November
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Monthly Investment Commentary

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Stocks lost ground in October, with the large-cap Vanguard 500 Index Fund (which replicates the S&P 500) falling 1.9%. For the year to date, that benchmark is still up just over 17%. In terms of market cap, the small-cap iShares Russell 2000 lost 6.8% in the month. Mid caps were down 4.4% for the month, but are up 26.7% for the year to date. Foreign stocks also lost ground in October, with the Vanguard Total International Stock Index Fund falling 2.2%, but remain well ahead of U.S. equities for the year to date. Emerging-markets equities (based on Vanguard Emerging Market Stock Index Fund) fared slightly better, losing 1.4% in October, though their year-to-date return remains north of 60%. Turning to fixed income, the intermediate-term, investment-grade Vanguard Total Bond Market Index Fund was up 0.4% for the month and is now up 6.3% so far in 2009. High-yield bonds, as measured by the Merrill Lynch U.S. High Yield Cash Pay index, returned 1.7% for the month and have surged by more than 50% so far this year.

What's Next for High-Yield?
An Interview with High-Yield Expert Christopher Garman

Given the huge gain in high-yield this year, we thought it would be appropriate to share the view of a leading high-yield expert on what's next for the high-yield market. One of our research providers, Litman/Gregory, recently conducted an interview with Christopher Garman and is allowing us to share their findings with our readers. Christopher Garman was a managing director at Merrill Lynch and headed the global high-yield strategy research group for six years before starting his own research firm, Garman Research, LLC. Garman Research is the publisher of Leverage World, a weekly publication dedicated to high-yield markets. Prior positions at Merrill Lynch included European credit strategist, and coverage of the U.S. leveraged loan sector. Garman has authored and coauthored contributions to the Financial Analysts Journal, Journal of Portfolio Management, Bondweek, and Credit Magazine, as well as several chapters in High Yield Bonds (McGraw-Hill, 1999). His published work also includes contributions to the Journal of International Affairs.

With high-yield up 50% year-to-date, we have to talk about valuation. Based on spreads, high-yield bonds are far less attractive than they were at the peak earlier in this cycle. At the same time, the economy still faces serious challenges like high unemployment, a stressed consumer, etc. What's your take on valuation?

Spreads are more or less in the zone that you'd expect for coming out of an economic slump as we've had. We're in that 700 to 750 basis points (bps) spread zone. This is what we call "stall speed" for high-yield. Spreads of 750 bps tend to be a holding area in which you can see high-yield bump around, both on the down leg of the cycle and during the recovery. In other words, there's the first initial sell-off and the default rate acceleration. Spreads tend to

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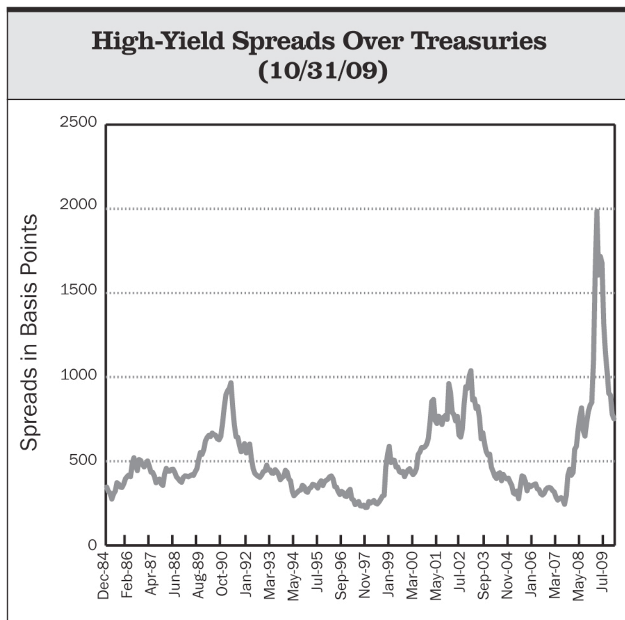

High-yield spreads this cycle were twice the level reached in prior credit bear markets.

widen out toward 750 or 800 or 850 bps, on average. You then typically see a secondary blow-off in which spreads widen out quite considerably toward 1,000 bps. That's when investors tend to really begin to panic about the long-run prospects for low-grade or low-quality bonds. Every single cycle, there's commentary about the boom-and-bust of the speculative-grade, and questions of whether the asset class will come back. The asset class does come back, and it's been a pretty ferocious comeback this cycle. We had spreads again initially widen out toward the 800 bps zone. Then with Lehman and all the fallout from the real estate market, spreads widened out toward 2,000 bps. We've just had a phenomenal comeback from those levels. We're again right back to where we started in this holding zone.

