

Commentary

Market Opinions and Topics of Interest

By James A. Bianco (847) 304-1511

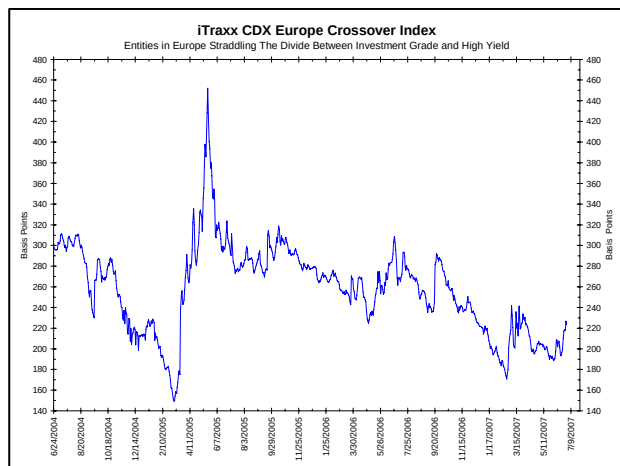
June 29, 2007

Credit Markets - Fear Trumps Greed

We had every reason to expect materially higher CDS costs over the past weeks, and just as we did not see materially wider credit spreads or significantly lower stock prices, we did not see evidence of greater credit insurance. – [Market Facts](#), Suppose They Gave A Credit Crisis and Nobody Came, June 28, 2007

There is an old adage on Wall Street that bull markets climb a wall of worry. Recognized problems are priced into the market. It is the unrecognized problems that produce the greatest damage.

In our [Market Facts](#) yesterday, quoted above, we noted CDS costs have **not** been materially higher in recent weeks. The European picture (below) is similar.



Can We Measure The Crisis?

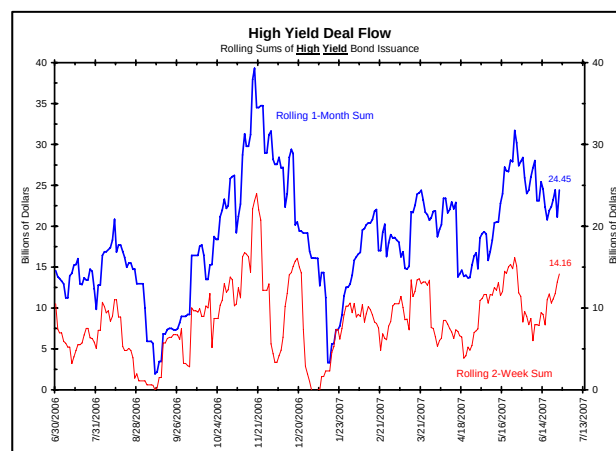
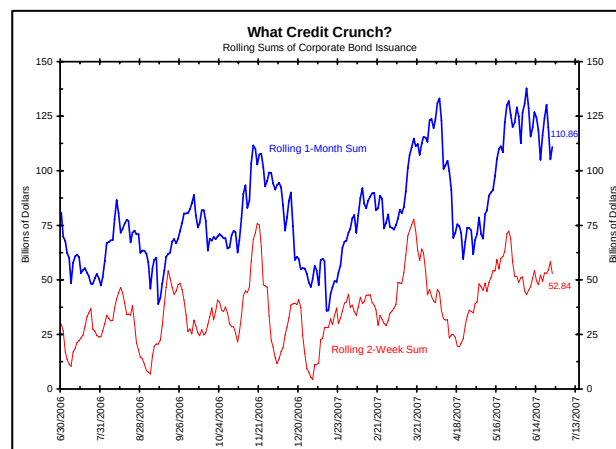
With all the talk about a credit crisis, one would think we could point to specific measures that show it. **We cannot because it has not happened in fact.** Rather we have fear that one might begin.

Many are pointing to press reports of high-yield investors balking at pending deals; surely this must be a sign of a credit crunch?

We are not aware of any measure of deals *not* getting done. But we can measure the number of deals getting done, and it is not falling as we might expect in an actual credit crunch.

The charts below show the amount of corporate bond issuance both on rolling 1-month basis (blue

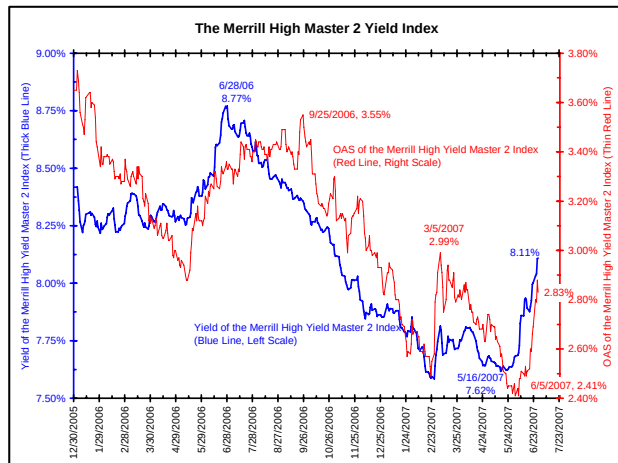
line) and rolling 2-week basis (red line). The first chart is for all corporate bond issuance and the second is for high-yield issuance only. These charts are current through June 27.



