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Executive Summary

US high yield ("HY") spreads widened throughout 2Q22 ("2Q") with June recording the 2nd largest monthly spread widening seen by the HY market since 2008. Persistently sticky inflation during the quarter lead to tougher rate hike talk from Federal Reserve ("Fed") members. This tough talk, coupled with large rate increases during the quarter, amplified market fears of a Fed led recession and drove a significant sell-off in HY bonds.

2Q in Review

Growing recession fears also impacted leveraged loan returns during 2Q as prices for loans fell despite the rise in interest rates between April and June. The pace of declines in the loan market continued to be much lower compared to the HY market. As we look further ahead into 2022, we expect a somewhat choppy market as investors balance a potential future economic slow-down with low default rates, improving economic data in parts of the market and more attractive HY bond and leveraged loan valuations.

Rising Treasury Yields And Wider Spreads Cause Tough Times For HY Bonds

US HY bond spreads gapped substantially wider this spring and early summer on the back of worse than expected inflation data, continued geopolitical risks overseas and a more aggressive Fed signaling a willingness to harm economic growth in order tackle inflation. While 2Q started with spreads widening in April, it wasn't until June when the widening accelerated. US HY bonds contended with the rising rates of US Treasury bonds which pressured bond pricing by driving yields higher. This weakness in the US Treasury markets combined with the aforementioned spread widening drove US HY bonds to fall -9.56% in 2Q with spreads up 221 bps and yields reaching 9.21% by quarter-end.

By ratings, split-BBB rated bonds were the top performing HY bonds in 2Q with losses limited to -6.93%. Credit risk sensitive CCC-rated bonds were the worst performers for the quarter given their -14.05% return. By sector, media was the best performing industry in the quarter with losses of -5.30%. The more recession resistant food & beverages industry was the second-best performing sector during this same time-period with losses limited to -6.95%. The worst performing sectors during the quarter were the broadcasting and retail sectors which fell -14.60% and -13.83%, respectively.

Leveraged loan returns continued to hold up better than those of HY bonds in 2Q due in part to their floating rate and secured nature. Leveraged loans lost -4.05% in 2Q besting returns of HY bonds by 551 bps. By ratings, split-BBB rated loans provided the highest relative returns in the quarter by falling -2.10%. Riskier split-B/CCC rated loans on the other hand were the worst performers by rating in the quarter given their -8.25% return. By industry, the largest loan sector outperformer in 2Q was energy which fell only -1.41%. On the opposite end of the spectrum, housing was the biggest underperformer in the second quarter with losses totaling -6.59%. (Source: JP Morgan)

Capital Market Indicators

The US HY primary market calendar in 2Q remained very light as investors and issuers contended with growing economic uncertainty and higher interest rates. Only $25b of new issuance priced in 2Q marking the second lowest issuance level since 2009. Refinancing activity remained the main driver of the limited issuance seen in 2Q by representing ~52% of new volume. By ratings, issuance became 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 the quarter. This is up substantially from the 28% of issuance they represented only one quarter ago. In the leveraged loan market, we witnessed a continued decline in new issuance year-over-year and quarter-over-quarter with only $61b of loans pricing in 2Q. Refinancing deals remained the main use of proceeds (~58%) in the leveraged loan market in 2Q while repricing deals grinded to a halt. Unlike bonds, B-rated loans continued to represent the largest amount of issuance by rating in the second quarter. At 69% of new issuance in 2Q vs ~80% of issuance in 1Q22. The term loan primary market also showed signs of greater risk aversion. (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 three years or less, underperformed the ICE BofA 1-3 Year US Corporate / Government Index but outperformed the ICE BofA 1-3 Year BB-Rated US Cash Pay HY Index. Economic fears impacted credit vs. US Treasuries, mainly in June. Economically sensitive names within retail, hotels, metals and chemicals sectors detracted as did specialty consumer financials. Strong security selection within consumer products and technology added value as did off-index yield curve positioning as the 0-1 year maturity bucket outperformed. Capital markets activities slowed versus the very active calendar year 2021; approximately 1% of the portfolio was refinanced during the first half of 2022, the majority of which were tender offers.

