

“Looks like history IS being repeated”



Newton Credit Strategy

By Paul Brain

*Stay Underweight:
looking for clearer
visibility on the economy.*

Back in March we wrote a piece highlighting the similarities with the savings and loans crisis of the late 80s and early 90s. Since March, the gradual unwinding of the financial engineering has continued, and now it looks like it is about to affect the broader economy.

Each day we need to learn a new acronym for the latest structure to be affected by the sub-prime malaise. The latest is the Asset-Backed Commercial Paper market or ABCP. What started as an isolated credit event in a specific part of the mortgage market in the US, has moved all the way up to prime issuers of commercial paper in Europe. The sequence of events has been as follows:-

First the treasury market sells off in isolation. Corporate credit markets ignore the signs for a while and then they too sell off (emerging market as well). Meanwhile equity markets are in denial and go to new highs before succumbing to a bout of anxiety. Investors in money markets become unwilling to lend to anything that is 'asset-backed' and prefer to lend at lower rates to governments hence driving Libor rates up, and treasury bill rates down. The final link is the unwinding of the carry trade which is in full flow right now. All this has occurred without a material change in underlying economic background.

The extent of the damage done to global wealth has been greater than many forecasters had anticipated, and as such, much of the market is trading on fear rather than knowledge. When you have a situation where bank's spreads are higher than their corporate customers, then lending ceases. The central bankers will not only need to provide sufficient capital to keep the system going, but they will also need to suggest that the banks actually lend the money to their customers, rather than hoard it.

The solution to the current money market problems can be found in the halls of the Central Banks, and the major liquidity providers – the banks. The Canadian ABCP market seems to have found its solution by working with the banks to switch their short term funding needs into floating rate notes that mature in line with their assets. While this is not good for their business model, it does keep the market open.

Now would be a good time to assess what has changed in the seven and a half months since the beginning of the year.

US 3-month treasury bill rates have fallen from 5.01% to 3.75%. The Federal Reserve has not changed policy so Fed funds are still at 5.25%. Meanwhile US\$ Libor has risen from 5.36% to 5.52%. So the costs for banks and corporates has gone up while the US government has a lower cost of borrowing.

Although bond yields have fallen recently, the long end is still marginally higher in yield than at the beginning of the year. Mortgage rates have risen by nearly 50 basis points. Normally in times of crisis, bond yields fall and start to push mortgage rates lower, thus helping the markets to stabilise – this hasn't happened yet.

What conclusions can we make from these numbers? The housing market slowdown is ongoing and hasn't received any help from rates. The cost of borrowing for companies has risen, and the benefit from merger and acquisition activity has gone. There has been too much damage to previous trends for some hedge funds not to be experiencing some extreme difficulty.

The current unwind of the sub-prime financial bubble is similar to the savings and loans crisis but not in terms of size. The Federal Reserve has estimated that the net losses from sub-prime will be between US\$50bn to US\$100bn (the savings and loans crisis was closer to US\$500bn). Recent concerns over hedge funds have raised the spectre of the LTCM hedge fund problems of 1998. A comparison with 1998 is also informative in gauging the extent of the dislocation in the markets:

In 1998 the US 5-year swap spread rose to 90 basis points – currently 75 basis points.

The volatility in the stock market (VIX index) rose to 34% – now 30%.

Default rates were at 2.77% – now 1.52%.

High yield spreads were 678 basis points – now 457 basis points.

Defaults, volatility and swap rates are used by many to value the spread over government bonds. It seems that we have nearly reached the extent of the damage done by two of the variables but if we get default rates rising from their historic lows then we will naturally see higher spreads.

Following the sharp sell-off in corporate bonds in June and July, the high yield corporate market has been relatively quiet. It feels like we are in the eye of the storm. For corporate bonds the economy holds the key. Although as yet there is little evidence that this financial crisis is affecting the underlying economy, the negative influences are rising.

The central bankers have been raising interest rates progressively for the last two years and, now this cost is finally making its way to companies. The days of cheap money financing increased leverage and supporting weak businesses have gone. US junk companies now have to pay over 9% to fund themselves, assuming someone is willing to lend them money. This was down at 7.5% in April. Watch for signs of consumers increasing savings and employment declining.

Credit response – Recent turmoil may be overdone but watch for the economic situation.

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