So where do we go from here?

We expect spreads to continue to narrow. Even assuming GDP growth is slower than earlier rebounds, I think what that means for the speculative-grade bond market is a period of prolonged balance sheet repair for the corporate sector. Imagine, all of a sudden, companies are faced [with] a huge shock: drying up of economic growth. Most companies' balance sheets are not well set-up for that. That's when you see the default wave arrive. Typically that is preceded by a pretty exuberant period of high leverage entering into the corporate space. Right now, I think we're well past that initial shock. The companies that were most able to make the necessary balance sheet adjustments and cut cost have done so. We're setting up really for a bit of an economic rebound. But, again, if that rebound comes in slower than expected, it really means companies are going to take a longer time to come back and start hiring. It increases the probability that you have a longer period of "jobless recovery"—not that you're looking at a sudden and expensive new default wave ahead.

So you're saying high-yield returns could be decent from here?

I think that high-yield is likely to generate returns somewhere on the order of 7% over the next 12 months. That really comes down to a default rate outlook for the next 12 months of somewhere around 5%, and recoveries gravitating back toward their long-term average of around $0.40 on the dollar.

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So even if we have a muted economic recovery, you think it's prudent to reach for yield in the higher-levered credits? What's the risk that many of the CCC-rated credits currently trading in that $0.70 or $0.80 price range—even after the recent strong rally—will ultimately default as they may still need strong economic growth to allow them to grow into their capital structures?

It's pretty consistent through the cycle. Distressed issues—about one-third of them—go on to default. What really varies is the number of distressed issues. What's kind of intriguing about this is that liquidity and the availability of capital seems to drive the bulk of these default waves. There's been a sizeable move into corporate bonds from individuals, from insurance companies, from households. Corporate debt has really benefited from this. This suggests to us that there's going to be enough capital so that companies are able to roll over their debt.

Triple-C bonds and distressed issues have had a phenomenal run. It's so phenomenal it's slightly unsettling. A lot of these companies remain somewhat challenged from an operational standpoint. It's difficult to see where a growth boom is going to emerge from. So, yes, a lot of the triple-Cs are not the value any more in corporate credit. We look much more closely at your traditional run-of-the-mill single-B issuers, at this point, as providing the best combination of potential capital appreciation and of better spread right now. Also, the somewhat lower quality of single-Bs also would defend against any sudden upsurge in interest rates. It's interesting to see that stretching for high quality may also be a bit of a danger going forward if interest rates rise. We've seen the price of gold break out of its range, and trade upwards of $1,000 an ounce. We've seen oil prices spike higher as well. We have not yet seen a similar upsurge in Treasury yields. The whole purpose to monetary policy, in some ways, is to herd investors out of the risk-free assets and into instruments with higher credit risk. I think that trend continues. I think it continues all the way down into equity.

Equity is very undervalued, compared to the broad corporate bond market, at present. If you presume that these companies are money-good and able to cover interest payments, and really, with the default rates decelerating, that's perfectly reasonable to expect that equity ultimately follows the high-yield market higher and is next in line to benefit.

Even looking at the strong performance in small caps and in equities, in general, we're nowhere near yet the levels that corporate bonds are now trading. Typically, small-cap equity and high-yield bond returns match one another over the cycle. Right now, high-yield returns have vastly exceeded Russell 2000 performance. Typically, what happens is that you see a catch-up trade where small caps outperform. In other words, equity stands to benefit, going forward. This will be a second life, I think, to the speculative-grade bond market.

