PENN CAPITAL

High Yield, Fallen Angels, and the Fed

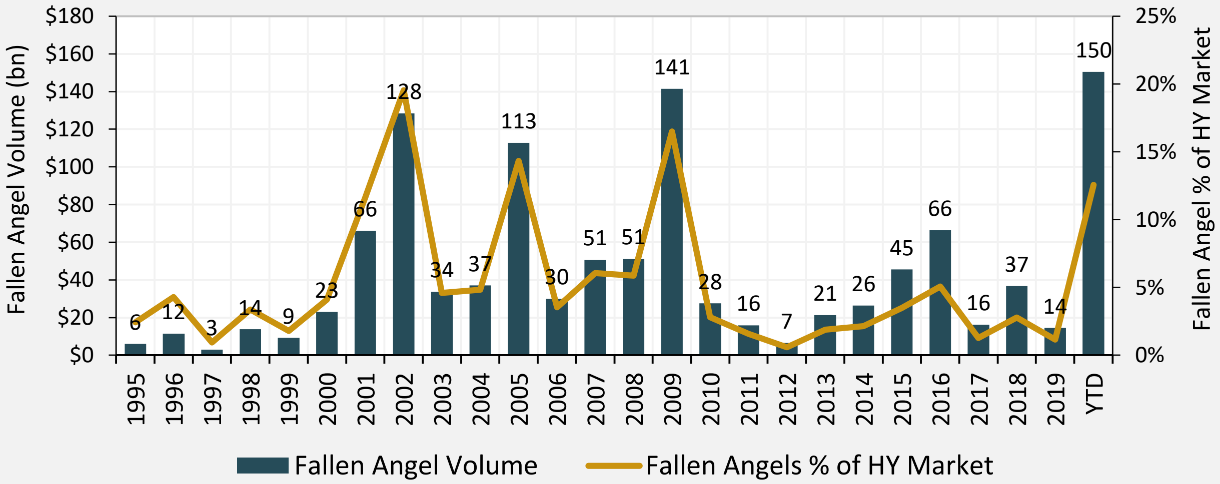
Peter Duffy, CFA and David Jackson, CFA

$150bn of YTD Fallen angel volume already surpasses 2009. In response, the Fed recently expanded its *Secondary Market Corporate Credit Facility* (“SMCCF”) to purchase fallen angels, as well as high yield bond ETFs. This backstop provides liquidity and price stabilization, helping to keep credit flowing amid the pandemic. But it does little to help cash-strapped companies from declaring bankruptcy. High yield bonds offer [attractive rebound potential], but investors will need to select quality issuances to help avoid defaults.

Forced selling will likely see fallen angels enter the high yield space at deeper than average discounts, further intensified by record volume and postponed rebalancing. ICE BofA postponed its 3/31 index rebalance, which would have seen $116bn of fallen angel outflows from investment grade indices. The upcoming 4/30 rebalance will include April and March, seeing more fallen angel flows in one month than the entirety of 2009.

Fallen Angels Volume and % of High Yield Market

Exhibit 1



As of 4/15/2020. Source: JP Morgan.

Extreme fallen angel volume periods have historically favored high yield bonds, as the bonds trade down prior to being downgraded. Post downgrade, the discounted issues often exhibit relatively strong balance sheets, with roughly two-thirds remaining BB-rated over the following 3 years. Excluding 2020, the top 5 periods of fallen angel volume from exhibit 1 are 2016 (Energy), 2009 (Financial), 2005 (Auto), 2002 (Accounting scandals), and 2001 (Dotcom & 9/11). High yield bonds delivered outsized returns in each period, surpassing the aggregate bond market and even equities, as shown in exhibit 2.

Top 5 Fallen Angel Volume Years and Asset Class Returns %

Exhibit 2

Fallen Angel Event	Period	High Yield	Fallen Angels	S&P 500	Agg Bonds
2001 Dotcom & 9/11 FA Volume: $66bn	2001	4.48	25.86	-11.89	8.44
	Next 12M	-1.89	-2.40	-22.10	10.26
	Total	**2.50**	**22.84**	**-31.36**	**19.56**
2002 Accounting Scandals FA Volume: $128bn	2002	-1.89	-2.40	-22.10	10.26
	Next 12M	28.15	34.67	28.68	4.10
	Total	**25.72**	**31.44**	**0.24**	**14.78**
2005 Auto Downgrade FA Volume: $113bn	2005	2.74	2.68	4.91	2.43
	Next 12M	11.77	15.23	15.79	4.33
	Total	**14.83**	**18.33**	**21.48**	**6.87**
2009 Financial Crisis FA Volume: $141bn	2009	57.51	64.88	26.46	5.93
	Next 12M	15.19	17.95	15.06	6.54
	Total	**81.44**	**94.48**	**45.51**	**12.86**
2016 Energy Crisis FA Volume: $66bn	2016	17.49	25.97	11.96	2.65
	Next 12M	7.48	10.42	21.83	3.54
	Total	**26.28**	**39.09**	**36.40**	**6.28**
2020 COVID-19 FA Volume: $150bn+	2020	?	?	?	?
	Next 12M	?	?	?	?
	Total	?	?	?	?

As of 4/15/2020. Source: Bloomberg. Indices: ICE BofA High Yield, ICE BofA Fallen Angels, S&P 500, BbgBarc Agg Bond.

The Fed has taken extraordinary measures to ensure liquidity flows throughout financial markets, launching three credit facilities to purchase and stabilize corporate credit: (1) *primary market* "PMCCF" for IG and fallen angel new issues, (2) *secondary market* "SMCCF" for IG bonds, fallen angel bonds, IG ETFs, and HY ETFs, and (3) *commercial* ("CPFF") for commercial paper issuers. A more detailed breakdown can be found in exhibit 2, as well as a comparison of the Fed to other central bank activities.

Fed Credit Facilities Details as of 4/9/2020

Exhibit 3

Primary Market Corporate Credit Facility ("PMCCF")	
Description	Purchase primary issuance as sole investor or up to 25% of syndicated issuance
Eligible Debt	BBB or above as of 3/22, IG downgraded to BB after 3/22, maturity 4 years or less
Issuer Limits	Refi from 3M ahead of maturity, additional debt any time, cannot exceed 130% outstanding debt
Initial Allocation	$50 billion
Max Allocation	$750 billion (split with SMCCF)
Leverage	10:1 for IG, 7:1 for all others
Termination	9/30/2020

Secondary Market Corporate Credit Facility ("SMCCF")	
Description	Can purchase individual bonds and ETFs in secondary market
Eligible Debt	IG and HY ETFs, BBB or above as of 3/22, IG downgraded to BB after 3/22, maturity 5 years or less
Issuer Limits	Cannot exceed 20% of ETF, issuer 1.5% of PMCCF/SMCCF combined, issuer 10% outstanding
Initial Allocation	$25 billion
Max Allocation	$750 billion (split with PMCCF)
Leverage	10:1 for IG, 7:1 for all others
Termination	9/30/2020

Commercial Paper Funding Facility ("CPFF")	
Description	Can purchase commercial paper through Fed primary dealers
Eligible Debt	A1 or above as of 3/17, downgraded to A2 after 3/17, active since 3/16/19, 3-month maturity
Issuer Limits	Cannot exceed issuer's prior max amount of commercial paper from 3/16/19 to 3/16/20
Initial Allocation	$10 billion
Max Allocation	Not disclosed
Leverage	Not disclosed
Termination	3/17/2021

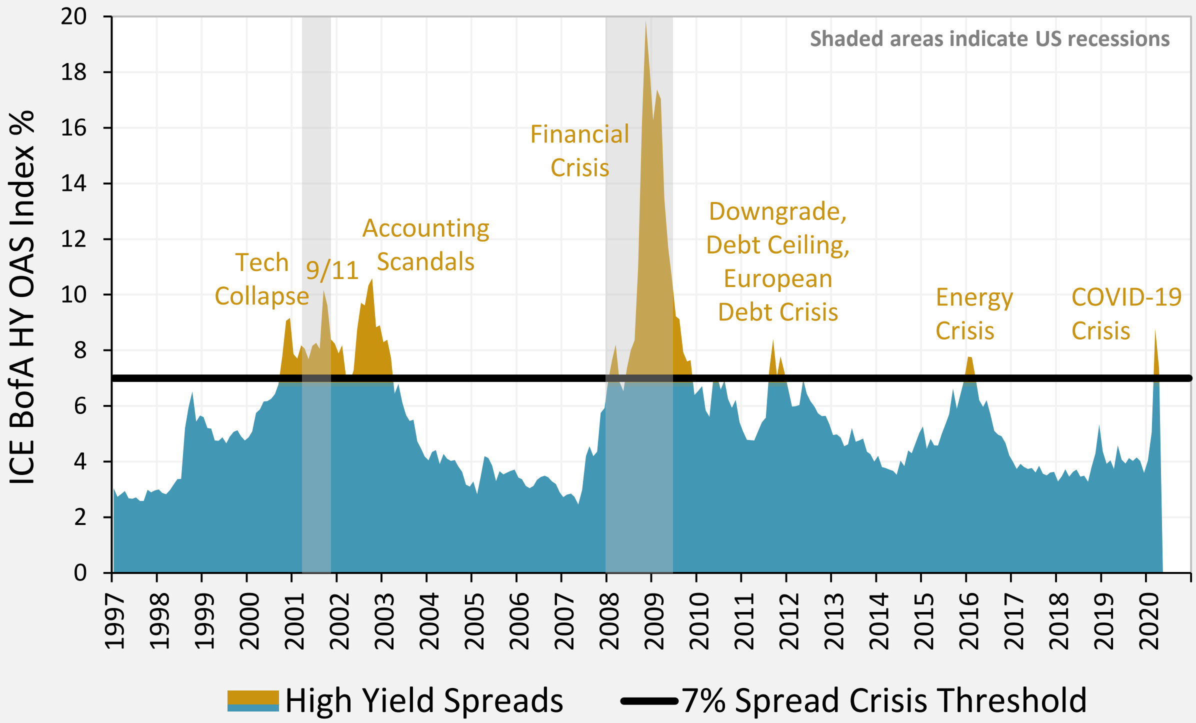
Others: Money Market Mutual Fund Liquidity Facility , Term Asset Backed Loan Facility

