Mike Salice, CFA
Director of Research
msalice@skyhcm.com
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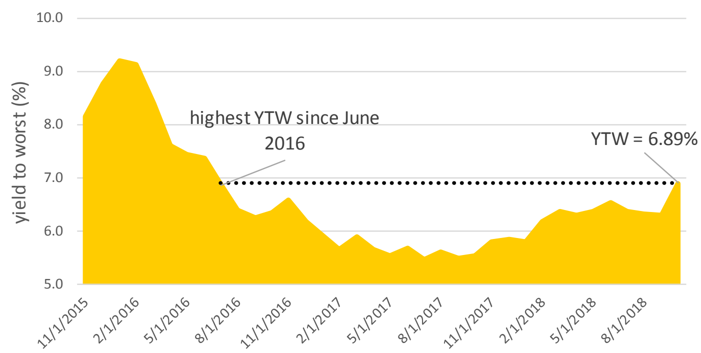
Weekly Briefing

SKYView: Valuations

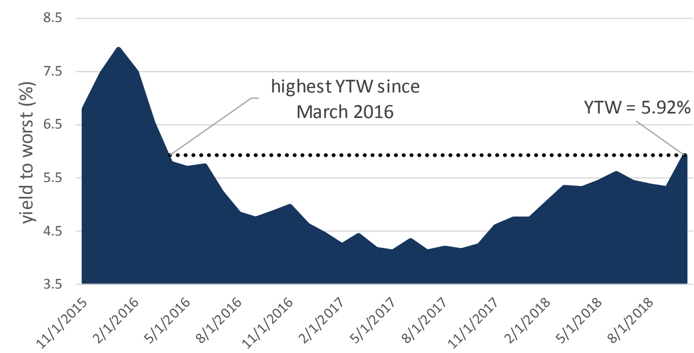
The sell-off in risk assets that occurred throughout most of October altered relative value across all asset classes. As such, this weekly briefing takes a fresh look at US high yield valuations, with a focus on downside protection across leveraged credit and adjacent fixed income products.

A modest rally subsequent to October month-end aside, yield-to-worst levels for both the ICE BofAML US High Yield Index (H0A0, a proxy for broad market high yield) and the ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index (JVC4, a proxy for short duration high yield) are among the highest we have seen in over 2 years (June '16 for broad high yield and March '16 for short duration high yield). While we concede that spreads were significantly wider in Q2'16 than they are at present, the market is offering equivalent yields despite a rapid reduction in TTM issuer-weighted default rates (5.98% in June '16 vs. 2.34% at present), lower index net leverage (4.0x in Q2'16 vs. 3.5x at present), and higher index interest coverage (4.1x at Q2'16 vs. 4.5x at present). The confluence of these factors leaves us inclined to expect spread tightening over the next several months.

ICE BofAML US High Yield Index (H0A0)
yield to worst (ytw), 3 years of monthly data



ICE BofAML 1-5 Year BB-B US High Yield Constrained Index (JVC4)
yield to worst (ytw), 3 years of monthly data



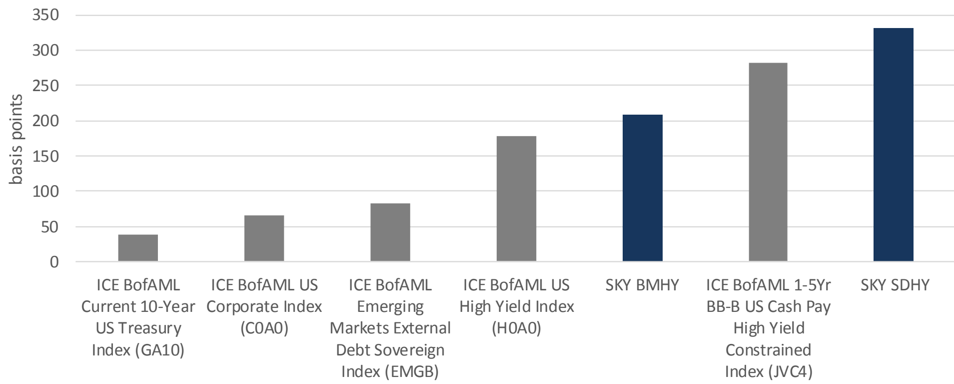
Source: SKY Harbor, ICE BofAML Indices, as of October 31, 2018

