Take a Hike without Breaking a Sweat

Bradley Rogoff, CFA
+1 212 412 7921
bradley.rogoff@barclays.com

Eric Gross
+1 212 412 7997
eric.gross@barclays.com

Anthony Bakshi
+1 212 412 5272
anthony.bakshi@barclays.com

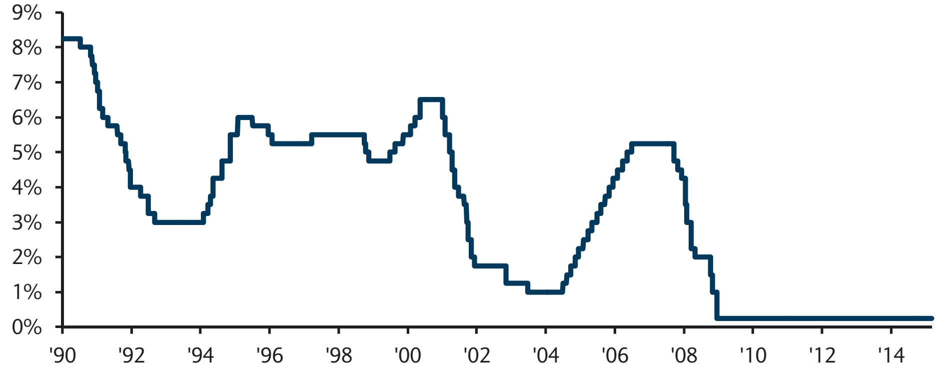
The fed funds target rate has been near zero since late 2008 (Figure 1), and the Fed looks poised to tighten this summer. According to news reports,[1] it is strongly considering removing language promising to be "patient." This is consistent with economist forecasts of upcoming Fed decisions. About one-third of economists participating in the Bloomberg survey expect an increase in fed funds in the second quarter, while only 15% expect the target rate to remain 0.00-0.25% in the third quarter. Of the remaining 85%, about half expect the rate to be 50bp in 3Q, while the rest expect a jump to 75-100bp.

We continue to believe that high yield investors are well protected from rates, with spreads typically absorbing a significant fraction of the change in Treasury yields. Historically, the average beta between spreads and rates in months when rates rise has been -1.0, implying full absorption of rates moves in spreads (see *Global Credit Outlook 2014*, pp. 41-43). The current situation is admittedly out of sample, given more than six years of zero interest-rate policy and the divergent courses set by the Fed and the ECB. In addition, the initial reaction to rising rates can certainly be less positive for the asset class, driven by retail outflows. That said, with an average high yield spread of over 450bp, representing about 73% of average yield, we are comfortable with the market's ability to withstand an increasing rate environment and expect high yield to perform well once any retail outflows abate.

Nonetheless, with the market focused on the imminent rate hike, we explored the historical relationship between such events and the Treasury and high yield markets. Going back to 1990, we find 31 instances of tightening, and the pattern in the rates market is both clear and intuitive: 2y, 5y, and 10y rates increase in the 100 days leading up to the Fed hike, with shorter maturity yields increasing the most (Figures 2-4). Rates are relatively flat, on average, in the 100 subsequent days, suggesting that the decision was mostly priced in.

While high yield has performed well through tightening events (Figures 5-7), the performance in the period leading up to the hike and the period following suggests skewing toward lower quality. Our lookback is limited to mid-1997 due to the availability of daily data. However, in our sample period (23 rate hikes), average double-B performance in the 100 days post-hike is 1.4x that of the pre-hike period. Single-B performance is more balanced pre- and post-, while triple-C bonds actually perform 1.7x better before the hike, as rates are rising, than after. These results are consistent with our previous analysis of spread and rates betas and support our view that double-Bs are poised for underperformance.

FIGURE 1
Fed Fund Target Rate



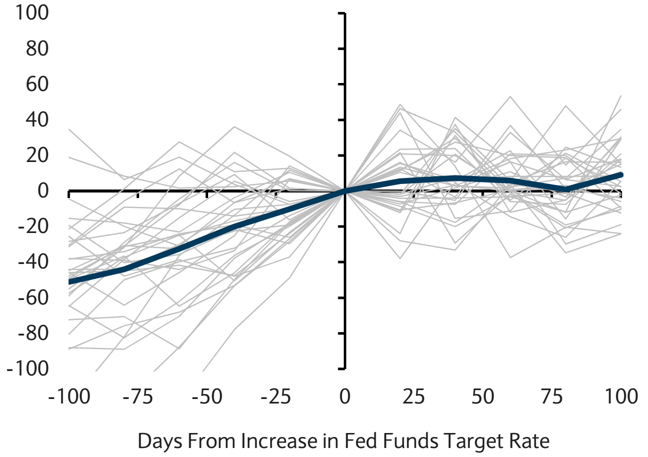
Source: Bloomberg

[1] "Fed Likely to Remove 'Patient' Barrier for Rate Increase as Soon as June," *Wall Street Journal*, March 11, 2015.

TREASURIES

FIGURE 2

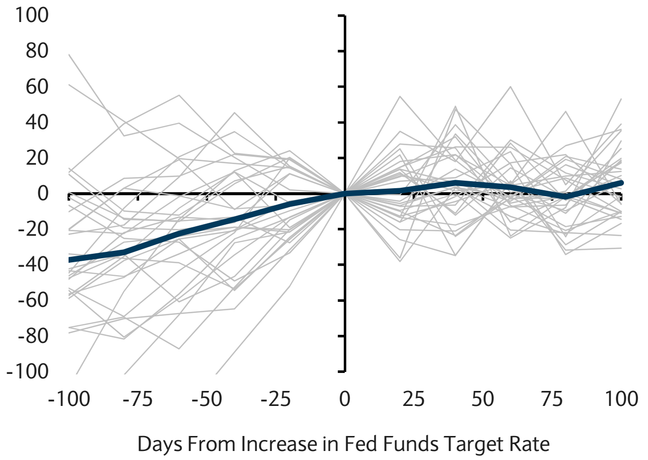
2y Treasury: Cumulative Yield Change around Fed Hikes (bp)



Note: Fed hikes since 1990 (N=31); Average in blue. Source: Barclays Research

FIGURE 3

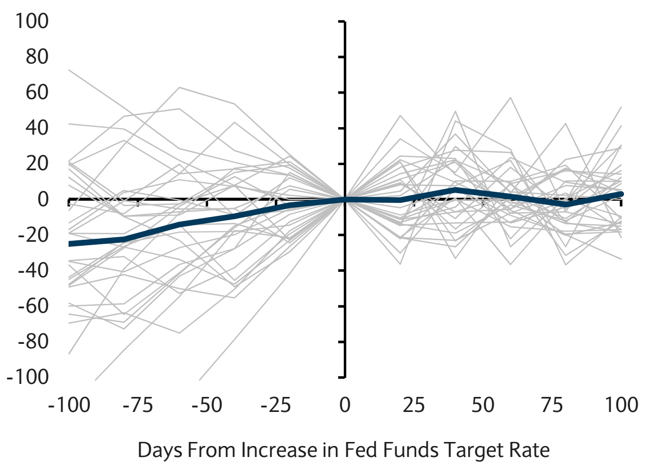
5y Treasury: Cumulative Yield Change around Fed Hikes (bp)



Note: Fed hikes since 1990 (N=31); Average in blue. Source: Barclays Research

FIGURE 4

10y Treasury: Cumulative Yield Change around Fed Hikes (bp)

