Previously published in the U.S. Credit Alpha
2 February 2018

Stumble and a Trip over Treasuries

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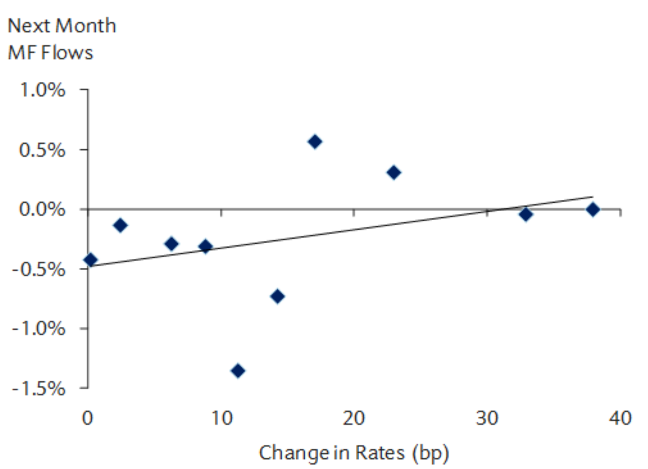
Persistent improvement in labor markets, a reasonably strong CPI print, and the related potential for a more hawkish Fed in light of its prepared comments on Wednesday have combined to propel Treasury yields sharply higher this month. Yields on 5y and 10y Treasuries have risen more than 30bp year-to-date and now sit slightly above our interest rates team's latest year-end 2018 forecasts. While Treasuries retraced some of the move into the close Wednesday afternoon following the Fed's decision to keep policy rates unchanged, our economics team notes a modestly hawkish tilt in Fed-speak with the inclusion of the word "further" in the statement (see *Everything is solid, 'further' gradual funds rate increases are likely*). The speed and magnitude of the moves have led credit investors once again to examine the link between risk-free yields and high yield.

In the meantime, high yield spreads have continued to rally through their 2014 tights even in the face of a pickup in supply and persistent outflows, with the 24bp spread tightening year-to-date through Wednesday almost offsetting the 31bp increase in 5y rates in January. As discussed in *Fuller Cushions In Lower Quality*, the ability of spreads to absorb rates is diminished when spreads have been at similar levels. And while markets have largely shrugged off weakening technicals, we take a more cautious near-term and tactical view considering tight valuations and the potential for further outflows driven by large adverse rate moves.

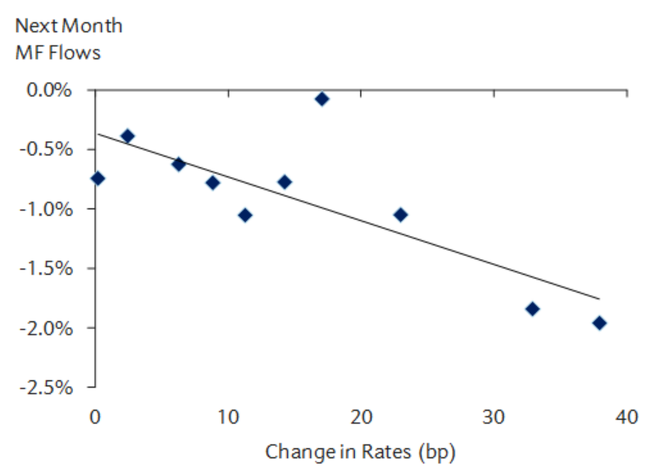
As noted in *Temporary Relief From Rate Fears*, outflows alone are typically not a catalyst for prolonged spread widening and particular pressure on returns. The recent experience has followed that playbook, and cumulative outflows of $23bn over the past 12 months have done little to derail cumulative total returns of 6.6% over the same period of generally stable or improving macro trends. But looking further back, episodes such as the “taper tantrum” suggest that the opposite can occur. Over the one-month period following the 34bp flare-up in 5y rates in May 2013, high yield mutual funds endured outflows of more than $8.5bn and the High Yield Index widened by more than 50bp. We do not anticipate a similar response, but believe that this could be indicative of the direction of fund flows, if not the magnitude.

