

Ben Bernanke May Have To Exchange "Opportunistic Disinflation" For Forced Reflation

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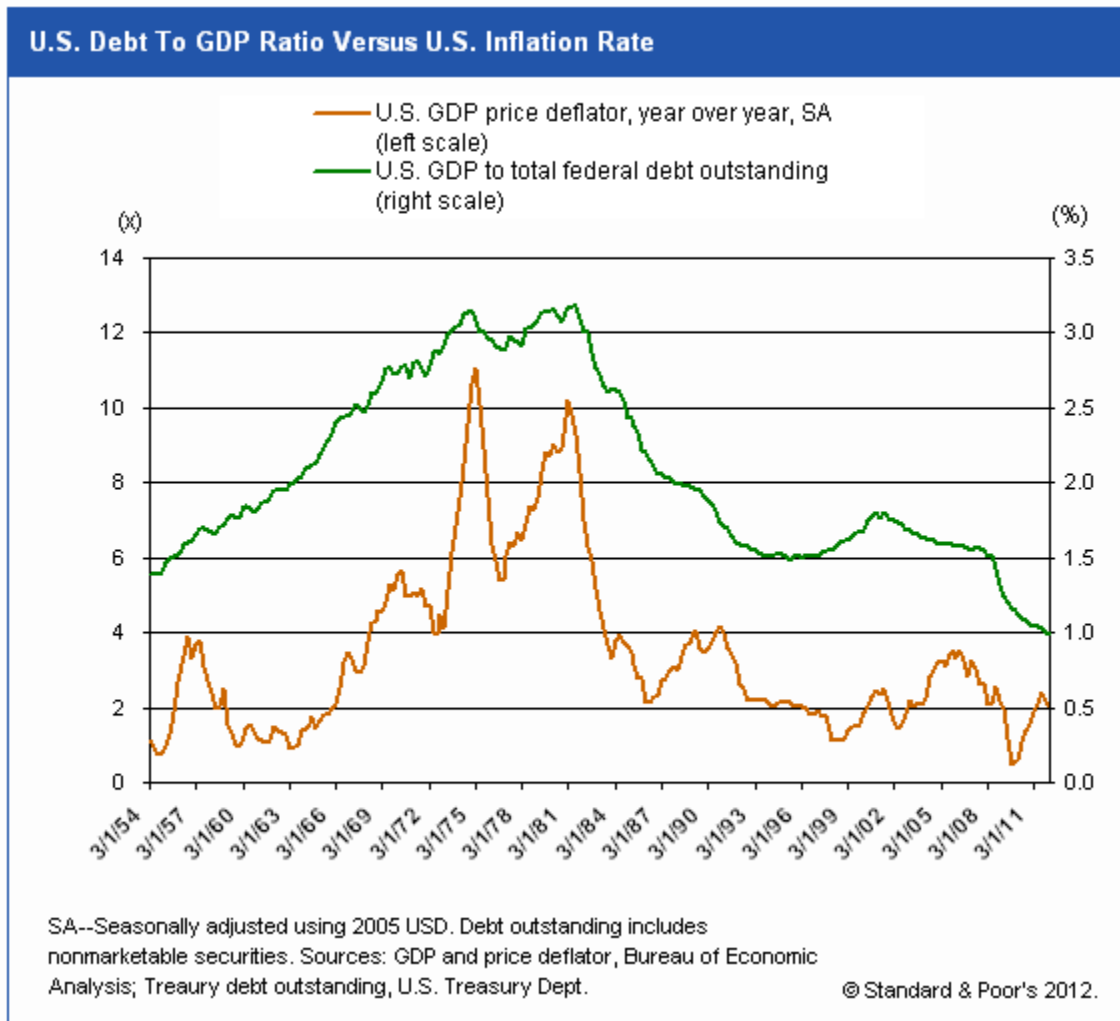
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The Lookout Report is a compendium of current data and perspectives from across S&P Capital IQ and S&P Indices covering corporate earnings, market and credit risks, capital markets activity, index investing, and proprietary data and analytics. Published 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.

Federal Reserve Chairman Ben Bernanke had a clear, direct message for Congress. In his prepared testimony to the Senate Tuesday, he said, "The most effective way that Congress could help support the economy right now would be to work to address the nation's fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery. Doing so earlier rather than later would help reduce uncertainty and boost household and business confidence." But considering that 2012 is an election year, the Global Markets Intelligence (GMI) research team is not particularly optimistic that Congress will soon be following Mr. Bernanke's advice.

Beyond the obvious near-term relevance and wisdom of Mr. Bernanke's recommendation, we were also struck by the potential longer-term implications and significance of his plea to Congress to get their fiscal house in order. Over the course of the past 30 years, while the federal government accumulated ever increasing amounts of debt on its sovereign balance sheet, the Federal Reserve, either officially or unofficially, has pursued "opportunistic disinflation." The doctrine is loosely defined as the reliance by U.S. central bankers on recession and assorted other supply shocks as opportunities for systematically ratcheting inflation rates lower. The byproduct of these two seemingly separate occurrences is that the U.S. GDP-to-debt ratio has steadily deteriorated to 1x today from 3.2x in 1981, while the U.S. inflation rate has declined to low-single-digits currently from the double-digits of the early 1980s (see chart 1). The notion of "opportunistic disinflation" has been around since the early 1980s, and many Fed watchers believe it's at the core of the steady 30-year improvement in U.S. inflation. With the U.S. GDP price deflator having dipped well below 1% in 2009 following the financial crisis and recession, it appears to us as though the Fed's path of opportunistic disinflation has come to an end.

Chart 1



In fact, over the past half-century, the U.S. inflation rate appears closely linked to the underlying directional trend in U.S. fiscal performance, or some might say, fiscal responsibility. For example, in the period between 1954 and the late 1970s/early 1980s, the U.S. inflation rate rose to more than 10% from 1.25% while the U.S. GDP-to-debt ratio improved to 3.2x from 1.4x. Both of these trends then simultaneously reversed course over the three decades that followed, leading to where we stand today.

Perhaps for the first time in the 236-year history of the United States, government policymakers must find a way to implement a responsible pro-growth economic policy when additional conventional monetary and fiscal policy isn't an option. U.S. short-term interest rates simply can't go much lower, and any further deterioration in U.S. economic and sovereign fiscal conditions risks additional negative credit ratings agency decisions against the U.S. This combined set of circumstances would then place tremendous pressure on the Federal Reserve to resort to even larger doses of unconventional monetary policy.

The GMI research team does not have a solution for finding a way out of this conundrum, and to be honest, we're not convinced anyone currently does. Policymakers for the past three years have attempted to jump-start modest but sustainable U.S. GDP growth in order to at least partially grow our way out of our fiscal challenges, but recent economic

data suggests that this strategy may not be working out as intended. The lack of a meaningful recovery in the U.S. housing market has certainly hampered this effort, despite the Fed's continued efforts, including "operation twist," to prop up housing. Perhaps Congress now needs to change bank regulations to resurrect the private-label mortgage securitization market from its postcrisis ashes.

GMI Research, however, does recognize that global investors and central bankers (who hold massive amounts of Treasury securities) aren't likely to regard the path of the U.S. economy between 1954 and 1980, when inflation rose to double-digit rates as the U.S. fiscal position improved, as an acceptable solution to this problem. This conclusion may be at the core of why Chairman Bernanke, in no uncertain terms, recommended that Congress establish a bipartisan policy that addresses "the nation's fiscal challenges in a way that takes into account both the need for long-run sustainability and the fragility of the recovery." Exchanging the doctrine of "opportunistic disinflation" for one of forced reflation would be most distasteful for any credible central banker, and especially the Federal Reserve. Under current circumstances, where Congress is either unable or unwilling to address relatively simpler short-term challenges such as the "fiscal cliff," we think the long-term solution seems a long way off.

Inside This Issue

Macroeconomic overview

Over the course of the past 30 years, while the federal government accumulated ever increasing amounts of debt on its sovereign balance sheet, the Federal Reserve, either officially or unofficially, has pursued "opportunistic disinflation." The byproduct of these two seemingly separate occurrences is that the U.S. GDP-to-debt ratio has steadily deteriorated since the early 1980s while the U.S. inflation rate has declined. With the U.S. GDP price deflator having dipped well below 1% in 2009 following the financial crisis and recession, and considering multiple rounds of unconventional quantitative easing, it appears to us as though the Fed's path of opportunistic disinflation has come to an end. The question now remains, what comes next?

