Executive Summary – High Yield Bond Yields Hit Record Lows Amid Economic Recovery, Declining Defaults, and Falling Inflation Fears

Spread tightening combined with a sharp drop in US Treasury rates in 2Q21 ("2Q") caused US high yield ("HY") bond yields to fall to historic lows. Continued global economic growth, reduced COVID-19 related restrictions, favorable corporate earnings, and low defaults were the main drivers behind the compression of spreads during the quarter, while US Treasury rates slid on decreased fears of long-lasting inflation.

Further Economic Progress Leads To Further Tightening

With the early stages of the global economic recovery now behind us, the US economy will be facing a relatively less accommodative monetary and fiscal policy moving forward. Nonetheless corporate and consumer spending are likely to pick up the slack. While the yields offered by the HY market might optically appear to be pricing in perfection, we believe there is still room in select areas of credit quality and end markets where yields can grind even tighter on a spread basis.

2Q US HY returns of 2.76% were driven by the same positive economic, vaccine, and earnings-related news that helped drive positive returns for US HY bonds in 1Q21 ("1Q"). Both spreads and yields fell in April on the back of positive corporate earnings and a retreat in US Treasury yields. May witnessed slight yield and spread increases as investors grew increasingly concerned over the potential effects of inflation and the rise of COVID-19 variants. June marked a return to spread and yield compression with significant declines in both due to reduced inflation concerns, news of vaccine efficacy on COVID-19 variants, and further evidence of an accelerating economic recovery. While falling US Treasury rates helped boost returns for longer duration higher quality credits in June, it was the lower rated Split-B and CCC credits that were top performers in 2Q returning 3.90% and 3.31%, respectively, according to JP Morgan versus BB-rated bonds which returned a healthy 2.65%.

Given the backdrop of steadily improving oil and gas prices, Energy (+5.61% return in 2Q) was once again the top performing HY sector in the quarter. The Transportation and Metals & Mining sectors provided the second (+3.63%) and third (+3.20%) highest returns in 2Q due to increased optimism on the return of leisure and business-related travel as well as static elevated commodity metal pricing. The worst performing industries during 2Q were the more defensive Utility, Telecom, and Cable/Satellite sectors which still experienced positive returns for the quarter. Year-to-date ("YTD") the US HY market posted gains of 4.20%.

The leveraged loan market also posted gains in 2Q, but unlike 1Q, loan gains lagged that of HY bonds. According to JP Morgan, leveraged loans provided gains of only 1.54% in 2Q as falling interest rates and heavy capital market activity dampened returns. Similar to the HY bond market, lower quality Split-B/CCC-rated credits led returns in the loan market in 2Q by posting gains of 3.61%. These gains significantly outperformed BB-rated loans which only returned 0.84% in the quarter. By industry, the largest loan sector outperformer in 2Q was Metals & Mining which provided a 4.61% return, while the leading underperformer was the Utilities sector posting a 0.46% loss in 2Q.

Capital Market Indicators: Green Shoots?

The US HY primary market calendar remained full in 2Q as $140b of new issuance was priced according to JP Morgan. This marks the third highest quarterly issuance level on record and indicates primary markets remain wide open for issuers who need to raise capital. Refinancing activity continued to be the main driver of issuance for the quarter by representing ~60% of new issuance, however, we did witness an uptick in acquisition financing. By ratings, issuance continued to be focused on the higher quality portion of the market with BB and Split-BB rated credits representing almost half of the new bonds issued during 2Q. Despite the general high-quality nature of recent bond issuance, CCC-rated financing has become more prevalent during the past three quarters. In the leveraged loan market, we experienced new issuance relax from the torrid pace of deals placed in 1Q. The ~$194b raised (according to JP Morgan) represents a significant recovery from a year ago and shows investor and issuer interest in the asset class continues to grow.

PENN CAPITAL

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. The strategy of mainly BBB-B rated corporate bonds rallied with credit markets led by industrial recovery industries such as Metals & Mining and Automakers. Similar to 1Q, strong security selection within Retail and Specialty Finance added value, along with the Cable and Gaming sectors. An underweight to the Banking and Energy sectors detracted; the strategy is structurally underweight the Energy sector in order to potentially limit volatility. Off-index yield curve positioning added value, as the 0-1 year maturity bucket outperformed, as did the strategy's allocation to single-B rated bonds. Loans, which performed well in 1Q (as inflation expectations increased) lagged bonds in 2Q as longer-term interest rates declined. Capital market activities continued to be strong during the quarter, with approximately 8% of the strategy refinancing (19% YTD).

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, outperformed the ICE BofA 1-3 Year BB-Rated US Cash Pay HY Index and performed in-line with the BB/B-rated version of the index mainly due to its typical conservative Energy exposure. Strong security selection within Telecommunications, Packaging, Automotive, and Insurance added value, whereas Gaming credits lagged the rally. Off-index yield curve positioning added value as the 3+ year maturity bucket outperformed the 0-1 year maturity bucket. Loans, which performed well in 1Q (as inflation expectations increased) lagged bonds in 2Q as longer-term interest rates declined. Capital market activities continued to be strong during the quarter with approximately 10% of the strategy refinancing (25% YTD).