FIGURE 1
Next Month Mutual Fund Flows (as % of AUM) versus Change in 5y Treasury Rates



Note: Measures the average one-month-forward mutual fund flow, ranked by deciles of moves in 5y Treasury rates in rising rate environments. Source: Bloomberg, Lipper

FIGURE 2
Next Month Mutual Fund Flows (as % of AUM) versus Change in 5y Treasury Rates in Tight Spread Environments

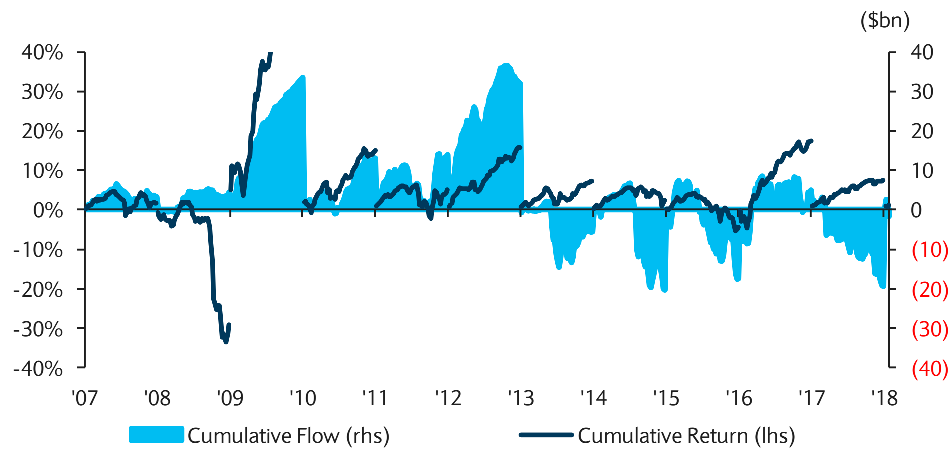


Note: Restricted to periods when high yield spreads are below 450bp. Measures the average one-month-forward mutual fund flow, ranked by deciles of moves in 5y Treasury rates in rising rate environments. Source: Bloomberg, Lipper

To examine the relationship between rate moves and flows in and out of high yield mutual funds more closely, we rank monthly moves in 5y rates by decile in rate rising environments and look at the average mutual fund flow as a percent of total AUM the following month. When considering all spread environments, Figure 1 shows that outflows tend not to materialize even when rates increase by more than 30bp, as they have recently. But restricting our analysis to months when the high yield market has started tighter than 450bp (approximately the long-term average, excluding the financial crisis), shows a clearer relationship: the sharper the rate move, the larger the outflow (Figure 2). The last two deciles, in particular, seem relevant today given a similar-sized increase in Treasury yields over the past several weeks.

FIGURE 3

Yearly Cumulative High Yield Mutual Fund Flows versus High Yield Total Returns



Source: Bloomberg Barclays Indices, Lipper

The recent divergence between flows and returns, particularly stark in 2017 (Figure 3), warrants further analysis of whether rate moves and associated outflows can be a drag on total returns. We thus tweak the analysis above to examine how High Yield Index returns vary with changes in rate movements in both normal and tight spread environments. Two things stand out:

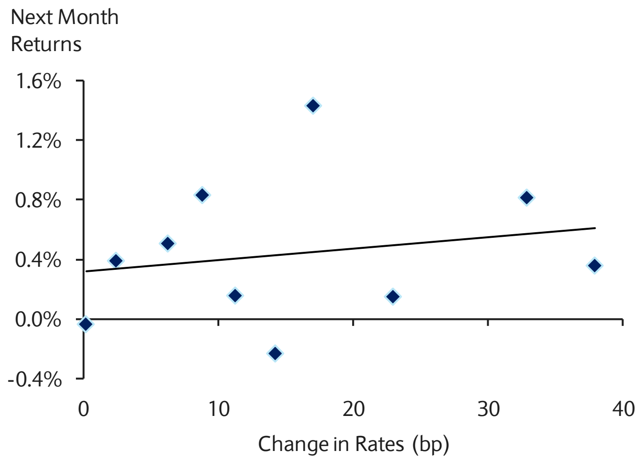
- When considering the full history of spread environments, increases in Treasury yields typically do not weigh on returns. Figure 4 shows no clear relationship between changes in 5y Treasury yields and one-month-forward total returns, largely in keeping with the results of Figure 1, which shows the ensuing fund flows.

