



Fixed income market dislocations

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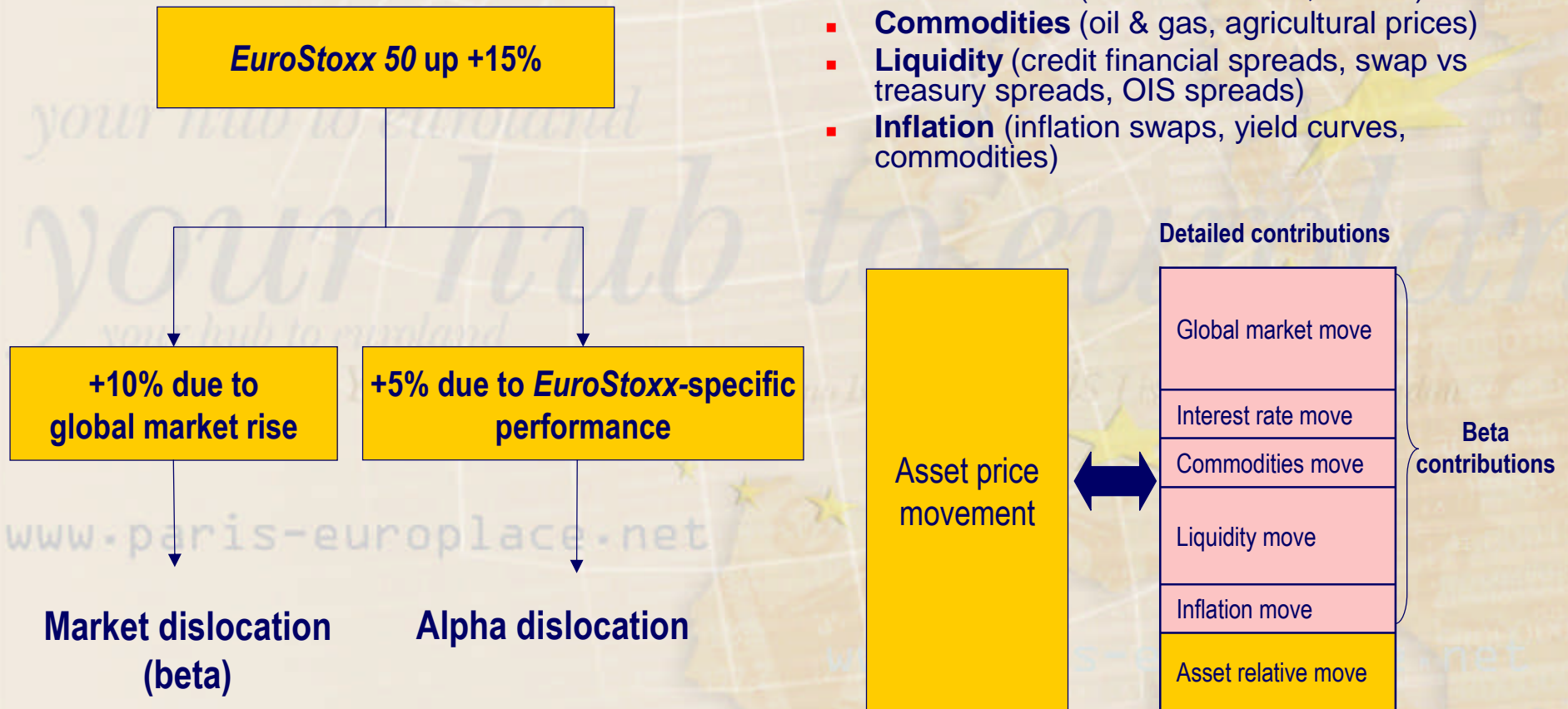
FINANCIAL FORUM

Dislocation: one word, two definitions

An extreme movement which can be absolute or relative

Five indicators are enough to explain most market movements

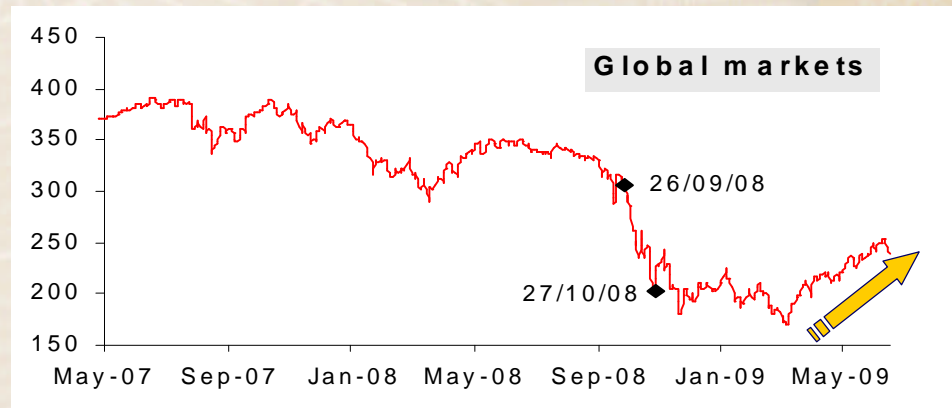
- **Global market** (equities, credit, volatility)
- **Interest rates** (short-term rates, curves)
- **Commodities** (oil & gas, agricultural prices)
- **Liquidity** (credit financial spreads, swap vs treasury spreads, OIS spreads)
- **Inflation** (inflation swaps, yield curves, commodities)



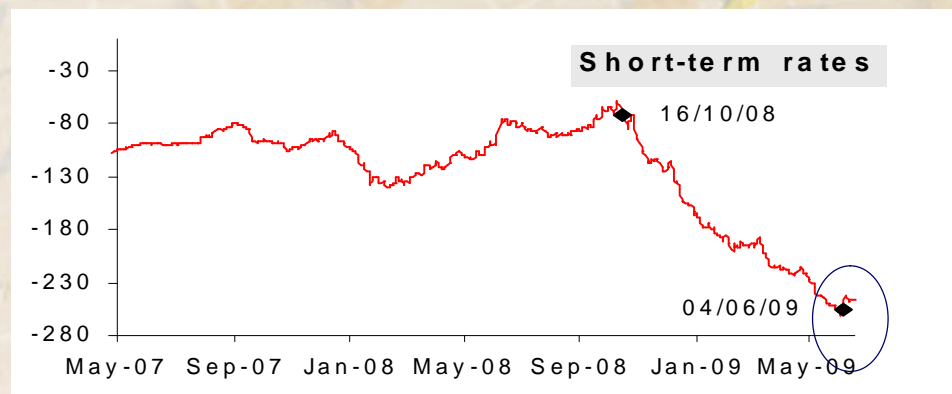
Market indicators



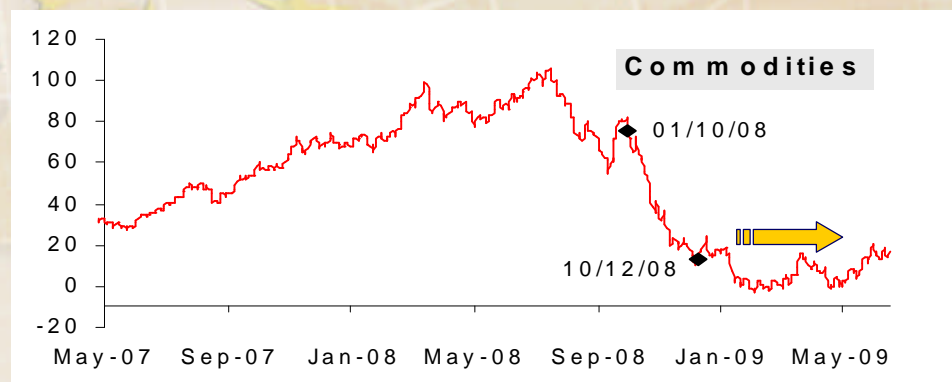
- Global markets have recovered half way since Lehman's collapse



