

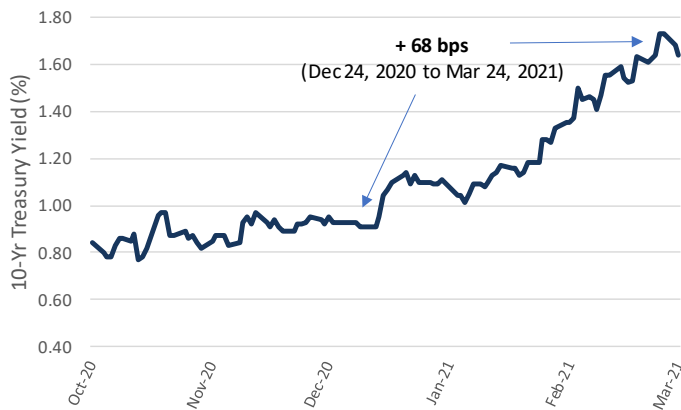
SKYView: Rising Rate Absorption

Rates took a breather this week, with 10-year treasury yields down ~ 9 basis points (bps) through the time of writing (Thursday, March 25th). At the same time, the ICE BofA US High Yield Index (H0A0) rallied, with total returns back in the black after dipping into negative territory during the week ended March 19th. The combination of easing rate concerns (perhaps merely in the near term) and continued vaccination progress improved both market technicals and sentiment, with resulting spread compression now offsetting ~ 80% of the Treasury move on a trailing 3-month basis. In this *Weekly Briefing*, we compare the pace of rate absorption to historical trends and identify areas of the market that appear “cheap” now that market volatility has at least temporarily subsided.

In a prior *Weekly Briefing* (see “The Threat of Rising Rates”), we noted 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. In examining data going back to the start of 2000, we found that high yield spreads struggled to offset moves in rates on a 1:1 basis only when the beginning spread cushion was sufficiently below 70%. Despite elevated spread cushions in December 2020, only 80% of the rate move has been offset thus far, underperforming our model expectations. So, has something fundamentally changed in the market?

Pace of Rising Rates Accelerated Over The Last 3 Months

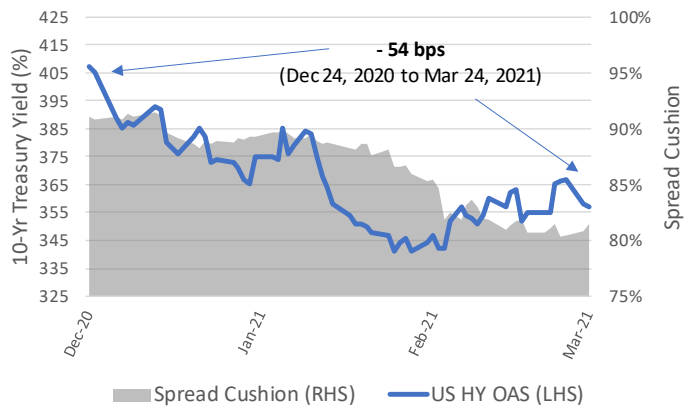
daily data, ICE BofA Current 10-Year US Treasury Index



Source: SKY Harbor, ICE Data Indices

US High Yield Has Absorbed ~ 80% of the Move

daily data, H0A0 OAS and Spread Cushion



As highlighted in a *Weekly Briefing* from earlier this month (see “The Duration Debate”) there have been only three periods over the last decade in which rates have risen more than 50 bps within a three-month period, and denote them in grey shaded areas within the chart below (left side). Spread cushions at the start of these periods – May ’13, September ’16, and the one we are in now, December ’20 – all exceeded the minimum threshold historically consistent with full absorption, with December ’20 the highest of the set (~ 91%). The magnitude of these rate moves, however, appears to have created a lag, with full absorption occurring only after several months have passed (between 3 and 13, using our dataset). Having just eclipsed the lower bound of this range, we remain confident that high yield bonds will eventually digest the move higher in rates, it just may take some additional time.

