

PERITUS

ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – January 2013

CERTAINTY, RATES AND THE YEAR AHEAD

“The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money.”

“I do not know if the people of the United States would vote for superior men if they ran for office, but there can be no doubt that such men do not run.”

— Alexis de Tocqueville, [Democracy in America](#)

Cliffs, Taxes and Insanity

Are there two more appropriate quotes given the last few months? Let's get this one out of the way since it is front and center. Taxes are going up, and don't believe the nonsense it is just on the “rich;” all working Americans will take a hit. People looking for certainty now have it. So now that we have established certainty, will this grow the economy and jobs? Nope. What amazes me to no end is that people are waiting for a massive rally in equities once we “fix” the fiscal cliff issue. Here's some news. Raising taxes and cutting the growth in spending doesn't fix anything. Governments and consumers still have too much debt, deficits are enormous and growing, and our entitlement/benefit programs of Medicare and Social Security are unsustainable. Interest rates are near all-time lows, liquidity is near all-time highs and yet we continue to push on a string with anemic economic growth and high unemployment.

If businesses have opportunities to grow profits and need people, they will hire them. This is why the notion of “uncertainty” constraining the job market and economic growth is pure folly. Certainty isn't going to change the math. So raising the debt ceiling and agreeing to a higher tax rate on incomes above \$400,000 and higher payroll taxes has led to a short-term equity rally, but it will not assist in growing the overall economy. Isn't one of our problems that we levered up for the last 20 years, effectively borrowing demand from the future?

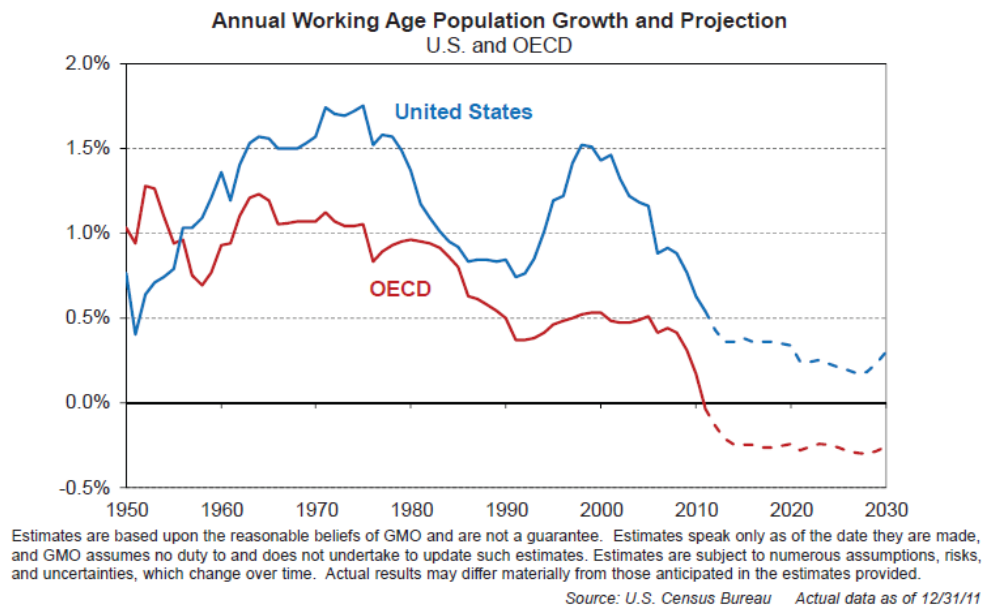
Think this through. Why were all of these automatic funding cuts and tax increases put into place? They were put there to force us to deal with the unsustainable budget deficits and long-term solvency issues we are now flirting with. The “cliff” was created by both parties the last time we had to increase the debt ceiling (August 2011). So should we celebrate because we have put a temporary band aid on, but have done nothing to address the real structural issues? But worry not. The Fed is coming to the rescue with QE-Forever. So in addition to buying \$40 billion worth of mortgage securities every month, they will do some more “twisting” by purchasing Treasuries, and of course keeping rates at 0% for the foreseeable future.

