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SKY HARBOR CAPITAL MANAGEMENT

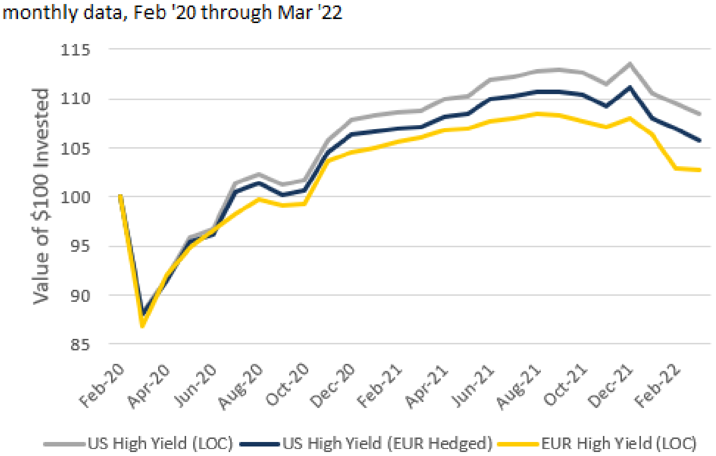
SKY Harbor Weekly Briefing

SKYView: The Rise of FX Hedging Costs

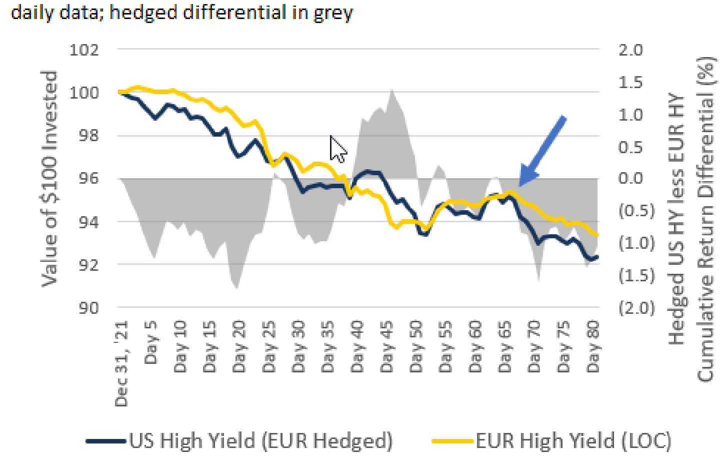
Since the onset of the pandemic, US high yield has outperformed EUR high yield on both a local currency (+573 bps) and EUR hedged (+301 bps) basis. In our view, a more rapidly falling default rate, strong fiscal stimulus measures, and alleviation of FX hedging costs were key drivers of this dynamic, all of which favored US-centric risk-taking (most notably in mid-2020 and late-2021). This dynamic has recently shifted, however, with EUR high yield YTD outperformance inflecting positively in early April '22. In this *Weekly Briefing,* we attempt to distinguish recent drivers of performance differentials and update an internal model created to identify which version of high yield is likely to generate stronger total returns on a go-forward basis.

The onset of the pandemic undoubtedly caused stress across high yield assets, with both US (ICE BofA US High Yield Index, ticker H0A0) and Euro (ICE BofA Euro High Yield Index, ticker HE00) indices suffering double-digit negative returns in March 2020. That period, however, marked a low point for high yield, with spreads rapidly recovering in the following months. As demonstrated below, **US high yield returns have outpaced that of EUR high yield, even on an FX-adjusted basis, since markets began to recover**. A key driver of this dynamic, in our view, had been a more rapidly improving US default rate (admittedly off of a much higher post-lockdown starting point), as well as additional stimulus measures that extended into 2021. However, **2022 YTD cumulative returns inflected in early April '22 – this time favoring the EUR HY index – in large part due to the acceleration of short-term rate differentials**. Will this dynamic persist, or is it more likely a short-lived reversal?

Post-COVID Total Returns Favor US over EUR High Yield
monthly data, Feb '20 through Mar '22



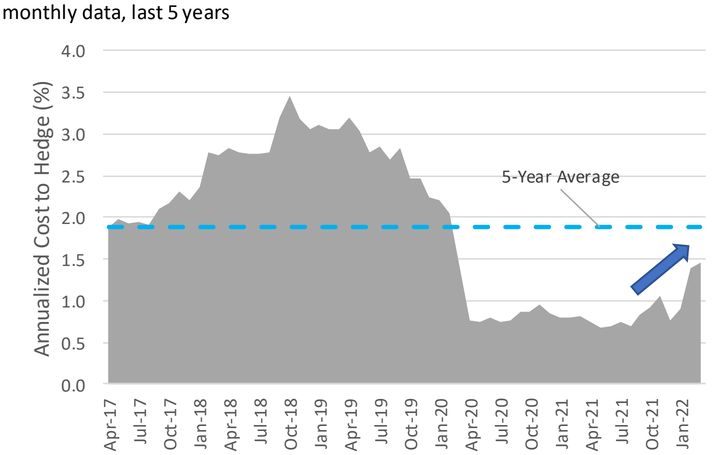
EUR HY Has Modestly Outpaced US HY Year-to-Date
daily data; hedged differential in grey



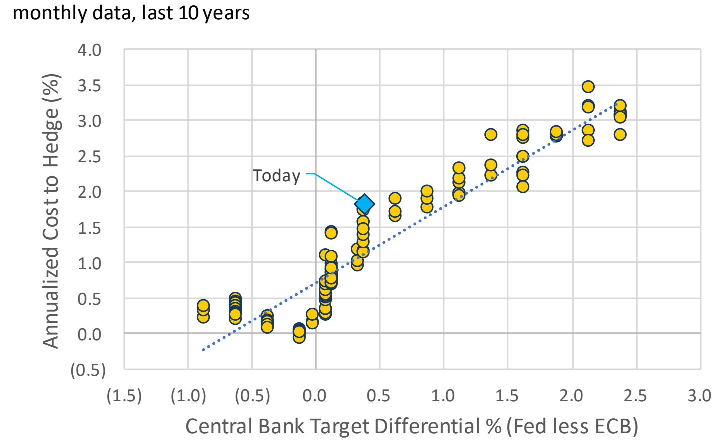
Source: SKY Harbor, ICE Data Indices; data as of April 26, 2022

For most of 2022, both US and EUR high yield bond markets have priced in relatively benign default rate outlooks, with sentiment incorporating similarly trending manufacturing data (capacity utilization, industrial production, etc.). The key difference, it would appear, was on the FX side. **Hedging costs – in particular, the cost to EUR investors for hedging USD exposure – had declined rapidly from nearly 350 bps (in Oct '18) to ~ 75 bps in the period immediately following COVID-induced lockdowns (April '20),** in large part due to Fed accommodation that brought US rates more closely in-line with the ECB. That relationship remained relatively steady until the end of FY'21, when central bank target rate differentials began to climb. As that occurred, USD-EUR hedging costs nearly doubled, pushing FX-adjusted yields (H0A0 vs. HE00) closer to parity, and ultimately paving the way for a modest amount of EUR HY index outperformance over the last several weeks.

USD-EUR Hedging Costs Have Risen; Now Just Below 5-Year Avg
monthly data, last 5 years



Central Bank Target Rate Differentials Driving Hedge Costs
monthly data, last 10 years

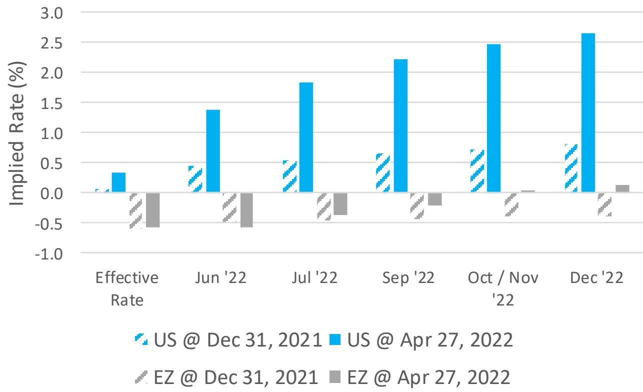


Source: SKY Harbor, Bloomberg, Federal Reserve Bank of New York, European Central Bank

A closer look at market-implied central bank rate expectations demonstrates how aggressively views have changed, particularly on the US side, over the last several months. As demonstrated below, Fed Funds Futures reflected a consensus view of ~ three rate hikes in 2022 – each 25 bps in size – as of December 31, 2021. By April, that view had evolved to include ten more rate hikes (again, 25 bps in size), in addition to the March move, for all of 2022. At the same time, Overnight Index Swaps implied a likelihood of just one hike by the ECB, as measured on December 31, 2021. The view moved up modestly since then, with the market pricing in perhaps three moves, but **continues to reflect an increasing divergence in policy normalization between the two regions**.

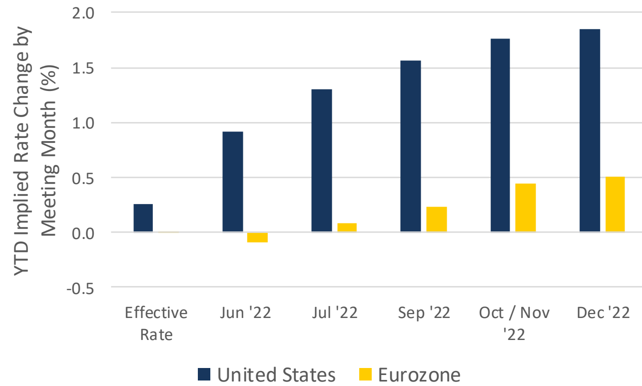
US vs. Eurozone Implied Rates by Central Bank Meeting Date

