

Weekly Briefing

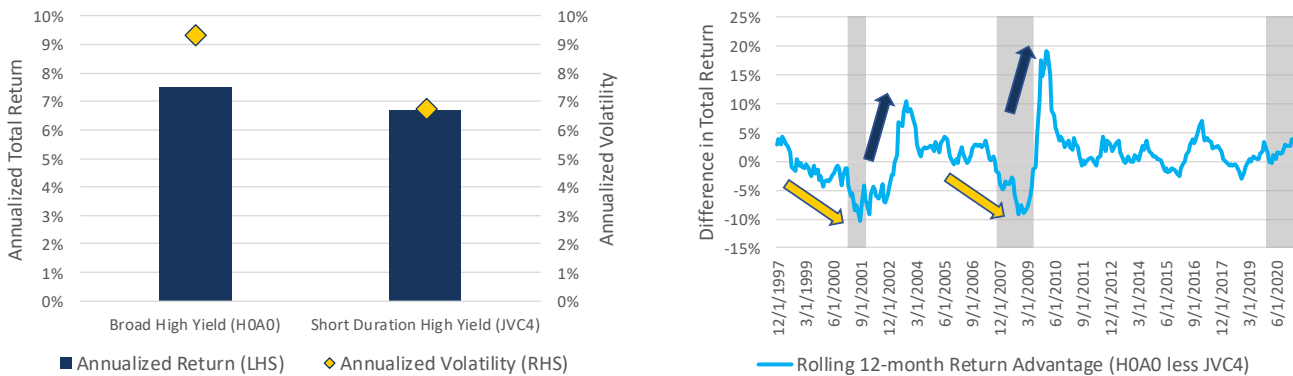
SKYView: A Sharp(e) Rebound in High Yield

In comparing the broad high yield market (we use the ICE BofA US High Yield Index, ticker HOA0 as our proxy) to its shorter-duration subset (we use the ICE BofA 1-5yr BB-B US High Yield Constrained Index, ticker JVC4 as our proxy), we find that over a cycle the former tends to generate superior absolute returns, while the latter generates superior risk-adjusted returns. Over the short run, however, this relationship can change, as has been the case over the last several months. On a year-to-date basis through the end of April, the shorter duration subset of the US high yield universe has outperformed, in our view driven by the fear of rising interest rates and disproportionate downside capture at the start of the pandemic. In this *Weekly Briefing* we examine broad and short duration high yield return trends over time, identifying optimal asset allocation shifts on the basis of prevailing market conditions.

Over the last twenty years, broad high yield (again, we use index HOA0 as our proxy) returns have outpaced the short duration high yield subset (we use index JVC4 as our proxy) by just over 75 bps on an annualized basis. At the same time, the volatility capture of JVC4 has been ~ 70% of HOA0, leading to a superior Sharpe Ratio¹ (0.65 and 0.79 for HOA0 and JVC4, respectively) as demonstrated below (left chart). Though performance varies throughout the cycle, **the broad market total return advantage (rolling 12-month returns of HOA0 less JVC4) tends to increase as a recession end date approaches, and accelerates through the early phases of a recovery. The short duration subset of the market, however, tends to outperform in late expansionary periods and through recessionary troughs**, with both trends visible in the chart below (right side). While clearly beneficial to be in the higher-beta / broad high yield market when the economy is recovering, and to be in the more resilient / less volatile short duration high yield market in periods of stress, the time in between - which makes up the majority of trading days within a business cycle – is a bit more nuanced.

Over Long Run, HOA0 Better Absolute Returns, JVC4 Better Risk-Adjusted Returns; Timing of Recession Drives Return Advantage

trailing 20-year annualized return and volatility metrics using monthly data; recessions shaded grey

