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A DISCUSSION PAPER FROM FRANKLIN TEMPLETON FIXED INCOME

Investment Grade Corporate Credit Markets: June 2009 Update

Spreads on investment-grade corporate debt have tightened from their historic wides of 2008. Is there still opportunity in the sector?

INTRODUCTION

In December 2008, the Franklin Templeton Fixed Income Group published a white paper titled *Investment Grade Corporate Credit Markets: Where Do We Go From Here?* One of our conclusions was that while we expected to see short-term volatility, we believed the sector offered an attractive investment opportunity, both in terms of current yield and the potential for capital appreciation should spreads tighten. In this follow-up piece, we provide a brief overview on what has happened to the global financial markets thus far in 2009, the state of corporate credit fundamentals, and our current views on the relative value of investment-grade corporate bonds.

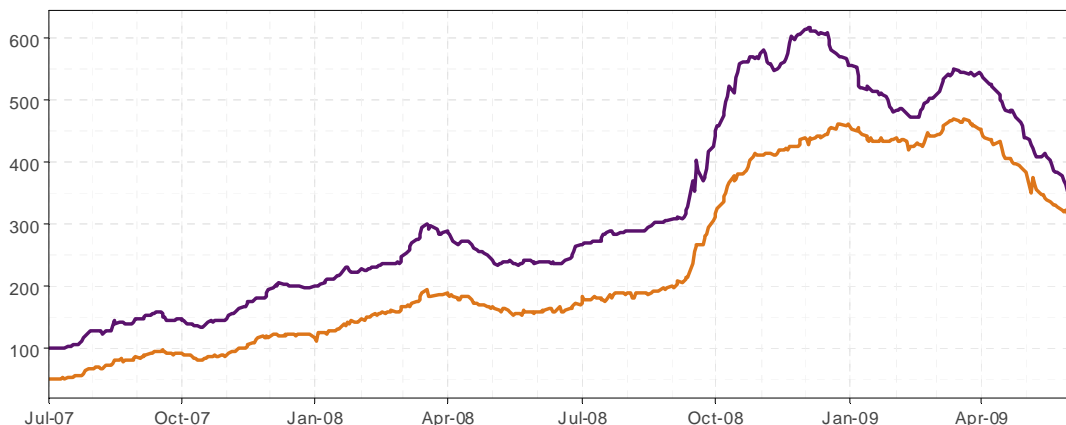
VALUATIONS

Although corporate spreads have been volatile since the start of 2009, we have witnessed a sustained tightening trend since early March. As of 5 June, U.S. dollar-denominated corporate bond spreads, as measured by the Barclays Capital U.S. Corporate Index, were 325 basis points (3.25%) above government bond yields. This was significantly tighter than the 560 basis points level that we cited in our previous paper, or the subsequent spread peak of 618 basis points. It is important to note that despite the recent rally, spreads have remained well above the historical longer-term average of 166 basis points.

We have seen a similar situation in Europe. Yield spreads on the Barclays Euro Corporate Index were 305 basis points on 5 June, compared to the 419 basis points as of the end of 2008 and the subsequent peak of 469 basis points. The historical average spread since the birth of the euro market over 10 years ago is 104 basis points.¹

1. Source: Barclays Capital's POINT® system.

U.S. and Euro Investment Grade Corporate Bond Yield Spreads¹



Key	Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change	
—	Left Euro-Aggregate: Corporates - OAS	305.247	48.018	468.922	03/12/2009	235.485	139.54€	4.219
—	Left U.S. Corporate Investment Grade	324.927	97.540	617.958	12/03/2008	322.240	155.49€	5.517

As of 5 June 2009, total returns for the Barclays Capital U.S. Corporate Index had reached 4.9%, while excess returns for the same period relative to comparable duration government bonds were 11.7%. In Europe, investment-grade total returns, as measured by the Barclays Capital Euro Corporate Index, were 4.5% and excess returns reached 4.6% year-to-date.

Utility bonds have been the strongest performers during the most recent period, while financial issues have lagged due to continued uncertainty in the banking, finance, and life insurance sectors. In an unusual situation, through 5 June 2009, Baa-rated bonds had significantly outperformed Aaa-rated bonds (+17.6% excess returns for Baa issuers compared to -0.7% for Aaa issuers), largely due to the downgrades of General Electric and Berkshire Hathaway.

TECHNICALS

Market liquidity conditions have generally improved since late 2008. The new-issue market has been very active and has been open to a large variety of companies, both in terms of industry and varying credit quality. New-issue concessions were initially wide relative to bonds traded in the secondary market. More recently, concessions have moderated due to strong investor demand. The demand for corporate credit has come both from traditional and nontraditional corporate bond investors and has been exacerbated by the strong tightening trend, which caused many investors to try to quickly add exposure to the asset class.

