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Greater Volumes for the Most Liquid Bonds

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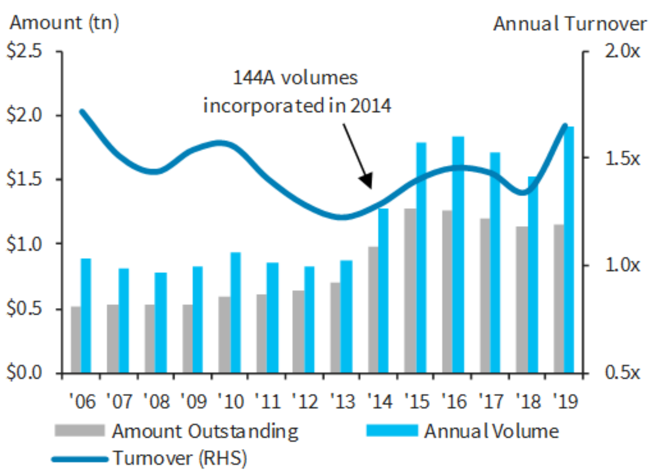
The high yield market has continued its march tighter through the first half of April, albeit at a much slower pace than in the first two months of the year. As we noted last week (*Checking in on Fundamentals and Technicals*), both the corporate backdrop and retail inflows have been supportive of high yield valuations, propelling the high yield index spread to under 350bp – a level last reached in early November of 2018, before the end of year sell-off occurred. The high yield index has returned 8.53% year-to-date, with the rally being led by higher quality as BBs (total return of 8.25%) have outperformed and CCCs (total return of 8.62%) have underperformed on a beta-adjusted basis. Given the lack of beta-compression in the rally, we find value further down the quality spectrum with preference for single Bs and select CCCs (*Categorizing CCCs*).

This rally has also been marked by increased trading volumes, with high yield turnover on pace for the highest level since 2006 (Figure 1). When we annualize 1Q19 volume based on historic quarterly seasonality, we find that 2019 is tracking for a turnover rate of nearly 1.7x, up from 1.4x in each of the last two years. On a quarter-over-quarter basis, trading volumes in the first three months of this year were in line with 1Q18, despite the index decreasing by over 4% in terms of amount outstanding and first quarter supply being down 4% relative to last year.

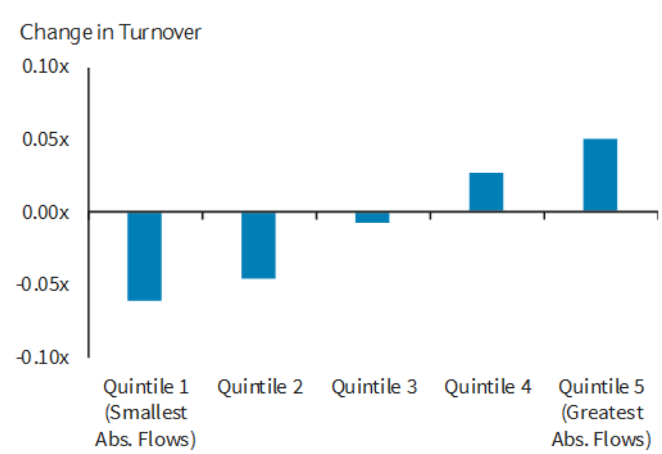
In addition to decreased supply, retail demand has also contributed to increased turnover. When we bucket the absolute level (both inflows and outflows) of quarterly retail flows since 2006 into quintiles, we find that there exists a direct relationship between large flows and increased market turnover. Figure 2 shows that the quarters with the smallest level of absolute flows result in a decrease in turnover while quarters with the largest absolute flows result in a notable increase in trading turnover. The first quarter of 2019 was in quintile five given the large level of flows ($10.6bn of inflows per Lipper) and helps explain the increase in turnover in the quarter.

