

INVESTMENT UPDATE

Just what is going on in the bond market, anyway?

As the late Hunter Thompson might've said, "bad craziness." We've seen massive underperformance in high quality bonds, relative to Treasuries, over the past year. We are now witnessing yield spreads (the incremental yields above Treasuries) on high-grade corporate (as well as mortgage and US Agency) bonds at levels not seen in the last

twenty-five years. This time period covers the S&L meltdown, the failure of Drexel Burnham and the junk bond market, the collapse of the commercial real estate market, the dot-com bust and the WorldCom/Enron/Global Crossing *et al.* blow-ups earlier in this decade. That's not just a catalog of financial crises; it's the Encyclopedia Britannica.

Now, take a look at the top chart on this page—it shows, in aggregate, the ability of nonfinancial US companies to pay their interest expense out of cash flow (the so-called "interest coverage ratio"), going back to 1980. As you can see, while this measure may have dipped a bit over the past year or two, companies have rarely been in a stronger financial position to cover their debt payments from their operating cash flow. Today's interest coverage ratio of 5.5 times cash flow is roughly twice what it was in the dark days of 2001's credit trough.

While it may be tempting to write this ratio off as an aberration, or attributable solely to the low interest rates companies are paying relative to the 80's and early 90's, that would be a mistake. Corporations have, in general, done a very good job over the past few years of strengthening and streamlining their operations, build-

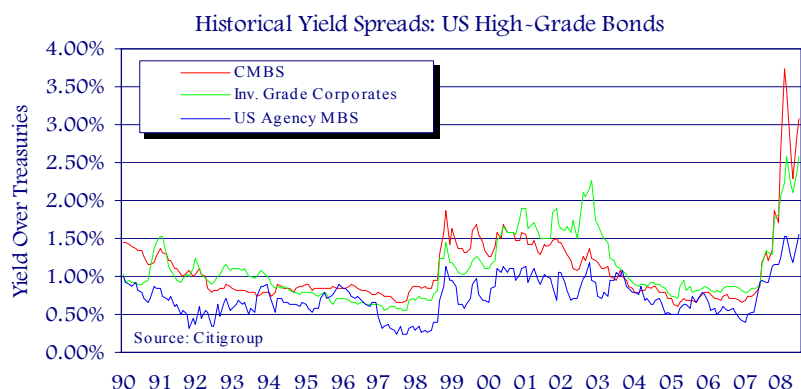
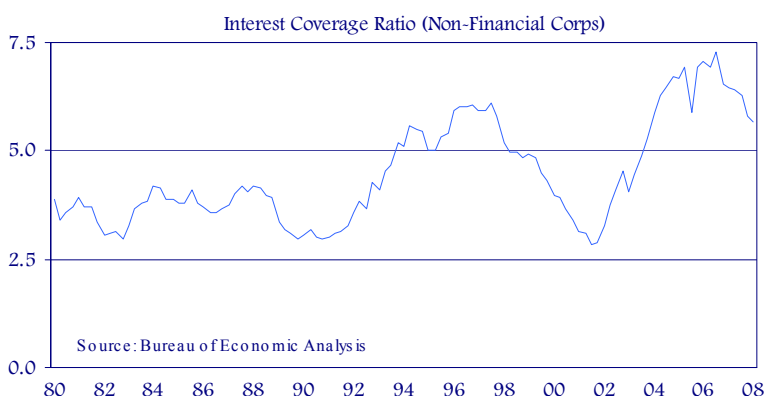
ing up equity, selling unprofitable lines, and running "lean and mean." So much so, in fact, that the economic expansion of this decade was known early on as "the jobless recovery."

As we've mentioned before, what's going on out there in the credit markets has very little to do with the fundamental ability of companies to meet their debt obligations.

Using conventional measures of corporate health, we would expect yield spreads on high-quality companies to be closer to their tightest levels than their widest. Just how wide is "wide?" As the bottom chart shows, over the past eighteen months, the yield spread of the average investment-grade corporate bond has more than tripled, from 80 basis points (0.80%) more than Treasuries to 260!

