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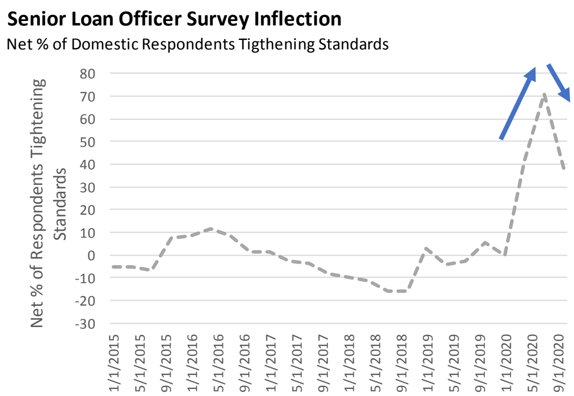
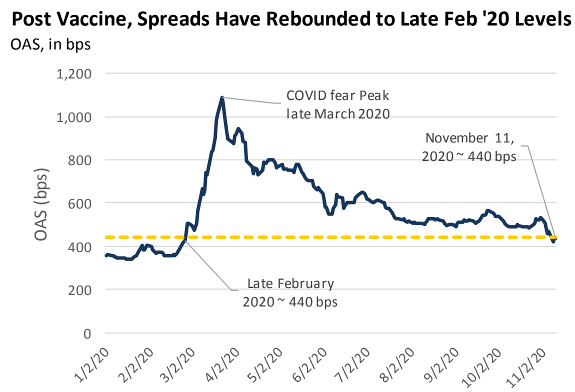
Weekly Briefing

SKYView: Vaccine Rally

On Monday, November 9, Pfizer announced that data collected from a COVID-19 vaccine under development implied an efficacy rate above 90%, leading to a strong rally in risk assets. This news, along with now diminished US election uncertainty and some positively trending macroeconomic data, led to 45 bps of spread tightening within the ICE BofA US High Yield Index (H0A0) in a single day. By Wednesday, November 11, US high yield spreads had compressed to approximately 440 bps, a level not seen since late February of this year, a period which predating the first confirmed US death from the coronavirus (February 29) and weeks before the first US counties issued shelter-in-place orders (March 16). Though aggregate index spreads are now nearly identical to February 28 levels, significant differentiation exists among and between various market cohorts. In this *Weekly Briefing*, we compare sector and issue-level spreads at present to those in late February 2020, identifying leaders and laggards in an effort to gauge relative value in a post-vaccine news environment.

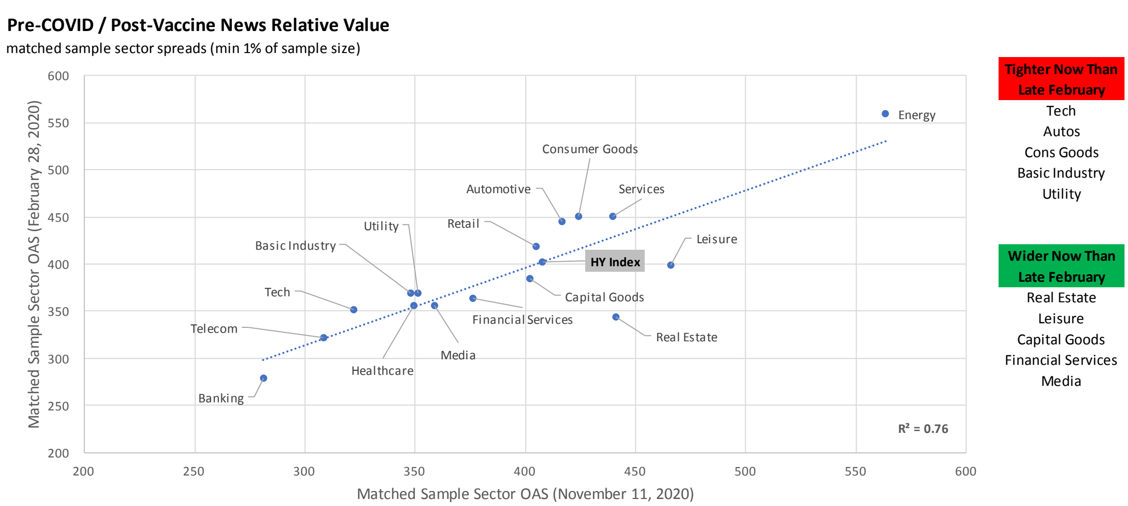
Global markets welcomed news that a COVID-19 vaccine, jointly developed by Pfizer and BioNTech, had achieved notable success in combating the virus during phase III clinical trials. US high yield bonds tightened 45 bps in the trading session that immediately followed, capping off a five-day run (beginning with the US election) in which H0A0 compressed 103 bps. In addition to vaccine hopes and reduced political uncertainty, an inflection in the Senior Loan Officer Opinion Survey on Bank Lending Practices (left chart below, and a key factor in our forward-looking default regression model) combined to push high yield spreads down to ~ 440 bps, a level that hadn't been reached since before the first reported coronavirus-induced death in the US. But, while index-level spreads at present are similar to those in late February 2020, trading levels of underlying constituents, in many cases, remains dramatically different.





