Previously published in the U.S. Credit Alpha
26 October 2018

Mapping Demand to a Shrinking Market

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com
BCI, US

Rizwan Hussain
+1 212 412 7997
riz.hussain@barclays.com
BCI, US

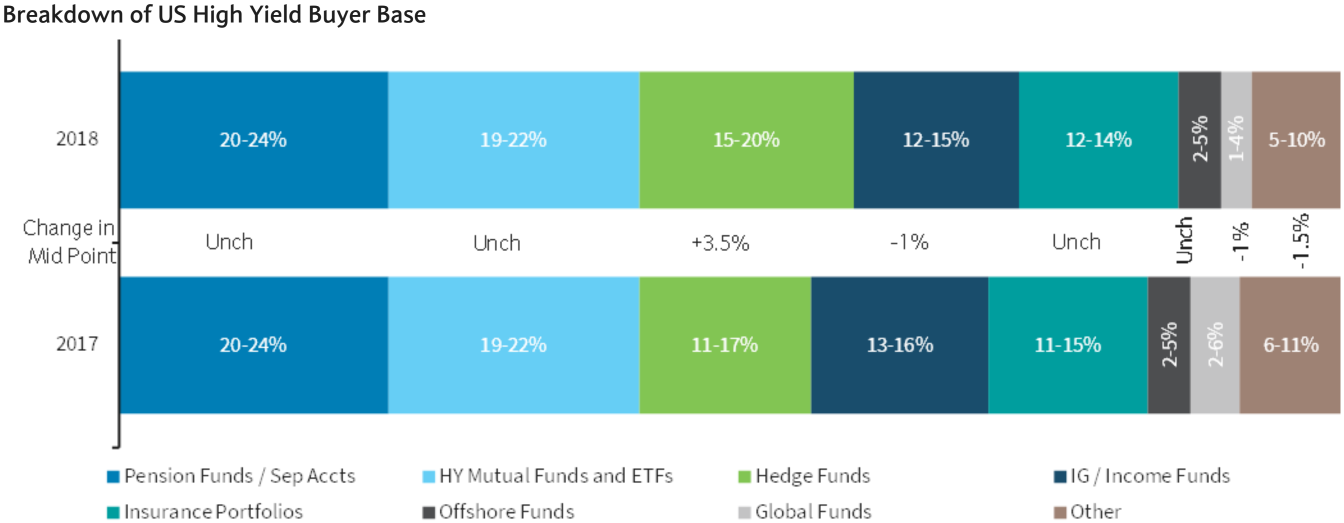
Scott Schachter
+1 212 526 9716
scott.schachter@barclays.com
BCI, US

US high yield has led performance among USD fixed income assets this year, although the paltry year-to-date total return of 1.32% is slim comfort to investors. Credit conditions have remained largely benign, rising stars have outpaced fallen angels for seven of the past eight years, and the aggregate credit quality of public non-financial issuers in the US High Yield Index sits at recent highs (*A Little More Leaning on Leverage*). The decline in the size of the high yield bond market (down 6.6% by market value and 3.1% by par since the start of the year) has been a powerful technical driver to support returns against the headwind of rising rates. Given an essentially shrinking asset class, we engage in our annual review of the ownership of the high yield bond market to determine which constituents have participated in the shrinking of the market and which have held their share. Importantly, while headlines have focused on record outflows from high yield-dedicated retail funds, the shrinkage of AUM for this investor cohort has only slightly outpaced the decline in size of the overall market.

Pension Funds/Separate Accounts (20-24%): While retail funds and flows garner more attention, this investor class holds a proportion of the overall asset class that is just as big, if not slightly larger. We estimate that its ownership stake is unchanged this year. Our conversations with asset managers suggest that AUM in SMAs have essentially mirrored the decline in the overall size of the US High Yield Index y/y. Utilizing data from the Federal Reserve's 2Q Flow of Funds release, a study from Willis Towers Watson, and other data, we estimate that high yield assets held by pension funds are down a touch less, at 2%.

High Yield-Dedicated Mutual Funds and ETFs (19-22%): Per Lipper, onshore high yield dedicated funds have seen nearly than $30bn of outflows thus far in 2018.. Unlike last year, both ETFs and mutual funds have experienced net outflows in 2018, as managers are increasingly using the former as a liquidity management tool (*Mutually Assured Destruction*). ETFs represent 10-15% of this segment, thus constituting roughly 3% of the entire high yield buyer base.

