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SKY HARBOR
CAPITAL MANAGEMENT
Responsible Investing for a Sustainable Future

SKY Harbor Weekly Briefing

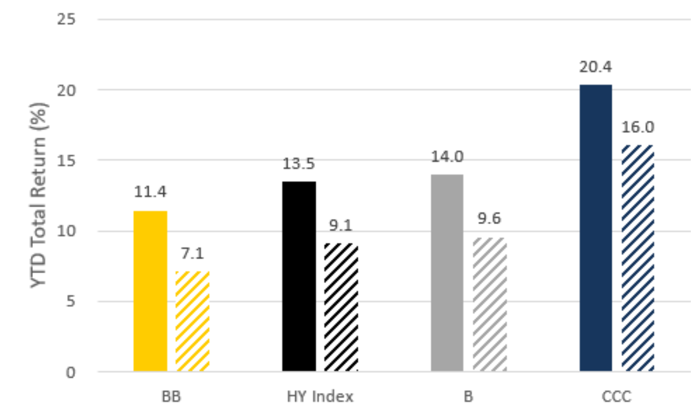
Christmas Came Early

A late-year rally pushed US high yield returns into double-digit territory, eclipsing even the most optimistic expectations at the start of 2023. Boosted by strong carry and spread compression amidst a benign default rate environment, total and excess returns (+13.5% and +9.1%, respectively) registered approximately 70th percentile based on annual data over the last couple of decades, more than offsetting a weaker environment in 2022. However, a late-year surge compels us to update our total return outlook for 2024. In this *Weekly Briefing*, we outline fundamental changes to our next 12-month view, and still see coupon-like return potential on the horizon.

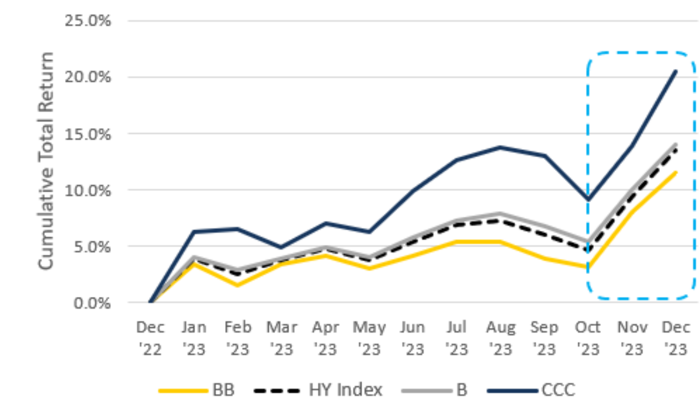
Double-Digit Returns

US high yield bond returns hit +13.5% in 2023, a figure heavily boosted by the late-year rally. More specifically, **~ 65% of the annual return was generated in November and December, a function of "soft landing" enthusiasm and line-of-sight to the end of the Fed rate hiking cycle**. As demonstrated below, lower-rated credit got off to a strong start in January and never ceded the lead, pulling up the index average despite a smaller than historically average cohort size (CCCs made up ~ 11% of the index by market value last year). Overall, returns were well ordered by risk bucket to start the year.

US HY Generated Double-Digit Returns in '23, Led by CCCs
data through 12/31; Tot Ret = solid, Excess Ret = striped



