SKY HARBOR
CAPITAL MANAGEMENT

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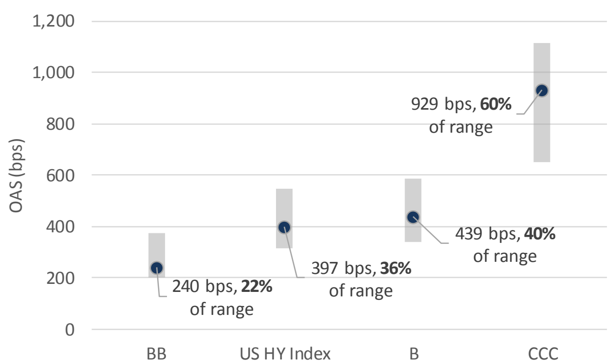
Weekly Briefing

SKYView: Valuations

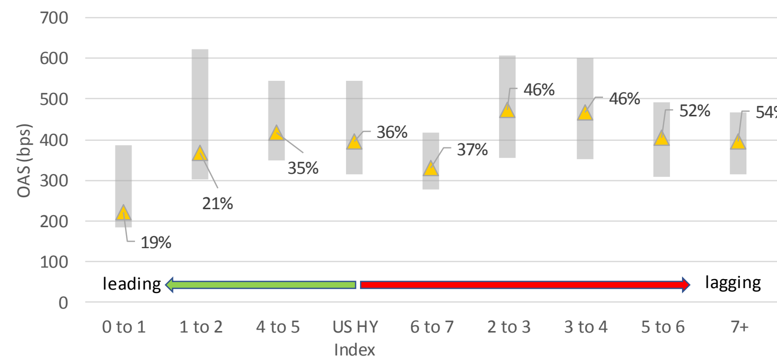
A rapid recovery in spreads following acute dislocation in Q4'18 has many investors concerned about valuations in the US high yield market. In this *Weekly Briefing*, we segment the market into various rating, duration, issue size, subordination, sector, industry and earnings volatility buckets, all in an effort to identify YTD laggards overlooked by investors.

At the time of our analysis (March 20, 2019), the option-adjusted spread (OAS) of the ICE BofAML US High Yield Index (H0A0, which we will use as a proxy for US HY risk) was 397 bps, above current cycle tights of 316 bps (October 3, 2018), but below post-correction wides of 544 bps (January 3, 2019). In looking at recent tight/wide ranges (228 bps spread levels between Oct. 3 and Jan. 3), H0A0 has recovered to 36% of the spread level range. Using 36% then as our performance benchmark and creating a matched sample of index constituents (only those present from October 3, 2018 through today), we find that BB credits have outperformed lower-rated cohorts, having tightened to 22% of the tight/wide range. Given our still benign outlook on defaults over the next 12 months, lower-rated credit could justifiably catch up to higher-rated counterparts on a tight/wide range basis. A similar exercise, this time bucketing our matched sample of index constituents into duration breaks, implies that the shortest duration issues have trended back more closely to cycle tights. In light of recent commentary out of the Fed and subsequent changes in the dot plot, longer duration bonds may be poised to recoup some of the YTD performance drag as well.

OAS Range by Rating Bucket
Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019



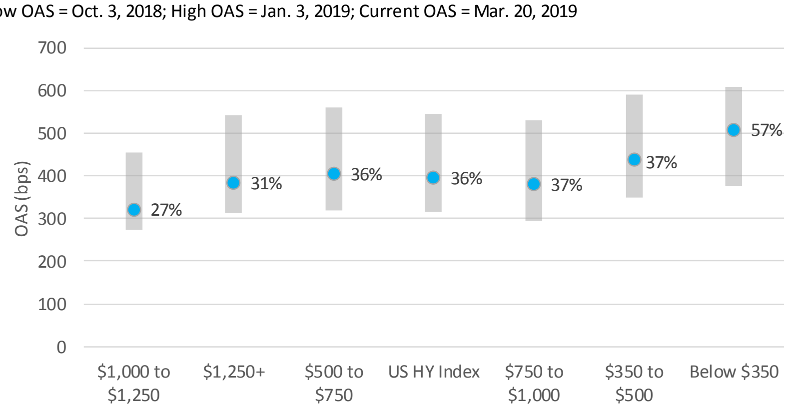
OAS Range by Duration Bucket
Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019



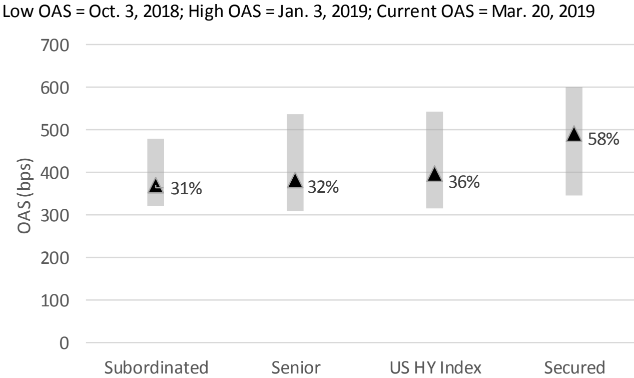
Source: SKY Harbor, ICE BofAML Indices

As highlighted in a prior *Weekly Briefing* ("Small Issue Illiquidity Premiums" from March 4, 2019), smaller issues have lagged the YTD recovery. Despite outperformance over the last week (issues $500mm in size and smaller have outperformed issues $1bn in size and larger by 10+ bps), the dislocation persists. In fact, thus far in 2019, the smallest bond issues in H0A0 haven't even recovered half of the spread widening that occurred in Q4'18. We attribute such disparity to fund flows into ETFs and their associated preference for the largest issuers. By subordination type, secured issues have underperformed the recent recovery. We believe this dynamic is also rooted in market technicals, as a spike in YTD secured bond issuance (partially to address leveraged loan outflows) has pressured existing securities via new issue premiums. As a result, and in line with our above findings that imply greater relative value in lower-rated and longer-duration securities, smaller and secured issuance appears attractive.

OAS Range by Issue Size
Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019



OAS Range by Subordination Type
Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019

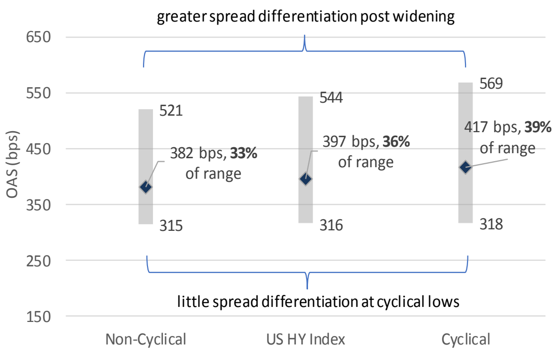


Source: SKY Harbor, ICE BofAML Indices

Looking back at OAS levels at cycle tights, the market demonstrated only minimal differentiation with regard to issues within cyclical vs. non-sectors, the former trading only 3 bps wide of the latter on October 3, 2018 (318 bps vs. 315 bps for cyclicals and non-cyclicals, respectively). As fears of a slowdown in global growth and a potential Fed misstep pushed risk premiums higher, cyclical sectors suffered more sizeable spread widening. As demonstrated below, non-cyclical sectors have recovered more rapidly in 2019, with current spreads of ~ 33% of recent tight/wide ranges, vs. 39% for cyclical sectors. Further delineating by sector classifications, recoveries look well-ordered when normalized for historical EBITDA volatility. Note that the Technology sector is an outlier - having tightened in excess of what historical EBITDA volatility would have implied - though recent IPO announcements, earnings beats, opportunistic refinancings, equity infusions and acquisitions by IG entities have distorted performance. In general, performance by cyclicality appears justified.

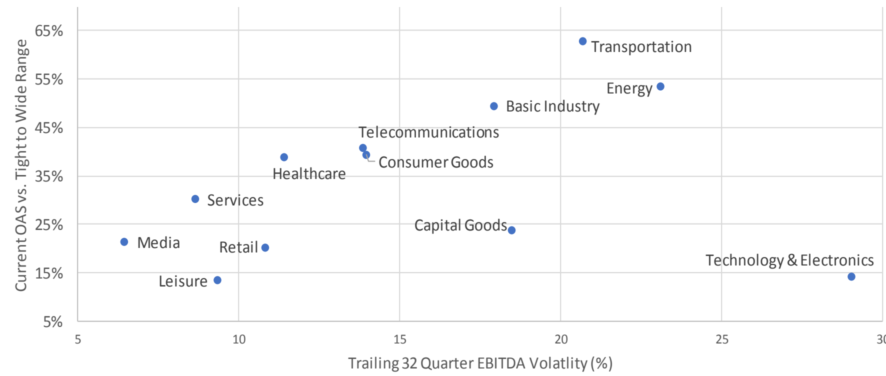
OAS Range by Cyclicality

Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019



Earnings Volatility vs. Spread Recovery

excludes small sectors and financial sectors

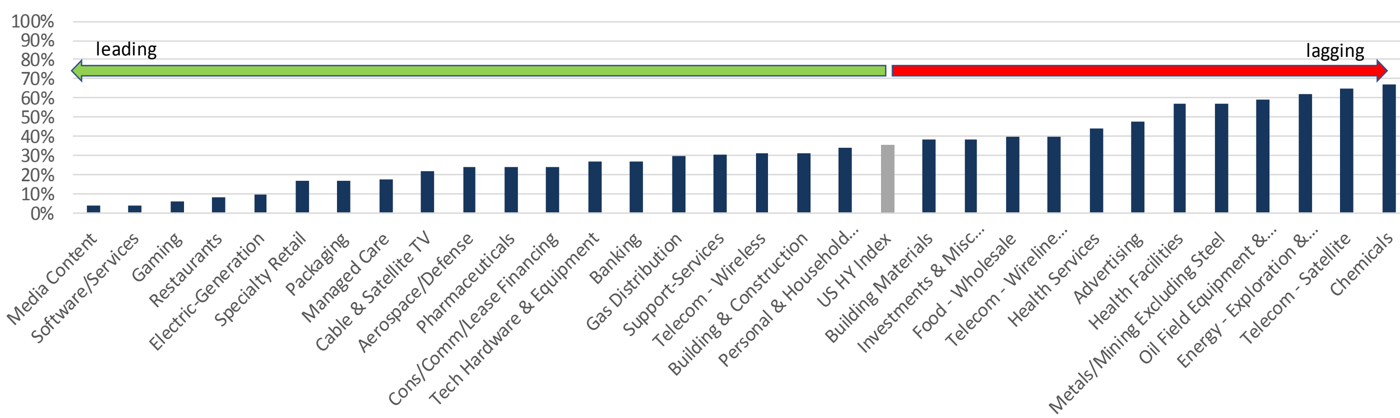


Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices

We also calculated OAS levels at present relative to tight/wide ranges on an industry basis. While classically cyclical industries are quite concentrated among the “lagging” group (Chemicals, Energy E&P, Metals & Mining, etc.), we do find some historically resilient niches that have performed below expectations (Health Services, Food, etc.).

Industry OAS Spreads Now vs. Tight / Wide Range

Low OAS = Oct. 3, 2018; High OAS = Jan. 3, 2019; Current OAS = Mar. 20, 2019



Source: SKY Harbor, ICE BofAML Indices

Screening the full high yield index for securities fitting the aforementioned characteristics, and limiting the pool to those with spreads in excess of 36% of their tight/wide range (i.e., bonds that have lagged index performance), many credits we like from a fundamental perspective emerge as offering attractive value. As such**,** and despite unquestionably rapid spread tightening thus far in 2019, **we continue to identify pockets of attractive value, particularly in the Single-B, longer duration, smaller size, secured, non-cyclical parts of the market.**

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Phila. Fed Business Outlook	21-Mar-19	Mar	4.8	13.7	-4.1
Markit US Mfg. PMI	22-Mar-19	Mar	53.5	52.5	53.0
Existing Home Sales	22-Mar-19	Feb	5.10m	5.51m	4.94m

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Chicago Fed Nat. Activity Index	25-Mar-19	Feb	-0.25		-0.43
Housing Starts	26-Mar-19	Feb	1220k		1230k
Conf. Board Consumer Confid.	26-Mar-19	Mar	132.0		131.4

Source: SKY Harbor, Bloomberg

Recommended Reading

Davies, Paul and Chilkoti, Avantika (2019, March 22). Twin Troubles Strike the Bond Market. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/dour-growth-outlook-sends-key-european-rate-negative-11553261029?mod=hp_lead_pos2

Dmitrieva, Katia (2019, March 22). US Posts Largest Monthly Budget Deficit on Record in February. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-03-22/u-s-posts-largest-monthly-budget-deficit-on-record-in-february

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