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SKY Harbor Weekly Briefing

SKYView: Unknown Unknowns (continued)

In light of recent market volatility stemming from the 2nd largest bank failure in US history, we thought it appropriate to distribute a running commentary to investors, summing up what we know, what we don't know, and how markets have reacted since the onset of bank stress caused volatility across the market. For simplicity, we have thus far presented these updates in Q&A format. In this *Weekly Briefing*, we close out this running commentary to include an update from the March FOMC meeting, as well as other recent developments. Note that new content is in black, prior content is in grey.

What Was the Outcome of the March FOMC Meeting?

The March FOMC meeting brought about another hike (9th in a row, and 25 bps in magnitude), which was **very much in-line with revised expectations since the SVB failure** compelled investors to re-think their rate market outlooks. In his post-meeting press conference[1], Chairman Powell stressed that **the labor market remains "very tight,"** with a pick-up in job gains over the last few months coinciding with an uptick in the labor force participation rate. Additionally, the Fed noted that **inflation remains "too high,"** well above their unchanged longer-run goal of 2%, and that economic indicators have come in "stronger than expected" since the last meeting date.

Did Chairman Powell Seem Concerned About the Banking System?

Chairman Powell's prepared remarks began with a recap of recent actions taken to stabilize the banking sector, and highlighted that **"our banking system is sound and resilient, with strong capital and liquidity."** With that said, he did acknowledge that recent events were likely to "result in tighter credit conditions for households and businesses, which would in turn affect economic outcomes." This then led to perhaps the most scrutinized statement of the press conference – that the Fed now anticipates **"some additional policy firming"** may be needed, which took the place of "ongoing rate increase" language. In our view, this was a downgrading of rate hike expectations, the thought being that credit restriction stemming from the banking crisis would further the Fed's cause outside of direct policy action.

Were There Any Notable Changes to the Fed's Summary of Economic Projections?

The Committee generally anticipates that economic growth will be muted in 2023, with the housing market remaining weak (by virtue of higher mortgage rates) and business fixed investment subdued as a result of output uncertainty. Furthermore, **the Committee lowered their GDP growth outlook to +0.4% in '23 and +1.2% in '24, down from +0.5% and +1.6%, respectively, at the December FOMC meeting**. Though the expectation for 2024 is broadly in-line with consensus expectations ahead of the meeting, economists had been expecting somewhat stronger '23 GDP growth in the +0.9% context. Finally, nearly all participants see risks to GDP growth "weighted to the downside."

Percent

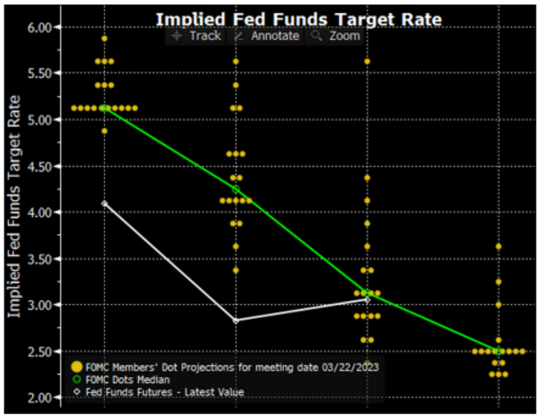
Variable	Median[1]				Central Tendency[2]				Range[3]			
	2023	2024	2025	Longer run	2023	2024	2025	Longer run	2023	2024	2025	Longer run
Change in real GDP	0.4	1.2	1.9	1.8	0.0–0.8	1.0–1.5	1.7–2.1	1.7–2.0	-0.2–1.3	0.3–2.0	1.5–2.2	1.6–2.5
December projection	0.5	1.6	1.8	1.8	0.4–1.0	1.3–2.0	1.6–2.0	1.7–2.0	-0.5–1.0	0.5–2.4	1.4–2.3	1.6–2.5
Unemployment rate	4.5	4.6	4.6	4.0	4.0–4.7	4.3–4.9	4.3–4.8	3.8–4.3	3.9–4.8	4.0–5.2	3.8–4.9	3.5–4.7
December projection	4.6	4.6	4.5	4.0	4.4–4.7	4.3–4.8	4.0–4.7	3.8–4.3	4.0–5.3	4.0–5.0	3.8–4.8	3.5–4.8
PCE inflation	3.3	2.5	2.1	2.0	3.0–3.8	2.2–2.8	2.0–2.2	2.0	2.8–4.1	2.0–3.5	2.0–3.0	2.0
December projection	3.1	2.5	2.1	2.0	2.9–3.5	2.3–2.7	2.0–2.2	2.0	2.6–4.1	2.2–3.5	2.0–3.0	2.0
Core PCE inflation[4]	3.6	2.6	2.1		3.5–3.9	2.3–2.8	2.0–2.2		3.5–4.1	2.1–3.1	2.0–3.0	
December projection	3.5	2.5	2.1		3.2–3.7	2.3–2.7	2.0–2.2		3.0–3.8	2.2–3.0	2.0–3.0	
Memo: Projected appropriate policy path												
Federal funds rate	5.1	4.3	3.1	2.5	5.1–5.6	3.9–5.1	2.9–3.9	2.4–2.6	4.9–5.9	3.4–5.6	2.4–5.6	2.3–3.6
December projection	5.1	4.1	3.1	2.5	5.1–5.4	3.9–4.9	2.6–3.9	2.3–2.5	4.9–5.6	3.1–5.6	2.4–5.6	2.3–3.3

