SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
April 11, 2022

SKY Harbor Weekly Briefing

SKYView: A Look Back at Q1'22

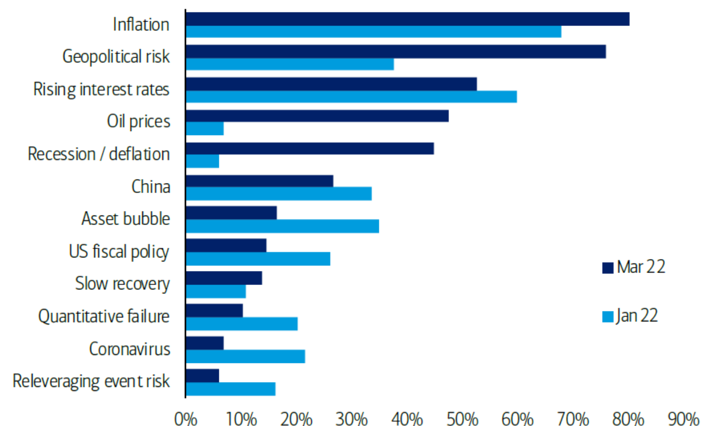
The end to a volatile Q1'22 has finally come, with the ICE BofA US High Yield Index (ticker H0A0, our proxy for US high yield risk) suffering its first negative return quarter since the lockdown-stricken start to 2020 (at March 31, 2022, year-to-date H0A0 total and excess returns were -4.51% and -0.45%, respectively). A number of factors conspired to push risk assets across the globe into the red - a highly transmissible COVID variant added risk to a tenuous global re-opening, which further pressured supply chains and led to labor shortages, which ratcheted up inflation to the point at which central banks were forced to embark on the first post-pandemic liftoff, and finally with theoretical geopolitical threats becoming reality following Russia's invasion of Ukraine. What follows is a deeper look at the drivers of high yield market returns in Q1'22, along with a view of how such risk factors may influence trading through the balance of the year.

Survey Results & Risk Positioning Overview

We start, as usual, with a look at the most recent BofA Merrill Lynch survey of credit investor concerns, the most recent iteration released just over one week ago. As demonstrated below, inflation remains the dominant risk factor – according to a survey of buy-side investment managers – with its position unchanged over the last several months. **Though at the time of writing there appears to be a modicum of progress toward a cease-fire, Russian sanctions and disruptions resulting from the fighting in Ukraine have further pressured an already elevated commodity price environment**. We suspect these forces will persist, and continue to think issuers that derive a majority of end-market demand from US-centric sources, as well as those with enhanced ability to push through further price increases without destroying demand (largely based on competitive positioning, product substitutes, and the value-added nature of their offerings) should fare best. We also expect geopolitical risk (factor #2) to remain elevated, as concerns over China's intentions with Taiwan, as well as recent ballistic missile tests by North Korea, create uncertainty beyond the current conflict in Eastern Europe. As such, the market is likely to be sensitive to issuer supply chain viability, with a particular eye on credits most at risk from further setbacks in semiconductor production. **Interest rates have also been on the rise (factor #3), providing further tailwinds for shorter-duration securities, particularly given the anemic compensation investors receive to push further out an already flat corporate credit curve**. Finally, elevated crude and natural gas prices (factor #4) have served to benefit Energy credits and their proxies, and continue to pressure the margins of those most exposed to rising raw material input costs.

