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Building a Better BB/BBB Basis

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This updates Building a Better BB/BBB Basis*, released 20 September 2019, 10:30 GMT, to replace the BB-BBB Basis (adjusted and unadjusted) data series in Figure 3.*

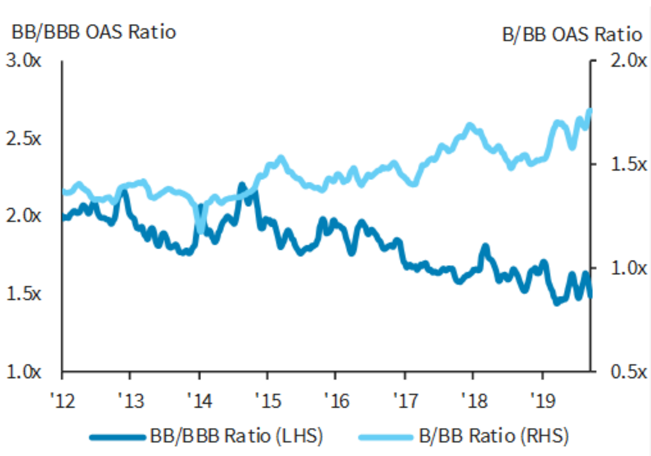
Despite the beta rally in recent weeks, higher quality has still led performance this year, with BB returns outpacing Bs and CCCs. As discussed last week, this outperformance can be attributed partly to market technicals, as retail inflows have supported BB demand while the high level of rising stars has offset the increased BB supply relative to last year (*Technical Balance in BBs*).

The tightening of BB spreads has been significant in comparison with the investment grade market as well, specifically BBBs. Thus far in 2019, non-financial BB spreads have tightened 145bp while non-financial BBB spreads have come in just 45bp, propelling the spread ratio of BBs to BBBs to the tightest level in history (Figure 1). The lower-quality portions of the high yield market have not kept up, with the B/BB spread ratio now at all-time highs. While headlines have focused on the record level of compression between BBs and BBBs, the comparison is a bit "apples to oranges," as the two cohorts have evolved in recent years, specifically in regard to duration, sector allocation, and ratings.

One of the biggest changes has been the divergence of duration between the two markets – BBBs are now at their longest all-time duration, while BBs are at their shortest. As shown in Figure 2, the duration difference between the two buckets has increased nearly two years since the end of 2011, with BB duration declining 1.2 years and BBB duration increasing 0.7 years, and this trend has accelerated in 2019. Understandably, these shifts in duration have helped propel compression in the BB/BBB relationship.

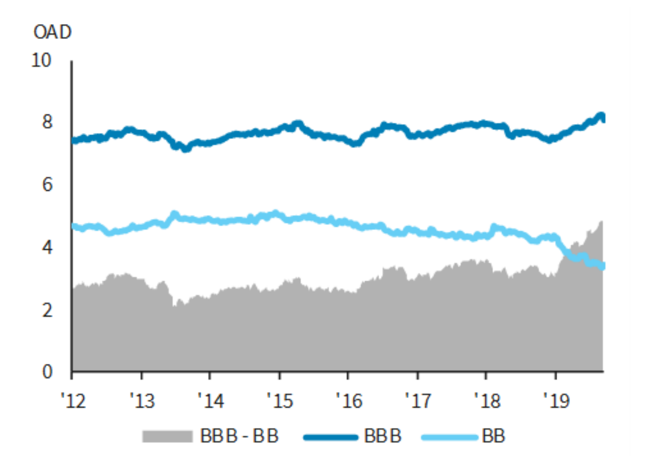
To account for this evolution in duration, we adjust spread levels by keeping the weights of various duration buckets unchanged from the levels in each BB and BBB cohort at a baseline period (we use the end of 2011). Figure 3 shows the effect of the changes in duration on the BB/BBB basis (BB OAS - BBB OAS) by comparing the unadjusted relationship between the two cohorts with the basis when duration is left unchanged.

FIGURE 1
The BB/BBB Spread Ratio Has Compressed to Record Lows…



Note: Excludes financials.
Source: Bloomberg Barclays Indices

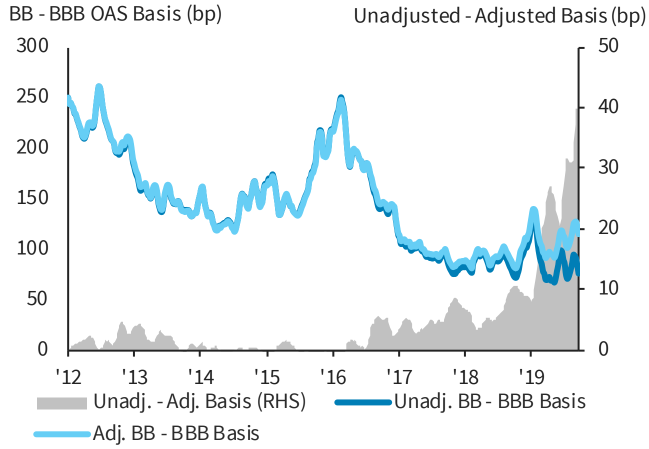
FIGURE 2
…While the Duration Difference between BBBs and BBs Has Reached Record Highs



