October 2008

U.S. Credit Perspectives

PIMCO

Trick or Treat?

"Follow the course opposite to custom and you will almost always be right." — Marc Faber, noted contrarian

My favorite holiday, Halloween, is approaching. Halloween brings back many wonderful childhood memories of trick-or-treating with my best friends Marty, Kevin and Scott in St. Joseph, Michigan. While we all enjoyed dressing up as Batman, Superman, Spider-Man and Scooby-Doo, our favorite part of Halloween was going out trick-or-treating, usually under the supervision of my dad. There were many houses close by, many families with children, and we saw it as one big treasure hunt.

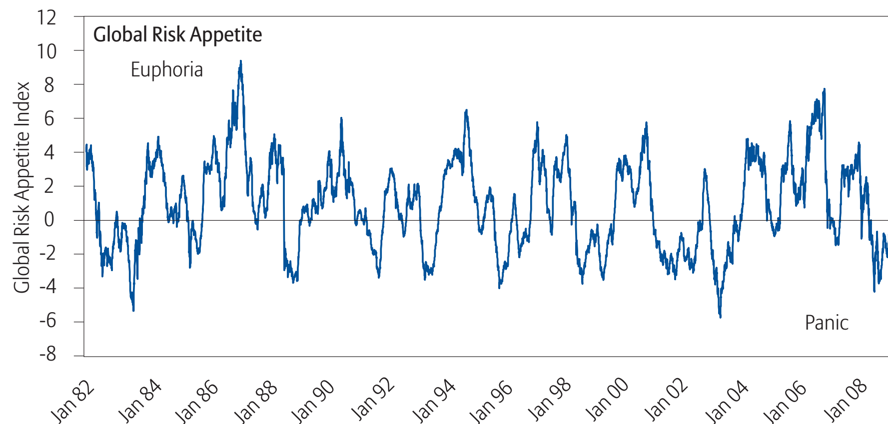
In his first year as trick-or-treat chaperone, my father didn't understand our strategy. He advised us to follow all the other kids to the houses with bright lights and with pumpkins, ghosts and witches decorating the doorsteps, saying "that's where the candy is." But my friends and I knew that those houses with all the lights always handed out the same tiny chocolate bars, lollipops, fruit or single sticks of sugarless gum—meager fare. In addition, the mobs of kids sometimes led to candy shortages at those houses. Why should we wait in line for a chance at a bite-sized Snickers?

So with my puzzled father in tow, we sought our treats elsewhere. We knew that full-sized Nestlé Crunches, Milky Ways, and full packs of Bubble Yum gum were out there, and our rigorous research, information sharing and hard work helped us to know which neighbors had the real treasure. While the hordes of kids were drawn to the lights and decorations, we targeted a select group of "underappreciated" neighbors, where we collected more and larger-sized candy and in less time than the other kids. Afterward, my dad fully understood our strategy as we unloaded the treasure on our family room floor. That was our lesson to my father on contrarian thinking.

All Going One Way

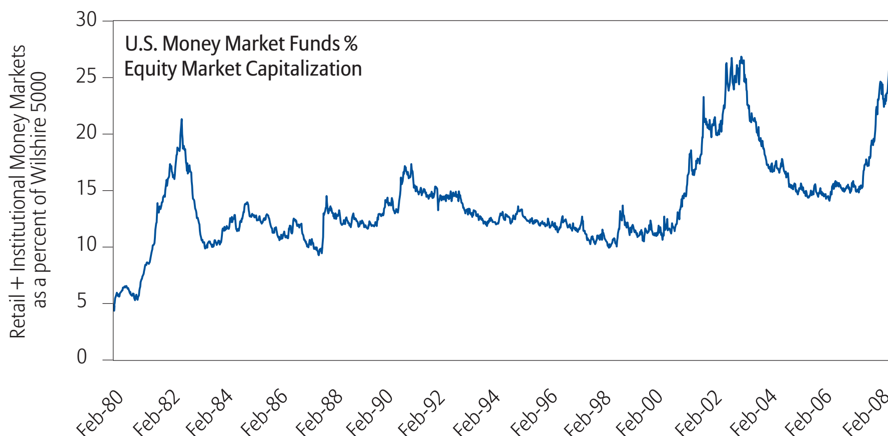
During this Halloween season, investors appear to be going one way, mesmerized by the same bright lights, similar to the masses of trick-or-treaters in my childhood. After several years of owning and leveraging up risk assets—stocks, corporate bonds and bank debt—hedge funds are now moving quickly in the other direction. What was once a massive flight towards risk assets, which compressed risk premiums to levels which PIMCO argued were not sustainable based on fundamentals,[1] has now moved swiftly in the other direction, causing credit spreads to move to new all-time wide levels. For investors, headlines about financial market fears are the lights

