DDJ CAPITAL MANAGEMENT, LLC
SPECIALISTS IN HIGH YIELD AND SPECIAL SITUATIONS INVESTMENTS

CELEBRATING 20 YEARS! 1996-2016

JULY 2016
VOLUME 3 • ISSUE 2

CIO's Perspective
2016 Half-Time Leveraged Credit Review and Outlook

> In our opinion, the most recent policy actions by central banks have extended the credit cycle

> Anemic economic activity and deteriorating issuer fundamentals will result in continued volatility, which we believe will produce attractive investment opportunities for credit selectors

David J. Breazzano
President, Chief Investment Officer, Portfolio Manager

Mr. Breazzano is a co-founder of DDJ and has more than 35 years of experience in high yield, distressed, and special situations investing. At DDJ, he oversees all aspects of the firm and chairs the Management Operating, Remuneration, and Investment Review Committees. Mr. Breazzano also serves as the portfolio manager of DDJ's U.S. Opportunistic High Yield and Total Return Credit Strategies.

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1st Half 2016 Review

In early 2016, concerns about global economic growth, including within the United States, placed pressure on commodity prices and resulted in a sell-off in the leveraged credit market. However, the market's mood shifted as constructive news flow in the form of more accommodative monetary policy from central banks, improving economic conditions and a recovery in oil prices began to positively affect the psyche of market participants.

As retail investors became more comfortable with the risks in the high yield market, high yield bond mutual funds experienced significant inflows, including approximately $14bn from mid- February through April 30th. These flows, coupled with weak primary market activity, provided a tailwind to complement a better-than-feared macroeconomic back-drop, which resulted in a strong bid in the secondary market for leveraged credit, especially high yield bonds. After a brief but sharp decline following June 23rd when British voters surprised markets and decided to "Brexit" from the European Union, leveraged credit markets recovered from losses earlier in the year to produce strong performance during the first six months of 2016.

Exhibit 1: High Yield Bonds and Leveraged Loans, calendar 2015, and 1H 2016 and 2015[1]

	Dec 31, 2015	1H 2016	1H 2015	∆ v. 1H 2015
High Yield Bonds (HYBI)				
Total Return YTD	-4.64%	9.32%	2.49%	+6.83%
Yield (YTW)	8.76%	7.36%	6.65%	+0.71%
Spread (OAS)	695 bps	621bps	500 bps	+121 bps
Price	88.82	95.27	98.21	-2.94
Coupon	6.66%	6.60%	6.79%	-0.19
Current Yield	7.50%	6.93%	6.91%	+0.02%
Average Rating	B1	B1	B1	Unch
Eff. Duration	4.38	4.41	4.49	-0.08
Default Rate (Par)	2.56%	4.68%	2.12%	+2.56%
Leveraged Loans (LLI)				
Total Return YTD	0.54%	4.31%	3.01%	+1.30%
Yield (3-Year)	7.55%	6.52%	5.81%	+0.71%
Spread (3-Year)	617 bps	571 bps	458 bps	+113 bps
Price	93.39	95.56	97.76	-2.20
Default Rate (Par)	1.74%	2.18%	1.79%	+0.39%

Source: BofA Merrill Lynch and JP Morgan.

The BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI") and the JP Morgan Leveraged Loan Index ("LLI")

Past performance is no guarantee of future results.

1. Default statistics for 2015 and 2016 include distressed exchanges.

...triple Cs outperformed both double B rated and B rated bonds during the period by 10.70% and 10.60%, respectively.

As one can see from Exhibit 1, high yield bonds (as measured by the BofA Merrill Lynch U.S. High Yield Bond Index ("HYBI")) produced strong gains of 9.32% in the first half of 2016 ("1H16"). However, 1H16's performance was not generated by way of a straight line of progressively increasing gains, but rather from a massive recovery after a plunge to start the year. Digging deeper into the numbers reveals that high yield bonds, after initially sliding -5.14% during the first six weeks of 2016, produced a gain of 15.24% from February 11th through June 30th. Triple C rated bonds, which gained 18.58% and saw spreads contract 239 bps, were the top performers during the first six months of 2016. More specifically, triple Cs outperformed both double B rated and B rated bonds during the period by 10.70% and 10.60%, respectively.

