energy represents roughly 15% of the CCC cohort, marginally higher than the 14% of US high yield it represents.

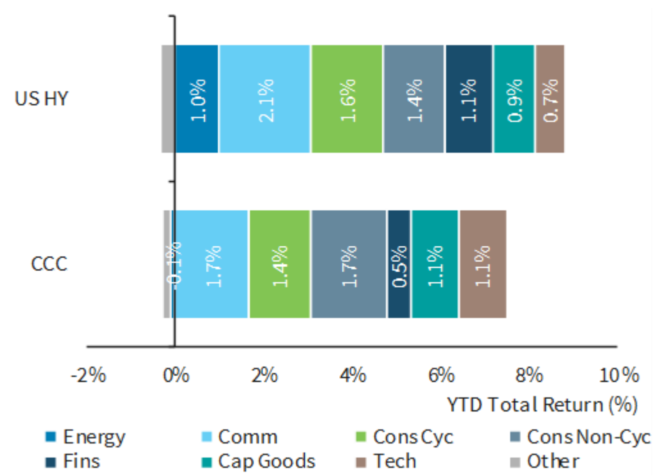
While some of this underperformance has been driven by now-defaulted energy issuers, CCC energy has lagged so significantly in returns that it has been a material drag on US high yield even when defaulted bonds are excluded. Specifically, as seen in Figure 3, CCC rated energy names have returned -0.7% this year, more than 10% below the returns of higher-quality energy (BBs and Bs). When we exclude energy, though, CCC industrials have returned more than 9%, still below BB/B returns, but not nearly the level seen in energy (Figure 4). Energy analyst Paul Chambers recently noted that the margin by which higher quality energy credit outperforms lower quality appears to be growing, indicating a potential acceleration of investor movement to quality (*see Energy Credit Performance by Rating*). We are cognizant of next week's OPEC meetings, as OPEC provided support for higher-beta energy names in the third quarters of both 2017 and 2018.

FIGURE 1
CCC Have Underperformed Beta-Implied Spread Moves in 2019…



Note: Spread relationship since June 2009 used to calculate beta.
Source: Bloomberg Barclays Indices

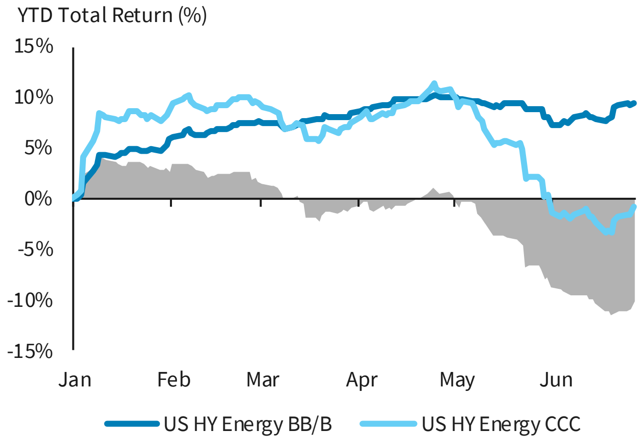
FIGURE 2
…with CCC Energy Significantly Underperforming US High Yield Energy



Source: Bloomberg Barclays Indices

FIGURE 3

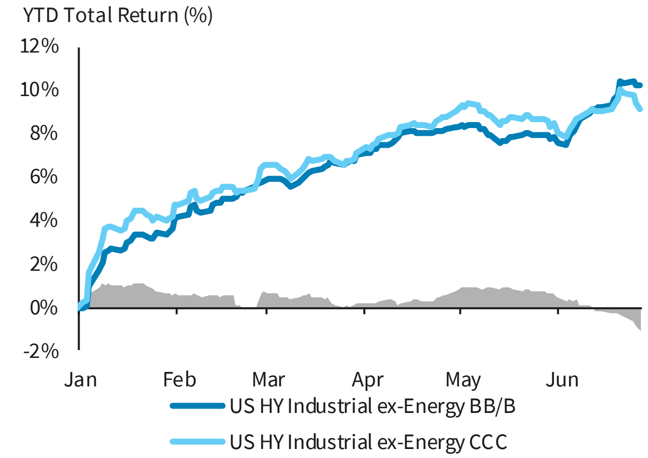
CCC Energy Has Significantly Lagged Higher Quality Energy…



Source: Bloomberg Barclays Indices

FIGURE 4

…While Non-Energy CCCs Have Performed More in Line with Their Higher-Quality Peers

