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April 17, 2023

SKY HARBOR CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

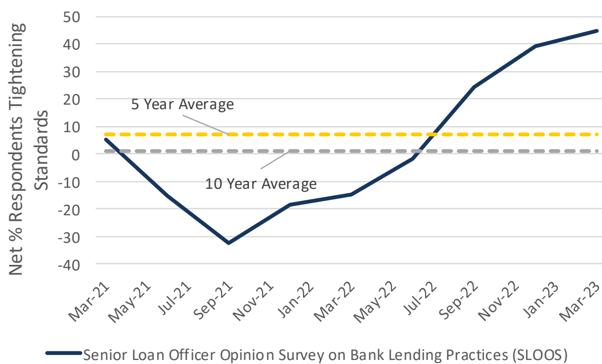
Dwindling Dollars

Market enthusiasm from cooler than expected March CPI and PPI data was restrained, in our view a function of lending condition uncertainty. The Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) – a quarterly assessment conducted by the Federal Reserve to measure net tightening of commercial and industrial lending standards by large and medium sized banks – is due out in three weeks, and investors are weary that bank sector stress, on top of already slowing business activity, may result in further credit constriction. In this *Weekly Briefing*, we use higher frequency Dallas loan data and trends in money market flows to goalpost SLOOS expectations, and find the impact to high yield default rates will likely remain manageable.

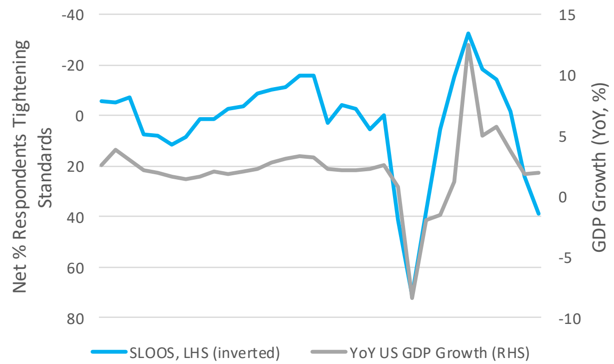
Data Dependence

Lending standards have been on the rise since the end of 2021, a function of both economic uncertainty and the tightening of monetary policy conditions. Though this trend was largely expected to persist given our position in the business cycle, **bank sector stress in March exacerbated the situation**. At issue, and as highlighted by a recent publication by Goldman Sachs[1], is the "macroeconomic impact of a pullback in lending," particularly given the outsized role small- and medium-sized banks play (50% of US commercial and industrial loans come from banks with assets of less than $250bn) against a backdrop of disproportionate deposit flight. The Fed, for its part, will gain access to SLOOS data in time for the May FOMC meeting – a full week before investors – with results expected to weigh heavily upon the Committee's decision as rate hikes and tighter lending standards similarly constrict growth.

Lending Standards Were Tightening Even Before SVB Collapse
quarterly data, since 2021



Restricted Lending Tends to Coincide W/ Lower Output
quarterly data, since 2021

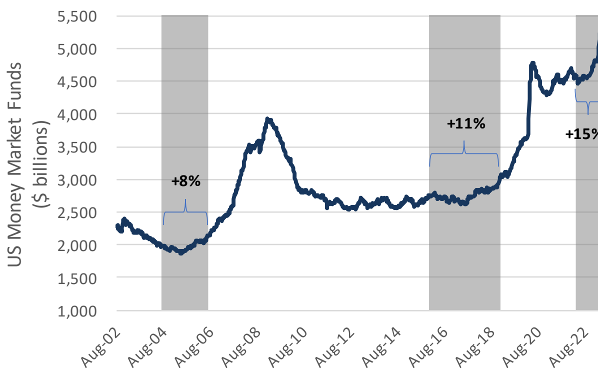


Source: SKY Harbor, Federal Reserve

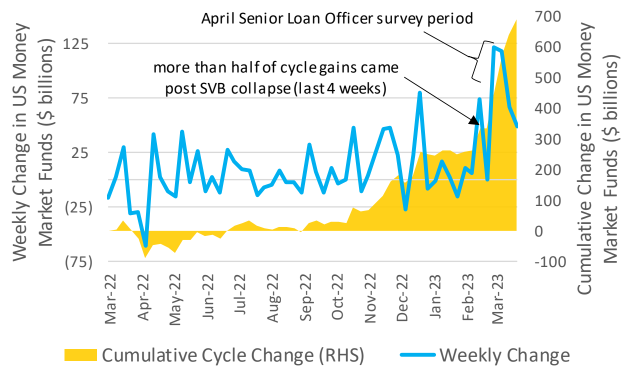
Deposit Flight Decelerating

In the wake of Silicon Valley Bank's collapse, Americans aggressively shifted assets to money market funds, particularly those concerned about regional bank viability given insured deposit limitations imposed by the FDIC. Acknowledging that money market inflows typically accelerate in Fed hiking cycles, the move this time around has already proven more aggressive than usual. In fact, **money market inflows are nearly $700bn in the current hiking cycle, over half of which have come in the month since bank solvency concerns grabbed headlines**. Though trends have shown deceleration over the last two weeks, the majority of responses in the yet-to-be-released SLOOS were recorded at the peak of deposit flight, giving rise to concerns that survey results are likely to show exceptional weakness.

