

May 10, 2004

## CREDIT SPREADS

Some are again discussing the peculiar confluence of forces that are mounting for another "Perfect Storm". Earlier in the year, we argued that in highly volatile financial markets the Perfect Storm includes both the speculative spike up and the *consequent* spike down as suddenly unsupportable positions suffer forced liquidation. Nothing peculiar at all.

It seems then that the Fed presides on the spike up and then involuntarily surrenders power to margin clerks who preside during the spike down.

Margin clerks have a vastly different job description to that of central bankers. For many years, we have proposed that, as part of their training, Fed employees (right up to the top) should have spent some time as margin clerks on the former Vancouver Stock Exchange or with a commodity broker.

### **Credit spreads continue to widen as rates increase.**

From the "narrow" of 286 bps in early April, spreads for Turkish obligations, over treasuries, have widened to 568 bps today. The yield went from 7.05% to 10.45%.

On the same move, Brazilian issues have widened from 462 bps to 670 bps as yields increased from 8.55% to 11.47%.

In the U.S., the high-yield spread widened to 252 bps on Friday. The breakout is at 265 bps and this is lagging other issues with spreads for medium and high-grade corps making new "wides" for the move.

This represents a serious loss of global liquidity which was led by the bellwether 10-year swap spread, which reversed to widening at 36.5 bps on March 23. Now it's at 54.25 bps.

Argentina has been way ahead with a spread of 3901 bps, over, at a yield of 43.78%

**The Problem:** Spreads are coming off a unique speculation. The breakdown in base metal prices this week sets a cyclical bear which, in the past, has been accompanied by a cyclical decline in S&P earnings. This is anticipating a serious reduction in the ability to service debt.

**The Outlook:** Credit down ratings could be the theme by October. Beyond this cyclical problem, the unwinding of the massive "carry" trade will likely force some big defaults – perhaps not as big as LTCM though.