

Policymakers as Rainmakers: A New Trend in Credit Selection

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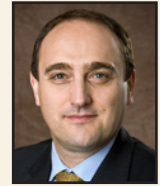
This summer, in the highest of fashion circles, we hear that “red is the new black.” As in the world of fashion, some truly extraordinary sights appeared on the credit catwalk in 2008. In credit, 85 cents is the new par (85 being the average price of investment grade bonds). The credit bear market has turned heads as well as stomachs. Expect more jaw-dropping events in 2009. The eye-catching new trend in credit is that governments and central banks (both “policymakers”) have become key players. In light of these new fashions in the credit world, we ought to revisit the art of credit selection.

The New Credit Paradigm

How should investors pick securities in the new global credit paradigm? Classic credit analysis is focused on the ability of a borrower to repay debt. The analysis usually begins with assessing the state of a corporate credit within the macroeconomic and sector backdrop. Analysts usually then determine the likelihood of default based on the strength of corporate management and how well it balances the interests of equity holders versus creditors. The key ingredients are operating performance, debt service coverage, financial leverage and liquidity. There are an array of financial ratios that have become “rules of thumb” in establishing conventional numerical ranges for investment grade and speculative grade corporates. In short, classic credit analysis has a strong emphasis on microscopic detail. It is almost forensic in nature.

So what’s changed? Why isn’t classic credit analysis sufficient any more?

First, traditional policy tools for stabilising credit markets are not working. We are seeing an unprecedented global credit crunch; the credit heat wave of recent memory has chilled into an ice age. As a result, there has been a synchronised collapse in global growth. So much for decoupling! The Keynesian response to diminished growth, both realised and expected,



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would be a forward thrust in fiscal policy. Aligned with a loosening of monetary policy, the seeds of growth would be sown. The trouble is that the mechanisms that transmit those policy impulses into the economy have broken down.

Second, policymakers have become both creditors and equity holders. Banks, as lenders, were too levered. Desperately in need of capital, banks went on a massive fundraising mission in 2008. The private sector provided a large chunk of the initial capital needed. However, markets in all assets continued to tumble. This is when governments and central banks stepped in, offering banks state guarantees on senior debt along with injections of equity, sometimes both at the same time. Some financial institutions have been effectively or totally nationalised, others have failed.

Third, credit risk is rising in other sectors beyond banking – and policy is changing fast to address it. The bailouts are moving away from banks into other industries. Policy and legislation are evolving at different speeds around the world: the US has already provided credit to its ailing auto industry, and the European states are in the process of clarifying their policies. We have seen a change in the US administration, and political cycles are underway in the UK and in some countries in Europe.

Justifications for policy action (and inaction), and the public mood and cross-country attitudes toward industry bailouts, will be front-page news for some time to come. With policymakers worldwide now acting as investors at all levels of the capital structure and across a wide range of sectors, issuer and credit selection must

be undertaken with this additional layer of complexity in mind.

Credit Selection and Stock Picking

The developments outlined above have complicated the process for credit selection. Here are some of the important features of the new credit paradigm:

- **Credit market features:** Banks as intermediaries of credit have lost a great deal of market power. For the foreseeable future, and compared to other credit cycles, expect to see lower levels of liquidity (making price discovery harder), more corporate defaults (and restructurings), and lower recovery values. You can no longer assume a 40% recovery rate as a bond investor.
- **Eclectic bank bailouts:** The global banking bailout is still evolving. Governments have invested in equity and subordinated debt and have offered state guarantees on senior debt. Some banks failed, others were nationalised. Some countries are considering the “bad bank” model, others prefer equity injections. Bank bailouts are a moving target.
- **Random character of other corporate bailouts:** Policymakers have yet to outline a clear strategy for bailouts of non-bank credits as well. Some policies appear almost deliberately vague – especially in terms of implementation. Policy may evolve on a per-case basis as governments deal with one corporate credit crisis after another. Bailouts will likely be based on political parameters, rather than commercial reasoning.

- **Competition among policymakers:**

If Country A bails out its auto sector, then Country B may be forced to do the same. Expect this line of argument to intensify going forward.

- **Regulatory oversight expected to increase:**

With more policymakers now making decisions at the sharp end of business, expect more industry oversight, especially in banking and finance. A transfer of power from private to public entities is likely.

- **Wealth and value transfers:** Policymakers are acting on behalf of their electorate, subject to public finance constraints. It's highly likely that new injections of capital by policymakers will subordinate some investors, but may support others. Investors can choose the senior parts of the capital structure to help mitigate risk.

- **Policy constraints:** The markets are monitoring all of this new activity by policymakers. Two key indicators are sovereign spreads and currency values. If policymakers go too far, then risk premia should rise in both – which could put a limit to policy involvement.

How should a policy programme affect your choice of sector, credit, seat in the capital structure, maturity preference, etc.? Is the policy guarantee feasible? Even if you believe it is, is the risk-reward trade-off prudent? In short, we still must apply good old-fashioned value judgments. Perhaps it boils down to asking one simple question: *Is your credit investment under the policy umbrella?* Every line of reasoning

gravitates toward answering this “too big to fail” question. This also raises questions for credits outside the umbrella: How can a fully private entity compete with a part-government-owned and -funded corporate? For PIMCO the implications for credit selection under the new paradigm are as follows:

1. **Slipstream:** Align interests and try to co-invest with policymakers. It's tempting to front-run policy, but given the dislocations in markets and the need for private capital to co-invest with policymakers, the new issue market is likely to give investors the chance to evaluate each opportunity.

2. **Umbrella:** Choose credits that are under the umbrella of policy support. Umbrella credits will likely emerge from sectors with many employees (voters), regulated industries (utilities and telecoms), sectors affected by liquidity shortage rather than solvency risk, and industries where other governments are already lending (e.g., the US auto industry, with Europe likely to follow). Credits outside the umbrella are likely to be more volatile and subject to more frequent repricing risk.

3. **Capital Structure:** The current environment requires not only the corporate issuer but the specific bond issued to be under the umbrella. It is possible for the issuer to be under the umbrella but for certain parts of the capital structure to end up adversely impacted. Bailouts could force deeply subordinated capital to lose out to senior investments. Choose your seat in the capital structure with great care.

Credit Catwalk: 2009 and Beyond

As credit investors, we at PIMCO have our eyes focused on the microscopic detail of line items – flanked by our team of 29 credit analysts, thankfully. Still, we have also spent a lot of time examining the way policy initiatives are changing the credit paradigm. Performance in 2009 and beyond will largely depend on how credit analysis and selection evolve under the policymakers' umbrella.

Much like “red is the new black”, this season look for two more trends to stand out on the credit catwalk. First, policymakers are the new rainmakers. Note, however, that the solvency

of the sovereign guarantor is subject to the same forensic scrutiny that other credits face – especially in the EMU (Europe's Economic and Monetary Union). Policymakers may have the will and (maybe) the wallet, but markets are watching. Second, credit is the new equity. Credit currently trades in equity risk premia territory, and with a lot less volatility.¹ And watch those equity dividends – we're seeing a transfer of value from equity to credit as companies look to preserve cash through dividend cuts. This development suggests that new investors will be coming to the credit markets, eyeing the new fashions.

¹ Mark Kiesel, *US Credit Perspectives: “Credit Now, Equities Later”* (December 2008), <http://australia.pimco.com/LeftNav/Global+Markets/US+Credit+Perspectives/2008/US+Credit+Now+Equities+Later+Kiesel+Dec+2008.htm>

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