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January 27, 2020

SKY HARBOR
CAPITAL MANAGEMENT

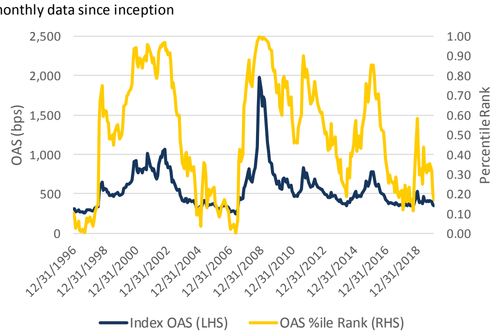
Weekly Briefing

SKYView: Spread Tights

US high yield spreads have rallied over 50 bps since the start of December 2019, ending at 349 bps at the close of the most recent trading day (January 22). Despite spreads compressing well inside of long-term index averages, we find valuations justifiable given solid credit metrics, limited credit losses expected over the next 12 months, opportunities for alpha generation given elevated dispersion, and protection in a suddenly acute or slowly drawn out yield-widening environment. Increased index quality, a persistent trend over the last several quarters, also supports our sanguine view of US high yield. In this *Weekly Briefing*, we take a deeper look at spread levels given underlying changes to the index over the last several years, and compare relative value of high yield to investment grade credit in the current market environment.

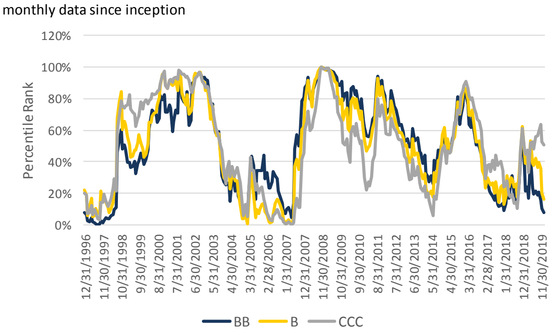
US high yield spreads have rallied ~ 50 bps since the start of December '19, owing to an extension of the positive sentiment and supportive technicals that largely characterized 2019. **While an OAS of 349 bps is tighter than average, the level does not register as bottom decile since the inception of the ICE BofA US High Yield Index (over two decades of data).** As of December 31, 2019 and January 22, 2020, high yield spreads were 360 bps and 349 bps, respectively, or 20th and 17th percentiles relative to the 23+ year history of the index. Furthermore, note that BBs (spreads of 202 bps, or 10th percentile) represent the tightest part of the index, making Single-B credits (our area of focus) more attractive than broad-based index averages would otherwise suggest.

ICE BofA US High Yield Index Spread Evoluation (OAS)
monthly data since inception



	Date:	OAS (bps)	%ile Rank
Prior Month End (Dec. 31, 2019)		360	0.20
Prior Day End (Jan. 22, 2020)		349	0.17
Month-End OAS	BB	202	0.10
	B	356	0.20
	CCC	1008	0.53

High Yield OAS Percentile Rankings by Rating Bucket
monthly data since inception



Source: SKY Harbor, ICE BofA Indices

Although bottom quartile at present, we highlight that **spreads have historically tightened much further than current levels in prior late-cycle periods**. In the expansion that ended in March 2001, spreads troughed at 244 bps, 105 bps tighter than they are today. Similarly, in the expansionary period ended December 2007, spreads registered as low as 241 bps, 108 bps tighter than they are today. Even in the current expansionary period, cycle tights of 316 bps (achieved October 3, 2018) imply further compression opportunity from present levels. Furthermore, we would note that **the quality of the US high yield bond index has improved relative to prior cyclically tight periods**, with the percentage of the market made up of BBs currently much higher than in the aforementioned spread tight periods of the past (the proportion of CCCs in the index at present is also lower than prior cyclically tight periods). **Adjusting for differences in quality, prior cycle tights would likely have approximated 250 bps, nearly 100 bps below current levels.**

US High Yield Index (H0A0)			Market Value by Rating			Quality Adjusted	
Expansion End Date:	OAS Tight	Date Achieved	% BB	% B	% CCC	OAS Tight	
March '01	244	10/17/1997	36%	51%	12%	225	
December '07	241	6/5/2007	38%	43%	18%	225	
Current (Ongoing)	316	10/3/2018	46%	41%	13%	309	
						253	Average
Spread Today	349	1/22/2020	49%	39%	12%		

