PENN CAPITAL

Executive Summary

US high yield ("HY") bonds posted positive returns in 2Q23 ("2Q") as strong macroeconomic data, receding banking crisis fears, favorable supply/demand dynamics and a balanced Federal Reserve ("Fed") helped push appetite for risker assets higher. As we enter the back-half of 2023, we continue to expect a volatile market as investors grapple with a still hawkish Fed, tighter monetary conditions and potentially slower future growth. Given certain portions of the HY market are not differentiating much between stronger and weaker business models, we believe investors have an opportunity to increase positions in higher quality businesses at little cost in overall yield. We also believe that identifying companies with experienced management teams that can handle higher costs of capital is more important now than ever given rising funding costs.

Spreads Fall To Near Year-To-Date Lows As Markets Take A Risk-On Tilt

The US HY bond market gained 1.87% in 2Q as spreads compressed 65 bps and yields fell to 8.71% at quarter-end. At current spread levels of 434 bps, the US HY market is trading within one basis point of its year-to-date tightest levels. The market had a noticeably risk-on tone in 2Q as banking crisis related fears abated, strong labor market data continued to be reported and the Fed paused interest rate hikes (albeit while still taking a hawkish tone toward potential future rate increases).

By rating, riskier split-B and CCC-rated bonds were the top performers in 2Q with returns of 5.26% and 4.97%, respectively. Higher quality BB-rated bonds were the worst performers for the quarter given their 0.80% return. The Telecom sector was the best performing industry in the quarter with gains reaching 5.7%. Automotive was the second-best performing sector during this same time period with gains reaching 4.81%. The worst performing sector during the quarter was Broadcasting which returned -0.62% in 2Q as investor fears over lower potential advertising spending continues.

Year-to-date, the best performing sector was the Automotive sector returning 11.02%. The worst performing sector was Broadcasting which returned -1.70% during this same time period. Market credit quality, as measured by ratings, improved on a dollar weighted basis in the quarter as the upgrade/downgrade ratio reached 1.3. The US HY default rate ticked up yet again in 2Q ending at 2.7%. With over $31b in bonds defaulting or taking part in a distressed exchange this quarter, 2Q marked the eighth largest quarterly total of defaults by volume on record. While this default level is somewhat elevated on an absolute basis the default rate is still below the historical average default rate levels of 3.2%. We continue to believe that default rates will creep up slowly throughout the year as the level of distressed bonds (those trading above 1,000 bps) remains elevated even after this recent wave of defaults. (Source: JP Morgan)

Capital Market Indicators

The US HY primary market calendar continued its recovery in 2Q as heavy issuance in April and May more than offset lighter June volumes. $55b of gross issuance priced during 2Q, representing a significant increase from 2022 levels where issuance averaged $26.6b per quarter. Refinancing activity remained the main driver of issuance in 2Q once again, with refi deals only representing ~55% of new volume due to an increase in LBO/acquisition financing transactions. By ratings, issuance remained focused on higher quality bonds in 2Q. In total, BB-rated deals represented ~55% of the new bonds issued during the quarter. This continues the general trend of higher quality issuance driving volumes which we have seen in the US HY market over most of the past few years. This higher rating bias continues to be absent from the leveraged loan market as ~73% of new issuance in 2Q remained single-B rated. (Source: JP Morgan data)

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. Weakness in the Specialty Retail industry and investment companies overcame strength in Telecom and Auto Loans. Our BB-rated credit quality overweighting was also a detractor during the quarter. Capital markets activities continue to lag when it comes to refinancing short-duration bonds as higher rates have dissuaded many issuers from calling bonds that mature in greater than a year's time.

Defensive High Yield

Our Defensive HY strategy slightly outperformed the FTSE BB/B Capped HY Index in 2Q. Strong security selection within Software, Chemicals and Cable & Satellite TV industries added value during the quarter. Detractors included security selection in Telecom and Specialty Retail and a sector overweight to Specialty Retail. Security selection in BB-rated companies drove positive performance during the period but this was offset by B-rated security selection. During the quarter we incrementally followed a barbel strategy for new positions by adding to both higher and lower rated bonds relative to the index. Yield curve positioning was a slight drag on performance due to an underweight to bonds maturing in the next 1-3 years as US Treasuries sold off during the quarter.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index during 2Q. Underweighting the Cable/Satellite TV sector along with strong security selection within the group helped drive performance. The Tech hardware and Aerospace industries also contributed with strong security selection that more than offset weakness within the Specialty Retail industry. We also generated strong performance from BB-rated bonds through security selection during the quarter compared to our B-rated holdings. We incrementally added to higher quality B-rated bonds while reducing exposure to B-/CCC rated credits. Yield curve positioning was not a significant factor in relative performance in 2Q as US Treasuries sold off across the curve during the quarter.

Outlook

The Fed raised interest rates aggressively over the past year challenging the fixed income market. These monetary decisions have a lagged effect, and their impact was recently seen with the Silicon Valley Bank failure in March 2023. The Fed paused at its most recent meeting to better assess the impact of past raises, but it continues to have a bias to increase rates in future meetings. It appears, based on Fed commentary, that rate cuts will not come for some time baring significant signs of financial stress. This policy of tighter money is focused on reducing inflation but will have the additional consequences of lower economic growth and bouts of financial stress. Companies with heavy exposure to bank loans are starting to see more signs of this stress so far as their loans typically reprice with higher rates within three months. More bond focused issuers are currently less impacted given the fixed rate nature of the average bond and the fact most issuers do not have maturities due until the 2025-2030 time frame. Most companies, whether bank loan or bond focused, are responding to a higher cost of debt world through a focus on principal paydown and a higher hurdle rate for capital investments.

The current environment continues to call for focusing on strong credits that can weather an economic slowdown over the next few months. In many areas, the credit market is not differentiating well between the strongest companies and weaker competitors. As a result, we are upgrading our portfolios by focusing our additions on more resilient businesses to reduce risk with little loss of return today. In addition, the current market is bifurcated with a few industries trading at recessionary trading levels. We are selectively finding opportunities in high conviction situations within these industries while being careful to avoid weaker business models. We are also carefully monitoring and selectively investing in investment grade companies at HY prices when the market provides an opportunity to do so.

Over the past 9 months, the HY market has produced solid returns after two years of low returns in 2020 and 2021 and absolute losses for the first nine months of 2022. The move to a higher interest rate environment requires companies to show capital discipline after a period of free money in response to the Covid pandemic. We need to identify companies that can manage and thrive in this new environment. Most importantly, we believe a normalization of interest rates provides investors a much better coupon return on investments going forward.

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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 a boutique investment management firm based in Philadelphia, PA. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

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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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