Executive Summary – Nothing but Red

Credit markets were hit with a one-two punch of the coronavirus and an oil price war, resulting in the second-worst high yield ("HY") bond market quarterly return on record.

Storm of the Century…

The world was turned upside-down in March. A recession appeared to be upon us as the coronavirus swept around the globe and the Saudis and Russians started another oil price war. During 1Q20 ("1Q"), BB-rated bonds rallied late to separate their performance from single-B rated and CCC-rated bonds. Still, all credit qualities within both bonds and loans delivered double-digit negative returns.

According to JP Morgan, all industry groups returned at least -5% during 1Q as the Energy sector by far suffered the most, dropping more than 40%. Consumer/Leisure and Cyclical Industries were also down double-digits in addition to Gaming, Leisure, Transport, Broadcasting, Metals & Mining, and Autos. The best performing industries were Telecommunications, Utilities, Technology, Packaging, Cable, and Healthcare. Loans generally did not offer shelter as they marginally outperformed bonds. It was difficult to avoid the impact of cancelled sporting events, postponed surgeries, and the closing of restaurants, bars, resorts, and casinos.

Capital Market Indicators: Green Shoots?

The Federal Reserve ("Fed") took extraordinary steps during March to backstop the investment grade ("IG") market, including backstopping the commercial paper market and authorizing the direct purchase of IG bonds inside of 5 years to maturity. That alone was an important step for the HY market, which opened $10b of issuance during the last week of March and first week of April. Granted, most of the issuance was shorter maturity and secured but still a step in the right direction. There was no new issuance in the HY market for four of the prior five weeks and the $10b raised in the last 2 weeks totaled the entire sum placed since mid-February.

As if the Fed's actions in March were not enough, on April 9th the Fed announced their ability to purchase "fallen angels" (investment grade bonds downgraded to HY status) that were downgraded after March 22nd as well as certain HY ETFs. The market reaction was extraordinary. The Fed's action one-upped Mario Draghi's 2012 historic "whatever it takes" moment. The path forward is still complex and uncertain, but the reality is that the HY market is much safer than it was several weeks ago.

Defensive High Yield

During 1Q, our Defensive HY strategy experienced a fair amount of dispersion given various client guidelines. Most accounts underperformed the ICE BofA BB-B Rated Non-Distressed Index but did outperform the broad ICE BofA HY Index. Accounts with individual loan exposure lagged in part due to the sharp drop in LIBOR. An underweight to BB-rated paper, the least cyclical within the HY market, was a detractor as the portfolio was not positioned for a sharp recession.

From a sector standpoint, Energy was a neutral impact. Outperformance from Energy E&P and Services industries offset underperformance within the normally defensive Pipelines industry, where most of the absolute exposure was located. The portfolio was relatively well positioned within the "core" coronavirus afflicted industries: Retail, Transports/Airlines, Lodging & Leisure, and Autos. Industries that underperformed the most on a relative basis were Aerospace & Defense, Healthcare, and Gaming, which are typically defensively positioned industries within our modeling. Underweights to less cyclical Cable, Telecommunications, and Packaging detracted and were partially offset by strong security selection within Chemicals and an overweight to supermarkets.

Opportunistic High Yield

Our Opportunistic HY strategy underperformed the ICE BofA US HY Constrained Index in 1Q. The portfolio benefitted from its underweight to CCC-rated credits but was offset by an underweight to BB-rated bonds. As the result of the portfolio focusing on single-B rated bonds, it was ill-suited for a sharp recession.

PENN CAPITAL

Opportunistic High Yield (cont.)

From a sector standpoint, Energy was a positive relative contributor thanks to strong security selection within the Energy E&P industry and an underweight to the Energy Services industry. The portfolio was relatively well positioned within the "core" coronavirus afflicted industries of Retail, Transports/Airlines, Lodging & Leisure, and Autos, although was negatively impacted by the rental car business. Aerospace & Defense and Healthcare industries, usually deemed more defensively positioned, underperformed in 1Q. Underweights to the less cyclical Cable and Packaging industries detracted and were partially offset by security selection within the Consumer Products industry and an overweight to supermarkets.

