

Weekly Briefing

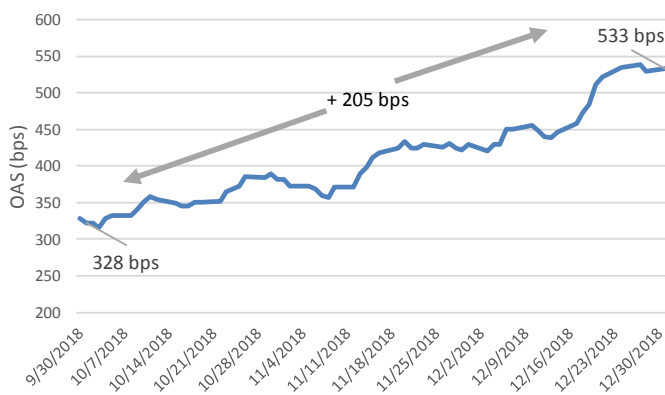
SKYView: Valuations

A steep Q4'18 selloff has given way to an equally sharp recovery thus far in January '19. While some investors may fear they've missed the high yield rally, spread per turn of net leverage metrics **imply further spread compression potential**. Furthermore, past periods of similarly rapid quarterly spread widening have, more often than not, been followed by significant and sustained episodes of OAS tightening. As such, **we remain optimistic about US high yield and continue to see attractive relative value in the asset class**.

Several high-profile corporate profit warnings, trade war tensions, the fear of slowing global growth, and concerns over a potential Fed misstep created a "perfect storm" in Q4'18, resulting in a sharp selloff of risk assets even through the (typically) quiet late-December holiday period. By the time selling pressure subsided, the US High Yield market had widened 205 bps. The move was remarkable, as a quarterly back-up in spreads greater than 200 bps has happened only seven times in the last 20 years, with the last occurring in Q3'11.

Q4'18 US High Yield Selloff

daily OAS

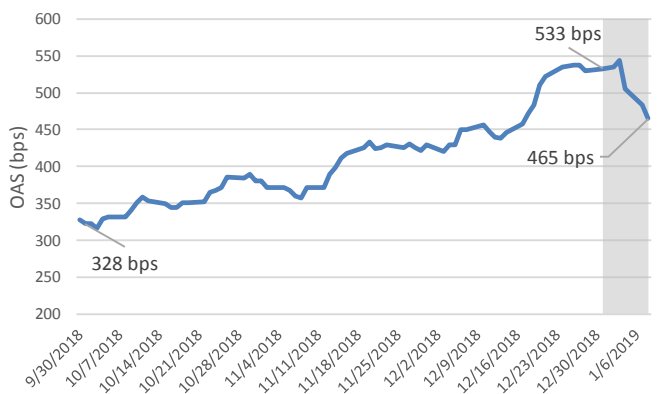


Source: SKY Harbor, ICE BofAML Indices

Aided, in part, by favorable economic releases (strong employment data, solid wage growth) and encouraging remarks from Fed Chair Jerome Powell (stressing patience and flexibility with regard to the path of future rate hikes), risk rallied in early January. Spreads on the US High Yield market compressed 68 bps in the five business days ended January 8, one of the most acute tightening periods in high yield market history. Looking at spread changes over rolling week-long periods throughout the last 20 years, spread tightening in excess of 50 bps has occurred in only 3% of observations.

January '19 US High Yield Rally

daily OAS, 2019 data shaded grey

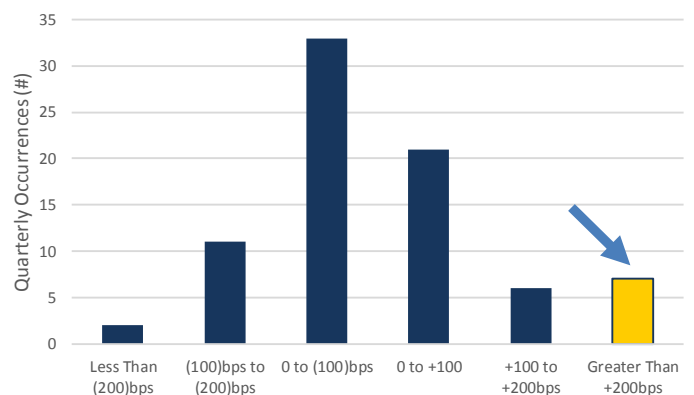


Source: SKY Harbor, ICE BofAML Indices

So, has the market fully corrected? We look to, in our view, the best gauge of market relative value – spread per turn of net leverage. Examining quarterly data of the last 20 years, we observe that spread per turn of net leverage metrics have been relatively stable within broad market cycle groupings. Breaking our data set into three distinct cohorts – 1) recessionary periods, 2) pre/post recessionary periods (spreads widen in anticipation of recessions, and take time to tighten following the conclusion of a recession) and 3) everything else – we find that leverage-adjusted spreads signaled significant recessionary concerns by the conclusion of Q4'18.

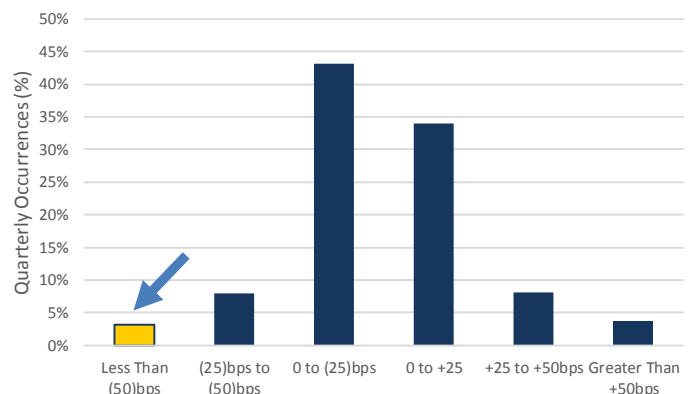
US High Yield Quarterly OAS Changes

trailing 20 years



US High Yield Weekly OAS Changes

trailing 20 years



Spread per Turn of Net Leverage (Periodic Averages)

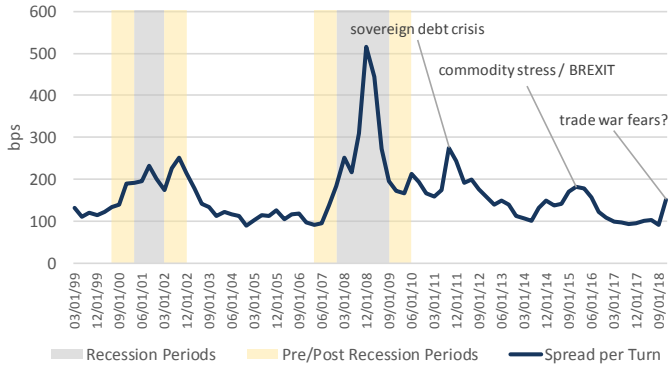
quarterly data, trailing 20 years

Period	Avg. Spread per Turn of Net Leverage
Recessions	293 bps
Pre/Post Recessions (4 quarters before and after a recession)	174 bps
All Other Periods	136 bps
Dec. 31, 2018	151 bps
Jan. 8, 2019	140 bps

Our internal view has been, and continues to be, that a recession is unlikely in the next 12 months. Under this assumption, and using the framework above as our guide, we find that high yield index spreads continue to trade wide of implied fair value even after 68 bps of compression this past week.

