



HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

Third Quarter 2011

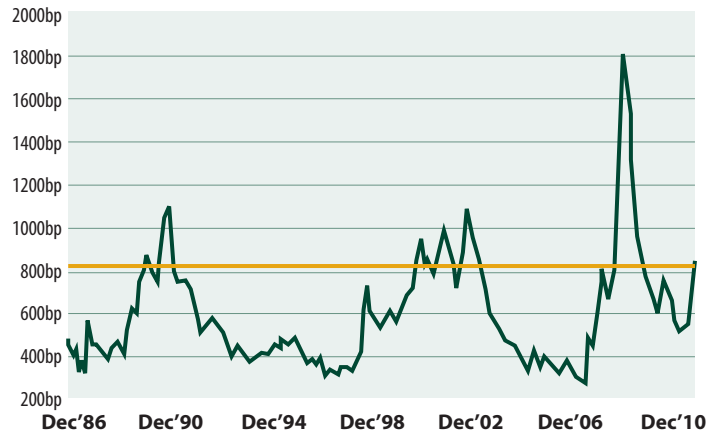
The months of August and September are an unpleasant reminder of the fragility of investor's mindsets in today's world. Equities alternated between euphoria and outright depression seemingly on a daily basis. The S&P ended up down -14% and the 10-Year Treasury rallied a head spinning 12% for the quarter (and this following a downgrade). High yield, faring better than equities, closed down -6.0% for the quarter, finishing its worst quarterly performance since Q42008. It hasn't taken much to put the "risk-off" trade back on in earnest, well, only the first downgrade in history of U.S. credit in early August, continuing anemic economic statistics here in the U.S. and most of Europe, and the realization that Europe is now in the grips of its own financial crisis. Recall that in Q32008, high yield fell -8.89% before heading straight to an all-time high spread of 2,100bps in Q42008. We acknowledge that this period was reacting to sheer panic amid the financial market seizure and forced selling of leveraged high yield bond and loan positions – the latter something we don't see reoccurring. We do believe, however, that we have reached an uneasy inflection point in high yield. From the tights in high yield spreads in the 2nd quarter of this year, spreads have now backed up over 300bps and are now perched at an ominous 845bp level. Why do we say ominous? Historically, this level of spread has been a solid predictor of more problems ahead. We have never seen it rally back from these levels without a culling of the weaker credits, brought on by recessionary conditions. In fact, we have always seen high yield spreads go wider in the short term (3-6 months) from these levels, as seen in the chart above.

Some economists still believe an outright recession (or the overused "double dip") can be averted, but the high yield market is clearly indicating otherwise. Another disconcerting metric is the level of distressed debt (issues trading wider than 1000bps) which, as shown to the right, is also flashing red. This has spiked up significantly just in this quarter.

So what is the likely path for spreads from here? This is a very difficult question to answer and depends on a lot of variables outside of our market (as was clear in 2008). We know that

HIGH-YIELD SPREADS

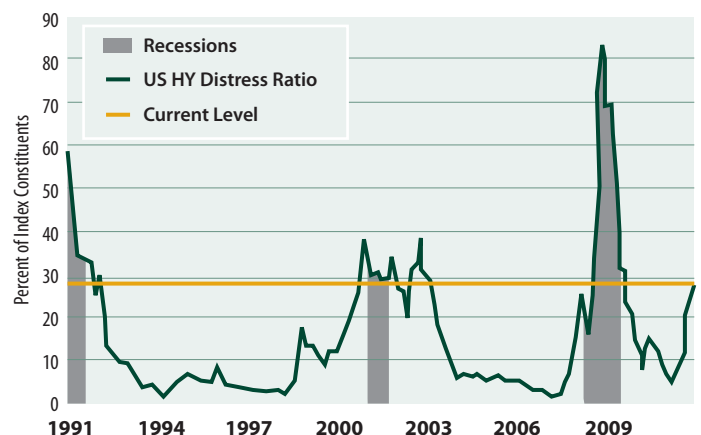
crossed above 800bp seven times in the market's history



Source: J.P. Morgan

2008 was the worst ever performance of the high yield market, exacerbated by the financial meltdown and unwinding of leveraged balance sheets. This drove prices down much more than corporate fundamentals might have dictated. In other words, there were many forced sellers in the market at a time when there was simply scant liquidity. This really was a perfect storm scenario, and we are comfortable this is a worst case scenario for the market. We are pricing in today roughly a default rate of 10%. This is a good average of where the high yield default rate ended up in all three previous recessions,

