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SKY HARBOR
CAPITAL MANAGEMENT

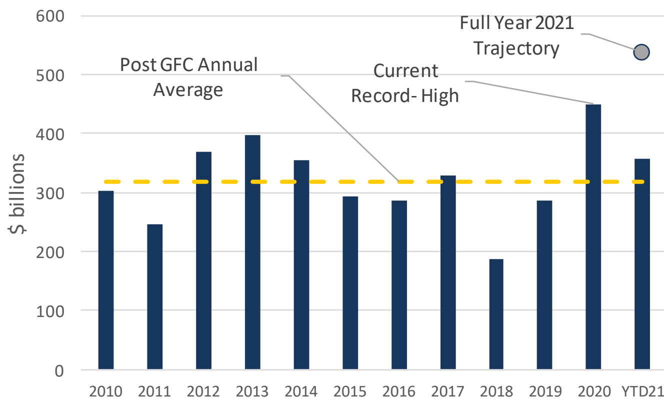
SKY Harbor Weekly Briefing

SKYView: Summer Recap

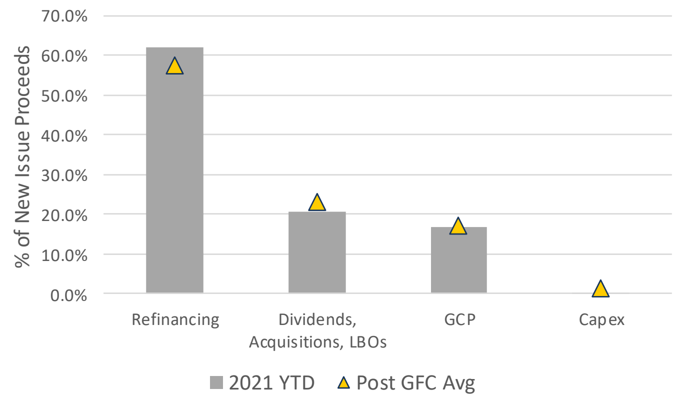
As August rolls to a close, we bring back our weekly publication, beginning with a recap of Summer '21. At the time of writing, high yield (we use the ICE BofA US High Yield Index, ticker H0A0, as our proxy) spreads are approximately 325 bps, nearly identical to OAS in early June. However, markets have been anything but flat over the last 3 months. Mixed economic datapoints, an uneven re-opening, geopolitical tensions, and evolving commentary from the Fed have contributed to several peaks and valleys in the market, including a period in July in which spreads moved over 40 bps in a two-week period. Though many topics are worthy of discussion, we decided to focus on two surges this summer – that of new bond issuance and the delta variant of the coronavirus. In this *Weekly Briefing*, we examine the impact new issue markets and new COVID cases have had on the market, and what their evolution may mean for high yield in the final four months of the year.

New issuance hit a record-high level in 2020, largely the result of general corporate purpose raises (to boost cash balances given uncertainty around COVID) and refinancing activity (as market yields dropped below coupon levels amidst a recovery in the back half of the year). The pace has yet to slow in 2021, as YTD new issuance through mid-August has already surpassed the post global financial crisis annual average. In fact, some strategists forecast **2021 issuance may exceed $500bn, with data through the first eight months of the year implying 20% growth vs. prior year**. As for the use of proceeds, they remain relatively conservative, with greater than average amounts going toward refinancing, and less than average amounts supporting more aggressive activities (dividends, acquisitions, LBOs, and growth capex).

Issuance on Track for Record-Setting Year (Again)
annual data, gross issuance



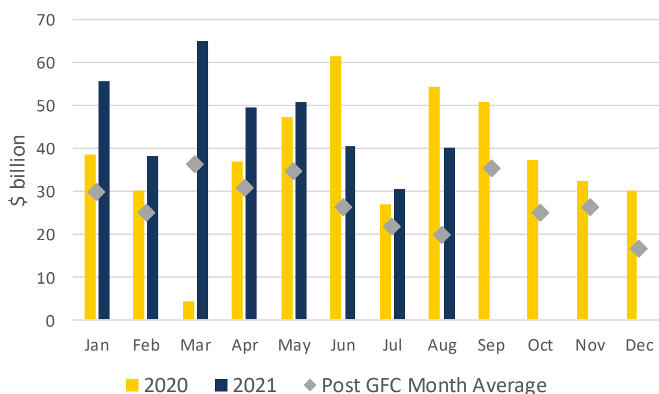
Issuance Remains Conservative, Skewed Toward Refinancing
2021 YTD data through July 31



