

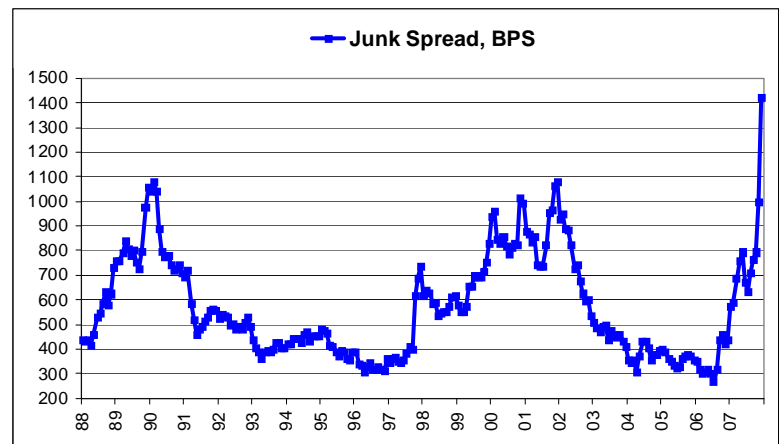
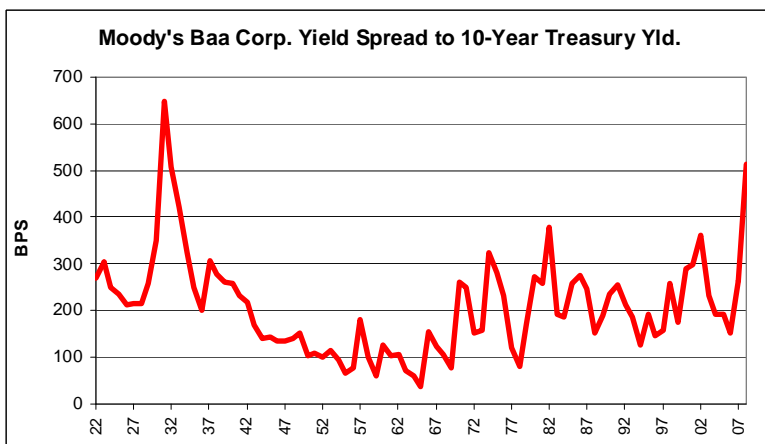
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Economics & Strategy

Tactical Call: Going Long Investment Grade & High Yield Credit

While we remain very negative on the growth outlook, we believe it has been fully priced into corporate credit markets. Investment grade bonds are now yielding more than 500 bps over Treasuries, the most since 1931. High yield spreads have risen to 1421 bps over Treasuries, the highest level ever. While we continue to believe that the unemployment rate will work its way to 8% during the next two years (which likely will trigger more defaults on credit cards, autos, commercial real estate), the widest credit spreads since 1930s seem to have priced in this eventuality -- and then some. If short-term funding market spreads continue to improve, investment grade and high yield spreads *should* come in from current levels (but probably won't return to normal until home prices get closer to a bottom, which may take several years).



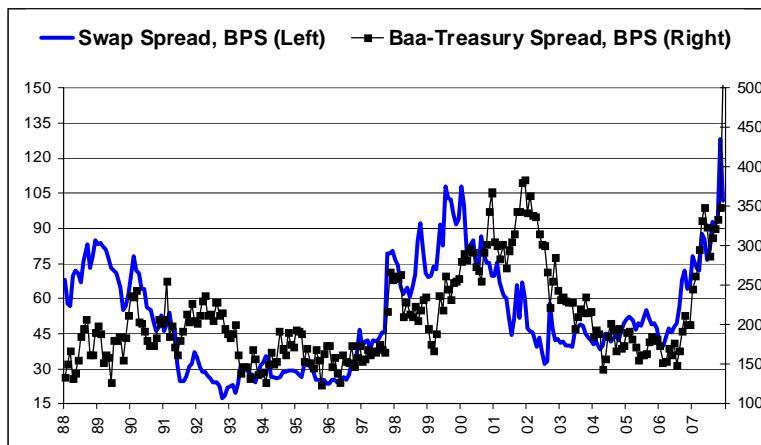
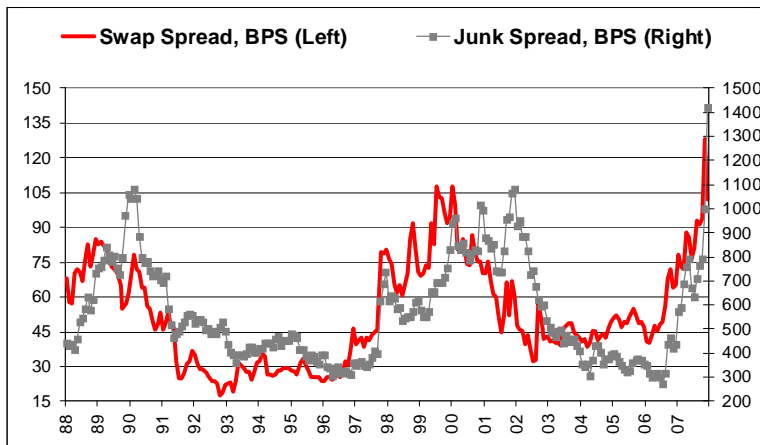
Source: Bloomberg; MKM Partners