Defensive Short Duration High Income

During 2Q, our Defensive Short Duration High Income strategy, which holds mainly BB/B rated bonds with an average portfolio maturity of three years or less, underperformed the ICE BofA 1-3 Year BB-Rated US Cash Pay HY Index but outperformed the BB/B version of the index. Strong security selection within consumer finance, REITs, cable and aerospace/defense led the way, as did an underweight to gaming. Energy was a net neutral contributor whereas security selection with packaging and services was a detractor; an underweight to telecom and health facilities also detracted. An underweight to BB-rated credits detracted, but accounts with bank loans benefitted from rising short-term rates. Off-index yield curve positioning detracted value, as the 3+ year maturity bucket underperformed the 0-1 year maturity bucket. Capital markets activities slowed versus the very active calendar year 2021; approximately 15% of the portfolio was refinanced during the quarter, the majority of which were tender offers.

Defensive High Yield

During 2Q, our Defensive HY strategy narrowly outperformed both its benchmark, the FTSE BB/B Capped HY Index, and the broad HY market. Strong security selection within Cable and Advertising coupled with an underweighting to pharmaceuticals added value. Telecom was a net detractor due to an underweight in the wireless sector as was security selection within software, services, gaming, metals and packaging, mainly due to lower quality. Energy was a net positive contributor mainly due to an overweight to exploration and production (“E&P”). Credit quality allocation detracted given an underweight to BB-rated credits, which are less economically sensitive. Yield curve positioning detracted due to an underweighting to the 1-3 year maturity bucket, offset slightly by an underweight to the 10+ year maturity bucket. Accounts with bank loan exposure benefitted from rising short-term rates.

Opportunistic High Yield

Our Opportunistic HY strategy underperformed its benchmark, the ICE BofA US HY Constrained Index in 2Q as contributions were led by strong security selection within the energy, financials and industrials sectors. Our underweight allocations compared to the benchmark to both wireline and wireless telecom offset each other. Credit selection within services, healthcare, media and metals detracted, mainly due to lower quality. Credit quality allocation detracted given an underweight to BB-rated credits, which are less economically sensitive. Yield curve positioning detracted due to an underweight to the 10+ year maturity bucket and an overweight to the 3-5 year maturity bucket. The convertible bond allocation was a detractor, but accounts with loans benefitted from rising short-term rates.

Defensive Floating Rate Income (cont.)

Our Defensive Floating Rate Income strategy outperformed its benchmark, the Credit Suisse Institutional Leveraged Loan Index, as well as the S&P/LSTA Leveraged Loan Index, in 2Q. 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. Large liquid loans are generally under pressure when the loan asset class experiences outflows ($7b in May and June). This technical caused the average price of the index to decline to $93.67 vs. $98.25 at the end of 1Q22. Contributing to performance was strong security selection in energy and an underweight to technology. Exposure to select consumer discretionary and retail credits were a drag on performance. The style remains focused on BB and B-rated credit selections given uncertainty in the US economy.

Outlook

With the Fed seemingly playing catch-up on taming inflation and Russia's invasion of Ukraine showing no signs of slowing, the risk of a recession in the near future has grown. While we still believe the Fed will try to balance inflation concerns with limiting the collateral damage rate hikes can cause to economic growth, we recognize that they are increasingly finding themselves in a difficult position. However, the outlook is not completely dismal. We continue to see supply chain issues easing and believe they will become less of a headwind to corporate earnings as the year progresses. China is emerging from its self-imposed strict Covid lockdowns and should show signs of improving economic growth as factories and consumers spring back to life. Lastly, defaults in the HY market remain relatively low.

Despite ticking up in June, largely due to the litigation related default of a large opioid producer, the US HY bond default rate sits at just over 1%. This still compares favorably with longer term historical default averages of 3.2% for the US HY market. In addition, despite ticking down in 2Q, upgrades in the US HY market continue to significantly outpace downgrades suggesting the credit quality of the market continues to improve. Lastly, valuations in the HY market are now at historically attractive levels and have already priced in some amount of future risk. In fact, with spreads at 620 bps at the end of June, the market is now wider than it has historically averaged the last 20 years. These wider spreads potentially provide some valuation support against larger sell-offs in future quarters and could spark renewed interest in the asset class. While it is too early to call a bottom in the HY market at the moment, we believe a case can be made that potential future risks are already priced into bond spreads and patient investors may find an attractive buying opportunity in the HY market in the not-too-distant future. (Source: JP Morgan)

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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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