SKY HARBOR
CAPITAL MANAGEMENT

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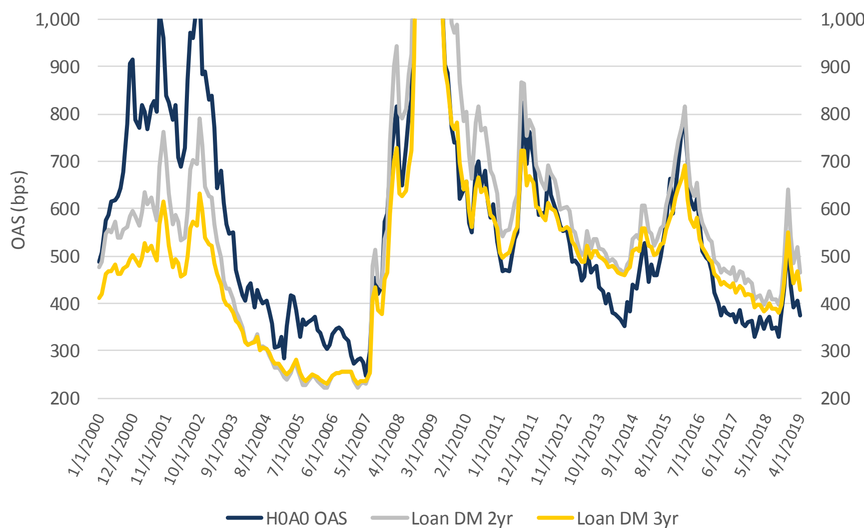
Weekly Briefing

SKYView: Bonds vs. Loans

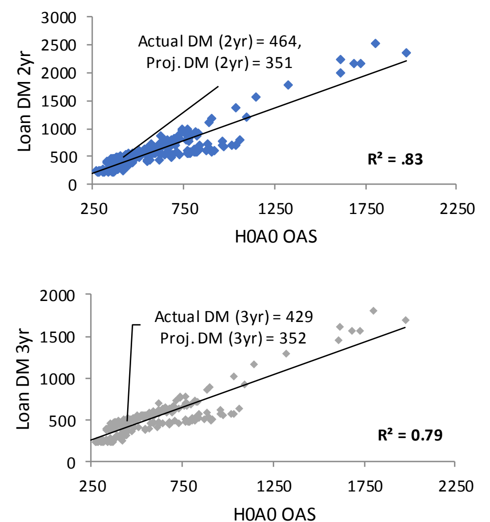
Last week, we provided our thoughts on the trade-off between US high yield bonds and US leveraged loans, with an emphasis on identifying the better positioned asset class through our F.A.S.T. (fundamentals, asset valuations, sentiment, and technicals) construct. Ultimately, the comparison left us biased toward bonds given both a fundamental and technical advantage in the current market environment, partially offset by more attractive asset valuations within the loan index. Our dilemma, therefore, is whether or not loan valuations are now sufficiently attractive to make up for elevated cycle leverage, weaker recovery rates, negatively skewed index constituencies, and technical headwinds thus far in 2019. In this *Weekly Briefing*, we seek to model the potential for loan vs. bond outperformance over the next twelve months, accounting for the various fundamental and technical drags identified in our most recent research note.

Since 2000, the option-adjusted spread (OAS) on the ICE BofAML US High Yield Index (ticker H0A0, our proxy for high yield bond risk) and the discount margin (both 2yr and 3yr) on the Credit Suisse Leveraged Loan Index (ticker LEVLOAN, our proxy for leveraged loan risk) have been highly correlated. Largely owing to issuer overlap and a similar risk/return profile through various points in the business cycle, this relationship makes sense intuitively. Using H0A0 spreads as our independent variable, a regression analysis implies that leveraged loan discount margins should be approximately 350 bps at present, well below actual levels of 464 bps and 429 bps assuming a 2yr or 3yr life, respectively.

ICE BofAML US High Yield (H0A0) OAS vs. CS Leveaged Loan Index Discount Margin
monthly data

