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The U.S. Corporate Bond Market – 2011 Year in Review and 2012 Outlook

It was the best of times, it was the worst of times...

Sentimental clichés are worthless crap – get us nowhere. Actually in terms of the corporate bond market it was of course *neither* the best of times (2003-2007) *nor* the worst of times (2008-2009). It had its variations like any other year, but these were small compared to the frightful movements of 2008 and early 2009. We had a high-yield spread rally of almost 100 basis points (bps) from New Year's Day 2011 until mid-April, then a correction with spreads widening almost 400 bps until late September. October, traditionally feared as a disastrous month for securities, was actually a great month, with spreads tighter by about 135 bps, but the rally had no “legs” as the European crisis took over big-time in November, widening spreads 70 bps to near September wides for the year. Finally a minor rally in late November and early December has brought spreads down 25 bps to their still-wide (compared to the daily average for the year) levels of today, with high-yield spreads up 215 bps for the year. Year to date returns have been good for investment-grade corporates (+6.72% per the Merrill Lynch/Bank of America Corporate Master Index) and poor for high-yield corporates (+3.38%). But U.S. governments have dwarfed them with an outsized 8.76% return through 12/8/11.

We like to over-dramatize things, especially at year-end. However, objectively one can't point to 2011 being the end of any particular era, the beginning of anything truly major, or even a highly emotional year. You know it's a slow news year when Steve Jobs' widely anticipated death got treated almost as if he were the President. But that may be a sign that we have been in the Corporate Era for so long that a huge outpouring of eulogies for a captain of industry's death seems normal nowadays. Even when Sam Walton died – heck, even when John D. Rockefeller or Andrew Carnegie died – I am sure the public reaction was much more muted. But then again, Rockefeller's and Carnegie's oil and steel companies didn't make trendy consumer products, and Wal-Mart doesn't actually invent anything.

If 2011 was a welcome relief from the 2008-2009 drama of Lehman Brothers and the Great Recession (if more nerve-racking in its economic weakness than the more robust recovery of 2010), there is the temptation to get all ominous about the future, as the *Economist* does by showing the Euro as a comet falling to fiery destruction. Nice try, guys, considering the boring name of your magazine. You may even have it right – the Euro might cease to be a currency union as soon as 2012 (although I personally doubt it – things tend not to happen that quickly).

I view 2011 as a transitional year, not between good times and bad, but between our tremendously inward-looking bias since the Great Recession began and a more balanced world view which accepts that we are part of a global political and economic system which we cannot always control, but should always be engaged in. Europe represents a huge economic test, just as Libya represented a minor political/military test, of how well we can be involved in the global community, both economically and politically (and, yes, militarily) without losing perspective and thinking it's always about us 24/7 (as we did with 9/11 and its aftermath).

Osama Bin Laden was finally killed, after living quietly in Pakistan (our long-term ally), near their premier military college. Tunisia freed itself from dictatorship, and this echoed 'round the Arab world as the fabled Arab Spring blossomed, with Egypt ousting our long-term ally and oppressive dictator Hosni Mubarak, and Libya finally killing its "Brother Leader" Gaddafi. (With luck I'll soon forget how to spell his name.) Other repressive Arab regimes tottered, such as Bahrain, Yemen and Syria, and the bloodshed continues.

The good news, from a bond and stock market perspective, is that we *didn't* get overly involved, except in the hitherto-wimpy method of joining an international force bombing Libya. We did almost nothing in Tunisia and Egypt, and did it very well! We also did little but to cheer as South Sudan became the U.N.'s 193rd country. You'll need a ton of luck, South Sudan!

Although it's a stretch to say how this might affect how well we do with "helping" the Europeans "solve" their years-long "crisis" it does offer hope that we can indeed help events without actually controlling them, as we insisted on controlling Iraq and Afghanistan. The recent coordinated efforts of the U.S. and European central banks should be viewed in that light – not necessarily successful, but a move in the right direction.

A review of 2011, even a strict "market review and 2012 outlook", would be incomplete without the attention to our major quadrennial event, the election of 2012. Campaigning has been under way so long, one forgets when it started, but already a few trends have emerged:

- 1) This is a classic election of the insiders, with everyone, possibly even the President, ineffectually posing as being an outsider. Let's see, we have two career politicians (Barack Obama and Newt Gingrich), a second-generation CEO-turned-politician who became governor of Massachusetts (Mitt Romney, son of George Romney) and the longest-continuously-serving governor in the U.S. (Rick Perry of Texas). Not a shred of "outsider" status to be seen.
- 2) It's all about the economy, stupid, again, says a long *New York Times* election analysis. It concludes that despite some foreign-policy wins by the incumbent (the incumbent always has the advantage in the foreign-policy experience category), if the economy is in recession Obama's finished, and even if it's just growing

weakly (+1% or so) he is likely to lose. I believe that although the *Times* didn't opine so exactly, any growth of 2% or more for the first three quarters of 2012 (on average) will more or less result in an Obama win. I'm sure everyone, even me, regards this as a gross oversimplification, but all candidates run such controlled candidacies these days that a last-minute gaffe making all that much difference is unlikely. The *Times* did point out that in almost every election since WWII the candidate who is the "less extreme for his party affiliation" tends to win, as Johnson swamped Goldwater, Nixon slaughtered McGovern, and Reagan trounced Mondale, in the most obvious examples. The only major counter-example was Truman, a left-wing Democrat, beating Dewey, a moderate "progressive" Republican. Look for Obama to try to get a jump on the Republican candidates in his attempt to appear more moderate, while the Republican candidates are still forced to slug it out and generally stay farther right than would be ideal from an election perspective.

Since markets hate uncertainty, the fact that the election is definitely up for grabs will not help, at least not until October, by which time it has usually been pretty much decided.

The theoretical plus-side for the markets of an election year is that one can expect a lot of pump-priming activities to at least be proposed. If they are blocked by Congress, as has recently been the case, this may increase uncertainty over the fate of the economy, especially as Europe sinks deeper into recession.

Am I saying that the extent of Europe's financial and economic crises will be determining our next President? It is possible to interpret it that way. But any time one strings together events they have a way of tripping you up. Even the simplest "analysis" of football, such as "Chicago beat Detroit and Detroit beat Minnesota, therefore Chicago will beat Minnesota" is not really used that much by savvy pro football analysts. They know a lot more is involved, including luck!

So I will predict a generally good year for the corporate bond markets, both investment-grade and high-yield. Yes there may be periods of massive underperformance in the run-up to the election, and in the many twists and turns of Europe's attempts to right its ship. The only thing that gives me confidence is that we start from spread levels (+258 bps for U.S. IG corporates, +306 bps for my personal favorite, BBB-rated corporates, and +756 bps for U.S. high-yield corporates) which are very attractive, so events will have to be a lot worse than we currently think in order to upset the tendency of spreads to narrow from these levels.

So invest with fear and trepidation – any time it's too comfortable, it's not worth investing in, I say!

Good luck and good investing,

Stephen Smart, CFA
Chicago (630-363-8511) stephen.h.smart@gmail.com

Carolina Capital Markets
Chapel Hill (919-960-0807) smart@bonddog.com
The Smart Bond Guy

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