SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
September 4, 2023

SKY Harbor Weekly Briefing

SKYView: No Summer Lull

Markets began August on a weak note but managed a near breakeven finish, as concerns over the viability of a "no landing" scenario in the US and renewed growth concerns out of China were neutralized by signs of labor market normalization. Treasury market volatility was prevalent throughout the month, with both 5- and 10-year indices underperforming high yield following a downgrade by Fitch and technical headwinds as investors struggled to absorb outsized 3-, 10-, and 30-year auctions. Powell's speech in Jackson Hole, largely regarded as hawkish, also did little to clarify the Fed's rate outlook, with the future-implied likelihood of one more hike in '23 hovering around 50/50 following his commentary. However, lower than expected JOLTS Job Openings and an uptick in the unemployment rate several days later provided renewed enthusiasm for disinflation progress. Against this backdrop, we reiterate our view that high yield remains an attractive investment option. In our first *Weekly Briefing* following a short summer break, we highlight the value of high yield in the current market environment, as either a standalone allocation (by virtue of strong carry and an end to the Fed hiking cycle) or part of a custom portfolio solution (high yield plus treasuries, which have historically generated more efficient returns than investment grade credit).

Powell Remains Hawkish

Investors hoping for increased clarity on the direction of the FOMC likely came away disappointed by Powell's Jackson Hole speech, as the Fed Chairman attempted to strike some degree of balance between "doing too little" and "doing too much." Though odds of a September hike have diminished over the last several weeks, above-trend inflation and better than expected output (even a downwardly revised Q2'23 GDP growth rate remained well above original expectations) keep the November meeting very much in play. This sentiment, as demonstrated below (right side), was the dominant driver of high yield performance in August, with **our custom attribution model implying duration penalization had the largest negative impact on price return for the month**. That said, better than feared 2Q earnings growth, along with muted relative duration, allowed high yield to outperform investment grade and treasury indices in August.

Highlights from Jackson Hole

Jerome Powell Commentary; Aug. 25, 2023

"Although inflation has moved down from its peak—a welcome development—it remains too high."

"We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective."

"The lower monthly readings for core inflation in June and July were welcome, but two months of good data are only the beginning of what it will take to build confidence that inflation is moving down sustainably toward our goal."

"Getting inflation sustainably back down to 2 percent is expected to require a period of below-trend economic growth as well as some softening in labor market conditions."

"...we are attentive to signs that the economy may not be cooling as expected...GDP growth has come in above expectations and above its longer-run trend, and recent readings on consumer spending have been especially robust."

"The rebalancing of the labor market has continued over the past year but remains incomplete. Labor supply has improved, driven by stronger participation among workers aged 25 to 54 and... the labor force participation rate of women in their prime working years reached an all-time high in June. We expect this labor market rebalancing to continue."

August Performance Driven by Rates Vol

SKY custom attribution, in basis points

		MTD	Notes
Sentiment	Market	17	
Macro	More Duration	(44)	5-Yr Tsy yields +7 bps MTD
Macro	More Credit Risk	49	Better than feared Q2 earnings
Macro	Energy	11	
Technicals	Top Ticker		
Technicals	Small Issues		
Momentum	BB Losers		Reversion to mean of
Momentum	B Losers	4	trailing 30-day laggards
Momentum	CCC Losers		
Momentum	BB Winners	(4)	Reversion to mean of
Momentum	B Winners		trailing 30-day leaders
Momentum	CCC Winners	(4)	
	Total	29	

Statistically insignificant factors are left blank
We remove OAS > 1,000, Dur < 1, Dur > 8 from our set
"Losers" = Bottom Quartile 1-Month OAS Change vs. Broad Rating Bucket
"Winners" = Top Quartile 1-Month OAS Change vs. Broad Rating Bucket

