BARCLAYS

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6 August 2019

US Credit Strategy

Low Yields Heighten Concerns for Long Bonds

- **Long-dated corporate yields have declined to all-time lows, driven by the sharp rally in Treasuries over the past week, with 10y Treasury yields decreasing 30bp.**
- **Dollar prices have risen sharply as yields have decreased, with the Long Index now trading at $117, up more than $10 over the past twelve months. The higher dollar price means that in default-adjusted terms, the spread is tighter than nominal levels suggest. By our estimate, the dollar price adjustment has doubled from 7bp to 14bp over this period.**
- **The move in Treasury yields has offset the decline in US 3m Libor, driving hedge-adjusted yields back to pre-FOMC levels, thereby eliminating the benefit of the rate cut for international demand. Additionally, the strengthening dollar has increased the value of international holdings, which could result in net selling of bonds as holders look to book gains to offset the losses on the hedges.**
- **Low all-in yields will likely weigh on demand for long-dated debt from yield-focused investors, driving 10s30s curves steeper. The 10s30s curves for A-rated debt in particular appear flat, leaving higher-quality long-dated debt most at risk of widening from declining yields.**
- **Low yields and flat curves create an attractive opportunity for corporates to term out debt. We highlight companies that have a large amount of short-dated debt, either in absolute terms or as a percentage of their total debt outstanding. More broadly, we continue to expect issuance to be biased to longer-dated debt.**

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Long-Dated Yields Decline to Record Lows

The latest escalation in trade tensions between the US and China has driven a significant sell-off in risk assets, as well as a further rally in US Treasuries, as investors flock to the safe-haven asset. 10y Treasury yields are 30bp lower since the FOMC meeting at the end of July and nearly 100bp lower on the year. While developments in US-China trade negotiations are likely to drive credit spreads, the decline in Treasury yields will also have a significant effect on corporate debt valuations, in our view. The yield of the Bloomberg Barclays US corporate index declined to 3%, the lowest level since November 2016. Further, the index yield has been propped up by shorter-dated debt, given the flat Treasury curve. In fact, the yield of the Long Corporate Index is at an all-time low of 3.78% (Figure 1).

While USD debt yields are low in absolute terms, they are still among the highest in DM. For instance, the EUR Corp index yields less than 0.5%. This is likely to ameliorate many of the risks emanating from the decline. Nevertheless, the historically low level of long-dated yields has several negative implications for the $-IG market:

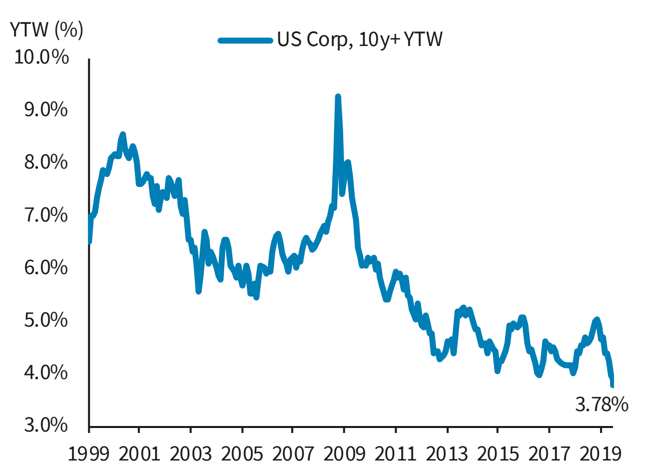
1. **Prices:** The decrease in yield has driven dollar prices higher. The effect is magnified in the long end, with the $px of the long index increasing to $117. Even though yields are at an all-time low, the index price is well below record highs as coupons have declined. The average coupon of the long index has declined more than 0.8% over the past five years. The two combined mean the modified duration of the index is at an all-time high.

   The higher $px of the Long index means that in default-adjusted terms (ie, accounting for the higher principal risk of high $px bonds), the spread is tighter than nominal levels suggest. Figure 2 compares valuations current vs. in August of last year, when the index OAS was at similar levels. By our estimate, the dollar price adjustment for the long-dated corporate index has doubled – moving from 7bp to 14bp in that period – as the $px of the index has increased. In other words, investors are now earning 7bp less in spread than in the previous period after adjusting for the premium levels.

