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Call Me Later

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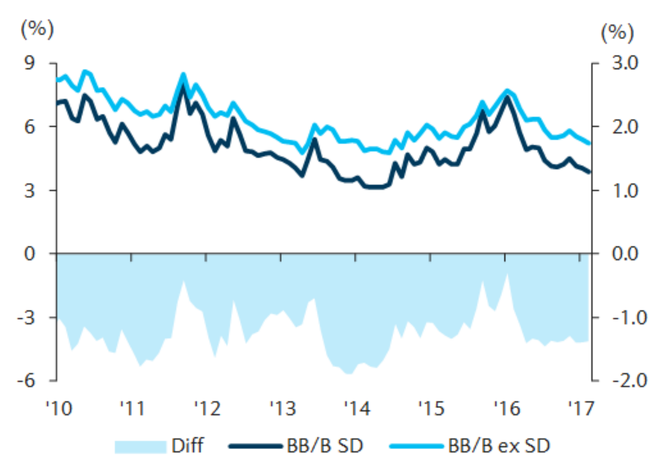
Fund flows finally turned negative in March, as the Fed hike-fueled ETF selling brought an end to four consecutive weeks of retail inflows. This marks a return to the status quo, as resilient technicals had been bucking the typical trend of outflows leading into a rate hike. While rates were back in focus, spreads responded surprisingly well to the initial sell-off in Treasuries, as spread compression outperformed historical betas (see *Technically Strong* for details). We think that high yield markets will be able to digest modestly higher Treasury rates over the long term, but this week's response to higher rates (and increased supply) is more consistent with typical short-term behavior.

The compression has translated into a thinner spread cushion, making lower-quality debt less effective in mitigating rate exposure than it had been in the past. Instead, the short-duration market is a sensible outlet for high yield investors concerned about rate risk. On average, short-duration bonds, which we define as BB/B bonds maturing within five years with a duration of less than three years, trade about 100-150bp tight to the rest of the high yield market (Figure 1). Negative convexity, however, makes the risk/reward of the segment more questionable in broader risk-off scenarios, as shown by the compression of the basis to just over 30bp at the peak of the commodity-led sell-off in February last year. That said, short-duration bonds have outperformed slightly in the lead-up to a potential rate hike next week (Figure 3), as rate risks have different implications than credit risks.

Negative convexity in short-duration callable bonds makes it more difficult to determine an appropriate way to assess relative value. The extension gap, which we quantify as the difference in yield to worst and yield to maturity, is much higher for short-duration paper than for the rest of the market because of deeper call constraints. This difference can reach as high as 100bp when most of the market is trading above its next call price, as is currently the case (Figure 2).

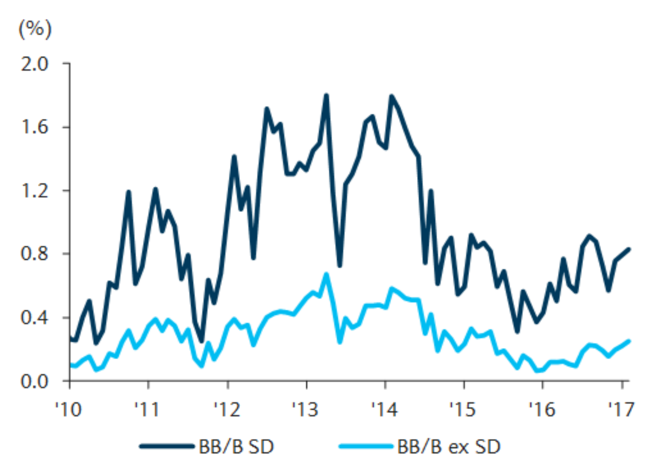
While we do not expect companies to keep bonds that are trading through their call price outstanding until maturity, our analysis suggests that it takes issuers an average of 6-8 months to call their bonds (Please see *When the Option Presents Itself*). This is a double-edged sword for short-duration investors since extension risk can be positive or negative depending

FIGURE 1
US High Yield BB/B Short Duration versus Rest of High Yield Yield to Worst



