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Executive Summary

US high yield ("HY") bonds provided positive returns in 4Q21 ("4Q") as investors shrugged off concerns related to the Omicron variant. Looking ahead, we expect a repeat for coupon like returns in 2022.

4Q in Review

US HY spreads tightened modestly by the end of 4Q as investor concerns dissipated surrounding the economic impact of the Omicron variant in December. In 2021, US HY bond spreads tightened 68 bps while yields remained virtually unchanged leading to coupon-like returns for investors. With Omicron fears seemingly in the rearview mirror, the market turned its attention to inflation with US Treasury rates rising in December.

As we look ahead to 2022, we expect a more hawkish Federal Reserve ("Fed") and less stimulative governmental policies combined with inflationary pricing pressures that businesses must nimbly navigate. We also expect supply chain pressure to ease in the second half of 2022 in addition to a continued recovery in corporate earnings that will keep defaults low. With spreads ending the year somewhat above previous lows, we expect the potential for slightly further spread compression in 2022. This compression can in turn partially offset further increases in US Treasury rates and set the stage for coupon-like returns in 2022.

A December to Remember

Despite negative returns for the US HY bond market (JP Morgan US HY) in both October and November due to Omicron related concerns, a significant December rally paved the way for a positive 0.75% return in 4Q. For the full year, US HY bonds returned 6.00% on the back of tightening spreads and virtually unchanged yields. Split-B rated bonds were the top performing HY bonds by rating in 4Q with returns of 1.13% and was nearly matched by single B-rated bonds which returned 1.07%. For the full year, split-B rated bonds were also the top performing HY bonds by rating with returns of 9.93%. Slightly riskier CCC-rated bonds were the second-best performers during 2021 with returns totaling 8.44%.

By sector, Media was the best performing industry in 4Q with returns of 2.34%. Metals and Mining was the second-best performing sector during this same time period with returns reaching 1.76%. The worst performing sector during 4Q was Broadcasting which fell 1.48%. In 2021, the top two performing sectors of the HY market were Energy and Transports which returned 14.71% and 12.20%, respectively. Oil prices improved dramatically from Covid induced lows as investors became more comfortable with the notion consumers will once again return to travel. The worst performing sector in 2021 was the Cable & Satellite industry with a return of -1.30%. It was also the only sector that did not post a positive return in 2021.

Leveraged loan returns mirrored that of HY bonds in 4Q with a December rally helping the asset class provide investors with 0.75% return (JP Morgan Leveraged Loan Index). In 2021, leveraged loans gained 5.46%, which lagged HY bonds by 54 bps. By ratings, single B-rated loans provided the highest returns in 4Q by returning 0.89%. Riskier split-B/CCC rated loans on the other hand fell 0.45% and were the worst performers by rating in 4Q. For the full year 2021 however, these riskier split-B/CCC rated loans were the top performers given their 12.32% return. Less risky split-BBB rated loans were the worst performers in 2021 by rating given their anemic 2.37% return. By industry, the largest loan sector outperformer in 4Q was the Metals & Mining industry with a 1.85% return. Metals & Mining was also the top performing loan sector on an annual basis with returns reaching 16.02%. Broadcasting was the biggest underperformer both in 4Q (-0.86%) and on an annual basis (-0.01%). (Source: JP Morgan).

Capital Market Indicators

The US HY primary market calendar took a bit of a breather in 4Q as issuance levels slowed from their torrid pace earlier in the year. $73.3b of new issuance priced in 4Q which brings full year issuance levels to $483b, 7% higher than 2020's historic issuance levels. Refinancing activity remained the main driver of issuance for both the quarter and the full year by representing ~43% of new issuance in 4Q and ~60% of new issuance in 2021.

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Compared to 2020, refinancing activity represented a smaller amount of total issuance in 2021 largely due to the growth of acquisition financing transactions which represented 20% of 2021 issuance. By ratings, issuance continued to be focused on the higher quality end of the market with BB and split-BB rated credits representing ~59% of new bonds issued during the quarter. In 2021, these higher quality BB and split-BB rated credits represented ~52% of issuance.

