The Long of It, in Short

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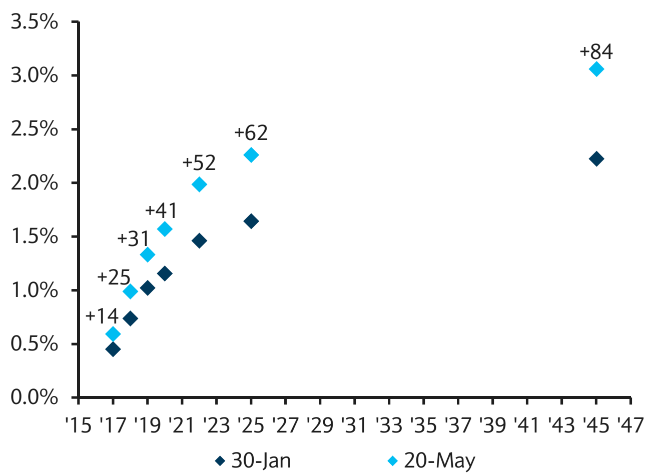
U.S. rates have backed up meaningfully since the end of January, as we highlighted a few weeks ago in *Getting Creepy*, and the moves have caused duration concerns to flare up for credit investors. As discussed in the investment grade section (and shown in Figure 1), the largest changes have come in the long end of the curve, but with 5y and 7y Treasuries up 41bp and 52bp, respectively, high yield investors have certainly taken notice as well.

We have shown in several reports[1] that the empirical duration of high yield is significantly lower than its calculated duration, i.e., that spreads absorb rate backups quite well. This makes macroeconomic sense and is also partly the result of a market quoted and traded in price terms. Nonetheless, increasing rates expectations consistently cause portfolio managers some palpitations. To be fair, the heightened concerns are to some extent warranted for managers with daily liquidity funds, as rates spikes have at times been associated with very large and brisk outflows and related sell-offs, as was the case in mid-2013. That said, the flows – and, importantly, valuations – have generally reversed over the medium term, making the episodes more of a liquidity concern than a performance concern.

As duration fears return, however, we examine the very long end of the high yield market. High yield issuers traditionally come for 8y or 10y paper, very occasionally at the 12y point. Maturities over twelve years are overwhelmingly fallen angels, with only about 7% of the bonds in that group having been issued to native high yield issuers (versus 91% in the sub-12y group). For context, the 12y+ category totals a little over $60bn in par and just under 5% of the high yield market by market value.

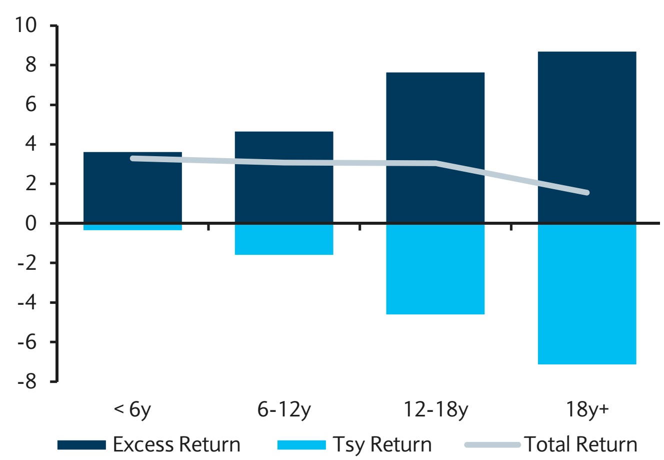
Looking at performance since the recent lows in rates (January 30), we find that the very long end of the high yield market has held up relatively well despite the rates environment. Bonds in the 12-18y bucket returned 3.04% through Wednesday, only 4bp less than those in the 6-12y bucket and 25bp less than those maturing in less than six years. While the 18y+ group fared less well, its significant excess return (8.75%) more than offset the losses due to Treasuries (-7.19%), for a total return of 1.56% in the period (Figure 2).

FIGURE 1
U.S. Treasury Yield Curve, January 30 versus May 20



Source: Bloomberg

FIGURE 2
Total Return Breakdown: Excess Returns and Treasuries (%)

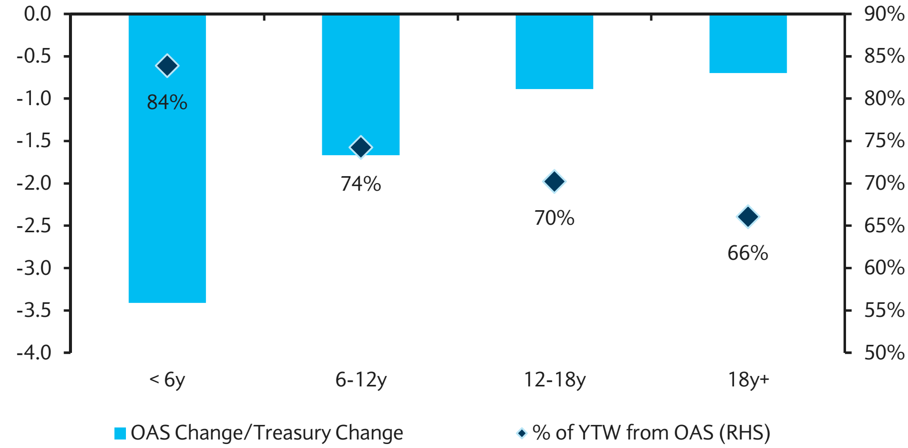


Note: Performance from Jan 30 to May 19. Source: Barclays Research

[1] *Take a Hike without Breaking a Sweat*, March 13, 2015; *Do the Shift and Twist*, October 17, 2014; *Global Credit Outlook 2014* (pp 41-43), December 6, 2013.

FIGURE 3

Longer Maturity Bonds Have Had Less Cushion to Absorb the Move in Rates



Note: We compare the sub-6y, 6-12y, 12-18y, and 18y+ buckets to the 3y, 6y, 12y, and 20y Treasury, respectively.
Source: Barclays Research

Furthermore, the extent to which the two longer maturity groups absorbed the move in rates is notable. Even though less of the yield in the 12-18y and 18y+ maturity groups comes from spread, they absorbed 90% and 70% of the change in rates, respectively,[2] as shown in Figure 3. While that is admittedly less than the -2.0x beta between spread and rates for the overall high yield market over the same timeframe, it is still respectable.

While we do not perceive long maturity high yield to be generally cheap following the recent back-up in rates, we do see select opportunities in that part of the market. On the long side, financials analyst Brian Monteleone sees upside in the new tranche of **Ally Financial's 8% notes due 2031**. The bond looks cheap to BBB monoline banks, and Brian believes Ally has a path to investment grade ratings in the next two years (see his *report* for more details).

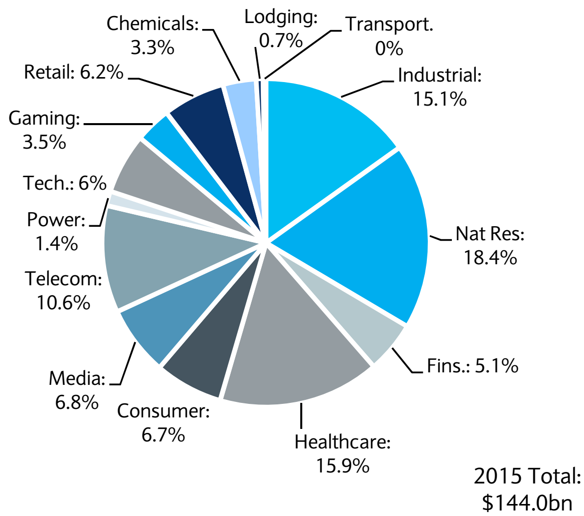
In the midstream sector, **DCP Midstream's (DCP) 6.75% notes due 2037** are crossover rated (Ba2/BB/BBB-), having recently been downgraded by Moody's and S&P. The company is co-owned by Phillips and Spectra Energy. In a cross-asset report with our equity analysts (*DCP Restructuring Scenario Analysis*), Gary Stromberg evaluated a scenario analysis whereby the issuer is collapsed into DCP Midstream Partners (DPM), which would take leverage significantly lower. Also in the midstream sector, **NGPL PipeCo** is pursuing strategic alternatives because of unsustainable cash burn. The outcome for its 7.768% notes due 2037 is somewhat binary, with significant upside if the strategic alternatives review ends with a sale to a company with stronger metrics and material downside if it is forced to restructure instead.

In retailers, Hale Holden just upgraded the entire JC Penney (JCP) bond complex to Overweight because of attractive valuations and several positive catalysts, including good operating and ratings momentum, as well as a lack of near-term supply (please see his *recent note* for details). **JCP's notes due 2036** are the lowest priced in the capital structure at $76, offering the best convexity profile for a high-beta issuer with good tailwinds, in our view.

