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Separating Hearts from Minds

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None of this is getting easier. Market participants trudge to work this winter with real and burdensome anxieties. It's like we are all carrying around big bags of bricks that weigh us down. Do we still have a job? Do our colleagues? Are the clients intact? What is going to hurt us today and how can we protect our clients and ourselves from it? Bond market participants, equipped with DNA matter that has them predisposed to be defensive, may be in their element. An equity colleague once remarked that distressing economic news often has the fixed income guys down the hall cheering. But, in reality, the bag of bricks is heavy and carrying it is wearying and brings no joy.

That is, unless one's portfolio happens to be very long credit risk. The last six weeks have seen a significant rally in credit. As measured by Merrill Lynch's indexes, high yield has had a total return of about 16% since December 15th and investment grade credit about 4%. These returns include rapid improvements in illiquid bonds that are hard to trade, but also a nice rally in industrial names. New issuance has also been met with good investor demand.

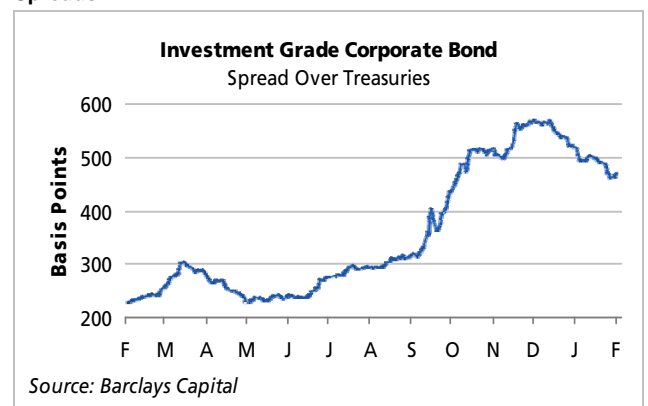
Against these returns, U.S. Treasuries have declined 2% in the last six weeks; that market appears to be frightened out of its wits. With a budget deficit of \$1+ trillion and a financial stabilization bill of similar size, \$2 trillion of financing needs sets up a record-breaking fund-raising effort. The market figures they'll have to pay up. While the short end of the yield curve has been anchored by accommodative monetary policy, the 10-year note and 30-year bond yields are 90 and 110 basis points above their December lows.

Credit's encouraging performance has come from a narrowing in spreads. High yield was 1500 basis points over Treasuries in mid-December according to readings by

Barclays Capital; it's 1100 now. Investment grade has narrowed from 570 to 480 by those same readings. Together with the back up in Treasury rates, snuggling of this magnitude in credit might suggest that prosperity has arrived.

Nothing could be further from the truth. The contraction in economic activity has deepened and broadened. Tax receipts are down over 10% for the fiscal year-to-date. The scope of the wealth destruction, the necessary deleveraging still to come, the impaired system of financial intermediation, and the inaccessibility of credit to so many continue to make for a troubled outlook. The outsized funding needs result from this outlook, which of necessity is met with an expected surge in outlays due both to automatic stabilizers (such as unemployment insurance) and the government's new fiscal policy initiatives.

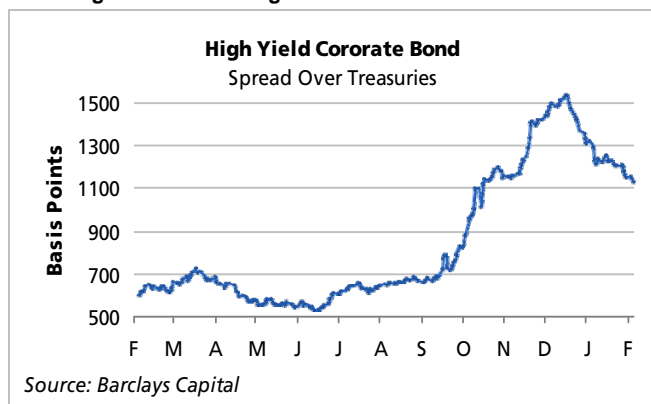
Backed Up Treasury Yields Tighten Corporate Credit Spreads...



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...For High Grades and High Yields Alike



Reconciling these improved market conditions with continuing economic deterioration is difficult. While I expect that markets will improve long before the economy does, the rapid snap back so far has been a surprise. My heart wants to be optimistic and jump in but my mind reckons that would be reckless.

Overriding all of this is a realization that the foundations of finance and the banking system have been pulled away. Fundamental promises have been broken. Increasingly confused and angry, citizens have turned to government for answers to a range of issues where the previously received wisdom has failed. What's the best economic system, what is fair in trade or taxes, do we solve a debt crisis by borrowing more, and what do we spend it on that would really make a difference? It may be some time before we get the answers that will relieve us of this bag of bricks. ■