

Where Is the Rate Risk?

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High yield tracked equities lower this week, breaking a 10-week streak of increasing prices in the cash market. Derivatives led the way lower, with HY19 down \$0.81 through Wednesday, closing at \$102.19. The U.S. High Yield Index price decreased by \$0.52 over the same period, ending at \$105.55.

A consistent increase in rates over the past few weeks (Figure 2) has stoked duration fears once again. While high yield investors should take solace in the Fed's unchanged stance with respect to asset purchases following weaker-than-expected domestic growth in 4Q, performance since the beginning of the rate increase sends an equally powerful message, in our view. Since the beginning of December, 5y and 10y rates are up 26bp and 40bp respectively, but the high yield spread is 80bp tighter over the same period – a beta of 2x to the 10y and 3.1x to the 5y. Naturally, the compression in OAS is more pronounced the further down in credit quality you go, but even BB-rated bonds more than absorbed the recent rate increase.

Admittedly, the capacity of high yield to absorb rate moves is not unlimited and, as we have shown in the past (most recently in *Global Credit Outlook 2013*), becomes weaker as the fraction of all-in yield coming from spread decreases. However, with approximately 15% of the U.S. High Yield Index yield (5.77%) coming from the 5y Treasury, we remain confident that high yield spread compression will continue to offset potential near-term rates increases.

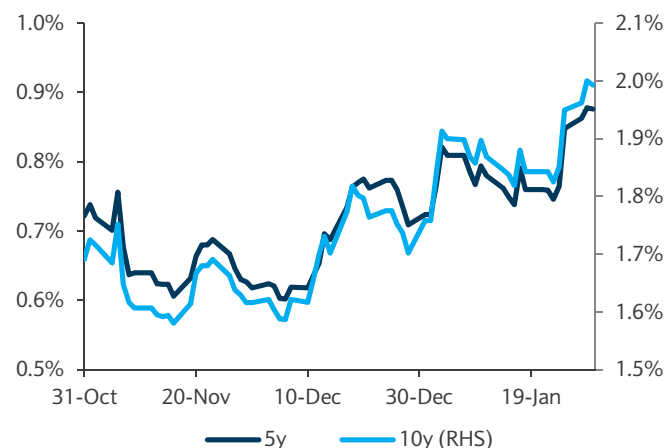
Nevertheless, an examination of rate shift scenarios is interesting, in our view. Assuming no spread changes and parallel shifts in the rate term structure, certain parts of the market reveal themselves as more sensitive to a yield backup (whether rate-driven or otherwise), in terms of both negative price performance and extension risk. Looking at credit quality first, it is clear that single-B bonds are the most susceptible to extension risk (Figure 3). This comes as no surprise given that this category is the most call-constrained within high yield,

FIGURE 1
Cash and CDS Movers

High Yield Cash					
Best	Px	Chg	Worst	Px	Chg
CPNO 7.125 '21	115.00	+6.3	AEE 7 '18	60.50	-5.3
CZR 5.75 '17	62.50	+3.5	ROCKIE 7.5 '38	89.00	-5.0
REYNOL 8.375 '27	95.25	+3.3	POLKOM 14.25 '20	109.25	-4.5
High Yield CDS					
Best	5y	Chg	Worst	5y	Chg
RSH	33.5 pts	-5.0 pts	CCU	42.2 pts	+2.7 pts
CHK	391 bp	-75 bp	ARM	14.6 pts	+2.4 pts
PKD	357 bp	-43 bp	SANM	2.6 pts	+2.4 pts