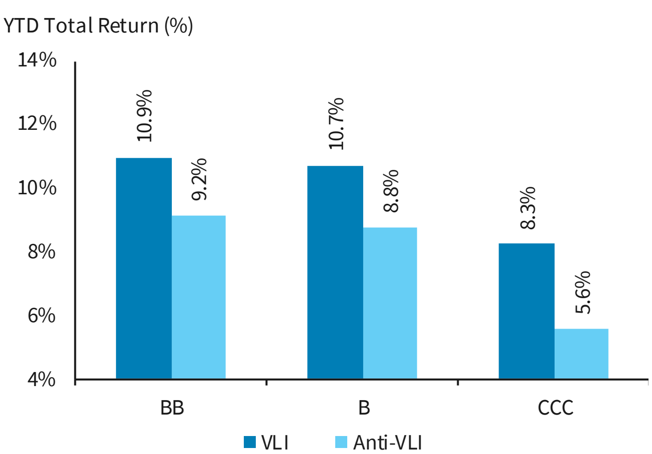


Source: Bloomberg Barclays Indices

Liquidity has also been a factor in year-to-date CCC performance. The Very Liquid Index (VLI), which includes only bonds with more than $500mn in par outstanding and issued in the past five years, has significantly outperformed bonds not included in the VLI, which we have named the "Anti-VLI" and represent approximately 40% of the market by par including the CCC component (Figure 5). The returns basis is even greater for lower quality, with an outperformance of 2.7% for CCCs, relative to just 1.7% for BBs. The relative outperformance of "liquidity" is most noticeable in the VLI and less so for other measures of liquidity such as LCS (bid/ask spread) and trading volumes. As a result, we believe this relative outperformance has been driven by the technical demand created by inflows to retail funds and, more specifically, ETFs, which tend to use issuance size as a measure for liquidity and are less likely to have a strategic underweight to CCCs (see *Liquid Alternatives* for more detail). Considering the point in the cycle, we understand why investors would want their CCC exposure to be more liquid so that they can alter it more quickly if the economic environment deteriorates.

FIGURE 5

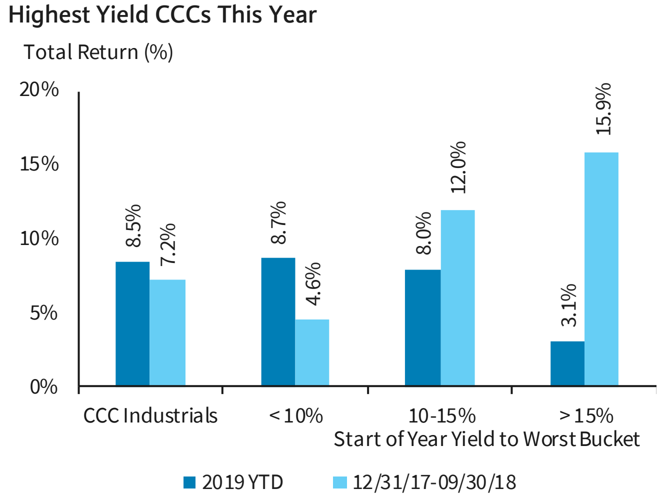
The Very Liquid Index (VLI) Has Outpaced the Rest of the Market Even More for CCCs



Source: Bloomberg Barclays Indices

FIGURE 6

CCCs with Lower Yield to Worst Have Outperformed the Highest Yield CCCs This Year



Source: Bloomberg Barclays Indices

Within the CCC cohort, there has been a meaningful underperformance of the widest trading bonds. CCC bonds, which had a yield to worst of over 15% at the start of the year, have returned just 3.1%, well below returns of 8.5% for CCC industrials as a whole (Figure 6). In a fashion similar to investors hoping to remain liquid late in the cycle, those who have allocated to CCCs are clearly focused on the "safer" CCCs.

We do not expect this behavior to change with respect to the riskiest CCCs unless economic growth rebounds significantly, to levels more commensurate with the first three quarters of last year. The widest yielding CCC bucket returned 15.9% during that period, compared with 4.6% for the sub-10% CCCs. In addition, the preference for liquidity we have seen this year was not present in the first three quarters of 2018. Specifically, the anti-VLI outperformed the VLI by 243bp for CCCs, compared with just 84bp for the overall index.

Since we do not expect economic growth to boom in 2H19, we believe that smaller CCCs and the highest yielding bucket are still unlikely to outperform. However, the carry of CCCs is now more than two times the BB portion of the market (10.2% and 4.4%, respectively). CCCs would have to underperform BBs by nearly 100bp of relative spread widening from already-elevated levels to have lower returns for the back half of the year.

