Loans versus Bonds: Secured Showdown

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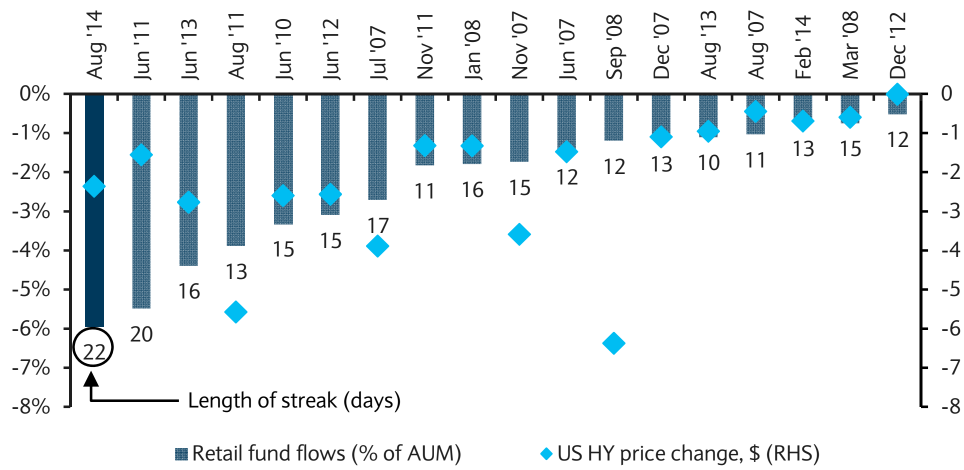
Last week we asked, somewhat tongue-in-cheek, whether the high yield market was experiencing its *Longest Outflow Streak Ever, or Just Top Two?* A week later, the answer is crystal clear, with the prior 20-day record having been broken on Monday. For those keeping track, retail funds have thus far seen 22 consecutive days of redemptions for a total of $16.9bn in assets (5.94% relative to the retail asset base). As previously mentioned, this extreme negative in retail sentiment appears still to be isolated to the U.S. high yield market.

The effect of retail selling on valuations has not been negligible, but it has also not been proportionate to the magnitude of the outflows (Figure 1). Anecdotal evidence suggests that this is partly due to increased high yield allocations in fixed income funds with flexible mandates, so-called balanced, core plus, and go anywhere funds. Furthermore, according to Lipper data, these sub-asset classes have been increasing assets over the past three weeks while dedicated high yield funds have been suffering their biggest outflows.

FIGURE 1

Longest Streaks of Daily Outflows from High Yield Retail Funds, versus Index Price Change



Note: Percent of AUM versus total assets for daily reporters. Source: EPFR, Barclays Research

Meanwhile, loan mutual funds and ETFs have not been immune to redemptions. That said, the intensity of outflows has been considerably more limited there. Furthermore, the negative sentiment from retail investors has been consistent over the past sixteen weeks, and in our view, it reflects a softening of duration fears as consensus expectations for rate increases have crept lower.

At the same time, the CLO machine continues to produce new deals, and volumes have far surpassed most market participants' expectations of what could get done in the first seven months of 2014. The resulting demand technical has been strong, even adjusted for the effect of legacy structures amortization, a point we highlighted last week in *Retail versus CLOs*.

A Brief Interruption on Yield and Spread Comparisons…

Interestingly, there is little to no overlap in conventionally used measures of yield and spread across both markets. That is a mainly a result of differences in the two products, including not only the difference in floating/fixed coupon but also differences in the structure and timing of prepayments/redemptions.

In high yield, the yield-to-worst (YTW) is by far the most widely used and represents the IRR of the bond's cash flows. However, there is no direct equivalent to YTW in the loan market. The situation is no better when looking at spreads. While bond investors compare bonds based on their OAS, Z-spread, or spread to worst, loan investors judge loan relative value based on discounted spreads to maturity or to a particular prepayment rate assumption.

