Good Riddance to 2008

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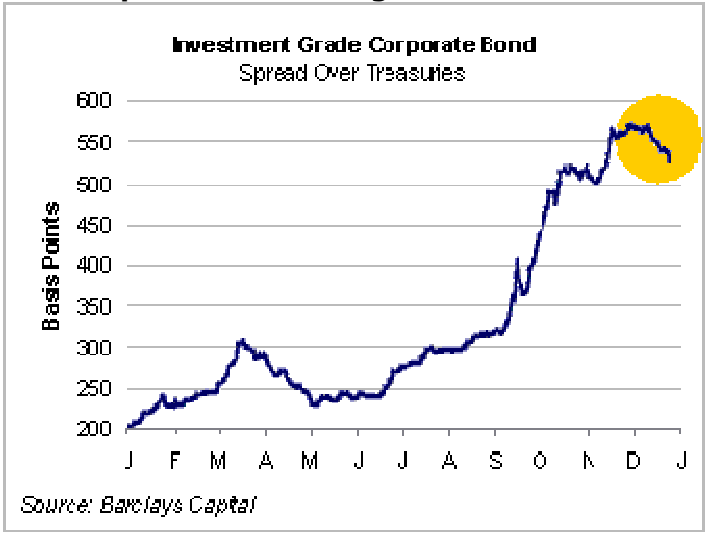
It's an old cliché that what doesn't kill you makes you stronger. We got through that 2008 mess! Now for the spoils! While portfolio managers are congenitally biased to be bullish on their own sectors, please grant me a bit of forbearance as I point out some opportunities. Two-thousand nine is likely to be a very different sort of experience. We are not out of the woods yet but for those with any money left, here are a few ideas I expect to become compelling:

Corporate bonds are screamingly cheap and priced for economic oblivion. The sluggish timetable for economic revival will indeed test much of the credit market in coming months, so choose individual bonds with care. Yet, for long-term investors, the risk/reward profile is attractive, offering eight and nine percent investment grade yields.

Government-backed paper offers valuable arbitrage opportunities. Treasuries have obviously done very well. They provided excellent performance in 2008 and may still be a safe harbor. The risk there is that regular buyers may deploy additional investing elsewhere. Foreign buyers may revert to home country investments. They, along with others, may search for more generous yields. Options might include Fannie Mae and Freddie Mac debt, Agency MBS, and FDIC-guaranteed issues from major financials, all of which provide more yield. While the markets are a bit two-faced about the explicitness of some of the government support and the liquidity is not the same as Treasuries, these are very much Uncle Sam in drag.

Credit Spreads Narrowing on 10-Year Investment Grade Bonds



Merger arbitrage is available to "long only" portfolios. As financial firms' balance sheets contract, hedge funds unwind and financing becomes difficult to source, trades that were historically arbitraged much further up the food chain present themselves to investment portfolios. Merrill and Countrywide bonds are cheap compared to Bank of America, which is the same entity. Golden West and Wachovia paper are likewise cheap compared to Wells Fargo. The list goes on.

Municipal bonds were hit with a perfect storm in 2008: the crumbling of the insurance back-up providers, a significant cutback in dealer community support for the secondary markets, and fears over the outlook for state and local budgets. With these factors still in play, munis remain very cheap. Here again, pick credits carefully to get ten-year after-tax yields that can be more than 2.5+ times that of Treasuries.

Our macro themes for the coming months include examining several unresolved tensions. First is the difficulty of finding a sense of value inside volatile markets. Low rates on Treasuries give pause, and yet late December auctions went well. Both fear and balance sheet dressing-up were strong forces, though near-zero yields challenge valuation metrics. This year will either be a bright one for returns on risk again, or volatility will remain a more persistent theme for investors. A related issue centers on whether current market conditions now constitute a cash bubble and, if so, where this cash eventually will go.

Second, while the Fed has begun to fight deflation, and many around the world fear a Japan-like "lost decade" in the United States, others worry that bountiful Fed-manufactured liquidity, and the current overhang of cash on the sidelines, will lead to a "Weimar Republic" reflation. An associated issue relates to the Fed's flooding the market with funding: this is the "quantitative easing" process that aims to supply the banking system with liquidity rather than targeting an interest rate. While the banks survive and get flush with cash in order to continue to shed distressed assets and unwind their leveraged positions, many other entities in need of funding are left either without access or facing onerous terms. Contracting these credit spreads will be critical to economic recovery.

Third, perhaps the biggest casualty of 2008 is the loss of confidence by investors of all categories. The Madoff scandal was significant. So was the washout of the hedge fund industry; these players will shrink by more than half. Their leverage will shift from something north of 10:1 to more like 2:1 or 3:1. Trillions of dollars will continue to unwind as risk takers face liquidation. This could mean the near-term and dominant investment themes will continue to be macro-driven, leaving by the wayside much of the traditional strengths of professional investors, that of value investing and bottom-up analysis. ■