first quarter 2010

bond market review & outlook

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FIRST QUARTER REVIEW

Fiscal woes rained on most developed government markets, but a slightly sunnier economic outlook led many investors to move into higher risk, higher yielding instruments.

FIRST QUARTER 2010 RETURNS BY SECTOR[1]

1Q TOTAL	1Q EXCESS	INDEX	COMMENTARY
2.0	1.0	Universal Index	Strong performance by high yield, emerging markets and CMBS lifted returns of the broad Universal Index over the Aggregate and Gov't/Credit indices. High yield gave stocks a run for the money, rising 4.6% to the S&P500's 4.9% gain.
1.8	0.8	Aggregate Index	
1.6	0.5	Gov't/Credit Index	
4.9	- --	S&P500 Index	
1.1	---	US Treasurys	Treasury yields were little changed. The benchmark 10-year yield dropped from 3.83% on Jan 1st to 3.56% in February as investors escaped the drama in Europe for the safety of UST. Lackluster demand for March's Treasury auctions pushed the yield back to 3.83% by quarter-end, a troubling development given the government's huge financing needs for 2010.
0.0	---	3-month T-bills	
0.7	---	2-year Treasury	
1.0	---	10-year Treasury	
(0.1)	---	30-year Treasury	
0.6		US TIPS	
1.3	---	Municipals	Municipals outperformed Treasurys. Muni yields fell for much of the quarter as demand continued to overwhelm supply.
1.1	0.3	Agencies	Agency debt and MBS earned slightly better returns than Treasurys. CMBS had a huge quarter, as investors were drawn to the sector for its attractive yield advantage, an increasingly rare commodity in investment grade offerings.
1.5	0.7	MBS	
2.2	1.3	ABS	
9.1	8.0	CMBS	
2.3	1.1	US Corporates	Investment grade corporates continued to attract investor demand, despite low yields. Robust issuance was readily absorbed and spreads marched tighter. Financials earned the highest returns in the sector, particularly REITs and insurance companies. Longer duration sectors like rails and telecom lagged.
1.8	0.7	AAA	
1.8	0.7	AA	
2.0	0.9	A	
2.9	1.7	BBB	
4.6	3.5	US High Yield Bonds	Investors, feeling slightly more positive about the near-term economic outlook and better about the liquidity condition of many issuers, were drawn to the yield advantage of speculative grade bonds. Heavy new issue supply was quickly bought up. Financials had the best gains. Insurance company returns were boosted by perceptions of improved investment portfolio results, greater market access and diminished concerns about annuities. Power companies fared the worst, as abundant gas supply pressured power prices lower.
4.5	3.3	BB	
3.5	2.5	B	
5.3	4.1	CCC	
4.8	- - -	US High Yield Loans	
4.2	---	JPM EMBIG	As sovereign debt worries plagued developed countries, fast growing emerging market bonds drew renewed interest from investors. EM currencies performed well too, especially MXN, IDR and KRW on higher oil prices and strong Asian growth.
4.2	---	JPM CEMBI-IG	
6.7	---	JPM CEMBI-HY	
3.8	---	JPM GBI-EM (LCL)	
		World Government Bond Index (WGBI)	
1.1	---	WGBI (lcl)	Global developed government bond returns were in line with Treasurys, but higher in Europe where yields fell on growth and debt worries. Fiscal worries hit the EUR and GBP, causing currency-adjusted returns to lag Treasurys. Canadian bonds were among the best performers, up 4.2% (USD, unhedged).
1.1	---	NonUS WGBI (lcl)	
1.1	---	US WGBI (lcl)	
(1.3)	---	WGBI, USD, unhedged	

[1]*All returns are from Barclays Capital Indexes, except the World Government Bond Index (published by Citigroup) and the JPM EMBIG, CEMBI and GBI-EM (published by JPMorgan). Excess return is the difference between the sector's total return and that of similar duration Treasurys and indicates the return earned for taking the additional risk.* **Past performance is no guarantee of future results.** *All indexes are unmanaged, and you cannot invest directly in an index.*

