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Weekly Briefing

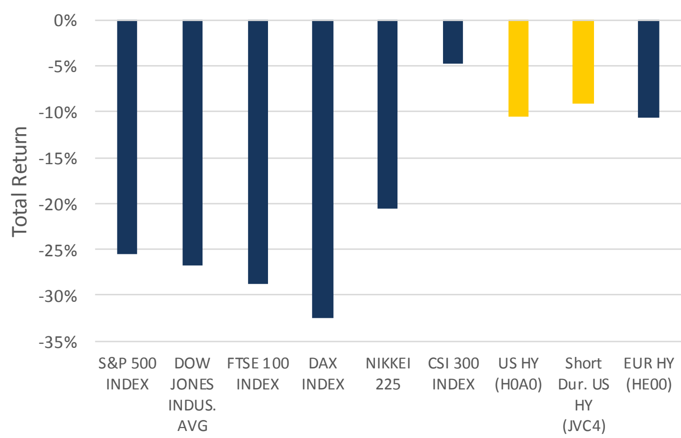
SKYView: The High Yield Market in Pictures

In this *Weekly Briefing* we offer a visual display of trends in the high yield market that we believe are most pertinent in evaluating where we are and where we may go from here. While uncertainty remains high, we hope the charts presented herein demonstrate how aggressive the market correction has been over the last three weeks. In our view, market spreads are implying too high a default rate for US high yield in 2020, and strong breakevens are likely to provide an element of protection for investors over the intermediate term should further erosion of sentiment occur.

Returns were weak across risk asset classes this week, with most equity indices reaching bear market territory. High yield was not immune to the stress, though short duration bonds outperformed broad market US and EUR indices. Note that US high yield spreads went from tightest quartile to widest quartile in a span of 3 months.

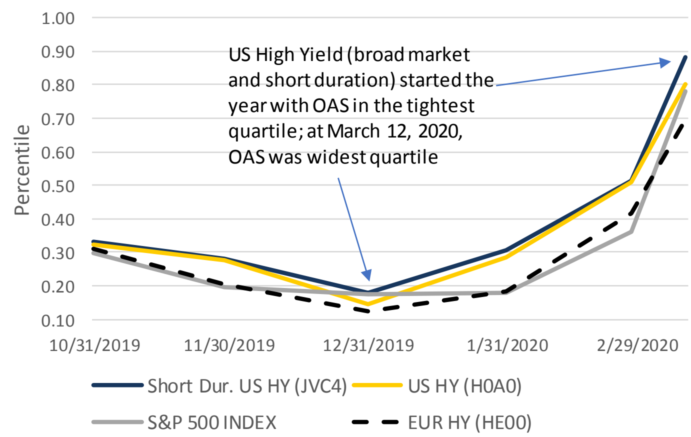
Indices Have Weakened Across the Globe…

total return, Feb 24 - Mar 12



…Leading to More Attractive Valuations

percentile rankings based on 20yrs of monthly data



Source: SKY Harbor, ICE BofA Indices, Bloomberg

High yield indices have cheapened considerably from the start of 2020, with spreads wider by over 300 bps across the board. Yields in the 8%+ range may be attractive for investors who have been on the sidelines. Excluding the Energy sector, US high yield (both broad market and short duration) significantly outperformed Euro high yield.

