‘Chicken or egg?’

By Paul Brain

Credit strategy: Overweight investment grade

With Libor rates still elevated and banks still writing off investments, are we in a ‘what comes first the chicken or the egg’ type situation? Libor won’t come down until the banks trust each other, they won’t do that while the economy is slowing rapidly as they worry that the slower economy means they will have to write off more assets, and the economy will not respond to lower official rates if they can’t be passed on to companies and to the consumer.

The crisis that has dogged the markets over the last 12 months has been extensively analysed and commented on already. To answer the question, ‘have we arrived at the end?’ is difficult, as there is little evidence to prove that assumption but there is clear evidence the authorities are alive to the dangers – witness yesterday’s Bank of England announcement on the Special Liquidity Scheme.

In a recent piece we speculated on what kind of measures were needed to stop the rot. Some of what we were taking about is coming out and leading to a growing belief that the crisis is over. Before we get too carried away we need to make the point that fixing the financial crisis is one thing but fixing the resulting economic slowdown is another and may take longer. It seems the Bear Stearns bail-out was a significant turning point for the credit markets as it suggested the US central bank would do whatever is necessary to under-pin the financial system in the US. Adding the initiatives together is a bit spurious but so far the US authorities have thrown over US$1 trillion at the problem which shows some commitment.

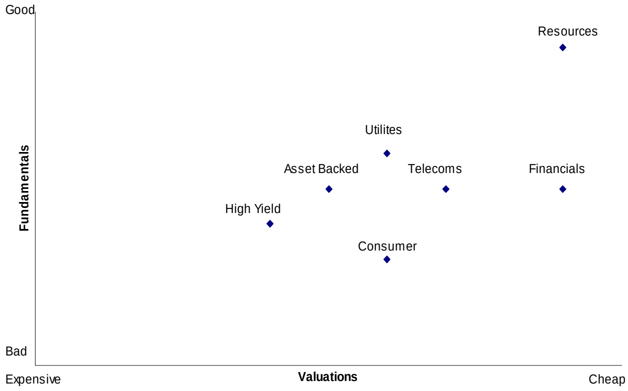
A useful guide as to whether the financial transmission mechanism is working probably is to **monitor the various LIBOR rates**. Until there is a narrower gap between Libor and the underlying official rates then victory cannot be declared. For this to happen there has to be a belief that there are no more skeletons in the cupboard. We may be another reporting cycle away from that point. While banks continue to write off investments that the market can’t quantify, Libor rates may still remain higher than they should be.

But for their bonds the story is much more encouraging. The UK banks are waking up and following their US counterparts by re-capitalising themselves. **Cuts in dividends and rights issues are very positive for bond holders**. The last credit crisis saw the telco’s doing the same thing and their bonds started to recover when management switched to raising capital

The slowing economy, leading to weaker consumer and declining profits is still a major concern. By cutting interest rates the Federal Reserve (and to a lesser extent the Bank of England) have tried to pre-empt this problem but until the banking system is fixed their rate cuts are worthless. The knock-on effect of the housing slowdown and the credit crunch is a weaker consumer. This raises another concern for the banks with exposure to consumer loans but at least much of this is quantifiable.

Having thrown money at the financial system and cut rates we wouldn’t be surprised to see a concerted effort to fix the underlying problem, the US housing market. Some sort of scheme that provides a floor to the market without jeopardising too much tax-payers money might eventually make it through Congress.

Meanwhile, investment grade corporate bonds are cheap compared to their history and cheap compared to their fundamentals. Within this broad asset class there are some sectors that offer better value than others. As commodity prices remain high this leads to higher production costs and the investor needs to focus on companies that are able to pass them on. The following chart loosely plots the various credit sectors and ranks them according to valuation and fundamentals. (NB. No scale used – just stylised).



Current investment grade bond spreads are over-compensating for a normal recession and there is some protection built in.

The following highlights the potential one year return from a broad group of 10 year investment grade bonds yielding 7.5% under three different scenarios:

1. Deep recession, more bank bailouts by the authorities.
Credit spreads widen 200 basis points (from already extra-ordinarily wide levels) to 500 basis points, Government yields fall 100 basis points to 3.5%.
Capital declines falls (-6.6%), however you do receive a coupon of 7.5%, total return of **+0.9%**.

2. Normal recession (not systemic meltdown, inflation falls).
Credit spreads tighten 100 basis points to 200 basis points (still wide!), Government yields fall 50 basis points to 4%.
Capital rises (+11.2%), and with a coupon of 7.5%, total return of **+18.7%**.

3. What were we worrying about? House prices stabilise, corporate profits stage a recovery.
Credit spreads tighten 200 basis points to 100 basis points (previous tight spreads were in the 70 basis points), Government yields rise 150 bps to 6%.
Capital rises (+3.6%), and with a coupon of 7.5%, total return of **+11.1%.**

Credit response – overweight investment grade bonds

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