2. **Hedge-adjusted yields:** With the Fed cutting rates 25bp, USD 3m Libor declined by the same amount last week. This drove cross-currency hedging costs lower. However, this has been almost completely offset by the rally in Treasuries, with hedge-adjusted yields back to pre-FOMC levels, thereby eliminating the benefit of the rate cut for international demand

FIGURE 1

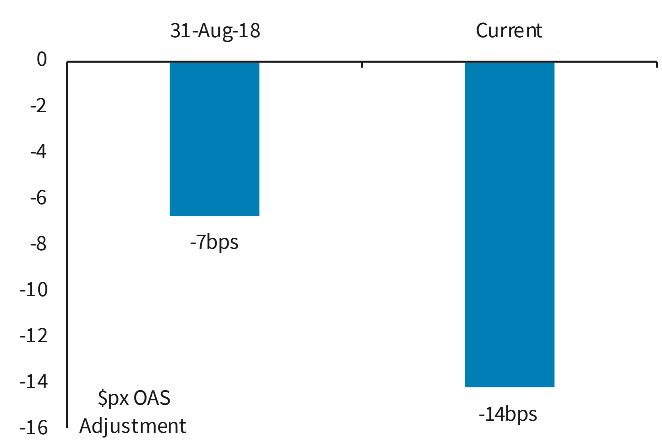
Long-dated yields are now at all-time lows



Source: Bloomberg, Barclays Research

FIGURE 2

Long index spreads are much tighter now in $px-adjusted terms



Source: Bloomberg, Barclays Research

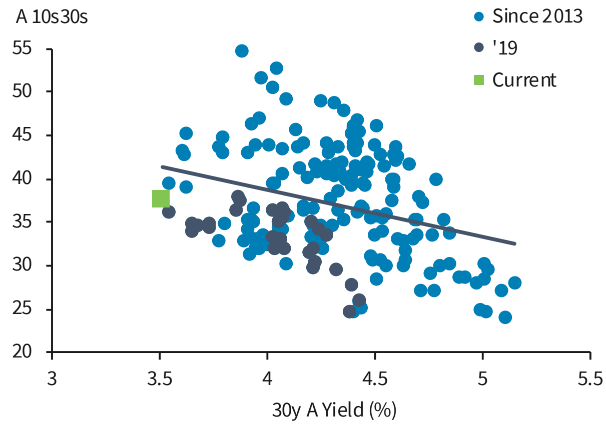
FIGURE 3

10s30s still appear flat for high-quality debt…

Source: Bloomberg, Barclays Research

FIGURE 4

….especially for the level of yields (A10s30s vs. yield)



Source: Bloomberg, Barclays Research

The accompanying currency volatility, specifically USD strengthening, could also have implications for near-term demand. For international buyers of USD debt, this means their holdings appreciate in value, which is partly offset by mark-to-market losses on the currency hedges. The decline in hedging ratios for Taiwanese investors, as discussed in *Taiwan: A lifelong thirst for yield*, means that net their portfolios have likely appreciated in value. However, in the past, periods of significant USD strengths have been met by net selling of bonds as holders look to book gains to offset the losses on the hedges.

3. **Long-dated demand:** The demand for long-dated debt could come under pressure more broadly, with the precipitous decline in yields weighing on insurance/ pension flows. Industrial 10s30s curves have steepened this year, but while BBB curves are steep from a historical standpoint, the A curves are not. In fact, adjusting for the level of yields, A 10s30s spread curves appear flat.

   Consequently, A rated long-dated debt is most at risk of widening from declining yields, in our view. In Figure 5, we provide a list of A or better issuers with flat 10s30s (less than 35bps) and 30y bonds yielding below the index level. We favor the10y part of the curve over the 30y part of the curve for these issuers.

FIGURE 5

Flat 10s30s with thirty year bonds below index yields

Ticker	Rating	10y Bond	30y Bond	10s30s OAS Basis (bp)	30y Yield
BABA	A1	3.4s of 2027	4.2s of 2047	21	3.74%
TOTAL	AA3	2.829s of 2030	3.461s of 2049	26	3.30%
PG	AA3	2.85s of 2027	3.5s of 2047	26	2.94%
PFE	A1	3.45s of 2029	4s of 2049	27	3.35%
WMT	AA2	3.25s of 2029	4.05s of 2048	28	3.09%
MRK	A1	3.4s of 2029	4s of 2049	29	3.19%
MA	A1	2.95s of 2029	3.65s of 2049	30	3.13%
V	AA3	2.75s of 2027	3.65s of 2047	32	3.03%
AMXLMM	A3	3.625s of 2029	4.375s of 2049	32	3.63%
HD	A2	2.95s of 2029	4.5s of 2048	35	3.31%