FIGURE 1
Breakdown of US High Yield Buyer Base



Source: S&P LCD, Lipper, Bloomberg, EPFR, HFR, Credit Flux, Federal Reserve, Refinitiv, Kaneri, Bloomberg Barclays Indices, Barclays Research

Using Bloomberg data, we find that the weighted average allocation to high yield bonds in these funds is 94%, mostly consistent with past years. The largest non-high yield bond exposure is a 3-4% allocation to loans. Our prior research suggests that high yield outflows will remain a persistent threat if risk-free rates continue to rise, all else equal. Anecdotally, for much of the year, managers have mentioned 7% as a nominal yield level at which they believe they would see inflows, although there is some variability around that largely subjective estimate.

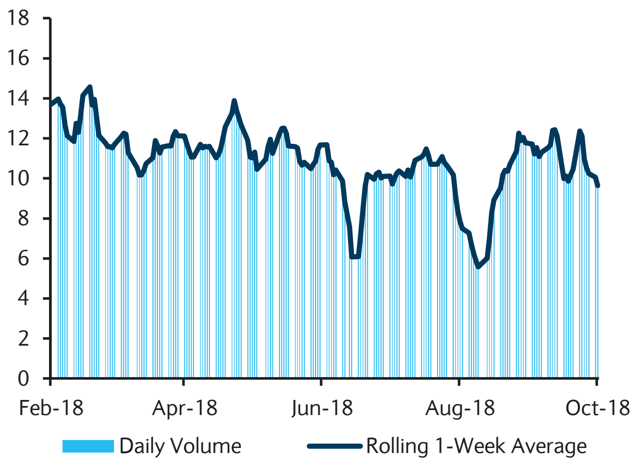
Hedge Funds (15-20%): We estimate that this segment's share of ownership grew incrementally in 2018, based on data from HFR. Hedge fund AUM among the strategies that we believe have an allocation to high yield are up approximately 4% y/y. While there is some risk in assuming that incremental allocations over the past year have been in line with historical levels, we think the lack of distressed opportunities in a low-default environment has once again led this investor base to be active in lower-quality high yield, in particular. The outperformance of CCCs in 2018 fits with that narrative, in our view.

Investment Grade/Income Funds (12-14%): This group of funds has experienced $14bn of outflows this year, but when we break out the split among investment grade, high yield, and other assets, we find an approximate 1pp y/y drop in share of high yield ownership by this universe of funds. With high yield not a core allocation for much of this higher quality-focused investor base and the general compression of valuations for much of this year, we are not surprised by this modest decline in ownership.

Offshore Retail Funds (2-5%): Offshore funds' share of the broader market is similar to last year. That said, there was a moderate increase in Japanese Toshin fund allocations to high yield, which is consistent with the continued incremental interest in US leveraged credit that investors see coming from the region broadly. That said, European-based retail was negative, leaving the segment's assets close to flat. This resilience is somewhat surprising considering increased hedging costs, but highlights the lack of yield elsewhere globally.

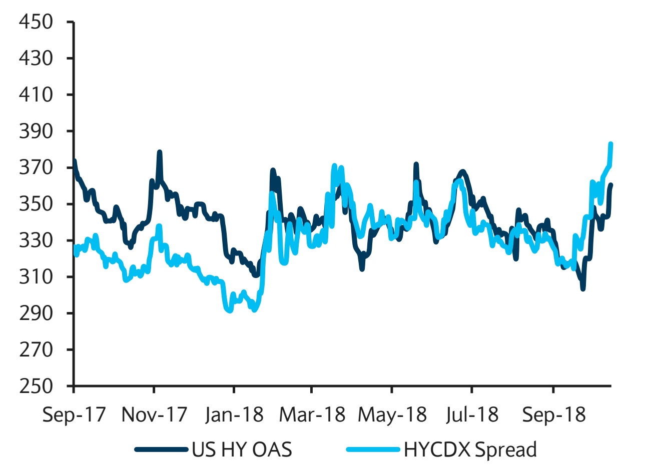
Global High Yield Funds (1-4%): The rise in currency hedging costs for non-USD investors has dimmed the relative value of US fixed income broadly, resulting in a decline in global fund ownership of high yield. As highlighted in *Seeing Value in EUR versus USD High Yield*, the shift in hedging costs has caused EUR bonds to appear attractive relative to USD bonds, and much of the European credit investor base with a global mandate seems to be deploying incremental capital closer to home.

High Yield Average Institutional Trade Volume ($bn)



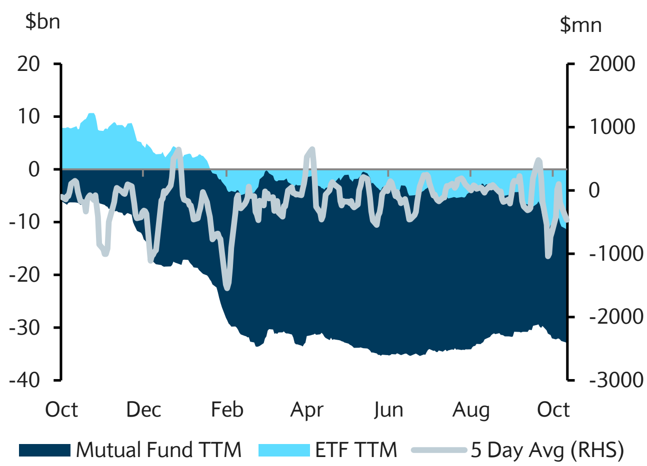
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



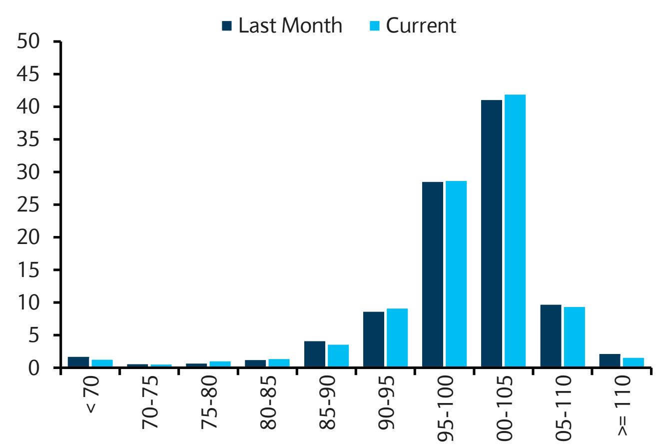
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



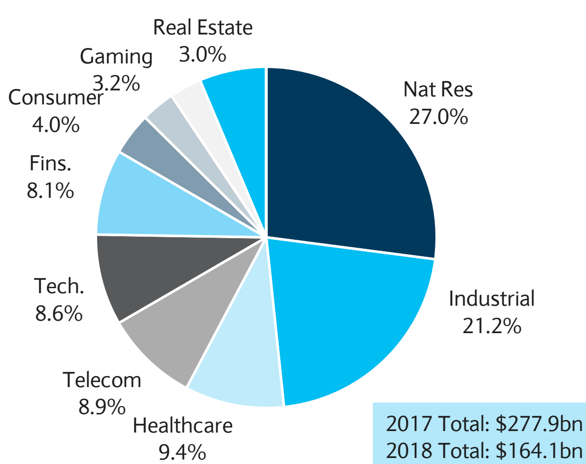
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



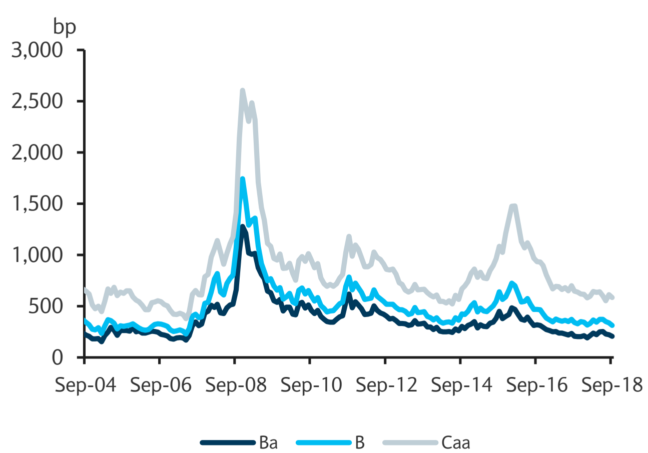
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

Analyst Certification

We, Rizwan Hussain, Bradley Rogoff, CFA and Scott Schachter, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

Important Disclosures:

Barclays Research is produced by the Investment Bank of Barclays Bank PLC and its affiliates (collectively and each individually, "Barclays").