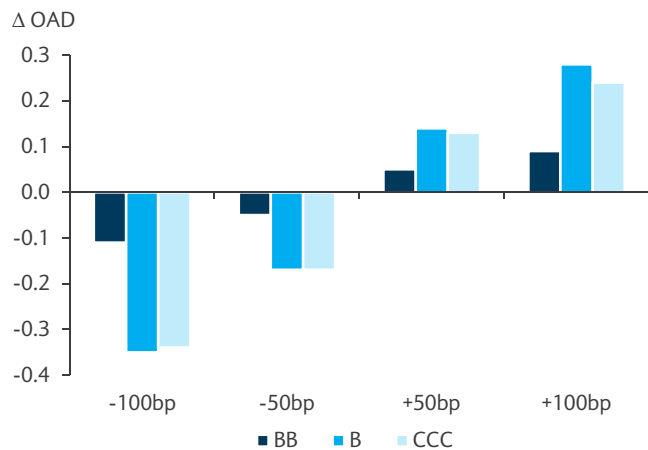
Source: Barclays Research

FIGURE 2
5y and 10y Treasury Yields



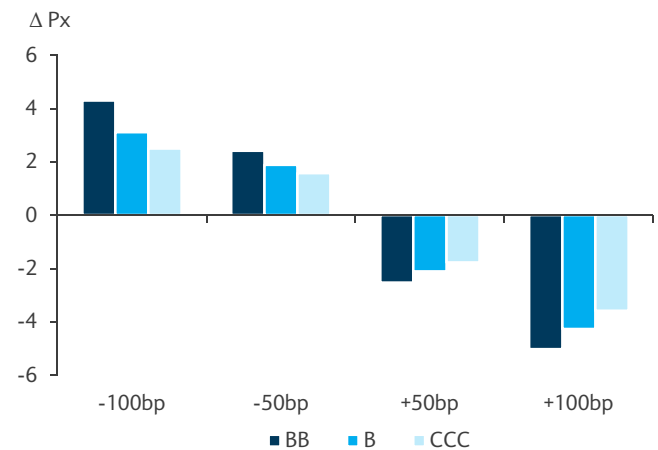
Source: Barclays Research

FIGURE 3
Change in Duration versus Parallel Rate Shift, by Quality



Note: Barclays U.S. High Yield ex Hybrids. Source: Barclays Research

FIGURE 4
Change in Price versus Parallel Rate Shift, by Quality

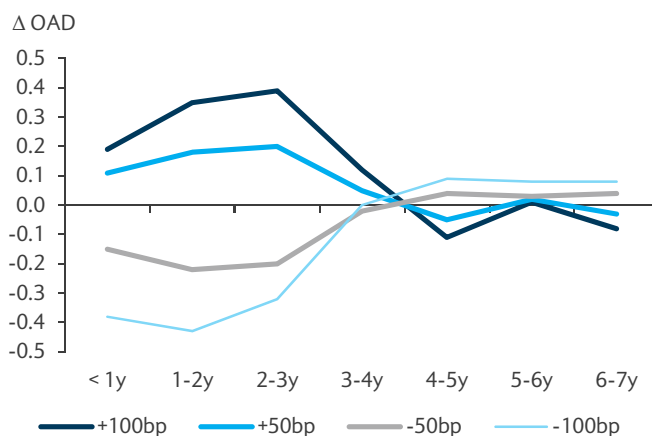


Note: Barclays U.S. High Yield ex Hybrids. Source: Barclays Research

with 59% trading at or above the next call price (compared with 36% for BBs, which skew downward because of fallen angel debt, and 42% for CCCs). However, even though single-Bs are more negatively convex currently, higher quality paper is more susceptible to negative price performance because of its longer average duration (Figure 4).

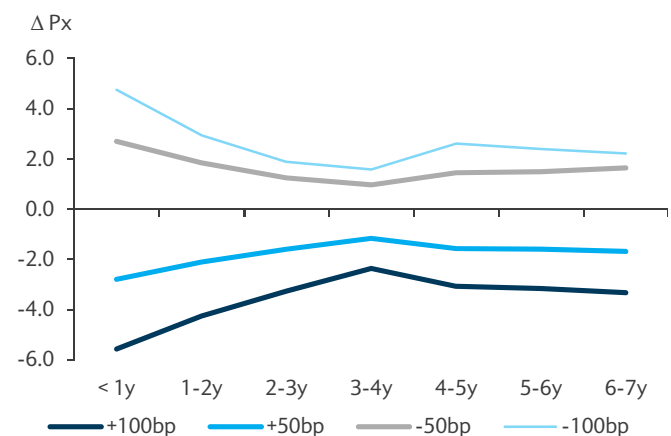
Separately, we examined what a parallel shift in the rate term structure does to the average duration and price of bonds in different age buckets. More recently issued bonds (0-3y) tend to be more negatively convex, with bonds in the 2-3y age bucket – which would likely be getting close to their first call date – most susceptible to extending (Figure 5). In contrast, bonds in the 3y+ age groups are likely to be well within their call periods. Thus, if they are trading to a call, they are likely to continue to do so, while if they are trading to maturity, a rate increase will not change that; in either case, duration changes are more muted for this group. On the other hand, the longer duration of newer bonds makes them most sensitive to a shift in rates in terms of price performance (Figure 6). This is especially pertinent now, given that the average coupon of bonds issued in the past year is nearly 240bp lower than that of 2009-vintage bonds (3-4y bucket), which also came at slightly lower maturities on average, making the duration gradient particularly steep.

FIGURE 5
Change in Duration versus Parallel Rate Shift, by Age of Bond



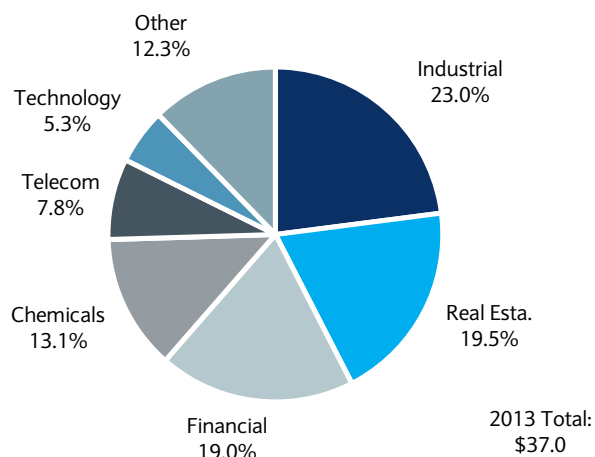
Note: Barclays U.S. High Yield ex Hybrids. Source: Barclays Research

