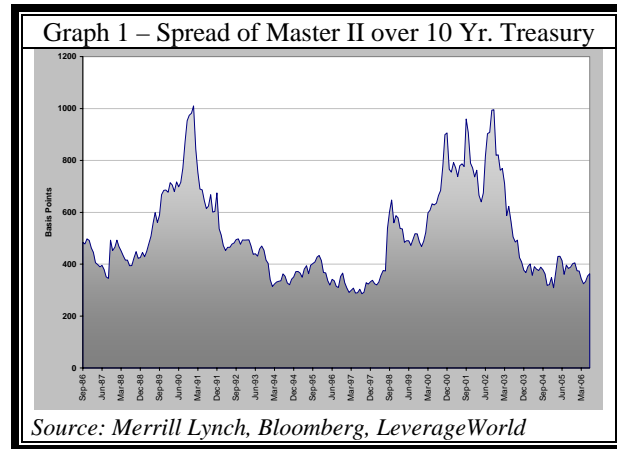


When Will Then Be Now? Prospects for the Credit Cycle

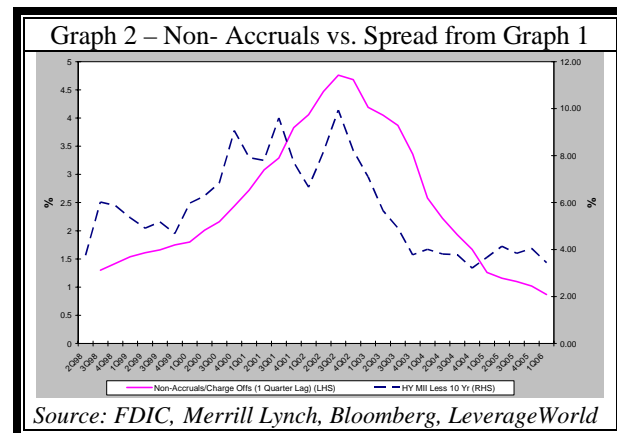
Tod Trabocco, CFA
Senior Analyst
LBC Credit Partners

The traditional indicators utilized by market watchers to predict the turn of a credit cycle appear to be diverging. These indicators fall into two broad categories, fundamental economics and credit metrics, and currently paint different pictures of the market's credit quality. This divergence may mean that the credit cycle could turn as early as next year. Before turning to a deeper discussion of the pillars of broad market default predictors, it is first useful to put the current credit cycle in historical context by referencing the current period to a representation of the markets. One way of reflecting the credit cycle is by examining the spread of high yield bonds over the 10 year Treasury Note. This method is used by industry observers as a proxy for the current state of the credit markets. Graph 1 shows the difference between historic yield-to-worst of a key market index (Merrill Lynch High Yield Master II Index) and the historic yield of the 10 year Treasury Note. The spread over time shows the ebb and flow of credit, which can be seen as a proxy for lender risk appetite driven by different forces, including *inter alia* increasing defaults. Graph 2 supports the use of credit spreads as proxy for credit quality and lender appetite by laying the spread from Graph 2 over commercial bank provisioning rates (non-accruals and charge offs) as reported by the Federal Deposit Insurance Corporation (FDIC). There is a high correlation between provisioning rates and spread dynamics. Therefore,

the spread over 10 year Treasuries is a reasonable proxy for credit quality.



As the first graph suggests, we are at a trough in the credit cycle. However, most market participants don't need this graph to tell them that liquidity is high, credit standards are relatively slack and interest rates are low (they may be rising, but are historically very low). Lenders and investors recognize the limited room for lending to grow more accommodative and reasonably conclude that the credit cycle will turn at some point in the future. The debate now really distills into the question of timing. As the graph suggests, the last credit trough lasted approximately 5 years and one may reasonably conclude that current conditions are likely to persist for a while longer.



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Various industry commentators, however, predicted a turn in the credit cycle as early as this year. Credit deterioration in the form of rising default rates has been shown by rating agencies to follow certain changes in economic indicators and broad credit market metrics. Both Standard and Poor's and Moody's Investors Service look to an array of economic indicators, including the term structure of interest rates (flat or inverted yield curves tend to indicate heightened probability of future recession), the Federal Reserve Bank's survey of lending conditions, industrial production, corporate profits and GDP growth. The agencies also comb through their proprietary databases for traces of deteriorating credit quality in the form of upgrade/downgrade ratios, positive/negative outlook ratios, the proportion of speculative issuances rated B- or lower and the distress ratio (defined by Standard and Poor's as the ratio of loans yielding over 1,000 bps to total outstanding loans).

