High Yield Strategies

Executive Summary

During 1Q 2019 ("1Q") the ICE BofA Merrill Lynch US High Yield Index posted its third best first quarter in history (best since 1992) after bouncing back from an overdone late-2018 swoon.

An Early Spring

Just as Punxsutawney Phil predicted an early spring, credit markets rallied strongly thanks to a cocktail of Federal Reserve ("Fed"), oil, and China. Last quarter we noted it was premature to declare an end to the credit cycle so long as the Fed was patient, oil was range-bound, and China trade relations improved. The Fed and oil surprised to the upside while US and China made steady progress towards a trade deal.

After spreads touched post-Lehman lows in 3Q18, then almost doubled in 4Q18, they rallied back under 400 basis points to start 2019. During 1Q, returns by credit quality were fairly distributed (around +7%) with Consumer Products, Retail, and Healthcare leading the way while Transports, Media, and Paper/Packaging lagged.

The Recession That Wasn't

The yield curve inverted inside of 10-year maturities, yet we do not forecast an imminent recession, in part because of the brevity of the inversion. Massive global central bank intervention leaves us skeptical to compare past recessionary clues on an apples-to-apples basis with the recent inversion. Additionally, this inversion only impacted less than half of the maturity pairs that "normally" predict a recession. Longer maturity pairs, such as the 5-10 year pair and 10-30 year pair, actually steepened during the quarter.

Corporate creditworthiness is strong. According to J.P. Morgan, high yield ("HY") balance sheets continued to improve in 4Q18. Despite higher leverage levels through their loan layer, publicly traded HY companies are nearing post-Lehman lows in total leverage at 3.98. Additionally, revenues grew at 6% and EBITDA margins hit a post-Lehman high of 17.4%.

Capital Market Indicators

In 1Q, the HY market recovered over $12b of mutual fund flows, recouping about a quarter of 2018's outflows of $46b. Conversely, as the Fed turned more dovish, leveraged loans lost $10b of flows. Outflows from loan funds, as well as over $25b of net new issuance, weighed on technicals, and notably, no loan repricings occurred. Bond technicals were aided by modest net new bond issuance of $27.5b while "rising stars" (high yield bonds upgraded to investment grade status) significantly outweighed "fallen angels" (investment grade bonds downgraded to high yield status) by a factor of 12x. Rising stars have outweighed fallen angels since the beginning of 2017. The overall quality of issuance in 1Q remained high, including a post-Lehman high in BB-rated issuance, as we have noticed an increased percentage of proceeds being used for acquisitions. While still not at a concerning level, this bears watching.

Concurrently, the equity market continues to be an important source of capital. The Russell 2000 Index rose over 14% and companies priced over $20b of primary and secondary stock. According to Bloomberg, primary and secondary equity issuance for 2018 totaled $140b which surpassed 2016 levels, but fell just short of levels achieved in 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.

Defensive High Yield

Our Defensive HY strategy outperformed the ICE

BofA Merrill Lynch BB-B Rated Non-Distressed Index during 1Q (accounts with loan exposure lagged slightly). The largest detractors to value were loan and cash allocations during the sharp Fed-induced rally. Loan returns trailed bonds by a factor of 2x during the quarter in which the Fed turned even more dovish. Top contributors tended to be the biggest detractors from 4Q18; security selection within commodity-oriented industries (Energy and Metals/Mining) as well as an underweight to the tight spread Packaging industry. Security selection within Services and Media/Broadcasting contributed whereas conservative security selection within Chemicals and Healthcare lagged the rally. An overweight to Transports (ex-autos) was a detractor while security selection within Autos contributed value.

Opportunistic High Yield

In 1Q, our Opportunistic HY strategy outperformed the ICE BofA Merrill Lynch US HY Constrained Index (accounts with loan exposure lagged slightly). The largest detractors to value were loan and cash allocations during the sharp Fed-induced rally. Top contributors tended to be the biggest detractors from 4Q18; security selection within commodity-oriented industries, Energy and Chemicals, as well as an underweight to the tight spread Packaging industry. Additionally, security selection within Food & Beverage, Services, and Building & Building Materials contributed whereas security selection within Retail and Financials lagged the rally. An overweight to Telecommunications and Transports (ex-Autos) were detractors while security selection within Autos contributed value.

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/Government Index in 1Q. Our strategy, consisting of mainly BBB-B rated corporate bonds, outperformed short-term Treasuries despite a Fed-induced rally on the front end of the curve. Loans lagged bonds but still outperformed the index. The strategy benefitted from its exposure within Media/Broadcasting, Technology, Telecommunications, and Healthcare whereas Industrials and Consumer Products returned positively but lagged the rally. Single-B and BB-rated bonds outperformed BBB/crossover-rated bonds within the strategy.

Defensive Short Duration High Income

In 1Q, our Defensive Short Duration High Income strategy, which maintains an average portfolio maturity of 3 years or less, underperformed the ICE BofA Merrill Lynch 1-3 Year BB/B Rated US Cash Pay High Yield Index, including accounts with loan exposure. Short-maturity floating rate loans underperformed short duration bonds given interest rate fears and continued asset class outflows. Security selection within Media/Broadcasting, Metals & Mining, Autos, and Gaming was a contributor, whereas conservative security selection within Energy, Financials, Technology, and Retail lagged the rally. Single-B and BB-rated bonds outperformed BBB/crossover-rated bonds within the strategy.

Defensive Floating Rate Income

Our Defensive Floating Rate Income strategy outperformed the broader Credit Suisse Institutional Leveraged Loan Index and underperformed its benchmark, the S&P/LSTA BB Loan Index in 1Q. Falling LIBOR triggered $10b in loan fund redemptions for the period and muted loans' participation in the first quarter rally. As a result, the strategy benefitted from its allocation to high yield bonds, which conversely benefitted from $12b of inflows. The strategy was also aided from its high quality BB-rated orientation as quality loans led during the quarter. Security selection within Metals & Mining and Telecom made positive contributions to performance. Performance was negatively affected by a Canadian satellite operator that experienced a sharp slowdown in a noncore business segment as well a healthcare facilities credit that reported weaker than expected results. Overall, we remain constructive on loans.

Market Outlook

We remain relatively optimistic on the US economy and corporate creditworthiness, a view that did not change during the 4Q sell-off. The US HY and loan last-twelve-month ("LTM") bond default rate fell below 2% and we continue to forecast a relatively low default rate for the remainder of 2019. 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. 4Q may have aided in ushering in the return of a "Goldilocks" economy, with modest growth and modest inflation, which would be a positive environment for credit.

2018 returned a rare negative number for the HY market; in calendar year terms, it marked only the seventh such occurrence in history and has never recorded back-to-back calendar years in the red. History suggests that 2019 will be a positive year for the asset class assuming that Xi Jinping, Jay Powell, and oil prices have found a bottom. We continue to favor the loan asset class as a bond complement due to our belief that Fed rate cuts expectations are overblown. In a stable rate environment, loans provide attractive diversification and secured debt safety, however, we continue to caution against CCC-rated and 2nd lien loans.

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.

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. 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 Russell 2000 Index is comprised of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 11% of the Russell 3000 total market capitalization. The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. An investor cannot directly invest in an index.

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