Economic And Market Outlook: North American And European Earnings

Of the 119 companies that have reported earnings thus far, 68% have beat estimates, higher than the historical norm of 62%. While this may seem positive, it's important to note that only 42% of companies are beating revenue estimates, causing investors to question the health of U.S. corporations. In Europe, growth estimates are now down in the low single digits, particularly alarming given the easy year-over-year comparisons.

Germany's Softening Economy Spells Further Trouble For The Eurozone

Dimming expansionary prospects for Europe's largest and most competitive economy don't bode well for the other 16 members of the European Monetary Union (EMU)--not to mention its own equity market, the DAX. German industry derives much, if not most, of its revenues from foreign sources. Having diversified their exposure abroad, captured increasing market share overseas, and made significant inroads into emerging markets, these companies now see their earnings outlook shrinking thanks to economic weakness sweeping across not just the advanced, but also the developing world.

S&P Index Commentary: New Pension Legislation Cuts Companies' Obligations Without Spending A Cent

On June 30, President Obama signed the Highway Investment, Job Creation, and Economic Growth Act of 2012 into law. Although highway investment and student loan rate adjustment were the primary focuses of the act, a pension

contribution relief component that was part of the legislation significantly changed forward funding requirements for companies' employee pension plans. This change makes pension analysis, already extremely difficult, even harder.

Leveraged Commentary And Data: After A First-Half Bonanza, The CLO Market Slows

CLO issuance has slowed in July. Two deals printed during the first half of the month for a total of \$826.1 million. July's slowdown isn't just a typical summer swoon, managers say. Rather, rising liability spreads and falling collateral yields have conspired to thin CLO arbitrage and are nicking CLO equity returns.

R2P Corporate Bond Monitor

Industrial production in the U.S. increased in June, with auto and machinery manufacturers reporting gains. Although the sluggish U.S. economy remains a source of concern, output at factories, mines, and utilities rose 0.4% last month. Other figures from the Federal Reserve showed consumer prices were unchanged and homebuilder confidence jumped in July to the highest level in five years. In this context, risk-reward profiles in the corporate fixed-income market--as measured by average Risk-to-Price (R2P) scores--improved in every sector in North America and in most of the sectors in Europe since the beginning of the month.

Credit Market Commentary: IT Spreads Are Headed In The Wrong Direction

The information technology (IT) sector is one of only three sectors that S&P Capital IQ analysts expect to report earnings growth for the second quarter, but IT's beat rate early in the season is one of the lowest of the 10 sectors so far (58.33% as of Wednesday compared with an overall beat rate of 66.2%). Five-year credit default swap spreads for IT companies widened 7.7% over the past month (ended July 17) to an average of 349 basis points. The question now is how much more the risk premiums for IT companies will increase.

Capital Market Commentary: The Number Of Foreign IPOs In The U.S. Has Fallen This Year

Just eight foreign companies have completed IPOs in the U.S. market to date this year, the lowest volume since 2008. We see this as another indication of economic sluggishness abroad. If these trends continue, underwriting fees for capital markets could fall.

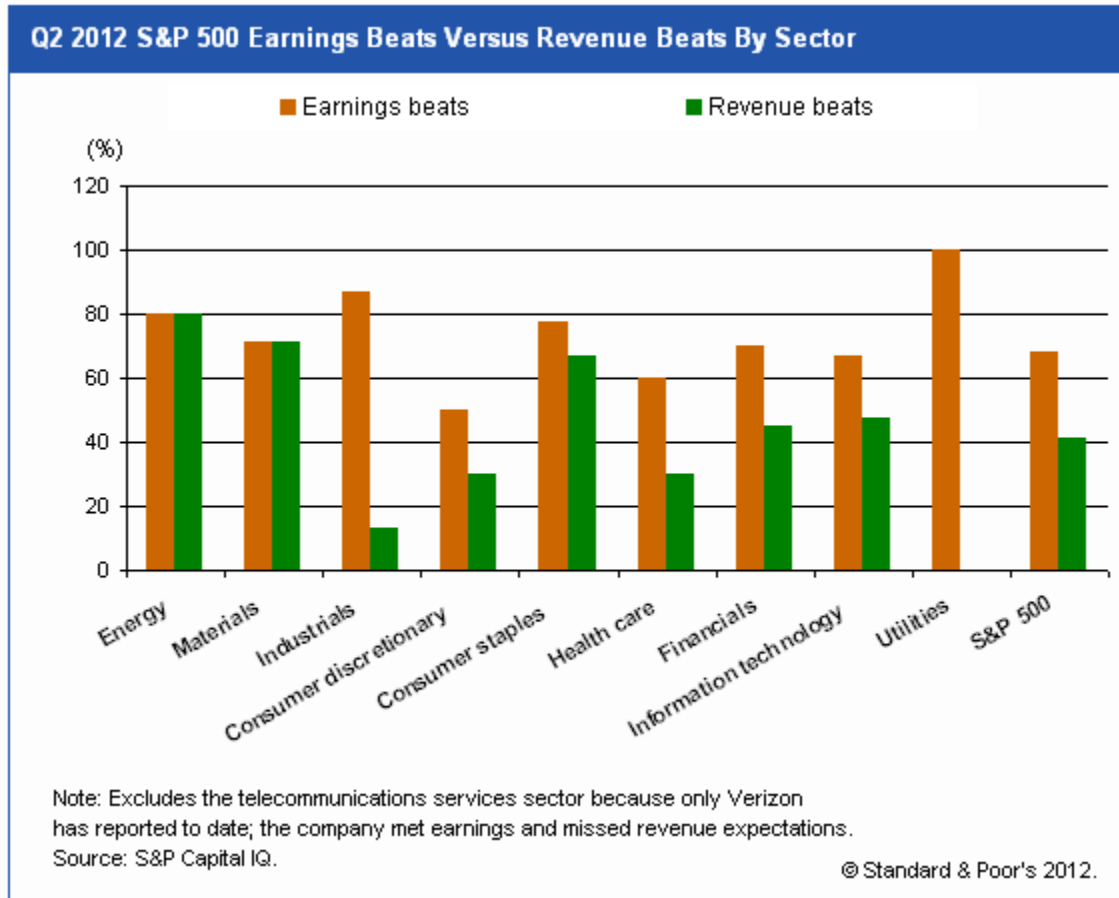
Economic And Market Outlook: North American And European Earnings

North America

Now that the first peak week of earnings season is complete, we have a better understanding of how corporations fared during the second quarter. Currently, S&P Capital IQ is expecting a 0.71% fall year over year for the S&P 500 Index, a bit of an improvement over last week's estimate of a 2% drop but still historically low. The 10-year average for earnings per share growth is 8%. If we end the quarter with negative 0.71% growth, it will be the lowest earnings growth rate for the S&P 500 since the third quarter of 2009.

Of the 119 companies that have reported earnings thus far, 68% have beat estimates, higher than the historical norm of 62%. While this may seem positive, it's important to note that only 42% of companies are beating revenue estimates, causing investors to question the health of U.S. corporations.

Chart 2



We believe a few factors make such a disparity between earnings beats and revenue beats possible:

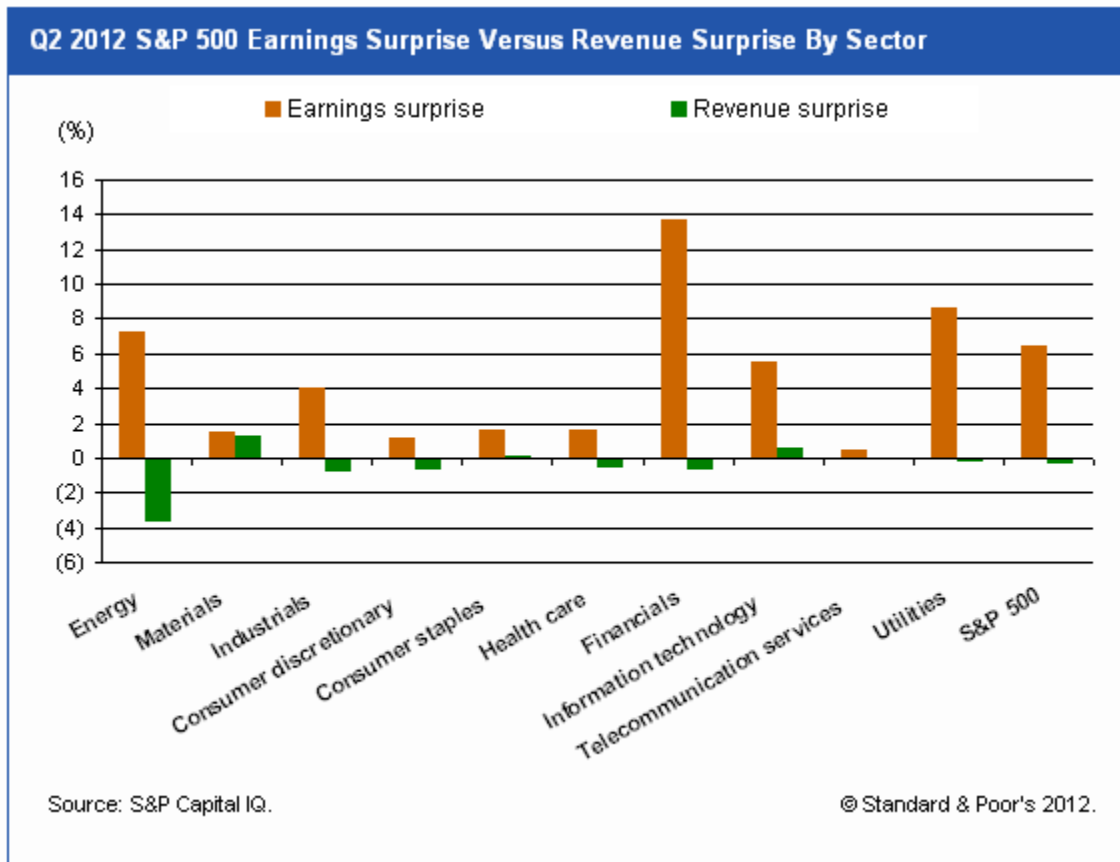
First off, analysts greatly reduced expectations for earnings growth prior to the start of the season; by doing so companies had a lower bar to clear, and inevitably the majority of them are doing just that. This is a trend we've seen over the past several quarters, as analysts tend to lower estimates by about 3% in the weeks ahead of earnings season, often prompted by negative company issued guidance and economic indicators. With the slew of negative economic data that's come out in the past couple of weeks--disappointing manufacturing numbers, stubbornly high unemployment, and retail sales declining for a third consecutive month for the first time since 2008--it's easy to see why estimates were down. However, many believe they were lowered too much.

Secondly, while companies within the S&P 500 are running very lean at this point, it seems they are still finding areas to cut costs. The Goldman Sachs Group, for instance, beat estimates by a whopping \$0.46 per share when they reported results on Tuesday, partially because of a 23% decline in operating expenses from the first half of 2012 versus the first half of 2011. Included in this was a 9% year-over-year drop in compensation and benefits.

Lastly, companies seem to be implementing clever but unsustainable accounting methods. Many companies are reporting large extraordinary costs that they are excluding from non-GAAP calculations. While these methods may be feasible in the current quarter, the only way for companies to expand is through strong top-line results. And while plenty of companies have revised their second-half guidance upward, the majority are doing the opposite, citing dismal growth in Europe and slowing demand in Asia-Pacific as their main concerns.

Not only are more companies beating earnings estimates than are beating revenue estimates, but they are also doing so by a greater percentage. The current earnings surprise ratio stands at a positive 6.4%, higher than the 10-year average of only 3%. On the other hand, companies are actually missing revenue estimates by an average of 0.4%.

Chart 3

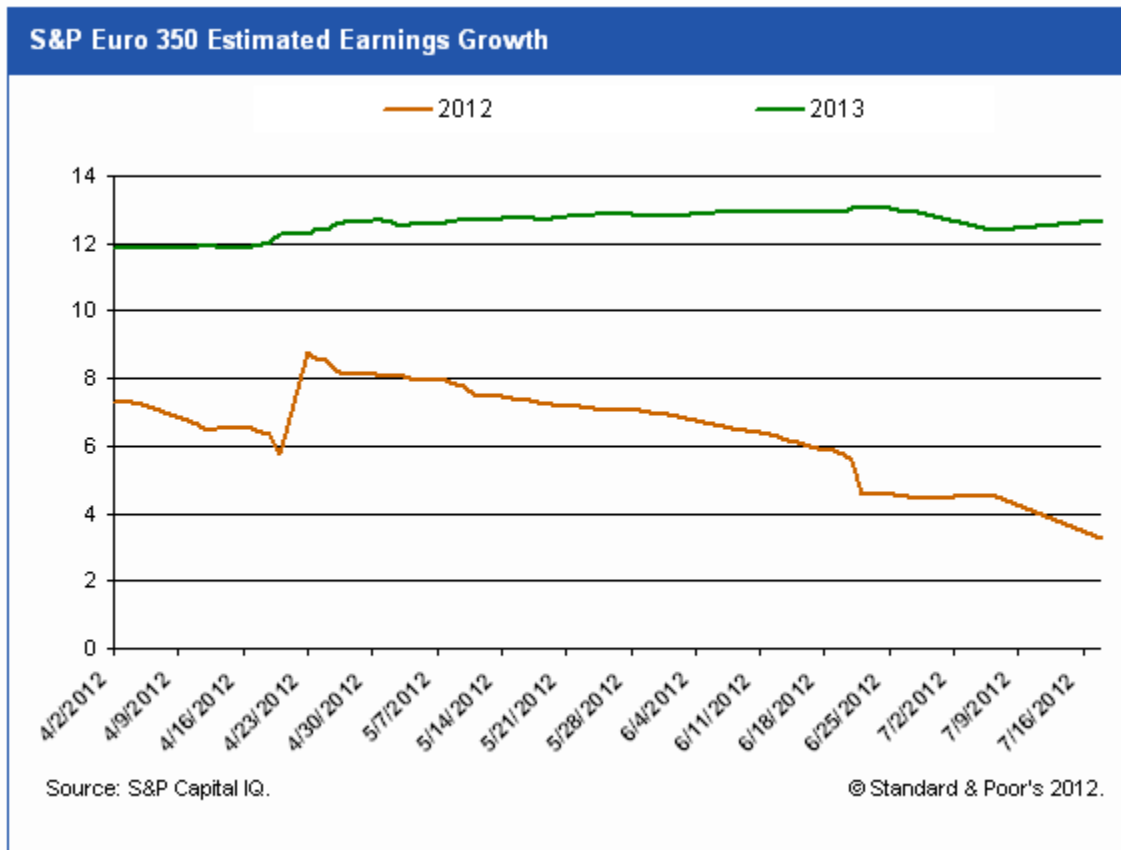


Despite missing revenue expectations, companies are still on target to report respectable revenue growth of 4.1% for the second quarter, compared with the 10-year average of 6%. In fact, seven of the 10 sectors are expecting revenue growth to come in stronger than earnings growth, causing concerns of margin pressure. GMI will be tracking this trend carefully as the remaining 80% of S&P 500 companies release their second-quarter results in the weeks to come.

Europe

While S&P 500 earnings growth figures for calendar year 2012 seem to be slightly rebounding from their lows at the end of last week, the opposite is true about companies on the Euro 350. In the last edition of the Lookout Report (July 5), European corporations were expecting 2012 year-over-year growth to come in at 4.5%. In just two weeks that figure has dropped 1.2 percentage points to 3.3%. Overall, growth expectations for the European index are down roughly 7% since the beginning of the year, when analysts were optimistic for a double-digit finish of 10.1% growth. This is in contrast to expectations for 2013, which remain quite strong at 12.7%.