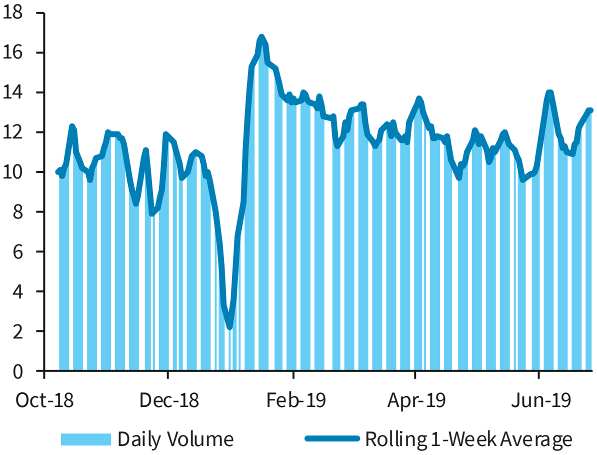
Since we see the index overall selling off less than that and an increasing probability that a proactive Fed will be supportive for spreads, we believe CCCs no longer warrant an underweight. Instead, we would look to bring allocations closer to market weight, but in a way that under-yields the overall CCC portion of the index, as we believe there is still elevated risk in the 15%+ bucket. This gives up some of the cushion, but should still allow for alpha generation. Figure 7 highlights specific CCC bonds that have a yield to worst below the average CCC level, but well above the market, and that our fundamental analysts believe offer attractive carry and/or some potential spread tightening.

FIGURE 7
Select CCC Bonds

Issuer	Ticker	Coupon (%)	Maturity Date	Amount Out. ($mn)	Sector	Analyst	Rating	Yield to Worst (%)	Price ($)	OAS (bp)
ARD Securities Finance	ARDSEC	8.75	1/31/2023	382	Packaging	Brian Lalli	OW	10.1	99	833
BWAY Holding	BWY	7.25	4/15/2025	1,350	Packaging	Brian Lalli	OW	8.0	97	587
Endo	ENDP	6	2/1/2025	1,200	Pharmaceuticals	Rishi Parekh	OW	14.4	68	1255
Endo	ENDP	6	7/15/2023	1,440	Pharmaceuticals	Rishi Parekh	OW	14.9	74	1313
Flex Acquisition	FLXACQ	6.875	1/15/2025	625	Packaging	Brian Lalli	OW	8.8	92	690
Flex Acquisition	FLXACQ	7.875	7/15/2026	500	Packaging	Brian Lalli	OW	9.6	91	755
IRB Holding	ARGIHC	6.75	2/15/2026	485	Restaurants	Hale Holden	Not Rated	6.9	99	464
Kronos Acquisition	KIKCN	9	8/15/2023	890	Consumer Products	Hale Holden	OW	13.2	87	1141
McDermott	MDR	10.625	5/1/2024	1,300	Oil Field Services	Paul Chambers	OW	13.6	89	1177
Tenet Healthcare	THC	6.875	11/15/2031	362	Healthcare	Rishi Parekh	OW	8.0	91	596
Tesla	TSLA	5.3	8/15/2025	1,800	Automotive	Chris Wang	OW	7.8	88	592
Transocean	RIG	7.25	11/1/2025	750	Oil Field Services	Paul Chambers	OW	8.6	93	665
Transocean	RIG	7.5	1/15/2026	750	Oil Field Services	Paul Chambers	OW	9.0	93	702
Transocean	RIG	6.8	3/15/2038	1,000	Oil Field Services	Paul Chambers	OW	10.1	72	792
Transocean	RIG	7.5	4/15/2031	588	Oil Field Services	Paul Chambers	OW	10.2	82	816

Source: Barclays Research, Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)

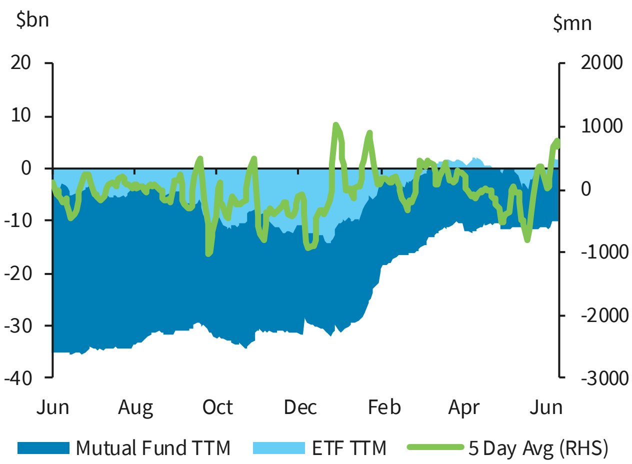


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

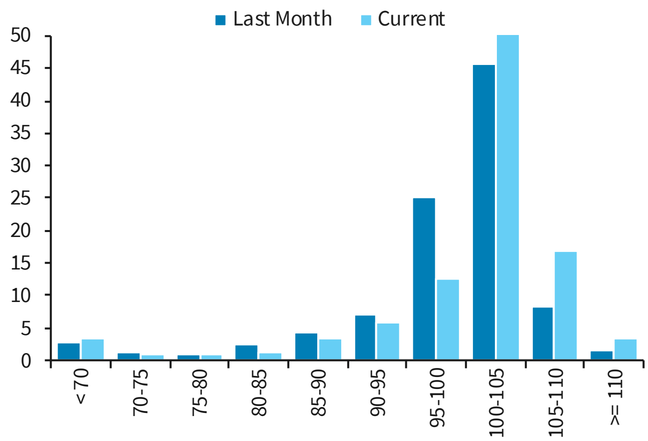
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



