Good Things Come in Small Packages

High Yield Strategy | United States
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Bank of America Merrill Lynch

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Stay tuned for next episode of budget drama

The market has breathed the sigh of relief last week as the executive and legislative branches of the US government have come to a compromise on avoiding the fiscal cliff, mostly by raising revenue through new taxes and postponing other fiscal decisions to the end of February. By that time, the US Treasury is also expected to run out of temporary measures to operate beyond its current debt ceiling, which was also technically breached on December 31. Here we are discussing our views on likely direction of these negotiations, probabilities of their success or failure as well as potential market impact.

Equities finally catch up with a message from bonds

HY bonds were trading consistently rich relative to their equities over the past few months, but this gap has started to close in the last few weeks. Bonds in our basket have been trading at dollar prices that were about 2x standard deviations away from what their equities would suggest as recently as in November. This gap has started closing in recent weeks, with our HY equity basket returning 10% since December 1st, while bonds being up 2.3%. At this juncture, bonds are still standing about 1.4x stdev higher in terms of dollar price then what their equities would suggest, implying another 10% move in equities on unchanged bonds.

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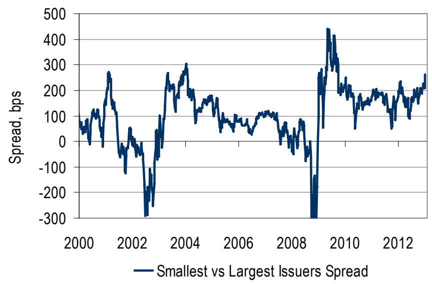
While there are plenty of overpriced bonds in this market, there are still places where investors can find value, at least in relative terms. One of such places are small cap HY issuers, with capitalization here measured by the total value of bonds outstanding. Of course investing in such names generally is considered a high maintenance endeavor, with issues ranging from poor secondary liquidity to incremental research resources required to follow them to more limited issuer access to lower degree of diversity of funding sources to constrained primary allocations – the list goes on and on. Naturally, investors require extra compensation for holding these bonds, and the real questions become: how significant such compensation has to be to make up for all these reasons to avoid investing in small caps, and where does it stand today relative to history. Here we describe our attempt to answering these questions.

HY ETFs: a different angle, similar outcome

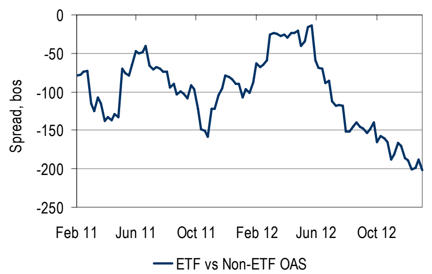
We also take a different angle on this story by examining valuations in bonds widely held by HY ETFs. Here, we separate bonds where ETFs hold more than 5% of total face value outstanding and compare them to bonds of the same issuers with no ETF ownership. Results of this analysis suggest valuations strongly favor bonds outside of ETF ownership boundaries. This result is in line with findings from our previous exercise on small- vs large cap issuer valuations.

HY small- vs large-cap issuer spread



Source: BofA Merrill Lynch Global Research

HY bonds with ETF ownership >5% vs non-ETF bonds of the same issuers



Source: BofA Merrill Lynch Global Research

Refer to important disclosures on page 7 to 9. Link to Definitions on page 6.

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The market has breathed the sigh of relief last week as the executive and legislative branches of the US government have come to a compromise on avoiding the fiscal cliff, mostly by raising revenue through new taxes and postponing other fiscal decisions to the end of February. By that time, the US Treasury is also expected to run out of temporary measures to operate beyond its current debt ceiling, which was also technically breached on December 31. Most political observers agree that President Obama has won this round of negotiations against Republicans as he achieved most of what he campaigned on without having to give much in return for it. Following this agreement, the President has reaffirmed his position that any future deficit reductions must come in equal parts new revenues and spending cuts. Republicans, still likely recuperating post tax hikes they perhaps reluctantly voted for, are positioning strongly against such an approach and looking for reasons to strike back and get the spending cuts they have been deprived of in this most recent round of negotiations.

Stay tuned for next episode of budget drama

All in all, this sets us up for another captivating round of political maneuvering, which would be even more interesting to watch if it was not involving a threat of US government failing to honor its debt obligations, even if temporarily. The issue here is two-fold: (1) breaching debt ceiling is not as painless as breaching tax-hike deadline, which everyone just assumed would be fixed retroactively anyway; and (2) the public opinion is on the opposite side of this issue as vast majority staunchly opposed across-the-board tax hikes (shocking!), but would not mind see the government spending curtailed and limit the mounting debt. In other words, the assumption that we will see just another last minute deal being cut in late February is very enticing and we are certainly hoping this would be the case, and yet we are not finding sufficient arguments to convince ourselves that this indeed would be the case.

