S&P CAPITAL IQ

Lookout Report

from Global Markets Intelligence

Recent High-Profile Economic Data Weren't Nearly As Weak As Investor Confidence Appears To Be

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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 economy added just 69,000 nonfarm payrolls in May, the weakest monthly improvement in employment since the 54,000 rise recorded in May 2011. The three-month average payroll growth rate has fallen to 96,000, just below the 100,000 to 300,000 range that we believe is consistent with sustaining 2% to 2.5% U.S. GDP growth. This report was weak and extremely disappointing, since the Global Markets Intelligence (GMI) research team has repeatedly said since the start of this year that "the rate of employment creation in the world's largest economy (the U.S.) is the most significant indicator for determining whether 2012 will be a risk-on or risk-off year." (See "Lookout Report: Three Key Economic Topics To Follow Closely In 2012: Jobs, Housing, And Sovereign Risk," published Jan. 20, 2012, on the Global Credit Portal.) With Italy and Spain credit default swap (CDS) spreads trading above 550 basis points (bps) and 600 bps, respectively, this past week, the weaker-than-expected jobs report added to the growing list of negative developments that investors must confront.

While the May employment report was a huge disappointment, the GMI research team continues to believe that the U.S. economy is not immediately at risk of falling into recession. The Institute for Supply Management (ISM) Purchasing Managers Index (PMI), reported the same day as May employment, registered 53.5 in May, suggesting that the U.S. economy continues to expand at an acceptable rate. The PMI report did not, however, support the equity market; the S&P 500 Index declined 32 points (2.5%) for the day (June 1). On June 5, the service sector PMI reported a value of 53.7, which is also inconsistent with an economy immediately at risk of recession. We believe that monthly PMI results between 52 and 55 are consistent with U.S. GDP growth between 2% and 2.5%. The relatively optimistic PMI data nonetheless did not stop the S&P 500 Index from trading earlier this week at just 12 times one-year-forward S&P Capital IQ consensus earnings. The historically cheap forward price-to-earnings (P/E) multiple is likely indicative of the existing low investor confidence environment, in our opinion.

Of the last 11 U.S. economic recessions dating back to 1948, the U.S. economy entered recession with the PMI Index at or above the current level of 53.5 just once--from November 1973 to March 1975, generally regarded as an OPEC energy-shock-triggered period of economic stagflation (see table 1). As we said in the prior edition of the Lookout Report, we will continue

to scrutinize ISM and employment reports, in addition to other key data such as retail sales and jobless claims, for signs that the U.S. economy may once again be slipping into recession. In the third year of what has been a subpar U.S. economic recovery, the sharp sell-off in the S&P 500 Index following Friday's key economic data indicates that investor anxiety, in our opinion, needs to diminish significantly before we can say that investor confidence has been restored following the 2008 financial crisis and the lingering European sovereign debt crisis.

Table 1

U.S. Recessions And The Purchasing Managers Index

U.S. recession start date	PMI at start of recession
December 2007	49.0
March 2001	43.1
July 1990	46.6
July 1981	46.7
January 1980	46.2
November 1973	68.1
December 1969	52.0
April 1960	45.3
August 1957	45.3
July 1953	46.3
November 1948	42.4

PMI--Purchasing Managers Index. Source: Institute for Supply Management, via Global Insight.

Inside This Issue:

Macroeconomic Overview

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Economic And Market Outlook

After a disappointing U.S. employment report last week, along with the lowest consumer confidence reading since January, second-quarter corporate earnings growth estimates fell to negative 0.21%. Meanwhile, elevated concerns in Greece and Spain have added to existing economic uncertainty in Europe, prompting analysts to trim their 2012 and 2013 European corporate earnings forecasts by 7.4% and 4.4%, respectively, since the start of the year.

S&P Index Commentary: The Evolution Of Post-Retirement Benefits

The average cost of U.S. products has increased as a result of rising costs for U.S. private medical retiree benefits. These benefit costs are higher than for many non-U.S. competitors, leaving U.S. products at a competitive disadvantage. U.S. companies must make up the difference of what foreign entities provide by substituting higher prices for their products for the sovereigns' ability to tax.

Leveraged Commentary And Data: Leveraged Loan Technicals Cool In May Amid Macroeconomic Uncertainty

External events held the loan market captive in May as darkening global macroeconomic conditions forced the S&P/LSTA Leveraged Loan Index to suffer its first monthly loss since November, retreating by 0.68%. High-yield bonds and equities endured even more severe downturns, with the Bank of America Merrill Lynch High-Yield Master Index and S&P 500 Index down 1.2% and 6%, respectively.

R2P Corporate Bond Monitor

Risk-reward profiles in the corporate fixed-income market--as measured by average Risk-to-Price (R2P) scores--varied among countries for the past two weeks (May 21 to June 5). Despite a 37% decrease in the probability of default (PD), U.S. scores deteriorated by 9%. In Europe, scores for Italy, France, and Germany increased by 16%, 9%, and 6%, respectively. On the other hand, scores for the U.K., Ireland, and Spain decreased by 14%, 10%, and 5%, respectively.

S&P Index Municipal Commentary: High-Yield Municipal Bonds: Is There More Room For Upside Potential

Yields for higher-yielding municipal bonds have quickly fallen in 2012. As a result, high-yield municipal bonds have outpaced the stock market and the overall municipal bond market by returning 9.4% year to date, as measured by the S&P Municipal Bond High-Yield Index. Investment-grade municipal bonds have returned 3.67% so far this year.

Market Derived Signal Commentary: The CDS Market Reveals Strength In Some U.S. Financial Companies

On June 1, the CDS spread for U.S. financial companies, as measured by the S&P/ISDA CDS U.S. Financials Select 10 Index, approached the widest point of 2012. Nevertheless, we were surprised that the spread hadn't widened further. But the relatively tighter spreads for Wells Fargo & Co. and American Express Co., for example, are offsetting the credit deterioration among diversified financial companies.

S&P/ISDA CDS Indices Commentary: May Review

With investors shedding risky assets in a massive flight to quality, it is no surprise that CDS spreads jumped across the board in May. The S&P 500 Index dropped 6%, and the S&P GSCI Index declined nearly 13%. The U.S. dollar rallied by more than 5% as investors piled into U.S. Treasuries. The ongoing eurozone crisis is affecting investors around the globe as increased predictions of a recession spread.

Capital Market Commentary: IPO Activity Slows After The Facebook Debut

Since Facebook Inc.'s IPO more than three weeks ago, no IPOs (excluding two closed-end funds) have come to market, according to S&P Capital IQ data. In addition, only five companies have since filed plans to sell common shares to the investing public, with private equity-owned CKE Restaurants Inc.'s planned $100 million offering ranking as the largest among them.

S&P Index Commodity Commentary: Precious Metals Limit Losses

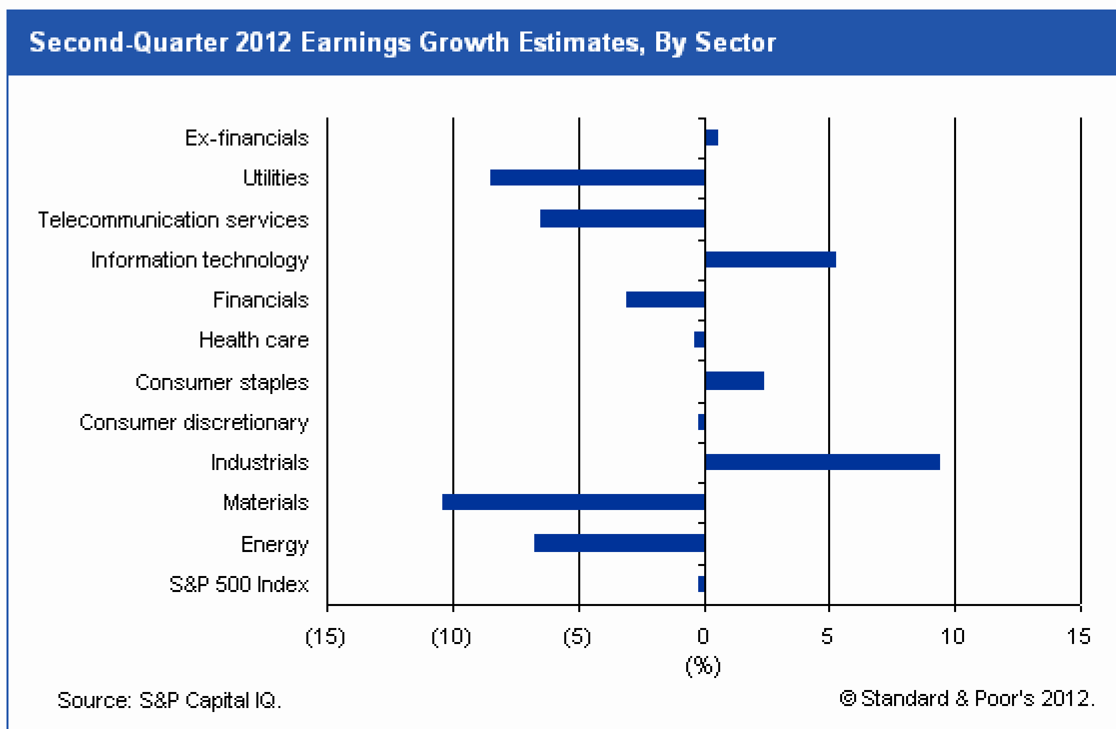
Commodity market weakness from May carried over into June, led by declining energy prices. Reflecting flight-to-safety fears, strength in precious metals has helped limit broad index losses. Nevertheless, weakness in the industrial metals sector over the past 12 months has offered little economic optimism.

Economic And Market Outlook: North American And European Earnings

North America

Now that all but one of the S&P 500 constituents have reported their first-quarter earnings, investors are focusing on second-quarter expectations. After a disappointing employment report last week, along with the lowest consumer confidence reading since January, second-quarter corporate earnings growth estimates fell to negative 0.21%. If the quarter ends this way, it will be the first time the S&P 500 Index has reported negative "growth" since the third quarter of 2009 (negative 1.69%), amid the Great Recession. Even at that time, only six of the ten sectors reported negative growth. Analysts currently expect seven sectors to report negative numbers for the second quarter (see chart 1).

