High Yield Market Update

Investor perception of risk shifted somewhat in the third quarter although risks associated with inflation remained the most often identified risk according to the BofA Merrill Lynch Credit Investor Survey. Risks associated with China rose sharply over the period and investors became more comfortable with the path towards higher interest rates, leading to a notching lower of rate-related concern. Concern surrounding COVID-19 remained elevated as the Delta variant led to a rise in hospitalizations and deaths in areas of the country characterized by low vaccination rates and limited mask mandates. Investors generally factored the consequences of inflation, China self-imposed restrictions, rates, and the lingering pandemic, into conviction that interest rates will rise as monetary policy is normalized. The high yield market out-performed other notable risk assets. Treasuries ended the period with the 2-year up 3 basis points (bps) to 0.28% and the 10-year up by 2 bp to 1.49% and the US Dollar Index was up 1.94%.

Technicals were not a significant contributor to directional moves in the third quarter of 2021 with minimal inflows and positive net supply. High yield funds and ETFs had inflows of $1.9bn while loan funds saw inflows of $8.1bn, as tracked by Lipper and reported by Barclays. Q3 bond new issuance was slightly down, with $108.9bn pricing in the quarter, offset by $100.3bn of bond redemptions, leaving net supply at $8.6bn for the period, per Barclays. The percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 0.8%; the comparable figure for the loan market (below 80% of par) was 1.3%, per JP Morgan. The par-weighted twelve-month high yield bond default rate decreased to 1.3% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned 0.94% in Q3, ending the period with an average price of 104.64, a 0.65-point decrease from the prior quarter. Credit spreads widened by 11 bps to 310 bps and the yield-to-worst (YTW) increased by 0.23% to 4.00%. High yield outperformed small cap equities, represented by the Russell 2000’s -4.60% return, as well as large cap equities, as represented by the S&P 500’s 0.23% return, and investment grade corporates, as represented by the ICE BofA US Corporate Index’s -0.06% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 1.08%, 0.69% and 1.01%, respectively. Returns were positive across all sectors for the quarter: Energy was the top performing sector in Q3'21, bolstered by rising crude and natural gas pricing with WTI Crude closing up $1.56/bbl (or 2.12%) to $75.03/bbl. the top performer was Energy, while Automotive was the bottom-performing sector as investors interpreted supply chain disruption to mean lower near term operating results.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) posted strong relative returns in Q3. By risk segment (defined by yield and duration to worst), security selection was a source of outperformance while allocation was a source of underperformance. Strong selection within the shortest duration part of the market and the better quality, more rate sensitive part of the market drove returns. Outperformance was somewhat reduced by an underweight to the top-performing, longest duration part of the market and weaker selection in the intermediate risk part of the market (yielding 6-7%). By sector, strong selection in Media, Financial Services, Transportation, Capital Goods and Media was a strong contributor to returns, partially offset by an underweight to Energy and weaker selection in Services. By rating, strong selection in Single-Bs and Double-Bs continues to be a positive contributor to relative returns but outperformance was reduced by an underweight to Double-Bs. BHYM portfolios continue to benefit from high conviction credit holdings, as 11 of the representative portfolio’s top 20 holdings had total returns which exceeded the portfolio return for the quarter.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted positive returns in Q3, capturing over 90% the US high yield market return (as measured by the ICE BofA US High Yield Index). By risk type, intermediate duration (2-3 years) continues to outperform the shortest duration, more defensive securities. All sectors were positive for the quarter, led by Transportation and Financial Services while Automotive and Leisure lagged. By rating, the portfolios' Triple-C securities outperformed Double-Bs and Single-Bs. Lower rated credits continue to drive strong performance as positive earnings momentum lowers the expected default rate over the next 12 months. 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 FASST positioning.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	6.1	6.5
Yield to Worst	5.13%	4.00%
Current Yield	6.53%	5.50%
Duration to Worst	3.2	3.7
OAS	422	310
Avg Coupon	6.78%	5.75%
Number of Issuers	105	934
Number of Issues	120	2117
Average ML Rating	B2	B1
Average Price	103.9	104.6

Distribution by Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	0.6%	0.0%
BB Holdings	19.5%	55.2%
B Holdings	55.5%	33.3%
CCC or Under	24.4%	11.4%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	5.2%	0.5%
250 - 500M	40.9%	24.0%
500 - 750M	27.1%	22.1%
750 - 1000M	12.9%	17.4%
1000+M	13.9%	36.0%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Basic Industry	18.6%	7.8%	237%
Capital Goods	15.2%	6.0%	254%
Media	13.4%	8.5%	157%
Services	10.9%	6.0%	182%
Retail	6.8%	4.9%	139%
Real Estate	4.7%	4.2%	112%
Automotive	4.5%	5.0%	92%
Transportation	4.1%	1.9%	220%
Leisure	3.9%	6.7%	59%
Financial Services	3.7%	4.4%	83%
Energy	3.5%	13.7%	26%
Technology & Electronics	3.4%	4.4%	77%
Healthcare	3.1%	9.0%	35%
Consumer Goods	2.7%	4.8%	56%
Telecommunications	1.4%	7.1%	20%
Insurance	0.0%	1.2%	0%
Utility	0.0%	3.0%	0%
Banking	0.0%	1.4%	0%

