October 2015

State of the Credit Markets: "Relative Value Opportunity in Credit Has Increased For the Discerning Investor"

Credit markets have faced tremendous headwinds this year. To name a few factors contributing to volatility: oil has dropped significantly, EM/China is driving a global growth scare, and uncertainty around Fed rate hikes is elevated. Further, investors are struggling to identify opportunities to capture cash flow without taking too much interest rate and/or credit risk.

In this market insight piece, we provide some detail on how Palmer Square has historically approached credit. From there, we provide data around relative value in credit and how there are many strategies available for an investor to utilize. We believe there is plenty of opportunity in corporate credit for the investor willing to do their homework!

Palmer Square Investment Approach/Positioning

Palmer Square believes one of the most important keys to success when investing in credit is a deep analyst and portfolio manager team capable of investing across all areas of credit with the goal of identifying relative value wherever it may exist. The Palmer Square credit platform has been built with this philosophy in mind.

Since inception, Palmer Square has launched numerous opportunistic credit products aimed at locating, identifying and executing on the best relative value in credit. As part of our investment process, we are continually weighing the relative risk/return available across both corporate credit (i.e., high yield bonds, bank loans, stressed/distressed, convertible bonds, etc.) and structured credit (i.e., Collateralized Loan Obligations ("CLOs"), mortgages, etc.). Having this flexible mandate has allowed us to move capital quickly to exploit opportunity. Sourcing strong risk-adjusted investment opportunities in credit depends on an ability to understand not only the top down aspects of credit such as the state of the economy and the stage of the credit cycle, but also an ability to perform rigorous industry and company-specific analysis. Many credit markets are intertwined, and we believe investors have an advantage if they can understand the structured credit markets, derivatives markets, and traditional "cash" bond markets. Past examples of this capital rotation that have occurred in different Palmer Square funds include adding to short duration high yield bonds in October 2011, CLOs in May 2012, bank loans opportunistically/tactically in 2013 and 2014, long/short credit in 2014 and 2015, and stressed credit in late 2015.

Opportunity in Credit Today For the Discerning Investor

In our opinion, over the past 18 months, very few areas within credit offered strong relative value until fairly recently. Outside of the opportunity we identified in CLOs, most areas of credit offered low potential returns, but high interest rate and credit risk. We continue to maintain our relative value call on CLOs; however, we now want to draw investors' attention to the fact that other areas of credit have also become increasingly more attractive. For example, recently, we have increased exposure materially to "Long/Short Credit" and "Stressed Credit/Corporate Credit" as the relative value and opportunity set has increased. We wrote to our investors on both topics.

For this piece, to help investors frame the "relative value" in corporate credit, we include the J.P. Morgan table below, which outlines historical high yield bond spreads by rating as well as historical leveraged loan spreads by rating.

Ratings: OW Single Bs & 2nd Liens, MW CCCs, UW BBs

Historical high yield bond spreads by rating

	HY	IG	BBB	BB	B	CCC	HY-IG	BB-BBB	B-BB	CCC-B
29-Sep-15	705bp	170	220	487	706	1238	535	268	219	532
All time low	266	74	74	173	251	466	176	69	58	210
20 year median	532	129	183	332	533	1027	404	181	192	507
% above/ below 20yr median	32.4%	32.2%	20.2%	46.6%	32.3%	20.5%	32.2%	48.0%	13.8%	4.9%
2004 median	452	95	130	281	439	955	353	152	157	515
2005 median	379	83	112	254	347	884	293	138	109	537
2006 median	350	88	116	244	336	731	261	124	99	388
Median 2004-2006	374	90	118	252	352	853	286	132	115	491
% above/ below 2004-2006 median	88.4%	89.0%	86.2%	93.4%	100.5%	45.1%	87.0%	103.5%	90.1%	8.3%

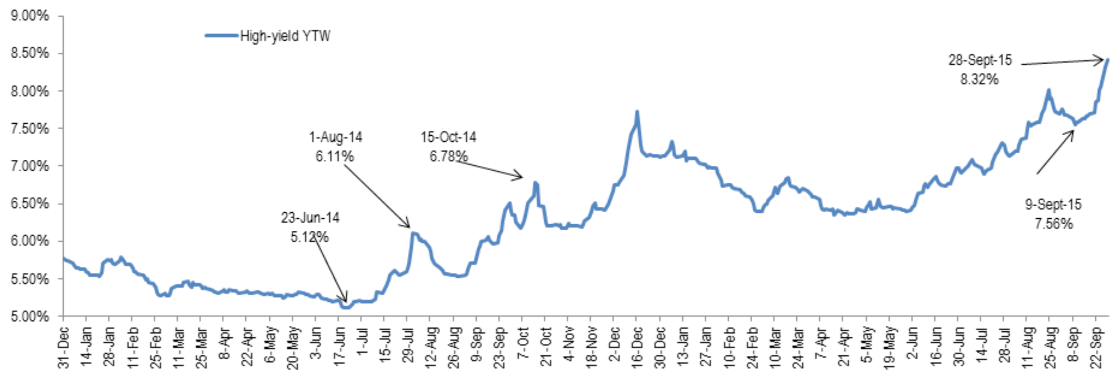
Historical leveraged loan spreads by rating

	Loans	HY	BB	B	CCC	Hy-Loans	B-BB	CCC-B
29-Sep-15	527bp	705	389	583	1908	178	194	1325
All time low	214	266	160	239	282	-283	1	32
15 year median	470	522	355	533	1072	52	177	540
% above/ below 15yr median	12.3%	35.0%	9.4%	9.4%	77.9%	239.4%	9.5%	145.4%
2004 median	289	452	222	317	504	163	96	187
2005 median	241	379	180	266	558	138	86	210
2006 median	245	350	191	259	566	105	68	511
Median 2004-2006	250	374	192	266	551	124	74	511
% above/ below 2004-2006 median	110.9%	88.4	102.0%	119.0%	246.1%	43.2%	163.2%	159.2%

Source: J.P. Morgan; S&P/LCD

In addition, J.P. Morgan also looked at high yield market conditions by analyzing the yield to worst from December 2013 through September 2015.

High-yield to worst



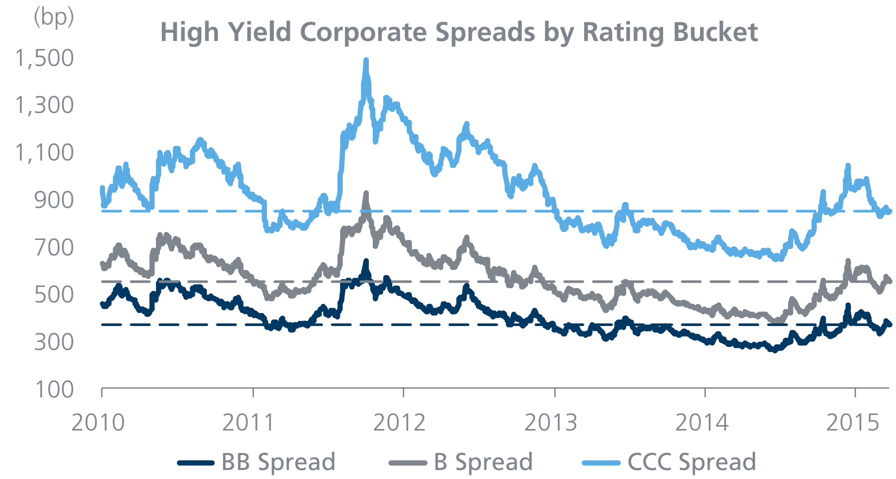
Source: JP Morgan

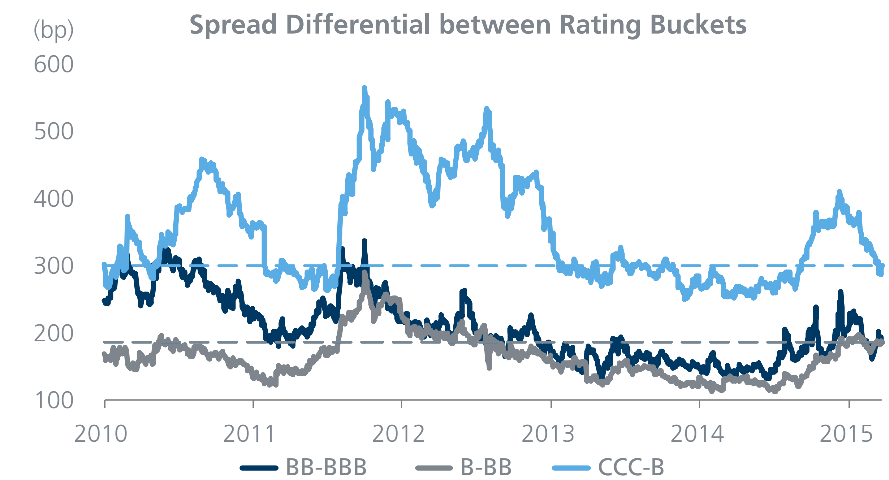
The graph illustrates how the overall high yield bond market has become more attractive from a historical valuation standpoint. The high yield bond market now offers an absolute yield which compares favorably to other fixed income options. Of note, these statistics represent the entire high yield bond space. We are not recommending taking "beta-like" exposure to high yield bonds. We would not view that as a strong risk/reward trade. **Palmer Square emphatically believes company-specific security selection can ultimately drive returns.** Investors need to thoroughly review and understand each high yield issuer's fundamentals and how their trends may impact creditworthiness. Traditional market metrics such as spread levels, default rates, and minimal near term maturities support the relative value argument; however, there are plenty of companies with a backdrop of rising debt levels, declining profitability, and poor industry dynamics, which are fraught with downside risk. We also believe that heightened volatility in credit will continue and investors need to be able to take a longer-term viewpoint.

While there are outright company-specific long positions in high yield or loans to explore within the construct of the relative value argument explored above, there are also other ways to invest in the relative value available in corporate credit. Below, we explore a few other options:

Stressed Credit – one of the more significant trends in the credit market has been the bifurcation of returns between the lower spread names and the wider spread names within the credit market. Below are charts that exhibit this trend – the first two charts showing spreads and yields by ratings bucket, and the second showing the much more pronounced bifurcation between distressed and high yield performance year-to-date. These charts reflect the carnage that is happening in certain segments of the market, which maybe aren't apparent when viewing the broad high yield bond or other credit indices.

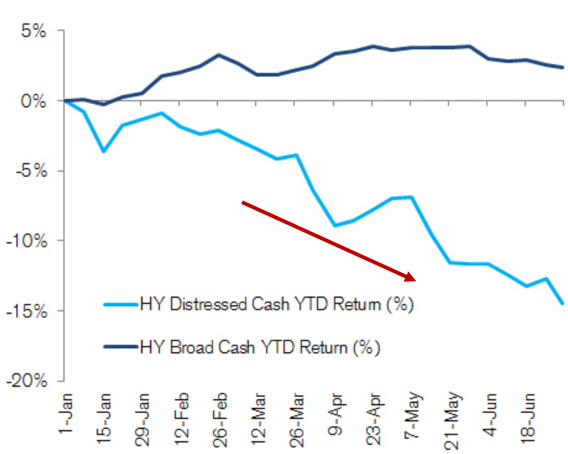
Valuations – Corporate Credit





Source: Morgan Stanley, the Yield Book

Distressed segment has been underperforming



Source: Credit Suisse

What has driven this drawdown in stressed credit? We believe shrinking dealer inventory and Wall Street proprietary desk closure have been factors which have increased market volatility and contributed to a lack of liquidity and drawdown. Liquidity is certainly a risk factor that is difficult to quantify. Lack of liquidity can be meaningful in two ways: it clearly exaggerates volatility but importantly can also produce opportunities for those investors waiting patiently. We believe the potential for larger price swings has increased and as such, market inefficiencies and mispricings are more available. We believe being a liquidity provider in a stressed environment can present a significant risk/return opportunity.

Capital Structure Arbitrage Investing – in addition, relative value is available in high yield credit through investing via a capital structure arbitrage strategy. At Palmer Square, our credit analyst team is primarily set-up by industry. Each analyst generates ideas by looking at full capital structures. They don't focus on only loans or only bonds. They review the entire capital structure and assess relative value. Within that construct, market volatility has historically created opportunities as discrepancies can be found in the relative value of securities within an issuers securities. Again, given the backdrop of macro uncertainty stemming from the Fed, Greece, China and other risk factors, we expect a robust opportunity set going forward.

Event-Driven Investing – we believe an improving environment for mergers & acquisitions ("M&A") will provide plenty of opportunity for the remainder of the year. Second quarter 2015 M&A dollar volume was over $800 billion in the U.S., up nearly 50% year over year (in terms of deal count though, the number was up 8%). Since most of our event investments are in the high yield category, we feel deal count is more relevant than dollar volume which tends to be skewed towards larger deals which typically are not high yield issuers. We believe the environment for M&A activity is robust with low interest rates and great ability to access the credit markets. Additionally, we believe event-driven strategies have and will continue to benefit from non-M&A related events such as spin-offs or asset sales. With ever increasing pressure from activist shareholders, we also expect great opportunities for event activity that is not tied to M&A.

Thank you for your continued interest in Palmer Square. Please contact us with any additional questions or information requests. We would be happy to describe in additional detail how we are navigating today's credit environment.

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