SKY HARBOR
CAPITAL MANAGEMENT

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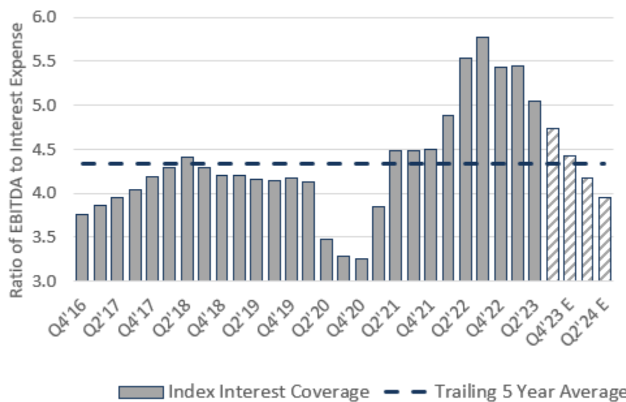
SKY Harbor Weekly Briefing

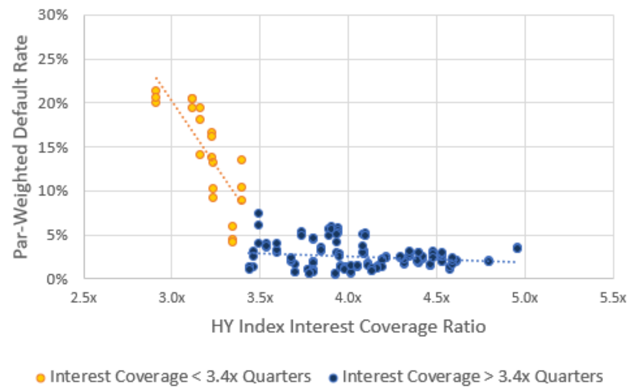
Notes from the Road – Miami Edition

We had the pleasure of meeting numerous clients and platforms this past week in Miami, a trip that coincided with both the September FOMC meeting and renewed concerns over the strength of the global economy. What follows is a summary of the most topical discussions, presented below using SKY Harbor's "FASST" construct (an acronym we use to describe our top-down assessment of the economy and markets, with a focus on **F**undamentals, **A**sset Values, **S**entiment, **S**ustainability, and **T**echnicals). In this *Weekly Briefing*, we reiterate our view that default rates will remain subdued, that modestly adding duration makes sense given the current Fed backdrop, and that issuers will continue to use non-traditional levers to reduce the impact higher rates have on their ability to roll maturities and generate free cash flow.

Defaults to Remain Manageable (Fundamentals)

We have previously noted that high yield issuer EBITDA growth rates have surprised to the upside, with H1'23 earnings up modestly y/y, outperforming our initial projection of a slight contraction. That said, **early signs of a slowing consumer, along with pressure associated with further monetary policy tightening, have led some to worry about fundamental credit ratio resilience in the coming quarters**. To address this, we ran a simulation to project interest coverage metrics – historically the key driver of high yield bond default rates – under a more onerous set of economic conditions than our base case outlook. More specifically, a -3% annual EBITDA growth rate (in-line with our view), a 25 bps rate hike at the November FOMC meeting and no cuts through mid-2024 (the updated Fed dot plot view), a pull-forward of issuer refinancing (i.e. a more rapid uptick in interest expense than we currently expect), elimination of all free cash flow generation (more draconian than our view), and no ability to issue equity or sell assets to stem resulting pressure (also more draconian than our base case) would result in an interest coverage ratio of ~ 4.0x by mid-2024. **Though down from nearly all-time high levels at present (~ 5.0x), this punitive scenario would fail to push coverage metrics below the crucial 3.4x threshold by next summer, the point typically associated with a rapid uptick in the default rate**. As demonstrated below, a 4.0x interest coverage ratio would historically correspond to a sub-5% default rate, consistent with our regression-based projection of 4.5% by mid-2024, and 4.7% by the end of 2024.

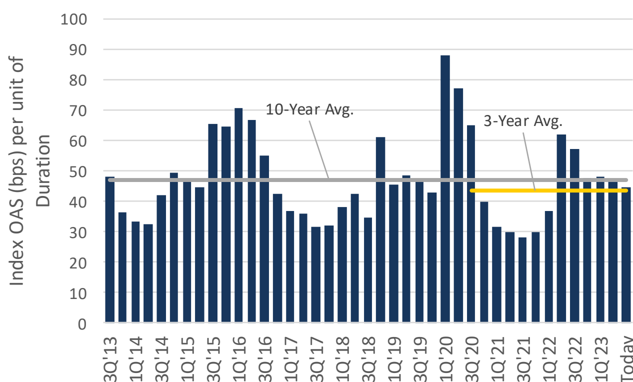


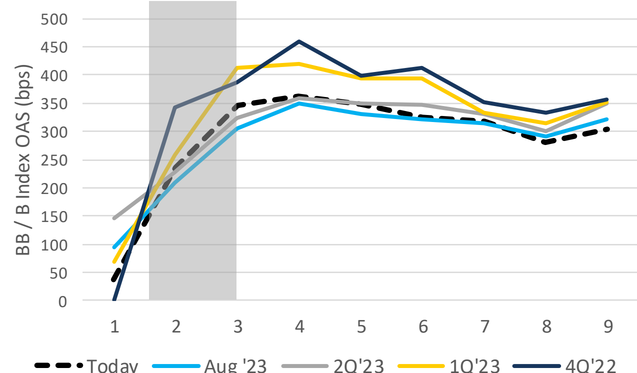


Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Capital IQ

The Case for Modestly Increasing Duration (Asset Valuations)

Over the last decade, the average high yield bond (single-B rated, ~ $650mm in size) has offered investors nearly 50 bps of spread per unit of duration, holding all else equal. This historical average is very much in line with our calculation of term risk premiums today, resulting in a fair value view of duration. However, as demonstrated below, the corporate credit curve at present is relatively steep in the 1.5 to 3.0 duration range, perhaps signaling an attractive total return opportunity in the coming quarters, particularly if Fed rate hikes subside. As such, **we have gone modestly longer in our short duration high yield fund**, with DTW now at ~ 2.6 (up from ~ 1.8 at the start of '22 before the Fed hiking cycle began, and at the upper end of our trailing 5-year range of 1.1 to 3.0.)





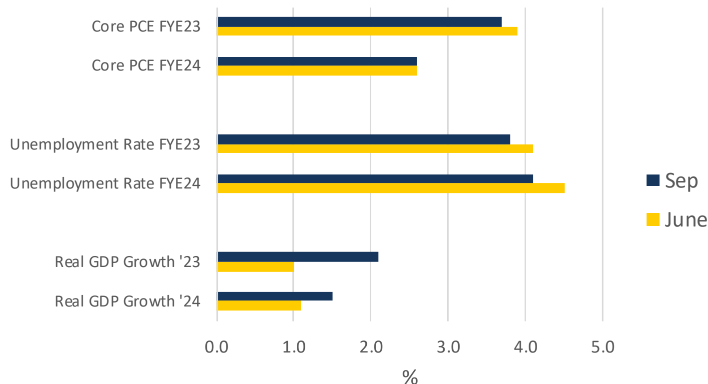
Source: SKY Harbor, ICE Data Indices, Bloomberg

Higher for Longer (Sentiment)

The September FOMC meeting resulted in a "hawkish pause," with 12 of 19 members expecting one more 25 bps hike before the end of the year. Though a vote to hold rates steady in September was widely expected, several changes to the Committee's summary of economic projections were notable. First, **the outlook for both unemployment and GDP growth improved from the June iteration**, with members still confident that PCE inflation could moderate to the mid-2% range by next year. As an offset, however, a stronger than expected economic backdrop prompted a change in the dot plot, with **the median projection now implying only two 25 bps cuts in 2024, down from a projection of four in June**. Fewer cuts may disappoint owners of long-dated corporate bonds (particularly investment grade) who had been looking for a sharper duration rally, and the "higher for longer" theme could prove problematic for those overweight more speculative / distressed issuers now faced with an increasingly onerous refinancing environment that likely persists for another year.

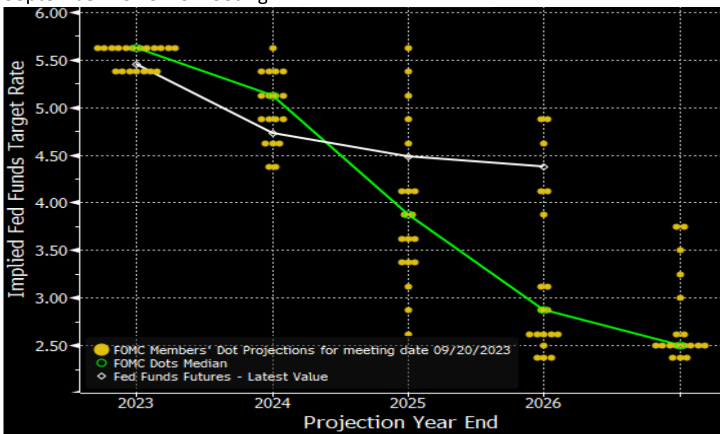
A Better Outlook for Economic Growth and Employment…

Summary of Economic Projections by FOMC Meeting Date



…Means Fewer Rate Cuts in '24

September '23 FOMC Meeting



Source: SKY Harbor, Federal Reserve, Bloomberg

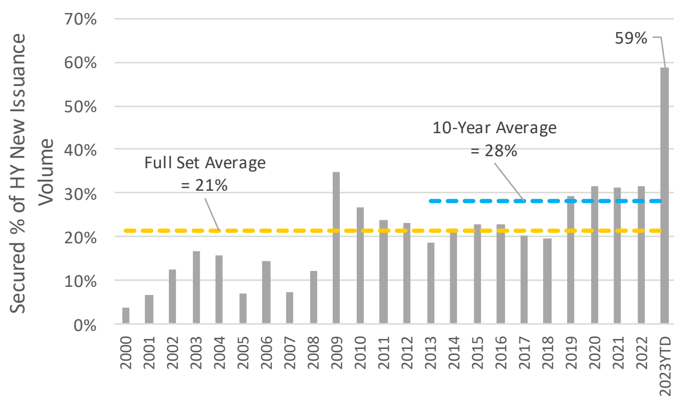
Issuers Get Creative (Technicals)

A concern coming into 2023 was the impact monetary policy would have on corporate interest expense, as the average par-weighted coupon of the ICE BofA US High Yield Index (H0A0) was 320 bps below prevailing market yields at the start of this year, one of the most extreme divergences in the post-GFC era. To alleviate some of this pressure, issuers have, where possible, sought to address upcoming maturities with secured debt. As demonstrated below, **secured issuance penetration of primary market activity is at a 20-year high, and is currently running at nearly 3x the long-run average**. In this way, corporate management teams have been able to use unencumbered assets to temper the average cost of debt uptick when unsecured obligations issued in a near-zero risk free rate environment come due.

Though effective for most would-be issuers in the high yield market, this tactic could not fully bridge the financing gap among more speculative credits, particularly as bank lending standards continue to tighten. As demonstrated in the chart below (right side), **cash injections from private equity sponsors, private market solutions amidst healthy fund flows, and voluntary extensions among current holders have served to facilitate refinancings** among even the more distressed credits in the high yield bond space this year, keeping the default rate well below historical norms.

Issuers Using Secured Debt to Address Maturities

annual data



Sponsors, Private Mkts, & Bondholders Providing Alt. Solutions

Examples from 2023

Issuer Name	Sponsor Equity Injection	Private Mkt Solution	Holder Extension
Brand Energy	X		
BWAY/Mauser	X		X
Finastra		X	
FXI Holdings	X		X
Heartland Dental	X		
Hyland Software		X	
Legends Hospitality		X	
New Home	X		X
Rayonier Adv. Mat.		X	
Sabre Corp		X	
Tecomet		X	
Trinseo		X	

Source: SKY Harbor, JP Morgan, Bloomberg

Everything in Moderation

In general, we would describe the tone of our recent meetings as constructive on high yield market risk, though an elevated amount of uncertainty is likely to persist in the intermediate term. In our view, a reduction in rate volatility that typically follows the end of a Fed hiking cycle gives us comfort to modestly increase portfolio duration, but at a measured pace where the credit curve is steepest. Additionally, a benign default rate environment should persist over the next year, though we think interest coverage metrics for the more speculative / CCC-rated / free cash flow constrained portion of the market will erode more rapidly under a "high for longer" regime. Finally, we would note that primary market volumes of ~ $130bn on a year-to-date basis – though below the trailing 10-year annualized average of ~ $300bn – have been sufficient to prevent a refinancing crunch, with private equity sponsors, private market investors, and current bondholders creatively extending maturity runways.

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