High Yield Market Update

A below expectation July CPI reading and Chair Powell’s July press conference comments that as “monetary policy tightens further, it likely will become appropriate to slow the pace of increases” drove rallies in US equity and credit markets between mid-July and mid-August. A very hawkish Jackson Hole Powell speech quashed hopes of an early Fed pivot and risk assets struggled most of September, only turning more positive late in the month when investors again started to anticipate a dovish pivot – this time with those hopes based not on any view that inflationary pressures were peaking but rather that market stress was going to result in some breakdown in financial market functionality. The Fed’s commitment to “higher for longer” was confirmed early in the new quarter as numerous Fed governors used speaking engagements to highlight ongoing risks around inflation, leading to a return to negative returns for risk assets. Energy was one of the top returning sectors for the quarter even as Oil prices came down, with WTI Crude closing down $26.27/bbl (24.84%) to $79.49/bbl. Volatility persisted in treasuries, ending the period with the 2-year up 132 basis points (bps) to 4.28% and the 10-year up by 82 bps to 3.83% as the yield curve flattened.

High yield market technicals were mixed in the second quarter with mutual fund outflows and negative net supply. High yield funds and ETFs had outflows of $5.9bn while loan funds saw outflows of $13.3bn, as tracked by Lipper and reported by Barclays. Q3 bond new issuance remained extremely low, with $18.5bn pricing in the quarter, offset by $27.1bn of bond redemptions or upgrades, 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 8.9%; the comparable figure for the loan market (below 80% of par) was 6.7%, per JP Morgan. The par-weighted twelve-month high yield bond default rate was 1.13% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned -0.68% for the quarter, ending the period with an average price of 83.71, a 1.91-point decrease from the prior quarter. Credit spreads tightened by 47 bps to 538 bps and the yield-to-worst (YTW) increased by 0.61% to 9.49%. High yield outperformed small cap equities, represented by the Russell 2000’s -2.53% return, as well as large cap equities, as represented by the S&P 500’s -5.28% return, and investment grade corporates, as represented by the ICE BofA US Corporate Index’s -5.11% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned -0.88%, -0.59% and -0.17%, respectively. Returns were mixed across sectors for the quarter with Transportation the top performing sector in Q3'22, returning 1.68% while the Banking sector was the weakest of the quarter, returning -4.34%.

Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy (BHYM)** underperformed the index in Q3. The underperformance was generated in the strong up market of July as the portfolio was less negative in the two down months, indicative of how we have positioned since Q2. By risk type (defined by yield and duration to worst), both allocation and security selection were sources of underperformance. By rating, weaker selection in Double-Bs and Triple-Cs drove relative returns, somewhat reduced by strong selection within Single-Bs. By sector, strong selection in Basic Industry and Healthcare were positive contributors to returns but were offset by weaker selection in Media (almost entirely due to our exposure to Audacy Capital). Audacy Capital structure had traded down on concerns around the company's more restricted financial flexibility in the face of lower ad spending.

Our **Short Duration High Yield** (SDHY) portfolios posted modestly positive returns in Q3, outperforming the broad US high yield market’s negative return (as measured by the ICE BofA US High Yield Index). A duration shorter than the broader market continues to be a positive contributor during periods of heightened volatility. By risk type, the shortest duration, most defensive securities outperformed longer duration (within the context of short duration) and more speculative securities. By sector, Insurance and Real Estate led in Q3 while Media and Capital Goods lagged. By rating, higher quality led, with Single-Bs and Double-Bs substantially outperforming Triple-Cs.

Portfolio Characteristics

Representative Broad High Yield Market Portfolio

Characteristics	Portfolio[1]	HY Market
Avg Years to Maturity	5.2	5.6
Yield to Worst	9.04%	9.48%
Current Yield	6.99%	6.85%
Duration to Worst	4.15	4.34
OAS	480	538
Avg Coupon	6.10%	5.73%
Number of Issuers	136	923
Number of Issues	175	1964
Average ML Rating	B1	B1
Average Price	87.3	83.7

Distribution by Rating	Portfolio[1]	HY Market
A Holdings	0.0%	0.0%
BBB Holdings	1.9%	0.0%
BB Holdings	42.3%	52.7%
B Holdings	46.2%	36.3%
CCC or Under	9.7%	11.0%

Distribution by Issue Size	Portfolio[1]	HY Market
0 - 250M	1.6%	0.5%
250 - 500M	35.1%	24.8%
500 - 750M	20.3%	22.5%
750 - 1000M	14.5%	17.0%
1000+M	28.6%	35.2%

Distribution by Sector	Portfolio[1]	HY Market	SKY as % of HY Market
Capital Goods	12.1%	6.4%	190%
Basic Industry	11.1%	7.5%	148%
Energy	10.0%	12.8%	78%
Services	9.6%	6.6%	145%
Healthcare	9.5%	8.9%	107%
Media	7.5%	8.7%	86%
Real Estate	5.9%	3.8%	154%
Technology & Electronics	5.6%	4.4%	129%
Leisure	5.6%	7.3%	77%
Consumer Goods	5.6%	3.6%	156%
Retail	4.5%	5.3%	84%
Transportation	4.2%	2.1%	199%
Automotive	3.6%	4.8%	73%
Telecommunications	3.2%	7.1%	45%
Financial Services	2.1%	5.0%	43%
Insurance	0.0%	1.5%	0%
Utility	0.0%	2.9%	0%
Banking	0.0%	1.3%	0%

