Relatively Well Valued

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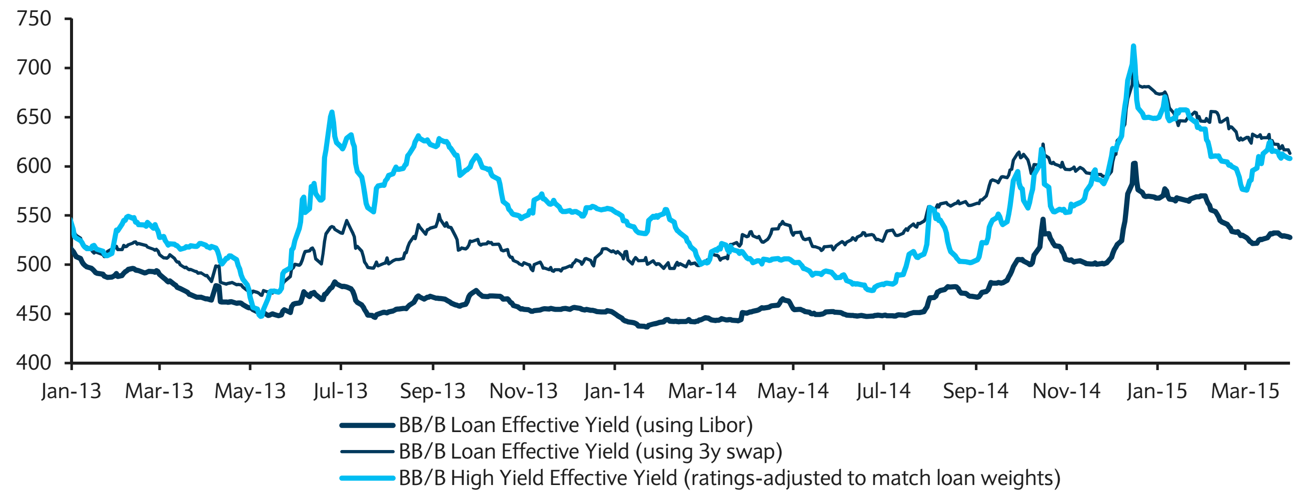
The high yield and loans markets have produced similar year-to-date returns of about 2.5% through Wednesday. While three quarters of 2015 remain, this outcome is consistent with our expectation that these markets will produce similar full-year returns. Nonetheless, it is always worth re-examining the relative value picture between the two. Unfortunately, there is no single measure that neatly encompasses all of the differences in the two asset classes, making like-to-like comparisons challenging. To that end, for both markets we calculate an "effective yield" measure that represents a combination of current yield and a pull-to-par over the expected life of the instrument. For loans, the current yield component amounts to taking the nominal spread (including any Libor floor), adding Libor, and dividing by price. To arrive at effective yield, this current yield is then added to an annual pull-to-par estimate, which we assume occurs over the shorter of three years and the loan's maturity. The comparable metric in high yield bonds is a current yield (coupon/price) added to gains from a pull to the redemption price over the bond's expected life, for which we use its option-adjusted duration.

When we calculate effective yields for the two asset classes broadly, several assumptions are made. For loans in aggregate, the average life is assumed to be three years (individual maturities are not considered). For bonds, we do not pull to an average redemption price, but simply use par. These assumptions likely introduce a small bias against bonds, on average.

Apart from using effective yields, we also incorporate two more adjustments to develop a cleaner relative value representation. First, we calculate a ratings-adjusted effective yield for the high yield index, specifically for its BB and single-B components. The adjustment is made by applying the market weights of BBs and Bs in the loans index as weights on the effective yields of the US HY BB and B indices. By using the resulting weighted metric, we adjust for differences in rating compositions in the two markets that would cloud any comparisons. Second, we introduce rate swaps to consider both the pure relative value (with rate swaps, to eliminate differences in rates sensitivity) and the relative value as the two asset classes are typically traded (ie, without rate swaps).

FIGURE 1
Effective Yields for BB/B Bonds and Loans



Note: 3y swap rate used in the swapped effective yield calculation. Source: Barclays Research

When the swap rate is incorporated into the loan effective yield, bonds and loans look fairly priced, each yielding about 6.1% (Figure 1). Admittedly, the apparent parity in swapped yields assumes the forward curve for rates will be realized, which may not happen if the recent string of disappointing economic data pushes out expectations of rate rises.

