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Executive Summary: Strong 4Q23 Returns Help Cement Solid 2023 Gains As The Setup For 2024 Remains Favorable

US high yield ("HY") bonds posted the highest quarterly return of the year during 4Q23 ("4Q") as corporate earnings remained resilient and expectations for a more dovish Federal Reserve ("Fed") in the future increased. As we look ahead to 2024, we believe the US HY market remains poised to deliver strong returns for another consecutive year if the Fed continues to navigate a soft landing successfully. While spreads are now at relatively tight levels, we believe that attractive market coupon rates, the potential for further cuts to US Treasury rates and a healthy backdrop for corporate earnings all have the potential to combine in 2024 and provide the potential for high single digit returns for market participants.

Lower Rated Credits Outperformed In '23 Despite Strong Duration Led BB Performance in 4Q

The US HY bond market provided gains of 13.51% in 2023 due in large part to strong 6.93% returns in 4Q. During the quarter, spreads compressed 43 bps and yields fell to 7.82% at quarter end. At current spread levels of 377 bps, the US HY market is now trading over 120 bps tighter than historical median levels. During 4Q, the market rallied as inflationary headwinds showed signs of abating and a Fed led economic "soft-landing" looked more likely.

By rating, duration sensitive BB-rated companies were the top performing HY bonds in 4Q with returns of 7.15%. Riskier CCC-rated credits did not fare much worse however as they were able to return 7.03% in the quarter due in part to the significant spread compression seen by the market in December. The lowest rate of return for the quarter was split B-rated bonds which returned a healthy 4.37%. For the full year 2023, CCC-rated bonds were the clear outperformers with returns of 20.39% at year-end while split BBB-rated bonds were the worst performers despite returning 10.39%.

The Retail sector was the best performing industry in 4Q with gains reaching 9.36% as consumer spending remained more robust than what was initially feared. Housing was the second-best performing sector during 4Q as gains reached 8.65% on the back of lower mortgage rates and continued consumer demand for new construction. The worst performing sectors in 4Q were Metals & Mining and Transports which returned a respectable 4.06% and 4.16%, respectively. For the full year 2023, the best performing sectors were Housing, up 17.31%, and Automotive, up 17.07%. The worst performing sector was Broadcasting which returned a still respectable 8.89% for 2023.

Market credit quality, as measured by ratings, declined slightly on a dollar-weighted basis in 4Q as the upgrade/downgrade ratio fell to 0.8. This marks the first quarterly negative reading for this ratio in 2023, but it was not negative enough to undue all the credit improvement seen earlier in the year as the ratio recorded a 1.3 level for 2023. The US HY default rate ended the year at 2.84%. While this is up 119 bps, year-over-year ("YoY") it is still well below the historical average default rate of 3.4%. (Source: JP Morgan)

Capital Market Indicators

The US HY primary market continued its YoY volume recovery in 4Q primarily due to heavy November and early December issuance. This late year flurry of activity was likely due to companies taking advantage of the significant drop in US Treasury rates which in turn allowed them to secure financing at lower coupon rates. At ~$42b in gross issuance, the 4Q new issue calendar was significantly busier than 2022 levels where issuance averaged $16.5b in 4Q. For the full year 2023 issuance totaled almost $176b, up ~65% from 2022 levels.

Refinancing activity remained the main driver of issuance in 4Q once again with refi deals representing ~78% of new volume in 4Q and ~66% of new issuance for the full year. By ratings, issuance reverted to focusing on higher rated BB credits in the quarter. In total, BB-rated deals represented ~56% of the new bonds issued during 4Q. For the full year 2023, BB-rated bonds represented ~47% of new issuance while B-rated bonds made up ~36% of new deals. CCC-rated issuance, at only 1% of new volume in 2023, was notably absent from the market this year despite an uptick in December. At year end, BB and split-BB rated bonds still represented the majority of HY market value. (Source: JP Morgan data)

Defensive Short Duration High Income

The Defensive Short Duration High Income strategy, which holds mainly BB/B rated bonds with an average portfolio maturity of 3 years or less, slightly underperformed the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index in 4Q. The Paper industry outperformed as a tissue maker benefitted from lower pulp prices. The Media sector benefitted from optimism after the conclusion of the Hollywood writers' and actors' strikes. Within the Aerospace sector, two companies successfully refinanced their maturities despite short term operating challenges. The strategy underperformed within the Industrial Services sector due to our underweight allocation. Specialty Retail also underperformed as the sector faced a consumer who is more focused on experiences compared to goods spending.

Defensive High Yield

The Defensive HY strategy outperformed the FTSE BB/B Capped HY Index during 4Q. In the Telecom sector, a company outperformed as it securitized assets and avoided a large issuer that entered into a transaction support agreement with key bondholders. In the Gaming sector, a company opened a new casino that exceeded initial expectations. Within Banking, the sector benefitted from lower interest rates as deposit disintermediation concerns ebbed.

The Airline sector lagged in 4Q as increased capacity coupled with weaker demand pressured margins. The Energy sector also lagged as oil prices declined during the quarter weighing on profitability. Higher rated BB bonds outperformed B-rated bonds during the quarter. We incrementally upgraded the credit quality of the portfolio by adding to BB+ rated bonds while reducing B-rated bond exposure as we focused on strong capital structures. Duration was slightly higher than the benchmark which was beneficial during the quarter.

Opportunistic High Yield

The Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index during 4Q. The Media and Advertising sectors outperformed during the quarter as advertising trends and 2024 expectations both improved within the market. Strong security selection drove performance in the Technology Hardware & Software sectors. The Airline sector lagged during the quarter as increased capacity coupled with weaker demand pressured margins in the second half of 2023. The Energy sector also lagged as oil prices declined during 4Q weighing on profitability.

The portfolio incrementally added to higher quality B-rated bonds while reducing exposure to CCC-rated credits. Higher quality bonds outperformed with BB-rated bonds returning 7.43% vs 6.52% for CCC-rated bonds in the index due to declining interest rates during the quarter. Portfolio duration was slightly longer than the benchmark which was a performance tailwind.

Outlook

The Fed signaled in December that the interest rate hiking cycle has ended providing projections of cuts to come in 2024. Interest rates have been a significant headwind to the HY market over the past three years; this is a welcoming signal. HY coupons have risen to 6.15% (at a $92.86 dollar price) over the past two years providing a stronger return environment for the asset class going forward. The pace of rate cuts will be a second factor for prospective returns in 2024 with a modified duration of 3.67 providing the prospect of high single to double digit returns based on the Fed rate guidance, in our opinion.

The current environment calls for focusing on strong credits that can weather economic slowdown due to higher rates. In many areas, the credit market is not differentiating well between the strongest companies and weaker competitors so we are upgrading our portfolio's by reducing risk with little loss of return today. New issuance has been muted but we have found a "buyer's market" with high coupons and strong covenants providing an attractive risk-return paradigm.

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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 a boutique investment management firm based in Philadelphia, PA. 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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A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
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