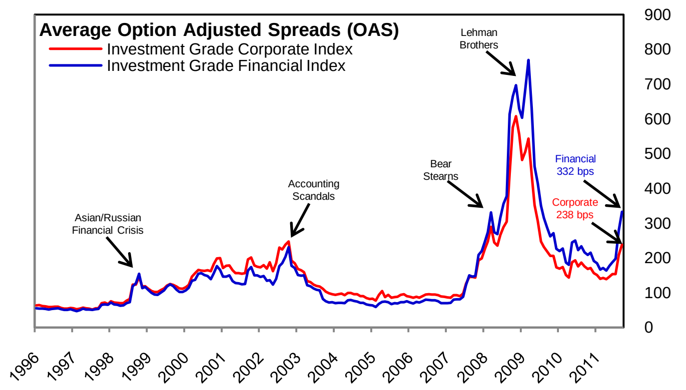
October 2011

Under Pressure

It has been an excruciatingly painful quarter for many markets. And like one of my favorite songs by the rock group Queen, most of us are feeling “Under Pressure.” Elected officials, pension trustees, brokers and money managers (including us) are feeling it. This quarter brought domestic budget deficit challenges, negative European headlines, some weaker economic statistics, legal challenges for banks, a new Fed initiative (Operation Twist) and a downgrade of U.S. debt.

The end result has been a painful stock market decline this past quarter of -14.3% as measured by the S & P 500 Index. But, probably the biggest story is the “flight-to-quality” in U.S. Treasuries and the underperformance of spread product as long treasury yields declined 146 basis points.

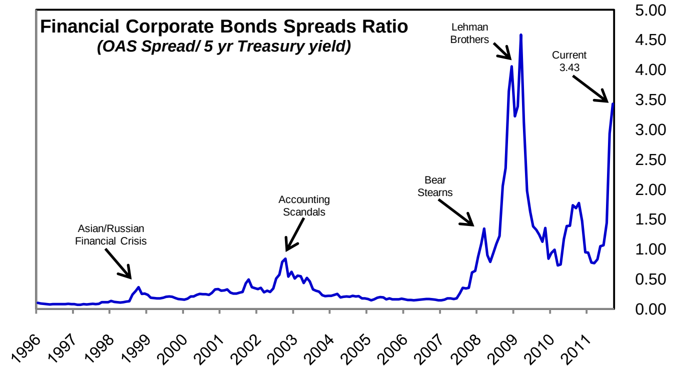
One sector especially hurt has been corporate bonds, particularly financials. Below is a chart of the Average Option Adjusted Spreads (OAS) of the Investment Grade Corporate Bond Index (red) and the Investment Grade Financial Index (blue). In less than 60 days, corporate spreads have widened over 80 basis points to 238 basis points, a level rivaling the crisis during the Bear Stearns rescue. Over the same period, financial spreads have widened over 130 basis points to end the quarter at 332, a level even wider than the Bear Stearns rescue.



Source: Barclays Live

But, it is one thing to earn an extra 200 basis points in spread over treasuries by owning a corporate bond in a higher interest rate environment. It is entirely different to earn that 200 basis points in spread in a lower interest rate environment. Thus, a more striking exercise is to look at the spread ratio which is the spread earned as a percentage of the yield of a similar duration treasury. For example, the spread ratio for 200 basis points in spread on a 6.00% base case treasury yield (ratio = 2.00/6.00) is a ratio of .33.

The following is a spread ratio graph for the Financial Index. As one can see, the ratio ended the quarter at a whopping 3.43! This is very close to the record levels seen during the peak of the Lehman crisis in 2008.



Source: Barclays Live

So, the question is, are we in the middle of another Lehman-like event and facing another Great Recession? Likewise, do financial spreads accurately reflect current fundamental risks or has the market overreacted? We are firmly in the “market has overreacted” camp.

We see many things that should prevent a repeat of 2008. From an economic standpoint, the economy appears to be growing. Furthermore, the Fed is taking deliberate and swift actions to encourage growth including maintaining the federal funds rate at zero for the next two years. During the Lehman crisis, the Fed deployed numerous tools including innovative lending techniques, quantitative easing and government guarantees to private sector debt. We believe the Fed will not hesitate to use these tools again if necessary.

Looking at financials specifically, many of the major issuers are trading near junk bond levels. Therefore, their bond breakevens, the amount their spreads need to widen before they underperform treasuries, are huge. As for their fundamentals, leverage is significantly lower with some names going from a 40 to 1 leverage in 2008 to leverage levels today in the low teens, near their historical lows. Furthermore, unlike the 2008 period when many names had trouble with their short-term funding needs, today these firms have ample liquidity and are far from experiencing any funding crisis.

One very important lesson we learned is the importance of financials to an economic recovery. This is the “too big to fail” or “systematically important” theme that still exists today.

While painful, we have been here before. We have seen crises such as the stock market crash in 1987, the savings and loan bailout, the Asian Contagion, 9-11, Lehman and now Greece. One common trait is that it is always the darkest before the dawn. We think the dawn is near as Europe stabilizes, the pending deficit reductions are announced and the economy improves. Thus, at this time, we are not changing our profile and remain overweighted in financials and underweighted in treasuries.

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A copy of our Form ADV, Part II is available upon request.

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