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SKY Harbor Weekly Briefing

SKYView: Notes from the Road

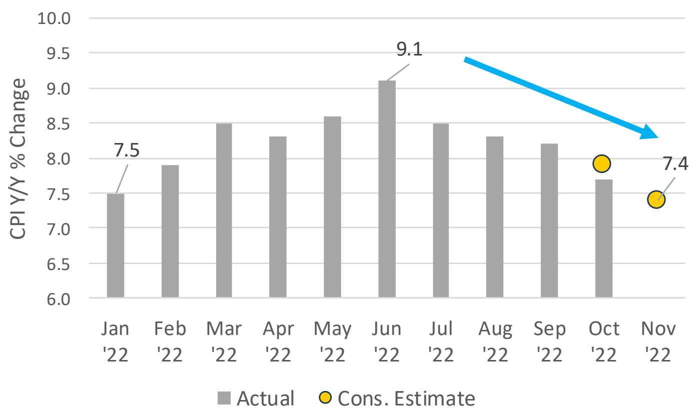
We had the pleasure of meeting numerous clients and prospects this past week as we travelled across Europe for our first international roadshow in nearly six months. Presenting our outlook for US high yield markets against a backdrop of rising uncertainty and depressed year-to-date returns across most asset classes (not to mention a Paris transit strike), we were pleasantly surprised at the level of attendance and engagement at each of our stops. Always acknowledging the value of questions and feedback received, we thought it appropriate to dedicate this *Weekly Briefing* to a recap of the most discussed topics from our journey (inflation, 3Q earnings season, and US midterm elections).

CPI Came in Cooler Than Expected

Inflation was, without a doubt, the most discussed topic of the past several days. Recall that our prior *Weekly Briefing*, entitled "The Pivot is on Pause," included two separate analyses that hinted at inflation normalization at a substantially more rapid pace than the prevailing consensus view. The first step toward price normalization may have just occurred, with **October CPI data (released Thursday, November 10) coming in at a still highly elevated +7.7%, albeit cooler than expectations by roughly 20 bps** (and only the second time this year in which CPI surprised to the downside). Broad-based deceleration of inflation led to a market rally on the day of the release, with US Treasury yields falling 25+ bps, and S&P 500 and US High Yield indices generating total returns of +5.5% and +1.7%, respectively. Furthermore, **market expectations for the December FOMC meeting now fall firmly in the 50bps hike camp** (had been a split between 50 and 75 bps prior) with the Fed Funds Futures implied terminal rate ratcheting down to 4.9% (~ 25 bps below recent highs). While there is still much work to be done, and the path to a soft landing remains "narrow," a continuation of inflation deceleration could give the Fed leeway in pausing hikes, lowering the chances of a policy misstep and reducing the likelihood of a US recession in 2023 (or, at the very least, reducing the likelihood of a *severe* recession).

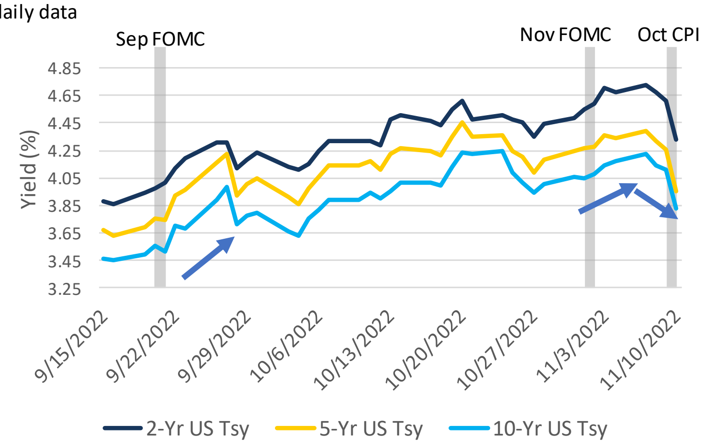
October CPI Reading Cooler Than Expected

