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Recent Events In The High Yield Market

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Fundamentals Remain Strong

Evolving monetary policy, geopolitical unrest, and the specter of rising interest rates have caused heightened anxiety amongst fixed-income market participants, even extending to the high yield market. What investors in the high yield market need to understand is that over the long term, credit risk far outweighs duration risk and overall sensitivity to changes in the Treasury yield curve. High yield issuers, particularly B- and CCC-rated, are much more sensitive to changes in underlying economic activity than to the threat of rising rates. In reality, high yield tends to outperform most other fixed-income asset classes in a rising rate environment precisely because of this fact. A rising rate environment is typically the result of an economy that is heating up. Revenue growth is up, corporate profitability is strong, healthy capital market events (M&A, IPOs, asset sales) are occurring, and credit fundamentals are improving. Rating agencies have acknowledged this improvement in high yield credit quality, and as a result, have upgraded 10% more debt than they've downgraded year-to-date 2014, and 10% more in 2013. This dynamic also helps to explain high yield's slightly negative correlation to the Treasury market. Due to this slightly negative correlation to Treasuries, higher spread cushion relative to other fixed-income asset classes, and generally improving economic conditions, high yield has historically outperformed investment grade bonds in rising rate environments.

Upgrade/Downgrade Ratio

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	YTD 2014
By Number of Issuers															
Upgrades	237	230	194	214	280	301	547	376	238	212	387	358	322	351	214
Downgrades	446	586	597	439	330	287	496	392	470	258	258	285	326	325	198
Upgrade/Downgrade Ratio	0.5	0.4	0.3	0.5	0.8	1.0	1.1	1.0	0.5	1.5	1.5	1.3	1.0	1.1	1.1
By Dollar Volume ($bn)															
Upgrades	95.0	96.6	72.6	119.0	166.8	222.4	351.6	266.5	147.7	242.4	365.6	407.9	352.0	442.1	213.3
Downgrades	126.9	245.1	391.3	227.3	196.8	268.2	446.3	333.5	506.8	418.7	216.4	243.4	296.6	312.4	209.4
Upgrade/Downgrade Ratio	0.7	0.4	0.2	0.5	0.8	0.8	0.8	0.8	0.3	0.6	1.7	1.7	1.2	1.4	1.0

Source: JP Morgan; Moody's Investor Service; S&P

Historical Correlations (December 31, 1993 through August 31, 2014)

