

When Does It Get Better?



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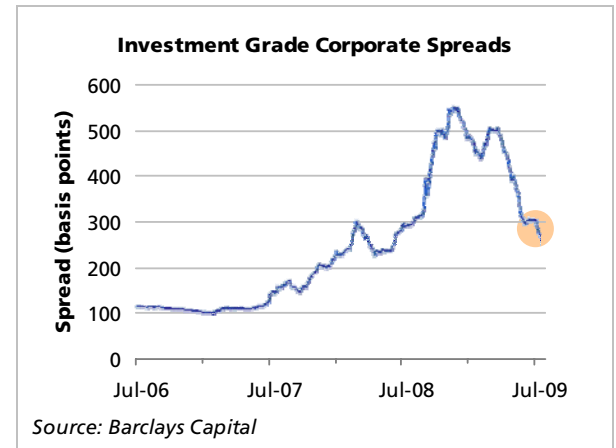
To judge by the price action in credit markets, happy days are indeed here again. Credit has returned +13.5% year-to-date as measured by the Merrill Lynch US Corporate Master Index, and 22.3% for the triple-B component. The graph at the top of the next column shows that the yield advantage of credit, compared with Treasuries, has narrowed relentlessly this year, producing that total return. Some of this represents a “coiled spring” bounce back from too-distressed levels of last autumn. Some relates to improved economic data and expectations of an economic recovery, though peaks in distress and default rates are clearly still in front of us. And further, this reflects the short-term dominance of microeconomic factors, supply and demand, as the supply of corporate issues coming to market is far less than the amounts maturing. Investors are scrambling to invest cash, gorging to satisfy their newfound appetite for risk.

The news is similar in the municipal market. Municipal credit spreads had also been wide due in part to concern over issuer credit conditions and weaker bond insurance. With bellwether California having resolved its budget problems – for the time being – and despite nationwide state and local budget challenges, high grade safe sector paper is in demand at current yield levels. New issue volume has fallen off and money continues to leave municipal money market funds in search of higher yields further out on the steep municipal curve.

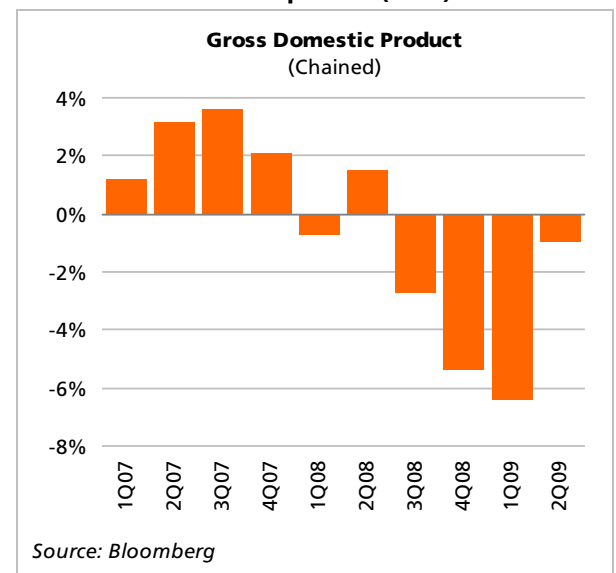
Fundamentally, a ray of hope is the turnaround in U.S. GDP data (second graph), which also supports the consensus view that the worst is behind us. Second quarter GDP fell at a 1.0% annualized rate and revisions show the drop in GDP in 2008 was bigger than previously thought. But going forward, government spending will be significant. Rebuilding drawn down inventories will also contribute to growth. Further, the surge in car sales under the clunker program, perhaps four or five months normal activity brought together, makes a positive GDP number in Q3 likely.

However, we expect consumer spending to remain challenged in the immediate term as both the willingness and ability to spend remain under pressure. Never has a bull market – in equities and in credit – climbed a steeper wall of worry. Even with the turn in economic indicators, the consensus remains resolutely gloomy. This forecast of a very

Narrowing Investment Grade Spreads Over Treasuries



Latest GDP Holds Out Hope for a (Slow) Turnaround



weak recovery is also at odds with history. The average forecast for Q3 GDP growth is less than a 1% increase, which would be by far the slowest start of any recovery on record.

The early stage of the recovery is going to be production-led, not demand-led. We see this in the ramp up in auto production and inventory rebuilding in general. It appears that the consumer is only along if there is some pent up demand and the goods are on sale. To maintain this production rebound – and

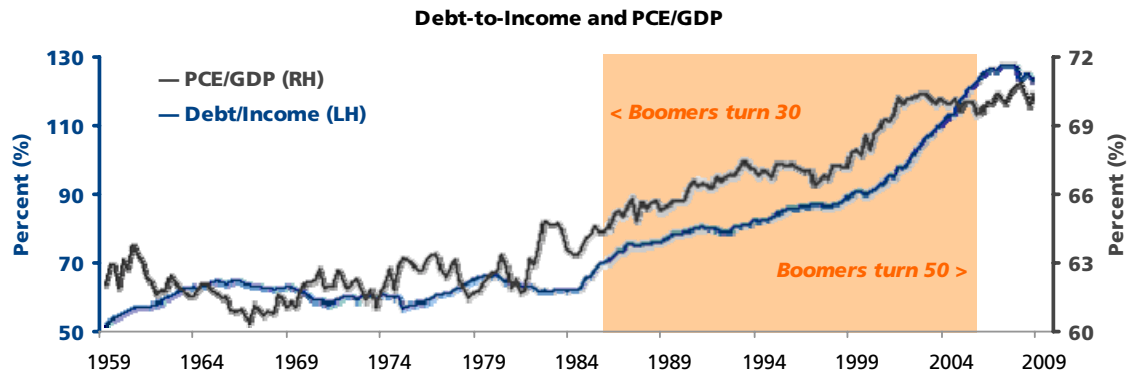
therefore be on trend for a sustained recovery going into 2010 – consumer spending will have to pick up in a more sustained way. This is the big uncertainty as the headwinds individuals face are so well known.

A sense of these pressures comes from the last chart, a long time series of the personal debt-to-income ratio, overlaid with a measure of personal spending as a proportion of total GDP, i.e., personal consumption expenditure (PCE)/GDP. The chart shows that there has been an excess of both borrowing and spending in the last 20 years, perhaps demographically driven. Over-spending financed by over-borrowing will have to unwind. Just as the banks have had to de-lever, so must consumers. This

process should take a protracted period of time as proclivities to spend decline and those to save increase. Therefore, the risk is that consumer spending, having increased to beyond 70% of our economy, will retrench and remain disappointing for some time.

The difficulty for us has been participating in a credit rally that has improved rapidly, appearing to be stoked by investors scrambling to get fully invested, while at the same time economic considerations point to a long process before sustainable consumer demand is rebuilt. ■

A Decline in Boomer Consumption May Foster A Weak Recovery



Source: Royal Bank of Scotland

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