2022 monthly data



Rates Rallied in Response to CPI Data

daily data



Source: SKY Harbor, Bureau of Labor Statistics, Federal Reserve, Bloomberg, ICE Data Indices

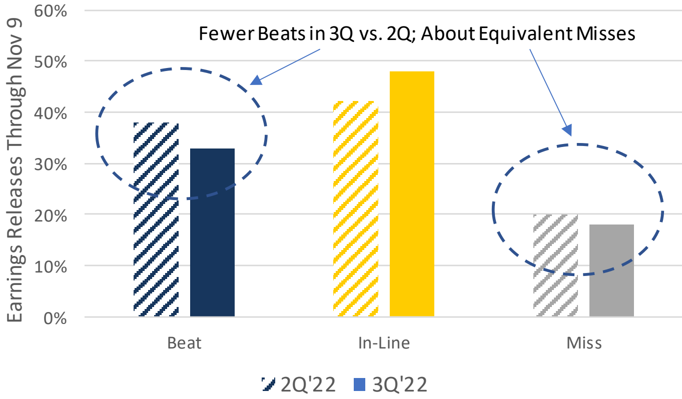
Earnings Faring Better Than Feared

Always a critical component in the formation of our views on high yield market fundamentals and valuations, 3Q earnings season was particularly important given rising concerns that corporate earnings trends may be on the precipice of an inflection. In an early October *Weekly Briefing* entitled "Downgrading EBITDA Growth," we noted that next 12 month EBITDA generation expectations appeared overly optimistic, with our internal regression model signaling ~ 1,000 bps of growth downside relative to the Street. In the interim, consensus expectations ratcheted down across several sectors, with many corporate management teams pre-announcing a softening outlook relative to their 2Q views, largely a function of persistent inflation, a deteriorating macroeconomic backdrop, and the strength of the US dollar. **A modest re-setting of expectations aside, 3Q earnings have come in better than feared, with more beats (33%) relative to misses (18%)[1], and overall trends essentially in-line with prior quarter results**. And, though we estimate that 25% of high yield constituents have yet to release financial results (among them some of the riskier issuers in our index), most investors have thus far breathed a collective sigh of relief. Among a multitude of risk factors on the horizon, **inflation remains the dominant concern of management teams, and an expected uptick in those opting not to issue forward-looking guidance did not materialize**.

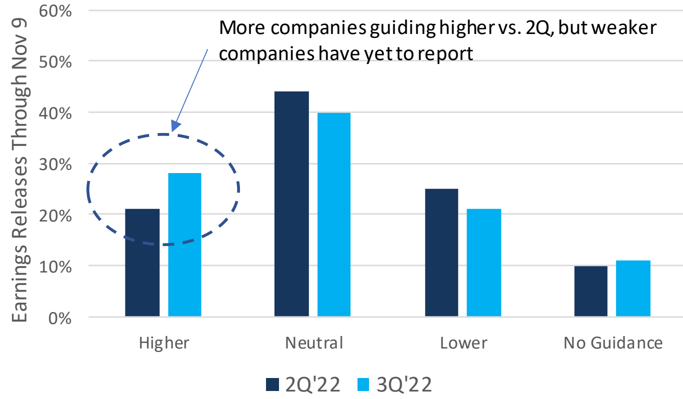
Also interesting from a bondholder perspective is the recognition of higher funding costs and less ease in accessing primary markets relative to the last few years. In fact, having already reached previously issued net leverage targets, some management teams have opted to continue prioritizing balance sheet repair instead of fully exercising share repurchase authorizations. On balance, **though we still expect EBITDA growth to be pressured in the coming quarters, 3Q earnings thus far have proven more resilient than expected several weeks ago**.

