SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Director of Research
msalice@skyhcm.com
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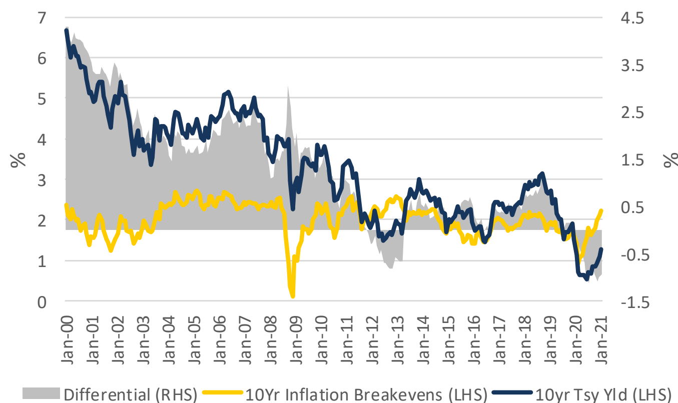
Weekly Briefing

SKYView: It's All Relative

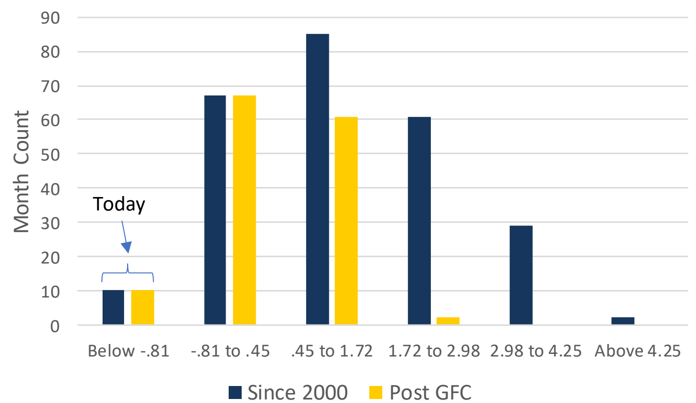
Shrinking risk premiums have led to tighter spreads and higher P/E ratios, leaving many investors apprehensive about asset valuations in the current market environment. The re-emergence of inflationary concerns has further clouded the path forward, driven by optimism for a re-opening amidst highly accommodative fiscal and monetary policies. In this *Weekly Briefing*, we attempt to frame valuations on a relative basis, with a focus on historical asset class performance during prior periods in which the tradeoff between inflation and economic growth was a dominant factor.

At the time of writing, (nominal) yields on the 10yr US Treasury have increased to 1.28% (up ~ 37 bps on a year-to-date basis), a meaningful step-up in the context of risk-free rates since the onset of the coronavirus. The move, however, has coincided with an uptick in inflation expectations (we use the 10-Year Breakeven Inflation Rate, a measure of investor expectations of inflation over the next decade, as our proxy) to ~ 2.22%, a level we've not seen since 2014. The -94bps differential implies the persistence of negative real rates, a relatively rare market occurrence and certainly within the most extreme bucket of the historical distribution chart shown below.

10yr Treasury Yields vs. 10 Year Inflation Breakevens
monthly data since 2000, grey shaded data = differential



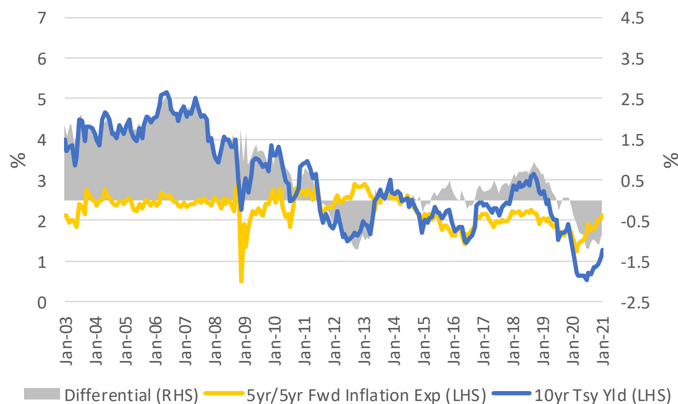
Differential (Real Rate) Distribution
month count since 2000