FIGURE 1
High Yield Volume and Turnover in 2019 Are on Pace to Near Recent Highs



Note: 2019 volumes annualized based on historic cadence of volumes by quarter.
Source: Bloomberg Barclays Indices, MarketAxess

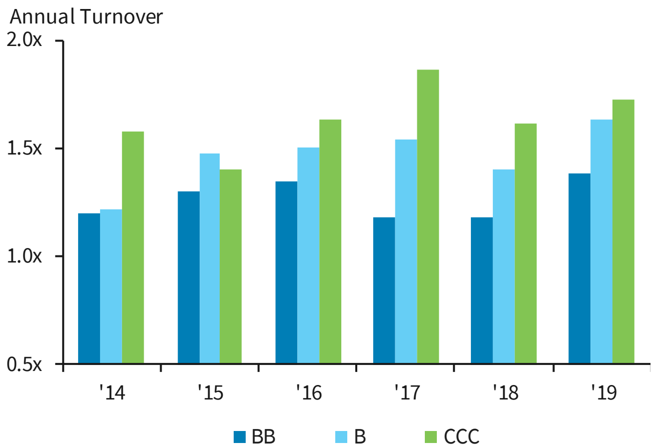
FIGURE 2
Quarters with Significant Retail Flows Result in Increased Turnover



Source: Bloomberg Barclays Indices, MarketAxess, Lipper

FIGURE 3

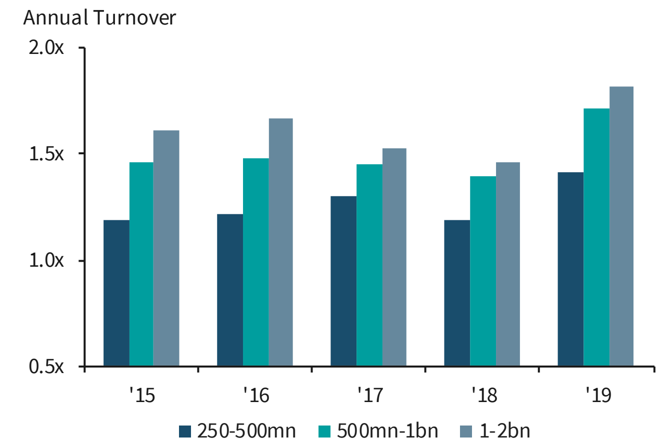
Turnover Is on Pace to Increase Significantly for BBs and Bs in 2019…



Note: 2019 volumes annualized based on historic cadence of volumes by quarter.
Source: Bloomberg Barclays Indices, MarketAxess

FIGURE 4

…as well as for Bonds with the Greatest Size



Note: 2019 volumes annualized based on historic cadence of volumes by quarter.
Source: Bloomberg Barclays Indices, MarketAxess

The increased trading activity was felt most in higher-quality and larger issuances, the same segments that retail funds generally prefer. Barring any significant change to the dovish stance by the Fed or the corporate fundamental backdrop, we expect retail fund inflows to persist, which should support trading volumes, specifically for the higher-rated and larger tranches.

While the year-over-year increase in volumes was felt for all ratings buckets, it was least notable for lower quality (Figure 3). BB and single-B annualized turnover was up 17% while CCC volumes were only up 7%. In fact, annualized turnover for BBs and Bs were at their highest levels in recent years. Conversely, while CCC annualized turnover of 1.7x was higher relative to 2018, it still did not reach the recent peak of 1.9x in 2017.

The increased trading volumes were also concentrated in the largest tranches of bonds. As seen in Figure 4, annualized turnover increased 25% for bonds with $1-2bn outstanding and just 19% for bonds with $250-500mn outstanding. Returns have also been greater for larger issuances, with year-to-date total return of 9% for bonds with $1-2bn outstanding, roughly 120bp greater than bonds with $250-500mn outstanding.

