Global High Yield Perspectives

1Q 2012

SUMMARY

- An exit by a euro-zone (EZ) member that would force recognition of potential losses associated with EZ member central bank imbalances is currently an underappreciated event.
- An EZ federalization of these imbalances will not occur and is not a viable solution for most EZ political democracies.
- The three-year Long-Term Refinancing Operation (LTRO) has reduced funding stress in EZ economies.
- Low quality credit assets and junk-rated financial asset prices have risen dramatically this quarter.
- Current dollar prices of low quality credit assets reflect excessive optimism on the stresses in Europe and economic growth in the U.S. and Asia.

"We can't go on together
with suspicious minds
And we can't build our dreams
on suspicious minds."

–Elvis Presley

"We're caught in a trap."

–Hans Werner-Sinn, President of the Ifo Institute for Economic Research

Most of us remember these lyrics from Elvis Presley's crooning of Suspicious Minds—or in the case of the more contemporary investor, from Fine Young Cannibals; however, to hear these words from the dour Hans Werner-Sinn should cause concern.

The trap, that Werner-Sinn has highlighted, is the imbalances in the payment claims between EZ central banks (see **Figure 1** on next page). To simplify, these claims develop and accumulate when cross-border bank transfers occur within the EZ; when certain member countries import more goods and services than they export, these countries are dependent on capital inflows to balance the difference. Yet the banks in many of these stressed sovereigns were unable to raise capital through deposit inflows or reasonably priced borrowings, and instead turned to their central banks to make up the capital shortfall.

These central banks simply printed euro to fill the capital gap for their banks, which then became a claim on the other EZ central banks via the European Central Bank (ECB).

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These imbalances have continued to grow (see **Figure 2**); the German response has been to demand austerity to reduce the financing gap—potentially tumbling the already overleveraged, stressed EZ economies into a multi-year severe recession.

The ultimate issue will be whether these recessions, if severe enough, cause a member country to exit the EZ. If, for instance, Greece were to leave the EZ and return to the drachma, these imbalances would be crystallized as real losses and the likelihood of the Greek central bank defaulting on the claims due to the Bundesbank would become a moot point.

While economic stress in the EZ has been reduced by the three-year LTRO, a return to synchronized economic growth will now determine if EZ economies can escape the monetary trap created by a common currency.

> "A national debt, if it is not excessive, will be to us a national blessing. It will be powerful cement of our union."
>
> –Alexander Hamilton, "Letter to Robert Morris," April 30, 1781

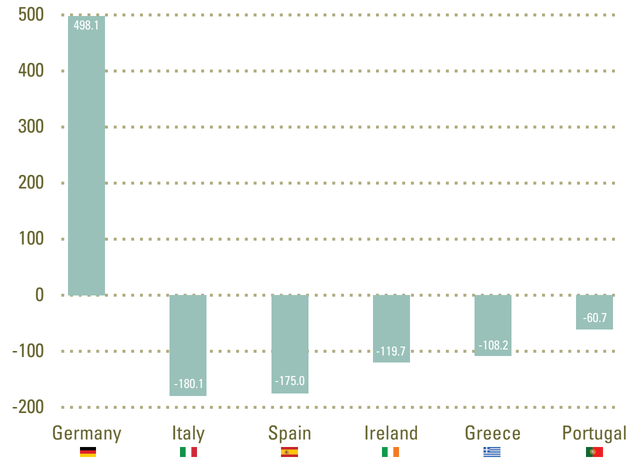
Many observers of the EZ difficulties have called for a "United States of Europe" as a solution to the financing problems of the stressed EZ sovereigns (see **Figure 3** on next page). The difficulty with this concept is that they neither accept the history of Europe nor understand Hamilton's response to early economic circumstances of the United States as the first Secretary of the Treasury.

In this case, Germany would be required to assume excessive liabilities without any taxing authority. The hardships Germans faced to combine into a unified Germany reduced growth and transferred investment throughout the 1990s. Today, there is no compelling political willingness to assume the debts of stressed Southern European sovereigns by Northern European sovereigns, nor is there a willingness to allow Northern European sovereigns to impose broad-based taxing authority and oversight on Southern European sovereigns.