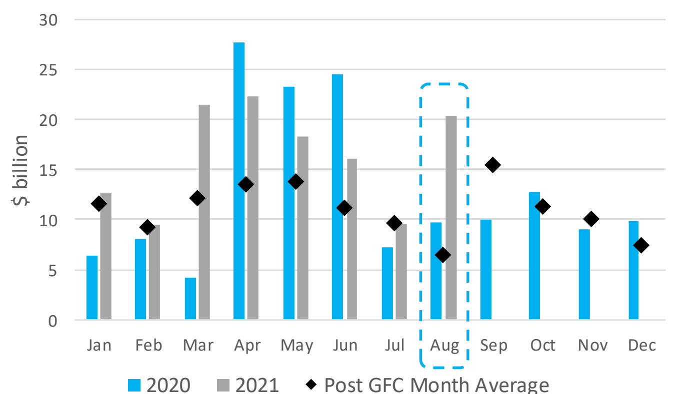
Source: SKY Harbor, JP Morgan, BofA Merrill Lynch, ICE Data Indices

On a more granular (monthly) basis, a surge in new issuance during a period historically consistent with a lull in activity (July and August are typically among the quietest three months of the year, along with a holiday-shortened December) has been notable. In fact, **data through the first three weeks of August already represents a record-high level of net issuance for that month** (and has perhaps ruined summer vacation plans for a number of high yield analysts in the process). Given a high number of index bonds with coupons that exceed their market yield (a driver for refinancing activity), rising CEO confidence amidst relatively low funding costs (a driver for M&A activity), and strong demand for yield from both foreign and crossover investors, a heightened level of new issuance is expected to persist for the balance of the year.

Gross Issuance Remains Elevated for Second Consecutive Year
Gross issuance monthly data, August is an estimate



August a Material Outlier on a Net Basis
Net issuance monthly data, August is an estimate



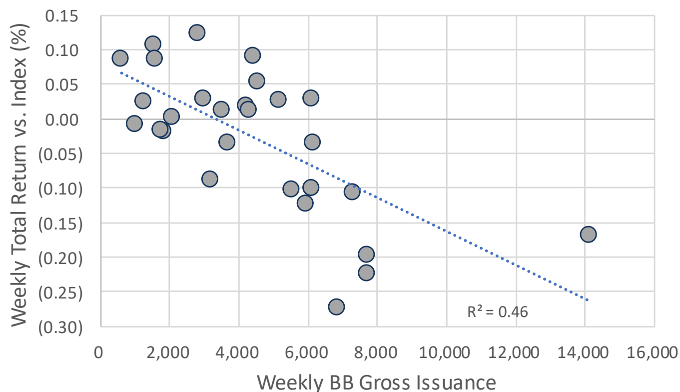
Source: SKY Harbor, JP Morgan, BofA Merrill Lynch, ICE Data Indices

So, what does this mean for high yield markets? Theoretically speaking, **an abundance of new issuance should, at least on the margin, weigh on high markets, as portfolio managers maneuver to make room for new deals**. However, in looking at new issuance data over the last three decades, we find no perceptible relationship. A significant amount of noise in the data – including treasury moves, defaults/downgrades that shift credits in and out of various cohorts, and recessions where credit markets freeze and returns turn negative amidst a complete lack of issuance – likely prevents us from finding any correlation (let alone causality) in the data. An examination of markets within smaller timeframes perhaps represents a better approach, and at least partially sidesteps the self-correcting nature of new issuance (in the intermediate term, deals can be pulled forward or pushed back based on the market environment).