Defensive High Yield

During 2Q, our Defensive HY strategy performed in-line with its benchmark, the ICE BofA BB-B Rated Non-Distressed Index, despite being underweight BB-rated credits, which outperformed on falling Treasury yields. Strong security selection within BB-rated Energy bonds as well as a Split-B rated allocation contributed value. The strategy also benefitted from security selection within Automotive, Retail, and Technology sectors while credits from the Food and Telecommunications sectors lagged the rally. An overweight to Pharmaceuticals, stemming from concern on drug pricing and opioid litigation, detracted value. While generally maintaining a duration-neutral stance, yield curve positioning detracted slightly due to an underweight to the 10+ year maturity bucket. Loans, which performed well in 1Q (as inflation expectations increased) lagged bonds in 2Q as longer-term interest rates declined.

Opportunistic High Yield

In 2Q, our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index. The strategy benefitted from its overweight to CCC-rated credits which offset being underweight BB-rated credits that outperformed on falling Treasury yields. Strong security selection within BB-rated Energy bonds as well as a Split-B rated allocation contributed value. The strategy also benefitted from security selection within Automotive, Retail, and Technology sectors while credits from the Food and Telecommunications sectors lagged the rally. An overweight to Pharmaceuticals, stemming from concern on drug pricing and opioid litigation, detracted value. Duration and yield curve positioning were not significant contributors during the quarter. Loans, which performed well in 1Q (as inflation expectations increased) lagged bonds in 2Q as longer-term interest rates declined.

Defensive Floating Rate Income

During 2Q, our Defensive Floating Rate Income strategy outperformed both the S&P/LSTA BB-Rated Loan Index and the broader S&P/LSTA BB/B-Rated Loan Index. Despite the bank debt market posting strong returns, they lagged HY bond returns which benefitted from their fixed rates as US Treasury rates fell. The low yield backdrop within fixed income resulted in robust demand for floating rate bank debt, with loan funds receiving $13.6b of 2Q inflows, fully reversing on a YTD basis last year's $27b full year outflow. Record levels of collateralized loan obligations ("CLO") creation bolstered loan purchasing demand as well.

Defensive Floating Rate Income (cont.)

However, only one year removed from the 2020 recession low, quality tiers of the loan market once again generated the strongest returns as defaults slowed and the economic reopening disproportionately benefitted highly levered and cyclical companies.

The strategy showcased strong credit selection in order to keep pace with the credit sensitive rally despite its emphasis on BB-rated loans. Performance typically lags the broad market in periods where low quality loans rally.

Our exposure to HY bonds, held for liquidity purposes, slightly aided performance as bonds outperformed loans in 2Q. Meanwhile the strategy's underweight exposure to large liquid loans (a proxy for ETFs) was a modest boost to performance. With the loan market still trading below par, the strategy modestly declined in credit quality in order to capture discounts and benefit from future pull to par, as the asset class is experiencing an acceleration of prepayments.

The strategy's best performing loan was Cole Haan, reversing the prior quarter's underperformance. Just as we expressed in our 1Q commentary, we viewed the pullback in the loan following the sponsor's decision to pull their IPO as temporary. The loan rebounded in 2Q, but still trades at a healthy discount to par. We remain constructive on the credit and believe this is an issue of timing and the sponsor will take the company public at a later date.

A midstream credit loan within the Energy – Distribution sector contributed to performance in 2Q. We believe the loan remains cheap given our expectation that it will be refinanced in the next 12 months. The credit rating of a Telecommunications loan was downgraded in response to the company borrowing additional secured bonds to invest in its low earth orbit satellite network, causing the loan to underperform. We still see significant asset value backing the loan and remain invested.

Outlook

While we are cognizant that tight spreads and low yields make the HY market look optically expensive, we believe bonds can still deliver coupon-like returns with the potential for further spread tightening in select credits and industries. Corporate balance sheets remain healthy and pent-up consumer demand seems to be only beginning to manifest itself as more local and national governments relax COVID-19 restrictions. Energy and metal prices remain high creating an opportunity for commodity-oriented issuers to direct significant free cash flow to deleveraging.

Defaults across the market for the first half of the year are at some of the lowest levels seen in nearly a decade, according to JP Morgan. This low default environment helps support the argument that tight spreads are not necessarily indicative of a market that is overvalued. While yields are at all-time lows, we have witnessed lower credit spreads in the past. While risks from Federal Reserve tapering, increased COVID-19 variants, and supply chain shortages remain very real, we believe the HY market should be able to clip its coupon at a minimum for the remainder of the year on the back of an improving default environment.

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