While the most technically correct yield comparison is to swap the loan's floating cash flows to fixed and calculate a corresponding yield, very few loan investors actually use rate swaps in practice. That is largely because the fixed versus floating decision is an intentional view with respect to rates, but also because of the difficulty in choosing a swap tenor when the underlying asset is prepayable at any time. Some form of "effective" yield – which is just current yield (all-in coupon / price) plus the effect of pull-to-par – is more traditionally used on the loan side. Naturally, the specific approach to accounting for pull-to-par is almost negligible when loans are very close to par, but can be very meaningful when they are not (Figure 2).

Despite the recent pullback, we remain in an environment where carry is the main driver of performance. As such, we see the loan effective yield (current yield plus pull-to-par) as a fair measure of expected returns. Further, average annual loan repayment rates make a three-year average life a reasonable assumption, which governs how the pull-to-par component of yield is estimated for loans. For bonds, the comparable measure is the current yield adjusted for a pull towards the redemption price (either par or a call price) between today and the redemption date (maturity or the relevant call date).

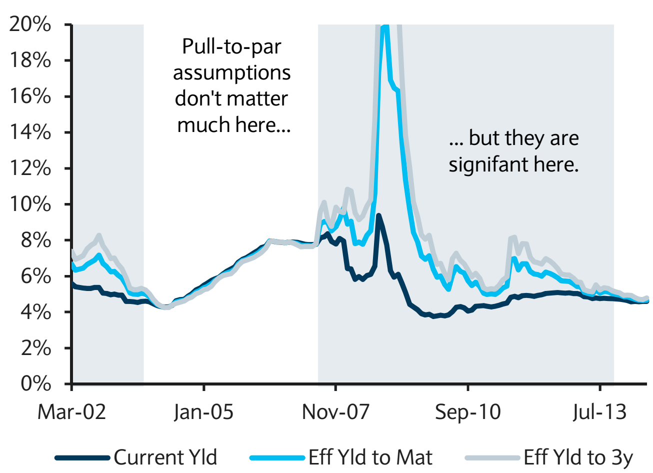
… We Now Return to Loans versus Secured Bond Relative Value

While high yield has seen some support from institutional funds and funds with flexible mandates, the relative stability in loans provided by CLOs has been remarkable. The effective yield (to redemption) on secured high yield bonds has climbed 101bp, to 6.5%, since the outflows began in early July. Meanwhile, the effective yield to a 3y average life on loans has backed up a more modest 23bp, to 4.99% (Figure 3).

Our outlook for the health of corporate issuers and the U.S. economy is unchanged since the retail selling began, and we therefore see the underperformance of secured high yield bonds as a potential buying opportunity. Admittedly, secured paper is more exposed to rates, which is one risk mismatch that we have yet to discuss. We continue to believe that any potential increase in rates will be met with an opposite reaction from spreads,

FIGURE 2

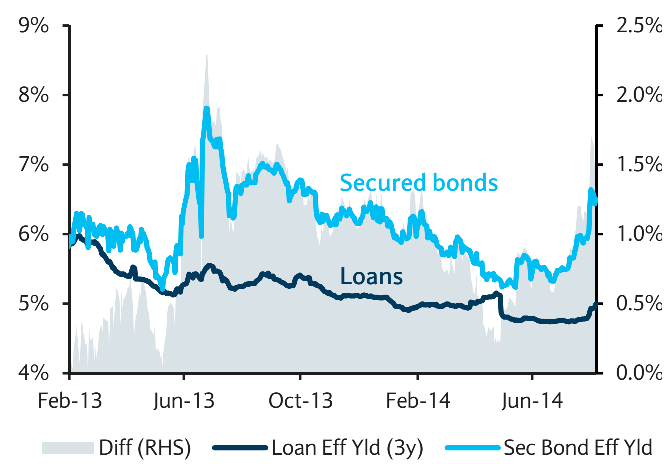
S&P/LSTA Loan Index Effective Yield with Different Pull-to-Par Assumptions



Source: S&P LCD

FIGURE 3

Secured Bonds Have Underperformed Loans Significantly as a Result of the Recent Divergence in Technicals



Source: Barclays Research

dampening the actual experienced rates duration. Furthermore, at an average spread of 514bp, secured high yield bonds have ample "cushion" to absorb rates increases, in our view.

