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SKY HARBOR CAPITAL MANAGEMENT

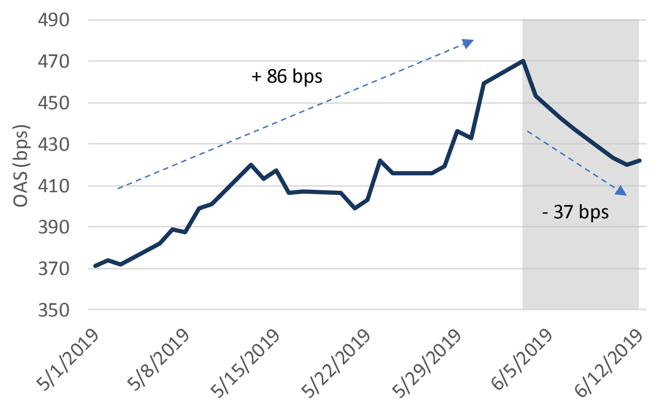
Weekly Briefing

SKYView: Fundamentals

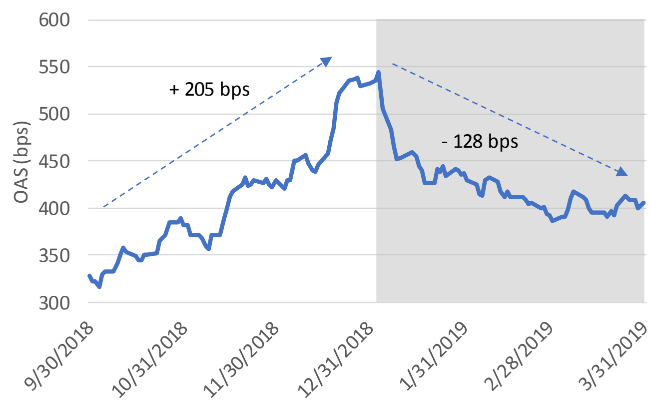
After a sharp May selloff, risk assets recovered through the first two weeks of June. At first glance, the pointed change in directionality was reminiscent of the Q1’19 rally that followed historical weakness in Q4’18. In this *Weekly Briefing*, we compare the two periods, with a focus on key differences and what such differences may suggest about investor thinking for the balance of 2019.

The high yield market selloff in May – primarily driven by trade negotiation setbacks – resulted in 86 bps of spread widening for the ICE BofAML US High Yield Index (ticker H0A0). Accelerating chatter around the potential for a Fed rate cut, further bolstered by a weaker-than-expected increase in payrolls, helped to spark an early June market rally. Through the time of publication, high yield bonds had retraced nearly half of prior-month weakness, resulting in a spread path quite similar to Q4’18 / Q1’19 market dynamics.

The May Selloff / June Rally...
daily spreads, June data shaded grey



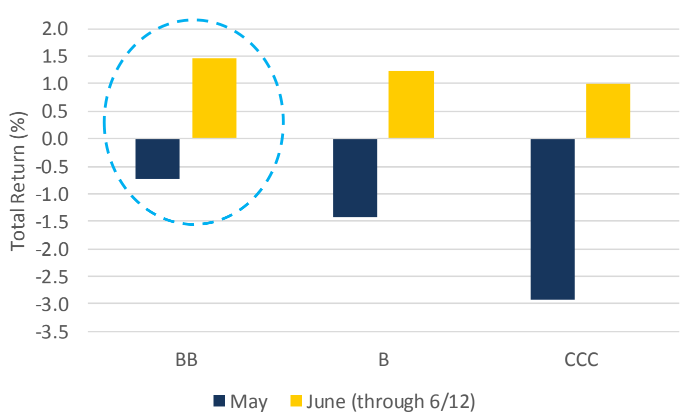
...Was Reminiscent of the Q4'18 Selloff / Q1'19 Rally
daily spreads, 2019 data shaded grey



