

Upside-Down BBs

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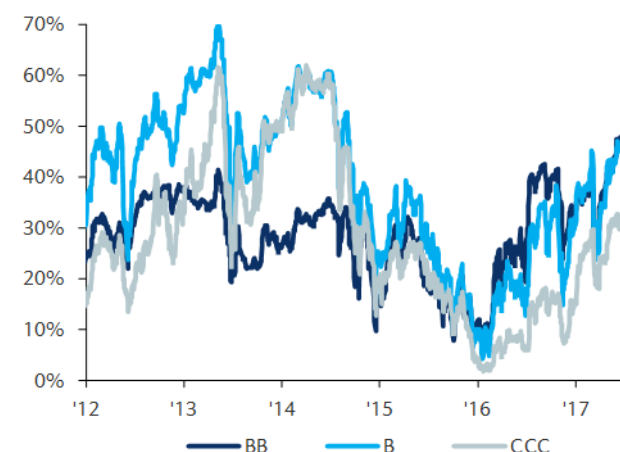
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The continued weakness in oil prices has begun to weigh meaningfully on the energy sector and broader index. The high yield energy sector is down 2pts this week, driving index yields about 15bp higher. With oil prices hovering near \$40-45/bbl, we expect the energy sector to see renewed sensitivity to oil given its oil price convexity (please see [High Yield Top Picks](#), March 31, 2017). Even away from the commodities exposure, risks seem tilted to the downside recently, as corroborated by 1Q17 earnings, with the upside potential from improving earnings expectations considerably less than the downside from deteriorating outlooks (see [Expectations versus Reality](#), June 2, 2017).

Any room for further upside is also limited by a more call-constrained high yield market (42% trading above the next call price), with BBs appearing particularly susceptible to the effects of negative convexity (Figure 1). In the aftermath of the US election, the share of call-constrained BBs has climbed to an all-time high of 46%, marking a deviation from the typical risk-on behavior: during the late-2013 rally, for instance, call-constrained paper remained below 35% for BBs, but burgeoned to 60% for Bs and CCCs.¹

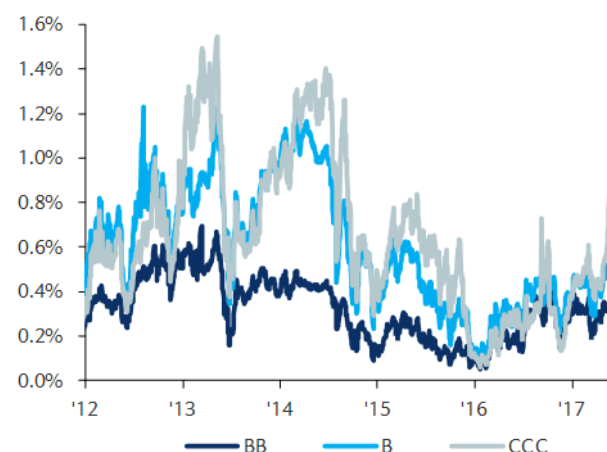
While call constraints are at all-time highs for BBs, extension risk also remains significant for this segment of the market. The difference in BB yield to worst and yield to maturity – a measure of the moneyness of the embedded call option – has remained low (35 bp), suggesting that even a modest increase in yield could trigger extension. In the post-election rally, this gap widened for higher-beta credits, increasing the probability that these bonds will eventually be called (Figure 2). Admittedly, higher-beta debt is likely to be more volatile, which means that the difference between yield to worst and yield to maturity can close more quickly than it would for lower-beta. However, even after accounting for their lower volatility relative to the rest of the high yield market, BBs are still characterized by a tighter yield gap and, as such, suffer from higher extension risk.