CHART 1
Massive 'Risk Aversion'



Source: CSFB

CHART 2
Cash in Money Markets At All-Time High



Source: Bloomberg

and pumpkins and ghosts that are drawing them to the bite-sized safe-haven returns of low-risk assets.

The combination of indiscriminate selling by leveraged investors and a significant global economic slowdown has caused sentiment in the financial markets to sink to extremely low levels. Investors are hoarding cash and Treasuries while selling anything with risk, including high-quality investment grade corporate bonds, senior bank debt, municipal bonds, Treasury Inflation-Protected Securities (TIPS) and domestic, international and emerging market equities. As a result, risk aversion is now at levels we have only seen twice before—back in 1982 and 2002—over the past 27 years (Chart 1).

Another piece of evidence that suggests the crowds are all going in the same direction—and away from risk assets—is the magnitude of flows into money market funds, which as a percentage of U.S. equity market capitalization are now at 28-year highs (Chart 2). As is the case with risk appetite, peaks in this measure—back in 1982 and 2002—were a good leading and contrarian indicator to go in the other direction as the crowd. It turned out in these prior periods of extreme risk aversion that buying "risk assets" like equities and corporate bonds when cash levels were at very high levels proved to be a winning strategy.

So, is it time to increase credit risk based on these measures? Maybe not. Just like our trick-or-treat strategy, we need to be guided by thorough research and leverage our experience in order to understand where today's investment treats may be. While sentiment is very pessimistic, it is not without good reason, as both credit market technicals and fundamentals have turned decisively more negative.

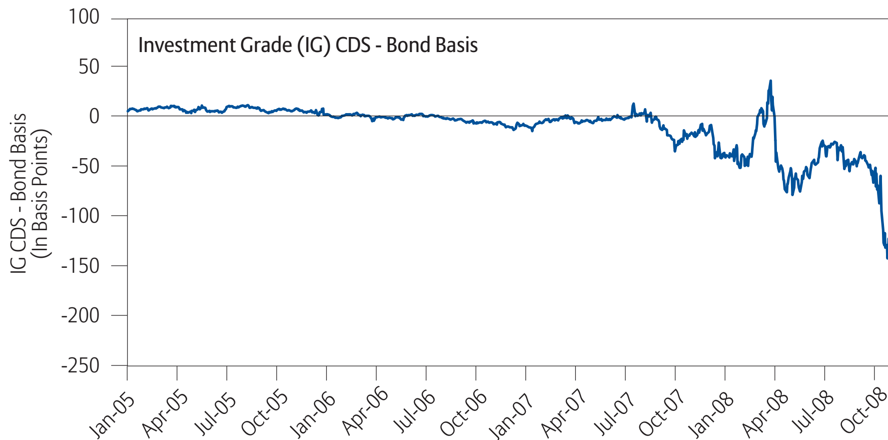
So before we hit the streets in search of Halloween treasure, let's take a look at the current technicals and fundamentals, and conclude with our thoughts on current relative value opportunities in the credit markets in light of recent global policy developments.

