Executive Summary

US High Yield ("HY") bonds provided negative returns for the third consecutive quarter as rising US Treasury yields drove bond prices lower. During 3Q22 ("3Q"), persistently sticky inflation data drove the US Federal Reserve ("Fed") to hike interest rates and ratchet up hawkish commentary in an attempt to quell continued inflationary pressures in the economy. This in turn increased fears of a Fed led recession and helped drive a highly inverted 2 year/10 year US Treasury yield curve and spread widening in the lowest rated portions of the US HY market. Leveraged loans on the other hand provided investors with positive returns in the third quarter as the floating rate nature of these debt instruments continued to help drive better returns than fixed rate bonds. As we look ahead to the end of 2022, we continue to expect a volatile market as investors balance a potential future economic slow-down with still low (albeit rising) default rates, relatively strong current domestic economic data and even higher HY bond and leveraged loan absolute yields.

Rising Treasury Yields Continue To Weigh On High Yield Bonds

Rising US Treasury yields were the main driver of negative performance witnessed in the US HY bond market for 3Q as overall spread levels tightened during the quarter. Spreads initially hit their widest levels of the year in early July before tightening significantly later in the month. Spread widening in August and September however left spread levels at 574 bps by the end of the quarter, a level that is roughly in-line with the average spreads historically offered by the HY market.

Despite this slight spread tightening, US HY bond returns could not overcome the aforementioned substantial rise in US Treasury rates which drove bond prices down in the quarter and led to -0.44% returns for the asset class. By credit quality, lower duration Split-B and B-rated bonds were the top performing HY bonds in 3Q with returns of 1.04% and -0.15%, respectively. Economically sensitive CCC-rated bonds were the worst performers for the quarter given their -1.21% returns as investors continued to worry about the state of the future economy.

The Energy sector, which benefited from declining but still robust oil pricing and growing natural gas prices, was the best performing sector in the 3Q with gains of 1.35%. Media was the second-best performing sector during this same time-period with gains of 1.29%. The worst performing sector during the quarter was Autos which returned -2.41% as supply chain constraints and concerns about future consumer demand weighed on the sector. Healthcare and Telecom were tied for the second worst performance in the quarter with returns of -2.16%.

Leveraged loan returns once again held up much better than those of HY bonds in 3Q due in part to their floating rate and secured nature and provided gains of 1.46% during the quarter. These returns easily bested those of HY bonds and mark the first positive quarterly return of either asset class this calendar year. By credit quality, higher quality BB-rated loans provided the highest returns in the quarter by gaining 2.47%. Riskier split-B/CCC rated loans on the other hand were the worst performers by rating for 3Q given their -1.88% return. By industry, the largest loan sector outperformer in 3Q was Utilities which gained 3.54%. On the opposite end of the spectrum, Metals/Mining was the biggest underperformer in 3Q as declining metal prices drove loan declines of -2.96%. (Source: JP Morgan)

Capital Market Indicators

The US HY primary market calendar in 3Q was the lightest since 1Q09, with only $18.9b of gross issuance pricing during the quarter. Issuance remained stunted due to the fact investors and issuers continue to deal with growing economic uncertainty and higher interest rates. Refinancing activity remained the main driver of the limited issuance seen in 3Q by representing ~51% of new volume. By credit quality, issuance remained more focused on higher quality BB-rated issuers who have less perceived credit risk. In total, BB-rated deals represented ~53% of the new bonds issued during 3Q. This is roughly unchanged from 2Q22 levels but up significantly from 2021 where BB-rated bounds only represented ~40% of issuance.

Capital Market Indicators (cont.)

