

## More than “cyclical” premium

Hanyi Lim  
+44 (0) 20 3555 0397  
hanyi.lim@barclays.com  
Barclays, UK

Soren Willemann  
+44 (0) 20 7773 9983  
soren.willemann@barclays.com  
Barclays, UK

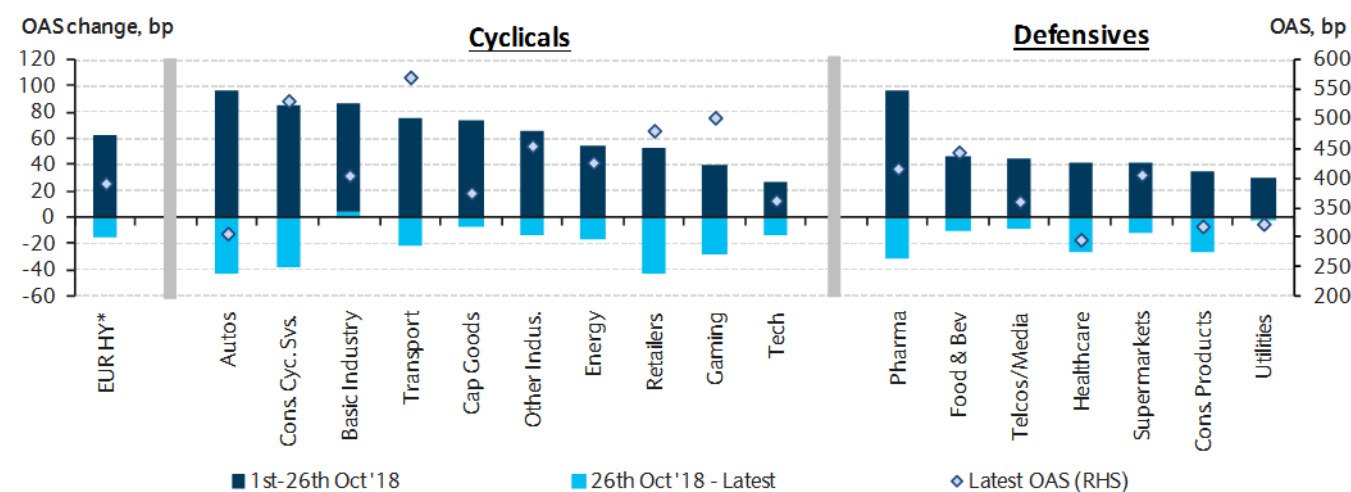
The underperformance of “cyclical” versus “defensive” sectors in October was driven by a decompression and a rising “rating” premium as well as a “cyclical” sector premium. Since then, however, the “rating” premium has reversed, while half of the “cyclical” premium has persisted and the “liquidity” premium for cyclicals has risen meaningfully. In sum, cyclical sectors have underperformed moderately, sitting at 12m wides versus defensive credits, but have also seen a deterioration in liquidity. We screen for wide trading “cyclical” names for investors who are comfortable holding relatively less liquid bonds and “cyclical” risk, and provide a list of defensive names trading relatively wide for investors focused on further cyclical underperformance.

## Defining “cyclical” and “defensive”

The EUR HY corporate market widened by about 60bp between 1 and 26 October, with the move led by “cyclical” sectors. By “cyclical” we refer to the equity market convention where “cyclicals” are those whose earnings have relatively higher beta to GDP growth/economic cycle. In contrast, “defensives” is made up of sectors that usually maintain a relatively stable earnings profile over the cycle<sup>1</sup>. For example, industrials and consumer discretionary goods are classified as cyclical, while food and beverage and utilities are classified as defensive. Adopting the MSCI Cyclical and Defensive indices<sup>2</sup> classification, except for Energy (which we think is more appropriately classified as “cyclical”, particularly in high yield), in Figure 1 we list sectors in both cohorts as well as their performance since 1 October.

Using these definitions, we construct indices to track the spread performance of Cyclical and Defensive sectors, subject to some additional constraints (excluding distressed and very short/long duration bonds, or bonds with zero/negative OAS). As per Figure 2, we confirm that Cyclical sectors have underperformed year to date, with the spread between these two segments of the market at 12-month wides.

