

SKY Harbor Weekly Briefing

SKYView: Sometimes the Best Offense is a Good Defense

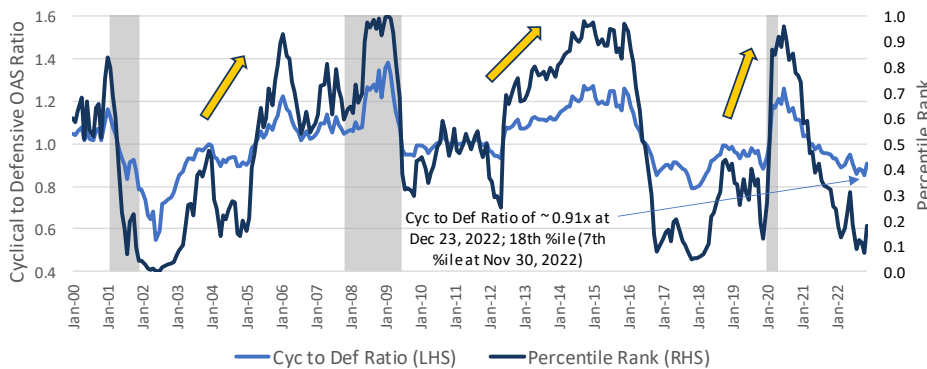
Risk asset performance has been mixed thus far in December, with US equities (S&P 500 Index) down over 5% while US High Yield (ICE BofA US High Yield Index) total returns have remained modestly positive at +.07%. A hawkish tone struck at the December FOMC meeting has contributed to a selloff in rates (the 5-year US Treasury yield is up 16 bps this month), all while corporate earnings expectations have moderated, a function of weakening economic data and fears that willingness for US consumers to continue spending has begun to wane. Given this backdrop, and an increasingly binary set of expectations for 2023 (both the recession and soft landing camps have gained followers, with little left in between), we use this *Weekly Briefing* to highlight portfolio positioning, with a focus on the trade-off between cyclical and defensive sectors.

Cyclical to Defensive Spread Ratio Now Bottom Quartile

In our 2023 *US High Yield Outlook* report, we highlighted our view of **better value among “defensive” sectors, in part due to a depressed cyclical (ex-energy) to defensive option-adjusted spread (OAS) ratio**. At the time of our outlook publication, that ratio was 0.85x, 7th percentile on an historical basis, having compressed meaningfully throughout 2022. Since then, defensive sector spreads have outperformed cyclicals, pushing the OAS ratio up to 0.91x – though still low historically at 18th percentile – and leading to modest defensive sector outperformance of approximately 7 bps. Going forward, we continue to expect the cyclical to defensive spread ratio to increase – historically consistent with market behavior going into periods of uncertainty – and believe this dynamic could contribute to outperformance in 2023.

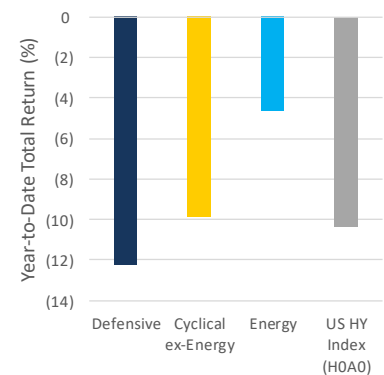
Cyclical (ex-Energy) to Defensive OAS Ratio Nearing All-Time Lows

monthly data since 2000, recessions shaded grey



YTD Returns Favor Energy & Cyclicals

data as of December 23, 2022



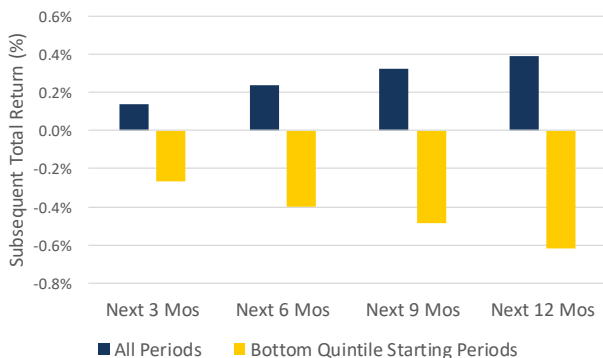
Source: SKY Harbor, ICE Data Indices, National Bureau of Economic Research
“Defensive” sectors include Banks, Consumer Goods, Financial Services, Healthcare, Insurance, Media, Services, Telecom, & Utility; “Cyclical ex-Energy” sectors include Autos, Basic Industries, Capital Goods, Leisure, Real Estate, Retail, Technology, & Transportation

