6% Yields In Senior Loans With A Cheap Market Hedge

We continue to like using a short Euro position in combination with risky assets. In our Fixed Income Strategy we're invested in senior loans through closed end funds such as BlackRock Defined Opportunity Credit Trust (BHL) and ING Prime Rate (PPR). They're both at a modest discount to NAV of around 5%, and yield over 6%. Their portfolios of leveraged loans to non-investment grade borrowers will no doubt go down if equities sell off, but holding this position in combination with a short Euro (we're long EUO) protects against the tail risk associated with Euro sovereign debt problems or Middle East conflict (such as an Israeli attack on Iran). The US has a 3% GDP differential over the Eurozone so over time this should favor the US$ anyway. Short Euro is akin to owning put options on the market – you just need to own something in addition that will generate a return.

There were a couple of interesting articles about energy over the past 24 hours. The WSJ noted that natural gas is eating into demand for coal. Over the past three years natural gas has gone from producing 21.4% of U.S. electricity to 24.4% (coal has dropped from 48.2% to 42.8%). It's a slow process and don't expect near month natural gas to trade at $4 anytime soon. But it does illustrate market forces at work. In another article, Bloomberg notes that the U.S. is on its way to achieving energy independence . By way of illustration, they report that Methanex, the world's biggest producer of methanol, is dismantling a factory in Chile and moving it to Louisiana to take advantage of cheap natural gas. We continue to own Comstock Resources (CRK), which reported earnings yesterday and expects production to be 20% oil by the end of 2012. They have minimal debt, low operating costs and while today's low natural gas prices don't help the company does control its own destiny and trades at a healthy discount to book value (even after taking a reserve writedown in 4Q11).

Finally, Bill Gross wrote an interesting piece on the problem with low interest rates in yesterday's FT. He suggests that QE2 and Operation Twist are keeping long term rates so low that banks don't see much upside in lending there. This slows down the recapitalization of the banking system that a steeper yield curve would provide. Whether he's right that this is slowing growth or not, he's certainly right that long term rates provide little incentive to lend. Long term high grade and government bonds are a safe way to lose purchasing power. An obscure but interesting trade can be found in the eurodollar futures curve. The spread between Sept 2013 and Sept 2014 is 35 or so basis points. The market is pricing for an increase in three month Libor of only 35 bps between 2013 (when a majority of FOMC members expect short term rates to be unchanged) and 2014 (when a majority expects them to be rising). This spread is unlikely to narrow much beyond 25-30 under those circumstances, and an upside surprise in GDP growth (perhaps led by housing?) could cause a substantial steepening in this part of the curve, straddling as it does the point at which the Fed has indicated it will start raising rates. We think it's an interesting trade, there's probably no need to rush into it though.

Disclosure: Author is Long PPR, BHL, CRK, EUO