High Yield

Making Sense of the Macro-Related Move

CORE

High yield bonds have sold off meaningfully in the past week, driven by macro-related concerns. Screening for only bonds that have had sufficient trading activity over this period, we isolate rating- and sector-specific moves.

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Concerns about the global spread of COVID-19 have increased in the past week, sending risk asset valuations meaningfully lower. This shift in sentiment seems to have accelerated starting last Friday; as a result, we look at the effects of the sell-off since the close on Thursday the 20th through the close on Wednesday the 26th. The US High Yield Index widened by 76bp over that period and has lost 1.2% in total return terms. This has been the largest one-week move wider since December 2018, and that occurred on much lower volumes.

Despite the dramatic sell-off, much of the market has not traded actively in the past week, with pricing based on matrix-implied levels. Not surprisingly, we find that liquid bonds that are actively traded tend to have the largest initial moves in volatile markets. This has been the case in this sell-off, with liquid bonds underperforming the market.

To filter out bonds whose pricing may not be based on sufficient trading volumes, we isolate bonds with at least $15mn in trading volumes in the past week based on TRACE data. This list includes more than 600 bonds that represent almost half of the market value of the US High Yield Index. As seen in Figure 1, this “Actively Traded” bucket has underperformed the index by 20bp and the remaining bonds (“Not Actively Traded”) by 40bp in total return terms. As a result, we believe that the Actively Traded bonds can provide a better guide for which ratings, sectors, and issuers may have sold off most significantly, as well as those that have been insulated from the sell-off.

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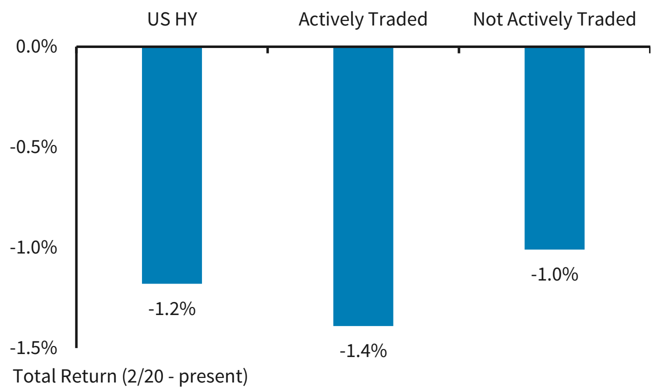
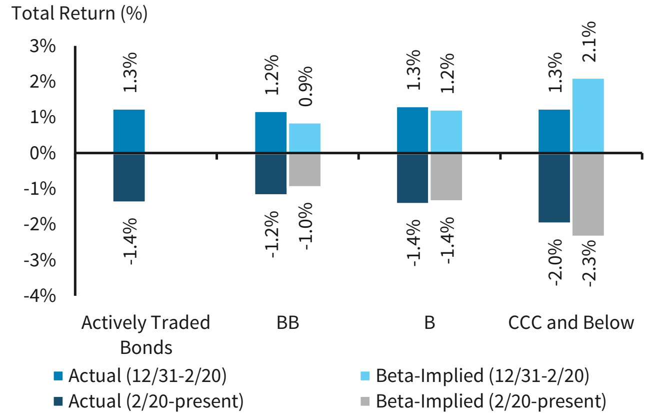
FIGURE 1. **The Most Actively Traded Bonds Have Sold Off More This Week**



Note: Actively Traded bucket defined as bonds with at least $15mn in trading volumes
Source: Bloomberg, Barclays Research

FIGURE 2. **Lower Quality Has Outperformed Beta-Implied Levels**



Source: Bloomberg, Barclays Research

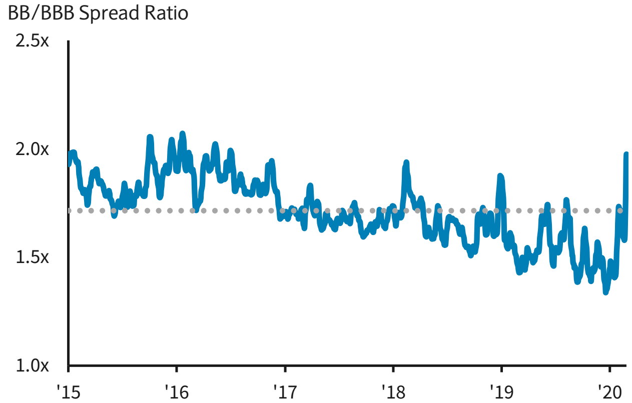
Ratings: Lower Quality Has Performed Better Than Expected

Looking at just the Actively Traded bucket of bonds, higher quality credits outperformed their implied levels up until last week (Figure 2). Specifically, BB-rated bonds had total returns of 1.2%, more than 30bp above the level implied by the rating bucket's historical beta to US high yield returns. Conversely, CCC and below bonds had returned only 1.3%, well below the expected level of 2.1%.