In Figure 4, we present swaps out of loans into bonds for credits that are not rated Underweight by our fundamental analysts. The bonds and loans are matched in terms of collateral (first lien) and rating and are closely matched in terms of expected life.

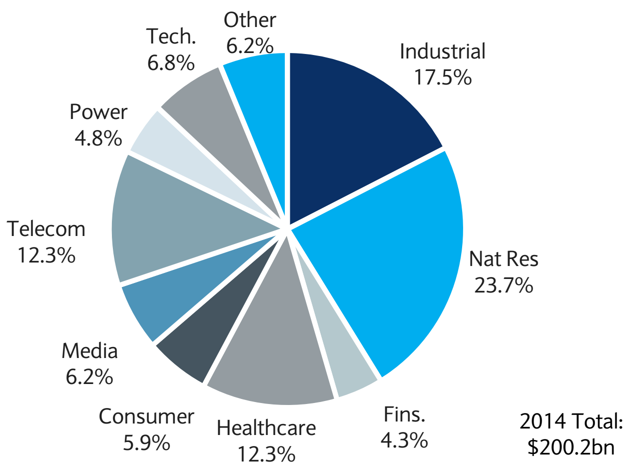
FIGURE 4

Swap Out of Loans into Secured Bonds and Pick Up Carry

	Bond							Loan						Difference	
Ticker	Cpn (%)	Maturity Date	Redeem Date	Par ($mn)	Price ($)	Effective Yield (%)	Rating	Cpn (%)	Maturity Date	Par ($mn)	Price ($)	Effective Yield (%)	Rating	Price ($)	Effective Yield (%)
MFW	9.75	Aug-18	Aug-17	285	106.8	8.51	B+	5.48	Jun-17	574	100.0	5.48	B+	6.8	3.03
MFW	9.75	Aug-18	Aug-17	285	106.8	8.51	B+	6.00	Aug-19	593	101.3	5.51	B+	5.5	2.99
AVYA	9.00	Apr-19	Apr-17	290	101.8	8.19	B	4.73	Oct-17	2,108	96.4	6.10	B	5.4	2.08
MFW	9.75	Aug-18	Aug-17	285	106.8	8.51	B+	7.00	May-18	731	101.3	6.47	B+	5.4	2.04
AVYA	9.00	Apr-19	Apr-17	290	101.8	8.19	B	6.50	Mar-18	1,131	99.5	6.68	B	2.2	1.50
VTG	7.50	Nov-19	Nov-18	1,149	101.3	7.11	B-	5.75	Mar-19	350	99.4	5.97	B-	1.8	1.14
REYNOL	5.75	Oct-20	Oct-18	3,250	102.5	5.01	B+	4.00	Dec-18	2,202	99.7	4.12	B+	2.8	0.90
UVN	6.75	Sep-22	Sep-17	1,108	107.5	4.95	B+	4.00	Mar-20	1,234	99.1	4.32	B+	8.4	0.63
UVN	6.75	Sep-22	Sep-17	1,108	107.5	4.95	B+	4.00	Mar-20	3,360	99.1	4.32	B+	8.4	0.63
FDC	6.75	Nov-20	Nov-18	1,400	106.0	4.95	BB-	3.73	Sep-18	1,008	98.2	4.39	BB-	7.8	0.56
FDC	6.75	Nov-20	Nov-18	1,400	106.0	4.95	BB-	3.73	Mar-18	4,600	98.2	4.40	BB-	7.8	0.55
FDC	6.75	Nov-20	Nov-18	1,400	106.0	4.95	BB-	4.23	Mar-21	1,004	99.3	4.51	BB-	6.7	0.44
CCMO	9.00	Dec-19	Jul-18	462	102.0	8.32	CCC+	7.73	Jul-19	1,300	99.2	8.08	CCC+	2.8	0.24
CCMO	9.00	Dec-19	Jul-18	1,538	102.0	8.32	CCC+	7.73	Jul-19	1,300	99.2	8.08	CCC+	2.8	0.24
CCMO	9.00	Dec-19	Jul-18	462	102.0	8.32	CCC+	6.98	Jan-19	5,000	97.3	8.08	CCC+	4.7	0.23
CCMO	9.00	Dec-19	Jul-18	1,538	102.0	8.32	CCC+	6.98	Jan-19	5,000	97.3	8.08	CCC+	4.7	0.23
CYH	5.13	Aug-18	Aug-17	1,600	103.4	3.84	BB	3.48	Jan-17	1,668	99.7	3.63	BB	3.7	0.21

