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SKY HARBOR
CAPITAL MANAGEMENT

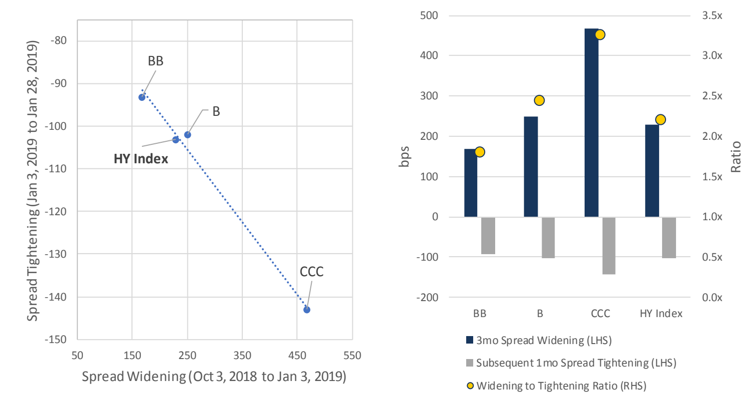
Weekly Briefing

SKYView: Valuations

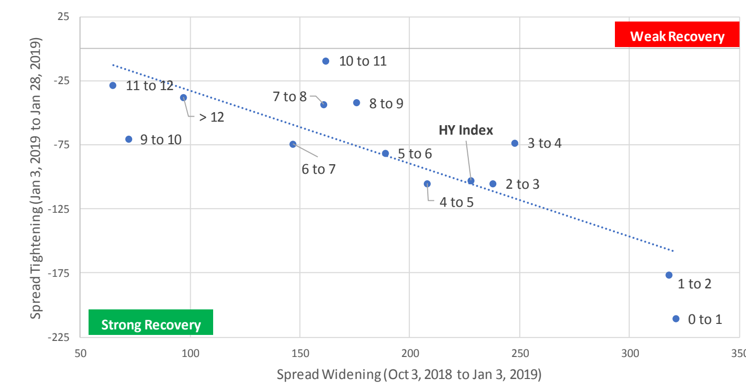
The US high yield market made a sharp recovery in January, reversing negative total returns suffered by the ICE BofAML US High Yield Index (ticker H0A0) in Q4'18. Our analysis of the January recovery points to several areas of increased relative value as we look to the balance of the year. While we remain optimistic that index spreads can generically compress based on key macroeconomic data, lower-rated and longer-duration issues appear to offer increasingly attractive value given disproportionately slower recoveries.

Looking at the path of H0A0 spreads over the last four months, we find that the index achieved cyclical tights on October 3, 2018 (316 bps). Fears of slowing global growth and rising concern of a Fed misstep damaged market sentiment, leading to spread widening through January 3, 2019 (544 bps, +228 bps from October tights). The ensuing January rally allowed spreads to retrace ~45% of prior quarter moves (through the time of publication). As demonstrated by the chart below (left side), the recovery was orderly but unequal, with higher quality rating cohorts achieving superior spread widening to subsequent tightening ratios. Also depicted below, the January rebound was felt unevenly across index duration buckets. Over the last thirty days, the lowest duration securities (0 to 1, 1 to 2 buckets) recovered more rapidly than what would be implied by prior quarter widening, while expected spread compression for higher duration buckets (7 to 8, 8 to 9, etc.) has lagged. As a result, compensation for both credit and term risk has improved relative to early October '18, leaving us biased toward Single-B and modestly longer duration issues across our high yield strategies.

ICE BofAML US High Yield Index: Rebound by Rating
change in OAS



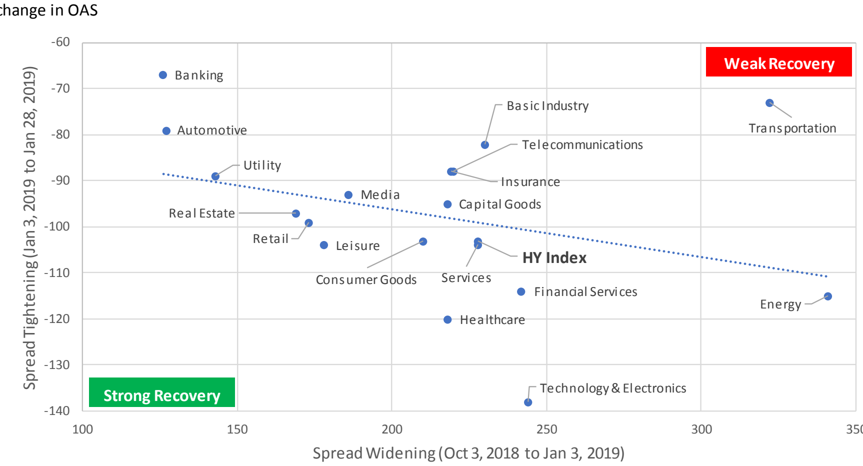
ICE BofAML US High Yield Index: Rebound by Duration Bucket
change in OAS