That dynamic shifted during this week's sell-off, with higher quality underperforming beta-implied levels. We would have expected the BB cohort to post -1.0% of total returns based on the index return of -1.4%, yet it shed 1.2% during the period. On the other hand, CCC and below rated credits have lost only 2.0% since the 20th, better than the beta-implied level of -2.3%.

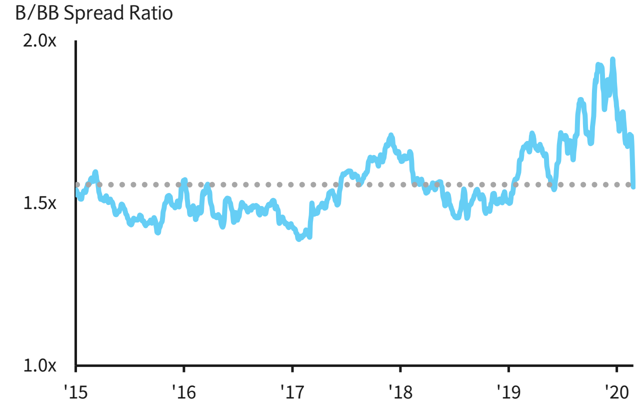
While the moves across these two periods net out, there was a meaningful beta compression of CCCs at the end of 2019. BB underperformance has caused the BB/BBB ratio to widen drastically, reaching levels not seen since the start of 2018 (Figure 3). This has also pushed the B/BB spread ratio significantly tighter, driving BBs cheaper relative to both BBBs and single-Bs. We believe BBs have the most attractive risk/reward profile from here, given 1) that lower-rated cohorts should underperform the most if a macro driven sell off continues and 2) a likely reversion of the below ratios if concerns subside.

FIGURE 3. **The BB/BBB Ratio Has Widened to Levels Not Seen in Over Two Years**



Note: Dashed line is 2015-present average.
Source: Bloomberg, Barclays Research

FIGURE 4. **The B/BB Ratio Has Compressed Dramatically in Recent Weeks**



Note: Dashed line is 2015-present average.
Source: Bloomberg, Barclays Research

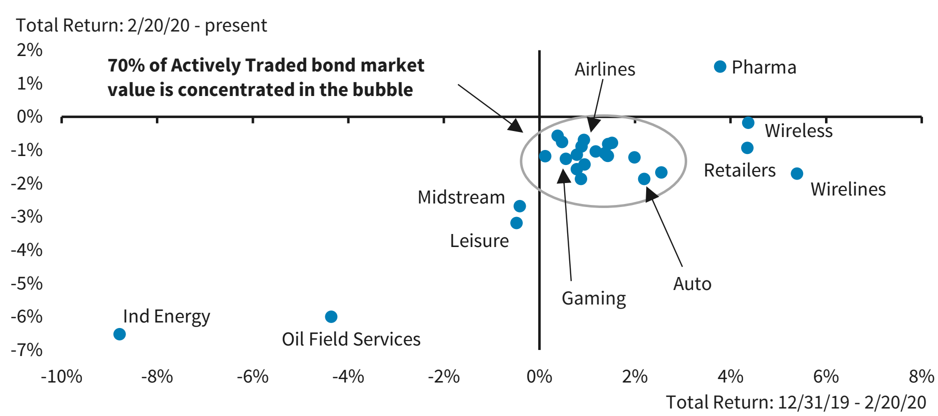
Sectors: Idiosyncratic Moves Are Responsible for the Biggest Dislocations

Sector returns have been fairly concentrated this year – both before the sell-off and during – aside from a small handful of idiosyncratic exceptions. Again, for this analysis, we look at only the Actively Traded subset of bonds. As seen in Figure 5, sectors representing 70% of the index returned between 0.0% and 2.6% before February 20 and between -0.6 and -1.9% since. The lack of sector differentiation is consistent with performance in 2019, when idiosyncratic volatility was significantly higher than expected for the level of sector volatility.

