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Bund yields are to blame for rating cliffs

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We build a simple model for the 'apples to apples' BB- to B+ spread pickup. We find strong evidence that the increase in this pickup has been driven by negative/low yields in general, and not the onset of CSPP. In turn, this means that we do not see the end of CSPP as a catalyst for BB underperformance; this will likely only happen when Bund yields rise.

'BB tourism' from traditionally IG-focussed funds is a recurring topic of conversation among HY investors. The narrative typically goes along the lines that "yields dropped and ECB QE started buying corporate bonds; IG investors needed yield so started buying BB bonds, which will quickly run in reverse when QE ends'. This is often used as a reason to be short/Underweight BBs.

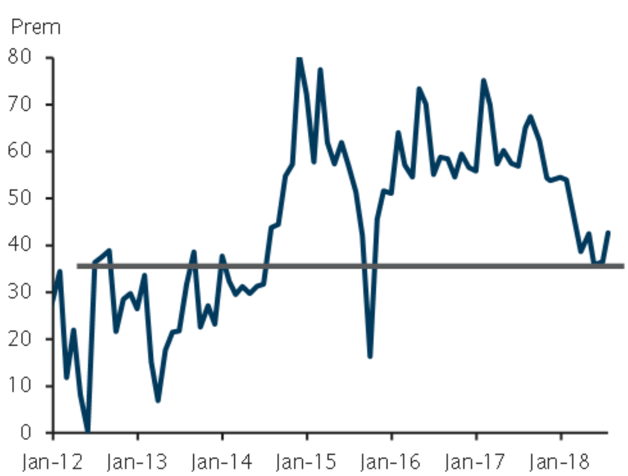
We dispense with emotions about any 'unwanted tourism' and look at BB RV from a quantitative perspective. Instead of relying on the generic rating buckets to gauge the evolution of BB RV, which can be obscured by maturity and sector mismatches, we rely on our cross-sectional HY spread model (*HY model refined - the rules*, 26 January 2018) to isolate the 'apples-to-apples' spread pickup for going from BB- to B+ (Figure 1).

There has been a meaningful change in this pickup over time. Pre-2014, this pick-up was essentially capped below 40bp, but since 2014 there has been a marked change, with the pickup rising to close to 80bp at one stage, and instead of having a cap at 40bp, this has been closer to the floor recently. As of the most recent data point, the pickup is now at 43bp. A few months ago, the pick-up was near 60bp, justifying a preference for Bs over BBs on valuation grounds only, but now the number is more 'middle of the range' and there are two questions to ask: how can we explain the evolution of this pickup, and is the pickup currently reasonable?

To answer this, we develop two simple models, explaining the BBB- to BB+ and BB- to B+ pickups (separately), using the PEHY spread level, V2X, 5y Bund yields and a dummy variable for when CSPP became active. The results (Figure 2) give a number of conclusions.

Focussing briefly on the BBB- to BB+ pickup, we find a good fit to historical levels, with the model being able to explain 63% of the variation in the pickup since January 2013. Away from HY spread levels, the single most important variable to explain the pickup are Bund yields: a decreasing Bund yield led to the pickup from going into HY from IG to drop. This is arguably a

FIGURE 1
BB- to B+ pick-up: current floor was pre-14 ceiling



Source: Barclays Research

FIGURE 2
Modeling BBB- to BB+ and BB- to B+ pickups

	Const	PE HY	V2X	5yr Bund	CSPP
BBB- -> BB+					
Param	-16.37	0.12	0.13	34.27	10.13
t	(-1.57)	(4.37)	(0.27)	(6.64)	(2.03)
R^2	63%				
BB- ->B+					
Param	86.44	-0.09	0.14	-40.45	-16.92
t	(8.29)	(-3.22)	(0.29)	(-7.82)	(-3.39)
R^2	61%				

Note: Monthly data since Jan-13, explaining spread pickups from our cross-sectional model using PEHY spreads, V2X, 5yr Bund yields and a dummy for Jun-16 onwards when CSPP started.

Source: Barclays Research

sign of yield-hunting behaviour: lower yields have reduced the pickup for buying BBs, indicating that BBs were bought by BBB investors. Equally important, the CSPP dummy variable is positive 10bp, and just about statistically significant. This means that the introduction of the CSPP *increased* the pick-up from going into BBs. This makes sense to the extent that CSPP caused BBB (and higher rated bonds) to tighten vs. out-of-scope HY bonds.

