CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"Are Credit Spreads Pricing Recession?" by Dominic Wilson et al., Goldman Sachs, October 12, 2011

European and U.S. credit markets have sold off sharply in recent months, with spreads for many indices approaching peak levels reached in prior recessions. While current spreads imply weaker growth than seen in the current economic environment, growth is likely to slow considerably in both regions with risks skewed to the downside (especially in Europe). Thus, credit markets are likely to remain under pressure until there is concrete evidence of a significantly more robust European policy response to the current crisis.

European and U.S. credit markets have sold off sharply in recent months, with spreads for many indices approaching peak levels reached in prior recessions. For instance, European financial spreads (as measured by the iTraxx CDS index for subordinated five-year financials) are trading 18% higher than their 2008 peak. Although U.S. spreads remain well below their 2008 levels, benchmarking to the recent crisis may be setting the bar too high. Compared to the two prior recessions (i.e., 2001 and 1990), current spreads look a lot wider. Spreads for the BofA Merrill Lynch High Yield Bond Index, for example, are now only 31% and 24% below peak levels seen in the 1990 and 2001 recessions, respectively. These data are a warning sign about economic growth, especially in Europe. In isolation, however, this simple comparison reveals neither the behavior of credit spreads over the business cycle nor the growth outlook implied by the current level of credit spreads.

Using historical Moody's Baa bond yield data published by the Federal Reserve to construct a historical spread series, we can establish some basic facts about business cycle properties of credit spreads. First, based on the past ten recessions, we have found that spreads generally (though not always) tended to widen gradually for several years before a recession began, but did not peak until closer to the end of the recession. More precisely, credit spreads have tended to peak, on average, nine months after a recession began. This pattern is consistent with the view that spreads tend to widen as data suggest activity is deteriorating, and then begin to narrow as the cycle turns. Put differently, credit spreads tend to be a coincident indicator of economic activity, rather than a leading one.

Given this coincident behavior, we can use the relationship between historical spreads levels and concurrent economic data to calculate the current "spread implied" economic growth rate. Comparing this estimate to current data will then determine whether credit is attractively priced. In the United States, for instance, credit spreads are pricing in a range of job losses from 20,000 per month (non-financial BBB credit spreads) to 330,000 per month (financial credit spreads), which is approximately the magnitude of the monthly job losses associated with the worst months of the 1990 and 2001 recessions. Eurozone credit, meanwhile, is also discounting weaker activity than the current growth environment. Here, non-financial and financial credit spreads are signaling mild recessions of -0.20% and -0.35% real GDP growth, respectively. Interestingly, non-financial spreads have deteriorated in sync with financial spreads in

Europe, whereas U.S. non-financials have shown more resistance to European turmoil.

Clearly, credit is signaling growth weaker than current statistics. Normally, this would lead to a conclusion that corporate bonds are attractively valued—especially for U.S. non-financial companies, where credit quality is near 25-year highs. However, current "spread implied" growth rates are broadly consistent with Goldman Sachs' economic outlook. Namely, growth is going to slow considerably in both regions with risks skewed to the downside (especially in Europe). Thus, bottom-up credit quality is no match for the top-down pressure on the pricing of credit risk that is likely to continue as a result of concerns over the adequacy of the policy response to the European sovereign crisis. Until there is concrete evidence of a significantly more robust policy response (e.g., bank recaps), credit spreads, especially in financials, should remain high and volatile.

"Credit Strategy Weekly Update" by Peter Acciavatti et al., J.P. Morgan, September 30, 2011

Economic and political uncertainty around the globe has led to a decrease in investor appetite for risk assets. Prices of high-yield bonds and leveraged loans are now tracking equity volatility closely as assets across the capital structure have become increasingly correlated. This has left high-yield spreads at their highest level since October 2009. With the outlook unclear and more questions than answers, investors are left with a difficult choice when it comes to leveraged credits and must weigh the positives in terms of valuation versus the negatives in terms of deteriorating fundamentals and murky outlook.

Economic and political uncertainty around the globe has led to a decrease in investor appetite for risky assets. Prices of high-yield bonds and leveraged loans are now tracking equity volatility closely as assets across the capital structure have become increasingly correlated. This has left high-yield spreads at their highest level since October 2009. Specifically, high-yield bond and loan spreads have widened to 812 basis points (bps) and 786 bps as of September 30, an increase of 231 bps and 202 bps, respectively, since the end of July. With the outlook unclear and more questions than answers, investors are left with a difficult choice when it comes to leveraged credit; and must weigh the positives in terms of valuation versus the negatives in terms of deteriorating fundamentals and murky outlook.

On a relative basis, high-yield bonds and leveraged loans look cheap and are effectively pricing in a high probability of recession next year, with implied default rates at 8.5% and 16.7%, respectively. As spreads on high-yield bonds passed 800 bps, this marks only the seventh time since 1986 that spreads have entered a month below 800 bps and ended above that level. Evaluating subsequent returns in the next three to six months after spreads broke 800 bps, some observations can be made. First, high-yield bond returns on a three- and six-month basis have varied but have often been negative. The average returns for high-yield bonds three and six months after spreads surpassed 800 bps are -5.9% and -1.1%, respectively. Unsurprisingly, equity performance was also weak during this time frame, with three- and six-month returns averaging -9.2% each.

However, expanding the time horizon further after spreads broke 800 bps, the story begins to change, especially when viewed relative to equities. On a one-, two-, three-, four-, and five-year basis, high-yield bonds returned 10%, 14%, 14%, 13%, and 12%, respectively. Of note, all

subsequent one-year returns were positive, albeit mildly so in some instances. It is important to note that in September 2008 as spreads were crossing 800 bps, investors would have had to endure spreads blowing out to a record high 1,900 bps over the next 12 months yet still received a 5.7% return over the next year as spreads eventually normalized and high coupons helped performance.

It is worth considering not only the relative valuation of high-yield bonds based on the spread over Treasuries, but also the absolute level of yields. In all of the prior instances where spreads have crossed 800 bps, beginning absolute yields were much higher than at present. Higher coupons and reinvestment clearly helped performance in past periods. As absolute yields are currently being held down by near-record low yields on Treasuries, it remains to be seen how well high-yield bonds will perform if and when spreads normalize. If history is an indication, based on valuation alone, high-yield bonds seem positioned to outperform equities. Much remains to be seen in terms of the economic outlook and the operating environment for highly leveraged companies, however, and thus near-term pain may ultimately be in the cards.

"Leveraged Finance Insights – Seniority Over Quality," by Adam Richmond and Jason Ng, Morgan Stanley, September 30, 2011

Despite recent woes, the next six to 12 months appear to be set for higher-beta credit to outperform. However, for those looking to remain defensive amid heightened volatility, an attractive option would be to move up the capital structure and purchase loans, rather than up the rating spectrum by buying high-quality bonds.

Over the past several months, investors have been fleeing risky assets in preference for the perceived "risk-free" status of Treasuries. This trend has also been evident in the credit space, as future macro uncertainty coupled with heightened volatility in the markets has left investors risk averse. Those that have ventured into high-yielding credit have been buying high-yield bonds carrying high credit ratings. Despite recent woes, the next six to 12 months could be set for the outperformance of all types of higher-beta credit. However, for those looking to remain defensive amid heightened volatility, an attractive option would be to move up the capital structure and purchase leveraged loans.

Over the last two months, high-beta credit has suffered the most as investors fled to safety. Even more so, loans have suffered and sold off with the re-pricing of risk, failing to benefit from falling risk-free rates. As a result, leveraged loans have underperformed high-yield bonds in 2011. Yields on leveraged loans are now greater than those on high-yield bonds, which has not occurred since mid-2009, with the price differential near its high for the past two years. While high yield offers considerable value, leveraged loans today offer a better opportunity relative to bonds rated BB as the loans offer little rate risk with better valuations.

If one is to assume no change in spread or Libor, small upward moves in rates could pretty quickly start to eat into BB returns. For example, a 135 bp move higher in rates (a similar move to what we saw post-QE2) is the breakeven where BB total returns are zero. The rise in rates generally would occur in a stronger growth scenario, where loan spreads tighten just as much, if not more, than high-quality bonds, but without the rate risk. The likely scenario that would trigger BB outperformance is one in which macro continues to disappoint and rates remain subdued; however, a 10 point discount in a portfolio of loans and

seniority in the capital structure should buffer the downside.

Another attractive aspect of loans is their relative valuation. A comparison of spread per unit of leverage shows loan spreads are only slightly below those for BB- and B-rated high-yield bonds, despite the seniority of loans in the capital structure. This implies investors are essentially getting covenants and seniority nearly for free. Additionally, with loans and high-yield bonds trading around the similar level of yields, loans are implying a much worse future default and recovery rate scenario, given their higher historical recovery rates. Indeed, across the high-yield market spreads are pricing in scenarios that exceed the worst default cycles experienced over the past several decades.

Nevertheless, this view is not without risks. Loans exhibit shorter duration, and leveraged loan issuers on average have greater leverage than high-quality high-yield borrowers, which may only have bonds outstanding. The higher leverage imposes greater risk on loans for a sustained downturn, disregarding the seniority in capital structure. Finally, the loan market is quite bifurcated, with the average yield not providing great insight about the wide range of yields. Indeed, issuers with higher leverage may have loans that trade at significantly higher yields, raising the average yield for the index. Finally, loans have been experiencing outflows in recent weeks while high yield has been experiencing inflows. Loans may begin receiving inflows again if the recovery improves; however, it is likely that it takes longer for confidence to be restored in the loan market. ■

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