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What could disrupt this cycle?

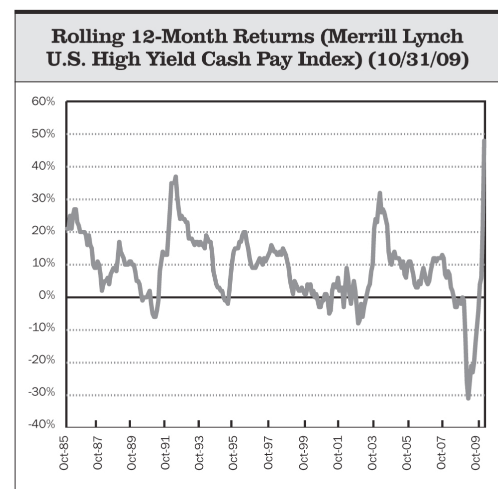
The biggest threat at this point in the cycle is really Fed tightening, or a dry-up of liquidity one way or the other. This could happen from a number of sources. We could uncover more troubles among the financials, for instance. That could lead to a risk pullback. But I think the biggest threat [relates to the question of] how does the Fed begin to exit its quantitative easing, and how damaging will this be for the bid for risk? At the end of the day, it's our belief that the monetary authorities will print as many dollars as needed to keep the default rates really on a downward trajectory.

Sticking with defaults, Moody's and J.P. Morgan are forecasting defaults to rise modestly over the next few months before falling to 4% this time next year. Actually, J.P. Morgan is calling for 4% in calendar year 2010. It seems like you think these forecasts are pretty realistic.

Back in December of 2008, we started to look at the landscape and said that, in effect, Armageddon was off the table. Monetary authorities were opening up the floodgates of liquidity. This traditionally takes a while to hit the marketplace as monetary policy works with a lag. So far, we've really only been enjoying a lot of easing that took place up until Lehman. There were pretty extraordinary measures that were instituted after the Lehman bankruptcy that have yet to be felt with full force. In other words, this will continue to drive defaults lower into 2010. We are looking at more of a 5% default rate for the next 12 months, likely nudging against 4% by the end of 2010.

How do you arrive at your 5% default rate estimate?

When it comes down to default rates, you have to look at multiple sources: both what the real economy is doing and the availability of capital in the secondary market. Also, we look at the leverage profile for the broad corporate market. Liquidity and the level of distress points [to a] 5% default-rate zone, as does corporate leverage. Going into this cycle, there were serious pockets of over-leverage in the corporate sphere. In those areas I've seen the worst fallout in credit markets and the highest default rates. When you look at the broad corporate market, we find that most companies did not, in fact, lever up very aggressively going into this downturn. And leveraged metrics never hit the highs of earlier cycles. So if anything, corporations [have some] of the best balance sheets in a pretty rough neighborhood. Consumer balance sheets are stretched. Financials are obviously still on life support. Even municipal and state balance sheets are not looking very healthy. But the corporate sector has actually deleveraged fairly effectively. This begins to also place us right into that 5% default-rate zone.



High-yield is up nearly 50% over the past 12 months.

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The capital markets have opened meaningfully to high-yield issuers over the past six months, and we've seen an abundance of new issuance, the clear majority of which has gone toward refinancing existing maturities. Now, the amount of debt (bonds plus loans) needing to be refinanced in 2010 and 2011 is at what seems to be very manageable levels. How strong of a connection is there between the amount of debt needing to be refinanced and default rates?

I haven't seen that close of a connection between the sheer volume of debt needing to be refinanced and default rates. But, there being a sizable number of maturities doesn't seem to power the default rate, per se. Let me put it this way. The primary market—the ability to get deals done—is really predicated on where the secondary market trades. In other words, investors have a choice in front of them. They can either buy new issue or they can go to the secondary market and pick up paper that way. So again, it's difficult, in our view, to simply state that default rates are coming down because the new issue market is opening.

So what drives lower defaults?

