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SKY HARBOR CAPITAL MANAGEMENT

Weekly Briefing

SKYView: Infrastructure, ISM, and Increasing Taxes

President Biden introduced “The American Jobs Plan” this past Wednesday (March 31), a proposal that aims to channel more than $2tn into the improvement of America’s aging infrastructure and to support the post-pandemic economic recovery for years to come. The plan’s size and primary funding source – increased taxes – are likely to generate opposition, but Democratic leaders appear willing to push the measure through Congress via reconciliation should GOP lawmakers fail to support the proposal. At the same time, various measures of economic activity continue to rise, with March’s ISM Manufacturing PMI hitting levels not seen since 1983. In this *Weekly Briefing*, we gauge the tradeoff between growth and taxes, with an aim to identify US high yield issuers best positioned in the current market environment.

Speaking in Pittsburgh last week, President Biden called on lawmakers to support a “once-in-a-generation investment” aimed at restoring America’s aging infrastructure, which by some accounts now ranks as low as 13th in the world[1]. The sweeping proposal - which includes funding for transportation infrastructure, electric vehicle development, an upgrading of the electric grid, school construction, job training, and R&D – would perhaps represent the most significant public investment since the space race of the ‘60s, with an estimated price tag in excess of $2tn. Funding for the plan, and source of most consternation for Republicans and moderate Democrats, would largely come from an increase in corporate and individual tax rates, the latter being limited to individuals earning more than $400k per annum. Most relevant for high yield investors, Biden seeks to reverse some of the Trump-era reforms, boosting the corporate rate to 28% (from 21%). For context, recall that The Tax Cuts and Jobs Act of 2017 lowered the corporate tax rate from 35% to 21%. In a 2017 white paper entitled “Tax Reform – US High Yield Market Implications” found here, we argued that tax cuts would represent a modest positive for our market. In general, our work suggested that higher-quality credits (i.e., BBs who were paying higher taxes to begin with) would be most positively impacted by tax cuts, while the most levered CCC credits would likely end up modestly worse off (based on the trade-off between lower tax rates and interest deduction caps). Using our proprietary dataset of high yield issuers with publicly available financials (we estimate our aggregate data covers ~ 70% of the ICE BofA US High Yield Index), we find that their tax rate has declined from ~ 28% in 2017 to ~ 21% at present (LTM Q4’20), with the BB rate remaining the highest (due to greater profitability) but having fallen the most significantly over the prior three years.

Key Elements of Biden's Infrastructure Proposal

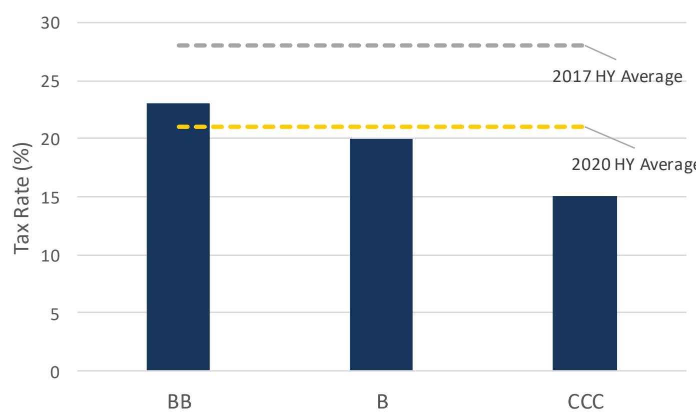
preliminary details released Wednesday, March 31, 2021

Where The Money Will Go
Transportation infrastructure (bridges, roads, airports, public transit, etc.)
Electric vehicle development (incl. a network of 500,000 vehicle chargers)
The care of elderly and disabled Americans
Upgrading of electric grids (particularly in marginalized neighborhoods)
Expand broadband access (aim to make access both universal and affordable)
Improve drinking-water infrastructure (replacing of lead pipes)
Creating new affordable housing (500,000 homes for low/middle income Americans)
Construction and upgrading of schools
Invest in American manufacturing, research & development, and job training
How It Will Be Funded
Hike in corporate tax rate from 21% to 28% (rates were cut from 35% in 2017)
Increase local minimum tax for multinational corporations to at least 21%
Higher tax rates for individuals making in excess of $400k per annum
Overall Size > $2 trillion

