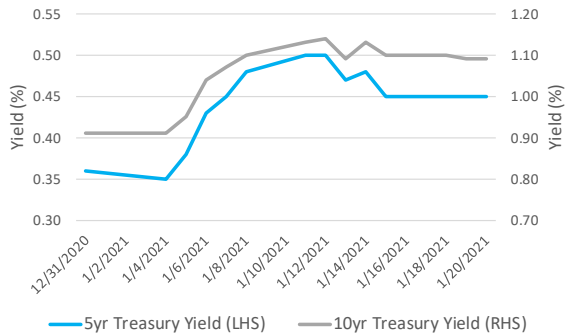


SKYView: The Threat of Rising Rates

In our January 11th *Weekly Briefing* entitled “Georgia Goes Blue,” we noted that Democratic victories in both Senate run-off elections led to heightened growth and inflation expectations, largely a function of additional stimulus optimism under a unified government. Yields on US Treasuries increased as polling data trickled in, though markets have since leveled off. Nevertheless, investors have become increasingly focused on duration risk, with year-to-date returns (admittedly a limited data set, through January 20, 2021) showing a reversal in trend relative to FY20. With building – though arguably premature – enthusiasm for the reflation trade, we focus this *Weekly Briefing* on gauging the relative resilience of high yield spreads amidst upward pressure on risk-free rates.

Rate Moves Tapered Off After Initial Georgia Election Reaction

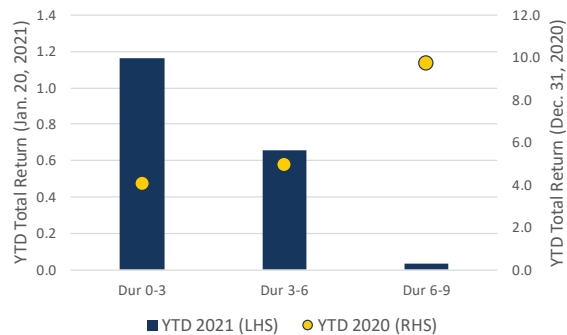
daily data, year-to-date



Source: SKY Harbor, ICE Data Indices

Market Preference for Duration Has Flipped

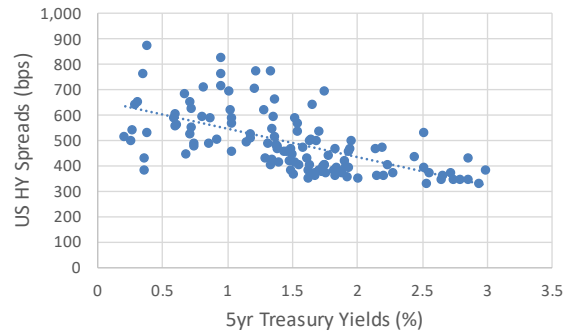
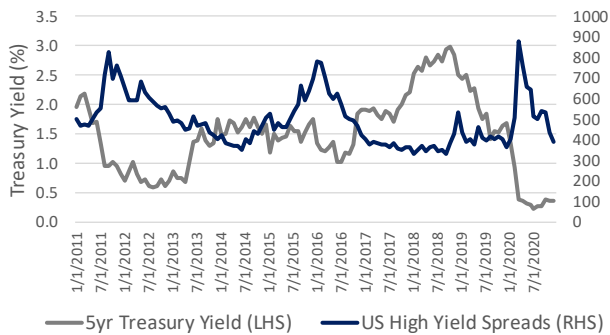
YTD Total Returns, 2020 (Dec 31, 2020) vs. 2021 (Jan 20, 2021)



Using the ICE BofA US High Yield Index (H0A0) as our proxy, we find a negative relationship exists between high yield spreads and treasury yields in most environments - that is, spreads on the high yield index tend to tighten when yields on government bonds rise. While the strength of this relationship varies over time, in our view this dynamic is due to the tendency for risk premiums to compress when the selloff in rates is driven by rising growth expectations, a scenario consistent with the current economic outlook. An analysis of rolling 3-month changes in 5yr Treasury yields vs. rolling 3-month changes in high yield spreads demonstrates a similarly inverse relationship over time, as demonstrated below.

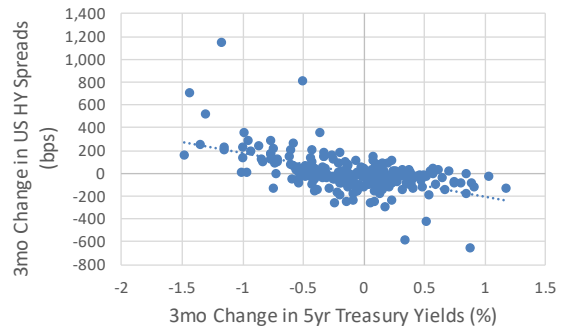
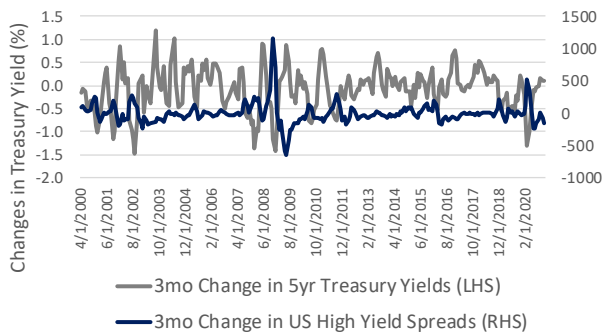
5yr Treasury Yields vs. US High Yield (H0A0) Spreads