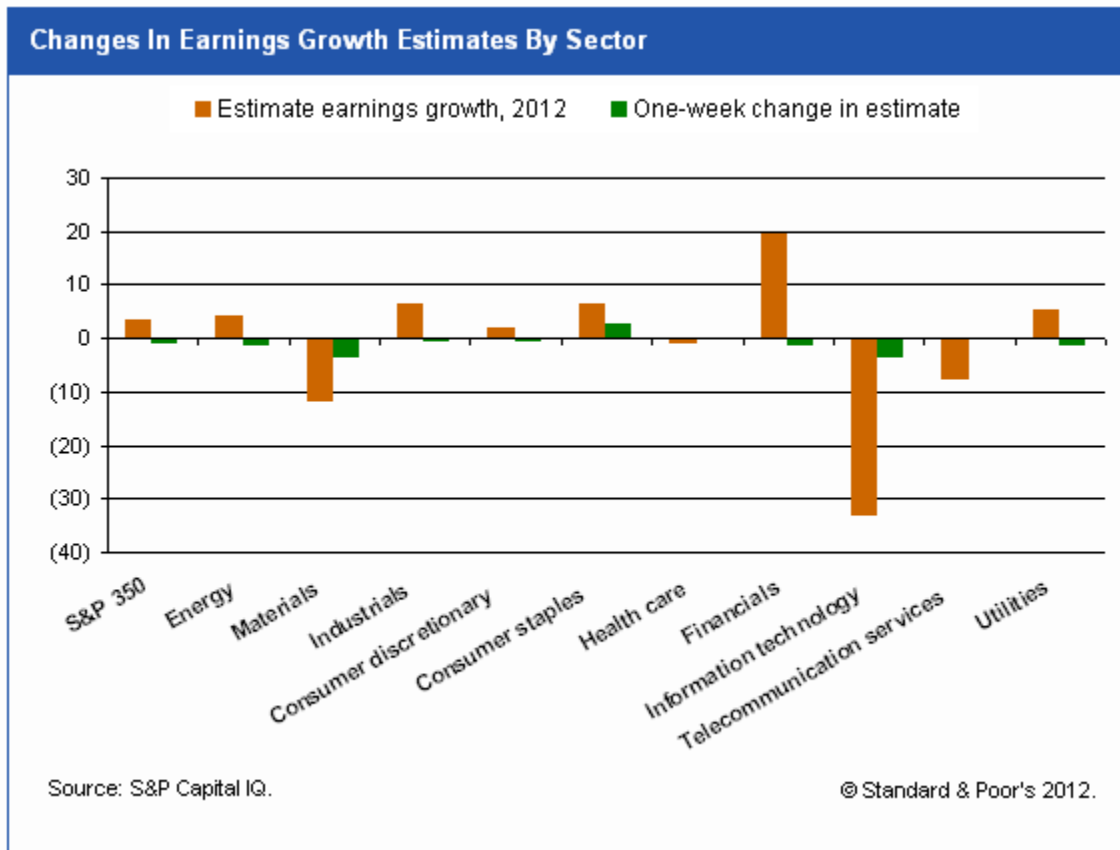
Chart 4



It is particularly alarming that estimates are now down in the low single digits, given the easy year-over-year comparisons. In 2011, the S&P Euro 350 reported a 2% drop in earnings. Given the downward trend in estimates, many investors worry 2012 could mark the second quarter of falling earnings for European corporations.

Analysts polled by S&P Capital IQ expect four of the 10 sectors of the S&P Europe 350 Index to be negative for 2012. The laggards still include the information technology (negative 33.3%), materials (negative 11.8%) sectors, and telecommunication services (negative 7.7%). Not only are information technology and materials expected to post the lowest growth rates for the year, but they are also the sectors that have seen their estimates slashed by the greatest degree over the last week. In just one week, analysts have lowered estimates for IT by 3.87% and materials by 3.79%, suggesting that estimates have not yet hit their bottom. Those expectations could continue to be cut through the balance of the year.

Chart 5



Given the information technology sector's status as the biggest laggard for 2012 growth, investors kept a close eye on Nokia OyJ's second-quarter earnings release on Thursday. Despite issuing two profit warnings earlier in the year, the company beat expectations of negative €0.09 by €0.01. Revenues also came in stronger than expected at €7.5 billion versus estimates of €7.3 billion. Nokia reiterated that the company anticipates headwinds in the second half of the year and warned investors that the third quarter will be challenging for smart devices because of product transitions. In order to meet profit expectations the company plans to continue reducing non-IFRS operating expenses in their devices and services division.

Similar to the U.S., the materials sector of the S&P 350 is expected to be one of the biggest laggards for 2012 growth. Lower prices for commodities have particularly hurt the metals and mining industry. In fact, eight of the 13 companies in that industry are expecting to post profit growth that is lower than the year-ago quarter.

Despite the gloomy reports for 2012, estimates for 2013 remain stable at 12.7%, with all 10 sectors expecting positive growth. Furthermore, analysts expect materials, industrials, consumer discretionary, financials and information technology to turn out double-digit growth.

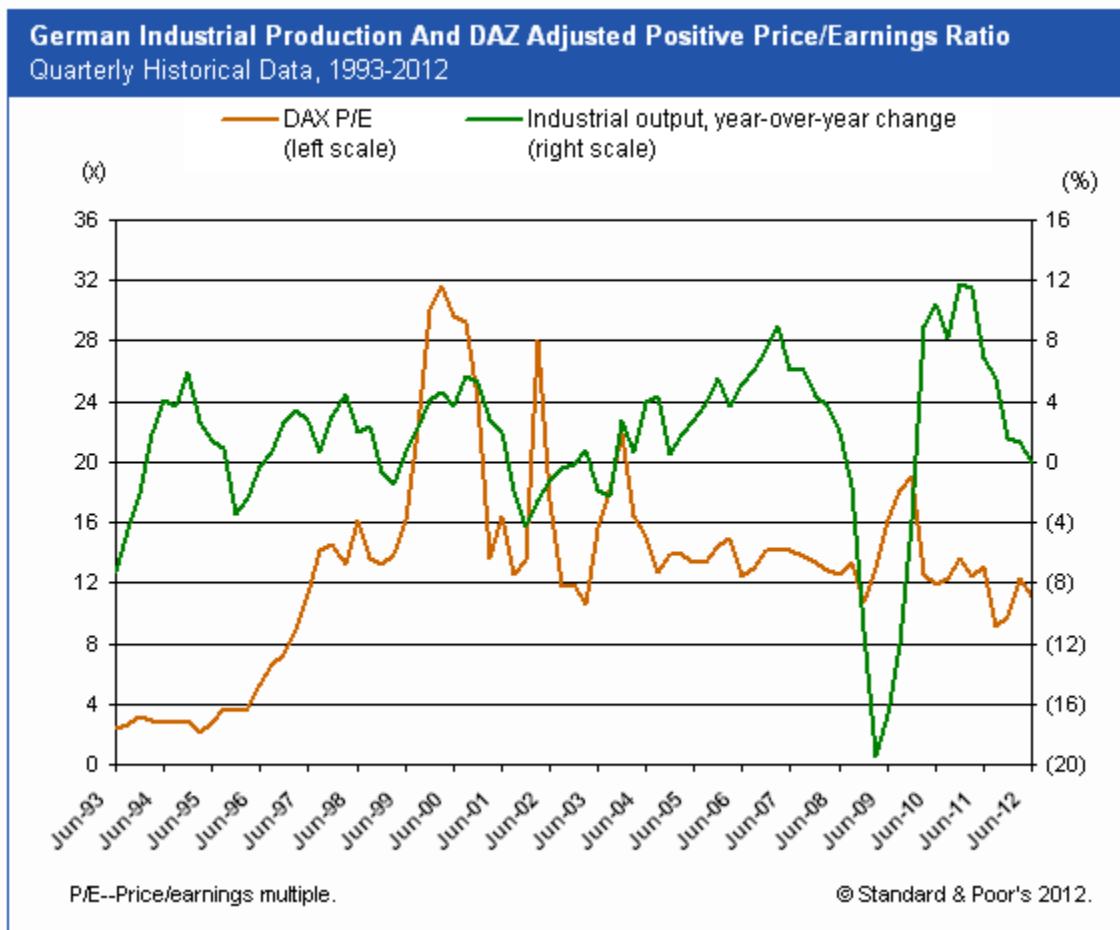
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Germany's Softening Economy Spells Further Trouble For The Eurozone

Dimming expansionary prospects for Europe's largest and most competitive economy don't bode well for the other 16 members of the European Monetary Union (EMU)--not to mention its own equity market, the DAX. German industry derives much, if not most, of its revenues from foreign sources. Having diversified their exposure abroad, captured increasing market share overseas, and made significant inroads into emerging markets, these companies now see their earnings outlook shrinking thanks to economic weakness sweeping across not just the advanced, but also the developing world.

Darkening clouds on the economic horizon worldwide are engendering growing discouragement with the trend of Germany's real GDP and corporate profits this year and next. The pace of economic activity is projected to decelerate in both developed and emerging countries this year to 1.4% and 5.6% percent. Correspondingly, the German economy is projected to lose 2.1 percentage points in momentum, subduing the rate of advance in real GDP to just 1% in 2012.