FIGURE 1  
EUR HY Corp: Definition of “cyclical” and “defensive” and their performance since 1 October



Source: Bloomberg Barclays Indices, Barclays Research

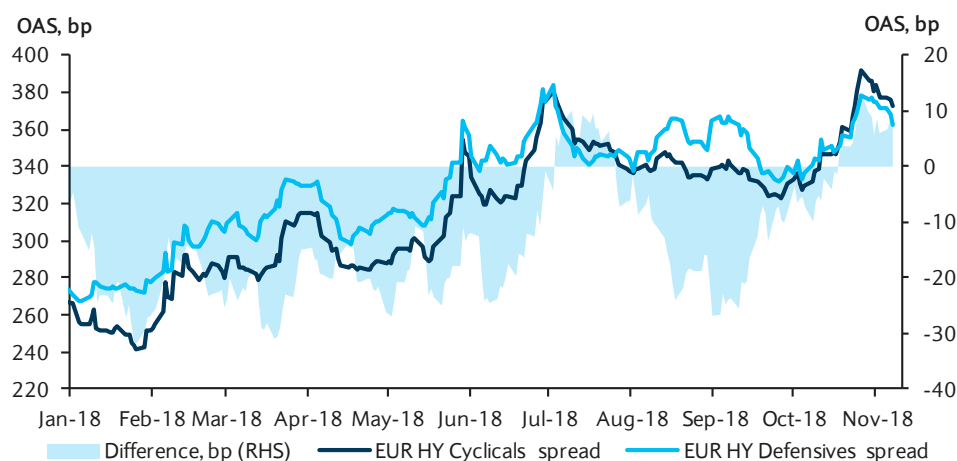
\*EUR HY index excludes financials, hybrids and bonds with OAS <40bp (to exclude call constrained bonds with negative/unusually low spreads).

Note: We have excluded three sub-sectors under “consumer cyclical” as they each contain only two bonds: Leisure, Lodging, and Restaurants.

<sup>1</sup> ETF Strategy: FTSE launches smart beta cyclical and defensive indices, 6 Feb 2013 and Morningstar Global Equity Classification Structure, 24 May 2011

<sup>2</sup> MSCI Cyclical and Defensive Sectors Indexes Methodology, June 2014

FIGURE 2

**EUR HY cyclical vs. defensive performance**

Source: Bloomberg Barclays Indices, Barclays Research

## Decomposing the underperformance in October

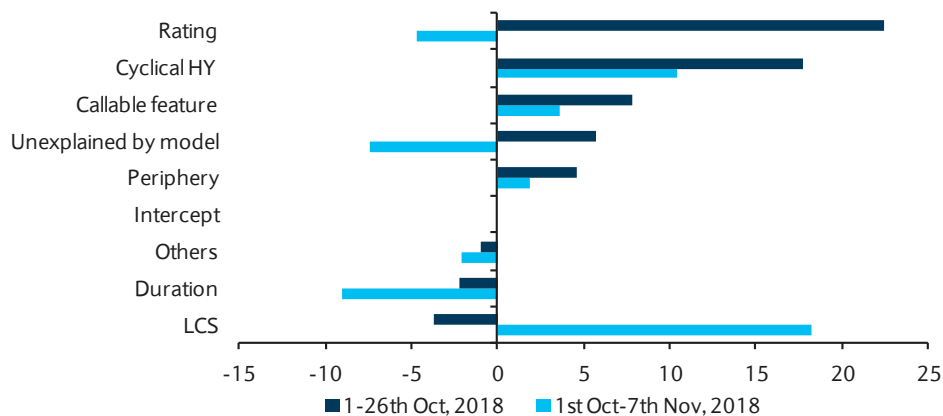
While this analysis is gratifying, it fails to account for other factors that could have driven the underperformance of cyclical sectors, such as differences in rating or callability. To adjust for this we measure the cyclical premium as a dummy variable in our HY spread model. In Figure 4, we look at how each factor in our model contributed to the relative performance of cyclical versus defensives, between 1 and 26 October. This shows that the underperformance of cyclical versus defensives in October was only partly due to a rise in “cyclical” premium, the rise in “rating” premium was a bigger factor.

Since the broader market started tightening from 26 October, however, this ratings-driven underperformance has unwound, and while the “cyclical” premium has fallen by about 8bp, it is still about 10bp higher than prior to market widening at the beginning of October. What is more, the “liquidity” premium for cyclical versus defensives has risen by 18bp.

