SKY HARBOR
CAPITAL MANAGEMENT

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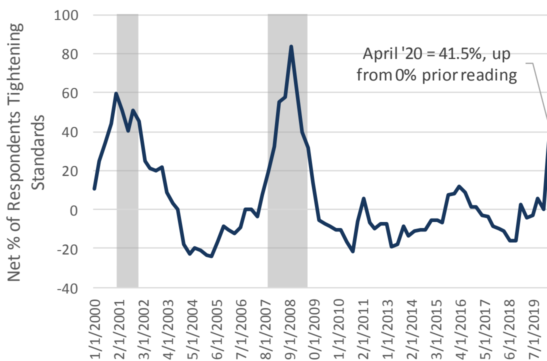
Weekly Briefing

SKYView: May Rally

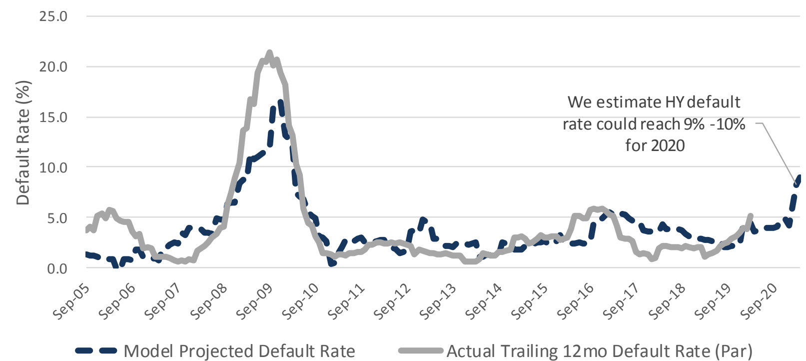
Risk assets have rallied thus far in May, with investors largely looking past weak macroeconomic data and an expectedly abysmal Q2'20 earnings season, focusing instead on signs of a successful re-opening of the global economy following several weeks of lockdown. Since recent spread peaks (1,087 bps on March 23, 2020), the ICE BofA US High Yield Index (ticker H0A0) has tightened ~ 400 bps, recouping nearly 60% of market widening that occurred from mid-February through mid-March. In this *Weekly Briefing*, we update our assessment of relative value in the context of now tighter spreads and rising default rates.

This unprecedented pandemic has caused a number of key economic indicators into territory never before seen, most notably record-high US initial jobless claims and steep reductions in consumer spending. This month, **the Senior Loan Officer Opinion Survey on Bank Lending Practices registered a 41.5% net tightening of lending standards**, up from net 0% tightening of standards in the prior month. This move represents the largest single month sequential change on record, and is a key indicator in our internal default projection model. Updating our model to incorporate this new data point, and moderately offset by improvements in other factors used to drive our projections, **we now believe the 2020 high yield default rate will reach 9% to 10% (6% to 7% excluding Energy)**, higher at the midpoint by approximately 75 bps relative to our prior estimate. For further context, this would be above the long-run average annual high yield default rate of approximately 4.5%, and above the trailing-twelve-months figure of ~ 5.0%.

Senior Loan Officer Opinion Survey on Bank Lending Practices
data since January 2000, recession shaded grey



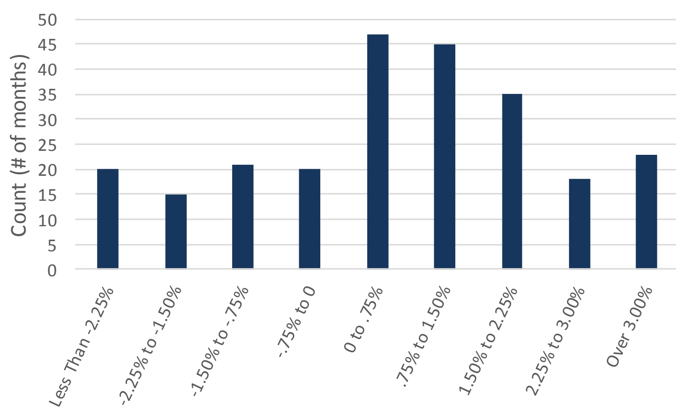
SKY Harbor Default Model Output
monthly data inputs



