PENN CAPITAL

Executive Summary

Although the Russell 2000 Index, a proxy for small cap equities, only declined -2.19% in 3Q22 ("3Q"), this modest headline contradicts the significant intra-quarter volatility investors experienced. Stocks rallied sharply through the first half of the quarter driven by better-than-feared 2Q22 earnings revisions coupled with investor optimism that mounting evidence of easing inflation (commodities, freight, labor) would provide cover for the Federal Reserve ("Fed") to slow its campaign of interest rate increases and potentially engineer a soft landing. Those hopes were dashed following hawkish comments from Fed Reserve Chairman Jerome Powell at their August Jackson Hole symposium in addition to a hotter than expected August Consumer Price Index. Subsequently, risk assets gave back all their early gains and small cap equities closed near their June 2022 lows.

Overview

The 10-year US Treasury yield increased from 2.88% to 3.83% during 3Q propelling mortgage rates above 7% for the first time since the early 2000's. Homebuilders began reporting sharp year-over-year order declines and previously white-hot home prices cooled sequentially. Supply of homes for sale remain at very low levels, particularly as many homeowners opportunistically refinanced at attractive rates during the pandemic. Oil prices declined steadily through the quarter, providing some relief to consumers at the pump. The Healthcare, Energy and Telecom sectors outperformed while Real Estate, Consumer Staples and Utilities lagged. Despite the sharp rise in interest rates, small cap growth stocks outperformed small cap value stocks in 3Q. The spread to worst on the JPM US High Yield ("HY") Index declined from 620 bps to 575 bps during the quarter. The index is down 13.7% year-to-date, reflecting 200 bps of spread widening along with the rise in interest rates.

Micro Cap Equity

Our Micro Cap Equity strategy underperformed its benchmark, the Bloomberg Micro Cap Index, during 3Q with top contributors including the Financials and Consumer Discretionary sectors. Within Financials, regional banks continued to see strong loan growth without delinquency issues as they began benefitting from rising rates as many of their loans reset with higher rates set by the Fed. In Consumer Discretionary, our underweight exposure benefitted as many consumer-related businesses struggled as the Fed raised rates while concerns over a consumer slowdown also impacted the sector.

The strategy experienced underperformance in the Consumer Staples, Real Estate and Industrials sectors. Within Consumer Staples, our holdings continued to be impacted by high inflationary burdens as it relates to labor and shipping costs which had negative impacts during the quarter. Within Real Estate, higher rates impacted cap rate valuations in the sector even though our companies continued to experience healthy rent growth outlooks. In the Industrial sector, two of our office furniture companies suffered as order rates slowed as companies struggled with fewer employees returning to the office in favor of telecommuting.

Small to Micro Cap Equity

The Small to Micro Cap Equity strategy slightly underperformed its benchmark, a mix of the Bloomberg 2000 and Bloomberg Micro Cap Indices, during 3Q. Top detractors included the Industrials, Information Technology ("IT") and Communications Services sectors. Within Industrials, a maker of office furniture reported a sharp reduction in orders and lowered guidance due to stubbornly slow return-to-office trends compounded by worsening macro conditions. In the IT sector, a provider of security data and analytic software solutions underperformed after the company warned that growing macroeconomic uncertainty was beginning to negatively impact customer demand, particularly in Europe. Within Communications Services, a provider of in-flight connectivity systems and services reported stronger than expected 2Q revenue and adjusted EBITDA, though delayed its 5G launch plans due to chip testing delays.

Top contributors included the Energy, Healthcare and Financials sector. In the Energy sector, an oilfield services and equipment provider reported a 2Q22 "beat and raise" (beating quarterly earnings estimates and raising full year guidance) as strong demand drove pricing power above the cost of inflation.

Small to Micro Cap Equity (cont.)

The company is in talks with their banks for a new credit facility that could bolster liquidity and enable faster paydown of higher coupon bonds. Within Healthcare, a maker of medical devices that focuses on spine surgery solutions reported robust organic sales growth and continued market share gains while raising its fiscal year guidance above street expectations. In the Financials sector, a southeastern US-focused regional bank continued to deliver attractive loan and deposit growth, expanding net interest margins and experienced stable credit quality metrics.

Small Cap Equity

The Small Cap Equity strategy underperformed its benchmark, the Bloomberg 2000 Index during 3Q. Top detractors included the Industrials, Healthcare and IT sectors. In the Industrials sector, a maker of office furniture reported a sharp reduction in orders and lowered guidance due to stubbornly slow return-to-office trends compounded by worsening macro conditions. Within Healthcare, a medical device and tissue company, focused on treatment of aortic disease, sold off after reporting a disappointing clinical trial outcome. In the IT sector, a provider of security data and analytic software solutions underperformed after the company warned that growing macroeconomic uncertainty was beginning to negatively impact customer demand, particularly in Europe.

