

Overview

Rates and Spreads Drive Solid HY Gains as Risks Recede

The US High-Yield bond market provided solid returns in the second quarter as Fed messaging became more dovish, geopolitical tensions lessened, and the worst tariff fears abated. This macro backdrop enabled spreads to retest recent tight levels in tandem with declining US Treasury rates, resulting in solid quarterly gains that helped propel the US High-Yield market +4.78% year-to-date, according to J.P. Morgan data. As we look ahead to the second half of 2025, we continue to believe the US High Yield market can deliver another two quarters of positive returns, with gains ultimately reaching the high single-digit level by year's end. While tariff-related pressures haven't completely gone away, it seems that the worst-case scenarios are off the table, for now. In addition, corporate tariff mitigation strategies have yielded decent results so far and helped reduce the impact of tariffs on corporate earnings and consumer wallets. US High-Yield market issuance trends remain on the higher-quality spectrum, defaults remain low, and market maturity walls are pushed out, suggesting that the current tight spread environment can continue. This sets the stage for coupon returns (about 6.5% annually), with the potential for mid-single-digit returns in the second half of the year, supported by spreads or rates that could rise from Fed cuts, pro-growth government policies, or reduced corporate uncertainty related to tariffs.

Spread Tightening and Lower Rates Help Drive Strong 2Q Gains

The US High-Yield bond market posted a strong +3.74% in the second quarter of 2025, as spread tightening and declining Treasury rates combined to drive the strongest quarter performance since 3Q 2024, according to J.P. Morgan data. At quarter's end, spreads ultimately fell 48bps as the market grew more optimistic about future trade deals, softening the negative impact of tariffs and a more dovish Fed helping to support the US consumer. This tightening caused spreads to hit 337bps by quarter's end and helped drive yields to 7.18% at the end of June - a seventh-month low. Given these declines, spread levels remain below the historical 20-year median level of ~498 bps. This suggests that the US High-Yield market continues to price in below-average default risk.

According to J.P. Morgan data, low-quality CCC companies were the top-performing high-yield bonds in

2Q25, with returns reaching +4.40%. In contrast, safer BB credits were underperformers, despite the benefit of falling Treasury yields, as returns totaled a still respectable +3.63%. Year-to-date, however, BB bonds are the best-performing credits by rating, indicating returns of +5.24%. By sector, Broadcasters captured the top-performing spot for the second quarter, with returns of +6.22% surpassing those of +5.35% posted by the second-best performing sector, Diversified Media. Year-to-date, broadcasting is now the top-performing sector in the US High Yield market, with returns totaling +7.44%. At the other end of the spectrum, Retail was the worst-performing sector in 2Q25, with meager gains of +0.94%. This represents slightly less than half the gains of the next-worst-performing sector, Energy, which posted relatively solid +2.04% during the quarter. Year-to-date, Retail has taken the title of the worst-performing sector in 2025 so far, with anemic gains of only +1.30%.

Market credit quality, as measured by ratings, declined slightly in the second quarter, with the dollar-weighted upgrade/downgrade ratio hitting 0.6x, according to JP Morgan data. This indicates that the pace of downgrades exceeded that of upgrades over the past three months; however, on a LTM basis, market credit quality is still showing improvement, with the upgrade/downgrade ratio still measuring a +1.39x. The US HY default rate also remains benign, with levels only reaching +1.41% at the end of 2Q25. This default level is only 26bps higher than last November's multi-year low and remains well below the historical average default rate of 3.4%. Taken together, low defaults and relatively strong credit quality should help to provide a benign environment for spreads in the near term.

Capital Market Indicators

The US High Yield primary market saw very strong volumes in both May and June, with a total of \$77 bn in gross volume issued during the quarter, according to J.P. Morgan. This amounts to just under \$78 bn, the market issued at this time last year, but it is a significant increase from the \$68 bn recorded in volumes, based on JP Morgan data. Refinancing activity continued to be the main driver of issuance in the second quarter of 2025, accounting for 70% of the new volume. Year-to-date, refinancings have also remained the primary driver, accounting for 72% of volumes so far. Issuance by ratings remained focused on higher-rated BB credits. Overall, BB and split BB-rated deals made up approximately 57% of the new bonds issued during the quarter. CCC issuance, at around 2% of the new volume in, remains relatively subdued compared to the levels reached in recent years, despite the strong performance of this bond class on a return

basis this quarter and last year. By year-end, BB and split-BB bonds still comprised 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 portfolio maturity of 3 years or less, outperformed the ICE BofA 1-3 Year BB/B Rated US Cash Pay HY Index on a gross basis. The Retail sector outperformed as an athletic goods store was acquired by an investment-grade competitor during the quarter. In the Transportation sector, a private aviation company managed to improve utilization as it closed on an additional equity investment. The Telecom sector underperformed, as the largest position generated a lower yield while awaiting acquisition by an investment-grade company. In Utilities, independent power producers maintained strong metrics but lagged more aggressive companies.