Understandably, there is some overlap between higher quality and larger issuance size as better-rated issuers generally have larger tranche sizes than lower quality issuers (as BBs are most likely larger companies and have greater access to capital). This relationship, though, is not as significant as many would expect –the average amount outstanding for BB bonds is $660mn, just 3% and 9% larger than the average size of single-Bs and CCCs, respectively. Given that the size difference between the ratings cohorts is limited, the increased turnover for larger issues this year has not been entirely driven by quality.

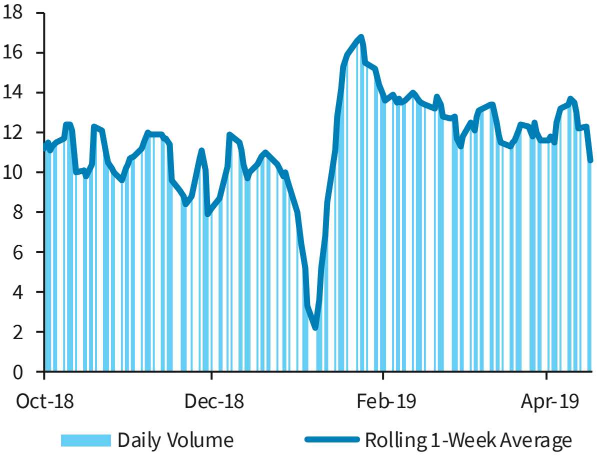
The increased trading levels for the high yield index, particularly for these segments of the market, can in part be attributed to strong retail inflows thus far in 2019. While retail funds represent roughly 20% of the high yield buyer base, they tend to have higher turnover than other segments of high yield demand (such as pension funds, investment grade/income funds, and insurance portfolios). These retail funds also tend to favor more liquid paper, which allows them to increase and decrease risk in a somewhat more cost-efficient manner.

This preference is evident in the outperformance of the most liquid portions of the market. For example, the US High Yield Very Liquid Index (VLI), which includes only US High Yield

Index bonds that have at least $500mn outstanding and were issued in the last five years, has returned 9.5% in 2019, nearly 100bp more than the US High Yield Index. The VLI is only modestly better in quality than the US High Yield Index, with BBs representing 46% and CCCs representing 14% of par relative to 44% and 15% for the High Yield Index, respectively. The more significant difference between the two indices is tranche size – with the VLI having an average par amount of over $900mn, well above $650mn for the US High Yield Index.

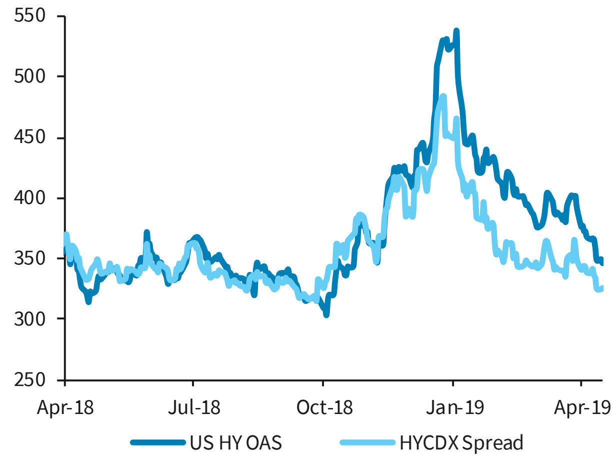
With liquidity higher thus far in 2019 as a result of fund inflows, this trend should continue, barring a radical shift in retail flows. Ultimately, we expect the macro economic backdrop to remain supportive for high yield fundamentals and technicals, especially given the dovish Fed positioning (our house view is for zero rate hikes through 2020). As a result, retail inflows will likely continue over the near term, even if at a slower pace. This technical should support trading volumes for the remainder of 2019, especially for higher quality paper and larger issuance sizes.

