

## The CDO and Credit Market

The Technical pressures have given way to fundamental concerns as the primary driver of the credit markets. For most of 2008, it seemed that the corporate credit markets were oversold for technical reasons such as Total Rate of Return (TRS) unwinds and market value CLO liquidations. Now, at the start of 2009, we are seeing the direct impact of global financial crisis on credit performance. The leveraged loan default rate jumped to 3.7% at 2008 year end according to S&P's Leveraged Commentary and Data and, if forecasts prove correct, we may see default rates near 10% by year-end 2009. Some may argue even that is optimistic.

A vicious, destructive cycle emerged/accelerated after Lehman Brothers' and AIG's collapse in early September. Seemingly overnight, the credit quality of all financial companies became suspect. Even large international banks didn't trust each other: the London Inter-Bank Overnight Rate (LIBOR) surged to 4.8% for 3 month maturity. But the pain wasn't confined to Wall Street as Main Street investors watched money market funds such as Primary Fund "break the buck." As a result, consumer and investor confidence plummeted and spending plunged.

Even consumers that were not rattled by compounding home price declines, the near collapse of major retail banks (e.g., Wachovia and Washington Mutual) or rising unemployment (7.2%) could not purchase big ticket items because credit effectively dried up. Car sales, for instance, fell 18% in 2008 according to Bloomberg. Finally, any doubts about the geographic extent of the current economic toil have been answered: This is a world-wide problem. ISI Group recently published global industrial production numbers that are down 19% quarter over quarter.

With all of this economic gloom as backdrop, one would expect that credit would have sold off considerably and, in fact, it did. Prices for large liquid bank loans tracked by Babson Capital fell from 88% to 59% between the start of September and the end of December, though prices have staged a modest recovery recently (to the mid 60's). Without massive monetary and fiscal stimulus from governments around the world (but primarily from the US and China), investor loan losses surely would have been even greater.

In fact, we believe that the impact of government programs should not be under-estimated. According to Barclays, global fiscal packages announced or expected now total \$1.5T to \$2.0T. On top of this, the Obama administration is set to announce an \$825 stimulus plan that will take the form of infrastructure spending and tax cuts among other spending programs. Considering the fact that the total notional of US RMBS securities is on the order of \$9T, these are hefty stimuli. While we have no misconception regarding the severity of the current recession, like many others, we look forward to the second half of 2009, when economic activity is expected to pick up.

## The CLO Market

Liquidity concerns in the CLO market gave way to fundamental concerns during 4Q08. Mezzanine CLO paper tumbled in price by 2/3 over the quarter and no longer trades on a spread basis but rather a price basis. Consequently, we have changed our pricing table (see Figure 1) to reflect this reality. AAA CLO spreads performed better on a relative basis, only widening approximately 100bps. Their relative strength is due not only to the secure position of those tranches but to a strong bid for paper from a large US bank during the quarter, which also kept prices in check. CLO equity, meanwhile, is generally trading at a price equal to one period of cash flow.

Figure 1. Trading Levels for Typical CLOs as of January 1, 2009

	AAA	AA	A	BBB	BB	EQUITY (EXPECTED IRR)
	CURRENT $\Delta$	CURRENT $\Delta$	CURRENT $\Delta$	CURRENT $\Delta$	CURRENT $\Delta$	CURRENT $\Delta$
CLOs	600 +100	35 -30	20 -35	15 -35	10 -25	<1 pmt

Source: Babson Capital Management LLC

In a sign of just how dire credit prospects have become, CLO tranches now trade in part based on the transaction's Event of Default (EOD) language. This is particularly relevant for AA investors who can expect to incur substantial write-downs upon liquidation but who do not share in the high expected yields of the more subordinate tranches. In some cases, mezzanine tranches (including AA tranches) are not able to block a liquidation of the collateral pool while in other cases, they can and trading levels are beginning to reflect this discrepancy. Please contact us for a detailed discussion of the issues surrounding events of default and implication for CLO debt investors.

Amid all the gloom there is a silver lining (for CLO debt investors anyway). CCC baskets in CLOs have exploded, causing many CLOs to trip interest diversion and overcollateralization tests. Therefore, cash is being withheld from equity (and managers) for the benefit of the CLO debt. Whether these provisions are strong enough to compensate for rising defaults and low recoveries remains to be seen but it is certainly a good start. In our opinion, many BBB CLO tranches and nearly all A-rated CLOs may still expect full payment of interest and principal but investors should expect a rather bumpy ride between now and payoff, which could be 10 years from now. For example, BBB rated CLO tranches may PIK interest payments for years at a time even though payments are ultimately made in full. In addition, high defaults and low recoveries aside, it seems that each of the rating agencies are re-evaluating their rating methodologies for CLO debt. Based on already published reports for investment grade synthetic CBOs, it seems that assumptions regarding credit correlation and recovery rates could be adjusted substantially. If existing CLO transactions are not "grandfathered," CLO debt tranches may experience downgrades regardless of underlying collateral performance.

## The ABS CDO Market

ABS CDOs continue to trade sporadically. According to recent S&P research, 283 ABS CDOs, representing \$289B in notional, have hit events of default. Of these, S&P reports that 161 deals are collateralized by single-A to double-B collateral (so called Mezz ABS CDOs) and 90 deals are collateralized by AAA to AA collateral (high grade ABS CDOs). The balance is collateralized by other CDOs or RMBS.

## Outlook and Strategy

Both loan and CLO prices have fallen considerably and both are pricing in exceptionally high levels of loan defaults—too high we would argue given the governmental assistance to unfreeze the credit markets and a buildup of distressed asset capital looking for a home. Default rates will undoubtedly continue to rise, but we do not currently believe that those rates will exceed levels which are manageable by CLO mezzanine debt (8-10% annually). Therefore, we remain bullish on CLO debt at current levels, though we acknowledge that the current credit crisis may cause a deeper recession raising default rates considerably. For investors with appetite for corporate credit risk and with limited liquidity needs, we suggest AA-rated and AAA-rated CLO debt. For those who need liquidity, an investment in corporate bonds and loans directly still offers a compelling opportunity.

We are closely monitoring our investments and continue to expand reporting capabilities in CDO WorldSM to highlight marginal changes in the risk profiles of our investments. When opportunities arise, we will sell bonds with less favorable collateral and/or structure and buying bonds from deals with more favorable management teams.

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### Sources:

10/3/08 edition of J.P. Morgan's "Global CDO Weekly Market Snapshot"

10/9/08 edition of LCD's LoanStats Weekly

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