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SHENKMAN CAPITAL MANAGEMENT, INC.
HIGH YIELD MARKET PERSPECTIVE LETTER

Special Report

The Great Credit Tsunami

Since September 12th, a financial tsunami has swept over the capital markets. Even the mighty drowned in a sea of debt and risk. Over a span of just three weeks, the U.S. government nationalized Fannie Mae, Freddie Mac and AIG; Lehman Brothers filed for bankruptcy; Washington Mutual was seized by federal regulators; and Merrill Lynch and Wachovia were acquired at fire-sale prices. Lost in the shuffle was a $25 billion loan by the federal government to the struggling automobile industry. This astounding chain of events resulted in a credit meltdown throughout the global financial markets.

After a failed attempt to approve a bailout, Congress and the President approved the Troubled Asset Relief Program), a $700 billion rescue package that will provide cash to banks in exchange for their toxic waste assets. This $700 billion bail out represents approximately 5% of U.S. GDP. Implementation of this bailout plan, however, will be a daunting task. In 1907, J.P. Morgan bailed out the U.S. government with a $25 million loan. A century later, it takes $700 billion from the government to bailout reckless lending by the banks. If consumers, investors and businesses believe that the economy will get worse, it surely will. However, if investors believe as we do that the system is damaged but not destroyed, the credit markets will survive this difficult time.

Toxic Assets Infect the Entire System

The unraveling of leverage and the demise of several blue-chip financial institutions have caused a severe contraction in credit availability, which continues to affect all corners of the financial system. Although almost all asset classes have been swept up in the storm, the meltdown's vortex can be found in the subprime mortgage market, including the supposedly highly rated "toxic assets" held in so many investment-grade portfolios. As the banking system broke down, price discovery for specific securities has become increasingly difficult. In addition, "stealth damage" caused by illiquidity and capital shortages has inflicted all segments of the financial sector.

Dislocations, sparked by subprime-tainted securities, continue to generate unbelievable, unintended consequences. Some of these astonishing events include:

1) Goldman Sachs and Morgan Stanley were forced to convert from investment banks to commercial banks in order to survive.

2) Venerable and AAA-rated General Electric felt compelled to raise $12 billion of new common stock and sold $3 billion of 10% perpetual preferred stock to Warren Buffett.

3) A pioneering money market fund, the Reserve Fund, "broke the buck" and saw massive redemptions.

4) The Common Fund, used by college endowments and not-for-profit organizations, has prohibited withdrawals over the next several years due to losses in its mortgage portfolio.

5) Custodian banks have incurred hundreds of millions of dollars of losses in their STIF (Short Term Investment Funds) accounts and securities lending programs.

6) Prime brokers are forcing hedge funds to de-lever and meet their redemptions with cash rather than utilizing their margin accounts.

7) The Federal Reserve, European Central Bank, the Bank of England, the Bank of Canada, and the Swedish Riksbank lowered their benchmark interest rates by 50 bps each in an unprecedented coordinated effort to unfreeze the credit markets.

8) The $1.6 trillion overnight commercial paper market (CP) seized up, adversely impacting major corporations' ability to meet daily expenses. As a result, the Federal Reserve invoked emergency powers to create a special fund to backstop the CP market.

9) Major banks have already announced write-offs and losses of $592 billion. It is possible that the unwinding of risk could ultimately result in over $1.4 trillion of losses and write-downs by global financial institutions.

10) The Federal Reserve has doubled its planned auctions of cash to banks to as much as $900 billion as it takes extraordinary measures to unfreeze the short-term lending markets and prevent a deeper credit debacle.

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The horror stories are nearly endless as the dominos continue to fall in the most severe credit contraction since the Great Depression. In light of the collapse of the Golden Era of Laissez Faire Capitalism and the increasing likelihood of a prolonged recession, virtually every asset class was pummeled in September, the third quarter, and year-to-date, as illustrated in **Exhibit 1**.