All authors contributing to this research report are Research Analysts unless otherwise indicated. The publication date at the top of the report reflects the local time where the report was produced and may differ from the release date provided in GMT.

Availability of Disclosures:

For current important disclosures regarding any issuers which are the subject of this research report please refer to https://publicresearch.barclays.com or alternatively send a written request to: Barclays Research Compliance, 745 Seventh Avenue, 13th Floor, New York, NY 10019 or call +1-212-526-1072.

Barclays Capital Inc. and/or one of its affiliates does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Barclays may have a conflict of interest that could affect the objectivity of this report. Barclays Capital Inc. and/or one of its affiliates regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). Barclays trading desks may have either a long and / or short position in such securities, other financial instruments and / or derivatives, which may pose a conflict with the interests of investing customers. Where permitted and subject to appropriate information barrier restrictions, Barclays fixed income research analysts regularly interact with its trading desk personnel regarding current market conditions and prices. Barclays fixed income research analysts receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the Investment Banking Department), the profitability and revenues of the Markets business and the potential interest of the firm's investing clients in research with respect to the asset class covered by the analyst. To the extent that any historical pricing information was obtained from Barclays trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not necessarily represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document. Barclays Research Department produces various types of research including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations and trade ideas contained in one type of Barclays Research may differ from those contained in other types of Barclays Research, whether as a result of differing time horizons, methodologies, or otherwise.

In order to access Barclays Statement regarding Research Dissemination Policies and Procedures, please refer to *https://publicresearch.barcap.com/S/RD.htm*. In order to access Barclays Research Conflict Management Policy Statement, please refer to: *https://publicresearch.barcap.com/S/CM.htm*.

All pricing information is indicative only. Prices are sourced from Thomson Reuters as of the last available closing price at the time of production of the research report, unless another time and source is indicated.

Types of investment recommendations produced by Barclays FICC Research:

In addition to any ratings assigned under Barclays' formal rating systems, this publication may contain investment recommendations in the form of trade ideas, thematic screens, scorecards or portfolio recommendations that have been produced by analysts in FICC Research. Any such investment recommendations produced by non-Credit Research teams shall remain open until they are subsequently amended, rebalanced or closed in a future research report. Any such investment recommendations produced by the Credit Research teams are valid at current market conditions and may not be otherwise relied upon.

Disclosure of other investment recommendations produced by Barclays FICC Research:

Barclays FICC Research may have published other investment recommendations in respect of the same securities/instruments recommended in this research report during the preceding 12 months. To view all investment recommendations published by Barclays FICC Research in the preceding 12 months please refer to *https://live.barcap.com/go/research/Recommendations*.

Legal entities involved in producing Barclays Research:

Barclays Bank PLC (Barclays, UK)
Barclays Capital Inc. (BCI, US)
Barclays Securities Japan Limited (BSJL, Japan)
Barclays Bank PLC, Hong Kong branch (Barclays Bank, Hong Kong)
Barclays Capital Canada Inc. (BCCI, Canada)
Barclays Bank Mexico, S.A. (BBMX, Mexico)
Barclays Securities (India) Private Limited (BSIPL, India)
Barclays Bank PLC, India branch (Barclays Bank, India)
Barclays Bank PLC, Singapore branch (Barclays Bank, Singapore)

Disclaimer

This publication has been produced by Barclays Research Department in the Investment Bank of Barclays Bank PLC and/or one or more of its affiliates (collectively and each individually, "Barclays"). It has been distributed by one or more Barclays affiliated legal entities listed below. It is provided to our clients for information purposes only, and Barclays makes no express or implied warranties, and expressly disclaims all warranties of merchantability or fitness for a particular purpose or use with respect to any data included in this publication. To the extent that this publication states on the front page that it is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors under U.S. FINRA Rule 2242, it is an "institutional debt research report" and distribution to retail investors is strictly prohibited. Barclays also distributes such institutional debt research reports to various issuers, media, regulatory and academic organisations for their own internal informational news