Index Characteristics

evoluation, Jan.1 to Mar. 12

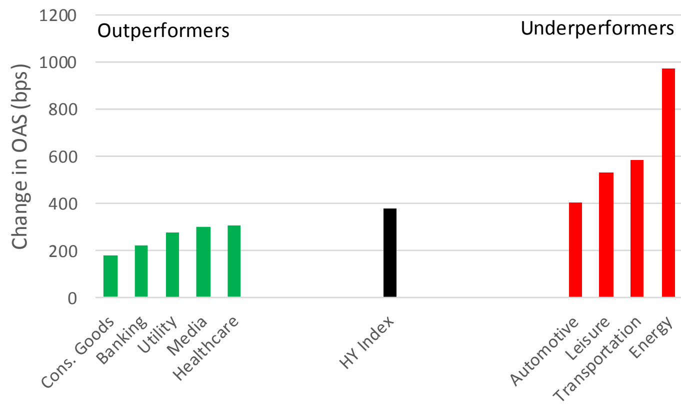
	ICE BofA US High Yield Index (Broad US HY, ticker H0A0)			ICE BofA 1-5Yr BB-B US HY Index (Short Dur. US HY, ticker JVC4)			ICE BofA Euro High Yield Index (Broad Euro HY, ticker HE00)		
	Jan. 1, 2020	Mar. 12, 2020	Δ	Jan. 1, 2020	Mar. 12, 2020	Δ	Jan. 1, 2020	Mar. 12, 2020	Δ
# of Issues	1,775	1,818	43	644	646	2	535	582	47
Face Value ($mm)	1,213,978	1,255,570	41,592	410,931	414,004	3,073	292,222	322,409	30,187
YTW (%)	5.41	8.25	2.84	4.35	8.13	3.78	2.62	5.50	2.88
OAS (bps)	360	742	382	270	741	471	308	629	321
Eff. Duration	3.30	4.22	0.92	1.83	2.53	0.70	3.23	4.04	0.81
Par. Wgt. Price	100.74	90.03	(10.71)	102.37	92.40	(9.97)	103.22	92.25	(10.97)
Par. Wgt. Coupon (%)	6.32	6.24	(0.08)	6.10	6.03	(0.07)	3.98	3.78	(0.20)
YTD Total Return (%)									
YTD Total Return (%) *USD Hedged*		-9.4%			-8.5%			-9.5%	
YTD Total Return ex Energy (%) *USD Hedged*		-6.1%			-4.7%			-9.6%	

Source: SKY Harbor, ICE BofA Indices

Sectors and industries most impacted by COVID-19 and the breakdown of OPEC+ have been clear underperformers, indicating that trading has been orderly despite large swings in volatility. Travel bans and quarantines continue to dampen sentiment in the Transportation and Leisure spaces.

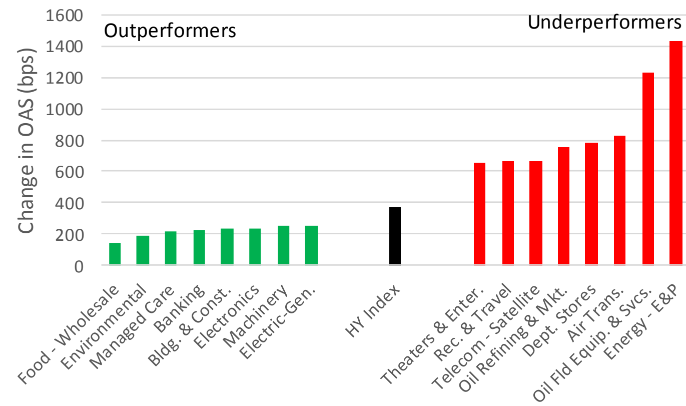
US High Yield Sector Reaction from Virus-Induced Selloff

change in OAS, Feb 24 - Mar 12



US High Yield Industry Reaction from Virus-Induced Selloff

change in OAS, Feb 24 - Mar 12

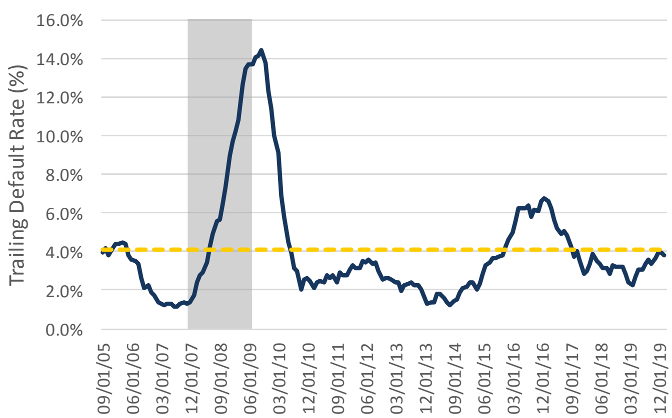


Source: SKY Harbor, ICE BofA Indices

The US high yield default rate remains below long-run annual averages, but a substantial rise in the index distress ratio implies growing concern that bankruptcies will begin to trend higher.