[1] Based on JP Morgan research team findings

3Q'22 Earnings vs. Expectations…Not As Bad As Feared
data through November 9, 2022



Guidance Relatively Upbeat, But Weak Reporters To Come
data through November 9, 2022



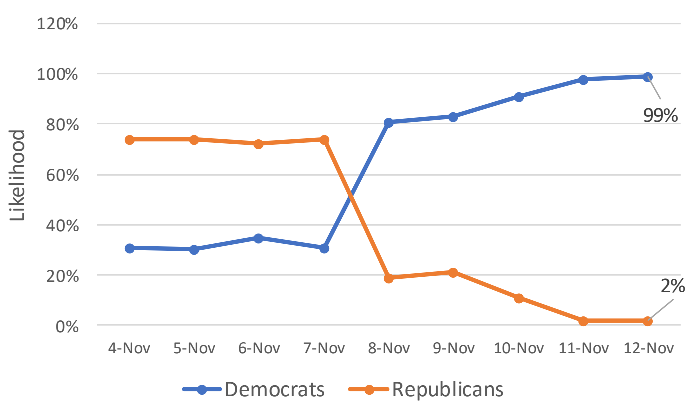
Source: JP Morgan

The "Red Wave" Failed to Materialize

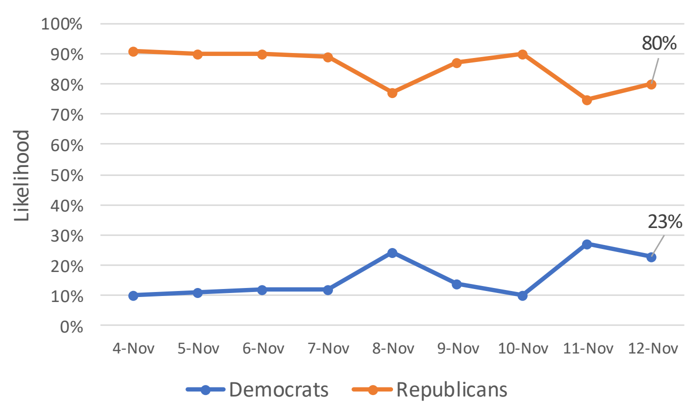
With President Biden's approval rating languishing in the low 40's / high 30's, **political pollsters and pundits were projecting a "red wave," with Republicans poised to wrest control of both the Senate and House of Representatives from the Democrats**. What ensued was comparatively underwhelming, with so many close races that neither chamber of Congress claims a clear-cut majority at the time of writing. In the Senate, Republicans will need to flip Nevada (though some news sources are already calling the race in favor of the Democratic incumbent) *and* prevail in the Georgia run-off election slated for December 6. As such, **prediction markets now put the odds of the Democrats maintaining a majority in the Senate at > 98%, a complete reversal from the outlook on the morning of election day**. In the House, Republicans currently lead 211 to 204, but remain 7 victories shy of a majority, with 20 races still too close to call. Though leadership of the House is still expected to change, **the Republican majority (if achieved) will be far tighter than originally anticipated**.

The prevailing thought heading into the midterms was that a "red wave" could lead to spending cuts, with solid Republican majorities in both the House and Senate pressuring Biden to scrap many aspects of his fiscal agenda. This now seems unlikely, with Republicans – likely at best – taking control of the House. However, **a divided government has historically been favored by the market, as unexpected / controversial legislation has little chance of passage, reducing uncertainty by virtue of a continuation of the status quo**.

Which Party Will Control the US Senate?
daily data, trailing 1 week



Which Party Will Control the US House of Representatives?
daily data, trailing 1 week



Source: SKY Harbor, PredictIt.org

A Permanent Shift or a Bear Market Rally?

Risk assets surged following Thursday's CPI data, but it will take some time before we know if enthusiasm is sustainable or if the reaction was simply part of a bear market rally spurred on by technicals. In the meantime, we continue to expect more rate hikes, a weakening of corporate EBITDA growth, and a still high chance of recession in 2023. These recent developments, however, may have taken some of the negative tail risk off the table, which should compel investors to take a closer look at elevated yields in the high yield space given lofty breakevens. For now, we continue to favor a more defensive stance in portfolio positioning, and will wait for further erosion of uncertainty before dipping further down the credit rating spectrum. Market sentiment, however, seems unambiguously better following this most recent week of corporate earnings and economic data releases.

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