Moderate Economies, Volatile Markets

July 2010

While economic growth was moderate during 2Q, volatility and anxiety ran high. Anxiety was driven largely by the sovereign crisis in Europe, although the oil spill in the Gulf of Mexico, evolving financial sector regulation, and geopolitical noise on the Korean peninsula contributed as well.

Relative Calm on the Economic Front

US economic growth remained moderate, with signs of leveling off. Although companies rebuilt inventories and invested in new equipment at an accelerating pace, private sector employment gains lost some momentum and retail sales turned lackluster. And once the first-time homebuyer tax credit expired, new home sales fell steeply, throwing cold water on anyone looking for a bottom in US housing. In this environment, inflation remained very low, with headline inflation around 2% and core inflation probing generational lows at 1%. With unemployment high and inflation low, the Fed remained committed to its 'low for long' interest rate policy.

Anxious? Who's Anxious?

Despite the relative calm in the US economy, anxiety raged off of US shores, and you didn't have to go far to find it. Just a few miles off the coast of Louisiana, a BP drilling platform explosion in late April triggered one of the largest oil spills in history. Despite the monumental ecological cost, the calamity at this point is not likely to significantly impact the US economy's overall growth rate. (The impact was felt more strongly in certain sectors of the bond market, discussed inside.)

In the Far East, the sinking of a South Korean naval ship unleashed a fresh round of stress, with South Korea vowing action and North Korea responding by threatening 'all out war' if attacked. China's announcement of a reform in its currency management system (conveniently announced one week before G-20 meetings) was welcomed, although it had little immediate market impact. Concerns over China's efforts to slow its economic growth, on the other hand, put episodic downward pressure on world equity markets.

The major source of anxiety in 2Q, however, was the European sovereign crisis. Since Greece's revelations of large budget deficits in late 2009, investors have become increasingly concerned that other Eurozone economies – primarily Spain, Ireland, and Portugal – will also have trouble funding themselves. As those countries' bond markets came under pressure in 2Q, concerns mounted over the exposure that European banks had to their sovereign and corporate debt. While the European Union and IMF have to date shown sufficient resolve in managing this situation, most notably by cobbling together nearly $1 trillion in support packages in May, European bond markets nonetheless remain on edge. *(For a fuller discussion of this crisis, see our May 2010 paper, "Greece, Thanks. And Estonia, Welcome!")*

Back on American shores, financial reform legislation was winding its way through Washington, a locale well-known for causing anxiety. The late June negotiations, likely to become law in July, are arguably less onerous than markets had feared, thus providing some relief for the beleaguered banking sector.

By quarter's end, nothing had materialized of the threats in Korea, efforts to cap the gushing oil well in the Gulf were underway, a trillion dollar "safety net" was cast under the European sovereign crisis, and US financial regulatory reform was being settled. So, all clear? Not as far as the markets were concerned. The S&P 500 remained roughly 15% below its April high, 10-year Treasury yields fell under 3%, and spreads in most fixed income sectors widened substantially. For example, B-rated high yield bonds widened from +607 to +736 bps, and US investment grade corporate bonds widened from +150 to +193 bps. *Source of spreads: Barclays as of 6/30/10.*

Continued Anxiety Short-Term, Positive Longer-Term

For now, high anxiety is still trumping economic fundamentals. We think this is misplaced. Most US and foreign leading and coincident indicators suggest the global economic recovery remains on track. Inflation is low, corporate profitability is high, and major central banks remain accommodative. Under normal circumstances, market volatility should be low and credit spreads should be narrowing.

But markets are markets, and summer months are notorious for their volatility. While concerns about European sovereigns or a US economic slowdown may continue to plague the markets in 3Q, the generally positive global macroeconomic backdrop should remain intact, and eventually, investors will focus again on fundamentals and attractive valuations. For this reason, it makes sense to continue to look for opportunities in the spread sectors.

