High Yield Market Update

Risk assets rallied in the quarter on optimism around an acceleration in economic activity. The Georgia run-off election shifted the balance of power in the Senate and opened the door for the new administration to move quickly to support Americans with additional stimulus spending and a well-organized plan for vaccine distribution. COVID-19 deaths have declined and in most of the country the race between variants and vaccines has vaccines in the lead. Enthusiasm for a strong economic recovery has shifted investors' focus to the threat of inflation and the timing of the removal of the extraordinary monetary policy that has supported the economy throughout the pandemic. Treasuries ended the period with the 2-year up 4 basis points (bps) to 0.16% and the 10-year higher by 82 bp to 1.74%. Oil prices moved higher in the first quarter as WTI Crude closed the period up $10.64/bbl (or 21.93%) to $59.16/bbl and the US Dollar Index was up 3.66%.

Technicals were a headwind in the first quarter of 2021 as large outflows were met with record new issuance. High yield funds and ETFs had outflows of $9.8bn while loan funds saw inflows of $11.0bn, as tracked by Lipper and reported by Barclays. Q1 bond new issuance was up significantly, with $149.7bn pricing in the quarter, offset by $107.2bn of bond redemptions, leaving net supply at $42.5bn for the period, per Barclays. The percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 0.7%; the comparable figure for the loan market (below 80% of par) was 1.9%, per JP Morgan. The par-weighted twelve-month high yield bond default rate decreased to 5.9% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned 0.90% in Q1, ending the period with an average price of 104.08, a 0.53-point decrease from the prior quarter. Credit spreads tightened by 54 bps to 329 bps and the yield-to-worst (YTW) was lower by 0.05% to 4.16%. High yield underperformed small cap equities, represented by the Russell 2000's 12.44% return, as well as large cap equities, as represented by the S&P 500's 5.77% return, but outperformed investment grade corporates, as represented by the ICE BofA US Corporate Index's -1.39% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned -0.21%, 1.18% and 5.21%, respectively. Returns were mixed across sectors for the quarter: the top performer was Energy, which saw a 3.87% return, while Utility was the bottom-performing sector with a -1.59% return.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) continued to generate strong relative returns in the first quarter of 2021. By risk segment, both allocation and security selection were positive contributors to relative performance in the quarter. The primary drivers of portfolio outperformance continue to be an underweight to the most rate sensitive (yielding 0-5%) part of the market and strong security selection within the short duration, most defensive part of the market. Outperformance was slightly reduced by the portfolio's underweight to the most speculative part of the market (yielding > 9%) and by an underweight to the Energy sector. By rating, Broad High Yield Market portfolios benefited from an overweight to lower-rated credits and strong selection in Single-Bs. This outperformance was somewhat offset by weaker selection in Triple-Cs.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted strong absolute returns again in Q1, outperforming the broader US high yield market (as measured by the ICE BofA US High Yield Index) on a gross-of-fee basis. By risk type (defined by yield and duration to worst), generally the most speculative securities (yielding > 9%), which tend to trade on credit-specific events, and longest duration (within the context of short duration) outperformed while the shortest duration, most defensive securities lagged in Q1. By sector, Transportation and Media led for a second consecutive quarter while Utility and Telecom fell behind. By rating, the lowest part of the market continued to show some of the strongest returns as has been the case with the overall high yield market. Looking forward, we continue to focus on maintaining a relatively high current income by selling when valuations are too tight or negative convexity limits further upside and rotating into issuers that align with our 2021 outlook.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	5.9	6.3
Yield to Worst	5.10%	4.15%
Current Yield	6.66%	5.72%
Duration to Worst	2.8	3.5
OAS	432	329
Avg Coupon	6.97%	5.96%
Number of Issuers	129	877
Number of Issues	156	2050
Average ML Rating	B2	B1
Average Price	104.6	104.1

Distribution by Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	0.0%	0.0%
BB Holdings	16.1%	53.8%
B Holdings	59.3%	33.6%
CCC or Under	24.6%	12.6%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	7.1%	0.7%
250 - 500M	41.2%	24.5%
500 - 750M	17.8%	22.4%
750 - 1000M	15.5%	17.3%
1000+M	18.5%	35.1%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Capital Goods	18.6%	6.6%	283%
Basic Industry	11.9%	8.5%	139%
Services	11.0%	4.9%	223%
Media	10.2%	9.0%	112%
Leisure	6.6%	6.5%	102%
Technology & Electronics	6.5%	5.0%	131%
Consumer Goods	5.7%	4.8%	121%
Automotive	5.5%	5.1%	108%
Energy	5.1%	13.5%	38%
Retail	4.7%	5.0%	94%
Transportation	3.6%	1.5%	250%
Healthcare	3.4%	8.7%	39%
Real Estate	3.0%	4.4%	68%
Financial Services	2.4%	4.1%	59%
Telecommunications	1.5%	7.0%	21%
Utility	0.4%	3.0%	12%
Insurance	0.0%	1.1%	0%
Banking	0.0%	1.3%	0%

Top 5 Holdings by Weight	BofA Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
QUAD/GRAPHICS 7.000% 01-May-2022	CCC1	238.7	98.80	Media	1.00	8.13	1.98
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	123.63	Transportation	3.42	5.49	1.79
Townsquare Media Inc. 6.875% 01-Feb-2026	B2	550.0	106.50	Media	1.71	3.19	1.61
Intertape Polymer Group Inc 7.000% 15-Oct-2026	B2	250.0	105.19	Capital Goods	0.51	3.68	1.56
Park-Ohio Industries Inc. 6.625% 15-Apr-2027	CCC1	348.8	101.00	Capital Goods	3.40	6.34	1.50

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	4.2	6.3	3.3
Yield to Worst	3.91%	4.15%	3.25%
Current Yield	6.50%	5.72%	5.81%
Duration to Worst	1.5	3.5	1.8
OAS	353	329	289
Avg Coupon	6.84%	5.96%	6.12%
Number of Issuers	148	877	459
Number of Issues	205	2050	713
Average Rating	B2	B1	BB3
Average Price	105.17	104.08	105.28

Distribution by Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.0%	0.0%	0.0%
BBB Holdings	1.3%	0.0%	0.0%
BB Holdings	25.0%	53.8%	57.9%
B Holdings	54.3%	33.6%	42.1%
CCC or Under	19.5%	12.6%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	8.1%	0.7%	0.1%
250 - 500M	31.0%	24.4%	18.6%
500 - 750M	21.1%	22.3%	28.5%
750 - 1000M	11.8%	17.2%	15.2%
1000+M	27.9%	35.3%	37.7%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Media	13.7%	9.0%	5.2%
Capital Goods	10.6%	6.6%	6.5%
Services	10.2%	4.9%	3.9%
Basic Industry	10.2%	8.5%	9.5%
Technology & Electronics	8.6%	5.0%	5.7%
Healthcare	7.0%	8.7%	7.4%
Financial Services	6.7%	4.1%	6.5%
Automotive	6.2%	5.1%	4.2%
Telecommunications	5.5%	7.0%	5.4%
Transportation	5.3%	1.5%	3.4%
Real Estate	5.0%	4.4%	5.4%
Leisure	4.8%	6.5%	8.3%
Consumer Goods	3.1%	4.8%	3.9%
Retail	2.4%	5.0%	5.1%
Other	0.5%	0.0%	0.0%
Utility	0.3%	3.0%	2.3%
Insurance	0.0%	1.1%	0.6%
Banking	0.0%	1.3%	1.8%
Energy	0.0%	13.5%	14.8%

Top 5 Holdings by Weight	Average Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Meredith Corp 6.875% 01-Feb-2026	CCC1	1,022.5	102.50	Media	0.79	5.79	2.20
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	123.63	Transportation	3.42	5.49	1.77
CommScope Technologies LLC 6% 15-Jun-2025	CCC1	1,300.0	102.01	Technology & Electronics	2.02	5.02	1.24
Banff Merger Sub Inc 9.750% 01-Sep-2026	CCC2	1,475.0	106.56	Technology & Electronics	0.41	5.32	1.21
Sabre GLBL Inc. 7.375% 01-Sep-2025	B1	850.0	108.98	Services	1.34	3.39	1.21

1 Exclusive of Cash. 2 ,3 The Short Duration High Yield strategy is not a benchmarked product; the HY Indices shown are provided solely as a relative market indicators.

This comparison of selected characteristics of representative SKY Harbor portfolios on or about March 31, 2021 is provided for illustrative purposes only and is subject to change without notice in accordance with the strategies' stated objectives and the sole discretion of SKY Harbor's portfolio management team.

Source: SKY Harbor, FactSet, ICE BofA US High Yield Index "H0A0" (HY Market) and ICE BofA 1-5 Year BB-B US Cash Pay High Yield Constrained Index "JCV4" (SD Universe).

Outlook

Risk assets have benefited from resolution of the dominant identified risk – the US election – and positive news regarding key vaccine developments and enhanced treatment protocols to reduce the ongoing risks associated with the second most identified risk – COVID-19. The sharp rise in interest rates suggests investors have shifted towards focusing on the potential for less supportive monetary policy and potentially an accelerated path to yet higher rates.

Investor perception of risks around fundamentals has benefited from widespread positive earnings surprises in the most recent quarter. We expect default rates to normalize rapidly in 2021 and the ratings cycle to shift toward more upgrades than downgrades. We believe the opportunity is that the path to lower defaults and higher recoveries is faster and that the credit quality for the overall market improves more rapidly than currently forecasted, creating support for additional spread compression.

We believe the market has excess return opportunity associated with sector allocation and credit picking and are mindful of tighter valuations across better-quality segments of the market. Unlike last year when picking bonds with recovering results and attractive valuations was a key driver of returns, this year we expect returns will be a function of missing companies that stumble and are rerated to higher yields. Our valuation work suggests a modest bias towards cyclicals versus defensive issuers and smaller issue sizes over larger issues that have been pushed tighter by ETF buying. We are also biased towards the sectors that are better positioned relative to risks of rising corporate tax rates, increased regulations and stimulus-induced spending.

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

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