S&P CAPITAL IQ

Lookout Report
from Global Markets Intelligence

Beware The Ides Of March And The Return Of The Bond Market Vigilantes

Michael Thompson
Managing Director
Global Markets Intelligence
(1) 212-438-3480
michael_thompson@spcapitaliq.com

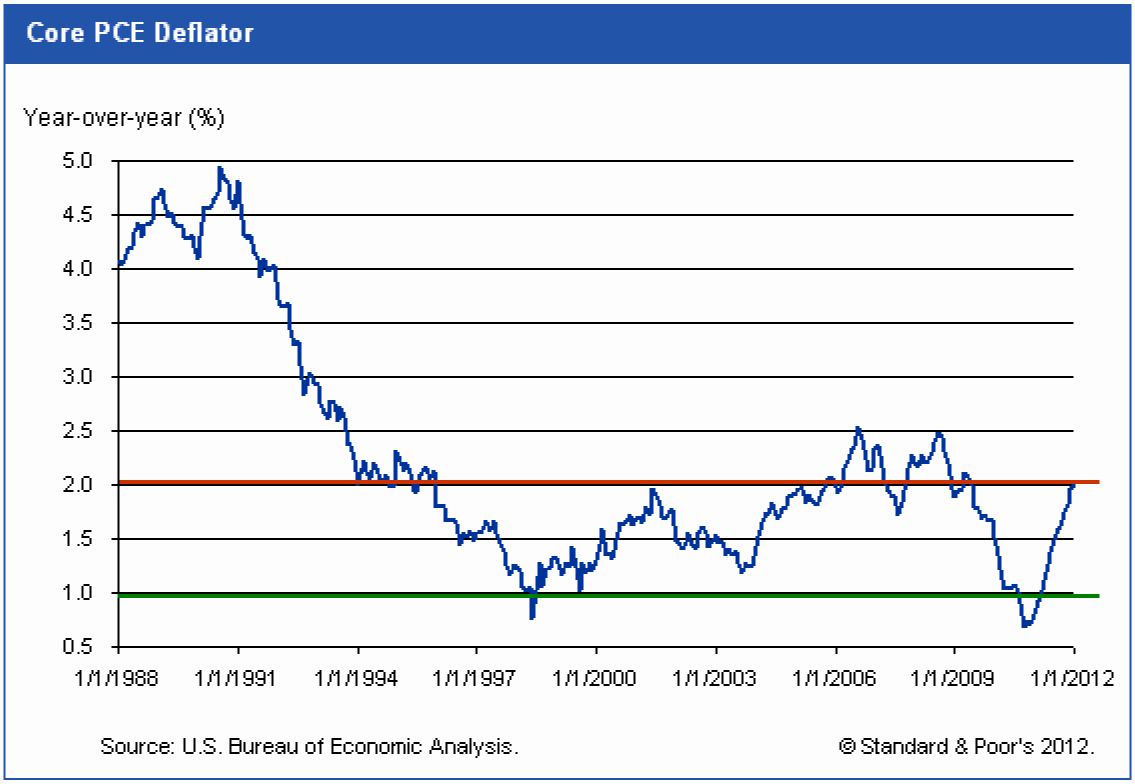
Robert Keiser
Vice President
Global Markets Intelligence
(1) 212-438-3540
robert_keiser@spcapitaliq.com

The Lookout Report is a compendium of current data and perspectives from across S&P Capital IQ and S&P Indices covering corporate earnings, market and credit risks, capital markets activity, index investing, and proprietary data and analytics. Published bi-weekly by the Global Markets Intelligence research group, the Lookout Report offers a detailed cross-market and cross-asset view of investment conditions, risks, and opportunities.

The strength in U.S. nonfarm payroll employment over the past three months (three-month average of 245,000) has set the stage for a powerful asset allocation trade that could benefit equities over time at the expense of the fixed-income market and even precious metals. This turn of events would require a belated-but-sustained cyclical upswing in job creation and wages, combined with the continuation of the multi-month trend of rising core inflation that exceeds the Fed's preferred target range. Such a scenario includes the classic set of conditions that has empowered the "bond market vigilantes" of the past.

Over the past year, Global Markets Intelligence (GMI) Research has closely followed the developing trend of rising core inflation. At the start of 2011, the core personal consumption expenditure deflator (PCE deflator, excluding food and energy) was rising at a very benign 0.8% year-over-year rate. The PCE deflator, widely acknowledged for years to be one of the Fed's favorite indicators of inflation, spent most of 2011 well within the 1% to 2% range known as the Fed's "comfort zone." Year-over-year core inflation as of January 2012, however, is now rising at 2%--the upper bound of the Fed's comfort zone (see chart 1).

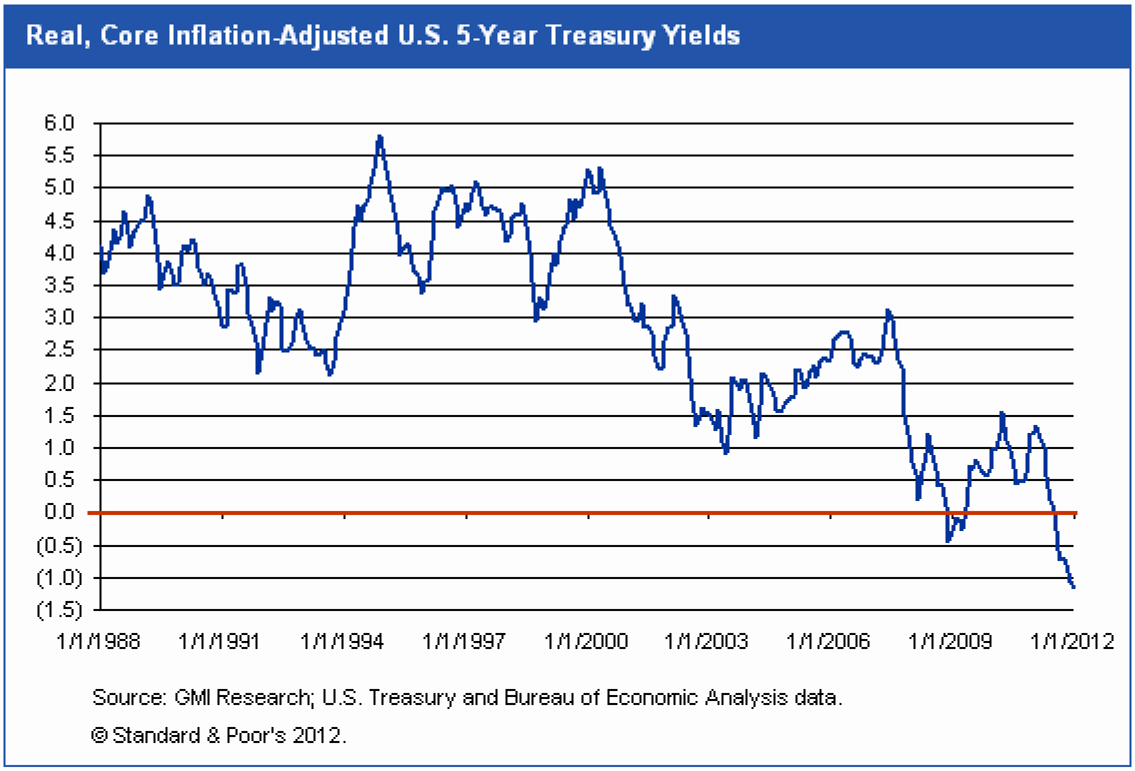
Chart 1



Investors, the Federal Reserve, bond vigilantes and even GMI Research have had--until recently--very little reason to worry about inflation. Core inflation was extremely low at the start of 2011, and while inflation has definitely been rising, most investors believe that monetary policy has been almost singularly focused on supporting the U.S. economy and financial system by maximizing employment. In its press release on Jan. 25, 2012, the Federal Reserve said that the Federal Open Market Committee (FOMC) had decided "to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant low levels for the federal funds rate at least through late 2014."

The GMI research team currently does not believe that inflation can rise substantially from current levels because the existing rate of U.S. wage growth, which is barely keeping up with the still historically modest rate of inflation, does not support the case for significantly higher inflation. Our base case for an upward adjustment in market-based interest rates is founded on the observation that professional bond market participants (i.e. the vigilantes) may soon conclude that real, inflation-adjusted yields are simply too low relative to the rapidly improving U.S. economy. The current yield on the five-year Treasury note is 1.08%, equating to negative 92 basis points (bps) after adjusting for the 2% inflation rate according to the January core PCE deflator. The real five-year yield drops even further to a negative 119 bps after compensating for the 2.27% core CPI inflation rate. There is simply very little historical precedent for sustained deeply negative five-year Treasury yields, in our view (see chart 2).

Chart 2



From our perspective, inflation does not have to increase from current levels in order to become a problem for the U.S. fixed-income markets; the economy only needs to continue to build expansion momentum. When enough financial market participants have concluded that the economy is moving in a direction where prospective employment and wage growth are no longer impeding further deterioration in the medium-term inflation outlook, the bond market vigilantes will look to profit from what will at some point become an unsustainable term structure of market-based interest rates. The Fed may control the front-end of the yield curve, but the bond vigilantes and global investors control the back-end of the curve.

While GMI Research does not expect an instant or violent steepening of the yield curve, it is important to note that the two-year to five-year Treasury yield spread has already steepened by 15 bps since the end of January, and investors currently have to extend out to the 10-year T-note on the Treasury curve to secure a yield that is higher than the Fed's preferred index of inflation. The stronger the U.S. economy gets, the less logical the flight-to-quality asset categories look, including Treasuries and gold, in our opinion. In our view, the S&P 500 Index remains relatively attractive from an earnings multiple valuation perspective. Should core inflation stall near current levels while the economy continues to grow at a reasonable pace, it is also conceivable that the FOMC may need to do relatively little tightening of monetary policy if the bond market vigilantes do much of the heavy-lifting tightening for the Fed.

