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bond market conditions & opportunities: where do we go from here?

by Teri Mason, Associate Director of Credit Research

As the global economic and credit crisis eased this year, financial markets rallied, racking up impressive gains. According to the *S&P 500 Index*, stocks were up 15% at the end of October, while the *Barclays Capital US Investment Grade Corporate Index* shows investment grade corporates have risen 18%, and high yield bonds gained a stunning 52% year-to-date as illustrated by the *Barclays Capital US High Yield Index*. Is it time to take some chips off the table? We've been doing that all along. Depending on the product or portfolio, we have used the rally to adjust sector weights and raise reserves by reducing exposure to less-favored credits. Despite rallies, we believe risk markets remain attractive and full of opportunity. However, returns may be driven more by specific risk than market risk in 2010.

WHAT A DIFFERENCE A YEAR MAKES

Risk appetites have done a 180° in the past 12 months. Late last year, the global economic and financial crisis had fueled a flight-to-quality and investors lumped almost all risk assets—corporate loans, bonds and equities, securitized assets, commodities and currencies—into a "bad" bucket. As they abandoned risk and ran to the relative safety of the US dollar and government markets, valuations quickly deteriorated.

In 2009, by contrast, investor sentiment is all good. With interest rates exceptionally low and confidence in systematic stability growing, investors have rushed to embrace yield. Unprecedented policy action pushed fears of a "Great Depression II" to the back burner, further fueling demand for risk. Valuations continued to improve over the summer as consensus viewed the economy as moving out of recession and into early stages of recovery. Where a year ago markets were incapacitated by the wave of selling pressure, markets have recently been functioning more normally. Investors are better able to transact among and within markets. This transition from illiquid to more liquid markets is another critical driver behind tighter spreads this year.

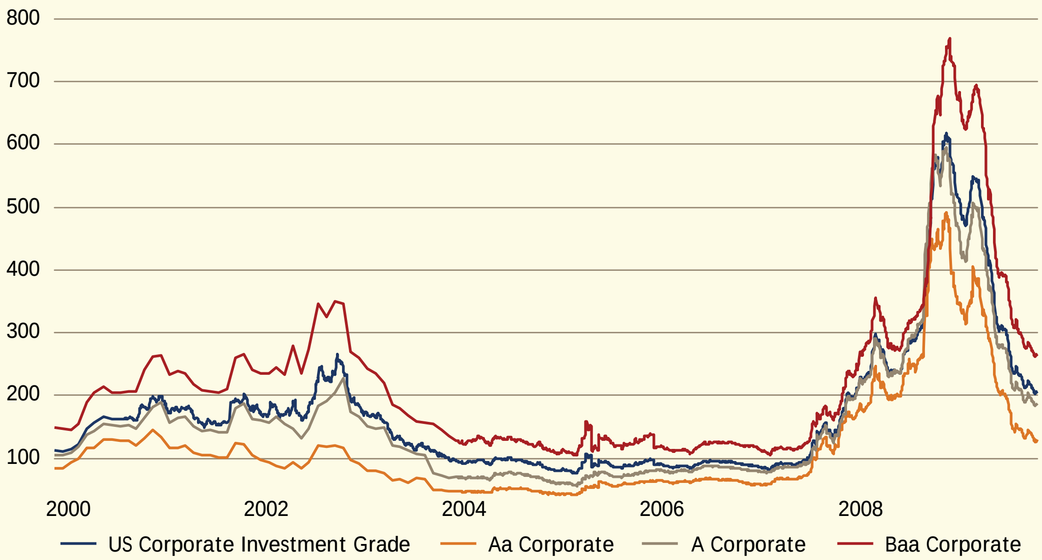
Investments as diverse as equities, corporate bonds and commercial mortgage-backed securities (CMBS) moved almost in tandem in 2008 and 2009. Correlation among price movements in these markets year-to-date is in the mid-to-high 90s. We expect that may change in 2010. With valuations generally reflecting where we are in the cycle and markets functioning more or less as they should, we believe returns will increasingly reflect the important differences among individual securities and markets and be less about an indiscriminate search for yield. For example, the CMBS market is generally driven by trends in commercial real estate, not by trends in investment flows.

IS IT TIME TO TAKE SOME CHIPS OFF THE TABLE?

We've already begun. For example, as valuations were bid up for corporate bonds, we did a little house cleaning. We sold off or reduced exposure to certain credits. However, it is too early to abandon risk assets entirely, despite substantial gains this year. We believe we are in the early stages of economic recovery and valuations have arguably moved from depression levels to factor in slow recovery. We do not see widespread overvaluation. As the economy expands, healthy credits can stabilize or potentially improve. This could lead to further spread tightening in many corporate bonds, though we do not anticipate large, broad market moves in spreads next year.