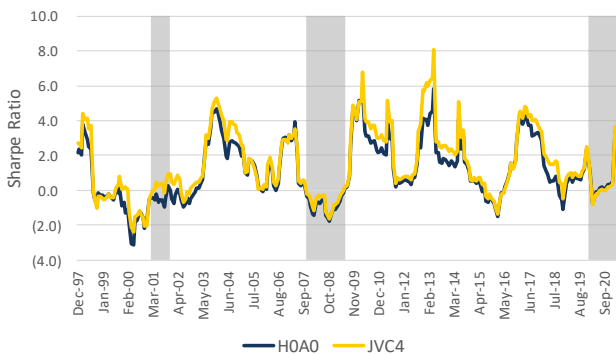


Source: SKY Harbor, ICE Data Indices

As noted above, the short duration high yield index (JVC4) tends to capture ~ 90% of the total return and ~ 70% of the volatility of the broad high yield index (HOA0) over the cycle, but the relationship can vary dramatically depending on market conditions. To demonstrate this dynamic, we calculated rolling 12-month Sharpe ratios of HOA0 and JVC4 over time, with the differential (JVC4 less HOA0) plotted below and to the right in blue. As is evident in the chart, **the risk-adjusted return advantage for JVC4 tends to accelerate in times of stress – including both recessionary and non-recessionary periods – before moderating and ultimately dropping below average upon an economic inflection.** The most recent COVID-induced recession was an exception, as we believe the rapid pace of the market selloff and subsequent correction, the latter aided by government intervention, disguised the historical resiliency of shorter-duration high yield bonds.

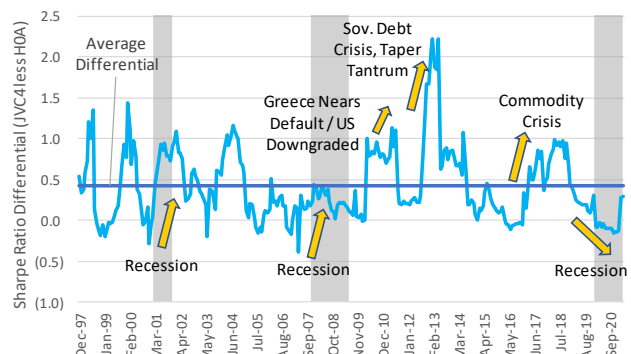
Rolling 12mo Sharpe Ratios

monthly data since Jan '97, recessions shaded grey



Rolling 12mo Sharpe Ratio Differential (JVC4 less HOA0)

monthly data since Jan '97, recessions shaded grey



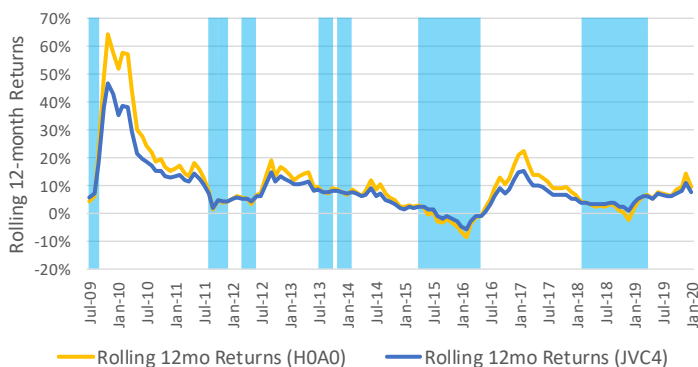
Source: SKY Harbor, ICE Data Indices, National Bureau of Economic Research, Bloomberg

¹ We use the ICE BofA US 3-Month Treasury Bill Index to approximate the risk-free rate in our Sharpe Ratio calculation

As previously stated, while it is clearly beneficial to be taking higher-beta / broad high yield market risk when the economy is recovering, and to favor the more resilient / less volatile short duration high yield market in periods of stress, the time in between - which makes up the majority of days in most business cycles - is less clear-cut. Odds favor outperformance of the broad high yield market over the short duration subset when a recession is unlikely, as demonstrated in the charts below, but it is far from a foregone conclusion. **Even the longest expansion in US history – the 128 months between the end of the global financial crisis and the start of the COVID pandemic – had significant periods of time (nearly 40% of months) in which JVC4 outperformed H0A0.** Having already experienced a rapid post-pandemic correction, and with fiscal and monetary policy unlikely to result in a double-dip recession, that “in-between” period in which the return advantage can swing in either direction is now at hand.

Expansionary Period (Post GFC to COVID) Rolling Returns

monthly data from July '09 to January '21, periods of JVC4 outperformance shaded blue



