![SKY HARBOR CAPITAL MANAGEMENT]

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July 3, 2023

SKY Harbor Weekly Briefing

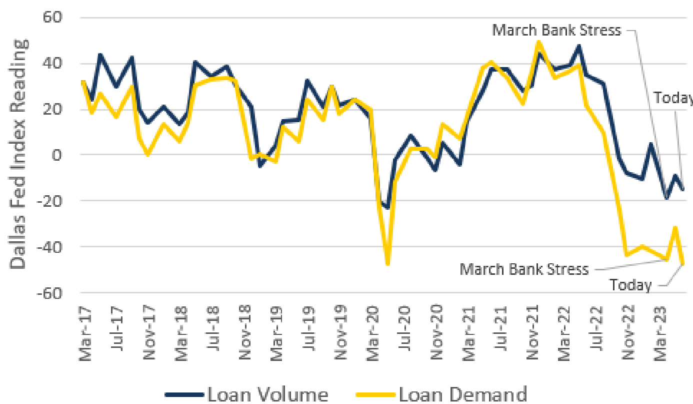
Model Refresh Heading into H2'23

Total returns are likely to settle in the +5% range on a year-to-date basis, stronger than we had anticipated but non-linear in nature from early January to late June. Given a number of surprises – both positive and negative – digested by the market to date, we thought it appropriate to update our fundamental projection models as we enter the back half of the year. In this *Weekly Briefing*, we highlight our improving view of defaults and spread fair value by FYE23, all of which augers for a moderating but still intact bias for higher-quality credit.

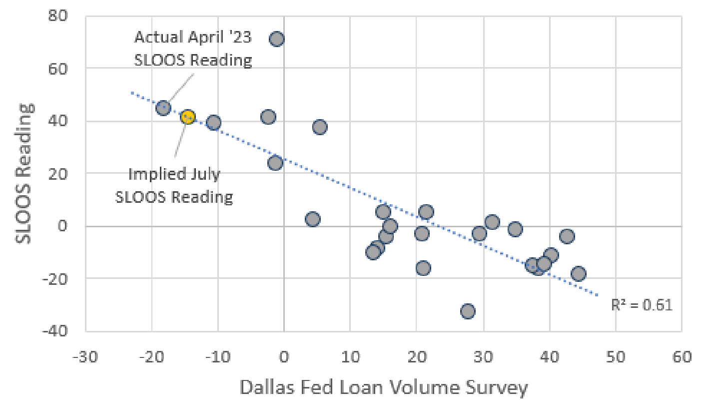
Tighter Standards

As mentioned in our April '23 *Weekly Briefing* entitled "Dwindling Dollars," **the Senior Loan Officer Survey on Band Lending Practices (SLOOS) data greatly improves the statistical significance of our forward-looking high yield index default model, and the default outlook largely dictates the path of spreads**. Unfortunately, the survey is only released on a quarterly basis, which can seem like an eternity when results are likely to demonstrate sequential volatility. To help solve this issue, we introduced higher frequency data into our model, including money market fund flows (available weekly) and Dallas Fed loan volume and demand metrics (released every six weeks). Notably, Dallas Fed loan volume and demand has not degraded further following SVB's collapse, in our view indicating SLOOS-implied lending standards may prove more resilient than originally feared.

Dallas Fed Loan Volumes & Demand Coming Off Lows...
measurements taken twice per quarter