It is noteworthy that Split-B and CCC-rated credits did not price in 3Q22. In the Leveraged loan market we also experienced a continued decline in new issuance with only $24b of loans pricing in 3Q. This marked the lowest amount of issuance in over a decade. Acquisition deals, at 79% of proceeds, were the main use of money raised in the leveraged loan market in 3Q as refinancing and repricing deals remained less economical for many issuers in the current spread environment. Unlike the HY bond market, B-rated loans continued to represent the largest amount of issuance by rating in 3Q by making up ~80% of total issuance volume in the quarter. (Source: JP Morgan)

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns mainly BBB-B rated corporate bonds maturing in only 3 years or less, outperformed ICE BofA 1-3 Year US Corporate / Government Index as Fed rate hikes pummeled short-term US Treasuries. Strong security selection within Financials, Telecomm, REITS and Services contributed value as did off-index yield curve positioning as the 0-1 year maturity bucket outperformed. Capital markets activities continue to lag versus the very active 2021; approximately 9% of the portfolio was refinanced during the quarter and almost 25% year-to-date, the majority of which were tender offers.

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 the BB/B version of the index. Strong security selection within Autos and Energy sectors as well as an underweight to Banking and REITS more than offset credit-specific weakness within Telecomm. Credit quality allocation contributed value via the single-B component. Off-index yield curve positioning net detracted value as the overweighted 0-1 year maturity bucket lagged the overweighted 3+ year maturity bucket. Capital markets activities continued to lag versus the very active 2021; approximately 9% of the portfolio was refinanced during 3Q and almost 25% year-to-date, the majority of which were tender offers.

Defensive High Yield

Our Defensive HY strategy outperformed its benchmark, the FTSE BB/B Capped HY Index as well as the broad HY market. An underweight to Pharmaceuticals added value as multiple companies suffered from high leverage and legal challenges. Strong security selection within Energy, Telecomm, REITS and Cable more than offset interest rate-related weakness within Media, Building and Metals/Mining. Credit quality allocation was not a major factor. Yield curve positioning detracted due to an underweight to the 1-3 year maturity bucket and an overweight to the 3-7 year bucket, offset slightly by an underweight to the 10+ year maturity bucket. Accounts with loans benefitted from rising short-term rates.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed its benchmark, the ICE BofA US HY Constrained Index in 3Q. An underweight to Pharmaceuticals added value as multiple companies suffered from high leverage and legal challenges. Strong security selection within Energy, Wireline Telecomm, Services, Retail and Cable more than offset poor selection within Health Facilities, Chemicals and Satellite Telecomm sectors. Credit quality allocation contributed value given an underweight to BB-rated credits, which are typically the most rate-sensitive, and an overweight to single-B rated credits. Yield curve positioning was not a major factor. The convertible bond allocation was a contributor while accounts with loans benefitted from rising short-term rates.

Outlook

As we look ahead to the end of 2022, we are aware that the risk of economic turmoil has intensified. Domestically, the Fed has taken an increasingly hardline stance against inflation and seems to be committed to bringing cost increases down at the expense of economic growth. Overseas, the indirect economic effects of Russia's invasion of Ukraine and the recession in the Chinese housing market paint a bleak picture for global growth. While we believe adopting a slightly more defensive posture is likely warranted, we would note there are some positive developments to look forward to over the next few months.

First, global supply chain issues are continuing to ease. This should lead to continued improvements in margins for corporate borrowers and should allow for a greater volume of sales in areas where demand remains robust and backlogs remain extended. In addition, leading domestic economic indicators and strong employment data suggest the US economy remains solid. Second, defaults in the HY market remain relatively low. While defaults ticked up again in 3Q, the US HY bond default rates sits at only 1.6%. This compares favorably with longer term historical default rate averages of 3.2% for the US HY market. In addition, despite ticking down in 3Q again, upgrades in the US HY market continue to significantly outpace downgrades suggesting the credit quality of the market continues to improve.

Lastly, while spreads in the HY market are hovering near historically average levels, yields are now approaching their highest levels in over a decade. This fact, combined with the significant inversion we are experiencing in the yield curve, suggests we may be closer to the end of the Fed rate hiking cycle than the beginning. If the Fed can thread the needle of lowering inflation with only slightly slowing the economy we may have a future of continued low defaults, decent corporate balance sheets and the end of rising yield headwinds. This scenario would set up HY bonds for solid returns in 2023. (Source: JP Morgan)

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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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