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CCC Compression in Context

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

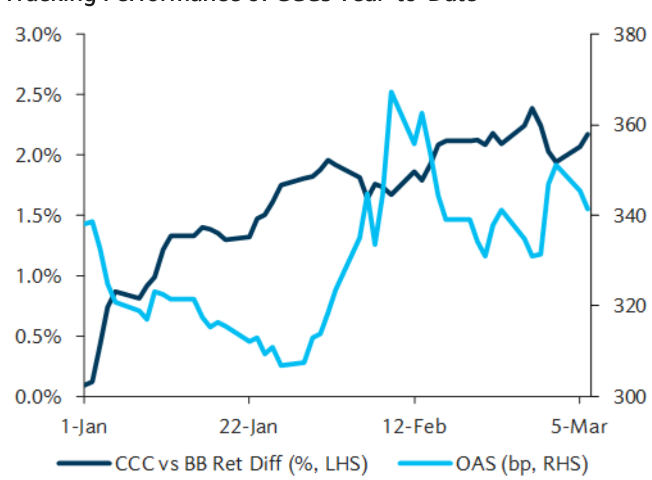
Arvind Kumar
+ 1 646 333 1184
arvind.kumar4@barclays.com
BCI, US

With corporate earnings season coming to a close, high yield credit has resumed taking its cues from broader macro developments. Treasury yields are now largely well behaved, but worries about an escalating trade war foreshadowed by the exit of White House economic advisor Gary Cohn are the latest source of external pressure on risk markets. Through all the headlines of 2018, it is notable that CCCs have outperformed broader high yield in total return terms even as high yield spreads hit their year-to-date wides in early February (Figure 1). This week, we explore both the rationale for such performance and what the historical record suggests about forward performance in similar periods.

As shown in Figure 2, CCCs have meaningfully outperformed BBs, with the spread ratio between the two rating cohorts hitting three-year lows. The outperformance has coincided with both climbing Treasury yields and an increase in the yield to worst of the High Yield Index, with the index spread essentially unchanged on the year. The lack of spread tightening in the US High Yield Index in response to higher risk-free yields indicates investor caution, in our view, as spreads typically offset around 70% of a move in Treasury yields in periods of similar starting spreads (see *Lift the Barbell, Trim the Belly*). The outperformance of CCCs, as measured by total return, can typically be explained by a better rate cushion given wider starting spreads in the short term. However, we would have expected CCCs to lag as the US High Yield Index moved wide of its January tights, which would also have been consistent with the index's higher-beta nature and the typical investor response of upgrading portfolio quality at a time of heightened risk aversion, as seen in other risk markets during February.

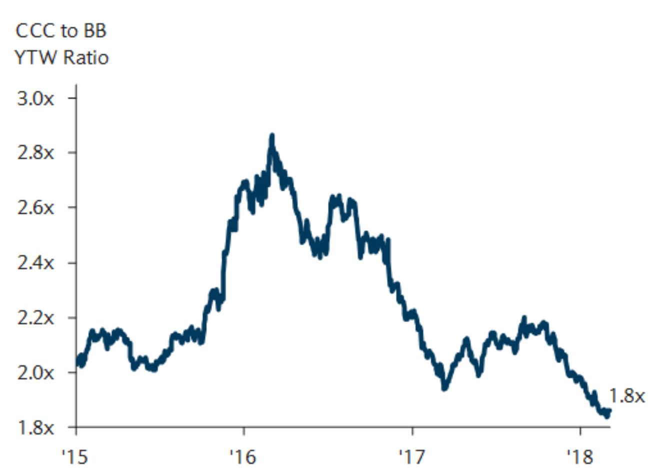
The outperformance of CCCs in 2018 raises the questions of how CCCs typically perform when rates-led sell-offs coincide with a climb in the asset's yield to worst and how that compares with other periods of climbing yield to worst? Specifically, we examine two subsets of post-crisis sell-offs starting from 2010:

FIGURE 1
Tracking Performance of CCCs Year-to-Date



Source: Bloomberg Barclays Indices

FIGURE 2
CCC to BB Yield-to-Worst Ratio



Source: Bloomberg Barclays Indices, Bloomberg

- Rates-led sell-offs: Periods when both Treasury yields and the US High Yield Index yield to worst increased. We specifically identify periods when the 5y UST yield rose by more than 10bp (about one standard deviation) in one week and the High Yield Index yield to worst climbed by more than 20bp (also about one standard deviation) over the same timeframe.

- Idiosyncratic sell-offs: Periods when the yield to worst of the High Yield Index increased without an associated spike in broader market volatility. More specifically, we identify periods when the one-week percentage change in the VIX remained within one standard deviation of the average.