Note: Excludes financials.
Source: Bloomberg Barclays Indices

FIGURE 3

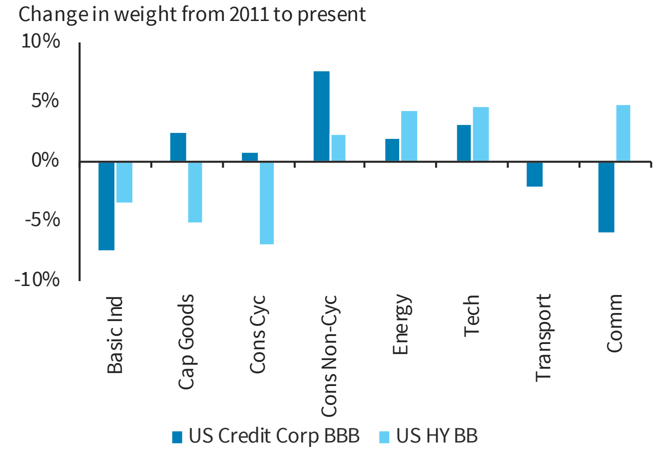
Duration Has Driven a Significant Portion of the BB-BBB Compression in 2019…



Note: Excludes financials.
Source: Bloomberg Barclays Indices

FIGURE 4

…with Sector Allocation Somewhat Mitigating the Duration Effect



Note: Industrial only.
Source: Bloomberg Barclays Indices

We find that duration shifts had a minimal effect on the BB-to-BBB spread basis up until the past three years, with a significant acceleration this year as BB duration declined significantly and BBB duration picked up. By our estimate, the shifts in duration in the two cohorts since the end of 2011 are responsible for 40bp of the compression in the BB-BBB basis.

Running the same analysis on sector weights shows that the current BB-BBB basis would actually be 11bp tighter if sector weights for the two cohorts had not changed since 2011, partially offsetting the duration effect. As seen in Figure 4, the BBB market has become weighted more toward consumer non-cyclical sectors since the end of 2011, while growth in the BB energy sector has outpaced energy BBBs. Although the tilt toward a more defensive sector mix for BBBs may have been mitigated by a deterioration in quality, we find that the average ratings of both BBBs and BBs have been generally unchanged over the past eight years.

Given that duration and sector skew cloud the BB/BBB comparison, we believe the best comparison between the two markets is at a fundamental level. Looking at just non-financial unsecured bonds, we create a custom bucket of large BB issuers that includes 20 tickers with a combined market value of nearly $150bn and represents more than 35% of the BB market.[1] Working with our fundamental analysts, we then construct another bucket of tickers made up of the largest comparable BBB issuers for each name in the custom BB list (see Appendix 1).

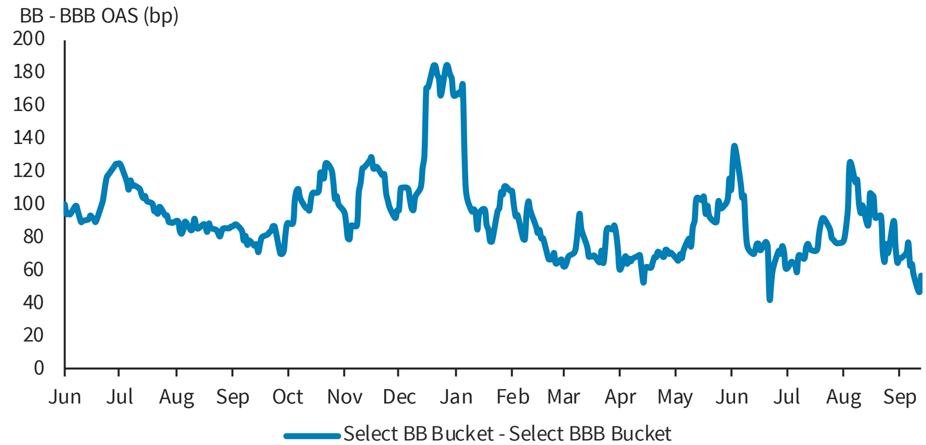
While the single-name matching process removes some of the sector bias, we also filter out bonds with durations of more than eight years to mitigate the influence of duration differences. As a result, these two custom buckets are not just similar in size and sector weight but also have a weighted duration difference of roughly one, compared with nearly five for the broader BB and BBB indices. Figure 5 plots the median spread basis between our matched pairs of BB and BBB tickers. We find that the average spread differential has compressed by roughly 30bp over the past twelve months and 120bp since reaching highs at the end of 2018.

