

An End to the Credit Crisis

THE AVAILABILITY, PRICE AND terms of credit drive market economies. Variations in these factors define the proverbial credit cycle, which largely determines the evolution of the real economy.

The current credit cycle abruptly turned down in August 2007. The resultant turmoil in banking and capital markets quickly became a crisis and initiated the ongoing period of defaults, retrenchments and deleveraging. Banks and securities firms to date have posted about \$330 billion in asset writedowns and credit losses. Some credit markets stopped functioning as security prices fell and investors refused to trade. Real economic growth stalled.

But the credit cycle, judged by some as the “largest financial shock since the Great Depression,” appears to have stabilized and is increasingly benefiting from improved investor sentiment and buying interest. The worst of the cyclical downswing, in other words, has passed. The evidence for this conclusion includes:

Mortgage-backed assets. Buyers for these securities are emerging. The most dramatic example has been BlackRock’s \$15 billion deal to buy a portfolio of distressed subprime mortgage debt from UBS of Switzerland for 75 cents on the

dollar. To many, this transaction represents a sophisticated investor, with substantial resources, calling the “market bottom.” In previous financial crises, the emergence of such buyers for distressed assets has clearly signaled a turning point.

During the past 10 months more than 80 funds have been raising money to buy distressed mortgage debt. This group includes an assortment of private equity, hedge funds and asset managers — for example, PIMCO, Fortress and Goldman Sachs. Some have gone beyond purchasing securities and have invested in mortgage servicing groups to gain further expertise in evaluating pools of home loans.

Prices of mortgage-linked securities, meanwhile, are firming. Many financial institutions are selling assets at their “writedown prices.” Moreover, the behavior of the ABX derivatives index, a barometer of market sentiment, suggests investors are starting to believe there is value at current prices. Finally, the Bank of England recently suggested that prices of many mortgage-related assets already *overstate* the likely losses that will ultimately be realized on subprime mortgage securities.

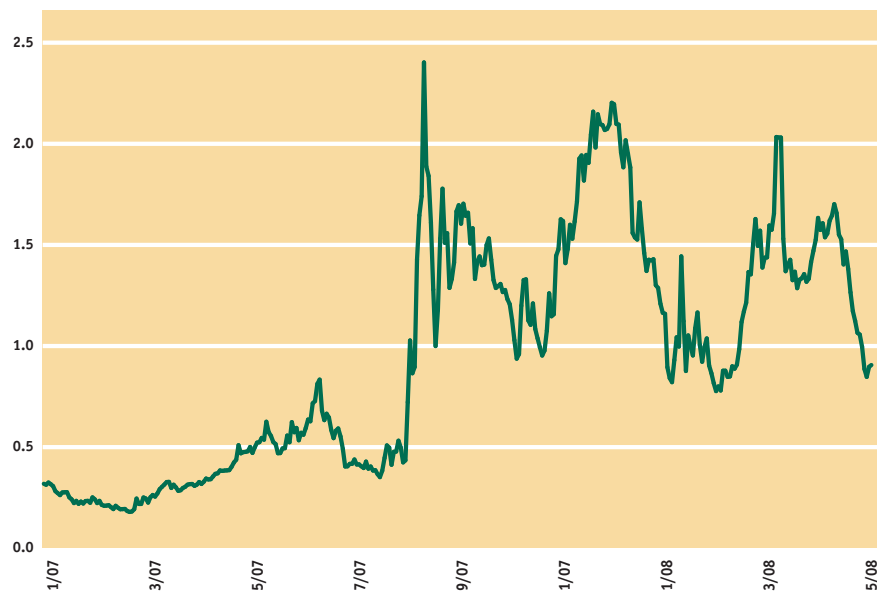
Leveraged loans. Banks have significantly reduced their exposure to leveraged loans that were mainly used to fund takeovers. The backlog of unsold assets on U.S. bank books is now below \$90 billion, down from a peak of almost \$250 billion. This reduction has been accompanied by a partial recovery in the price at which these assets are traded in secondary markets. Prices recently reached a three-month high — exceeding 92% of face value, up from lows of 86% in mid-February.