Meanwhile, leveraged loans (as measured by the JP Morgan Leveraged Loan Index) generated healthy year-to-date performance equal to 4.31%. However, leveraged loan prices continue to fight an uphill battle as a "lower for longer" rate environment, a reduction in CLO issuance, and continued outflows combined to place pressure on loan prices. The current interest rate environment in particular continues to weigh heavily on loan prices, as 2, 5 and 10 year U.S. Treasury yields declined 51 bps, 75 bps and 82 bps, respectively, during the first six months of 2016.

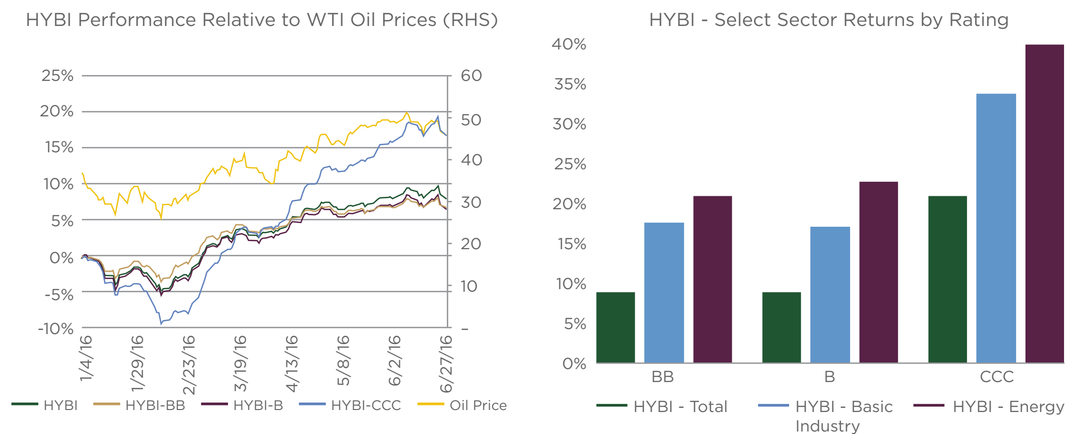
Concerns over rising rates have all but vanished to the detriment of leveraged loan funds, which experienced significant outflows to begin the year. CLOs continue to supply a bid in the loan market; however, new issue activity for CLOs in 2016 is down year-over-year. These factors, combined with a lower exposure to the Energy and Metals & Mining sectors, has left leveraged loan performance lagging high yield bonds, as well as other higher duration fixed income products in 1H16.

...oil prices increased 23% during the 1H16... a 74% rise from the low on February 11th...

The Troublemakers become Teacher's Pets

As we discussed in our last CIO's Perspective, three sectors stood out as being the main drivers of the broader high yield market's negative performance in 2015: Metals & Mining, Energy and Steel. Similarly, these sectors once again exerted their influence on high yield bond performance, though this time in a much more beneficial way. As Exhibit 2 details, the recovery in commodities was a key theme for HYBI performance. In particular, oil prices increased 23% during the 1H16, which included a 74% rise from the low on February 11th and was attributed primarily to supply disruptions in Canada and Nigeria, as well as to a more constructive economic outlook.

Exhibit 2: Rally in Commodity Sectors Drove HYBI Performance in 1H16



Source: BofA Merrill Lynch

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A further analysis of these drivers of performance shows that the Energy and Basic Industry sectors, which includes Metals/Mining and Steel Producers/Products, significantly outperformed the broader high yield market across all quality tiers. The recovery in oil prices and its effect on the high yield bond market's performance cannot be overstated. Exhibit 3 shows the strength of the relationship between HYBI returns and oil prices during the period. These two assets became significantly positively correlated during Q1 2016, although the relationship weakened during most of Q2.

Exhibit 3: Correlation of Trailing HYBI returns and WTI Oil Prices

Source: BofA Merrill Lynch and the Federal Reserve Bank of St. Louis

Past performance is no guarantee of future results.