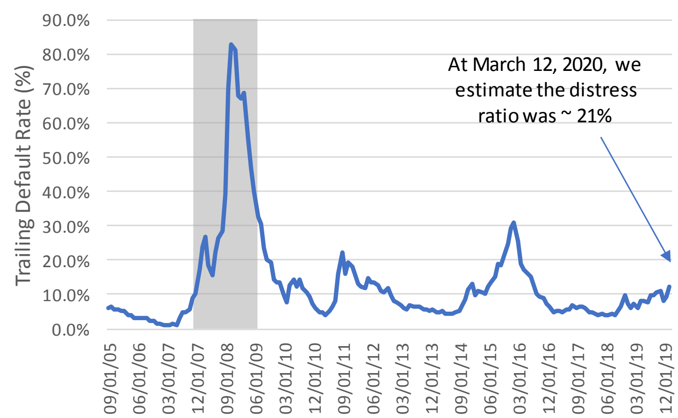
US High Yield Issuer Default Rate

monthly data through Feb. '20 month end, recessions shaded grey



US High Yield Distress Ratio

monthly data through Feb. '20 month end, recessions shaded grey

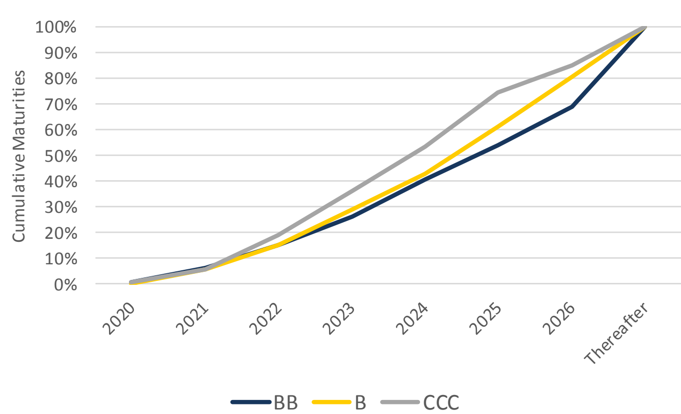


Source: SKY Harbor, BofA Merrill Lynch

A potentially underappreciated aspect of US high yield – very little debt matures over the next 24 months, so most companies will not be forced to access new issue markets. Also, market volatility through February was insufficient to push BB and B subindex yields wider than average coupons (as we said last week, strong interest coverage metrics are likely to persist for some time).

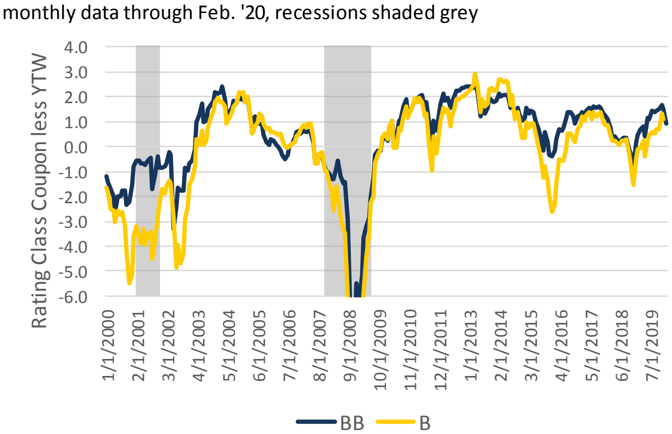
No Maturity Wall Concerns in US High Yield