Exhibit 1

Performance For Key Benchmarks
As of September 30, 2008

	Sept-08	3Q08	YTD
10-year U.S. Treasury(1)	+0.24%	+2.35%	+4.40%
Merrill Lynch U.S. Corp. Master(1)	-7.34%	-7.49%	-8.24%
Lipper High Yield Index(2) (Top 30)	-7.47%	-8.55%	-10.39%
Merrill Lynch HY Index(1) (H0A0)	-8.30%	-9.48%	-10.64%
Credit Suisse High Yield Index(2)	-7.04%	-8.04%	-9.09%
S&P 500 Index(3)	-8.90%	-8.36%	-19.27%
Dow Jones Industrial Average(3)	-5.82%	-3.71%	-16.57%
Russell 2000(3)	-7.96%	-1.11%	-10.37%
NASDAQ(3)	-11.60%	-8.59%	-20.63%

Sources: (1) Merrill Lynch; (2) Credit Suisse; (3) Bloomberg

One year ago, the S&P 500 stood at a record 1,565 and the DJIA reached 14,164, the peak of a five year equity bull market, that helped investors recoup returns from the bursting of the dot.com bubble. Since then, the S&P 500 has nose-dived 41.9% and the DJIA has plummeted 39.4%, wiping out more than $8.4 trillion of equity value in the last year.

Myriad Causes and Devastating Effects

The carnage in the financial markets has been brewing for a decade, and signs of the impending implosion were evident even before the credit cycle began shifting in June 2007. Indeed, we have been warning of hyper-ventilating markets since 2006, based on our view of excessive leverage, poor deal structures and aggressive risk taking in investors' quest to outperform illusory benchmarks. We cautioned clients and consultants that the financial markets were rising on a shaky foundation of unmitigated risk, poor due diligence and lack of investor skepticism. While we were unable to predict the triggering event or timing of the inevitable correction, it was apparent to us that prevailing conditions—including over-leverage, the global search for alpha and too much capital chasing the same strategies—were an invitation to a massive correction.

A Recipe for Disaster

The root causes of the bursting of the credit bubble are numerous. We have identified 25 critical factors, shown in **Exhibit 2**, that contributed to a "casino mentality" among investors, bankers, traders, hedge funds, private equity firms and rating agencies. Any one of these influences would have had a detrimental effect on the markets, but the combination of so many adverse forces at once magnified the damage.

Of these 25 critical factors, the four most glaring issues are:

1) The passage and subsequent strengthening of the Community Reinvestment Act, in which banks were scored based on their willingness to provide mortgages to lower-income families. Failure to receive a high score prevented banks from pursing acquisitions and expansion, thus punishing them if they did not provide mortgages to unqualified borrowers.

2) Home prices were supposed to climb at an ever-increasing rate, so lower housing values were never factored into loan-to-value ratios. Meanwhile, bad mortgages were repackaged as good ones, additional leverage was employed in the form of securitization, and these assets were sliced into more tranches of debt based on an already impaired mortgage assumption.

3) The repeal of the Glass-Steagall Act in 1999 provided commercial banks with a competitive advantage over investment banks, as their lower cost, more stable depositor base served as a plentiful source of cheap capital. In contrast, investment banks used short-term funding and 30x to 35x leverage to generate high returns for their bonus pools!

Exhibit 2

25 Reasons Why the Risk Bubble Burst

1. Passage of the Community Reinvestment Act in 1977 and amended in 1995
2. Bad mortgages repackaged as good mortgages
3. Mortgage brokers gone wild
4. Toxic waste in subprime mortgages
5. Out-of-control home prices
6. Broker-dealers levered 30x and relying on short-term financing
7. Repeal of the Glass Steagall Act in 1999
8. Inaccurate ratings
9. Massive short selling and the removal of the uptick rule
10. Cheap and easy credit by the Federal Reserve
11. Lack of regulatory oversight
12. Explosion of derivatives and credit default swaps
13. No lending standards at banks
14. Too much financial engineering by Wall Street firms
15. Burdensome consumer indebtedness
16. Massive growth of hedge funds
17. The Golden Era of Private Equity Firms
18. Investors wanting to be the "next Harvard" with superior returns
19. Excessive leverage throughout the global financial system
20. The birth of mega-LBOs at overinflated prices
21. Locked-in bridge financing with inflexible terms
22. Too much money chasing the same ideas
23. Global search for alpha without consideration of beta
24. Prop-desk conflicts with their customers
25. Too much greed!

