SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

SKYView: Labor Markets Refuse to Cool

Hawkish Fed commentary and strong jobs data led to market volatility toward the end of the first week of the new year. The Job Openings and Labor Turnover Survey (JOLTS) came in hotter than expected, with demand for workers showing no signs of cooling despite looming recessionary fears. Higher than expected job openings, minimal unemployment, and a still subdued labor force participation rate has kept the number of job openings per employee elevated at ~ 1.7x, an unwelcomed datapoint for those hoping for Fed rate hike capitulation. In this *Weekly Briefing*, we highlight pertinent commentary from recently released Fed minutes, relate incoming jobs data to wage pressure, and gauge the associated impact on various high yield industries (i.e., bad news for labor-intensive issuers, but such pressure appears priced into spread levels, at least for now).

Markets May be Underestimating Rate Path

Recently released FOMC minutes and commentary from a number of Fed officials served to warn investors against assuming the fight against inflation was nearing an end. Notably, minutes from the December FOMC meeting highlighted participant concerns over prematurely loosening monetary policy conditions. **Rather than signaling a near-term pause, officials continue to remind investors that market-implied terminal rate expectations appear too low, and hopes of rate cuts in the back half of 2023 remain, thus far, unwarranted**. In response, Fed Funds Futures implied rates crept marginally above 5.0% on Thursday (Jan 5), though they remain below the median forecast from last month's dot plot (5.1%). Additionally, markets continue to price in rate cuts in the back half of this year, despite zero FOMC participants signaling such a move as of mid-December.

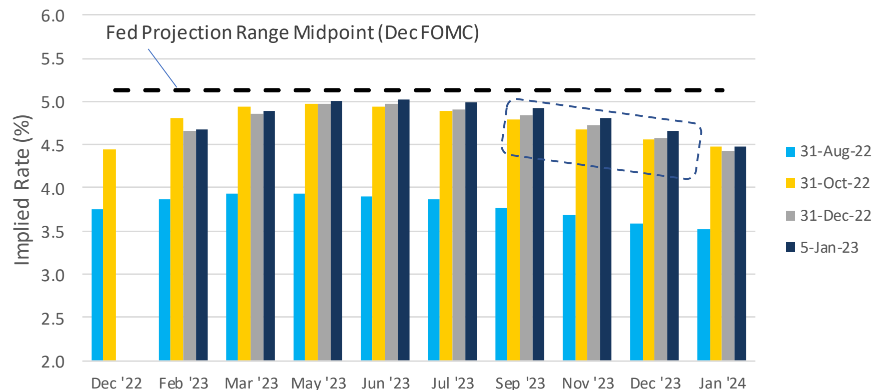
Markets May Be Underpricing Fed's Resolve
December FOMC Minutes

"In view of the persistent and unacceptably high level of inflation, several participants commented that historical experience cautioned against prematurely loosening monetary policy"

"...maintaining a restrictive policy stance for a sustained period until inflation is clearly on a path toward 2 percent is appropriate..."

"...ongoing increases in the target range would be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time." **No FOMC participants expect rate cuts in 2023**.

Market Pricing In a Terminal Rate Below Fed Forecast; Expecting Cuts in H2'23
data as of January 5, 2023