Source: Barclays Research

High Yield Supply by Sector – 2014 Breakdown



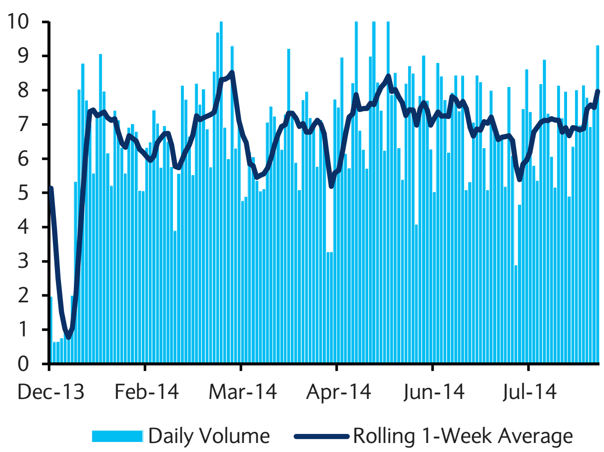
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 8/1/14 ($mn)
	Gross	Net	Gross
MBIA Insurance	44.3	1.7	1,065.5
RadioShack	24.9	0.7	865.7
Caesars Ent. Op.	29.4	2.4	572.8
Sprint	18.8	1.1	487.4
Ally Financial	17.9	0.9	468.5
Frontier	10.1	0.5	448.8
McClatchy	9.5	0.6	447.5
Clear Channel Inc.	17.7	1.1	379.9
Lennar	18.4	0.9	355.9
General Motors	4.8	0.8	347.8

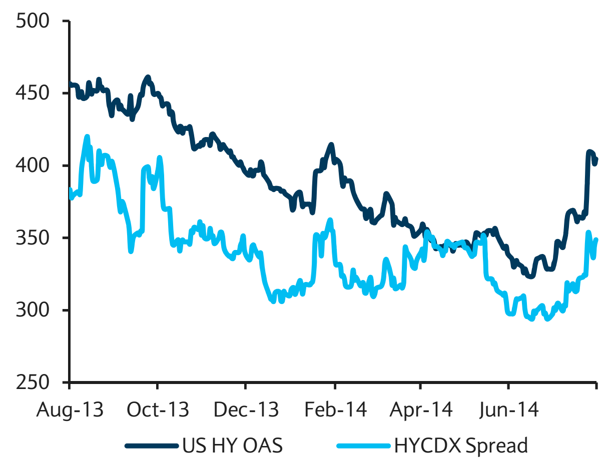
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



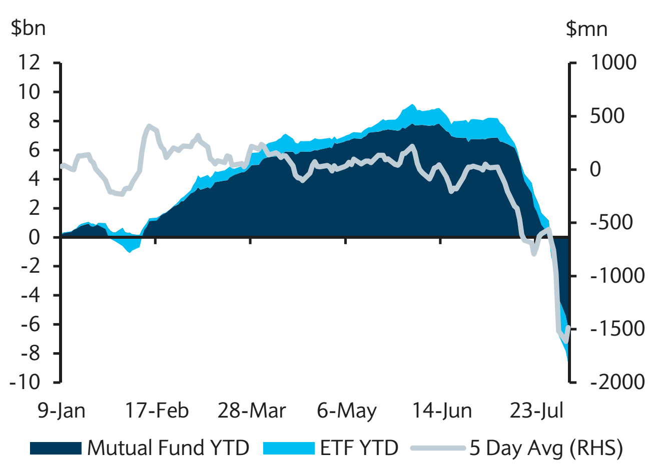
Source: FINRA TRACE

On-the-Run HYCDX versus U.S. High Yield Index (bp)



