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Credit Market Overview Cites Fourth Quarter Activity

Editors note: This overview of the U.S. credit markets was provided by Prime Advisors, Inc. Prime, based in Redmond, Washington, currently manages $9.6 billion in core fixed income investments. To learn more about Prime, contact Ryan Leahy at 425-202-2018 or ryan.leahy@primeadvisors.com.

Credit markets enjoyed outstanding performance in 2009. This was in strong contrast to 2008, the worst year for credit spreads in decades. Liquidity returned to the credit market, assisted by various government programs. In addition to government support, there is now a very strong technical bid that has developed in the market. The strong bid is largely driven by the vast amount of cash and cash equivalents being invested. Investors, tired of earning near zero for money markets and their equivalents, entered the market in an effort to capture part of the spread tightening from the opportunities created in 2008. The combination of government programs and technical support tightened spreads and revived the new issue market to near record levels. Corporations continue to reduce leverage and expenses to improved balance sheets and maintain profit margins. In addition, financial companies have built reserves to cover potential future loan write-downs and have paid back TARP capital to the government.

These efforts spurred corporate spreads to tighten 46 basis points in the fourth quarter. Similarly, spreads for BBB rated companies and the bank and finance sector tightened 62 basis points in the fourth quarter. Industrials tightened 38 basis points and utilities tightened 39. Over the course of 2009, the corporate index rallied an unprecedented 383 basis points. Notably, BBB's tightened 510 and financials tightened 403 basis points.

Although corporate spreads have rallied significantly, select BBB and financial names still have room to tighten further with about 220 basis points of spread over Treasuries, versus only 61 basis points for the aggregate index. Therefore, we retain a positive outlook on credit. This positioning should equate to positive returns in an economic environment that does not expand too quickly or succumb

Option Adjusted Credit Spreads in Basis Points[1]

Index Sector	12/31/08	09/30/09	12/31/09	4Q09 Change	FY09 Change
Aggregate Index	213	82	61	-21	-152
Corporates	555	218	172	-46	-383
Industrials	500	176	138	-38	-362
Utilities	537	200	161	-39	-376
Financials	629	288	226	-62	-403
AAA	329	74	62	-12	-267
AA	373	141	110	-31	-263
A	506	198	158	-40	-348
BBB	727	279	217	-62	-510

[1]Data from Barclays Capital as of 12/31/09

to an unanticipated contraction. Furthermore, volatility has diminished but risks have not disappeared. For this reason we are not reaching for yield at this time but rather investing in top tier names throughout the credit rating mix. Interest rate, economic, merger and acquisition, and political risks continue to be potential economic hazards. Consequently, it is imperative that the investor remain cautious, focusing primarily on credit selection for the foreseeable future.

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