cumulative index maturities, data as of Jan. 1, 2020



BB and B Coupons Remained Above YTW Through February

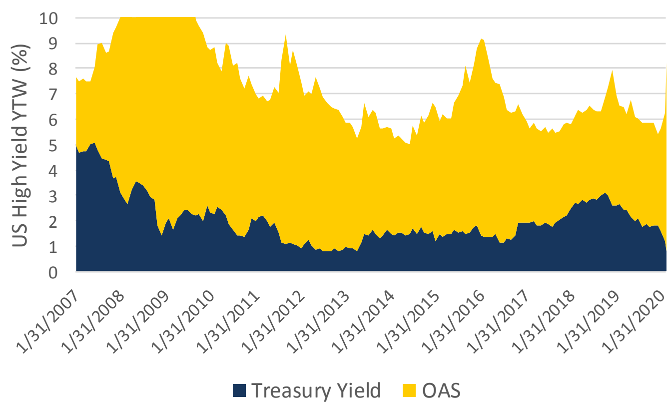
monthly data through Feb. '20, recessions shaded grey



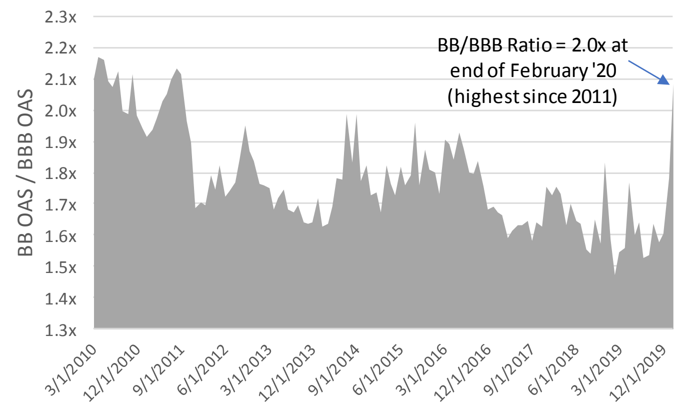
Source: SKY Harbor, ICE BofA Indices

As of Thursday, March 12, the ICE BofA US High Yield Index (H0A0) YTW hit 8.23% (mostly made up of OAS), the highest level since a period of acute commodity stress in Q1'16. BBB/BB decompression has been significant.

Yield-To-Worst Split
monthly data



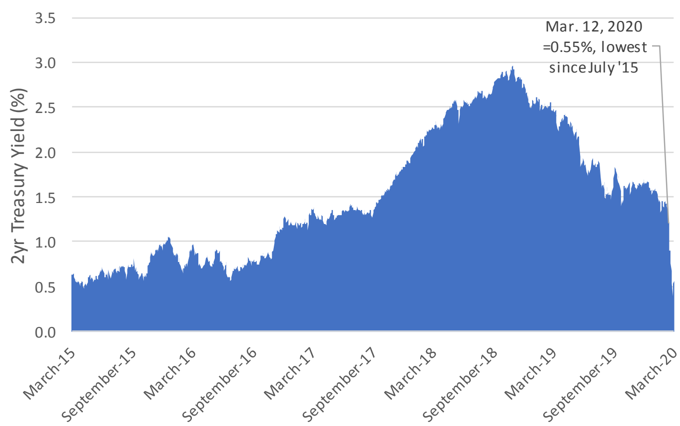
BB/BBB Ratios Widened Significantly in Feburary
monthly data