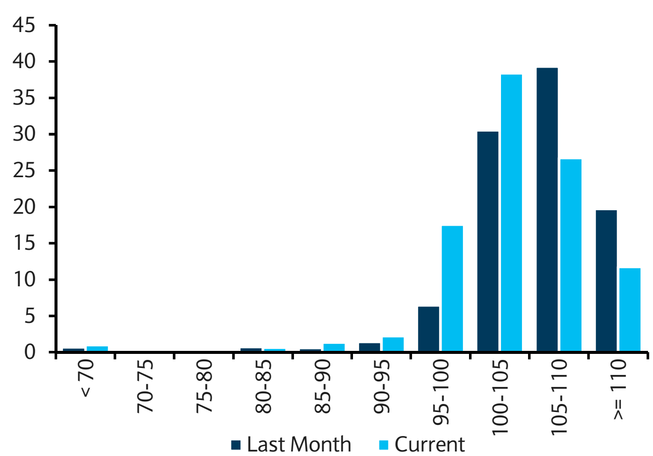
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



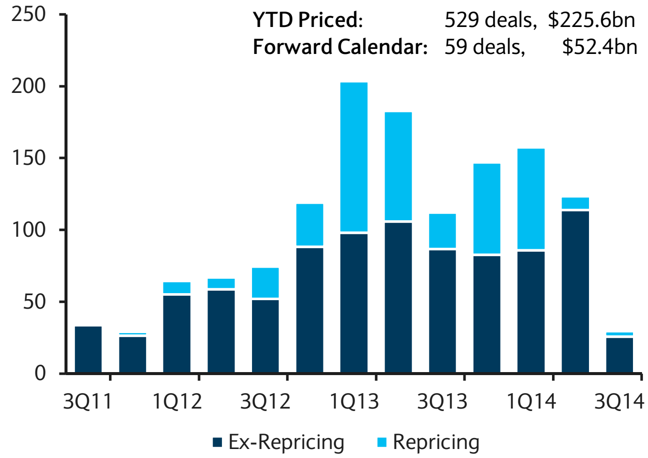
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



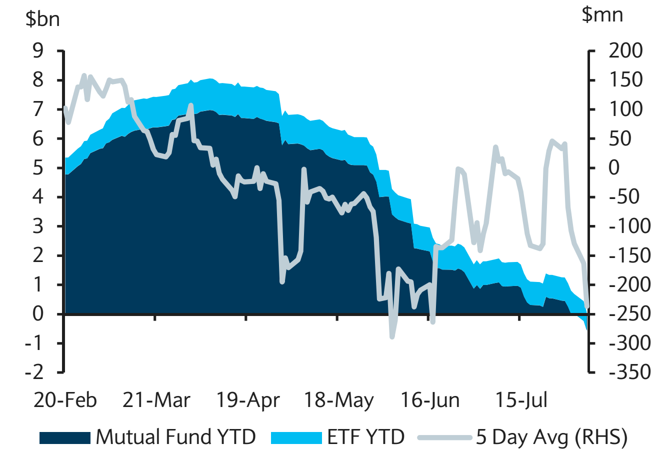
Source: Barclays Research

Quarterly Institutional Leveraged Loan Issuance ($bn)



