Energy Market Imbalances and Heavy Inventory Pressure Oil and Natural Gas Prices Lower

Perspectives

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West Texas Intermediate (WTI) Crude Oil, the benchmark for most oil produced or refined in the US, dropped below the psychological level of $40 per barrel oil equivalent, or "boe", in December 2015. Brent Crude, the global benchmark, followed course.

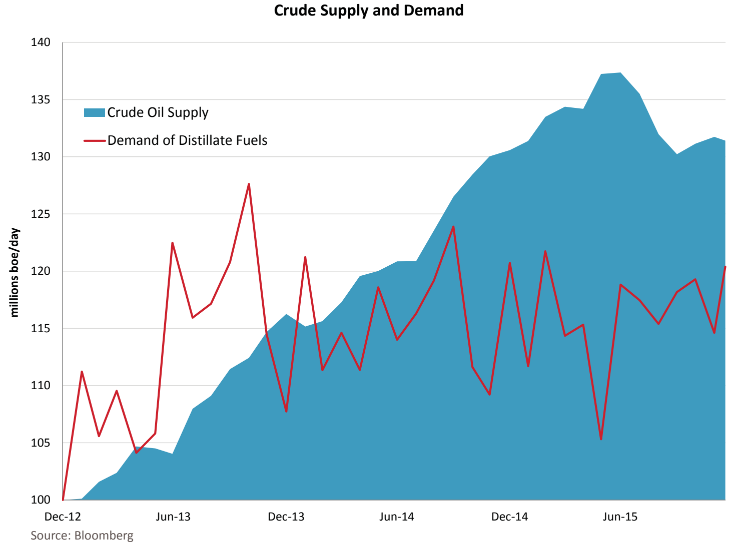
The persistent drop in prices, down about 60% since July 2014, is in response to continued oversupplied global energy markets. 2016 global production is estimated to exceed demand by 1 – 2MM boe/day.

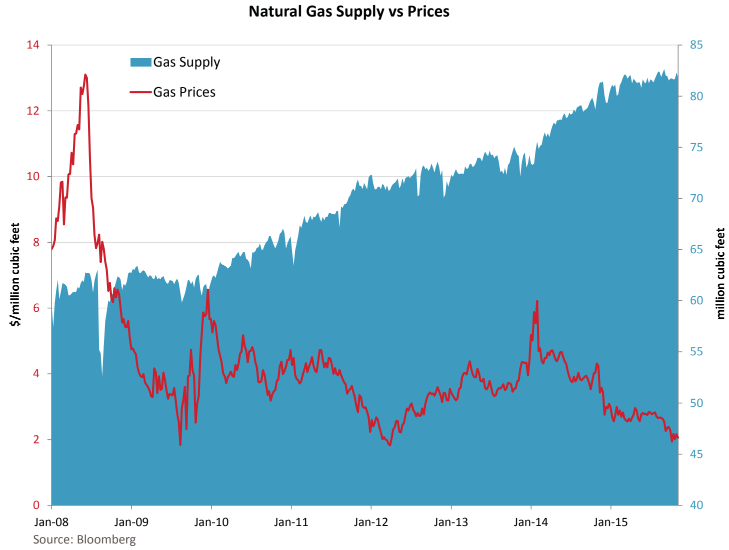
- At the end of 2015 US supply was at 9.2MM boe/day, up modestly from about 9.1MM at the beginning of 2015 despite a significant decline (-64%) in rig counts over the same period. Demand for distilled product, such as gasoline and naphtha, is softer year-to-date. Shale wells have proven to be more prolific than original estimates with slower decline rates.
- At its November semi-annual meeting, OPEC announced production would increase by 1.5MM boe/day as both Iran and Russia increase exports in 2016.
- Storage utilization, measured quarterly, was 68% as of 9/30/2015. Additional technical pricing pressure is possible as storage nears capacity. A stronger US dollar compared to other global currencies technically creates price inflation on the demand side.

Natural gas prices have also returned to historic lows. Strong production has led to supply exceeding demand and historically high storage levels. In the US, average weekly supply during 2015 was 81.5 Bcf (billion cubic feet) while demand has averaged 72.7 Bcf. Storage is historically high at about 4 Tcf (trillion cubic feet). Until natural gas liquids exports come on line in 2016/2017, demand will rely on industrial production and weather; natural gas being the most used feedstock for electricity production and heating homes.

Energy companies have responded to this new pricing environment by cutting capital budgets 20-30% for both 2015 and 2016. Issuers aim to live within their cash flow whereby capital budgets are less than or equal to cash flow from operations. Asset sales have been a source of funding and dividends are coming under pressure as a significant use of cash.

For our view of the various energy subsectors please see a summary on the next page.





Energy Subsector Notes

- Integrated energy providers operate across the energy value chain with assets in production, storage, processing, refining and marketing. These issuers are generally considered the "Majors" of oil producers and are highly rated (A or higher). All are focused on protecting the dividend while managing across their business lines. We view the credit profile as declining across this subsector of the industry and find relative value opportunities weak.

- Independent energy providers are highly tied to realized oil and gas prices. In recent quarters, management teams have sought to maximize profitability through encouraging field service providers to accept lower prices. Capital for financing activities has become more expensive as investors require a higher return for perceived higher risk; therefore management teams are reducing capital expenditures to manage within their cash flow and avoid accessing the capital markets. Our security selection is focused on higher quality credits with diversification across basins and product lines, greater financial flexibility and management teams with a proven history of supporting their balance sheet.

- Field service providers are the most impacted, as producers negotiate prices lower and/or discontinue service when contracts reopen. Revenues across the subsector have fallen 10-20% over the past 4 quarters. This sector is bifurcated with larger bellwether issuers benefiting from historically conservative financing practices and smaller players that will continue to face rapidly declining credit profiles.

- Midstream issuers have had some near-term concerns of market liquidity. As shale energy has grown exponentially, demand for infrastructure to support these projects has grown with it; mostly supported by long-term contracts and external funding. This largely fee-based business has historically been able to protect cash flow during times of market stress. Credit profiles are generally intact and relative value appears attractive. We favor issuers that are able to cover dividends/distributions from internally-generated cash flow.

- Refiners are particularly well positioned since most regions are capacity constrained and oil producers are accepting discounted pricing which in turn raises crack spreads (the profit margin an oil refinery makes by cracking crude oil. i.e., breaking hydrocarbons into petroleum.) In theory, the proposed lifting of the Federal ban on US crude oil exports would negatively impact US-based refiners since producers will have other end-use markets. In the near-term, the refining space appears resilient and benefits from strong production as demand for refined products is robust. Investment grade issuers in this subsector generally have solid credit profiles and offer attractive relative value.

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