SKY HARBOR
CAPITAL MANAGEMENT

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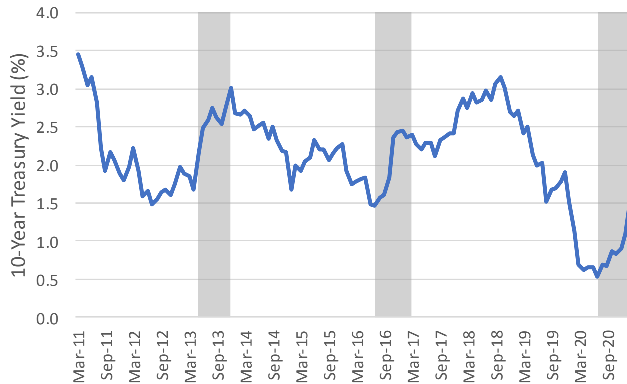
Weekly Briefing

SKYView: The Duration Debate

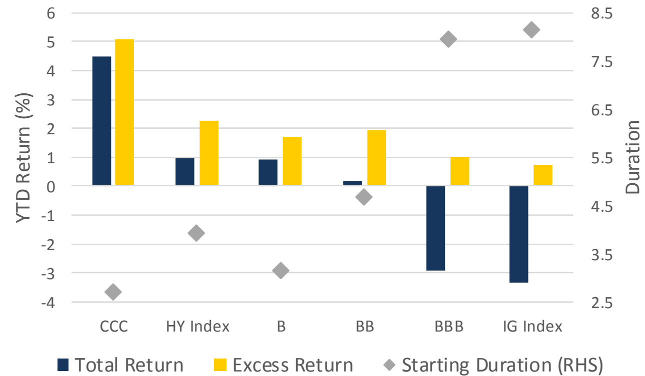
Fed Chairman Powell's speech did little to ease concerns over rising rates at Thursday's Wall Street Journal Jobs Summit (March 4, 2021), with yields on the 10-Year reaching 1.55% (+ 8 bps on the day) despite his expressed view that the economy is not at risk of overheating. In the interview, Powell noted his expectation for an uptick in economic activity as the re-opening progresses, which would likely cause consumer prices to increase in the coming quarters. Despite his belief that employment and inflation would remain below levels necessary to elicit an FOMC rate hike for "some time," yields on US Treasuries continued to climb toward levels not seen since the onset of the pandemic. In this *Weekly Briefing*, we take a closer look at the toll heightened growth and inflation forecasts have had on duration since the start of the year, and update our views on risk compensation in the current environment.

Expectations for stronger economic growth and a pickup in inflation have directly led to higher Treasury yields, with the 10-Year up over 60 bps since the start of the year. Looking back over the last decade, we find only three periods in which rates have risen more than 50 bps within a three-month period, and denote them in grey shaded areas within the chart below (left side). During those periods, US high yield bonds outperformed the 10-Year Treasury Index, the Bloomberg Barclays Global Agg, US investment grade credit, mortgage backed securities, and emerging market sovereign debt. More granularly, the shorter duration part of the high yield market performed best. Those trends appear consistent with what we have seen on a year-to-date basis, with both total and excess returns negatively correlated with cohort duration at the start of the period (right side).

Third Period in Last Decade Where Rates Increased Rapidly
grey = periods in which rates sustainably increased 50bps+ in a six month period



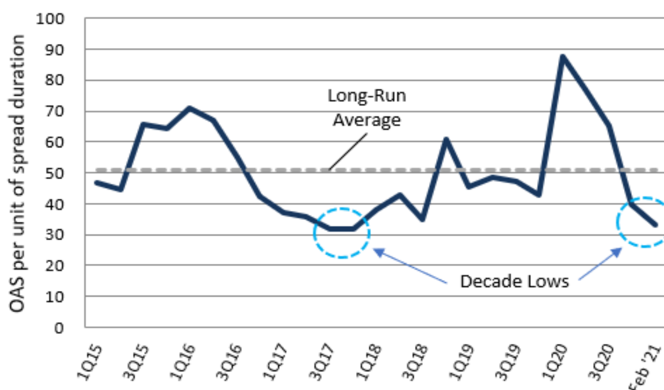
YTD Returns Clearly Show Duration Penalization
as of March 3, 2021



