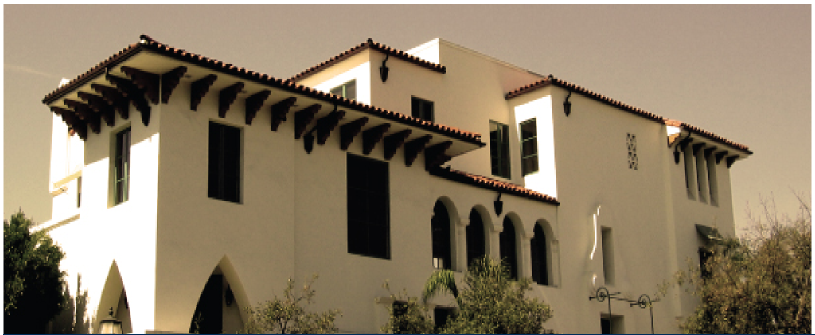

PERITUS
ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leverage Finance – August 2010

As we have discussed over the last few quarters we believed that equity investors have been involved in the biggest head fake in history. The notion that nothing in the economy has been fixed is now coming to the forefront. Economic growth is grinding to a halt and the belief that China can save the world is also beginning to unravel.

Our view is straightforward. Business stopped in Q4-08 and Q1-09. Inventories of everything were depleted and needed to be rebuilt. Orders surged as 2009 went on and continued this way through Q1-2010. Investors and strategists extrapolated these trends into the future but the underlying fundamentals have not really changed. “Real” order levels are now becoming evident and they are nowhere near the levels seen or hoped for in this recent uptick. Further exacerbating this situation were tax credit programs for real estate. Now that these have expired most homebuilders we have looked at are now showing orders down 30-40% from the same time last year. But somehow we are being told that housing has bottomed and is improving?

Though some are telling us that a bond bubble has developed we think the Treasury market is actually forecasting the real world. One of little to no growth with a whiff of deflation. This bodes ill for equities and equity valuations. It also explains why companies have so much cash stashed away on their balance sheets.

So where does that leave high yield? The key remains an active and thoughtful credit approach. The game of everything going up has ended and there will likely be a separation between those businesses that will experience stress in the muted economy of the future and those that are well positioned. Indexing in high yield is a dangerous and ill advised activity. There are still plenty of highly leveraged LBO’s that will not make it through this cycle. Unfortunately, many of the indexed products are loaded with these names because they are available and available in size.

But in our individual credit analysis we are seeing value and opportunity. Very few management teams are drinking the growth Kool-Aid, meaning balance sheet and debt management are still forefront in their minds. With the wide open new issue market, many companies have refinanced near term maturities and have excellent liquidity. The 5 year Treasury currently yields around 1.5% so a 9.5% yield to worst (lots of seemingly good names in the high yield space around that yield level) means a spread of around 800 basis points. This level is well above implied fair value based on the expectation that defaults will likely remain muted for the next several years.[1] With the muddling economy around us and lack of growth, we believe that high yield is right in the sweet spot.

[1] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Alisa Meyers. “Credit Strategy Weekly Update.” J.P Morgan. July 9, 2010, p. 13-15.