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A Little More Leaning on Leverage

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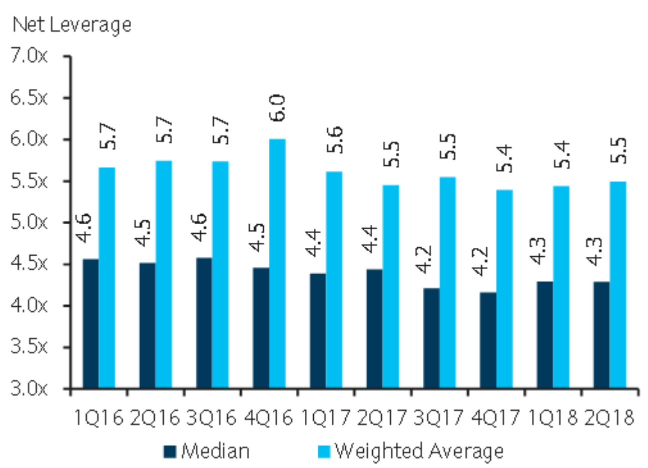
Strength in the US corporate backdrop persists when viewed through the lens of the largely complete second-quarter earnings period, as both sales and earnings surprised to the upside. Sales growth for the S&P 500 exceeded estimates by 1.4%, with earnings growth 5.4% above estimates. For the Russell 2000, those numbers were 1.3% and 2.6%, respectively.

The general strength has continued to support solid credit fundamentals, with par-weighted average net leverage across high yield now sitting at 5.5x. Net leverage did tick up slightly q/q (though it remained flat y/y – Figure 1), while gross leverage matches post-recession lows. Meanwhile, par-weighted average interest coverage declined sequentially, but is offset by median interest coverage that is at decade highs (Figure 2). The modest tick higher in par-weighted net leverage and lower in coverage may suggest slight fundamental deterioration (particularly among the larger-cap universe) but we are inclined to view these small changes as statistical noise for now and would look for any adverse trends in 3Q before turning cautious on these fronts.

That said, we believe a portion of the growth in corporate earnings can be attributed to the changes in the tax code, which benefit the bottom line but have little immediate effect on EBITDA through a reduction in the tax rate. While this change should benefit creditors in the long run, they take longer than many may have hoped. As a result, spread reaction to the resulting increase in cash flows may be delayed or even muted. We are still in the early days of the implementation of the new tax policy, and management teams are spending their excess cash on capex, M&A, or equity holders, in line with pre-existing plans, before committing cash to deleveraging (see *A Little Less Taxation, a Little More Action*).

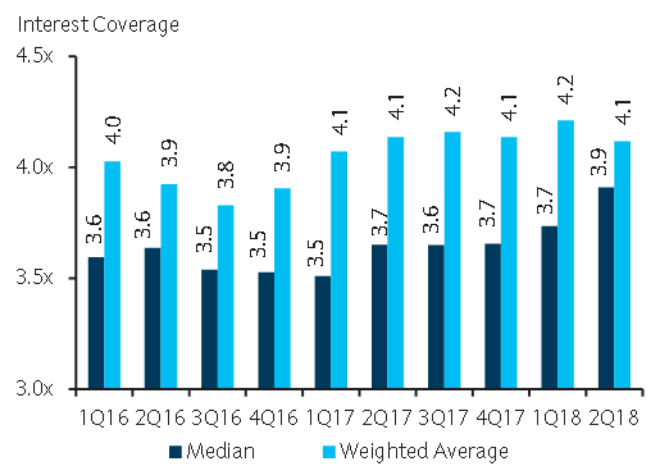
Out of the companies for which we can source data that are currently in the US High Yield Index, 46% saw leverage decrease from 2Q17 to 2Q18 while 40% saw leverage increase (the remainder were unchanged). We find some comfort in the balanced breadth of improving and deleveraging credits as a counterpoint to the 0.1x sequential rise in par-weighted leverage more broadly.

FIGURE 1
Par-Weighted Average Net Leverage Increased Slightly in 2Q18 but Essentially Range-bound and Flat Y/Y



Note: Data exclude financials
Source: Capital IQ, Bloomberg Barclays Indices, Barclays Research

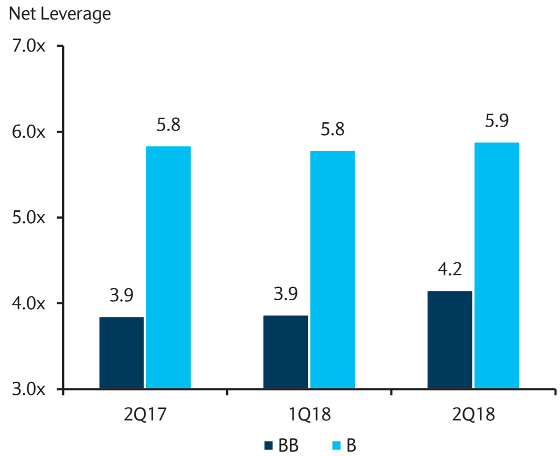
FIGURE 2
Par-Weighted Average Interest Coverage Declined a Touch, but the Median Hit a Post-Crisis High



