HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

Fourth Quarter 2011

After a dismal third quarter, the high yield bond market rebounded with a 6.4% fourth quarter return to lift the Barclays High Yield Index into positive territory at 4.98% for the year. As is typical for such bullish periods, riskier issues far outperformed safer high yield credits during the fourth quarter. However, also typical in times of widening credit spreads, riskier issues substantially underperformed over the course of the entire year. As of year-end, the High Yield Index traded at +750 bp over Treasuries; BB-rated bonds traded at a spread of +458bp, B-rated bonds were at +617 bp, and CCC bonds were at +1029 bp. These spreads are all by far the highest in the high yield market's history as measured 18 months after the end of a recession, which directly reflect the sluggishness of the economic recovery despite very low actual default rates for the last two years and a consensus that defaults will remain well below historical averages for the next two years.

Despite marginally good U.S. economic news during the quarter that helped drive the rally in risk assets, we are reminded that during historical periods of macroeconomic peril the high yield correlation to equities has tended to shift from traditionally low to uncharacteristically high. During the fourth quarter, the S&P500 rose more than 11% and the VIX index that tracks the volatility of the S&P 500 declined by nearly half. We believe this explains the booming rally in the high yield market, and that high yield debt is currently being driven by market sentiment regarding the resolution – or lack thereof in the European debt crisis.

The market seems to hope that each new Greek accord will "solve" the problem, however we believe the changes needed in Europe are behavioral, cultural and demographic – and as such beyond the ability of either governments or central banks to deliver. The current expected bailout of Greece hinges on huge haircuts to private debt holders (never a good sign), and with each successive announcement Southern European countries continue to fail to meet their deficit reduction targets. It is hard to imagine decimated private investors agreeing to resume lending to such profoundly uncompetitive economies based on a pot of public money on the other side of the "firewall," meaning that the various pan-European bailout funds will require more infusions in the future - probably more than the thrifty Germans will be willing to make. We believe the required austerity and massive delivering and the subsequent diminished lending by banks, portends a long and grim recession for most of Europe – and additional supply of newly issued high yield bonds from European issuers.

We expect that the key drivers of equity prices and perceived risk will deliver bad news in 2012, and thus we anticipate that high yield bond prices will at some point in 2012 display similar weakness as we saw in the third quarter of 2011; however this time Europe should be in an actual contraction. The important question for us is the effect of that overseas recession on the U.S. economy and, ultimately, on corporate default rates.

Only about 11 percent of U.S. GDP is attributable to exports, and of that only 2.5 percent is exported to Europe. A secondary exposure to Europe is profits earned by U.S. firms on output manufactured and sold in Europe, rather than exported to Europe. We believe that even a lengthy recession in Europe should diminish U.S. GDP by less than one percent. However, the profits of some exporting industries that we underweight may be hit much harder. In conjunction with structural weakness in the U.S. – the 1.7 percent GDP growth in 2011 was achieved with a return to negative savings and by inventory restocking – the potential drag from

Europe could push the U.S. GDP below the 1.5 percent threshold where default rates have historically risen significantly. A European recession need not mean a U.S. recession – the two economies' GDP rates have correlated at just 60 percent since World War II; plus the experiences of 1991 and 1993 show that one of the economies can experience a recession while the other does not. So we will boldly use the dangerous phrase and say, "this time it's different" - because unlike other U.S. periods of sluggish growth, high yield issuers are better positioned than ever to withstand a weak economy. The average corporate leverage is lower than in past cycles after two years of strong cash flow growth, plus the average coupons on debt are low. Although weakening slightly in the fourth quarter of 2011, the profit margins of high yield issuers actually increased during the great recession, and today remain well ahead of where they were in 2007. Massive refinancing has pushed maturities well into the future; and in fact, following the two largest years of issuance in the history of the high yield market, over half of the entire index now consists of bonds issued less than two years ago. Corporate liquidity is very high, and importantly the most vulnerable credits have already been cleansed from the market by the severe recession of 2008-2009. Therefore, we believe that even if the U.S. does experience a recession in concert with Europe, peak corporate defaults should be less than half of the double-digit rates of all prior recessions. As more bad news surfaces about Europe and the promised deficit reductions of major countries like Spain and Italy, we believe high yield bond prices will weaken in the near term and provide excellent buying opportunities. While the market currently trades as if Europe is the lever that moves the world, the most important fundamental fact is that at today's promised spread of +750 bp, default loss rates could permanently quintuple from their current level of .92% to a level more than twice as high as their long-term average, yet high yield would still easily outperform a Treasury bond held to its maturity.

Liquidity in the high yield market, as measured by trading volume as a percent of total debt outstanding is at an all-time low, having declined nearly 40 percent below its average calculated in the modern TRACE reporting era, while dealer inventories of corporate bonds are at their lowest point in ten years. Part of this is normal cyclical behavior – when bond prices fall and rise by over five points in close succession as they did in the third and fourth quarters of 2011, inventories become riskier to hold. We believe the Street is also acting on what it anticipates will be final Dodd-Frank regulations, which could prove to substantially change the economics of market making. This lower dealer liquidity in turn increases many investors' required compensation for holding bonds whose sale may require a week rather than a day. We believe this dynamic was reflected during 2011 in the return underperformance of -200 bp by smaller ($100 -$300 million issue size) bonds - the average issue in the high yield market is over $500 million. Going forward, we believe this makes the smaller issues more attractive – because it adds return to new bonds issued at these spreads without adding to default risk.

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