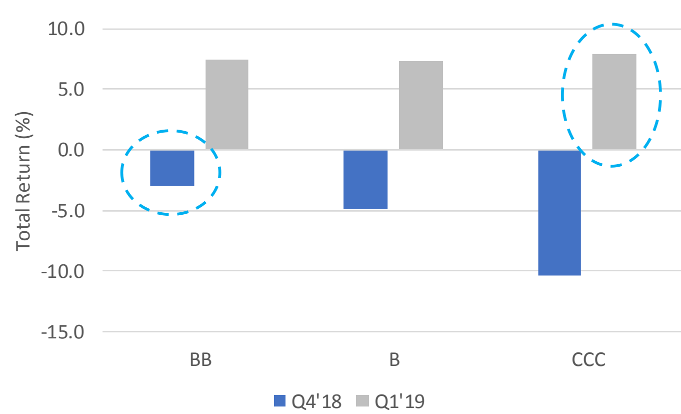
Source: SKY Harbor, ICE BofAML Indices

A more granular look at performance, however, highlights some key differences. In both the May ’19 and Q4’18 selloffs, BBs outperformed lower-rated credit buckets, as would be expected in a risk-off environment at least partially driven by fears of slowing global growth and the anticipated impact on corporate profitability. The subsequent June ’19 and Q1’19 rallies, however, have played out differently. CCCs outperformed in the Q1’19 bounce-back (on an absolute, though not beta-adjusted, basis), consistent with more severe Q4’18 selling pressure and risk-on sentiment following progress on the trade front. Thus far in June, CCCs have continued to lag while BB outperformance through both the ups and downs of the prior six-week period have pushed the CCC/BB spread ratio to bottom quartile levels (vs. median levels to start the year).

BBs Outperformed Through the May Selloff & June Rally
data through June 12



BBs More Resilient in Q4'18 Selloff; CCCs Rallied in Q1'19
quarterly data

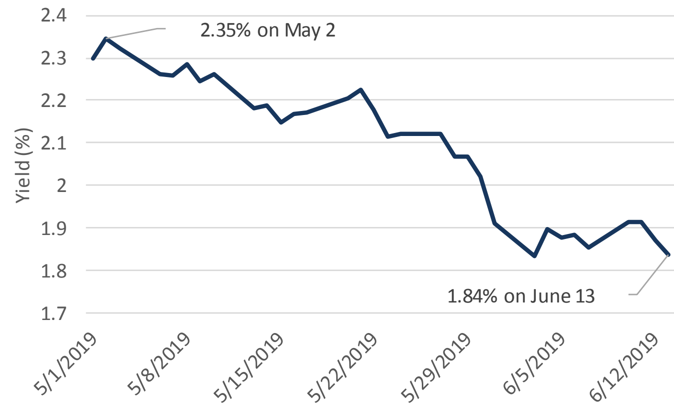


Source: SKY Harbor, ICE BofAML Indices

The trajectory of rates has played a role in this dynamic. The market is now pricing in three cuts from the Fed in 2019, exacerbating outflows from the leveraged loan asset class and alleviating fears of taking on duration risk. As demonstrated below, 5yr US Treasury yields are down ~ 50 bps over the last six weeks, and the **inherently longer duration of BBs relative to the US high yield index in general has added momentum to the up-in-quality trade.**

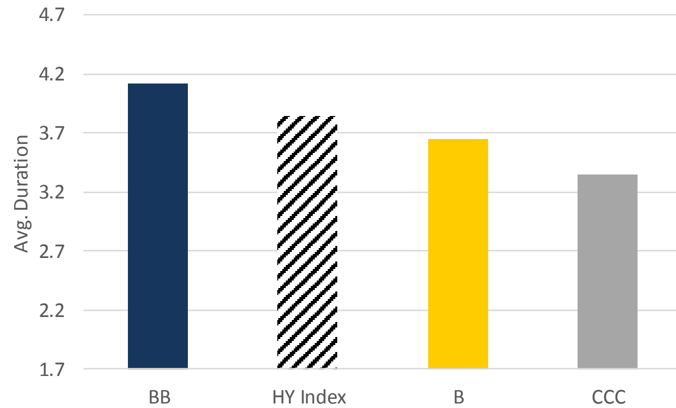
Rates Have Rallied Since May 1

5yr US Treasury Yields



BB Index Maintains the Highest Duration

duration by rating bucket as of May 31, 2019



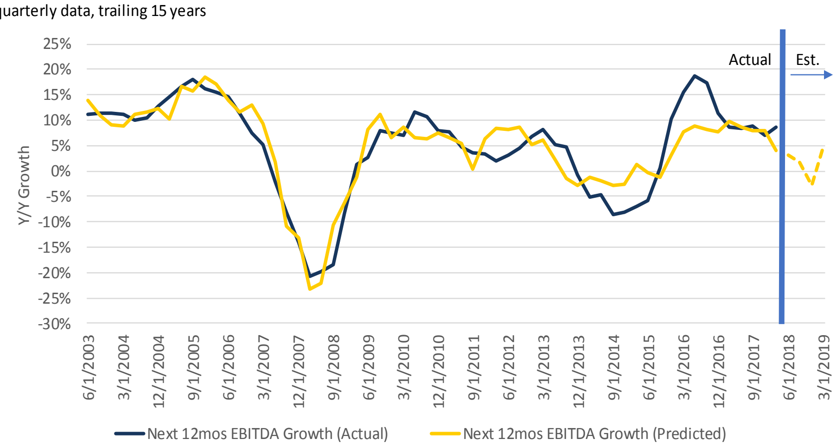
Source: SKY Harbor, ICE BofAML Indices, Bloomberg

