

Weekly Briefing

SKYView: Asset Valuations

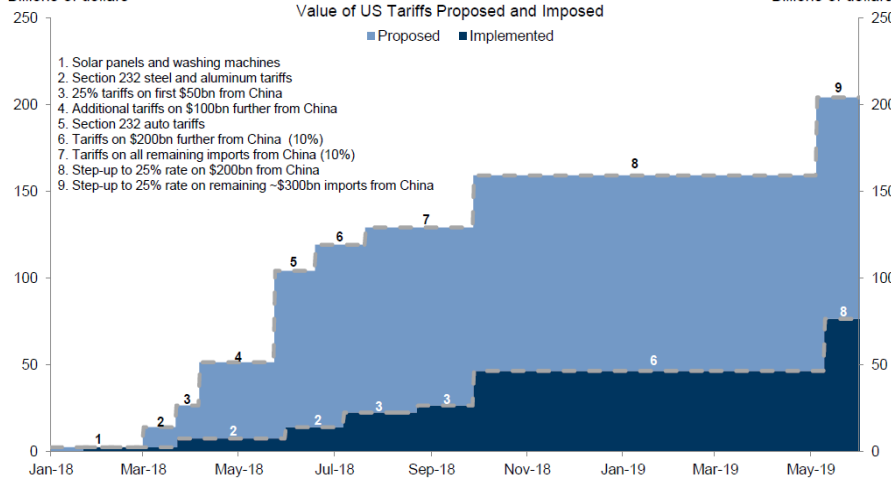
Markets have been volatile over the last couple of weeks, largely a function of an ever-evolving outlook on US-China trade relations. In this *Weekly Briefing*, we seek to frame the impact varying degrees of trade tension might have on US high yield spreads. Additionally, we examine month-to-date index performance in an effort to identify mispriced sector and industry risk based on historical correlations to manufacturing and production (particularly companies with outsized exposure to non-domestic end markets).

Market sentiment began to wane following a May 5 tweet by President Trump that proposed a step-up in tariffs (from 10% to 25%) on ~\$200bn of Chinese goods by the end of that week. Despite the rhetoric, a trade delegation led by Chinese Vice Premier Liu He arrived in Washington several days later, although resolution failed to materialize. Tariffs imposed on Chinese goods ratcheted up to 25% on May 10, China retaliated in kind, and the two sides moved further apart from a trade deal. An economic research piece published by Goldman Sachs entitled "The Return of the Trade War"¹ updates the magnitude of proposed and implemented tariffs since the start of 2018 (pictured below, left). Risk assets reacted negatively to the series of events, with the S&P 500 and the ICE BofAML US High Yield indices declining amidst an uptick in volatility.

Timeline: Tariffs on Imports from China

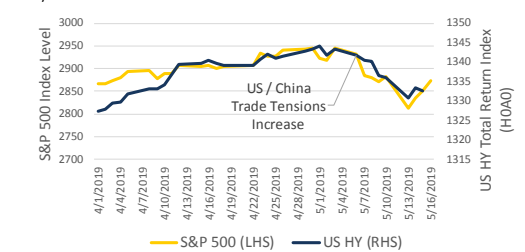
proposed and implemented measures

Billions of dollars



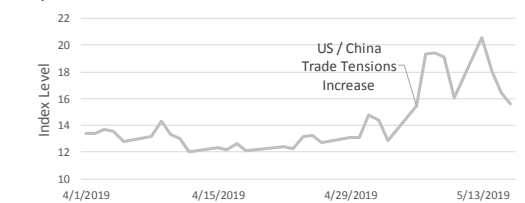
US Equity and US High Yield Performance

daily values



CBOE Volatility Index (VIX)

daily values

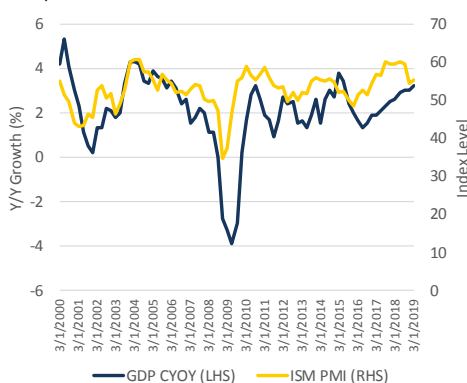


Source: SKY Harbor, Goldman Sachs Investment Research, Bloomberg, ICE BofAML Indices, Chicago Board Options Exchange

While an eventual agreement between the US and China remains our base case assumption, we nevertheless recognize the negative impact a prolonged trade war can have on global growth. The correlation between US GDP growth and both ISM Manufacturing PMI and Capacity Utilization (as demonstrated below) is of particular concern, as the latter two indicators feature prominently in our high yield spread projection model.