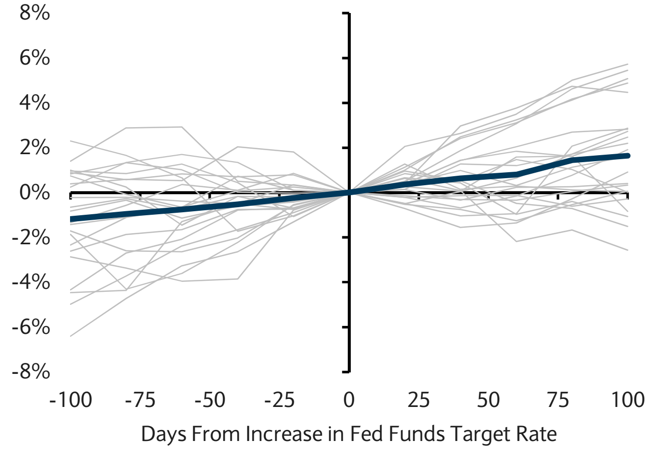


Note: Fed hikes since 1990 (N=31); Average in blue. Source: Barclays Research

HIGH YIELD

FIGURE 5

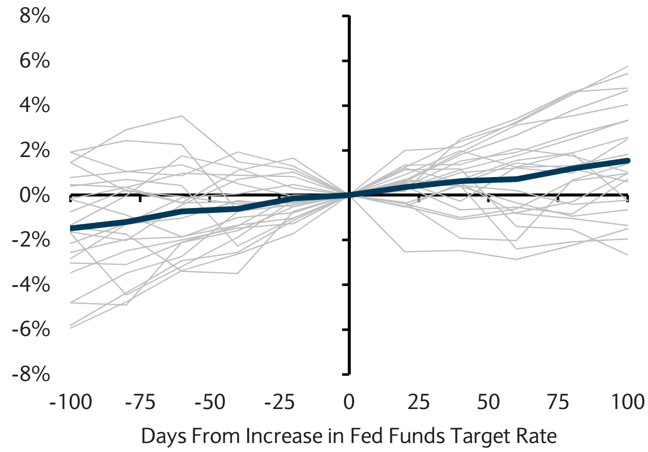
U.S. HY BB: Cumulative Total Returns around Fed Hikes



Note: Fed hikes since 6/97 (N=23); Average in blue. Source: Barclays Research

FIGURE 6

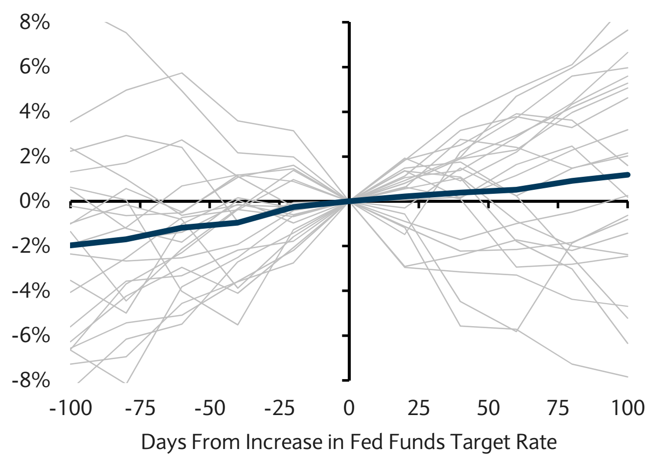
U.S. HY B: Cumulative Total Returns around Fed Hikes



Note: Fed hikes since 6/97 (N=23); Average in blue. Source: Barclays Research

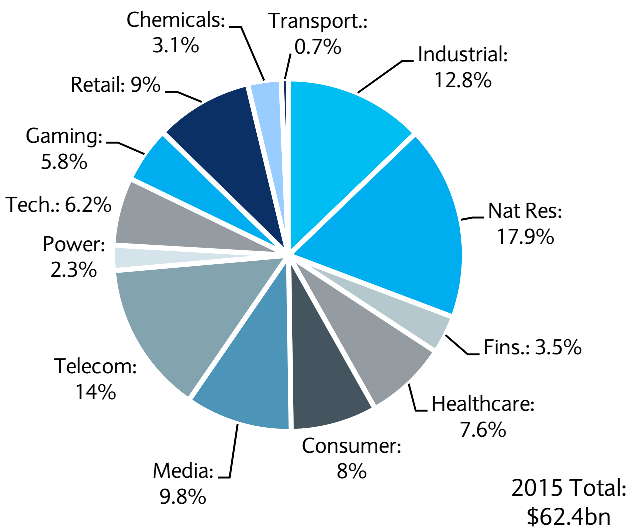
FIGURE 7

U.S. HY CCC: Cumulative Total Returns around Fed Hikes



Note: Fed hikes since June 1997 (N=23); Average in blue. Source: Barclays Research

