Build Knowledge/Valuation & Analysis

Opportunity in Debt

By Barry Mendelson, CIMA
May 14, 2009

March was apparently an inflection point for positive economic news. Still lagging are bond spreads, which should start narrowing soon, setting up investment-grade corporates as a great opportunity.

Economic news appears to be improving. The change in Q1 GDP (preliminary estimate) was -6.1%, similar to the decline in 4Q08. We expect upward revisions toward -5.0% because of positive momentum in March.

Housing may finally be showing signs that the worst is over. Home sales are picking up. Housing starts are at levels below the formation of new households. Inventory can be worked off over the next few years, when demand can cause an uptick in starts and presumably prices. President Obama's $8,000 tax credit for first-time homebuyers is helping sales.

Consumer sentiment is improving according to the Reuters/University of Michigan consumer measure. Sentiment rose to 65 from 57 in March, the largest advance in over 10 years (now near September '08 levels). Favorable gas prices, the end of winter heating bills, the stock market rally, and historically low mortgage rates have provided some much-needed relief, even as unemployment concerns remain high.

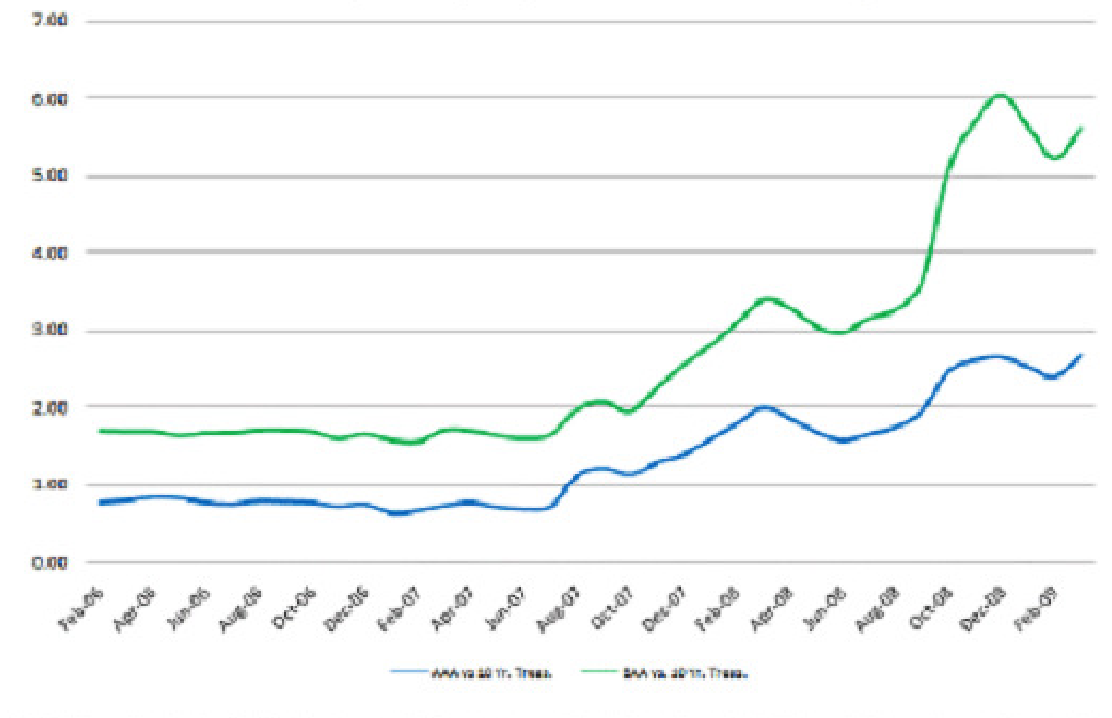
Whether consumer behavior has shifted permanently into a lower gear, as some claim, is still in question, but consumption is still a big deal at two-thirds of GDP. Consumer spending rose over 2% in 1Q09 after a long draught. Consumer expectations also rose in March, from 53 to 63, reflecting some renewed optimism about the direction of spending.

The ISM Index rose to 40 in March from 36 in February. This reading of manufacturing activity was higher than expected. Production may be on the verge of expanding a bit to rebuild depleted inventories. ISM readings below 50 signal manufacturing contraction.

But investment-grade corporate bonds still languish, as shown in the chart below. While riskier stocks have bounced, the senior security has not. The corporate earnings outlook remains uncertain. Guidance lacks clarity and conviction. We have heard 2009 S&P 500 operating earnings estimates of $50-$65 from our investment manager interviews this quarter. S&P (as of 4/28/09) estimates $58 for 2009. If realized, that would be a 17% increase from actual 2008 earnings. A closer look at the sector level reveals that a return to profitability in financials is expected to drive this increase. S&P 2010 estimates are for a broad-based improvement in earnings, but still below 2007 levels of $83.

Assuming economic performance continues to improve as the year progresses and 2010 earnings estimates hold, bond spreads should decrease and investment-grade corporates should have a heck of a run. They look like an interesting opportunity as we consider asset allocation guidance and rebalancing moves.

Three-Year Spreads—Corporates Over Treasuries



Source: CMC eResearch

Barry K. Mendelson, CIMA and managing partner of [Capital Market Consultants, LLC (CMC),](Capital Market Consultants, LLC (CMC)) consults with mid- to small-sized financial organizations and RIAs. The group assists with product development, investment due diligence, and advisor training services covering SMAs, mutual funds, exchange-traded funds, hedge funds, and other alternative investments. CMC offers an extensive array of online research services including a robust chart library with monthly updates, long-term performance analysis of over 10,000 mutual funds with monthly updates, a qualitative manager database, returns- and holdings-based style analysis, and performance attribution.