US Investment grade spreads of 99 bps, at first glance, appear to offer slightly better value (22nd percentile over the same 23-year timeframe, vs. 17th percentile for US high yield). However, the rapid growth of the BBB portion of the market has led to quality degradation over the last two decades. Similarly **adjusting for differences in quality of the ICE BofA US Corporate Index, prior cycle tights would likely have been only 20 bps below current levels.**

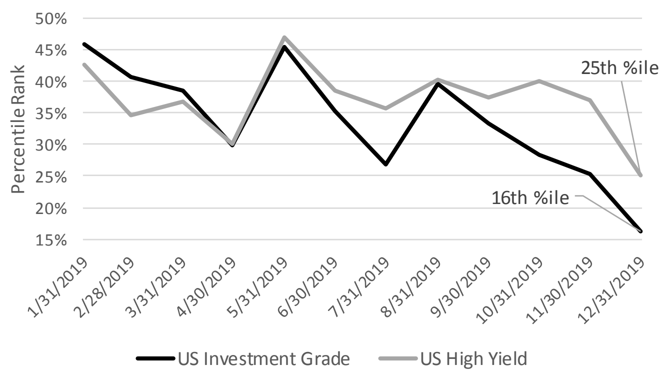
US Investment Grade Index (C0A0)			Market Value by Rating				Quality Adjusted	
Expansion End Date:	OAS Tight	Date Achieved	% AAA	% AA	% A	% BBB	OAS Tight	
March '01	53	10/3/1997	5%	17%	49%	30%	59	
December '07	79	3/2/2005	6%	17%	38%	40%	85	
Current (Ongoing)	90	2/1/2018	2%	9%	41%	48%	91	
							79	Average
Spread Today	99	1/22/2020	2%	8%	40%	50%		

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

The resulting OAS percentile rankings, adjusted for differences in index quality over time, reverse the modest investment grade advantage identified earlier into a more significant advantage for high yield. For more risk-averse investors, or for those that prioritize the limiting of volatility in the current market environment, we view short duration high yield as being favorable to investment grade credit. In addition to greater carry (yield-to-worst of ~ 4.7% for JVC4, our proxy for short duration HY vs. ~ 3.0% for C0A0, our proxy for investment grade credit) **short duration high yield has provided superior risk-adjusted returns over the cycle relative to IG**. As shown in the chart below, short duration high yield has generated annualized returns that are over 100 bps greater than investment grade credit, with identical volatility.

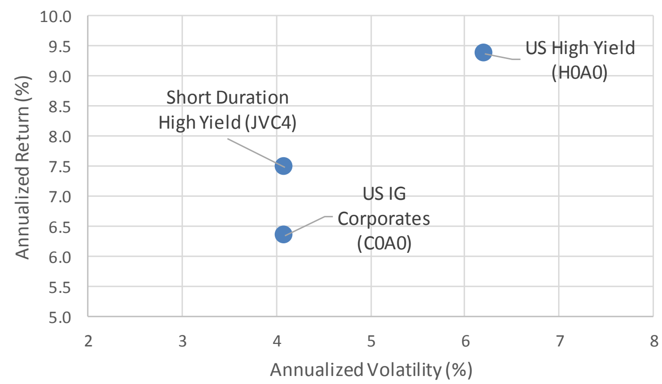
Quality-Adjusted OAS Percentiles: IG vs HY

based on monthly data since inception (1997)



Risk vs. Return: Current Cycle (July '09 to Present)

annualized return and volatility based on monthly data



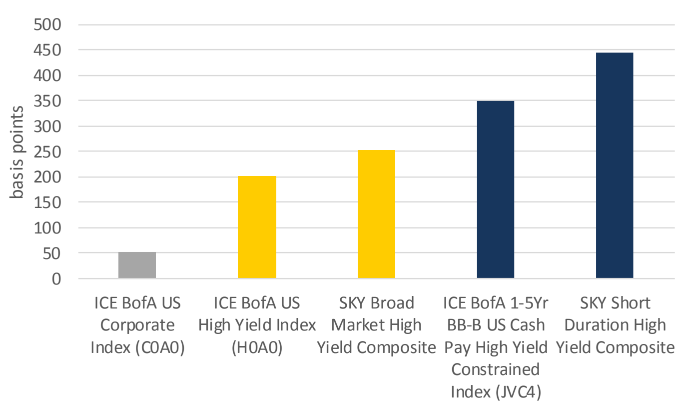
Source: SKY Harbor, ICE BofA Indices. JVC4 = ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index

