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Credit Quarterly Outlook Q3 2011

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In this issue

Fundamentals:

- **Economic activity is slowing down, double dip not central case but in the aftermath of a debt super cycle not impossible.**
- **Spanish credit decouples from other GIIPS countries. An export led recovery and the austerity package is working out slowly.**

Valuation

- **Investment grade still cheap, high yield attractive and cheapened recently.**

Technical:

- **For investment grade markets low supply and limited inflows, vice versa for high yield making the technical neutral. Big concerns about policy errors impacting sentiment.**

Unstable, unbalanced and unsustainable– *With the risk to keep repeating ourselves we would like to stress that the US and parts of Europe are in a balance sheet recession. In the aftermath of the burst of the debt super cycle things are different than in a normal economic cycle. Growth barely reaches trend growth and the private sector reacts to the uncertainty around employment and government finances. The private sector does not consume, invest and will not leverage up. In this paradigm soft patches (US economy) and even debt restructurings (Greece) are part of the healing process. A big risk is how politicians handle this situation; they could easily make things worse than necessary.*

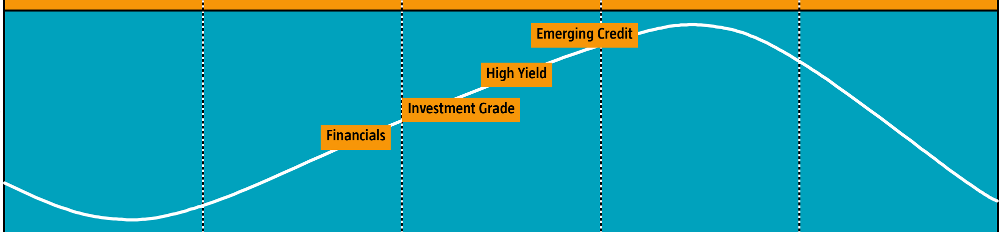
In terms of valuations we still believe the investment grade market is very cheap. The deleveraging cycle is driven by the financial sector (Basle III) but certainly also non-financials are managing leverage and investments cautiously. Looking at spreads, the only conclusion is one of attractive potential returns. For high yield the recent widening gives opportunities again.

Technically we are afraid that every now and then very thin trading books and politicians will continue to cause severe volatility.

We are on track to achieve excess return over government bonds of around 4% for investment grade and 6% for high yield for the year. We expect this to translate into 6% and 8% total return under the assumption that government bonds return 2%. For investment grade portfolios, we will be overweight beta with a beta-usage between 0-25% of the maximum. For high yield we will end up with a beta-positioning of around 1, both a bit more cautious on the short run..

Market Phase	BOTTOM	EARLY STAGE RECOVERY	MID-STAGE BULL MARKET	PEAK OF BULL MARKET	BEAR MARKET

General vertical direction of asset price movements



Fundamentals	20% Improving but ignored	30% Solid underlying performance	40% Sweet summer of growth	20% Optimistic, long-duration projections	30% Overawareness of deteriorating conditions
Valuation	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	20% Revised models justify stretching	20% Shocked recognition of outlandish prices paid
Psychology/Technical/Liquidity	60% Exhaustion, disbelief, and demoralization	20% Doubt, reflection, and conversion	30% Faith, hope, and charity	60% Euphoria, greed, and extrapolation	50% Fear, panic, and loathing

Fundamentals

The title of this quarterly outlook refers to a statement of Wen Jiabao to rebalance the Chinese economy from an investment led economy to a more consumer driven economy. According to us, the title could also refer to most countries in the West though. In the US savings rates are too low and causing a current account deficit with around 90 countries including China. At the same time we fear that US consumers will behave like zombie consumers in the future. This term we borrow from the famous zombie corporates in Japan during the lost decade. US consumers badly need a better employment situation and thus income growth to make the economic recovery really sustainable. Talking about sustainability, at some point the US government needs to address its horrifying fiscal position. In the medium term the AAA rating of the US is definitely at risk. We do believe that the rating agencies do not dare to act soon. For the time being we expect lots of political battles about the debt ceiling, short term solutions and then holding elections first.
We want to warn for the rubber band syndrome that many US economists are suffering from. The economy will not just bounce back easily after a soft patch because of pent up demand or investment plans. We are in a phase of a multi year debt adjustment and the government has not even started this process of debt reduction themselves.

In Europe the situation is on the surface a bit better with a healthier aggregate financial position. Under the surface though, Germany and France are leading the recovery and the periphery suffers from austerity packages. At the moment though, the periphery is heavily benefiting from the cyclical upswing in Germany and France. Spanish exports are keeping Spain out of recession and on the margin the employment situation is improving. Further Spain seems to digest social unrest which accompanies the austerity packages well.
The big Spanish issue to solve is its banking system though. A swift and decisive plan is needed. Almost all scenarios on potential bank loss costs on real estate are centered around 5-10% of GDP. This is manageable considering the starting point of the overall debt to GDP ratio of Spain. Transparency and disclosure must comfort investors though.

A while ago we wrote ‘trust me, I work for the government’. It means we fear that sometimes politicians decide things that are contra productive to solve the crisis due to ignorance or some hidden agenda (like preparing for elections). In other words we need to trust that the Greek situation does not get out of control due to the fact politician’s fear very vocal populist visions in the sponsor countries (Germany, Finland, and the Netherlands). On the positive side, if one takes a helicopter view, some quarters ago the GIIPS problem was huge, threatening the EURO, and now it has been reduced to a Greek/Portuguese/Irish problem. So, the problem is getting smaller. A controlled burden sharing or some kind of voluntary debt roll over is maybe wishful thinking to organize but would decrease the problem further.
We just state that politicians, regulators and tax payers do not always act rational. This risk needs to be taken into account.

