



THAMES RIVER CAPITAL

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MONTHLY NEWSLETTER

Q & A with Bernt Tallaksen

GLOBAL CREDIT TEAM

Michael Warren: Bernt, has the past nine months been the most challenging period that you have experienced since launching Hillside Apex and subsequently High Income?

Tallaksen: They have certainly been challenging and interesting. However, the first twelve months after the launch of the Hillside Apex Fund would probably count as the most challenging we have seen with the Russia and LTCM crises and later on the Brazil crisis. After that, managing through crises has become an important part of managing the risk of the funds. What makes this crisis special is that it did not originate in an emerging market but in the US, a developed G7 market. Emerging markets have to a large extent learnt from the past crises and with a few exceptions (Venezuela and the like) now conduct fairly prudent macro economic and monetary policies. However one could argue that what has saved them from being the originators of this crisis is that they are emerging markets and with that they have experienced less financial innovation and much lower levels of credit intermediation which means that there was less room for excesses.

What are the macro risks you see at present?

Tallaksen: We see two main macro risks at the moment. The first is that the US slowdown might be deeper and longer than we think. US consumers are already under pressure from high food and energy prices and lower house prices - if the labour market deteriorates even more sharply, consumption might take a big hit, and it accounts for over two-thirds of US growth. With the US financial sector under stress, a credit squeeze would exacerbate the impact on the consumer. And if US growth performance worsens significantly, then this would imply a more serious slowdown in other developed markets such as the Eurozone and Japan - which again could test the resilience of emerging markets.

The second risk is connected to the first: commodity prices might fall significantly if we see a deeper US downturn and therefore a more significant slowdown in global growth. Lower global growth would mean lower global demand for commodities, which would reduce prices. This would pose a secondary specific risk to commodity exporters in emerging markets, with much of Latin America and some CIS countries suffering. On the other hand, emerging markets commodity importers would benefit as pressures on their balance of payments would go down. Moreover, a sell-off in commodities would help cool inflation pressures world-wide, which would

clearly be a good thing, apart from giving central banks greater room for manoeuvre.

However in both of these scenarios there will be some interesting trades to do, particularly in local rates as yield curves are likely to steepen and widen out at the same time as the economies are slowing down and inflation is coming down.

Has the Fed done enough in aggressively cutting rates and by comparison, why has the ECB been so reluctant to follow suit?

Tallaksen: The Fed has responded to the credit crisis in a very frontloaded and aggressive manner. And as our economists are pointing out traditional monetary policy rules such as the Taylor Rule would have actually suggested a smaller interest rate response, given the high headline and core inflation rates. You can also see this in the fact that today current and expected real yields are substantially negative - putting them at the lowest level seen in the US over the last 25 years. But to give the Fed its due, the extent and nature of the credit crisis has called for innovative monetary policy responses: first, the Fed has expanded its toolset in a step-wise manner to address the liquidity problems in the financial system directly; second, by cutting rates sharply, it has pulled money market rates and interest charged on mortgages and other loans down. So we have had both a monetary stimulus to the economy and a positive yield curve. These should provide incentives to banks to re-start financial intermediation and also help them to gradually restore profitability. As such, we think the Fed has done an appropriate job in addressing the credit crisis. We expect another 25-50bps of rate cuts in the near future and further measures to resolve liquidity problems at banks and broker dealers.

It is important to remember that the ECB has been, if anything, even more proactive than the Fed in addressing the liquidity problems faced by European banks, maybe in part because it already had the appropriate tools. However, the ECB has not cut interest rates yet, as the euro area economy is only marginally exposed to the severe problems seen in US mortgage markets and has generally sounder underlying macro fundamentals at this juncture. Also, the ECB's policy mandate is more restrictive than that of the Fed - rather than growth and inflation, it only targets inflation. And with headline inflation running at 3.5% (compared with its objective of close to, but below, 2%), there has been simply no justification for rate cuts in the euro area yet. However, we do expect the

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slowdown in the US to eventually spill into euro area activity and to trigger a couple of rate cuts by the ECB towards the end of 2008.

What opportunities are arising out of the re-pricing of credit and is it too early still to take advantage of these?

Tallaksen: This is a good time to slowly accumulate and cherry pick credits although we do not find the index levels that attractive at the moment after adjusting for expected market defaults. In terms of opportunities we have so far barbelled the new names which are either very strong credits at high single digit yields or more special situations at mid teen yields. As an example we did a two year deal in Russia at L+600 for a very large world player in the metals industry that is 1.75x levered with strong free cash flows. An example at the other end of the spectrum is a deal that we consider to have strong collateral and cash flow stream at a yield of 16.5%. In terms of developed market opportunities we found a three year bond in Europe at 16% yield, which matures before a massive amount of senior bank debt that trades at half the spread. This company is 3.5x levered and it does have some cyclical to it - but with 85% of the debt maturing after this bond you can stress test the numbers significantly before you risk not getting repaid.

Still there are quite a few credits where we do not want to get involved currently. In general this goes for the lower end of the capital structure in cyclical credits where you have a thin layer of debt sandwiched between a lot of bank debt and the equity which is really only an option on the upside - and although the yield's look attractive the possibility of getting zero in a default is very real and the upside in a recovery is limited to the yield - unlike the equity.

The weighting in the distressed area has been low for some time; do you envisage this changing at the next 6-12 months?

Tallaksen: Yes we do envisage this growing over the next year and on. Default levels are at an historical low, hence the low current weighting in distressed. However, as the US and world economy slows, default rates will go up. One thing to keep in mind is that the initial supply of distressed debt will be of the lowest quality i.e. the weakest companies will default first and if distressed investors are lining up en masse to get involved then the price levels initially will not be attractive. However, distressed is a multi year game so there should be sufficient opportunities to get involved along the cycle.

Lastly, returns for both Hillside Apex and High Income have been consistently strong since launch, what do you think will be the level of return over 12 and 24 months?

Tallaksen: The repricing of credit that we have seen over the last six months on the corporate side and to a lesser extent on the sovereign side means that, after quite a lengthy dry spell, lenders of capital can once again get paid well for taking risk, without compromising quality. Having said this we expect that the near term will remain challenging for most asset classes, albeit interrupted by bear market rallies. Our approach therefore is twofold: (1) On sovereign risk, we intend to be cautious but opportunistic; (2) On the corporate side we will look to slowly add on the most convincing opportunities after

carefully selecting the credits as we see the emergence of serious value.

We believe this approach should enable us to deliver returns in the 10-15% range in the medium term for Hillside Apex, consistent with its objective and for High Income consistent with its objective a regular dividend (currently 7% per annum), with the prospect of some additional capital gains in the medium term.