Executive Summary

The Russell 2000 Index, a proxy for small cap equities, declined -17.2% in 2Q22 (“2Q”). Riskier assets were punished across the board as recession fears intensified. Stubbornly high inflation forced the Federal Reserve’s (“Fed”) hand by raising rates into an already slowing economy. Spending on goods weakened as consumers reprioritized experiences post-pandemic, a dynamic that has been compounded by difficult comparisons as we lap stimulus efforts, the drag of inflation on purchasing power and a stock market sell-off that has dampened sentiment at the high end.

Overview

Consumers that have both the ability and willingness to spend have been frustrated by high prices, shortages for goods (homes, autos) and a lack of capacity for services (airlines). While overall unemployment remains low, the decline in stock valuations has driven some layoffs and belt-tightening at early-stage growth companies that rely on equity capital markets to finance growth and stock-based compensation to attract and retain talent.

The 10-year US Treasury yield marched from 2.32% at the end of March to an intraday high of 3.49% in mid-June, before settling at 2.98% at quarter-end. The rise in interest rates has all but halted the mortgage refinance market (in addition to slowing originations) and has driven some job cuts and employee repurposing at financial institutions. The domestic political environment is as toxic and divisive as ever as geopolitics remain an overhang with no clear endgame for Russia’s tragic and deadly invasion of Ukraine. The consumer staples, utilities and financials sectors outperformed while information technology (“IT”), consumer discretionary and real estate lagged. Small cap value stocks continued to outperform small cap growth stocks in 2Q. High yield (“HY”) spreads were remarkably sanguine in 1Q22 (“1Q”) despite equity weakness, although spreads began to play catch-up on the downside in 2Q as the spread-to-worst on the JP Morgan US HY Index increased from 375 bps to 620 bps; the index fell -13.3% year-to-date, reflecting both higher benchmark interest rates and wider spreads.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 2Q with top contributors including the utilities, industrials and consumer discretionary sectors. Within utilities, our overweight to this defensive sector during a period of high volatility contributed strongly to performance as the group was less negatively impacted during the 2Q market downturn. Within the industrials sector, a payment processing company explored a strategic sale as buy interest in the company surfaced during the quarter which contributed strongly to sector performance. Our underweight to the consumer discretionary sector led to a strong sector allocation effect as recession fears in the US reached a fever pitch in 2Q.

The strategy underperformed in the IT, financials and energy sectors. Within IT, our exposure to travel-related lead generation internet services companies performed negatively as recession fears mounted and energy prices continued to increase dampening the prospects for these companies’ bookings prospects in the future. Our underweight to financials was a significant allocation detractor as banks performed significantly better in the index relative to other areas of the market. Within energy, our exposure to oil services companies lagged companies with exploration and production exposure during the quarter.

Small to Micro Cap Equity

The Small to Micro Cap Equity strategy underperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 2Q. Top detractors included the consumer discretionary, healthcare and IT sectors. Within consumer discretionary, a provider of out-of-home display advertising gained market share amid improving consumer transit/mobility trends. Nonetheless, shares underperformed as higher credit spreads pressured levered equities and the combination of rising interest rates and slowing macro conditions cast doubt on the company’s plan to divest European assets. In the healthcare sector, a hospital operator reported disappointing first quarter results due to disruption related to the Omicron variant and ongoing labor cost pressures.

Small to Micro Cap Equity (cont.)

Within IT, a provider of technology solutions to the global travel and tourism industry reported upside to 1Q revenue and EBITDA estimates due to steady ongoing recovery in travel demand, though lowered its fiscal year EBITDA outlook to account for incremental investments in technology transition and other initiatives.

The top contributor was the real estate sector. A hotel REIT reported solid first quarter results driven by strong leisure demand at their Florida-based properties and improved occupancy across their urban portfolio. The company also announced the sale of seven hotels which will further de-leverage their balance sheet.

