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SKY HARBOR
CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

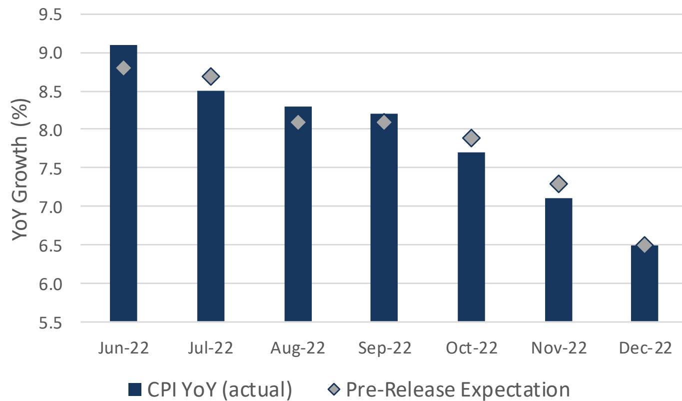
SKYView: Too Far Too Fast?

A slew of economic data has been released over the last several weeks, largely contributing to stronger than expected market returns to start the year. On balance, inflation continues to trend toward mean reversion (despite a still strong jobs market), outweighing initial signs that the health of the US consumer has begun to decline. In the process, fixed income has outpaced equities through the first half of January, largely buoyed by an underlying rally in Treasury rates. In this *Weekly Briefing*, we highlight the impact economic data and market technicals have had on recent high yield performance, and identify areas of interest for the credit research team stemming from a heightened level of index dispersion amidst a rapid move tighter in spreads.

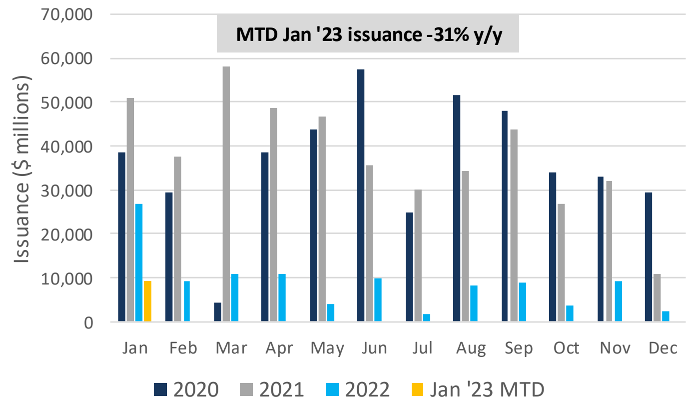
Inflation Normalization Meets Supportive Technical Backdrop

Inflation has come down appreciably in recent months, with the last three readings cooler or in-line with street expectations. On a sequential basis we actually saw deflation in December's CPI data – the first such reading in over 2.5 years – with expectations that the shelter component is close to turning as well. **The market is now pricing in two additional 25 bps hikes in '23, with a growing (though still in the minority) cohort predicting a single hike in February could end up being the Fed's last move**. At the same time, cash balances (see our October '22 *Weekly Briefing* entitled "From Pause to Pivot") remain elevated, partially due to an underwhelming primary calendar thus far in 2023. More specifically, **YTD issuance of ~ $9.1bn is 31% below incredibly depressed '22 levels**, and represents a 77% reduction to average January (full month) averages over the last three calendar years. As such, investment managers have had to look toward secondary market opportunities to get invested during the early month run-up.

