

**SKY Harbor Weekly Briefing**

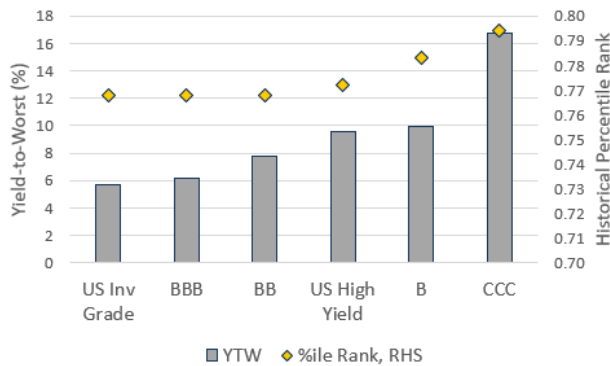
**SKYView: From Pause to Pivot**

Risk assets began to rally this past week, with better than expected economic data and signs that inflation is beginning to moderate providing much needed relief for those concerned about a future recession. Rumors of a change in Fed sentiment – from the potential of a “pause” to growing expectations of a “pivot” – led to a strong rally in Treasuries. Though we are not yet seeing interest in the high yield asset class increase sharply (beyond ETF inflows), a search for spread could begin to pick up steam in the coming weeks despite lingering risk factors. As such, we focus this *Weekly Briefing* on the value of a longer-term investment horizon when evaluating high yield in the current market environment.

**Cash Balances Remain Elevated**

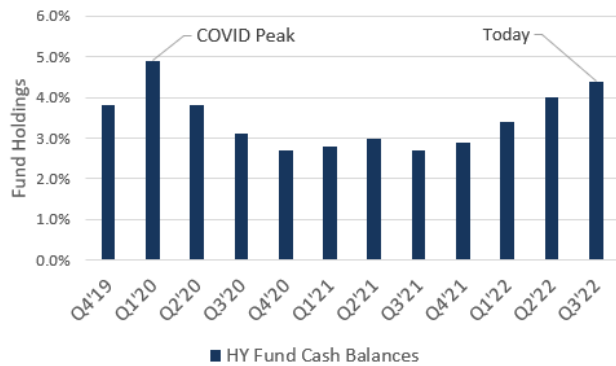
Historically speaking, yield-to-worst levels in the 8% range have provided meaningful incentive for investors to increase their exposure to US high yield, provided the economic outlook was not dire. More recently, perhaps due to recessionary concerns, we have seen index (ICE BofA US High Yield Index, ticker H0A0) yields breach 9%, all while actively managed fund flows remained in the red. Given uncertainty surrounding the future path of spreads (particularly if the global economy is heading toward contraction) and potential concerns about redemptions, **high yield portfolio managers have maintained above-average cash balances in recent months.** In fact, cash levels are now approaching COVID-era peaks, allowing yields across the ratings spectrum to enter top quartile territory.

**Credit Yields Hovering Around 77th Percentile...**  
monthly data, since Jan 2000



Source: SKY Harbor, ICE Data Indices, JP Morgan, Bloomberg

**...But HY Funds Allocating to Cash**  
quarterly data

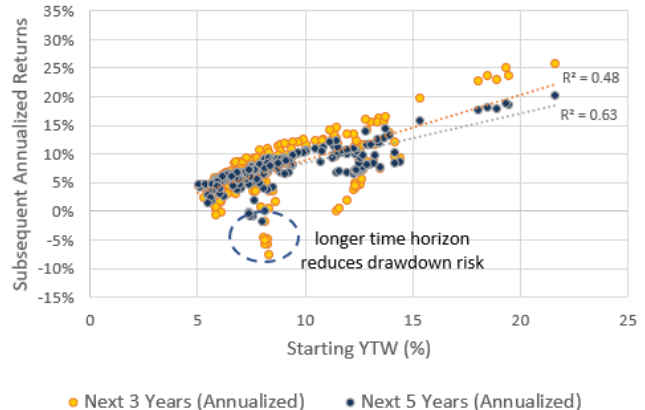
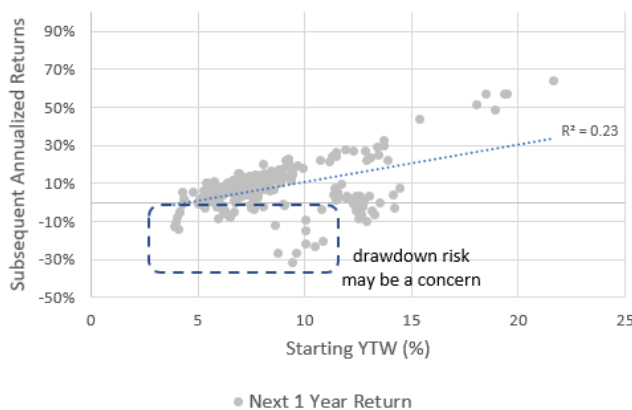


