SKY HARBOR
CAPITAL MANAGEMENT

Mike Salice, CFA
Director of Research
msalice@skyhcm.com
June 8, 2020

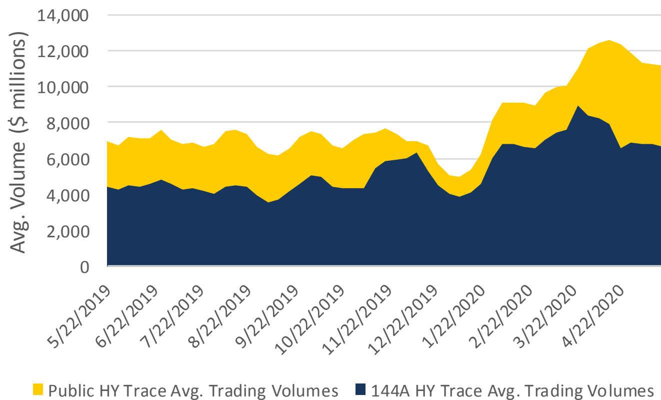
Weekly Briefing

SKYView: May Market Recap

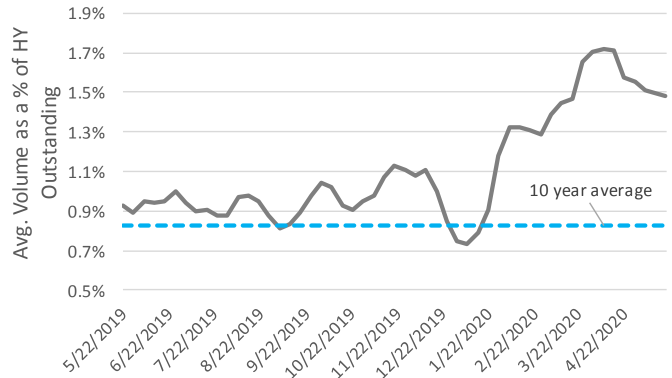
US high yield market activity in May was remarkable in many ways, with trading levels, total returns, new issuance, and default volumes registering well above historical norms. Economic data, while in many ways unprecedentedly weak on lockdown headwinds, has more often than not come in less awful than feared, further supporting a "risk-on" market sentiment. In this *Weekly Briefing* we recap key market developments in May - including a reduction in high yield bid/ask spreads, outperformance of CCCs, and the likely peaking of monthly defaults – all of which lead us to believe that the worst is now behind us.

A significant repricing of risk occurred during Q1'20 as governments around the world initiated social distancing measures to combat the coronavirus pandemic. At the same time, investors were forced to extrapolate potential secular headwinds arising from presumptive future changes in consumer behavior, all while one of the longest-running expansionary periods in US history came to an end. ICE BofA US High Yield Index (H0A0) spreads widened 730 bps in just over a month in one of the most aggressive sell-offs in market history. Trading volumes, as aggregated by the Trade Reporting and Compliance Engine (TRACE), accelerated during this period. Weekly average index turnover, including both public and 144A issues, essentially doubled, and has remained elevated even as spreads recover from March 23 wides.

Trading Activity Remains Elevated…
weekly data, trailing 1 year



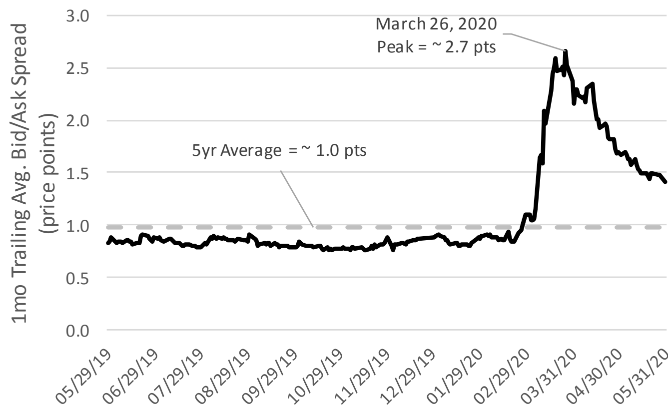
…Even Adjusted for Changes in Index Size
weekly data, trailing 1 year