FIGURE 1
Share of Call-Constrained Bonds by Quality



Source: Bloomberg Barclays Indices

FIGURE 2
Difference between Yield to Maturity and Yield to Worst



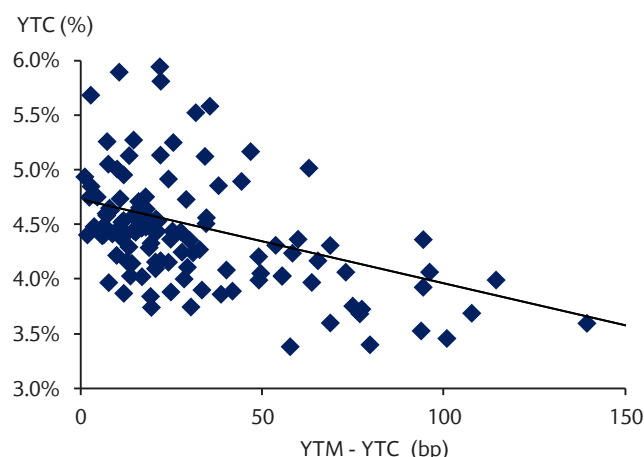
Source: Bloomberg Barclays Indices

¹ Callable paper has historically accounted for 55% of BBs, versus 83% for the rest of the market on average, keeping the share of BB call-constrained bonds in check. Lighter fallen angel volumes and the recent rally in BBs helped contribute to the recent increase in BB call-constrained paper.

Furthermore, volatility in rates markets could emerge as a key driver of total return volatility, with the 5y projected to reach 2.05% by year-end. Under this scenario, BB yields can back up more quickly than Bs and CCCs given a thinner spread cushion (see *Basis Point Break* May 5, 2017). This again suggests that investors seeking to add exposure to BBs should be wary of the potential downside from extension.

As such, Figure 3 compares extension gap (the difference between the yield to call and yield to maturity) against the upside from call (the yield to call) for call-constrained BB bonds.² As mentioned, bonds with a tighter extension gap should have higher extension risk. Indeed, there is a clear relationship between extension risk and valuations: the yield to call is higher for bonds with the tightest extension gap. Figure 4 thus highlights select call-constrained bonds that trade below 4% and have an extension gap of less than 50bp; in our view, upside appears limited for these bonds at current levels.

FIGURE 3
Compensation Required for Incremental Extension Risk



Source: Bloomberg Barclays Indices

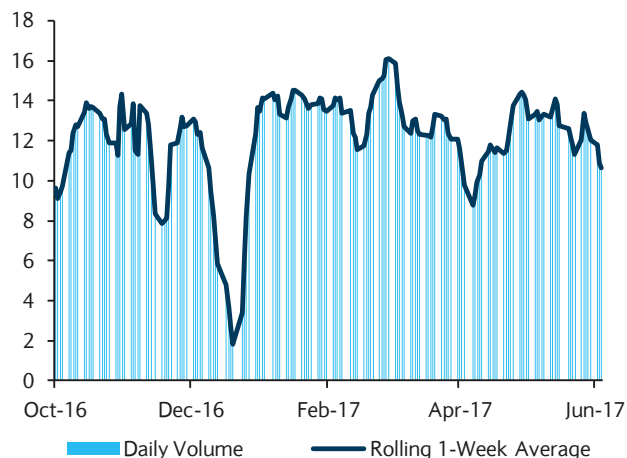
FIGURE 4
Tight-Trading Call-Constrained BBs with Low Extension Gap

Ticker	Security	Amt Out (\$ mn)	Yield (%)	Price (\$)
HILDOC	4.25s of 2024	1,000	3.74	102.0
HLT	4.625s of 2025	900	3.74	103.8
SHAEFF	4.5s of 2023	500	3.84	102.6
ARMK	5s of 2025	600	3.88	105.8
BMCAUS	5.375s of 2024	1,100	3.99	105.6
TLLP	5.25s of 2025	750	4.00	106.2

Source: Bloomberg Barclays Indices

² For the purpose of our analysis, we excluded bonds that are callable within two years. Please refer to *Call Me Later* (March 10, 2017) for a more detailed discussion of extension risk in short duration.