We see no signs of a credit crunch in these charts. In fact, high-yield issuance over the last two weeks has been among the heaviest seen all year.

What about spreads? We have been using the chart below frequently in our [NewsClips](#) product. Today we said:

While it is true spreads have widened and the absolute level of yields has risen in recent weeks, we would not term these rises as punishing. Admittedly, they are beginning to approach levels that might be considered punishing, but they are not yet there. Further, see yesterday's [Newsclips](#). We had a ton of stories worrying about a credit crunch, yet spreads actually narrowed 5 basis points yesterday.

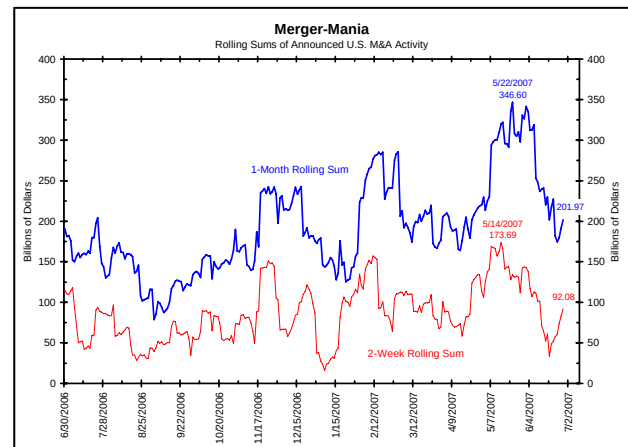


So, even if we measure spreads, it is hard to point to an actual credit crunch underway.

Is The Buyout Boom Over?

Bond issuance, including high-yield deals, are getting done, albeit with more advantageous terms for bondholders. Won't this lead to a reduction in M&A activity and drive stock returns down?

The chart below shows the pace of activity of M&A over the last year. The blue line is a rolling 1-month sum. The red line is a rolling 2-week sum.



It does appear that M&A activity has declined in recent weeks. Maybe it is bouncing back (recent rebound in the red line), but it remains to be seen if this is sustainable.

On its face this should be bearish for stocks. In a [Commentary](#) last month entitled, "Private Equity/M&A How They Drive Stock Returns And Corporate Bond Issuance," we showed the following table illustrating how big an influence M&A activity has had on stock returns.

M&A Activity's Affect On 2007 S&P 500 Total Returns

Through June 27, 2007

Period	Days	% of Days	Total Return	Comment
All of 2007	128	100%	7.17%	Avg. Day = \$10.9B Announced MA
Top M&A Days	20	16%	3.88%	All M&A Days Greater Than \$16.4 Billion
Bottom M&A Days	20	16%	1.38%	All M&A Days Less Than \$2.0 Billion

Data Source: Bloomberg (MA <go>)

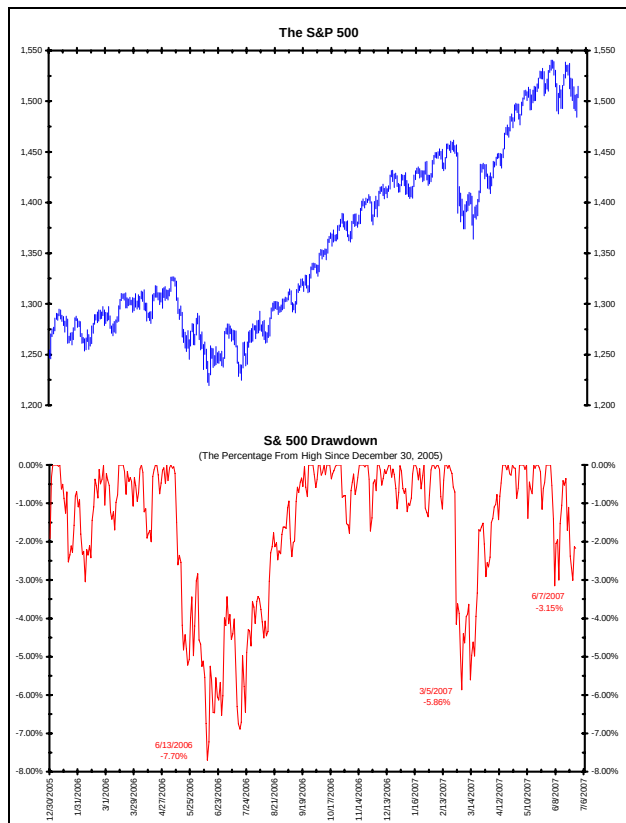
M&A Activity (MAATUS) = M&A announced transactions, US, is the daily sum of mergers, acquisitions, divestitures, self-tenders and spinoffs announced involving either a US target or acquirer. All Amounts not in US dollars have been converted using the spot rate on announcement date of the transaction. The values are based on a seven day week that begins on Saturday and end on Friday. All daily values for Monday include activity from the previous weekend. These include terminated transactions.