Expansionary Period Statistics: H0A0 vs. JVC4

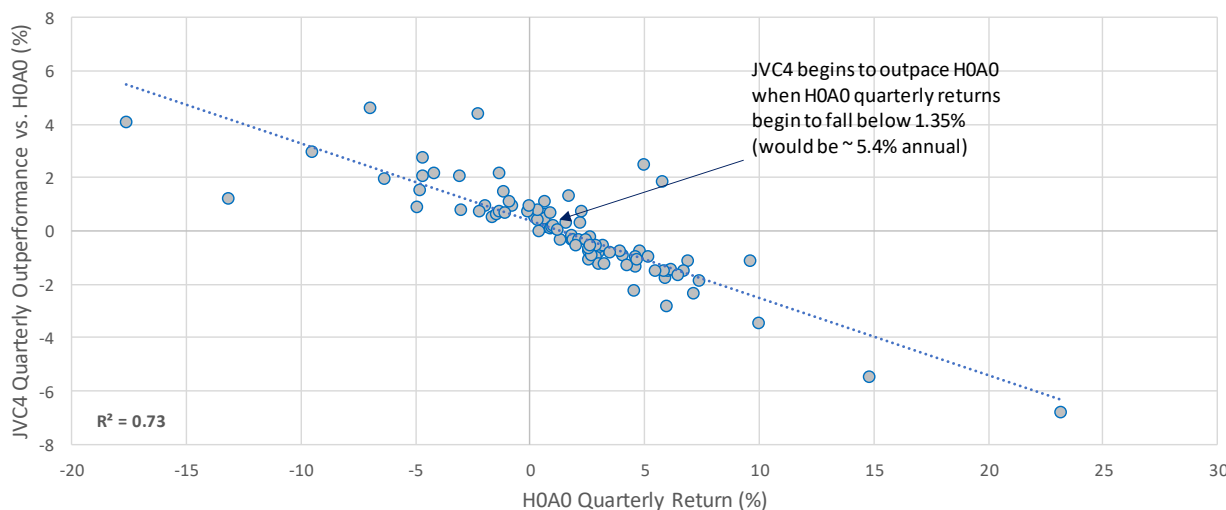
	H0A0	JVC4
Monthly Outperformance	61%	39%
Annualized Returns	9.1%	7.3%
Sharpe Ratio	1.37	1.66

Source: SKY Harbor, ICE Data Indices, Bloomberg

So, what factors influence our internal asset allocation views? We find that JVC4’s total return capture of H0A0 is highly correlated to the magnitude of H0A0 returns. Using total return data for both indices going back to 1998, **JVC4 outperformance of H0A0 (y-axis) hits breakeven levels and eventually turns positive when H0A0 quarterly returns (x-axis) are 1.35% or lower.** Annualized, this would approximate 5.4% total returns for the broad high yield index, a modestly sub-coupon type of year on an historical basis, and consistent with what we expect to see in 2021. In fact, year-to-date total returns through April 30 favor JVC4 over H0A0 (2.4% vs. 2.0%, respectively), and our FY21 estimated total return model (see **Appendix Table #1** for further details) similarly favors JVC4 over H0A0 (6.0% and 5.2%, respectively).

JVC4 Return Capture Rises as H0A0 Returns Decline; JVC4 Outperforms When H0A0 Annual Return Below 5.4%

using quarterly return data since 1997



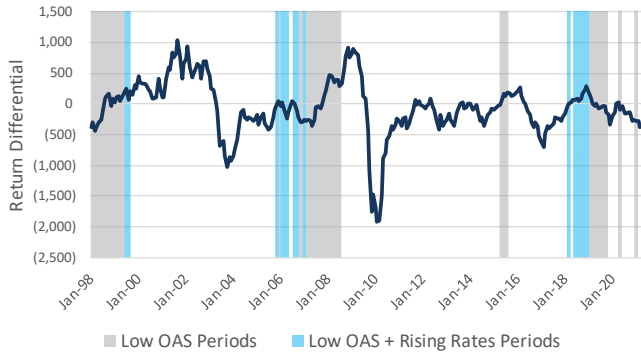
Source: SKY Harbor, ICE Data Indices

We next augmented our data set of return differentials (the short duration high yield index, or JVC4, less the broad high yield index, H0A0) with two additional variables - spread levels at the beginning of the rolling 12-month return period and the change in 10-year treasury yields during the 12-month return period. For simplicity, we will call rolling 12-month return periods that begin with spreads in the bottom quartile of historical observations (< 376 bps) as “Low OAS” periods, and rolling 12-month return periods during which Treasury yields rise by a top quartile amount (> 31 bps) as “Rising Rate” periods.

Using the full data set (all 280 observations, going back to January '98), rolling 12-month returns favor H0A0 by ~ 60 bps, and volatility capture of JVC4 is approximately two-thirds of the broad high yield market. When we limit the dataset to only “Low OAS” periods (70 observations), rolling 12-month returns favor H0A0 by only 2 bps, and volatility capture of JVC4 is reduced to 58%. When we further limit the data set to concurrent “Low OAS” and “Rising Rate” periods (14 observations), JVC4 has a return advantage of ~ 38 bps and captures only 56% of the return volatility of H0A0. As such, we would say that **H0A0’s subsequent total return advantage over JVC4 (on average ~ 60 bps per 12-month rolling period) erodes almost entirely when starting spreads are weakest quartile (“Low OAS” environments), and turns into a return disadvantage when you further add rising rates into the outlook (“Low OAS” and “Rising Rate” environments).** Furthermore, we find that JVC4 volatility capture remains low (50% to 70%) in all periods. This dynamic underpins our bias toward short duration high yield at present, as H0A0 spreads are currently bottom quartile (328 bps at the end of April '21), and consensus expectations call for the 10-year Treasury yield to rise ~ 35 bps in the coming quarters.

