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September 30, 2019

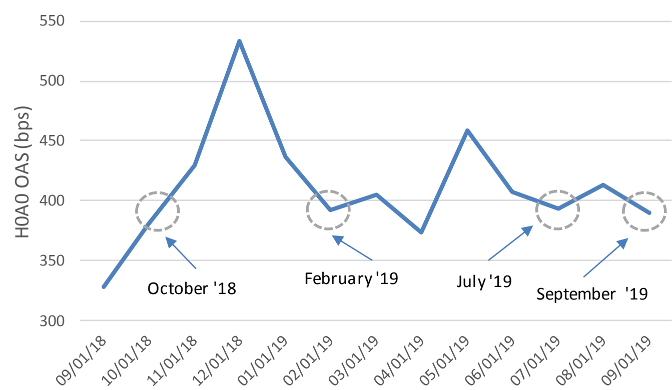
Weekly Briefing

SKYView: Asset Values

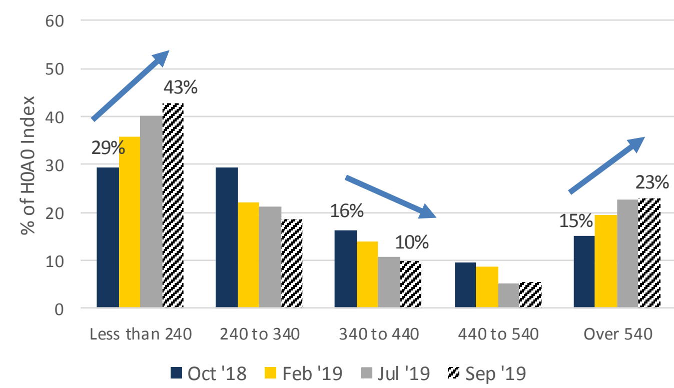
Investor confidence in the US high yield market has persisted, with spreads tightening ~ 30 bps over the last month. While this has been a familiar trend thus far in 2019, the gap between perceived "winners" and "losers" among corporate issuers has continued to expand. In this *Weekly Briefing*, we examine the growing level of dispersion in the US high yield market, and explore potential ramifications ranging from future default rates to active manager alpha generation.

Favorable market technicals and a spate of supportive macroeconomic data served to strengthen the bid for US high yield bonds in September, with the ICE BofAML US High Yield Index (ticker H0A0) tightening to the 390 bps context at the time of writing this piece. While an OAS of 390 bps is far from uncommon at various times in the last year (we identify four such periods below), **the degree of dispersion among issues in the index has risen substantively**. In particular, the percentage of H0A0 trading +/- 50 bps of the index (the 340 to 440 bps bucket) shrunk to 10%, down from 16% in October 2018. As expected, tails have increased in tandem, with the percentage of H0A0 trading more than 150 bps tight or 150 bps wide of the index (the "less than 240" and "over 540" bps buckets, respectively) migrating higher over time. Therefore, although absolute spreads near 390 bps appears insignificant in and of itself, there are increasingly fewer investment options hovering around index averages.

390 bps Spreads Have Already Been Achieved in the Last Year…
monthly data, trailing 1 year



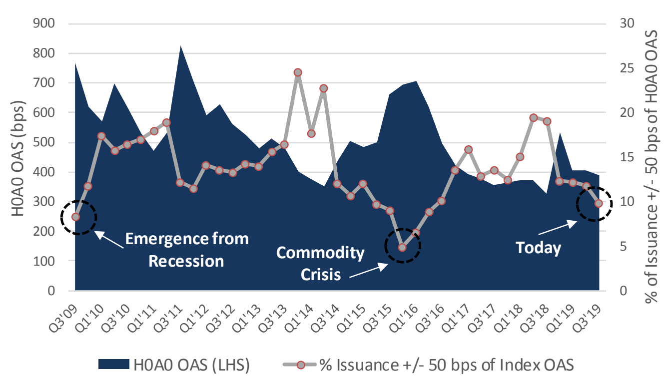
…But Index Dispersion Has Increased
month end data, % of index trading within various basis points buckets



