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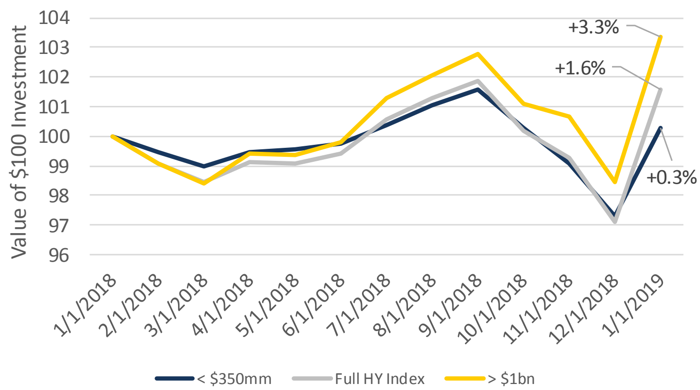
Weekly Briefing

SKYView: Valuations

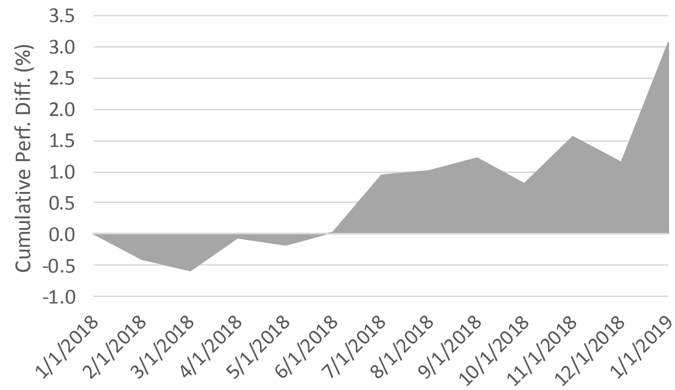
As markets continue to rally, the divergence in performance between small and large issues within the ICE BofAML US High Yield Index (H0A0) has accelerated. Due, perhaps, to retail inflows into ETFs (which have historically favored the largest / most liquid high yield bonds) and lingering economic uncertainty (which may compel investors to opt for liquidity in case sentiment were to change), the ratio of spreads between relatively small ($350mm in size and lower) and large ($1bn in size and higher) issues has reached top-decile levels (using trailing 20-year data). In this installment of our *Weekly Briefing*, we examine the growing illiquidity premium within high yield markets, with a focus on how such dislocation may impact total returns on a forward-looking basis.

Looking at total returns over the last 12 months, we find that large issues began to outperform small issues in June ’18, both experienced similar declines during acute Q4’18 market weakness, and then large issues resumed outperformance amidst a sharp YTD rally. On a trailing 12-month basis, outperformance of $1bn+ issues relative to $350mm and smaller issues exceeds 300 bps, the most significant disparity favoring large issues since 2012.

US High Yield Performance by Issue Size (Cumulative)
monthly data, trailing 12 months



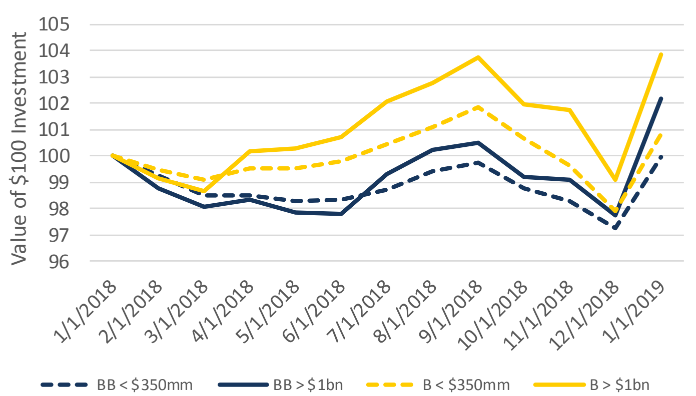
Cumulative Performance Differentials: Small vs. Large Issues
Small = < $350mm; Large = > $1bn



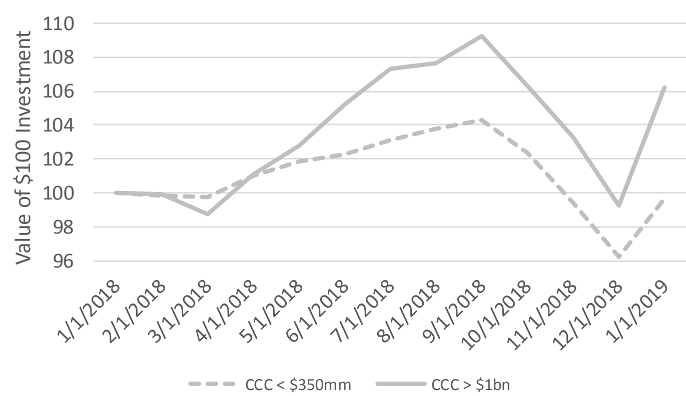
Source: SKY Harbor, ICE BofAML Indices

Importantly, this dynamic has occurred across all ratings classes over the past 12 months. As demonstrated below, smaller issues have underperformed their larger / more liquid counterparts across the quality spectrum, without significant changes in index concentration and duration. We find performance differentials at present to be particularly interesting, especially within the BB credit space. While we can understand investor hesitance to add lower-quality illiquid securities to portfolios at this point in the cycle (particularly if their confidence in continued spread compression and limited default risk is low), performance dispersion among higher-quality credits appears to be technical in nature because sustained dislocations have been rare over the last 20 years.

Small vs. Large Bond Cumulative Performance: BB and B
monthly data, trailing 12 months



Small vs. Large Bond Cumulative Performance: CCC
monthly data, trailing 12 months

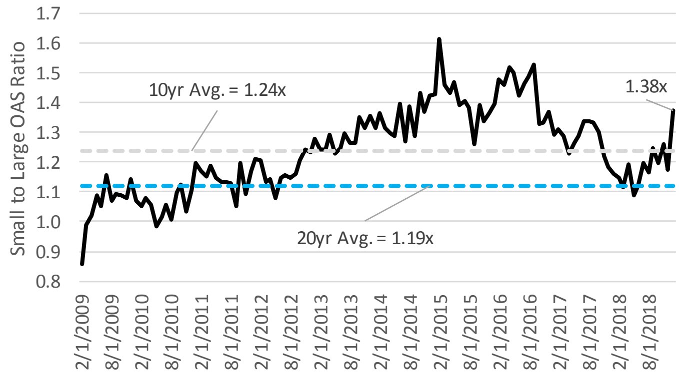


Source: SKY Harbor, ICE BofAML Indices

To account for differences in absolute levels of spread over time, we normalized our series by creating a ratio of small to large issue OAS. As demonstrated below, the current ratio (1.38x) is above both trailing ten (1.24x) and twenty (1.19x) year averages and ranks top decile within the full dataset. Further delineating by rating, we find that the ratio of small to large issue OAS in the BB space at present is the highest it's been in the current market cycle (since July '09), with CCC and B rating classes also elevated but not to such an extreme (first and second quartile, respectively).

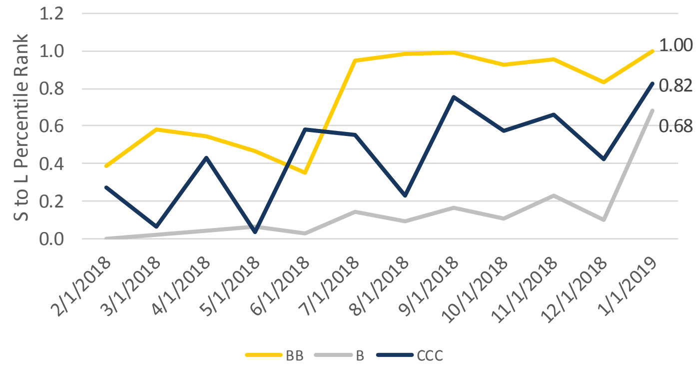
Small Issue to Large Issue OAS Ratio, Trailing 10yrs

Small = < $350mm; Large = > $1bn



Small Issue to Large Issue OAS Ratio: Percentile Ranks by Rating

monthly data, percentile ranks <u>based on current market cycle</u>; trailing 12mos shown

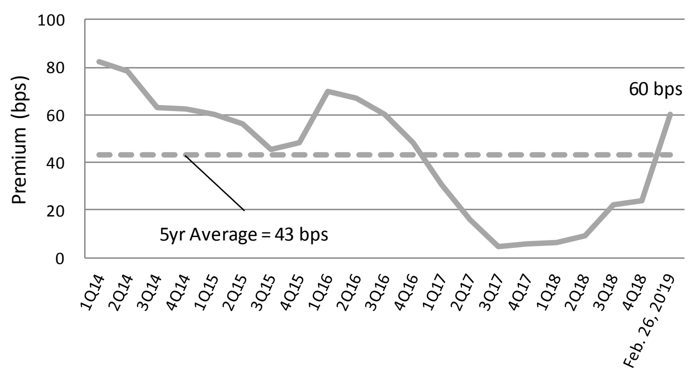


Source: SKY Harbor, ICE BofAML Indices

Analyzing the full high yield index (H0A0) and controlling for differences in credit risk (using WARF, or weighted average rating factor, as a proxy) and term risk (using duration as a proxy), we calculate that the illiquidity premium for an average quality (Single-B) issue of smaller size ($350mm and under) to be approximately 60 bps at present, above the trailing 5-year average of 43 bps. In our view, this rapid increase in illiquidity compensation, which has accelerated since the beginning of 2019, offers a compelling incentive to invest in smaller issues that largely missed the market rally over the last two months. Furthermore, isolating periods over the last twenty years in which the small to large issue OAS ratio was a standard deviation above the set average (it is now and has occurred 40 times in the last 240 months), we find that subsequent 1, 3, 6 and 12 month performance all favored small issues.

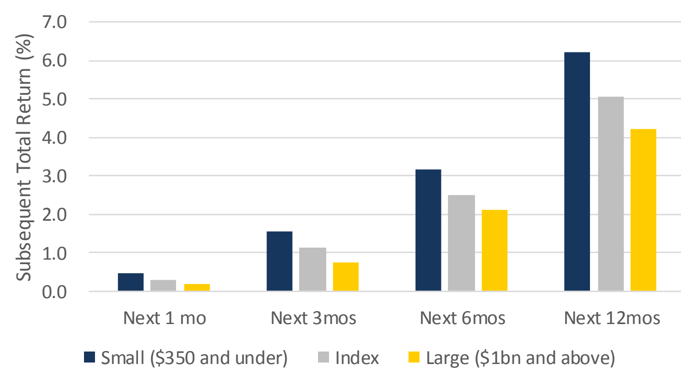
High Yield Index Average Compensation for Illiquidty

OAS premium for bonds $350mm and smaller



Returns When Small to Large OAS Ratio is 1 S.D. Above Average

monthly data; 16% of observations over the last 20 years



Source: SKY Harbor, ICE BofAML Indices, Moody's

In our view, large issue outperformance is being fueled by market technicals (i.e., retail flows into ETFs, Core Plus funds increasing exposure to high yield, etc.), driving small to large OAS ratios and illiquidity premiums to elevated levels. Over the last twenty years, periods with similar dislocations have preceded small issue outperformance relative to the full high yield index in general, and large issues in particular.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Housing Starts	26-Feb-19	Dec	1256k	1078k	1256k
Conf. Board Consumer Confid.	26-Feb-19	Feb	124.9	131.4	120.2
GDP Annualized QoQ	28-Feb-19	4Q	2.2%	2.6%	3.4%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Markit US Services PMI	5-Mar-19	Feb	57.3		56.7
New Home Sales	5-Mar-19	Dec	583k		657k
Initial Jobless Claims	7-Mar-19	2-Mar	225k		225k

Source: SKY Harbor, Bloomberg

Recommended Reading

Torry, Harriet (2019, February 28). US Economy Grew 2.6% in the Fourth Quarter. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/u-s-economy-grew-2-6-in-the-fourth-quarter-11551360960?mod=hp_lead_pos2

Leonard, Jay, Mayeda, Andrew, and Mohsin, Saleha (2019, February 28). US Said to Ready Final China Trade Deal as Hawks Urge Caution. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-02-28/u-s-said-to-ready-final-china-trade-deal-as-hawks-urge-caution?srnd=premium

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