Inside This Issue:

Macroeconomic Overview

The strength in U.S. nonfarm payroll employment over the past three months (three-month average of 245,000) has set the stage for a powerful asset allocation trade that could very well benefit equities over time at the expense of the fixed-income market and even precious metals. This turn of events would require a belated-but-sustained cyclical upswing in job creation and wages, combined with the continuation of the existing multi-month trend of rising core inflation that exceeds the Fed's preferred target range.

Economic And Market Outlook: North American And European Earnings

For the first time since we began tracking first-quarter estimates, analysts polled by S&P Capital IQ expect six of the 10 sectors (energy, materials, health care, financials, telecommunication services, and utilities) to report a year-over-year decline in earnings. Meanwhile, analysts continue to cut 2012 earnings expectations for European companies, despite some encouraging signs of recovery in the past few weeks.

S&P Index Commentary: The U.S. May Only Be Part Of The Global Economy And Equity Market--But It's Still The Largest

While the U.S. economy may still be the largest in the world, it is long past the point where it can go it alone, in our opinion. From the opposite perspective, while the U.S. may not be as nimble as some of its smaller emerging counterparts, it nonetheless remains a vital destination for trading partner exports.

Leveraged Commentary And Data: The Loan Default Rate Is Still Set To Rise, But Managers Temper Forecasts

After another low-default stretch during the first quarter, when two S&P/LSTA Index issuers defaulted on just $475 million of loans, managers have reduced their default-rate forecasts for 2012 and 2013. On average, managers expect that the default rate will end 2012 at 1.6% and then push to 2.7% in 2013, according to LCD's latest quarterly buyside poll (taken in March). Those figures compare to expectations of 1.9% and 2.9%, respectively, in LCD's last buyside survey, from December.

R2P Corporate Bond Monitor

From Feb. 29, 2012, to March 12, 2012, risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--seemed to have taken into account the current economic climate, with improving scores in North America and deteriorating scores in most sectors in Europe. Unlike North America, the average probability of default in Europe increased.

Market Derived Signal Commentary: The Sovereign CDS Market Is Alive And Well After Greek Debt Trigger

Eurozone sovereign credit default swap spreads widened 13% in the week ended March 9 after a credit event triggered $3.2 billion of Greek default protection contracts. The S&P/ISDA Eurozone Developed Nation Sovereign Index (Eurozone index), whose largest constituents are France, Germany, and Italy, expanded 88 bps to 750 bps, just 7 bps shy of the record of 757 bps set on March 8.

Capital Market Commentary: IPOs Perform In Line With Overall Market

So far, S&P 500 fourth-quarter 2011 earnings results indicate that 70% of companies have met or exceeded analyst consensus expectations. With that in mind, the Global Markets Intelligence research team reviewed the earnings performance for companies from last year's crop of IPOs priced in the U.S. We found that these companies have performed similarly to the overall index, as 49 of 69 (71%) companies have reported fourth-quarter 2011 financial results that beat or met consensus earnings expectations.

S&P Index Commodity Commentary: Commodities Show Divergence

The strong dollar has contributed to pressure on most commodity prices in March, with the notable exception of energy. Energy continues to support gains in the S&P GSCI Index, but the index has declined on the month (as of March 14), despite strength in equities. Commodities may be flashing early warning signals, but continued divergence between the

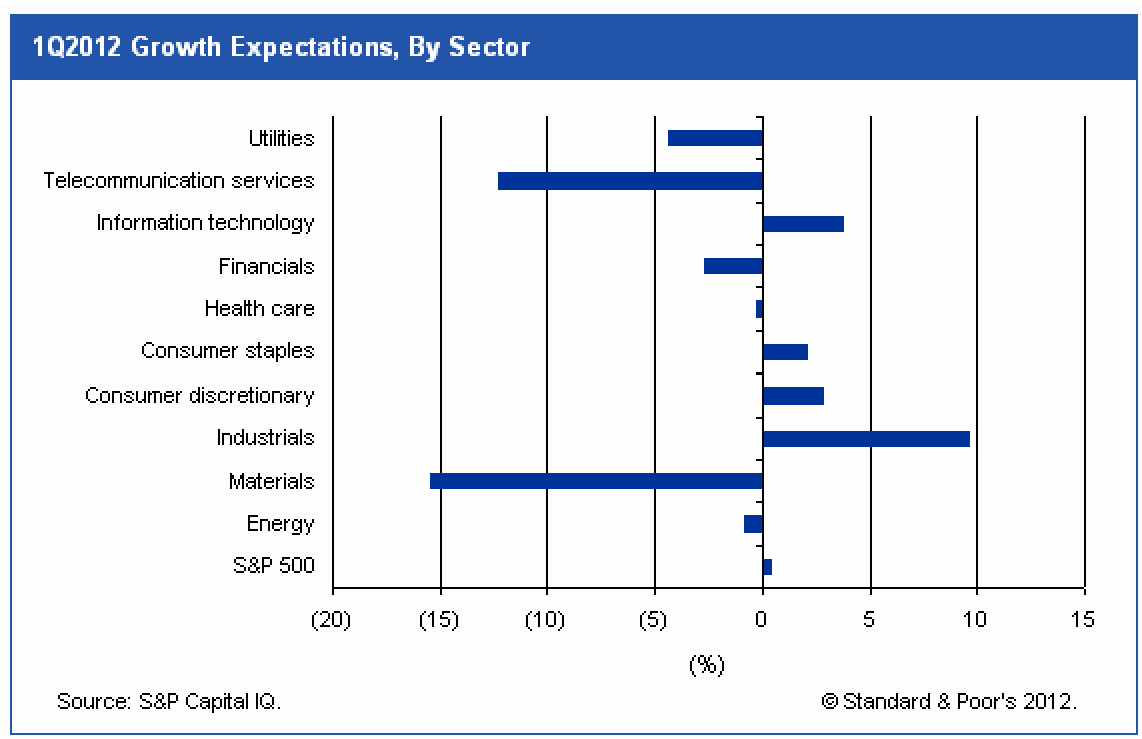
S&P GSCI Index and S&P 500 Index, along with a decline in the stubbornly high correlation measures, could be a sign of the improving post-2008 investment environment.

Economic And Market Outlook: North American And European Earnings

North America

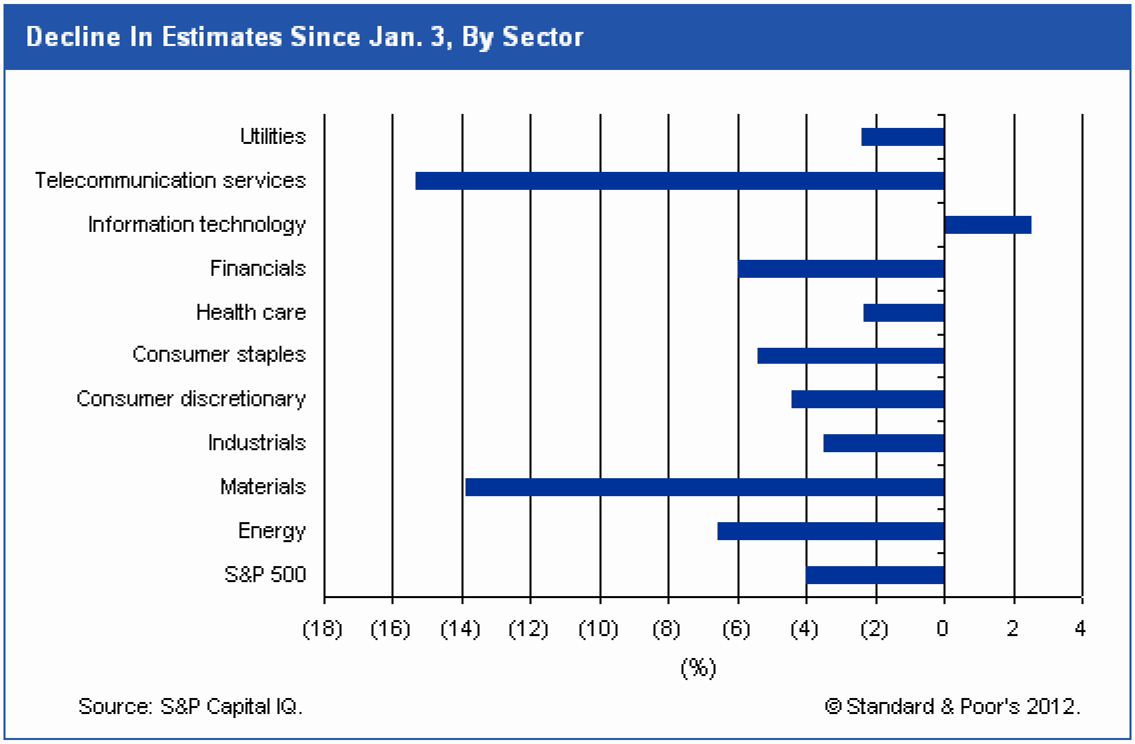
With only GameStop Corp., SAIC Inc., and Tiffany & Co. left to report earnings for fourth-quarter 2011, investors have turned their focus to first-quarter 2012 expectations. Currently, analysts expect the S&P 500 Index to grow at a lackluster 0.52% for the quarter, a figure that has been on the decline for several weeks. Just this week, for the first time since we began tracking first-quarter estimates, analysts polled by S&P Capital IQ expect six of the 10 sectors (energy, materials, health care, financials, telecommunication services, and utilities) in the index to report a year-over-year decline in earnings (see chart 3). If the quarter ends with these six sectors in the red, it will be the first time that more than half of the sectors have reported negative growth since the third quarter of 2009.