Negative Credit Market Technicals

Hedge funds flows, curtailed foreign demand, the lack of a new-issue corporate bond market and tightening bank lending standards all seem to be contributing now to what many refer to as negative market technicals. Put simply, there are currently more sellers of

CHART 3

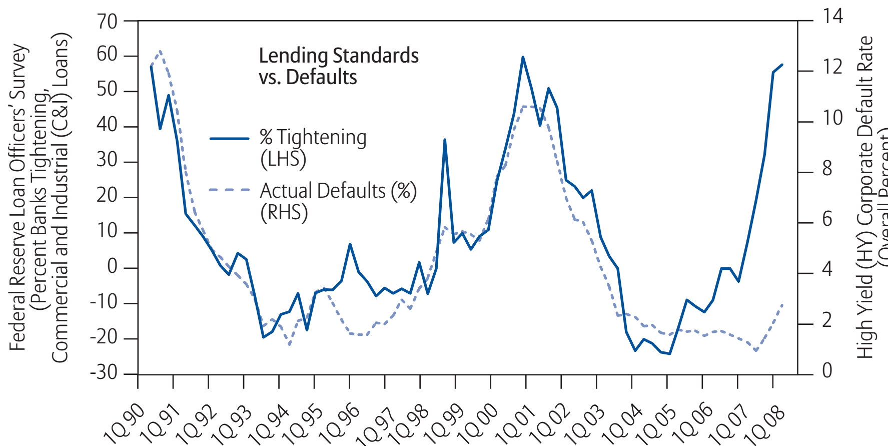
Corporate Bonds Now Over 2% 'cheap' to CDS



Source: JPMorgan

CHART 4

Banks Tighten Credit Before Material Rise in Defaults



Source: Bloomberg

credit risk than buyers. Hedge fund performance has been miserable this year, leading to significant redemptions. Actual and potential fund withdrawals are causing managers of leveraged money to sell assets into a market with limited liquidity.

While Wall Street has traditionally been a liquidity provider, there are two major reasons why it is not much help these days. First, dealers are deleveraging and not willing to take risk, resulting in wider bid/offer spreads and lower bids and prices on bonds. Second, dealers are increasing margin requirements for leveraged players, causing some "forced and indiscriminate sales" by some hedge funds needing cash due to margin calls.

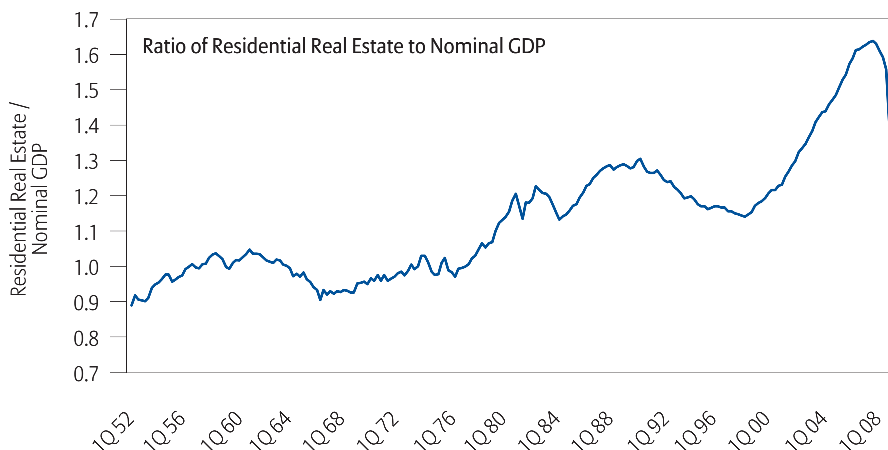
The result is a market with more sellers than buyers, causing corporate bonds to now trade over 2% "cheap" to underlying credit default swap (CDS) levels (Chart 3).[2]

In addition to large hedge fund withdrawals, foreign buying of credit risk has recently slowed from its formerly brisk pace. Weaker growth overseas and sharp declines in commodity prices are leading to less money recirculating back into credit markets. At the same time, the new issue market for corporate bonds has been effectively closed for over a month. A few high-quality A-rated companies have been able to raise money at 8%–8?% yields, but these new bonds are being issued into the market at (approximately) a large 1% premium to existing secondary bonds.[2] Companies are "paying up" for liquidity.