Top contributors in the quarter included the Real Estate, Energy and Financials sectors. Within Real Estate, a real estate investment trust, focused on group-oriented and destination hotel assets, reported solid 2Q22 results and raised fiscal year guidance driven by a continued recovery in occupancy levels and significant growth in room rates. In the Energy sector, an oilfield services and equipment provider reported a 2Q22 "beat and raise" (beating quarterly earnings estimates and raising full year guidance) as strong demand drove pricing power above the cost of inflation. The company is in discussions with banks for a new credit facility that could bolster liquidity and enable faster paydown of higher coupon bonds. Within Financials, a southeastern US-focused regional bank continued to deliver attractive loan and deposit growth, expanding net interest margins and experienced stable credit quality metrics.

Small Cap Value Equity

The Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg 2000 Value Index, during 3Q as top contributors included the Healthcare and Financials sectors. Within Healthcare, several of our medical device companies performed well during the quarter as procedures ramped up after a difficult start to the year as Covid and the flu season impacted visitations. Within Financials, our regional banks continued to see strong loan growth without any delinquency issues as they started to benefit from rising rates as many of their loans reset with higher rates set by the Fed.

Top detractors to performance included the Energy, Real Estate and Consumer Staples sectors. Within Energy, our underweight was a significant allocation detractor as energy companies rallied significantly after falling the previous quarter due to recessionary fears associated with the Fed's aggressive interest rate policy. Within Real Estate, higher rates impacted cap rate valuations in the sector even though our companies continued to see healthy rent growth outlooks during the quarter. Within Consumer Staples, our holdings were negatively impacted by high inflationary burdens as it relates to labor and shipping costs.

As the Fed has become steadfast in their fight against inflation, their aggressive interest rate policy has negatively impacted all areas of the market. They have made it clear that the economy may suffer to attain its goals of bringing inflation down to its 2% target level. During 3Q, supply chain issues started to ease but shortages of materials, including semiconductors, continued to be a problem. Although some commodities have fallen in price during the quarter, broadly speaking, prices remain high and the labor market remains tight. Although high tech startups that depend on venture capital to fund their businesses have been mostly impacted, employees who were laid off have moved to larger more established tech companies.

The Fed's focus on lowering inflation has increased rates and borrowing costs for every company across the spectrum from high grade to HY. It is imperative to focus on stable companies with conservative balance sheets as the burden of interest rate costs increases and demand trends for most businesses likely slow in the future as a result.

Small Cap Value Equity (cont.)

Currently, the market is fixated on timing the Fed's exit from this aggressive policy stance. It may take some time as employment rates likely remain steady but some inflationary headwinds are likely to start abating in 4Q22 and more largely into 2023. The Russian invasion of Ukraine has created more problems for Europe as it has cut crucial gas supplies and increased pricing dramatically. The invasion has also kept oil prices high during the period further contributing to the inflationary problem. We expect the Fed to continue its path into the end of the year and volatility will be a common theme for the market.

We are focused on companies that have strong balance sheets to weather the storm and business fundamentals that will be less severely impacted during a market slowdown. We believe many companies currently have improved balance sheets, but the question remains: how does the Fed's policy potentially impact various credit markets around the globe? Ultimately, this could be the biggest driver of equity markets in the future and we believe our credit expertise gives us an edge in navigating these difficult markets.

Small to Mid Cap Equity

The Fed's path of higher interest rates raised underlying growth concerns that a recession was looming in the next 12 to 18 months. Stocks broadly sold off as higher rates weighed on equity values. Recession valuations are beginning to be priced into the market providing opportunity if the economy performs better than feared.

Small to mid cap stocks were down in 3Q as the Fed hiked interest rates during the quarter after a big drop in 2Q22 as Russia invaded Ukraine. Energy was the only sector with a positive return during the quarter as US producers benefitted from the Ukraine conflict. The interest rate sensitive sectors, Utilities and Real Estate, lagged during the period.

Our Small to Mid Cap Equity strategy underperformed its benchmark, the Bloomberg 2500 Index, during 3Q. The strategy underperformed in the Healthcare, Industrials and IT sectors. Materials, Consumer Discretionary and Communication Services sectors outperformed during the quarter.

Healthcare companies that contributed to Covid vaccines and therapeutics experienced slowing demand for their services. A defense contractor provided disappointing guidance as they struggled with sophisticated equipment due to supply chain issues. In IT, semiconductor companies saw demand slow during the quarter.

