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U.S. CORPORATE FUNDING: RISKS, OPPORTUNITIES, MFR's OPINION

Today we comment to corporate treasurers who: (i) have a need to access U.S. debt capital markets and; (ii) have the flexibility to time their issue(s) over the coming six months.

MFR's OPINION:

Given that market interest rates are already extremely low in absolute terms, and the relatively high possibility that global financial markets could experience considerable turmoil in the not too distant future, it is MFR's opinion that corporations should seek to secure as much liquidity as possible as soon as possible.

While significantly lower yields might be reached further down the road, this would probably only occur in an environment that was not conducive to many corporations being able to access the market.

Moreover, the current low yields in the long end are in part due to fear and safe-haven flows, and are not solely due to expectation of recession. So, in the event (not terribly likely in our view, but possible) that fears that are driving safe-haven flows abate significantly, longer term rates could rise despite Federal Reserve efforts to keep such yields low.

In essence, the main tradeoff that must be assessed at the moment is whether one should hold out for potentially lower interest rates from current already very low levels, but in doing so risk missing the current window of opportunity because markets stop functioning normally. Our opinion is that this is not a prudent risk to take at this time.

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The current situation:

- Treasury yields are at or near all-time lows. Shorter-term yields are at or below the cost of funds and can go no lower.
- While spreads have widened, corporate yields are also extremely low in absolute terms.
- The U.S. economy is facing at best a prolonged period of weak growth, and at worst will experience renewed recessionary conditions.
- The situation in Europe is worse than that in the U.S., with the periphery of the Eurozone crumbling under mountains of debt and many European banks in need of massive recapitalization.
- The Federal Reserve is widely expected to pursue some variation of "Operation Twist", wherein it sells shorter duration Treasuries from its portfolio and buys longer duration Treasuries.

Market scenarios with highest probability (in descending order of probability):

1. **Status Quo:** Treasury yields remain very low or sink even a bit further due to safe-haven flows. Markets continue to function relatively normally. Short-term yields remain at rock-bottom, and the belly of the curve suffers a bit on a relative basis while longer term securities benefit on a relative basis from Federal Reserve actions.
2. **Downward Spiral:** Europe blows up, the U.S. sinks into recession or something closely resembling a recession, medium and longer term Treasury yields move appreciably lower, spreads blow out, markets do not function normally.
3. **Fears Prove Overdone:** Fears of global recession / financial turmoil prove overdone, safe-haven flows to U.S. reverse, placing upward pressure on Treasury yields across the curve, but especially in the intermediate to longer end of the spectrum.

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In our "Status Quo" scenario, there is no rush to issue longer-term debt unless funding needs are pressing. However, if there is a need to issue debt in the 3-5 year range, sooner is probably better than later given the possible market effect of Federal Reserve action if they are selling the short end.

Our "Downward Spiral" scenario presents the largest risks for corporate funding, as in this environment it is very possible (probable, even) that companies could be shut out of the market if the global economy / financial system is wracked by renewed recession and turmoil.

Our "Fears Prove Overdone" scenario, which we do not feel has a very large probability of occurring in sustained fashion, argues for doing as much funding as possible as soon as possible because interest rates would head significantly higher.

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