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4) Over the past 10 years, many bright and precocious business school graduates wanted to make a boatload of money in a short period of time. They were convinced they had a magic formula called "financial engineering with high doses of leverage." They must have missed the class on risk management, or they would have known that high returns come with high levels of risk. As a result of this myopia, the financial sector became addicted to "risk on steroids" in the form of mega private equity deals, credit default swaps, CLOs and other asset backed products few people understood. In addition, investors wanted to match the returns of Harvard and Yale endowment, but without their massive asset bases. Chasing returns without proper risk controls doomed many investors when the credit cycle unwound.

Many financial institutions were built on quicksand of CDS, CLO's, mortgages, prime brokerage for hedge funds, and bridge loans for mega-LBO's. Once these revenue-generators collapsed, their businesses toppled.

On the Brink of a Major Recession

The U.S. economy is reeling from a broken banking system. The public is frightened by dire headlines. Small businesses have panicked as banks have become unwilling to lend, and large corporations are drawing down their lines of credit to ensure that they have the capital required to meet their obligations before nervous banks sever their financial lifelines. Credit is the oil of the U.S. economic engine, and without credit, job creation and business expansion are thwarted.

The U.S. economy has been overwhelmed by two key variables: home prices and household debt. The S&P/Case-Shiller Home Price Index plunged 16.3% in July compared to one year earlier. Since peaking in July 2006, the index has slumped 19.5%. Until home prices stabilize, the U.S. economy cannot rebound.

Meanwhile, U.S. household debt has soared to $14 trillion, nearly equal to the annual output of the entire domestic economy. Consumers' debt burdens will continue to cause defaults and delinquencies in credit card receivables, student, home equity and auto loans, not to mention mortgages. Consumers have been on a spending binge since 2000, and they need to re-liquefy and repair their personal balance sheets before a recovery is sustainable.

This consumer-led recession could be deep and prolonged. Since 70% of the U.S. economy is predicated on consumer spending, a major curtailment of their expenditures will adversely impact GDP.

Consumer reaction to the financial crisis has been swift. In August, borrowing by U.S. consumers unexpectedly fell by the most since statistics began in 1943. According to the Federal Reserve, consumer credit declined by $7.9 billion in August and stands at $2.58 trillion.

Meanwhile, the unemployment rate has escalated as various sectors—including financial services, autos, retail and airlines—continue to shrink their work forces. As a result, consumers are hunkering down as they watch their 401(k)s and other assets become depleted. In September, automobile sales dropped by 27% as consumers either were unable to obtain car loans and leases or were unwilling to add to their already overextended debt burdens.

One of the brighter areas of the U.S. economy had been the manufacturing sector, which was supported by robust export activity. However, with foreign markets facing their own recessions, export demand is likely to slow dramatically. The Institute for Supply Management's manufacturing index dropped from 49.9 in August to 43.5 in September, a recessionary level and the lowest reading since October 2001. The ISM production index also fell precipitously from 50.1 in August to 40.8 in September. We expect further deterioration in manufacturing over the months ahead.

Fed and Treasury Open the Vault

It is clear that the Federal Reserve and U.S. Treasury are acutely aware of the severity of the credit crisis. Disturbingly, the U.S. government had already agreed to more than $900 billion of cash infusion plus special loans before Congress approved a $700 billion bailout package, $120 billion of tax credits, and $25 billion in loans to the automotive industry. The Fed also is boosting daily liquidity to banks in order to avert a complete shutdown of the banking system. How many more "windows" does the Fed Reserve have to open before their vaults are drained?