Stage May Be Set for Defensive Outperformance

Looking back over the last decade, cyclicals (ex-energy) have outperformed defensives in aggregate, the former typically better positioned in times of spread compression (which occurred in 58% of our dataset observations). **Limiting our dataset to include only starting periods in which the cyclical to defensive OAS ratio was bottom quintile (as it is now), subsequent 3, 6, 9, and 12-month periods all favored defensive sectors, on average.** In fact, and as demonstrated below (right side), defensive sectors have outperformed cyclicals in 73% of all rolling 3-month periods over the last decade that begin with a bottom quartile cyclical to defensive OAS ratio. Over 12-month periods, the defensive total return advantage has on average exceeded 60 bps.

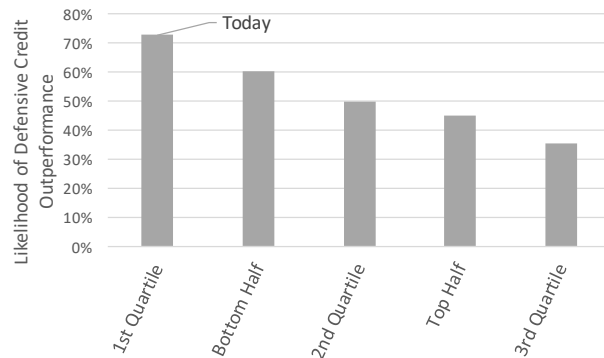
Cyclical (ex Energy) Outperformance vs. Defensive Credits

monthly data, trailing 10 years



Historical Likelihood Defensives O/P Cyclicals by Starting OAS Ratio

over next 3 month period



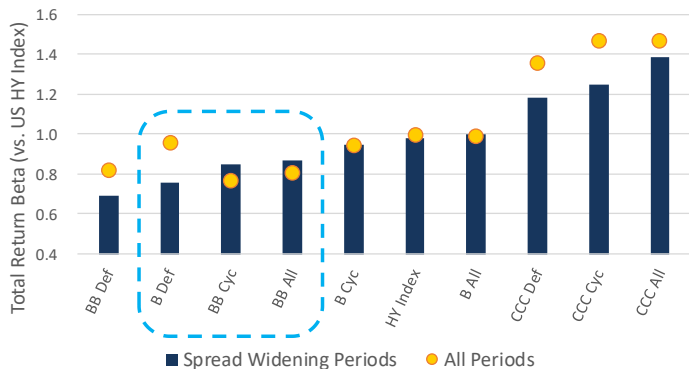
Source: SKY Harbor, ICE Data Indices

"Defensive" Designation May Matter More Than Rating

Expanding upon our analysis, and anchoring our work under the assumption that index spreads may widen in the coming 12-month period (recall that we noted in our 2023 US High Yield Outlook report that our base case fair value of spreads was in the 570 bps range, ~ 115 bps wide of levels at present, though manageable from a total return perspective in the context of elevated yield-to-worst levels), we calculated total return beta by rating bucket and sector type. As highlighted below (left side), **single-B "defensive" sector constituents have shown less downside return volatility than BB "cyclical" sector constituents in spread widening periods despite an inferior credit rating.** As such, we might expect defensive single-Bs to outperform cyclical BBs in 2023 should index spreads widen out to our base case target. Furthermore, defensive single-B credits (even after excluding several distressed issuers from our dataset) maintain a carry advantage vs. the index that exceeds the trailing 10-year relationship, while cyclical BBs are tighter to overall index yields than has historically been the case.