- Interest rates have fallen steadily with monetary easing policies



- Commodities: a difficult rally



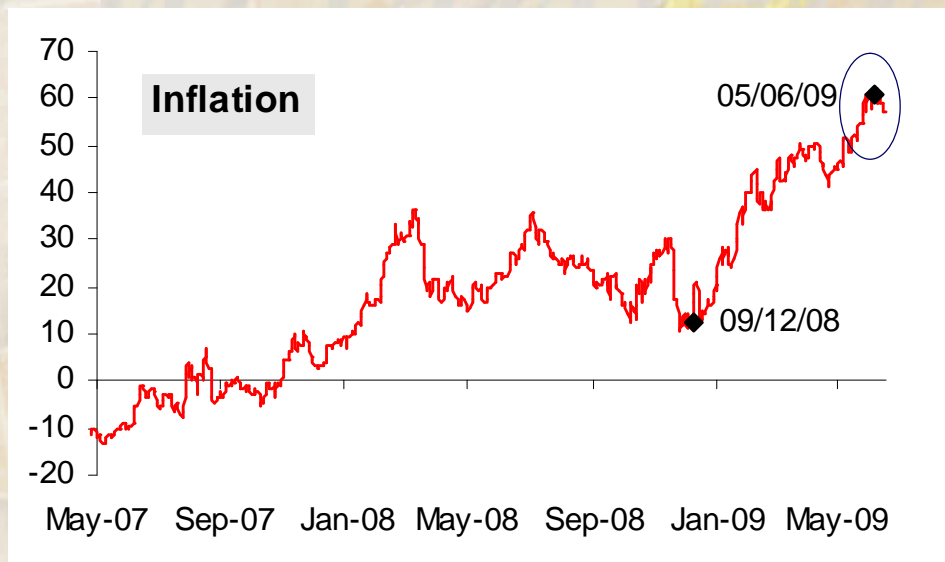
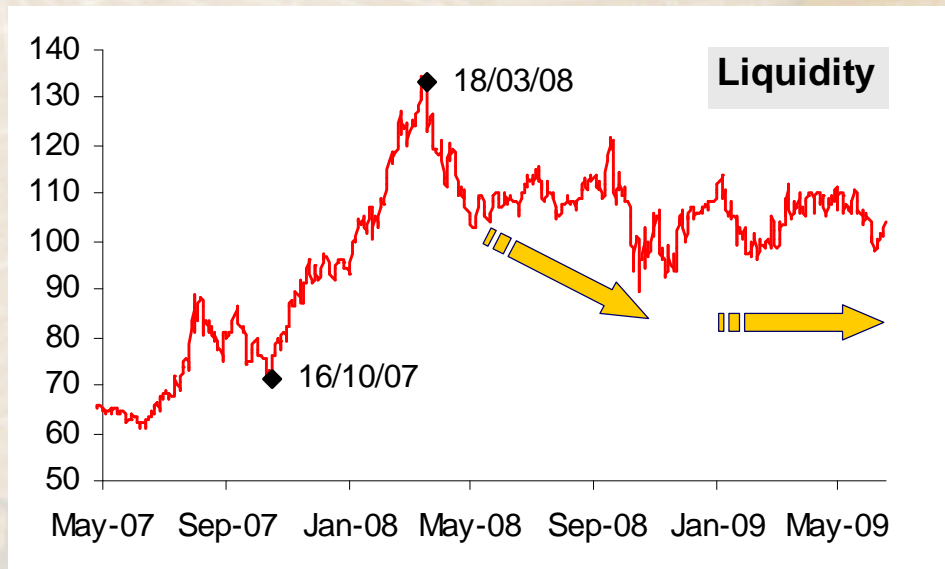
Market indicators



- Liquidity risk has improved since the Bear Stearns bailout, but has remained under stress since Jan 09

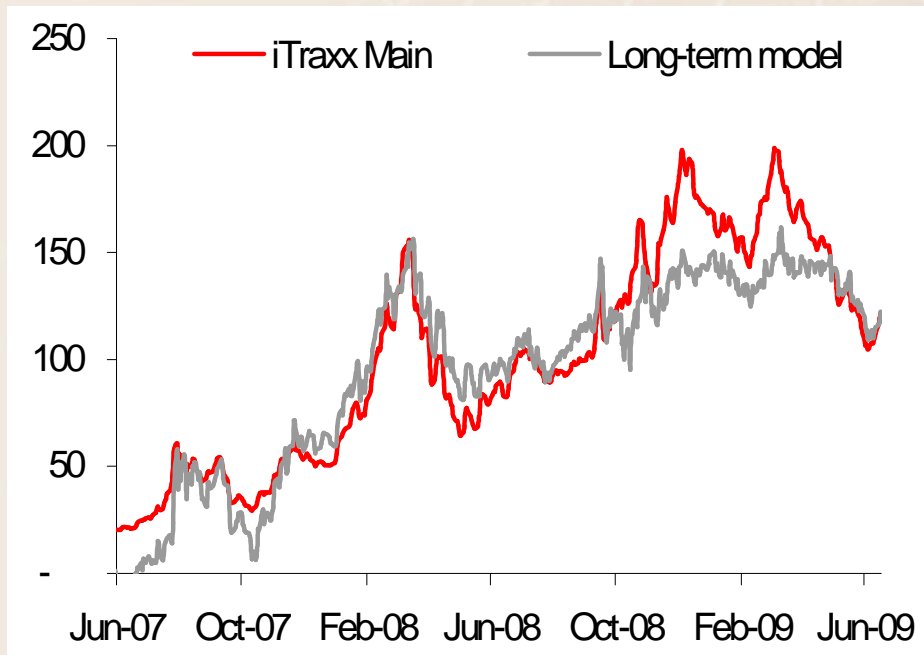


- Inflation risk has exploded since the beginning of 2009

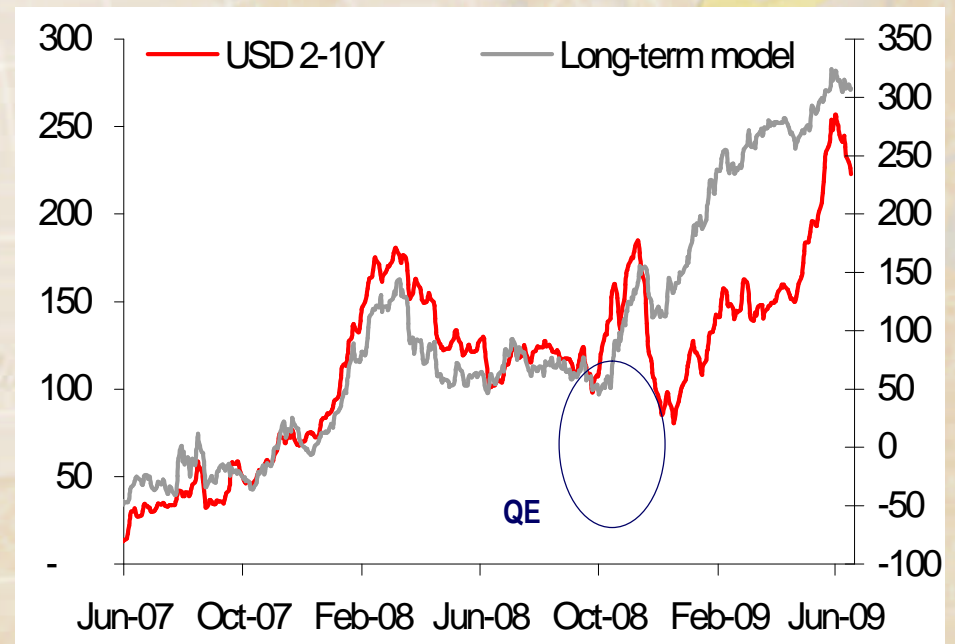


Alpha dislocations at top-down level

Credit spreads (especially financials) overreacted after Lehman. This dislocation corrected in May-June 2009.



