Mike Salice, CFA
Director of Research
msalice@skyhcm.com
November 11, 2019

SKY HARBOR
CAPITAL MANAGEMENT

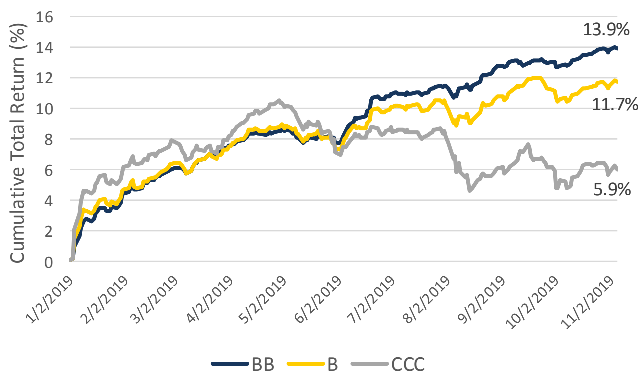
Weekly Briefing

SKYView: Lagging CCCs

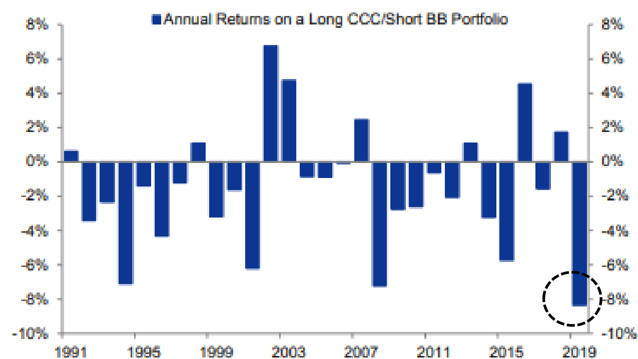
CCC underperformance has been a consistent theme throughout 2019, and the dynamic has shown no signs of mean reversion despite a grind tighter in spreads through October. CCC bonds have screened increasingly "cheap" to the BB cohort within most relative value models, and as such we devote this *Weekly Briefing* to evaluating the opportunity set in the current economic environment.

Year to date (data through November 5), the US high yield bond index (as always, we use the ICE BofAML US High Yield Index, H0A0, as our proxy) has returned a lofty 12.1%. Despite strength across risk assets in general, it's the BB component of the index that has demonstrated the largest gains (+13.9% total return). **CCCs, for their part, have lagged, returning a relatively paltry 5.9%, and the disparity continues to grow**. More specifically, according to a recent research piece published by Goldman Sachs,[1] 2019 is "still shaping up as the worst year on record for the risk-adjusted performance of CCC rated bonds vs. BB rated bonds," a graphic of which is displayed in the chart below (right side).

US High Yield YTD Total Returns by Ratings Bucket
daily data, cumulative



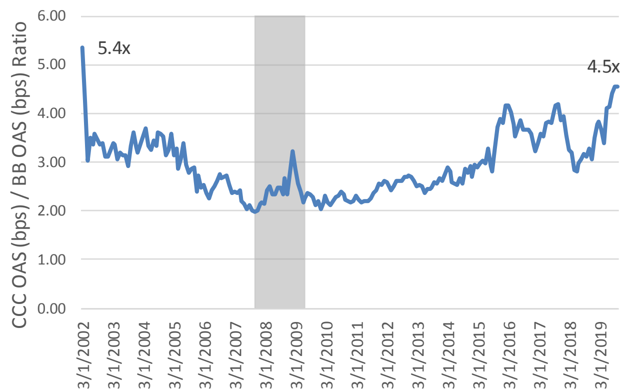
Goldman Notes CCCs On Track for Worst Relative Year on Record
annual excess returns from a long-short portfolio of CCC bonds (beta-adj) vs. BB bonds



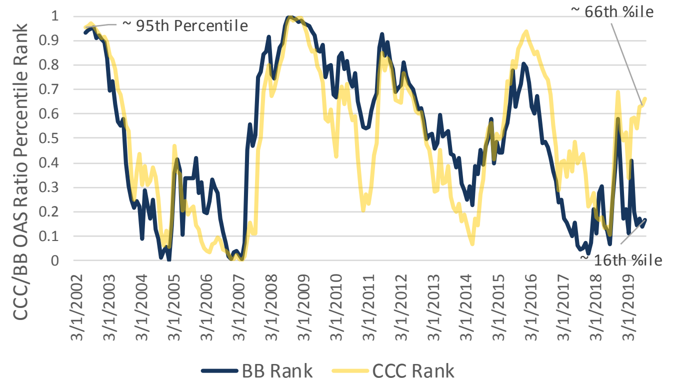
Source: SKY Harbor, ICE BofAML Indices, Goldman Sachs

