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SKY Harbor Weekly Briefing

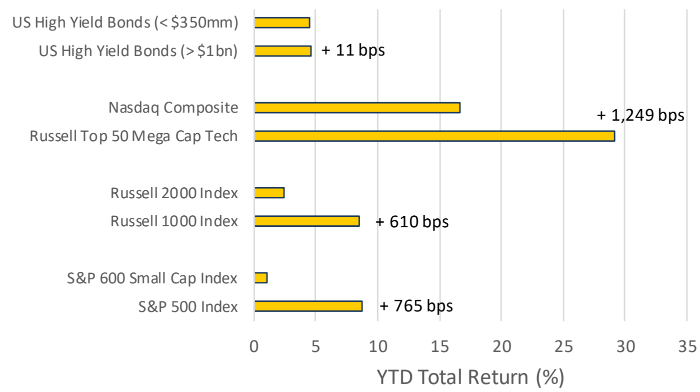
Small Talk

A notable trend that emerged from equity markets during Q1 was underperformance of small caps, primarily a function of sector biases and idiosyncratic behavior, exacerbated by banking stress that gave rise to the perceived notion of large cap safety in uncertain times. This distinction was not evident in high yield market returns, however, prompting us to examine differences among large and small issuer constituencies within our market. In this *Weekly Briefing*, we identify looming risk factors should credit availability constrict, and reiterate our view that issue size may contribute to return dispersion in the coming months.

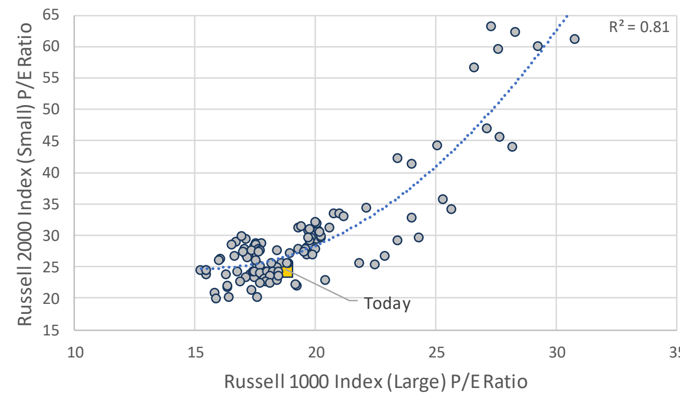
Sizing Up Market Trends

Large cap equities outperformed their small cap peers in Q1'23, and the dynamic has persisted thus far in April. Significant large cap outperformers (including Meta, Apple, and Amazon, to name a few) have partially driven the performance gap, as have differences in underlying sector concentration (small caps have greater exposure to financial services, particularly hard-hit regional banks, and benefitted less from tech). In our view, **investors may also have been lured into large cap names due to perceived safety, with underlying constituents perhaps benefitting from greater access to capital and additional levers to combat inflation**. As demonstrated below, and unlike equities, large cap outperformance has not been prevalent in the high yield bond space.

Large Cap Equities Favored in Q1; HY Showing Little Differentiation
data as of April 19, 2023



Small vs. Large Equity Valuations Appear In-Line w/ Historical Norms
Russell 1000 Index vs. Russell 2000 Index; P/E ratios, monthly data, trailing 10 years

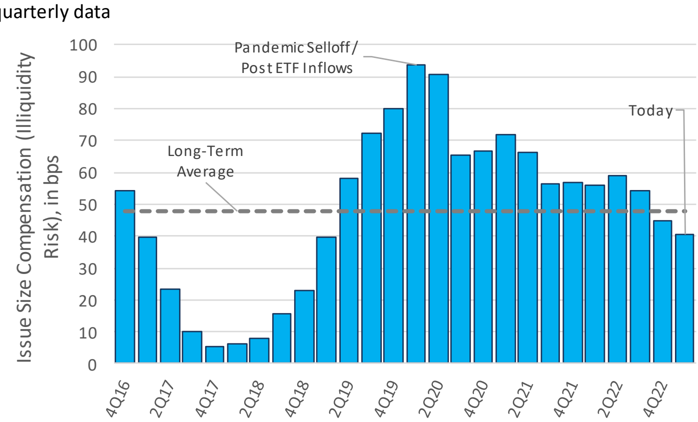


Source: SKY Harbor, Bloomberg, ICE Data Indices

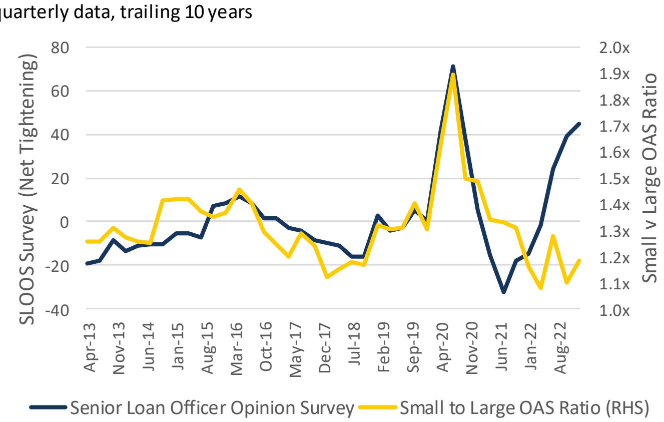
A Small Price to Pay

As noted in our *Weekly Briefing* from early March entitled "Recalculating Factor Compensation," liquidity premiums had fallen below the long-run average for the first time since late 2018, and as a result we no longer viewed smaller issues as generically "cheap" in the high yield space. Despite these findings and trends in equity markets, **small vs. large bond performance has been nearly indistinguishable on a year-to-date basis, with the former actually outpacing the latter thus far in April.** Additionally, and as highlighted last week in our piece entitled "Dwindling Dollars," deposit flight (stemming from bank sector stress) and economic uncertainty is expected to constrict lending in the coming months, with the Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) likely to signal the tightening of standards when released in early May. Historically, the small to large option-adjusted spread (OAS) ratio has risen in tandem with SLOOS tightening, a trend noticeably absent from recent market activity.

Small Issue Premiums Now Back to Below-Average Levels
quarterly data



Small Bonds Historically Penalized When Credit Conditions Tighten
quarterly data, trailing 10 years



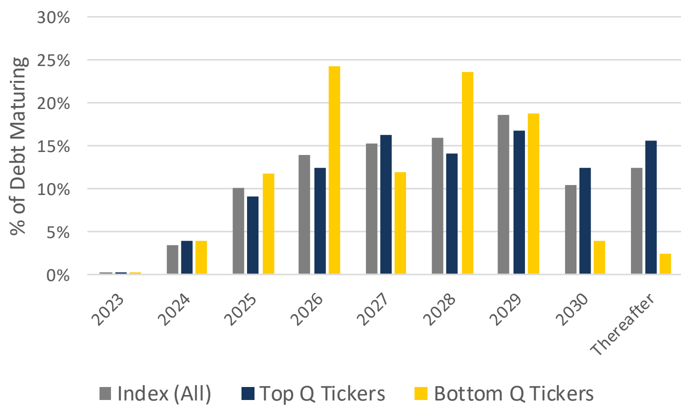
Source: SKY Harbor, Federal Reserve, ICE Data Indices

Is it Time to Sweat the Small Stuff?

Constituencies, of course, change over time, and small sample sizes can lead to distortion from outliers. In an attempt to neutralize these impediments, we divided the ICE BofA US High Yield Index (H0A0) into quartiles by capital structure size, denoting the largest as “Top Q Tickers” and the smallest as “Bottom Q Tickers” (with each containing approximately 225 issuers). In the context of tightening lending standards, we focused first on maturity runway. As demonstrated below, **“Bottom Q Tickers” have a more onerous maturity wall, with 40% of bonds on a cumulative basis coming due by 2026** (vs. 25% for “Top Q Tickers”). Additionally, “Bottom Q Tickers” have disproportionately more CCC-rated debt to refinance over the same timeframe (nearly 30% of maturities over the next 36 months are rated CCC, vs. less than 10% within the “Top Q Tickers” bucket). Though primary market activity has picked up from 2022 levels, and maturity walls in general appear manageable in the context of high yield funding needs over the last two decades, these findings do call into question the ability for high yield small caps to continue to outperform larger structures should credit availability concerns heighten.