Defaults come down because the cost of being out of risk is too high, in effect. When cash is yielding negative in real terms and corporate credit is offering 800 bps, that's a very sizable spread. It forces investors out into risk. That is what leads to the primary market opening. Looking ahead two years, the real question is going to be, "Is there going to be a large Treasury spike, or is inflation going to really begin to rear its head?" That will be the determining factor of whether these companies are going to be able to adequately roll over their debt. Even then, we are past the initial shock. Companies, when faced with rising rates and potentially rising inflation, will have time to either adjust their balance sheets and/or find alternate ways of getting hold of capital to push off maturities. Companies can do a lot, as long as at the end of the day, capital is not spooked away from fixed income.

With the capital markets open for business, the availability in debtor-in-possession (DIP) financing is clearly no longer as big a concern for defaulting companies as it was earlier this year.

Yes. The distressed market has had a phenomenal run. There's a lot of cash willing to take a long, hard look at distressed companies. DIP financing is really part-and-parcel of that. As the economy stabilizes, these workouts should become more and more straightforward and more and more capital should become available for these issuers.

One major source of potential corporate actions, going forward, will be mergers and acquisitions (M&A). At the moment, the financing window in high-yield has opened up quite considerably, mainly in bonds. This will enable issuers to roll over debt. But there is a dividing line between companies that obviously deserve to live and those that deserve to have the plug pulled. Issuers that run into liquidity problems may, in fact, be M&A candidates as well because of today's relatively low equity valuation. It's intriguing, what's happening right now—this schism between corporate credit and equity markets. We cannot wholly rule out

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the possibility for very low yields in corporate credit, at present. If you take today's Treasury yields, nominally, Treasury yields should shift higher; somewhere on the order of maybe 3% on the five-year Treasury. You then begin to tack on the traditional long-run spread to Treasury; that's somewhere like 450 bps. You're looking at a potential, at least, for very low yields in the high-yield space.

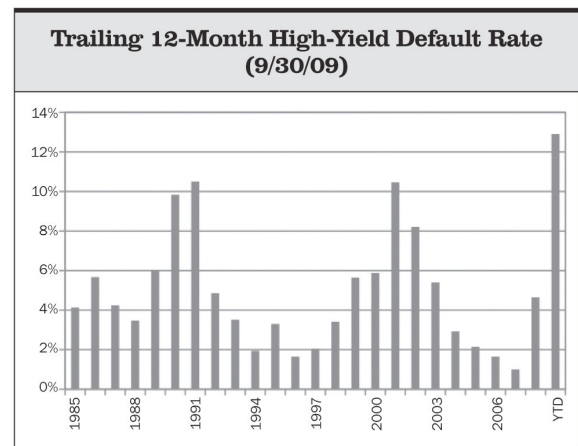
This actually would fall right in line with how the speculative-grade bond market has recovered, coming out of earlier recessions. Every cycle, we see companies emerge with lower and lower yields. That would actually begin to open up the door, in our view, for a re-leveraging, if anything. The fact that cash has not been moving as aggressively into equity as it has into corporate credit will—at some point, I think over the next two years—begin to encourage companies to simply lever up again. To issue debt and buy back equity; engage in M&A. And potentially you could even see the rebirth of LBOs [leveraged buy-outs].

Earlier you mentioned that you expect recoveries to move back up to the average rate of 40%. It seems like estimating recoveries is more art than science, how do you get there?

At the end of the day, there's a tight relationship between defaults and recoveries. If you have a 12% or 13% default rate, then you tend to see lower recoveries—all the way from your most-senior to your most-subordinated bonds. Recoveries, on average, sort out somewhere between $0.25 and $0.30 on the dollar during periods of high default rates. So this drop-off we've seen in recoveries fits hand-in-glove with the default rates we've been seeing lately. When default rates decline, you also see recoveries go up.

Let's move to return expectations. Can you talk about your bull case, and what type of returns you might see there?

The bull case is that in effect, the economy doesn't show a whole lot of volatility and that inflation remains muted. Employment only picks up very slowly and the Fed remains on hold. The Fed on hold is like manna from heaven for corporate bond investors. That is the sweet spot of the cycle in which corporate bonds outperform all other periods. Corporate bonds tend to underperform a bit, at least in total-return terms, when the Fed is tightening. They also tend to underperform whenever the Fed is easing. It's that sort of steady state in which the Fed really continues to pump liquidity into the economy and get employment rolling. That is the bull case for speculative-grade bonds.



