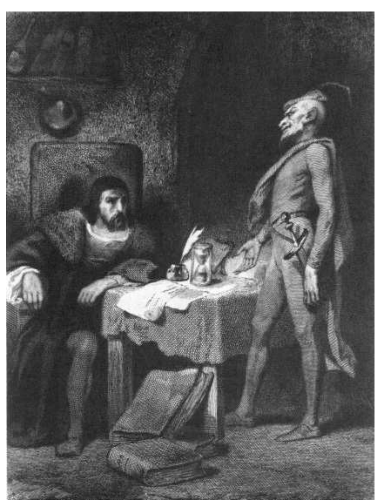
Visceral Need for Yield Leading to a Faustian Bargain

April 28, 2016

Market Overview: Lack of yield across global financial markets has created a number of challenges that lead investors to "pick their poison" and invest in some type of yield / spread product. The incremental yield is certainly not without risk as it requires true credit work and a disciplined approach to portfolio construction. Extreme bifurcation across the market enables investors to source attractive risk on both the long and short side of your portfolio – potentially creating a credit picker's market. While there may be opportunities for the astute investor to generate intelligent returns, we believe the market is a true Faustian bargain at these levels.

Portfolio Construction Implications: While we expect credit to grind higher given the lack of yield alternatives, we believe investors should incrementally reduce exposure into strength. Investors should not over-stay their welcome. Attempting to top-tick the market may mean that you have stayed too long as trading liquidity may not permit investors to elegantly turn your portfolio over. So while there is room for the rally to continue, we believe it makes sense to remain disciplined while incrementally reducing exposure into continued strength.



Executive Summary: Market Overview

Global Search for Yield Intensifying: With Japan and the Eurozone rates markets continuing to hover around and in many cases breach the zero "bound" and the ECB going full steam ahead with its Corporate Sector Purchase Programme (CSPP), yields across global markets are being attacked. This is not a particularly new problem as markets have been intermittently dealing with some version of this dilemma for a few years now. Central bankers have driven rates persistently lower in hopes that the monetary stimulus would enable some type of economic catalyst. While this experiment has yet to create true organic economic growth, yield continually gets sucked out of the global market. The recent strength in the US Treasury (UST) market has only served to intensify this dynamic.

This presents a real challenge for all types of investors (institutional and individuals) as much of conventional portfolio construction is predicated upon the idea that a mixture of fixed income and equity securities could provide a stable, positive return. Endowments, retirees, risk parity funds, insurance companies and pension funds all depend upon fixed income investments to help them meet their return targets. With rates this low, it becomes difficult for those objectives to be met – so anything with yield becomes very enticing.

Why is this important? Recognizing this fundamental and visceral need for yield allows us to frame the "Faustian bargain" that all investors are currently faced with – forgo investment income and sit in cash or pick your poison and reach for some type of spread product.

The ongoing tension that this need for yield creates is likely to have lasting implications for decisions around portfolio construction and security selection going forward. Coupling this "visceral need" with the episodic bouts of illiquidity in the credit markets is like to create sharp bouts of market volatility. Those bouts of market volatility are likely to create opportunity and peril simultaneously.

Having the proper framework to evaluate the macro environment and synthesizing that process with an astute and differentiated security selection process will go a very long way towards generating intelligent returns on behalf of our investors – our primary goal of professional money managers.

Executive Summary: Framing Current Market Scenarios

Bullish Outlook – Sign the Faustian bargain, have faith in Mrs. Yellen and address the "visceral need" for yield

If one were to take Mrs. Yellen and the recent Fed minutes to heart, an investor could convince themselves to aggressively position their portfolio to earn a positive carry as the market grinds tighter into the summer months. They will likely evaluate the "usual suspects" – government bonds, corporate credit, mortgages and structured product. Each asset class has its own story to tell with advantages and disadvantages. In an attempt to briefly summarize a few of the options:

- European Rates: Ongoing European QE has largely eliminated any yield across the government markets.
- UST Rates: Accommodative Fed policy and lack of alternatives emboldening investors despite nearing historic low yields.
- Investment Grade - Europe: Yield likely to become increasingly difficult to source given the CSPP set to commence Jun-2016.
- Investment Grade – US: Room for further spread tightening but likely bounded by low nominal yields
- High Yield – Europe: Despite already trading through US markets, spreads with potential to tighten further
- High Yield - US: Yields of 8.3% look optically attractive but real caution is required given all types of terrifying fundamentals

Given lack of yield in global financial markets, with the soothing reassurances of the US Fed, there is room for credit to continue to tighten. With a "visceral need" for yield, investors should follow the road paved with carry towards the Promised Land and invest in spread product.

Bearish Outlook – "Didn't you see what just happened?"

Fundamentals have not changed tremendously. Oil is off its lows but the economy continues to sputter along unable to truly turn over and generate real growth – continuing to experience "magneto trouble" in the words of Mr. Krugman's hero John Maynard Keynes. Corporate earnings are weak as top line growth is difficult to generate, profit margins are peaking and companies are forced to revert to financial engineering (i.e. buying back stock) to generate EPS growth.

To argue that the markets have turned a corner permanently and are now on a straight glide path towards last spring's spread tights seems aggressive. Given the ongoing deterioration in trading liquidity across the high yield credit markets, we don't need a huge change in the underlying market to shift prices meaningfully – small changes in sentiment and flows can produce very significant changes in the market. As such, it is likely that episodic but extreme spikes in market volatility will prove to be more regular.

Given the difficulty in turning one's portfolio in the midst of that market volatility, investors should consider reducing exposure into strength to better enable them to be a liquidity provider rather than suffer the pain associated with being a liquidity taker during those periods of indigestion.

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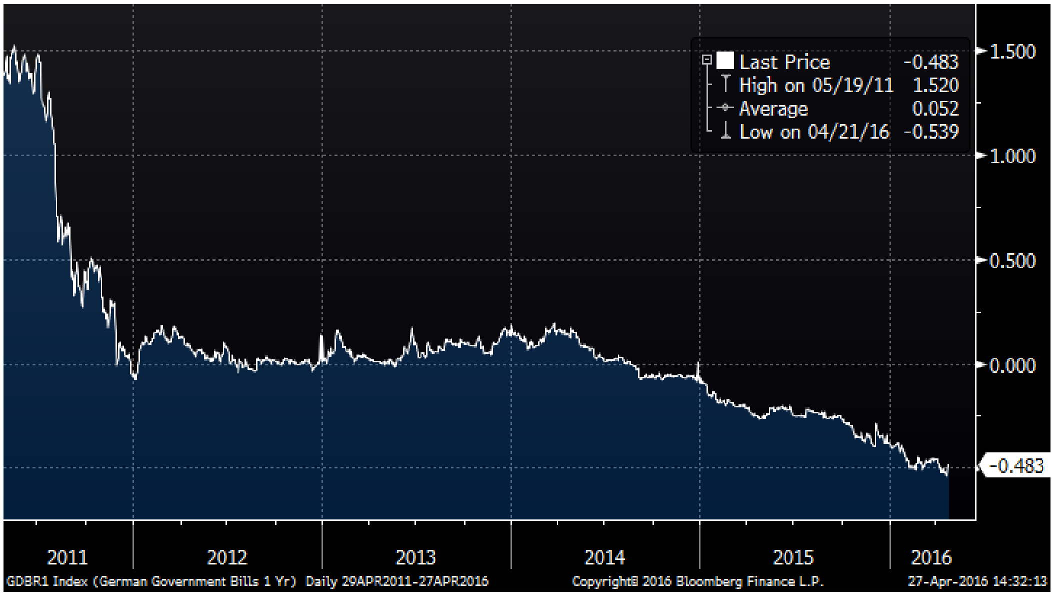
Global Rates: Search for Yield Intensifying

German 1 Year Yield: Firmly in Negative Territory



German 10 Year Bund Yields – Near All-Time Lows

Eurozone rates leaves investors unsatisfied: Global markets continue to search for yield as there is a wide swath of government rates all somewhere in the vicinity of 0%. This conundrum leads investors of all stripes to begin to reconsider where things "can" trade and what prospective rates of returns are likely to be. Japan has long dealt with this problem. With the Eurozone now contributing to the problem, the global search for yield has intensified. This has led to a re-evaluation of the UST market.

UST Market: "Don't Fight the Fed?"

Mrs. Yellen's 29-Mar-2016 speech confirmed what the rest of the global rates markets have already been indicating – that central banks within the US and globally remain committed to accommodative monetary policy. After preparing to remove monetary stimulus and raise rates gradually to a more normalized level, the Fed appears to be on hold. While unemployment has continued its descent, inflation remains stubbornly low. Create some volatility in "oil prices, interest rates and stock values" and plans get delayed.

In true Keynesian manner, Mrs. Yellen went on to refer to the recent drop in longer term interest rates as an "automatic stabilizer for the economy" that would help support consumer spending and partially offset weakness in the global economy. In some of her most direct commentary, Mrs. Yellen indicated that some version of Operation Twist 2.0 may be instituted to maintain policy accommodation without having to reverse course on the planned "gradual" rate hikes.

> ***"One must be careful, however, not to overstate the asymmetries affecting monetary policy at the moment. Even if the federal funds rate were to return to near zero, the FOMC would still have considerable scope to provide additional accommodation. In particular, we could use the approaches*** **that we** ***and other central banks successfully employed in the wake of the financial crisis to put additional downward pressure on long term interest rates and so support the economy--specifically, forward guidance about the future path of the federal funds rate and increases in the size or duration of our holdings of long-term securities. While these tools may entail some risks and costs that do not apply to the federal funds rate, we used them effectively to strengthen the recovery from the Great Recession, and we would do so again if needed."*** **– Janet Yellen**[1]

