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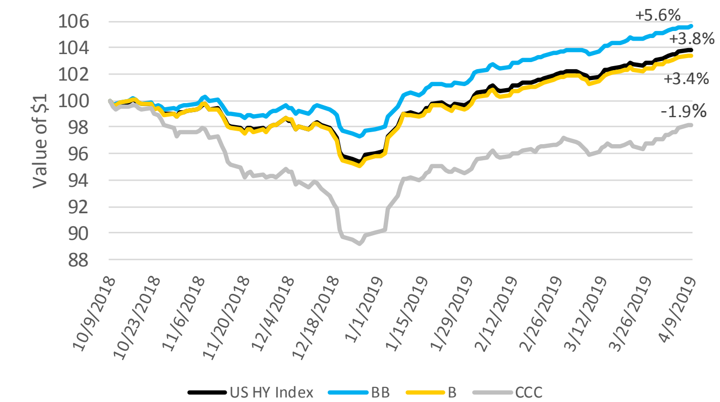
Weekly Briefing

SKYView: Valuations

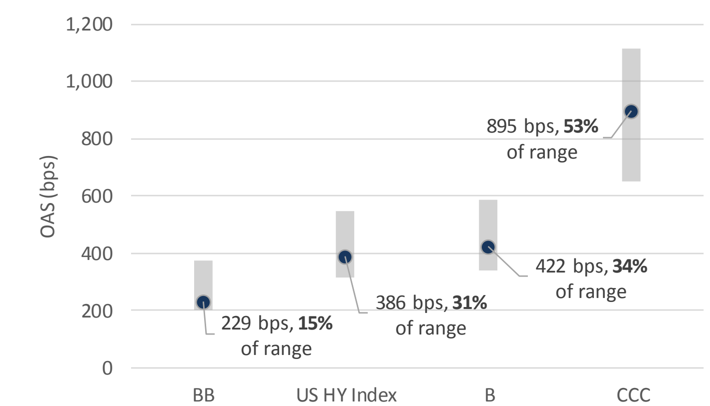
CCC total returns, especially on an historical beta-adjusted basis, have significantly lagged the ICE BofAML US High Yield Index over the past six months. This weak CCC performance, particularly in the context of elevated US high yield and domestic equity market total returns, compels us to take a closer look at the lowest-rated securities within the High Yield index. In this *Weekly Briefing*, we discuss the risks and opportunities of reaching down in quality in the current market environment.

Over the trailing six-month period, **the CCC cohort of the US high yield index has meaningfully underperformed higher-rated credit in both down (Q4'18) and up (Q1'19) markets**. As discussed in a prior briefing (and updated below through April 9), the CCC index has recovered less than half of the Q4'18 spread widening thus far in 2019, well below equivalent recoveries of BB and Single-B indices.

Cumulative Total Returns, Trailing 6 Months
daily data



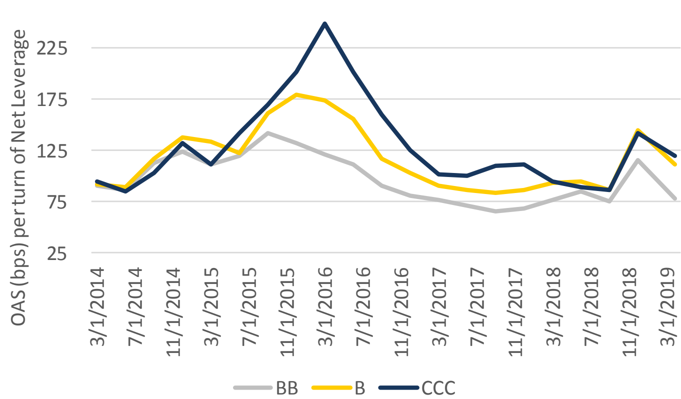
OAS Range by Rating Bucket
Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Apr. 10, 2019



Source: SKY Harbor, ICE BofAML Indices

This phenomenon, from an aggregate fundamental perspective, seems unwarranted. As demonstrated below, **net leverage among CCC constituents through Q4'18 is in line with current cycle averages**, much the same as equivalent measures for both the BB and Single-B indices. Furthermore, CCC spread per turn of net leverage – in our view the best gauge of relative value – is above the trailing five-year median (55th percentile), and screens favorably relative to the same measure for both BB and Single-B indices.