- But in tight spread environments, adverse rate movements can affect the near-term performance of the High Yield Index. The inflection point beyond which returns are dragged down by rate movements appears to be around 23bp. Past that threshold, rate moves have, on average, tended to produce negative returns for high yield credit in the next month (Figure 5).

The findings in Figure 5, particularly the negative high yield total returns after months of large moves in Treasury yields in tight spread environments, are logical and intuitive. Carry in tighter spread environments is not able to offset the drag on total returns produced by large increases in base yields. But we think this is amplified by our findings that escalations in Treasury yields similar to those seen year-to-date have historically preceded larger-than-average outflows from high yield mutual funds the following month. Finally, last week, in *Vol Hunting Heading into Earnings*, we noted that there is historical evidence to support a pause or outright reversal

FIGURE 4

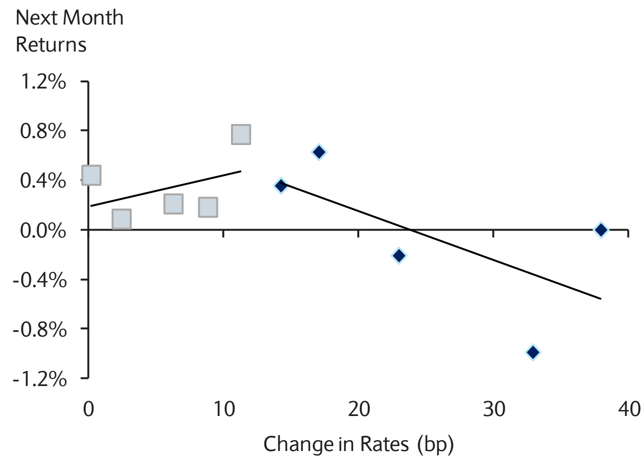
Next Month High Yield Total Returns versus Change in 5y Treasury Rates



Note: Measures average one-month-forward high yield total returns, ranked by deciles of moves in 5y Treasury rates in rising rate environments. Source: Bloomberg

FIGURE 5

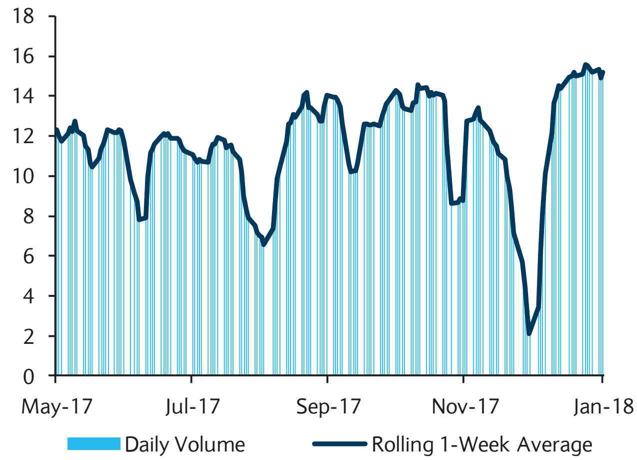
Next Month High Yield Total Returns versus Change in 5y Treasury Rates in Tight Spread Environments



Note: Restricted to periods when spreads are below 450bp. Measures average one-month-forward high yield total returns, ranked by deciles of moves in 5y Treasury rates in rising rate environments. Source: Bloomberg

in spreads during earnings seasons in similarly tight spread environments. All of these data suggest near-term caution toward the high yield asset class.

