SKY HARBOR
CAPITAL MANAGEMENT

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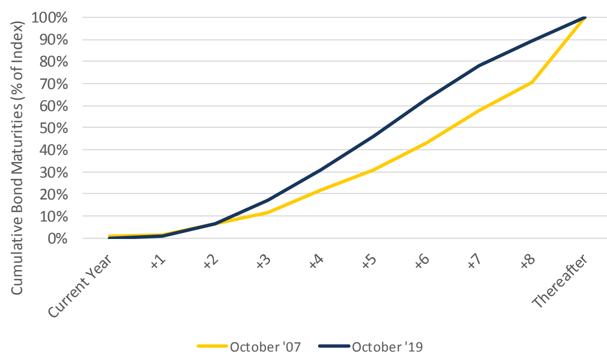
Weekly Briefing

SKYView: Sentiment

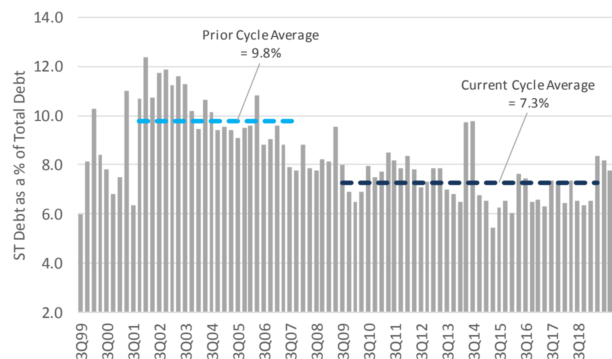
A spate of disappointing economic releases – most notably a 47.8 US ISM Manufacturing Index reading, the lowest since June 2009 – has once again brought recessionary concerns to the fore. While we remain unconvinced of an imminent end to the expansionary cycle, we find comfort in the current level of corporate conservatism and strength of the US consumer should a downturn be closer than our outlook envisions. In this *Weekly Briefing*, we compare the current corporate and economic environment to the late-cycle period immediately preceding the "Great Recession" (December '07 through June '09).

The US high yield bond new issue market has been strong thus far in 2019, with YTD volumes of $208bn, up 24% relative to the first nine months of 2018. In September '19 alone, 51 bond issues priced (total proceeds of $31bn), making it the strongest new supply month in two years. A combination of attractive rates and asset class inflows have allowed high yield issuers to readily access primary markets, pushing out maturity walls and locking in relatively favorable coupons for the foreseeable future. Comparing the current ICE BofAML US High Yield Index (H0A0, our proxy for the US high yield bond index) maturity schedule to that of October '07 (for simplicity, we use the same month in the lead up to the last recession), results look quite similar (i.e., no near-term wall, little debt due in the next two years). Augmenting our analysis to include debt not counted among bonds found within H0A0 (notably term loans and outstanding revolver balances), we find that the ratio of short term to total debt for H0A0 constituents has trended lower during this cycle relative to last. As a result, we find that high yield issuers at present have a higher degree of financial flexibility relative to the prior late-cycle period, a dynamic that ought to dampen volatility should an end to the current expansion materialize more quickly than we anticipate.

HY Bond Cumulative Maturity Schedule
October '07 vs. October '19



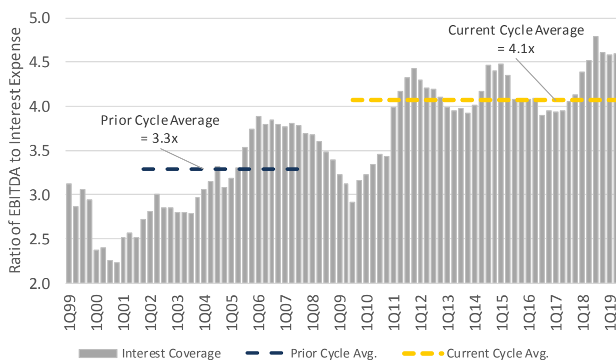
Short Term Debt as a % of Total Debt
quarterly data, trailing 20 years



Note: Oct '19 data is as of October 9, 2019 (time of writing); other periods use month-end data
Source: SKY Harbor, ICE BofAML Indices, BofA Merrill Lynch

