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April 25, 2022

SKY HARBOR
CAPITAL MANAGEMENT

SKY Harbor Weekly Briefing

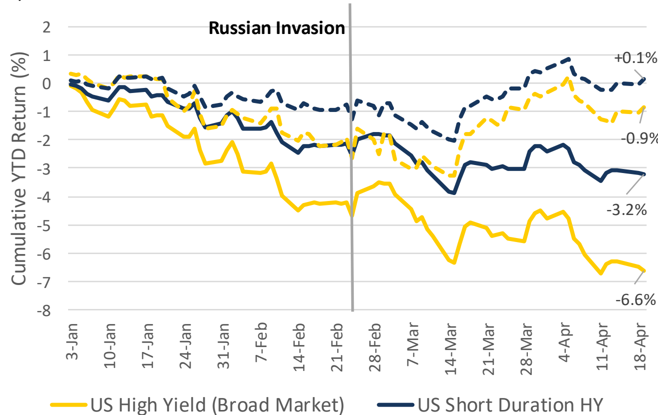
SKYView: A Losing Streak

Investors continue to express a relatively subdued appetite for risk, with the continuation of geopolitical tensions and hotter-than-anticipated measures of inflation the most recent drivers of negative fixed income returns. While a sustained inflection toward spread compression remains thus far elusive, there are indications that the worst of several key market headwinds may finally be behind us. In this *Weekly Briefing*, we evaluate the sluggish start to 2022 in the context of historical returns, and gauge the degree to which expectations for inflation and rising rates have already been priced into market trading levels.

As we noted in our most recent *Weekly Briefing* entitled "A Look Back at Q1'22," the end to a volatile Q1'22 finally arrived, with the ICE BofA US High Yield Index (ticker H0A0, our proxy for US high yield risk) suffering its first negative return quarter since the lockdown-stricken start to 2020. **Markets have failed to reverse course thus far in April, putting the index at risk of achieving the dubious distinction of four consecutive negative total return months, something observed only once before in our dataset that goes back to January 2000, and never for a longer period of time**. Encouragingly, though all such negative streaks occurred for different reasons and in varying market environments (both within and outside of recessions), subsequent three and six-month returns have tended to be both positive and above all-period mean levels. To be clear, we don't highlight this trend in an effort to suggest that negative sentiment simply runs out of steam. Rather, we seek to highlight that high yield markets tend to quickly incorporate changing risk factors on the horizon (often over-compensating for such risks), with a proactive selloff re-setting bond yields. The resulting higher levels of current income – the primary driver of index returns over the long run – eventually offer investors attractive carry as volatility begins to subside, with opportunity for spread compression should initial market reactions prove overly punitive in hindsight.

Year-to-Date Total Returns Have Underwhelmed

daily data; solid lines = total returns, dotted lines = excess returns



Rare to See 3 Consecutive Negative Return Months

monthly data

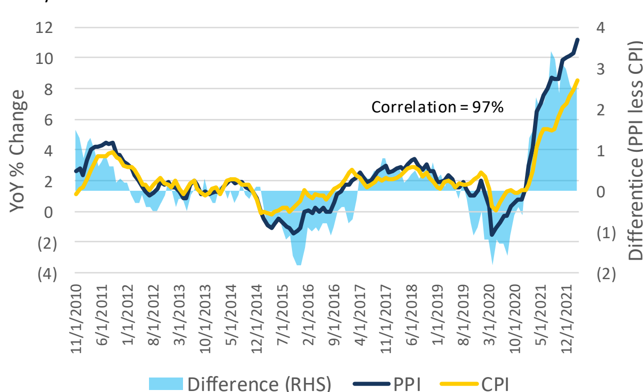
Period	Consec. Neg. Months	Recession ?	Next 3mo Total Return	Next 6mo Total Return
Sep '00 to Nov '00	3	N	10.4%	8.6%
May '02 to Jul '02	3	N	0.5%	11.1%
Jan '08 to Mar '08	3	Y	1.8%	-7.8%
Sep '08 to Nov '08	3	Y	9.3%	34.8%
Jun '15 to Dec '15	4	N	-2.2%	1.0%
Nov '15 to Jan '16	3	N	9.1%	13.9%
Oct '18 to Dec '18	3	N	7.4%	10.2%
Jan '22 to Apr '22	?	N	?	?
Set Mean			5.2%	10.2%
All Period Mean			1.8%	3.6%
Set Median			7.4%	10.2%
All Period Median			2.2%	3.3%
% Positive			86%	86%
All Period % Pos			73%	75%

Source: SKY Harbor, ICE Data Indices; data as of April 20, 2022

There are, unfortunately, several recent economic datapoint surprises that have generated investor unease. Foremost among them may be producer prices, with headline PPI reaching 11.2% y/y growth in April, a record-setting level. As demonstrated below, PPI – the more forward-looking metric in our chart – has outpaced CPI, **implying the continuation of inflationary pressures, as well as heightened risk to corporate margins should the ability to pass along higher costs begin to erode**. While corporate gross margins have actually improved over the last several quarters despite a rapid rise in inflation – in no small part due to healthy consumer demand bolstered by recent wage increases – this dynamic may not persist indefinitely. Ultimately, we believe more insulated corporates with truly exceptional pricing power will begin to emerge from the field of price-takers, the latter of which appeared more resilient than was justified purely due to re-opening momentum and pent-up demand.

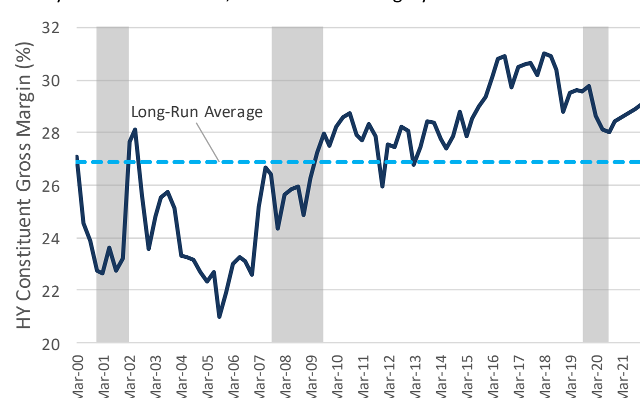
Producer Price Index vs. Consumer Price Index

monthly data



Further Inflation Puts Margins At Risk; Strong Resilience Thus Far

quarterly data since Jan 2000; recessions shaded grey



Source: SKY Harbor, Bloomberg, Bureau of Labor Statistics, BofA Merrill Lynch, Capital IQ

With inflation weighing most heavily on sentiment, we analyzed consensus EPS forecast changes among S&P 1500 constituents (strong read-through for high yield issuers) over the last two months (a period that contains both the start of war in Ukraine, as well as the uptick in PPI during the survey timeframe). Eliminating sub-industry groups with less than five observations**, we find a general reduction in EPS forecasts (-3% to -4% for the index), but significant dispersion among GICS classifications**. More specifically, sell-side analysts have become increasingly concerned with the earnings outlook for labor-intensive (specialty retail) and supply-chain-disrupted (auto components, technology hardware & storage) corporates, as well as those with limited ability to rapidly change pricing either due to contracts (healthcare providers) or competition (hotels & restaurants). On the other side, commodity producers (paper & forest products, metals & mining) and industries that cater to pent-up demand (airlines) appear poised to perform better. We continue to use these indicators to inform positioning as we head into Q1'22 reporting season, and anticipate management commentary will continue to provide valuable insights into earnings volatility in the second half of the year.

S&P 1500 Consensus EPS Revisions, Trailing 2 Month Change

data as of April 20, 2022

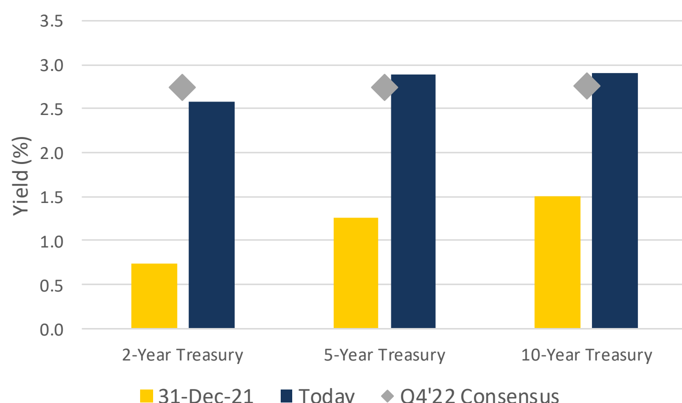
Most Significant Downward Adjustments to EPS		Most Significant Upward Adjustments to EPS	
GICS Industry	**Trailing 2mo EPS Est. Change (%)**	**GICS Industry**	**Trailing 2mo EPS Est. Change (%)**
Diversified Consumer Services	(19.9)	Real Estate Management & Dev.	21.3
Auto Components	(17.1)	Paper & Forest Products	15.1
Biotechnology	(16.5)	Multiline Retail	12.6
Mortgage Real Estate Investment	(10.7)	Oil, Gas & Consumable Fuels	11.0
Hotels, Restaurants & Leisure	(10.5)	Airlines	10.1
Technology Hardware, Storage	(10.2)	Trading Companies & Distributors	9.3
Specialty Retail	(10.0)	Metals & Mining	7.4
Health Care Equipment & Supp.	(8.7)	Personal Products	5.2
Health Care Providers & Svcs	(8.4)	Containers & Packaging	4.1
Beverages	(8.4)	Electric Utilities	2.3

Source: SKY Harbor, Bloomberg

Though persistent inflation represents a risk factor for high yield constituents – mainly via downside risk to earnings should no relief materialize – **a key positive is elevated post-selloff yields, particularly as the bulk of key market headwinds may now be behind us**. Most notably, and as highlighted in our *Weekly Briefing* entitled "A Look Back at Q1'22," our statistical analysis found that the underlying move in Treasury rates was the factor most damaging to high yield returns in the first quarter of the year. At the time of writing, Treasury yields (2, 5, and 10-Year) were up between 140 bps and 190 bps on a year-to-date basis, one of the most aggressive moves we have ever seen. At the same time, the market has priced in nearly ten more 25 bps rate hikes between now and the end of 2022. As such, and despite our view that rates will continue to rise in the coming quarters, **we estimate that 80% to 90% of the Treasury selloff likely to occur for all of 2022 has already taken place, potentially alleviating what had been the most significant headwind to total returns in the second half of this year**. At the same time, fears of a yield curve inversion have already led to an uptick in recession risk, with a survey of Bloomberg economists now placing the odds of a US contraction occurring over the next twelve months at 25%. Historical data for this probability forecast (goes back to 2008) has never gone below 10%, and has typically been capped at 35% in all periods except ones in which a recession is actually occurring. With this in mind, the incorporation of a 25% chance of a recession into market expectations is significant, perhaps implying that much of the pain is now behind us.

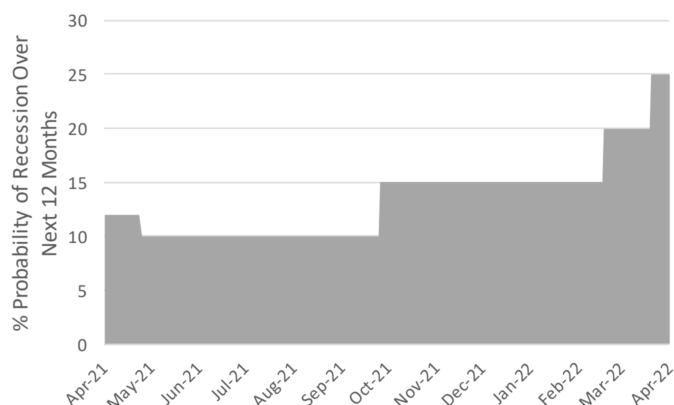
The Bulk of Rate Pressure May Be Behind Us

Treasury yields, Apr. 19, 2021 vs. Dec. 31, 2021



Some Recession Risk Already Priced In

daily data, trailing one year



Source: SKY Harbor, ICE Data Indices, Bloomberg

Fixed income returns remain challenged, with hotter than expected readings of inflation most recently pressuring secondary market trading levels. Partially offsetting this dynamic is a much-improved index current yield, which follows a nearly unprecedented string of negative total return months. Though interest rate and recession risks remain, these factors – in our view – have largely been priced into corporate bond yields, potentially diminishing market headwinds in the coming quarters as the overall risk/reward ratio rises.

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