Chart 3



Since the beginning of the first quarter (Jan. 3), analysts have reduced estimates for nine of the 10 sectors (see chart 4) and only increased expectations for the technology sector, by 2.6 percentage points. Meanwhile, analysts have most significantly lowered estimates for the telecommunications (down 15.3 percentage points) and materials (down 13.9 percentage points) sectors. Companies in the materials sector cite both raw materials price inflation as well as softening demand for raw materials as their top concerns for 2012, while telecommunications companies such as AT&T Inc., Sprint Nextel Corp., and Verizon Communications Inc. struggle with higher-than-average churn levels as customers drop service plans. Once again, this quarter looks to be a "cyclicals" story, as those sectors drive overall growth.

Chart 4



Analysts have also cut 2012 growth estimates to 6.61% from 10.05% on Jan. 3 for companies within the S&P Europe 350 Index. However, analysts have increased estimates for some companies in other regions, including companies in the Nikkei 225, especially among the machinery, automotive, and retail industries. As the S&P 500 Index is composed of mostly multinational companies, which derive roughly 50% of their sales from outside the U.S., the increase in earnings expectations in other parts of the world could explain the recent rally in the stock market. The S&P 500 Index is up 9.8% since the beginning of the year, as of the close on March 15. The rally in share prices, paired with declining earnings forecasts in the U.S., has led to rising price-to-earnings ratios, causing concerns that equities could soon be overpriced.

Europe

As fiscal-year 2011 earnings season comes to an end, analysts continue to cut 2012 earnings expectations for European companies, despite some encouraging signs of recovery in the past few weeks.

- The six-month forward-looking German business confidence Ifo index for February increased to a seven-month high.
- Greek private bond investors have agreed to a €206 billion debt swap deal that will allow Greece to receive the second round of bailout money (€130 billion) from the "troika" financial institutions, hopefully preventing debt crisis contagion.
- The German investor confidence ZEW Index, which aims to predict economic developments six months in advance, jumped to a 21-month high in March. That's the fourth straight increase and the highest reading since June 2010. The European Central Bank (ECB) helped to boost confidence by injecting more than €1 trillion ($1.3 trillion) of three-year loans into the banking system in an attempt to provide access to credit for companies and households.
- The ECB now suggests that the eurozone has avoided a short-term crisis, but it is now refocused on the issue of inflation. On March 8, the ECB announced that it would keep its benchmark interest rate at a record-low 1%. "Inflation rates are now likely to stay above 2 percent in 2012, with upside risks prevailing," ECB president Mario

Draghi said. "We see many signs of returning confidence in the euro."

- The S&P Europe 350 Index is up 9.5% since the start of the year. The S&P 500 Index is up 11%.

Although analysts still forecast earnings growth of just less than 7% for 2012, at the end of February, the S&P Capital IQ consensus forecasted a year-over-year decline in earnings for 2011 (see chart 5).

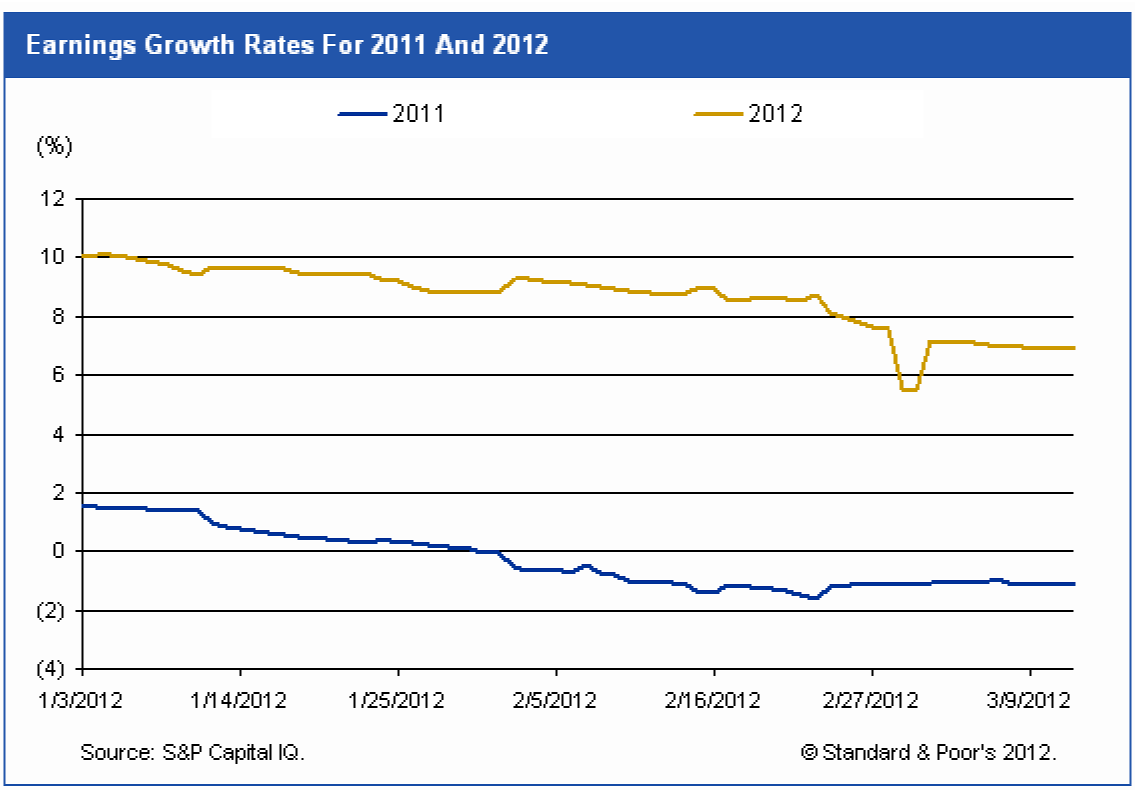
Of the 155 S&P Europe 350 companies that reported their fourth-quarter results as of March 13, 48% beat, 47% missed, and 5% exceeded expectations.

Sector leaders for 2012 earnings include the financials (19.09% expected growth) and industrials (11.84% expected growth) sectors. Earnings laggards for 2012 include the information technology (decline of 16.92% expected) and telecommunications (0.77% decline expected) sectors.

Although the ECB has suggested the worst of the European sovereign debt crisis has passed, the analyst consensus reflects the widespread economist view that the European economy will be in recession this year but will return to growth in 2013. Analysts expect that the sovereign debt crisis in Europe and overall economic uncertainty will continue to affect corporate earnings in 2012. In 2011, many European companies, particularly in the financials sector, booked large write-downs and struggled with high raw materials costs, while also trying to maintain low and stable prices to encourage consumer spending.

The European Commission's eurozone consumer confidence index has been improving for the last three consecutive months to February; it now stands at negative 20.3, up from negative 21.3 in December. However, the historical average of negative 14.2 suggests the current improvement still remains sluggish at best.

Chart 5



Contact Information: Christine Short, Senior Manager—Global Markets Intelligence, Christine_Short@spcapitaliq.com

Victoria Chernykh, Director—Global Markets Intelligence, Victoria_Chernykh@spcapitaliq.com

S&P Index Commentary: The U.S. May Only Be Part Of The Global Economy And Equity Market--But It's Still The Largest

Markets, as we have all learned, are interconnected. Global markets and free trade are imperative to the U.S. economy. While the U.S. economy may still be the largest in the world, it is long past the point where it can go it alone, in our opinion. From the opposite perspective, while the U.S. may not be as nimble as some of its smaller emerging counterparts, it nonetheless remains a vital destination for trading partner exports.

S&P Indices divides the global equity market into three major markets: developed, emerging, and frontier. Developed and emerging markets are part of the S&P Broad Market Index (BMI), which attracts the majority of investors' attention. Developed market corporations are typically less volatile, more capital intensive, and generally considered to be comprised of relatively "old" industrial companies. On the other hand, emerging markets offer higher growth along with elevated volatility and less liquidity. Political stability is still a major consideration, especially in periods of stress, with currency strength and sound underlying sovereign fiscal policies as important as corporate balance sheet strength. Tables 1 through 4 provide an overview and relative perspective of the global equity market according to the S&P BMI.

Table 1

S&P Global Broad Market Index (BMI)

	Country	Float (mil. $)	Weight (%)
Developing	Australia	1,091,182	3.19
Developing	Austria	47,572	0.14
Developing	Belgium	129,854	0.38
Emerging	Brazil	677,120	1.98
Developing	Canada	1,579,468	4.61
Emerging	Chile	102,214	0.30
Emerging	China	807,229	2.36
Emerging	Columbia	54,449	0.16
Emerging	Czech Republic	14,152	0.04
Developing	Denmark	145,600	0.43
Emerging	Egypt	18,555	0.05
Developing	Finland	132,059	0.39
Developing	France	1,088,313	3.18
Developing	Germany	976,511	2.85
Developing	Greece	21,044	0.06
Developing	Hong Kong	471,140	1.38
Emerging	Hungary	13,960	0.04
Emerging	India	362,039	1.06
Emerging	Indonesia	133,693	0.39
Developing	Ireland	54,420	0.16
Developing	Israel	91,852	0.27
Developing	Italy	336,658	0.98
Developing	Japan	2,727,266	7.97
Developing	Korea	758,994	2.22

Table 1

S&P Global Broad Market Index (BMI) (cont.)			
Developing	Luxembourg	40,472	0.12
Emerging	Malaysia	141,970	0.41
Emerging	Mexico	204,597	0.60
Emerging	Morocco	14,205	0.04
Developing	Netherlands	307,372	0.90
Developing	New Zealand	22,411	0.07
Developing	Norway	148,492	0.43
Emerging	Peru	34,352	0.10
Emerging	Philippines	46,402	0.14
Emerging	Poland	63,387	0.19
Developing	Portugal	31,013	0.09
Emerging	Russia	325,814	0.95
Developing	Singapore	244,837	0.72
Emerging	South Africa	333,462	0.97
Developing	Spain	350,581	1.02
Developing	Sweden	413,430	1.21
Developing	Switzerland	973,226	2.84
Emerging	Taiwan	590,101	1.72
Emerging	Thailand	101,381	0.30
Emerging	Turkey	74,215	0.22
Developing	U.K.	2,711,458	7.92
Developing	U.S.	15,220,574	44.47
	Global	34,229,094	100.00

Source: S&P Indices.

Table 2

S&P Global BMI Broad Market Index (BMI)--Global Sector Data			--Stock return (%)--			
	Market cap (bil. $)	**Weight (%)**	**Year-to-date**	**1-year**	**2-year**	**3-year**
S&P Global BMI Energy	3,831	11.19	10.48	(6.67)	21.87	73.80
S&P Global BMI Materials	2,921	8.53	15.26	(11.62)	15.94	113.07
S&P Global BMI Industrials	4,065	11.88	12.88	(4.94)	21.58	102.02
S&P Global BMI Consumer Discretionary	3,769	11.01	14.28	2.57	32.85	125.80
S&P Global BMI Consumer Staples	3,131	9.15	4.28	9.22	22.90	75.56
S&P Global BMI Health Care	2,923	8.54	5.01	7.19	14.71	60.02
S&P Global BMI Financials	6,680	19.52	15.11	(13.13)	(0.14)	80.77
S&P Global BMI Information Technology	4,355	12.72	15.47	2.22	25.46	111.22
S&P Global BMI Telecommunication Services	1,324	3.87	2.26	(5.70)	10.54	41.39
S&P Global BMI Utilities	1,231	3.60	2.38	(8.47)	(1.53)	19.45
S&P Global BMI	34,229	100.00	11.29	(3.88)	15.98	83.35

Source: S&P Indices.

Table 3

S&P Global Broad Market Index (BMI) Global Returns

(%)	Year-to-date	1-year	2-year	3-year
Global	11.29	(3.88)	15.98	83.35
Global Ex-U.S.	13.01	(8.54)	9.27	76.19
Emerging	18.95	(4.49)	13.00	114.83
Brazil	21.44	(6.34)	4.81	118.44
Chile	18.19	1.39	28.90	117.71
China	18.75	(5.40)	5.25	84.85
Columbia	15.94	7.70	37.00	195.14
Czech Republic	10.59	(11.93)	(3.80)	59.45
Egypt	44.34	(7.84)	(24.08)	38.11
Hungary	29.17	(28.36)	(22.01)	107.70
India	26.99	(7.46)	(2.62)	108.19
Indonesia	4.00	9.75	45.73	294.17
Malaysia	10.04	9.19	46.37	128.03
Mexico	10.45	(3.55)	20.21	142.93
Morocco	6.60	(14.84)	(1.03)	4.22
Peru	11.18	(4.39)	37.52	170.61
Philippines	16.00	26.87	82.91	216.67
Poland	22.34	(20.59)	(4.12)	107.83
Russia	25.07	(12.12)	18.66	176.83
South Africa	15.41	2.24	33.18	137.42
Taiwan	19.48	(5.79)	16.41	104.46
Thailand	18.88	19.64	75.21	225.72
Turkey	27.68	(9.09)	7.44	138.45
Developed	10.31	(3.80)	16.40	80.12
Dev Ex-U.S.	11.47	(9.56)	8.35	68.42
Australia	12.27	(6.39)	11.97	122.80
Austria	18.65	(26.15)	(9.42)	66.51
Belgium	13.07	(8.49)	0.07	70.28
Canada	10.11	(12.24)	16.73	104.21
Denmark	20.45	(5.56)	24.00	98.67
Finland	18.32	(20.18)	(12.00)	43.02
France	13.69	(16.23)	(3.17)	44.41
Germany	19.15	(11.25)	14.23	74.77
Greece	22.31	(54.99)	(64.94)	(54.30)
Hong Kong	17.79	(3.91)	17.76	99.09
Ireland	15.46	5.84	10.20	87.38
Israel	5.69	(21.47)	(22.48)	20.25
Italy	13.24	(27.94)	(21.87)	13.24
Japan	9.02	(10.92)	3.12	35.57
Korea	14.27	6.29	35.29	171.67
Luxembourg	12.32	(26.64)	(22.67)	46.91
Netherlands	9.05	(14.96)	(0.57)	60.68
New Zealand	9.60	7.14	18.10	94.77

Table 3

S&P Global Broad Market Index (BMI) Global Returns (cont.)				
Norway	20.33	(6.67)	21.21	125.80
Portugal	2.61	(34.75)	(30.31)	(7.30)
Singapore	18.99	(0.77)	16.80	133.24
Spain	2.71	(24.72)	(21.38)	11.58
Sweden	17.63	(7.31)	27.01	146.34
Switzerland	7.15	(4.95)	9.22	70.42
U.K.	9.34	(3.52)	17.20	77.06
U.S	9.21	2.48	25.42	92.97

Source: S&P Indices.

Table 4

S&P Global BMI Broad Market Index (BMI)--25 Largest Issues

Company	Ticker	Market cap (mil. $)	Weight (%)	Country	GICS sub-industry
Apple Inc.	AAPL	504,149	1.47	U.S.	Computer hardware
Exxon Mobil Corp.	XOM	414,612	1.21	U.S.	Integrated oil and gas
Microsoft Corp.	MSFT	237,632	0.69	U.S.	Systems software
Intl Business Machines Corp.	IBM	231,870	0.68	U.S.	IT consulting and services
Chevron Corp.	CVX	217,311	0.63	U.S.	Integrated oil and gas
Nestle SA Reg	NESN	202,575	0.59	CH	Packaged foods
General Electric Co.	GE	201,118	0.59	U.S.	Industrial conglomerates
Procter & Gamble	PG	185,769	0.54	U.S.	Household products
AT&T Inc.	T	181,276	0.53	U.S.	Integrated telecommunication services
Johnson & Johnson	JNJ	177,724	0.52	U.S.	Pharmaceuticals
Wells Fargo & Co.	WFC	165,009	0.48	U.S.	Banks
Pfizer Inc.	PFE	162,195	0.47	U.S.	Pharmaceuticals
Samsung Electronics Co.	Mar-16	158,790	0.46	KR	Semiconductors
Coca-Cola Co.	KO	158,668	0.46	U.S.	Soft drinks
HSBC Holdings PLC	HSBA	158,499	0.46	GB	Banks
Google Inc.	GOOG	156,190	0.46	U.S.	Internet software and services
Novartis AG Reg	NOVN	150,227	0.44	CH	Pharmaceuticals
BP	BP	149,162	0.44	GB	Integrated oil and gas
JP Morgan Chase & Co.	JPM	149,103	0.44	U.S.	Diversified financial services
Philip Morris International	PM	145,073	0.42	U.S.	Tobacco
Berkshire Hathaway	BRK.B	137,920	0.40	U.S.	Property and casualty insurance
Intel Corp.	INTC	136,873	0.40	U.S.	Semiconductors
Vodafone Group	VOD	135,991	0.40	GB	Wireless telecommunication services
Royal Dutch Shell PLC	RDSA	133,000	0.39	GB	Integrated oil and gas
TOTAL S.A.	FP	131,911	0.39	FR	Integrated oil and gas
Total		4,782,646	13.97		

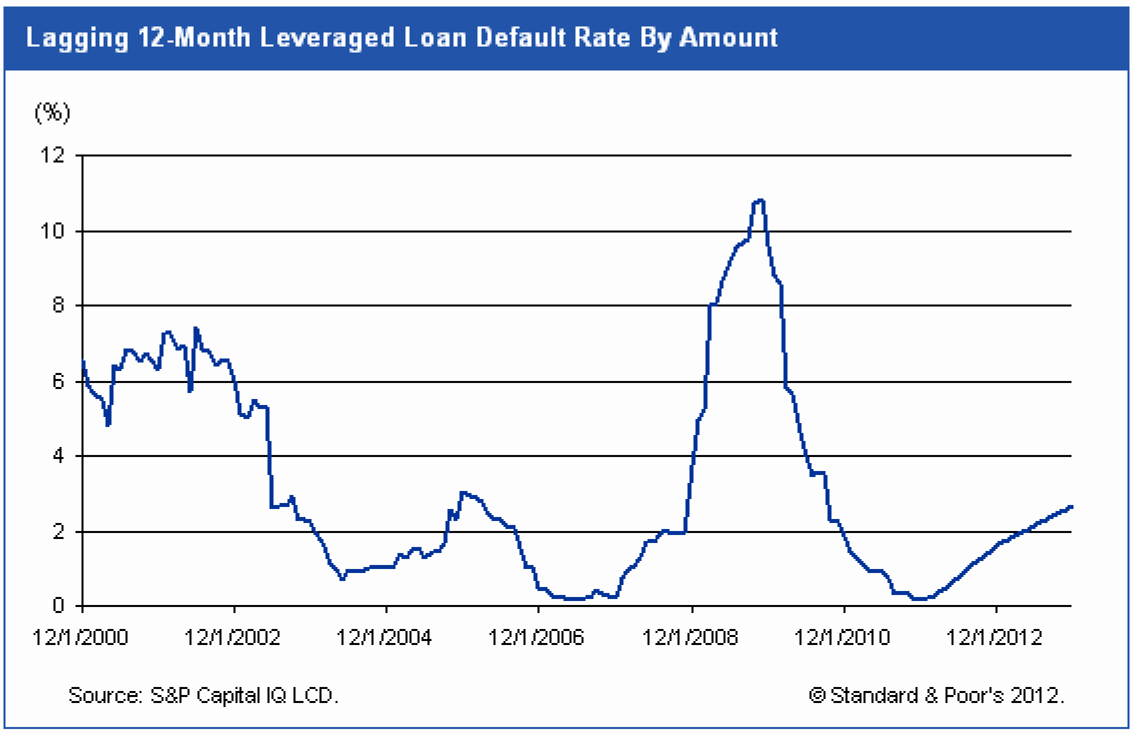
Source: S&P Indices.