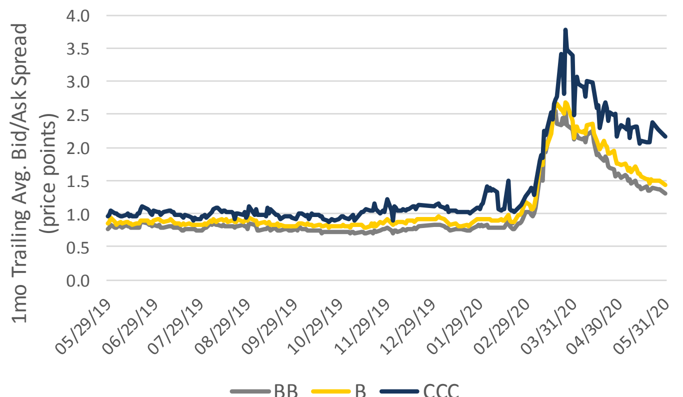
Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices

Despite an uptick in trading volumes since the coronavirus pandemic began, costs associated with both buying and selling of securities have increased materially. Average US high yield bid/ask spreads peaked out at approximately 2.7 points in late March, a nearly three-fold increase relative to long-run averages. Anecdotally, we view the increase as a function of both economic uncertainty and the physical dislocation of traders on both the buy and sell sides. As the market began to rally and, presumably, market participants adapted to socially-distanced workstations, bid/ask spreads began to compress. By the end of May, higher-quality bid/ask spreads had converged closer toward long-term norms, though many CCC bonds remain costly to trade.

US High Yield Bid/Ask Spreads Beginning to Normalize
daily data through end of May, trailing 1 year



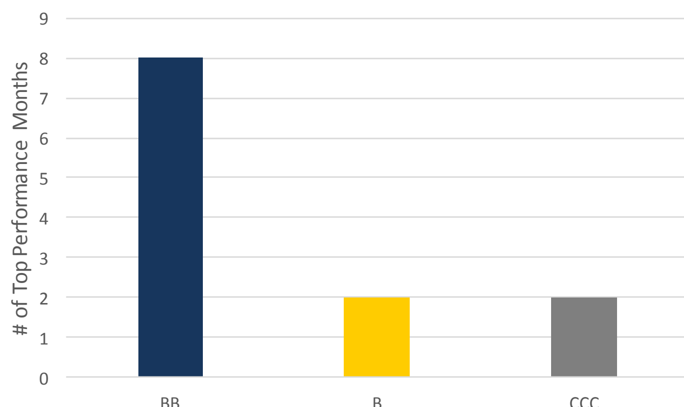
CCC Bid/Ask Spreads Remain Elevated
daily data through end of May, trailing 1 year



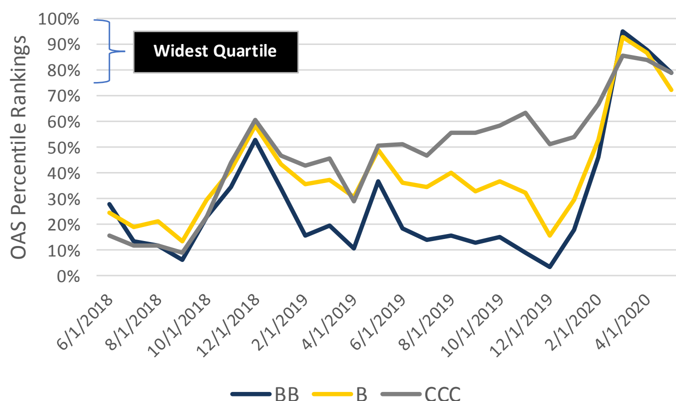
Source: SKY Harbor, BofA Merrill Lynch, ICE BofA Indices

The CCC sub-index returned approximately 5.9% in May, outperforming BB and single-B ratings buckets for only the second month in the last twelve (and for the first time in 2020) as investors remain willing to look past what most believe to be a temporary growth shock. CCC returns were even more notable in the context of BB dominance (the top-performing rating bucket for 14 of the last 22 months) in what has been a high-quality late-cycle period and recovery. Barring an acceleration of US-China trade tensions and/or a second lockdown later in the year, OAS levels across the rating spectrum appear reasonably attractive, still residing within or close to the widest quartile (based on 20 years of month-end data).