On an unswapped basis, the BB/B bond market pays 80bp more than loans of comparable quality. That said, despite quality adjustments, the two asset classes experience very different volatility, with bonds roughly 1.9 times as volatile as loans (1.5x versus rate-swapped loans) since 2013. This makes sense, given that about half of the loan market is owned by CLOs, which act as a stabilizer, while nearly half of the high yield market is owned by retail funds. Thus, the incremental spread in bonds compensates not only for higher exposure to rates, but also for higher exposure to daily fund flows.

At the aggregate level, an 80bp differential does not make either market stand out as exceptionally rich or cheap to the other. That said, there is still significant compensation to be earned by drilling down into specific credits and intra-capital structure opportunities. In the tables below, we present opportunities for yield pickup by swapping out of loans into bonds, and vice versa, on a duration-matched basis. While we typically focus on pairs of secured bonds and loans (see *Resilient Loans, Undervalued Bonds*), we extend our universe here to include unsecured bonds as well. The pairs are sorted by the differences in effective yields between bonds and loans without rate swaps, although swapped loan yields are also presented for additional context.

FIGURE 2

Swaps into Loans and out of Bonds

		Bond							Loan								Differences (Loan – Bond)		
Issuer	Ticker	Cpn (%)	Mat Date	Redeem	Par ($mn)	S&P Rating	Bid Price ($)	Eff. Yield (%)	Facility	Cpn (%)	Mat Date	S&P Rating	Par ($mn)	Ask Price ($)	Eff. Yield Libor (%)	Eff. Yield Swap (%)	Price ($)	Eff. Yield Libor (%)	Eff. Yield Swap (%)
MGM Resorts	MGM	11.375	Mar-18	Mar-18	475	B+	120.75	2.31	TL-B	3.50	Dec-19	BB	1,715	100.00	3.50	4.37	-20.75	1.19	2.06
MGM Resorts	MGM	11.375	Mar-18	Mar-18	475	B+	120.75	2.31	TL-A	3.00	Dec-17	BB	1,029	100.00	3.00	3.79	-20.75	0.69	1.48
Cablevision	CVC	8.625	Sep-17	Sep-17	900	B	112.50	2.59	TL-B	2.75	Apr-20	BB+	1,371	100.00	2.75	3.62	-12.50	0.17	1.03
CSC Holdings	CVC	7.875	Feb-18	Feb-18	300	BB	112.50	2.66	TL-B	2.75	Apr-20	BB+	1,371	100.00	2.75	3.62	-12.50	0.09	0.96
CSC Holdings	CVC	7.625	Jul-18	Jul-18	500	BB	112.75	2.89	TL-B	2.75	Apr-20	BB+	1,371	100.00	2.75	3.62	-12.75	-0.14	0.73
Hertz	HTZ	4.250	Apr-18	Apr-18	250	B	100.75	3.97	TL-B1	4.00	Mar-18	BB	735	100.50	3.81	4.66	-0.25	-0.15	0.69
Level 3 Financing	LVLT	6.125	Jan-21	Nov-18	640	B	104.88	4.50	TL-B5	4.50	Jan-22	BB	2,000	100.88	4.17	5.04	-4.00	-0.32	0.54
US Airways	AAL	6.125	Jun-18	Jun-18	500	B	105.25	4.16	TL-B2	4.25	Oct-21	BB	750	101.13	3.83	4.69	-4.13	-0.33	0.53
MGM Mirage	MGM	8.625	Feb-19	Feb-19	850	B+	114.00	3.92	TLB	3.50	Dec-19	BB	1,715	100.00	3.50	4.37	-14.00	-0.42	0.45
Virgin Media	VMED	5.375	Apr-21	Apr-19	1,000	BB-	104.88	3.92	TL-B	3.50	Jun-20	BB-	2,755	100.13	3.46	4.32	-4.75	-0.46	0.41
US Airways	AAL	6.125	Jun-18	Jun-18	500	B	105.25	4.16	TL-B1	3.75	Jun-19	BB	1,872	100.38	3.61	4.48	-4.88	-0.55	0.32
Hertz	HTZ	4.250	Apr-18	Apr-18	250	B	100.75	3.97	TL-B2	3.50	Mar-18	BB	1,348	100.25	3.41	4.26	-0.50	-0.56	0.29
Realogy	RLGY	4.500	Apr-19	Apr-19	450	B	101.25	4.14	TL-B	3.75	Mar-20	BB	1,887	100.50	3.57	4.43	-0.75	-0.57	0.30

