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SKY Harbor Weekly Briefing

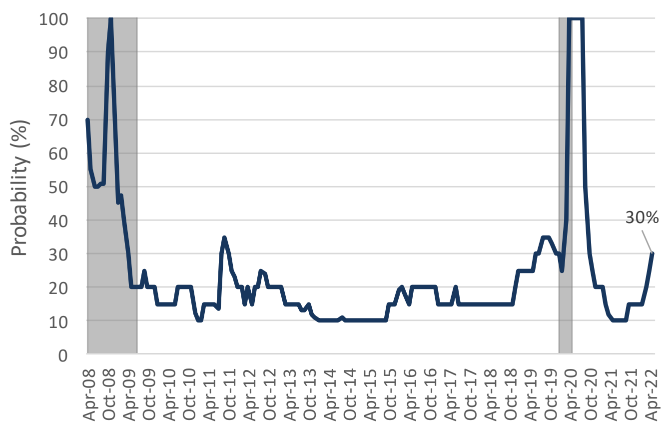
SKYView: Wow, What Just Happened?

Recently back from our second European roadshow in the post-lockdown era, we thought an overview of perceived investor sentiment could prove helpful for our readers, particularly those (likely many) still attempting to digest extreme market volatility in the month of May. Undoubtedly the most common topic of conversation was recession risk, particularly as the US high yield market appeared destined to record a fifth consecutive negative monthly return, which would have been a first for the asset class. Though a late-month rally saved the market from this dubious distinction, perceived risk of a looming recession continues to weigh on market trading levels. In this *Weekly Briefing*, we attempt to gauge recession risk using a multitude of economic indicators, feedback from investors, and market-implied probabilities.

According to a survey of economists, **the probability of the US falling into a recession over the next 12 months is now 30%**, the highest reading in 20 months. At the same time, the probability of recession in the coming year – based on the New York Fed measure of treasury spreads – is a meager ~ 3.71%. It should be noted, however, that this second reading rarely rises above 40%, even in the middle of a recession. Perhaps a better interpretation is the percentile rank of the 3.71% yield curve derived probability, which equates to ~ 0.52. These approximations – ~30% and ~ 50% based on economist estimates and the slope of the yield curve, respectively – fall very much in-line with an informal survey conducted during our recent European roadshow (locations included London, Paris, Luxembourg, Geneva, Zurich, Madrid, and Milan). **Across these stops, approximately 50% of attendees expected a US recession to occur in the next twelve months, with tremendous consistency regardless of geographic location** (those in Madrid may have been modestly more bearish).

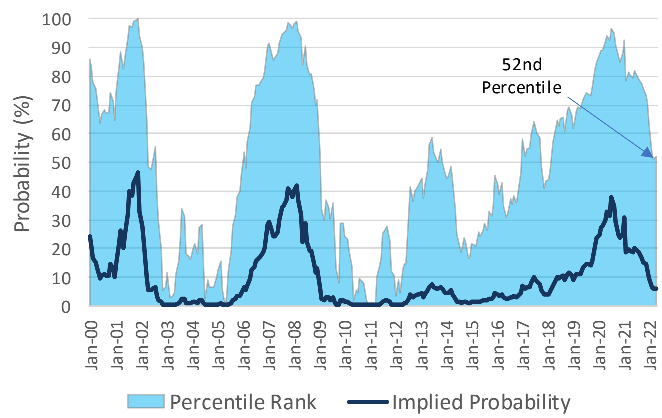
US Recession Probability Forecast, 1-Year Time Horizon

median Bloomberg contributor forecast; actual recessions in grey



NY Fed Yield Curve Implied Recession Probability in 12 Months

monthly data since 2000; percentile rank shaded in light blue



Source: SKY Harbor, Bloomberg, National Bureau of Economic Research, Federal Reserve Bank of New York