BofA Merrill Lynch Credit Investor Survey

updated as of March 2022



Notes on Updated Survey Results

updated as of March 2022

Factor	Thoughts
Inflation	Russian sanctions and conflict-related disruptions causing further inflation, especially in the commodity space; further supply chain disruption risk stemming from uncertain semiconductor production out of Taiwan and COVID shutdowns in China
Geopolitical Risk	Clearly ratcheting up vs. Jan '22 survey on Russian aggression in Ukraine; ballistic missile tests in N. Korea also a concern
Rising Interest Rates	Remains a Top 3 risk factor, with an updated Fed Dot Plot adding upward pressure to underlying Treasury yields
Oil Prices	Most rapidly accelerating risk since prior survey, with crude prices rising sharply on effective reduction of global supply due to Russia sanctions; China's COVID shutdowns could reduce pressure by virtue of adding risk to global growth estimates
Recession/Inflation	Yield curve inversion could spark recession fears despite long lag
China	Handling of Taiwan will be in focus if Ukraine issues subside

Source: SKY Harbor, BofA Merrill Lynch Global Research, Bloomberg. The BofA ML survey queries a range of institutional investors, including money managers, hedge funds insurance companies, banks and pension funds.

Return Attribution by Factor

Price returns have been negative through the first three months of 2022, atypical on an historical basis (prior to this quarter, we have only seen three consecutive negative return months on seven occasions dating back to January 2000). On a year-to-date basis (data through March 31), US high yield (H0A0) has generated a price return of -5.85%, unattractive in isolation but comparatively resilient versus the ICE BofA US Corporate Index (our US investment grade proxy, at -8.52%). Using our internal statistical model to identify the impact various market factors have had on the high yield index, we find that **rates were most damaging to total returns thus far in 2022**. In fact, the drag associated with duration was more impactful than all other factors combined.

Credit risk (using an issuer's weighted average rating factor, or "WARF" score) was rewarded, contributing a modest – albeit positive – amount of return to the overall index. In fact, and despite waning sentiment stemming from a variety of risk factors, **credit contributed positively to index price returns above and beyond what can be attributed to the inherently shorter-duration nature of the CCC portion of H0A0 relative to higher-quality credits**.

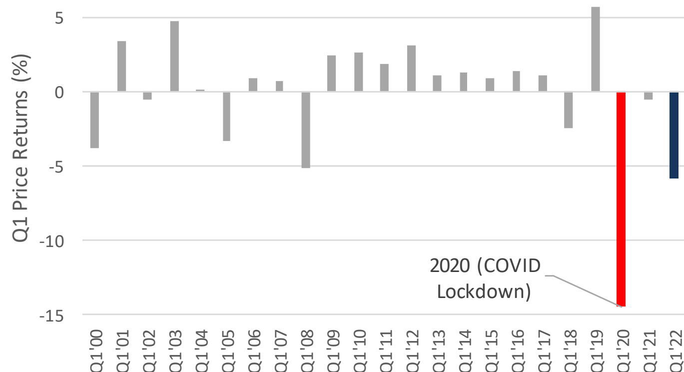
Energy, the top performing sector within H0A0 thus far in 2022, also contributed positively to index price returns, largely a function of rising crude (+33% YTD) and natural gas (+51% YTD) prices as outrage compels many countries and corporations to shun Russian production.

Finally, small issues (< $350mm in size) have been relative outperformers this year, in our view the result of valuation dislocations at the start of the period, coupled with technical pressure being felt by ETFs and mutual funds alike (see our prior *Weekly Briefing* entitled "Go With the Flow" for additional details).

These moves, which in aggregate led to the second worst start to any year since the turn of the century (the only Q1 that was worse was the lockdown-stricken quarter to start 2020) and bottom decile returns based on all rolling 3-month periods in the last two decades, are depicted below:

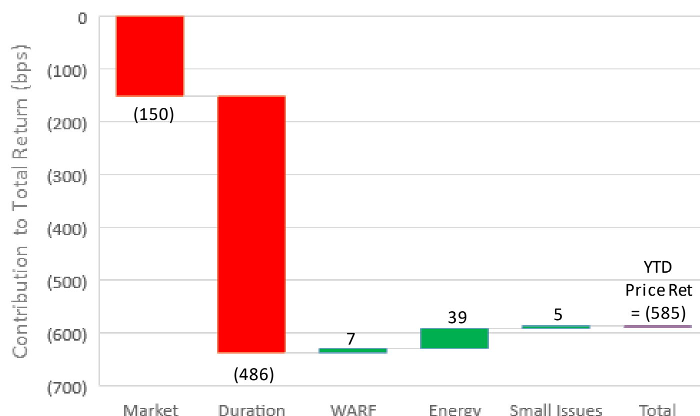
Second Worst Quarterly Start to Year Since 2000

monthly data, since Jan 2000



Duration Most Penalized Factor in YTD Price Return Model

YTD data through March 31, 2022

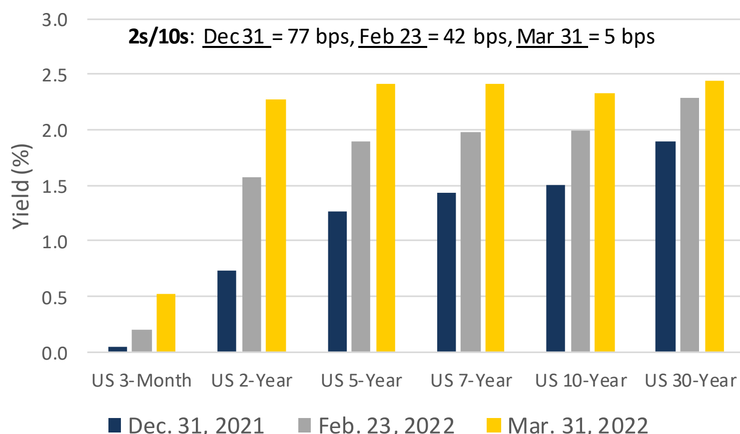


Source: SKY Harbor, ICE Data Indices, Moody's

We first focus on duration, the most significant detractor from Q1'22 returns. **Inflation – the result of re-opening dynamics, labor shortages, supply chain disruptions, etc. – has been a dominant risk factor over the last several months, and concerns over its non-transitory nature was the driving force behind a major shift in the Fed dot plot following the March FOMC meeting** (see our *Weekly Briefing* entitled "Rate Hikes & Breakevens" for additional details). Yields on the 5-year US Treasury, which has a duration that most closely approximates that of the US high yield index, increased by 116 bps thus far in 2022, among the most volatile moves in rates over any 3-month period the market has experienced. Unsurprisingly, longer-duration securities were penalized severely, with a clear pattern discernable in the chart below even after breaking the index into separate rating buckets. Compounding this dynamic, we entered the period with historically low compensation to take on duration risk (see our *Weekly Briefing* entitled "January Selloff" for additional details of our compensation analysis). **In our view, the path forward is likely one of higher rates which, coupled with still below-average term risk compensation, likely supports outperformance of the shorter-duration portion of the market.**

Treasuries Have Sold Off Sharply YTD; Curve Has Flattened

daily data (start of year, day before Ukraine invasion, and today)



Duration Penalization Evident Across Quality Buckets

YTD returns through March 31, 2022

Total Return	Duration Bucket				
	0 to 2	2 to 4	4 to 6	6 to 8	8+
BB	(1.4)	(4.2)	(5.7)	(7.4)	(11.2)
B	(0.8)	(2.8)	(5.2)	(6.8)	(10.8)
CCC	(0.3)	(4.3)	(6.5)	(4.2)	(9.7)

Excess Return	Duration Bucket				
	0 to 2	2 to 4	4 to 6	6 to 8	8+
BB	0.1	(0.6)	(0.7)	(1.8)	(3.8)
B	0.6	0.7	(0.2)	(1.4)	(3.9)
CCC	1.1	(0.8)	(1.6)	1.1	(7.1)

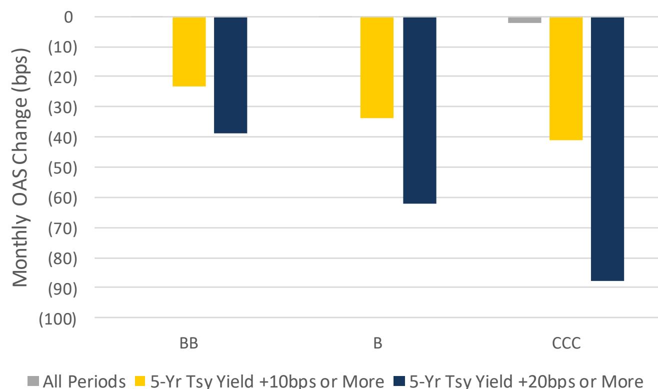
Regression-Implied Term Risk Compensation (per additional unit spread duration)	
Dec 31, 2021	30
Today	38
Long-Run Avg.	44

Source: SKY Harbor, ICE Data Indices, Bloomberg

Credit (WARF) risk was a positive contributor to price returns YTD, though the impact did little to offset the aforementioned duration selloff. Nevertheless, incremental credit risk proved additive to returns, with BBs underperforming single-Bs and CCCs despite a myriad of market concerns – both old and new – that served to dent sentiment. We highlight below that **credit risk outperformance is consistent with historical outcomes in similar economic environments.** First, lower-rated credit has historically demonstrated greater OAS compression in periods of rising rates. Second, lower-rated credit tends to outperform the index in periods of elevated EBITDA growth. Given our anticipation that rates will rise further and that EBITDA growth will remain healthy in the +10% range (see our *Weekly Briefing* entitled "Revisiting our US High Yield Outlook After a Weak Start to 2022" for additional details), **we continue to see a strong risk-reward environment for lower-rated bonds**. With that said, any forced selling of BB-rated debt (perhaps sellers needing to raise cash to fund redemptions) could result in attractive relative value opportunities even among the highest-rated subset of the index.

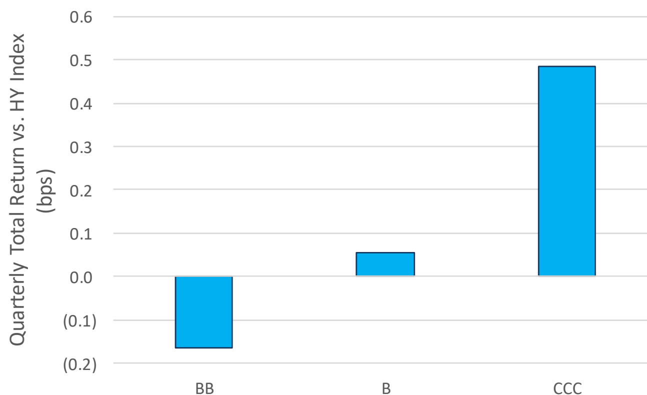
Credit Risk Outperforms in Rising Rate Environments

monthly data, since 2000



Top Quartile EBITDA Growth Leads to Credit Risk Outperformance

quarterly data, since 2009

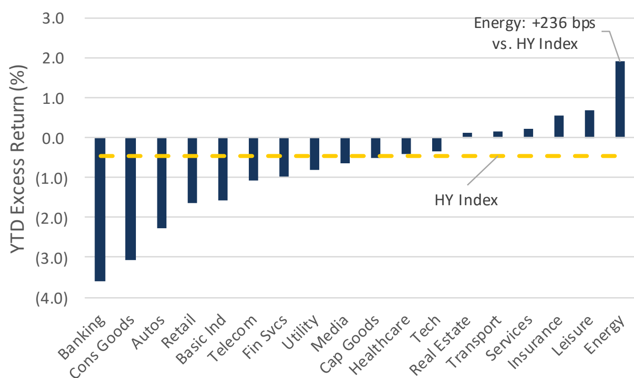


Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Bloomberg

Sector return dispersion has been elevated thus far in 2022, even after removing the impact starting duration has had on YTD total returns. Below, we highlight sector excess returns, with Energy leading (+236 bps vs. H0A0) and Banking lagging (-314 bps vs. H0A0). **Note that only several sectors have a positive excess return thus far in 2022 – with Insurance and Leisure up modestly at +0.56% and +0.68%, respectively, and Energy a clear standout at +1.91%.** As previously mentioned, Russian sanctions have resulted in significantly higher crude and natural gas prices, all while Iranian supplies remain in limbo, a clear tailwind to Energy sector performance. However, many other beneficiaries exist (prices for steel, fertilizer, grains, etc. have risen sharply) but remain somewhat hidden, particularly those buried within diverse sector classifications. For greater clarity, we divided the index into broad-based groupings, defined below and to the right on the basis of being "commodity buyers", "commodity sellers", and industries with issuer business models generally regarded as being "rate sensitive" (i.e., not simply a cohort of long duration bonds, but rather those that suffer earnings volatility when rates are on the move). As demonstrated below, **the performance gap between "commodity sellers" and "commodity buyers" is significant, a dynamic that won't likely subside until a full cease-fire is negotiated**. As such, we think Energy credits and associated proxies may be able to achieve above-average margin expansion in the current market environment, particularly those issuers with enhanced ability to push through further price increases without destroying demand (issuers with superior competitive positioning, limited threat of substitutes, and a high value-added nature of their product offerings).

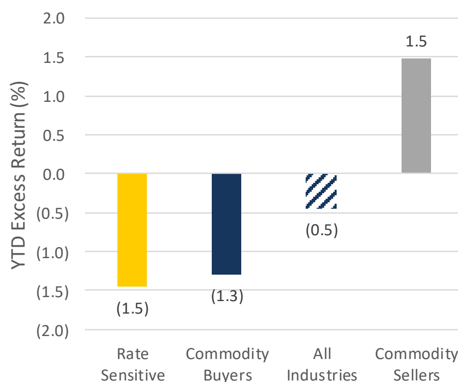
Energy a Key Outperformer Thus Far in 2022

YTD excess returns through March 31, 2022



Returns Driven by Commodity Exposure

YTD excess returns through March 31, 2022



Rate Sensitive
Banking, Auto Loans, Lease Fin., Inv. & Misc. Fin Svcs, RE Dev & Mgmt.

Commodity Buyers
Autos, Food, Pers & Household Prods, Bev, Tobacco, Paper, Auto Parts, Div. Cap Goods, Food & Drug, Bld Mats, Homebuilders, Air Transport, Tech, Elec Gen., Restaurants, A&D, Electronics, Machinery, Packaging, Dept. Stores

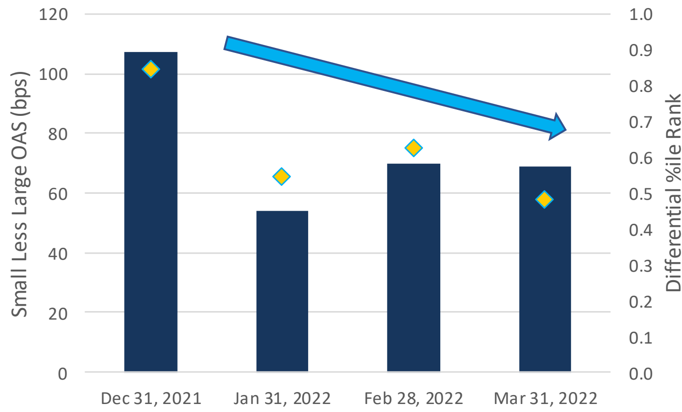
Commodity Sellers
All Energy, Steel, Metals & Mining, Environmental, Chemicals

Source: SKY Harbor, ICE Data Indices

Small bonds (issue size < $350 million) have outperformed large bonds (issue size > $1 billion) thus far in 2022, even after accounting for differences in credit quality and duration. **The spread differential between the two groupings compressed another 41 bps since the start of the year, extending small issue outperformance that has been pervasive since April 2020**. Exacerbating this valuation dislocation has been persistent high yield outflows, particularly among the largest ETFs, leading to increased selling pressure among the most liquid bonds in the index (see our *Weekly Briefing* entitled "Go With the Flow" for additional details). However, this dynamic of small issue outperformance for nearly two years may be on the verge of inflecting. The rationale for this is two-fold – first, the valuation dislocation between small and large issuance has all but disappeared, with rating and duration-adjusted illiquidity premiums now in-line with historical averages and, second, because our recent work shows that top ticker risk is most often the first rewarded upon alleviation of geopolitical tensions (see our *Weekly Briefing* entitled "Rapid Escalation" for further details).

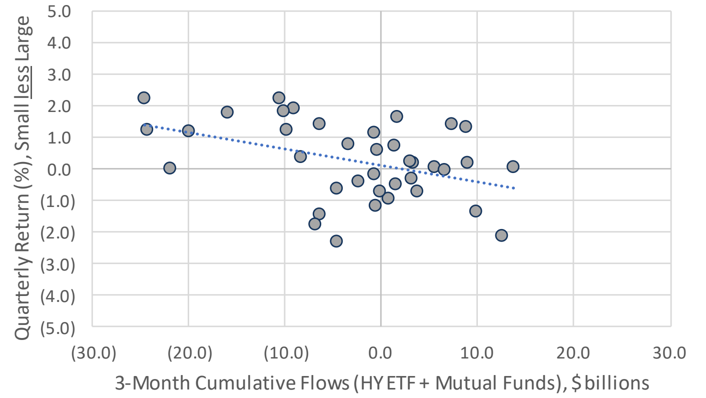
Small (<$350mm) vs. Large (>$1bn) Spread Basis Contracted

percentile ranks based on data since Jan '00



Fund Flows Impact Small vs. Large Performance

quarterly data, trailing 10 years (ex COVID lockdown)



Source: SKY Harbor, ICE Data Indices

The year has admittedly gotten off to a difficult start, with at least three shocks to global markets all occurring within a relatively short period of time. On balance, however, a bias toward shorter duration securities, lower-rated credit, and smaller issues would have proven beneficial in portfolio construction, along with bonds that have benefitted from a run-up in various commodity prices. As we look forward to the balance of the year, we remain cautiously optimistic for high yield, with spread levels still wide of our revised fair-value target (325 bps), increased opportunity for alpha generation via Q1'22 return dispersion, and an historical tendency for consecutive negative return months to be followed by strong recoveries. Based on historical data in the context of our market outlook, negative year-to-date returns are unlikely to persist at similar levels, in our view, and so we believe the current environment is attractive for net new investment into the asset class.

Important Disclosures and Disclaimers

This analysis and the opinions expressed herein are intended solely for institutional and professional investors that are responsible for assessing their own risk tolerances under prevailing market conditions. SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed. SKY Harbor, its affiliates, officers, directors and employees hereby disclaim any liability whatsoever related to the use of this publication or its content and make no express or implied warranties of merchantability or fitness for any particular purpose or use with respect to the data, projections, analysis, content, or conclusions included in this publication.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

Gross performance results do not reflect the deduction of investment advisory fees, which would reduce an investor's actual return. For example, assume that $1 million is invested in an account with the Firm, and this account achieves a 6% compounded annualized return, gross of fees, for five years. At the end of five years that account would grow to $1,338,226 before the deduction of management fees. Assuming management fees of 0.55% per year are deducted annually from the average annual AUM, the value of the account at the end of five years would be $1,302,846, which is the equivalent of an annual compounded rate of 5.43%. For a ten-year period, the ending dollar values before and after fees would be $1,790,848 and $1,697,408, respectively. SKY Harbor's asset-based fees are generally billed monthly or quarterly in arrears. Please refer to the SKY Harbor's ADV Part 2A or applicable Offering Documents for more information on fees. Consultants supplied with gross results are to use this data in accordance with SEC, CFTC, NFA or the applicable jurisdiction's guidelines.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofA Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofA") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofA PERMITS USE OF THE ICE BofA INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.

© 2022 SKY Harbor. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor.