

Weekly Briefing

SKYView: Asset Values

Stable credit fundamentals and positive technical tailwinds have served to bolster sentiment for US high yield bonds, particularly strategies that focus on the shorter duration part of the market. As such, we remain constructive on the asset class despite spread tightening thus far in 2019. At the same time, we recognize that some competing strategies – most notably EM short duration high yield – have offered similarly attractive returns for investors over the last several years. In this overview, we compare US and EM short duration high yield in the current market environment.

Periodic Performance

Using performance for the SKY Harbor Short Duration High Yield strategy (SKY) in comparison to what we understand are commonly used EM short duration high yield benchmarks – the JP Morgan CEMBI Broad Diversified 1-3yr Index (CEMBI) and the JP Morgan EMBI Global Diversified 1-3yr Index (EMBI) – we create the total return and volatility comparisons below. In general, total returns over the last three years have been most favorable for SKY, while CEMBI has generally provided the best return per unit of volatility (although periodic exceptions exist).

SKY Short Duration High Yield vs. EM Short Duration High Yield

monthly data through July 2019

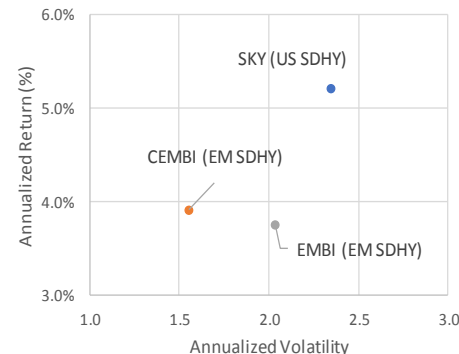
Total Returns	YTD	Annualized		2018	2017	2016
		1 Year	3 Year			
SKY Harbor US Short Duration HY	6.8%	5.5%	5.2%	0.9%	5.0%	7.9%
JP Morgan CEMBI Broad Diversified 1-3yr	5.2%	6.7%	3.9%	1.8%	3.4%	6.1%
JP Morgan EMBI Global Diversified 1-3yr	4.7%	5.1%	3.8%	0.6%	4.2%	8.7%

Return per Unit of Standard Deviation	YTD	Annualized		2018	2017	2016
		1 Year	3 Year			
SKY Harbor US Short Duration HY	1.9%	1.5%	2.2%	0.4%	4.7%	3.1%
JP Morgan CEMBI Broad Diversified 1-3yr	3.7%	3.2%	2.5%	1.0%	3.9%	3.9%
JP Morgan EMBI Global Diversified 1-3yr	1.8%	1.9%	1.8%	0.3%	3.1%	2.9%

Source: SKY Harbor, ICE BofAML Indices, JP Morgan Markets

Return & Risk Comparison

Trailing 3yrs through July 2019

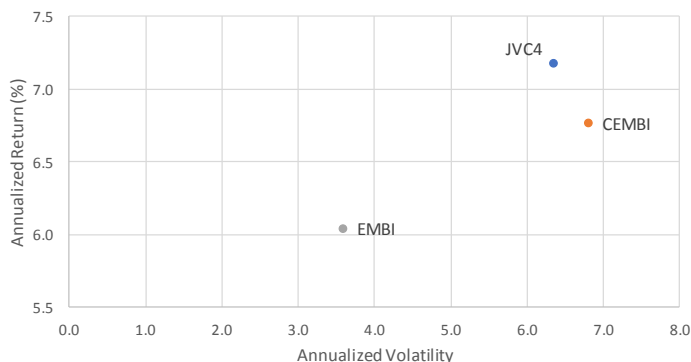


Long-Term Performance

In order to provide risk and return metrics over a longer period of time (beyond SKY Harbor's inception), we ran a similar analysis, this time substituting the SKY Harbor Short Duration High Yield strategy (SKY) performance with a widely used US short duration high yield index – the ICE BofAML 1-5yr BB-B US Cash Pay High Yield Constrained Index (JVC4). Using all available information (in this case, the CEMBI BD 1-3yr is the limiting factor, with monthly returns starting January 2002), we generated the risk/return comparisons below. In the full data set (~ 17.5 years of monthly returns), we find JVC4 (our proxy for US short duration high yield) to be more efficient than CEMBI in terms of return per unit of risk.

