Pick Your Credits and Pick Liquidity

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The rally in high yield has lost some steam, with the cash market down in 10 of the past 11 sessions. After barely exceeding $106 for two days in late June, the average price of the Barclays U.S. High Yield Index has dropped to $105.62 as of Wednesday's close. That said, the index yield remains below 5%, as it has been for more than a month. During that time, the derivatives index has been stuck at $108.5-109.0, and the recent underperformance of cash has caused the basis to become a bit more negative.

As we have discussed extensively, the pre- and post- financial crisis trading environments exhibit some stark differences, with cash market liquidity standing out as a key differentiating factor. In *Liquidity Preference* and *Liquidity Diet*, we showed the ways that liquidity had both deteriorated and become more concentrated (e.g., by bond size and age). And in *More, Smaller Trades*, we used trade size and trade count statistics to show that the height of the crisis (1Q09) represented the breakpoint in a pre- to post-crisis regime shift in the way high yield bonds trade.

Separately and more recently, as volatility has plummeted (this week's flare-up notwithstanding), the correlation between assets classes has declined, which in turn has led to lower correlation across single names within credit markets. With limited price upside and credit selection once again becoming the main source of alpha, investors have been forced to take more idiosyncratic risk.

The return of name-picking in this "new normal" lower liquidity environment begs the question of whether taking more idiosyncratic risk also means taking more liquidity risk. To answer this question we looked at the relationship between liquidity and volatility today and over time. More specifically, we used liquidity cost score (LCS), which measures round-trip transaction costs, as our gauge of liquidity and ran monthly regressions of LCS versus bond par amount and spread volatility. Our sample was further constrained to the 200 largest bonds in each monthly period, with spread volatility capped at 200% and LCS capped at 4pts.

FIGURE 1
Cash and CDS Movers

High Yield Cash					
Best	Px	Chg	Worst	Px	Chg
CPN 7.5 '21	111.48	+3.2	RTSX 9.875 '17	77.00	-15.0
FE 7.375 '31	118.52	+2.1	VRS 11.75 '19	90.00	-5.0
WLT 8.5 '21	56.50	+2.0	PHH 6.375 '21	102.87	-2.9
High Yield CDS					
Best	5y	Chg	Worst	5y	Chg
RSH	61.9 pts	-1.0 pts	JNY	5.8 pts	+1.3 pts
X	382 bp	-10 bp	CHK	166 bp	+18 bp
ABS	458 bp	-9 bp	JCP	9.7 pts	+1.0 pts

Source: Barclays Research

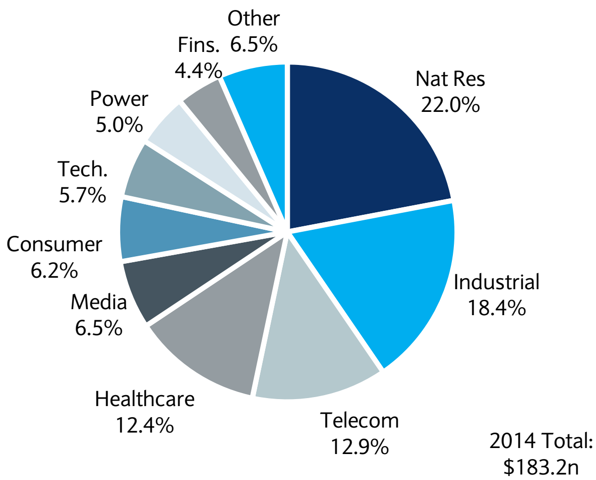
FIGURE 2
Beta of LCS and Spread Volatility, Par

Note: 3m moving average of monthly betas. Source: Barclays Research

The dark blue line in Figure 2 shows that the relationship between liquidity and volatility has itself been quite volatile. In most periods the beta is negative, meaning that bonds with higher spread volatility have lower LCS, holding size constant; therefore, in normal times, higher idiosyncratic risk actually comes with the benefit of higher liquidity, a result similar to what we observed in the CDS market (see *The Long and Short of CDS*). In rare instances when broad market volatility has been extreme (e.g., the global financial crisis, the debt ceiling debacle), the relationship has inverted, with the most volatile bonds becoming the most expensive to trade.