The Fed and Treasury appear to be getting some traction -- finally. Libor, commercial paper and swap rates have all dropped relative to Treasury bill yields, a good sign. While short-term funding markets remain far from normal, change takes place *at the margin*, and the recent move down in funding rates and spreads is an important sign. Some of these markets (swaps in particular), have a highly significant, *leading* relationship to other areas of credit. As the charts below show, swap spreads tend to *lead* both high yield and investment grade credit spreads. If swap spreads can

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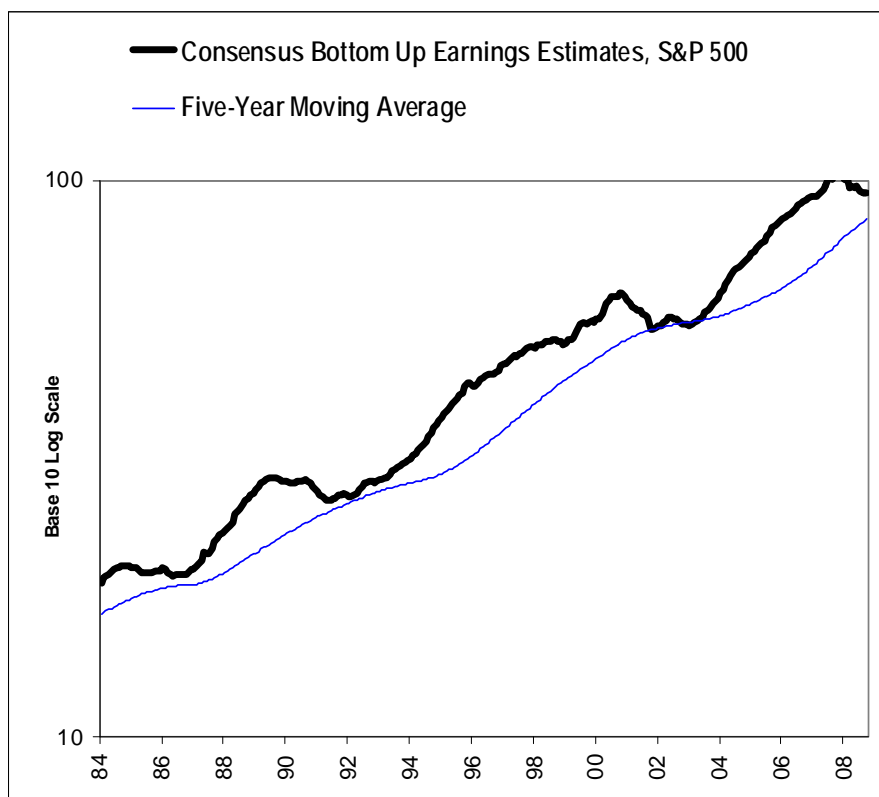
hold near 100 bps, corporate and high yield spreads should come in significantly from current levels (although they would still remain well above levels consistent with a healthy economy).



Source: Bloomberg; MKM Partners

We believe forward earnings estimates are way too high, but the stock market appears to have priced this in. As the nearby chart shows, forward earnings

estimates dropped back to their five-year moving average during the last two recessions. We believe this would be a best-case scenario in the current environment, and that forward estimates could be hacked down closer to the 10-year moving average (credit spreads widened to levels in September and October consistent with this kind of decline). The good news is that stocks appear to have priced in this eventuality.¹ In order for stocks to rise on a sustained basis, however, we're going to need to see a turn in the corporate bond market (which should begin to occur if swap and other funding spreads hold near



Source: Bloomberg; MKM Partners

¹ The 10-year moving average for estimates is \$71 compared with the \$95 consensus. Our method takes the earnings yield (based on the 10-year moving average for estimates) and compares it to its average historical ratio to Moody's Baa yields. This method shows equities to have priced in the likely damage to earnings estimates so long as corporate bond yields don't continue to rise from here.

current levels or improve further).

Conclusion: We continue to expect *at least* 6-9 more months of recession followed by a very weak recovery cycle. The good news is that this appears to be *fully* priced into corporate credit markets. Investment grade bonds are now paying more than five percentage points over Treasuries, the most since 1931. High yield securities are paying more than 14 percentage points above Treasuries, an all-time high. If the current downturn proves to be no worse than the 1930s (the Fed never doubled the size of its balance sheet during the 1930s), then investment grade and high yield credits offer a compelling risk-reward in the current environment. While we do not expect spreads (or the economy) to return to normal anytime soon, there still could be significant gains in investment grade and high yield credits from current levels if the recent improvement in short-term funding markets holds.

Credit Indicator (BPS)	October Peak	Today	Change
2YR swap sprd.	164.75	111.50	-53.25
3mth. LIBOR/OIS sprd.	3.64	2.93	-0.71
TED sprd.	4.64	3.27	-1.37
Asset backed CP sprd.	500.74	298.77	-201.97
LIBOR/OIS, 3mths. forward sprd.	1.86	0.98	-0.88

Source: Bloomberg; MKM Partners

(Equity) Investment Implications: We are assuming forward earnings estimates for the S&P 500 are about 25% too high, but the current level of equity prices appears to have taken this into account (based on a stringent earnings yield/corporate bond yield comparison). However, we will need to see the corporate bond market improve for stocks to move higher on a *sustained* basis. If our call on investment grade and high yield credit works out, the backdrop for equities would improve. However, credit spreads are not likely to return to “normal” anytime soon, so the upside in risk assets may be limited. In any event, the opportunities in credit are probably greater than in equities for the time being. Stocks typically bottom 3-6 months before the economy and we see no prospects for an economic recovery until the second half of 2009 *at the earliest*. This may set stocks up to re-test the October lows sometime early next year.

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