SKY HARBOR
CAPITAL MANAGEMENT

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October 24, 2022

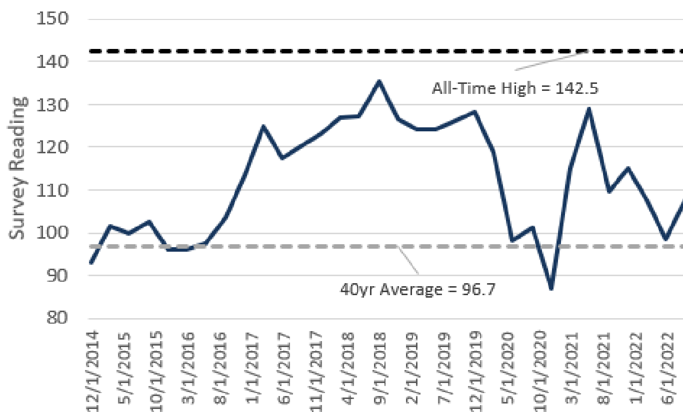
SKY Harbor Weekly Briefing

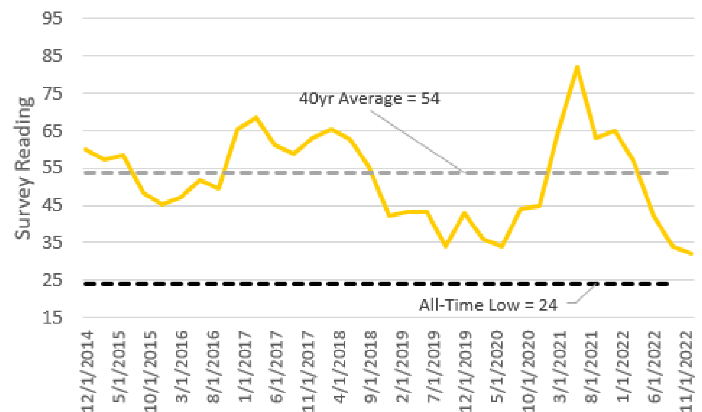
SKYView: Slumping Sentiment

An integral – though often difficult to gauge – element of our research process is the tracking of sentiment, particularly as a qualitative tool that provides context to our quantitative measures of corporate fundamentals, asset valuations, and market technicals. Sentiment, by virtue of the often self-fulfilling nature of consumer and investor behavior, can also provide valuable insights into future trends, of particular consequence when on the verge of capitulation. Given the relative importance of sentiment measures in forming our outlook, and due to the often conflicting (as they are now) viewpoints of consumers and business leaders, we focus this *Weekly Briefing* on measures of confidence that are likely to impact risk-taking in the near term.

Who Is Right?

The Conference Board Consumer Confidence Survey is a monthly report that captures consumer attitudes toward prevailing business conditions and expectations for the months ahead. The index reading, which **increased in September for the second consecutive month, now stands at 108.0, well above recent COVID-era lows and the 40-year trailing average**. At the same time, the Conference Board Measure of CEO Confidence – a gauge of busines leader views of current and expected business conditions – declined to 32 at the start of Q4'22, **a low point not seen since the worst of the Global Financial Crisis** (GFC) in late 2008. So, which measure is right? Perhaps both.

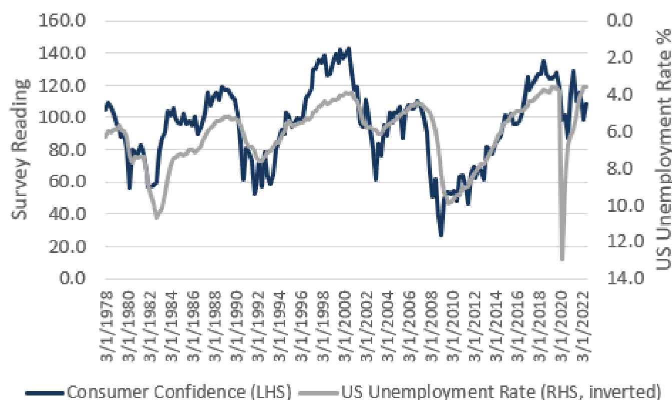


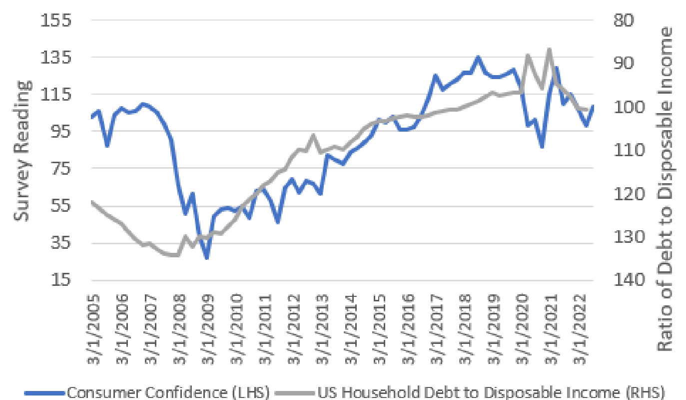


Source: SKY Harbor, The Conference Board

Consumer Confidence Resilient Thus Far

Historically, US consumer confidence has been driven by the unemployment rate and relative levels of household income, both of which continue to trend positively. The Fed's desire to lift unemployment toward its more natural rate notwithstanding, **the labor market has shown limited signs of cooling, and average hourly earnings have continued to grow ~ 5% above prior year levels in every month this year**. And, though inflation has somewhat increased the ratio of debt to disposable income among US households, relative levels of stress are still trending well below the post-GFC average. In our view, the confluence of these factors (low unemployment and wage growth) has boosted consumer confidence levels despite a number of risk factors on the horizon, though we suspect some adjustment to spending habits will materialize in the coming months.



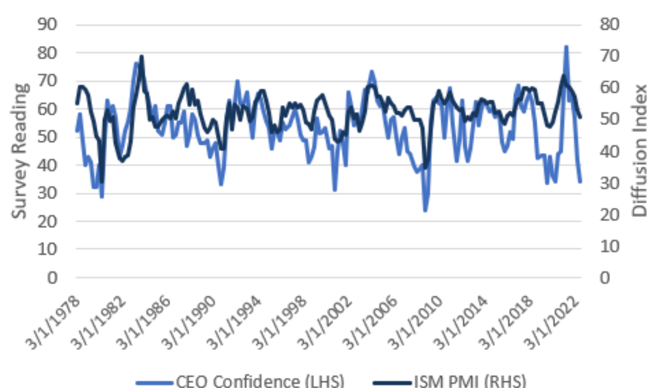


Source: SKY Harbor, The Conference Board, Bloomberg

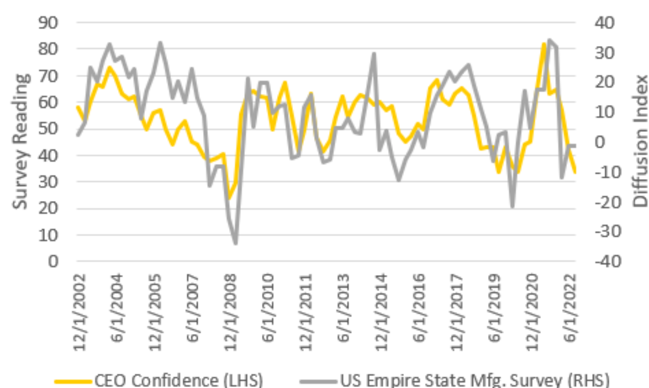
CEOs See Recession as Nearly Inevitable

CEO confidence, on the other hand, typically takes cues from different measures of economic health. **A contraction in manufacturing activity over the last several months – partially in response to the European energy crisis and a slowdown in China, both of which have constrained new export orders – has dampened sentiment**. In fact, according to the most recent survey results,[1] 98% of respondents expect a US recession in the next 12-18 months, albeit one that is both shallow and short-lived. Slightly more (99%) anticipate a recession in the EU over the same timeframe, with nearly 70% of respondents expecting such a contraction to be "deep," with potential for "global spillover."

CEO Confidence Positively Correlated to Business Conditions…
quarterly data, since 1978



…and Manufacturing Trends / Growth Capex
quarterly data, since 2002



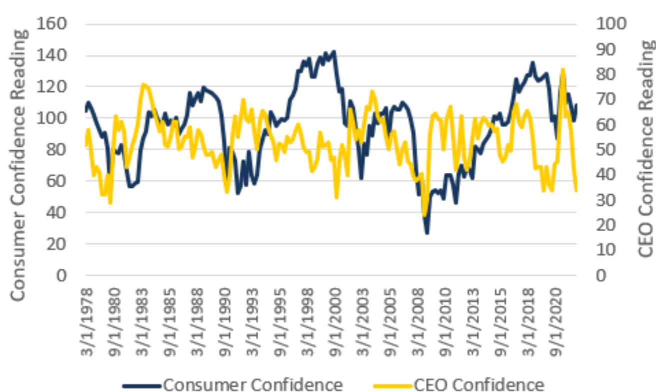
Source: SKY Harbor, The Conference Board, Institute for Supply Management, Federal Reserve Bank of New York

Periods of Acute Divergence Have Historically Ended Badly

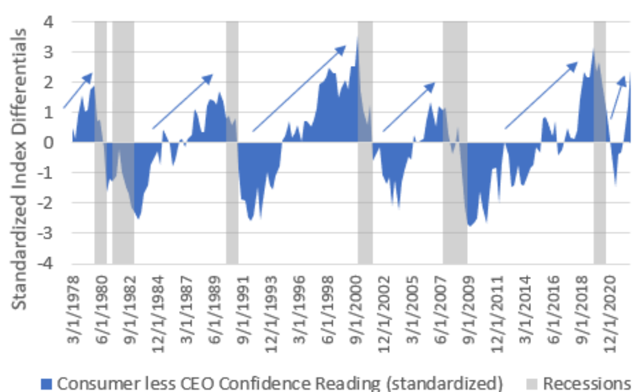
What could boost CEO sentiment in the coming months? In our view, it would likely take both material improvement on the inflation front (setting the stage for a Fed pivot) and a cease fire in Ukraine (removing the threat of a nuclear attack and resolving energy concerns in Europe). In such a scenario, we would envision a rise in CEO confidence readings, closing the gap with consumers and supporting economic growth via increased business expenditures and a reluctance to cut respective workforces. We acknowledge, however, that a lot has to go right in order for this scenario to materialize, and as such it remains more optimistic than our base case view. If, however, CEO confidence remains depressed (due to an absence of progress on inflation and geopolitics, or should China invade Taiwan), expectations of economic contraction could become a self-fulfilling prophecy. Under this scenario, business leader pessimism in the economy further constrains business investment, jobs are cut, and consumer confidence falls toward CEO confidence levels given tight correlations to the unemployment rate.

History, it appears, is on the side of the latter. As demonstrated below, **periods of acute divergence between consumer and CEO confidence typically lead to recession, although the timing can differ broadly**. Index reading differentials (consumer less CEO confidence, standardized to account for differences in methodology) presented below imply that CEO readings are typically leading indicators, with a recession (grey bar) often the consequence of consumer-led upward divergence. There are, however, instances of false positives in the past, and periods of divergence can last for many years. Nevertheless, and despite a non-zero chance of a soft landing that prevents economic contraction, we have on the margin adopted a more conservative bias with regard to portfolio positioning under the assumption that sentiment remains depressed in the near term.

Consumer and CEO Confidence Readings Can Diverge…
quarterly data, since 1978



…Though Divergence Typically Precedes a Recession
quarterly data, since 1978



Source: SKY Harbor, The Conference Board, The National Bureau of Economic Research

It's All Relative

The potential for a slowdown over the next 12-18 months is not a novel idea, with the Federal Reserve, International Monetary Fund, World Bank, and other institutions all recently downgrading economic growth expectations in 2023. Furthermore, markets are very forward-looking, with **significant pain having already been incorporated into asset prices**. Nevertheless, we continue to test our views as the economic backdrops evolves. As such, and as noted in our *Weekly Briefing* entitled "Valuation in Uncertain Times," **we continue to believe an up-in-quality bias makes sense here**,

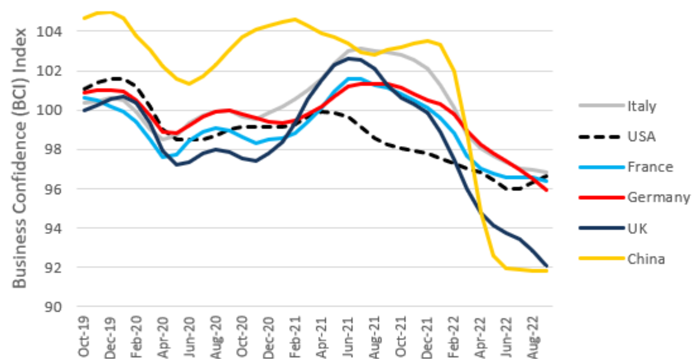
[1] https://www.conference-board.org/topics/CEO-Confidence

particularly as our spread ratio analysis in periods of economic contraction imply that BBs can continue to outperform on an excess return basis. At the same time, our view of sectors poised to demonstrate greater resilience in a negative EBITDA growth environment, as highlighted in our recent piece entitled "Downturn Sensitivity," **leave us biased toward the more defensive business models in the high yield market**, including those in the healthcare, telecom, packaging, and food / beverage spaces. With regard to geography, the exercise becomes one of relative risk.

As demonstrated below, data from the Organisation for Economic Co-operation and Development (OECD) shows that consumer confidence has proven relatively resilient in the US, Italy, France, and Germany, while the **UK and China continue to experience a more significant downgrading of sentiment**. At the same time, the Composite Leading Indicator (CLI) measure points to building risk factors consistent with slowing growth in most major economies, though a seemingly better outlook exists for the US relative to the UK and continental Europe. Based on this, and in conjunction with management team commentary and fears of energy-related production disruptions in Europe, **we continue to favor high yield issuers with above-average exposure to US sources of demand**.

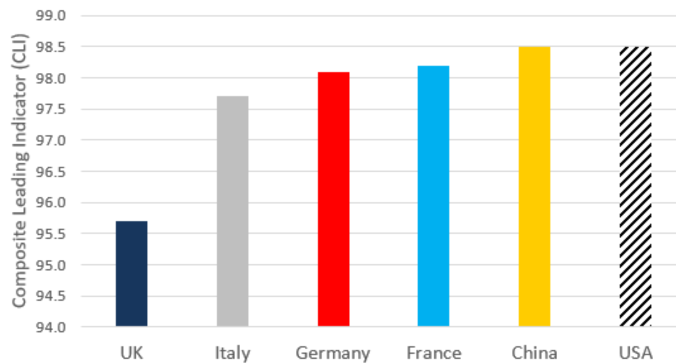
US Consumers More Confident Than Most Given Economic Backdrop

monthly data, trailing 5 years



Composite Leading Indicator (CLI) Readings Suggests Less Eco Risk in US

data as of September '22



Source: SKY Harbor, OECD.org

In conclusion, consumer and CEO confidence level divergence is neither rare nor unfounded, the former driven by employment and relative household income levels (unambiguously strong), the latter by manufacturing data and business investment (decidedly weakening). Unfortunately, CEO confidence readings have historically proven to be the more forward-looking measure, and market returns this year have echoed similar sentiment. Though a soft landing and easing of geopolitical tensions remain possibilities, the consensus view is coalescing around a modest recession in 2023. With that in mind, we maintain a preference for issuers with higher than average exposure to US-centric sources of demand, as we continue to believe a domestic contraction should be less severe than what may come for most other geographies.

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