The Fed's decisive, pro-active policies are essential to unclog the flow of credit to businesses. Federal Reserve Chairman Ben Bernanke is a scholar on the Great Depression. When he was a professor at Princeton, Bernanke blamed the severity and duration of the depression on poorly managed money supply on a worldwide basis. He is now putting his academic knowledge to practical application. However, the Fed is depleting its own balance sheet by exchanging good cash for bad assets, taking $6 billion in write-offs on Bear Stearns' toxic collateral, and providing ample liquidity to banks. In addition, the $700 billion bailout will need to be financed with new government debt. At some point, the Fed's flexibility and options may become limited.

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High Yield Bonds Tumble in Sympathy

The high yield market has suffered significant collateral damage as a result of the meltdown in mortgages, commercial paper, auction-rate securities, and other highly rated, investment-grade issues that were supposed to be safer than high yield bonds. The average of the top five high yield indices returned -7.68% in September, -8.73% for the third quarter, and -9.88% year-to-date.

These results represent the high yield market's worst monthly, quarterly, and year-to-date performance since the market's modern era began in February 1976. **Exhibit 3** highlights the 10 worst months, quarters and years since the inception of the Merrill Lynch High Yield Index in 1986. Remarkably, September's damage was not caused by rising default rates or fundamental credit deterioration, but by the technical reverberations emanating from higher-rated securities and deteriorating trading liquidity. When blue-chip corporations borrow short-term funds at around 9%, it is difficult for B-rated paper to maintain its relative value.

Exhibit 3

Historical Context - Worst Periods for High Yield Bonds					
10 Worst Years *Since 12/31/1986*		10 Worst Quarters *Since 12/31/1986*		10 Worst Months *Since 9/30/1986*	
Date	Return	Date	Return	Date	Return
YTD 2008	-10.64%	Q3-2008	-9.48%	9/30/2008	-8.30%
12/31/2000	-5.12%	Q2-2002	-6.98%	6/30/2002	-7.74%
12/31/1990	-4.36%	Q3-1990	-6.19%	9/30/2001	-6.91%
12/31/2002	-1.89%	Q4-2000	-4.78%	8/31/1998	-5.05%
12/31/1994	-1.03%	Q3-2001	-4.65%	8/31/1990	-4.57%
12/31/2007	2.19%	Q3-1998	-4.19%	9/30/1990	-4.11%
12/31/1989	2.31%	Q1-2008	-3.04%	7/31/2002	-3.88%
12/31/1999	2.51%	Q3-2002	-3.02%	11/30/2000	-3.84%
12/31/2005	2.74%	Q4-1989	-2.73%	3/31/1994	-3.23%
12/31/1998	2.95%	Q1-1990	-2.37%	10/31/2000	-3.19%

Source: Merrill Lynch High Yield Index (H0A0)

The average price of a bond in the Merrill Lynch High Yield Index slid from $85.62 in August to $77.00 in September. According to the Credit Suisse High Yield Index, spreads exceeded 1,000 basis points in September, up from 794 basis points in August and 589 basis points on December 31, 2007. September marks only the third time since 1990 that spreads have broken the 1,000 basis points barrier; each previous time represented a bottom for the high yield market!

In contrast to the high-profile problems encountered by highly rated paper of Lehman Brothers, Washington Mutual, Wachovia and AIG, September saw only three defaults among high yield issuers, aggregating $2.1 billion. For the year-to-date, 25 high yield credits have defaulted, totaling $11.3 billion. At the end of August, the Moody's trailing 12-month default rate was only 2.65%, well below the historical average of 4.86%. *Amazingly, despite a major credit contraction over the past 15 months, default rates in the high yield market have remained near historical lows.*

The most significant forces affecting the high yield market in September were poor liquidity and the overhang of inventory as troubled banks, brokers and insurers cleaned up their books, raised cash, and wound down operations. Indiscriminate selling, combined with forced liquidations by hedge funds, meeting redemptions and margin calls, added to selling pressure. In fact, demand for weak credits has been so anemic, many portfolio managers are compelled to retain their sicker bonds and shed better-quality names on which they can execute trades. Indeed, with the demise of some major dealers and a pullback in capital by others unwilling to take risks in a faltering market, trading activity has been severely limited.

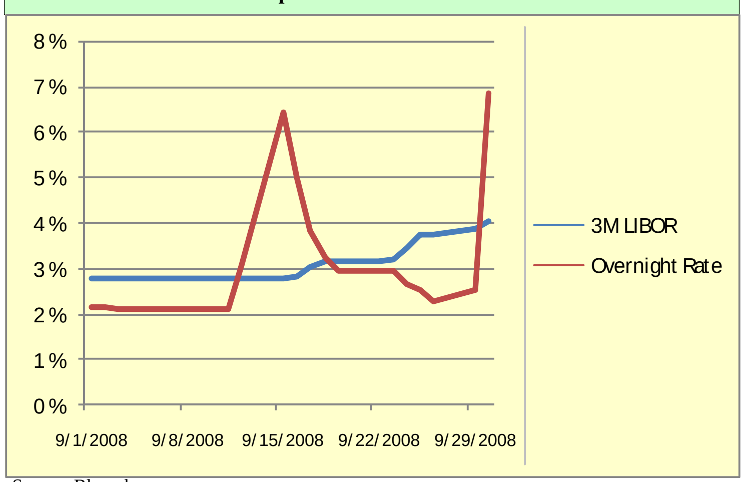
Secured Bank Loans Suffer Meltdown

The bank loan market has not fared much better than the high yield market. The LSTA Index returned -6.15% in September, -6.99% for the third quarter and -8.00% for the year-to-date, the worst performance ever recorded for each of these periods. The average price for a high yield bank loan was $82.44 in September, down from $88.37 in August.

These poor returns indicate a breakdown of the bank loan market, the unwinding of total rate of return swaps by hedge funds, and a sharp increase in LIBOR rates, reflecting banks' reluctance to lend to one another. As **Exhibit 4** illustrates, three-month LIBOR rates stood at 2.81% on

Exhibit 4

September LIBOR Rates



Source: Bloomberg

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September 1st, and overnight LIBOR was 2.17%. By September 30th, three-month LIBOR had jumped to 4.05%, and the overnight rate skyrocketed to 6.87%. These astonishing developments reinforce investors' perceptions that banks do not trust even one another to repay loans!

The market for senior secured floating-rate paper currently is more fragile than the subordinated high yield bond market. Hence, bank loans could provide significantly better opportunities for returns when the markets thaw. However, it may take longer to repair the damage inflicted by hedge funds, investors in total rate of return swaps, and CLOs that overdosed on excessive leverage and overinflated ratings.

Far-Reaching and Long-Lasting Aftershocks

The U.S. economy has entered a very challenging and uncertain period. The biggest incursion in history by the U.S. government into the financial markets represents uncharted territory, and the outcome may not be known for several years. If the federal bailout proves to be inadequate or is mishandled, the financial markets could react extremely negatively.

One thing seems most certain: the fallout from the credit meltdown will forever change Wall Street. In our judgment, the ripple effect is likely to include the following:

1) Banks will not be in the lending business for at least several quarters, despite the $700 billion bailout, because their depleted capital bases cannot support new risks.

2) The consolidation of banks into four colossal giants could transform the financial system by concentrating the availability of credit into an oligopoly, which is never positive for borrowers.

3) The nationalization of AIG probably will rein in the $62 trillion credit default swap and derivatives markets, bringing them under tighter regulations and reporting requirements.

