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## A Statistical and Qualitative Review of 2009 & 2010 Outlook

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### Background and Market Returns

The capital markets staged a remarkable rally in 2009 after nearly collapsing the prior fall following the demise of several major financial institutions. The unprecedented coordinated global response by central banks provided the liquidity and support that fueled the comeback. The equity and credit markets, which had the largest declines in decades, appeared to have no bottom as investors fled risky assets to the relative safety of cash, Treasuries and gold. After a brief uptick in late 2008, the markets again sold off in the first quarter of 2009 until a rally materialized in early March. Over the last nine months of 2009, risk aversion was cast aside and investors piled back into risky assets. In fact, those asset classes, such as high yield that had sold off the most, rallied the strongest as Exhibit 1 shows.

Index	Q1-09	Q2-09	Q3-09	Q4-09	2009	2009 Excess Returns
Barclays US Treasury <sup>1</sup>	-1.32	-3.02	2.10	-1.30	-3.57	—
Barclays US Intermediate Treasury <sup>2</sup>	-0.29	-2.14	1.66	-0.61	-1.41	—
Barclays US Long Treasury <sup>3</sup>	-5.23	-7.14	4.53	-5.33	-12.92	—
Barclays US Corporate <sup>4</sup>	-1.93	10.45	8.12	1.35	18.68	22.76
Barclays US Intermediate Corporate <sup>5</sup>	-0.07	9.12	6.71	1.89	18.56	19.78
Barclays US Long Corporate <sup>6</sup>	-7.26	14.75	12.54	-0.27	19.44	31.74
Merrill Lynch High Yield Master II <sup>7</sup>	5.02	23.19	14.82	6.04	57.51	59.55
S&P 500 <sup>8</sup>	-11.01	15.90	15.57	6.04	26.46	
VIX* <sup>9</sup>	44.14	26.35	25.61	21.68	—	—

\* VIX is actual level at each quarter end.

Source: Bloomberg

At the center of the storm were financial institutions posting massive losses as mortgage-related securities were marked down. When it became apparent in early spring that the largest systemically important global banks would not be allowed to fail, investor confidence appeared to have been gradually restored. The Troubled Asset Relief Program (TARP) provided capital to most banks and finance companies whether or not they had requested assistance. The Temporary Liquidity Guarantee Program (TLGP) provided funding so that institutions that could not roll over commercial paper or short term debt would not default unnecessarily and escalate the crisis. Other programs such as the Fed's Term Asset-Backed Securities Loan Facility (TALF) were initiated to support the asset-backed and mortgage markets. The price of the help was of course greater scrutiny, criticism and even outrage by the public and politicians. Despite the turnaround in markets, the "Great Recession" left the economy weakened.

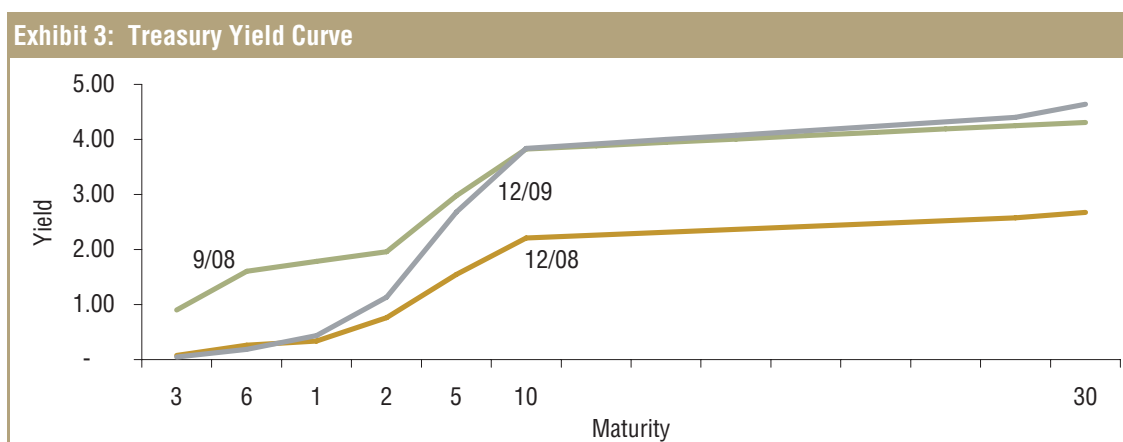
The figures in Exhibit 2 show that returns were highest for the lowest credit quality categories for both investment grade and high yield. Within the investment grade category, most credits rated BBB proved resilient as these were concentrated in stable industries such as utilities, telecommunications, media, railroads, and supermarkets. Ironically, many of the credit issues were concentrated in the higher rated financial institutions. AAA-rated credits, which have become an immaterial part of the market given the secular decline in credit quality, posted negative returns as their tight spreads did not offset the interest rate rise.