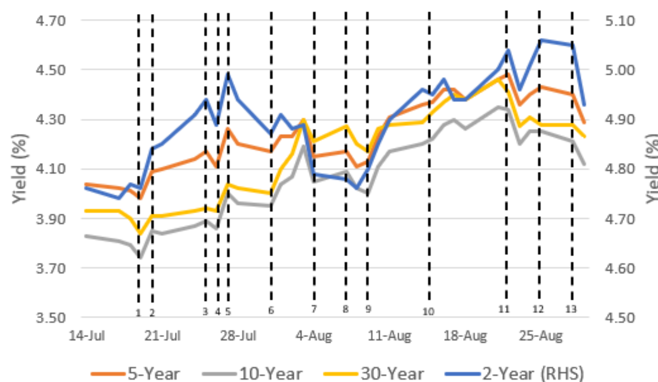
Attribution based on price return (MTD through August 31, 2023) of the ICE BofA US High Yield Index (ticker H0A0)
Source: SKY Harbor, Federal Reserve, ICE Data Indices

A Rocky Road

Speeches from central bankers aren't solely responsible for underlying Treasury volatility of late. As demonstrated below, we have identified more than a dozen developments that have influenced government bond yields over the last few weeks, with **an encouraging JOLTS report most significant in reversing upward momentum demonstrated throughout most of the summer**. At the time of writing, downward revisions (though still representing upside surprise) to Q2'23 GDP growth and personal consumption have alleviated rate hike fears, but numerous datapoints lay ahead of the September FOMC meeting (Sep 19-20), including August CPI.

US Treasuries Have Been Volatile

daily data, trailing 1 month



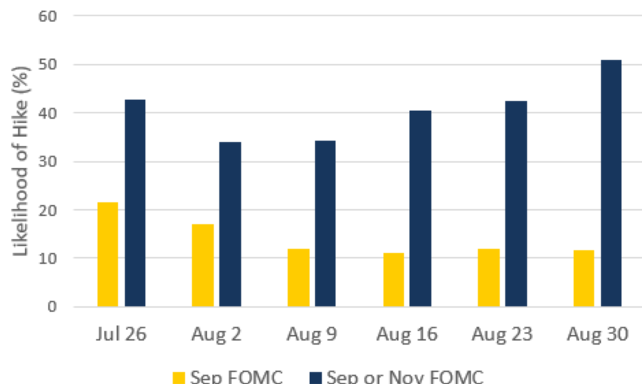
Event Key

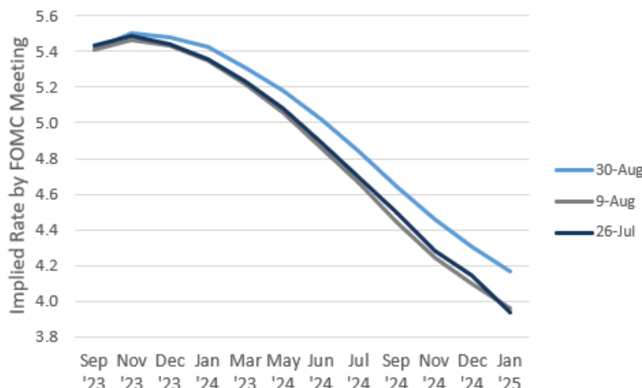
- #1 Lower Than Expected Jobless Claims
- #2 Weaker Than Expected Business Outlook
- #3 FOMC Rate Decision
- #4 Stronger Than Expected 2Q GDP Growth
- #5 Core PCE Cooler Than Expected
- #6 Fitch Downgrades US Debt to AA+
- #7 Unemployment Rate Falls to 3.5%
- #8 China Reports Weak Exports and Imports
- #9 Larger Than Anticipated Treasury Auction
- #10 Retail Sales Above Expectations
- #11 Weak Home Sales data
- #12 Powell Speaks at Jackson Hole
- #13 Lowe Than Expected JOLTS

Source: SKY Harbor, Bloomberg, Federal Reserve

The Fed Will "Proceed Carefully"

