HIGH YIELD

MARKET COMMENTARY

The ICE BofA US High Yield Index returned -10.0% in the second quarter of 2022 and is now down -14.0% since the beginning of the year. Several economic developments in the quarter sparked fears of a recession. Real GDP was -1.6% quarter-over-quarter (1Q), the war in Ukraine showed little signs of abating, the Consumer Price Index increased 8.6% year-over-year, and an increasingly hawkish FOMC raised the Fed Funds rate by 125 basis points via two hikes (from 0.5% to 1.75%). The Fed signaled further rate increases going forward to combat the highest inflation level in more than 40 years. The futures market implies that investors expect the Fed Funds rate to exceed 3% by year end with more rate hikes expected in 2023. Treasury yields of all durations increased, more so on the short end resulting in a rather flat yield curve—the yields on the 10-year and 2-year are only basis points apart. Historically, inverted yield curves have been efficacious recession predictors, which has us sensibly cautious.

The trailing 12-month default rate for the high yield bond market increased to 1.08%, including distressed exchanges. While this is an increase from extreme lows, it remains well below the 20-year average of 2.7%. Post default recovery rates over the last 12 months are 68%, which is higher than any calendar year in the market's history—though it only includes 8 observations. The market's 25-year average recovery rate is about 40%. Spreads over treasuries widened by more than 240 basis points in the quarter, suggesting that the market expects default activity to increase meaningfully going forward. The market's spread over treasuries finished at 587 basis points, up from 343 basis points at the beginning of the quarter and 310 basis points at the beginning of the year. More than a tenth of the market trades at a spread wider than 1,000 basis points. The yield-to-worst on the market rose 2.9% in the quarter, finishing at 8.9%, a function of both rising rates and widening spreads. This represents the market's highest yield-to-worst since March of 2020 when uncertainty regarding the pandemic was at its peak. About 6% of the market trades for less than 70% of par value, while about 1% trades for less than half of par.

Rating agency upgrades continue to outpace downgrades, though the ratio in recent months has begun to approach 1:1. The trailing 12-month upgrade-to-downgrade ratio is 2.17:1 by number of issuers and 2.89:1 by volume, both down from the records reached earlier in the year. The number of downgrades in investment grade corporates is also low. Accordingly, the number and volume of fallen angels entering the high yield universe has been nearly non-existent in the past year and a half.

The primary market has been light this year, running well below the typical volume over the past decade. There has been a total of $71 billion in new issue volume in 2022 compared to last year's record $483 billion. About half of this year's issuance has been used for refinancing, slightly less than the average run rate of the past few years. CCC-rated new issuance as a percentage of total issuance has ticked up. Normally we view this as a sign of an overzealous market, but the statistic is a bit misleading given the overall volume is so light.

The number of attractive valuation opportunities has increased this year, though it took a negative market to get here. Nonetheless, we are more optimistic about our prospect to add value going forward than we were at the year's outset. We will continue to adhere to our competitive research advantage, particularly in small and mid cap credits, with a focus on strong asset coverage.

ATTRIBUTION – 2Q22

The Hotchkis & Wiley High Yield portfolio outperformed (declined less than, gross and net of management fees) the ICE BofA US High Yield Index and underperformed the ICE BofA BB-B US High Yield Constrained Index in the second quarter of 2022. Relative to the broad benchmark, the underweight exposure to CCC-rated securities helped relative performance as this was the market's worst performing group, declining nearly -15% in the quarter. Positive credit selection in energy was significantly helpful as well, along with positive credit selection in basic industry and services. Credit selection in retail and leisure detracted from relative performance. The underweight exposure to the utility sector also hurt, albeit modestly.

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

Fundamentals (2)
The fundamentals score was reduced from last quarter (3 to 2). Cash positions remain solid, and the maturity schedule leaves little concern. Demand is starting to weaken, however, and profit margin pressures are coming. Weaker credits could be at risk.

Technicals (3)
The technical score was increased from last quarter (2 to 3). Improved valuations are attracting buyers, and docile new issuance provides support. The Fed signaling more rate hikes creates uncertainty.

Valuation (4)
The valuation score was increased from last quarter (3 to 4). Yields are the highest we have observed in years. Current spreads compensate for the likely increase in default activity. The dispersion of spreads is creating opportunities. Spreads remain below typical recession levels, however.

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.

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