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What Trading Near the Tights Can Teach Us

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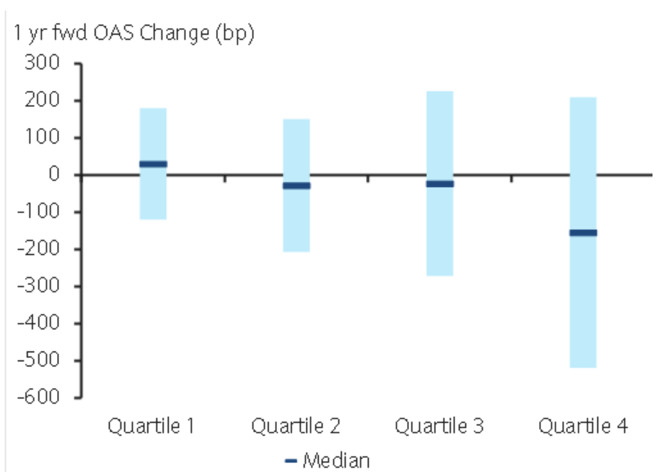
The US High Yield Index OAS has oscillated in a reasonably narrow band of roughly 60bp this year (between 310bp and 370bp). The index is currently slightly tighter on the year (339bp, versus 343bp to start the year), not far from the post-recession tights reached in January of this year (311bp) and well inside the average of 495bp since the start of 2010. When we take a broader view, however, we note that current spreads are much further from the tights reached in pre-2008 cycles.

Relatively tight trading levels and an uncomfortably narrow trading band, coupled with the extended length of the credit cycle, have many investors concerned that spreads are hovering near a floor – and skewed to widen in the year ahead. We still expect high yield spreads to remain reasonably stable in the near term and do not think that we are approaching a floor (given a number of factors, including a largely supportive financing, corporate, and macro fundamental backdrop and a benign one-year-forward default outlook – see *Default, Dear Brutus, Is Not in Our Stars*). However, we also appreciate that many investors are cautious about mean reversion, with concerns of contagion from emerging market worries and the potential for growing trade frictions to negatively affect the US economy serving as the latest potential catalysts.

Putting medium- to long-term views aside because we have not yet formalized our outlook on 2019, we evaluate historical statistics to determine if the index's spot level has any meaningful implications for spreads one year forward and if there is any particular directional skew that follows. Figure 1 shows the one-year-forward median spread change and a two-standard-deviation band for the US High Yield Index based on then-current spread level broken into quartiles, using data since 1993. Quartile 1 represents when the index was trading at the tightest levels over this period (average spread of 299bp) while Quartile 4's spreads were the widest (average spread of 828bp). The High Yield Index currently trades at 339bp, on the cusp of the first and second quartiles (which is 342bp).

FIGURE 1

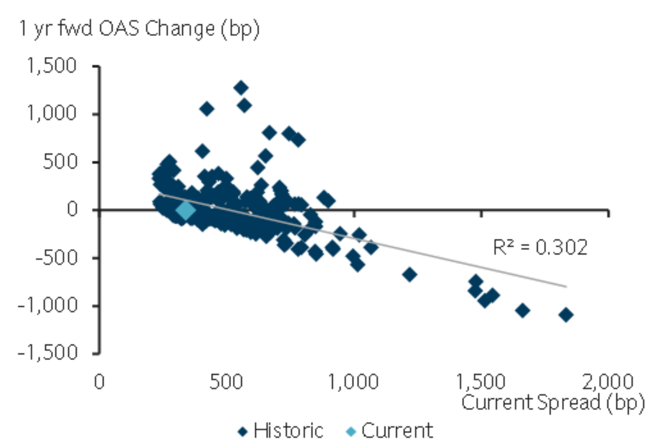
Periods of Tight Spreads Have Historically Been Followed by Modest Widening in the Next 12 Months



Note: Bar indicates median one-year-forward spread change, and shaded band is one standard deviation above and below average.
Source: Bloomberg Barclays Indices

FIGURE 2

Regression of Historical One-Year-Forward Spread Changes Implies Widening from Here, but Disperse Outcomes Exist



Source: Bloomberg Barclays Indices

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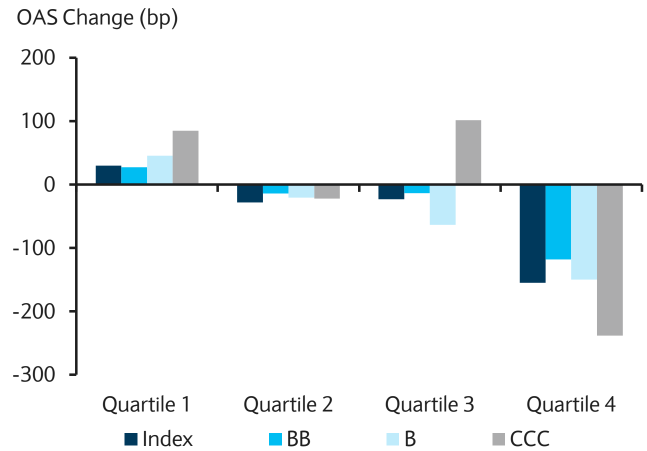
FIGURE 3

