

**Weekly Briefing**

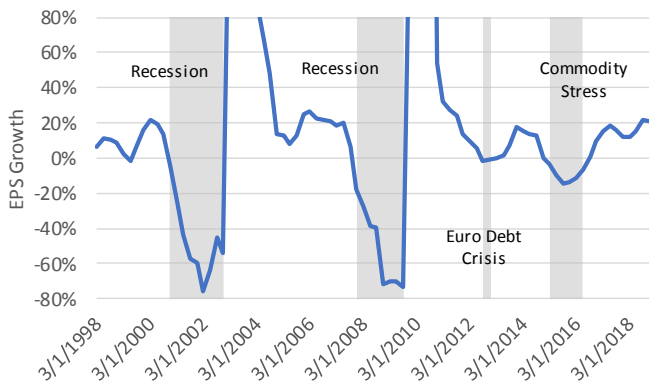
**SKYView: Fundamentals**

As a somewhat uneventful Q4'18 earnings season nears completion, investor attention will inevitably shift toward probable Q1'19 profitability headwinds. As such, the focus of this *Weekly Briefing* is to translate slowing (and potentially negative) S&P 500 earnings growth expectations into a read-through for US high yield issuers, identifying parts of the market that may be at greater risk for fundamental degradation and spread volatility in the near term.

At the time of publication, 99% of S&P 500 constituents had reported Q4'18 (or equivalent) results. While earnings growth remains positive (+13%), the peak is now behind us (earnings growth had exceeded +20% from Q1 through Q3 2018). More concerning is the consensus view that S&P 500 constituents will report negative earnings growth in Q1'19, the worst results for most companies since recovering from the collapse in commodity prices in 2015 and 2016. Such an inflection would be notable as S&P 500 earnings growth rates have only been negative in four periods over the last 20+ years (shaded below in grey). The numbers, however, are not without noise. The buying back of shares over the last several years has artificially boosted company-reported EPS growth, and the grandfathering of US tax reform make prior-year earnings levels more onerous to exceed from a technical standpoint. Therefore, we think it more appropriate to compare S&P 500 EBITDA growth rates over time, as they largely eliminate distortions associated with the aforementioned factors.

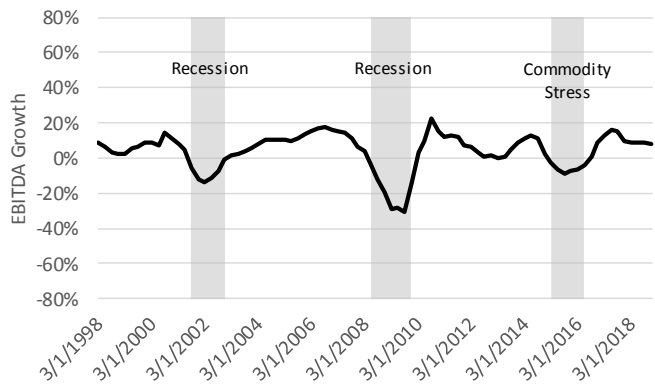
**S&P 500 Index EPS Growth**

quarterly data, negative growth periods shaded grey



**S&P 500 Index EBITDA Growth**

quarterly data, negative growth periods shaded grey

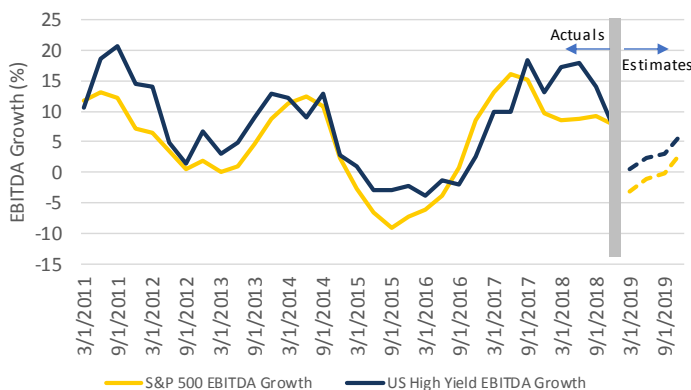


Source: SKY Harbor, Bloomberg, Standard & Poor's, National Bureau of Economic Research

Given the highly correlated nature of earnings and EBITDA growth trends between S&P 500 and US high yield constituents (demonstrated in the left-hand chart below), we used statistical analysis to translate the consensus view on large cap equity earnings to our focus market (as EBITDA growth projections for the high yield universe are not as well-articulated). By our estimates, forecasted Q1'19 earnings growth of -3.4% for S&P 500 members likely translates into EBITDA growth of +0.5% for the US high yield universe (even without taking into consideration the typical downward bias of sell-side equity projections).

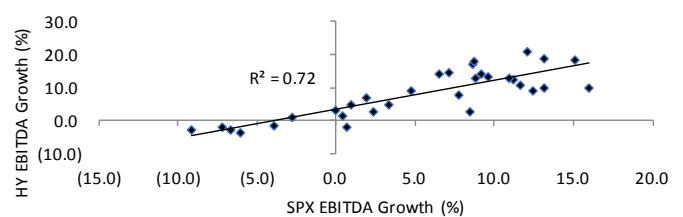
**S&P 500 vs. US High Yield EBITDA Growth**

quarterly data, estimates represented by dotted lines



**Implied US High Yield EBITDA Growth**

projections based on consensus S&P 500 earnings growth estimates



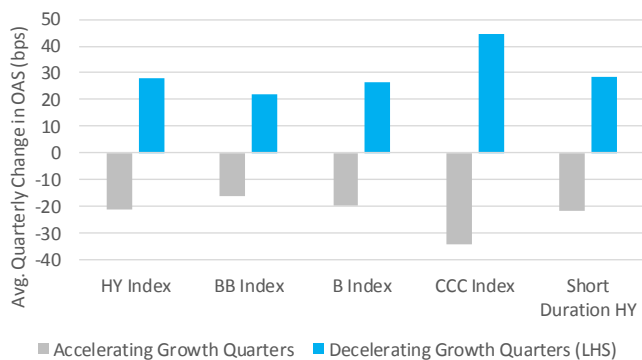
Period	S&P 500 Consensus Earnings Growth (%)	Implied US High Yield EBITDA Growth (%)	90% Confidence Range	
			Lower	Upper
Q1'19	(3.4)	0.5	(0.4)	1.5
Q2'19	0.2	2.3	1.0	3.6
Q3'19	1.7	3.1	1.6	4.5
Q4'19	8.1	6.2	4.2	8.3

Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, FactSet

With a Q1'19 US high yield constituent EBITDA growth estimate range of -0.4% to +1.5%, we can be reasonably sure that the trajectory of profits will slow next quarter, even if they do not turn negative. To better gauge the potential impact such deceleration would have on high yield markets, we bifurcated our data set of quarterly changes in OAS into earnings growth acceleration and deceleration periods (52% and 48% of quarterly observations since 1997, respectively). As expected, spreads tend to widen (on average) during quarters in which earnings growth decelerates on a sequential basis, and vice versa. Furthermore, BBs tend to be more resilient than CCCs in such earnings deceleration quarters, which makes sense intuitively. Noteworthy, however, is the relatively poor upside/downside spread change beta ratio of the BB index, which we largely attribute to the impact of convexity on the rating subset. Since we believe earnings growth will improve in Q2'19, and by virtue of BB outperformance YTD, we remain constructive on Single-Bs.