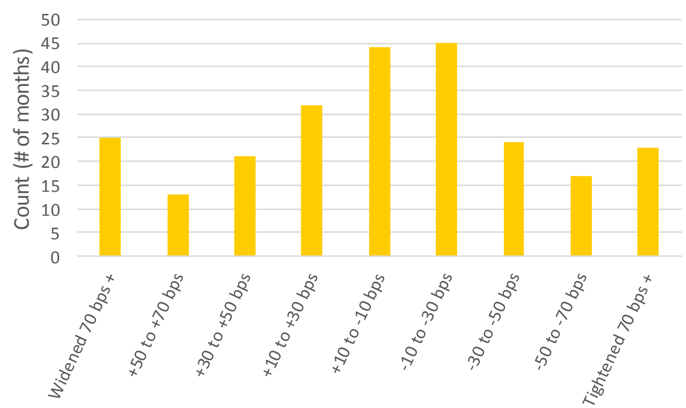
Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices, Federal Reserve

Despite degradation of economic indicators, investors have been enthusiastic about US high yield in the preceding weeks. At the time of writing (data through May 27) trailing 30-day total returns and OAS tightening have been +5.1% and -131bps, respectively, both measures strong enough to register among the best 5% of monthly occurrences based on data going back to January '00. Though seemingly counter-intuitive, recall that index spreads tend to be forward-looking in nature, with **inflections typically materializing one quarter before trough earnings and three quarters before peak default rates**. Given recent market moves, investors appear to believe the re-opening of the economy will go smoothly, and that demand will recover in the back half of 2020 and into 2021.

Distribution of Monthly Total Returns
monthly data, since January 2000



Distribution of Monthly OAS Changes
monthly data, since January 2000

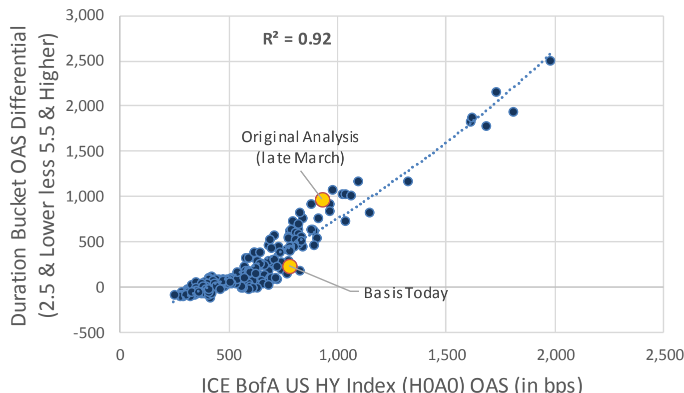


Source: SKY Harbor, ICE BofA Indices

Given spread compression over the last several weeks, our focus now turns to a reassessment of value across a variety of metrics. First, we look at duration. At peak levels of fear and in the midst of government-mandated lockdowns, high yield credit curves inverted. The most severe reading coincided with recent OAS peaks, at which time the average spread of index-eligible bonds with a duration of 2.5 and lower traded nearly 1,000 bps wide of bonds with a duration of 5.5 and higher. At that point in time, we found the portion of the market trading with a duration of 0 to 2 to be most attractive. The anticipated economic re-opening, along with supportive high yield market technicals, served to flatten the credit curve over the last several weeks via material front-end compression. **We now find the duration 2 to 4 bucket to be most attractive given all-in average spread levels and its location along the steepest part of the credit curve**.

