SKY HARBOR
CAPITAL MANAGEMENT

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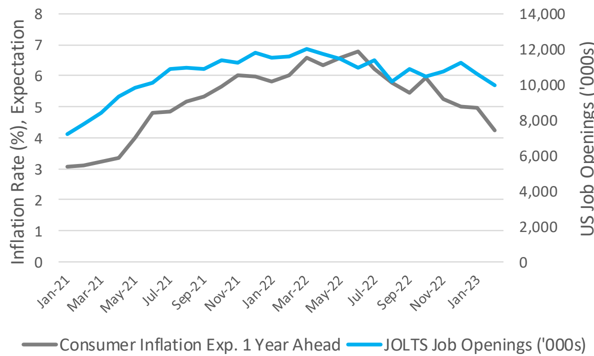
SKY Harbor Weekly Briefing

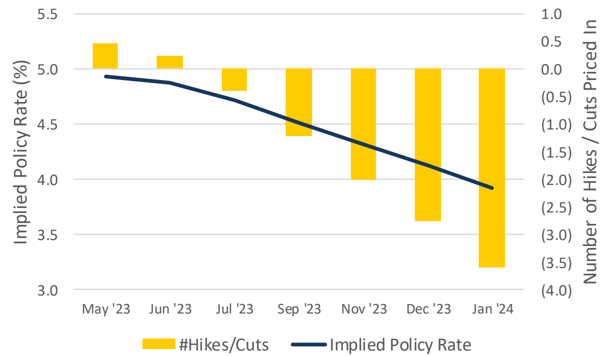
SKYView: The Final Hike?

The first quarter of 2023 has come to an end, with 70th percentile high yield index returns generated despite elevated volatility. Though markets were influenced by a number of risk factors over the last three months, the most impactful, in our view, were Fed rate hikes, an evolving economic growth outlook, and stress across the bank sector. One of those factors – Fed rate hikes – may soon be off the table, prompting us to examine the historical market reaction to monetary policy inflection points since the late 1980's. In this *Weekly Briefing*, we discuss strong high yield index returns in periods immediately following the final hike of prior tightening cycles.

Markets Bet Fed is Done

Despite some indications that the disinflation trend was going off track, recently released data implies a continuation of cooling input prices, particularly on the labor side. On Tuesday, April 4, **JOLTS Job Openings came in at 9,931k, below all surveyed economist estimates and overall consensus of 10,500k, and the first sub-10 million reading since 2021**. The following day, ADP data showed that US companies added fewer jobs in March (145k) than expected (210k), bringing labor market supply and demand metrics into better balance. These improvements continue to work their way into sentiment, with the Survey of Consumer Expectations conducted by the Federal Reserve Bank of New York signaling moderating inflation expectations for the year ahead (the most recent reading of 4.23% is the lowest since May 2021). Such developments, along with the expectation that tighter lending standards (as a function of banking stress) will simultaneously cool market conditions, **have led investors to believe the Fed hiking cycle may be nearing an end**. According to Fed Funds Futures, the market expects a less than 50% chance of one more 25 bps hike this year (May FOMC meeting), with rate cuts likely by this summer (July FOMC meeting).





Source: SKY Harbor, Federal Reserve Bank of New York, Bureau of Labor Statistics, Bloomberg