Of course, the pain goes way beyond just the corporate sector, as essentially every non-Treasury security in the US bond market is trading at or near record levels of incremental yield. As the second chart demonstrates, commercial mortgage-backed securities (CMBS) yield in excess of 300 basis points over Treasuries (down from 375 earlier in the year) and even US Agency-backed MBS offer yields (fully adjusted for prepayment risk) at 1.5% more than Treasuries.

Clearly, something big is at work to warrant these historic valuations; that something is the US housing market. While it could be argued that every bit of bad news in the housing market has been known for months, the effects, both direct and indirect, continue to crush both the operational side of the capital markets and the ever-important emotional component of investor behavior. Let's look at both—the numbers and the sentiment.



On August 12th, after UBS announced their latest write-down for bad mortgage loans (to the tune of \$5.1 billion), Bloomberg announced that a threshold had been reached: One-half trillion dollars. That's the total losses to investment and commercial banks, worldwide, from the popping of the US housing bubble. That \$500 billion has ravaged the institutions that were set up to fund and distribute the loans created in the US housing market, as well as maintain orderly markets for corporate and other high quality bonds. In the wake of these losses (and, incidentally, the writedowns are still coming, and could total another \$200 billion before it's all over) even Fannie Mae and Freddie Mac, the quasi-governmental institutions charged with providing liquidity for mortgage lenders and borrowers alike, may have used up all their accumulated capital; they are, for the time being, unable to provide any real support to the mortgage market.

At its most basic, the problems in the US housing market boil down to two numbers: the amount by which home prices may fall, and the degree of leverage that was used to buy these homes. A simplistic calculation reveals that if a home buyer takes out a 90% loan, the lender can only withstand a 10% decline in the market value of that home before the equity is wiped out; once the equity is gone, the lender is on the hook for any additional losses.

As we are all now painfully aware, loans were made under the fallacy that already-inflated home prices couldn't go down. Worse, many of these loans were extended to non-creditworthy borrowers, using "creative" mortgage products with lax (or worse) underwriting standards. These factors together fed on each other, escalating prices to bubble-like proportions, ensuring that the pain would be even more severe on the day of reckoning.

Every speculative bubble ends badly, from 17th century tulip bulbs to cash flow-less Internet stocks, and housing prices are no different. The S&P/Case-Shiller National Index shows that US single-family homes prices are now falling at a 14% rate (see chart on this page), after rising at or near double-digit annual rates from 2000 to 2006.

Falling home prices are at the root of most of our current problems, and unfortunately aren't likely to turn around any time soon, judging by the continued imbalance between the supply and demand for housing. The only

good news on this front is that inventories of new homes are beginning to fall (currently at 10 months, down from a record 11.2 months in March), as home-builders have drawn their operations to a crawl. Any absorption of supply should at least help slow the rate of decline in home prices; that's about as good as we can hope for right now.

With peak-to-trough US home prices likely headed for a 20% "correction," even more writedowns are expected from the financial institutions and other holders of these loans who use leverage to buy them. Traditional money managers who don't utilize borrowed funds and who own Government-backed bonds or otherwise well-protected mortgage securities (e.g., senior classes in issues tranching out in senior/subordinated

structures) can withstand the volatility and will end up "money good," getting their principal and interest back in whole and on time. Nevertheless, the severity of the losses elsewhere in the capital markets has created a dark cloud of doubt over every participant. There are those who even doubt the Federal Government's resolve

in dealing with the lack of liquidity—how else to explain the doubling of risk/yield premiums on GNMA's, mortgage securities that have always had the full backing of the US Treasury?

It is precisely this psychological miasma that makes our job most difficult. All the analytical tools in the world can't reliably predict human emotion, making it nearly impossible to predict exactly when things might begin to turn around. The standard answer is, "when there's blood in the streets;" figuratively speaking, of course, we're already there (to the tune of \$500 billion). And as much as we agree that prices currently appear to reflect all the bad news, and then some, that is likely to befall the investment grade bond market, we alone cannot pronounce the end of this painful period.

We've been around long enough, and have seen enough gut-wrenching down cycles to know that the only thing that will pull this market out is large blocks of institutional money put in place by investors with staying power and a longer time horizon than the next options expiration date (sovereign wealth funds, anyone?). In the meantime, we are keeping extremely close tabs on our bonds, and the companies and collateral that underpin them.

