SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

SKYView: Higher for Longer?

Markets have given back a portion of January's gains, largely driven by fears that inflation normalization has hit a speed bump. Labor market strength has been the primary culprit, with increasing prices for shelter, food, and energy also playing a role. In response to "hotter than expected" readings from key economic indicators, investors have boosted their terminal rate outlook, which may have to rise even further based on recent commentary from Fed officials. Given a changing landscape, we use this *Weekly Briefing* to highlight the drivers of high yield market returns thus far in February, and update our thoughts on positioning in the current market environment.

Inflation Proving Hard to Kill

A number of economic datapoints over the last two weeks have reminded investors that inflation may linger for longer than previously anticipated. Perhaps **the most striking example was a 517,000 increase in Nonfarm Payrolls, coming in nearly twice the magnitude of the prior month, and nearly 3x consensus expectations**. This of course led to a drop in the unemployment rate to 3.4% – the lowest level since May 1969 – along with an uptick in average hourly earnings (consistent with the view presented in an early January '23 *Weekly Briefing* entitled "Labor Markets Refuse to Cool"). Central bankers, for their part, have become increasingly vocal about recent developments, with some now making the case for a 50 bps hike merely weeks after a quarter-point February FOMC move that many investors viewed as perhaps the last of its kind for this cycle.

Inflation Normalization Has Recently Been Interrupted
key economic data releases in Feb '23

Date	Event	Expectation	Actual	Inflation Implication
2-Feb	Initial Jobless Claims	195k	183k	Hotter Than Expected
2-Feb	Continuing Claims	1684k	1655k	Hotter Than Expected
3-Feb	Change in Nonfarm Payrolls	189k	517k	Hotter Than Expected
3-Feb	Unemployment Rate	3.6%	3.4%	Hotter Than Expected
3-Feb	Average Hourly Earnings (YoY)	4.3%	4.4%	Hotter Than Expected
14-Feb	CPI (YoY)	6.2%	6.4%	Hotter Than Expected
14-Feb	CPI ex Food and Energy (YoY)	5.5%	5.6%	Hotter Than Expected
15-Feb	Retail Sales Advance (MoM)	2.0%	3.0%	Hotter Than Expected
16-Feb	PPI Final Demand (MoM)	0.4%	0.7%	Hotter Than Expected
16-Feb	PPI ex Food & Enegy (MoM)	0.3%	0.5%	Hotter Than Expected

Fed Commentary Leaves Door Open for More Hikes
past week commentary

"Inflation is normalizing but it's coming down slowly..." and "...if inflation persists at levels well above our target, maybe we'll have to do more."
- Richmond Fed President Tomas Barkin

"We must remain prepared to continue rate increases for a longer period than previously anticipated, if such a path is necessary to respond to changes in the economic outlook or to offset any undesired easing in conditions"
- Dallas Fed President Lorie Logan

"...I am prepared for a longer fight to get inflation down to our target."
- Fed Board of Governors Member Christopher Waller

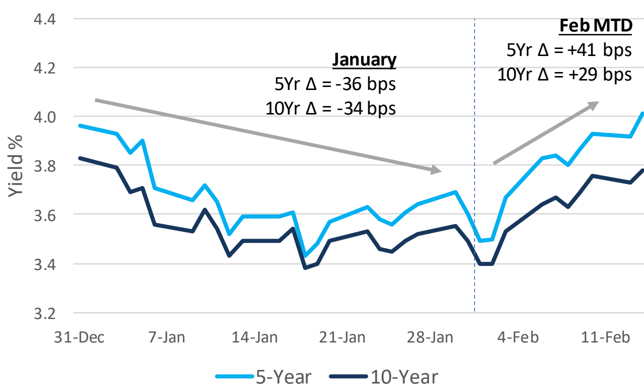
"We need to retain a sufficiently restrictive stance of policy. We're going to need to maintain that for a few years to make sure we get inflation to 2 per cent."
- New York Fed President John Williams

Source: SKY Harbor, Bloomberg, Dept. of Labor, Bureau of Labor Statistics, US Census Bureau, Financial Times, Wall Street Journal

