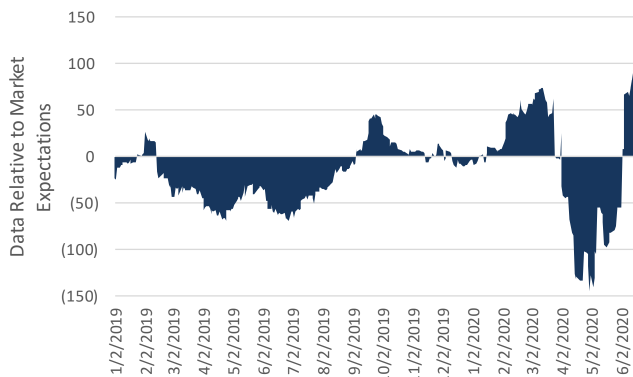
SKYView: Time to Rotate

After a 78 bps backup in spreads during the week of June 7, US high yield bonds have returned to tightening mode, bolstered by better than expected economic releases (including a 17.7% jump in May retail sales, the largest monthly improvement ever) and support from the Fed. While economic data remains admittedly weak on an absolute basis, we remain mindful that readings *relative* to expectations are often the dominant driver of risk premiums over the short term, and so view the rally as justified. In this *Weekly Briefing*, we highlight the recent surge in the Citi Economic Surprise Index and find historical evidence in support of our increased exposure to Cyclical credits in the current market environment.

The Citi Economic Surprise Index (United States) – which shows how economic releases are trending relative to consensus expectations – has been on the rise since the start of May, most recently bolstered by retail sales strength (+17.7% in May, well above consensus expectations of +8.4%). Looking at quarterly data since index inception (January 2003), there exists a correlation between economic surprise and the magnitude of ICE BofA US High Yield total returns, with Cyclicals (excluding Energy) an even greater beneficiary of beats relative to the consensus view. Additionally, as we highlighted in our June 1, 2020 *Weekly Briefing* entitled "Re-opening Relative Value," Cyclical ex Energy credits continue to trade wide of Defensive bonds, with spread ratios above 1.2x consistent with past peak periods of credit stress. **Since the ratio typically compresses as we exit a recession, cyclicals are potentially poised to outperform in the coming months should the economic re-opening be a success**.

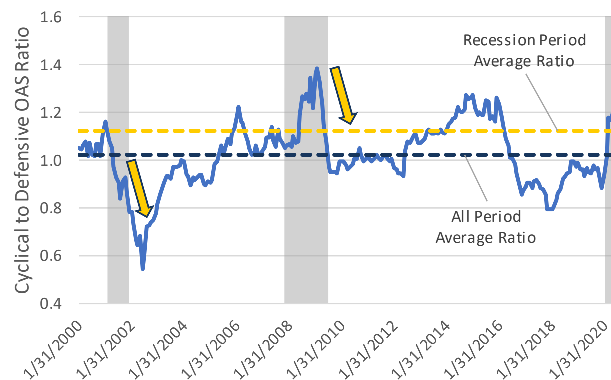
Citi Economic Surprise Index Supportive of Spread Compression

monthly data, recessions shaded grey



Cyclical (ex Energy) to Defensive OAS Ratio Yet to Compress

OAS ratio, recessions shaded grey

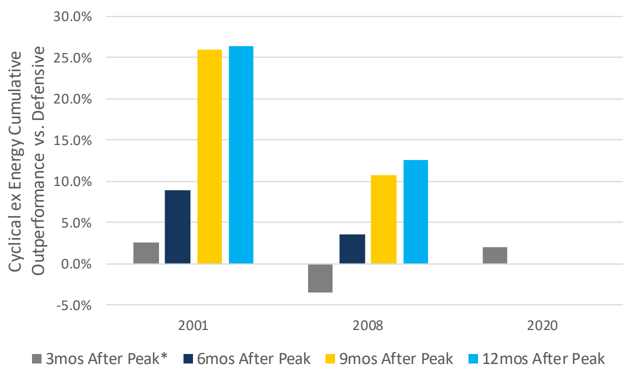


Note: Automotive, Basic Industry, Capital Goods, Leisure, Real Estate, Retail, Technology and Transportation assumed to be "Cyclical ex Energy"; Banking, Consumer Goods, Healthcare, Financial Services, Insurance, Media, Services, Telecom and Utility assumed to be "Defensive."
Source: SKY Harbor, Citigroup Global Markets, ICE BofA Indices, Bloomberg

Examining post-recession recoveries of the past, outperformance of Cyclicals (again, excluding Energy) relative to Defensive sector bonds tend to accelerate over time. In the graphic below (left side) we chart cumulative total return outperformance of Cyclicals vs. Defensives in the 3, 6, 9, and 12-month periods after peak recession OAS is reached. If late March 2020 proves representative of peak OAS for the current recession, we would expect strong Cyclical outperformance over the next several quarters. What if March 2020 was not an OAS peak? Examining data since the start of 2000, **we calculated next 12 month returns on a rolling monthly basis, and found that Cyclicals tend to outperform Defensive credits, on average, by over 300 bps when the Cyclical to Defensive OAS ratio is over 1.2x at the start of the period** - which it is now – regardless of whether or not peak OAS has been reached. As such, a rotation into Cyclicals may be prudent even if March 2020 OAS levels are not indicative of current recession highs.

