Aquila High Income Fund

PODCAST TRANSCRIPT

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Interviewer:

Hello. Thank you for listening into our Aquila Group of Funds Podcast. I will be your host today, Phil Felice. I'm the Director of Internal Sales here at Aquila. And very excited to have Dave Schiffman joining me, today. Dave is the Lead Portfolio Manager of Aquila High Income Fund. And today, we're going to take a very close look at the high-yield markets, what they look like, and where they're potentially heading. But first, I should say, welcome Dave, and thank you for being here today.

Dave Schiffman:

Thanks, Phil. Great to be here.

Interviewer:

Let's dive right in. 2022 was a challenging period for the fixed income asset classes, and really a challenging period for all asset classes. And high-yield corporate bonds were no different. With that in mind, with 2023 unfolding, already one quarter down, what are some of the key factors that you're seeing in the high-yield markets?

Dave Schiffman:

Great question, Phil. And no doubt, 2022 was extremely challenging for all fixed income investors. A combination of U.S. Treasury rates rising dramatically higher, along with credit spreads moving wider, that really resulted in most major indices producing negative total returns, really not seen in decades. However, the first quarter of 2023 saw a bit of a rollercoaster ride for fixed income markets. Investors tried to decipher mixed signals from various economic data, along with uncertain expectations regarding future Fed policy.

The high-yield market really was, in particular, very choppy. Strong risk on trade drove credit spreads about 40 basis points tighter in January. CCC-rated bonds, in particular, posted a monthly total return of over 6%. Pretty remarkable. The overall high-yield market was up about 4%, just in the month of January. However, surprisingly strong inflation data in February moved overall rates higher and resulted in negative monthly total returns for the high- yield benchmark. The month of March rounded out the quarter with total returns of about 1% for the high-yield index. And that was really mostly driven by the underlying Treasury yield dropping after the surprise banking failures in the middle of the month.

I would say, key factors to watch going forward in 2023 would really be the upcoming earnings season. As we expect many companies to announce downward revisions to earnings estimates, the result of the aforementioned banking crisis will likely lead to tighter lending standards, especially by small and medium-sized banks. These are the folks that lend to small businesses across the country. As we know, small business owners are really the major driver of the overall economy, so any reduced lending to these folks could really be detrimental to the economic growth. In addition, as certain components of inflation remain sticky, we really expect the Federal Reserve (the "Fed") to be vigilant in their fight to drive inflation lower.

With that in mind, we expect at least one more Fed rate hike in May, of 25 basis points, and probably another one over the summer of another 25 basis points. Finally, other factors to consider are geopolitical risks, such as the ongoing Russia-Ukraine crisis, and the upcoming debt limit issues currently debated in Washington, as well as a continued uncertainty about really how high the Fed has to go to get inflation in check.

Interviewer:

Thanks, Dave. A great overview. You mentioned in there, interest rates. And rates, as they tend to do, certainly have their effect on corporates. As we look out at the current yield curve, where do we see relative valuations and potential opportunity for attractive returns?

Dave Schiffman:

With our view that rates will likely move higher from current levels, putting pressure on the overall economy, we continue to really remain slightly defensive. Specifically, we feel that staying focused on shorter duration assets, higher-quality companies, that will really lend itself to attractive risk adjusted returns, all-in rates in the high-yield market hovering right around 8.5%. So, on a relative basis, the asset class really does offer compelling relative value opportunities for investors.

Although rates may move higher during the next few quarters, the relatively low interest rate risk that we see in the high-yield universe, because of the lower duration, combined with corporate balance sheets in better shape than even before the great financial crisis. The asset class has plenty of room to absorb near-term volatility compared to longer duration, less-yielding areas, such as investment-grade corporate bonds and mortgage-backed securities.

Interviewer:

We talked about interest rates. So, I suppose we should mention credit. And another important factor for markets is the default rate of high-yields. Can you talk a bit about current trends and the underlying credit strengths of high-yield bond issuers?

Dave Schiffman:

Sure, absolutely. Listen, the higher rate environment and the likelihood of rates staying higher for longer, as we've heard many times from the Fed, that'll undoubtedly have wide-ranging effects on the capital markets. However, at current levels in the mid-400s, option-adjusted credit spread levels really don't reflect any fear of imminent recession. And really, on a historic basis, balance sheets remain very strong and many companies have refinanced upcoming debt maturities. So far in 2023, the default rate remains pretty low. We've seen a little bit of an uptick from the lows of last year. However, hovering right around a 1.8%-1.9% default rate, it's still really well below the longer-term average at 3%.

Interviewer:

Many of the issuers within high-yield may need to soon issue new bonds as their existing bonds come to maturity. What does this high rate environment mean for potential distress for companies that need to continue to raise capital?

Dave Schiffman:

Well, specifically in high-yield, new issue supply could be a bit challenging, especially for lower-rated issuers, as credit fundamentals begin to weaken later this year and spreads start to widen out. Specifically, we're becoming a little bit more concerned about the large increase in interest expense for those companies with floating-rate debt on their books. Prior to the pandemic, if you remember, rates were actually very low, at historic lows, and that really made it very compelling, especially for high-yield issuers, to issue floating rate debt. Just kept their interest expense low, and it just made a heck of a lot of sense. However, as the Fed executed its aggressive monetary policy, the interest expense that these companies are now faced with are dramatically rising. And that's really putting a lot of pressure on underlying fundamentals.

So, the abilities for these companies to refinance their debt, along with upcoming maturities, will really be one of the keys to the overall performance of the high- yield market in the remainder of 2023. And it's something that we're intently focused on. We're taking a hard look at balance sheets, really reviewing how much exposure these companies have, the floating rate debt versus fixed rate, and really shying away from any companies that will need to refinance their floating rate debt going forward in the upcoming year.

Interviewer:

I'm going to ask you to do some forecasting. And I know that's a portfolio manager's favorite thing to do. But if we experience an economic recession, are there areas of the high-yield market that may be more exposed to potential credit and even default risks?

Dave Schiffman:

Well, as I mentioned earlier, default rates have ticked up slightly, but they still do remain fairly low on a long-term basis. What we're really doing now with an anticipation of a likely rollover of the economy. We're watching the CCC sector of the market very closely, as well. As I mentioned earlier, any company that has a high percentage on their books, a floating rate note, because that's going to be tough for them in terms of the interest expense that they're incurring now.

Another sector that we're watching extremely closely is the REIT sector and the current developments in the commercial real estate space, which has really become very bifurcated over the last year or so. Since the economic recovery from the pandemic, the office space has really lagged other sub-sectors, as many companies continue to have employees work from home. We've seen occupancy levels, especially in Class B and Class C office space remain well below historic levels, making it very difficult for building owners to service their debt. We've started to see some really high-profile defaults in the commercial real estate sector. And we do expect to see more in the coming quarters. Therefore, what we've done is really avoided any exposure to the office space within the reallocation we have in the portfolio, and really have focused our investment in areas that rebounded nicely since the pandemic.

As we saw the switch in consumer behavior from buying goods with the stimulus that they received during the pandemic, now folks are focused on travel and entertainment, getting out of the house after being cooped up for so long. This really has benefited names we own in both hotels and casinos in the REIT sector.

Interviewer:

A bit earlier, you mentioned supply and demand. Can you talk further about new issues and what that means for the high yield market, and even a bit on investor demand?

Dave Schiffman:

Phil, after an anemic end in 2022, which we saw supply in December coming in at only about $2 billion, in the first quarter of 2023, we're really off to the races, as issuers took advantage of the risk-on-trade I talked about earlier on. As you might remember, January was an extremely strong month in terms of total returns for the high-yield market. A lot of issuers came to market very quickly. Through the end of March, we saw over 40 billion in new issue high-yield bonds, which was really the highest quarterly total since the first quarter of 2022, according to J.P.Morgan Credit Research.

Yet, a combination of negative fund flows in the quarter, combined with many high yield investors becoming just a bit more cautious from a credit perspective, that's really driven demand lower over the last three months. We expect this ebb and flow to continue throughout the year, as markets still face a lot of uncertainty related to both the economic data and movements in interest rates.

Interviewer:

Thanks, Dave. And overall those are some great insights. But just to briefly summarize, here are a few takeaways that I took from our conversation today. With absolute yields well above 8%, high-yield bonds are attractive and offer greater income on a relative basis versus other fixed income asset classes. They also enable valuable diversification to a well-rounded investment portfolio, as price moves tend to be less-correlated to other investments. The high-yield market is off to a good start this year, but investors should be prepared for potential volatility along the way. And then, the last thing I took is our current bias within the Fund is relatively short duration and up in quality. And Dave, I don't know if that's summed up your points, but was there anything you wanted to add to that?

Dave Schiffman:

That was a great overview of some of the things we discussed, Phil. The only other points I would add to it would be, just thinking about my experience throughout the years, I would say in managing institutional investment portfolios for well over 30 years, this is probably one of the most uncertain environments I've seen. Hence, we believe active portfolio management with an intense focus on comprehensive due diligence is really going to be vitally important.

We never lose sight of our mantra of "do no harm." We're going to remain disciplined in our approach. We'll keep a keen eye on being opportunistic and adding bonds with exceptional relative value on a risk adjusted basis. And really, our ability to cover the entire high-yield universe will allow the team to identify themes and investments that will truly add incremental yield while maintaining a well-diversified conservative low-volatility portfolio.

Interviewer:

Well, Dave, thank you for your time today. I always appreciate the conversations. And I'm happy that we get to share this one with our advisory universe and our clients. Thanks for being here, today.

Dave Schiffman:

You're very welcome, Phil. I really enjoyed our conversation.

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