Small Cap Equity

The Small Cap Equity strategy underperformed its benchmark, the Bloomberg 2000 Index during 2Q. The top contributor was the energy sector as an oil and gas exploration and production company reported better than expected 1Q results driven by positive pricing realization and lower lease operating expenses and announced an accretive acquisition in the northern Delaware Basin.

Top detractors included the industrials, consumer discretionary and IT sectors. Within industrials, a maker of aircraft components missed their fiscal 4Q22 consensus and offered initial fiscal year 2023 guidance below street expectations. This was driven by short-term order deferrals on commercial widebody and supply chain constraints as the company remained optimistic on sustained aviation recovery. In the consumer discretionary sector, a provider of out-of-home display advertising gained market share amid improving consumer transit/mobility trends. Nonetheless, shares underperformed as higher credit spreads pressured levered equities and the combination of rising interest rates and slowing macro conditions cast doubt on the company's plan to divest European assets. Within IT, a provider of technology solutions to the global travel and tourism industry reported upside to 1Q revenue and EBITDA estimates due to steady ongoing recovery in travel demand. The company did lower their fiscal year EBITDA outlook to account for incremental investments in technology transition and other initiatives.

The strategy continues to overweight the energy sector due to improving demand, tight supply and compelling valuations relative to strong earnings and cash flow. We remain overweight consumer discretionary given our view that current valuations price in too much pessimism.

Small Cap Value Equity

Our Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 2Q as top contributors included the industrials, utilities and materials sectors. Within the industrials sector, a payment processing company began exploring a strategic sale as buy interest in the company surfaced during the quarter which contributed strongly to sector performance. Within utilities, our overweight to this defensive sector during a period of high volatility contributed strongly to performance as the group was less negatively impacted during the 2Q market downturn. Within the materials group, one of our gold exploration companies was acquired during the quarter contributing to outperformance within the sector.

Top detractors included the IT, healthcare and energy sectors. Within IT, our exposure to travel-related lead generation internet services companies performed negatively as recession fears mounted and energy prices continued to increase dampening the prospects for these companies' bookings prospects in the future. Within healthcare, our exposure to medical device technology companies significantly contributed to underperformance as concerns over the ability of hospitals and surgery centers to appropriately staff their facilities during a period of higher wages and extreme labor shortages. Within energy, our exposure to oil services companies lagged, specifically within exploration and production in 2Q.

The concern over an overly aggressive Fed combating inflation combined with slowing leading economic indicators created major concerns over a global economic recession. Although inflation has likely peaked, the market does not see a path to inflation subsiding to current Fed targets as the employment market remains very strong and labor shortages persist causing further increases in labor costs.

Small Cap Value Equity (cont.)

The Ukraine-Russian conflict continues to create a shortage of oil and natural gas supply in the market which continues to keep those prices stubbornly high even in the face of global recession.

The market is likely now looking for weaker economic data that would likely suppress the inflationary outlook which would in turn create a less hawkish Fed view of the economy. As job openings remain high and supply chains continue to normalize, the Fed will likely remain on course to target Fed funds rate closer to neutral. As economic indicators started to signal a slowing economy, companies' earnings prospects have also started to be revised lower. These factors create some complexity in the market as we cheer for the Fed to navigate a soft landing. The market has become increasingly negative on these prospects as we have seen credit spreads widen throughout the quarter. Valuations today are becoming very attractive, but we remain cautious as we continue to monitor credit spreads as our main tool in helping to identify signals to become more constructive.

Small to Mid Cap Equity

The Russian invasion of Ukraine has exasperated inflation concerns as Western countries have de-invested in Russia which is primarily an oil and gas export economy. Ukraine is a key supplier of agricultural products which could provide additional stress especially in emerging markets. Companies are challenged to raise prices to maintain margins in this cost environment.