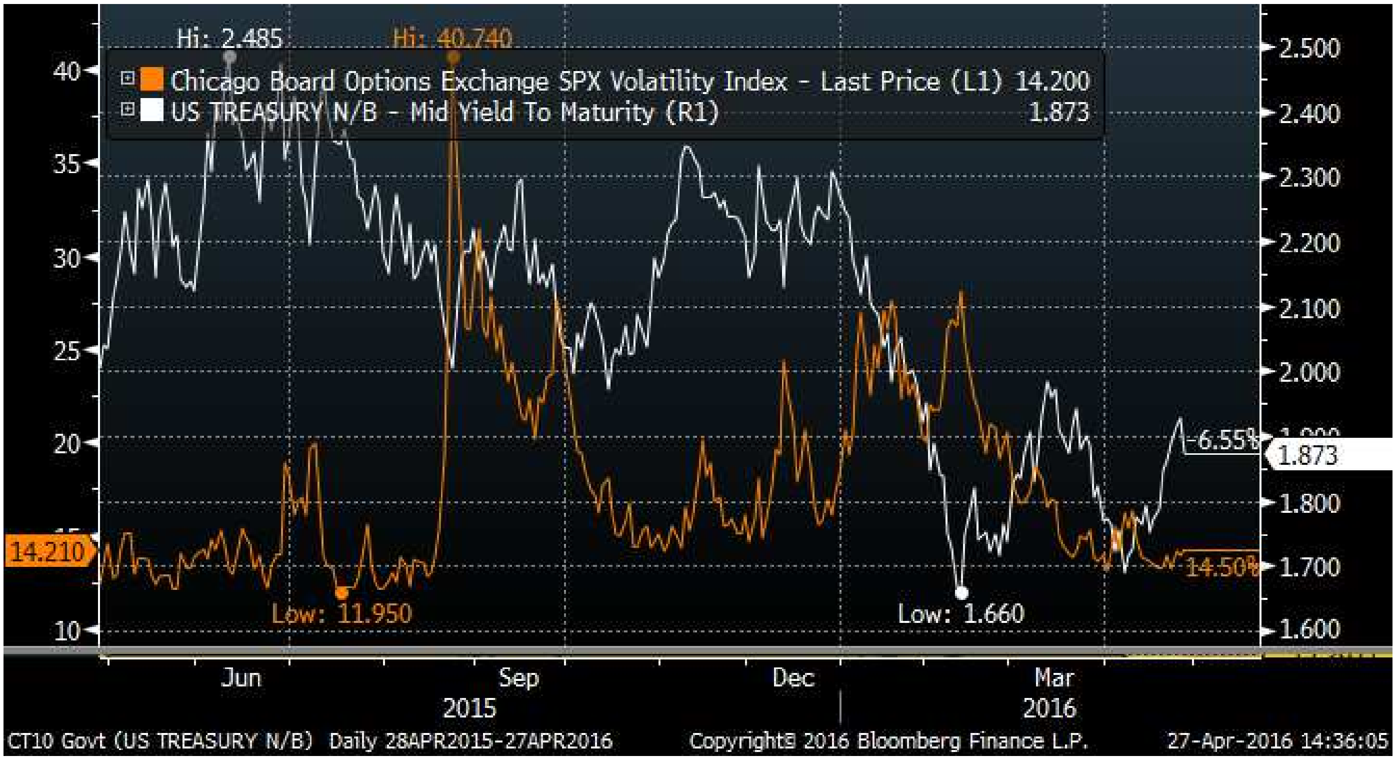
<u>Rationale for a further rally in rates:</u> The combination of limited investable alternatives across developed markets, a "Goldilocks" NFP report, soothing comments from Mrs. Yellen and the recent Fed minutes offered any dove the mental ammunition to argue that the UST market has the ability to set new lows across the yield curve.

UST 10 Year Yield - 5 Year History:

[1] The Outlook, Uncertainty, and Monetary Policy

UST Market: Rate Rally in a Risk-On Environment - Redefining where rates can go to?

UST 10 Year Yield vs. VIX Index:

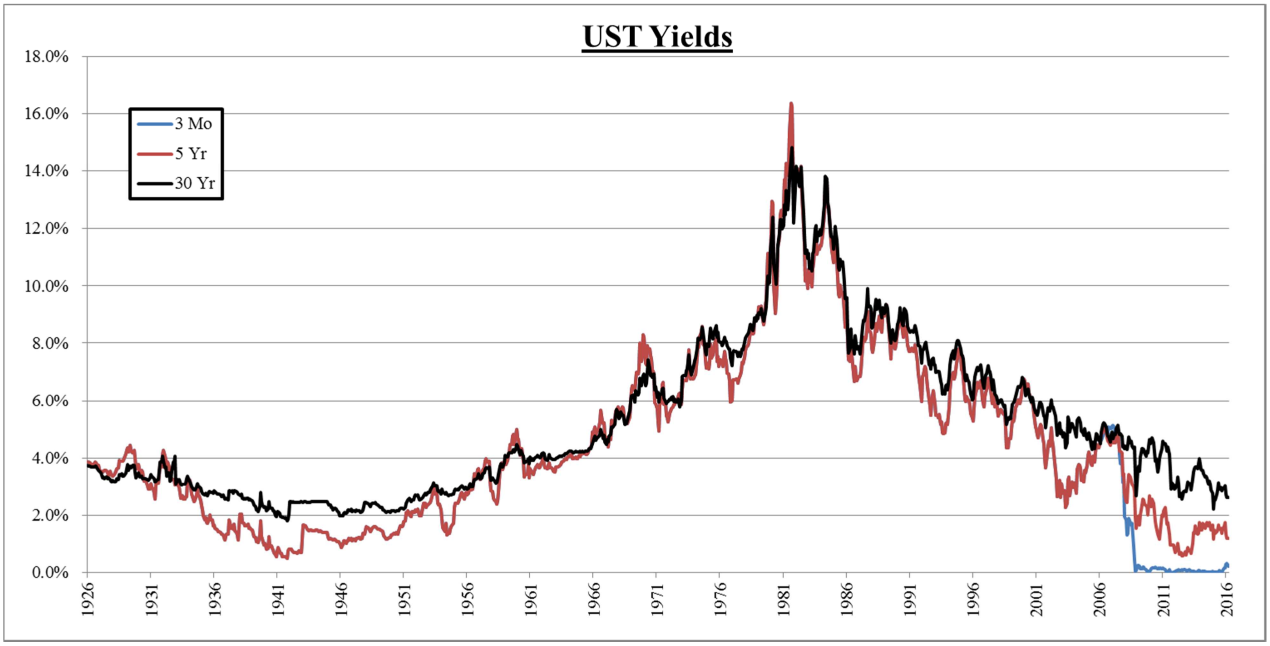


<u>**Implications of a Rate Rally in the midst of a Risk-On Environment:**</u> The chart above comparing the yield on the on-the-run UST 10 year relative to the VIX index is instructive. While off the recent low yields, the UST market remains very well bid. At 1.86% yield on the UST 10 year, we have to go back to the height of QE in 2012 to get to comparable levels for any sustained period of time.

Importantly, current levels do not appear to be the by-product of a flight to quality bid – as was the case in the with the 11-Feb-2016 lows. Given the rally across the rest of the capital markets since those early February lows, it is somewhat telling that yields on longer dated UST bonds are still within 20 bps of those lows despite a material drop in overall risk premiums.

Combining the fundamentals of an accommodative central bank with this shift in the market relationship between rates and volatility make it seem possible that UST rates have the potential to redefine their recent and longer term trading ranges and establish a new low in yields. Is it lunacy to advocate that long term rates still have room to rally? That is a provocative question that will no doubt elicit some impassioned responses but one worth examining.

UST Market: Long Term Perspective on UST Bond Yields



UST Bond Yields	Current		Distribution of Historical Yields				
1926 to 26-Apr-16	Yield	% Dist	0%	25%	50%	75%	100%
3 Mo	0.24%	4%	0.0%	1.7%	3.9%	6.5%	16.4%
5 Yr	1.35%	14%	0.5%	2.0%	3.9%	6.5%	16.4%
30 Yr	2.71%	20%	1.8%	2.9%	4.2%	6.9%	14.8%

Source: Ibbotson Associates and Bloomberg

Can long term rates continue to rally? Some would argue that it is blasphemous to believe that yields can continue their downward trajectory. Looking at the table and graph above, skeptics would make that argument with history on their side.

The short end of the UST curve remains near its all-time lows – driven by central banking policy. Looking further out the curve on longer duration 30 year UST assets, the market very briefly pierced the 2.5% level in early 2015. Beyond that brief moment in time, to get back to current levels, we need to look to the truly dark days of Great Depression (i.e. 1937 when the Fed prematurely tried to remove policy accommodation and the Depression intensified) and World War II (Oct-1941: Low of 1.86% two months prior to the attack on Pearl Harbor).

With rates that are well within the 1st quartile of their historic trading range (near their respective low yields over the last 90 years of trading history) and approaching the zero bound, markets are wrestling with some historic yield levels.

Those are daunting statistics that would make even the most ardent bull take pause and consider how “visceral” that need for yield is. During that moment of introspection, it is useful to examine historical rates of returns as the natural consequence of low nominal yields.

UST Market: Low Nominal UST Yields and Prospective Real Rates of Return -- Caveat Emptor

Period		Yield % : Start		Yield % : Change		Annualized Return %				Annualized Real Return %		
Start	End	5 Yr	30 Yr	5 Yr	30 Yr	3 mo	5 Yr	30 Yr	Inflation	3 mo	5 Yr	30 Yr
1926	1929	3.9%	3.7%	(0.2%)	(0.3%)	2.8%	2.8%	3.0%	(0.7%)	3.5%	3.5%	3.7%
1930	1934	3.6%	3.4%	(1.1%)	(0.5%)	1.0%	4.7%	4.9%	(4.8%)	4.9%	8.1%	8.3%
1935	1939	2.5%	2.9%	(1.5%)	(0.7%)	0.1%	4.5%	4.8%	0.3%	(0.2%)	4.2%	4.5%
1940	1944	**1.0%**	**2.3%**	0.4%	0.2%	0.2%	2.0%	3.0%	4.2%	**(4.8%)**	**(2.6%)**	**(1.4%)**
1945	1949	**1.4%**	**2.5%**	(0.2%)	(0.4%)	0.6%	1.7%	3.5%	4.7%	**(5.0%)**	**(3.7%)**	**(1.5%)**
1950	1954	**1.2%**	**2.1%**	0.5%	0.6%	1.4%	1.7%	1.5%	2.0%	**(0.7%)**	**(0.3%)**	**(0.5%)**
1955	1959	**1.7%**	**2.7%**	3.3%	1.8%	2.3%	1.0%	(1.7%)	1.9%	**0.5%**	**(1.0%)**	**(3.9%)**
1960	1964	5.0%	4.5%	(0.9%)	(0.2%)	2.8%	4.9%	5.2%	1.2%	1.7%	3.8%	4.1%
1965	1969	4.0%	4.2%	4.3%	2.6%	4.9%	2.1%	(2.1%)	3.8%	1.3%	(2.0%)	(7.1%)
1970	1974	8.3%	6.9%	(1.2%)	0.7%	5.9%	8.1%	6.7%	6.6%	(0.9%)	2.0%	0.2%
1975	1979	7.1%	7.6%	3.2%	2.5%	6.7%	5.9%	4.3%	8.2%	(2.0%)	(3.2%)	(5.4%)
1980	1984	**10.3%**	**10.1%**	0.7%	1.6%	11.0%	12.4%	9.8%	6.5%	**5.6%**	**7.3%**	**4.1%**
1985	1989	**11.0%**	**11.7%**	(3.1%)	(3.5%)	6.8%	11.4%	15.5%	3.6%	**3.7%**	**8.7%**	**13.2%**
1990	1994	7.9%	8.2%	(0.1%)	(0.2%)	4.7%	7.5%	8.3%	3.5%	1.4%	4.5%	5.5%
1995	1999	7.8%	8.0%	(1.4%)	(1.2%)	5.1%	7.0%	9.2%	2.4%	3.0%	5.0%	7.4%
2000	2004	6.5%	6.8%	(3.0%)	(2.0%)	2.7%	7.5%	10.3%	2.5%	0.2%	5.4%	8.5%
2005	2009	3.5%	4.8%	(2.6%)	(1.8%)	2.8%	4.9%	5.1%	2.6%	0.3%	2.6%	2.8%

data source: Ibbotson Associates

Looking at real rates of return on the UST market over time is an interesting history lesson. Very real fear associated with the equity market in the aftermath of the Great Depression combined with a sense of patriotism associated with helping to finance the war effort lead investors to drive yields across the UST curve to their all-time lows. Not surprisingly, those yields led to the worst real rates of returns over the last 90 years as inflation picked up meaningfully with WWII and the ensuing economic expansion. While one could argue that the 1940’s are not a good comparison to modern given the influence of WWII and its aftermath (post war reconstruction of Europe and US baby boomers), it is nevertheless instructive to see what can happen to fixed income returns in an environment where rates begin to rise while inflation picks up. So while it is easy to adhere to the old adage of “Don’t Fight the Fed”, a cursory study of market history should cause one to pause as those low yields in the early 1940’s led to two decades of low rates of return and negative real rates of return across the UST market. **Caveat emptor.**

