Fixed Income Market Comments

Ascent Investment Partners

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from Montage Investments

HP Fundamentals Offer Solid Intermediate-Term Credit, Despite Moody's Downgrade

On November 28, Moody's downgraded the corporate credit rating of Hewlett-Packard Company (**HPQ/NYSE, rated Baa1/BBB+/A-**) to Baa1 from A3. Moody's had previously placed HP's ratings under review for downgrade in October, and the current rating action concludes the company's review of HP's credit profile. Moody's assigned a negative outlook to its rating; S&P and Fitch currently have stable outlooks on their ratings of HP.

While Moody's downgrade comes amidst the train-wreck-in-progress that is HP's disastrous acquisition of Autonomy, it was not triggered specifically by HP's $8.8 billion write-down related to that purchase. Rather, Moody's action reflects the agency's expectation that "the company's credit profile will remain weaker than previously expected over the intermediate term." The negative rating outlook reflects Moody's concerns over "HP's ability to contend with the significant competitive, secular and execution challenges facing the company" over the next few years.[1]

Despite Moody's action, we continue to view HP as a solid credit that we expect will remain in the BBB+ range over a one to three-year investment horizon. At current market yields, we believe HP can offer an attractive investment opportunity for taxable investors in one to three year maturities.

The company certainly faces fundamental challenges as well as headline risk. It is entirely possible that HP could receive negative outlooks from either S&P or Fitch in the near term, reflecting adjusted earnings guidance from the company and additional developments related to Autonomy. Our outlook for HP acknowledges that Fitch may well downgrade HP in the next one to three years, bringing the rating into the triple-B range.

Fundamentally, the factors driving Moody's downgrade and negative outlook include a number of near-term challenges, including:

- Weaker than expected cash flows projected for FY2013 due to slowing economies in Europe and growing competitive pressure globally in many of HP's core business segments;
- Resulting weakening of credit metrics to levels in line with triple-B ratings;
- Execution risks in HP's business strategy and in the Autonomy purchase;
- Management's expectation that improvements in business performance will take longer than expected, delaying anticipated improvements in the company's balance sheet metrics; and
- The potential for more restructuring actions and associated charges related to reducing headcount to better match long-term business prospects, as well as the potential for additional surprises related to Autonomy.

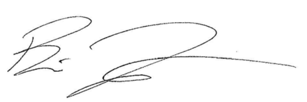
Despite these rating pressures, we believe that HP's ratings will remain stable in high triple-B range due to underlying fundamental credit strengths that include:

- A very strong liquidity position, including more than $11 billion in balance sheet cash and access to $7.5 billion of bank lines through 2015;
- Expected free cash flow that, while lower than projected last year, will still top $4 billion in 2013;
- The expectation that the company will significantly reduce net debt over the next three years, significantly improving debt metrics;
- A broad, global portfolio of products and services with leading worldwide market share in servers (#1), PCs (#1), and IT services (#2);
- Fully one-third of revenue in the form of recurring revenues from printer supplies, outsourcing and tech services, and software maintenance; and
- Very strong geographic diversification.

Because of the trashing that HP has taken in the business press, we believe the market for HP bonds has overreacted and that bonds are currently priced to more than compensate for the level of intermediate term risk to investors. Yields on HP bonds have widened substantially in response to the company's well-publicized business challenges and the resulting poor equity performance. In extreme low-yield environments like today, we believe it makes sense to look at out-of-favor issuers with solid underlying fundamentals in order to capture additional yield.

- HP one-year yield spreads are currently more than 40 basis points wider (yields are 0.40% higher) than financials like Bank of America (BAC/NYSE, Baa2/A-/A) and twice the level (approximately +140 bps versus +70 bps) of solid mining or industrial credits like Barrick Gold (ABX/NYSE, Baa1/BBB+)[2].

- HP three-year spreads are also much wider than comparably rated credits in other sectors, touching levels of approximately 250bps over Treasuries in the current market. By comparison, financials like BAC and Citigroup (C/NYSE, Baa2/A-/A) have recently traded at spreads ranging from +160 to +220. Alternatively, high triple-B and low single-A non-financials like Rio Tinto (RIO/London, A3/A-/A-), Burlington Northern (private, A3/BBB+), and Caterpillar (CAT/NYSE, A2/A/A) are offering investors very slim spreads, ranging from approximately +55bps to as thin as +34 bps[2].



Brian Tournier
Director of Research
Ascent Investment Partners

[1] Source: "*Rating Action: Moody's lowers Hewlett-Packard's senior unsecured rating to Baa1, outlook negative*," Moody's Investor Service, Nov. 28, 2012.

[2] Source: Bloomberg. Pricing information for individual securities as of November, 30, 2012.

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