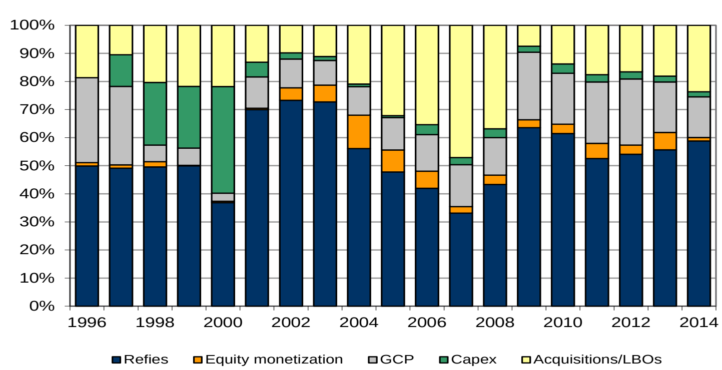
	USHY	Lev. Loans	Mortgages	UST 10Yr	UST 3Mo	IG	S&P500	Russell 2000	Distressed	EM Sov.	EM Equity	AAA-Rated	AA-Rated	A-Rated	BBB-Rated	BB-Rated	B-Rated	CCC-Rated	BB/B-Rated
USHY	1.00																		
Lev. Loans	0.76	1.00																	
Mortgages	0.13	-0.12	1.00																
UST 10Yr	-0.08	-0.32	0.82	1.00															
UST 3Mo	-0.12	-0.10	0.21	0.11	1.00														
IG	0.57	0.34	0.70	0.66	0.01	1.00													
S&P500	0.62	0.41	0.00	-0.18	0.01	0.26	1.00												
Russell 2000	0.61	0.42	-0.11	-0.25	-0.06	0.17	0.81	1.00											
Distressed	0.45	0.44	-0.22	-0.30	-0.25	0.08	0.22	0.31	1.00										
EM Sov.	0.52	0.23	0.31	0.16	0.01	0.46	0.52	0.49	0.11	1.00									
EM Equity	0.62	0.41	-0.05	-0.21	-0.09	0.25	0.72	0.71	0.31	0.67	1.00								
AAA-Rated	0.21	-0.08	0.79	0.88	0.11	0.88	0.04	-0.04	-0.14	0.31	0.01	1.00							
AA-Rated	0.38	0.13	0.77	0.78	0.09	0.96	0.14	0.05	-0.04	0.38	0.11	0.94	1.00						
A-Rated	0.52	0.30	0.69	0.67	0.02	0.99	0.22	0.14	0.06	0.43	0.22	0.90	0.96	1.00					
BBB-Rated	0.67	0.49	0.64	0.55	-0.02	0.97	0.33	0.25	0.16	0.50	0.32	0.75	0.87	0.92	1.00				
BB-Rated	0.95	0.72	0.27	0.07	-0.07	0.68	0.56	0.54	0.35	0.53	0.55	0.33	0.50	0.63	0.78	1.00			
B-Rated	0.98	0.74	0.07	-0.15	-0.11	0.50	0.60	0.60	0.47	0.50	0.61	0.14	0.31	0.46	0.61	0.90	1.00		
CCC-Rated	0.92	0.71	-0.05	-0.22	-0.19	0.39	0.59	0.63	0.51	0.42	0.61	0.05	0.21	0.36	0.50	0.81	0.89	1.00	
BB/B-Rated	0.99	0.75	0.16	-0.05	-0.10	0.59	0.60	0.59	0.43	0.53	0.60	0.23	0.40	0.54	0.70	0.97	0.98	0.88	1.00

Source: JP Morgan

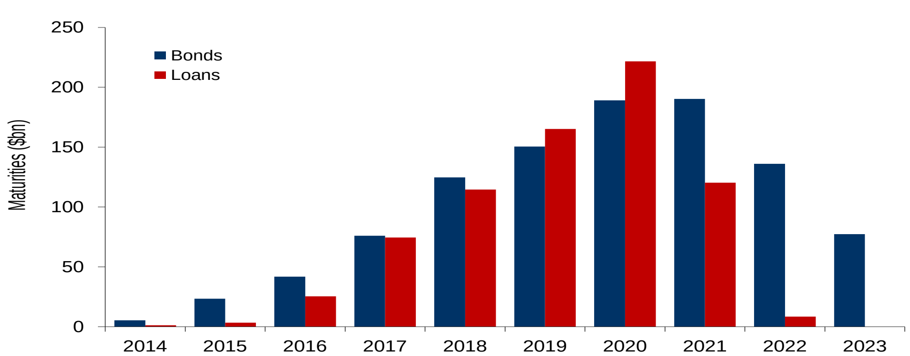
Healthy New Issuance

Modest economic growth, improving credit fundamentals, a historically low default rate, and aggressive Federal Reserve (Fed) policy all set a very strong backdrop for the high yield market over the past four years. Refinancing remains the main use of proceeds for the new issue market, and high yield companies continue to focus on balance sheet repair, lowering their cost of capital, and extending maturities. While the economy is steady, we also think companies will continue to remain prudent and default rates will remain low. Currently, the LTM default rate stands at 1.93% (as of 8/31/2014) on a par-weighted basis, well below the long-term average of 4.0%. As economic growth conditions have remained modest, business behavior has remained conservative, maintaining an emphasis on de-leveraging versus re-leveraging, and limiting risky issuance that was commonplace ahead of previous default cycles. Corporate balance sheets, trailing profits, and liquidity are much healthier in 2014 than in the past 5 years. In addition, new-issue conditions for high yield issuers are the strongest on record. From a percentage of use of proceeds, refinancing has averaged 61% since 2009. In addition, CCC-rated issuance has dropped from 32.9% in 2007 to 14.3% YTD 2014 (8/31/2014). With negligible 2015 and 2016 maturities coming due, we do not see a catalyst for a material uptick in the default rate.

