Spread Limit

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Investment grade corporate spreads have been range-bound in 2013, even as equity markets have seen a steady rally. While the U.S. Corporate Index OAS has tightened about 10bp year-to-date, it has been unable to move inside the 130bp tights first reached in early May. In our view, that 130bp level may near the lower bound for spreads unless a structural premium for risk that first appeared during the 2008 financial crisis begins to ease.

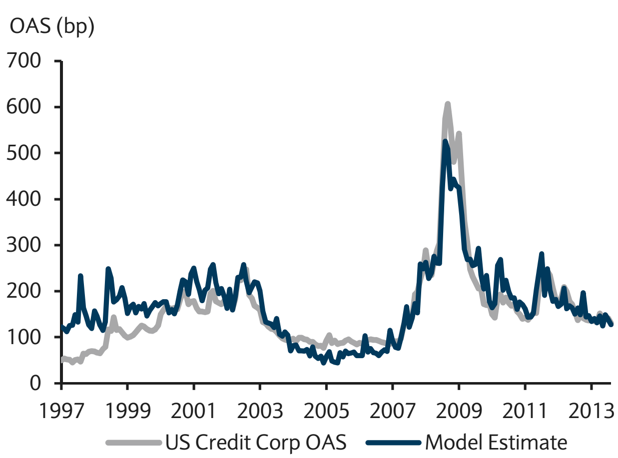
This apparent limit in spreads is not simply a matter of stalled momentum in risk appetite; the S&P 500 index has risen nearly 7% since May. It does not appear to be a function of a minimum total yield that investors are willing to accept for bonds; yield to worst on the corporate index has risen by more than 60bp since spreads first touched 130bp, while spreads are unchanged.

We think our macro model of spreads can help illuminate what needs to happen for spreads to tighten further. The model explains U.S. Corporate Index spread moves and levels (Figure 1) as a function of:

- VIX index, as a measure of the implied volatility being priced in the market. This is the most significant component of the model, which is consistent with the option-like characteristics of corporate debt.
- The percentage of banks tightening lending standards for commercial and industrial customers. This is a measure of the credit conditions corporate issuers face in primary markets and is a useful predictor of future defaults (see *2014 Default Outlook* for details).
- A dummy variable for pre- and post- the 2008 financial crisis. This is very statistically significant and suggests that investors have required a premium to hold corporate credit risk post-crisis.

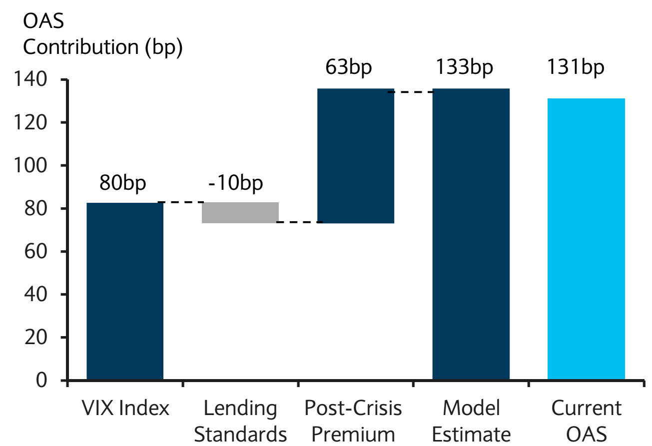
There is limited room for further improvement from lower implied volatility. VIX has recently averaged in the 13 area, only 3pts above the lows (near 10) seen in the mid-2000s. Even if VIX again reaches those low levels, it would suggest further tightening of only about 10bp in corporate spreads. Similarly, while credit conditions could loosen further, the model

FIGURE 1
Macro Model Explains Most of the Moves in Credit Spreads



Source: Barclays Research

FIGURE 2
There Is Limited Room for Further Tightening from Better Liquidity or Increased General Risk Appetite