CFOs and treasurers, bracing for a deterioration in the economy, are now starting to tap bank lines, mainly because they are finding it increasingly difficult to raise money in a market with limited buyers of risk. PIMCO's internal credit research team has tracked 36 companies that have tapped bank lines for a total of $29.7 billion in under a month.[2] Banks are now seeing unforeseen and growing lending requirements at uneconomic rates (e.g., LIBOR+25–150) that were set several years ago. At the same time, the quality of banks' loan portfolios, particularly consumer loans, is deteriorating. With bank lines now being tapped, banks are forced to use their capital for loans they would prefer not to make. Fortunately, government injections of new capital to the tune

CHART 5

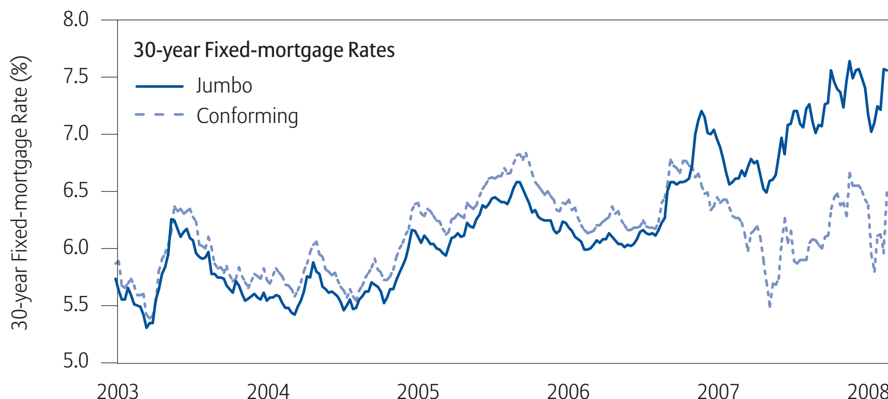
Housing Prices 'Expensive' Relative to GDP



Source: Federal Reserve and Bureau of Economic Analysis

CHART 6

Mortgage Rates Still Elevated



Source: FHLMC and Bankrate.com

of $250 billion will help to recapitalize the U.S. banking sector, though more money may be needed. However, in the near term, banks are pulling back credit due to a weaker economy, deteriorating credit portfolios and unforeseen bank line draw downs, despite a relatively low corporate default rate (Chart 4).

Deteriorating Economic Fundamentals

In January of this year, our bias for high-quality investments and overall caution in the credit markets was outlined in our *U.S. Credit Perspectives:* "Triple Play" (January 2008),[3] where we forecasted:

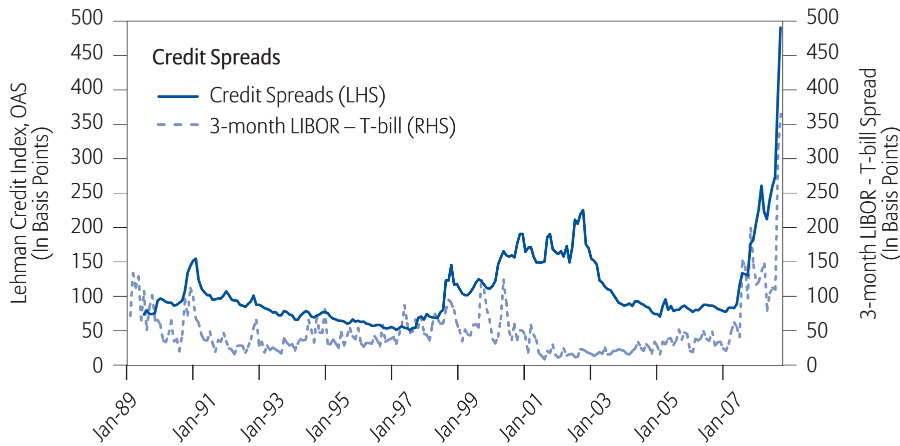
- Housing prices would continue to fall due to tightening credit conditions, high inventories, rising delinquencies and foreclosures and poor affordability,
- Unemployment would rise as weak profits and a growing output gap would lead to rising economic slack, and
- Stocks would increasingly come under pressure due to a sharp slowdown in U.S. and global economic growth and "unrealistic" bottom-up equity analyst earnings estimates.

Our view at the time was that these three distinct "Triple Play" factors would lead to a recession and cause credit spreads to widen further.

