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SKY Harbor Weekly Briefing

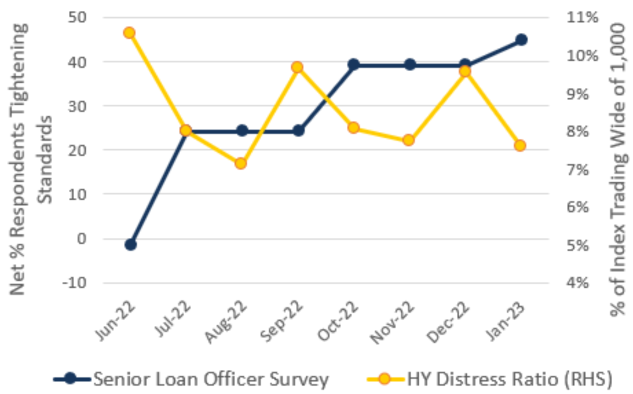
SKYView: Recession Risk on the Decline?

An abnormally strong January jobs report led to an uptick in volatility to start the month, with markets now pricing in a terminal rate above 5.1%. The persistence of labor market strength has now pushed 5-year Treasury yields up over 20 bps on a month-to-date basis, the impact fully absorbed by the high yield market given spread compression of a similar magnitude. With ICE BofA US High Yield Index (H0A0) spreads now in the low-400 bps range, are markets priced to perfection? We don't think so, but admit it's getting close. In this *Weekly Briefing*, we attempt to calculate the implied likelihood of a recession as reflected in spread levels, and gauge total return implications should investor enthusiasm for a "soft landing" diminish.

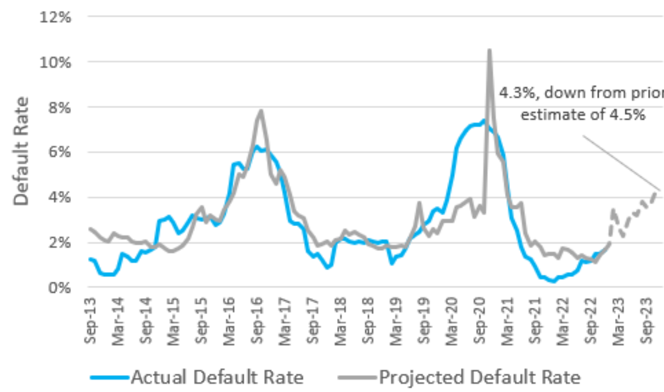
Lending Standards Up, Distress Down

According to the most recent survey, **banks reported tightening lending standards and lower demand for commercial and industrial loans to large, middle-market, and small firms in Q4'22**. In general, higher premiums were charged on riskier loans, and more stringent covenants and collateralization requirements were imposed on firms of all sizes. This data – collected through the Federal Reserve's Senior Loan Officer Opinion Survey – factors heavily into our default rate projection model, and would otherwise increase our expectation of bankruptcy filings in the coming year, all else being equal. At the same time, however, high yield distress ratios continue to decline, and issuer credit metrics have thus far proven more resilient than expected through the start of Q4'22 earnings season. Incorporating all of these datapoints**, our default rate projection for the year <u>declined</u> to 4.3%**, 20 bps below the original estimate included in our *2023 US High Yield Outlook* report from December '22.

Lending Standards Tighten, Disress Ratios Fall
monthly data



SKY Harbor Default Rate Estimate Improves to 4.3%
data as of February 8, 2023

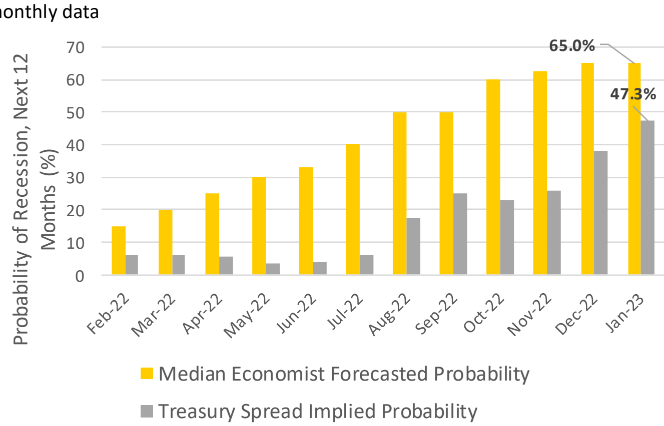


Source: SKY Harbor, Federal Reserve, Bloomberg, BofA Merrill Lynch

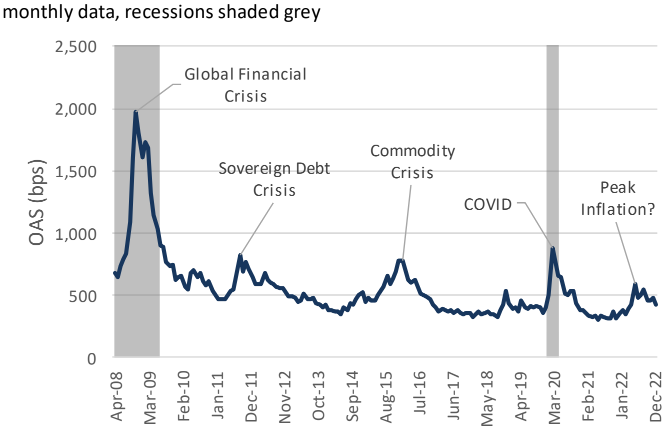
Odds of "Soft Landing" Increasingly Priced into Spread Levels

Given the focus of our work, we do not believe we possess a competitive advantage in GDP growth forecasting relative to the 57 economists surveyed by Bloomberg, who on average see a 65% chance of recession in 2023. **We do, however, think the high yield market is incorporating a likelihood of recession far below that level by virtue of credit spreads in the low-400 bps context**. Utilizing a dual approach – involving the observation of OAS behavior in historical recession run-ups as well as implied default losses in constant excess spread environments – we estimate that high yield spreads are incorporating a mere 10% to 20% chance of a recession in the coming year, well below the consensus view from professional forecasters.

Recession Probabilities Still Elevated...
monthly data



...But Spreads Have Tightened, Reflect 10% - 20% Recession Prob
monthly data, recessions shaded grey



Source: SKY Harbor, Bloomberg, Federal Reserve Bank of New York, ICE Data Indices, National Bureau of Economic Research

Justifiable Optimism

There are a lot of things to like about high yield markets right now, including **meaningful developments over the last few months that justify an overall improvement in sentiment**. Such developments include relaxation of COVID protocols in China that should alleviate supply chain pressure, a lower default rate projection which, in the context of low dollar price bonds and high dispersion, should limit credit losses in the coming year, and inflation normalization that has reduced severe recession tail risk. Even Fed Chairman Powell appears to be moving toward the "soft landing" camp given recent commentary ("I continue to think there's a path to getting inflation back to 2% without a significant economic decline or significant increase in unemployment"). In fact, **execution of a "soft landing" would likely lead to further spread tightening relative to current levels, in our view**. However, tighter index spreads also leave the asset class more vulnerable to a repricing shock should conviction change.

Priced to Perfection?

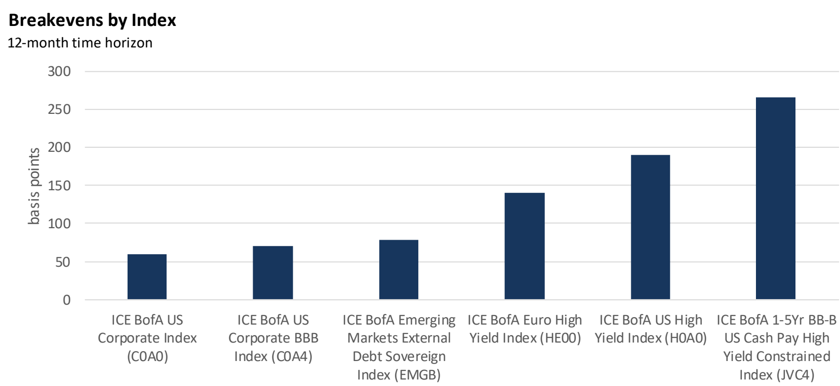
Though we disagree that a "soft landing" is fully priced into high yield credit spread levels (our analysis finds that markets are still factoring in a 10% to 20% chance of recession in the coming year), we have received a number of questions regarding the requisite amount of widening needed to incorporate a likelihood of recession more consistent with macro models. Notwithstanding a significant number of estimates and assumptions needed for such an analysis, **our work suggests a 100 bps move wider in index spread is certainly in the realm of possibility should "soft landing" enthusiasm moderate.**

A Refreshed Breakeven Analysis

Consistent with breakeven work presented over the past several years, the following simulation aims to calculate the maximum all-in yield increase an asset class could handle before total returns fell below breakeven levels (i.e., the point at which interest income is fully offset by the negative impact of rising yields). Our model maintains the following assumptions:

- 12 months investment horizon
- Increases in yield are linear in nature across all asset classes and occur in equal monthly increments
- No credit losses via defaults; no performance drag via downgraded securities exiting an index
- Coupon payments are reinvested in their respective strategies
- The driver of higher yield (whether by an increase in Treasury yields or a widening of spreads) is not specified
- No absorption of increased Treasury yields through spread compression (and vice versa)
- We include an estimate for duration extension for relevant asset classes under various widening scenarios
- No impact from roll-down as we assume investments are within a fund and repositioning would mitigate this impact
- Metrics are re-set monthly (increased carry and extension-related duration)
- Goal Seek is utilized to find the maximum increase in yield that would correspond to a 0% (breakeven) return

Our findings show that both broad and short duration high yield (H0A0 and JVC4, respectively) can absorb the estimated 100 bps points of widening needed to incorporate a more onerous recession probability without pushing returns into negative territory by virtue of higher breakevens (in the 190 to 270 bps range).



Source: SKY Harbor, ICE Data Indices

Off to a Strong Start

Be it the January Effect, increased conviction for an economic "soft landing," or a combination of other factors, investor enthusiasm drove high yield markets to the second strongest start to any year since the global financial crisis, easily outpacing our expectations. High yield spreads, perhaps justifiably so given several unambiguously positive developments in recent months, continue to tighten, and now incorporate a far lower likelihood of recession than economist expectations. Though recession avoidance may soon become the consensus view, we take comfort in attractive high yield index breakevens, implying significant cushion to offset well over 100 bps of spread widening should markets give back some recent gains.

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