

Crescent Capital High Yield Bonds

Last year proved to be a tale of two halves. As we started 2015 our biggest concerns were interest rates and oil prices. While both weighed on investors' minds, the latter receded as oil rallied during the spring of 2015. By the end of May, the Bank of America Merrill Lynch US High Yield Master II Index ("BAML Index") had posted a return of 4.1% and was on-track for a coupon year. The market began to turn in June as oil dropped from its recent peaks and began a steady decent, ultimately dragging high yield along with it. From its peak of \$64.57 on 5/7/15, oil declined 43% to its low point of \$36.87 on 12/21/15. With energy still one of the largest sectors in high yield, it was inevitable that the sector's decline would pull down the overall market. In the back half of the year, commodity fears soon combined with apparent cracks in the global economy. China, the world's fastest growing economy, showed signs of stress with speculation that growth was slowing at an alarming rate. The emerging markets, many heavily dependent on oil revenues, were under scrutiny as well. These factors put further pressure on already fragile economies in Western Europe and Asia. The US was the lone stalwart on the globe, but investors began to fear that even the domestic economy could not be insulated from a global downturn. All of these concerns led to a general "risk-off" trade with investors shedding exposure to leveraged credit. High yield proceeded to post a negative return for six of the seven months from June to December (the longest streak of negative monthly returns for the asset class) with the BAML Index ending the year at -4.6%. To put that in perspective, this was the first negative year since the 2008 credit crisis and only the fifth negative year in the 30 year history of the asset class. It was also the worst performance in a non-recession year in over a decade.

Digging deeper into the performance of the high yield asset class in 2015 reveals the weakest parts of the market were commodities and lower-rated (CCC) credits. According to JPMorgan, the worst two sectors were Metals/Mining and Energy which fell a staggering 27.9% and 24.0%, respectively. That was a huge margin relative to the rest of the market as the third worst sector was Utilities which was down a relatively benign 5.2%. Stripping out Energy and Metals/Mining, the return for the high yield index would have actually been flat (+0.36%) highlighting the divergence between those two sectors and the overall asset class. Commodities weren't the only victims though as investors aggressively shed the riskiest credits. By year end, CCC names in the BAML Index were down 15.0%, dramatically underperforming BB and B credits which were only down 1.0% and 5.0%, respectively. While there was much overlap between the CCC names and the commodity sector, CCCs would have still been down 6.0% excluding the Energy and Metals/Mining sectors.

Not surprisingly the heightened fears around commodities and the macro environment led to technical pressure in the asset class from both a supply and demand standpoint. Credit Suisse reported that new issue volumes ended the year at \$286 billion, down 10.2% year-over-year and the slowest pace we've seen since 2011. It's worth noting, though, that almost 70% of last year's new issues took place in the first two quarters of the year. Market volatility in the latter half of the year drove new issue volumes down 29.0% as issuers and underwriters that weren't forced to do deals opted to stay on the sidelines rather than take their chances in a choppy and uncertain market. The decline in supply was met by investor outflows as JPMorgan reported that \$13 billion of capital left the asset class via retail mutual funds in 2015. Continuing the theme of good 1H/bad 2H, the outflows were heavily concentrated in the last two quarters of the year with \$14 billion leaving during that time frame, wiping out the net inflows of \$100 million from H1.

All of the challenges mentioned above pushed the market to the widest valuations we've seen in several years. The yield to worst on the BAML Index was 8.8% on 12/31/15 compared to 6.6% on 1/1/15. On a spread-to-worst basis, the BAML Index ended the year 698 basis points over treasuries, well-wide of the 20 year average of 579 bps and 191 bps wider than where we started the year. The last time the BAML Index was this wide was during the European debt crisis in 2011. Spreads of this level have historically indicated a future spike in defaults and a heightened risk of recession. According to Moody's, the last twelve months par-weighted default rate for high yield at the end of 2015 was 3.4%. The current range of default estimates published by market strategists and the major rating agencies for 2016 is 3.5-4.5%, modestly higher than 2015 but still below the long-term historical average of 4.9%.

Despite a difficult year for the asset class, we were able to insulate our investors from much of the downside. As mentioned in our previous quarterly letters, we began taking a defensive stance midway through the year by aggressively reducing our exposure to CCCs and "high grading" our Energy exposure. While we were inevitably impacted by the exposure in Energy, our strategy of moving higher in credit quality paid off as it was the lower quality commodity names that were the hardest hit. The combination of strong security selection and a higher-quality bias led our high yield composite to post its 2nd best year of outperformance in its 24 year history coming in 360 bps ahead of our benchmark (our best year was 2008 at 370 bps). As we head into 2016, many of the same fears that gripped the market at year end still weigh on the asset class. Commodities have continued their downward trend with oil now off another 22% at the time of this letter. High yield Energy has followed suit posting double digit declines just one month into the year. With Energy representing 10.9% of the BAML Index at year end, it still remains an important driver factor in the overall market. Our overall positioning remains largely unchanged from where we ended 2015 as we continue to have a substantial underweight to CCCs and modest underweight to Energy with our exposure concentrated in higher quality credits. We are also closely monitoring the ability of borrowers to access capital markets, as this could lead to higher defaults in 2016 and beyond. The good news is few borrowers need to access the debt markets. Only 14% of the high yield market matures over the next 36 months, so debt amortizations should not be a significant factor in near-term default rates.

As we look ahead, we believe high yield spreads appear to be pricing a far worse macro scenario than we believe likely to occur over the short term. To be sure, there are several risks on the horizon, not the least of which is the prospect of \$25 oil. Still, the biggest fears in the market appear to be driven by a slowdown in the global economy and diminished liquidity in the asset class. The high yield market is predominantly exposed to domestic companies and is most directly impacted by trends in the US economy. While fundamentals for our portfolio companies have decelerated from earlier in 2015, we are not expecting a recessionary environment in the coming quarters.

The harsh sell-off in the back half of last year has continued into January, with spread levels beginning to suggest an attractive entry point into the asset class. Since the beginning of June 2015, high yield is down 10.2% through the end of January and spreads for the BAML Index are near 800 bps, levels last seen in previous recessions in 1990 and 2002. In historical terms spread levels today are wider than they had been for 80% of the time during the last 20 years. Even excluding energy and metals/mining spreads are approaching the highest quartile. The average dollar price of a high yield bond is 85% of par. While valuations appear to be cheap by historical standards, we are looking for early signs of stability before becoming more constructive on the

asset class. We expect fund outflows in the near-term to moderate, and are mindful that according to Goldman Sachs and the Federal Reserve Board over 75% of high yield bonds are held by “steady hands” that include pension funds, insurance companies, banks/financial institutions, non-profits, and foreign institutions. Less than 25% are held by mutual funds and ETFs. We do believe in light of current valuations, risks are more tilted to the upside over the near-term. While we are not making any significant changes to our current positioning just yet, we are beginning to see attractive valuation levels outside of energy and metals/mining and believe investors with a 2-3 year time horizon will find spreads fair to cheaply valued in a world where very few assets are close to fair value.

Thank you, as always, for your business and please contact us with any questions.



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