Rating Bucket Top Performance Months Skewed Toward BBs
monthly data, trailing 1 year



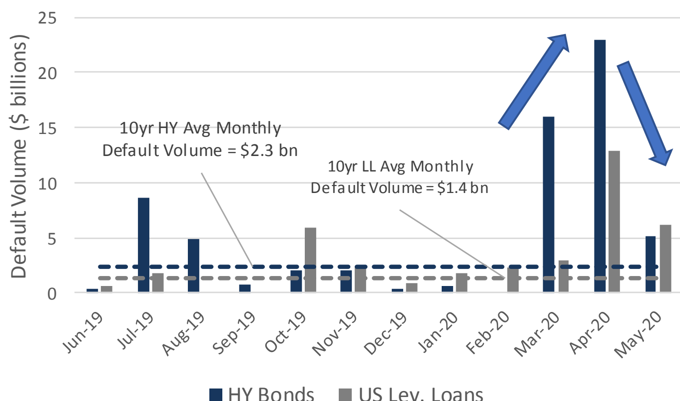
Rating Bucket OAS Percentile Rankings Favor Barbell Approach
percentile rankings based on month-end data over the last 20 years



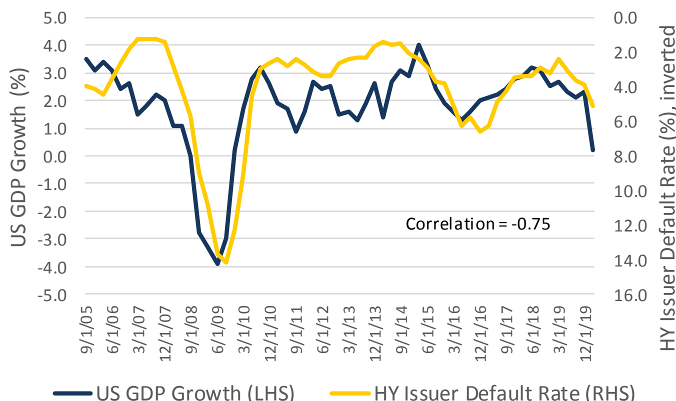
Source: SKY Harbor, ICE BofA Indices

May default activity was elevated, with eight issuers in the leveraged credit space (bonds + loans) either filing for bankruptcy or missing a coupon payment. In total, defaults impacted $11.2bn of debt ($5.1bn in bonds, $6.1bn in loans), the 4th highest monthly total in the last three years. However, bankruptcies dropped significantly relative to the prior two months, potentially signaling an April peak. Though we continue to believe US high yield bond defaults will reach 9% to 10% in 2020 (see our June 1, 2020 *Weekly Briefing* entitled "Re-Opening Relative Value" for model output), the most extreme sequential uptick may now be behind us. Furthermore, we remain cautiously optimistic that defaults will trend down in 2021. Though beyond the projection scope of our regression model, we would highlight that default rates and GDP growth tend to be highly correlated over time. Consensus expectations of an economic rebound next year – at the time of publication the median analyst surveyed by Bloomberg sees 2021 GDP growth of ~ 3.9% - would imply a reduction in defaults to levels more closely in-line with long-term annual averages (~ 4.5%).

April Default Volumes May Represent Near-Term Peak
monthly data, trailing 12 months



'21 Est. GDP Growth Implies Long-Run Avg. Default Environment
quarterly data, trailing 15 years



Source: SKY Harbor, JP Morgan, BofA Merrill Lynch, Bureau of Economic Analysis, Bloomberg

In conclusion, the month of May appears to have been pivotal for the high yield market. Bid/ask spreads continue to come down, reducing transaction costs in the secondary market after an historic spike over the last few months. Additionally, CCC outperformance implies investor willingness to credit-pick outside of the highest quality portions of the market, and coincides with the potential peaking of monthly default volumes. While uncertainties remain, we view recent developments – upside surprise in several key economic indicators, progress on the re-open, new issue market strength facilitating the bolstering of corporate balance sheets, and continued fiscal stimulus measures – as offering a catalyst for further spread compression.

Important Disclosures and Disclaimers

This analysis and the opinions expressed herein are intended solely for institutional and professional investors that are responsible for assessing their own risk tolerances under prevailing market conditions. SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

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.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofA Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofA") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofA PERMITS USE OF THE ICE BofA INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.

© 2020 SKY Harbor. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor.