SKY HARBOR
CAPITAL MANAGEMENT
Responsible Investing for a Sustainable Future

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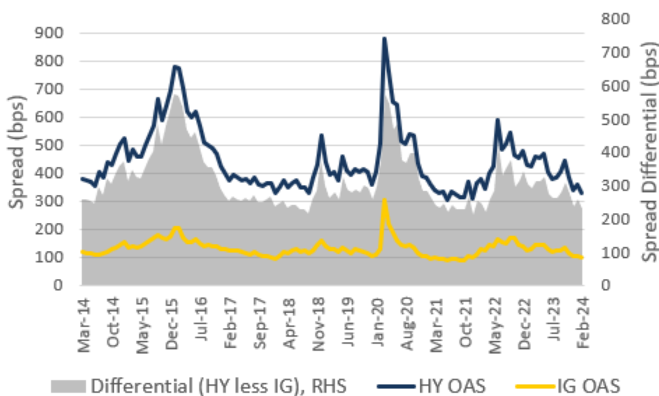
SKY Harbor Weekly Briefing

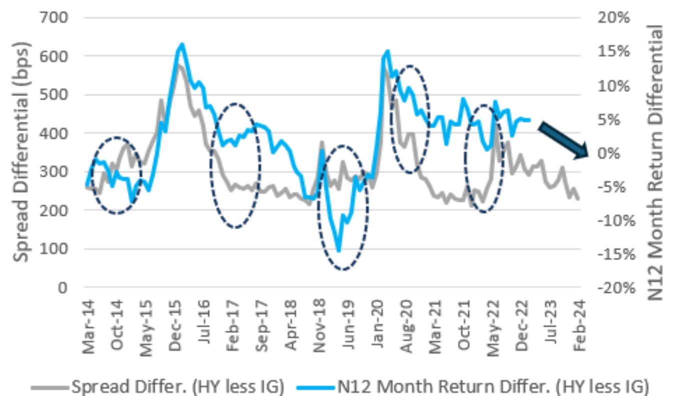
A Case for HY Over IG

High yield spreads have hovered below 350 bps over the last month, largely a function of continued "soft landing" enthusiasm, line-of-sight (though perhaps somewhat delayed) to the first Fed rate cut, and a relatively upbeat Q4'23 earnings season that has seen fewer than 20% of index constituents reporting downside earnings surprises. While the case for recession avoidance remains, in our view, intact, some investors have questioned the attractiveness of spread differentials between high yield and investment grade markets. In this *Weekly Briefing*, we introduce our new relative performance model, and find that high yield continues to appear well positioned to outperform ancillary asset classes in 2024.

Spread Differentials Are Compressed

Through the end of February, the spread differential between US high yield and US investment grade (using the ICE BofA US High Yield and the ICE BofA US Corporate indices, respectively) was 229 bps, a bottom decile observation based on monthly data over the last ten years. Historically, **spread differentials have demonstrated reasonable efficacy in predicting next 12 month return differentials between the asset classes**, as demonstrated below (right side). Though there have been a number of false signals in the past (circled), this relatively simple single-factor model ($R^2 = 0.34$) projects total returns to modestly favor investment grade credit over the next year, by virtue of compressed spread differentials as our starting point.

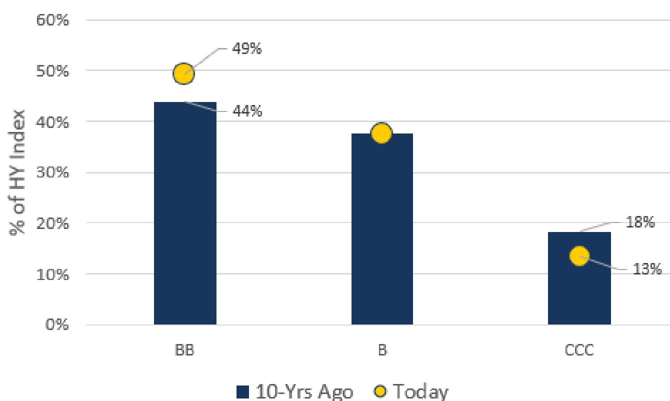


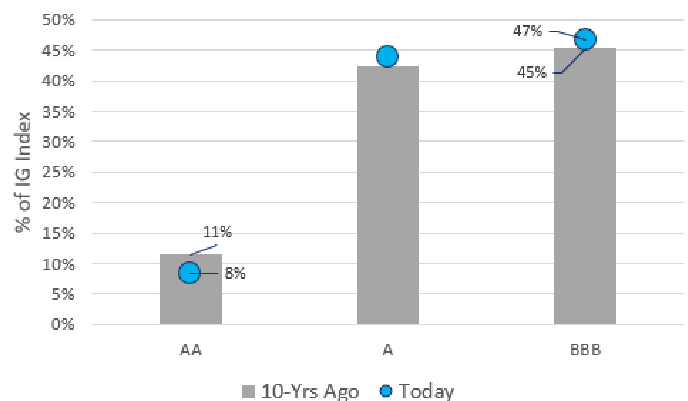


Source: SKY Harbor, ICE Data Indices

Index Quality Has Shifted

Index constituent sets change, however, and we have noted in many prior *Weekly Briefings* that the overall quality of the US high yield bond market has generally improved over the last decade. More specifically, **the CCC-rated cohort within the high yield index (most speculative and, as such, most likely to default) has shrunk from ~ 18% in 2014 to ~ 13% today**, while BB-rated bonds have grown share – the latter occurring despite a wave of rising stars in recent quarters. At the same time, the lowest-rated portion of the investment grade index (BBB-rated bonds) has increased, much at the expense of AA-rated bonds. This shift, we would argue, should result in spread compression between the two markets, making long-term percentile rankings less meaningful.





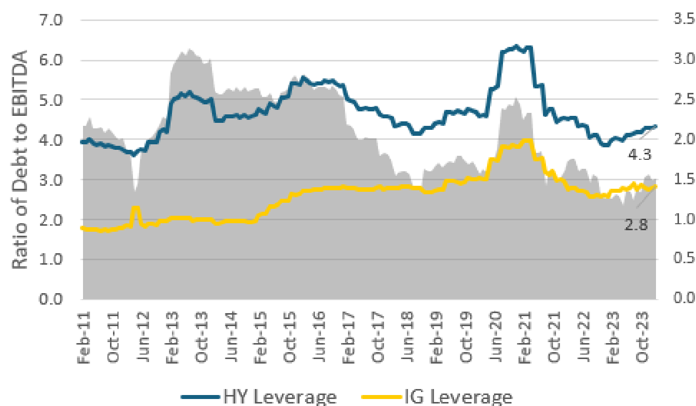
Source: SKY Harbor, ICE Data Indices

Fundamental Credit Ratios Have Converged

Consistent with the aforementioned quality migration, fundamental credit metrics between high yield and investment grade constituent sets have also converged. Through Q4'23, high yield issuer gross leverage was approximately 4.3x, 0.4x lower than the long-run average for the index. This improvement, in our view, is driven by the greater penetration of BB-rated bonds in the index, and has been enhanced by a post-pandemic boost in underlying earnings, as well as conservatism on the part of corporate management teams (limited amounts of debt raised to support aggressive LBOs and/or shareholder friendly initiatives). At the same time, investment grade constituent gross leverage is now approximately 2.8x, 0.2x higher than the long-run average for the index. **The resulting leverage differential of 1.5x (HY leverage of 4.3x less IG leverage of 2.8x) is well below the 2.1x historical average, implying more recent fundamental credit ratio convergence**. The same dynamic can be found within interest coverage metrics. As demonstrated below (right side), current differentials are compressed on better than average high yield / weaker than average investment grade coverage ratios.

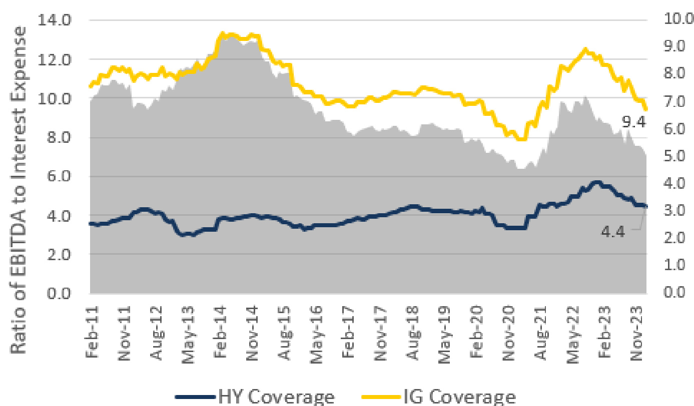
HY Issuer Leverage 1.5x Above IG; Inside 2.1x LT Average

monthly data, differentials shaded grey (RHS)



HY Issuer Coverage 5.0x Below IG; Inside 6.7x LT Average

monthly data, differentials shaded grey (RHS)



