

# SSgA CAPITAL INSIGHTS

## THE TICKER

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## Potential Fixed-Income Opportunities in a Liquidity Challenged Market



by  
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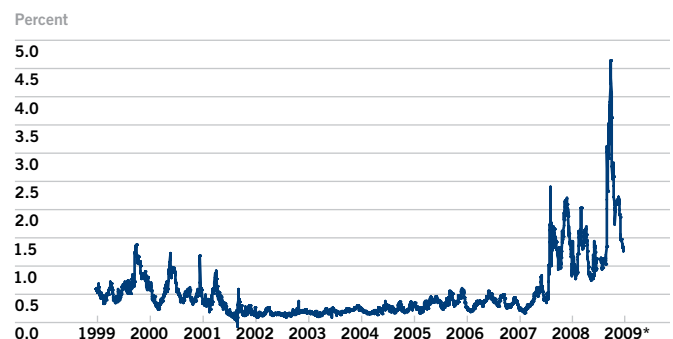
Over the past year and a half, global fixed-income markets have gone through a dizzying array of changes. We have charted new territory relative to the modern history of the fixed-income markets in terms of absolute interest rate levels, the relative price of risky assets, and the magnitude of volatility in the market. Over the past two decades, human nature, emboldened by new developments in financial engineering, securitization, and the use of leverage, caused asset prices to balloon to unsustainable levels. As this asset bubble broke, we saw the unsavory side of globalization. Investors around the world were forced to unwind leverage in their portfolios to accommodate the margin calls that resulted. Forced to sell something, investors chose more liquid assets to avoid the massive markdowns they faced in the impaired parts of their portfolios. With levered positions at record levels, the crisis then spread from less liquid sectors of the market to the more liquid sectors, which had never before experienced a massive unwind of this magnitude.

As markets for many instruments ceased to trade, prices dropped precipitously. Financial institutions, deeply entrenched in the situation as owners, traders and agents, suffered from a lack of clarity regarding what they owned and how it should be priced. This caused a key turn of events — financial entities lost the crucial element of trust from their constituents and in one another. Due to a lack of transparency around whose positions were at risk, financial institutions began to balk at supporting one another and extraordinary fallout resulted. In the United States,

Wall Street institutions such as Bear Stearns, Lehman, Goldman Sachs and Morgan Stanley merged, closed down or were reborn as more risk-averse commercial banks. Within economies around the world, similar scenarios played out. In the fixed-income realm, basic financing rates in the short-term markets (on which broader pricing and liquidity depend) reached levels where the healthy flow of capital was unsustainable (see Figure 1).

At this juncture participants across the entire world market were forced to either adjust their real activity down to sustainable levels that were based on reduced capital market flows, or find a way to fill the gap. Governments and regulators have scrambled to find ways to do just that with varying amounts of success, both independently as well as in coordinated fashion. At many points over the past months, many areas of the fixed-income markets have barely functioned. The only US instruments with consistent liquidity throughout the crisis have been Treasuries, which are at their lowest yields in decades. The media has been very generous in bombarding the public with a continuous litany of what went wrong and who is to blame.

Figure 1: LIBOR Spreads to 3-Month Treasury Bill



Source: SSGA

\*Ending January 30, 2009.

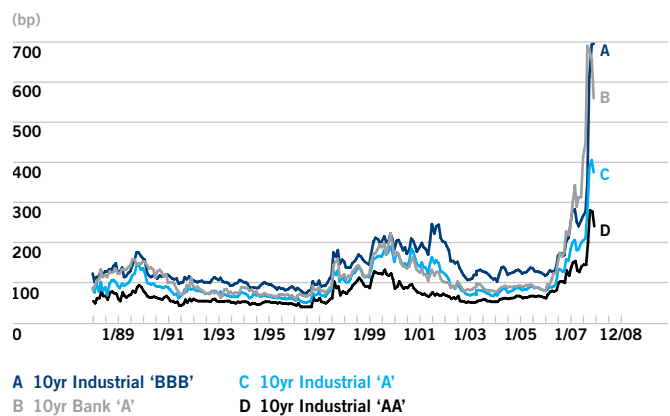
### How Did We Get Here?

For many years, the US led the world in encouraging support for residential development. As securitization techniques moved from the public sector into the private sector, more and more innovative means to accommodate special circumstances in borrowers' history were developed. Eventually, this trend reached a point where the combination of aggressive mortgage lending, lack of effective analysis from raters, and subpar regulation resulted in real estate defaults and spawned a housing crisis. In early 2007, as subprime residential collateral for some securitized mortgage investments developed track records indicating they were not of the quality that was represented, investors reassessed risks and bid down prices on the structures. Rating agencies realized they had underestimated risk on structured products and reassessed ratings downward. The subprime fallout spawned a contagion across global capital markets due to its ubiquitous positioning in portfolios and markets around the world. The deleveraging of capital markets which resulted created unprecedented liquidity issues and a domino effect across sectors and around the world.

Thus far, the result of this precedent-shattering activity is global recession, due to the fact that capital markets have shrunk to the point where there is not enough capital to sustain the level of economic activity of the recent past. More ominous, however, is the fact much of the capital that is available is being hoarded in fear rather than lent out of greed. For example, the Port Authority of New York and New Jersey received no bids for \$300 million in AAA-rated taxable debt with a three-year duration on December 3, 2008, giving investors another glimpse into the continuing liquidity drought plaguing the credit markets. While equity market volatility and economic news such as housing and jobs data continue to make headlines, some areas of the credit markets remain locked-up, though a host of government programs designed to loosen things up has shown some promise. The markets as we knew them have been disassembled and need to be stitched back together under different assumptions about how business is done.

