Market Insight

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January 1, 2009

Goodbye 2008! It was a year of significant financial losses, even for income sectors that, traditionally, were relatively safe havens for investors. Two years ago – before the word subprime was fully appreciated – credit spreads (the difference between the yield on an income security and a U.S. Treasury of a similar maturity) were historically tight. In one camp were those (not many) who felt risk premiums were dangerously low and prices of many income securities too rich for the risks assumed. In the other camp were those who believed financial technology had enabled credit risk to be "particle-ized" and spread globally in a manner preventing any local credit problem from becoming a contagion.

It is easy to say a global **credit bubble** existed. But the truth is more complicated. No question, subprime loans were made available to underqualified and allegedly unsuspecting borrowers. But most importantly, it was fear from investors in this sector that spread to other non-investment-grade asset classes with very low current default rates (bank loans and high-yield bonds) and even to investment-grade income classes with historically negligible or even zero default rates over a full credit cycle (high-quality municipal bonds, investment-grade corporates and agency securities). This fear led to a situation of many more sellers than buyers; market prices dropped and spreads widened. Also, extreme levels of financial leverage, taken on by investors to generate higher yield, added fuel to the fire. Lower asset prices forced deleveraging, which created even more sellers and even lower prices. Fear increased and credit spreads widened dramatically following the collapse of Lehman Brothers. That leaves us where we are today, with average credit spreads for investment-grade corporate bonds higher than the 10-year historical average credit spread for high-yield or "junk" bonds, which has been about 500 basis points (5%) over comparable Treasuries.

The cost of new credit has skyrocketed for many borrowers and has been cut off for many others. Today, loans are generally available only to the most creditworthy individuals and companies. Little doubt this will take a toll on the global economy, and has already begun to do so. Fortunately, actions by central banks and governments to lower target borrowing rates, inject massive liquidity and make direct capital investments into the world's largest banks have had positive effects. The

benchmark rate at which banks lend to each other—3-month LIBOR—jumped to over 4.5% in the fall and most recently dropped to about 1.5%. This indicates that large banks are more willing to lend to each other. However, banks do not yet seem willing to use their newfound strength to extend loans to creditworthy borrowers. Instead, their focus appears to be on shoring up and deleveraging their own balance sheets.

Despite this, we are encouraged by the actions of major central banks and governments across the globe. There is now nearly universal acceptance that the paramount concern in the near term is deflation and that policies should be set accordingly. No question that inflation will be back at some point, but with credit so constrained and likely to remain so, inflation seems a back-burner issue currently. Many governments, including our own, are planning major fiscal stimulus packages, with the goal of jumpstarting the world's largest economies. We believe central banks/governments will do whatever it takes to generate liquidity, get the banks out of bunker mode and start the wheels of credit turning again.

Implications for Eaton Vance's income funds…

During the year, bank loan, long-term municipal bond and high-yield bond funds were particularly hit hard by the credit crisis. Currently, all three have spreads at historic highs and, in our opinion, offer solid value. Depending on how you account for the market-price discount, senior secured bank loans have average spreads between 1000 and 1500 basis points over 3-month LIBOR, compared with a historic average of about 250 basis points. Municipal bond ratios for high-quality municipal bonds (the ratio of yield on 30-year munis to the yield on Treasuries of roughly equivalent maturity) exceed 170%, an all-time high. As markets stabilize and expectations grow for higher individual federal tax rates, we expect muni ratios to drop, making municipal bonds more valuable. For those willing to take more risk and seek high potential return, high-yield bond spreads are currently about 2000 basis points (20%) above comparable Treasuries. Importantly, each of these asset classes currently has a relatively low default rate. Though default rates have been rising (and we expect them to continue throughout the new year), we believe debt markets are discounting much more pain (credit losses) than is likely to occur.

Income markets currently offer two types of opportunity. One includes relatively low-risk/low-return investments, including funds that invest in Treasuries and Treasury-like securities. Further out the risk spectrum are short/intermediate high-quality municipal bond strategies, as well as relatively short-duration diversified investment-grade income funds. The second major opportunity is in the asset classes mentioned previously: bank loans, long municipal bonds and high yield. Each has more risk, but for those willing to hold for three to four years, we believe they offer the possibility for equity-like returns.

Now more than ever, investors need financial guidance, making it an opportune time for financial advisors to distinguish themselves. During uncertain times, investors are inclined to second-guess their own judgment. The informed, well considered advice of an investment professional can make a real difference and is one of the most powerful tools investors have at their disposal.

Sincerely,

Payson Swaffield

Investing in mutual funds is subject to financial market volatility. Income funds may be subject to additional risks such as issuer credit, changes in interest rates, economic factors and other market events.

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Since its founding in 1924, Eaton Vance has held fast to Charles Eaton's belief that "a well-rounded investment management organization is not engaged in a guessing game with other people's money. It is doing a highly specialized professional job, endeavoring to apply knowledge, judgment and decisiveness in action."

This combination of tradition, experience and long-term performance are the enduring values that have helped make Eaton Vance the investment manager of choice for many of today's individual and institutional investors.

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2009 - 01/09 MIPS1209