monthly data, trailing 10 years



3-Month Change in 5yr Treasury Yields vs. 3-Month Change in US High Yield (H0A0) Spreads

monthly data, trailing 20 years



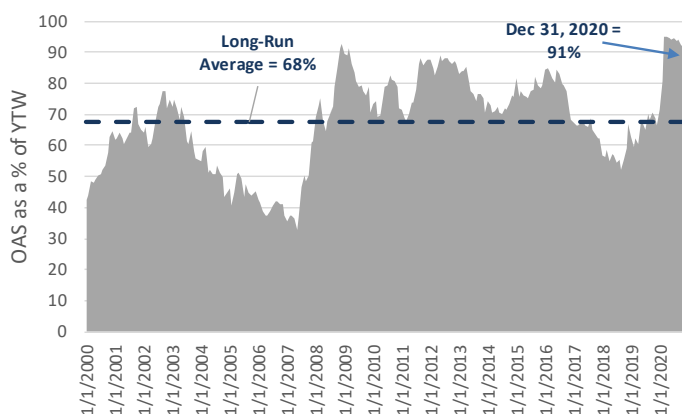
Source: SKY Harbor, ICE Data Indices

Looking at data going back to January '00, we find that a key factor in determining whether or not a rise in rates can be fully absorbed by the high yield index depends upon the spread cushion present at the start of the period, as defined by the percentage of yield that is made up of spread. For example, the

spread cushion at December 31, 2020 was ~ 91% (386 basis points or bps OAS, 4.24% Yield-to-Worst or YTW), above the long-run index average of ~ 68% despite the proximity to bottom-quartile OAS levels (left chart below). We further calculated rolling 12-month spread change betas (change in HOAO spread vs. change in 5yr Treasury yield) to better identify spread cushions necessary to fully absorb changes in risk-free rates (beta of -1.0 or greater). Based on groupings below, the index has historically struggled to fully offset a move in rates when the spread cushion migrated below the 65% to 75% bucket. Should this relationship persist, relatively lofty spread cushions at present imply an ability for the index to fully absorb the next 80 to 100 bps of increased yield on the 5yr Treasury, all else being equal.

US High Yield (HOAO) Spread Cushion

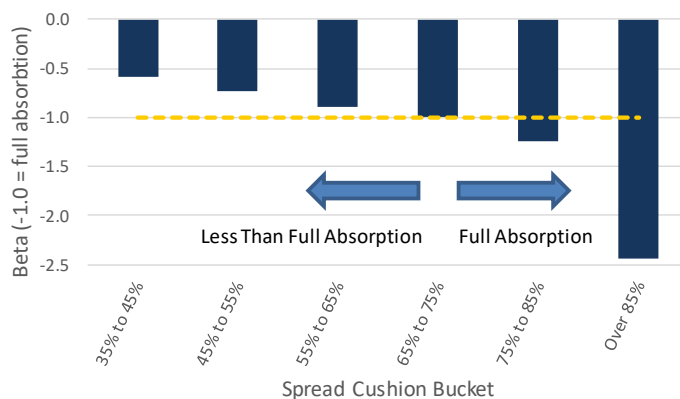
spread as a % of YTW; monthly data since 2000



Source: SKY Harbor, ICE Data Indices

Spread Change Beta by Cushion Bucket

rolling 12-month periods; beta of changes in HOAO OAS to changes in 5yr Tsy yields



In conclusion, reflation concerns may be overblown given historically negative correlations between Treasury yields and US high yield spreads. Though we concede that this inverse relationship tends to weaken at sufficiently low levels of OAS, elevated spread cushions at present portend full absorption of the next 80 to 100 bps of increased yield on the 5yr from current levels. Should the consensus expectations calling for a 25 bps move in the belly of the curve by year end come true, high yield appears well insulated from the threat of rising rates.

Definitions

Basis points (bps) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market. For example, if a stock's beta is 1.2, it's theoretically 20% more volatile than the market.

Credit Ratings are used by the S&P and Fitch credit agencies for long-term bonds and some other investments. They range from the highest rating of AAA (the borrower's capacity to meet its financial commitment the obligation is extremely strong) to D (the borrower is in default). Ratings in order of quality include AAA, AA, A, BBB, BB, CCC, CC, C and D.

Duration risk (also referred to as interest rate risk) is the possibility that changes in interest rates may reduce or increase the market value of a fixed-income investment.

ICE BofA US High Yield Index: An index that tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The index is further defined by sub-indexes associated with credit ratings (e.g., the CCC sub-index).

Option-Adjusted Spread (OAS) is the measurement of the spread of a fixed income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

Yield-to-Worst (YTW) is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures.

Important Disclosures and Disclaimers

Past performance does not guarantee future results. The referenced indices are shown for informational purposes only and are not meant to represent the AXS Investments Funds. Investors cannot directly invest in an index.

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