...But Still Imply Tightening of Lending Standards
trailing 5 years of data

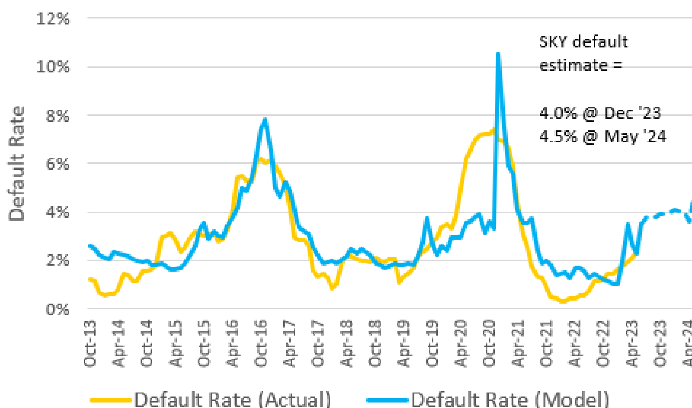


Source: SKY Harbor, Federal Reserve Bank of Dallas, Bloomberg

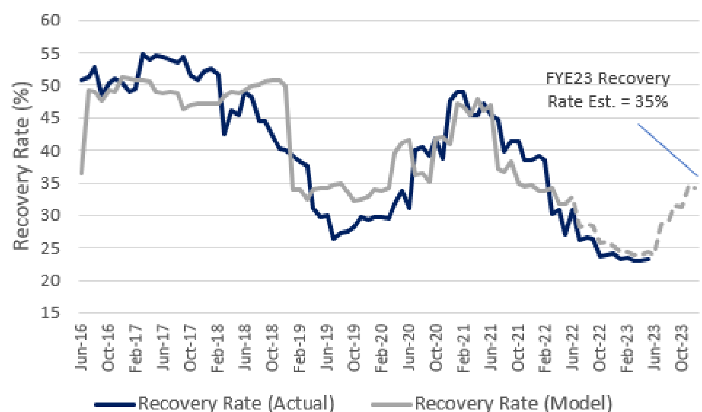
A Lower Default Peak

With our slightly less punitive (though still expected to signal constriction) SLOOS projections in hand, **we updated our multi-factor default projection model, which has moderated to an implied 4.0% rate by year end** (had been 4.3%). At the same time, better than expected Q1'23 earnings resilience appears perfectly offset by a higher for longer interest rate outlook, resulting in no change to our recovery rate model, which we keep at 35% through the end of this year. On balance, our estimate of index credit losses stemming from defaults (4.0% default rate multiplied by 1 minus a 35% recovery rate) goes to 260 bps, down from 280 bps in our prior iteration.

SKY Default Rate Projection Model
monthly data, dotted lines are forward projections



SKY Recovery Rate Projection Model
monthly data, dotted lines are forward projections



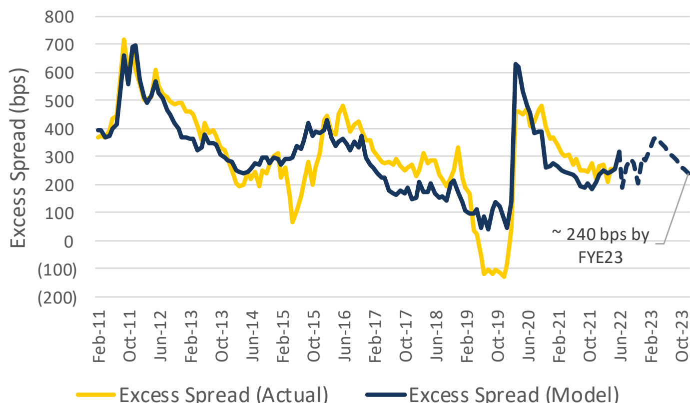
Source: SKY Harbor, ICE data indices, Federal Reserve, Bank of America Merrill Lynch, Bloomberg, Capital IQ

A Moving Target

Historically, investors have demanded, on average, another 300 or so basis points of "excess spread" above and beyond what is associated with expected default losses. This premium can vary widely through the cycle, having hit a minimum of -130 bps and a maximum of +720 bps over the last decade. The trailing 5yr and 3yr averages have been lower at approximately 230 bps, in our view a function of both depressed risk-free rates for a long stretch of the dataset and an improving high yield index constituency. At extreme levels, excess spreads are likely impacted by market technicals, along with investor error in estimating expected default and/or recovery rates on a go-forward basis. However, after excluding tail events, we find excess spread levels to be more readily projectable based on economic and market variables. Using statistical analysis on our monthly dataset collected over the last decade, **we find that excess spread demanded by the market is typically a function of prevailing risk-free rates, yields offered by ancillary assets classes, FX hedging costs, and credit fundamentals**. Incorporating estimates for these values into our model, we think excess spreads should be ~ 240 bps by the end of the year, a value admittedly below the long-run average of 300 bps, but representing an uptick relative to the trailing 5-year average. Putting it all together, our FYE23 spread fair value target for the broad high yield index improves to 500 bps (260 bps of credit losses + 240 bps of excess spread), vs. our prior iteration of 530 bps.

