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SKY Harbor Weekly Briefing

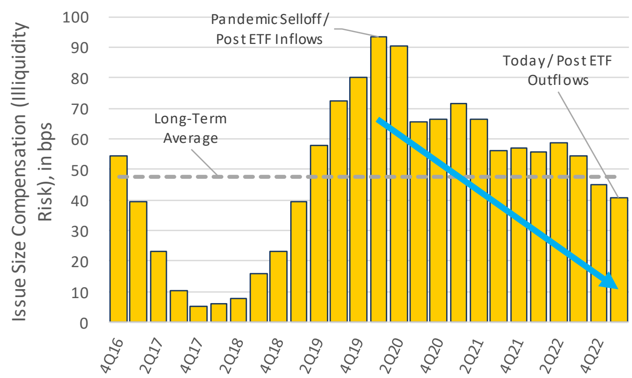
SKYView: Recalculating Factor Compensation

January's jubilation was met with frailty in February, as hotter than expected inflation and concerns over economic resilience in the face of further rate hikes led to a partial reversal in index total returns. Dissecting performance by our factor-based framework, duration was most heavily penalized in the month of February, largely a function of 5-Year Treasury yields gapping up 57 bps, a clear reversal of trends earlier in the year. Issue size was the second most impactful factor, perhaps related to asset class outflows that were pervasive for most of the month. Given underlying volatility, we thought it appropriate to use this *Weekly Briefing* to update our factor compensation regression model.

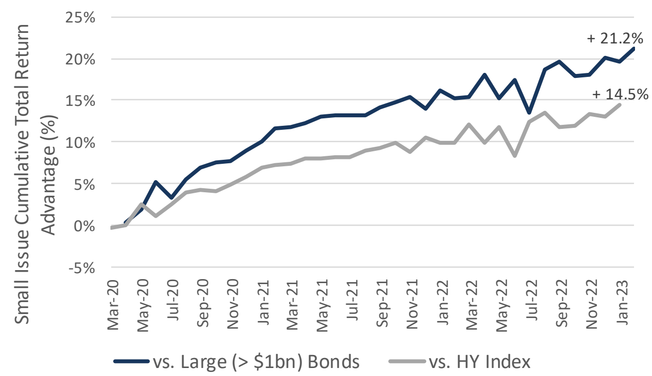
All Good Things Must Come to an End

As discussed in prior *Weekly Briefing* publications, we aim to generate, on a monthly basis, a regression-derived estimation of compensation per unit risk factor, with differences in credit quality (via weighted average rating factor), tenor (via duration), and liquidity (via bond issue size) constituting ~ 90% of index option-adjusted spread variability, in our view. **At the onset of the pandemic, we observed a rapid uptick in compensation to hold smaller high yield bonds (issue size < $350mm), with an estimated premium of 94 bps (after accounting for differences in duration and credit rating), or nearly twice the long-run average**. Consistent normalization of that relationship, capped off by technically induced volatility amidst ETF outflows in February (see our *Weekly Briefing* entitled "When Technicals Turn,") **led to small issues outperforming large issues and the index in general by over 2,100 bps and 1,450 bps, respectively, in the 35 months ended February 28, 2023**. As a result, however, issue size compensation has now fallen meaningfully below the long-run average for the first time since late 2018, and as a result we no longer view smaller issues as generically "cheap" in the current market environment.

We Identified Cheapness of Small Issues During Pandemic Onset
quarterly data



Relationship Normalized Following Small Issue Outperformance
cumulative small issue outperformance, Apr 1 '20 to Feb 21, 2023

