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Price Check for Credit Spreads

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Despite the recent issuance-driven widening, investment grade spreads are about 12bp tighter for the year. The rally in risk-free yields has led to a steepening in credit curves, but otherwise, high-beta credit has outperformed. The BBB-A basis has compressed slightly (we still prefer BBBs to As), and the liquidity premium has declined significantly.

Figure 1 compares the results of a cross-sectional regression to explain spreads of securities in the corporate index at the beginning of the year and today. It uses factors for duration, rating number, and liquidity (a flag that is set to one for bonds issued more than a year ago and zero otherwise). Compared with the beginning of the year, the premium for duration has increased as credit curves have steepened, while that for rating has gone down, which captures the compression in the BBB-A basis. The liquidity premium has also declined substantially, with illiquid bonds (defined as those issued more than a one year ago) offering no spread pickup now, compared with about 6bp at the beginning of the year.

In the regression, we also use a price factor, calculated as the price of a bond above or below par, to capture the spread premium for high dollar price bonds. The rule of thumb used for pricing premium bonds is 1.0bp/$ compared with lower-priced securities, and the regression results are broadly consistent with this assumption. The spread premium for high dollar price bonds is currently about 0.8bp/$, having decreased slightly from 0.9bp/$ at the start of the year.

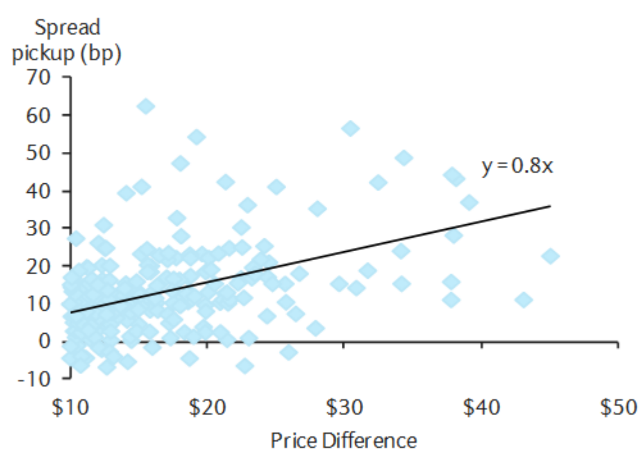
Figure 2 shows the spread difference of matched pairs of bonds of the same issuer (and similar maturity) trading at least $10 apart. The overall compensation for dollar price is similar to the above analysis. In addition to technical factors (for instance, some traditional buyers are unable to buy high dollar price bonds), the wider spread of high dollar price bonds is due partly to their lower expected recovery and, consequently, higher loss in default. Therefore, the spread difference between low and high price bonds should be higher for riskier credits, and we find that this is indeed the case. Breaking down the bond pairs by rating, the spread compensation is 1.0bp/$ for BBBs, compared with 0.7bp/$ for A rated bonds.

FIGURE 1
Explaining Credit Spreads

Factor	Current	12/31/2016
Intercept (bp)	(54.4)	(52.8)
Rating Number (bp/Notch)	16.4	18.1
Duration(bp/yr)	6.2	5.2
Liquidity Premium	(0.4)*	5.5
Price (bp/$)	0.84	0.89

Note: *Not statistically significant. Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 2
Spread Pickup Offered by High Price Bonds



Source: Bloomberg Barclays Indices, Barclays Research

On average, the high priced bonds in Figure 2 trade about 14bp wider than corresponding lower-price securities. Using the BCDS methodology, we estimate that the lower recovery potential of high dollar price bonds explains about 12bp of the spread difference, suggesting that, in general, they are fairly priced relative to the rest of the index. While that is true on average, there are some instances of mispricing, in our view.

Figure 3 screens for select liquid bond pairs where the recovery-adjusted spread difference between the high and low dollar price bond is greater than 15bp. Select high dollar price bonds of VIA, VZ, ETP, and JEF appear cheap compared with corresponding lower-priced securities, For instance, investors can swap out of VIA 4.85s and into 6.875s, putting in 16pts to pick up 56bp in z-spread. The lower potential recovery of the 6.875s is worth about 22bp in spread terms, meaning that the swap offers a 34bp pickup on a recovery-adjusted basis. There is also one example of a high price bond trading too rich: the swap out of VIA 5.85s and into the 4.375s allows investors to pick up 15bp (on a recovery-adjusted basis).

FIGURE 3

Select High/Low Dollar Price Bond Pairs That Appear Mispriced

	High Coupon Bond				Low Coupon Bond				Spread Difference (bp)	
Ticker	Coupon	Maturity	Price	Z-Spread (bp)	Coupon	Maturity	Price	Z-Spread (bp)	Absolute	Recovery-Adj
VIA	6.875	Apr-36	$110.2	365	4.85	Dec-34	$93.8	309	56	34
VZ	5.15	Sep-23	$111.2	117	2.45	Nov-22	$98.7	85	32	31
ETP	6.625	Oct-36	$113.6	314	4.9	Mar-35	$98.9	267	47	31
JEF	6.45	Jun-27	$115.7	234	4.85	Jan-27	$105.4	205	29	19
VIA	5.85	Sep-43	$101.9	334	4.375	Mar-43	$84.2	315	19	(15)

Source: Bloomberg Barclays Indices, Barclays Research

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ETP 4.9 03/15/35 (USD 98.37, 13-Sep-2017)
ETP 6 5/8 10/15/36 (USD 113.30, 13-Sep-2017)

JEFFERIES GROUP LLC, CD/J/K/M
JEF 4.85 01/15/27 (USD 105.32, 13-Sep-2017)
JEF 6.45 06/08/27 (USD 115.69, 13-Sep-2017)

VERIZON COMMUNICATIONS INC, A/CD/CE/D/E/J/K/L/M/N
VZ 2.45 11/01/22 (USD 98.89, 13-Sep-2017)
VZ 5.15 09/15/23 (USD 111.30, 13-Sep-2017)

VIACOM INC, CD/CE/J
VIA 4 3/8 03/15/43 (USD 83.70, 13-Sep-2017)
VIA 4.85 12/15/34 (USD 94.39, 13-Sep-2017)
VIA 5.85 09/01/43 (USD 102.00, 13-Sep-2017)
VIA 6 7/8 04/30/36 (USD 110.43, 13-Sep-2017)

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