Contact Information: Howard Silverblatt, Senior Index Analyst—S&P Indices, Howard_Silverblatt@standardandpoors.com

Leveraged Commentary And Data: The Loan Default Rate Is Still Set To Rise, But Managers Temper Forecasts

After another low-default stretch during the first quarter, when two S&P/LSTA Index issuers defaulted on just $475 million of loans, managers have reduced their default-rate forecasts for 2012 and 2013. On average, managers expect that the default rate will end 2012 at 1.6% and then push to 2.7% in 2013, according to LCD's latest quarterly buyside poll (taken in March). Those figures compare to expectations of 1.9% and 2.9%, respectively, in LCD's last buyside survey, from December (see chart 6).

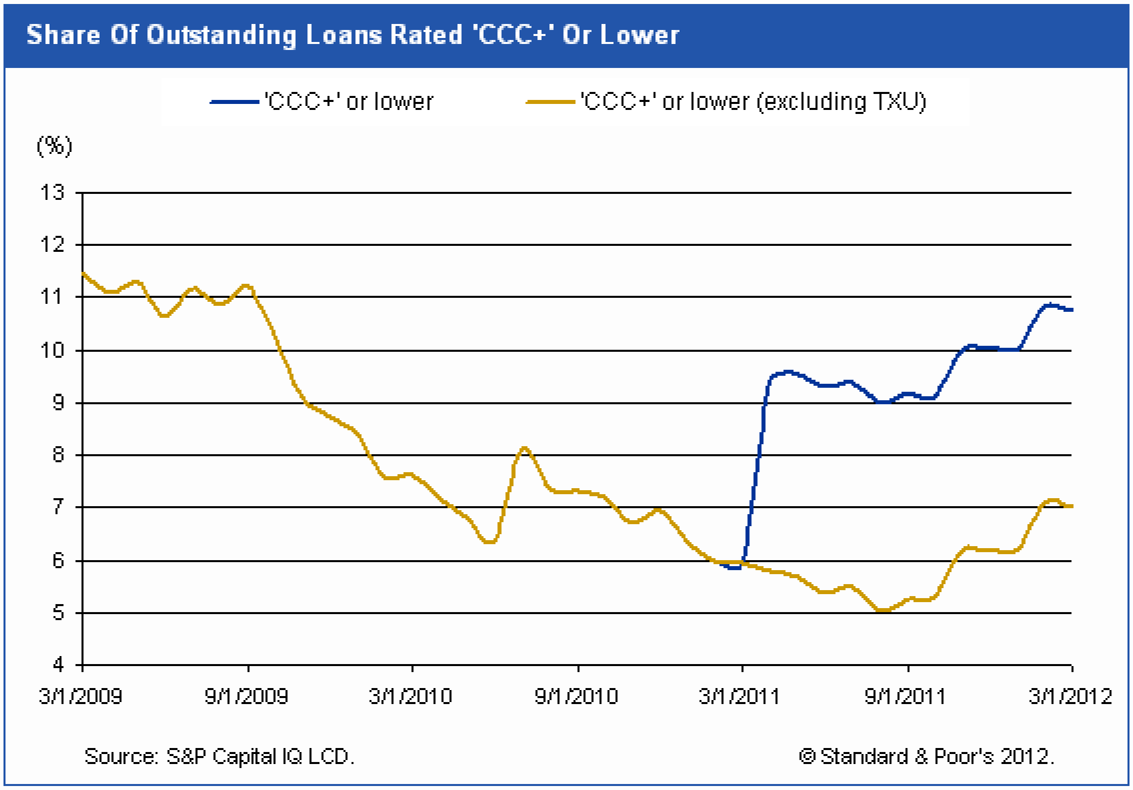
Chart 6



Managers still expect that over the next 21 months, default rates will revert toward--but not all the way to--the historical mean of 3.5% by principal amount. The logic here is clear. Even if the economy continues to improve and TXU staves off what many participants think is an inevitable reorganization, default rates have nowhere to go but up. After all, the loan default rate by principal amount was tracking to 0.21% in March, just off its near-record low reading of 0.17% at year-end.

What's more, the percent of performing S&P/LSTA Index loans that Standard & Poor's Ratings Services rates 'CCC+' or lower crept up to 10.76% in March, from 10.01% at year-end (see chart 7).

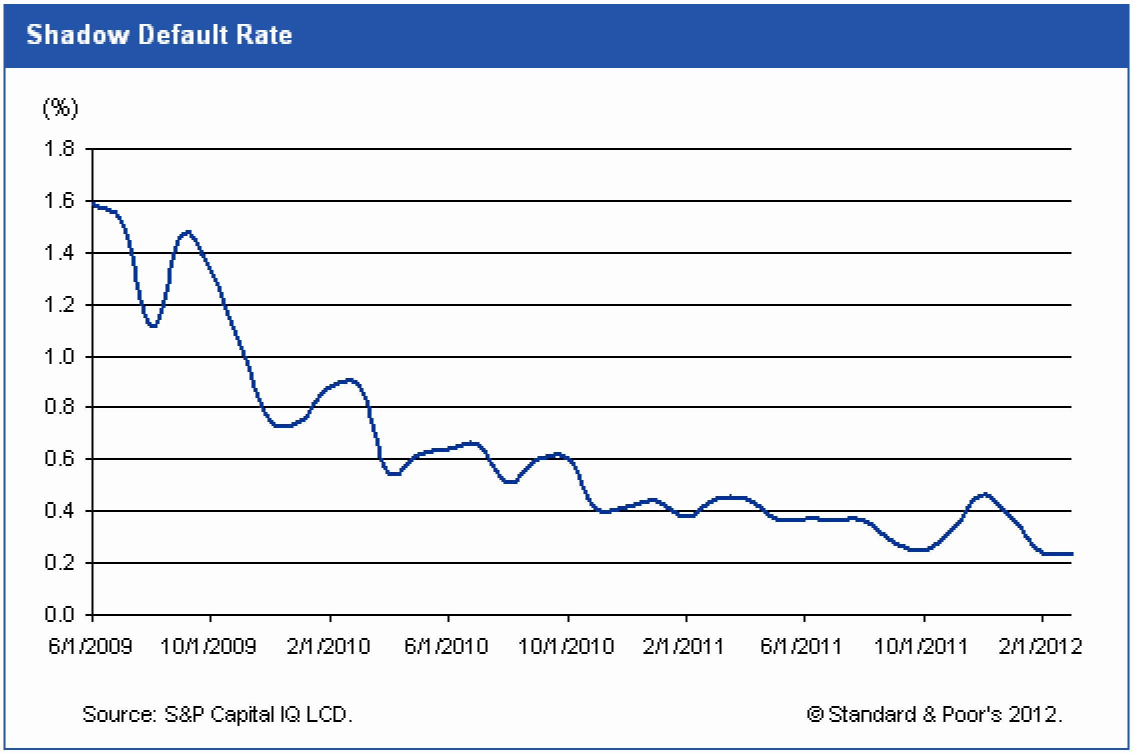
Chart 7



While most managers expect rates to rise, they're not expecting a spike, at least not in the near term. Managers say the watch list of potential 2012 and 2013 bankruptcies is contained--assuming of course the recovery persists and there are no disruptive outside shocks to the system.

This view lines up with the empirical data. Take LCD's shadow default rate, a measure of the most immediate potential candidates for bankruptcy. On March 12, 0.23% of performing S&P/LSTA Index issuers had either missed a bond payment, entered a forbearance agreement, or hired bankruptcy counsel. That's down from 0.46% at year-end (see chart 8).

Chart 8



A quick scan of the overall market, too, shows a small universe of what accounts describe as the most vulnerable names: those with an issuer rating of 'B-' or lower and a bid of 80 or lower. In all, 17 issuers with $29 billion of outstanding debt fit this profile, equating to 6% of the rated performing loans in the S&P/LSTA Index, with the lion's share concentrated among the 10 largest names in the troubled population (see table 5).