Structured finance. Collateralized debt obligations (CDOs), the epicenter of subprime mortgage turmoil, are staggering back to life. The Blackstone Group, the largest buyout firm, sold three CDOs totaling \$1.3 billion in April. Meanwhile, two structured funds (Avoca and Harbourmaster) recently issued collateralized loan obligations (CLOs) worth a combined \$1.09 billion. These CLOs weren’t designed to shift loans off the books of banks (balance sheet deals) but to profit by earning more from the loans they buy than they pay out in funding costs (arbitrage deals).

Investment-grade debt. Global bond issuance is increasing sharply as investors, particularly pension funds and insurance companies, return to the market.

APPETITE FOR CREDIT RISK RETURNING TO MONEY MARKETS

The TED spread has narrowed significantly since March 19.



Left Axis: Difference between the yield on the three-month Eurodollar and the three-month U.S. Treasury bill (%)

Source: Bloomberg



Global bond issuance exceeded \$300 billion in April and experienced a record week (\$43 billion) in early May. Spreads, meanwhile, have tightened, and a standard investment grade issue is being priced about 15 basis points above the secondary bond market, instead of the 100 basis points typical a month ago.

The performance of financial stocks. Financial equities no longer are leading the market down and appear to be basing. Fears of a financial collapse have evaporated, partially because banks are aggressively recapitalizing and central banks have injected massive liquidity into the system.

Money markets. The difference between the yield on three-month Treasury bills and the rate on dollar-denominated loans in London — known as the TED spread — has been narrowing significantly since March 19. This suggests an appetite for credit risk is returning to money markets.

The illiquidity of the London Interbank Offered Rate (LIBOR) markets may be less a function of banks distrusting one another and more a function of external investors (money market funds, pension funds, corporations, etc.) distrusting banks. This distrust is now diminishing as banks raise capital and strengthen their balance sheets.

Money market funds, meanwhile, now hold more than \$4 trillion of assets and appear increasingly ready to buy higher-risk assets to bolster returns. Customers will begin demanding yields above the modest rate being earned on cash, and management will tire of waiving fees to prevent returns turning negative as cash yields fall.

In short, activity is resuming in most credit markets and investors are returning. The availability, price and terms of credit are improving, and the risks of financial collapse — the feared “black swan” event — have nearly disappeared. The credit cycle is turning more positive.

Orie L. Dudley Jr.
Chief Investment Officer

INVESTMENT STRATEGY

What Has Changed

- The S&P 500 rallied sharply, rising almost 12% since the Federal Reserve orchestrated the purchase of Bear Stearns in mid-March.
- Activity is resuming in many credit markets, including short-term funding markets.
- The powerful uptrend in commodity and energy prices continues, reflecting tight supply-demand balances and speculative buying.
- The dollar is poised for a near-term rally, as negative sentiment has reached extremes.

Labor Markets and Consumer Spending Faltering But Not Collapsing

- Consumer resilience, typified by a surprising rise in April “core” retail sales, remains impressive.
- Exports are contributing more to growth than originally estimated, causing first-quarter gross domestic product (GDP) estimates to be revised up from +0.6% to +1%.

Fed Lowered Federal Funds Rate 25 Basis Points to 2% and Is Ready to Increase Credit Auction Size

- Bond issuance by banks reached its third-highest monthly level ever (\$303 billion), as banks took advantage of improving credit conditions.
- BlackRock, an investment manager, agreed to pay \$15 billion for a portfolio of distressed subprime mortgage debt from UBS of Switzerland, suggesting a sophisticated investor might be calling the bottom in this market.

Equity Markets Bolstered by Strong Corporate Results Outside Beleaguered Financial Sector

- First-quarter revenues and earnings, excluding financial companies, grew at double-digit rates.
- Merger and acquisition activity is increasing, exemplified by Hewlett-Packard’s agreement to acquire Electronic Data Systems and the Mars takeover of Wrigley.

Global Finance Center of Gravity Shifting Toward the Persian Gulf, Russia and China

- Brazil, a global power in agriculture and natural resources, is growing near 5%, contributing to a solid global business cycle.
- The Eurozone, driven by better-than-expected results in France and Germany, reported first-quarter GDP growth of 2.2%.
- Japanese consumer prices, excluding energy and food, rose for the first time since 1998, suggesting Japan could be shaking off 10 years of deflation.
- The European Central Bank and the Bank of England, reflecting continued inflation fears, left their main policy rates unchanged.

Conclusion

- The credit crisis is abating, and the global business cycle remains healthy. Portfolio positions in riskier assets — stocks and alternative asset classes — should therefore be maintained at strategic norms.

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