Godsey & Gibb Associates

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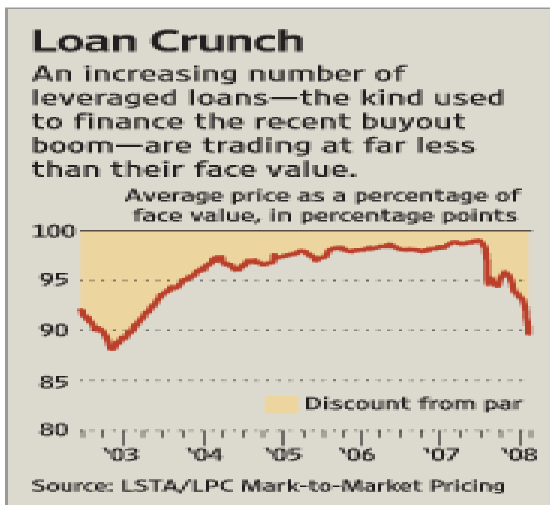
Mid Quarter Update: Credit Issues Spread to Low-Rated Corporate Loans and Municipal Debt, the Economy Slows and the Federal Government Responds

In addition to ongoing weakness in the housing market and higher energy prices, issues in the credit markets recently contributed to slow the pace of economic growth in the U.S. In an effort to minimize the fallout and stimulate economic growth later in the year, the U.S. Federal Reserve, Congress, the President, and other government agencies responded.

Problems in the loan market for U.S. companies with low credit ratings escalated in the first quarter. In recent years, investment banks issued a record number of low-rated loans, known as leveraged loans, to finance private-equity buyouts. The recent decline in investor demand and the market value for these loans is increasingly problematic for investment-banking firms, which still hold a large amount of leveraged loans on the books. With the market value of the loans falling, banks could be forced to sell them in the secondary market at prices below face value, which could lead to increased losses, additional capital depletion and tighter lending standards.



Source: The Wall Street Journal

Godsey & Gibb Associates maintains no direct exposure to leveraged loans. The majority of our fixed income investments are in U.S. Government and Agency bonds. When we invest in corporate bonds, the underlying credit rating must be A or better. Moreover, in anticipation of the on-going weakness in the Financial sector due in part to leveraged loans, we proactively reduced exposure to the equity securities of investment banks and regional banks in the second half of 2007.

Municipal-bond-insurance firms, known as the monolines, also came under pressure in the first quarter. These institutions have agreed to repay interest and principal for bonds issued by municipalities should the municipality default. However, recently the monolines branched out by agreeing to insure mortgage-backed bonds, exposing them to the rising mortgage-related losses of late. The mortgage-related losses are forcing the monolines to search for additional capital in order to maintain triple-A credit ratings. One monoline has already lost its top

Source: The Wall Street Journal

rating and requested a breakup from regulators to ensure its future as a going concern. By splitting into two separate companies, one firm could focus on the safer insurance of municipal debt while a second, riskier company, would be responsible for insurance of loans backed by mortgages and other structured products.

Municipal bond insurance allows low-rated municipalities the ability to issue debt that trades like more highly-rated bonds. The value of municipal bonds insured by the monolines is dependant on the underlying credit rating of the insurance firm. As the credit ratings of the monolines fall, the insurance becomes less valuable. Without the backing of a top-rated insurer, the market value of municipal bonds that would have low credit ratings without insurance will decline to price levels of similar low-rated uninsured bonds. As the credit risk of the monoline insurers increases, billions of dollars worth of low-rated municipal debt could be at risk of losing its value.

However, for high-quality municipal bond investors like Godsey & Gibb Associates, the risk of loss to principal and interest is minimal. We only invest in highly-rated, investment grade municipal bonds, rated A or better. This focus on quality minimizes the need for insurance. When we invest in insured bonds, we invest in bonds with underlying ratings of A or better. As credit issues related to the municipal insurers persist in the market, we believe investment grade municipal bonds continue to offer investors attractive, tax-advantaged yields. We believe that low-rated, non-investment grade municipal bonds, which we avoid, are most at risk.

As we anticipated, the continuation of the credit crisis has impacted the overall growth of the economy. Year-over-year growth in gross domestic product in the fourth quarter of 2007 measured just 0.6%, down from 4.9% in the third quarter. Additional signs of economic weakness have emerged in slower consumer spending, lower employment levels, and slower manufacturing and business services activity.

Policy makers have responded to the weaker economic data with a number of stimulus measures. Fed Chairman Bernanke testified that, "more-expensive and less-available credit seems likely to continue to be a source of restraint on economic growth." The Fed cut its short-term policy rates aggressively in the quarter and he said it, "will act in a timely manner to support growth and to provide adequate insurance against downside risks."

In addition to actions by the Fed in the quarter, President Bush and Congress signed an economic stimulus package with $168 billion in provisions. The measure will provide one-time payments based on specific income levels of up to $600 for individuals, $1,200 for couples and $300 additional dollars for each child. The IRS will begin mailing checks in May to more than 131 million households. Moreover, the bill allows for more rapid depreciation of capital investment by businesses and a temporary increase in the conforming loan limits for Fannie Mae, Freddie Mac and the Federal Housing Authority. The later provision makes less expensive credit more readily available.

Lastly, the U.S. Treasury, the Department of Housing and Urban Development, Fannie Mae and seven major U.S. lenders introduced a program named "Project Lifeline" to aid distressed homeowners. The program will apply to many loan types including prime and sub-prime mortgages, as well as home-equity and second-lien loans. The plan will offer a 30-day freeze option on foreclosures for borrowers who are more than 90-days overdue in order to possibly modify the terms of the loans.

While we believe these policies will eventually stimulate economic growth, the recently enacted measures will work with a time lag. Therefore, we have become more cautious about the economy in the short-term and believe that the possibility of an economic recession is heightened. As such, we have proactively raised cash levels across portfolios to minimize volatility and preserve wealth until the visibility for economic growth improves.

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