

SKY Harbor Weekly Briefing

SKYView: Reversing Our Domestic Bias

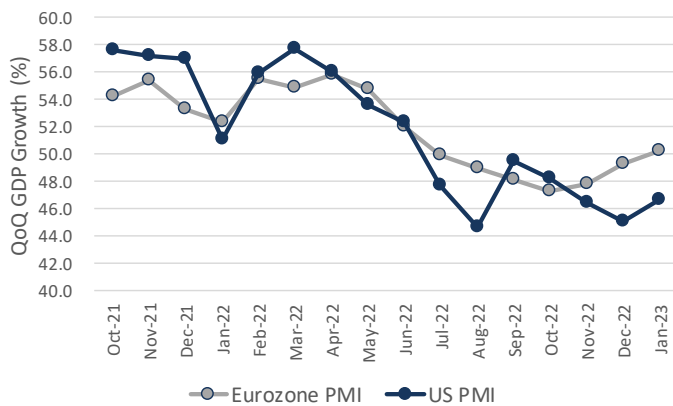
With January now in the books, we took some time to reflect upon recently released economic data, particularly as it compared to portfolio biases outlined in our *2023 US High Yield Outlook* report (published in early December of last year). One of the more notable divergences from expectations has been the resilience of the European economy, giving rise to some doubt that recession remains a foregone conclusion in the coming quarters. In this *Weekly Briefing*, we take a comparative look at trends within the US and Europe, and highlight potential opportunities to enhance portfolio returns based on relative regional concentration of high yield issuers.

More Resilient Growth, But More Persistent Inflation

Recently released Eurozone PMI data points to economic stabilization, with readings stepping up to “expansion” territory after an admittedly weak end to 2022. In contrast, US PMI increased to 46.6 in January, up from prior month but still squarely in “contraction” mode. European inflation normalization, however, has lagged. Driven, perhaps, by a less active central bank – the Fed began hiking in March of last year while the ECB did not move until July, and the increase in policy rates of the former has outpaced the latter by over 150 bps – Eurozone CPI remains elevated in comparison to the US.

Eurozone Composite PMI Now Outpacing US

quarterly data



Inflation Slower to Normalize in Europe

quarterly data, striped bars are estimates



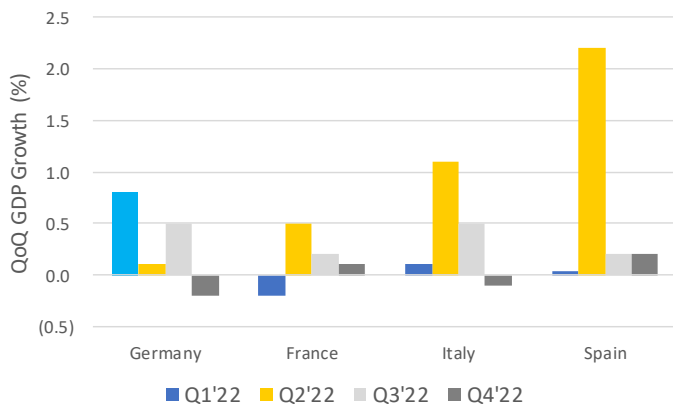
Source: SKY Harbor, Bloomberg, S&P Global

GDP Outlooks Converging

European GDP growth – at least partially driven by disruptions stemming from the war in Ukraine – trailed that of the US in the second half of last year. The Eurozone economy, however, managed to avoid contraction in Q4'22 via upside surprise in output (+0.1% vs. consensus estimates of -0.1%). Furthermore, a combination of mild winter temperatures and fiscal support have bolstered the outlook for Eurozone GDP growth in the coming quarters, with the consensus view now incorporating a potential path toward recession avoidance (or at least a shallower than expected contraction if one were to occur). Though positive for most issuers with exposure to the region, disproportionate benefit, in our view, should accrue to those with operations on the more energy-intensive end of the spectrum, particularly with natural gas price declines in the double-digit range over the last month.

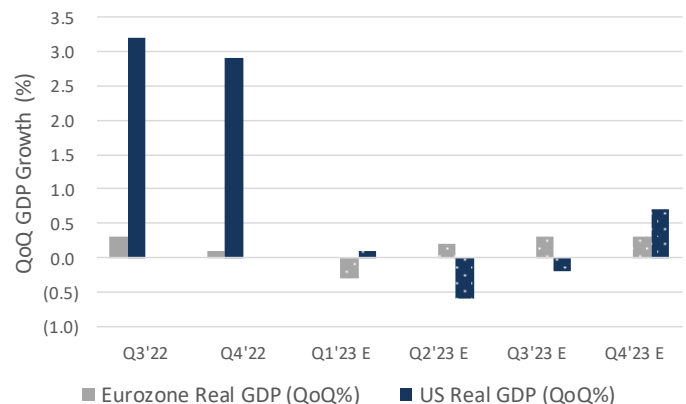
Mild Temps Have Stabilized Eurozone GDP Growth

quarterly data



Outlook for US and Europe Converging

quarterly data



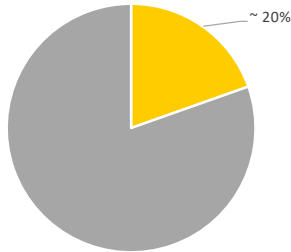
Source: SKY Harbor, Bloomberg, Eurostat

Which Issuers Stand to Benefit?

