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Temporary Relief from Rate Fears

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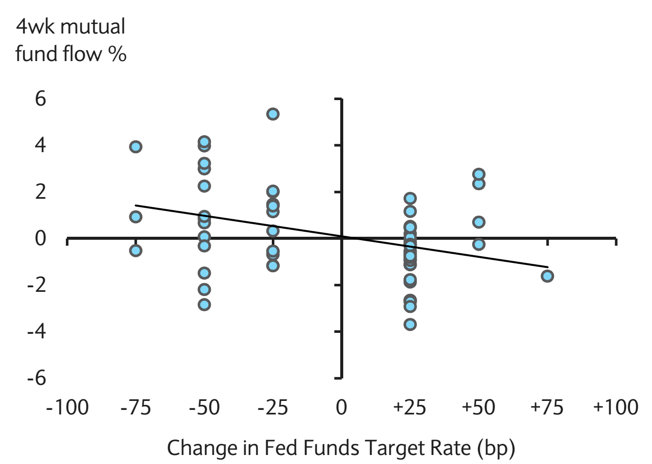
High yield experienced significant outflows in the ten days leading up to the September FOMC rate decision. The bulk of the capital came out of ETFs ($2.2bn, or 4.7% of AUM), but mutual funds were not immune, with daily reporters shedding $775mn, or 35bp of AUM. The negative demand technical translated into a relatively modest $0.75 drop in the average price of bonds in the Bloomberg Barclays US High Yield Index over the same period. Risky assets have rallied following the FOMC's decision to keep the fed funds target rate at 50bp, and we expect most of the technical to abate.

Market concerns about the FOMC decision will surely return in December. While the consensus was for no change in September, economist estimates are squarely centered on a 25bp hike in December. We have consistently found rates to be more of a distraction than a genuine concern for high yield investors, especially when spreads represent a significant share of total yield, as they do today. See *Take a Hike without Breaking a Sweat* and our *Global Credit Outlook* (*GCO 2014* page 42; *GCO 2012* page 35; *GCO 2011* page 56) for more on this point.

Looking at all fed funds target rate changes since 1993, it is clear that there is a modest near-term relationship between FOMC decisions and asset allocation to or away from high yield retail funds (Figure 1). In most cases, the distribution of fund flows in the four weeks following the decision[1] straddles the x-axis, meaning that the direction is hardly guaranteed, but on average, hikes produce outflows. For 25bp increases (going back to 1993), we see an average of 81bp of AUM outflows, equivalent to $1.3bn, given total assets managed by dedicated retail funds currently. Outflows have certainly been much more severe in some instances. For example, the most recent hike, in December 2015, was followed by cumulative outflows of 2.65% over four weeks. However, our averages do not control for other market conditions, and the outflows in December occurred while oil was plummeting to $26. Assuming no other market-wide risk roiling markets, we would expect only modest outflows following a widely anticipated December 2016 hike.

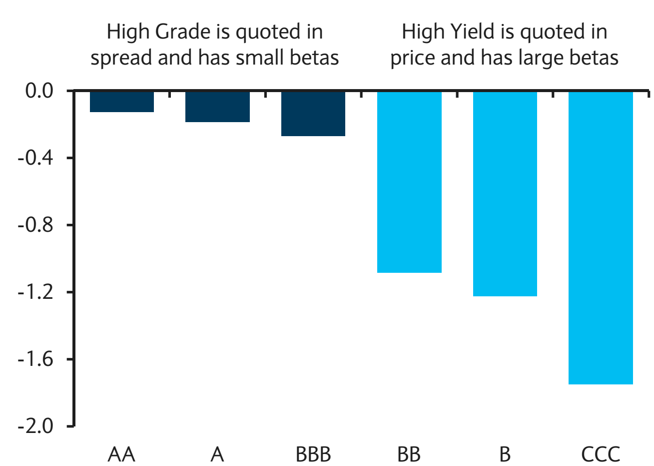
We find that the near-term effects of rates mostly reverse over the medium term. Furthermore, from a valuation perspective, high yield is generally quite insensitive to rates because it is quoted in price terms. The relationship between investment grade spreads and

FIGURE 1
Four-Week Fund Flows Following Fed Fund Rate Changes



Note: Data since 1993. Excludes ETFs. Source: Bloomberg, Lipper

FIGURE 2
Beta of Weekly OAS Changes to 10y Treasury Changes

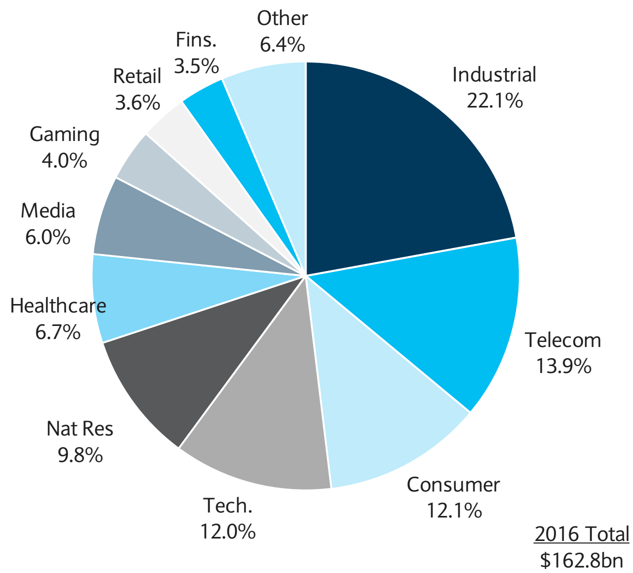


Note: Data since 2004. Source: Bloomberg

[1] Including the decision week and the three weeks following.

changes in the 10y Treasury yield is strong, but the beta is relatively small, as investment grade traders make their markets in spread terms, and tightening must therefore come from incremental demand. In contrast, the beta of weekly high yield OAS changes to 10y Treasuries is very large and comes mechanically from the fact that bonds are quoted in price terms. These differences are clear in the jump in beta from BBB to BB in Figure 2 and should be another source of comfort for high yield investors with respect to rates.