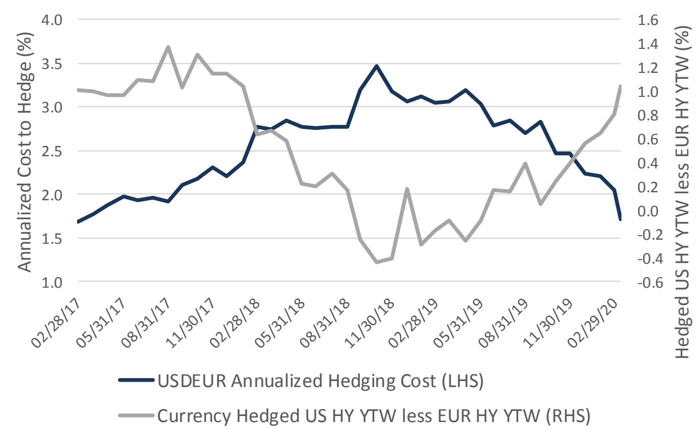
Source: SKY Harbor, ICE BofA Indices, Bloomberg

US Treasuries have rallied, with yields on the 2yr compressing to 0.55%, a nearly 5-year low. At the same time, the cost to EUR investors for hedging USD has been on the decline, leading to a rise in the YTW advantage of currency-adjusted US HY vs. EUR HY.

Rate Cut Expectations Have Pushed Treasury Yields Down
daily data, trailing 5 years



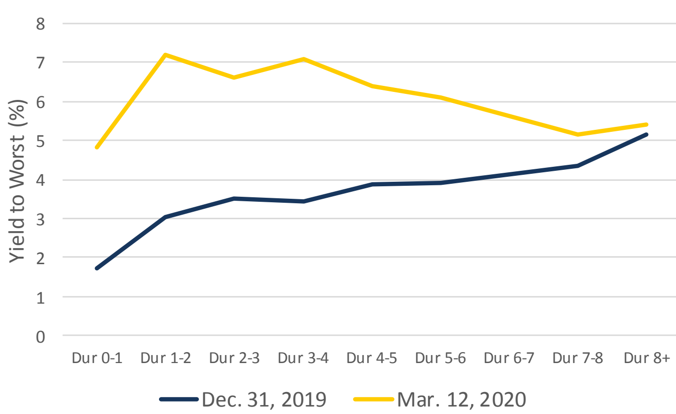
Hedging Costs Decline; Currency Hedged US HY Advantaged vs. EUR HY
monthly data, trailing 3 years



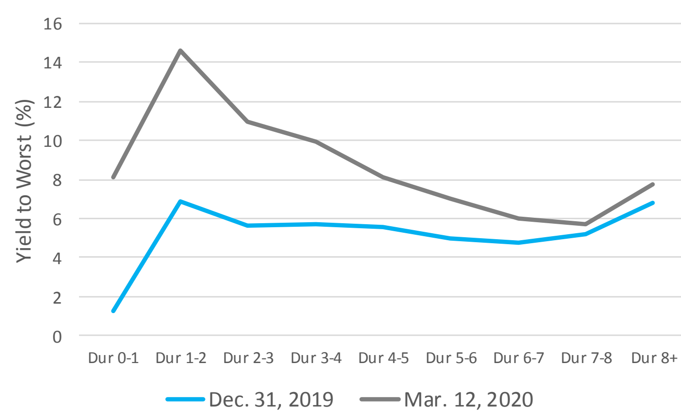
Source: SKY Harbor, ICE BofA Indices, Bloomberg

At the same time, yield curves have flattened (even inverted in the case of single-Bs) relative to the start of 2020.

