HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

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Fourth Quarter 2014

The high yield market, as measured by the Barclays U.S. Corporate High Yield index, returned -1.00% for the fourth quarter ending December 31, 2014. For the twelve-month period ending December 31, 2014, the high yield market returned 2.45% vs 7.44% the prior year. The higher rating categories outperformed in the fourth quarter: Ba rose 0.92%, B declined 1.51%, Caa declined 3.94%, and the Ca-D category declined 25.7%. Additionally, the higher rating categories outperformance for the full year (Ba +5.37%, B +1.47%, Caa -1.11%) was in stark contrast to the market's performance in 2013, where the lower rating categories outperformed (Ba +5.05%, B +7.27%, Caa +13.82%). There seemed to be a general belief that intermediate and long term interest rates would increase as we entered 2014. To the surprise of many, the Treasury curve flattened with a 9 bps decrease in the 5 Year Treasury yield and an 86 bps decrease in the 10 Year Treasury yield, providing an unexpected tailwind for longer duration (BB) bonds. The high yield market trailed most of the other major markets in 2014, including investment grade, emerging markets and equities. The average spread widened 91bps over the course of 2014, to 519 bps, and the average price closed the year just under $100. This marks the first time in three years that the market yield is higher than the average market coupon. Retail flows from high yield mutual funds were $6.4 billion in the fourth quarter.

2014 marked the sixth consecutive year of positive returns for the high yield market, albeit 2014 being the most modest. The US economy was fairly steady with slightly better than expected GDP growth and declining unemployment. In this environment corporate credit fundamentals remained strong throughout the course of the year and aside from one mega-default, Energy Future Holdings, defaults remained subdued, ending the year with a 2.09% default rate (Credit Suisse). Despite the generally stable domestic economic environment, market performance was erratic throughout 2014. The first half of the year experienced positive monthly returns and modest inflows in high yield mutual funds. The market yield to worst reached a cycle low in June, breaching the 5% threshold at 4.91%. The market performance turned in July, when concerns surrounding geopolitical events captured the market's attention. In the back half of the year, the market experienced monthly positive returns on only two occasions, August and October, and High Yield mutual funds witnessed inflows only in November. For the year a cumulative $19.5 billion exited retail high yield mutual funds.

In October, oil prices commenced a precipitous decline with prices falling more than 40% in the fourth quarter, creating uneasiness in the high yield market. The energy component of the Barclays High Yield index constituted a 13% weighting and produced a -10.6% return in the fourth quarter, creating an overall drag on the high yield markets performance.

Despite the outflows from retail high yield mutual funds, the market priced $61.4 billion of dollar-denominated new issuance in the fourth quarter. New issuance for the year was roughly 7% lower than 2013, with the market pricing $303.2 billion. This issuance came with the lowest average coupon, 6.45%, in the history of the market. The spread for new issuance was the lowest since 2007, at 434 bps, however, it was still wider than the 2005-2007 period (Credit Suisse).

As we entered the year, there was an overriding concern that, with the wave of refinancing deals completed since 2010, new issue credit metrics would start to deteriorate, as merger and acquisition activity and LBO deals garnered a larger share of new issue activity. New issue activity for the year was a mixed bag given market expectations at the beginning of the year. Merger and acquisition deals represented 32.5% of proceeds for new issuance in the year, up from 20.6% in 2013. However, proceeds related to LBO transactions represented 13.3% of new issuance proceeds, down from 14.2% in 2013 and 17.8%

in 2012. The largest share of new issuance proceeds continued to be applied to refinancing existing bond deals (29.8%) as well as loans (18.7%). The percentage of proceeds from B credits was 29.8% for the year, which is well below its long-term average of 42.4%. Issuance of CCC bonds comprised 9.8% of proceeds, ahead of its long term average of 6.7%, but down from 11.3% in 2013. At the higher end of the ratings spectrum, BB and split BB represented 43.9% of new issue proceeds, which is well ahead of the long term average (34.6%). Credit metrics for deals placed in the year were consistent with the average credit metrics of new issuance since 2001. The average leverage (Debt/EBITDA) of deals issued in 2014 was 4.9x, which mirrors the average during the period 2001-2014, while interest coverage was slightly above the average during this period at 2.9x, versus a 2.7x average.

The energy sector represented the second largest industry in terms of new issue proceeds in 2014, with 102 new issues pricing in 2014, fueled in part by the growth in "fracking" activity in the US. The average credit metrics for the 102 energy deals priced during the year appeared to be conservative at the time of issuance, with 4.0x leverage and 3.2x interest coverage. The general consensus is that oil prices will remain at subdued levels in the near future, and we expect to witness a material deterioration in energy credit metrics during 2015.

The major decline in oil prices in the fourth quarter will likely result in some industries feeling the impact as we move into 2015. Other variables to monitor in 2015 are the recent strengthening of the US dollar versus other major currencies as well as continued uncertainty surrounding the various ongoing geopolitical events. Economic conditions in the US appear to be fairly stable as we enter 2015, which should result in relatively stable corporate credit fundamentals across most industries. We expect new issue activity to moderate in 2015, as most refinancing needs have been satisfied with the "maturity wall" pushed out to 2017.

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