High Yield Strategies

Executive Summary

After a bout of tax reform euphoria, the high yield ("HY") market posted its first quarterly negative return since 2015 on concerns about rising rates and trade policy, whereas the 2015 sell-off was more commodity-credit related. We would classify 1Q 2018 ("1Q") as a healthy pull-back where fundamentally not much has changed.

All good things must come to an end...

Despite returns, spreads ended 1Q approximately where they began, thanks to Treasury yields. BB-rated credits underperformed while the lowest quality CCC-rated bonds outperformed given their sensitive nature to economic activity and lower sensitivity to interest rates. Within the overall index, sectors such as Energy, Metals & Mining, and Retail were stronger, while the Automotive sector performed the weakest on duration and trade concerns.

Capital Market Indicators

HY bond new issue volume for the first quarter totaled $73b, mostly used to fund calls, tenders and maturities however. According to JP Morgan, that pace of net new supply would be close to rivaling 2016 as the lowest since 2008. The $19b worth of HY mutual fund outflows, which matched the outflows for the entire calendar year of 2017, was almost exactly offset by coupon payments. The dollar amount of fallen angels was almost exactly offset by rising stars, signaling that market technicals were somewhat muted during the "sell-off". The amount of leveraged buyout (LBO) new issuance as a percentage of the HY market is near its lowest since 2002 and 2009. The overall quality of issuance year-to-date (YTD) has been high, with less than 0.5% of proceeds YTD being used by lower-rated issuers for non-refinancing purposes, setting a pace for the lowest since 2002. By comparison, this figure was 2.2% in 2013 and over 5% in both 2007 and 1998. Likewise, typically aggressive dividend and non-cash pay issuance remained near all-time low levels.

Concurrently, the equity market continues to be an important source of capital. According to Bloomberg, secondary equity issuance of $34b during 1Q was on pace to top both 2016 and 2017. In these regards, capital markets remained 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.

Attribution

Defensive High Yield

Our Defensive HY strategy outperformed the ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index in 1Q. In a reversal from 4Q 2017 ("4Q"), Telecommunications was the main contributor as wireline names rebounded from tax-loss selling amidst refinancing opportunities. Both Energy and Technology also added value across security selection, as did Media & Broadcasting and Utilities. Sectors with the most rate-sensitive bonds lagged, such as Metals & Mining, Gaming, and Financials. For accounts with loan allocations, senior floating rate loans returned positively and outperformed bonds as LIBOR rallied with the Federal Reserve Rate.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA Merrill Lynch US HY Constrained Index as the CCC-rated bucket outperformed in the rising rate environment. In a reversal from 4Q, Telecommunications was a main contributor as wireline names rebounded from tax-loss selling amidst refinancing opportunities. Both Energy and Technology also added value on security selection, as did Media & Broadcasting, Gaming, and Retail. Weakness within Restaurants and Pharmaceuticals, as well as in some longer duration bonds, modestly offset gains elsewhere. For accounts with a loan allocation, senior floating rate loans returned positively and outperformed bonds as LIBOR rallied with the Federal Reserve Rate.

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, outperformed the ICE BofA Merrill Lynch 1-3 Year US Corp/Gov Index. Our strategy of mainly BB-rated sub-investment grade holdings, which includes corporate bonds and loans, returned positively whereas short-term Treasuries returned negatively on Federal Reserve and deficit fears. The strategy benefitted from its exposure within Telecommunications, Financials, and Healthcare. Metals & Mining was weaker on trade-war fears whereas Homebuilding was weaker on rate fears. For accounts with a loan allocation, senior floating rate loans outperformed bonds and the benchmark as LIBOR rose. Looking forward, we continue to expect capital markets to remain open to high-quality sub-investment grade companies. During 1Q, our short duration strategies continued to benefit from positive catalysts including over a dozen refinancings and multiple equity issuances.

Defensive Short Duration High Income

Our Defensive Short Duration High Income strategy, which maintains an average portfolio maturity of 3 years or less, underperformed the BAML 1-3 Year BB-B Cash Pay High Yield Index but outperformed the BB-version of the index. Security selection within Telecommunications and Technology added value and more than offset weakness within Media & Broadcasting, Retail, and Services. For accounts with a loan allocation, senior floating rate loans outperformed bonds and the benchmark as LIBOR rose. Looking forward, we continue to expect capital markets to remain open to high-quality sub-investment grade companies. During 1Q, our short duration strategies continued to benefit from positive catalysts including over a dozen refinancings and multiple equity issuances.

Defensive Floating Rate Income

During 1Q, our Defensive Floating Rate Income strategy underperformed its benchmark, however, the strategy did outperform the S&P/LSTA BB Index. New issue volume continued at an accelerated pace during 1Q ($242b) of which re-pricings and refinancing represented approximately 47% and 22% of total volume, respectively. Net issuance (ex-repricing/refinancing) of $76b was up 17% year-over-year (YoY). Retail inflows ($3.7b), collateralized loan obligation (CLO) creation ($29b net of refinancing/resets), and the continued rise in 3-month LIBOR (+60 bp) continued to provide solid technical support for the loan market where approximately 73% of the loan universe was trading in excess of par at quarter-end.

The strategy continues to favor a higher quality bias as we remain underweight to single B-rated and CCC-rated exposure vis-à-vis the broader loan indexes. During 1Q, the strategy remained exposed to corporate bonds with an approximate weighting of 12%, which was a slight headwind to performance given YTD bond market volatility. In addition, we continued to be selectively active in the primary market. Sectors positively contributing to performance were Transportation, Technology, and Utilities. Given the expectations for further rate increases in 2018, we continue to believe loans remain an attractive opportunity for investors, particularly compared to high-quality fixed income classes.

Outlook

We view 1Q as a healthy pull-back for a market which experienced positive returns for 8 consecutive quarters. The US HY and loan last-twelve-months (LTM) bond default rate is now hovering around 2%. We remain optimistic on the US economy and corporate creditworthiness. We continue to forecast a relatively low default rate and expect merger & acquisition (M&A) activity to benefit small-cap oriented asset classes like HY. Generally, we expect fundamentals for HY companies, most of which are US-centric non-global-traders, to remain relatively healthy, and we expect commodity-industry defaults to remain below historical HY averages.

HY indices returned a rare coupon-like 7% in 2017, in line with our estimates. We expect 2018 to be similar, if less, with the main variable being the direction of interest rates. Significantly higher interest rates across the Treasury curve would negatively impact HY market return expectations, however we would expect the asset class to outperform higher quality fixed-rate strategies as it has during the past rate hike cycles. To the extent that long-term interest rates will rise in a growing economy, we believe that larger-cap dividend paying equities and longer duration fixed income asset classes, including investment grade corporates, may underperform as a result. We continue to favor the loan asset class, particularly for more conservative investors, and have been increasing our allocation gradually over the last several years for those clients with loans in their portfolio. Although loans generally lack call protection and returns have generally lagged bonds, loans provide an effective complement, not substitute, to bonds given their seniority and floating rate nature.

Specialists in capital structure investing

At Penn Capital, we believe that understanding a company's entire capital structure is the best way to identify investment opportunities with the most value. In fact, we've found that managing bond portfolios makes us better equity managers, and vice versa. Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing. We are an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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The ICE BofA Merrill Lynch 1-3 Year US Corporate & Government Index is a subset of the ICE BofA Merrill Lynch 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. An investor cannot directly invest in an index. The ICE BofA ML US HY Cash Pay BB-B Rated 1-3 Year Index is a subset of The ICE Bank of America Merrill Lynch 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-B. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch US High Yield Constrained Index contains all securities in The ICE BofA Merrill Lynch US High Yield Index but caps issuer exposure at 2%. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index is a subset of The ICE BofA Merrill Lynch 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 Credit Suisse Institutional Leveraged Loan Index is designed to more closely reflect the investment criteria of institutional investors by sampling a lower volatility component of the market. An investor cannot directly invest in an index.

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

