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March 28, 2022

SKY HARBOR
CAPITAL MANAGEMENT

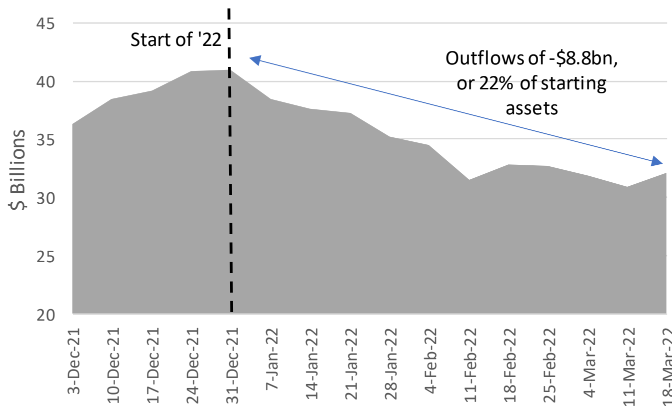
SKY Harbor Weekly Briefing

SKYView: Go With the Flow

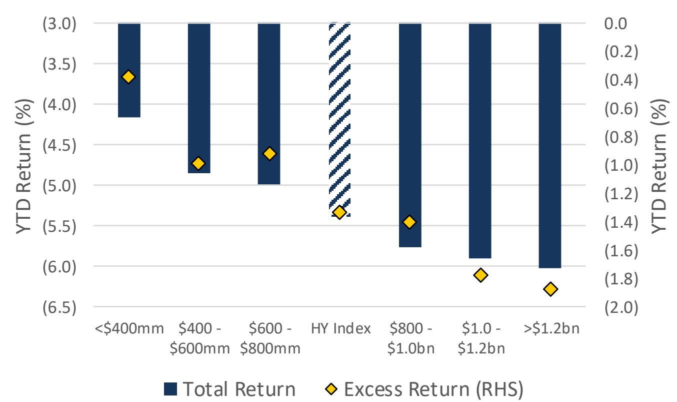
A combination of factors – among them rate volatility and negative geopolitical developments – have led to significant high yield fund outflows since the start of 2022. This dynamic has contributed to yield widening over the last several months, with larger / more liquid issues bearing a disproportionate amount of the pressure. But, like most things, flows tend to be cyclical in nature. In this *Weekly Briefing*, we measure the magnitude of yield correction historically necessary to reverse acute outflow periods, leading us to conclude that market technicals may be on the verge of an inflection.

In aggregate, **four of the most prominent US high yield exchange-traded funds (tickers HYG, JNK, SHYG, and SJNK) have recorded sizeable outflows since the start of the year, with total fund assets down approximately 22%**. At issue is the ratcheting up of both geopolitical risk factors – Russia's invasion of Ukraine has diminished risk appetite across global markets – and fears of rising rates, the latter of which was magnified by the Fed's March rate hike (first of its kind since 2018). With regard to rising rates, we highlighted in a late-December '21 *Weekly Briefing* entitled "A Shifting Dot Plot" that high yield has historically demonstrated negative empirical duration, and that market spreads have typically tightened through the first several quarters of prior Fed hiking cycles (including 2004, 2015, and 2017). Nevertheless, in the past (like now), investors have initially grouped high yield with rate-sensitive fixed income products, the benefits of spread cushion only acknowledged on a lagging basis. As such, **outflows have contributed to negative total and excess returns thus far in 2022, with larger issues – which tend to be favored ETF holdings – capturing a disproportionate amount of the downside**.

US High Yield ETFs Have Suffered Significant YTD Outflows
weekly data, total fund assets of HYG, JNK, SHYG, and SJNK



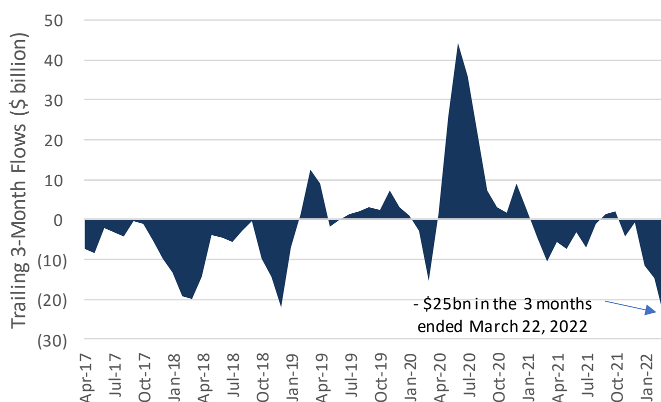
Outflows Have Most Negatively Impacted Large/Liquid Issues
data as of March 22, 2022



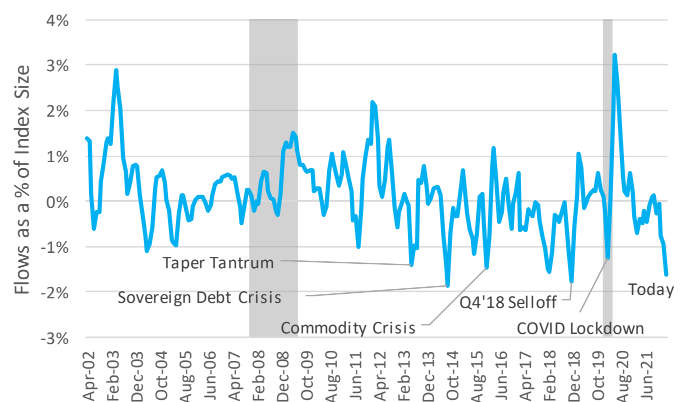
Source: SKY Harbor, Bloomberg, ICE Data Indices