Chart 1



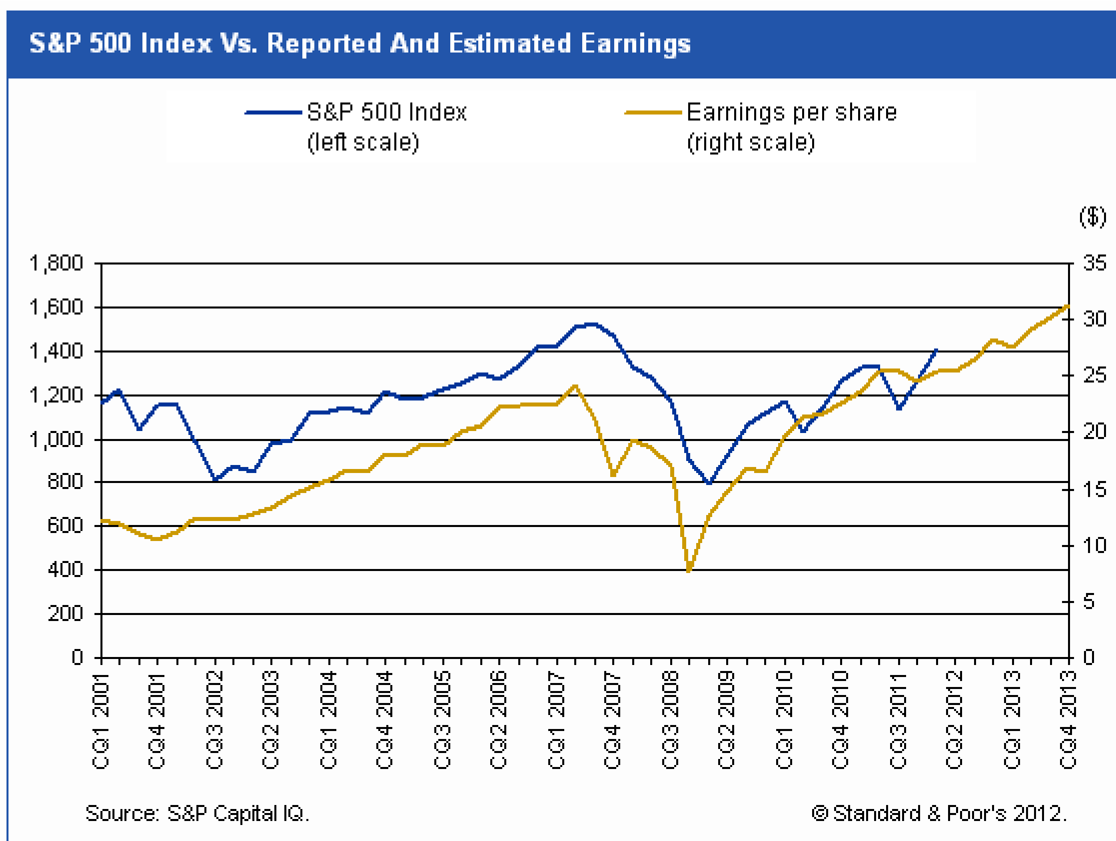
Two of the biggest laggards, materials and energy, have revenue streams that rely heavily on commodities prices. As commodities reached multiyear highs, these two sectors reported the most significant growth among the sectors from fourth-quarter 2010 through third-quarter 2011. However, natural gas at decade lows and a steady decline in metal prices since the fourth quarter of 2011 has significantly hurt the bottom line of both sectors. And since the beginning of the quarter on April 2, Brent crude oil has dipped nearly 20% to $100.64 a barrel from $124.77. This week, oil fell below the $100 mark for the first time since February 2011. In metals, domestic hot rolled coil steel dropped nearly 15% since the beginning of the year, and gold prices, though still holding up at $1,634 an ounce, up 4.3% for the year, have retreated from their September 2011 high of $1,875.

The materials sector is expected to post the lowest earnings growth figure (negative 10.39%) for the second quarter, while maintaining respectable revenue growth of 4.57%. Four of the five industries within the sector are expecting declines for the quarter, with the metals and mining industry expected to fare the worst. All but one company--Newmont Mining Corp.--in that industry are expecting negative growth in the second quarter.

The energy sector is expecting the third lowest growth level (negative 6.7%), yet the highest revenue growth rate (18.3%). Despite high expected sales growth, higher oil prices have raised the cost of goods sold, pressuring gross margins. Of the two industries in the sector, the oil, gas, and consumable fuels industry is projected to report negative growth of negative 8.5%, while the energy equipment and services industry expects stronger growth of 12.5%.

While forward earnings estimates have been falling, prices have dropped even more. Despite closing 30 points higher on Wednesday, the S&P 500 Index is still down 7% since the beginning of the quarter (see chart 2). Currently, the forward P/E ratio stands at a low 12.2, indicating that stocks are cheap. In such a volatile stock market that reacts to the European sovereign debt crisis and the U.S. employment situation, among other factors, it's hard to gauge where prices are headed next. However, if forward earnings continue on their downward decline, we can expect a higher P/E ratio in the future.

Chart 2



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Europe

On May 30, the European Commission released eurozone economic and business confidence data that fell short of economist expectations. The eurozone's latest unemployment rate climbed to 11% in April from 10.9% in the previous month. Although inflation for May (measured by CPI estimates) slightly improved in the eurozone to 2.4% from 2.6%, it remains higher than the European Central Bank's 2% ceiling. Elevated concerns in Greece and Spain have added to existing economic uncertainty in Europe, prompting analysts to trim their 2012 and 2013 earnings forecasts by 7.4% and 4.4%, respectively, since the start of the year (as of June 1).

Amid the deteriorating political and economic climate in Europe in the last two weeks (ended June 1), analysts cut their 2012 and 2013 earnings forecasts for seven of the 10 sectors by 0.5% to €97.02, and for eight sectors by 0.4% to €109.44, respectively, according to data aggregated by S&P Capital IQ.

Analysts continued to lower their 2012 and 2013 earnings expectations the most for the typically highly economy-sensitive materials sector (decline of 1.5% and 0.9%, respectively). In addition, analysts trimmed their 2012 and 2013 earnings forecasts for the energy (decline of 0.4% and 0.7%) and telecommunications sectors (0.6% and 1%).

In particular, BP PLC's oil rig disaster in 2010 and subsequent announcement that Mikhail Fridman resigned as chief executive of their Russian joint venture TNK-BP will likely hurt the company's performance. The TNK-BP venture accounts for about 29% of BP's production and a sizable portion of its reserves. As a result, analysts lowered their earnings forecasts for the sector.

Of the 10 sectors, analysts only raised their estimates for the consumer discretionary sector as a result of some European carmakers' extensive sales outside Europe. Since the start of 2012, analysts have cut their 2012 estimates the most for the information technology sector. Nokia OyJ and other companies in the sector have offered profit warnings and poor guidance. Not surprisingly, the materials and financials sectors have absorbed a lot of negative business sentiment since the start of the year, and analysts lowered their earnings forecasts for the sectors as a result. Although S&P Europe 350 Index 2012 growth expectations currently stand at a relatively high 6.9%, this is partly due to easy comparisons with calendar-year 2011 earnings (decline of 3.1%). Nevertheless, analysts still expect robust earnings growth of 12.8% in 2013 (see charts 3 and 4).

As of June 1, sector leaders for calendar-year 2012 earnings include the financials (31.98% expected growth) and industrials (8.18% expected growth) sectors. Earnings laggards for calendar-year 2012 include the information technology (expected decline of 29.94%) and telecommunications (expected decline of 7.04%) sectors.

