SKYView: Fiscal Stimulus as the Next Positive Catalyst

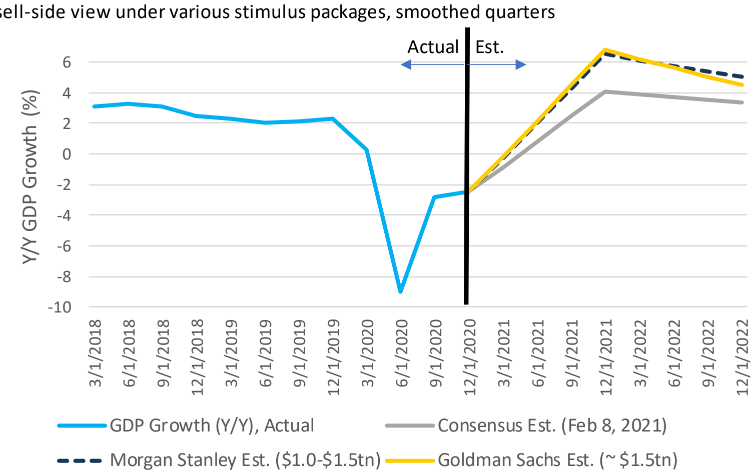
News headlines over the last several weeks have been dominated by stimulus talks, and once again we find lawmakers at odds over the size and scope of spending needed to put the economic recovery on solid footing. Amidst often conflicting economic reports and the ballooning of the federal debt load to a level that now exceeds a full year of gross domestic product, key Congressional decision-makers remain divided along party lines as to the most appropriate fiscal response. In this *Weekly Briefing*, we take a closer look at the impact the next coronavirus relief bill may have on Gross Domestic Product (GDP) growth, and extend our analysis a step further to gauge potential implications for the US high yield market.

Much like our March 2020 research piece - which attempted to frame the impact a then-emerging coronavirus might have on high yield spreads - we believe a scenario analysis approach is most appropriate in assessing the effect a wide range of possible fiscal stimulus paths may have on the economy. We also tie in our own approximation of resulting US GDP growth under each scenario, leveraging sell-side research and the historical relationship between government spending and economic activity to inform our estimates. The resulting four scenarios incorporated into our analysis are detailed below:

Scenario #1: most closely aligned with the recent "moderate" Republican proposal, this scenario involves $500-$900bn in stimulus spending, an amount equal to what most calculate is the current output gap in the US economy. We estimate 2021 US GDP growth of ~ 3.8% under this set of assumptions.
Scenario #2: essentially the consensus view (as of early February), this scenario calls for an upsize to the Republican proposal, perhaps a bill in the $900bn-$1.25tn range, and is directed at appeasing moderate Democrats in the Senate. In this case, we leave 2021 and 2022 US GDP growth at current consensus levels (4.1% and 3.4%, respectively).
Scenario #3: an even larger upsize to Scenario #2, which would approximate the Biden plan less some of the more controversial spending provisions that both Republicans and moderate Democrats appear to be biased against. In this case, consensus estimates for US GDP appear too low at present, with 2021 growth potentially rising to +6.5%.
Scenario #4: assumes the full Biden plan comes to fruition via budget reconciliation, which is the path the administration is moving toward at present. In this case, we think GDP growth could exceed 7%.

US GDP Growth Expectations on the Rise

sell-side view under various stimulus packages, smoothed quarters



Source: SKY Harbor, Morgan Stanley, Goldman Sachs, Bloomberg

Stimulus Magnitude to Drive GDP Growth Revisions

SKY Harbor scenario estimates

Scenario #	Description	Size	2021E	2022E
1	Moderate Republican Target	$500 - $900 bn	3.80%	3.30%
2	Consensus View (early Feb '21)	$900bn - $1.25tn	4.10%	3.40%
3	Upsize but Compromise	$1.25 - $1.65 tn	6.50%	4.75%
4	Biden Plan via Reconciliation	$1.65 - $2.0 tn	7.25%	5.25%