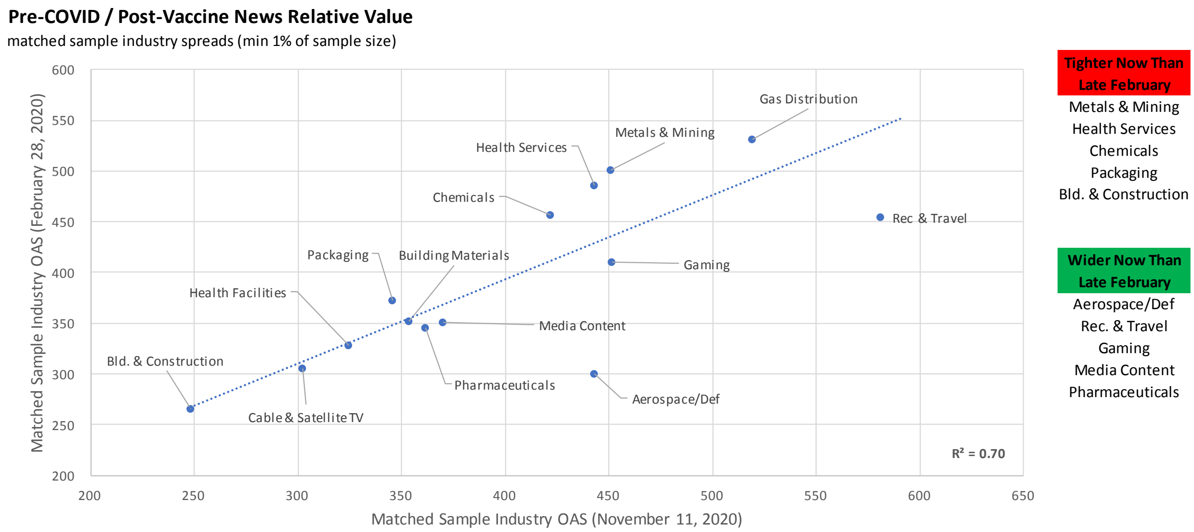
Source: SKY Harbor, Federal Reserve, ICE Data Indices

Given significant sector-level changes over the last several months – most notably from fallen angels entering and defaulted securities exiting the index – we created a matched sample universe limited to constituents contained within H0A0 both today and in late February. Furthermore, in an effort to exclude bonds whose spread may have been influenced by technical or structural factors, we eliminated any issue that traded at distressed levels or outside of a duration range of 2 to 8 in either period. The resulting data set, which numbered 600 issues and represented nearly half a trillion dollars in face value, was then segmented by sector. Below, we chart each sector on a scatterplot, with average spreads at the time of publication along the x-axis, and average spreads at February 28, 2020, along the y-axis. Percentile rankings derived from a ratio of current to Feb 28 OAS levels show that Technology, Autos, and Consumer Goods have tightened most significantly (and now on average trade inside of late February levels), while Real Estate, Leisure, and Capital Goods compression has lagged (and on average continue to trade wide of late February levels).