Angels and Demons

Fallen angel[2] and default volumes come to mind as yet another corner of our market where the issuers in the Energy and Metal & Mining sectors have dominated the headlines. From a dollar perspective, fallen angel volume in 1H16 has already eclipsed the previous annual record set in 2009, and follows 2015's elevated total. However, when the year-to-date 2016 total dollar value of fallen angels is scaled relative to the size of the overall high yield market, the percentage is much smaller than in previous episodes. Typically, a spike in such volume coincides with a decrease in primary market activity and 1H16 was no exception. New issue activity was anemic in Q1 when fallen angel volume peaked. In addition, fallen angels were some of the strongest performers in 1H16; the BofA Merrill Lynch U.S. Fallen Angels Index gained 16.18% for the period and outperformed the HYBI by 6.86%.

Default volume for 1H16 was also elevated and is already poised to produce the highest total since the 2007-08 credit crisis. During the first six months of 2016, issuers in the Energy and Metal & Mining sectors have accounted for approximately 83% of default and distressed exchange activity, according to JP Morgan data. Of note, the trailing twelve month default rates for the Energy and Metals & Mining sectors are very close to, or already at, record levels. Conversely, recovery rates on defaults for these sectors have been in the mid-20s, which is well below the 25 year average of approximately 40% for the broader high yield market. Although commodity prices have rallied since February, many high yield issuers remain in a precarious financial position and the likelihood of continued defaults in these sectors appears to us to be high.

Overall, the developments in the commodity sectors during 1H16 were near -term positives for the broader high yield market. However, it remains to be seen as to whether or not these short-term gains will translate into a sustained compression in high yield credit spreads. Our guess is that this most recent recovery reflects a volatile market searching for a bottom, and that spreads will oscillate for some time as the market progresses through the credit cycle.

2. For our purposes, a fallen angel is a debt instrument that previously had an investment-grade rating, but has since seen its rating reduced below investment grade.

...approximately $10+ trillion in government debt around the globe with negative yields...

2nd Half 2016 Outlook

Macroeconomic and Geopolitical Risks Continue to Create Market Unease

Globally economic activity remains a concern. Emerging markets, especially commodity exporters, continue to feel the pain from a slowdown in China and from commodity price weakness. Conversely, the U.S. economy has remained relatively more resilient. The U.S. consumer has been a bright spot, but recent employment figures have been mixed and may influence consumer spending trends negatively moving forward. The policy response by central banks outside of the U.S. has been to become more accommodative. Such accommodation has taken the form of rate cuts and aggressive bond purchasing programs that have moved beyond government debt and into corporate bonds, including issuers with below investment grade ratings, in an effort to stimulate growth and inflation.

The result is approximately $10+ trillion in government debt around the globe with negative yields, including some developed markets with negative yields on maturities beyond 15 years. It is really anyone's guess as to whether or not these types of actions will eventually spur growth. Only time will tell if these policy decisions will merely stave-off deflation or produce the controlled inflationary environment that is so sought after by central banks.

In contrast, the U.S. Federal Reserve ("the Fed") has been in a holding pattern since it hiked rates for the first time in almost ten years this past December. Coming into 2016, market participants were expecting up to four interest rate hikes during the year. Since that time, expectations for even a single rate hike have declined precipitously as concerns over the economy, both domestically and abroad, have given the Fed pause. Furthermore, the aggressive monetary stimulus by global central banks described above puts the Fed at odds with several developed economies, making it more difficult to raise rates in future periods. A rate hike in the current environment could result in a strong U.S. dollar rally, potentially resulting in negative consequences for domestic economic growth.

Furthermore, while the lasting effects from "Brexit" are far from certain, we think it is safe to assume that in the short to intermediate term, Great Britain's decision to exit the European Union will act as a drag on economic growth globally, especially in the U.K. and Europe and to a lesser extent in the U.S. Increasing rates at a time when a stronger dollar is already expected to crimp corporate profits could lead to diminishing gains for the U.S. economy. Ultimately, we believe that the current credit cycle has most likely been extended and it is unlikely that the Fed will raise interest rates during the remainder of the year.

