

Credit Markets – Do you believe what they are saying?

Here are a few things that were priced into the credit markets at the end of 2008:

- **Near zero inflation for the next 10 years**
- **About 20% of investment grade debt will default over the next 3 years**
- **More than 50% of high yield debt will default over the next 3 years**

Back in the 1980's when Michael Lewis wrote about the bond dealing escapades of Salomon Brothers in *Liar's Poker*, fixed income trading floors were "affectionately" referred to as kindergarten playrooms without adult supervision. Well it's time for a Time Out.

STOP listening to the talking heads and reading the latest article comparing today to the 1930's. We will offer you another comparison you later in this note.

Let's pause and think about what the credit markets are offering up. Where can you be reasonably well compensated for the risks you take? We share a few ideas below, but first a reminder:

Don't hold too much cash

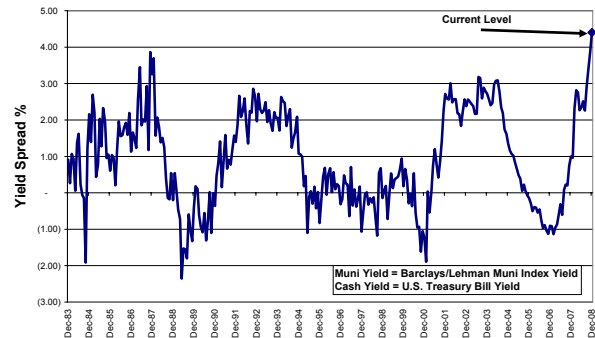
With all the depression and deflation talk in the headlines, we know way too many people who have excessive cash positions. Worse, some cash was raised after the equity and credit markets tanked in October.

Having some cash is prudent, but too much will put long-term returns and goals in jeopardy. The return on cash is essentially zero. Yes, you get your principal back, but that is it. Decide how much cash you *need*, even pad it a little, but then look at some of the opportunities out there and construct a portfolio of diversified, compensated risks.

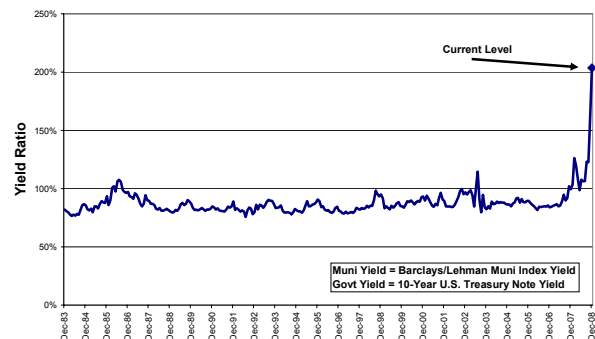
Idea # 1: Buy Muni Bonds

Municipals are a great place to stash some of that excess cash. Muni bonds are the cheapest they have been over the past 25 years, by far, when measured against cash rates or government yields.

Muni Yields over Cash
Last 25 Years



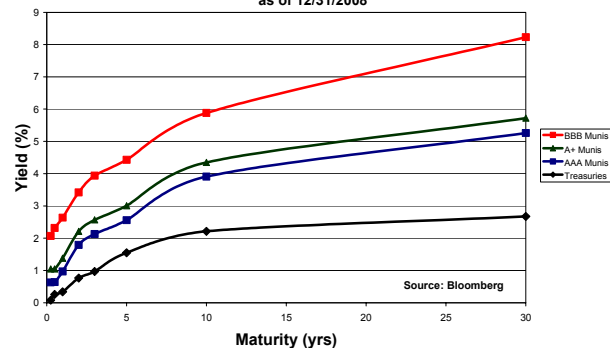
Muni Yield/Government Yield
Last 25 Years



As of year-end, munis were yielding more than twice the T-Note yield and almost 4.5% above cash. Both are 25-year highs. As you can see from the Muni/Govt yield ratio, muni yields rarely move higher than government yields. For an investor in the 33% federal tax bracket, the pre-tax equivalent yield on the Muni Index is about 6.7%.

How you express a position in munis will depend on your client risk tolerance and, to some degree their views. The chart below shows a range of choices.