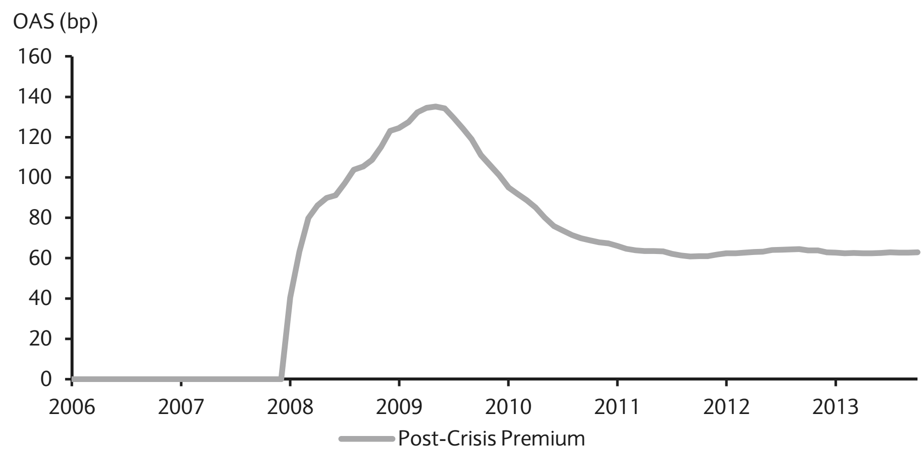
Source: Barclays Research

suggests that spreads have already benefited from relaxing credit standards (Figure 2). Given the already-low default rate, this seems to offer limited room for further upside.

That leaves us with the post-crisis premium, which we believe is compensation investors are demanding for risks that have structurally increased since 2007. These risks may include decreased liquidity, increased financial system risk, and heightened aversion to tail events. For now, at least, we do not see much evidence that it is dissipating. Although a running estimate of its magnitude was highest early in the crisis, it stabilized near its current value as early as mid-2010 and has not varied much since (Figure 3). Until one of those key risk factors (or the compensation investors demand) changes, it appears that we may be close to the lower limit for spreads.

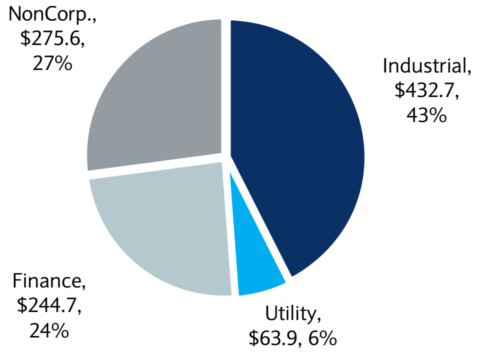
FIGURE 3

Post-Crisis Premium Has Been Stable since the Middle of 2010



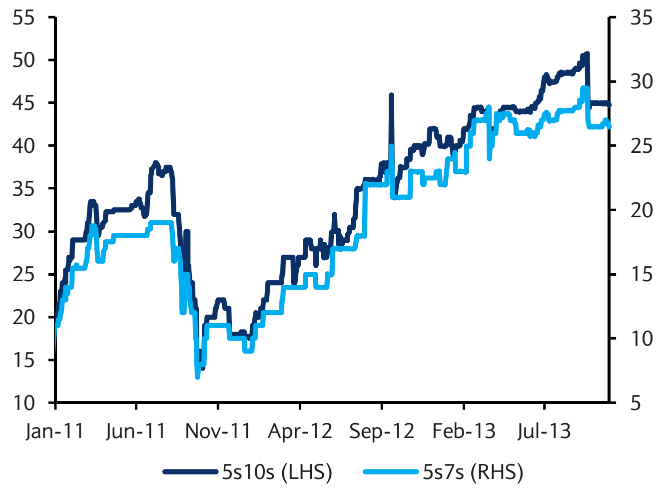
Source: Barclays Research

Year-to-Date 2013 Fixed Investment Grade Supply ($bn)