By virtue of this underperformance, the CCC to BB spread ratio has reached 4.5x, a level not seen since 2002. So notable is this that a market selloff during February 2009 – arguably one of the greatest risk aversion periods in recent memory – failed to produce a CCC/BB ratio of 3.5x. Additionally notable is how relative spread levels differ now relative to 2002 and 2009 peaks, of which the former saw trading levels of both BB and CCC rated securities within the 95th percentiles. Today, by comparison, spreads for the CCC bucket are elevated but are merely 3rd quartile. **The CCC/BB spread ratio is elevated, therefore, not because CCCs are so cheap, but because BB bonds are trading so tight.**

CCC to BB Spread Ratio
monthly data, recession shaded grey



CCC and BB OAS Percentile Rankings
monthly data



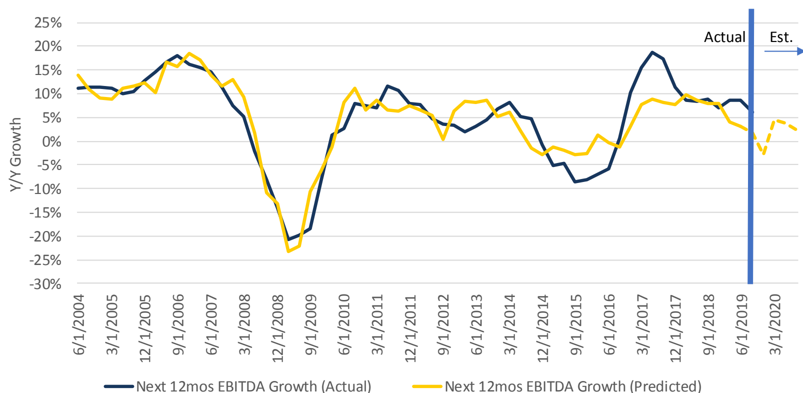
Source: SKY Harbor, ICE BofAML Indices

While CCC/BB spread ratio elevation appears driven more by BB "richness" than CCC "cheapness," there does appear to be greater spread compression potential among the lower-rated portions of the US high yield bond market, if only on the basis of the latter being wider from typical levels at this point in the cycle than the former. Despite this, **there are matters on the horizon that dampen our enthusiasm for reaching too far down in quality in the near term.**

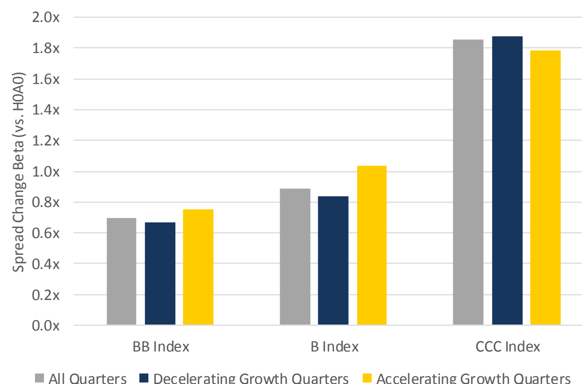
[1] 2019 October 31, *The Credit Trader: Active beats passive in HY*, Goldman Sachs Credit Strategy Research

First, **our internal model suggests corporate earnings growth may disappoint over the next couple of quarters**. Using the S&P 1500 Index (which includes a significant number of high yield constituents, and represents a broad cross-section of corporate constituencies), we developed a multi-factor regression model with the aim of projecting next-12-months EBITDA growth. Our model, with a relatively healthy R^2 of 0.82, implies modest y/y EBITDA declines (-2% to -3%) in Q4’19 and a modest EBITDA recovery in 2020 (+2% to +5%). If accurate, our modeled growth estimate would represent downside relative to the consensus view, which could pressure issuer trading levels. As would be expected (and further demonstrated below), lower-rated securities are far more sensitive to declining earnings (or earnings surprises), a dynamic that may justify CCC underperformance until earnings clarity improves.