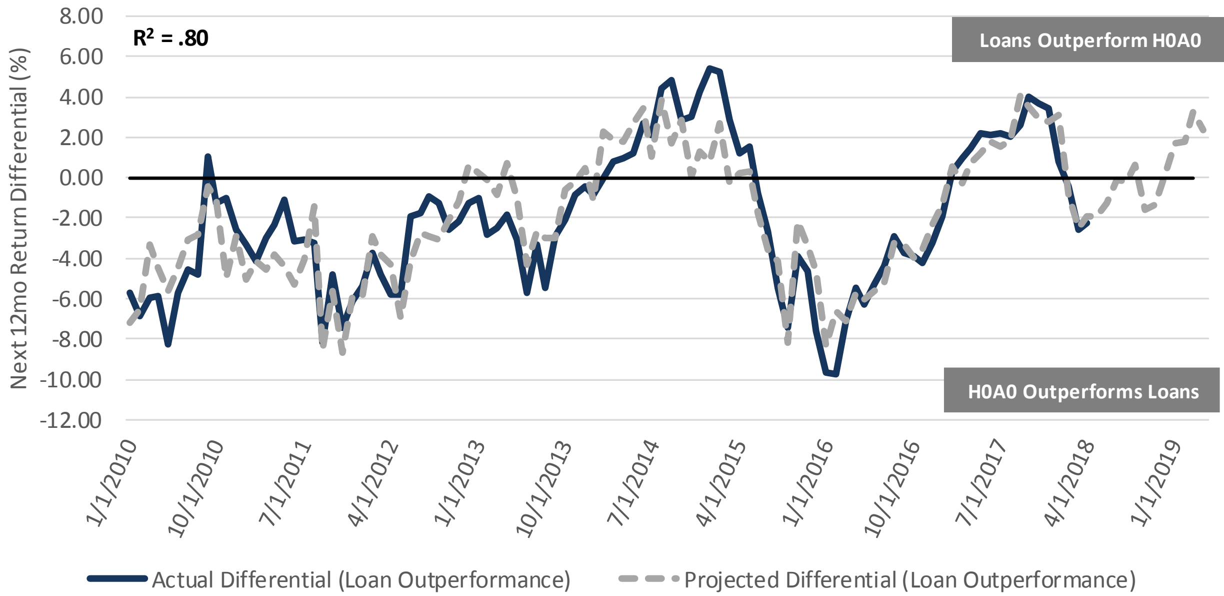


Leveraged Loan DM Fair Value
monthly data



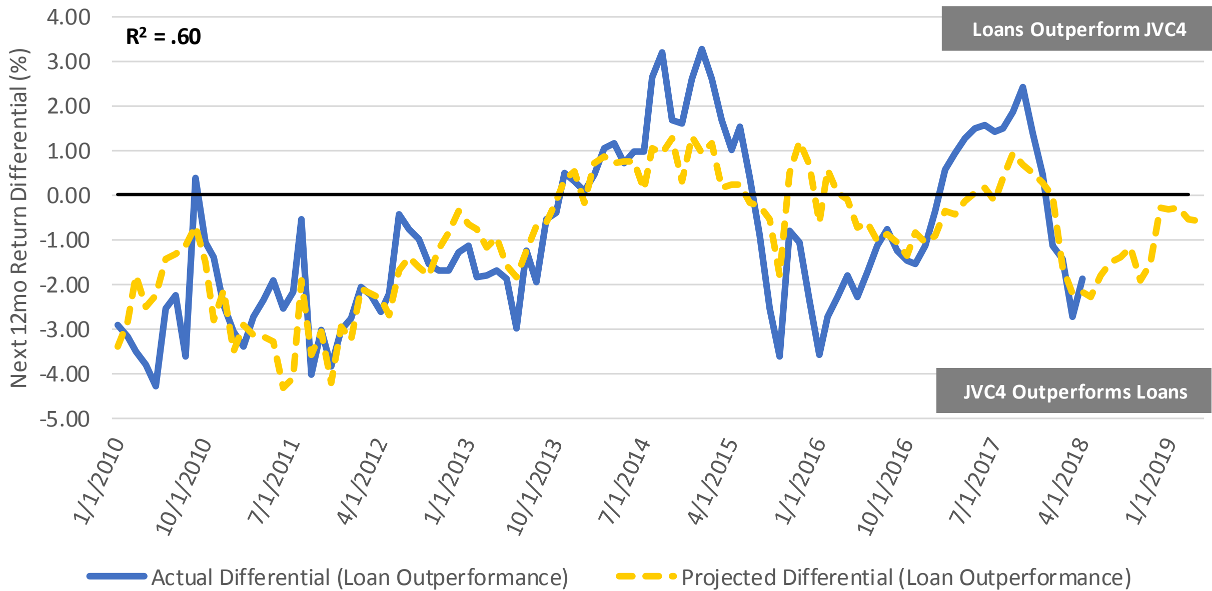
Source: SKY Harbor, ICE BofAML Indices, Credit Suisse Index Workbench

At first glance, the analysis presented above suggests that loans are trading "cheap" to bonds given the disconnect between actual and regression-implied discount margins. This simple analysis, however, fails to account for market technicals and fundamental index differences that have arisen over the last several years, much of which we highlighted in our most recent *Weekly Briefing*. To address these concerns, we augmented our data set to include asset class yield differentials, prevailing government bond yields, covenant-lite and loan-only index penetration, and differences between key loan and bond metrics (net leverage ratios, issuer-weighted default rates, unsecured vs. secured recovery rates, and fund flows), in addition to actual vs. projected loan discount margins. Utilizing all factors that proved to be statistically significant in the context of explaining future leveraged loan performance relative to high yield bonds, we generated the model provided below. This output – actual and projected LEVLOAN returns *less* H0A0 returns – **projects that loans should outperform high yield bonds over the next 12 months** (regression output, denoted by the dotted grey line, is now <u>above</u> 0 along the vertical axis).



Source: SKY Harbor, ICE BofAML Indices, Credit Suisse Index Workbench, BofA Merrill Lynch, Bloomberg, JP Morgan, Capital IQ

Applying the same framework to project leveraged loan (LEVLOAN) performance relative to the ICE BofAML 1-5yr BB-B US High Yield Constrained Index (JVC4, our proxy for short duration high yield risk), our output differs. Considering actual vs. projected loan discount margins (this time driven by the historical relationship between LEVLOAN and JVC4), and controlling for the same fundamental and technical items outlined previously, our regression output **projects JVC4 will outperform LEVLOAN over the next twelve months** (denoted by the dotted gold line, which remains below 0 along the vertical axis).

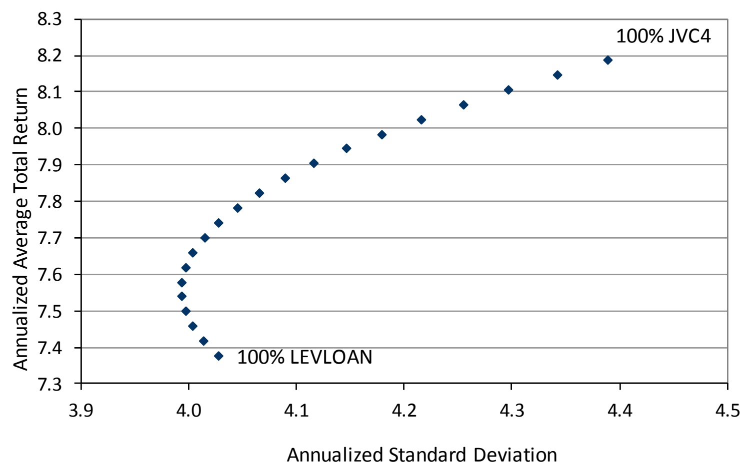


Source: SKY Harbor, ICE BofAML Indices, Credit Suisse Index Workbench, BofA Merrill Lynch, Bloomberg, JP Morgan, Capital IQ, Barclays

Despite the statistical significance of our models, we acknowledge an admittedly modest expected total return disparity over the next 12 months (particularly between short duration high yield bonds and leveraged loans). As such, we feel compelled to highlight the benefits of diversification arising from exposure to both asset classes, particularly in an environment where outperformance conviction may be limited. As demonstrated by the efficient frontier plotted below - generated with monthly data over the trailing 10-year period – an allocation to both asset classes has produced better risk-adjusted returns over the long-run than a portfolio consisting of only leveraged loans.

Efficient Frontier: Short Duration HY Bonds (JVC4) vs. Loans (LEVLOAN)

monthly data, trailing 10 years



Source: SKY Harbor, ICE BofAML Indices, Credit Suisse Index Workbench, BofA Merrill Lynch, Bloomberg, Bloomberg

Average Monthly Returns per Unit of Risk

monthly data, since 2000

Period	JVC4	LEVLOAN
All (Jan '00 - Apr '19)	0.30	0.24
Rising Default Months	0.24	0.18
Elevated Volatility Months	(0.01)	(0.12)
Rising Rate Months	0.53	0.64

JVC4 = ICE BofAML 1-5yr BB-B US High Yield Constrained Index
LEVLOAN = Credit Suisse Leveraged Loan Index

Can year-to-date outperformance of high yield bonds relative to leveraged loans persist, or are we heading toward an inflection point? To better frame the debate we built a regression model that utilizes the difference between actual and expected loan discount margins (driven by bond spreads) to predict loan outperformance (relative to bonds), all while controlling for the evolution of fundamental and technical index changes over time. The output of these models project outperformance of leveraged loans (LEVLOAN) vs. the full high yield bond index (H0A0) and outperformance of the short duration high yield bond index (JVC4) vs. leveraged loans (LEVLOAN) over the next 12 month period.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Personal Income	29-Apr-19	Mar	0.4%	0.1%	0.2%
Conf. Board Consumer Confid.	30-Apr-19	Apr	126.8	129.2	124.1
ISM Manufacturing	1-May-19	Apr	55.0	52.8	55.3

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Trade Balance	9-May-19	Mar	-$51.3bn		-$49.4bn
PPI ex Food and Energy YoY	9-May-19	Apr	2.5%		2.4%
CPI YoY	10-May-19	Apr	2.1%		1.9%

Source: SKY Harbor, Bloomberg

Recommended Reading

Romei, Valentina (2019, May 2). Eurozone Manufacturing Continues to Contract in April. *Financial Times* (subs. req.), Retrieved from https://www.ft.com/content/776c84c2-6caf-11e9-a9a5-351eeaef6d84

Ward, Jill, Meakin, Lucy, and Goodman, David (2019, May 2). Bank of England Set for Faster Rate Hikes if Brexit Resolved. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-05-02/bank-of-england-ready-for-faster-rate-hikes-if-brexit-resolved?srnd=economics-vp

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