Crescent Capital High Yield Bonds

For the first time all year, interest rates took a back seat to a host of other concerns. At the beginning of the quarter we saw commodity prices swoon again in a scary repeat of what we experienced in the fourth quarter of last year. Pressure on commodity names pushed the Energy and Metals & Mining sectors lower in July and August and led to negative monthly returns. For most of the summer, though, the broader high yield market held steady. That changed in late August when fears over China's slowing growth stoked doubts about the global economy which had negative implications for several high yield sectors. With buyers sitting on the sidelines in early September, large new issues in the Chemicals, Telecom and Cable space were forced to price at deep discounts to draw interest which in turn re-priced existing names. A downgrade of Sprint, the largest high yield issuer, to Caa1 by Moody's caught the market by surprise and dragged Wireless Telecom down with it. Pharmaceuticals, long viewed as a safe haven for high yield investors, came under government scrutiny for aggressive drug pricing and Valeant, the largest pharma name and one of the largest high yield issuers, sold off hard as a result. All in all, the Bank of American Merrill Lynch High Yield Master II Index (the "HY Index") was down 4.9% for Q3 '15, its worst quarterly performance in four years. At quarter end, the HY Index yield to worst was 7.99% and the spread over Treasuries was 658 bps, nearly 150 bps wider than where we started the year.

Unlike previous sell-offs we've seen in high yield, this quarter's decline was not precipitated by any single catalyst, but rather, it was the confluence of multiple negative headlines on the macro economy as well as company and sector specific issues. Through the end of the third quarter, 10 of the 21 sectors in the JPMorgan HY index had generated negative total returns for 2015. Despite all the negative headlines, we found reasons for optimism about our asset class. As we've mentioned in previous quarterly letters, earnings from our high yield credits have shown signs of decelerating growth and that remained the case in company results seen during the quarter. However outside of commodity-related credits, earnings were generally positive with JPMorgan noting that EBITDA growth ex-commodities was up 10.9% during the quarter. At the same time, defaults continue to be below historical averages. Credit Suisse reported the LTM par weighted default rate through 9/30 was 2.4% compared to the long-term average of 3.6%. More than 50% of the defaults were in the Energy and Metals & Mining sectors, and excluding Caesars Entertainment, the default rate drops to just 0.31%, showing that much of the high yield market outside of commodities remains healthy.

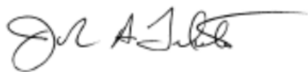
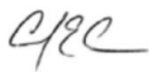
With all the volatility, it should come as no surprise that the technical picture for the high yield market was weak. Per Credit Suisse new issue activity in Q3 '15 slowed to $57.0bn, down from $94.1bn in Q2 '15 and off nearly 19.3% from the prior year. Historically a busy month as investors return from summer vacations, this September was the worst in four years with volume down nearly 50% from 2014. The deals that did get done during the month were concentrated in a couple large new issues from Frontier ($6.6bn) and Cablevision ($4.8bn) that priced well-wide to their existing paper which ultimately drove secondary levels lower. You would expect the pressure in the primary market to be indicative of weakening standards, but Credit Suisse noted that the average total leverage for new issues this quarter was 5.0x, unchanged from the 5.0x area we've been hovering at for several quarters now. Lower-quality issuance (rated CCC+ or below) was also a small portion of the activity in Q3 accounting for just 7.9% of new issues, less the half the percentage in 2014. The demand picture wasn't much different from the supply one

as JPMorgan reported mutual funds outflows of $6.8bn during the quarter, continuing a weak trend from Q2 (-$9.0bn). Year-to-date, outflows for the asset class were $6.7 bn.

Our forward outlook for high yield is cautiously optimistic. The sell-off in Q3 has re-priced the market and created opportunities in certain segments. We remain mindful about where we are in the credit cycle and have been focused on upgrading the overall credit quality of our portfolios by reducing our exposure to CCC-rated credits and increasing our BB names. This shift has come at the expense of lengthening duration, but we are less sensitive to interest rates than we are to credit quality. We continue to avoid adding any new exposure to commodity names and have been steadily pruning our remaining exposure to those issuers we feel are best positioned to ride out current challenges. That said, we maintain a meaningful exposure to Energy as we continue to believe the entire sector is being unfairly painted with the same brush. Not all credits in the commodity space are created equal and we believe that the stronger ones will ultimately be rewarded when industry conditions normalize. Outside of Energy, we see value in the higher quality segments of our market. At quarter end, JPMorgan noted that BBs were trading at a spread of 487 bps over Treasuries, nearly 42% above its 20 year median of 343 bps. We find those levels compelling and have been adding BB exposure during October. JPMorgan also estimated that high yield spreads at quarter end were implying a default rate of 6.4%, well in excess of strategist estimates in the 3% to 4% range. While we concede credit defaults are likely to increase over the coming year, we don't believe they'll reach 6% which suggests market fear is exceeding reality. For these reasons, we are more optimistic about our asset class over the near-term and have been comfortable putting money to work in higher quality names.

While we remain focused on the Fed and a potential increase in interest rates, we are still of the belief that the timing of the first interest rate hike is less important to our asset class than the pace of future increases. We think that an uneven domestic recovery and increasing global challenges will keep the Fed from moving aggressively on rates which should bode well for our asset class in general. Economic growth expectations have certainly been reset with the data we saw during the quarter, but all the indicators we monitor suggest that the risk of a recession is low. Commodities will remain a wild card and likely the biggest catalyst to drive incremental high yield performance, however, the rest of the market is still relatively healthy leaving room for attractive current yields to drive returns.

Thank you, as always, for your business and please contact us with any questions.

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