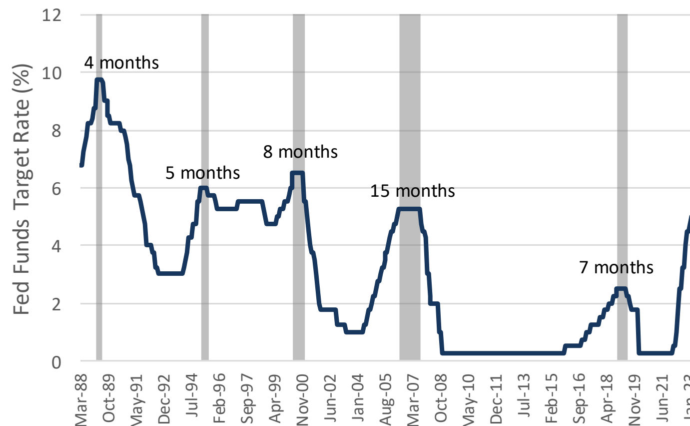
Fed Sees Normal "Transition" Period

Investors continue to price in Fed cuts later this year (at the time of writing, 75 to 100 bps, beginning in July) despite policymaker commentary to the contrary. In fact, the most recently released March dot plot projects no cuts in 2023, with Chairman Powell reiterating the point in his post-FOMC press conference. Assuming for the moment that markets are correct, how would such capitulation compare to prior cycles? Going back to the late 1980s (a period that effectively covers the history of the high yield market), **the median timeframe between the final Fed rate hike of a cycle to the first rate cut is approximately 7 months**. If a cut were to come in July, this "transition" period would span a mere 2 to 4 months (depending on whether or not we see a hike in May), and would fall on the short end of the range, as demonstrated below. **Using the Fed's dot plot data, one more rate hike in May, followed by a first cut in January '24, would essentially match the prior five cycle average**.

Recent Rate Hiking Cycles: Last Hike to First Cut Can Be Brief

monthly data, shaded grey areas are transition periods

Last Hike	First Cut	Distance
Feb '89	Jun '89	4 Months
Feb '95	Jul '95	5 Months
May '00	Jan '01	8 Months
Jun '06	Sep '07	15 Months
Dec '18	Jul '19	7 Months
	Median	**7.0 Months**
	Mean	7.8 Months



Source: SKY Harbor, Bloomberg, Federal Reserve

"Transition" Periods Have Been Kind to High Yield

On an historical basis, the periods between the final rate hike and first rate cut of a cycle (which we will refer to as the "transition" period) have coincided with strong high yield index returns. As highlighted in the table below, **the median periodic return (4 to 15 months) has been approximately 9%, with an annualized equivalent rounding up to the double-digit range**. Importantly, and in the context of our view that high yield spreads may widen in the coming months, the historical "transition" period spread reaction has been varied despite a positive skew in returns (note that index return data is available going back to the 1980s, but spread data only dates to 1996). In the spread widening "transition" periods ('00/'01 and '06/'07 cycles), **the change in OAS was almost perfectly mirrored by a rally in Treasuries, with attractive periodic returns largely a function of elevated yields less default & downgrade losses**. In this way, achievement of wider spreads (we believe fair value to be ~ 50 bps above current levels) may come from lower risk-free rates, eliminating the need for high yield bond prices to decline. Note that this concept of attractive carry driving returns, in our view, continues today, and we have published our view that credit loss avoidance (whether by default or downgrade) will likely be of the utmost importance in 2023 (see our *Weekly Briefing* entitled "Beware the Downgrade Wave" for additional color).

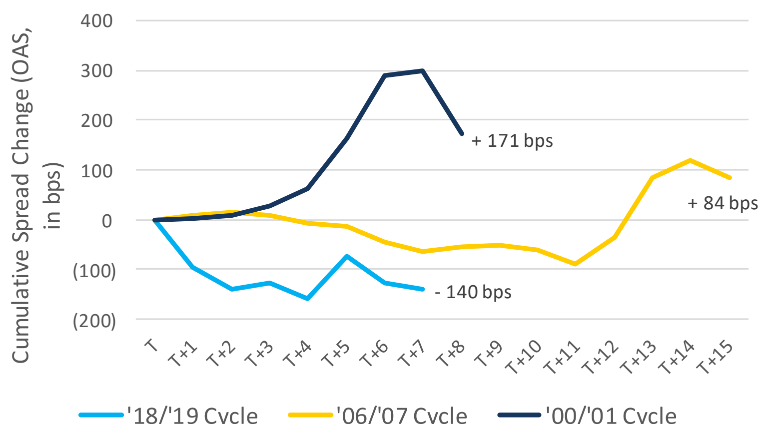
"Transition" Periods Historically Good for High Yield

periods between last hike and first cut of Fed rate cycle

Last Hike	First Cut	Distance	Spread (OAS) Change	Periodic Return	Annualized Return
Feb '89	Jun '89	4 Months	n/a	3.1%	9.5%
Feb '95	Jul '95	5 Months	n/a	9.3%	23.8%
May '00	Jan '01	8 Months	171	3.9%	5.9%
Jun '06	Sep '07	15 Months	84	12.1%	9.6%
Dec '18	Jul '19	7 Months	(140)	10.7%	19.1%
	Median	**7.0 Months**	**84**	**9.3%**	**9.6%**
	Mean	7.8 Months	38	7.8%	13.6%