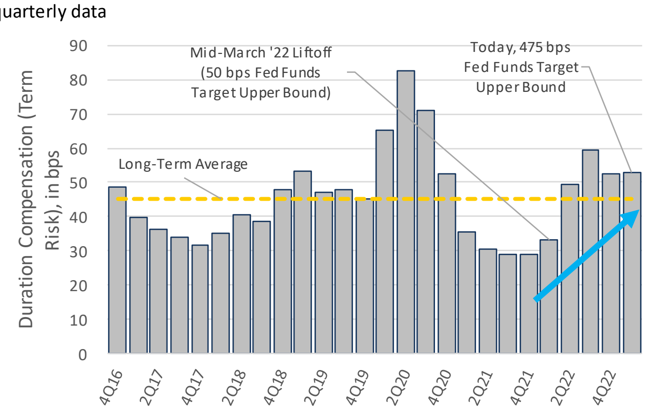


Source: SKY Harbor, ICE Data Indices

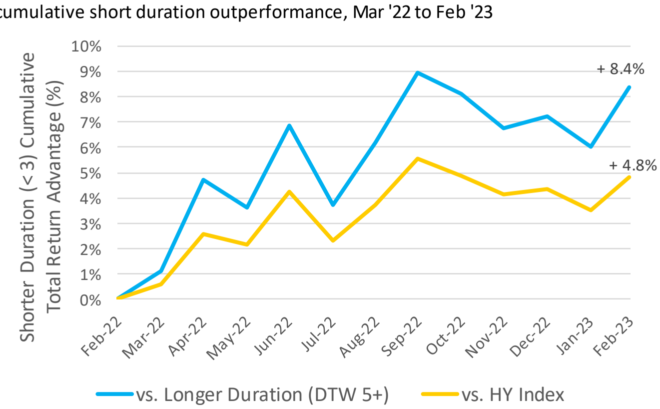
When One Door Closes…

Though the issue size dislocation has largely closed, other opportunities remain. **As outlined early in 2022, the onset of a liftoff in rates, coupled with below-average compensation to take on term risk, compelled us to reduce portfolio duration relative to respective benchmarks**. From March '22 through the present, the FOMC has raised their target range by 450 bps, allowing shorter duration (dur < 3) to meaningfully outperform longer duration (dur > 5). At the same time, **term risk compensation moved from a dataset low (our model goes back to 2009) to above-average at present**. Though hotter than expected inflation datapoints and the persistence of labor market strength continue to ratchet up terminal rate expectations, recent penalization of duration has finally brought compensation levels up to more attractive levels, in our view, prompting a moderation of an underweight that had served portfolios well in recent quarters.

We Went Underweight Duration Once Fed Hiking Cycle Began
quarterly data



Comp Normalization Following Shorter Dur Outperformance
cumulative short duration outperformance, Mar '22 to Feb '23



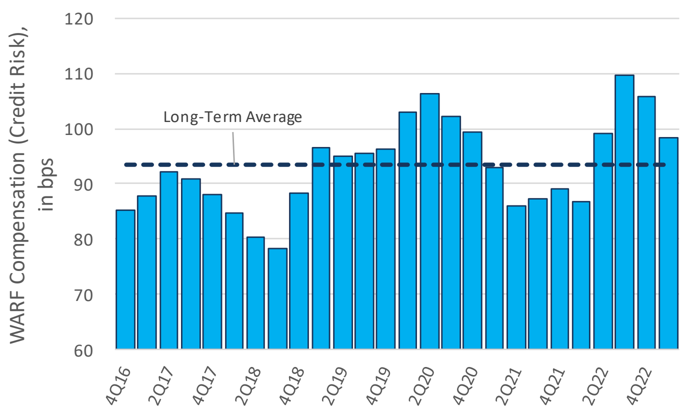
Source: SKY Harbor, ICE Data Indices

A Rising Default Rate Environment

Last, but not least, we come to credit risk, or compensation to take on each additional unit of weighted-average rating factor (WARF). Unsurprisingly, this factor tends to be quite volatile, and constitutes an increasingly large portion of total OAS in times of stress. Though our credit rating biases have fluctuated over the past year, we note (as demonstrated below), that **credit risk compensation tends to rise and fall with a forward-looking view of index default rates**. Over the next six months, we project defaults will steadily rise toward 4%, on their way to a 4.3% FYE23 estimate (see our *Weekly Briefing* entitled "Recession Risk on the Decline?" for additional details). As such, we do not view credit risk as generically "cheap" by virtue of compensation being modestly above average, but rather view valuations as being "fair" given our default loss outlook. At present, **we would consider holdings of higher-yielding / lower-rated bonds as selective in nature, driven by heightened index dispersion and idiosyncratic opportunities, not a function of expected compensation normalization**.

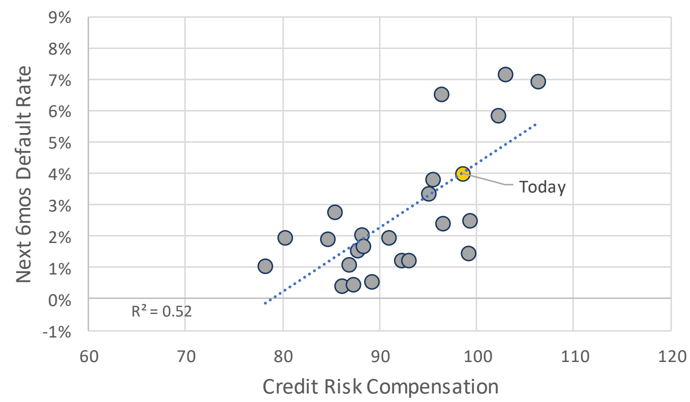
Our Views on Credit Risk Have Been More Fluid

quarterly data



WARF Comp In-Line w/ Our Default Rate Outlook

credit risk comp vs. next 6mos default rate



Source: SKY Harbor, ICE Data Indices

Adjusting Our Factor Views

Our factor compensation estimates have moved materially over the last several quarters, with liquidity risk below average for the first time in over four years, and term risk compensation above the long run average following duration penalization throughout the Fed hiking cycle. Going forward, we plan to moderate our previous factor positioning biases (small issue overweight, duration underweight). With regard to WARF compensation, we continue to think downgrade loss avoidance will be paramount this year, and do not view lower-rated credit risk as generically attractive absent a material reduction in our default rate estimate.

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