High Yield Strategies

Executive Summary

The high yield ("HY") market bounced back from its first negative return quarter since 2015 as longer-term interest rates stabilized and economic fundamentals remained solid. Whereas longer term interest rates did find stability, shorter term interest rates continued to rise in response to the Federal Reserve ("Fed") and inflation fears.

Inversion Fears

Many wondered if the flattening yield curve would invert, and if so, whether that would indicate an imminent recession. Yet, corporate credit fundamentals remain relatively strong and we would tend to agree with JP Morgan's assessment that 2019 should experience a lower default rate than 2018.

In some ways, 2Q 2018 ("2Q") and 1Q 2018 ("1Q") were similar in that spreads, again, ended 2Q about where they started, and BB-rated bonds again underperformed. CCC-rated bonds outperformed given that they are more sensitive to economic activity and least sensitive to interest rates. During 2Q, Retail led the way for returns along with Telecommunications, Healthcare, and Energy, whereas the Automotive sector clearly underperformed.

Trade War or Trade Spat?

The rally in credit, as well as the small-cap oriented Russell 2000 Index (which overlaps with much of the HY universe), occurred despite a backdrop of concern on trade wars. Despite reprisal exchanges occurring across borders, securities of these mostly US-centric companies were relatively unscathed given their underexposure to export markets. The markets may also be treating new tariffs as a negotiating ploy and not permanent policy; we would tend to agree.

Capital Market Indicators

Despite over $25b in HY mutual fund outflows year-to-date (YTD), which already exceeds the worst calendar year ever, market technicals showcased their resilience thanks to historically low net new supply. HY bond gross new issue volume for 1Q totaled a modest $54b, however, the amount used to fund calls, tenders, and maturities exceeded this figure. According to JP Morgan, this pace of net new supply would be close to rivaling 2016 as the lowest since 2008. Further, "rising stars", or bonds upgraded to investment grade status, totaled $38b which is on pace to be the second-best year on record. The overall quality of issuance in 2018 continued to be high with only less than 0.5% of proceeds YTD used by lower-rated issuers for non-refinancing purposes, on pace for the lowest since 2002. The amount of LBO (leveraged buy-outs) new issuance as a percentage of the HY market is near its lowest since 2002 and 2009. By comparison, this number was 2.2% in 2013 and over 5% in both 2007 and 1998. Likewise, despite higher borrowings to fund dividends, non-cash pay issuance remains near all-time low levels.

Concurrently, the equity market continues to be an important source of capital. According to Bloomberg, YTD primary and secondary equity issuance of $82b was on pace to top both 2016 and 2017. 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.

Attribution

Defensive High Yield

During 2Q, our Defensive HY strategy outperformed the ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index, as an overweight to single-B rated credits continued to outperform more rate-sensitive BB-rated credits.

Strong security selection within Telecommunications once again led the way as the overall Financial Services sector lagged as the yield curve flattened, however, our strategy benefitted from security selection and an underweight position compared to the Index. Remaining underweight relative to both Packaging and Building & Building Materials sectors also added value during 2Q. Healthcare contributed with positive security selection and being overweight the Index, whereas the Retail & Apparel sector contributed via an underweight position coupled with strong security selection. Credit-specific weakness detracted value within Paper & Forest Products and Media & Broadcasting sectors. For accounts with a loan allocation, senior floating rate loans continued to outperform bonds in 2Q.

Opportunistic High Yield

During 2Q, our Opportunistic HY strategy performed in-line with the ICE BofA Merrill Lynch US HY Constrained Index as the CCC-rated bucket continued to outperform in the rising rate environment. Security selection within Automotive, Healthcare, and Restaurants added the most value, as did an underweight to Packaging and Building & Building Materials sectors. Financial Services sector lagged as the yield curve flattened, however, our strategy benefitted from security selection and an underweight position compared to the Index. Credit-specific weakness detracted value within Energy, Media & Broadcasting, and Telecommunications.

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in three years or less, outperformed the ICE BofA Merrill Lynch 1-3 Year US Corp/Gov Index in 2Q. Our strategy of mainly BB-rated sub-investment grade holdings, which include corporate bonds and loans, outperformed short-term Treasuries which were relatively flat during 2Q. The strategy benefitted from its exposure within Building & Building Materials, Telecommunications, and Healthcare sectors, whereas Automotive was weaker with trade-war concerns. Looking forward, we continue to expect capital markets to remain open to high quality sub-investment grade companies; during the first half of 2018, our short duration strategies continued to benefit from positive catalysts including over a half-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 three years or less, underperformed the ICE BofA Merrill Lynch 1-3 Year BB-B Cash Pay High Yield Index in 2Q but outperformed the BB-version of the Index. Security selection within Telecommunications, Technology, and Utilities sectors added value but were offset by security selection within Retail and Technology. For accounts with a loan allocation, senior floating rate loans underperformed short duration bonds during 2Q despite LIBOR rising. Looking forward, we continue to expect capital markets to remain open to high quality sub-investment grade companies; during the first half of 2018, our short duration strategies continued to benefit from positive catalysts including over a half-dozen refinancings and multiple equity issuances.

Defensive Floating Rate Income

During 2Q, our Defensive Floating Rate Income strategy outperformed its broader loan Index as well as the S&P/LSTA BB-Rated Index. New issue volume continued at an accelerated pace during 2Q ($259b) of which re-pricings and refinancing represented approximately 42% and 23% of total volume, respectively. Net issuance (ex-repricing/refinancing) of $91b in 2Q and $167b YTD was up 21% and 19% year-over-year, respectively. Retail inflows ($7b in 2Q and $11.9b YTD), collateralized loan obligation (CLO) creation ($70b YTD

net of refinancing/re-pricing/re-issue), and the continued rise in LIBOR (1 and 3-month) continued to provide solid technical support for the loan market. Elevated net issuance in May and June of this year equaling $75b resulted in a decline in secondary prices. At quarter end, only 24% of the loan universe was trading in excess of par vs. approximately 73% at the end of the March. We expect loan prices to recover given expectations for a more measured primary calendar.

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 2Q, the strategy remained exposed to corporate bonds with an approximate weighting of 11%, which was a slight headwind to performance given YTD bond market performance. In addition, we continued to be selectively active in the primary market. 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 asset classes.

Outlook

Just as we viewed 1Q as a healthy pull back for a market which had positive returns for eight consecutive quarters, we view 2Q as the market getting back on track. The US HY and loan last-twelve-month ("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 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 positive, but less than 2017, with the main variable being the direction of interest rates. Significantly higher interest rates across the US 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 past interest 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 as a bond complement, particularly for more conservative investors that desire floating rate exposure, and have been increasing our allocation gradually over the last several years for those clients with loans in their portfolio.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns.

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.

Specialists in capital structure investing

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