S&P 1500 Index EBITDA Growth: Actual vs. Next 12mos SKY Model Predicted
quarterly data, trailing 15 years



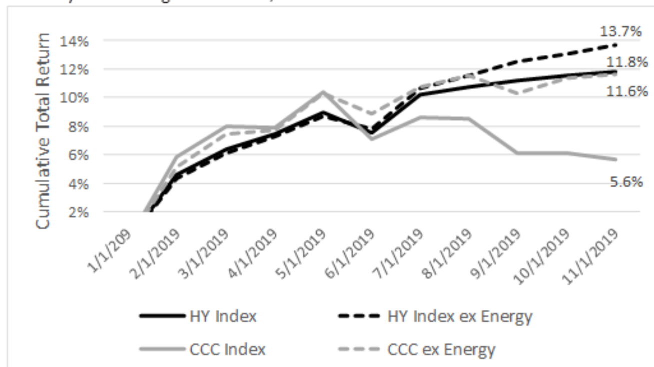
Rating Bucket Spread Change Betas by EBITDA Growth Environments
quarterly data, since 1997



Source: SKY Harbor, Chief Executive Magazine, Federal Reserve, Bloomberg, Baltic Exchange, ICE BofAML Indices

Additionally, **there remain notable differences in the makeup of the CCC index relative to the full US high yield index**. As noted below, CCCs have an over-representation of Energy credits that have been out of favor and suffer from significant commodity volatility. Additionally, Retail and Telecom, two sectors battling secular challenges, are also over-represented in the CCC index, as is Healthcare (significant political risk, particularly given the US election cycle). Finally, CCCs have a below-index concentration of Media credits, which benefit from political spending and have been a haven given US-centric end markets, and has less Basic Industry exposure, particularly the parts levered to a strong US consumer (building & construction). But the Energy mismatch is the biggest differentiator: excluding the sector would have allowed CCCs to return +11.8% YTD (in line with the full high yield index). Furthermore, an acceleration of negative ratings migration rates, which have been primarily focused within the lower-rated issuer constituencies, may portend some technical headwinds for the CCC index in the near term.

Energy the Main Culprit of CCC Underperformance
monthly data through October 31, 2019



CCC Sector Weights Screen Unfavorably
data as of November 5, 2019
Key Differences:

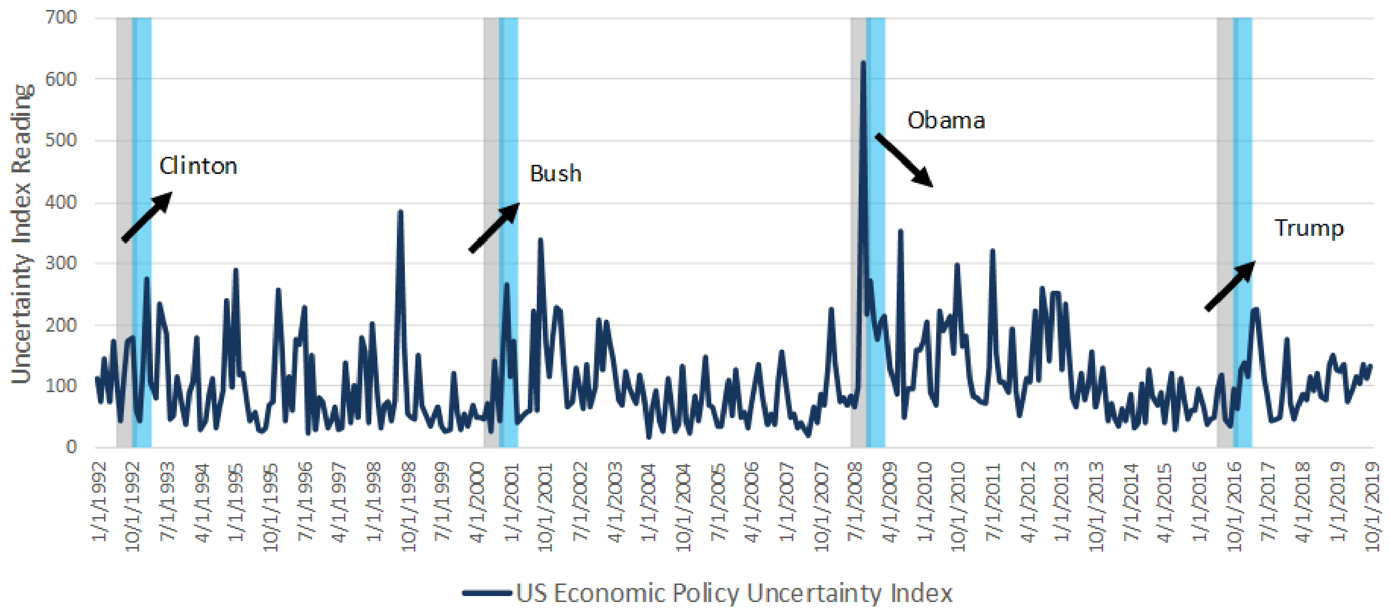
Sector	Relative Size: Full HY Index	Relative Size: CCC Index	Δ	Notes
Basic Industry	10%	5%	5%	Global growth pressure offset by consumer strength
Energy	14%	17%	-3%	Out of favor / commodity pressure
Healthcare	10%	16%	-6%	Political risk
Media	10%	4%	7%	Election year strength, domestically focused
Retail	5%	7%	-2%	Secular headwinds
Telecom	11%	17%	-6%	Secular headwinds

