

Overview

High Yield Market Sees Rate Headwinds in Q3 2026

The US High Yield bond market continues a seesaw 2026 with a selloff in Q3 driven by surging interest rates, high energy prices and rising inflation concerns monitored by a hawkish Federal Reserve. High-yield bond yields rose as Treasuries sold off and credit spreads drifted wider during the quarter. The default environment remains manageable with the par-weighted HY bond default rate at 2.68%, below the 25-year average of 3.2%. If macro concerns recede then the US High Yield bond market should return to fundamentals and coupon returns.

Rates Drive Weak Q3 Returns

The US High Yield bond market posted a -1.82% loss in Q3 2026. Spreads widened by 37 basis points during the quarter to 312 basis points while the Yield to Worst rose 115 bps to 8.30% as rates rose. For reference, HY spreads touched 260 bps on August 28th before widening to 312 bps on September 30th.

By rating, Single B-bonds outperformed in 3Q26 with a return of -1.26% compared to BB bonds at -1.95% and CCC bonds at -3.09%. By sector, Technology (+0.81%) was the strongest performer in 3Q26 followed by Banking (-0.06%) and Healthcare (-0.51%). At the other end of the spectrum, Telecommunications (-4.81%) was the worst performing sector in the quarter followed by Insurance (-3.17%) and Media (-3.05%).

The par-weighted US high-yield bond default rate (including distressed exchanges) stands at 2.68% compared to the 25-year average default rate of 3.2% with payment defaults totaling \$6.9bn and distressed transactions totaling \$2.7bn during the quarter. The current default rate compares favorably to the 25-year average default rate of 3.2%. JP Morgan forecasts a 2026 high-yield bond default rate of 2.25% which is expected to rise to 2.75% in 2027. The current lending market continues to be constructive though default forecasts can change quickly based on market and geopolitical events.

Capital Market Indicators

Capital markets for high-yield bonds produced higher activity in 3Q26 with bond issuance totaling \$96.4bn (\$48.3bn ex-refi) and Year to Date Gross New Issuance volume of \$283B vs \$267B and Net New Issuance volume of \$130B vs 74B. AI financing is a growing area of the High Yield market and is approximately 5% of total issuance. Most AI related deals are 5-year maturity that fund data center construction where the borrower has a 15 year to 20 year lease with a IG rated hyperscaler as the counterparty providing lenders construction risk with limited upside.

Defensive Short Duration High Income

The Defensive Short Duration High Income strategy, which holds mainly BB/B rated bonds with an average portfolio maturity of 3 years or less underperformed the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index on a gross basis during Q3 2026. The best performing sector was Telecommunications through having no exposure to the worst performing area during the quarter. In Media, performance was driven by shorter maturity issues in Match Group and Charter Communications during the quarter. Healthcare companies Embecta and Acadia saw improving operating metrics during the quarter. On the downside, Leisure companies focused on consumer spending such as Hilton Grand Vacations saw slowing sales due to a cautious consumer. Retail companies faced similar challenges due to weak footwear sales during the Back to School season at Under Armor and Crocs. In Basic Industry, higher mortgage rates weighed on homebuilder sales despite favorable demographics.

Defensive High Yield

The Defensive High Yield strategy outperformed the ICE BofA BB-B US Non-Distressed HY on a gross basis during Q3 2026. The strategy outperformed in the Telecommunications sector through underweighting the sector as AI construction bonds lagged during the quarter. The Media sector performed well with improving advertising trends driven by the US political cycle. In Healthcare, Patterson Companies saw improving distributor trends during the quarter. In Leisure, Norwegian Cruise Lines lagged due to higher fuel prices and slowing bookings. Within Capital Goods, O-I Glass dealt with rising fuel costs and weak volumes during the quarter. Lagged in the Technology sector as legacy software credits bounced as AI disruption concerns eased during the quarter.

Opportunistic High Yield

The Opportunistic HY strategy outperformed the ICE BofA US HY Constrained Index on a gross basis during Q3 2026. The strategy avoided weak cable companies that are seeing rising competition in the Telecommunications sector. In Basic Industry, Clearwater Paper redeemed their bonds earlier than expected providing a strong quarterly return. Network affiliates realized strong advertising rates in local political races during the quarter. The Leisure market lagged as theme parks saw poor weather negatively impact attendance. Hardware companies lagged the software recovery in the Technology sector during the quarter. Trucking and automotive manufacturers lagged during the quarter due to higher material inputs and rising financing costs.

Outlook

High Yield Market Should Get Back to Fundamentals

If geopolitical concerns recede, the US High Yield market can return to underlying credit fundamentals. The High Yield market has its highest credit quality in asset class history with over 50% of bonds rated BB- or better. Most companies have termed their maturities out to the 2029-2030 period and have ample liquidity. Strong underlying credit fundamentals and earnings constructiveness should help support the market to return to coupon returns.

Penn Capital Products		QTD	YTD	1 YR	3 YR	5 YR	10 YR	Since Inc.	Inc. Date
Net Performance (%) – as of September 30, 2026									
Small to Mid Cap Equity		-12.07	7.28	6.56	12.70	4.05	8.47	9.26	Dec-02
<i>Bloomberg 2500 Index</i>		-6.71	11.07	13.12	16.26	6.47	10.26	11.29	
Small Cap Equity		-11.17	13.58	12.25	17.13	6.18	11.00	12.02	Dec-93
<i>Bloomberg 2000 Index</i>		-7.80	13.43	16.17	17.49	6.19	10.09	10.49	
Smaller Company Equity		-11.79	15.56	15.89	19.63	7.94	17.36	16.48	Dec-11
<i>Bloomberg 2000 Index</i>		-7.80	13.43	16.17	17.49	6.19	10.09	11.45	
Micro Cap Equity		-7.74	5.35	1.43	7.99	-3.13	5.80	7.45	Aug-06
<i>Bloomberg Microcap Index</i>		-7.80	7.32	8.40	15.45	-0.78	8.04	7.37	
Defensive Short Duration High Income		-0.43	1.64	3.44	6.90	4.71	-	3.87	Jan-13
<i>ICE BofA 1-3 Year BB US Cash Pay High Yield Index TR</i>		-0.15	1.80	3.40	6.59	4.31	4.41	4.42	
Defensive High Yield		-1.60	0.20	1.84	7.66	3.38	4.25	6.25	Dec-93
<i>ICE BofA BB-B US Non-Distressed High Yield Index TR USD</i>		-1.66	0.35	1.97	7.74	3.41	4.78	-	
Opportunistic High Yield		-1.52	0.27	2.13	7.92	3.28	4.90	6.72	Dec-93
<i>ICE BofA US HY Constrained Index</i>		-1.82	0.04	1.39	7.93	3.55	4.93	-	

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