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Rates Drag Returns

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As the yield curve flattens and the 5y US Treasury yield reaches its highest levels since 2009, we revisit our total return forecast for high yield. In our 2018 outlook, published in early December, we forecast a 4.5-5.5% total return for US high yield, largely based on our modestly constructive view on spreads and benign default outlook, against a backdrop of rising risk-free rates throughout the year (see *Lower Highs*). However, our assumptions about Treasury yields were not bearish enough, thus far, as carry has essentially been offset by price declines driven by a base 5y Treasury yield that is more than 70bp higher than at the close of 2017. Given the performance to date and Barclays' current view on Treasury yields for the remainder of the year, we lower our 2018 total return forecast for US high yield by 100bp, to 3.5-4.5%.

What has changed since early December (Figure 1)? First, Barclays US Economics has upgraded its 2018 GDP estimate from 2.3% to 3.0% and its 2019 estimate from 1.9% to 2.6%, as the previous forecasts did not formally account for the uplift from the late December passage of the Tax Cuts and Job Act or the March passage of the 2018 Spending Bill. In line with this revision, it now calls for four hikes of 25bp by the FOMC in both 2018 and 2019, whereas the prior forecast was for two hikes in 2018 and three in 2019. While our economists now highlight a rising risk of a hard landing for the US at some point in 2020, the improved growth prognosis for 2019 alleviates some of the caution reflected in our 2018 year-end spread forecast. Second, Barclays' interest rate strategy team has revised its 4Q18 UST yield targets higher. Most relevant to US high yield, it now forecasts 5y and 10y UST yields of 2.70% and 2.75%, respectively, at year-end, compared with 2.50% and 2.70% at the time of our 2018 outlook.

Despite these underlying changes, we maintain our original spread target and default forecast. High yield spreads have outperformed both emerging markets and investment grade credit year-to-date, with the US High Yield Index 12bp tighter, while the longer-duration and higher-quality EM USD Aggregate and US Investment Grade Indices are 25bp and 13bp wider, respectively. At the same time, Figure 2 shows that since late January, the US High Yield Index spread has underperformed its historical beta to moves in Treasury yields in tight-spread environments (see *Fuller Cushions in Low-Quality Short Duration*). While we can understand that underperformance in light of the spike in volatility across all financial assets at the time,

FIGURE 1
What Has Changed since December?

	As of Dec. '17	Today
2018E GDP	2.3%	3.0%
2019E GDP	1.9%	2.6%
# of Fed hikes in '18	2	4
# of Fed hikes in '19	3	4
4Q18E 2 yr UST yield	2.10%	2.60%
4Q18E 5 yr UST yield	2.25%	2.70%
4Q18E 10 yr UST yield	2.50%	2.75%

Source: Barclays Research

FIGURE 2
High Yield Has Underperformed Its Beta to Rates

Source: Bloomberg, Barclays Research

we also note that high yield credit, equity, and rate volatilities have retreated significantly from their peaks. Short of a return to the elevated volatility seen for much of February, high yield spreads should at least partially close the gap with their beta-implied levels, in our view.

What scenarios drive our revised total return forecast? With projected returns summarized in Figure 3, we detail five potential reasonable outcomes:

Scenario A: Our base case keeps the spread target from December unchanged, updated with a 2.70% forecast for the 5y UST, as currently projected by Barclays US Interest Rate Strategy. The return of 4.2% falls just above the midpoint of our revised forecast of 3.5-4.5%. While tightening spreads and falling Treasury yields may seem an unlikely combination, it could result from less hawkish Fed projections that benefit risk assets, among other drivers identified by the rates strategy team. The resulting yield to worst (YTW) for US high yield would approximate 6.0%. A total return of 3.5%, at the lower end of our range, would lead to a year-ending YTW of around 6.20% for high yield. The spread beta for 2018 would come to -0.4x, well within the historical average of -0.8x in tight-spread environments.

Scenario B: Similar to Scenario A, but employs the current consensus forecast for 5y UST yield of 3.04% (higher than the Barclays forecast). This reflects the traditional response of modest spread tightening amid a gradual drift higher in rates.

Scenario C: Spreads and Treasury yields are unchanged at year-end (essentially current carry through the rest of the year minus leakage from defaults).