Source: Bloomberg Barclays Indices, Bloomberg

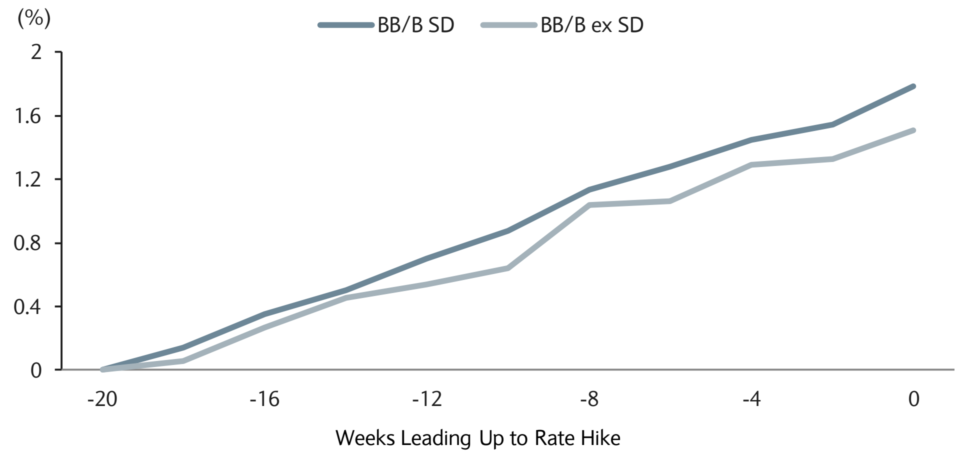
FIGURE 2
Extension Gap Is Larger for Short-Duration Bonds



Source: Bloomberg Barclays Indices, Bloomberg

FIGURE 3

Short Duration Bonds Have Outperformed Slightly in the Weeks Leading up to the Potential Rate Hike



Source: Bloomberg Barclays Indices

on the situation. The yield pickup when bonds are extended can be substantial (Figure 4), and most short-duration investors hope that their high-quality yield-to-call bonds will be extended somewhat when the market is strong. However, in a true credit risk-off environment, the increase in yield shown in Figure 2 as a result of extension can be more concerning than comforting. Despite the recent market softness, we are in the midst of the largest new issue week of 2017, and refinancing activity is leading the way, as it has all year. Given that the primary market is still wide open, in contrast to the technical backdrop in a credit risk-off scenario, we believe that the current environment is still supportive of selectively adding exposure to yield-to-call paper with a high probability of modest extension.

There are several reasons that healthy issuers may keep their debt outstanding even if it is trading above the call price. In particular, companies are likely to delay refinancing to make themselves more attractive to potential acquirers, which would be able to take out debt without triggering punitive make-whole or equity claw provisions. There can also be delays due to refinancing for M&A, corporate restructuring, or asset sales that have been announced, but not closed. Apart from M&A, we believe that management teams are less likely to stress their balance sheets by stacking maturities too closely together and are less likely to refinance if they have already paid down a bulk of their debt load. We thus screened for bonds that offered the sharpest pickup in yield assuming a six-month call extension (see *Technically Strong* for details) and specifically highlight the JBS SA 2020s, REYNOL 2021s, and LVLT 2021s.

- We view JBS SA (JBSSBZ) 2020s as an attractive carry opportunity and do not think that the company will extend the maturity before the completion of broader corporate restructuring. The trade picks up 5.4% assuming a six-month extension.
- Given that Reynolds Group (REYNOL) refinanced just shy of $5bn of debt in 2016 and anticipates working capital needs in 1H17, fundamental analyst Andrew Keches does not believe that the company will undertake a near-term refinancing or call its secured notes due 2021, which are currently callable at $102.3.
- With $7.5-8.0bn of expected secured financing to fund the Level 3 (LVLT) acquisition and refinance maturing debt, the callable LVLT 6.125s due 2021 is not a likely a near-term refinancing candidate, in our view.