That behavior makes sense intuitively. In a low vol environment, the “story” credits will be both among the most traded (i.e., most liquid) and the most volatile. When macro risks flare up, the same credits are generally much lower because of their higher beta, making them much less likely to trade. The relationship between volatility and liquidity has admittedly become somewhat weaker recently. That said, it remains true that the higher beta credits are among the most liquid, which should give solace to investors who share our view that, in the current environment, outperformance must come at the cost of higher idiosyncratic risk.

High Yield Supply by Sector – 2014 Breakdown



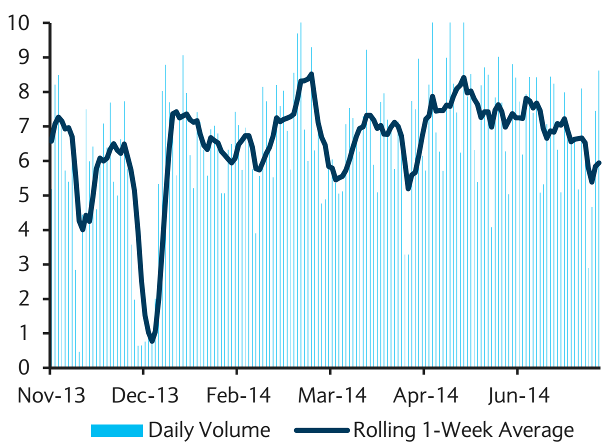
Source: Barclays Research

Top On-the-Run CDX Index Names by Weekly CDS Volume

	Notional Outstanding ($bn)		Volume – Week Ending 7/4/14 ($mn)
	Gross	Net	Gross
MBIA Insurance	47.0	1.8	982.4
L Brands	16.9	0.9	745.6
Caesars Ent. Op.	27.6	2.2	744.0
McClatchy	9.5	0.5	517.4
Supervalu	8.7	0.5	387.4
Avis Budget Group	7.8	0.4	371.3
Radian Group	23.7	1.0	367.4
MGIC Investment	18.9	0.7	352.7
Lennar	17.3	0.9	293.2
Kate Spade	11.9	0.5	290.8

Source: DTCC

High Yield Average Institutional Trade Volume ($bn)

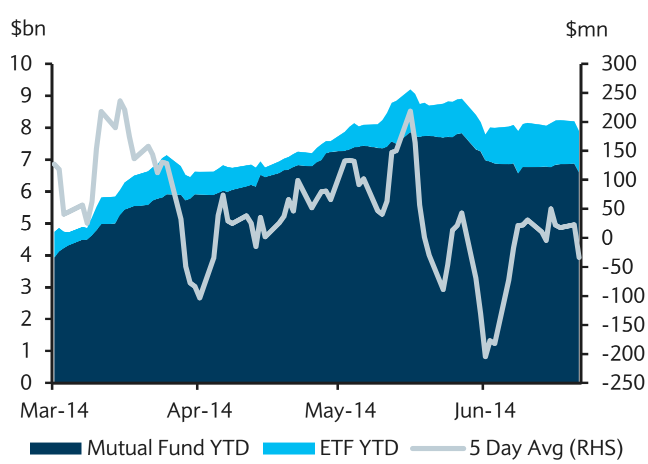


Source: FINRA TRACE

On-the-Run HYCDX versus U.S. High Yield Index

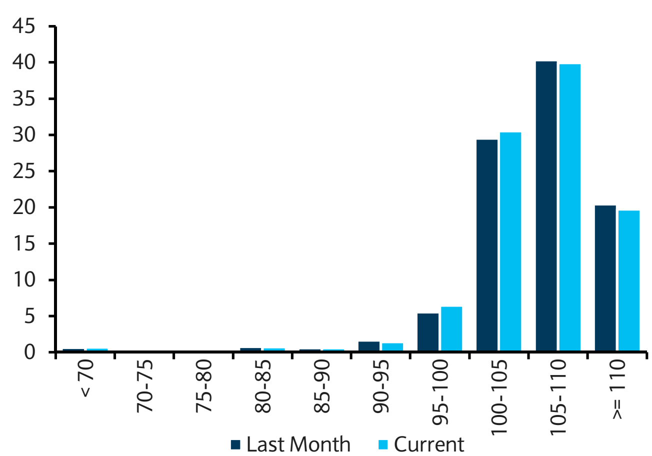
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

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