

TRANSCRIPT

Merrill Lynch Global Wealth Management Webcast

Signs of Strength in Financial Services

January 7, 2010

AQ: Jeff, Guy, thanks for joining me today. We're here to talk about the outlook for financial services stocks and the credit markets in 2010.

Guy, I'd like to start with you. Since I guess roughly the fall, a lot of areas of financial services started a, a recovery and in some cases quite strong. Just give us your sense of how we start the year, have we run too far too fast, and what's the outlook for the rest of the year?

GM: Sure. Well, the, the reason that, that the sector started to do better in the stocks, anticipating that, started to do better earlier last year, was really early hints of, of economic stabilization.

The economy went into free fall as we all know late in 2008 and we've seen stabilization recently, for example, in unemployment and other areas and therefore there's the belief that credit costs, the cost of charging off bad loans, will start to stabilize even though it's been on the rise for quite some time.

And of course for banks that have capital markets activities as a large part of their revenue base, capital markets actually following the fact that, that markets were going up, capital markets activity and the revenues from that were, were actually quite strong during much of last year.

So that's, that's what happened with the stocks. I think as we go into 2010 we're looking at continued improvement, probably on the credit side, it's very slow but, but, but probably going to continue to discount that that's going to happen.

And in terms of capital markets activity, from what we're seeing it's starting off reasonably robustly; we have good pipelines for underwriting activity; M&A is actually starting to recover. So we, we think that the stocks will do well, earnings will continue to improve, although not anywhere nearly at the rate that we saw last year.

AQ: And in terms of the sector getting back to what you might call full profitability or a normal level of, of profitability, when does that happen? Is that in sight at any point of this year, or is it 2011, 2012? How long is it going to take for the industry to rebuild itself?

GM: Well, it'll, it'll take quite a while because, as I said, credit quality is still poor. The losses that, that banks are experiencing on consumer credit, mortgages, credit card debt, are still very high and won't really start to get better until unemployment has been stable and even starts to improve a little bit and probably until the housing market shows so, shows more signs of strength.

So I wouldn't expect credit costs to get much better until much later this year or, or really more likely into 2011. And, and, and there are other elements of the core profitability of some of the banks which are probably going to be under pressure for some time for, for regulatory reasons.

Credit card pricing and overdraft fees have all been regulated now in ways that they weren't in the past and many, many of those are, are, are very probably fair regs but they will crimp bank profitability to an extent.

So I don't know if we'll get back to where we were for quite some time but I think the process of healing will continue through this year and it'll probably really accelerate in 2011.

AQ: To just bring it down to the stocks, where are we with the stocks? Are we in the second innings, the fifth innings? How much more of the stock's got to run just thinking through the balance of this year?

GM: I think it really depends on the sector and, and what the business mix of the company is. We've, we still like the capital markets names even though they've come very far off their, their bottoms. Some of these names have doubled or more off their, their late 2008 or early 2009 bottoms.

But Goldman Sachs, JP Morgan, which has a, a balance of, of capital markets and credit we think will continue to do well here because the valuations are still not terribly challenging. And on the large cap more regional bank side we like US Bank Corp.

Essentially what we're saying is we, we like the quality names which we think can continue to

see, to see improvement.

AQ: OK, Jeff, well, well, turning to you on credit and by that we mean corporate bonds, '09 was a pretty spectacular year I think in terms of performance so, are we going to see anything like that in 2010 or is that a one off?

JR: It's a one off. It's historically the best year we, we've ever seen and it follows dramatic dislocation in the credit markets. 2009 was the year where debt beat equity broadly across almost every category of, of credit. 2010, it's not going to be able to repeat that.

2010, our outlook is very simple. Credit and the credit asset class should be thought of in its more traditional sense, which is you invest in fixed income and you invest in credit for income.

And most of the returns that are going to be generated out of the credit asset class, they're going to come from the income component and less from the price appreciation. Last year was all about the price appreciation. So we go back to kind of a more normal way of thinking about credit for 2010.

AQ: And just help me a little bit understand the way you're looking at the market, investment grade, high yield. How should investors think about those two parts of the credit market on where they should be focusing their investments or their attention in the year ahead?

JR: So, historically they're very different markets with very different risks and so risk preference and risk tolerance is very important when thinking about decisions between the

two. If we just look at our absolute return forecast for next year, high yield as an asset class has a lot more risk associated with it. So it offers a higher degree of that coupon income that I was talking about.

And as a result it has a higher total return forecast for us in 2010 of around 10% which is right around where its current yields are. But there's a lot more risk entailed in investing in that, in that asset class. And if our more bullish, optimistic outlook doesn't play out then you're going to have more risk of principal loss in that, in that asset class.

High grade by contrast is a lot more defensive. The companies that make up it, make it up are, are a much higher credit quality and so the yield that's on offer is smaller, it's under 5% today. And there's greater interest rate sensitivity because there's less credit risk. So you're taking on interest rate risk, and our outlook on interest rate risk is that rates are going to rise in 2010. So some of the coupon income that's available in high grade is going to be not by some modest increases in interest rates. We're expecting around a 2 to 3% total return for high grade.

