

“Through the dark clouds there may be a ray of sunlight, or maybe you need to stand on a tall building”

By Paul Brain

Newton Credit Strategy:

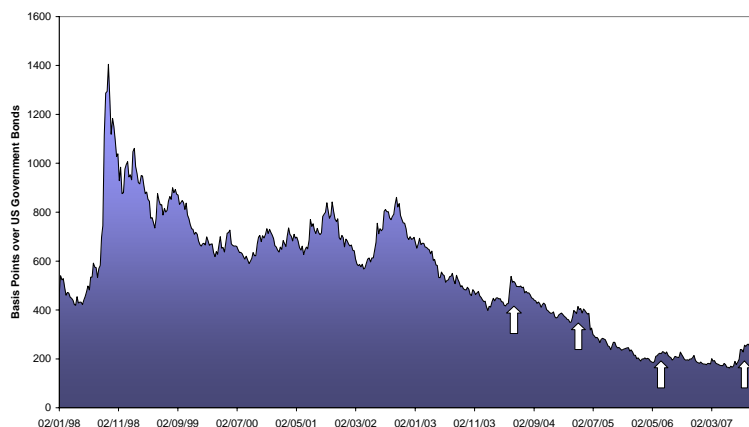
Still underweight on credit, but tempted to play a short-term rally.

The current outlook for credit markets seems to hang on one central decision: is the recent financial crisis going to significantly add to the negative effects of the US housing slowdown and de-rail the global economy? If the world economy slows and as a result default rates rise, then the current level of high yield and emerging market (EM) spreads is too low.

The US housing slowdown is firmly in place and will take time to work through. The more recent financial problems in the US, UK and Europe have added an extra concern to global growth forecasts. Over the past three years there has been a high degree of financial engineering enabling banks to move to volume driven models of lending (originate and distribute) rather than holding on to the loans. Credit appetite has been high as investors have searched for yield in a stable economic environment. This expansion depends on trust and was bound to end at some point. The catalyst was the sub-prime problems in the US which brought to light a problem with the true value of some of these re-engineered assets.

The US housing slowdown has been with us for several months and so far the effects have been limited. The global economy continues to grow and commodity prices remain high. Those economies awash with commodities have continued to build up reserves and where appropriate pay down debt. The average credit quality of emerging market sovereign bonds has improved as a result. The recent financial crisis barely registered as an annual blip on the EM bond spread scale – see chart below.

Emerging Market Sovereign Bond spreads over US Government Bonds



Source: Bloomberg and JPMorgan

The problems for corporate bonds have been more pronounced as their markets have seized up. The main impact has been felt in the mainstream banks as they adjust to the unplanned expansion of their balance sheets. The principal worry for the leveraged credit markets has been the overhang of supply and the perceived drying up of demand from CDO (collateralised debt obligations) and CLO (collateralised loan obligations) type funds and also hedge funds.

As a result of the previous rapid build-up of LBO (leveraged buy-out) transactions, the supply pipeline of finance for these transactions has reached a staggering US\$350 billion. Since the shutters came down on the credit markets, this supply overhang has been sitting over the markets like a dark grey cloud pushing yields of existing debt to higher levels. There are signs that this cloud could gradually lift over the coming months:

- Some deals are getting done albeit at higher levels, such as First Data.
- Banks have taken some of the bridging finance onto their balance sheets.
- A few deals could be cancelled or renegotiated resulting in less supply.
- Central Banks are focussed on resolving the current malaise in the cash markets by cutting interest rates and/or adding liquidity.

The credit markets are a hostage to the fortunes of the equity markets or at least the volatility of equities. The r2 between high yield and equity volatility is somewhere between 70 and 80 depending on your measurement period.

Equities are also dependent on global growth forecasts. Back to the original question; this is a difficult one to answer because so far the evidence is slim. The Federal Reserve appears to be concerned enough about the risk to cut interest rates. 'What do they know that we don't?' is the usual response to unforeseen rate changes.

We would offer another form of analysis. If the Fed is prepared to cut interest rates, and they have more ammunition up their sleeve, then maybe we can invest in risky assets, and sleep at night.

Meanwhile the countries with growing reserves and a domestic population to enrich through economic growth continue to march onwards. The BRIC (Brazil, Russia, India and China) countries are experiencing their own version of the industrial revolution and 100 basis points of extra borrowing costs is not going to stop it. As the US economy struggles with the housing slump and Europe slips, the domestic economies of the EM world will continue to grow, thus accelerating the economic power shift away from the borrowers towards the providers of capital.

One area that uniquely illustrates this is the world's tallest building. The latest world's tallest building (WTB) will be finished in 2008. The Shanghai World Financial Centre was delayed by the 1998 Asian crisis but is now nearing completion. Seven out of the current top ten are in Asia (six in China). There are numerous examples of how this pinnacle in building can also be a pinnacle in terms of economic performance. Let's not forget that the Petronas Towers in Malaysia (previous WTB holders) completed in 1998. Meanwhile the Middle East countries have at least two giant structures which are to be completed in late 2008 and are due to wrestle the WTB title away from Asia.

There are similarities with the 1998 experience, but we continue to suggest that the current environment has greater links to the 'savings and loans' crisis of the late 80's. The slow drag on the US economy back then did eventually cause a US recession which did affect global growth, but it took its time.

Eventually higher borrowing costs and slower growth will result in higher default rates (don't follow the light all the way), but for now that seems to be next years story. So, we are getting involved in risky assets once again.

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