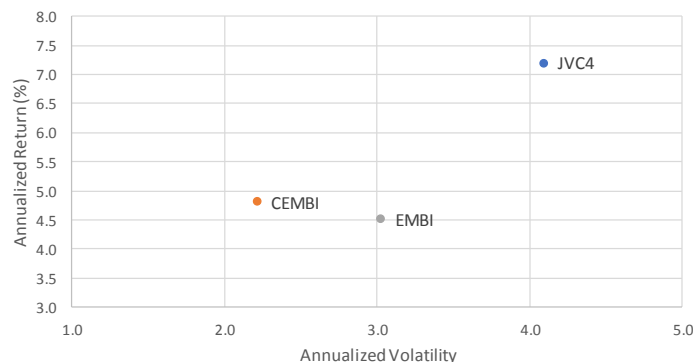
Return & Risk Comparison

full data series (Jan '02 through July '19)



Return & Risk Comparison

Trailing 10yrs through July 2019



JVC4 = ICE BofAML 1-5yr BB-B US Cash Pay High Yield Constrained Index (proxy for US Short Duration High Yield)

CEMBI = JP Morgan CEMBI Broad Diversified 1-3yr (proxy for EM Short Duration High Yield)

EMBI = JP Morgan EMBI Global Diversified 1-3yr (proxy for EM Short Duration High Yield)

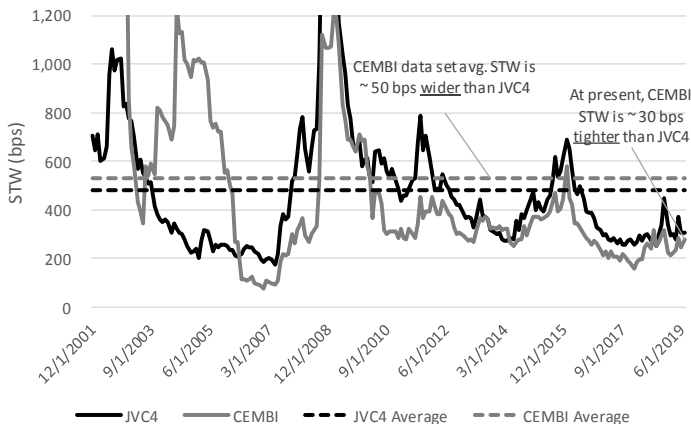
Source: SKY Harbor, ICE BofAML Indices, JP Morgan Markets. Data set January 2002 (start of CEMBI) through June 2019.

Current Spread Levels

While spreads among both US short duration high yield (using JVC4 as a proxy) and EM short duration high yield (we use CEMBI BD 1-3yr as a proxy) indices have tightened on a year-to-date basis, we find better value on the US side. As of July 31, 2019, CEMBI BD 1-3yr spread-to-worst (STW) was ~ 30 bps tight to JVC4, despite the former trading ~ 50 bps wider relative to JVC4 over the long run (again, data going back to January 2002). Furthermore, peak spreads for CEMBI BD 1-3yr within our data set (3,137 bps) are well above peak spreads for JVC4 (1,900 bps). Normalizing spread levels by using percentile ranks, we find JVC4 (STW of 305 bps, or 30th percentile relative to the time series) screens modestly better than CEMBI (STW of 277 bps, or 27th percentile relative to the time series).

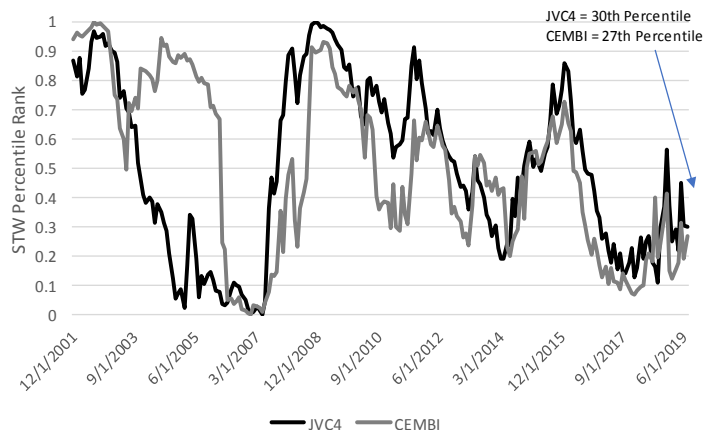
Spread to Worst History: US vs EM Short Duration High Yield

monthly data since December 2001 (max CEMBI data)



Spread to Worst History: US vs EM Short Duration High Yield

monthly data since December 2001 (max CEMBI data)



Source: SKY Harbor, ICE BofAML Indices, JP Morgan Markets. Data set January 2002 (start of CEMBI) through July 2019.