Investment Grade	AAA	AA	A	BBB
	-2.57	9.09	15.36	29.02
High Yield	BB	B	CCC	Ca-D
	46.06	44.73	90.65	136.34

Source: Barclays Capital Indices

## A Statistical and Qualitative Review of 2009 & 2010 Outlook

Treasuries, on the other hand, did not fare well in 2009 as the 10-year started the year yielding 2.21% and sold off to end at 3.84%\*. Treasury indices posted losses for the year for several reasons. First, investors reallocated from low yielding securities into riskier securities as quantitative easing accomplished part of its goal of pushing investors into the riskier end of the spectrum. Second, the issuance of over \$2 trillion in government related securities caused rates to be higher at the end of the year due to excess supply. Finally, the debate over inflation vs. deflation intensified over the year with enough concern generated to push yields higher. As Exhibit 3 illustrates, after a brief Q408 rally, Treasuries commenced the sell off at the beginning of the year and while volatile the sell off continued throughout the year. Investors in corporate bonds were able to offset the interest rate loss with spread tightening.



Source: Bloomberg and Standish as of December 31, 2009

Credit spreads widened during 2007-2009 to levels not reached since the Great Depression. In December 2008, the average spread of the Barclays US Corporate Index reached over 640 bps\*. Liquidity was abysmal as dealers shrank their balance sheets and trading in credit markets was hobbled. Many investors refused to sell securities at distressed prices. In most instances, these low prices were not justified by fundamental reasons unless a cataclysmic scenario played out. New issues or secondary paper from the largest issuers constituted most of the trading. A key dynamic that evolved over that period was an inversion of credit curves as Exhibit 4 shows.

**Exhibit 4: Average Spread of Corporate Bonds in 2009**

Barclays Index	3/31/2009	6/30/2009	9/30/2009	12/31/2009	Weighting
Corporate	566	317	225	173	100%
Intermediate	600	330	229	174	75
Long	461	276	214	171	25
10+ vs. 1-10yrs	-139	-54	-15	-3	—

Source: Barclays

Last April, we at Standish Mellon Asset Management Company LLC published a paper titled, “*The Long Corporate Cure for Pension Deficit Disorder – The Eye of the Storm.*” In that paper, we recognized that the eventual tightening of spreads would cause pension liabilities to be revalued upwards. We suggested that if sponsors did not hedge by investing in long corporate bonds, the assets risked underperforming liabilities. Numerous plan sponsors did in fact implement long corporate mandates that had a decisive impact on the market. Consider the composition of the Barclay’s US Credit Index in Exhibit 5.

\* Source: Bloomberg

## A Statistical and Qualitative Review of 2009 & 2010 Outlook

**Exhibit 5: Composition of Barclays US Credit Index**

Credit	\$3,131m	100%
Non Corporate	\$577m	18%
Corporate	\$2,555m	82%
Intermediate	\$1,915m	61%
Long	\$640m	21%

Source: Barclays, based on market not par values, as of December 31, 2009.

The Barclays US Long Corporate index, a good proxy for the investment universe of long maturity bonds, is relatively small at \$640 billion. On the demand side, pension fund liabilities total several trillion dollars. In addition, insurance companies and other investors invest in long maturity bonds. The increased demand in 2009 overwhelmed the availability of paper, precipitating the tightening of spreads in the long end. Since many plan sponsors use high quality bond yields to discount liabilities, numerous mandates were implemented for corporate bonds rated single A or better, thus putting additional positive pressure on that sub-segment of the market.

