

Weekly Briefing

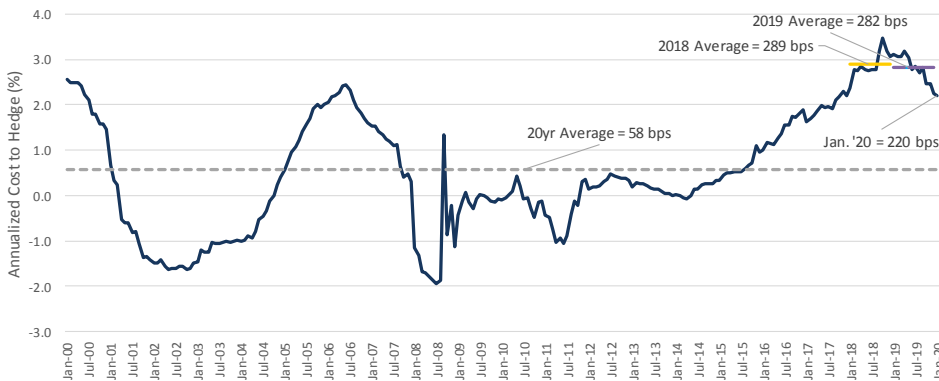
SKYView: Hedging Costs Moderate

Hedging costs – at present, we will focus on the cost to EUR investors for hedging USD – have been elevated over the last several years, owing to the ever-growing short-term rate disparity between the two regions. In a period of relatively modest yields on even the riskiest of fixed income products, such onerous currency hedging costs have become an increasingly relevant factor in the asset allocation process. In this *Weekly Briefing*, we track recent trends in FX, and compare relative attractiveness between US and EUR short duration high yield indices on a currency-hedged basis.

Currently, hedging costs in the 220 bps context are below recent peak levels (~ 346 bps in October 2018), but remain elevated on an historical basis—the 20-year average is ~ 58 bps, while the FY18 and FY19 averages were 289 bps and 282 bps, respectively. Note that our cost estimates are driven by Bloomberg data (FXHCUSEU Index), which is an annualized figure based on the three-month dollar hedge cost for euro-based investors in a USD product.

3 Month Hedging Costs (EUR to USD)

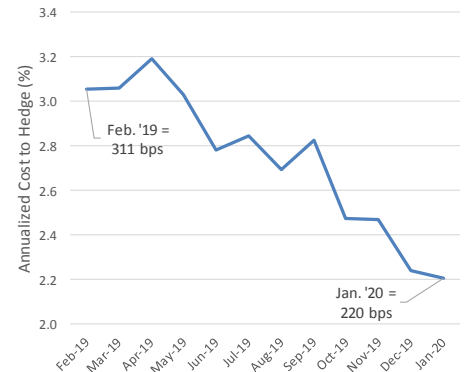
20 years of data, annualized



Source: SKY Harbor, Bloomberg

3 Month Hedging Costs (EUR to USD)

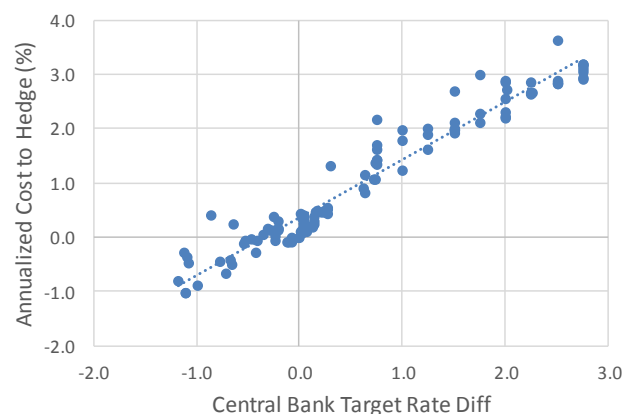
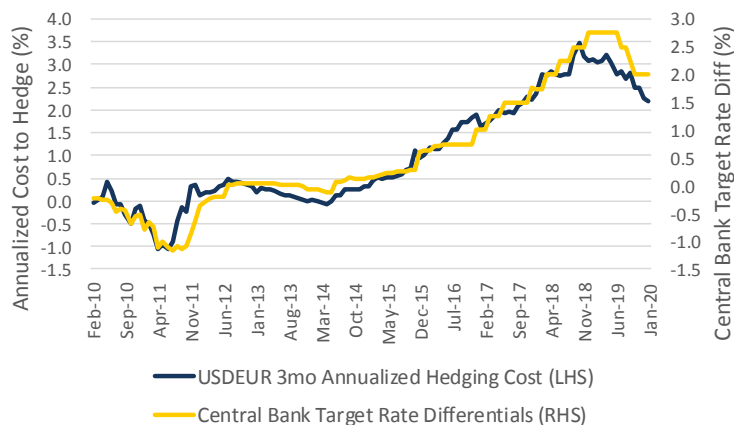
annualized monthly data, last 12 months



Primarily driving these onerous hedging costs has been divergent short-term interest rates between the US and the Eurozone. Aggressive rate cuts in 2019 by the Fed, however, began to diminish the gap between the Federal Funds Target Rate (midpoint) and the ECB Main Refinancing Operations Announcement Rate. During the same period, the cost to hedge USD from the perspective of a EUR-based investor decreased from 20-year record-high levels, a response very much in line with historical correlations between the two measures.

USD-EUR Hedging Costs vs. Central Bank Target Rate Differentials Remain Highly Correlated

monthly data, trailing 12 months

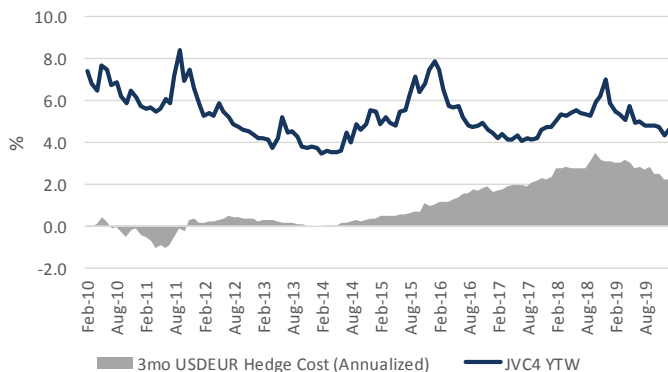


Source: SKY Harbor, Bloomberg, Federal Reserve, European Central Bank

So, has the moderation in hedging costs made US high yield attractive relative to EUR high yield? For this analysis, we will use the ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index, ticker JVC4, as our proxy for US short duration high yield risk. On the EUR high yield side, an equivalent short duration index does not exist. As such, we have created our own, using the ICE BofA BB-B Euro High Yield Index (ticker HE40) as our foundation, and then further limiting the constituents to only those with a maturity between one and five years. As demonstrated below, hedge-adjusted yields for the US short duration high yield index are approximately 3 bps higher than our custom EUR equivalent index, the relationship having fluctuated over the prior decade.

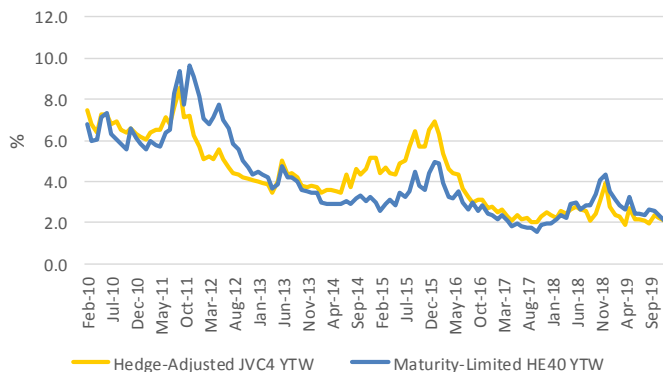
ICE BofA 1-5yr BB-B US Cash Pay HY Constrained Index (JVC4)

monthly data, trailing 10 years



Hedge-Adjusted JVC4 YTW vs. Ratings Constrained EUR HY*

monthly data, trailing 10 years

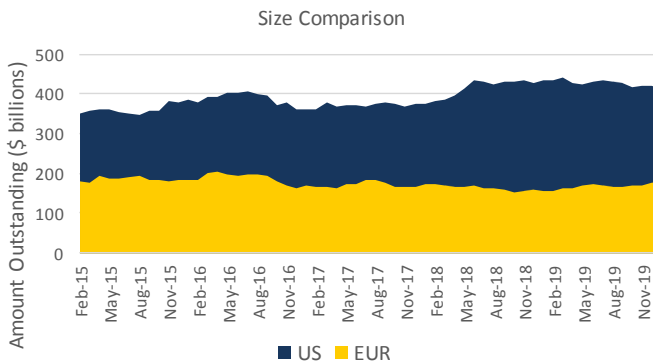
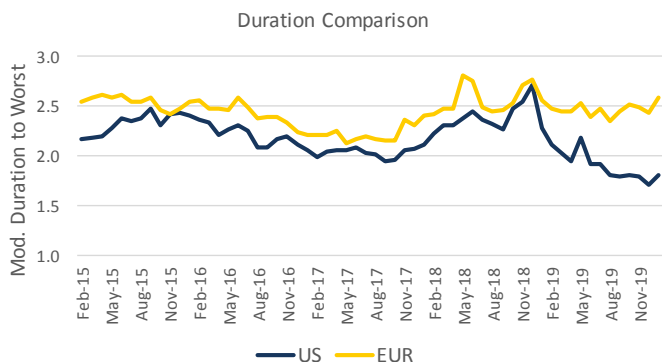