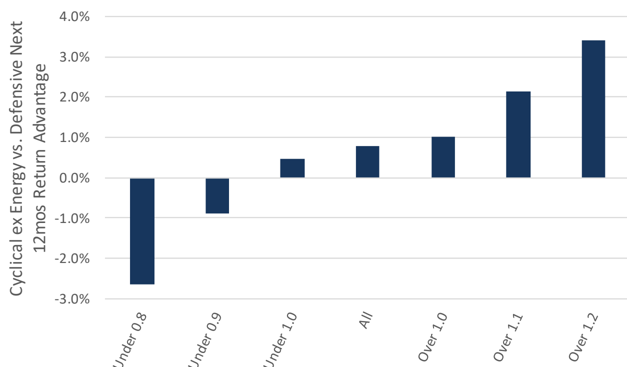
Total Returns After Peak Recession OAS

cumulative return differential: Cyclical ex Energy less Defensive



Cyclical ex Energy less Defensive Returns: Next 12mos Advantage

Cyclical ex Energy OAS to Defensive OAS Ratio starting point buckets



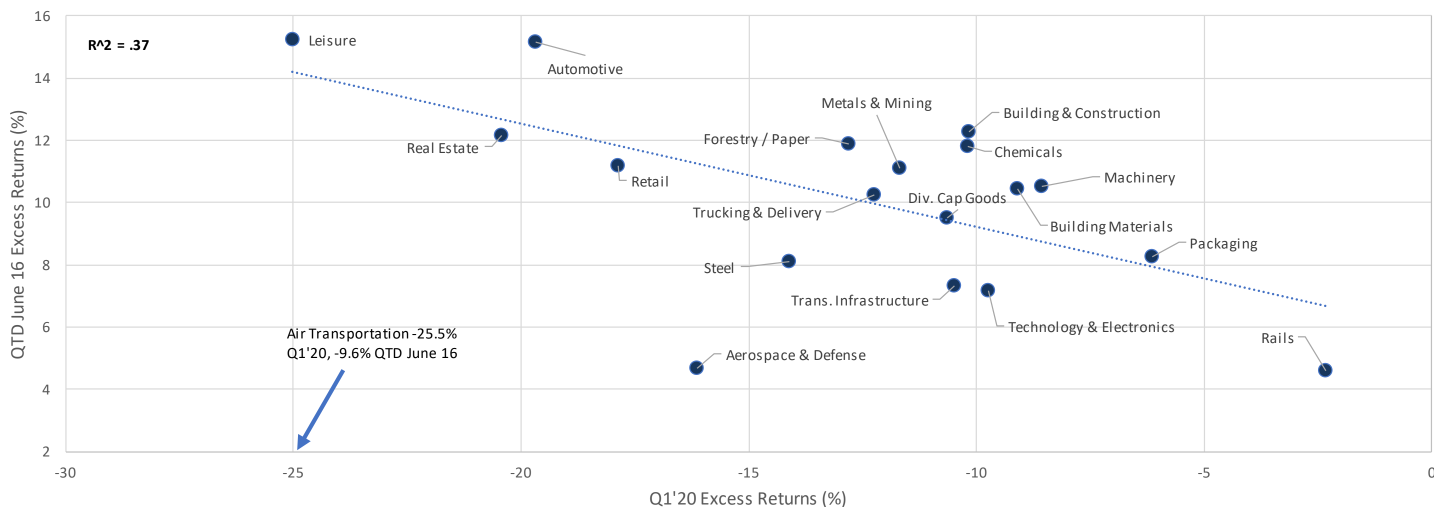
*for 2020, the "3mos After Peak" reading represents the two-month period following late March spread wides
Source: SKY Harbor, ICE BofA Indices

With a rotation into Cyclicals in mind, we looked for unjustified laggards in the recent rally. In the scatterplot below, we chart Q1'20 excess returns across the x-axis, and quarter-to-date returns available through the time of writing (June 16, 2020) across the y-axis (note that we use sector classifications in this exercise, but further break out Basic Industry, Capital Goods, and Transportation into industry-level cohorts given highly varied operating characteristics). We observed below the better-than-implied recovery in Automotive, Building & Construction, and Chemical constituents, while Aerospace & Defense and Steel

have justifiably lagged. In our view, **Technology & Electronics and Transportation Infrastructure may offer attractive value given weaker-than-implied QTD recoveries and our sense that post-COVID demand should not be secularly challenged**.

