SKY HARBOR
CAPITAL MANAGEMENT

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# SKY Harbor Weekly Briefing

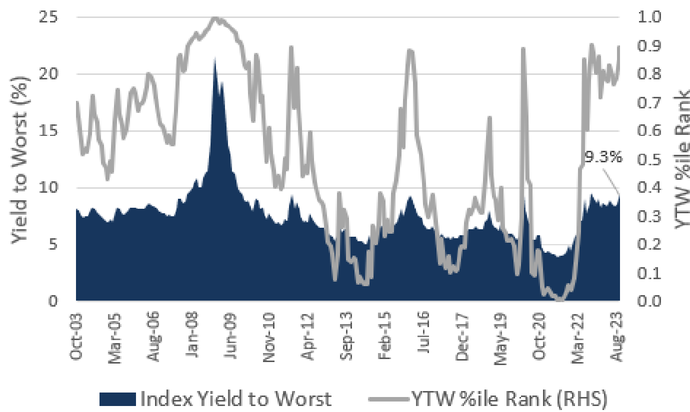
## No Time to Stress

US high yield market yield-to-worst (YTW) levels have jumped since the start of the month, driven by a combination of inflation-induced rate volatility, tensions in the Middle East, a leadership vacuum in Congress, and new questions surrounding the soft landing narrative. Now top quartile in nature, we think increasingly attractive carry will entice investors to boost allocations to the asset class, particularly since such yields can be achieved without taking on risk associated with the most speculative credits in the index. In this *Weekly Briefing*, we make the case that high yield remains attractive, particularly since the distressed tail is unlikely to meaningfully skew results in the coming months.

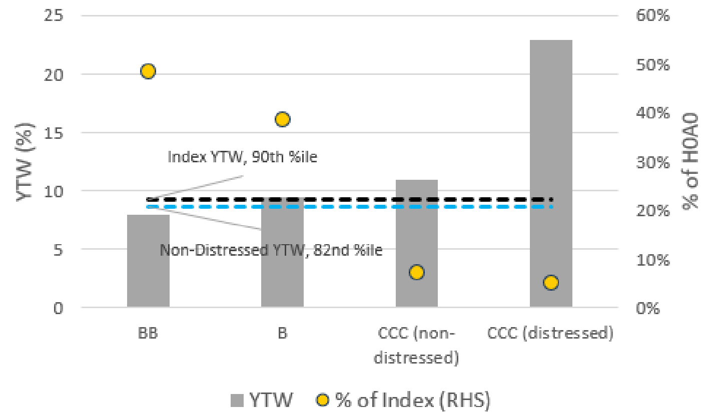
### Yields Enter Top Decile

The ICE BofA US High Yield Index (ticker H0A0) ended September with a YTW of ~ 8.9% – a full 25 bps below levels at present – with the most recent uptick coinciding with the Israel-Hamas war, hotter than expected CPI and PPI data, and uncertainty surrounding House leadership. Despite this, the overall fundamental backdrop for high yield credit (i.e., weakening but manageable leverage and coverage ratios), in our view, remains intact. As such, **we think 90th percentile yields represent attractive value given our continued expectation that a benign default rate environment will persist**. Additionally, and as noted in the right chart below, investors need not dip into the distressed tail of the market (> 1,000 bps spread, or the bottom 6.5% of the index) for strong yields. Full exclusion of this most speculative basket would only lower index YTW levels to 82nd percentile, further limiting default risk in the process.