In light of data suggesting better than anticipated Eurozone resilience in 2023, our fundamental analyst team went through all index constituents, pinpointing those believed to have the greatest exposure to European sources of demand (we estimate, in aggregate, US high yield issuers derive 20% to 25% of revenue from outside the US, with Europe the greatest contributor to that bucket, followed by Asia). The exercise resulted in the identification of 121 issuers contained within the ICE BofA US High Yield Index, representing ~ 20% (by face value) of the benchmark. We refer to this group as the “High European Exposure” bucket, and compare dynamics to the balance of the index. Note, as demonstrated below, several sector biases in the set (Energy has disproportionately low European exposure, while Autos, Banking, and Capital Goods are relatively over-represented). These biases, however, have remained relatively consistent over time (our dataset goes back 15 years), as have the relative trading levels of sectors in comparison to the overall index, after adjusting for differences in credit quality, issue size, and duration.

High European Exposure Issuers

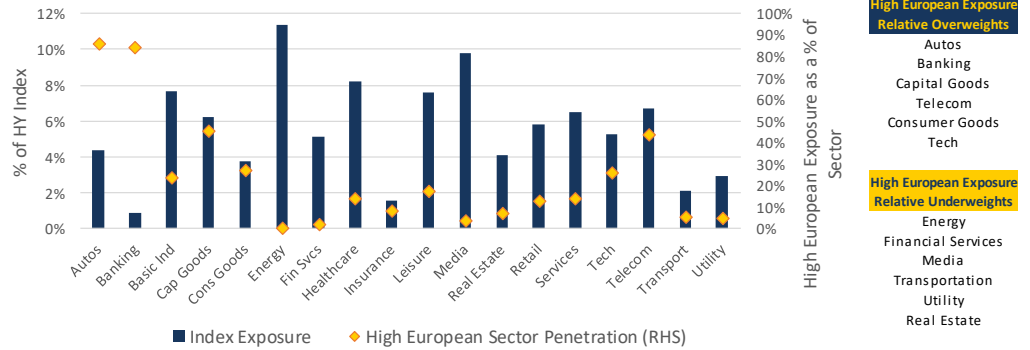
data as of Jan 30, 2023



■ High European Exposure ■ Rest of Index

High European Exposure Cohort Shows Some Sector Bias

data as of Jan 30, 2023



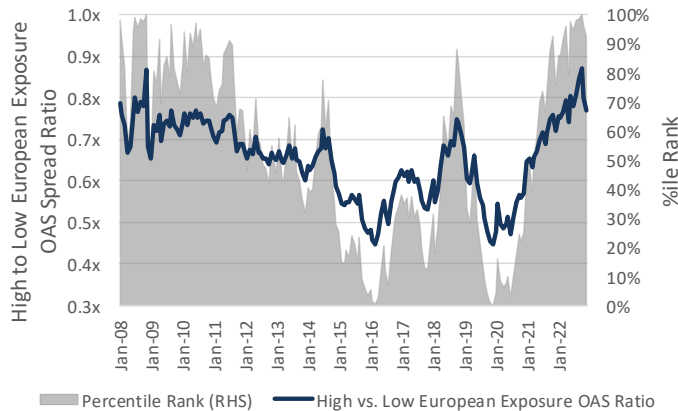
Source: SKY Harbor, ICE Data Indices

European OAS Penalty Appears Unwarranted

Making some modest adjustments to our dataset in an effort to normalize output (the “High European Exposure” cohort is, on average, slightly larger, slightly higher quality, and slightly longer relative to the balance of the index), we next generated an option-adjusted spread ratio time series. As demonstrated below, the ratio of “High European Exposure” OAS to the balance of the index is elevated at present (93rd percentile), reaching heights not seen since the Global Financial Crisis and the onset of the European Sovereign Debt Crisis over a decade ago. Historically, this “High European Exposure” constituent set has outperformed the balance of the index in nearly 2/3 of observations that began with a top decile dislocation (as is the case today). As such, we think moderating our bias toward US/domestically-focused credits has merit given prevailing market conditions.

High European Exposure Credits Screen Cheap...

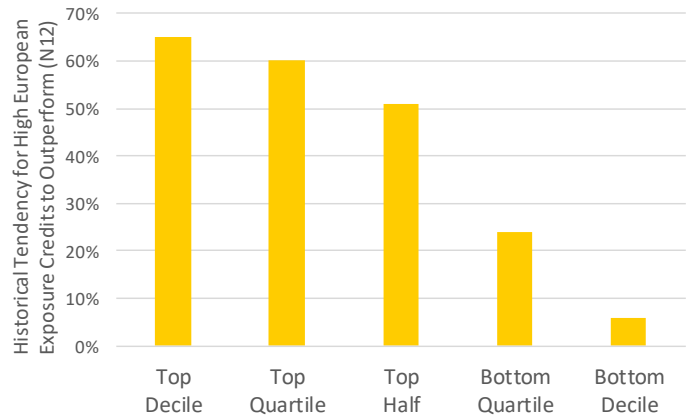
monthly data, trailing 15 years



Source: SKY Harbor, ICE Data Indices

...Historically Likely to O/P Next 12 Months Given Valuation

based on 15 years of monthly data



All Things in Moderation

Lower energy prices have bolstered Eurozone economic resilience while at the same time the impact of aggressive rate hikes have dampened US consumer enthusiasm, resulting in GDP growth expectation convergence between the two regions. Though headwinds remain (in particular, the ECB likely has further to go before pausing, at least relative to the Fed), we think valuations for “High European Exposure” credits have reached attractive levels. Though we continue to favor the overall US backdrop, we acknowledge a total return opportunity emerging in pockets of the index. On the margin, rotation into some of the “High European Exposure” credits – particularly ones that have meaningfully underperformed in the last few months – may prove beneficial to portfolio returns given our analysis of historical reversion when spread ratios reach distribution tails.

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