High Yield Market Update

Q2 was the third worst quarterly return for the high yield market in the last 20+ years, behind Q1’20’s COVID lockdown impacted quarter (-13.12%) and Q4’08’s peak of the Great Financial Crisis (-17.63%). A reweighting of the risk of a recession, on-going Fed policy moves to combat high inflation, COVID related lockdowns in China and the ongoing war in Ukraine weighed on investor sentiment. WTI Crude closed up $5.48/bbl (5.46%) to $105.76/bbl. Treasuries saw historic volatility, ending the period with the 2-year up 62 basis points (bps) to 2.96% and the 10-year up by 68 bps to 3.02% with intermittent curve inversion.

High yield market technicals were marked by negative net supply, with an all-but dead primary market. Using JPM supplied data, the high yield market has shrunk by the second most on record and is running a supply shortage of over $100 billion despite retail outflows. High yield funds and ETFs had outflows of $17.2bn while loan funds saw outflows of $2.2bn, as tracked by Lipper and reported by Barclays. Q2 bond new issuance remained extremely low, with $24.4bn pricing in the quarter, offset by $53.7bn of bond redemptions or upgrades, leaving net supply at -$29.3bn for the period, per Barclays. The percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 5.9%; the comparable figure for the loan market (below 80% of par) was 3.7%, per JP Morgan. The par-weighted twelve-month high yield bond default rate was 0.5% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned -9.97% in Q2, ending the period with an average price of 85.62, an 11.43 point decrease from the prior quarter. Credit spreads widened by 249 bps to 585 bps and the yield-to-worst (YTW) increased by 2.95% to 8.88%. High yield outperformed small cap equities, represented by the Russell 2000’s -17.49% return, as well as large cap equities, as represented by the S&P 500’s -16.45% return, but underperformed investment grade corporates, as represented by the ICE BofA US Corporate Index’s -6.71% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned -8.62%, -10.70% and -13.91%, respectively. Returns were negative across all sectors for the quarter with Utility the top performing sector in Q2'22, returning -7.72%, while the Healthcare sector was the weakest performing of the quarter, returning -12.43%.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) were not well positioned for the historic selloff in Q2 and underperformed their respective benchmarks. Unlike in the first quarter where rate risk was mostly penalized, the second quarter saw a dramatic repricing of credit and liquidity risk. Our portfolios generally benefited from our more down in quality positioning and focus on smaller sized issues where we saw attractive relative value in the face of a strong upgrade cycle last year. While we began rotating early in the year, the market’s repricing of risk was too rapid and market liquidity too low to fully reposition the portfolio in advance of a selloff of risk. By risk type (defined by yield and duration to worst), both security selection and allocation were sources of underperformance. The primary drivers of relative returns were an overweight to the bottom-performing, most speculative securities and weaker selection within the better-quality part of the market (yielding 6-7%). Underperformance was moderated by an underweight to the longest duration securities. Cash was also helpful in a historic down quarter. By sector, our underweight to lower performing Healthcare and overweight to higher performing Capital Goods were positive contributors to relative returns but were offset by weaker selection in Media and Technology. By rating, higher quality led and our overweight to Triple-C rated credit and weaker selection within Single-B rated securities hurt relative returns.

Our **Short Duration High Yield** (SDHY) portfolios were not immune to the sharp sell-off in Q2, posting a negative return but outperforming the broader US high yield market’s negative return (as measured by the ICE BofA US High Yield Index). A duration shorter than the broad market helped to dampen volatility throughout the quarter. By risk type, the most defensive securities (maturing in 3 years or less) outperformed longer duration (within the context of short duration) and more speculative securities. By sector, Real Estate and Leisure led while Media and Technology lagged though all sectors were negative for the quarter. By rating, higher quality led, with Double-Bs outperforming Single-Bs and Triple-Cs.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	5.21	5.84
Yield to Worst	9.26%	8.88%
Current Yield	7.31%	6.68%
Duration to Worst	4.12	4.50
OAS	615	585
Avg Coupon	6.42%	5.72%
Number of Issuers	122	933
Number of Issues	145	1997
Average ML Rating	B1	B1
Average Price	87.8	85.6

Distribution by Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	0.3%	0.0%
BB Holdings	36.2%	52.5%
B Holdings	46.8%	36.8%
CCC or Under	16.7%	10.8%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	2.1%	0.5%
250 - 500M	44.8%	24.6%
500 - 750M	20.9%	22.2%
750 - 1000M	7.6%	17.4%
1000+M	24.5%	35.3%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Capital Goods	16.7%	6.3%	265%
Basic Industry	13.2%	7.4%	178%
Services	10.1%	6.5%	155%
Media	8.1%	8.5%	96%
Healthcare	7.5%	9.2%	81%
Energy	7.4%	13.0%	57%
Consumer Goods	6.5%	3.5%	186%
Technology & Electronics	5.8%	4.4%	131%
Real Estate	5.4%	3.9%	138%
Leisure	4.1%	6.9%	59%
Transportation	4.1%	2.0%	205%
Retail	3.7%	5.3%	70%
Telecommunications	3.1%	7.9%	40%
Automotive	2.3%	4.7%	50%
Financial Services	1.9%	4.8%	40%
Insurance	0.1%	1.5%	8%
Utility	0.0%	2.9%	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
Interface Inc. 5.500% 01-Dec-2028	B1	300.0	84.71	Basic Industry	5.14	8.65	2.25
The Manitowoc Company Inc. 9% 01-Apr-2026	B3	300.0	93.10	Capital Goods	3.00	11.30	1.89
Kennedy Wilson Inc 5.000% 01-Mar-2031	BB3	600.0	77.50	Real Estate	6.46	8.76	1.85
Neon Holdings Inc 10.125% 01-Apr-2026	B3	495.0	95.29	Services	2.95	11.70	1.84
Danaos Corp. 8.500% 01-Mar-2028	BB3	300.0	99.00	Transportation	4.29	8.72	1.78

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	3.6	5.8	3.4
Yield to Worst	8.90%	8.88%	8.54%
Current Yield	7.08%	6.68%	6.66%
Duration to Worst	3.0	4.5	2.8
OAS	581	585	549
Avg Coupon	6.49%	5.72%	6.12%
Number of Issuers	154	933	461
Number of Issues	182	1997	670
Average Rating	B1	B1	BB3
Average Price	91.62	85.62	91.85

Distribution by Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.0%	0.0%	0.0%
BBB Holdings	2.4%	0.0%	0.0%
BB Holdings	39.2%	52.5%	52.2%
B Holdings	49.6%	36.8%	47.8%
CCC or Under	8.8%	10.8%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	5.4%	0.5%	0.0%
250 - 500M	36.6%	24.5%	19.5%
500 - 750M	21.2%	22.1%	28.9%
750 - 1000M	15.1%	17.4%	14.1%
1000+M	21.7%	35.5%	37.6%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Basic Industry	12.9%	7.4%	5.6%
Capital Goods	12.2%	6.3%	7.5%
Services	10.4%	6.5%	5.9%
Healthcare	9.3%	9.2%	6.5%
Media	8.1%	8.5%	6.0%
Telecommunications	6.8%	7.9%	7.2%
Automotive	6.6%	4.7%	4.1%
Financial Services	6.1%	4.8%	7.4%
Leisure	5.7%	6.9%	9.3%
Consumer Goods	4.4%	3.5%	2.7%
Real Estate	4.4%	3.9%	5.1%
Retail	4.3%	5.3%	4.4%
Technology & Electronics	4.3%	4.4%	2.9%
Transportation	4.1%	2.0%	3.8%
Other	0.5%	0.0%	0.0%
Energy	0.0%	13.0%	15.8%
Utility	0.0%	2.9%	3.0%
Insurance	0.0%	1.5%	1.1%
Banking	0.0%	1.3%	1.7%

Top 5 Holdings by Weight	Average Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
Townsquare Media Inc. 6.875% 01-Feb-2026	B2	550.0	89.00	Media	2.96	10.64	1.87
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	103.90	Transportation	2.40	10.22	1.69
Neon Holdings Inc 10.125% 01-Apr-2026	B3	495.0	95.29	Services	2.95	11.70	1.48
Uber Technologies, Inc. 8.0% 01-nov-2026	B3	1,500.0	99.55	Technology & Electronics	3.56	8.12	1.42
Tenneco Inc. 5.375% 15-Dec-2024	B3	225.0	96.81	Automotive	2.25	6.80	1.37

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 June 30, 2022 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

Fed Chairman Powell commented in recent testimony that "we hope that growth will remain positive." While "hope" appears to have become a monetary policy tool, we remind ourselves that "hope" is not part of our fundamental investment process. Our process is grounded in quantifying issuer-specific corporate financial flexibility that is associated with profitability trends and credit market conditions. As a reminder, Q1 earnings generally surprised to the upside as companies were in many cases able to push through sufficient price increases to recoup margin lost to supply chain related pressures over the last year. We acknowledge the negative impact on overall economic growth and corporate profitability associated with the feedback loop of weak consumer, business, and investor confidence. Upcoming quarterly earnings are likely to quantify that negative impact and redefine credit market fundamentals, leading investors to price in more default risk. Our probability weighted spread target model suggests fair value remains about 100 bp's higher than present market spreads, but incoming data is likely to shift our scenario weightings, leading to a higher spread target.

Our portfolios have been very much offsides for indiscriminate selling of lower rated credit risk – the exact risk that drove our excess returns as the market recovered from pandemic lows. We have continued to moderate our conviction levels overall, bring down our high conviction weights in some cases and add higher rated risk with durations generally inside of the overall market in the case of broad high yield market portfolios and inside the duration of the portfolio in short duration high yield portfolios. There are risks that are unique to this market cycle that are redefining sector and industry cyclicality, leaving us more focused on screening for strong management execution skills and track records than for sector/industry-based valuation opportunities.

As a note, we have updated our ESG-factor based Value Rubric, having completed our 4th annual bottom-up assessment of the overall US high yield issuer universe for factors that we believe help us to calibrate the risks and opportunities associated with a transition to a more sustainable and inclusive economy. While the perception is that the high yield issuer is rife with "ESG laggards", we would note that over 70% of the issuer universe (up over 60% from 2021) have either a sustainability report and/or notable sustainability commentary, nearly half have dedicated sustainability ownership through either a Chief Sustainability Officer (or committee), over 40% have Chief Diversity Officers (or committees) and nearly 40% highlight sustainable products or services as part of their corporate offerings.

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Broad High Yield Market Strategy portfolios may include 6%-12% of USD-denominated below-investment-grade corporate debt securities that are not included in the ICE BofA US High Yield Index ("Index"). These securities may have variable coupon schedules, scheduled maturity of less than one year, USD-listed issuers domiciled outside the US, issues with less than $250 million in debt outstanding and new-issue securities not yet in the Index due to routine timing lag. The Index reflects no deductions for fees, expenses or taxes.

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Gross performance results do not reflect the deduction of investment management 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. These calculations do not include custodial fees or transaction costs. SKY Harbor's asset-based fees are generally billed monthly or quarterly in arrears. Please refer to 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.

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