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Mid-Week Briefing

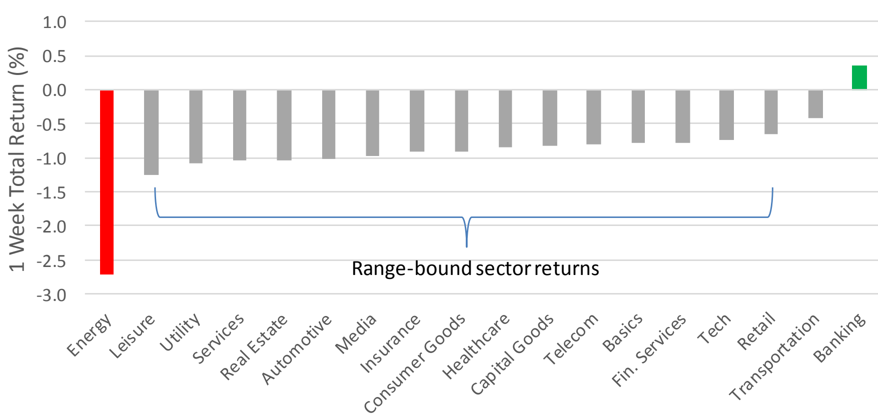
SKYView: Market Selloff

Markets experienced an acute selloff on Monday, largely driven by investor fears that the coronavirus would threaten global economic stabilization. Spread widening in the US high yield market was ~ 65 bps in the five trading days ended January 27, pushing OAS back above 400 bps for the first time since early December '19 (the period immediately preceding the market rally sparked by phase one of a US / China trade deal). The bullet points below summarize recent market reactions, our thoughts around the scope and scale of the correction, and positioning in the current market environment.

- US high yield spreads (we use the ICE BofA US High Yield Index, ticker H0A0, as our proxy) widened 35 bps on Monday, a 3-plus standard deviation move that was more severe than all but 6 trading days in the current cycle and 29 trading days since January 2000. The weekly change in OAS was +65 bps, a move whose post-recession severity is rivaled by only the December '18 market selloff, the commodity crisis in Q1'16, concerns over Greece in December '14, the Q3'11 European sovereign debt crisis, and the May '10 flash crash. **Such prior periods of spread widening proved temporary in nature.**

- In our view, sector returns were less discriminate than we would have expected. Energy is a clear loser in a scenario in which the coronavirus spreads and dampens the outlook for global growth, with oil demand likely to suffer on a decline in China GDP. Beyond Energy, as well as Banking on the outperforming end of the spectrum, sector returns were mostly clustered in the -1.0% to -0.05% range. Investors largely expect Gaming / Leisure, Transportation and Retail to be negatively impacted (reduced travel, avoidance of public places, etc.), as well as Basic Industries (metals are highly levered to Chinese demand). **Given nearly uniform returns among most sectors (excluding Energy), the disruption should prove opportunistic for active management ahead of what we expect will be a more nuanced market reaction in the coming weeks.**

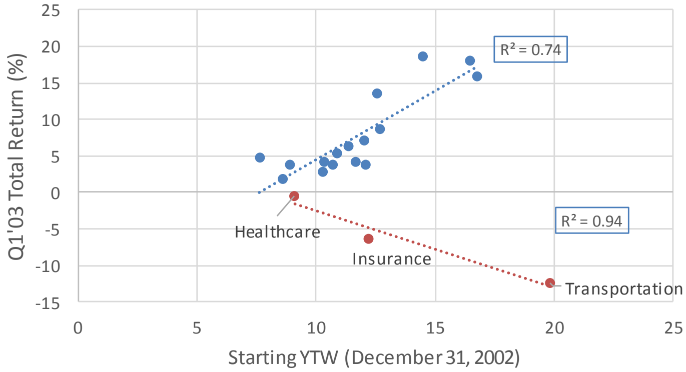
Trailing 1 Week Total Returns by Sector
period ended Jan. 27, 2020



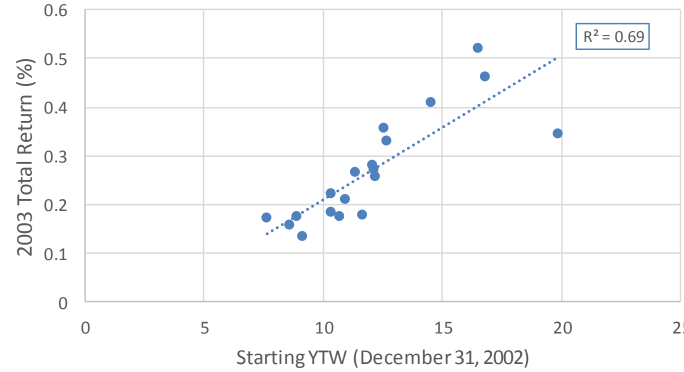
Source: SKY Harbor, ICE BofA Indices

- We expect sector stress, however, to ultimately reverse as the virus moves toward containment. Using the SARS epidemic as our template (it took about six months to resolve, with peak market impact occurring from Q1'03 to Q2'03), we examined US high yield sector returns before, during, and after the outbreak. In general, 2003 returns were quite strong (+28% for the full year) in what was largely characterized as a "risk-on" environment. As such, there was a high degree of correlation between starting yield and subsequent return on a sector basis. Sector weakness during the peak of SARS concerns is evident below, with starting yield (at December 31, 2002) vs. total return (Q1'03) trends highlighting disruption in healthcare, insurance and transportation (China was far less service / consumer oriented in the early 2000s). By the end of 2003, the dislocation had mostly normalized. **We think it makes sense to be opportunistic ahead of sector differentiation, and again when markets normalize, as we do not expect market weakness to result in long-term contagion**.

Starting Yields vs. Total Returns by Sector
Peak SARS Concern Quarter (Q1'03)



Starting Yields vs. Total Returns by Sector
2003 Total Returns



Source: SKY Harbor, ICE BofA Indices

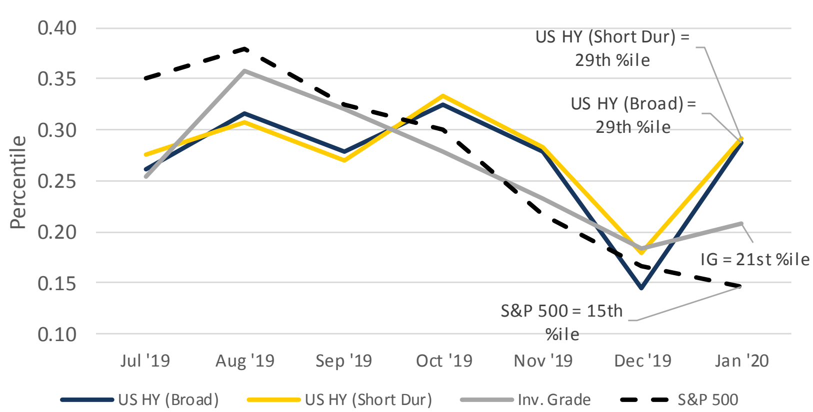
- **Volatility markets are also signaling that the selloff in risk assets may be nearly over**. Following Monday's stock market slump, a Bloomberg article noted that we are now experiencing "…the rare situation where the term structure for the CBOE Volatility Index is inverted. As the VIX surged to its highest level since October, the spot price exceeded the March future prices, indicating more perceived risk in the immediate term rather than the longer term. Such an inversion usually doesn't last long and can be a sign that the selloff may be nearing its end, according to Susquehanna's co-head of derivatives strategy, Chris Murphy." https://www.bloomberg.com/news/articles/2020-01-27/rare-vix-inversion-points-to-potential-end-of-u-s-equity-rout

- **HY ETFs have been volatile, and we expect this to persist given technical pressures**. On Monday, the largest US high yield ETF (HYG) experienced a $1.37bn outflow, partially contributing to underperformance relative to the US high yield index (H0A0) and still trading at a NAV discount. In our view, this dynamic reinforces the value of active management, particularly in times of market stress, and leaves intact our expectation of alpha generation given index dispersion levels. Additionally, our bias for smaller issues ($350mm in size and smaller) due to elevated illiquidity premiums should prove helpful if ETF outflows continue, as HYG and JNK holdings are most concentrated among the largest and most liquid bonds in the index.

- **We believe SKY Harbor was well positioned during Monday's spread shock**. Our fundamental bias towards more domestically focused issuers should prove helpful given the disproportionately negative impact arising from Asian demand drivers. Additionally, smaller issues (defined as a size of $350mm or smaller), which we have sought to focus on following underperformance in 2019, outperformed larger / more liquid structures in the week ended January 27 (total returns of -0.6% for smaller issues vs. total returns of -1.1% for bond issues $1bn in size and larger). Should near-term stress result in ETF outflows, this positioning tilt should provide protection for our portfolios. Finally, shorter duration outperformed longer duration.

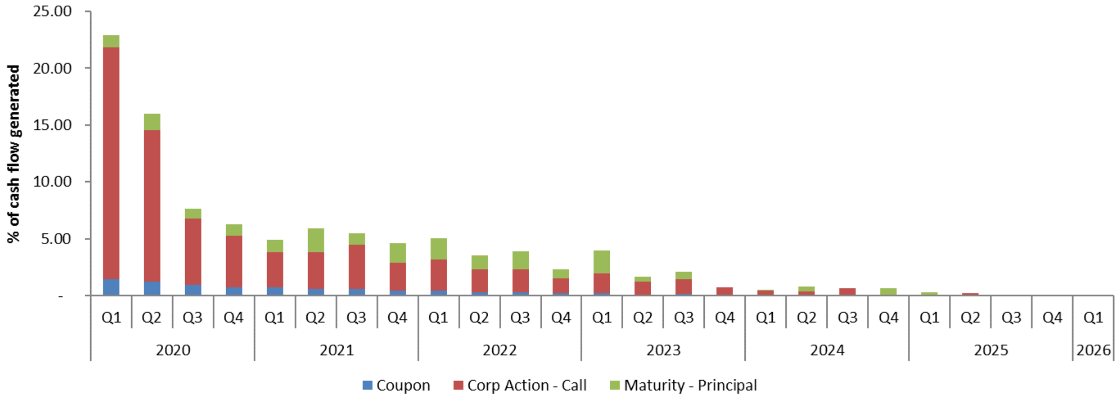
- Following the correction this week, US high yield OAS (both broad market and short duration) widened to 29th percentile levels relative to month-end spreads for each index going back to January 2000. **Compared to US investment grade spreads (21st percentile) and S&P 500 Index P/E ratios (15th percentile), high yield valuations look attractive.**

Asset Class Attractiveness (Percentile Rankings)
based on monthly data since 2000



Note: we use OAS to gauge value for broad high yield (H0A0), short duration high yield (JVC4) and investment grade credit (C0A0); for the S&P 500 (SPX), we use P/E Ratios
Source: SKY Harbor, ICE BofA Indices

- **The near-term turnover of our short duration high yield portfolios should allow us to reposition in the midst of market volatility in a costless manner**. In fact, as much as 23% of our short duration high yield portfolios may be converted to cash in Q1'20 alone.



Source: SKY Harbor, based on SKY Harbor Global Funds–US Short Duration High Yield Fund as of December 31, 2019

- **Our total return expectations for broad high yield (ICE BofA US High Yield Index, ticker H0A0) and short duration high yield (ticker JVC4) remain intact post selloff**. Recall our return expectations for both indices were in the 5% to 6% range for 2020 before the December '19 market rally materialized. Following the selloff this week, broad market and short duration high yield spreads widened to 403 bps and 305 bps, respectively, in line with November 30, 2019 levels used to generate return expectations in our outlook report (402 bps and 301 bps, respectively).

ICE BofAML US High Yield Index - H0A0		
	HY	5yr Trsy
Current Spread	402	163
Target	425	170
Predicted Change	23	7
Duration	3.1	
Index Price	99.1	
Avg Par Coupon	634	
Tsy Change	7	
Total Change in Yield	30	
Capital Gain	-89	
Period Multiplier	1.00	
Current Yield	615	
Default Rate	4.00	
Price (default universe)	48.0	
Credit Loss	25	
Expected Periodic Return (12/1/19 to 11/30/20)	**5.0 %**	

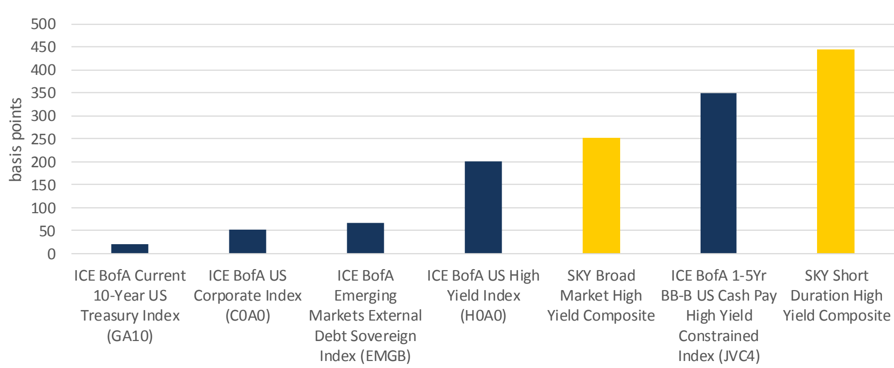
ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index - JVC4		
	SD HY	3yr Trsy
Current Spread	301	160
Target	345	162
Predicted Change	44	2
Duration	1.9	
Index Price	101.3	
Avg Par Coupon	607	
Tsy Change	2	
Total Change in Yield	46	
Capital Gain	-86	
Period Multiplier	1.00	
Current Yield	588	
Rating Migration Rate	2.00	
Price (downgrade universe)	72.6	
Downgrade Loss	7	
Expected Periodic Return (12/1/19 to 11/30/20)	**5.0 %**	

Source: SKY Harbor, BofA Merrill Lynch Model, SKY Harbor variable estimates

- If the coronavirus-derived market dislocation proves less transient than we expect, and yield widening persists, we again highlight the benefits of our broad and short duration high yield strategies with regard to breakevens. As noted in our *Weekly Briefing,* January 27, 2020, **high yield – particularly short duration high yield – can better handle the impact of yield increases (whether due to a rise in Treasury rates or risk premiums)**. In fact, the embedded cushion for SKY Harbor's SKY Short Duration High Yield Composite (~ 450 bps) is nearly 9x greater than the investment grade index (~ 50 bps).

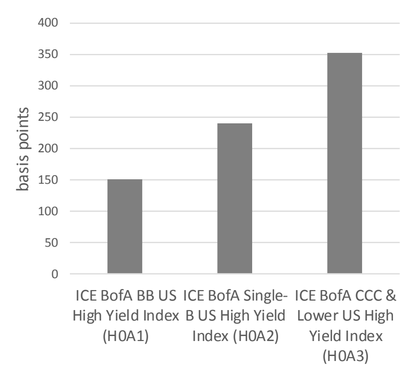
Breakevens by Index

12-month time horizon



US High Yield Breakevens by Rating

12-month time horizon



Source: SKY Harbor, ICE BofA Indices; data as of January '20

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