[1] We excluded secured debt from our analysis in order to remove any bias from potential secured/unsecured pairs. Our custom bucket of large BB issuers includes 1) the ten largest non-financial issuers by market value in the BB cohort, as well as 2) the largest issuer in each sector that is at least 2% of the market value of the non-financial BB Index that is not represented in the top ten issuer list.

While duration and ratings have played a role in the evolution of the BB/BBB ratio over time, even adjusting for these factors, the spread compression between the ratings buckets has been significant. Given this dynamic and our preference for BBBs in the investment grade market (*Terming Out Is Good for Credit Health*), the current environment appears to provide a relatively inexpensive opportunity for investors to move up in quality from BBs to BBBs.

FIGURE 5

The Basis for Our Select BB and BBB Buckets Has Tightened Significantly



Note: Excludes financials and bonds with durations longer than eight years.
Source: Bloomberg Barclays Indices

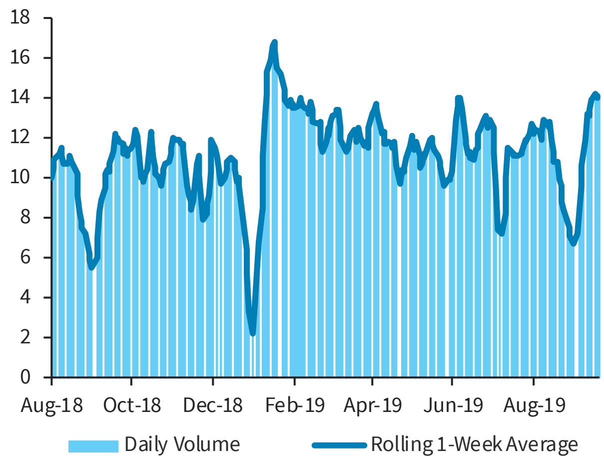
APPENDIX 1

Large BB and BBB Issuers Used in our Select Comparable Analysis

BB			BBB		
Ticker	Issuer	Sector	Ticker	Issuer	Sector
GT	Goodyear Tire & Rubber	Automotive	APTV	Aptiv	Automotive
CHTR	Charter	Cable Satellite	T	AT&T	Wirelines
SIRI	Sirius	Cable Satellite	DISCA	Discovery Communications	Media Entertainment
CSCHLD	CSC Holdings	Cable Satellite	T	AT&T	Wirelines
OLN	Olin	Chemicals	DOW	Dow Chemical	Chemicals
URI	United Rentals	Construction Machinery	CNHI	CNH Industrial	Construction Machinery
VST	Vistra Energy	Utility	EXC	Exelon	Utility
JBSSBZ	JBS	Food and Beverage	TSN	Tyson Foods	Food and Beverage
MGM	MGM Resorts	Gaming	SANLTD	Sands China	Gaming
HCA	HCA	Healthcare	CVS	CVS Health	Healthcare
LEN	Lennar Corp	Home Construction	DHI	DR Horton	Home Construction
AR	Antero Resources	Independent	EQT	EQT	Independent
NFLX	Netflix	Media Entertainment	FOXA	Fox	Media Entertainment
FCX	Freeport-McMoRan	Metals & Mining	SCCO	Southern Copper	Metals & Mining
NGLS	Targa Resources	Midstream	PAA	Plains All American	Midstream
BLL	Ball	Packaging	AMCR	Amcor	Packaging
LB	L Brands	Retailers	M	Macy's	Retailers
DELL	Dell	Technology	HPQ & HPE	Hewlett Packard	Technology
TMUS	T-Mobile	Wireless	VZ	Verizon	Wirelines
LVLT	Level 3	Wirelines	EQIX	Equinix	Technology

