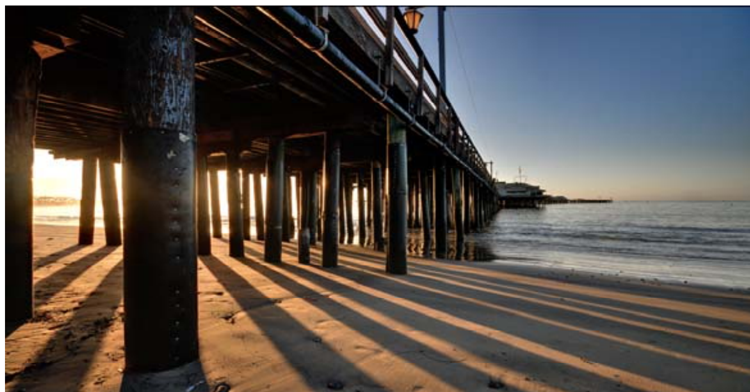


PERITUS
ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – February 2017

PRICING RISK AND PLAYING DEFENSE

"Make America Great Again!" The election of Donald Trump has put half the population in shock while the other half remains celebratory. Since the election, we have watched equity markets soar, bond yields rise dramatically and animal spirits returning to life. Is this the beginning of new trends or the beginning of the end of the rallies that began in 2009? The reality is that none of us know the future. What we do know is that the two monsters of debt and demographics remain in the room and nobody is going to change their impacts. And they have a far bigger impact than much of the optical engineering we are now witnessing with Trump-O-Nomics.

We believe that the biggest surprise awaiting investors in 2017 involves bond yields and interest rates. What we also believe is that political reality is going to set in now that we are post the inauguration. This political reality is that Trump has not been given a mandate. He lost the popular vote and this is not lost on Republicans. Remember, politicians have one major and constant job: to get re-elected. Other political realities include but are not limited to the following:

- Republicans have a slim majority in the Senate and many key issues require 60 votes. This means that the Senate Republicans will have to get a handful of Democrats on board to get certain reforms passed.
- Donald Trump is not a traditional Republican. He will have serious disagreements within his own party on a variety of issues including trade, immigration and Russia, likely causing delays and modifications from the current rhetoric.
- The Office of the President is bigger than any man. Foreign affairs, global and national security and global trade all are complex beasts and tend to suppress change.

None of this is to say that there are not some very positive changes on the horizon. I do believe that tax reform is likely in 2017. The reduction of Federal corporate taxes to 20% from 35% is long overdue and appears to have bipartisan support. But the forecasted positives here are over-stated. Very few companies in the S&P 500 actually pay anywhere near this statutory rate. There are a number of budget proposals floating around Congress that have to be reconciled into a single bill and this will take time. Some of the proposed tax law changes appear radical and unlikely to gather enough support. Two of the most aggressive include the inability of companies to deduct interest expense on their debt and the ability to write off all capital expenditures in the year they are made. In short, stay tuned because in this era, everything is

possible. At this juncture it is too early to comment on potential ramifications of some of the more radical potential changes, but change of some kind does appear to be on its way.

Interest Rates and Final Demand

With Trump's election, it is now "consensus" that the Federal Reserve is going to raise rates another three times in 2017. I question this assumption. In fact, we may have already seen the highs on the 10-year Treasury in mid-December 2016 as it breached 2.6%. Global growth has not changed since Trump was elected. The Euro Zone remains a complete mess and Brexit is not going to help. Waiting in the wings are key elections (France in particular) and these elections are likely to be won by those hostile to immigration and global trade and are firmly in the protectionist camp. Similar to the Trump rhetoric, these politicians are playing on voter's nostalgic and blurry memories.

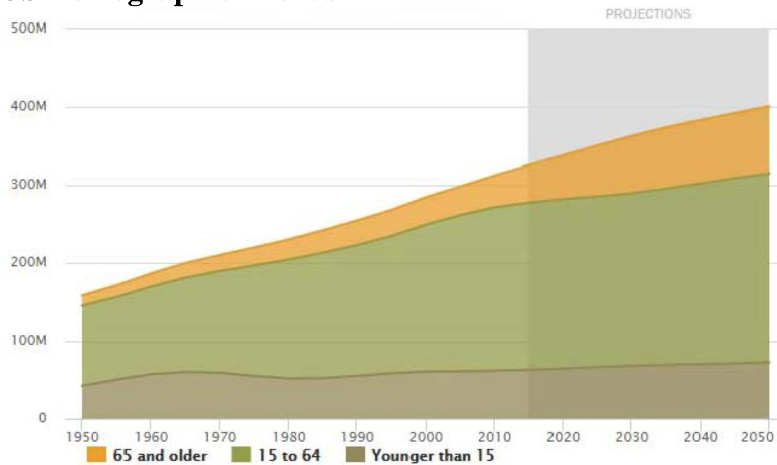
Frighteningly, there appears to be congressional support behind the notion of a "border tax." At first, it appeared the targets were specifically China and Mexico, but this is spreading rapidly with Trump's recent comments in the German newspaper *Bild* where he targeted and threatened BMW and other German automakers with a 35% import tariff. Ironically, BMW is one of the (if not the largest) exporters of autos from the United States. Auto supply chains are incredibly global and complex so this type of rhetoric is not positive. The real question remains whether this is negotiating bluster or something more tangible. Do not forget that trade is one area where the President has real and independent authority. Stated another way, many of these potential trade policy decisions do not require congressional approval. If tariffs/border taxes are enacted, most will be challenged in various courts and tribunals. But this takes time and the damage can be instant and long lasting. So as Trump looks to make his mark early, there is little mystery as to why trade is front and center. While this type of strong arming plays very well to a Midwest manufacturing/industrial audience, does anyone believe that protectionist policies are good for broad economic growth? For that matter, are higher interest rates and higher energy prices stimulative or regressive for consumer spending?

Regardless of the outcomes of these issues, we do have considerable certainty on one key variable—demand. Our portfolios are broad and eclectic. As such, this gives us a very granular look at pricing and volumes for most major industries. Every quarter over the past couple of years has felt like "Groundhog Day." Revenues down a few percent (often blamed on a strong dollar or the weather, which is our favorite because you can use good weather—people are doing other things versus shopping like going to the beach—or bad weather—they stay inside and don't go to the mall), while EBITDA is up slightly helped by factors such as cost reductions. While putting smart, successful business people (i.e., Wilbur Ross, Steven Mnuchin, Rex Tillerson) in charge of key government positions is a great idea, how does this change final demand for goods? In our view it doesn't.

Demographics and a massively levered global economy continue to be the dominant themes. The world is aging and this has enormous economic ramifications, including a shrinking labor force in the richest, most developed countries, swelling pension burdens, and slowing consumption. According to Pew Research, "Growth from 1950 to 2010 was rapid—the global population nearly tripled, and the U.S. population doubled. However, population growth from

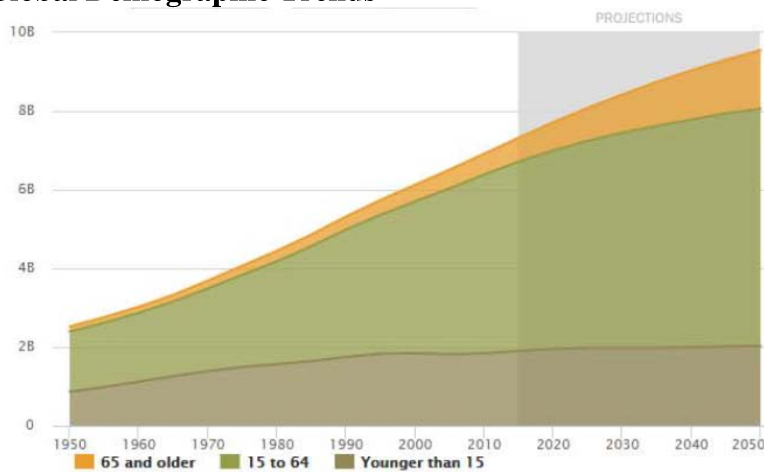
2010 to 2050 is projected to be significantly slower and is expected to tilt strongly to the oldest age groups, both globally and in the U.S." That population shift is graphically pictured below.[1]

US Demographic Trends



Source: United Nations, Department of Economic and Social Affairs, World Population Prospects: 2012 Revision, June 2013

Global Demographic Trends



Source: United Nations, Department of Economic and Social Affairs, World Population Prospects: 2012 Revision, June 2013

We expect these demographic trends to have a continued and lasting impact on economic growth and final demand.

A focus on bringing manufacturing back onshore can certainly be viewed as a possible source of inflation given that costs to produce the same goods inside the US may be higher. As prices rise, demand can fall. This is known as the price elasticity of demand. In a no growth world, this elasticity of demand applies to everything from commodities to interest rates. Even ignoring the

---

[1] "Global Population Estimates by Age, 1950-2050." Pew Research Center, Washington, D.C. (January 30, 2014). http://www.pewglobal.org/2014/01/30/global-population/.

threatened tariffs, higher interest rates are likely to temper demand from their recent record highs in areas like auto. Think of real estate today. Will higher interest rates help or hurt this industry? We are already seeing the impacts of higher interest rates on mortgage origination. If higher rates are due to a growing and robust economy, demand is more inelastic because everyone is making more money. While the government statisticians continue to tell us we are at full employment and everything is rosy, the real world tells a different story. So in our view we have both price and demand ceilings on most everything.

Oil prices provide an excellent example. As we discussed last year, oil prices in the $20s and $30s were unsustainable as this price did not cover the cost of even the best wells outside of the Middle East. While we are not surprised to see prices above $50, we believe that there is a ceiling on oil prices for a couple of reasons. First, the majority of demand for oil still involves gasoline. While miles driven in the US surprised to the upside in 2016, this was due to the aforementioned price elasticity of demand. As prices collapsed, demand increased. This demand "chip" has been spent. Additionally, excess Chinese demand for storage kicked in during 2016. However, this demand is highly sensitive to pricing. We have seen recent storage demand estimates of around 400,000 bpd, but this demand can simply disappear as prices grind higher. So while gasoline is one of the most "inelastic" commodities it is not perfectly inelastic. We are all inundated with analyst data on supply and the ability of OPEC to bring supply in balance, but for us it is all about demand. We see very little focus on understanding the demand drivers—and ultimately we see these demand drivers as putting a cap on just how much higher oil prices can rally from here.

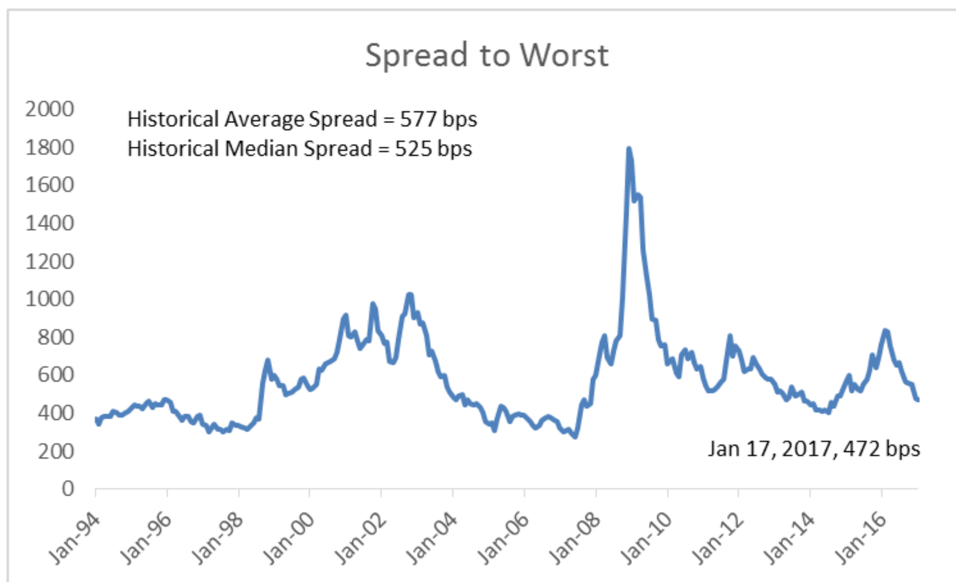
We also see ceilings on interest rates. The Fed and numerous analysts talk about "normalizing" interest rates. What does that mean? The amount of government, corporate and consumer debt in the world is probably uncountable. So as rates rise, more of everyone's cash flows go to servicing that debt, stealing buying power away from other areas. Should rates rise too high, this would create defaults in mortgages, corporate bonds and loans and even government bonds. How high is too high? Nobody knows that answer. But what we do know is that we have had effectively zero percent interest rates for eight years now, yet what has that done to stimulate the real economy globally? Not much. So how would higher rates stimulate growth? They won't. Rather we can be in a situation where higher rates thwarts higher rates because of the demand impact.

So you can see the paradox we are now involved with. The equation is debt + demographics = no demand. We can talk about infrastructure spending, keeping jobs in America, and a reduction in corporate taxes, but we don't see that as moving the needle enough to outweigh the continued drags from the debt burden and a demographic shift away from consumption of goods. What this means to us is that should the Fed pursue further rate hikes, we will likely see a flattening of the yield curve. We would expect that medium to long term interest rates will do nothing.

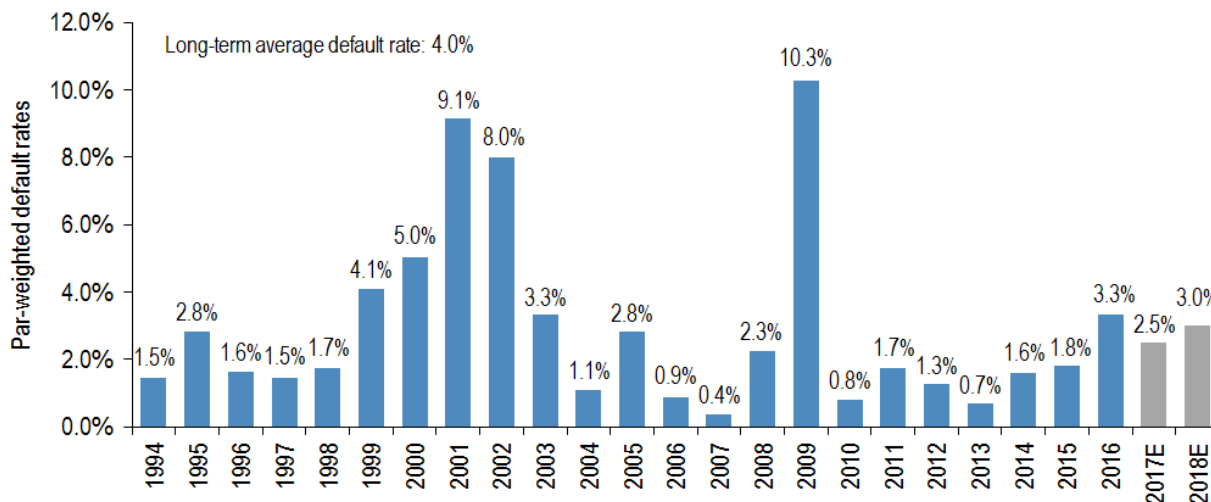
Pricing Risk and Playing Defense

Against this backdrop, how does one invest? For us it is all about "pricing risk." Every investment opportunity set (asset classes and individual securities) has risk. The key is to identify the risk and price it correctly. For us, assessing and pricing risk involves analyzing credit spreads in light of their expected default rates. This can be done for the high yield bond

and loan asset classes as a whole and for individual securities. For the indexes today, those spreads have narrowed significantly and currently sit at 472bps, relative to historical medians of 521bps and historical averages of 574bps.[2]



As we look forward, spreads are pricing in a very low default rate, which is expected to be 2.5% this year, versus historical averages of 4%.[3]



While we do not disagree that default rates will be subdued for the next couple of years, there is no arguing that spreads for the indexes seem to be pricing in near perfection. Given that spreads are below average as we enter 2017, we do not want to be tightly correlated to the indexes.

[2] Jantzen, Nelson, CFA and Peter Acciavatti, "JPM High-Yield and Leveraged Loan Morning Intelligence," J.P. Morgan North American Credit Research, January 18, 2017, January 3, 2017, and December 21, 2016, data covers January 31, 1994 to January 17, 2017. Chart and average/median based on month ending spread levels over the period.

[3] Jantzen, Nelson, CFA and Peter Acciavatti, "JPM High-Yield and Leveraged Loan Morning Intelligence," J.P. Morgan North American Credit Research, January 5, 2017.

Rather, we will be opportunistic in our approach to buying securities and expect that 2017 will reward bond pickers not asset allocators.

Portfolio Strategy

Active management will be key as we move through 2017. As always, credit is a negative art. This means what you don't own is just as important as what you do own. As we enter this New Year, we see that securities of many cyclical industries have rebounded to a level where investors are not being compensated for the volatility of revenues and we will steer clear in our portfolio. But in terms of what we do own, as active managers, we continue to look for credits where the three "U's" are firmly in place: undervalued, unloved and most importantly—**UNDEROWNED**. It is hard to argue that any asset classes today fits that bill but we can certainly make a very good argument that individual securities can.

As active credit investors, we are contrarians by nature. But we are not contrarians for the sake of being different, but rather for trying to generate real alpha. We want to purchase securities that have low expectations, not securities that are priced to perfection. Thought of another way, there are very few bad bonds but lots of bad prices and it is our job to figure out if securities are priced where they are for the right or wrong reasons. Sometimes this mis-pricing (under-valued situation) is created through company specific news and sometimes it is industry contagion.

One industry where we believe opportunities will evolve is in healthcare with the "repeal" of Obamacare. Nobody really knows what "repeal and replace" actually means but the volatility created by President Trump's rhetoric is likely to produce some interesting opportunities as the year develops. It is highly unlikely that currently insured patients will be simply dropped from coverage. Hospitals have been hit the hardest so far and we are beginning to stress test a few of them to determine who we view as survivors in the space. Specialty pharma is another area that we continue to like. We have exited a number of names here (some by our design some because they were refinanced away) but look to re-establish positions as the inevitable bashing on drug pricing works its way through Congress. This is one of the few industries that we have seen substantial organic revenue growth, and while more competitive bidding is likely to pressure some companies, many others not impacted will be thrown out in the inevitable contagion trade.

In terms of the "under-owned" credits, that involves looking in areas other aren't and not setting arbitrary restraints that force us to invest in the same, often largest issues everyone else is. For instance, the largest high yield index-based ETFs invest according to underlying indexes that have size restrictions of $500mm or $400mm in individual tranche size/$1billion in total debt outstanding.[4] So this can serve to eliminate approximately half of individual bond issues[5], and historically it has often been in these eliminated medium-sized, niche companies where we have found the most value.

---

4 Fund restrictions sourced from the ETF prospectus and summary prospectus at https://www.spdrs.com/product/fund.seam?ticker=JNK and http://us.ishares.com/product_info/fund/overview/HYG.htm. Size limitation based on the underlying indexes for each fund. The fund may use a representative sample of the underlying index, which means it is not required to purchase all securities in the underlying index. Both funds may invest up to 20% of the portfolio in assets not in the underlying index.

5 See our piece "Tranche Size Constraints in High Yield ETFs," http://www.peritusasset.com/2016/02/tranche-size-constraints-in-high-yield-etfs/, February 16, 2016. Statement based on assessing the amount of individual tranches under $500mm in the Bank of America Merrill Lynch US High Yield Index as of 2/11/16, data sourced from Bloomberg. Similar analysis with similar results was done as of 1/12/17. 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.

There are always attractive opportunities within the high yield market but 2017 is a time to focus on value and price in risk as you strategically compile a portfolio. One thing we are highly confident of in 2017 is that volatility will increase significantly. European elections (along with Brexit) are sure to add some fuel to the protectionist fire. This could have the effect of increasing risk premiums and credit spreads. Since we have a sanguine view on default risk, we think the biggest challenge for 2017 will be volatility and manic risk premiums. We can envision a credit market that suffers bouts of neurosis as President Trump's threats ebb and flow. So we will manage this technical and liquidity risk very deliberately by using our strategic new issue allocation, by which we purchase newly issued bonds. This allocation is focused on market technicals and includes tight sell parameters and a short term holding period. In addition to a liquidity and stability focus, this portfolio segment also provides capital gains potential as many of our sales are done at prices nicely higher than purchase price.

Regardless of interest rate views, floating rate loans serve to reduce portfolio duration (interest rate sensitivity) and can also provide added stability. We will continue to maximize our loan allocation within our strategy. We will continue to have the focus of the strategy on our core, value-based bond holdings, and as industry themes or asset class opportunities present themselves, we will use proceeds from the new issue allocation to redeploy into such alpha-generating investments. These core, fundamentally-driven holdings are complemented by our new issue allocation, allowing us to take advantage of the opportunities we see from both a fundamental and technical side of the market. Our end goal is to compile a portfolio with greater stability and liquidity than our competitors, while working to outperform both the indexes and our competitors.

Conclusion

We are not believers in a significantly higher interest rate environment. The global economy is simply too weak to tolerate higher rates. The Fed will raise rates in 2017, however, we believe any increase will be moderate and gradual. The bond market has already anticipated and priced in at least two, 25 basis point increases in the Federal Funds rate and with any action they do take, we don't expect the medium and long end of the curve to do anything. As stated, the equation we are dealing with is debt + demographics = no demand.

However, we continue to see demand for one important investment characteristic—yield. We believe that a tight and thoughtful portfolio within the high yield bond and loan markets will provide that yield for investors. Given both the changing policy and interest rate backdrop, we view our asset classes much more favorably than other fixed income areas. We believe that high yield debt will outperform the longer duration and lower yielding fixed income cousins such as investment grade corporates, munis, and mortgages by a wider margin in 2017. While 2016 seemed to be dubbed the year of indexing by financial commentators, we believe 2017 will prove to be the year of active management. We believe volatility will return to markets and what you don't own will be as important as what you do. It is time to play good defense and we will do just that while also capitalizing on the select value-based opportunities within today's high yield market.

Sincerely,

PERITUS ASSET MANAGEMENT, LLC

Timothy J. Gramatovich, CFA
Chief Investment Officer

Ronald J. Heller
Chief Executive Officer

Heather Rupp, CFA
Director of Communication, Research Analyst

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 loans and other fixed income, equity, and fund securities involves various risks and uncertainties, as well as the potential for loss. High yield bonds are lower rated bonds and involve a greater degree of risk versus investment grade bonds in return for the higher yield potential. As such, securities rated below investment grade generally entail greater credit, market, issuer, and liquidity risk than investment grade securities. Interest rate risk may also occur when interest rates rise. Past performance is not an indication or guarantee of future results. The index returns and other statistics are provided for purposes of comparison and information, however an investment cannot be made in an index.