

## May 2010 Monthly Report

### Introduction

Sensible and responsible strategies already in place in global pension fund portfolios were turned on their heads in May as all major asset classes came under pressure, often with little volume and general inactivity.

Derivative, relative value and proprietary traders, seemingly backed into a corner with very public displays of hostility and a pandering to populism by the politicians and regulators, reacted by encouraging extreme perhaps in the hope of encouraging flows which would offset loss of revenues in trading books.

It seems however this had the opposite effect, as real money managers, confused and wrong-footed, went on general strike and did little.

The team at Banquo have never been one to pass an opportunity to extol the virtues of the predictable cash flows that corporate credit can provide, so we would cite May's grim performance across equity, currency, commodity and most European sovereign debt classes, as something that could likely force an asset allocation review by global investment managers, leading to higher allocations for IG credit.

### Markets

Global markets were dominated by sovereign and equity market volatility. In the credit markets, financial names were the first to react and, within financials, Tier 1 followed by LT2 followed by senior debt. In Tier 1, the strong credits with complicated hybrid capital structures were eight to twelve points lower in price. Corporate names held in remarkably well, but even these names were wider by mid month. ABS also gave up ground as the buying momentum came to an abrupt halt.

The stark lack of new issue supply and a heavy redemption calendar this summer is underpinning corporate spreads. The few new issues seen in the corporate space have been hugely oversubscribed at levels tighter than expected. As with all asset classes in May, volatility in secondary prices was high with little or no volume.

This price action underlines the importance of new issues in enabling the credit markets to function, for both pricing and liquidity, and enticing new money to be put to work.

Few real money managers put any meaningful amounts of cash to work during the month, particularly in the euro sovereign sector, leaving the ECB as the buyer of last resort.

### Indices

The Merrill Lynch Global Large Cap index (G0LC) produced a negative excess return over swaps of -1.97% as the spread over swaps widened by 34 bps to 171 (WAL of 7.8 years). The Financial Index component underperformed swaps by -2.35% last month.

EMU Industrials (EJ00) delivered a negative -1.08% while EMU Financials (EB00) lost -1.7% against swaps and the EMU Subordinated Financial index (EBSU) lost -3.7%.

### Migration

The improving trend in investment grade migration continued in May as Moody's upgraded 21 ratings and downgraded 14. The lion's share of upgrades was in the US with 17 upgrades against 3 downgrades; the North American financial sector produced a positive upgrade/downgrade result of 3:2 while Western Europe experienced 3 upgrades (2 financials) against 7 downgrades (5 financials).

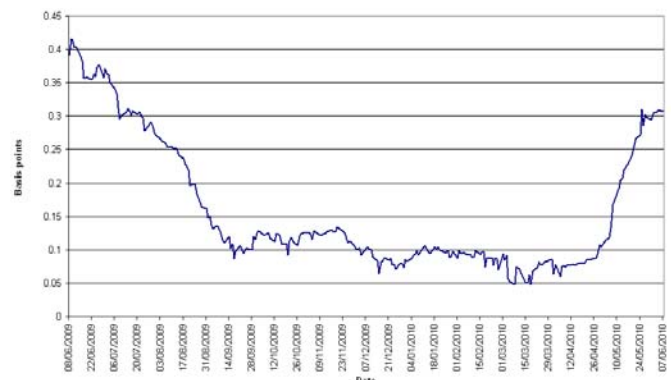
### Money Markets

The crisis in Euro zone peripheral country debt has renewed bank counterparty risk fears in the interbank money markets, affecting both secured and unsecured lending. The EU support package did not reverse the risk aversion that started in April and, by the end of May, the commercial paper, deposit and repo markets were all showing signs of stress for the first time since March 2009; this was in spite of the liquidity backstop measures put in place by central banks and governments.

As seen by the rise in 3 month US\$ fixings, most pressure on financing has been seen in US\$ lending, with US banks again becoming reluctant to lend to smaller, weaker European banks. This pressure directly led to the ECB re-opening swap lines, with the Fed to allow them to finance Euro zone banks in US\$. The 3-month OIS spreads also show the increased tension in the market, especially in US\$ and EUR, with the US\$ spread widening to levels not seen since July 2009.

For Greek, Spanish and Portuguese government collateral, liquidity in the repo market has been greatly reduced and liquidity for the smaller Spanish banks has been constrained, increasing their reliance on the central bank and the larger Spanish banks for their liquidity requirements.

3 Month USD Libor/OIS Spread - 8/June09 to 7/June10



## Research Viewpoint – Sovereigns

The euro is first and foremost a political project and is likely to hold together because of the political advantages it confers. Core Euro members also have vested interests; in Germany's case, returning to a hyper-strong Deutsche Mark would present a set of challenges similar to those Japan faces today. A Greek restructuring would blow a sizeable hole in northern European bank balance sheets which will be concentrating the minds of core euro members. This suggests that there will continue to be extreme volatility in sovereign credit markets.

