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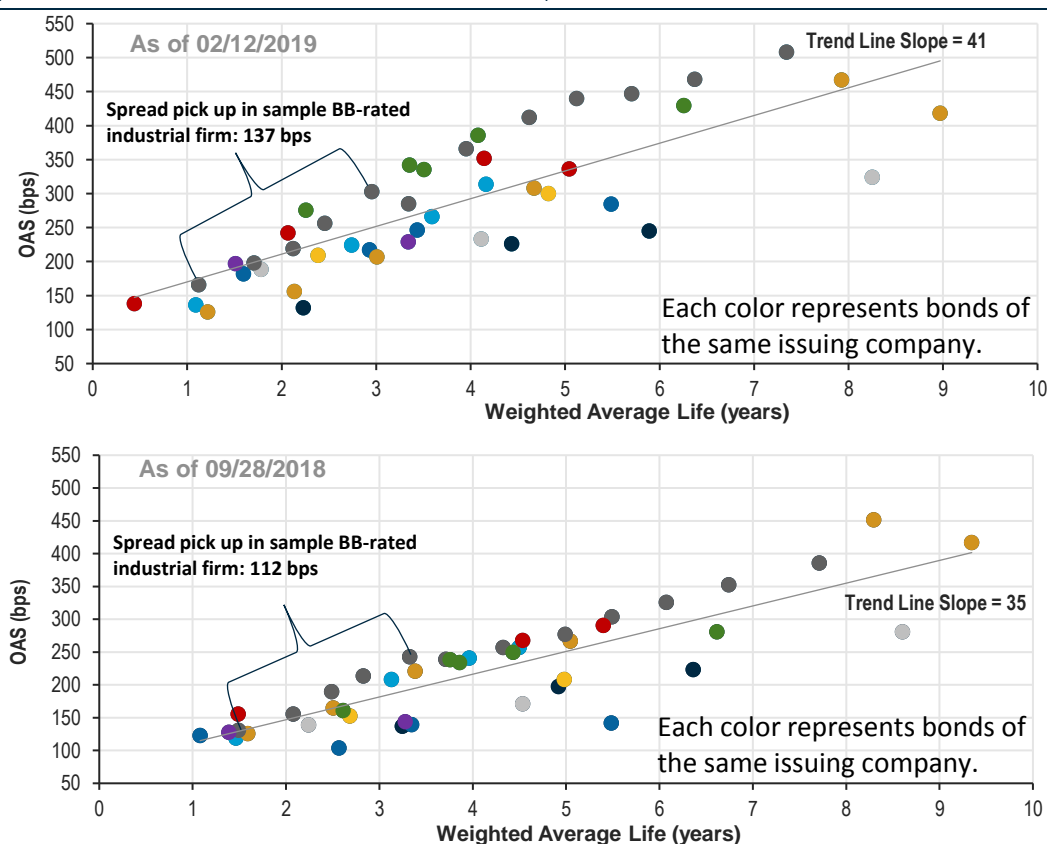
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Seeking Spread Along Steep High Yield Curves

While many sectors have partially recovered since the worst of the December 2018 market volatility, a shift in the U.S. leveraged finance market continues to present attractive opportunities. By selling short-dated issues that have experienced solid spread compression and slightly extending along particularly steep spread curves, investors can pick up significant spread in what is still a stable economic backdrop. Indeed, the spreads available on these curve extensions imply a probability of future recession or economic downturn that is higher than our current expectations.

Spreads at the front of the U.S. high yield curve widened notably during the worst of December's volatility as we believe investment managers sold relatively liquid holdings to raise cash and meet fund redemptions. Yet, as investors have returned to the market amid the Federal Reserve's rate-hiking pause, many have sought the front end given the relatively wide spreads and lingering economic uncertainty. As flows into the market resumed—including the fourth-largest weekly flow of \$3.9B in mid-February—spreads at the front of many curves compressed, steepening the curves significantly.

FIGURE 1: CHANGE IN SPREAD CURVES AMONG SAMPLE BB-RATED ISSUERS
(FEBRUARY 12, 2019 AND SEPTEMBER 28, 2018)



Source: PGIM Fixed Income.

