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SKY HARBOR
CAPITAL MANAGEMENT

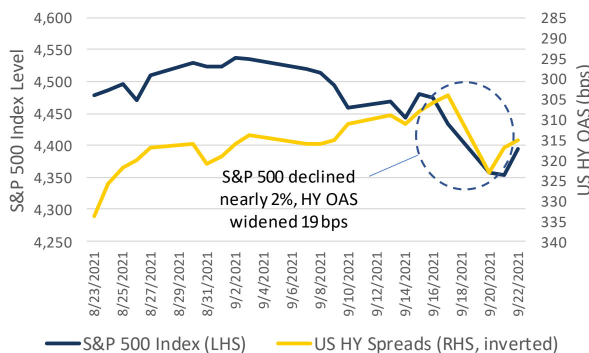
SKY Harbor Weekly Briefing

SKYView: Distress, Defaults, and Dots

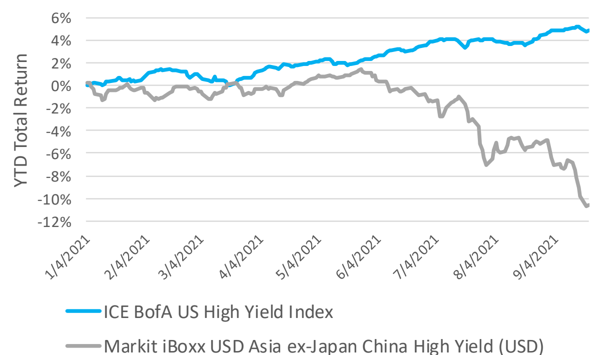
Government crackdowns and distress in one of China's largest property developers set off a sharp selloff in risk assets, with many market participants fearing a large default would usher in China's "Lehman moment." Monday's toll – which included a 2.4% decline in the Russell 200 Index and a 34 bps hit to US high yield returns – was met with assurances from Chinese banks that exposure to Evergrande was manageable, spurring a rally in US assets as investors became increasingly comfortable that Western institutions were even further insulated from any potential fallout. Attention quickly turned to the Fed, with risk assets continuing to recover despite somewhat hawkish developments in FOMC projections and a clear indication that a start to tapering was imminent. In this *Weekly Briefing*, we examine Monday's selloff and subsequent recovery, identifying market laggards that appear mispriced following highly volatile market conditions.

Founded in 1996, Evergrande is one of China's leading property developers. Fueled by debt issuance, the company grew significantly over the last decade, a period marked by significant private investment in real estate and surging home prices across the country. In response to the rapid rise in corporate indebtedness, leaders in China created the "Three Red Lines" policy in mid-2020, requiring highly indebted property developers to adhere to strict guidelines, all with the aim of deleveraging key players. Concurrent with enhanced scrutiny over the sector, **Evergrande has, over the last few months, been dealing with eroding liquidity, frozen bank deposits, and various work stoppages, all of which has led to an increasingly high risk of default**. With significant interest payments coming due over the past week, many investors feared a default could lead to a "Lehman moment," triggering a collapse in the financial system given disperse exposure to Evergrande debt. As a result, US high yield sold off this past Monday (September 20th), though pressures are seemingly negligible in comparison to the stress dollar-denominated China HY indices have fared year to date (right chart below).

China Evergrande Stress Dampened Markets on Monday
daily data, trailing 1 month



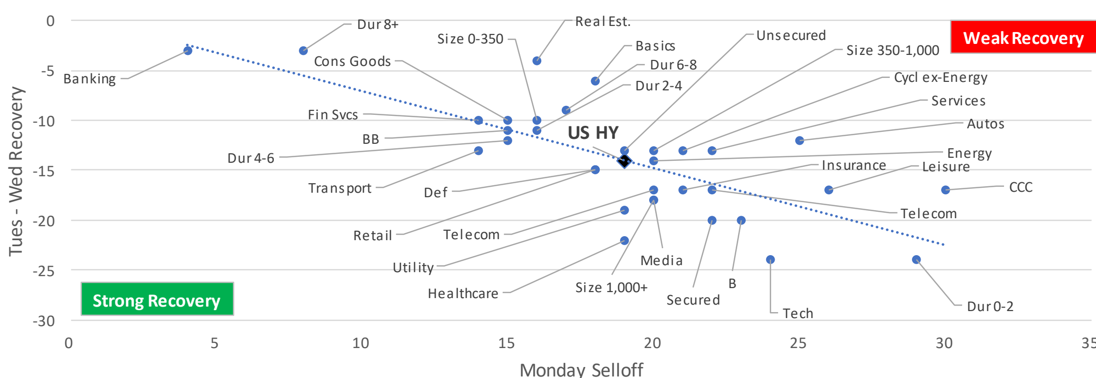
China HY Continues to Lag US HY in 2021
daily data, since the start of the year