Positive Returns Despite Varying Spread Environment

monthly data, last hike = month "T"



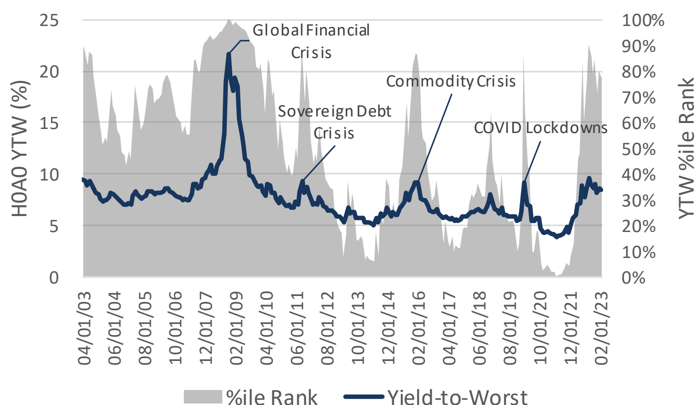
Source: SKY Harbor, ICE Data Indices, Bloomberg, Federal Reserve

In the Meantime, Enjoy Top Quartile Yields

At the time of writing, the yield-to-worst (YTW) on the ICE BofA US High Yield Index (H0A0) was 8.5%, a 77th percentile observation based on trailing 20 years of data (84th percentile when you exclude the '08/'09 recession). **In addition to top quartile carry, index YTW and option-adjusted spread (OAS) are not dissimilar from average and median levels when final Fed hikes occurred in prior cycles**, which we know from our initial analysis have marked the beginning of above-average market return periods. Also similar to prior "transition" periods, we anticipate upward pressure on the index default rate in 2023, with exceptionally low bankruptcy filings over the last twelve months (less than 2% of the index on a par-weighted basis) reaching a higher but manageable, in our view, 4.0-4.5% by year end. Given similar market backdrops and starting index metrics, we would anticipate strong carry less default/downgrade losses to form the foundation for "transition" period returns in the intermediate term, all while acknowledging that higher than average levels of uncertainty on the horizon could cause markets to react differently in this cycle.

Top Quartile ICE BofA US High Yield Index Yield-to-Worst

monthly data, trailing 20 years



Yields and Spreads Today In-line W/ Prior "Last Hike" Levels

periods between last hike and first cut of Fed rate cycle

Last Hike	Index YTW	Index OAS
Feb '89	n/a	n/a
Feb '95	n/a	n/a
May '00	12.6	616
Jun '06	8.6	335
Dec '18	8.0	533
Today	8.5	473
Median	**8.5**	**503**
Mean	9.4	489

Source: SKY Harbor, ICE Data Indices, Bloomberg, Federal Reserve

End of an Era

Volatility has somewhat subsided in April (thus far), and though we are not definitively out of the woods just yet, improving sentiment signals that the worst of the banking crisis may be behind us. Additionally, markets have grown increasingly confident that the Fed may soon pause, compelling investors to consider what happens next. Our historical analysis suggests strong high yield performance in prior "transition" periods with, on average, high-single digit annualized index returns generated in months that follow the final hike of a monetary tightening cycle. The driver of Fed policy changes, of course, matters, and so our optimism is somewhat restrained by virtue of the still elevated risk of recession. However, top quartile index yields and a manageable default outlook provide, in our view, an opportunity to increase exposure to the asset class, particularly for those who maintain a more sanguine view of global growth in the coming quarters.

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