SKY HARBOR CAPITAL MANAGEMENT

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September 9, 2022

SKY Harbor Weekly Briefing

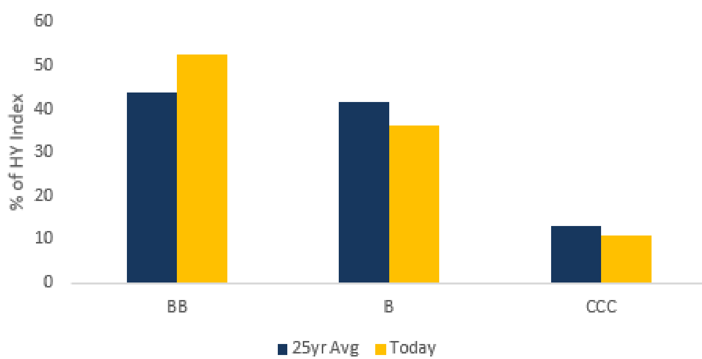
SKYView: Don't buy high yield

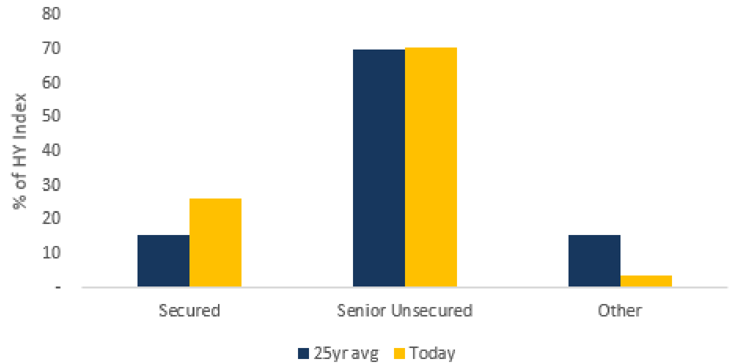
"Don't buy high yield" and "stay up in quality at this point in the cycle" seem to be favorite recommendations from retail market strategists when you turn on financial news. Strategists also dwell on the fact that September is historically a weak month for risk assets. We can't argue that high yield is cheap, and we recognize that the market technical is fragile and subject to turning negative if the valve controlling new-issue supply is left in the open position for too long.

But…

While high yield spreads during past recessions have been well wide of today's 500 bps- averaging 1,050 and 850 with and without the Global Financial Crisis included in the calculation – we remind ourselves that the economic and market conditions behind the three recessions covered by the "modern era" of US high yield index data are each unique. As a result, we are focused on what is **different** about today's economic and market conditions to identify fair value and drive our risk-taking.

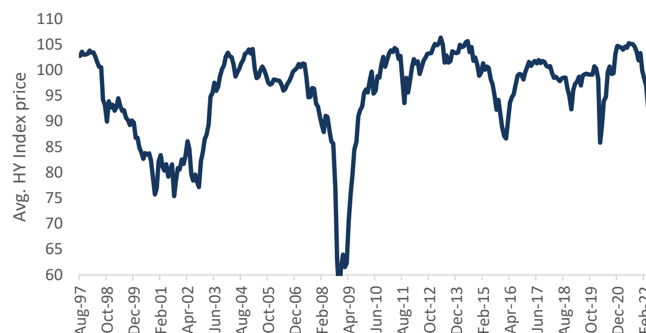
Today's high yield market is up in quality with a higher percentage of secured bond issuance.





Source: SKY Harbor, ICD BofA US High Yield Index

US high yield is also lower in dollar price (a function of higher rates and historically low average coupons), reducing the implied principal loss in the event of a default.



Source: SKY Harbor, ICD BofA US High Yield Index

The unwinding of sector-based excesses also is likely to be less of a driver of a spike in the high yield default rate this cycle than in past economic downturns. The Housing, Telecom/Tech, Gaming, Energy, Financials and Autos sectors have each at various times been behind spikes in the high yield market default rate. The market's largest sector, Energy (12.6% weight at market), is now largely up in quality and benefiting from new-found capital discipline that has significantly de-risked the sector irrespective of energy commodity

prices. At present, Healthcare, Services, Retail and Media have the largest weights within the market's widest decile. In each case, a single issuer accounts for the sector's high concentration (Bausch Health - Healthcare, Staples-Services, Carvana-Retail, and Dish – Media.) We would characterize the issues at work for the elevated default risk in the case of these issuers as idiosyncratic rather than related to specific sector headwinds that would result in more broad-based sector distress.

So what?

Projecting fair value spreads is an inexact science given the dynamic nature of the component of credit spreads that is not directly attributable to default risk. That said, higher quality, more secured debt, a lower average dollar price and less sector-based default risk concentration suggests a lower default rate and higher recovery rate, leading to a lower fair value spread target in the case of a modest recession. If we take 100 bps off the non-GFC average spread (848 bps becomes a rounded 750 bps) then our probability-weighted scenario analysis of fair **value moves from 630 bps to 600 bps – still wide of yesterday's close of 498 bps** (for the ICE BofA US High Yield Index we use for our broad high yield market analytics.)