4) Significant new regulations and greater transparency are inevitable, likely resulting in more imitation than innovation in investment strategies.

5) The rating agencies will need to develop new business models, including greater transparency, to reestablish their credibility. Ratings should be paid for by investors, not issuers, and agencies should license their proprietary models to portfolio managers for independent verification of ratings.

6) Monumental federal budget deficits, probably $2 trillion over the next 18 months will crowd out capital from the private debt markets. Another key question is: "Who will purchase $1 trillion of new Treasury securities?"

7) The U.S. residential mortgage market may be altered for decades as only qualified borrowers with substantial down payments will receive loans.

8) Short selling regulations may be significantly changed, including the reinstitution of the uptick rule.

9) Alternative assets, such as hedge funds and private equity, will feel greater pressure as annual returns of 20% or more become part of a bygone era. Moreover, investors may be less willing to pay high fees and assume risky leverage for only mediocre performance. It is our view that private equity firms should be forced to mark-to-market their equity investments in partnerships. Who are they fooling? For example, TXU bonds are trading at 70 and the bank debt is quoted at 72. How is it possible that KKR's equity investment can be valued at original cost?

10) The Fed may run out of capital. Without operating the printing presses on overtime, future bailouts and guarantees could jeopardize the United States' AAA credit rating.

Turbulence Is Likely to Persist

For high yield investors, we expect continued turbulence over the next several quarters as deleveraging progresses. We expect high yield default rates to approach 3.5% by the end of 2008, and jump to the 8% range by the end of 2009 due to the faltering economy and issuers' inability to fund their short-term cash requirements.

The precarious high yield market reflects the problems in other assets classes. We caution investors that concerns affecting investment-grade bonds and other higher-quality assets could be ascribed to the high yield market due to the false sense of security that higher ratings convey. Junk bonds have always been junk, and investors should never pretend that it is anything else. In contemporary terms, a junk bond with lipstick is still a junk bond!

At Shenkman Capital, we believe more than ever that our conservative, defensive investment style remains the superior philosophy in a difficult market environment. Our disciplined process, numerous risk controls, no exposure to fads, underweighted positions in over leveraged companies, and avoidance of riskier industries has been our winning strategy for 23 years. We do not have to change our style or philosophy to overcome current conditions. We anticipated this credit wreckage, and in large measure, our client portfolios already are constructed for a challenging 2009.

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Once fear, panic and capitulation sets in, a bottom of this horrific credit cycle should occur. We may be nearing a bottom although major uncertainties remain. However, psychology is the ultimate driving force in stemming the loss of confidence in the market. Fundamentals are being ignored and over looked as credit becomes frozen. Irrational exuberance has been replaced by irrational fear!

Contrary to popular belief, governments cannot legislate a recovery or force businesses to create jobs. Several critical questions remain unanswered:

1. Will the impact of a serious U.S. recession spiral into a global crisis?
2. How long will consumer retrenchment last?
3. Will new taxes and tough regulations stifle economic activity?
4. Where are the new sources of capital to drive demand for investments?
5. Will the $700 billion rescue plan be sufficient to re-ignite lending by banks, and how soon will the bailout kick-in?

Historically, October has been a cruel month for the financial markets. This October is no exception. The unwinding of risk is painful but necessary in order to irradiate years of excesses in which many investors took for granted the risk and leverage required to achieve desired returns. The days of easy and cheap credit are now etched in the history books to be studied by scholars.

Once the fear and panic subside, there should be significant opportunity for capital appreciation in the bank and bond markets. However, since the U.S. economy could be entering a major recession, patience and perseverance will be required during these unsettling times.

SHENKMAN CAPITAL MANAGEMENT, INC.

262 HARBOR DRIVE, 4TH FLOOR
STAMFORD, CONNECTICUT 06902
(203) 348-3500

www.shenkmancapital.com

461 FIFTH AVENUE, 22ND FLOOR
NEW YORK, NEW YORK 10017
(212) 867-9090