PENN CAPITAL

Executive Summary

Despite U.S. high yield ("HY") bonds starting the year with positive quarterly returns in 1Q23 ("1Q"), it was a rocky road nonetheless as yields and spreads gyrated around numerous macro events. During the quarter, the market absorbed both falling and climbing U.S. Treasury rates, asset class outflows, stronger (and then weaker) economic data and a budding banking crisis that revealed cracks in the financial system related in part to past Federal Reserve ("Fed") rate increases. As we look deeper into 2023, we continue to expect a volatile market as investors digest past rate increases, a more fragile banking system and potentially slower future growth. We believe that the current environment calls for a focus on more defensive credits with stronger financial metrics, disciplined management teams and a greater competitive moat in their respective industries.

Gains Continue In 1Q But Volatility And Risks Increase

The U.S. HY bond market gained +3.84% in 1Q as spreads compressed 11 bps and yields fell to 8.76% at quarter-end. Despite ending the quarter tighter, spreads had a wide intra-quarter trading range with levels reaching both 66 bps lower and 61 bps higher compared to quarter-end closing levels of 499 bps. At current spreads, the U.S. HY market is trading roughly in-line with its median historical spread levels.

Fears over persistent inflation, due to a strong economy, gave way to fears over a nascent banking crisis and the knock-on effects to economic growth. This led to wide trading ranges and the necessity of government intervention late in March in the financial sector to seemingly calm the biggest market worries for now. By rating, riskier CCC-rated bonds were the top performers in 1Q with returns of +5.00%. Higher quality split BB-rated bonds were the worst performers for the quarter given their +3.46% returns.

The Gaming & Leisure sector was the best performing industry in the first quarter with gains reaching +6.04% whereas Automotive was the second-best performing sector with gains of +5.92%. On the flip side, the worst performing sector in 1Q was Broadcasting which returned -1.09% as investor fears over lower potential advertising spending continued.

Market credit quality, as measured by ratings, remained roughly static as upgrades slightly outpaced downgrades by dollar volume in 1Q. The U.S. HY default rate however ticked up 26 bps in the quarter to end March at 1.91%. This level remains below the historical default rate average of 3.2% but is slowly rising as the level of distressed bonds (those trading above 1,000 bps) has grown significantly since the start of 2022. (Source: JP Morgan)

Capital Market Indicators

The U.S. HY primary market calendar started off strong in early 1Q only to have issuance take a pause mid-March amidst the height of market fears related to prominent bank failures. $40.5b of gross issuance priced during the quarter with January deals accounting for more than half of the quarterly volume. Refinancing activity remained the main driver of issuance in 1Q by representing ~71% of new volume. By ratings, issuance remained focused on the higher quality bonds that had at least one BB-rating in 1Q. In total, BB-rated deals represented ~38% of the new bonds issued during the quarter, while slightly riskier split-BB credits represented a further ~23% of issuance. This continued the general trend of higher quality issuance driving volumes which we have seen in the U.S. HY market over most of the past few years. This higher rating bias continues to be absent from the leveraged loan market as ~72% of new issuance in 1Q remained single-B rated. (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 U.S. HY credits had a solid start to 2023. Strong security selection in Media, REITs and Gaming more than offset relative weakness in Transportation and Telecom. Capital market activities continued to lag as higher rates dissuaded issuance; approximately 5% of the strategy was refinanced during 1Q, the majority of which were issuer calls.

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, slightly outperformed the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index. Weakness in Telecom and Software overcame strength in Specialty Retail and Cable TV sectors. Credit quality overweight to single-B rated bonds was a negative detractor during the quarter. Capital market activities continued to lag as higher rates dissuaded issuance; approximately 5% of the strategy was refinanced during 1Q, the majority of which were issuer calls.

Defensive High Yield

Our Defensive HY strategy outperformed the FTSE BB/B Capped HY Index as well as the broad HY market. An underweight to and strong security selection within the Telecommunications and REIT sectors added value during the quarter. Security selection was a driver of return in Support Services and Exploration & Production. Detractors included security selection in Software and an underweight to Recreation & Travel. Strong security selection in BB-rated companies drove performance during the period as we incrementally increased our allocation to higher quality bonds. Yield curve positioning also added value to performance due to an overweight in the 5-7 year maturity bucket and an underweight in the 1-3 year bucket as the long end of the yield curve flattened due to risk aversion after the Silicon Valley Bank and Credit Suisse events.

Opportunistic High Yield

Our Opportunistic HY strategy underperformed the ICE BofA US HY Constrained Index during Q1. Strong security selection within Healthcare and Exploration & Production more than offset weakness within the Media and Software sectors. An underweight of the Telecom and Cable/Satellite sectors was a positive contributor. We incrementally added to higher quality bonds during the quarter which helped drive outperformance during the period. Yield curve positioning also added value to performance due to an overweight to the 5-7 year maturity bucket and an underweight to the 1-3 year bucket, as the long end of the yield curve flattened due to risk aversion after the Silicon Valley Bank and Credit Suisse events.

Outlook

The Fed raised interest rates aggressively over the past year causing continued challenges in the fixed income market. These monetary decisions have a lagged effect, and the impact was seen with the Silicon Valley Bank failure during the quarter. Tighter money is focused on reducing inflation but also has the additional consequence of lower economic growth as well as bouts of financial stress. Bank loans reprice with higher rates within three months and these companies are seeing more stress than bond issuers who have maturity walls that are typically between 2025 - 2030. Companies are adjusting to this higher cost of debt through a focus on principal paydown and a higher hurdle rate for capital investment.

The current environment calls for focusing on strong credits that can weather economic slowdowns 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 with investments in these stronger credits to potentially both reduce risk and minimize loss of returns given current market pricing dynamics. The recent market volatility can also provide opportunities to invest in companies that are oversold due to technical trading factors. We are carefully monitoring and selectively investing in investment grade companies at HY prices as the market provides opportunity to do so.

Over the past six months, the HY market has returned to delivering solid gains after two years of low returns in 2020 and 2021, which was then followed by absolute losses for the first nine months of 2022. The move to a higher interest rate environment requires companies to exhibit capital discipline after a period of free money in response to the Covid pandemic. As a result, it is important to identify the companies that can manage and thrive in the new environment. Most importantly, a normalization of interest rates provides investors with a potential for better returns on their investments.

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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.

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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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