

July 8, 2010



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## Fixed Income Commentary June 2010 Corporate Update

While macroeconomic concerns and event risk were still dominant themes in June, we did see a decoupling between the equity markets and credit spreads, with the S&P 500 down 5.38% during the month while the Barclays Capital U.S. Corporate Index was down just 0.09% and only 6 basis points (bps) wider during the same period. The negatives, including soft economic data (employment, housing) and European sovereign concerns, were mitigated by the near completion of the financial reform bill, which was perceived positively by the market. Additionally, technicals were supported by modest investment grade supply and healthy inflows into investment grade bond funds. Year-to-date (YTD), flows into high grade bond funds have been roughly \$68 billion (+8.8% year-over-year) as equity volatility shifts assets into fixed income.

Of the three main sectors, financials outperformed industrials and utilities. The excess return for financials was -5 bps vs. -10 bps for industrials and -12 bps for utilities. The near-completed financial regulation bill is being perceived positively by the market, certainly compared to the perception a month ago. Key provisions of the bill were tempered, specifically the Lincoln amendment (derivatives) which would still allow banks to trade interest rate and currency swaps while most uncleared swaps would move to the non-banking entity. Additionally, the Volcker rule would also allow proprietary trading if it's for liquidity and market making, which seems like a difficult thing to differentiate. All in all, the bill is certainly more benign than the market anticipated a month ago.

**Bank spreads:** Spreads for the U.S. money center banks widened 5-7 bps on average. Bank of America and Morgan Stanley underperformed, each widening 15 bps in 10-year senior bonds. Premium dollar priced Trust Preferred Securities (TRUPs) sold off another 1-2 points as the market received more clarity on The Collins Amendment. It stipulates that Trust Preferreds will have a five-year phase out period, with banks losing partial capital treatment at the start of year three. The majority of these securities have par call language in the event of significant regulatory change (this qualifies), thus the market is expecting the majority of the high coupon TRUPs to be called starting on January 1, 2013. This makes the deeply discounted TRUPs look even more attractive, particularly the FRN TRUPs which are trading in the \$70s, at ~ 8% yields. Upcoming catalysts for bank spreads include second-quarter earnings reports which begin mid month, and European bank stress tests which according to the Financial Times are being expanded to include 100 banks.

**Industrials:** The main contributor to the underperformance in industrials was the energy sector, which was once again the worst performer as the oil spill names moved another 150 to 200 bps wider in June. The excess return for the energy sector was -198 bps, with oil field services issuers fairing the worst at -384 bps. Significant curtailment in offshore drilling going forward will have negative ramifications on demand and profitability for the servicers. Outside of energy, most sectors posted positive excess returns. Outperformers include metals and mining, which rallied on the heels of the watered down Australian resource tax proposal, which

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### June 2010 Corporate Update (cont'd)

would have imposed onerous taxes on mining profits. Airline enhanced equipment trust certificates (EETCs) also outperformed, posting excess returns of +.49%. Delta priced a 5.5-year average life A tranche EETC at 6.2%. The deal was several times oversubscribed and traded well on the break. At these types of yields, airlines are issuing debt at 2007-type levels. While lower refinancing rates are obviously good for the airlines, given the significant rally in this space, we are approaching new issues with caution. We find better value in some of the off the run, 2000 - 2002 vintage deals, with similar collateral but at yields in the 7-7.5% range. The dislocations in this market present good relative value opportunities as less liquid, off the run issues don't get the attention of the newer deals.

**Utilities:** The underperformance came from pipelines with spreads widening another 20 bps in June. Outside of energy, pipelines have experienced the most weakness YTD, mainly on technicals. We view the sector as defensive (Federal Energy Regulatory Commission (FERC)-regulated, stable assets) and believe it represents one of the more attractive relative value opportunities within corporates.

We have opportunistically added exposure in names like SUG (30-year paper) and Citcor (10-year) at attractive spreads. In the high +200s over the 10-year Treasury at the end of June, Citcor was trading at about twice the spread of similarly rated electric utilities. These are operating company-level bonds for a FERC-regulated gas pipeline that provides ~ 70% of Florida's natural gas. Off takers are highly-rated electric utilities like NextEra Energy and Progress Energy.

**Supply:** Investment grade corporate net supply YTD is just \$52 billion, and is forecast to be between \$130 - \$200 billion for the full year, significantly lower than the \$535 billion average for years 2000-2007. With Global M&A volumes down (~ 35% vs. historical levels), capital expenditures down, and bank balance sheets shrinking, supply technicals have been favorable. Going forward, one would expect M&A and share repurchases to rise, particularly in industrial credits, as companies get less defensive and start to utilize the cash they've been hoarding since the start of the recession.

	MTD Excess Return	MTD Total Return	2Q Excess Return	YTD Excess Return	YTD Total Return	OAS
U.S. Corporate Index	-0.09%	2.13%	-2.25%	-1.10%	5.79%	193
Industrials	-0.10%	2.25%	-1.80%	-0.99%	6.26%	160
Financials	-0.05%	1.83%	-2.96%	-1.26%	4.73%	249
Utilities	-0.12%	2.53%	-2.07%	-1.12%	6.92%	177

Source: Barclays Capital

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