HIGH YIELD

MARKET COMMENTARY

In calendar year 2022, the economy and capital markets experienced numerous milestones that had not been observed for quite some time. The ICE BofA US High Yield Index declined -11.2%. Since its 1985 inception, only 2008 was a worse calendar year (-26.4% during the financial crisis). Inflation peaked midyear at 9.1%, the highest reading in more than 40 years[1]. To combat rising prices, the FOMC increased the Fed Funds rate by more than 400 basis points over the course 2022, from 0.25% to 4.5% (upper bounds). This was the largest rate hike in any calendar year since 1973, and the current 4.5% level is its highest in more than 15 years. Other interest rates followed suit. 10-year treasury yields peaked above 4% for the first time in more than a decade; 30-year mortgage rates peaked above 7% for the first time in more than 2 decades. Yields on corporate credit also increased significantly. The high yield market's yield-to-worst rose 4.7% over the course of the year, from 4.3% to 9.0%. The treasury yield curve remains significantly inverted, which has been a harbinger of recessions historically. The tight labor market exhibited strong contrasting signals, however, with the unemployment rate reaching a 50-year low.

Forecasting economic growth and/or predicting recessions is not our expertise. We do, however, fully acknowledge current warnings signs, e.g., continued Fed tightening and the yield curve. Two things providing solace in the event of an economic slowdown are modest financial leverage and attractive valuations. There are fewer excesses in the system compared to prior recessionary periods like 2008. Unlike then, balance sheets of both consumers and financial institutions are quite strong today. Further, high yield valuations are reasonable, and in select market segments, unusually attractive. A strong argument could be made that a recession is already priced in. While several signs point to an economic slowdown, several others suggest that the severity would be manageable and/or much of the pain has already been felt.

The trailing 12-month high yield default rate increased over the course of the year, rising from a near all-time low of 0.4% at the beginning of the year to 1.7% at the end of the year. This remains well below the 30-year average of 3.2%, but uncertain economic growth and increasingly restrictive capital markets could cause this to increase. Post default recovery rates were 55% for the year, above the 40% long term average, though there were a limited number of observations.

Credit valuations improved over the year, as yields increased by 4.7% (4.3% to 9.0%) and spreads over treasuries widened by 171 basis points (310 to 481 bps). Yields and spreads increased for lower rated credits disproportionately, as higher rated credits outperformed. About 9% of the high yield market trades for less than 70% of par, and about 3% trades for less than half of par, both notable increases from the beginning of the year. The trailing 12-month ratio of rating agency upgrades to downgrades was 1.35 to 1 by number of issuers and 1.74 to 1 by total volume, but this has been trending down in recent months. In fact, downgrades have outpaced upgrades in each of the last three months. The new issue calendar was notably light in 2022, with a little more than $100 billion in total new issuance. This compares to 2021's record of $483 billion.

We continue to view the high yield market's prospects as roughly average relative to history. Questionable growth and increased cost pressures could very well increase distressed situations, though much of this appears priced in, i.e., valuations are attractive. Valuation dispersion is sufficiently wide, which is conducive for our bottom-up credit picking approach and our penchant for small and mid cap credits. US CPI Urban Consumer year-over-year, not seasonally adjusted.

ATTRIBUTION – 4Q22 & 2022

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 fourth quarter of 2022. Relative to the broad benchmark, positive credit selection in Energy, Leisure and Consumer Goods helped relative performance. Credit selection in Basic Industry, Media, and Healthcare detracted from performance.

For the full calendar year, the portfolio also outperformed both benchmarks (gross and net of management fees). The focus on small and mid-sized credits helped performance as smaller credits declined less than larger credits. Relative to the broad benchmark, the underweight to CCC-rated credits helped as this cohort lagged the rest of the high yield market. Credit selection was decidedly positive, with credit selection in Energy, Capital Goods, and Technology leading the way. The overweight to Energy also helped. Credit selection in Basic Industry, Media, and Retail hurt relative performance in the year.

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 cost pressures are building. Defaults and distressed situations are likely to rise.

Technicals (3)

The technical score remains unchanged from last quarter. There have been large outflows in the asset class and low new issuance. The Fed creates uncertainty. The economy is slowing, and labor markets are tight.

Valuation (4)

The valuation score remains unchanged from last quarter. Yields are attractive. Spreads over treasuries are above average yet below typical recession spreads. Dispersion in valuations across the market is creating opportunity for active credit pickers.

[1]US CPI Urban Consumer year-over-year, not seasonally adjusted

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 December 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.