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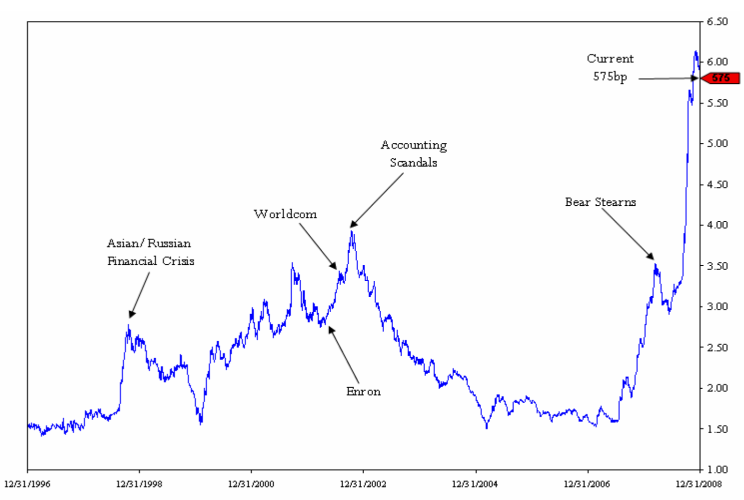
Tuning in to the Sounds of 2009

Over the years, I have written several monthly letters that started with a theme expressed by a particular song. With this letter, I turn off the background music from 2008 and reflect on the past unbelievable year. The news headlines were incredible and read like a bad dream: Sub-Prime, CDO's, Bear Stearns, FNMA, FHLMC, Lehman, Merrill, AIG, WaMu, Recession and TARP, to name just a few. But, let's skip all the superlatives for 2008 and "turn the dial" to 2009.

The opportune question we should all be asking is "where do we invest now." In stocks, the losses were pretty broad based across capitalization and quality. Thus, staying or becoming fully invested may be the simple answer. In bonds, the carnage was widespread and historic for all sectors outside US Treasuries. Thus, opportunity in fixed income spread product is truly historic for those with the flexibility to move into undervalued sectors and the courage to be early.

Whether one's specialty is corporate bonds, asset-backed securities, CMBS, or agency guaranteed mortgages, the bond market truly has something for everyone. Despite being a self-proclaimed "mortgage guy" from my early days at Salomon Brothers, even I must admit that corporate bonds may be the investment du jour for 2009.

Based on historical metrics, this is an exciting time to invest in corporate bonds. The graph below shows the difference between 10-year US Treasury yields and 10-year investment grade corporate bond yields. Presently, the spread is over 550 basis points. In other words, one can get an extra 5.5% yield over Treasuries by owning a high quality corporate bond. As a historical comparison, the spread difference during the Asian crisis of 1998 and the recession of 2001 was only 244 and 393 basis points, respectively.



Source: Bloomberg, DHJA

Looking at the corporate yield spread on a ratio basis makes today's opportunity even more compelling. Keep in mind that

the general level of Treasury yields was much higher in 1998 and 2001 than it is today. Thus, the yield spread available today in corporate bonds expressed as a ratio of the current 10-year Treasury yield is unprecedented.

Within corporates, the sector with the most glaring potential is the high quality financial sector. Let's examine the potential of a finance issue if the credit crisis subsides. Below is a box that shows the total return of owning a current 10-year A-rated finance name over two different time horizons - six months and one year. Furthermore, the box contains two scenarios. The first is if spreads narrow by 150 basis points to levels just before the Lehman bankruptcy. The other is if spreads narrow 300 basis points to levels of late 2007.

Total Return Analysis - 10 Year Finance Issue

Spreads	1 year	6 months
-150	17.36%	28.53%
-300	27.06%	51.33%

Source: Bloomberg, DHJA

The total return potential is extraordinary! Over a one year horizon, if finance spreads narrow to pre-Lehman levels, the total return would be 17.36%. If by summer the credit markets thaw and spreads return to levels of late 2007, the total return is a jaw-dropping 51.33%. Both look like equity returns of old. Even better, if realized, these returns will be achieved by owning a debt instrument which is ahead of the equity in the company's capital structure and in some cases ahead of the government's newly acquired capital position. Keep in mind that the debt also pays a semi-annual coupon payment over 6% at a price in the high 80's even if spreads do nothing. Sweet deal!

The market always tends to surprise us. But, with depression-like scenarios already priced into many fixed income sectors, the surprise may be how quickly things improve. Thus, at DHJA, we have already started "tuning in to the sounds of 2009."

Finally, all of us at DHJA wish you a very happy and prosperous 2009.

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