> "As a general marches at the head of his troops, so should they march at the head of affairs, insomuch that they ought not wait until the event to know what measures to take, but the measures they have taken ought to produce the event."
>
> –Alexander Hamilton, "Papers of Alexander Hamilton"

ECB President Mario Draghi's three-year LTRO has had the desired impact on risk premiums in Europe. Spreads on the riskiest segments of the credit markets have been dramatically reduced. European banks and lower quality credits have regained access to the capital markets.

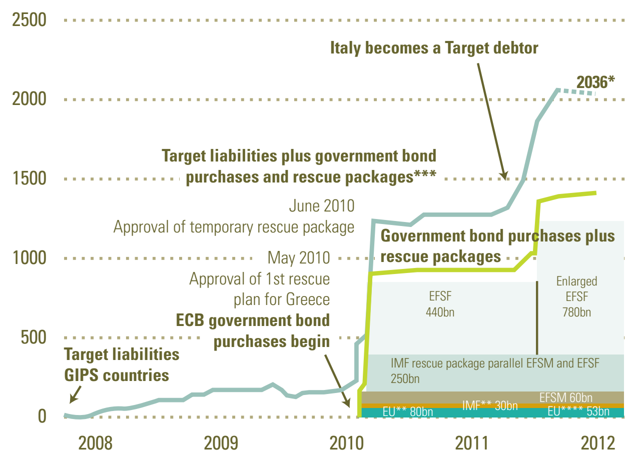
Figure 1 Current TARGET2 Balances of Euro-Zone Central Banks
Billions of Euros*



*Germany, Italy as of Jan 2012; Ireland, Greece, Portugal as of Nov 2011; Spain as of Dec 2011.

Source: Ifo

Figure 2 Rescue Activities Over Time
A Breakdown of the Bail-Out Funds; Billions of Euros



*Total bail-out funds; data as of figure 1.

