SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
June 0, 2022

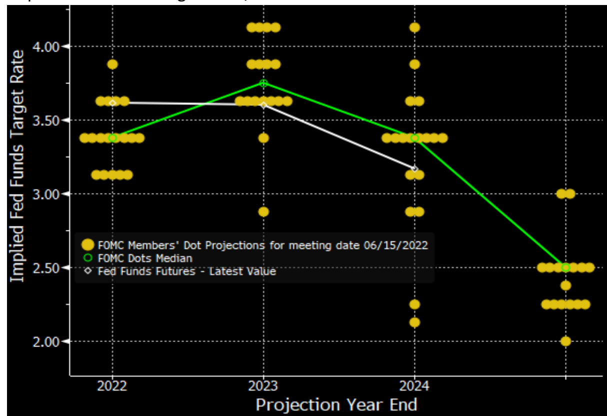
SKY Harbor Weekly Briefing

SKYView: Where Do We Go From Here?

Hotter than expected May CPI data (released June 10, 2022) and an historically weak University of Michigan Sentiment reading resulted in significant market volatility over the last couple of weeks, with mounting signs of economic growth vulnerability leading to a sharp repricing of risk assets. Shortly after these worrisome economic datapoints were released, the *Wall Street Journal* published a prescient article portending a 75-bps rate hike during the June FOMC meeting[1], further re-setting near-term Treasury expectations and putting upward pressure on risk premiums. With additional uncertainty being added to an already tenuous market backdrop, we have fielded a number of requests to update our internally generated default rate and OAS targets, all while adding some historical market context behind such estimates. In this *Weekly Briefing*, we put forth a spread analysis that attempts to goalpost index widening and tightening scenarios, all based on an emerging view of how the economy may evolve in the coming year.

First, a quick recap of the June FOMC meeting. Consistent with speculation immediately preceding the meeting (recall the WSJ article), but 25 bps above the consensus view over the last several weeks, **the Fed voted to boost rates by 75 bps (target rate now 1.75%), the largest move since 1994**. While insisting that a "soft landing" is still a possibility, Powell conceded that recent events have "raised the degree of difficulty" in pulling off such a feat, particularly given the rise of risks beyond the control of the Fed. Real GDP growth expectations have declined 110 bps to +1.7% in 2022, and the chairman is now guiding to a 50-75 bps hike at the next FOMC meeting (July). Shortly after the Fed's decision, the Swiss National Bank boosted their policy rate by 50 bps (was a surprise to the market, as the expectation was for rates to remain steady). Hungary and Brazil also hiked more aggressively than expected, **in-line with the overall view that inflation is proving more persistent than many central banks had originally expected**.

Fed Hikes by 75 bps, Dot Plot Shifts Again
Implied Fed Funds Target Rate / FOMC Dot Plot



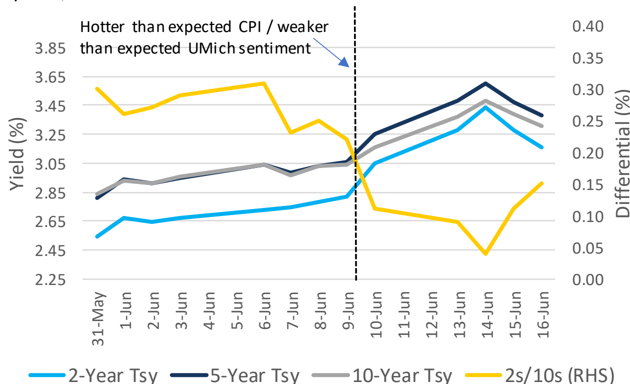
Central Banks Seeing More Persistent Than Expected Inflation
selected commentary

- Fed sees real GDP growth slowing to 1.7% in 2022, down from a 2.8% projection following the March meeting; sees Core PCE inflation at 4.3% by year end, up from 4.1%
- Powell sees inflation down sharply over the next 12 - 24 months, sees neutral rate in the mid-2% area
- Powell noted that he did not expect 75 bps moves to become the norm, but admitted the possibility of similar future actions should inflation continue to exceed expectations
- ECB's Governing Council held an emergency meeting, confirming it will use PEPP in a flexible manner, with reinvestments aimed at stemming the widening of sovereign spreads
- Swiss National Bank hiked policy rate by 50 bps (to -0.25%), surprising the market (exp. was for no change); Hungary and Brazil also hiked 50 bps each (also surprises)