As of 4/9/2020. Source: Board of Governors of the Federal Reserve.

Conclusion: high yield bonds have historically offered excellent performance to long-term investors, with a higher return than the S&P 500 and agg bond market in the 20-year period ended 3/30/2020*. High yield managers and more tactical investors should consider the implications of fallen angel volume, Fed activity, [credit conditions], historically similar events, and [post-crisis rebound potential]. The pandemic will eventually subside, and high yield companies with strong balance sheets will likely rebound significantly, as they have after in every major crisis over the last 25 years.

Historical Credit Spreads and Crisis Periods

Exhibit 4



As of 4/15/2020. Source: ICE BofA. Index: ICE BofA High Yield Option Adjusted Spread Index.

Subscribe to Penn Capital Weekly Research

*Indices: ICE BofA High Yield, S&P 500, BbgBarc Aggregate Bond. Source: Bloomberg.
Past performance does not guarantee future results. Investors cannot invest directly in an index.

Investment Discipline from Credit Data

Credit is the lifeblood of the modern economic system. The daily analysis of macroeconomic credit fundamentals (liquidity, solvency, interest rates, leverage) can provide equity and credit investors with a disciplined framework for understanding and reacting to market conditions. This is especially true in today's market of record-breaking volatility.

Stock prices are roughly 20 times more volatile than their fundamentals, as noted by Robert Shiller, when pointing out the excess volatility could not be explained by the efficient market theory. Excess volatility appears to be derived from behavioral psychology. Credit fundamentals, especially their positive/negative directional momentum, have historically cut through behavioral price noise, offering indication of where we are in the cycle and where we're going.

Credit risk, interest rate risk, and yield curve risk are 3 key components of macroeconomic credit. Penn Capital's daily credit reviews focus on these core factors, seeking to help investors make disciplined and informed decisions. Daily updates can be accessed on our website.

High yield credit, the bonds and loans of companies rated below BBB, provide especially useful indication (such as high yield credit spread movements). High yield credit has historically exhibited earlier and greater sensitivity, and therefore indication, to changes in macroeconomic credit conditions that we believe truly drive the market. For that reason, we emphasize high yield credit in our analysis.

PETER DUFFY, CFA
Deputy CIO – Credit
Senior Portfolio Manager
Senior Managing Partner

DAVID JACKSON, CFA
Senior Portfolio Manager
Senior Partner

Disclosure

The subject matter contained herein has been derived from several sources believed to be reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Under no circumstances should this information be construed as a recommendation or advice. The views expressed herein reflect the professional opinions of the portfolio managers and are subject to change. Penn Capital does not accept any liability for losses either direct or consequential caused by the use of, or reliance upon, this information. These views are subject to change at any time and they do not guarantee future performance of the markets. **Investing in the stock market involves gains and losses and may not be suitable for all investors. Investors have the opportunity for losses as well as profits.**

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Penn Capital), or any non-investment related content, made reference to directly or indirectly contained within this commentary be suitable for your portfolio or individual situation, or prove successful. Comparisons to indices are inherently unreliable indicators of future performance. The strategies used to generate the performance vary from those used to generate the returns depicted in the benchmarks. Penn Capital makes no representation as to the methodology used to generate the benchmark returns. Portfolio holdings are subject change and may or may not be held by one or more Penn Capital portfolios from time to time. Transactions in such securities may be made which seemingly contradict the references to them for a variety of reasons, including but not limited to, liquidity to meet redemptions or overall portfolio rebalancing.

The S&P 500 index is comprised of the 500 largest US publicly traded companies. The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The ICE BofA US Fallen Angel High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt, that had previously been rated investment grade prior to being downgraded, publicly issued in the US domestic market. The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The ICE BofA High Yield OAS (Option-Adjusted Spreads) Index is the calculated spread between a computed OAS index of all bonds in a given rating category and a spot Treasury curve. An OAS index is constructed using each constituent bond weighted by market capitalizationThe ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request. Investors cannot invest directly in an index.

PC – WR041520