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Executive Summary

US High Yield ("HY") bonds provided the first positive quarterly returns of the year during 4Q22 ("4Q") as spreads compressed for the second quarter in a row. During 4Q we saw better than expected corporate earnings, evidence of softening inflation data and hope for a more dovish Federal Reserve ("Fed") drove positive returns in the fall only for the market to give back some of those gains in December as investors grew increasingly worried about continued hawkish Fed actions and weaker economic data.

Leveraged loans also provided investors with positive returns in 4Q largely on the back of early quarter spread compression. For the full year 2022, leveraged loans clearly outperformed HY credit due in large part to the floating rate nature of the asset class. As we look ahead to 2023, we continue to expect a volatile market as investors balance what looks like the start of a future economic slow-down with low default rates, a potential Fed pivot on interest rates later in the year and historically attractive HY bond and leveraged loan absolute yields. (Source: JP Morgan)

Early Quarter Gains…but Risk Remains

The US HY bond market started the quarter with significant strength, as yields and spreads compressed 48 bps and 72bps, respectively, to drive gains of +2.69% for the market in October. This strength was driven by better than expected corporate earnings, light primary market volumes, some increased investor inflows and optimism around a potentially less hawkish Fed. Positive returns continued for November on these same themes. The beginning of December showed continued market strength but growing fears around weakening economic data and a still hawkish Fed led to a late month sell-off which turned returns negative for the month. This end of year weakness could not offset the positive gains witnessed earlier in the quarter and thus the US HY bond market was able to achieve solid +3.60% gains for 4Q.

US HY spreads ended the year at 511 bps which is only slightly elevated from historical median levels. By rating, higher quality BB-rated and split BB-rated bonds were the top performing HY bonds in 4Q with returns of +4.47% and +4.81%, respectively. Once again, economically sensitive CCC-rated bonds were the worst performers for the quarter returning -0.94% as investors continued to worry about the state of the future economy. The Metals & Mining sector, which is expected to benefit from a nascent China recovery and decent developed market demand, was the best performing industry in 4Q with gains of +7.94%. Housing was the second-best performing sector during this same time-period with gains of +7.09% as mortgages rates fell during the quarter. For the full calendar year 2022, Energy remained the best performing sector by limiting losses to only -3.92%. On the flip side, the worst performing sector during the quarter was Telecom which returned -0.82% while the worst performing sector for the full calendar year 2022 was Broadcasting which returned -19.67%. (Source: JP Morgan)

Turning our attention to the loan market, 4Q was the first time this year that leveraged loan returns did not outpace those of US HY bonds as they provided gains of +2.79%. These returns fell short of those delivered by HY bonds by almost 80 bps as interest rates did not cause a significant headwind for bonds during the quarter. By ratings, higher quality BB-rated loans provided the highest returns in the quarter by gaining +3.95%. Riskier split-B/CCC rated loans were the worst performers by rating for 4Q given their -2.38% return. By industry, the largest loan sector outperformer in 4Q was Metals & Mining which gained +4.88%. Healthcare was the biggest underperformer in the quarter with gains only reaching +1.23%. Energy was the best performing industry for the full calendar year 2022 with returns of +7.37% while Consumer Products was the worst performing industry with losses totaling -4.19% on the year. (Source: JP Morgan)

Capital Market Indicators

The US HY primary market calendar remained light with only $16.5b of gross issuance pricing during the quarter. Issuance remained stunted due to the fact investors and issuers continue to contend with growing economic uncertainty and higher interest rates. Refinancing activity remained the main driver of the limited issuance seen in 4Q by representing ~43% of new volume. Refinancing's were also the main driver of issuance on a full-year basis as well, representing ~47% of new volume.

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Capital Market Indicators (cont.)

By ratings, issuance remained focused on higher quality bonds that had at least one BB-rating in 4Q. In total, BB-rated deals represented ~32% of the new bonds issued during the quarter, while slightly riskier split-BB rated credits represented a further ~24% of issuance. This marks a slight increase in risk tolerance given the large quarter-over-quarter increase of split-BB rated issuance but also suggests that the new issue market is still primarily focused on higher quality deals. In the leveraged loan market, we saw $47.5b of new issuance priced in 4Q. This marked a significant uptick in issuance from the incredibly low volumes seen in 3Q22 but still represents much lower levels of issuance than was seen as recently as earlier in the year. Refinancing deals, at 62% of proceeds, were the main use of money raised in the leveraged loan market in 4Q. Acquisition deals fell to a yearly low of 31% of issuance during the quarter as many businesses put levered M&A on hold. Unlike the HY bond market, B-rated loans continue to represent the largest amount of issuance by rating in 4Q by making up ~56% of total issuance volume. (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 credit breathed a sigh of relief on the pace of Fed rate hikes. Strong security selection within Real Estate, Financials, Telecommunications and Aerospace/Defense more than offset an underweight to Banking and security selection within Forestry/Paper. Off-index yield curve positioning was a detractor, as the 0-1 year maturity bucket underperformed. Capital markets activities continue to lag versus the very active 2021; approximately 7% of the strategy was refinanced during 4Q and over 30% YTD, the majority of which were tender offers.

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 underperformed 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 Software, Packaging and Media was offset by weakness within Financials, Energy and Building. Credit quality allocation was not a material factor during the quarter. Net off-index yield curve positioning detracted value as the overweighted 0-1 year maturity bucket lagged the overweighted 3+ year maturity bucket. Capital markets activities continue to lag versus the very active 2021; approximately 6% of the strategy was refinanced during 4Q and over 30% year-to-date, the majority of which were tender offers.

Defensive High Yield

Our Defensive HY strategy outperformed its FTSE BB/B Capped HY Index as well as the broad HY market. An underweight to and strong security selection within the Cable and Telecommunications sector added value, in addition to an overweight and security selection within Healthcare Facilities, Energy Services and Metals/Mining. Strong security selection within Gaming helped to offset weakness within Energy Distribution, Recreation & Travel and Autos. Credit quality allocation was not a major factor, although security selection within both the single-B and BB rated segments contributed. Yield curve positioning also added value due to an underweight to the 10+ year maturity bucket and an overweight to the 5-7 year bucket, despite the US Treasury curve flattening. Accounts with loans lagged from a lower Fed-induced short-term rate outlook.

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index during 4Q. Strong security selection within Retail, Healthcare and Real Estate sectors more than offset weakness within the Cable and Media sector. An overweight and strong security selection within Energy Services and Metals/Mining sectors also positively contributed during the quarter. Credit quality allocation had a slight positive impact given an underweight to CCC-rated credits. Yield curve positioning was a slight detractor given an overweight to the front end of the curve. The convertible bond allocation was a detractor while accounts with loans lagged from a lower Fed-induced short-term rate outlook.

Outlook

As we look forward to 2023, we believe that markets will continue to be pushed and pulled by both inflation and recession fears. Despite recent signs of softening inflation, the Fed seems committed to bringing cost increases down further, even at the expense of economic growth, in our view. This sets the stage for further rate hikes in the first half of 2023 despite early signs the economy may be weakening. Complicating things further is the ongoing war in Ukraine which continues to roil energy markets and China's ever changing Covid-19 policies which seem to be easing for now. This sets the stage for continued volatility in 2023 and increases incentives for a slightly more defensive posture in portfolio construction, in our view.

We also see reasons for optimism in the new year. First, while the quantum of Fed rate hikes in 2023 is unknown, we believe it is highly unlikely we will see a rate hike cycle as aggressive as experienced in 2022. With inflation moderating and economic data softening, there is even a chance for rate cuts at the end of next year, in our view. This means that one of the biggest impediments of HY bond performance in 2022, higher US Treasury rates, will be noticeably absent or greatly reduced in 2023. In addition, while spreads remain near historical averages, defaults in the HY market remain relatively low compared to historical averages. Despite defaults ticking up again in 4Q22 and downgrades in the HY market now outpacing upgrades, the US HY bond default rates sits at only 1.65%. This still compares favorably with longer term historical default averages of 3.20% for the US HY market and suggests spread compression is potentially warranted if defaults stay at these low levels.

Lastly, absolute yields remain high by historical standards. This could continue to draw investor interest to the HY asset class while keeping a lid on new issuance and at the same time thereby creating a positive technical backdrop for 2023. Putting all these pieces together, it is our view that 2023 will be a year of volatility but also one of opportunity for potentially better HY performance.

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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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