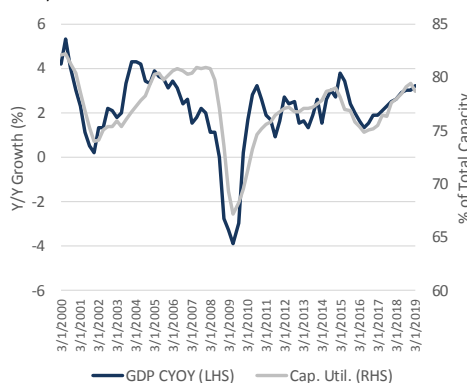
US GDP Growth vs. ISM PMI

quarterly data

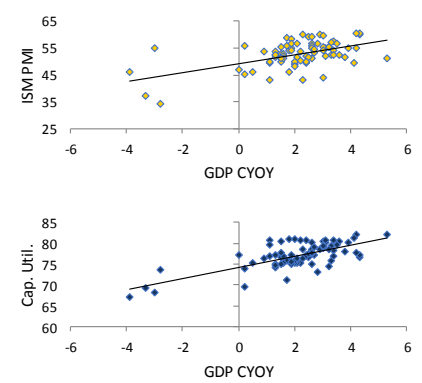


US GDP Growth vs. Capacity Utilization

quarterly data



Regression Output



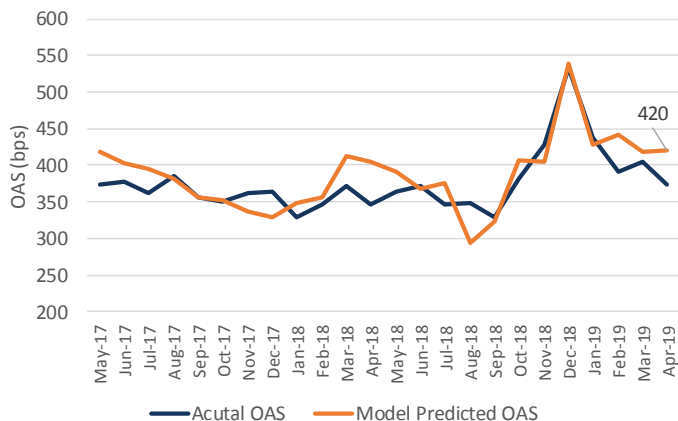
Source: SKY Harbor, ICE BofAML Indices, Institute for Supply Management, Federal Reserve

¹ Hatzius, Jan et al., (2019, May 11). The Return of the Trade War. Goldman Sachs Economics Research, retrieved from <https://research.gs.com/content/research/en/reports/2019/05/11/6576d0ea-6522-4c2d-a1c5-385603f2ac95.pdf>

In the absence of trade resolution, and assuming the situation worsens before it gets better – i.e., the US imposes similar tariffs on essentially all imports from China, and China responds with tariffs of its own – most economists estimate an eventual drag on US GDP growth of ~ 20 basis points. Updating our spread regression model to assume a weaker growth environment (a 20 bps reduction in GDP likely equates to a 0.30% hit to capacity utilization, a quarter point hit to ISM PMI, etc.), we think fair value spreads for the US high yield index increases to ~ 465 bps, meaningfully above spreads at the end of April (373 bps, and before new trade tensions arose). Interestingly, the high yield market widened to ~ 417 bps (mid-May, at the time of publication), or nearly halfway between pre-tweet spreads of 373 bps and our regression-implied trade war continuation fair value estimate of 465 bps. In a more draconian scenario in which US GDP growth is reduced by 100 bps (the most aggressive estimate on the Street), fair value spreads rise to ~ 550 bps. In all, the market seems to be placing a 25% to 50% chance of a trade war persisting (depending on one’s estimate of GDP drag).

US High Yield OAS - Actual vs. SKY Model Predicted

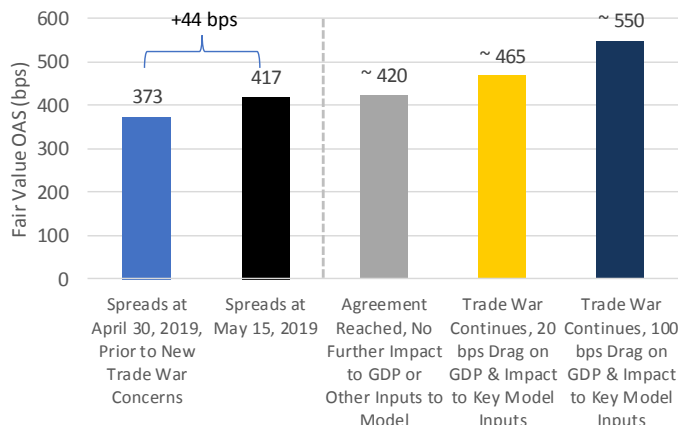
monthly data



Source: SKY Harbor, ICE BofAML Indices, Institute for Supply Management, Federal Reserve