Strong demand for corporate credit can be seen in the growth of inflows into U.S. investment-grade corporate bond mutual funds. More specifically, Lipper reported a 40% increase in 1Q09 flows versus the same time period in 2008, as measured by asset flows into corporate bond funds in the A and BBB categories. Institutional demand

1. Source: Barclays Capital's POINT® system. All data is historical for the time periods indicated and ended 5 June 2009.

for investment-grade corporate bonds is less transparent, since flows are not recorded in the same fashion. However, there has been a noticeable increase in search activity by plan sponsors and other institutional investors, including a large number of those who are not domiciled in the U.S. Corporate plan sponsors have taken a keen interest in the more attractive yields of long duration investment-grade corporates, especially when matched against longer-dated liabilities.

CORPORATE FUNDAMENTALS

As expected, corporate earnings and credit metrics have been negatively impacted by the severe global economic downturn. The magnitude of the impact has varied by sector and company, but companies in general have reported weaker demand for their products and services, which has lowered profits and diminished cash flow. Many management teams have responded by cutting both operating and capital expenses in order to try to maintain profitability and liquidity. Some companies have decided to preserve cash through dividend cuts, or even raised capital through new equity offerings as equity share prices have recovered. Most companies continue to be cautious about their ability to refinance their maturing obligations and many have proactively sold bonds as market conditions allowed.

Credit ratings agencies have reacted to the weak economic climate and have increasingly downgraded credit ratings or assigned negative rating outlooks to issuers. A number of the rating downgrades to weaker investment-grade credit have caused issues to fall out of the investment-grade indices, although in many cases the yields on these securities were already comparable to high-yield issues.

Among financial issuers, the big news has been the role that governments around the world have taken in supporting the largest, most systemically important financial institutions. From the nationalisation of Royal Bank of Scotland and HBOS in the UK to further capital injections into Citigroup, Bank of America, and AIG in the U.S., we have seen unprecedented actions that have helped reduce systemic risk. The alphabet soup of government programs, including TLGP, TALF, and CPFF, have all helped to stabilise certain parts of the financial system, and the recent bank stress tests in the U.S. will force some banks to raise additional capital. Many banks began the year raising primarily government-guaranteed debt, but in recent weeks a number of institutions have been able to sell nonguaranteed debt, which we view as a positive indicator. More recently, some of the more subordinated bank issues, which had been the biggest losers in last year's downturn, have shown signs of recovery. Loan losses continue to be high, however, and have shifted from subprime mortgages and structured securities into the loans of prime borrowers. Banks continue to increase loan loss reserves for their consumer credit card debt and commercial real estate portfolios. The road ahead for financial institutions is expected to be bumpy over the coming quarters, and financial results are not likely to truly stabilise until we see a sustained improvement in economic conditions.

CONCLUSION

We expect corporate fundamentals to remain pressured in the near term, as profitability and cash flow feel the impact of the global economic slowdown. Yet, early signs of economic stabilisation provide some comfort that the rate of fundamental deterioration is at least slowing, if not bottoming. As we stated in the original paper, we believed that most investment-grade issuers entered the current downturn in relatively strong financial condition.

Current data indicates that most companies should continue to have sufficient liquidity or market access to meet their debt obligations. The global banking system remains stressed, but many of the government support programs have had a positive impact and we expect continued assistance for the most important institutions.

Investment-grade corporate bonds have performed well so far in 2009, but we continue to see good long-term opportunity within the sector since spreads have remained well above historical averages. In addition, corporate bonds may still provide relatively attractive current yields. Corporate bond index yields as of 5 June 2009, as measured by the Barclays Capital Corporate Index, were over 6.5% in the U.S. as tighter spreads have been partially offset by higher government bond yields.

The main spread drivers over the near term will likely be continued investor risk appetite, economic developments, corporate earnings news, and the ability of the market to absorb new-issue supply. The fear of systemic risk has diminished, at least temporarily, but the market will remain focused on the idiosyncratic risk of individual bond issuers in this uncertain economic environment. We expect continued spread volatility over the near term, but

believe that investment-grade corporate bonds remain attractive at current valuations. Our current security selection is emphasising obligations of what we consider to be the strongest and most important global financial institutions, as well as certain relatively stable industrial and utility credits. We have also begun to establish selected positions in more cyclical industrial credits at risk-adjusted yields that we find appealing.

IMPORTANT INFORMATION

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