Spread per Turn of Net Leverage
quarterly data, trailing 5 years



Credit Metric Rankings: Now vs. 5yr Average
quarterly data

	Net Leverage		
Rating Class	Now	5yr Avg.	Difference
BB	3.1x	3.1x	0.0x
B	4.0x	4.0x	-0.1x
CCC	7.8x	7.8x	0.0x

	Spread per Turn	
Rating Class	Now	%ile Rank
BB	79	30%
B	111	50%
CCC	120	55%

Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices, Capital IQ

We next look at rating class constituencies. As we have noted in the past, investors typically avoid cyclical risk in late-cycle periods. Furthermore, as discussed in our *Weekly Briefing* entitled "Small Issue Illiquidity Premiums" from March 4, 2019, small issues have underperformed YTD, in our view driven by fund flows into ETFs and their associated preference for the largest bonds in the index. Consistent with YTD underperformance, the CCC index appears to have a bias toward cyclical and small issue risk relative to both BB and Single-B indices. Although these biases at present are less pronounced than trailing five-year and cycle averages, such differences remain meaningful as we are now closer to the end of the cycle.

Rating Class Representation by Various Measures

monthly data

Index	% Cyclical (by Face Value) Now	5yr Avg.	Now v. 5yr	Cycle Avg.	Now v. Cycle
US HY Index	51%	51%	100%	52%	99%
BB	52%	50%	105%	51%	103%
B	50%	50%	99%	51%	97%
CCC	53%	60%	88%	57%	92%

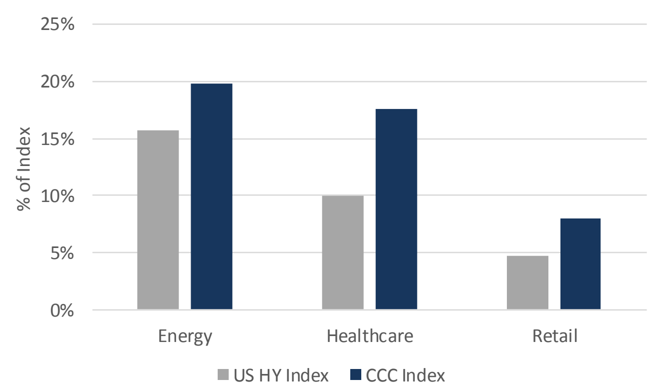
Index	% Small Issuers (Face Value < $350mm) Now	5yr Avg.	Now v. 5yr	Cycle Avg.	Now v. Cycle
US HY Index	8%	11%	73%	16%	47%
BB	6%	8%	77%	13%	46%
B	8%	11%	77%	17%	49%
CCC	11%	17%	64%	23%	49%

Source: SKY Harbor, ICE BofAML Indices

Aggregate credit metrics aside, sector concentrations within the CCC index are cause for some concern. Among the more topical worries within the US high yield market over the last several quarters have been volatility of commodity prices and the inability of E&P companies to live within their internally generated cash flow, legislative uncertainty amidst rising healthcare costs and drug price scrutiny, and secular challenges within the brick-and-mortar retail space. As demonstrated below, the CCC index has greater concentration of Energy, Healthcare and Retail credits relative to the full index. While we think pockets of value exist within all of these groups (by virtue of uniquely positioned business models and various other merits), we cannot ignore negative sentiment on a sector basis. Additionally, dispersion – as measured by the difference between 75th and 25th percentile constituent spreads within each index, or the interquartile range – has been on the rise within the CCC index. **We view this as increased investor differentiation between anticipated survivors and those headed toward a restructuring, which has made average CCC spreads (which our internal macro model signals as "cheap") less representative of the true opportunity set (i.e., an increasing number of CCC issues trade either well below or well above the sector average).**

