Relative Value: The last mile

Rachna Ramachandran
MLPF&S
rachna.ramachandran@baml.com

Michael John
MLPF&S
michael.john@baml.com

The idea of developing a theme for the calendar year ahead has always been somewhat of an artificial construct; not much changes at the stroke of midnight on 31st December, or at least no more so than it does every midnight hour. It has been particularly hard to get away from this in compiling our thoughts for 2018. Our house forecasts for the US economy and credit returns next year are very similar to their performance this year. In a similar vein, we think credit volatility will continue to remain subdued for the most part of 2018.

That volatility is low is undeniable. That it needs to be higher is debatable. Yes, policy uncertainty is high and the risk of geopolitical flare-ups remains elevated. But these risks are hard to price or time with any precision. On the other hand, the constancy of central banks and the steady improvement in global economic data are immediate and far easier to evaluate. To us, low volatility doesn't represent complacency as much as helplessness in the face of a large amount of capital chasing too few assets. Time and again over the last two years, the cost of being underinvested has proven to be higher than the benefit of sitting it out.

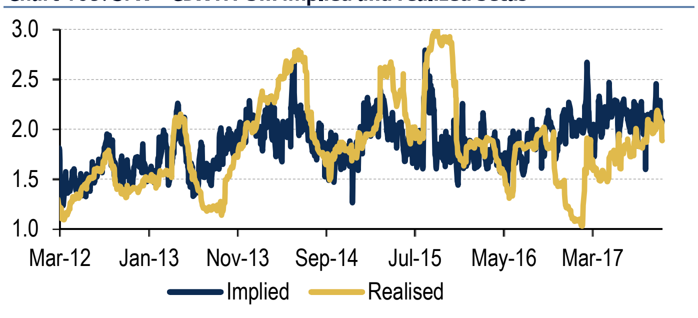
Of course, like every other one before it, this cycle too will age and eventually turn. When the economy falters and default risk becomes material, volatility will spike up. For now however, we're still in the last mile, the final stretch of this extremely long business cycle. Our trade ideas for the next year focus on low cost hedges, positive carry trades, and holdouts that have yet to embrace the rally and may yet want to catch-up.

To hedge risk of tax reform legislation falling through

Buy S&P 500 puts, sell CDX HY puts

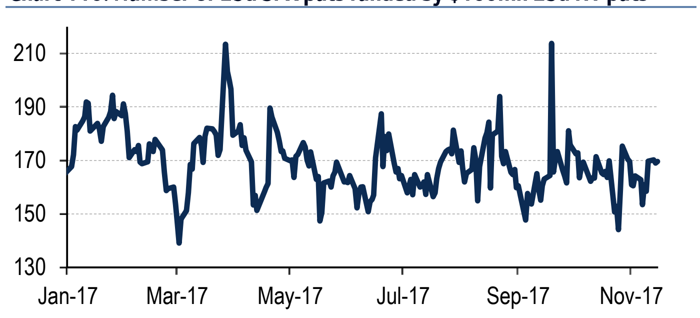
This scenario would hurt equities more than credit. Most of the immediate benefits of the current proposals accrue to shareholders, while low quality credits may even be detrimentally affected by the elimination of full deductibility of interest expenses. To hedge or position for this scenario, we recommend buying S&P 500 puts, funded by selling CDX HY puts. As Chart 109 shows the option implied beta between SPX and HY is in line with what they have been realizing. And in the event that tax reform is abandoned or delayed materially, we'd expect the realized beta between the two to spike up, similar to what occurred in 2013-14 and 2015-16.

Chart 109: SPX – CDX HY 3m implied and realized betas



Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

Chart 110: Number of 25d SPX puts funded by $100mn 25d HY puts



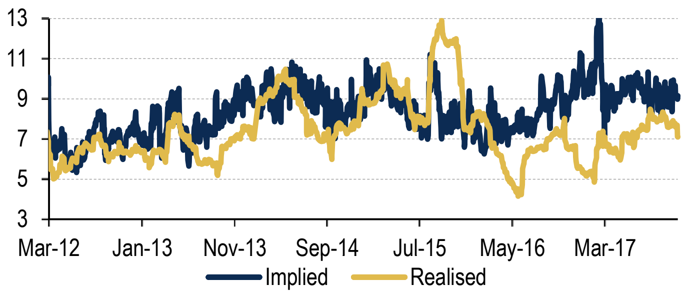
Source: BofA Merrill Lynch Global Research

