HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned -4.5% in the first quarter of 2022. The Consumer Price Index reached 7.9% year-over-year, its highest level in 40 years, raising the threat of tightening monetary policy. Russia's invasion of Ukraine fueled inflation worries further. Sanctions and trade disruptions create supply shocks, putting inflationary pressures on significant Russian exports like oil, natural gas, and metals—each experienced meaningful price increases in the period. The number of job openings continues to hover around its highest level in 20 years, increasing the risk of further wage inflation.

To combat these inflationary threats, the FOMC increased the Fed Funds rate by 0.25% and signaled more aggressive rate increases in the coming year. Treasury yields increased across the curve, more so on the short end. Yields on the 2-, 5-, 10-, and 30-year treasuries rose 1.6%, 1.2%, 0.8%, and 0.5%, respectively. The 10-year/2-year yield curve ended the period essentially flat, both slightly above 2.3%. Historically, an inverted yield curve has been a harbinger for eventual recessions. While this gives us pause, other yield curves that have been at least as efficacious in forecasting recessions are showing a different story. The 10-year/3-month T-Bill, for example, widened in the quarter and remains rather steep. Advocates of this curve seem to contend that the 10-year yield is unnaturally low because there has been a large "artificial buyer" in the form of the US Government's quantitative easing. Both yield curves have merit, and so a recession is a possibility, but the path is not clear. Our penchant for attractive asset coverage in more senior parts of the capital structure should help guard against a potential economic slowdown.

The yield on the ICE BofA US High Yield Index increased by 1.7%, ending the quarter at 6.0%. Spreads over treasuries widened by 33 basis points, finishing at 343. Changes in yields and spreads were relatively constant by quality, size, and sector. Energy was a notable exception, with yields rising just over 1% and spreads tightening slightly. Lower rated credits widened slightly more than higher rated credits.

High yield market defaults remain benign. The trailing 12-month default rate, including distressed exchanges, was 0.5% for the period ended March 31. This is well below the long-term average of 3.6%. Rating agency upgrades have exceeded downgrades for 15 consecutive months. The trailing 12-month upgrade/downgrade ratio closed the period at 2.5/1 by number of issuers and 3.6/1 by volume, both all-time records. A negligible portion of the high yield market trades at distressed prices: just 1.2% trades at less than 70% of par and 0.7% trades at less than 50% of par.

New issue volume has been considerably lighter in 2022 than it has been in recent years. There was $46 billion in new issuance year-to-date compared to last year's quarterly average of $120 billion—though last year's $480+ billion of new issuance was a record. While less active, the primary market has shown nascent signs of increased aggressiveness. Less than half of new issuance was used for refinancing, and 25% was used for LBO/acquisition financing. In recent years, closer to two-thirds of new issuance was used for refinancing and the percentage used for LBO/acquisitions was in the mid-teens. None of this is particularly surprising, however, considering the rise in interest rates.

We will continue to adhere to our competitive research advantage, particularly in small and mid cap credits, with a focus on strong asset coverage. We believe this will benefit our clients irrespective of economic developments or general market temperament.

ATTRIBUTION – 1Q22

The Hotchkis & Wiley High Yield portfolio outperformed (declined less than, gross and net of management fees) the ICE BofA US High Yield Index and the ICE BofA BB-B US High Yield Constrained Index in the first quarter of 2022. Relative to the broad benchmark, positive credit selection drove nearly all the outperformance. Credit selection was significantly positive in energy (+2.9% vs. -2.4% for the index) and basic industry (-2.8% vs. -5.5% for the index). Positive credit selection in consumer goods and transportation was modestly helpful. The overweight position in basic industry detracted from performance in the quarter. Negative credit selection in telecommunications and automotive hurt modestly.

OUTLOOK (SCORING SCALE: 1=VERY NEGATIVE, 5=VERY POSITIVE)

Fundamentals (3)

The fundamentals score was reduced from last quarter. Revenue and cash flow have been robust. Leverage has declined and liquidity remains high. Defaults remain low. EBITDA margins, however, remain elevated, while cost pressures continue to build.

Technicals (2)

The technicals score was reduced from last quarter. The FOMC has pivoted to monetary policy tightening and signaled its intent to move aggressively. Fund flows have turned decidedly negative, and the new issue market has cooled considerably.

Valuation (3)

The valuation score was increased from last quarter. Yields and spreads both widened in the quarter. Excess spreads (after adjusting for low defaults) remain reasonable, so long as defaults remain subdued. The dispersion of spreads is sufficiently wide, a good sign for active credit pickers.

HIGH YIELD

Unless otherwise noted, the “high yield” market refers to the ICE BofA US High Yield Index

Composite performance is available at www.hwcm.com, located on the strategy’s Performance tab. Returns discussed can differ from actual portfolio returns due to guideline restrictions, cash flow, tax and other relevant considerations. Portfolio characteristics and attribution based on representative High Yield portfolio. The performance attribution is an analysis of the portfolio's return relative to the index and is calculated using trade information and does not reflect cash flow transactions and the payment of transaction costs, fees and expenses. Absolute performance for the portfolio may reflect different results. No assurance is made that holdings, or all investment decisions by H&W were or will be profitable.

The discipline used in managing accounts in the High Yield strategy may prevent or limit investment in major bonds in the ICE BofA US High Yield and ICE BofA BB-B US High Yield Constrained, and returns may not be correlated to the indexes. Quarterly characteristics and portfolio holdings are available at www.hwcm.com, located on the strategy’s Characteristics and Literature tabs. Portfolio information is subject to the firm’s portfolio holdings disclosure policy.

Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles, which should be considered when investing.

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Market Disruption: The global coronavirus pandemic has caused disruption in the global economy and extreme fluctuations in global capital and financial markets. H&W is unable to predict the impact caused by coronavirus pandemic, which has the potential to negatively impact the firm’s investment strategies and investment opportunities.

Portfolio managers’ opinions and data included in this commentary are as of March 31, 2022, and subject to change without notice. Information based on forecasts, proprietary or third-party estimates cannot be guaranteed and are subject to change. Information obtained from independent sources is considered reliable, but H&W cannot guarantee its accuracy or completeness.

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Past performance is no guarantee of future results.