Table 5

'B-' Or Lower And Bid At 80 Or lower

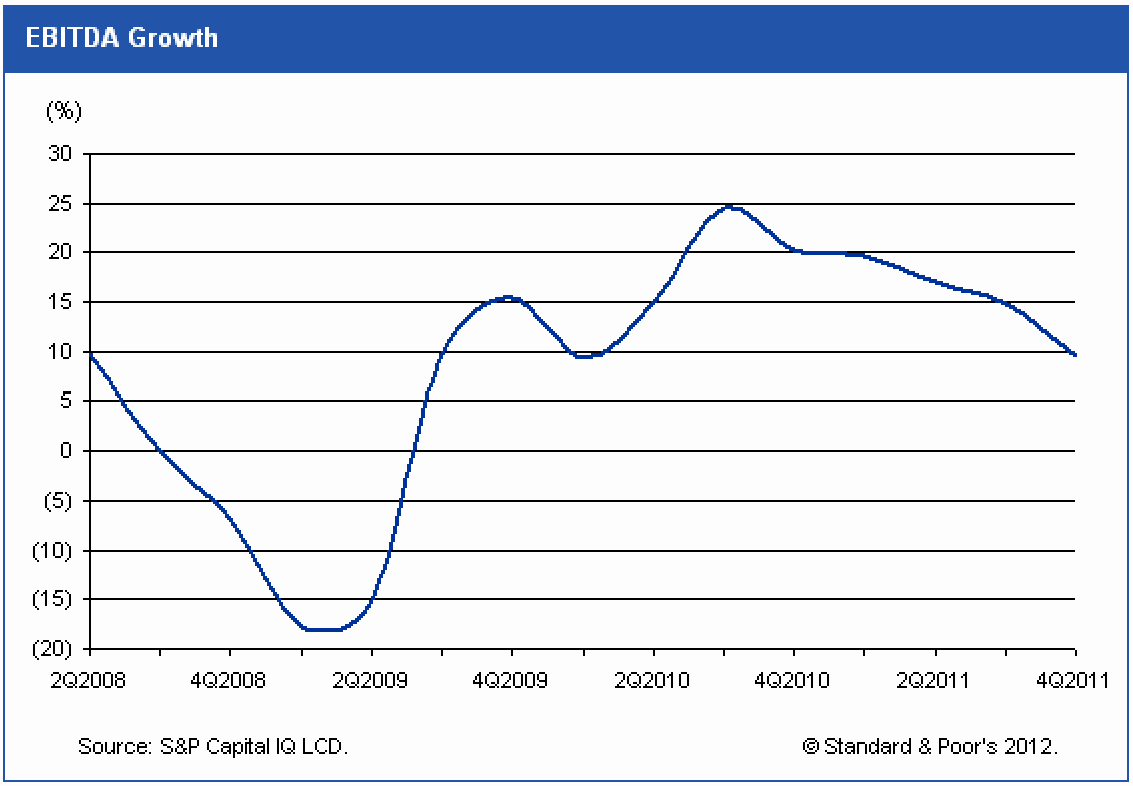
Issuer	% of rated performing loans
TXU	4.03
SuperMedia	0.37
Hawker Beechcraft	0.31
GateHouse Media	0.25
RH Donnelly & Dex Media	0.48
Penton Media	0.13
Culligan International	0.11
Brand Aquisition	0.06
Bicent Power	0.05
Kik Custom	0.05

Source: S&P Capital IQ LCD.

Of course, TXU is far and away the top name on this dubious leader board, and most managers agree with Warren Buffett's prediction that the utility firm will eventually be forced into bankruptcy, rendering its bonds worthless. The issuer's extended loans ranged in price from 55.69 to 63.71 during the first quarter, according to Markit Loans, while its 10.25% unsecured notes due 2015 traded at an even deeper discount of 24.5 to 35, according to S&P Capital IQ. Though these price levels are a good indication that the market thinks a TXU reorganization is likely, the timing may be beyond the 2013 forecast under discussion. After all, the issuer reduced debt maturities through 2013 to just $91 million as a result of its $15 billion amend-to-extend exercise last April. The catalyst for a Chapter 11 filing may come in 2014, when $4.3 billion comes due, or 2015, when another $3.3 billion matures.

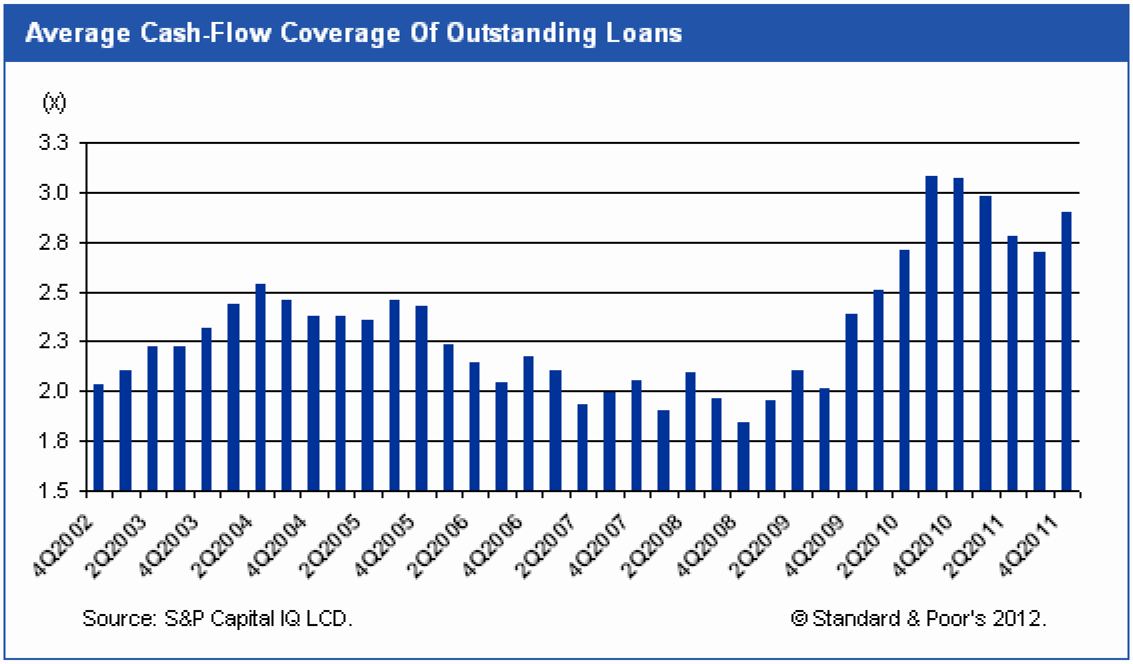
Beyond the at-risk names reviewed above, managers say the broad population of leveraged loan issuers is in good shape after 10 successive quarters of muscular cash-flow growth since the recession ended in June 2009 (see chart 9).

Chart 9



As a result, the average ratio of EBITDA less capital expenditures to cash interest among publicly filing S&P/LSTA stood at 2.9x at year-end, providing creditors with a margin of safety against defaults in the near term (see chart 10).

Chart 10



Risks To The Forecast

Of course, managers' prognostications for low default rates are predicated on the low-wattage growth scenario to which most economists subscribe. Standard & Poor's, for instance, forecasts that U.S. GDP will expand 2.1% in 2012 and 2.3% in 2013. Even these less-than-heroic growth levels likely will keep corporate America's profit engine humming, managers say, and thus put a damper on defaults.

The Street takes a similar view for corporate earnings more broadly. According to Bob Keiser of S&P Capital IQ, stock analysts expect that earnings for S&P 500 companies will expand 6% on average in 2012, and 13.5% in 2013.

Of course, potential problems--some catastrophic--lurk. The many threats to the fragile economic recovery and corporate earnings growth include:

- A meltdown in Europe's debt situation,
- A spike in oil prices,
- A geopolitical event,
- Mounting tensions in the Middle East, and
- Gridlock in Washington that threatens the credit rating on the U.S.

If the economy and markets set off one or several of these land mines--or trip on one now unseen such as last year's tragic Japanese earthquake--default rates might well overshoot the modest predictions offered above. For this reason, perhaps, several managers said rates would climb to 4% by 2013. But that level is at the outer edge of the forecasts, most of which ranged from 2% to 3%.

Contact Information: Steve Miller, Managing Director—Leveraged Commentary And Data,
Steven_Miller@spcapitaliq.com

R2P Corporate Bond Monitor

The U.S. economy grew at a 3% annual rate in fourth-quarter 2011, the fastest pace since the spring of 2010. It exceeded the previous estimate of 2.8% and was higher than the 1.8% growth rate of the third quarter. In addition, U.S. nonfarm payrolls expanded by a higher-than-expected 227,000 jobs in February following the upwardly revised and very strong 284,000 jobs created in January.

Since July, however, Markit's Eurozone Manufacturing Purchasing Managers' Index has been below the 50.0 mark that differentiates growth from contraction, though the index rose to 49 last month from 48.8 in January.

From Feb. 29, 2012, to March 12, 2012, risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--seemed to have taken into account the current economic climate, with improving scores in North America and deteriorating scores in most sectors in Europe. Unlike North America, the average probability of default (PD) in Europe increased (see tables 6 and 7).

In the U.S., option-adjusted spreads (OAS) remained unchanged on average. However, scores improved by 7% as a result of an 8% decrease in both the average PD and average 20-day historical bond price volatility.

In Europe, OAS tightened by 4 bps on average, and the PD increased by 165%, more than offsetting a 14% decrease in bond price volatility. As a result, scores deteriorated by 9%.

Table 6

North American Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	9	5	(5)	(6)
Consumer staples	5	(6)	(8)	(10)
Energy	6	6	13	(8)
Financials	6	3	(13)	(10)
Health care	5	(1)	(4)	(5)
Industrials	5	4	3	(10)
Information technology	8	(13)	(28)	(8)
Materials	6	(2)	(5)	(10)
Telecommunication services	9	3	(19)	(4)
Utilities	8	3	(11)	(11)

Change as of March 12, 2012, from Feb. 29, 2012.

Table 7

European Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	0	(6)	100	(8)
Consumer staples	(29)	1	603	(14)
Energy	(9)	(2)	132	(13)
Financials	(12)	(1)	127	(9)
Health care	12	2	77	(9)
Industrials	(12)	(5)	105	(20)
Information technology	(31)	9	168	(11)
Materials	5	(6)	12	(14)
Telecommunication services	(17)	(4)	266	(19)

Table 7

European Risk-Reward Profiles By Sector--Average R2P Score And Components Changes (cont.)				
Utilities	5	(28)	60	(25)

Change as of March 12, 2012, from Feb. 29, 2012.

