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Executive Summary – Fed Jump Starts the Recovery, But Now the Hard Part Begins

During 2Q20 ("2Q") credit markets staged a significant recovery from March lows on the back of massive governmental intervention and slowly improving economic data. As we look ahead to the back-half of 2020, we expect further gains to be hard fought as the economy attempts to find its footing amidst the backdrop of continued COVID-19 related disruption.

Policy Response Staves Off Worst Fears

Credit markets were jolted from their lows during the end of March due in large part from the Federal Reserve's ("Fed") announcement of extraordinary liquidity measures as well as from the passage of the CARES Act. This one-two punch of governmental stimulus and the promise of direct purchases by the Fed in numerous credit markets helped stave off investors worst fears and provided the base for a spread tightening rally that lasted throughout April, May, and the beginning of June in the high yield ("HY") market. According to JP Morgan, 2Q HY returns of approximately +9.5% represented the strongest performance of the asset class in over a decade. While all credit qualities participated in this broad-based rally, CCC-rated bonds performed best with gains of 11.6% followed by B-rated bonds (+9.9%) and BB-rated bonds (+9.1%). By sector, many of 1Q20's ("1Q") biggest losers were now 2Q's biggest winners as investors were more comfortable with cyclical and consumer related industries on the back of slowly improving economic data, progress on COVID-19 related medical treatments, phased economic re-openings in many states, and the aforementioned supportive Fed and congressional actions.

Based on JP Morgan data, Energy was by far the biggest sector winner in 2Q, gaining nearly 33% post its substantial sell-off in 1Q. Rounding out the top performers for 2Q were the Automotive, Gaming & Leisure, Housing, and Chemicals sectors which all posted positive double-digit returns. The "worst" performing sector for the quarter was Transports which posted a marginally negative return. Other laggards in 2Q included Broadcasting, Cable & Satellite, Telecom, and Industrials, however, these sectors were still able to post low to mid-single digit positive returns. Loans kept pace with bonds torrid pace of recovery during 2Q and provided slightly better returns once the dust settled. Loan returns were driven by the same strong rally in lower rated and cyclical/consumer related credits.

Capital Market Indicators: Green Shoots?

New issuance in the HY market reached a record of nearly $145b in 2Q following Fed actions that effectively thawed the freeze in primary market activity that was seen for much of 1Q. A significant amount of money raised in 2Q was used for general corporate purposes as companies took advantage of reopened markets to shore up liquidity given COVID-19 related earnings uncertainty. Companies also took the opportunity in the middle and end of the quarter to refinance short dated debt to assuage investor concerns over balance sheet risks. Issuers in the primary market were mostly in the upper quality tier of the HY universe with JP Morgan data showing that 57% of issuance in 2Q was rated split BBB or BB. This trend toward quality issuance was because primary markets opened to safer credits first before moving down the risk spectrum later in the quarter.

Unlike the HY bond market, loan primary markets have been much slower to recover. 2Q issuance of nearly $46b was the lowest quarterly total in over 4 years according to JP Morgan data. Anemic collateralized loan obligations ("CLO") formation and continued fund outflows have weakened demand for loans at a time when issuers prefer to tap the HY bond market to take advantage of the substantial fund flows that have percolated to the asset class.

Ultra Short Duration High Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, outperformed ICE BofA 1-3 Year US Corporate/ Government Index but underperformed the ICE BofA 1-3 Year BB US Cash Pay HY Index. Our strategy of mainly BBB-B rated corporate bonds rallied with credit markets but, as is usual, held no Energy sector exposure and as a result lagged the rally in that industry.

Ultra Short Duration High Income (cont.)

Strength in Homebuilding and strong security selection with Retail and Technology added value. Aerospace was the only negatively returning industry on concerns for airline capital expenditures. Loans added value (for applicable accounts) as first-lien instruments bounced back from severely discounted prices after the 1Q collapse in LIBOR; it was ill-suited for a sharp recession.

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 as well as both the BB/B rated and broad 1-3 year versions of the index. Most of the underperformance was concentrated within the Energy sector as well as from cash drag. Within Energy, conservative positioning detracted value as the sector rallied significantly despite extreme volatility and negative front-month prices. Cash levels were normal but contributed to lag as 2Q rallied stronger than at any time since 2009. Conservative positioning within Retail and single-B rated bonds generally were detractors whereas strong security selection within Services, Metals/Mining, Transports, and Consumer Products added value. Loans added value (for applicable accounts) as first-lien instruments bounced back from severely discounted prices after the 1Q collapse in LIBOR.

Defensive High Yield

During 2Q, our Defensive HY strategy underperformed its benchmark, the ICE BofA BB-B Rated Non-Distressed Index, as well as the broad ICE BofA HY Index. An underweight to BB-rated paper, the least cyclical within HY markets, was a detractor once again as this segment of the market rallied the most after having fallen the least in 1Q. The Fed's exceptional actions most directly helped BB-rated bonds relative to single-B and CCC-rated bonds. Most of the underperformance was concentrated within the Energy sector as well as from cash drag. Within Energy, conservative positioning detracted value as the sector rallied significantly despite extreme volatility and negative front-month prices. Cash levels were held below 1Q average levels but contributed to lag as 2Q rallied stronger than at any time since 2009.