HY breaches more records, in price and yields…

With the first set of budget drama in Washington being over, the market has taken it in strides to see at least some compromise being found with risk assets rallying across the board. The HY bond index (H0A0) has tightened over 50bps in a matter of weeks, with post-New Year's rally accountable for half of that. This leaves us at 506bp spread, a striking distance to our 475bp spread target which looked aggressive as recently as early December, when spreads stood at 560bp. As we pointed in our year-ahead report, the important point here is that any spread tightening outside of Treasury yields rising is going to be limited, and now, that such tightening has taken place, we would say it is over for all practical purposes. This spread move has taken our dollar price to 105pts, or 1/2pt higher than its previous historical record. Breaching historical record in HY price is not inconceivable at the time when so many other fixed income asset classes distorted by Fed's monetary policy. And yet, we believe, every subsequent quarter point beyond that historical record would be harder and harder to come by given the call ceiling constraints, which leaves us exactly where we are standing here today, with no meaningful prospects for further price appreciation.

… maintains capacity to offset rate moves

Looking from spread standpoint, HY still has good capacity to tighten, even from current levels, but any such tightening could only come as a function of Treasury yields rising. And if in writing our year-ahead we made a caveat of this being the case beyond the first 25-50bp of pure credit move, now even such a hedge is no longer applicable. Thus, we believe capital gains in HY are now fully exhausted, and all we are left with is sub-coupon returns and capacity to offset Treasury moves, which is still worth something, in our view. This last point remains the last strongest argument in favor of HY at these levels.

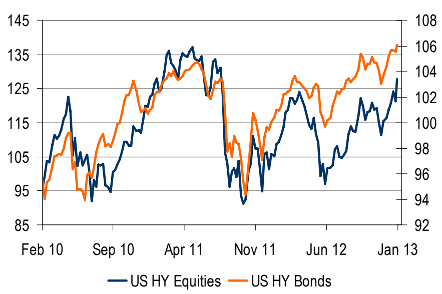
A coincidence or sign of things to come?

Many investors will continue to find HY an attractive place to be in at the time when global macro picture is expected to remain uncertain with US pulling the rest of the world forward and Europe mired in recession. This push-and-pull global economy implies that it may be just a bit too early to fully abandon the relative safety of leveraged credit in favor of upside potential in equities. This last point remains particularly true in the next couple of months, as it follows from our view on the debt ceiling described earlier. Tactically, we believe the market would remain well bid in the next few weeks before euphoria of a "solved" fiscal cliff evaporates and focus shifts to tough realities of avoiding a technical default and another downgrade of US sovereign credit. Thus, we would look to this interim period to lighten up on risk as we go into February, with an eye towards becoming more aggressive once/if the confrontation around next round of fiscal talks results in a market selloff. At the end of the day, we still believe a compromise will be reached, even if it requires a meaningful market weakness or, as some would argue, taking the US into short-term technical default [sic] in order to achieve a long-term solution. The timing of last week's news of Treasury Secretary Geithner preparing to depart before the next round of debates, even if not completely unexpected, perhaps suggests something about how difficult that round might be.

Equities finally catch up with a message from bonds

HY bonds were trading consistently rich relative to their equities over the past few months, but this gap has started to close in the last few weeks (Figure 1). As a reminder, our methodology is based on perfectly-matched bond and equity baskets, represented by the same issuers on both sides, and weighted in exactly the same way[1]. Bonds in our basket have been trading at dollar prices that were about 2x standard deviations away from what their equities would suggest as recently as in November. This gap has started closing in recent weeks, with our HY equity basket returning 10% since December 1st, while bonds being up 2.3%. At this juncture, bonds are still standing about 1.4x stdev higher in terms of dollar price then what their equities would suggest, implying another 10% move in equities on unchanged bonds. Alternatively, a 2% drop in bond prices into unchanged equities would put the two sides into equilibrium again.

Figure 1: US HY bond vs equity baskets
Dollar price indexes, equities LHS, bonds RHS



Source: BofA Merrill Lynch Global Research

Good things come in small packages

While there are plenty of overpriced bonds in this market, there are still places where investors can find value, at least in relative terms. One of such places are small cap HY issuers, with capitalization here measured by the total value of bonds outstanding. Of course investing in such names generally is considered a high maintenance endeavor, with issues ranging from poor secondary liquidity to incremental research resources required to follow them to more limited issuer access to lower degree of diversity of funding sources to constrained primary allocations – the list goes on and on. Naturally, investors require extra compensation for holding these bonds, and the real questions become: how significant such compensation has to be to make up for all these reasons to avoid investing in small caps, and where does it stand today relative to history.

