Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

Update on U.S. Credit Markets

Euro Sovereign Debt Woes Spark Uptick in U.S. Borrowing Costs

KEY TAKEAWAYS

- **Anxieties about European sovereign debt issues have sparked concerns about financial contagion in the world's still-fragile credit markets, with potential impact on the trajectory of global economic growth.**
- **Indeed, U.S. credit market conditions have deteriorated in recent weeks amid the European financial turmoil, leading to higher borrowing costs for some (particularly corporate) issuers.**
- **However, current credit market conditions are nowhere near as strained as they were during the 2008-'09 global financial crisis.**

The Greek debt crisis interrupted the year-long recovery in global credit markets, leading to increased risk aversion and fears of potentially contagious influence reverberating beyond Europe. Rising borrowing costs may reflect tightening credit conditions and result in slower growth, making them important real-time indicators of how recent events in Europe could impact the global economy. The lending rates in this article offer an illustration of the credit conditions faced by certain U.S. borrowers today.

EXHIBIT 1: Short-term borrowing rates have risen slightly in recent weeks, but remain well below 2008-'09 crisis levels.

Commentary

Short-term borrowing conditions have deteriorated some in recent weeks. Banks have become less willing to lend to each other, as evidenced by a recent doubling of three-month LIBOR and tripling of the TED spread. Furthermore, some European banks have paid higher rates to obtain short-term funding, particularly in dollar borrowing. While the recent increase in short-term borrowing costs reflects a rapid spread in risk aversion reminiscent of the 2008 financial crisis, current rates remain far below the punitive levels seen during the peak of the global financial crisis in 2008-'09, and on an absolute level they also are very low from a historical perspective. Meanwhile, U.S. banks and money markets no longer need many of the central-bank liquidity facilities that previously existed to help stabilize the distress in the short-term credit markets.

Short-Term Credit Indicators[i] (Annual %)

	LIBOR	TED Spread	Counterparty Risk Index
2008 Peak	4.82	4.57	291
2010 Low	0.25	0.11	80
May 2010	0.54	0.38	155

Source: Financial Times, Federal Reserve Board, Credit Derivatives Research, Haver Analytics, FMRCo (MARE) as of 5/31/2010.

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.

- London Interbank Offered Rate (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)
- Counterparty Risk Index – measures the perceived creditworthiness of major credit derivative dealers based on the average cost to insure against a default of their debt obligations.

EXHIBIT 2: Long-term borrowing rates have risen for corporate issuers, but mortgage and muni rates have remained low.

Commentary

Credit conditions for U.S. corporate borrowers have worsened. Investment-grade corporate issuance fell in May from earlier months in 2010, with even more severe declines in Europe.[iii] Several new (U.S.$) corporate issuances were postponed in May, while some successful new issuances were forced to offer large yield premiums. Corporate spreads (yields relative to risk-free Treasury yields) rose in May, reflecting higher risk aversion, though the absolute yields of investment-grade bonds rose only slightly due to the large drop in Treasury yields. However, despite the weaker conditions, corporate borrowing costs and access have remained far better than during the 2008-'09 crisis. Mortgage and municipal borrowing rates stood near historical lows on an absolute basis.

Long-Term Credit Indicators[ii] (Annual %)

	Mortgages	Investment-Grade Bonds		High-Yield Bonds		Municipal Bonds
	Rates (%)	Yield (%)	Spread (bps)	Yield (%)	Spread (bps)	Yield (%)
2008 Peak	6.48	9.09	575	22.65	2130	5.45
2010 Low	4.85	4.27	143	7.96	555	3.33
May 2010	4.92	4.46	187	9.19	698	3.37

Spreads are option-adjusted spreads expressed in basis points (bps). Source: Merrill Lynch, Barclays Capital, Bloomberg, Haver Analytics, FMRCo (MARE) as of 5/31/2010.

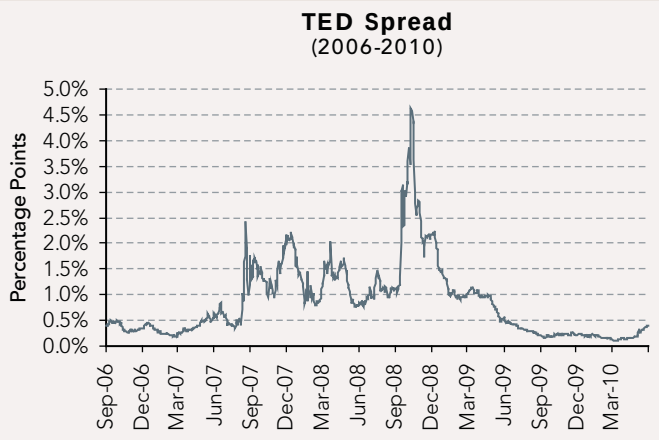
Long-term rates provide a gauge for how well corporations, municipalities and other borrowers are able to fund their long-term borrowing needs.

