Executive Summary – High Yield Bond Yields Rise Modestly from Record Lows

US High Yield ("HY") spreads widened modestly in 3Q21 ("3Q") as investors grew slightly more cautious on the trajectory of global growth. Fears of a China-led slowdown and uncertainty surrounding the economic impact of the highly contagious COVID-19 Delta variant helped push spreads slightly higher than the near historic low levels witnessed last quarter. In addition to widening spreads, the US HY market grappled with slightly higher US Treasury rates as the market began to price in a tapering of Fed stimulus. Despite slowing growth and less accommodative Fed policies, we expect strong corporate cash flows will lead to improved balance sheets and low default rates. US HY bond yields remain near record lows which suggests the probability of coupon-like returns with spread tightening in select end markets and areas of credit quality.

Returns Moderate In 3Q

The US HY market gained 0.97% during 3Q despite a modest uptick in spreads and US Treasury rates. During the start of the quarter, investors grew increasingly concerned regarding the impact the Delta variant could have on the reopening of markets. In addition to Delta fears, quarter-end also featured rising concerns over China's property market as Evergrande's looming bankruptcy forced investors to contemplate the impact a slow-down in Chinese construction spending would have on global GDP.

Despite this slightly more risk averse backdrop, the split-B rated HY bond segment was the top performer in 3Q with returns of 1.17% (JP Morgan). This performance was nearly matched by higher quality BB-rated bonds which returned 1.13% in 3Q. Diversified Media was the highest performing sector in the quarter with returns of 1.95% (JP Morgan). Energy was the second highest performing sector in 3Q with returns of 1.32% and remains the best performing sector YTD by a wide margin. The worst performing sector during the quarter was the Auto industry with returns that were just barely positive. This underperformance stemmed from investor concerns over the long-lasting semiconductor shortage which continues to wreak havoc on auto production schedules. The Cable & Satellite sector was the second worst performing sector for 3Q with returns of 0.31% and is the worst performing sector in 2021. The US HY market has now posted gains of 5.21% year-to-date ("YTD").

Buttressed by September's rising rates, the leveraged loan market outperformed the US HY bond market in 3Q. According to JP Morgan, leveraged loans provided gains of 1.18% in the quarter as rising interest rates, favorable retail inflows, and an underwhelming primary calendar all supported returns. Similar to the HY bond market, lower quality split-B/CCC rated credits led returns in the loan market for 3Q with gains of 2.10%. These gains significantly outperformed BB-rated loans which returned 0.82% in 3Q. By sector, the largest loan outperformer in 3Q was Metals & Mining which provided 3.97% returns, while the biggest underperformer was the Cable & Satellite sector which recorded only a 0.72% gain in 3Q.

Capital Market Indicators

The US HY primary market calendar remained full in 3Q as $108.5b of new issuance was priced (JP Morgan). While this was a slight step back from last quarter's torrid issuance pace, it still marks the seventh highest quarterly issuance level on record and indicates primary markets remain wide open for issuers who need to raise capital. Refinancing activity remained the main driver of issuance for 3Q by representing approx. 56% of new issuance, however, acquisition financing continues to grow in importance for the new issue market as it represented approx. 27% of new proceeds in 3Q. By ratings, issuance continued to be focused on the higher quality end of the market with BB and split-BB rated credits representing over half of the new bonds issued during 3Q. In the leveraged loan market, we witnessed another step down in quarterly issuance as 3Q proceeds of approx. $161b marked a decline from 2Q21 levels. These issuance levels represent a significant recovery from a year ago and suggests investor and issuer interest in the asset class remains significant. We are monitoring a rise in buyout-related loan new issue activity and should such activity continue for at least the next 12-24 months, it will become red-flagged as a sign of froth.

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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 1-3 Year US Corporate / Government Index in 3Q. The strategy of mainly BBB/B rated corporate bonds rallied with credit markets led by strong credit selection within the Metals sector. Security selection within pandemic-recovery industries of Retail, REITs, Autos, and Leisure added value. Gaming credits lagged on COVID-19 and Macau concerns, and an underweight to the Banking sector detracted. Off-index yield curve positioning added value, as the 0-1 year maturity bucket outperformed. The loan allocation outperformed, as did the strategy's allocation to single-B rated bonds. Capital markets activities continued to be strong during 3Q, with approximately 13% of the strategy refinanced in the quarter and 32% YTD.