Note: Loan coupons include benefit of Libor floors. Swapped yields are interpolated based on each loan's effective maturity. Source: Barclays Research

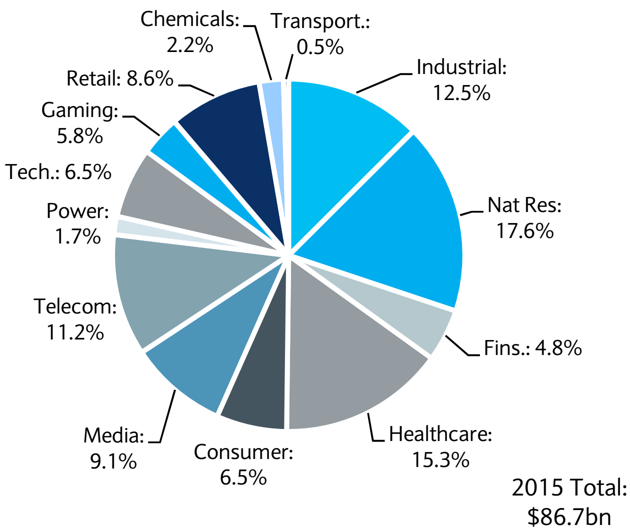
FIGURE 3

Swaps Into Bonds and Out of Loans

		Bond							Loan								Differences (Bond-Loan)		
Issuer	Ticker	Cpn (%)	Mat Date	Redeem	Par ($mn)	S&P Rating	Ask Price ($)	Eff. Yield (%)	Facility	Cpn (%)	Mat Date	S&P Rating	Par ($mn)	Bid Price ($)	Eff. Yield Libor (%)	Eff. Yield Swap (%)	Price ($)	Eff. Yield Libor (%)	Eff. Yield Swap (%)
Alphabet Holding	NTY	7.750	Nov-17	Nov-17	1,000	CCC+	99.00	8.21	TL-B2	3.50	Oct-17	B+	1,508	98.50	4.16	4.89	0.50	4.05	3.32
NPC Int'l	PIZA	10.50	Jan-20	Jan-18	190	CCC+	105.00*	8.21	TL-B	4.00	Dec-18	B	404	97.50	4.96	5.85	7.50	3.25	2.36
Ineos	INEGRP	6.125	Aug-18	May-17	678	B-	100.50*	5.86	TL-B	2.75	Dec-16	BB-	243	100.13	2.68	3.15	0.38	3.18	2.71
BMC Software	BMC	7.250	Jun-18	Jun-18	300	CCC+	96.50	8.62	TL	5.00	Sep-20	B	2,751	97.88	5.83	6.72	-1.38	2.78	1.89
Sears Holding	SHLD	6.625	Oct-18	Oct-18	1,234	B-	94.25	8.65	TL	5.50	Jun-18	B	988	98.75	5.99	6.87	-4.50	2.66	1.78
Intelsat Jackson	INTEL	7.500	Apr-21	Apr-19	1,150	B+	103.50	6.37	TL-B2	3.75	Jun-19	BB-	3,095	99.50	3.94	4.81	4.00	2.43	1.56
WideOpenWest	WOWFIN	10.250	Jul-19	Jul-18	825	CCC+	108.00	7.06	TL-B	4.75	Apr-19	B	1,533	100.13	4.70	5.57	7.88	2.36	1.49
Intelsat Jackson	INTEL	7.250	Oct-20	Oct-18	2,200	B+	103.25	6.10	TL-B2	3.75	Jun-19	BB-	3,095	99.50	3.94	4.81	3.75	2.16	1.29

Note: *Starred bond prices are bid side due to lack of pricing data. Loan coupons include benefit of Libor floors. Swapped yields are interpolated based on each loan's effective maturity. Source: Barclays Research

