Insights

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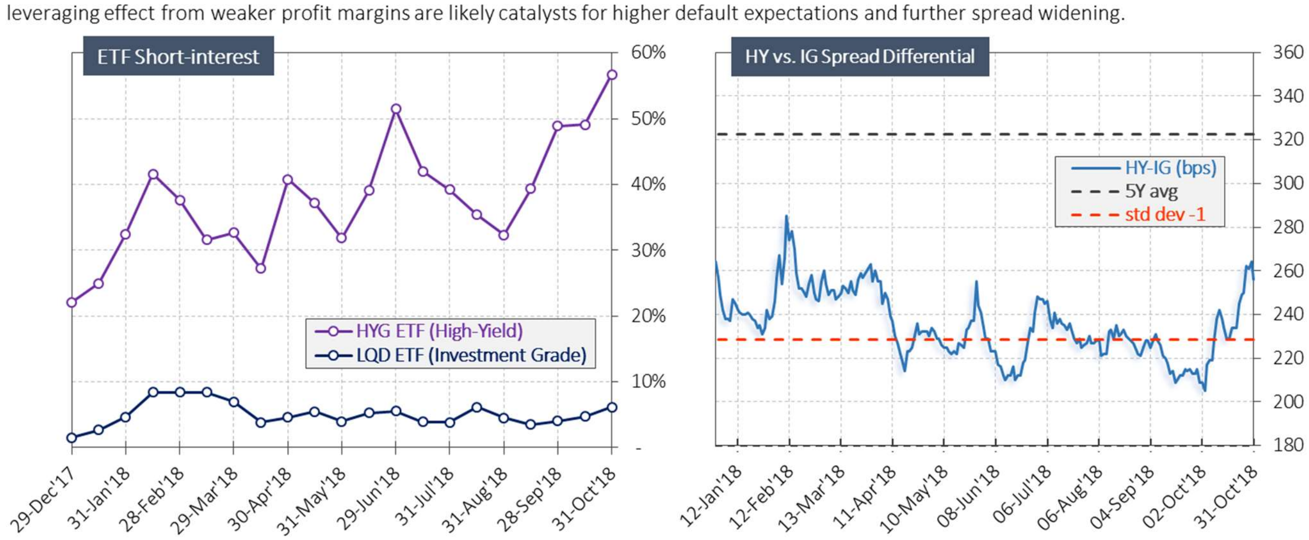
Rising Short Interest in High-Yield ETFs

The sell-off in equities and the return in volatility during the month of October weakened sentiment in high-yield markets. After reaching a post-Great Recession low of 316bps earlier in the month, the ICE BofAML US High Yield Master II index spread widened 65bps and ended the month at 381bps. Year-to-date, lower quality issuers have driven outperformance in the sector with excess returns of +2.6% for Single-B and +4.3% for CCC & lower compared to +0.4% for BB.

High-yield sentiment has weakened, but valuations are still rich

Short interest in high-yield ETFs has surged in recent months reflecting weakened investor sentiment. However, despite recent spread widening, the high-yield sector is still expensive compared to investment grade. Prospects for slower top-line growth and the additional leveraging effect from weaker profit margins are likely catalysts for higher default expectations and further spread widening.



Source: Bloomberg, ICE BofAML, Clearwater Advisors

Elevated levels of volatility in equity markets is not good for the high-yield sector as spreads are highly correlated with changes in VIX based on analysis from Moody's. While many market commentators have indicated that equity markets generally fare better under a split party government, partisanship can also drive negative sentiment as evidenced during the 2011 debt-ceiling crisis when VIX spiked from levels below 20 to a peak of 48 over the course of a week.

Rich valuations are another good reason to be pessimistic over the prospects for high-yield credits. Spreads have failed to break out from tight levels achieved at the beginning of the year, and over this time global trade tensions have ratcheted up while the economy has only moved closer to the end of the cycle. And while high-yield spreads widened significantly during the month, they are still very tight relative to investment grade from a longer-term perspective.

While highly levered firms have compensated investors for taking on additional credit risk year-to-date, these companies are also most vulnerable to a reversal in market sentiment and deterioration in fundamentals. An acceleration in wage growth due to tighter labor markets, in addition to increased transportation and input costs, reduces expectations for sustained profit growth and compresses cyclically high profit margins. Margin erosion and a slowdown in profit growth also has a re-leveraging effect that worsens already elevated leverage metrics and further constrains financial flexibility.