Cyclical ex Energy Performance

Q1'20 Returns vs. QTD (June 16, 2020) Returns



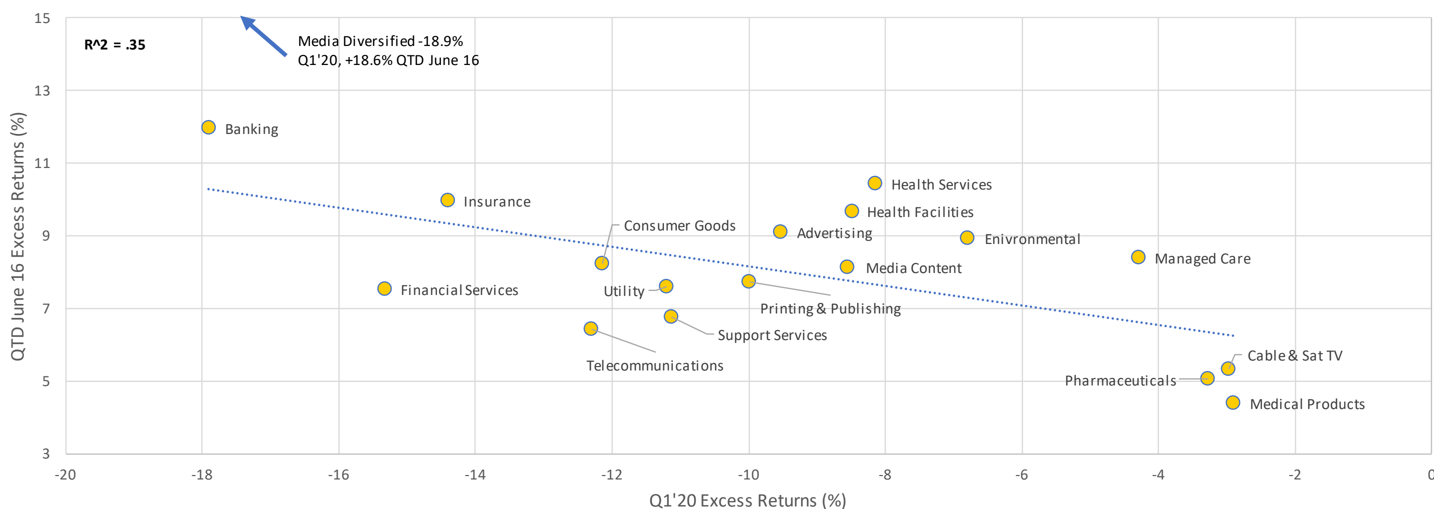
Note: For Basic Industry, Capital Goods, and Transportation sectors, we present data at the industry level given varied characteristics; for all others, we roll up to the sector level

Source: SKY Harbor, ICE BofA Indices

In searching for potential sale candidates among Defensive issuers, we noted that **Media Diversified, Health Services and Health Facilities appeared to have staged a better-than-implied rally, and may potentially contain bonds that have tightened too sharply in the last two months**. Note that like above, we used sector classifications in this exercise, but had further delineated Healthcare, Media, and Services into industry-level cohorts given highly varied operating characteristics.

Defensive Performance

Q1'20 Returns vs. QTD (June 16, 2020) Returns



Note: For Healthcare, Media, and Services sectors, we present data at the industry level given varied characteristics; for all others, we roll up to the sector level

Source: SKY Harbor, ICE BofA Indices

In conclusion, a highly supportive Fed and a string of positive economic surprises have allowed spread compression to continue. Using history as our guide, we found it prudent to boost our allocation to Cyclical ex Energy sectors (where appropriate given portfolio objectives and constraints), as this move has typically been rewarded in the quarters following recessionary spread peaks. If March 2020 turns out to be a premature peak, we take comfort in Cyclical outperformance in subsequent 12-month periods that begin with Cyclical to Defensive OAS ratios as elevated as they are now (> 1.2x). Finally, our research team continues to focus on identifying attractively priced Cyclical credits contained in sectors that have lagged from a recovery perspective QTD, while also being mindful of Defensive issues that have generated better-than-implied excess returns relative to their Q1'20 selloff.

Important Disclosures and Disclaimers

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