

Credit market outlook

December 2011

Insight believes that credit markets currently look cheap on both an absolute and a relative basis. Investors remain reluctant to commit to credit investments, particularly in eurozone corporates. Financials in this area are even more unloved. We also believe that over the next two years European credit is likely to be one of the main drivers of a global fixed income portfolio's performance.

As shown in charts 1 and 2 below, equities (shown inverted) and credit weakened together over the summer months but the subsequent recovery in equities has not been matched by credit. As a result credit looks particularly attractive in comparison.

Chart 1 – Markit iTraxx Europe index versus S&P 500 index



Source: Bloomberg, data as at November 2011.

Chart 2 – Markit iTraxx Europe index versus FTSE 100 index



Source: Bloomberg, data as at November 2011.

In contrast, government bonds look expensive on valuation grounds, with real yields at exceptionally low levels, even negative in some cases. Chart 3 highlights the additional yield available on European corporate credit. Therefore, the argument for a strategic allocation to credit rather than to government bonds or equities on value grounds appears to be compelling. The latter is particularly true when you compare dividend yields and bond yields, considering the greater vulnerability of equities in a growth downturn.

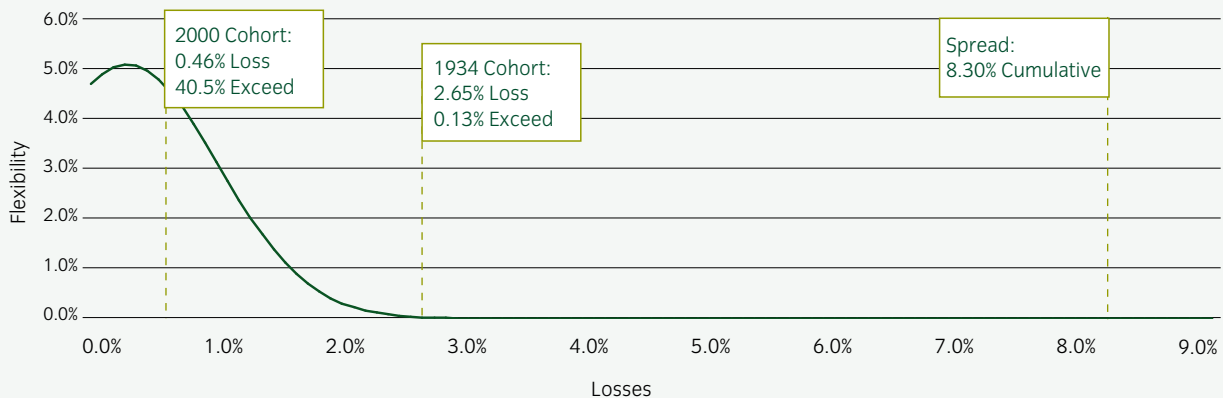
Chart 3 – UK, European and US real yields - 20 yr (%) versus European corporate yields



Source: Bloomberg, data as at November 2011.

