

Weekly Briefing

SKYView: Valuations

US Treasuries rallied following what was considered dovish commentary from the March 20 Fed meeting, with yields on the 10-year falling to 2019 lows. Despite the potential for economic headwinds arising from trade tensions, a slowing European economy and dwindling tax cut stimulus, we believe US high yield markets can benefit from moderate GDP growth in the context of lower year-end rate expectations. In this *Weekly Briefing*, we examine the impact lower Treasury yields may have on high yield index returns in 2019.

The March 20 Federal Open Market Committee (FOMC) meeting proved more dovish than expected, with the Fed indicating to the market that there would likely be no rate hikes in 2019 (down from a previous indication of two). Furthermore, Fed Chairman Powell noted continued strength in economic fundamentals, but cautioned that growth is likely to slow given domestic and international headwinds (the Fed is now expecting 2019 GDP growth of ~ 2.1%, down 20 bps from prior estimates). As a result, implied probabilities for a 2019 rate cut increased from ~ 25% (pre meeting) to ~ 60% (post meeting), a significant move in a relatively short period of time.

World Interest Rate Probability		United States - Instrument: Futures: Fed Funds - Effective - Fed Effective Rate: 2.40									
Current Implied Probabilities		Calculated 03/19/2019 - Based on rate: 2.25-2.50									
Dates	Meeting	Hike Prob	Cut Prob	1.5-1.75	1.75-2	2-2.25	2.25-2.5	2.5-2.75	Fwd Rate		
03/20/2019		0.8%	0.0%	0.0%	0.0%	0.0%	99.2%	0.8%	2.40		
05/01/2019		0.8%	2.1%	0.0%	0.0%	2.1%	97.2%	0.8%	2.40		
06/19/2019		0.7%	7.5%	0.0%	0.1%	7.4%	91.8%	0.7%	2.38		
07/31/2019		0.7%	11.5%	0.0%	0.4%	11.0%	87.8%	0.7%	2.37		
09/18/2019		0.6%	16.7%	0.0%	1.1%	15.6%	82.7%	0.6%	2.36		
10/30/2019		0.6%	20.0%	0.1%	1.6%	18.3%	79.3%	0.6%	2.35		
12/11/2019		0.6%	25.4%	0.2%	2.8%	22.4%	74.0%	0.6%	2.33		
01/29/2020		0.5%	33.7%	0.5%	5.0%	28.2%	65.8%	0.5%	2.30		

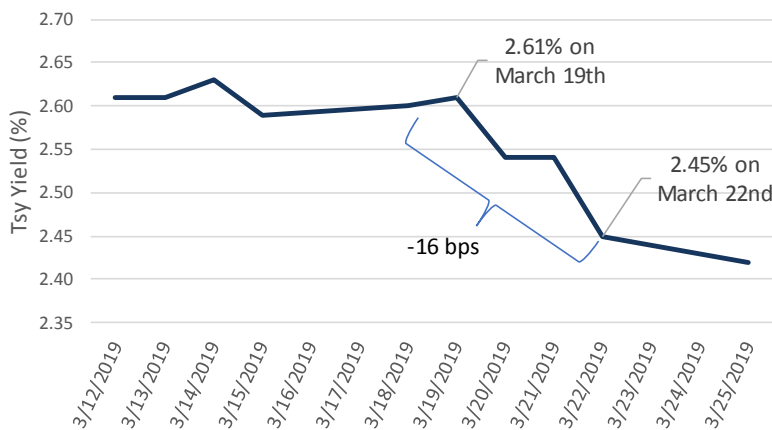
World Interest Rate Probability		United States - Instrument: Futures: Fed Funds - Effective - Fed Effective Rate: 2.40									
Current Implied Probabilities		Calculated 03/22/2019 - Based on rate: 2.25-2.50									
Dates	Meeting	Hike Prob	Cut Prob	1.25-1.5	1.5-1.75	1.75-2	2-2.25	2.25-2.5	Fwd Rate		
05/01/2019		0.0%	4.1%	0.0%	0.0%	0.0%	4.1%	95.9%	2.40		
06/19/2019		0.0%	18.4%	0.0%	0.0%	0.6%	17.8%	81.6%	2.36		
07/31/2019		0.0%	25.7%	0.0%	0.1%	2.2%	23.5%	74.3%	2.34		
09/18/2019		0.0%	43.8%	0.0%	0.6%	7.4%	35.9%	56.2%	2.28		
10/30/2019		0.0%	49.2%	0.1%	1.2%	10.1%	37.8%	50.8%	2.25		
12/11/2019		0.0%	60.8%	0.3%	3.2%	16.4%	40.8%	39.2%	2.20		
01/29/2020		0.0%	69.1%	0.9%	6.0%	21.6%	40.4%	30.9%	2.14		