Source: SKY Harbor, ICE BofAML Indices

Sector performance through the Q4'18 selloff and subsequent January rebound has also been unequally distributed. Below, we plot Oct. 3, 2018 through Jan. 3, 2019 spread widening across the x-axis, and Jan. 3, 2019 through Jan. 28, 2019 spread tightening across the y-axis. Apparent in the underlying chart, we find that several sectors have tightened far less in January than their Q4 widening would have implied (sectors above the dotted best fit line) and vice versa. While much of the dispersion can be explained by broadly defined cyclical vs. defensive classifications (Basic Industry vs. Healthcare, for example), investors have clearly expressed certain sector biases (some justified, some not, in our view). As we look toward the reporting of Q4'18 results, we remain focused on alpha generation through identification of misunderstood and otherwise underappreciated business models in sectors that have lagged the current recovery.

ICE BofAML US High Yield Index: Rebound by Sector
change in OAS

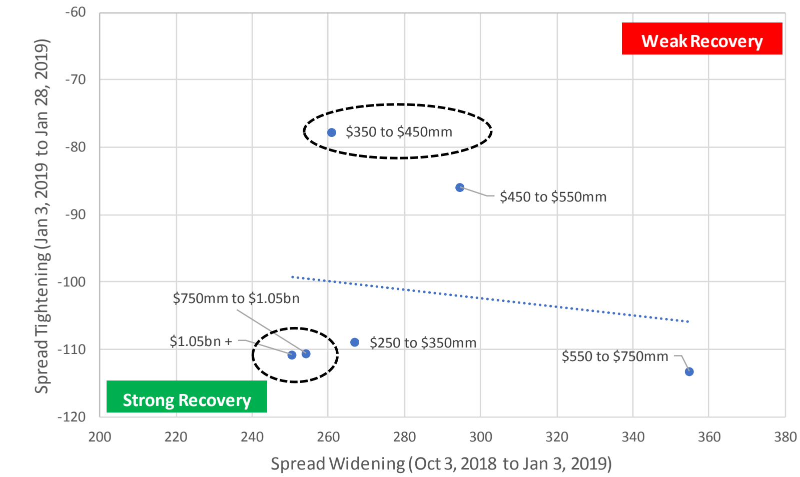


Source: SKY Harbor, ICE BofAML Indices

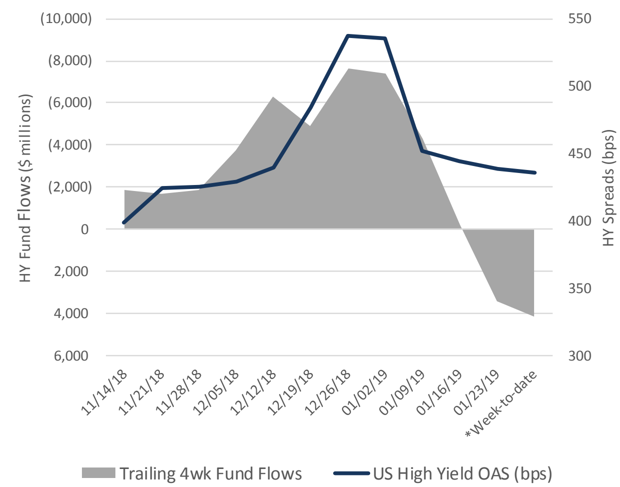
An examination of performance by issue size over the focus period also leads us to interesting discrepancies. Dividing the ICE BofAML US High Yield Index into issue size groupings of similar constituents counts (~ 300 securities in each), we find that the largest issues by face value have rebounded disproportionately faster than small to mid-size issues. The parallel improvement in US high yield fund flows and index spread tightening (coincident or otherwise) likely inflated demand for the largest and most liquid issues (typically the preferred option for ETFs), causing more moderately sized bonds to lag the recovery. Given this dynamic, we remain well positioned to take advantage of the resulting dislocation.