To illustrate the volatility in European sovereign credit last month, Spain's 5 year CDS spread started at +153bps and widened 102 bps to +255bps. Short covering following the €750 billion EU support package collapsed spreads by 118 bps to +137bps and subsequent uncertainty edged the month end 101 bps wider at +238bps. Unsurprisingly, the loss of Fitch's AAA rating at the month end barely registered.

The month began with a looming government debt buyer's strike focussed on individual countries with unsustainable fiscal balances. The €750 billion EU package, and the ECB's willingness to monetise government debt, addressed the immediate liquidity concern.

A *quid pro quo* for the support package was greater fiscal discipline and within days Portugal, Spain and Italy announced new and tougher deficit reduction plans. This triggered a new round of concern regarding the impact of reduced government spending on GDP growth and the risk of recession, which was the main reason cited by Fitch for their downgrade of Spain.

For Greece, the support package fails to address the critical element of how to regain competitiveness and achieve growth rather than a negative spiral of deflation. A massive re-pricing of Greece's major export – tourist holidays – through devaluation would achieve this, yet Greece might still require debt relief through restructuring, depending on the speed of recovery. Other countries suffering from an accumulated lack of competitiveness include Portugal and Italy.

The Euro zone support package also drew attention to the interconnected nature of funding, in particular, how much southern European debt is held by northern European banks. For example, France owns €900 billion of Greek, Irish, Spanish, Italian and Portuguese debt. Its own government debt maturing in the next 12 months totals €460 billion and almost half of government debt is held by foreigners.

Sovereign credit concerns have been rapidly translated into pressure on funding; bid-to-cover ratios fell across the board and, in an auction on 18th May, Spain fell short of its target for selling Treasury bills and yields almost doubled. The focus on funding has highlighted the dependence of peripheral Euro zone countries on foreign investors to buy government debt.

Governments have less margin for manoeuvre as fiscal stimulus is no longer an option. Markets have decided credible government finances are a prerequisite for funding and discipline is being enforced by the EU commission. The need to maintain growth as stimulus is withdrawn, means there is a higher chance of currency devaluation and exit from the monetary union – although Ireland and Latvia have shown it is possible to cut nominal wages and prices while remaining in the union.

On the upside, we can see signs of re-balancing which sets the Euro zone on a more sustainable path. Fiscal rectitude is essential to stable government finance and is finally being enforced on profligate governments. Austerity budgets are accompanied by tax reforms to make the system fairer and more efficient, which should broaden consensus and make taxes easier to collect. The funding pressure on Spanish cajas is finally forcing a rationalisation of the sector which has been talked about since the 1980s. Governments will seek to cultivate a savings culture on their domestic investor base – Portugal recently announced it would target households for government debt issuance – which lends stability in a return to the days when domestic households financed virtually the entirety of Italy's government debt. Even last month's 8% decline in the exchange rate makes Euro zone countries more competitive, improving the external position across the board.

Across the portfolios, Banquo has selected individual exposures with strong cash flow characteristics, limiting overall concentration in weaker European banks and those with high concentrations of government debt, in the belief that current prices adequately compensate the sovereign risk in a well diversified portfolio.

## Research Viewpoint – Corporates

The apparent anomaly that the CDS of southern European corporates trade inside their respective sovereigns has been highlighted before in this monthly. Last month attention was also drawn to the fact that we also highlighted that these corporates had raised about €14 billion in the bond markets, which represented almost 28% of the year to April Euro corporate issuance according to Société Générale. As a result, these entities are less likely to face the funding pressures experienced by banks and sovereigns.

This said, the worsening economic outlook has started to have some impact on the southern European corporates. On 25 May, the Portuguese toll road operator Brisa was downgraded from BBB to BBB- by S&P. It has to be recognised that Brisa's position was relatively weak (Moody's Baa1 rating has been in negative watch since 24 December 2008), but the worsening outlook seems to have been the marginal event triggering a downgrade.

The rating actions taken by S&P on OTE is of particular interest. On 27 May, S&P downgraded OTE by one notch to BBB-/Stable, meaning that S&P considers OTE to be of higher credit quality than the Hellenic Republic which is rated BB+/Negative outlook. The downgrade reflected S&P's expectations that the Greek austerity package will translate into weaker demand, that OTE's operating and financial profile is likely to remain weak and that OTE will face new taxes, including 10% tax on profitable companies and a 10% tax on distributable earnings.