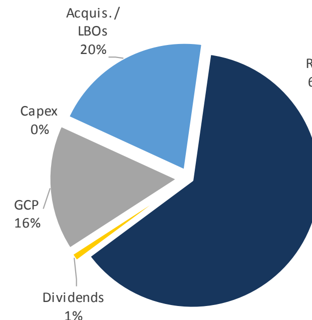
From a credit metric perspective, we take further comfort in issuer interest coverage metrics, which at present are nearly a turn above October '07 levels. In fact, current cycle average interest coverage (4.1x) is materially above prior-cycle averages (3.3x). Given strong correlations to eventual high yield default occurrences, we may infer that peak defaults in the next recession may come in below the prior recessionary peak rate (~ 15%). A likely driver of elevated interest coverage ratios – aside from the favorable interest rate environment – is the relatively conservative new issue market use of proceeds. Perhaps driven by the depths of the prior recession, as well as tax reform that now disincentivizes excess leverage, high yield issuers have shunned traditionally aggressive uses of debt proceeds. As demonstrated below, 64% of 2019 YTD new issue dollars have been raised to support a refinancing (in our view, a conservative use of proceeds), well above the 2007 average of 31%. As a corollary, a staggering 53% of new issue dollars raised in 2007 went toward supporting an acquisition or LBO (in our view, an aggressive use of proceeds), far exceeding the 19% used for such purposes on a YTD 2019 basis.

US High Yield Coverage Ratio
20 year time series



Source: SKY Harbor, ICE BofAML Indices, BofA Merrill Lynch

New Issue Use of Proceeds (US High Yield Bonds)
YTD data through October 2019

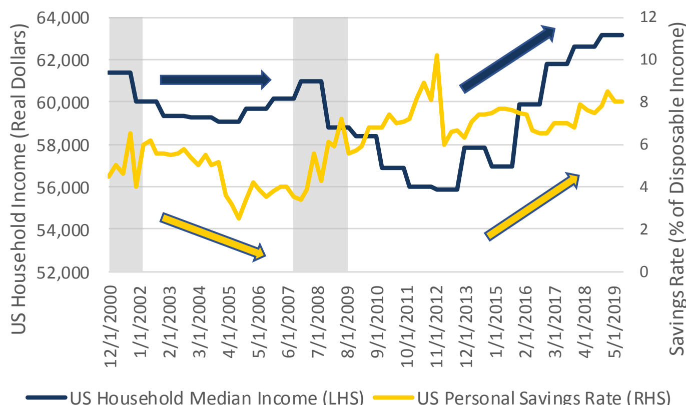


	Percent of all Proceeds		
Use:	2019 YTD	20yr Avg.	2007
Refis	64%	56%	31%
Dividends	1%	4%	2%
GCP	16%	14%	12%
Capex	0%	4%	3%
Acquis. / LBOs	19%	23%	53%

The strength of the US consumer has been credited with keeping economic growth going amidst trade uncertainties and geopolitical turmoil over the last couple of years. How does this compare to the previous late-cycle period? In the run-up to the last recession, US Household Income was relatively stagnant, with a drop in personal savings rates supporting a rise in consumerism. More recently, an uptick in household income has coincided with higher savings rates, boosting the economy in a manner not fueled by debt or excess. As further exemplified below, the Federal Reserve US Household Debt Service Ratio (ratio of required household debt payments to total disposable income) is well below levels experienced in the run-up to the March ’01–November ’01 and December ’07–June ’09 recessions. As such, an eventual downturn is unlikely to impact the average US household as severely as 2001 and 2008.

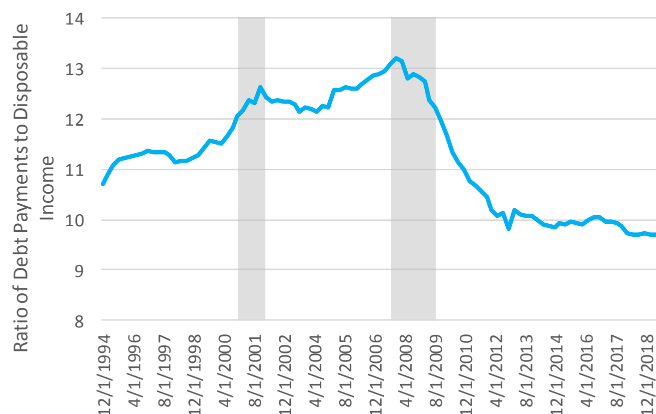
Household Income and Savings Up Since Great Recession

quarterly data since 2000; recessions shaded grey



US Households Better Prepared for Downturn

25 years of quarterly data; recessions shaded grey



Source: SKY Harbor, US Census Bureau, Federal Reserve, Bureau of Economic Analysis, National Bureau of Economic Research

