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MarketWatch

SPECIAL REPORT

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Are corporate bonds ready to rally in 2009?

By Deborah Levine, MarketWatch

NEW YORK (MarketWatch) -- Fixed-income investors say the best opportunities in 2009 will be in corporate debt, as financial markets settle down from this year's turmoil.

Yields that companies pay on their debt have jumped to record highs relative to AAA-rated Treasurys, overshooting rational levels, investors said. At the same time, the credit crisis and continuing recession have Treasury yields at unattractive, record-low levels with little room to rally.

"I have never seen more investment opportunities in my whole career" spanning 29 years, said Mark MacQueen, co-founder of Sage Advisory Services, which oversees $6.5 billion in assets.

COMMODITIES

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Global stimulus efforts and production cuts could help revive commodities by the second half of 2009, sector forecasters say. But it's going to be a long, cold winter.

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Still, investors remain skittish and are staying in high-quality debt, which includes investment-grade corporate bonds, as well as in securities sold by government-supported mortgage agencies Fannie Mae and Freddie Mac .

Investment-grade debt yielded 5.74 percentage points more than similar-maturity Treasurys in early December, according to Standard & Poor's. That's more than three times the five-year average of that gap, indicating that investors are demanding much higher returns to take on the additional risk of a company's debt.

MacQueen likes debt sold by consumer companies that aren't as impacted by slowdowns, such as energy companies and supermarkets.

Wider corporate-bond spreads mean investors are finally being compensated for taking on that risk, said Jason Brady, who helps oversee about $6 billion in fixed-income assets at Thornburg Investment Management.

Before the credit crunch, investment dollars were so plentiful that even risky companies could borrow money at thin spreads to Treasurys, or less than 4 percentage points.

Such willingness to lend money at low rates has evaporated this year as institutional investors such as banks, mutual funds and hedge funds sold off holdings to raise cash or satisfy redemptions. In turn, some bond sectors have seen huge sell-offs and spreads have spiked.

"It's not the asset that is the problem; it's the investor base that has been stressed," Brady said. In funds that invest in stocks and bonds, "we're investing in bonds, not because we're running away from risk, but because they provide a better long-term opportunity to take risk."

In searching through the rubble, he looks for companies with good cash flow, including telecommunications firms such as Verizon Communications Inc. and Spain's Telefonica SA , as well as and cable companies including Comcast Corp.

Good old T-bills

After the best year in more than decade and yields at record lows, gains in Treasurys may be limited in 2009, investors said.

Treasurys have returned 13.7%, the most since 1995, when they gained 17.3%, according to an index compiled by Merrill Lynch.

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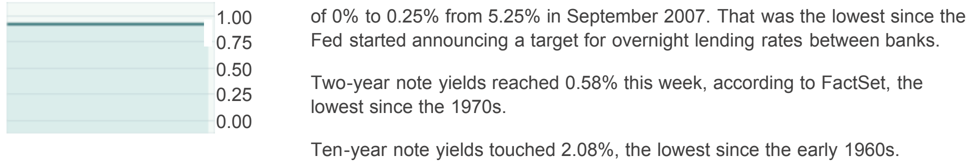
Those gains came as the economy dove off a cliff, U.S. equities plunged around 40% and investors fled all riskier assets for the relative safety of government debt. The Federal Reserve also helped, slashing rates to a range



of 0% to 0.25% from 5.25% in September 2007. That was the lowest since the Fed started announcing a target for overnight lending rates between banks.

Two-year note yields reached 0.58% this week, according to FactSet, the lowest since the 1970s.

Ten-year note yields touched 2.08%, the lowest since the early 1960s.

Thirty-year bond yields also dipped under 3% for the first time on record, dropping to 2.6% in the wake of the Fed's Dec. 16 announcement.

"We've had a humungous rally in Treasurys," said Robert Tipp, chief investment strategist at Prudential Fixed Income Management, which oversees more than $200 billion of bonds. "The market is going to be vulnerable on a short-term basis."

Treasury investors are also wary of U.S. government's borrowing needs to fund its promised bailouts of banks, mortgage-finance giants and insurance companies. Estimates for U.S. debt sales, including short-term bills, already range as high as a record $2 trillion for the current fiscal year.

Increased issuance tends to be a negative for Treasurys because it makes the existing debt less attractive. What's more, when President-elect Barack Obama takes office, he is expected to lay out a multibillion-dollar program to encourage economic growth.

"There will be a heightened desire in a recession for stimulus spending," Tipp added. "Normally, you would expect that to push rates up."

Agencies and mortgages

The Fed and Treasury Department's combined efforts to push down mortgage rates to revive the moribund housing market is expected to attract investors to another type of government debt: agency bonds.

At the beginning of December, the Fed began buying from investors debt issued by Fannie, Freddie and the Federal Home Loan Banks to make it easier for those agencies to finance purchases of mortgage loans.

On Tuesday, the Fed said it "stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant."

The pledge sent credit spreads sharply lower on mortgage-related debt.

The agencies are now paying yields of about 1 percentage point more than Treasurys, down from 1.7 percentage points before the Fed said it would start buying that debt, according to a Merrill Lynch index. Those levels had roughly doubled in the prior six months.

That kind of support from the government, as well as the liquidity offered in the agency-debt market, make agency debt, as well as mortgage-backed securities packaged by the agencies, attractive to investors like Thornburg's Brady.

"Agency mortgages are tremendously interesting right now," he said. After putting Fannie and Freddie in conservatorship in early September, "the agencies are owned by the U.S. government right now and are clearly tools for the U.S. government" to make mortgage rates more favorable.

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