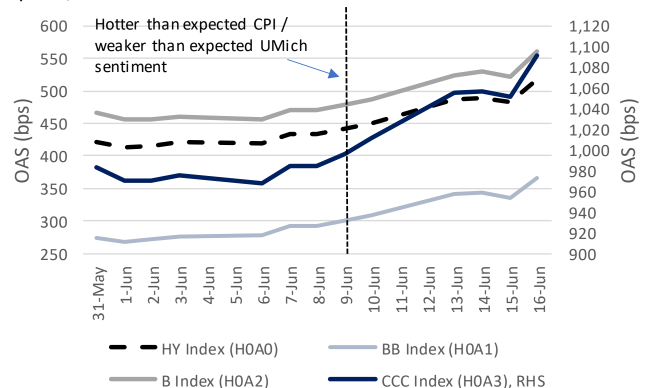
Source: SKY Harbor, Bloomberg, Federal Reserve

Markets, having anticipated *some* of the surprise hike, continue to be volatile. **Treasury yields have ratcheted up dramatically following May CPI data (again, from Friday, June 10), while the curve has generally flattened**. More specifically, 5-Year Treasury yields have increased 57 bps since the start of the month, with over 1/2 of the move occurring in the past week. At the same time, high yield spreads have widened 95 bps since the beginning of June, with lower-rated credit underperforming only over the last several days, perhaps when markets began to worry less about higher rates (duration led the selloff earlier this month) and more about the risk of recession (credit risk was the driving factor in explaining market price returns this past week).

Treasuries Were Volatile Leading Up to FOMC Meeting…
daily data, June month-to-date



…Which Contributed to US High Yield Spread Volatility
daily data, June month-to-date



Source: SKY Harbor, Bloomberg, ICE Data Indices

[1] https://www.wsj.com/articles/bad-inflation-reports-raise-odds-of-surprise-0-75-percentage-point-rate-rise-this-week-11655147927

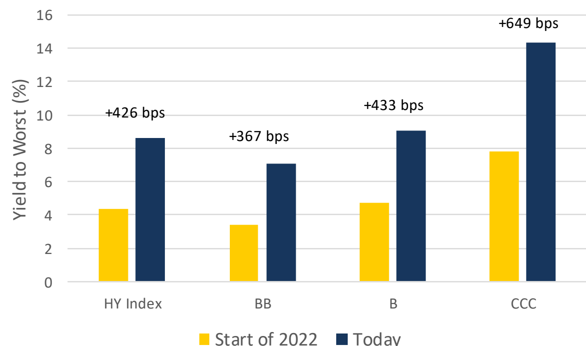
So, where do we go from here? With all of the uncertainty on the horizon, we thought a scenario analysis would be most appropriate. Below, **we highlight four potential paths for the US high yield asset class over the coming four to eight quarters, listed in order of increasing levels of stress**. In general, a default rate estimate – driven by starting levels of index interest coverage and the resulting metric migration on the basis of EBITDA growth/declines, prevailing levels of interest rates, and the evolution of risk premiums – forms the foundation of our analysis. These estimates are augmented by additional internal projection models (recoveries, over/under shooting vs. expectations, etc.), as well as observations of high yield issuer performance during expansion and contraction cycles of the past three decades. Our resulting spread targets are informed by an estimate of index credit losses under each default rate environment, which were then added to long-run average excess spread compensation. Finally, adjustments are made on the basis of historical default rate and index spread trajectories during similar economic backdrops since the 1990s.

Various Spread and Default Rate Targets by Scenario
data as of June 16, 2022

	US HY Index @ June 16, 2022	Scenario #1 Soft Landing	Scenario #2 Elevated Inflation, Recession Avoided	Scenario #3 Elevated Inflation, Modest Recession	Scenario #4 Normal Recession
Index OAS*	517	400	525	650	1,200
LTM Default Rate	0.6%	2.0%	3.5%	6.25%	12.0%
Est. Chance of Occurring		15%	45%	35%	5%