In our view, diminished confidence in the continuation of corporate fundamental strength is also at play. In the past, we have used consensus EPS growth expectations for the S&P 500 Index to frame our outlook for underlying US high yield EBITDA growth given tight historic correlations. (The high yield market has too many private companies and lacks clearly articulated consensus expectations on a majority of constituents to be used in isolation.) Unfortunately, this method has become less reliable for several reasons. First, the grandfathering of tax reform creates added EPS volatility, creating unnecessary noise as it relates to our expectations for EBITDA growth. The acceleration and deceleration of share repurchases uniquely impacts EPS and skews true profitability. Furthermore, S&P 500 constituents typically have larger international sales exposure, which has become an increasingly relevant point of differentiation as of late (according to FactSet, S&P 500 companies that derive <50% of revenue outside of the US had average earnings growth of +6.2% in Q1'19, while companies that derive >50% of revenue outside of the US had average earnings growth of -12.8% in Q1'19).

To avoid such issues, we created a model to project future EBITDA growth using the S&P 1500 Index (greater overlap of high yield issuers relative to the S&P 500 Index) and five key economic indicators. The resulting model, which has an R^2 of 0.82, implies risk of EBITDA growth deceleration in H2'19. As would be expected (and further demonstrated below), **lower-rated securities are far more sensitive to declining earnings, a dynamic that is likely contributing to a lag in CCC performance on a month-to-date basis**. Furthermore, our work suggests that the Tech, Autos, Energy, Consumer Goods, and Basic Industry sectors have historically exhibited greater EBITDA growth volatility, while Retail, Telecom, Healthcare, Hotels & Leisure, and Services are typically more stable.

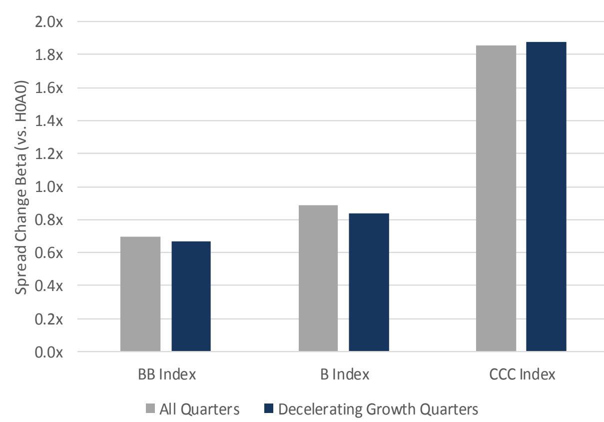
S&P 1500 Index EBITDA Growth: Actual vs. Next 12mos SKY Model Predicted

quarterly data, trailing 15 years



Spread Change Beta in Various S&P 1500 EBITDA Growth Environments

quarterly data, since 1997



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

In conclusion, the path of June spreads implies greater pessimism for sustained fundamental strength in the back half of 2019, resulting in diminished investor appetite for CCC securities. Additionally, our corporate EBITDA model implies the potential for better-than-consensus growth in the near term (Q2'19), while highlighting the risk of negative growth revisions in the second half of this year. Ultimately, BB and Single-B credit appears most attractive to us at present, and we remain biased toward sectors that have demonstrated more muted downside EBITDA volatility in the past.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
NFIB Small Business Optimism	11-Jun-19	May	102.8	105.0	103.5
CPI MoM	12-Jun-19	May	0.1%	0.1%	0.3%
Retail Sales Advance MoM	14-Jun-19	May	0.6%	0.5%	-0.2%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Empire Manufacturing	17-Jun-19	Jun	11.0		17.8
Housing Starts	18-Jun-19	May	1,235k		1,235k
Initial Jobless Claims	20-Jun-19	15-Jun	220k		222k

Source: SKY Harbor, Bloomberg

Recommended Reading

Kerr, Simeon et al. (2019, June 14). Donald Trump Blames Iran for Oil Tanker Attacks. *Financial Times* (subs. req.), Retrieved from https://www.ft.com/content/8791be48-8e93-11e9-a24d-b42f641eca37

Bloomberg News (2019, June 14). As Trade War Hits, China Factories See Slowest Growth Since 2002. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-06-14/china-s-industrial-output-growth-slows-to-weakest-since-2002?srnd=premium

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