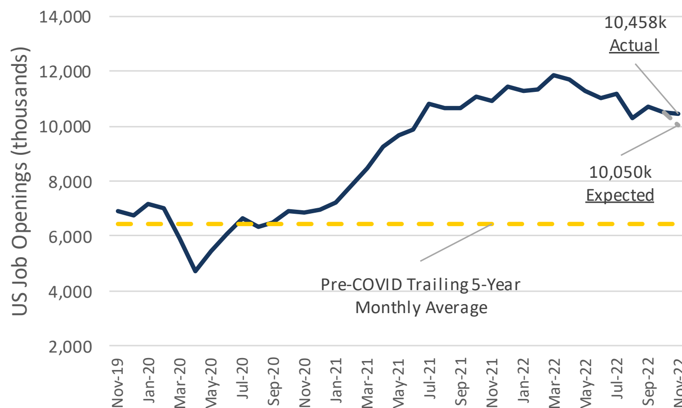


Source: SKY Harbor, Bloomberg, Federal Reserve

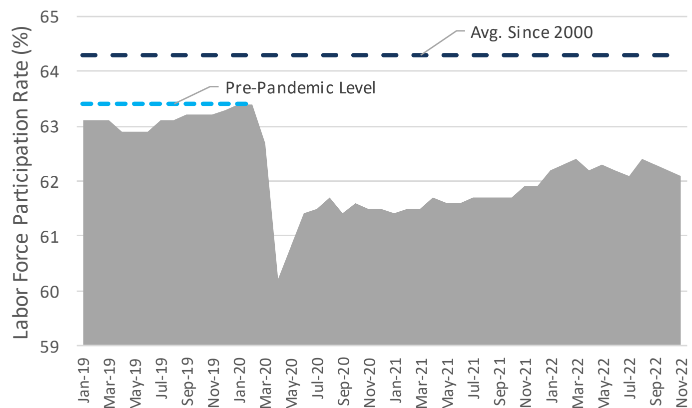
JOLTS Surprises to Upside, Initial Jobless Claims Surprise to Downside

US job opening remained elevated in November, keeping pressure on the Fed to tighten further. **The number of open positions declined modestly to 10.46 million for the month, lower by 0.5% sequentially, but came in 4.1% above consensus expectations (over 400k "extra" jobs).** Openings as a percentage of the labor force remained steady at 6.4%, while a still depressed labor force participation rate implies persistent tightness despite Fed efforts to cool the economy. Additionally, workers continue to quit jobs at elevated rates, implying confidence in finding new employment remains quite high.

Job Openings Remain Elevated; Nov. Data Above Consensus
monthly JOLTS Job Openings



Labor Force Participation Rates Still Below Pre-COVID Levels
monthly data



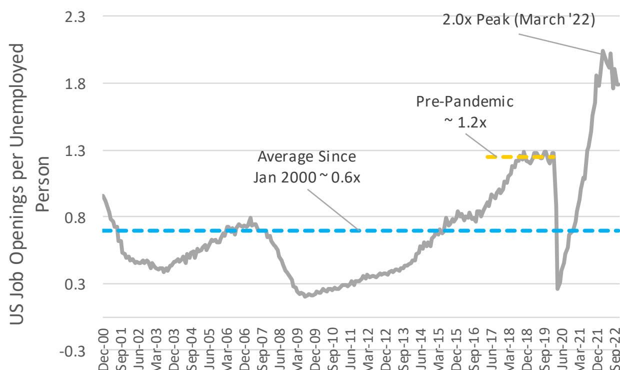
Source: SKY Harbor, US Bureau of Labor Statistics, Bloomberg

Elevated Openings per Employee Correlated to Wage Growth

Though job openings and quits have come down from recent (and all-time) highs, labor markets have shown considerable resilience. To better put numbers into context, **the 10.46 million job openings from the November JOLTS report far outnumber the 6.01 million unemployed workers in the labor force, leading to an opening per unemployed person ratio of 1.7x** (left chart below). Down from a peak of 2.0x in March '22, the ratio remains well above the 1.2x level that preceded the pandemic, and is multiples above the 0.6x monthly average since January '00. Further pressuring this dynamic is the labor force participation rate – currently 62.1% – which remains 130 bps below pre-pandemic levels. Normalization of the participation rate could theoretically add 2+ million job seekers into the equation, partially offsetting but not fully eliminating the job opening gap. Of more near-term concern, however, is the **positive correlation between job openings per employee and eventual average hourly earnings growth** (right chart below). As such, persistent labor force tightness makes alleviation of issuer margin pressure via wage disinflation unlikely in the very near term, in our view.

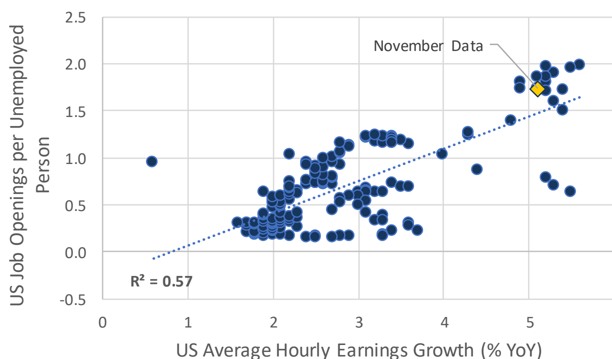
Job Openings per Unemployed Person Elevated at 1.7x…

