SKY HARBOR
CAPITAL MANAGEMENT

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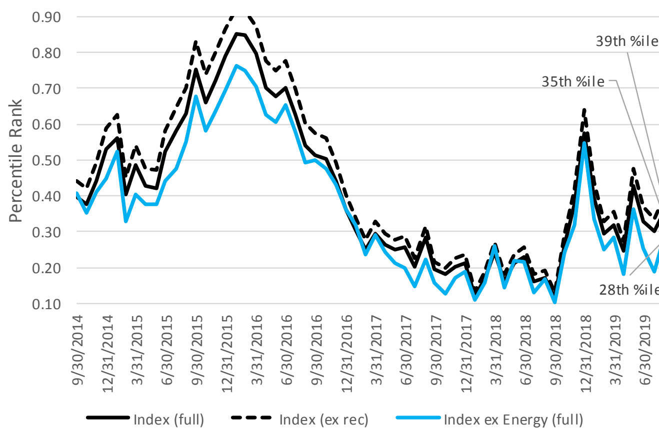
Weekly Briefing

SKYView: Valuations

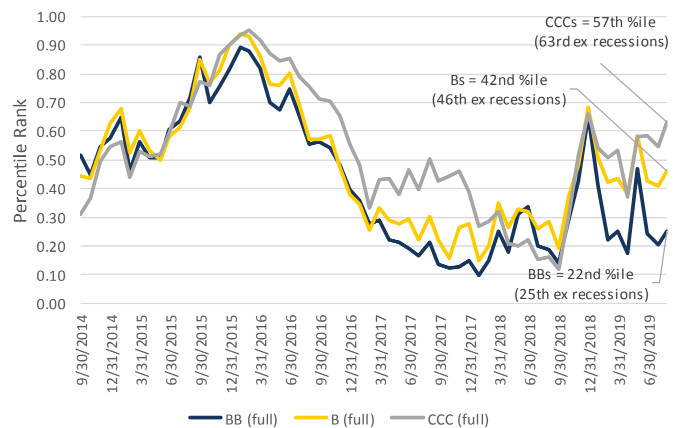
After a brief summer hiatus, we resume our *Weekly Briefing* with a focus on forward positioning in light of year-to-date market performance. In particular, we examine the staying power of an up-in-quality / long duration trade that has dominated high yield returns in 2019, and identify sector opportunities amidst the backdrop of an inverted yield curve.

The US high yield bond market (using the ICE BofAML US High Yield Index, ticker H0A0, as a proxy) has tightened ~114 bps thus far in 2019 (through the time of publication). Despite such tightening, option-adjusted spread (OAS) for the index of ~420 bps is above tightest-quartile levels (using monthly spreads dating back to December 1996) even when prior recessionary environments and the Energy sector are excluded. Performance, however, has been unevenly driven by quality, as BB rated bonds have demonstrated the greatest amount of strength, outperforming Single-B and CCC securities despite above-coupon returns. As shown below, relative attractiveness of the highest-quality cohort of the index has diminished, particularly since late May 2019, on such outperformance.

ICE BofAML US High Yield Index (H0A0) OAS Percentile Rank
based on all months since Dec. '96



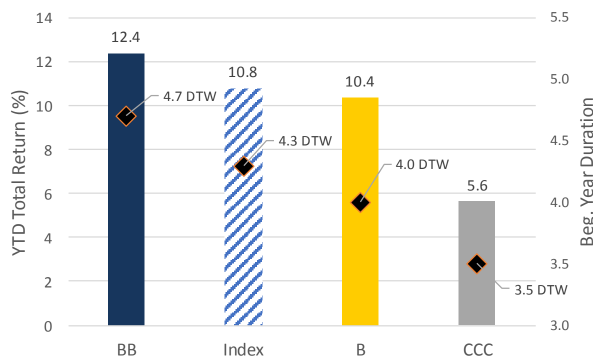
OAS Percentile Ranks by Rating
based on all months since Dec. '96



