

SKY Harbor Weekly Briefing

Notes from the Road - Q2'23 Edition

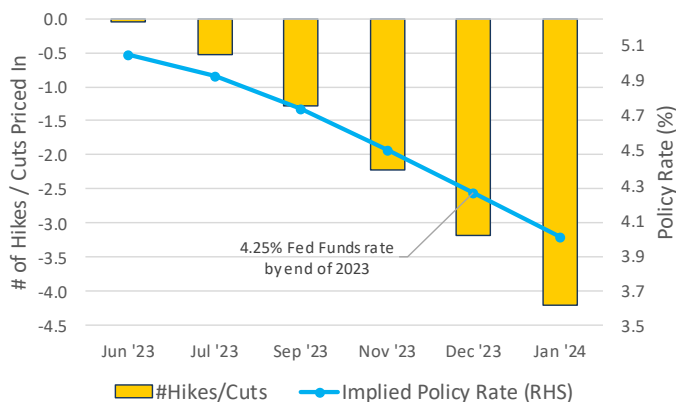
We had the pleasure of meeting numerous clients and prospects over the last several weeks as we travelled across Europe for our first international roadshow of 2023. Presenting our outlook for US high yield markets against a backdrop of rate uncertainty and recessionary concerns, we were pleasantly surprised at the level of attendance and engagement at each of our stops. Always acknowledging the value of questions and feedback received, we thought it appropriate to dedicate this *Weekly Briefing* to a recap of the most discussed topics from our journey, which include Fed activity on the horizon and our case for high yield over investment grade credit.

An Open Door for More Hikes

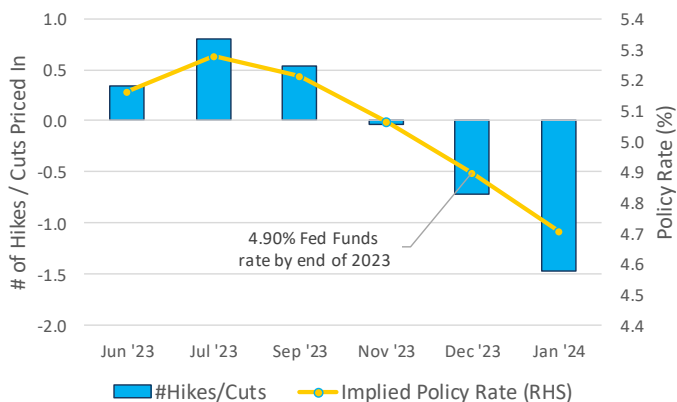
As discussed in our *Weekly Briefing* entitled "[On the Precipice of a Pause](#)," markets were quick to price in the end of the rate hiking cycle following Chairman Powell's post-FOMC press conference in early May, largely due to the absence of the word "anticipating" in relation to future additional increase language contained within his formal policy statement. In the second half of May, somewhat more persistent than expected inflation (Core PCE surprised to the upside, labor markets remain overheated) and Fed commentary (Cleveland's Mester sees no "compelling" reason to pause) put rate hikes back in play, with the market now pricing in another 25 bps in either June or July. **Most noteworthy, the likelihood of three rate cuts in the back half of 2023 have largely diminished.** As such, we remain of the view that we are near the end of the rate hiking cycle, but perhaps not quite there yet.

Fed Funds Futures Have Moved Sharply in May; Now Pricing In Another Hike in June/July, Fewer Cuts in H2'23

as of May 3, 2023



as of May 31, 2023



Source: SKY Harbor, Bloomberg

A Refreshed View on Breakevens

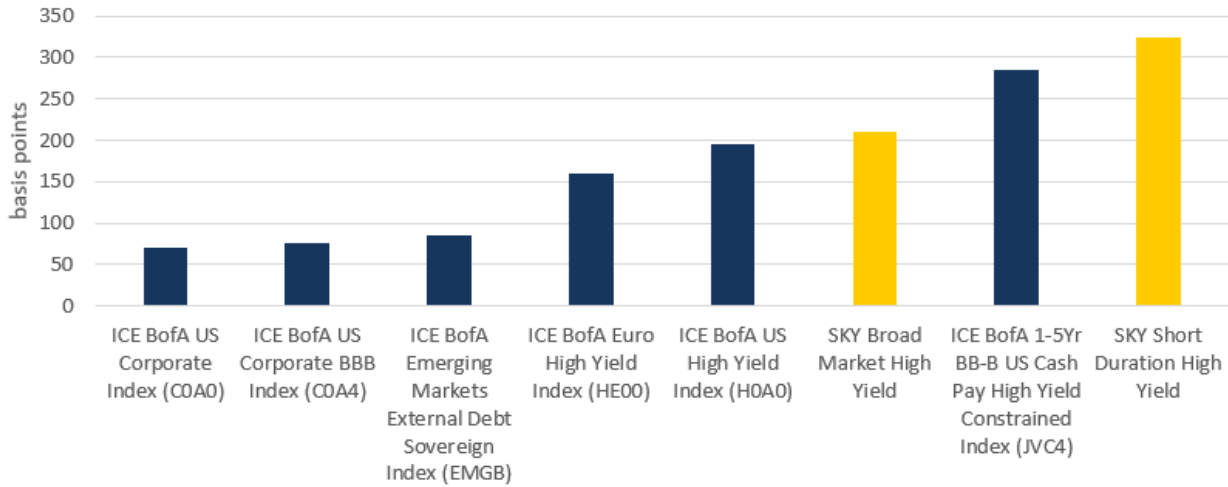
Top quartile yield-to-worst levels for high yield bonds – in the context of an approaching end to the Fed's rate hiking cycle – is in our view the most compelling argument for investing in the asset class at present. We acknowledge, however, risk factors on the horizon, including the potential for a modest recession that could very well result in yield widening. While our higher-quality, more defensive portfolio tilt should provide some protection in such a scenario, **asset class breakevens demonstrate the resilience afforded to investors by way of strong carry and limited duration.** Consistent with breakeven work presented over the past several years, the following simulation aims to calculate the maximum all-in yield increase an asset class could handle before total returns fell below breakeven levels (i.e., the point at which interest income is fully offset by the negative impact of rising yields). Our model maintains the following assumptions:

- 12 months investment horizon
- Increases in yield are linear in nature across all asset classes and occur in equal monthly increments
- No credit losses via defaults; no performance drag via downgraded securities exiting an index
- Coupon payments are reinvested in their respective strategies
- The driver of higher yield (whether by an increase in Treasury yields or a widening of spreads) is not specified
- No absorption of increased Treasury yields through spread compression (and vice versa)
- We include an estimate for duration extension for relevant asset classes under various widening scenarios
- No impact from roll-down as we assume investments are within a fund and repositioning would mitigate this impact
- Metrics are re-set monthly (increased carry and extension-related duration)
- Goal Seek is utilized to find the maximum increase in yield that would correspond to a 0% (breakeven) return

Our findings show that **both broad and short duration high yield (HOA0 and JVC4, respectively) provide greater breakeven protection than most other fixed income asset classes**, with an ability to absorb 195 bps and 285 bps, respectively, of yield widening before returns are pushed into negative territory. Furthermore, our broad market and short duration composites outperform breakevens of their respective benchmarks, coming in at 210 bps and 325 bps, respectively.

Breakevens by Index

12-month time horizon



Source: SKY Harbor, ICE Data Indices

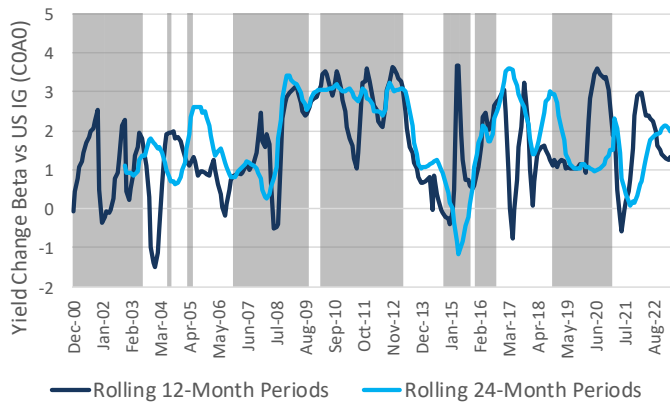
Rating ≠ Resilience

Client feedback from our travels also underscored a preference for investment grade credit over high yield, with most allocators overweight the former – despite our breakeven output – given prevailing economic uncertainty. As such, we thought it appropriate to expand upon our analysis. As demonstrated above, **the representative short duration high yield index (JVC4) could absorb ~285 bps of yield widening over a 12-month period before all carry is exhausted, which is just over 4x the breakeven level for the investment grade index (COA0, or ~70 bps).** Is this breakeven advantage sufficient to offset the added volatility incurred from JVC4's lower-rated constituent set?

Using data going back to January 2000, we find that the yield change beta of short duration high yield relative to investment grade typically falls within the 1x to 3x range, and is largely dependent upon both the economic backdrop and periodicity of results. In fact, **relative yield change beta in even the most challenged environments (in this case, using only periods in which rates are falling) tend to be ~2.5x, falling short of the 4x breakeven advantage of short duration high yield over investment grade.** Said differently, a 12-month yield change in excess of the investment grade breakeven (70 bps) has occurred in 20% of rolling monthly observations over the last two decades. A 12-month yield change in excess of the short duration high yield breakeven (285 bps) has occurred in only 10% of observations over the same timeframe. As such, we think a compelling argument can be made for short duration high yield over investment grade in the current market environment.

Yield Change Beta of Short Duration HY vs. US Inv. Grade

monthly data; shaded periods are those in which trailing 12-mo Tsy ylds declined



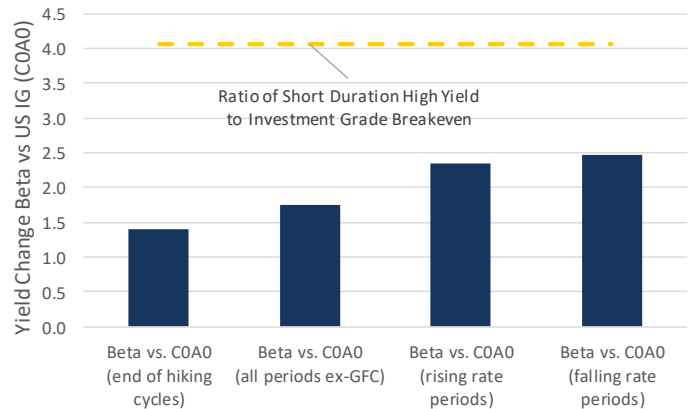
Source: SKY Harbor, ICE Data Indices

The Power of Carry

Better than expected Q1'23 earnings growth, an uptick in primary issuance, and (near) resolution to the debt ceiling showdown are all positive market developments in recent weeks. In our view, however, lofty yields and elevated breakevens provide the most support for our improved view of high yield market opportunities. Acknowledging known risk factors on the horizon, we continue to believe investors are well compensated to increase exposure to high yield, including, in our view, some compelling evidence that shorter duration may prove relatively more resilient than investment grade in the coming quarters.

Breakevens Sufficient to Offset Higher Yield Change Beta

monthly data



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