

Market Analysis, Research & Education

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U.S. Credit Market: Is the Financial Crisis Abating?

The first in a new series monitoring key credit market indicators

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KEY TAKEAWAYS

- Though distressed, the U.S. credit markets appear to have improved from near-panic levels in October.
- Government efforts to restore confidence in short-term credit markets have begun to bear some fruit, but long-term borrowing rates remain elevated.
- The U.S. credit market crisis was at the root of the recent global asset sell-off, and going forward the credit markets will be critical to the outlook for the economy.

The crisis in the U.S. credit markets was at the root of the recent global asset sell-off, causing a breakdown in confidence among financial institutions that led to rising borrowing rates and reduced expectations for global economic growth in the coming months.

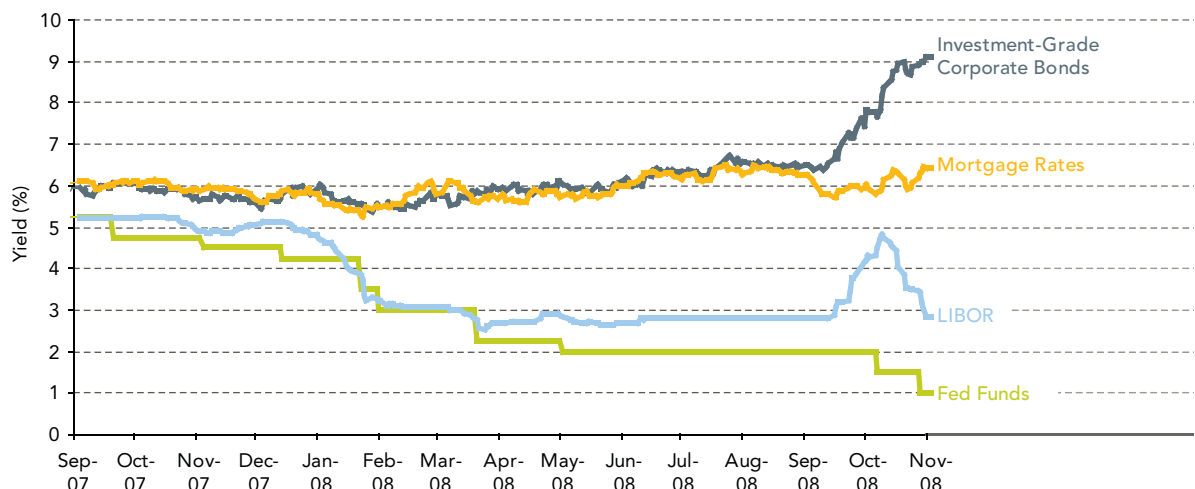
The credit markets have been the focal point for historic U.S. government intervention. The Federal Reserve (Fed) announced a litany of new lending programs to shore up the banking system, and the federal government bolstered

the capital positions of some U.S. financial institutions by purchasing equity stakes in them.

The need for such extraordinary actions has been evident by looking at key indicators of the cost of borrowing. In a typical economic downturn, interest rate cuts by the Fed traditionally have been enough to lower the cost of borrowing for businesses and consumers, and with a time lag have eventually sown the seeds of a recovery in lending and the broader economy. Recently, however, the trauma in the financial system has undercut the ability of the Fed to lower actual borrowing rates. Despite nine separate Fed rate cuts since September 2007 (from 5.25% to 1% as of 10/31/08), many actual borrowing rates in the marketplace are the same or even higher than when the Fed started easing (see Exhibit 1, below).

The longer borrowing rates remain elevated, the more challenging the economic impact of tighter credit is likely to become. Because the trajectory of the credit markets will be critical to determining whether the worst of the financial market turmoil is behind us, this article will be the first of a new MARE series that follows key indicators of borrowing rates as proxies for the overall health of the credit markets.

EXHIBIT 1:
Although the Fed has cut target interest rates substantially, rates for mortgages, corporations and banks haven't followed suit.



Data series represented by: Investment-Grade Corporate Bonds – Lehman Brothers (LB) Corporate Bond Index; Mortgage Rates – Bank-rate.com U.S. 30-Year Fixed Mortgage Rate; LIBOR – 3 month LIBOR. Source: Bloomberg, FMRCo (MARE) as of 11/3/2008.

U.S. Credit Market Update: Borrowing conditions remained difficult at the end of October, with tightened lending standards, difficulty of new debt issuance, and a general lack of credit availability at any price. Although no indicator can gauge the aggregate health of all credit markets, the lending rates below offer a quantitative illustration of the conditions faced by borrowers.

Although still at elevated levels, short-term borrowing rates have fallen from recent peaks...

Commentary

Overall, short-term borrowing rates have declined from their near-panic peaks in early October, although they still remain at distressed levels compared to historical averages. Since the peaks seen during the week of Oct. 10, 2008, inter-bank lending rates, both on an absolute basis (LIBOR) and relative to Treasury yields (TED spread), have declined significantly. This is the first sustained decline in these rates since the spring of 2008, although inter-bank rates are still very high relative to Treasury yields on a historical basis (and were even significantly higher than early September 2008). Commercial paper rates also have declined from their peaks, but still remain elevated compared to levels in mid-September.

Short-Term Credit Indicatorsⁱ (Annual %)

	LIBOR	TED Spread	Commercial Paper
1 year ago	4.89	0.95	5.05
Early September	2.82	1.11	3.14
October Peak	4.82	4.57	6.69
Today	3.03	2.57	4.33

Source: U.S. Treasury, Financial Times, Federal Reserve Board, Haver Analytics, FMRCo (MARE) as of 10/31/2008.