Chart 3

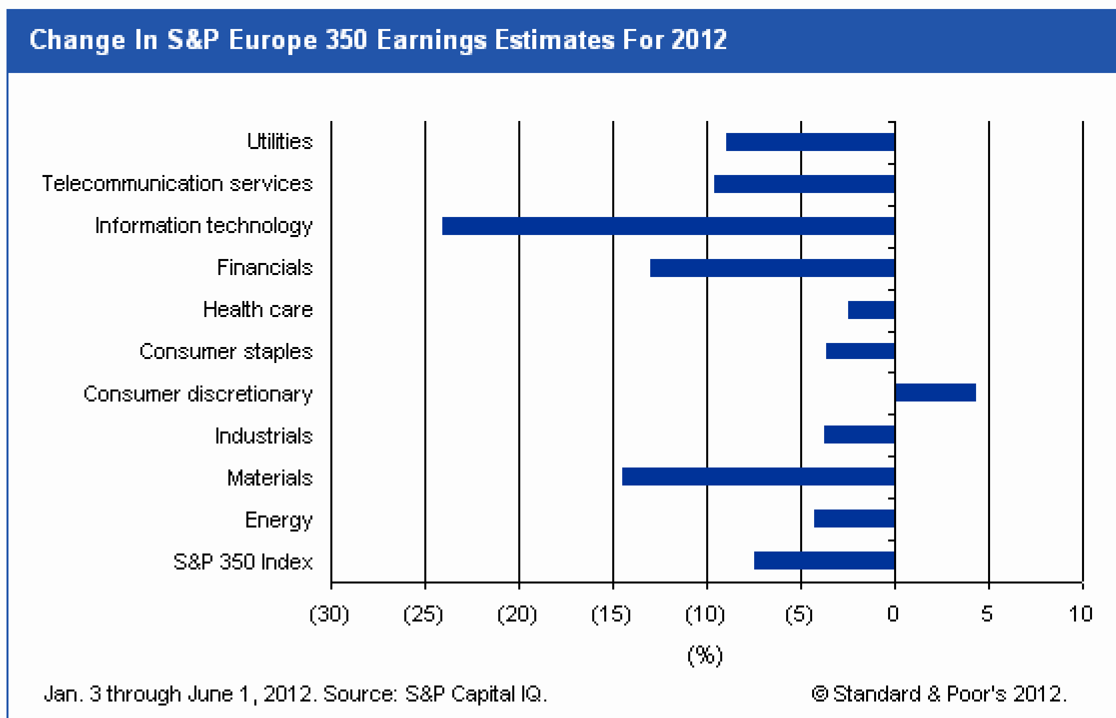
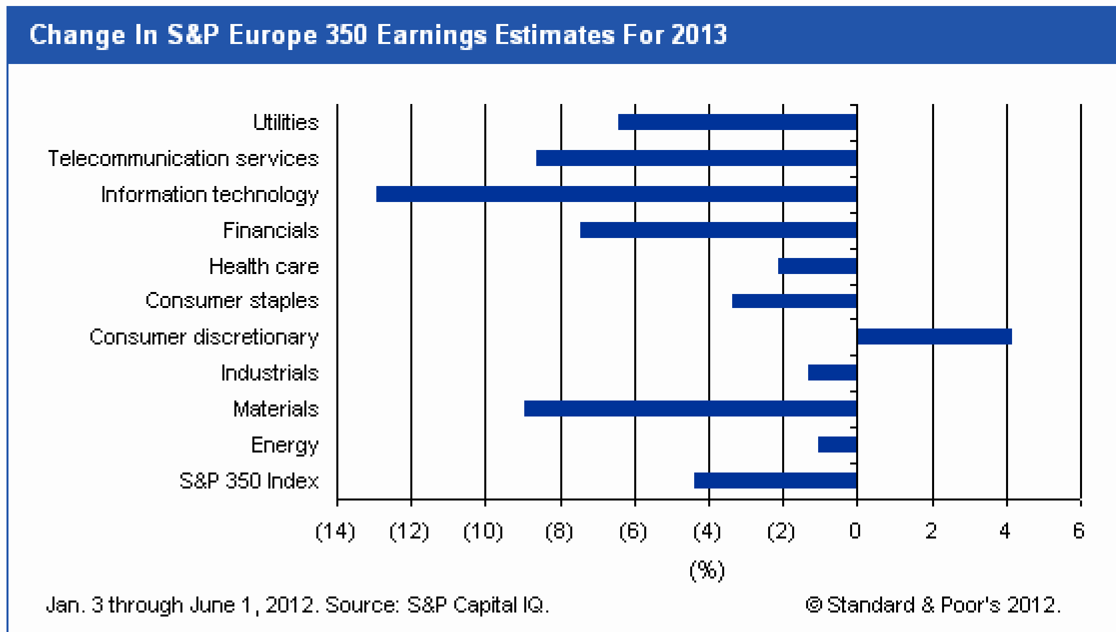


Chart 4



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S&P Index Commentary: The Evolution Of Post-Employment Benefits

For more than 75 years, the relationship between employee and employer not only encompassed the exchange of services for compensation, but extended to obligations in the form of Other Post Employment Benefits (OPEB). These benefits became staples of the American Dream, and employers and companies subsequently built these related expenditures into the cost of products and services. Over the last quarter of a century, globalization of markets, materials, and services has grown dramatically. As U.S. economic dominance has shifted and the effects of the last two recessions have become more prevalent worldwide, the ability of U.S. companies to pass along these costs to consumers--an ability that many foreign competitors do not have--has significantly diminished to a level that endangers many companies' competitiveness.

The full breadth and scope of OPEB remains unclear because of an absence of available uniform information as well as a lack of funding requirements. As medical and drug costs continue to outpace inflation and average life expectancy continues to increase, the present value of OPEB has become a major concern for corporations. In 2011, the aggregate underfunding of OPEB obligations reached $223.4 billion, a 6.3% increase from $210.1 billion in 2010 (see table 2). Nevertheless, underfunding remains 30.4% lower than in 2005 ($320.9 billion), a result of reduced coverage for employees and lower corporate contributions (similar to pensions, companies are shifting risk from the corporation to the employee). The funding rate decreased to 21.8% from 23.5% in 2010.

Table 2

S&P 500 2011 OPEB Report

	Assets (mil. $)	Obligations (mil. $)	Funding status (mil. $)	Funding status ratio (%)
Consumer discretionary	647	13,899	(13,252)	4.66
Consumer staples	4,666	21,609	(16,943)	21.59
Energy	1,489	24,786	(23,296)	6.01
Financials	7,403	17,047	(9,643)	43.43

Table 2

S&P 500 2011 OPEB Report (cont.)				
Health care	4,758	17,904	(13,146)	26.58
Industrials	9,656	57,639	(47,983)	16.75
Information technology	1,316	10,663	(9,347)	12.34
Materials	1,909	19,875	(17,966)	9.60
Telecommunication services	13,216	66,689	(53,473)	19.82
Utilities	17,210	35,536	(18,326)	48.43
Total	62,270	285,646	(223,376)	21.80

Source: S&P Indices.

The average cost of U.S. products has increased as a result of rising costs for U.S. private medical retiree benefits. These benefit costs are higher than for many non-U.S. competitors, leaving U.S. products at a competitive disadvantage. U.S. companies must make up the difference of what foreign entities provide by substituting higher prices for their products for the sovereigns' ability to tax. With the U.S. government now taking a more active role, companies will look to shift their expenses. Just as defined pensions shifted to defined contributions and 401K-type savings accounts, the responsibility of providing post-retirement medical care is now shifting from corporate programs to individuals and to U.S. social policy.

Companies continue to take the necessary steps to reduce costs in the face of global competition. While workers and unions have resisted the changes, society has begun to accept the need for reduced benefits amid the economic reality of globalization and current market conditions. Workers now tend to have more concern for their current jobs and current medical coverage than their eventual retiree benefits. Over several years, this disproportionate contribution rate will shift significant portions of the OPEB responsibility and costs from the company to the individual. Although individuals unable to afford the additional expense may choose to drop their coverage, the government would require coverage under the current health care legislation (or individuals would face financial penalties). In many of these cases, government programs would need to cover medical needs, though this system is already showing signs of strain.

Medical coverage (doctors, hospitals, and medications) has emerged as a major issue within the U.S. government. In general, corporations believe that traditional U.S. benefits burden them with additional costs that do not exist for many foreign competitors. While the government looks for short-term solutions, it could be difficult to actually implement and pay for such plans, especially in an economy with high unemployment levels and expectations for a slow recovery. As a result, the government might implement slower, more limited, step-by-step benefits coverage, with the economy and politics playing significant roles.

Unfortunately, the longer the debate goes on, the worse it will become. Eventually, the government will be forced to address the situation and take the necessary painful steps. The concern remains that while both the public and private sectors have accepted the current situation and are starting to address the issues, neither have shown a tolerance for the pain associated with necessary actions. The longer the government avoids action by applying short-term band-aids, the stronger the measures will ultimately have to be. In the end, individuals--either as taxpayers or consumers--will need to pay the bill while accepting a reduction in their benefits and lifestyle.

S&P will issue a series of pension and OPEB reports later this month, with one devoted to the S&P 500 Index, and other reports from the both the corporate and sovereign ratings groups.

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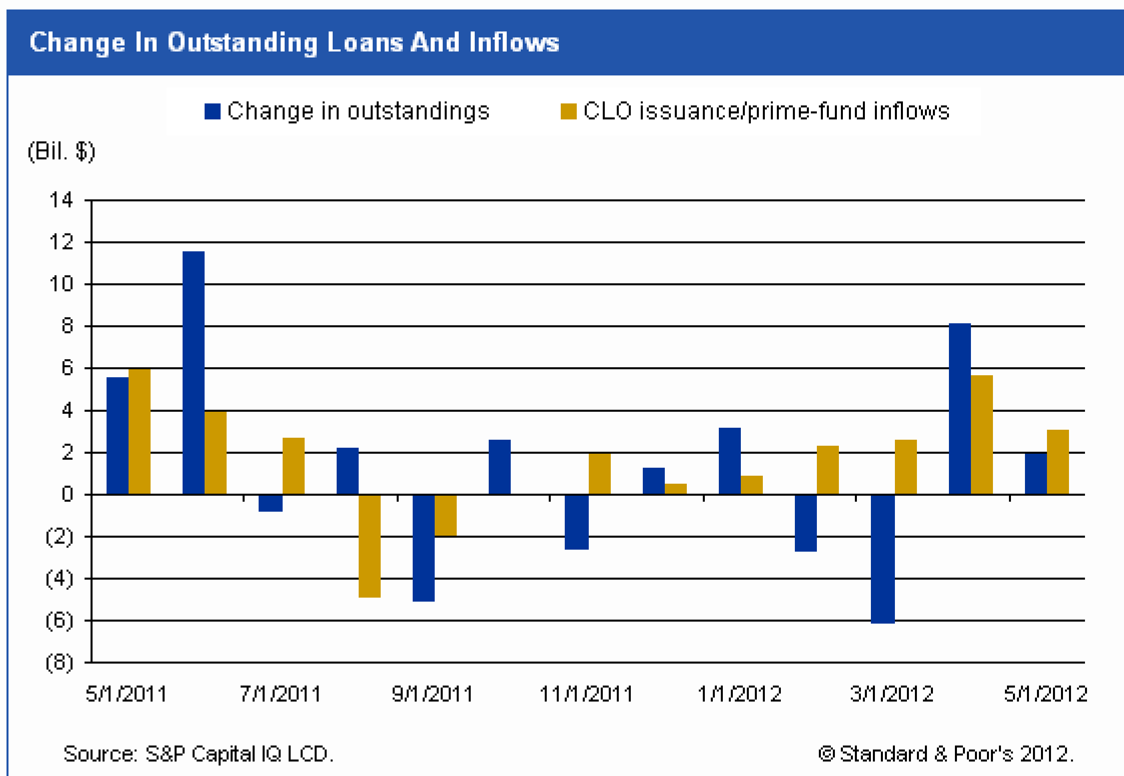
Leveraged Commentary And Data: Leveraged Loan Technicals Cool In May Amid Macroeconomic Uncertainty

External events held the loan market captive in May as darkening global macroeconomic conditions forced the S&P/LSTA Leveraged Loan Index to suffer its first monthly loss since November, retreating by 0.68%. High-yield bonds and equities endured even more severe downturns, with the Bank of America Merrill Lynch High-Yield Master Index and S&P 500 Index down 1.2% and 6%, respectively.