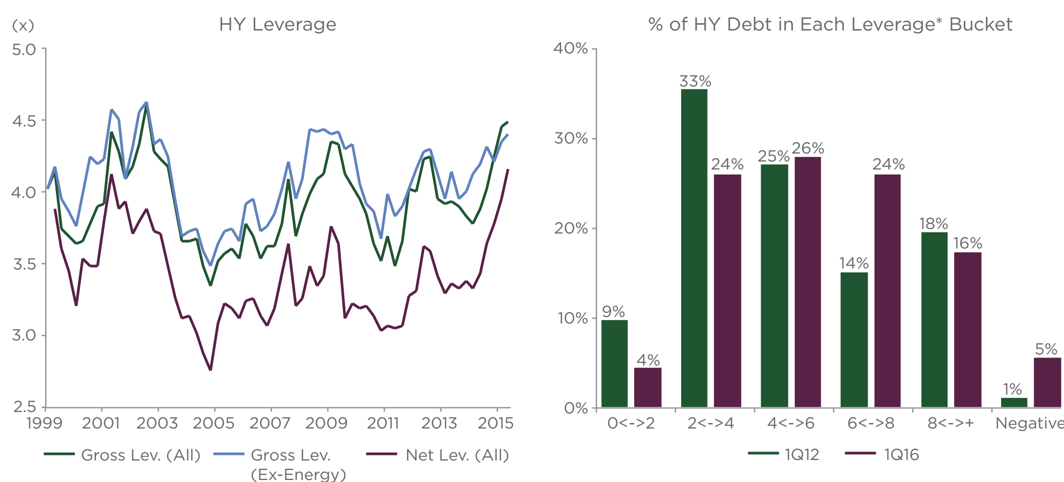
Finally, we would be remiss if we did not at least briefly touch on what will most likely be another key geopolitical event in the second half of 2016 ("2H16"): the U.S. presidential election. At this point in the election cycle, both presumptive nominees have very low approval ratings, which according to the NY Times[3] are some of the lowest in decades. U.S. politics has been in a state of extreme partisanship for some time and regardless of the eventual outcome of the election, it appears clear to us that such an environment will remain pervasive, as both candidates appear to have a polarizing effect on the electorate. As a result, we anticipate that market participants will have to navigate an increasingly volatile landscape brought about through uncertainty around fiscal policy and the regulatory environment in the U.S.

[3] Clinton and Trump Have Terrible Approval Ratings. Does It Matter? By KAREN YOURISH JUNE 3, 2016 http://www.nytimes.com/interactive/2016/06/03/us/elections/trump-and-clinton-favorability.html?_r=0+.

Fundamentals Remain a Concern

A closer look at issuer fundamentals reveals that while their financial position remains in decent shape, it has been deteriorating for several quarters. For example, interest coverage, defined as EBITDA divided by total interest expense, although still at elevated levels, has been declining since 2014. In addition, leverage, or a company's earnings relative to its debt load, has been growing for some time. From Exhibit 4, one can see that issuers have experienced a pick- up in leverage levels, and although Energy sector issuers have been the primary driver of the growth in leverage in the high yield bond market more recently, issuers throughout the high yield market have been affected. Furthermore, the percentage of the high yield market that is levered greater than 6x has also increased, and research has shown that the size of this "tail" meaningfully effects future defaults.

Exhibit 4: Increasing Leverage



Source: Morgan Stanley

Past performance is no guarantee of future results.

* Leverage is equal to Total Debt/EBITDA

Although not depicted in Exhibit 4, decomposing leverage statistics further demonstrates that the increase in leverage is being driven by a deterioration of EBITDA, rather than an expansion of total debt. Total debt levels remaining constant is a positive for issuer fundamentals; however, a weakening of EBITDA is concerning, especially given the current outlook for economic activity. As growth slows, or fails to accelerate, companies may experience declines in revenue, thereby placing pressure on corporate profits and creating a negative feedback loop that results in a further deterioration in corporate fundamentals.

