

Frank Moon observes the DEBT DOT COM risks.



Getting you there.



The world doesn't seem to be pricing risk appropriately. Investors are snapping up riskier assets from high-yield bonds to emerging-market debt. A drop in oil prices and surging consumer confidence is boosting investors' optimism that the world's economy will grow fast enough to limit defaults. It simply hasn't been this good since the Dotcom mania of 1999-2000.

Investors are not currently being paid enough for the risks they are taking. The premiums they receive for holding high-yield, high risk debt has declined alarmingly. Investors only demand an extra 2.6% in yield on average to own junk bonds instead of US Treasuries, the smallest gap in a decade and compared with a five year average of 5.17%. European high-yield bonds are trading at 190 basis points (1.9%) above government bonds, the lowest risk premium investors have accepted since the late 1990s. There was a time when the gap was closer to 1,000 basis points (10%).

The appetite for junk bonds is being fuelled by a default rate that is well below historic averages, even though it is beginning to creep up on some measures and in some countries. The rate of junk bonds defaulting hit an all-time low of 0.8% in America in 2006, down from 3.1% in 2005. This is well below the long-term default average of 5%. Moody's Investor Service predicts the rate will be more than 3% by early 2008.

Today's renewed "rush to junk" will heighten fears that companies and investors are taking too much of an advantage of the excessive liquidity available in the markets. There has been massive credit creation outside the traditional banking system which has led to unprecedented growth in hedge funds, leveraged buy-outs, private equity and credit swaps. An unexpected interest rate rise or dip in profits could send yields soaring and prices crashing down.

Cheap debt has helped fuel a takeover bonanza for leveraged buyout firms. These firms, which use a combination of their own funds and debt secured on the companies they buy to finance takeovers, have announced an unprecedented US \$700 billion of acquisitions the past 12 months.

In a report issued late last year, Standard and Poor's issued a warning about the "overstretched, aggressive structures and exorbitant debt levels that arrangers are applying." When the debt cycle turns, sentiment shifts with alarming rapidity – and the record high-yield issuances of today can easily turn into the record defaults of tomorrow.

The International Monetary Fund observed, as long ago as last April, that asset price volatility tends to increase with falling prices for risky investments, as economies enter the mature periods of the business cycle and begin to run short of capacity, leading to greater inflation risks and rising interest rates. We are now moving into just such a time.

As a further warning indicator, much of the demand for fresh paper is coming from organisations that are already highly leveraged: hedge funds and special-purpose vehicles known as collateralised debt obligations (CDOs). Hedge funds are currently at their most leveraged since 1998, – the time of the demise of Long Term Capital Management. You've got leveraged investors owning leveraged bonds. So investors are undoubtedly making some extremely risky bets on junk bonds.

Investors in today's increasingly risky junk bonds should remember that the debt markets are a deeply cyclical business punctuated by bitter crashes. The optimists - and there are plenty in the markets – believe that it could take until 2010 before all the unbalanced and over-leveraged deals of the past year start to go awry. But they shouldn't forget that there is always the risk of an unforeseen shock to start the edifice crumbling. A hard landing for the American economy, a significant fall in the Dollar, a new war in the Middle East involving Iran or a higher than expected hike in interest rates could bring the debt crunch on early. The debt mania is going to give investors a very nasty hangover when the party is over.

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