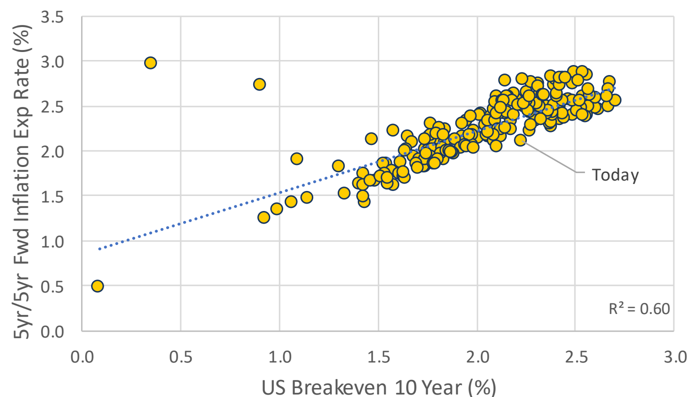
Source: SKY Harbor, ICE Data Indices, Bloomberg

As an alternative to the 10-Year Inflation Breakeven Rate, we re-ran our analysis using the 5yr/5yr Forward Inflation Expectation Rate, and generated similar findings (i.e., around the most negative real rate environment observed in the last two decades).

10yr Treasury Yields vs. 5yr/5yr Forward Inflation Expectation
monthly data since 2003, grey shaded data = differential



10 Year Inflation Breakevens vs. 5yr/5yr Fwd Inflation Exp. Rate
monthly data since 2003

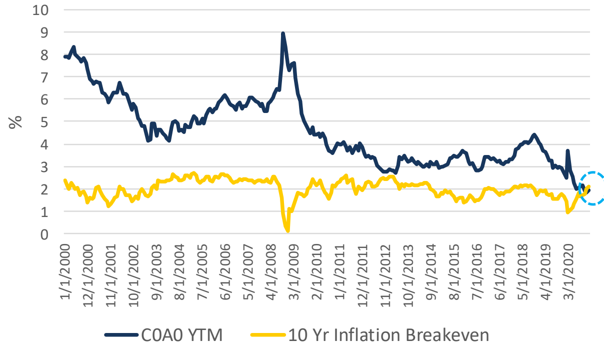


Source: SKY Harbor, ICE Data Indices, Bloomberg, Federal Reserve Bank of St. Louis

Though the proliferation of negative real yields on government bonds has, in recent times, become the rule rather than the exception, this dynamic has now migrated down into the investment grade credit universe. At present, the yield to maturity of the ICE BofA US Corporate Index (C0A0) is ~ 1.96%, falling below the 10-Year Inflation Breakeven Rate for the first time in our 20+ year data set. Breaking down C0A0 more granularly, we find that 59% of the index by face value is offering investors a negative real yield based on inflation expectations.

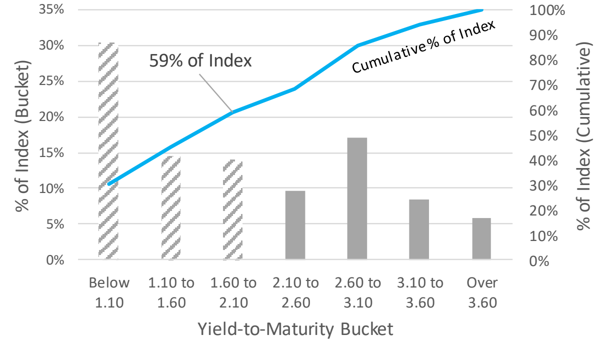
Investment Grade (C0A0) YTM vs. 10 Year Inflation Breakevens

monthly data since 2000



Large Portion of IG Index (C0A0) May Have Negative Real Yields

Yield-to-Maturity Buckets by Face Value

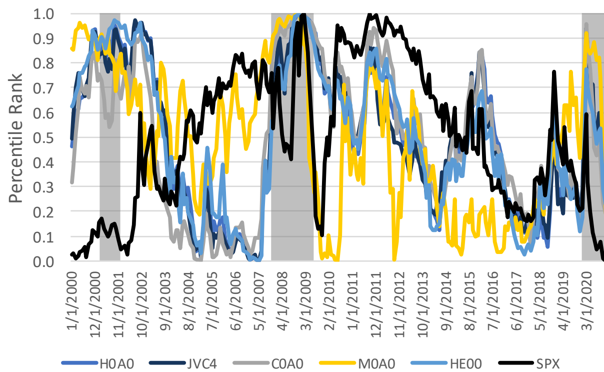


Source: SKY Harbor, ICE Data Indices, Bloomberg

With a significant portion of the US investment grade market now going the way of trillions of dollars of negative yielding government debt, the push to move further out the risk spectrum in search of positive real returns has perhaps never been higher. As a direct response, we have seen spreads compress across a variety of fixed income products, with equity indices reaching all-time highs in the process. On a percentile ranking basis (we use OAS and P/E ratios as a proxy of value for bonds and equities, respectively) both short duration and broad market US high yield bonds screen favorably relative to IG corporates and Euro high yield, with mortgage-backed securities and equities looking most extended.

Asset Class Valuation by Percentile Rank

monthly data since 2000, recessions shaded grey



Month-End Valuation Snapshot

data as of January 31, 2021

Index	Ticker	OAS	P/E Ratio	%ile Rank*
ICE BofA US High Yield Index	H0A0	384		0.23
ICE BofA 1-5Yr BB-B HY Index	JVC4	350		0.37
ICE BofA US Corporate Index	C0A0	103		0.19
ICE BofA US Mortgage Backed Index	M0A0	17		0.06
ICE BofA Euro High Yield Index	HE00	350		0.21
S&P 500 Index	SPX		30.4	0.01

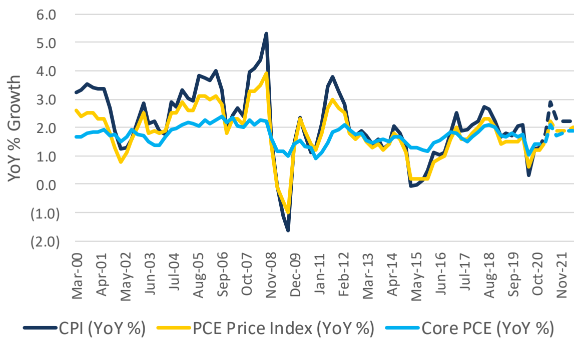
* For the S&P 500 Index, we use the inverse of P/E Ratio percentile rank

Source: SKY Harbor, ICE Data Indices, Bloomberg

Consistent with 10-Year breakeven and 5yr/5yr forward rate trends, consensus expectations call for a boost in the Consumer Price Index (CPI) and the Personal Consumption Expenditures Price Index (PCE and Core PCE) over the next 6 quarters. Looking at the US high yield market in rising vs. falling CPI and PCE environments, the former (rising) typically coincides with stronger overall performance. As shown below, quarterly price returns tend to be higher, and quarterly spreads tend to tighten, when CPI and PCE are on the rise. This is consistent with past findings (see our *Weekly Briefing* entitled "The Threat of Rising Rates" here) that the high yield market does better in a rising rate environment due to the tendency for risk premiums to compress as economic growth expectations improve.