Some of the sectors that have fallen outside of these ranges this year have had unique credit-driven return stories. For example, pharmaceutical returns have been driven by Mallinckrodt's recent opioid litigation settlement, which propelled bonds higher not only for MNK but for other pharmaceutical companies (such as Endo) as well (for more information, see *Settling is the new beat*).

The wireless and wirelines sectors performed broadly in line with the index and most other sectors over the past week. Prior to the sell-off, though, the two sectors had outperformed, driven by company-specific events such as progress on the Sprint/T-Mobile merger (see *Sprint (S) / T-Mobile (TMUS): State AG Suit Win Sets Stage for Merger Completion* for details).

FIGURE 5. **The Sector Performance of Actively Traded Bonds Has Been Concentrated, with the Exception of a Few Outliers**



Source: Bloomberg, Barclays Research

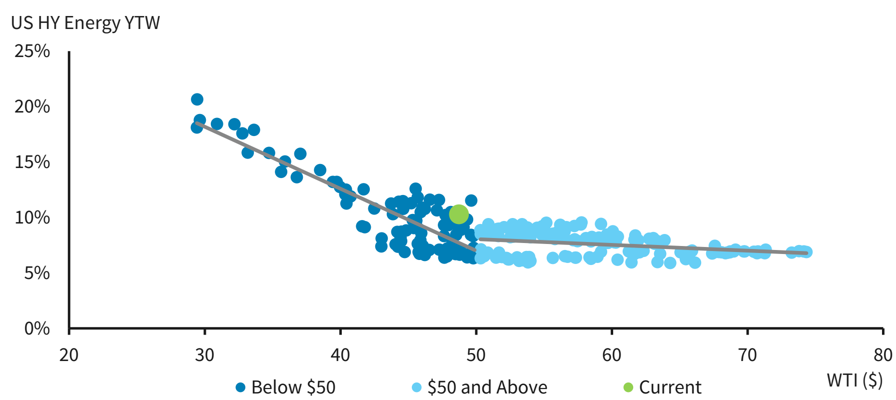
One of the most interesting trends has been the performance of sectors that would generally be viewed as having relatively high risks associated with the spread of the coronavirus. In fact, some of these sectors have had resilient returns. Leisure, gaming, automotive, and airlines all have business models viewed as being heavily affected by COVID-19, but returns for these sectors have not been drastically different from those in the concentration of other sectors. In fact, the gaming and airlines sectors have actually outperformed the broader Actively Traded cohort of bonds since February 20. Using equity returns of the Russell 2000 as a reference, all four of these sectors (leisure, gaming, automotive, and airlines) have materially underperformed the equity index, implying that credits in these sectors have held in better than expected. We think that trimming exposure in these sectors makes sense, as they could underperform meaningfully if the macro concerns worsen but also have limited upside if there is a return to pre-sell-off levels.

On the other hand, the clearest underperformance has come from energy, with all three of its major subsectors posting negative returns in both periods of our study. While these sectors were underperforming before this week's sell-off, a potential slowdown in global demand, specifically related to Chinese manufacturing, has clearly weighed on energy prices and, as a result, energy-related credits.

We have previously noted that the $50 level in WTI has been an inflection point for energy yields in recent years (Figure 6). With WTI crossing below that level this week, energy performance could suffer. That said, the market appears already to be pricing in the downside potential, with high yield energy yields at 10.3%, well wide of the implied level of 7.7% (based on the regression for WTI below $50 shown on the left side of Figure 6).

Ultimately, aside from energy, much of the sector performance over the past week has been either fairly concentrated or driven by idiosyncratic developments unrelated to macro concerns. Despite this relatively uniform move, these sectors are not uniformly exposed to the risks that have been weighing on risk assets. As a result, we believe this is an attractive time to add to sectors such as media entertainment, food & beverage, and cable satellite, which have less exposure to these macro risks.

FIGURE 6. WTI below $50 Is an Inflection Point for US High Yield Energy



Note: Based on weekly US high yield energy spreads and WTI levels since the start of 2015.
Source: Bloomberg, Barclays Research

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