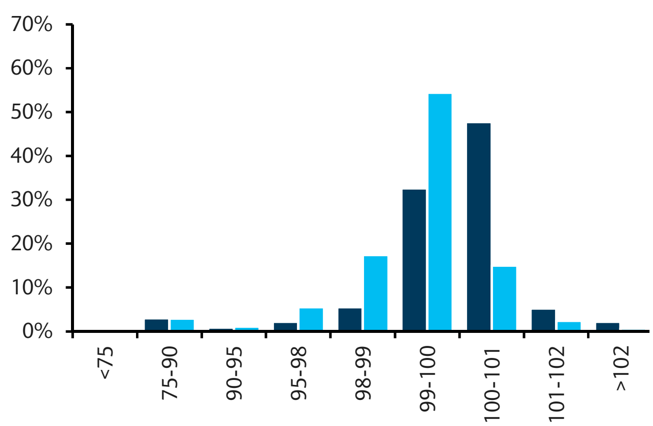
Source: S&P LCD, Barclays Research

Flows to Loan Mutual Funds and ETFs



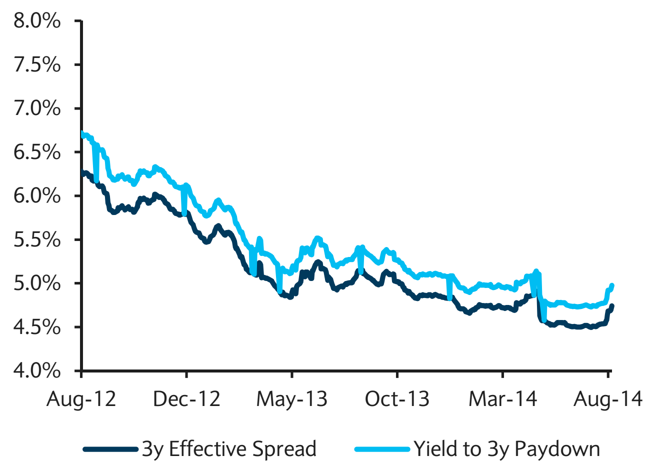
Source: EPFR

Loan Index Price Distribution by Par



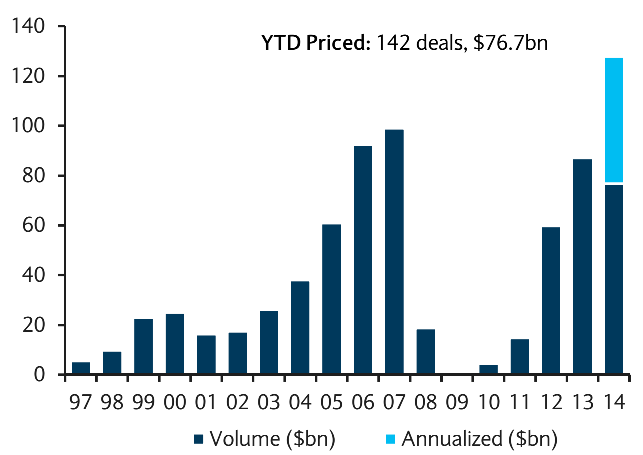
Source: Barclays Research

Barclays Performing Loan Index Yield and Spread



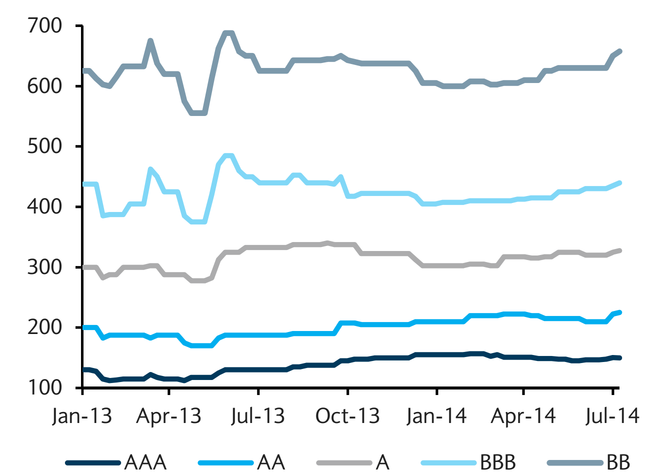
Note: Yield and spread calculation assumes a three-year paydown period, amortizing any premium or discount to par accordingly. Source: Barclays Research

Annual CLO Issuance



Source: S&P LCD

U.S. CLO 2.0 Spread Performance by Rating (bp)



Note: Spread data from BWIC levels. Source: Moody's, Intex, Barclays Research

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Market Weight: Expected six-month total return of the sector is in line with the six-month expected total return of the Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

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Market Weight: The analyst expects the six-month total return of the rated debt security or instrument to be in line with the six-month expected total return of the Barclays U.S. 2% Issuer Capped High Yield Credit Index, the Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, or the EM Asia USD High Yield Corporate Credit Index, as applicable.

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