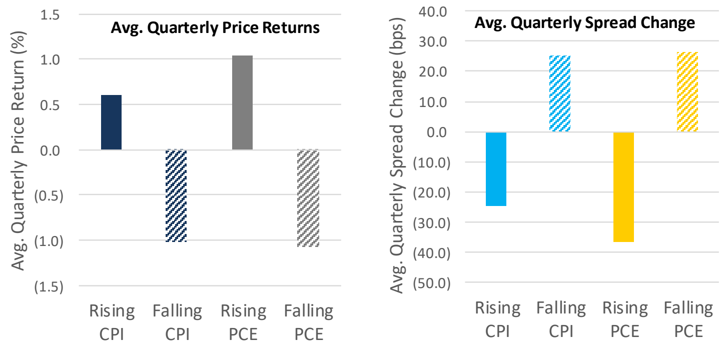
Consensus View is for CPI and PCE to Rise Over Next 6 Quarters

quarterly data, since 2000; dotted lines are estimates



Rising CPI/PCE Periods Historically Not a Hindrance to US High Yield

based on quarterly data since 2000



Source: SKY Harbor, Bloomberg, Bureau of Economic Analysis

To be sure, key officials have downplayed the risk inflation poses in the near term, with a sizeable cohort of economists expecting the measure to remain below the Fed's longer-term target for the foreseeable future. As noted in our *Weekly Briefing* entitled "Short Squeezes, Sentiment, Spending, and Surprises" found here) Fed Chairman Powell continues to insist that any initial jump in prices driven by a "burst" of spending upon a re-opening would likely be temporary in nature. Newly confirmed Treasury Secretary Janet Yellen has also de-emphasized the risk posed by inflation, expecting potential near-term changes to be transient in nature, and has continued in her efforts to encourage support for the President's stimulus package.

Several Key Figures Appear Less Concerned About Inflation Than Markets
recent commentary

"Indeed, inflation has been much lower and more stable over the past three decades than in earlier times." --- J. Powell

On the potential for inflation when we re-open, particularly given stimulus spending..."We're going to be patient. Expect us to wait and see and not react if we see small, and what we would view as very likely to be transient, effects on inflation." --- J. Powell

"I've spent many years studying inflation and worrying about inflation, and I can tell you, we have the tools to deal with that risk if it materializes...But we face a huge economic challenge here and tremendous suffering in the country. We've got to address that. That's the biggest risk." --- J. Yellen

"There's no signs, in my mind, right now, that inflation is going to go out of control." --- P. Harker (Philadelphia Fed)

Recent damange done to the labor market likely prevents inflation from being a "significant problem in the near term." --- E. Rosengren (Boston Fed)

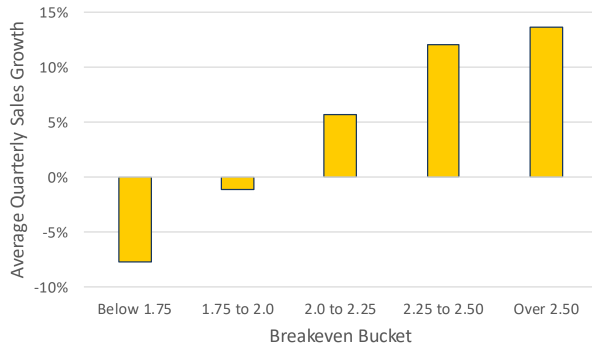
On broad-based inflation at a sustained level of 2%..."I don't think we're going to see that this year. I'd be surprised if we see it before the end of next year." --- E. Rosengren (Boston Fed)

Some actually see "continuing disinflationary pressures from global labor markets, technology which enables price transparency and purchasing organizations with market power." --- T. Barkin (Richmond Fed)

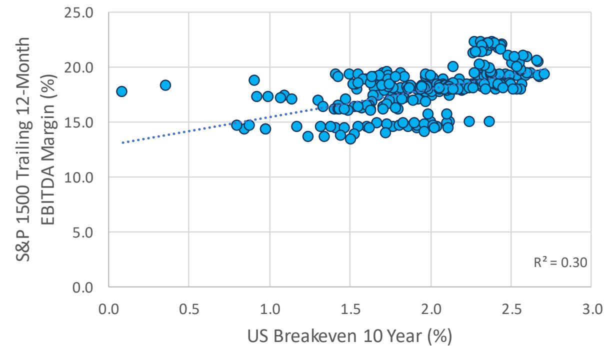
Source: SKY Harbor, Federal Reserve, The Wall Street Journal, Financial Times, CNBC

