SKY HARBOR
CAPITAL MANAGEMENT

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Weekly Briefing

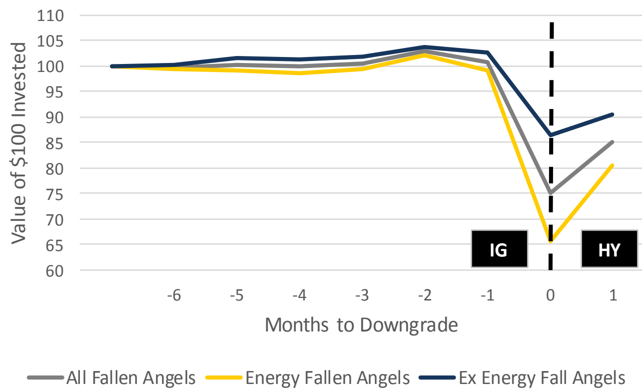
SKYView: Performance Update

Fallen Angels have now surpassed $100bn on a year-to-date basis, trending closer to our $250bn estimate for 2020. Recent fallen angel performance has been strong despite an uptick in volumes, bolstered by changes to the Fed's corporate bond buying facilities which now include BB paper recently downgraded from investment grade. At the same time, lower-quality credit (CCC) continues to lag, with several issuers announcing a missed coupon payment this week. In this *Weekly Briefing*, we quantify fallen angel performance before and after rating agency downgrades, highlight changes to the Fed's Primary and Secondary Market Corporate Credit Facilities, and gauge the risk of principal loss in light of index price, dispersion, and our newly revised recovery rate estimate.

As we have noted in the past, fallen angels have historically performed well following entrance into the high yield index, the majority of selling pressure having most often incurred while still an investment grade rated entity. Recent performance (left chart) is largely consistent with historical trends, albeit with a sharper rebound than usual. As demonstrated below, a select group of large / well-known fallen angels from 2020 have recorded double-digit total returns month to date (through April 16), far exceeding their respective indices.

Fallen Angel Performance: Pre and Post Downgrade

time 0 = month of downgrade, average ticker returns (non-weighted)



Source: SKY Harbor, ICE BofA Indices, Bloomberg

Selected Month-to-Date Fallen Angel Performance

data through April 16, 2020

Issuer (non Energy)		MTD Return (Ticker)
Ford	F	5.0
Kraft Heinz	KHC	2.2
Macys	M	10.3
Royal Carribbean Cruises	RCL	13.2
Spirit Aerosystems	SPR	0.0

Index		MTD Return Index
HY Index	H0A0	4.7
HY ex Energy		3.7
HY BB Index	H0A1	5.4
HY BB ex Energy		4.2

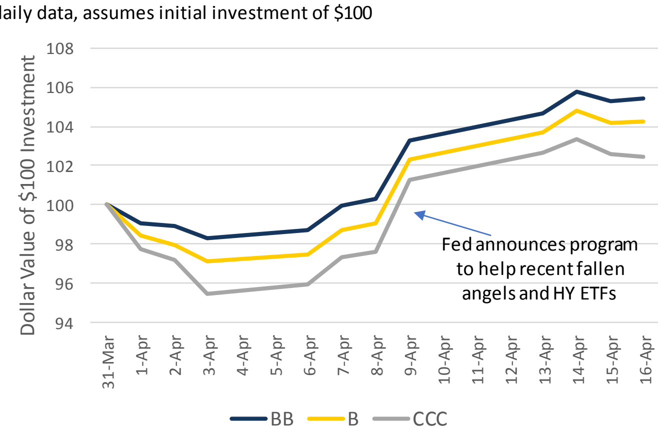
Issuer (Energy)		MTD Return (Ticker)
Continental Resources	CLR	39.0
EQM Midstream	EQM	35.5
EQT corporation	EQT	19.3
Occidental Petroleum	OXY	30.1
Rockies Express	ROCKIE	24.2
Western Midstream	WES	68.7

Index		MTD Return Index
HY Index	H0A0	4.7
HY Energy (H0EN)	H0EN	14.9
HY BB Index	H0A1	5.4
HY BB Energy		18.7