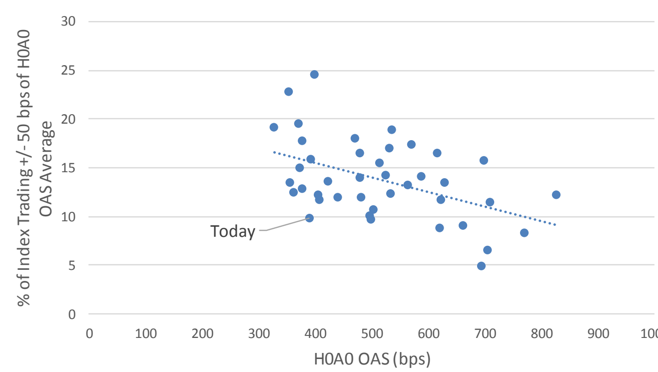
Note: Sep '19 data is as of September 24, 2019 (time of writing); other periods use month end data
Source: SKY Harbor, ICE BofAML Indices

How uncommon is this phenomenon? The percentage of H0A0 constituents trading +/- 50 bps of the index average (~ 10% at present) is below historical averages (~ 14%) but falls within the current cycle range. What does stand out is the degree of dispersion at relatively low index spread levels. As demonstrated below, there is a positive correlation between dispersion and overall index spread levels, with OAS at present about half as wide as the degree of dispersion would otherwise imply. Said differently, the last times we saw this level of dispersion was during the commodity crisis (in late '15 / early '16) and upon emergence from the last recession, both of which occurred when H0A0 spreads were ~ 700 bps or higher. Ultimately, we are encouraged by these market dynamics - in our view, **such data supports the idea that while bond spreads have tightened, they have not done so indiscriminately.**

% of Index Trading +/- 50 bps of H0A0 Average
quarterly data, current cycle



High Dispersion for Index OAS Level
quarterly data, current cycle



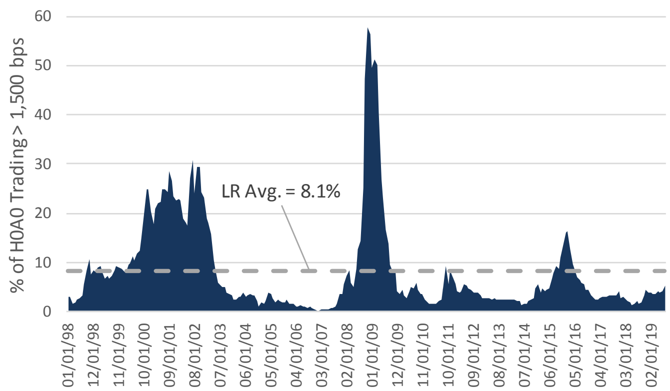
Source: SKY Harbor, ICE BofAML Indices, Citi

As an extension of that last point, we find that higher levels of dispersion would imply that HY bond managers are being selective with portfolio holdings despite "risk-on" sentiment for most of 2019. This **bolsters the view that the bond universe has been thoughtfully grouped into "winners" and "losers," with those likely to default already identified via investors pushing their spreads to highly distressed levels**.

Below, we present a time series showing the percentage (face value weighted) of H0A0 that traded wide of 1,500 bps over the last two decades. Despite spread tightening since the start of the year (-143 bps from December '18 to September '19), the percentage of H0A0 trading above 1,500 bps has actually increased from 3.4% to 5.2% (note this is still below the long-run average of 8.1%). Additionally, a comparison between the percentage of the market trading wide of 1,500 bps and the high yield market default rate seven months into the future displays a very high degree of correlation. The current percentage of the index trading wide of 1,500 bps implies a high yield default rate of ~ 3.5% seven months from now (the best fit lag between the two factors), which is very close to our SKY Default model output estimate of 3.6% (note that this model utilizes other factors, more notably the senior loan officer survey). Therefore, **while both measures imply an uptick in defaults over the intermediate term (from ~ 2.6% now to ~ 3.5% in seven months), we still expect overall defaults to remain below the long-run index average (~ 4.3%)**. Additionally, the market appears to have identified credits likely to default (the implied default rate driven by the percentage of H0A0 trading to highly distressed levels matches our multi-factor regression estimate), limiting the risk of negative surprises that lead to principal loss.