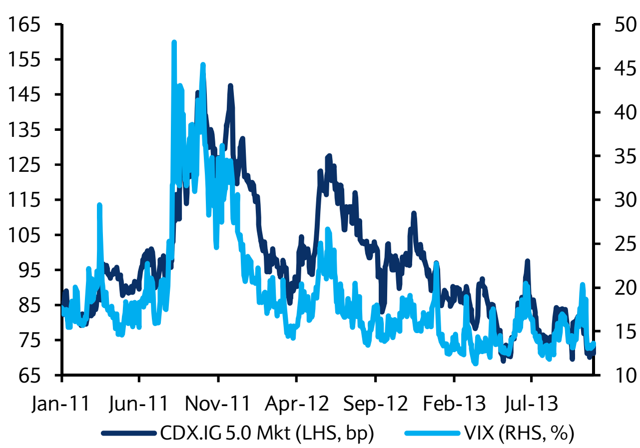
Note: Levels on this page as of Wednesday close. Source: Barclays Research

On-the-Run CDX.IG Curve (bp)



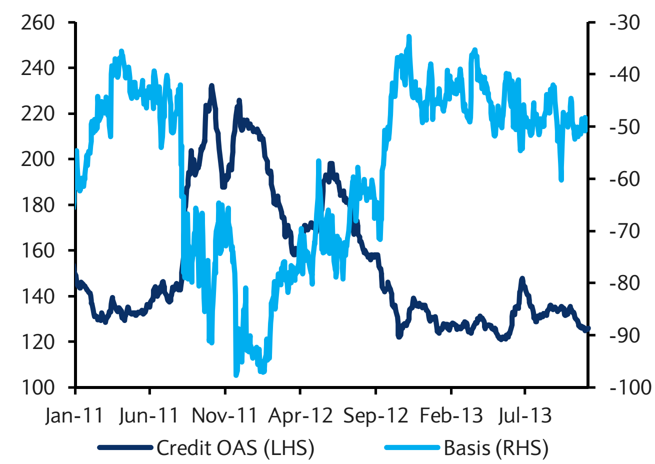
Source: Barclays Research

CDX.IG versus VIX



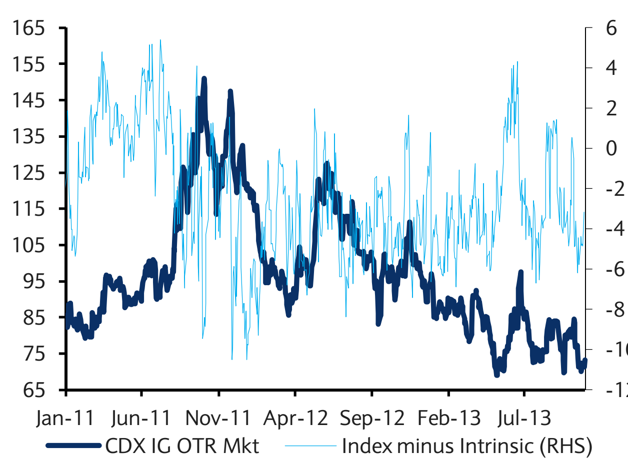
Source: Markit, Barclays Research

CDS-Cash Basis (bp)



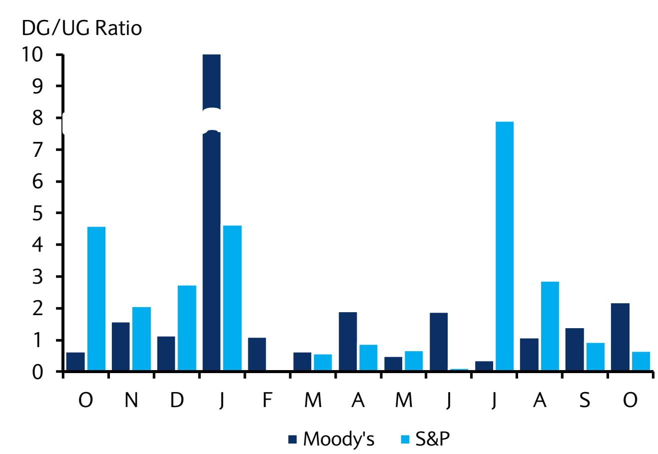
Note: Basis defined as CDX.IG spread – corporate Libor OAS.
Source: Barclays Research

CDX.IG OTR Market versus Intrinsic (bp)



Source: Barclays Research

Par Downgrade/Upgrade Ratio



Note: Broken bars indicate a value of greater than 10x. Source: Barclays Research

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