

SKY Harbor Weekly Briefing

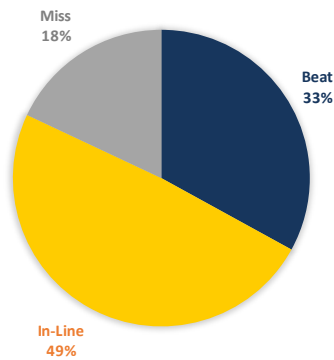
SKYView: Better Than Feared

Fed Chairman Powell’s two days of testimony on Capitol Hill dominated financial news headlines this past week, though the commitment to stay data-dependent before a March FOMC decision is made offered little in the way of near-term rate path clarity. Rather than add to Fed speculation, we will focus on real data as well – interest rates continue to rise, corporate earnings have demonstrated resilience but are likely to soften, and default rates are expected to remain muted despite known headwinds on the horizon. In this *Weekly Briefing*, we take a look at Q4’22 earnings thus far, highlighting updated expectations for fundamental credit ratio migration in the coming quarters given negative revisions to our EBITDA growth model, as well as spread implications stemming from the tight historical correlation to default rates.

Limited Visibility

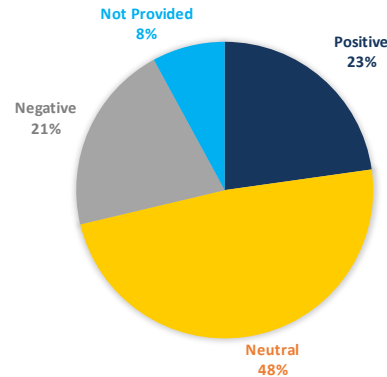
At present, we estimate that ~ 75% of US high yield issuers have released Q4’22 earnings, and results have largely come in better than feared. In fact, **we estimate that issuer EBITDA growth has been essentially flat on a y/y basis (vs. our model projection of -2%) owing to efforts to boost prices in tandem with input cost inflation, operating efficiencies, and progress in alleviating labor-related strains.** As demonstrated below, downside earnings surprise has remained muted, with only 18% of reporters missing street expectations (in-line with Q3’22). One notable deviation from prior quarters – the tendency for management teams to issue positive earnings guidance has come down by ~ 400 bps, albeit falling into the “neutral” rather than the “negative” camp. We largely attribute this dynamic to limited economic visibility into the second half of ’23 as well as uncertainty regarding disinflation trends, both of which skew the directionality of potential near-term earnings surprises to the downside.

More Issuers Beating than Missing
data through March 2, 2023



Source: JP Morgan, Bloomberg, Company Filings

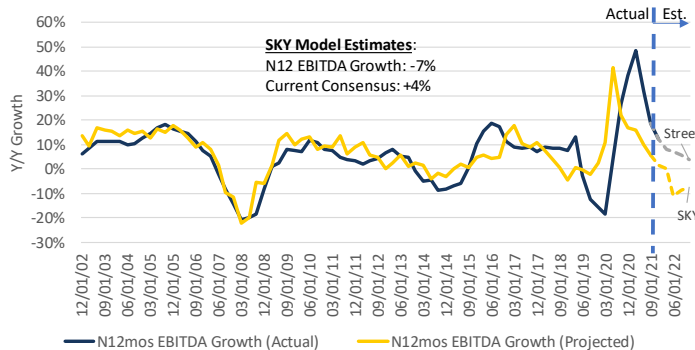
Proliferation of Positive Guidance Coming Down vs. Prior Q
data through March 2, 2023



Two Steps Forward, One Step Back

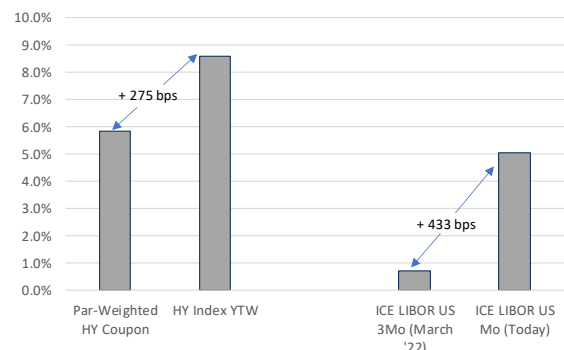
Weaker manufacturing trends and a drop in sea freight demand throughout January and February served to **lower our 2023 high yield issuer EBITDA growth projection to -7% (vs. our prior estimate of -5%), which continues to hover well below street expectations.** At the same time, the difference between par-weighted high yield coupons and index yield-to-worst levels, as well as upward pressure on the London Interbank Offered Rate, portend higher issuer borrowing costs in the coming quarters, though this dynamic is somewhat muted in the high yield bond market by virtue of limited near-term maturities and modest amounts of floating rate debt. Neutralizing these fundamental headwinds, however, is better than expected Q4’22 financial results. Specifically, **more resilient than anticipated EBITDA growth and stronger free cash flow generation in the final quarter of 2022 has pushed high yield index net leverage toward all-time lows, with the metric now approaching a full turn below its long-run average.** On balance, recent earnings outperformance has improved the starting point of fundamental credit metrics, but we now expect a slightly more rapid degradation as 2023 progresses.

S&P 1500 Index EBITDA Growth: Actual vs. Next 12mos SKY Model Projection
quarterly data, trailing 20 years



Source: SKY Harbor, Federal Reserve, Baltic Exchange, Chief Executive Magazine, Bloomberg, ICE Data Indices

EBITDA More Resilient Than Expected, But Rates Rising Faster
data as of March 8, 2023

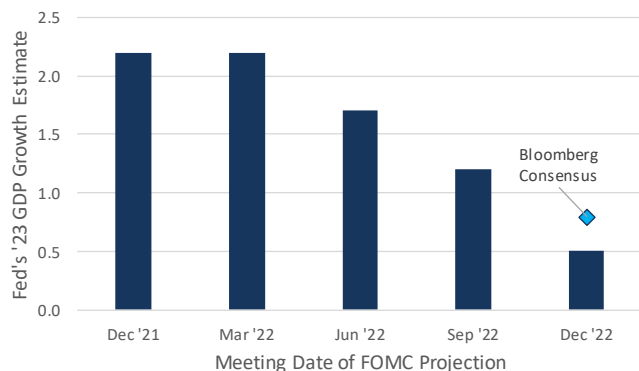


A Quick Sanity Check

Aware of the sizeable (1,100 bps) delta between our regression model output and consensus estimates, we thought it prudent to sanity-check EBITDA growth projections using an alternative approach. Below, we present the historically tight relationship between US GDP growth (Y/Y, no lag) and US high yield issuer TTM EBITDA growth. **Using consensus expectations and the Fed's projection of 2023 US economic activity – both of which have fallen over the last several quarters – we find an implied corporate EBITDA growth rate of -3% to -6%.** Though modestly more optimistic than our model output, results still imply a reduction in consensus expectations may be on the horizon, particularly given limited visibility with regard to demand and inflation toward the back half of 2023, as noted by corporate management teams. A moderation in consensus expectations, unfortunately, has historically come at the cost of wider spreads.

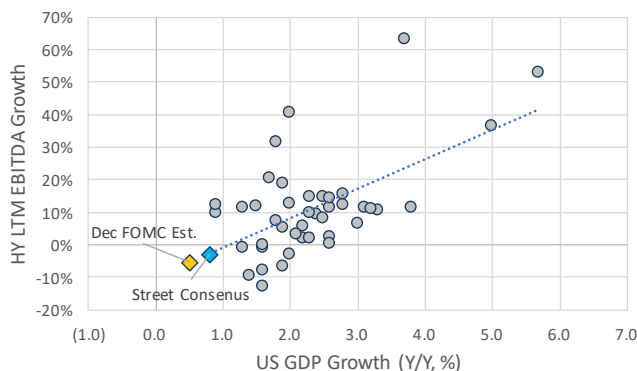
Fed Projection of '23 US GDP Growth Has Fallen

FOMC quarterly summary of economic projections



Sub-1% US GDP Growth Implies A Contraction in EBITDA

quarterly data, trailing 10 years (ex-COVID)



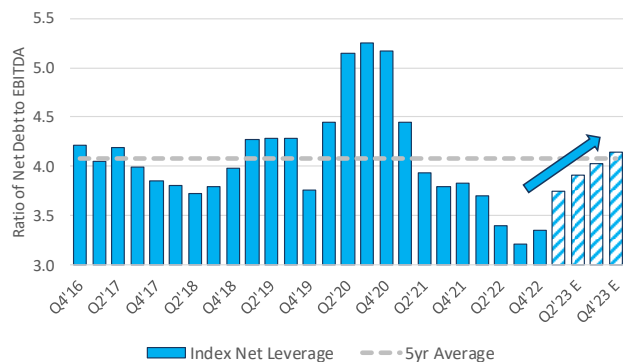
Source: SKY Harbor, Federal Reserve, Bureau of Economic Analysis, BofA Merrill Lynch, Bloomberg, Capital IQ

The Long and Winding Road

At the time of publication – we use metrics through Q4'22 – average high yield net leverage and interest coverage ratios were 3.3x and 5.4x, respectively, both notably stronger than trailing 5-year averages. If we overlay our estimation of EBITDA growth through the next year (-7%), assume an 80/20 average fixed/floating debt mix, assume little in the way of interest rate hedges in place near-term, and force companies to refinance fixed-rate debt one year ahead of maturity dates (with an interest expense uptick equal to the difference between current coupons and prevailing market yields), we can clearly see credit metrics eroding over the next twelve months. With that said, and **under our current set of assumptions, leverage and coverage ratios merely revert to their trailing 5-year average by the end of the year.** Furthermore, and acknowledging that underlying assumptions are quite sensitive to any changes in the economic outlook, strength in corporate balance sheets **better position high yield index constituents to weather a downturn than in recent years**, in our view. Notably, interest coverage is now at a better starting point (5.4x) than prior to COVID (4.2x) and in quarters leading up to the Global Financial Crisis (3.8x).

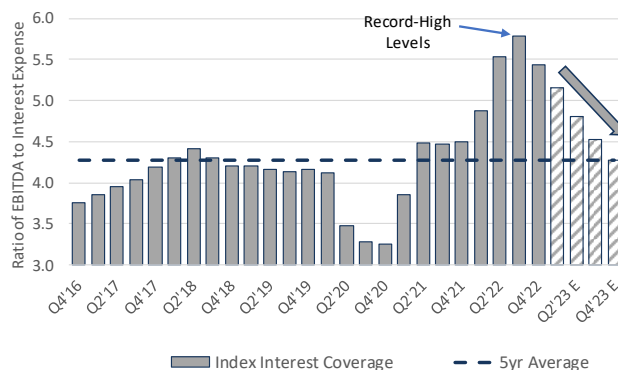
US High Yield Net Leverage Ratio

quarterly time series; striped bars are SKY Harbor projections



US High Yield Coverage Ratio

quarterly time series; striped bars are SKY Harbor projections



Source: SKY Harbor, BofA Merrill Lynch, Capital IQ, Bloomberg

It's All Relative

A "higher for longer" rates outlook and downward revisions to our issuer EBITDA growth projection imply an uptick in leverage and reduction in interest coverage as we make our way through 2023. Though post-COVID balance sheet repair and more resilient than anticipated corporate profitability in Q4'22 has provided significant cushion for issuers – translating into worsening, albeit manageable, credit metric migration in the coming quarters – **our base case outlook still appears worse than what is baked into consensus expectations.** Sure, credit ratios should merely revert to long-run averages, but spreads at present are 33rd percentile (409 bps at the time of writing), and as such likely need to widen as earnings growth expectations moderate. We do not, however, expect spreads to gap out toward prior recessionary levels, as index yield-to-worst is comparatively attractive (69th percentile), and default rates are projected to stay range-bound.

Finally, a brief note on defaults – credit loss anticipation has been the primary driver of high yield spreads on an historical basis. **Higher than average index credit quality, limited near-term maturities, and near-best index leverage and coverage metrics at present should, in our view, reduce the sensitivity of default rate projections to downward revisions in earnings growth in the near term.** In fact, index coverage metrics have historically had to fall below 3.4x in order for default rates to rise meaningfully above the long-run 4% average, and that type of degradation would only come if earnings were to decline ~ 30% over the next year. In this way, though we might expect some degree of spread widening on the horizon, we would not expect high yield to weaken linearly as earnings growth estimates come down. In our view, other risk assets, particularly equities with lofty P/E ratios, are likely to show greater sensitivity to negative surprises or a reduction in consensus earnings expectations in the coming quarters.

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