

The Credit Crisis: Market Update and Investment Opportunities

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These are extraordinary times. The “credit crunch,” which has now been with us for over more than a year, has evolved from a quiet beginning in U.S. sub-prime mortgages into the most significant liquidity and solvency crisis that has faced markets in modern times. As the crisis has spread across markets and assets, it has prompted over \$500 billion of asset write-downs, the seizing up of the corporate bond and money markets, and the failure of some of the world’s largest and most respected financial institutions.

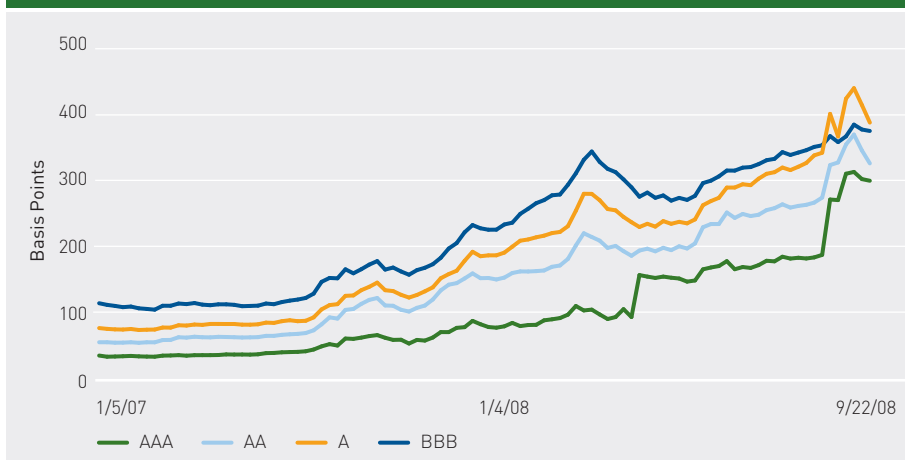
Although the situation remains fluid, in view of recent events that have rocked markets—the nationalization of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, near-default of AIG, the merger of Lloyds and HBOS, and the U.S. Treasury’s \$700 billion proposal to stabilize the banking system—we would like to share some thoughts on these and other related issues.

The ability to transact in global credit markets has been deteriorating since last September. Banks have historically provided risk capital, but the near closure of the inter-bank lending market has seen them effectively cease to make markets in corporate bonds. Deprived of access to a ready supply of financing, banks have hoarded cash against increased collateral and capital requirements. The inability to access capital markets has been the catalyst for the Lehman, AIG and HBOS debacles.

The actions of the U.S. Federal Reserve to arrange a “merger” for Bear Stearns in March gave markets grounds for optimism it would stand behind the U.S. banking sector. That expectation prompted a strong rally in financial sector issues globally as a consequence. Recent events have, however, shown that institutions would also be allowed to fail.

Corporate bond spreads, the additional yield over government bonds that investors demand for taking the risk of default, have risen to new record levels this week, as illustrated by Figure 1 below.

Figure 1. Credit Option-Adjusted Spreads by Credit Quality



Source: Lehman Brothers; data through September 24, 2008.

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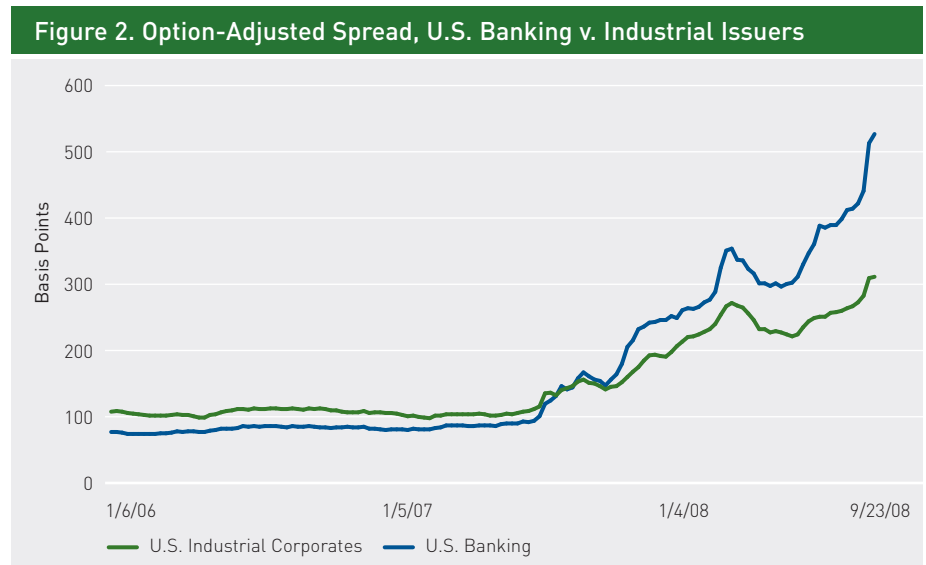