Yield curves flattened due to Quantitative Easing (QE) at the end of 2008. This dislocation has since partly corrected.



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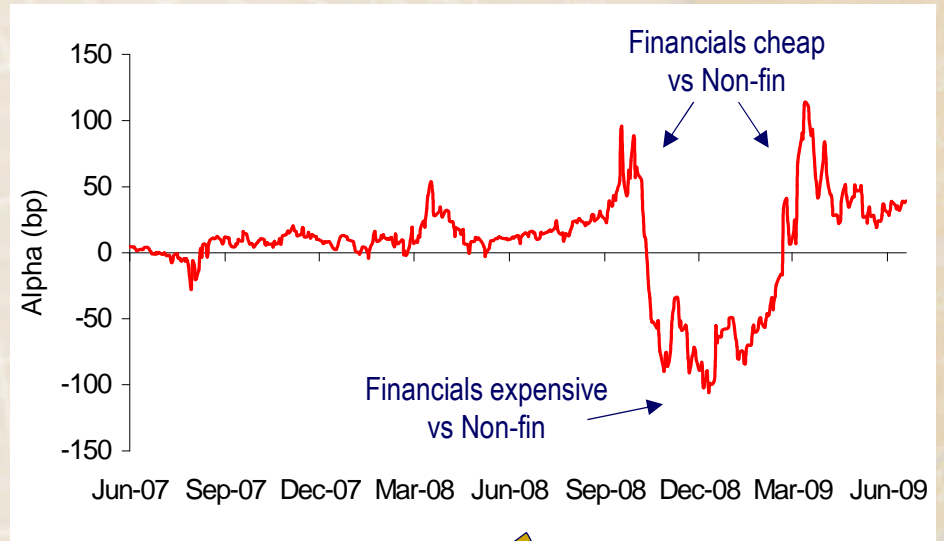
Credit dislocations

- Credit sectorial indices have suffered massive dislocations
 - Cheap financials signals concerns about the banking system
 - Cheap cyclicals signals concerns about the economy

Cyclicals (most impacted by economic cycles) vs others



Financials vs corporates



Crisis has transferred from the financial world to the real economy...

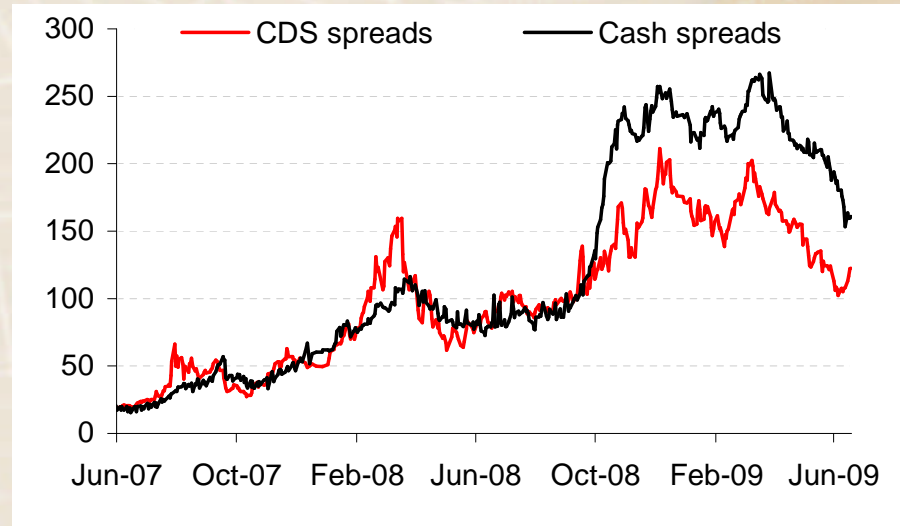
... and back again...

... what's next?

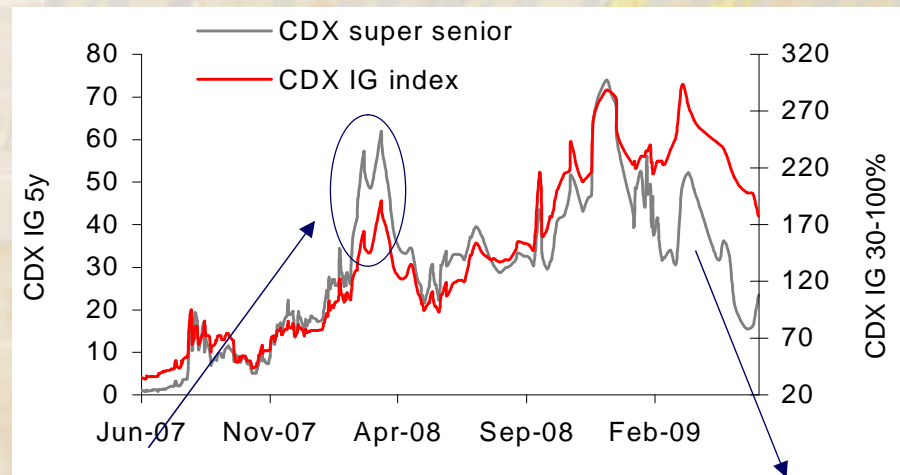
Credit dislocations

- Cash credit spreads exploded vs CDS spreads (swaps) after Lehman's collapse because of
 - funding costs
 - counterparty risk
 - liquidity issues

This dislocation has started to correct but remains strong



- The most senior investments have been extremely volatile
 - Super senior CDOs were used as a proxy for systemic risk
 - This dislocation has corrected but still has some potential



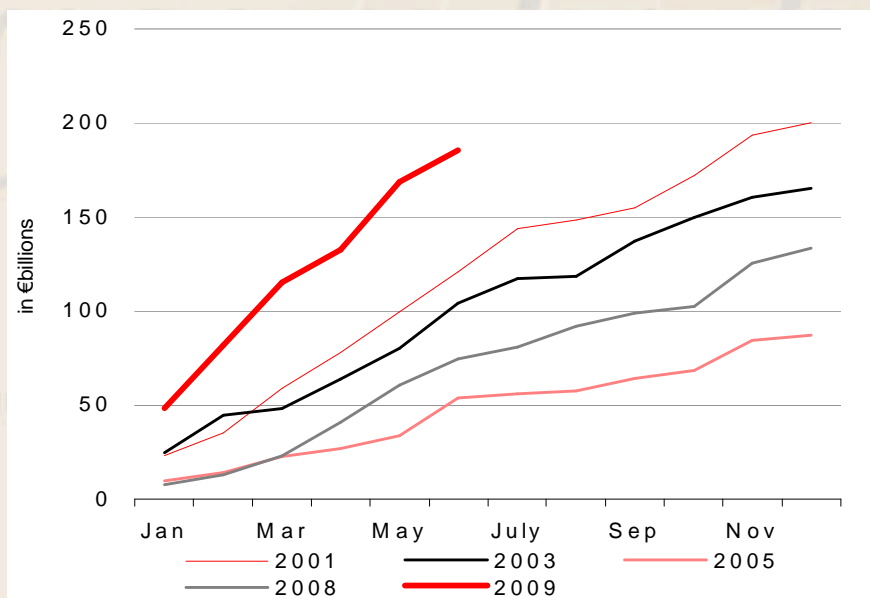
Systemic fears reach a climax following BS bailout