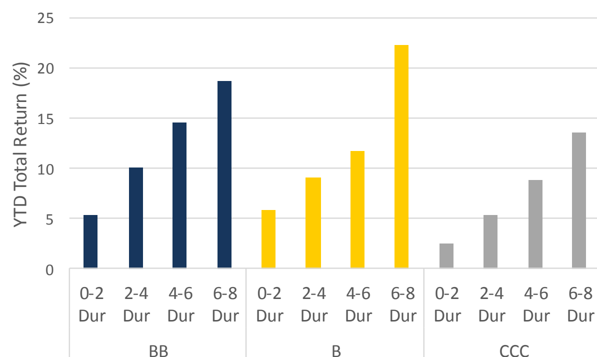
Source: SKY Harbor, ICE BofAML Indices

While a desire to remain in high-quality issuance given the age of the expansionary cycle may be partially driving this dynamic, a reach for duration following the Fed's pivot toward more accommodative policy has been the primary impetus for BB outperformance. As demonstrated in the below chart at left, total returns by credit quality bucket somewhat mask the embedded duration component lingering in the background. By holding ratings constant in the right-side chart below, the importance of duration in explaining YTD returns becomes evident.

YTD Total Returns by Rating
data through August 27, 2019



YTD Total Returns by Duration
data through August 27, 2019

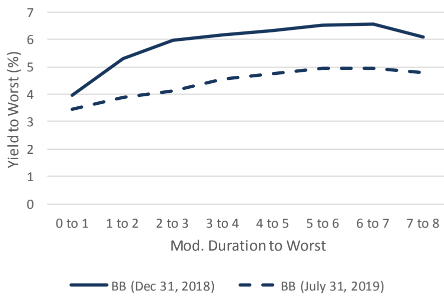


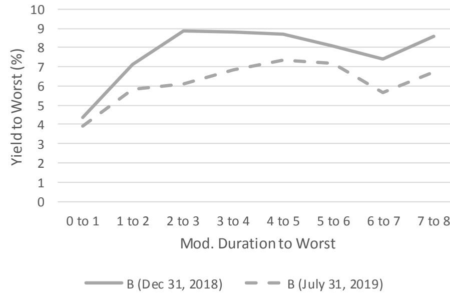
Source: SKY Harbor, ICE BofAML Indices

The question that inevitably arises is whether this dynamic can continue. Despite decent economic releases of late (personal consumption, retail sales, small business optimism, etc.), rates continue to decline. However, bond price appreciation has increased the number of call-constrained bonds in the market (over 70% of BBs now trade above their next call price) and high yield corporate credit yield curves continue to flatten. As such, we think continued upside to the long duration trade has diminished. Further bolstering this view, our analysis of average compensation per unit of duration for H0A0 index constituents is below cycle averages, having declined from above 60 bps at the start of the year to ~45 bps at present.

HY Corporate Yield Curves Have Flattened

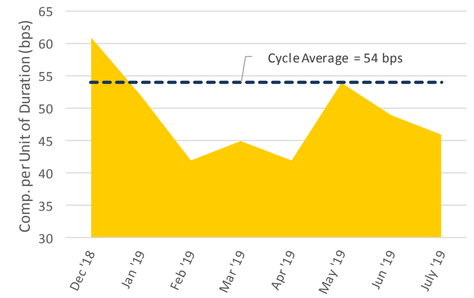
monthly data





Spread Duration Compensation Has Declined

monthly data

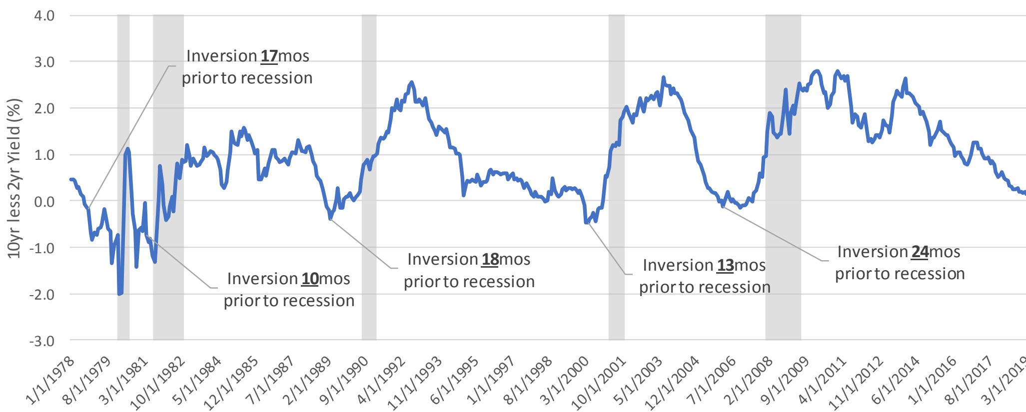


Source: SKY Harbor, ICE BofAML Indices, Bloomberg

Another topic garnering significant attention is the recent inversion of the Treasury curve, with the 2s10s curve at -4bps at the time of publication. While this recession indicator must typically be sustained to be relevant, and despite the proliferation of negative yielding debt on a global basis contributing technical distortions to the measure, we concede adverse investor sentiment may arise from such a signal. In a study of the prior five recessions, we found that Treasury yield curve inversion pre-dated a recession by 10 to 24 months, with a median of 17 months. Segmenting the high yield index into duration buckets, we find that average monthly returns of the shorter subset (duration of 0 to 3) have exceeded returns of a longer subset (duration of 3 to 8) in the 10, 17 and 24 months before the start of the last two recessions. This dynamic – along with flat yield curves, below average spread duration compensation, and OAS percentile rankings – leave us favoring short duration high yield in the current market environment.

Inverted 2s/10s Curve May Foreshadow Recession

monthly data, recessions shaded grey



US High Yield Returns by Duration

data through last two recessions

Months Prior to Recession	Average Monthly Returns: 0 to 3 Duration Bucket	3 to 8 Duration Bucket
10 Months (bottom of range)	0.39	0.21
17 Months (median obs.)	0.44	0.39
24 Months (top of range)	0.46	0.36

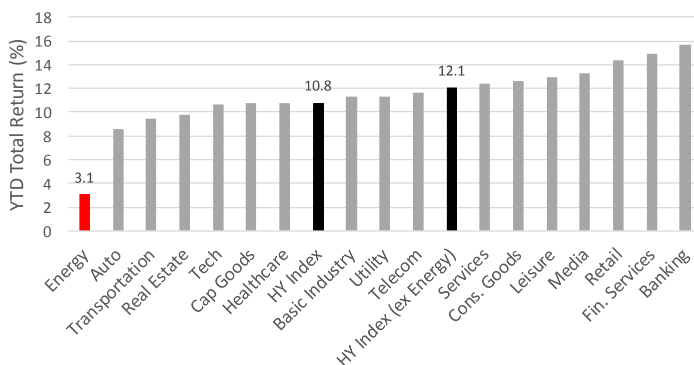
2019	Average Monthly Returns: 0 to 3 Duration Bucket	3 to 8 Duration Bucket
7mos ended July 31	0.92	1.71

Source: SKY Harbor, Bloomberg, The National Bureau of Economic Research, ICE BofAML Indices

Shifting our attention to sector performance, we note a relatively homogenous distribution of returns thus far in 2019. As demonstrated below, all sector returns have been positive, and nearly all exceed coupon levels (Energy being the exception). Energy has been the clear laggard this year, as it was in three of the prior nine annual periods (note that no other sector shows up more than once as a primary laggard).