Outlook: Fixed Income Credit Sectors to Outperform

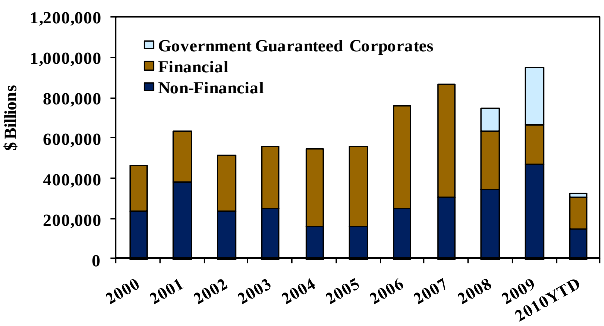
US AND EUROPEAN CORPORATE BONDS

US investment grade corporate bonds delivered returns of +3.42% in 2Q, although spreads widened +43 bps as the European sovereign crisis spread across the financial markets. US corporate bonds posted -225 bps in negative excess return to US Treasuries. European corporate bonds, particularly those in peripheral Europe, were especially vulnerable, with spreads widening +56 bps over mid-swaps so far this year.

In both the US and Europe, issuers in the financial sector, particularly banking, were most volatile, partly due to their exposures to the countries in crisis and partly over fear that financial reform in the US would curtail bank profits. Energy and pipelines lagged in response to the Gulf oil spill. Cyclical and other higher beta issues also suffered, as they often do in volatile markets.

One factor supporting corporate bonds during 2Q was a sharp decline in new issuance, illustrated below:

Significant Drop-off in New Corporate Issuance So Far in 2010



The decline reflects the fact that so many companies issued new debt just last year and, given rising corporate profitability, many companies are able to internally fund projects without needing to tap the public markets.

At today's higher spread levels, corporate bonds look attractive, particularly from a longer term perspective. Stable-to-improving credit fundamentals across many industries, including the financial sector, should provide support, as will lower new issue supply. For these reasons, we believe corporate bonds are attractive for longer-term buyers, despite the near-term uncertain tone.

As we enter 3Q, we continue to emphasize select well-researched BBB-rated issues and money center banks. We believe the new financial reform bill could be a silver lining for bondholders, as it will force banks to become better capitalized. In the US, we favor insurance issuers that have demonstrated improving fundamentals. We continue to find value in some Build America Bonds (BABs) and also still favor 30-year maturities.

In Europe, we hold a more cautious stance, given the ongoing sovereign debt turmoil. In fact, in global corporate portfolios, we see an attractive opportunity to overweight US versus European credit.

Outlook: Positive. Moderate economic growth, steadily improving credit fundamentals, and investor "reach for yield" should promote spread tightening.

LEVERAGED FINANCE

High yield bonds ended 2Q essentially flat, delivering a -0.11% total return. High yield spreads over similar-maturity US Treasuries widened by +120 bps to +731 bps, their highest level since November 2009. Year-to-date, high yield bonds have earned their coupon, returning +4.51%. Bank loans lagged high yield, with US loan issuers returning -2.03% in 2Q.

The barrage of negative headlines in 2Q increased risk aversion among high yield investors. Higher quality, more defensive BB and B-rated issues outperformed lower quality CCC-rated issues during the turmoil. The finance and energy industries both lagged, as the prospects for financial reform and the Gulf oil disaster weighed on these sectors. Technology also underperformed, hurt by two large LBO issuers that needed access to healthy bond and equity markets to meet ongoing financing needs.

On a positive note, credit fundamentals across the high yield market continued to stabilize. Earnings are rising across a wide range of industries, and defaults are trending much lower, with the weakest bonds having been "cleared out" over the past two years. Near-term refinancing risk is no longer a significant concern, as many companies took advantage of the strong new issue market last year. However, fundamentals will remain challenging for some issuers, particularly if economic growth stalls. Fundamental credit research remains critical in this market.

Within the high yield sector, we are emphasizing short-maturity yield-to-call bonds and, despite an up-in-quality bias, we are finding value in select CCC issues. We like defensive industries with mostly US exposure as well as cyclical credits with global exposure. We are also finding value in stressed bank loans with full asset protection and early redemption potential.

Outlook: Cautiously optimistic. Expect volatility to continue. Fundamentals are improving and spreads are attractive, but the economic recovery is still fragile and investors remain wary.

Source of all data in text on this page: Barclays as of 6/30/10. Source of graph: JPMorgan as of 6/24/10.