China Slowdown

In our view, the threat of a reduction in global growth, most notably through weakening expectations for China GDP, represents the dominant risk factor in leveraged credit markets at present. As such, we compared relative correlations of China GDP growth and the STW of both US and EM short duration indices over time. The EMBI GD 1-3yr is the only index with a statistically significant correlation and, as such, we view spreads to be more at risk of widening should China GDP growth decline with consensus expectations.

China GDP Growth

quarterly data, actuals and consensus expectations



Correlation to China GDP Growth

quarterly data since Q4'06 (furthest back for EMBI data)

Correlation to China GDP Growth

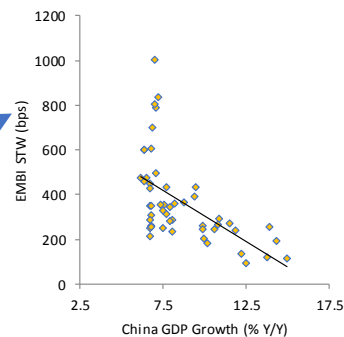
JVC4 (0.02)
CEMBI (0.13)
EMBI (0.56)

China GDP Growth vs. **US Short Duration HY STW**
p-value = 0.86, statistically insignificant

China GDP Growth vs. **CEMBI BD 1-3yr STW**
p-value = 0.36, statistically insignificant

China GDP Growth vs. **EMBI GD 1-3yr STW**
p-value = 1.75E-05, statistically significant

China GDP Growth vs. EM Short Duration HY STW (EMBI)



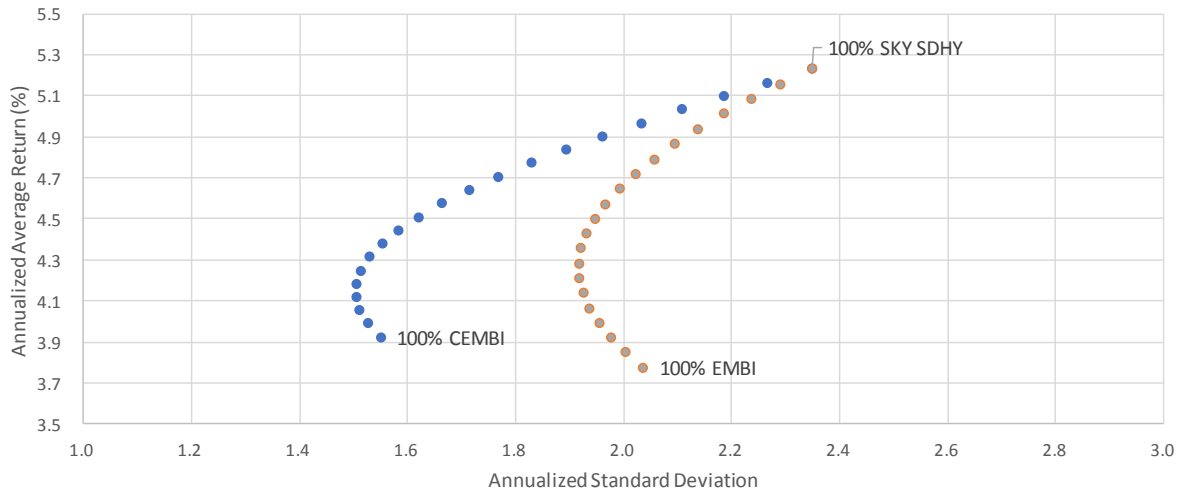
Source: SKY Harbor, ICE BofAML Indices, JP Morgan Markets

Benefits of Diversification

By virtue of limited correlation to EM short duration high yield indices, we believe the SKY Harbor Short Duration High Yield strategy (SKY) can improve portfolio diversification. As demonstrated below, an allocation to SKY can expand the efficient frontiers of a CEMBI BD 1-3yr (CEMBI) and an EMBI GD 1-3yr (EMBI) portfolio. Furthermore, using a longer data set (~ 17.5 yrs, limited by CEMBI history), JVC4 (proxy for US short duration high yield) can improve the efficient frontier of a CEMBI-only portfolio.