YTD Total Returns by Rating

data through August 27, 2019



Historical Sector Laggards

full years since last recession

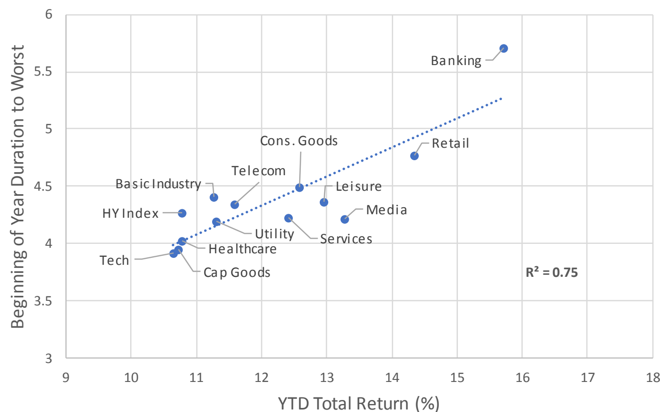
Year	Index Return	Sector Laggard	Laggard Return	% Capture
2010	15.2	Utility	4.2	28%
2011	4.4	Banking	(4.7)	NM
2012	15.6	Energy	11.4	73%
2013	7.4	Telecom	4.3	58%
2014	2.5	Energy	(7.6)	NM
2015	(4.6)	Energy	(23.6)	508%
2016	17.5	Healthcare	4.1	23%
2017	7.5	Retail	1.1	14%
2018	(2.3)	Auto	(8.3)	367%
YTD 2019	10.8	Energy	3.1	28%

Source: SKY Harbor, ICE BofAML Indices

Despite a strong rally in 2019 that has allowed for high yield index returns of over 10% YTD, sector returns have been driven by duration, not beta. As illustrated below, beginning of year sector duration (left chart) has explained a significant amount of YTD sector returns (R^2 = 0.75), while beginning of year sector yield-to-worst (right chart) has been insignificant.

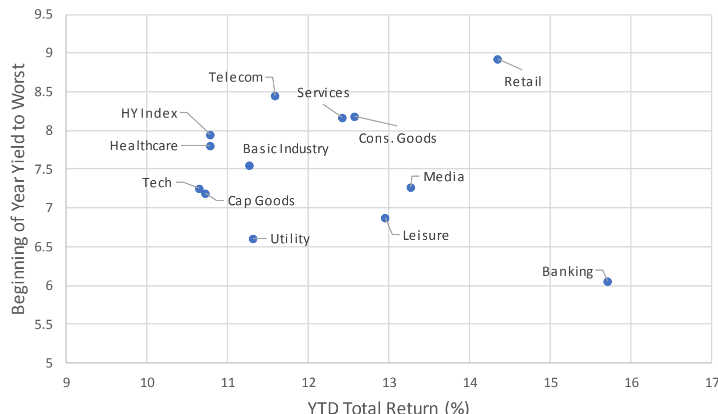
Sector Returns vs. Beginning of Year Duration

data through August 27, 2019; excludes Energy and small sectors (<2% of index)



Sector Returns vs. Beginning of Year YTW

data through August 27, 2019; excludes Energy and small sectors (<2% of index)