Turning to the BB- to B+ pickup instead, we find a good relationship between the actual historical pickup and the model (Figure 3), explaining 61% of the variation in the pickup. The beta to 5y Bunds is large, statistically significant and negative. This means that when Bund yields dropped, the pick-up from buying Bs over BBs increased – fitting with yield-hunting behaviour from IG investors causing a bid for BBs. The CSPP effect is negative at -17bp. This means that the onset of CSPP caused the pick-up to *drop* – effectively with Bs outperforming BBs at the onset of CSPP, amid a general increase in risk-seeking behaviour, beyond what can be explained by HY spreads in general.

This is the key point to us: The 'regime shift' in BB-B pickup was caused by low Bund yields in general and not the introduction of CSPP specifically. In turn, from this quantitative angle, we do not see the end of CSPP as a catalyst for BB to underperform Bs. Rather, this will likely only happen as and when Bund yields rise.

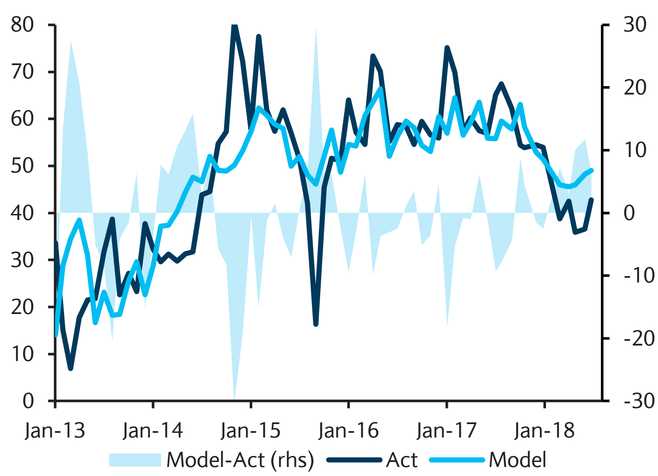
To put some numbers on this, we consider the 'model pickup' assuming that our economists' forecasts for 5y Bund yields in Q4 18, Q1 19 and Q2 19 prevail, and we also consider a retracement to average 5y Bund yields from 2014 of c64bp. We consider two cases. In the first, we assume the CSPP effect disappears in Q1 19 (effectively seeing CSPP as having had a 'flow effect'). In the second case, we assume the CSPP effect remains (effectively seeing CSPP as having had a 'stock effect').

The results (Figure 4) are revealing. Focussing on the light-blue bars, which assume no change from CSPP ending, the model implies that the BB- to B+ pickup will drop from the current model level of 50bp to about 27bp in Q2 19, all else equal. Further, if we see 5y Bund yields at the level of 2013, the pickup could shrink towards the low teens, as was seen in early 2013.

If we assume that we will get a 'reverse CSPP' impact in Q1 19 when CSPP has (presumably) ended, this will completely negate the impact from rising Bund yields, with the pickup remaining close to 50bp, as the end of CSPP (in the model) should cause Bs to underperform somewhat. In this setting, all else equal, if Bund yields retrace to 2013 levels, the pickup will drop from the model-implied 50bp to about 30bp.

FIGURE 3

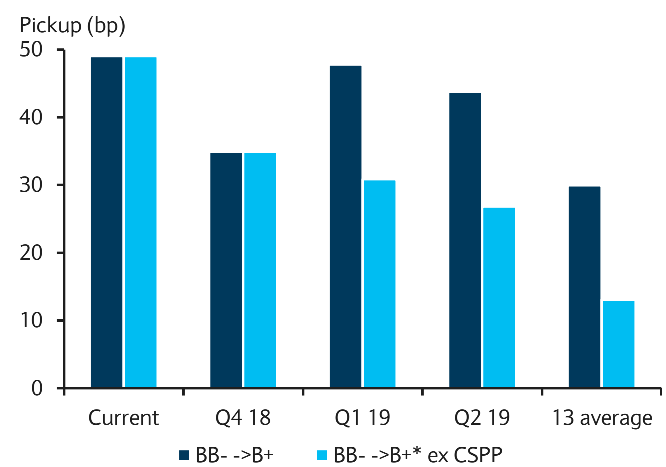
BB- to B+ pickup – actual and model



Source: Barclays Research

FIGURE 4

BB- to B+ modeled pickup – for different 5y Bund scenarios



Note: Our 5y Bund forecasts are for Q4 18, Q1 19 and Q2 19 0.1, 0.2 and 0.3 respectively. Source: Barclays Research