2016 High Yield Supply by Sector



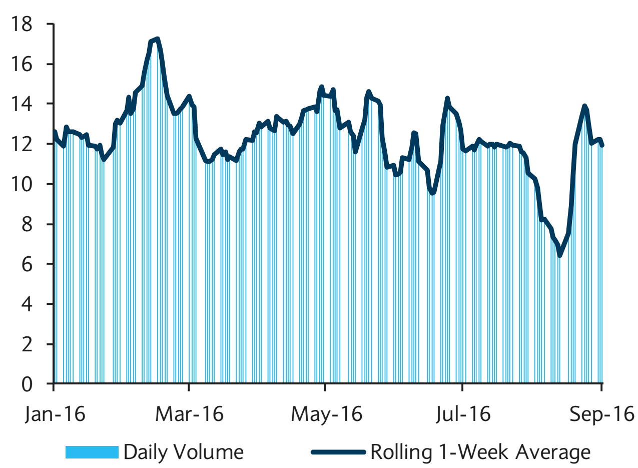
Source: Barclays Research

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

	Notional Outstanding ($bn)		Volume – Week Ending 9/16/16 ($mn)
	Gross	Net	Gross
Royal Caribbean	6.3	0.5	263.1
Adv. Micro Devices	3.2	0.4	239.4
Chesapeake	7.6	0.6	203.4
DISH	3.8	0.6	195.7
Lennar	9.5	0.8	180.8
Sprint	12.1	0.9	170.7
Tenet Healthcare	4.2	0.6	169.0
JC Penney	10.1	0.7	164.2
Dell	7.6	0.7	151.0
Avon	9.4	0.5	149.6

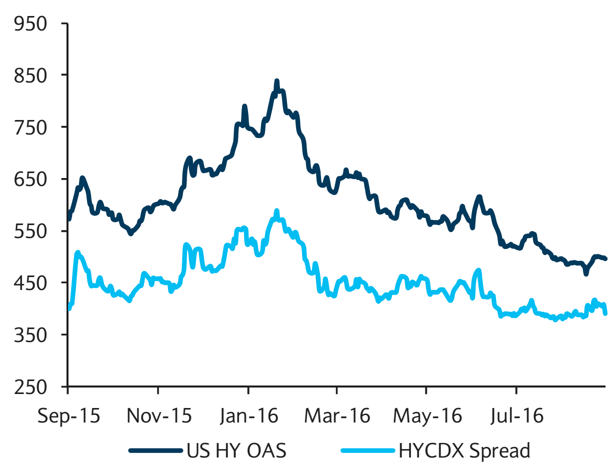
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



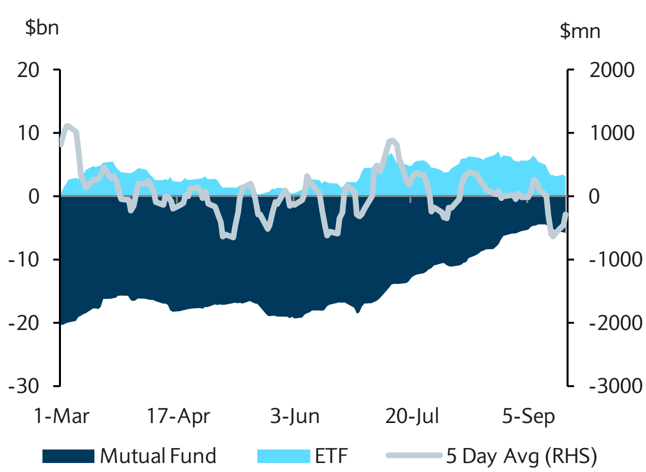
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



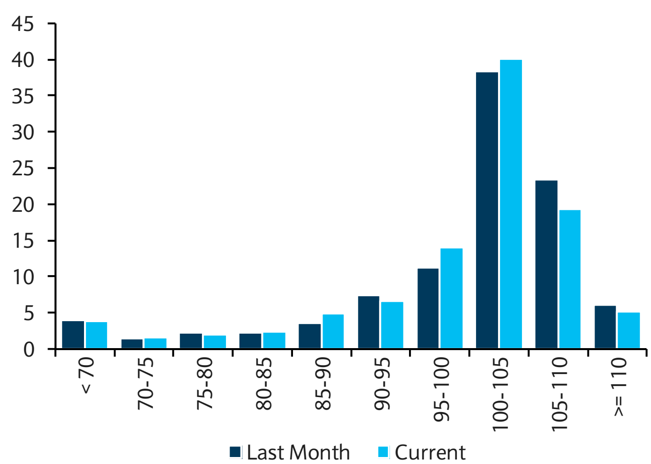
Source: Bloomberg Barclays Indices, Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Bloomberg Barclays Indices, Barclays Research

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