

Fixed Income Investor

March 2009

ECONOMIC OVERVIEW

Slip-Sliding Away

The economy continues to slide into recession. Continued job losses and the slide in factory orders and housing starts prove that the worst is not yet here. However, it is possible that the economy will find a bottom in the next six months, boosted late this year by the \$789 billion stimulus package recently agreed on by Congress.

The major problem remains the credit markets. Although there have been some encouraging signs, credit for even prime commercial bond issuers and borrowers remains relatively costly. Overall lending activity is light. Federal Reserve intervention has opened up the conventional mortgage and commercial paper markets, and highly rated bond

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MARKET OVERVIEW

With the onset of the global credit crunch eighteen months ago, fixed-income investors have been forced to become more conversant in the language of risk. And the hazards are continually evolving.

Adding an important layer of complication is the fact that the days when banks simply took in cash deposits and lent the cash out again at a mark-up are long gone. The sharp rise in the repackaging of loans such as home mortgages and then selling them off to investors has put an end to that. Now, with the recent dearth of new issuance in the mortgage bond and other structured finance markets, many lenders are holding significant volumes of loans for the first time in years, and they find themselves stuck with assets of shrinking value.

It now appears that the global credit crisis is severe, and may get much worse before it gets better. The conventional wisdom says banks have been unwilling or unable to lend due to capital constraints or a desire to avoid risk. However, that may be an oversimplification, particularly in the United States.

Consider that a credit crunch is typically defined as a period in which creditworthy borrowers can't get financing. If the United States were in a crunch like that today, observers would have seen some reduction in the overall amount of credit outstanding in the U.S. economy. But borrowing in most sectors is continuing to grow, albeit at a much slower pace than in the heyday of easy money a few short years ago.

The problem has been for companies and individuals with less-than-stellar creditworthiness. For them, borrowing has become much more difficult and expensive. These potential borrowers are having trouble finding lenders or they are being offered borrowing rates they simply can't afford. As a result, they are forced to stabilize themselves by decreasing their debt. As this trend develops, bond investors can expect to see an improvement in the average level of credit quality in the market, even as the supply of new issuance slows.

Meanwhile, worldwide corporate bond defaults continue to rise rapidly in 2009. Through mid-February, there have been 31 defaults, affecting debt worth \$49 billion. For all of 2008, 125 defaults were recorded, up from 22 in 2007 and 30 in 2006. The default rate for the 12-month period that ended January 2009, was 3.83%, up from 3.47% for the comparable period ended December 2008, and nearing the long-term average of 4.25%. Based on current trends in corporate finance and the economy, the global default rate over the next year is expected to reach near 14%, which would be the equivalent of more than 17 defaults per month. ■

Slip-Sliding Away

issuance has picked up. The Federal Reserve has taken the federal funds rate down as low as it can go, and has promised to intervene in other markets, including Treasury notes, if necessary in order to get the economy and the financial markets moving again. They will succeed, but it will take awhile.

Meanwhile, the housing market continues to decline. The Standard & Poor's/Case-Shiller home price index is now down more than 25% from its peak back in July 2006. Prices are depressed by the sales of distressed properties, which accounted for 45% of December sales. The new home market remains depressed, as new home sales and housing starts both dropped to record lows. Builders have cut back by three-fourths, producing an annual rate of 550,000 new housing starts in December 2008 compared with the peak rate of 2.1 million starts in 2005.

Little recovery is likely in 2009. The still-high inventory of unsold homes will keep downward pressure on home prices, so prices are expected to continue to decline — perhaps another 12% by early 2010, which would bring home prices to their lowest level relative to income in history.

Investment is not likely to accelerate in the near future, even with tax incentives likely to be included in the stimulus bill. Production is far below capacity. Last year's investment incentives, which accounted for one third of the tax cuts in the 2008 stimulus package, had no apparent impact on business equipment spending, which plunged 27.8% in the fourth quarter.

The Federal Reserve is expected to hold the federal funds rate at its current near-zero level for some time, but to expand its purchases of other assets in an attempt to bring targeted rates down further. The Fed has been reasonably successful in restoring the commercial paper market and bringing mortgage rates down. Next on their agenda is to try the same actions for other classes of lending, including student and car loans. ■

Yields in the Treasury market have rebounded from the unprecedented lows of late January, but still appear paltry by long-term standards. The increase in market yields caused the market values of existing bonds to decline proportionately.