Based on these indicators, the agencies predicted that 2006 would see a meaningful uptick in speculative bond defaults. Moody's, in its March 2006 revised *Default and Recovery Rates of Corporate Bond Issuers, 1920-2005*, predicted an increase in default rates from 1.9% to 3.3% by November of this year. Much of this prediction was founded on deteriorating economic data. At the time, GDP showed signs of slowing, the yield curve was flattening and the number of Caa issuers amounted to almost one third of new speculative grade issuers in 2004.

As of the writing of this article, four months have elapsed and there appears to be little sign of credit deterioration in

the relevant metrics followed by the agencies. Moody's reported that its July default rates of speculative bonds stood at 1.7% on a trailing twelve months (TTM) basis, slightly less than the 1.8% the previous month. Standard and Poor's reported in its August *Global Bond Markets' Weakest Links and Monthly Default Rates* analysis that the twelve month trailing global corporate speculative default rate fell to a record low of 1.03% in July. Standard and Poor's distress ratio (defined as the ratio between speculative grade bonds with an option adjusted spread above 1,000 basis points and the total number of speculative grade issues outstanding) fell to 3.2% in July from 3.7% in June, the lowest level since May of 1998.

However, the divergence between economic and credit indicators may portend risks of sooner credit deterioration. Economic fundamentals suggest that the economy is slowing and that the impact of input prices is only now beginning to diffuse throughout the economy. As a result, the upbeat credit metrics in the market should begin to slide a bit as 2006 comes to a close and throughout 2007.

Recent indicators point to a slowing in the economy and the Federal Reserve has heeded these warnings, electing to pause rate raising on August 8th. One indicator that contributed to this sentiment is the slowing GDP growth in the second quarter of 2006. GDP grew at 2.6%, on an annualized basis, compared to 5.6% the previous quarter. Similarly, personal consumption also declined on the quarter as did exports. The yield curve offers some insight into the interest rate market's assessment of the US's economic prospects. LBC

estimates that since the third quarter of 1986, the month ending difference in yields between two and thirty year Treasuries has been +/- 25 basis points for only 12 months. Not since February to May of 1990 has this 'flatness' endured for two consecutive months except for June and July of this year. Although generally a predictor of economic recession, our current flat and inverting yield curve is more likely predicting a mere slow down in growth rather than an actual contraction in GDP.

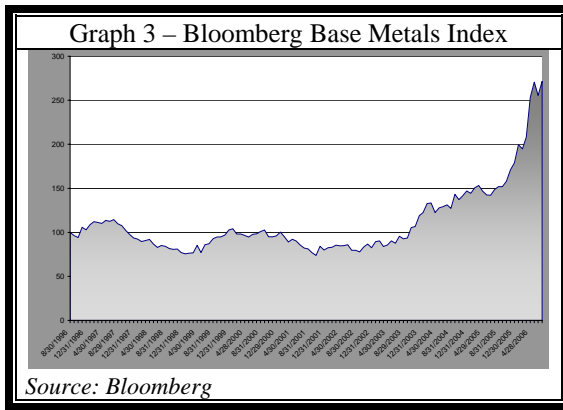
Looking past these macroeconomic indicators, we see a different and yet reinforcing picture in the corporate world. More specifically, two historic indicators strongly suggest that corporate credit quality will deteriorate. The first is the historic loan performance as tracked by the FDIC that is displayed in the first series of graphs. On average, the total combined proportion of non-current and charged off loans (including commercial, credit cards, mortgages, loans to individuals, etc.) has been 2.47% since the second quarter of 1998. The standard deviation of these rates has been 1.22%. The current rate stands at 0.8%, or approximately 1.32 standard deviations from the mean. Even a half-hearted belief in the predictive power of statistics should cause market participants to anticipate an increase in provisioning rates. Anecdotal evidence from the primary syndicates of several major banks reveals that in July and August pricing began to back up and covenant-light structures began to become less prevalent in both first and second lien loans, suggesting that lenders may have already begun to rethink their credit strategies.