The result is that the price discovery which normally occurs by investors transacting with one another is largely inoperative. Most core fixed-income strategies have traditionally focused on searching for yield, protecting capital and controlling costs through investing in more liquid areas of the market. The ongoing financial crisis, however, has presented many challenges to this focus as liquidity has virtually disappeared in all spread sectors, and even conservative investors have experienced unexpectedly sharp losses. Some of the supposed safest investment strategies turned into the riskiest during the current crisis, proving that principal protection and liquidity aren't a given, even with short-term, lower-yielding highly rated investments. Even on high-quality investment-grade securities, credit spreads have widened considerably, causing sharp price declines (see Figure 2). For investors, highly rated investment-grade fixed income was supposed to entail little, if any, risk in the form of spread volatility. In the securitized sector, many structures accommodated demand for a "reach for yield" and lost sight of the focus on safety and liquidity that should be the hallmark of AAA-rated securities. Reaching for a few extra basis points can be achieved, especially through the effects of leverage. However, as investors are now learning, it shouldn't come at the expense of safety and liquidity.

Figure 2: US Investment-Grade Corporate Bond Spreads



Source: SSGA, Merrill Lynch, Bloomberg

### Where is the Opportunity?

Investors in today's markets are left wondering what is next, where the next danger lurks, and what opportunities have been created by these dramatic events. That said, we can measure prices in historical context and recognize they are very cheap, under even the most onerous of future scenarios. We can see points of light in the darkness which we believe represent more than a train traveling toward us. We believe investors with the ability and willingness to put capital to work for the long term can enjoy potential positive returns out of the current market developments. Market events, government intervention, and the structural change of Wall Street all have significant implications for the future prospects of all aspects of fixed-income investing. As investors begin to take tentative steps away from the safest areas of the market, we believe by incorporating strong, thorough research with a sound risk management approach emphasizing liquidity and safety, opportunities for attractive relative returns can be exploited. We briefly review some of these examples below.

#### US Agency Notes and Debentures

US Agency securities have seen significant widening to historically attractive incremental spreads over Treasuries. We believe implied and/or explicit government guarantees supporting these issues clearly augur for tightening of spreads through time, despite probable intermittent discontinuities in that process.

#### FDIC Temporary Liquidity Guarantee Program Instruments

These instruments, issued by banks in maturities of three years or less, but carrying the guarantee of the FDIC may come at attractive levels relative to short agency securities, and can be interesting substitutes for agency notes and bonds in the short end of the yield curve.

### Short Credit Cards

Short "on-the-run" credit cards may be a very attractive option in the half-year average life area at unprecedented yield spread levels above Treasuries. Given recent liquidity in the markets, it is best to be in a position to hold these issues to eventual maturity. Equally important is the need to have strong capabilities for examining the underlying structure of these instruments and performing monthly surveillance activities to track their performance. Many AAA tranches of major credit card master trusts are able to withstand extreme default scenarios of 40%–65%, compared to recent charge-off rates of 6%–8%. Previously mentioned government programs in support of asset-backed markets and credit card-issuing banks further bolster the case for development of a more normal trading environment for these securities.

### Commercial Mortgage Backed Securities

With the proviso that security selection is very important due to volatility and underwriting, AAA super-senior class CMBS securities are an attractive opportunity for investors who are capable of the deep research needed to understand and monitor these structures. Other key aspects regarding CMBS are the depth and tenor of the current recession, nationally as well as regionally, and relative to the type of real estate underlying any specific structured instrument. With continually changing liquidity conditions underlying this sector, investors must have the flexibility of long-term holding periods. Finally, while the situation is fluid, at present commercial property oversupply is less severe than during previous recessions.

### Corporate Bonds

Investment-grade corporate bonds are very cheap by any historical standard. And with careful research in support of sector and security selection, a well-diversified exposure to focused areas of the market can likely be an attractive long-term opportunity. Entities which can be deemed survivors through careful analysis, including those benefiting from government support in the financial sector, and more noncyclical sectors such as industrials and utilities can potentially provide attractive relative returns and the potential for strong price returns as spreads normalize with improved market liquidity. For investors with a higher risk tolerance, high-yield bonds have also recently achieved all-time wide spreads to Treasuries, though not of the same relative magnitude to their history as their investment grade brethren. However, with intensive and effective research aimed at owning the healthiest names in this universe, a well-diversified portfolio of high-yield bonds has the potential to provide very attractive nominal total returns compared to other fixed income segments. Here again, investors must be able to hold their position through the transition to healthier markets.

### Treasury Inflation Protected Securities (TIPS)

TIPS have suffered due to a confluence of selling and deflation fears, and have recently been priced to imply a deflationary environment for most of the next decade and only 1% inflation thereafter. Adding TIPS as a value-added component in government strategies should garner incremental value as inflationary expectations reappear and feed into the pricing of these instruments through time.

### Fluid Circumstances

The above ideas are what we feel to be potentially the best opportunities at the time of this writing. Clearly, in a changing economic and market environment, investors should be cautious about the expected life of any specific recommendation. We are currently in uncharted territory in so many areas that constant reassessment is the watchword. We would welcome the opportunity to work with investors to update the above ideas in the context of current markets or work closely to design portfolio products to help meet their unique challenges at any time. The rollercoaster markets that we've experienced would seem to have more time to run.

We believe we are in an environment where there may be sound investment opportunities, but it may be necessary to buckle up and ride out the turbulence a while longer.

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