*In particular, the Committee decided to keep the target range for the federal funds rate at 0 to ¼% and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2%, inflation between one and two years ahead is projected to be no more than a ½% above the Committee's 2% longer-run goal, and longer-term inflation expectations continue to be well anchored. The Committee views these thresholds as consistent with its earlier date-based guidance.*¹

So now they will target an unemployment rate of 6.5%. Any casual reading of the recent payroll reports would suggest this could happen soon as more and more people just stop looking for work. Interestingly, the “twist” I referenced earlier could be more accurately likened to a Ponzi. The old program had the Fed selling shorter dated Treasury bonds to purchase longer dated bonds. Now, they are just going to print money to buy the longer ones. Does this pass anyone’s smell test? The question on my mind is why does the Fed feel the need to do this? The first reason I can think of is that they have no other bullets in the gun and are out of ideas. Secondly, are they trying to pre-empt a run on the U.S. dollar and the Treasury market from our foreign creditors? The fact is rates are at or near all-time lows and have been for a number of years; we have already cashed in that benefit and even lower rates will likely have no real economic impact going forward.

Demographics, Global Economics and Demand

Let’s turn our attention back to something that we don’t believe most investors pay enough attention to, and that is demographics. The following chart depicting a declining working-age population was displayed in Jeremy Grantham’s excellent quarterly client letter entitled, “On the Road to Zero Growth.”²

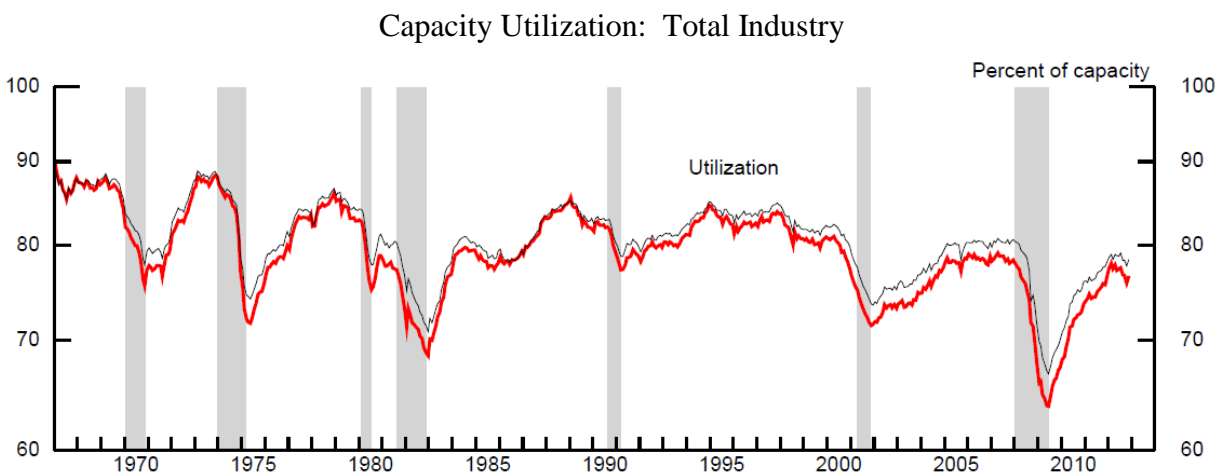


¹ Board of Governors of the Federal Reserve, press release, December 12, 2012.

² Grantham, Jeremy, “On the Road to Zero Growth,” GMO Quarterly Letter, November 2012, p. 4. OECD indicates the Organization for Economic Cooperation and Development countries.

The stark reality is that most of the developed world is facing the same issues. Earners (and therefore consumers) are rapidly decreasing, meaning they will pay fewer taxes, consume less and, of course, begin to tap the massively underfunded social programs. Think about the largest economies of the developed world outside of the U.S., including Japan, Germany, Italy and France. You don't have to be an economist to realize that these economies are struggling mightily to grow.