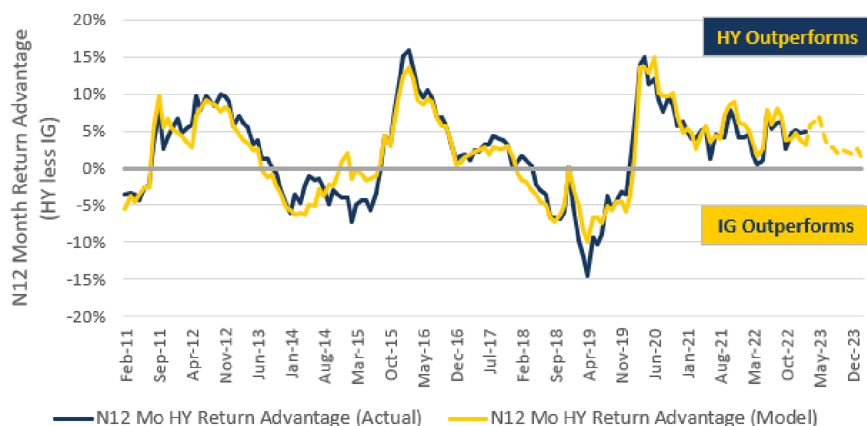
Source: SKY Harbor, BofA Merrill Lynch, company filings

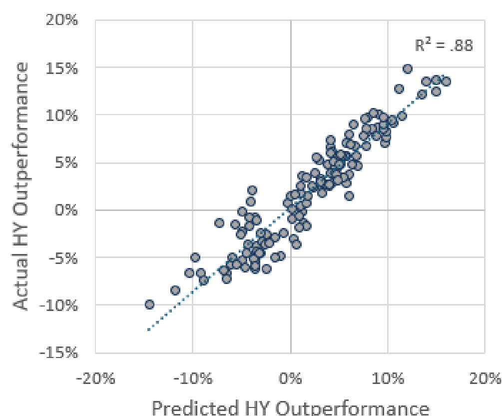
An Improved Model

Using a single-factor model with spread differentials as our starting point (first set of *Weekly Briefing* charts, right side), and examining periods in which actual returns deviated from our projected path, we set out to improve the efficacy of our HY vs. IG regression by testing a few dozen additional variables. We found that by adding the expected path of 10-year treasury yields, starting interest coverage metric differentials, trailing GDP growth rates, and a dummy indicator that takes the value of "1" if a recession occurred within the return projection timeframe (12-months), our model R^2 improved materially from 0.34 to 0.88. Furthermore**, the output suggests high yield is likely, under our base case assumptions, to outperform investment grade over the next year despite bottom decile spread differentials at present**.

Despite Compressed Spread Differentials, Our Model Still Projects HY > IG Returns

based on monthly data; dotted lines are projections





Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Bureau of Economic Analysis, The National Bureau of Economic Research

Flexing Our Assumptions

In our 5-factor model above, three independent variables are lagged, implying that we need only project the remaining two. For those factors – the path of 10-yr Treasury yields and the presence of a recession – we use consensus estimates (i.e., 10-yr treasury yields decline by ~ 44bps over the next 12 months, and the US avoids a recession). In order to push the model into HY vs. IG parity or worse (HY underperforms), our 10-yr Treasury yield estimate would need to fall an additional 60 bps (would represent the "low" estimate in Bloomberg) or the US would need to fall into a recession. Given recent economic releases that continue to demonstrate output growth resilience, along with persistent pockets of inflation that have delayed a more aggressive cutting posture by the Fed, we remain comfortable in our view of high yield outperformance in the coming year.

Addendum: An Update on Climate-Related Disclosures

SKY Harbor Capital Management applauds the recent announcement by the US Securities and Exchange Commission (the "Commission") that it has adopted final rules to enhance and standardize climate-related disclosures by public companies and in public offerings. The final rules reflect the Commission's

efforts, first proposed in March 2022, to respond to investors' demand for more consistent, comparable, and reliable information about the financial effects of climate-related risks on a registrant's operations and how it manages those risks while balancing concerns about mitigating the associated costs of the rules. SKY Harbor submitted extensive comments in a letter broadly supportive of the Commission's initial proposal as evidenced by the Commission's nearly fifty references to our comments in the final release. We are pleased that among those references, the final release attributes to SKY Harbor the notion that, "because long-term climate-related risks can quickly become financially impactful, the proposed requirement [to disclose climate-related risks] would elicit disclosure that, at a minimum, would indicate the quality of a company's governance and risk management." We believe this notion captures a key feature of how, why, and what we integrate into our comprehensive, holistic, and sustainability-oriented investment approach. Again, we applaud the Commission in finalizing its climate-related financial disclosures, and we look forward to the enhanced flow of information and data that we believe will undoubtedly benefit the financial markets, investors and importantly, society as whole.

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