Market Insight

PALMER SQUARE
CAPITAL MANAGEMENT

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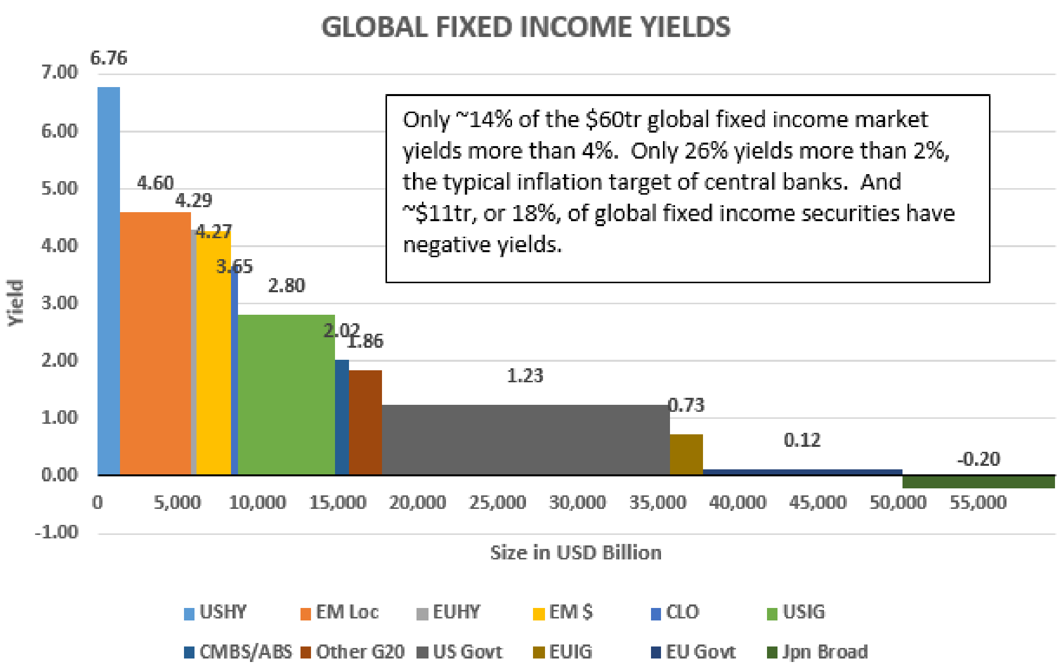
Where's the Beef (i.e., Is There Yield Anywhere)? Why Certain U.S. Credit Markets May Have a Massive Technical Tailwind?

While it is difficult to actually believe (and even write I must admit), 25% of the global sovereign bond market or $11.7 trillion in debt now yields 0% or less[1]. Yes, that is 0% or less equating to some investors actually "paying" to have their money held by certain governments. Many countries that have historically been perceived to be poor credits such as Italy and Lithuania pay creditors rates such as 0.5% and 1.25% or less. This begs the question: Is there any yield left in this world?

To put this abnormality into even better perspective and answer the question about yield (or lack thereof), the team at Palmer Square put together the below chart which shows the various yields of the major fixed income classes (weighted by size). In summary, only 14% of the $60 trillion global fixed income market yields more than 4%, and only 26% yields more than 2% (note: 2% is the typical hurdle to earn a real return).



Source: Palmer Square and Bloomberg

So, yes, there is yield, but it is puny. As sovereign wealth funds, pensions, endowments, foundations, and other investors who require a certain rate of return or cash flow amount search for yield, they will be hard-pressed to find many options. As another example, consider the situation that Japanese fixed income investors now confront. Bloomberg just highlighted that Japanese investors can no longer earn a positive yield on 10-year U.S. treasuries after currency hedging costs are netted out. Please refer to the chart below.

Why U.S. Credit Has a Massive Tailwind?

In our opinion, the above technical factors contribute a massive tailwind to certain segments of the U.S. Credit markets. The U.S. economy is relatively strong and our markets "actually" have opportunities for investors to capture yield. As an initial example of the potential power of this technical tailwind, the U.S. high yield bond market had a $2 billion inflow on Monday, July 11th. This inflow registered as one of the strongest inflow days ever in U.S. high yield. You can debate whether the high yield bond market is rich, fairly-valued, or cheap; however, you can't debate that it continues to offer a 7% yield-to-worst.

Where does Relative Value Exist in U.S. Credit?

At Palmer Square, many of our investment solutions are structured to be opportunistic in nature in that we have the ability to look across credit for the best relative value and position portfolios around what we believe to be the best long-term risk/return. In seeking to exploit the best relative value available in credit, the Palmer Square investment process is a blend of top-down and bottom-up. As far as the top-down view, our team meets every morning to discuss valuation levels, new issuance, secondary market trends, M&A activity, and many other macro-type metrics. For ease of analysis for this piece, we have included an abbreviated version below of one of the valuation tools we utilize. While not exhaustive in nature, Exhibit 1 allows us to quickly grasp valuation data for the broader investment landscape. In addition, it allows us to analyze not only year-to-date returns, but also how much the various markets have retraced since credit started widening in June 2015 (i.e., how much markets have rallied to recoup the spread widening seen).

	Current Levels				TTM %	Total Return					
Name	Price	C Yld	YTW	Duration	Retrace	MTD	Jun-16	May-16	Apr-16	YTD	2015
CORPORATE CREDIT											
USD AAA	110.6	3.1	2.32	9.9	72%	0.9%	2.4%	0.1%	0.8%	8.8%	0.6%
USD AA	108.9	3.0	2.13	6.8	97%	0.6%	2.0%	0.0%	0.7%	7.0%	0.9%
USD A	109.7	3.6	2.50	7.0	79%	0.7%	2.0%	-0.1%	1.0%	7.5%	0.6%
USD BBB	108.0	4.3	3.39	7.2	86%	1.1%	2.4%	-0.1%	1.9%	9.9%	-2.2%
USD BB	103.7	5.7	4.93	5.2	87%	2.4%	0.9%	0.2%	2.9%	10.5%	-1.0%
USD B	97.9	7.0	7.12	4.6	80%	2.9%	0.8%	0.5%	4.0%	11.1%	-5.0%
USD CCC	79.5	10.4	14.41	3.5	67%	2.9%	2.3%	3.2%	8.1%	22.1%	-15.0%
US IG	108.6	3.7	2.72	6.8	80%	0.8%	2.1%	-0.1%	1.2%	8.1%	-0.5%
US IG ex-EMM	108.8	3.6	2.62	6.8	76%	0.8%	2.0%	-0.1%	0.9%	7.5%	0.3%
US HY	97.6	6.8	7.01	4.7	78%	2.7%	1.1%	0.7%	4.0%	12.2%	-4.6%
US HY ex-EMM	99.5	6.7	6.62	4.7	57%	2.5%	0.5%	0.4%	2.1%	8.8%	-0.2%
Europe IG	109.0	2.6	0.80	5.3	61%	0.8%	1.0%	0.3%	0.3%	4.9%	-0.4%
Europe HY	101.5	5.4	4.75	4.1	65%	1.2%	-0.5%	0.2%	1.9%	4.6%	1.6%
EM (IG+HY)	101.6	5.0	4.46	4.9	100%	1.2%	2.1%	0.2%	1.7%	9.3%	1.1%
HY Distressed	71.4	11.7	18.07	3.3	113%	3.8%	3.7%	4.3%	12.4%	30.6%	-38.0%
Lev Loans (B/BB)	97.4		5.09	3.9	90%	0.8%	-0.3%	0.5%	1.7%	5.5%	-1.2%
CLO											
CLO AAA	99.7	2.1	2.53	3.1	70%	0.1%	-0.1%	0.2%	0.3%	1.6%	1.5%
CLO AA	99.0	2.8	3.41	4.3	66%	0.1%	-0.1%	0.4%	1.8%	1.5%	2.0%
CLO A	98.1	3.7	4.48	3.9	58%	0.3%	-0.5%	1.2%	0.7%	2.5%	3.0%
CLO BBB	92.2	4.8	6.42	5.3	44%	0.7%	0.3%	0.7%	3.0%	1.7%	-0.8%
CLO BB	82.6	7.3	10.15	5.3	40%	1.4%	0.6%	-0.6%	4.7%	1.3%	-5.8%
CLO B	63.4	10.7	15.62	4.9	15%	0.8%	0.8%	-0.9%	3.7%	-6.9%	-10.9%
CMBS											
CMBS AAA	106.1	3.4	2.12	4.9	114%	0.1%	1.6%	0.0%	0.4%	5.7%	1.2%
CMBS AA	104.4	4.8	2.55	3.0	59%	0.3%	0.9%	0.2%	1.0%	3.9%	1.1%
CMBS A	103.2	4.7	3.12	3.7	49%	0.6%	1.2%	0.2%	1.4%	4.5%	1.2%
CMBS BBB	95.2	5.0	4.46	4.0	24%	0.8%	1.0%	0.0%	1.4%	2.9%	0.7%
EQUITY / RATES											
S&P 500	2,153					2.7%	0.3%	1.8%	0.4%	6.6%	1.4%
10Y Treasury	101.3			8.8		-0.2%	2.9%	-0.1%	-0.1%	7.4%	1.6%

Source: Palmer Square. Note: "TTM % Retrace" shows the % spread retracement from the wide levels of 11-Feb-16

Relative Value observations (as of July 12th):

- Collateralized Loan Obligations ("CLOs") are still universally cheap retracing a relatively small percentage of the price widening (especially BBB/BB/B-rated CLO debt). This low level of retracement is especially pronounced when compared to high yield and leveraged loans which have staged a huge rally of late.
  - » B-rated CLO debt has only retraced 15% of the spread widening back to June 2015
  - » BB-rated CLO debt has only retraced 40% of the spread widening back to June 2015
- High yield and investment grade have seen a major rally; however, as you perform the bottom-up fundamental analysis, there are specific industries and companies whereby you can obtain not only yield, but also total return (across loans and bonds).
- Commercial mortgage-backed securities ("CMBS") are still universally cheap (with the exception of AAA-rated CMBS which has retraced all of its price decline). We believe that up-in-quality, single issuer deals are highly attractive. While not in this abbreviated version, we have also found relative value in other areas of Asset-Backed Securities ("ABS") including high quality, senior debt of seasoned non-agency paper and consumer ABS.

Thank you for your continued interest and partnership. Please let us know if you would like to speak further on either the credit markets or any of Palmer Square's investment solutions. We would be happy to arrange a call or meeting.

[1]Source: Bank of America Merrill Lynch and Fitch Ratings

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