

Lift the Barbell, Trim the Belly

This publication has been updated to add important conflict of interest disclosures for one or more of the companies that are the subject of this report.

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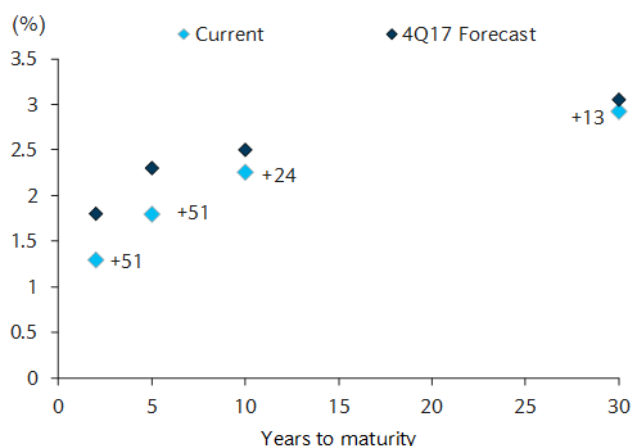
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The Treasury curve has flattened meaningfully in the aftermath of the March hike, last week's rally in short-term rates notwithstanding. Despite somewhat softer inflation prints and a pickup in geopolitical uncertainty since March, our rates strategists believe that rate curves will continue to flatten given solid labor markets, hawkish Fed speak, and expectations of a more regular hiking cycle. Based on this assumption, they forecast that Treasury 2s10s will compress by more than 26bp, with short-term rates expected to back up more than 50bp (Figure 1).

Investors typically shorten duration in a rising rates environment, but this decision is now complicated by the fact that the short end of the rates curve is expected to sell off meaningfully. To help investors assess this trade-off, we identify the part of the curve that is most attractive from a total returns standpoint. A comparison of the 2s10s Treasury curve with the slope of the credit curve suggests a clear relationship: spread curves generally steepen as rates curves flatten (Figure 2). We estimated the slope of the high yield 2s10s curve by looking at the difference in spread between bonds with durations of 1-3 years and 5-8 years. While the maturities do not align perfectly, we believe they are sensible proxies for short-duration and long-duration paper, respectively. In particular, we excluded deeply call-constrained bonds with durations of less than one, since second-order effects from rate changes can be significant.

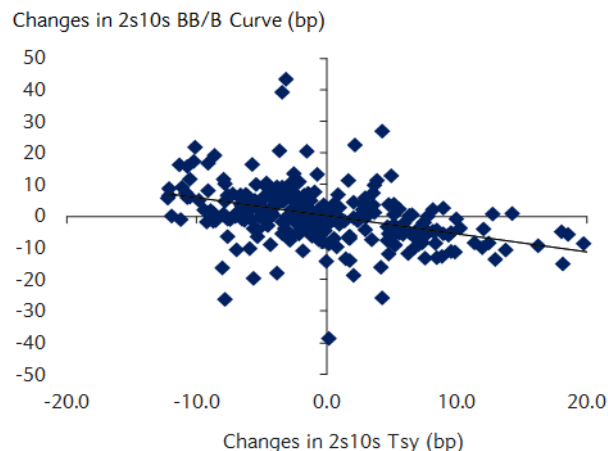
Given that the slopes of the curves tend to move in opposite directions, shortening duration may still make sense assuming that spreads counterbalance the move in rates. To assess the potential implications of our rates forecasts on the full curve, we treat each part of the credit curve separately and thus quantify the extent to which spreads may offset rate moves.¹ We then calculate spread betas, comparing weekly changes in spreads with weekly changes in yields of a representative treasury for each tenor. The analysis confirms that spread changes tend to vary by term, which is especially true at the tails of the credit curve. In particular, short-end spreads have historically offset more than 150% of the move in front-end rates, so shortening duration is a sensible way to mitigate rate exposure (Figure 3).