Inflation Continues to Fall
monthly data



Issuance Yet to Pick Up; Trending Below Minimal '22 Volumes
monthly data

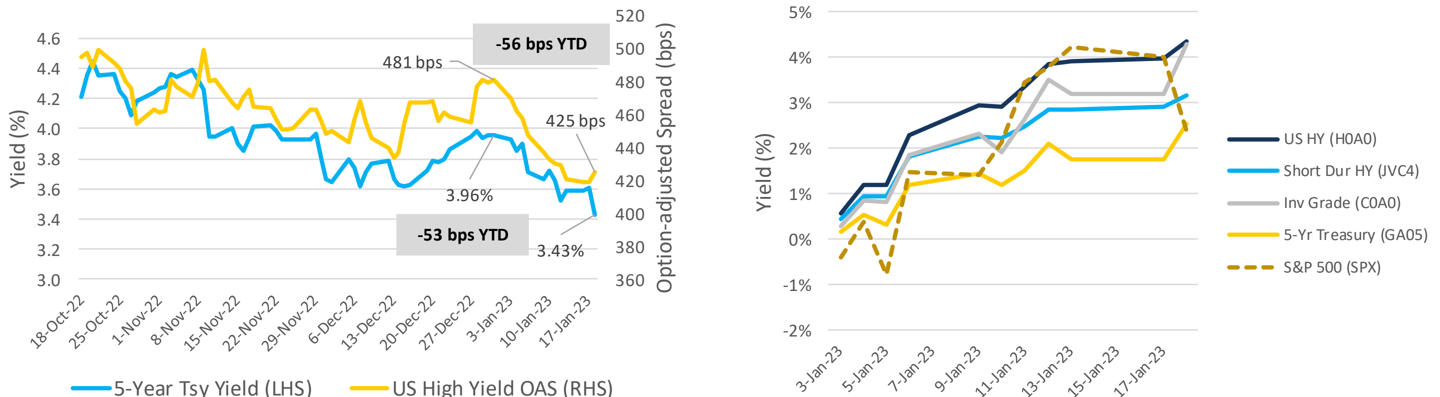


Source: SKY Harbor, Bureau of Labor Statistics, Bloomberg, BofA Merrill Lynch, JP Morgan

Treasury Yields and Spreads Have Fallen Rapidly

Lower inflation and (presumed) line of sight to a Fed pause have sparked a rally in the rates market, with yields on the 5-Year Treasury down 53 bps just since the start of the year. **High yield spread levels have compressed even more swiftly, particularly with the soft-landing narrative gaining steam**. All said, year-to-date (as of Jan 18th) total return on the ICE BofA US High Yield Index of ~ 4.34% has outpaced the S&P 500 Index, and would be the fourth strongest January in our 36 year dataset (only 2019, 2009, and 2001 were stronger at +4.59%, +5.31%, and +6.33%, respectively).

Falling Inflation + Supportive Technical = Lower Treasury Yields, Lower HY Spreads, Strong Total Returns
daily data



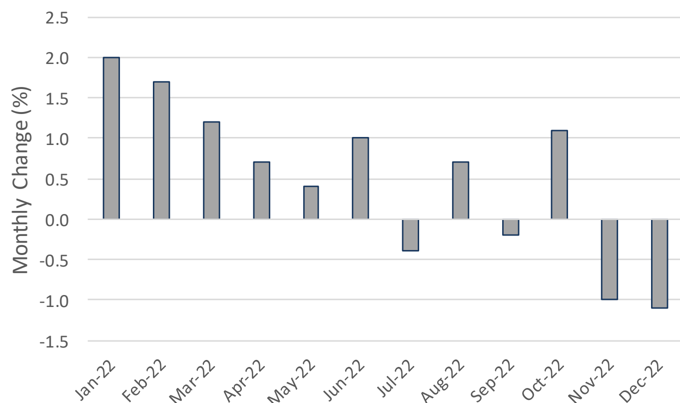
Source: SKY Harbor, ICE Data Indices, Bloomberg

Not All News Has Been Supportive

December retail sales came in below consensus (-1.1% vs. -0.9% expected), a function of **normalizing demand following the post-pandemic spike, savings erosion, and higher borrowing costs**. Excess inventory levels also played a role, with heavy discounting creating a drag as the data series is constructed in nominal terms. At the same time, several strategists have noted the increasing attractiveness of holding cash, now a competitor to risk assets after two years of near-zero riskless yields. As demonstrated below (right side) US high yield index yield-to-worst levels appear compressed relative to cash yields (we use the Fed Funds Effective Rate as our proxy). In fact, **the differential at present is below 3.7%, a 6th percentile observation using monthly data going back to January 2000**. Though we believe fundamental credit metric improvement, superior issuer quality, and a relatively muted default rate outlook partially justify this dynamic, some spread widening to reverse the breakneck pace of compression in recent weeks may be on the horizon.

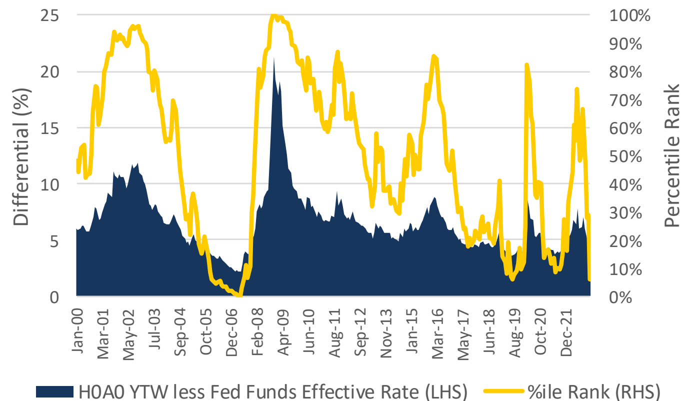
December Retail Sales Surprised to the Downside