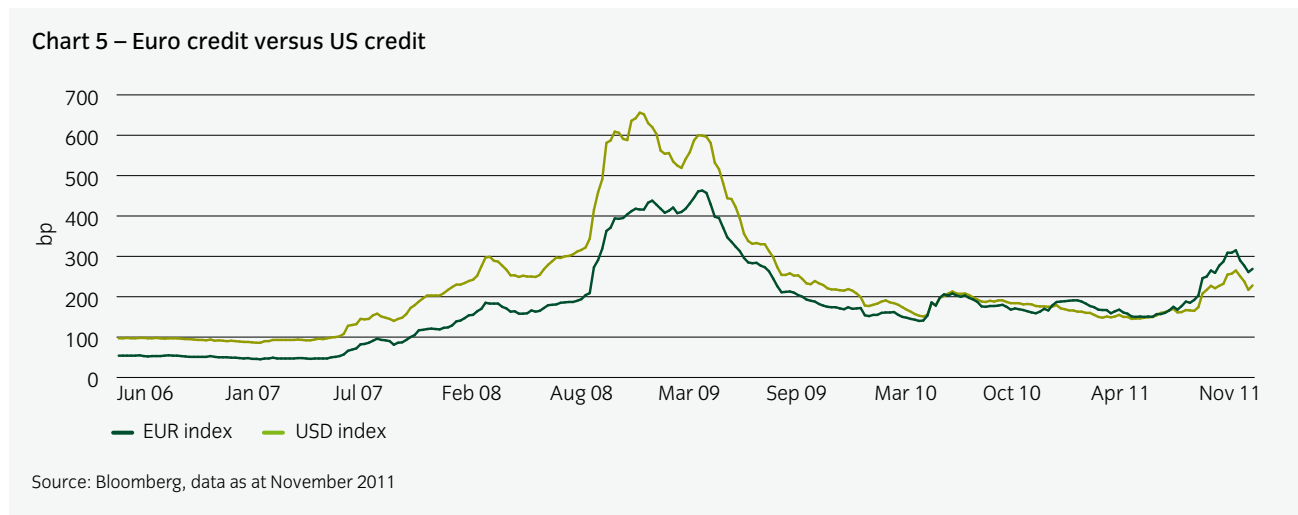
Investors appear to be well compensated for any risk they would be taking. Chart 4 shows the probability of losing capital on credit (based on A rated bonds) over a 5-year period. In the 5-year period starting 1 January 2000 (including the Worldcom and Enron defaults), the 5-year cumulative loss was 0.46%. This is close to the long term mean of 0.37%. Even in the economic depression of the 1930s the cumulative 5-year loss only reached 2.65%. Currently, the level of forward losses assumed in European credit prices compared to government bonds is around three or four times worse than in the 1930s. While investors may view the current environment as far worse than normal, the outlook would have to be incredibly negative to justify this kind of extreme scenario.

Chart 4 – Cumulative 5-year “A” losses



Source: Moody's, Barclays.

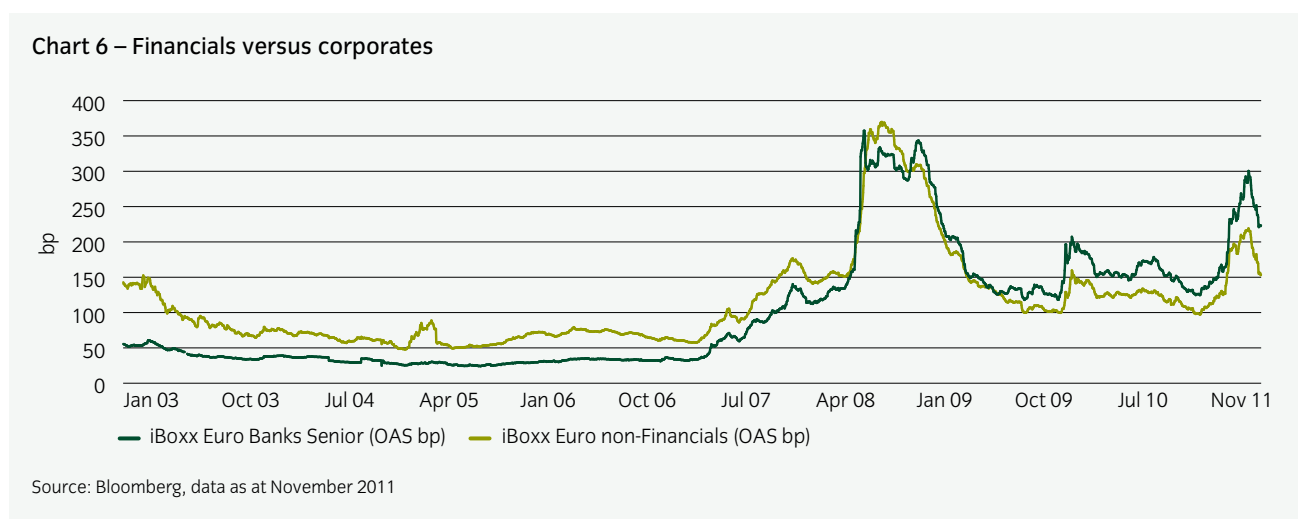
Chart 5 illustrates the outperformance of US credit compared to European credit. This is an unusual situation, as Europe is a higher-quality market than the US (the average rating is A in Europe compared to BBB in the US) and historically spreads have traded tighter in Europe.