This grim backdrop took its toll on the loan market's technical picture, with investors quickly becoming risk-averse (though not entirely risk-off). Thus, CLO issuance, though still robust by recent standards, fell to $2.9 billion in May from a 4.5-year high of $5.1 billion in April. Likewise, inflows to daily access loan mutual funds fell to $133 million in May--including a $201 million outflow during the final week of the month, the biggest net redemption in six months--from $557 million in April, according to EPFR.

On the supply side of the ledger, an increase in new-issue activity and a slowdown in bond takeouts caused the amount of S&P/LSTA Index loans to increase by $1.9 billion, or 0.37%. That followed an $8.1 billion (1.59%) increase in April. Altogether, the muscular inflow surplus of $12 billion during the first quarter gave way to a slight deficit of $1.4 billion in April and May (see chart 5).

Chart 5

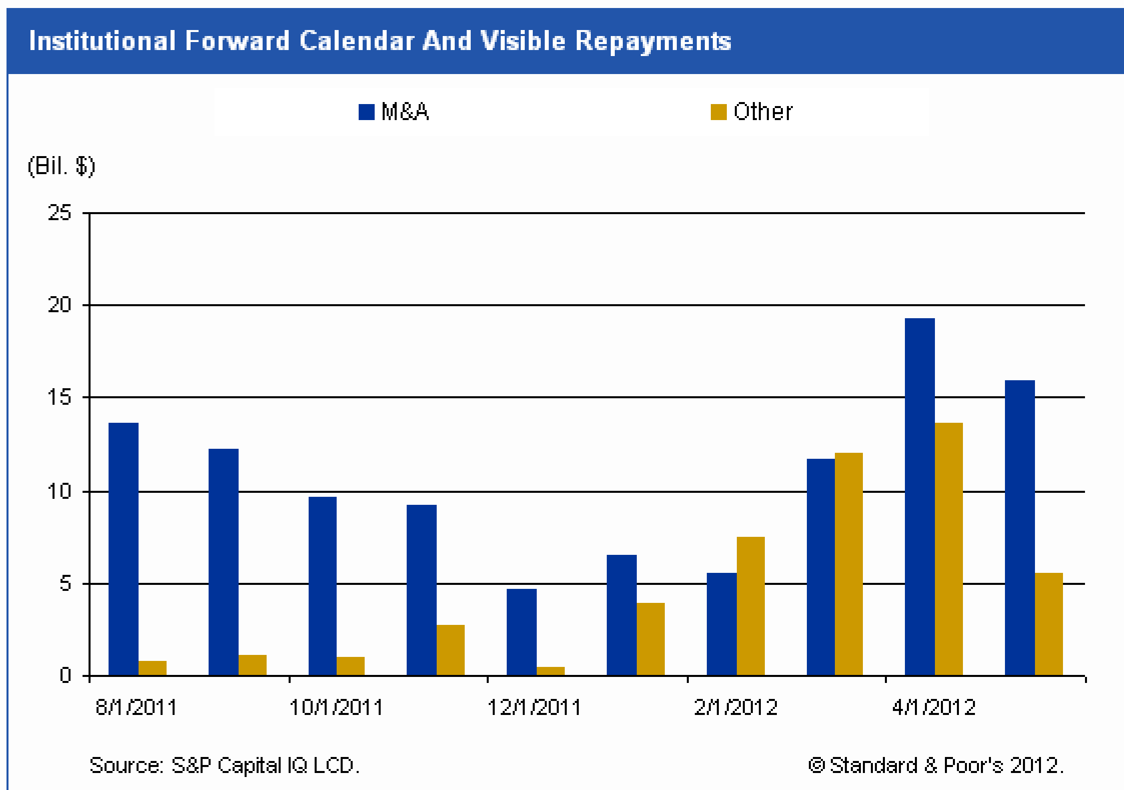


Looking ahead, the bumpy ride of the past month shows no sign of abating. In fact, supply is currently set to exceed demand in June, despite the fact that the total forward calendar of loans contracted to $21.5 billion as of May 30, from a post-credit-crunch high of $32.9 billion a month earlier. Here's why:

First, the pipeline of M&A-driven loans remains robust, at $15.9 billion (though that is down from April's high of $19.2

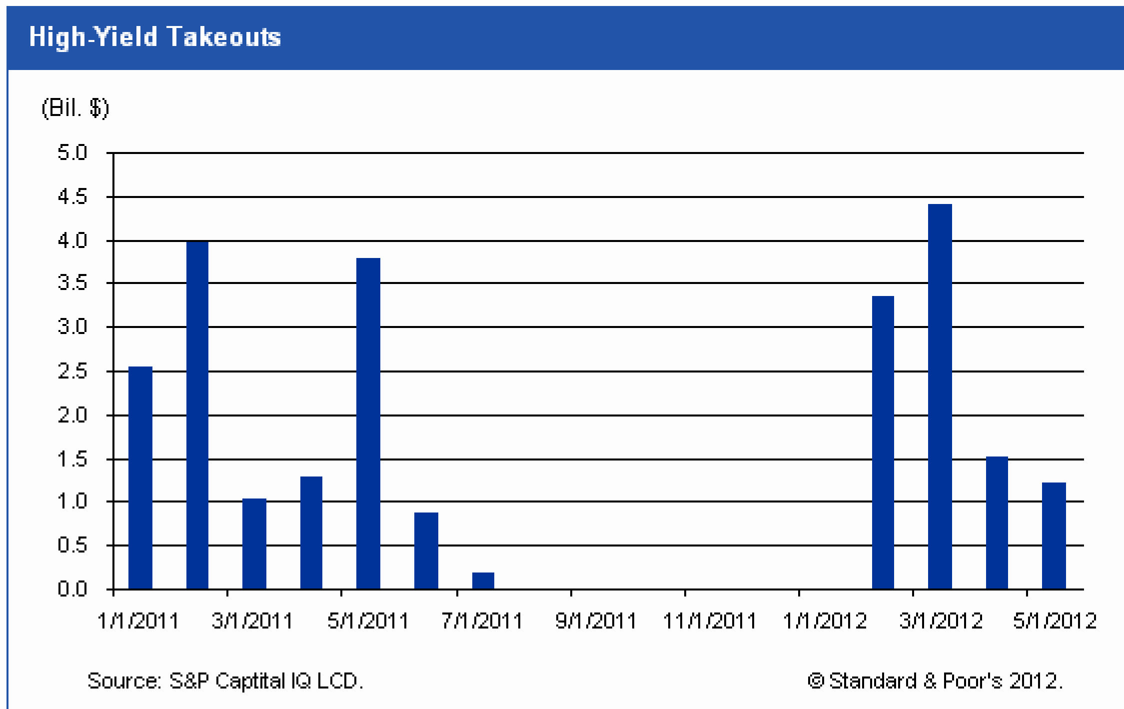
billion; see chart 6).

Chart 6



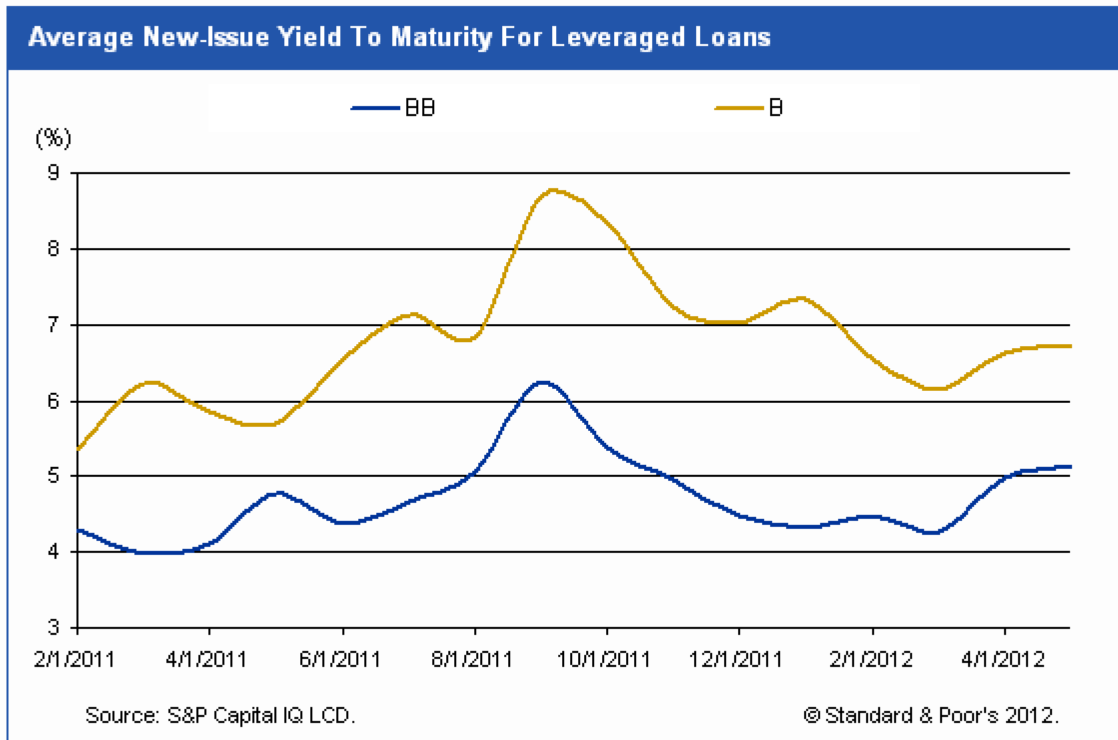
Second, managers expect investors will remain guarded, at least until Greece's June 17 elections give some indication about whether an exit from the eurozone is likely or whether Greece will remain committed to its EU/IMF bailout plan. Managers say the uncertainty that precedes this election likely will limit capital flows into the asset class, whether CLOs issuance, retail inflows, or institutional allocations. And with the high-yield market also anemic, takeout activity, by all accounts, will remain light (see chart 7).