BB Yield Curve Has Flattened
current vs. start of year



Single-B Yield Curve Has Inverted
current vs. start of year

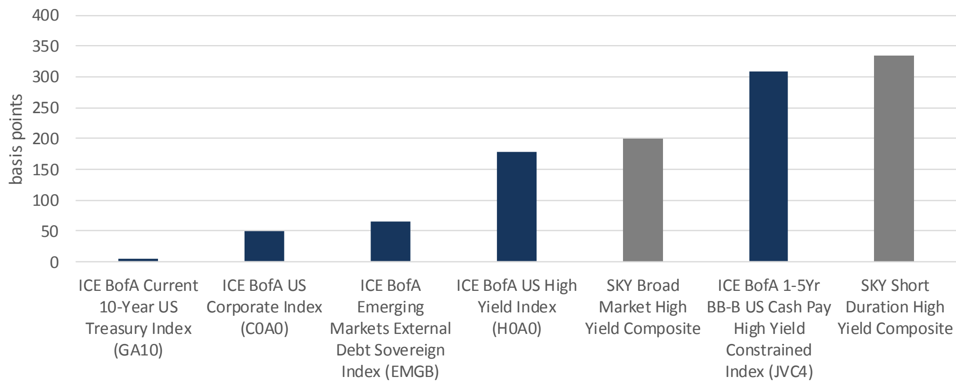


Source: SKY Harbor, ICE BofA Indices

We have re-simulated the impact an environment of rising yields would have on various fixed income asset class returns. The chart below demonstrates the maximum all-in yield increase an asset class could handle over a 12-month period before total returns fell below breakeven levels (i.e., the point at which interest income is fully offset by the negative impact of rising yields). Both broad market and short duration US high yield screen favorably.

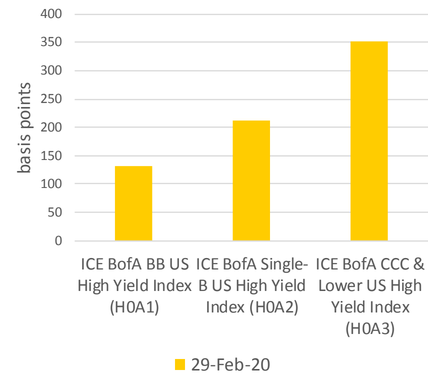
Breakevens by Index

12-month time horizon, as of month end Feb. 2020



US High Yield Breakevens by Rating

12-month time horizon, as of month end Feb. 2020

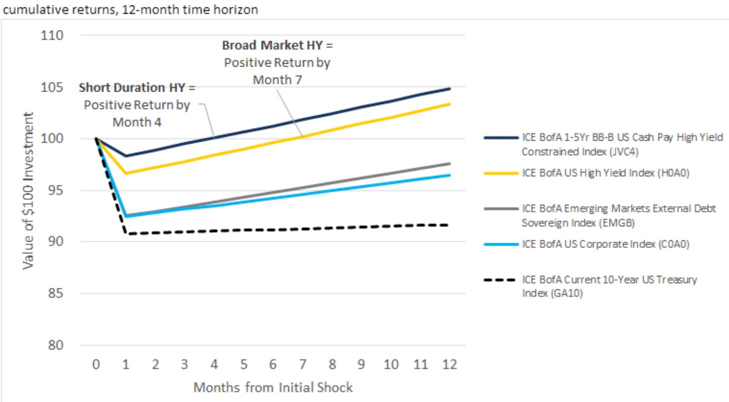


Source: SKY Harbor, ICE BofA Indices

Unlike the analysis above in which yields rise linearly over a 12-month time horizon, we simulated the timing to breakeven following an instantaneous shock to risk premiums. Again, US broad market and short duration high yield outperform other fixed income indices.

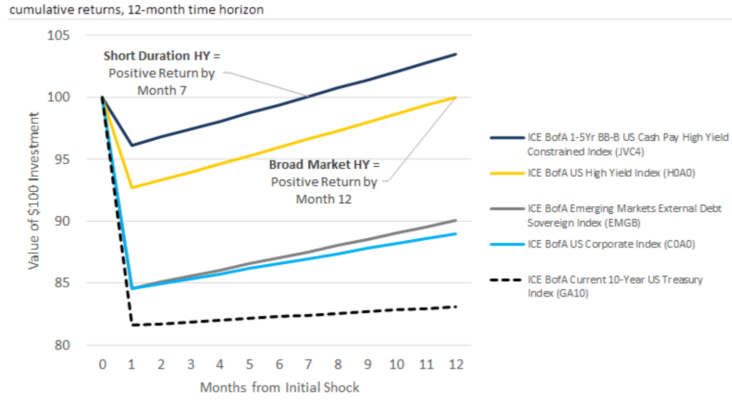
Timing to Breakeven Returns Following Instantaneous <u>100 bps Yield Shock</u>

