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Investing in Today's Markets – Is Opportunistic Credit Becoming Increasingly Attractive?

While we remain cautious near-term on the equity markets given the continued risk of European debt contagion and concerns over slowing global growth, we are beginning to see opportunities in the credit markets. Our thesis resonates from a combination of the viewpoints of our underlying hedge fund managers which provide Palmer Square with an important source of direction and our own internal proprietary analysis given the Palmer Square team has a deep history investing in credit and managing credit risk.

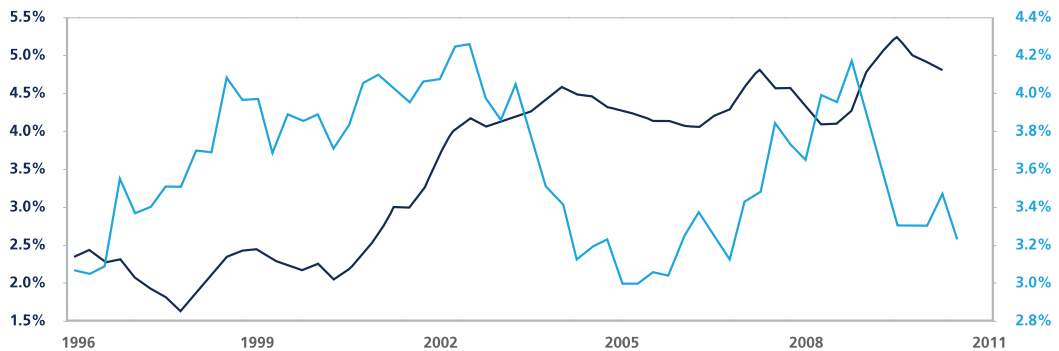
Before outlining the attractive backdrop we see for credit investing, it is imperative to highlight that investors still need to exercise caution and be selective with how they implement an allocation to opportunistic credit. Global macro risks can distort fundamentals in the short-term and drive prices materially lower. In addition, during times of stress, certain areas of credit become less liquid and bid/ask spreads increase significantly. As a result, Palmer Square believes gaining exposure to credit is not as simple as allocating to a high yield mutual fund or ETF, as credit is a complex asset class. Rather, it is our opinion that investors should obtain this type of exposure by utilizing an active fund manager who has been through credit cycles, has managed credit risk, and can opportunistically increase long exposure to credit when conditions are attractive (and vice versa). In addition, we currently believe a portion of an opportunistic credit allocation should be in higher-quality, short-duration high yield bonds which can also serve to mitigate risk in today's environment.

Positive Backdrop for Credit

Slow growth environment positive for high yield. Slow growth environments have historically been attractive environments for high yield credit investments. Companies tend to be more conservative in slow growth environments eschewing excess leverage with the hope of maintaining higher cash balances and greater flexibility. And, in sharp contrast to the time period leading up to 2007-2008, many companies within the high yield universe the last few years have already worked diligently to reduce their debt burden. As shown in the chart on the next page, corporate cash flow has increased while leverage has decreased. For investors considering an allocation to high yield credit in a slow growth environment, the ability to capture higher yields relative to other traditional investments presents an attractive investment opportunity.

U.S. Corporate Free Cash Flow As % GDP

U.S. High Yield Non-Financial Net Debt / EBITDA



Source: Empirical Research Partners, BofA Merrill Lynch

Historically Attractive Entry Point. At times recently, high yield spreads have approached 900 basis points over Treasuries. According to recent JPMorgan research, high yield has historically performed well after reaching those spread levels providing average annual returns on a one, two, and three-year basis of 15.4%, 14.3%, and 13.1%, respectively for BB performance. The table below provides the detail from JPMorgan’s report. Most interestingly, during the five periods where spreads reached these levels, returns the following year were positive in every situation.

BB performance

Date	STW	3mo	2mo	Annualized return				
				1yr	2yr	3yr	4yr	5yr
Sep-90	448bp	2.59%	10.68%	21.77%	18.58%	17.76%	13.59%	14.31%
Nov-00	451bp	7.55%	10.30%	13.07%	9.39%	11.53%	11.15%	9.75%
Sep-01	610bp	5.89%	8.64%	7.61%	12.45%	11.93%	10.22%	9.66%
Jul-02	608bp	2.16%	7.59%	15.24%	12.93%	11.79%	9.42%	9.04%
Sep-08	684bp	-11.54%	-2.93%	19.44%	18.28%	12.70%	N / A	N / A
Average	560bp	1.33%	6.85%	15.43%	14.33%	13.14%	11.09%	10.69%

B performance

Date	STW	3mo	2mo	Annualized return				
				1yr	2yr	3yr	4yr	5yr
Sep-90	930bp	2.08%	21.65%	39.32%	31.13%	25.27%	19.62%	18.81%
Nov-00	904bp	11.17%	8.91%	8.92%	6.37%	11.47%	11.74%	10.32%
Sep-01	954bp	7.90%	10.75%	6.52%	15.50%	14.52%	12.53%	11.83%
Jul-02	873bp	-0.22%	8.90%	21.89%	17.36%	14.84%	12.21%	11.68%
Sep-08	1053bp	-21.13%	-15.99%	9.99%	12.46%	9.19%	N / A	N / A
Average	963bp	-0.04%	6.84%	17.33%	16.56%	15.06%	14.03%	13.16%

CCC performance

Date	STW	3mo	2mo	Annualized return				
				1yr	2yr	3yr	4yr	5yr
Sep-90	2732bp	-19.35%	8.36%	43.90%	28.85%	29.5%	20.97%	18.86%
Nov-00	2211bp	6.55%	-0.48%	-2.73%	-6.31%	11.01%	13.16%	10.65%
Sep-01	2519bp	8.04%	11.48%	-7.53%	20.23%	20.01%	16.98%	15.98%
Jul-02	2286bp	-10.56%	4.74%	34.36%	28.21%	23.21%	18.45%	16.77%
Sep-08	1727bp	-36.72%	-36.11%	20.81%	22.58%	13.74%	N / A	N / A
Average	2295bp	-10.41%	-2.40%	17.76%	18.71%	19.49%	17.39%	15.56%

Source: JPMorgan

Below is another table comparing the annual returns of high yield bonds, as represented by the Merrill Lynch High Yield Master II Index, over three and five year periods that began with spreads greater than 800 basis points. It is interesting to note that returns in high yield bonds outperformed the S&P 500.

High Yield Annualized Total Returns and Spreads

Date	Merrill Lynch High Yield Master II					S&P 500	
	Starting Spread	3-Year Total Return	5-Year Total Return	5-Year Ending Spread	3-Year Ending Spread	3-Year Total Return	5-Year Total Return
10/16/98*	678	1.50%	5.51%	963	462	2.55%	1.31%
11/27/00	842	8.88%	8.27%	455	372	-6.31%	0.42%
3/22/01	840	8.35%	7.91%	452	320	0.96%	4.91%
6/21/01	840	8.62%	8.19%	402	334	-1.35%	1.98%
2/25/02	831	12.54%	10.66%	285	255	4.79%	7.43%
6/25/02	827	12.22%	10.72%	393	280	8.80%	10.93%
1/6/03	841	13.36%	10.37%	356	636	13.44%	10.74%
3/20/08	840	12.88%	N / A	502	N / A	0.97%	N / A
9/2/08	842	11.86%	N / A	733	N / A	-0.57%	N / A

*High yield spreads peaked for the selloff during this period

Source: Bloomberg, September 30, 2011

Spreads Implying Unusually High Default Rates. A big question that investors may be asking is, “do recent price declines portend a dramatic increase in default rates among the companies in the high yield universe?” High yield spreads had been much tighter to US Treasuries during the first half of 2011; however, the US government bond downgrade, the sovereign debt crisis worries, and the economic slowdown concerns have driven record outflows from high yield mutual funds. These developments have caused spreads to widen significantly implying default rates of 7-9% --much greater than the 25-year asset class average of 4.2%¹. Further, those implied default rates are significantly greater than current default rate projections which are expected to be at 1.0% for 2011 and 1.5% for 2012¹. In contrast to the implied high default rates, current credit metrics have actually remained fairly healthy as many companies have reduced debt loads, re-financed to extend maturity dates, and generally, profit growth has been robust.

Ultimately, we believe that the strength of credit fundamentals will drive the long-term performance of the high yield market; however, investors need to balance the positive backdrop for credit with the risk factors present in today’s environment. Will the economy enter a serious economic downturn that could cause default rates to rise consistent with what current spreads imply? While we believe the credit environment is different than 2008, could a large financial institution or sovereign fail causing forced liquidations? Given the balance investors needs to strike between risk /reward within the credit space, Palmer Square believes in a deliberate approach which uses alternative mutual funds that seek to be opportunistic and increase exposures in areas which may offer a unique opportunity in an otherwise difficult investing environment.

(1) Default data provided by Lord Abbett and JPMorgan

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