High Yield Average Institutional Trade Volume (\$bn)



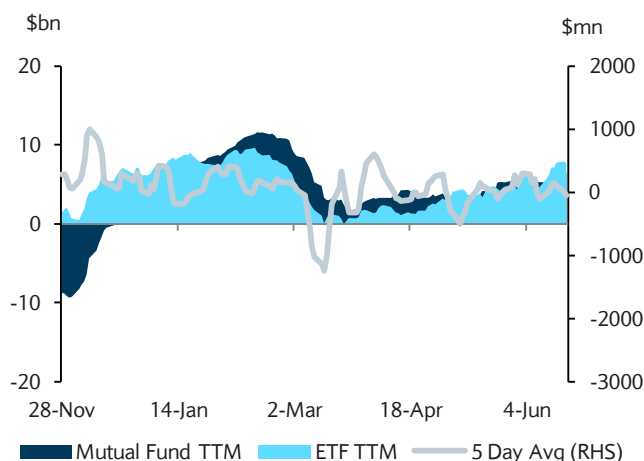
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



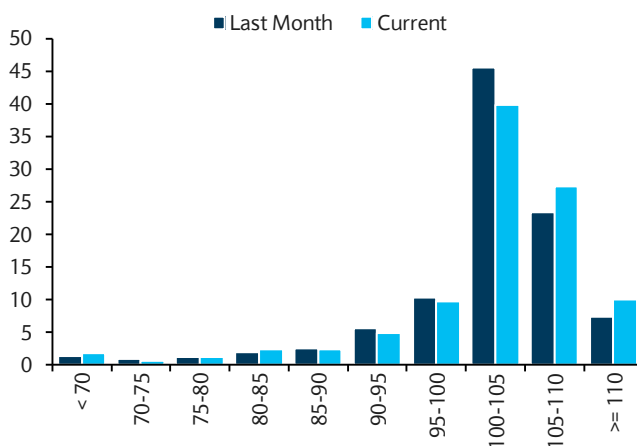
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



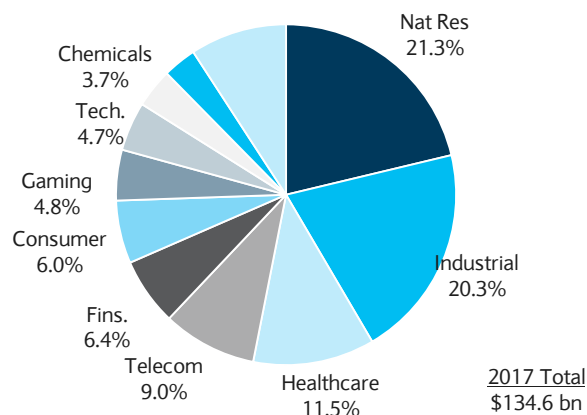
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



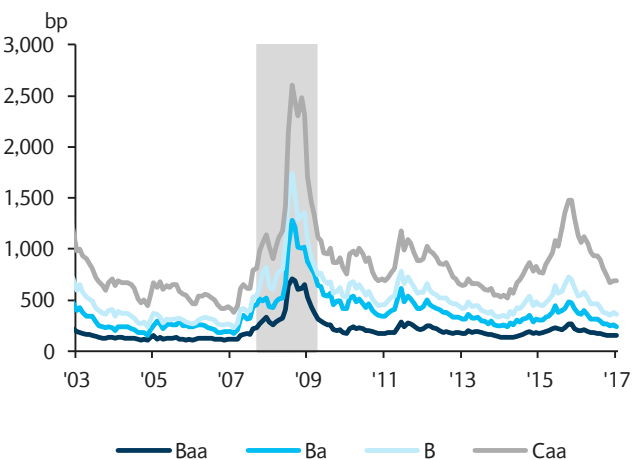
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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ARMK 5 04/01/25, Market Weight (USD 105.75, 21-Jun-2017)

HILTON DOMESTIC OPERATING CO INC, A/CD/D/E/J/K/L/M

HILDOC 4 1/4 09/01/24 (USD 101.75, 21-Jun-2017)

HILTON WORLDWIDE FINANCE LLC / HILTON WORLDWIDE FINANCE CORP, A/CD/D/E/J/K/L/M/N

HLT 4 5/8 04/01/25 (USD 103.25, 21-Jun-2017)

IHO VERWALTUNGS GMBH, CD/J/K/M/N

SHAEFF 4 1/2 09/15/23 (USD 102.38, 21-Jun-2017)

STANDARD INDUSTRIES INC/NJ, CD/J/K/M

BMCAUS 5 3/8 11/15/24 (USD 105.50, 21-Jun-2017)

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TLLP 5 1/4 01/15/25 (USD 105.63, 21-Jun-2017)

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