Dislocation has mostly corrected

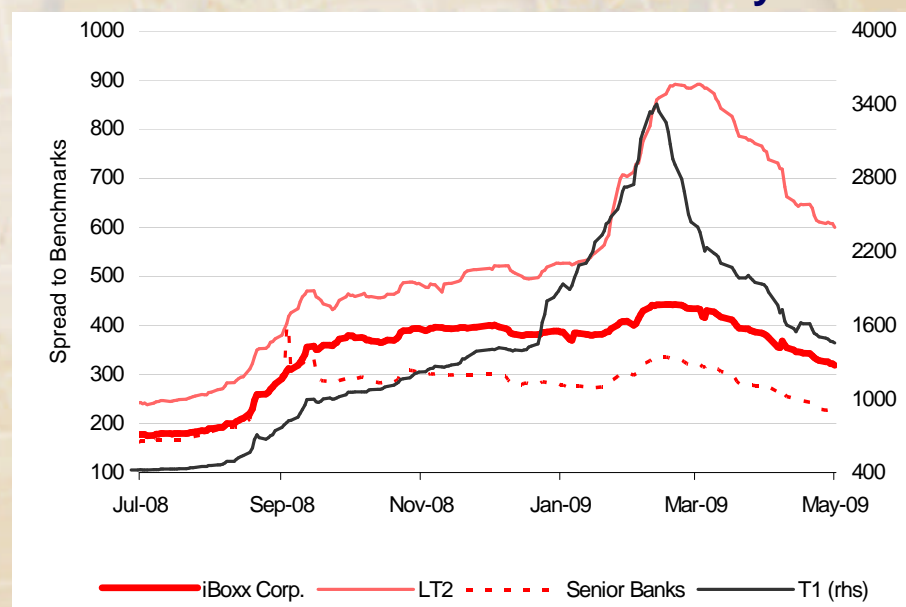
Inflexion or turning point?

- Q1 stock market recovery may herald a turning point - need for clarity on success of monetary/fiscal/QE measures and on the exit...
- In credit markets, there is still a dislocation between high grade non-fin. corporates and everything else, but financials are beginning to recover

Primary market supply set to break records

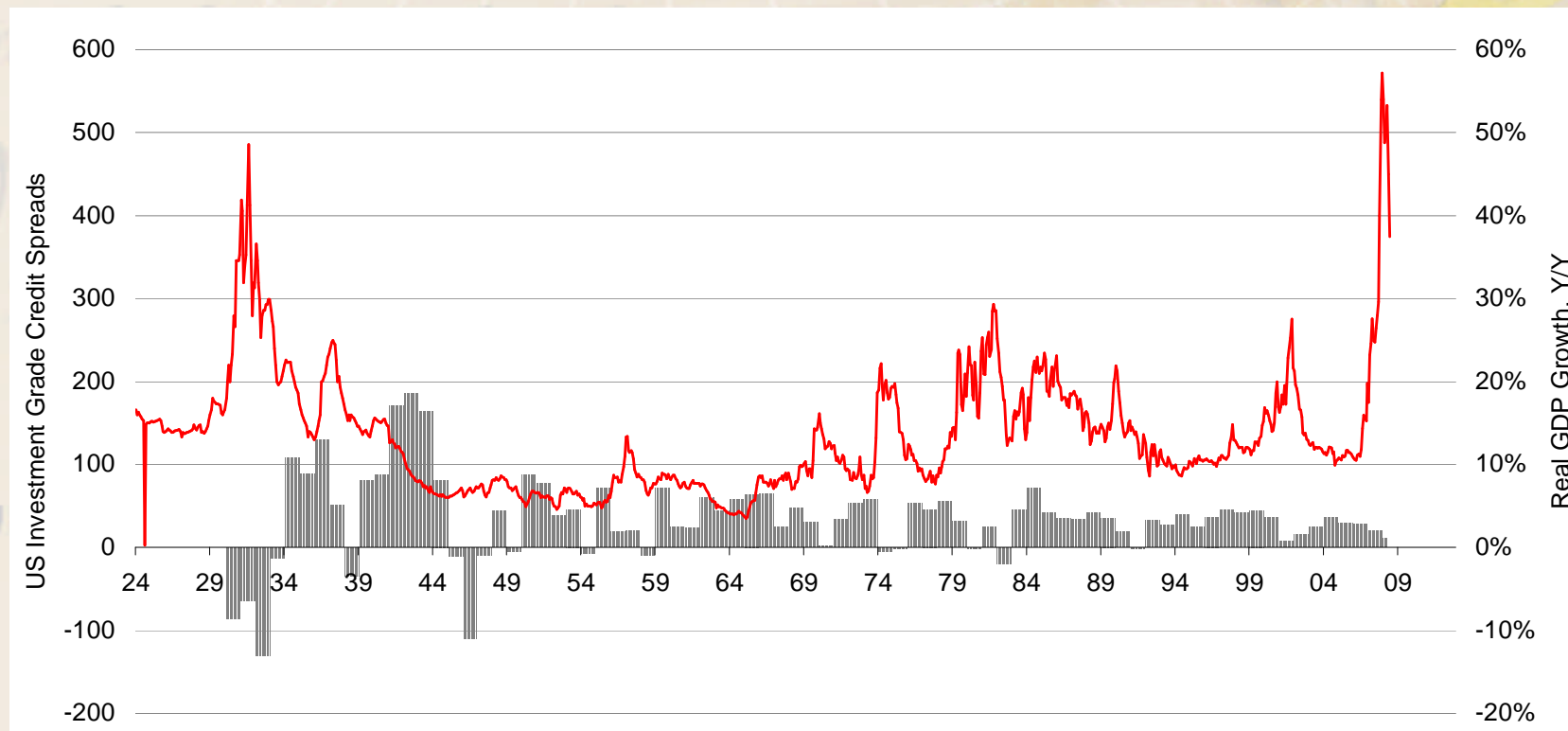


Subordinated financials push cash index wider but aid the recovery



Long spread history confirms overreaction

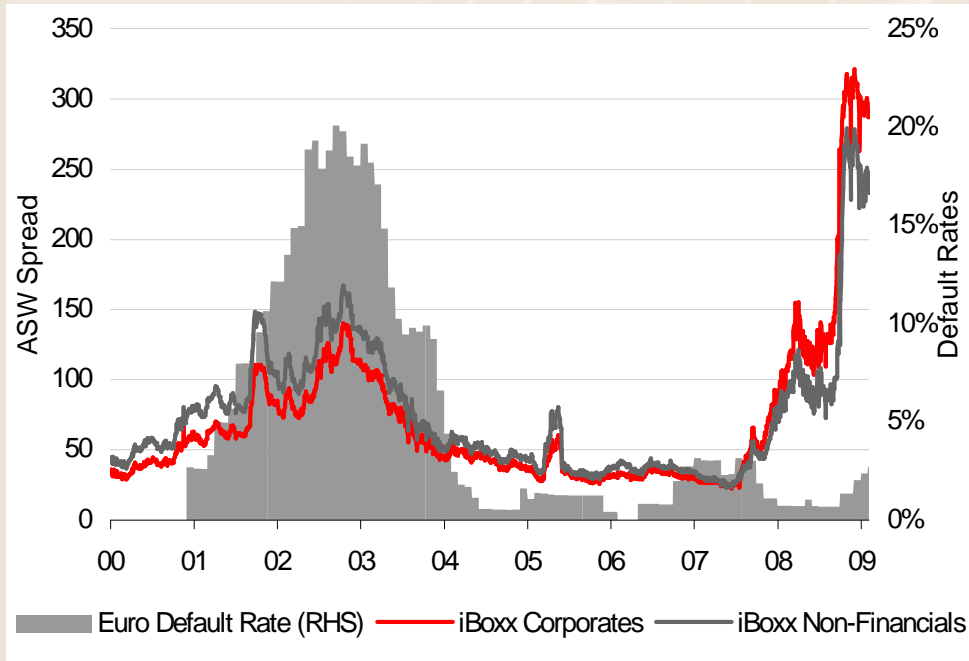
- The omens do not presage risk asset performance into a weakening economic environment
- GDP swung from -13% to +13% between 1930 and 1936 – expect nothing like that now, but a severe spread reaction