FIGURE 6
Change in Price versus Parallel Rate Shift, by Age of Bond



Note: Barclays U.S. High Yield ex Hybrids. Source: Barclays Research

High Yield Supply by Sector – 2013 Breakdown



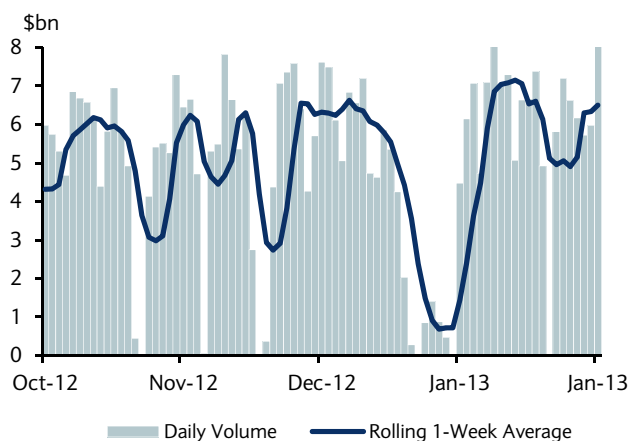
Source: Barclays Research

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

	Notional Outstanding (\$bn)		Volume – Week Ending 1/25/13 (\$mn)
	Gross	Net	Gross
MBIA Insurance	76.7	2.1	416.0
Tex Comp Elec Hld	14.4	0.7	390.2
ILFC	29.4	1.6	382.9
Clear Channel	24.2	1.2	357.0
Caesars Ent.	23.2	1.3	316.1
Sprint Nextel	26.0	1.5	296.8
MGIC Investment	30.0	1.3	213.5
First Data	17.1	0.9	208.7
iStar Financial	18.4	0.9	197.9
R.R. Donnelley	26.5	1.4	186.4

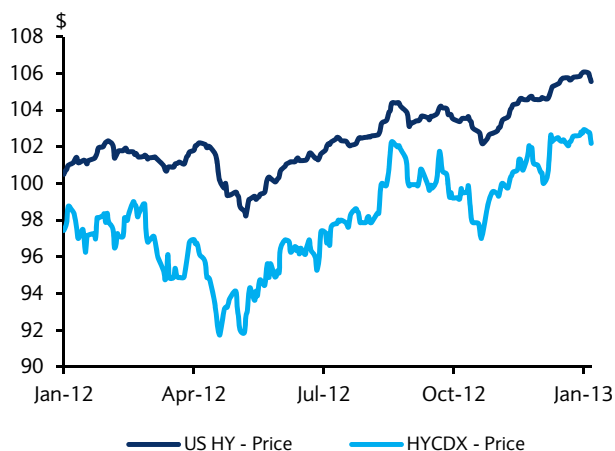
Source: Barclays Research

High Yield Average Institutional Trade Volume



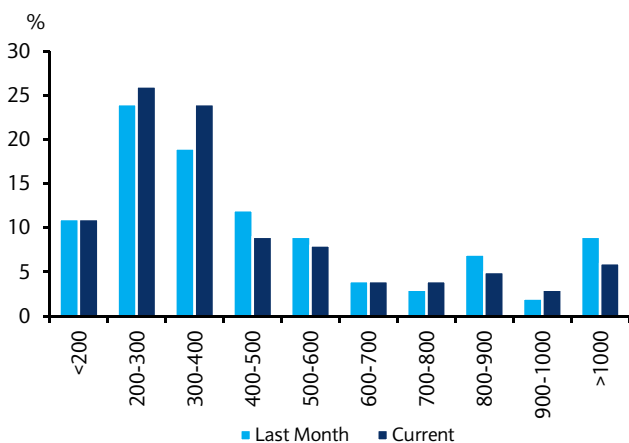
Source: Barclays Research

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



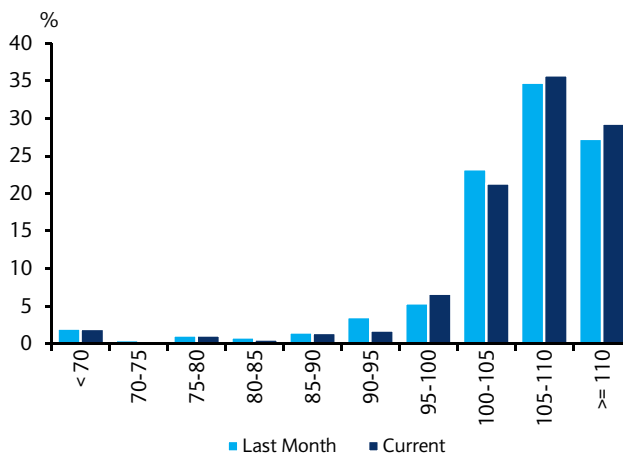
Source: Barclays Research

On-the-Run HYCDX Spread Distribution



Source: Barclays Research

High Yield Index Price Distribution by Par



Source: Barclays Research

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