

# Opportunities amidst uncertainty

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The sub-prime crisis has played havoc with credit markets over the past six months. While the outlook remains uncertain, there are signs of emerging opportunities in credit markets around the world.

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## What has been happening in the market?

Credit markets have suffered a significant correction since June 2007. While the sub-prime crisis has grabbed the headlines, much has occurred across credit markets since this story broke. The crisis has broadened beyond sub-prime and is now impacting all areas of financial markets.

The aggressive lending practices and blind optimism that have influenced credit markets pricing over the last few years have been caught out and markets have aggressively reversed.

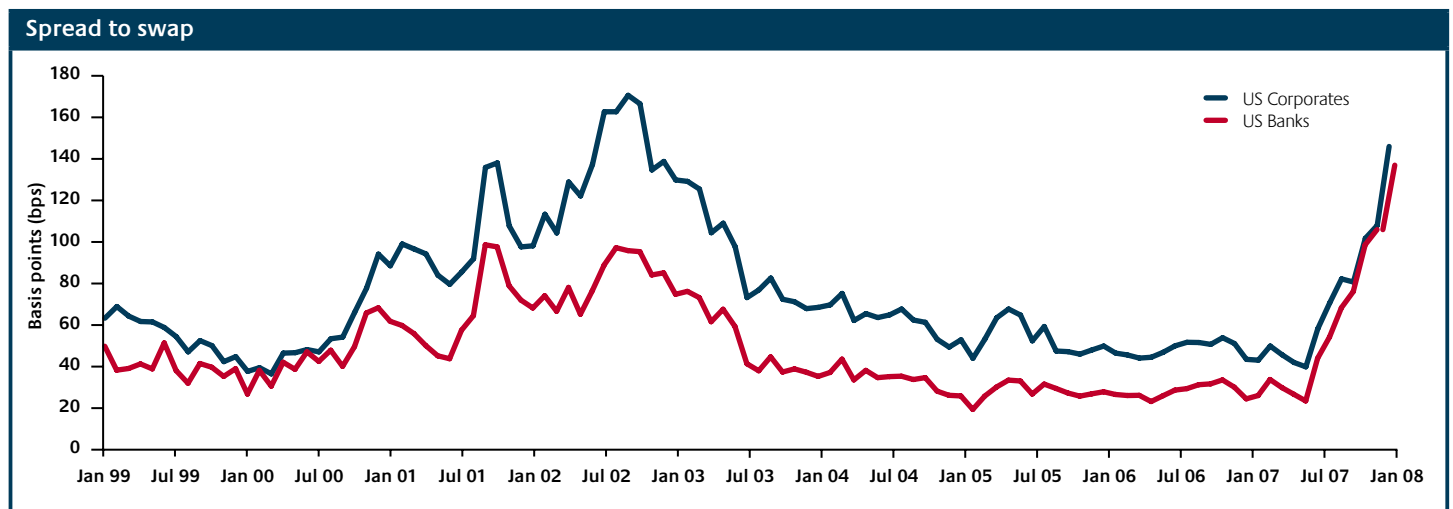
Losses from mortgage lending in the US have filtered through US and global financial institutions. This has impacted their willingness and ability to lend money.

The rapid deterioration in credit and the lack of transparency of the sub-prime and leveraged debt (CDO) market has created

a confidence crisis which has led to a significant withdrawal of liquidity from the global financial system. As a result, central banks globally have acted within their banking systems in a coordinated way to ensure interbank liquidity and reduce the risk of systemic crises.

Many global banks have reported significant losses on the back of the broader credit malaise and not just related to their sub-prime exposures. For the year ended 31 December 2007, UBS has written off US\$14.7 billion, Merrill Lynch has written off US\$25.9 billion and Citigroup has written off US\$21.9 billion. Many have also added substantially to their provisions for future credit losses.

This has seen credit spreads widen globally to levels that have not been seen since early 2003. Indeed, the spreads on financial and bank securities are wider now than those experienced in that period.