High Yield Supply by Sector – 2015 Breakdown



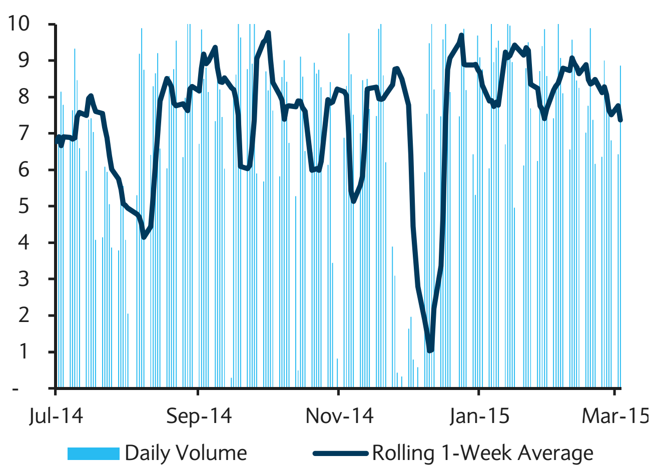
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 3/27/15 ($mn)
	Gross	Net	Gross
Heinz	12.2	0.8	792.0
Chesapeake	9.4	0.9	390.1
U.S. Steel	8.0	0.8	302.4
Freescale	4.1	0.5	248.4
Olin	7.1	0.3	219.7
MGM Resorts	7.6	1.0	201.9
Ryland Homes	8.8	0.4	195.3
JC Penney	18.3	0.9	193.8
Amkor Technology	3.5	0.4	168.5
Dell	11.7	1.1	166.6

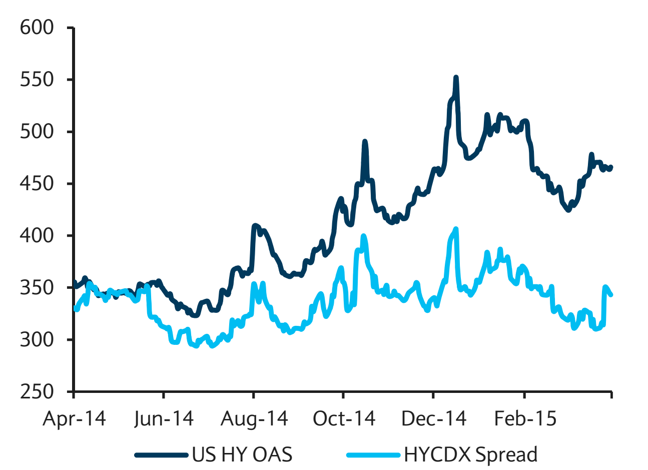
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



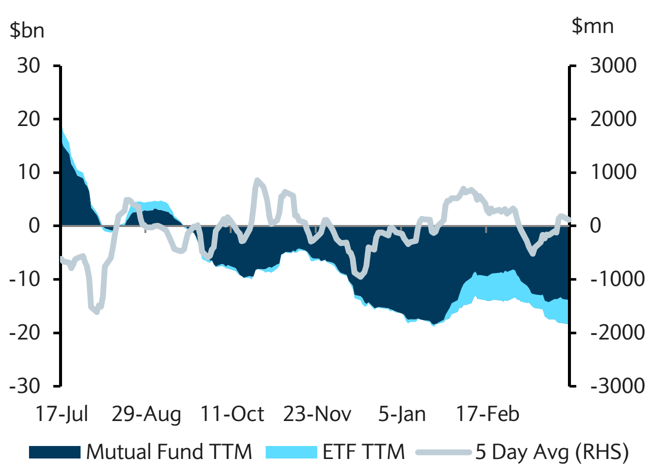
Source: FINRA TRACE

On-the-Run HYCDX versus U.S. High Yield Index (bp)



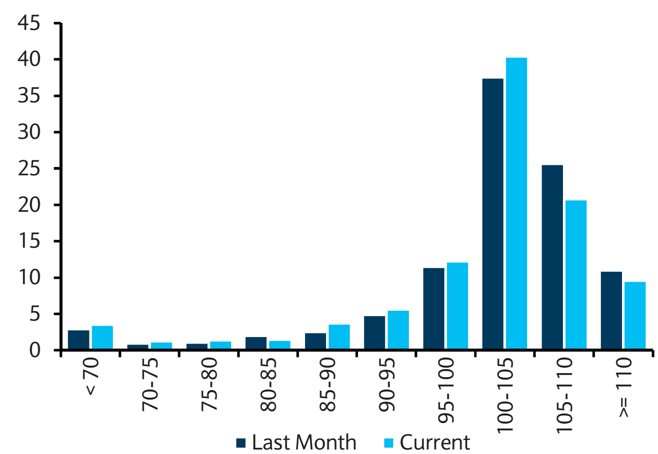
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



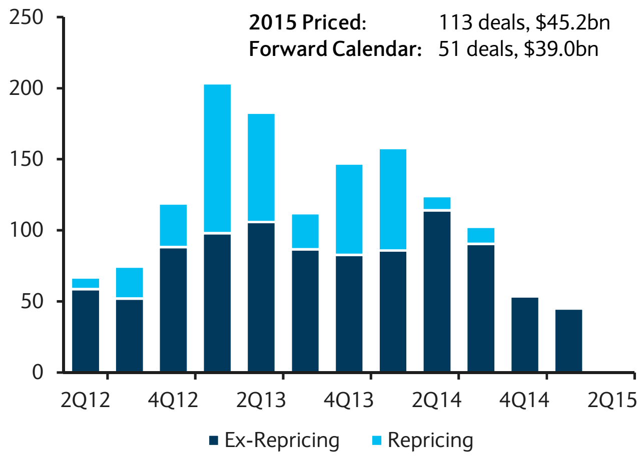
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



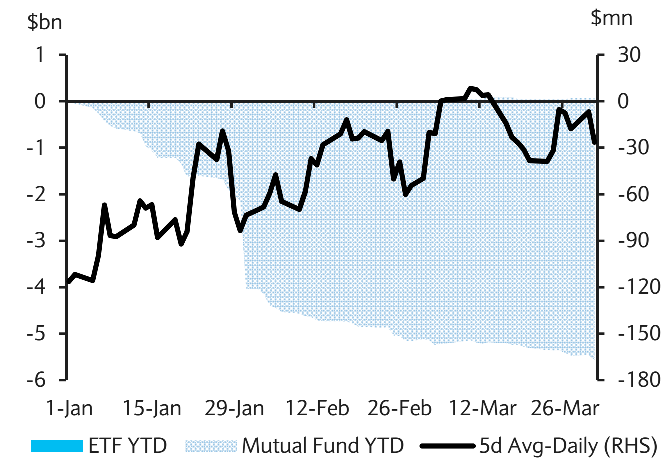
Source: Barclays Research

Quarterly Institutional Leveraged Loan Issuance ($bn)



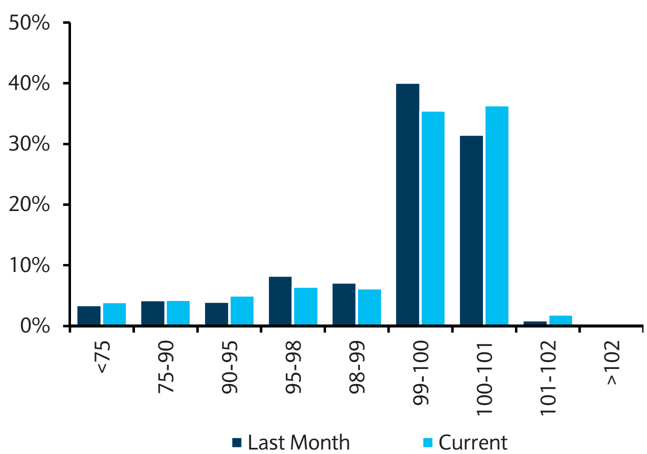
Source: S&P LCD, Barclays Research

Flows to Loan Mutual Funds and ETFs



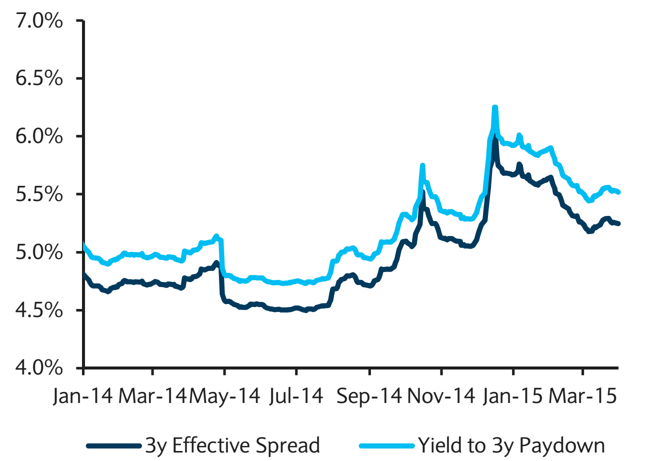
Note: Five-day average includes only flows of daily reporters. Source: EPFR

