December 2009 Monthly Report

Introduction

Credit markets in the final days of 2009 were so intriguing that these themes will dominate this month's report, rather than a look-back at the events of 2009.

The dreadful blow-out in spreads, particularly financials, during last February and March that defined the last phase of the bear market, was understandable, although unjustified in so far as it was indiscriminate; long standing bull or bear trends in any asset class usually end with such a spectacular blow-out.

The indiscriminate market rally is largely over, and the next phase of the credit market cycle has begun. During this phase, there are still many sectors and individual credits that provide compelling and attractive risk adjusted returns; as virtually all market-oversold opportunities have evaporated, outperformance in credit portfolios will be substantially down to single name selection. As a result, Banquo is planning to launch a new Absolute Return 130/30 long/short fund, and will have the ability to take advantage of credit shorting opportunities.

2010 will inevitably contain a meaningful number of single event catastrophes, or, at least, accidents-in-waiting. Over the past few months Banquo monitored, with great interest, the market reaction to events in Dubai and Greece. Their sharp sell-off due to genuine credit concerns reinforced how quickly spreads can move when bad news hits; these two incidents will not be the last of their type; Banquo's investment approach will be adapted to take advantage of these events. Selective shorting in market disruption can be a very useful tool and one we are seeing pension funds for one moving towards as part of their overall strategy

The intended launch of a long/short absolute return 130/30 fund under Credit flex, Banquo's UCITS III umbrella structure, is timed to coincide with the next phase of the cycle, which provides the best environment for such a strategy. Banquo will be describing, shortly, its long/short active investment approach in a separate communiqué in the New Year.

This fund serves to complement, not replace, Banquo's other long-only and net long funds, and it also looks forward to launching a series of such funds in 2010.

As 2009 ends and 2010 begins, one of the biggest stories is the steepening of global government curves and the implications thereof. This is all about the market dictating the price which the massive supply needs to be priced at in order to clear; the same market movements may force the hand of monetary policy across the western world, and will influence 1Q 2010 new issue calendar with a heavy supply expected.

The prospect of higher long term rates, irrespective of the pace that quantitative easing is unwound, will dictate borrowers funding tactics; Banquo expects new issue calendars to be brought forward and longer maturities to be issued. For Banquo's new fund offerings, share classes offering fixed rate, as well as floating rate, return structures will be available.

Selected corporates in the right currency and right maturity with the right coupon will garner retail and institutional demand irrespective, or maybe because, of sovereign debt issuance ambitions. Financials will be heavy issuers in 2010; as the ECB borrowing window shortens repo maturities, medium term funding will become a necessity. Bank deals need to be assessed against a changing regulatory backdrop, but may present real value.

The fixed income markets kick started the credit lending cycle in February 2009 when the banking system was on its knees; it is likely to dictate investment trends again in 2010. Whatever happens in the other asset classes, once again the world's eyes will be on the global bond and credit markets; they are unlikely to disappoint.

Markets

Issuance in Europe dropped off around mid December and was limited mostly to shorter dated senior banks on a small scale, except for one utility of note, DONG Energy. Issuance continued a little longer in the US$ for domestic issuers, but also for Australian banks, Westpac and CBA, which issued several billion US$ of more short dated senior deals. Overall, not a particularly exciting new issue market in December.

The sector winners during the month were the 2009 vintage high coupon Tier 1 issues, Korea Expressway, National Grid and almost all non-Dubai Gulf corporates, which returned to their pre-November tights. iTraxx main also put in a very respectable performance during the month.

Any sector losers in December were unremarkable, and were overshadowed by Greece and by the steepening of all government yield curves.

The Merrill Lynch Global Large Cap Corporate Index (G0LC) produced an excess return over swaps of 1.39% for the month, as spreads tightened to +150 bps (by -19 bps in the month -254 bps for the year) on a WAL of 7.6 years. In contrast to previous months industrial companies, (G0LD) produced the higher excess return; 1.55% compared to 1.31% for banks (G0LB), as spreads tightened by -19 bps on both indices to +120 bps on an 8.8 year WAL for corporates and to +186 bps on a 6.1 year WAL for banks.

The BBB index (GLC4) outperformed the single-A index (GLC3), tightening by -30 bps to give an excess return of 2.21% compared to -20 bps tightening and 1.38% return for single-As. In 2009, single-A banks and BBB industrial companies have tightened by -358 bps and -355 bps, respectively; monthly excess returns were 1.66% for A banks and 2.12% for BBB industrials on tightening of -26 bps and -29 bps, respectively.

