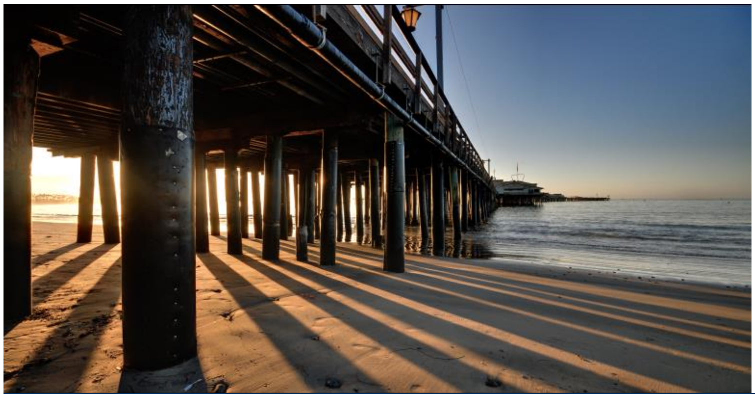

PERITUS
ASSET MANAGEMENT, LLC

Active Credit

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THE ELECTION IMPACT ON THE HIGH YIELD MARKET: RATES AND REGULATION

Now that Donald Trump has surprised virtually everyone with his Presidential victory, what does that mean for the high yield market? For us, it looks like the most relevant impacts are interest rates, taxes, and regulations. We are already starting to see Treasury rates increase, and if that continues, what does that mean for the high yield market? And since the moment Trump's victory became certain, there has been incessant discussion of the various legislative and regulatory changes he may enact, so where does that leave us? As we evaluate both of these aspects, we believe that the underlying factors point to potential positive long term benefits for the high yield market.

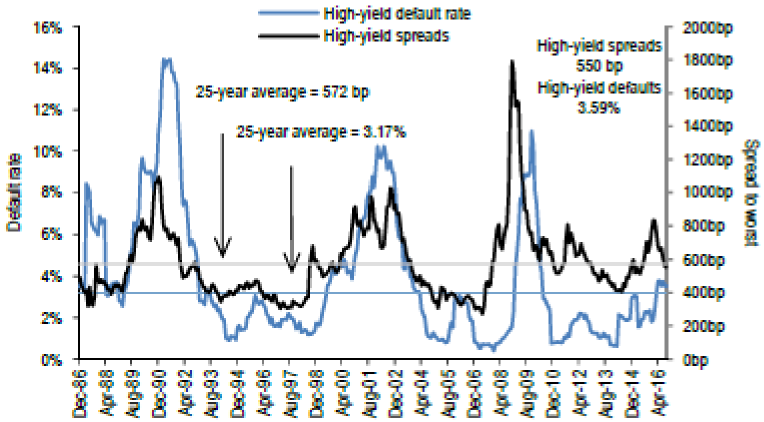
Interest Rates and Economic Growth

First, let's look at interest rates. The 10-year Treasury has gone from 1.83% on Monday, November 7th, the night before the election, to cross above 2.3% over the course of the next couple weeks. Yes, this is a sizable move and has been primarily attributed to a couple of underlying factors, both of which we view as potential positives. First is the expectation that the Trump/Republican initiatives, including infrastructure and other government spending, will drive economic growth. Second is the idea that with a Republican controlled House and Senate, tax cuts are very likely to get passed, and those tax cuts in turn could cause demand-pull inflation. There have been promises of tax cuts on both the individual side, putting more money in the pockets of the consumer, and on the corporate side, allowing for greater profits which can in turn be invested in growth and capital spending. Additionally there is the discussion of a corporate "tax holiday," allowing corporations to repatriate cash held overseas, which they can then apply to things such as stock buybacks or debt reduction. We know that consumer spending is nearly 70% of GDP and corporate spending another sizable piece of the pie, so whether it is tax cuts putting more money into the hand of the consumer and corporations or the infrastructure spending improving the job situation, we would see both as positives from an economic growth perspective.

Prices of high yield bonds have historically been much more linked to credit quality than to interest rates. The biggest cause of spread widening (price declines) over the years has been spikes (or anticipated spikes) in default rates.[1]

[1] Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "Default Monitor," J.P. Morgan North American Credit Research, November 1, 2016, p. 7, https://markets.jpmorgan.com/?#research.na.high_yield.