Credit Market Overview: Balancing the "Visceral Need" for Yield with a Challenging Fundamental Market

Faustian Bargain – Investors forced to reach for yield in spread product but accept the potential problems: Investors of all stripes, politicians, policy makers, economists, retirees, pensioners, insurance companies, endowment funds, risk parity investors and corporate issuers are all looking for a "safe" way to generate investment income. Many of the aforementioned business models are predicated upon the idea of generating a stable return via a combination of presumably lower risk fixed income assets and higher return risk assets. With global rates all near their respective lows, the structural lack of yield across global financial markets has created a number of challenges for many of these investors. Those challenges have forced investors to "pick their poison" and invest in some type of spread product. This dynamic has most certainly helped to fuel the recent market rally across both the IG and HY markets and appears likely to remain a fixture in the investment landscape until there is a meaningful shift in monetary policy.

This lack of yield leads investors to a Faustian bargain – whereby investors are forced to choose between satisfying a current need (i.e. yield) at the expense of a long term loss (i.e. drawdown risk). Making the decision to reach aggressively down the credit spectrum in to the HY market and target incremental yield is certainly not without risk as it requires true credit work and a disciplined approach to portfolio construction. There may be opportunities for the astute investor to generate intelligent returns but following the sharp rally of the last 2 months, the cost of associated with signing that bargain are very real.

Longer term HY credit fundamentals remain challenging – incrementally reduce exposure into strength: The current market requires an investor to consider the following challenges: weak corporate earnings, increasing financial leverage, leveraging corporate M&A, shareholder friendly activity, tightening lending standards, rising default rates, an energy sector that remains in disarray, discontinuous markets due to lack of trading liquidity and extreme episodic market volatility.

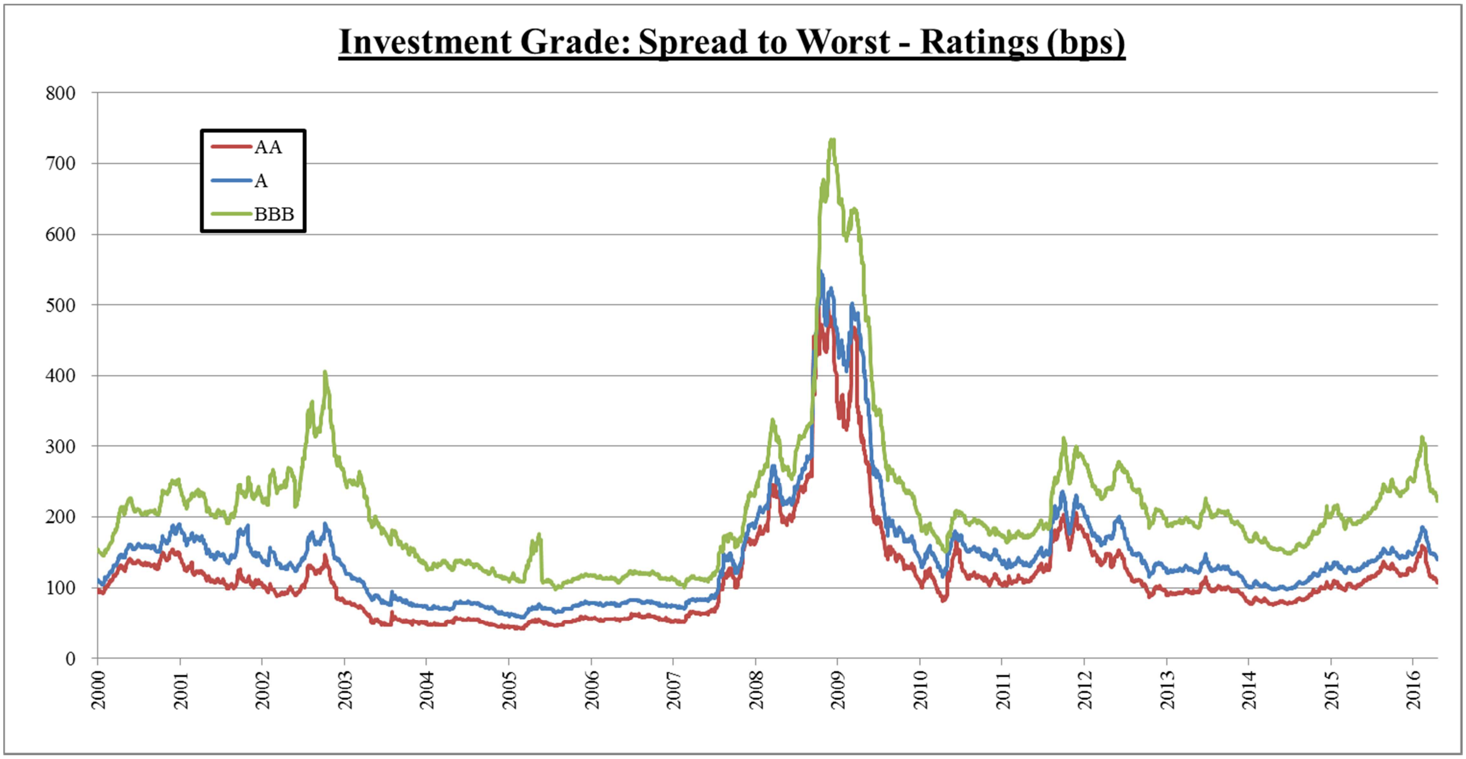
"Leave when you can, not when you have to": While there has been a very sharp rally from the Feb-11th lows and this "visceral need" for yields is real, these remain very challenging markets that have the potential to change very quickly on limited trading volume. Investors should not over-stay their welcome in the high yield market. Attempting to top-tick the market may mean that you have stayed too long as trading liquidity will not permit investors to elegantly shift your portfolio over when the market turns. We believe there is additional room for the rally to continue and spreads to tighten, we believe investors should remain disciplined and incrementally reduce exposure into strength.

Credit Market Overview: Recent Market Levels

												Recent Market History
JPM HY Cash Indices	**Current**		**Local Low**		Change:		**11-Feb-16**	**Local High**		Change:		**04-Nov-15**
26-Apr-16	YTW	STW	YTW	STW	YTW	STW	Return %	YTW	STW	YTW	STW	Return %
HY	8.3%	697	10.5%	924	(219)	(227)	**11.4%**	7.9%	647	36	50	**0.8%**
HY_ex_ENER_METL	7.4%	606	8.9%	776	(156)	(169)		6.9%	547	48	59	
Industry Type												
Cyclical	7.8%	655	9.8%	861	(200)	(206)	9.6%	7.6%	614	29	41	2.3%
Defensive	7.2%	588	8.7%	752	(151)	(164)	7.7%	6.9%	541	32	47	1.9%
Energy	12.9%	1,141	19.0%	1,754	(613)	(613)	30.6%	11.7%	1,007	118	134	**(7.0%)**
Ratings												
IG: AA	2.9%	103	3.2%	160	(29)	(57)	1.7%	3.4%	118	(41)	(15)	3.0%
IG: A	3.4%	134	3.6%	186	(24)	(52)	2.3%	3.7%	142	(30)	(8)	4.2%
IG: BBB	4.1%	213	4.8%	313	(70)	(100)	4.8%	4.6%	230	(43)	(17)	3.9%
BB	5.4%	407	7.4%	617	(193)	(210)	8.2%	5.7%	418	(31)	(11)	1.1%
B	7.7%	646	10.4%	931	(270)	(285)	10.6%	8.1%	674	(38)	(28)	0.4%
CCC	16.8%	1,535	21.6%	1,963	(478)	(428)	**21.6%**	14.4%	1,298	238	237	**(0.5%)**
Ratings Differentials												
IG-HY_Ratings		524		673		(149)			461		64	
BBB-BB_Ratings		194		304		(110)			188		6	
BB-B_Ratings		239		314		(75)			256		(17)	
B-CCC_Ratings		889		1,032		(143)			624		**265**	
Sector												
Food & Beverage	6.6%	543	7.9%	686	(134)	(142)	5.3%	6.8%	556	(24)	(13)	2.5%
Healthcare	6.6%	530	7.9%	674	(132)	(144)	6.2%	6.1%	470	45	60	2.3%
Cable & Satellite	6.4%	485	7.1%	583	(76)	(98)	6.4%	6.1%	443	26	42	3.2%
Consumer Product	6.5%	542	7.6%	656	(106)	(114)	5.8%	5.9%	475	61	67	1.2%
Transportation	10.5%	936	11.8%	1,086	(125)	(150)	7.3%	8.7%	739	188	197	(2.5%)
Diverse Media	7.6%	636	9.4%	833	(176)	(197)	7.4%	7.6%	623	(1)	13	1.6%
Housing	6.9%	565	8.4%	728	(149)	(163)	7.1%	6.5%	514	43	51	2.4%
Financial	6.8%	551	8.4%	725	(158)	(174)	7.0%	6.4%	495	43	56	1.6%
Paper & Packaging	6.7%	540	8.1%	694	(141)	(155)	7.4%	6.9%	543	(20)	(4)	2.3%
Technology	8.1%	682	9.4%	814	(125)	(132)	7.8%	6.8%	547	131	135	1.0%
Telecom	8.2%	677	9.7%	836	(142)	(159)	8.9%	7.5%	583	76	94	0.2%
Auto	6.1%	483	8.1%	693	(199)	(210)	8.8%	5.8%	459	26	24	2.6%
Utility	7.4%	610	9.6%	840	(220)	(230)	10.0%	7.2%	554	25	56	2.6%
Gaming & Leisure	6.6%	531	8.3%	714	(171)	(183)	9.0%	6.6%	521	(6)	10	3.5%
Retail	8.4%	718	9.9%	871	(146)	(153)	8.9%	7.3%	591	109	127	1.5%
Broadcasting	8.4%	719	10.5%	934	(209)	(215)	9.6%	7.6%	620	82	99	0.1%
Industrial	9.0%	730	10.9%	948	(196)	(218)	10.5%	8.3%	686	63	44	1.9%
Services	7.9%	663	10.2%	897	(232)	(234)	10.2%	7.6%	635	24	28	2.3%
Chemical	8.4%	717	11.2%	1,003	(272)	(286)	**13.2%**	8.3%	685	15	32	4.2%
Metal & Mining	10.8%	951	16.8%	1,488	(597)	(537)	**22.0%**	13.2%	1,156	(241)	(205)	6.1%
Energy	12.9%	1,141	19.0%	1,754	(613)	(613)	**30.6%**	11.7%	1,007	118	134	(7.0%)

