HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned +3.7% in the first quarter of 2023, a welcomed rebound from last year's -11.2% decline. Inflation fears appear to have lessened as the CPI decelerated to 6% year-over-year, a far cry from its mid-2022 peak of more than 9%. The FOMC increased the Fed Funds rate twice during the quarter, both 25 basis point hikes. The important benchmark rate now stands at 5.0% (upper bound), the first time it has reached this level in more than 15 years. The market implied probability of another small rate hike at the next meeting is about 50/50. The 3-month T-Bill followed suit, rising by about 0.5% to close the quarter at 4.8%. Treasury yields of other durations declined in the quarter, however, by roughly 20 to 35 basis points depending on the maturity. Both the 10-Year/2-Year and the 10-Year/3-Month yield curves remain meaningfully inverted. This has signaled recessions historically and we remained guarded accordingly, though responsible leverage/interest coverage levels and extended maturity profiles provide solace.

The high yield market largely rose in unison during the quarter. Modest exceptions include lower rated credits outperforming higher rated credits and large cap credits outperforming small cap credits. The yield-to-worst on the high yield market declined from about 9.0% at the beginning of the quarter to 8.5% at the end of the quarter. Spreads over treasuries tightened by about half this much, going from 481 basis points to 458 at quarter-end.

The high yield market's trailing 12-month default rate, including distressed exchanges, was 1.9% at the end of the quarter, up 26 basis points from 3 months ago and up 141 basis points from 12 months ago. This remains notably lower than the market's 30-year average of 3.2%. The market's post default recovery rate over the past 12 months was 47%, slightly better than its 30-year average of 40%. The portion of the high yield market trading at distressed levels has crept up but remains well below levels typically reached during recessionary periods. About 10% of the market has a spread-over-treasuries of more than 1,000 basis points. About 8% of the market trades below 70% of par, and less than 3% trades below 50% of par.

Credit rating agencies have been busy, but balanced. Year-to-date, there have been 85 upgrades and 90 downgrades, with similar total par values among the two groups. The trailing 12-month upgrade-to-downgrade ratio ended the quarter at 1.04 to 1 by number of issuers, and 1.19 to 1 by total par value. This is down considerably from the all-time high reached last year.

The pace of the primary issue calendar is slightly ahead of last year's pace but remains somewhat dormant. There was $40 billion in new issuance during the year's first quarter. This compares to $106 billion in all of 2022, and $483 billion in 2021 which was an all-time high. Nearly 70% of this year's new issues was used for refinancing, while just 8% was used for acquisition activity. These percentages reflect a well-behaved new issue market.

Our overall view of the high yield market remains about average, with better-than-average fundamentals but valuations that reflect a rather sanguine outlook. We believe our positions' attractive valuations combined with strong asset coverage and a focus on the more senior part of the capital structure represents a compelling and appropriate balance in the current environment.

ATTRIBUTION – 1Q23

The Hotchkis & Wiley High Yield portfolio (gross and net of management fees) outperformed the ICE BofA US High Yield Index and the ICE BofA BB-B US High Yield Constrained Index in the first quarter of 2023. Positive credit selection drove all the outperformance in the quarter. It was particularly positive in retail, telecommunications, and consumer goods. The underweight position in telecom also helped. Credit selection in banking and healthcare detracted from performance in the quarter.

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

Fundamentals (2)
The fundamentals score remains unchanged from last quarter. Leverage and asset/interest coverage remain solid. Liquidity and maturity profiles are attractive. Growth appears to be inflecting and margins are holding. Defaults and distressed situations are rising but below historical levels.

Technicals (3)
The technical score remains unchanged from last quarter. Upgrades into investment grade have been shrinking the market. New issuance in recent years has reduced refinancing risks. Fed uncertainty has kept investors on the sidelines.

Valuation (4)
The valuation score remains unchanged from last quarter. Yields are above historical averages, though spreads are below typical recession levels. Dispersion in valuations across the market is creating opportunities for active credit pickers.

Past performance is no guarantee of future results

HIGH YIELD

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

Net of fee composite performance as of 3/31/23: -2.62%, 2.39% and 3.70% for 1-, 5-, and 10-year, respectively. Net performance results are presented after management fees and all trading expenses but before custodial fees. **Past performance is no guarantee of future results.**

Portfolio managers’ opinions and data included in this commentary are as of March 31, 2023, 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.

Portfolio characteristics and attribution are based on a representative High Yield portfolio. Attribution is an analysis of the portfolio's return relative to the index, is calculated using daily holdings information and does not reflect management fees and other transaction costs and expenses; interaction effect is combined with stock selection. Returns can differ from certain client portfolio(s) due to data differences, cash flows, trading, and other activity. 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. Composite performance is available at www.hwcm.com, located on the strategy’s Performance tab along with important disclosures included in the strategy’s GIPS Report; quarterly characteristics and portfolio holdings are located on the Portfolio and Literature tabs. Portfolio information is subject to the firm’s portfolio holdings disclosure policy.

The ICE BofA BB-B US High Yield Constrained Index contains all securities in the ICE BofA US High Yield Index rated BB+ through B- by S&P (or equivalent as rated by Moody’s or Fitch), but caps issuer exposure at 2%. Index constituents are capitalization weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. The ICE BofA US High Yield Index tracks the performance of below investment grade, but not in default, US dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody’s and S&P. The ICE BofA index data referenced is the property of ICE Data Indices, LLC (“ICE BofA”) and/or its licensors and has been licensed for use by Hotchkis & Wiley. ICE BofA and its licensors accept no liability in connection with its use. See www.hwcm.com for full disclaimer.

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.

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.

All investments contain risk and may lose value. The commentary is for information purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product.

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