Default rate vs high-yield spreads



Note: Default rate is par-weighted

Source: J.P. Morgan; Moody's Investors Service

On the flip side, historically, interest rates are usually increasing during a strengthening economy and a strong economy is generally favorable for corporate credit and equities alike. We believe investors should focus on default/credit risk when investing in the high yield sector, paying attention to the company's fundamentals and credit prospects. When the economy is expanding, profitability, financial strength, and credit metrics generally improve. Additionally, if corporations have more money in their pockets due to lower taxes and repatriation of cash that can allow for more money to service and pay down debt, further keeping default rates at bay.

After years of muted economic growth, during which the broad high yield market has still performed well, we would view a stronger economy as undoubtedly a positive from a credit perspective. Under this scenario, default rates (excluding energy/commodities) should continue their below average trend.

Interest Rate Outlook

If this economic growth scenario were to become a reality, potential inflationary pressures could mean that the Fed would be more aggressive in increasing rates, and we are already seeing the various securities on the Treasury yield curve reflect this possibility. The Federal Reserve directly controls the Federal Funds Rate, a short term intra-bank lending rate. However, expectations of its movement and market forces impact US Treasury rates, which, as we noted above, were 1.83% on the 10-year the day before the election and now have touched above 2.3%—a 50bps move.[2] Will rates keep moving up? We believe the market has overacted over the past two weeks and wouldn't expect a dramatic move upward from where we are now.

There are a few important factors to consider. First, no matter who the president is or how much government spending/tax reductions are applied, it doesn't change global demographics. We have an aging population domestically and worldwide. As people age, their investment focus tends to shift from capital appreciation expected from equities and instead favors income

[2] US 10-year Treasury rate for the dates 11/7/16 and 11/14/16.

generation and capital preservation—which fixed income securities can provide. With this demographic reality, pension plans are likely to continue their concentration on matching assets and liabilities, again which the fixed income market provides. Pension plans and retail investors alike are huge participants in the financial markets and we'd expect that given these continuing demographic shifts, these aging buyers will be shifting out of equities into fixed income over time. Additionally, the aging population will also have a negative impact on global demand, in turn lessening the need for the Fed to be aggressive with rate increases. Spending on everything other than healthcare tends to decline with age, which can serve to stall the growth story. For more on this reality, see our writings "Zero Sum Game" and "Of Elephants and Rates."

Another consideration is the yield on medium and longer term US Treasury debt versus sovereign debt rates globally. How much can US rates dislocate from the rest of the world? 10-year bonds in much of the rest of the developed world are yielding around 0-1% and many of these economies are still in the midst of quantitative easing and stimulus.[3]

Country	10-Year Bond Yield
Switzerland	-0.24%
Japan	0.02%
Germany	0.22%
Denmark	0.32%
Netherlands	0.37%
Sweden	0.45%
Austria	0.49%
Belgium	0.61%
France	0.70%
Hong Kong	1.24%
United Kingdom	1.36%
Spain	1.52%
Canada	1.54%
Italy	2.02%
Singapore	2.28%
United States	2.31%
Australia	2.69%

So comparatively, with our higher rates and better economic conditions, we believe this keeps buyers in our market. The dollar will certainly be a consideration for investors—but the dollar will be a consideration for the Fed as well as they look at how aggressive to be with rates.

[3] Data sourced from Bloomberg, as of 11/22/16.

Also keep in mind that higher rates can become self-fulling; in essence higher rates thwart growth and the need for rates to keep increasing. A key point of monetary policy is to manage economic growth as the Fed works to fulfill their mandate of keeping inflation in line. As growth declines, lower rates can be used to stimulate growth, and vice versa, as growth increases, higher rates can be used to slow whatever growth there is.

But this would assume we get to a scenario of moderate growth—an assumption that we still don't believe is valid. Economic growth, lower taxes, an increasing inflation scenario and higher rates along with it are certainly not foregone conclusions. While the Republicans control Congress, it is only by a narrow margin in the Senate, so there may be some negotiation and moderation that may have to happen as they look to make a change to individual and corporate taxes and we would expect it to take some time. So ultimately maybe there is a reduction of taxes which may drive some consumer spending…or instead do consumers use it to repay debt or increase their savings after years of having to pull from it?

The "politics of rage" as it has been called is sweeping across the globe with elections in France and a host of European nations up next. Protectionism and nationalism are on the rise and none of this is good for global trade and growth rates. Rates have risen too far and too fast in our opinion. The Fed is very likely to hike rates 25 basis points in December to save any credibility. How many more rate hikes might be coming is certainly up for debate, but we remain skeptical. Eight years have passed since the 2008 crisis and we have seen trillions of dollars of stimulus force fed into the economy to what end? The election of Donald Trump is unlikely to change the course set for us by demography. Interest rate risk (duration) is now the fashionable topic but it will fade as quickly as it came.

High Yield in a Rising Rate Environment

While we are not a believer in a run in rates, let's take that side of the trade for a minute. For the sake of argument, let's say the Fed raises the Fed Funds Rate 25bps in December and then does another 3, 25bps rate increases in 2017. So now the Fed Funds Rate is up 1% and let's assume over this year, Treasuries have increased 1% as well from the pre-election levels. What would that mean for us in the high yield market? First, we need to keep in mind again that Treasury rates are forward looking so will price in expectations long before the Fed takes any action. Additionally, we would expect the short end of the curve to get hit more, less so for the medium and longer end of the curve that matter more to us in the high yield market. Given the massive back up in rates over the last two weeks, the market has likely priced in much of this potential move. In Street parlance, buy the rumor, sell the news.

History gives us a picture of how high yield has reacted during times of increasing rates. During the more recent "Taper Tantrum" in 2013, we saw the 10-year move up 136bps from April 30th to December 31st 2013, and the 5-year move 107bps over that same timeframe. During the first couple months of that Treasury move, we saw the 10-year increase about 80bps and while that increase was happening, the high yield market fell 3.1%. But over the course of the rest of year (July-December), during which the 10-year moved up another 54bps, we saw the high yield market return 5.8%.[4] Keep in mind, going into this move in rates in 2013, the yield-to-worst on the high yield index was 160bps lower in April 2013 than it is today, and was hitting all-time lows in yields right as the "Taper Tantrum" was beginning.[5] Not only that, yields today are right about where they were at the peak of the "Taper Tantrum."[6] So the high yield market looks to have been more sensitive to changes in rates then versus where we are today given the yield levels at the time.

If we expand this view to look at the long-term 30-year history of the high yield market, we continue to see that the high yield market has performed well in the face of rate increases.[7]

Move in the US 10-Yr	Return over prior 6		Return over prior 3 month		Return over current		Return over next 1 month		Return over next 3 months		Return over next 6 months	
Treasury yield over	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median
>30bps move over 1 calendar month	4.96	4.65	2.65	2.46	0.69	0.22	0.03	0.47	1.78	1.57	3.15	4.07
>50bps move over 3 calendar months	4.13	2.19	1.16	0.85	0.12	0.33	0.33	0.35	1.89	2.08	2.20	4.59
>70bps move over 3 calendar months	5.55	4.01	1.25	-0.45	0.20	0.65	0.73	0.66	3.06	2.34	4.80	5.05
>100bps move over 6 calendar months	2.19	1.51	1.01	0.34	0.10	0.40	0.42	0.46	1.48	1.57	3.38	2.17

On average, returns have remained positive in the midst of the increases, and have performed very well over the next 3-6 months. So while we remain skeptics of a rising interest rate environment, we believe investors are well served by the high yield market whether rates rise or not.

For more as to the impact of rates and how the market has historically performed during periods of increases, see our writings "Strategies for Investing in a Rising Rate Environment" and "High Yield in a Rising Rate Environment". As noted in these pieces, historically the high yield market is negatively correlated to Treasuries, meaning as Treasury prices decline and rates/yields increase, high yield prices increase. This market has historically performed well during years when we have seen rising rates, helped by the improving economy that has traditionally corresponded with increased rates, as well as the higher starting yields and a shorter maturities we generally see in the high yield market versus other fixed income sectors, both of which help reduce duration.

Duration is a measure of interest rate sensitivity, and that, along with yield, are important metrics to consider in the face of potentially higher rates. Keep in mind the high yield market is not homogenous. As we have seen a swift rebound in high yield bond prices so far this year, we

[4] Based on performance for the Bank of America Merrill Lynch High Yield Index. The Bank of America Merrill Lynch High Yield Index monitors the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Index data sourced from Bloomberg.

[5] Yield referenced is the yield-to-worst on the Bank of America Merrill Lynch High Yield Index for the dates 4/30/2013 versus 11/14/16.

[6] Yield referenced is the yield-to-worst on the Bank of America Merrill Lynch High Yield Index with the top during the 2013 period of 6.85% on 6/15/2013 versus 6.86% on 11/14/16.

[7] Data analyzing the month end levels of the 10-yr US Treasury yield versus the monthly returns for the Bloomberg Barclays High Yield Index, looking specifically at performance for the High Yield Index during periods when the 10-year yield moved above the noted thresholds from one month end to another. Intra-month data was not analyzed. Trailing performance numbers are for the prior 6months and 3 months before the month end in which we saw the Treasury yield cross the threshold, for the current month in which is crossed threshold and for the one, three, and six month periods after the calendar month in which Treasury yields cross the threshold. Bloomberg Barclays Capital U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Data sourced from Barclays and Bloomberg and covers the period of 12/31/1986 to 10/31/2016.

have seen spreads compressed to very low yield levels on a number of high yield issues. In looking at the Bank of America High Yield Index, nearly 40% of the individual tranches trade at a yield to worst of 5% or less[8], while there is also a large portion of the market that offers yields that we would view as attractive. So if we were to see a 1% increase in rates, that would have a much more significant impact on securities yielding 3% or 4% within the high yield market, along with investment grade and municipals that are yielding even less, versus the securities yielding 7, 8, 9% or even more, also available within the high yield space. Yield is one of the main components of duration, so all else equal, the higher the yield, the lower the duration and vice versa, the lower the yield the higher the duration. This is just one way where an actively managed approach can add value.

Regulatory Changes

Regulation is another post-election area of potential impact on the high yield market—or more precisely the potential repeal of regulation. The potential repeal of Obama Care is the headline that is getting the most attention. We are already starting to see certain areas of healthcare within high yield, namely hospitals, get severely hit on the uncertainty over what this could look like and the potential impact any change could have on these individual credit issuers. At some point these securities will have priced in a worst case scenario and may be a tremendous trade. Given the speed of markets today, this is likely soon.

But the biggest potential regulatory change that may impact the entire high yield market relates to the potential repeal of Volcker inside Dodd-Frank. This provision virtually eliminated proprietary trading at investment banks, which has in turn severely curtailed their participation in marketing making activities in the high yield sector. As we have seen less dealer participation and inventory, we have seen an impact on liquidity and larger pricing swings in high yield bonds. This has been something markets have adjusted to over the past couple years, but if some regulations were to be eased and market making activity were to increase, that could improve liquidity within the high yield market.

Liquidity within the bond market has been an area of scrutiny by investors and regulators alike in this post Dodd Frank/Volcker environment. Rolling back or amending any sort of regulation on this front for the banks may serve to improve their profit levels and reduce compliance costs on not only them, but also the droves of other fund managers that have and will have to face additional compliance costs and reporting burdens as they address some the outcropping of rules addressing liquidity. This is certainly something we will be paying close attention to. Even if none of this ultimately gets changed, Peritus has been proactively addressing some of investors' liquidity concerns with recent strategy enhancements (see our piece "Liquidity Management" and read monthly manager commentaries at www.advisorshares.com/fund/hyld).

8 The Bank of America Merrill Lynch High Yield Index monitors the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market. Index data sourced from Bloomberg, as of 11/7/16.

Peritus' Approach/Conclusion

Successful investing is all about pricing risk. This holds true for equity and credit investors alike. We have been and remain value investors in the credit markets. We remain industry/rating and size agnostic. We simply want to build and manage a portfolio of undervalued bonds and loans. This requires discipline and a great deal of work; it is easy to talk about, but difficult to execute. Today, we find opportunities in industries (i.e. healthcare, specialty finance) and on a name by name basis. The knee jerk reaction of investors to sell all "bonds" because rates are going to go up provides us with a very nice entry point across high yield bonds and loans, especially given the very short duration of the asset class. We are not a believer in the rising rate script but remain vigilant and highly sensitive to the reality of stagnant global growth rates and an aging population. For those who believe that rates are bound to rise from here, we see our high yield bond and loan asset classes as one of the few places inside the fixed income universe that investors can make money.