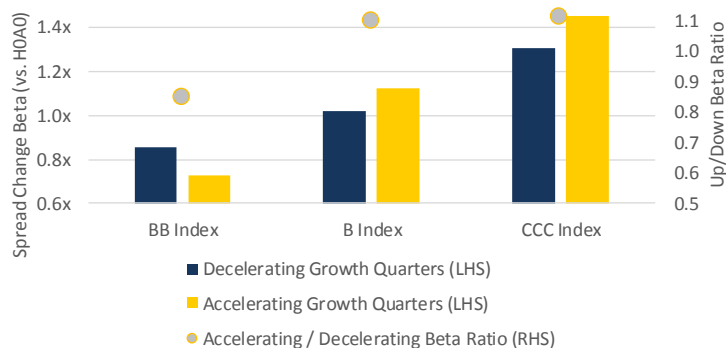
### Change in HY Spread vs. S&P 500 EBITDA Growth Trajectory

quarterly data, since 1997



### Spread Change Beta in Various S&P 500 EBITDA Growth Environments

quarterly data, since 1997

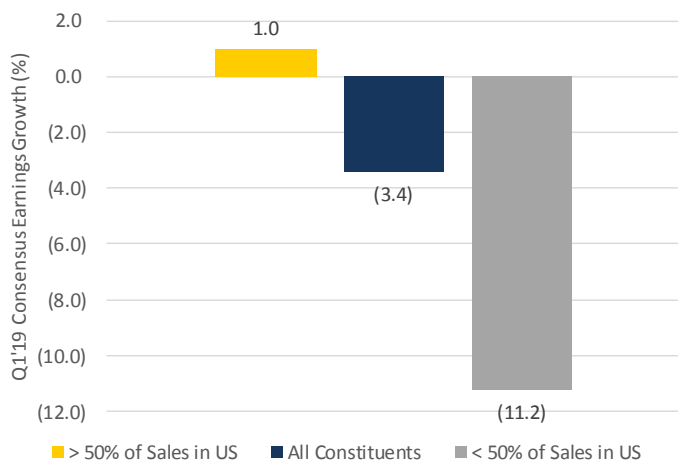


Source: SKY Harbor, ICE BofAML Indices, Bloomberg, Standard & Poor's

Digging into management commentary following the release of Q4'18 results, a couple of themes emerge. First, domestic demand appears markedly stronger than ex-US, with inventory destocking and concerns surrounding slowing China and European economies inhibiting the issuance of high-conviction guidance. S&P 500 constituent earnings growth expectations for Q1'19 appear to echo this sentiment, with analysts expecting US-centric businesses to encounter less severe headwinds (left chart below). Additionally, many management teams have hinted at reducing capex in order to limit y/y declines in free cash flow. Given the highly negative correlation between large corporation capital expenditures and US high yield index spreads and fundamentals, the news has made us more cautious on sectors with sales and EBITDA generation more closely tied to business investment (right chart below).

### S&P 500 Earnings Expectations by Geographic Exposure

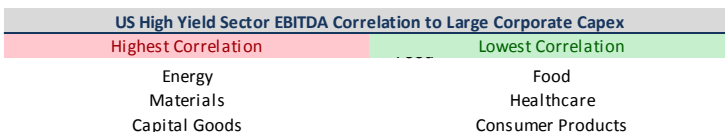
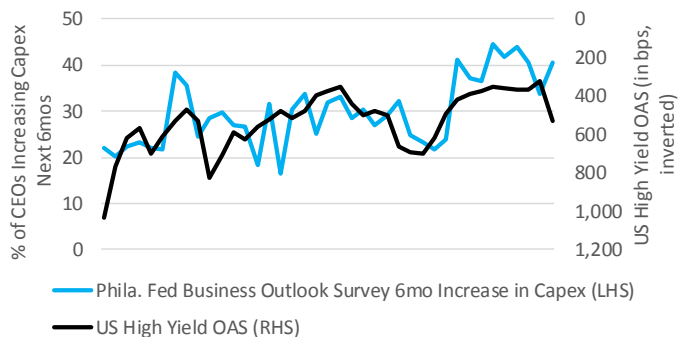
Q1'19 consensus expectations



Source: SKY Harbor, FactSet, ICE BofAML Indices, BofA Merrill Lynch, Philadelphia Federal Reserve

### Large Corporate Capex Negatively Correlated to HY Spreads

quarterly data



In conclusion, investor focus will likely shift toward decelerating (and potentially negative) earnings growth expectations in Q1'19. While this has not historically augured well for US high yield spreads, the trend is expected to reverse by the second quarter. In general, BBs tend to be more resilient in spread-widening environments (as expected) but have historically demonstrated weak upside/downside spread change capture, particularly relevant as earnings improvement for the balance of the year remains our base case assumption. Finally, companies with limited non-US exposure and those less reliant upon larger corporate capex should fare better in the near term, in our view.