Long-term Treasury yields were hovering below 3% in the last week of February, well below the long-term average posted in the previous decade, which was 4.6% for the 10-year benchmark bond. The yield on the three-month Treasury note was about one quarter of 1%. The spread between fixed-rate and inflation-protected Treasuries remained small, suggesting that the Treasury market sees little likelihood of significant inflation in the near future. Assuming that assessment is correct, the Federal Reserve is likely to try keeping yields at their current levels through at least mid-2010. Also limiting upward pressure in the U.S. Treasury market is the trend toward declining rates in other major markets. The Bank of England cut its rate to a historical low of 1.0% on February 5. The European Central Bank voted to hold its key rate steady in February but officials did suggest they could reduce the rate in the coming months. The Bank of Japan policy board cut its key rate by two-thirds, to 0.10%, on December 12. And the Bank of Canada cut its benchmark by one-third to 1.5% on December 9. As long as major countries keep their benchmark rates low, markets will have little competitive pressure to attract investors by boosting market yields. ■

AGENCY AND MORTGAGE-BACKED SECURITIES

Pressure continues on mortgage-backed securities. The repayment prospects for many types of mortgage bonds are poorer now than they were in the waning months of 2008.

The latest signs of quality decline come in the prime jumbo and Alt-A sectors of the mortgage bond market. Jumbo prime loans are loans made for amounts greater than Fannie Mae or Freddie Mac can accept for repackaging, but whose borrowers otherwise meet the same high credit standards. The latest analysis of loan losses caused by the decline in underlying property values suggests that write-offs on some recent bonds in the jumbo loan sector are now edging close to 5% on average. Even harder hit are loans in the Alt-A sector. These are loans whose borrowers are not-quite-prime quality. Losses on recent bonds in this sector now average as much

as 20%. Note that in both situations, the hardest hit issues are the most recent. Those are the loans written against the highest average property values and thus the loans most likely to turn upside down in the face of real estate price declines.

Meanwhile, the mounting pace of property loan losses may soon threaten the ratings of mortgage insurers. Although no firm is threatened with insolvency, one or more could be downgraded as its operating capital is depleted by claims. An insurer downgrade could cause a surge of ripple-effect downgrades in mortgage bond issues. ■



The ongoing turbulence in financial services is impacting a wide range of banks' income-focused securities, not just the most visible bonds and notes.

The latest class of bank securities to be subject to across-the-board rating revision is hybrid capital securities. This is a broad category that can include convertible bonds and preferred shares — investments that are readily available to retail investors seeking bond-like income-producing potential. In this case, the specific subject of action is the various forms of so-called preferred stock. These investments are typically treated as a form of equity on bank balance sheets but they tend to operate like bonds in an investor's portfolio and are subject to bond-like credit analysis for investors.

Preferred stock dividends typically represent significant cash flows to investors, like bonds. That is why analysts use bond rating tools and techniques to judge whether a dividend level is sustainable. However, keep in mind that a preferred issue may carry a stated dividend rate but the issuer generally has the right to defer these dividend payments indefinitely. Sometimes issuers even have the right to reduce the dividend rate unilaterally. Typically, the primary advantage for preferred share cash flows is that they must be paid in full before common shareholders can receive any dividends. This is taken into account by the ratings assigned to the preferred shares.



In the case of major banks, a recent analysis has found widespread loss of the financial ability to sustain preferred dividend payments at their current levels. Here are some of the more noteworthy actions (as you review the list, keep in mind that this downgrade does not directly impact any other bank-related credit assessments). The following were reduced at least one notch, but their hybrid securities remain investment grade: American Express Co., Bank of America Corp., Bank of New York Mellon Corp., PNC Financial Services Group, and Wells Fargo & Co. The following hybrid issuers were reduced to speculative grade: BancorpSouth Inc., Capital One Financial Corp., and KeyCorp. ■

MUNICIPAL BONDS

While the steady long-term decline in cigarette consumption may be a favorable development from a public health perspective, any acceleration of that decline could have adverse consequences for municipal bonds financed by the tobacco master settlement agreement. The new federal cigarette excise tax threatens to do so.