SKY Harbor Excess Spread Model

monthly data, dotted line is our projection



Default Losses + Excess Spread = OAS Target

based on updated model output

2023	Default Rate						
Recovery Rate	3.3%	3.5%	3.8%	4.0%	4.3%	4.5%	4.8%
46.0%	176	189	203	216	230	243	257
43.5%	184	198	212	226	240	254	268
41.0%	192	207	221	236	251	266	280
35.0%	211	228	244	260	276	293	309
36.0%	208	224	240	256	272	288	304
33.5%	216	233	249	266	283	299	316
31.0%	224	242	259	276	293	311	328

260 bps of credit losses
+ 240 bps excess spread
= ~ 500 bps forward-looking spread target

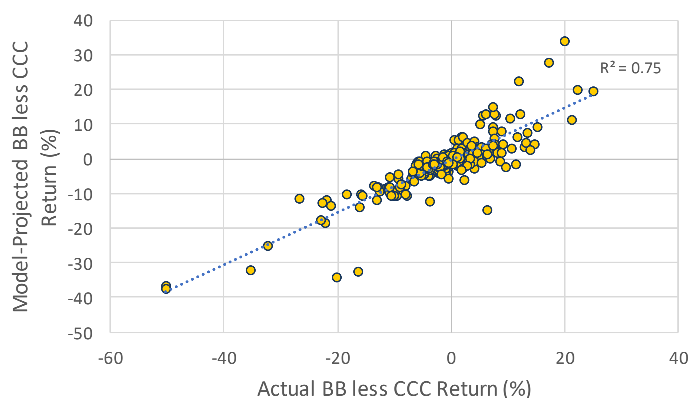
Source: SKY Harbor, ICE Data Indices, BofA Merrill Lynch, Bloomberg, Capital IQ, Federal Reserve, Moody's

A Higher-Quality Bias

Our spread target of 500 bps (+70 bps from current levels) and a default rate of 4.0% (up from 2.3% on an LTM basis) still imply, in our view, an attractive outlook for high yield total returns given starting yield-to-worst levels in the 8.5% to 9.0% range. The question of portfolio positioning, however, remains. To address this, we developed a regression model that projects next 6 months relative performance of BBs vs. CCCs based on the outlook for index-level spread fair value, default rate migration, and underlying treasury moves, all rooted in spread, yield, and duration differentials at the start of the period. The output of our model is demonstrated in the scatterplot below. To add greater flexibility, the bar chart to the right incorporates our internal spread and default rate target, but allows for the sensitization of 5-year treasury yields by the end of the year. At present, **the CCC carry advantage (relative to BBs), reduced by index spread widening (higher capture rate for CCCs) and default losses (also higher capture rate for CCCs) should be fully offset if 5-year Treasury yields tighten by ~ 20 bps from current levels (since BBs have higher starting duration)**. Given a consensus view of 30 bps of 5-year Treasury yield tightening by year end, we still see a modest advantage for BBs over CCCs for the balance of 2023. In our view, a complete reversal in our underweight to CCC-rated debt would require a tighter FYE23 spread target (either by a reduction in credit losses or excess spread), a lower default rate estimate, or higher treasury yield expectations than is currently baked into our base case outlook, though the hurdle rate has come down in recent weeks.

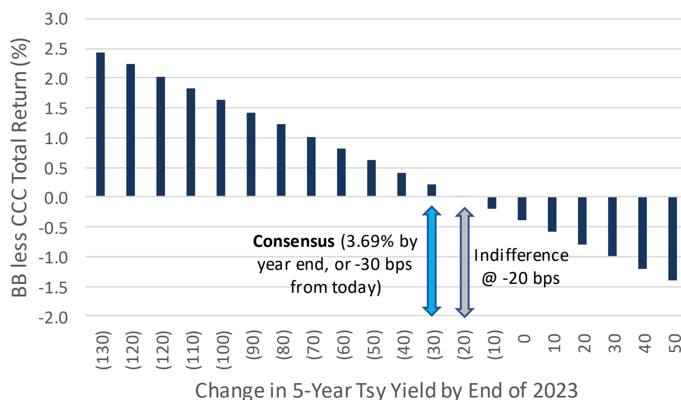
6-Month BB less CCC Performance: Actual vs. Model Estimate

monthly data, trailing 20 years



Rating Bucket Outperformance Dependent Upon Rates

assumes 70 bps OAS widening, 4.0% default rate, current YTW differentials



Source: SKY Harbor, ICE Data Indices, Bloomberg

Focus on Carry and Loss Avoidance

Consistent with our practice over the last several years, we will temporarily suspend publication of our *Weekly Briefing* during the summer months. We will, however, send out notes on an ad hoc basis should market-moving news materialize. As always, please feel free to reach out to us with any questions or analytical requests in the interim. In the meantime, we maintain our optimism for high yield market risk, and believe attractive returns can be generated without the need to take on full exposure to the lowest-rated and most cyclically exposed credits in the index.

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