European indices performed less well by some margin in December; EMU corporate ex-BBB (E5X4) delivered excess returns of 0.28%, as spreads tightened by -4 bps to +115 bps on a WAL of 4.4 years, while EMU BBB industrials (EJ40) produced only 0.34% excess return as spreads tightened by a mere -6 bps to +135 bps on a WAL of 4.9 years.

Liquidity remained good in the secondary markets until well into the third week of December in both the US and Europe, although business seemed more buoyant in the US, where it was apparent that new money was still being put the work. The main focus of real money was on corporates although interest still remains for LT2 FRNs.

Once the Dubai excitement subsided after Abu Dhabi announced their loan to Dubai, spreads generally stayed firm and tightened somewhat into the month end, though from Dec 17th onward this was on meagre flows. The itraxx Main broke through the 80 resistance level and continued on down to the low 70s. Tier 1s also saw a small drip feed of gains back from their lows of November, although still not reaching their highs of late October and early November.

Migration

Despite earlier signs of improving migration ratios, migration remained conclusively negative for Europe and America in December. Moody's rating changes for investment grade corporates comprised 4 upgrades and 23 downgrades in North America, and 3 downgrades versus 22 downgrades in Western Europe. Financial institutions accounted for almost all of the downgrades in North America; 1 upgrade versus 21 downgrades. Western European Financial institutions experienced 2 upgrades versus 13 downgrades last month.

In contrast to the downgrade/upgrade ratios of 6 – 7 x in America and Europe, ratio for Asia-Pacific Rim and emerging markets countries were in the 1 to 2 x range overall. In Asia-Pacific Rim the 4 upgrades were matched by an equal number of downgrades, South America experienced 6 upgrades and no downgrades, Eastern Europe saw no upgrades and 2 downgrades and, following actions on Gulf issuers, the Middle East/Africa suffered 11 downgrades with no upgrades.

Research viewpoint-Sovereigns

The focus on sovereign creditworthiness continues to intensify, even as the fears concerning the financial sector abate. Following the events in Dubai, Greece's fiscal problems caused CDS spreads to widen dramatically and provoked rating downgrades by S&P and Fitch from A- to BBB+. As with corporate entities, the ultimate arbiter of viability is funding; sovereigns which are dependent on foreign purchasers to issue government debt have been in the spotlight, most notably the UK, as large investors expressed disquiet about the state of its fiscal imbalances.

It is difficult to predict possible knock-on effects of sovereign financial pressures. Dubai, within the UAE, and Greece, within the EU, have brought to light strains with their respective federal structures. Stronger members will seek to impose discipline on their profligate siblings while stopping short of secession, while individual governments must face their domestic constituencies.

Research viewpoint - Corporates

Corporates have benefited from spread tightening during 2009. The single-A Euro Non-Financial Corporates iBoxx index tightened in from 229bp in December 2008 to 82bp in December 2009, whilst the BBB Euro Non-Financial Corporates iBoxx index tightened in from 404bp to 147bp.

This spread movement merits a few observations. On a proportional basis, both single-As and BBBs have tightened by a similar amount, about two thirds, but on an absolute basis BBBs have clearly outperformed single-As (257bp against 147bp). Yet despite this tightening, credit spreads remain at historically attractive levels. Yields have, however, fallen to low levels: Single-A yields decreased from 5.7% to 3.8% and BBB yields from 8% to 4.3% as a result of lower interest rates.

This evolution will have implications for Banquo. The attractiveness of bond financing is likely to support bond issuance during 2010. The spread compression across rating bands, together with higher absolute performance of BBBs, means that single name selection will become an increasingly important value driver.

Banquo has had a cautious approach to cyclical BBBs and only invested in those that have been perceived as being the better positioned names, like Rio Tinto and Saint-Gobain. The spread rally in BBBs may, however, have been overdone resulting in a reduction of these exposures in favour of names in more stable sectors.

The improvement in default rates and migration ratios are related to global liquidity and the consequent reduction in refinancing risk. The real economy is still searching for a growth engine, and should sovereigns find themselves constrained in their ability to support liquidity, marginal credits may suffer.

Research viewpoint - REITs

REIT secondary bonds remained well bid, particularly for shorter maturities, as investor demand for large cap names remained strong into the year end. In 2009, the REIT sector was one of the highest performing sectors relative to other credit sectors with regard to spread performance.