"Defensive" Single Bs Historically More Resilient Than "Cyclical" BBs

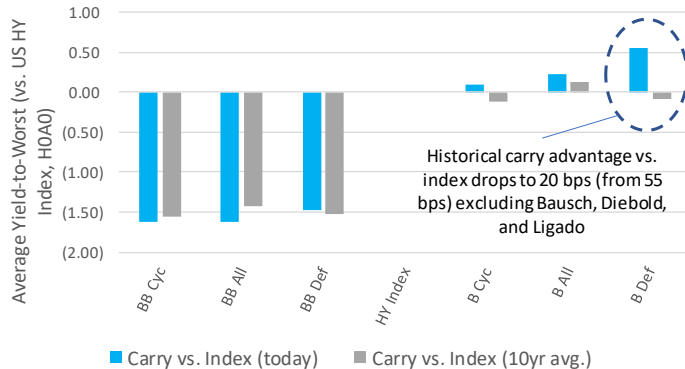
monthly data, last 10 years



Source: SKY Harbor, ICE Data Indices

"Defensive" Single B Carry Advantage Historically Elevated

monthly data, last 10 years

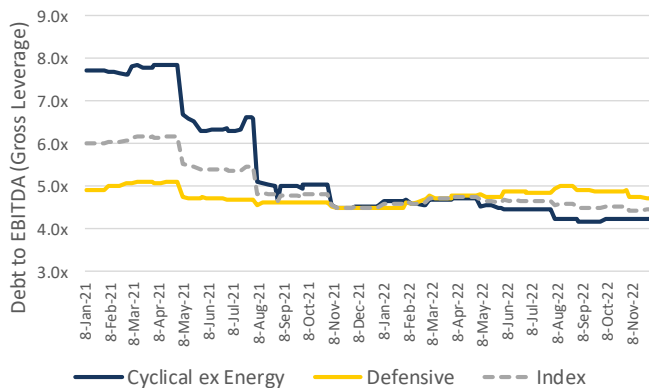


Leverage Has Converged, Perhaps Only Temporarily

From a fundamental perspective, cyclical credit outperformance thus far in 2022 appears justified, as gross leverage metrics have improved more rapidly than the defensive cohort of the index (left chart below). In fact, **gross leverage for both groups is relatively consistent in the mid/high 4x range at present.** However, as noted in our October '22 Weekly Briefing entitled "[Downturn Sensitivity](#)," we expect aggregate high yield constituent EBITDA growth to be negative in 2023, with significant performance dispersion across issuers. Limiting our decade-long dataset to include only periods in which EBITDA growth was negative or decelerating, we calculated earnings betas relative to the high yield index as a whole (beta = 1.0). As demonstrated below (right side), **more defensive sectors and industries (denoted by a "D") have lower downside EBITDA growth betas relative to cyclical sectors and industries (denoted by a "C").** As such, we would anticipate a more resilient EBITDA growth environment among defensive credits in 2023, which should lead to less upside pressure on gross leverage metrics over the next four quarters.

Cyclical Gross Leverage Has Come Down Rapidly Post COVID

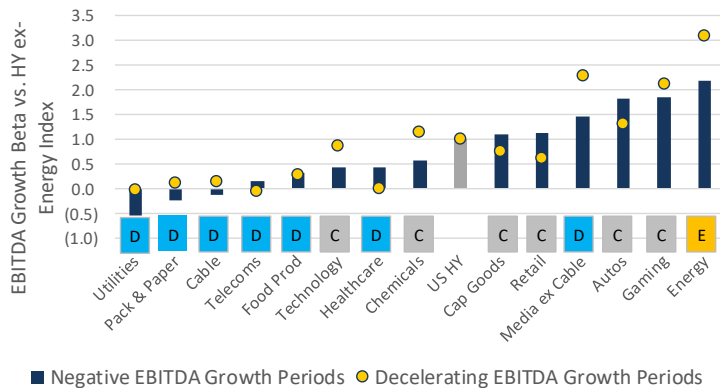
weekly data, trailing 2 years



Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, Capital IQ, ICE Data Indices

But We Expect Defensive Issuers to Show Greater Resilience in '23

based on 10 years of trailing 12-month EBITDA growth



Optimistic but Cautious

Reiterating the outlook expressed across our three continent roadshow over the last six weeks, **we remain cautiously optimistic about high yield in 2023**, with our view that spreads may need to widen offset by attractive starting yield-to-worst levels. We do, however, expect market volatility and issuer return dispersion to pick up in the coming months. As such, we think rotating – on the margin – into more defensive credit exposure makes sense, particularly as there is no yield or spread penalty to do so at present. A more sanguine view on lower-rated / cyclical credit exposure could come if geopolitical tensions cool and inflation continues to trend downward. For now, however, we think defensive credits offer better relative value given the economic backdrop.

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