

# U.S. Credit Perspectives

by Mark Kiesel

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## Opportunities in High-quality Credit



Mark Kiesel

*Financial turmoil, economic weakness and widespread deleveraging in global markets over the past year have raised what we believe are historic opportunities in high-quality corporate bonds for investors that know where to find them. In the following interview, PIMCO managing director Mark Kiesel outlines PIMCO's views on credit.*

**Q: With all of the dislocations across credit markets, where are you seeing the most attractive opportunities?**

**Kiesel:** We're seeing the most attractive opportunities in what we believe are high-quality, senior, investment grade corporate bonds. There are three reasons we think it's a good time to own select investment grade credits: first, we believe valuations are attractive for selective companies on both an absolute and relative basis. Second, we see opportunities in key areas of the market that should benefit from aggressive policy support. Third, we believe increased global government bond issuance and spending should support selective credit investments as investors allocate out of government bonds and into higher-yielding, high-quality corporate bonds.

The U.S. government—through Treasury, Federal Reserve and FDIC programs—is 'pedal to the metal' with fiscal stimulus as well as direct support for certain companies and industries. These types of policy moves are not limited to the U.S.—central banks and governments around the world are aggressively expanding their balance sheets as they buy assets and support the flow of credit to the private sector.

**Q: Why is now a good time to buy high-quality credit?**

**Kiesel:** In terms of valuation, investment-grade credit spreads are currently at or near their widest levels in decades, and in some sectors they are approaching the widest since the Great Depression. This asset class has not been so attractively valued in a very long time. Additionally, we think yields at or around 7% to 8%, based on yield-to-maturity (YTM) on investment grade corporate debt look particularly compelling because we believe equity returns will be low over the next several years. In addition, Treasury yields are now near historical lows (see Chart 1). Given the current economic environment, we expect corporate profits to grow at roughly the same pace as nominal gross domestic product (GDP), which we expect to remain weak and below historical averages. And dividends, currently around 3.5% for large cap companies, may get cut, rendering the equity market far less attractive than investment-grade corporate bonds.

**Q: Which sectors are at the focus of your credit strategy?**

**Kiesel:** We are investing in sectors that are non-cyclical, defensive and most likely to benefit from ongoing government support.

Within financials, we believe that a select group of companies are mission critical for a sustained economic recovery. Specifically, select "national champion"

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banks receiving policy support are the lynchpin of efforts to start circulating credit again. If the economy is going to start a recovery, banks have to start lending. Individuals need loans to buy homes and cars, students need loans to go to college, small businesses need loans to expand and large businesses need capital. But at the moment private-sector capital markets are barely functioning—even for high-quality borrowers. For the weaker high yield borrowers, the market simply isn't functioning.

Private sector lending rates are roughly 7% to 8% for investment grade companies and approaching 15% for high yield borrowers. In a world where nominal GDP is zero, those borrowing costs are not sustainable; this is why the government will, we believe, continue to tap its resources to restore the health of the banking system in an effort to help facilitate credit flow back into the private sector. There are other opportunities in credit. In fact, we like other selected investments in government-supported and regulated sectors like pipelines and utilities. These are companies with hard assets and infrastructure vital for the country. We are seeing attractive opportunities now in high-quality bonds of pipeline operating companies with

potential yields of 7% to 9% and utilities yielding 6% to 8% based on the constituents of the Barclays Capital Utility sub-index.

A third sector we like is defensive, non-cyclical issuers. Although the economy is fragile and the credit markets are still ailing, creating headwinds in consumer spending and jobs, non-cyclical industries, such as telecom, healthcare, pharmaceuticals, cable and tobacco, have the potential to outperform in an environment of below-trend growth. Bonds in these sectors currently yield 5% to 7%

**Q: Are there sectors you are actively avoiding?**

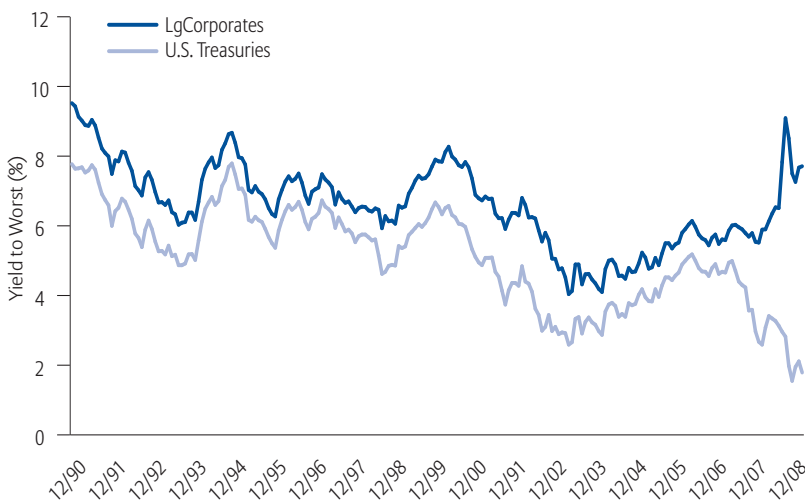
**Kiesel:** We're avoiding issuers that are highly leveraged, have poor liquidity, are less likely to be supported by the government, or have significant excess capacity. We are also cautious on consumer cyclical areas given the process of consumer de-leveraging, particularly in the U.S., is still likely in the early stages.

