SKY HARBOR
CAPITAL MANAGEMENT

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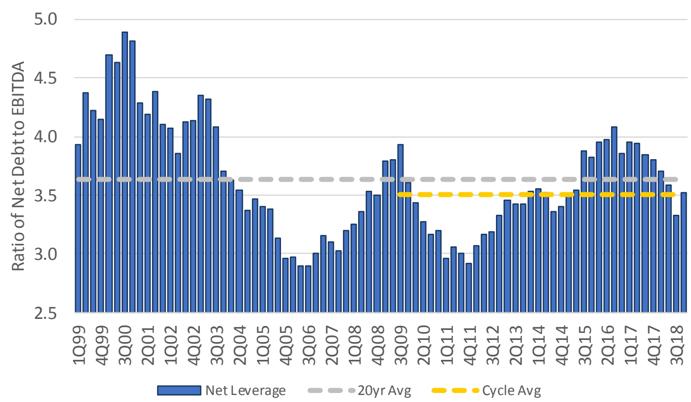
Weekly Briefing

SKYView: F.A.S.T.

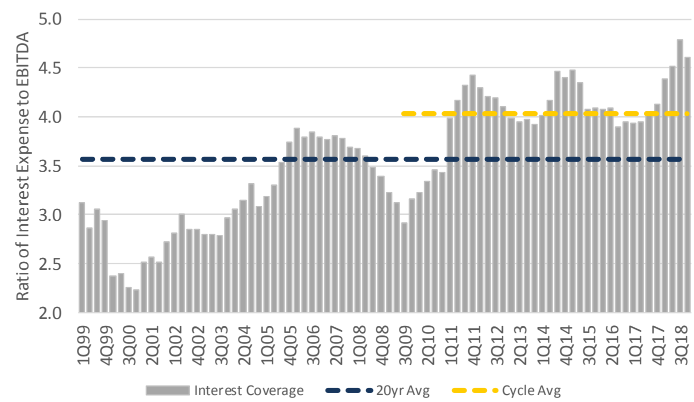
As earnings through Q4'18 have now largely been reported, we thought it useful to use this *Weekly Briefing* to share our assessment of the US high yield market using our F.A.S.T. construct (fundamentals, asset valuations, sentiment and technicals). Similar to last year, we continue to see credit fundamentals and market technicals as the greatest strength of the US high yield market, with asset valuations a spot of weakness. We discuss in greater detail both positive and negative attributes in the balance of this briefing.

Fundamentals: Owing to double-digit EBITDA growth through most of 2018, a margin recovery within commodity-related sectors, persistently low interest rates and the lack of aggressive debt issuance (little LBO and debt-funded dividend undertakings), credit metrics have largely improved since the most recent stress point in Q3'16. As demonstrated below, net leverage through Q4'18 was 3.5x, below a recent peak of 4.1x (Q3'16) and the trailing 20-year average (3.6x). Interest coverage has been even stronger, ending 2018 at 4.6x, above a recent trough of 3.9x (Q3'16) and the trailing 20-year average (3.6x).

US High Yield Leverage Ratio
20 year time series



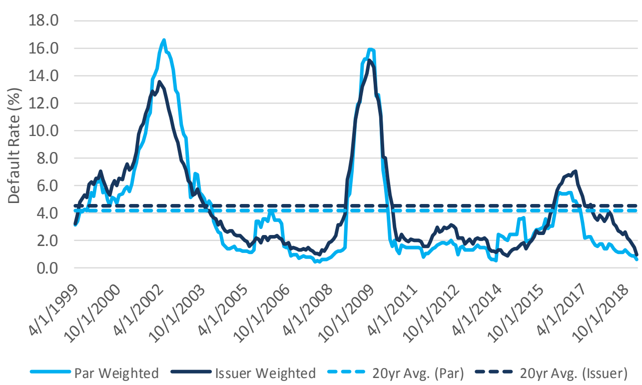
US High Yield Coverage Ratio
20 year time series



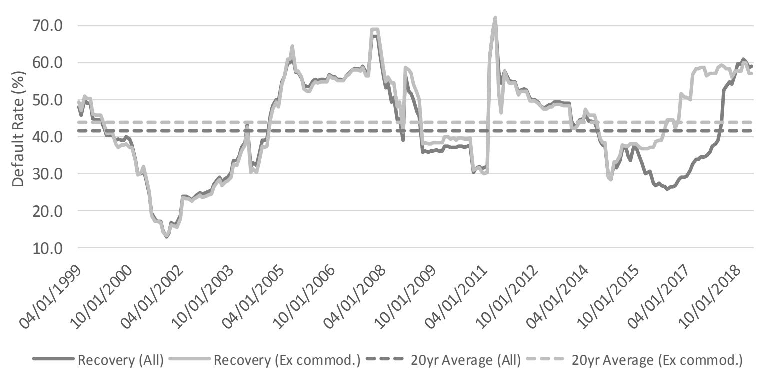
Source: SKY Harbor, BofA Merrill Lynch, Capital IQ

Default rates – both par-weighted and issuer-weighted – have continued to shrink since a near-term spike in 2016. Specifically, the par-weighted default rate as of March 31, 2019 was 0.6%, well below the 20-year average of 4.1%. The issuer-weighted default rate as of March 31, 2019 was 1.0%, well below the 20-year average of 4.5%. Concurrent with falling default rates, recovery rates of defaulted securities have improved markedly. Specifically, the senior unsecured recovery rate through the end of March was 58.9% (57.1% ex commodities), significantly higher than the trailing 20-year average of 41.7% (44.0% ex commodities). While our internal projection model anticipates an increase in defaults from current trough-like levels, we do not anticipate such occurrences to exceed long-run averages over the next twelve months.

US High Yield Default Rates
monthly data, 20 years



US High Yield Unsecured Recovery Rates
monthly data, 20 years



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

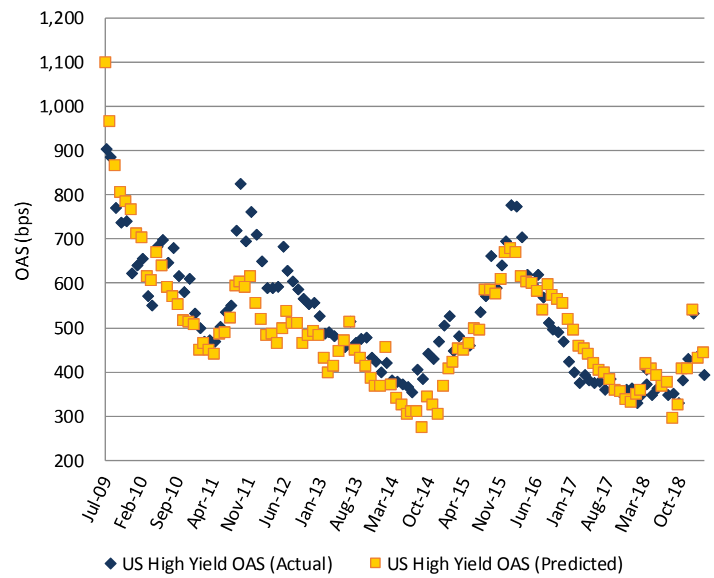
By virtue of credit metrics that are healthier than 20-year averages, as well as muted default rates (both now and projected over the next 12 months), we continue to find fundamentals to be one of the greatest strengths of the US high yield market.

Asset Valuations: Generally improving key economic indicators used in our internal spread regression model have served to reduce our estimate of OAS fair value since early 2016. Actual market spreads, however, have rapidly tightened during the same period. As a result, and despite a relatively constructive outlook on the US economy, our high yield regression model signals "Fair Value" in the current market environment. Note, however, greater attractiveness in lower-quality credits following BB outperformance on a YTD basis. **In this period of below-average index spread levels, we have focused on identifying misunderstood or underappreciated capital structures with a positive catalyst on the horizon, as we believe credit selection will be paramount in generating performance in the coming quarters.**

Index	Ticker	Actual OAS	Model Predicted OAS	Relative Value
ICE BofAML US High Yield Index	H0A0	405	418	Fair Value
ICE BofAML BB US High Yield Index	H0A1	244	301	Rich
ICE BofAML Single-B US High Yield Index	H0A2	438	420	Fair Value
ICE BofAML CCC & Lower US High Yield Index	H0A3	936	736	Cheap

As of March 31, 2019. Ratings classes use the same factors as the HY Index regression.
Source: SKY Harbor, ICE BofAML Indices, Federal Reserve and Bloomberg
1 Variable definitions available upon request

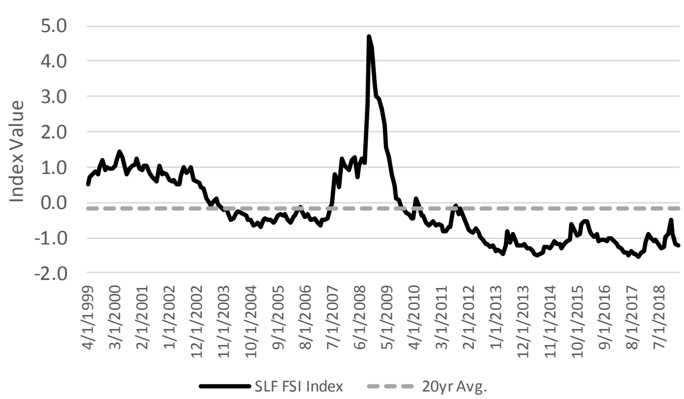
This multivariate linear regression analysis is for information purposes only. This analysis uses historical month-end data for the four factors shown and is not intended as the basis of a model portfolio or buy/sell decisions on any particular security. The analysis is is one of many inputs in our investment decision-making process. High R^2 values are not intended to be taken as a guarantee of future results as differences in any of the four factors going forward can result in significant departures from predicted values. See additional disclaimers included with this presentation.



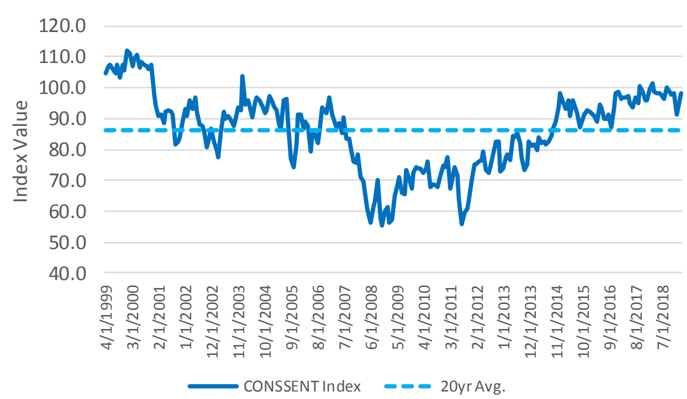
Source: SKY Harbor, ICE BofAML Indices, Bloomberg, Federal Reserve, Institute for Supply Management

Sentiment: Our metric of choice with regard to leading economic variables – the St. Louis Federal Reserve Bank Financial Stress Index – continues to trend favorably following a brief uptick in December '18, and has been below its 20-year average since late 2011. The US consumer, bolstered by low rates of unemployment, upward pressure on wages and lingering benefits from tax cuts, continues to represent one of the strongest cohorts of the economy. As demonstrated below, the University of Michigan Consumer Sentiment Index remains above average, having recently recovered from a brief period of stress in January '19.

St. Louis Fed Financial Stress Index
monthly data



U. of Michigan Consumer Sentiment Index
monthly data

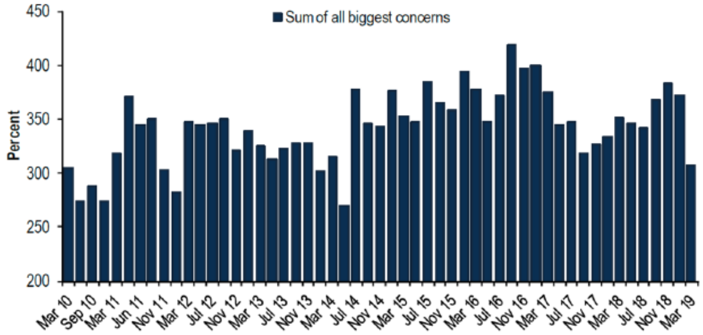


Source: SKY Harbor, Federal Reserve Bank of St. Louis, University of Michigan

Several key risks – the threat of rising rates most prominent among them – have subsided over the last few months. This dynamic is perhaps best captured by the BofA Merrill Lynch Credit Investor Survey, which now shows that the sum of all biggest concerns not only decreased from January '19 survey levels, but recorded its lowest value since H1'14 . Furthermore, investors remain hopeful that a US/China trade deal will reduce tariff-related uncertainty within the domestic economy and alleviate pockets of geopolitical tension.

Sum of Credit Investors' Biggest Concerns

bi-monthly survey data



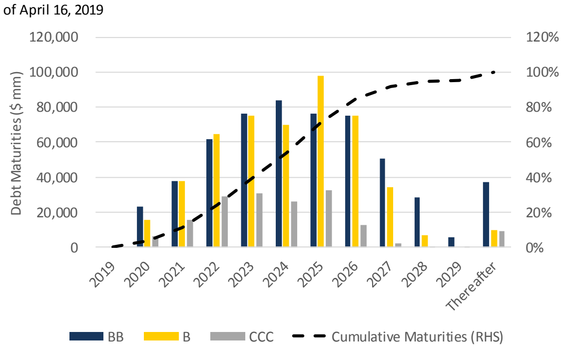
Source: BofA Merrill Lynch

While a generally positive outlook at present bodes well for the US high yield market, we are cognizant that negative y/y corporate earnings growth in Q1'19 (even if temporary in nature) will do little to ease concerns of a slowing global economy. **For these reasons, and due to the swiftness in which sentiment can change, we consider this element of our F.A.S.T. process to be providing a neutral signal at present.**

Technicals: A relatively healthy new issue market over the past several quarters has allowed management teams to address near-term maturities. As of April 16, 2019, we estimate that only 11% (by face value) of the ICE BofAML US High Yield Index (H0A0) has a maturity date between now and the end of 2021. While the CCC index has modestly greater front-end concentration (13% of the index has a maturity date within the same time frame), the index as a whole appears to have little maturity wall risk over the intermediate term. Additionally, and comforting from a credit investor perspective, management teams have not taken advantage of favorable lending conditions, as the vast majority of new issuance has been directed toward the refinancing of debt (the leading use of funds for 26 consecutive months). Note that aggressive issuance of debt, which we would define as proceeds used to pay equity dividends or complete acquisitions/LBOs (22% in 2018, 32% YTD 2019) is well below what the market experienced in the prior late-cycle period (55% of proceeds in 2007).

ICE BofAML US High Yield Index Maturity Schedule

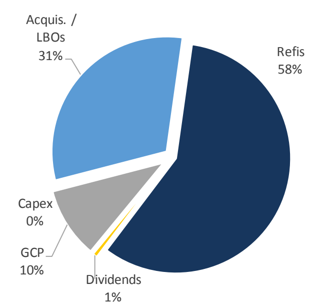
as of April 16, 2019



	Maturities Through '21	
Index	Absolute	% of Index
BB	61,011	11%
B	53,741	11%
CCC	21,752	13%
HY Index	136,504	11%

New Issue Use of Proceeds

YTD data through March 31, 2019



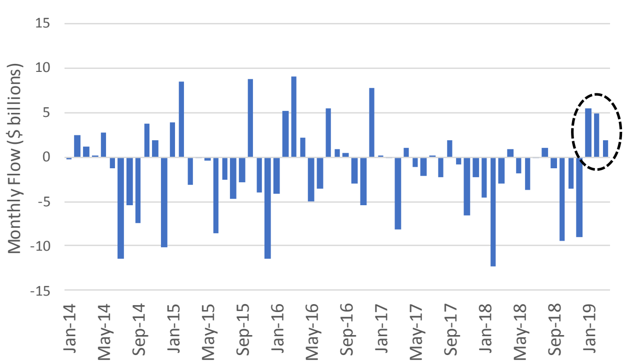
	Percent of all Proceeds		
Use:	2019 YTD	Cycle Avg.	2007
Refis	58%	57%	31%
Dividends	1%	3%	2%
GCP	10%	18%	12%
Capex	0%	2%	3%
Acquis. / LBOs	31%	21%	53%

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

Fund flows have further improved the technical picture for the US high yield market. As demonstrated below, retail flows have been positive each month YTD, potentially driven by the reduced threat of rising rates (a change in sentiment that has led to outflows in the leverage loan space). Furthermore, coupon reinvestment and a favorable ratio of rising stars to fallen angels have further contributed to technical tailwinds in the market.

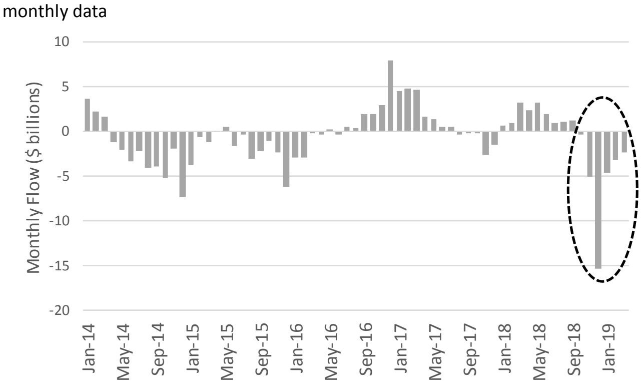
US High Yield Mutual Fund Flows

monthly data



US Leveraged Loan Mutual Fund Flows

monthly data



Source: JP Morgan, Lipper

Despite a significantly changed economic environment relative to early 2018, we continue to find fundamentals and technicals to represent the greatest strengths of the US high yield market. A negative inflection in corporate earnings growth for Q1'19 will be, in our view, a temporary dynamic, and we are optimistic that management team prudence and balance sheet improvements over the last several quarters should provide US high yield issuers a cushion necessary to weather near-term margin pressures. Technical tailwinds have already surpassed our expectations for the year, and a combination of muted rate risk and rising balances of negative yielding debt on a global basis should serve to minimize any potential reversal. At the same time, we concede that valuations remain fair at best, particularly among higher-rated securities, with sentiment balancing precariously as the expansion ages. Taking all factors into account, we remain cautiously optimistic on the US high yield market, and have focused our research efforts on identifying attractively priced and domestically focused issuers benefiting from a strengthening consumer, particularly those contained within segments of the market that have lagged the YTD rally.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
Industrial Production MoM	16-Apr-19	Mar	0.2%	-0.1%	0.1%
Capacity Utilization	16-Apr-19	Mar	79.2%	78.8%	78.2%
Retail Sales Advance MoM	18-Apr-19	Mar	1.0%	1.6%	-0.2%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Existing Home Sales	22-Apr-19	Mar	5.33m		5.51m
New Home Sales	23-Apr-19	Mar	650k		667k
GDP Annualized QoQ	26-Apr-19	1Q	1.8%		2.2%

Source: SKY Harbor, Bloomberg

Recommended Reading

Mauldin, William and Zumbrun, Josh (2019, April 17). US, China Set Tentative Timeline for Next Round of Trade Talks. *The Wall Street Journal* (subs. req.), Retrieved from https://www.wsj.com/articles/u-s-china-set-tentative-timeline-for-next-round-of-trade-talks-11555521885?mod=hp_listb_pos1

Coy, Peter (2019, April 17). Did Capitalism Kill Inflation. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2019-04-17/did-capitalism-kill-inflation?srnd=economics-vp

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