For emerging markets we have had a difficult debate. Like for many of our guests and research publishers we agree that getting the China strategy right is the most important strategic call investors have to make. This China growth miracle is muddying the cyclical and secular vision we try to establish. This is not a shame since everybody suffers from the same issue. This unprecedented experiment called China just has a huge impact but is difficult to understand. To be pragmatic as credit investors we should always remember we do not share in the upside like shareholders. To that extent we can just take a view that as we do not get paid enough (spread) we do not have to run China exposure. Already some time ago we have been reducing metal & mining exposure and are wary of concentrated China and general emerging market exposure.
We question monetary policies in emerging markets in general. While the consensus is that investors seem to be afraid EM countries keep tightening for too long, we notice still low real yields in fast growing economies. We acknowledge governments are trying to reduce unemployment, food inflation and build social housing but such low yields cause asset bubbles and speculation too.

A very interesting phenomenon is that it seems that corporates are the winners in this balance sheet adjustment. Margins are high to historic standards, low labor negotiation powers and low investment plans in the Western world are generating lots of cash. In the US we see that the overwhelming majority of GDP recovery since the trough of the economic cycle has been captured by higher profits, despite being a much smaller part of the economy than consumers.
For example the automotive industry is benefiting from EM exposure to boost margins. A lot of margin improvement comes from overseas profits. At the same time electricity use points to slow growth. E.g. Dutch industrial electricity usage is still below 2007 levels, pointing to the fact we are experiencing growth again but still at a low level. All in all this drives a conservative financial policy by CFOs, meaning further deleveraging, and maybe, just maybe, we should consider large cap blue chip companies as a safe haven and not government bonds.

Finally some notes on the banking sector. Basically we keep being surprised about the market turbulence around this sector. Despite not underperforming to industrials anymore for over a year on a risk adjusted basis, it still feels heavy. Greek losses on French banks are a profitability event at worst. Banks have been heavily recapitalized on aggregate and benefit of a reduction in provisioning levels.

The conclusion is that the fundamental picture has deteriorated a bit recently. It still fits in our slow growth balance sheet adjustment process but risks are a bit more on the downside, maybe even more politically so than economically.

Valuation

Investment grade credit is cheap by all standards. This used to be driven also by very cheap GIIPS corporates. We notice that GIIPS large cap corporates have tightened a lot to non-GIIPS credit. For us this means GIIPS credit is again less attractive. We reconsider this after some turbulence might cause GIIPS spreads to underperform non-GIIPS credit.

The recent sell off has caused spreads to back up to almost flat year to date levels. This means valuation is a getting better again. The recent sell off is comparable size to the November 2010 sell off.

At the moment the premium one gets for investing in a cyclical credit compared to a non cyclical credit is small. We will become more careful on very cyclical companies.

Another topic to discuss is the volatility in the credit market. On one hand volatility is a good thing because it enables us to generate stock pick alpha. On the other hand market sell offs are aggressive and by definition unexpected. This means for some sectors or very liquid sub sectors we want to get paid extra spread to bare that volatility. We do not expect broker dealer to increase appetite for market making considering Basel III regulations coming up.

The high yield market enjoys a continuation of very low to sometimes even zero defaults. At the moment the default rate is below 1%. We are still cautious on CCC rated debt. If the much needed GDP growth stays away for too long this rating class is vulnerable. Also, it trades at below median levels while BB rated issues trade at 1.2 times median spreads. No reason to chase yield here.

Within high yield we prefer European high yield over global high yield now. The growth outlook for the US is just more vulnerable than the European one we believe. Further, in Europe sovereign risks have been priced in and we do not believe fiscal adjustment is priced in for the US credit market.

Technicals

On a positive note we have indications that there are US and UK distressed investors looking at Spain to buy assets (and maybe even a bank). This together with a successful IPO of at least Bankia could be a nice catalyst going forward. On the negative side we know that FROB and the government have a very heavy fund raising schedule to do. We continue to believe that the correlation with the rest of Europe will become bigger and less to the other GIIP countries.

Broker trading books are still very small and brokers panic quickly. This means the above mentioned volatility is here to stay and we will try to benefit of that. It might lead to some more trading within our target beta range.

Investment grade supply is low and even negative for corporate debt. This balances the limited inflow. For high yield the opposite is true. We need to see continued inflows to match still ever big supply. This supply comes from the refinancing of the loan market of 2012 maturities.

The market will continue to react violently to surprise remarks about senior debt burden sharing at Irish banks, or politicians letting the pressure increase to panic mode before coming up with a compromise (in Europe).

Every now and then banks do not call its lower tier II or hybrids. These still are exceptions but banks have been capitalized well enough to be able to take the risk of not calling for liquidity or Basel III reasons.

Conclusions

We continue to be constructive on credit, both on Investment Grade as well as High Yield. The fundamental situation has deteriorated a bit but is basically sound from a cyclical perspective. Valuations are back to the levels where we started the quarter and technicals only weigh negatively due to political uncertainties. The credit team reduces the beta on the margin since too many uncertainties are too difficult and big to gauge its effects. The end of QE II, Chinese production numbers, a Greek restructuring and a Spanish banking situation to solve weigh negative for us. It is not offset by historic cheap spreads and a long term deleveraging scenario of the private sector. We will look for an excuse to scale back in. We target the first quarter of beta usage (max 25%) for Investment Grade and a neutral beta for High yield for now. On emerging markets we will operate a bit more careful and start this capability with a small underweight beta.

Guests

We would like to thank our guests who contributed with valuable presentations and discussions to the new quarterly outlook. The views of Stephan Dulake (JP Morgan), Marlene Puffer (Bank Credit Analyst), Gilles Moec (Deutsche Bank) and Rikkert Scholten (Robeco) have been taken into account establishing our central view.

Important information