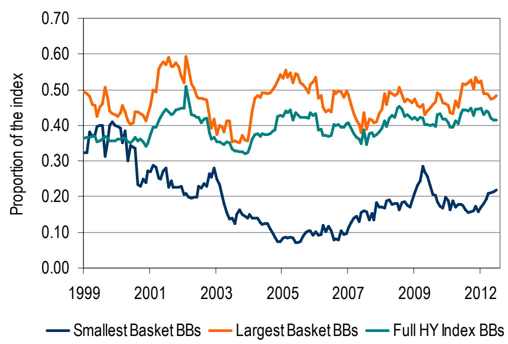
[1] Specifically, we adjust equity weights to match those in our bond basket.

While these questions sound straightforward on their surface, answering them conclusively represents a challenge, given that the impact of issuer size has to be separated from other factors, such as credit quality and sector composition of portfolios in question. To tackle these issues we have created a multi-step procedure that follows these steps before arriving, at what we consider to be a relatively clean comparison samples:

- Rank issuers of our HY index[2] by their size (face value), and separate top 10 and bottom 10 percent of names into two baskets[3];
- Take three largest bonds on large issuer side and any bonds (often the only one) on small issuer side;
- Determine credit qualities (on the alpha-numeric level) and industry sectors that have the largest weight mismatches within each of the two baskets;
- Increase CUSIP weights falling into the most underweighted sector/rating buckets by 1%, while reducing the weights in most overweighted buckets accordingly;
- Iterate through the last step as many times as necessary to arrive at weights that closely correspond to those present in overall HY index.

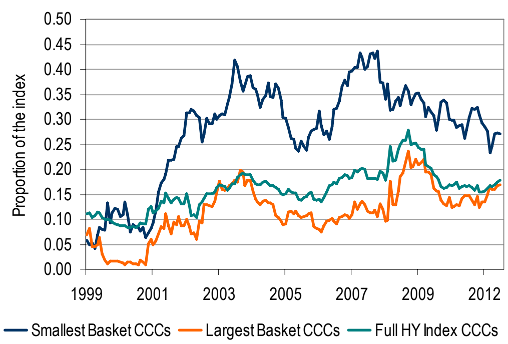
As it turns out, the quality/sector mismatch in original unadjusted baskets is quite significant. Figure 2 and Figure 3 below show the history of weighting in BB and CCC categories respectively. Aside from a simple observation that the quality weight mismatch could be very wide at times, these charts also suggest that smaller-cap issuers tend to be lower quality compared to larger cap names or the broad HY index.

Figure 2: Double-B unadjusted weights in large- vs small-cap baskets



Source: BofA Merrill Lynch Global Research

Figure 3: Triple-C unadjusted weights in large- vs small-cap baskets



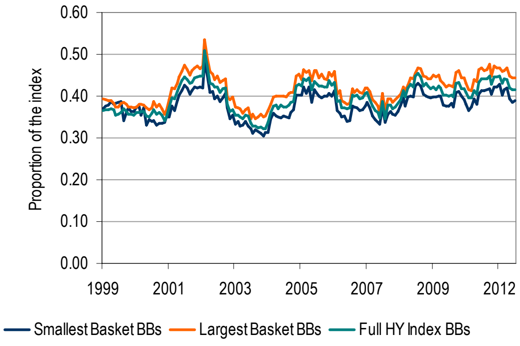
Source: BofA Merrill Lynch Global Research

Figure 4 and Figure 5 show the history of quality weightings between our smallest- and largest-cap-issuer baskets as well as overall HY index following the application of our re-weighting algorithm described above. The charts confirm that such quality mismatches are largely eliminated by such an approach. As described earlier, this process also ensures that any meaningful industry sector mismatches are addressed in this same fashion. As a result, we are looking at the two baskets of US HY issuers, where the only meaningful differentiating factor becomes their debt capitalization size.

[2] In order to neutralize the effects of admittedly minor, but nevertheless present factors such as issuer domicile and currency, we limited our sample to US-dollar bonds of US HY issuers only.

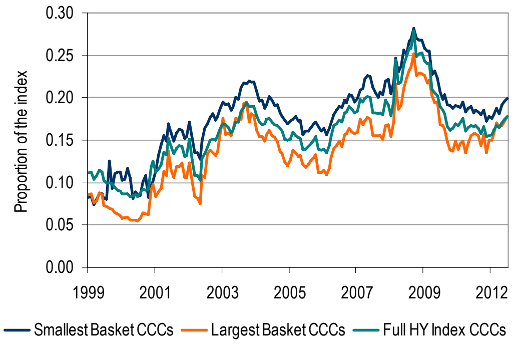
[3] At today's index size of 893 issuers, this step yields 89 names on each side.

