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SKY HARBOR
CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

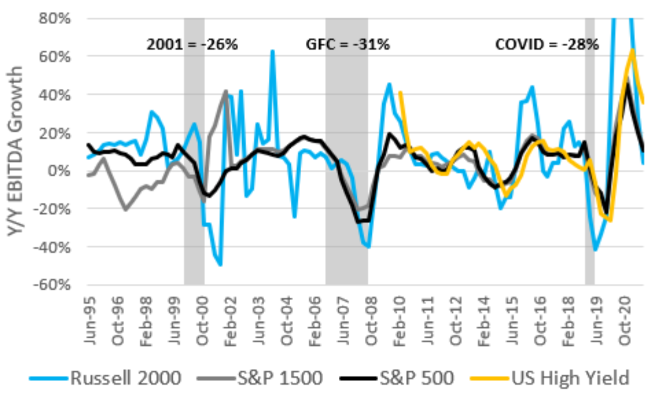
SKYView: Downturn Sensitivity

Last week, we outlined our case for EBITDA growth to come in below consensus expectations, driven by a strengthening USD, persistent inflation, energy disruptions, and tightening monetary policy conditions. While this view has not changed, we remain mindful that the associated impact of such earnings pressure merely push credit metrics and default rates back to their long-run averages, albeit with the potential for further revisions should macro expectations migrate downward. In this *Weekly Briefing*, we take a closer look at sector positioning, all in an attempt to identify subsets of the market that should prove more resilient in times of uncertainty, particularly if the macroeconomic outlook should degrade further.

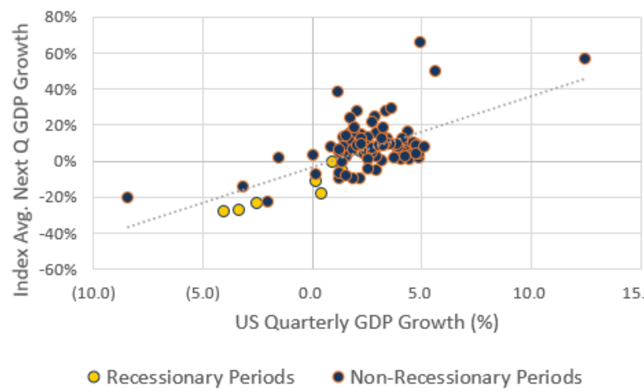
Downside Risk to Our -3% EBITDA Growth Estimate

In our most recent *Weekly Briefing* entitled “Downgrading EBITDA Growth,” we presented our corporate earnings growth regression model, which implied that **consensus expectations (+7% over the next year) were at least 1,000 bps too optimistic**. A look at the relationship between earnings and US GDP growth over time also implied that investor expectations needed to moderate, particularly in light of the Fed’s projection of output falling to 1.2% in 2023. Though OpEx reductions, automation, maturity extensions, and conservative balance sheet management should, in our view, cushion high yield index constituents in the coming quarters despite known headwinds, we highlight below that EBITDA declines have come in significantly worse in past recessions than our current base case scenario. In fact, **EBITDA declines of ~ 20% can occur in non-severe recessionary environments**.

EBITDA Can Decline Over 30% in Recessions
quarterly data since 1995, recessions shaded grey



US GDP Growth vs. Next Q Index Average EBITDA Growth
quarterly data since 1995, recessions shaded grey

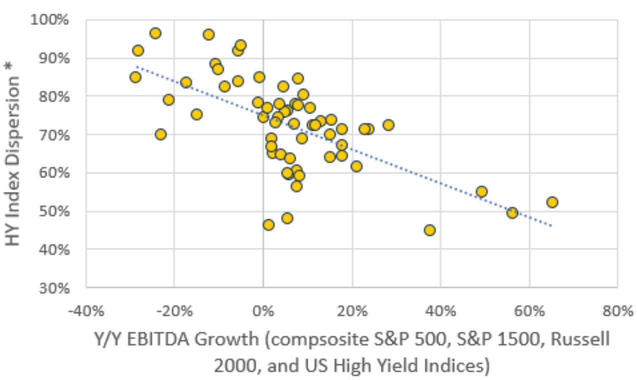


Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, National Bureau of Economic Research, Bureau of Economic Analysis