To hedge credit against a surge in rates volatility

Buy IG payers

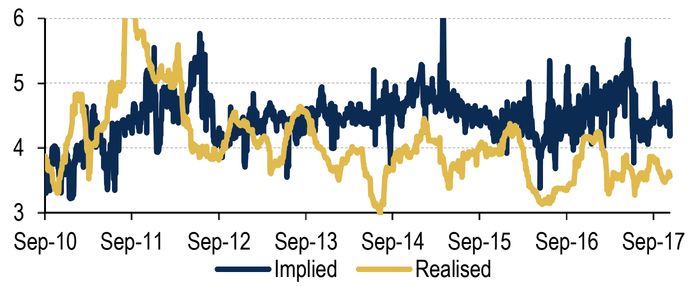
Really this is a catch-all for multiple tail risks, be that a central bank policy mistake, a bond market crash, a geopolitical flare-up or trade wars. Though the direction of rates will vary across these events, volatility is likely to surge if any of them occurs. Puts on high grade credit offer the best hedge for this scenario, in our opinion. We think it is better executed through CDX IG payers rather than a trade in a HG cash product, because depending on the exact scenario that materializes, the latter may benefit from the negative correlation between rates and spreads. IG volatility looks cheap relative to stocks, HY and until a week back even relative to rates. This isn't necessarily a mispricing, rather an indication that the market assigns a low probability to an extreme tail event, which is what IG offers protection against.

Chart 111: SPX – CDX IG 3m implied and realized betas



Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

Chart 112: CDX HY – CDX IG 3m implied and realized betas



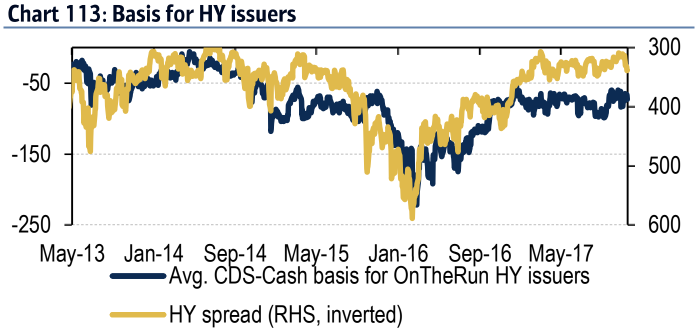
Source: BofA Merrill Lynch Global Research, implied betas based on ATM straddle price ratio

For downside protection in credit

Buy high yield cash puts, sell CDX HY puts

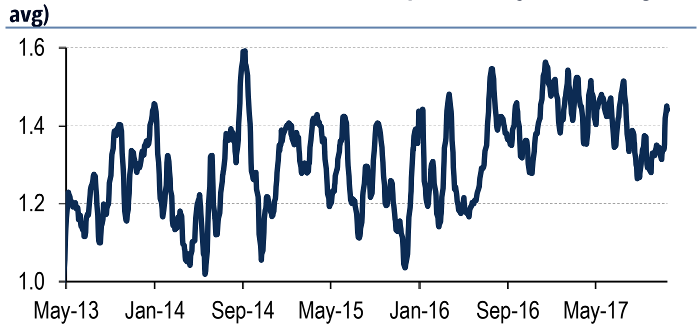
The CDS-cash basis is much less negative now than it was last year. However, even though CDX is near/inside its 2014 tights, the basis has struggled to compress beyond a certain level. The limiting factor we think has been funding. The other interesting thing about the basis, since 2013, has been its directionality – it turns more negative when spreads widen and more positive when spreads rally. The increasing popularity of ETFs, especially in HY, as a way to express views on credit, ensures that the lag that used to exist between bonds and CDS has all but disappeared. At the same time, bonds do carry a liquidity premium, which typically increases in risk-off. Together, this implies that the basis will likely remain directional, becoming more negative into a sell-off and vice-versa.

Chart 113: Basis for HY issuers



Source: BofA Merrill Lynch Global Research

Chart 114: Ratio of HYG to HY 3m 25delta put volatility (10d moving avg)



Source: BofA Merrill Lynch Global Research

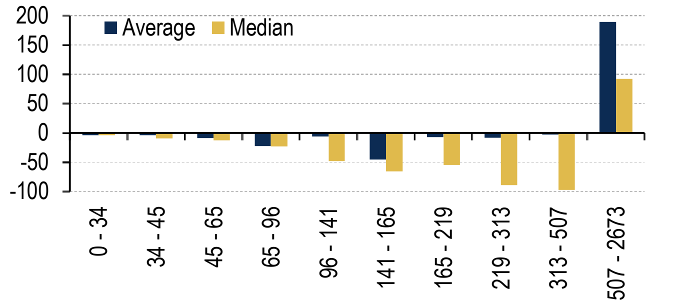
This pattern opens up an interesting opportunity between CDX HY and HYG volatility. In a recent piece we discussed how a principal component analysis (PCA) of volatility across IG, HY, HYG and LQD suggests that HYG volatility is almost full explained by credit (CDX) volatility and the CDX-cash index basis. The directionality of the basis relative to spreads also implies that HYG tends to realize more volatility in general compared to HY. We like owning downside credit protection through HY cash puts, while selling CDX HY puts against it.

Dispersion and a HY long for those with conviction

Dispersion has been relatively high in credit since 2015. Even so, it is startling, that in a year where stocks have been on a tear and we've had positive excess returns across credit, the widest part of the market did not deign to participate (Chart 115).