In our view, recent fallen angel performance has been significantly boosted by support from the Fed. As a reminder, on April 9, the Fed announced that it had augmented the scope of recently announced corporate credit facilities to include the purchase of fallen angels (had to be rated IG as of March 22, 2020, and has to be rated at least Ba3 / BB- at the time of purchase). **While on an historical basis fallen angels have outperformed after dropping into the high yield index, we believe the funding backstop explicitly provided by the Fed served to boost sentiment among recently downgraded names**. Of note, the two worst-performing non-Energy fallen angels (Kraft Heinz and Spirit Aerosystems) were not IG rated as of March 22, and therefore ineligible for purchase under the SMCCF. The Fed further announced that they would be open to buying HY ETFs, though the "preponderance" of purchases would focus on the investment grade market. In our view, this announcement represents a material positive for the BB index (both recent fallen angels and existing BBs that may have otherwise been pressured), although lower-rated credit benefits are limited (only via ETF support). Since the announcement, BBs have continued to outperform, while several distressed names have recently filed for bankruptcy protection or elected to not pay their April coupons.

Performance Since April 1

daily data, assumes initial investment of $100



Source: SKY Harbor, ICE BofA Indices, Bloomberg, Federal Reserve

More Bankruptcies on the Horizon

recent announcements

Recently announced bankruptcy filings:

Name	Ticker	Sector	HY Debt ($ millions)
Frontier Communications	FTR	Telecom	13,498

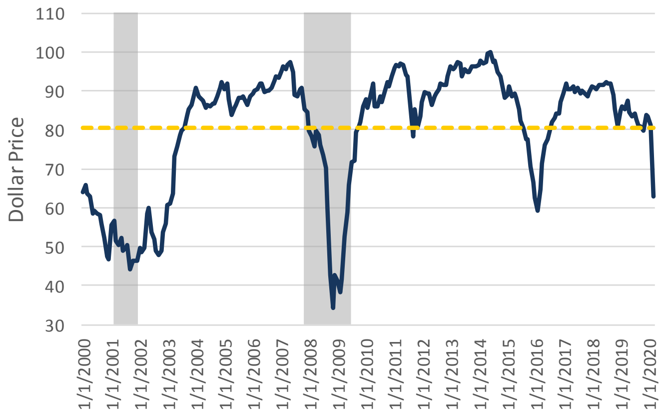
Missed April 15 coupon payments:

Name	Ticker	Sector	HY Debt ($ millions)
Diamond Offshore Drilling	DO	Energy	2,000
J.C. Penney	JCP	Retail	2,101
Neiman Marcus	NMG	Retail	1,228

Although we continue to believe defaults will ratchet up materially in 2020 (in our last *Weekly Briefing*, we projected a 2020 default rate of 8.0% to 8.5%, including 5.5% to 6.0% ex Energy), and acknowledge Fed actions to date have been somewhat disappointing for the CCC rated index cohort, **dispersion should somewhat limit principal losses in the near term**. As demonstrated below, the average CCC index price is now approximately 60, down from nearly 84 at the start of this year. Furthermore, CCC index dispersion (defined as the % of the CCC universe trading outside +/- 400 bps of index average spreads) is quite elevated at present. More specifically, ~ 77% of CCCs now reside outside a +/- 400 bps band surrounding index averages, which is above the OAS-implied fair value level of ~ 70%.

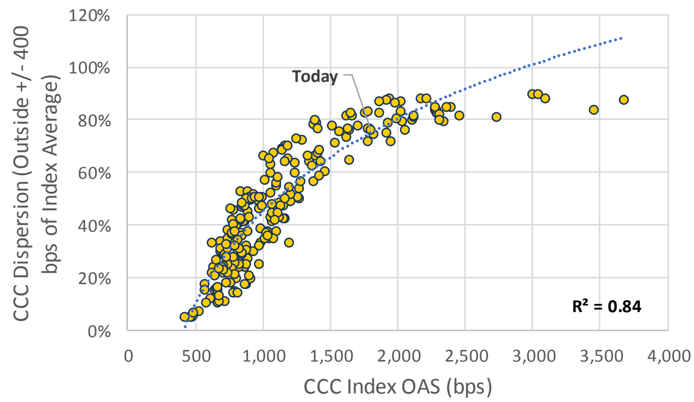
CCC Index Prices Reflect Upcoming Stress

