

Where next for credit?

2007 was big and ugly. But how will the themes it introduced play out in 2008?

Euan Hagger asked a panel of senior investment managers for their assessment

Q What will happen to credit spreads in 2008?

Jim Finkel: Credit spreads should progressively widen over the course of 2008 due to increased defaults and lower credit availability, which will be more pronounced in the sub-investment grade sector.

We expect greater volatility and index trading to remain the focus. The US subprime mortgage 'hangover' will be a prolonged headache as periodic negative news will continue to suppress confidence.

Continued announcements of government interventions and public-private bailouts will do little more than temporarily buoy the market. Clearly, the extent of credit spread widening is dependent on a US recession, which is still anybody's question, but is looking more likely.

Jamie Stuttard: We expect credit spreads to remain volatile in the first half of 2008. Volatility will – at the wider end of the range – offer cyclically very attractive entry levels into default-based credit products.

Why cyclically attractive? With global high yield spreads trading at 4.5% to 5.5% above risk free rates, (assuming 30-40% recovery rates) a default rate of above 6.5%-9.25% is already priced into credit markets. Default rates will rise in 2008, economic activity will slow and volatility will remain. But with credit spreads in their cheapest half of the cycle, risk compensation and investment opportunities to lock in spreads for the long-term have improved.

George Marshman: We believe that credit spreads will be tighter at the

end of the year than at the beginning. This is largely because the market has over-sold bank and other financial spreads, pricing in a severe recession.

Miguel Ramos: We expect unsecured spreads to stay within a range, with current levels (for example, iTraxx Europe at 52bp, iTraxx Xover at 348bp) somewhere between the middle and the tight end of this range. Equity markets have been too optimistic: fears of a US recession are likely to increase, the real estate markets in the UK and Europe will suffer from negative news flow and the solution to the liquidity crunch in the "shadow banking system" will be long and painful. We'll see, however, significant dispersion in terms of single issuers and sectors.

We are more optimistic in secured credit. Loans have suffered more

than proportionally from the liquidity crunch.

Jim Irvine: Referencing structured credit, 2008 will see a gradual tightening of spreads, particularly in European ABS, commencing perhaps in late Q1 or early Q2. The lack of forced sellers, coupled with a dearth of new supply will be the driving force.

Greg Stoeckle: We expect credit spreads in the loan market to go wider as the new issue market aligns with the effective spreads of the secondary market.

Q How will subprime write downs from banks play out?

Marshman: The financial sector faces several challenges in 2008. First, write-downs and losses will continue in the near term. Second, impaired balance sheets will reduce lending and securitisation activity.

Third, mortgage lenders will continue to struggle and more non-banks are likely to exit the mortgage industry (including the brokers). Fourth, falling home prices and reduced homebuilding activity could put the US in or close to recession.

As consumer credit worsens, banks will be faced with increased balance sheet pressure and, eventually, rating agency pressure. We expect a major recapitalisation of the banking industry throughout 2008.

However, a strong counter-current of remedial measures being taken by the US government and large private institutions will support and alleviate the potential crisis in the US banking system.

Finkel: Banks are still adapting from

The panel

Jim Finkel: a partner of New York-based alternative investment manager Dynamic Credit.

Jim Irvine: London-based head of structured credit at investment manager Henderson Global Investors.

George Marshman: Stamford, Connecticut-based CIO of alternative fixed income asset manager Aladdin Capital.

Miguel Ramos: London-based managing partner of credit specialist asset manager Washington Square.

Greg Stoeckle: New York-based head of bank loans at Invesco.

Jamie Stuttard: London-based head of structured credit at investment manager Schroders.

previously being in the structured finance “moving” business to being in the structured product “storage” business. Banks will continue to contend with re-evaluations of their complex subprime holdings contained within CDO positions. Financial institutions with smaller positions will likely develop mark-to-market/risk management fatigue and sell. On the other hand, institutions with larger positions may prolong their situations with a



“A different form of bid list will surface from time to time: banks in denial”
Jim Finkel

view towards a global (potentially structured) solution.

A different form of bid list (a banks-in-denial list) will surface from time to time as the loss purging continues. There will be a gradual bridging of the bid/offer gap between banks and investors, but that will happen incrementally and idiosyncratically.

Clearly, one of the biggest risks for financials in 2008 is their exposure to the monolines. To the extent the monolines lose their claim-paying ability, the banks will be forced to recalculate their exposures on subprime ABS and subprime-backed CDOs.

Ramos: It is tempting to think that banks have taken advantage of the current market environment to completely write off their subprime exposure and manage future expectations. The reality is that the initial write-downs of subprime (ABS or CDOs) are just the beginning.