Source: Federal Reserve

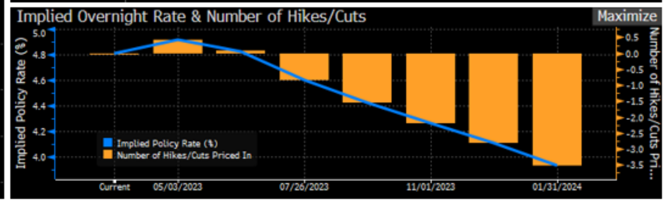
Any Change to the Dot Plot?

The median dot now shows a terminal rate of 5.125% in 2023, unchanged from the prior iteration in December. However, **the median rate in 2024 has increased modestly to 4.25%, up from 4.125%.** We highlight that the adjustment was modest in nature, and is perhaps due to Governor Brainard dropping from the survey as she transitions to Director of the National Economic Council (there is no clarity on dot placement by member, but it was thought that she was on the more dovish side). At the time of writing (Thursday, March 23), Fed Funds Futures imply an approximately 40% chance of a 25 bps hike at the next FOMC meeting (May 3), with cuts to follow (~ three 25 bps cuts, with one potentially coming as early as June).

[1] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf



Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate
05/03/2023	+0.421	+42.1%	+0.105	4.918
06/14/2023	+0.067	-35.4%	+0.017	4.829
07/26/2023	-0.840	-90.7%	-0.210	4.602
09/20/2023	-1.550	-71.0%	-0.387	4.425
11/01/2023	-2.192	-64.2%	-0.548	4.265
12/13/2023	-2.807	-61.5%	-0.702	4.111
01/31/2024	-3.520	-71.3%	-0.880	3.932



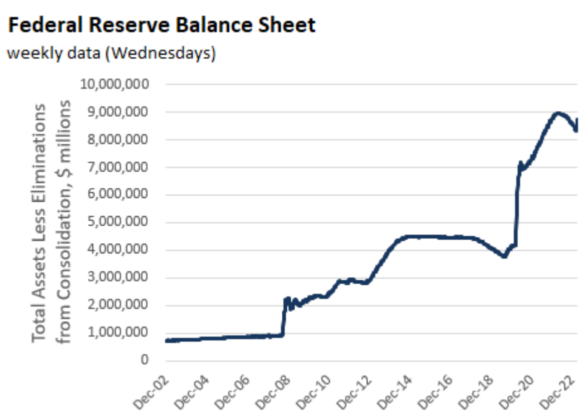
Source: Bloomberg

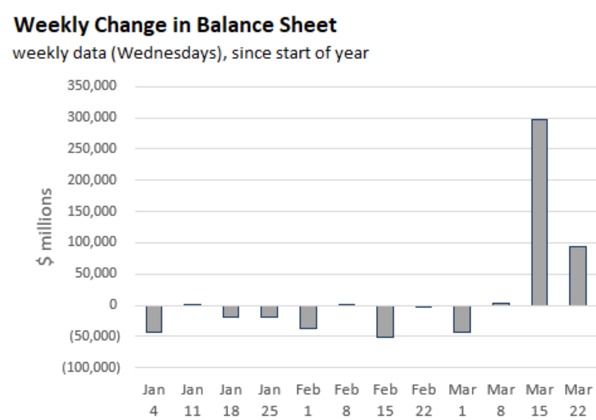
So, Why Did Markets Sell Off After Powell's Press Conference?

Despite assurances that the banking sector was "sound and resilient" and signaling Fed hiking is close to being done (perhaps there already), **equities sold off in the final hour of trading on Wednesday, March 22**. In a somewhat unusual situation, Fed Chairman Powell was conducting his post-FOMC press conference at the same time as Treasury Secretary Janet Yellen was testifying before the Senate Appropriations Subcommittee, making it somewhat difficult to isolate exactly what dampened sentiment. Several news outlets, however, speculated that **Yellen's refusal to commit to providing "blanket insurance" to banking deposits sparked the selloff**. A closer analysis of her comments, however, reveal her having said that she has "not considered or discussed anything having to do with blanket insurance or guarantees of all deposits" as it relates to Treasury circumventing Congress. As such, her statement may be far more benign than market participants initially assumed. As of Thursday, March 23, Yellen further clarified her prior commentary by stating "Certainly, we would be prepared to take additional actions if warranted."

Is Fed Balance Sheet Growth Worrisome?

The Federal Reserve released balance sheet data on March 22, which showed an acceleration of borrowing since the banking crisis began. Though much has been made of the ~ $400bn draw, we would highlight that **the vast majority occurred at the onset of the crisis, with additional borrowings tapering off this past week**. Furthermore, discount window borrowing plus draws on the Bank Term Funding Program net to approximately zero this past week, implying that regional bank worries may have somewhat moderated. According to Jefferies strategist David Zervos, "the funding pain appears to be contained."

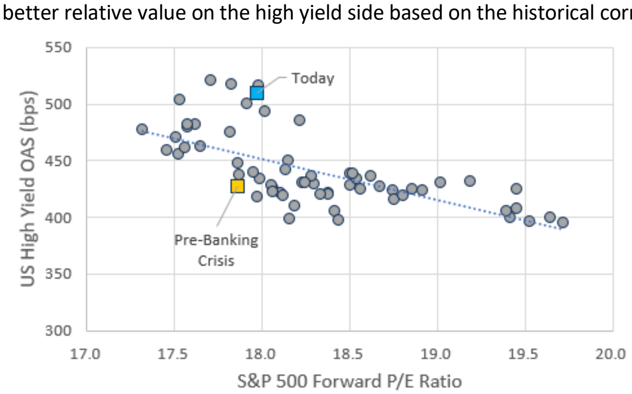




Source: SKY Harbor, St. Louis Fed

How Did High Yield Markets Perform Over This Period?

Since the start of the banking crisis (let's call it Friday, March 10), **ICE BofA US High Yield index spreads have widened out 83 bps, reaching 510 at the end of the trading day on Thursday, March 23**. Rates have rallied, however, essentially offsetting the pressure (5-Year Treasury yields declined 81 bps over the same timeframe) and leading to flat total returns for the period. Equities have fared better, with the S&P 500 Index returning +0.9%, and leading to (in our view) better relative value on the high yield side based on the historical correlation between index spreads and forward-looking equity market P/E ratios.



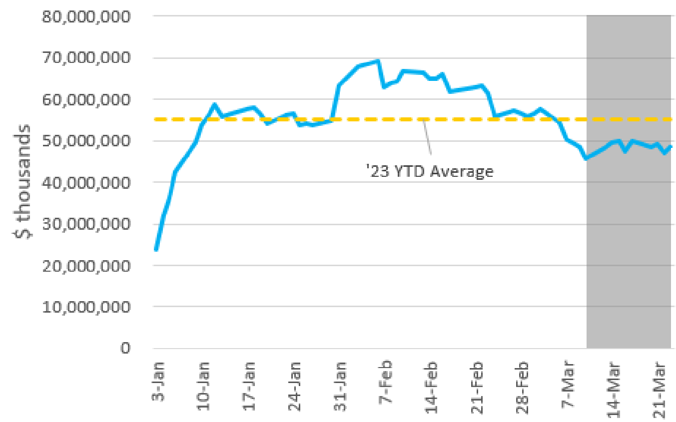
Source: SKY Harbor, Bloomberg, ICE Data Indices

Within the index, and on a month-to-date basis, **higher-quality has outperformed lower-quality** (likely on fears of a slowdown in economic output stemming from tighter lending standards), and mid-sized bonds have outperformed both small and large issues (likely on concerns over capital market support and ETF flows). By sector, **Banking and Media have been laggards, while Tech, Basics, and Consumer Goods have outperformed**. On balance, the S&P 500 index has benefitted from a much higher concentration of tech-related constituents (~ 28%, including outperformers like Meta, Apple, and Microsoft) relative to high yield (~3%), partially offset by greater exposure to Banking and Financial Services.

Another nuance to highlight is divergence in trading volumes. As demonstrated below, high yield activity slowed down to below-average levels in the two weeks since the start of the banking crisis, likely driven by limited (zero) new issuance and investor conferences. Equities, however, saw an uptick in trading volumes over the same period.

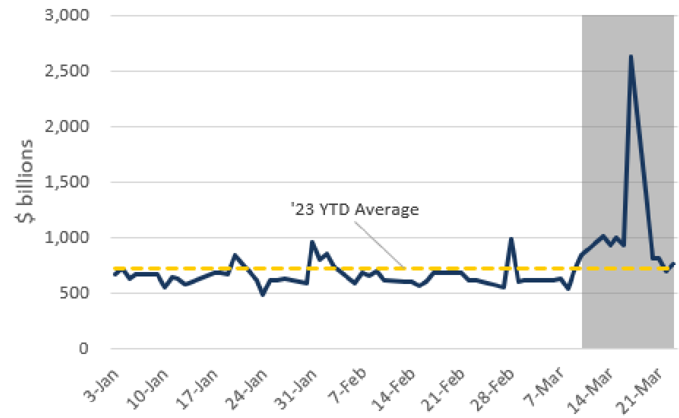
High Yield Estimated Trailing 5 Day Volumes Decreased

daily data, banking crisis period shaded grey



S&P 500 Daily Volume Increased

daily data, banking crisis period shaded grey



Source: Bloomberg

Q&A from Monday, March 20

UBS Acquires Credit Suisse

Over the weekend (March 19th) **UBS announced the acquisition of Credit Suisse**, with FINMA, the Swiss National Bank, the Swiss Federal Dept. of Finance, and other regulators providing guidance via a pre-agreement arrangement. The deal is valued at CHF 3 billion, with shareholders receiving one share of UBS for each 22.48 shares of Credit Suisse (equates to ~ CHF 0.76 per share, vs. ~ CHF 2.90 at the start of 2023 and ~ CHF 8.60 at the start of 2022). UBS will be responsible for the first CHF 5 billion in losses, after which CHF 9 billion in protection will be extended from Swiss authorities. Nearly CHF 16 billion in Credit Suisse AT1s will be written down to zero as part of the deal (more on this to come).

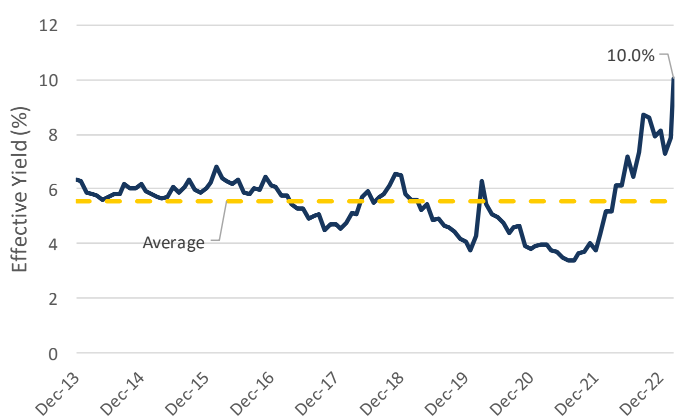
What Implications Stem from Wiping Out AT1s?

As the most junior part of the capital structure, ~ CHF 16 billion of Credit Suisse AT1s will be written down to zero, constituting the largest loss for AT1 investors since the beginning of the asset class, which followed the Global Financial Crisis. The potential for lawsuits that may increase uncertainty in the near-term aside (some will argue AT1s should not be subordinated to equity), we note that **over the longer-run, AT1 funding costs may rise, representing earnings downside to issuers**. In response, banks may choose to limit growth via the **tightening of lending standards, which could then put pressure on economic output**. We highlight that SKY Harbor does not directly own any AT1 securities. Additionally, though they are no longer contained within the ICE BofA US High Yield Index, our understanding is that such securities remain held by high yield managers.

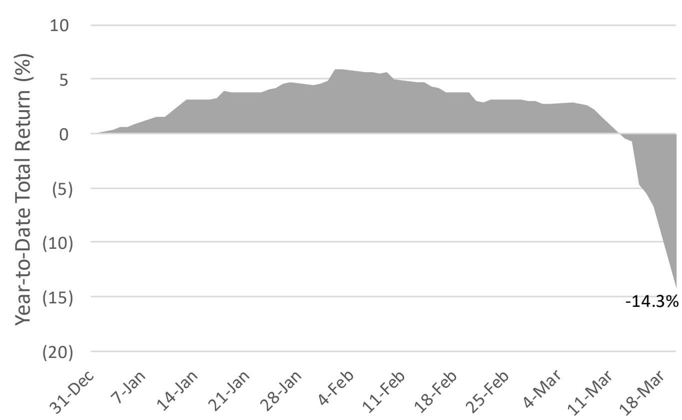
Note that market color before the start of the trading day (early on Monday morning, March 20th) had AT1s down 7-15 points, with yields in the 6.75% to 9.75% range. Yields ended the day at 10.0%, with the index now down over 14% YTD.

ICE BofA Contingent Capital Index (COCO) - Yields Rising, Weak YTD Total Returns

monthly data



daily data



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

What Is Left to Break?

FDIC Chairman Martin Gruenberg, speaking at the Institute of International Bankers (March 6, 2023), noted that "The current interest rate environment has had dramatic effects on the profitability and risk profile of banks' funding and investment strategies," resulting in unrealized losses on securities. He further noted that these **unrealized losses amounted to approximately $620 billion as of year-end 2022**[2]. Given these yet-to-be-realized losses, and as evidenced by continued market volatility despite government intervention (and First Republic receiving $30 billion in interbank deposits), we do not yet feel confident that all turmoil is behind us. Furthermore, even if unrealized losses remain manageable (i.e. they are not concentrated), economists are estimating **a tightening of lending standards as a direct result of bank stress might reduce GDP growth by 25 – 50 bps in 2023**. As such, we continue to employ a more defensive stance within our portfolios, with a focus on issuers that have historically possessed a lower EBITDA growth beta relative to the index.

Another pertinent datapoint came last week with news that borrowings via the Fed discount window grew to over $150 billion, surpassing the previous record of ~ $110 billion during the GFC. Banks also took an additional $12 billion in loans through the new Bank Term Funding Program. Again, all of this gives rise to risks associated with a pullback in lending.

What Does the Fed Do?

The March FOMC meeting is set for Wednesday, March 22nd, and significant uncertainty is building ahead of Chairman Powell's post-meeting press conference. At present, Fed Funds Futures are pricing in a 70% chance of a 25 bps rate hike this week, with terminal rates peaking at 4.9% in May, and 100 bps of cuts predicted for the balance of the year. According to a recently published article by *The Wall Street Journal's* Nick Timiraos, **"The decision over whether to raise interest rates by a quarter-percentage point is likely to hinge in part on how markets digest the forced marriage Sunday of two Swiss banking giants, UBS and Credit Suisse, and other steps to calm fears of contagion in the banking system."** The article goes on to mention that economists at Goldman Sachs believe tightening lending standards stemming from recent bank stress are already equivalent to a 25 – 50 bps hike, perhaps giving the Fed cover to pause for the time being.

What Has Been the Reaction in High Yield Spreads?

Through Monday, March 20, US high yield spreads (using the ICE BofA US High Yield Index as our proxy) hit 515 bps, wider by 118 bps relative to a recent tight of 397 bps (March 6, 2023). **Though index spreads are quickly approaching our previously published 530 bps fair value target, we note that significantly more uncertainty has been added to the overall market outlook, and as such we believe valuations may need to overshoot in the near / intermediate term**. As such, we continue to believe our more defensive bias has merit given the market environment, with a focus on remaining flexible as the situation evolves. Furthermore, we remind investors that our focus on sustainability has led to an underweight within the Energy sector, and that positioning proved disadvantageous in 2022 when Energy was (by far) the best performing sector in high yield. On a month-to-date basis, crude oil and natural gas prices have fallen 12% and 18%, respectively, largely a function of global growth concerns arising from banking stress. As such, Energy sector allocation has proven beneficial thus far in March.

How is SKY Harbor Positioned?

Our Funds and client portfolios have no direct holdings of the securities of SVB, Silvergate, Signature Bank, First Republic, UBS, or Credit Suisse. Additionally, we do not hold any AT1 securities (UBS, Credit Suisse, or any others). Additionally, **SKY Harbor portfolios have no exposure to the Banking sector, despite a weight of 0.8%, 1.0%, and 5.2% in broad high yield (H0A0), short duration high yield (JVC4), and global high yield (HW00) ICE Indices, respectively**. We are assessing the impact on risk assets in general and continue to be mindful of our portfolio risk-taking. As such, we will have further updates to our market views over the next few days.

Q&A from Wednesday, March 15

Have We Seen Signs of Contagion?

In the second trading day following announcement of the Bank Term Funding Program (BTFP), regional banks appeared to have stabilized (at least for now). More specifically, the S&P Regional Bank ETF (KRE) was up 2%, only modestly offsetting 12% and 4% declines in the prior two trading days, but demonstrating some easing of concerns. Individual stocks in the crosshairs of investors over the last several days – such as First Republic and Keycorp – were up more meaningfully (+27% and +7%, respectively). **With the benefit of time to more fully digest information presented by these institutions, it has become increasingly clear that SVB and Signature had some meaningfully different characteristics that likely hastened a run, most notably with regard to the percentage of deposits beyond the traditional $250k FDIC insurance limit**. In the case of Signature Bank and SVB, an estimated 85% to 90% of deposits were uninsured by the FDIC, making them more vulnerable to client defections. First Republic (~ 68%), Keycorp (47%), and Fifth Third Bancorp (42%) remain relatively better insulated. All banks, in our view, stand to benefit from swift action by the Federal Reserve, US Treasury, and FDIC to stabilize market conditions.

Even If Near-Term Contagion Risk Is Low, Are There Intermediate Term Concerns?