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	105.25	Media	1.27	2.83	2.39
Cengage Learning Inc. 9.500% 15-Jun-2024	CCC2	620.0	102.33	Services	0.66	6.05	2.32
United States Steel Corp 6.875% 01-Mar-2029	B2	750.0	106.62	Basic Industry	3.79	5.18	2.27
QUAD/GRAPHICS 7.000% 01-May-2022	B3	238.7	101.37	Media	0.56	4.56	2.27
Park-Ohio Industries Inc. 6.625% 15-Apr-2027	CCC1	348.8	99.88	Capital Goods	4.44	6.65	2.24

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	4.3	6.5	3.4
Yield to Worst	3.74%	4.00%	3.10%
Current Yield	6.48%	5.50%	5.79%
Duration to Worst	1.6	3.7	1.8
OAS	331	310	270
Avg Coupon	6.80%	5.75%	6.11%
Number of Issuers	153	934	453
Number of Issues	196	2117	673
Average Rating	B2	B1	BB3
Average Price	105.00	104.64	105.53

Distribution by Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.0%	0.0%	0.0%
BBB Holdings	0.8%	0.0%	0.0%
BB Holdings	22.3%	55.2%	56.2%
B Holdings	62.3%	33.3%	43.8%
CCC or Under	14.6%	11.4%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	5.7%	0.5%	0.2%
250 - 500M	32.5%	23.9%	18.3%
500 - 750M	21.5%	22.0%	26.4%
750 - 1000M	15.9%	17.4%	15.7%
1000+M	24.3%	36.2%	39.3%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Capital Goods	12.4%	6.0%	7.7%
Basic Industry	12.3%	7.8%	7.5%
Media	11.9%	8.5%	5.2%
Services	10.0%	6.0%	5.1%
Technology & Electronics	8.9%	4.4%	4.5%
Automotive	7.2%	5.0%	4.3%
Healthcare	7.0%	9.0%	7.4%
Telecommunications	5.2%	7.1%	5.2%
Transportation	4.6%	1.9%	4.2%
Leisure	4.5%	6.7%	8.1%
Financial Services	4.5%	4.4%	7.1%
Retail	4.3%	4.9%	4.9%
Real Estate	3.8%	4.2%	5.2%
Consumer Goods	2.9%	4.8%	3.1%
Other	0.5%	0.0%	0.0%
Utility	0.0%	3.0%	2.5%
Insurance	0.0%	1.2%	0.6%
Banking	0.0%	1.4%	1.9%
Energy	0.0%	13.7%	15.5%

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	1,022.8	103.25	Media	0.33	2.19	2.06
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	123.75	Transportation	3.10	4.81	1.65
Avaya Inc. 6.125% 15-Sep-2028	B1	1,000.0	105.15	Technology & Electronics	3.49	4.68	1.42
TENNECO INC 5.375% 15-Dec-2024	B3	225.0	99.92	Automotive	2.46	5.39	1.21
Plastipak Holdings Inc. 6.250% 15-Oct-2025	B3	500.0	101.78	Capital Goods	0.08	3.57	1.20

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 relative market indicators.
This comparison of selected characteristics of representative SKY Harbor portfolios on or about September 30, 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

Investors in credit assets remain torn between a focus on the generally improving fundamentals of corporate issuers as the economy pushes through various headwinds and the threat associated with rising interest rates. US fiscal policy is creating drama and presents a clear and present danger should the game of brinkmanship being played around the debt ceiling spiral out of control.

In our view, current valuations are broadly supported by fundamentals which have benefited from a strong recovery in earnings and generally strong aggregate economic data. Default risk is rapidly normalizing, and the credit ratings cycle is swinging to the positive after a pandemic-induced downgrade cycle. We continue to believe that there remains an opportunity around spread compression based upon lower defaults and strong economic and market conditions.

We believe the market has excess return opportunity associated with carry, sector allocation and credit picking and are mindful of tighter valuations across better quality segments of the market that are vulnerable to a duration-based sell-off as rates move somewhat higher. Unlike last year where picking bonds with recovering results and attractive valuations was a key driver of returns, this year we expect returns will be a function of avoiding companies that stumble and are rerated to higher yields. Our valuation work suggests a bias towards lower rated credit that typically is lower duration and shorter duration assets in general.