SKY HARBOR
CAPITAL MANAGEMENT

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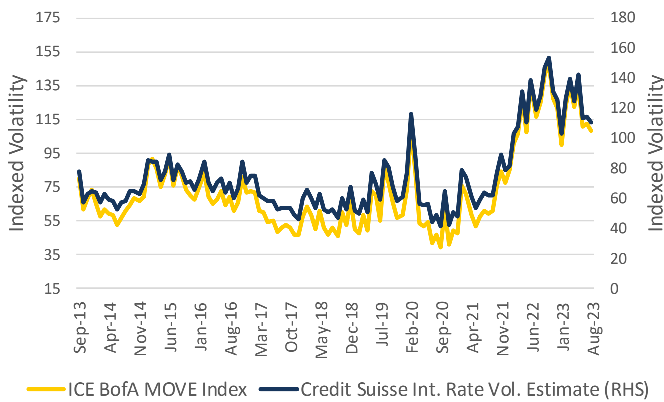
SKY Harbor Weekly Briefing

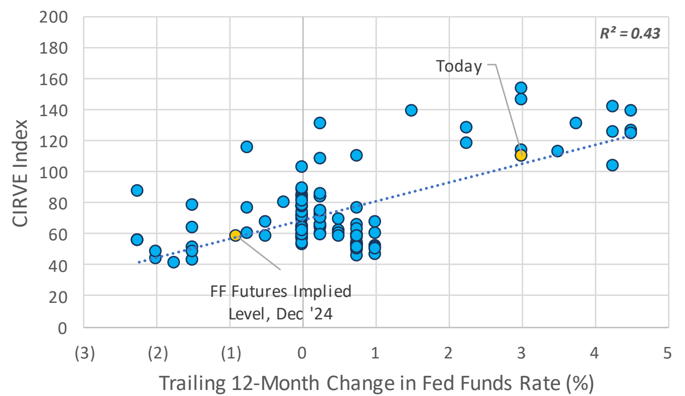
A Rates Story

In a note to clients earlier this month, we highlighted that treasury market volatility has been prevalent for months, more recently driven by Fed uncertainty, a downgrade of US debt by Fitch, and technical headwinds as investors struggled to absorb outsized auctions. Though volatility remains well above historical averages, recent trends suggest some degree of normalization may be on the horizon. In this *Weekly Briefing*, we find that higher-quality, longer-duration bonds tend to benefit most from a reduction in underlying rate volatility, with additional evidence suggesting high yield flows may turn positive in such an environment.

A MOVE Lower?

Two indices that track interest rate volatility – the ICE BofA MOVE Index[1] and the Credit Suisse Interest Rate Volatility Estimate[2] – have recently signaled a modicum of normalization, albeit from elevated levels. More specifically, the MOVE Index value of approximately 108 (August month end) remains well above the trailing 10-year average of 73, albeit down from a recent peak of 136 (May '23). Not surprisingly, and as demonstrated below (right side), **both measures of volatility tend to be highly influenced by the Fed Funds rate, with prior hiking cycles also coinciding with above-average MOVE and CIRVE readings**. Despite modestly hotter than expected CPI and PPI readings this past week, along with elevated retail sales figures (largely driven by a spike in energy prices), investors continue to price in a less than 50% chance of one additional 25 bps hike between now and the end of 2023. Historically speaking, rate volatility tends to decline after the final Fed hike of a cycle, and we would expect a similar market dynamic to unfold this time around.

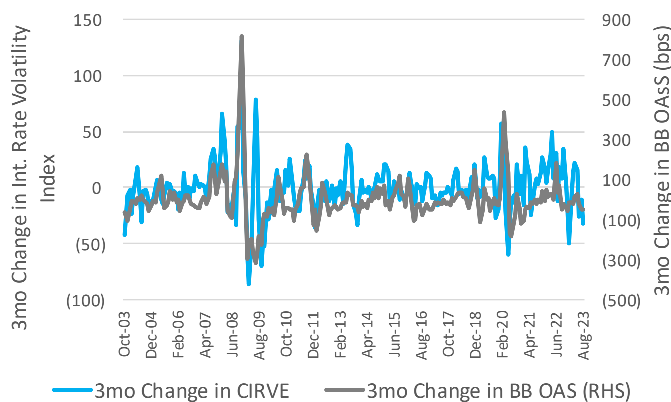


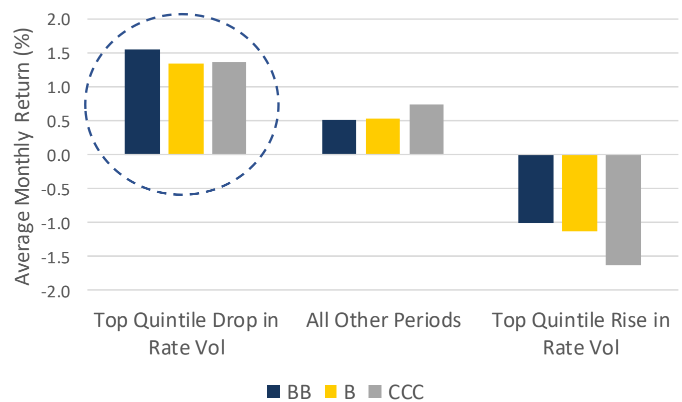


Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Credit Suisse

A BB Rally?