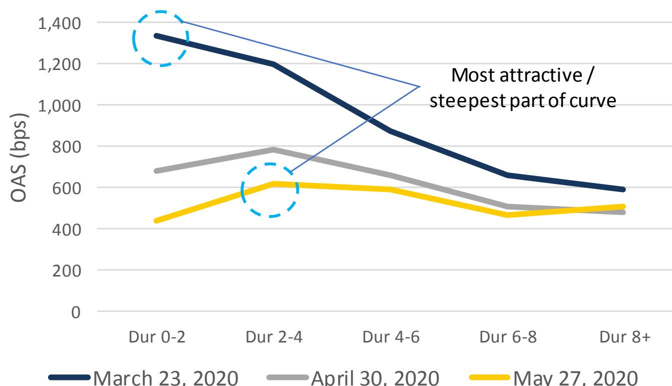
Front-End Was 200 bps Cheap, Now 100 bps Rich

monthly data since 2000



B/BB (H0A0) Curve Has Flattened

snapshot data



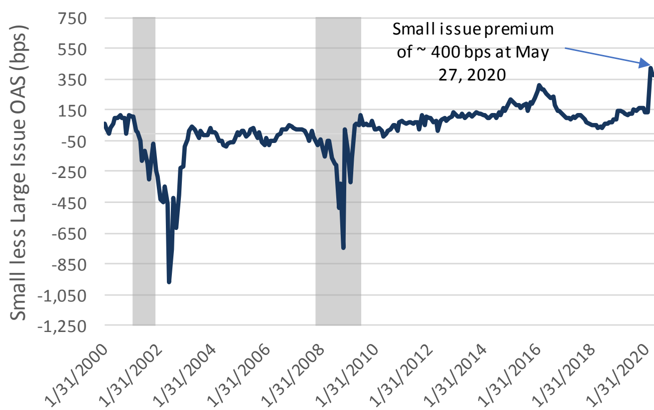
Source: SKY Harbor, ICE BofA Indices

Small issue premiums remain elevated, in our view, particularly given historical performance during periods of rising credit stress. At present, **smaller issues within H0A0 (bond size of $350mm and smaller) trade at average OAS levels nearly 400 bps higher than larger issues in the index (bond size of $1bn and larger) despite equivalent credit ratings.** This is well above the average monthly small issue premium of ~ 25 bps (data going back to January '00) and serves as a stress period outlier given typical spread *discounts* during prior recessions. Significant inflows into US high yield (~ $30bn over the last eight weeks) likely account for much of this phenomenon, as ETFs have been key beneficiaries of net new money and have historically favored larger and more liquid securities. In our view, smaller issues represent attractive relative value, and we think the premium offered to investors will normalize in the coming months.

Cyclical (ex Energy) credits continue to trade wide of Defensive bonds, with spread ratios nearing 1.2x consistent with past periods of credit stress. We would note, however, that the ratio typically compresses as we exit a recession, with cyclical sectors potentially poised to outperform in the coming months should the economic re-opening be a success.

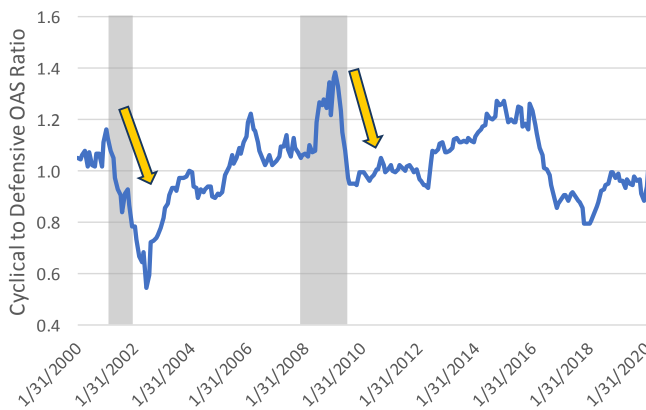
Spread Pickup for Small (< $350mm) vs. Large (> $1bn) Elevated