source: JP Morgan JULI US High Grade Index and JP Morgan High Yield Index

IG Spreads: Room for Spreads to Tighten Further but Getting Tougher to Justify



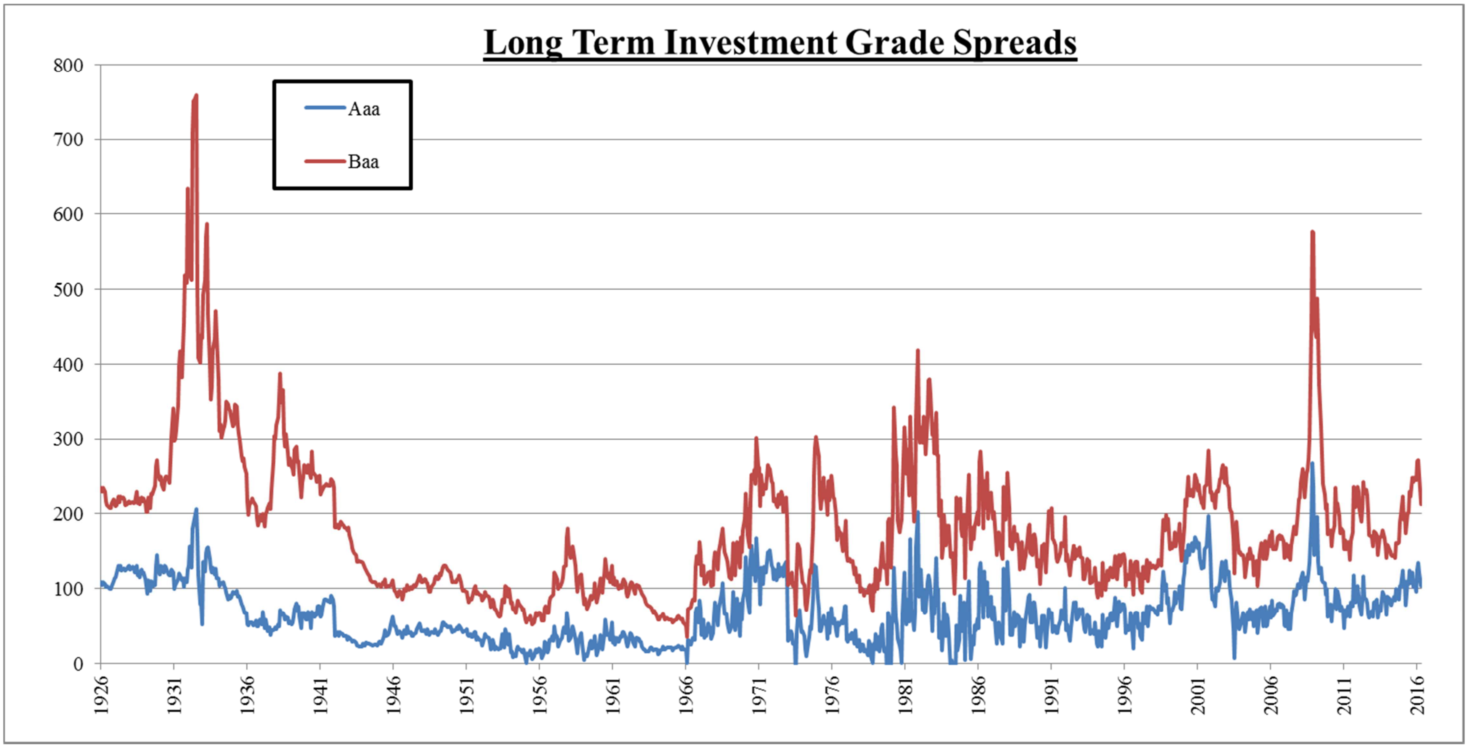
IG Spread History	**Current**		**Distribution of Historical Spreads**				
2000 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
IG: JULI	173	58%	79	123	163	193	542
IG: AA	103	49%	42	65	104	129	508
IG: A	134	50%	58	88	134	163	548
IG: BBB	213	59%	97	155	197	242	735

source: JP Morgan JULI US High Grade Index

Near Term Perspective: After tightening materially from the Feb-2016 lows, the IG markets are re-testing the Nov-2015 tights. Given the lack of spread product globally, IG credit is a very natural focal point in today's world. While the BBB's are tricky given the risk associated with being downgraded to HY, it is understandable that investors look to AA and A credits for excess spread opportunities during periods of macro weakness. Given the need for spread product, there appears to be room for further tightening but it is getting more difficult to be extremely excited given the strength of the recent rally.

Long Term Perspective: Clearly there are lots of relevant concerns to address here. Any view on further spread tightening will be colored by your confidence in the broad macro landscape, monetary policy and general risk premiums. Looking statistically, it is arguable that given the need for yield in today's world, IG spreads are still too wide sitting in the 3rd quartile of the historical spread distribution.

IG Spreads: Longer Term Perspective Feeds Optimism Around Further Tightening Potential

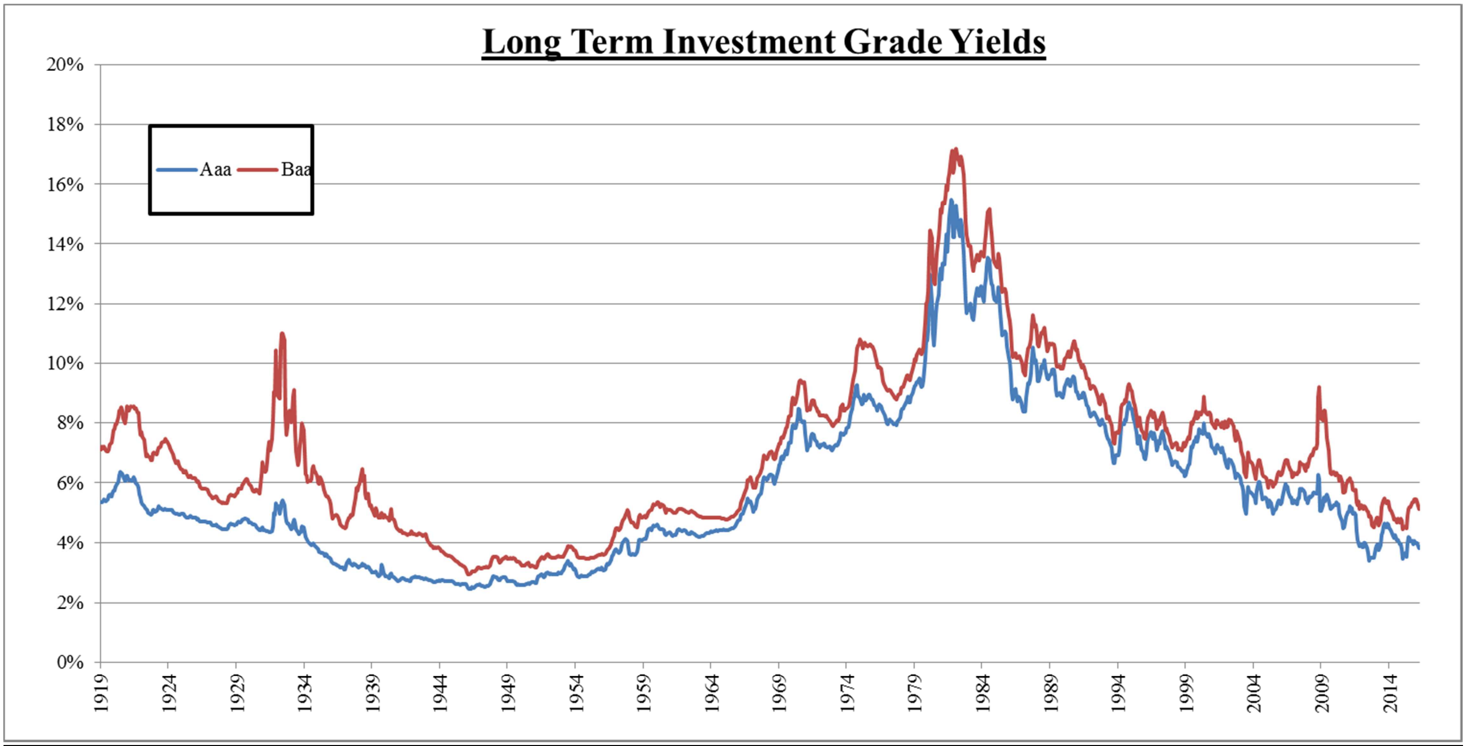


IG Bond Spreads	Current		Distribution of Historical Yields				
1926 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
Aaa	103	77%	(53)	37	58	90	268
Baa	213	70%	35	112	159	224	759

Source: US Federal Reserve & Ibbotson

Longer term spread statistics tell similar story: Current levels have spreads sitting near in the fourth quartile of historical spread distribution. Again, in a risk-on environment where investors are looking for incremental yield, there is likely room for further spread compression. The problem spot will likely be all-in yields.