Moreover, credit threats lie not just in corporate and asset based portfolios but also in related asset classes. Threats to credit and capital bases lurk in rising defaults in mortgages (the Federal Reserve's July Senior Loan Officer Opinion Survey reports that sub-prime residential mortgage portfolios are showing signs of deterioration) and in unsustainable consumer debt. Both asset classes have deep penetration in the commercial banking sector and their souring may cause aggressive lenders to pull in their horns. *Moody's Economy.com* notes that 50% of the residential mortgages originated in 2005 were adjustable rate (ARMs). A recent FitchRatings report by Alla T. Sirotic on the US residential mortgage backed securities market estimates that with constant interest rates a 30 year mortgage with a 2 year ARM or a 2 year interest only option can result in monthly payment increases between 30% to 50%. FitchRatings further estimates that 35% of all outstanding sub-prime residential mortgages will reset in calendar 2007. These are a just a few of the ancillary threats to credit portfolios that could contribute to a reversion to mean default levels.

The second historic indicator is corporate profits. The US Department of Commerce reports that at the end of the fourth quarter of 2005, corporate profits increased 21.5% and accounted for the largest share of national income in 40 years. Moreover, in 2005, pretax profits totaled \$1.35 trillion, up from \$1.16 trillion in 2004 and \$767 billion in 2001. Unless we believe we have achieved a new paradigm of corporate profitability we can really only conclude that corporate profitability will revert to more normal levels. A recent

Bloomberg article quoted Ian Shepherdson of High Frequency Economics and Henry McVey of Morgan Stanley as predicting a decline of 10% in S&P 500 earnings and a reduction in S&P 500 earnings growth to 5% from a projected 11.4% on 2006, respectively.

The causes for this reversion may be driven by both demand and supply developments. For example, the cooling housing market may chill consumer appetites, although to date, certain purchases (e.g. furniture and high end electronics) are at all time highs. Similarly, the upcoming ARM resets mentioned above, when layered on high and sustained oil prices and rising consumer prices may stretch the US consumer too far. Another likely driver of lower profitability will be rising input costs in the form of labor and raw materials. Labor costs rose 3.2% in the last 12 months from June 2006, while the average from 2000 to 2005 was 0.8%. Labor productivity is declining as our economy burns off ever more spare capacity. Similarly, raw materials are only now beginning to work their way into our economy. Graph 3 shows the Bloomberg Base Metals Index and tells an interesting story.



From August 1996 to July 2006, the index has increased 171.5%. From August 1996 to October 2005, the index rose 58%. From October 2005 to July 2006, the index rose 71.7%. Put another way, the compounded annual growth rate of the index from August 1996 to October 2005 was 5.1%. The CAGR over the next 9 months was 105.6%. Many end producers, however, were probably able to shield consumers from these price increases as they sold historically lower costing inventory and inventory purchased under cheaper forward agreements. Now that lower costing inventory is probably washing through company balance sheets and manufacturers will be forced to increase prices to consumers. On a recent round of earnings calls, many companies cited rising input prices as a major concern over future profitability. For example, the Kellogg Company (NYSE:K) (although probably not a large buyer of base metals has exposure to the less explosive soft commodities) announced in its earnings call that it plans to implement price increases in certain key segments, thus bringing to 100% the proportion of its business units that have increased prices in the past twelve months.

Predicting the timing and severity of the actual turn is difficult. Economic indicators are more bearish and a key signal of the credit market's direction may come from a realignment of credit metrics and economic indicators. But for now, the indicators do not support a clear conclusion. In the absence of clarity, lenders can be more vigilant or rely on alternative insights into market trends. For example, at LBC, we believe that one such leading indicator of a turning credit cycle is the point when

mergers and acquisitions (M&A) activity declines without a concomitant deceleration in refinancings. For the moment, asset based and senior lenders will continue on their current pace, but should be on the lookout for the convergence of the economic and credit indicators.

LBC Credit Partners is a structured finance fund focused on providing debt capital to middle market companies primarily in the form of second lien, Tranche B and mezzanine loans.

CONTACTS:

John Brignola
1-215-972-8901
jbrignola@lbccredit.com

Chris Calabrese
1-215-972-8902
ccalabrese@lbccredit.com

Nate Cohen
1-215-972-8903
ncohen@lbccredit.com