

**Weekly Briefing**

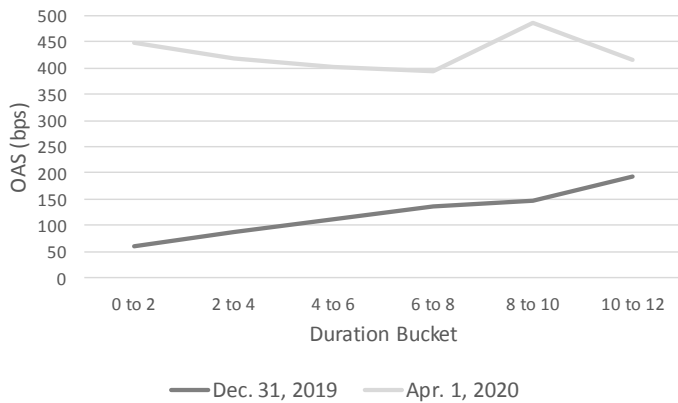
**SKYView: Curve Inversion**

US high yield spreads appear to be heading toward another week of net widening as cases of those infected with the coronavirus rises above the 1 million mark. Concurrent with the selloff across global markets, high yield credit curves have aggressively inverted to a degree not seen since the global financial crisis. In this *Weekly Briefing*, we examine corporate credit curves in the context of past periods of stress, ultimately finding value in short-dated paper despite ongoing uncertainty.

In comparison to year-end 2019, corporate credit curves have flattened (BBBs) and in some cases inverted (high yield) over the last few months. Inversion in the high yield space, including BBs, appears a consequence of mounting refinancing concerns amidst an economic shutdown, with new issue volumes generally slowing over the last several weeks. Investment grade curves have been a bit more resilient since the announcement of the Secondary Market Corporate Credit Facility (SMCCF), a Fed program tasked with buying short-dated BBB rated bonds with maturities inside of 5 years. The SMCCF, as least for now, does not extend down into high yield markets.

**BBB Credit Curve Has Flattened**

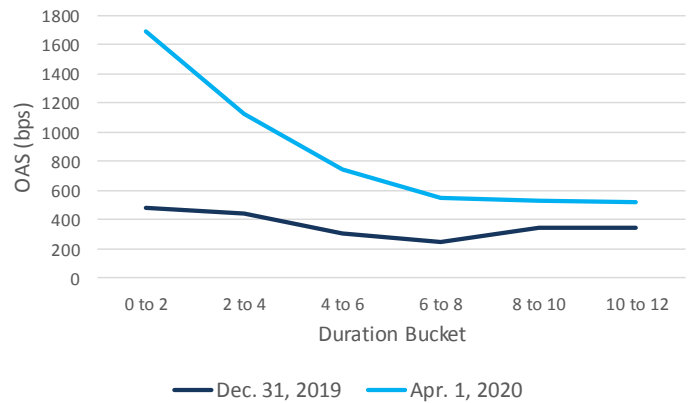
data from Dec. 31, 2019 and April 1, 2020



Source: SKY Harbor, ICE BofA Indices

**High Yield Credit Curve Has Inverted**

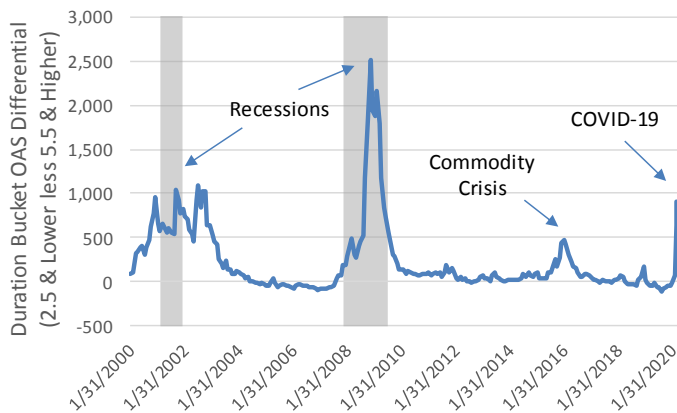
data from Dec. 31, 2019 and April 1, 2020



To get a better picture of high yield curve inversion, we first break the index down into short and long duration buckets. With average duration historically hovering around 4, we denoted bonds with a duration of 2.5 & lower as our “short” bucket, and those with a duration of 5.5 & higher as our “long” bucket. At present, 21% (by face value) of the ICE BofA US High Yield Index (ticker H0A0) falls into each bucket, with similar values on an historical basis. Through the time of publication, **the OAS differential (“short” duration bucket less “long” duration bucket) is nearly 1,000 bps, a level similar to peaks reached during the ‘01/’02 recession, and well above peaks during the Q1’16 commodity crisis.** Levels reached during the global financial crisis, by virtue of frozen credit markets, were understandably higher. Notable, however, is that significant inversion is occurring despite superior credit quality and limited near-term maturities relative to prior peaks.

**Inversion Indicative of Refi Concerns; Prevalent in Recessions**

monthly data since 2000, recessions shaded grey



Source: SKY Harbor, ICE BofA Indices

**Superior Credit Quality, Limited Near Term Maturities**

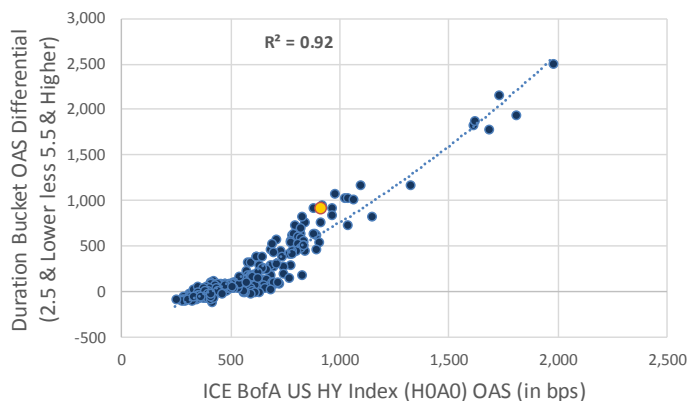
monthly data since 2000

Date	Index Constituency			% Face Value Maturing	
	% BB	% B	% CCC	Next 12 mos	Next 24 mos
Dec. 31, 2000	30%	54%	16%	1%	3%
Nov. 30, 2008	37%	39%	25%	1%	6%
Feb. 29, 2016	45%	38%	17%	1%	6%
Apr. 1, 2020	48%	36%	16%	0%	6%

Historically, index spreads and OAS differentials between shorter-dated and longer-dated paper have been highly correlated. **At present, the front end of the curve (2.5 years and below) appears 200 bps too wide in the context of H0A0 spreads in the 900 bps range.** Further adjusting our dataset to include only issuers with a bond in both duration buckets (i.e., using only issuers that have their own calculable curve, which we will loosely refer to as a matched sample), we find similar disparity between actual and model-implied fair value duration bucket differentials (~ 150 bps). Current levels are denoted by gold markers on the scatterplots below.

### Front-End 200 bps Cheap Based on Index OAS Levels

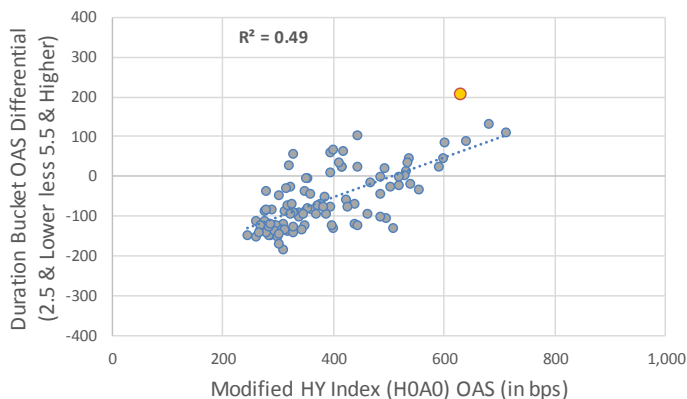
monthly data since 2000



Source: SKY Harbor, ICE BofA Indices

### Front-End 150 bps Cheap Based on Matched Sample

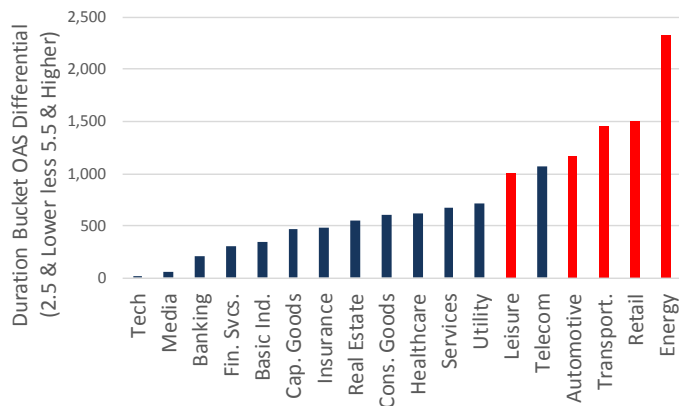
monthly data since 2011



Curve inversion at the sector level varies significantly. As shown in the chart below (left side), **sectors commonly agreed to be most at risk from coronavirus-related business interruptions (shaded red) are demonstrating the most acute curve inversion.** Also worth noting, virus-related uncertainty appears to be the main driver of inversion, as OAS differentials between short-dated and long-dated bonds show little correlation to the relative amount of sector debt maturing in the next 24 months. In our view, this dynamic is further evidence that the market is over-estimating the magnitude of defaults in the near term.

### COVID-19 Impacted Sectors Show Most Significant Inversion

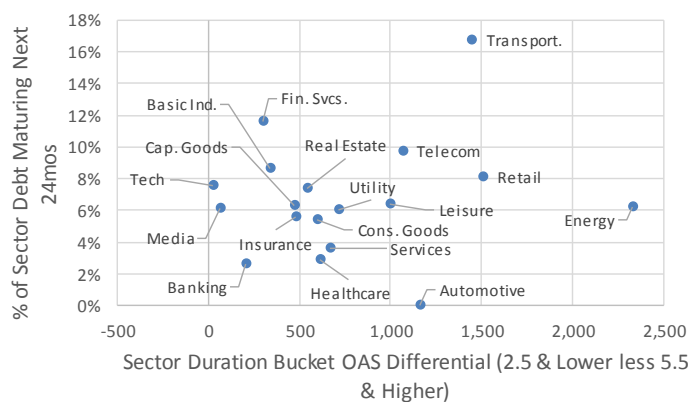
OAS Differential, Duration 2.5 & Lower vs. Duration 5.5 & Higher



Source: SKY Harbor, ICE BofA Indices

### Near-Term Maturities Not Primary Driver of Inversion

OAS Differential, Duration 2.5 & Lower vs. Duration 5.5 & Higher



In conclusion, high yield curves have, in our view, inverted beyond what would be reasonably envisioned based on two decades of historical data, and have done so despite above-average credit quality and a manageable maturity profile. Furthermore, high yield new issuance re-emerged over the last few days (albeit in modest volumes), snapping a several week drought and providing a crucial first step toward credit market normalization. For credits less exposed to coronavirus-related disruptions, and for impacted sectors that are likely to make a strong recovery once social distancing practices subside, front-end dislocations appear attractive, particularly so for issuers with multiple liquidity levers.

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