# Crescent Capital High Yield Bonds

After beginning the year on a strong note with a 2.5% return in Q1 the high yield market faced renewed concerns in Q2 about the potential for higher interest rates as well as the looming default of Greece. The second quarter began with continued momentum from Q1 with gains in both April (+1.2%) and May (+0.3%) for the Bank of America Merrill Lynch U.S. High Yield Master II Index ("Index"). The market reversed course in early June, driven largely by a sell-off in global sovereign debt. German Bund yields increased 50 basis points in the first week of June and U.S. Treasuries followed suit with yields pushing out 30 basis points during that same period. The 10-year U.S. Treasury yield hit a year-to-date high on June 10th of 2.48%, a stunning turnaround from its low in January of 1.64%. A series of strong economic data points released early in the month provided fuel to ignite concerns about a hawkish response from the Fed. The high yield market initially absorbed much of this volatility until fears about Greece entered the headlines. The potential impact of a Greek default sent investors looking for safety and away from riskier assets like high yield bonds. Those concerns reached their peak at the end of the quarter with a critical Greek referendum scheduled for July 6th. Uncertainty over the vote drove high yield down 1.5% in June, leaving the Index with a return of -0.05% for Q2 '15. The benchmark yield to worst rose to 6.65% (from 6.08% at Q1) and the spread over Treasuries was 509 basis points, modestly higher than where it started the quarter (486 bps).

On the fundamental front, earnings momentum continued to decelerate. Of the 375 high yield companies covered by BAML analysts, revenues declined on average 5.3% over the prior year period while EBITDA was down 4.9%. As was the case last quarter, the troubles in the energy sector dragged down those statistics. Excluding energy, revenue and EBITDA growth would have been -0.3% and flat, respectively, when compared to the prior year. Energy remains an area of concern for the overall market as it still ranks as the largest sector in high yield representing 14.4% of the Index. Crude oil rallied through most of the quarter with WTI crude up 24.9% during Q2, however, it has since plummeted in July which has put further pressure on the outlook for the sector and, by extension, the high yield asset class. Adding to our concerns about the fundamental health of the market is an uptick in the trailing default rate. Per Moody's, the TTM par-weighted default rate hit 2.0% at the end of the quarter driven largely by defaults in the energy and mining sectors. While being the highest level this year, the default rate still remains well below the 3.8% long-term historical average for the asset class.

It should come as no surprise that with all of the fundamental concerns surrounding interest rates and Greece, the technical picture was volatile as well. According to JPMorgan, what started as modest outflows in both April ($108.0 million) and May ($390.0 Million) accelerated with the flight to quality in June. $4.5 billion flowed out of high yield mutual funds and ETFs alone that month which brought the year-to-date inflow down to $4.1 billion. While still a net positive, it was a sharp change from the $10.0 billion of inflows we saw in Q1. Mirroring the flow of funds during the quarter, monthly new issue volume was strong in April and May only to collapse in June. Even with the drop-off at the end of the quarter, the pace in the first two months was enough for $94.1 billion of volume during Q2 (per Credit Suisse) which brought the year-to-date total to $187.5 billion, ahead of last year's pace. Average yields on new issues for the first half of the year were 6.41%, slightly lower than last year. Leverage and interest coverage were 5.0x and 3.0x, respectively, which is consistent with historical averages.

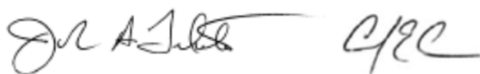
As we begin Q3, crude oil has returned once again as a major headwind for our asset class. Since the end of June, crude oil prices have plummeted with WTI testing the March 2015 low. While the

reasons remain the same (weakening global demand, peak production levels from OPEC producers, increasing US shale production), sentiment on the commodity has swung dramatically over the last month, putting pressure on most high yield energy issuers. Given the difficulty in predicting oil prices, we have chosen to focus our energy exposure on credits with strong balance sheets, attractive assets and solid liquidity positions.

Lost in all of the volatility at the end of the quarter was relatively dovish commentary coming out of the June FOMC meeting. Their commentary suggested that the pace of interest rate increases in 2016 and 2017 may be slower than many expect with no preset glide path. In her speeches since the June meeting, Janet Yellen has reiterated her expectation of an interest rate increase this year given significant improvement in labor markets but also maintained that the Fed's future increases would be gradual and data-dependent. Unlike previous situations where an initial hike was followed by a steady pace of increases in subsequent meetings, we believe the number and pace of interest rate hikes may be measured and cause less pain for fixed income investors than in past cycles. With lingering worries about Greece, concerns about slowing growth in China, and a likely default in Puerto Rico, the challenges to the U.S. economy remain meaningful which could provide support for a "lower for longer" rates scenario.

The outlook for energy, decelerating corporate earnings, modestly higher default activity and the potential for an interest rate increase in Q3 suggest we may be approaching a turning point in the credit cycle. Accordingly, we have positioned our portfolios conservatively relative to the Index. We have been selective in underwriting new investments and have carefully managed our triple-C rated exposure. We continue to overweight double and single-B bonds and underweight triple-Cs, the worst performing credit tier this year, across most of our portfolios. We continue to have a favorable view of the incremental yield and spread associated with smaller high yield issues as that liquidity premium remains well above the historical average in light of recent regulatory changes. While we do not expect to see an imminent increase in defaults, we are preparing for an inevitable downturn by increasing credit quality and maintaining broad portfolio diversification. We have also reduced exposure to commodities to reflect our growing unease with weakening trends in China which are likely to have the greatest impact on global commodity prices. In the current environment we believe investors will be best served by managers utilizing an investment process that emphasizes strong fundamental credit analysis and default avoidance. As always, we appreciate your support and welcome any questions you may have.

Sincerely,



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