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SKY HARBOR
CAPITAL MANAGEMENT

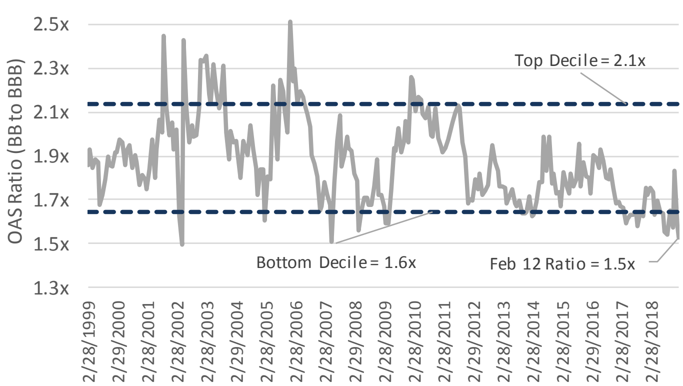
Weekly Briefing

SKYView: Valuations

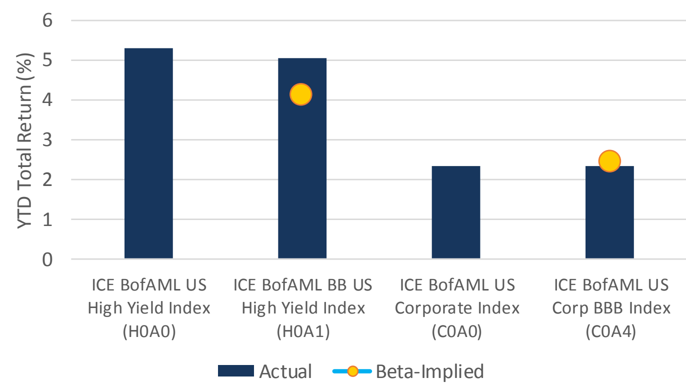
Consistent with data we have presented in past weeklies, the recovery of US high yield markets continues to be uneven in nature, with BBs outperforming lower-quality credit on an historical beta-adjusted basis. Concurrent with this theme, the ever-shrinking spread differential between BBB and BB indices has been brought to the forefront by the Street, with most strategists now calling the highest quality portion of the high yield index significantly overbought. As such, this *Weekly Briefing* will focus on corporate fundamentals and the underlying market dynamics driving this trend, all in an effort to gauge the justifiability of current trading levels.

The ratio of BB to BBB spreads (as of February 12) stands at 1.5x, below the bottom decile ratio of 1.6x (based on monthly data over the trailing 20 years) and represents the **third lowest value in the modern history of the high yield market** (we have data going back to the late 1990s). In general, and highlighted in the chart below, BB credits have outperformed their beta-adjusted expected returns YTD, while BBB credits have underperformed. As a result, the BB to BBB spread ratio, which had sporadically dropped below bottom decile levels throughout H2'18, has compressed even further thus far in 2019.

BB to BBB Spread Ratio
monthly data, trailing 20 years



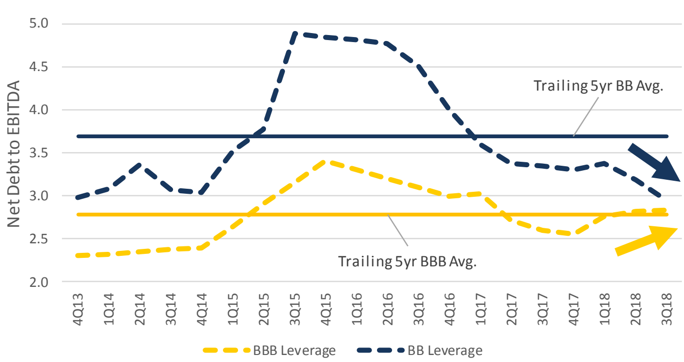
YTD Total Returns: Actual vs. Beta-Implied
daily data



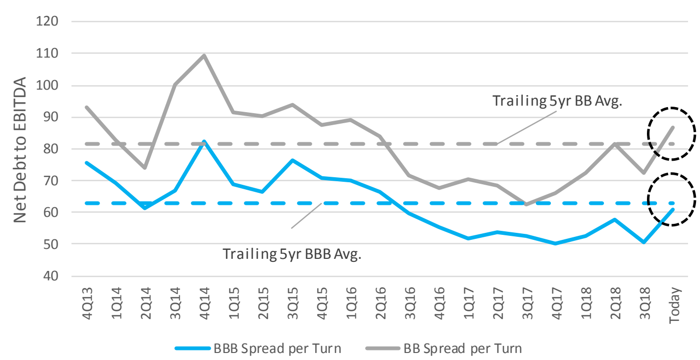
Source: SKY Harbor, ICE BofAML Indices

A look at underlying rating cohort fundamentals provides a more sanguine view on BB spread attractiveness. As demonstrated below, **BBB and BB net leverage trends have converged since Q1'18, with the differential now representing a five-year low**. Further normalizing value on a spread per turn of net leverage basis, we find that BBs offer compensation in excess of their trailing five-year average, while BBBs fall modestly below the mark. By this measure, BB/BBB spread ratio compression seems defensible, and could reasonably be expected to shrink further given current net leverage trajectories (BBs falling, BBBs rising).