FIGURE 1
US Treasury Yield Curve Projections



Source: Bloomberg, Barclays Research

FIGURE 2
Changes in the 2s10s Treasury Curve versus Changes in the 2s10s BB/B Curve

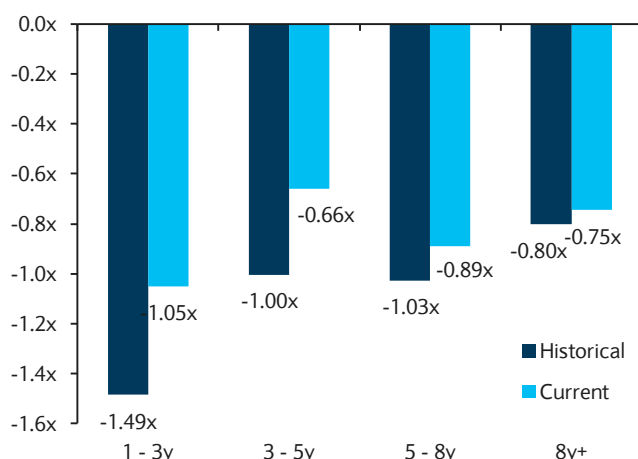


Source: Bloomberg Barclays Indices

¹ We considered the 1-3y (short), 3-5y (belly), 5-8y (long), and 8y+ (ultra long) duration buckets for our analysis.

FIGURE 3

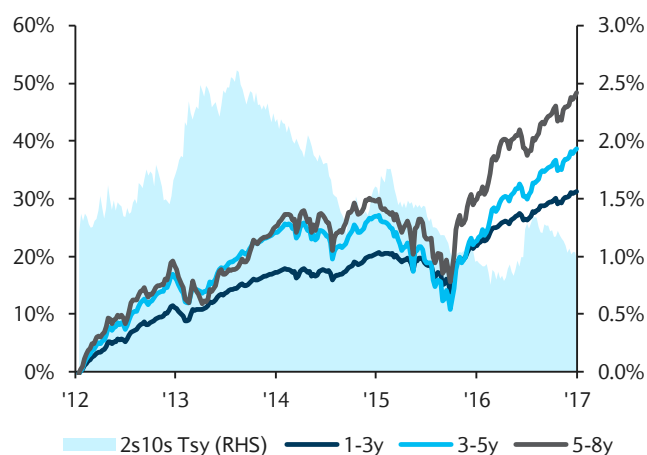
Term Structure of Spread Betas to Treasuries



Note: Historical betas consider weekly changes in spreads and representative Treasuries for the past five years. Current betas consider periods when BB/B spreads were 275-325bp. Source: Bloomberg Barclays Indices

FIGURE 4

Cumulative Returns by Duration versus 2s10s Treasury Yields



Source: Bloomberg Barclays Indices, Barclays Research

Furthermore, spread absorption also tends to vary with the level of spreads, as we noted in *BB versus BB: Basis Point Break*, and some investors may, in turn, be concerned about a lower spread cushion. To control for this, we reproduced the analysis considering only periods when BB/B spreads were in the current range (275-325bp). Once again, the front end of the curve offers the best rates protection, while longer-term spreads offer the least. Surprisingly, the belly of the curve stands out, and 3-5y spreads offset only 66% when rates back up. As such, we are comfortable in principle with extending duration for appropriate compensation and note that the long end of the curve (5-8y bucket) offers superior rates protection (Figure 4).

Positioning for Treasury Bear Flattening

Combining our rates forecasts with the spread betas conditioned on current levels, we estimate that the 1-3y bucket will perform in line with the 3-5y bucket. For context, this bucket has historically lagged on a total return basis owing to its shorter duration, so the outcome would suggest that short duration offers more compelling duration-adjusted returns (Figure 4 and 5). We acknowledge that investors moving into shorter duration should be wary of potential extension risk. While this is certainly a valid concern, we believe that modest extension risk can actually be a positive for short-duration investors in high-quality credits, as further discussed in *Call Me Later*. For investors that do not want to shorten duration, the 5-8y part of the curve is more attractive from a total return standpoint.