High Yield Supply by Sector – 2015 Breakdown



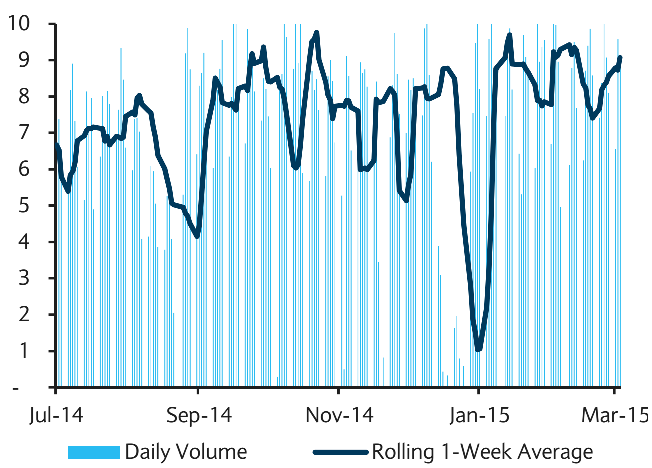
Source: Barclays Research

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

	Notional Outstanding ($bn)		Volume – Week Ending 3/6/15 ($mn)
	Gross	Net	Gross
MBIA Insurance	37.0	1.2	683.2
Bombardier	9.4	0.7	242.7
Heinz	12.3	0.9	217.0
Freescale	4.2	0.6	208.7
ILFC	16.4	1.2	177.7
JC Penney	19.4	1.0	166.4
Chesapeake	9.8	0.9	163.5
Tenet Healthcare	5.4	0.5	159.3
Centurylink	12.1	0.9	151.5
PulteGroup	12.9	0.6	151.1

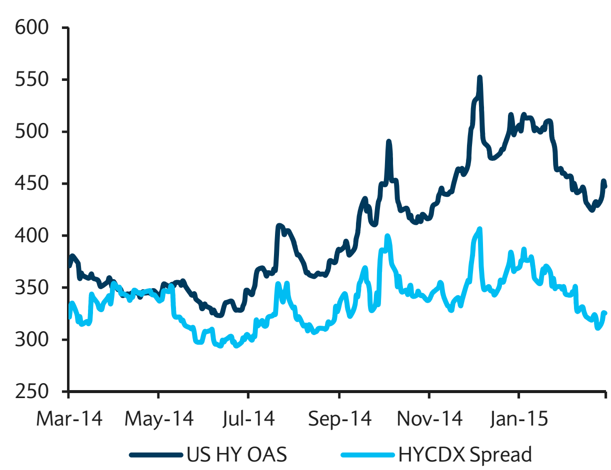
Source: DTCC

High Yield Average Institutional Trade Volume ($bn)



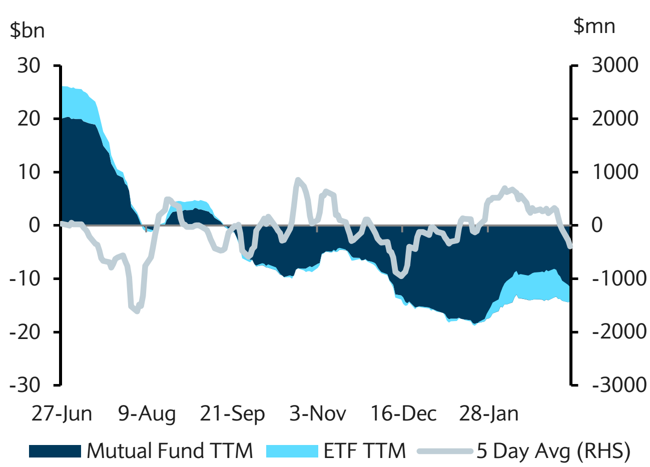
Source: FINRA TRACE

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



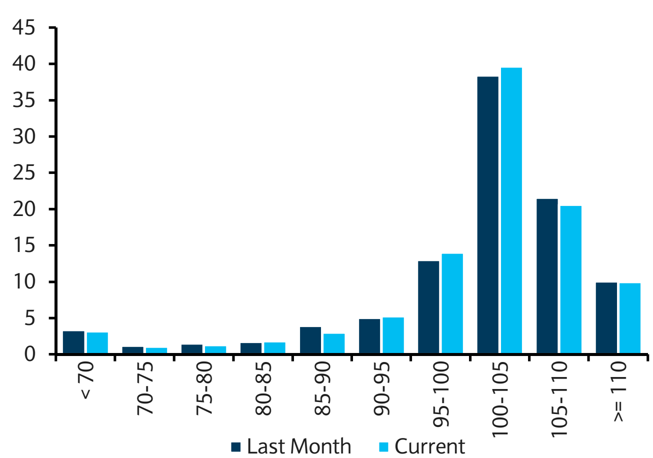
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



Source: Barclays Research

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