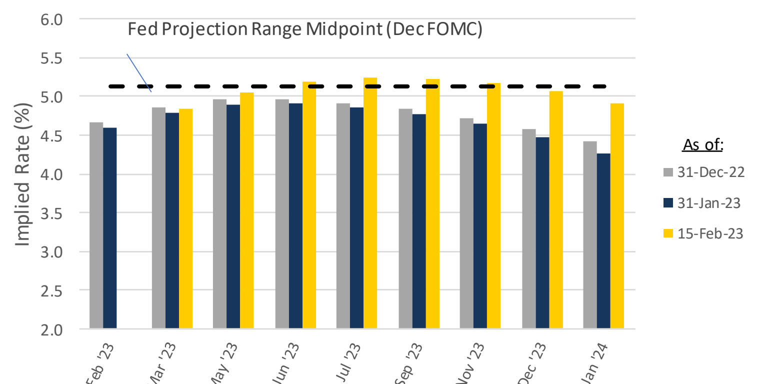
Markets (Finally) in Agreement with Fed

With inflation running at multiples of the Fed's 2% target and the pace of deceleration at least temporarily on pause, economists have begun to re-evaluate the likely path of rates in the coming months. Treasuries have sold off aggressively in response to this change in sentiment, with yields on the 5-year more than fully reversing January's impressive rally. At the same time, **Fed Funds Futures imply a terminal rate of 5.23%, up 31 bps since the start of the month, and now <u>above</u> the December FOMC dot plot**. Furthermore, two 25 bps cuts in the second half of 2023 are no longer anticipated by the market, another move that has brought consensus expectations in-line with statements made by Fed Chair Powell and other key officials in recent months.

Treasury Yields Rising, Offsetting January's Rate Rally
daily data



Futures-Implied Terminal Rate Now Above Dececember FOMC Dot Plot
monthly data



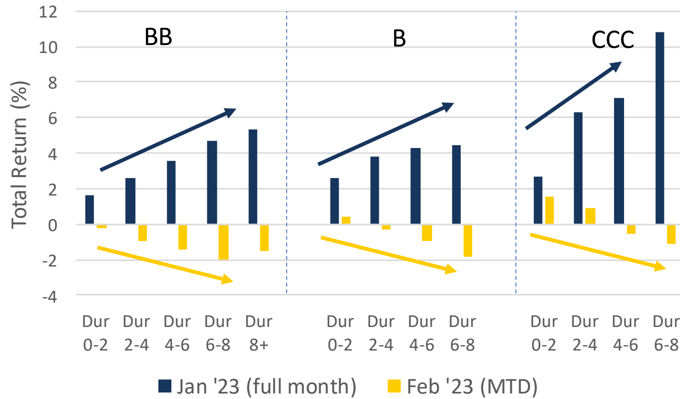
Source: SKY Harbor, Bloomberg, ICE Data Indices

Giving Back (Some) Gains

A perceived end to the Fed rate hiking cycle and increased conviction for an economic "soft landing" led to an exceptionally strong January for high yield markets, with total returns representing the second strongest start to any year since the global financial crisis. Recent market developments – largely the persistence of inflation – have caused a partial reversal of last month's gains through the first two weeks of February. As demonstrated below, **duration was the most rewarded factor in our attribution model last month, with returns positively correlated to starting rate sensitivity across all ratings buckets**. A selloff in Treasuries thus far in February has had an opposite impact on total returns, and **we anticipate continued weakness on the longer end of spectrum as rates come under additional pressure**. The rewarding of credit risk has remained consistent for the entire year thus far, as demonstrated below (right side). For now, the market appears to be interpreting inflationary pressure as mostly a duration issue, with limited spillover into higher default rate expectations.