striped bars = as of Dec 31, 2021; solid bars = as of Apr 27, 2022



US Implied Rates Have Moved Up More Rapidly Year-to-Date

Apr 27, 2022 vs. Dec 31, 2021

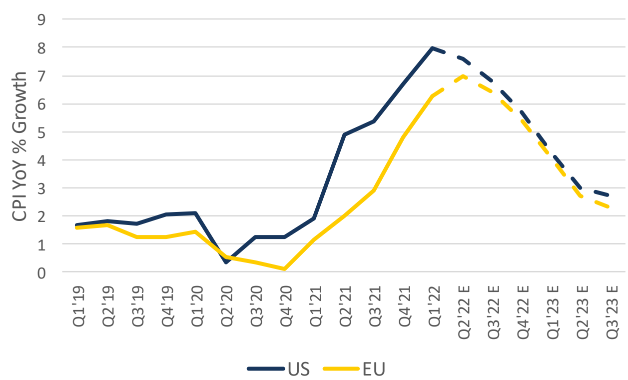


Levels based on Fed Funds Futures and Overnight Index Swaps
Source: SKY Harbor, Bloomberg

While not perfectly comparable – Europe is more closely tied to armed conflict in Ukraine, is suffering higher energy prices due to an exogenous shock (rather than the self-inflicted nature of rising prices in the US following aggressive stimulus spending), and has not been forced to deal with higher wages – **the ECB does appear to be an outlier among central banks given a somewhat dovish policy stance**. With inflation running well above their 2% target and employment at relatively healthy levels (though recognizing the ECB does not have a dual mandate like the Fed), perhaps short-term rate differentials are poised to compress in the coming months (either via Fed expectations coming down, or ECB expectations rising).

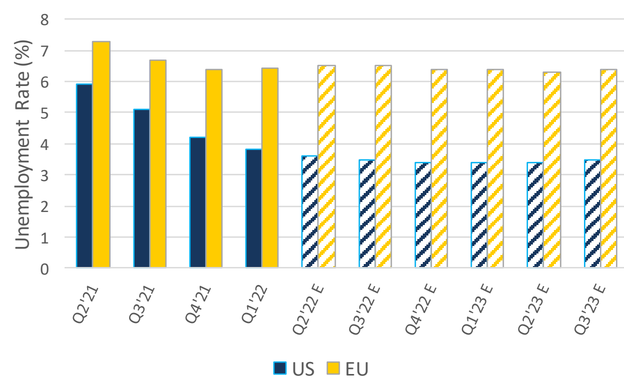
Inflation Running Hot in Both Regions

quarterly data; solid = actuals, dotted = expectations



Wage Inflation More Pronounced in US

quarterly data; solid = actuals, striped = expectations

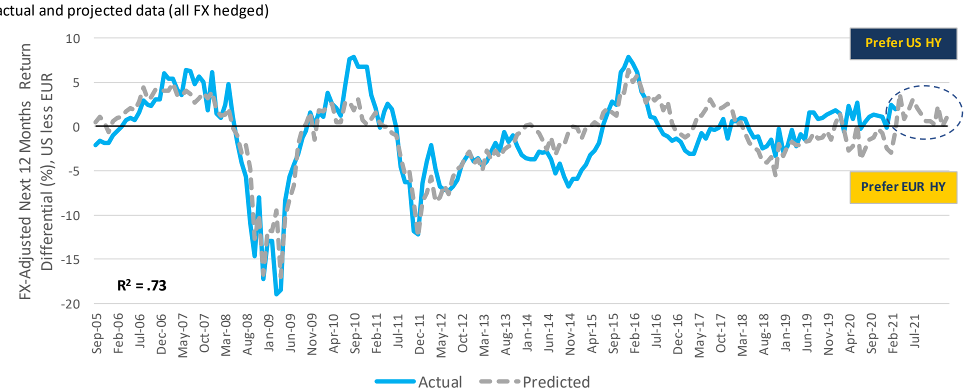


Source: SKY Harbor, Bloomberg

So, how does all of this feed into total return expectations over the next twelve months? **To support our internal positioning, we developed a return projection model, using US vs. EUR industrial production, default rate, short-term rate, and GDP growth differentials**. What follows is the output of that regression model, which predicts a modest (albeit positive) total return advantage for US over EUR high yield over the next 12 months, all on an FX-hedged basis.

Next 12 Month Returns: US High Yield (H0A0) less EUR High Yield (HE00)

actual and projected data (all FX hedged)



Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Federal Reserve, European Central Bank, Bundesministerium fur Wirtschaft und Arbeit, Bureau of Economic Analysis, and Eurostat

US high yield has outperformed EUR high yield cumulatively since the onset of the pandemic. In our view, a more rapidly falling default rate, significant fiscal stimulus measures, and alleviation of FX hedging costs have served to benefit US returns. More recently, however, significant divergence in short-term rates have coincided with more onerous currency hedging costs, advantaging EUR high yield since the start of April. We anticipate this dynamic will be short-lived, however. Our updated regression model – geared to project future outperformance on the basis of regional differentials in underlying economic growth, credit stress, and short-term rates – points toward a modest but positive advantage for US high yield in the coming 12-month period.

Important Disclosures and Disclaimers