Trade War Scenario Analysis: Fair Value OAS

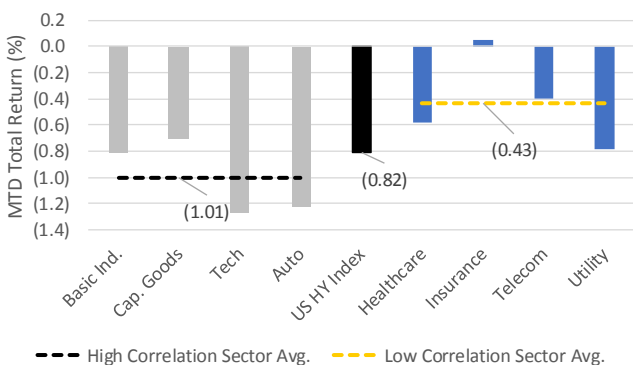
data as of May 15



Comparing correlations between ISM PMI (at risk should trade tensions escalate) and US high yield sector spreads (monthly data, since January 2000), we find Basic Industry, Capital Goods, Tech and Automotive to be at most risk in an escalating trade war scenario, while Utility, Telecom, Insurance and Healthcare should be most insulated. The market appears to agree – average total returns for sectors most at risk through the first two weeks of May (-1.01%) were below the full high yield index (-0.82%) and below average total returns for sectors least at risk (-0.55%). Taking our analysis to the industry level (given how broad some sector classifications are), we find similar results. As depicted in the righthand chart below, industries most correlated to ISM PMI have underperformed industries with little correlation. While idiosyncratic risks and opportunities are likely driving some deviations, this analysis leaves us a bit cautious on several diversified capital goods issuers (highly correlated, but did not sell off as much as their peers) and optimistic on several health services issuers (limited correlation, and sold off too much relative to peers).

Month-to-Date Sector Performance (through May 15)

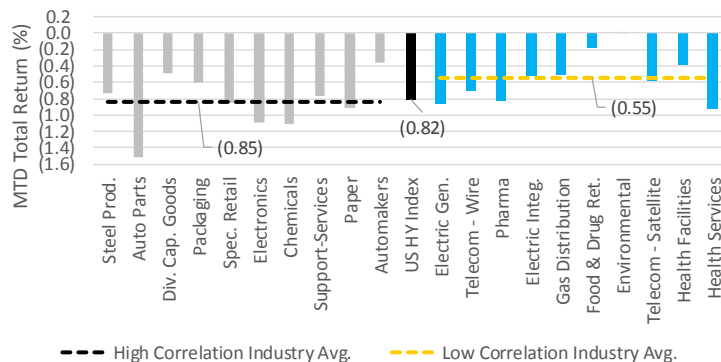
grey bars = sectors highly correlated to ISM PMI; blue bars = low correlation



Source: SKY Harbor, ICE BofAML Indices, Institute for Supply Management

Month-to-Date Industry Performance (through May 15)

grey bars = industries highly correlated to ISM PMI; blue bars = low correlation



We continue to believe that resolution is the most likely outcome for currently contentious US-China trade tensions (perhaps when Trump and Xi convene at the G20 summit in June). However, the market could be volatile in the interim. Although spread widening since April 30 seems justified given the introduction of further uncertainties, we think the market-implied odds of a sustained trade war appear too high (25%+), and remain constructive on high yield at present. Furthermore, we see underappreciated risks and opportunities in several industries where the correlation to manufacturing and production (or lack thereof) is at odds with MTD total returns.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Trade Balance	9-May-19	Mar	-\$50.1bn	-\$50.0bn	-\$49.4bn
PPI ex Food and Energy YoY	9-May-19	Apr	2.5%	2.4%	2.4%
CPI YoY	10-May-19	Apr	2.1%	2.0%	1.9%

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Existing Home Sales	21-May-19	Apr	5.35m		5.21m
Initial Jobless Claims	23-May-19	18-May	215k		212k
New Home Sales	23-May-19	Apr	675k		692k

Recommended Reading

Politi, James, et al. (2019, May 17). Trump Eases Trade Conflicts with US Allies. *Financial Times* (subs. req.). Retrieved from <https://www.ft.com/content/9aca49e0-78a3-11e9-be7d-6d846537acab>

El-Erian, Mohamed (2019, May 16). China Could Pay a High Price for Trump's Tariffs. *Bloomberg*. Retrieved from <https://www.bloomberg.com/opinion/articles/2019-05-17/china-could-pay-high-price-for-trump-tariffs>

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