In light of this, there are a couple of points to consider. Firstly, most companies are global and default rates do not tend to deviate between regions, although in extremis, a break-up of the euro could change this. Therefore, at current prices, European credit is offering greater compensation against the risk of default than US credit.

Secondly, it is our view that the decision whether to own European credit is going to be a key driver of global fixed income performance over the next few years. Developments in this market should not be ignored, as European market movements have implications for all other corporate markets, in the same way that the US subprime crisis was not just contained to the US.

This brings us to financials, which are key to the whole story. Chart 6 shows how financials have moved to trade at wider spreads than corporate bonds. This is unusual as financials need to trade tighter than corporates in order to make provision of funding a viable business. If it costs a bank more to borrow than it receives in interest from those to which it lends, then the marginal lending decision for any rational bank is likely to be ‘no’.



At present, average senior bank funding with a 3-5 year term costs a bank around Libor plus 2%. However, the bank can only lend to investment grade companies at around Libor + 1.5%. This gives the bank a negative return on equity of around 3%, as shown in chart 7.

Chart 7 – Bank borrowing and lending levels

		Bank lending levels								
		Bps + Libor	50	100	150	200	250	300	350	400
Bank borrowing levels	50	50	1.0%	6.5%	12.0%	17.5%	23.0%	28.5%	34.0%	39.5%
	100	100	-4.0%	1.5%	7.0%	12.5%	18.0%	23.5%	29.0%	34.5%
	150	150	-9.0%	-3.5%	2.0%	7.5%	13.0%	18.5%	24.0%	29.5%
	200	200	-14.0%	-8.5%	-3.0%	2.5%	8.0%	13.5%	19.0%	24.5%
	250	250	-19.0%	-13.5%	-8.0%	-2.5%	3.0%	8.5%	14.0%	19.5%
	300	300	-24.0%	-18.5%	-13.0%	-7.5%	-2.0%	3.5%	9.0%	14.5%
	350	350	-29.0%	-23.5%	-18.0%	-12.5%	-7.0%	-1.5%	4.0%	9.5%
	400	400	-34.0%	-28.5%	-23.0%	-17.5%	-12.0%	-6.5%	-1.0%	4.5%

Source: Insight, data as at November 2011.

With current bank leverage around ten times, a long-term sustainable credit differential between banks and other companies should be around 1%. The question is therefore, how are markets likely to get back to this point?

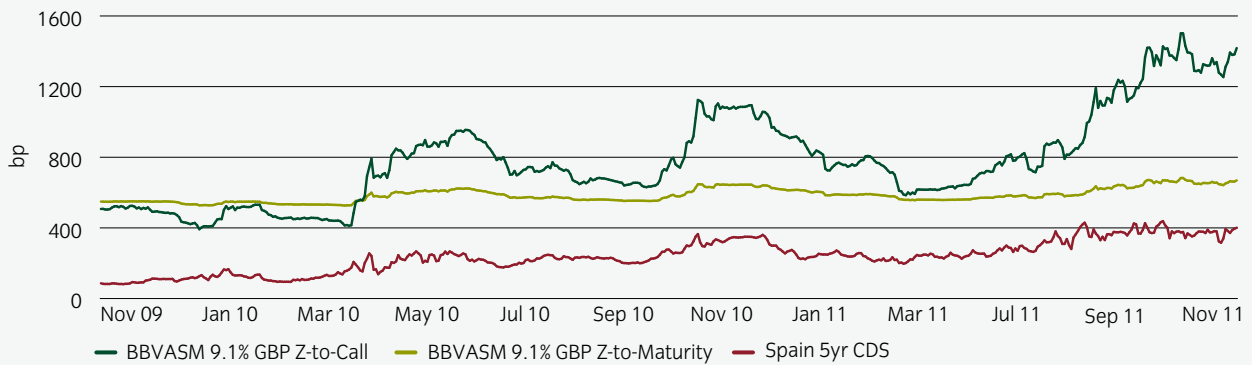
One possibility is that banks will not renew debt. This is significant as around 60% of the European debt market originates through bank loans, rather than bond issuance. The banks are least likely to extend further loans to those companies that have borrowed on the tightest terms. For the most part this means companies outside of Europe that are seen as separate from the eurozone problems. In our view, therefore, the contraction in lending is likely to hit companies outside of the eurozone first.

In addition, while those who have invested in non-financial corporates have done well so far, we believe there could be problems on the horizon. As banks stop financing loans (which are short dated so the impact could be felt quite quickly), companies are likely to try to come to the bond markets to gain funding. Corporate bond investors will need to be willing to take up this issuance, thus pushing corporate spreads wider, or see defaults. Whatever happens, the relative spread between banks and corporates is likely to revert to the mean as corporate supply increases.

In our view, whether invested in European banks or not, it is important to have a view on them, as the implications of their reduced lending levels are truly global. With all levels of credit interlinked in this way, it makes more sense to us to go long the area of the market that is trading at wide spreads (banks) and short that which is trading at tight spreads (non-eurozone corporates).

Furthermore, we believe the best rewards from financials should come from investing in their debt, not their equity. The dividend yield on BBVA equity is just 4.7%, while the yield to call on its average tier one debt is 15%, or 8.5% for the final maturity yield. Even by hedging out the risk of Spain defaulting through buying credit default swap (CDS) protection on the sovereign, a positive carry of 4.6% to maturity still remains.

Chart 8 – Financials versus sovereigns

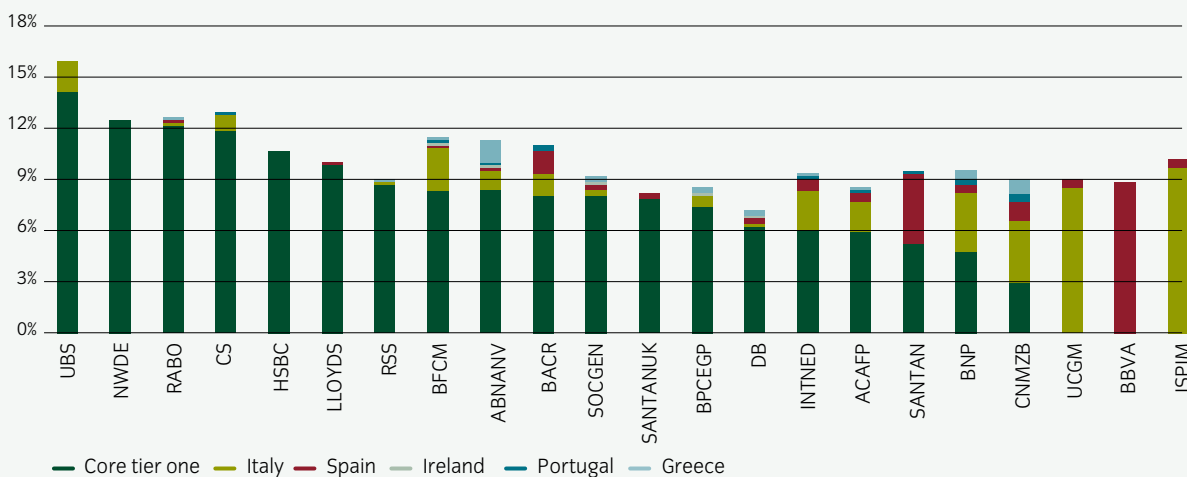


Source: Bloomberg as at November 2011

Alternatively, instead of buying BBVA equity where your known dividend yield is 4.7% and the value of your shares could fluctuate considerably, a ten times levered position in Spain CDS could be taken, which currently yields 39%. Chart 9 shows how BBVA has a similar return profile to a ten times leveraged play on Spain.

