Portfolio Manager Insights

SKY HARBOR CAPITAL MANAGEMENT

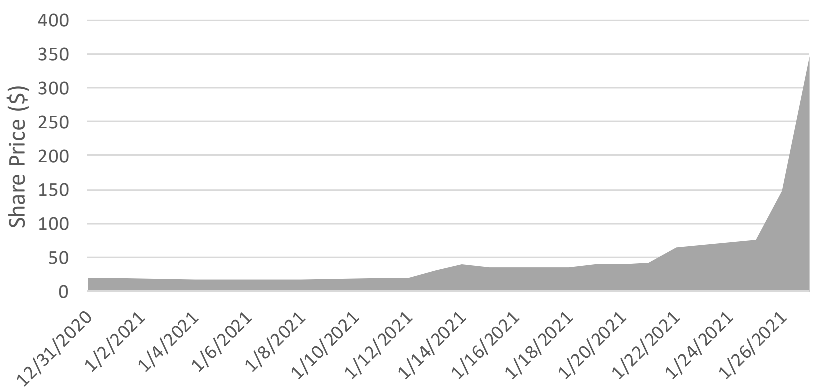
SKYView: Short Squeezes, Sentiment, Spending, and Surprises

Despite a calendar full of activity – an Federal Open Market Committee (FOMC) meeting, the start of Q4'20 earnings season, the release of key economic indicators, etc. – it was a group of retail investors posting on Reddit that dominated most of the financial headlines over the past week. Less attention-grabbing but nevertheless relevant for markets, the FOMC left rates and the pace of asset purchases unchanged, while financial results out of early reporters imply that Q4 will be another quarter in which double-digit upside earnings surprises remain the norm. In this *Weekly Briefing*, we break down key events of late January and their potential impact on high yield markets.

A David vs. Goliath-esque battle between amateur traders and some of the most well-known hedge fund managers began in earnest last week, with a Reddit subforum called "WallStreetBets" inciting a short squeeze in several stocks. Most notable among the targets was GameStop, whose stock skyrocketed 1,745% (YTD through January 27) as a result of the power struggle between professional and amateur speculators. The carnage quickly spread to other tickers with sizeable short interest, leading to some of the worst total return sessions for long/short hedge funds in history. Importantly, the disruption to high yield market trading was minimal, even among constituents with heavily shorted public equities. As demonstrated in the tables below, members of the ICE BofA US High Yield Index (H0A0) caught up in the drama have not, through the time of publication, experienced the same magnitude of volatility in their underlying bond prices.

GameStop (GME) Stock Chart

daily data, Jan 1 to Jan 27



Source: SKY Harbor, Bloomberg, ICE Data Indices

Prominent Short Squeeze Targets

through Jan 27

Name	Ticker	Short Interest (%)	YTD Total Return
GameStop	GME	123	1745%
AMC Entertainment	AMC	13	839%
Bed Bath & Beyond	BBBY	66	198%
Nokia	NOK		68%
Russell 2000 Index	**RTY**		**7%**

Bond	Ticker	Rating	YTD Total Return
GME 10% Notes due '23	GME	B2/B-	3.8%
AMC 10.5% Notes due '25	AMC	Caa2/CCC-	37.6%
BBBY 3.75% Notes due '24	BBBY	B1/B+	1.8%
NOK 3.375% Notes due '22	NOK	Ba2/BB+	0.4%
ICE BofA US High Yield Index	**H0A0**		**0.3%**

In complete opposition to the drama unfolding on social media, the January 26-27 Federal Open Market Committee meeting appeared relatively devoid of surprises. The Committee left guidance on rates unchanged and maintained the current pace of asset purchases ($120bn per month). In Fed Chairman Powell's subsequent remarks, he admitted that the pace of the recovery has recently "moderated," but also pointed to "an improved outlook" later in 2021. On the topic of inflation, Powell noted that any potential liftoff in rates was tied to sustained inflation in excess of 2%, and emphasized that any initial inflation driven by a "burst" of spending as a result of a re-opening would likely be transient, not necessarily triggering FOMC action.

Key Takeaways from Fed Chairman Powell's Speech

January 27, 2020

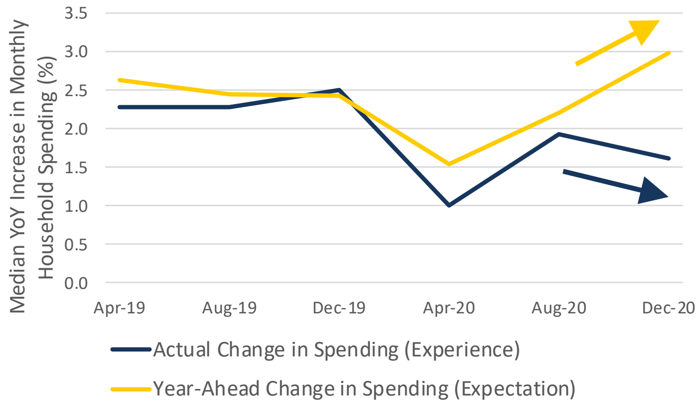
Negatives	*Positives*
"Following a sharp rebound in economic activity last summer, the pace of the recovery has moderated in recent months..."	"In contrast, the housing sector has more than fully recovered from the downturn, supported in part by low mortgage interest rates."
"Household spending on services remains low, especially in sectors that typically require people to gather closely, including travel and hospitality."	"Business investment and manufacturing production have also picked up."
"And household spending on goods has moderated following earlier large gains."	"While we should not underestimate the challenges we currently face, several developments point to an improved outlook for later this year."