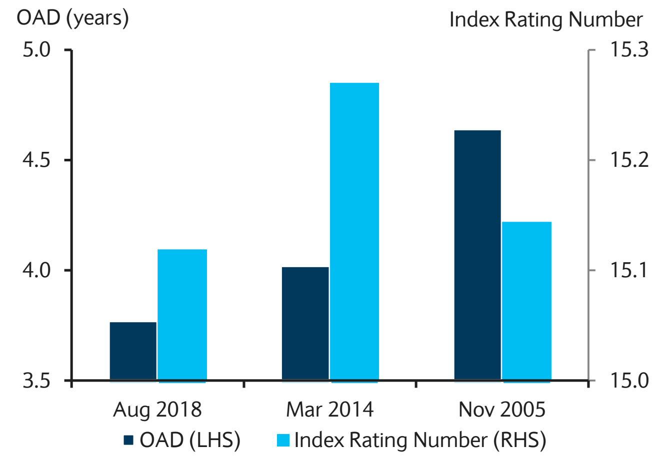
One-Year-Forward Spread Change Is Magnified for CCCs at the Extremes



Source: Bloomberg Barclays Indices

FIGURE4

The Current Index Is Shorter in Duration and Modestly Higher in Quality than Prior Periods When Spreads Were Similar



Note: Index Rating Number is a market value-weighted measure of ratings with higher numbers representing lower ratings (for example, the number 12 corresponds to Ba1/BB+, 13 corresponds to Ba2/BB, etc.)
Source: Bloomberg Barclays Indices

When starting in the tightest quartile, median spread widening was roughly 30bp in the ensuing year, while median spread tightening was 150bp when starting in the widest trading quartile. That said, when we take the average of Quartile 1 instead of the median, we find that spreads widen roughly 85bp in the following year – pointing to select outlier data points of massive widening following tight trading periods (primarily in 2007). When these extreme data points are excluded, the analysis points to much more moderate spread widening potential.

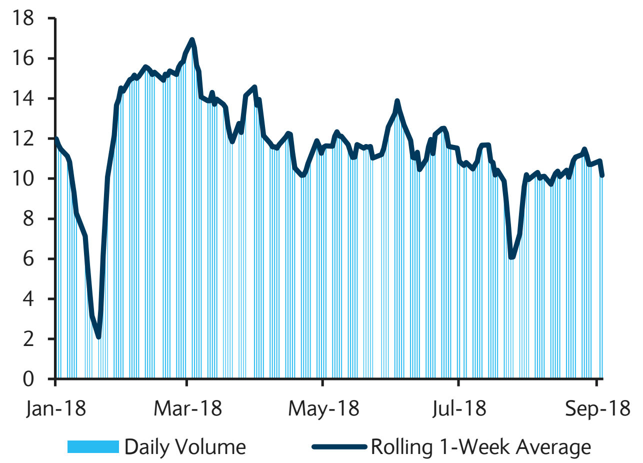
What is most notable to us is that the two-standard-deviation band of Quartile 1 is not very different from that of Quartile 2, and there is not a differing apparent skew toward spread widening in the year ahead when starting in this quartile. Based on a regression of these data points (Figure 2), we find that the current High Yield Index spread implies widening of roughly 100bp over the next year. While the regression points to widening, there is large dispersion of results (represented by a small R-square), and we further believe that the duration and quality differences shown in Figure 4 should limit reliance on the regression alone.

As shown in Figure 3, CCCs experienced the most widening when the index was the tightest (Quartile 1) and the most tightening when the index was the widest (Quartile 4), following intuition at the extremes. Based on rating cohort regressions similar to Figure 2, the data imply that CCCs could widen the most from current levels, by roughly 280bp, while BB widening would be just 67bp. Even on a beta-adjusted basis, the regression still implies the potential for greater CCC widening, as the historical spread beta relationship between CCCs and BBs has been roughly 2x.

Elements of the output of this regression make sense to us because CCCs have outperformed higher-rated cohorts materially thus far in 2018 as investors have sought shorter-duration, wider-spread credit to offset rising rates. Limited supply and a heavy weighting of energy within CCCs (due to an uplift in sector credit quality and oil prices) have also helped (see *Where All the CCCs Have Gone* and *Drilling into CCC Energy*). The OAS of BBs has widened 11bp year-to-date, while the CCC OAS is basically unchanged, supporting the regression data's indication that one-year-forward widening would be led by CCCs should the overall high yield market experience weakness in the coming twelve months. More specifically in the near term, a new issue calendar that is tilted toward CCCs could result in pressure on CCCs in the secondary market if large new issue concessions are required, as new issue CCC paper has struggled at times this year (see *Parsing Primary Pricing*).