Larger Issues Have Rebounded More Sharply Than Smaller Issues

change in OAS



Performance Disparity Likely Driven by Retail / ETF Flows

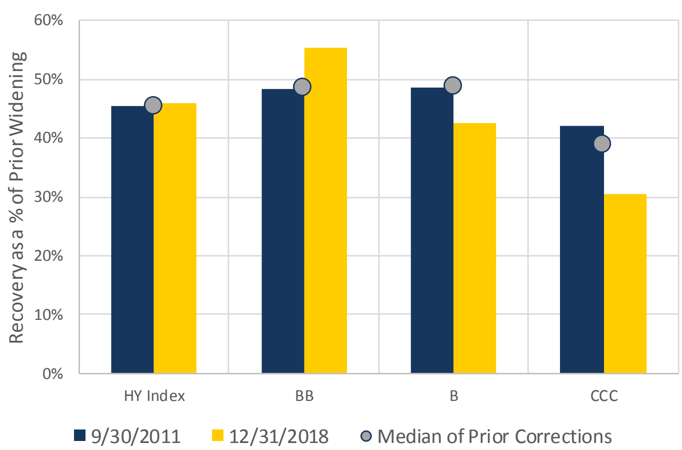


Source: SKY Harbor, ICE BofAML Indices, JP Morgan

As discussed in our Weekly Briefing from January 14, 2019, Q4'18 was only the seventh quarter in the last 20 years to register spread widening in excess of 200 bps. In 6 of those 7 quarters (Q4'18 included) spreads moved tighter over the subsequent one-month period. Comparing the current rebound to the median rebound of prior corrections (particularly the most recent observation, Q3'11, as it has the largest constituent overlap), we find that the magnitude of tightening in January was in line with historical precedence, but that BB performance demonstrated unusual strength. Furthermore, despite 94 bps of tightening in January, further spread compression potential exists over the next three and six months based on prior correction periods.

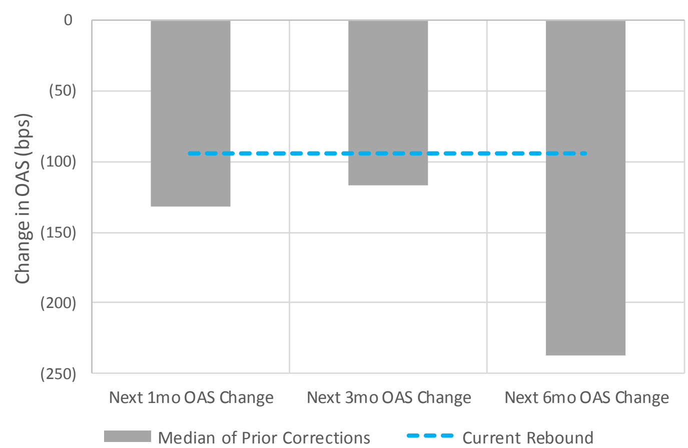
Recovery by Rating Class

OAS Tightening as a % of Original Widening



Subsequent Spread Tightening

change in OAS



Source: SKY Harbor, ICE BofAML Indices

Conclusion

The US high yield market made a sharp recovery in January, reversing negative total returns suffered by the ICE BofAML US High Yield Index (ticker H0A0) in Q4'18. Our analysis of the swift but unequal January recovery points to several areas of increased relative value as we look to the balance of the year. While we remain optimistic that index spreads can generically compress based on key macroeconomic data, lower-rated and longer-duration issues appear to offer increasingly attractive value given disproportionately slower recoveries.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Dallas Fed Manf. Activity	28-Jan-19	Jan	-2.7	1.0	-5.1
Conf. Board Consumer Conf.	29-Jan-19	Jan	124.0	120.2	128.1
ADP Employment Change	30-Jan-19	Jan	181k	213k	271k

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Factory Orders	4-Feb-19	Nov	0.3%		-2.1%
Durable Goods Orders	4-Feb-19	Nov	1.5%		0.8%
Trade Balance	6-Feb-19	Nov	-$54.0bn		-$55.5bn

Source: SKY Harbor, Bloomberg

Recommended Reading

Hong, Shen (2019, February 1). Corporate China Faces Wave of Losses. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/corporate-china-braces-for-wave-of-losses-11549021914?mod=hp_lead_pos2

Chandra, Sho (2019, February 1). US Payrolls Rise 304,000 as Wage Gains Cool Amid Shutdown. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-02-01/u-s-payrolls-rise-304-000-while-wage-gains-cool-amid-shutdown?srnd=premium