The potential impact of mono-

lines being downgraded is not priced in: at the moment 91,000 triple A securities are on review for downgrade based on this possibility. This is the \$1 trillion problem. The ECB and Fed are providing liquidity to banks to finance assets to the tune of \$500 billion [in the week beginning 17 December]. But mismatched funding vehicles, which were created to absorb a large portion of this debt, are gone for good. Are central banks going to finance these assets permanently?

Irvine: Bank write downs (subprime, CLOs, ABS, correlation etc) are currently severely limiting most banks from taking on such exposures. Ultimately that position will change and risk takers will resurface in 2008.

The write downs suffered will result in: bank spreads remaining wide; more ‘private’ securitisations; the death of CDO squared structures; far less by way of market value type deals; reduction in leverage; longer lock-in periods (hedge funds/opps funds); and far less warehousing of structures by banks. That will leave a risk opportunity for others to take advantage of – banks needing to recapitalise and/or consolidation within the banking sector.

Stuttard: UBS and Citi have already illustrated a process of rehabilitation that has played out at many financial institutions when material losses begin to emerge.

This process follows several steps moving from an initial period of denial, to market speculation of how big losses will be, followed by write downs, asset reductions and disposals, dividend cuts and ultimately rights issues/ announcement of strategic investments. We expect this process to be repeated across financial institutions that have been involved in the affected areas.

We would caution that the liability sides of banks actually pose more immediate problems than the asset sides and as such we continue to

favour large banks with diversified funding sources over small banks.

Stoeckle: There will be constrained appetite for risk and tighter credit standards across the board.

Q Where will the greatest areas of value be next year?

Ramos: Structured credit has suffered from its reliance on ABS subprime collateral and “non-traditional investors”. As such, forced selling and liquidation have been indiscriminate. We see great opportunities in specific areas such as secondary CLO tranches.

Finkel: Obvious value plays are in discounted senior tranches of subprime RMBS, but also in non-subprime assets where prices have been dislocated due to general lack of liquidity in the market, such as mezzanine CLO tranches.

More than finding value through discounts, value will be created by those who can obtain and structure alternative and stable forms of financing. Value also will be found in increasingly complex “situations,” rewarding those who have the combined attributes of sourcing through relationships, highly developed analytics, and sophisticated, cross-disciplinary credit skills.

Irvine: Some of the best opportuni-



“The initial write-downs of subprime are just beginning”
Miguel Ramos

ties will be found in ‘stressed’ (not distressed) European ABS. Europe is guilty by association with the US. Purchasing relatively short duration, deeply discounted secondary pieces

of triple B and double B assets that will benefit from both a tightening in spreads and the 'pull to par' could be one of the better trades to put on for 2008.

Stuttard: On the long side there are a number of options. Firstly, financials are the area of greatest value but also highest risk, requiring significant bottom-up credit research and discrimination.

Secondly, European credit indices have widened by the same ratio as the US. In many places this is not justified and affords some opportunity for those that can withstand volatility.

Thirdly, curves have flattened significantly. For deteriorating and distressed credits this is fair enough and to be expected. However, hedging of either loan risk or jump to default has in cases led to curves that are too flat relative to sound fundamentals, offering good opportunities in selling protection in 5-year or even in 3s in certain specific names.

On the short side we see two areas. Corporate credit single names have generally widened much less than financials. For cyclically vulnerable names such as cyclical retailers and certain industrials, this offers opportunities to get short.

In addition, brief and temporary market rallies should offer opportunities to re-short vulnerable and cyclically sensitive names that have widened significantly in 2007.

Marshman: The greatest value to be found in credit markets in 2008 will be in the financial sector.

Although there are problems related to the subprime market and related derivative products, we think there is little likelihood of a major failure. Thus, with financials priced for an exceedingly grim scenario, we expect a reversal of the excessive selling of bank, broker, and mortgage insurance company credits.

Stoeckle: Bank loans are a compelling value and have been oversold.

While defaults are likely to revert from today's historic lows to more historically average levels, this is already priced in to the market and covered by collateral protection and capital structure seniority.

Q What is the outlook for the CDO market?

Irvine: The market will demand simplicity in structures going forward. CLOs are likely to be the first asset class to be issued in any size or with any regularity in 2008.



"Bull market demand was abused, which has tarnished client trust"

Jamie Stuttard

It will be a transitional year. New triple A buyers (it's been SIVs and conduits for the last 15 years) need to be found. Bank buyers may be attracted by new Basle rules; mezz (triple and double B) buyers may come from real money funds attracted by the pull to par of secondary pieces; new issues may be structured as deeply discounted for the same reason; issuance trends will change dramatically (banks will only issue at cost effective levels).

Finkel: The structured finance CDO market will remain dormant until confidence in the ratings process can be rebuilt, which could take up to two years. Underwriting at the collateral level, as well as structural credit enhancement, will have to undergo significant reinforcement. The CLO market will struggle given the miniscule funding gap that currently exists between assets and liabilities, and the lack of willingness of investment banks to commit capital and

take the risk to open warehouses.