FIGURE 3

**EUR HY spread model: Decomposing spread moves by factor**

Cyclical vs. Defensive: Change in spread contribution by factors, bp



Source: Bloomberg Barclays Indices, Barclays Research

Thus we can see that cyclical have underperformed (by about 10bp) since the beginning of October, and that they have also suffered a deterioration in liquidity (widening bid-offer spread causing their Liquidity Cost Score to rise). Given the relatively small rise in the

cyclical premium (versus a longer history), this is not obviously a buying opportunity but for clients who are interested in capturing this rise in the premium or (instead) the rise in the liquidity premium associated with these securities, in Figure 5 we screen for securities that trade wide versus our model-implied fair value in the cyclical basket.

For long-only investors worried about a continued sell off led by cyclical, we note that there is greater liquidity and potentially less downside, in defensive bonds that trade cheap versus our model. We screen for these in Figure 6.

FIGURE 4

For investors comfortable taking the “cyclical” premium and holding relatively illiquid bonds, we screen for cyclical names trading relatively wide

ISIN	Security Name	Sector	Index Rating	Price	YTW	OAD	Market OAS	Model Implied OAS	Rich / (Cheap)	Analyst Rating
XS1251078009	DOUGR 6 1/4 07/15/22	Retailers	B2	87	10.7	3.1	1108	560	-548	MW
XS1265917481	BALTAL 7 3/4 09/15/22	Capital Goods	B1	92	10.3	3.0	1058	537	-521	MW
XS1400707771	PREEM 11 3/4 05/15/21	Energy	B2	107	8.8	2.1	932	541	-390	NC
XS1043961439	OHLSM 4 3/4 03/15/22	Capital Goods	B3	82	11.4	2.9	1184	803	-381	NC
XS1694628287	ALMAIN 7 1/4 10/15/22	Technology	B2	94	9.2	3.2	950	603	-348	NC
XS1513765922	CDRSM 6 3/4 11/01/21	Gaming	B2	95	8.8	2.5	921	579	-342	OW
XS1685702794	INLOTG 5 1/4 09/15/24	Gaming	B2	78	10.3	4.7	1041	750	-290	MW
XS1357678322	VERITS 7 1/2 02/01/23	Technology	B2	99	7.7	2.6	759	480	-279	NC
XS1074596344	OFFMAC 5 3/4 06/01/21	Capital Goods	B3	93	8.9	2.2	944	689	-255	NC
XS1647100848	CMACG 6 1/2 07/15/22	Transportation	B3	95	8.1	3.0	849	595	-254	MW
XS1206510569	OHLSM 5 1/2 03/15/23	Capital Goods	B3	83	10.4	3.7	1068	821	-247	NC
XS1435297202	IPGIM 3 3/4 06/24/21	Other Industrial	BA2	95	5.6	2.5	608	370	-238	NC
XS1071419524	GALAPG 5 3/8 06/15/21	Other Industrial	CAA1	88	11.0	2.3	1152	914	-238	MW
XS1244815111	CMACG 7 3/4 01/15/21	Transportation	B3	100	7.6	1.4	778	554	-224	MW
XS1703065620	CMACG 5 1/4 01/15/25	Transportation	B3	85	8.4	5.0	846	625	-222	MW

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 5

For investors concerned about downside risks to cyclical from here, we screen for defensive names trading relatively wide