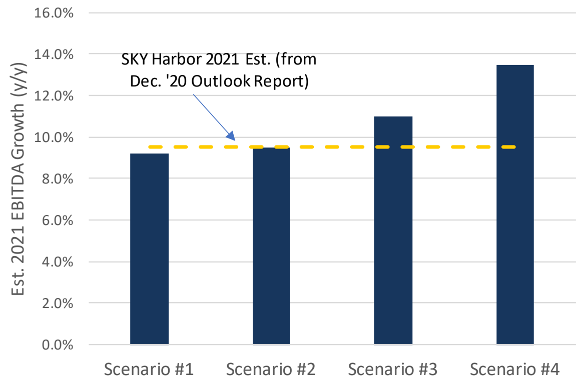
assumed to be priced in at present
SKY Harbor view of most likely

Based on our analysis above, **all scenarios except #1 – which we believe to be very unlikely given enthusiastic support of a sizeable stimulus package from both the Treasury Secretary and the Federal Reserve Chair – should result in either stability or upward revisions to the consensus view of 2021 GDP growth**. As a key barometer of economic health, it is not surprising that GDP and US high yield issuer EBITDA growth have been highly positively correlated over time, and as such we would also expect an upward revision to the corporate earnings outlook should fiscal stimulus exceed $1.25tn. Updating the inputs that drive our multi-factor regression model, we believe corporate EBITDA growth could surpass the +9.5% estimate provided in our *2021 US High Yield Outlook* (published in December '20, a summary of which can be found here), rising to +11% and +13.5% in scenarios #3 and #4, respectively. Due to greater underlying EBITDA growth, we also envision more meaningful reductions in FYE21 leverage for the ICE BofA US High Yield Index (H0A0) constituent set as a whole. The credit ratio trajectories included in the chart below show meaningful fundamental improvement potential over the next four quarters, all of which could prove conservative should management teams use excess cash flow generation to proactively reduce debt.

All referenced indices are for informational purposes only and are not meant to represent the AXS Investments Funds. Investors cannot directly invest in an index. There is no guarantee that any projection, forecast or opinion will be realized. Forecasts are inherently limited and cannot be relied upon. Actual results may vary.

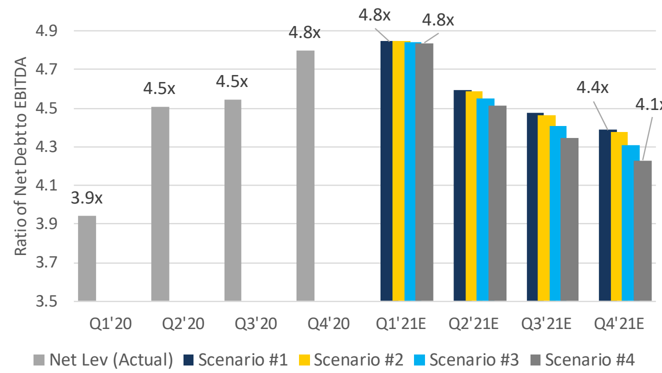
EBITDA Growth Outlook by Stimulus Scenario

2021 and 2022 Estimate



Net Leverage Outlook by Stimulus Scenario

assumes no change to absolute debt levels

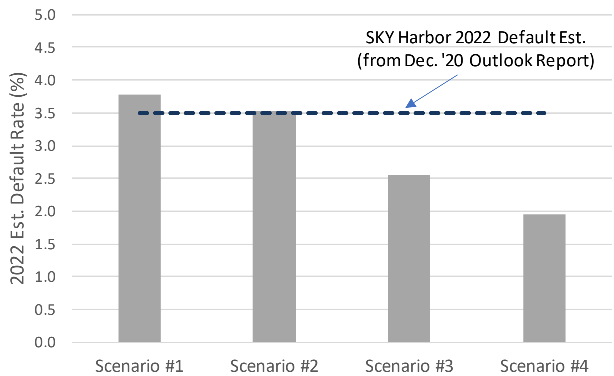


Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg

Just as we would expect higher GDP growth to boost corporate EBITDA generation and facilitate a more rapid de-leveraging of the index, a move toward **stronger credit metrics and the greater availability of cash should also serve to reduce the expected credit loss rate**. Sensitizing the inputs that drive our internal regression models under various GDP growth scenarios, we would anticipate downward pressure on the default rate and upward pressure on the recovery rate as the magnitude of fiscal stimulus rises. Again, all scenarios except #1 represent an improvement to the view presented in our previously published outlook report.

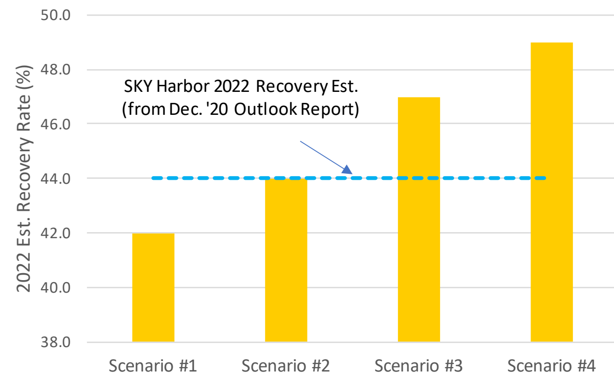
Default Rate Outlook by Stimulus Scenario

2022 Estimate



Recovery Rate Outlook by Stimulus Scenario

2022 Estimate



Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Federal Reserve, Moody's, Capital IQ, Bloomberg

The sensitivity table below translates our scenario analysis into index default loss estimates, demonstrating the near-term benefits that a more sizeable relief plan will likely have on the high yield market. Even after adjusting for an updated view of excess spread* demanded by investors, our model output implies that **high yield OAS levels should be negatively correlated to the size of the fiscal stimulus package that is ultimately passed, with a bill in excess of $1.25tn representing a near-term catalyst for spread tightening**.

Default Loss Sensitivity Analysis

principal loss, in bps (default rate * 1-recovery rate)

		Default Rate										
		1.80%	2.00%	2.20%	2.40%	2.60%	2.80%	3.00%	3.20%	3.40%	3.60%	3.80%
Recovery Rate	49%	92	102	112	122	133	143	153	163	173	184	194
	48%	94	104	114	125	135	146	156	166	177	187	198
	47%	95	106	117	127	138	148	159	170	180	191	201
	46%	97	108	119	130	140	151	162	173	184	194	205
	45%	99	110	121	132	143	154	165	176	187	198	209
	44%	101	112	123	134	146	157	168	179	190	202	213
	43%	103	114	125	137	148	160	171	182	194	205	217
	42%	104	116	128	139	151	162	174	186	197	209	220

Scenario #4 Scenario #3 Scenario #2 Scenario #1

SKY Harbor Spread Target Analysis

Excess Spread = OAS after credit losses

Scenario	Default Loss	+	Excess Spread	=	Spread Target
#1	220		149		369
#2	190		154		344
#3	138		182		320
#4	102		197		299

H0A0 Reference Period	OAS (bps)	Date
All-Time Tight	241	1-Jun-07
Prior Cycle Tight	316	3-Oct-18
Start of 2020	356	2-Jan-20
Month End	384	31-Jan-21

*we define excess spread as the OAS demanded by investors after accounting for anticipated credit losses; this value has fluctuated over time, but we find that higher inflation / Treasury rates upwardly bias excess spread

Source: SKY Harbor, ICE Data Indices

In conclusion, we believe the market is currently pricing Scenario #2 into index-wide spread levels. In our view, Scenarios #3 and #4 are more likely to come to fruition, which should lead to upward revisions to consensus GDP growth expectations. Higher GDP growth should lead to stronger than expected EBITDA generation by high yield issuers, allow for greater de-leveraging, and ultimately prove our previously generated default and recovery rate estimates too conservative in nature. A re-setting of our internal projection models imply the potential for another 40 to 60 bps of spread compression should the next fiscal stimulus package come in above $1.25tn in size, providing a near-term catalyst for spread tightening in the high yield market.

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.
EBITDA is earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances.
Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.
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).
Leverage is an investment strategy of using borrowed money, specifically, the use of various financial instruments or borrowed capital, to increase the potential return of an investment.
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.
Sell-side refers to the part of the financial industry that is involved in the creation, promotion, and sale of stocks, bonds, foreign exchange, and other financial instruments that are made available to the “buy-side” of the financial industry.

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