This is why we expect that keeping interest rates suppressed will have almost no impact going forward. It doesn't matter how cheap money is if there is no demand for goods and services. Take a look at domestic capacity utilization. The economic "recovery" over the past three years has basically pushed the capacity utilization number to the bottom of the range for the recessions of 1982 and 2002.³

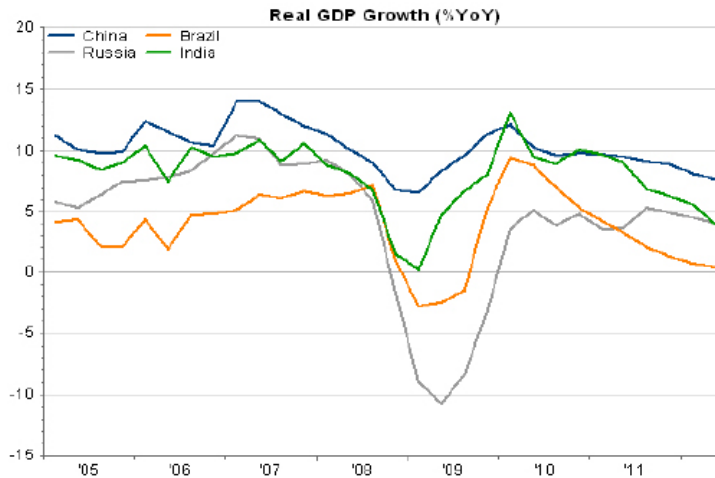


Note: The shaded areas are periods of business recession as defined by the National Bureau of Economic Research (NBER).

Final demand for goods and services in the western world is not being made up for by the emerging world in the near-term. How about those "BRICs" that we hear so much about? Brazil, Russia, India and China have been producing most of the growth for the last decade but reality has set in. They will still be growing, but in the best case, it will likely be about half the growth rate of the past ten years.

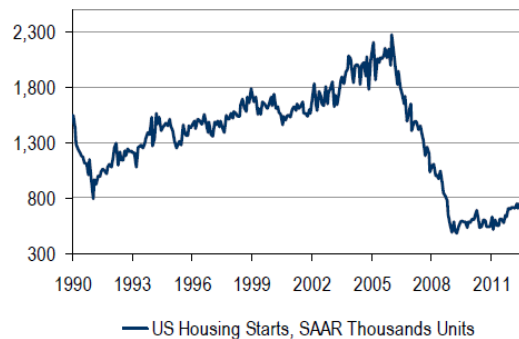
³ Federal Reserve Statistical Release, "Industrial Production and Capacity Utilization," December 14, 2012.

BRIC GROWTH RATES HAVE SLOWED⁴



Source: FactSet

What about the “recovery” in housing? Won’t that lead to a virtuous circle and a robust economic recovery? While we are all happy to see the bottom in housing, what we need to do is put things into perspective. We were building over 2 million homes per year at the peak, and now we are at about 40% of that level.⁵ So while residential construction will be a positive economic contributor, its impact will be muted.



Source: US Census Bureau

While pontificating about such topics is stimulating, is there an investment point? Yes there is. GDP growth in the U.S. and globally will likely be constrained for the foreseeable future. This means earnings growth will also be limited. So this remains very problematic for those believing that the equity game is going to flourish during 2013. While there will surely be rallies over the

⁴ “Growing Pains in the BRICs,” Neuberger Berman, Investment Strategy Group, September 2012.

⁵ Mikkelsen, Hans, Oleg Melentyev, CFA, Vineet Ahluwalia, Christopher Hays, and Neha Khoda, “High Yield, Loans in 2013: Against All Odds,” Bank of America Merrill Lynch, December 26, 2012, p. 8.

coming year, the backdrop does not support sustainable P/E multiple expansion or earnings growth.