In conclusion, these findings support the view that high yield issuers are better prepared at present to weather an upcoming recession than they were in the months leading up to the last recession. With short-term debt making up a smaller portion of total balance sheet debt, largely addressed maturity walls, and elevated interest coverage ratios (in part driven by the avoidance of aggressive debt issuance), the degree of financial flexibility of the average high yield issuer in October ’19 appears greater than that of the average high yield issuer in October ’07. Furthermore, upward trends in household income and savings, as well as better debt service ratios, would infer that consumer spending is likely to fall off less severely in the next recession relative to the last. And, since consumer spending constitutes ~ 68% of the US economy, declines in GDP growth may be relatively muted.

Finally, in recognition of the current expansion surpassing its 123rd month, we end this briefing with a cursory look at the relationship between expansionary cycle length and subsequent recession severity. As demonstrated by the charts below, expansions that last longer (in this case, we measure in months from start to finish) are typically followed by relatively mild recessions. (We remove the last recession from our set given its extraordinary magnitude and the fact that it’s the only post-war downturn primarily driven by a housing bust and, as such, carries different economic ramifications.) We postulate that longer recoveries may demonstrate a more measured degree of growth, thus necessitating a less severe correction in the period that follows. Given the length of the current expansion (longest in history, and still going), historical evidence would suggest the next recession may be relatively mild.

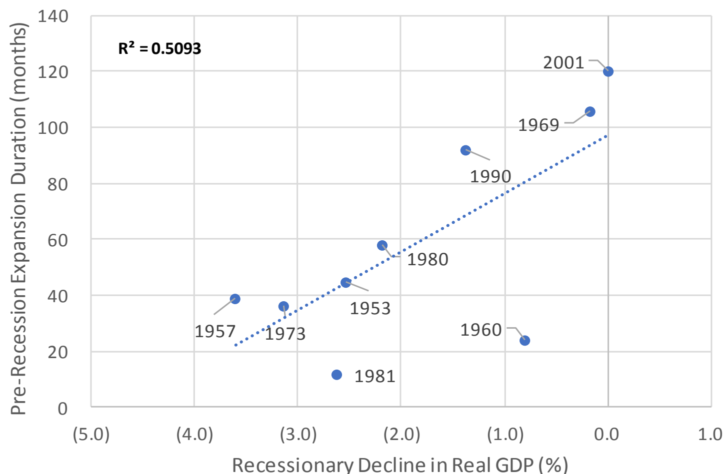
Recovery Length vs. Subsequent Recession Magnitude

Trailing 10 Recessions

Recession Year	Prior Expansion Duration (Months)	Max Decline* in Real GDP (%)
1953	45	(2.5)
1957	39	(3.6)
1960	24	(0.8)
1969	106	(0.2)
1973	36	(3.1)
1980	58	(2.2)
1981	12	(2.6)
1990	92	(1.4)
2001	120	0.0
2007	73	(4.0)

* Max cumulative change in Real GDP from expansion peak

Note: Scatterplot excludes 2007



Source: SKY Harbor, National Bureau of Economic Research, Federal Reserve Bank of Minneapolis

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	1-Oct-19	Sep	50.0	47.8	49.1
Construction Spending MoM	1-Oct-19	Aug	0.5%	0.1%	0.1%
ADP Employment Change	2-Oct-19	Sep	140k	135k	195k

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Empire Manufacturing	15-Oct-19	Oct	0.0		2.0
Retail Sales Advance MoM	16-Oct-19	Sep	0.3%		0.4%
Housing Starts	17-Oct-19	Sep	1320k		1364k

Source: SKY Harbor, Bloomberg

Recommended Reading

Torry, Harriet (2019, October 10). WSJ Survey: Majority of Economists Say Manufacturing Sector in Recession. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/wsj-survey-majority-of-economists-say-manufacturing-sector-in-recession-11570716000

El-Erian, Mohamed (2019, October 9). Why Dollar Strength Poses Risks to the Global Economy. *The Financial Times* (subs. req.), Retrieved from https://www.ft.com/content/27410a10-e9da-11e9-a240-3b065ef5fc55

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