Our analysis, therefore, focuses on new issuance from 2021 alone, where we further break down deal volumes based on summary ratings buckets. Grouping our time series into weeks, we then compared issuance volumes to rating class out/(under)performance relative to the index as a whole. Interestingly, and as demonstrated below, **BB performance relative to the index tended to weaken during weeks in which BB issuance was high**. The same relationship did not hold for lower-quality issuance (right side), which shows no correlation.

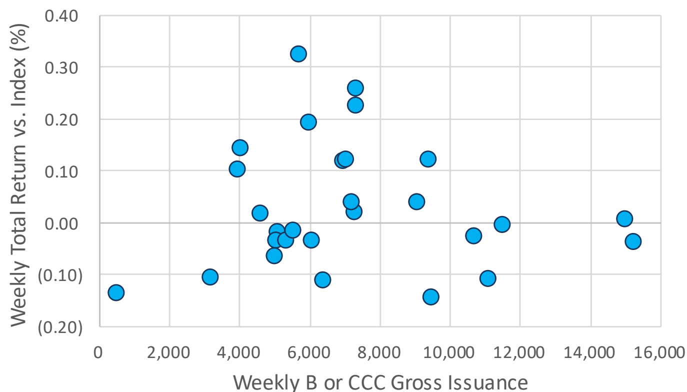
BB Performance Negatively Correlated to Issuance Trends

weekly data, since the start of 2021



Issuance Has Not Impacted Returns for Balance of Market

weekly data, since the start of 2021



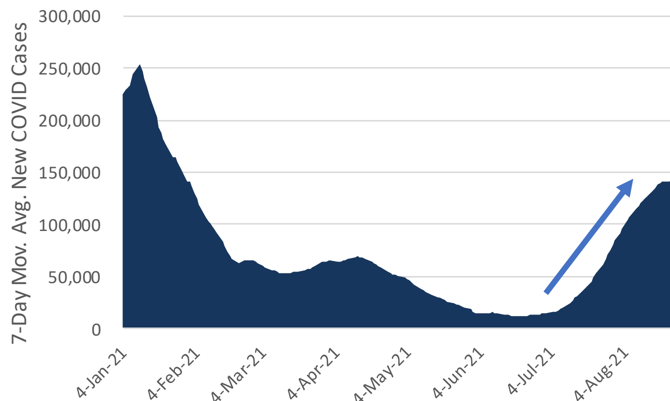
Source: SKY Harbor, JP Morgan, ICE Data Indices

While a certain amount of noise (like we saw in long-run data) could explain some of the differential, we think the amount and source of embedded credit risk is also an explanatory variable. More specifically, **the limited amount of credit risk within the BB cohort likely leads to greater "fungibility" among higher-rated issues, perhaps leading to portfolio managers trimming exposure to existing BB holdings in order to play a new BB deal with some sort of premium**. Conversely, unique credit risks associated with lower-quality issuance reduces fungibility. Furthermore, CCC new issuance hitting the primary market may signal **investor willingness to extend credit risk, creating a positive catalyst for similarly rated debt previously weighed down by a looming maturity overhang**. Ultimately, we anticipate new issuance will continue to outpace the post-GFC monthly average for the balance of 2021. From a positioning standpoint, we suspect such activity may create more of a headwind to BB performance, and remain comfortable taking on credit risk in the current market environment.

The second – and far more troublesome – surge this summer has been COVID cases as a result of the new delta variant. As demonstrated below, **new cases in the US have ratcheted up sharply since mid-July, creating a fourth wave of the pandemic**. Though vaccination efforts have ramped up to combat the spread of the virus, a full economic re-opening has been slower to materialize as a result of these headwinds. As demonstrated below (right side), CCC-rated credit has underperformed over the last several weeks, with spreads more sensitive to the downgrading of global growth relative to higher-rated bonds.

