

## High Yield Market Update

Despite the fourth quarter of 2020 experiencing the much-anticipated second wave of the COVID-19 pandemic, risk assets continued to rally. Markets reacted positively to the US election results as well as US lawmakers agreeing on the terms of the long-awaited second relief package to help ease economic strains. Positive news on the effectiveness of the vaccines and their emergency use authorizations diminished the concerns of the ever-rising number of COVID-19 cases throughout the world. Oil prices rose in Q4 as WTI Crude closed the period up \$8.30/bbl (or 20.64%) to \$48.52/bbl. For the quarter the US Dollar Index was down 4.21% and Treasuries ended the period with the 2-year down 1 basis point (bps) to 0.12% and the 10-year higher by 23 bp to 0.92% as the yield curve slightly steepened.

Technicals were positive in the fourth quarter of 2020 as larger inflows were met with a slowdown of new issuance. High yield funds and ETFs had inflows of \$9.2bn while loan funds saw continued outflows of \$683mm, as tracked by Lipper and reported by Barclays. Q4 bond new issuance was down, pricing \$93.6bn in the quarter, offset by \$78.0bn of bond redemptions, leaving net supply at \$15.6bn for the period, per Barclays. The

percentage of the market trading at distressed levels (below 70% of par) ended the quarter at 1.7%; the comparable figure for the loan market (below 80% of par) was 2.8%, per JP Morgan. The par-weighted twelve-month high yield bond default rate decreased to 7.0% by quarter-end, per BofA Merrill Lynch.

The ICE BofA US High Yield Index returned 6.48% in Q4, ending the period with an average price of 104.61, a 5.47-point increase from the prior quarter. Credit spreads tightened by 152 bps to 383 bps and the yield-to-worst (YTW) was lower by 1.49% to 4.21%. High yield underperformed small cap equities, represented by the Russell 2000's 30.99% return, as well as large cap equities, as represented by the S&P 500's 11.69% return, but outperformed investment grade corporates, as represented by the ICE BofA US Corporate Index's 2.99% quarterly return. In high yield, the Double-B, Single-B and Triple-C sub-indices returned 5.73%, 5.72% and 12.19%, respectively. Returns were positive across all sectors for the quarter: the top performer was Energy, which saw a 13.35% return, while Technology was the bottom-performing sector with a 3.52% return.

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## Portfolio Performance

Portfolios managed according to our Unconstrained **Broad High Yield Market Strategy** (BHYM) posted strong relative returns in Q4. By risk segment, both allocation and security selection were positive contributors to relative performance. The primary drivers of outperformance were an underweight to the most rate sensitive part of the market (yielding 0-5%) and strong security selection within the short duration, most defensive part of the market. Partially offsetting that was an underweight to the higher-performing, long duration segment of the market. By sector, the primary driver was strong security selection within Media and Capital Goods. Outperformance was partially offset by an underweight to top-performing Energy. By rating, BHYM portfolios benefited from an overweight to Triple-C securities as lower quality led, although this was slightly offset by weaker selection within lower-rated credit.

SKY Harbor's Unconstrained **Short Duration High Yield Strategy** (SDHY) portfolios posted solid absolute returns again in Q4, capturing nearly 60% of the broader US high yield market return (as measured by the ICE BofA US High Yield Index) on a gross-of-fee basis, which is in line with the historical capture rate for the strategy. By risk type (defined by yield and duration to worst), the most speculative securities (yielding > 9%), which tend to trade on credit specific events, outperformed while the shortest duration, most defensive securities lagged during the rally in Q4. By sector, Transportation and Media led while Telecom and Insurance fell behind although all sectors were positive for the quarter. 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.

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## Portfolio Characteristics

### Representative Broad High Yield Market Portfolio

Characteristics	Portfolio <sup>1</sup>	HY Market	Distribution by Sector	Portfolio <sup>1</sup>	HY Market	SKY as % of HY Market	
Avg Years to Maturity	6.0	6.4	Capital Goods	17.0%	6.7%	256%	
Yield to Worst	5.08%	4.21%	Services	11.2%	4.4%	257%	
Current Yield	6.67%	5.76%	Media	9.7%	9.1%	107%	
Duration to Worst	2.8	3.3	Basic Industry	9.3%	9.3%	100%	
OAS	475	383	Leisure	6.8%	6.1%	112%	
Avg Coupon	7.03%	6.03%	Healthcare	6.2%	8.8%	70%	
Number of Issuers	113	857	Automotive	5.9%	5.3%	111%	
Number of Issues	145	2003	Technology & Electronics	5.5%	4.8%	115%	
Average ML Rating	B2	B1	Retail	5.4%	4.9%	111%	
Average Price	105.5	104.6	Consumer Goods	5.4%	5.0%	109%	
			Real Estate	4.8%	4.2%	112%	
			Energy	4.2%	13.4%	31%	
			Transportation	2.8%	1.4%	196%	
			Financial Services	2.6%	4.3%	61%	
			Telecommunications	1.9%	6.9%	28%	
			Utility	1.2%	3.1%	39%	
			Insurance	0.0%	1.1%	0%	
			Banking	0.0%	1.3%	0%	
Distribution by Rating	Portfolio <sup>1</sup>	HY Market					
A Holdings	0.0%	0.0%					
BBB Holdings	0.7%	0.0%					
BB Holdings	21.8%	55.2%					
B Holdings	51.9%	32.5%					
CCC or Under	25.6%	12.3%					
Distribution by Issue Size	Portfolio <sup>1</sup>	HY Market					
0 - 250M	8.1%	0.8%					
250 - 500M	39.7%	24.3%					
500 - 750M	12.7%	22.3%					
750 - 1000M	17.0%	16.9%					
1000+M	22.5%	35.6%					
Top 5 Holdings by Weight	BofA Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	115.32	Transportation	3.40	7.68	1.70
Townsquare Media Inc. 6.500% 01-Apr-2023	B3	273.5	101.76	Media	0.04	0.19	1.65
QUAD/GRAPHICS 7.000% 01-May-2022	CCC1	243.5	90.00	Media	1.19	15.50	1.63
Kennedy Wilson Inc 5.875% 01-Apr-2024	BB3	1,150.0	101.50	Real Estate	0.25	3.68	1.53
Park-Ohio Industries Inc. 6.625% 15-Apr-2027	CCC1	348.8	103.50	Capital Goods	3.66	5.69	1.52

### Representative Short Duration High Yield Portfolio

Characteristics	Portfolio <sup>1</sup>	HY Market <sup>2</sup>	SD Universe <sup>3</sup>	Distribution by Sector	Portfolio <sup>1</sup>	HY Market <sup>2</sup>	SD Universe <sup>3</sup>
Avg Years to Maturity	4.1	6.4	3.4	Media	11.6%	9.1%	5.3%
Yield to Worst	4.04%	4.21%	3.49%	Capital Goods	11.1%	6.7%	5.8%
Current Yield	6.37%	5.76%	5.77%	Basic Industry	10.4%	9.3%	9.9%
Duration to Worst	1.6	3.3	1.8	Services	9.0%	4.4%	3.7%
OAS	387	383	330	Technology & Electronics	8.8%	4.8%	4.6%
Avg Coupon	6.69%	6.03%	6.04%	Financial Services	6.9%	4.3%	6.9%
Number of Issuers	152	857	434	Healthcare	6.6%	8.8%	7.5%
Number of Issues	209	2003	702	Real Estate	6.3%	4.2%	6.0%
Average Rating	B2	B1	BB3	Automotive	6.1%	5.3%	4.6%
Average Price	105.07	104.61	104.76	Telecommunications	5.8%	6.9%	4.9%
				Transportation	5.0%	1.4%	3.2%
				Leisure	4.6%	6.1%	8.5%
				Consumer Goods	4.0%	5.0%	4.1%
				Retail	3.0%	4.9%	5.3%
				Other	0.5%	0.0%	0.0%
				Utility	0.3%	3.1%	2.3%
				Insurance	0.0%	1.1%	1.0%
				Banking	0.0%	1.3%	1.6%
				Energy	0.0%	13.4%	14.8%
Distribution by Rating	Portfolio <sup>1</sup>	HY Market <sup>2</sup>	SD Universe <sup>3</sup>				
A Holdings	0.0%	0.0%	0.0%				
BBB Holdings	2.0%	0.0%	0.0%				
BB Holdings	30.6%	55.2%	60.1%				
B Holdings	49.3%	32.5%	39.9%				
CCC or Under	18.1%	12.3%	0.0%				
Distribution by Issue Size	Portfolio <sup>1</sup>	HY Market <sup>2</sup>	SD Universe <sup>3</sup>				
0 - 250M	6.2%	0.8%	0.2%				
250 - 500M	28.9%	24.2%	19.5%				
500 - 750M	22.0%	22.2%	28.2%				
750 - 1000M	10.1%	16.9%	14.0%				
1000+M	32.9%	35.8%	38.1%				
Top 5 Holdings by Weight	Rating	Issue Size (\$mil)	Current Price	BofA Industry	Duration to Worst	Yield to Worst (%)	% of Portfolio
American Airlines Inc. 11.750% 15-Jul-2025	B1	2,500.0	115.32	Transportation	3.40	7.68	1.72
Meredith Corp 6.875% 01-Feb-2026	CCC1	1,272.5	97.50	Media	4.09	7.47	1.69
Banff Merger Sub Inc 9.750% 01-Sep-2026	CCC2	1,475.0	108.01	Technology & Electronics	0.63	4.66	1.27
Sabre GLBL Inc. 7.375% 01-Sep-2025	B1	850.0	108.50	Services	1.54	4.20	1.24
Diebold Nixdorf Incorporated 9.375% 15-Jul-2025	B3	700.0	112.00	Services	1.39	4.22	1.14

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 December 31, 2020 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 "HOAO" (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. Control of the US Senate has now also been settled, providing more clarity around the way forward for the Biden/Harris administration and additional near-term fiscal stimulus. The sharp rise in interest rates in recent trading sessions suggests investors have shifted towards focusing on the potential for less supportive monetary policy and potentially a path to higher rates.

While rising COVID-19 cases are likely to create some headwinds for a recovering economy, we believe this third wave will result in a less negative economic impact than earlier in 2020. Investor sentiment will continue to focus on the risks and opportunities associated with both additional fiscal stimulus and the availability of various monetary policy tools should economic conditions warrant.

Investor perception of risks around fundamentals has benefited from widespread positive earnings surprises in the most recent quarter. We expect default rates to peak at 9%-10% but normalize to 5% in 2021. Earnings should recover strongly next year which, along with declining default rates, is a key support for high yield market 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 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 not owning the bonds of companies that stumble and are related to higher yields. Our valuation work suggests a bias towards cyclicals versus defensive issuers and smaller issue sizes over larger issues that have been pushed tighter by ETF buying.

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