High Yield New Issuance Use of Proceeds



Current High Yield Maturity Schedule



Source: BofA Merrill Lynch, as of 8/31/2014

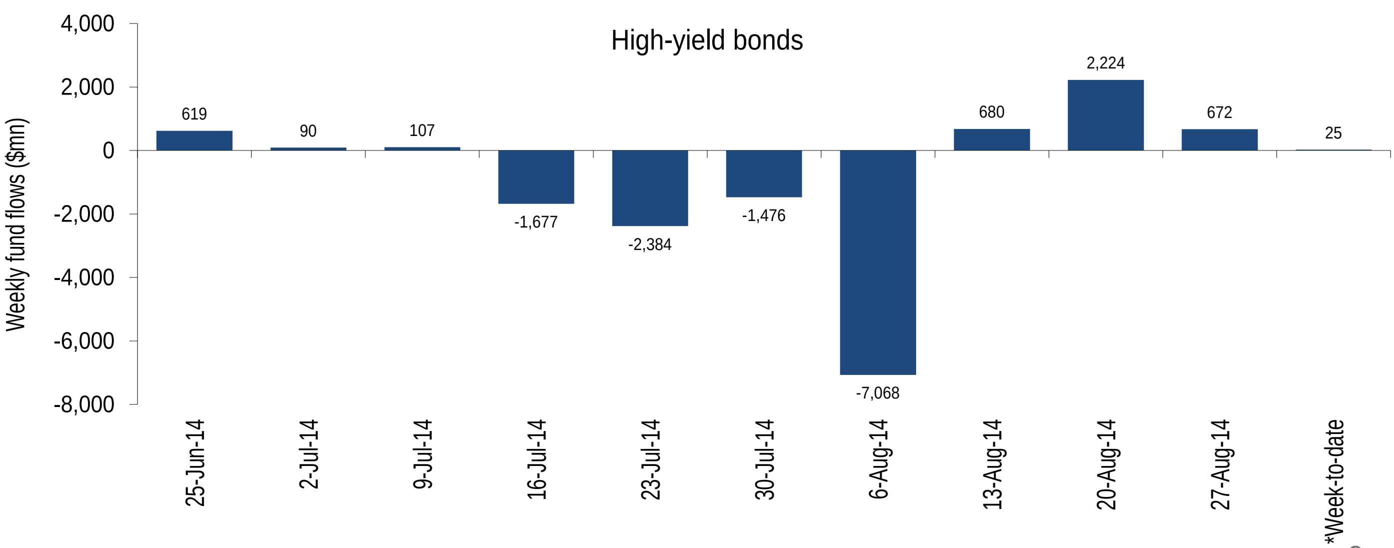
Recent Market Activity

We now turn our attention to the recent volatility witnessed in the credit markets. The high yield market experienced a correction in July as the market fell 1.32%. This sell-off was even across the ratings categories with CCCs seeing mild underperformance, down 1.45% in July. The last day of the month was the worst day of the month, and it continued into the first day of August.

The catalyst for the sell-off was a confluence of factors. Most importantly, the market had been grinding tighter for a while and yields and spreads had gotten tighter, creating less room for surprises in valuation. Meanwhile, in July, markets began to wonder if steady economic growth would potentially lead the Fed to begin raising interest rates a bit sooner than expected. Furthermore, augmented sanctions against Russia raised the likelihood of some disruptions for those companies with business there, and ISIS continued to conquer vast provinces in both Syria and Iraq. To a lesser degree, investors were reminded about risks by other problems in the world such as Argentina's conflicts with certain bondholders, and a conglomerate's problems in Portugal, Iraq, and Israel. The S&P sold off 1.50% in July for these reasons.