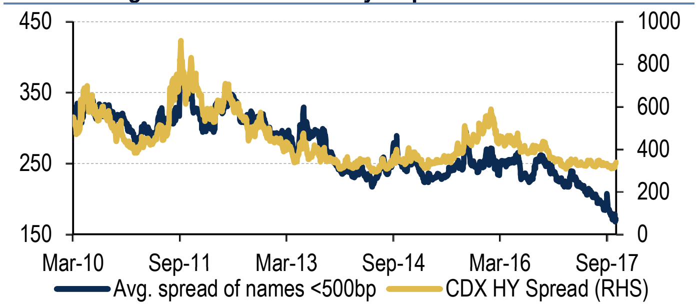
Chart 115: YTD change in 5y CDS for different spread cohorts

For issuers in CDX29, grouped by spread deciles as of 31-Dec-2016



Source: BofA Merrill Lynch Global Research

Chart 116: Tight names have massively outperformed HY index



Source: BofA Merrill Lynch Global Research

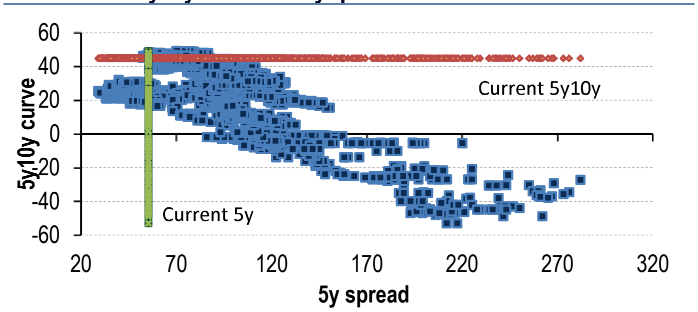
For CDX HY to tighten significantly from here dispersion has to decrease and wide names have to outperform. It is difficult to see how this is accomplished, in the absence of 'animal spirits'. After all, the dispersion exists because of elevated jump and idiosyncratic risk. Another point of concern surrounding the HY tail names is tax reform. If passed, the legislation in its current form is hardly beneficial to these issuers. It may put some business models and capital structures into question while the benefit of a lower tax rate is a moot point for several names in this cohort.

However, for those who are bullish HY for 2018 with a high level of conviction, the best way to express this view is through a long equity tranche trade as it is immediately sensitive to the performance of the wide tail names. The tranche has persistently underperformed the rest of the capital structure this past year and stands to benefit the most from a true 'risk-on' rally.

Curves, a long and a carry trade

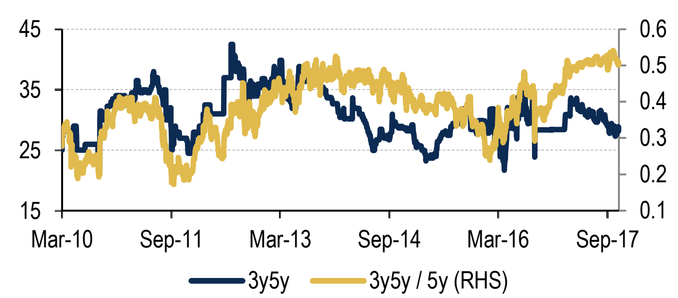
Credit spread curves are very steep. This may be in part related to higher longer term uncertainty versus low near-term risk as a consequence of central bank actions. As it pertains to IG, relative liquidity may play a role too. The 10y point is far less liquid than the 5y and the steep curve partly reflects this premium. The 3y on the other hand has benefited from the recent revival of the synthetic CDO market which has led this tenor to tighten at a quicker pace than the 5y (Chart 118).

Chart 117: IG 5y10y relative to 5y spread



Source: BofA Merrill Lynch Global Research

Chart 118: CDX IG 3y5y curve



Source: BofA Merrill Lynch Global Research

Long 10y IG

The 5y5y forward spread for IG is 156bp, almost 3x the 5y spread. We think 10y IG provides good value as a long, especially now that the 5y is at post-crisis tights. As Chart 117 shows the curve has rarely been steeper than current levels. The passage of tax reform legislation should be positive for the 10y part of the curve. Corporates have indicated that most intend to deploy repatriated cash holdings towards paying down debt. Also, the elimination of full interest expense deductibility for tax purposes will increase the cost of debt relative to equity, encouraging companies to de-lever over time. Low liquidity and onerous capital requirements for banks have kept the 10y spread elevated. However, for yield starved investors who are less sensitive to daily mark-to-market, 10y IG stands as one of the few spots in high grade credit that hasn't rallied whole-heartedly.

3y5y DVO1-neutral flattener

While the 3y5y curve has begun flattening in absolute terms, we think it has more to go, especially if spreads continue to rally. Since the 3y is limited on the lower end, further tightening in credit should lead to more bull flattening. As Chart 118 shows, relative to the 5y, 3y5y is close to the steepest ever. We like a 3y5y DVO1-neutral flattener in IG. The trade is positive carry and roll. Unlike an equal notional curve trade, which is more directional, the DVO1-neutral weighting will perform even with bear flattening. The risk to the trade is that the curve steepens with wider spreads, which is certainly possible, but less likely we think from current levels.