Chart 6



Key valuation metrics, however, still show the German equity market in a more favorable light than many of its main rivals on either side of the Atlantic Ocean. The 9.18 forward price-earnings multiple of the DAX renders German stocks, overall, rather attractive historically (averaging 13.04x since June 1993) and in relation to some of its foremost competitors in the developed world. Currently, the DAX looks inexpensive versus the S&P 500 (11.87x) and the S&P Global 1200 (10.82x) in addition to the FTSE 100 (9.58x), Swiss Market (11.21x) and Stockholm's OMX (11.24x). At its

present earnings multiple, the DAX may seem high by comparison with its historical low (2.16x), but it remains far lower than its 31.69x 19-year high.

Even so, a slew of data highlight the ongoing moderation in domestic economic activity: export volumes and manufacturing orders (domestic and foreign) are slumping, as are foreign plant and machinery orders; consumer confidence is creeping lower; business and investor sentiment (as measured by IFO and ZEW, respectively) are plumbing new lows; and unemployment is bottoming as household income and domestic demand continue to drop despite the erratically climbing volume of retail sales (excluding the volatile automobile component). Based on current and forecast data patterns, domestic and foreign sources of German macroeconomic weakness argue indisputably for underweighting the German shares market in the present and coming years regardless of anticipated further depreciation in the euro fostered by record low yields on debt securities in reaction to faltering trends in national economic fundamentals.

Although Germany is not expected to slip into recession any time soon, the striking erosion of domestic activity will make it harder for the country's activity to hold off a further contraction in eurozone economic growth. In time, we expect that this will only deepen the gloom already engulfing the EMU. Still, though German equities may have lost their luster amid the persistent turbulence in the eurozone periphery, the nation's sovereign debt (bunds and schatz) should still attract demand from safe-haven seekers as will fixed-income securities issued by its highly rated corporate sector.

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S&P Index Commentary: New Pension Legislation Cuts Companies' Obligations Without Spending A Cent

On June 30, President Obama signed the Highway Investment, Job Creation, and Economic Growth Act of 2012 into law. Although highway investment and student loan rate adjustment were the primary focuses of the act, a pension contribution relief component that was part of the legislation significantly changed forward funding requirements for companies' employee pension plans.

The bill changes the discount interest rate used for determining discounted pension liabilities from the current two-year average to a 25-year average, which translates into an estimated increase of 130 basis points (bps) in pension fund rates. So, the higher the interest, the lower the current value and the lower the funding requirements.

To illustrate, the U.S. 10-year Treasury note's two-year average is 2.56%; its 25-year average is 5.59%. Using the 25-year average figured into a \$100 annual payment over the next 10 years, the present value of the 10 payments (\$1,000) would lower the funding requirement by 12.3% to \$764. Throughout the lifetimes of the 16.2 million S&P 500 employees covered by pension plans, using the longer-term discount rate would cut billions from funding requirements.

The change only affects funding, not change the GAAP treatment of balance sheet items. Any funds that companies don't contribute directly to pension obligations will boost already high levels of cash and equivalents on their balance sheets (interest income would, as expected, remain low for the funds).

Lower pension contribution payments translate into lower income tax deductions, leading to higher earnings. Higher income would also create a larger tax liability, meaning more income for government entities—an extra \$17 billion, according to the U.S. Joint Committee on Taxation (\$18 billion with PBGC increased premiums). Under the current process, S&P 500 companies have a 7.6% assumed pension rate of return for their pension funds. This means that if a company contributes \$100 million less, it will not be able to sweep \$7.6 million in expected income into pretax earnings.

This change makes pension analysis, already extremely difficult, even harder. The Society of Actuaries has issued a

statement saying that currently 62% of companies are funded at least 80%, and under the new formula the 62% will rise to 91%. At this point, we believe that GAAP accounting and presentation, while far short of satisfactory, is much more representative of the current state of affairs.

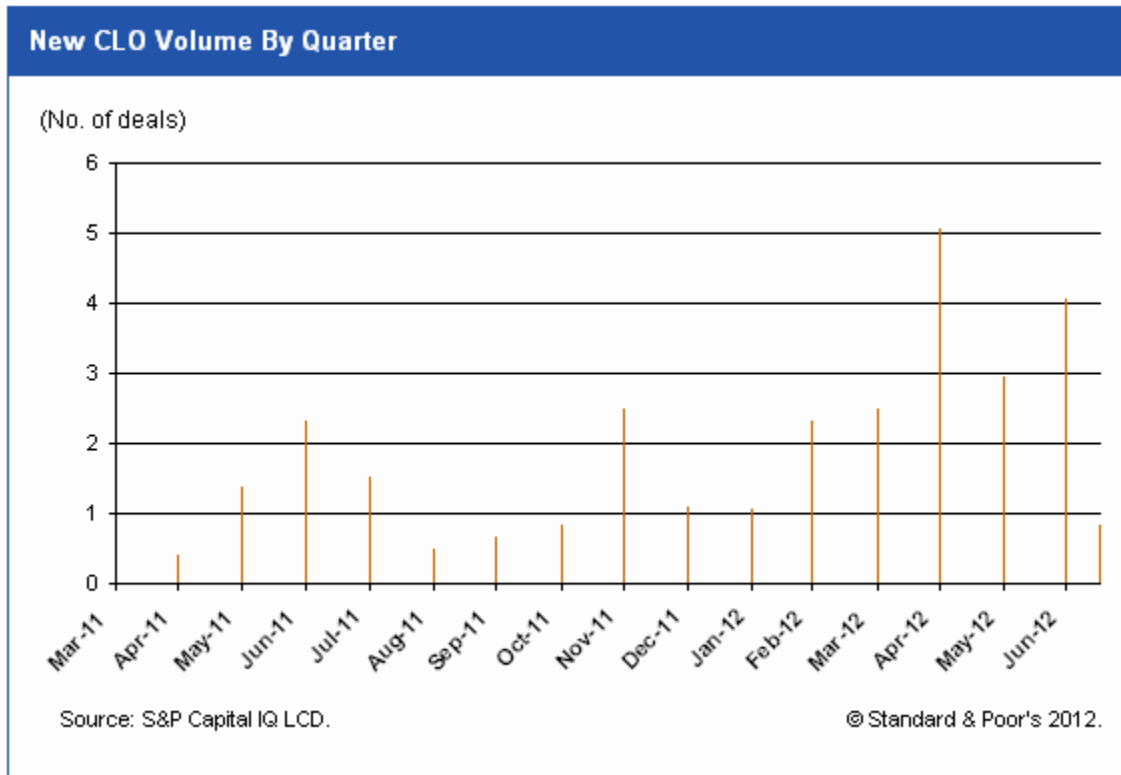
The change also has implications for the upcoming political discussion on earnings repatriation. It appears that Congress was willing to permit future payments to obtain tax receipts now, even though the expected net return would turn negative after five years since Congress will have to weigh the current need for cash against future decreases. Therefore, after the election, when taxes become a major issue (tied to the deficit and debt ceiling), repatriation of foreign earnings--and cash--may have a better chance of passing, as members wrestle with the goal of trying to give companies a tax break (similar to the American Jobs Creation Act of 2004) versus increasing current taxes and/or reducing current programs. S&P Dow Jones Indices will continue to monitor the situation, and issue updates as needed.

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Leveraged Commentary And Data: After A First-Half Bonanza, The CLO Market Slows

CLO issuance has slowed in July. Two deals printed during the first half of the month for a total of \$826.1 million: Blackstone GSO's \$513.6 million Gramercy Park CLO and Jefferies Finance's \$312.5 million JFIN CLO 2012. That compares with a \$4-billion-a month pace during the second quarter, when issuance spiked to a four-year high of \$12.1 billion.