The high yield market rebounded strongly in August, as most market participants realized that valuations had significantly improved since June. The sell-off in July attracted investors who felt that spreads above 400bps were attractive given that the fundamental outlook for the asset class remained positive. Sentiment improved throughout August as US interest rate and monetary policy fears subsided, geopolitical tensions eased a bit, and corporate earnings were generally solid. From a technical perspective, the record set of retail outflows experienced in July reversed in early August as the market experienced three consecutive weekly inflows. New issuance slowed to a 2.5 year low of $4.9bln in August, creating more demand in the secondary market. As a result, the high yield market posted a 1.52% gain in August, led by BB-rated issuers which posted a gain of 1.86%, followed by B-rated and CCC-rated issuers which posted gains of 1.42% and 1.03% respectively.

High Yield Retail Fund Flows



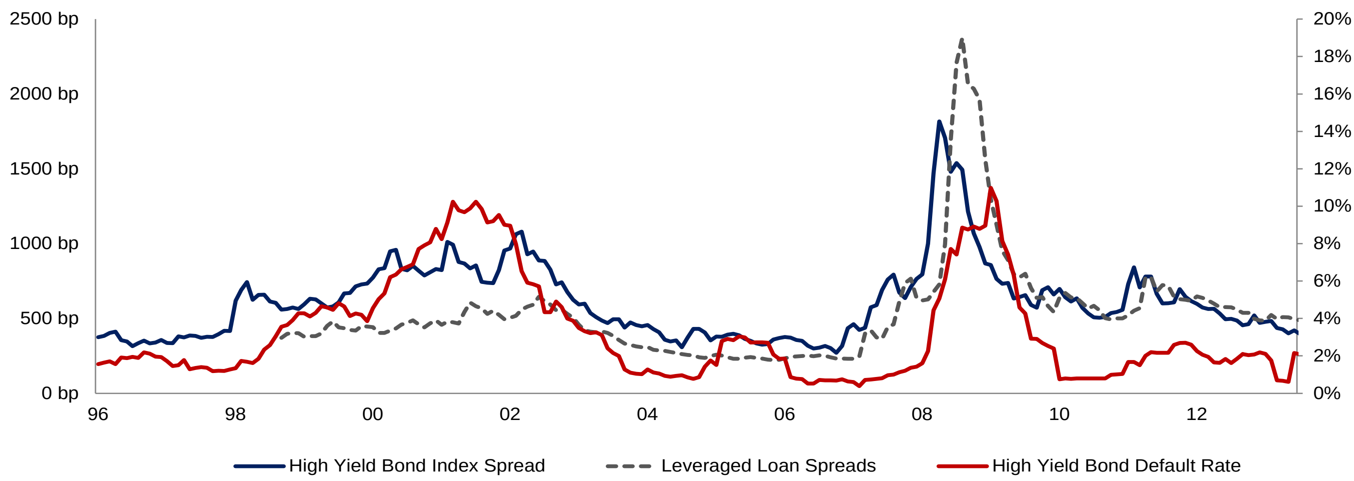
Source: JP Morgan, as of 8/31/2014

High Yield Spreads and Valuations

High yield valuations adjusted significantly in July. The market ended June with a spread of 350bps and a yield of 4.93%. Spreads widened 48bps to 398bps during July and yields adjusted to 5.66%. The US Treasury curve flattened during the month of August, with 5-year Treasury yields declining 13bps to 1.63% while the 10-year Treasury yields decreased 22bps to 2.34%. As mentioned earlier, many market participants saw the buying opportunity, and as a result, spreads narrowed 19 bps to 380bps to end the month of August. Yields ended the month at 5.27%.