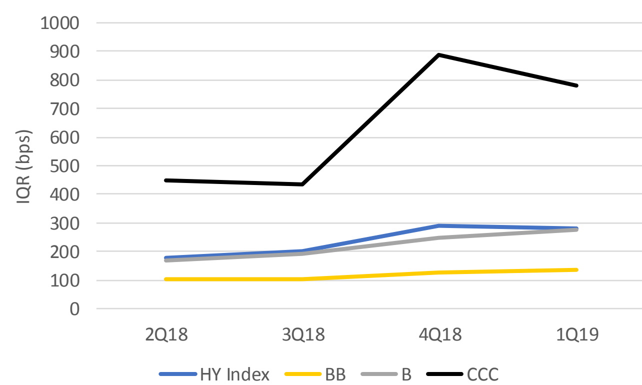
Sector Imbalances

data as of April 9, 2019



Interquartile Ranges

quarterly data

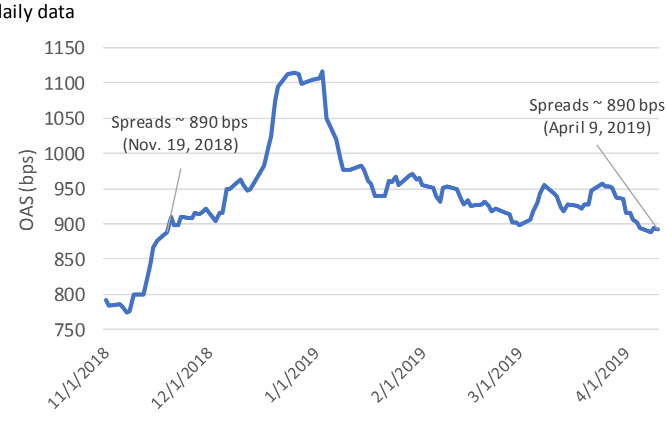


Source: SKY Harbor, ICE BofAML Indices

To further exemplify this point, we look at ICE BofAML CCC US High Yield Index (H0A3) spreads, which were ~ 890 bps at the time of publication. The last time spreads approximated 890 bps was back on November 19, 2018. Using a matched sample of constituents, we find that **an increasing percentage of the CCC index now resides within spread extremes, with the concentration of debt trading inside of 425 bps (Single-B levels) and wide of 1,000 bps (distressed levels) up ~ 10% since November '18, even though average index spreads are identical.**

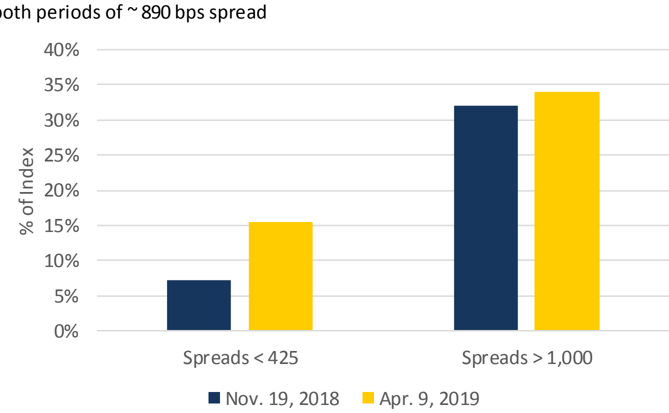
ICE BofAML CCC US High Yield Index (H0A3) Spreads