We acknowledge that very strong 2019 high yield returns, tight valuations and completion of US/China trade deal "phase 1" have some investors concerned that the path of least resistance in 2020 is one of yield widening. While we do not share this view, we nevertheless re-simulated the impact a hypothetical environment of rising yields would have on investment grade and high yield index returns, updated to reflect post-rally metrics. Like our original analysis *(*see *Weekly Briefing,* November 12, 2018*)*, the following simulation aims to calculate the maximum all-in yield increase an asset class could handle before total returns fell below breakeven levels (i.e., the point at which interest income is fully offset by the negative impact of rising yields). Also similar to our original analysis, it becomes apparent that **high yield – particularly short duration high yield – can better handle the impact of yield increases (whether due to a rise in Treasury rates or risk premiums)**. In fact, the embedded cushion for SKY Harbor's SKY Short Duration High Yield Composite (~ 450 bps) is nearly 9x greater than the investment grade index (~ 50 bps).

Should the market experience a rapid increase in yields rather than measured and linear widening over the next 12-month period, high yield remains similarly advantaged. To better visualize this risk, we ran a simulation which assumes the high yield market suffers a 100 bps shock on day 1 of an investment in the asset class. After 100 bps of widening, we then assume yields remain steady over the next twelve months and quantify how long it would take the resulting carry to offset the initial drop in investment value. As demonstrated below, short duration high yield would recoup initial losses in the subsequent 4 months while still generating a total return of ~ 5.25% for the full year. Assuming a 25 bps shock on day 1 to the US investment grade index (spread change beta for C0A0 relative to high yield indices is ~ 0.25), the IG investment is slower to recover initial loss of principal (6 months, vs. 4 months for short duration high yield) and full-year returns are lower at ~ 2.00%.

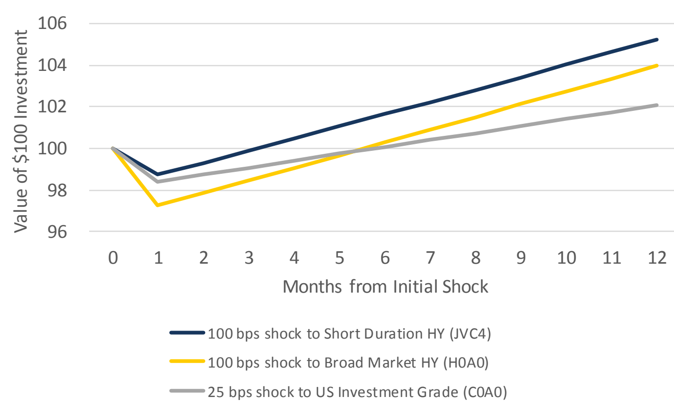
Breakevens by Index, Linear Yield Widening Scenario

12-month time horizon



Recovery Timing, Rate Shock Scenario

cumulative returns, 12-month time horizon



Source: SKY Harbor, ICE BofA Indices; data as of January '20

We continue to be optimistic about the US high yield bond market despite material spread compression in December '19 and thus far in January '20. While index-wide spreads are below average, we find valuations justifiable given solid credit metrics, limited credit losses expected over the next 12 months, opportunities for alpha generation given elevated dispersion, and protection in a suddenly acute or slowly drawn out yield-widening environment. Adjusted for the evolution of index quality, high yield spreads appear more attractive, in our opinion, than those of investment grade at present, and our simulations suggest to us superior downside protection for high yield should yields temporarily increase.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Industrial Production	17-Jan-20	Dec	-0.2%	-0.3%	1.1%
U. of Michigan Cons. Sentiment	17-Jan-20	Jan	99.3	99.1	99.3
Housing Starts	17-Jan-20	Dec	1,380k	1,608k	1365k

Source: SKY Harbor, Bloomberg

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Durable Goods Orders	28-Jan-20	Dec	0.5%		-2.1%
Conf. Board Consumer Confid.	28-Jan-20	Jan	128.0		126.5
FOMC Rate Decision (upper)	29-Jan-20	30-Jan	1.75%		1.75%

Recommended Reading

Fink, Larry (2020, January). A Fundamental Reshaping of Finance, Retrieved from https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

Yang, Stephanie and Abbott, Brianna (2020, January 24). Coronavirus Death Toll Rises in China as US Reports Second Case. *The Wall Street Journal (subs. req.)*, Retrieved from https://www.wsj.com/articles/spreading-chinese-coronavirus-death-toll-rises-as-more-cities-are-locked-down-11579860808?mod=hp_lead_pos2

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