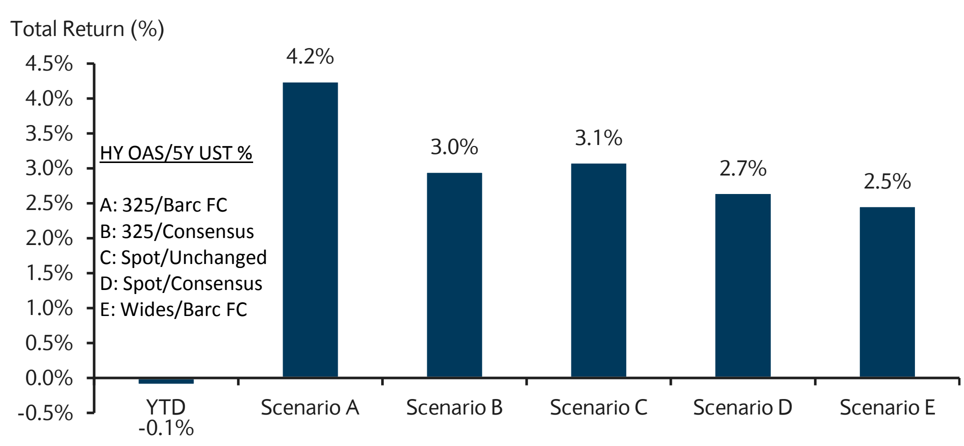
Scenario D: Spreads are unchanged through year-end, while Treasury yields drift higher, as projected by consensus. We ascribe a relatively low probability to this scenario and, as a result, view the resulting total return estimate as conservative.

Scenario E: Spreads return to their year-to-date wides (369bp) and the Barclays Treasury yield forecast is realized.

We appreciate that volatility and risk aversion have increased abruptly since earlier this year, when the US High Yield Index reached new post-crisis tights of 311bp and the YTW fell below 5.6%. However, we do not believe that the volatility of February and March will be sustained over the course of the year, and we think that sentiment and positioning are more balanced today. We noted recently that year-to-date high yield mutual fund returns are clustered, the

FIGURE 3

2018 Total Return Scenarios for US High Yield



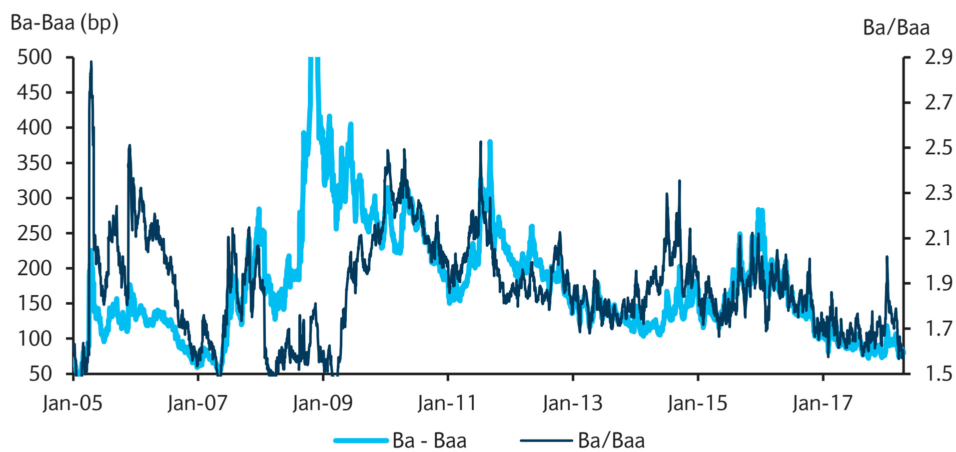
Note: Scenarios A and B reflect original spread forecast published in 2018 Outlook.
Source: Bloomberg, Barclays Research

dispersion of single-name returns and yields has continued to compress, and primary dealers and investors are relatively light on risk when gauged by balance sheets and HY CDX, respectively (see *Dealing with Disappearing Dispersion*). Furthermore, as rate volatility has subsided, mutual fund flows have become better balanced, with $3.1bn in net outflows since April 1, compared with $18.1bn over February and March (per EPFR, all reporters).

Finally, weak demand technicals have weighed on investment grade credit, leading it to underperform both high yield and equities. However, with the macro and corporate fundamental backdrop still robust and demand technicals not as weak as investors feared (see *Plenty of Cushion as Cash Gets Repatriated* and *International Demand – Taiwanese Edition*), our investment grade strategists expect spreads to tighten in the medium term. That view, when reconciled with our forecast for high yield, would put the BB-BBB basis at approximately 75bp, or close to today's level. As Figure 4 suggests, that leaves relatively little room for high yield to compress against investment grade valuations and, hence, reinforces our scenario analysis, as rates remain a key driver of total returns.