RIDE THE RECOVERY

A cliché perhaps, but often said: bond investors are rarely contented souls. There usually seems to be something to worry about. For now, it appears that the global economy may have sufficient momentum to plod along. We believe the US economy could grow at roughly a 3.0% annual rate in 2010, which would mean many companies and credits could fare just fine. This may allow investors to continue to pile into riskier corners of the market to satiate their thirst for yield. However, they would likely do so while fearfully looking ahead. What's that on the horizon? Lower yields and another recession, caused by a consumer frantic to de-lever, facing a burdensome tax load and a government too deep in debt to offer more stimulus? Or, is it higher yields as the world's central banks push up rates to help ward off the inflation bogeyman? Bondholders would likely prefer to follow a path somewhere in between those two potential outcomes, with growth strong enough to support the types of credit risk they're taking in portfolios, but not so strong as to push yields up and prices down. Perhaps we're optimists, but after several years of crisis, being a pessimist has grown old. Our current belief is that the global economy may follow a road somewhere in the middle, and we remain slightly more concerned about higher than lower rates in the future.

ECONOMIC OUTLOOK

We believe that the US and non-Japan Asia may be the engines of global growth. Resource-rich countries in Asia and the Americas are potential prime beneficiaries, and our sovereign analysts see Europe as likely continuing to struggle. In their view, the Eurozone may grow by less than 1% in 2010. For the US, government spending drove the recovery in 2009, but that move appears to be exhausted and we will likely need someone else to take the wheel. Neither the federal government nor state and local municipalities seem to be in a solid position to bump up spending. In our view, US growth may be driven largely by three factors: inventories, investment and net exports. The severe draw down of inventories in the recession slowed in the fourth quarter of 2009 and inventories appear to have been rising mildly so far in 2010. Inventory investment may be a short-term boost to the economy, according to our economist. Companies may also be busier with hiring and spending, in our view. Having made deep cuts in both during the downturn, companies will likely need to reverse some in order to meet current demand and replace obsolete or worn equipment. Already, we have seen a jump in business spending on equipment and software. Small businesses, however, may participate less in this move as they have continued to face tough credit conditions. Finally, it's encouraging that after falling by 12.2% in 2009, the World Trade Organization is forecasting a rise of 9.5% in world trade for 2010 and President Obama has a goal of doubling American exports over the next five years.

We believe that the increased investment and export activity may gradually lift incomes and lead to a sustained expansion. At the moment, the consumer has been showing some signs of recovery with retail sales better than expected. However, we believe that the consumer lacks the desire and ability to drive recovery. Confidence appears to have improved, but consumers have remained less ebullient about future conditions than may be typical at this stage of a recovery. There are many potential reasons for this, but a few key ones include the labor market, housing prices and equity values.

First, job destruction in this recession was severe compared to past episodes. The labor market appears to be stabilizing. However, it takes over 120,000 new jobs each month to absorb population growth; it would take much more to make a dent in the pool of un- and under-employed. There are further reasons tempering our enthusiasm about labor markets. Our economist worries businesses may be cautious about re-hiring given tepid demand remains. Higher taxes and health insurance issues, a higher minimum wage, and uncertainty about policy are also concerns.

Second, housing prices may be going up modestly in some areas, but generally, the overhang of foreclosure activity is keeping a lid on prices. Until foreclosures stop pumping up inventories, homeowners cannot rely on their biggest asset (for many) as a significant wealth generator.

Third, equity prices have been going up for a year, yet broad market measures like the S&P 500 have remained at values below those of pre-crisis or 2007. So, while 401k statements seem less painful to review than they were in 2008 or 2009, there is still little joy.

Some good news is that while consumers have remained heavily in debt, that burden appears to be easing. The bad news is that the reason we have seen a better balance between financial obligations and income is that improvement has largely come from defaults. Still, however they get there, consumer balance sheets are being repaired, a positive for their ability to consume in the future.