Money Market Fund Inflows Already Surpass Prior Hiking Cycles
weekly data, shaded areas represent rate hiking cycles



Recent MM Slowdown Came After SLOOS Date
weekly data, current Fed hiking cycle



Source: SKY Harbor, Federal Reserve, ICI US Money Market Mutual Fund Assets, Bloomberg

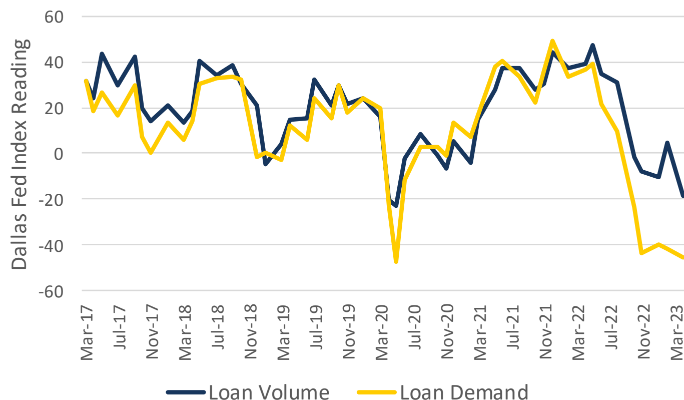
[1] https://www.goldmansachs.com/insights/pages/stress-among-small-banks-is-likely-to-slow-the-us-economy.html

Dallas Demand Disappoints

SLOOS data greatly improves the statistical significance of our forward-looking high yield index default model, and the default outlook largely dictates the path of spreads. Unfortunately, the data is only released on a quarterly basis, which can seem like an eternity when results are likely to demonstrate sequential volatility. To help solve this issue, we collected higher frequency data, including aforementioned money market fund flows (available weekly) and Dallas Fed loan volume and demand metrics (released every six weeks). **Using post-SVB data in the context of historical correlations, we anticipate the upcoming SLOOS results will show net respondent tightening of 45% to 55%**, up from 44.8% in January and close to prior recessionary peaks excluding the Global Financial Crisis.

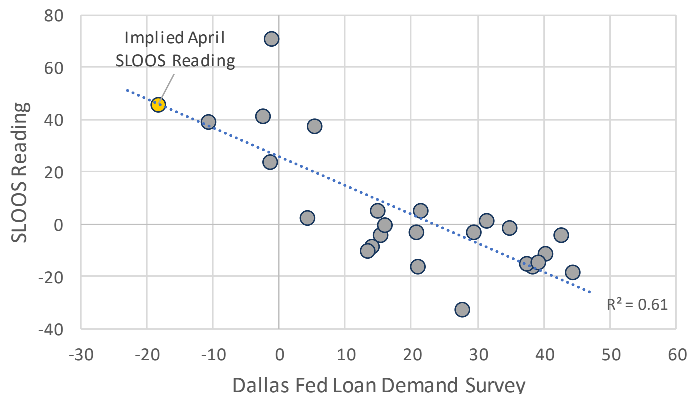
Dallas Fed Loan Volumes & Demand Continue to Fall…

measurements taken twice per quarter



…Providing a Negative Read for April SLOOS

trailing 5 years of data



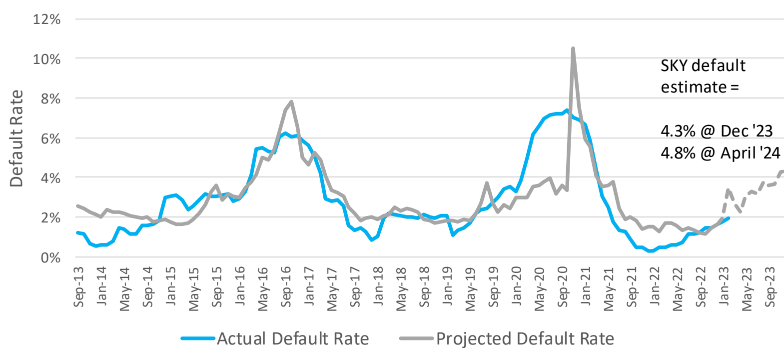
Source: SKY Harbor, Federal Reserve Bank of Dallas, Bloomberg

A Driver of Defaults

With a new SLOOS estimate in hand, we updated our multi-factor default rate projection model for the first time since bank stress emerged in mid-March. **Our output now implies a 4.8% default rate over the next twelve months**, representing a 50 bps increase from our year-end 2023 estimate, and foreshadowing a nearly 300 bps increase relative to the default rate at present. As highlighted in recent *Weekly Briefings*, superior index quality and fundamental credit metrics near all-time highs should keep default rates well below prior recessionary levels even if economic output contracts (our April '24 estimate is merely 80 bps above the long-run index average). That said, the timing of the April SLOOS and its weight within many credit loss estimate models keep us biased away from lower-rated credit at present, particularly distressed issuers likely in need of funding over the next several quarters.

SKY Default Rate Projection Model

monthly data



Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Moody's, Federal Reserve Bank of New York, National Bureau of Economic Research

Stay Defensive

The ICE BofA US High Yield Index (H0A0) has tightened 22 bps and generated 55 bps of total return in the week since our last briefing, underscoring easing of labor market conditions and an overall continuation of the disinflation trend. Furthermore, a yield-to-worst of 8.5% remains top quartile based on trailing 20 years of data, which continues to garner investor attention. Even so, we see near-term SLOOS data risk as being skewed to the downside, and so continue to favor higher-quality, more defensive risk across portfolios.

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