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`Armageddon' Prices Fail to Lure Buyers Amid Selling

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Credit markets have fallen so far that they are providing a "once in a lifetime opportunity," and investors are still selling.

Prices of loans rated below investment grade declined to a record low 66.1 cents on the dollar, virtually guaranteeing investors get their money back, based on historical recovery rates, according to data compiled by Standard & Poor's. Yields on corporate bonds show investors expect 5.6 percent of the market to go bust, the highest default rate since the Great Depression, according to Christopher Garman, chief executive officer of debt research firm Garman Research LLC in Orinda, California.

While central banks injected $3 trillion into the global economy, credit markets are tumbling because banks are clamping down on lending, forcing investors to unload assets they bought with borrowed money. The Federal Reserve said Aug. 11 that its quarterly survey shows most "domestic institutions reported having tightened their lending standards and terms."

"There has been widespread liquidation of assets that has nothing to do with fundamentals," said Scott D'Orsi, a partner at Boston-based Feingold O'Keeffe Capital, a hedge fund which has $1.3 billion in assets. "Investors in bank debt are being presented with a vast number of extraordinary opportunities; opportunities that I would characterize as once in a lifetime."

The selling is being compounded by hedge funds and mutual funds dumping holdings to meet redemptions, which may push prices even lower, according to analysts at UBS AG.

Assets Seized

Barclays Plc, the U.K.'s second-biggest bank, is auctioning $642 million of loans seized this week from Dallas-based Highland Capital Management LP, according to people with knowledge of the sale who declined to be identified because the sale hasn't been announced. Hedge funds Tudor Investment Corp., run by Paul Tudor Jones, and SAC Capital Advisors LLC, managed by Steven Cohen, sold assets this month to raise cash as stock prices dropped, according to people with knowledge of the sales.

Barclays spokesman Brandon Ashcraft, and Jack Yang, a partner at Highland, declined to comment.

Prices of high-yield, or leveraged, loans tumbled 22.2 cents since Sept. 9, and are down from 95 cents on the dollar since the start of the year, according to New York-based S&P's LCD unit. Because bank debt holders typically recover about 70 cents on the dollar in bankruptcy, almost every loan in the market would need to default before investors would lose money, LCD said.

Corporate debt has been pressured by "incessant selling by hedge funds and leveraged institutions as they unwind," Bill Gross, manager of the world's biggest bond fund at Newport Beach, California-based Pacific Investment Management Co., said in a Bloomberg Radio interview today.

`Priced in Armageddon'

New York-based BlackRock Inc., the biggest publicly traded U.S. asset manager, asked investors to commit more equity to a $3 billion fund that owns bank loans to reduce its leverage, according to Ron Schmitz, chief investment officer for Oregon's state pension fund, which this week agreed to invest an additional $72 million.

Corporate bond prices plunged to 79.9 cents on the dollar on average from 94 cents at the end of August and 99 cents at the end of 2007, according to index data compiled by New York-based Merrill Lynch & Co.

About 90 percent of the market trades like high-yield, high- risk, or junk, debt, Garman said in an Oct. 3 report to clients. Prices imply a 5.6 percent default rate, the most since the record 8.4 percent in 1933, he said. Junk bonds are rated below BBB- by S&P and Baa3 at Moody's Investors Service.

"It's quite possible that we had priced in Armageddon," said Robert Gahagan, head of taxable fixed-income in Mountain View, California at American Century Investment Management, which oversees $23 billion in fixed-income assets.

`The Big Picture'

Wall Street firms have curbed lending after taking $661 billion of credit losses and writedowns since the beginning of last year, according to data compiled by Bloomberg. The collapse last month of Lehman Brothers Holdings Inc., the fourth-largest securities firm, sparked a new round of selling as investors became concerned that more banks may fail, curbing lending even more.

The sales may hamper efforts by Treasury Secretary Henry Paulson to unlock credit markets and challenge the next president as a slowing economy drives prices even lower. Industrial output fell 6 percent in the third quarter, the most since 1991, and a factory index for the Philadelphia region hit an 18-year low this month, Federal Reserve figures showed yesterday.

"The big picture is the economy is just starting to deteriorate," said Mark Kiesel, executive vice president at Pimco, who runs $180 billion in corporate bonds. "We still think there are a lot of redemptions and hedge fund liquidations coming."

No `Turnaround'

Hedge funds may be forced to dispose of half their $135 billion in high-yield loans to fund redemptions, Stephen Antczak, a UBS credit analyst in Stamford, Connecticut, wrote in an Oct. 10 report to clients. That may send loan prices as low as 60 cents, he said.

“The de-leveraging that we’re witnessing will probably continue,” said Paul Scanlon, team leader for U.S. high yield and bank loans at Boston-based Putnam Investments LLC, which manages $55 billion in fixed income. “My sense is that’s not turning around in the very near term.”

The biggest hedge fund run by Citadel Investment Group, which manages $18 billion, fell as much as 30 percent this year because of losses on convertible bonds, stocks and corporate debt, people with knowledge of the returns said. Citadel founder Kenneth Griffin blamed “reduced availability of credit” for the declines.

Commercial Mortgages

Investors withdrew a record $43 billion from hedge funds in September, according to TrimTabs Investment Research, which has been tracking the data since 2000. The industry had declines of 9.4 percent this year through the end of September, according to Chicago-based Hedge Fund Research Inc., the worst year in two decades.

For buyers to lose money on some top-rated bonds backed by mortgages on offices, hotels, apartment buildings and other commercial properties, the circumstances would have to surpass the worst conditions on record, according to Darrell Wheeler, global head of securitized strategy at Citigroup Inc.

Commercial-mortgage securities rated AAA that require an unprecedented three-quarters of the underlying loans to default for any loss of principal are trading at about 70 cents, according to New York-based Citigroup.

“We’re not at these prices because of the fundamentals: We threw those out the window a year ago,” he said. “This is strictly people want to sell something to raise cash, and it’s easy to sell these CMBS because it’s a liquid market.”

Yields on AAA commercial mortgage bonds were at a record 620.7 basis points over benchmark swap rates on Oct. 15, up from 47.8 basis points a year ago, according to Bank of America Corp. A basis point is 0.01 percentage point.

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