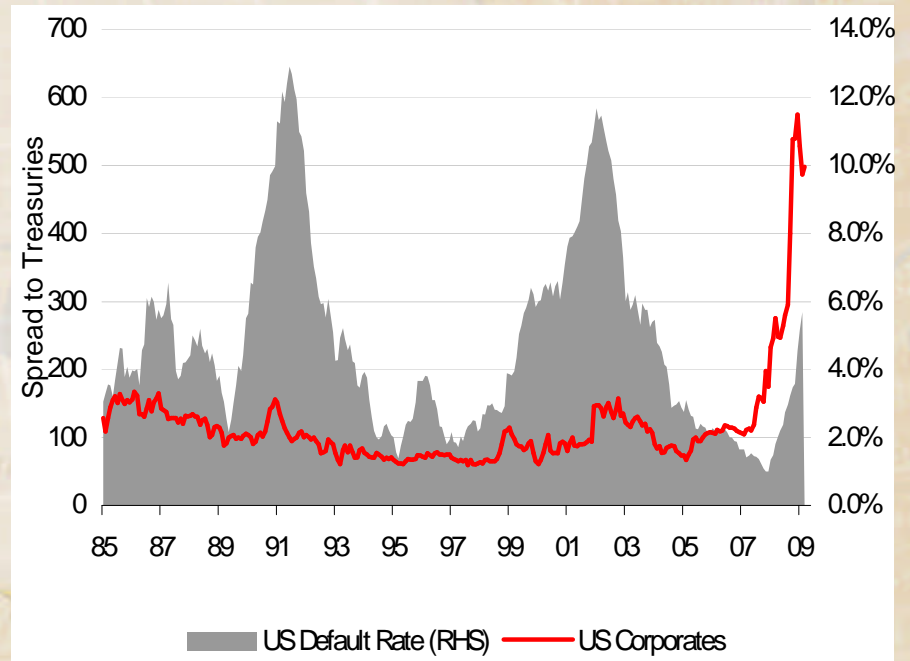
Source: Various, SG Credit Research

Spreads extremely high compared with default rate

In Europe...



... and in the US

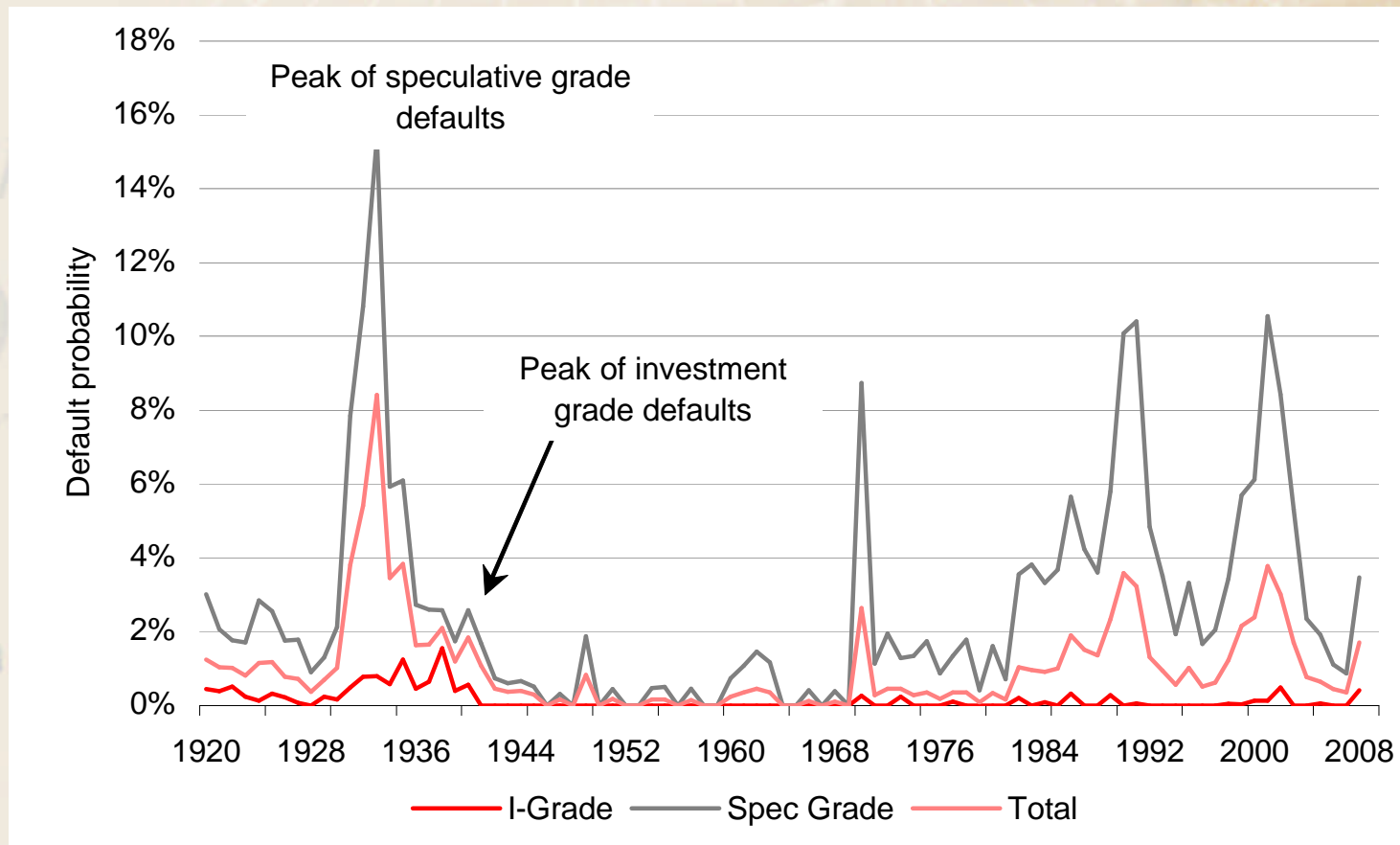


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...but defaults set to increase