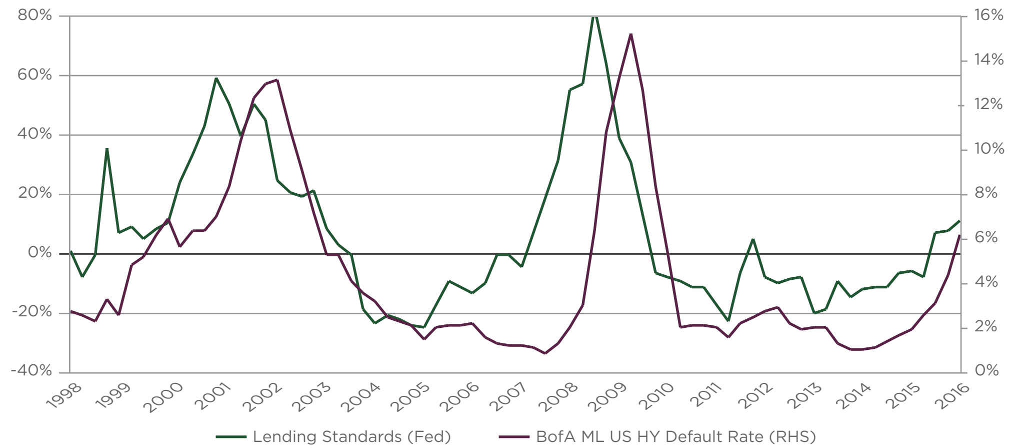
Riding the Wave

Declining revenues and EBITDA can lead to rapid increases in leverage, ultimately resulting in a broader default wave. However, rather than the rapid acceleration in defaults like that experienced during the last default cycle (i.e., 2008), we expect a slower, steadier climb in default rates for the broader high yield market. The leverage that exists in the system today is not the same as in 2007 (e.g., structured products, LBOs, etc.), and as a result it is more likely that this wave of defaults will be similar to that experienced during the early 2000s. At that time, U.S. high yield default rates peaked in the mid-teens, but took several years to reach their zenith.

...the tightening of lending standards has proven to be a leading indicator of future default rates.

Access to capital is one metric that we focus on in gauging the credit cycle, and the tightening of lending standards has proven to be a leading indicator of future default rates. As one can see from Exhibit 5, tightening lending standards have preceded an increase in default rates during previous default waves. The U.S. Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, which was released on May 2nd, detailed tightening lending standards for a third consecutive quarter on commercial and industrial loans, as well as on commercial real estate loans. Although reducing the availability of credit is potentially painful for certain sectors/issuers, it is a rational behavior in the current environment.

Exhibit 5: The net percent of banks tightening lending standards



Source: BofA Merrill Lynch

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As excesses start to build in the system, there is typically some event or shock that instills credit discipline back into the market (the most recent examples of which would be the decline of oil prices and potentially the Brexit decision and its ensuing ramifications). However, unlike in the previous cycle (i.e., 2008), where such events would most likely have resulted in an inflection point, today's market appears to be more resilient. Although it is late in the credit cycle, and fundamentals are starting to weaken, these "mini-shocks" appear to be resulting in a more measured approach to credit discipline that, in an odd way, further extends the current credit cycle.

As Exhibit 6 shows, based on current spread levels, as well as historical default and recovery rates, the broad high yield universe is providing spread in excess of expected default losses above its historical average. Furthermore, default rates on the non-commodity universe are expected to remain below the market's historical average of 3.5%, while their recovery rates are projected to be in-line with past experience. As a result, there appears to be an opportunity for investors to capture excess spread in the non-commodity universe, using reasonable assumptions about default and recovery rates, as the market continues through the latter stages of the credit cycle.

Exhibit 6: Excess Spread given expected defaults and historical recoveries

	Average	**June 30, 2016**	**June 30, 2016 (Ex-Commodities)**
HYBI OAS[1]	602 bps	621 bps	575 bps
HY Default Rate[2]	3.5%	6%	2%
HY Recovery Rate[3]	41%	41%	41%
Expected Default Loss	207 bps	354 bps	118 bps
Excess Spread	395 bps	267 bps	457 bps

Source: BofA Merrill Lynch and JP Morgan

Past performance is no guarantee of future results.

