

Bonds Suffer Subprime Hit [Q]

Risk Reshapes the Bond Markets

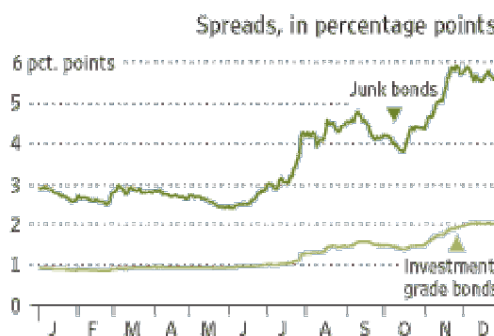
Safety first

Treasury yields plummeted as prices rose when investors rushed to buy the safest assets during the credit crunch, and the Federal Reserve lowered its target federal-funds rate by one percentage point.



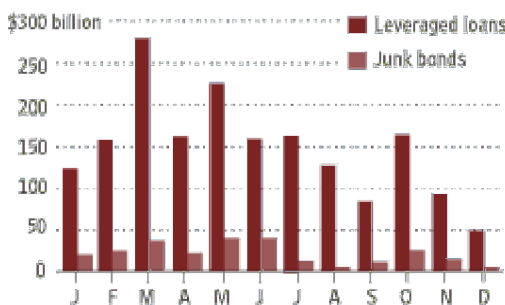
Investors demanded to be paid more for riskier investments...

The difference between yields on corporate bonds and Treasury bonds widened sharply as the subprime mortgage crisis deepened.



...As junk debt issuance slowed to a trickle

Bankers found fewer buyers for lower-rated corporate debt during the second half of 2007.



Sources: Merrill Lynch (spreads); Ryan ALM, Reuters via WSJ Market Data Group (Treasury, target rate); Dealogic (debt issuance)

Liquidity Crunch Hangs Over Market for Corporate Debt By SERENA NG January 2, 2008;

The corporate-debt market unwittingly became a victim of contagion from the subprime-mortgage turmoil in 2007, as prices of many bonds and loans plunged even while corporate defaults remained very low.

Investors are hoping for a reprieve this year, but they expect more volatility in the coming months.

The subprime downturn severely hurt many large banks and Wall Street firms, which took billions of dollars in write-downs and losses on the mortgage-related securities they held. The ensuing liquidity crunch in the credit and money markets created problems for other financial institutions and lenders, which found it more difficult and costly to raise short-term debt needed to fund their operations.

All this will continue to weigh on the markets in 2008, and corporations that need to sell debt to refinance older loans or to stay in business could feel the pinch.

"Whenever you see short-term funding becoming tighter, you know there is going to be strain somewhere in the corporate world," says Jerry Webman, chief economist of OppenheimerFunds in New York. "Someone is going to find a bank line unavailable when they need it, and get into serious problems as a result."

To be sure, corporate balance sheets are still strong by most measures. Leverage ratios at industrial corporations, or the amount of debt these firms have relative to their equity, are near their lowest levels in a decade, according to Deutsche Bank credit strategist John Tierney. Many companies, he adds, are still sitting on sizable piles of cash.

However, a large volume of corporate debt is coming due in 2008 -- about \$604 billion as compared with \$484 billion in 2007, according to J.P. Morgan Chase & Co. data -- meaning that many firms will need to tap the markets for cash. About half of the refinancing will be for financial firms, which may have to pay hefty interest rates to obtain funds. Also, some financial institutions could be forced to raise more capital following their mortgage-related losses, and that could crowd out other corporations and pressure the values of their debt.

"It's going to be bumpy," says Therese Esperdy, managing director and head of global debt capital

markets at J.P. Morgan in New York. She adds that the market for shorter-term bonds with maturities of three years or fewer -- a segment made up of mostly debt issued by financial institutions -- "has mostly shut down."

In 2007, the additional interest that investment-grade corporate bonds pay over yields on Treasury bonds jumped to 2.03 percentage points on average from 0.91 percentage point, according to data from Merrill Lynch & Co. That sharp widening in spreads over a relatively short period was led by financial companies, and it brought spreads to levels last seen during the credit downturn of 2002. Overall, investment-grade corporate bonds returned 4.6% in 2007, as compared with 4.4% in 2006, according to a Merrill index that tracks their total return, which includes price changes and coupon payments.

Banks' reluctance to lend also is likely to weigh on the market for low-rated junk debt, which choked up during the summer of 2007 after one too many companies tried to sell loans and bonds to investors at the same time to pay for acquisitions and leveraged buyouts. The pipeline of new leveraged loans has shrunk to \$156 billion from more than \$200 billion six months ago, according to Standard & Poor's Leveraged Commentary & Data, but that is still a large volume for investors to digest. However, analysts say there are investment funds that are holding cash and sitting on the sidelines, waiting to dive in at the right time and terms.

"It's all a matter of price, and the banks are likely to be more pragmatic about pricing" in 2008, says Steve Tananbaum, chief investment officer of GoldenTree Asset Management LP in New York.

Spreads on below-investment-grade, or junk, bonds over Treasuries hit a record low of 2.4 percentage points in the middle of 2007, but in the past six months they widened to 5.92 percentage points, according to Merrill data. Junk bonds returned an anemic 2.2% in 2007, versus 11.8% in 2006, after factoring in their coupon payments and price changes. Leveraged loans, meanwhile, returned 2.1% in 2007, their lowest return in five years, according to S&P LCD.

Last year's downturn in corporate and mortgage bonds helped Treasury securities, which benefited from a flight to quality by many investors. The yield on the benchmark 10-year Treasury note fell to 4.033% at the end of 2007 from 4.708% a year earlier as prices rose. Treasuries outperformed most other types of bonds, returning 9.1% in 2007, including price appreciation and interest, according to Merrill data.

During the second half of 2007, some investment banks were unwilling to sell loans and bonds to investors at heavily discounted prices because it would mean losses for the banks. They are expected to take bigger steps this year to offload risk from the large volume of corporate debt sitting on their balance sheets to free up capital for other uses.

Still, it isn't clear whether bankers will be able to find enough investors for the junk debt they need to sell, in part because the formation of giant loan pools called collateralized loan obligations, or CLOs, has slowed significantly.

Furthermore, investors are becoming more concerned about the health and outlook of companies that have heavy debt loads and weak credit ratings. "The credit cycle has peaked and is rolling over," says Jim Keegan, a portfolio manager at American Century Investments in Mountain View, Calif. "I think leveraged companies are going to be very challenged going forward. Not only has the tone of the market changed, but they will have to deal with the head winds of a macro economy that is slowing," he adds.

Mariarosa Verde, a managing director of credit-market research at Fitch Ratings, a unit of Fimalac SA of Paris, said the rating firm expects "a meaningful increase" in the default rate among junk-rated U.S. corporations in 2008 to between 4% and 5%, from less than 1% in 2007.

Despite the pessimism, investors say there is light at the end of the tunnel. While the housing-market downturn isn't over and some financial institutions could announce further write-downs in the coming months, analysts note that prices of many mortgage-related securities have fallen to rock-bottom levels and seem to be stabilizing. In addition, foreign investment funds from Asia and the Middle East are making large investments in U.S. and European banks such as Merrill Lynch & Co., Morgan Stanley, UBS

AG and Citigroup Inc.

"The plummeting seems to have stopped for now, and the sovereign-wealth funds are coming in with a vengeance," notes Jim Sarni, managing principal of Payden & Rygel in Los Angeles. "That is a positive sign because there is some sentiment that we are flirting with the bottom."

Mary Ellen Stanek, chief investment officer of Baird Advisors in Milwaukee, says the credit correction of 2007 "has been very therapeutic for the market." She adds that she sees good value in high-quality corporate bonds and agency mortgage securities that have fallen sharply in price and now bear attractive yields. "The market is still very illiquid, but you can't get too negative. This is exactly when opportunities are created, and it is going to be an environment where patience will be rewarded," Ms. Stanek says.

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QUESTIONS:

- 1.) Why is there a difference in the spread (compared to Treasuries) on junk bonds and the spread on investment-grade bonds?
- 2.) How did the spread on junk bonds and investment-grade bonds change over 2007?
- 3.) Why would the spread on investment-grade bonds rise despite corporations having the lowest debt to equity ratios in a decade?
- 4.) How did the amount of junk bonds and leveraged loans issued in December 2007 compare to the amount issued in March 2007?
- 5.) Do you think that the increase in spreads lead to the decrease in issues, that the decrease in issues lead to the increase in spreads, or that some other factor lead to both the increase in spreads and the decrease in issues? Explain.