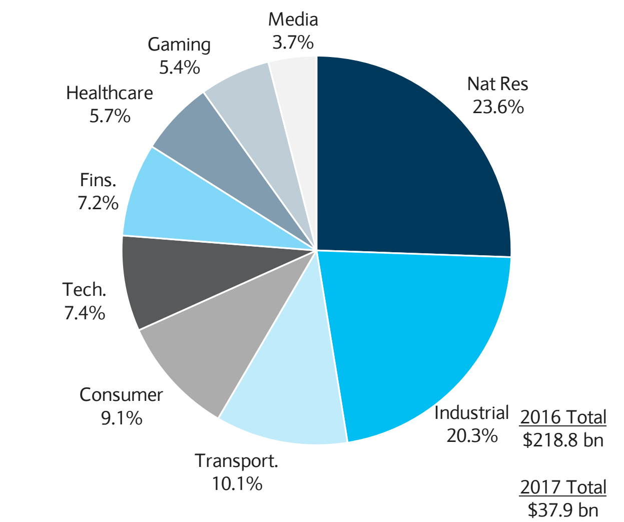
FIGURE 4

Currently Callable Bonds with Sharpest Pickup in Yields Assuming a Six-month Extension

Ticker	Coupon	Sector	Price	Current Call Price	Current Call Date	Duration	Yield to Notice (%)	Yield to Notice + 6mo (%)	Pickup (%)
TPC	7.625s of 2018	Industrial Other	101.00	100.00	11/1/2016	0.09	-6.53	5.81	12.33
ALTICE	9.875s of 2020	Cable Satellite	105.88	104.94	12/15/2016	0.09	-3.34	7.77	11.11
PIZA	10.5s of 2020	Restaurants	103.38	102.63	1/15/2017	0.10	-0.29	8.89	9.18
STACAS	7.5s of 2021	Gaming	104.25	103.75	3/1/2017	0.09	0.29	6.36	6.08
REYNOL	6.875s of 2021	Packaging	102.75	102.29	2/15/2017	0.09	0.27	5.92	5.64
JBSSBZ	8.25s of 2020	Food & Beverage	102.50	102.06	2/1/2017	0.09	1.89	7.31	5.42
LAMR	5.875s of 2022	Media Entertainment	103.38	102.94	2/1/2017	0.09	-0.40	4.95	5.35
NTI	7.125s of 2020	Refining	104.00	103.56	11/15/2016	0.73	0.78	6.11	5.33
PBFENE	8.25s of 2020	Refining	102.38	102.06	2/15/2017	0.09	3.65	7.53	3.89
LVLT	6.125s of 2021	Wirelines	103.38	103.06	11/15/2016	0.09	1.54	5.39	3.85
SHEARE	9s of 2019	Food & Beverage	104.75	104.50	11/1/2016	0.58	5.00	8.16	3.16
ROCK	6.25s of 2021	Building Materials	103.31	103.13	2/1/2017	0.58	3.41	5.74	2.32
CLEAVB	8.75s of 2019	Industrial Other	104.50	104.38	12/15/2016	1.03	6.52	8.16	1.64
AMC	5.875s of 2022	Leisure	104.50	104.41	2/15/2017	0.09	4.31	5.47	1.16

Source: Bloomberg Barclays Indices. Note: The "Yield to Notice" calculation takes into account a notice period of 30 days.

High Yield Supply by Sector



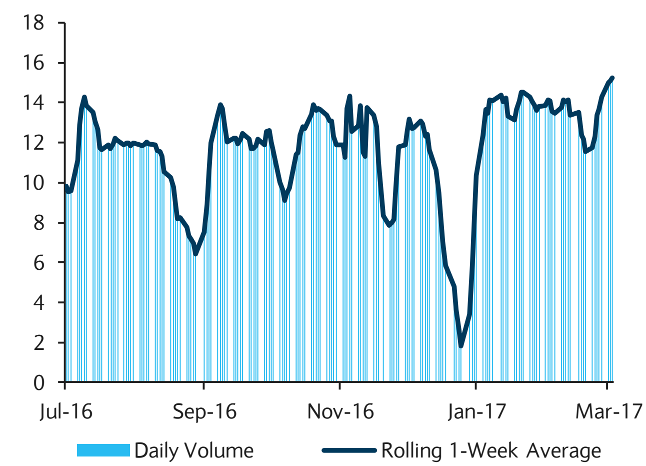
Source: Barclays Research.