Chart 7



For all of these reasons, the new-issue market cooled significantly in May. Flex activity tells the story here. In May, arrangers sweetened pricing on 21 loans while making issuer-friendly changes to just nine. The ratio was even more lopsided over the final two weeks of the month, at 13 to four. During the first four months of 2012, by contrast, reverse-flexes outnumbered those of the investor-friendly variety by a score of 59 to 23. With investors calling the tune, new-issue clearing yields widened (see chart 8).

Chart 8



The more forbidding primary landscape, arrangers say, will keep opportunistic deal flow--repricings, recaps and A-to-E's--to a minimum, while making underwriting new M&A transactions challenging.

Before we get carried away with the doom and gloom of the moment, it's worth looking back at the state of play a month ago. During the first 4.5 months of 2012, greed ran freely despite an undercurrent of fear that the loan market was getting too hot, promoting such issuer-friendly features as second-lien, covenant-lite, and repricings.

May's sudden bull market in safety (to borrow Jim Grant's excellent phrase) has reversed the market's psychological bent, to the benefit of buyers and the determinant of issuers and sellers, at least for the time being.

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R2P Corporate Bond Monitor

On Monday, Spain warned that it was locked out of capital markets, adding to fears that the fourth largest economy in the eurozone will default on its debts. Spain has been unable to refinance its debt, and markets currently demand well over 6% for 10-year loans. As a result, the country has sought an international bailout, which some market analysts expect will cost about €150 billion.

Demand for one-week funding from the European Central Bank (ECB) also spiked to its highest level since before November, when policymakers injected €500 billion of three-year loans into Europe's banks. The use of its one-week 1% fixed-rate loans reached €119 billion from 96 banks, versus €51 billion from 87 banks last week.

Fleeing risky assets such as Greece, Spain, and Italy, investors poured cash into safer German, British, and U.S.

government debt, pushing the countries' 10-year borrowing costs to record lows: 1.27% for Germany, 1.65% for the U.K., and 1.63% for the U.S. The borrowing costs for Greece, Spain, and Italy soared to 30.13%, 6.66%, and 5.94%, respectively.

Nevertheless, all four of the largest eurozone economies contracted last month. Markit's composite PMI fell to a three-year low of 46 from 46.7 in April, indicating an accelerating decline in private-sector activity far below the "no change" level of 50. Spain led the decline, with a six-month low of 41.2, while Italy registered a two-month high of 43.5. France's PMI fell to a 37-month low of 44.6, and Germany's dipped below the breakeven level of 50 to a 34-month low of 49.3.

The U.S. also joined the global slowdown with another unexpected rise in jobless claims and a downward revision to GDP growth last week. The number of Americans that filed requests for jobless benefits climbed for the fourth consecutive time, by 10,000 in May to 383,000, the highest level in five weeks, according to the U.S. Labor Department. Meanwhile, the Commerce Department revised its first-quarter GDP estimate to 1.9% from 2.2% after lower-than-expected consumer and government spending results. This represents a slowdown from the 3% GDP growth in fourth-quarter 2011.

European concerns resulted in a decrease in debt issuance from governments and financial institutions as well as an increase in corporate debt issuance in the fixed-income markets. Euro-denominated issues fell 22% to $635.5 billion, the lowest level since 2004 and the lowest percentage of European debt issued in euros since the single currency began. On the other hand, corporate debt issuance in Europe rose 12% since last year to $237 billion, as more firms spurn bank loans in favor of bond issues.

In this context, risk-reward profiles in the corporate fixed-income market--as measured by average Risk-to-Price (R2P) scores--varied among the countries for the past two weeks (May 21 to June 5; see table 3).

Despite a 37% decrease in the probability of default (PD), U.S. scores deteriorated by 9% as a result of a tightening in the option-adjusted spread (OAS) of 6% and a 5% increase in the 20-day historical bond price volatility.

In Europe, scores for Italy, France, and Germany increased by 16%, 9%, and 6%, respectively. On the other hand, scores for the U.K., Ireland, and Spain decreased by 14%, 10%, and 5%, respectively.

Overall, scores deteriorated in most of the sectors in North America and in Europe, with risks increasing more than returns (see tables 4 and 5).

In North America, scores decreased overall by 16% as a result of a 13% increase in the average PD and an 8% increase in bond price volatility, more than offsetting the widening in the average OAS of 2 bps.

In Europe, scores decreased by 8% as a result of an 11% increase in the average PD and a 12% increase in the bond price volatility, more than offsetting the widening in the average OAS of 4 bps.

Table 3

Risk-Reward Profiles By Country--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
U.S.	(9)	(6)	(37)	5
France	9	3	(7)	(19)
Germany	6	2	(45)	2
Ireland	(10)	(12)	55	11
Italy	16	(1)	(36)	(7)
Portugal	2	(14)	(24)	(13)

Table 3

Risk-Reward Profiles By Country--Average R2P Score And Components Changes (cont.)				
Spain	(5)	5	59	(22)
U.K.	(14)	2	42	15

Change as of June 4, 2012, from May 21, 2012.

Table 4

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

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	(17)	2	16	18
Consumer staples	(16)	3	7	(84)
Energy	(24)	5	34	14
Financials	(6)	(3)	(13)	11
Health care	(20)	7	36	25
Industrials	(16)	(1)	2	19
Information technology	(20)	9	11	29
Materials	(20)	1	28	28
Telecommunication services	(15)	(1)	(10)	15
Utilities	0	(4)	17	5

Change as of June 4, 2012, from May 21, 2012.

Table 5

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

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	4	(4)	(17)	5
Consumer staples	(18)	(6)	38	31
Energy	(11)	23	16	10
Financials	(2)	2	(4)	(11)
Health care	(17)	(8)	14	16
Industrials	(9)	(4)	11	(2)
Information technology	9	5	10	(21)
Materials	(5)	8	(5)	37
Telecommunication services	(21)	18	24	20
Utilities	(5)	8	18	30

Change as of June 4, 2012, from May 21, 2012.

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S&P Index Municipal Commentary: High-Yield Municipal Bonds: Is There More Room For Upside Potential

Yields for higher-yielding municipal bonds have quickly fallen in 2012. As a result, high-yield municipal bonds have outpaced the stock market and the overall municipal bond market by returning 9.4% year to date, as measured by the S&P Municipal Bond High-Yield Index. Investment-grade municipal bonds have returned 3.67% so far this year.

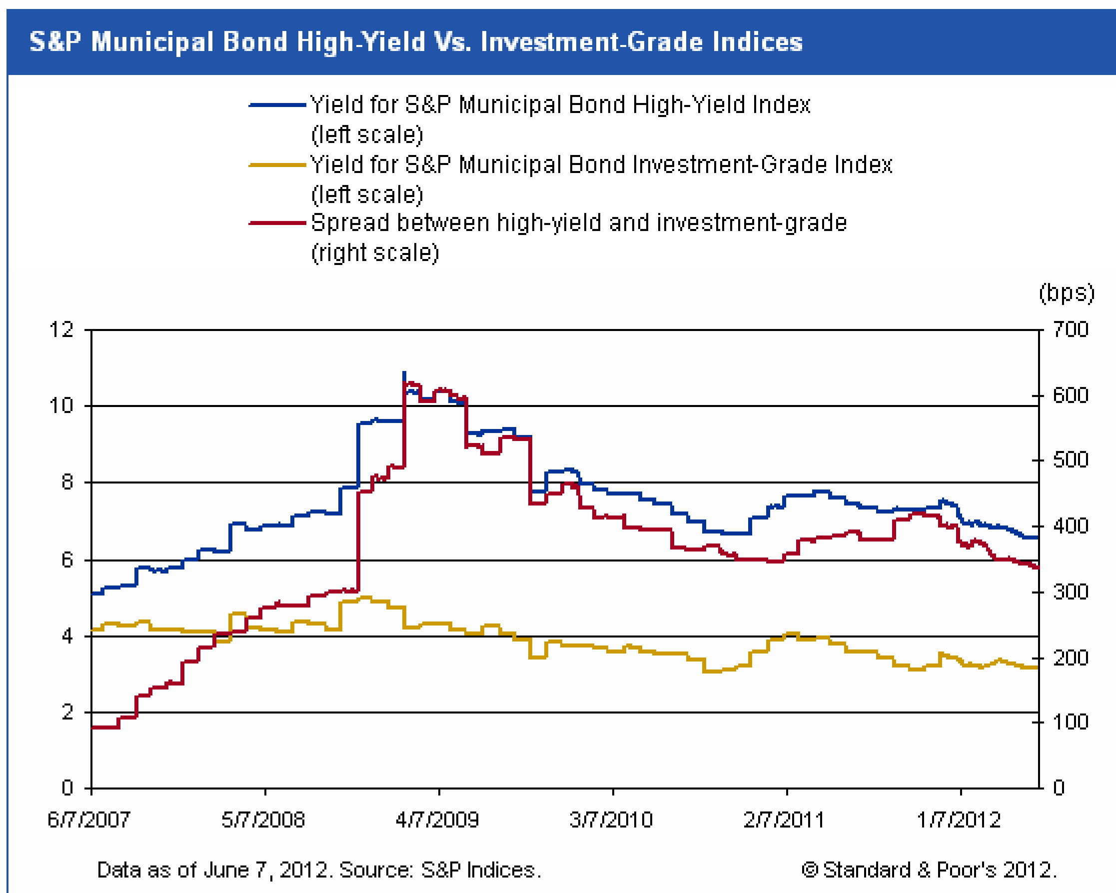
Will high-yield bonds continue on their upswing, or has the risk-reward pendulum started to swing the other way? We compared 10-year investment-grade municipal bonds with the 10-year Treasury; this part of the municipal market continues to be relatively cheap with other fixed-income asset classes. The weighted average yield to maturity of actual

municipal bonds maturing in 2021 tracked by the S&P AMT-Free Municipal Series 2021 Index (nine-year noncallable investment-grade bonds) ended June 6 at 2.46%, or 80 bps higher than the yield on the 10-year U.S. Treasury. Using a 35% tax rate, the taxable equivalent yield of these same bonds is 3.78%, or about 212 bps higher than the yield on the 10-year U.S. Treasury.

