# High Yield Strategy

# Solving the CCC Puzzle

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## HY shrugs off the formal end to accommodative policy

HY has widened modestly by 3bps from its low print last week (324bps) on lower Trsy yields alongside the FOMC meeting that concluded largely as expected. The combination of spread and yield moves produced a negligible total return of +0.02% over the past week, which ranged from -0.04% in BBs to +0.24% in CCCs. In terms of excess return, CCCs outperformed both HY and BBs by 20bps and 30bps respectively.

Most sectors widened for the week with healthcare (HCA, UHOS, MNK), materials (NCX, AKS, HL), and media (CCO, NLSN, SIRI) being the top contributors. The opposite end of the spectrum was energy (CRC, EPENEG, ASCRES) and cable (SFRFP, ATCNA, CVC).

Overall US HY had a good month of September, edging higher by 0.4% in total and 1.1% in excess return terms, and bringing its YTD numbers to 2.4% and 3.3% respectively. EM HY outperformed DM USD HY by 100+bps in excess returns over the past week, with EM single-Bs outperforming its US counterpart by 150+bps. So far in September, EM single-Bs have outperformed the US comps by over 2.8%, and their valuation gap remains at 75th percentile of its historical range to this day.

The FOMC raised rates by 25bps to 2.0-2.25% on Wednesday, as was widely expected. The overall tone of the press conference sounded a bit soft to the market, leading to a decline in 10yr Trsy yields and flattening of the yield curve. The former came down from its recent peak of 3.10 earlier this week to 3.05% at the time of this writing, and the latter gave back most of its recent re-steepening, returning to 22bps.

The removal of "accommodative" policy language from the FOMC statement is nothing more than stating an observable fact, even if it sounds like an end to an era. With this rate hike, the level of Fed Funds now exceeds the level of core PCE for the first time since the financial crisis. We are officially out of negative real rates.

In technicals this week, we saw marginal fund outflows (-$200mn) coupled with quiet coupon/calls/maturities (+$800mn across all three combined) and -$900mn decline in dealer inventories. Albeit modest, this marks the first such week of negative net cash in our market since March. Looking forward, next week brings heavy coupon intake (+$4.7bn) and calls/maturities (+$2.5bn). The week of Oct 12th shows little in a way of coupons and +$2.7bn for calls/maturities.

The new issuance currently runs at $4.7bn for this week, contributing to the $17.8bn tally for the month of September, a bit short of our $19bn initial projection. Looking into October, we are projecting $9.7bn in coupons, $3.2bn in maturities, and $13bn in calls/tenders coming in to offset $22bn in potential issuance. October/November issuance tends to benefit from some of the strongest seasonal trends. Our full year 2018 estimate remains at $225bn, which would represent a 17% drop from 2017, if achieved. Our next-12mo estimate currently stands at $265bn.

Overall, we continue to view the market as being a decent fundamental value but struggling with tight valuations. We recommend continued modest de-risking over time and discuss our quality positioning in-depth on the following pages. We still like EM over US, albeit naturally less so given the strong outperformance there in recent weeks.


**Refer to important disclosures on page 5 to 6.**
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Timestamp: 28 September 2018 05:00AM EDT

Our commodity strategists have lifted their average Brent crude oil price forecast for 2019 from $75/bbl to $80/bbl compared to forwards of $75. Their previous projections assumed Iran supply losses of 500 thousand b/d, which is now revised upward to 1mn b/d on a more aggressive US stance. Meanwhile, demand projections for 2019 are roughly unchanged as weaker growth in EM offsets stronger growth in DM.

The HY market has an established track record of positive correlations to oil, which was etched in memories during the 2014-2016 episode. All else being equal, higher oil implies tighter HY spreads.

## Solving the CCC Puzzle

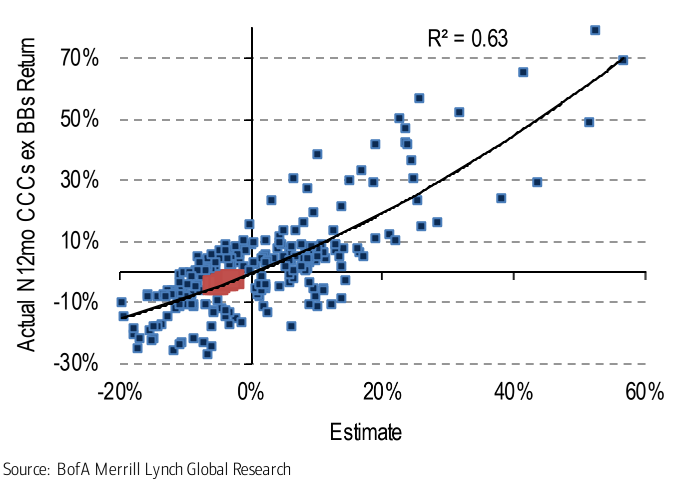
CCCs have outperformed higher quality segments of the HY market by a wide margin so far this year (+5.6% in excess returns). Most of this outperformance happened in the first 5.5 months of the year, as their edge over the past three months has narrowed to just +0.29%.

Our views on this sector have evolved from being overweight going into the year, to marketweight by mid-spring, to an underweight by early summer. We still believe that an underweight stance is the right way to position in CCC risk here, and we do not view the 29 basis points of outperformance they delivered since mid-June as the right level of compensation for the amount of credit risk investors are taking in this market segment.

Having said that, an "underweight" stance is not a black-or-white, all-or-none type of decision, and we advise against reading our opinion as such. As we discussed on a number of occasions since June, we think CCCs are trading on the tight side of things, but their levels are not at extremes yet.

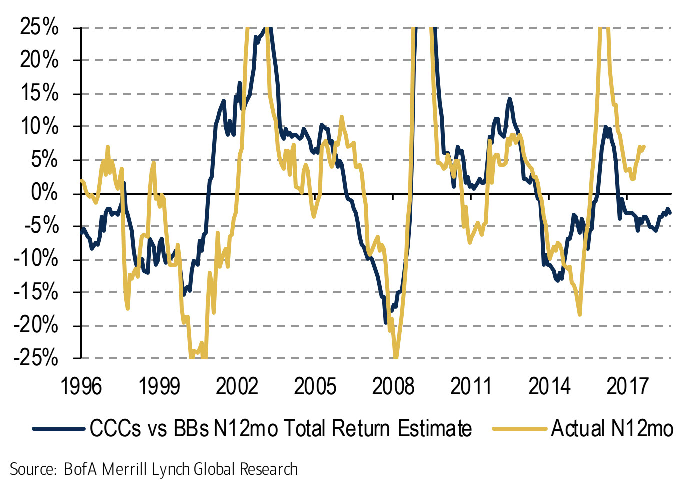
To witness, Figure 1 shows that our model estimates for next-12mo excess returns in CCCs ex BBs (calculated as a difference between respective total returns) on a horizontal axis and actual realized next-12mo returns on the vertical axis. The graph demonstrates a tight 63% r-sq relationship between the two series.

**Figure 1: Actual vs Estimated next-12-month CCCs ex BB total return**




Source: BofA Merrill Lynch Global Research

**Figure 2: Actual vs Estimated next-12-month CCCs ex BB total return**




Source: BofA Merrill Lynch Global Research

Red dots highlight the latest observations – estimates produced over the last 11mo, for which the actual realized performance is not yet known. The scatterplot suggests that while expected excess returns in CCCs over BBs are modestly negative, they are not material (latest prints are coming in the -2..-3% zip code).

Importantly, the scatterplot makes it evident that in the past, actual realized excess returns for estimates in this zip code sometimes came in positive, even if only in rare cases. Thus, the proper way to read this signal is to be prepared for likely modest CCCs underperformance against BBs, but not rule out a possibility of a continued, somewhat surprising, outperformance. The model estimate needs to be more negative for the confidence in CCC underperformance to reach stronger levels. We are just not quite there yet, so while an underweight in CCCs is warranted here, it is not the right time for an all-in move.

Figure 2 provides additional color around this relationship by plotting it in a time-series form, with our next-12mo estimates in blue graphed against actual realized next-12mo total return differential between CCCs and BBs in yellow. Naturally, the last 11mo on the yellow line are absent, as those values are not yet known.

Two key observations come out of this graph. First, it further demonstrates a relatively tight, albeit imperfect, fit between the two series: when blue line is materially away from zero, yellow line tends to follow it with only rare exceptions. And second, it helps put the current estimate (-2..-3%) on the map of known historical ranges. At extremes, its values could go materially lower and reach -15..-20%, just like they did in March 2014, August 2007, and November 1999. So way more to go before we get to the "big short" kind of levels.

Piecing all these bits of evidence together, we come to the conclusion that now is the right time to be building an underweight in CCCs. The current level of deviation in CCC vs BB expected return is equivalent to a 0.5x standard deviation event. At its previous bottoms in March 2014, August 2007, and November 1999 this measure was at equivalent of 1.25-1.5x st dev event. So when we think of the appropriate scale of risk tolerance for this trade, we think along those lines.

The most appropriate strategy is, in our view, to begin building a CCC underweight here while remaining willing and able to go into a deeper underweight if they continue to tighten against BBs going forward. Given the actual CCC market weight of 12.8% in our DM USD HY index, we think current signal supports a 20% cut in CCC positions, bringing their index weight down to roughly 10.3%. Also, because the signal is still relatively weak, we think it is appropriate to spread that excess risk budget between single-Bs and BBs in equal proportions. So the share of BBs grows modestly from 45.7% to 46.9% and the share of single-Bs grows from 41.5% to 42.8%.

The combined new weights (46.9% + 42.8% + 10.3%) still add up to 100%. Importantly, the new portfolio effective yield (6.14%) and OAS (317) are only 9bps below respective measures of the passive index (6.23% and 326bps).

Therefore, our expected returns from this point on should not be materially different from a passive portfolio, even though we are taking 20% less CCC risk. As Figure 2 shows, this signal strength is not new, and it lasted throughout the summer since we recommended an original shift towards underweight. Looking back at recent performance, a portfolio structured this way would have posted total and excess returns that are within 1bps of the realized measures on H0A0.

If CCCs continue to outperform from here, such positioning allows us to further cut our risk allocation to this sector, while not experiencing an immediate performance drag. We would also continue to re-allocate risk to both single-Bs and BBs as/if the model signal grows from its current deviation of -0.5x towards -0.75x, 1.0x, and beyond. At those later stages, it would make sense to cease adding allocations to single-Bs and move more aggressively to BBs. At extreme signal levels of 1.25x and beyond, our allocation model would imply zero weight in CCCs and all excess risk budget going to BBs. We are miles away from those levels at the moment however.

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