Source: SKY Harbor, ICE BofAML Indices

With a (likely) contentious US presidential election slated for 2020, we once again highlight the US Economic Policy Uncertainty Index, which has proven to be positively correlated with US high yield spreads over time. The index - which tracks newspaper publications for key words like “economy,” “uncertainty,” “legislation,” “deficit,” “regulation,” and other factors related to policy changes – has historically risen when a new president takes office. Below, we highlight that average policy uncertainty readings in the four months containing the presidential election, inauguration, and first month in office (shaded in blue) most often increase relative to uncertainty readings in the four months immediately preceding those events (shaded in grey). The exception, listed below, was Obama’s first victory, although we would note the prior four-month period was likely distorted as the US was in the midst of the Great Financial Recession. Given the vast differences in politics and ideology between President Trump and the leading Democratic contenders, we think an increase in the policy uncertainty index is likely to occur, particularly if the incumbent fails to achieve re-election. **As heightened uncertainty is likely a negative for the most speculative types of risk, we find yet another factor dissuading us from getting too excited about CCC bonds at this point in time.**

US Elections Likely to Increase Economic Policy Uncertainty

monthly data



Grey shaded areas include the 4 months leading up to the election
Blue shaded areas inlcude election month through first month in office (post inauguration)

Source: Baker, Bloom, & Davis, SKY Harbor

In conclusion, CCC underperformance has persisted, and the CCC/BB spread ratio approaching highs appears to be more a function of BB richness than CCC cheapness. Although CCC credits appear more attractive on an historical spread basis vs. higher-quality cohorts, our anticipation that corporate earnings growth may surprise to the downside and economic policy uncertainty may surprise to the upside keep us cautious on purchasing the widest spread issues in the high yield index at present. Additionally, given sector concentration mismatches, an overweight position in CCCs would likely necessitate a more bullish view on Energy credits, which is not our base case thinking at present.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Factory Orders	4-Nov-19	Sep	-0.5%	-0.6%	-0.1%
Trade Balance	5-Nov-19	Sep	-$52.4 bn	-$52.5 bn	-$54.9 bn
ISM Non-Manufacturing Index	5-Nov-19	Oct	53.5	54.7	52.6

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
NFIB Small Bus. Optimism	12-Nov-19	Oct	102.0		101.8
CPI MoM	13-Nov-19	Oct	0.3%		0.0%
PPI Final Demand MoM	14-Nov-19	Oct	0.2%		-0.3%

Source: SKY Harbor, Bloomberg

Recommended Reading

Bloomberg News (2019, November 7). China, US Agree to Tariff Rollback if Trade Deal Reached. *Bloomberg* (subs. req.), Retrieved from https://www.bloomberg.com/news/articles/2019-11-07/china-says-it-agreed-with-u-s-to-roll-back-tariffs-in-phases?srnd=premium

Torry, Harriet (2019, November 7). WSJ Survey: Economists Split on Causes of Hiring Slowdown. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/wsj-survey-economists-split-on-causes-of-hiring-slowdown-11573138800

Important Disclosures and Disclaimers

SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. The information herein is intended solely for the person to whom it has been delivered. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofAML Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofAML") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofAML PERMITS USE OF THE ICE BofAML INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofAML INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.

© 2019 SKY Harbor. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor.