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SKY HARBOR
CAPITAL MANAGEMENT

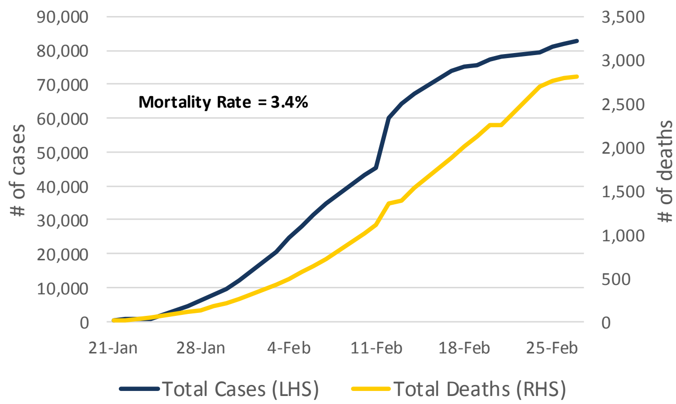
Weekly Briefing

SKYView: Coronavirus-Induced Market Selloff

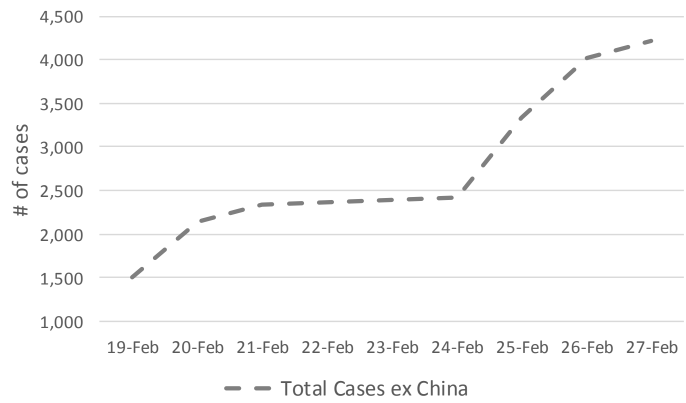
COVID-19 anxiety took a toll on markets this week, as the spread of the virus outside of China increased the chances the situation devolves into a global pandemic. Meanwhile, economic activity in China remains sluggish, with investors alarmed that reduced consumption and supply chain disruptions may eventually weigh on US industries. Corporate profit warnings, analyst revisions, and what many perceived to be an ineffective coronavirus press conference by President Trump have all added to heightened uncertainty. In this *Weekly Briefing*, we examine the global market selloff over the last four trading days.

Total coronavirus diagnoses showed signs of tapering off mid-February, but an uptick in cases outside of China have officials worried that containment may prove elusive in the coming months. This week, the number of cases in Italy and South Korea have risen sharply, and the US confirmed their first "community transmission" case in Northern California. Amidst the turmoil, analysts have begun to lower Q1'20 global GDP growth estimates, with transmission fears depressing travel, tourism, and brick & mortar retail sales most directly.

Coronavirus Trends: Total Cases Started to Level Off...
daily data since January 21, 2020



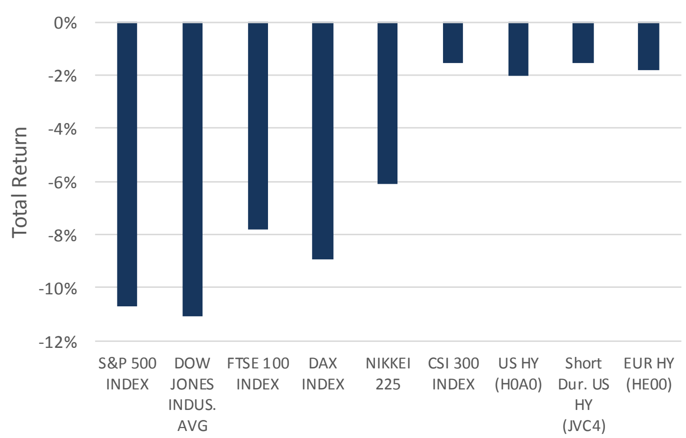
...But Are Now Impacting the World ex China
daily data since February 19, 2020



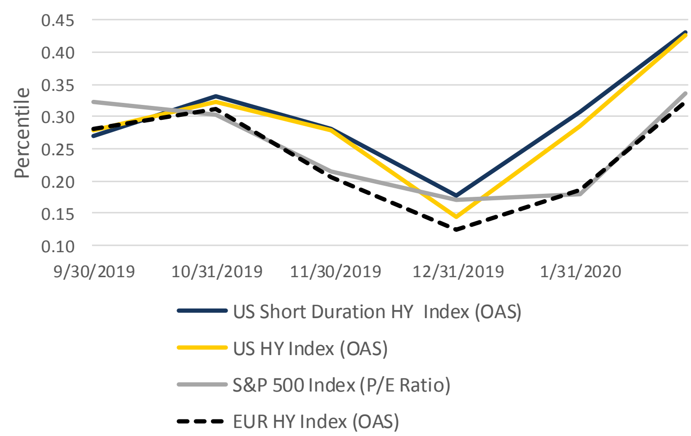
Source: SKY Harbor, Bloomberg

Fresh off of record-highs on February 19, the S&P 500 Index declined over 10% this week in one of the most aggressive corrections in history. Europe and Japan didn't fare much better, with the FTSE 100, Dax, and Nikkei 225 all down mid-single-digits or worse. Through Thursday, the ICE BofA US High Yield Index (H0A0) and ICE BofA Euro High Yield Index (HE00) had week-to-date losses of 2.0% and 1.8%, respectively, while the US short duration high yield index (JVC4) weathered the turmoil slightly better (-1.5%). If there is a silver lining, it may be that valuations, which had become stretched, are much improved following the selloff. Based on monthly data over the last 20 years, both broad market and short duration US high yield spreads have improved to 43rd percentile, comparatively attractive versus S&P 500 P/E ratios (34th percentile) and EUR high yield spreads (32nd percentile).

Indices Have Weakened Across the Globe...
total return, Feb 24 - Feb 27 (WTD through Thursday, or 4 cumulative trading days)



...Leading to More Attractive Valuations
percentile rankings based on 20yrs of monthly data

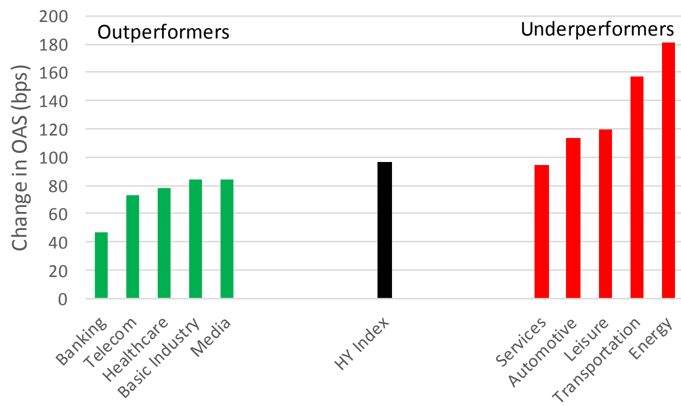


Source: SKY Harbor, Bloomberg, ICE BofA Indices

The Energy sector has been most severely punished, with expectations of slowing global growth eroding the demand picture for crude oil. Transportation and Leisure names were also hit hard as quarantines and travel bans take their toll on airlines, hotels, cruise ships, and casinos. Somewhat insulated industries such as Telecom and Media have outperformed, and may see a boost if Americans avoid public places in favor of shopping and consuming digital content from the confines of their home. Some elements of Basic Industry have done well this week on better than expected home sales growth. The prospect of lower rates should also make mortgage payments more affordable, a potential tailwind for homebuilders. Healthcare has outperformed this week, but a scenario in which threats of contagion and/or over-crowded facilities lead to delays in higher margin discretionary procedures could eventually generate headwinds for the sector.

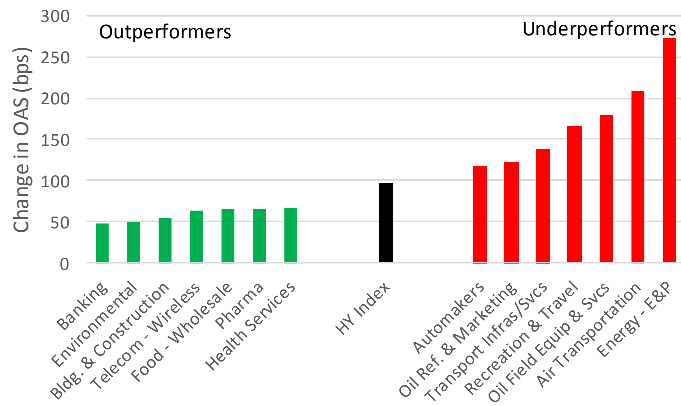
US High Yield <u>Sector</u> Reaction from Virus-Induced Selloff

week ended Thursday, Feb. 27



US High Yield <u>Industry</u> Reaction from Virus-Induced Selloff

week ended Thursday, Feb. 27



Note: Industry groups making up less than 1% of the high yield index by face value were omitted
Source: SKY Harbor, ICE BofA Indices

For the week (through Thursday), US high yield spreads widened by 96 bps, an extraordinary move by almost any standard. Going back to the start of 2000, there have been only 9 periods in which weekly spread widening was at least as significant (0.9% of all observations). On a relative basis, 96 bps of spread widening from a starting OAS of 366 bps represents a 26% move – the second most severe widening week over the same time period. As demonstrated in the table below, these acute spread widening weeks were more often than not followed by positive index total returns in subsequent 3, 6, and 12 month periods, even though most occurred during or in the period immediately preceding recessions.

Worst Spread Widening Weeks (Absolute)

weekly data ended Fridays (current move is through Thursday Feb 27)

Date	1 Week OAS Δ	Next 3mos Return	Next 6mos Return	Next 12mos Return	Notes
10/10/2008	310	2.0	2.6	43.0	In Recession
11/21/2008	274	11.8	33.6	63.9	In Recession
10/3/2008	199	(12.7)	(6.9)	26.5	In Recession
3/6/2009	126	30.1	43.4	65.4	In Recession
9/14/2001	119	(1.0)	5.6	(4.0)	In Recession*
6/28/2002	109	(7.1)	3.4	22.2	
9/26/2008	107	(22.5)	(13.5)	19.9	In Recession
8/12/2011	104	2.5	6.3	13.1	
12/5/2008	96	7.7	40.0	68.7	In Recession
2/27/2020	96	?	?	?	
% Positive		56%	78%	89%	
Average Return (%)		1.2	12.7	35.4	

Worst Spread Widening Weeks (Relative)

weekly data ended Fridays (current move is through Thursday Feb 27)

Date	1 Week OAS Δ	Starting OAS	Next 3mos Return	Next 6mos Return	12mos Return	Notes
7/27/2007	92	27%	3.2	1.8	0.3	Pre-Recession
2/27/2020	96	26%	?	?	?	
10/10/2008	310	25%	2.0	2.6	43.0	In Recession
4/1/2005	58	20%	2.6	3.6	7.2	
10/3/2008	199	19%	(12.7)	(6.9)	26.5	In Recession
12/21/2018	76	17%	7.8	10.6	14.5	
8/12/2011	104	17%	2.5	6.3	13.1	
11/21/2008	274	16%	11.8	33.6	63.9	In Recession
5/7/2010	85	15%	2.3	8.4	15.4	
4/15/2005	50	15%	3.6	2.3	8.0	
% Positive			89%	89%	100%	
Average Return (%)			2.6	6.9	21.3	

*Post terrorist attacks
Source: SKY Harbor, ICE BofA Indices, National Bureau of Economic Research

Investors are now pricing in multiple rate cuts in 2020, a dramatic change in sentiment relative to early January when the consensus view was for the Fed to remain on hold for most of the year. As of Feb. 27, Fed Funds Futures imply multiple cuts and a target rate below 1% by year end, or ~ 60 bps lower than the early January outlook. While neither the Fed nor the ECB have openly suggested the need for intervention, there are signs that accommodative policy may emerge. In an op-ed for the *Wall Street Journal*[1], former Fed Governor Kevin Warsh called the coronavirus outbreak a "material risk to the economy," further stating that the situation "represents an unexpected shock, and the Federal Reserve should lead the world's central banks in taking immediate action."

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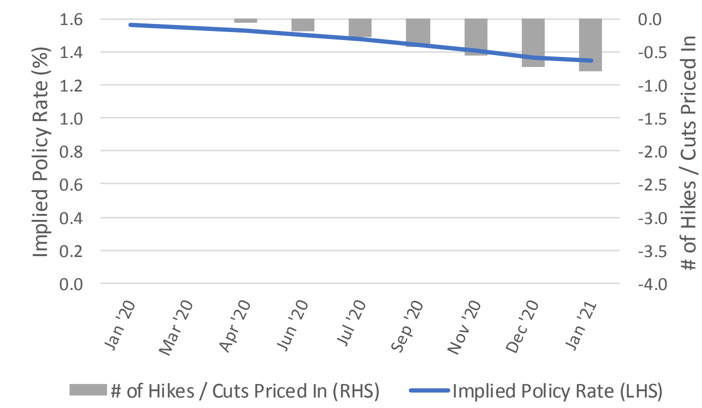
[1] Warsh, Kevin (2020, February 26). The Fed Can't Wait to Respond to the Coronavirus. *The Wall Street Journal (subs. req.)*, Retrieved from **https://www.wsj.com/articles/the-fed-cant-wait-to-respond-to-the-coronavirus-11582763355?mod=opinion_lead_pos5**

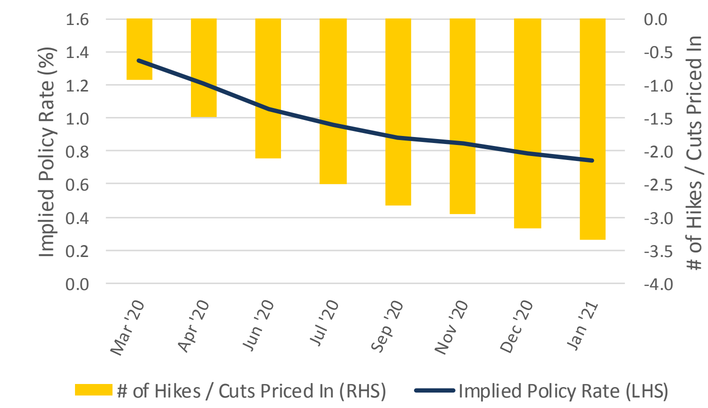
Pre-Coronavirus, Market Expected Minimal Fed Activity in '20

data as of January 2, 2020



Fed Funds Futures Now Imply Multiple Rate Cuts This Year

data as of February 27, 2020

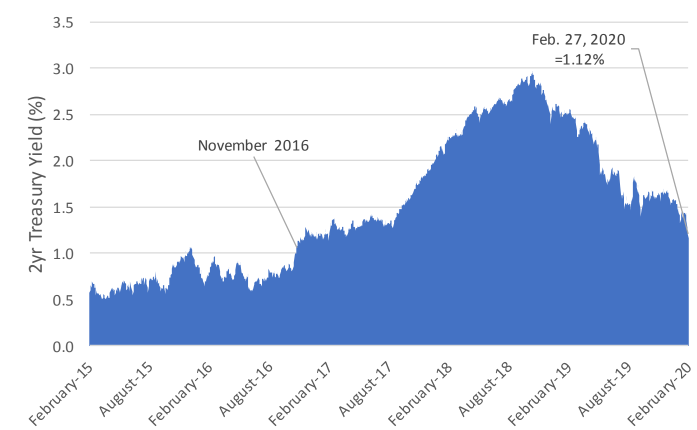


Source: SKY Harbor, Bloomberg

Expectations of Federal Reserve easing, as well a general flight to safe haven assets, caused a significant rally in US Treasuries. By Thursday, yields on the 2-year had declined to 1.12%, the lowest level since November 2016. At the same time, the 10-year US Treasury yield hit 1.30%, an all-time low. The move helped USD-EUR hedging costs further abate, and in conjunction with a back-up in bond prices have made currency-adjusted US high yield index YTW advantaged relative to EUR high yield index YTW by nearly 75 bps.

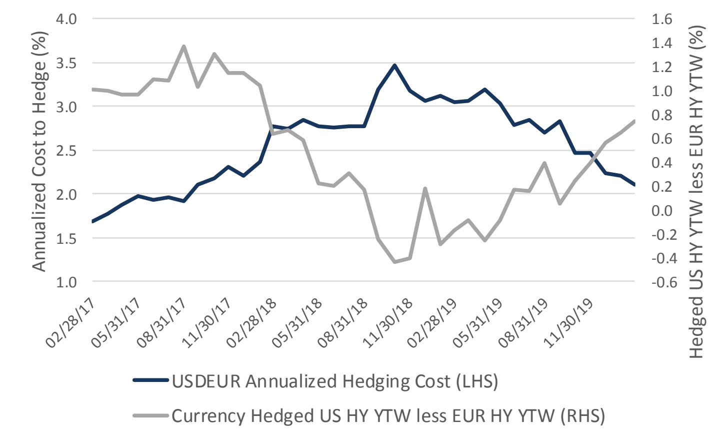
Rate Cut Expectations Have Pushed Treasury Yields Down

daily data, trailing 5 years



Hedging Costs Decline; Currency Hedged US HY Advantaged vs. EUR HY

monthly data, trailing 3 years



Source: SKY Harbor, ICE BofA Indices, Bloomberg

In conclusion, coronavirus-driven threats to global growth have led to severe drawdowns across risk assets, and investors have thus far been unwilling to call a bottom given ongoing uncertainty. US high yield markets have, in our view, traded the news in an orderly fashion, with sectors most exposed to virus-related shocks underperforming those that are more insulated. While we do not deny that uncertainties abound, valuations have improved markedly, and prior instances of severe spread widening in such a condensed period of time have more often than not resulted in positive returns in subsequent quarters. In the near term, more accommodative central banking policies and other forms of government stimulus may provide a catalyst to boost sentiment and bring markets back into balance.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Conf. Board Consumer Confid.	25-Feb-20	Feb	132.2	130.7	131.6
New Home Sales	26-Feb-20	Jan	718k	764k	694k
GDP Annualized QoQ	27-Feb-20	4Q S	2.1%	2.1%	2.1%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Markit Manufacturing PMI	2-Mar-20	Feb	50.8		50.8
Construction Spending MoM	2-Mar-20	Jan	0.7%		-0.2%
ADP Employment Change	4-Mar-20	Feb	170k		291k

Source: SKY Harbor, Bloomberg

Recommended Reading

Hajric, Vildana et. al. (2020, February 27). As Rout Gets Nasty, Traders Hunt for Signs of Where It Will End. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2020-02-27/as-rout-gets-nasty-traders-hunt-for-signs-of-where-it-will-end

Warsh, Kevin (2020, February 26). The Fed Can't Wait to Respond to the Coronavirus. *The Wall Street Journal (subs. req.)*, Retrieved from https://www.wsj.com/articles/the-fed-cant-wait-to-respond-to-the-coronavirus-11582763355?mod=opinion_lead_pos5

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