So, where are we now in the Triple Play? Unfortunately, housing and job growth, two of the three factors, likely have further downside risk. Specifically, U.S. housing prices, despite having fallen roughly 20% from their peak back in the second quarter of 2006,[4] remain 10%–15% overvalued based on long-term historical measures such as price-to-income, price-to-rent and price-to-economic growth (Chart 5). In addition, total new and existing inventories of 4.7 million units[5] are higher now than at the beginning of the year, and roughly 12 million homes[6] are now in a negative equity position in which homeowners owe more on their mortgage than the home is worth. More challenging credit markets also mean fewer potential buyers. As a result, in terms of housing's total peak-to-trough decline, a 30%–35% total decline from peak now looks possible. This type of decline would restore mid-1990s affordability

CHART 7

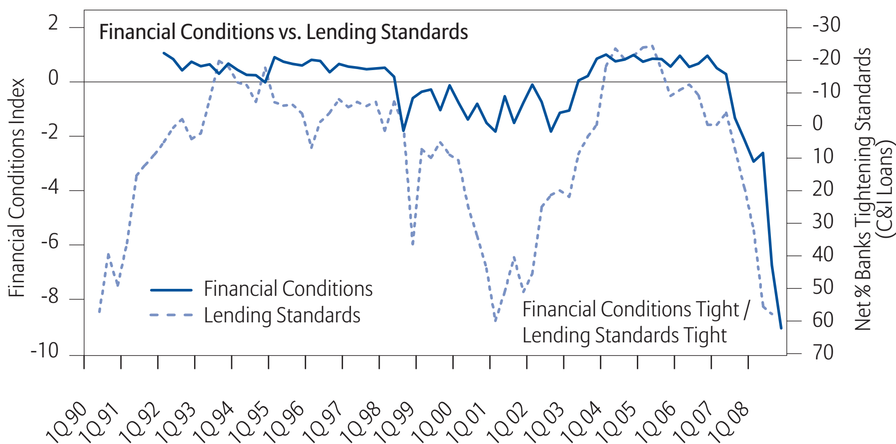
Credit Spreads At All-Time Wides



Source: Bloomberg

CHART 8

Tight Financial & Credit Conditions



Source: Bloomberg and Federal Reserve. Bloomberg financial index combines yield spreads and indicies from the money markets, equity markets and bond markets into a normalized index.

levels, something that will likely be needed in the face of mortgage rates which remain at or near five-year highs (Chart 6). Historically, the peak-to-trough in a housing cycle takes at least four years, and this cycle will likely be no different, implying a 2010 bottom and additional headwinds for the economy and consumers.

The unemployment rate has risen sharply to 6.1% this year. However, corporate profits will likely continue to disappoint given the sharp slowdown in U.S. and global economic growth. The deteriorating fundamental outlook should lead to heightened business cautions, particularly for consumer cyclical industries as consumers are pulling back significantly on discretionary purchases due to the negative wealth effect of falling housing and stock prices. As a result, CEOs who sense a weak top-line growth outlook and whose businesses face a deteriorating financing environment will likely continue to downsize staff. A growing output gap and rising capacity should therefore cause the unemployment rate to rise to 7% over the next year. Unfortunately, there will likely be further deterioration in the labor market over the near term.

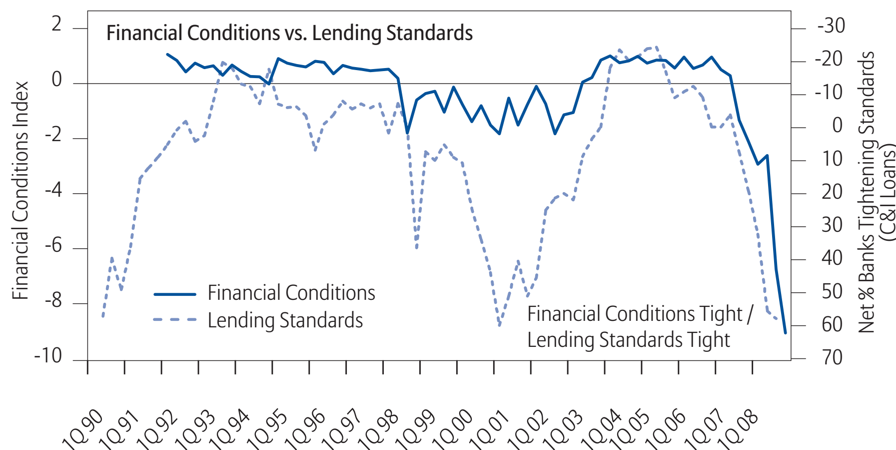
Stocks have fallen considerably in 2008. While some equity selling has been technical in nature due to risk reduction and hedge fund liquidations, most investors have significantly reduced their outlook for the U.S. and global economy in light of the significant deterioration in the credit markets. The good news is that stocks are now actually "cheap" on a valuation basis, trading at roughly 10 times next year's bottom-up earning estimates for the S&P 500.[7] While equity analysts are still likely too bullish on forward earnings, stocks are now pricing in a lot of bad news, having fallen some 40% from recent peak levels.

