Leveraged Loans, CLOs, RMBS, CMBS, and ABS

- **Summary Comments**

A little over a year ago, in a missive dated April 2009, we were discussing how much each of the following contributed to observable prices: fundamentals, technicals, liquidity and fear. At that time, the Dow Jones traded from approx 8,000, hit a low 6,470 and bounced back to 7850, with other major equity indices following a similar pattern.

After more than a year of predominately positive price action, the implementation and removal of various government initiatives, and a return to more "normalized" markets, the battle wages on; however, one other contributing factor has become more observable in prices - *hope*. For anyone fortunate enough to have witnessed the "rolling thunder" storms that rumble across the great plains states of the U.S., where you can see and hear a storm coming at you from miles away with all of its blustering fury, and all you can do is run for cover and brace yourself for the power of mother nature, recent events may have a similar look and feel.

Start with a small "subprime" issue in sunny warm states, watch it roll into a funding/liquidity predominantly U.S based issue, and then debate the scale of damage caused to the U.S. consumer. A lull in the storm offers a brief reprieve and then the storm moves onto the European Sovereigns, of course starting with the smaller sunny sovereign states, with fear building that it may move to the larger sovereign states, and then potentially back to the U.S. to rain on all the local and state municipalities.

However as opposed to the "duck and cover" actions taken when the thunderstorm rolls across the plain states, *smart experienced credit managers prepare for and are ready to take advantage of "rolling thunder" in the global markets*. One cannot deny that for the foreseeable future, there will be strong macro rallies, where weaker credits will be lifted by strong market sentiment, only to be followed by violent corrections, where stronger credits will get pushed as overleveraged institutions look to de-lever into illiquid markets.

The current primary fears are derived from European Sovereign risks, potential political risks in Asia and the Middle East, the BP mess, and the highly touted death of the American consumer. However recent fundamental news, such as corporate earnings, auto and home sales, consumer spending and lastly consumer sentiment is offering some comfort to the battle fatigued. As of the end of May, equity markets are down 10%, loan prices are off as much as 8-10 pts from the high and structured products have almost ceased trading since the "flash crash" of May 6th. MJX strongly believes that these large fluctuations (and subsequent ones sure to follow) offer opportunities to many credit investors, as they allow for better entry points into stronger credits and structures, and exit (short) of weaker credits and structures as all boats gets lifted on the upswing.

- **Leveraged Loans**

The corporate credit market is a market typically measured in basis points. We invest in assets with basis point (sometimes hundreds of basis point) spreads over an Index. To achieve a positive return, we have to realize a yield greater than realized credit losses. Credit losses are realized in several ways such as by holding through a bankruptcy and obtaining a recovery, or by selling the debt in the secondary market either before of after default (the further from the default the better). Sale proceeds are then reinvested in assets with a better risk/return profile in the further pursuit of yield. This fairly simple concept is made to seem easier when Moody's reports that over 98% of single-B (99% of double-B) issuers did not file for bankruptcy or engage in a distressed exchange during 2008.

During 2009, almost 92.3% of single -B (97.6% of double-B) issuers did not file for bankruptcy or engage in a distressed exchange. Expectations for 2010 are that more than 97% of single-B issuers will not file for bankruptcy or engage in a distressed exchange. With the three year 2008-10 period reporting over 95% of single-B and 98% of double-B issuers meeting their contractual debt obligations, a credit investor and manager might be lulled into statistical complacency even as credit defaults remain above historical averages. After all, 4-6% defaults were ordinary during this period, but it is important to emphasize that the difference between 95% not defaulting and 96% not defaulting is not the 1% many practitioners discuss - but from the leveraged investor point of view, a 20% difference in defaults and a similar difference in related investment performance. For this reason, investors should identify managers that performed well during the recent market crisis.

The technical overhang of leveraged loans that was so evident in early 2009 and dissipated in early 2010 has once again appeared, driving prices lower. However the current spread widening is at odds with the visible fundamental credit performance of the companies which are borrowing the money, thus MJX views this as an opportunity for investors to extract excess return for the risks involved.

- **Structured Credit**

The securitized mortgage market landscape has evolved from the "bank game" of using TARP (2008) money to buy many of the same assets which created the crisis to opportunity funds (2009), to increased exposure of broker dealer balance sheets (2009-2010) to recently a strong feeling or sense of the market being once again worriedly long. Credit curves are moving substantively higher and steeper with very limited trading activity as the longs can not find any bid in close relation to just a few weeks ago, particularly for longer duration or mezzanine tranches.

While CLO tranches have behaved in similar fashion to the mortgage tranches, the price movement has been much more muted, while durations are slightly extending and the curve steepening, cash flow equity tranches (1st loss) are retaining a reasonably strong bid. MJX feels this reflects the positive underlying fundamentals regarding the underlying corporate collateral as well as the robust nature of the CLO structure (strong equity bid), while at the same time recognizing the fears regarding the banking industry and potential supply of senior tranches (weakness in debt tranches).

With consumer based securitized assets - the two main concerns are (1) unemployment and (2) regulatory changes which may have an adverse effect. For example, Credit card charge-off rates were generally in the 3%-4% range in the late 1980s, when securitization of credit cards was still in its infancy, according to data from the Federal Reserve. At that time, credit card accounts were mainly issued to a bank's customers with well-known credit histories. The credit crunch of the late 1980s and the recession that followed pushed charge-off rates higher, to the 5% - 6% range, though charge offs recovered as the economy began its recovery in the mid 1990s. In early 2008, both charge-offs and the unemployment rate were at approximately 5%, prior to both spiking to 11% and 10%, respectively, by early 2010. We expect consumer based assets such as credit cards and autos to perform well but for reasons that take on a "new normal" flavor, thank you Bill Gross. While structural unemployment may stay stubbornly high, charge-off rates are likely to decline as credit card lenders work through the problem accounts in their portfolios. Tighter lending standards for credit cards and autos are already in place and consumers (bloodied yes, but unbowed) are still unable to take on substantial additional debt. Additionally, as published by Corelogic on May 10, 2010, 11.2 million, or 24%, of all residential US properties with mortgages were in negative equity at the end of Q1 2010, with approximately 10% of these having mortgage debt 25% greater than the value of the properties. More regulation of the credit card business may mean that lenders will be less willing to make incremental loans.

- **Trading data points**

While heavy cross winds continue to fan the debate between fundamentals and technical's, MJX views the risk adjusted expected returns across many fixed income assets as a generational opportunity. Credit fixed income investments, rightly or wrongly, are trading with parallel similarity to the global equity markets. However, if a sound credit selection or investment process is strictly adhered to, better credit managers on a risk adjusted basis or maybe even outright, may well produce better returns than other assets classes such as global equities.

DISCLAIMER

This report has been prepared solely for informational purposes and is not an offer of investment advisory services or an offer or a solicitation with respect to the purchase or sale of any security. Nothing in this report constitutes legal, tax or accounting advice or a recommendation of any investment or investment or trading strategy. The information contained in the report has been obtained from sources believed by MJX to be reliable but MJX makes no representation as to the accuracy or completeness of such information. MJX accepts no responsibility for any loss arising from the use of this report or its contents. Opinions contained in the report are subject to change without notice.

MJX ASSET MANAGEMENT LLC
12 EAST 49TH STREET, 29TH FLOOR ● NEW YORK, NY 10017
Telephone: (212) 705-5300 ● Facsimile: (212) 705-5390