Contact Information: Fabrice Jaudi, Senior Director—Global Markets Intelligence, Fabrice_Jaudi@spcapitaliq.com

Market Derived Signal Commentary: The Sovereign CDS Market Is Alive And Well After Greek Debt Trigger

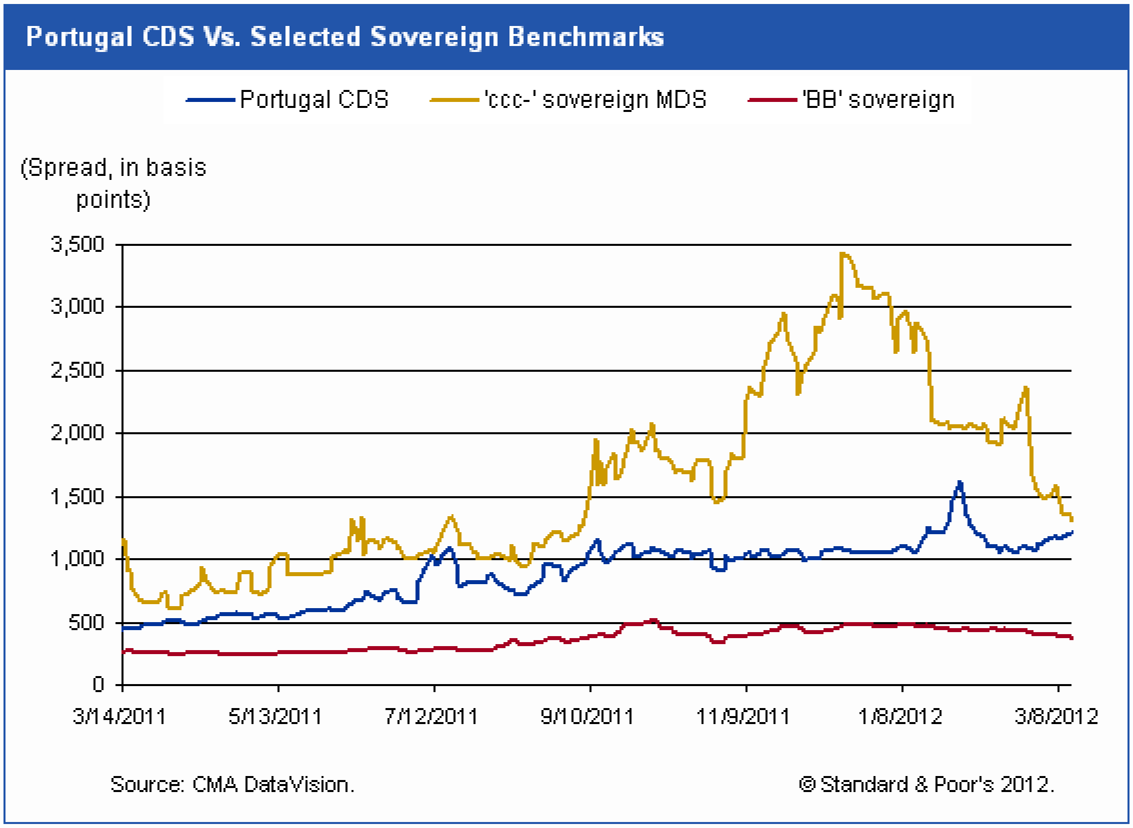
Eurozone sovereign credit default swap (CDS) spreads widened 13% in the week ended March 9 after a credit event triggered $3.2 billion of Greek default protection contracts. The S&P/ISDA Eurozone Developed Nation Sovereign Index (Eurozone index), whose largest constituents are France, Germany, and Italy, expanded 88 bps to 750 bps, just 7 bps shy of the record of 757 bps set on March 8.

The International Swaps and Derivatives Association (ISDA) declared a restructuring credit event on March 9, which in Greece's case was a reduction in the rate of interest or amount of principal payable, including a "haircut." There will be an auction on March 19 to establish the recovery value of Greek debt, which will then determine the net payouts made under CDS contracts during a credit event, the association said in a statement.

ISDA did not initially declare a credit event, which called into question the viability of using CDS to hedge government debt, Bloomberg reported Monday. It appeared that the ISDA decision on March 9 showed that the process works--the cost to purchase protection against sovereign default rose after the announcement, showing buyers were purchasing contracts with the confidence that they would receive a payment in the event of a credit trigger.

Apart from the inner workings of the CDS market, the spreads continue to serve as a useful indicator of credit risk. Portugal, on which Standard & Poor's Ratings Services has a credit rating of 'BB' with a negative outlook, has the most expensive protection contract among the 11 eurozone nations in the Eurozone index. The spread of 1,213 bps for Portugal is 839 bps wider than the credit rating benchmark, but only 88 bps tight of the Market Derived Signal benchmark of 'ccc-'. Portugal's spread widened another 1% on Wednesday, building on a 3% expansion after the ISDA credit declaration (see chart 11).

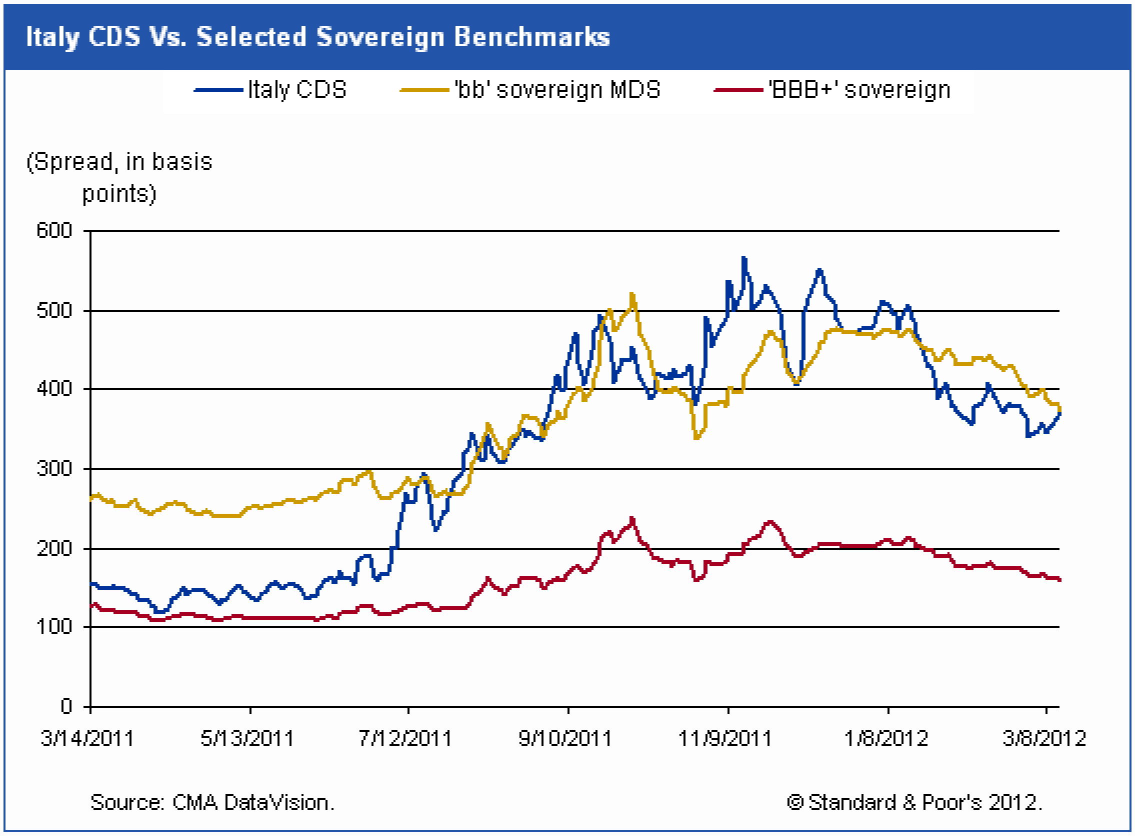
Chart 11



On Jan. 13, 2012, Standard & Poor's lowered its rating on Portugal to 'BB' from 'BBB-'. The negative outlook indicates a 33% chance of another downgrade in the next 12 months, which, among other factors, appears to be fully priced into the CDS spread.

On the other hand, the perception of Italy's credit risk has been steadily improving. The five-year CDS spread for that sovereign is 370 bps, still firmly in speculative-grade territory, but 35% tighter than the year-high of 568 bps on Nov. 15, 2011. The spread tightened 5% Wednesday, erasing a 5% expansion after the ISDA announcement (see chart 12).

Chart 12



On Jan. 13, Standard & Poor's lowered its credit rating on Italy to 'BBB+' with a negative outlook from 'A'. This also implies a one-in-three chance of another downgrade in 2012 and 2013. Italy's CDS spread began to trade tight of the Market Derived Signal benchmark on Jan. 23, 2012, suggesting the market has absorbed the January downgrade and now awaits fresh indicators.

Contact Information: Lisa Sanders, Director—Global Markets Intelligence, Lisa_Sanders@spcapitaliq.com

Capital Market Commentary: IPOs Perform In Line With Overall Market

IPOs

So far, S&P 500 fourth-quarter 2011 earnings results indicate that 70% of companies have met or exceeded analyst consensus expectations. With that in mind, the GMI research team reviewed the earnings performance for companies from last year's crop of IPOs priced in the U.S. We found that these companies have performed similarly to the overall index, as 49 of 69 (71%) companies have reported fourth-quarter 2011 financial results that beat or met consensus earnings expectations. Fourth-quarter results are also similar to those of the third quarter, when 61 of 86 companies that went public last year met or beat expectations, while 25 companies missed.

However, only three of the 10 largest IPOs by current market capitalization managed to exceed earnings expectations by more than 10% (see tables 8 and 9). Of the top 10 2011 IPOs with positive earnings surprises for fourth-quarter 2011, only three companies have a market valuation higher than $1 billion. Therefore, it seems that company size is not necessarily a factor in large earnings surprises.