HY credit at a glance

FIGURE 5

iTraxx Crossover vs. iTraxx Main

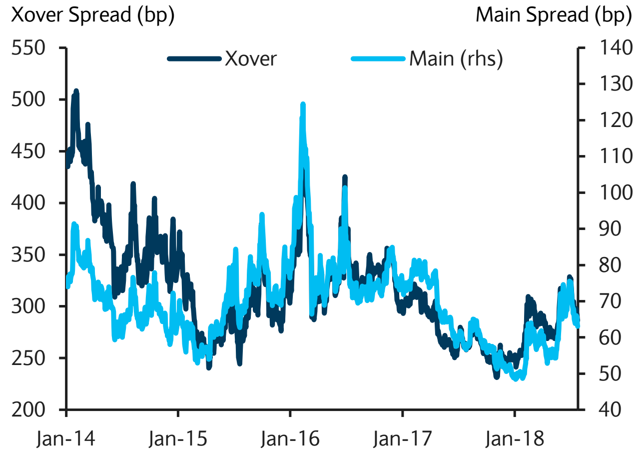


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FIGURE 6

Pan-European HY vs. US HY, both excluding Financials

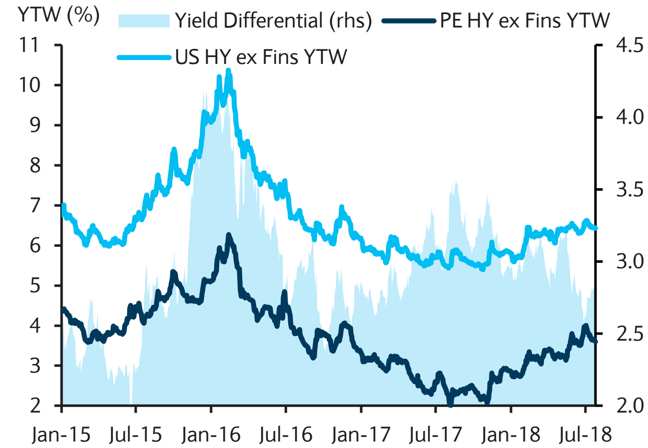

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FIGURE 7

Pan-European HY excluding Financials spread by rating

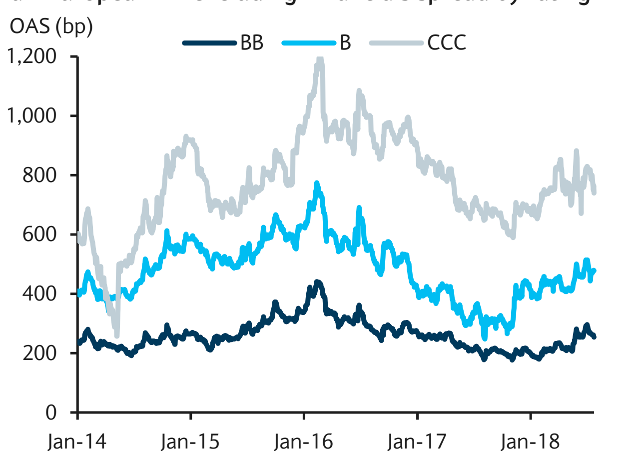

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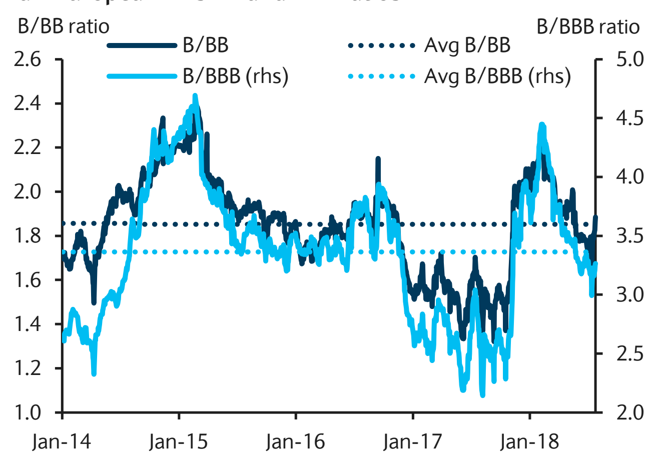
FIGURE 8

Pan-European B vs BB and BBB ratios



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Note: HY spreads exclude Financials

FIGURE 9

European HY issuance

Issuers:	All firms, in any European currency		European firms
Market:	Pan-European High Yield		US High Yield
Crncy:	€	£, CHF, other	$
WTD	0.0	0.0	0.0
MTD	3.1	0.0	1.5
YTD	38.2	2.6	8.4
YoY	-10%	-73%	+172%
YTD '17	42.3	9.7	3.1

Supply in € bn.

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

FIGURE 10

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	1.5		1.1
Feb	6.2	3.3	0.7	0.1	1.3	1.3
Mar	11.2	8.7	1.5	0.5	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	6.5	2.1		0.4	0.8
Jul	6.8	3.1	0.7		0.5	1.5
Aug	-	-	-	-	-	-
Sep	9.1		1.8			
Oct	13.0		1.1		2.6	
Nov	7.8		0.5		1.1	
Dec	4.3		0.8		0.3	

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

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