- Mortgages (conforming) – borrowing cost for a 30-year, fixed-rate mortgage loan
- Investment-grade bonds – rate at which high-credit-quality companies borrow
- High-yield bonds – rate at which lower-credit-quality companies borrow
- Municipal bonds – rate at which municipalities borrow, including obligations of states, cities, hospitals and universities

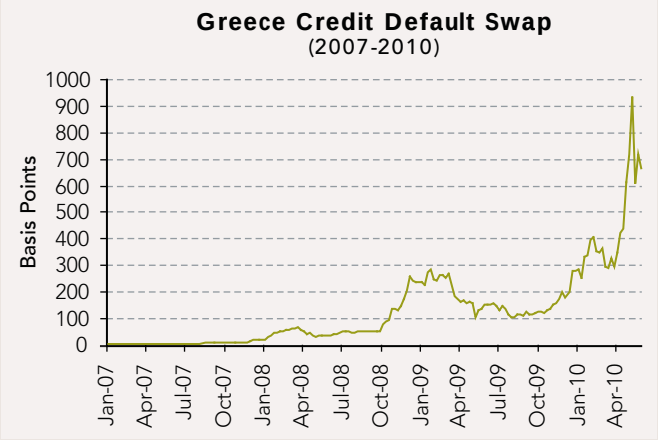
Investment Implications

The recent worsening of U.S. borrowing conditions reflects an increased nervousness among financial institutions, in large part because of the uncertainty around the Euro-region sovereign debt problems and its potential to spread risk aversion through global financial markets. An indication of this can be found in the elevated cost of credit default swaps on Greek sovereign debt, which investors use as insurance to hedge against a default (see Exhibit 3, below). However, so far, increased risk-aversion in the U.S. credit markets has been fairly modest and contained, especially in comparison to the widespread credit market turmoil and unprecedented spike in borrowing costs following the Lehman Brothers bankruptcy in 2008. While some highly leveraged U.S. companies and those with European exposure are paying more for capital than they were a few months ago and issuance levels have declined, the credit-markets have been neither disorderly nor dysfunctional. Given the ongoing concerns about Euro-zone debt woes, however, investor fears about further risk contagion to the still-fragile U.S. credit markets is likely to lead to above-average volatility. Credit markets were central to the 2008-'09 economic and financial downturns, and their ongoing convalescence will be necessary to support the continuation of the global economic recovery. ■

EXHIBIT 3: The recent uptick in the TED spread reflects a modestly higher perceived risk of inter-bank short-term lending (left), while the cost to insure against a default on Greek sovereign bonds has risen more substantially (right).



TED spread is the difference between yields on three-month Treasury yields bills and inter-bank EuroDollar rates (three-month LIBOR). Source: Bloomberg, FMRCo (MARE) as of 5/31/10.



Greece credit default swap represents the annual cost, in basis points, to insure against a default of Greek sovereign debt over the term of a 5-year swap agreement. Source: Bloomberg, FMRCo (MARE) as of 5/28/10.

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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. LIBOR 2008 peak: 10/10/08; LIBOR 2010 low: 1/25/10. TED Spread – the difference between yields on three-month Treasury yields bills and inter-bank EuroDollar rates (three-month LIBOR). TED Spread 2008 peak: 10/13/08; TED Spread 2010 low: 3/16/10. Counterparty Risk Index – represents the CDR Counterparty Risk Index, which measures the average of the market spreads of the credit default swaps of 14 major credit derivative dealers: Bank of America Corp., BNP Paribas, Barclays Bank Plc., Citigroup Inc., Credit Suisse Group, Deutsche Bank AG, Dresdner Bank AG, Goldman Sachs Group Inc., HSBC Bank PLC, J.P. Morgan Chase & Co., Merrill Lynch & Co. Inc., Morgan Stanley, Royal Bank of Scotland Group, and UBS AG. Counterparty Risk Index 2008 peak: 9/29/08; Counterparty Risk Index 2010 low: 1/11/10. May 2010 data as of 5/31/10.

[ii] Long-Term Credit Indicators represented by the following: Mortgage Rates – Bankrate.com U.S. 30-Year Fixed Mortgage Rate. Mortgage Rate 2008 peak: 8/6/08; Mortgage rate 2010 low: 5/25/10. Investment-Grade (IG) Bonds – Barclays Capital® (BC) Corporate Bond Index. IG Bonds 2008 peak: 10/31/08; IG Bonds 2010 low: 4/30/08. High Yield (HY) Bonds – Merrill Lynch High Yield Master II Index. HY Bonds 2008 peak: 12/12/08; HY Bonds 2010 low: 4/27/10. Municipal Bonds – BC Municipal Bond Index. Muni Bond Index 2008 peak: 10/16/08; Muni Bond Index 2010 low: 5/25/10. May 2010 data as of 5/31/10.

[iii] Companies issued 8.75 billion euros ($10.8 billion) of debt in Europe in May, the slowest month on record. Sales in the U.S. fell to $33 billion, the least since November 2008, when issuance totaled $45.8 billion. Source: Bloomberg as of 5/28/10.

You cannot invest directly in an index.

The Merrill Lynch High-Yield 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. Barclays Capital® (BC) 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 BC 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. BC U.S. Treasury Index—an index which covers public obligations of the U.S. Treasury with a remaining maturity of one year or more.

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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