Mike Salice, CFA
Director of Research
msalice@skyhcm.com
October 21, 2019

Weekly Briefing

SKYView: Fundamentals

Before Q3'19 earnings season begins in earnest, we thought it useful to re-visit recent sector fundamental trends. In addition to measuring credit improvement over the last twelve months, we also look at key risk factors on the horizon, and which sectors may be most exposed to such headwinds over the intermediate term. In this *Weekly Briefing*, we take a fresh look at sector positioning, attempting to identify an optimal mix of fundamental momentum and risk factor resiliency as we update our allocation preferences.

Fundamental Trends

US high yield issuers (we include constituents of the ICE BofAML US High Yield Index, ticker H0A0) have been resilient over the last four quarters despite significant changes in the macroeconomic environment. The ebbs and flows of the US/China trade war, a massive Fed pivot that resulted in both rate hikes and cuts within a seven-month period, ongoing tensions in the Middle East, lingering Brexit uncertainties, a major terrorist attack on Saudi Aramco oil facilities, and a reshuffling of 2020 Democratic frontrunners for US President failed to de-rail corporate issuers. In fact, during the last twelve months, high yield issuer EBITDA has grown over 9% despite a substantial amount of noise. Below, we gauge the path of sector trends over nine key fundamental metrics. In general, we assign a "+" to sectors showing improvement relative to the index, a "–" to sectors showing degradation relative to the index, and a "=" for sectors moving in line with the index.

HY Sector Trends

trailing 4 quarter trends (through Q2'19)

Sector	EBITDA Growth	EBITDA Growth vs. Index	Net Leverage	Interest Coverage	Default Rate (issuer)	Default Rate (par)	Recovery Rate	Net Debt to EV	Distress Ratio
Automotive	+	+	-	-	-	-	=	-	+
Basic Industry	-	-	-	-	-	-	=	-	+
Capital Goods	+	+	-	+	=	=	=	-	+
Consumer Goods	+	+	+	+	+	+	=	+	+
Energy	+	+	+	+	-	-	+	-	-
Healthcare	+	+	+	+	=	=	=	+	-
Leisure	+	+	-	-	=	=	=	-	+
Media	+	-	+	-	+	+	-	+	+
Retail	+	-	-	+	+	+	-	-	-
Services	+	+	+	-	+	-	=	+	+
Technology & Electronics	-	-	-	-	-	-	=	-	+
Telecommunications	+	+	+	+	-	-	=	+	-
Transportation	+	+	-	+	=	=	=	-	=
Utility	+	-	+	-	+	=	=	+	+
HY Index	+	=	=	=	-	-	-	=	-

Source: SKY Harbor, BofA Merrill Lynch, Bloomberg, Capital IQ

Sector Leaders & Laggards

cumulative directionality over trailing 4 quarters

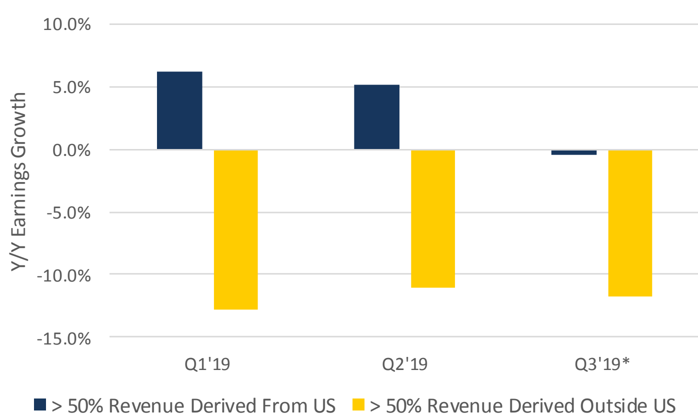
Superior Sector Performance	Inferior Sector Performance
Consumer Goods	Technology
Healthcare	Basic Industries
Services	Autos
Media	Retail

Risk Factor #1: Non-US Customer Base

By virtue of an appreciating USD, as well as generally weaker economic trends outside of the US, large cap corporates with greater foreign exposure have trailed US-centric counterparts in earnings growth in 2019. Trends have persisted since the first quarter, and early indications point to essentially the same as we enter Q3'19 earnings season (note, however, that only 5% of S&P 500 Index constituents have reported Q3 results thus far). For example, in Q2'19, companies that derive greater than 50% of quarterly revenue from US sources had average earnings growth of +5.2%, well above the -11.1% of average earnings growth for companies that derive greater than 50% of quarterly revenue from non-US sources. In the chart below, we assign "+", "–" or "=" marks next to each sector based on non-US sales exposure (for example, the average Media issuer in the high yield index derives ~ 11% of revenue outside of the US, which is below the index average; given headwinds associated with non-US exposure, we view this as a positive, and assign Media a "+" rating).

S&P 500 Earnings Growth: Non-US Exposure Has Been a Drag

quarterly data



HY Sector Impact

LTM revenue data

Sector	
Automotive	-
Basic Industry	-
Capital Goods	-
Consumer Goods	=
Energy	+
Healthcare	=
Leisure	=
Media	+
Retail	+
Services	=
Technology & Electronics	-
Telecommunications	+
Transportation	=
Utility	=

Sectors Most at Risk
Automotive
Capital Goods
Technology & Electronics

Sectors Least at Risk
Retail
Telecommunications
Media

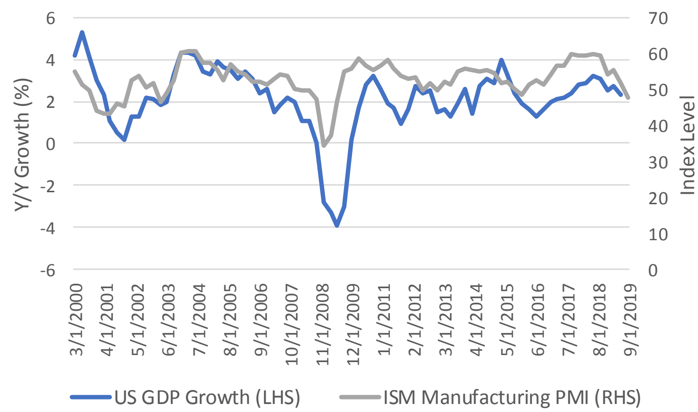
*only 5% of the S&P 500 Index has reported Q3'19 results thus far; Source: SKY Harbor, FactSet, Jefferies, Bloomberg, Capital IQ

Risk Factor #2: Weakening Global Growth / Weak ISM PMI

Earlier this week, the International Monetary Fund (IMF) cited trade tensions as the impetus for a further reduction in 2019 global growth estimates, with global GDP likely to slow to 3.0%, below the 3.2% projection issued in July. Weakening global growth is likely to further depress future PMI readings, as manufacturing woes deepen further from demand erosion brought on by economic uncertainty. Comparing correlations between ISM PMI and US high yield sector spreads (monthly data, since January 2000), we find Basic Industry, Capital Goods, Tech and Automotive to be at most risk in a weakened global growth environment, while Healthcare, Telecom, Utility and Insurance should be most insulated.

US GDP Growth vs. US ISM PMI

quarterly data since 2000



HY Sector Impact

data set correlations

Sector	
Automotive	-
Basic Industry	-
Capital Goods	-
Consumer Goods	+
Energy	-
Healthcare	+
Leisure	=
Media	=
Retail	=
Services	=
Technology & Electronics	-
Telecommunications	+
Transportation	=
Utility	+

Sectors Most at Risk
Basic Industry
Capital Goods
Technology & Electronics

Sectors Least at Risk
Healthcare
Telecommunications
Utility

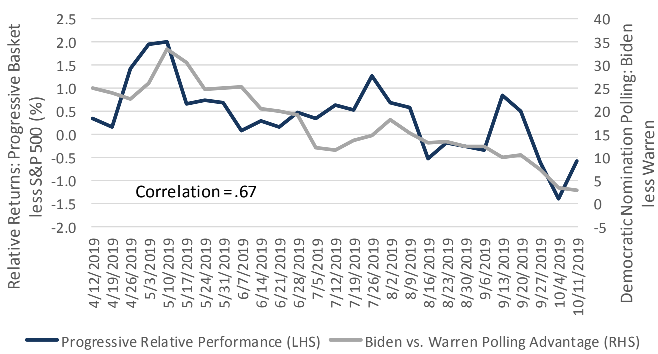
Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices, Bureau of Economic Analysis, Institute for Supply Management

Risk Factor #3: US Presidential Elections

Over the last several months, the front-runner to receive the Democratic nomination to run against President Trump in the 2020 US Presidential election has been Vice President Joe Biden, although he has lost significant ground to Senator Elizabeth Warren in recent months. Goldman Sachs constructed its own "Progressive Policy Basket" (in Bloomberg, ticker GSXUPROG), an index which consists of stocks in industries that it believes would be impacted by progressive policies that could be implemented under a Warren administration (key elements include greater financial and energy regulation, large tech and media anti-trust implications, a wealth tax, Medicare for all Americans, a highly boosted minimum wage, etc.). Below, we plot over-/under-performance of this index relative to the broad market (we use the S&P 500 Index as our proxy) and find a high correlation of this output to Biden's polling position relative to Warren. In general, we find that relative performance of this custom basket has diminished as Biden's lead over Warren in national polls has eroded (i.e., stocks in the index are those that would likely suffer under a more progressive administration, and they have underperformed as Biden's lead over Warren has decreased). Looking at sector constituencies within this custom index, as well as the degree of correlation between the Progressive Policy Basket and monthly changes in US high yield index sector spreads, we find Healthcare (Medicare for all), Energy (increased regulation, more stringent drilling / fracking rules), and Financial Services (increased regulation) to be most at risk. Other sectors at risk could include Capital Goods (negative implications for defense spending), Leisure (higher wage costs via a boost to the minimum wage), and Tech (anti-trust).

<u>Relative Performance</u>: GS Progressive Policy Basket vs. S&P 500 Index *and* Biden vs. Warren Polling Data

weekly data, last 6 months



HY Sector Impact

data set correlations

Sector	
Automotive	=
Basic Industry	=
Capital Goods	-
Consumer Goods	=
Energy	-
Healthcare	-
Leisure	-
Media	-
Retail	=
Services	=
Technology & Electronics	-
Telecommunications	=
Transportation	=
Utility	=

Sectors Most at Risk	Industries Most at Risk
Healthcare	Pharmaceuticals
Energy	Medical Products
Financial Services	Investments & Misc Fin. Svcs

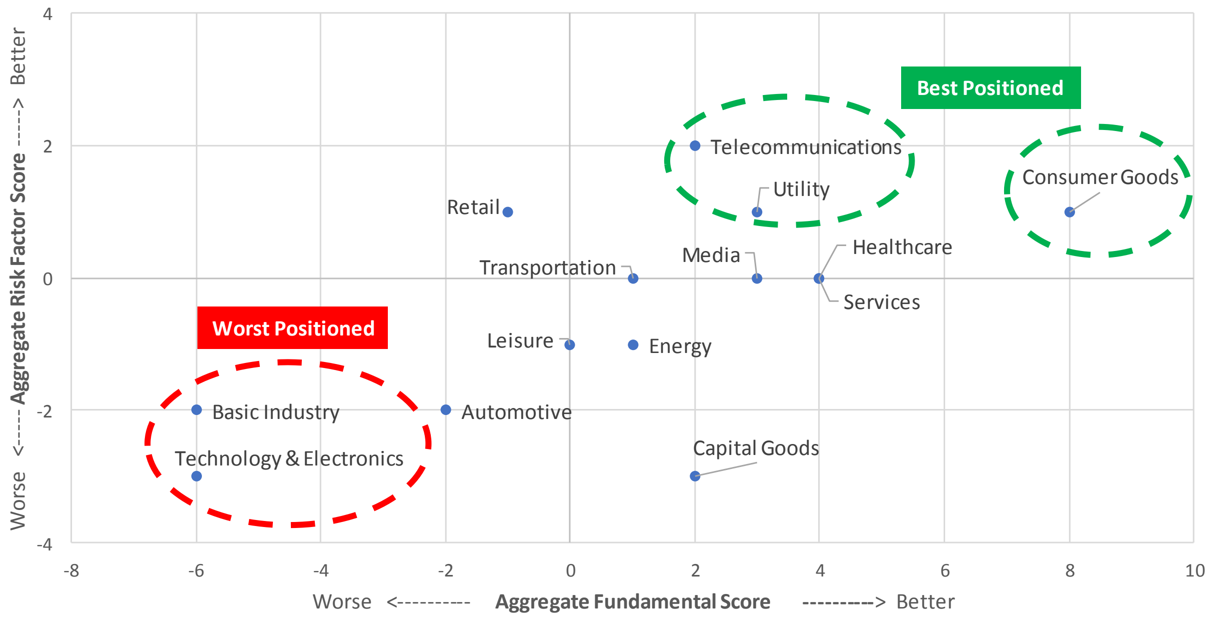
Sectors Least at Risk	Industries Least at Risk
Utilities	Telecom - Wireline Integ. & Svcs
Consumer Goods	Environmental
Transportation	Printing & Publishing

Source: SKY Harbor, Goldman Sachs, Real Clear Politics, Bloomberg, ICE BofAML US Indices

Putting all of these elements together, we aim to evaluate sector attractiveness by plotting trailing four quarter fundamental improvement across the x-axis and the aggregate risk factor score across the y-axis. More specifically, we calculate a fundamental improvement score by adding up our findings in the sector trends table (a "+" is equal to 1 point, a "–" is equal to -1 point, and a "=" is equal to zero points). As there are nine fundamental categories, each sector can receive a score between +9 and -9. Along the y-axis, our risk factor score is generated through a similar framework. Among the three risk factors we have identified (non-US exposure, weakening global growth, a Warren/progressive administration), we tally up +/–/= scores under the same methodology above. As there are three risk categories, each sector can receive a score between +3 and -3. The chart below shows our findings: the best positioned sectors reside in the upper right quadrant (better-than-average fundamental improvement over the last four quarters, better-than-average insulation from the three identified primary risks on the horizon); the worst positioned sectors reside in the lower left quadrant (weaker-than-average fundamental improvement over the last four quarters, weaker-than-average insulation from the three identified primary risk factors on the horizon).

HY Sector Matrix: Degree of Fundamental Improvement (x-axis) by Risk Factor Score (y-axis)

data as of Q3'19



Source: SKY Harbor, BofA Merrill Lynch, ICE BofAML Indices, Jefferies, Bloomberg, Capital IQ, Goldman Sachs, Real Clear Politics, Bureau of Economic Analysis, Institute for Supply Management

In conclusion, these findings support the view that issuers in the Consumer Goods, Telecom and Utility sectors look attractive (strong fundamental improvement, insulation from risk factors), while Basics, Tech and Autos look poorly positioned (weak fundamental improvement, exposure to risk factors). While individual issuers may have business models that differ from aggregate sector traits, we continue to believe fundamentally improving credits that are domestically focused, less susceptible to a slowdown in global growth, and insulated from progressive policies a Warren administration would likely pursue are best positioned for outperformance in the near to intermediate term.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Empire Manufacturing	15-Oct-19	Oct	1.0	4.0	2.0
Retail Sales Advance MoM	16-Oct-19	Sep	0.3%	-0.3%	0.4%
Housing Starts	17-Oct-19	Sep	1320k	1256k	1364k

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Existing Home Sales	22-Oct-19	Sep	5.46m		5.49m
Durable Goods Orders	24-Oct-19	Sep	-0.6%		0.2%
New Home Sales	24-Oct-19	Sep	710k		713k

Source: SKY Harbor, Bloomberg

Recommended Reading

Chaney, Sarah (2019, October 17). Manufacturing Sputters as Broader US Economy Slows. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/u-s-manufacturing-production-declined-in-september-11571318254?ns=prod/accounts-wsj

Bloomberg News (2019, October 16). What to Watch in China GDP Report: Investment, Trade, and Savings. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-10-16/what-to-watch-in-china-gdp-report-investment-trade-and-savings?srnd=economics-vp

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.