A LEVEL THAT NEVER FAILED BEFORE



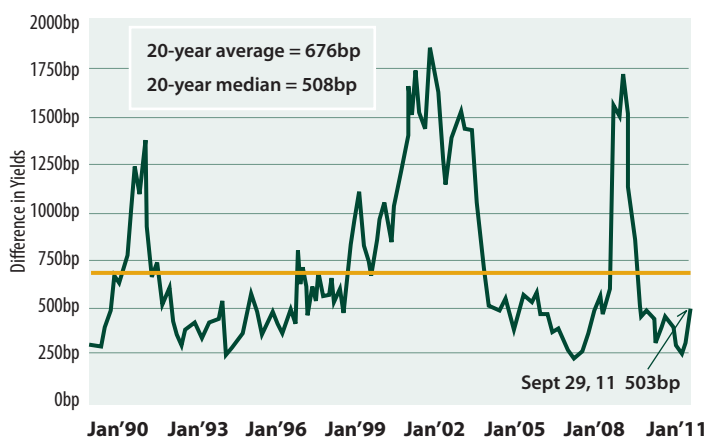
Source: BofA Merrill Lynch Global Research

with nominal dispersion. We do not foresee default rates reaching previous recessionary levels. Our baseline forecast would have default rates maxing out around 5-6%, or one-half of previous peaks. This doesn't mean that spreads won't go higher but we think it should limit spread widening beyond what we witnessed in 1990 and 2002 (between 1100-1200bps). We have previously written about the better credit quality of the high yield universe today as well as the lack of LBO sponsored new deals since 2008 (refinancings continue to hover around 60% of issuance). Most of the credits have been successful in terming out maturities over the past 2 years at very low absolute rates, thus improving interest coverage buffers. We also note the lack of a lurking bubble industry within the universe, like telecom in 2001-2002 which represented fully 1/3 of defaults in those years. All of the above factor into our belief that we will see more modest peak default levels going forward. This means, yes, that high yield will eventually prove cheap at today's spread levels but fear and uncertainty (as it always has) will likely dominate trading levels in the near-term.

Looking in more granular detail at the quarter, BB's, B's, and CCC's returned -3.7%, -5.3%, and -11.5%, and spreads widened 215bps, 246bps, and 411bps, respectively. This is the first time we have seen CCC's meaningfully underperform both higher tier classes since 2008. As can be seen in the chart to the right, despite CCC's weak performance in the quarter, spread differential remains well below the long-term average versus B's. We would be mindful that there is still a considerable amount of downside risk in this sector. Graphically, this same graph for B's versus BB's would indicate similar spread widening concerns but materially less (only 30%-40%) of the downside price volatility.

Default rates are still very low at 1.2% on a trailing 12-month basis, but as mentioned the distress ratio is climbing fast. New issuance slowed to a virtual halt in August and September with the quarter coming in at \$23 billion, the lowest annualized level since 2008. In summary, we are not in the camp that the sky is falling for high yield, but we are of the belief that things may get worse in the near-term. Our baseline case is that we could see high yield spreads widen further over the next 3-6 months, and this would be predicated on the U.S. entering recessionary conditions over this horizon. As mentioned

SPREAD BETWEEN BONDS RATED B & CCC



Source: J.P. Morgan

previously, we believe that defaults will be significantly below prior recessions and that high yield investors will be very well paid through the cycle. Scaling into high yield exposure over the near-term should prove to be very profitable for those investors with a longer term view.

Within the PIA portfolio, we have tried to identify securities which will have the flexibility to endure another downturn. We will likely look to add risk selectively as our baseline case unfolds and we see attractive mispricings. We don't believe we are at that stage yet and foresee further downside (especially in weak B and CCC credits). We will add risk selectively to the portfolio when we see prices become more compelling, and our focus will be defensible businesses with simple capital structures (low or no bank debt ahead of us). As usual in a weakening economy, we expect to see the cyclical industries (automotive, chemicals, paper and packaging etc.) perform the worst into the downdraft, but these are areas we would look to add to opportunistically as economic fundamentals stabilize.

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