Despite challenges facing the consumer, we see this as a relatively benign outlook, assuming conditions unfold as anticipated. However, if the consumer stays sidelined too long, the recovery could sputter. Further, we worry about the increased involvement of the government in the economy, and the risk of policy errors relating to monetary (tightening too soon or too late), fiscal (inadequately addressing the debt) or trade (protectionist acts). Our yield curve team believes the Fed may hike rates after the election, sometime in the fourth quarter—at the earliest. Already, the Fed has ended its quantitative and credit easing and the team believes that may be enough "tightening" for now. The Fed could easily wait until later in 2011, as the economy is still too fragile and disinflationary trends give them room to hold off. We are closely watching the labor market for signs that the recovery has legs, and banks for signs that they are lending out that pile of excess reserves they're sitting on.

A word on the risk du jour or sovereign debt risk, as played by southern Europe. Fears have diminished with an agreement of sorts by the Eurozone members to support Greece, and Greece's ability to access the debt markets with a seven-year bond this month. Our global sovereign analysts believe that the region may continue to muddle through this situation, piecing together whatever efforts are necessary to keep the union alive and economic activity growing. However, they don't anticipate major moves to address the underlying problems. Thus, this drama could easily flare up again, possibly spawning a flight to quality which could undermine our "ride the recovery" thesis on risk assets, at least temporarily.

PERFORMANCE OUTLOOK

Looking ahead, we believe that the better returns in fixed income portfolios may come from balancing the challenges of a low yield environment with the opportunities of a growing, albeit slowly, economy. In our opinion, this means bulking up portfolios with yield-advantaged strategies where possible, boosting exposure to less market sensitive sectors or issuers, and gradually guarding against a shift up in rates.

Our yield curve team believes yields may remain low for much of 2010, but with a bias higher as increasing Treasury supply and continued positive economic growth will likely overwhelm disinflationary pressures on yields. Treasurys (and other developed sovereign bonds) may offer relatively poor returns in that scenario. In addition, we continue to dislike the near-term prospects for agency bonds and mortgage-backed securities. The Fed's purchase program has driven their valuations to extremes. With the program now ending, spreads may widen out, though we think demand from banks and others may cap that move. CMBS returns may not be as robust as this past quarter's, but we believe that the sector still may have value to offer investors given its relatively high yield level for an investment grade sector.

Corporate bonds offer more return potential in the investment grade space, in our view. Fundamentals appear to be strong, with companies well positioned to generate earnings growth with low rates, contained costs and improved productivity. In our opinion, the concern with investment grade corporates is yields are low, making the sector sensitive to shifts in interest rates. Still, we generally see good values in intermediate corporates and in specific individual issuers which our research team has identified as potentially improving credits.

We also believe that speculative grade corporates could benefit from the same fundamental trends as investment grade, but with less interest rate sensitivity. Further, high yield may get an added boost from lower defaults in 2010 (as forecasted by our high yield team and others). This sector, both in the US and global offerings, is particularly well positioned to generate attractive returns, in our opinion, though primarily from "coupon clipping."

This past quarter, the currency market offered a wide range of returns, as it typically does. Our global team views the US dollar as gaining against some major currencies like the euro, the Japanese yen or the British pound, but losing ground against a broad basket of smaller currencies. Thus, they see return potential in exposure to currencies like the Canadian dollar or Mexican peso, or a variety of Asian currencies, which are likely to benefit from global demand (particularly from China). While most developed nations struggle with slow growth and budget issues, some emerging countries appear to be poised for faster growth with fewer fiscal challenges.

Given low but eventually rising yields and slow economic growth (as forecast by our economist), this "risk on" or "ride the recovery" strategy in CMBS, selected corporates, global bonds and currencies, may offer some attractive returns for bond holders. However, the risk of a global economic stumble is not small and some indicators hint that 2011 may be a tough year. As always, we're watching the incoming data closely for signs that the strategy may need to be adjusted or abandoned. We're bondholders; we worry.