

INVESTMENT UPDATE

Every year at this time comes the annual pilgrimage of professional baseball players making their way south to begin Spring Training. It's a sign of hope for those of us who reside in less temperate climes, as we bundle up and watch the days lengthen, that warm weather is just around the corner.

The cyclical nature of the seasons has its parallel in the oscillating behavior of investors. In the capital markets, participants seem to either bask in the warm sunshine when risk-taking is in season, or hunker down by the woodstove in the bitter times when fear chills investors' hearts. "Fear and greed" are the psychic equivalents of "winter and summer."

Unfortunately for investors, knowing exactly where you are in the cycle isn't as straightforward as looking at a calendar. It is nevertheless imperative to analyze the environment to determine which tactics will work best based on where one is in the cycle. Adding risk in your portfolio when the cycle is still heading south is akin to taking off your snow tires after a couple of warm days in December.

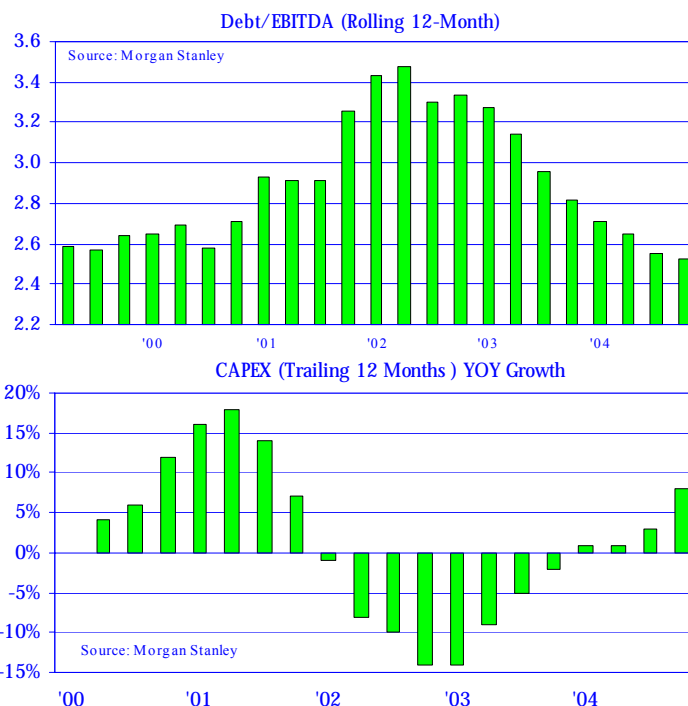
As a quick review, the credit market cycle goes something like this: When the economy is growing strongly, demand for credit is high as businesses borrow to expand productive capacity and meet the growing demand of their customers. Individuals, optimistic of their future prospects, borrow to add to and upgrade their own personal lifestyles. The cycle turns down when interest rates become so high (or debt levels rise to the point) that borrowers begin to struggle to service their indebtedness. Credit quality plummets, lenders become more stringent (sometimes cutting off credit), consumers'

demand for goods and services falls, economic growth turns down, and interest rates decline. After bottoming, sales begin to pick up, rates fall low enough to become attractive, and to the extent that borrowers have put their financial affairs in order, they begin thinking about borrowing to fund (first) replacement of and (later) expansion of their durable goods and capital equipment.

That's the typical case, and of course there are variations on what triggers the "boom" and "bust" phases. Traditionally, a combination of high inflation and Fed-induced monetary parsimony chokes off the capital markets, signaling the end of the expansionary phase. But the most recent recession was caused instead by an excess of optimism by the promise of a "New Economy;" believing that the business cycle had somehow been repealed, individuals risked their life savings on risky assets (toys.com, anyone?) while businesses levered up their balance sheets to pay for what we now know was unnecessary expansion.

Now we find ourselves well into an economic recovery, two and a half years after the credit cycle hit rock bottom in September of 2002. Are we really approaching the end of the cycle, as some market pundits now claim? We will present some evidence that shows that we've still got some room to go.

The first chart shows how US industrial companies' ratio of long-term debt to cash flow rose to dangerously high levels at the "bottom" of the credit cycle in 2002. Borrowing, in and of itself, is not necessarily "bad" as long as cash flow is adequate to service the debt. But when the economy falters, companies with highly levered balance sheets may have significant problems paying for all that debt. In 2002, banks had all but pulled out of the unsecured lending business, and levered companies with maturing debt had considerable difficulty in "rolling over" these maturities. The first chart also shows how, since mid-2002, financial leverage



has improved impressively, and is now back to levels (debt is down to roughly 2.5 times annual earnings before interest, taxes, depreciation and amortization) that reflect very healthy credit fundamentals.

Even though cash flow has improved over the past couple of years, companies have been using much of that cash to rebuild their balance sheets. The bottom chart on the front page shows how industrial America, after a long dry period, is now starting to boost expenditures on capital equipment. At this point in the cycle, this is a very healthy economic indicator, since it reveals that product demand is strong enough to warrant the commitment for companies to increase their productive capacity. It is an affirmation that the economy is well along in its recovery. Of course, capital spending can go too far, and becomes a negative when expensive projects and acquisitions are made that return little on their investment, but those sorts of projects tend to come later in the cycle. The sudden growth spurt in the fourth quarter of 2004 will likely prove to be a result of long-delayed and necessary upgrades to existing facilities.

The top chart on this page shows how the credit improvements that companies have made in the past couple of years are being recognized by the ratings agencies. Back in 2002, more than \$650 billion in debt was downgraded by Moody's Investors Service, and the dollar volume of downgrades outnumbered upgrades by almost four to one. By 2004, upgrades and downgrades were roughly equal, and in the first two months of 2005 there were more than \$60 billion of upgrades and only \$5.5 billion of downgrades—a positive ratio of more than ten to one!

As the fundamental health of the economy and the corporate bond market improved in recent years, interest from investors has swung back strongly, not just from US investors, but from those overseas as well. The middle

chart shows how purchases (net of sales) of US bonds by foreigners has risen in the past few quarters after falling off in 2002 and 2003. Net of sales, in 2004, foreigners bought more than \$300 billion of US corporate bonds, including \$43.5 billion in September alone; both of these figures represent all-time highs.

The final chart demonstrates another positive trend for the corporate market—a lack of new supply. This is, of course, related to the “balance sheet repair” story; not only have US companies been building up cash and paying off debt, they’ve not issued much new debt in the past couple of years. This year is projected to be the fourth year in a row that net new issuance of high-grade debt will be below the previous year’s. Like the CAPEX chart, however, we expect that this series is now hitting bottom, and going forward we’re looking for a gradual increase in new corporate issuance over the next few years as companies boost their expenditures of new plant and equipment. Nevertheless, it’s clear that the supply-demand equation (often

referred to as “market technicals”) is still quite favorable for the corporate bond market.

As surely as autumn follows summer, the corporate market will eventually become a much more hostile environment for investors, and we will do well to position our clients’ funds accordingly as that time approaches. But when we carefully examine the evidence, we believe that the predictions of a looming chill for the credit markets are premature at this point. While we will make hay as long as the sun shines, we won’t forget to put up stores for the winter.

