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Credit to Support Equity Again

Summary

- **Equity markets have NOT completely priced in the improvements in the credit markets**
- **Cross capital structure relative value relationships are likely to dictate some basic management decisions during the 1H10...many of these decisions will reflect the dramatic improvement in the credit markets**
- **At the onset of 3Q09 earnings season we stated that company management teams that announced debt financed share buybacks would be honored as brilliant....the ability to issue low cost debt has increased...management teams unable to tap the corporate market to fund a share buyback are likely to be considered goats...**

The economic recovery is well underway and is likely to gain sustainability as 2010 progresses. We expect that equity and fixed income credit investors will gain greater confidence as progressively easier year over year comparables are exceeded during the first half of 2010 along with increasing confidence that last year's \$787 billion stimulus plan is entering its expansionary "sweet spot." Additionally, last year vicious circle in which credit market weakness negatively affected equity market valuations and economic growth appears to have been successfully broken. The benefits of breaking this vicious circle are not fully priced into the housing, corporate, equity, or structured finance markets, in our opinion. Therefore, we expect that all boats will continue to rise in 2010.

Although we expect that "all-boats will rise in 2010," we also expect that the pace of the global economic recovery and the rise in equity market valuations in 2010 will be determined by improvements in the corporate credit markets and the continued firming of the structured credit markets. **We do not believe that the equity markets have completely priced in the improvements in the credit markets. We also do not believe that credit, equity, or cross capital structure relative value relationships are properly reflecting the dramatic improvement in the credit markets.**

An example of how much the corporate credit market has improved and its ability to influence cross-capital structure relative value can be illustrated by comparing Harley-Davidson's (HOG) last two bond issues. Last February, in order to assure investors and bankers that it was not a liquidity risk, HOG issued a 15% Senior Unsecured bond maturing in 2014. The last week in November HOG issued a 5.75% bond due in 2014 that is currently trading with a YTM of 5.28% and a dollar price of \$102.

That nearly 10% reduction in yield brings HOG's incremental cost of debt back in line with pre-crisis levels even though its equity is trading 47% discount to its December 2007 high. In order to reduce this difference, we expect that firm management teams who are unable to find suitable businesses to purchase will increasingly embrace debt financed equity buybacks as well as implement dividend increases. We expect this to be a major trend in the 1H10.

The improvement in the credit markets has also caused many highly levered companies and banks to give away temporary equity type returns to fixed income investors to protect their equity ownership stakes. As we have published before, we believe the Lloyd's new 12% subordinated issue is essentially an equity security wrapped up to look like a bond. The bond, which came at a spread of greater than 700bps more than its senior secured credit spread, is providing boat loads of return to investors in a government sponsored company.

The recent \$2.5billion dollar CCU issue would also cause us to look at its longer dated bonds more as an equity equivalent rather than cheap survivability option on a company that was recently considered an investment grade company.

Conclusion:

We do not believe the strengthening of the credit markets is completely priced into the equity markets or into individual firm capital structures.

We also expect that attempts to attain "temporary equity" financing from the fixed income credit markets by providing them with equity market type returns will remain popular until equity market valuations rise another 20-30% and make convertible debt issues less onerous to existing shareholders. A spike in IPO volumes and IPO prices will also reduce the length of this trend.

We are reiterating our recommendation...

To be added to our intra-day comments please

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