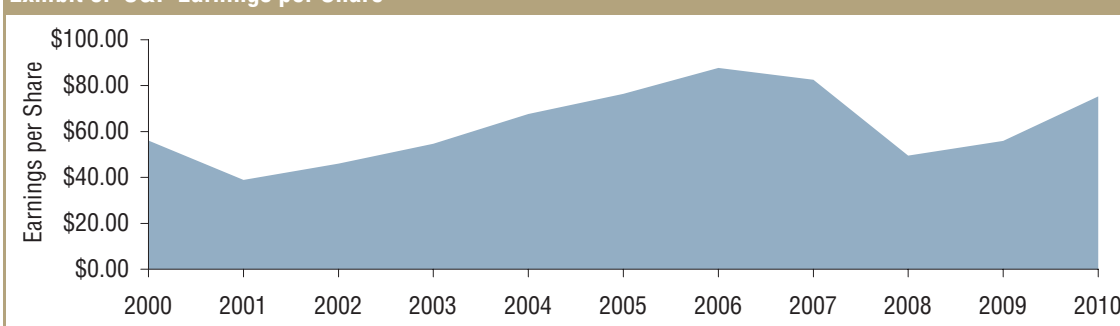
The demand for long corporate bonds was only part of the reason that credit curves inverted over the past few quarters. Since default risk cumulates over time, credit curves are normally upward sloping. In times of distress as we experienced in 2008-2009, front end bonds tend to drop in price to trade in line with longer dated bonds on a price basis. As prices drop in the front end, spreads widen more in front end maturities relative to long maturities. Financial institutions were the culprit for the sell off in the front end, as investors priced in jump to default risk. Exhibit 4 on the previous page shows how extreme the inversion was at the beginning of the year but eventually corrected as the year progressed.

### Fundamentals

The economy was generally weak during the year punctuated by persistently high unemployment and the continued deleveraging of the consumer. The earnings picture remained bleak throughout 2009 as weak demand and deflation in most industries resulted in lower revenues. Companies responded to lower demand by cutting expenses and capital expenditures and strengthening balance sheets. Cash has been built up and margins are improving, resulting in a negative financing gap. Companies, therefore, have the funds to expand, assuming they see a pickup in activity. While the lack of growth may not be ideal for equity investors, bondholders are in an attractive part of the credit cycle. Company management teams are doing the right things to navigate the weak economy and capital markets, placing the safety of the company ahead of shareholder pressures.

Exhibit 6 shows the trend in operating earnings for the S&P 500 over the decade. Earnings appeared to hit a trough in 2009, with a modest rebound anticipated for 2010. Any rebound in 2010 makes the year over year comparisons look optimistic but earnings remain well off the peaks. Earnings grew for 22 straight quarters until 2006, then “fell off a cliff” in 2007.

**Exhibit 6: S&P Earnings per Share**



Source: Standard & Poor's; 2009 and 2010 are estimates as of December 31, 2009.

## A Statistical and Qualitative Review of 2009 & 2010 Outlook

The turnaround in the markets last year was in part the result of a shift in investor sentiment as the worst case scenario was dismissed. Fundamentals played a lesser role in terms of driving returns in the credit markets. Companies took advantage as capital markets recovered early in the year to improve liquidity. As the window of opportunity first opened, issuers tapped the markets to finance front end maturities and in many cases, buy back bonds in the open market or through tenders. While only the highest-rated borrowers accessed the market early in the year, by the end of 2009, even distressed companies were issuing into oversubscribed deals. Concessions on new issues relative to secondary levels were as high as several hundred basis points in late 2008 and had all but disappeared by the end of 2009.

At the peak of the crisis, defaults were expected to continue to rise over the next several years as the loose underwriting of the credit boom caught up with investors. To wit, issuance of Triple C debt accounted for 33% of the new issuance volume in 2007, although it accounted for only 15.6% of the total market at the beginning of that year<sup>†</sup>, setting the stage for increased defaults under a challenging economic and liquidity environment. The leveraged buyouts that were done at the peak of the market had impending maturities that might not be refinanced given the state of the capital markets. When it became evident that even low-rated issuers could tap the markets, the rally in high yield bonds took hold and reversed the downward spiral. The trailing 12 month high yield Moody's US default rate fell to 13.2% by issuer and 16.5% by par through December 31, 2009<sup>†</sup>. Our expectation is that defaults will be in the range of 4-6% in 2010, making high yield attractive at current spreads.

The companies and industries with the grimmest prospects at the beginning of the year, rallied the most in 2009. Exhibit 7 and Exhibit 8, respectively show the best and worst performing sectors expressed on an excess and total return basis. Only industries that represent 1% or more of the index are included. Interestingly, every single sector (regardless of size) posted positive double digit excess returns.