Consensus default estimates for next year are as low as 4%.

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That implies price will run from today's $0.92 on the dollar to about $1.02 on the dollar, so 10% price appreciation?

Yes, and that zone in which high-yield is trading at a premium tends to be, at least historically, the area when the Fed begins to tighten rate policy. Only during one instance, in about 1999, have you seen the Fed tighten policy when high-yield was still trading at a discount. All other periods, high-yield traded up, and then the Fed steps in and begins to pull back some of that liquidity. If monetary policy continues to pump away up until that $1.02 price, then we're definitely looking at a bull environment for high-yield.

When you add the coupon to the price appreciation, you're looking at a mid- to upper-teens bull-case scenario.

It's certainly a possibility, but I would spread that out over two years. But given how fast the market has been moving, you can't rule something like that out over the more intermediate term. As a side note, I'll throw in that employment tends to lag spreads, so we don't think the employment backdrop will get much worse. You tend to see employment turn positive when spreads break below 600 bps. So we're not really looking for a traditional economic expansion until we see more spread tightening. And even then, this continues to hold out the possibility that employment will continue to be sluggish, and spreads would have the opportunity to narrow considerably before the Fed pulls back on the reins.

What's the scenario for your bear case?

Well, the bear case is twofold. It centers around the extremes of deflation or inflation. It may come to pass that the U.S. consumer is so bent on bringing down debt, and the Treasury and Federal Reserve don't keep up the accommodative monetary conditions. In other words, suddenly the Fed and Treasury begin to pull back too soon. That's a potential scenario for the bear case.

The other is that we see inflation much earlier than I think investors may realize. Again, the Fed would have to yank back policy sooner—and harder—than investors anticipate. One of the wild cards, I think, in these scenarios, is really how does corporate America utilize this cheap cost of capital? Hiring, obviously, would be the best outcome from a policy perspective. Companies may simply begin to just return to the status quo circa 2005 to 2007 to start adding leverage, and LBOs may begin to make an appearance again. I think that might easily happen. There's a real demand for new issuance right now.

If corporations begin to lever up, you could actually see the Fed begin to tighten policy earlier, in advance of the long-anticipated recovery in employment. This is not particularly likely. Traditionally, the Fed will continue to let liquidity conditions rip until employment begins to pick up again.

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But from a risk-management standpoint, part of the reason why we've seen the recovery that we've enjoyed so far is that the corporate sector did not overburden itself with debt going into this downturn. If the LBO phenomena had continued for another year or two, I think we would've had a lot more difficulty shrugging off the Armageddon scenario.

Financial engineering in LBOs could be a source of the Fed's pulling back liquidity conditions a little bit earlier than anticipated. The results of that could be twofold. On one hand, this could be the [right] long-term approach to correct for an overly cheap cost of capital. But on the other hand, it could snuff out a recovery. So this is nothing new to monetary policy, but I think that the monetary authorities will be increasingly on the horns of a dilemma over the next year as default rates come down. If hiring does not begin to pick up, then we could see an increased probability of a double-dip [recession].

So in that type of scenario, where do spreads go? Do they go back to over 1,000? And what does that mean for defaults?

[Spreads going above 1,000] would be pretty well the benchmark for a double-dip. The surviving companies that would be impacted by a secondary economic slump would be the more robust issuers. Issuers that have survived the last 12 months will have had a longer time frame to repair their balance sheets. They will have gotten their cost structures more in line. I would not expect a repeat of 12% default rates. Our sense is that the companies left standing would be stronger and better equipped to deal with another downturn. But also issuers will have had more capital with which to work, and avoid default at the end of the day. The real issue is, I think, monetary. How sharply the Fed pulls back on the reins. In our view, that will drive the possibility for a double-dip and another bearish market. But you can see spreads widen out for a while, given a secondary economic slump.

Thank you for your time.

- CB&T Investment Team 11/2009

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