

## SKY Harbor Weekly Briefing

### SKYView: Rate Hikes & Breakevens

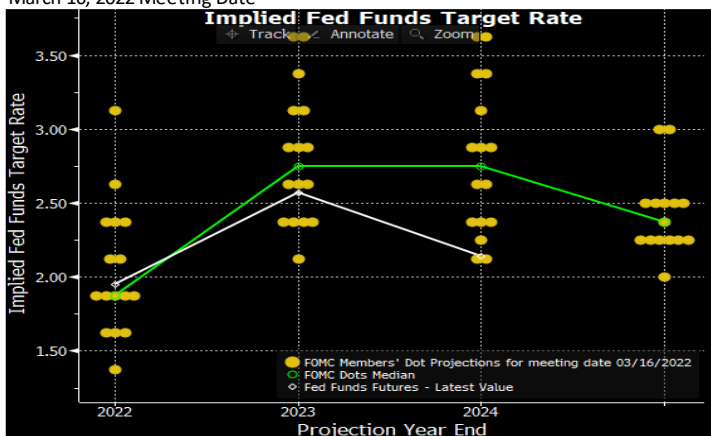
This past week, focus shifted toward the Federal Reserve, with post-FOMC commentary by Chairman Powell and a fresh set of committee expectations adding volatility to Treasury markets before reverberating across a multitude of asset classes. In general, investors viewed output from the Fed as being a bit more hawkish than anticipated, though significant revisions relative to the December '21 meeting had mostly been reflected in market-implied expectations in the preceding weeks. With the path of inflation – highly influenced by recent geopolitical events – likely to be the primary driver of Fed decision-making in the coming months, we shift our attention to downside protection in a measured yield widening environment, updating our breakeven analysis in this *Weekly Briefing*.

The Fed **increased rates by 25 bps (range of 0.25% to 0.50%) at their March 16 meeting, the first move of its kind since 2018, and signaled an expectation for six more increases by the end of 2022.** A closer look at median projections have rates rising further to the 2.75% range by the end of next year, a level not seen since 2008. At issue is inflation, buoyed by continued supply chain constraints and a tight labor market, with more recent pressure coming from the impact of rising commodity prices following Russia's invasion of Ukraine in late February. Chairman Powell also noted that officials could articulate a plan to begin shrinking the \$9 trillion balance sheet in the coming quarters, stopping just short of citing a specific date.

The Fed dot plot also shifted materially, with the **median expectation of seven ¼ percentage point hikes in 2022, up from three following the December '21 FOMC meeting** (though not dissimilar from prevailing market expectations over the last several weeks). The Fed also moved up its expectation of inflation to 4.3% by the end of the year (expectations were 2.6% at the December meeting), as US PCE hovers around 40-year highs. Finally, GDP growth expectations have declined to ~ 2.8%, down from the ~ 4.0% expected last December, though not terribly surprising as the prior survey came before omicron peaked and geopolitical tensions escalated. A more detailed summary of the shifting dot plot and key economic revisions is presented below:

### Fed Dot Plot Shifted Further at the March '22 Meeting

March 16, 2022 Meeting Date



Source: Bloomberg

### Key Revisions: December '21 vs. March '22 FOMC

data rounded to nearest 1/8 percentage point

Measure	2022	2023	2024	Longer Run	
Real GDP	March '22	2.8%	2.2%	2.0%	1.8%
	December '21	4.0%	2.2%	2.0%	1.8%
	Change	-1.2%	0.0%	0.0%	0.0%
Unemployment Rate	March '22	3.5%	3.5%	3.6%	4.0%
	December '21	3.5%	3.5%	3.5%	4.0%
	Change	0.0%	0.0%	0.1%	0.0%
PCE Price Index	March '22	4.3%	2.7%	2.3%	2.0%
	December '21	2.6%	2.3%	2.1%	2.0%
	Change	1.7%	0.4%	0.2%	0.0%
Fed Funds Rate	March '22	1.9%	2.8%	2.8%	2.4%
	December '21	0.9%	1.6%	2.1%	2.5%
	Change	1.0%	1.2%	0.7%	-0.1%

Cognizant of a changing rate landscape and higher risk premiums that have materialized over the last few months, we thought it prudent to update our breakeven analysis, particularly as some investors do not yet believe yields have peaked. As such, **we re-simulated the impact a hypothetical environment of rising yields would have on various fixed income asset class returns, updated to reflect current market metrics.** Like our original analysis, 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:

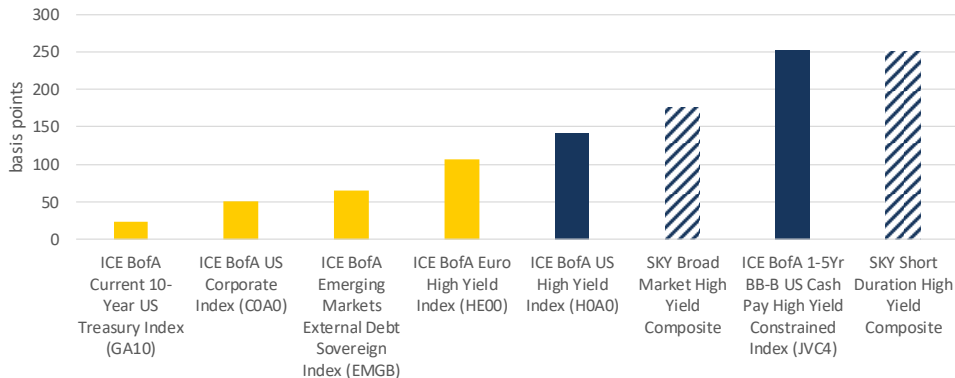
- 12 months investment horizon
- Increases in yield are linear in nature across all asset classes and occur in equal monthly increments
- No credit losses via defaults; no performance drag via downgraded securities exiting an index
- Coupon payments are reinvested in their respective strategies
- The 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

Broadly speaking, key asset class characteristics have shifted since our last simulation. In particular, **continued refinancing activity has pushed down average coupon levels and extended the average tenor across the fixed income space**, both of which have contributed to rising levels of duration. At the same time, wider spreads – driven in part by geopolitical tensions and a general increase in risk premiums demanded by the market – have put downward pressure on average index dollar prices, **leading to higher current yields that offset some of the increased sensitivity brought on by duration extension.**

Ultimately, our findings show both broad and short duration high yield (HOA0 and JVC4, respectively, and denoted by blue bars in the chart below) are better positioned than adjacent fixed income indices (ICE BofA Euro High Yield Index, 10-yr Treasuries, investment grade corporates, EM, etc.) to generate breakeven returns in a rising yield environment. For example, our simulation estimates that JVC4 (a proxy for short duration high yield) could absorb ~ 250 bps of linear yield widening over a 12-month period and still generate a total return of 0%. In contrast, the ICE BofA US Corporate Index (COA0, a proxy for investment grade credit) could only absorb ~ 50 bps of linear yield widening over a 12-month period before returns fall below 0%. The chart below plots breakevens for several fixed income indices under the assumptions listed above. Additionally, we further delineate breakevens for our broad market and short duration SKY Harbor composites (striped bars), as well as for rating buckets within the US high yield index (grey bars).

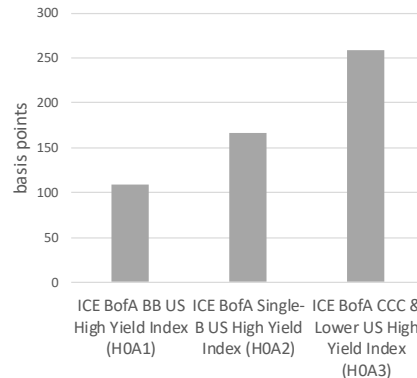
### Breakevens by Index

12-month time horizon



### US High Yield Breakevens by Rating

12-month time horizon



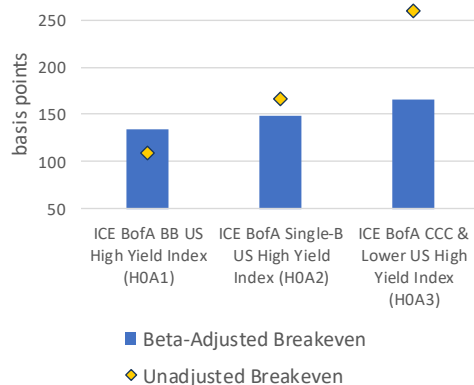
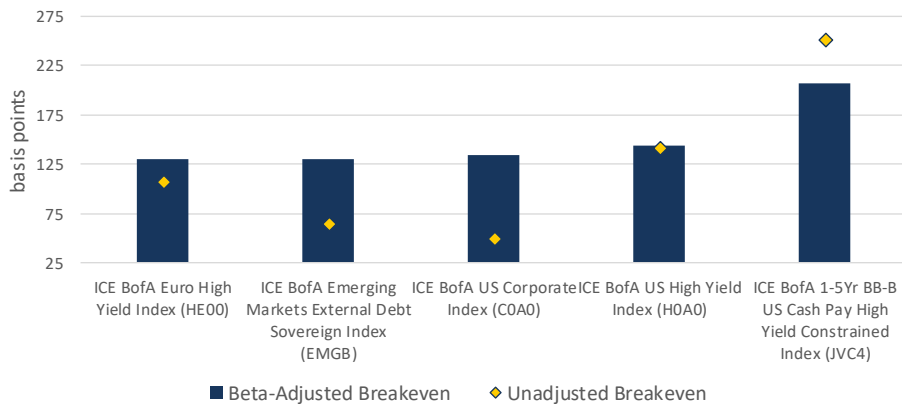
Source: SKY Harbor, ICE Data Indices