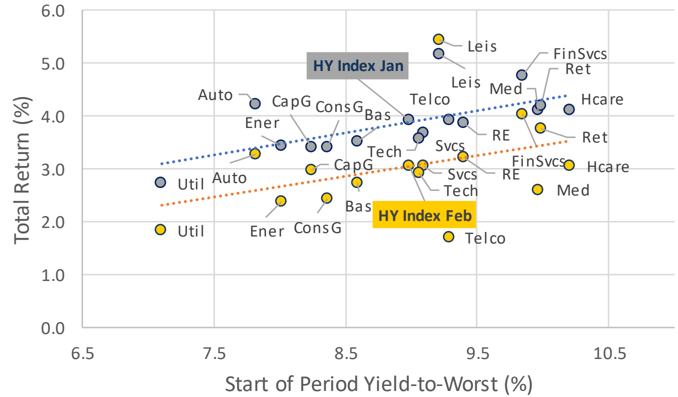
Duration Rally Now Reversing

current month as of February 14, 2023



Credit Risk Still Being Rewarded

current month as of February 14, 2023



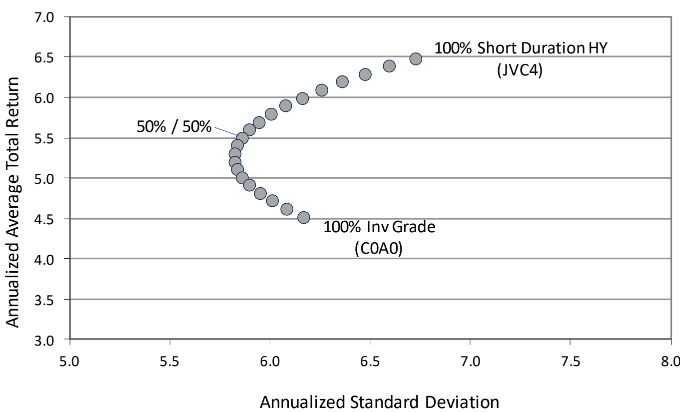
Source: SKY Harbor, ICE Data Indices

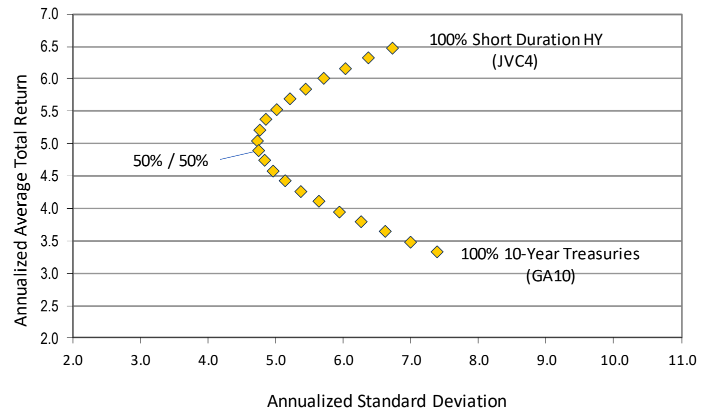
Thoughts on Efficient Positioning

Labor market strength and lingering inflation means the Fed will likely have to keep policy rates higher for longer, a dynamic that is already pricing itself into markets. **A key unknown, however, is the extent to which a more aggressive Fed will stoke recessionary fears**. As noted in our most recent *Weekly Briefing* entitled "Recession Risk on the Decline," high yield market spreads (though our findings were consistent with investment grade and other asset class valuations as well) imply a mere 10% to 20% chance of economic contraction in the coming year, a likelihood below that of professional forecasters. If concerns of a Fed misstep work their way back into investor sentiment, a defensive portfolio tilt may prove additive to returns in the near term. Strength among US consumers – by virtue of low unemployment and higher wages, and as evidenced by strong retail sales readings – have thus far dampened such concerns, leaving most more concerned about duration at present. In light of this, and as demonstrated below**, adding short duration high yield risk into an investment grade or government bond portfolio can boost yields and lower duration, and has historically led to a reduction in volatility and an improvement in efficiency**, all favorable attributes if the "higher for longer" view continues to roil rates markets.

Investors Can Add Credit Risk, Avoid Duration, Improve Return per Unit of Risk w/ Short Duration High Yield

efficient frontiers based on monthly data, trailing 20 years





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

(Still) A Strong Start

Recent moves notwithstanding, risk assets are still off to a strong start to the year. Additionally, we have long since been of the opinion that the path of spreads throughout 2023 would be non-linear in nature, and view recent downside volatility as something to be expected given the uniqueness of the market backdrop and the "long and variable" lags associated with monetary policy. As such, we continue employ a somewhat defensive portfolio tilt that aims to minimize negative surprises – as discussed at length over the last several *Weekly Briefings* – while still selectively adding risk in credits with, in our view, idiosyncratic upside not yet appreciated by the market. In the context of a negative re-pricing of duration risk, we continue to believe an allocation to short duration high yield can serve to benefit investment grade and government bond portfolios, particularly with yields of the former approaching top quartile levels.

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