**Double-Digit Returns Over the Long Run, Drawdown Risk in the Short Run**

Historically, **starting index yield-to-worst levels have demonstrated a reasonably strong correlation to future total returns, with the R<sup>2</sup> rising as the time horizon increases** (below, we show subsequent 1, 3, and 5 year average annualized returns based on starting index YTW levels). Encouragingly, and as noted in our early October *Weekly Briefing* entitled “[Valuation in Uncertain Times](#),” starting yields in the mid-9% range, consistent with current index data, have led to approximately double-digit average annualized returns over longer periods of time (3 to 5 years). The risk, however, is drawdown over shorter timeframes. Using our dataset that goes back to January '00, we find a max drawdown when using a mid-9% starting YTW (and all that fall in the same decile) is ~ -31%, and occurred between November '07 and November '08, the depths of the global financial crisis. Keep in mind, however, that average annualized returns over the 3 and 5 year periods following the worst-timed investment in our dataset were still attractive at +9.6% and +9.7%, respectively, despite the inclusion of the max drawdown figure over the first 12 months. As such, **current H0A0 yields, in our view, may be attractive to those willing to commit to longer investment holding periods.**

**Starting Yield-to-Worst Levels Correlated to Subsequent Total Returns; Correlation Increases w/ Time Horizon**

ICE BofA US High Yield Index (ticker H0A0), monthly data since 2000



Source: SKY Harbor, ICE Data Indices

## IG Has Less Drawdown Risk, But Also Less Return Potential

We acknowledge that some investors may prefer investment grade to high yield credit at this point in time, a function of year-to-date underperformance of the former (at the time of writing, IG has underperformed HY by 650 bps on a total return basis, and 20 bps on an excess return basis) and drawdown risk of the latter (max drawdown over the last two decades given current starting YTW levels is -31% and -14% for HY and IG, respectively). However, as highlighted below, **max drawdowns and average annualized returns at starting YTW levels consistent with current index metrics all favor high yield over longer periods of time.** And, we highlight, that the depths of the global financial crisis highly skew 1-year drawdown figures presented below. More specifically, eliminating the GFC from our dataset leads to max 1-year drawdowns in similar YTW environments to -1.3% and +1.5% for HY and IG, respectively, closing the gap to 280 bps (vs. the full set gap of 1,700 bps).

### Annualized Returns Based on Starting Index Yield-to-Worst Buckets

using monthly data since Jan 2000

Index	Ticker	YTW Today (%)	Decile Range	# of Occurrences	% Positive Occurrences			Max Drawdown / Worst Return			Average Return		
					Next 1 Year	Next 3 Years (Annualized)	Next 5 Years (Annualized)	Next 1 Year	Next 3 Years (Annualized)	Next 5 Years (Annualized)	Next 1 Year	Next 3 Years (Annualized)	Next 5 Years (Annualized)
US High Yield	HOA0	9.4	8.8 to 10.7	25	72%	100%	100%	-31.3%	7.3%	6.6%	7.0%	10.5%	9.1%
US High Yield Constrained (ex CCC)	HOA4	8.6	8.1 to 9.9	25	68%	100%	100%	-28.1%	2.1%	6.6%	5.1%	9.7%	9.0%
US Short Duration HY Index	JVC4	8.9	7.8 to 10.1	25	76%	100%	100%	-22.1%	7.4%	6.2%	5.0%	9.7%	8.6%
US Investment Grade	COA0	6.1	5.8 to 6.3	25	84%	100%	100%	-14.3%	1.6%	5.5%	5.8%	7.3%	6.9%