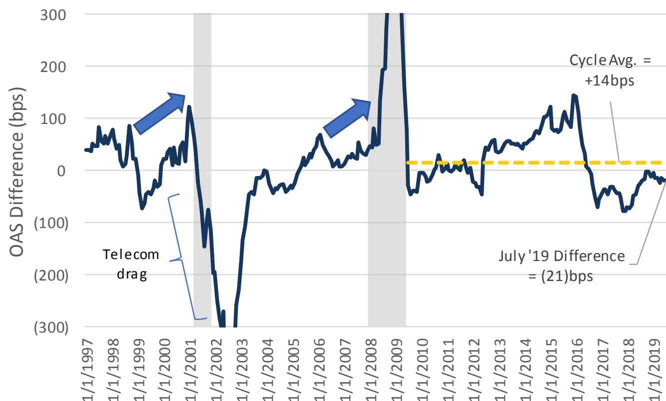


Source: SKY Harbor, ICE BofAML Indices

As a result of investor focus on duration, we think the relationship between historically cyclical and defensive sectors has created some attractive opportunities. As shown below, and excluding Energy credits from the "cyclical" bucket due to current trading dislocations, cyclical sector spreads are now 21 bps tighter than defensive sector spreads, despite a long-term average premium. Furthermore, should the yield curve be signaling a recession in the coming years, we note that cyclical sectors have historically widened relative to defensive sectors in the 24 months leading to a downturn. As such, we think the reach for duration has made defensive credits cheap, particularly in the context of corporate earnings growth pressure expected in the second half of 2019.

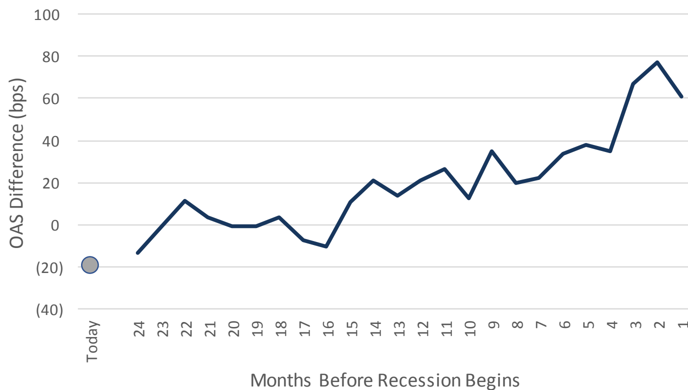
Historical OAS: Cyclical (ex Energy) less Defensive Sectors

monthly data, recessions shaded grey



Cyclical ex Energy less Defensive Sector OAS

monthly data, average of prior two cycles



Note: We include Banking, Consumer Goods, Healthcare, Insurance, Media, Services, Telecom and Utility in the "Cyclical ex Energy" group; we include Autos, Basic Industries, Capital Goods, Leisure, Real Estate, Retail, Tech and Transportation in the "Defensive" group

Source: SKY Harbor, Bloomberg, The National Bureau of Economic Research, ICE BofAML Indices

In conclusion, duration has been a key driver of credit market performance thus far in 2019, with underlying moves in rates driving more than half of YTD US high yield market returns (and nearly 75% of investment grade corporate returns). However, the shape of the HY corporate yield curve, spread duration compensation (or lack thereof), and the impact of convexity may diminish the efficacy of this trade as we progress through the second half of the year. Furthermore, we think a shift toward more defensive sectors makes sense on a relative value basis, particularly if the Treasury yield curve is signaling an economic downturn in late 2020 or 2021.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Existing Home Sales	21-Aug-19	Jul	5.40m	5.42m	5.27m
Initial Jobless Claims	22-Aug-19	17-Aug	216k	209k	220k
Leading Index	22-Aug-19	Jul	0.3%	0.5%	-0.3%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	3-Sep-19	Aug	51.2		51.2
Construction Spending MoM	3-Sep-19	Jul	0.3%		-1.3%
Trade Balance	4-Sep-19	Jul	-$55.3bn		-$55.2bn

Source: SKY Harbor, Bloomberg

Recommended Reading

Mander, Benedict et al. (2019, August 29). Argentina Seeks to Restructure $101bn of Debt. *Financial Times* (subs. req.), Retrieved from https://www.ft.com/content/1792542c-ca2f-11e9-af46-b09e8bfe60c0

Bloomberg News (2019, August 29). China Indicates It Won't Retaliate Now on New US Tariffs. *Bloomberg.com*, Retrieved from https://www.bloomberg.com/news/articles/2019-08-29/china-indicates-it-won-t-retaliate-against-newest-u-s-tariffs?srnd=premium

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