

HIGH YIELD COMMENTARY

Fourth Quarter 2011



Market Review

The U.S. high yield market recovered the entire third-quarter decline of -6.10% (Barclays Capital U.S. High Yield Constrained Index¹) by advancing 6.48% during the fourth quarter. The rally brought 2011 performance back to positive territory, at 4.96%. As risky assets outperformed, the high yield market was bested only by U.S. equities (11.82%). All other credit asset classes lagged behind in the quarter, including crossovers (4.05%), emerging market bonds (4.93%), investment grade bonds (1.70%) and U.S. government bonds (0.84%).

The market ebbed and flowed between positive and negative returns during the quarter. A strong October (6.00%), was followed by a weak November (-2.16%) and a strong December (2.66%). Global macro news was the biggest culprit, resulting in wild swings of investor risk appetite. In October, investors became optimistic about a potential deal in Europe to stem the contagion concerns that were caused by the growing sovereign debt problem. Good third-quarter earnings and guidance from companies also propelled the market higher in October. The final week of October represented the largest inflow ever into the asset class and brought the month to \$7.2 billion of inflows, according to Barclays Capital. November was marred with political failure both at the ECB and with the U.S. Congressional super committee, and volatility paralyzed investors. Slowing growth in Europe also was becoming a larger concern during November. Finally, in December, better economic news out of the U.S. and political progress in Europe (an interest rate cut and announced liquidity plans around banks and Italy) began to quell market volatility.

U.S. high yield corporate spreads tightened 94 bps, from 847 bps September 30 to 753 bps December 30. The high yield market reached its tightest level of 498 bps since the end of 2007 on April 11, 2011. Spreads are now about 200 bps wider than the long-term average of 550 bps.

The yield to worst for the high yield market ended the fourth quarter at 8.39%, which is 87 bps wider than the 2010 yearend level of 7.52% and relatively in line with the average YTW over the past 10 years.

New issue volume did pick up from an anemic third quarter level of \$24.6 billion to \$35.6 billion in the fourth quarter. After a record pace during first half of the year, however, which saw more than \$168 billion of new issuance, the year closed out with \$228.3 billion priced, according to Barclays Capital. Despite the slower second-half pace, 2011 marked the second highest issuance total ever. The fourth quarter's new issues were generally higher in quality, with BBs and non-cyclical sectors leading the way.

On the demand side, investors moved money into the high yield market to the tune of approximately \$3 billion in December. Following a third-quarter outflow of \$2.8 billion, the fourth quarter saw an inflow of \$11.7 billion, bringing the 2011 inflows to \$13.8 billion. For comparison, 2010 recorded \$13 billion of inflows.

Lower quality bonds outperformed higher qualities in the quarter, as investors increased their risky positions. BBs returned 5.61%, while Bs returned 6.40%, and CCCs returned 8.42%.

Home construction and gaming had the two of the best returns in the fourth quarter, at 12.34% and 8.51%, respectively. Among individual issues, Quadra Mining, which was acquired by KGHM Polska Miedz in December for \$2.26 billion, recorded one of the highest returns, as bonds rose more than 15 points. Airlines, refiners and consumer captive financials were the only sectors with negative returns for the quarter.

The Moody's Investors Service U.S. issuer-weighted default rate continued its downward trend and reached 1.8% at the end of November, compared to the November 2009 peak of 13.48%. Moody's forecasts the default rate to decline to 1.7% by the end of 2011 and to rise slightly, to 2.4%, in 12 months.

The high yield credit trend remains positive, despite deteriorating from previous quarters. The number of upgrades outpaced the number of downgrades in December and for the year, at 358 to 285 on an issuer basis and \$408 billion to \$243 billion on a volume basis, according to J.P. Morgan.

Outlook and Strategy

Throughout the fourth quarter, the market was dictated by headline news about the European sovereign crisis and the potential for a global economic slowdown. The high yield market ended 2011 in positive territory, at 4.96%, after a very strong fourth quarter.

We think the market will remain volatile as the European sovereign issue continues to play out, potentially resulting in a recession in Europe. High yield technicals are currently very positive due to continued inflows and very little primary market activity.

We are still positive on the fundamentals of the U.S. economy and corporations, even with questions around global growth. The balance sheets of U.S. corporations remain very strong after just coming out of a recession, and corporations have remained disciplined during the last year, focusing on refinancing rather than leveraging up. Corporate earnings have been strong, and we see stability in top-line growth, as well. The ISM was 53.9 in December, indicating expansion

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in the manufacturing sector. Another positive indicator came on the job front in the U.S.: Payroll growth came in at 200,000 for December; the jobless rate fell to 8.5%; and hours worked and earnings climbed.

We think valuations also are fair at this level. Spreads at the 750-bps level imply a default rate of closer to 6%, which is significantly higher than Moody's 12-month default forecast. We think current valuations, which are approximately 200 bps above the long-term average, properly account for the some of the larger macro risks in the market.

We believe that the best risk and return profiles are not from an outright add to the riskiest and highest yielding credits, but from fundamentally strong companies that can realize the earnings from an economic recovery and weather any macro volatility should the market pull back. We continue to recommend an overweight to BB and B rated bonds over CCC credits. We believe security selection will be the key to outperformance during this volatile time. We would like to reiterate our recommendation of a marketweight to the high yield asset class.

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