- Speculative default rate lags the economic cycle by 4-7 months

History of default rates

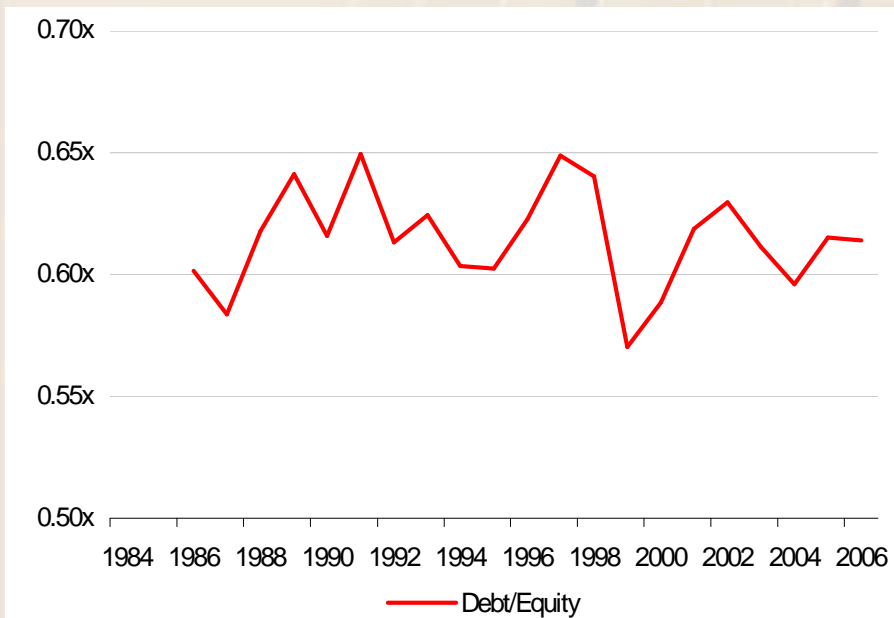


Source: SG Credit Research, Moody's

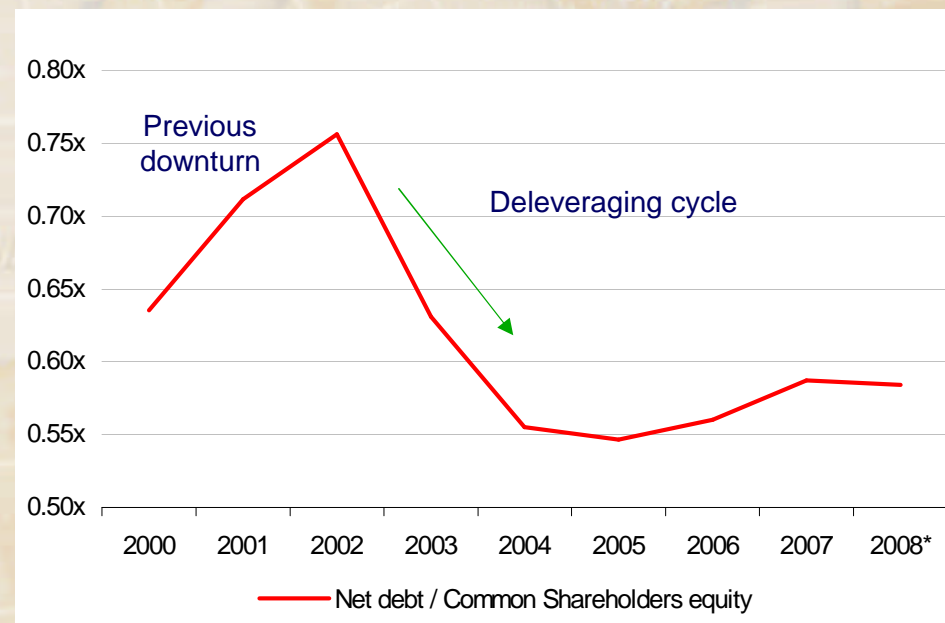
Corporate sector heads into downturn in better shape

- Excess liquidity conditions in 2003-2007 and productivity gains boost balance sheet deleveraging
- Corporate sector balance sheets in much better shape

Debt/equity lower



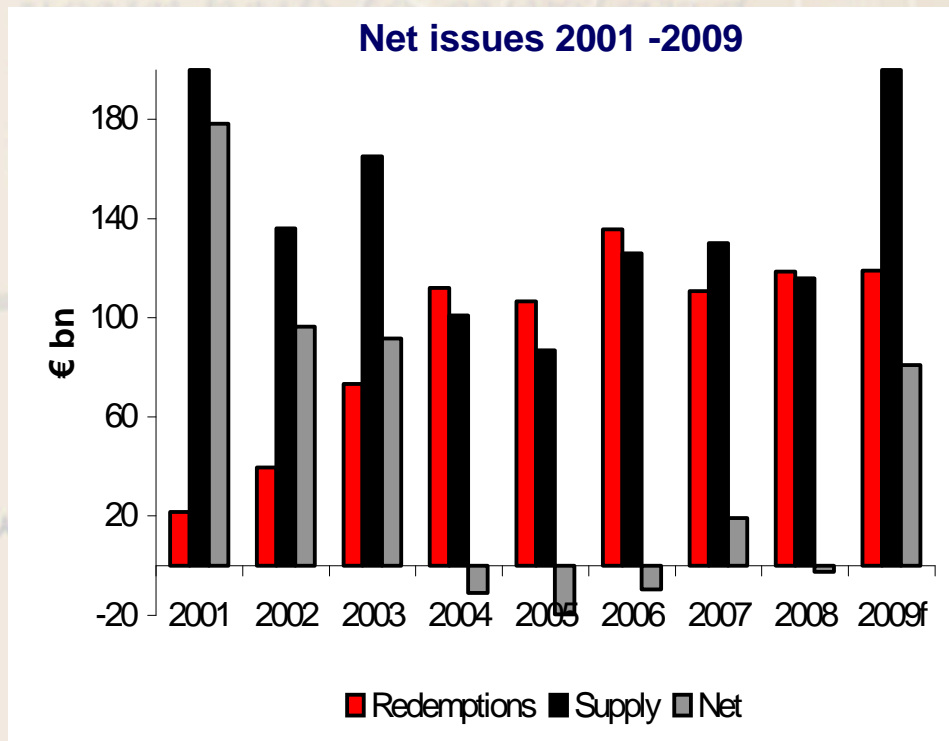
Net position much more supportive



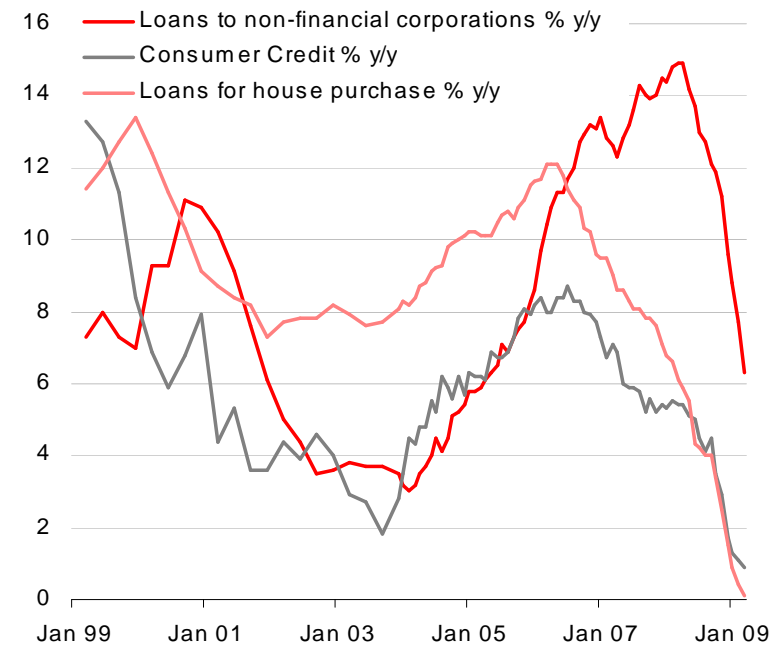
Source: SG Credit Research, FTSE 500

Market financing replacing bank lending

- Deleveraging by banks is ongoing; the impact on the economy is still limited as public financing is supporting the recovery
- The disintermediation trend will continue, as regulator pressure on capital will be long-lasting - though governments are still asking banks to finance the whole economy