REITs which is a sector that Standish has historically been active in, sold off dramatically in 2008. From a fundamental perspective, we believe that the sector is unique within the investment grade universe because most issues have very strong covenant protection that typically is not found in indentures away from high yield.

Life Insurance companies suffered from a decline in market value of their substantial holdings within primarily high quality bonds, as well as the implications of guaranties associated with the popular variable annuity product. Many of the issuers in this sector are large, well capitalized names that have withstood these types of crises.

Industry	% of Corp Index	Total Return %	Excess Return %
REITs	1.6	54.5	55.8
Metals & Mining	2.3	34.9	38.9
Pipelines	2.6	33.1	37.6
Life Insurance	2.4	33.6	36.6
Media Non-Cable	1.2	28.4	33.1

Source: Barclays

A key takeaway from Exhibit 8 is that every industry did well and even the worst performers posted "excellent" results. The sectors in Exhibit 7 are generally more defensive and did not sell off materially in 2008, therefore had less room to rebound in 2009. The one exception is the non-captive diversified industry, comprised almost entirely of GE Capital. The non-captive diversified industry saw its spreads widen early in the year to over 600 bps. Investors had become concerned with wholesale funded models, such as GE, Sallie Mae, and CIT. While the larger GE fared well given the support of its strong industrial arm, CIT was less fortunate and filed for bankruptcy.

<sup>†</sup> Source: Moody's

## A Statistical and Qualitative Review of 2009 & 2010 Outlook

Industry	% of Corp Index	Total Return %	Excess Return %
Non-captive Diversified	3.8	9.9	12.9
Aerospace & Defense	1.0	9.5	14.2
Diversified Manufacturing	2.2	12.0	16.0
Consumer Products	1.3	12.8	17.3
Food & Beverage	3.9	14.0	18.0

Source: Barclays

There are several industries that we believe are poised to perform well in 2010. Our analysis considers fundamentals, credit momentum, and valuation in assessing relative attractiveness across industries over a three to six month horizon. Currently, insurance, metals and mining, cable, and banking appear relatively attractive as compared to other sectors. Within the financial institutions group, we continue to emphasize large global firms given their progress in fixing the balance sheet and the continual importance to sustaining the recovery.

### Market Technicals

Technical drivers to a great extent fueled the rally in 2009 as fundamentals took a back seat. The implied level of defaults and downgrades that was priced into spreads was multiple times that experienced during any previous period †. Once the worst case scenario was off the table, investors had an insatiable demand for securities. Liquidity, however, remained constrained over most of the year. Since the crisis appeared to have centered on the very financial intermediaries that had previously facilitated trading, the deleveraging of that sector reduced flows. Dealers moved from acting as principals to acting as agents.

The demand for bonds was partly met by substantial new issuance. Total issuance for 2009 by investment grade companies in the US corporate bond market totaled \$1,075 billion, while those rated below investment grade issued \$162 billion.\* Corporate issuance should exceed \$600 billion in 2010, with about 50% coming from the financial sector and the balance from industrials. Note that this level of issuance is insufficient to offset maturities and coupon payments. An uptick in mergers and acquisitions, which appears likely, should result in some incremental issuance. Build America Bonds (BABs), and other taxable municipal issuance, will constitute a material component of supply in 2010. While these are not in the Barclays US Corporate Index, they will be a more meaningful part of the Barclays US Credit Index with over \$100 billion expected in new issues during 2010.

† Source: Bloomberg league tables

### Our Outlook

The financial crisis and weakened economy will likely pose some volatility and risks in 2010, which we outline as follows:

- Concern with sovereign credit quality will increase. These include, not only the ones most in the headlines, such as Dubai and Greece, but others that have deficits and substantial debt issuance. Municipalities will also be facing fiscal challenges.
- The impact of the eventual removal by central banks of emergency liquidity and support programs.
- A weak economy punctuated by persistently high unemployment and troubled housing market could result in a less robust recovery.
- Regulation and legislation centered around banks and health care may result in unintended consequences.
- Idiosyncratic or event risk will heighten in 2010 as the lack of organic growth and the reopening of the capital markets are both drivers of transactions.
- A continuation of the inflation vs. deflation debate and resultant volatility around interest rates.

The events of the previous two years will require time to heal. Our outlook for the corporate bond market remains constructive for 2010 despite the massive spread rally that transpired last year. The “easy money” has been made to a great extent and returns in 2010 will likely be in line with historical figures. Our expectation is that spreads will continue to grind tighter and are expected to end the year in the +100 bps to +125 bps ranges for investment grade. Excess returns are expected to be positive with corporate bonds outperforming Treasuries. Compression should continue with less distinction by credit quality. This will present opportunities in the BBB and crossover (BBB/BB and high BB) segments. Credit curves should normalize as the imbalances in the market is exploited, providing the most attractive opportunities in the intermediate part of the curve.

2009 was the year of “beta” with virtually all companies, and industries posting incredible gains. Going forward with spreads normalizing, low breakeven spreads<sup>§</sup> will necessitate careful credit assessment and relative value. Currently, we believe spreads are fairly valued, but under our base case scenario as the economy recovers, spreads should continue to tighten. Our themes for 2010 are:

- Gradual economic recovery will lead to improved corporate fundamentals.
- Continued strong demand from pension funds, insurance companies and foreign buyers will provide a strong technical. Supply will be insufficient to meet demand and concessions will be close to zero.
- Credit momentum will remain positive as improving fundamentals are somewhat offset by an increased focus on shareholders. Expect heightened event risk although not as detrimental as experienced in the last cycle.
- Valuation march toward historical averages. Some parts of the market are overpriced, while others offer value, resulting in the need for careful credit selection as the “beta” trade will not be effective past the early part of 2010.
- Credit curves and capital structures inefficiencies will normalize.

<sup>§</sup> Breakeven = amount of spread that offsets widening, approximately = spread/duration.

## A Statistical and Qualitative Review of 2009 & 2010 Outlook

### Disclosures

- <sup>1</sup> *Barclays US Treasury Index is defined as public obligations of the US Treasury with a remaining maturity of more than one year. In addition, securities must have at least one year to final maturity regardless of call features, have at least \$250 million par amount outstanding, be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade, be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, and be dollar-denominated and non-convertible.*
- <sup>2</sup> *Barclays US Intermediate Treasury Index, which is a subset of the broader Barclays US Treasury Index, is defined as public obligations of the US Treasury with a remaining maturity of more than one year, but less than 10 years. In addition, securities must have at least one year to final maturity regardless of call features, have at least \$250 million par amount outstanding, be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade, be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, and be dollar-denominated and non-convertible.*
- <sup>3</sup> *Barclays US Long Treasury Index, which is a subset of the broader Barclays US Treasury Index, is defined as public obligations of the US Treasury with a remaining maturity of greater than 10 years. In addition, securities must have at least one year to final maturity regardless of call features, have at least \$250 million par amount outstanding, be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade, be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, and be dollar-denominated and non-convertible.*
- <sup>4</sup> *Barclays US Corporate Index, which is a subset of the broader Barclays Capital US Credit Index, is representative of publicly issued, investment-grade, fixed rate, dollar-denominated, non-convertible, US corporate debt securities that have at least \$250 million par amount outstanding.*
- <sup>5</sup> *Barclays US Intermediate Corporate Index is a subset of the broader Barclays Capital US Corporate Index, which is representative of publicly issued, investment-grade, fixed rate, dollar-denominated, non-convertible, US corporate debt securities that have at least \$250 million par amount outstanding and an average maturity between 1 and 10 years.*
- <sup>6</sup> *Barclays US Long Corporate Index is a corporate-only subset of the Barclays US Long Credit index and represents publicly issued, investment-grade, fixed-rate, dollar-denominated, non-convertible, US corporate debt securities with maturities greater than 10 years.*
- <sup>7</sup> *The Merrill Lynch High Yield Master II Index is a market capitalization weighted index of all domestic and Yankee high yield bonds that have maturities of one year or more and have a credit rating of lower than BBB/Baa3, but are not in default. The index tracks the performance of high yield securities trades in the US Bond Market.*
- <sup>8</sup> *S&P 500 Index is considered to be generally representative of the US large capitalization stock market as a whole. It is an unmanaged capitalization-weighted index of 500 commonly traded stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of those stocks. The index assumes reinvestment of dividends.*
- <sup>9</sup> *VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk.*
- <sup>10</sup> *Moody's Default Rate Moody's defines a bond default as any missed or delayed disbursement of interest and/or principal, bankruptcy, receivership, or distressed exchange where (i) the issuer offered bondholders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount) or (ii) the exchange had the apparent purpose of helping the borrower avoid default.*

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## A Statistical and Qualitative Review of 2009 & 2010 Outlook

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