Third Period in Last Decade Where Rates Increased Rapidly

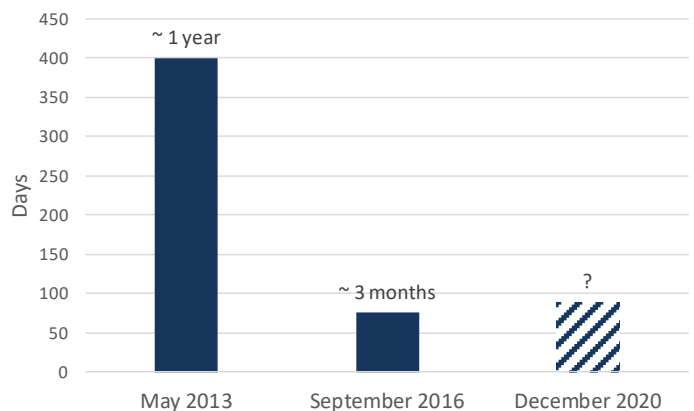
grey = periods in which rates sustainably increased 50bps+ in a three month period



Source: SKY Harbor, ICE Data Indices

Time to Fully Absorb Rapid Rate Rise

using grey periods previously highlighted

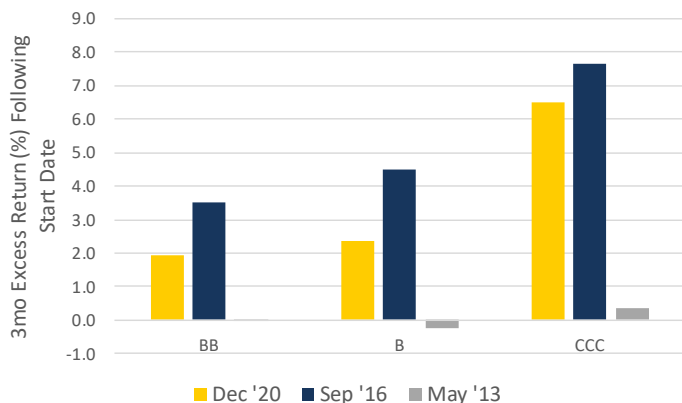


As anticipated, the CCC cohort of the high yield index has outperformed higher-quality credit as Treasury yields have climbed, due to the tendency for risk premiums to compress when the selloff in rates is driven by rising growth expectations, a scenario consistent with the current

economic outlook. Similarly, CCCs outperformed higher-quality credit in the first three months of the other two occurrences of rapidly rising rates in the last decade – May '13 and September '16 – aided in part by higher relative spreads and a favorable duration dynamic across all periods (BB duration > B duration > CCC duration). Extending this analysis out another three months (three month returns that begin after the first three months of a rapidly rising rate environment), we find that CCCs have historically maintained an excess return advantage, albeit to a lesser degree. Importantly, we would note that CCC bucket option-adjusted spread (OAS) was well above historical medians at the start of all three periods (759 bps, 1187 bps, and 809 bps for the periods beginning May '13, Sep '16, and Dec '20, respectively).

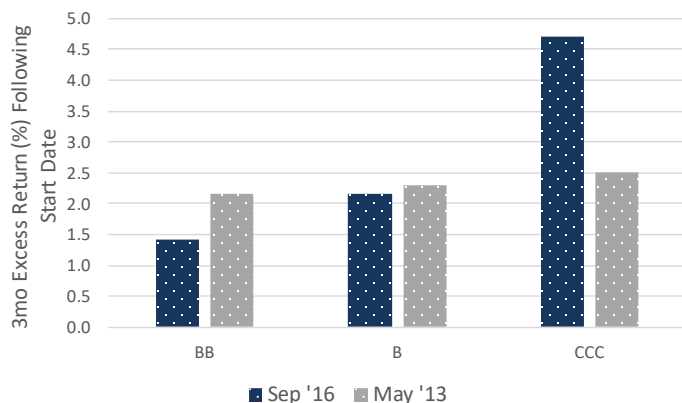
CCC Returns Are Best in 3mos Period After Rapid Rate Rise

excess returns (total returns show same pattern)



CCC Returns Stay Best in 3mos Period After That, But O/P Slows

excess returns (total returns show same pattern)



Source: SKY Harbor, ICE Data Indices

Though our findings above keep us biased toward lower-quality and shorter-duration credit, we do acknowledge that the 80% absorption rate for high yield is not evenly distributed across the index. To identify pockets of the market that have been laggards in offsetting rate pressure, we created a matched sample dataset, measuring total spread compression over the three months since the rise in rates began to accelerate. To eliminate migration across rating and duration groups over time, we bucketed all issues according to their classification at December 24, 2020 (the start of our time series), and eliminated outliers (new issues or any bond not in the dataset for the full three month period, bonds trading to a call within 1 year, and highly distressed securities). We then measured average spread compression by rating and duration bucket against the magnitude of Treasury moves (by equivalent position across the curve) to generate a more granular view of relative rate absorption. Our findings show that lower-quality and shorter-duration absorption rates are well-above the index average of 80%, while longer-duration (in particular, the 4-6 bucket) BBs have trailed significantly (left chart below). Screening for underlying constituents within this grouping, we note a potentially over-penalized subset (right chart below) that still scores favorably within our internal credit analysis framework.

Rate Absorption Weakest Among BBs w/ Duration of 4-6

data as of March 24, 2021

OAS Δ		Duration Bucket		
Rating		3 to 4	4 to 6	6+
BB	(29)	(24)	(48)	
B	(64)	(59)	(71)	

Absorption		Duration Bucket		
Rating		3 to 4	4 to 6	6+
BB	107%	57%	79%	
B	232%	136%	116%	

weakest absorption bucket

Underperforming Subset Issues That Screen Well Internally

data as of March 24, 2021

Name	Ticker	Coupon	Maturity	Rating	Trailing 3mo OAS Change	YTW (Offer)
NOVA Chemicals	NCX	5.25	06/01/27	BB3	17	~ 4.4%
Howmet Aerospace	HWM	5.90	02/01/27	BB1	17	~ 3.3%
Sealed Air	SEE	4.00	12/01/27	BB2	13	~ 3.6%
Graphic Packaging	GPK	3.50	03/15/28	BB2	3	~ 3.5%
Lamb Weston	LW	4.88	05/15/28	BB2	3	~ 3.7%
Clearwater Paper	CLW	4.75	08/15/28	BB3	(16)	~ 4.4%
Ford Motor Co	F	4.35	12/08/26	BB1	(18)	~ 3.4%

Source: SKY Harbor, ICE Data Indices

A reprieve – though perhaps only temporary – from the concern of rising rates led to strong total returns for the ICE BofA US High Yield Index over the past week, ratcheting up rate absorption to ~ 80% since the selloff in Treasuries began to accelerate three months ago. Elevated spread cushions and the underlying driver of higher rates give us confidence that full absorption will eventually be achieved, though historical precedence implies that this could take many more months. Looking back at rapidly rising rate periods in the prior decade, CCCs and short duration bonds have similarly outperformed on a relative basis (both in the first three months after rates began to rise, and in the subsequent three months after that), leaving us comfortable with our barbell positioning. We remain cognizant, however, that rate absorption has clearly lagged in several pockets of the high yield index, most notably in BBs with a duration between four and six. Given our favorable view on many of the underlying credits within this cohort, we may opportunistically reduce our underweight to the highest quality segments of the index to capture this valuation dislocation, while still maintaining an overweight in lower-quality and shorter-duration credit in aggregate.

Definitions

Barbell is an investment strategy applicable primarily to a fixed income portfolio where half the portfolio contains long-term bonds and the other half holds short-term bonds.

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.

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 is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

ICE BofA 10+ Year Treasury Index measures the total return performance of U.S. Treasury bonds with an outstanding par that is greater than or equal to \$25 million. The maturity range of these securities is greater than ten years.

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.

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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