Source: SKY Harbor, White House, CNBC, Bloomberg, Capital IQ, company filings

Expect Some Reversal of 2017 Tax Cuts

estimated tax rate of public index constituents

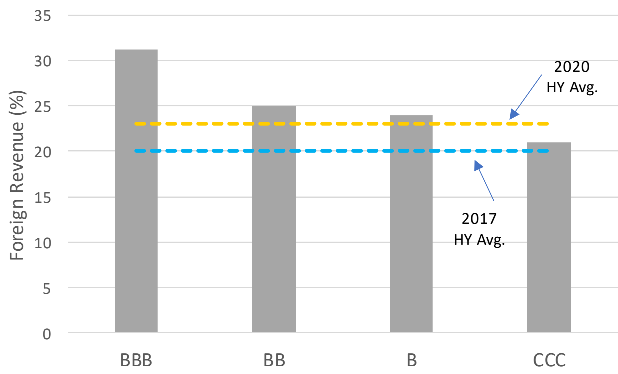


Since BBs benefitted the most from tax cuts several years back, we envision a partial reversal will most negatively impact that group as well, all else being equal. As is most often the case, however, there are other considerations that merit discussion. One provision of the plan that has garnered particular scrutiny is a proposed global minimum tax for US multinational corporations of 21%, designed to disincentivize the shifting of profits and jobs overseas. If passed, this provision of the plan is likely to be more onerous for issuers with a higher percentage of non-domestic revenue sources. Using the same dataset of corporate issuers with publicly available financial statements, we find that foreign revenue generation for high yield constituents has generally increased over the last several years (~ 300 bps by our estimates), with higher-rated entities typically generating a greater percentage of overall sales from outside the US (we have included data from the BBB portion of the investment grade space to further demonstrate the trend). Overall, we view currently contemplated corporate tax hike proposals as being a net negative for corporate issuers, with higher-quality (IG vs. HY, BB vs. CCC) credit and those with greater exposure to foreign revenue streams (which also happen to be higher-quality issuers) most adversely impacted. Infrastructure spending, however, should lead to greater economic activity, providing a significant offset to the tax drag.

[1] The White House; “FACT Sheet: The American Jobs Plan,” https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/

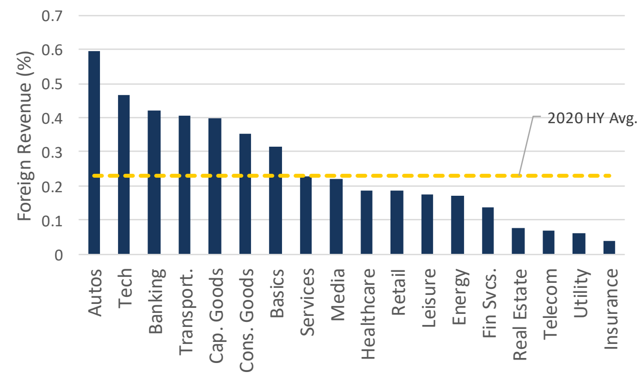
Foreign Revenue Most at Risk From Tax Hike Proposal

estimated foreign revenue exposure of public index constituents



Autos and Tech Have Largest Foreign Revenue Exposure

estimated tax rate of public index constituents

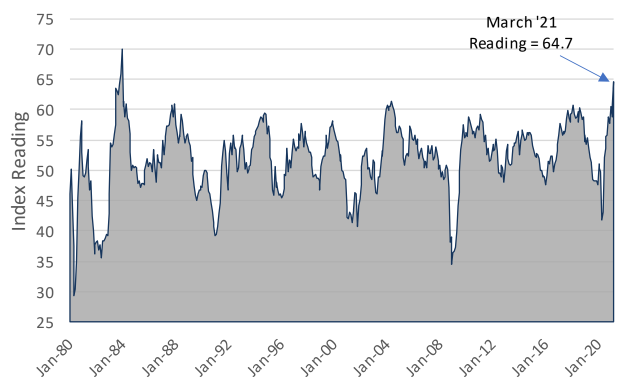


Source: SKY Harbor, Bloomberg, Capital IQ, company filings, ICE Data Indices

In a sign that the economy has already begun to heal, recently released ISM Manufacturing PMI data surprised to the upside, rising to 64.7 (vs. 60.8 in the prior month, and consensus expectations of 61.5). March data (released on April 1st) led to the highest monthly reading since 1983, and represented the 10th consecutive month of expansion (a reading above 50). Furthermore, all five sub-components (new orders, production, employment, supplier deliveries, and inventories) increased and are within expansionary territory, with new orders exceptionally strong (68.0, and indicating a favorable outlook on future activity). Continued distribution of stimulus checks and other provisions contained within the recently passed $1.9bn relief package should further boost manufacturing activity, with an infrastructure bill (if passed) representing even further upside.

