Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
June 19, 2023

SKY HARBOR CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

A Hawkish Pause

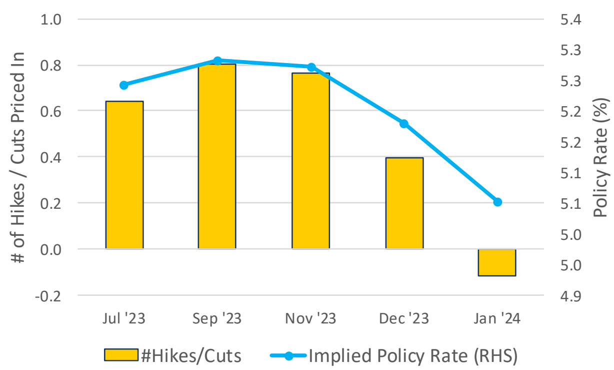
After ten consecutive hikes since liftoff began in March '22, the Fed opted to keep rates unchanged at their June meeting. Though the decision to pause was widely anticipated by markets, a new dot plot that projected two additional rate hikes in 2023 caught many investors off guard. Perhaps most importantly for high yield market risk, this shift was driven by a modest increase in economic activity, as Fed officials now see better output growth in the coming quarters only partially offset by the need to get more aggressive in taming inflation. In this *Weekly Briefing*, we discuss the impact of recent data on our spread fair value models, with a refreshed Summary of Economic Projections contributing to compression of our OAS target.

A "Live" July FOMC Meeting

Insisting that no decision has been made with regard to the July meeting, Chairman Powell seemed to tip his hand a bit after referring to the June decision as a "skip," though he promptly retracted his words. Nevertheless, **investors will be focused on labor-related data and the June CPI number**, key releases ahead of the July FOMC meeting (26th – 27th). Thus far, the market seems caught in the middle, with Fed Funds Futures implying one more 25 bps hike left in 2023, likely in anticipation of inflation moderation that reduces the need for the Fed to act as aggressively as what was inferred by the new dot plot. Importantly, and somewhat lost amidst commotion stemming from dot plot drama, was a general upgrading of economic expectations. More specifically, **Fed officials now see real GDP growth coming in at +1.0% in '23 (up from a previous estimate of +0.4%)**, while also moderating unemployment rate expectations to 4.1% (down from a previous estimate of 4.5%).

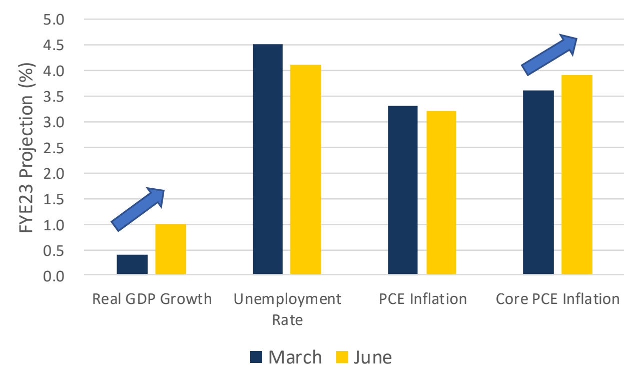
Market Sees One More Hike

Fed funds futures implied rate by FOMC meeting date, as of June 15, 2023



Fed Boosts GDP Growth Outlook; Inflation Likely Higher

March vs. June Summary of Economic Projections



Source: SKY Harbor, Federal Reserve, Bloomberg

Valuations Improve

Perhaps the most impactful aspect of the recently updated Summary of Economic Projections – at least from the perspective of a high yield investor – is **the upgrading of economic growth that underpins Chairman Powell's anticipation of a "soft landing."** Mindful that economic contractions that follow Fed rate hiking cycles have historically been the rule, rather than the exception, recession avoidance is not without precedent[1]. In fact, the Atlanta Fed's GDPNow model is signaling Q2 output nearing 2%, and Fed officials now see real GDP Growth of +1.0% in '23, a 60 bps improvement relative to the March outlook. As it relates to high yield, our economic scenario analysis below shows how sensitive a 5% shift in favor of a "soft landing" (scenario #1) at the expense of a "severe recession" (scenario #5) can be, compressing spread fair value to ~ 495 bps. Similarly, our recently updated macro spread regression model also signals a more favorable outlook, with our fair value estimate improving to 485 bps (vs. 530 bps last month).