We then compared the overall investment-grade market with the high-yield market. The weighted average yield of high-yield bonds in the S&P Municipal High-Yield Index ended June 6 at 6.54%, compared with 3.19% for the S&P Municipal Bond Investment-Grade Index--a spread of 3.34 bps, or more than double the yield. From a taxable equivalent yield perspective, high-yield bonds are yielding 10.06%, compared with 4.9% for investment-grade bonds.

In June 2007, the yield margin between high-yield municipal bonds was at its narrowest, just over 90 bps (see chart 9). That spread peaked in January 2009 (extreme "risk-off") at 622 bps, and has migrated down to 334 bps as of June 6.

Chart 9



So is there more room for upside? Another extreme risk-off environment represents the real risk to more upside for high-yield municipal bonds, in our opinion. Meanwhile, investors might continue to use the relative safety of the municipal market, as demonstrated by the historically low default rates, as an alternative destination for incremental yield over U.S. Treasuries. If this occurs, demand will continue to outpace supply, helping to drive prices higher.

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Market Derived Signal Commentary: The CDS Market Reveals Strength In Some U.S. Financial Companies

On June 1, the credit default swap (CDS) spread for U.S. financial companies, as measured by the S&P/ISDA CDS U.S. Financials Select 10 Index (Financials Index), approached the widest point of 2012. At an average spread of 229 bps, the benchmark index is only 12 bps tight of its year-to-date high of 241 bps and 17 bps wide of 195 bps on April 11 (see "Credit Market Commentary: Market Derived Signal: Eurozone Sovereign Risk Taints U.S. Financials," published April 12, 2012).

The move is unsurprising, given JPMorgan Chase & Co.'s significant trading loss and Bank of America Corp.'s failure to disclose to shareholders that acquiring Merrill Lynch would lead to huge losses at the bank. These recent events add to significant eurozone sovereign contagion fears and have renewed concerns about a recession in the U.S. after a disappointing jobs report last week.

Nevertheless, we were surprised that the CDS spread for the Financials Index hadn't widened further. In the equity market, financial companies have given back more than all of their gains so far this year (through June 4). The GMI research team took a closer look at the five-year CDS spreads for the 10 companies that constitute the Financials Index for more information (see table 6).

Table 6

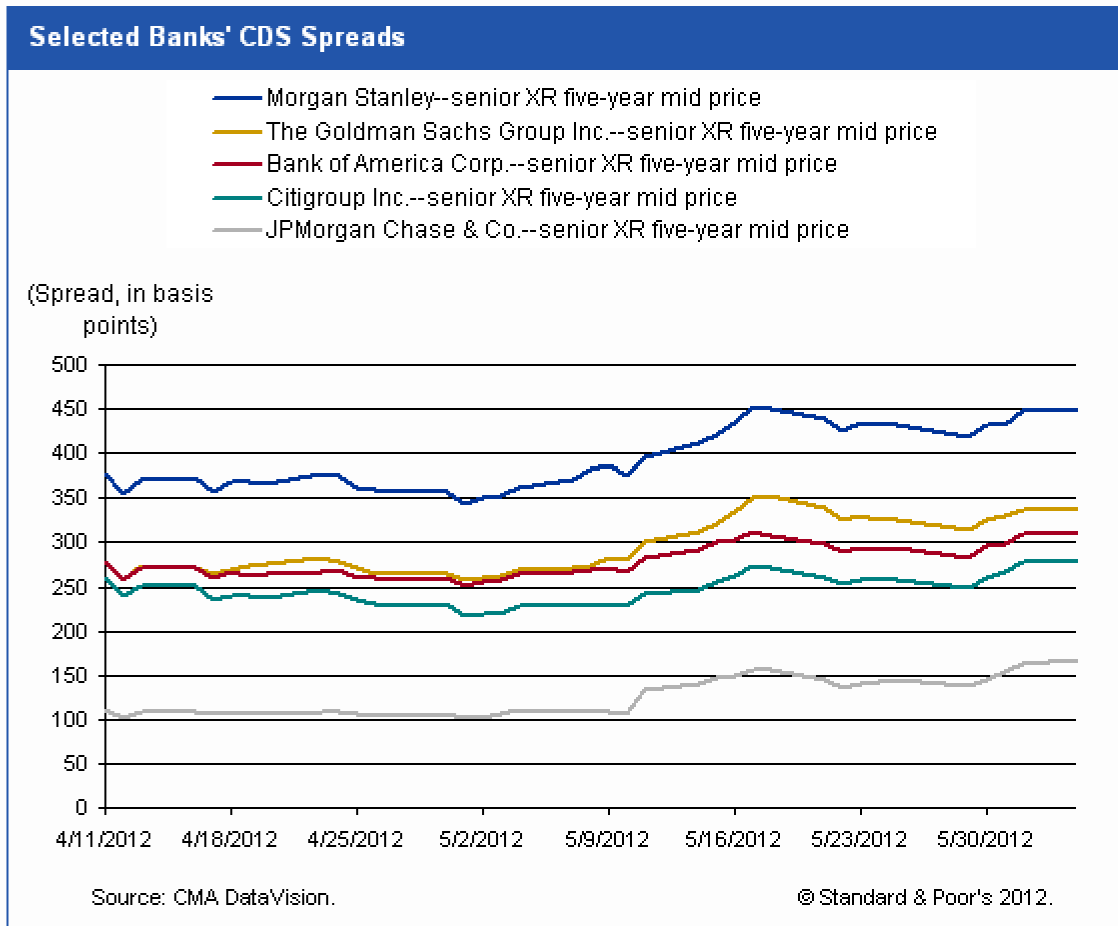
S&P/ISDA CDS U.S. Financials Select 10 Index

Company	CDS (bps)	Benchmark (bps)	S&P credit rating/outlook	Market Derived Signal
Morgan Stanley	450.5	223.1	A-/Negative	bb-
The Goldman Sachs Group Inc.	337.4	223.1	A-/Negative	bb+
General Electric Capital Corp.	182.3	122.3	AA+ Stable	bbb
American Express Co.	113.6	254.4	BBB+/Stable	a+
HSBC Finance Corp.	198.8	195.6	A/Negative	bbb
Bank of America Corp.	309.0	223.1	A-/Negative	bb+
JPMorgan Chase & Co.	167.6	195.6	A/Negative	bbb+
Citigroup Inc.	279.4	223.1	A-/Negative	bb+
Capital One Financial Corp.	132.6	290.2	BBB/Negative	a
Wells Fargo & Co.	133.1	178.0	A+/Negative	a

Source: CMA DataVision.

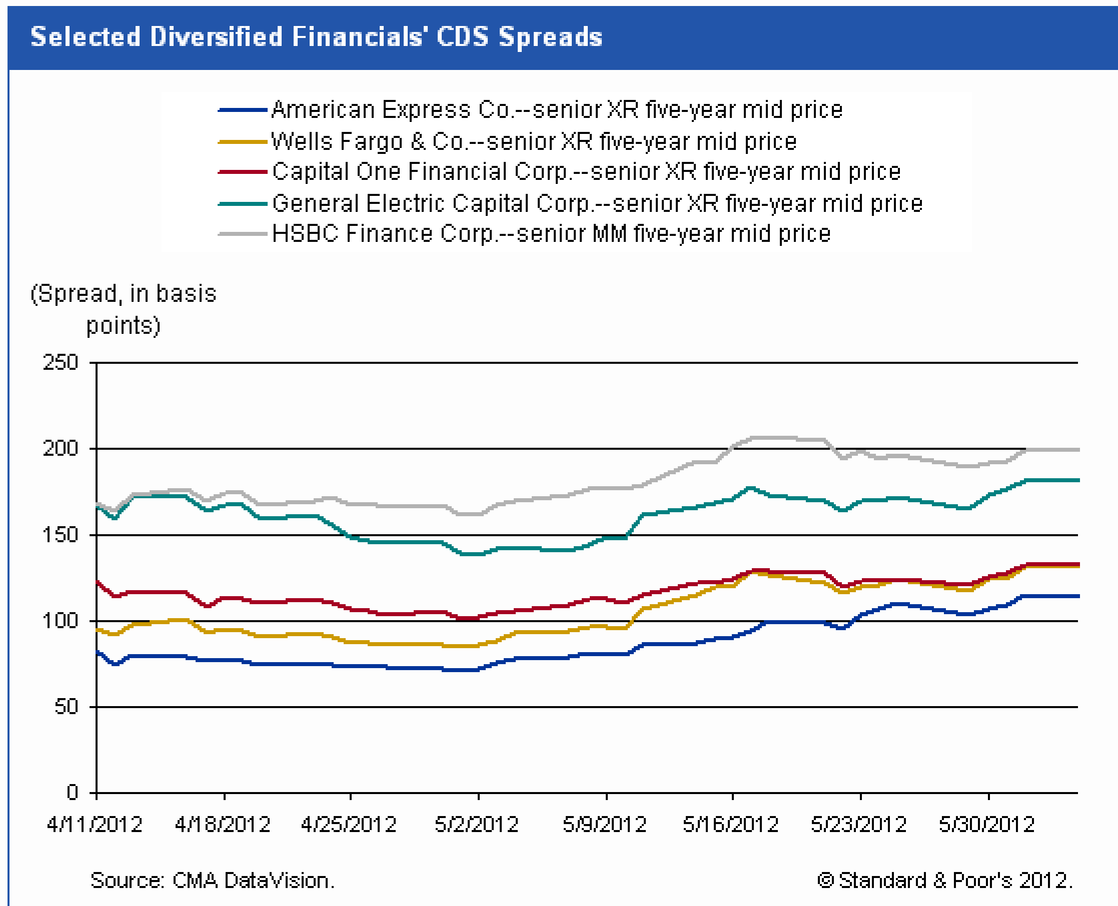
It was no surprise that spreads were widest for the most beleaguered banks: Morgan Stanley, The Goldman Sachs Group Inc., Bank of America, and Citigroup Inc. (see chart 10). JPMorgan's CDS, while wider by 51.4% since April 11, continues to trade in investment-grade territory.

