

## Overview

The first quarter opened with solid positive momentum, but sentiment deteriorated as hostilities with Iran escalated and mounting concerns over oil supply drove a sharp spike in crude prices, reigniting inflation fears and raising the specter of future stagflation. The period also marked an important inflection in the real economy, with key manufacturing indicators such as the PMI and ISM turning positive after nearly three years of contraction. However, the subsequent surge in oil prices introduced elevated volatility, particularly over the final month of the quarter.

Policymakers initially appeared to assume that the Iran conflict would resolve quickly, with Tehran expected to acquiesce to U.S. demands and move rapidly toward some form of agreement. Instead, as the quarter drew to a close, the conflict broadened, with Iran expanding its attacks to several oil-producing neighbors and effectively shutting the Strait of Hormuz, triggering an abrupt and pronounced spike in crude prices. The resulting shock reverberated across markets, driving a sharp move higher in interest rates on renewed inflation concerns and placing downward pressure on equities amid growing anxiety over the potential impact on future growth.

## Micro Cap Equity

Our Micro Cap Equity strategy modestly underperformed its benchmark, the Bloomberg Micro Cap Index, during the first quarter. The period began on a strong note amid improving sentiment toward the U.S. economy, but cyclical weaknesses weakened late in the quarter, ultimately resulting in slight underperformance. The strongest contributors were the Materials, Healthcare, and Communication Services sectors. In Materials, a specialty chemicals company producing refrigerants for data-center cooling delivered strong returns as accelerating data-center demand drove robust growth in its refrigerant products. In Healthcare, a healthcare facilities operator focused on rehabilitation clinics and outpatient therapy was acquired in a management-led buyout, providing a meaningful uplift. Within Communication Services, a wireline telecommunications company outperformed on market speculation that it might be acquired by a consortium of private equity investors and a large-cap telecom company.

The primary detractors were the Consumer Discretionary, Technology, and Energy sectors. In Consumer Discretionary, two companies in the second-hand retail space came under pressure as rising oil prices dampened consumer sentiment, despite both reporting strong quarters supported by a growing preference for second-hand retail in a constrained spending environment. In Technology, our sole software services holding lagged after revenue expectations tied to signing large AI customers to use its data in training models were pushed out; while we remain cautious on AI's near-term impact on software, we continue to believe the company's data and tools will ultimately help power many AI applications. In Energy, our emphasis on oil services companies, rather than exploration and production names, weighed on results as services underperformed businesses more directly leveraged to rising commodity prices and less exposed to potential disruption in Middle East oil and gas production. Over time, we believe our services holdings could benefit from increased activity required to rebuild and reinforce energy infrastructure in the region.

## Small Cap Value

Our Small Cap Value Equity strategy underperformed its benchmark, the Bloomberg Small Cap Value Index, during the first quarter. The quarter opened with strong performance amid improving sentiment toward the U.S. economy, but weakness in cyclical areas later in the period ultimately led to underperformance. The strongest contributors were the Materials, Financials, and Communication Services sectors. In Materials, a specialty chemicals company producing refrigerants for data-center cooling generated exceptional returns as accelerating data-center demand drove robust growth in its refrigerant products. In Financials, a leading pawn operator benefited from a significant rise in gold prices, which supported higher valuations within its jewelry portfolio. Within Communication Services, a wireline telecommunications company outperformed on market speculation that it could be acquired by a consortium of private equity investors and a large-cap telecom company.

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## Outlook

As we move through 2026, a central question for markets is how long the Iran conflict and related disruptions to energy supply will continue to affect the price and availability of oil globally. A prolonged war with repeated interruptions in oil flows would likely weigh on a wide range of industries worldwide, while a resolution could help sustain the recent acceleration in U.S. industrial growth. Oil prices are unlikely to derail the secular build-out of data center infrastructure for AI, but any moderation in the pace of incremental data center spending could pressure equities that have significantly outperformed over the past several years. At the same time, the growing impact of AI continues to reshape the opportunity set, as increased adoption has the potential to displace certain services and products. Software has been the most visibly affected segment so far, but markets may be extrapolating very negative outcomes for a broader set of business models as AI usage expands.

Stresses in private credit are also beginning to emerge following a decade-long boom in the asset class and a materially higher rate environment since 2022, which has challenged many leveraged borrowers. Persistent credit strains can ultimately result in bankruptcies and capital impairment for issuers, and any meaningful credit shock has the potential to spill over into public markets and drive higher equity volatility. While the equity market currently rests on a seemingly solid foundation of reasonable growth and healthy employment trends, these evolving risks warrant close attention as the year progresses.

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

**Past performance is no guarantee of future results.** There can be no assurance that any Penn Capital product or investment will achieve its objectives or avoid substantial losses. Performance is annualized for multi-year periods, and it is cumulative for one year or less. Source: Morningstar Direct, Bloomberg, HFRX. Indices are unmanaged and not available for direct investment. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. **Institutional Use Only. Not for Public Distribution. All Rights Reserved.**

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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.

**Past performance is not 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, referred 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 to change and may or may not be held by one or more Penn Capital portfolios from time to time. Please note that comparing the performance to a different index might have materially different results than those shown. The Bloomberg Micro Cap Index is a float market cap weighted benchmark of those securities in the Bloomberg Aggregate Equity Index with a market capitalization ranking of lower than 2,500. The Bloomberg US 2000 Index is a float market-cap-weighted benchmark of the lower 2000 in capitalization of the Bloomberg US 3000 Index. The Bloomberg US 2000 Value Index is screened from the Bloomberg US 2000 Index (B2000) and is constructed based on a linear combination of risk factors. The four factors are 1) Earnings Yield, 2) Valuation, 3) Dividend Yield, and 4) Growth. The factors are equally weighted when forming a composite signal, where Growth is considered to be a negative indicator and thus flipped to be a negative. The Indices are market-capitalization-weighted. The current price is used to calculate the price-based ratios. The Bloomberg US 2500 Index is a float market-cap-weighted benchmark of the lower 2500 in capitalization of the Bloomberg US 3000 Index. Investors cannot directly invest in an index.

A copy of Penn Capital's current written disclosure statement discussing our advisory services and fees is available upon request.



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