Overview

Geopolitics Create a Weak Start to '26 But Credit Fundamentals Are Strong

The US High Yield bond market posted its first negative quarter since 3Q2023 as investors contended with a highly uncertain conflict in the Middle East, rapidly rising rates, and the largest retail withdrawals since Liberation Day. High-yield bond yields and spreads increased 66bp and 41bp year-to-date to 7.44% and 355bp, respectively. Despite that rough quarter, markets have already slightly recovered from intraquarter wide spreads as peace talk hopes, decent earnings and a benign default environment keep a lid on bearish sentiment. Looking ahead, although the market faces uncertainty from Middle East geopolitics and elevated Treasury yields, we see the scope for coupon returns in 2026 as a more accommodative Fed chief takes over later this year, prospects for peace brighten and stronger corporate earnings bring spreads back to their previously tighter levels.

Weak 1Q Returns as Geopolitics Weigh on Markets

The US High Yield bond market posted a -0.34% loss in the first quarter of 2026, snapping a streak of positive quarterly returns, according to JP Morgan data. Spreads widened 41bp during the quarter to 355 basis points while the Yield to Worst rose 66 bps to 7.44%. For reference, HY spreads touched a post-GFC low of 295 bps on January 22nd before widening to as high as 373bp on March 30th. The 10-year median High Yield spread is approximately 400 bps so there is not widespread credit fear priced into the market. Additionally, the market rallied sharply in early April when a ceasefire was declared on April 8, 2026.

By rating, BB bonds outperformed in 1Q26 with losses of only -0.17%, compared to Single-B bonds at -0.46% and CCC credits at -1.16%. By sector, Energy (+2.46%) was the strongest performer with rising oil prices followed by Chemicals (+1.63%) and Telecom (+1.58%). At the other end of the spectrum, Paper/Packaging was the worst performing sector year-to-date with losses of -4.37%, followed by Housing at -2.21% as interest rates rose challenging affordability.

Market credit quality, measured by ratings, continued to improve as the dollar weighted Upgrade/Downgrade ratio hit 1.3x. In 1Q26, the US high-yield bond default rate stands at 2.07% compared to the 25-year average HY default rate of 3.2%. JP Morgan's forecasts a 2026 default rate of 1.75% with a preliminarily forecast to rise to 2.25% in 2027 well below the long-term average. The current lending market continues to be constructive though default forecasts can change quickly based on market and geopolitical events.

Capital Market Indicators

US High Yield primary market issuance ticked up the first quarter of 2026 with ~$80bn of gross volume placed, according to JP Morgan versus only ~$68bn issued in 1Q 2025. Refinancing activity remained the main driver of issuance in the first quarter of 2026 once again with refinancing deals representing ~59% of new volume. There was a notable uptick in LBO financings in the quarter which represented ~22% of gross issuance in 1Q and 49% of issuance in the month of March alone. By ratings, issuance remained focused on higher rated BB credits. In total, BB and Split BB-rated deals represented ~58% of the new bonds issued during the quarter. CCC issuance has crept up to ~6% of new volume in 1Q 2026 and bears watching, in our view, but the majority of US High Yield market value remains firmly at BB rating levels.

Defensive Short Duration High Income

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Defensive High Yield

The Defensive High Yield strategy slightly underperformed the ICE BofA BB-B US Non-Distressed HY on a gross basis during Q1 2026. The Technology sector outperformed during the quarter due to a focus on software company RingCentral while avoiding credits with high risk of AI disruption. Acadia Healthcare initiated a turnaround by an experienced, well-respected industry executive. Within Financial Services, investment grade issuer Brinks Company announced the acquisition of NCR Atleos. Telecom lagged as Cable One dealt with increased competition from fiber overbuilders competing in their markets. In Basic Industry, Cleveland-Cliffs saw weak sell through due to foreign steel inventory stocking due to higher tariffs. In Media, Snap saw weaker advertising rates and slightly lower user engagement during the quarter. Increased credit quality during the quarter increasing the allocation to BB or better bonds and reducing B finding opportunity in stronger capital structures.

Opportunistic High Yield

The Opportunistic HY strategy performed in line with the ICE BofA US HY Constrained Index on a gross basis during Q1 2026. Venture Global grew cargoes at their second LNG facility as they firmed up off tanker economics. The Technology sector outperformed during the quarter with Seagate Technology seeing strong data center demand while underweighting software. Community Health continued to reduce leverage through accretive hospital sales. Within Basic Industry, the paper industry was weak due to soft pulp prices and rising input costs. Within Media, Midcontinent was weighed down by concerns about competition from possible LEO entrants. Underweighted fiber optic equipment companies that are benefitting from new financing structures in the asset backed securities market. Incrementally increased the allocation to BB rated securities as compared to B names during the quarter.

Outlook

High Yield Market Tied to Geopolitical in the Short Term and Fundamentals Long Term

In early April 2026, the High Yield market responded well to improving geopolitical headlines. Much like a year ago when tariff concerns weighed on the market, geopolitics provides uncertainty for the market. The High Yield market retains its highest credit quality in asset class history with slightly over 50% of bonds rated BB- or better. Most companies have termed their maturities out to the 2028-2030 period and have ample liquidity. Despite the near-term headwinds, strong underlying credit fundamentals and constructive earnings should help support the market through this period of elevated uncertainty.

Penn Capital Products Net Performance (%) – as of Mar 31, 2026	QTD	YTD	1 YR	3 YR	5 YR	10 YR	Since Inc.	Inc. Date
Small to Mid Cap Equity	-0.79	-0.79	21.09	9.25	2.88	9.18	9.10	Dec-02
Bloomberg 2500 Index	*2.08*	*2.04*	*22.28*	*13.05*	*5.27*	*10.42*	*11.14*	
Small Cap Equity	2.65	2.65	28.37	12.54	5.60	11.48	11.87	Dec-93
Bloomberg 2000 Index	*1.70*	*1.70*	*25.63*	*12.85*	*4.27*	*10.26*	*10.28*	
Smaller Company Equity	0.96	0.96	27.36	13.68	7.13	18.03	16.01	Dec-11
Bloomberg 2000 Index	*1.70*	*1.70*	*25.63*	*12.85*	*4.27*	*10.26*	*11.02*	
Micro Cap Equity	-3.93	-3.93	12.06	0.27	-5.54	6.20	7.14	Aug-06
Bloomberg Microcap Index	*-1.73*	*-1.73*	*32.97*	*9.43*	*-3.03*	*8.74*	*7.08*	
Defensive Short Duration High Income	0.13	0.13	6.70	7.09	4.74	4.34	4.01	Jan-13
ICE BofA 1-3 Year BB US Cash Pay High Yield Index TR	*0.19*	*0.19*	*5.93*	*6.85*	*4.36*	*4.78*	*4.40*	
Defensive High Yield	-0.55	-0.55	6.79	7.71	3.87	4.99	6.32	Dec-93
ICE BofA BB-B US Non-Distressed High Yield Index TR USD	*-0.40*	*-0.40*	*7.31*	*7.90*	*3.99*	*5.55*	-	
Opportunistic High Yield	-0.77	-0.77	7.15	8.25	3.74	5.83	6.80	Dec-93
ICE BofA US HY Constrained Index	*-0.55*	*-0.55*	*6.90*	*8.50*	*4.19*	*6.04*	-	

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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.

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