Domestically, the Fed has indicated short term interest rates will increase as they reduce securities through 2022 which will tighten lending standards. Companies that maintain ready access to capital can weather these headwinds.

Our Small to Mid Cap Equity strategy underperformed its benchmark, the Bloomberg 2500 Index, during 2Q. The strategy underperformed in the consumer discretionary, financials and industrials sectors. Healthcare, materials and energy sectors outperformed during the quarter.

Higher energy prices and concerns over a weakening consumer weighed on travel and leisure companies that are currently experiencing strong demand as pandemic concerns recede. A consumer lending marketplace saw lower activity as higher interest rates reduced demand. In Industrials, tightening lending standards was a concern for construction which impacted equipment rental companies.

Within healthcare, a medical imaging company experienced very strong initial sales of a new contrast for the prostate market. Biopharma companies with strong cash flows also outperformed the more speculative areas like biotechnology. In the materials market, a lithium producer expanded production over the next three years to supply higher performance electrical vehicles. A natural gas producer used higher prices to lock in strong cash flows over the next year.

The Fed's path of interest rate increases including the June 2022 three-quarter point hike raised underlying growth concerns that there could be a recession in the next 12-18 months. Recession valuations are beginning to be priced into the market providing opportunity if the economy performs better than feared. Tightening lending standards have eliminated speculation in the market challenging cryptocurrencies, meme stocks and money losing companies that are not focused on generating free cash flow in the intermediate term.

The strategy is invested in companies that we believe can generate strong 2022 cash flows in an inflationary environment. While looking for opportunity, strong balance sheets and improving cash flow generation are key indicators for inclusion. We will continue to utilize credit spreads to guide overall portfolio positioning, sector exposures and security inclusion through a volatile market environment. This is a critical indicator that differentiates between stock market sell offs and an adverse turn in the business cycle.

Outlook

Economic conditions are moderating, and the US is undergoing a choppy and uneven normalization as we emerge from the pandemic. Nonetheless, we believe market expectations are overly pessimistic and underestimate the durability and resilience of consumers and businesses alike. The consumer is in good shape underpinned by low unemployment, rising wages, elevated savings and under-levered balance sheets. Corporate credit fundamentals are robust. Companies took aggressive steps during the pandemic to bolster liquidity, reduce structural costs, refinance debt at low interest rates and extend debt maturities. Overall leverage is low, interest coverage is high and the percentage of the BB-rated HY market is at or near all-time highs, all of which should keep credit spreads and default rates low relative to previous downturns, in our opinion.

While the headline data has yet to react, we feel the rate of inflation has peaked and will moderate further over time especially as we lap easier comparisons. The consumer pivot to experiences is reducing demand for goods which is taking pressure off global supply chains and driving retailers to offer discounts to clear excess inventory. Shipping container rates are down significantly from their peak while port congestion has improved materially with shorter container pick up times and a reduced backlog of ships waiting to be unloaded. Over the past few months many key industrial commodity inputs (ex. lumber, steel, aluminum, copper) have declined significantly and stubbornly high food and energy prices have begun to soften in recent weeks.

The labor market remains tight and we feel staffing levels and applicant flows are normalizing as the pandemic fades. Less use of higher cost contract/temporary labor as well as reduced overtime and improved productivity are helping offset general wage inflation. Margin tailwinds from lower costs could help cushion the blow of softer revenue. Companies that have been forced to carry excess inventory due to supply chain disfunction will have a significant source of cash as working capital normalizes. Ultimately, we believe the Fed will err on the side of allowing inflation to run somewhat above its long-term objectives (assuming a deceleration becomes evident in the next few months) rather than raise rates to the point of significant job destruction.

After a near 24% year-to-date decline in the Russell 2000 Index (the Index's worst first half return in its 42+ year history), small cap equity valuations are compelling (particularly versus large caps). Investor sentiment is depressed and at levels consistent with prior cycle lows suggesting a favorable long-term risk-reward.

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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.

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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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