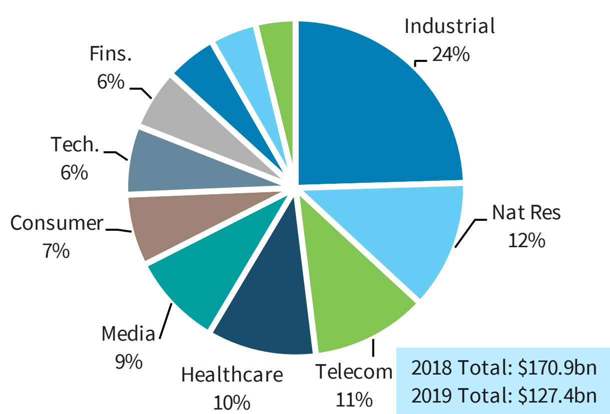
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



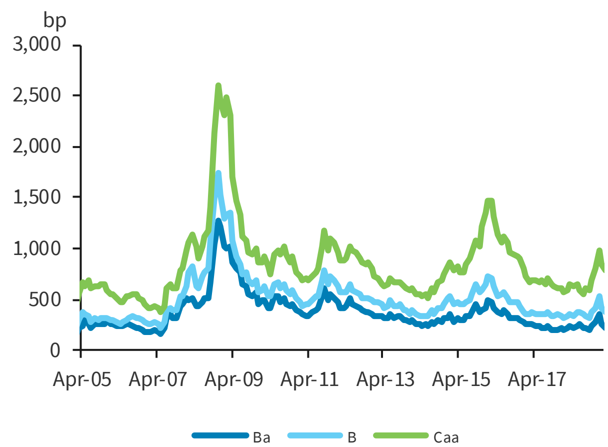
Source: Barclays Research

High Yield Supply by Sector



Note: 2019 new issue data as of June 26.
Source: Bloomberg Barclays Indices

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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ARDSEC 8 3/4 01/31/23, Overweight (USD 100.50, 26-Jun-2019)

BWAY HOLDING CO, CD/J/K/M
BWY 7 1/4 04/15/25, Overweight (USD 96.63, 26-Jun-2019)

ENDO DAC / ENDO FINANCE LLC / ENDO FINCO INC, CD/D/J/L
ENDP 6 02/01/25, Overweight (USD 67.25, 26-Jun-2019)
ENDP 6 07/15/23, Overweight (USD 72.25, 26-Jun-2019)

FLEX ACQUISITION CO INC, CD/J
FLXACQ 6 7/8 01/15/25, Overweight (USD 91.75, 26-Jun-2019)
FLXACQ 7 7/8 07/15/26, Overweight (USD 93.00, 26-Jun-2019)

IRB HOLDING CORP, CD/D/J/K/L/M
ARGIHC 6 3/4 02/15/26 (USD 100.25, 26-Jun-2019)

KRONOS ACQUISITION HOLDINGS INC, CD/J/K/M
KIKCN 9 08/15/23, Overweight (USD 87.50, 26-Jun-2019)

MCDERMOTT TECHNOLOGY AMERICAS INC / MCDERMOTT TECHNOLOGY US INC, CD/D/J/K/L/M/N
MDR 10 5/8 05/01/24, Overweight (USD 93.25, 26-Jun-2019)

TENET HEALTHCARE CORP, A/CD/CE/D/J/K/L/M
THC 6 7/8 11/15/31, Overweight (USD 90.25, 26-Jun-2019)

TESLA INC, A/CD/CE/D/FA/FB/J/K/L/M
TSLA 5.3 08/15/25 (USD 87.50, 26-Jun-2019)

TRANSOCEAN INC, A/CD/D/J/K/L/M/N
RIG 6.8 03/15/38, Overweight (USD 74.25, 26-Jun-2019)
RIG 7 1/2 04/15/31, Overweight (USD 84.75, 26-Jun-2019)

RIG 7 1/2 01/15/26, Overweight (USD 95.25, 26-Jun-2019)
RIG 7 1/4 11/01/25, Overweight (USD 95.00, 26-Jun-2019)

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The analyst expects the six-month excess return of the country's index eligible bonds to be in line with the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the six-month excess return of the country's index eligible bonds to be less than the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity.

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