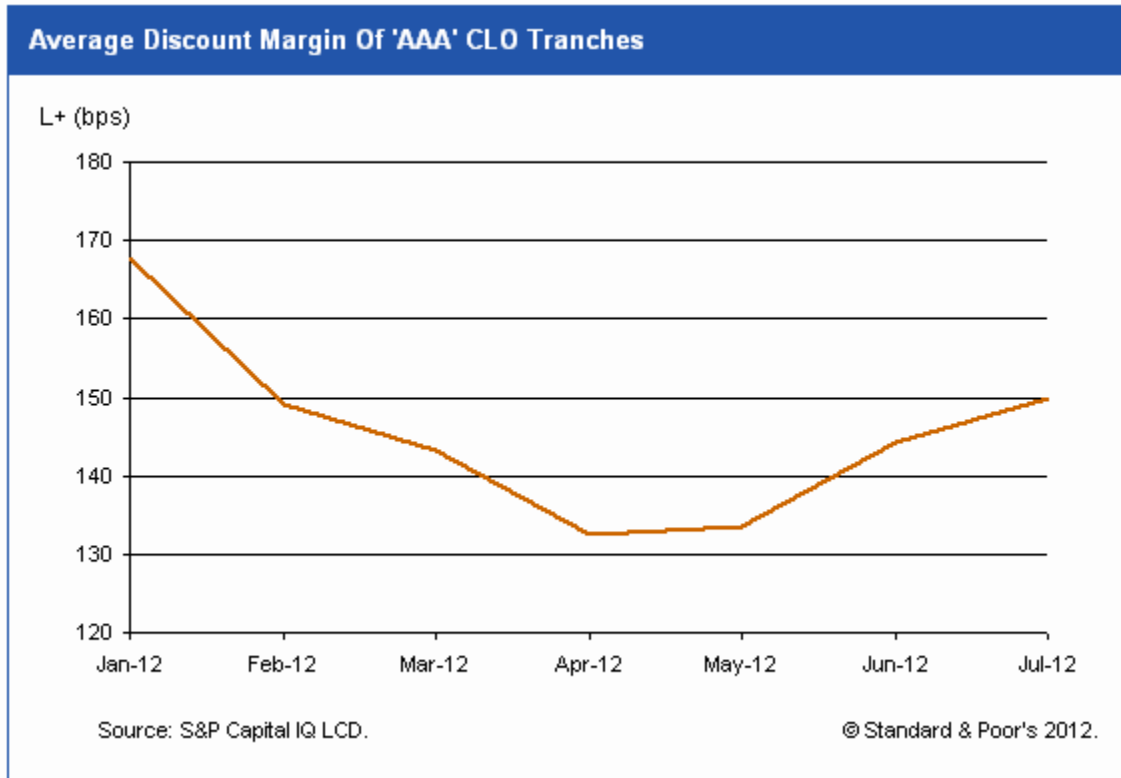
Chart 7



July's slowdown isn't just a typical summer swoon, managers say. Rather, rising liability spreads and falling collateral yields have conspired to thin CLO arbitrage and are nicking CLO equity returns.

Start with liabilities: The Gramercy Park CLO on July 12 shows that the conversation on 'AAA' discount margins now starts at L+150, up from clearing levels of L+130-135 in the spring when the market was running hot.

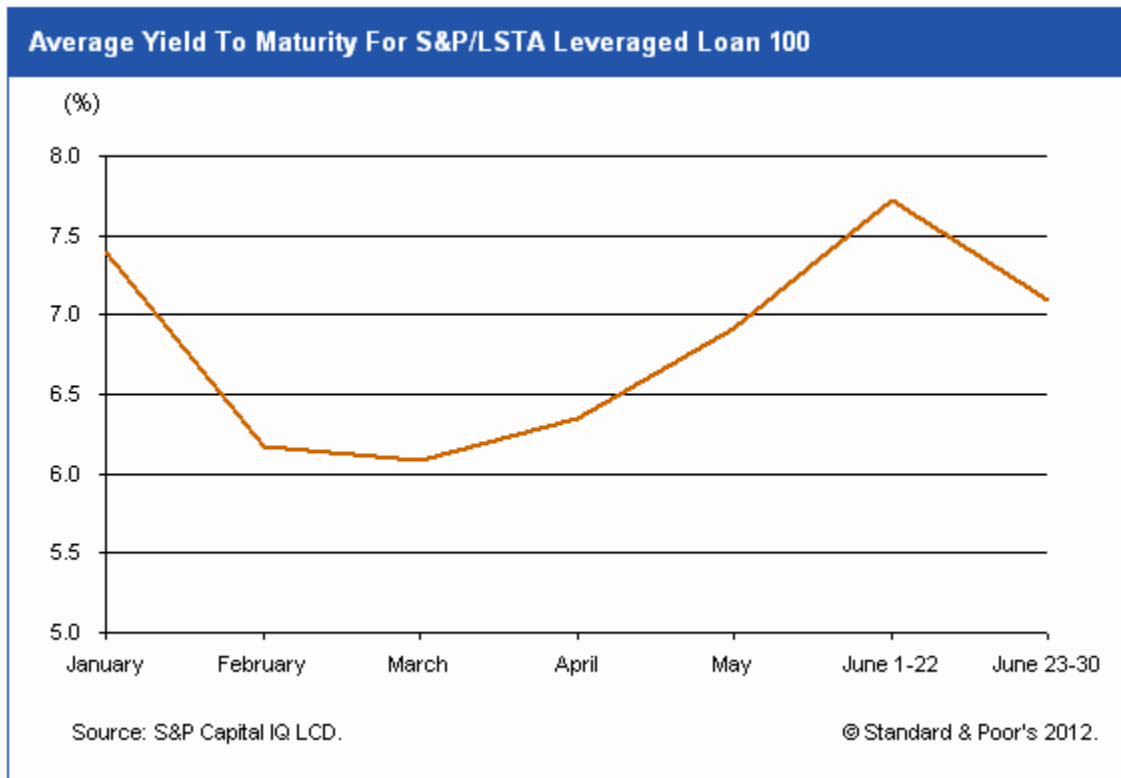
Chart 8



'AAA' spreads have trended higher for a few reasons. For one, managers say the ranks of 'AAA' buyers have thinned to just a handful in recent months in response to Europe's difficulties, a series of worse-than-expected economic reports, and the fallout from the various banking scandals. For another, managers say that some buyers have had their fill, at least for now, after the relative CLO bonanza of the first half, when \$18 billion of new deals cleared, including roughly \$11 billion of 'AAA' notes.

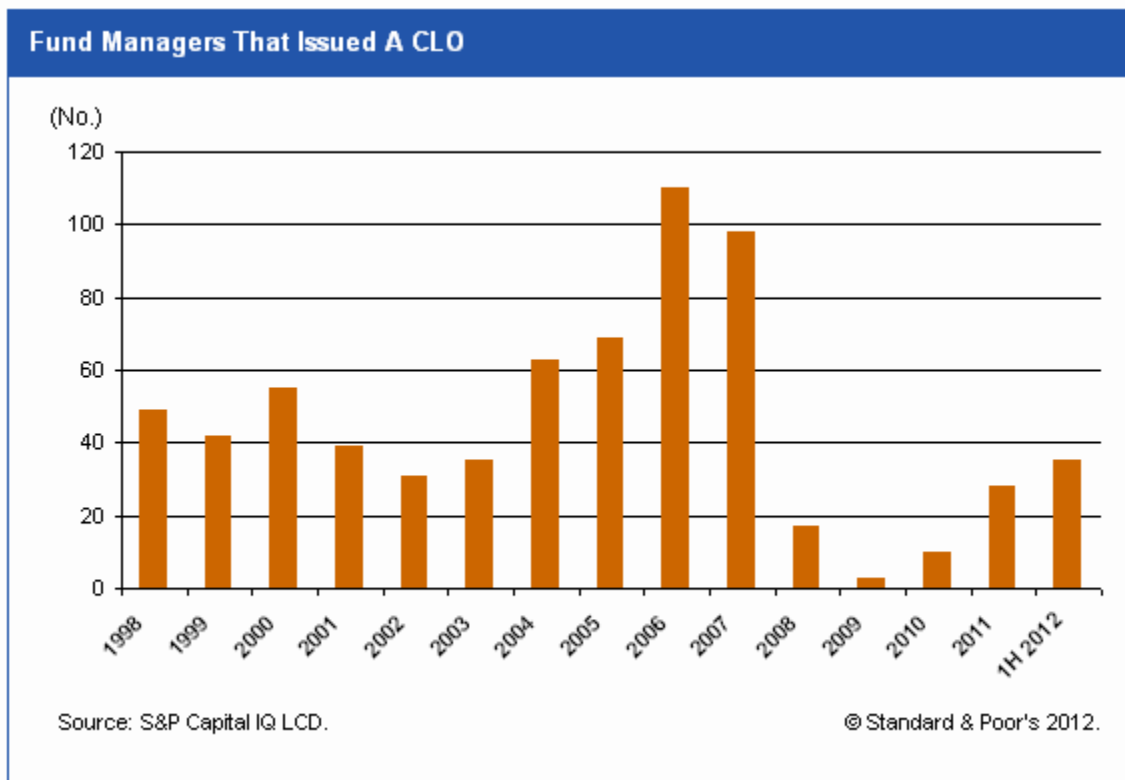
On the other side of the ledger, the loan market's recent rally has pushed down collateral spreads. The average yield to maturity of the S&P/LSTA Loan 100, for instance, fell to 5.82% on July 12, from a second-quarter peak reading of 6.31% on June 5.