Yield Curves
as of 12/31/2008



If you or your clients are most worried about deflation and default risk, longer dated AAA muni bonds are probably best. If your concern with respect to muni defaults is low, but worry that inflation may return with excessive government stimulus, then lower rated, intermediate to short dated munis would be preferred. Of course, decisions around credit quality and maturity should be made in the context of the total portfolio.

Idea #2: Buy TIPS, Sell Nominal T-Notes

We are essentially saying you should take your U.S. Treasury exposure in inflation protected real return bonds, not nominal bonds. Why?

Nominal Treasury yields are too low for the long term investor. For trader types that want to speculate on short-term moves they are a great trading vehicle. However, **for the long-term investor, 10-year T-Notes yields around 2.5% offer little but the comfort of a deflation hedge with a government guarantee. As we discuss below, you can get both the government guarantee and deflation protection by buying newly issued TIPS, plus you also get inflation protection.**

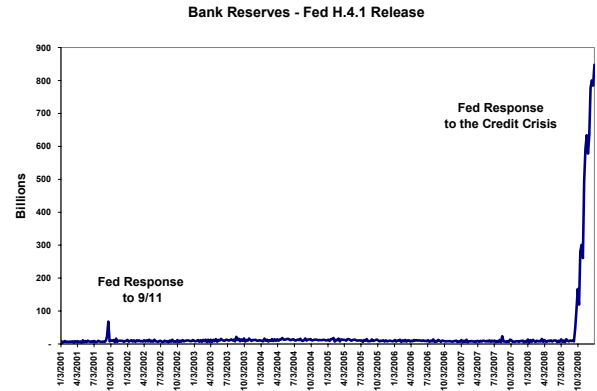
Markets rarely offer such a one-sided bet. Few people are concerned that a rise in inflation is on the near-term horizon, which is one reason TIPS present such an opportunity. While we are not worried about inflation in the short run, we like TIPS as these levels.

As of the year-end, the spread between real and nominal 10-year Treasuries was a mere 0.12%. This means the market expects inflation to average just 0.12% a year for the next decade. Even if you agree, do you want to bet on it? If so, buy 10-year Treasuries at about a 2.5% pre-tax yield and pray.

If, instead, you prefer better compensation for the risk you take, buy TIPS, especially recently issued ones. Recently, 20-year TIPS were auctioned at a 2.5% real yield. Buyers receive 2.5% a year plus inflation. The principle value rises and falls with the inflation rate, but it can never go below par. So, if you buy new issues that have no accrued inflation, you can't lose it. *You get a yield similar to nominal Treasuries plus inflation protection.*

Not concerned about inflation? Think there is no chance of inflation surprise? Remember, back in June the Fed was worried about inflation, not

deflation. Today, they are contemplating a stated inflation target to tell us a little inflation is good. In the meanwhile, the Fed is sewing the seeds of potential inflation by pulling out all the stops to grease the locked up credit markets. Since inflation is essentially a monetary phenomenon, we leave you the chart below to contemplate as we move on to the next idea.

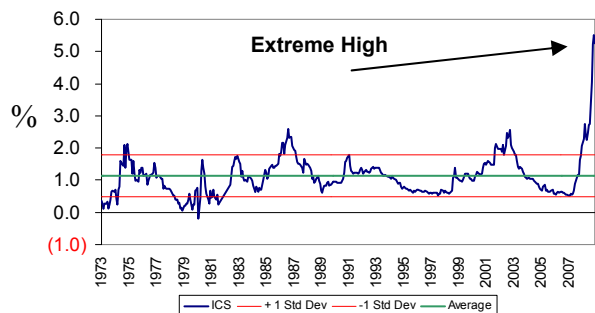


Bank reserves at the Fed drive growth in the money supply when banks lend, but they have been reluctant to do so given their weak balance sheets. In October, when reserves were less than half of current levels, Bob McTeer, Distinguished Fellow at the National Center for Policy Analysis and former president of the Federal Reserve Bank of Dallas, wrote, **“the extremely high growth is probably appropriate, and not inflationary, while credit markets remain frozen... It is something that will have to be corrected as we return to normal in credit markets, or accelerating inflation will become a serious concern.”**

Idea #3: Buy Credits, Sell T-Notes

As you can see, we are not a fan of Treasuries at current yield levels. Yields are low because of “flight to safety” of the government guarantee, and the guarantee is not so special nowadays with the government guaranteeing just about anything. Still, is it a good bet to buy “investment grade” credits in this environment? Take a look at the chart below:

Intermediate Investment Grade Credit Spreads



The chart previous shows the credit spread as the extra yield you can earn over Treasuries by holding investment grade bonds. The credit spread compensates investors for potential losses from defaults. As of year-end, the spread was 5.25%.

