SKY HARBOR
CAPITAL MANAGEMENT
Responsible Investing for a Sustainable Future

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SKY Harbor Weekly Briefing

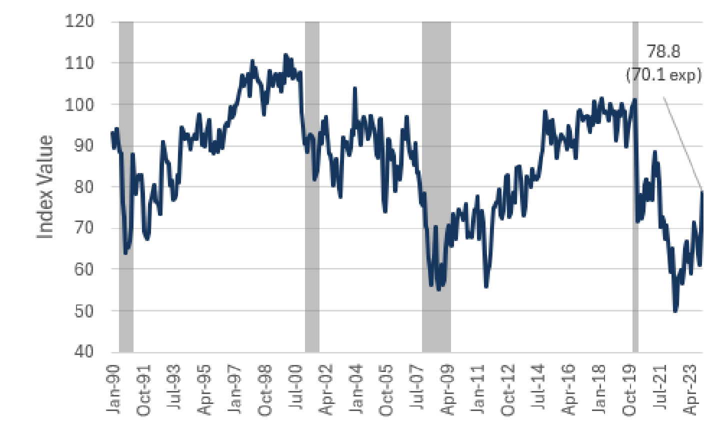
A "Goldilocks Scenario"?

Another wave of stronger than expected economic datapoints – without upward pressure on inflation – improved investor sentiment this week, particularly across risk asset classes. Merely a year removed from fears of an almost certain recession, the economy now looks poised to beat all odds, developments Fed Chairman Powell must certainly be pleased with. Acknowledging lingering risks on the horizon, we use this *Weekly Briefing* to highlight implications for improved EBITDA growth and monetary policy easing as a result of recent upside surprise to key economic indicators.

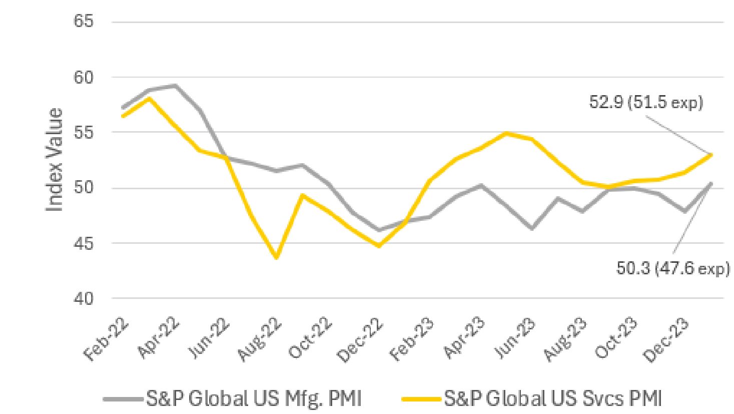
All About the Consumer

A generational wave of inflation, persistent economic uncertainty, and the start of what will likely be a contentious election year appears insufficient to derail US consumers, with the University of Michigan Consumer Sentiment Index (CONSSENT) handily beating expectations in January. Bolstered by falling gasoline prices and the expectation of inflation normalization, **the index posted its highest reading since July '21, at the same time recording its largest one month improvement in nearly 20 years**. Additionally, S&P Global PMI data came in better than expected in both manufacturing and services sub-groups, with both measures reaching "expansion" territory and further supporting the "soft landing" narrative.

U of Michigan Consumer Sentiment Surprises to Upside
monthly data, recession shaded grey



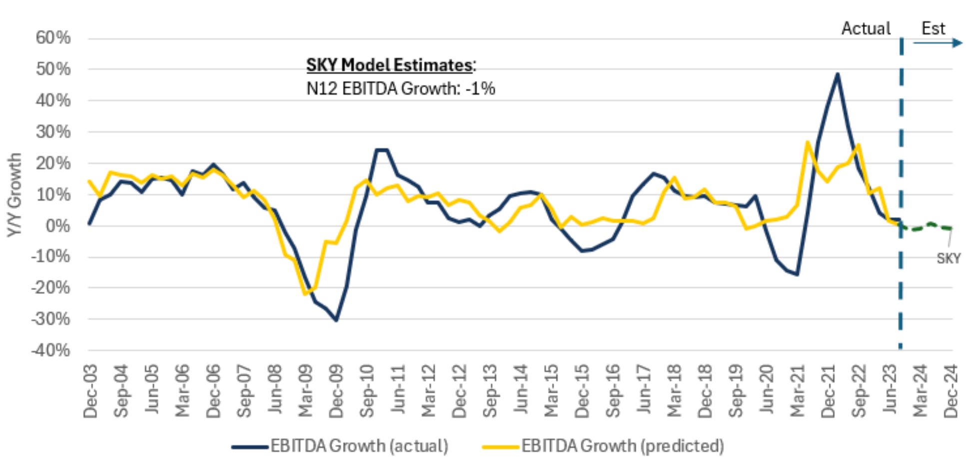
S&P Global PMI Data Also Beat Expectations
monthly data, trailing 2 years