Chart 9



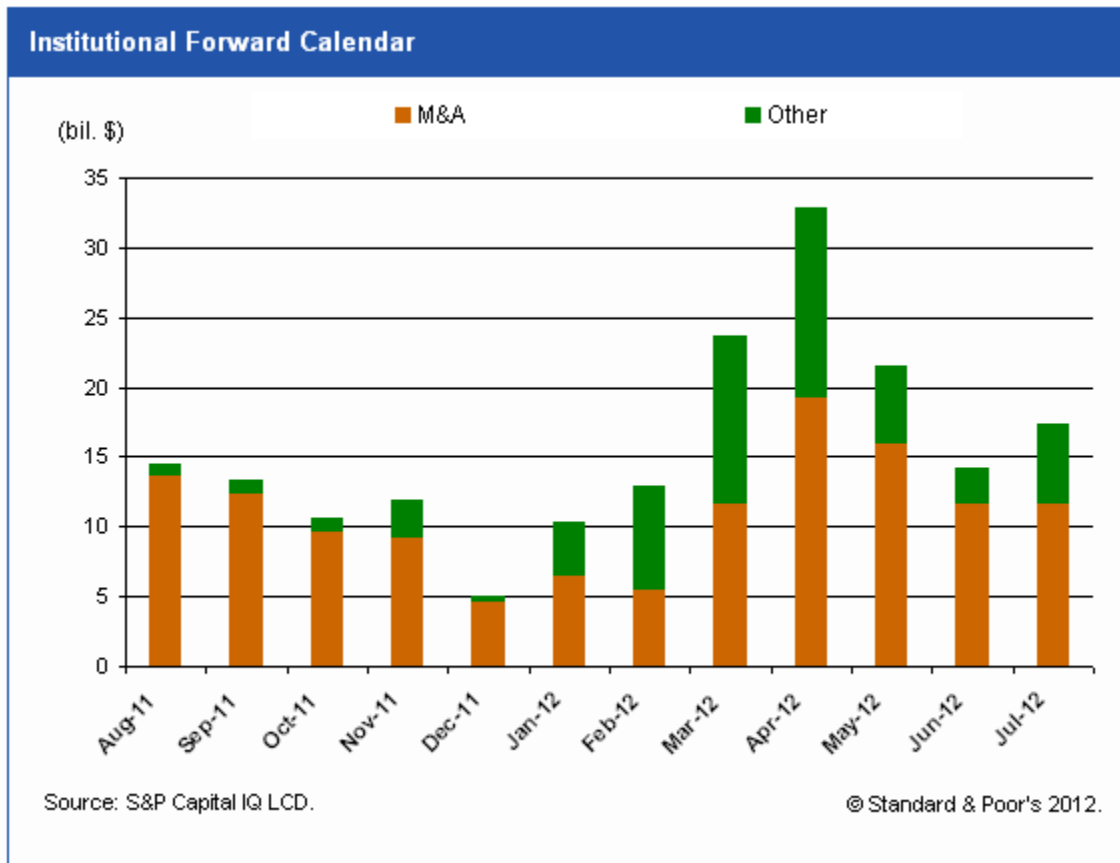
Given these trends, managers estimate that model internal rates of return for CLO equity have retreated to 12%-14%, from 15%-17% earlier in the year. Understandably, then, participants say raising equity dollars--particularly in the open market--has become more difficult. As a result, the number of managers able to ink a new CLO may contract after expanding early in the year beyond the large platforms and private-equity affiliates that dominated issuance in 2011.

Chart 10



The challenge, managers say, goes beyond thinning arbitrage. At a more basic level, sourcing paper in today's market is difficult because seasoned paper is largely tucked away--and sometimes selling at prices higher than axe-sheet levels--and the new-issue calendar remains lackluster. This is a particular difficulty for smaller managers that don't have the capacity to pre-assemble portfolios before raising a CLO, managers say.

Chart 11



With all of this in mind, managers expect a trickle of new issuance during the summer months. The calendar remains chock-full of deals, but the number that appear imminent has faded. Further out, participants remain hopeful that the CLO market will click back into gear after Labor Day if 'AAA' liability spreads narrow and, as most participants expect, new-issue loan volume picks up.

Well Fargo CDO strategist David Preston, for one, predicted in a July 12 report that 'AAA' spreads will narrow to L+130 by year-end. Based on that, Preston affirmed his forecast that CLO issuance will total \$8 billion-\$12 billion over the balance of 2012, bringing volume to \$25-30 billion. Likewise, JP Morgan CDO analyst Rishad Ahluwalia is keeping his \$30 billion 2012 estimate in place.

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R2P Corporate Bond Monitor

Industrial production in the U.S. increased in June, with auto and machinery manufacturers reporting gains. Although the sluggish U.S. economy remains a source of concern--Federal Reserve Chairman Ben Bernanke told Congress on Tuesday that economic activity appears to have decelerated somewhat during the first half of this year--output at factories, mines, and utilities rose 0.4% last month. The gain followed a 0.2% drop in May, larger than previously reported, according to data the Federal Reserve issued on Tuesday.

Bernanke also predicted that any reduction in the U.S. unemployment rate--which remains above 8%--would be

"frustratingly slow." The debt crisis in the eurozone threatens to drag on with policymakers "muddling through," he added.

But other figures from the Federal Reserve showed consumer prices were unchanged and homebuilder confidence jumped in July to the highest level in five years, indicating further improvement in residential real estate. The National Association of Home Builders/Wells Fargo sentiment index rose six points to 35 this month (readings less than 50 mean more respondents said conditions were poor). The gauge exceeded the most-optimistic projection in a Bloomberg survey of 46 economists.

In this context, risk-reward profiles in the corporate fixed-income market--as measured by average Risk-to-Price (R2P) scores--improved in every sector in North America and in most of the sectors in Europe since the beginning of the month (July 2-17; see tables 1 and 2).

In North America, scores increased by 20% as a result of a 9% decrease in the average 20-day historical bond price volatility and a two-basis-point (bp) widening in the average option-adjusted price (OAS). These improvements offset the 78% increase in the average probability of default (PD).

In Europe, scores increased in all but the consumer staples, energy, and consumer discretionary sectors. As a result, scores increased overall by 4%. An 11% decrease in the average bond price volatility offset the increase in the average PD of 4%, and the 5-bp tightening in the average OAS.

Table 1

North American Risk-Reward Profiles By Sector

Average R2P Score And Component Changes				
	R2P scores (%)	OAS (bps)	PD (%)	Bond price volatility (%)
Consumer discretionary	28	8	33	(11)
Consumer staples	5	33	152	5
Energy	28	(1)	0	(13)
Financials	9	(12)	3	(13)
Health care	23	6	(40)	(7)
Industrials	20	4	36	(10)
Information technology	8	(1)	640	(10)
Materials	24	3	26	(10)
Telecommunication services	34	(10)	(36)	(12)
Utilities	22	(6)	(32)	(13)

Change from July 2 to July 17, 2012.

Table 2

European Risk-Reward Profiles By Sector

Average R2P Score And Component Changes				
	R2P scores (%)	OAS (bps)	PD (%)	Bond price volatility (%)
Consumer discretionary	(1)	7	(12)	20
Consumer staples	(5)	(9)	12	(9)
Energy	(3)	(10)	(4)	10
Financials	5	(10)	18	(15)
Health care	12	(2)	(6)	(16)
Industrials	9	(3)	17	(23)

Table 2

European Risk-Reward Profiles By Sector (cont.)				
Information technology	1	17	(4)	(19)
Materials	14	(4)	7	(19)
Telecommunication services	4	(20)	(19)	(15)
Utilities	1	(11)	27	(26)

Change from July 2 to July 17, 2012.