daily data



Matched Sample Spread Distribution

both periods of ~ 890 bps spread

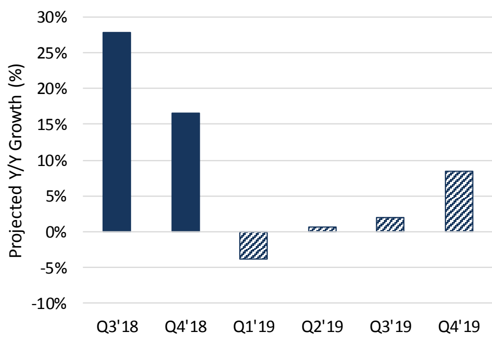


Source: SKY Harbor, ICE BofAML Indices

Another consideration is the potential for an earnings and default rate inflection in the coming months. Consensus expectations call for modest y/y earnings declines among S&P 500 constituents in Q1'19, followed by a modest recovery in H2'19. While absolute growth estimates are relatively small and fall within historical error rates associated with such bottom-up estimates, peak earnings in the current expansionary cycle are very likely behind us. Furthermore, despite the expectation that high yield index default rates will remain below long-term averages (~ 4.5%), our internal projection model anticipates an uptick in the coming quarters. As shown in the table below**, CCC spreads have historically demonstrated a higher degree of correlation to earnings growth and default rates relative to BB and Single-B credits**, which could add pressure to the ratings bucket should consensus and our internal expectations prove accurate.

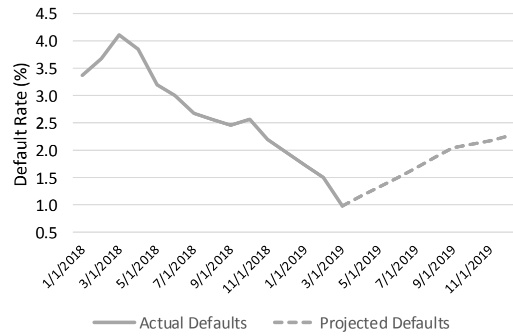
S&P 500 Quarterly Bottom-Up EPS Growth

estimates derived from consensus data



US High Yield Defaults: Actual and SKY Projections

monthly data



OAS Sensitivity to Earnings & Defaults

correlation data

Index	OAS Correlation to: Earnings Growth	Default Rates
US HY Index	-17%	53%
BB	-4%	45%
B	-14%	49%
CCC	-44%	62%

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

Elevated cyclical and small issue risk, adverse sector concentration, and the potential for an earnings growth and default rate inflection to dampen sentiment leave us **unconvinced that CCC risk will <u>generically</u> outperform the broader index in the coming months, despite recent underperformance**. However, we plan to add to our portfolios select CCC credits which have traded poorly in sympathy with the full CCC index (unjustifiably, in our view). We believe credit picking – in particular, finding over-penalized credits that offer a differentiated business model, positive near-term catalyst or positive earnings momentum – in the CCC space offers upside return potential for the balance of the year as a result of recent market dislocations.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	1-Apr-19	Mar	54.5	55.3	54.2
Durable Goods Orders	2-Apr-19	Feb	-1.8%	-1.6%	0.3%
Initial Jobless Claims	4-Apr-19	30-Mar	215k	202k	211k

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Industrial Production MoM	16-Apr-19	Mar	0.3%		0.1%
Capacity Utilization	16-Apr-19	Mar	79.2%		78.2%
Retail Sales Advance MoM	18-Apr-19	Mar	0.8%		-0.2%

Source: SKY Harbor, Bloomberg

Recommended Reading

Kubota, Yoko and Wei, Lingling (2019, April 11). China Sweetens Its Cloud Offer in US Trade Talks. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/china-sweetens-its-cloud-offer-in-u-s-trade-talks-11554976562?mod=hp_lead_pos3

Davison, Laura and Mohsin, Saleha (2019, April 11). Defying Data, Kudlow Says Trump's Tax Cuts Covering Their Costs. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-04-11/kudlow-says-trump-s-tax-cuts-already-paying-for-themselves?srnd=premium

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