Chart 10



But the relatively tighter spreads for Wells Fargo & Co. and American Express Co., for example, are offsetting the credit deterioration among diversified financial companies, showing that the credit market doesn't view all financial company securities as perilous investments (see chart 11).

Chart 11



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S&P/ISDA CDS Indices Commentary: May Review

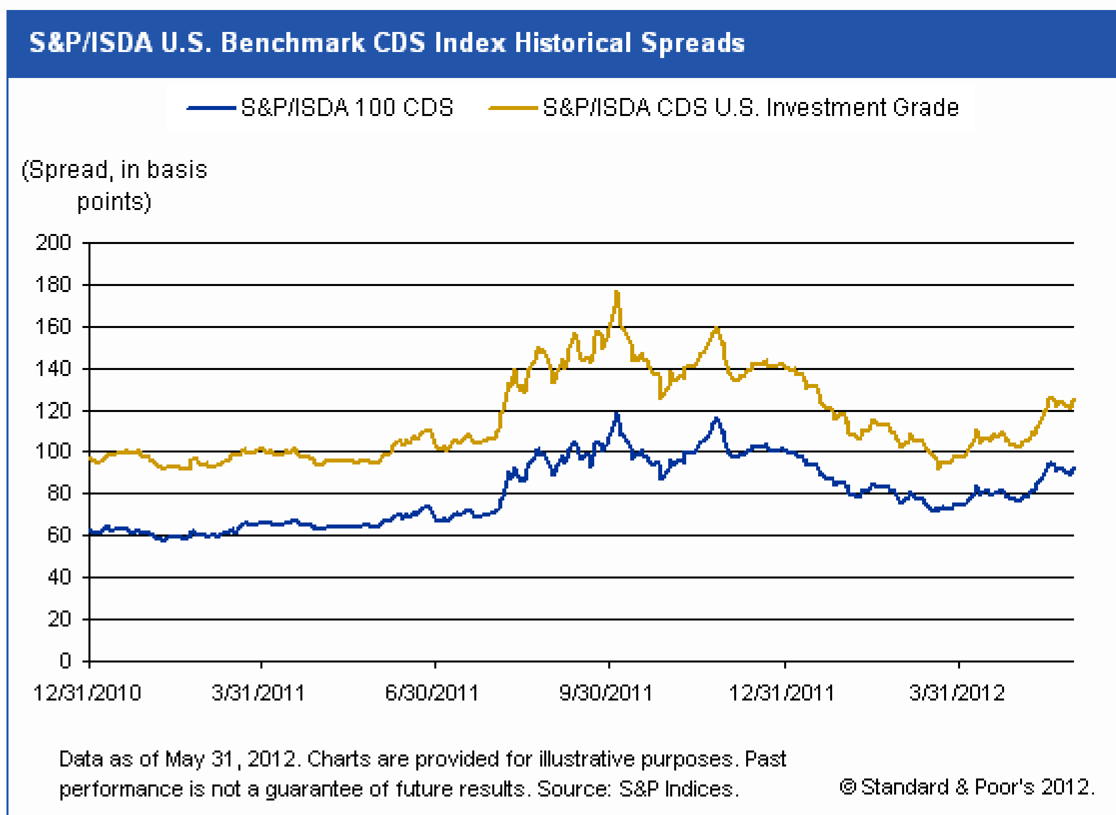
With investors shedding risky assets in a massive flight to quality, it is no surprise that CDS spreads jumped across the board in May. The S&P 500 Index dropped 6%, and the S&P GSCI Index declined nearly 13%. The U.S. dollar rallied by more than 5% as investors piled into U.S. Treasuries. The ongoing eurozone crisis is affecting investors around the globe as increased predictions of a recession spread.

The eurozone continues to be the problem area for sovereign and bank CDS spreads, which deteriorated further in May. The S&P/ISDA Eurozone Developed Nation Sovereign CDS Index jumped to 324 bps, and the S&P/ISDA CDS European Banks Select 15 Index rose to 349 bps. The 72-basis-point jump in European bank spreads (a 26% rise) was the highest percentage move in the CDS index family. Only the S&P/ISDA CDS U.S. High-Yield Index increased more (75 bps), as investors shed their riskiest assets.

As is usually the case when the equity markets fall, CDS spreads rose. On May 18, the S&P/ISDA 100 CDS Index spread rose to 95 bps before drifting lower to close the month at 93 bps, a 19% rise for the month. At month-end, 26 out of 84 reference entities had a spread north of 100 bps. On $10 million face value of bonds, 100 bps is equivalent to paying $100,000 per year for the life of the swap for protection against default. On April 30, only 21 reference entities had a spread over 100 bps.

The S&P/ISDA CDS U.S. Investment-Grade Index continues to exhibit a strong correlation to the S&P/ISDA 100 CDS Index (see chart 12). For the month, the investment-grade index spread rose 22 bps. The 21% change for investment-grade issuers is only slightly higher than the 19% increase for the S&P/ISDA 100 CDS Index. We track the spread differential between the S&P/ISDA CDS U.S. Investment-Grade Index and the S&P/ISDA 100 CDS Index. In May, the spread differential rose to 33 bps from 26 bps at the end of April. For the period shown below, the investment-grade credit spreads averaged 36 bps higher than the spread of the S&P/ISDA 100 CDS Index. After tightening earlier in the year, the spread differential is approaching its 17-month average, indicating worsening investor expectations for the lower credit quality investment-grade names relative to the higher credit quality S&P/ISDA 100 CDS Index.

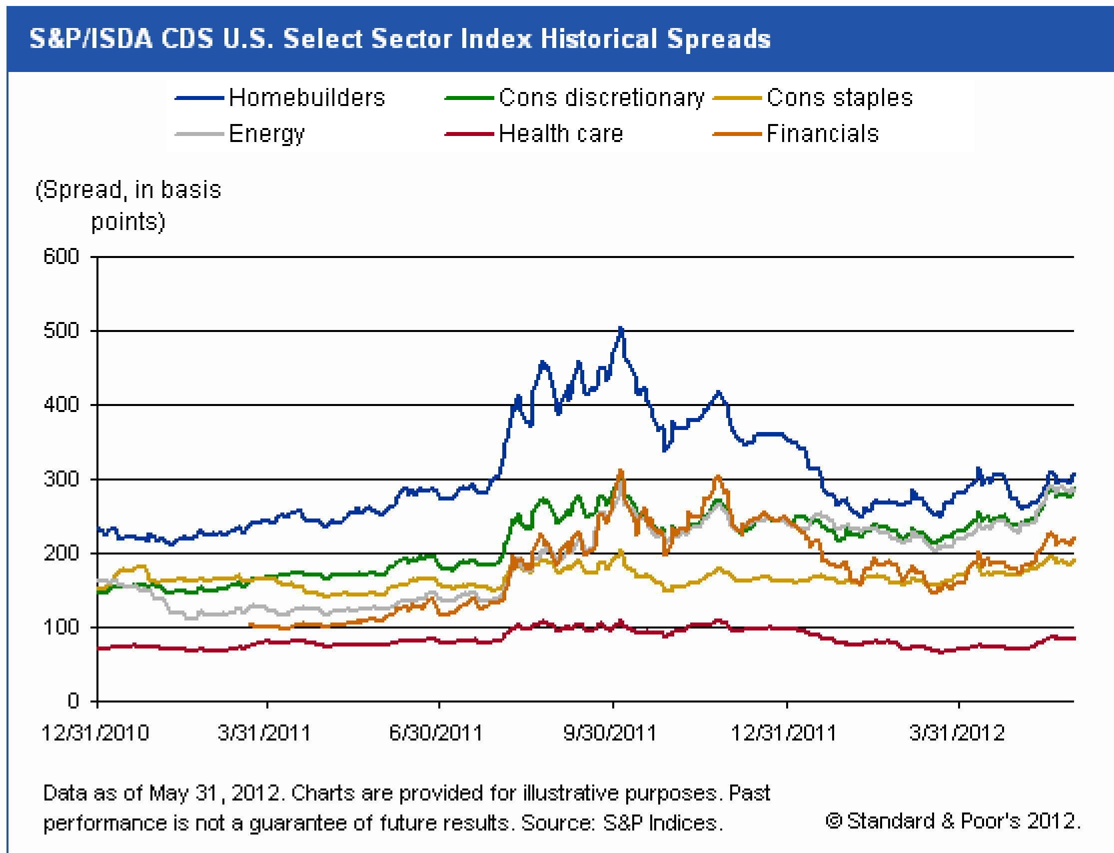
Chart 12



Sector CDS spreads were higher in May, all rising 15 bps or more (see chart 13). The S&P/ISDA CDS U.S. Health Care Index had the lowest spread by a wide margin, closing the month at 85 bps. The 15-basis-point jump in health care is equivalent to 22% credit deterioration, which is about middle of the pack from a relative performance standpoint. The best relative performer, not surprisingly, is the S&P/ISDA CDS U.S. Consumer Staples Select 10 Index. Defensive sectors, like consumer staples, tend to outperform in times of stress.

Somewhat surprisingly, the homebuilders sector, often considered a cyclical sector dependent on the state of the economy, was the next-best relative performer. The S&P/ISDA CDS U.S. Homebuilders Select 10 Index spread increased just 13%. It still has the highest spread among the U.S. sector indices, but investors are not seeing the downside in the housing sector that they saw at the end of summer last year.