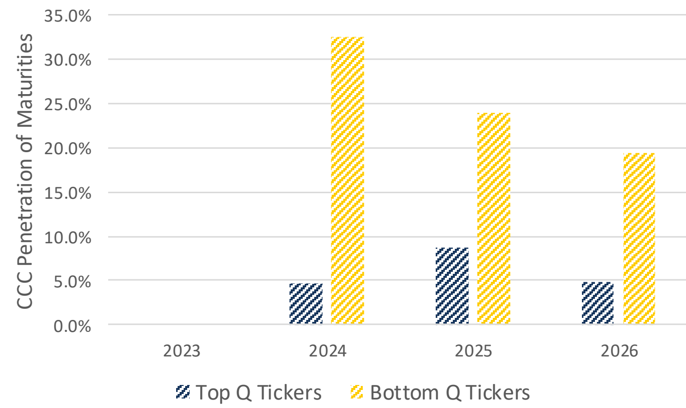
Smaller Cap Structures Have More Onerous Maturity Wall...

data as of April 19, 2023



...Including More CCCs to Refi Over Next 36 Months

data as of April 19, 2023



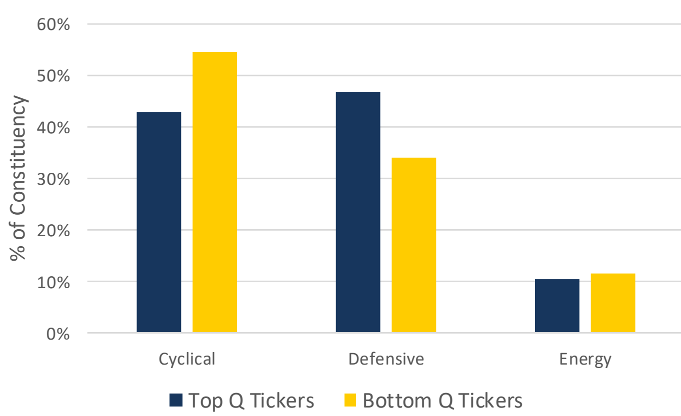
Source: SKY Harbor, ICE Data Indices

Sensitize by Size

Drilling down to the sector level, **we also find “Bottom Q Tickers” to be disproportionately more Cyclical in nature relative to larger capital structures**. In our *Weekly Briefing* entitled “Sometimes the Best Offense is a Good Defense,” we highlighted our expectation that aggregate index earnings will likely turn negative in 2023, and as such find greater comfort in Defensive sector exposure given more muted EBITDA growth betas over time. Furthermore, the potential for more significant earnings deceleration among “Bottom Q Tickers” (greater Cyclical and less Defensive sector exposure) could be met with higher interest expense, particularly given **a more pronounced differential between in-place coupons maturing over the next 36 months and bond-specific prevailing market yields relative to the large cap constituency**. Again, these findings appear at odds with recent small cap outperformance in the high yield market.

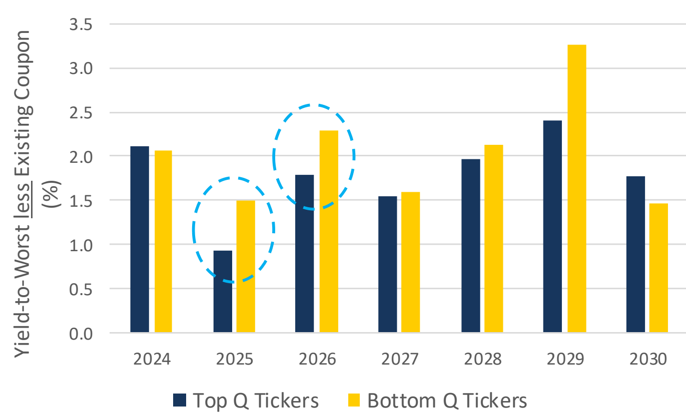
Small Cap Structures Have More Cyclical Exposure...

data as of April 19, 2023



...And Greater Near-Term Risk to Interest Coverage Metrics

data as of April 19, 2023



Source: SKY Harbor, ICE Data Indices

By and Large the Same View

To be clear, maturity runways remain very manageable in the high yield space, a function of record-setting issuance from 2020 to 2021 that allowed management teams to extend their obligations while lowering funding costs. There is also very little CCC-rated debt in our index at present (~ 12% by face value, vs. a trailing 20-year average of over 17%), exemplifying the meaningful improvement in overall credit quality since the Global Financial Crisis. However, small vs. large capital structure performance in the high yield market has bucked some very significant equity market trends so far this year…and did so despite a less favorable technical backdrop and below-average illiquidity premiums. In our view, continuing to moderate small issue exposure makes sense in the current market environment, particularly if lending conditions continue to tighten.

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