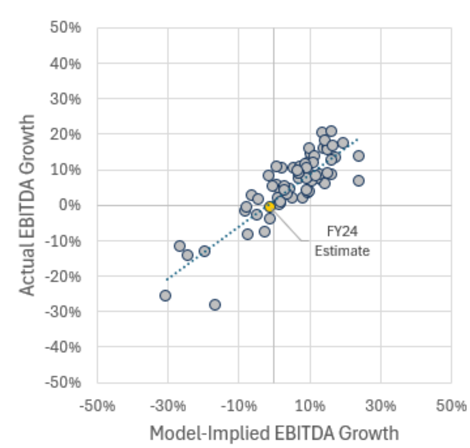


Source: SKY Harbor, Univ. of Michigan, S&P Global

Our Earnings Model Improves (Again)

Tailwinds to sentiment aside, better than expected results noted above improve many of our fundamental projections, with the consumer sentiment index a direct feed into our high yield issuer aggregate EBITDA growth model. As demonstrated below, **various instances of upside surprise have improved our model output by 300 bps since publication of our initial '24 estimates** (see our US High Yield – 2024 Outlook report for further details), and we now see EBITDA growth of just under breakeven levels over the next four quarters. Ultimately, more resilient earnings growth, coupled with less onerous than feared refinancing costs (see our prior *Weekly Briefing* entitled "Chipping Away" for additional details) should mitigate interest coverage metric erosion, which further improves the default outlook for our market.





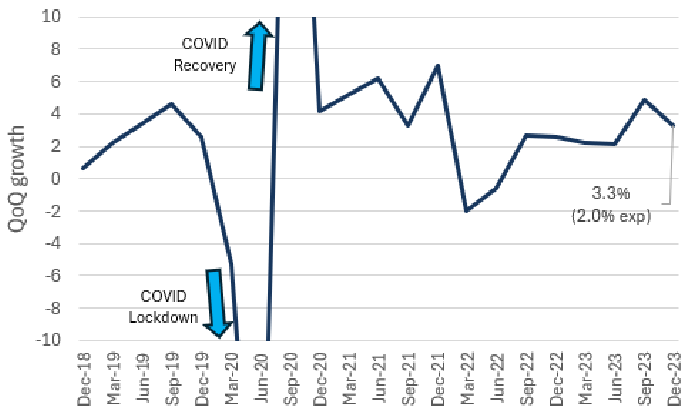
Source: SKY Harbor, Federal Reserve, Baltic Exchange, Chief Executive Magazine, Univ. of Michigan, Bloomberg

Encouraging Growth

Q4'23 GDP growth also surprised to the upside, coming in at a brisk 3.3%, significantly above consensus expectations in the 2.0% context. Strength in consumer spending drove most of the output growth, with government spending also providing some lift. Perhaps most encouragingly, **stronger than anticipated growth did not come at the expense of hotter inflation, as core PCE remained steady at 2.0%.** Taken together, investors priced the odds of a March '24 rate cut at 53%, up from ~ 42% prior day (Wednesday, Jan 24), but well below the 78% reading two weeks earlier.

