PERITUS
ASSET MANAGEMENT, LLC

Market Commentary

Independent Credit Research – Leveraged Finance – October 2012

MORE THAN A FEELING

I looked out this morning and the sun was gone
Turned on some music to start my day
I lost myself in a familiar song
I closed my eyes and I slipped away

This 1970's anthem from Boston's first album remains one of my favorite songs of all time. The title is more than apropos as we evaluate the state of the market today. We see trouble developing and this has recently been supported by "more than a feeling." Tangible signs of fundamental weakness are appearing everywhere, yet financial market participants are simply choosing to ignore these signs. Discipline is once again absent, and "don't fight the Fed" is now the mantra, though maybe fading a touch in recent weeks. This behavior always leads to bad outcomes. Perhaps Mario Draghi and Ben Bernanke have seen the future and it is so grim that they wanted to somehow get as much ahead of it as possible.

Since I appear to be stuck in the '70s with this piece, there was a game show back then called the $10,000 pyramid. Dick Clark was the host and celebrities and contestants took turns giving word clues to each other without saying the actual answer. I'd like to play that game today. So here are my clues:

1. Jose Conseco
2. Ben Johnson
3. Global Financial Markets

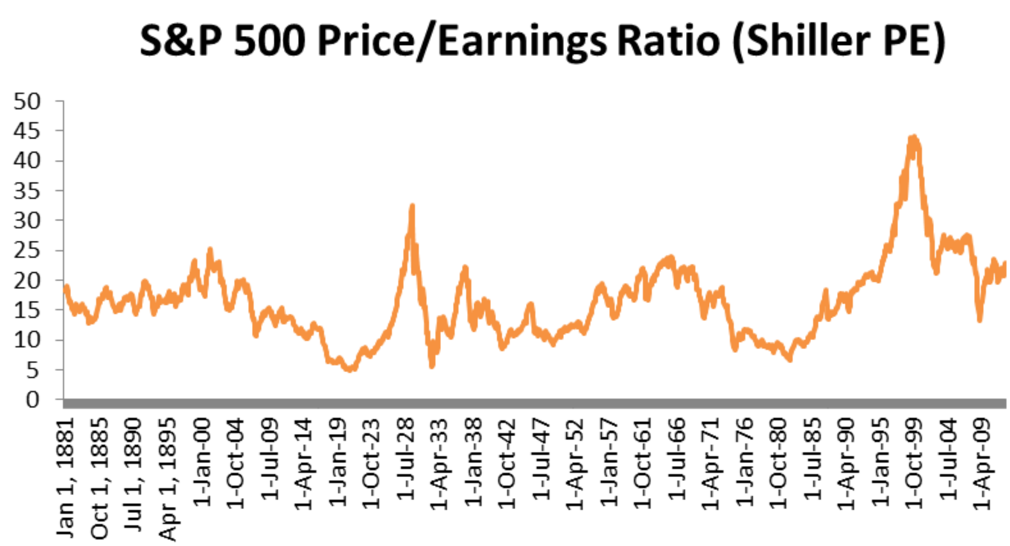
If you answered, "Things that were juiced," you win! But here's the problem with steroids, once you go off of them, you are often worse off than when you started. Your strength was temporary and your weight gain was all water. The incredible run in all risk assets up to and through the recent QE3 announcement has lost its punch quickly. It has yet to be explained to me how the Federal Reserve buying $40 billion worth of mortgages every month will improve the job picture. Interest rates have been low for a long period of time, so how does the current round of easing changing anything? Real estate is bottoming (simple supply and demand game over a few years) without QE3, but everything requires time. Qualifying for a mortgage and coming up with a down payment remain the biggest challenges to real estate. QE3 will not fix this.

There remains a significant disconnect between the real economy and financial markets. The consensus is that fundamentals simply don't matter and "don't fight the Fed" is the only thing you need to know. Our take is simple: fundamentals don't matter until they do. Think back to 1999-2000. Fundamentals didn't matter in the new world of the internet for years. Remember it was "eyeballs" not revenue that mattered. Until they did. But when they did, lots of companies went bankrupt and investors were killed. Though we are not calling for a massive default cycle ahead, we are seeing signs of trouble. The challenge is navigating the weak fundamental picture with what we believe to be the beginning of a 15-20 year positive technical backdrop for fixed income, yield generating assets.

Opposing Forces

In the world of credit, we are dealing with two opposing forces. Call it whatever you want, technicals versus fundamentals, or macro versus micro. First, let's take a look at the macro or technical picture. The reality is that we are in a zero percent interest rate environment for the foreseeable future. Yes, this is orchestrated/rigged and not likely the "free market" rate, but that is not relevant. It is the world we are dealing with. But, as we look ahead, we continue to see the tide shifting from equities to fixed income and this cycle is going to be a very long one as demographics are destiny. The generation with investable assets is hitting retirement age and they are not interested in stocks or the growth myth any longer. Those Ibbotson stock charts haven't worked for them. They want predictable income and protection of principal.