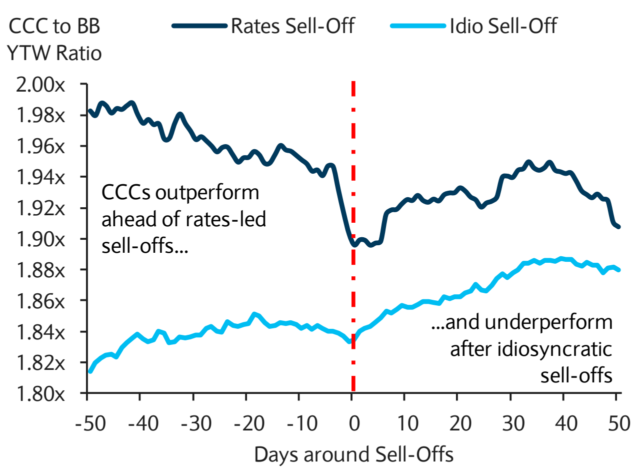
Figure 3 shows that, on average, CCC spreads compress to BBs in the lead-up to rates-led sell-offs, which dovetails well with the 58bp tightening in CCCs from the start of the year through January 26. However, history shows that CCC spreads tend to reverse briefly following a rates-led sell-off, after which the price action is more mixed. But the behavior around idiosyncratic sell-offs is very different – CCC spreads perform roughly in line with BBs prior to sell-offs, but then underperform meaningfully.

The recent outperformance of CCCs during a period of rising rates has generally followed this playbook, and the compression in the ratio of CCC to BB spreads of 0.10x through January 26 appears largely commensurate with the average compression of the ratio during similar periods (Figure 3). We believe this is more a reflection of positive idiosyncratic developments for larger credits than of true "risk-on" behavior. Figure 4 lists the largest contributors to CCC returns for the year-to-date. The larger healthcare companies shown were key beneficiaries of positive event risk, with Tenet bonds rallying after the company announced that it is exploring the sale of subsidiary Conifer Health Solutions, with proceeds used to help the company deleverage; Community Health bonds are also up on the year based on the possibility of an exchange, although sentiment has waned since 4Q earnings were released in late February (see *Setting up for An Exchange*). Meanwhile, the Intelsat structure rallied as a result of investor optimism following Chairman Pai's comments that the FCC plans to propose the next steps toward making C-band spectrum available for commercial terrestrial use.

In our view, the idiosyncratic risks of CCC issuers appear tilted to the downside in coming months, particularly if equity markets remain listless or come under renewed pressure. Indeed, a key reason for our cautious view of CCCs in 2018 is the belief that changes in the US tax code will become more apparent headwinds for lower-quality high yield credits as the year progresses. Should the release of 1Q17 earnings confirm that changes in the tax code are

FIGURE 3

CCC to BB Yield Ratio around Sell-Offs



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

CCCs Driving Outperformance Year-to-Date

Ticker	Market Value ($mn)	Total Return (%)	Contribution to Return (bp)
CYH	4,686	9.9	25
THC	6,620	4.7	17
INTEL	6,376	2.6	9
HXN	2,551	5.3	7
ENMC	1,341	9.4	7
NE	2,499	3.5	5
PETM	2,670	2.8	4
MNI	315	17.8	3
TFM	563	9.5	3
CARLTV	245	20.5	3

Source: Bloomberg Barclays Indices

starting to have an effect year-over-year, we would trim exposure to CCCs in anticipation of fundamental weakness, which, as shown in Figure 2, can lead to lower-quality underperformance.

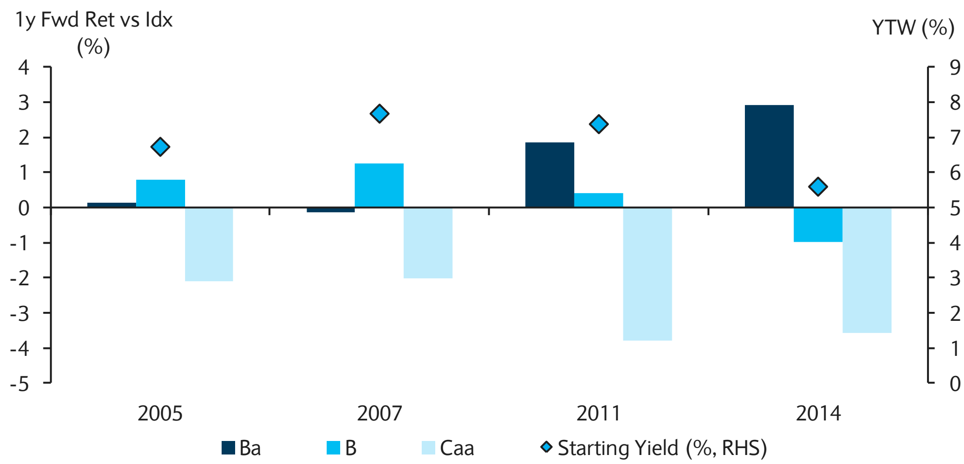
More generally, as shown in Figure 5, CCCs have underperformed in each year of sub-carry returns for the US high yield market. Assuming that our projection of sub-carry returns for 2018 is correct (see *Lower Highs*), it would be an anomaly for CCCs to outperform the broader market for the full year, considering that Bs led the way in 2005 and 2007 while BBs outperformed in 2011 and 2014.

Finally, as a couple more data points, our fundamental analysts take a more cautious view on CYH and UNIT, whose valuations do not appear to compensate sufficiently for heightened idiosyncratic volatility:

- **Community Health (CYH):** Fundamental analyst Rishi Parekh recently lowered his rating on the CYH secured notes and maintains an Underweight rating on the rest of the structure, as weak results and deteriorating fundamentals may dilute expectations on exchange levels (see *Community Health: Setting up for an exchange*)
- **Uniti Group (UNIT):** Fundamental analyst Jeff Harlib recently downgraded the UNIT unsecureds given challenges associated with the company's M&A diversification strategy, less attractive funding conditions, limited secured debt capacity, and risk of an extended restructuring process (see *4Q17: Diversification/M&A Outlook More Challenging*).

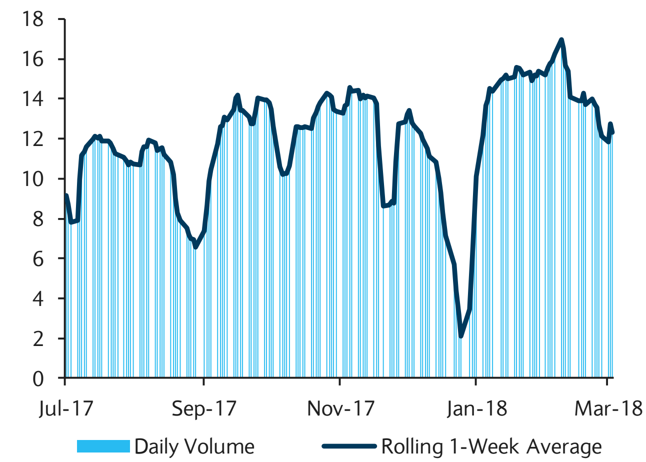
FIGURE 5

Total Returns by Rating Category in Sub-Carry High Yield Total Return Years



Source: Bloomberg Barclays Indices

High Yield Average Institutional Trade Volume ($bn)

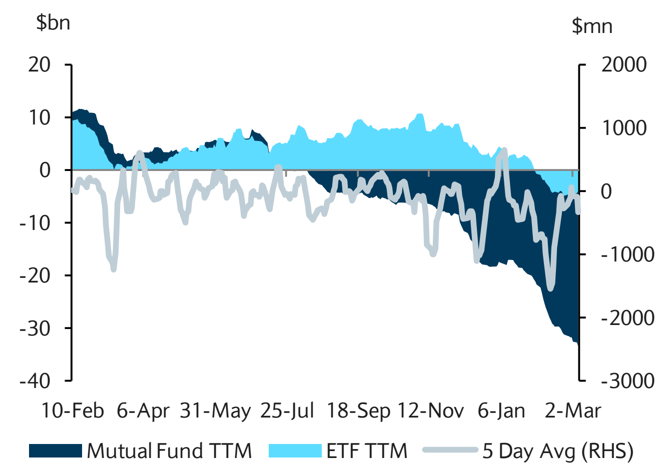


Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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

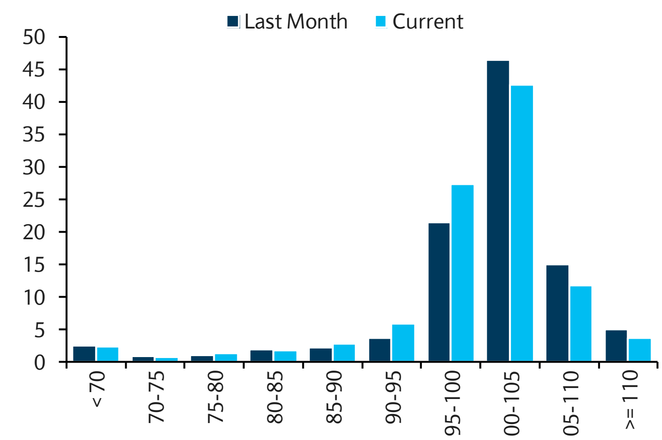
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



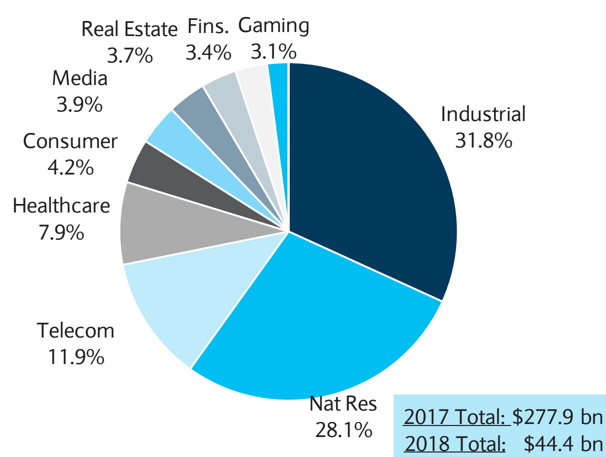
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



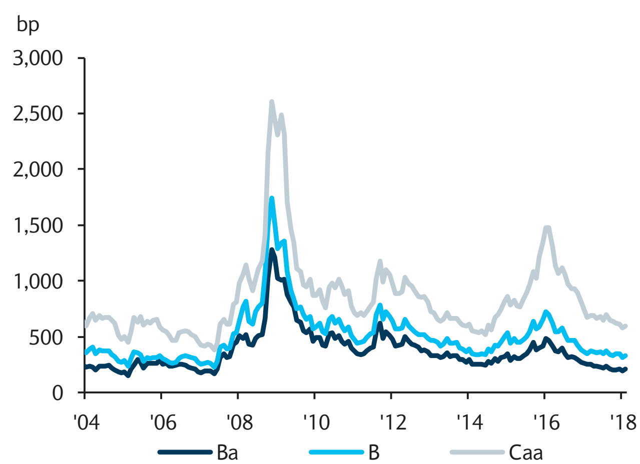
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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Materially Mentioned Issuers/Bonds

CHS/COMMUNITY HEALTH SYSTEMS INC, CD/J/K/M

CYH 5 1/8 08/01/21, Underweight (USD 91.50, 07-Mar-2018)

Valuation Methodology: Fundamentally, CYH faces a number of challenges, and we do not believe there is a path to EBITDA improvement. Furthermore, we believe the company's guidance is aggressive and free cash flow is tight. Based on this, it is difficult to assume the bonds should trade at current levels. The company's asset sale focus is a positive, but we view the EBITDA multiples are misleading. In our opinion, these asset sales are important considering secured leverage declines ahead of a possible exchange with secured notes. Despite the fundamental issues, the focus shifts to CYH's options to refinance certain maturities, thereby creating a fulcrum security that is leveraged within the normalized multiple of 5-7x. with the elimination of the interest coverage maintenance covenant, there may be near-term repricing risk that could affect 1st lien trading levels. Therefore, we rate the 1st Liens Underweight. We realize there may be a par takeout of the 2019 notes but there remains little clarity around an exchange (implying a par takeout is not definite – especially considering it does not meaningfully benefit the long-term view on the credit). We rate the 2019 notes Underweight.

Risks that May Impede Achievement of the Rating: The company may not complete the refinancing in the next 3-4 months, and the appetite for secured debt my wane under weaker fundamentals. We expect fundamentals to remain under pressure, and any delay will affect levels. Risks to the 2022 notes: the company completes a broader refinancing including the 2022 notes, the equity holders may infuse equity to shore up CYH's balance sheet, volumes improve, costs decline, and the government decides to not repeal the ACA. Risks to our 2020 rating: The company considers a par takeout or exchanges the notes at a higher level than at the time of downgrade. Risks to our UW on the 2019: par takeout. Risks to our UW on 1st liens: further clarity around 20% exclusion, if the company maintains less than 4.5x 1st lien leverage (on real EBITDA).

UNITI GROUP LP / UNITI GROUP FINANCE INC / CSL CAPITAL LLC, A/CD/D/J/K/L/M

UNIT 8 1/4 10/15/23, Underweight (USD 93.00, 07-Mar-2018)

Valuation Methodology: With a more challenging M&A diversification strategy, given continued weakness in Uniti's security prices/high cost of capital and limited secured debt capacity, a more capital-intensive growth strategy (with increased focus on towers), and high credit risk at WIN (with uncertain treatment/outcome of the Uniti lease in a potentially protracted restructuring process), we believe risk is weighted to the downside on the unsecured notes.

Risks that May Impede Achievement of the Rating: Uniti is able to diversify revenues at a faster-than-anticipated pace through acquisitions that do not significantly increase leverage.

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Market Weight (MW):

For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.
Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.
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The analyst expects the three-month excess return of the country's index eligible bonds to be in line with the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
Underweight (UW):
The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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27% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 50% of issuers with this rating category are investment banking clients of the Firm; 90% of the issuers with this rating have received financial services from the Firm.

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