We will likely see a rise in the corporate default rate, particularly for high-yield issuers, and we will also likely experience low recovery rates in certain sectors of the economy. We remain cautious on the outlook for retailers, REITs, technology, gaming, lodging, paper and chemicals. These are all industries that tend to be very cyclical, and that took advantage—either directly or indirectly—of the easy credit standards of the last five or six years to leverage themselves to unsustainable levels. Now, they are the sectors under the most pressure and they'll likely stay that way as deleveraging continues and credit remains tight and selective. In the current environment investments in these companies just don't make sense to us until we see the economy stabilizing.

**Q: Many clients are thinking about rebalancing back to their target equity allocations. Should they consider credit as a substitute?**

**Kiesel:** Yes, with high-quality corporate yields around 7 to 8% YTM, investors have the opportunity to earn equity-like returns. If spreads tighten modestly from here, capital gains could add to yields. But even while returns are comparable with the average historical returns of equities, investment-grade bonds have about one-third the historical volatility of stocks.

**Chart 1 | Historical Yield Comparison: Investment Grade Corporates and U.S. Treasuries**



IG Corporates= Barclays Capital Investment Grade Corporate Index  
 Source: Barclays Capital

We also think equity holders are the most at risk in an economy which is deleveraging. Government and any private sector support will likely be injected above equity in the capital structure, so equity runs the risk of both dividend cuts and further subordination as additional capital comes in above it. We believe that now is the time to be a lender at the top of the capital structure rather than an equity holder at the bottom.

**Q: Given the current level of interest in corporate credit, how long is this window of opportunity likely to last?**

**Kiesel:** It really depends on the economy and the economic fundamentals. Right now we are in an economic and financial crisis unlike any experienced before. This recession is likely to be more extended and more severe—particularly for the U.S. consumer—than any since the Great Depression.

We are in the process of unwinding a massive credit boom and a debt super cycle. While there are opportunities for yield on these bonds, there's also risk.

Corporate bond yields are as high as they are, and spreads are as wide as they are, because the market is obviously worried about the economic and fundamental credit deterioration. The global economy is weak and appears to be getting weaker. The consumer is retrenching. What started out as a housing bubble has now morphed into an outright consumer retrenchment and economic contraction, particularly in developed countries.

We believe investing in this environment requires quality research and due diligence, and an understanding not only of the fundamentals but also the technical factors influencing the market. We also believe issue selection is more important than ever and investors have to take a bottom-up view in addition to the top-down view. It's vital to understand the details of indentures, the covenants and deferral features, as well as how policy may affect different industries and companies.

So there is value in the market, but investors need to be discerning. As the economy improves, investors will likely show more interest in higher yielding corporate

Yield to maturity reflects the total return an investor receives by holding the bond until it matures. A bond's yield to maturity reflects all of the interest payments from the time of purchase until maturity, including interest on interest. Equally important, it also includes any appreciation or depreciation in the price of the bond.

This disparity between our expectations for high-quality credit versus equity is interesting, because it implies that an investor can go up in the capital structure by owning senior bonds, and get higher return potential than equity holders are getting at the bottom of the capital structure. Yet, corporate bonds, because of their seniority in the capital structure, generally have less risk (and volatility) than equity holders. The current risk/reward makes high-quality corporate bonds a particularly attractive alternative to stocks.

bonds and the spreads will likely tighten considerably. But in the near term, that's not our expectation because we expect a prolonged period of relatively poor economic growth.

The window of opportunity for investors should be open for a while given PIMCO's expectations for a gradual improvement in high-quality spreads in fits and starts. But ultimately, credit fundamentals, the economy and market technicals—the balance between supply and demand—will determine where spreads go, and how long this window will remain open.