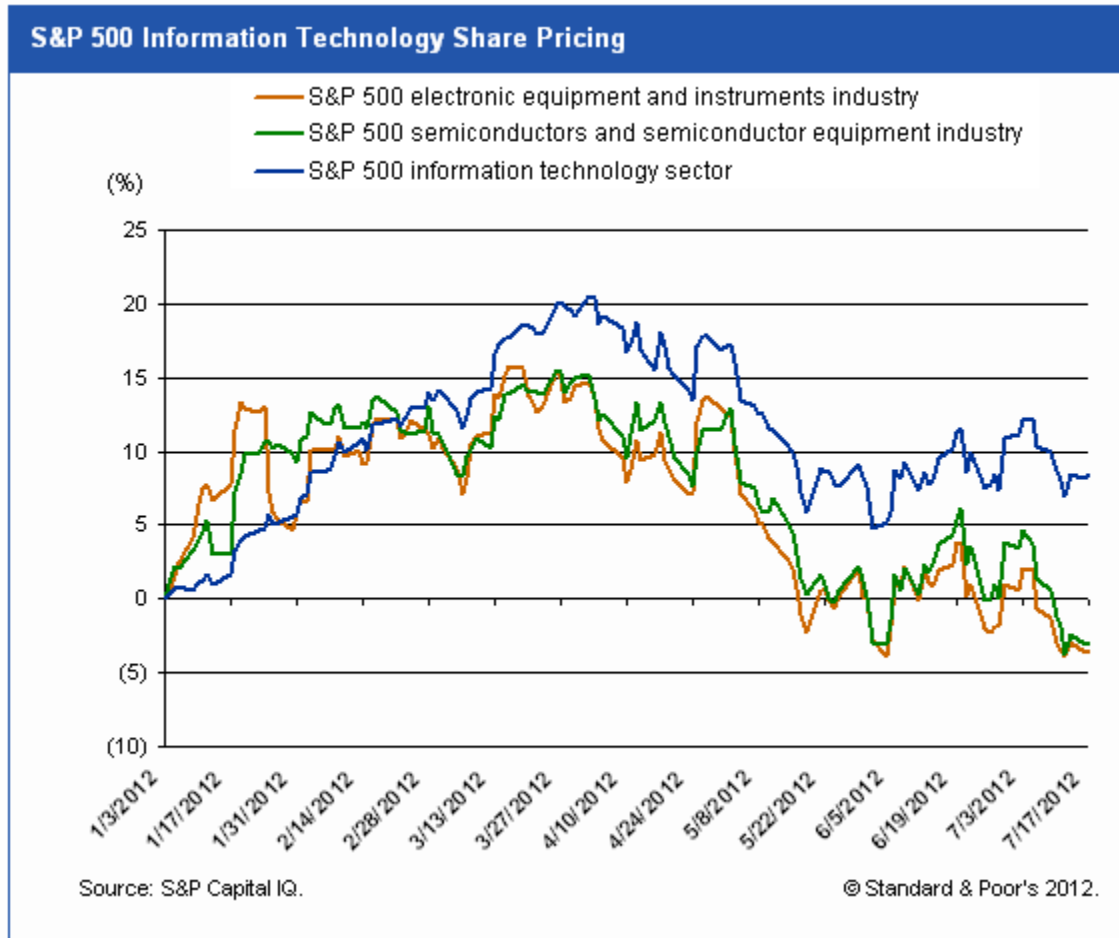
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Within IT, electronic equipment and instruments (-21.6%) and semiconductors and semiconductor equipment (-16.6%) are the subsectors expected to report the lowest second-quarter growth, according to data aggregated by S&P Capital IQ.

Chart 12



These negative growth figures may prove conservative. Ahead of its earnings report on Aug. 15, Applied Materials Inc. said an extreme decline in demand from chipmakers both at home and abroad would detract from second-quarter results by as much as \$0.20 per share. Intel Corp., which beat the consensus estimate by \$0.02 per share, warned that its third-quarter growth would be slower than expected because of weak consumer demand. Lexmark International Inc. slashed its second-quarter earnings estimate to a range of \$0.87 to \$0.89 per share from \$0.95 to \$1.05 on weak demand, particularly in Europe.

The Global Markets Intelligence (GMI) research team found that five-year credit default swap (CDS) spreads for IT companies widened 7.7% over the past month (ended July 17) to an average of 349 basis points (bps), according to CMA DataVision, a S&P Capital IQ business. At 349 bps, the average spread for the tech sector is 7 bps wide of Standard & Poor's IT credit rating benchmark of 'BBB-'. A year ago, the average spread was 171 bps, in between the 'A-' benchmark and the 'BBB+' benchmark.

The question now is how much more the risk premiums for IT companies will increase. Pre-announcements and actual results support a continuation of the negative trend. We think it unlikely that warnings and earnings misses will be confined to these few companies, so, along with broader concerns about the health of the U.S. economy and the eurozone debt crisis, investors will remain on high alert. So will the GMI research team, and we will revisit the sector's CDS spreads after the conclusion of the earnings reporting season.

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Capital Market Commentary: The Number Of Foreign IPOs In The U.S. Has Fallen This Year

IPOs

To what degree has the recent sluggishness in the U.S. IPO market affected foreign companies seeking to price offerings in the United States? Through the use of S&P Capital IQ data, we extracted the volume totals for non-U.S. companies pricing IPOs on major U.S. exchanges to plot trends and determine their market share among all IPOs priced.

Just eight foreign companies have completed IPOs in the U.S. market to date this year, the lowest volume since 2008 (see table 3). Should current trends continue, the IPO market is on track to see just 15 foreign company offerings this year. That would be the third slowest annual pace, based on the number of issues, of foreign IPOs in the U.S. since 2004. More striking, foreign company IPOs make up just 11% of all IPOs, excluding closed-end funds and real estate investment trusts, priced on U.S. major exchanges. That's less than half the full-year 2011 level of foreign company IPOs in the U.S. and the lowest level in more than a decade. The most recent year with a lower percentage was 1999, when the foreign company IPOs priced in the U.S. represented 7.3% among all IPOs completed on major U.S. exchanges.

We see this as another indication of economic sluggishness abroad. If these trends continue, underwriting fees for capital markets could fall.

Table 3

	Total value (bil. \$)	No. of issues	% of all IPOs priced in the U.S.*
1998	0.73	8	9.6
1999	3.75	9	7.3
2000	14.4	30	24.8
2001	7.18	9	18.0
2002	3.17	5	11.6
2003	4.04	7	17.9
2004	4.81	17	16.5
2005	3.44	20	15.7
2006	8.09	27	19.4
2007	13.29	46	29.1
2008	0.53	6	20.7
2009	9.18	10	23.8
2010	5.74	45	31.5
2011	9.81	29	23.6
2012ytd	0.96	8	11.1

*Excludes closed-end funds and REITs. Ytd--Year to date, through July 12.

Mergers and acquisitions

Given that merger and acquisition (M&A) activity tends to track economic growth, the monthly trends in strategic acquisitions of domestic targets by U.S. buyers and investors provide some evidence of possible softness ahead. Specifically, an examination of data from S&P Capital IQ reveals that the dollar volume of U.S. M&A activity involving strategic acquisitions by domestic acquirers so far in July is trending slightly below June's deal value of \$34.9 billion,

which was the second lowest monthly volume of deals of this type in 2012. Additionally, domestic buyers closed nearly 1,000 U.S. strategic M&A deals each month, on average, over the full past 12 months. However, July's activity to date indicates less than 800 deals likely for the month. To market observers, the drop in strategic deals could be evidence of a lack of business confidence in the U.S.

Table 4

Strategic U.S. M&A With Domestic Buyers		
	Total value (bil. \$)	No. of deals
July 2011	75.2	951
August 2011	82.8	1,077
September 2011	54.8	974
October 2011	74.4	976
November 2011	51.5	970
December 2011	39.1	1,008
January 2012	38.9	1,112
February 2012	43.1	975
March 2012	30.4	965
April 2012	45.1	911
May 2012	50.1	1,058
June 2012	34.9	961
July 2012*	20.3	464

*Through July 19.

Fixed-income

Security identifier requests among various debt types is beginning to diverge. In 2012, domestic corporate debt CUSIP orders increased year over year by a low-single-digit percentage advance while municipal debt identifier requests have increased year over year by nearly 50%. Long-term muni note CUSIP demand has gained this year while short-term muni note identifier requests have dropped, though the latter is running 190% ahead of long-term muni note CUSIPs requests so far this year. Meanwhile, international debt CUSIP requests for the week ending July 13 nearly doubled from the previous week, but volume to date this year is off 15.5% from a year ago.

Table 5

CUSIP Requests						
Security type	Week ending July 13	Week ending July 6	2012ytd	2011ytd	Year-over-year change (%)	
Domestic corporate debt	66	570	5,892	5,657	4.2	
Municipals	338	149	9,529	6,493	46.8	
Long-term muni note	28	22	262	230	13.9	
Short-term muni note	42	32	760	816	(6.9)	
International debt	28	13	859	1,017	(15.5)	
PPN domestic debt	41	36	1,194	1,005	18.8	
Total	543	822	18,496	15,218	21.5	

ytd--Through July 19.

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