In aggregate, **high yield exchange-traded and actively managed funds have suffered an estimated $25bn in outflows on a year-to-date basis (through March 22, 2022), nearly twice the magnitude of redemptions recorded during 2021 in its entirety.** On a rolling 3- month basis, this ranks as the largest absolute outflow in our dataset, which goes back to February 1992. Normalizing flow data by market size (recall that the US high yield asset class consisted of barely more than $100bn in bonds in the early 1990's, vs. ~ $1.5 trillion today), trailing 3-month outflows equate to ~ 1.6% of index-eligible high yield debt at present, the third worst relative observation in the last 20 years, and the seventh worst in the last 30 years. Included with additional detail below, YTD relative outflows have surpassed technical headwinds during COVID lockdowns, the 2016 commodity crisis, and the taper tantrum, and are rapidly approaching levels not seen since the sovereign debt crisis and a perfect storm of negative developments that preceded a rapid Q4'18 market correction (the Fed was on the verge of tightening, the economy was slowing, and the US and China were engaged in a contentious trade war).

Trailing 3-Month Flows Hit an All-Time Low
monthly data, trailing 3 month ETF + actively managed flows



Adjusted for Index Size, 3rd Worst Outflow Stretch in 20 Years
trailing 3-month flow as a percentage of HY face value



Source: SKY Harbor, JP Morgan, Lipper

Despite our best efforts, attempting to predict fund flows over the last decade has felt like a fool's errand. We have found some statistical support in attributing technicals to momentum, with trailing 1-week and 1-month total returns often coinciding with flows in the same direction. The predictive power of our analysis, however, has always been lacking. We have, however, found that **inflection points in flows are a bit more grounded and based on observable data**, and so took a look at top decile outflow periods of the past in an effort to find commonality. Our analysis of the data, coupled with anecdotal evidence (conversations with asset allocators and the like), imply that investors are often enticed back into high yield not when associated concerns have subsided, but when yields become sufficiently attractive to compensate for risks inherent to the asset class. As demonstrated below, **similarly severe outflow periods of the past have typically coincided with a rise in yield (outflow peak vs. yield tights in the preceding 12-month period) of approximately 150 bps**. At present, US HY bond yields have ratcheted up over 230 bps from recent tights, well above our data set median and mean, and second only to disruptions brought on by an energy selloff in early 2016 (crude fell below $27/bbl, at a time when Energy was the largest sector in the index). As such, though we aren't predicting a near-term pivot to fund inflows with a high degree of confidence, **the recent market correction appears sufficient for an inflection based on historical investor behavior**. Furthermore, the cost to be uninvested at this point in time, particularly in the context of core PCE exceeding 5%, continues to be onerous, and in our view may compel allocators to take a fresh look at our asset class given positive real yields.

Top Decile Outflow Periods, Last 20 Years

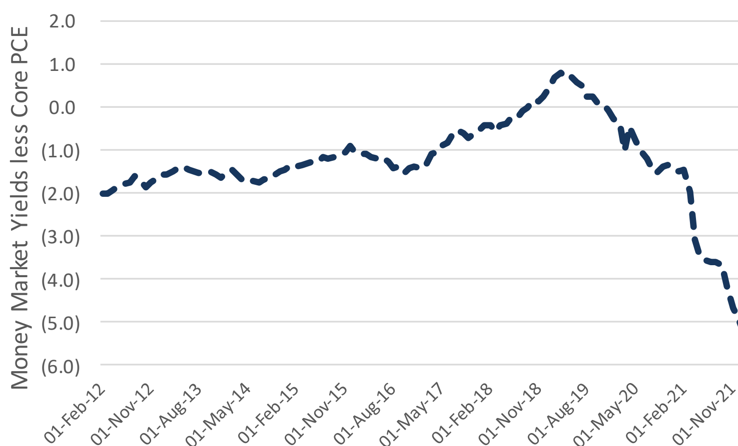
based on rolling 3-month flows as a % of existing HY market size

	Max Change vs. Preceding 12-month Low		Consec. Top Dec.
Date	Yield-to-Worst	OAS	Outflow Months
31-May-04	0.87	37	2
31-May-05	1.11	130	4
31-Aug-11	1.63	249	1
30-Jun-13	1.38	66	2
30-Sep-14	1.13	87	2
31-Aug-15	1.45	140	3
31-Jan-16	3.29	331	1
31-Mar-18	0.89	43	3
31-Dec-18	2.15	205	2
Median	1.38	130	2
Average	1.54	143	2
22-Mar-22	2.34	85	3

Yield correction already exceeds prior top decile outflow median and mean, and is second to only the Jan '16 commodity crisis

Inflation Making it Difficult to Stay in Cash

monthly data



Note: Excludes one recessionary period
Source: SKY Harbor, ICE Data Indices, Bloomberg, Bureau of Economic Analysis

Outflows have reached historically high levels on a year-to-date basis, largely a function of geopolitical uncertainty and underlying rate volatility. While a temporary decline in primary market issuance has largely offset this dynamic, in our view the case for spread compression will strengthen upon a reversal of flows. Unfortunately, our analysis of prior outflow periods failed to uncover a universally attractive yield level that stems retail flight. However, the recent yield response now exceeds the historical median and mean correction, potentially setting up market technicals for an inflection.

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