In the leveraged loan market, we saw an acceleration in issuance in 4Q from 3Q21 levels as ~$180b of loans priced. This brings full year leveraged loan issuance volumes to $835b, up a resounding 98% from 2020 levels. Issuance for the full year was largely single B-rated loans and just over half of the volume issued was used for refinancing and repricing activities. (Source: JP Morgan).

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, returned positively and outperformed the ICE BofA 1-3 Year US Corporate / Government Index which returned negatively. The portfolio of mainly BBB-B rated corporate bonds rallied with credit markets and performance was led by strong credit selection within the Specialty Finance and Autos sectors. Security selection within Covid-recovery industries, such as Recreation & Travel, REITS and Gaming, added value. Off-index yield curve positioning added value, as the 0-1 year maturity bucket outperformed. Our loan allocation also outperformed in addition to the portfolio's allocation to single-B rated bonds. Capital market activities continued to be strong during 4Q; almost 45% of the portfolio was refinanced during 2021, two-thirds of which were tender offers.

Defensive Short Duration High Income

During 4Q, 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 both 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 Recreation & Travel and REITs sectors benefitted the strategy in addition to an underweight position within Banking and an overweighting to Insurance. Security selection within Energy detracted as well as an underweighting to Utilities. An overweight position to single-B rated credits contributed whereas cash drag was a modest negative; our loan allocation was neutral. Off-index yield curve positioning added value, as the 3+ year maturity bucket outperformed the smaller 0-1 year maturity bucket. Capital market activities continued to be strong during 4Q; almost 50% of the portfolio was refinanced during 2021, the majority of which were tender offers.

Defensive High Yield

During the quarter, our Defensive HY strategy outperformed its benchmark, the ICE BofA BB-B Rated Non-Distressed Index, in addition to the BB/B version of the index. Healthcare and Technology sectors benefitted from strong security selection as natural gas-oriented names contributed within Energy. An overweight to Automakers and security selection within Auto Parts contributed as well. One of the main detractors during the quarter stemmed from credit selection within the Media sector. Credit quality allocation was a nonfactor regarding performance whereas cash drag was a modest detractor. While generally maintaining a duration-neutral stance, yield curve positioning detracted slightly due to an underweight to the 10+ year maturity bucket and an overweight to the 7-10 year bucket.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index during the quarter primarily based on strong credit selection within the Telecommunications, Media and Energy Distribution sectors. An overweight sector position within Automakers and security selection within Auto Parts contributed as well. Our convertible bond allocation was the main detractor, particularly in travel-related credits as the Omicron variant spread. Credit quality allocation, duration and yield curve positioning were nonfactors regarding performance whereas cash drag was a modest detractor.

Defensive Floating Rate Income

Our Defensive Floating Rate Loan strategy outperformed both its benchmark, the S&P/LSTA BB-Rated Loan Index, and the S&P/LSTA BB/B-Rated Loan Index during 4Q. Strong selections within the Consumer Discretionary and Retail sectors added value while Technology credits were the main detractor. The strategy's allocation to HY bonds, held for liquidity purposes, was a slight drag on performance. Cash was a modest drag as well. An underweight to the constituents making up the S&P/LSTA US Leveraged Loan 100 Index, widely held by loan ETFs, made a positive contribution to performance. The strategy benefitted from its lack of exposure to CCC-rated loans, which significantly lagged higher quality loans in the quarter.

Outlook

The Fed's hawkish pivot on inflation has led to expectations for higher US Treasury rates in 2022. These expectations were already playing out in early January as rates pushed higher and pressured bond prices. We see the scope for some spread compression in 2022 to help offset some of these rate increases. While spreads remain tight relative to historic levels, they are not yet at all-time lows. We expect that continued strength in corporate earnings will yield further improvement to balance sheets and credit metrics in 2022 driving spreads lower.

We have seen evidence for this credit improvement story continue to play out in 4Q as credit rating upgrades continue to outpace downgrades twofold. In addition, defaults across the HY market in 2021 were at the lowest levels ever (JP Morgan) and an improving earnings environment in 2022 coupled with a wide-open primary market for refinancing activities suggests defaults should continue to be subdued in 2022 as well. While risks from Fed interest rates increases, material inflationary pressure, supply and labor shortages and further Covid outbreaks remain evident, we believe the HY market should be poised to repeat another year of coupon-like returns similar to what we experienced in 2021.

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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.

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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