Source: SKY Harbor, Bloomberg

Concurrent with a change in sentiment, 10-year Treasury yields declined 16 bps, with higher-quality credit (IG corporates and BBs) outperforming CCCs. Going forward, we believe consensus expectations for year-end 2019 rates are likely to come down. (We view 5-year Treasuries as most relevant for the ICE BofAML US High Yield Index and 3-year Treasuries as most relevant for the ICE BofAML 1-5Yr BB-B US Cash Pay High Yield Constrained Index.)

10Yr US Treasury Yield

daily data, pre and post Fed meeting



Source: SKY Harbor, Bloomberg, ICE BofAML Indices

Market Reaction

week of Mar. 18 through Mar. 22

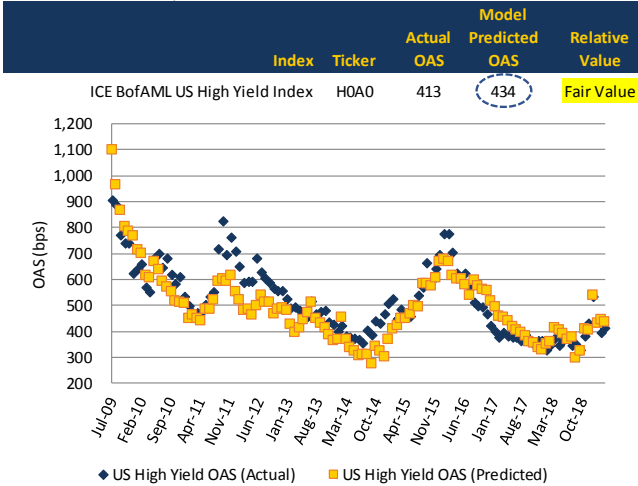
Index	Ticker	Return (%)
ICE BofAML US High Yield Index	HOA0	0.26
US High Yield BB	HOA1	0.39
US High Yield B	HOA2	0.20
US High Yield CCC	HOA3	-0.09
ICE BofAML 1-5yr BB-B Constrained Index	JVC4	0.16
ICE BofAML US Corporate Index	COA0	1.09

	Q4'19 Yield Expectation (Median of Consensus)			
	Feb Survey	Mar Survey	Δ	Apr Survey
US 10-Year	3.00	3.00	0.00	?
US 5-Year	2.85	2.86	0.01	?
US-2 Year	2.85	2.85	0.00	?

Acknowledging the Fed's observance of slowing economic growth relative to 2018, we re-ran our macro spread and forward-looking default rate regression models. An updated set of economic indicators did little to change our internal view on fair value of high yield spreads and expected defaults through the balance of the year, leaving us comfortable with our OAS target estimate of 445 bps (the average of the two methods as presented below).

SKY Harbor US High Yield Spread Model

based on coefficients updated at March 25, 2019



As of March 26, 2019.

Source: SKY Harbor, ICE BofAML Indices, Federal Reserve and Bloomberg

Variable definitions available upon request; This multivariate linear regression analysis is for information purposes only. This analysis uses historical month-end data for the model's four factors and is not intended as the basis of a model portfolio or buy/sell decisions on any particular security. The analysis is one of many inputs in our investment decision-making process. High R² values are not intended to be taken as a guarantee of future results as differences in any of the four factors going forward can result in significant departures from predicted values. See additional disclaimers included with this presentation.

Implied Spreads Based on Expected Default and Recovery Rates

assumes excess spreads=310 bps (20yr average)

Expected Recovery Rate	Expected Default Rate								
	2.10%	2.20%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%
55%	405	409	414	418	423	427	432	436	441
50%	415	420	425	430	435	440	445	450	455
45%	426	431	437	442	448	453	459	464	470
40%	436	442	448	454	460	466	472	478	484
35%	447	453	460	466	473	479	486	492	499
30%	457	464	471	478	485	492	499	506	513
25%	468	475	483	490	498	505	513	520	528

We do not expect to receive a fresh set of 2019 year-end consensus rate expectations until mid-April, but remain confident that they will move lower in accordance with Fed commentary. Assuming 2019 year-end OAS targets for the full US high yield index (HOAO) and the short duration US high yield index (JVC4) of 445 bps and 360 bps, respectively, along with internal estimates of default, downgrade, recovery and loss from migration rates, we provide sensitized index return estimates below. Note that outlined scenarios (7.6% for HOAO, 7.1% for JVC4) represent our 2019 index return estimates prior to the most recent Fed meeting, with most iterations representing upside to those returns (shaded in green) as year-end rate expectations decline.