Source: SKY Harbor, Federal Reserve

Consistent with Fed Chairman Powell's remarks on a moderating recovery, recently released Survey of Consumer Expectations (SCE) Household Spending Survey data shows that the median increase in monthly household expenditures decelerated to +1.6% in December, down from +1.9% in August. Expectations for spending in the coming year, however, increased to +3.0%, up from +2.2% in August, as consumers remain optimistic for an eventual re-opening. Also notable are changes in large purchases, with an increase in spending on Electronics and Home Appliances funded via a reduction in Vacation expenditures. These trends appear consistent with Q3'20 corporate earnings releases, and hint toward the continuation of spending to enhance home comfort – a theme that has been reflected in underlying portfolio positioning.

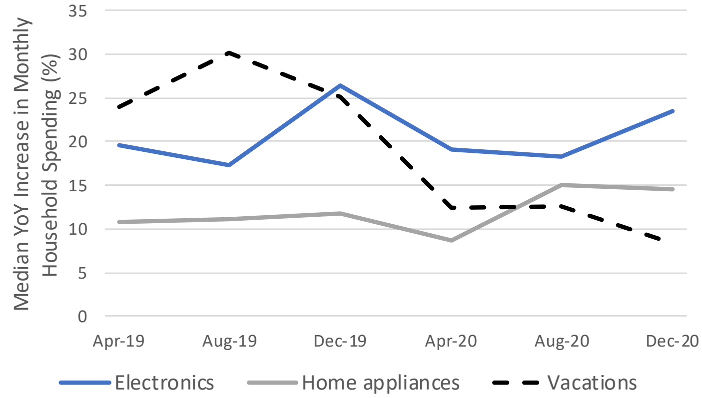
SCE Household Spending Survey

last 2 years data



Vacation Money Going Toward Electronics & Home Applicances

data collected every 4 months



Source: SKY Harbor, Federal Reserve Bank of New York

Finally, though Q4'20 earnings season has just recently begun, we note that growth continues to surprise to the upside. The strong historical earnings correlation between small cap equities and high yield issuers provide a positive read-through for our market, though only an admittedly small portion of constituents (14%) have reported thus far. Nevertheless, we remain mindful that earnings relative to expectations – more so than absolute earnings growth – drive returns, and we therefore remain optimistic for high yield spread compression in the coming quarters.

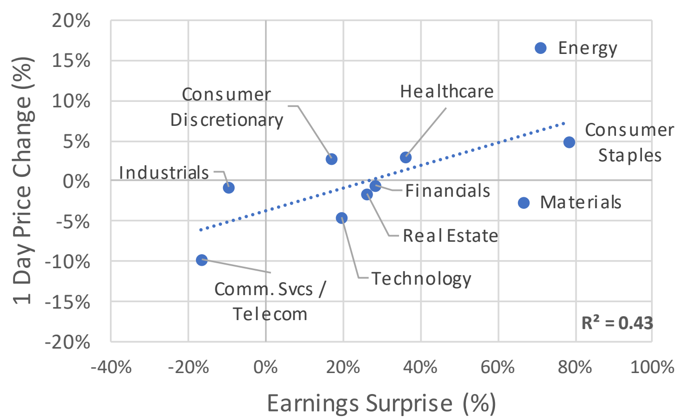
Russell 2000 Index (RTY)

Q4'20 Earnings Summary (14% have reported through publication)

Sector	Q4'20 Earnings Growth	Q4'20 Earnings Surprise
Energy	514%	71%
Materials	-23%	67%
Industrials	-69%	-10%
Consumer Discretionary	38%	17%
Consumer Staples	44%	78%
Healthcare	-6%	36%
Financials	24%	28%
Technology	30%	20%
Comm. Svcs / Telecom	-45%	-17%
Utilities	NM	NM
Real Estate	32%	26%
All Securities	12%	26%

Price Reaction vs. Earnings Surprise

earnings surprise vs. 1 day Price Change



Source: SKY Harbor, Bloomberg

A showdown between Wall Street and Main Street was the main attraction over the past week, but we believe relatively dovish commentary from the Fed and a strong start to Q4'20 earnings season represent the most relevant news for high yield markets. With tapering seemingly off the table and corporations continuing to adjust to new market realities, our optimistic view for spreads over the intermediate term remains intact.

Definitions

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).
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.
Long is the buying of a security such as a stock, commodity or currency with the expectation that the asset will rise in value. All market indices are unmanaged.
Russell 2000 Index is a small capitalization index consisting of the smallest 2,000 securities in the Russell 3000 Index and widely regarded in the industry as the premier measure of small capitalization stocks.
Short is a sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume they will be able to buy the stock at a lower amount than the price at which they sold short.
Short squeeze is a situation that occurs when a stock or other asset jumps sharply higher, forcing traders who had bet that its price would fall, to buy it in order to forestall even greater losses.