Loans added value (for applicable accounts) as first-lien instruments bounced back from severely discounted prices after the 1Q collapse in LIBOR. Elsewhere, weakness in Broadcasting companies and an underweight to a new-entrant auto maker detracted value, whereas security selection within Technology and Healthcare added value. Strong security selection also added value within "core" pandemic-related industries (Lodging/Leisure, Restaurants, and Metals/Mining) despite an underweighting to those sectors.

Opportunistic High Yield

Our Opportunistic HY strategy underperformed the ICE BofA US HY Constrained Index during 2Q. The strategy benefitted from its underweighting to CCC-rated credits, but that positioning was offset by an underweighting to BB-rated bonds. An underweight to BB-rated paper, the least cyclical within HY markets, was a detractor once again as that segment of the market rallied the most after having fallen the least in 1Q. Most of the underperformance was concentrated within the Energy sector as well as from cash drag. Within Energy, conservative positioning detracted value as the sector rallied significantly despite extreme volatility and negative front-month prices. Cash levels were held below 1Q average levels but contributed to lag as 2Q rallied stronger than at any time since 2009.

Loans added value (for applicable accounts) as first-lien instruments bounced back from severely discounted prices after the 1Q collapse in LIBOR. Elsewhere, weakness in Broadcasting companies and rental cars detracted value, whereas security selection within Technology and Telecommunications added value. Strong security selection also added value within "core" pandemic-related industries (Restaurants and Metals /Mining) despite an underweighting to those sectors.

Defensive Floating Rate Income

During 2Q our Defensive Floating Rate Income strategy outperformed its benchmark, the S&P/LSTA BB-Rated Loan Index as well as the broader Credit Suisse Institutional Leveraged Loan Index. The strategy lagged its benchmark year-to-date but did outperform the Credit Suisse Index for the same six-month period. The loan market rallied in 2Q thanks to Fed stimulus and a rebound from CLO demand, helping single B and triple C rated loans to outperform higher quality double B rated loans. Given the strategy's BB-rated loan emphasis, performance typically lags the broad market in periods when B-rated loans lead. The strategy benefitted from its underweight exposure to large liquid loans, considered a proxy for ETF performance, as the Credit Suisse Leveraged Loan 100 Index constituents failed to repeat their outperformance experienced in 1Q. The strategy's allocation to HY bonds, held primarily for liquidity purposes rather than yield enhancement, detracted from performance. Loan funds experienced $6b of outflows during 2Q, quite the opposite of the record inflows into HY funds in the same period, highlighting the continued rotation away from floating rate assets. While borrowers once again returned to the primary market in 2Q, loan issuance failed to reach the record levels sold in the HY market.

The strategy's best performing position was an investment in a private energy infrastructure company that rebounded with the improved overall outlook for the US energy industry. We expect the company to be reacquired within the next few years by their prior owner, a double B rated midstream company, and for our term loans to be retired at purchase. The largest detractor to performance was an investment in a steel mill that is in the process of being sold to a publicly listed strategic buyer. While we continue to have strong conviction in the company's asset base, management team, and the prospect for the completed sale of the company, we exited the position given our expectation for continued weakness in steel prices as global auto and aerospace supply chains remain in a prolonged state of disconnect.

The strategy maintains its conservative positioning. While we believe the likelihood and severity of a selloff like we witnessed in 1Q is unlikely to repeat, partly due to central bank intervention and also because the threat of falling LIBOR poses to loan income has passed, the strategy maintains its double B rated emphasis. Loan prices rebounded and the combination of low LIBOR and the absence of floors has resulted in lower coupon rates than before the crisis. We prefer the safety of double B rated first-lien loans in that backdrop and think the best risk-reward scenario rests with high quality loans.

Outlook

While the market has made a decisive recovery from recent lows and primary markets are reopened, we are by no means out of the woods yet. Spiking COVID-19 infection rates in certain states, the expiry of certain government stimulus programs in a few months, and rising political uncertainty all set the stage for a volatile second half of the year. With spreads remaining at historically elevated levels (722 bp as of June 30th according to JP Morgan) we are cautiously optimistic there is room for the market to slowly grind higher over the remainder of year. This path higher will not be linear, but instead punctuated with periods of substantial volatility surrounding coronavirus news, election politics, and potential further governmental support.

Underpinning our cautiously positive bias is the Fed's success thus far in restoring confidence in the HY markets. While much firepower has been directed by the Fed toward purchases in the treasury and mortgage backed security markets, the Fed has accomplished much in the way of HY ETF or direct "fallen angel" (investment grade bonds downgraded to HY status) bond purchases. Much of the current market recovery predated actual Fed ETF and corporate bond purchases during mid-May and June and is likely due to the halo effect of perceived Fed support for corporate bond markets. It is our belief the Fed has the mechanisms and desire in place to keep "Bond Armageddon" off the table for now while companies and governments grow increasingly adept at dealing with the new realities of a post COVID-19 world.

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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-CRCOM071720

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