Sensitized Return Expectations for the US High Yield Index (HOAO)

outlined return = 2/28/2019 estimate; returns shaded in green are higher than Feb. estimate

HOAO OAS (Year End 2019)	US 3yr Yield (Year End 2019)									
	2.95	2.90	2.85	2.80	2.75	2.70	2.65	2.60	2.55	
465	6.9	7.1	7.3	7.4	7.6	7.8	7.9	8.1	8.3	
460	7.1	7.3	7.4	7.6	7.8	7.9	8.1	8.3	8.4	
455	7.3	7.4	7.6	7.8	7.9	8.1	8.3	8.4	8.6	
450	7.4	7.6	7.8	7.9	8.1	8.3	8.4	8.6	8.8	
445	7.6	7.8	7.9	8.1	8.3	8.4	8.6	8.8	9.0	
440	7.8	7.9	8.1	8.3	8.4	8.6	8.8	9.0	9.1	
435	7.9	8.1	8.3	8.4	8.6	8.8	9.0	9.1	9.3	
430	8.1	8.3	8.4	8.6	8.8	9.0	9.1	9.3	9.5	
425	8.3	8.4	8.6	8.8	9.0	9.1	9.3	9.5	9.6	

Sensitized Return Expectations for the US Short Duration High Yield Index (JVC4)

outlined return = 2/28/2019 estimate; returns shaded in green are higher than Feb. estimate

JVC4 OAS (Year End 2019)	US 3yr Yield (Year End 2019)									
	2.90	2.85	2.80	2.75	2.70	2.65	2.60	2.55	2.50	
380	6.6	6.7	6.8	7.0	7.1	7.2	7.3	7.4	7.5	
375	6.7	6.8	7.0	7.1	7.2	7.3	7.4	7.5	7.6	
370	6.8	7.0	7.1	7.2	7.3	7.4	7.5	7.6	7.7	
365	7.0	7.1	7.2	7.3	7.4	7.5	7.6	7.7	7.8	
360	7.1	7.2	7.3	7.4	7.5	7.6	7.7	7.8	7.9	
355	7.2	7.3	7.4	7.5	7.6	7.7	7.8	7.9	8.0	
350	7.3	7.4	7.5	7.6	7.7	7.8	7.9	8.0	8.1	
345	7.4	7.5	7.6	7.7	7.8	7.9	8.0	8.1	8.2	
340	7.5	7.6	7.7	7.8	7.9	8.0	8.1	8.2	8.3	

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

In conclusion, we view FOMC commentary and the anticipated downward re-setting of year-end rate expectations to represent upside potential for US high yield returns in 2019. US high yield indices have historically performed well in low-to-moderate growth GDP environments consistent with revised Fed expectations, and the alleviation of rate pressure (which had represented the greatest drag to our modeled high yield returns for the balance of the year) bodes well for high yield investors. As such, we remain constructive on high yield markets, and think the re-setting of spreads above 400 bps amidst reduced concerns for rising rates could generate near-term technical tailwinds.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Chicago Fed Nat. Activity Index	25-Mar-19	Feb	-0.38	-0.29	-0.43
Housing Starts	26-Mar-19	Feb	1210k	1162k	1230k
Conf. Board Consumer Confid.	26-Mar-19	Mar	132.5	124.1	131.4

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	1-Apr-19	Mar	54.6		54.2
Durable Goods Orders	2-Apr-19	Feb	-1.7%		0.3%
Initial Jobless Claims	4-Apr-19	30-Mar	216k		211k

Recommended Reading

Otani, Akane and Kruger, Daniel (2019, March 29). Tame Inflation Fuels Government Bonds' First-Quarter Rally. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/bond-investors-bets-against-inflation-face-test-friday-11553851800?mod=hp_lead_pos6

Chaney, Sarah and Kiernan, Paul (2019, March 29). US Consumer Spending Edged Up in January. *The Wall Street Journal* (subs. req.), Retrieved from <https://www.wsj.com/articles/u-s-consumer-spending-edged-up-in-january-11553862739>

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