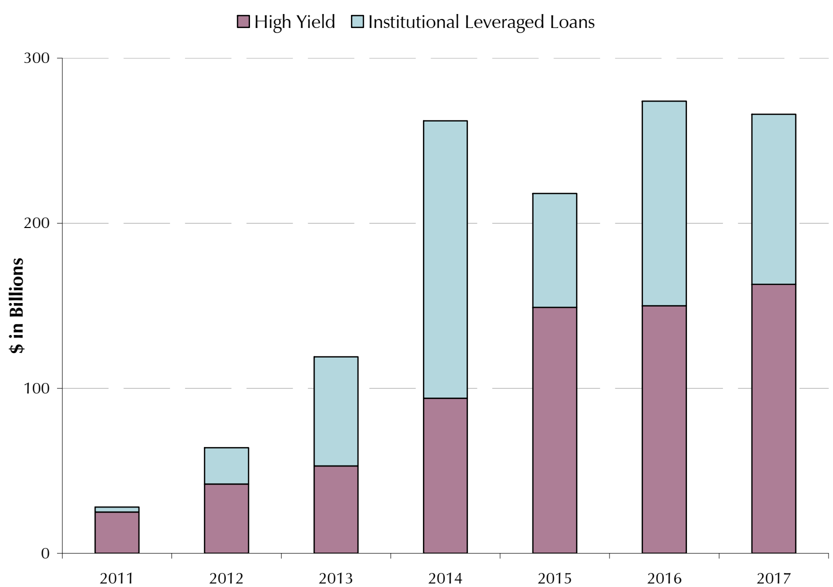
Debt Markets in 2011

Following a strong recovery during 2010 from the Global Financial Crisis, debt markets finished the first half of 2011 essentially unchanged from the prior year end. After continuing to narrow through the first quarter, high yield spreads ticked back up at the end of the second quarter, driven by growing investor unease over the slow pace of the economic recovery, geopolitical instability in the Middle East, and potential sovereign debt issues in Europe. At the end of June, the EU committed an additional $17 billion of bailout funds to help Greece avoid a default, although the longer term outlook for avoiding default without additional support remained negative. The record high yield market new issuance of 2010 continued into 2011, and a large portion of the U.S. maturity wall was pushed to the latter half of the decade through refinancing transactions. Default rates and yields both remained low, while syndicated debt traded at or above par, as investors continued to accept greater risk in search of yield. As of the end of June, concerns over the impending need to raise the U.S. debt ceiling were on investors' minds, but had not yet manifested themselves broadly, as the debt markets appeared to heavily discount the odds that a resolution would not be reached.

U.S. Maturity Schedule[1]



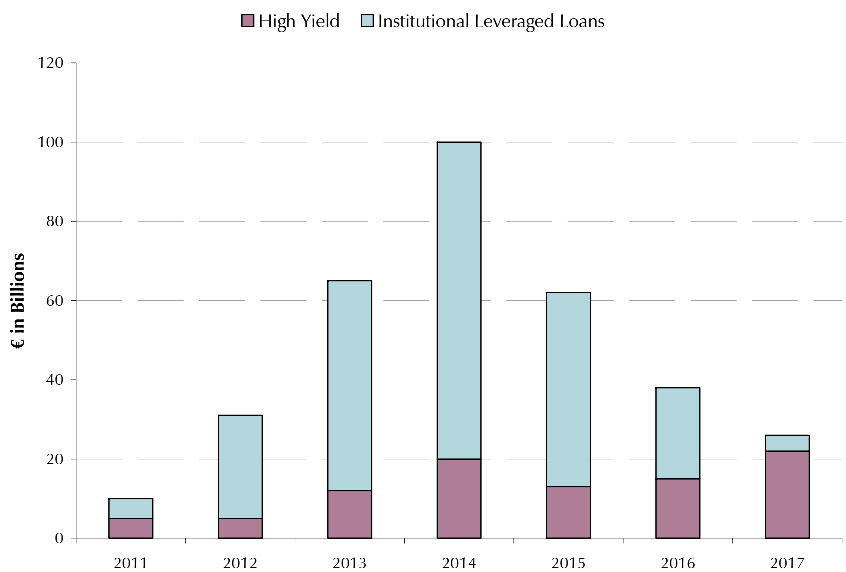
U.S. Corporate High Yield Spread Over Treasuries[2]

[1] Source: JP Morgan, as of June 30, 2011
[2] Source: Barclays Capital

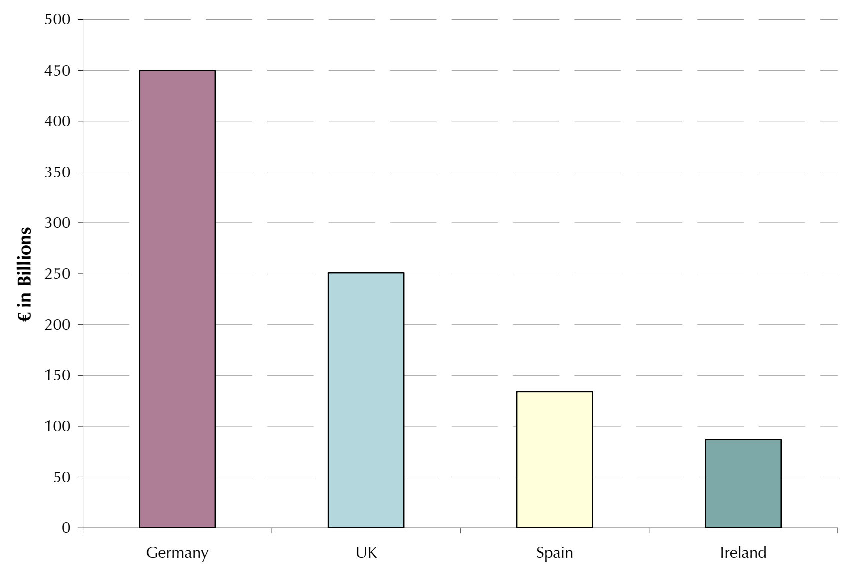
Distressed & Opportunistic Debt

Investment opportunities for distressed debt managers, and especially non-control managers focusing on the larger end of the market, were largely non-existent during the first half of 2011. As a result, most distressed managers appeared to take a more cautious approach to deploying capital. They generally refrained from trading into new positions, opportunistically exited existing positions, and made toehold investments with a longer term view towards a bankruptcy or restructuring event. The longer term outlook continued to suggest a more robust pipeline of potential investment opportunities, including within the European distressed debt market. The high yield market in Europe is considerably smaller and less active than in the U.S., which has led to less refinancing activity. More than €330 billion of European debt is set to mature over the next few years, peaking in 2014. Additionally, a substantial portion of European corporate debt remains held by banks, most of which will be required to divest a substantial portion of their holdings over the next several years to comply with stricter regulatory capital requirements under Basel III. A sample of these government mandated bank asset sales is shown below, totaling more than €900 billion in just four countries.

European Maturity Schedule[1]



Selected Government Mandated European Bank Asset Sales[2]



[1] Source: JP Morgan, as of March 31, 2011
[2] Source: Avenue Capital

Mezzanine Debt

Mezzanine debt deal activity and fundraising remained active during the first half of 2011, in connection with continued healthy levels of buyout and refinancing transaction activity. Mezzanine debt managers broadly reported robust pipelines of investment opportunities at relatively conservative total leverage ratios. Pricing terms for mezzanine deals were pressured by the low interest rate environment and alternative financing sources, including the high yield and leveraged loan markets, but remained in line with, or above, long term historical norms.

The Fed & Economy

In June 2011, the U.S. Federal Reserve ended Quantitative Easing 2 (QE 2), aimed at stimulating the economy through an injection of capital. During the same period, interest rates remained at historic low rates, making borrowing very appealing. QE 2 was started in November 2011 and was limited in scope, at $600 billion in size. Despite all the efforts by the U.S. Federal Reserve since the GFC, the unemployment rate was static and the economy grew at a meaningfully lower level. All indications are that the U.S. Federal Reserve is running out of options to stimulate the economy. On the other hand, partisan political bickering led to a lack of confidence in the political system and its ability to fix economic problems. The U.S. GDP grew at a rate of 1.3% in Q2 2011, which followed low first quarter growth of 0.4%.[1] Based on this data, major institutions reduced their forecast for U.S. GDP growth for rest of 2011 and 2012.

There were renewed fears of a double dip recession and weak economic output and the growing sovereign debt crisis in Europe made matters worse. Globally, emerging markets continued to grow at a robust pace but faced high levels of inflation, leading to policy tightening by central bankers in these economies. Overall, global economic growth was projected to be slower in 2011, with reduced contribution for faster growing economies.

Market Outlook

Meketa Investment Group continues to believe that a steady allocation to private debt strategies offers portfolio diversification and stability. Short-term opportunities through trading-oriented and non-control distressed debt strategies remained limited, but opportunities for distressed debt managers overall are likely to persist for at least the next few years, including within Europe. Mezzanine debt strategies also continue to be attractive, as buyout and recapitalization activity remained high, increasing the demand for mezzanine capital and allowing mezzanine managers to be more selective in evaluating opportunities.

[1] Source: Bureau of Economic Analysis