Looking forward, we believe a steady growth environment, low defaults, and positive capital market events such as M&A and IPOs will continue to support high yield in the second half of 2014. Spreads of 380bps and yields of 5.27% continue to seem attractive relative to defaults of 1.0-1.5%, and we believe investors will view this as a buying opportunity.

Historical Spreads and Default Rates



Historical Spread Analysis

Historical OAS	USHY	EMHY	EUHY
Mean	618bps	745bps	703bps
Median	562bps	671bps	627bps
Mode	486bps	642bps	694bps
Ann. OAS Vol.	10.03%	14.18%	13.76%
Min	245bps	251bps	193bps
Max	1,969bps	2,658bps	2,221bps

Source: BofA Merrill Lynch, as of 8/31/2014

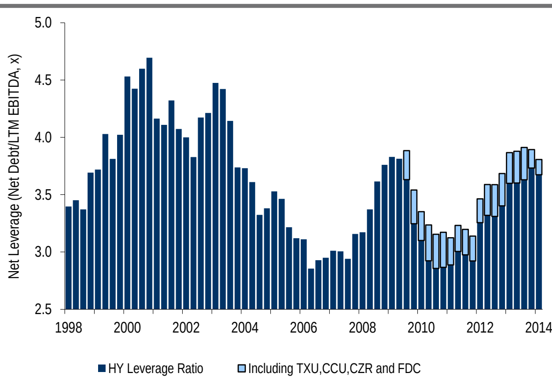
Economic Growth

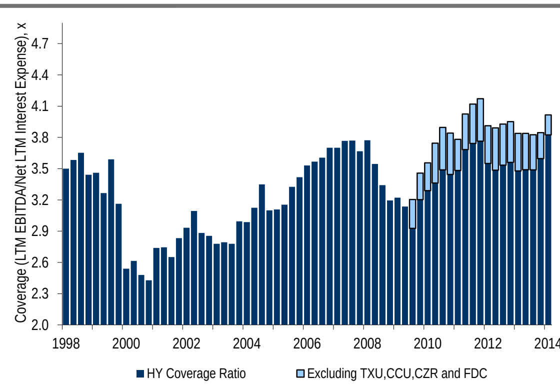
Turning towards the fundamentals of the US economy, we believe that it is firmly in the steady growth environment that we have enjoyed for the past few years. For example, measures such as job growth and PMI data are consistent with GDP growth of roughly 3.0%. Corporate profits seem strong in Q2 with a good outlook for the second half of 2014. Geo-political concerns are a minor negative, but we do not believe they will have a large effect on the world economy at this point. High yield companies have pushed off maturities and reduced interest expense, so with a good economy the default outlook for high yield companies remains low.

Q2 GDP was revised up to 4.2% from 4.0% in the second estimate. More importantly, the composition of growth shifted toward more demand as final sales were revised up to 2.8% from 2.3%, suggesting better momentum in H2. Also, the annual revisions to GDP point to more acceleration in business fixed investment and a higher saving rate path for households in 2013, which should be supportive for growth in 2014.

Recent monthly indicators, such as the ISM surveys and the Conference Board's consumer confidence index, show good momentum in Q3 2014. In this context, we continue to believe that the economy will grow at a healthy pace over the next four quarters. Robust growth should generate a solid pace of employment gains, which we expect to push the unemployment rate lower by the end of 2014.