Figure 4: Double-B adjusted weights in large- vs small-cap baskets



Source: BofA Merrill Lynch Global Research

Figure 5: Triple-C adjusted weights in large- vs small-cap baskets



Source: BofA Merrill Lynch Global Research

Historical path of small- vs large cap HY premium

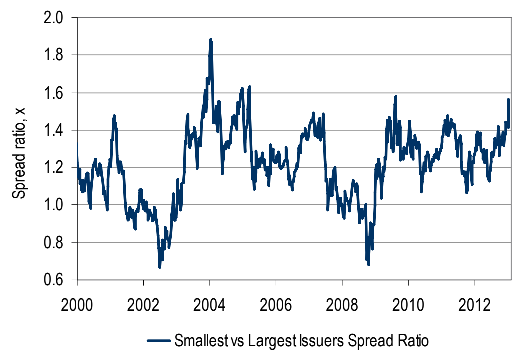
In Figure 6 below we are showing the history of spread between the two baskets following the quality/sector readjustment procedure. The chart confirms that smallest-cap issuers generally spend most of the time trading at spread premiums over largest-cap names, as they naturally should, with historical average standing at 100bp. Notice how this historical average has shifted from about 70bp in pre-2008 interval to 170bp post the credit crisis as reduced secondary market liquidity pushed such premium meaningfully wider.

Also, a very interesting observation here is that not only smaller-cap names provide investors with consistent premium over time but also they tend to hold up better in early stages of market selloffs. For the most notable example of this, see how small cap premium stayed stable all the way through Aug 2008 as the market was gradually unraveling, and then turned deeply negative by Dec 2008, meaning larger-cap names selling off significantly more than small-caps. The relationship then reversed abruptly by early 2009 as smaller cap bonds finally caught up with reality of market meltdown. A similar experience has been observed in 2002 credit cycle.

Figure 6: Small- vs large-cap HY issuer spread

Source: BofA Merrill Lynch Global Research

Figure 7: Small- vs large-cap HY issuer spread ratio



Source: BofA Merrill Lynch Global Research

In other words, not only do small cap names offer investors better premiums all along in times of stable markets, they also tend to be less affected by negative market turns. Of course, to some extent, such an outcome is predicated by nearly total loss of liquidity in smaller cap names at the time of abrupt market moves, which often makes it impossible to trade in and out of such positions. Acknowledging such a limitation, portfolio managers could still get an edge in being able to trade around peaks and troughs on this chart, where by definition, such a view would be in small minority and go against the "market wisdom".

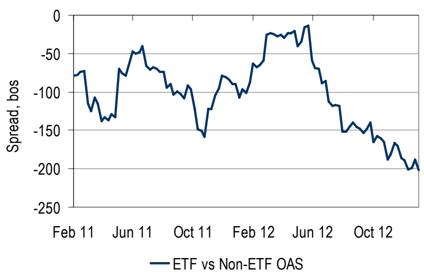
Today's pricing suggest value in small-cap names

At current levels, our small-cap issuer basket is trading at a 260bp premium against larger-cap names, which makes it the widest such spread since Oct 2009. Furthermore, Figure 7 demonstrates, how the ratio of two spreads (small cap over large cap) today stands at 1.56x, almost matching the 1.6x level where this metric peaked in most instances in the past, except for a very brief period in Dec 2003. Both of these indicators lead us to believe that smaller cap HY names are offering historically attractive relative value against their larger cap counterparts at current levels.

HY ETFs: a different angle, similar outcome

We also take a different angle on this story by examining valuations in bonds widely held by HY ETFs. Here, we separate bonds where ETFs hold more than 5% of total face value outstanding and compare them to bonds of the same issuers with no ETF ownership. Notice the difference from the pervious exercise, where we examined different sets of issuers (small cap and large cap); here the issuer set is the same, only the bonds in question differ.

Figure 8: HY bonds with 5%-plus ETF ownership vs non-ETF bonds of the same issuers



Source: BofA Merrill Lynch Global Research

The two bond baskets created this way – one with significant ETF ownership and one with none – are calculated historically with their membership and weights reassigned at the end of each month (i.e. ETF ownership determination is dynamic over time). Figure 8 plots the difference in spreads between the two baskets going back to Feb 2011 or as far as membership data availability goes. The chart suggests that bonds with significant ETF ownership are always trading at tighter spreads against their non-ETF counterparts, perhaps a not a very surprising outcome. More interestingly, it defines the range where those sets of bonds have traded relative to each other historically, with an average standing at 100bp and bounds being zero to 150bp. Most importantly, today this premium stands at never-before-seen level of 200bp.

Going back to the point we made on value being in smaller cap HY names, the relative valuations in ETF space suggest that the largest most-on-the-run bonds typically being the focus of ETF interest are trading at very significant premium discount to the rest of the market. Once the again, the conclusion here being that with so many bonds in this market priced to perfection, one of the few places where investors could look for value, if not in absolute than at least in relative terms, is smaller-cap, off-the-run issuers and non-ETF bonds of larger cap names.

Link to Definitions

Credit

Click here for definitions of commonly used terms.

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Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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