monthly data



…Contributing to Upward Pressure on Wages

monthly data since 2007, excludes COVID lockdowns



Source: SKY Harbor, US Bureau of Labor Statistics, Bloomberg

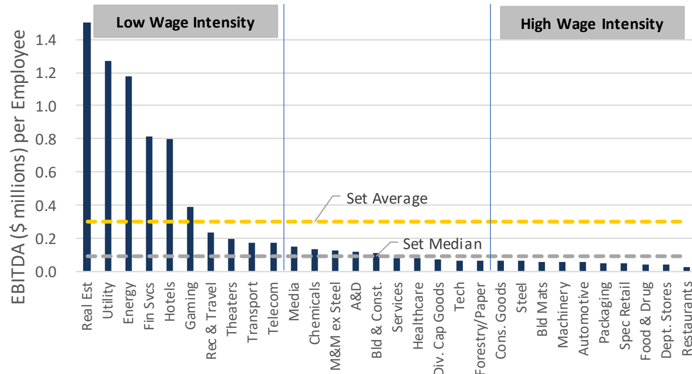
Labor Pain May Persist

With recent jobs data giving way to a view that wages may end up a more persistent component of inflation, we attempted to identify segments of the high yield market where margins may be more susceptible by virtue of greater labor intensity. We first generated a list of ICE BofA US High Yield Index (H0A0) constituents with publicly available financials, leveraging a combination of Bloomberg, Capital IQ, and company filings. We then calculated 2019 EBITDA generation per employee, in an attempt to diminish the negative impact COVID-19 disruptions and subsequent re-opening distortions may have had on company earnings over the last 36 months. While the resulting metrics are not a perfect proxy for labor intensity (companies may outsource a large portion of their labor needs, certain skill sets may prove more/less difficult to source, etc.), we believe it's a viable methodology and one of the few ways to efficiently quantify relative sensitivities for what turned out to be ~ 70% of a $1.4 trillion universe.

As demonstrated below, **sectors and industries such as Real Estate, Utilities, Energy, and Financial Services appear to generate far more EBITDA per employee than Restaurants, Department Stores, Food & Drug retailers, etc**., leading us to conclude that the latter are likely more labor-intensive and remain at greater risk should the jobs market remain hot (we name these the "High Wage Intensity" group). In comparing this cohort to those that score on the opposite end of the spectrum ("Low Wage Intensity" group), spread levels seemed to have adjusted accordingly. As demonstrated below (right side), **the options-adjusted spread (OAS) ratio of "High Wage Intensity" to "Low Wage Intensity" groupings has moved up in tandem with the rise in average hourly earnings since the onset of the pandemic**, the market seemingly compensating investors for continuing wage pressure. We remain cautious, however, of this dynamic over the longer run. While consumers have thus far continued to spend despite higher prices, their willingness to do so in the future remains uncertain. As such, we continue to have concerns over wage intensive industries without the offset of possessing a defensive and differentiated product offering, despite some spread widening in recent quarters.

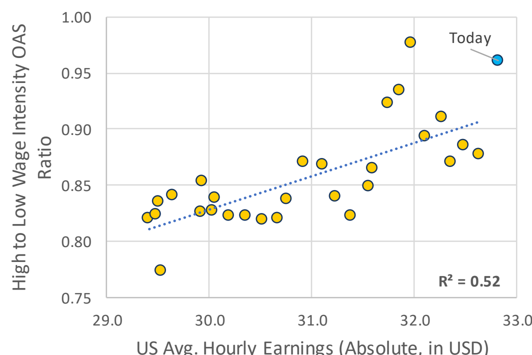
Sector & Industry Wage Sensitivity Varies Significantly

2019 (Pre-COVID) EBITDA to employee count



High / Low Wage Intensity OAS Ratio Screens Fair

monthly data, since start of pandemic



Source: SKY Harbor, ICE Data Indices, Capital IQ, Bloomberg

(Still) Optimistic but Cautious

Reiterating the thoughts expressed in our prior *Weekly Briefing*, **we remain cautiously optimistic about high yield in 2023**, with our view that spreads may need to widen offset by attractive starting yield-to-worst levels. We do, however, expect market volatility and issuer return dispersion to pick up in the coming months. As such, we think credit selection – in particular avoiding names with greater earnings cyclicality and more acute margin pressure – will prove beneficial to portfolio returns. Absent greater conviction that a soft landing can be achieved, we think it appropriate to stay up in quality, with greater exposure to more defensive credits with limited susceptibility to margin compression via wage inflation.

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