NOT SURE WE NEED TO KEEP THE FOLLOWING SECTION WITH ALL OF THE NECESSARY CUTS

AQ: And a question for both of you about the, the banking sector in general. One thing that people are concerned about having seen the tough time that the banks have had is their ability to help finance and support the growth of the economy.

GM: Well, you know, the, the banks today, because they have capital markets and lending capabilities, support the economy really in a couple of different ways. One is lending, as you say, and the other is, is making markets and, and creating liquidity.

The largest banks, the, the nineteen banks that went through the, the, the stress testing program last spring, coming out of that a number of them were required to raise capital in order to be adequately capitalized for a stressful environment.

And then a number of those banks also chose over the, the course of the, the last six months of last year to pay back their TARP investments that the government injected into them and in order to do that they had to go to the capital markets and raise permanent equity capital.

If you look at the capital ratios of these banks they are really extremely well capitalized at this point. So, you know, to the extent that that's an important part of being able to make markets and lend, we think that the largest banks in, in the system are actually quite well capitalized and, and ready to do that.

Part of the issue in terms of loan, the loan growth that we've seen, which is that the actual loan assets have been declining, has been that the, the loan demand among credit worthy borrowers hasn't really been very strong.

Corporates haven't been seeing growth in the economy and so they haven't really been looking to borrow and, and of course many of them went, many corporates actually went into the downturn with excellent balance sheets themselves.

And of course borrowers have been, consumer borrowers have really been more focused on reducing debt rather than taking on new debt. So the loan demand hasn't been that great but we think that as loan demand recovers the larger banks at least will be positioned to, to meet that.

AQ: And you mentioned the loan growth recovering Guy. Where are they, are the early signs of that growth coming from and, and maybe Jeff you can comment on that from a, a public market point of view, where is the bond issuance coming from that's helping finance companies? So maybe Guy, sort of address it from a banking point of view and Jeff, you can follow on and talk about the capital market side of it.

GM: Well, from, from a banking point of view, you know, one of the big areas of loan demand that we saw last year was, was mortgage refinancing because of course rates were, were very attractive and banks were, were pretty tough and even so there, there was a, a tremendous amount of refi activity. That's probably one of the biggest single areas where we actually saw it manifested.

AQ: And what's happening in the public markets Jeff?

JR: Well, you know, when we talk about this credit availability there's, there's something going on in, in, in capital markets that's very interesting, which is, there's a dichotomy between public market activity and, and then the loan demand, the, the Fed data that shows C&I loans, for example, with negative year over year growth.

The public markets are at levels of activity that exceed their peak levels of activity pre-crisis. It's a remarkable turnaround in just a year following the, the worst of the, of the capital markets. So for public bond issuers there's tremendous liquidity and this has benefited the re, the, the returns that we talked about for both high grade companies and high yield companies.

So the capital markets activity has been very robust. We expect it to be robust next year as well. So there's lots of new issue activity, there's lots of refinancing activity and in the corporate space that's pretty much taking you across the credit spectrum for public borrowers.

AND GET TO HERE...

AQ: So an area that it's still a problem I think if the markets are recovering, the banks if demand picks up, have the ability to lend, an area that's out there that people are concerned about is commercial real estate. I think there's a lot of worry about future write downs against major development projects, existing buildings.

So starting with you Guy, how would that affect the banking sector? Is there a big residual exposure to commercial real estate write downs that as an investor I should be worried about?

GM: Well, for, for, for the large universal banks, the ones that are diversified in pre (?) capital markets and, and, and traditional lending, a lot of that exposure was actually held in securities format in the capital markets areas and those banks, for better or for worse, they had to mark it down mark it to market.

That contributed very significantly to the demise of Lehman Brothers and Bear Stearns. But it's done. The banks that are survi—that, that have survived have largely written these portfolios down to much, much lower levels. They put hedges in place against them which over the course of last year were mostly pretty effective.

So that's not that much of an issue for the banking sector any more. The lending side is still an issue. Again, for the very large banks, commercial real estate credit is, is typically not more than 10% of total assets.

As we tick down the list though, as you get down to, you know, bank #30 or bank #40, what you often find is that commercial real estate lending is 50 or 60% of the asset base. So there we think investors need to be very, very selective and we do think that there will be continued pressure on some of those banks. We do expect among the, the smaller banks for there to continue to be quite a lot of FDIC activity, which is code for bank failures.

AQ: And Jeff, you mentioned that the credit markets are really quite healthy. Is there anything from the commercial real estate, real estate space that could shock the credit markets? Or is it off to one side, if you want to call it that?

JR: Well, again, I, I, when I say the credit markets are healthy we're really talking about the public side of the credit markets. When you go to the smaller banks, and you talk about—let, let's, let's be clear, there are a lot of problems in the balance sheet that remain. The strategy has been to stretch out the recognition of those problems to buy time for the hopeful recovery

in the economy.