Note: Data exclude financials
Source: Capital IQ, Bloomberg Barclays Indices, Barclays Research

FIGURE 3

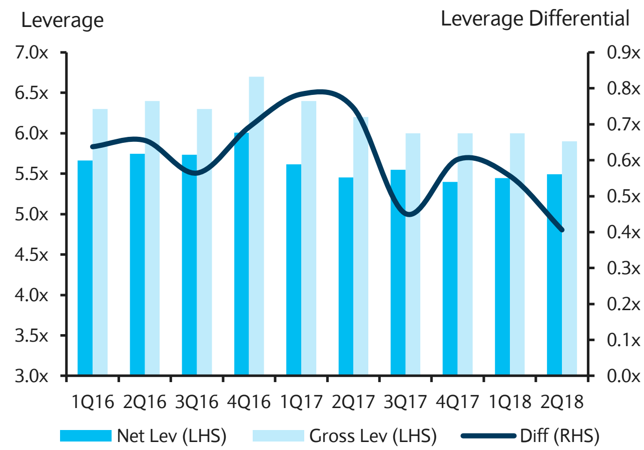
BB Net Leverage Has Bumped Higher Both Sequentially and Y/Y, with B Net Leverage Essentially Stable



Note: Data exclude financials
Source: Capital IQ, Bloomberg Barclays Indices, Barclays Research

FIGURE 4

Gross Leverage Has Decreased to Post-Crisis Lows as the Gap to Net Leverage Shrinks



Note: Data exclude financials
Source: Capital IQ, Bloomberg Barclays Indices, Barclays Research

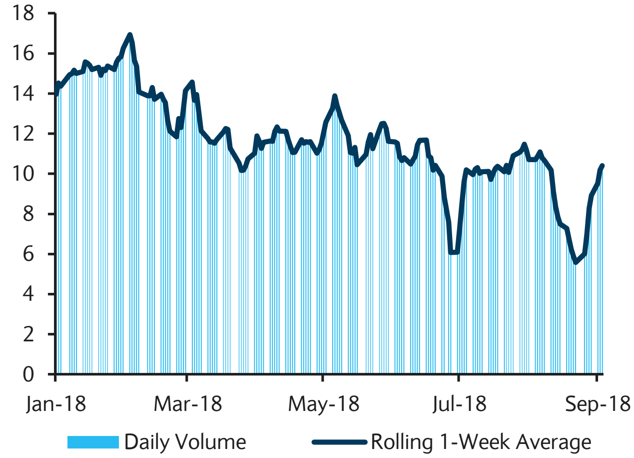
When we look at leverage across rating cohorts (Figure 3), we find that BB leverage has climbed the most on both a q/q and a y/y basis. Of the limited publically available data we have for CCCs, we find that current leverage has decreased sequentially, now back in line with 2Q17. This discrepancy also highlights the slight climb in leverage among the larger issuers, as suggested earlier, with the index-eligible debt of the average BB issuer now more than twice that of the average CCC issuer. However, we have recently witnessed a bias for investors to move slightly up in quality in their portfolios, as gauged by the climb in the CCC/BB spread ratio, viewing any balance sheet deterioration as reasonably contained for now (see *Barclays Tuesday Credit Call: Back to Quality*). This recent preference for quality is largely explained by the underperformance of BBs relative to CCCs year-to-date (31bp versus 501bp, respectively) as investors have sought to offset the rise in risk-free yields in yieldier segments of the market for much of 2018.

While net leverage has been relatively stable, the trend in gross leverage has been slightly more favorable, with the par-weighted average falling to 5.9x, the lowest since 2011 (Figure 4). The modestly different trajectories of gross and net leverage have become pronounced with the basis between the two metrics at lows. What explains the narrowing gap? Aggregate cash levels have declined 3% y/y and 6% q/q. While this trend could be viewed positively as a sign that management teams view the economic backdrop over the investable horizon favorably, some creditors may find the decrease in cash worrisome. Yet we find no particular relationship between year-to-date performance and changes in the cash/debt measure at the single-bond level, again suggesting that investors remain relatively comfortable with issuers' access to liquidity and cash generation potential for now.

