

Overview

Spreads and Yields Remain Low as Capital Markets Activity Ramps Up

The US High-Yield bond market delivered strong returns again in the third quarter, driven by a still buoyant US consumer, better-than-expected economic data, and an accommodative Fed, which all fostered a risk-on environment. This macro environment allowed spreads to once again test recent lows alongside declining US Treasury rates, resulting in solid quarterly gains that have propelled the US high-yield market up +7.34% over the past nine months. With three quarters of financial results reported, we are optimistic about our ability to achieve high single-digit returns in 2025. Although some smaller players are beginning to show signs of weakness, overall economic data and consumer spending remain resilient. Additionally, it seems the worst-case tariff scenario was avoided, and new trade agreements and corporate tariff mitigation strategies are helping to lessen tariff impacts. Lastly, US high-yield market issuance trends continue to favor higher-quality bonds, defaults stay low, and market maturity walls are extending, indicating the current tight spread environment may persist. This positions 2025 for a strong finish, with stable spreads and lower rates providing a tailwind into 2026.

Modest Spread and Yield Declines Fuel Another Quarter of Gains

The US High-Yield bond market delivered a +2.45% return in the third quarter of 2025, as slight spread tightening helped sustain a streak of positive gains for High-Yield bonds that now spans 12 consecutive quarters. By the end of the quarter, spreads decreased by 17 basis points as a Fed rate cut, stronger-than-expected 3Q economic growth, and resilient US consumers all boosted investor confidence. This tightening pushed spreads down to 319 basis points by September 30, 2025, and contributed to a market yield of 6.91%, which was near its lowest level in seven months, according to J.P. Morgan. Despite these declines, spread levels remain historically low compared to their 20-year median of approximately 498bps. We believe this indicates that the US High-Yield market continues to price in below-average concerns about credit risk compared to its historical levels.

According to J.P. Morgan data, low-quality CCC companies were the top performers among high-yield bonds in 3Q25, delivering returns of +2.84%. Meanwhile, safer BB credits underperformed despite declining US

Treasury yields, earning a respectable +2.19%. Year-to-date, BB bonds have the best-performing credit rating, with returns of +7.54%. Sector-wise, Media led the third quarter with outsized returns of +8.01%, surpassing the +4.71% posted by the second-best Retail sector. Year-to-date, Media has returned +12.76% and is now the top-performing sector in the US High-Yield market. On the other hand, the Chemical sector was the worst-performing sector in 3Q25, with a small gain of +0.43%. This was narrowly worse than Paper & Packaging, which posted a return of +0.50% during the quarter. The Paper & Packaging sector's return of +4.39% is now the worst in 2025.

Market credit quality, as measured by ratings, rebounded from the decline seen in the second quarter, with the dollar-weighted Upgrade/Downgrade ratio reaching 1.3x, according to J.P. Morgan data. This indicates that the pace of credit upgrades has once again surpassed that of downgrades over the past three months. On a trailing twelve-month basis, market credit quality also continues to improve, with the Upgrade/Downgrade ratio at a positive 1.2x. The US High-Yield default rate remains low at 1.39% as of September 30, 2025. This default level is down 8 basis points in 2025 and stays well below the historical average default rate of about 3.3%. Overall, low default rates and relatively strong credit quality should support a benign environment for spreads in the near term, in our view.

Capital Market Indicators

The US High-Yield primary market saw another strong quarter with about \$122 billion in gross issuance during the third quarter. September's issuance reached the third-highest on record, with volumes rising approximately 65% from 3Q24 and significantly surpassing the roughly \$77 billion recorded in 2Q25, according to data from J.P. Morgan. Refinancing activity remained the primary driver of issuance in both 3Q25 and year-to-date, accounting for approximately 72% of the new volume during these periods. By ratings, issuance continued to focus on higher-rated BB credits. Overall, BB and split BB-rated deals accounted for roughly 57% of the bonds issued this quarter. Meanwhile, low-quality CCC issuance, at about 3% of new volume, was relatively subdued compared to recent levels. By year's end, BB and split-BB bonds still represent the majority of the US High-Yield market value.