Defensive Short Duration High Income

During 3Q, 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 version of the index. Strong security selection within Metals and Telecommunications sectors added value, whereas Energy was a net neutral contributor. An underweight to Technology and Banking sectors detracted. Off-index yield curve positioning added value, as the 3+ year maturity bucket outperformed the 0-1 year maturity bucket. The strategy's loan allocation outperformed as did security selection within the single-B rated bond allocation. Capital markets activities continued to be strong during 3Q with approximately 15% of the strategy refinanced in the quarter and 40% YTD.

Defensive High Yield

Our Defensive HY strategy underperformed the ICE BofA BB-B Rated Non-Distressed Index in 3Q as rate sensitive BB-rated credits outperformed on falling US Treasury yields. Energy was a net detractor as higher natural gas prices impacted a distributor. Credit specific weakness within Telecommunications and Technology was also a detractor, as was a mortgage finance company that was under pressure from significant competition. The strategy added value by avoiding weakness within the Media and Utilities sectors. While generally maintaining a duration-neutral stance, yield curve positioning detracted slightly due to an underweight to the 10+ year maturity bucket.

Opportunistic High Yield

During 3Q, our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index as rate sensitive BB-rated credits outperformed on falling US Treasury yields. Energy was a net detractor as higher natural gas prices impacted a distributor. Credits exposed to movie theaters, recreation, and travel were weaker on COVID-19 concerns and a mortgage finance company came under pressure from significant competition. The strategy added value by avoiding weakness within Utilities coupled with strong security selection within the Metals and Transports sectors. Duration and yield curve positioning were not significant contributors in the quarter.

Defensive Floating Rate Income

During 3Q our Defensive Floating Rate Income strategy underperformed the S&P/LSTA BB-Rated Loan Index and the broader S&P/LSTA BB/B-Rated Loan Index for the quarter. The bank debt market posted strong returns in 3Q, leading HY bonds as a steady August and September rise in interest rates created headwinds for fixed rate instruments compared with floating rate loans. The specter of rising interest rates resulted in robust demand for floating rate bank debt with YTD retail inflows surpassing $34b as of quarter-end, well in excess of last year's $27b full year outflow.

Quarterly net new issuance slowed to the lightest pace of the year, complementing those positive asset class inflows to create healthy supply & demand dynamics. The primary market experienced an increase in issuance earmarked for equity dividend payouts, a sign that issuers are responding to demand by more aggressively testing the market. The strategy's exposure to HY bonds (held for liquidity purposes) slightly hindered performance as bonds underperformed loans in 3Q. The strategy's underweight exposure to large liquid loans (a proxy for ETFs) caused a modest drag to performance.

Defensive Floating Rate Income (cont.)

Performance benefitted from strong security selection within IT and pandemic-related recovery sectors, airlines in particular. The strategy benefitted from the performance of new issue credits as well. Security selection within the Consumer sector was a detractor. The strategy's best performing loan was a commercial filter and paper manufacturer whose loan rallied on favorable operating results. An investment management position also outperformed on better-than-expected fundamentals.

The strategy's worst performing position in 3Q was the best performing loan in 2Q21, a premium footwear retailer. We continue to believe this company is positioned to emerge successfully from the pandemic and is ultimately an IPO candidate as we remain committed to this holding. During 3Q, the strategy exited an investment in Telesat, a Canadian satellite company, after disappointing results.

Outlook

Despite the small rise in spreads during 3Q, the HY bond market remains at historically low yields. While we do not expect to experience massive spread compression, we continue to believe bonds can deliver coupon like returns with the potential for modest spread tightening in select credits and industries. YTD, we have continued to witness a positive inflection in corporate earnings that has led to improved credit metrics and healthier balance sheets across most of the HY universe. This balance sheet improvement has materialized into credit rating upgrades which have outpaced credit rating downgrades by over 2x YTD. In addition, defaults across the HY market in 2021 are on track to remain at one of the lowest levels witnessed in over a decade (JP Morgan).

This improving credit environment coupled with low default rates continues to support the argument that tight spreads are not necessarily indicative of a market that is overvalued. It also suggests that we can return to the even lower credit spread environment the market has experienced in the past during strong economic times. While risks from Fed tapering, a Chinese slowdown, and supply chain shortages remain very real, we believe the HY market will continue to post positive gains for the balance of the year. Importantly, the Evergrande situation in the USD Chinese HY market does not have a direct impact on the US market, rather, it is more relevant to the significance regarding the broader Chinese real estate market.

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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.

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PC-CRCOM100721