In the Materials sector, a lithium producer signed a large customer as they expanded capacity to meet electric vehicle demand. A discount retailer experienced attractive inventory purchases as consumers retrenched and focused on this sector. A media conglomerate that trades at a significant discount to the sum of its parts contemplated ways to close the gap.

Higher rates and monetary tightening have impacted financial markets but have not fully flowed through the broader economy. We expect companies and consumers to adjust spending plans over the coming quarters. Tightening lending standards has 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. Companies that can internally generate capital will be better positioned to grow in this environment.

The strategy is invested in companies that we believe can generate strong 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.

Mid Cap Equity

The Mid Cap Equity strategy outperformed its benchmark, the Bloomberg Midcap Index, during 3Q. Top contributors included the Materials, Financial Services and Energy sectors. Within Materials, a US nitrogen producer realized strong prices due to a favorable global supply demand environment. Regional banks experienced rising net interest margins as they lend at higher rates with deposit costs increasing at a slower rate. A natural gas company is seeing strong demand for their product as Western customers shift away from Russian supply.

Top detractors included the Industrials, IT and Communication Services sectors. A credit bureau experienced slowing credit report requests as higher interest rates slowed consumer spending. In IT, semiconductor companies saw demand slow during the quarter. An online dating company experienced slowing growth for its most popular app as they update the user experience.

Outlook

While inflation remained stubbornly high and roiled financial markets in 2Q22, we continue to believe the rate of inflation has peaked and will moderate further as 4Q22 progresses. Importantly for the Fed, consumer inflation expectations have begun to recede, and the labor market is softening evidenced by lower job openings and a growing number of corporate layoff/hiring freeze announcements. As noted last quarter, many key industrial commodity inputs (lumber, steel, aluminum, copper) have already declined significantly. Global supply chains are normalizing post-pandemic with dramatic improvement in ocean container rates. Retailers with excess inventory are resorting to heavy discounts and promotions to clear goods and are reducing future orders which will further benefit supply chains. There are various timing lags associated with each of these phenomena, however, they are all directionally consistent with lower inflation ahead.

While the economy is necessarily slowing, we believe consumers and businesses are fundamentally healthy and durable enough to take the Fed's inflation fighting medicine. Overall unemployment remains low, wages are higher and consumer balance sheets are in good shape. Corporate credit fundamentals are robust as companies took aggressive measures 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 HY market that is rated BB is at or near all-time highs, all of which should keep credit spreads and default rates low relative to previous downturns.

While revenue performance may exhibit higher than normal variability in 2023 given macro concerns and pandemic-related distortions in prior year comparisons, (stimulus, goods vs. services reversion) many companies will benefit from lower input and freight costs, easing wage rate pressure and lower working capital needs.

Ultimately, we believe the Fed will err on the side of letting inflation 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 widespread job destruction. A pause or reduction in the rate of future Fed funds rate increases would be a significant positive catalyst for depressed equities. After a -25.1% year-to-date decline in the Russell 2000 Index, small cap equity valuations are compelling. Tactically, the market is oversold on many measures of technical breadth and investor sentiment is bearish, suggesting a favorable long-term risk-reward.

PENN CAPITAL

The views and opinions expressed are for informational and educational purposes only as of the date appearing in this material only and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. These views are subject to change at any time and they do not guarantee future performance of the markets.

Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. It does not take into account the specific objectives, financial situation, or particular needs of any specific person. You should not assume that any discussion or information provided here serves as the receipt of, or as a substitute for, personalized investment advice. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals. Investing in the stock market involves gains and losses and may not be suitable for all investors. Investors have the opportunity for losses as well as profits.

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.

Past performance is not indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns. Portfolio holdings are subject change and may or may not be held by one or more Penn Capital portfolios from time to time. Please note that comparing the performance to a different index might have materially different results than those shown. The Bloomberg Micro Cap Index is a float market cap weighted benchmark of those securities in the Bloomberg Aggregate Equity Index with a market capitalization ranking of lower than 2,500. The Bloomberg US 2000 Index is a float market-cap-weighted benchmark of the lower 2000 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US 2000 Value Index is screened from the Bloomberg US 2000 Index (B2000) and is constructed based on a linear combination of risk factors. The four factors are: 1) Earnings Yield, 2) Valuation, 3) Dividend Yield and 4) Growth. The factors are equally weighted when forming a composite signal where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. The Bloomberg US 2500 Index is a float market-cap-weighted benchmark of the lower 2500 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US Midcap Index is a float market-cap-weighted benchmark of those securities in the Bloomberg US 1000 Index ranked 201 to 1000 by market capitalization. Investors cannot directly invest in an index.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.
PC-EQTYCOM_10102022