Top 5 Holdings by Weight	Average 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	84.69	Basic Industry	4.91	8.65	2.24
IEA Energy Services LLC 6.625% 15-Aug-2029	B2	300.0	97.54	Basic Industry	5.38	7.08	1.72
Kennedy Wilson Inc 5.000% 01-Mar-2031	BB3	600.0	72.51	Real Estate	6.32	9.89	1.67
Delta Air Lines Inc 7.375% 15-Jan-2026	BB1	857.1	101.09	Transportation	2.78	6.99	1.45
ATS Automation Tooling Systems 4.125% 15-Dec-2028	B1	350.0	82.92	Capital Goods	5.18	7.63	1.33

Representative Short Duration High Yield Portfolio

Characteristics	Portfolio[1]	HY Market[2]	SD Universe[3]
Avg Years to Maturity	3.2	5.6	3.3
Yield to Worst	8.82%	9.48%	8.91%
Current Yield	6.70%	6.85%	6.65%
Duration to Worst	2.7	4.3	2.8
OAS	450	538	463
Avg Coupon	6.17%	5.73%	6.04%
Number of Issuers	148	923	464
Number of Issues	175	1964	685
Average Rating	B1	B1	BB3
Average Price	92.01	83.71	90.88

Distribution by Rating	Portfolio[1]	HY Market[2]	SD Universe[3]
A Holdings	0.0%	0.0%	0.0%
BBB Holdings	2.0%	0.0%	0.0%
BB Holdings	36.9%	52.7%	52.9%
B Holdings	55.4%	36.3%	47.1%
CCC or Under	5.7%	11.0%	0.0%

Distribution by Issue Size	Portfolio[1]	HY Market[2]	SD Universe[3]
0 - 250M	7.2%	0.5%	0.0%
250 - 500M	37.3%	24.7%	18.7%
500 - 750M	20.4%	22.3%	28.8%
750 - 1000M	15.3%	16.9%	14.0%
1000+M	19.7%	35.5%	38.5%

Distribution by Sector	Portfolio[1]	HY Market[2]	SD Universe[3]
Basic Industry	13.2%	7.5%	6.4%
Services	9.3%	6.6%	6.3%
Capital Goods	8.3%	6.4%	8.8%
Healthcare	8.3%	8.9%	5.2%
Media	8.2%	8.7%	8.0%
Real Estate	7.8%	3.8%	4.8%
Automotive	7.1%	4.8%	4.0%
Retail	6.4%	5.3%	4.5%
Leisure	6.4%	7.3%	9.7%
Financial Services	6.1%	5.0%	7.0%
Consumer Goods	5.2%	3.6%	2.4%
Energy	4.0%	12.8%	14.1%
Telecommunications	3.8%	7.1%	6.3%
Technology & Electronics	3.8%	4.4%	2.8%
Transportation	0.7%	2.1%	3.8%
Utility	0.7%	2.9%	3.5%
Insurance	0.6%	1.5%	0.7%
Other	0.0%	0.0%	0.0%
Banking	0.0%	1.3%	1.9%

Top 5 Holdings by Weight	Average Rating	Issue Size ($mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
TENNECO INC 5.375% 15-Dec-2024	B3	225.0	97.55	Automotive	0.01	6.00	1.53
Select Medical Corporation 6.250% 15-Aug-2026	B3	1,225.0	94.09	Healthcare	3.32	8.05	1.10
OneMain Financial Corp. 6.125% 15-Mar-2024	BB2	1,270.4	96.32	Financial Services	1.35	8.87	1.10
Uber Technologies, Inc. 8.0% 01-Nov-2026	B3	1,500.0	100.38	Technology & Electronics	1.83	7.80	1.10
iStar Inc 4.750% 01-Oct-2024	BB2	753.6	98.62	Real Estate	1.88	5.49	1.06

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 September 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

While Chairman Powell's speech at Jackson Hole had the effect of realigning the market's expectation of higher rates for longer, it did not materially change SKY Harbor's expectations for the path of rates over the next twelve months. In the intermediate term, we believe that inflation will continue to recede but prove sticky at the 4-5% level if labor markets remain tight. At that point, the Fed would need to either accept higher inflation for some period of time while acknowledging the longer term 2% path or reset expectations for further rate hikes. With additional rate pressure, business expansion and related hiring would likely flounder – tipping the economy into a recession by 2024 but creating labor market slack and eventually a lower rate of overall inflation.

We are of the belief that consensus earnings expectations need to fall in the coming months, and anticipate EBITDA growth for high yield constituents will likely turn negative in 2023. With that said, rapid balance sheet repair in the post-COVID era has provided some cushion for issuers, which we think will translate into worsening – albeit manageable – credit metric migration in the coming quarters. Still, given downside risk to our underlying assumptions, we continue to think a focus on higher-quality credits within the ICE BofA US High Yield Index provides the best risk-reward tradeoff.

We continue to believe that consumer focused industries, particularly retail, will remain under pressure as companies work through excess inventory. We expect current trends in consumer spending will deepen as the cost of heating for the winter season further pressures discretionary spending. The sectors where pricing power remains are also likely to ultimately be forced to roll back prices, although the negative impact on margins may be less severe if costs have been adequately managed. We expect some sectors to remain resilient, like those that are tied to government funded programs, such as semiconductor chip manufacturing on-shoring, EV battery production, and infrastructure build-out. Our focus is less on sector and industry-based risk taking and more on identifying those companies that have demonstrated solid execution in the face of what is now well-known headwinds and who have positioned their business for market share gains in a more constrained economy.

Market spreads in our view remain tight to fair value. We are biased towards up in quality but also mindful that when there is broad-based sentiment to "stay up in quality" that lower rated credit valuations become attractive even when discounted for economic and market headwinds. As a result, we remain disciplined credit pickers – opportunistic across the investment universe and believe that the broad portfolio repositioning we did in the second quarter positions our portfolios for attractive risk-adjusted returns over the next twelve months.

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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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