

Market Overview

- US high yield rose slightly in February
 - After declining over 3% in the first two weeks of the month, the Credit Suisse High Yield Index rebounded sharply, ending the month up 0.31%
 - Spreads tightened just one basis point to 825, after hitting an intra-month high on February 11 of 914 basis points.
- Funds posted significant inflows, while new issuance supply remained subdued
 - US high yield mutual funds and ETFs recorded inflows of \$6.7 billion in February, including a weekly record \$5 billion inflow in the last week. (source: JP Morgan)
 - Twenty deals priced for a total of \$14.1 billion in the primary market. Year-to-date \$23.0 billion has come to market, far below 2015's pace of \$55.5 billion. (source: JP Morgan)
- Higher quality bonds outperformed, while CCCs underperformed
 - BB-rated bonds gained 1.69% and Single B credits rose 0.42%. CCCs lost 2.37%.
 - Metals/Minerals was the top performer, up 4.85%, with higher iron ore and copper prices. Chemical companies gained 2.60% and the Gaming/Leisure sector increased 2.20%.
 - Energy companies were lower by 3.80% during the month. Utilities lost 1.31% and Financials decreased by 0.93%.

Portfolio Overview

The portfolios underweight to CCC bonds added to relative returns. Security selection within CCCs added to positive absolute returns for the month.

Security selection within Energy – Exploration & Production was the top contributor to relative performance. The portfolio remains underweight Energy - Service & Equipment issuers which added to performance as the sector lagged the market.

The portfolio's investment in a recent fallen angel, a copper miner, had a positive impact on performance. An overweight to Other Metals/Minerals and credit selection contributed to performance. Credit selection contributed to positive absolute performance within Utilities as the portfolio avoided some bonds which fell in price.

An underweight to integrated steel producers was the largest detractor to relative performance as a few companies outperformed. An underweight to the Gaming sector also subtracted from relative returns as the sector outperformed the market. Within Refining, an overweight to one firm was negative for performance as the company lagged the sector.

Outlook

The high yield market overall has rebounded sharply since mid-February. From the recent lows of February 11, the Credit Suisse High Yield Index has gained 6.4% through March 9, and spreads have tightened from 914bps to 767bps. The recent high yield rally has coincided with gains in equity markets (the S&P 500 has returned 9% over the same period), heavy mutual fund/ETF inflows, and higher commodity prices. Not surprisingly, oil and commodity related credits have outperformed. In the first 9 days of March, the Energy and Metals/Minerals sectors have returned nearly 9.0% and 4.5%, respectively.

We believe the current rebound in oil and commodity credits underscores the extreme level of investor pessimism that had been reflected in energy and commodity bond prices. In reality, low dollar priced bonds have optionality. In addition, many commodity companies have shown financial flexibility, including asset sales, dramatic cuts in expected capital spending, and equity issuance (e.g. Oasis Petroleum and PDC Energy).

In addition, the widespread fear of a significant negative market impact of fallen angels has so far proved to be overblown. In recent months, many Wall Street strategists have issued warnings for severe market dislocation as significant amounts of energy and metals/minerals bonds (with estimates ranging from

\$100-200 billion) are downgraded and partially change hands from investment grade to high yield investors. In reality, not only is the total supply of fallen angels a manageable 5-10% of the entire high yield market, but these bonds typically experience the most severe price declines before their downgrade. For example, copper producer Freeport-McMoRan's 6.875% senior notes due 2023 plunged from a high of \$111 in June 2015 to a low of \$45 on January 21. Since Moody's announced the long anticipated downgrade on January 27 (from Baa3 to B1), the bonds have rallied from \$48 to \$75.

It is important to keep energy and commodities in perspective. The Energy and Metals/Minerals sectors in total represent only 15% of the high yield market. And even after the recent rally, prices still reflect a "lower for longer" scenario. The average energy and metals/mining bond now trades at 64 and 71 cents on the dollar, respectively – similar to where they were at the beginning of December 2015. We continue to view commodity credits with a long-term perspective, focusing on their yields compared to the asset coverage.

We believe both the fundamentals and value – both absolute and relative – of the US high yield market continue to be strong. Of the 40 largest issuers in the BofA Merrill Lynch High Yield Bond Index, 35 are publicly traded and have multi-billion equity market caps. As of March 9, the BofA Merrill Lynch High Yield Index had a yield of 8.7%, and its spread of 723bps over Treasuries remains significantly wider than the median of 556bps since the start of 2000. Meanwhile, US and global interest rates remain extremely low (according to Bloomberg, approximately 29% of developed sovereign debt globally has a negative yield).

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