We believe that risk markets remain attractive and full of opportunity, but investors will need to work harder next year to earn returns that will likely be much lower than those experienced in 2009. However, do not be fooled by the fact that spreads have come in a lot and may appear to have limited room for further tightening.

Option-Adjusted Spreads (OAS) by Quality



Source: Barclays Capital; Data as of 11/9/09

Within each of these markets, there are many issues with significantly tighter or wider spreads. We believe investors can profit from this dispersion by carefully sorting potentially stronger credits from the weaker ones. Our large and experienced credit research staff truly works to earn its stripes in markets like these.

A LOOK AT SPREADS

Let's look at the Baa-rated corporate market to help illustrate these points. Above is a chart showing option-adjusted spreads (OAS) for the *Barclays Capital US Investment Grade Corporate Index* by quality bucket. The spread for the Baa-rated portion of the corporate index is in red.

The move toward wider spreads accelerated dramatically in the second half of 2008, with Baa-rated bonds jumping from roughly 300 to 770 basis points seemingly in the blink of an eye. Since then, spreads have tightened back to below 300 basis points. Current spreads have come a long way, but are still wider than the long-run (10-year) average of 223 basis points and significantly cheaper than the pre-crisis levels of 125-150 basis points in 2004-2006. Our investment grade sector team believes spreads will narrow modestly next year toward long-run average levels. But that's not what gets them excited about this market.

PICKING YOUR SPOTS

Dispersion is key. There are 927 issues in the Baa-rated index with an OAS of 250 basis points or below, as shown on the graph on the next page. Yet there are 687 issues with an OAS greater than 250 basis points. Some of those wider issues deserve the wide spread and may be downgraded, but there are others we believe merit a higher valuation. It's our job to determine which is which, and, in our view, the markets offer us many opportunities to do so.

The story is similar for high yield, though that market has to grapple with default risk. We believe, as does Moody's, that default rates may be peaking and are likely to be considerably lower a year from now. This provides solid support for improvements in high yield valuations, though it makes navigating the CCC sector particularly arduous, but potentially rewarding.

One major difference between investment grade and high yield is, well, yield. Investment grade yields have shrunk, leaving the sector generally more vulnerable to interest rate swings, which is another argument for carefully picking your spots. High yield offers more income potential, boosting returns if rates are flat and providing some protection against rising rates. Our focus is on identifying credits in either market with strong fundamental credit standing that may be positioned to earn attractive returns. Within the high yield universe, that includes sectors like convertibles. More broadly, the emerging market sector offers a potential spot to pick a credit story, and pad returns via currency gains if an investor chooses not to hedge.

BEYOND THE GREENBACK

Foreign currencies have strengthened against the US dollar this year, some significantly, but we continue to see attractive opportunities. The US dollar has been suffering from the twin perceptions of sluggish growth and low rates and we don't see either condition changing near term. In fact, the gradual US recovery we anticipate may cause Fed rate hikes to lag other major economies. The question is, against which currencies might the US dollar weaken?

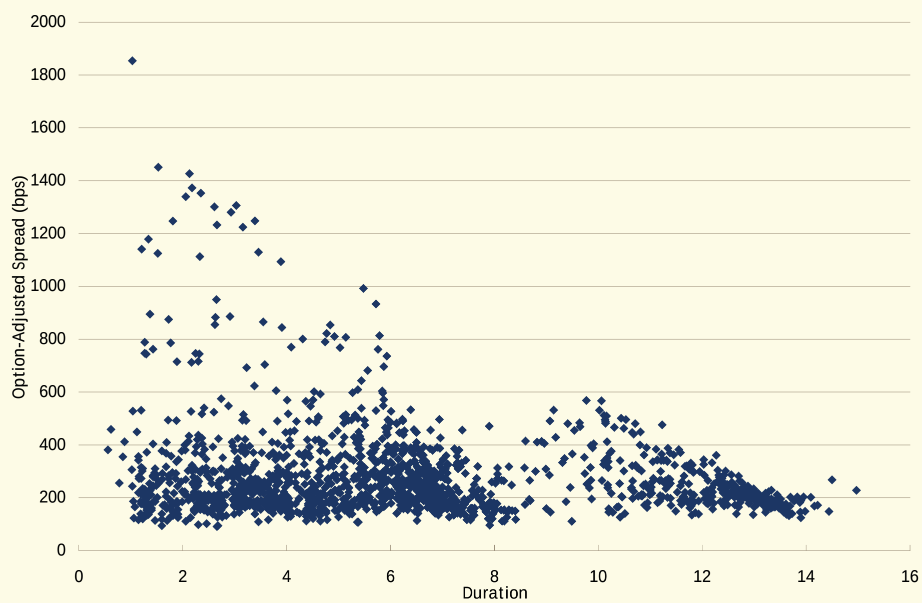
Our sovereign analysts believe the euro and Japanese yen are not the answer. The US dollar may strengthen against those currencies as the two regions have challenges of their own. Both have been growing slower than potential, with consensus estimates (and ours) for GDP growth in the 0-2% range for 2010. Still, there are currencies that our team recommends in Europe, such as the Norwegian krone, which can gain from rising oil prices, or the Swedish krona, which may be oversold on economic concerns.