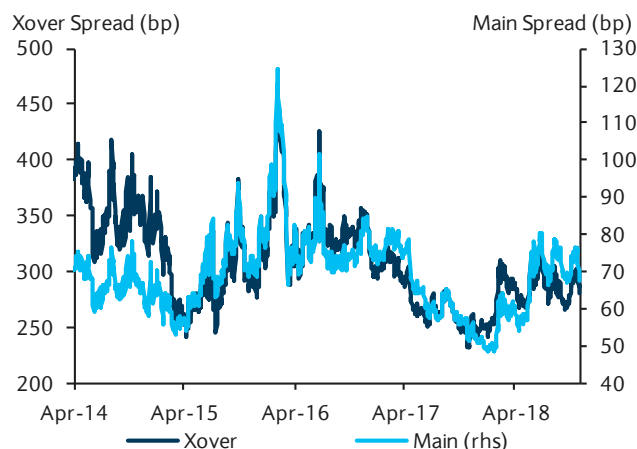
ISIN	Security Name	Sector	Index Rating	Price	YTW	OAD	Market OAS	Model Implied OAS	Rich / (Cheap)	Analyst Rating
XS1061642317	ATCNA 7 1/4 05/15/22	Communications	B3	97	8.1	2.4	822	506	-316	OW
FR0011400571	COFP 3.311 01/25/23	Supermarkets	BA2	97	5.2	3.7	548	253	-296	MW
FR0011765825	COFP 4.498 03/07/24	Supermarkets	BA2	95	5.4	4.6	557	276	-281	MW
XS1117300241	ATCNA 6 1/4 02/15/25	Communications	B3	89	8.5	4.7	850	578	-272	MW
XS1608040090	SENGR 3 7/8 10/25/22	Utility	B3	83	9.2	3.5	957	696	-261	NC
XS1684385591	SOFTBK 4 09/19/29	Communications	BA1	88	5.4	8.6	499	245	-254	MW
XS1793255941	SOFTBK 5 04/15/28	Communications	BA1	99	5.2	7.4	490	239	-251	MW
FR0013260379	COFP 1.865 06/13/22	Supermarkets	BA2	91	4.7	3.4	507	257	-251	MW
FR0011052661	COFP 5.976 05/26/21	Supermarkets	BA2	104	4.1	2.3	460	213	-247	MW
FR0012369122	COFP 3.58 02/07/25	Supermarkets	BA2	90	5.4	5.4	541	300	-240	MW
FR0012074284	COFP 4.048 08/05/26	Supermarkets	BA2	90	5.5	6.5	539	309	-230	MW
FR0013183571	TEREOS 4 1/8 06/16/23	Food and Beverage	BA3	95	5.2	4.1	546	339	-207	NC
FR0011215508	COFP 5.244 03/09/20	Supermarkets	BA2	103	2.9	1.3	359	161	-198	MW
XS1266661013	SOFTBK 5 1/4 07/30/27	Communications	BA1	102	4.9	6.9	468	270	-198	MW
XS1684385161	SOFTBK 3 1/8 09/19/25	Communications	BA1	93	4.2	6.1	419	236	-183	MW

Source: Bloomberg Barclays Indices, Barclays Research

## HY credit at a glance

FIGURE 6

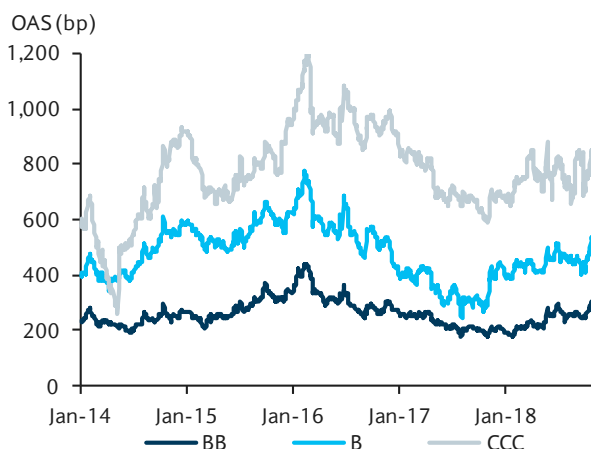
## iTraxx Crossover vs. iTraxx Main

Please click [here](#) to see on Barclays Live.

Source: Markit, Barclays Research

FIGURE 7

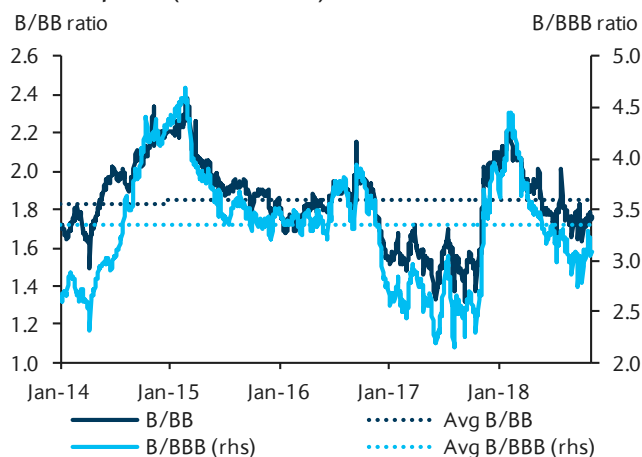
## Pan-Europe HY (ex-financials) spread by rating

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Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 8

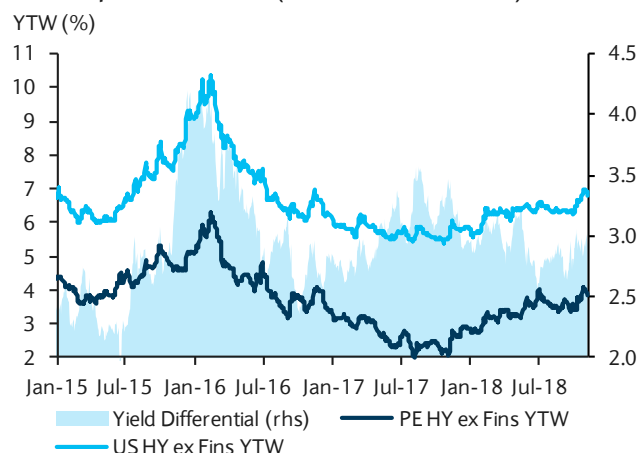
## Pan-Europe HY (ex-financials): B vs. BB and BBB ratios

Please click [here](#) to see on Barclays Live.

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 9

## Pan-Europe HY vs. US HY (ex-financials for both)

Please click [here](#) to see on Barclays Live.

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 10

## European HY issuance

Issuers:	All firms, in any European currency		European firms
Market:	Pan-European High Yield		US High Yield
Crncy:	€	£, CHF, other	\$
WTD	0.5	0.0	0.0
MTD	0.5	0.0	0.0
YTD	51.2	4.4	9.5
YoY	-23%	-66%	+60%
YTD '17	66.9	12.8	5.9

Source: S&amp;P LCD, Bloomberg, Barclays Research Note: Supply in billion.

FIGURE 11

## European HY issuance monthly trends

Issuers:	All firms, in any European currency				European firms	
Market:	Pan-European High Yield				US High Yield	
Crncy:	€		£, CHF, other		\$	
Year:	2017	2018	2017	2018	2017	2018
Jan	2.9	4.7	2.8	1.6		1.1
Feb	6.2	3.3	0.7	0.1	1.3	1.3
Mar	11.2	8.7	1.5	0.6	0.4	1.4
Apr	6.1	8.4	1.2	0.3		1.4
May	2.2	3.6	0.6	0.3	0.5	0.8
Jun	7.2	6.7	2.1		0.4	0.8
Jul	6.8	5.4	0.7		0.5	1.5
Aug		0.5				
Sep	9.1	6.6	1.8	1.3		0.6
Oct	13.0	3.0	1.1	0.3	2.6	0.4
Nov	7.8	0.5	0.5		1.1	
Dec	4.3		0.8		0.3	
<b>Total</b>	<b>76.7</b>	<b>51.2</b>	<b>13.9</b>	<b>4.4</b>	<b>7.0</b>	<b>9.5</b>

Source: S&amp;P LCD, Bloomberg, Barclays Research Note: Supply in billion.

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ATCNA 6 1/4 02/15/25, Market Weight

ATCNA 7 1/4 05/15/22, Overweight

**CASINO GUICHARD PERRACHON SA, CD/FA/J/K/M**

COFP 1.865 06/13/22, Market Weight

COFP 3.311 01/25/23, Market Weight

COFP 3.58 02/07/25, Market Weight

COFP 4.048 08/05/26, Market Weight

COFP 4.498 03/07/24, Market Weight

COFP 5.244 03/09/2020, Market Weight

COFP 5.976 05/26/21, Market Weight

**CMA CGM SA, CD/J**

CMACG 7 3/4 01/15/21, Market Weight

CMACG 5 1/4 01/15/25, Market Weight

CMACG 6 1/2 07/15/22, Market Weight

**CODERE FINANCE 2 LUXEMBOURG SA, CD/J**

CDRSM 6 3/4 11/01/21, Overweight

**DOUGLAS GMBH, CD/J/K/N**

DOUGR 6 1/4 07/15/22, Market Weight

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GALAPG 5 3/8 06/15/21, Market Weight

**INTRALOT CAPITAL LUXEMBOURG SA, CD/J**

INLOTG 5 1/4 09/15/24, Market Weight

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BALTAL 7 3/4 09/15/22, Market Weight

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SOFTBK 3 1/8 09/19/25, Market Weight  
SOFTBK 4 09/19/29, Market Weight  
SOFTBK 5 04/15/28, Market Weight  
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For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.

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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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 less than the six-month total return of the relevant index.

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**Market Weight (MW):** The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.

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The analyst expects the six-month excess return of the country's index eligible bonds to exceed the six-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

##### **Market Weight (MW):**

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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