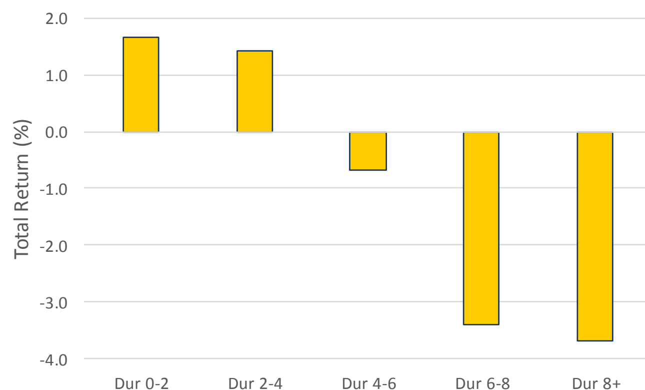
Source: SKY Harbor, ICE Data Indices

Our past work on the negative correlation between high yield spreads and rates (see "*The Threat of Rising Rates,*" found here) and the positive impact inflation has had on leveraged credit issuer fundamentals (see *"It's All Relative,"* found here) underpin our sanguine view of the asset class. However, though we continue to believe high yield will tighten further before year end, our estimation of compensation by risk factor leaves us biased toward picking up excess spread via credit or liquidity risk rather than extending duration. As demonstrated in the chart below (left side), regression analysis of compensation afforded investors for taking on duration (term risk), after accounting for differences in credit quality and issue size (liquidity risk), is well below historical norms. In fact, OAS per unit of spread duration now matches a decade low, recently falling to a level not seen since Q4'17 despite well-telegraphed concerns by Treasury markets. As shown in the chart below (right side) longer duration returns suffered in the six months that followed the Q4'17 term risk trough. Notably, that period also coincided with modestly rising Treasury yields, not dissimilar to current expectations.

Spread Duration Compensation (Term Risk) Below Average
compensation after adjusting for credit quality and issue size



Duration Didn't Perform Well The Last Time Comp Was This Low
6 months ended June 30, 2018

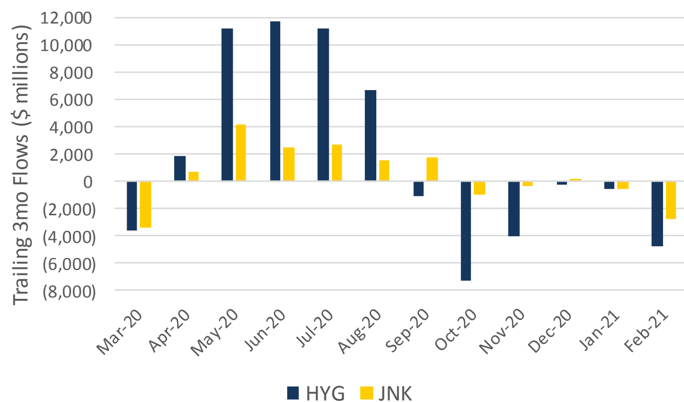


Source: SKY Harbor, ICE Data Indices

While spread duration compensation appears meager, illiquidity premiums (compensation to hold less-liquid bonds, after accounting for differences in credit quality and duration) remain above-average. Peaking in April 2020, the subsequent reduction in illiquidity premiums via outperformance of small vs. large bonds, in our view, still has room to run, and may even accelerate should high yield ETF outflows persist. Historically discounted and more comfortably removed from technical selling pressures, our high-conviction preference for smaller issues appears well justified in the current market environment.

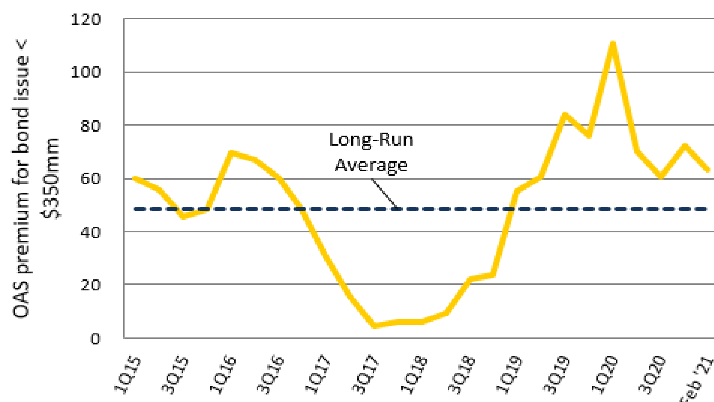
High Yield ETFs Suffering Outflows…

monthly data, trailing 12 months



…While Illiquidity Premiums Are Elevated

compensation after adjusting for credit quality and duration



Source: SKY Harbor, Bloomberg, ICE Data Indices

We also view the potential for a large stimulus package in the coming weeks as being further supportive of a sharp improvement in credit fundamentals. Strong GDP growth expectations – driven by re-opening momentum and with additional upside from fiscal measures – continue to ease default concerns in the near and intermediate term. In our view, the inherent rate risk associated with BB credit more than offsets the benefit of principal preservation in a market characterized by rising inflation and a drop in bankruptcies. The same can be said as justification for moving out of investment grade and into high yield in general.

Despite the Fed's best efforts, market forces continue to push rates higher, causing duration to underperform across credit markets thus far in 2021. These pressures notwithstanding, we expect further spread compression through year end, primarily driven by improving high yield market fundamentals (at present the strongest leg of our FASST framework). Furthermore, we think stimulus negotiations are likely to result in a relief bill sized at the upper end of the expectation range, providing the next positive catalyst on the horizon. The implications of heightened stimulus spending (most notably lower defaults and higher rates), along with our statistical analysis of factor compensation, lead us to believe that the compression theme is best expressed through credit and liquidity risk-taking. As such, we do not yet think it is the time to step in and buy the part of the market most impacted by rates – better quality longer duration.

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