Whilst it is unlikely that there will be such a similar degree of outperformance in 2010, Banquo does expect the sector to perform, not only because the REIT sector continues to trade cheaper than triple-B corporates, but also because market technicals should support spreads as only US$ 5-6 billion of bonds are expected to refinance during 2010.

Research viewpoint – Financials

Documents published this month by the Basel Committee, represent a major shift in the relationship between the banking sector and the state or regulatory authority. The 1980s heralded an era of banking deregulation in which central banks provided the liquidity which, in turn, induced complacency towards leverage and funding risks. The true cost of these policies, and the exact liability of a "lender of last resort", became evident in the recent crisis as sovereigns had to step in to take on risk assets and borrowing from the banking sector. The Basel document is a first draft of a new, more muscular regulatory regime; the aims are to ensure permanent deleveraging improve quality of capital (discounting tier two and "failed" Tier 1 instruments, instead focussing on pure equity) and improving liquidity.

The sector will run at lower leverage, lower risk and lower profitability. Banks will review risk/ return hurdles of specific business lines in the light of a new regulatory environment. Though Basel does not follow the Glass-Steagall route of separating deposit-taking businesses from other financial activities, regulators have the ability to influence the returns indirectly by raising capital or liquid asset requirements for certain risk asset or funding profiles.

Banquo views the Basel proposals as largely positive from a credit investor's standpoint and remains extremely constructive on the banking sector. Allocations to banks average around 40% in each of Banquo's funds.

LT2 is the sweet spot in the capital structure. The Basel document does not explicitly phase out LT2, but it removes the ability of Tier 2 to absorb regulatory deductions and further shifts market focus away from total capital to Tier 1 capital. Banquo believes there will be little issuance at LT2 level in 2010 and instruments will be called at the first call date as their regulatory capital importance diminishes.

Issuance of senior unsecured bank debt will be promoted, as the regulatory penalty for short term funding increases. At the same time, the unsecured debt-holder's asset coverage will continue to be eroded by, and subordinated to, the rights of retail depositors and secured debt including covered bonds and assets on repo with central banks. sound banks have increased the amount and the quality of equity capital underneath, supporting senior debt. At a price which reflects these considerations, senior debt will offer value.

The publication of the Basel document marks the end for the current style of Tier 1 hybrids. The document recommends that only those instruments outstanding at the date of publication should be grandfathered. All Tier 1 hybrids issued from now on will need to conform to the new standards. Banks are unlikely to rush out and issue in this space until there is more clarity from a regulatory perspective. This should provide technical support to the current stock of Tier 1, as investors search for yield in a rallying market. When issuance arrives, the new T1 instruments are likely to be predominantly sub-investment grade, but Banquo believes that the state of flux in this asset class due to regulatory changes will produce many opportunities throughout 2010.

Research viewpoint – ABS

The strong rally in ABS spreads finally petered out during December, however, active trading in the sector continued right up to the Christmas/New Year break. During 2009, the European ABS sector saw a significant spread rally as senior tranche, plain vanilla RMBS spreads tightened >200bps on the year. Despite this rally, the basis between European ABS and senior financials and covered bonds remains, reflecting the ongoing substantial liquidity/complexity premium requirement of investors.

As such, during early 2010, European ABS is likely to continue to offer a strong pick-up relative to other comparable credit.

The key to more substantive European ABS issuance and investment opportunities in 2010 remain : (i) how successful the ECB/UK central bank's actions are in weaning banks off their repo funding facilities; (ii) European banks taking steps to issue some of the €300bn of ABS retained on-balance sheet; and (iii) success in the widening of an active ABS investor base.

In November, the ECB, as part of the re-launching of the European ABS market, tightened standards for accepting ABS as collateral by requiring them to have two separate credit ratings to be eligible from March 2011.

Although the sale of more retained deals to investors should be seen as the next step in the market recovery, this will not be as straightforward as coupons on many retained deals have been set unrealistically low. The market ought to see a substantial restructuring effort before retained deals start flow into the market at current secondary spreads with any new deals specifically addressing investor concerns regarding calls/non-calls, deal credit enhancement levels and structural simplicity.

Money Markets

Despite heightened perceived sovereign risk through news flow from Dubai and Greece, the money markets remained unaffected throughout December as the continued excess of central bank liquidity ensured all banks were well financed through the year end.

3 month OIS spreads also maintained their low levels through December, with little change on the month, similarly not reacting to heightened sovereign risk concerns. The OIS spreads reflected the next 25bp base rate increase in November 2010 for EUR (was December 2010), July 2010 for GBP (was September 2010) and for USD August 2010 (was September 2010).

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