High Yield Strategy

Value Traps and Opportunities in HY

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Time to lighten up on risk again as HY returns to tights

The HY market ended the tumultuous week mostly unchanged, with spreads oscillating around 380bps. The 10yr Trsy yield peaked at 1.90% last Friday, a 48bps reversal from post-Labor Day lows, before gradually giving back 12bps on the way lower.

Single-Bs remained the top performing sector, posting a +0.44% total return for the week, ahead of both BBs (+0.01%) and CCCs (-0.05%); CCCs were dragged lower by MDR – ex energy they came right behind BBs at +0.38%. Longer duration segments generally did better, with 4-6yr buckets outperforming 2yr-in paper across quality segments by about 50-75bps in excess returns.

Energy continued to outperform all other sectors this week even as initial Monday bounce was partially reversed. Net-net, the energy subindex added 50bps of total return advantage to the 170bps cumulative over the past month. The plunge in MDR (McDermott International) bonds subtracted 30bps of total return from the energy subindex performance this week. The worst performing segments included cable, gaming, financials, food, and real estate. Smaller/less liquid capstructures generically did better than large/liquid names.

Flows have picked up momentum in recent sessions with $2.3bn entering HY funds over the past week as both higher rates and energy rebound have driven marginal dollars towards this asset class. Extending the time horizon to early Aug, HY funds are still about $3bn in the red in terms of cumulative flows. Issuance slowed down to more normalized levels this week, with $5.6bn priced so far, which was offset by $5.2bn in coupons and calls. This leaves us with $23.5bn in mtd September primary volume. Looking ahead, we are projecting $3.2bn cash intake next week ($3.0bn calls/maturities + $0.2bn coupon), and $6.9bn the week after ($2.5bn calls/maturities + $4.4bn coupon).

What do we think here

The crowded consensus positioning in major asset classes has received a due shake up in recent days and weeks. The squeezes occurred almost simultaneously in rates moving sharply higher, in value equities having a 5x sigma move vs growth, in oil reacting to developments in the Middle East, and in repo funding markets exposing the gap between bank reserves and Treasury borrowing needs.

Going into September, we thought rates would retrace 50-75bps higher on the 10yr, so the +48bps move through the end of last week has covered a good portion of that ground, with some reversal since then only natural.

We think higher rates have a connection to the funding pressures exposed earlier this week. The squeeze in repo funding was the result of heavy Treasury issuance last week poorly timed to coincide with corporate tax payments, both being a drag on bank reserves. The federal budget deficits of $1trln+ in coming years are likely to provide support to rates as well as increase chances of similar reserve pressures going forward.

While the Fed intervention seems to have taken immediate pressure off the repo market, it had to continue to intervene to keep things stable. We still believe that rates are biased higher from here as a function of extreme recent positioning that was only partially unwound, large Treasury borrowing needs, and CPI impact from trade tariffs. We think the 10yr Trsy equilibrium yield is somewhere in the 2.00-2.25% area.

HY spreads at around 380bps provide poor starting point for future performance as demonstrated by its ytd patterns. Overall index ytd excess return is 7.1%, which came as a product of -1.8% in days that started with spreads in the bottom quartile (365-400bps), +6.6% in days starting with top quartile (430bps+), and the balance in the two middle quartiles.

The last time [we recommended](#) adding risk was in mid-August at 450bps; now is the time to be doing the opposite at 380. We recommend lowering the risk profile here and be prepared to add risk back at wider levels.

We think the most overpriced categories of the HY bonds are BBs, large/liquid names, short-duration, defensive sectors (cable, financials, gaming, real estate, food). In the opposite corner are single-Bs, smaller cap structures, longer duration names in essentially all other sectors, and particularly energy.

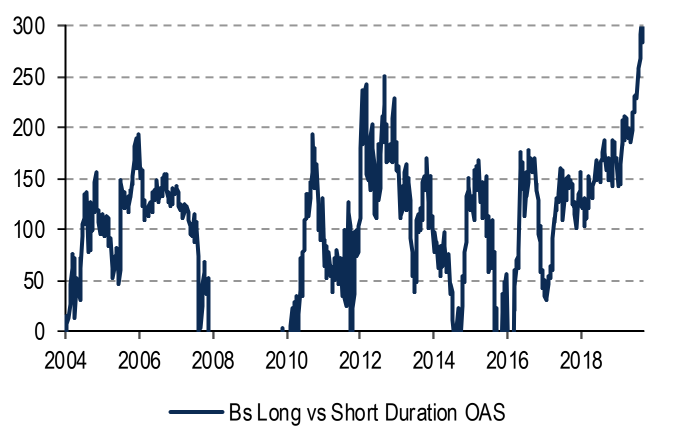
Overall BBs are trading only 20bps away historical tights whereas single-Bs spreads are at the bottom of second quartile historically and have 130bps to go to all-time tights. We think BBs are also more vulnerable to tourist flows coming out of HY than other quality segments in our market.

See Figure 1 for spread differentials between long-and short duration baskets in single-Bs, and Figure 2 for spread differentials between small- vs large-size debt capital structures.

> The spread pickup between short-duration single-Bs, largest cap structures in five tightest sectors (cable, financials, gaming, real estate, food) compared to longer-duration single-Bs in smaller capstructures in all other sectors is +400bps.

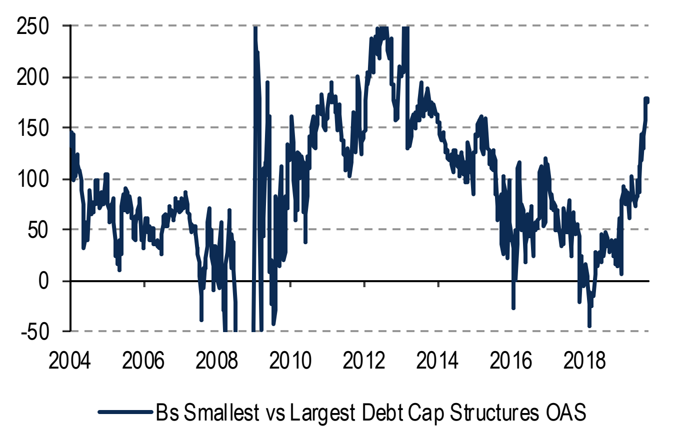
Removing the energy from the wider basket above narrows the differential to 350bps. The same differential in BBs currently brings 185bps of spread pickup overall, 175bps ex-energy.

Figure 1: Single-Bs long (4-6yr) vs short (0-2yr) eff duration baskets



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

Figure 2: Single-Bs small ($400mn-in) vs large ($1.4bn+) cap structures



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

Figure 3 shows the DM USD HY index breakdown by issuer (ticker-level) size of bond capital structures. The lowest 4th quartile captures issuers with $400mn in index-eligible HY bonds, the 3rd quartile is $400mn-$700mn, the 2nd is $700mn-$1.5bn, and the top quartile covering the largest cap structures starts at $1.5bn+.

As is usually the case, these value opportunities do not come as a free lunch – they do carry incremental risks, particularly the liquidity risk of smaller cap structures, the duration risk of longer tenors, and the fundamental risk of more cyclical sectors.

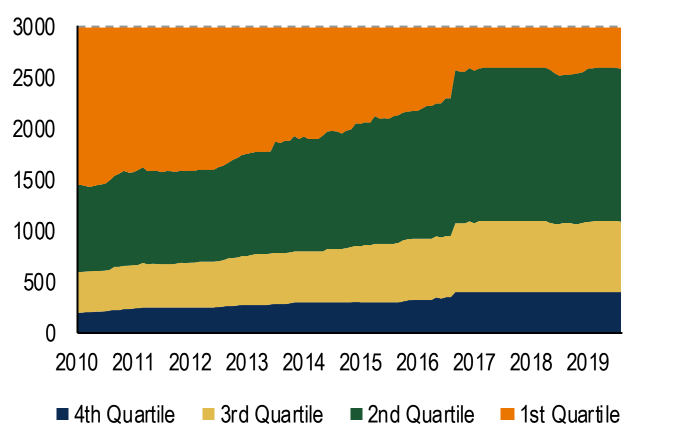
We do recommend taking the liquidity risk in smaller cap structures deliberately, as we believe 175bps of additional spread (Figure 2) provides good compensation (an equivalent of 9.1% over five years). The larger capstructures are also more prone to unnecessary volatility of daily flows in ETFs and other large daily liquidity funds. This attribute implies good probability you will be able to pickup those larger bonds in the next volatility episode at discounted levels, as this is where the crowded exit door always is.

In taking longer-duration credit exposures, we continue to prefer partially hedged rate duration exposure: over the past three weeks we recommended gradually reducing the original rate duration hedge that existed going into September. Based on our expectation of 10yr equilibrium in the 2.00-2.25% area, the recent extremes at 1.42% post-Labor Day, and the current level of 1.78%, we would recommend roughly 35-45% of the original rate hedges remaining in place here. And if you disagree with our views on rates, taking the longer overall duration risk in HY should be a no-brainer.

In sectors, we continue to like the defensive nature and solid fundamentals of cable, financials, gaming, real estate, and food sectors, we just think they are priced to perfection.

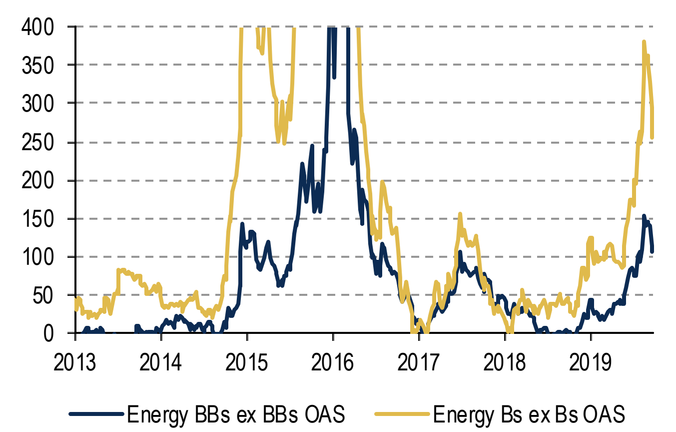
Figure 3: HY bond cap structures by size quartile

$400mn and in, $400-700mn, $700mn-$1.5bn, and $1.5bn+



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

Figure 4: Energy vs overall HY spreads by rating



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC

Energy remains as topical as ever here, now that it has outperformed the broad HY index for five weeks in a row with a cumulative 170bps in excess return terms over the past month. We were going into this episode with an overweight in energy, and continue to think this sector has capacity to outperform going forward based on the original argument of materially elevated spread levels (Figure 4) now complemented with rising geopolitical risks in the Middle East.

Taken in combination, these two factors suggest that the underweight position in energy carries a greater risk of underperformance than the alternative. Having said that, we continue to reiterate that the call in energy remains perhaps the most difficult sector call in this asset class, and as such risk limits need to be set defensively, assuming things could go in a wrong direction, to a significant degree, and for a long time. Keep capacity and be prepared to add more risk if this happens. Within energy, we continue to advise higher quality tilt for any overweight risk allocations.

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