High Yield Average Institutional Trade Volume ($bn)



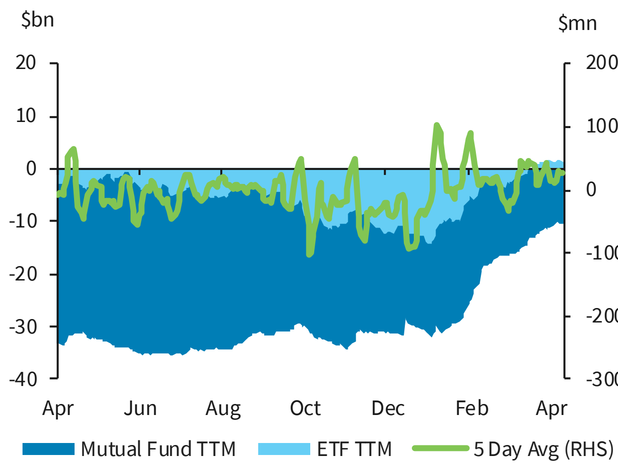
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

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



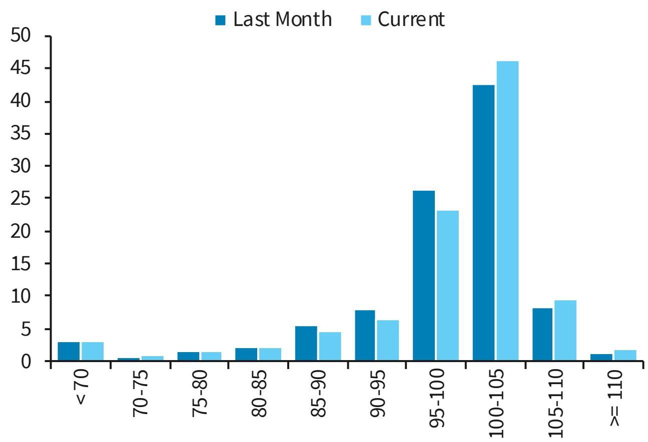
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



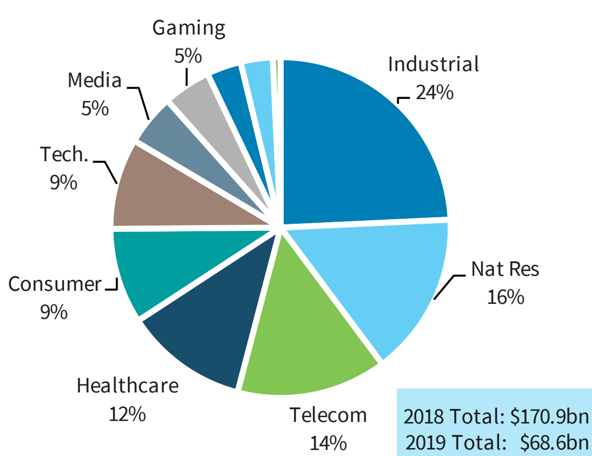
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



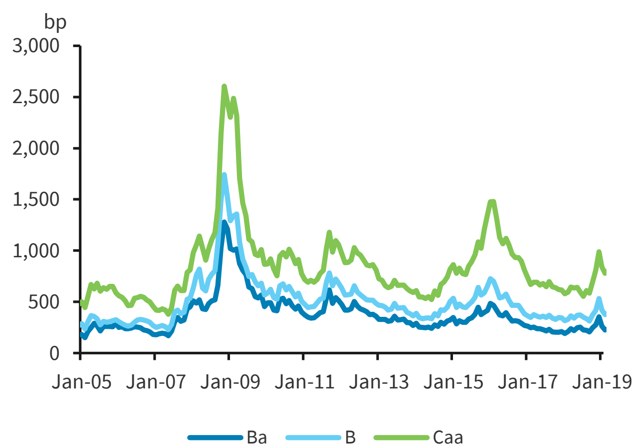
Source: Barclays Research

High Yield Supply by Sector



Note: 2019 new issue data as of April 16.
Source: Bloomberg Barclays Indices

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

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