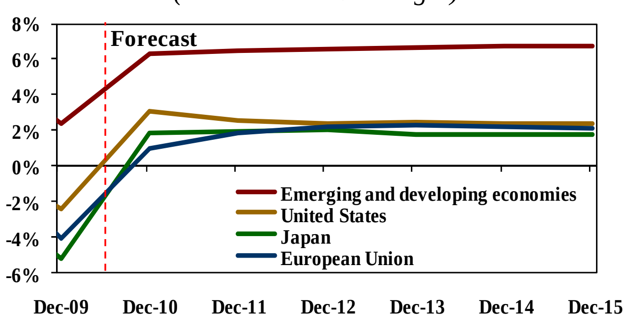
Emerging Markets Debt

Emerging markets debt posted modestly positive returns in 2Q. Sovereign US$-denominated debt returned +1.24%, rebounding after a bout of risk aversion mid-quarter. Local debt (hedged to USD) also posted steady gains, returning +1.60%, while emerging markets corporate debt delivered +0.96%. Emerging markets currencies, on the other hand, were down about 4%.

The strongest performers in 2Q were Iraq (up by 9% due to local buying) and the high quality Latin American countries Panama, Peru, Chile, and Mexico (up 3 to 4% on strong growth data and strong inflows). Venezuela was the poorest performer at -12%, a victim of economic growth concerns and negative political headlines. US$-denominated bonds from eastern European countries Hungary, Croatia, and Bulgaria were down 3 to 6%, hurt by contagion from Greece and peripheral Europe. Eastern European currencies were also hard hit, with the Polish zloty, Hungarian forint, Romania leu, Czech koruna, and Slovakian koruna down 10 to 15%.

Overall, emerging markets countries continue to outperform developed countries. Many emerging economies have implemented more effective internal domestic policies as well as policies to reduce their external funding vulnerability. Their structural and fiscal reforms helped them remain resilient during the global financial crisis and continue to do so. Given their stronger fundamentals, we are not surprised to see continued flows into both hard and local currency issues. The investment flows leaving the *developed* world and heading into the *developing* world are a key reason we hold a constructive outlook for emerging markets debt in the medium-term.

Emerging Markets Are Growing Faster Than Developed Markets
(GDP Annual % Changes)



We are more cautious near-term. Emerging markets debt is likely to be buffeted by continued skittishness over Europe's sovereign debt crisis, China's economic slowdown, the impact of financial sector reform, and a high correlation to a volatile emerging markets equity market. As such, we have reduced risk in our emerging markets debt portfolios.

That said, certain US$-denominated debt of select emerging markets countries does look attractive. Argentina, for example, could offer compelling value, especially in shorter maturities, following the reopening of its bond exchange. Venezuela may also offer tactical opportunities as one of the highest yielding emerging markets countries. We also like currencies of higher-yielding countries with strong growth prospects such as Mexico, Russia, and Indonesia, as well as undervalued currencies such as the Korean won. Local bonds also offer select opportunities, especially now that lower inflation could delay interest rate hikes.

Outlook: Optimistic medium-term, but guarded near-term until markets stabilize. Key risk would be weaker-than-expected global growth or increased volatility surrounding peripheral Europe.

Municipals

Tax-exempt municipal bonds underperformed US Treasuries in 2Q, with the 30-year Municipal/Treasury ratio rising to 102% from 88%. Underperformance reflects weaker demand given low absolute yields and ongoing concerns regarding issuer budget gaps. Year-to-date, high yield municipals have outpaced investment grade issues, with returns of +7.3% vs. +3.3%.

Taxable Build America Bonds (BABs) had outperformed comparable duration corporate bonds through May, but underperformed in June as investors focused on state and local budget gaps and unfunded pension liabilities. Since their introduction in 2009, BABs have become a key component of the market, accounting for about 30% of municipal supply in 2010. They have also become an important segment of the taxable credit market, particularly the long duration segment. Taxable municipals now account for about 9% of the Barclays Capital US Long Credit Index.

We expect favorable technicals to support the tax-exempt market through the summer months. However, low absolute yields could temper investor demand. State and local budget troubles as well as a focus on unfunded pension liabilities will also weigh on the market.