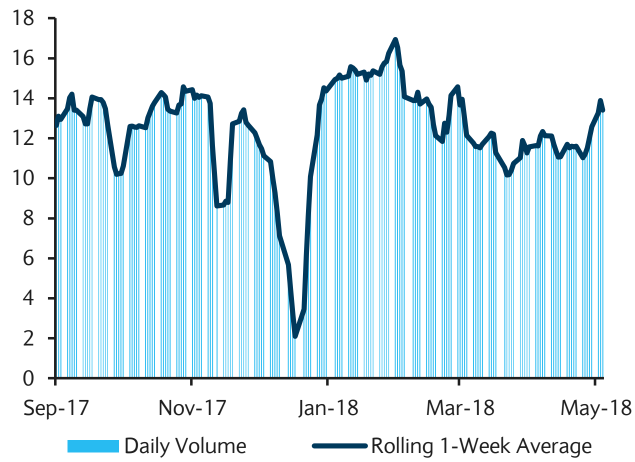
FIGURE 4

Not Much Precedent for BBs to Compress to BBBs from Here, but the Relationship Can Persist



Source: Bloomberg Barclays Indices, Barclays Research

High Yield Average Institutional Trade Volume ($bn)

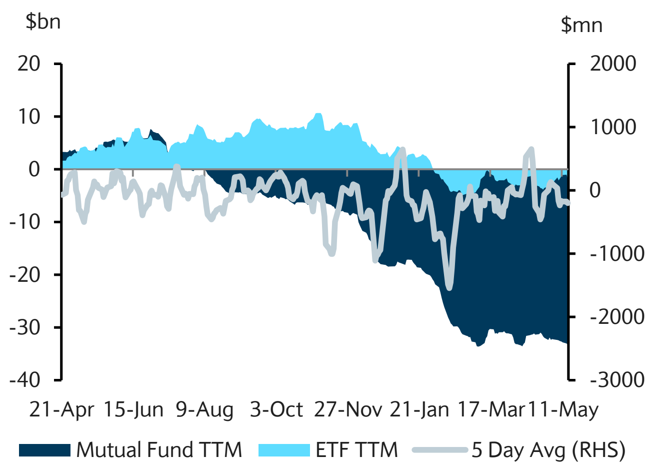


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

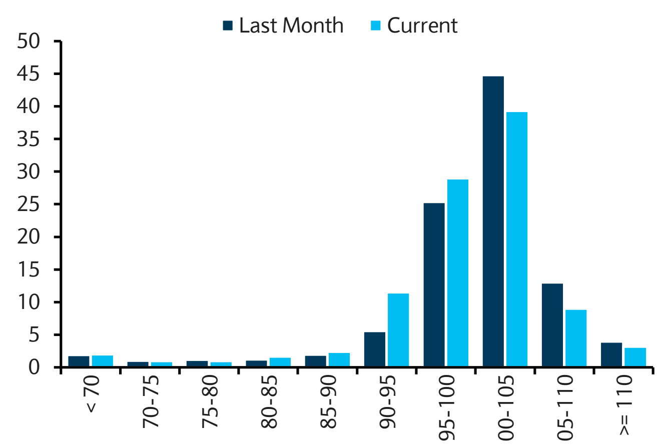
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



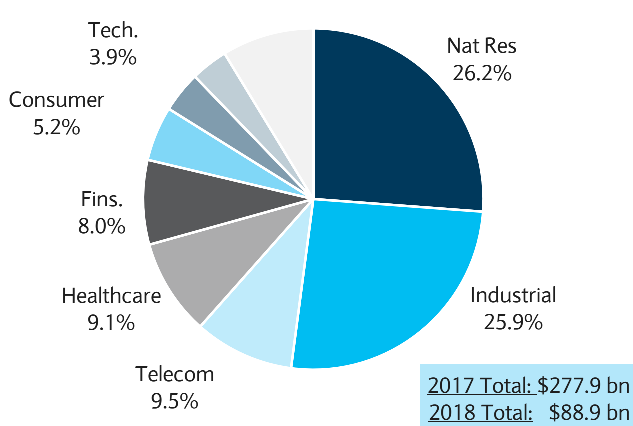
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



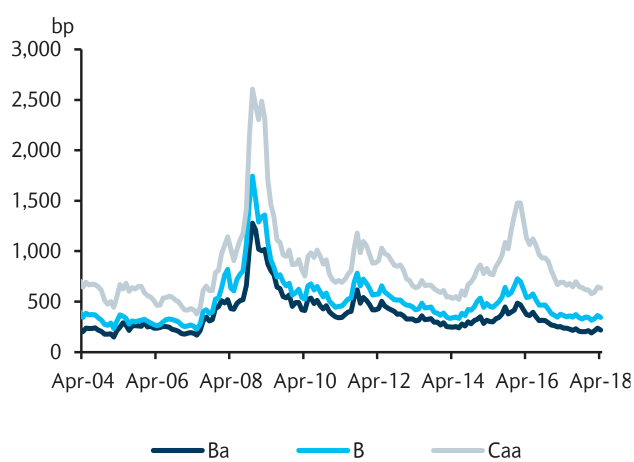
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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