Loan Index Price Distribution by Par



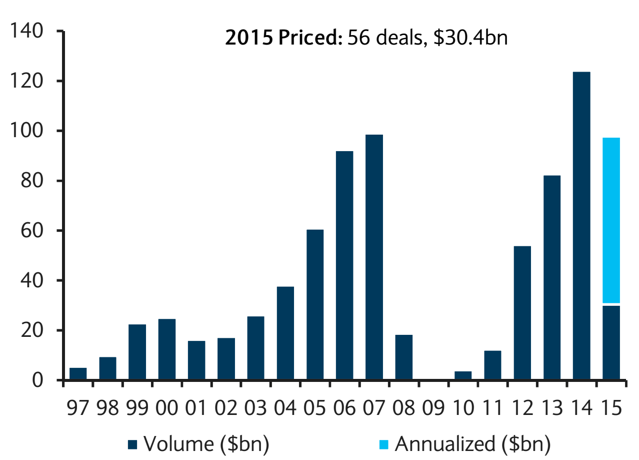
Source: Barclays Research

Barclays Performing Loan Index Yield and Spread



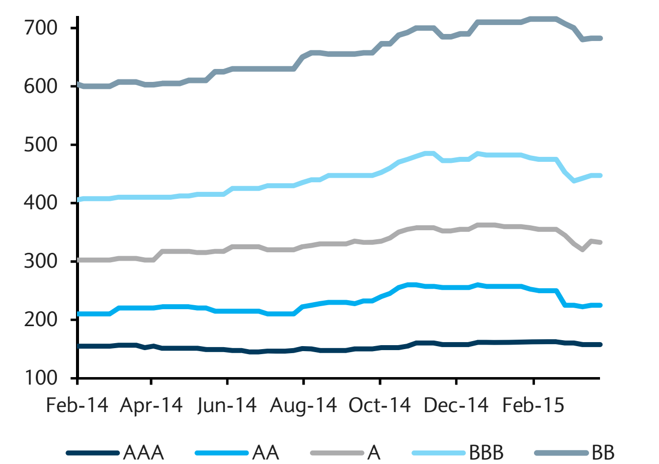
Note: Yield and spread calculation assumes a three-year paydown period, amortizing any premium or discount to par accordingly. Source: Barclays Research

Annual CLO Issuance



Source: S&P LCD, Creditflux

U.S. CLO 2.0 Spread Performance by Rating (bp)



Note: Spread data from BWIC levels. Source: Moody's, Intex, Barclays Research

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For sectors rated against the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials or the Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

Market Weight (MW):

For sectors rated against the Barclays U.S. Credit Index, the Barclays Pan-European Credit Index, the Barclays EM Asia USD High Grade Credit Index or the 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 Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials or the 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 Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials or the 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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To view sector definitions and monthly sector returns for Asia, EEMEA and Latin America Research, go to https://live.barcap.com/go/RSL/servlets/dv.search?pubType=4511&contentType=latest on Barclays Live.

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Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.
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.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
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Overweight (OW): The analyst expects the six-month total return of the debt security subject to this rating to exceed the six-month expected total return of the relevant sector.
Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.
Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.
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For all issuers in South Africa, the credit rating system is based on the analyst's view of the expected total return over a six-month period of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) relative to the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively.

Overweight (OW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to exceed the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively.
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*In EEMEA and Latin America, analysts may occasionally rate issuers that are not part of the Barclays EM USD Corporate and Quasi Sovereign Index. In such cases the rating will reflect the analyst's view of the expected excess return over a six-month period of the issuer's corporate debt securities relative to the expected excess return of the relevant sector, as specified on the report.