We acknowledge that the recent sell-off has some investors concerned that yield tights have already been achieved in this cycle. While we do not share this view, we nevertheless simulated the impact an environment of rising yields would have on various fixed income asset class returns. With an aim 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), we developed a model that makes the following assumptions:

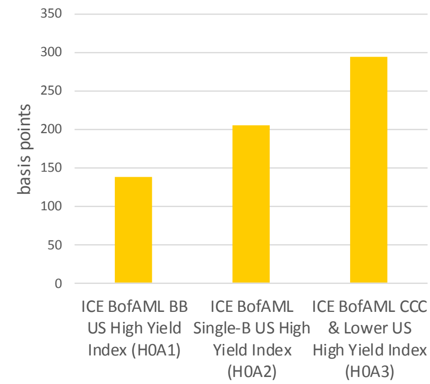
- 12 months investment horizon
- Increases in yield are linear in nature across all asset classes and occur in equal monthly increments
- No credit losses via defaults; no performance drag via downgraded securities exiting an index
- Coupon payments are reinvested in their respective strategies
- The 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 both broad and short duration high yield to be better positioned than adjacent fixed income indices (10-yr Treasuries, investment grade corporates, EM, etc.) to generate breakeven returns in a rising yield environment. For example, our simulation estimates that the ICE BofAML 1-5 Year BB-B US Cash Pay Constrained Index (JVC4) could absorb over 300 bps of linear yield widening over a 12-month period and still generate a total return of 0%. In contrast, the ICE BofAML US Corporate Index (C0A0, a proxy for investment grade credit) could only absorb ~ 65 bps of linear yield widening over a 12-month period before returns fall below 0%. The chart below plots breakevens for several fixed income indices under the assumptions listed above. Furthermore, we ran SKY Harbor UCITS funds (both broad market and short duration) through the same simulation, with each achieving higher breakevens than the respective index (driven, in part, by our bias to maintain portfolio duration below the index average, but with similar aggregate yield levels). Finally, we further delineate breakevens for rating buckets within the US high yield index in the right side chart.

