

Mapping Demand to a Shrinking Market

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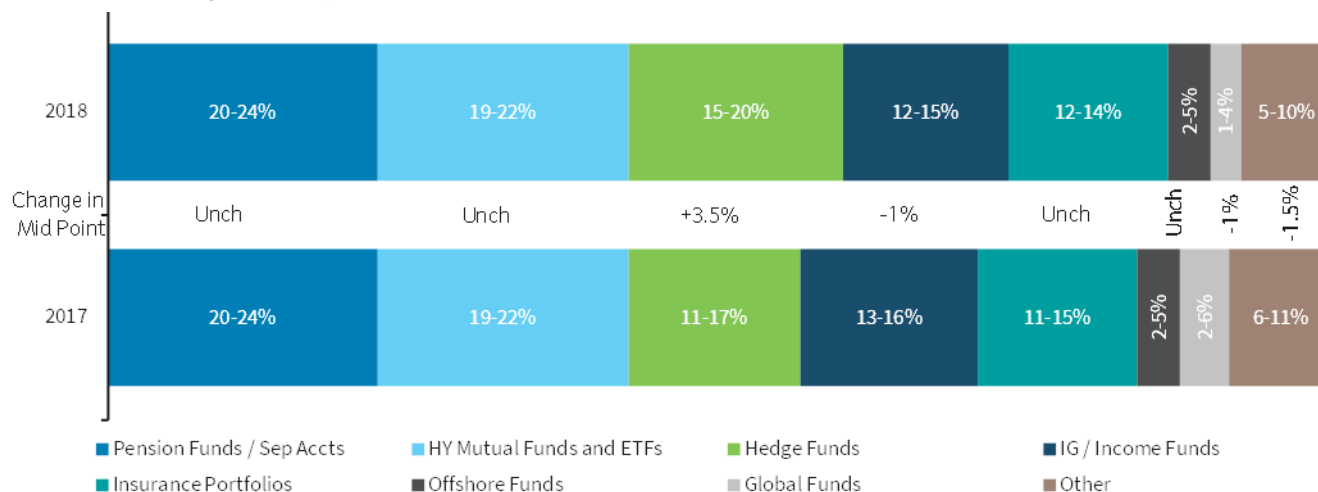
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US high yield has led performance among USD fixed income assets this year, although the paltry year-to-date total return of 1.32% is slim comfort to investors. Credit conditions have remained largely benign, rising stars have outpaced fallen angels for seven of the past eight years, and the aggregate credit quality of public non-financial issuers in the US High Yield Index sits at recent highs (*A Little More Leaning on Leverage*). The decline in the size of the high yield bond market (down 6.6% by market value and 3.1% by par since the start of the year) has been a powerful technical driver to support returns against the headwind of rising rates. Given an essentially shrinking asset class, we engage in our annual review of the ownership of the high yield bond market to determine which constituents have participated in the shrinking of the market and which have held their share. Importantly, while headlines have focused on record outflows from high yield-dedicated retail funds, the shrinkage of AUM for this investor cohort has only slightly outpaced the decline in size of the overall market.

Pension Funds/Separate Accounts (20-24%): While retail funds and flows garner more attention, this investor class holds a proportion of the overall asset class that is just as big, if not slightly larger. We estimate that its ownership stake is unchanged this year. Our conversations with asset managers suggest that AUM in SMAs have essentially mirrored the decline in the overall size of the US High Yield Index y/y. Utilizing data from the Federal Reserve's 2Q Flow of Funds release, a study from Willis Towers Watson, and other data, we estimate that high yield assets held by pension funds are down a touch less, at 2%.

High Yield-Dedicated Mutual Funds and ETFs (19-22%): Per Lipper, onshore high yield dedicated funds have seen nearly than \$30bn of outflows thus far in 2018.. Unlike last year, both ETFs and mutual funds have experienced net outflows in 2018, as managers are increasingly using the former as a liquidity management tool (*Mutually Assured Destruction*). ETFs represent 10-15% of this segment, thus constituting roughly 3% of the entire high yield buyer base.

FIGURE 1
Breakdown of US High Yield Buyer Base



Source: S&P LCD, Lipper, Bloomberg, EPFR, HFR, Credit Flux, Federal Reserve, Refinitiv, Kaneri, Bloomberg Barclays Indices, Barclays Research

Using Bloomberg data, we find that the weighted average allocation to high yield bonds in these funds is 94%, mostly consistent with past years. The largest non-high yield bond exposure is a 3-4% allocation to loans. Our prior research suggests that high yield outflows will remain a persistent threat if risk-free rates continue to rise, all else equal. Anecdotally, for much of the year, managers have mentioned 7% as a nominal yield level at which they believe they would see inflows, although there is some variability around that largely subjective estimate.

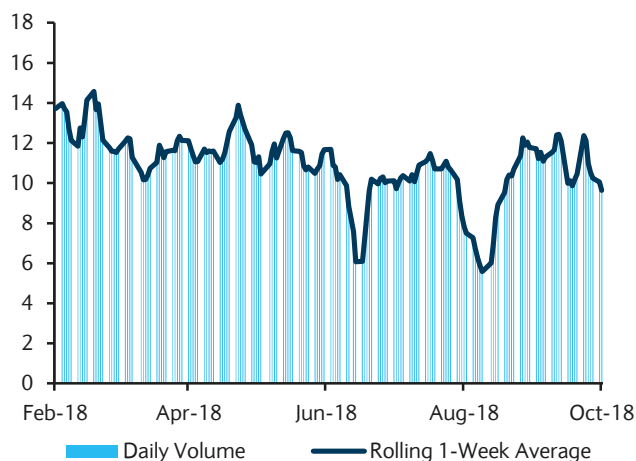
Hedge Funds (15-20%): We estimate that this segment's share of ownership grew incrementally in 2018, based on data from HFR. Hedge fund AUM among the strategies that we believe have an allocation to high yield are up approximately 4% y/y. While there is some risk in assuming that incremental allocations over the past year have been in line with historical levels, we think the lack of distressed opportunities in a low-default environment has once again led this investor base to be active in lower-quality high yield, in particular. The outperformance of CCCs in 2018 fits with that narrative, in our view.