**Q: Is now a good time to also move into high yield and bank loans?**

**Kiesel:** We think that it's too soon to move into either equities or high-yield corporate bonds. We are still at a point in the business cycle where we think defaults will increase significantly, and we think the recovery rates are going to be very poor at the bottom of the capital structure. A lot of these companies went through the last leveraged buyout (LBO) wave with a tremendous amount of bank debt, so there is senior secured bank debt that has the first claim on the company's assets.

In the case of a default, high-yield bondholders are basically left with nothing. Because bank loans have a senior claim on the company's assets, the recovery rates for bondholders are likely going to be much lower than what historical studies would lead you to believe. For example, the average recovery rate for high-yield bonds during the first quarter of 2009 has been 9.5%, compared to 26.5% during 2008 and the long-term average of 35% to 40%.<sup>1</sup>

Ultimately, before jumping into high yield, we'll need to see the economy stabilize. The global economy is obviously very weak and appears to be getting weaker. We need to see credit recirculate through the system, and right now the credit markets for lower-rated companies are not functioning. While the government is doing everything it can to help repair the credit markets, and while we have seen improvement in inter-bank lending and liquidity, we still haven't seen a lot of improvement in broad credit circulation to individuals or to companies. We will need to see credit flowing more freely to the economy before turning more bullish on high yield.

Regarding bank loans, we are selectively buying in that market. We have a bias for what we believe are high-quality loans, and we are avoiding second-lien loans. We're favoring very select, high-quality, asset-rich companies in defensive industries like healthcare and utilities.

**Q: What is the outlook for defaults and recovery rates?**

**Kiesel:** In the investment grade market, the current default rate is about 0.4%, so it's minimal. Could defaults go to 1.0% or even 1.5% in the investment grade market? Yes, that's possible. But spreads are currently around 480 basis points over comparable Treasuries, indicating that the market is already pricing in a much higher rate of default than we expect in the investment grade market.<sup>2</sup>

In the high yield market, the current default rate is around 5.2% and we are expecting that default rate to potentially go to 10% or even 15% with very poor recoveries.<sup>3</sup>

Another thing happening with high-yield issuers—and this is an important point—is that there are a lot of debt exchanges. These are effectively like defaults because as the companies exchange current debt, the investors are typically forced into making a concession by taking a price “haircut.” Including distressed debt exchanges, the high-yield default rate is already approaching 10%.<sup>4</sup> So the potential impairment to bondholders is pretty onerous in these highly-leveraged cyclical companies. That is one more reason to stay in the senior bonds of very high-quality companies which are supported by ongoing government programs.

**Q: Is there sufficient supply in the corporate bond market to accommodate pension plans considering long credit to help match their liabilities?**

**Kiesel:** This is an important issue. We are seeing a lot of demand for high-quality 30-year corporate debt. Part of the demand is simply driven by the attractiveness of historically wide spread levels. Additionally, with the nominal Fed Funds rate at about zero and the Fed essentially printing money, investors are rightly concerned that current government policies could ultimately lead to deflation. These concerns, together with the increasing risk of substantially greater supplies of global government bonds make long maturity Treasury rates around 3½% look unattractive. In this scenario, going into longer maturity, high-quality corporate

bonds makes sense, particularly given current yields of 7% to 8%.

As a result of significant demand from liability-driven investors and a limited supply of high-quality long maturity corporate bonds, spreads for long corporates could tighten to a greater degree than might be the case for intermediate corporates. For example, recent larger new 30-year issues from major pharmaceutical companies were met with significant demand and their prices subsequently rallied.

Once the economy begins recovering, you could see renewed new corporate bond issuance across a broader group of industries. But right now, with the economy so weak and with nominal GDP approximately at zero, companies are in no hurry. Only a relatively limited number of higher-quality issuers are able to raise money in the current environment. In addition, new supply in the bank/financial sector has been limited in the unsecured market because these issuers have been raising capital through the FDIC/government-guaranteed market. Thus, we expect the demand and supply imbalance in the 30-year part of the market to persist

in the near-term. Investors are increasingly seeking principal preservation and stable income. Plan sponsors are also looking to match long-term liabilities with low risk long-duration assets. These trends should continue to support long-maturity, high-quality credit assets.

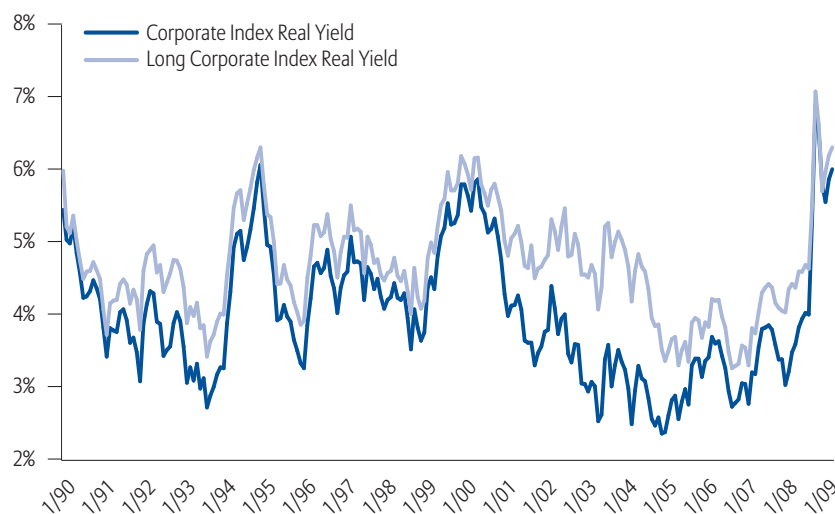
**Q: How do corporate bond spreads affect the stock market? Is there good news in this for equities?**

**Kiesel:** Not necessarily. This economic recession is very different from those experienced during previous business cycles, and will likely be more severe for the consumer. We are experiencing the unwinding of a major asset bubble in housing, which was generated through massive debt creation, loose credit standards and extraordinary liquidity. The unwinding of this process will take years. Housing cycles typically last about five or six years from peak to trough. If that pattern holds in this cycle, then we may be only slightly more than halfway through with further pressure on housing prices.

Recognizing this, the government is stepping in to provide support to the economy and the financial system, spending taxpayer money to effectively provide a bridge loan to the banking industry. This effort is likely to be greater in size and longer in duration than most tax payers probably suspect or want, and necessitates a tradeoff between spending the taxpayer's money now and protecting them over time by providing transparency and accountability.

In addition to political pressure for accountability, there is widespread expectation that private shareholders or other equity holders—including senior management of the companies that get bailed out—should not benefit from this government spending. So the very nature of the politics sends a signal that the government will likely increasingly support senior creditors and bond holders at the expense of equity holders or management. In some cases, increased 'burden sharing' could mean junior bondholders face 'haircuts.' This environment favors senior investments in the capital structure.

**Chart 2 | Real Yields Intermediate and Long Investment-grade Credit Near Historic Highs**



Source: Barclays Capital, U.S. Bureau of Labor Statistics

**Q: PIMCO hasn't been bullish on corporate credit for quite a while. Can you explain why you've changed your mind?**

**Kiesel:** PIMCO's underlying philosophy for the credit markets is to be a contrarian—we only like to take risk when we believe our clients are getting paid for that risk. In the years prior to the current crisis, we saw many other investors reaching for yield in lower-quality credits—junior subordinated bonds with unfavorable terms—and we thought it was too risky. So it's true that we were bearish on credit for quite a while, which helped us to avoid some of the hardest hit sectors such as subprime mortgages, cyclicals and subordinated credit.

Now that credit markets are finally paying a premium for taking risk—with credit spreads near historical wides—we are selectively stepping back into high-quality corporate credit, and we believe our contrarian approach will again serve us well.

The last time we thought the credit market was cheap was when spreads widened out in 2002, and the Fed dropped interest rates. We invested in bonds from select energy and pipeline companies, among other distressed securities, that were trading at \$0.35 to \$0.50 on the dollar, and which later recovered to prices at or above par.

When we bought the debt of those energy and pipeline companies, we did so because they had hard assets and we believed it was mostly technical selling pressure that was pushing their prices so low.

So we stepped in when only a limited group of investors wanted to, and when our clients got paid for the risk. Not all investments turn out so well, but we believe it is important for clients to take on risk when they are appropriately compensated.

Seven years later, we believe selective high-quality credit risk makes sense given attractive valuations and government support in certain sectors. Real yields for intermediate and long maturity corporate bonds are

near the highest levels we have seen in the past 18 years (Chart 2). These factors make us more bullish today, given our belief that we are finally getting paid to be in high-quality credit.



1. Source: JPMorgan
2. Source: Barclays
3. Source: JPMorgan
4. Source: JPMorgan

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Gross Domestic Product (GDP) is the value of all final goods and services produced in a specific country. It is the broadest measure of economic activity and the principal indicator of economic performance. Nominal GDP is a measurement of economic performance not accounting for inflation. Excess capacity occurs when the demand in the market for a product is below what the firm can supply to the market.

*Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Equities may decline in value due to both real and perceived general market, economic, and industry conditions. Investing in distressed loans and bankrupt companies are speculative and the repayment of default obligations contains significant uncertainties. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. High-yield, lower-rated, securities involve greater risk than higher-rated securities.*