IG Advantage
All But Next 1 Year Drawdown Favors HY Over IG

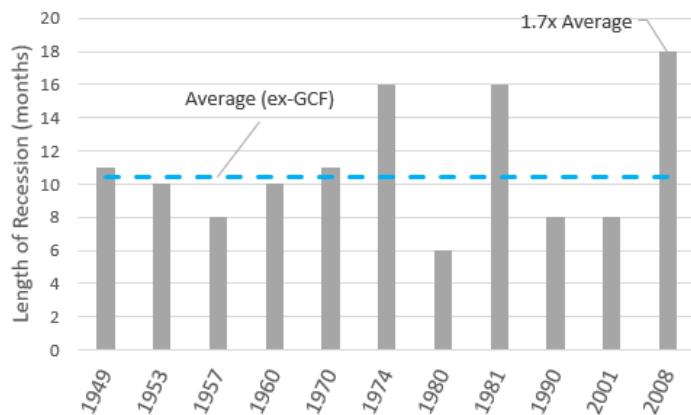
Source: SKY Harbor, ICE Data Indices

## Taking the Tail Off of the Table

Now, the global financial crisis did happen – and it can surely occur again – so scrubbing that period from our analysis is certainly unfair. However, the likelihood of it occurring in the coming year seems to be on the decline as US GDP and inflation data give way to renewed hopes of a soft landing. It is also important, in our view, to put the GFC into proper context. **Though it is one of only three recessions to occur in our dataset (i.e., the modern history of the US HY market), it registers as the most severe since the second World War.** As further demonstrated below, the length of the GFC was 1.7x longer than the post-WW2 era average, and was over 2x more severe as measured by the cumulative decline in real GDP. As such, deriving a downside case using data from that period might be overly draconian in nature.

### Results Skewed by Length of Global Financial Crisis...

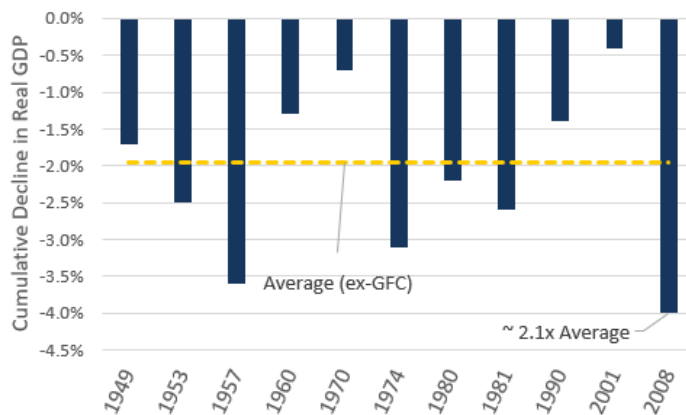
post World War II Recessions



Source: SKY Harbor, The National Bureau of Economic Research, BofA Merrill Lynch, Bloomberg

### ...As Well as the Severity

post World War II Recessions



## The Right Mix of Caution and Enthusiasm

Recent market enthusiasm notwithstanding, we acknowledge significant global economic uncertainty on the horizon, and believe high yield index spreads are likely to be volatile in the coming months. That said, those with a long-term investment horizon should take note of the strength of subsequent HY credit market returns when similar levels of yield were attainable over the last two decades. Furthermore, elevated yields in the higher-quality portion of the index (BBs, high-single-Bs) also appear attractive while remaining, in our view, bankruptcy-remote even if a moderate recession were to materialize. Given the speed at which markets can compress when incoming datapoints appear to reduce the likelihood of a severe global contraction, and due to sizeable HY fund cash balances available for deployment, we do think it makes sense to add a modicum of risk to portfolios at this point in the cycle.

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