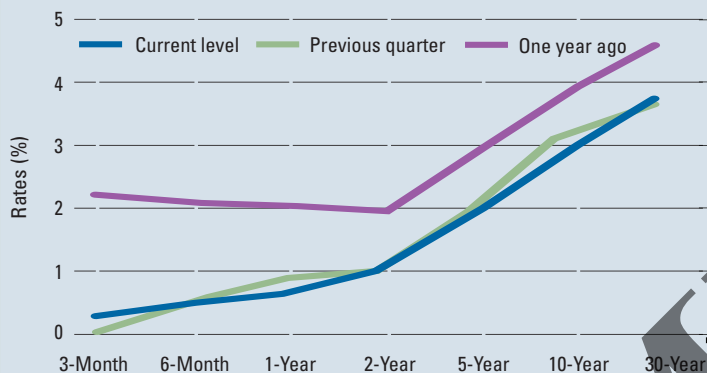
Tobacco settlement bonds were issued by the city, state, and regional entities that shared in the bounty of a successful class-action lawsuit against cigarette manufacturers. The bonds are financed by tobacco industry profits to be earned in the coming years. They were initially valued based on the assumption that cigarette sales would decline by a small amount per year with a concurrent decline in tobacco earnings. Thus, any acceleration in the rate of decline has the potential to undercut the revenue stream that supports the bonds.

Recently, Congress voted to raise the federal excise tax on each pack of cigarettes sold in the United States to \$1.01 from 39 cents. Historically, noticeable retail cigarette tax increases have been associated with declines in cigarette sales volume. For example, the federal excise tax on a pack of cigarettes jumped to 39 cents from 24 cents between 2000 and 2002. Cigarette sales declined 5.65% during that period. Economists estimate that a 10% increase in the price of a pack of cigarettes reduces demand between 3% and 5%. If that relationship bears out, the new tax could further reduce demand by more than 5% in the coming years, more than doubling the previously assumed decline. What is more, given the added pressure of the economic slowdown, remaining demand is likely to shift to lower-priced products, and many of those are manufactured by companies that do not participate in the tobacco settlement. That means that the pool of funds supporting the settlement bonds is likely to shrink even faster than the market, increasing financial stress on all bonds in the sector. ■





Yield curve of U.S. Treasury issues, with historical comparisons to three months earlier and previous year, as of February 20, 2009



Source: Standard & Poor's.

	Current level	Change from previous quarter	Change from previous year
3-Month	0.30%	0.27%	-1.90%
6-Month	0.51%	-0.01%	-1.59%
1-Year	0.67%	-0.20%	-1.38%
2-Year	1.01%	0.01%	-0.97%
5-Year	1.89%	-0.05%	-0.91%
10-Year	2.85%	-0.25%	-0.92%
30-Year	3.68%	0.04%	-0.86%

Selected S&P Upgrade and Downgrade Notices

Issuer	New Rating	Old Rating
Nissan Motor Co, Ltd	BBB	BBB+
Toyota Motor Corp.	AA+	AAA
Weyerhaeuser Co.	BBB-	BBB
Amazon.com	BBB	BB+
Questar Gas Co.	BBB+	A-
Kansas City Power & Light	BBB+	BBB
CA Inc.	BBB	BB+
TRW Automotive Inc.	B+	BB
Puerto Rico Port Authority Airport Revenue Bonds	BBB-	A-
Kent County (MI) International Airport	BBB+	A-
Fashion Institute of Technology (NY)	AA-	A+
Scotts Valley Water District (CA)	A+	BBB+
Warner Chilcott Corp.	BB-	B+
Allbritton Communications Co.	B-	B
San Luis Obispo (CA)	AA-	AA-

Selected Bond Fund Performance Benchmarks: Total return for periods ended January 31, 2009

	1-year	3-year annualized	5-year annualized	10-year annualized
General Intermediate Bond Funds	-6.56%	0.83%	1.50%	3.86%
High-Yield Bond Funds	-20.91%	-5.63%	-1.34%	1.40%
Mortgage-Backed Securities Funds	0.25%	3.73%	3.27%	4.53%
Investment-Grade Long-Term Municipal Bond Funds	-8.45%	-0.94%	0.91%	2.65%

Fund reference data provided by Morningstar®.

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