PENN CAPITAL

Executive Summary: Spreads Compress But Risks Related To Higher Treasury Rates Rise

US high yield ("HY") bonds posted positive returns in 3Q23 ("3Q") against the backdrop of still resilient economic data and adequate corporate earnings. As we look ahead to the end of 2023, we expect a volatile market as investors continue to weigh the future impacts of a still hawkish Federal Reserve ("Fed"). Given certain portions of the HY market are still 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 there are opportunities in the shorter dated discounted bonds of solid companies given the openness of credit markets for refinancings.

Lower Rated Credits Continue to Outperform as Duration Weighs On Higher Rated Bonds

The US HY bond market provided gains of 0.65% in 3Q as spreads compressed 9 bps and yields rose to 8.97% at quarter end. With current spread levels of 420 bps, the US HY market is trading just under 80 bps; tighter than historical median levels. During 3Q the market continued to balance relatively robust current economic data on the one hand with fears of further Fed rate hikes causing a recession in the future on the other.

By rating, riskier split-B and CCC-rated bonds were the top performing HY bonds in 3Q with returns of 3.37% and 2.44%, respectively. Higher quality (and higher duration) split-BBB and BB-rated bonds were the worst performers for the quarter given their respective -1.59% and -1.32% returns. The Cable & Satellite sector was the best performing industry in the quarter with gains reaching 2.34%. Energy was the second-best performing sector with gains reaching 2.02% on the back of higher oil prices. On the flip side, the worst performing sectors were Retail and Housing which returned -0.64% and -0.50%, respectively, against the backdrop of earnings trouble in certain retail subsectors and higher interest rates. The best performing sector year-to-date was Gaming and Leisure returning 9.46%. The worst performing sector was Broadcasting which returned 0.31% during this same time period.

Market credit quality, as measured by ratings, improved once again on a dollar weighted basis in 3Q as the upgrade/downgrade ratio hit 2.3. In addition, the US HY default rate ticked down quarter over quarter in 3Q ending September at 2.11%. With only $11.5b in bonds defaulting or taking part in a distressed exchange this quarter, 3Q marked the lowest level of quarterly defaults this year. Given this retreating pace of defaults, the current rate of defaults is still well below the historical average default rate levels of 3.4% despite being up year-over-year. (Source JP Morgan)

Capital Market Indicators

The US HY primary market continued its year-over-year volume recovery in 3Q primarily due to heavy September issuance. At ~$25b in gross issuance, September 2023 marked the highest monthly new issuance volume level the market has experienced since January 2022. For the quarter as whole, $41.1b of gross issuance was priced; a significant increase from 2022 levels where issuance averaged ~$19b in 3Q. Refinancing activity remained the main driver of issuance in 3Q once again with refi deals representing ~66% of new activity.

Issuance conditions remained favorable enough to also witness a return of dividend deals for the first time this year in 3Q, but volume levels for these types of transactions still remain very low. By ratings, issuance started to focus more on lower quality credits for the first time this year. In total, B-rated deals represented ~54% of the new bonds issued during the quarter. This bucks 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. The majority of the market still remains weighted to split-BB or higher rated credits.

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, underperformed the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index in 3Q. Weakness in the Financial Services sector overcame strength in Gaming and Auto Loans sectors. Credit quality overweight to BB-rated bonds was a negative during the quarter as Treasuries sold off. The portfolio continues to be defensively positioned as compared to the index in the current environment. Capital market activities continued to lag as higher rates dissuaded issuance with issuers leaving maturities out that are due after 2024.

Defensive High Yield

During 3Q, our Defensive HY strategy underperformed the FTSE BB/B Capped HY Index. The Energy sector led returns due to an overweight into rising oil prices. The Food industry outperformed and strong security selection in the Media sector provided positive returns. Security selection within the Chemicals sector was a detractor to returns as well as an overweight to the high-quality Healthcare sector. Lower rated single B bonds outperformed BB-rated bonds during the quarter. We incrementally upgraded the credit quality of the portfolio during the quarter as we focus on strong capital structures. Yield curve positioning was a drag on performance due to an underweight to 1-3 year duration bonds as Treasuries sold off during the quarter.

Opportunistic High Yield

Our Opportunistic HY strategy underperformed the ICE BofA US HY Constrained Index during 3Q. Overweighting the Energy sector along with strong security selection within the group drove performance. The portfolio also benefitted from strong security selection in the Food industry and underweighting the REIT sector which appears to have strong headwinds. The Healthcare sector lagged during 3Q, particularly in higher quality bonds that struggled due to rising rates. We incrementally added to higher quality B-rated bonds while reducing exposure to B-/CCC rated credits. Lower quality bonds outperformed during the quarter as the 5-year US Treasury yield rose by 35 bps to 4.61% during the quarter. Underweighting bonds with a duration of 1-3 years was a drag on performance.

Outlook

Since 2022, the Fed has aggressively raised interest rates challenging the fixed income market. This action has slowed its cadence in the four most recent meetings by raising rates 25 bps twice in that period. The Fed is contemplating leaving rates at a constrictive level for some time to return inflation to their 2% goal. These monetary decisions have a lagged effect and is most clearly visible when debt refinances. Bank loans typically reprice with higher rates within three months and these borrowings are causing more stress than fixed rate corporate debt that matures between 2025 to 2030. Companies are adjusting to this new regime by paying down debt to reduce leverage and to slow rising interest costs.

The current environment calls for focusing on strong credits that can weather economic slowdown over the next few months. In many areas, the credit market is not differentiating well between the strongest companies and weaker competitors so we are upgrading our portfolios to reducing risk potential with little loss of return today. The current market is bifurcated with a few industries trading at recession levels where we are selectively finding opportunities in high conviction situations. New issuance has been muted in 2023 but we have found a “buyer’s market” with higher coupons and strong covenants providing an attractive risk-return paradigm.

Higher rates detracted 3Q returns in the HY market overall as the market internalized a “higher for longer” interest rate regime to fight inflation exiting the pandemic. The HY market is now providing attractive new money yields of about 9.00% on the ICE BofA US HY Constrained Index.

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 ICE BofA 1-3 Year BB US Cash Pay High Yield Index is a subset of the ICE BofA US Cash Pay High Yield Index, which tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB. The ICE BofA 1-3 Year BB/B US Cash Pay High Yield Index is a subset of the ICE BofA US Cash Pay High Yield Index, which tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB/B. The ICE BofA US High Yield Constrained Index contains all securities in The ICE BofA US High Yield Index but caps issuer exposure at 2%. The FTSE BB-B Capped High Yield Index is a subset of the FTSE US High Yield Index including all securities rated BB through B. 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-CRCOM_10092023