IG Yields: Can't Escape the Impact of Low UST Yields



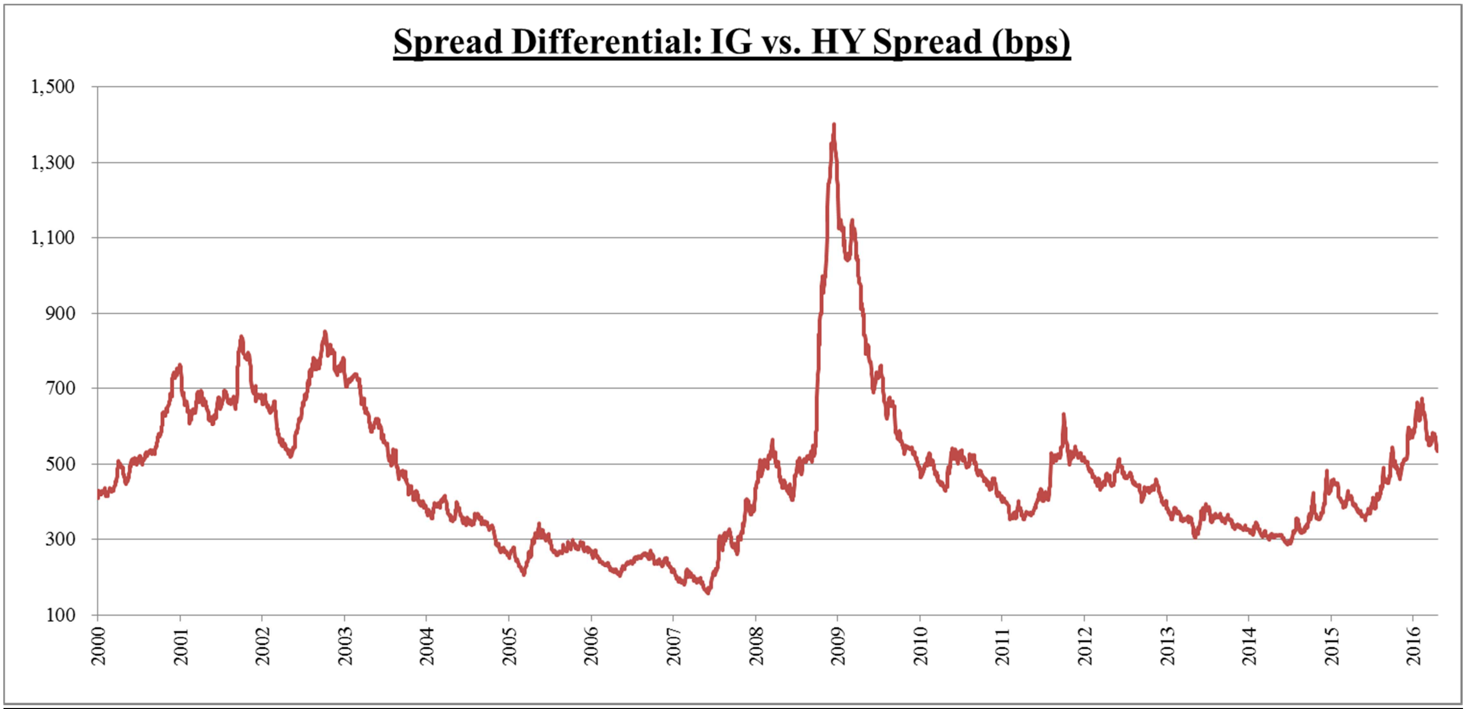
IG Bond Yields: 30 Year	**Current**		**Distribution of Historical Yields**				
1919 to 26-Apr-16	Yield	% Dist	0%	25%	50%	75%	100%
Aaa	3.7%	23%	2.5%	3.8%	5.1%	7.5%	15.5%
Baa	4.8%	24%	2.9%	4.9%	6.4%	8.4%	17.2%

Source: US Federal Reserve

Low yields are a gating factor for further rally in investment grade corporates: Similar to the UST market, investors need to look back to 50+ years to get to a time when the IG corporates were inside 5% yields on Baa paper. This lack of yield across markets may require all types of sub-optimal decision making in the interest of return optimization. Determining the inflection point where generating any yield no longer outweighs the benefits of simply sitting in cash will likely go a long a way in helping to guide portfolio construction and tactical trading strategies. So while there may be opportunities in the current market and room for further spread compression, I think we are getting close to that indifference point on absolute yields in the IG market.

IG yields during the 2008 Financial Crisis looks like a "blip" relative to the inflationary crisis of the late 1970's / early 1980's: This chart provides another interesting history lesson with regards to the 2008 Financial Crisis as the spike in yields was dwarfed relative to the impact of the inflationary pressures in the 1970's that drove UST rates towards 15% on the long end of the curve.

IG vs. HY Spread Differential: Are you willing to sign the Faustian Bargain?



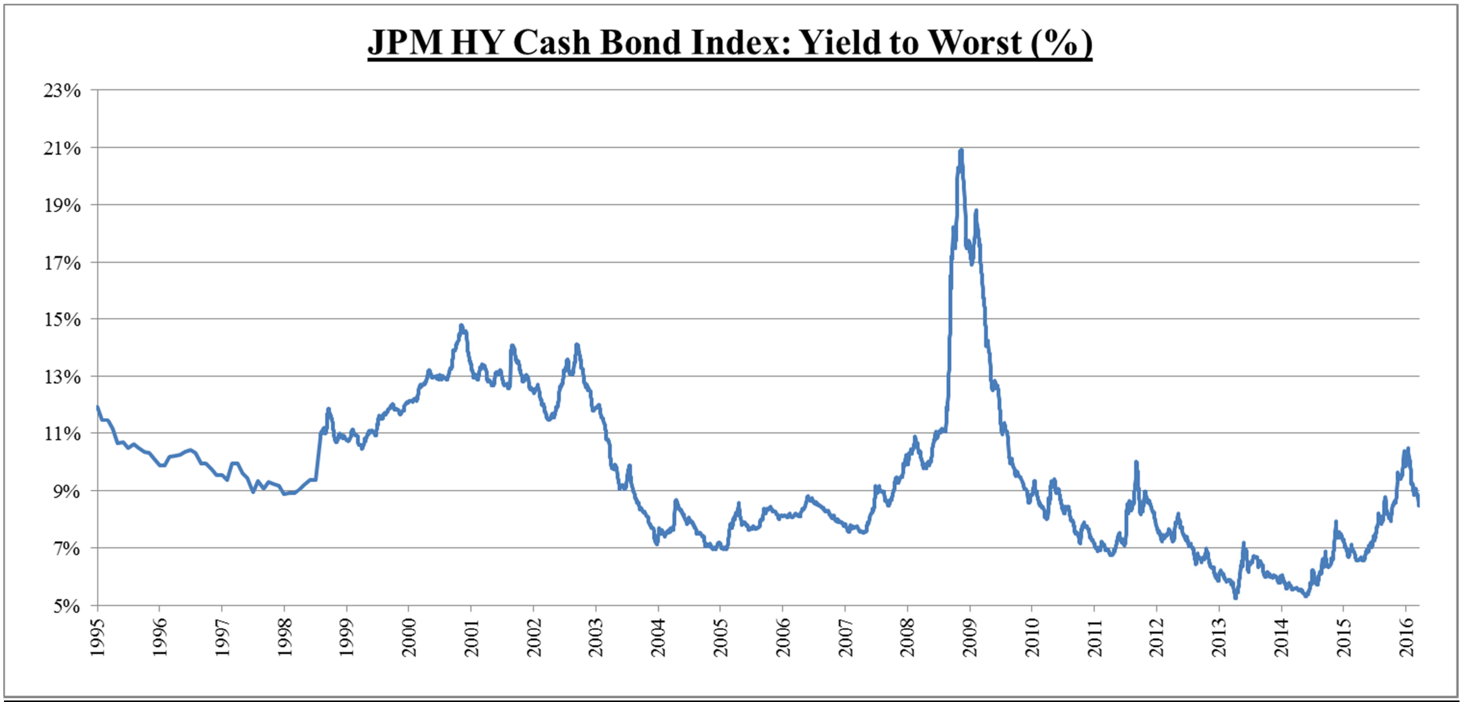
Credit Mkt Spread History	Current		Distribution of Historical Spreads				
2000 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
IG: JULI	173	58%	79	123	163	193	542
HY	697	67%	263	471	594	742	1,925
IG-HY_Ratings	524	69%	157	340	441	549	1,404

source: JP Morgan JULI US High Grade Index and JP Morgan High Yield Index

Defining the Faustian Bargain: Bearing the incremental risk associated with going from IG to HY requires some thought as it carries with it some very real tradeoffs – in theory you get to generate incremental yield but that yield carries with it incremental credit risk, higher volatility and reduced trading liquidity. A true Faustian bargain requiring real thought.

How far are you willing to go to generate a return? Picking up an incremental 525 bps going from the IG index to the HY market is substantial – particularly in a world with very low all in yields. Looking historically, it appears we are towards the wider end of the relationship which is not surprising given the current market conditions. The question remains how far are investors willing to go to pick up that incremental yield. How much do they truly “need” that income?

HY Market: 8.3% Yields are interesting in a Yield-Starved Environment but can you find it?



HY Market History	Current		Distribution of Historical Spreads				
1994 to 26-Apr-16	HY	% Dist	0%	25%	50%	75%	100%
YTW	8.30%	45%	5.2%	7.5%	8.5%	11.5%	20.9%
STW	697	67%	263	471	594	742	1,925

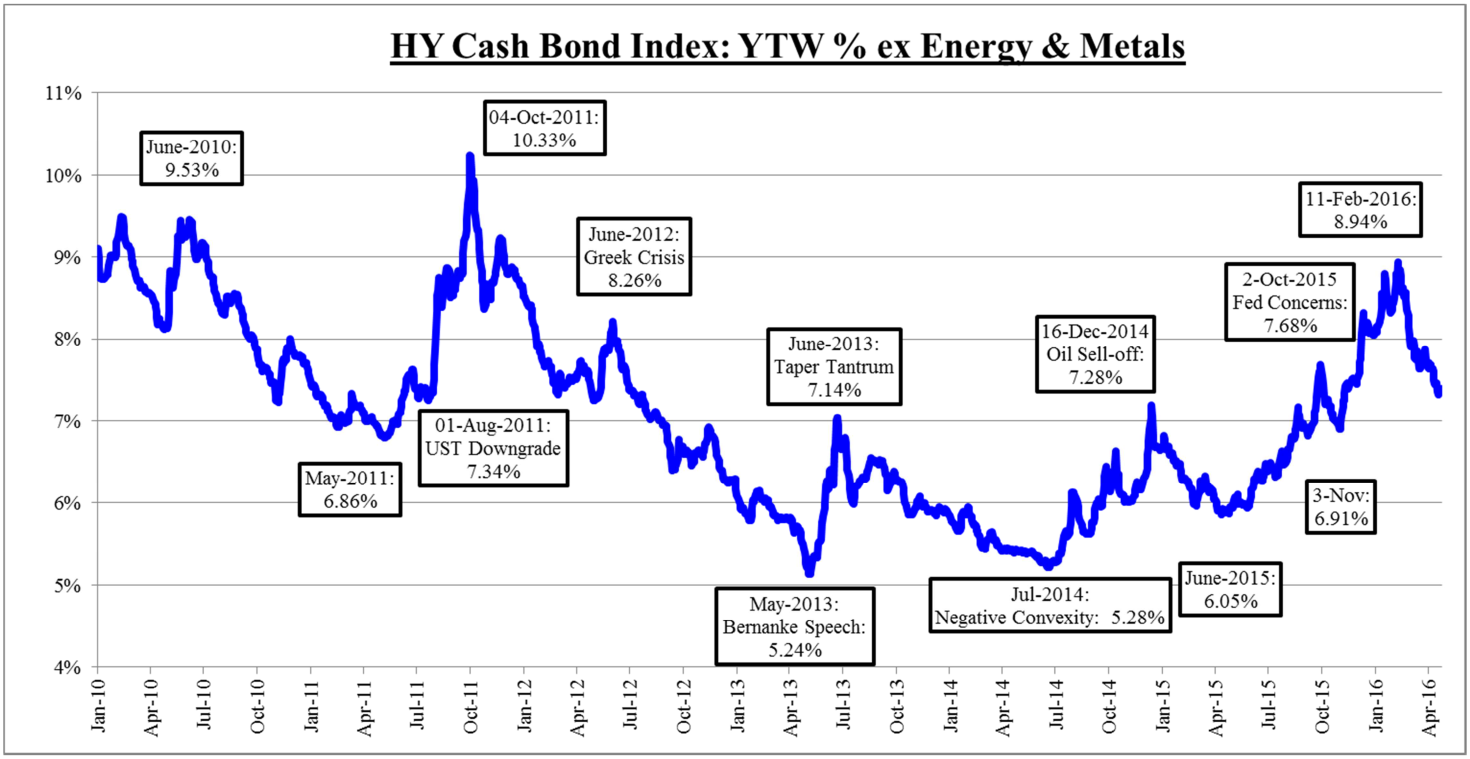
source: JP Morgan High Yield Index

8.3% yield appears optically attractive: The idea of generating 8-8.5% yields in HY credit sounds to be very appealing on the surface – but is actually very difficult to source. Two problems with this idea:

(i) Influence of the Energy and Metals & Mining Sectors Continues to Skew Data: As the table on page 9 demonstrates, the Energy and Metals sectors trade materially wider than the rest of the HY universe making it difficult to evaluate the yield on the broad index.

(ii) Bifurcation across the market is extreme: Looking even further within industry segments, there is a very significant bifurcation between the "haves" and "have-nots". After being beaten soundly over the last 12 months, many investors remain in capital preservation mode and are hiding in "safe" credits that won't cause obvious credit problems. The problem is that they are truly paying up for those credits – much of the high yield universe trades in the 5-7% yield range. Alternatively, anything with any type of credit concern trades at a material discount to the broader market.

HY Index Ex Energy & Metals and Mining YTW %: Less Attractive Following Recent Rally

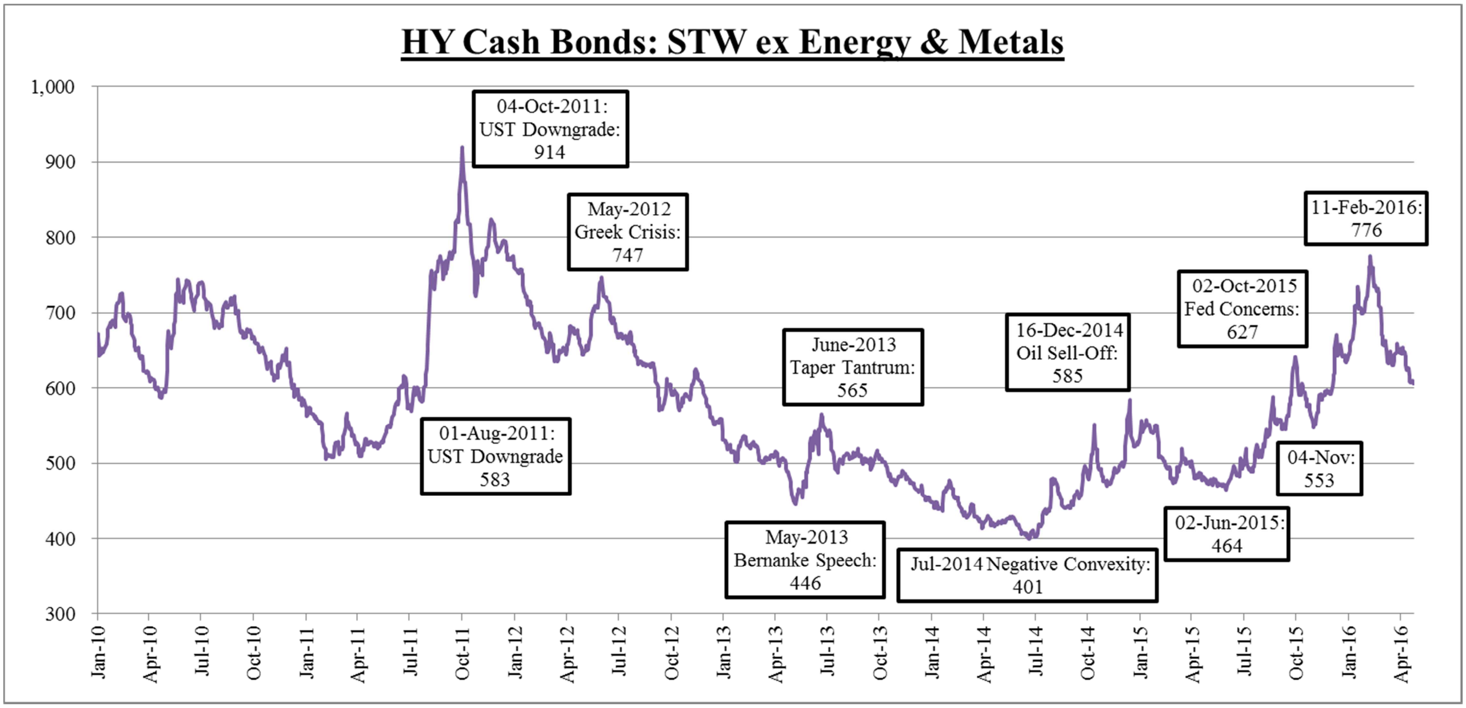


HY YTW History	Current		Distribution of Historical Spreads				
1994 to 26-Apr-16	YTW	% Dist	0%	25%	50%	75%	100%
HY	8.30%	45%	5.2%	7.5%	8.5%	11.5%	20.9%
HY_Base	7.38%	27%	5.2%	7.3%	8.4%	11.1%	21.2%

source: JP Morgan High Yield Index

HY YTW % Ex Energy and Metals is less appealing: Once we strip out the energy and metals sectors, the HY index heads back in the low 7% range. Looking historically, that level is fast approaching the 1st quartile of the historical yield distribution. That is a material difference when considering the fundamental risks that you are accepting in today's market. So the market is not quite as exciting as it looks on the surface – part of the Faustian bargain that an investor accepts in the quest for incremental yield.

HY Index Ex Energy & Metals & Mining STW (bps): Spreads still wide but further tightening more difficult



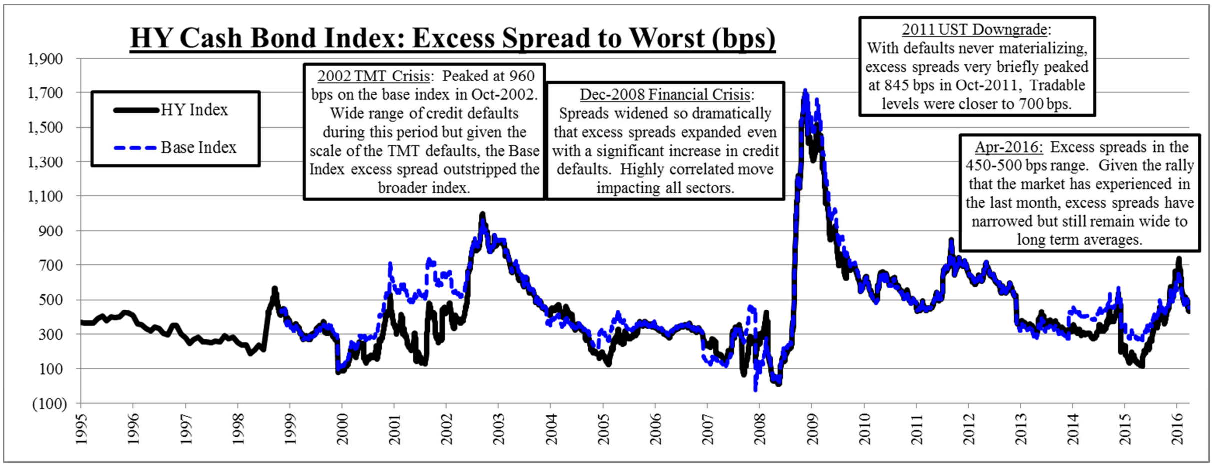
HY STW History	Current		Distribution of Historical Spreads				
1994 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
HY	697	67%	263	471	594	742	1,925
HY_Base	606	53%	263	470	586	721	1,944

source: JP Morgan High Yield Index

HY ex energy & metals can grind higher but expect spread tightening to be more modest given strength of the recent rally: Given the ongoing search for yield and lack of alternatives in rate product, we believe investors will be forced to sign the Faustian bargain and look for yield amidst the HY market. This dynamic is likely to support further spread tightening but we anticipate the pace to slow given dollar-priced and yield constraints following the recent rally. Importantly, this move in rates will likely impact the BB's the most directly – ultimately causing further bifurcation in the HY credit market.

Is HY even a spread product? This is somewhat of a philosophical question but an important one nonetheless as it drives investment allocations across the credit spectrum. During good times when markets are open and yields are low, investors can begin to justify positions in HY based on spread. During normal times, yield becomes the primary barometer for the asset class. And during bad times, "high level" mathematical concepts of yields and spreads are cast aside in favor of good old-fashioned price. Clearly that is a bit of an over-simplification as effective sensitivity to the UST market will remain dependent on the underlying credit, rating and price range. As noted above, longer duration, higher quality BB's will exhibit much higher effective spread DV01 than dollar priced CCC exposure.

HY Index: Excess Spread – Less attractive following recent rally



HY Excess Spread	**Current**		**Distribution of Historical Excess Spreads**				
1994 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
HY	431	59%	11	284	362	555	1,694
HY_Base	454	55%	(29)	324	421	590	1,716

source: JP Morgan High Yield Index and internal estimates

	HY Index: Default Scenarios						**Base Index: Default Scenarios**					
Excess Spread	Current	Low		Mid		High	Current	Low		Mid		High
Current Spread	697	697	697	697	697	697	606	606	606	606	606	606
Expected Loss	(266)	(190)	(228)	(266)	(304)	(342)	(152)	(114)	(133)	(152)	(171)	(190)
Excess Spread	431	507	469	431	393	355	454	492	473	454	435	416
Default Rate	7.0%	5.0%	6.0%	7.0%	8.0%	9.0%	4.0%	3.0%	3.5%	4.0%	4.5%	5.0%
Loss Given Default	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)
Expected Loss	(266)	(190)	(228)	(266)	(304)	(342)	(152)	(114)	(133)	(152)	(171)	(190)
CCC Price	68%	68%	68%	68%	68%	68%	68%	68%	68%	68%	68%	68%
Recovery Rate	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%
Loss Given Default	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)	(38%)

source: JP Morgan High Yield Index and internal estimates

Excess Spread on HY Index: To properly evaluate current spreads in the context of prior market sell-offs, it is helpful to analyze the "excess spread" embedded in the market. As the tables above detail, excess spread is calculated by taking the current spread on the market and adjusting for the impact of the forward 12 month defaults and loss given defaults. We have done this analysis on the broader HY market and the Base Index.

Excess Spread – Current Levels: Assuming a 7% forward default rate and a 30% recovery rate on the HY index (inclusion of energy and metals), the current excess spread is roughly 430 bps on the HY Index. At current levels, the excess spread is wider than the historical average and median statistics but considerably less attractive following the recent market rally. Excluding the Energy sector, excess spreads on the Base HY market are at similar levels. Assuming a 4% forward default rates with a 30% recovery rate, the excess spread is roughly 450 bps – again wide of historical statistics but materially tighter over the last 2 months.

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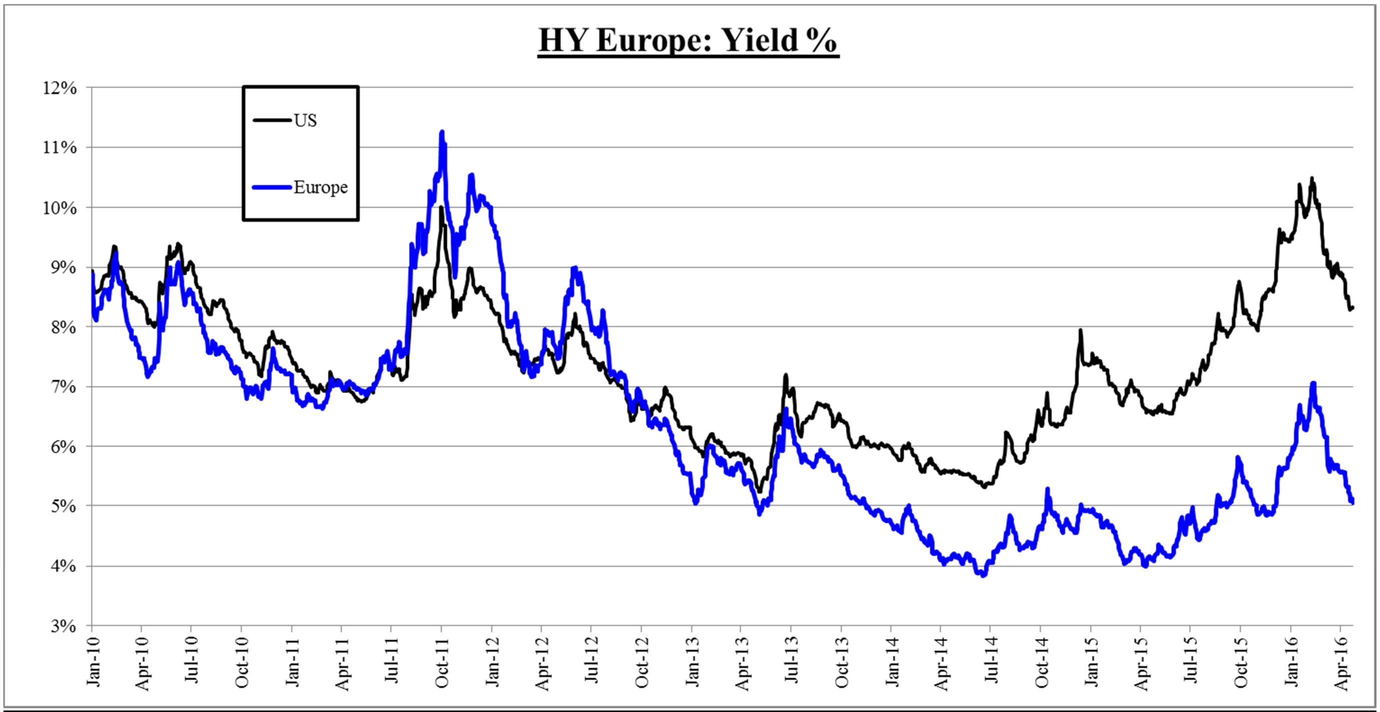
HY Index: US vs. European Yield %



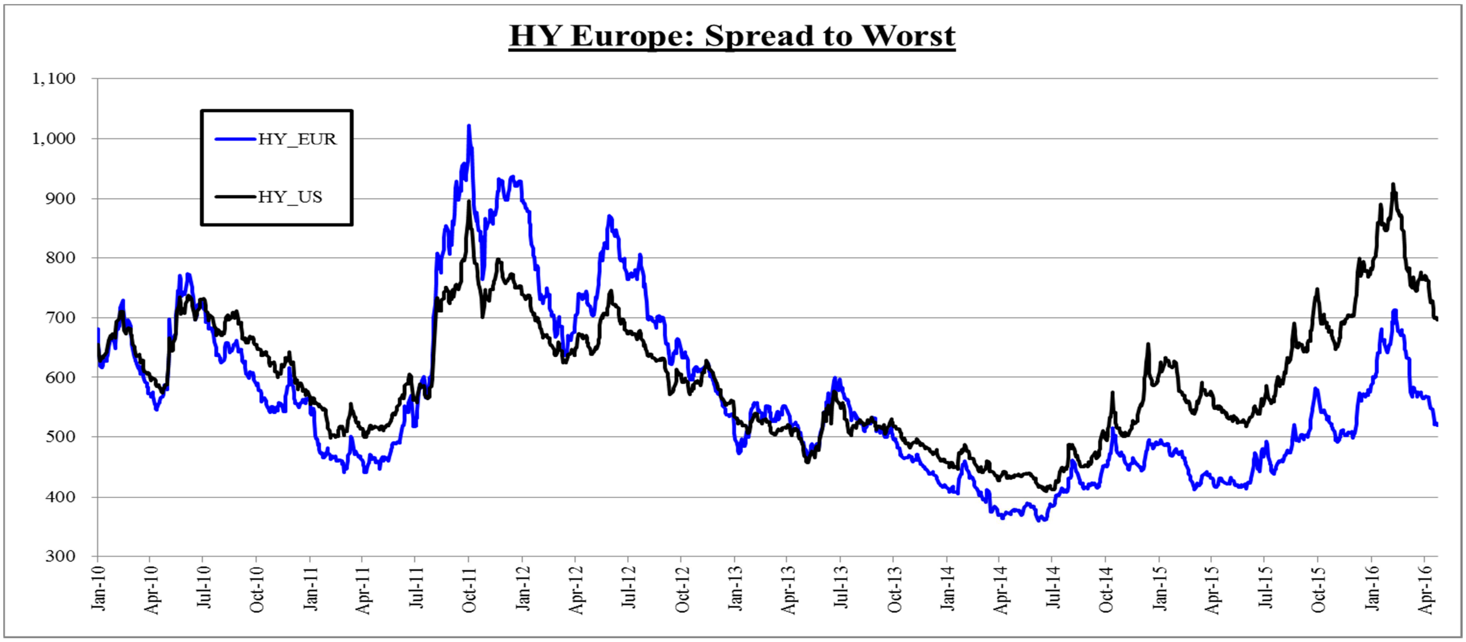
HY Yield % History	**Current**		**Distribution of Historical Spreads**				
2000 to 26-Apr-16	YTW	% Dist	0%	25%	50%	75%	100%
HY	8.3%	45%	5.2%	7.5%	8.5%	11.5%	20.9%
HY_EUR	5.1%	13%	3.8%	6.2%	7.5%	11.2%	25.3%

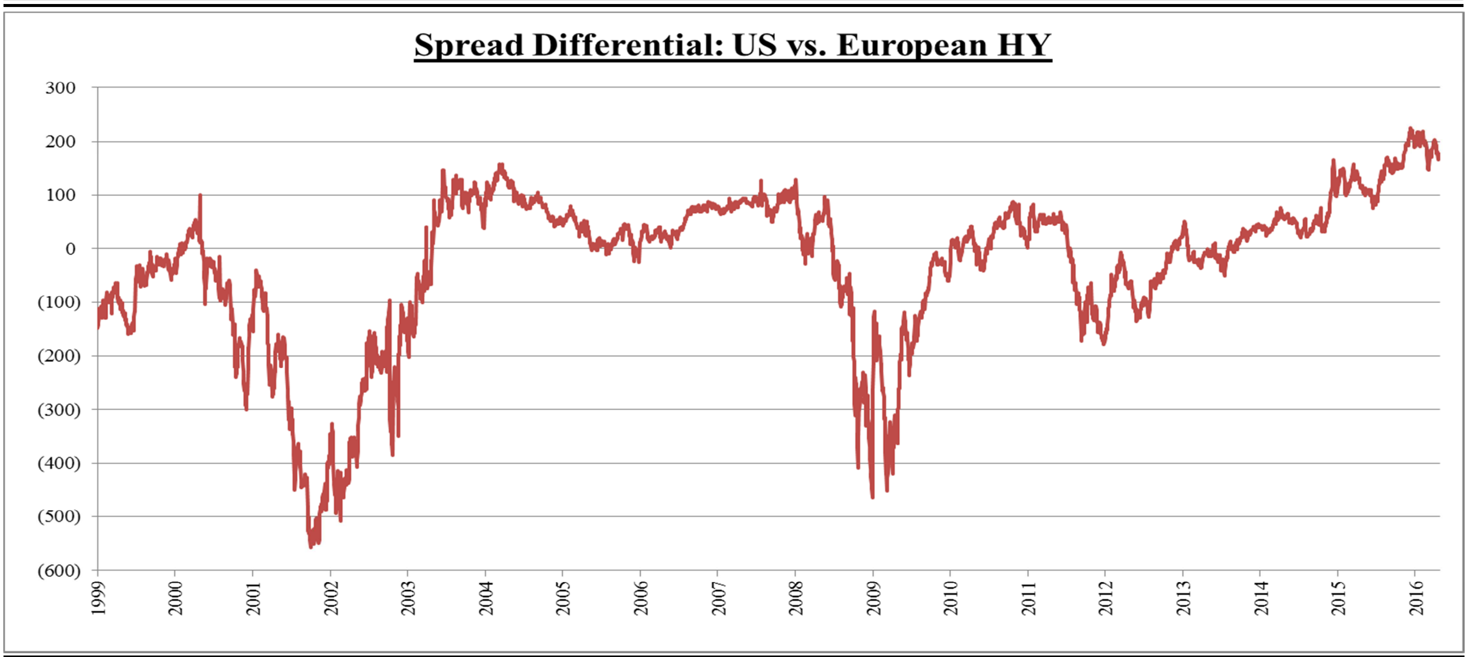
Source: JP Morgan High Yield Index and JP Morgan Euro High Yield Index

European HY Market – Yield disappearing systematically: While 5.1% on the European HY index low by historical standards, given that the majority of the European rates market continues to hover around 0%, European corporates offer investors some much needed yield. As the graphs and table on the next page indicate, even with yields on European HY corporates near their historic lows, spreads across the European market are materially tighter than the US high yield market. While this is partially a function of more limited exposure to the energy sector, spreads across the non-energy sectors within the European high yield market are also trading through their US counterparts. With upcoming implementation of the Corporate Sector Purchase Programme (CSPP) to provide a strong tailwind for corporate credit across continent, European spreads have the potential to rally further despite trading materially tighter than the US market.

Implication for US Market: With the ECB scheduled to begin purchases of investment grade corporate securities in June-2016, this initiative will only serve to reinforce the demand for yield across global markets – providing a positive technical for spreads within the US investment grade and HY market.

HY Index: US vs. European Spread Differential





HY Spread History	**Current**		**Distribution of Historical Spreads**				
2000 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
HY	697	67%	263	471	594	742	1,925
HY_EUR	520	41%	179	414	572	799	2,255
HY_EUR_vs_US	177	92%	(557)	(89)	14	69	225

Source: JP Morgan High Yield Index and JP Morgan Euro High Yield Index

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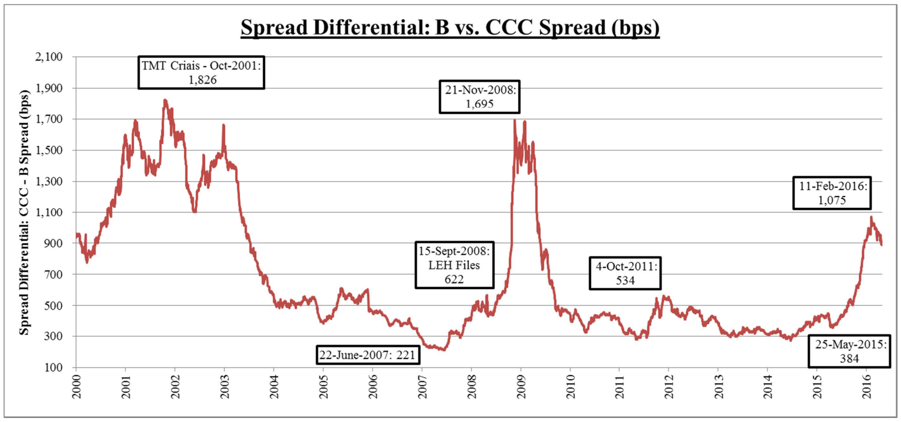
HY Index: B vs. CCC spread differential creating a credit picker's market



HY Spread History	Current		Distribution of Historical Spreads				
1994 to 26-Apr-16	Spread	% Dist	0%	25%	50%	75%	100%
B	646	59%	251	472	603	728	1,866
CCC	1,535	73%	466	887	1,120	1,556	3,382
B-CCC_Ratings	889	73%	210	389	504	914	1,826

source: JP Morgan High Yield Index

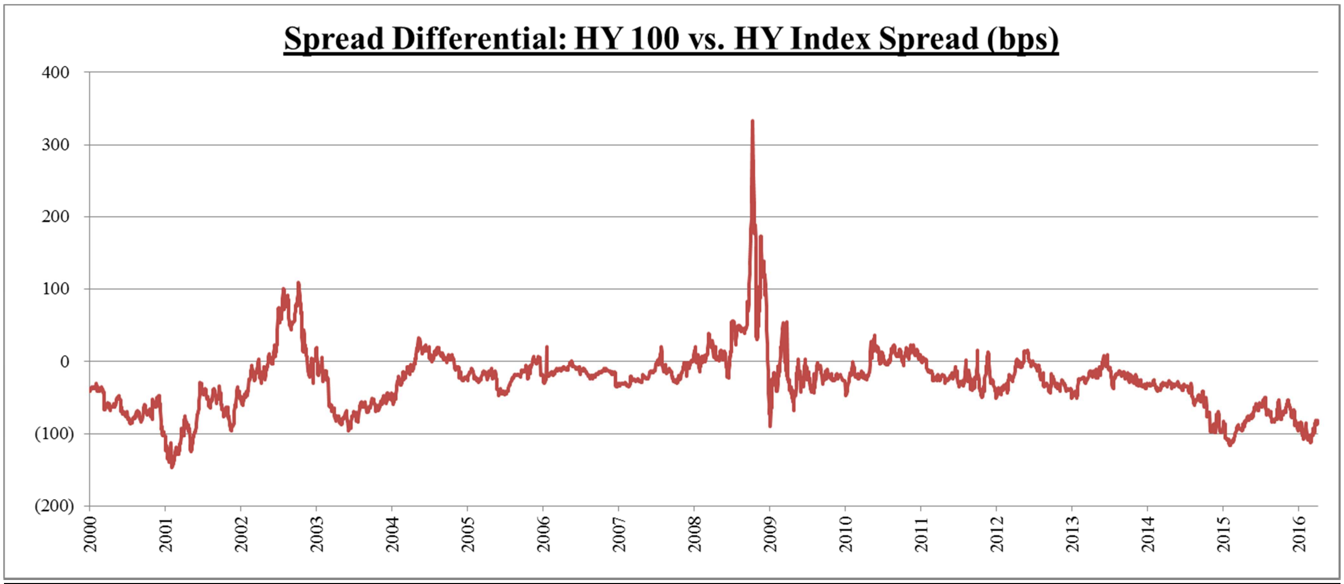
The bargain that few are willing / capable of making: While there has been some spread compression from the 11-Feb lows, credit spread differentials remain extremely wide across the market. This dynamic may continue to create a "Credit Picker's Market" that may provide a target rich environment for a fundamental long-short credit strategy capable of properly evaluating credit risk. Considerations:

(i) Fundamental Credit Deterioration: This broad rise in credit spread differentials makes intuitive sense – as the fundamental macro environment deteriorates and risk rises, the risk premiums associated with the weaker credits should rise disproportionately. This dynamic is consistent with the performance of the most leveraged equities significantly underperforming the broader market (i.e. HYG equities vs. SPX Index).

(ii) Onerous Regulatory Capital Requirements: While there is fundamental justification for this steepening, regulatory changes have made it more onerous for financial institutions to own CCC risk (i.e. higher capital requirements). With higher capital requirements, it is logical that the unleveraged return on the underlying asset needs to rise to justify holding a position. This dynamic has effectively turned the CCC segment of the market into an "orphaned" asset class -- providing the potential for an interesting investment opportunity for those with flexible investment mandates and the capability of thoroughly analyzing underlying credit fundamentals.

(iii) Deteriorating Trading Liquidity: Exacerbating the impact of higher capital charges, more stringent regulatory oversight has largely eliminated proprietary risk-taking within the dealer community and shifted their operations to an agency based business model. While this shift in policy has limited the risk within large financial institutions, the most significant unintended consequence of this policy action is the reduction in trading liquidity. This dynamic has most certainly contributed to this increase in spread differentials.

HY Index: Analyzing the Expanding Liquidity Premium Embedded in the Market



HY Spread History 2000 to 26-Apr-16	Current Spread	Current % Dist	Distribution of Historical Spreads 0%	25%	50%	75%	100%
HY100	608	57%	244	450	565	709	2,029
HY	697	67%	263	471	594	742	1,925
Differential	(89)	15%	(147)	(50)	(24)	(9)	333

source: JP Morgan High Yield Index

<u>HY Index: "Liquid" bonds trade at meaningful premium – again potentially creating a credit picker's market</u>: The JPM HY 100 represents the most liquid subset of the broad HY market. In the analysis on the prior page, we examine the effective liquidity premium embedded in the HY market by looking at the spread differential between the between the HY100 and the broader HY index

Similar to the widening B-CCC spread differentials, the premium associated with liquidity has structurally expanded over the last 3 years. As indicated in the graph and table above, the spread differential currently sits at (89 bps) or the 15 percentile of the historical distribution. While this dynamic makes intuitive sense given the structural changes in the HY market (i.e. more onerous capital requirements and deteriorating trading liquidity), we believe that the credit market has begun to over-pay for perceived liquidity.

During periods of market stress, correlations trend towards 1.0 with liquidity across all bonds deteriorating in tandem – reducing the effective value of this perceived liquidity. Compounding this dynamic, securities that are perceived to be liquid typically bear the brunt of the actual selling pressure during periods of market turmoil as investors rely upon those positions to raise cash. While perceived liquidity in HY securities is most certainly of value, there is an appropriate price to be paid for that privilege. <u>At current levels, this dynamic is providing the potential for interesting investment opportunities for an astute credit picker with a broad mandate.</u>

HY Index: HY Credit Market Correlation to Oil - "Baby with the Bathwater" Scenario

JPM HY Total Return Index vs. WTI 1 Month with 30 Day Correlation

Date	Oil: WTI	HY: Index			HY: Energy			HY: Defensive		
	Price	YTW	Spread	30D Correl	YTW	Spread	30D Correl	YTW	Spread	30D Correl
30-Aug-15	45.22	7.94%	652	**0.63**	11.56%	996	**0.71**	**6.72%**	**528**	**0.60**
02-Oct-15	45.54	8.76%	748	0.42	12.85%	1,147	0.45	7.64%	629	0.38
04-Nov-15	46.32	7.94%	647	0.23	11.68%	1,007	0.20	6.90%	541	0.26
11-Feb-16	26.21	10.49%	924	**0.65**	18.98%	1,754	**0.63**	**8.72%**	**752**	**0.61**
26-Apr-16	44.04	8.30%	697	0.35	12.86%	1,141	0.47	7.22%	588	0.26

source: JP Morgan High Yield Cash Index and Bloomberg

Correlations – Causal or Coincident? Looking at the rolling 30 day correlation of WTI prices and the various HY cash bond indices above, it is clear that at various points of the last year, it seemed as if the only thing that "mattered" within the HY market were oil prices. Correlations peaked in Aug-2015 at .63 for the HY index. That made intuitive and statistical sense in the early stages of the HY market sell-off given the high sector weighting and tighter spreads across the energy sector.

Aug-2015 – Causal: Fully recognizing that correlations across all types of asset pricing tend to head towards 1.0 during periods of market turmoil, examining the 30 day correlation of oil to the Defensive segment of the HY market is instructive. Similar to the HY market, that sector correlation peaked in Aug-2015 as the energy contagion "spread" across the rest of the market. Given yields on the HY Defensive index in the 6.5% range at that point, that correlation made sense as overall valuation levels were not compelling enough to incentivize investors to take idiosyncratic credit risk. The correlation was essentially causal – making it rational to reduce exposure.

Feb-2016 – Coincident: Fast forward to the Feb-2016 lows and that correlation once again went north of .60. The difference was that at that point, yields on the HY Defensive index were at 8.7% yield. At that point, this correlation did not make sense to us. An incremental 200 bps of yields appropriately compensated investors for the for the idiosyncratic credit risk they were being asked to bear. The correlation was essentially coincident – making it rational to increase exposure.

Leveraged Equities - Canary in the coal mine that bears close watching

HYG vs. HYG Equity Index: The rally from the Feb-2016 lows in HYG has been largely corroborated by the move in HYG related equities. This relationship bears close watching as leveraged equities led the HY and broader equity market lower in following the early Nov-2015 tights – potentially serving as the "proverbial canary in the coal mine" for the HY market.

HYG Equities vs. S&P 500:

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