And what about the calendar?

As outlined above, we still see the market as tight to fair value even if adjusted for "what's different" about today's high yield market. But investors are quick to reprice risk. Chairman Powell's clear and convincing Jackson Hole speech led to better alignment between market expectations and the path of the Fed Funds rate as outlined in the June, 2022 FOMC Survey of Economic Projections- higher for longer. Since Jackson Hole (August 26th), the ICE BofA US High Yield Index has returned -1.98% and spreads have widened 34 bps with less-than-market friendly calendar-based risks still in front of us. September has in fact been the worst returning month for **equities** over the last 15 years, but it is merely the second worst performing month for high yield, with November taking top (worst) billing with 66% of September returns positive although the average is modestly negative.

Average of ranking each year over last 15 years ending December 31, 2021

Month	ICE BOFA US HY Index	ICE BOFA BB-B 1-5 YR Index	CS Leveraged Loan Index	S&P 500 Index	Russell 2000 Index	ICE BofA Current 5-Year Treasury Index	ICE BofA US Corporate Index	Bloomberg Barclays Global Agg Index	ICE BofA Emerging Markets External Sovereign Index	ICE BofA Mortgage Backed Securities Index
1	5.00	5.20	3.40	6.73	6.47	5.07	5.80	5.73	6.67	5.27
2	6.07	5.87	6.67	6.33	6.33	7.13	6.93	7.07	6.40	6.93
3	7.13	6.80	6.53	6.13	6.13	6.87	8.07	7.27	6.33	5.87
4	3.80	3.47	3.93	4.93	5.73	6.13	4.47	5.00	4.87	5.33
5	6.87	7.13	6.47	6.80	6.67	5.67	6.20	7.87	6.93	6.40
6	6.87	6.93	7.87	7.80	7.00	7.40	6.80	6.73	7.00	8.27
7	4.93	5.67	5.40	5.67	6.73	5.20	3.93	4.07	4.33	5.47
8	6.73	6.67	8.00	7.27	7.13	4.87	5.80	6.07	6.53	5.27
9	7.47	7.47	6.27	7.60	7.13	7.60	8.27	7.40	7.53	7.33
10	7.07	6.87	7.20	6.20	6.60	7.53	6.60	7.47	6.60	7.53
11	9.87	9.60	9.00	5.93	6.20	6.40	7.80	7.13	8.40	7.07
12	6.20	6.33	7.27	6.60	5.87	8.13	7.33	6.20	6.40	7.27

Average return over same period

Month	ICE BOFA US HY Index	S&P 500 Index
1	1.32	(0.09)
2	0.46	0.30
3	0.01	1.34
4	2.51	3.36
5	0.66	0.40
6	0.28	(0.07)
7	1.23	2.31
8	0.32	0.42
9	(0.09)	(0.11)
10	0.08	0.77
11	(0.86)	1.59
12	1.28	1.13

Source: SKY, Bloomberg, ICE BofA Indices. Monthly data as of August 31, 2022

We see less technical pressures this September than in past years. True to history, the new issue spigot is opening with several well-telegraphed deals announced this holiday-shortened week with deals to refinance higher coupon callable bonds likely to be slotted in as well. However, we believe investor demand will prove to be an effective regulator of capital market flow in general and supply will clear the market.

On the demand side, outflows from high yield funds were $9.6b the last two weeks of August and another $1.5b has exited week-to-date (as provided by JP Morgan and tracked by Lipper), reversing out the $9.2b that flowed in the four weeks prior to the Jackson Hole speeches. Anecdotally, hedge funds have reset shorts and the Street risk-taking is "flat" to set up for a weaker month.

What we are doing…

While Chairman Powell's speech at Jackson Hole had the effect of realigning the market's expectation of higher rates for longer, it did not materially change SKY Harbor's expectations for the path of rates over the next twelve months. Good, not great second quarter earnings also did not impact our forward view of corporate profitability over the next 6 months. We continue to believe that consumer focused industries, particularly retail, will remain under pressure as companies work through excess inventory. We expect current trends in consumer spending will deepen as the cost of heating for the winter season further pressures discretionary spending. The sectors where pricing power remains are also likely to ultimately be forced to roll back prices, although the negative impact on margins may be less severe if costs have been adequately managed. We expect some sectors to remain resilient, like those that are tied to government funded programs, such as semiconductor chip manufacturing on-shoring, EV battery production, and infrastructure build-out. Our focus is less on sector and industry-based risk taking and more on identifying those companies that have demonstrated solid

execution in the face of what is now well-known headwinds and who have positioned their business for market share gains in a more constrained economy.

We are biased towards up in quality but also mindful that when there is broad-based sentiment to "stay up in quality" that lower rated credit valuations become attractive even when discounted for economic and market headwinds. As a result, we remain disciplined credit pickers – opportunistic across the full ratings and maturity spectrums of our investment universe and believe that the broad portfolio repositioning we did in the second quarter positions our portfolios for attractive risk-adjusted returns over the next twelve months.

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