Update: Optimistic. Positive seasonal technicals, combined with lower tax-exempt supply due to BAB issuance as well as higher tax rates, should support performance.

Source of emerging market data: JPMorgan as of 6/30/10. Source of municipal bond data: Barclays as of 6/30/10.
Source of graph: International Monetary Fund (IMF) World Economic Database as of June 2010. Projections are not guaranteed and actual results may vary.

US GOVERNMENTS

US Treasury yields fell sharply in 2Q as investors sought the safety of US Treasuries amid uncertainty over Europe's financial debt crisis, signs of a lackluster US economic recovery, and indications the Fed would keep short-term interest rates at record lows longer than expected. These factors, along with muted inflation, suggest a trend of lower yields, at least for now. Two-year yields closed lower at a mere 60 bps, while 10-year yields now stand at 2.93%, their lowest level in more than a year.

US Agency debentures continued to outperform US Treasuries, delivering +20 bps in excess return in 2Q. In general, shorter maturity agencies outperformed longer maturities on better buying by foreign investors and demand from domestic real money accounts.

Entering 3Q, we remain neutral on US Agencies vs. Treasuries, as Agencies appear fully priced. Relative to more attractive spread product, we are underweight shorter maturity Agencies and neutral 30-year Agencies, given their more attractive spread levels. In the interest rate swap market, we look for tighter spreads, particularly in the 3- to 10-year range.

Outlook: Underweight Governments in favor of more attractive spread sectors.

MORTGAGES

Agency mortgage-backed securities were flat vs. US Treasuries in 2Q. So far this year, mortgages have delivered +75 bps in excess return vs. US Treasuries. Although they appear to be fully valued from a fundamental perspective, mortgages continue to benefit from a favorable supply/demand landscape and remain attractive to yield-driven buyers.

Exceedingly low net new supply is the key factor driving the mortgage market. Current origination is insufficient to meet demand levels and is expected to remain light unless the mortgage rate declines below 4.5%. Challenging economic conditions and tight credit also remain obstacles to homeowners seeking mortgage credit. In addition, the delinquent loan buyout program by Freddie Mac and Fannie Mae continues to remove billions of dollars of outstanding mortgage securities from the market. Many investors who received early prepayments from this program reinvested their cash proceeds back into the mortgage market, increasing demand. Higher CMO production is also contributing to stronger demand levels for a smaller universe of securities.

Although supply/demand technicals are positive, the recent sharp market moves in reaction to the NY Fed's announcement that it would be conducting coupon swaps shows how headline risk can affect relative value in the mortgage market. For this reason, and the tight OAS levels, we are negative on the mortgage sector. Within the sector, we prefer seasoned bonds to limit extension risk.

Outlook: Negative, given rich valuation levels and more attractive spread product options.

STRUCTURED PRODUCT

High quality structured product issues turned in mixed performances in 2Q, despite the risk averse environment.

In the CMBS market, spreads widened +50 bps for recent vintage AAA issues and were roughly unchanged for more seasoned bonds. Delinquencies are still increasing, particularly for recent vintage collateral. Servicers are likely to begin modifying loans facing default, causing duration extension. That said, we think spreads are attractive for well-researched intermediate pay bonds and seasoned last-cash flow AAA bonds.

In the consumer ABS market, spreads on AAA auto, credit card, and student loan issues were range-bound, while BBB credit cards were wider by 25 bps. Losses and delinquencies have stabilized, albeit at high levels. We expect high quality bonds to continue to be well bid.

Non-agency mortgage prices declined by 3 to 5 points in sympathy with the global reduction in risk. However, there is hope the worst may be behind us. New delinquencies have declined so far in 2010, but remain high. Housing values appear to be stabilizing, although a large inventory from delinquent mortgages could pressure values. That said, most non-agency mortgage bonds trade at high discount rates to stress scenarios, and we think offer value for investors who can withstand near-term price volatility to achieve long-term results.

Outlook: Very positive on "top-of-the-capital structure" structured product bonds.

Source of all data on this page: Barclays Capital as of 6/30/10.

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