Global High Yield Perspectives

1Q 2016

THE GOLDEN AGE OF DEBT

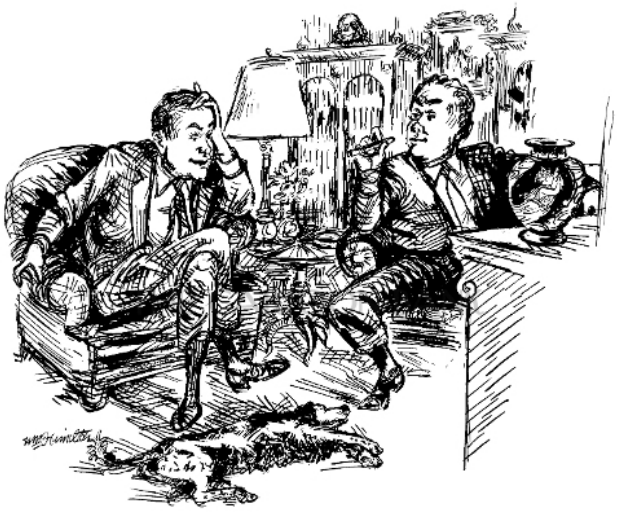
The harmful side of the aggressive use of leverage by global corporate and government sectors became fully transparent once their debt binges were coupled with lower global growth rates and the prospect of rising U.S. short-term interest rates.

We anticipate that the trend of aggressive leverage will be the key theme in 2016 and beyond. The necessary deleveraging has simply not taken place in lower-quality global credit markets, and most weaker developed markets—such as peripheral European countries like Portugal and Spain—and developing markets used "low" interest rates to increase household and government leverage.

The irony is that most market participants believe equity markets to be relatively efficient and reflect reasonable future growth and earnings estimates. However, when these same market participants look at interest rates, they don't see the prospect of low interest rates and inflation, but instead see a significant "mispricing" or a "mistake."

So, here's a toast to a successful 2016 and the opportunity to generate outsized returns and alpha in the Golden Age of Debt.

A review of our global valuation models highlights the challenges we face in the Golden Age of Debt. The U.S. economy is flashing warning signs; widening credit spreads, increasing instances of ratings, downgrades, increasing defaults, and relaxing or tightening lending standards. Our recession indicator makes clear that the country is on the verge or has already entered recession, with the Federal Reserve (Fed) seemingly intent on raising rates 3-4 more times in 2016. The Fed's focus on the Phillips Curve—which outlines the trade-off between the inflation and unemployment rates—unfortunately points the central bank toward the direction of raising rates (see **Figure 1** on next page).



"Who would ever have guessed that there'd be a golden age of debt?"

Source: From Cartoonbank.com

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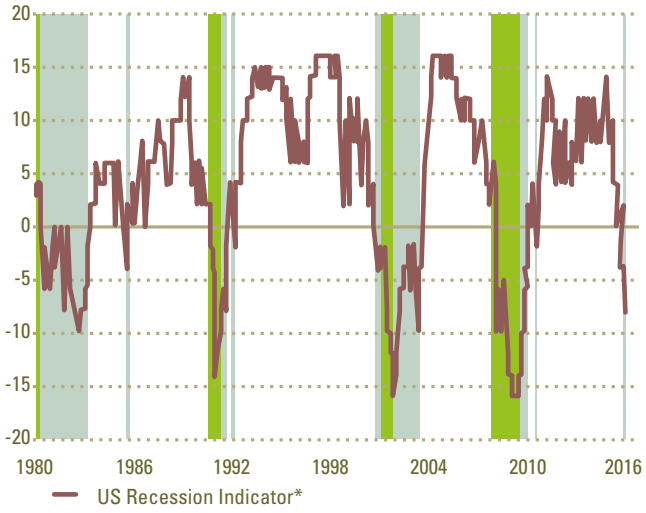
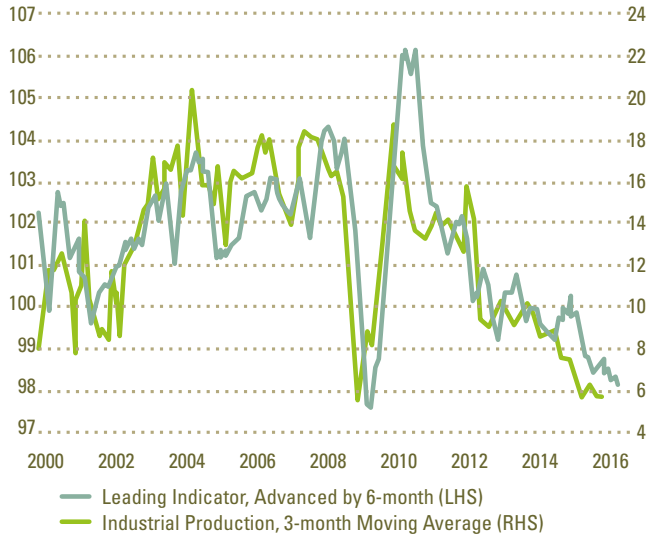
Figure 1 U.S. Recession Indicator
As of 1/8/2016



*Based on 16 components including interest rates, high yield spreads, business confidence and activity, corporate profits, equity and lumber price. Shaded gray: Indicator is negative. Shaded green: U.S. Recessions.

Source: Thomson Datastream

Figure 2 China: Leading Indicator & Industrial Production
(Ann % Chg); As of 11/30/2016



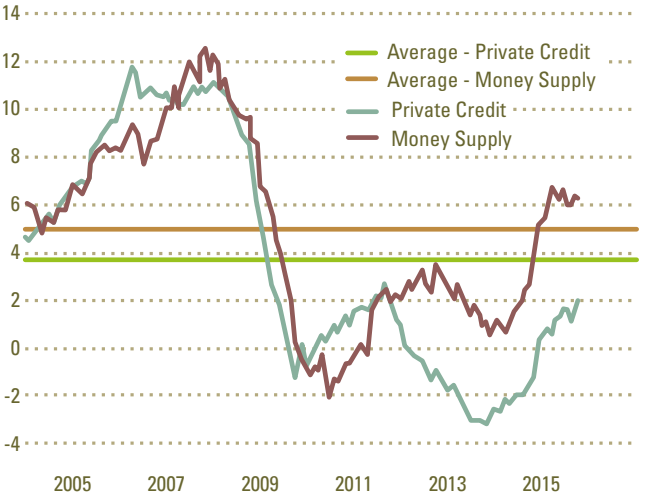
Source: Thomson Datastream

The macroeconomic data out of China is no better. Manufacturing, the secondary industry in China, continues to signal recession and is significantly overleveraged. The necessary rebalancing to the tertiary industry, services, will take place but with that brings significant risk as economist Michael Pettis has highlighted the last several years (see **Figure 2**).

Meanwhile, Europe continues to sputter forward helped by easy monetary policy and a weakened currency. Political risk brought about by wealth inequality—despite the social safety net that seems extravagant from an admittedly U.S. perspective—is the primary risk going forward, and one that is very difficult to quantify and price (see **Figure 3**).

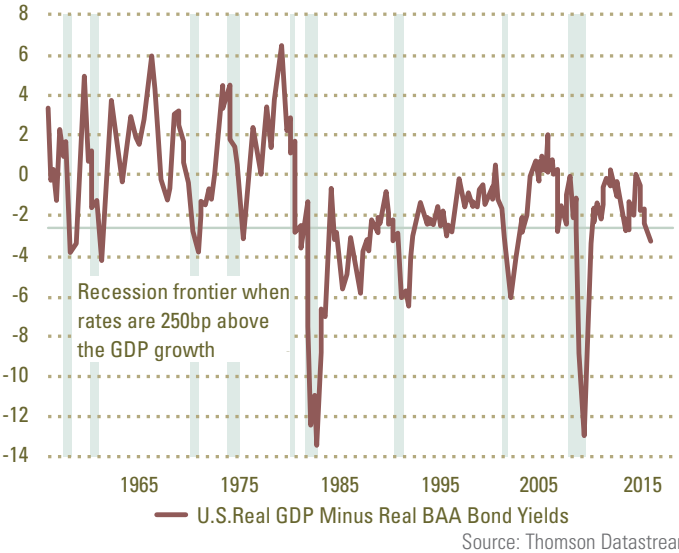
Many of our more specific credit-oriented research models are flashing warning signs as well. One of our favorites, the Wicksellian indicator, highlights that the cost of credit is now quite expensive relative to gross domestic product (GDP) growth. Corporate treasurers who have gorged on cheap and abundant credit may have yet again misunderstood that low interest rates are in fact forecasting lower growth and inflation (see **Figure 4**).

Figure 3 Eurozone - M3 & Private Credit
(Ann % Chg); As of 11/30/2015



Source: Thomson Datastream

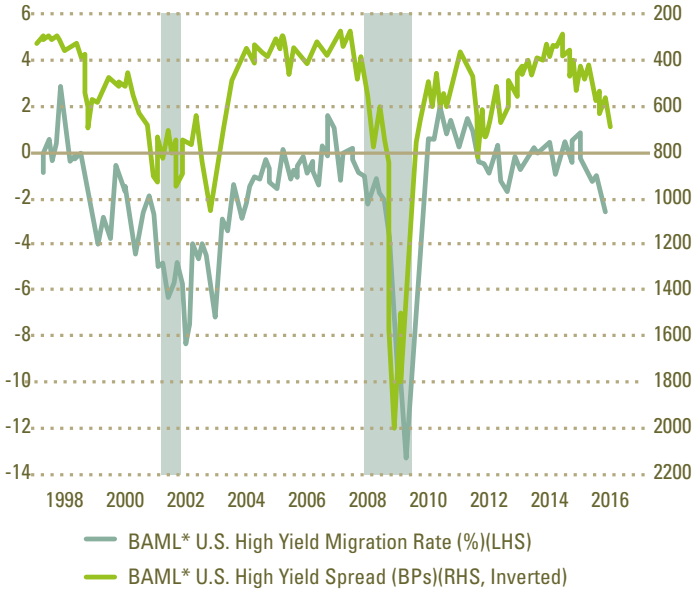
Figure 4 U.S. Real GDP Minus Real BAA Bond Yields
(%); As of 1/8/2016



Source: Thomson Datastream

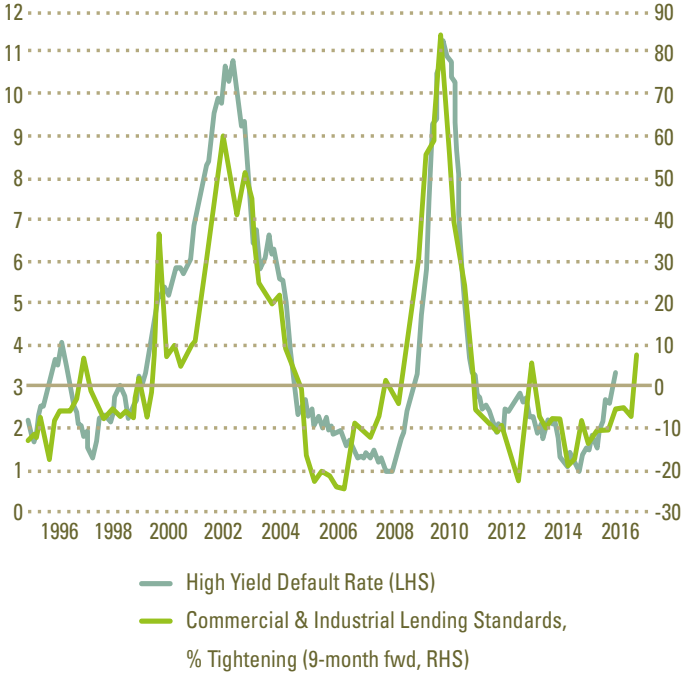
Credit ratings agencies—which were maligned during the Global Financial Crisis—have reasserted their role in markets and are quickening the pace of their downgrades that are predicated upon weakening earnings before interest taxes depreciation and amortization (EBITDA) and lowered prospects for revenue growth. We would anticipate for this trend to continue given the anticipation of further tightening of monetary policy from the Fed (see **Figure 5**).

Figure 5 U.S. High Yield Rating Change & HY Spread
As of 1/8/2016



*BAML = Bank of America Merrill Lynch
Source: Thomson Datastream

Figure 6 Default Rates & Lending Standards
(%); As of 12/31/2015



Source: Thomson Datastream

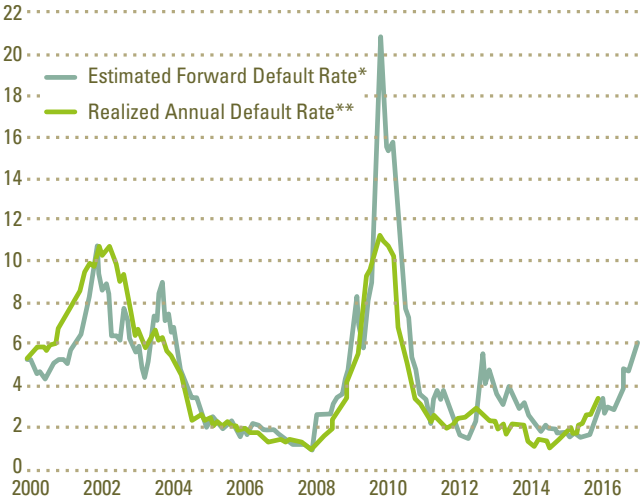
Lending standards have tightened as covenant-light leveraged loan deal prices have declined. Investors severely mispriced the option to be structurally subordinated once cash flow is inadequate to service the debt burden.

As expected, data on lending standards has been tightening as the inappropriately priced option of covenant-light deals is better comprehended by market participants. Coercive debt exchanges and structural subordination are being utilized to avoid some restructurings or even liquidations, but we anticipate that lending standards will continue to tighten and defaults will rise (see **Figure 6**).

We believe default rates will likely rise above 6% in 2016—which is above historical averages. Rising default rates are the result of an environment of low nominal growth and aggressive use of leverage. Investors who relied on historical breakeven default rates as the crutch to support their low-quality high yield positioning have paid dearly in terms of underperformance (see **Figure 7**).

The focus on quality credit and sovereign markets will be the key differentiator in performance over the next few years, especially given the potential for credit investors to be "crucified" on the Fed's Phillips Curve proverbial "cross."

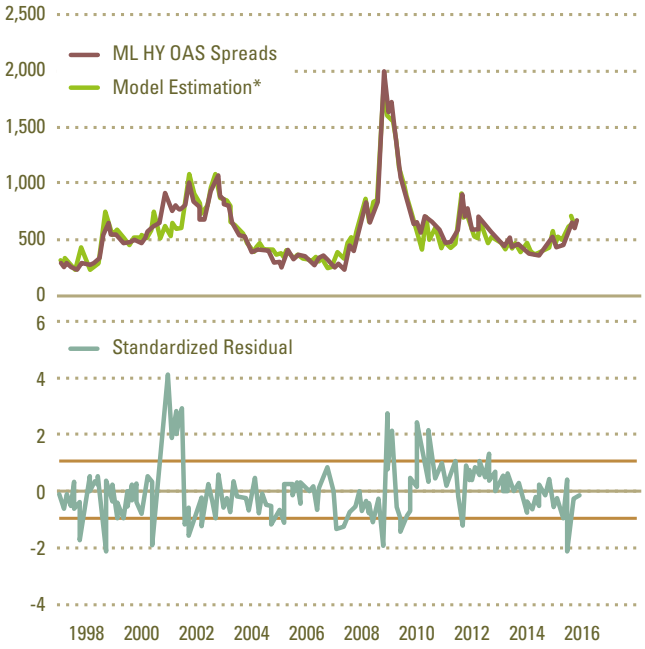
Figure 7 Default Rates
(%); As of 12/31/2015



*Source: Brandywine Global
**Source: Bank of America Merrill Lynch

Given our poor outlook and cautionary stance, we must ask if the market has "priced in" our sentiment? Our valuation indicators say not yet, as shown in **Figure 8**. Just as the commodity collapse has not been priced in—who can possibly forget the oil trade of a lifetime espoused this very time last year—we believe allocations in global high yield must be made very cautiously. The overarching quality of the strategy will trump regional or idiosyncratic sector allocations.

Figure 8 High Yield Spread Model
(BPs); As of 12/31/2015



* Based on 3-month tbill rate, industrial production, S&P 500, CBOE Volatility Index, and predicted default rate.

Source: Thomson Datastream

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