Assuming a recovery rate on defaulted bonds of just 30%, the current credit spread implies that 7% of investment grade debt will default each year, and more than 20% will default over the next 3 years.

From an investment perspective, if you own government bonds instead of investment grade debt now, you are betting default rates will reach or exceed severe depression levels, a worst case scenario.

Depression era statistics vary, but according to a recent *CFA Institute* presentation by James Montier, Co-Head of Global Strategy for Société Générale Cross Asset Research, the annual default rate for all grades of debt peaked at around 8.5% during the 1930's. Of course, lower grade credits were a big contributor to that peak rate. To put this peak default rate in context, during the Great Depression, GDP was cut in half and unemployment reached 25%. Unemployment today is around 7%, perhaps on its way to 10%. We are currently in a severe recession, but the market is pricing investment grade debt as if we were in a severe depression.

While the current environment raises default risk, the economy is performing well above depression era levels with a massive stimulus coming. In a well diversified portfolio, using professional credit risk managers, increased exposure to investment grade credits offers good compensation for risk.

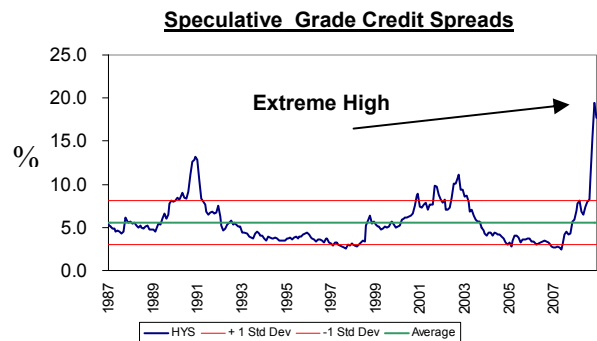
We believe that a good portion of the credit spread expansion is being driven by fear and technical conditions in the credit markets. Not only did the default of Lehman hurt many in their pocketbooks, it damaged the psyche of market participants. *The Economist* estimates that Lehman was a party to 7-10% of all trades in the credit default swaps market, a market where participants can buy and sell insurance against defaults by companies that issue debt. Those who had Lehman as a counterparty were losers when Lehman's defaulted... and if Lehman could default, who might be next? Better to just sell the bonds than buy default insurance from someone unable make good on the guarantee.

So, while the facts will reveal themselves over time, fear and unknowable counterparty risk has contributed to the sharp increase in credit spreads. To be sure, default risk has risen with the recession, but for investment grade companies, it appears spreads have move well beyond the deterioration their ability to pay.

Idea #4: Consider high yield bonds, either as an extended fixed income play using professional management, or as an equity substitute.

A high yield bond can be thought of as being long a T-Note and short a put on the value of the company. If the company goes bankrupt, you own a worthless company and have to sell the T-Note to pay for it. In today's environment, with bankruptcies expected to spike, **the equity component of speculative grade debt is dominating and correlation with equity markets is high.**

Historically, the average credit spread has been just over 1% for investment grade bonds and over 5% for speculative grade bonds. The market is pricing investment grade bonds today as if they were junk. How is the market pricing speculative debt now?



At year-end, junk credit spreads were almost 18% with implied default probabilities near 20% a year. Moody's is forecasting a 15.3% default rate for 2009. So, there is compensation for the risk based on Moody's forecast. That said, even if speculative grade companies have access to credit, the price of access may precipitate higher defaults than Moody's forecast. The yield on the Barclays/Lehman High Yield Index was nearly 20% at year-end – a high hurdle to beat with business performance. The yield on the Intermediate Credit Index was about 6.7% - a manageable hurdle rate to exceed and run a profitable business.