Chart 13



Financials were hit particularly hard in May as the eurozone situation hurt banks' balance sheets (see table 7). The S&P/ISDA CDS European Banks Select 15 Index spread rose 72 bps in May, a 26% increase, making it the worst relative performer in the S&P/ISDA CDS Index family. The S&P/ISDA CDS U.S. Financials Select 10 Index had a more modest increase of 42 bps, but still a 23% rise, indicating the U.S. banks are not isolated from the worsening situation in Europe.

Table 7

S&P/ISDA CDS U.S. Financials Select 10 Constituent Performance

Change (bps)	American Express Co.	Bank of America Corp.	Capital One Financial Corp.	Citigroup Inc.	General Electric Capital Corp.	Goldman Sachs Group Inc.	HSBC Finance Corp.	JPMorgan Chase & Co.	Morgan Stanley	Wells Fargo & Co.
Month to date	37	40	23	37	31	65	26	48	74	39
Year to date	(5)	(108)	(16)	(16)	(76)	3	(57)	10	15	(20)

Data as of May 31, 2012. Charts are provided for illustrative purposes. Past performance is not a guarantee of future results. Sources: S&P Indices and CMA Datavision.

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Capital Market Commentary: IPO Activity Slows After The Facebook Debut

IPOs

Since Facebook Inc.'s IPO more than three weeks ago, no IPOs (excluding two closed-end funds) have come to market, according to S&P Capital IQ data. In addition, only five companies have since filed plans to sell common shares to the investing public, with private equity-owned CKE Restaurants Inc.'s planned $100 million offering ranking as the largest among them.

Although a majority of IPOs this year have traded lower since the Facebook IPO, a number of companies have appreciated in value (see table 8). As Facebook shares have dropped about 30% since the debut, several recent IPOs have posted double-digit percentage gains, including mortgage servicer Nationstar Mortgage Holdings Inc. and online internet software and service company Synacor Inc.

Table 8

Leading 2012 U.S. IPOs Since Facebook IPO

			--Day close price--		
Effective date	**Target/Issuer**	**Value (mil. $)***	**May 17, 2012 ($)**	**June 5, 2012 ($)**	**Change (%)**
3/7/2012	Nationstar Mortgage Holdings Inc.	233.3	16.97	19.80	16.7
2/9/2012	Synacor Inc.	34.1	9.58	11.13	16.2
2/23/2012	Proto Labs Inc.	68.8	31.07	35.75	15.1
2/1/2012	Matador Resources Co.	160.0	8.71	9.83	12.9
5/9/2012	WageWorks Inc.	58.5	10.55	11.76	11.5
2/7/2012	EPAM Systems Inc.	72.0	15.06	16.75	11.2
2/7/2012	Roundy's Inc.	163.1	10.05	10.68	6.3
2/1/2012	Greenway Medical Technologies Inc.	66.7	14.72	15.29	3.9
1/26/2012	Doubleline Opportunistic Credit Fund	375.3	25.47	26.30	3.3
1/26/2012	Verastem Inc.	55.0	9.83	10.14	3.2

*Total transaction value. Source: S&P Capital IQ.

M&A

After three consecutive quarters of declining activity, U.S. leveraged buyout (LBO) activity in second-quarter 2012 is already on the upswing thanks to private-equity firm Thomas H. Lee Partners' definitive agreement to acquire a majority stake in specialty retailer Party City Holdings Inc. for $3.67 billion, which included assumed liabilities, on June 5, 2012 (see table 9). The transaction ranks as the ninth largest U.S. private-equity M&A deal since fourth-quarter 2008 and the second largest LBO among consumer discretionary deals over the same period. U.S. LBO activity for second-quarter 2012 to date stands at $13.8 billion, compared with $11.8 billion for the full first quarter of 2012, according to S&P Capital IQ. Given the abundance of unspent capital among many financial sponsors, these recent developments may suggest deal making could be on the upturn.

Table 9

Announced U.S. LBOs

	Dollar volume (bil. $)	**Deals (count)**
4Q2008	4.3	255
1Q2009	4.9	219
2Q2009	2.4	229
3Q2009	7.4	221

Table 9

Announced U.S. LBOs (cont.)		
4Q2009	14.2	253
1Q2010	9.4	289
2Q2010	23.8	284
3Q2010	25.6	261
4Q2010	35.3	294
1Q2011	13.6	280
2Q2011	20.3	255
3Q2011	19.2	256
4Q2011	18.7	239
1Q2012	11.8	254
2Q2012*	13.8	195

*As of June 5, 2012. Source: S&P Capital IQ.

Fixed Income

The pace of CUSIP orders in several debt asset classes accelerated last month, based on data released by CUSIP Global Services. Domestic corporate debt CUSIP requests last month reached 1,099, the best monthly showing of the year and the first month since last September in which investors sought more than 1,000 identifiers for forthcoming domestic corporate debt issues (see table 10). Municipal CUSIP requests totaled 1,729 in May, up 6% from 1,626 in April. The recent results marked the fourth consecutive monthly gain for municipal CUSIP orders and the best showing since October 2010, when 1,747 identifier requests were handled. Municipal CUSIP requests exceeded 7,200 for the first five months of 2012, compared with 4,641 during the comparable year-ago period. Identifiers for international debt securities rose last month to 172 from 137 in April. That was the year's second highest monthly tally for CUSIPs for that asset class as well as the second highest monthly volume since March 2011.

Table 10

Selected Securities CUSIP Requests For 2012

	January	February	March	April	May	Total
Domestic corporate debt	635	736	990	898	1,099	4,358
Municipals	938	1,332	1,617	1,626	1,729	7,242
International debt	99	117	181	137	172	706
PPN domestic debt	167	93	236	212	201	909

Source: CUSIP Global Services.

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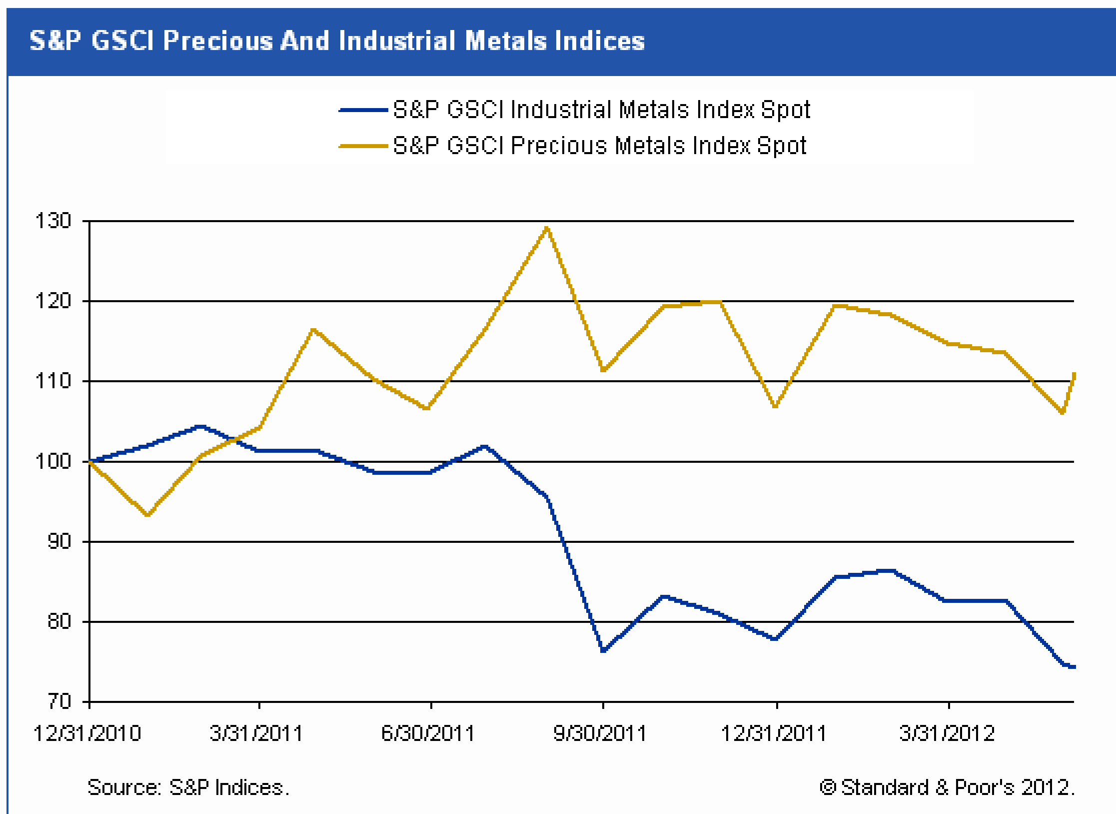
S&P Index Commodity Commentary: Precious Metals Limit Losses

The S&P GSCI Index began the new month under continued pressure, with a month-to-date decline of 0.53% as of June 6. Global economic slowdown risks and accelerating European recession fears continued to weigh on commodities, as measured by the second-quarter decline of 13.88% in the S&P GSCI Index, negating gains from earlier in the year and resulting in a year-to-date decline of 8.81%. The reversal in energy prices has been the biggest drag on S&P GSCI Index returns, as measured by the year-to-date decline of 10.58% in the S&P GSCI Energy Index. Reflecting flight-to-quality fears and the anticipation of additional global monetary stimulus, the S&P GSCI Precious Metals Index represented the only major sector to post a year-to-date gain as of June 6.

Industrial Metals Underperform Precious Metals

The S&P GSCI Precious Metals Index ended June 6 with a year-to-date gain of 4.02% and a 12-month increase of 0.72%, bested only by the 5.05% increase in the S&P GSCI Livestock Index. In the past 12-months, the industrial metals sector performed the worst among major sectors, as measured by the 23.94% decline in the S&P GSCI Industrial Metals Index on the back of a 4.28% year-to-date decline. Often considered a relevant gauge of global economic activity, many analysts view the decline in industrial metals prices as quite worrisome. The S&P GSCI Industrial Metals Index has declined since July 2011 (see chart 14). Continued declines in energy prices should have a positive effect on global GDP, but many analysts are looking to the industrial metals sector for signs of a revival in global economic demand.

Chart 14



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