Credit Crunch

We are effectively now in a credit crunch. Credit spreads, in light of our Triple Play factors, have now hit all-time wide levels (Chart 7). Specifically, investment grade credit spreads are now at +486 basis points over Treasuries for cash corporate bonds and yields are now at 8.16%.[8] Why are spreads at these levels? Investors lack trust in light of recent events surrounding Lehman's bankruptcy, AIG's rescue package from the Fed, Merrill's forced marriage with Bank of America

CHART 9

Tight Credit To Slow Economic Growth



Source: Bureau of Economic Analysis and Federal Reserve

and Goldman and Morgan Stanley's sudden conversion to bank holding companies. All of this in basically one month's time.

The lack of trust and heightened uncertainty can also be seen in the historical relationship between three-month LIBOR and T-bills, which is now near all-time wide levels of roughly +300 basis points.[9] To see recent three-month LIBOR rates of 4%–4.75%, when the Fed Funds rate is 1.50%, is extremely rare and attests to the fact that banks are hoarding cash and reluctant to lend. This reluctance is leading to very tight financial and credit conditions (Chart 8). LIBOR rates, or the rate at which banks lend money to one another, will be a key leading indicator for when credit market conditions may start to improve.

Real Economy Implications

So, what are the implications for the real economy of the current credit crunch? In short, real economic growth is likely to slow significantly (Chart 9). Overall credit conditions for individuals are not only onerous, given high and rising interest rates on conforming and jumbo mortgages, home equity lines of credit and auto loans, but credit availability is severely restricted. Simply put, not enough consumers can get access to affordable loans to buy a house or a car, or even get student loans.

Credit conditions for businesses are similarly difficult. With U.S. nominal gross domestic product slowing to a 3%–4% pace and high-quality companies funding at 8+% yields, corporate profit margins are set to fall. High interest rates on corporate bonds, mortgages and auto loans should lead to weaker economic growth, particularly for consumer cyclical industries. Not surprisingly, lower-quality companies focused on consumer spending have seen credit markets freeze up. The high yield new issue market remains closed and, as discussed above, only a select group of high-quality companies currently have access to the capital markets through the new issue market.

Global Policy to the Rescue

Fortunately, help is on the way in the form of an unprecedented global policy package, injecting capital into the banking system and set to provide a new balance sheet to help companies with near-term debt and commercial paper maturities. Monetary policy is also on the move in the U.S., U.K., Europe, Australia and New Zealand, and is set to become more accommodative. The global combination of fiscal and monetary stimulus should help the credit markets over time, and specifically the banking system. In the U.S., the Treasury has already directed $250 billion of the Troubled Asset Relief Program (TARP) toward capital injections into U.S. banks. Bank of America, JPMorgan Chase, Citigroup, Wells Fargo, Merrill Lynch, Goldman Sachs, Morgan Stanley, State Street and Bank of New York alone are set to receive $125 billion.

Necessary? Yes! Sufficient? Time will tell! What is likely is that we'll avoid a severe recession, thanks to heightened and increased global policy coordination. Nevertheless, despite new capital entering into the global banking system, risk appetite remains extremely suppressed. This means banks may continue to be cautious on making new loans and individuals and companies may continue to be reluctant to make new purchases. If banks are slow to recycle new capital coming from the TARP back into the real economy, we should expect to hear about it from

the Treasury and Congress. In addition, direct government support could increase, as in the case of loans to the auto industry, and there may be more aggressive measures in an Obama administration to directly support consumers and housing prices. We have not heard the last word on the fiscal initiatives coming out of Washington.

Treasure Hunt

In light of the tremendous uncertainty surrounding the markets, the economy and future policy initiatives, credit markets are likely to remain volatile with spreads at elevated levels for some time. Who wins? Who loses? In terms of winners, banks—particularly large deposit-bearing global national champions—stand to benefit most. Mortgages should also benefit due to increasing government support and efforts to lower mortgage rates.

As we have searched for treasure over the past several months, we have focused our credit risk primarily in mortgages and in large, global national deposit-bearing banks. We remain underweight lower-quality credit risk and consumer cyclicals, given our cautious view on economic growth, labor creation and housing prices. While near-term the stock market appears oversold, we will wait to add credit risk until the technical and fundamental outlook in the credit markets is more clear.

Trick or Treat?

PIMCO's contrarian investment strategy in the credit markets has served our clients well over the past several years. Our historically cautious stance on credit was the result of the combination of our negative cyclical outlook on housing, stocks and employment conditions; our negative secular outlook given the democratization of credit (which we wrote about in U.S. Credit Perspectives: "Credit Innovation and Opportunities" (December 2006); and poor relative valuations on credit spreads. It turns out that narrow credit spreads, which we wrote about over the past several years, were a rather nasty trick instead of a tasty treat, given the risks at the time.

Now, with credit spreads at all-time wides, we are more positive on credit valuations, simply from the standpoint that investors are finally getting paid now to take selective credit risk. The credit markets today offer some tempting treats, particularly in high-quality mortgages and banks, for investors who can be patient and have a long-term investment horizon. Given large monetary and fiscal stimulus, the U.S. economy will likely avoid a prolonged recession. Nevertheless, the real effects of the credit crunch will be felt throughout the overall economy over the next year, and near-term deleveraging is likely to result in continued near-term negative market technicals.

As we discussed above, the credit markets will likely further differentiate between the winners and losers over the course of the next few quarters. Credit investors, just like those trick-or-treaters on Halloween night, must approach opportunities with a discriminating eye and not always follow the crowd. PIMCO's contrarian approach and high-quality bias in credit portfolios helped avoid many unpleasant tricks, and we are confident this same disciplined approach will uncover many treats in the months and quarters ahead.

Mark Kiesel
October 20, 2008

1. U.S. Credit Perspectives: "Credit Innovation and Opportunities" (December 2006), http://www.pimco.com/LeftNav/Global+Markets/Global+Credit+Perspectives/2006/U.S.+Credit+Perspectives+-+December+2006+-+Credit+Innovation+and+Opportunities.htm
2. Source: PIMCO internal research, October 2008.
3. U.S. Credit Perspectives: "Triple Play" (January 2008), http://www.pimco.com/LeftNav/Global+Markets/Global+Credit+Perspectives/2008/U.S.+Credit+Perspectives+1-2008.htm
4. U.S. Credit Perspectives: "For Sale" (June 2006), http://www.pimco.com/LeftNav/Global+Markets/Global+Credit+Perspectives/2006/Kiesel_For_Sale_06+2005.htm
5. Source: National Association of Realtors (existing homes) and U.S. Census Bureau (new homes), as of August 2008.
6. Wall Street Journal, Housing Pain Gauge: Nearly 1 in 6 Owners 'Under Water,' October 8, 2008.
7. Source: Bloomberg, October 17, 2008.
8. Source: Lehman Brothers U.S. Credit Index, October 17, 2008.
9. Source: Bloomberg, October 17, 2008.

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The London Interbank Offered Rate (LIBOR) represents the interest rate offered by a group of London banks to the most creditworthy international banks on deposits of a stated maturity; it is often used as the base index for setting rates on variable-rate loans. The Option Adjusted Spread (OAS) measures the spread over a variety of possible interest rate paths. A security's OAS is the average return an investor will earn over Treasury returns, taking all possible future interest rate scenarios into account. It is not possible to invest directly in an unmanaged index.

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