S&P notes that "lack of support from DT [Deutsche Telekom] could, in the absence of other refinancing means, translate into a multi-notch downgrade of OTE." In other words, OTE remains investment grade only through DT's support, which is likely to be reflected in CDS spreads. In Banquo's opinion, such external factors contribute to explain the relative stability of the southern European corporate spreads.

Separately, S&P put Portugal Telecom on negative watch on 13 May, despite announcing in line results in line with expectations a week earlier. Deleveraging at Portugal Telecom had not met S&P's expectations, in particular due to an increase in off-balance sheet operating lease commitments.

DN and SR 2014 have exposure to neither Brisa nor OTE, but do have exposure to Southern European names such as Iberdrola, Repsol, Telefónica, EDP, Enel and Telecom Italia. Whilst the worsening economic outlook could put some pressure on the ratings, these names will remain well positioned because of factors like international diversification.

### Research Viewpoint - Financials

Legislation producing the most sweeping changes to US financial regulation since 1933 may be on the President's desk as soon as the Independence Day holiday.

A Consumer Financial Protection Bureau will be created, consolidating the responsibilities of several agencies. This will not just stop banks from selling negative amortisation mortgages to the penniless; increased regulatory oversight will restrict the profitability of consumer lending, which has been a significant contributor to US bank revenues over the last decade.

The Financial Stability Council will be created to address systemic risk. This will prevent banks from growing rapidly in size or complexity through credit growth or M&A. It may also demand higher capital ratios or better liquidity metrics from larger institutions. This reduces revenues and increases costs. The legislation also seeks to shift the cost of failure of systemic institutions from the taxpayer to both creditors and the wider banking sector. The House and Senate versions differ in their approach, but banks will contribute far more to the cost of future failures in the system (potentially via a Resolution Fund).

The legislation also carries several amendments which, if included in the final version, could have important effects. The 'Volker rule', which prevents banks from owning hedge funds, proprietary trading desks or private equity businesses, may survive in some form. This would reduce capital markets revenues. The 'Collins Amendment' excludes Trust Preferreds from the definition of Tier 1 capital. This may also become law, with discretion afforded to regulators to phase these instruments out over time. US banks are well capitalized, but this amendment would increase the weighted average cost of Tier 1 capital.

Perhaps the most contentious insertion is the 'Lincoln Amendment', which amounts to a *de facto* ban on swaps trading at a bank. It would force banks to house swaps desks in separately capitalised affiliates. It is unlikely that there will be an effective form of the Lincoln amendment which makes the final version, however, Banquo does expect the rules requiring mandatory use of exchange trading and clearing for dealers and Major Swap Participants to become law. This is likely, again, to reduce capital markets revenues.

The intention of legislators is to make the sector safer and less profitable. If the legislation is effective, the sector will become more attractive to bondholders and less attractive to equity holders. As bondholders, Banquo prefers well regulated utility-like banks with predictable revenues, higher capital ratios and better liquidity. Equity investors, used to 20% ROEs generated from capital markets activities and the consumer lending boom of the last decade, will be disappointed. Those days are gone.

Equally important are the unintended consequences of this legislation. Who foresaw the role of the Gramm-Leach-Bliley Act of 1999 in the great recession of 2008-9? It is too early to draw conclusions, but banks are likely to re-allocate capital away from activities attracting greater regulation. Commercial and SME lending may be prioritised over consumer lending and capital markets activities may be pared back. This would leave banks with strong commercial and SME lending profiles, such as Wells Fargo, in a better position than banks with large retail franchises, such as Bank of America. Similarly, regional banks would be better positioned than the universal banks which have greater reliance on capital markets revenues.

## Research Viewpoint - REITs

The US REIT sector saw a substantial repricing across the month as investors looked to shed risk on the heels of a volatile equity market and the negative headlines coming out of Europe. The credit compression trade evident earlier in the year quickly switched to a decompression trade with lower rated names widening the most.

## Research viewpoint – ABS

The European ABS market capitulation of early May continued throughout the month as trading desks significantly widened bid-offer spreads and sold down inventory. Rating downgrades of peripheral country assets caused some forced selling and liquidity all but evaporated. Though a number of peripheral country asset bid lists appeared, there has not been a panic sell-down of assets.

Buyers are sitting out the spread volatility. Most prime RMBS names ended the month some 10-20bps weaker over the month – with UK prime quoted around 150bps and Dutch RMBS at 135bps at the AAA level at month end. Secondary market trading has been light as a result and investor participation was limited as most of the trades seemed to be triggered by bank trading desks unloading inventory they had built up.

There was a firmer tone in the secondary market at the end of the month as the market found some stability through real money buyers picking up good assets at wide levels. In the CMBS sector, selling from funds facing redemptions weakened senior tranches despite stable fundamentals and ratings and this sector remained soft into the month end. Mezzanine CMBS notes were unaffected by the softening and still saw good demand during the month.