Asian currencies (ex-Japanese yen) may be the answer. The global team favors those currencies tied to the improving global growth story, particularly those closely aligned with Chinese growth. This includes currencies such as the South Korean won and the Indonesian rupiah, as well as the broader commodity currency group such as the Brazilian real, or the Canadian, Australian and New Zealand dollars.

PURSUING DIVERSE RETURN POTENTIAL

Thus, in our view, it is too early to exit risk sectors. We believe there are still many opportunities to earn attractive returns, even if levels are less compelling and returns less generous. In our opinion, as long as rates are low (and we believe they will be for some time), investor preference will remain with taking risk to earn yield. The cost to do otherwise may be high. For example, mutual fund investors could move into money market funds, which currently offer slim yields of near 1%. The yield on the 10-year US Treasury is about 3.5%. Not only does this represent a substantial loss of income relative to many credit alternatives, but it increases interest rate risk. If rates rise even slightly, returns suffer. For example, if the Treasury yield moved up 1% to 4.5% in the next 12 months, an investor would lose 3.5%.

Option-Adjusted Spreads (OAS) on Baa-Rated Issues in
Barclays Capital US Investment Grade Corporate Bond Index



Source: Barclays Capital; Data as of 11/3/09

Investor portfolios, of course, typically involve multiple strategies. We see opportunities to gain from specific risk in corporate bonds, convertibles, emerging market debt and various currencies. Bank loans have their own charm. They offer another way to benefit from specific risk, as the loan market is broadly defined across many industries, and as floating-rate instruments, the sector appeals to those who wish to begin to build some inflation protection into portfolios. We believe that slow growth and low inflation will keep rates low for at least the next year or so. However, at some point, investors will become increasingly fearful about inflation, which can take a particular toll on returns for longer maturity bonds. We view bank loans as a more compelling investment than TIPS at the moment, which currently offer low yields.

Federal Reserve purchases of agency-backed bonds and mortgages have driven those valuations to extremes. As the Fed's purchase program concludes in 2010, we expect spreads to widen, which could cause those sectors to underperform. However, the credit sector of the securitized market (or non-agency sector) has continued to offer good value. The sector offers another way to begin building inflation or interest rate risk protection into portfolios, given it offers an attractive yield and short duration. For example, the *Merrill Lynch US ABS & CMBS Index* has duration of 2.2 years and a yield of 4.62% as of this date.

Our securitized assets sector team favors down-in-credit trades within the asset-backed securities (ABS) market. True, fundamentals are not great, with consumers particularly stressed by rising unemployment. However, the team rigorously monitors specific credit trends, and sees no indication that consumers would perform materially worse than unemployment trends currently indicate. Further, floating-rate instruments comprise three-quarters of the ABS index, offering additional flexibility for portfolios.

The commercial mortgage-backed securities (CMBS) market has a longer duration, but otherwise offers a similar profile of additional yield to compensate for weak fundamentals. Our team's strategy has been to focus on the senior part of deal structures which we believe are reasonably protected from loss due to generous credit enhancement features. Short-term, valuations may suffer as commercial real estate continues to deteriorate, and more junior classes take losses. However, we believe our super senior, AAA-rated CMBS can hold up well, based on our team's careful evaluation of the collateral and structure. In fact, market volatility or negative headlines may generate opportunities to add to positions.

FORGING AHEAD WITH AN EYE ON VALUE

We believe the global economy is in a gradual recovery and that rates will remain low for the foreseeable future. Investors will need to be more discerning, with a focus on careful security selection, to generate above average returns. We will continue to carefully monitor macro conditions, such as how policy makers unwind stimulus applied this year and potential growth stumbles, particularly in China. When we see the need, we will make mid-course corrections, as has already been done across many of our portfolios. Market conditions and opportunities are never static. Our focus remains on finding the best avenues to generate attractive returns.