Leverage Metrics: BBB vs. BB
quarterly data



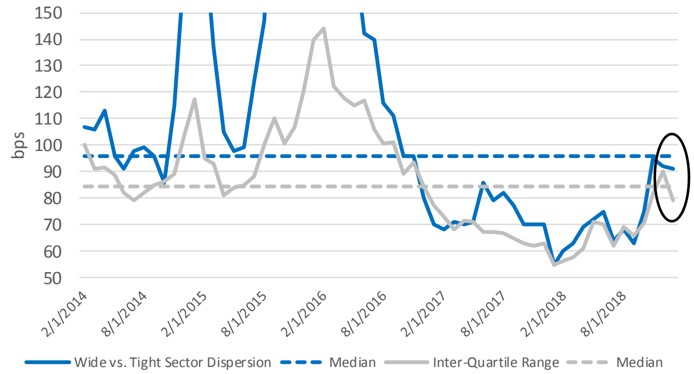
Spread per Turn of Net Leverage
quarterly data



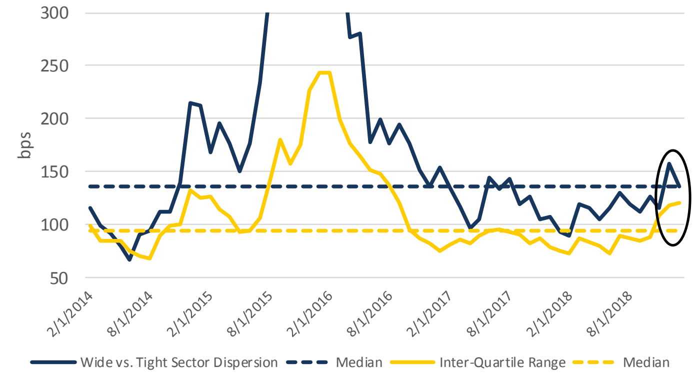
Source: SKY Harbor, ICE BofAML Indices, BofA Merrill Lynch, Capital IQ, Bloomberg

The distribution of spreads within the rating indices under review may also imply greater investor discernment and potential for outperformance through active management on the BB side. Whether comparing spread differentials between the widest and tightest sectors within each rating bucket, or a time series of interquartile ranges (difference between 75th and 25th percentile spreads), the amount of relative dispersion within the BB index appears superior in comparison to BBBs. As such, despite stronger-than-expected beta-adjusted performance on a year-to-date basis, **BB credits do not appear to have tightened indiscriminately**. On the BBB side, increasingly limited dispersion seems counterintuitive, in our view, given the much-maligned fallen angel risk as a result of M&A in the lower-quality tranches of the corporate investment grade index.

BBB Index Dispersion
monthly data, trailing 5 years



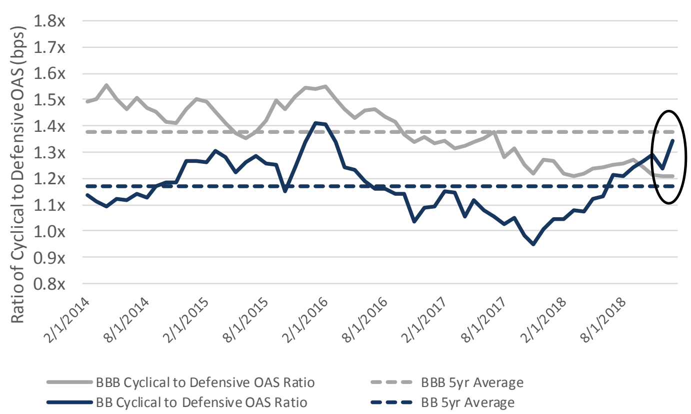
BB Index Dispersion
monthly data, trailing 5 years



Source: SKY Harbor, ICE BofAML Indices

The cyclical to defensive spread ratio, using generally accepted industry-level classifications, also **points to measured risk taking in the BB space despite year-to-date outperformance**. As demonstrated in the chart below, the BB index appears to show greater differentiation between cyclical and defensive credit spreads in this admittedly late-cycle period, while the equivalent ratio is below trailing five-year averages within the BBB index.

Cyclical to Defensive Spread Ratio
monthly data, trailing 5 years



Source: SKY Harbor, ICE BofAML Indices, MSCI, Bloomberg

In our view, the concurrent softening of Fed rate hiking expectations (alleviating pressure on longer-duration BB securities) and lingering concerns over the sustainability of global growth (leaving investors unwilling to dip down into the riskiest portions of the high yield index) have justifiably led to BB outperformance on a beta-adjusted basis. Furthermore, spread compression between BBB and BB rating cohorts appears warranted once normalized by underlying net leverage trends. **The greatest risk to BB credit, in our view, is the potential for marginal high yield buyers to retreat from the space** – anecdotal evidence suggests that BB performance has been buoyed by core plus funds dipping into higher-quality high yield markets, the reversal of which could generate technical pressure that dwarfs our underlying fundamental justification for BB/BBB spread compression. As such, we continue to favor Single B risk in the current market environment, but see little need to shed BB holdings unless fund flows begin to reverse in earnest.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
NFIB Small Business Opt.	12-Feb-19	Jan	103.0	101.2	104.4
CPI MoM	13-Feb-19	Jan	0.1%	0.0%	-0.1%
Empire Manufacturing	15-Feb-19	Feb	7.0	8.8	3.9

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Initial Jobless Claims	21-Feb-19	Feb	220k		239k
Durable Goods Orders	21-Feb-19	Dec	1.8%		0.7%
Markit US Manufacturing PMI	21-Feb-19	Feb	54.9		54.9

Source: SKY Harbor, Bloomberg

Recommended Reading

Peterson, Kristina and Andrews, Natalie (2019, February 14). Trump to Sign Spending Deal, Declare National Emergency. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/lawmakers-set-to-vote-on-spending-package-to-keep-government-open-11550157589?mod=hp_lead_pos1

Townsend, Matthew, Matthews, Steve, and Boesler, Matthew (2019, February 14). Analysts Are Questioning the Latest Retail Sales Figures *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-02-14/delayed-data-confirms-it-u-s-christmas-spending-disappointed?srnd=economics-vp

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