Lending by monetary and financial Institutions



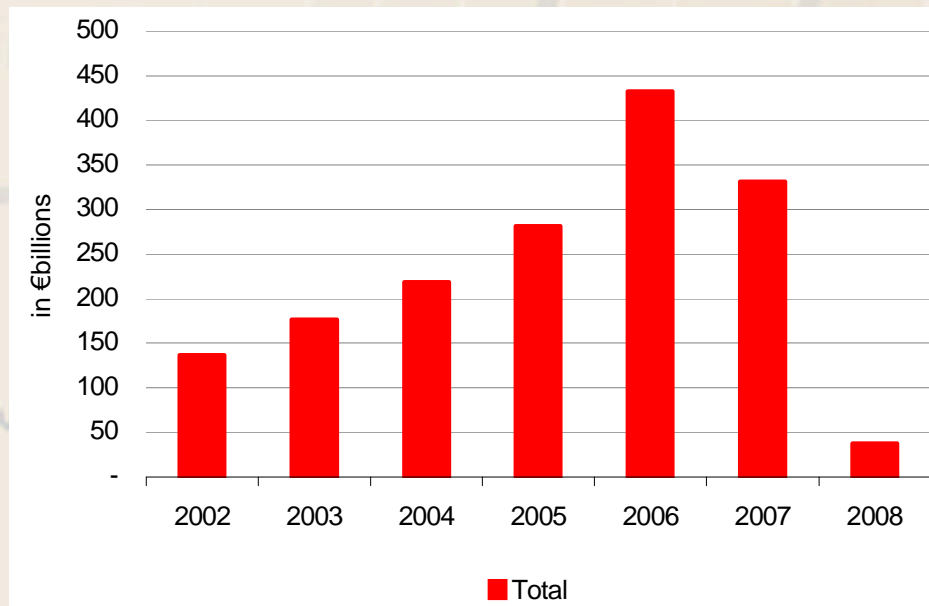
Source: ECB, Datastream, SG Economic Research

Source: SG Credit Research

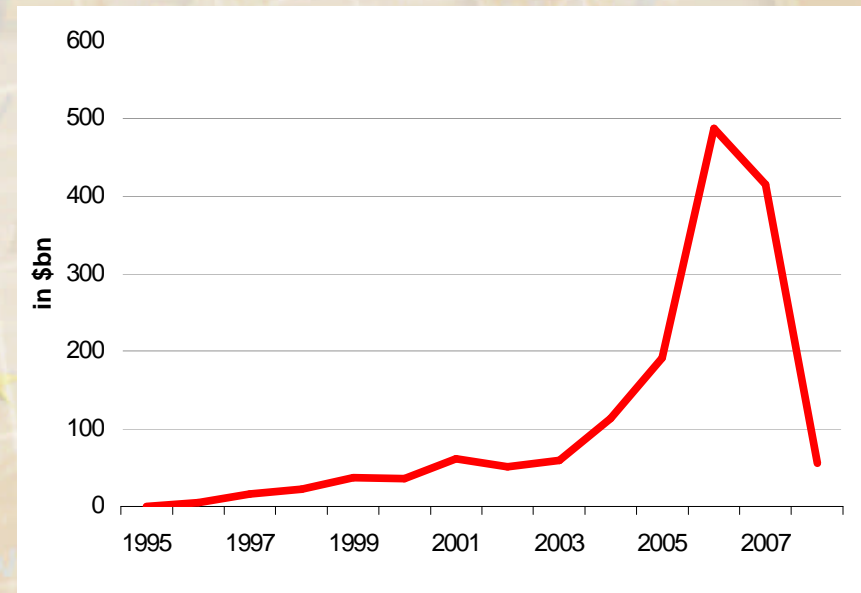
Usual marginal buyer is absent, which will limit recovery potential

- Hedge funds were the predominant marginal buyer of risk in 2003. Replaced by structured credit bid in 2004-2007, today by private banking?
- Depressed issuance of structured products in 2009 is leading to contained spread recovery

ABS issuance drops and marginal buyer fades



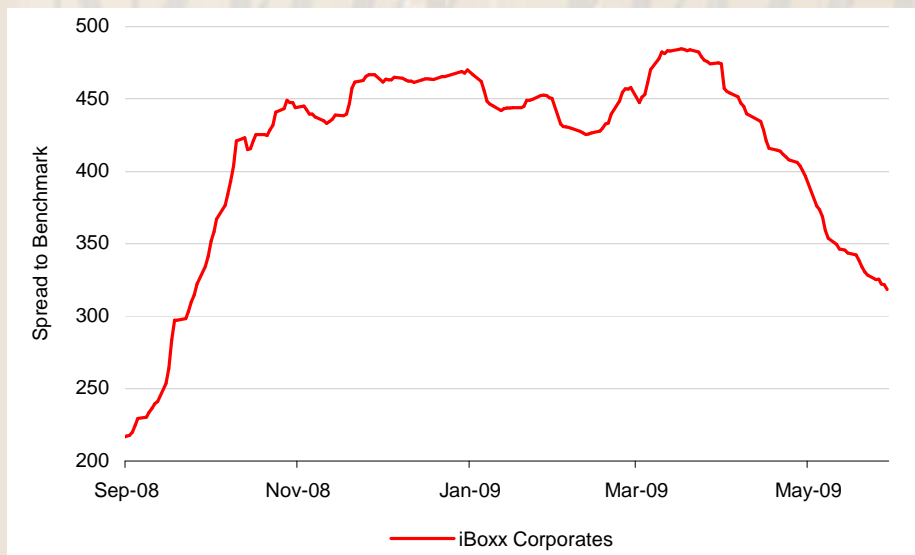
Demise of CDO removes the other marginal buyer



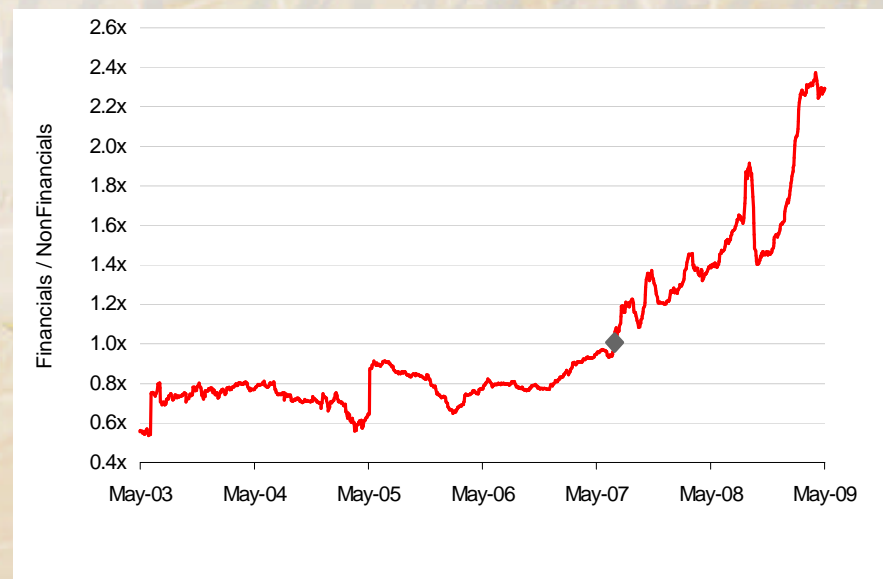
Credit begins to recover in March 2009

- Financial crisis engulfs credit and banks/insurers take the pain: corporates hold firm
- Subordinated debt recovery in March sees tightening at the same rate as non-financial corporates

iBoxx index recovery well entrenched



iBoxx cash financials vs non-financials

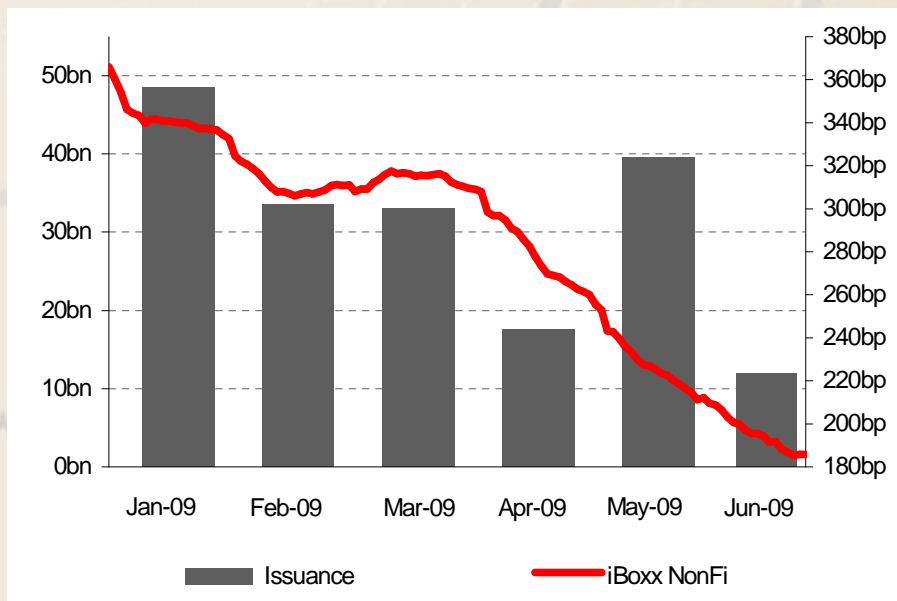


Source: SG Credit Research

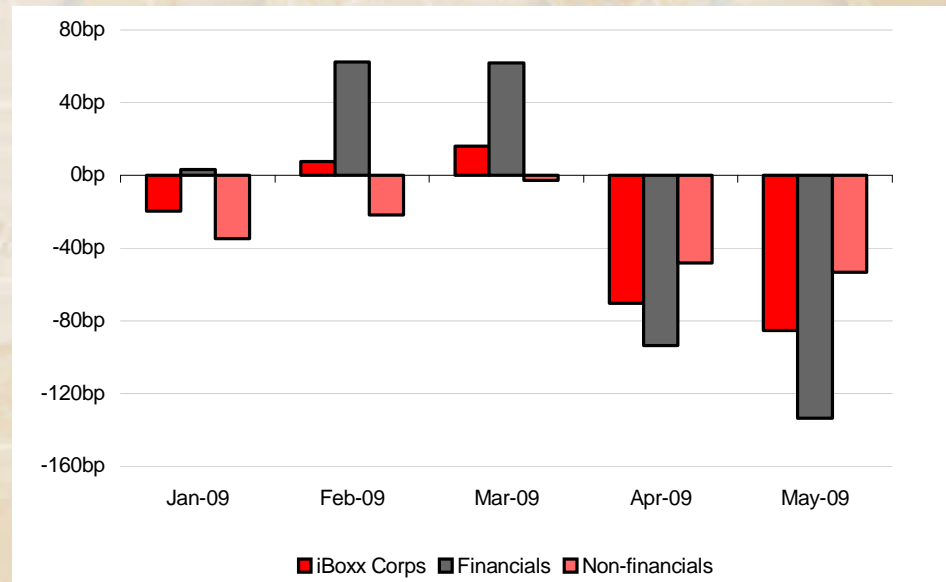
Secondaries tighten faster

- The relative “lack” of new issue product forces a move into the illiquid secondary market
- Supply and demand economics push spreads to tighten by the biggest margin this year in April

Primary supply versus non-financial secondary spreads

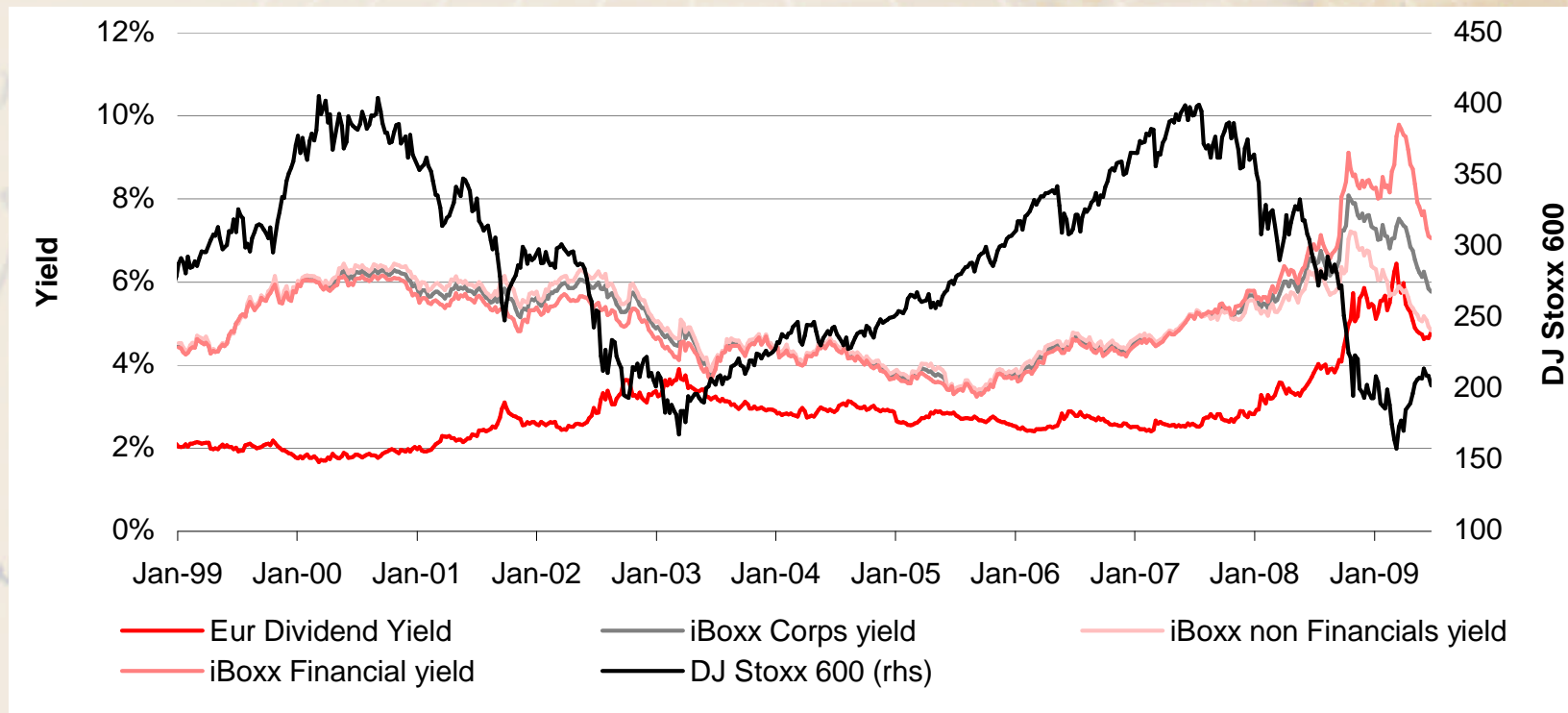


Spread changes on a monthly basis



Credit: all that glisters is gold?

- Asset reallocation rather than IG asset deterioration is the biggest risk for sustained spread weakness
- HG investment grade credit remains the asset class of choice



Source: Various, SG Credit Research

Highest total returns YTD 2009

- Equities hit multi-year lows, but recovered from April onwards
- High yield boasts the biggest positive return of any asset class

