Penn Capital Credit Month in Review

Executive Summary

Both high yield (HY) bonds and leveraged loans started the year strong but concerns over a rising 10 year US Treasury rate tempered returns for bonds and bolstered interest in loans driving a divergence in returns near the end of January.

Bonds

The HY bond asset class returned +0.72% in January as yields fell 5 bp and spreads tightened 32 bp to end the month at 6.05% and 372 bp, respectively. Returns were strong early in the month as oil and the stock market rallied but a rising 10 year US Treasury yield began to weigh on sentiment before the month was over, limiting gains. Retail (+1.84%), Energy (+1.64%), and Metals/Mining (+1.34%) were the biggest industry outperformers during January while Cable/Satellite and Food/Beverage were the largest underperformers, returning -0.37% and -0.10%, respectively. By rating, CCCs (+2.36%) were the top performers in January, beating the +0.91% and -0.02% returns posted by B-rated and BB-rated bonds during the month. Gross new issue activity reached ~$31b in January, the heaviest start to the year in four years, but this activity remained heavily skewed toward refinancing transactions (~$23b) over net issuance (~$8b). While total issuance is above recent averages, net issuance has started the year well below the $11.9b per month it has averaged since 2011. Including distressed exchanges, the US HY bond default rate decreased ~29 bp to 1.17%, down 372 bp from 2016's May peak rate of 4.89%.

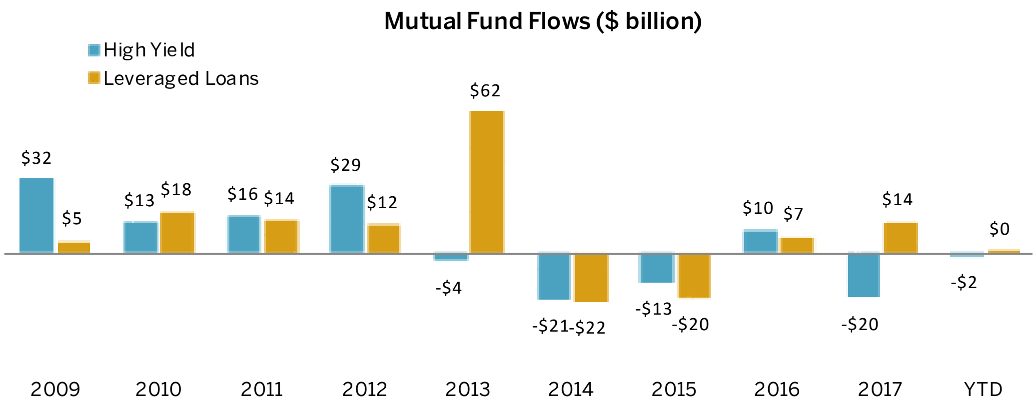
Loans

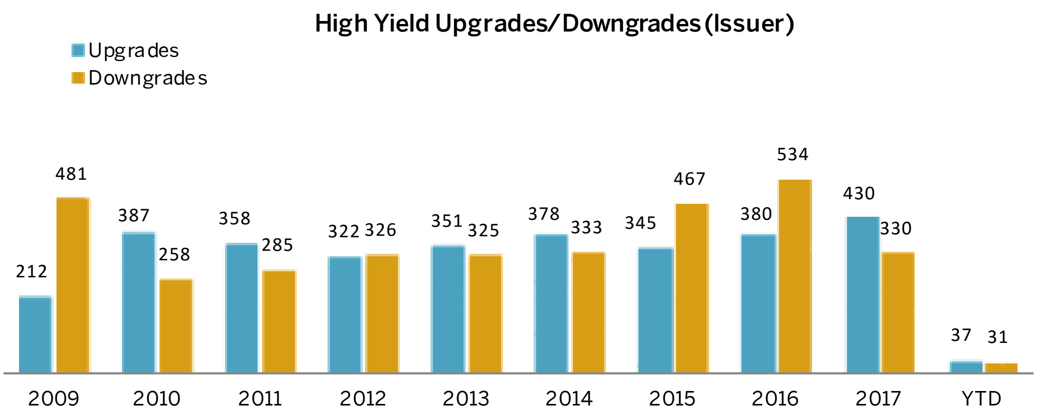
Leveraged loans returned +1.07% in January as fears of rising rates helped bolster the appeal of floating rate products. Metals & Mining (+2.81%) and Retail (+2.48%) were the best performing industries for the month while Paper & Packaging and Gaming & Leisure were the largest laggards returning +0.63% and +0.69%, respectively. During the month, CCC-rated loan returns of +3.59% handily bested the returns offered by B-rated (+1.04%) and BB-rated (+0.82%) loans. New issue activity totaled ~$49b in January, down 31% from December 2017 and 70% year-over-year. Most of this volume continues to be related to refinancings/repricings. Specifically, ~$34b, or ~68% of this new issuance, was related to refinancings/repricings. Gross US collateralized loan obligations (CLO) volume of ~$21b in January (up ~6% month-over-month) was the ninth highest monthly total on record. ~$13b, or 60%, of this volume was used for refinancing/reset deals while ~$8b was used for new CLOs. The US leveraged loan default rate fell 6 bp in January, starting the year at 1.78%.

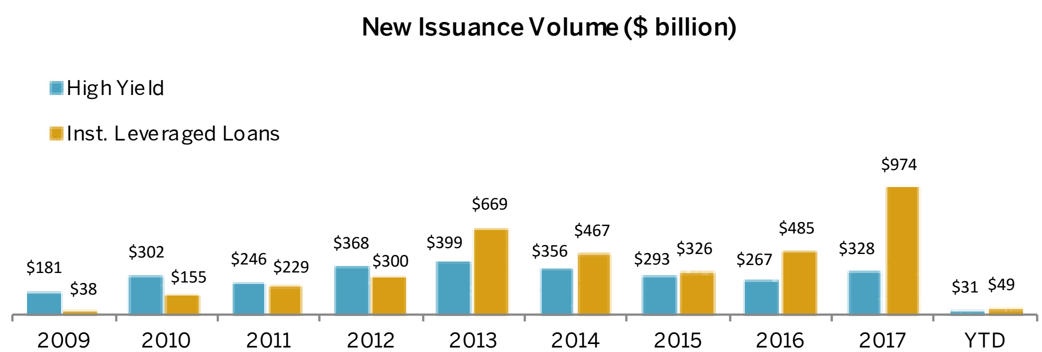
Source: JP Morgan

	Performance		Characteristics				
As of January 31, 2018	Month	YTD	Spread	YTD Change	Average Price	YTW	YTM
10-Year Treasury	-2.46%	-2.46%	---	---	---	2.7%	2.7%
Bloomberg Barclays US Aggregate Bond Index	-1.15%	-1.15%	45 bp	-4 bp	$101.61	3.0%	3.0%
JP Morgan BB/B Loan Index	0.87%	0.87%	317 bp	-18 bp	$100.03	5.7%	---
ICE BofA Merrill Lynch 1-3 Year BB-B Rated US Cash Pay High Yield Index	0.48%	0.48%	195 bp	-24 bp	$103.08	4.0%	4.5%
ICE BofA Merrill Lynch BB-B Rated Non-Distressed High Yield Index	0.37%	0.37%	260 bp	-24 bp	$102.89	5.0%	5.4%
ICE BofA Merrill Lynch BB-B Rated US High Yield Constrained Index	0.43%	0.43%	272 bp	-25 bp	$102.44	5.1%	5.5%
ICE BofA Merrill Lynch US High Yield Constrained Index	0.64%	0.64%	341 bp	-32 bp	$100.77	5.8%	6.2%

Sources: Barclays, BofA Merrill Lynch, JP Morgan. Past performance is no guarantee of future results.







Source for Charts: JP Morgan

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 an independent, employee-owned boutique based in Philadelphia. We forge our own ideas, we respect hard work, and we are committed to our clients, our staff and our community.

Historical Spreads / Default Rates	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD
ICE BofA Merrill Lynch US BB-B Rated High Yield Index	521 bp	485 bp	612 bp	443 bp	344 bp	434 bp	558 bp	348 bp	297 bp	272 bp
ICE BofA Merrill Lynch US BB Rated High Yield Index	445 bp	399 bp	503 bp	357 bp	281 bp	336 bp	427 bp	286 bp	228 bp	208 bp
ICE BofA Merrill Lynch US B Rated High Yield Index	613 bp	573 bp	736 bp	524 bp	417 bp	549 bp	722 bp	432 bp	381 bp	350 bp
ICE BofA Merrill Lynch US CCC Rated High Yield Index	980 bp	874 bp	1,262 bp	943 bp	766 bp	976 bp	1,648 bp	977 bp	843 bp	775 bp
Moody's 12-Month Default Rate (US)	13.2%	3.5%	1.8%	3.2%	2.2%	1.9%	3.2%	5.7%	3.3%	3.3%*
Moody's 12-Month Default Rate (Global)	12.5%	3.3%	1.7%	2.6%	2.6%	2.1%	3.4%	4.4%	2.9%	2.9%*

Sources: BofA Merrill Lynch, Moody's

* As of 12/31/2017. Past performance is no guarantee of future results.