Despite May's credit market volatility, the market saw one public deal successfully close as Santander's UK Master Trust (UKMT) issued FOSSM 2010-2 successfully at levels inside of secondary spreads, though again there was a substantial lead order from JP Morgan. Another two ABS deals were announced, excitingly both from previously 'closed' sectors - UK credit cards from Barclays' Gracechurch UKMT) and Moorgate Funding 2010-1 from BAML's UK Non Conforming platform. The Moorgate deal, the first UKNC since August 2007, is particularly welcome. Should the issuer achieve good funding levels, this may prompt other issuers to bring more seasoned UKNC products to the primary market. Elsewhere, there was further structural good news in the RMBS sector as Lloyds TSB Bank provided further support through a cash injection to their UKMT Arkle to meet upcoming bond maturities. Additionally, both Fortis and The Cooperative Bank called their respective Delphinus 2000-1 and LEEK 15 bonds on their optional call dates.

#### **Disclaimer**

This document is issued by Banquo Credit Management LLP ("Banquo") (Partnership Number OC307336) whose registered office is at 5th Floor, 70 Gracechurch Street, London EC3V 0XL. Banquo is authorised and regulated by the Financial Services Authority. The information supplied in this document is supplied as a guide only and has not been verified by an independent source. This document is not intended for distribution to any person in any jurisdiction where such distribution would be unlawful or in any jurisdiction that would require the registration, notification or filing of a prospectus. This document is being communicated to you solely for the purposes of providing our views on current market conditions and information on the markets in which Diversification Notes plc has or will invest. Nothing in this document is intended to constitute legal, tax, securities, or investment advice, or opinion regarding the appropriateness of any investment, or a solicitation for any product or service. The use of any information set out in this document is entirely at the recipient's own risk. The document contains various opinions that are those of the Managing Partners ("Managing Partners") of Banquo and are based upon the best information available to them. These opinions are subject to change without notice. No representation is made nor warranty given as to the accuracy or completeness of the information contained herein. Further, no liability is accepted in respect of its contents by Banquo, its Managing Partners, Partners, employees, agents or advisors or any other person and Banquo expressly disclaims any and all liability for any written or oral communication transmitted or made available to an interested party save to the extent required under the regulatory system established under the Financial Services and Markets Act 2000. Neither Banquo nor any of its representatives take any responsibility for any party acting upon its contents or for the contents. The statements contained in this presentation that are not historical facts are forward-looking statements. These forward-looking statements are based on current expectations, estimates and projections about the industry and markets in which Diversification Notes plc will invest, and Banquo's beliefs and assumptions. Words such as "expects", "targeted", "anticipates", "should", "intends", "plans", "believes", "seeks", "estimates", "forecasts", "projects", variations of such words and similar expressions are intended to identify such forward looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties, and assumptions which are difficult to predict. Therefore, actual outcomes and returns may differ materially from what is expressed or forecasted in such forward-looking statements. Banquo does not accept any responsibility for any errors whether caused by negligence or otherwise or for any loss or damage incurred by anyone in reliance on anything set out in this document. The information in this document reflects prevailing conditions and our views as of this date, all of which are subject to change. In preparing this document Banquo has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources or which was provided to it or which was otherwise reviewed by it. All financial projections are illustrative only and none of the projections or assumptions should be taken as forecasts or promises, nor should they be taken as implying that these assumptions are necessarily correct or exhaustive.

#### **Performance**

Banquo has prepared and presented this performance report in accordance with the Global Investment Performance Standards (GIPS®). The returns set out in this document have not been independently verified. The returns are calculated in Euro, net of management fees (DN 1 - 0.45% p.a.) and other expenses, and include reinvestment of Euribor coupon and any Excess Returns. The returns portrayed represent the return of all floating rate Euribor notes issued by Diversification Notes plc (DN) and are time and asset weighted. DN 1 uses moderate levels of leverage – maximum 2.2 times for DN plc. The returns for DN 1 are calculated from October 28th 2004 following the initial investment period for DN 1 ('ramp up'). Cost of ramp up was approximately 29bps. Past performance cannot be a guide to future performance and is no guarantee of future returns. The actual return on individual notes issued by DN plc is a function of the class of note and in particular, the Factor, the currency, and return elections, the date of investment and the cumulative reinvestment in the note.

#### **Distribution**

This document is confidential and is intended only for the information of the addressee. It may not be copied or distributed (except to the addressee's professional advisors who must be informed of its confidentiality) and by accepting receipt you agree not to copy or reproduce it in any way in whole or in part or to relay its contents or any part thereof to any other person, save as above or to utilise or copy the business model described herein in whole or in part.