Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

U.S. Credit Market Update: Government Efforts Yielding Improvement

KEY TAKEAWAYS

- **During the past two months, credit conditions have improved in both short-term and long-term markets.**
- **Unprecedented government action—and growing expectations for more support—have been the main sources of this improvement.**
- **Despite recent progress, credit market conditions remain severely strained and are still far from "normal."**

The U.S. credit market crisis was at the root of the global asset sell-off in the fall of 2008, and the trajectory of those markets is critical to the economic outlook. Although no indicator can gauge the aggregate health of all credit markets, the lending rates below illustrate the conditions faced by both corporate and consumer borrowers. Monitoring the U.S. credit market may help investors evaluate whether the U.S. financial crisis is abating.

EXHIBIT 1: Short-term borrowing rates have declined, but risk aversion remains.

Commentary

Short-term borrowing rates are now well below their near-panic peaks in October 2008. Government injections of capital into banks, guarantees for money-market funds, and liquidity facilities that assist in the buying and selling of commercial paper have all provided considerable support to short-term markets. However, despite some improvement, credit conditions are far from normal. While inter-bank lending rates (LIBOR) are low on an absolute basis, they remain historically high when compared to Treasury yields (TED Spread). Furthermore, commercial paper markets remain stressed.

Short-Term Credit Indicators[i] (Annual %)

	LIBOR	TED Spread	Financial Commercial Paper
October 2007	4.89	0.95	4.60
Oct 08 Peak	4.82	4.57	3.99
Late Nov 08	2.22	2.21	1.30
Today	1.18	0.94	2.21

Source: U.S. Treasury, Financial Times, Federal Reserve Board, Haver Analytics, FMRCo (MARE) as of 1/30/2009.

Short-term rates provide a measurement of how well companies, particularly banks and other financial institutions, are able to roll over existing obligations and continue to fund their day-to-day operating needs.

- LIBOR – a key inter-bank lending rate, shows the cost of banks borrowing from other banks.
- TED spread – the difference between 3-month LIBOR (inter-bank rate) and the 3-month Treasury bill (risk-free rate), shows the willingness of banks to lend to each other relative to the government (proxy for bank risk aversion)
- Commercial paper – short-term debt used by financial companies to address near-term borrowing needs

EXHIBIT 2: Since late November 2008, longer-term borrowing rates have declined.

Commentary

Long-term borrowing rates have fallen but are still at strained levels. Bonds, particularly corporates, outpaced returns to Treasuries during the past two months (see Exhibit 3, below). Government actions and anticipated future policies to support distressed assets and limit forced-selling created positive sentiment. Among the efforts: Fed purchases of mortgage-backed securities; a new Fed program (Term Asset-Backed Security Lending Facility) to support asset-backed securities; government guarantees of troubled assets at two major U.S. banks; and rumors of a revised plan for the TARP (Troubled Asset Relief Program) to buy distressed assets.

Long-Term Credit Indicators[ii] (Annual %)

	Mortgage Rates	Investment Grade Bonds	High Yield Bonds	Municipal Bonds
October 2007	5.90	5.79	8.69	4.10
Oct 08 Peak	6.46	9.09	19.50	5.45
Late Nov 08	5.76	8.51	21.72	4.70
Today	5.34	7.26	18.18	4.02

Source: Merrill Lynch, Barclays Capital, Bloomberg, Haver Analytics, FMRCo (MARE) as of 1/30/2009.

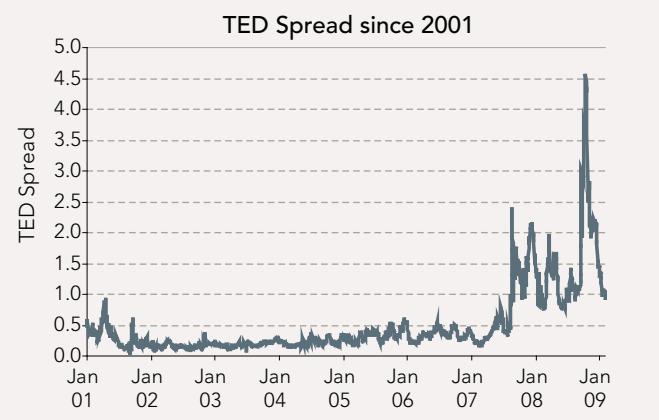
Long-term rates provide a gauge for how well corporations, municipalities and other borrowers are able to fund their long-term borrowing needs.