1. Average option adjusted spread (OAS) calculated based on month end OAS from 1998-2016. All other OAS figures are as of the date provided.
2. Average default rate during the past 25 years according to JP Morgan Data. Other default rates reflect JP Morgan's forecasted default rate for 2016.
3. Approximate average high yield bond recovery rate during the past 25 years according to JP Morgan data.

...it is not uncommon for the high yield market to experience periods of solid gains, partially offsetting the more extreme losses, during broader market sell-offs.

Security selection remains paramount

It is difficult, if not impossible, to predict how the market will behave going forward; however, the current credit cycle is displaying a similar pattern to that of the early 2000s, as a strong rally has followed a significant sell-off. If the market is in fact following a similar form, one would expect to see spreads achieve progressively higher highs in sell-offs, and higher lows during rallies, as the market remains volatile and winds its way through the current default cycle.

Exhibit 7: HYBI OAS: Oct'97 – Oct'02 and Jun'14 – Jun'16

Source: BofA Merrill Lynch

Past performance is no guarantee of future results.

Exhibit 7 depicts daily HYBI OAS for the default cycle that began in October 1997 and culminated in October 2002, with an overlay of the daily spread movements of the current cycle that we believe began in June 2014. One can see that spread movements during these two cycles seem to be following a similar pattern. This makes sense given that today's default environment is centralized in a couple of troubled sectors (i.e. , Energy and Metals & Mining) similar to that of the early 2000s, which had its own problem sectors (e.g., Technology, Media and Telecommunications). Furthermore, one can also see that throughout the cycle that began in 1997, there were several instances where spreads widened and tightened as the market searched for a bottom. In fact, it is not uncommon for the high yield market to experience periods of solid gains, partially offsetting the more extreme losses, during broader market sell-offs.

Another similarity between the two periods is concerns over aggressive accounting practices. Some very notable accounting scandals occurred during the early 2000s (e.g., WorldCom, Adelphia and Global Crossing), which resulted in increased regulation. More recently, concerns over accounting irregularities at certain Pharmaceutical companies has lifted the veil on aggressive drug pricing practices and put certain business models at risk. However, it remains to be seen if this similarity will blossom into one of the defining characteristics of the current cycle. In our opinion, today's environment of heightened volatility creates opportunity for discerning investors to spot value and act accordingly, but also demands that investors closely monitor existing positions to avoid problem credits.

Summary

The first half of 2016 was a challenging environment for credit selectors as a strong bid for high yield credits materialized, most notably in the Energy and Metals & Mining sectors, rapidly lifting the broader high yield market.

The economic back-drop continues to be a wild-card and its influence on commodity prices will be something that high yield investors will need to closely monitor. Furthermore, as central banks continue to inject stimulus through bond purchase programs and negative yields, the lasting effects of which are yet to be determined, the runway for the cycle appears to have been lengthened.

As 1H16 has shown us, macro-risks, such as the Brexit outcome, are extremely difficult to predict and can compound existing volatility. In particular, when the margin for error is so slim, as was the case leading up to the vote on June 23rd, if the market's expectation of what will happen fails to become reality, corrections can occur swiftly. In addition, the disconcerting trends in fundamentals continue to stress the importance of careful credit selection in an effort to avoid names that sell-off rapidly following the announcement of poor operating results.

In my experience, today's environment is just part of the normal ebb and flow of the credit cycles that I have seen over the last 35 years. What's most interesting to us is that a period of increased volatility typically creates great opportunity for discerning investors. Investment managers can utilize sell-offs in the market to identify and invest in solid credits that offer premium yields to the broader high yield market, while taking advantage of market strength to sell credits in situations where relative value has been realized. Remaining disciplined when others are not should allow astute investors to capitalize on investment opportunities where the risks are being overstated by the current volatility, thus allowing for the potential to produce attractive risk- adjusted performance over the long term.