FIGURE 5

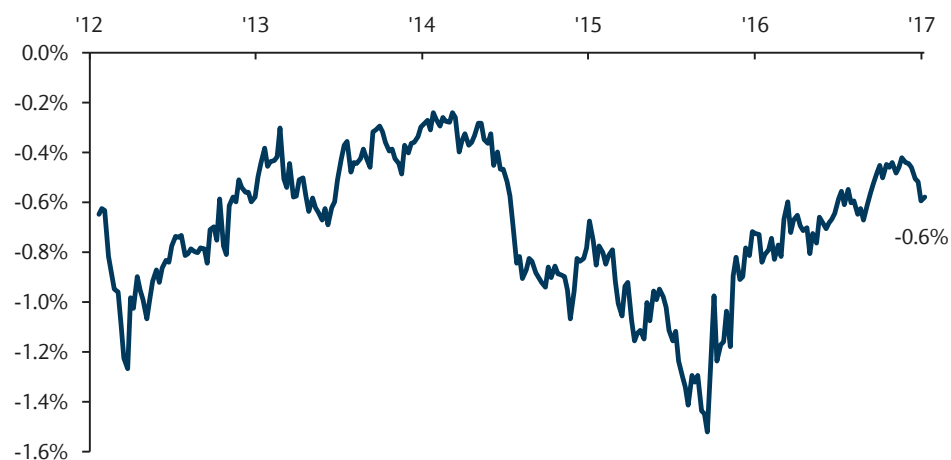
Implied Excess and Total Returns

| | Implied Spread Change (bp) | Implied Excess Returns (bp) | Implied Yield Change (bp) | Implied Total Returns (bp) |
|---------------------------|----------------------------|-----------------------------|---------------------------|----------------------------|
| Current Level Beta | | | | |
| 1 - 3y | -55 | 269 | -3 | 259 |
| 3 - 5y | -33 | 330 | 17 | 247 |
| 5 - 8y | -22 | 321 | 3 | 310 |
| 8y+ | -11 | 348 | 9 | 300 |

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 6

Difference in Yield between Duration-Matched 2y10y Blended Portfolio and 5y Maturities



Source: Bloomberg Barclays Indices, Barclays Research

In terms of overall positioning, we essentially favor a 2y10y barbell strategy over the belly of the curve. A blended 2y10y portfolio is particularly attractive, noting that the basis over the 5y has compressed from roughly -150bp in late 2015 to just shy of -60bp (Figure 6). When combined with the fact that the 3-5y bucket does not provide an adequate shield against rates, we think that the belly looks too tight and, in turn, recommend minimizing exposure to this part of the curve. On a single-name level, Figures 7 and 8 highlight select matched issuer swaps from the belly of the curve and into the front and back ends of the curve, respectively. The highlighted extension trades pick up more than 50bp in spread and take out \$3.5 in price on average. For swaps into shorter duration, we screened for bonds that traded below their next call price and give up at most 50bp in spread.

FIGURE 7

Swap out of the Belly of the Curve and Extend Duration for Attractive Spread Pickup

| Swap out of Bond 1 | | | | | Swap into Bond 2 | | | | Difference | | |
|--------------------|----------------|------------|----------|-----------|------------------|------------|----------|-----------|------------|----------|-----------|
| Ticker | Security | Price (\$) | OAS (bp) | Yield (%) | Security | Price (\$) | OAS (bp) | Yield (%) | Price (\$) | OAS (bp) | Yield (%) |
| URI* | 4.625s of 2023 | 103.9 | 147 | 3.61 | 5.875s of 2026 | 105.9 | 245 | 4.90 | 2.1 | 97 | 1.29 |
| CAA | 6.25s of 2021 | 111.0 | 165 | 3.33 | 5.875s of 2024 | 107.6 | 246 | 4.59 | -3.4 | 82 | 1.26 |
| ALLY | 4.25s of 2021 | 102.6 | 187 | 3.52 | 4.625s of 2025 | 99.0 | 261 | 4.78 | -3.6 | 74 | 1.26 |
| YUM | 3.875s of 2020 | 103.1 | 133 | 2.86 | 3.875s of 2023 | 98.8 | 203 | 4.09 | -4.3 | 70 | 1.23 |
| TCKBCN | 4.5s of 2021 | 105.3 | 129 | 2.84 | 3.75s of 2023 | 98.6 | 204 | 4.02 | -6.7 | 76 | 1.18 |
| FCX | 4s of 2021 | 97.6 | 281 | 4.60 | 4.55s of 2024 | 93.7 | 342 | 5.59 | -3.9 | 60 | 0.99 |
| DISH | 6.75s of 2021 | 110.0 | 234 | 4.02 | 5.875s of 2024 | 105.5 | 285 | 4.99 | -4.6 | 51 | 0.97 |
| LEN | 4.125s of 2022 | 102.8 | 166 | 3.44 | 4.75s of 2025 | 102.5 | 219 | 4.37 | -0.3 | 54 | 0.93 |
| RDC | 4.875s of 2022 | 94.9 | 416 | 6.07 | 4.75s of 2024 | 89.0 | 469 | 6.83 | -5.8 | 53 | 0.76 |