cumulative returns, 12-month time horizon



Timing to Breakeven Returns Following Instantaneous <u>200 bps Yield Shock</u>

cumulative returns, 12-month time horizon



Source: SKY Harbor, ICE BofA Indices

At March 12, the ICE BofA US High Yield Index (H0A0) had an OAS of 742 bps, having risen 382 bps from the start of the year. In what we believe to be a conservative approach (for example, we do not factor in the likely depressed bond prices of issuers likely to default), we created the implied default rate sensitivity table below. To the right, we undertake the same analysis, this time stripping the Energy sector from the rest of the index. Despite uncertainties in the market, we find an OAS-implied 6% default rate for the index excluding Energy to be overly pessimistic, consistent with stress-period default overestimation of approximately 2x.

Market Implied Default Rate: Sensitivity Analysis

US HY OAS = 742 bps on March 12, 2020

Expected Recovery Rate	Excess Spread: 260	270	280	290	300	310	320	330	340
55%	10.7%	10.5%	10.3%	10.0%	9.8%	9.6%	9.4%	9.2%	8.9%
50%	9.6%	9.4%	9.2%	9.0%	8.8%	8.6%	8.4%	8.2%	8.0%
45%	8.8%	8.6%	8.4%	8.2%	8.0%	7.9%	7.7%	7.5%	7.3%
40%	8.0%	7.9%	7.7%	7.5%	7.4%	7.2%	7.0%	6.9%	6.7%
35%	7.4%	7.3%	7.1%	7.0%	6.8%	6.6%	6.5%	6.3%	6.2%
30%	6.9%	6.7%	6.6%	6.5%	6.3%	6.2%	6.0%	5.9%	5.7%
25%	6.4%	6.3%	6.2%	6.0%	5.9%	5.8%	5.6%	5.5%	5.4%

Market Implied Default Rate: Sensitivity Analysis <u>ex Energy</u>

US HY ex Energy OAS = 639 bps on March 12, 2020

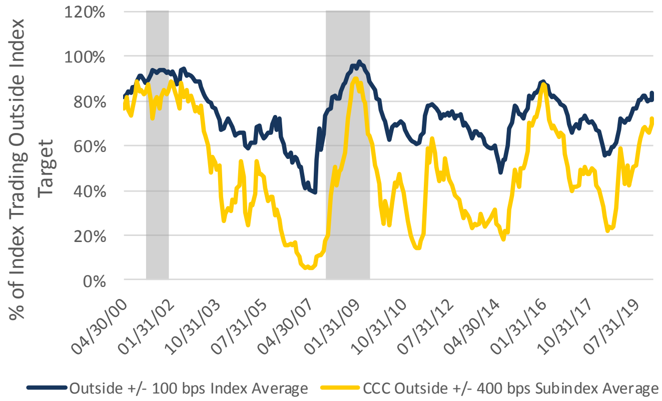
Expected Recovery Rate	Excess Spread: 260	270	280	290	300	310	320	330	340
55%	8.4%	8.2%	8.0%	7.8%	7.5%	7.3%	7.1%	6.9%	6.6%
50%	7.6%	7.4%	7.2%	7.0%	6.8%	6.6%	6.4%	6.2%	6.0%
45%	6.9%	6.7%	6.5%	6.3%	6.2%	6.0%	5.8%	5.6%	5.4%
40%	6.3%	6.2%	6.0%	5.8%	5.7%	5.5%	5.3%	5.2%	5.0%
35%	5.8%	5.7%	5.5%	5.4%	5.2%	5.1%	4.9%	4.8%	4.6%
30%	5.4%	5.3%	5.1%	5.0%	4.8%	4.7%	4.6%	4.4%	4.3%
25%	5.1%	4.9%	4.8%	4.7%	4.5%	4.4%	4.3%	4.1%	4.0%

Source: SKY Harbor, ICE BofA Indices

Index dispersion remains high, particularly so in the Single-B portion of the market. Historically, periods of high dispersion have preceded periods of elevated active manager alpha.