- Mortgage rates (conforming) – borrowing cost for a 30-year, fixed-rate mortgage loan
- Investment-grade corporate bonds – rate at which high-credit-quality companies borrow
- High-yield corporate bonds – rate at which lower-credit-quality companies borrow
- Municipal bonds – rate at which municipalities borrow, including obligations of states, cities, hospitals and universities

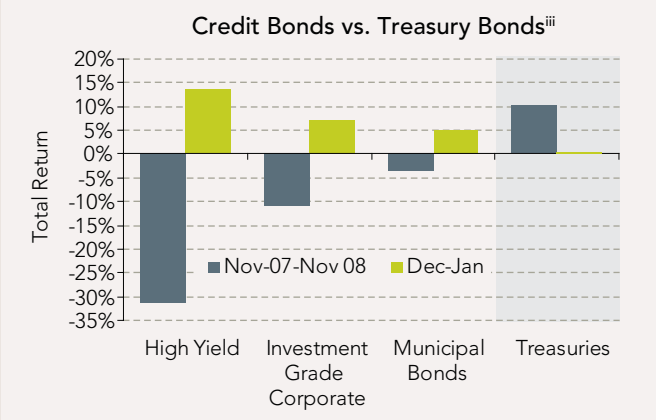
Investment Implications

Credit markets appear to be less dysfunctional today than they were in late November 2008. Borrowing costs have fallen both in absolute terms and relative to safe Treasuries. Some borrowers now have better access to debt markets than they did a couple of months ago. Many new investment-grade corporate bond deals have successfully come to market recently, in part due to federal government guarantees of new bank debt issuance. However, considerable policy uncertainty still exists around such issues as which specific distressed credit assets the government might buy in any future plan, from whom, and at what price. Furthermore, the fundamental economic conditions that impact bond creditworthiness remain highly difficult, as corporate earnings, consumer confidence, and housing prices have hit new lows. The challenge for fixed-income investors is to determine whether today's historically high yield spreads adequately compensate them for the uncertainty that still exists. Meanwhile, the broader investment community will be looking to see if the recent credit market improvement continues. ■

EXHIBIT 3: Short-term rates have fallen far from panic-level peaks in the fall, and long-term credit bonds have rallied after extremely poor performance in 2008.



Source: U.S. Treasury, Financial Times, Haver Analytics, FMRCo (MARE) as of 1/30/2009.



Nov 07-Nov 08 reflects total return from 11/30/07 to 11/30/08. Dec-Jan reflects total return from 12/1/08 to 1/30/09. Source: FMRCo (MARE) as of 1/30/2009.

The **Market Analysis, Research and Education** (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), provides timely analysis on developments in the financial markets.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Past performance is no guarantee of future results.

[i] Short-Term Credit Indicators represented by the following: LIBOR – 3-Month London Interbank Offered Rate; TED Spread – the difference between yields on three-month Treasury yields bills and inter-bank EuroDollar rates (three-month LIBOR); Commercial Paper – 3-Month Financial Commercial Paper. Late November 2008 data as of 11/30/08. October 2007 data as of 10/31/2007. Oct 08 Peak: represents peak yield for each respective category during the month of October 2008.
[ii] Long-Term Credit Indicators represented by the following: Mortgage Rates – Bankrate.com U.S. 30-Year Fixed Mortgage Rate; Investment-Grade Bonds – Barclays Capital® (BC) Corporate Bond Index; High Yield Bonds – Merrill Lynch High Yield Master II Index; Municipal Bonds – BC Municipal Bond Index. Late November 2008 data as of 11/30/08. October 2007 data as of 10/31/2007. Oct 08 Peak: represents peak yield for each respective category during the month of October 2008.
[iii] Performance represented by the following indices: Investment-Grade Corporate - BC Corporate Bond Index; High Yield - Merrill Lynch High Yield Master II Index; Municipal Bonds - BC Municipal Bond Index; Treasuries - BC Treasury Bond Index.

You cannot invest directly in an index.

The Merrill Lynch High-Yield Master II Index is an unmanaged index that tracks the performance of below-investment grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Barclays Capital® (BC) U.S. Corporate Bond Index is an unmanaged index that tracks publicly issued U.S. corporate bonds that meet the specified maturity, liquidity, and quality requirements to be considered investment-grade. To qualify, bonds must be SEC-registered. The BC U.S. Municipal Bond Index covers the USD-denominated long-term, tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. BC U.S. Treasury Index—an index which covers public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Although bonds generally present less short-term risk and volatility than stocks, bonds do entail interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default.

Lower-quality securities generally offer higher yields but also carry more risk of default or price changes due to potential changes in the credit quality of the issuer.

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