From the short side, some longer-dated bonds have held in relative well but are exposed to specific fundamental risks. For instance, in chemicals, Brian Lalli remains **Underweight Ashland's 6.875% notes due 2043**, largely as a result of the company's focus on shareholder returns (see his *recent report* for details). In oil field services, we see downside risk to **Transocean's 6.8% notes due 2038,** as the company may tap the primary market for secured issuance to facilitate refinancing activity and fund new vessels.

[2] Measured versus a Treasury with duration similar to the bonds in each bucket.

High Yield Supply by Sector – 2015 Breakdown



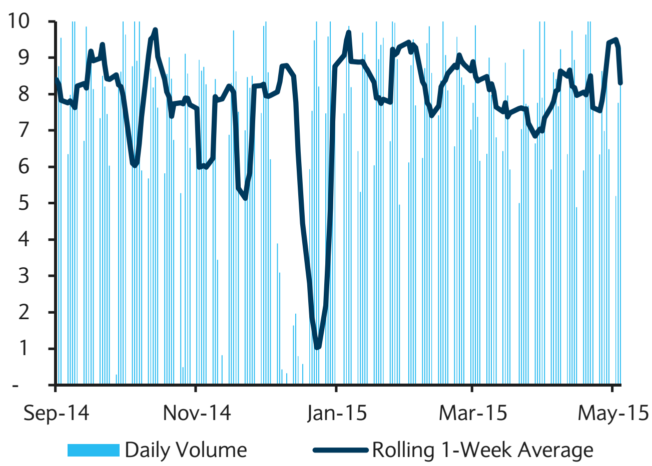
Source: Barclays Research

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

	Notional Outstanding ($bn)		Volume – Week Ending 5/15/15 ($mn)
	Gross	Net	Gross
General Motors	6.8	1.2	303.8
Royal Caribbean	9.4	0.7	222.3
Ally Financial	14.2	1.1	208.8
JC Penney	17.3	0.8	194.5
U.S. Steel	8.4	1.0	182.7
MGM Resorts	7.6	0.9	148.6
Goodyear	5.5	0.5	145.6
Frontier	9.6	0.6	115.5
Chesapeake	9.2	1.0	93.3
Owens-Illinois	2.0	0.3	93.1

Source: DTCC

High Yield Average Institutional Trade Volume ($bn)

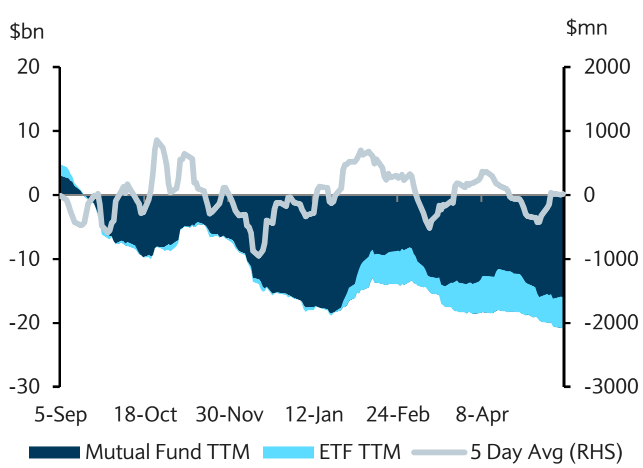


Source: FINRA TRACE

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

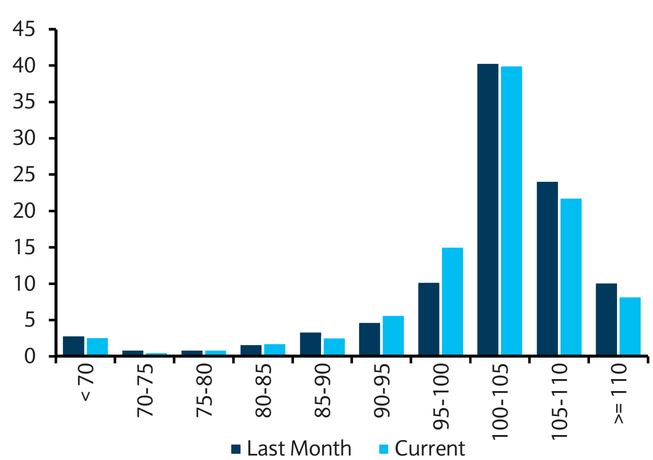
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

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