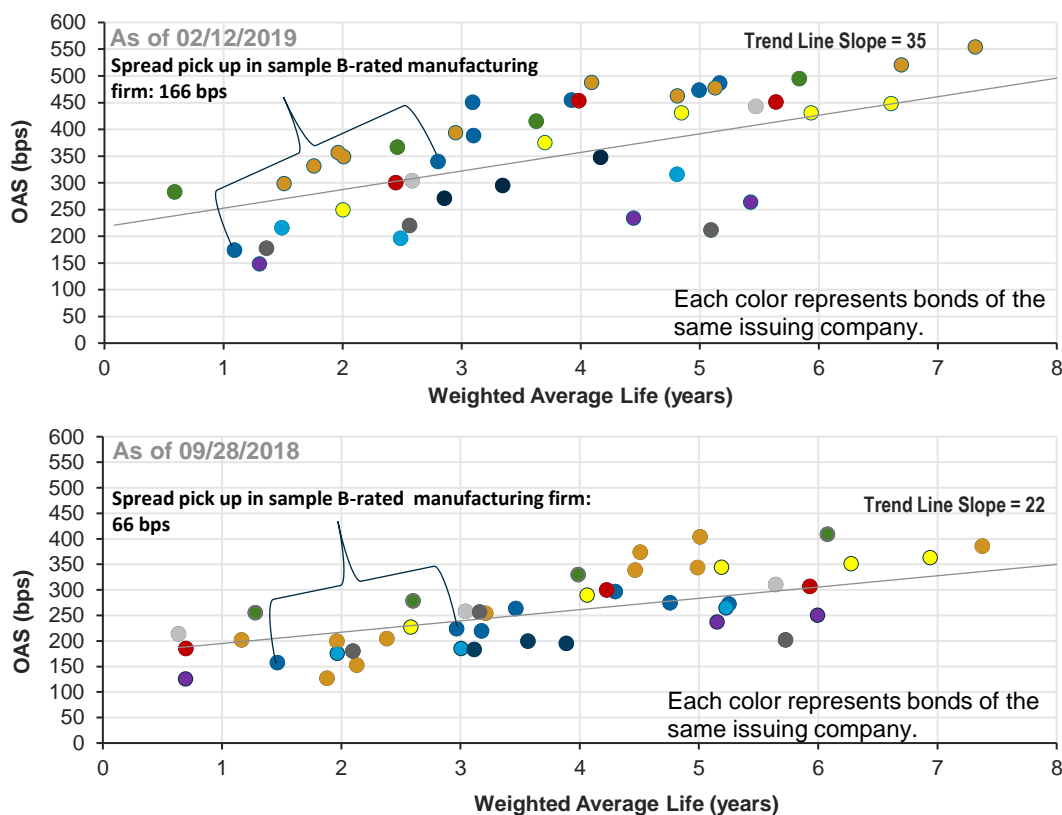
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Thus far, the opportunities we've seen to extend out on certain spread curves include an industrial BB-rated credit with an issue due in March 2020 that is trading at an OAS of about 166 bps as observed in Figure 1.^{1,2} Yet, the credit's issue due in January 2022 is trading at an OAS of slightly wide of 300 bps. That steep spread differential of roughly 137 bps is about 25 bps more than the differential in September 2018. Figure 2 shows that the same dynamic extends across the credit curve as an extension of about 18 months in a B-rated manufacturing firm provides a pickup of about 166 bps, whereas that pickup was closer to 66 bps in late September 2018.³

FIGURE 2: CHANGE IN SPREAD CURVES AMONG SAMPLE B-RATED ISSUERS

(FEBRUARY 12, 2019 AND SEPTEMBER 28, 2018)



Source: PGIM Fixed Income.

Importantly, this spread curve dynamic and the respective opportunities also exist within the leveraged loan market and across varying capital structures, such as those comprised of only leveraged loans. Another aspect of extending out on steep credit curves is the ensuing rolldown effect as the issue approaches maturity and spreads potentially compress.

The steepness at the front of the high yield spread curve is partially indicative of investors' economic uncertainty, especially as it pertains to the probability of a recession in 2020 or beyond. Thus, it is possible that the front to intermediate portion of the spread curve remains relatively steep until there is a change in investors' economic expectations.

While the relatively stable U.S. economic backdrop has contributed to the market recovery since December, lingering global uncertainties have also contributed to some particularly steep U.S. high yield spread curves. Slight extensions along these curves can provide notable spread pick ups—as well as the consequent roll-down effects—as investors' search for spread and yield continues.

¹ Stated credit ratings are proprietary PGIM Fixed Income ratings.

² Stated OAS levels are based on a proprietary PGIM Fixed Income OAS model.

³ For reference, the spread curve in the European high yield market remains near historical norms with the spread pickup on a BB-rated issue said to be about 30 bps per year.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of February 2019.

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