PENN CAPITAL

Executive Summary

Despite evidence of a slowing economy, the ICE BofA Merrill Lynch US High Yield ("HY") Index posted its 3rd straight positive quarter amidst tailwinds from lower interest rates.

Don't Fight the Fed

The Federal Reserve ("Fed") was quite active in 3Q19 ("3Q"). Rates were cut twice, and despite their efforts, parts of the Treasury curve remained inverted for most of the quarter. Additionally, the Fed was active in the repurchase ("repo") market providing liquidity for banks. Mixed economic results and China trade talks produced volatile commodity prices and headwinds for the credit markets. Consumers continued to be relatively resilient whereas corporations were uncertain of their spending plans while others continued to rehash their supply chains.

Despite volatility, overall HY spreads ended the quarter precisely where they began (around +400 basis points). During 3Q, returns by credit quality were led by higher quality BB-rated bonds, whose longer durations responded positively to rallying interest rates. CCC-rated bonds lagged sharply, with returns in negative territory. During the quarter, the battered Auto industry lead returns to the upside while Telecommunications was the worst performing industry.

Capital Market Indicators

After a light 3Q inflow, the HY market has recovered over $15b of mutual fund flows YTD, recouping about a third of 2018's outflows of $46b. Bond technicals were strongly aided by modest net new bond issuance of over $2b and "rising stars" (HY bonds upgraded to investment grade status) significantly outweighed "fallen angels" (investment grade bonds downgraded to HY status) to push the YTD net rising star advantage to over $40b. Bond issuance totaled $67b during 3Q, but was almost fully offset by $66b of calls, tenders, and maturities. In fact, rising stars have sizably outweighed fallen angels since the beginning of 2017.

Conversely, as the Fed turned more dovish, leveraged loans lost over $8b in retail flows in the quarter and nearly $30b YTD. Net new issuance of loans YTD was a modest +$10b, as paydowns, repricings, and collateralized loan obligations ("CLO") issuance almost offset gross loan issuance. Whereas the overall quality of bond issuance in 1Q19 remained high, including a post-Lehman high in BB-rated issuance, we have noted an increased percentage of loan issuance proceeds being used for acquisitions. While still not at a concerning level, this bears watching.

Concurrently, the equity market continues to be an important source of capital although the IPO market is slowing, particularly for cash-poor companies. The Russell 2000 Index recovered from the May swoon to post a positive return in 3Q and has returned +14% YTD. Companies priced over $30b of primary and secondary stock during 3Q and over $95b YTD. According to Bloomberg, primary and secondary equity issuance for 2018 totaled $140b which surpassed 2016 levels but fell just short of 2017 levels. Both debt and equity capital markets remain open to higher quality sub-investment grade companies to grow their businesses responsibly, even if doing so by acquiring other companies with modest additional leverage.

Defensive High Yield

Our Defensive HY strategy underperformed the ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index (accounts with loan exposure lagged slightly more during another strong Fed-induced rally). Yield curve positioning and an underweight to BB-rated paper, the most rate sensitive within the HY markets, detracted from performance in 3Q. Security selection within Healthcare and Metals & Mining sectors also detracted value. Performance within Energy sub-industries was mixed although the strategy added value within Energy on a YTD basis. Despite strong cash flows, Pharmaceutical credits remained under pressure regarding pricing and the opioid crisis. An overweight allocation and security selection within Media & Broadcasting added value as did security selection within Technology. For global benchmarks, such as Bloomberg Barclays and ICE BofA Merrill Lynch family of indices, an underweight to European credits was a detractor.

PENN CAPITAL

Opportunistic High Yield

Our Opportunistic HY strategy outperformed the ICE BofA Merrill Lynch US HY Constrained Index (accounts with loan exposure lagged slightly more during another strong Fed-induced rally). Security selection within Energy, Telecommunications, and Media & Broadcasting more than compensated for an underweight allocation to the two most rate sensitive areas of the index: BB-rated and European paper. Healthcare was the main detractor, despite strong cash flows, as Pharmaceutical credits remained under pressure regarding pricing and the opioid crisis.

Ultra Short Duration High Income

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in 3 years or less, outperformed the ICE BofA Merrill Lynch 1-3 Year US Corporate/Government Index in 3Q. Our strategy of mainly BBB-B rated corporate bonds rallied despite Fed-induced strength in short-term Treasuries. The strategy benefitted from its exposure within Telecommunications and Media & Broadcasting, as well as from security selection within Financials. Only one industry group (Restaurants) returned negatively in absolute terms during 3Q as the strategy's average exposure to this sector remained low (approximately 10bps). Loans performed in-line with HY bonds and single-B and BB-rated bonds outperformed BBB/crossover-rated bonds within the strategy.

Defensive Short Duration High Income

Our Defensive Short Duration High Income strategy, which maintains an average portfolio maturity of 3 years or less, underperformed the ICE BofA Merrill Lynch 1-3 Year BB Rated US Cash Pay High Yield Index but outperformed the BB-B rated version of the index. Our strategy of mainly BBB-B rated corporate bonds added value via security selection within Metals & Mining, Utilities, and Building & Building Materials. Detractors included security selection within Technology and Healthcare whereas returns within Financials and Energy were mixed. Despite lower short-term rates, loans outperformed bonds on strong security selection, but conservative paper maturing in 0-1 years lagged index securities maturing in 1-3 years.

Defensive Floating Rate Income

Our Defensive Floating Rate Income strategy outperformed the broader Credit Suisse Institutional Leveraged Loan Index and slightly underperformed its benchmark, the S&P/LSTA BB-Rated Loan Index in 3Q. The strategy benefitted from its high quality BB-rated emphasis as single-B and CCC-rated loans materially underperformed during the quarter. The market appetite for high quality BB-rated loans is intensifying as signs of distress reemerge, particularly in Retail, Energy, and Technology sectors where the strategy is underweight. The share of distressed loans trading below $0.80 on the dollar reached $60b by the end of September; a 40-month high. The contribution from the strategy's allocation to HY bonds was relatively neutral as Fed rate cuts remained top of mind.

Redemption headwinds out of the asset class persisted with only a single week of positive inflows during 3Q. Security selection within Media, Airlines, and Cable all factored favorably into performance. Security selection within Healthcare and Technology detracted from performance and two names were exited in accordance with our sell discipline. We continue to favor loans given their security, relative safety, and comparable yield versus unsecured HY bonds although we expect asset class performance could remain hampered by additional Fed rate cuts.

Outlook

Although some pairs of the yield curve inside of 10-year maturities continued to invert or flirt with inversion, we still do not believe a recession is imminent. Rather, we see an economic slowdown driven by manufacturing, reduced trade, and supply chain reconfiguration. Massive global central bank intervention leaves us skeptical to compare past recessionary clues on an apples-to-apples basis with the recent inversion. Additionally, this inversion only impacted less than half of the maturity pairs that "normally" predict a recession. Longer maturity pairs, such as the 5-10 year pair and 10-30 year pair, continued to steepen during 2Q19 as they did to start the year.

Outlook (cont.)

Ex-Energy, the US HY and loan last-twelve-month ("LTM") bond default rates are now both below 2% as we continue to forecast a below-average default rate for 2019 and 2020. We expect fundamentals for HY companies, most of which are US-centric, non-global-traders, to remain relatively healthy, and we expect commodity-industry defaults to remain below historical HY averages. The "Trade War" could help usher in the return of a "Goldilocks" economy, with modest growth and modest inflation, which would be a positive environment for credit.

2019 appears to be on track for double-digit HY bond market returns and coupon-plus loan returns. 2020 will be unlikely to repeat this strong return pattern, although we expect loan and bond returns to remain positive yet closer together next year. We continue to favor the loan asset class as a bond complement, particularly higher quality first-lien loans that offer downside protection in the event of an unexpected economic recession. Because the valuation gap between BB-rated and CCC-rated paper is historically wide, we would expect this relationship to consolidate during 2020 in a non-recessionary scenario.

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 an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

The ICE BofA Merrill Lynch 1-3 Year US Corporate & Government Index is a subset of the ICE BofA Merrill Lynch US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a remaining term to final maturity of less than three years. The ICE BofA Merrill Lynch 1-3 Year BB US Cash Pay High Yield Index is a subset of The ICE Bank of America Merrill Lynch 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 Merrill Lynch US High Yield Constrained Index contains all securities in The ICE BofA Merrill Lynch US High Yield Index but caps issuer exposure at 2%. The ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index is a subset of The ICE BofA Merrill Lynch US High Yield Index including all securities rated BB1 through B3, inclusive, with an option-adjusted spread less than 1,000 basis points. The Credit Suisse Institutional Leveraged Loan Index is a sub-index of the Credit Suisse Leveraged Loan Index. The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the $US-denominated leveraged loan market. The S&P/LSTA BB Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market and is comprised of loans whose rating is BB+, BB or BB-. Standard & Poor's Rating Services is used to determine membership within this sub-index. The Russell 2000 Index is comprised of the 2,000 smallest companies in the Russell 3000 Index, representing approximately 11% of the Russell 3000 total market capitalization. The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. An investor cannot directly invest in an index.