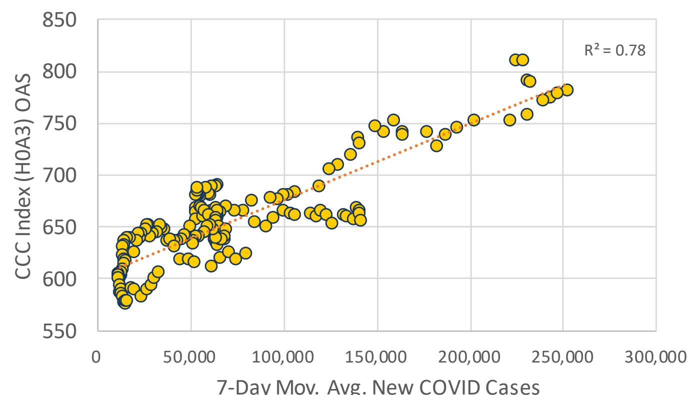
New COVID Cases Have Dampened Sentiment

daily data, since beginning of year (US)



CCC Risk Has Been Most Sensitive to Rise of Delta Variant

daily data, since beginning of year (US)

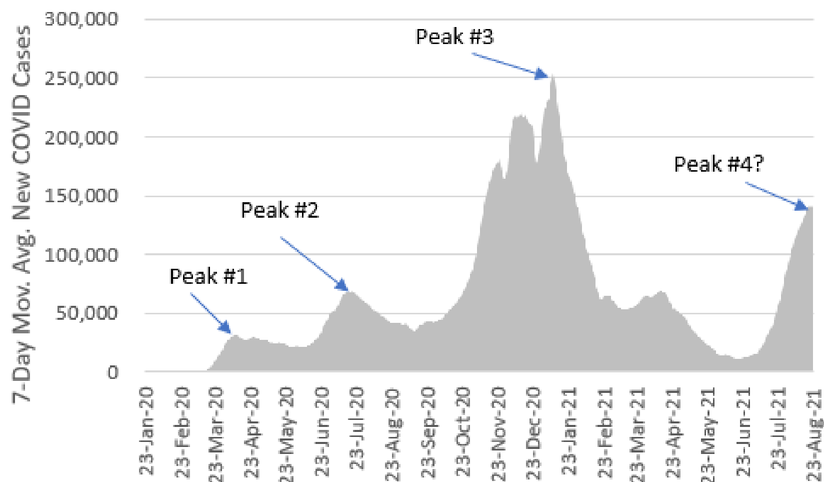


Source: SKY Harbor, covid.cdc.gov, ICE Data Indices

Fortunately, many medical experts believe a peaking of the fourth COVID wave may arrive in the coming weeks. The Centers for Disease Control and Prevention (CDC) have, in the past, noted that viral surges do not typically last more than a few months. Building upon these findings, as well as high frequency data collected across various regions in the US, **some forecast models project new cases peaking between late-August and mid-September. While an exact timetable remains elusive, we note below that risk has generally rallied in the 30 days following previous COVID peaks**, another optimistic datapoint in support of high yield spread compression in the balance of the year.

When Will the Fourth Wave Peak?

daily data



Post Peak Period (Usually) Favors CCC Risk

1 month returns following wave peak

			30d Following Peak	
Peak #	Date		Total Ret	Excess Ret
1	13-Apr-20	BB	0.52	(0.05)
		B	0.77	0.27
		CCC	(1.41)	(1.82)
2	20-Jul-20	BB	1.94	1.88
		B	1.89	1.77
		CCC	3.05	2.95
3	10-Jan-21	BB	0.79	0.87
		B	0.75	0.74
		CCC	2.53	2.50

Source: SKY Harbor, covid.cdc.gov, ICE Data Indices

It's been an atypical summer for a variety of reasons, foremost among them record new issuance and yet another COVID surge. Though we suspect the primary calendar will remain elevated for the balance of the year, concerns over its impact on bonds in the secondary market appear overblown, with all but the highest-quality securities showing resilience in the face of heavy issuance thus far in 2021. COVID fears, in our view, have been the larger driver of high yield spreads over the last several weeks. We are, however, cautiously optimistic that a peak in new cases may be reached in the coming weeks. Based on market returns in the 30 days that followed the three earlier peaks since the start of this pandemic, risk may be poised to rally in late Q3'21 / early Q4'21.

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