Weighted Scenario Average	
Defaults	4.7%
OAS (bps)	584

HY Yields Have Reset Significantly Higher
data as of June 16, 2022



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

- ***Scenario #1***: A soft landing, with the Fed able to temper inflation without stifling economic growth; in this scenario, we think defaults rise modestly to 2% by the end of 2023, and high yield fair value OAS is ~ 400 bps (probably the market's base case prior to May CPI and the U. of Michigan sentiment results released on June 10, 2022)
- ***Scenario #2***: Inflation continues to run hotter than the Fed's longer-run target, with a higher neutral rate but one that is not onerous enough to tip the economy into contraction; in this scenario, we think defaults rise to 3.5% by the end of 2023, and high yield fair value OAS is ~ 525 bps (has become the market's base case following weak economic data releases on June 10, 2022, with some risk that consensus migrates into scenario #3)
- ***Scenario #3***: Inflation continues to run hotter than the Fed's longer-run objective, and the economy dips into a recession as the target rate jumps to over 4%; in this scenario, a modest recession ensues, defaults rise to 6.25% but remain well below COVID lockdown and Global Financial Crisis levels (better starting metrics, fewer excesses have been built up in the system), and high yield fair value OAS is ~ 650 bps (may become the market's base case post June FOMC meeting, particularly if economic data continues to surprise to the downside)
- ***Scenario #4***: Inflation spirals out of control, and the global economy experiences a full scale recession; in this scenario, significant economic contraction and frozen credit markets push the default rate up to 12%, with increased risk premiums resulting in a highly distressed market as spreads approach 1,200 bps (an unlikely scenario, in our view, but consistent with stressed situations of the past)

On a weighted-average basis, **our scenario analysis implies the potential for spread widening in the near-term**. More specifically, using Scenario #2 as our base case (elevated inflation but recession avoided), Scenario #3 as a close second (elevated inflation that leads to a modest recession), and diminished chances for tail risks materializing (soft landing / normal recession), we arrive at an average spread target in the 585 bps range. Though admittedly above current OAS levels of ~ 517 bps, we would note that **carry could nicely offset negative capital gains with index yield-to-worst levels now exceeding 8.5%**. If market jitters push our base case to Scenario #3 (we boost the estimated chance of occurring to 45%, and reduce Scenario #2 odds to 35%), OAS fair value rises to approximately 600 bps. Unfortunately, the impact of the Fed's recent actions to stifle inflation will likely remain an unknown for several months, with resulting uncertainty likely to cause some spread widening in the near term absent a positive catalyst on the horizon. **On balance, we expect the near-term path of least resistance to be one of modest spread widening, but view elevated yields (now 97th percentile based on monthly data over the last decade) as an attractive counterbalance**.

Concluding Thoughts & A Personal Note

On a more personal note, I wanted to take the opportunity to thank all of you who have read (and contributed to via thoughtful questions and feedback) our *Weekly Briefing* over the last five years. It has truly been a privilege to write, converse, debate, and learn from such a diverse group of investors, and I can truthfully say that my career in high yield has been enhanced by the experiences gained through the sharing of these investment viewpoints over the years. As a firm, we set out to provide not only attractive risk-adjusted returns, but to augment our value proposition by sharing investment insights with clients and prospective investors alike. While I would like to think that the creation of the *Weekly Briefing* in 2018 furthered our progress in achieving such goals, I know for sure that the experience was rewarding from a personal perspective. It is, therefore, with some underlying sadness – but also with an overall feeling of excitement for what lies ahead – that I announce that this will be my final publication for SKY Harbor. After significant thought and deliberation, I have decided to pursue an opportunity outside of the investment management field. To that end, I will work diligently over the coming days to ensure a smooth transition with my very capable colleagues, and have the utmost confidence that SKY Harbor's communication and engagement will persist at a level you have all become accustomed to. Beyond that, I truly wish all of you the best in your investing endeavors, and ask that you accept my sincerest thanks for providing me the opportunity to more closely interact with you and your firms during my tenure at SKY Harbor.

Best,
Mike Salice

Important Disclosures and Disclaimers

This analysis and the opinions expressed herein are intended solely for institutional and professional investors that are responsible for assessing their own risk tolerances under prevailing market conditions. SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed. SKY Harbor, its affiliates, officers, directors and employees hereby disclaim any liability whatsoever related to the use of this publication or its content and make no express or implied warranties of merchantability or fitness for any particular purpose or use with respect to the data, projections, analysis, content, or conclusions included in this publication.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

Gross performance results do not reflect the deduction of investment advisory fees, which would reduce an investor's actual return. For example, assume that $1 million is invested in an account with the Firm, and this account achieves a 6% compounded annualized return, gross of fees, for five years. At the end of five years that account would grow to $1,338,226 before the deduction of management fees. Assuming management fees of 0.55% per year are deducted annually from the average annual AUM, the value of the account at the end of five years would be $1,302,846, which is the equivalent of an annual compounded rate of 5.43%. For a ten-year period, the ending dollar values before and after fees would be $1,790,848 and $1,697,408, respectively. SKY Harbor's asset-based fees are generally billed monthly or quarterly in arrears. Please refer to the SKY Harbor's ADV Part 2A or applicable Offering Documents for more information on fees. Consultants supplied with gross results are to use this data in accordance with SEC, CFTC, NFA or the applicable jurisdiction's guidelines.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofA Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofA") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofA PERMITS USE OF THE ICE BofA INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.

© 2022 SKY Harbor. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor.