

## SKY Harbor Weekly Briefing

### Earnings Resilient Thus Far

Q4'23 earnings season has just begun in the high yield space. Despite signs of labor market normalization and thus far resilient US GDP growth, global macro uncertainty has, in some cases, led to pockets of investor trepidation. Fortunately, late reporting cycles for many high yield issuers relative to public counterparts can be advantageous, with small- and mid-cap equity index constituents typically providing a preview of what is likely to come in our market. In this *Weekly Briefing*, we reiterate our expectation of a benign earnings season, and note that recently released economic datapoints, which have largely surprised to the upside, are likely to put downward pressure on high yield market default rates in 2024.

### Market Rewarding Earnings Beats

A material degree of business and end market overlap make various public equity index constituents good proxies for our high yield holdings, a dynamic that is particularly helpful since the former typically release quarterly results before the latter. At the time of writing, approximately 25% and 50% of Russell 2000 and S&P 1500 constituents, respectively, have released Q4'23 results. On balance, **earnings have modestly surprised to the upside, with strength in Industrials (relative to expectations) offsetting some disappointment within the Healthcare sector.** Furthermore, and as demonstrated in the scatterplot below, the market has rewarded upside surprise – and penalized misses – by equivalent magnitudes.

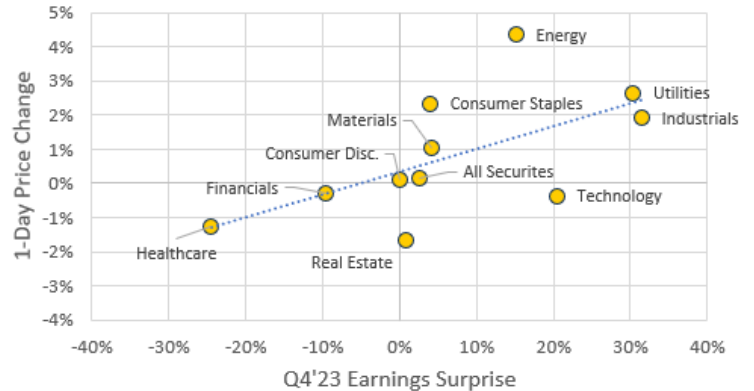
### Russell 2000 Index (RTY): Current Quarter

Q4'23 Earnings Summary (~ 25% have reported through publication)

Sector	Q4'23 Sales Surprise	Q4'23 Earnings Surprise
Materials	4%	4%
Industrials	0%	31%
Consumer Staples	1%	4%
Energy	0%	15%
Technology	2%	20%
Consumer Discretionary	1%	0%
Communications	0%	NM
Financials	0%	-10%
Healthcare	-1%	-25%
Utilities	-18%	30%
Real Estate	7%	1%
All Securities	1%	3%

### Equity Markets Have Rewarded Upside Surprise

Q4'23 results, through February 7



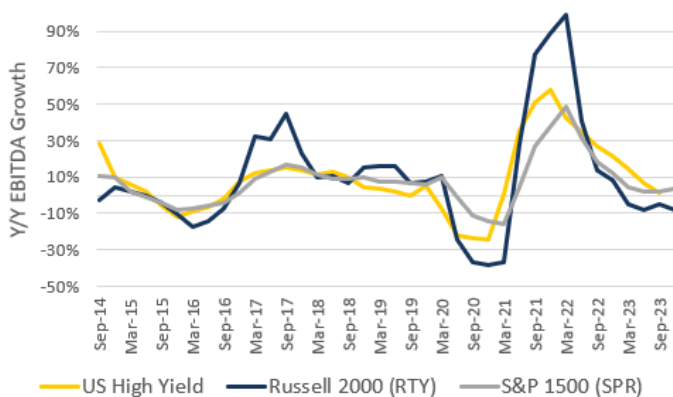
Source: SKY Harbor, Bloomberg, company filings

### Flat Growth?

Over the last decade, quarterly EBITDA growth rates of US high yield issuers have been highly correlated to both Russell 2000 (.85) and S&P 1500 (.84) constituents, and we suspect the same relationship will continue to hold in the near term. At the time of writing, **known results from the aforementioned equity indices imply essentially flat high yield issuer EBITDA growth in Q4**, falling in between our somewhat conservative internal estimate and consensus expectations. Based on commentary from management teams, inflation alleviation and falling shipping/logistics costs bode well for earnings trends over the balance of 2024, though overarching macro uncertainty, in many cases, appears to have limited enthusiasm to upwardly revise guidance.

### Mixed Q4'23 EBITDA Growth Rates Among Public Companies

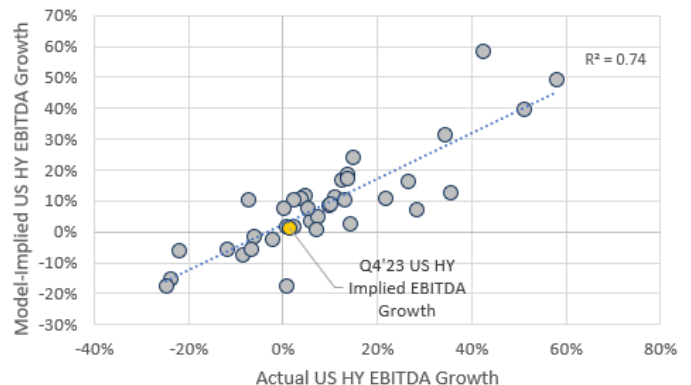
quarterly data



Source: SKY Harbor, Bloomberg

### Read-Through for HY Implies Flat EBITDA Growth

quarterly data



## Conditions Beginning to Loosen?

Through much of January and thus far in February, economic data has surprised to the upside, as evidenced by a recent spike in the Citi Economic Surprise Index presented below (left side). At the same time, **the recently released Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) reported a smaller proportion of institutions net tightening their standards relative to 3Q'23 across all loan categories.** Additionally, banks are reportedly expecting an increase in loan demand, perhaps driven by expectations that overall interest rates will continue to decline. Ultimately, this data is supportive of output growth, and positive for overall market sentiment.

### Economic Data Continues to Surprise to the Upside

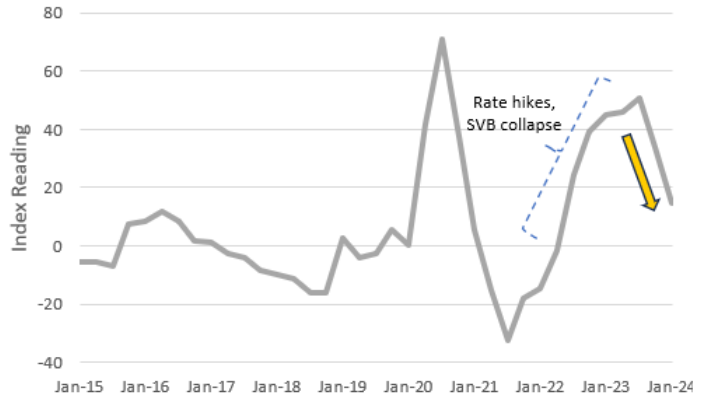
Citi Economic Surprise Index, daily data, trailing 1 year



Source: SKY Harbor, Citi, Federal Reserve, Bloomberg

### Senior Loan Officer Opinion Survey (SLOOS) Has Inflected

net % respondents tightening lending standards for C&I loans

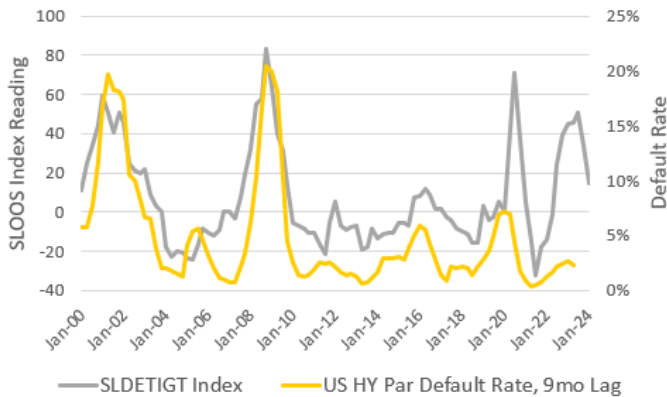


## Less Default Pressure

The SLOOS is important to high yield investors, most notably due to its high correlation to subsequent default rates. As demonstrated below (left side), survey results tend to foreshadow high yield default rates 9 months in advance. Because of this dynamic, the SLOOS has always been one of the key factors driving our SKY Harbor Default Rate Projection Model. By virtue of less restrictive lending conditions, a moderating distress ratio, and driven by more resilient than feared fundamental credit ratios, **we now expect the FY24 high yield default rate to be ~ 3.5%, a 50 bps improvement relative to our last model update.**

### SLOOS Highly Correlated to Next 9mo HY Default Rate

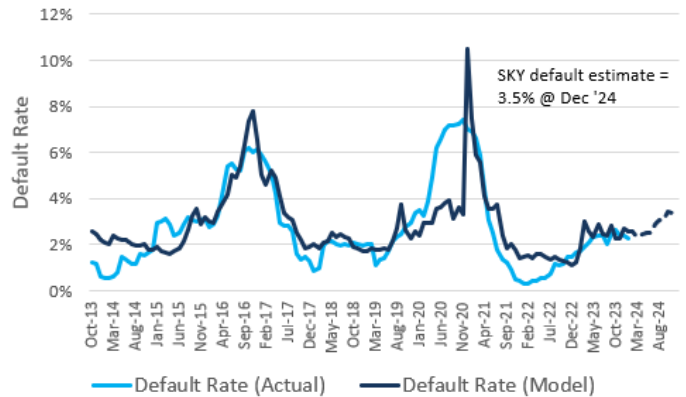
quarterly data, since 2000



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

### Loosening Standards + Less Distress = Lower Defaults

SKY Harbor Default Rate Projection Model; dotted lines are fwd projections



## A Supportive Backdrop

In our view, flat EBITDA growth and upside economic surprise provide a supportive backdrop for high yield credit risk. Furthermore, we continue to see the asset class as offering attractive yield in the context of limited risk of principal loss, and think carry will be the main driver of total returns in 2024. We acknowledge, however, that further alleviation of default risk should serve to benefit the more speculative parts of the market, and must therefore continue to selectively add exposure to issuers with above-market yields, with a bias toward those with extended maturity runways.

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