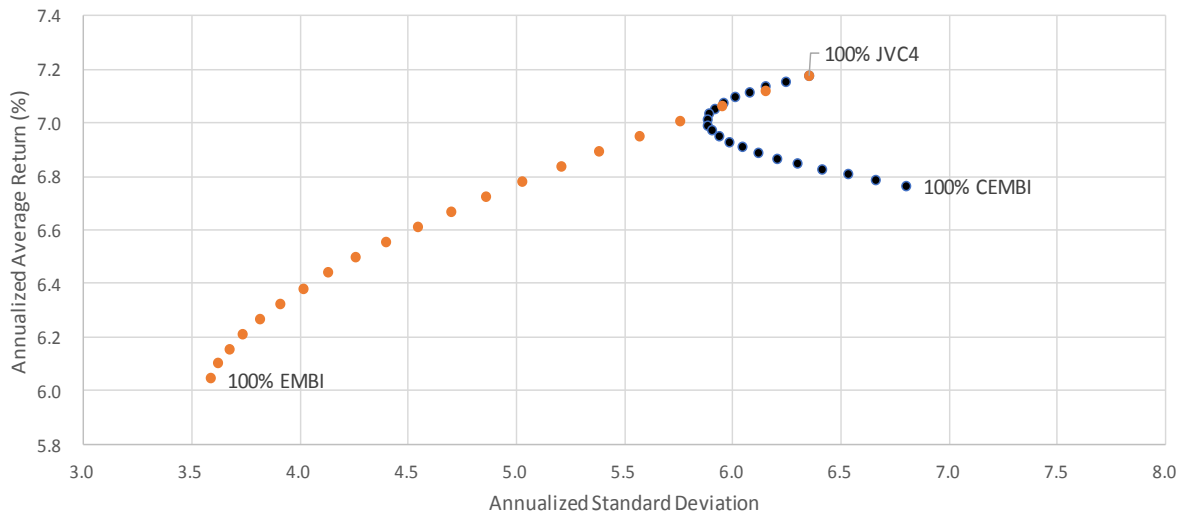
SKY Harbor Short Duration High Yield (SKY SDHY) vs. JP Morgan CEMBI Broad Diversified 1-3yr (CEMBI) and JP Morgan EMBI Global Diversified 1-3yr (EMBI)

monthly data, trailing 3 years



ICE BofAML 1-5 Yr BB-B US Cash Pay HY Index (JVC4) vs. JP Morgan CEMBI Broad Diversified 1-3yr (CEMBI) and JP Morgan EMBI Global Diversified 1-3yr (EMBI)

monthly data, trailing 17.5 years (EMBI data max)



Source: SKY Harbor, ICE BofAML Indices, JP Morgan Markets

Conclusion

In conclusion, we remain constructive on US short duration high yield, with stable credit fundamentals and technical tailwinds supporting positive sentiment within the market. In comparison to EM short duration high yield, we find US spreads at present to represent more favorable relative value. Furthermore, we think greater insulation from falling China GDP growth, particularly ahead of recently imposed tariffs, represents a key area of differentiation that favors US over EM short duration high yield. Finally, we highlight the benefits of diversification arising from the inclusion of the SKY Harbor US Short Duration High Yield strategy to existing CEMBI and EMBI portfolios by virtue of improved efficient frontiers.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
ISM Manufacturing	3-Sep-19	Aug	51.3	49.1	51.2
Construction Spending MoM	3-Sep-19	Jul	0.3%	0.1%	-1.3%
Trade Balance	4-Sep-19	Jul	-\$53.4bn	-\$54.0bn	-\$55.2bn

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
PPI Final Demand MoM	11-Sep-19	Aug	0.0%		0.2%
CPI MoM	12-Sep-19	Aug	0.1%		0.3%
Retail Sales Advance MoM	13-Sep-19	Aug	0.2%		0.7%

Source: SKY Harbor, Bloomberg

Recommended Reading

Badkar, Mamta and Smith, Colby (2019, September 5). Wall Street Rallies and Bonds Drop as US-China Agree to Trade Talks. *Financial Times* (subs. req.), Retrieved from <https://www.ft.com/content/4c6304f8-cfd9-11e9-b018-ca4456540ea6>

Stirling, Craig and Schneeweiss, Zoe (2019, September 5). Mario Draghi's Last Salvo of Stimulus is Under Threat. *Bloomberg*, Retrieved from <https://www.bloomberg.com/news/articles/2019-09-05/draghi-faces-biggest-ever-pushback-as-ecb-core-doubts-ge-need?srnd=economics-vp>

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