**First rescue package for Greece (granted by euro countries and IMF)

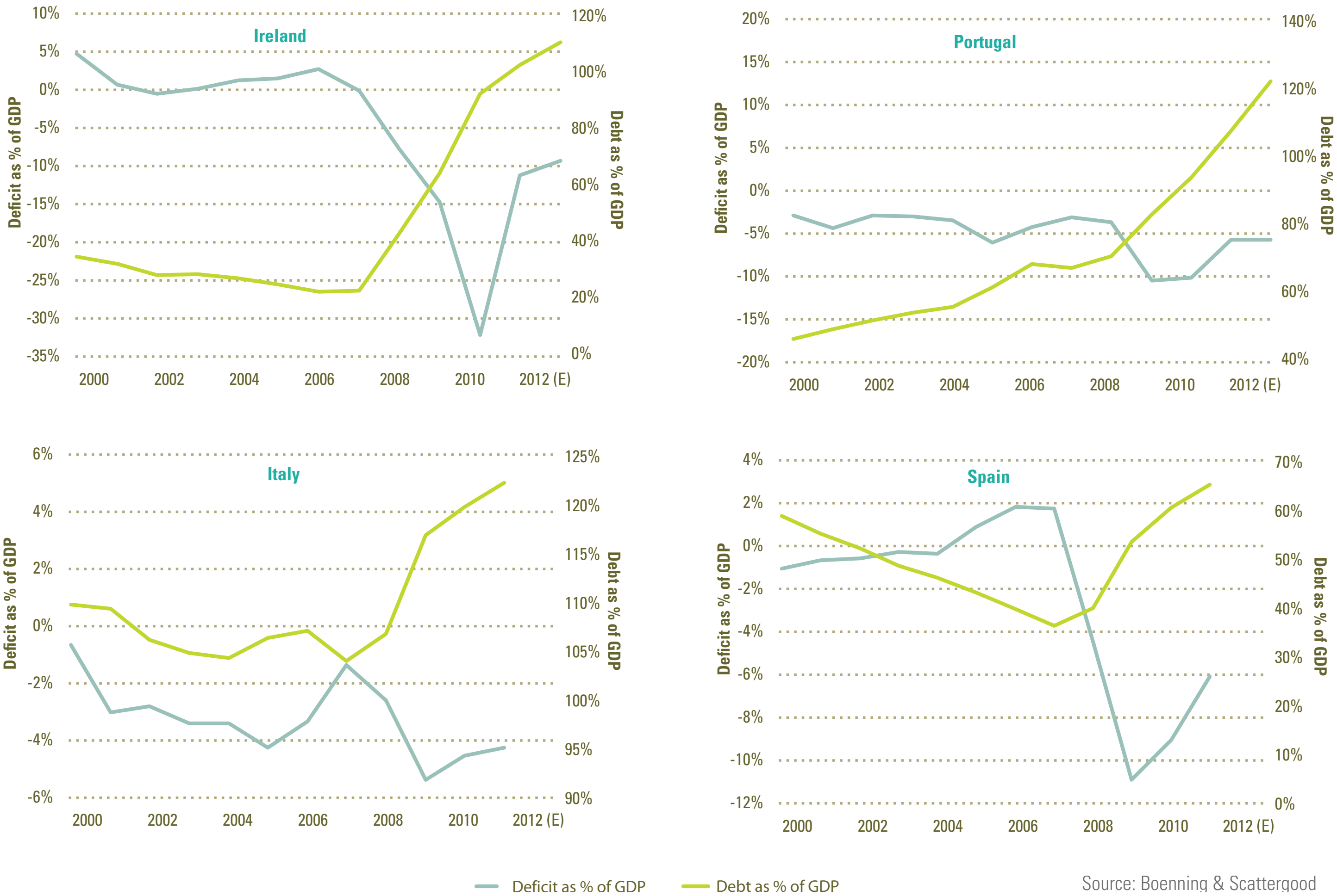
***Calculated using month-end figures

**** Credits disbursed by the end of 2011, unused resources to be released by EFSF

Greece, Italy, Portugal, Spain (GIPS); European Financial Stabilization Facility (EFSF); European Financial Stabilization Mechanism (EFSM)

Source: Ifo

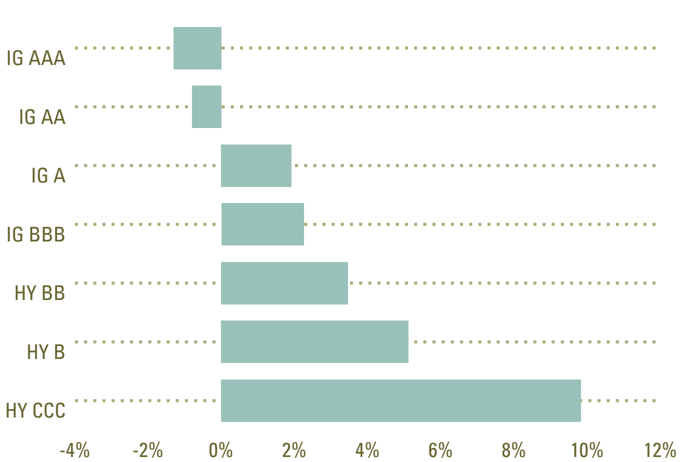
Figure 3 Deficit and Debt as Percent of GDP by Country



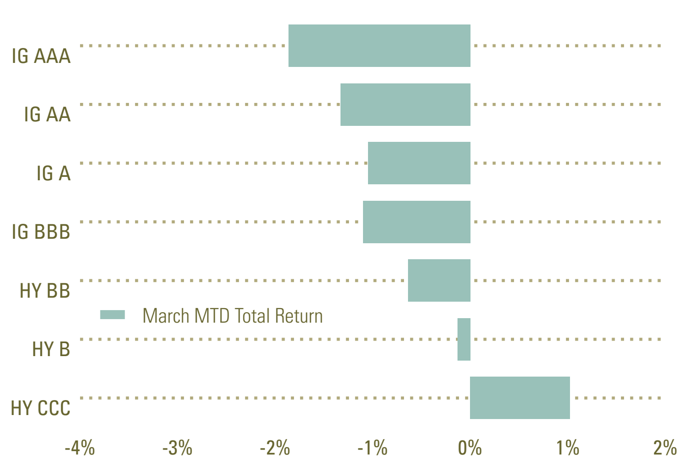
Source: Boenning & Scattergood

A portfolio heavily skewed to these segments of the credit markets has achieved sizeable returns in a very short period of time (see **Figure 4**). Yet, we are troubled (see **Figure 5** on next page) by the absolute high dollar price investors are now paying for the opportunity to earn income in the most default-prone segment of the credit markets.

Figure 4 2012 YTD Total Return by Rating Category (%)



March 2012 MTD Total Return by Rating Category (%)



Source: RBS Securities, The Yield Book

While our global high yield credit portfolios were not positioned to capture the CCC or lower Tier-2 junk financial rally, the prices being paid today to take on this risk do not—in our estimation—account for 1) the likelihood of recession in the next several years in the United States; 2) the small, but devastating probability of one of the EZ members leaving the euro zone; or 3) the need of an additional bailout of another stressed EZ sovereign.

We are now metaphorically "buying puts" against our performance risk proxies in a low volatility economic environment (see **Figure 6**) by structuring and maintaining a higher credit quality portfolio to withstand future business-cycle and funding stresses.

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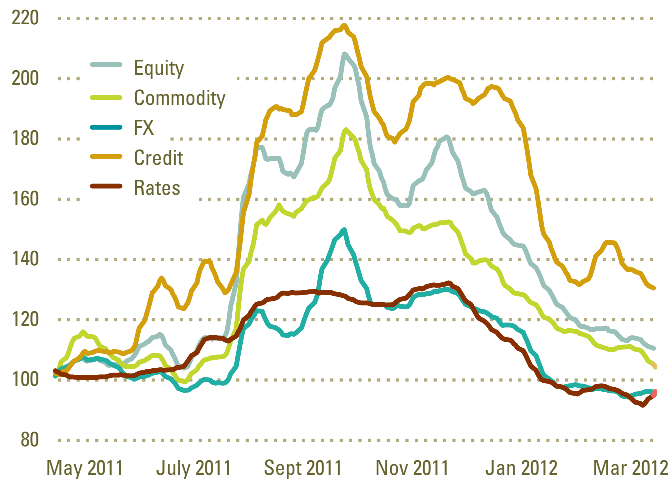
Figure 5 Agencies Propose Revisions to Leveraged Finance Guidance
March 26, 2012

"The agencies observed tremendous growth in the volume of leveraged credit leading up to the crisis and in the participation of non-regulated investors. While there was a pull-back in leveraged lending during the crisis, volumes have since increased while prudent underwriting practices have deteriorated. As the market has grown, debt agreements have frequently included features that provide relatively limited lender protection, including the absence of meaningful maintenance covenants and the inclusion of other features that can affect lenders' recourse in the event of weakened borrower performance. In addition, capital structures and repayment prospects for some transactions, whether originated to hold or to distribute, have been aggressive. Management information systems (MIS) at some institutions have proven less than satisfactory in accurately aggregating exposures on a timely basis, and many institutions have found themselves holding large pipelines of higher-risk commitments at a time when buyer demand for risky assets diminished significantly."

–Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation Office of the Comptroller of the Currency

Figure 6 Price Volatility Falling in Global Asset Classes
May 2011 - Present



Volatility is calculated from three-month, at-the-money option prices. Equity includes S&P, EuroStoxx, Nikkei, Kospi, Bovespa, Hang Seng. Commodity includes gold, oil. FX includes EURUSD, JPYUSD, USDKRW, AUDUSD. Rates includes USD Libor, Euribor, JPY Libor 3m3m 10y vol. Credit includes CDX IG, iTraxx Main.
Source: Bloomberg, Quantitative and Derivative Strategies, Morgan Stanley Research