Table 8

4Q2011 IPO* Earnings

Aggregate results	
Total unreported	27
Total reported	69
Exceeded	43
Met	6
Missed	20

Largest 2011 IPOs by current market capitalization earnings surprise 4Q2011

Company, ranked by market capitalization	Recent market cap (mil. $)	4Q2011
Kinder Morgan Inc.	26,522.7	(17.857)
HCA Holdings Inc.	11,211.8	20.513
Nielsen Holdings N.V.	10,606.1	6.25
LinkedIn Corp.	9,230.9	N.A.
Yandex N.V.	7,612.1	10.526
Kosmos Energy Ltd.	5,114.2	(18.182)
Arcos Dorados Holdings Inc.	4,085.8	9.091
Freescale Semiconductor Holdings I Ltd.	3,703.1	133.333
Dunkin' Brands Group, Inc.	3,665.9	0

*2011 IPOs. N.A.--Not available. Source: S&P Capital IQ.

Table 9

Reporting 2011 IPOs With Largest Percentage Earnings Surprise 4Q2011

Company	Recent market cap (mil. $)	4Q2011
ServiceSource International Inc.	1,240.9	200.0
Zillow Inc.	851.8	200.0
Ellie Mae Inc.	187.5	160.0
Freescale Semiconductor Holdings I Ltd.	3,703.1	133.3
Apollo Residential Mortgage Inc.	200.1	104.0
Interxion Holding N.V.	1,109.1	77.8
Responsys Inc.	486.3	50.0
RPX Corp.	889.1	42.9
BCD Semiconductor Manufacturing Ltd.	92.2	42.9
Phoenix New Media Ltd.	558.4	40.0

Source: S&P Capital IQ.

M&A

U.S. merger and acquisition (M&A) transactions between $100 million and $500 million had 791 deals with an aggregate value of $177.2 billion in 2011, according to S&P Capital IQ data (see table 10). Dollar volume for deals in this size range was the highest its been since 2000, when $178.7 billion in total transactions took place. However, as has been the case for many aspects of deal activity in early 2012, M&A in this size range has tumbled since last year. Current dollar volume for M&A between $100 million and $500 million presently stands at $21.8 billion, 31.7% lower than in the same period in 2011. Similarly, the number of deals in this range is 30% lower.

Although overall activity has been lower, some sectors remain active. So far this year, the financials sector has been the most active target for deals in this size range, with 25 deals, followed by the information technology sector, with 17 transactions. The financials sector also ranked first at this time last year, with 41 deals, followed by the information technology sector, with 20 transactions.

Table 10

U.S. M&A Transactions--$100 Million To $500 Million

	Dollar volume (bil. $)	Deals	Average size (mil. $)
2000	178.7	783	228.2
2001	104.0	488	213.1
2002	96.6	445	217.1
2003	110.5	518	213.3
2004	124.8	565	220.9
2005	138.4	617	224.3
2006	162.5	714	227.6
2007	170.0	753	225.8
2008	117.4	537	218.6
2009	81.9	377	217.2
2010	146.9	667	220.2
2011	177.2	791	224.0
2011*	31.9	142	224.9
2012*	21.8	100	218.0

*As of March 14. Source: S&P Capital IQ.

Fixed Income

While debt issuance in a variety of categories is on the rise in 2012, identifier orders (in the week ended March 9) for various debt issues decreased sharply. For the six security classes profiled in table 11, requests decreased by 46.7% overall, with domestic corporate debt responsible for the bulk of the decrease. On the other hand, demand is up for this group by 17.1% from a year ago, though much of that advance is the result of increased CUSIP orders for municipals and short-term muni notes.

Table 11

Selected Debt CUSIP Requests

	Week ended March 9	Week ended March 2	2012*	2011*	Year-over-year change (%)
Domestic corporate debt	123	595	2,029	2,052	(1.10)
Municipals	367	384	2,824	1,868	51.20
Muni--long-term note (more than one year)	7	10	53	70	(24.30)
Muni--short-term note (less than one year)	22	33	237	189	25.40
International debt	40	37	270	365	(26.00)
PPN domestic debt	16	20	283	321	(11.80)
Total	575	1,079	5,696	4,865	17.10

*As of March 9. Source: CUSIP Global Services.

Contact Information: Rich Peterson, Director—Global Markets Intelligence, Rich_Peterson@spcapitaliq.com

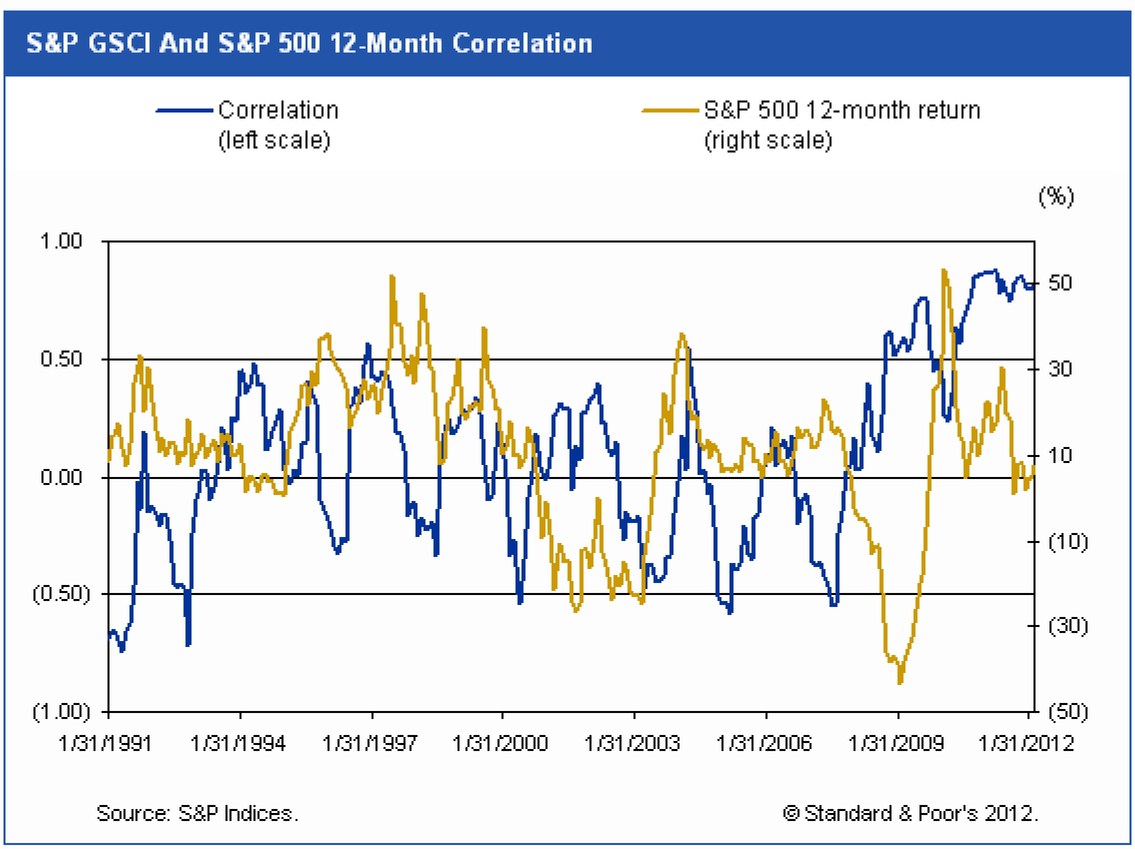
S&P Index Commodity Commentary: Commodities Show Divergence

Despite a monthly increase in the S&P 500 Index of 2.20% as of March 14, the S&P GSCI Index has demonstrated divergent weakness in March, with a decline of 0.33%, as the U.S. dollar has strengthened. The U.S. Dollar Index ended March 14 with a monthly gain of 2.35%, adding pressure to dollar-based commodities, notably metals. The S&P GSCI Precious Metals Index has led index sector losses in March, with a decline of 4.47%, lessening the S&P GSCI Index increase in 2012 to 8.08%. Energy is the only major sector to gain on the month as of March 14, partially as a result of increasing political tension, notably with Iran. The S&P GSCI Energy Index remains the best performer in 2012, as measured by the 10.1% year-to-date increase, compared with a 3.29% increase for the S&P GSCI Non-Energy Index on the back of a 2.15% decline on the month (as of March 14).

Correlation Normalization?

Because the S&P GSCI Index and S&P 500 Index represent fundamentally different asset classes, the two indices have historically had a very low correlation. In the aftermath of the 2008 global financial crisis, however, the correlation between these two indices has remained above historical norms. Chart 13 depicts the 12-month correlation ended March 14 at 0.83. From January 1991 to January 2008, this correlation measure averaged negative 0.03. Money managers have been attracted to commodity index-related investments for portfolio augmentation due to the history of low correlations to equities that commodities have demonstrated but with equity-like returns. Returning to more sustained historical asset class correlation norms would likely be welcomed by most investors, as it might provide additional evidence of improvement in the investment environment.

Chart 13



Contact Information: Mike McGlone, Senior Director, Commodities—S&P Indices,
Mike_McGlone@standardandpoors.com

About S&P Capital IQ and S&P Indices Research & Analytics

S&P Capital IQ Research & Analytics

Global Markets Intelligence

Provides event-driven, multi-asset class market commentary and analysis; model development, and investment advisory services.

Research

Provides global company and funds research including insight into the performance of the world's leading investment funds.

Leveraged Commentary and Data

Delivers insight into the leveraged loan market through a combination of data, commentary, analysis, and real-time news.

S&P Indices

The world's leading index provider maintaining a wide variety of investable and benchmark indices to meet an array of investor needs.

Sign up for your complimentary subscription: www.standardandpoors.com/lookout