



## Weekly Bulletin – 30<sup>th</sup> July 2007

The debt markets continued their rally last week as the implications of the collapse of the US sub prime market started to produce a reaction which, in some areas, was not far short of panic. The results were impressive; the USD staged a major rally, the FTSE 100 saw its biggest one day fall in four years and several major transactions were put on hold as the syndicated debt market collapsed.

The US housing market would appear, at first glance, to be producing a reaction in other markets that is difficult to justify. However, a report emanating from Moody's last week suggested that there was considerably more pain to be borne by lenders to that sector as house prices would continue to decline. Further, it suggested that the US economy would react to this problem with growth this year dropping to below 1%. This compares with a current median expectation of something closer to a 3% increase.

The US sub prime market might have been regarded in isolation if there had not already been a variety of commentators raising concerns about the level of debt that borrowers, and particularly Private Equity supported companies, could raise as multiples of EBITDA. The fact that some of these loans had been achieved on a 'covenant-lite' basis and at reduced spreads has simply enhanced the concerns of most central banks and other commentators on the risks that banks were taking. The underwriting banks, of course, are not inclined to hold on to this risk for very long as they pass it down the line through the syndication process or wrap it up in a securitisation, thus spreading any individual risk across a broad spectrum.

While there had been some difficulty in syndicating a few deals over the past couple of months, nothing had prepared the market for last week's collapse in the secondary market. The biggest casualty in the UK would appear to be the circa £9 bill loan facility supporting the Alliance Boots buy-out where the eight banks underwriting the deal have ceased trying to sell down the senior loan portion and have had to produce a significant improvement in terms in order to move the junior tranches. Any problems in the UK, however, are small in comparison with the US where the Chrysler transaction is one of the larger transactions that the underwriting banks can expect to be holding for much longer than they would have expected.

It would appear that the days of covenant-lite loans are already numbered, the improvement in terms that securitisations can produce in comparison with standard bank debt will decline (although loan margins will rise as well) and the more risky end of the market, like high yield bonds, will disappear until the end of the year.

The increase in costs to borrowers is unlikely to be restrained to just the margin. The spread between government bonds and swap rates has risen sharply over recent weeks as investors run to a safe haven in times of uncertainty. While gilt yields have fallen fairly dramatically, the widening of the gilt/swap has reduced the advantage that borrowers wishing to fix their costs may achieve.

In times of uncertainty the FOMC has normally erred on the side of caution and reduced rates to ward off any threat to the financial system. Nobody knows just how large the losses emanating from the US sub prime market may prove to be although the Fed itself has estimated that they could be as high as USD100bn. This may appear a large figure; in itself, it is probably only enough to bring down a series of over geared hedge funds. The problems will come if these and other funds are forced to sell other assets across a wide spectrum, thus triggering off further stop loss points in a sort of wave of pyramid selling.

Our view is that this is a reaction that was well overdue. At the end of a very frothy market in most sectors, it was inevitable that leverage levels, margins, spreads and volatility would come under pressure. The relief should be that it has occurred through a revolt on terms in the syndication market rather than through a default by a major borrower.

This week sees the MPC and ECB meet to set monetary policy. The concerns that the MPC might raise rates two months in a row have almost completely subsided and a 'no-change' decision is confidently expected from both institutions. None of the economic news being released in the UK this week is likely to have much influence on the market, although today's mortgage application figures are expected to show a marked reduction from last month. Credit crunch is an unpleasant epithet to end this bulletin, but its potential likelihood will remain the market's main concern this week.

**JCD Rathbone**