**HY Index Yields Now 90th Percentile**
based on monthly data, trailing 20 years




**Top Quartile Yields Available w/o Dipping Into Distressed**
based on monthly data, trailing 20 years

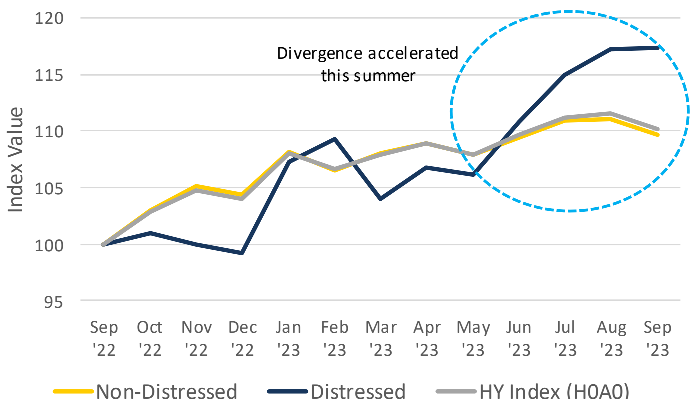



Source: SKY Harbor, ICE Data Indices

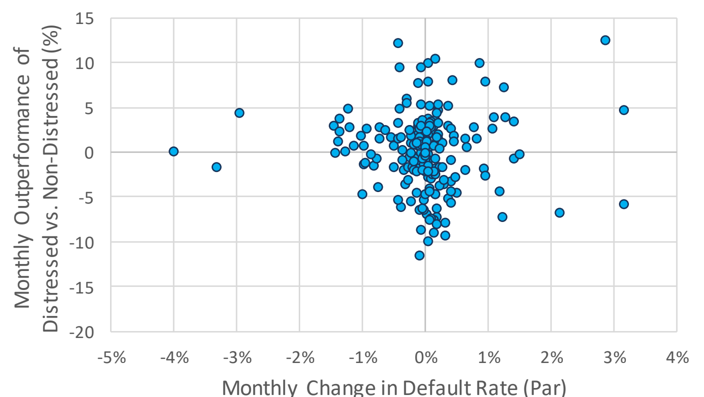
### Distressed Divergence

On a trailing 12-month basis, the distressed portion of the high yield bond market outperformed H0A0 by over 700 bps, though the divergence was largely generated from May to September '23. In our view, **recent distressed outperformance was at least partially driven by greater investor acceptance of the "soft" or "no-landing" narrative, which rewarded credit risk-taking, as well as more substantial spread cushions** with which to absorb a 125 bps increase in 5-year treasury yields over the same timeframe. So, will an underweight to the distressed portion of the market continue to dampen relative portfolio returns? Though we expect a modest, albeit measurable, uptick in the default rate in the coming months, such trends have proven statistically insignificant in explaining the distressed vs. non-distressed return trajectories over time (right chart below).

