

Executive Summary – Clean Sweep

Amidst thawing trade tensions and a patient Federal Reserve (“Fed”), the high yield (“HY”) bond and leveraged loan markets both posted positive returns for all four quarters of 2019.

Sigh of Relief

With fears of a recession diminished, the leveraged credit markets continued to grind. Overall HY bond spreads ended 4Q19 (“4Q”) more than 40 basis points (“bp”) tighter and firmly below 400 bp according to the ICE BofA US HY Constrained Index. During 4Q, returns by credit quality were led by lower quality CCC-rated bonds, whereas BB-rated bonds returned positively but lagged. According to JP Morgan, all industry groups returned positively during the quarter. The Auto industry once again led returns along with Housing and Healthcare, whereas Media and Services returns were barely positive. Within loans, lower quality issuers led the way along with the Retail industry; Energy and Metal & Mining were the only negatively performing loan industry groups.

Capital Market Indicators

After continued 4Q inflows, the HY bond market recovered over \$18b of mutual fund flows in 2019, recouping about a third of 2018’s outflows of \$46b. Strong bond technicals were aided by very modest net new bond issuance of over \$4b and “rising stars” (HY bonds upgraded to investment grade status) significantly outweighed “fallen angels” (investment grade bonds downgraded to HY status) to push the YTD net rising star advantage to over \$40b. Rising stars have sizably outweighed fallen angels since the beginning of 2017. Bond issuance totaled \$78b in 4Q, but was almost fully offset by calls, tenders, and maturities.

As the Fed turned more dovish, leveraged loans lost almost \$8b in retail flows in 4Q and almost \$38b in 2019. Net new loans issuance YTD was a modest +\$8b as paydowns, repricings, and collateralized loan obligations (“CLO”) issuance nearly offset gross loan issuance. Whereas the overall quality of bond issuance remained high, including a post global financial crisis peak in BB-rated issuance, we have noted an increased percentage of loan issuance proceeds being used for acquisitions. While still not at a concerning level, we believe this bears watching. The equity market continues to be an important source of capital, although

the IPO market is slowing, particularly for cash-poor companies. The Russell 2000 Index recovered from its summer swoon to post a near +10% return in 4Q and finished the calendar year returning over 25%. Companies priced over \$23b of primary and secondary stock during 4Q19 and over \$120b in 2019. According to Bloomberg, primary and secondary equity issuance for 2018 totaled \$140b which surpassed 2016 levels but fell just short of 2017 levels. Both debt and equity capital markets remain open to higher quality sub-investment grade companies to grow their businesses responsibly, even if doing so by acquiring other companies with modest additional leverage.

Defensive High Yield

Our Defensive HY strategy outperformed the ICE BofA BB-B Rated Non-Distressed Index in 4Q (accounts with loan exposure also outperformed albeit slightly less). An underweight to BB-rated paper, the most rate sensitive within the HY markets, contributed to performance. Security selection within Energy, Telecommunications, Technology, Services, and Retail sectors added value whereas Financial Services and Auto sectors detracted slightly. An overweight allocation and security selection within Metals & Mining was the primary detractor in 4Q. For global benchmarks, such as the ICE BofA family of indices, an underweight to European credits continued to be a detractor in 4Q as it has been all year.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index in 4Q (accounts with loan exposure also outperformed albeit slightly less). An underweight to BB-rated paper, the most rate sensitive within the HY markets, contributed to performance. Security selection within Energy was the top contributor as well as the Services, Utilities, Food/Beverage, and Gaming sectors. Security selection within Telecommunications and Metals & Mining sectors were the primary detractors, although Telecom remained a positive contributor for the calendar year. An underweight to European credits continued to be a detractor in 4Q as it has been all year.

Ultra Short Duration High Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, outperformed the ICE BofA 1-3 Year US Corporate/Government Index in 4Q. Our strategy of mainly BBB-B rated corporate bonds rallied as short-term Treasury yields remained stable in response to an “on-hold” Fed. The strategy benefitted from exposure within the Media & Broadcasting sector as well as from security selection within the Financials and Healthcare sectors. All industry groups returned positively in absolute terms during 4Q although Building/Building Materials and Utilities sectors lagged the most. Loans outperformed the index but trailed HY bonds as B-rated bonds outperformed BBB/crossover-rated bonds within the strategy.

Defensive Short Duration High Income

During 4Q, our Defensive Short Duration High Income strategy, which maintains an average portfolio maturity of 3 years or less, outperformed the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index but underperformed the BB-B rated version of the index (accounts with loan exposure lagged bond-only accounts). Our strategy of mainly BBB-B rated corporate bonds added value via security selection within the Consumer Products, Services, Financials, and Healthcare sectors. Detractors included security selection within Energy and Telecommunications sectors. Our conservative paper maturing in 0-1 years lagged index securities maturing in 1-3 years. B-rated bonds outperformed both BB-rated and BBB/crossover-rated bonds within the strategy.