Ultra Short Duration High Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, underperformed the US Treasury-dominant ICE BofA 1-3 Year US Corporate/Government Index while outperforming the ICE BofA 1-3 Year BB US Cash Pay HY Index. Our portfolio of mainly BBB-B rated corporate bonds was negatively impacted by a variety of pandemic-sensitive industries such as Gaming, Transports, Retail, and Building & Building Materials. Strong security selection in Packaging, Healthcare, Chemicals, and Metals/Mining industries was beneficial to performance in 1Q. Loans underperformed the benchmark but did manage to outperform our bond holdings as single-B rated bonds underperformed BBB/crossover-rated bonds within the portfolio.

Defensive Short Duration High Income

Our Defensive Short Duration High Income strategy, which holds mainly BB-B rated bonds with an average portfolio maturity of 3 years or less, underperformed the ICE BofA 1-3 Year BB Rated US CP HY Index (accounts with loan exposure lagged bond-only accounts). However, the portfolio did outperform both the BB/B rated and broad 1-3 year versions of the index. An underweight to the Packaging industry detracted in addition to security selection within the Media/Broadcasting, Technology, and Transports industries. Contributors included both security selection and an underweight to Energy, Retail, and Aerospace & Defense industries, as well as strong security selection within Services, Metals/Mining, and Autos industries. Single-B rated bonds underperformed BB-rated and BBB/crossover-rated bonds within the portfolio.

Defensive Floating Rate Income

During 1Q, the Defensive Floating Rate Income strategy underperformed its benchmark, the S&P/LSTA BB Rated Index, but did outperform the BB/B rated version of the index. The combination of the COVID-19 pandemic and an oil price war triggered the second worst quarterly return for leveraged loans on record, matched only by 3Q08. In both periods, emergency Fed rate cuts led to a sudden collapse in LIBOR, reducing future coupon income and causing loans to underperform HY bonds.

The Fed's aggressive response, which included the purchase of collateralized loan obligation liabilities, helped secure a floor under loan prices and enabled the market to stage a late March rally. The portfolio's emphasis on high quality BB-rated loans proved beneficial throughout the selloff, as did risk limits preventing ownership of CCC-rated or second lien loans. The top 3 performing credits in the portfolio carried IG ratings by at least one agency. The portfolio's exposure to HY bonds, held for liquidity, detracted from performance as did the portfolio's underweight to the S&P/LSTA US Leveraged Loan 100 Index constituents, which outperformed BB-rated loans.

Outlook

We believe a recession is clearly upon us as HY spreads have easily surpassed 1,000 bp. Near-term, the market will move in sympathy with "flattening the curve" and oil (which is mainly a demand issue related to the virus). The exact timing of a bottom is hard to pinpoint and the nature of the "invisible" virus is hard predict.

We expect a slow but steady improving economy when social distancing measures are alleviated allowing for near-normal operation of businesses and restoring consumer spending habits. It is hard to predict if spreads widen from here, however, we believe elevated spread levels are typically a buying (or nibbling) opportunity for HY.

The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Under no circumstances should this information be construed as a recommendation or advice. The views expressed herein reflect the professional opinions of the portfolio managers and are subject to change. Penn Capital does not accept any liability for losses either direct or consequential caused by the use of, or reliance upon, this information. These views are subject to change at any time and they do not guarantee future performance of the markets. Investing in the stock market involves gains and losses and may not be suitable for all investors. Investors have the opportunity for losses as well as profits.

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. Every investment program has an opportunity for loss as well as profit. 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. Portfolio holdings may change and bonds noted may or may not be held by one or more Penn Capital portfolios from time to time. Transactions in such securities may be made which seemingly contradict the references to them for a variety of reasons, including but not limited to, liquidity to meet redemptions or overall portfolio rebalancing. Holdings are subject to change.

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 BofA 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 1-3 Year BB/B US Cash Pay High Yield Index is a subset of the ICE BofA 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. The ICE BofA 1-3 Year US Cash Pay High Yield Index is a subset of the ICE BofA US Cash Pay High Yield Index, which tracks the performance of corporate bonds with a remaining term to final maturity less than three years. 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 S&P/LSTA US Leveraged Loan 100 Index tracks the market-weighted performance of the largest institutional leveraged loans based on market weightings, spreads and interest payments. 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. PC-CRCOM041420

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.