Finally, as we have discussed above and in previously published work (see *How Much More Room to Run?*), today's high yield market is of higher quality (using ratings cohorts) and shorter duration than in previous periods of tight spreads. This highlights the potential for further tightening from current levels purely on account of compositional differences that have emerged over time. Figure 4 highlights the modestly better quality based on rating cohort weights than in prior periods of similar index-wide OAS (essentially driven by a lower proportion of CCC risk today). Furthermore, the OAD of the index is currently 3.8 years, compared with 4.0 years and 4.6 years in March 2014 and November 2005, respectively, which should limit reliance on historical spread data alone.

High Yield Average Institutional Trade Volume ($bn)

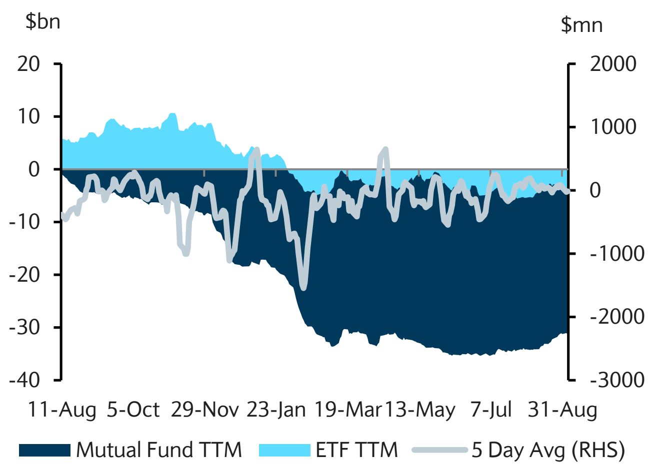


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

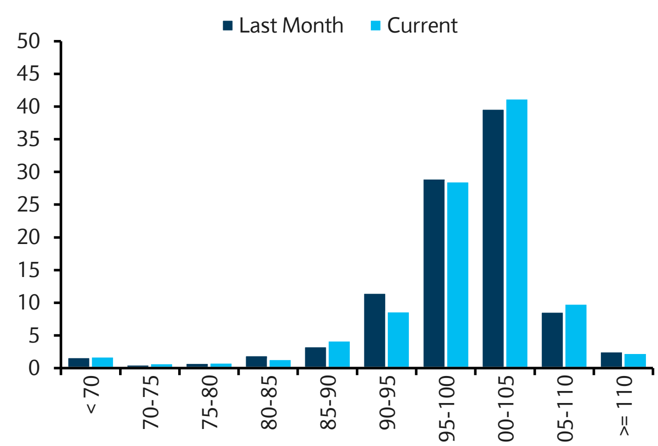
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



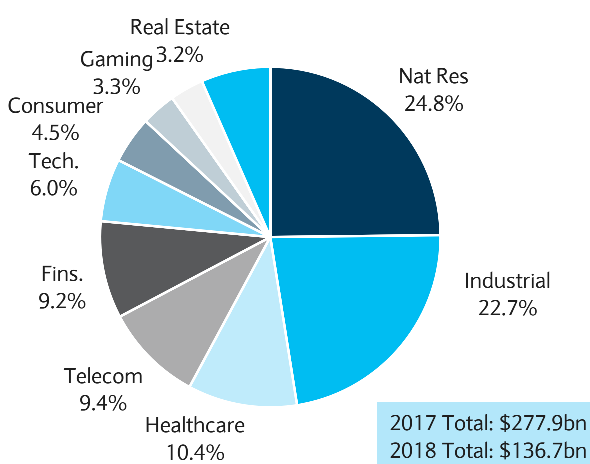
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



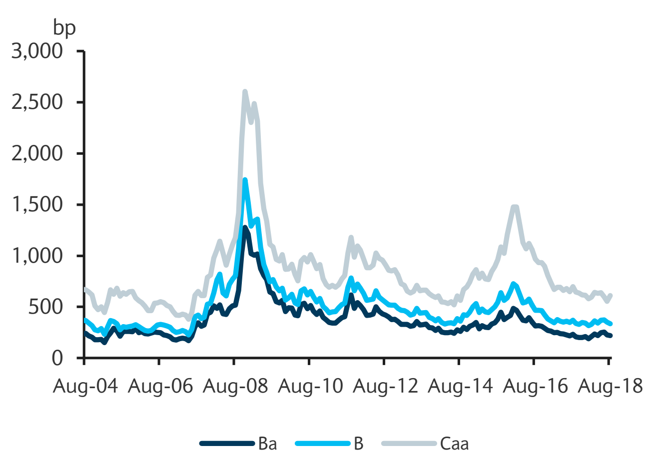
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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