* Euro High Yield Index (HE40) limited to maturities between 1 and 5 years
Source: SKY Harbor, ICE BofA Indices, Bloomberg, Federal Reserve

Our custom EUR short duration high yield index, however, does differ somewhat from JVC4. First, duration is higher, a dynamic that has accelerated over the last 12 months. Additionally, while average credit ratings are identical today (BB3), there have been differences in the past (typically with the EUR index being more highly rated than the US index, most often by ~ 1 notch). Finally, we would note that JVC4 is a much larger index, with 644 issues and \$413bn in face value, vs. 301 issues and \$179bn in face value for the EUR short duration high yield equivalent index. As such, we would expect greater market depth and liquidity on the US side, but make no adjustments to account for these differences in particular.

US Short Duration HY (JVC4) vs. EUR Short Duration HY (HE40 limited by maturity)

monthly data, trailing 5 years

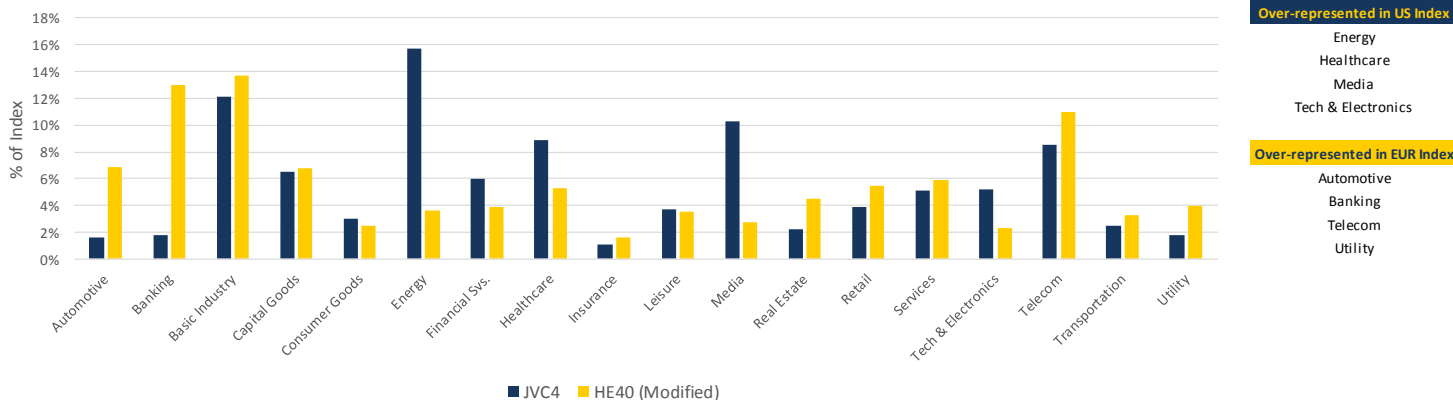


Source: SKY Harbor, ICE BofA Indices

On a sector basis, JVC4 has a greater concentration in Energy, Healthcare, Media and Technology, while the EUR short duration high yield equivalent is more heavily skewed toward Automotive, Banking, Telecom and Utility. Additionally, we would note that while average ratings are the same at present (BB3) our custom EUR index has a greater proportion of structurally subordinated issues.

Sector Concentration

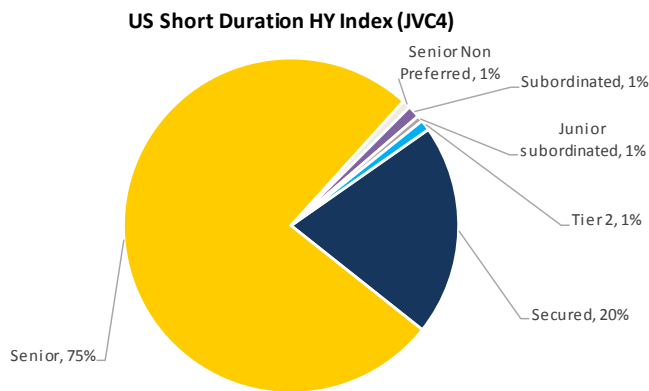
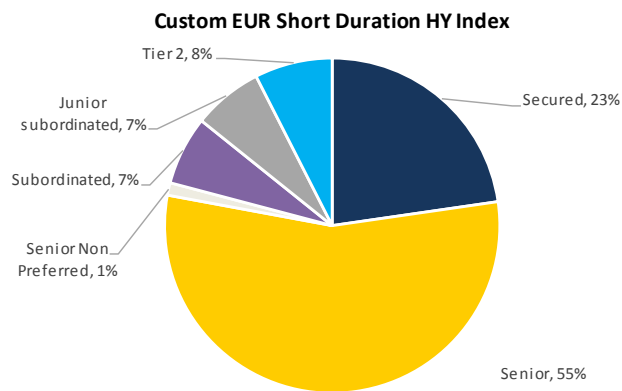
data as of Jan. 31, 2020



Source: SKY Harbor, ICE BofA Indices

Custom EUR Index Skews More Subordinated Than JVC4

data as of Jan. 31, 2020

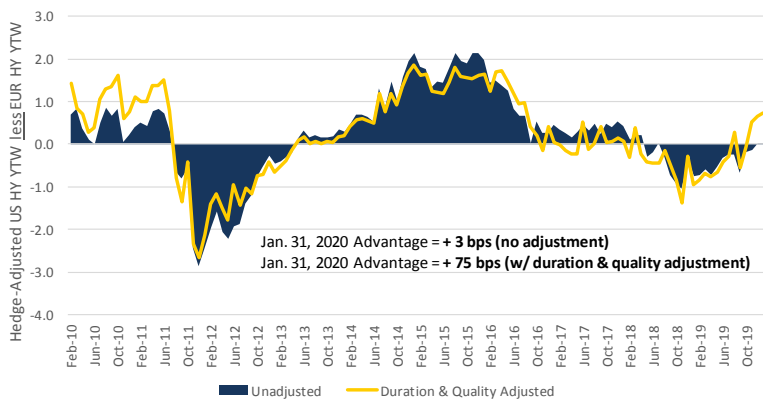


Source: SKY Harbor, ICE BofA Indices

Adjusting our custom EUR short duration HY Index YTW for differences in rating and duration relative to the equivalent US index, we find the hedge-adjusted JVC4 YTW to be ~ 75 bps higher (vs. + 3 bps on an unadjusted basis). This 75 bps US YTW advantage is the highest we have seen since August 2016. Furthermore, we view hedge-adjusted YTW advantages to be significant given the positive correlation between such figures and rolling-12-month total return differentials over time.

Yield Pickup for EUR Investor (US High Yield after Hedging Costs less Euro High Yield)

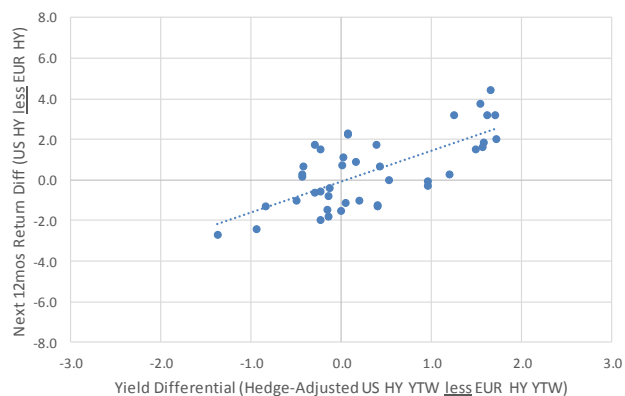
10 years of data



Source: SKY Harbor, ICE BofA Indices, Bloomberg

Post Hedge Yield Pickup Correlated to Next 12 Mos. Return Differential

5 years of data



In conclusion, the cost of currency hedging has declined significantly over the last couple of months, but nevertheless remains high on an historical basis. With that said, the YTW of the US short duration high yield index (JVC4), net of hedging costs, screens favorably in comparison to our custom EUR short duration high yield index, even more so after adjusting for differences in duration and quality. Importantly, currency-adjusted yield advantages have typically preceded currency-adjusted total return advantages over subsequent 12-month periods, leaving us biased toward US short duration high yield at present.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Empire Manufacturing	18-Feb-20	Feb	5.0	12.9	4.8
Building Permits	19-Feb-20	Jan	1450k	1551k	1416k
PPI Final Demand MoM	19-Feb-20	Jan	0.1%	0.5%	0.1%

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Conf. Board Consumer Confid.	25-Feb-20	Feb	132.0		131.6
New Home Sales	26-Feb-20	Jan	713k		694k
GDP Annualized QoQ	27-Feb-20	4Q S	2.1%		2.1%

Recommended Reading

Gordon, Craig and Korte, Gregory (2020, February 19). Bloomberg Hammered, Warren Shines and Sanders Dodges Trouble. *Bloomberg*, Retrieved from <https://www.bloomberg.com/news/articles/2020-02-20/bloomberg-catches-flak-warren-shines-and-sanders-dodges-trouble>

Banerji, Gunjan and Ostroff, Caitlin (2020, February 21). US Stocks Drop on Coronavirus's Economic Impact. *The Wall Street Journal (subs. req.)*, Retrieved from https://www.wsj.com/articles/global-stocks-fall-on-signs-of-coronaviruss-economic-impact-11582280430?mod=hp_lead_pos6

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