**Distressed Bonds Have Outperformed Over The Prior Year**
cumulative (monthly) returns, since September 2022



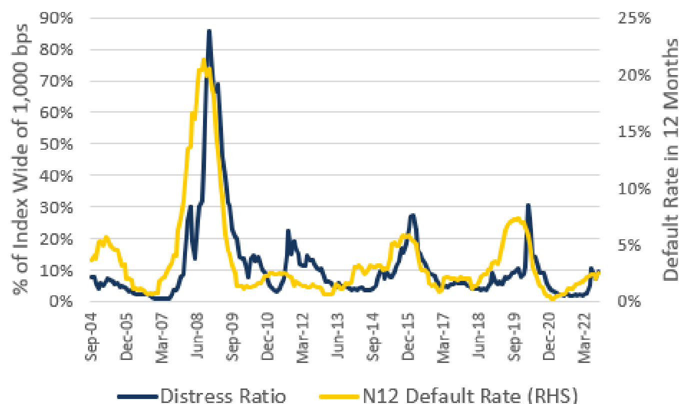

**Default Rate Trend Doesn't Drive Distressed Performance**
monthly data, since 2005

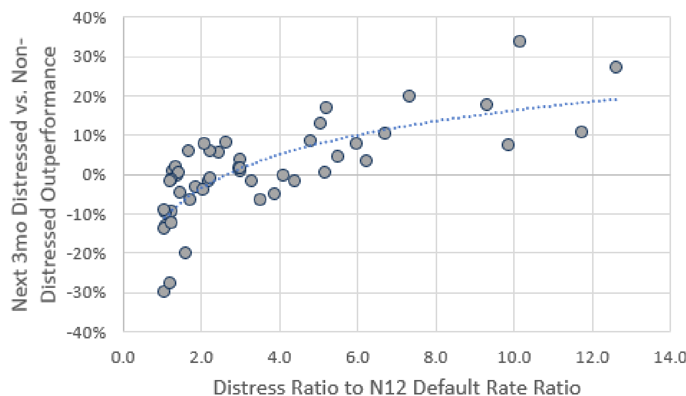



Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Moody's

## A More Meaningful Metric

The high yield distress ratio, defined as the percentage of the index made up of bonds with an option-adjusted spread (OAS) of 1,000 bps or higher, has historically been a strong indicator of future defaults. More specifically, and as demonstrated below, **we find a .74 correlation between the distress ratio and the subsequent default rate 12 months into the future**. With this in mind, we examined periods in which the distress ratio meaningfully differed from the subsequent default rate environment (i.e., when investors significantly over- or under-estimated the future risk of default), and found such periods to be key inflection points in the performance differential between distressed and non-distressed credits. As demonstrated below (right side) subsequent 3-month total returns tend to favor distressed credits when the distress to future default rate ratio rises above 2.0x, and vice versa.

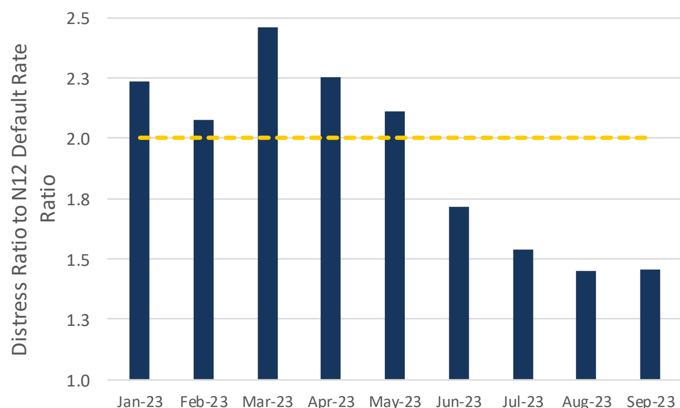


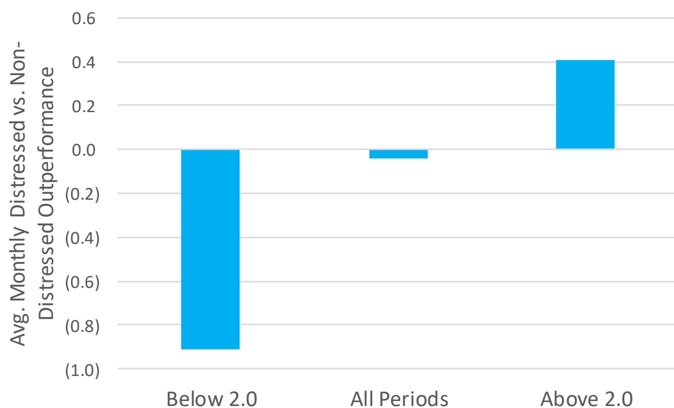




Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch

## The Advantage Has Shifted

For the above analysis to be actionable, however, a high-conviction view of the future default rate environment must be generated. Further updating our proprietary regression model, we continue to expect the default rate to hit 4.7% by the end of 2024, moving up in a linear fashion each month from 2.5% at present. Therefore, overlaying our estimates to the known distress ratio at each month-end period so far in 2023, **we find the distress to subsequent default ratio as having recently moderated, now falling below that critical 2.0x threshold**. As such, we believe the risk of underperforming the benchmark as a result of avoiding the most speculative parts of the high yield market has significantly diminished relative to earlier this year.




Source: SKY Harbor, ICE Data Indices

## Clip Your Coupon

Recent events that have served to dampen sentiment aside, we continue to see a relatively supportive backdrop for credit risk taking. Additionally, though distressed credits have outperformed the index year to date, our analysis of the distress to subsequent default ratio implies tailwinds for the most speculative portions of the market are likely to dwindle now that trading levels more closely coincide with the risk of principal loss. As such, we continue to believe high yield carry remains quite attractive, with investors now able to capture top quartile yields even absent exposure to distressed credits at further risk of default should geopolitical tensions and inflation fail to ease in the near term.

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