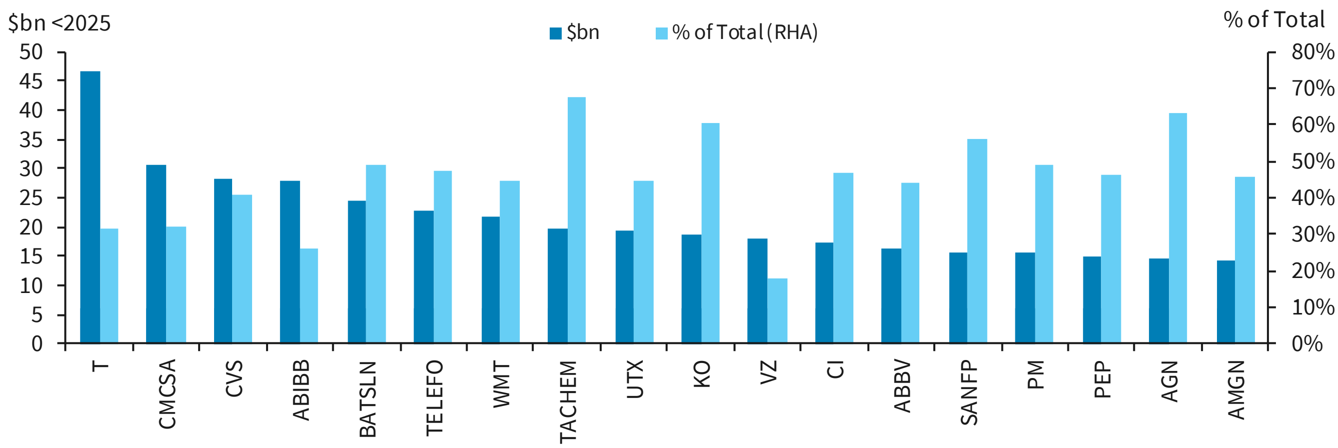
Source: Bloomberg, Barclays Research

We are more positive on longer-dated BBBs, particularly mid- and low-ones, given that 10s30s BBB curves screen as steeper than historical levels. Further, to the extent A paper does not meet yield-bogeys, we would expect marginal demand to move down in quality, which should support BBB valuations.

4. **Long-dated supply**: With corporate yield curves still pretty flat and all-in yields at record lows, the opportunity for terming out debt appears particularly attractive. The cost of doing so is still low from the issuer's standpoint, and for corporates concerned that the end of the economic cycle is approaching, it is beneficial to term out short-dated debt while funding conditions are still benign. As we show in *Love Me Tender*, between 2005 and 2007, when corporate yield curves were also flat, non-financial corporates reduced the portion of debt maturing in less than seven years, thereby terming out debt.

   We have already seen several examples of such transactions: ABIBB and AT&T took out short-dated debt and replaced it with longer funding. Even more extreme examples were Pfizer and Merck, which issued long-dated debt with the intention of reducing CP. We expect this trend to continue and highlight companies that have a large amount of short-dated debt, either in absolute terms or as a percentage of their total debt outstanding (Figure 6). More broadly, low long-dated yields are also likely to drive supply to that curve, a trend we have already seen this year and expect to continue (see *Signs of Good Health from Supply*).

FIGURE 6
Select Companies with Large Amounts of Debt Maturing before 2025



Source: Bloomberg, Barclays Research

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ALIBABA GROUP HOLDING LTD, CD/CE/D/J/K/L/M/N
BABA 3.4 12/06/27 (USD 102.07, 05-Aug-2019)
BABA 4.2 12/06/47 (USD 105.91, 05-Aug-2019)

AMERICA MOVIL SAB DE CV, A/CD/CE/D/E/J/K/L/M
AMXLMM 3 5/8 04/22/29 (USD 106.25, 05-Aug-2019)
AMXLMM 4 3/8 04/22/49 (USD 112.27, 05-Aug-2019)

HOME DEPOT INC/THE, A/CD/CE/D/E/J/K/L/M
HD 2.95 06/15/29 (USD 103.32, 05-Aug-2019)
HD 4 1/2 12/06/48 (USD 121.61, 05-Aug-2019)

MASTERCARD INC, A/CD/CE/D/J/K/L/M/N
MA 2.95 06/01/29 (USD 104.65, 05-Aug-2019)
MA 3.65 06/01/49 (USD 110.43, 05-Aug-2019)

MERCK & CO INC, CD/CE/D/J/K/L/M/N
MRK 3.4 03/07/29 (USD 108.40, 05-Aug-2019)
MRK 4 03/07/49 (USD 115.00, 05-Aug-2019)

PFIZER INC, A/CD/CE/D/E/J/K/L/M/N
PFE 3.45 03/15/29 (USD 107.09, 05-Aug-2019)
PFE 4 03/15/49 (USD 114.24, 05-Aug-2019)

PROCTER & GAMBLE CO/THE, A/CD/CE/D/E/J/K/L/M
PG 2.85 08/11/27 (USD 105.74, 05-Aug-2019)
PG 3 1/2 10/25/47 (USD 110.55, 05-Aug-2019)

TOTAL CAPITAL INTERNATIONAL SA, A/CD/D/E/J/K/L/M/N
TOTAL 2.829 01/10/30 (USD 102.34, 05-Aug-2019)
TOTAL 3.461 07/12/49 (USD 101.78, 05-Aug-2019)

VISA INC, CD/CE/D/J/K/L/M/N
V 2 3/4 09/15/27 (USD 103.62, 05-Aug-2019)
V 3.65 09/15/47 (USD 111.06, 05-Aug-2019)

WALMART INC, A/CD/CE/D/J/K/L/M/N/R
WMT 3 1/4 07/08/29 (USD 108.07, 05-Aug-2019)
WMT 4.05 06/29/48 (USD 116.85, 05-Aug-2019)

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