

May 6, 2010



Gino Nucci
Senior Vice President
U.S. Fixed Income

Fixed Income Commentary High-Yield Update: April 2010

April Performance

The high yield market, as measured by the Merrill Lynch U.S. High Yield Master II Constrained Index, returned 2.3% during the month of April as spreads tightened 24 basis points (“bp”) over comparable Treasury yields. Once again, the lowest quality segment of the market, CCC-rated securities, led the way and returned 3.7% during the month. The top three sectors during the month were Insurance (+4.8%), Gaming (+3.9%) and Broadcasting (+3.9%), while the bottom three sectors were Cable (+1.0%), Food (+0.9%) and Financials (+0.3%).

	Spread		MTD	Total Return	
	3/31	4/30	Change	MTD	YTD
ML 2% HY	585 bp	561 bp	-24 bp	2.27%	7.22%
BB	418 bp	411 bp	-7 bp	1.87%	6.55%
B	576 bp	558 bp	-18 bp	1.85%	5.47%
CCC	935 bp	864 bp	-71 bp	3.71%	11.49%
5 Yr UST	2.54%	2.42%	-13 bp		

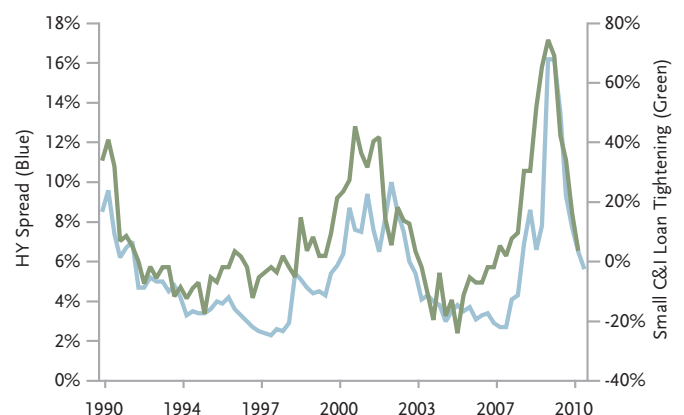
Source: Bank of America Merrill Lynch (BAML)

New Issue Market / Lending Standards

After a record high \$41 billion of high yield bond issuance in March, another \$33 billion was priced in April, and nearly \$70 billion in last eight weeks alone. The YTD total of \$111 billion is on pace to easily surpass the 2004 record of \$158 billion. Given that a “rolling loan gathers no loss,” the robust demand in the new issue market has significantly reduced default risk, correctly resulting in lower spread

premiums for high yield bonds. Nearly 65% of the \$111 billion of YTD issuance was for refinancing purposes, 33% of which was used to repay bank loans, down slightly from 76% in 2009. In fact, this dynamic is also evident in today’s Federal Reserve Senior Loan Officer Survey below. An increasingly smaller percentage of lenders are tightening standards (only 3.7% for small firms). Not surprisingly, this is highly correlated with high yield spreads and both appear to be remediating towards their respective longer term averages.

HY Spreads vs Lending Standards



Source: BAML, Federal Reserve

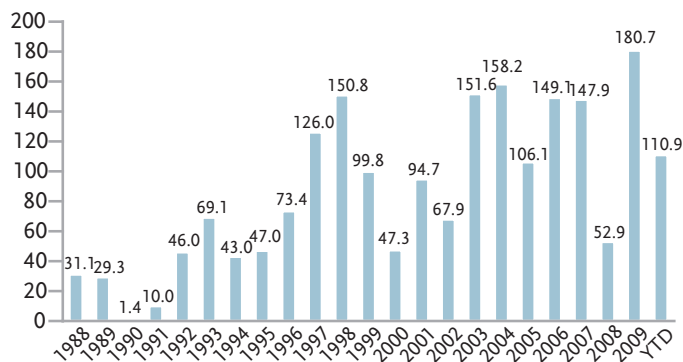
We also appear to be entering into the beginning phases of the re-leveraging stage of the credit cycle as well. For lower-rated, defined as B-/CCC and below, issuance has increased YTD to 17% from 11% in 2009 and M&A issuance has increased YTD to 13% (18% in April) from 5% in 2009. Given the strong demand for bonds and

Fixed Income Commentary

High-Yield Update: April 2010 (cont'd)

relatively low yields, we expect leveraging transactions to rise further. This record supply has been easily absorbed into the marketplace as most deals are well “oversubscribed” and trade well on the break. According to JP Morgan, 88% of 2010 new issues currently trade above offer price, at an average premium of \$3.64. Needless to say, lenders have been forced to incrementally relax underwriting standards given the strong demand.

New-Issue Volume



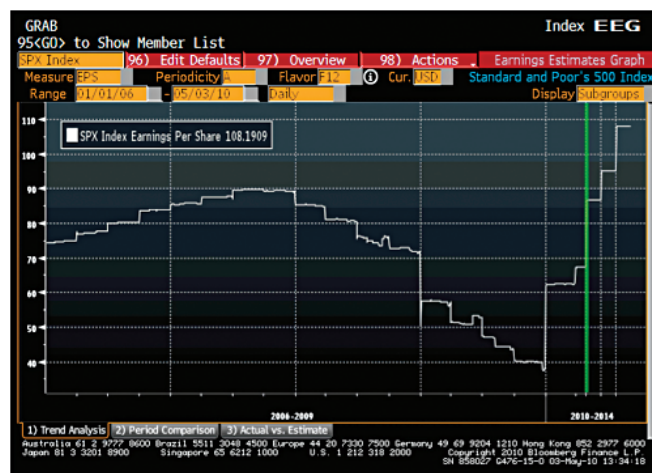
Source: JP Morgan
Note: Includes only U.S. dollar-denominated securities.

The leveraged loan market also continues to improve, albeit at a much slower pace. Institutional bank loan issuance is \$41 billion YTD, already surpassing the 2009 total of \$38 billion. However, the current pace is still well below the 2007 record of \$387 billion. New deals are benefitting from lower LIBOR floors, down from 3.5% to 1.25% currently, which may suggest that floating rate securities are being viewed as a better prospective investment in a rising rate environment. Issuers are also refinancing loans in the unsecured bond market, which is less restrictive from an issuer’s perspective. On average, companies are paying 200 bp to extend maturities, remove covenants, and reduce encumbered assets via the high yield bond market. The elimination of maintenance covenants significantly improves an issuer’s “runway” and ability to weather downturns, thus reducing default risk.

Fundamentals

While Goldman Sachs, increasing rhetoric about financial reform and Greece weighed on bonds late in the month, the first quarter of 2010 earnings season is off to a good start, providing solid fundamental support for risky assets. Nearly 60% of the S&P 500 has reported earnings thus far and 79% beat consensus expectations. According to JP Morgan research, current S&P 500 EPS estimates for Q1'2010 have been revised up to \$19.56 from \$17.48 (+12%) since the beginning of the month. Furthermore, forward twelve month earnings are now projected to return to the 2007 peak in profits (\$90) by early 2011 and hit \$108 the following year.

S&P 500 EPS Estimate, 12m Forward



Source: Bloomberg

Outlook

While the high yield market has experienced a significant rally from depressed prices, spreads are still wide of the historical median and are attractive relative to comparable Treasury notes. This is especially true for the higher quality (BB and B-rated) segment of the marketplace, where default risk is lower. Strong liquidity and improving fundamentals should reinforce the continued trend of tighter spreads as the credit cycle matures. However, prospective returns will be less dramatic given the absolute level of yields.

This publication is for information purposes only. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. Any opinions expressed are current only as of the time made and are subject to change without notice. TCW assumes no duty to update any such statements. Copyright TCW 2010