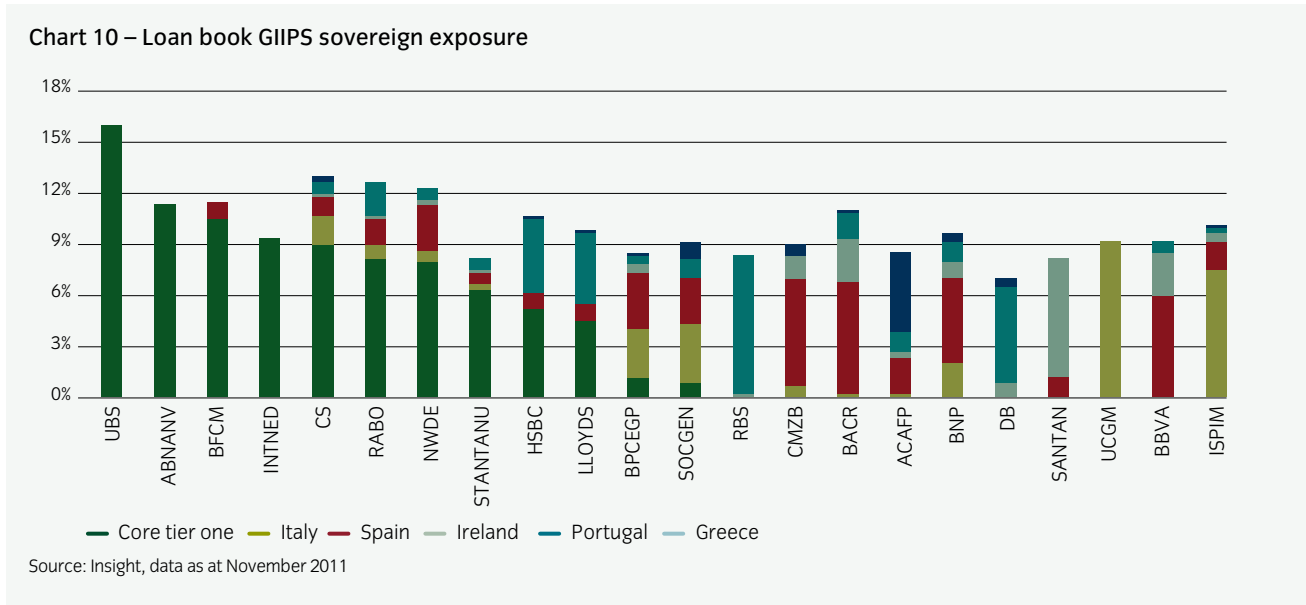
Looking further at the fundamentals of some of the leading European banks, we believe the whole sector should not all be viewed as being synonymous. There is lots of diversity in terms of their exposures to peripheral sovereigns and corporates. However, the market does not appear to be making any distinction between differing banks. Looking at BBVA in Chart 9, it is clear that it is solely exposed to Spain. While it has no other peripheral exposure, if Spain defaults, its core tier one of 10% is wiped out. UBS meanwhile has core tier one of around 16% which only falls to around 14% if the GIIPS (Greece, Ireland, Italy, Portugal and Spain) default. Nationwide, the UK bank, has no GIIPS exposure, nor have HSBC or Lloyds. The Italian banks would follow BBVA if Italy and Spain defaulted. Despite market nerves, the French banks appear to be in fairly good shape.