Using rolling 3-month moves in the Credit Suisse Interest Rate Volatility Estimate (CIRVE Index) as our proxy, we find that BB option-adjusted spreads demonstrate a stronger correlation to changes in rate volatility than single-Bs and CCCs. Taking our analysis a step further by dividing monthly changes in rate volatility over the last decade into quintiles (5th quintile representing the most significant declines in volatility, and consistent with end-of-hiking cycle dynamics), **we find that BB-rated credit typically performs best among all rating buckets when rate volatility declines rapidly, as evidenced by the highest average monthly returns** (right chart below).





Source: SKY Harbor, Conference Board, Bloomberg, ICE Data Indices

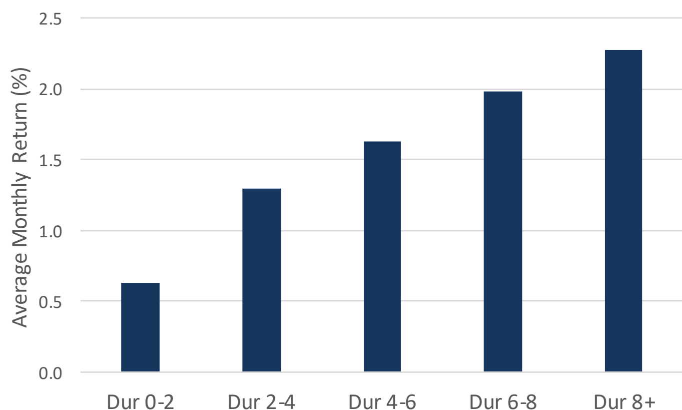
[1] MOVE Index, (tracks the implied normal yield volatility of a yield curve weighted basket of at-the-money one month options on 2-, 5-, 10-, and 30-year constant maturity interest rate swaps)
[2] CIRVE Index (a yield curve weighted index of normalized implied volatility on a rolling series of at-the-money one-month expiry swaptions)

Duration Dominates

Cutting our data in a different way, we further find that duration is a key attribute of high yield bond returns as rate volatility drops. As demonstrated in the chart below (left side), **there exists a strongly positive correlation between starting duration-to-worst groupings and average monthly returns during periods in which rate volatility declines most significantly** (i.e. during top, or 5th quintile observations). As such, some of the benefits accruing to BB-rated securities – the top performing rating bucket in our analysis above – is driven by their inherently longer-duration (the duration tailwind in falling rate volatility periods, however, does not appear to benefit CCC-rated bonds as much as higher-quality index constituents). Furthermore, **average monthly fund flows into high yield tend to be strongest during periods in which rate volatility is declining the fastest** (top, or 5th quintile observations), giving hope that year-to-date asset class outflows could reverse once the Fed hiking cycle comes to an end.

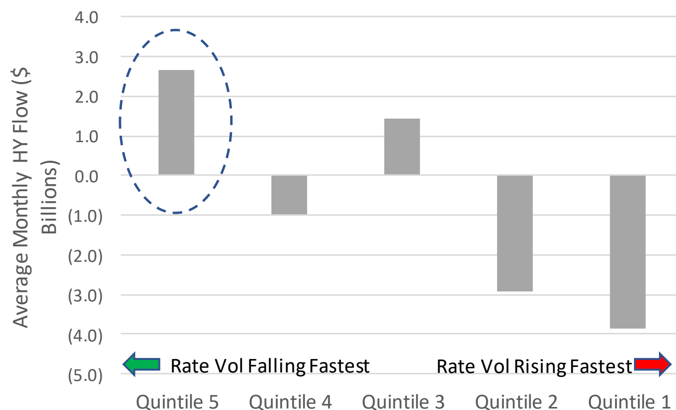
Duration Outperforms During Top Quintile Drops in Rate Vol

average monthly return by duration bucket, top quintile rate vol drop periods



HY Flows Tend to Improve When Rate Vol Declines

monthly data, trailing 10 years



Source: SKY Harbor, ICE Data Indices, JP Morgan, Lipper, Bloomberg, Credit Suisse

Nearing the End

Though the market is almost evenly split on the odds of another 25 bps rate move this year, we remain confident that an end to the Fed's hiking cycle is near. As such, we would expect a marked reduction in rate volatility to ensue, consistent with historical observations. At present, we think marginally increasing duration, rather than credit risk, is the more prudent way to boost portfolio yield, further aligning our risk taking to be consistent with factor beneficiaries at similar inflection points over the last couple of decades.

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