Net Leverage and Interest Coverage





Nomura Securities Forecasts

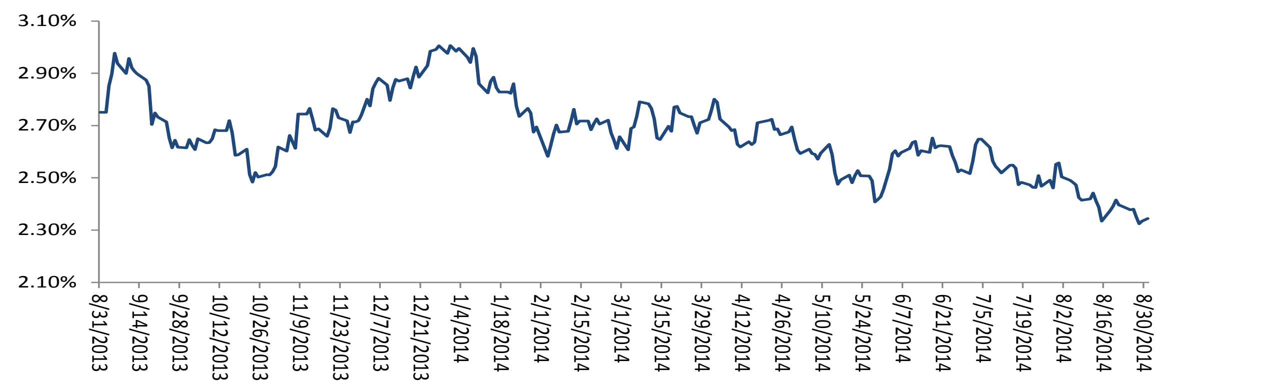
%	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016
Real GDP	**-2.1**	**4.0**	3.2	3.1	3.1	3.0	2.8	2.7	2.5	2.4	2.3	2.1	2.1	3.1	2.5
Personal consumption	**1.2**	**2.5**	2.6	3.1	3.1	3.2	3.0	2.7	2.5	2.3	2.2	2.1	2.3	3.0	2.6
Non residential fixed invest	**1.6**	**5.5**	6.3	5.9	6.0	6.0	5.6	5.1	4.5	3.9	3.5	3.0	5.3	5.9	4.5
Residential fixed invest	**-5.3**	**7.5**	7.0	9.0	8.9	5.3	4.5	5.5	5.6	5.6	6.9	6.7	2.2	7.1	5.7
Government expenditure	**-0.8**	**1.6**	1.3	0.0	0.4	0.6	0.5	0.4	0.4	0.4	0.4	0.3	-0.4	0.6	0.4
Exports	**-9.2**	**9.5**	4.5	4.8	5.1	5.3	5.4	5.5	5.5	5.6	5.6	5.6	3.0	5.3	5.5
Imports	**2.2**	**11.7**	2.0	4.0	5.0	5.7	5.3	5.0	5.0	4.5	4.5	4.4	4.0	5.0	4.9
Contributions to GDP:															
Final sales	**-0.9**	**2.3**	3.3	3.1	3.1	3.0	2.8	2.7	2.5	2.4	2.3	2.1	2.0	3.0	2.5
Net trade	**-1.7**	**-0.6**	0.3	0.0	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.3	-0.1	-0.1
Inventories	**-1.2**	**1.7**	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0
Unemployment rate	**6.7**	**6.3**	6.1	5.9	5.8	5.6	5.5	5.5	5.4	5.4	5.3	5.2	6.3	5.6	5.3