We acknowledge that our sensitivity analysis makes some broad assumptions for the sake of simplicity, perhaps most controversially by ignoring the underlying driver of linear yield widening. If asset class yields widen as a result of higher underlying Treasury yields, the more lofty breakeven nature of HOA0 and JVC4 (duration of 4.5 and 2.5, respectively) relative to other asset classes (COA0 and EMGB have a duration of 7.7 and 7.9, respectively) would understate the benefits of the former, largely based on an historical analysis of rate absorption through spread compression. If, however, higher asset class yields are the result of rising risk premiums / spread widening, we might expect effective breakeven differentials to compress given greater OAS sensitivity of the high yield group. **More simply put, if asset class yields rise because risk sentiment turns negative, does the more severe spread reaction for a leveraged credit asset class more than offset higher implied breakeven levels in a vacuum?**

To better address this issue, we augment our analysis and account for varying reactions to risk-off sentiment – i.e., distortion as a result of yields rising because of higher risk premiums, rather than higher rates – by normalizing results based on spread change betas. More specifically, we use the high yield index (HOA0) as our base asset class (beta = 1.0, so our “unadjusted breakeven” of ~ 140 bps is the same as our “beta-adjusted breakeven” of 140 bps). Breakevens for other asset classes, however, are volatility adjusted in order to better represent behavior in a rising yield environment that is driven by spread widening. As demonstrated below, **high yield (both broad and short duration) continue to offer better protection relative to EUR high yield and higher-quality indices (EMGB, COA0), even after making these adjustments.** Said otherwise, we continue to believe risks associated with being invested in US high yield are more than fairly compensated at this point in time.

### Breakevens Adjusted by Spread Change Beta

12-month time horizon

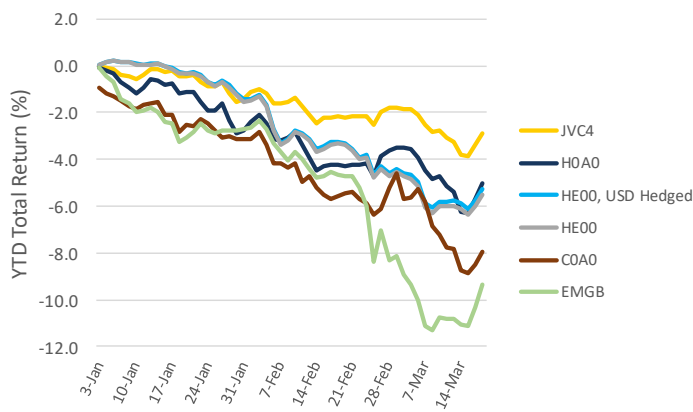


Source: SKY Harbor, ICE Data Indices

The FOMC signaled a greater willingness to increase interest rates at the March meeting, a sign that taming inflation may be a more onerous task than originally anticipated. While the path of future rate hikes (and efforts to reduce the size of the balance sheet) remains data dependent, we continue to see upside pressure on Treasury yields in the coming months. This dynamic, coupled with increasing risk premiums as a result of a tenuous geopolitical backdrop, compelled us to update our breakeven analysis. **As was the case in our prior iteration, breakeven levels (the point at which asset class interest income is fully offset by the negative impact of rising yields) screen favorably for high yield (short duration high yield in particular).** Though our simulation is indifferent as to the source of yield widening, we recognize that higher yields as a result of rising risk premiums could flatten breakeven differentials. To account for this, we further augmented our analysis by calculating beta-adjusted breakevens, the output of which continues to demonstrate the favorable risk-return characteristics of the US high yield market. **As demonstrated below, most fixed income asset class returns have lagged US high yield on a year-to-date basis. In our view – which incorporates the results of our breakeven analysis – this dynamic is not likely to reverse in the coming quarters.**

## Year-to-Date Total Return by Index

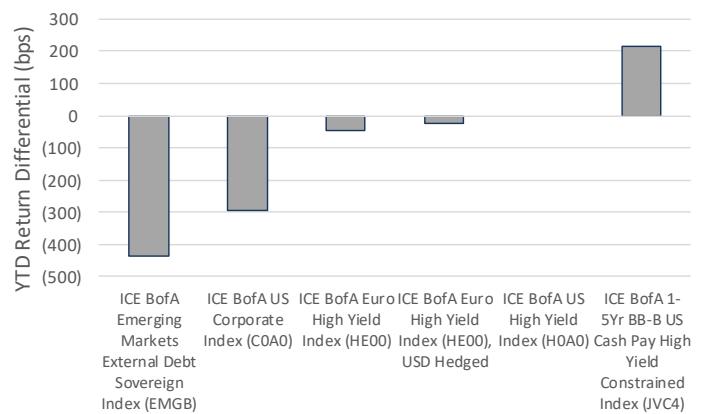
data through of March 17, 2022



Source: SKY Harbor, ICE Data Indices

## YTD Total Return Relative to US High Yield (H0A0)

data through of March 17, 2022



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