Source: SKY Harbor, ICE Data Indices

Using the same matched sample universe, we repeat the process, this time breaking down some of the more diverse sectors into industry-level segmentations. Again, using percentile rankings derived from a ratio of current to Feb 28 OAS levels, we find that Metals & Mining, Health Services, and Chemicals have tightened most significantly (and now on average trade inside of late February levels), while Aerospace & Defense, Recreation & Travel, and Gaming have lagged (and on average continue to trade wide of late February levels).



Source: SKY Harbor, ICE Data Indices

Upon further examination of the scatterplots included above, trading levels of most sectors and industries appear rational. For example, Technology trading tight to February levels – at least at the sector level – seems reasonable given a strong boost from coronavirus-related stresses throughout most of 2020 (more demand to serve and protect an increasingly disperse workforce) and the prospects of secular tailwinds to persist on the likely permanence of many work-from-home roles even when coronavirus concerns subside. Some sector trading levels, however, appear less justifiable, and may contain attractive total return opportunities. Having not suffered disproportionate credit metric degradation over the last few months, and potentially in a position to capitalize on stimulus spending and a sharp rebound in US GDP growth in 2021, should Capital Goods spreads remain persistently wide of pre-virus levels? As is most often the case, opportunities are best evaluated on a bottom-up basis.

Continuing the analysis on a more granular basis, we compared spreads of our matched sample universe at the issue level, focusing our efforts on bonds that fell in either extreme within our percentile ranking system (again using the ratio of current to Feb 28 OAS). In our view, alpha generation opportunities may exist in buying top decile laggards that are expected to fully recover in a post-vaccine world, and at the same time selling top decile leaders that are unlikely to continue to outperform once coronavirus stresses subside.

Representative Issuer Leaders & Laggards: Late Feb '20 vs. Today

bonds are among top decile leaders and laggards

Among Top Decile Lagging Group ("Cheap" screen)

Bond	Moody's	S&P	Sector	Current OAS	Late Feb OAS	Δ
CBSR 6 1/2 05/01/27	B3	B-	Media	756	423	334
WWW 5 09/01/26	Ba2	BB-	Retail	401	254	147
STWD 4 3/4 03/15/25	Ba3	B+	Real Estate	461	321	141
WYND 4.15 04/01/24	Ba3	BB-	Leisure	371	240	131
SAH 6 1/8 03/15/27	B2	B+	Retail	461	335	127
PKOH 6 5/8 04/15/27	Caa1	B-	Capital Goods	592	501	92
TMHC 5 5/8 03/01/24	Ba3	BB	Basic Industry	295	229	67

Among Top Decile Leading Group ("Rich" screen)

Bond	Moody's	S&P	Sector	Current OAS	Late Feb OAS	Δ
CCK 4 1/2 01/15/23	Ba3	BB-	Capital Goods	135	286	(151)
FCX 4.55 11/14/24	Ba1	BB	Basic Industry	152	298	(146)
TROX 5 3/4 10/01/25	B3	B	Basic Industry	442	563	(121)
NFLX 5 3/8 11/15/29	Ba3	BB	Media	184	303	(119)
MAT 5 7/8 12/15/27	B1	B+	Cons. Goods	249	360	(111)
ADT 4 1/8 06/15/23	Ba3	BB-	Services	177	251	(74)
DELL 3 3/8 06/01/23	WR	BB-	Technology	163	205	(42)

Source: SKY Harbor, ICE Data Indices

In conclusion, US high yield spreads tightened to levels not seen since Q1'20 due to progress on the vaccine front, post-election uncertainty alleviation, and some positive macroeconomic datapoints. While index spreads in the 440 bps context are similar to those in a pre-lockdown world, there are still areas of sector, industry, and issuer-level dislocation. In our view, alpha generation opportunities may exist in buying top decile laggards that are expected to fully recover in a post-vaccine world, and at the same time selling top decile leaders that are unlikely to continue to outperform once coronavirus stresses subside.

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