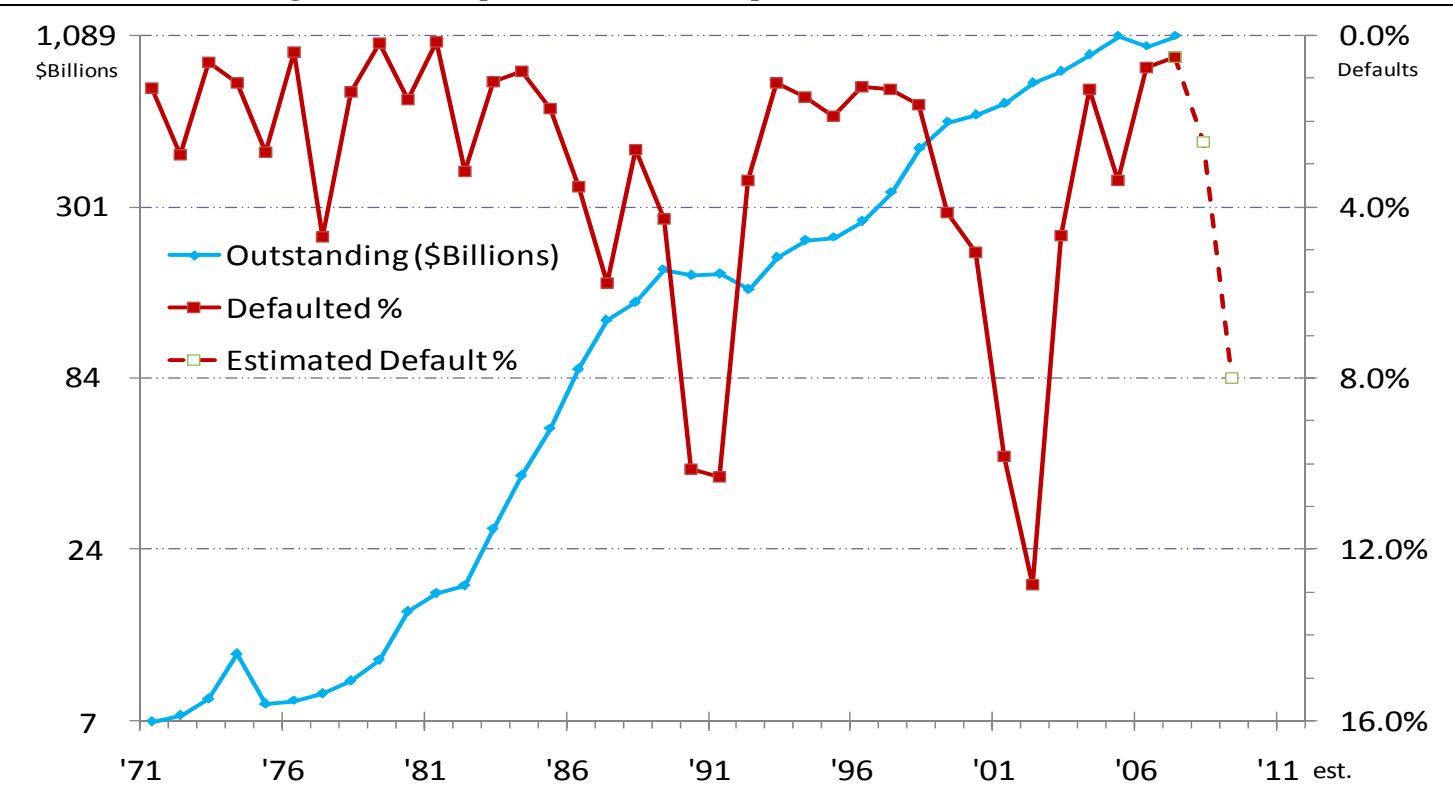


Q: Who's Afraid of the Big, Bad Defaults? A: We Are.

