Moody's Analytics **Middle East Risk Solutions Newsletter**
Issue 03, February 2010

Market signals to watch for

Based on an interview by Banker Middle East with David Munves, Managing Director at Moody's Analytics, published in Sept 09

David Munves, Managing Director, Moody's Analytics

Searching for the right signs and aiming to understand what the market is actually telling him, Robin Amlot investigates where to look to ensure your credit portfolio and your equity portfolio don't provide any nasty surprises

Anyone managing an equity portfolio or a credit portfolio will have had a stomach-wrenching ride over the past couple of years. Many traders and fund managers who thought they could walk on water sank without trace. But there are market signals that are at least potentially reliable indicators that one should be watching. The question is, "Which are the right signals for the portfolio under management?" because, to state what should be obvious, different signals mean different things to different people.

Some market watchers would have us believe that more than one market signal is now suggesting that the worst credit crisis since the 1930s is easing, noting the return of private investors to markets they had shunned as recently as the first quarter this year, a surge of corporate debt issuance, and the easing of inter-bank lending rates.

But can these all be taken at face value? David Munves, Divisional Managing Director of the Capital Markets Research Group at Moody's Analytics offers perhaps one cheer, "Nine months ago there was widespread talk of a 'depression' for the world's economy. There were also real fears of a systemic blow to the global financial system. I think the concerted efforts of regulators and governments around the world have largely removed those concerns."

LOOKING FORWARD

While others cite a revival of corporate bond issuance and the narrowing of spreads from their peaks as good news, Munves is more cautious, saying, "Credit spreads are good signals of the credit market's view of risk. Markets are forward-looking, of course, so the fact that spreads have fallen quite a bit in the past few months is a reflection that the market expects the major economies to recover. Indeed, this is consistent with indications that the world is beginning to emerge from recession. However, the rate of default in the corporate bond market will not peak until the autumn, in our view, signalling that underlying risks remain significant.

"Shareholders are often happy to invest in a high-risk, high-reward company, since they have unlimited upside. But their interests are not always aligned with the interests of the firm's creditors."

"Credit spreads are down significantly from their high levels, but are still historically elevated. The average spread on Barclays Capital's US high yield index is 785 basis points, above its long-term average of approximately 550 basis points. It was as low as around 250 basis points before the credit crisis hit."

However, given the pricing of systemic risk in the markets at the beginning of the year, when the sky did not fall it was not unreasonable to see a rally. Whether that rally should have taken the form it did is another matter - in a record-breaking six-month surge, riskier, US 'junk' bonds returned about 30 per cent in the first half of the year.

"The persistently high level of risk means that institutions are increasingly looking for market-based signals such as credit spreads and signals from the equity market. Nothing can predict the future with certainty, of course. But such signals provide good indications of which credits are more likely to default and which ones are less likely to default," said Munves. "The advantages of using market-based signals are that, firstly, markets are forward-looking and, secondly, market prices instantaneously reflect news and the decisions of a lot of informed people. In other words, there is a lot of 'intelligence' built in."

MARKET INTELLIGENCE

This market intelligence can take many forms. There are a number of key factors worth taking into account. Sales rather than earnings hold the key to the medium-term future for most companies. Cost-cutting may well be propping up corporate earnings in the short term. Thus earnings will not provide a reliable indicator of economic trends. However, such cost-cutting will itself gain significance later in the economic cycle, offering great potential to leverage earnings as economies pick up once more.

Corporate capital spending forecasts are also important. In terms of indicators for the broader global economy, the three sectors whose capital spending guidance are worth watching are technology, industrials and basic materials.

The performance of transport companies and of their shares will also provide valuable clues as to the broader economic outlook. After all, transportation links producers and consumers. These companies are also important energy consumers and their shares will suggest trends for the market outlook for energy prices.

Many transportation businesses, notably airlines, carry a lot of debt (British Airways, for example, was once described as a hedge fund which owned some aeroplanes). Therefore, how shares in this sector perform offer useful clues to the market attitude towards loan-default risk.

SORTING THE SIGNALS

Of course, on a regional basis, market-based signals assume an even greater importance as a result of the relative lack of economic transparency in many Gulf Cooperation Council (GGC) countries. "Logic suggests that, if published company information is not as complete and timely in the GCC as it is elsewhere, then signals from the equity and credit markets become more important in supplementing published information," Munves said.

Across the region's banking sector, the figures that excited most comment in the Q2 results season were non-performing loans and non-performing finance.

According to Munves, "Most investors and credit risk managers look at market signals in the form of credit spreads and equity prices. This is cheap and easy to do. However, just looking at raw equity prices without a model to transform them into default risk probabilities has its drawbacks. Shareholders are often happy to invest in a high-risk, high-reward company, since they have unlimited upside. But their interests are not always aligned with the interests of the firm's creditors.

"Nobody wants a company to go bankrupt, but since creditors just want to get their money back, they're more risk-averse. So while stock price movements do contain information for creditors, it is better to filter the data through a model that extracts the credit risk signal from stock prices. There are a number of analytical tools available - Moody's offers one of them, of course."

Contact Us

For more information, please contact Wael Jadallah at **mena@moodys.com** or +971 4401 9545.