Defensive Floating Rate Income

During 4Q, our Defensive Floating Rate Income strategy outperformed its benchmark, the S&P/LSTA BB-Rated Loan Index but underperformed the broader Credit Suisse Institutional Leveraged Loan Index. The strategy generated strong performance during the first 9 months of the year, but lagged in the final quarter as B-rated loans staged a strong December rally to close 2019. Given the strategy's BB-rated loan emphasis, performance lagged in periods of B-rated loans leadership. The strategy's allocation to HY bonds, held primarily to enhance liquidity, helped during the quarter whereas our underweight exposure to large liquid loans detracted.

The best performing position was an investment in a previously leveraged buyout data center service company that posted healthier than expected results. The sponsor remains focused on buying back bonds in the open market and strengthening its balance sheet. The investment remains a core holding in the portfolio. The largest detractor to performance was an investment in a public pharmaceutical company that declined on missed expectations and, to a lesser degree, exposure to opioid liability risk. We exited the position in 4Q stemming from our sell discipline.

Despite lagging HY bonds in 2019, primarily due to less asset class duration, loans generated an outsized return for the year relative to their history and risk profile. The loan market shrugged off headwinds, including a global industrial manufacturing recession, falling LIBOR, record ETF outflows, and a Chinese trade war. By year end most loans were once again trading above par, helping to facilitate a flurry of repricing activity in 4Q. This stands in sharp contrast to 4Q18 when the asset class fell 5 bp and suffered from a wall of record redemptions.

We remain constructive on bank loans in 2020, notwithstanding valid red flags like slowing global GDP, Mideast geopolitical tensions, and a divided political climate. We believe 2019's interest rate cuts have cushioned the US economy and ushered in a return of “Goldilocks” financial conditions ripe for coupon clipping. Similar to last year, our borrowers face minimal debt maturities, loan technicals remain in balance, and 2020 default rates are expected to remain well below long term averages. Despite being secured and senior in priority, loan yields rivaled HY bond yields of the same credit rating, a relationship that could help lessen redemptions and renew buyer interest in the asset class. We acknowledge that low interest rates and an intense search for yield will enable borrowers to consider taking bigger risks. Name constrained mandates, like our strategy, typically thrive in this environment as we are not required to buy the market and can remain highly selective in choosing where to invest.

Outlook

Although some pairs of the yield curve inverted or flirted with inversion during 2019, we still do not believe a recession is imminent.

Outlook (cont.)

Rather, we see an economic slowdown driven by manufacturing, reduced trade, and supply chain reconfiguration. Massive global central bank intervention leaves us skeptical to compare past recessionary clues on an apples-to-apples basis considering the inversion events. Additionally, this inversion only impacted less than half of the maturity pairs that “normally” predict a recession. All maturity pairs which we track were positive to start 2020 and maintained a steepening trend.

Ex-Energy and Ex-Metals/Mining, the US HY and loan last-twelve-month bond default rates are now both below 2% and we continue to forecast a below-average default rate for 2020. We expect fundamentals for HY companies, most of which are US-centric non-global-traders, to remain relatively healthy, although commodity-industry defaults may remain elevated. The “Trade War” could help usher in the return of a “Goldilocks” economy, with modest growth and modest inflation, which would be a positive environment for credit.

2019 was the first double-digit returning year for HY bonds in which BB-rated bonds led the way; bonds also outpaced loans twofold during the calendar year. We believe 2020 will be unlikely to repeat this strong return pattern, although we expect loan and bond returns to remain positive yet closer together. We continue to favor the loan asset class as a bond complement, particularly higher quality first-lien loans that offer downside protection in the event of an unexpected economic recession. Because the valuation gap between BB-rated and CCC-rated paper is historically wide, we would expect this relationship to consolidate during 2020 in a non-recessionary scenario.

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An investor cannot directly invest in an index. The ICE BofA 1-3 Year US Corporate & Government Index is a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a remaining term to final maturity of less than three years. The ICE BofA 1-3 Year BB US Cash Pay High Yield Index is a subset of The ICE Bank of America US Cash Pay High Yield Index, which tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB. The ICE BofA US High Yield Constrained Index contains all securities in The ICE BofA US High Yield Index but caps issuer exposure at 2%. The ICE BofA BB-B Rated Non-Distressed Index is a subset of The ICE BofA US High Yield Index including all securities rated BB1 through B3, inclusive, with an option-adjusted spread less than 1,000 basis points. The Credit Suisse Institutional Leveraged Loan Index is a sub-index of the Credit Suisse Leveraged Loan Index. The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the \$US-denominated leveraged loan market. The S&P/LSTA BB Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market and is comprised of loans whose rating is BB+, BB or BB-. Standard & Poor's Rating Services is used to determine membership within this sub-index. The Russell 2000 Index is comprised of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 11% of the Russell 3000 total market capitalization.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request. PC-CRCOM011520

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