Source: SKY Harbor, ICE Data Indices, Bloomberg

Though no Evergrande debt is present in the ICE BofA US High Yield Index (H0A0), **spread levels widened 19 bps on Monday, a function of contagion risk and an additional sign of mounting pressures in China**. The widening represented the second steepest one-day move in US high yield markets thus far in 2021 (the beginning of COVID wave #4 on July 19th was the biggest move, with H0A0 widening 26 bps on that day). However, markets quickly ascribed a lower probability of spillover risk, leading to a high yield (and other risk assets, for that matter) rally in the subsequent three-day period. By the time of writing (Thursday evening), H0A0 spreads had recovered 74% of Monday's selloff, in-line with the 77% spread recovery in the three trading days that followed the July 19th selloff. In comparing both periods of stress, we find significant similarities in initial market reactions (lower-rated credit hit worse than higher-rated credit, shorter duration widened more than longer duration, large bonds sold off more than small bonds, cyclicals suffered more selling pressure than defensives, etc.) and in aggregate recovery cadence. However, **leading and lagging market constituency recoveries were quite different, with re-opening / infrastructure credits (Real Estate, Basics, Capital Goods), lower quality (B and CCC), and longer duration (Dur 8+, Dur 6-8) slower to rebound this time around**.

Post-Selloff Recovery Has Been Orderly
Monday selloff vs. Tue/Wed Recovery



Source: SKY Harbor, ICE Data Indices

Recovery Leaders & Laggards
Tue/Wed Recovery vs. Monday Selloff

Top Recoveries	
Healthcare	116%
Tech	100%
Utility	100%
Transport	93%
Secured	91%
Size 1,000+	90%
Media	90%
US HY Index	**74%**
Bottom Recoveries	
Real Est.	25%
Basics	33%
Dur 8+	38%
Autos	48%
Dur 6-8	53%
CCC	57%
Services	59%

Though we highlight several areas of the market that have lagged in the trailing 3-day recovery, we are mindful that news out of the Fed on Wednesday may have altered investor preferences. In general, Powell was his usual measured self, cognizant of still-lingering effects of the delta variant while noting continued progress in economic growth as the re-opening progresses. While the Fed Funds target rate range of 0% - .25% remained unchanged, his prepared remarks did note **that the committee feels as though "moderation in the pace of asset purchases may soon be warranted."** On balance, the consensus view seems to be that the start of tapering will be announced at the November meeting, and will likely conclude by the middle of 2022 (implying a $15bn ratcheting of the taper pace per month). Furthermore, the committee's Summary of Economic Projections included a downgrading of GDP growth in '21 (from +7.0% to +5.9%), partially offset by upgrading of GDP growth in '22 (from +3.3% to +3.8%) and '23, broadly in-line with recent high-frequency data, and something already incorporated into our recently revised high yield constituent EBITDA growth and default model forecasts. Additionally, updated projections also call for higher than previously expected inflation, largely the result of supply chain issues and other recent economic developments.

FOMC Statement Highlights

released September 22, 2021

Key Commentary from Fed Chairman Powell

"Real GDP rose at a robust 6.4% pace in the first half of the year, and growth is widely expected to continue at a strong pace in the second half."

"Partly reflecting the effects of the virus and supply constraints, forecasts from FOMC participants for economic growth this year have been revised somewhat lower since our June summary of economic projections, but participants still foresee rapid growth."

FOMC participants project the labor market to continue to improve..."

"If progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted."

"...participants generally view that so long as the recovery remains on track a gradual tapering process that concludes around the middle of next year is likely to be appropriate."