Note: The ticker marked with an asterisk represent swaps from secured notes into the unsecured notes. Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 8

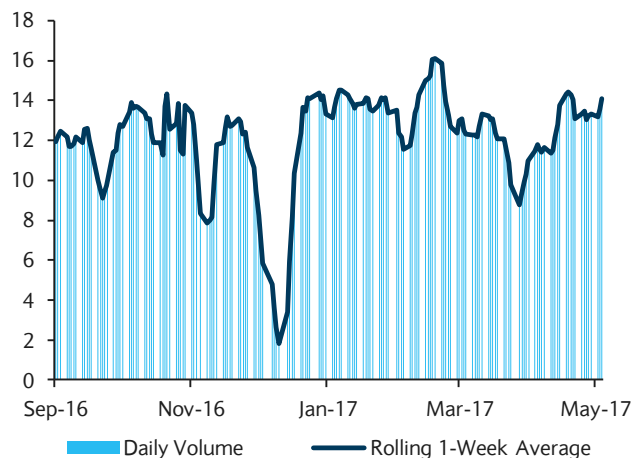
Swap out of the Belly of the Curve and Shorten Duration into Bonds That Are Not Call Constrained

| Swap out of Bond 1 | | | | | Swap into Bond 2 | | | | Difference | | |
|--------------------|----------------|------------|----------|-----------|------------------|------------|----------|-----------|------------|----------|-----------|
| Ticker | Security | Price (\$) | OAS (bp) | Yield (%) | Security | Price (\$) | OAS (bp) | Yield (%) | Price (\$) | OAS (bp) | Yield (%) |
| ESV | 4.7s of 2021 | 101.5 | 262 | 4.26 | 6.875s of 2020 | 106.2 | 322 | 4.78 | 4.7 | 60 | 0.51 |
| LB | 6.625s of 2021 | 110.9 | 193 | 3.56 | 7s of 2020 | 110.5 | 175 | 3.22 | -0.4 | -18 | -0.35 |
| CCO* | 6.5s of 2022 | 102.0 | 382 | 5.85 | 6.5s of 2022 | 103.1 | 344 | 5.50 | 1.1 | -39 | -0.35 |
| ALLY | 4.25s of 2021 | 102.6 | 187 | 3.52 | 4.125s of 2020 | 102.6 | 171 | 3.16 | 0.0 | -16 | -0.36 |
| MGM | 6.625s of 2021 | 112.5 | 186 | 3.62 | 5.25s of 2020 | 106.0 | 157 | 3.02 | -6.5 | -29 | -0.61 |
| DISH | 6.75s of 2021 | 110.0 | 234 | 4.02 | 5.125s of 2020 | 104.9 | 190 | 3.36 | -5.2 | -45 | -0.65 |
| CIT | 5s of 2022 | 107.7 | 151 | 3.38 | 5.375s of 2020 | 107.7 | 122 | 2.68 | 0.0 | -29 | -0.70 |
| CAA | 5.375s of 2022 | 107.4 | 193 | 3.83 | 6.625s of 2020 | 110.4 | 143 | 2.89 | 3.0 | -49 | -0.94 |

Note: For the ticker marked with an asterisk, there are covenant differences between the series A and B securities; please see our [initiation report](#) for details.