Rolling 12-month Return Differentials (JVC4 less H0A0)

based on monthly returns since January 1998



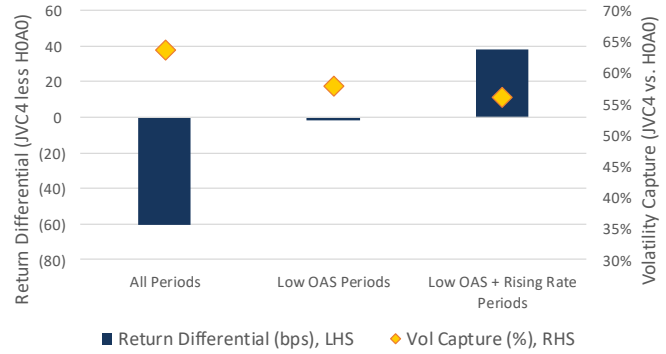
Low OAS Periods = Bottom Quartile Starting OAS

Low OAS + Rising Rate Periods = Bottom Quartile Starting OAS and Top Quartile Rising Rate Periods

Source: SKY Harbor, Ice Data Indices, Bloomberg

Rolling 12-month Return Differentials & Volatility Capture by Period Type

based on monthly returns since January 1998



Over the very long run, broad high yield (we use index H0A0 as our proxy) returns have outpaced the short duration high yield subset (we use index JVC4 as our proxy) by ~ 75 bps on an annualized basis. At the same time, the volatility capture of JVC4 has been ~ 70% of H0A0, leading to a superior Sharpe Ratio. Though performance varies throughout the cycle, the broad market (H0A0) total return advantage tends to increase as a recession end date approaches, and accelerates through the early phases of a recovery. The short duration subset of the market (JVC4) tends to outperform in late expansionary periods and through recessionary troughs. Performance in between the two cycle extremes is a bit more nuanced, but our analysis suggests that JVC4 is best positioned (generating better absolute and risk-adjusted returns) in rising rate environments that begin with high yield spreads in the tightest quartile of historical observations. This dynamic underpins our bias toward short duration high yield over the next year, as H0A0 spreads are currently bottom quartile (328 bps at the end of April '21), and consensus expectations call for the 10-year Treasury yield to rise ~ 35 bps in the coming quarters.

Appendix Table #1

Broad US High Yield Return Outlook

projections based on the ICE BofA US High Yield Index (H0A0)

	HY	5yr Trsy
Current Spread	328	86
Target	295	100
Predicted Change	-33	14
Duration	3.8	
Index Price	104.6	
Avg Par Coupon	588	
Tsy Change	14	
Total Change in Yield	-19	
Capital Gain	70	
Period Multiplier	0.67	
Current Yield	543	
Default Rate	3.50	
Price (default universe)	86.6	
Credit Loss	172	
Expected Periodic Return (5/1/21 to 12/31/21)	3.2 %	
YTD Return @ 4/30/21	2.0	
Implied Total Return (FY2021)	5.2 %	

Short Duration US High Yield Return Outlook

projections based on the ICE BofA 1-5yr BB-B US HY Index (JVC4)

	SD HY	3yr Trsy
Current Spread	287	34
Target	269	50
Predicted Change	-18	16
Duration	2.0	
Index Price	105.8	
Avg Par Coupon	613	
Tsy Change	16	
Total Change in Yield	-2	
Capital Gain	4	
Period Multiplier	0.67	
Current Yield	568	
Rating Migration Rate	2.00	
Price (downgrade universe)	97.3	
Downgrade Loss	40	
Expected Periodic Return (5/1/21 to 12/31/21)	3.6 %	
YTD Return @ 4/30/21	2.4	
Implied Total Return (FY2021)	6.0 %	

As of April 20, 2021

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

BofA Merrill Lynch Model, SKY Harbor variable estimates. The predictions herein are forward-looking statements, subject to change without notice due to changing market conditions, expectations, or judgments that could cause actual results to differ materially from those contained herein.

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