Chart 9 – Direct sovereign exposure versus core tier one



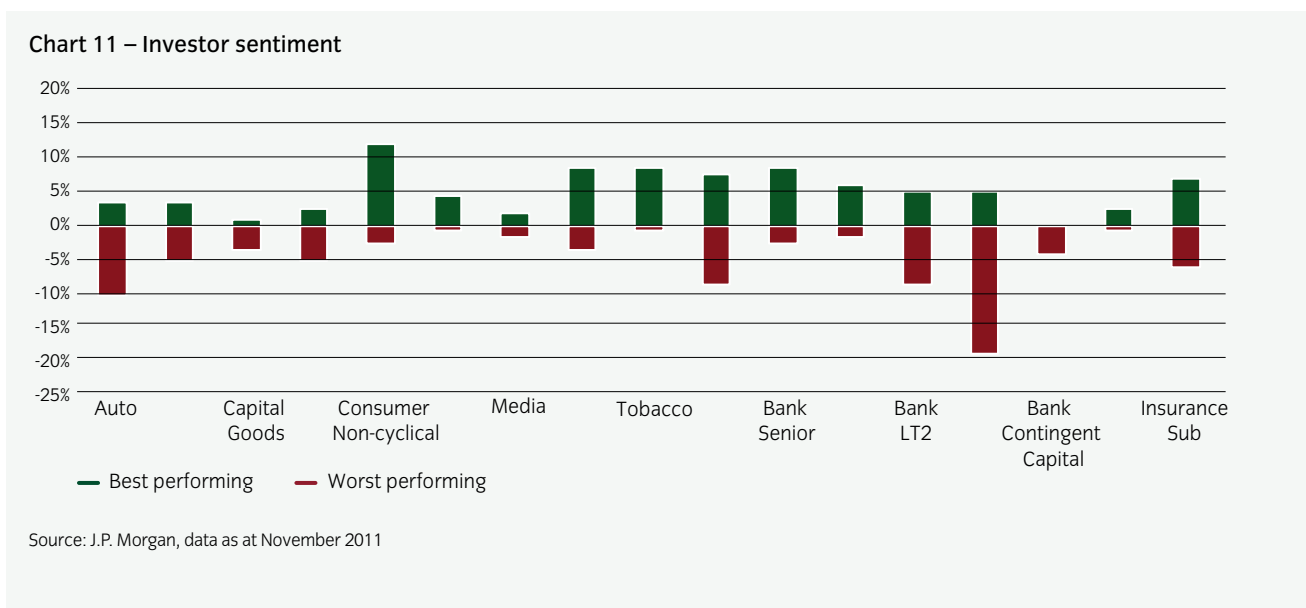
Source: Insight, data as at November 2011

Chart 10 looks at lending to GIIPS corporates, clearly showing that neither UBS nor ABN Amro have any exposure to companies in peripheral Europe. Unsurprisingly, however, some of the peripheral lenders themselves do indeed have exposure to peripheral companies. This means that problems would arise if a country leaves the euro and companies suddenly have to service debt in euros while their own assets have converted into lira or pesetas of less value.



In our view, those banks that will still have capital left after any sovereign defaults, as well as those that have lower exposure to potential bad loans, look the most attractive. The information to make these decisions is clearly available but the market does not appear to have priced it in.

Chart 11 originates from an investor sentiment survey showing which sectors investors expect to do well in the coming year. We read this as indicative of positioning and therefore believe that investors are likely to be overweight consumer non-cyclical companies and underweight subordinated bank debt.



In conclusion, therefore, while the fundamentals and valuations both appear to favour the banks, the market is positioned for entirely the opposite outcome. With the majority of other market participants underweight the banks, we believe now could be an opportune moment to buy them.

The value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

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For further information please contact:

Client Relationship Management

cddirect@insightinvestment.com
020 7321 1499

Consultant Relationship Management

consultantrelations@insightinvestment.com
020 7321 1209

Institutional Business Development

business.development@insightinvestment.com
020 7321 1547

International Business Development

internationalsales@bnymellon.com
+44 (0) 20 7163 2367

Wholesale Business Development

brokersupport@bnymellon.com
0500 66 00 00

www.insightinvestment.com

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