Updated (September) Summary of Economic Projections

	2021	2022	2023	2024	Long Run
Real GDP Growth	**5.9**	**3.8**	**2.5**	**2.0**	**1.8**
(June Projection)	7.0	3.3	2.4		1.8
Unemployment Rate	**4.8**	**3.8**	**3.5**	**3.5**	**4.0**
(June Projection)	4.5	3.8	3.5		4.0
PCE Inflation	**4.2**	**2.2**	**2.2**	**2.1**	**2.0**
(June Projection)	3.4	2.1	2.2		2.0
Core PCE Inflation	**3.7**	**2.3**	**2.2**	**2.1**	
(June Projection)	3.0	2.1	2.1		

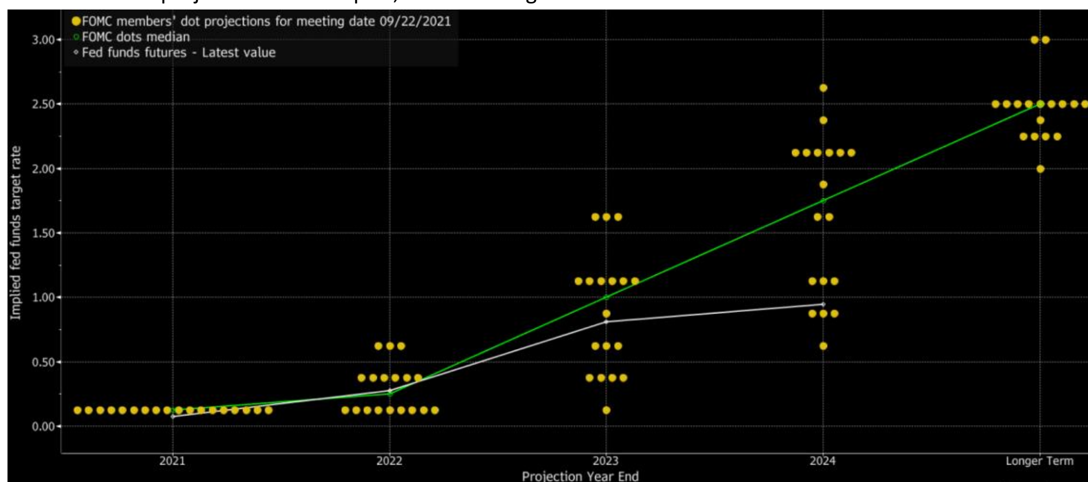
Direction Key: Higher | Lower

Source: SKY Harbor, Federal Reserve

Perhaps most surprising was a migration in the dot plot, with two additional FOMC members expecting a liftoff in 2022 (in the June meeting, 11 signaled no hikes in 2022 and 7 signaled one hike; in September, the count was even at 9 vs 9). Furthermore, the median dot implied three additional hikes in 2023 and 2024, both representing an increase vs. our view of consensus expectations ahead of the meeting. With perhaps a slightly more hawkish than expected tone, a lagging recovery in longer-duration securities (recall that the 8+ and 6-8 duration buckets have shown a slower recovery cadence relative to the last selloff, and are lagging the market recovery in general this time around) appears justified. However, and notwithstanding the potential for slower growth out of China, a weak recovery in **Real Estate, Basics, and Capital Goods appears like an investment opportunity, particularly for constituent credits that derive most of their demand from US end markets**. Finally, our updated projections for corporate de-leveraging and minimal defaults remain intact, and as such we view a weaker than expected recovery of lower-rated credit as a buying opportunity.

Fed Dot Plot Shows Liftoff May Happen Sooner Than Expected

FOMC member projections from Sep 22, 2021 meeting



FOMC Member '22 Rate Expectations

Meeting	Same	Higher
June	11	7
September	9	9

FOMC Member Exp. Hikes Through '23

Meeting	#
June	2.0
September	3.5

Source: SKY Harbor, Federal Reserve, Bloomberg

In conclusion, Evergrande default fears that jumpstarted the early-week selloff proved fleeting in nature, as investors almost immediately factored in a lower than originally feared risk of contagion. The ensuing recovery (through Thursday, September 23rd), though sharp, created some notable laggards. Excluding portions of the market impacted by a slightly more hawkish than expected Fed, we now find attractive buying opportunities in higher-yielding and industrial / manufacturing focused credits insulated from economic and geopolitical risks in China.

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