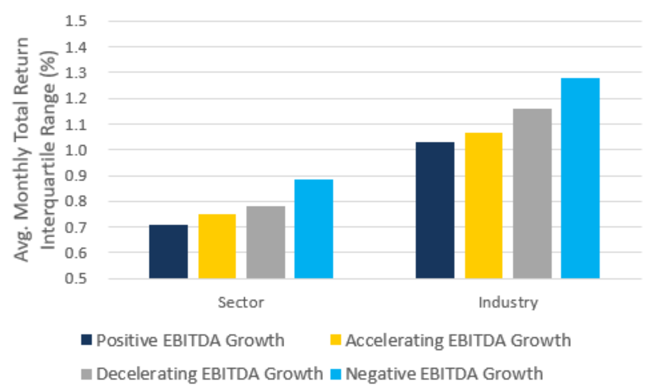
An Expected Uptick in Dispersion

In periods of declining EBITDA generation (we use a composite of indices given the limited history of the modern high yield market), **bond dispersion tends to rise dramatically** (we define dispersion as the percentage of the ICE BofA US High Yield Index that trades outside a range of +/- 100 bps of the H0A0 average). This makes sense intuitively, as we would expect investors to increase scrutiny of portfolio holdings in tenuous market environments when the threat of default is on the rise. This dynamic appears to heighten the importance of sector and industry allocation as well. As demonstrated below, **monthly total return interquartile ranges – perhaps a better measure of dispersion as outliers are trimmed from the dataset – tend to increase as the EBITDA growth outlook weakens**. In fact, total return industry IQRs can increase by nearly 30 bps when going from a positive to a negative earnings growth environment.

HY Index Dispersion Ratchets Up When Earnings Growth Falls
quarterly data, trailing 10 years



Sector and Industry Total Return IQRs Increase as Growth Slows
monthly data, trailing 10 years



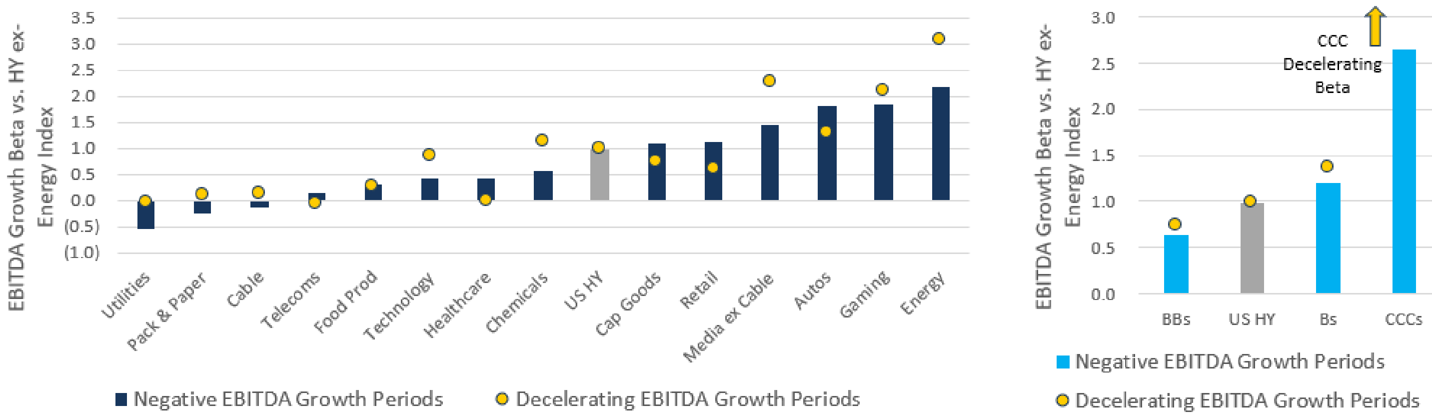
Source: SKY Harbor, ICE Data Indices, Bloomberg, BofA Merrill Lynch, Capital IQ

Pockets of Resilience

Though we expect high yield constituent EBITDA, in aggregate, to decline over the next 12-month period, **there are parts of the market that have shown consistent resiliency amidst economic downturns**. Limiting our decade-long dataset to include only periods in which EBITDA growth was negative or decelerating, we calculated earnings betas relative to the high yield index as a whole (beta = 1.0). As demonstrated below, and not surprisingly, we find CCC-rated credit to generically be at most at risk, with downside EBITDA growth beta at multiples of the index average. On a sector basis, **Energy, Gaming, Autos, and Media ex-Cable have also shown greater downside earnings volatility relative to the index, while Utilities, Paper & Packaging, Cable, Telecoms, and Food Producers have demonstrated relative stability**. In our view, historical sector resiliency (or lack thereof) should not dramatically change in the context of headwinds currently anticipated by the market, save potentially Utilities and Energy given input/output price dislocations brought on by geopolitical tensions.

Sensitivity to EBITDA Varies by Sector and Rating Bucket

based on 10 years of trailing 12-month EBITDA growth



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

Continue to Prefer High-Quality and Defensive Issuers

As stated last week, we are of the belief that consensus earnings expectations need to fall in the coming months, and anticipate EBITDA growth for high yield constituents will likely turn negative in 2023. With that said, there are areas of the market that should prove more resilient given the current economic backdrop. We continue to believe an up-in-quality bias and security / sector selection based on bottom-up research efforts and findings consistent with our historical downside capture analysis can reduce underlying volatility. Double-digit yields and year-to-date underperformance on an excess return basis for CCC-rated credit notwithstanding, we think greater clarity on a Fed pivot and steps toward resolution in Ukraine are necessary preconditions to generically increase portfolio credit risk.

Important Disclosures and Disclaimers