monthly data



Yield Over Cash Has Narrowed

US HY YTW less Fed Funds Effective Rate



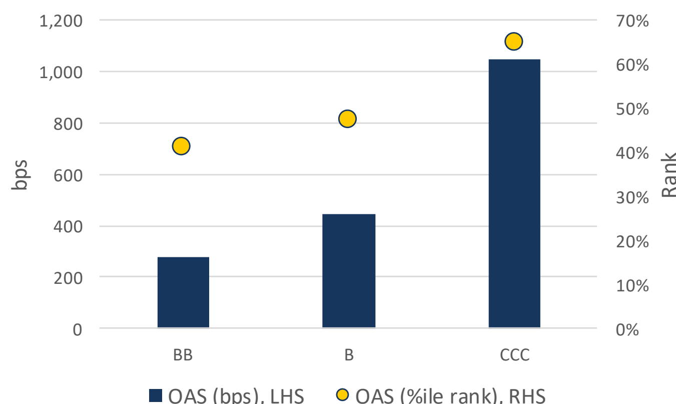
Source: SKY Harbor, US Census Bureau of Labor Statistics, Federal Reserve Bank of New York, ICE Data Indices, Bloomberg

Dispersion Creates Opportunity

The potential for some spread widening in the coming weeks is best managed, in our view, via several portfolio themes outlined in our three most recent *Weekly Briefing* publications, namely **a preference for defensive over cyclical credits** (found here), **an aversion to wage-intensive issuers** (found here), and **marginal rotation into credits likely to benefit from supply chain pressure alleviation** (found here). And, while our overall positioning has, admittedly, remained on the more conservative end of the risk spectrum, we have begun to see a modicum of idiosyncratic opportunities emerge in higher-yielding bonds. Highlighted below, CCC-rated spreads are most elevated on a relative basis, registering 65th percentile and screening favorably in comparison to BBs and single-Bs at 41st and 47th percentile, respectively. Though this dynamic is likely driven by a heightened risk of default should the economy fall into recession, **elevated dispersion among that cohort of the market underscores credit picking opportunities**. As further demonstrated in the scatterplot below, dispersion (the % of bonds trading outside a +/- 400 bps range of the rating bucket average) of ~ 58% is 1,000 basis points above what would otherwise be expected given OAS levels. Presented differently, OAS of this group has widened 309 bps over the last year (from 734 bps to 1,043 bps) while dispersion has tripled, implying increased potential for enhanced issue-level return differentiation in the coming quarters.

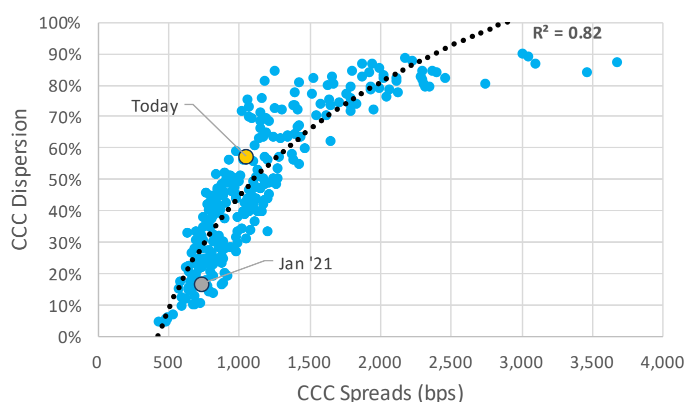
CCC Spreads Trade Widest on Percentile Ranking Basis

data as of January 18, 2023



High CCC Dispersion Provides Opportunities for Credit Picking

based 20 years of monthly data



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

A Strong Start to 2023

Market returns have admittedly outpaced our expectations thus far in 2023. While inflation normalization has justifiably increased the likelihood of a soft landing (at the expense of the severe recession tail), **we think the pace of spread compression over the last two weeks may perhaps overstate the actual reduction in uncertainty**. Therefore, though we remain constructive on high yield markets by virtue of resilient fundamentals and supportive technicals, we continue to think our modestly defensive bias has merit given aggregate spread levels. At the same time, **heightened dispersion, particularly within the lower-rated portion of the index (low single-B, CCC), has in our view created valuation dislocations** and highlights the advantage of active management in the current market environment. As such, we plan to offset some of our defensive posture with selective credit picks in the 10%+ yield range, taking advantage of mis-priced (in our view) pockets of risk arising from market volatility.

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