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 and non-financial companies to address near-term borrowing needs.

...while longer-term borrowing rates stood at historically high levels at the end of October 2008.

Commentary

Overall, long-term borrowing rates are at extremely high levels and most continued to deteriorate through the end of October. Corporate borrowing rates, for both investment-grade and high-yield companies, spiked to absolute yield levels not seen in at least two decades and yield spreads (relative to safe Treasury yields) rose to the highest levels on record. Municipalities suffered similar results, as muni bond yields rose to record highs relative to Treasury bond yields. Fixed 30-year mortgage rates failed to follow the 10-year Treasury bond yield lower, and ended October higher than a year ago.

Long-Term Credit Indicatorsⁱⁱ (Annual %)

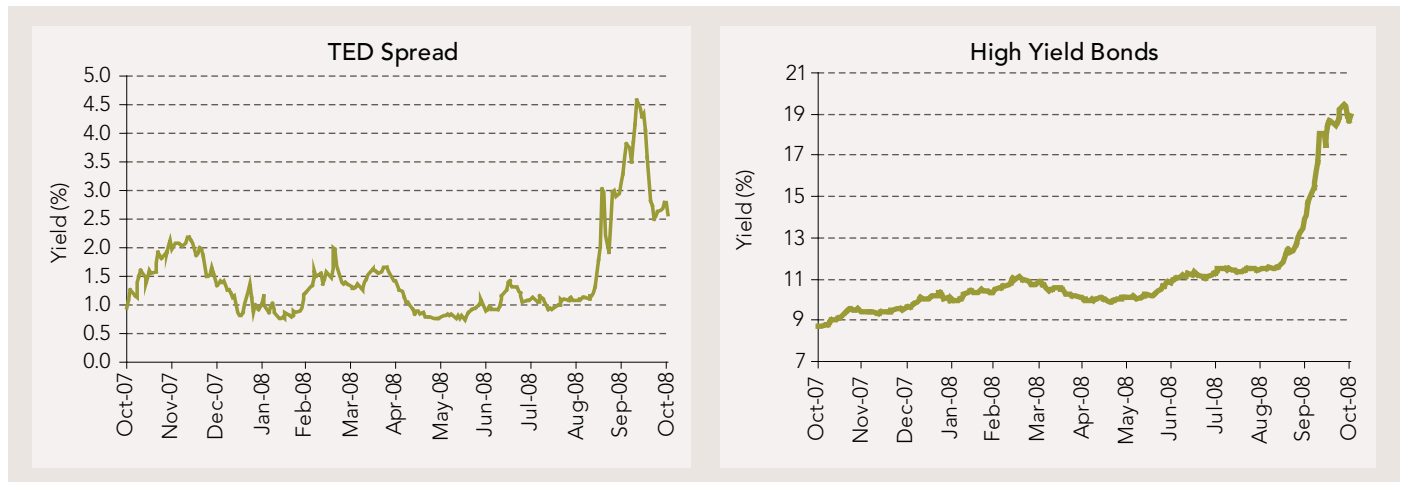
	Mortgage Rates	Investment Grade Bonds	High Yield Bonds	Municipal Bonds
1 year ago	6.33	5.79	8.69	4.10
Early September	5.93	6.43	11.42	3.99
October Peak	6.46	9.09	19.15	5.45
Today	6.46	9.09	18.80	4.84

Source: Merrill Lynch, Barclays Capital, Federal Home Loan Mortgage Corporation, Haver Analytics, FMRCo (MARE) as of 10/31/2008.

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.

EXHIBIT 2: Short-term rates (e.g. LIBOR) fell from recent peaks, but long-term rates (e.g. high yield bonds) have remained high.



Source: Financial Times, U.S. Treasury, Haver Analytics, FMRCo (MARE) as of 10/31/2008.

Chart shows ML High Yield Master II Index Yield-to-Worst. Source: Merrill Lynch, FMRCo (MARE) as of 10/31/2008.

Investment Implications

On the positive side, financial markets appear to have improved from near-panic levels in early October. Government efforts to restore confidence in short-term credit markets have begun to bear fruit. (These actions include the government guarantee of short-term bank debt, recapitalizing healthy banks, guaranteeing some money market funds, the Federal Reserve’s program to directly provide commercial paper lending, as well as several Fed programs to bolster money markets.) Short-term borrowing rates are not yet normal—they remain at distressed levels

relative to history—but the trend clearly reversed and improved through the second half of October (see Exhibit 2, above). On the other hand, the long-term borrowing environment remains challenging. Distress in credit markets is still blunting the impact of lower official interest rates offered by the Federal Reserve. The markets will be watching closely to see if lenders push their slowly recovering short-term risk appetite out to longer maturities, which will be crucial to stem the tide of higher borrowing costs that has negatively impacted corporations, municipalities and potential new homeowners in recent weeks. ■

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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 A2/P2/F2 Nonfinancial Commercial Paper.

[ii] – Long-Term Credit Indicators represented by the following: Mortgage Rates – FHLMC 30-Year Fixed Rate Mortgage Rate; Investment-Grade Bonds – Lehman Brothers (LB) Corporate Bond Index; High Yield Bonds – Merrill Lynch High Yield Bond Master II Index; Municipal Bonds – LB Municipal Bond Index.

You cannot invest directly in an index.

The Merrill Lynch High-Yield Bond 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.

LB 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 LB 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.

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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