monthly data since 2000



CCC Dispersion Above OAS-Implied Levels

monthly data since 2000

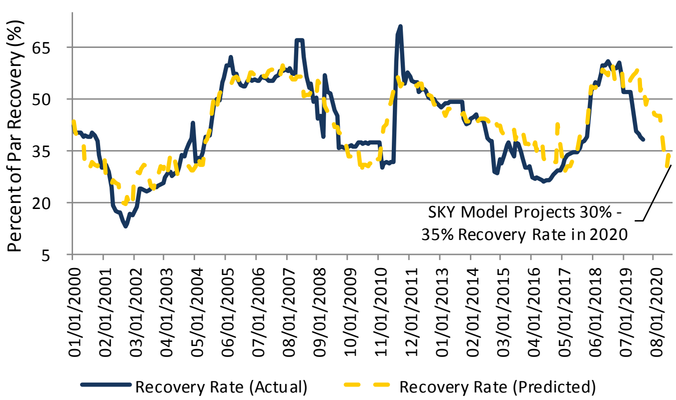


Source: SKY Harbor, ICE BofA Indices, BofA Merrill Lynch

Recovery rates tend to vary somewhat dramatically through the cycle, typically influenced by factors such as industry-wide credit metrics, default concentration at the sector level, the prevalence of defaults among asset-lite industries, lending standards, and the availability of DIP financing and other pools of money typically associated with distressed investment strategies. Using such variables, **we re-ran our internal model, which projects 2020 recoveries falling to ~ 30% to 35%** (below the long-term annual average of 42%, and below recoveries in the 40% range over the last couple of months). Exceptional dispersion within the CCC index, however, should reduce the risk of principal loss despite an expected uptick in defaults and downward pressure on recoveries. In the chart below (right side), we calculate the average bond price of securities trading within the widest 5% to 20% of the high yield index. For example, the average price of the widest 12.5% of the market is ~ 35, essentially in line with our 2020 recovery estimate of 35%. By this measure, and keeping in mind our 2020 default estimate of 8% to 8.5%, we think likely default candidates have largely been identified by the market.

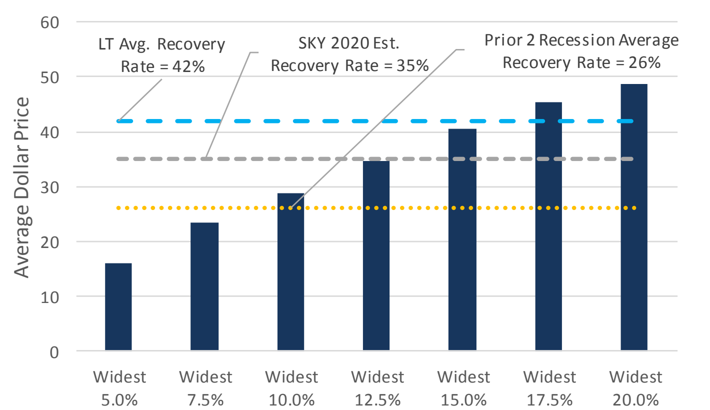
SKY Harbor Recovery Model - Actual vs. Predicted (Monthly)

monthly data, 12 month lag, includes forward looking estimates



Avg. Price of Widest Portions of HY Index Close to Recovery Levels

Issuer-weighted; data as of April 16, 2020



Source: SKY Harbor, ICE BofA Indices, BofA Merrill Lynch, Federal Reserve, Bloomberg

In our view, action by the Fed has bolstered sentiment for BBB rated securities at risk of a downgrade, recent fallen angels and the existing base of BB securities that may have experienced technical pressures from a wave of new paper entering their space. April outperformance of recent fallen angels – and underperformance of credits missing the March 22 IG deadline - highlight this point. At the same time, the lowest-rated portion of US high yield continues to lag, with several credits in the CCC index missing coupon payments this week. Despite an expected uptick in defaults and reduction in average recovery rates for 2020, CCC dispersion and relatively low dollar prices should reduce principal losses incurred by investors under our base case scenario.

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