If you look at, for example, the, the bank regulator guidance on commercial real estate loan modifications, it, it talks about how the losses on a commercial real estate loan should be thought of in the context of the ability to service the loan. If you can still service the loan, that's not necessarily an impaired loan.

And so, you're, you, you have the economy as the key of, if there's still activity in these strip malls and so there's net operating income coming through, even though the prices, the collateral value has collapsed, what you're hoping for is you give it enough time, the economy strengthens where you're still able to service the debt, that the prices go up and you're able to eventually refinance your way out of it.

That remains the big uncertainty and that's why there's this kind of overhang in, of both commercial real estate as well. We have a similar trend going on with regards to residential real estate.

So the best news is the stuff I talked about earlier. That's the refinancing activity in the public credit markets. That's where the health is in terms of refinancing ability. Where you still have a lot of problems are in these loans now held on balance sheets in smaller banks and we've got a lot of future issues and a lot of uncertainty still to work through.

GM: But again, to Jeff's point, you're not going to see the kind of shock to those banks that we saw with some of the investment banks like Lehman that went out because of the marks.

Because they don't have to mark them down, they can simply, you know, as Jeff said, continue to carry them on their balance sheet as long as the debt service is being covered.

(inaudible)

AQ: So Jeff, going back to the, the plain vanilla corporate bond market, at some point the Fed's going to start raising rates so the short end is going to start going up in terms of rates. We expect long term rates to go up for a bunch of reasons. Just explain how that affects, you know, your names, the corporate bond market, and, again, how investors should think about that.

JR: Well, in, in the context of a portfolio, fixed income is generally for income and preservation of principal and we've had the backdrop for the last 25 years of secular decline in interest rates. And we could be going into a secular increase in interest rates. And so what that does is it starts to create principal losses.

The more risk you take in a fixed income portfolio, getting out of high grade debt, getting out of money markets, going into high yield debt, the more you insulate the portfolio's principal from losses from rising interest rates, but you take on other risks such as default risk and, and credit risk.

So we expect rising interest rates and what that means is that when you look at the NAVs of your bond fund, for example, you might see some declines that are going to be offset by the coupon income that's coming through.

The more rapid increases that we see in interest rates, the greater that principal risk is going to dominate fixed income investing and this is going to really kind of challenge the way that we thought about fixed income investing over the last 20 years.

We've been taught to think that fixed income, look at some of the names of the largest funds that are out there, as total return vehicles. Total return vehicles work and make a lot of sense when you're in a declining interest rate environment because, as the Wall Street Journal will remind us every time we read it, right? If the yields go up then the prices go down. Well, yields went down so the prices went up and the total returns were very attractive.

So you go back to some more 1970's style and you open up your old text books and what's the best protection against rising interest rates? It's maturity. That is, you want to shorten the maturity of your investments so that if you're going into a rising rate environment you're getting your principal back sooner that you can reinvest at those longer rates.

That's not really our, our fear and our outlook for 2010 because we only have modest increases in interest rates. But for those who are more concerned about rising inflation and rising interest rates, shortening your maturities is, is a good strategy.

AQ: So that's, that's pretty clear. If you're worried about rates rising, particularly rising fast, you bring your maturity in. Any more specific advice about where people should be in the, the credit world, what, where you see better or less value in that context?

JR: Well, the curve is very steep right now. So the, the, the challenge when you say shorten

your maturity is, well, there's a tremendous yield give-up. I mean, I get 0% in my money funds and if I buy a 5 to 10 year maturity corporate bond I can be out in the 5% region.

So there's a big yield give-up to shortening and the steepest part of the curve is really between 0 and 2 years. So going out the curve a little bit, 2 years, because our horizon of interest rate increases isn't that significant up front, is a very attractive part on the curve.

Locking in 10 year, 15 year, 30 year debt, from my vantage point if you're investing in specific bonds, doesn't make a lot of sense at this point. The shorter part of the curve is more attractive.

AQ: And as we close out here I'll ask both of you one straightforward question which is, when you look at your areas of expertise and coverage and you look at 2010, what's the one key theme that you think is going to play out during the year, the one key theme that investors should focus on?

GM: A theme that I would bring to investing this year because the economic recovery is still so early, so nascent, so fragile, is be very, very selective. Focus on, on business mix, as I said before.

And be nimble. Be ready to change tacks fairly quickly if it turns out that the economic recovery isn't, isn't panning out or if it's something, you know, negative were to happen and we were to slow down again, you might need to change your investment approach very quickly.

AQ: Jeff? Big credit idea for 2010?

JR: Well the big theme for looking at fixed income, both last year and continuing into this year, is if you think about the financial market that is impacted most and first by Federal Reserve policy, low interest rates and quantitative easing, it's credit investing.

And our outlook and our theme for this year is that liquidity continues. The, the Fed's turning off the spigot but they're not yet opening the drain so it's still a positive outlook. But if there's a shift in that outlook and there's, and there's a more up front withdrawal of liquidity, fixed income investments are going to suffer in terms of their principal performance and that's the main theme, liquidity and watching trends in liquidity.

AQ: OK. Well, Jeff, Guy, thanks very much indeed for your time.

END