Source: Nomura forecasts

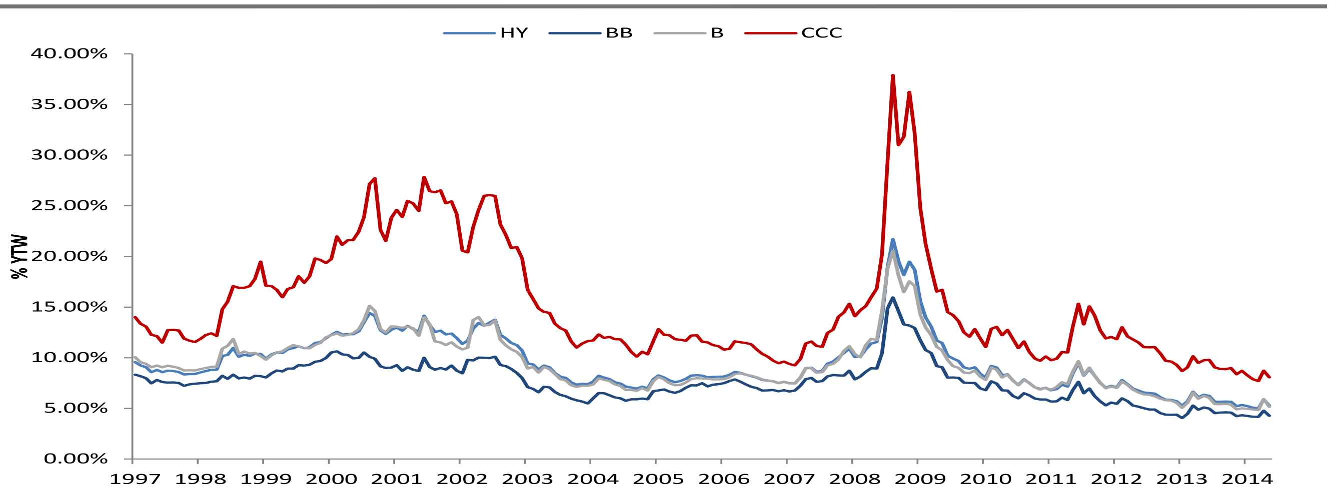
The Fed and Monetary Policy

With regard to the Fed, any change in the timing and pace of interest rate increases is most likely relatively small. While Janet Yellen has clearly articulated a dovish philosophy and frequently points to slack in the labor force and muted wage growth, she has recently argued that assessing the state of the labor market now requires more nuanced judgment. She stressed that in a range of areas the FOMC has to judge whether performance reflects cyclical or structural factors. Similarly, she argued that structural changes in the economy may also mean that real wages will grow more slowly, even when the economy is operating at potential. Given the changing structural factors that drive wages and prices, Yellen argued that wages and inflation should not be used as simple trigger variables for key monetary policy decisions to keep interest rates low. We still think that the most likely timing for the first interest rate hike is mid-2015 (June). However, the combination of the July FOMC minutes and Yellen's speech has clearly shifted the risk around our call forward, but we don't think the recent economic statistics have changed her timing more than a few months. The 2-year Treasury backed up 7 bps in July, implying a slightly sooner rate hike, though yields were back down in early August. The 5-year and 10-year Treasury yields ended August at 1.63% and 2.34% respectively.

US 10-Year Treasury Yields Over The Past Year



Historical Credit Yields



Source: BofA Merrill Lynch

Conclusion

In conclusion, we remain positive on both the return prospects and the underlying credit fundamentals of the high yield market. High yield spreads of 380bps and yields of 5.27% continue to seem attractive relative to defaults of 1.0-1.5%, and we believe investors will view this as a buying opportunity. Further, we believe that the economy is firmly in the steady growth environment that we have enjoyed over the past few years. Revenue growth is up, corporate profitability is strong, healthy capital market events (M&A, IPOs, asset sales) are occurring, and credit fundamentals are improving. High yield issuers continue to refinance higher-coupon debt, extend maturities, and focus on balance sheet repair. From a monetary policy perspective, we still think that the most likely timing for the first interest rate hike is mid-2015 (June). However, the combination of the July FOMC minutes and Yellen’s speech has clearly shifted the risk around our call forward, but we don’t think the recent economic statistics have changed the Fed’s timing more than a few months.

Recent developments in Europe further add to the attractiveness of the high yield market. On September 4th, The European Central Bank cut interest rates and announced that it will start buying assets to ease the flow of funding for the Euro-region. As a result, Italian sovereign yields dropped 9bps to 2.36%, French sovereign yields dropped 4bps to 1.29%, and Spanish sovereign yields dropped 9bps to 2.17%. European investors in particular should see this as further evidence that high yield is attractive at 5.27%. So while the market rallied in August following July’s selloff, we still believe that there is value in the high yield asset class at these valuations.

Disclosures

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