monthly data since 2000



Cyclical (ex Energy) to Defensive OAS Ratio Yet to Compress

regression output

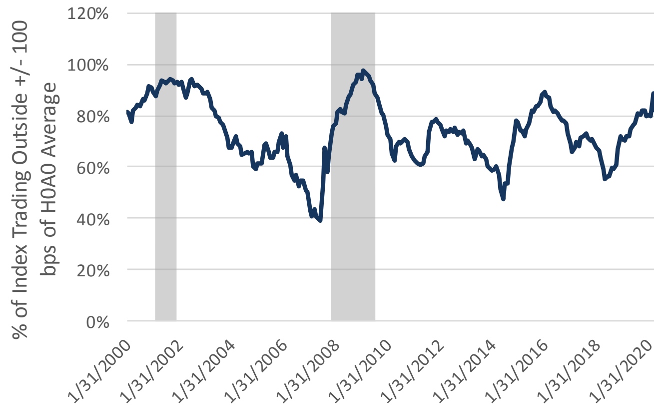


Note: Automotive, Basic Industry, Capital Goods, Leisure, Real Estate, Retail, Technology and Transportation assumed to be "Cyclical ex Energy"; Banking, Consumer Goods, Healthcare, Financial Services, Insurance, Media, Services, Telecom and Utility assumed to be "Defensive."
Source: SKY Harbor, ICE BofA Indices

Finally, we would highlight that market dispersion remains elevated, with approximately 83% of index constituents trading outside a range of +/- 100 bps of H0A0 OAS. This reading – well above the 20-year index average of ~ 74% – is elevated even when normalized for H0A0 spread levels that are above long-term medians. As demonstrated in the righthand chart below, **current levels of index dispersion appear 500 bps too high in the context of overall index spreads of ~ 670 bps**. In our September 30, 2019 *Weekly Briefing* entitled "Dispersion Presents Alpha Opportunity," we demonstrated through an analysis of 50 US high yield bond manager return streams contained within the eVestment database that high levels of dispersion and subsequent period active manager alpha generation were positively correlated. We see no reason why this relationship would have deteriorated over the last few quarters, and believe there to be an above-average number of bonds trading at spread levels wide of 770 bps that should be tighter, or tight of 570 bps that should be wider.

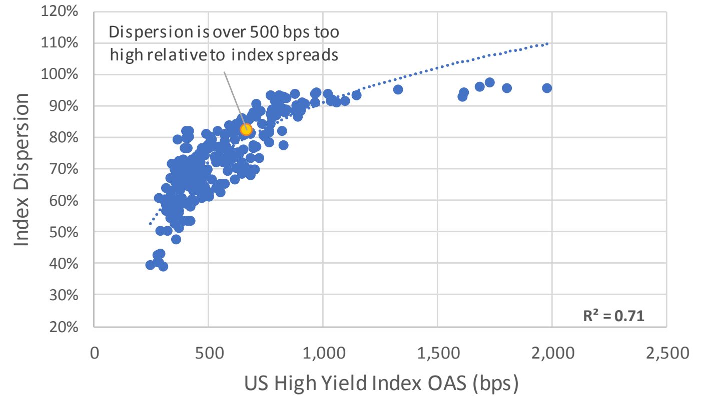
Dispersion Remains Elevated

monthly data since January 2000, recessions shaded grey



Too Many Issues Trade 100 bps Tight or Wide to Index Average

monthly data since January 2000, recessions shaded grey



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

In conclusion, we think investors are justified in looking past an expectedly weak Q2'20 earnings season provided a successful re-opening of the economy remains on track, as this coincides historically with the forward-looking nature of credit spreads after periods of stress. Mindful of relative value following the recouping of ~ 60% of spread widening from mid-February through mid-March, we highlight opportunities in the shorter (but not shortest) part of the market (duration 2 to 4) and among smaller issues ($350mm in size and below) that should also be more immune to technical pressures that could arise from a reversal in fund flows. Additionally, further evidence of a successful re-opening should incentivize a rotation away from defensive and into cyclical ex-Energy sectors, particularly if demand from China continues to rebound. Finally, elevated dispersion points to opportunities for alpha generation both from buying higher-yielding issues that have been unjustifiably penalized by pandemic-related credit concerns and from selling lower-yielding issues that have unjustifiably rallied on re-opening optimism.

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