Finally, some investors' motivation to upgrade portfolio quality is simply a rational reaction to the extended duration of the credit cycle, spreads that are hovering at decade tights, and the potential for earnings deceleration in 2H19. Recently, we argued that we do not necessarily believe there is a "floor" for credit spreads based simply on history given changes in the composition and duration of the high yield market over time (see *What Trading Near the Tights Can Teach Us*). To address concerns about a potential deceleration in EBITDA growth (and a climb in leverage), we first note that small-cap LTM EBITDA growth is now running at 11.1%, the fastest pace since 2011. Furthermore, Barclays forecasts 14% growth for full-year 2018, although history suggests that pace is unsustainable, with median and average EBITDA growth rates of 7.8% and 8.8%, respectively (see *US Small & Mid Cap*

Strategy: Small caps rise for sixth month powered by earnings). To put the inevitable slowdown in EBITDA growth to a pace closer to long-run growth rates in more historical perspective, we note that credit markets were reasonably well supported in the mid-2000s, when LTM EBITDA growth decelerated similarly after the outsized rebound post-recession. Finally, we note that outright declines in EBITDA have typically been observed only during recessions, which is not part of our US economics team's base case over the investable horizon.

High Yield Average Institutional Trade Volume ($bn)

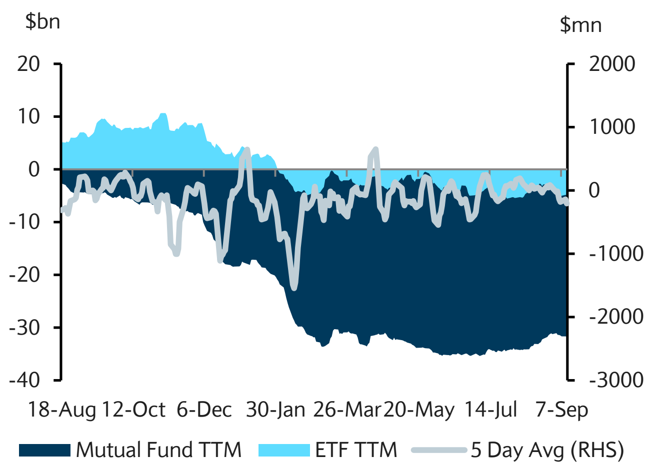


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

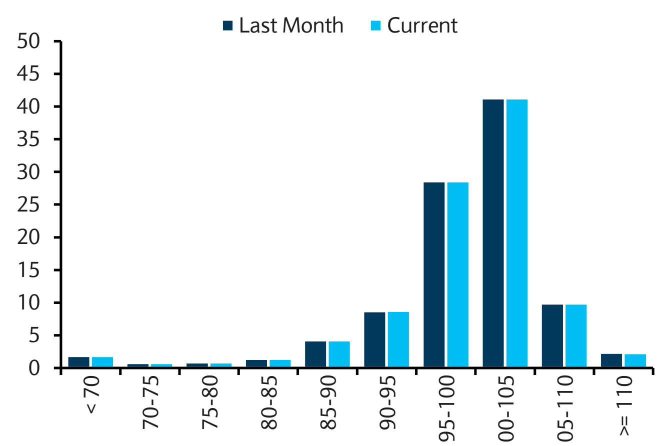
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



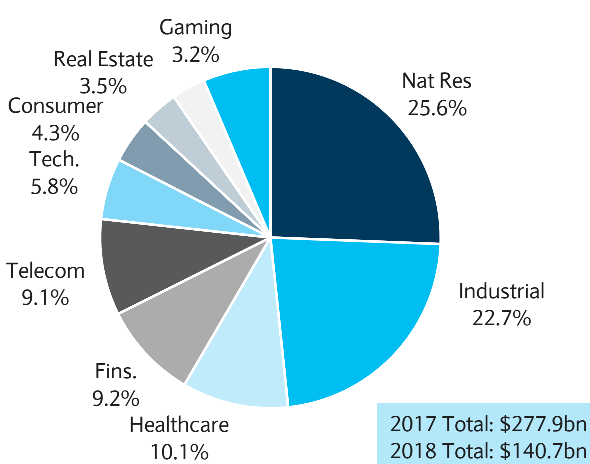
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



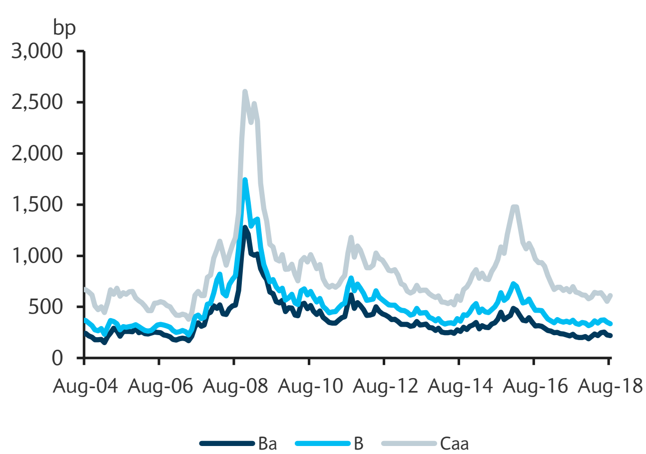
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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