Breakevens by Index
12-month time horizon



US High Yield Breakevens by Rating
12-month time horizon

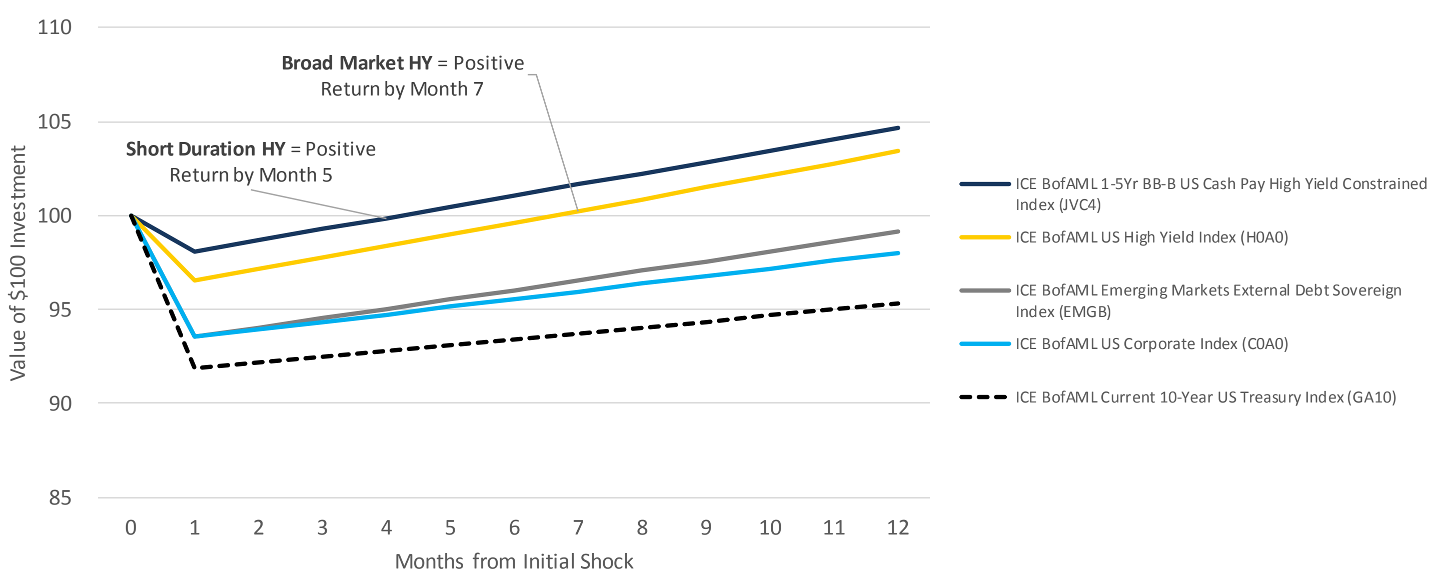


Source: SKY Harbor, ICE BofAML Indices

Recall, importantly, that our simulation assumes spreads absorb no increases in Treasury yields, and vice versa. In reality, this is unlikely, particularly for credit products with greater spread cushions. In a past analysis, we found that a key factor in determining whether a rise in rates can be offset (partially or in full) by a corresponding reduction in spread is most dependent upon the spread cushion present at the start of any period (as defined by the percentage of yield that is made up of spread). As such, our analysis likely underestimates breakevens for credit asset classes above, particularly those with higher spread cushions at present (broad and short duration high yield).

While the analysis above is helpful in determining total return resilience in an environment in which yields rise over a 12-month time horizon, we acknowledge that some investors may be more concerned with market timing (the risk of investing just before a rate shock, for example). Using October to illustrate our point, an investor putting to work a new US high yield allocation at the start of the month would have suffered ~ 60 bps of widening within the first couple of weeks. To better visualize this risk, we re-ran our prior simulation, but this time assuming the market suffers a 100 bps shock on day 1. After 100 bps of widening, we then assume yields remain steady over the next twelve months and quantify how long it would take the resulting carry to offset the initial drop in investment value. As demonstrated below, short duration and broad market high yield would recoup initial losses in the subsequent 5 and 7 months, respectively, while ancillary asset classes (investment grade credit, EM, Treasuries) would continue to be in the red twelve months out.

Timing to Breakeven Returns Following Instantaneous 100 bps Yield Shock
cumulative returns, 12-month time horizon



Source: SKY Harbor, ICE BofAML Indices

Overall, we believe the October sell-off has made both short duration and broad market high yield increasingly attractive and note that resulting yields are now in line with what the market offered back in Q2'16 (when defaults and index leverage were higher, and interest coverage was lower). Furthermore, our analysis shows that short duration US high yield is likely to be an attractive place to invest should yields continue to widen out, by virtue of elevated breakeven levels and quicker relative recoveries following an immediate yield shock.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
FOMC Rate Decision	8-Nov-18	Nov	2.00% to 2.25%	2.00% to 2.25%	2.00% to 2.25%
PPI Final Demand MoM	9-Nov-18	Oct	0.2%	0.6%	0.2%
U of Mich Sentiment	9-Nov-18	Nov	98.0	98.3	98.6

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
NFIB Small Business Optimism	13-Nov-18	Oct	108.0		107.9
Empire Manufacturing	15-Nov-18	Nov	20.0		21.1
Industrial Production MoM	16-Nov-18	Oct	0.2%		0.3%

Source: SKY Harbor, Bloomberg

Recommended Reading

Faucon, Benoit, Alessi, Christopher and Said, Summer (2018, November 9). OPEC and Russia Prepare for Clash Over Oil Output Cuts. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/opec-and-russia-prepare-for-clash-over-oil-output-cuts-1541780468

McCormick, Liz, Chen, Vivien Lou, and Harris, Alex (2018, November 8). Wall Street Says Fed Is In Denial About $4 Trillion Dilemma. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2018-11-08/-fed-is-in-denial-how-a-4-trillion-dilemma-could-get-ugly