Powell's Jackson Hole speech twice noted his intent to "proceed carefully" with future rate hike decisions, underscoring the small margin for error in negotiating an economic soft landing. The market appears to have reflected this dynamic in the pricing of Fed Funds Futures, with the odds of a September hike falling by half (to ~ 11%) relative to the days immediately following the July FOMC meeting (though the likelihood of an additional hike at some point in 2023 still hovers around the 50% mark). Perhaps as meaningful is a revised set of assumptions on the timing of a rate cut. **The market now expects a start to the normalization of the funds rate to be delayed until June '24**, concurrent with a reduction in the odds of a recession over the next 12 month period.



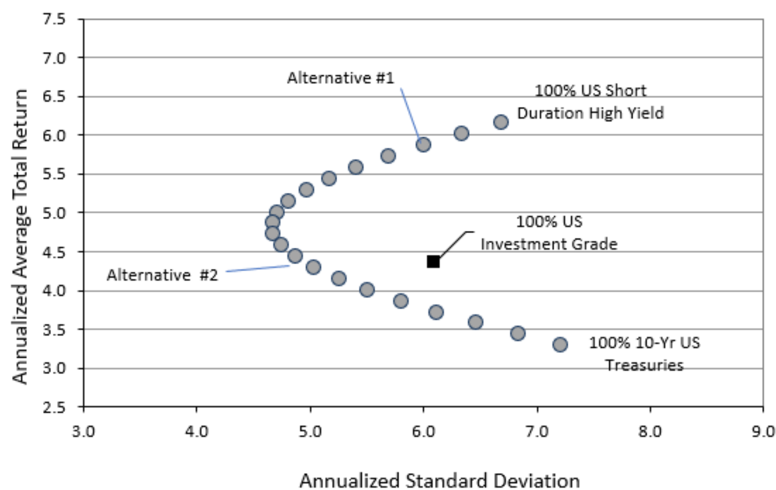


Source: SKY Harbor, Bloomberg, Federal Reserve

Is Investment Grade a Crowded Trade?

Top quartile carry and falling recession risk, in our view, augur well for high yield return potential over the next twelve months. However, investors have thus far remained more firmly entrenched in their investment grade allocations this year, by our understanding a function of below median high yield option-adjusted spread (OAS) levels and lingering concerns over the soft landing narrative. The now limited potential for H2'23 rate cuts – recall that four had originally been anticipated by the market – has since removed a near-term positive catalyst for owners of longer-duration IG credit, at least partially weakening the investment rationale over leveraged credit.

These arguments aside, and **for those not yet willing to increase pure high yield exposure, we highlight below (left side) the benefits of a hybrid (US Short Duration High Yield, 10-Year US Treasuries) portfolio**. Created using monthly index data over the last twenty years, "Alternative #1" (90% US Short Duration HY, 10% US 10-Yr Treasuries) has generated 150 bps of additional average annualized return with similar volatility as US Investment Grade. Over the same period, "Alternative #2" (40% US Short Duration HY, 60% US 10-Yr Treasuries) has generated similar average annualized returns with less volatility in comparison to US IG.



US Short Duration High Yield =
ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index (JVC4)

10-Year US Treasuries =
ICE BofA Current 10-Year Treasury Index (GA10)

US Investment Grade =
ICE BofA US Corporate Index (C0A0)

Source: SKY Harbor, ICE Data Indices

A Decent Start

The US economy has demonstrated far greater than expected resilience in recent months, contributing to ~ 7% year-to-date high yield index returns. Going forward, we think elevated carry – particularly if recession risk and treasury volatility subsides – creates a compelling argument in favor of the asset class. For investors hesitant to outright add risk in the current environment, a hybrid portfolio of short duration HY and 10-Yr US Treasuries has historically represented an attractive alternative to investment grade credit, either by enhancing return potential or limiting volatility.

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