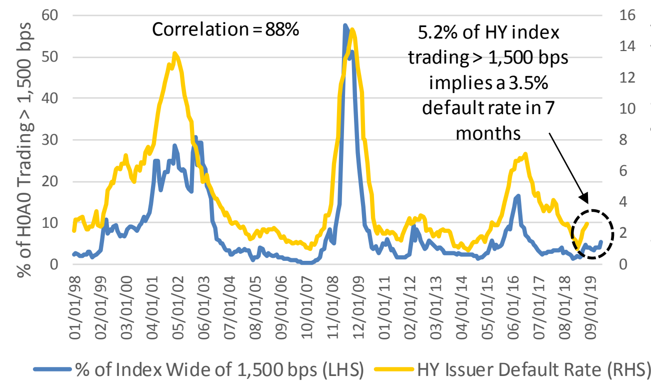
Highly Distressed Constituency Below Average But Has Grown…

monthly data since 1998



…And Now Reflects Forward-Looking Default Estimate

monthly data since 1998, distress rate **lagged 7 months**



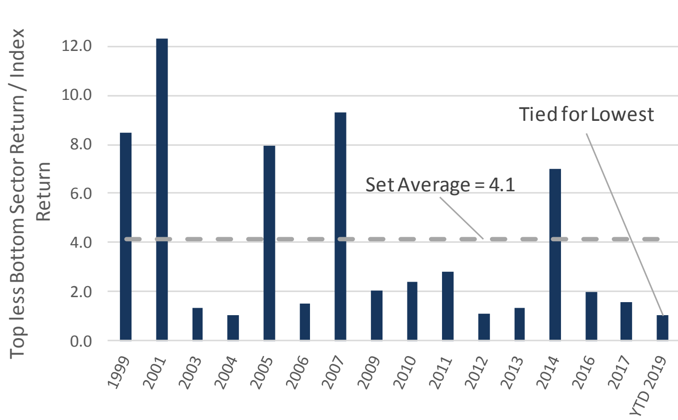
Source: SKY Harbor, ICE BofAML Indices, BofA Merrill Lynch, Federal Reserve, Bloomberg

All else being equal, elevated dispersion and the (presumed) delineation of credits likely to default should create an opportune environment for active managers to generate alpha, in our view. Additionally, it should be difficult for quasi-indexed managers to perform in this market since there are so few bonds actually trading at spreads near the index average.

Below, **we can see that the market has not rewarded sector allocation this year**. By way of example, we present sector return differentials in the left side chart below (top sector returns less bottom sector returns), normalized by dividing the result by the corresponding index average return. 2019 YTD differentials are among the lowest in the last two decades (using only positive returning years) despite acute Energy underperformance. Even adjusting our data set to include only years in which returns were over +10% (right side chart below), sector differentials in 2019 appear muted.

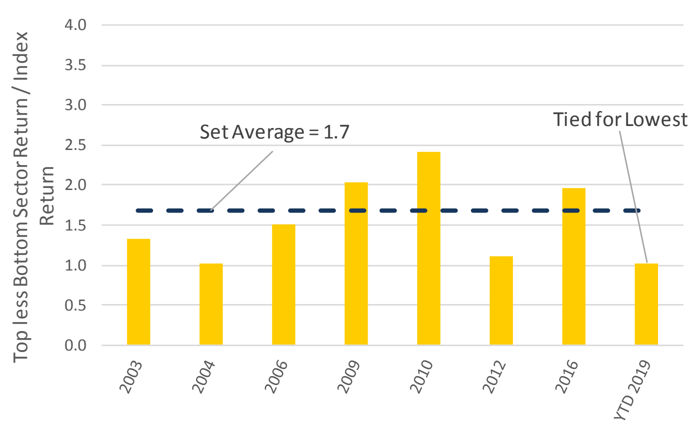
Return Differentials: (Top less Bottom Sector) / Index