So, while high yield credit spreads appear somewhat attractive relative to forecast and historical default rates, high yield bonds currently behave like equity securities in fixed income clothing. The primary role of fixed income in a portfolio is to reduce risk, so if you choose to implement an increase in high yield as an extended fixed income play, think in terms of a small increase at the margin. As an equity substitute, exposures can be larger.

Whether you express a position as an extension of fixed income, or as an equity substitute, will depend on the existing allocations and needs of your clients. However, **be mentally prepared for the rise in defaults and use a professional bond manager with solid expertise.** Individuals selecting a handful bonds on their own is a recipe for loss. The next several years in the high yield market offer superior return opportunities to those well-positioned to identify and capture mispricings. This means having the ability to identify bonds with much lower probabilities of default than those implied by their yields, and the necessary scale to manage default risk through diversification. The likely road to success for the individual investor is a commingled vehicle or mutual fund using a professional manager with superior company analysis, security selection and credit risk management skills

A Depression Reprise?

At the beginning of this note we asked you to silence the stream of negative news and comparisons to the Great Depression long enough to think about what the credit markets are saying and the opportunities they are offering up. We also promised another comparison to the 1930's, so here goes.

First, we do believe that we are in most severe economic situation *since* the Great Depression. It is also a different situation than the 1930's for many reasons including the use of the gold standard, the scope of the federal government, and the initial response of policymakers. Common to both is the human element and the self-reinforcing aspects of bull and bear markets. Referencing the 1930's is a regular habit of the financial press during times of crises as shown by the "Depression Index" on [Economist.com](http://www.economist.com):

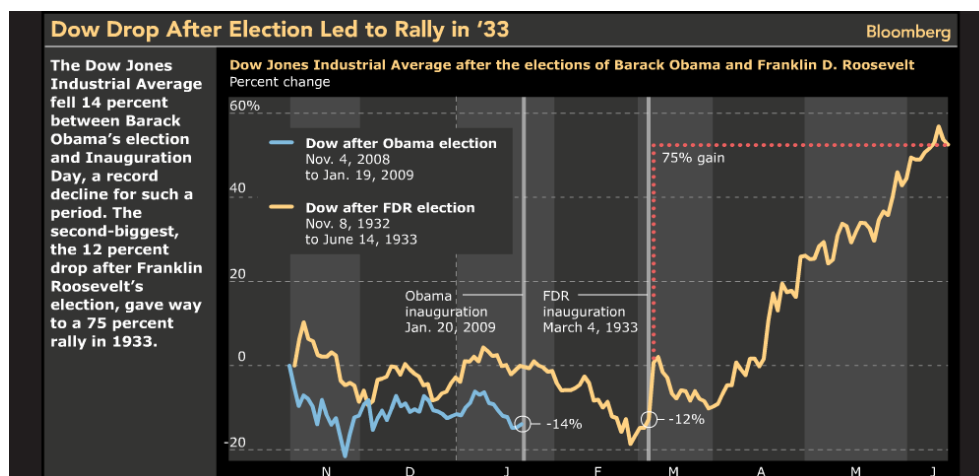
http://www.economist.com/daily/chartgallery/displaystory.cfm?story_id=12332693

"A survey of newspaper articles over the past two decades shows a sharp spike in mentions of the dreaded D-word, as commentators have started to think the worst. The prognostications may possibly turn out to be true, or perhaps the only thing we have to fear are the fears of journalists themselves." - Economist.com

Constantly drawing negative parallels tends to reinforce perceptions that things can only get worse, especially when President Obama keeps telling us so to help sell his stimulus package. So, we found it a bit refreshing for someone to find a potential positive to draw from that era.

Our thanks go to Jeff Kearns, Stocks Reporter for *Bloomberg News*, for identifying a potential positive parallel and sharing it with us. See the chart below and his story at:

<http://www.bloomberg.com/apps/news?pid=20601109&sid=aTv4IsA.Y7t8&refer=home>



Important Information and Disclosures

Sources of information for this report include The Wall Street Journal, The Economist, Bloomberg, Standard & Poor's, Moody's, Conference Board, US Department of Labor, Bureau of Economic Analysis, The Federal Reserve, Barclays/Lehman, MPI Stylus, The CFA Institute and FDX Advisors.

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