Defensive High Yield

The Defensive HY strategy outperformed the ICE BofA BB-B US Non-Distressed HY on a gross basis during Q2 2025. The Retail sector outperformed as broader tariff concerns moderated over the quarter. The Leisure sector outperformed, led by cruise ship operators that continue to see strong booking trends through the spring booking season. In the Capital Goods sector, a glass maker observed a bottoming in the demand cycle as customer inventories normalized. The Healthcare sector lagged as a clinical research organization provided disappointing revenue guidance, with new clinical trials starting to slow. In the Telecom industry, a rural cable company experienced weaker new subscriber additions and lower-than-expected average pricing as competition intensified in their markets. Quarterly performance was driven by B+/B-rated credits, with market returns in the BB category.

Opportunistic High Yield

The Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index during Q2 2025. The Retail sector outperformed, avoiding weaker companies and focusing on solid credits that sold off due to tariff concerns. The Leisure sector outperformed, led by Las Vegas casino operators, which recovered after lapping the Super Bowl in 2024. In Capital Goods, a glass maker saw a bottoming in the demand cycle and improving trends going forward. Lagged in the Services sector, a cash-burning car rental company rallied as a new equity investor provided optimism regarding its operations. In the Telecom sector, a US rural

cable company experienced weaker pricing as underweight European telecom companies outperformed. In Banking, European banks performed well, which is an area the strategy avoided. Performance by credit quality was driven by B-through strong security with market returns in CCC.

Outlook

High-Yield Market Climbed the Wall of Worry in Q2

On April 2, 2025, President Trump proposed new broad tariffs that surprised the capital markets. The credit market overcame tariff fears during the quarter as initial levels were reduced with the continued implementation of the policy. High-Yield spreads tightened by over 50 bps during the quarter. The High Yield market is at its highest credit quality in the asset class's history, with approximately 50% of rated BB or better. Most companies have termed their maturities out to the 2027-2030 period and have ample liquidity. Most issuer balance sheets are strong today and would require a prolonged downturn to challenge repayment. As we observe the impact of tariffs, we believe the High-Yield market is well-positioned to manage the headwinds and has the potential to deliver strong returns over the next two years.

Penn Capital Products	QTD	YTD	1 YR	3 YR	5 YR	10 YR	Since Inc.	Inc. Date
Net Performance (%) – as of June 30, 2025								
Small to Mid Cap Equity	13.85	6.00	13.94	9.42	8.76	5.99	9.12	Dec-02
<i>Bloomberg 2500 Index</i>	7.74	-0.32	9.38	11.23	11.46	8.30	10.91	
Small Cap Equity	13.36	4.11	13.32	11.15	16.09	7.66	11.72	Dec-93
<i>Bloomberg 2000 Index</i>	7.84	-3.04	7.99	9.84	11.15	7.52	10.01	
Smaller Company Equity	11.69	1.55	13.91	12.89	21.86	13.61	15.84	Dec-11
<i>Bloomberg 2000 Index</i>	7.84	-3.04	7.99	9.84	11.15	7.52	10.42	
Micro Cap Equity	10.75	3.17	6.61	0.56	8.42	4.47	7.33	Aug-06
<i>Bloomberg Microcap Index</i>	13.13	-5.75	10.93	2.47	7.96	5.17	6.46	
Defensive Short Duration High Income	2.96	4.25	8.31	7.95	5.41	4.13	3.96	Jan-13
<i>ICE BofA 1-3 Year BB US Cash Pay High Yield Index TR</i>	2.49	3.93	7.81	7.66	5.17	4.54	4.40	
Defensive High Yield	3.61	4.54	9.40	9.45	5.56	4.35	6.37	Dec-93
<i>ICE BofA BB-B US Non-Distressed High Yield Index TR USD</i>	3.62	4.84	9.15	9.20	5.29	5.08	-	
Opportunistic High Yield	3.80	4.39	9.60	9.70	6.15	4.50	6.86	Dec-93
<i>ICE BofA US HY Constrained Index</i>	3.57	4.55	10.24	9.85	6.00	5.28	-	

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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.