June 2016

Brexit: Effect on the High Yield and CLO Credit Markets?

Dear Partners and Prospective Partners:

As many people had feared, the bookmakers and party leaders in London got it wrong and the UK decided to leave the European Union (aka Brexit). I guess the often-repeated lesson of never trust the bookies applies once again!

There is no doubt that the vote in favor of Brexit came as a big surprise to markets, as the market had rallied in the days leading up to the vote as both the polls and the London bookmakers suggested that a "remain" vote was increasingly probable. The unexpected outcome hit equity markets particularly hard Friday and Monday. While credit markets have held up better, some volatility over the last three days has ensued causing high yield bonds to be down 1.81% (as defined by the BofA Merrill Lynch U.S. High Yield Index), bank loans down 0.64% (as defined by the Credit Suisse Leveraged Loan Total Return Index), and CLO BB-rated debt down 1.60% (as defined by the Palmer Square CLO BB Price Index). Please note that the portfolios managed by Palmer Square have seen less downward price volatility given we already had the portfolios positioned in shorter-duration, higher quality paper. We are incredibly pleased with portfolio performance in a tough price-action environment.

As far as the markets going forward, we do expect volatility in the financial markets to continue given the increased political and economic uncertainty in Europe. While these concerns could potentially affect global growth, it is too early to tell and there are more questions than answers. As of now, Palmer Square believes that growth will not slow enough to cause a recession here in the U.S. or trigger the start of the next default cycle. Slow growth environments are typically very positive for credit. Finally, the likelihood of the U.S. Fed raising rates in 2016 has diminished significantly, and in fact, the market is now placing an equal probability for either a rate cut or a rate hike by year end.

As far as our portfolios are concerned, we believe we are very well-positioned. We are constantly re-evaluating our portfolios in an attempt to seek out the best relative value in credit (wherever that may lie). Given that mandate, we have had very little exposure to the UK and EU. Our exposure is U.S.-dominated. We own corporate credit and structured credit securities that we believe have a very low probability of experiencing a default (regardless of how Brexit unfolds). Finally, we believe we have positioned our portfolios to, not only generate significant yield/total return in a lower-for-longer interest rate environment, but also either benefit from or are resistant should interest rates rise once again. From a supply/demand standpoint, we believe there will continue to be lower new issuance/supply in the areas of corporate and structured credit where Palmer Square is focused while demand continues to increase. As fuel to the opportunity, we believe flows out of Europe and Japan will move to U.S. credit given our economy is stronger and U.S. credit has significantly higher yields than fixed income assets in other parts of the world.

While Brexit has created a plethora of new questions and unknowns, it is clear that the UK leaving the EU will have meaningful near- and long-term implications. The market will continue the question the viability of the EU going forward. That said, it is in the best interests of the UK and the EU to stay closely aligned in whatever form possible. Market pundits such as Goldman Sachs are already suggesting there are many ways this could play out should the UK leave the EU. For example, they suggest the UK can join Norway in the EEA and cut a bilateral deal with the EU. The UK can join the EFTA (Swiss-style) and cut a bilateral deal with the EU. The UK can agree to a "special" association agreement (to speed things up and limit risk of contagion; in return for speed, the UK gets generous concessions). Finally, the UK can enter into a custom union arrangement (similar to Turkey) or enter into a special Free Trade Agreement (FTA) with the EU, similar to Canada. In the near term, we believe the UK will be the most affected, with trade, investment and consumption suffering until more details of the exit process are sorted out. Over the longer term, it is difficult to predict the impact. Most investors believe we should expect some additional weakness in the European periphery which will elicit a response from global central banks once again. At Palmer Square, we are watching the strength of the U.S. dollar, the price of oil, and finally, whether more countries opt to go the route of the UK.

In summary, we believe Brexit is more of a political event than a fundamental economic event for Palmer Square portfolios. We are pleased with how our high yield, bank loan, and structured credit portfolios have been positioned.

Given the opportunity, please do not hesitate to contact us should you want more information or to set-up a conference call or meeting. We can be reached at investorrelations@palmersquarecap.com or 816-994-3200.

Best regards,

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