TD Wealth Management

Investment Outlook

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What are Credit Markets Telling Us?

BY R.J. GORMAN, CFA, CHIEF PORTFOLIO STRATEGIST

In our January 2009 forecast column, we cited improving credit conditions as a positive factor entering the New Year. Subsequent events seem to be bearing this out.

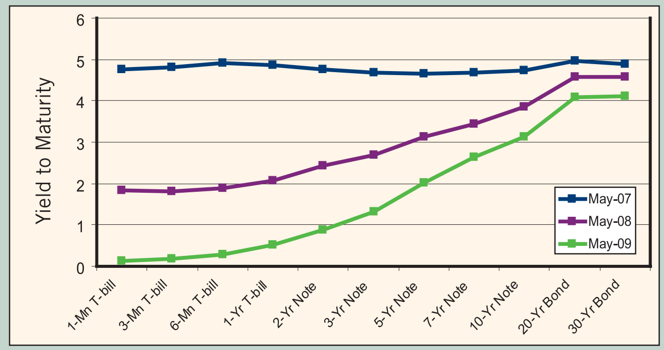
Five Clear Signals

► First, consider LIBOR (the London Interbank Offered Rate), an interest rate between large institutions which can be thought of as a gauge of fear in credit markets – the higher the rate, the greater the fear of not being repaid. From its peak of about 4.8% in late 2008, the three-month LIBOR rate has fallen to 0.8% at the time of writing, one measure of diminishing fear in the system.

► Next, examine what's termed the TED Spread. The "T" in TED stands for Treasury Bill, the yield of which is generally regarded as the risk-free rate of return. The "ED" in TED refers to Eurodollar, a reference to short-term corporate investments with some credit risk. The difference, or TED Spread, between the risk-free T-Bill rate and the Eurodollar rate is another measure of fear that the investor in the Eurodollar instrument will not be repaid. After rising from 1% to over 4.6% last Fall, the TED Spread has retreated to 1%, again signaling a reduction of fear in the credit markets.

► Third is the yield curve, the line or curve depicting the relationship between short- and long-term interest rates. Generally, short-term rates are lower than long-term rates (see Chart), a state called a normal or positive yield curve. The shape of the yield curve is very important for the banking system as our banks tend to borrow "short", taking in short-term deposits such as checking or savings accounts and lend "long" in the form of thirty-year mortgages, for instance. The difference between the short and long-term rates is the banks' "spread" or profit margin. After having been relatively flat in 2007, the yield curve has steepened over the past two years (see Chart), meaning wider profit margins for the beleaguered banking sector and typically, an improving economy.

Steepening of the Yield Curve: 2007-2009



Source: The Federal Reserve

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► Fourth are investment-grade corporate bonds, those issued by America's most creditworthy corporations. In 2008, the dominant theme in the bond market was a flight to quality, with investors flocking to government issues and generally avoiding corporate bonds, fearful the issuers might default on their interest payments. In January, we stated this would change, with a reversal of the flight to quality and greater interest in corporate bonds, with their higher yields. This has happened and new corporate bond issuance topped $824 billion in this year's first quarter, more than double the count in the same period a year ago, another signal of the breakup in the credit logjam. Meantime, the incremental yield on corporate bonds versus Treasury issues is shrinking, yet another display of improving confidence among investors.

► Finally, high yield bonds, sometimes referred to as "junk bonds" are issues that are not deemed investment grade and are more likely to default on interest payments. Due to their higher risk, these bonds respond very negatively to signs of a deteriorating economy and conversely, very positively to any signs of improvement in the economy. Of note, the high yield market was extraordinarily cheap in December 2008, reflecting widespread concern over the economic outlook. Since then, the high yield index is up about 20%, due to a more positive outlook.

While tight credit, foreclosures, credit card default rates and other woes continue to weigh on credit markets, the trends cited above are positive and are key reasons for financial markets' improvement in recent months.

Key Indicators

Apart from the aforementioned improvement in credit conditions, there are other indicators, originally cited in our January 2009 column, that are worth re-stating.

We had identified low stock valuations, expressed as low Price/Earnings (PE) multiples and relative to bonds, as a reason for optimism. The equity market remains relatively inexpensive by both measures, though the recent increase in both stock prices and bond yields have brought valuations closer to the norm.

Monetary and fiscal policies remain very supportive as short-term interest rates continue to be extremely low and the Federal Government injects large sums into the economy. Meanwhile, cash on the sidelines in the form of money market funds remains at an exceptionally high $3.7 trillion, serving as a source of latent buying power as investors become more willing to shift into stocks and corporate bonds in search of higher returns. Finally, a host of economic indicators, from housing to consumer sentiment, while still soft, are showing improvement.

After a difficult start to 2009, which saw the S&P 500 fall as much as 25% from January 1 to the equity market's March 9 low, stocks have rebounded sharply. As investors look ahead to a return to economic growth in 2010, we remain confident in our forecast of solid stock market returns this year.

Transferring vacation property to your heirs

BY TD WEALTH MANAGEMENT

In many families, vacation properties are used by several generations. However, difficulties may arise when the actual ownership of the property passes from one generation to the next. The transfer of vacation property to your heirs raises issues of estate and gift taxes as well as future use and enjoyment of the property.

If you will be in a position to transfer property to the next generation, it's important to start planning today. Here are some things to consider.

Open the discussion. Speak to your children about whether they want to keep the property and share in its upkeep. Involve them in discussions about sharing it and potential upgrades that may be needed. This is a very important step, as the lifestyles and financial resources of your children may differ.

Expanded estate planning. If one child is not interested in the property, you may want to think about equalizing that child's share of your overall estate with other assets.

Hold the property in trust. One way to possibly save on taxes and retain control of the property is through the use of a trust. The trust can hold the property for your children and grandchildren and can even control the future use and disposition of the property. Be sure to advise your children of your decision.

Choose your trustee carefully. Given the complex nature of a trust, think carefully about the selection of an experienced trustee to administer the trust.

Your Private Investment Councel Portfolio Manager can put you in touch with a Private Trust Specialist, who can assist you with keeping the vacation property in the family and other estate planning needs you may have.

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