65% of '23 Return Generated in November & December
monthly data

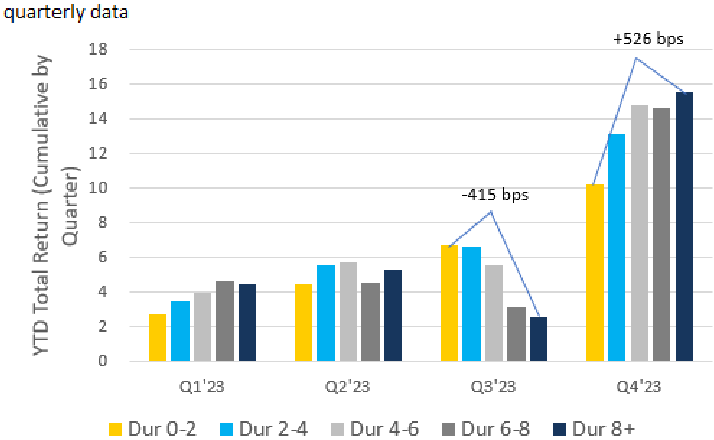


Source: SKY Harbor, ICE Data Indices

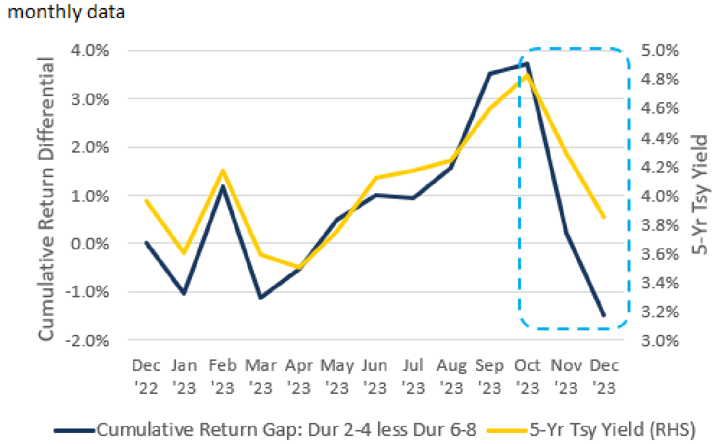
An Aggressive Reaction in Rates

In addition to credit risk, duration was also rewarded in 2023, though it took an aggressive rate rally in the final quarter of the year to push results in favor of longer-dated bonds. By year end, the Duration 8+ cohort had outperformed Duration 0-2 by over 500 bps, in stark contrast with cumulative results through Q3'23. More specifically, **cooler than expected October inflationary data sparked a rally in fixed income markets, with investors aggressively pulling forward rate cut expectations in '24**. Once the dust settled, 5-Year Treasury yields had fallen nearly 100 bps over the final two months of the year, further enhancing high yield total returns (particularly on the longer end).

Duration Outperformed, Driven by Q4'23
quarterly data



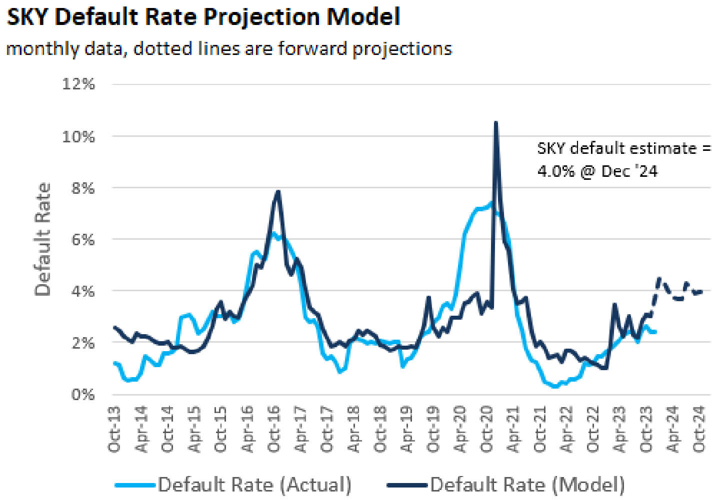
Duration Outperformance Mirrored Treasury Rally
monthly data

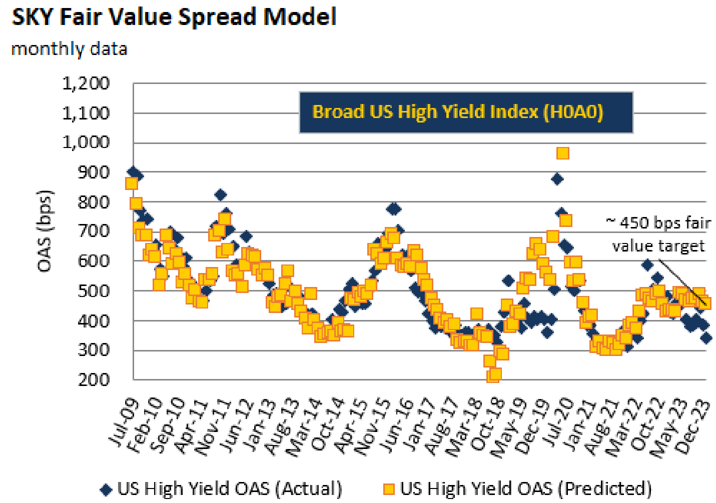


Source: SKY Harbor, ICE Data Indices

An Improved Outlook

Since publishing our *2024 US High Yield Outlook* report in early December, several key economic indicators have demonstrated directional improvement. More specifically, **a lower distress ratio, lower implied probability of recession based on the yield curve, and less restrictive lending standards have served to improve our FYE24 default rate projection**, which we now moderate to 4.0% (had been 4.4%). Additionally, upside surprise to ISM PMI and further moderation of the St. Louis Fed Stress Index improved our spread fair value estimate, which now stands at 450 bps (had been 460 bps).





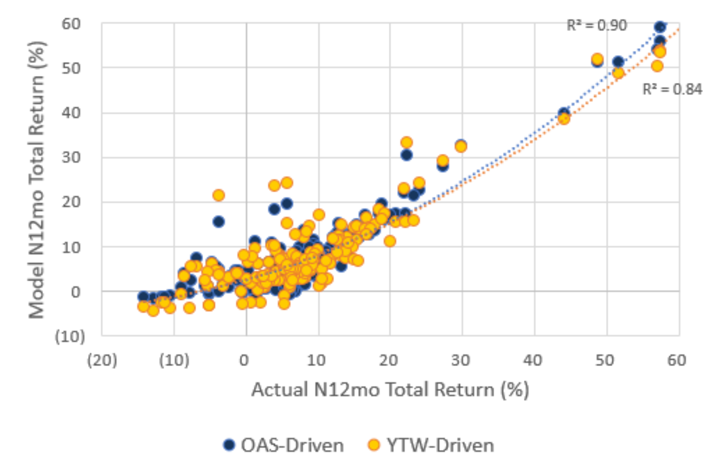
Source: SKY Harbor, ICE Data Indices, Federal Reserve, Bloomberg, BofA Merrill Lynch

What's Left for Returns?

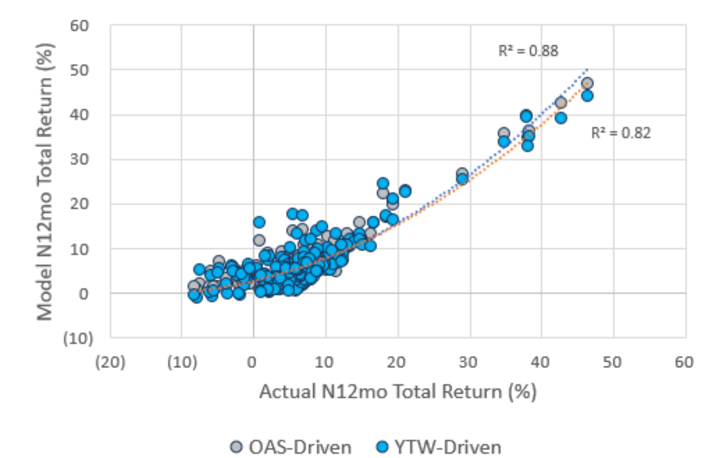
Fundamental improvements aside, return potential following a strong December has garnered investor attention in recent weeks. Recall that in our *2024 US High Yield Outlook* report (published in early December using index metrics through November 30), both correlation-driven and our more nuanced model based on the BofA Merrill Lynch framework pointed to next 12-month returns in the +7% context. With returns of nearly 4% in December alone, what remains?

To address this question, we update both models using current index data (through the time of writing, or January 3, 2024) and our most recent default rate and OAS fair value metrics. First, our correlation-driven estimate: using an equal-weighted model and a starting point of option-adjusted spread (OAS) and yield-to-worst (YTW) levels of 371 bps and 8.0%, respectively, **subsequent 12-month returns have historically averaged ~6% for the broad high yield market** (index ticker H0A0). For short duration high yield (index ticker JVC4), the implied next 12-month return is quite similar.

	Starting OAS (bps)	Model N12 Tot Ret (%)	Starting YTW (%)	Model N12 Tot Ret (%)	Average Method
Broad HY Index (H0A0)					
Today (Jan 3, 2024)	371	0.9	8.00	11.0	5.9



	Starting OAS (bps)	Model N12 Tot Ret (%)	Starting YTW (%)	Model N12 Tot Ret (%)	Average Method
Short Duration HY Index (JVC4)					
Today (Jan 3, 2024)	297	1.9	7.46	10.6	6.2



Source: SKY Harbor, ICE Data Indices

We next utilize the BofA Merrill Lynch index return framework, augmented with our own variable estimates. With lower starting yields and spreads relative to our original '24 Outlook Report, less underlying potential from Treasury yield compression following the November/December rate rally, and partially offset by a tighter fair value spread target and lower default rate projection, **we arrive at an estimated return for the high yield bond index of ~ 5.5%** over the next twelve months, modestly below our correlation-based estimate of ~ 6.0%.

ICE BofA US High Yield Index - H0A0	HY	5yr Trsy
Current Spread	371	389
Target	450	360
Predicted Change	79	-29
Duration	3.2	
Index Price	91.9	
Avg Par Coupon	608	
Tsy Change	-29	
Total Change in Yield	50	
Capital Gain	-156	
Period Multiplier	1.00	
Index Yield	800	
Default Rate	4.00	
Price (default universe)	52.2	
Credit Loss	132	
Expected Periodic Return (next 12 months)	**5.1 %**	

ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index - JVC4	SD HY	3yr Trsy
Current Spread	297	408
Target	370	367
Predicted Change	73	-41
Duration	2.2	
Index Price	95.6	
Avg Par Coupon	607	
Tsy Change	-41	
Total Change in Yield	32	
Capital Gain	-63	
Period Multiplier	1.00	
Index Yield	746	
Rating Migration Rate	11.50	
Price (downgrade universe)	85.5	
Downgrade Loss	121	
Expected Periodic Return (next 12 months)	**5.6 %**	

Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch model framework, Bloomberg

A Strategic Allocation

The sharp market rally to end 2023 admittedly pushed index metrics to less attractive levels than originally anticipated, necessitating some moderation in our return outlook for the coming 12 month period. That said, there is still a lot of uncertainty baked into estimates, resolution of which could meaningfully change the path of returns going forward. For example, a more sustained trajectory toward a soft landing would tighten our spread target, as would a more optimistic rate outlook. Additionally, over 100 bps of potential alpha exists in avoidance of credit defaults and downgrades, and opportunistic refinancing of capital structures could add incremental return, particularly given recent examples of bonds being called earlier than expected, resulting in dollar price appreciation. Admittedly, a case could be made for further downside as well, though we continue to expect benign defaults and elevated breakevens will mitigate some of this risk. Ultimately, we maintain a cautiously optimistic view of the high yield market, and continue to see an attractive risk/reward profile as 2024 begins.

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