The 20 largest M&A days, with deals totaling \$16.4 billion or more, accounted for only 16% of the trading days this year, but accounted for over half (54%) of the stock market's total return. The stock market does well on days that have a lot of merger announcements.

Conversely, the 20 smallest M&A days, with deals totaling \$2.0 billion or less, also accounted for 16% of all trading days. However, these days only accounted for 19% of the year's total return.

This relationship makes sense as M&A premiums are driving valuations and thus stock returns. Reduce M&A activity and stock market returns should suffer.

One problem with this reasoning is the stock market does not seem to be bothered by this fall in M&A activity. As the chart below shows, stocks have barely corrected 3% in recent weeks (if 3% can be called a correction), the smallest such correction in years. If M&A activity was reversing, we should expect to see more than a 3% correction.



Conclusion

Fear is dominating greed in the bond market. **There is not an actual credit crunch taking place. M&A activity has not stopped.** The fear is fixed-income investors will demand so many concessions to buy the bonds to finance M&A deals that private equity firms will not be able to make money. This will lead them to walk away from pending deals or stop future deals. Investors fear this is going to happen imminently. Why? As we wrote [yesterday](#):

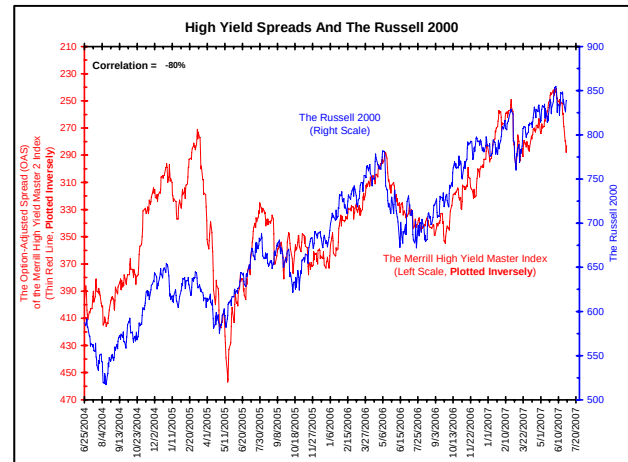
[T]he financial system is aware of its own high degree of leverage and multiyear excesses: Everyone is aware everyone else could be the source of the next problem.

[Years ago](#) we noted that Wall Street does a poor job of predicting issuance calendars and M&A activity. **Today's credit crunch is predicated on the belief Wall Street now has an ability to see these things into the future.** Maybe, but we have our doubts.

What is not in doubt is a wave of fear has gripped investor thinking. Such thoughts are always dangerous to one's performance. How to play this?

So long as equity prices do not close below their June 7th low (S&P 500: 1,490.72), any credit crunch has been held at bay. If stocks make a new high, this entire episode will be reduced to a trivia question for *The Wall Street Journal's* year-end news quiz.¹

If, however, stocks make a new low, all bets are off. A credit crunch becomes more likely. As the chart below shows, high-yield spreads probably will continue to widen with lower stock prices.



Here as elsewhere, the stock market will dictate the general market environment.

¹— the largest point decline in the Dow Jones Industrial Average in 2006 was 214 points on January 20, 2006. The news story, which gripped world's financial markets in a panic was the Japanese internet firm Livedoor was shown to have engaged in fraudulent accounting practices. Japan had its version of Enron and this was the trigger than would usher in a bear market. At the time this was a **very** big deal.

Within weeks stocks rebounded from these losses. Within months most astute observers of the financial markets forgot all about this episode.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511

Fax (847) 304-1749

e-mail: research@biancoresearch.com
<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599

James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

Ryan Spokas rspokas@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 625-1860

Fritz Handler fritz.handler@arborresearch.com

Norma Mytys norma.mytys@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
<http://www.arborresearch.com>

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602

Daniel Lustig dan.lustig@arborresearch.com

Phone (866) 877-0266 Fax (312) 269-1681

New York Sales Office

The Chrysler Building, 405 Lexington Ave
New York, NY 10174

Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57

London England EC2M 2QY

Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com

European Sales

James L. Perry james.perry@arborresearch.com

Phone (847) 756-3510 Fax (847) 304-1595

Rich Kleinbauer rich.kleinbauer@arborresearch.com

Phone (41) 22 363-9229

Far East Sales

Robert Reynolds robert.reynolds@arborresearch.com

Phone (847) 756-3680 Fax (435) 647-3073