Spread per Turn of Net Leverage

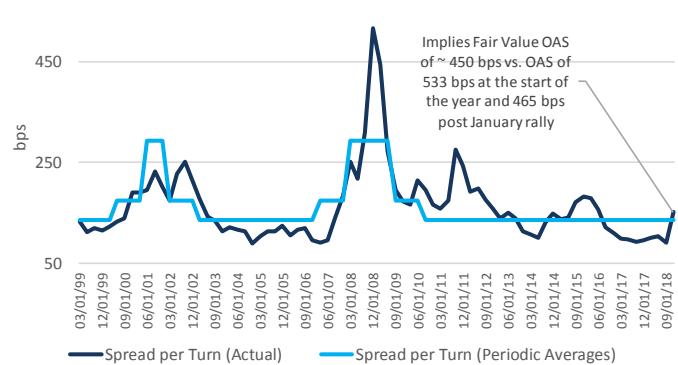
quarterly data, trailing 20 years



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

Spread per Turn of Net Leverage (Actuals vs Periodic Averages)

quarterly data, trailing 20 years



Looking back at quarterly periods in which spreads widened by at least 200 bps (admittedly limited in number), we find that subsequent spread levels were often tighter both three and six months into the future. Expanding our dataset by using monthly observations with trailing three-month OAS change look-backs, we find a similar dynamic. As a result, and with periodic medians in mind, we find further spread tightening to not only be possible, but probable.

US High Yield Quarterly OAS Change > 200 bps

occurrences over the last 20 years, quarterly data

Period	Trailing 3mo OAS Change	Next 3mo OAS Change	Next 6mo OAS Change
12/31/2000	239	(98)	(100)
9/30/2001	202	(194)	(310)
3/31/2008	225	(86)	277
9/30/2008	363	710	591
12/31/2008	710	(119)	(770)
9/30/2011	291	(117)	(237)
12/31/2018	205	?	?
Occurrences			
Subsequent Tightening (#)	5	4	
Subsequent Widening (#)	1	2	
Tightening Observations (%)	83%	67%	
Median Move	(108)	(169)	

Source: SKY Harbor, ICE BofAML Indices

US High Yield Rolling 3 Month OAS Change > 200 bps

occurrences over the last 20 years, monthly data

Period	Trailing 3mo OAS Change	Next 3mo OAS Change	Next 6mo OAS Change
11/30/2000	263	(136)	(138)
12/31/2000	239	(98)	(100)
9/30/2001	202	(194)	(310)
7/31/2002	283	88	(142)
8/31/2002	234	(79)	(124)
8/31/2007	208	120	311
1/31/2008	257	(11)	102
3/31/2008	225	(86)	277
9/30/2008	363	710	591
10/31/2008	814	4	(285)
11/30/2008	1,148	(252)	(831)
12/31/2008	710	(119)	(770)
8/31/2011	216	45	(130)
9/30/2011	291	(117)	(237)
12/31/2018	205	?	?
Occurrences			
Subsequent Tightening (#)	9	10	
Subsequent Widening (#)	5	4	
Tightening Observations (%)	64%	71%	
Median Move	(83)	(134)	

In summary, the steep Q4'18 selloff has given way to an equally sharp recovery thus far in January '19. While some investors may fear they've missed the high yield rally, spread per turn of net leverage metrics imply further spread compression potential. Furthermore, past periods of similarly rapid quarterly spread widening have, more often than not, been followed by significant and sustained episodes of OAS tightening. As such, we remain optimistic about US high yield and continue to see attractive relative value in the asset class.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
ISM Non-Mfg. Index	7-Jan-19	Dec	58.5	57.6	60.7
NFIB Small Business Optimism	8-Jan-19	Dec	103.0	104.4	104.8
Initial Jobless Claims	11-Jan-19	5-Jan	226k	216k	231k

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
New Home Sales	14-Jan-19	Nov	566k		544k
Empire Manufacturing	15-Jan-19	Jan	11.5		10.9
Housing Starts	17-Jan-19	Dec	1253k		1256k

Recommended Reading

Timiraos, Nick (2019, January 10). Fed's Powell Affirms Flexible Rate Outlook. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/fed-chairman-to-answer-questions-on-economy-and-rate-increases-11547116200?mod=hp_lista_pos1

Miller, Rich and Curran, Enda (2019, January 9). US and China Try to Seek a Rare Dual Soft Landing in the Middle of a Trade War. *Bloomberg*, Retrieved from <https://www.bloomberg.com/news/articles/2019-01-09/u-s-china-economies-seek-rare-soft-landing-feat-amid-trade-war?srnd=economics-vp>

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