Similar to the early 1980's for equities, we see this "yield" culture for the next 15-20 years. Let's revisit the "myth" of equity returns again. We have made the point on previous occasions that the valuation expansion game for equities was a once in a generation occurrence from the early 1980's through to the peak in 2000. This is not going to be repeated and has cost investors a great deal of money.[1]



So while the valuation expansion is not there to be had, investors have to rely on dividends (yields) for returns. People tend to have a very short view of history. Prior to the late 1950's stocks always had a higher yield than bonds. This makes perfect sense to us. Equity is the

[1] http://www.multpl.com/shiller-pe/, data courtesy of Robert Shiller, Yale Department of Economics, data as 10/8/12. Price earnings ratio is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio (CAPE Ratio), Shiller PE Ratio, or PE 10.

riskiest part of the capital structure so investors needed to be paid a premium for holding it. Then someone decided that investors weren't smart enough to allocate these payouts so management would help them out by retaining all the earnings and allocating capital to "grow," and ultimately this lead to the disappearance/decline in dividends. We have argued many times that companies should pay out all true free cash flow to investors. Their "growth" plans would then be subject to capital market discipline (i.e., raising equity or debt). But this has certainly not been the case and equity investors are now left with a security with no valuation growth and no yield.

The reason this matters is that those waiting for the end of the bond "bubble" are going to be severely disappointed. The technical picture (money flows) for fixed income is not going to change for a long time. Why? Because of those darn demographics. Think about what is happening. The "institutional" investor (defined here as large defined benefit pension plans) is effectively in liquidation or distribution. The money is returning to the individual and those individuals now have different concerns and needs (that predictable income and principal protection). The equity market is irrelevant economically and will rise and fall as traders create and trade volatility, all the while investors pile into yield generating assets. Conclusion: the technical picture (demand/money flows) for yield assets is in the beginning innings.

Let's then turn our focus to "fundamentals" in the markets. What has really caught my attention has been the recent earnings warnings from two bell cows, Federal Express and Caterpillar. Caterpillar went so far as to reduce guidance all the way out to 2015. I'm not sure I've ever seen that before, but what they are both telling us is that the global economy is weak and getting weaker. It appears that the commodity super cycle may have ended. This doesn't mean that there won't be trading opportunities but the rising tide seems to have crested. The Chinese engine is sputtering. Why should that surprise anyone? The Eurozone is the biggest economic area in the world and there is little doubt they are in a severe recession and de-leveraging phase which is beginning not ending. The second biggest economic zone, the U.S., is holding together but not growing.

It is clear that there are fundamental challenges to the global economy, and in the midst of this we are seeing some worrisome trends in credit markets. The strong technical picture for credit has resulted in some lost discipline. Up until recently, bond issues were of good quality and purpose, though arguably a bit over-priced in certain circumstances. This is beginning to change both in the leveraged loan market and the high yield bond market. The words "covenant lite" (lack of covenant protections for investors) are beginning to pop up in loan-land almost daily. In high yield bonds, we are beginning to see the very bad curse words "PIK-Toggle" and "dividend recap." The "PIK" here stands for pay-in-kind, which means the company has the option of paying bondholders in more bonds instead of cash. Well if the company can't afford to pay me in cash, then why would I want more bonds they can't pay? Dividend recap simply means the proceeds of the bond are going to be used to pay a dividend to the current owners.

Three recent examples use both of these expletives.[2]

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[2] Fuller, Matt. "EMCS preps $450M of PIK toggle notes backing dividend; pricing Fri," September 20, 2012. "PETCO dividend-supporting toggle notes traded higher on break," October 4, 2012. "Jo-Ann Stores sets price talk on PIK-toggle dividend deal with OID," October 9, 2012. Standard & Poor's Leveraged Commentary & Data, September 20, 2012, https://www.lcdcomps.com/lcd/f/home.html. Emphasis added. Peritus has not owned, does not own, and is not making any recommendation to own or not to own the securities referenced.

STANDARD & POOR'S **Leveraged Commentary & Data**

EMSC preps $450M of PIK toggle notes backing dividend; pricing Fri.

Emergency Medical Services Corp. is driving by the red-hot high-yield market with a $450 million offering of five-year, callable senior PIK toggle notes backing a dividend to shareholders. Bank of America, Morgan

PETCO dividend-supporting toggle notes traded higher on break

The 8.5% senior PIK-toggle notes due 2017 from **PETCO Holdings** priced at 99.5, to yield 8.625%, and post-break markets edged up to

Jo-Ann Stores sets price talk on PIK-toggle dividend deal with OID

Price talk is for a 9.75-10% yield after a 1-2 point discount to par for a $325 million **Jo-Ann Stores** PIK-toggle dividend deal. The guidance on

It is amazing just how quickly investors lose their discipline and composure. As we look ahead, we believe performance in leveraged credit will be determined by pure alpha, or in other words, the ability to select individual credits.

Scenarios

Given today's environment, we feel that there are three scenarios that can play out. They are as follows:

Scenario 1:
The fixed income markets continue to see tremendous money inflows as the yield game remains dominant for investors. Spreads have plenty of room to compress further in high yield as we are nowhere near the tight levels of 2007. We are just beginning to heat up and there remains room for much further price appreciation and silly trades to print.

Scenario 2:
The high yield market begins to weaken as "traders," not investors, lighten up positions going into the 4th quarter to lock in gains. The passive high yield index funds (HGY and JNK) begin to experience outflows and the large, on-the-run names that dominate the holdings of these funds

are sold down. Yet, the weakness is neither prolonged nor severe as interest rates remain near zero and investors remain favorable to yield.

<u>Scenario 3:</u>
The risk-off trade hits in full force. Equities are sold-off hard, and high yield is a casualty of the "sell everything" mentality. The flight to quality trade ensues, with Treasury bonds soaring along with the U.S. dollar.

Which of these scenarios do we believe is the likely outcome? All three! Money is going to seek yield and the default cycle for corporate credit will remain muted,[3] even with a no growth or a recessionary environment. All the while, there will be periods of severe sell-offs in equities as economic data continues to weaken and disappoint both at home and overseas. Markets, like human beings, are manic. We have gone from the euphoria of QE3 to skepticism in two weeks. And tomorrow the concern could be that a depression is just around the corner. This is why you cannot "trade beta" (i.e., trade the market) in the high yield universe. With the manic markets, trying to time and ride the market moves it is a pointless exercise—not only do you run the risk of not timing the market correctly, you also forego the constant yield that bonds provide.

Strategy

So how are we planning on dealing with this environment? First, in the search for yield, discipline is going to be maintained, and it is through that discipline that alpha can be generated. As we have discussed the ability to say no is crucial as markets heat up. There will be many temptations that need to be avoided. Use of proceeds and coupon/covenant structure remain at the top of the list of things we are watching carefully. Additionally, value traps will be set along the way. A very recent example[4]:

STANDARD &POOR'S **Leveraged Commentary & Data**

Alpha Natural Resources notes price to yield 10%; terms

Alpha Natural Resources today completed an offering of senior notes via bookrunners Citi, Barclays, J.P. Morgan, Bank of America, and RBS, according to sources. Pricing came at the middle of talk and at the $500 million target size. The coal-mining concern intends to use the net proceeds from the SEC-registered offering to partially fund a tender offer for up to $350 million of the $659 million outstanding in 3.25% convertible notes due 2015. Excess monies back general corporate purposes, according to SEC filings. Terms:

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[3] Acciavatti, Peter, Tony Linares, Nelson Jantzen, CFA, and Rahul Sharma, "Credit Strategy Weekly Update: High Yield and Leveraged Loan Research," J.P. Morgan, July 13, 2012. High yield bond default projections of 1.5% in 2012 and 2.0% in 2013 outlined on p. 7.

[4] "Alpha Natural Resources notes price to yield 10%; terms." Standard & Poor's Leveraged Commentary & Data, September 28, 2012, https://www.lcdcomps.com/lcd/f/home.html. Peritus has not owned, does not own, and is not making any recommendation to own or not to own the securities referenced.

Issuer	Alpha Natural Resources
Ratings	B+/B2
Amount	$500 million
Issue	senior notes (off the shelf)
Coupon	9.75%
Price	98.959
Yield	10%
Spread	T+939
FRN eq.	L+926
Maturity	April 15, 2018
Call	nc-life
Trade	Sept. 28, 2012
Settle	Oct. 11, 2012 (T+8)
Joint Bookrunners	Citi/Barc/JPM/BAML/RBS

To the uninitiated this looks like a tremendous value. A 10% yield and decent ratings, but one big problem: it is a coal producer. While numbers look reasonable for 2012, with the recent decline in coal prices, the following years are frightening as most coal producers do not have a hedged or sold book. Coal is used for two primary purposes: electricity generation and steel production. Cheap natural gas has caused utilities to switch as much electricity production to gas fired as possible, causing a lower demand for coal, and if there is one business I do not want to be investing in during the next year or two, it is steel. There are also draconian environmental/EPA issues coming to a head in 2015. This looks like a distressed business/industry with a stressed bond price. We prefer the opposite: a slightly stressed business with a distressed bond price where you get paid for the risk. We'll pass here.

The next item relates to bond prices and call prices. As we have discussed in our prior writings, passive funds have no ability to sell bonds with very thin yields that are trading way above their next call price. This locks in an automatic capital loss (assuming bond is called) for investors purchasing those bonds today. It is better to be the beneficiary of this pricing silliness and take the opportunity to sell at these very large premiums when you can.

Finally and most importantly, we want to continue to lend money to companies that can pay their bills in a bad economic environment. We are not drinking any growth Kool-Aid and continue to believe that the world remains mired in a no growth/recessionary mode for the foreseeable future. Our economic forecast is always recession heading to depression. This is how one avoids making dumb loans. And as we look at the tangible evidence around us, it does appear this conservatism is warranted.

Market Inefficiencies

While our focus is on what to avoid, the other piece of the equation is finding the opportunity set in high yield. As we look for potential investments, one of the natural by-products of our investment strategy is our ability to take advantage of market inefficiencies. The Peritus mantra is that credit is AAA or D. We effectively arbitrage credit ratings. What happened to all that rhetoric about removing credit ratings from the investment landscape? Answer: nothing. They remain as ingrained in the system as ever and this continues to create opportunities for those not constrained by ratings. Remember there are still States that do not allow their public pensions to buy non-investment grade bonds. And of course, these same States have huge equity portfolios. Time for a finance class maybe?

Additionally, there is a new force to be dealt with (taken advantage of) in the passive high yield bond ETFs. These products have become an important player in the high yield space yet set limitations and restrictions on what they can and can't buy. The most bizarre is their size restrictions:

> The two largest high yield ETFs exclude a huge portion of the actual high yield market. By their investment mandates, **the SPDR Barclays Capital High Yield Bond ETF (ticker JNK) prohibits investments in bond tranches below $600 million and iShares, iBoxx $ High Yield Corporate Bond Fund (ticker HYG) prohibits investments in bond tranches below $400 million and from issuers with less than $1 billion of outstanding face value.[5] This immediately eliminates much of the market by issues. In fact, the Barclays High Yield Index has 1,928 bond holdings and only 546 of them are over $600 million, or only 28% of the available issue universe, and only 37% of issues in this index meets the $400 million issue size and $1 billion issuer size threshold**.[6] (See "The Necessity of Active Management in High Yield Investing" for a further discussion.)

This limitation on size has created a tremendously bifurcated high yield market. Larger, on-the-run names often trade expensively irrespective of credit quality or fundamentals and tend to be more volatile. The opposite is also true. Tranche sizes that are slightly smaller are orphaned and represent excellent value, and are often less volatile. Do not be fooled by the concept of liquidity in the high yield market. Our experience has been that liquidity is ultimately determined by credit fundamentals, not how many bonds the company has outstanding.

Summary and Conclusion

We see a technical shift underway that puts yield generating assets, such as high yield bonds, in the sweet spot. This not a "bond bubble," but rather the beginning stages of the next cycle. With the lack of economic growth, valuation expansion, and dividend generation in equities, the yield trade is in full swing and we expect that with the favorable market technicals and demographics, this will continue. While we have seen both absolute yields and spreads come in as this search for yield has ensued, we are still finding plenty of true high yielding credits available today. This is not 2007 where EVERYTHING in the market was expensive. But discipline and the ability to say "NO" are now at the forefront, especially given the fundamental backdrop.

Ultimately, we expect that performance in the credit markets will be determined by pure alpha, which comes from the ability to select individual credits—the right credits—and to invest in areas others can't or won't. Though risk-off periods will invariably occur, they are likely to be muted in our world, frustrating investors looking to "trade" the high yield asset class. Given the constant income provided, we always view the high yield asset class as a permanent allocation for any portfolio, and that is especially called for in the current environment. Today, investors need to focus on adding value through security selection and maximizing income while minimizing risk.

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[5] Fund restrictions sourced from the ETF prospectus at https://www.spdrs.com/product/fund.seam?ticker=JNK and http://us.ishares.com/product_info/fund/overview/HYG.htm.

[6] Barclays High Yield Index holdings sourced from Barclays Capital, as of August 17, 2012. The Barclays U.S. High Yield Index is an unmanaged index considered representative of the universe of U.S. fixed rate, non-investment grade debt. One cannot invest directly in an index.

Active management in high yield does not show its value when the tide is rising and everything is following the upward trend without discretion. It is only when the cycle turns does it shine, as both credit risks and over-valued situations can be exposed. In investment parlance, the beta trade has ended but the alpha trade is always in vogue in this yield generating asset class.