Stress in the tech space has been building for months, the sector beset by layoffs even prior to the banking crisis (just today, Meta announced another 10,000 job cuts and the elimination of 5,000 open positions). Furthermore, SVB occupied a relatively unique position in the sector, having co-funded an estimated 50% of all venture capital-backed tech and life sciences companies in the US. As noted yesterday (see the section entitled "What are the Known Unknowns"), periods of uncertainty can lead to an unwillingness of management teams to deploy cash on capital expenditures. In addition, **fear of deposit flight, particularly as individuals and corporations further scrutinize where to park assets (particularly those over the insured limit), could limit credit availability from small / regional banks, who themselves are responsible for a disproportionate share of lending**. In our view, a disruption in access to credit, particularly for such high growth companies, could begin to weigh on economic output should the dislocation persist.

What is the Fed Likely to Do?

Generally speaking, February CPI (released Tuesday, March 14) was in-line with expectations, though the data excluding food and energy came in roughly 10 bps above consensus (on a MoM basis). In general, however, **the data was normally bounded relative to expectations, making a 25 bps hike next week most likely**. To that point, the terminal rate implied by Fed Funds Futures ratcheted up to 4.95% (+ 20bps relative to Monday the 13th), with the likelihood of a 25 bps hike at the March FOMC reaching 77%, up from 57% during the prior trading day. The natural concern, however, is how prudent it would be for the Fed to focus on monetary policy when financial stability is at risk.

[2] https://www.fdic.gov/news/speeches/2023/spmar0623.html#:~:text=The%20total%20of%20these%20unrealized,capital%20of%20the%20banking%20industry.

Perhaps the most relevant case study is action taken by the Bank of England amidst the September '22 selloff in gilts. During that timeframe, **the BoE was forced to implement an emergency asset purchase program and a term-repo liquidity facility to support pension funds facing margin calls**. These programs were put into place in the middle of a rate hiking campaign designed to moderate double-digit inflation. A research piece by Goldman Sachs (https://marquee.gs.com/content/research/en/reports/2023/03/14/ea683010-1c3a-4a0b-ba65-c50c037f4788.pdf?utm_medium=pa) finds that this successful separation of monetary policy from financial stability worked because the root of the problem was a liquidity crisis, not a solvency crisis. In contrast, issues facing the ECB in 2011 were not as successful, as efforts to reduce headline inflation with hikes in April and July of that year were at odds with widening sovereign credit spreads. As it relates to the current situation, the case to pause rate hikes or at least moderate their tempo seems justified given market fragility, particularly if officials hope to stem this banking sector liquidity crisis before more problematic solvency issues arise.

February PPI data also came out weaker than expected, supportive of the disinflation trend and likely to keep some pressure off the Fed. Retail sales softened but were essentially in-line with expectations.

How Did High Yield Markets React on Tuesday, March 14?

The high yield market showed relative resilience today, partially reversing extraordinarily weak performance on Monday. More specifically, index spreads compressed to 474 bps, tightening 29 bps from yesterday's close, partially driven by a selloff in Treasuries that led to 5-year yields climbing 14 bps. All told, total and excess returns on Tuesday, March 14 were +0.42% and +1.02%, respectively, recovering nicely from Monday (-0.36% and -1.51% in total and excess return, respectively). In fact, **performance was notable not only because excess returns were particularly robust (99th percentile based on daily data going back to January '00), but also because they moved counter to historical trends**. As noted in the section entitled "How Did High Yield Markets React on Monday, March 13?" similarly weak excess return observations of the past (bottom percentile days) were most often followed by additional pressure when trading next resumed (average excess return of -0.8%, with positive returns occurring only 23% of the time). Anecdotally, our head trader noted that ETF proliferation in recent years has made the shedding of risk a more quickly executed task, perhaps exacerbating market moves in times of volatility (whereas, for example, it may have taken several days to reduce positions during the global financial crisis). As such, divergence from the historical tendency of extraordinarily weak days to be followed by additional selling may become more commonplace.

Q&A from Monday, March 13

What Happened?

On March 12, the Federal Reserve, FDIC, and US Treasury issued a statement highlighting that all Silicon Valley Bank deposits would be backstopped – including amounts that exceeded $250k in size – and be available to depositors by Monday morning (March 13). At the same time, and representing further efforts to boost confidence in the financial system, the Fed announced a "Bank Term Funding Program," offering loans (up to one year) for banks under less onerous than normal conditions. Of note, **the Fed "relaxed" lending terms through the discount window, offering to value collateral at par** and paving the way for institutions to secure bigger loans despite holding out of the money investments.

How Did Rates React?

Treasury markets, as expected, adjusted rapidly to the news. **5-Year Treasuries rallied on Monday, with yields down 27 bps on the day (to ~ 3.68%).** At present, Fed Funds Futures imply a terminal rate of ~4.80%, down from ~5.5% last Thursday (the day prior to SVB news). Additionally, the likelihood of a 50 bps hike at the March FOMC was nearly 60% late last week. At present, the market is pricing in a 75% chance of a 25 bps hike at the next Fed meeting, with a growing minority highlighting the potential for a rate cut.

How Does this Impact the Fed?

While consensus appears to be coalescing around a 25 bps hike in March, we believe economic data due out tomorrow – CPI in particular – will be a critical component in the Fed's ultimate rate decision next week. At present, **investors are expecting CPI to come in at +0.4% and +6.0% on a MoM and YoY basis, respectively, with the potential for "noise" in the data arising from atypically cold winter weather in parts of the US**. In our view, and without making a specific prediction on inflationary trends in the near term, we think recent developments likely reduce the path of rates in the near term (consistent with the directionality of the initial market reaction), and think the Fed will respond with a slower rate hiking path (or even a pause) in order to ensure financial stability and to account for aforementioned long and variable lags associated with the work they have done over the last few quarters. We also note that economist and former Treasury Secretary Larry Summers, in a speaking event hosted by Citi, noted that a nearly 75 bps adjustment to the implied terminal rate seems overdone, at least in his view, unless CPI undershoots expectations and the disinflationary trend immediately reverts back to the December narrative (also not what he expects).

How Did High Yield Markets React on Monday, March 13?

US high yield markets posted an extraordinary day on Monday, with spreads widening 42 bps (the ICE BofA US High Yield Index now has an option-adjusted spread of 503 bps). That spread move was the 27th worst day since January 2000, and the weakest since the early days of the pandemic. **Stripping out the rather meaningful move in underlying treasuries, high yield excess returns were -1.5% on Monday, a bottom percentile observation using the same dataset (over 6,000 datapoints)**. Other days within that cohort tend to be clustered around the onset of the COVID-19 pandemic, the commodity crisis, and of course the Global Financial Crisis. Furthermore, excess returns on the next trading day for this subset tended to be negative (73% of the time), and on the order of -80 bps.

Worst US High Yield Excess Return Days

since January 2000

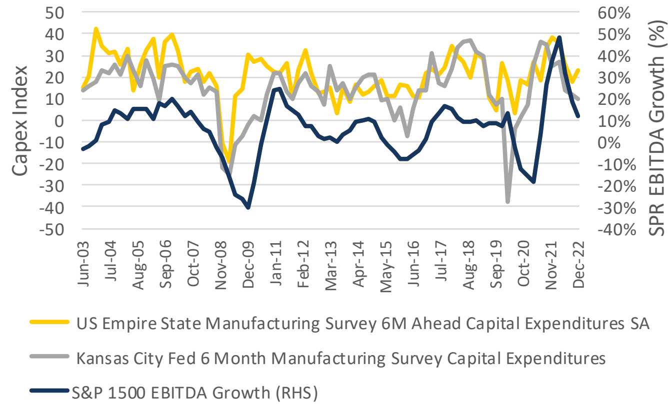
Date	Excess Return	Next Day Excess Ret	Date	Excess Return	Next Day Excess Ret	Date	Excess Return	Next Day Excess Ret
10-Oct-08	(4.9)	0.1	18-Mar-20	(2.7)	(3.2)	12-Nov-08	(1.7)	(0.7)
26-Jun-02	(4.6)	(0.0)	19-Nov-08	(2.4)	(3.1)	11-Jun-20	(1.7)	0.4
14-Sep-01	(4.5)	(1.0)	15-Oct-08	(2.4)	(2.1)	8-Feb-16	(1.7)	(0.5)
16-Mar-20	(4.3)	(0.1)	8-Aug-11	(2.4)	(1.4)	20-Jan-16	(1.7)	0.6
9-Mar-20	(4.3)	1.2	15-Sep-08	(2.2)	(1.0)	26-Sep-08	(1.6)	(2.0)
12-Mar-20	(3.3)	0.6	16-Oct-08	(2.1)	(0.7)	4-Oct-11	(1.5)	0.5
19-Mar-20	(3.2)	(1.1)	6-Mar-20	(2.0)	(4.3)	2-Mar-09	(1.5)	(0.8)
20-Nov-08	(3.1)	(1.4)	29-Sep-08	(2.0)	(0.2)	6-May-10	(1.5)	(0.8)
6-Oct-08	(3.1)	(0.3)	18-Nov-08	(1.9)	(2.4)	13-Mar-23	(1.5)	?
2-Oct-08	(3.0)	(0.6)	26-Jul-07	(1.8)	(0.6)			
23-Mar-20	(2.9)	1.3	24-Jun-16	(1.8)	(1.0)			

Average 2nd Day Move	**(0.8)**
Likelihood of Non-Neg 2nd Day Move	23%

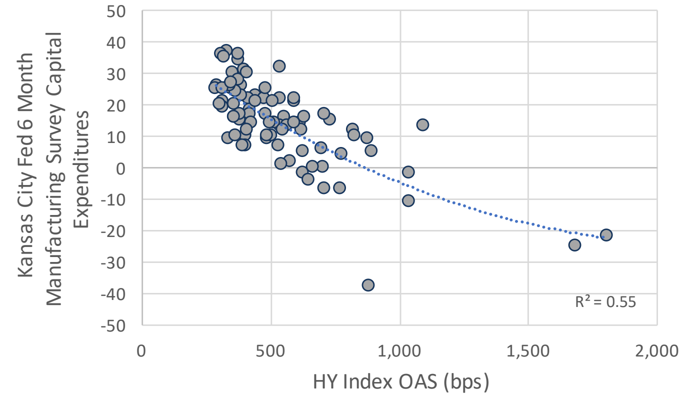
What are the Known Unknowns?

The reaction of management teams, particularly as it relates to business investment, is a key risk arising from recent developments. Historically speaking, periods of uncertainty can lead to an unwillingness of management teams to deploy cash on capital expenditures, preferring instead to preserve liquidity as their return on investment is difficult to gauge. As demonstrated below, **a pullback in capex (using next six month Empire State and Kansas City Fed survey data) is highly correlated to corporate EBITDA growth**. Furthermore, and as a result of fundamental headwinds posed by a lack of business investment, high yield spreads tend to widen.

Capex Highly Correlated to Issuer EBITDA Growth
quarterly data



Capex Highly Correlated to HY Index OAS
quarterly data



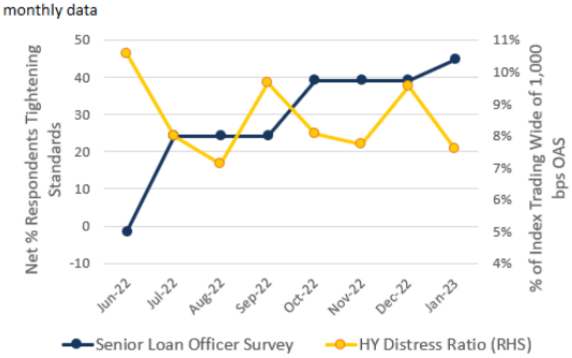
Source: SKY Harbor, ICE Data Indices, Federal Reserve Bank of New York, Federal Reserve Bank of Kansas City, Bloomberg

Consumer confidence may also be impacted by uncertainty arising from the banking shakeup. **Personal consumption drives nearly 70% of economic output in the US, and the willingness of consumers to spend despite inflationary pressures has contributed to credit ratio resilience among high yield issuers over the last several quarters**. As such, the impact on consumer spending patterns, which won't be known immediately, is likely to have a meaningful impact on overall sentiment.

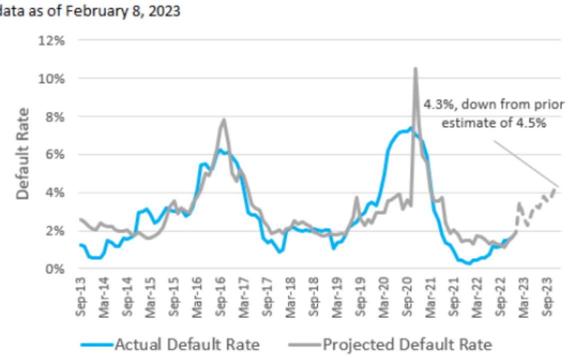
What Happens to Lending Standards?

Lending standards were already tightening before the SBV failure, and **financial institutions may be less willing to extend credit if they think economic conditions will begin to deteriorate**. The availability of credit is the dominant driver of our default rate projection model, and further limitations could force us to re-visit our relatively benign credit loss outlook for 2023.

Lending Standards Tighten, Disress Ratios Fall
monthly data



SKY Harbor Default Rate Estimate Improves to 4.3%
data as of February 8, 2023



Source: SKY Harbor, Federal Reserve, Bloomberg, BofA Merrill Lynch

That said, perhaps the Fed backstop and discount window accommodation will loosen lending standards, particularly if strategic investments into regional financial institutions reverse the recent selloff in those equities. We also note that **record-setting issuance in 2020 and 2021 effectively pushed out maturity walls into the 2025/2026 time frame, so the need to access liquidity and address near-term maturities is actually quite low at present**. Additionally, balance sheets are, generally speaking, cash-laden, with healthy free cash flow metrics expected to persist in the near term despite an increase in funding costs.

How is SKY Harbor Positioned?

Our Funds and client portfolios have no direct holdings of the securities of SVB, Silvergate, Signature Bank or First Republic securities. We are assessing the impact on risk assets in general and continue to be mindful of our portfolio risk-taking. As such, we will have further updates to our market views over the next few days.

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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.

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