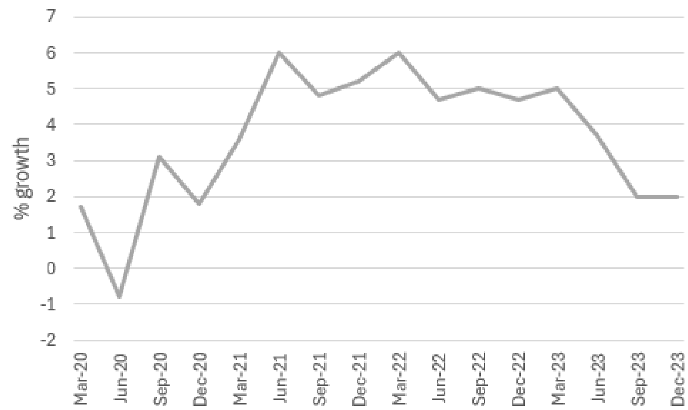
US GDP Growth Followed With a Beat

quarterly data, trailing 5 years



Stronger Growth w/o Uptick in Inflation

US GDP Personal Consumption Core Price Index QoQ, SAAR



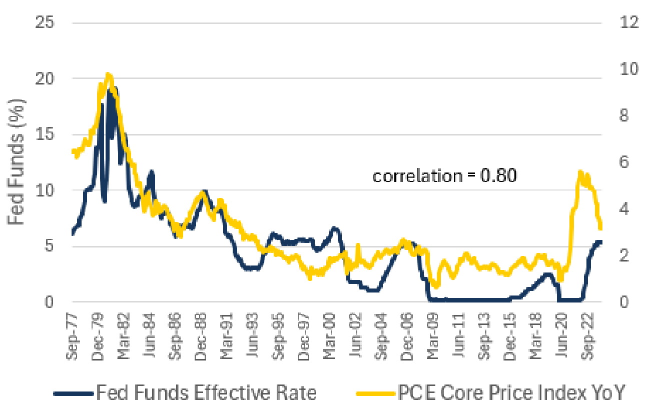
Source: SKY Harbor, Bureau of Economic Analysis, Bloomberg

The Fed vs. Markets

As noted above, and despite Fed commentary to the contrary, investors continue to see at least a 50% chance of a March rate cut. Furthermore, at the time of writing, Fed Funds Futures imply 5.6 cuts this year, notably above what is reflected by the median dot (3 cuts). So, who is right? As demonstrated below, **there exists, as expected, a high historical degree of correlation (0.80) between the Fed Funds rate and Core PCE**. Using an admittedly over-simplified model, alleviation of Core PCE by FYE24 to a level commensurate with the consensus view (~ 2.5%) would imply a Fed Funds rate that is ~ 150 bps too high at present, lending some credibility to the market view.

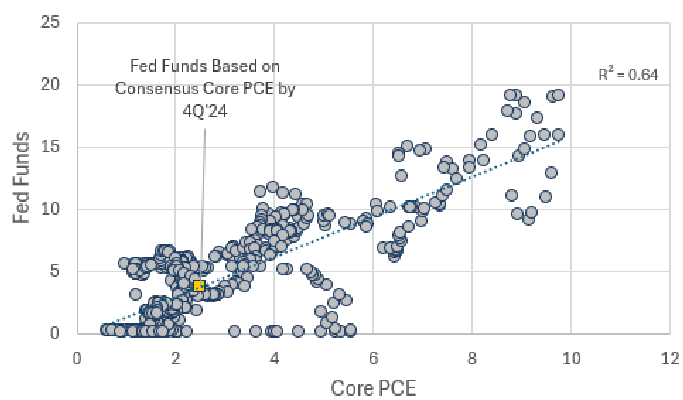
Fed Funds Effective Rate vs. PCE Core Price Index

monthly data, trailing 50 years



Consensus View of Inflation Implies Potential for 6 Cuts in '24

based on consensus as of Jan 24, 2024



Source: SKY Harbor, Federal Reserve Bank of New York, Bureau of Economic Analysis, Bloomberg

A Balancing Act

With 2/3 of the economy driven by consumer spending, an uptick in sentiment bodes well for recession avoidance. That said, we acknowledge many unknowns on the horizon, with a Presidential election set against a backdrop of rising budget deficits perhaps joining geopolitical uncertainty as dominant risk factors for 2024. For now, healthier output growth, fundamental resilience, and dissipating maturity wall concerns should benefit high yield risk taking, and we continue to see opportunities for outperformance as we enter Q4'23 earnings season.

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