BlackRock’s Fixed Income Investment Strategy Group (ISG) is a globally integrated strategic team that consists of all of BlackRock’s fixed income portfolio managers and several representatives of BlackRock’s risk management team. The ISG meets weekly to discuss key economic and market trends, and to evaluate the opportunities present in the fixed income markets to identify potential risks and rewards. The ISG sets the broad strategy guidelines used to manage fixed income portfolios across the firm.

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In general, we believe that the additional yield of corporate bonds at these elevated levels compensates investors for the heightened level of default risk. However, issue selection is critical, and diversification is particularly important in reducing risk. The financial sector has been subject to the most pressure and appears cheap to us on a highly selective basis (Figure 2).



Source: Merrill Lynch; data through September 24, 2008.

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On the positive side, there is the likelihood of further consolidation among financials as weaker institutions are encouraged to combine with better capitalized suitors. On the negative side, there is the significant risk of further downgrades in the sector as the rating agencies attempt to re-establish their credibility. Overall, we are cautious on the industrial sector, where the impact of high commodity prices (albeit off their peaks), higher debt servicing costs, less access to borrowing and falling demand have been underappreciated and are only now being felt.

Perhaps the most compelling opportunity in the current market turbulence is located at the eye of the storm, U.S. non-agency mortgages. The unprecedented expansion of this sector over the past five years was fueled by intense competition among broker-dealers for securitization volumes and by growing demand from collateralized debt obligations with increasing levels of imbedded leverage. The complete disappearance of this support system has caused prices to fall well beyond levels consistent with the now historic levels of defaults, offering the potential of double-digit yields to severely stressed assumptions.

An ancillary effect of the recent market turmoil is the withdrawal of large amounts of capacity from financial markets, possibly to the detriment of secondary market liquidity in securities markets. The failure of the independent broker-dealer model and concern about the operations of hedge funds are driving consolidation and reducing the available number of counterparties.

We expect liquidity to remain poor and pricing to be erratic until this process of consolidation and balance sheet reconstruction has run its course and confidence is restored. In the near term, we are concerned that ratings downgrades will place extreme pressure on affected institutions, and forced selling will further compound difficult market conditions.

Ultimately, there is no single solution that will quickly resolve the problems facing today's markets. However, there are a number of steps that we believe will help restore market confidence:

1. Central banks need to continue to provide short-term financing until such time as markets begin to function and bank balance sheets can be recapitalized. The normal functioning of interbank lending is an important and essential step toward a return to the functioning of capital markets.
2. Interest rates need to be lowered. In order that the right message is sent, this rate reduction would need to be coordinated across the major markets, and crucially, in order to be effective, the European Central Bank would need to cut rates. The specter of inflation remains, but at this point the systemic failure of the global financial system with ensuing deflation remains a greater risk to stability.
3. There needs to be a floor put under U.S. asset prices. The amount of poor quality assets that banks hold and the downward impact of de-leveraging and forced selling on prices creates a vicious spiral. Stabilization of the U.S. housing market and the return of a functioning mortgage finance system are necessary precursors to restoring confidence in, and among, banks.
4. We support the recent discussions around the creation of a government-backed fund similar to the Resolution Trust Company that managed assets from failed savings and loan institutions in the 1990s. While details have yet to be agreed upon, this represents an attempt to address the challenges facing the industry as a whole, rather than the case-by-case basis that has prevailed to this point.

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