Source: Bloomberg Barclays Indices, Barclays Research

High Yield Average Institutional Trade Volume (\$bn)



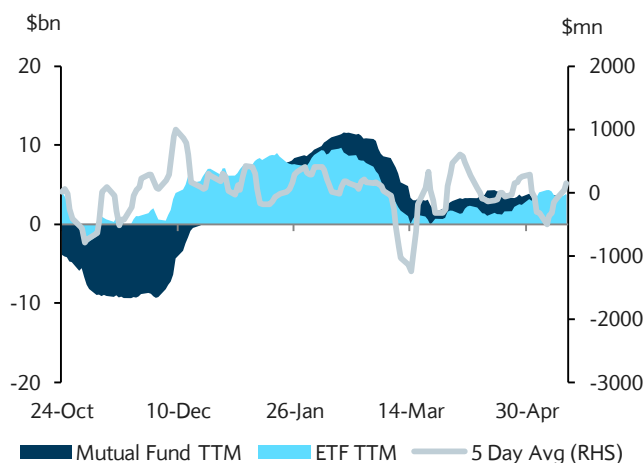
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



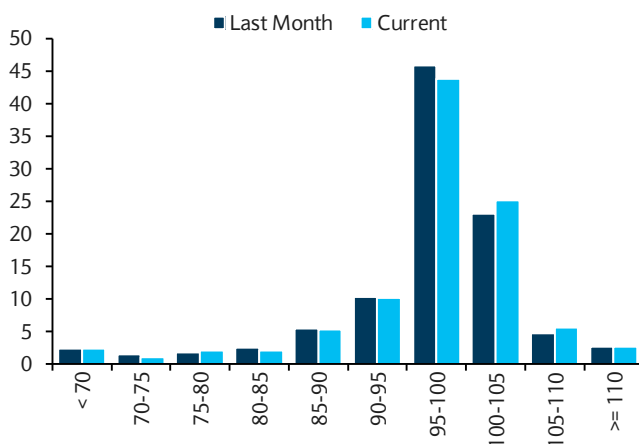
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



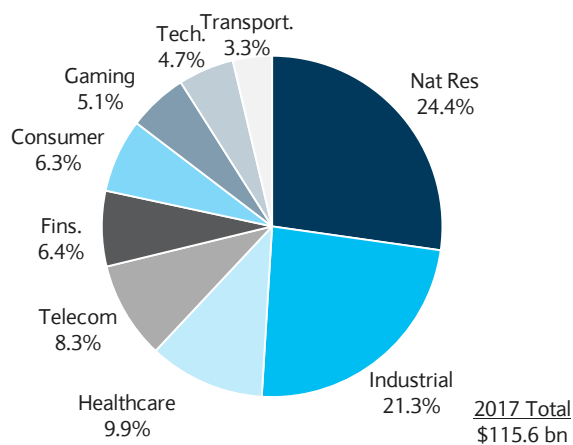
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



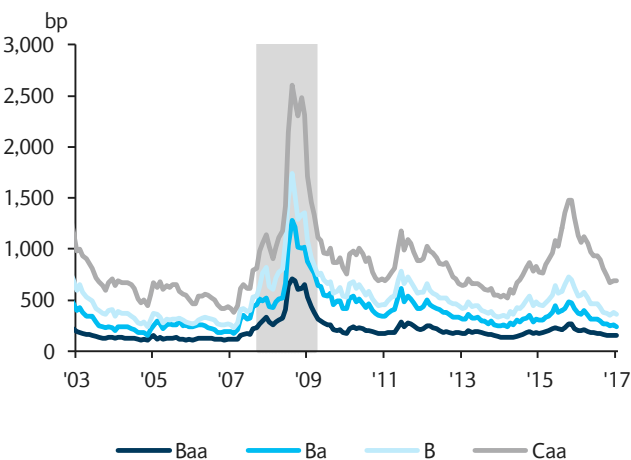
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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ALLY 4 1/4 04/15/21, Market Weight (USD 102.63, 24-May-2017)

ALLY 4 1/8 03/30/20, Market Weight (USD 102.25, 24-May-2017)

ALLY 4 5/8 03/30/25, Market Weight (USD 99.00, 24-May-2017)

CABLEVISION SYSTEMS CORP, CD/D/E/J/K/L/M

CVC 8 04/15/20, Market Weight (USD 111.50, 24-May-2017)

CALATLANTIC GROUP INC, CD/CE/J

CAA 5 3/8 10/01/22, Market Weight (USD 107.50, 24-May-2017)

CAA 5 7/8 11/15/24, Market Weight (USD 107.25, 24-May-2017)