High Yield Average Institutional Trade Volume ($bn)

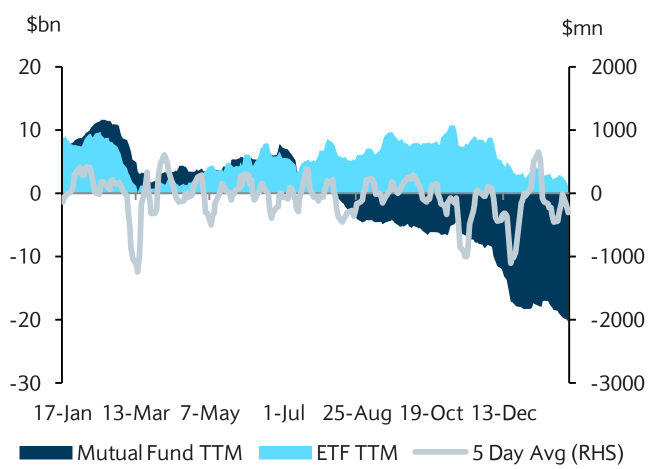


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

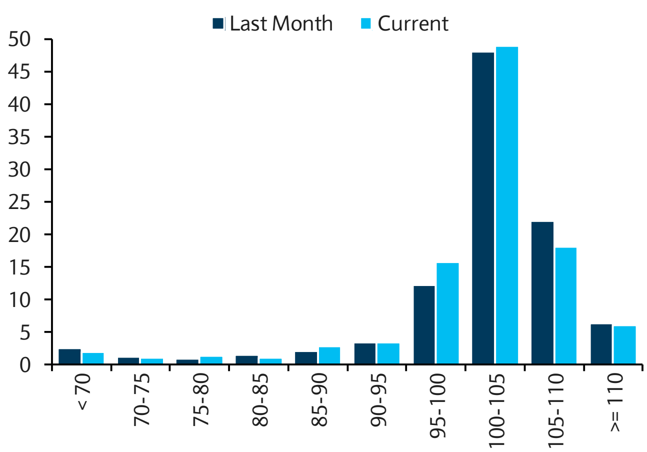
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



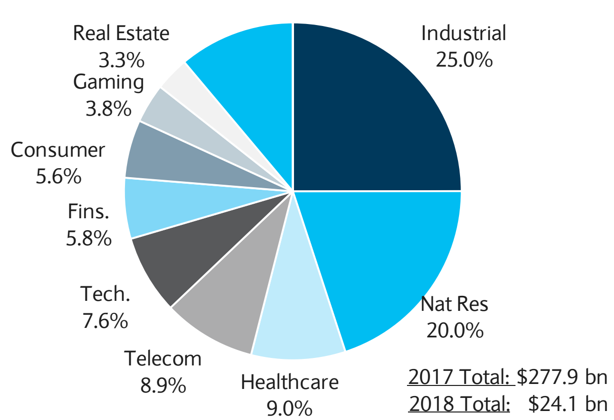
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



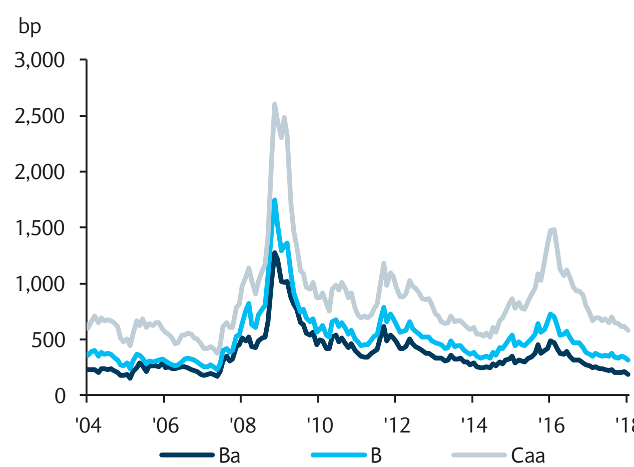
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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