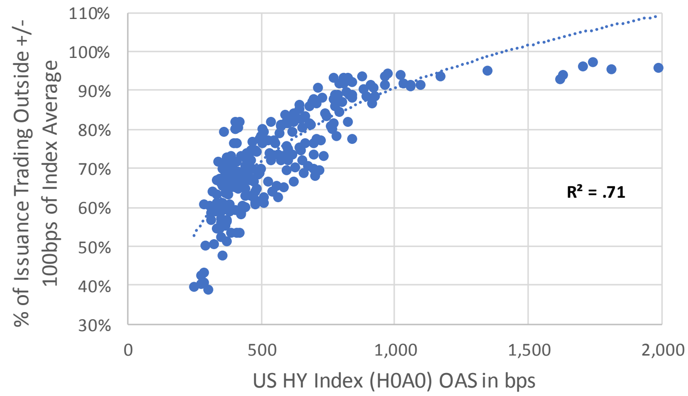
US High Yield Index Dispersion on the Rise

monthly data, last 20 years



US HY Index Dispersion Remains Above Spread-Implied Levels

monthly data, last 20 years

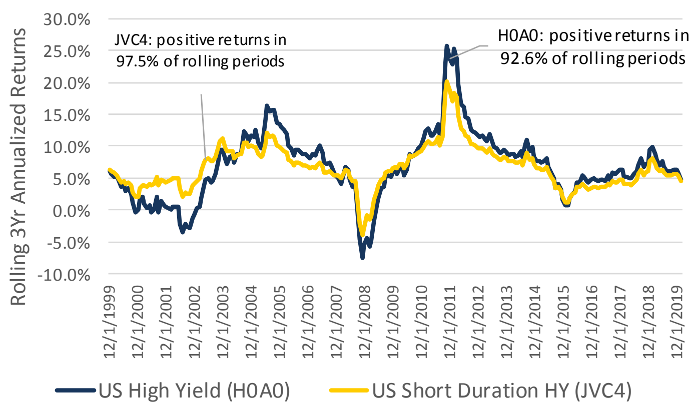


Source: SKY Harbor, ICE BofA Indices, BofA Merrill Lynch

Finally, we highlight that both broad market and short duration US high yield indices have generated consistently positive annualized returns for investors, even if market timing is sub-optimal.

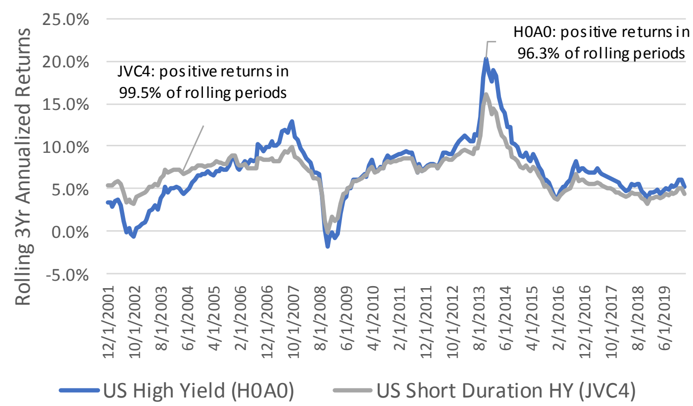
3 Year Rolling Annualized Returns

monthly data



5 Year Rolling Annualized Returns

monthly data



Source: SKY Harbor, ICE BofA Indices

Conclusion

While uncertainty remains high, we believe market spreads are implying too high a default rate for US high yield in 2020, and strong breakevens are likely to provide an element of protection for investors over the intermediate term should further erosion of sentiment occur. Clearly, the situation remains fluid, and we intend to update these charts on an ongoing basis for readers.

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