SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Sr. PM, Dir. of Research & Strategy
msalice@skyhcm.com
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SKY Harbor Weekly Briefing

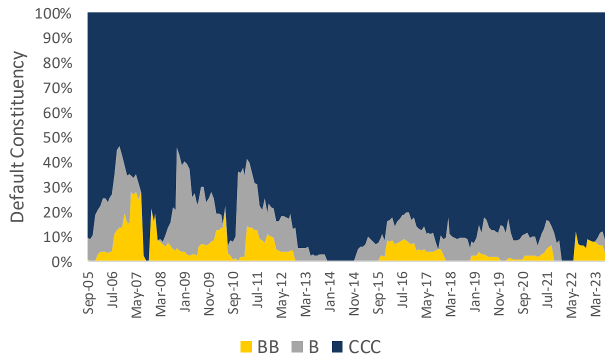
Notes from the Road – European Edition

We had the pleasure of meeting a number of clients and platforms as we made our way across Europe for our fall roadshow. What follows is additional commentary on several of the most discussed topics, presented below in no particular order. Additionally, we note a few observations relative to our last European roadshow back in May - First, having met with approximately 75 institutions, very few expect a recession in the coming year (single digits), down meaningfully from six months earlier. Second, though most investors remain underweight the asset class (similar to May), there was an overall greater sense of interest in the case for high yield, and as such we think demand has inflected from cyclical lows. Third, and notwithstanding a few notable dissenters, investors have become more comfortable with the inflation outlook, with a cooler than expected CPI print in the middle of our travels improving sentiment.

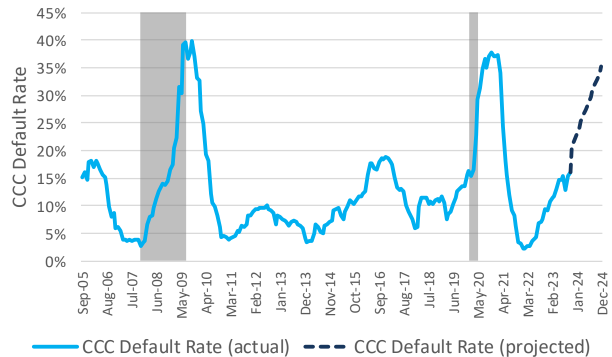
Is a Spike in Defaults on the Horizon?

We recently updated our multi-factor regression model, the output of which suggests the high yield bond default rate will rise to ~ 4.7% by the end of 2024, modestly above long-run average levels for the asset class, but relatively benign in the context of slowing output growth. **What keeps the default rate muted, in our view, is a "soft-landing" base case outlook, conservative balance sheets (leverage and coverage remain stronger than historical norms), and a higher-quality index constituency**. As to the latter point, CCC-rated debt makes up less than 12% of the ICE BofA US High Yield Index, well below the trailing two decade average (~ 18%). As such, even if underlying economic growth were to surprise to the downside, defaults likely remain below prior recessionary peaks due to a more limited subset of speculative credits in the index. As outlined below, approximately 90% of index defaults have historically come from the CCC-rated subset of the market, with 30% to 40% of the rating bucket typically filing in a recessionary environment. Assuming a similar portion of our 4.7% default rate projection comes from the CCC bucket in '24, an implied 35% of the cohort exits via bankruptcy, in-line with global financial crisis and COVID peaks. As such, we do not believe our default outlook for the coming year is overly optimistic.

CCCs Typically Make up ~90% of Index Defaults
rolling 12 month data



Under Our Base Case Outlook, ~35% of CCCs Default in 2024
rolling 12-month data, recessions shaded grey

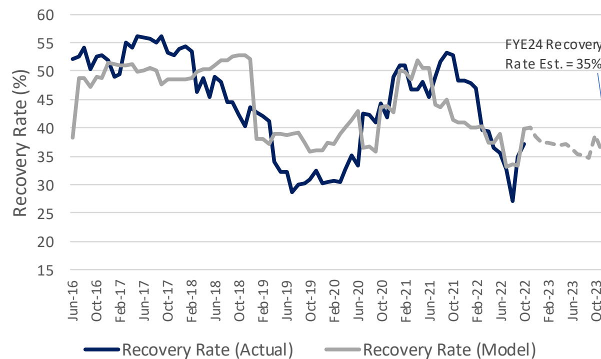


Source: SKY Harbor, BofA Merrill Lynch

Will Recovery Rates Improve?

Recovery rates for defaulted issuers have trended well below their 40% historical average for much of 2023. This is seemingly at odds with an analysis we conducted several years ago that suggested periods characterized by low default rates and with limited sector concentration (both fitting the current market backdrop) typically lead to superior recoveries. Upon closer examination, we think downside surprise to recovery rates thus far in 2023 (we hit a recent low of ~ 27% in August) remain a function of a limited dataset (a mere 26 issuers have defaulted over the last 12-month period, leaving the aggregate calculation susceptible to outliers) and **proliferation of defaults among sectors with historically below-average recoveries** (technology, retail, etc.). Additionally, given several years of strong EBITDA growth (including a period of peak earnings) and relatively accommodative funding costs (average par-weighted coupons for HY constituents were 5.8% in 2023, the 2nd lowest going back to the year 2000, and nearly 175 bps below the trailing 20-year average), we could surmise that issuers defaulting in this environment were exceptionally weak credits to begin with. Nevertheless, looking forward to 2024, **we project recovery rates for defaulted issues will rise to ~ 35%, only modestly below long-run averages for unsecured bonds**.

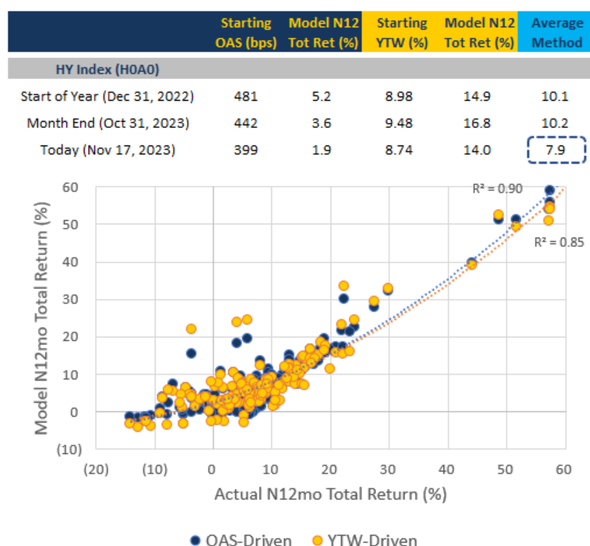
SKY Recovery Rate Projection Model
N12 Month Estimates based on Monthly Data



Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Federal Reserve, Moody's, Bloomberg

What is the Total Return Outlook in 2024?

Before we get into estimates, a cautionary note: returns for an asset class are dependent on many variables, most of which are difficult to estimate on their own. Additionally, banks typically employ different methodologies to generate their expectations, all of which are subjected to debate by the investing public. Furthermore, high yield bond return estimates cannot be estimated in isolation, as changes in sentiment in other asset classes during the year can prompt funds to flow across strategies, causing technical implications that impact performance. Despite these pitfalls, return expectations remain one of the more popular questions from investors. As such, we aim to provide our best estimates below. To frame expectations, we first look to correlation-driven return estimates, as they have historically provided reasonable goalposts on which to base more specific forward-looking projections. Assuming 2024 begins with spreads and yields similar to levels in the market at the time of writing this piece, **we believe total returns in the 7% to 8% range would be consistent with historical trends**. More specifically, using an equal-weighted model and a starting point of option-adjusted spread (OAS) and yield-to-worst (YTW) levels of 399 bps and 8.74%, respectively, subsequent 12-month returns have been, on average, approximately 7.9%.



	Starting OAS (bps)	Model N12 Tot Ret (%)	Starting YTW (%)	Model N12 Tot Ret (%)	Average Method
HY Index (H0A0)					
Start of Year (Dec 31, 2022)	481	5.2	8.98	14.9	10.1
Month End (Oct 31, 2023)	442	3.6	9.48	16.8	10.2
Today (Nov 17, 2023)	399	1.9	8.74	14.0	7.9

Source: SKY Harbor, ICE Data Indices

For the sake of transparency, we also provide a more nuanced return model, utilizing the BofA Merrill Lynch index return framework as we believe it strikes the appropriate balance between complexity and transparency. As always, we augment this model with our own variable estimates, with further explanation below. Also, note that these return projections are for the broad US high yield market (the ICE BofA US High Yield Index, ticker H0A0), and not our internal portfolios.

• **Treasury Yield Target** – We use consensus expectations contained within Bloomberg as our estimate of 5yr Treasury yields by the end of 2024; at the time of publishing this outlook, the median 5yr Treasury yield estimate for Q4'24 was 361 bps.
• **Index Default Rate** – Utilizing our multi-factor regression model, we anticipate that tightening lending standards, weaker free cash flow via the re-setting of existing coupons, and lower (albeit manageable) interest coverage metrics will modestly increase the index default rate, which we project will rise to ~ 4.7% by the end of 2024.
• **Recovery Rate** – Utilizing our multi-factor regression model, we anticipate that weakening but still strong credit metrics in the context of only moderate but rising defaults (see above) should put downward pressure on recovery rates relative to historical norms, and expect modest degradation to ~ 35% in 2024.
• **Index OAS Target** –Based on our internal macro spread regression model, which uses key economic indicators to estimate spread fair value, we anticipate index OAS will widen to approximately 485 bps by the end of 2024. Higher conviction with regard to recession avoidance could significantly tighten this estimate.

Using these estimates, as well as various index measures as of November 17, 2023, **we arrive at an estimated return for high yield bonds of ~ 7.2%** over the next twelve months, which is in-line with our correlation-based estimate of ~ 7.9%.

ICE BofA US High Yield Index - H0A0	HY	5yr Trsy	Notes
Current Spread	399	445	Tsy target based on consensus expectations
Target	485	361	OAS target based on macro spread reg. model
Predicted Change	86	-84	
Duration	3.5		index data as of Nov 17, 2023
Index Price	88.7		index data as of Nov 17, 2023
Avg Par Coupon	598		index data as of Nov 17, 2023
Tsy Change	-84		
Total Change in Yield	2		
Capital Gain	-7		
Period Multiplier	1.00		
Index Yield	874		index data as of Nov 17, 2023
Default Rate	4.70		SKY model estimate
Price (default universe)	51.8		avg. price of widest 5% (by OAS) of market
Credit Loss	152		assumes 35% recovery rate for defaulted issues
Expected Periodic Return (next 12 months)	7.2 %		**Base Case**

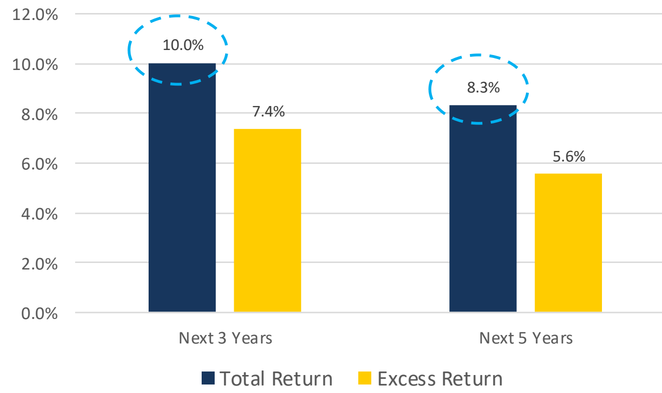
Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch model framework, Bloomberg

Do You Have a Longer-Term Perspective on Return Potential?

Near-term uncertainty, particularly given a non-zero chance of an exogenous shock to the market, typically makes returns over the short run increasingly difficult to predict. As such, though our next 12-month return estimate (7% to 8%) appears justifiable based on two different models, average annualized returns over a longer period of time should lead to higher conviction projections. Below, using data since the end of the global financial crisis, we find that current YTW levels offered by the high yield bond market (~ 8.8%) have typically resulted in **subsequent average annualized total returns in the high-single-digit range over 3 and 5 year periods**.

Next 3 & 5yr Avg. Annualized Returns Based on Starting YTW

rolling monthly data, post GFC



Source: SKY Harbor, ICE Data Indices

Conclusion

In conclusion, we continue to believe the US high yield asset class offers attractive value within the fixed income space, with top quartile yields, in our view, sufficient compensation for identifiable risks on the horizon. However, we do acknowledge that rising (albeit modest) defaults and slowing (albeit manageable) output and earnings growth represent risks for the most speculative issuers in the index, and therefore remain underweight CCCs in our portfolios. Finally, as a reminder, we plan to begin working on our more encompassing *2024 US High Yield Outlook* report after the Thanksgiving holiday, with planned distribution at some point in the middle of December.

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