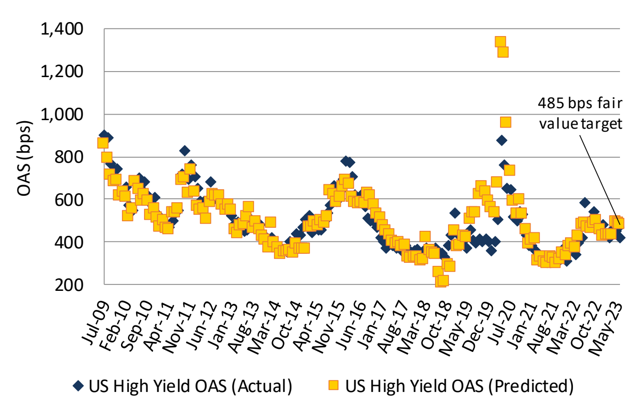
Fed Outlook Improves Fair Value Spread Target

before and after June FOMC Meeting commentary

Scenario	Summary	Target OAS	Est. Likelihood (Pre-FOMC)	Est. Likelihood (Post-FOMC)	Δ
#1	"Soft Landing"	375	25%	30%	+ 5%
#2	Elevated Inflation, Mod. Pos. Growth	450	35%	35%	
#3	Elevated Inflation, Mod. Neg. Growth	700	25%	25%	
#4	Moderate Recession	825	10%	10%	
#5	Severe Recession	1125	5%	0%	- 5%
	Weighted Average OAS Target (bps)		565	528	
	Quality-Adjusted Target(bps)		**530**	**495**	

Macro Spread Regression Model Target Falls Below 500 bps

generated using monthly data



Source: SKY Harbor, ICE Data Indices, Federal Reserve, Bloomberg, NBER, Institute for Supply Management

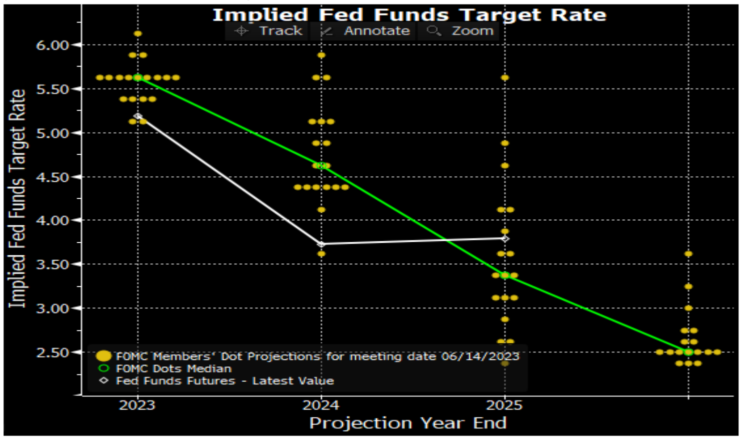
[1] https://piper2.bluematrix.com/sellside/EmailDocViewer?encrypt=10a3d02e-a460-44aa-bf57-2be5effc5c54&mime=pdf&co=Piper&id=dwessel@brookings.edu&source=mail

Two More Hikes Penciled In

Though the decision to pause coincided with the consensus view in days leading up to the FOMC meeting, **a move in the median dot to 5.625% caught markets by surprise**. Representing a two hike / 50 bps increase from the median March projection, the updated dot plot included a relatively wide range of views as to where rates finish the year. Of the 18 opinions cast, three anticipated more than two hikes during the balance of 2023, while six came in below the median. Furthermore, looking toward 2024, the median view is for 100 bps of cuts (vs. 87.5 bps in March), but for rates to end at 4.625% (up from 4.25% in March). Consistent with updated expectations, the post-FOMC statement struck a hawkish tone, including language that suggested the committee would determine the extent “of,” rather than “to which,” “additional policy firming may be appropriate” in the coming months. Though this uncertainty, in our view, represents downside risk to an otherwise improving economic narrative, we continue to believe the committee will be highly data dependent going forward, and that member expectations are likely to evolve as new data comes in.

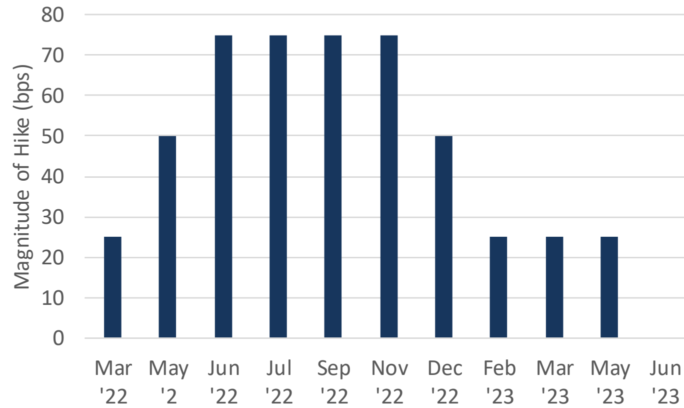
Median Dot Moves to 5.625%

post June '23 FOMC Meeting



Pace Had Already Tapered Off Meaningfully

rate hikes by FOMC date



Source: SKY Harbor, Federal Reserve, Bloomberg, Goldman Sachs

Some Room for Risk

Though we remain of the view that higher-quality credit and exposure to less cyclical capital structures make sense at this point in the cycle, we do think a modest moderation of our underweight to higher-yielding bonds within the index has some merit, particularly in light of the recent upgrading of GDP growth expectations by Fed officials. Furthermore, CPI base effects and other progress on the inflation front may preclude the Fed from acting as aggressively as signaled in the most recent dot plot, which could further boost sentiment. And, though the market may be a bit premature in incorporating a “soft landing” as the base case outlook, we concede that risks appear to have somewhat moderated in recent days.

Important Disclosures and Disclaimers