Valuations aside, we next shift our attention to the fundamental impact inflation has historically had on company financials. Given a fully public constituent set and a longer time series of available quarterly reports, we used S&P 1500 members as a proxy for the high yield index in this analysis. As demonstrated below (left chart), corporate revenue growth has typically been greater when inflationary expectations (via the 10-Year Breakeven Inflation Rate) were on the rise, implying success in passing higher costs onto consumers without triggering a full offset through reduced demand. Furthermore, if we compare EBITDA margins of S&P 1500 constituents to 10-Year Inflation Breakevens (right chart below), we find that companies have either maintained or even increased profitability in periods consistent with higher inflation outlooks. This implies that inflation has not historically been an impediment to either the top or bottom line.

S&P 1500 EBITDA Quarterly Sales Growth vs. Breakeven Bucket
quarterly data, recessions (and 3 quarters before and after) removed from set



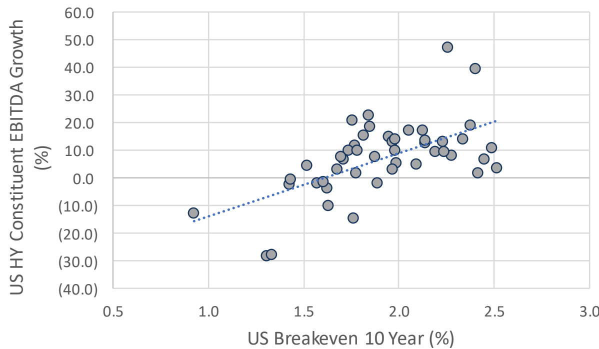
S&P 1500 EBITDA Margin vs. Inflation Breakevens
monthly data since 1998 (limit of data set)



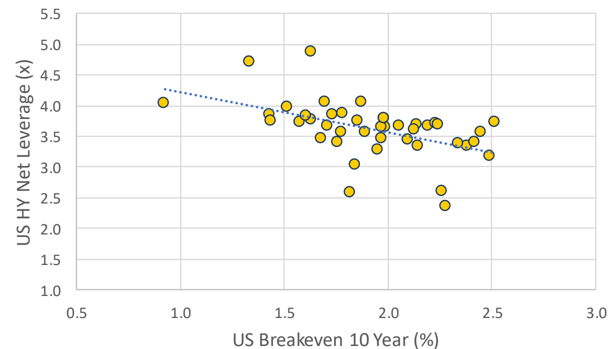
Source: SKY Harbor, Bloomberg

Furthermore, using a subset of the high yield universe with available financial history, we find that EBITDA growth tends to rise, and leverage tends to fall, when inflation expectations are higher. This appears consistent with results from the S&P 1500 index analysis above (companies can pass on costs), and implies that high yield issuers are perhaps more able to "grow into" their capital structures when inflation is on the rise given the fixed nature of interest payments. The relationship further results in downward pressure on the default rate, which in turn compresses our estimate of spread fair value.

US High Yield EBITDA Growth vs. Inflation Expectations
constituent quarterly data since 2009



US High Yield Net Leverage vs. Inflation Expectations
constituent quarterly data since 2009



Source: SKY Harbor, Bloomberg, BofA Merrill Lynch, Capital IQ

In conclusion, spread tightening has admittedly occurred faster than we originally anticipated, but valuations appear less stretched in US high yield relative to ancillary asset classes. At the same time, inflationary concerns are likely to enhance demand for high yield bonds as investors continue to search for positive real returns. Ultimately, the historically positive impact inflation has had on HY index fundamentals should make further spread compression justifiable, reinforcing our optimistic view of the asset class through reduced credit risk.

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