## On the Calendar

### Occurred

Event	Release Date	Period	Survey	Actual	Prior
Markit US Services PMI	5-Mar-19	Feb	56.2	56.0	56.2
New Home Sales	5-Mar-19	Dec	600k	621k	657k
Initial Jobless Claims	7-Mar-19	2-Mar	225k	223k	225k

Source: SKY Harbor, Bloomberg

### Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Phila. Fed Business Outlook	21-Mar-19	Mar	4.0		-4.1
Markit US Mfg. PMI	22-Mar-19	Mar	54.0		53.0
Existing Home Sales	22-Mar-19	Feb	5.10m		4.94m

## Recommended Reading

Fidler, Stephen and Norman, Laurence (2019, March 14). UK Parliament Votes to Delay Brexit as Turmoil Drags On. *The Wall Street Journal* (subs. req.), Retrieved from [https://www.wsj.com/articles/u-k-lawmakers-set-to-delay-brexit-as-political-turmoil-drags-on-11552571318?mod=hp\\_lead\\_pos3](https://www.wsj.com/articles/u-k-lawmakers-set-to-delay-brexit-as-political-turmoil-drags-on-11552571318?mod=hp_lead_pos3)

Kennedy, Simon and Schneeweiss, Zoe (2019, March 13). Why the Worst May Already Be Over for the Global Economy. *Bloomberg*, Retrieved from <https://www.bloomberg.com/news/articles/2019-03-14/the-case-for-the-world-economy-s-defense-even-as-growth-slows>

---

## Important Disclosures and Disclaimers

SKY Harbor Capital Management, LLC ("SKY Harbor") provides this document for informational purposes only. The information herein is intended solely for the person to whom it has been delivered. Nothing contained in this document is or should be construed as an advertisement, or an offer to enter any contract, investment advisory agreement, a recommendation to buy or sell securities of any kind, a solicitation of clients, or an offer to invest in any particular fund, product, investment vehicle, or derivative.

This document contains forward-looking statements that are based on SKY Harbor's current views and assumptions. Forward-looking statements such as the findings of our analytical research, our outlook for interest rates, Fed policy, the economy, high yield markets and the like, or our intended adjustments to the portfolios within our strategies are subject to inherent risks, biases and uncertainties that are beyond SKY Harbor's control and may cause actual results to differ materially from the expectations expressed herein.

The information contained herein is subject to change, and SKY Harbor is under no obligation to update any information contained herein. Certain information contained in this document has been obtained from third-party sources and, although believed to be reliable, has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Investing in securities involves risk of loss and past performance is not necessarily indicative of future results. Fixed income securities, especially high yield debt securities, are subject to loss of income and principal arising from credit risk, which is the risk that the issuer will be unable to make interest and principal payments when due. Material risks in investing in high yield debt securities also include, but are not limited to, opportunity cost (the risk that an issuer's credit trends deteriorate resulting in a higher level of compensation demanded by the market relative to the initial investment), interest rate risk, liquidity risk, selection risk, and overall market risk. In general, issuers of high yield debt securities have a greater likelihood of defaulting on the payment of interest or principal than issuers of investment grade bonds. There can be no assurance that the investment objectives described herein will be achieved or that substantial losses can be avoided.

SKY Harbor is not a tax or legal advisor. Prospective investors should consult their tax or legal advisors before making tax-related investment decisions.

The ICE BofAML Index data referenced herein is the property of ICE Data Indices, LLC ("ICE BofAML") and/or its licensors and has been licensed for use by SKY Harbor. ICE BofAML PERMITS USE OF THE ICE BofAML INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BofAML INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND SKY Harbor or ANY OF ITS PRODUCTS OR SERVICES.

© 2019 SKY Harbor. This document may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior written consent of SKY Harbor.