Interest Rates

As we look to 2013, we believe that nothing will be more important than interest rates. It is tough to see rates getting a whole bunch lower, though the flight to quality/fear trade is always around the corner. The 5-year Treasury began 2013 at a yield around 0.7%. Surprisingly, even last year there was considerable volatility in this yield.⁶



Source: BofA Merrill Lynch Global Research

The most difficult thing to assess is what impact the Fed is having on these yields. Having a printing press running full-out is problematic. But whether rates rise for the wrong reason (bond vigilantes and/or foreign investors leaving) or a better reason (some global stabilization or at least perceived as such), a case can be easily made for 5-year rates to approach their highs of last year (1.2%). While this is still near historical lows, a 50 basis point move off of a beginning yield of 0.7% is massively problematic for many fixed income investors, particularly those who have been gobbling up investment grade (“IG”) corporate debt, which has little spread over Treasuries. In an almost 30-year career, I still have no idea why investors buy IG credit. Regardless of how comfortable you are with those ratings, you have credit risk, duration (interest rate) risk, often limited trading liquidity, and limited covenants, all while clipping a coupon that is maybe 1-2% better than Treasuries. No thanks.

On the other hand, while high yield investors understand they have credit risk, we also have tight covenants, generally greater trading liquidity and much lower interest rate risk. Duration (interest rate sensitivity) is minimized because high yield bonds tend to have shorter maturities and significantly higher coupons. The higher the initial spread a portfolio has, the less sensitive it is to rising rates; a 50bps change in interest rates has significantly less impact on a credit with a 7% beginning yield than one with a 1.5% yield.

Overall, the high yield asset class today possesses a spread-to-worst of over 550 basis points above comparable maturity Treasuries.⁷ As can be seen by the following chart,⁸ there is actually

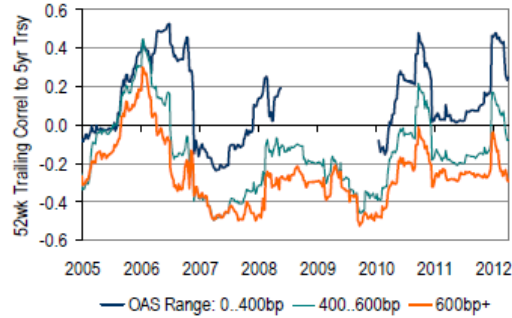
⁶ Mikkelsen, Hans, Oleg Melentyev, CFA, Vineet Ahluwalia, Christopher Hays, and Neha Khoda, “High Yield, Loans in 2013: Against All Odds,” Bank of America Merrill Lynch, December 26, 2012, p. 10.

⁷ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, “Leveraged Finance Outlook: 2013 Outlook for U.S. High Yield and Leveraged Loans,” Credit Suisse Fixed Income Research, December 3, 2012, p. 2.

⁸ Mikkelsen, Hans, Oleg Melentyev, CFA, Vineet Ahluwalia, Christopher Hays, and Neha Khoda, “High Yield, Loans in 2013: Against All Odds,” Bank of America Merrill Lynch, December 26, 2012, p. 17.

a negative correlation to the 5-year Treasury for bonds with spreads over 400 bps above Treasuries, so rising rates are not the enemy of high yield as they are for many other lower yielding fixed income asset classes.

HY correlation to 5yr Treasuries, by spread bucket



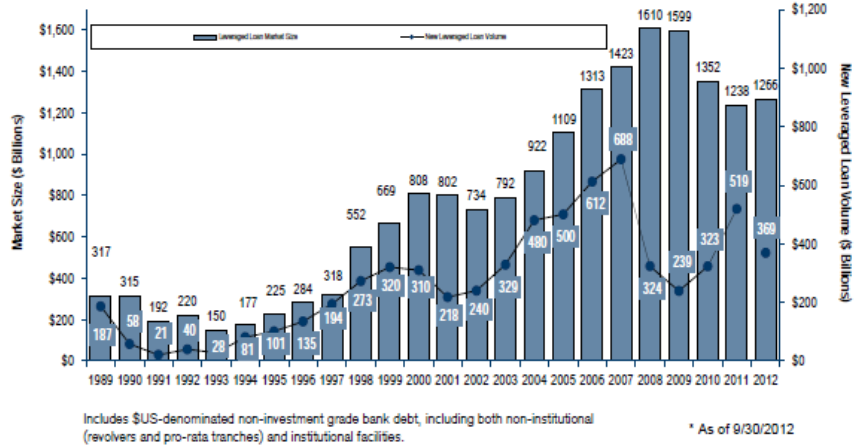
Source: BofA Merrill Lynch Global Research

Leveraged Loans versus High Yield Bonds

While we are on the topic of interest rates, we need to address the recently popular and somewhat misguided notion that leveraged loans are simply a better bet than high yield bonds. This sounds intuitively appealing, as the pitch goes something like this: leveraged loans have similar yields to high yield bonds, have less risk as they are senior in the capital structure and offer floating rates which protect investors from a rise in rates. While there is nothing wrong with any of this, the reality is generally a little cloudier.

Let's start by saying that we have and will continue to invest in the leveraged loan market. Currently, the market size for loans, at approximately \$1.3 trillion⁹, is very similar to that of high yield bonds.

Leveraged Loan Market Size



Includes \$US-denominated non-investment grade bank debt, including both non-institutional (revolvers and pro-rata tranches) and institutional facilities. * As of 9/30/2012

Source: Credit Suisse

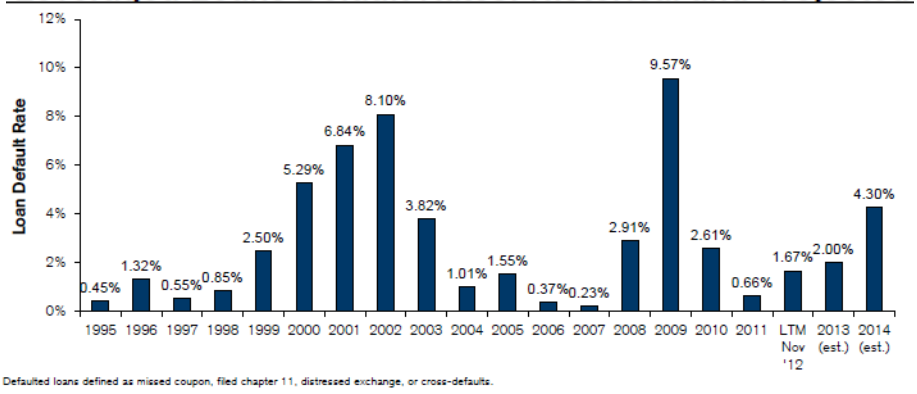
⁹ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, "Leveraged Finance Strategy Weekly," Credit Suisse Fixed Income Research, January 4, 2013, p. 34.

Within these markets, there are companies that issue just bonds and companies that issue just loans. So for us, while the benefit of potentially reducing volatility and further reducing interest rate risk (duration) with an investment in the loan market is attractive, it is the ability to access certain credits that do not have bonds in their capital structure that we are primarily interested in. With the loan market, we are able to expand our available investment universe without having to sacrifice a huge amount of yield.

However, two additional points about the loan market need to be made. First loans are tied to the London Interbank Offering Rate or “LIBOR.” The relationship between LIBOR and Treasury rates is not a perfect correlation. So you could see a sell-off in Treasuries with a corresponding rise in rates, while LIBOR does nothing. Secondly, if LIBOR does experience a substantial rise, loans could suffer as well. This is purely a fundamental issue. A company that has substantial exposure to floating rate debt will see its interest bill rise and could see its credit metrics deteriorate.

What the loan market is not is a “no-brainer.” Similar to the high yield market, we do not believe in a market or “index” trade (in other words, buying a passive or index-based vehicle). There are lots of bad loans that need to be avoided. To fully explain this, a brief history lesson is in order. The leveraged loan market began to grow in earnest in the late 1990’s due to the aggressive ramp of the collateralized loan obligation (“CLO”) business. This growth ramped up significantly in the mid part of the last decade as loans were the vehicle of choice to fund the LBO (leveraged buyout) heyday. Fast forward to today, we are faced with the reality that the expected default rates for loans over the coming couple of years are actually higher than those for the bond market (profiled later).¹⁰ This is primarily due to those loan-heavy structures of some of the biggest LBO’s from the mid 2000’s.

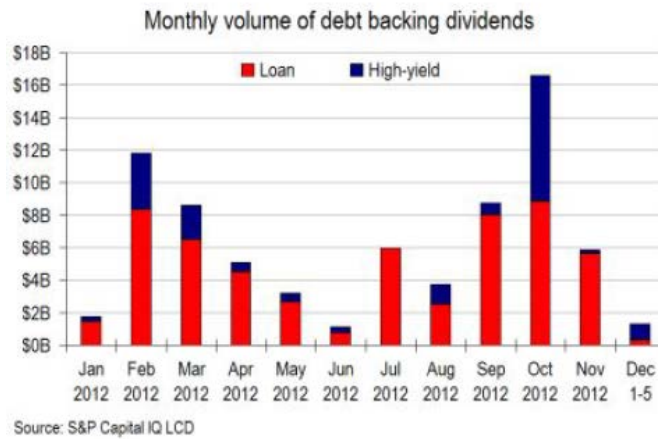
Leveraged Loans Default Rates: Historical and Projected



In addition, much has been made about the recent use of proceeds for new issues in the leveraged finance world. Specifically the use of proceeds toward dividend deals for private equity sponsors. While we have commented about this in prior correspondence (see our piece, “[More than a Feeling](#)”), it should be noted that the leveraged loan market has been the primary sponsor of such dividend deals, not the high yield market. We would expect this to continue as CLO

¹⁰ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, “Leveraged Finance Outlook: 2013 Outlook for U.S. High Yield and Leveraged Loans,” Credit Suisse Fixed Income Research, December 3, 2012, p. 13.

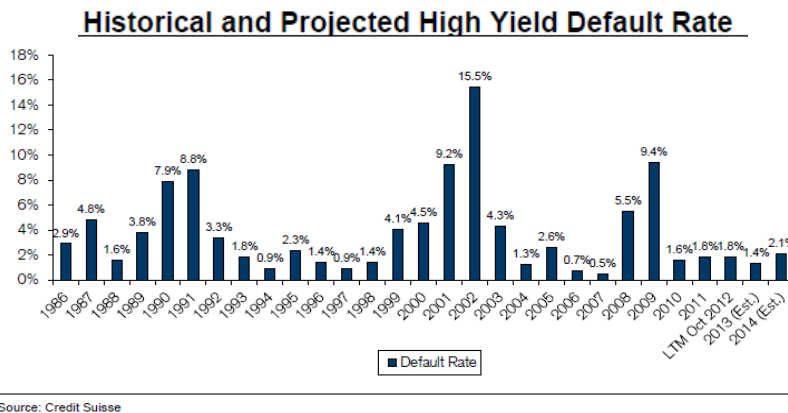
issuance has created a tremendous amount of dry powder desperate for loan product, and these desperate investors tend to be a bit more lenient.¹¹



Now all of the dividend and use of proceeds talk needs to be put into perspective. Leveraged finance investors do not like to fund dividends to sponsors as it is a non-productive use of capital and lessens the commitment these owners may have to their companies should they experience a problem down the road. Even considering both markets, nearly \$75 billion of dividends¹² against a \$2.5 trillion bond and loan market¹³ is less than 3%. In high yield the number is closer to 1%. That is hardly a disturbing figure and one that has been blown way out of proportion in the media.

State of the High Yield Market

What high yield investors, such as Peritus, are primarily concerned with is credit risk. Overall high yield default rates for the coming years are forecasted to be well below the average of approximately 4%.¹⁴



¹¹ Miller, Steve, "Dividends, though off from October peak, surge to record high," Standard & Poor's Leveraged Commentary & Data, www.lcdcomps.com, December 7, 2012.

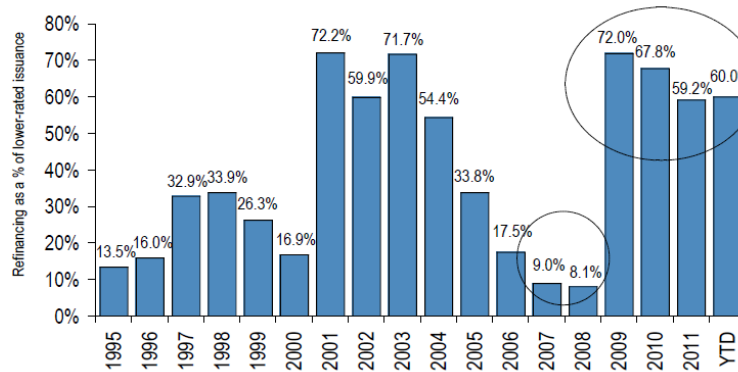
¹² Miller, Steve, "Dividends, though off from October peak, surge to record high," Standard & Poor's Leveraged Commentary & Data, www.lcdcomps.com, December 7, 2012.

¹³ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, "Leveraged Finance Outlook: 2013 Outlook for U.S. High Yield and Leveraged Loans," Credit Suisse Fixed Income Research, December 3, 2012, p. 4, 34.

¹⁴ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, "Leveraged Finance Outlook: 2013 Outlook for U.S. High Yield and Leveraged Loans," Credit Suisse Fixed Income Research, December 3, 2012, p. 34.

Given the shaky economic backdrop, how can anyone have confidence that these default forecasts will hold? Several things should provide investors some confidence in these forecasts. First, corporate liquidity and access to capital have rarely been greater, as evidenced by a record setting new issue market in 2012. But what has caused the default rates to spike three times in 30 years gets back to that use of proceeds more than anything else. Back in the late 1980's, the market grew from the LBO business and over the course of time, leverage multiples became excessive causing the hiccup in the early 1990's. In the late 1990's, it was the financing of business plans with no revenues or cash flows (known to us as "TMT," or telecom, media, and technology businesses during the internet bubble). The latest issues in 2006-2007 that led up to some of the problems of 2008 (though that was a systemic issue not just a high yield or leveraged loan issue) were of the same making as the late 1980's, namely massively over-levered LBO's. However, the last few years in the high yield space have seen the use of proceeds primarily directed at refinancing, which is extremely healthy.¹⁵

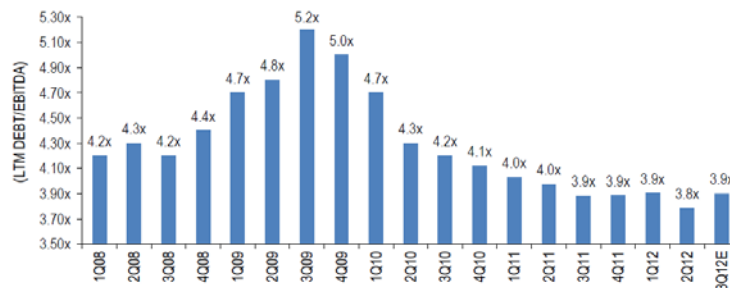
Majority of lower-rated new issuance used to refinance debt



Source: J.P. Morgan.

Additionally, we just have not seen the re-leveraging of balance sheets; leverage metrics remain relatively conservative.¹⁶

Despite weak GDP growth, leverage remains near its trough



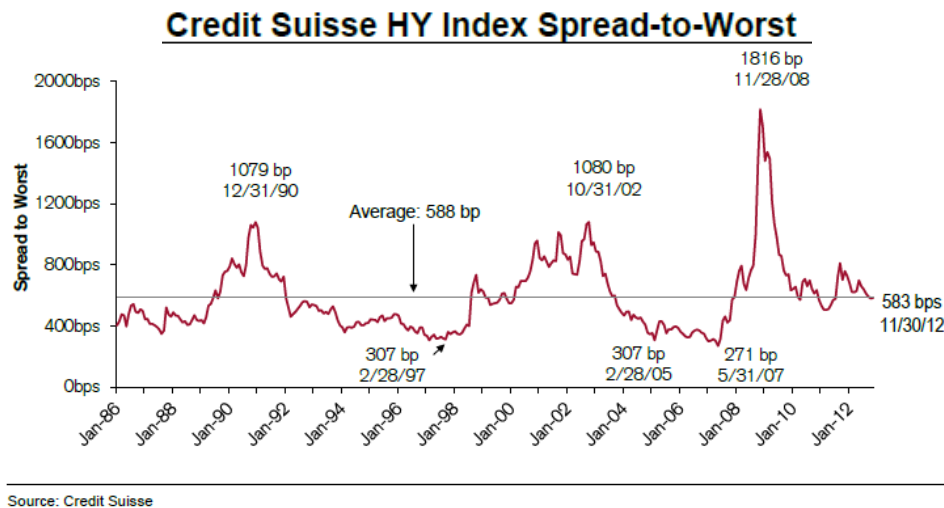
Sources: J.P. Morgan; Capital IQ.

¹⁵ Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Rahul Sharma. "2012 High-Yield Annual Review" J.P.Morgan North America Credit Research, December 2012, p.16.

¹⁶ Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Rahul Sharma. "2012 High-Yield Annual Review" J.P.Morgan North America Credit Research, December 2012, p.25.

High Yield Remains in the Sweet Spot

So in an environment of historically low default rates and conservative balance sheets, let's take a look at the high yield market as it stands today. Contrary to many media reports, high yield is not in bubble territory and, even when looking at the index, represents what we believe to be excellent value.¹⁷



While the average spread is 583 basis points over the 5-year Treasury, this “average” is deceiving and skewed, particularly given the 2008 period. The median spread levels are closer to 530 basis points. **More importantly, nearly 60% of the time the market has traded below the average spread level.**¹⁸ The outlier periods of 1990, 2002 and 2008 were created by increasing default rates which were caused by excessive leverage and a poor use of proceeds. None of these conditions are present today in the high yield market. Given this, we see the potential that existing spreads will be coming in over the next year.

Summary and Conclusion

So to summarize our thoughts on why we believe high yield is positioned well for 2013:

- High yield has a short duration and has limited interest rate sensitivity, given the shorter maturities and higher coupons. We would expect to see higher rates in 2013, which will punish investors in high grade bonds that are more sensitive to rate changes.
- The primary risk for high yield investors is credit risk, which looks to be very tame and manageable over the coming years, as evidenced by the historically low default rates projected and conservative leverage metrics.
- While all the talk is about the leveraged loan market, we are not convinced. The default outlook for this market is even higher than that for high yield bonds, which would indicate the concept of “lower risk” is an illusion. Additionally, while higher rates would

¹⁷ Blau, Jonathan, Daniel Sweeney, and Karen Friedlander, “Leveraged Finance Outlook: 2013 Outlook for U.S. High Yield and Leveraged Loans,” Credit Suisse Fixed Income Research, December 3, 2012, p. 2.

¹⁸ Based on monthly data for the Credit Suisse High Yield Index for the period 1/31/86 to 11/30/12. The Credit Suisse High Yield Index is designed to mirror the investible universe of U.S. dollar denominated high yield debt market.

favor the lower duration/floating rate of leveraged loans, the higher interest cost would hurt the credit metrics of loan-heavy capital structures. We encourage investors to use the loan market to expand the number of opportunities to invest in, not to produce what could be illusionary portfolio math.

- While generally low rates and a risk-on mentality appear to favor equities, poor global growth patterns will likely put a cap on returns and will hamper earnings growth and multiple expansion.

We truly do believe that even after a strong showing in 2012, the high yield bond market remains in the sweet spot for investors in 2013.

Peritus I Asset Management Disclosure:

Although information and analysis contained herein has been obtained from sources Peritus I Asset Management, LLC believes to be reliable, its accuracy and completeness cannot be guaranteed. This report is for informational purposes only. Any recommendation made in this report may not be suitable for all investors. As with all investments, investing in high yield corporate bonds and other fixed income securities involves various risks and uncertainties, as well as the potential for loss. Past performance is not an indication or guarantee of future results. Historical performance statistics and associated disclosures available upon request and qualification.