annual and YTD Sep. 24, 2019 data; positive return years since '99



Return Differentials: (Top less Bottom Sector) / Index

annual and YTD Sep. 24, 2019 data; double-digit positive return years since '99



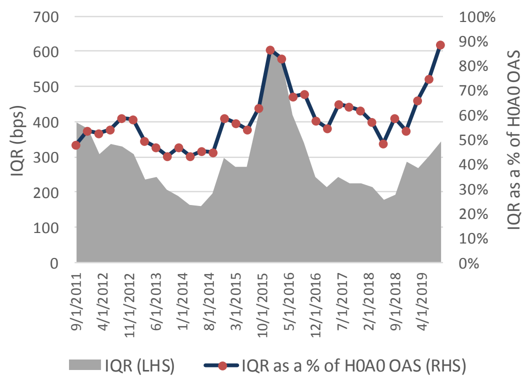
Source: SKY Harbor, ICE BofAML Indices

With sector rotation presently going unrewarded, we are left with individual security selection. Below, as an additional display of index dispersion, we show H0A0 index interquartile ranges (IQR) since 2011. Calculated by taking the spread differential between 75th and 25th percentile (by OAS level) bond issues in the index, we find the IQR at present (~345 bps) to be well above the quarterly average of our data set (~ 290 bps). Normalizing IQRs based on prevailing market conditions, we divide each by the average index OAS. By way of example, and utilizing data as of December 31, 2017, we find that the OAS for a 75th and 25th percentile bond was 412 bps and 188 bps, respectively, leading to an IQR of 224 bps (412 *less* 188 = 224). Therefore, the difference in spread between upper and lower quartiles was 224 bps, or ~ 62% of the index average OAS of 363 bps at that point in time. At the time of publication, H0A0 had an IQR of ~ 345 bps, or 88% of the index average OAS of 390 bps, the highest level of relative dispersion in our data set going back to 2011.

We postulate that high dispersion (which we have now) should lead to opportunities for alpha generation, but have managers actually demonstrated this in practice? In order to test the theory, we generated a list of ~ 50 US high yield bond managers in the eVestment database, and calculated median and 25th percentile manager performance over the last several years. Through regression analysis we find that next period active manager alpha (median and 25th percentile active manager returns less H0A0 returns on a quarterly basis) tends to increase when IQR as a percentage of H0A0 OAS is elevated, **implying that alpha generation and dispersion are indeed positively correlated**.

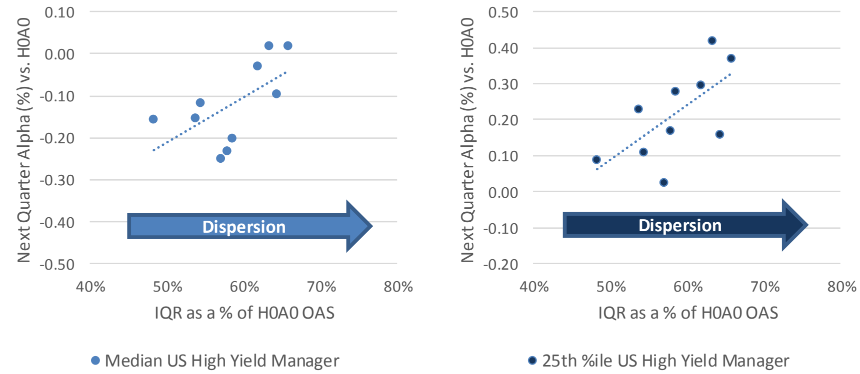
Interquartile Ranges (IQR) are Elevated

quarterly data since 2011



High Dispersion Positively Correlated With Active Manager Alpha Generation

US High Yield Managers from eVestment, trailing 10 quarters



Source: SKY Harbor, ICE BofAML Indices, eVestment

In conclusion, we find high levels of bond dispersion within H0A0 despite YTD spread tightening. We also think the market has identified the bulk of issuers with significant risk of principal loss, increasing the proportion of the index trading wide of 1,500 bps to a level commensurate with expected future defaults. Finally, we find evidence that high levels of dispersion coincide with next period active manager alpha generation, with the potential for intermediate-term outperformance likely a function of security selection amidst a backdrop of anemic sector return differentials.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Markit US Manufacturing PMI	23-Sep-19	Sep	50.4	51.0	50.3
Conf. Bd. Consumer Confidence	24-Sep-19	Sep	133.0	125.1	135.1
GDP Annualized QoQ	26-Sep-19	2Q	2.0%	2.0%	2.0%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	1-Oct-19	Sep	50.5		49.1
Construction Spending MoM	1-Oct-19	Aug	0.4%		0.1%
ADP Employment Change	2-Oct-19	Sep	140k		195k

Source: SKY Harbor, Bloomberg

Recommended Reading

Krauss, Melvyn (2019, September 25). Why Draghi's Policies Might Work Better Without Him. *Financial Times* (subs. req.), Retrieved from https://www.ft.com/content/15e9567a-df79-11e9-9743-db5a370481bc

Maher, Kris (2019, September 26). GM Strike Starts to Ripple Through Michigan Economy. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/gm-strike-starts-to-ripple-through-michigan-economy-11569490204?mod=hp_lead_pos5

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