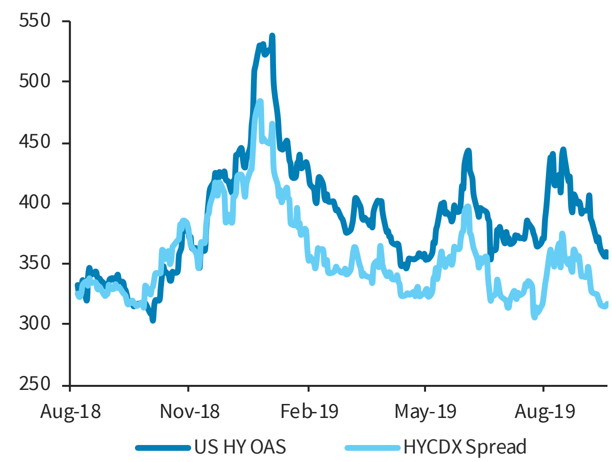
We excluded secured debt from our analysis in order to remove any bias from potential secured/unsecured pairs. Our custom bucket of large BB issuers includes: 1) the ten largest non-financial issuers by market value in the BB cohort, as well as 2) the largest issuer in each sector that is at least 2% of the market value of the non-financial BB Index that is not represented in the top ten issuer list. Source: Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)



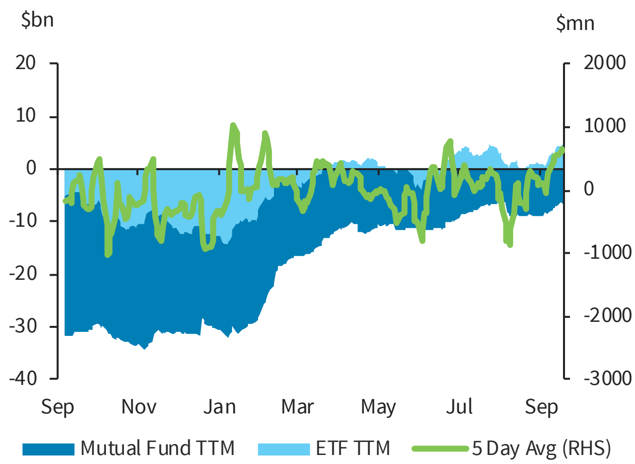
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



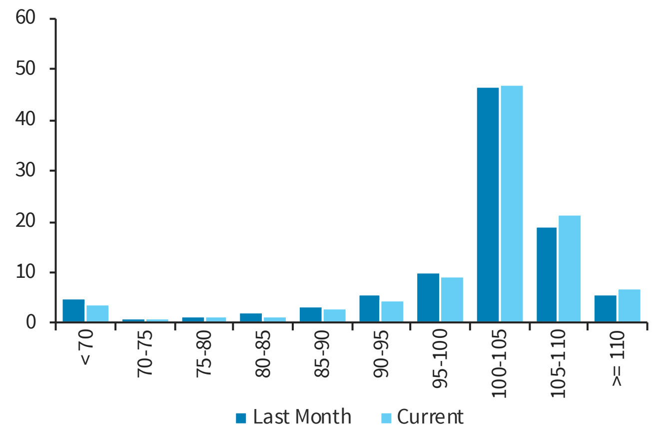
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



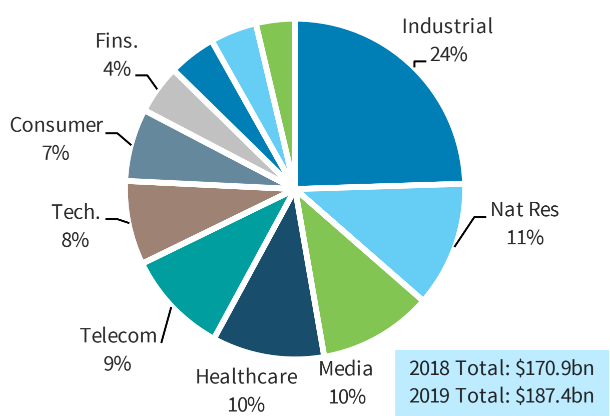
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



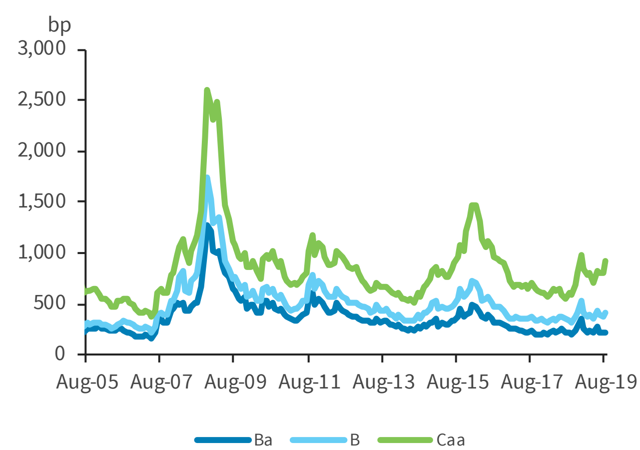
Source: Barclays Research

High Yield Supply by Sector



Note: 2019 new issue data as of September 18.
Source: Bloomberg Barclays Indices

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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