Organizational Update

Six Months Ending	June 30, 2016	December 31, 2015
Total Assets Under Management (MM)	$7,074	$7,401
Total Number of Accounts	42	43
Personnel Updates: Material Changes (Positions)	David Breazzano[1] (Portfolio Manager of the Opportunistic High Yield & Total Return Credit Strategies) Ben Santonelli[1] (Assistant Portfolio Manager of the Opportunistic High Yield & Total Return Credit Strategies) John Sherman[1] (Assistant Portfolio Manager of the Opportunistic High Yield)	John Sherman (Lead Portfolio Manager of the Opportunistic Loan Strategy)
Material Departures (Positions)	Anthony Ranaldi[1] (Executive VP, Portfolio Manager of the Opportunistic High Yield & Total Return Credit Strategies) Scott McAdam[2] (Portfolio Specialist, Business Development and Client Service) Erika Kennedy (Director, Business Development and Client Service)	Dimitri Cohen (Senior Research Analyst) Michael Yeomans (Director, Business Development and Client Service)
Material Additions (Positions)	Andrew Ross[3] (Director, Business Development and Client Service)	Michael Weissenburger (Managing Director, Head of Origination)

1. Anthony Ranaldi departed from DDJ as an employee as of May 31, 2016. David Breazzano, co-founder and chief investment officer of DDJ, has assumed Mr. Ranaldi's portfolio management responsibilities with respect to DDJ's U.S. opportunistic high yield and total return credit strategies. John Sherman and Ben Santonelli, long-tenured members of DDJ's investment team, have both been named assistant portfolio managers on the U.S. opportunistic high yield strategy, while Mr. Santonelli has also been named assistant portfolio manager on the total return credit strategy.
2. Scott McAdam departed DDJ on July 1, 2016.
3. Andrew Ross joined DDJ on July 18, 2016.

Appendix

BPS: Stands for basis points. A basis point is one one-hundredth of one percent (0.0001).

Collateralized Loan Obligation ("CLO"): A CLO is a form of securitization where payments from multiple middle sized and large business loans are pooled together and passed on to different classes of owners in various tranches.

Coupon: The stated interest rate paid on a bond. Coupon payments for high yield bonds are typically made semi-annually.

Effective Duration: A duration calculation for bonds with embedded options. Effective duration takes into account that expected cash flows will fluctuate as interest rates change.

High Yield Bond: A high yield bond is a debt security issued by a corporate entity where the debt has lower than investment grade ratings. It is a major component – along with leveraged loans – of the leveraged credit market.

Investment Grade: investment grade are those securities rated Baa3/BBB-/BBB- or above by Moody's, S&P, and/or Fitch, respectively.

LBO: A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money to meet the cost of acquisition.

Monetary Policy: Monetary policy is the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).

Option Adjusted Spread: A measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst would use the Treasury securities yield for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

Spread: The yield of a bond minus the yield of the government bond that matches the maturity (or appropriate call date) of the bond.

Disclosures

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The BofA Merrill Lynch US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Please note that one cannot invest in the index.

Moody's Investors Service and Standard and Poor's Financial Services use a different nomenclature for their ratings system. For example, the Moody's equivalent to a S&P rating of CCC+ is Caa1. For information on the rating agencies' methodology go to: https://www.moodys.com or www.standardandpoors.com.

DDJ000129 6/30/2017

JULY 2016
VOLUME 3 • ISSUE 2

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ABOUT DDJ CAPITAL MANAGEMENT

DDJ Capital Management's goal is to consistently produce attractive long-term investment returns, while minimizing downside risk for our investors, which include:

- Corporate pension accounts and public retirement plans
- Endowments and foundations
- Insurance companies
- Other institutional clients

The underpinning of DDJ — a disciplined investment philosophy, coupled with a commitment to exhaustive credit research — has remained constant since our founding in 1996. Our highly skilled team is steadfast and focused on executing our strategy to identify strong risk-adjusted investment opportunities in the leveraged credit markets.

For information on DDJ's investment capabilities, please contact:

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Jack O'Connor, head of business development and client service at DDJ, is a representative of ALPS Distributors, Inc.