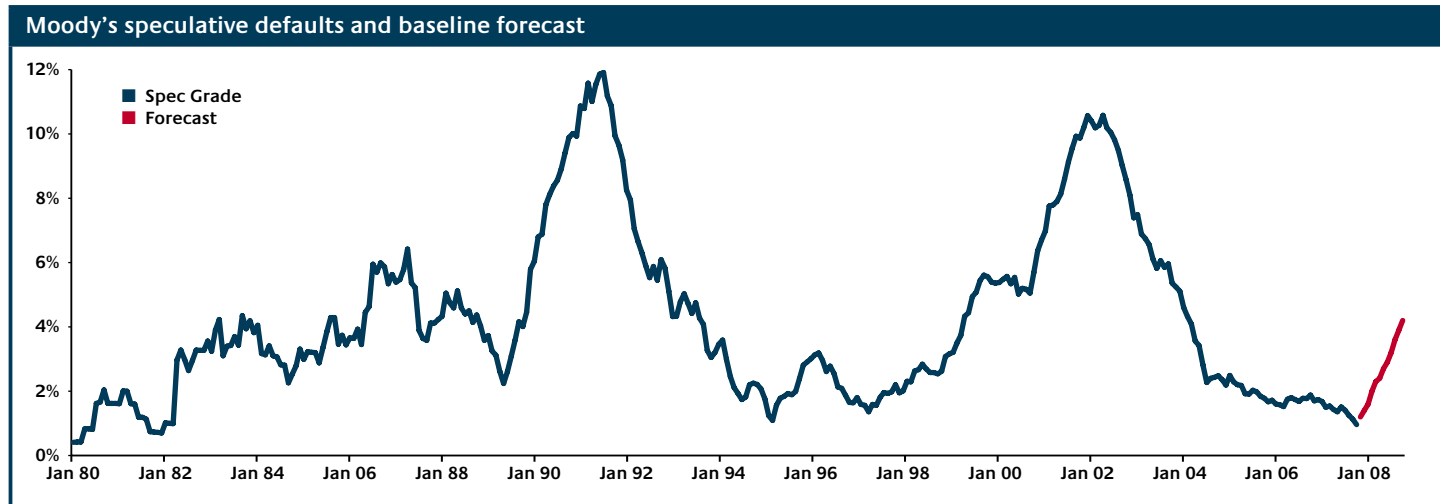
Source: Credit Suisse Liquid US Corporate Index (LUCI). Past performance is no indication of future performance.

## What about defaults?

Despite the turmoil in credit markets, defaults are still running at historically low levels. The chart below shows Moody's default rates over the last few cycles and their 2008 forecast.

The fact that corporate defaults have fallen to such low levels is, in part, why spreads also contracted to the levels that they did.

And while default rates are not necessarily expected to return to 2002 levels, it is expected that defaults will rise through 2008 and 2009. Weak high yield (rated CCC) and structured credit securities are expected to bear the brunt of these defaults as over-leveraged companies or structures fall victim to higher borrowing costs and tight credit markets limiting their ability to refinance their debts.



Source: Moody's Investors Service

## What is the outlook?

The outlook for global credit markets remains very uncertain. Sub-prime delinquencies are still rising, banks continue to report increasing losses, and liquidity remains a key issue for central banks and markets.

While the risk of a global slowdown has increased over the last few months and the earnings outlook for banks is uncertain, our view is that the large global banks are not facing the risk of default on their debt, with many recapitalising their balance sheets to further shore up their financial position. There has been a significant repricing of risk, however, and many credits are now paying very attractive returns for their risk.

## What opportunities has this created for investors and fund managers?

The widening of spreads globally has resulted in a downward revaluation on most of the existing assets in managed funds and investors' portfolios. While this capital revaluation has reduced returns over the past year, it has not affected the levels of income from the assets.

The revaluation effects reflect the general widening in corporate spreads rather than significant deterioration in the underlying credit fundamentals of the majority of corporate bond assets. As a result of this widening of spreads, the average yield on managed funds and investors' portfolios would have increased substantially.

The turmoil in the markets is presenting significant opportunities for patient investors. Fire sales, cross border/currency anomalies and a re-evaluation of the spread between credit derivatives and bonds are all providing great opportunities. Some observed opportunities include:

- selling one company's subordinated perpetual notes and buying their senior debt at wider spreads. This will achieve a better return and reduce loss risk by moving higher up the company's capital structure
- unwinding long positions in the credit derivative market and replacing it with bonds of the same corporate credit with similar term at much better levels. Not only does this give exposure to a known bond and more return, but it is likely to deliver reduced volatility in revaluations, and
- selling foreign issuers who have issued bonds domestically in A\$ and buying the same issuer's bonds in US\$ which swap back to A\$ at better spreads. This also has the benefit of increasing the liquidity of the bond holding as the holding is now held in the 'home market' of the issuer where dealers are more ready to make markets in the bond.

Managed funds and investors whose portfolios have maintained a fairly conservative position over the last few years and have avoided the temptation to trade down in credit quality or into longer dated maturities just to grab yield, now have good opportunities. This defensive approach to credit duration and the avoidance of the US mortgage backed securities and structured credit markets would have protected them from the worst of the market sell off. This means that they may now be in a position to take advantage of the opportunities like those above. Managed funds and investors whose portfolios that did pursue yield and are therefore now holding assets that have been severely devalued and offer no liquidity will have to try and ride out the storm.

For managed funds, redemptions are likely to increase for funds that have underperformed because they held large or concentrated holdings in the sub-prime assets and assets subject to the sub-prime contagion. These redemptions have the potential to exacerbate concentration problems as the lack of liquidity in the weak assets will force managers to sell the better, more liquid names to meet redemptions.

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