Defensive Short Duration High Income

The Defensive Short Duration High Income Strategy, which primarily holds BB/B rated bonds with an average maturity of three years or less, outperformed the ICE BofA 1-3 Year BB/B Rated US Cash Pay HY Index on a gross basis during 3Q25. The Capital Goods sector gained momentum as

Park-Ohio secured a strong backlog during the quarter. In Healthcare, two pharmaceutical companies performed well, benefiting from improving margins and stronger cash flow metrics. The Automotive sector underperformed due to a cautious stance and underweight position, for example, even though Nissan Motor Acceptance performed well despite tariff challenges. The Utility sector also lagged due to an underweight position and focus on Calpine, which rallied last quarter after Constellation Energy announced a proposed acquisition of the company.

Defensive High Yield

The Defensive High-Yield Strategy underperformed the ICE BofA BB-B US Non-Distressed HY Index on a gross basis during 3Q25. The Healthcare sector outperformed, driven by Embecta, which continues to see improved performance since its spinout from Becton Dickinson. In the Capital Goods Sector, truck parts suppliers rallied as tariff concerns appear to be manageable. In the Media sector, cable companies like Charter Communications lagged as Warner Discovery (which is not owned) rallied on speculation about a possible acquisition. In the Retail sector, Bloomin' Brands lagged as Outback Steakhouse underwent menu changes to boost sales. Quarterly performance was led by B-rated credits, with market returns in the BB category.

Opportunistic High Yield

The Opportunistic High-Yield Strategy underperformed the ICE BofA US HY Constrained Index during 3Q25. In the Capital Goods sector, trucking and RV-related credits like Patrick Industries outperformed as tariff concerns seem manageable. In the Healthcare sector, contract research organizations gained as clinical trial funding remains strong despite headwinds in the academic market. The Basic Industry sector lagged as weak pulp prices weighed on two paper and pulp companies in the portfolio. In the Media sector, Midcontinent Communications and other cable companies lagged, for example, the EchoStar bond complex as management shifted from considering bankruptcy to monetizing assets by selling wireless spectrum to AT&T and SpaceX. Quarterly performance was driven by B and CCC-rated securities.

Outlook

High-Yield Market Continues to Have Solid Fundamentals

The High Yield market showed continued positive momentum as it rebounded from tariff fears on April 2, 2025, with tighter credit spreads. The interest rate

environment appears more favorable as 2025 draws to a close, particularly since the Federal Reserve resumed rate cuts in September. The High-Yield market is at its highest credit quality ever within this asset class, with just over 50% of bonds rated BB- or higher. Most companies have extended their maturities to 2028-2030 and maintain ample liquidity. Today, most issuer balance sheets are robust and would likely only face challenges in a prolonged economic downturn. We believe the High-Yield market is well-positioned to handle any headwinds and deliver solid returns in this environment.

Penn Capital Products Net Performance (%) – as of Sept 30, 2025	QTD	YTD	1 YR	3 YR	5 YR	10 YR	Since Inc.	Inc. Date
Small to Mid Cap Equity	7.93	14.41	18.17	14.08	9.20	8.73	9.38	Dec-02
<i>Bloomberg 2500 Index</i>	9.18	8.84	9.69	15.74	12.07	10.42	11.21	
Small Cap Equity	11.62	16.21	22.28	16.62	16.46	10.79	12.01	Dec-93
<i>Bloomberg 2000 Index</i>	11.84	8.44	9.85	15.11	12.44	10.12	10.31	
Smaller Company Equity	12.62	14.37	23.16	19.02	20.75	17.29	16.53	Dec-11
<i>Bloomberg 2000 Index</i>	11.84	8.44	9.85	15.11	12.44	10.12	11.12	
Micro Cap Equity	9.39	12.85	15.37	6.46	9.27	7.17	7.78	Aug-06
<i>Bloomberg Microcap Index</i>	18.41	11.60	21.55	9.92	10.14	8.57	7.31	
Defensive Short Duration High Income	1.77	6.10	6.99	8.12	5.23	4.37	4.02	Jan-13
<i>ICE BofA 1-3 Year BB US Cash Pay High Yield Index TR</i>	1.56	5.56	6.35	7.97	4.91	4.83	4.44	
Defensive High Yield	1.98	6.61	6.77	10.26	5.03	4.90	6.39	Dec-93
<i>ICE BofA BB-B US Non-Distressed High Yield Index TR USD</i>	2.31	7.26	7.04	10.26	4.89	5.69	-	
Opportunistic High Yield	2.13	6.61	6.64	10.65	5.42	5.41	6.87	Dec-93
<i>ICE BofA US HY Constrained Index</i>	2.40	7.06	7.23	10.97	5.53	6.06	-	

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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.