- The great Credit Crunch of 2007-08 will probably last through 2009 and into 2010, we believe, even if the broad US economy hits bottom sometime in the middle of next year. The recovery, as we see it, will be led by sectors relatively immune to the freeze-up in credit, and spread gradually to other sectors that rely heavily on the confidence of borrowers to spend and lenders to extend loans.
- Meanwhile, the Federal Reserve has shifted its monetary engine to full thrust, lowering interest rates on overnight loans to near zero and signaling they expect rates to remain this low for an extended period, and promising to do whatever it takes to prevent the worst recession since 1980 from inflicting severe damage to the economy.
- President-elect Obama's financial team is fleshing out its plans to stimulate the economy by spending hundreds of billions over the next two years primarily on infrastructure, hoping to create two million new jobs. By some estimates, a million or more jobs have been saved, if only temporarily, by the lifeline extended to the Detroit automakers by the outgoing Bush administration.
- Spending programs like these depend on our Federal credit, which is good. Relative to the size of our economy, our debt is manageable, especially at super-low interest rates like those we are seeing now. The benchmark 10 year Treasury note is priced to yield only 2.13% per year until maturity. That is the lowest in at least 50 years.
- But households and corporations are not enjoying the benefit of the government's extraordinarily low interest costs, because the market is pricing in a hefty premium on consumer and commercial loans, concluding that the risk of default is extra-high in these difficult times.
- The so-called "default risk premium" has surged for all types of credit, especially for bonds of risky companies. Firms in this category may have suffered a fall from grace, like the automakers, whose credit was considered good when most of their bonds were issued. But increasingly, companies in riskier businesses or even companies in seemingly stable businesses like cable TV or telecommunications have turned to the high yield bond market to access needed capital. If profit margins in a given business are thin but steady, management will often try to increase shareholder returns by boosting debt.
- The chart (Fig. 1) overleaf shows the size of the market has increased from \$7 billion in outstanding debt in 1971 up to \$1 trillion in 2007. Over that time, it has risen from less than 1% of the size of the US stock market to a little less than 10%. This data is provided by Prof. Edward Altman at the New York University School of Business. Professor Altman has been tracking the development of this market for many years.
- The chart (Fig. 1) also shows the annual rate of defaults in the high yield market, according to Prof. Altman's figures. J.P. Morgan estimates the default rate will rise to 8% in 2009, and most suggest 2010 will be even worse, even if the economy hits bottom in 2009 as we are hoping.
- Of course, owning a bond of a defaulting company does not mean the investment is worthless. In a reorganization (depending on the seniority of their claim), bondholders typically recoup some portion of their investment. This is usually not the case for shareholders, whose investment is often reduced to zero.
- Today, investors are drawn to high yield bonds by their discounted prices. We figure the investible universe is trading around 75% of par, and the average coupon is around 8.5%. So a new investor might achieve a current yield over 11%, if all of the companies were to continue to pay interest.

Default Rate of High Yield Corporate Debt is Expected to Rise to 8% in 2009



(Fig. 1) Note: Outstanding is based on par value of debt. Default percentage shown on reverse scale. Source: E. Altman, NYU Stern School of Business, J.P. Morgan.

Those who are optimistic about the prospects of high yield bonds claim that the low prices of the bonds already compensate investors for inevitable defaults by some issuers. They suggest that when a risky company manages to pay all interest and principal, bondholders' returns will be attractive relative to the returns of shareholders in the same company. The attractiveness of that return depends on a number of factors that we cannot address here, but the shareholder bears more risk in an individual company, and thus requires a higher return to compensate for that risk. It is impossible to prove ahead of time that the stock will appreciate sufficiently to compensate for the additional risk of loss.

We do not agree that the high yield universe is a more attractive asset class than popular benchmarks of US common stocks. Our analysis of the industry composition and default potential indicates that the companies that comprise high yield indexes are substantially riskier than those that make up the equity benchmarks. Equity investors who are worried about a continuing credit squeeze and increasing defaults should favor growth over value, large cap stocks over smaller ones, and be wary about companies in industrials, materials and the consumer discretionary sectors. Technology, health care, staples and large diversified energy companies appear much less prone to default, according to our analysis.

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Additional Information Available Upon Request

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