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

	Notional Outstanding ($bn)		Volume – Week Ending 3/3/17 ($mn)
	Gross	Net	Gross
Frontier	7.1	0.8	207.9
DISH	3.5	0.6	124.3
Ally Financial	6.1	0.6	106.0
Chesapeake	6.3	0.6	93.3
Bombardier Inc.	5.9	0.7	86.4
Bombardier	5.8	0.8	81.9
Tegna	6.8	0.4	75.5
Hertz	3.8	0.6	61.9
AK Steel	3.0	0.4	59.7
Royal Caribbean	5.5	0.4	58.3

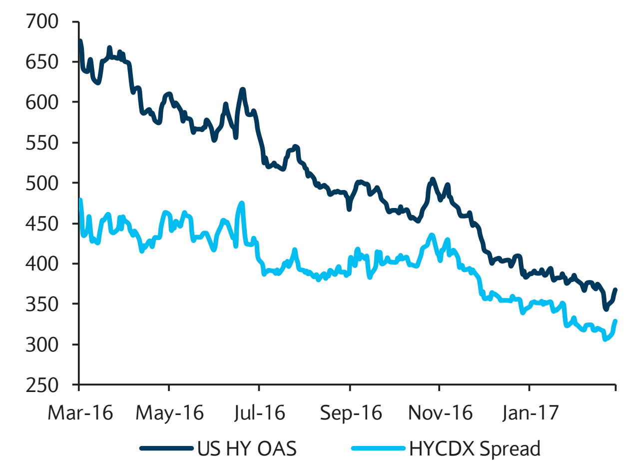
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



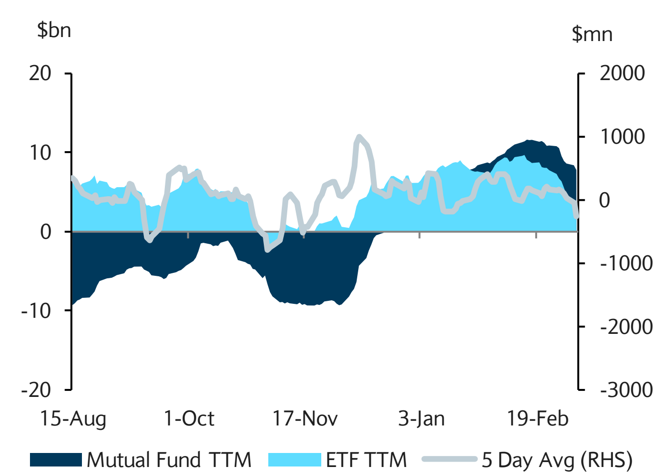
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



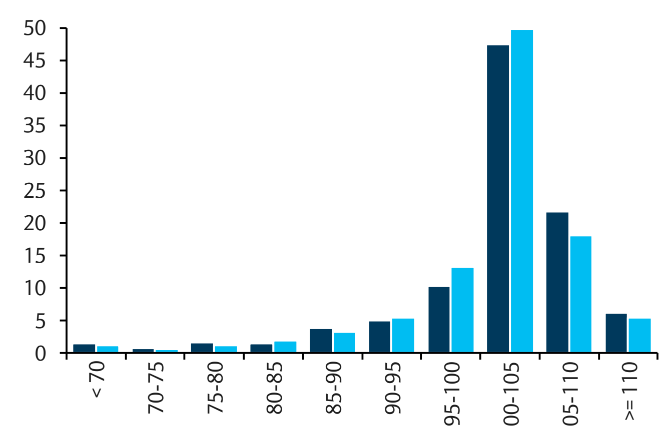
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

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Materially Mentioned Issuers/Bonds

JBS USA LUX SA / JBS USA FINANCE INC, CD/D/J/K/L/M/N
JBSSBZ 8.25 02/01/2020, Market Weight (USD 102.00, 08-Mar-2017)

LEVEL 3 FINANCING INC, CD/D/J/K/L/M
LVLT 6 1/8 01/15/21, Market Weight (USD 103.38, 08-Mar-2017)

REYNOLDS GROUP ISSUER INC / REYNOLDS GROUP ISSUER LLC / REYNOLDS GROUP ISSUER LU, CD/J/K/M
REYNOL 6 7/8 02/15/21, Market Weight (USD 102.50, 08-Mar-2017)

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

Underweight (UW):
For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be less than the six-month excess return of the relevant index.
For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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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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