CAA 6 1/4 12/15/21, Market Weight (USD 111.25, 24-May-2017)

CAA 6 5/8 05/01/20, Market Weight (USD 110.25, 24-May-2017)

CIT GROUP INC, CD/D/E/J/K/L/M/N

CIT 5 08/15/22, Market Weight (USD 108.13, 24-May-2017)

CIT 5 3/8 05/15/20, Market Weight (USD 107.25, 24-May-2017)

CLEAR CHANNEL WORLDWIDE HOLDINGS INC, CD/J/K/M/N

CCO 6 1/2 11/15/22, Market Weight (USD 102.00, 24-May-2017)

CCO 6 1/2 11/15/22, Market Weight (USD 103.13, 24-May-2017)

CSC HOLDINGS LLC, A/CD/D/E/J/K/L/M

CVC 6 3/4 11/15/21, Market Weight (USD 110.25, 24-May-2017)

DISH DBS CORP, CD/D/J/L

DISH 5 1/8 05/01/20, Market Weight (USD 104.75, 24-May-2017)

DISH 5 7/8 11/15/24, Market Weight (USD 105.75, 24-May-2017)

DISH 6 3/4 06/01/21, Market Weight (USD 109.88, 24-May-2017)

ENSCO INTERNATIONAL INC, CD/J

ESV 7.2 11/15/27, Overweight (USD 94.75, 24-May-2017)

ENSCO PLC, B/CD/CE/J

ESV 4.7 03/15/21, Market Weight (USD 101.50, 24-May-2017)

FREEPORT-MCMORAN INC, CD/CE/D/J/L

FCX 4 11/14/21, Market Weight (USD 97.25, 24-May-2017)

FCX 4.55 11/14/24, Market Weight (USD 93.50, 24-May-2017)

L BRANDS INC, CD/CE/D/J/L

LB 6 5/8 04/01/21, Market Weight (USD 110.75, 24-May-2017)

LB 7 05/01/20, Market Weight (USD 110.50, 24-May-2017)

LENNAR CORP, CD/CE/J/K/M

LEN 4 1/8 01/15/22, Market Weight (USD 102.13, 24-May-2017)

LEN 4 3/4 05/30/25, Overweight (USD 102.75, 24-May-2017)

MGM RESORTS INTERNATIONAL, A/CD/CE/D/FA/J/K/L/M

MGM 5 1/4 03/31/20, Market Weight (USD 105.75, 24-May-2017)

MGM 6 5/8 12/15/21, Market Weight (USD 112.00, 24-May-2017)

PRIDE INTERNATIONAL LLC, CD/J

ESV 6 7/8 08/15/20, Market Weight (USD 106.50, 24-May-2017)

ROWAN COS INC, A/CD/D/J/K/L/M

RDC 4 3/4 01/15/24, Market Weight (USD 88.50, 24-May-2017)

RDC 4 7/8 06/01/22, Market Weight (USD 94.75, 24-May-2017)

TECK RESOURCES LTD, A/CD/CE/D/E/J/K/L/M/U

TCKBCN 3 3/4 02/01/23, Market Weight (USD 97.88, 24-May-2017)

TCKBCN 4 1/2 01/15/21, Market Weight (USD 103.63, 24-May-2017)

UNITED RENTALS NORTH AMERICA INC, A/CD/D/J/K/L/M

URI 4 5/8 07/15/23, Market Weight (USD 104.13, 24-May-2017)

URI 5 7/8 09/15/26, Market Weight (USD 105.75, 24-May-2017)

UNITI GROUP INC / CSL CAPITAL LLC, A/CD/D/E/J/K/L/M

UNIT 6 04/15/23, Market Weight (USD 104.63, 24-May-2017)

UNIT 7 1/8 12/15/24, Overweight (USD 99.88, 24-May-2017)

YUM! BRANDS INC, A/CD/CE/D/J/K/L/M/N

YUM 3 7/8 11/01/20, Market Weight (USD 102.50, 24-May-2017)

YUM 3 7/8 11/01/23, Market Weight (USD 98.13, 24-May-2017)

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Market Weight (MW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to be in line with the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively..

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Underweight (UW):

The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

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