Using a less direct approach, we highlight US high yield spread decompression, which picked up meaningfully in May. With a specific focus on CCC-rated issues – clearly the cohort most susceptible to a slowdown in economic activity – we note that average spreads (OAS) widened by 128 bps in May, **the most negative market reaction since the lockdown-impacted month of March 2020**. In comparison to monthly data going back to 1999, 128 bps of CCC spread widening ranks 88th percentile, a clearly aggressive correction that moved the ICE BofA CCC & Lower US High Yield Index (ticker H0A3) above long-run median levels. On a relative basis, CCC spreads widened 15% from prior month-end OAS levels (855 bps at the end of April), registering 92nd percentile based on all monthly activity dating back to 1999. **Though these moves are clearly extreme – top <u>quintile</u> on an absolute basis, top <u>decile</u> on a relative basis – have they accurately foreshadowed a recession in the past?**

May OAS Action by Rating

based on monthly data since Sep 1999

Ticker	Group	Month End OAS	%ile Rank	OAS Change on Month	%ile Rank	Relative OAS Change (vs. starting OAS)	%ile Rank
H0A0	HY Index	422	0.37	25	0.75	6%	0.77
H0A1	BB	274	0.35	(11)	0.37	-4%	0.37
H0A2	B	467	0.45	46	0.83	11%	0.86
H0A3	CCC	983	0.51	128	0.88	15%	0.92

Source: SKY Harbor, ICE Data Indices

As previously indicated, 128 bps of CCC spread widening in May registered 88th percentile based on monthly data going back to 1999. Focusing only on the top quintile of occurrences over that time period (50 of 254 total dataset observations, with an average of 211 bps of spread widening), 26 occurred either during or within 18 months of the start of a recession (we use 18 months as it covers today through the end of 2023, the period at the epicenter of the current recession debate). **Offering little more than even chance (implied likelihood of recession under such circumstances was ~ 52%), we do not view May's absolute CCC spread widening as a strong indicator of a looming recession.**

On a relative basis, CCC bonds widened 15% of starting OAS levels in May (855 bps at April 30, 2022, to 983 bps at May 31, 2022), registering as a 92nd percentile move. Focusing only on the top decile of occurrences over that time period (25 of 254 total dataset observations, with average widening of 24% of starting spread levels), 17 occurred either during or within 18 months of the start of a recession. **This measure is statistically significant (though not definitive), as 68% of monthly CCC spread widening events of an equivalent magnitude took place during or within 18 months of the start of a recession.**

Extreme Spread Widening as a Recession Predictor

based on monthly data since Sep 1999

Top Quintile (80th Percentile) 1-Month Absolute CCC OAS Change		
Total Periods	254	
Positive Observations	50	Implied Likelihood
In Recession Or One Followed Within 18 Mos	26	52%

Top Decile (90th Percentile) 1-Month Relative CCC OAS Change		
Total Periods	254	
Positive Observations	25	Implied Likelihood
In Recession Or One Followed Within 18 Mos	17	68%

Source: SKY Harbor, ICE Data Indices, Bloomberg, NBER

In summary, various gauges of recession risk – those derived from economist surveys, yield curves, CCC-rated credit spread widening, etc. – all point to some degree of economic contraction probability on the horizon, with an average of methods coming very close to the 50% likelihood we measured by a show of hands throughout our client engagements in Europe over the last few weeks. Though admittedly above the minimal amount of recession risk factored into markets for most of 2021, a high degree of uncertainty remains. As noted in our recent publications, we continue to expect a 2% default rate by the end of 2023, with a Fed-orchestrated soft landing still included in our base case outlook, all of which translates into a fair value spread target of ~ 400 bps. Should our estimates prove optimistic and a moderate recession begins to take shape, we think a 6% 2023 default rate is a more reasonable estimate, boosting our fair value spread target to ~ 600 bps. Consequently, we would expect high yield spreads to remain range-bound until greater clarity is achieved, and view the path of inflation as being the key driver of sentiment in the coming months.

Important Disclosures and Disclaimers