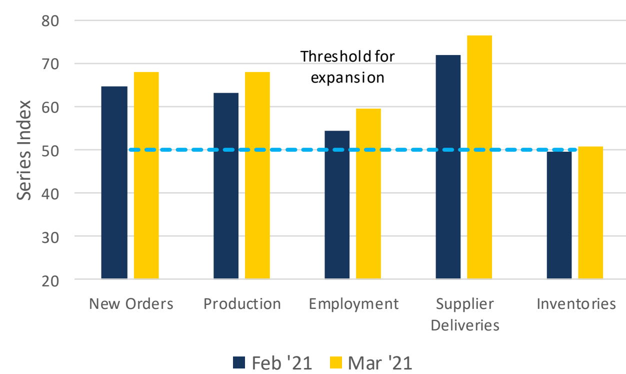
ISM Manufacturing PMI Hits Highest Level Since 1983

monthly data



All Components Up Sequentially And In Expansion Territory

quarterly data

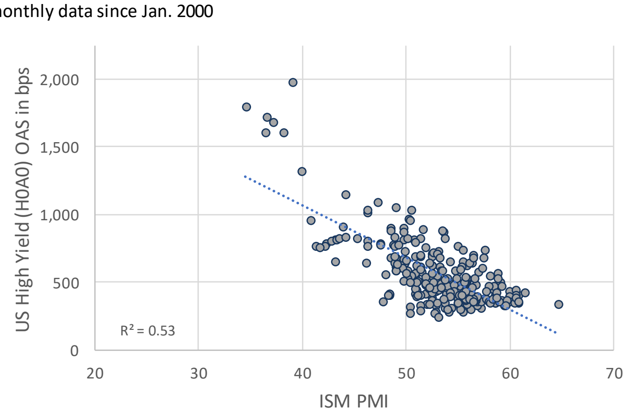


Source: SKY Harbor, Institute for Supply Management

Looking back at data over the last two decades, we find that rising ISM PMI readings are historically consistent with the tightening of high yield spreads (left chart below), as the former is usually indicative of improving economic conditions. In this way, infrastructure spending – and the subsequent impact to the economy – is a clear positive for corporations, particularly those most sensitive to growth (lower quality). The tradeoff, of course, is the funding of such spending, in this case via a corporate tax hike, with perhaps a disproportionate hit to foreign revenue. In our view, issuers optimally positioned in the current market environment are those most correlated to economic growth (in this case, we use ISM PMI as our proxy) with proportionately lower foreign exposure. We plot sectors by both metrics in the scatterplot below (right side), identifying potential beneficiaries (those below the line of best fit) including Basics, Retail, Leisure, Services and Media.

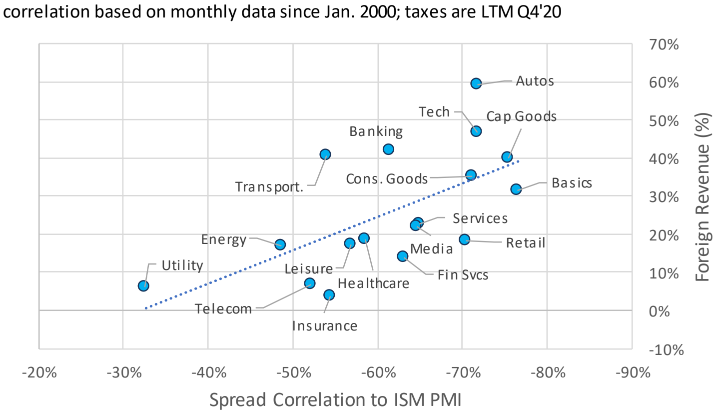
Rising ISM PMI Historically Consistent w/ Tightening Spreads

monthly data since Jan. 2000



Low Foreign Revenue / High ISM PMI Correlation Likely Best Positioned

correlation based on monthly data since Jan. 2000; taxes are LTM Q4'20



Source: SKY Harbor, Institute for Supply Management, Bloomberg, Capital IQ, company filings, ICE Data Indices

In conclusion, Biden's infrastructure proposal – if passed in its current form – is likely to spur economic growth, but higher taxation is a significant offset for corporate issuers. In our view, lower marginal taxpayers with limited foreign income and greater leverage to economic growth stand to benefit the most (high yield, in general), while the plan likely represents a net negative development for investment grade credit. Additionally, passage of another multi-trillion-dollar package aimed at boosting the economy will further stoke inflationary fears, adding pressure to higher-duration securities with limited spread cushion (again, investment grade credit). Going forward, we continue to favor shorter-duration high yield, with an ongoing emphasis on sectors with disproportionate leverage to manufacturing growth relative to foreign revenue exposure. A summary of our sector-based thoughts is included below:

Non-Financial Sector Summary: Potential Beneficiaries

preliminary thinking from "The American Jobs Plan" outline

Targeted Infrastructure Spending	Limited Foreign Exposure	Overall Taxes / ISM PMI Trade-Off
Autos	Energy	Basic Industry
Basic Industry	Leisure	Healthcare
Capital Goods	Retail	Media
Consumer Goods	Telecom	Retail
Tech	Utility	Services

SKY Existing Overweights →

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