Investment Grade/Income Funds (12-14%): This group of funds has experienced \$14bn of outflows this year, but when we break out the split among investment grade, high yield, and other assets, we find an approximate 1pp y/y drop in share of high yield ownership by this universe of funds. With high yield not a core allocation for much of this higher quality-focused investor base and the general compression of valuations for much of this year, we are not surprised by this modest decline in ownership.

Offshore Retail Funds (2-5%): Offshore funds' share of the broader market is similar to last year. That said, there was a moderate increase in Japanese Toshin fund allocations to high yield, which is consistent with the continued incremental interest in US leveraged credit that investors see coming from the region broadly. That said, European-based retail was negative, leaving the segment's assets close to flat. This resilience is somewhat surprising considering increased hedging costs, but highlights the lack of yield elsewhere globally.

Global High Yield Funds (1-4%): The rise in currency hedging costs for non-USD investors has dimmed the relative value of US fixed income broadly, resulting in a decline in global fund ownership of high yield. As highlighted in [Seeing Value in EUR versus USD High Yield](#), the shift in hedging costs has caused EUR bonds to appear attractive relative to USD bonds, and much of the European credit investor base with a global mandate seems to be deploying incremental capital closer to home.

High Yield Average Institutional Trade Volume (\$bn)



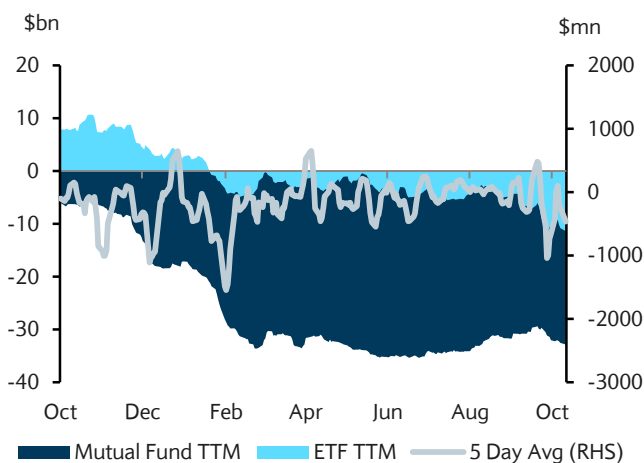
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



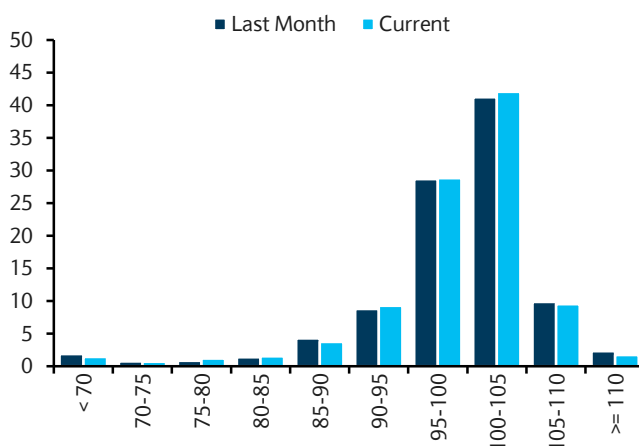
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



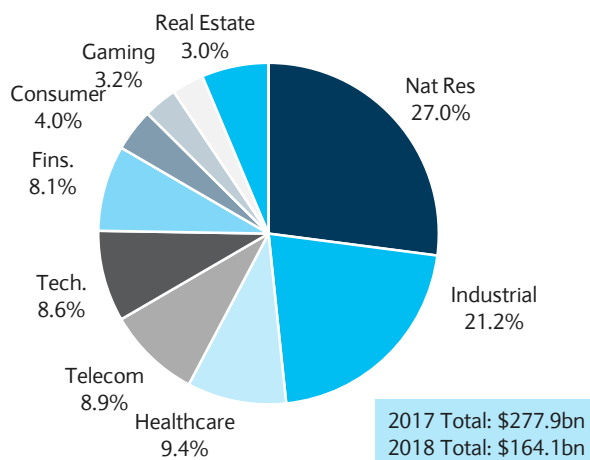
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



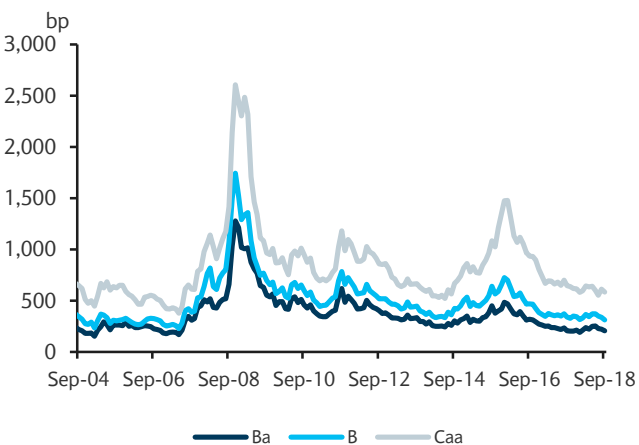
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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