

## Market Update

### Overview

Since our last update in mid March 2009 all asset classes have rallied strongly as the effects of the emergency liquidity injections by the ECB, Federal Reserve etc. began to take effect. Doomsday scenario implied valuations have recovered but structured credit asset prices remain substantially lower than historic “norms”. Liquidity concerns were replaced by solvency concerns as institutions shifted their focus to capital raising from private and/or sovereign sources.

Most financial institutions continue to focus on deleveraging as they look to rebuild their capital base. Banks and insurers worldwide have taken write downs of €1.1trn and raised €1.0trn of capital since the crisis began<sup>1</sup>. Many of the weakest institutions are under de facto control by sovereign authorities and have scaled back their activities. This has led to reduced competition in many markets, which combined with recent asset revaluations has enabled a small group of top tier institutions to prosper.

New issuance in European bond markets reached record highs in 2009 as shifts in investor’s asset allocation helped fund large European corporates. European bond issuance volumes have exceeded the syndicated loan market for the first time, though it is not clear if this disintermediation of risk is permanent or temporary. European corporate cash index returns have exceeded 15% this year as spreads rallied hard. Concerns persist about the availability of credit to consumers and small and medium sized enterprises.

GDP is expected to fall by 3.4% in advanced economies in 2009<sup>2</sup> and though recent indicators point to renewed growth, unemployment continues to rise as do delinquencies and defaults for consumer and mortgage debt.

### ABS Markets

Market activity remains weak as a large segment of the traditional investor base has collapsed (shadow banking sector: SIVs, conduits etc.). Some new investor classes (hedge funds, insurance and pension funds etc.) have been attracted by higher yields but the scale of their involvement is a fraction of the historic demand for ABS product.

Credit trends have continued to deteriorate and this is reflected in widespread rating downgrades.

### US ABS

Arrears and foreclosures in the RMBS market continue to increase month on month. Weak performance first seen in the subprime space has migrated to all RMBS sectors and very substantial downgrades have occurred. Prepayment rates have fallen substantially with voluntary prepayments running in low single digits as borrowers’ ability to refinance is largely closed off.

We expect to see continued pressure on this sector with substantial principal losses for more recent vintages.

### European ABS

Most new issuance is destined for ECB refinancing operations though there have been tentative signs of a gradual re-opening of the primary market (e.g. UK Prime RMBS and German auto loans).

Pressure continues to build in the CMBS sector as falling commercial property values and rising corporate defaults have led to breaches of LTV covenants and ICR breaches.

<sup>1</sup> Source: Bloomberg, 30/11/09

<sup>2</sup> Source: IMF - US expected to fall by 2.7%, Euro area by 4.2%

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### Market Outlook

Many institutions remain reliant on the refinancing operations of the ECB, Federal Reserve etc. and the process of weaning participants off these emergency facilities is one of the main challenges facing the market today.

Credit metric deterioration shows few signs of having reached a peak and AC Capital remains concerned about default risk in the most senior tranches of Alt-A and CMBS exposures.

Market pricing should continue to stabilise as distressed selling pressure has moderated and some new market participants emerge, though the impact of any reduction in emergency refinancing facilities from the ECB etc. may lead prices lower.

The fallout from the proposed restructuring Dubai World's liabilities, an unguaranteed subsidiary of that Emirate, demonstrates the lack of confidence in both equity and credit markets about the sustainability of the recent asset price rally.

We maintain our cautious approach but continue to identify significant relative value trading opportunities in the sector. We would expect to see some pull back in spreads following the substantial tightening witnessed in recent months.