Increasing default levels will surely suppress recovery of new issue volumes. Secondary trading will continue. However, volumes will remain light and most business will be done "by appointment". CDO asset manager replacement, as well as consolidation, looms on the horizon. Fully synthetic CDOs are most likely to emerge first, and deals by another name (perhaps called "managed securitisations?") will follow.

Stuttard: Good structures include the following important themes: sensible design for liability sides, short buckets, contained leverage, deep thought before the use of triggers, liquid underlyings in particular focusing on synthetic rather than cash.

We think certain client types have a natural demand for well designed and well managed products that utilise extensive global credit research, quantitative, structuring and portfolio management skills. This opportunity was abused in our view in the late phase of the bull market, which has tarnished client trust.

Marshman: The CDO structure is a natural and efficient risk distribution and funding mechanism and we expect it to therefore continue to thrive under different credit regimes over the long term. We expect that, in the short term, issuance will come to market in more simplified formats.

Investors will continue to invest in CDO monitoring and analysis tools to extend their own analysis and monitoring of transactions. Investor expectations of asset managers will also increase. Investments required in personnel and technology, as well as selectivity on the part of investors, will result in consolidation among CDO managers.

Alongside the continued pipeline of CDOs backed by leveraged loans, middle-market enterprises, synthetic investment-grade corporate risk and other relatively traditional corporate credit asset classes, we expect to see

a further development in, and emergence of new, alternative CDO asset classes. These might include the pooling and tranching of insurance risk, private equity and hedge fund CDOs, municipal bond CBOs, commodity linked CCOs, and perhaps some EDS-backed transactions.

Also, as some mortgage backed CDOs hit ratings triggers and/or are unwound, we expect legal challenges to pickup regarding diverting of cash flow to senior debt holders. This action will help to set a stronger case history for future transaction documents and, after some short-term uncertainty, create a more stable and predictable legal framework.

Ramos: There is very little demand for structured finance rated debt and secondary market supply continues to be massive. The ongoing liquidation by structured credit vehicles will continue into 2008. In this environment, there is little scope for new issues. The focus will be in the secondary market.

Stoeckle: The market will certainly be muted in 2008 but as investors differentiate underlying collateral classes we expect to see some new



“We expect a major recapitalisation of banking throughout 2008”

George Marshman

issue activity with bank loans (CLOs) and investment grade corporate credit (CSOs) leading the way.

Q What are the prospects for monolines?

Stuttard: Firstly, already ACA has

shown that not all monoline insurers are destined to be going concerns. Secondly, we would caution that for monolines, until there is some range of expected losses (when home prices stop falling) all remediation plans are intermediate and confidence is deferred.

Irvine: The market refuses to believe that the monolines could operate at anything other than triple A. That theory may well be tested in 2008 as downgrades look quite likely across the sector.

Marshman: Monolines will be required to implement updated processes and procedures more akin to those common in mainstream structured finance, such as rigorous capital models and frequent and comprehensive reports of holdings.

Along these lines, credit derivative product companies could thus emerge as the more natural providers of credit protection and be accepted as the correct channel through which credit risk should be transferred. Significantly, CDPCs require far greater transparency and disclosure and must have robust capital models to operate.

There will be a consolidation of the monoline sector, with the current nine companies probably shrinking to a more manageable number of three to four.

Finkel: As CDOs go into default and monolines assume control (in their role as controlling secured party), they will find themselves with greater asset management roles and the need to make market and trading decisions, and should be looking to team up with entities having those competencies.

Q 2008 will be a good year for...

Irvine: anyone who invests in a Henderson managed structured product.

Marshman: structures, such as cash and synthetic CDOs and CDPCs, that are not affected by mark-to-

market movements; funds investing in distressed credits, especially those focused on real estate and structured assets; basis and curve trades that take advantage of the market returning to normalcy; hard-asset based sectors like utilities, infrastructure, industrials, energy to outperform media, consumer, retail, leisure and travel sectors and emerging markets;



“European ABS is one of the better trades to put on”

Jim Irvine

and financial sector spreads in the second half of the year.

Stuttard: synthetic versus cash; corporate credit versus ABS; Europe and Asia versus US; actively used short buckets; well resourced bottom-up credit research; Arsenal in the Premier League.

Finkel: taking a hard look at existing exposures; searching out new avenues for capital; expanding product knowledge laterally into new areas; and partnering with others for risk-sharing and capital utilisation in ways not previously seen. It will also give some a chance to get to know friends and family better; and to make up for the time lost travelling and working long hours during the bull market cycle.

Ramos: secondary CLOs being very selective and proactive.

Stoeckle: prudent managers and investors, who adhere to strong fundamental credit disciplines to unlock value in the oversold par loan market; and for distressed managers and investors, who are likely to see more opportunities coming into the market.